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China's Macroeconomic Development in 2001

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Abstract

The Chinese economy has entered a critical stage in the beginning of 21st century. High growth continues despite the global economic slowdown and the country's difficult structural transformation. However, it will become ever more challenging to secure robust growth in the near future. The US recession and the worldwide slowdown in the demand for information technology products caused serious problems for many East Asian economies in 2001. China's export growth decelerated significantly. China's domestic demand, particularly public investment, replaced exports as a driving force in economic growth, and fiscal policy continued to be the main policy instrument for stimulating economic growth in 2001. The Chinese government continued its relatively loose stance regarding monetary policy since inflationary pressure was very mild. To meet the imminent challenges of WTO accession, China needs to tackle its non-performing loans in the banking sector and an increasingly large income disparity between urban and rural areas. Despite short-term difficulties, the prospects for China's medium- to long-term growth remain favourable. China will continue to benefit from the efficiency gains achieved in the transitions from a rural to an industrialised economy, from a centrally planned to a market one, and from a closed to an open one. Foreign direct investment will be instrumental in transforming China into a global manufacturing base.

Key words: China, macroeconomic development, policy challenges, global manufacturing base

1 Introduction

The Chinese economy has entered a critical stage in the beginning of the 21st century. High growth continues despite the global economic slowdown and the country's difficult structural transformation. However, it will become ever more challenging to secure robust growth in the near future for two reasons. First, the Chinese economy is more dependent on the global economy than at any other time in its history. Accession to the World Trade Organisation, WTO, will integrate China more intensively into the global economic system. The recent downturn in the global economy has already put great pressures on the Chinese economy. Second, China cannot circumvent the most demanding part of the reform that touches deeply upon the foundations of the current economic system. The thorough reform of the state-owned enterprises and banks calls for a clear definition of property rights and the enforcement of rule of law.

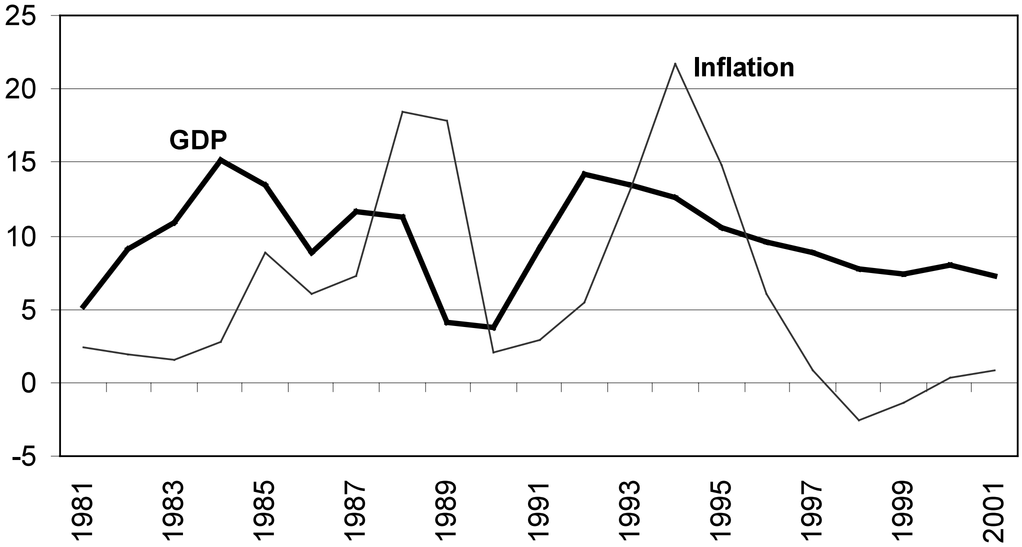
The nature of the Chinese economy reflects a dual structure of five dimensions. The Chinese economy can be characterised, to some extent, as both agricultural and industrialised, centrally planned and market-oriented, closed and open, low income and middle income, labour-intensive and emerging high-tech. And the Chinese economy is in a process of industrialisation, transition, urbanisation and globalisation amid vast divergence across the country. The complexity of this process has become ever more prominent in recent years.

The US recession and worldwide slowdown in the demand for information technology products caused serious problems for many East Asian economies in 2001. However, the performance of the Chinese economy was particularly satisfactory, if compared with the considerable difficulties experienced by other East Asian economies. Domestic demand, particularly investment, replaced exports as a driving force in economic growth in 2001. Total domestic demand contributed to over 90 per cent of GDP growth. Public investment maintained a strong growth momentum, supported by large-scale infrastructure projects. Private investment also showed signs of revival. In contrast, the role of external demand in GDP growth was minor in the same period. The deceleration in export growth was rather significant in 2001.

In response to a slowdown in economic growth, especially in the latter part of 2001, the Chinese government adopted expansionary fiscal and monetary policies. Fiscal policy continued to be the main policy instrument for stimulating economic growth in 2001. The Chinese government continued its relatively loose stance regarding monetary policy since inflationary pressure was very mild.

China joined the World Trade Organisation, WTO, at the end of 2001. To tackle the imminent challenges of WTO accession, the Chinese government has actively promoted competition by restructuring several state monopoly sectors, and has initiated a social welfare system in the urban areas. The main challenges lying ahead include non-performing loans in the banking sector and an increasingly large income disparity across the country. Despite short-term difficulties, the prospects for China's long-term growth are still favourable. China will continue to benefit from the efficiency gains achieved in the transition from a rural economy to an industrialised one, from a centrally planned one to a market one, and from a closed economy to an open one. Foreign direct investment, FDI, will be instrumental in transforming China into a global manufacturing base.

Figure 1. China's economic growth and inflation over the last two decades



The terrorist attack on the US on September 11th has had a double impact on China. On the one hand, the attack may provide an opportunity for China to co-operate with the US administration. The US administration has downplayed the previous key foreign policy strategy that is based on assuming China to be a strategic competitor, as China joined the alliance with the US in the new "war". On the other hand, the fundamental differences between these two countries still exist. The success in Afghanistan may strengthen the hawkish factions on the US side, and lead to a tougher stance towards China in the future. Moreover, the attack prolonged the global recession, and increased the cost of global trade and investment, which has inevitably affected China's exports and FDI inflows.

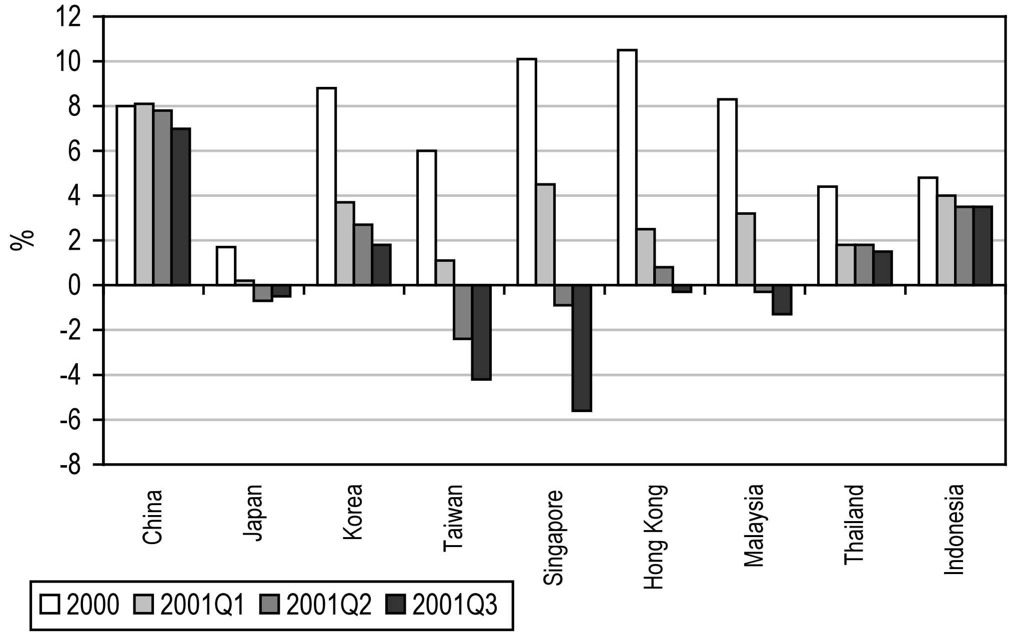
2 Economic slowdown in East Asia

Economic activity has deteriorated sharply in most East Asian economies since the beginning of 2001, after an extraordinary performance in 1999-2000. The US is the largest export destination and the information technology sector is particularly important for most East Asian economies. In 2001, over-investment and subsequent collapse in the information technology sector were attributable to the US recession; moreover, the East Asian economies were still recovering from the 1997-98 crisis. Substantial restructuring work was incomplete, especially concerning the disposal of non-performing loans in the financial sectors. The US recession and worldwide slowdown in the demand for information technology products caused serious problems for many East Asian economies.

The economic downturn in East Asia in 2001 differed from the Asian crisis in 1997-98. In 1997-98, the crisis had been triggered by speculative currency attacks. A number of East Asian economies with large short-term foreign debts, particularly Thailand, Indonesia and South Korea, had initially suffered from a liquidity crisis. In contrast, in 2001 the East Asian economies did not suffer any sharp depreciation in their currencies, and international capital did not flee the region. It was those economies with a predominant information technology sector that suffered the worst recession, such as Singapore and Taiwan. These two economies had escaped recession during the Asian crisis, and had been regarded as among the most resilient economies in the world. This time, however, Singapore and Taiwan, and Korea and Malaysia to a lesser extent, suffered the sharpest downturn. Their exports contracted at a double-digit pace in most of 2001, an event not seen since the middle of the 1980s.

Across East Asia in 2001, while external demand deteriorated, domestic demand held up relatively well during the downturn, though not enough to prevent the region from a severe slowdown. A number of governments used expansionary fiscal policy to stimulate consumption and investment. Monetary policy was either neutral or expansionary. This policy mix will be conducive to economic growth in 2002.

Figure 2. Economic growth in East Asia



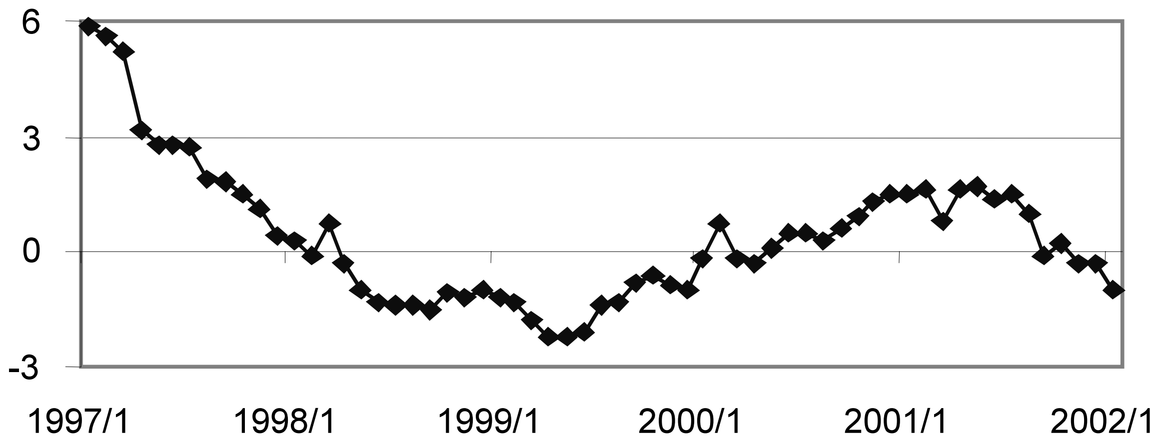
Within East Asia, Japan was in serious trouble. The economy was in recession in 2001, the fourth time in a decade. Asset prices continued to fall, and financial institutions were plagued with large numbers of non-performing loans. With depressed sentiments and bleak prospects, households saved more and firms invested less. Monetary policy was ineffective, as interest rates were already near zero. Repeated fiscal stimulus packages didn't lift the economy out of deflation, but resulted in a ballooning of fiscal debts. It became clear that without a deep restructuring of the financial sector, economic fatigue would continue in Japan. The inability of Japan to recover quickly has left the East Asian economies without a driving force.

China has become more competitive in comparison to the other economies of East Asia. The integration of the Chinese economy into the regional economy has prompted a rethinking of East Asia's export-oriented development strategy. Emphases on domestic demand and innovation will be increasingly prominent in East Asia's new development strategy in the near future.

3 China's domestic demand as a driving force in 2001

In 2001, the performance of the Chinese economy was rather satisfactory, if compared with the considerable difficulties experienced by other East Asian economies. China's GDP and industrial production grew by 7.3 and 8.9 per cent year-on-year respectively. The economy was particularly robust in the first half of 2001. Affected by the global downturn, this strong momentum subsided in the second half of the year. The growth rate declined in each quarter. In the last quarter of 2001, GDP grew by 6.7 percent year-on-year, compared with growth rates of 8.2, 7.6 and 7 percent in the first three quarters, respectively. Inflation was subdued in 2001, with the consumer price index, CPI, rising only 0.7 per cent. Towards the end of 2001 and in the beginning of 2002, prices even fell, prompting a renewed deflation scare.[1]

Figure 3. CPI: Deflation persists in China



In 2001, domestic demand, particularly investment, replaced exports as a primary driving force in economic growth. Domestic demand contributed to over 90 per cent of growth in GDP. Public investment maintained a strong growth momentum, supported by large-scale infrastructure projects. Private investment also showed signs of revival. Particularly residential building investment grew by 25.3 per cent in 2001. Total asset investment grew by 12.1 per cent. Growth in private consumption was rather steady. Retail sales of consumer goods grew by 10.1 per cent in real terms in 2001. Residential building, car, education, tourism and household appliances became pillars of growth for private consumption. The changing consumption structure was compatible with a booming service sector. Housing, catering services, transportation, and logistic services were all expanding rapidly. Household savings were large, at RMB 7400 billion (USD 900 billion) in the end of 2001, which in principle could support private consumption.

[1] China's consumer price index (CPI) went down one percent in January 2002 from the same month of 2001, and in the big cities, the CPI dropped much more substantially. For example, in Beijing it dropped by 2.8 percent.

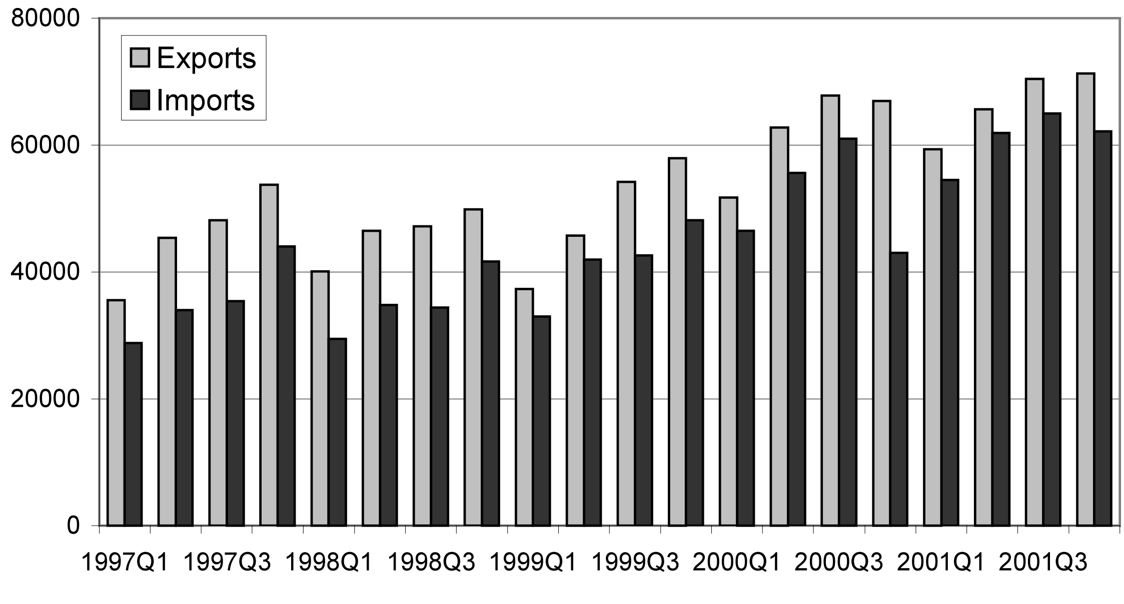
China's financial markets experienced rapid expansion. China's total capitalisation of domestic equity markets equalled [or: was equal to] around 50 per cent of GDP by the end of 2001. The improvement of market information and tightening of supervision led to more discoveries of faults and manipulations in the markets. This, together with expectations of weak earnings and more listings, resulted in a steady decline in stock prices since the middle of 2001.

4 Foreign trade

In contrast, the role of external demand in GDP growth was minor in 2001. The deceleration in export growth was rather significant during the year: China's exports grew by 6.8 per cent in 2001, compared with a growth rate of 28 per cent in 2000. Total exports reached USD 266.1 billion, while total imports reached 243.6 billion, with a growth rate of 8.2 per cent. China's trade surplus declined by 6.5 per cent compared with the previous year, equalling USD 22.5 billion in 2001. The current account surplus fell by 20.5 per cent, reaching USD 16.3 billion.

Other Asian countries were still China's dominant trading partners in 2001, accounting for 52 and 60 per cent of total exports and imports, respectively. North America was the second most important export destination, but the third most important import source. Europe was the third most important export destination, but the second most important import source. However, this picture may be distorted because China's trade with Hong Kong was often actually trade with third parties, with Hong Kong being the transit port. The US is the single most important export destination country for China.

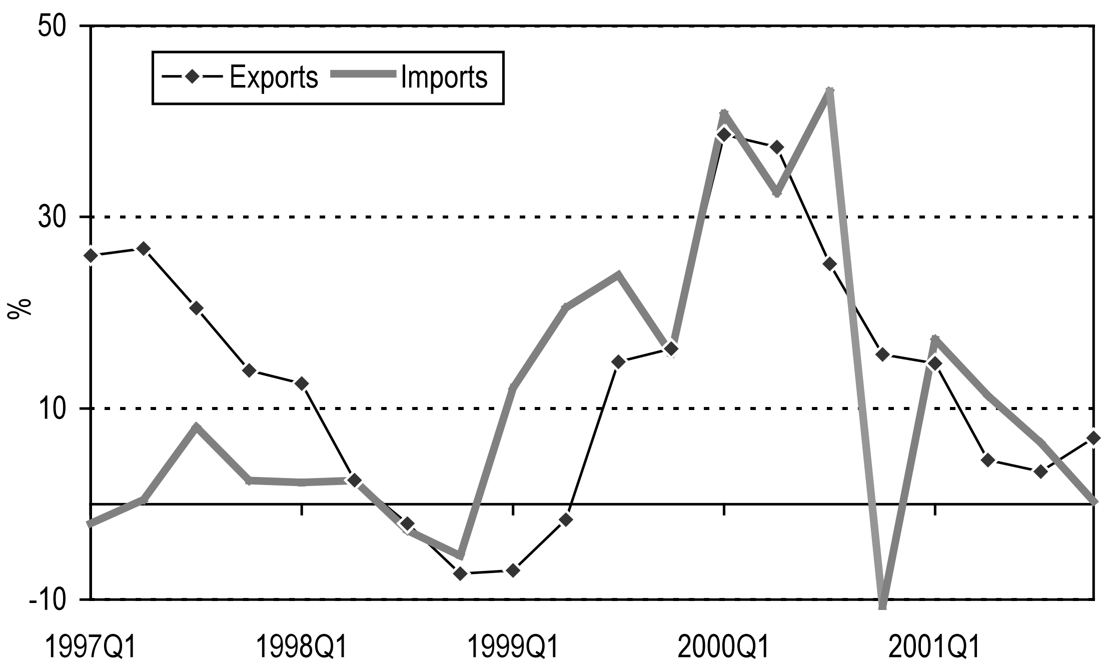
Figure 4. China's foreign trade, mil. USD



China's exports were mainly composed of manufactured goods, particularly machinery and transportation-related products. Electronics and telecom products increased significantly, while exports of garments, shoes and toys grew steadily. Machinery and transportation-related products were the dominant import goods, accounting for almost half of total imports. The other significant import goods in 2001 were electronics and telecom products, as well as chemicals and raw materials.

China's exports-to-GDP ratio was relatively high in 2001, at about 23 per cent. However, large proportions of these exports were processing activities, which generated little value added. Therefore, the contribution of the export sector to GDP is much lower than suggested by the exports-to-GDP ratio. Nevertheless, external demand is still important in China's economic growth. Industrial production and private investment generally follow trends in export growth.

Figure 5. China's foreign trade, yoy growth



Given the expectation of WTO accession, China continued to attract a large amount of foreign direct investment (FDI). In 2001, FDI reached USD 46.8 billion, representing a growth rate of 14.9 per cent year-on-year. The forward momentum was still robust, as evidenced by an increase in contractual FDI.[2] The US has been ranked first as the source of FDI for the past three years.

China's foreign exchange reserves continued to increase, reaching over USD 210 billion in the beginning of 2002. China has the second largest foreign exchange reserves in world, second only to Japan. Total foreign debts amounted to 172 billion, of which 34 per cent were short-term debts.

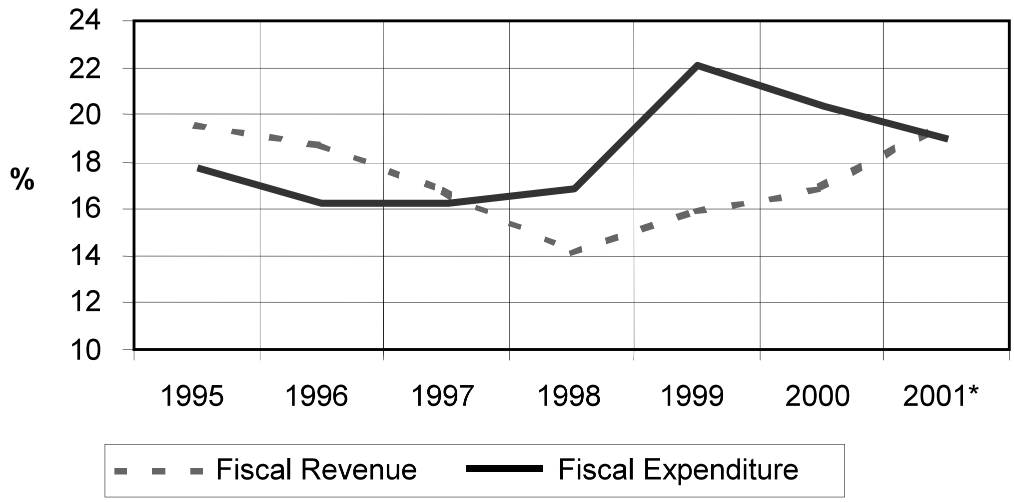
[2] According to statistics from MOFTEC, in 2001, China approved 26,139 new foreign investment projects, an increase of 16 percent over the previous year. The total contractual foreign capital exceeded USD 69.2 billion, an increase of 10 percent over the previous year. The September 11th terrorist attack dampened the growth momentum of contractual FDI in the end of 2001.

5 Monetary and fiscal policy

In response to the slowdown in economic growth, especially in the latter part of 2001, the Chinese government adopted expansionary fiscal and monetary policies. Fiscal policy continued to be the main policy instrument for stimulating economic growth. The government issued extra bonds of RMB 150 billion, a practice seen in a number of years to accelerate infrastructure investment, especially in the western parts of the country.

In 2001, China's fiscal revenue increased by 20 percent, providing room for a large expenditure increase. The growth of fiscal expenditure was estimated at around 19 percent, leaving a fiscal deficit of RMB 250 billion, representing 2.6 percent of GDP.

Figure 6. Fiscal Revenue & Expenditure: % growth



The infrastructure investment boom was very impressive, but there were concerns over over-investment and inefficiency in some of the projects. Total government debts were around 15 per cent of GDP. Though very low by international standards, the debt ratio has increased rather rapidly in recent years, and there are substantial implicit government liabilities, such as the non-performing loans of the state-owned banks and under-funded pension funds. The total contingent liability is estimated at 50-100 per cent of GDP.[3]

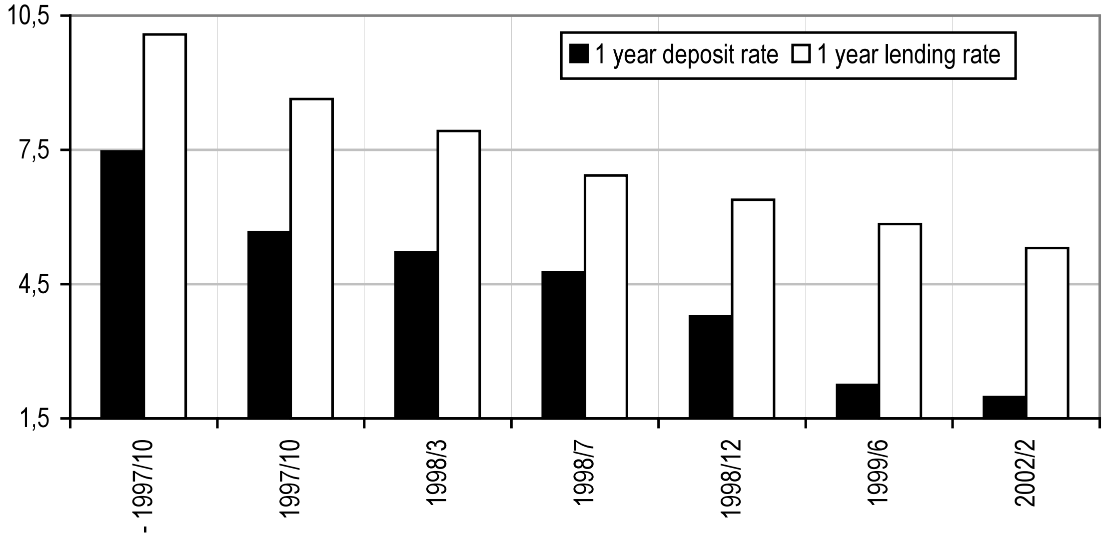
Moreover, a rapid increase in tax revenues was noted in 2001, indicating a tightening in tax administration, which could be a deterrent to private investment. The expansionary fiscal policy could also have a crowding-out effect on other fiscal spending, such as on education and social services.

The government maintained a relatively loose stance on monetary policy since inflationary pressure was very mild. A surge in housing prices was offset by a decline in the prices of durable consumer goods. The central bank had cut interest rates aggressively from October 1997 to September 1999. In 2000 and 2001, the primary interest rates were stable. Only in the latter part of February 2002 did the central bank cut the interest rates

[3] The estimation differs substantially in various studies. A research report by Ma Jun (2001) of Deutsche Bank provides a survey and detailed analyses.

again to support consumption and investment. By early 2002 the one-year time deposit and lending rates stood at 1.98 and 5.31 per cent, respectively.

Figure 7. Interest rates decline steadily



The focus of China's monetary authorities, including the financial market supervisory institutions, was to improve policy instruments, clean up the non-performing loans of the major state-owned banks, and impose discipline in the scandal-ridden stock markets. One of the hot topics of China's financial markets was the gradual liberalisation of interest rates, which was also closely related to a possible change in China's virtually fixed exchange rate regime. As a first step, the central bank authorised banks to determine their foreign currency lending rates, and foreign currency deposit rates for deposits over USD 3 million. (For deposits of less than USD 3 million, the China Banking Industry Association decided the rates). The central bank planned to liberalise interest rates gradually, first in rural areas, then in urban areas, and first in loan rates, then in deposit rates in the coming years.[4]

Concerning China's exchange rate system, the development of capital and money markets, capital control, trade and investment liberalisation, and banking sector restructuring are interrelated and should be considered in a comprehensive fashion. See Box 1 for details.

[4] In late 2001 the central bank postponed the gradual liberalisation of interest rates for technical reasons.

Box 1: China's foreign exchange rate system

The IMF officially registers China as having a managed floating exchange rate, but its foreign exchange system might be better characterised as a virtual peg to the US dollar combined with comprehensive, direct capital account controls that severely restrict foreign portfolio investment and short-term foreign borrowing. When China abolished its dual exchange rate regime in 1994, it implemented significant reforms in its foreign exchange system and abolished the right of domestic enterprises to retain their foreign exchange earnings. The old system was replaced with compulsory foreign exchange settlement. Domestic enterprises had to sell their foreign exchange earnings to designated banks, but could purchase foreign currency as long as they furnished proof of commercial contracts. At the end of 1996, China reached an important milestone by permitting official renminbi (RMB) convertibility under current accounts.

Since the beginning of 1994, China's exchange rate has been determined in the China Foreign Exchange Trading Centre (CFETC), an inter-bank foreign exchange market. The RMB was initially launched at an exchange rate of RMB 8.7 to the dollar. After allowing a modest appreciation, China's central bank, the People's Bank of China (PBOC), has actively sought to hold the exchange rate at around RMB 8.3 to the dollar.

A fixed exchange rate policy does not necessarily conflict with WTO accession. However, in China's case, the resulting liberalisation of trade and investment will inevitably increase shocks to the domestic economy. More importantly, WTO membership will force changes to China's current capital control regime.

Underdeveloped financial markets and financial institutions are particularly susceptible to wild fluctuations in exchange rates and overflows of capital. Due to market imperfections and inexperienced market players, currency stability is important to achieve before attempting the transition to liberal capital account transactions. Thus, a pure floating of the currency is not a viable choice for China in the near future. Liberalisation of capital controls needs to take into account of both exchange rate policy and the state of financial market development. Policymakers should provide China with time to develop its domestic financial markets and give domestic enterprises and banks a chance to learn to deal with the challenges of international capital mobility. The financial supervisory authorities also need time to strengthen their supervisory capabilities. Thus, some sort of capital control measures could be temporarily utilised in conjunction with flexible systems, e.g., soft pegs that limit currency movements or a managed float within a wide band. Contrary to conventional wisdom, these intermediate arrangements between a peg and a free-floating system could be quite useful for China in the medium term.

Eventually, of course, China will become integrated into the global economy and its financial markets will have developed. At that point, a flexible foreign exchange regime, i.e., a managed floating exchange rate system with capital account convertibility is appropriate. This conclusion is based on the following three considerations.

First, China already has a large economy – and it continues to grow rapidly. In PPP terms, China is the second largest economy in the world after the US according to both the World Bank and the OECD. Large economies typically opt for a floating exchange rate policy.

Second, China's increasingly open economy and the need to enhance financial market efficiency demand liberalisation of capital market controls. As capital controls lose their effectiveness, the liberalisation of capital controls becomes inevitable. While these intermediate arrangements are vulnerable to currency crises and not viable over the long term, nonetheless certain types of floating systems seem the best candidates in the medium term.

Finally, China's accession to the WTO will increase nominal shocks such as capital flow shocks and real shocks such as trade and unemployment shocks. To maintain high economic growth and external balance, China's exchange rate will likely require periodic adjustments. A managed floating exchange rate policy can both mitigate shocks and maintain real exchange rate stability without real adjustments in domestic prices and wages. Independence in conducting monetary policy is essential in dealing with such shocks.

Source: Shen (2001): China's exchange rate system after WTO accession: some considerations, BOFIT online 2001/17.

6 Main policy challenges

China joined the World Trade Organisation, the WTO, at the end of 2001. To tackle the imminent challenges of WTO accession, the Chinese government has actively promoted competition by restructuring several state monopoly sectors, and has initiated a social welfare system in urban areas. The main challenges lying ahead include non-performing loans in the banking sector and an increasingly large income disparity across the country.

6.1 Non-performing loans in the banking sector

China's banking sector has been plagued by massive non-performing loans, NPLs, for a long time. There are no exact figures about the total NPLs in the banking sector. Estimates range from 20 to 50 per cent of total bank assets. Two reasons are often cited for the high NPL ratio. The first is the banking sector's own structural faults. The second is the old system of using commercial banks to extend policy loans.

Until now China's major state-owned banks have been more like bureaucratic organisations than commercial banks. The lack of a proper incentive structure and internal control mechanism has led to the mismanagement of many state-owned banks. Furthermore, low profitability and huge waste in the state-owned enterprises have resulted in a huge loss of state assets and a heavy burden for the banking sector. State-owned enterprises are willing to borrow as much as possible because the punishment for not repaying the loans is often mild. Smaller local government-owned banks are more risky due to their limited resources and concentration of loan clients. Their demise may threaten the whole banking system. Despite efforts to make commercial banks really market-oriented, some types of policy lending continue in order to prevent large-scale bankruptcy and unemployment.

In spite of many disadvantages, Chinese banks have substantial advantages in competing with foreign banks since WTO accession. Foreign banks have a very low risk appetite for lending to China's state-owned enterprises, especially after the GITIC incident. The murky accounting standard and financial difficulties in SOEs will reduce the willingness of foreign banks to expose to SOEs. In addition, the overall exposure of each foreign bank in China is limited by its global portfolio management. How much capital each foreign bank can commit to the Chinese market will depend on their risk assessment of the global market. Limited RMB sources will also prevent foreign banks from competing directly with large Chinese banks on RMB loan business. Moreover, the initial cost of building up a bank network is very high. Generally foreign banks are more risk averse. They are not interested in going into less developed regions in China.

Foreign banks will focus on multinational firms operating in China. Foreign banks will also focus on trade settlement, cash management, risk management, foreign exchange hedging, consulting services, etc., for corporate customers, i.e., both foreign and domestic firms in China. Retail banking business will focus on credit card business and Internet banking services. Co-operation with large Chinese banks is very likely. To identify a strategic partner in China and develop a close relation with it is the next step for foreign banks. Competition will be keener among China's major state-owned banks.

WTO accession will stimulate improvement in banking sector management, as the participation of global powerhouses will help improve China's overall financial markets, which are now plagued by the misallocation of capital and rampant irregularities. Chinese banks focus now on providing and improving personal banking services, credit card services, and Internet banking. More sophisticated corporate services will need a learning-by-doing process.

Box 2: Structural problems of China's banks

China's banking system suffers from six major structural problems. These problems are partly arising from the legacy of the central planning system and partly from the underdevelopment of the financial system.

First, China's banking system is by nature a monopoly. The largest four state-owned banks remain overwhelmingly dominant. These are the Agricultural Bank of China, Construction Bank of China, Industrial and Commercial Bank of China, and Bank of China. These four banks accounted for 83 per cent of total deposits of the banking system and nearly 72 percent of total loans in 2000. This concentration in the banking system is very high compared to most other countries.

Second, Chinese banks are confined to basic banking services and are barred from conducting insurance, investment, and security businesses. Banking, insurance and security businesses are separated into three different types of financial entities.

Third, China's banking system is almost completely public-owned. The government and central bank decide the fundamental policies and operations of the banking system. Bank managers are also regarded as government officials.

Fourth, China's bank lending mostly goes to state-owned enterprises. Private enterprises can hardly gain access to bank lending. It is estimated that only about 10 per cent of outstanding bank loans were to the non-state sector, with foreign investment enterprises having the majority share. While state-owned enterprises account for less than half of China's GDP, they receive over 80 per cent of bank lending. Due to the declining profitability of the state-owned enterprises, Chinese banks have difficulty in improving bank assets.

Fifth, Chinese banks depend exclusively on deposits and central bank money to fund bank activities. None of the major banks are listed in the stock markets. The money market is still small and its use is confined to short-term liquidity adjustments.

Finally, Chinese banks have few bank products and services. Deposit taking from the public and basic lending to enterprises are the overwhelmingly dominant activities of most banks.

Source: OECD (2002): Reaping the benefits of China's trade and investment liberalisation

6.2 Widening income disparity

The increase in income disparity across China is remarkable. This will result in social tension. The current fiscal system is characterised by unfair redistribution, especially to rural residents. The regional disparity in China is huge. The falling growth rate of farmers' incomes has resulted in a growing income gap between urban and rural households. Urban households now earn nearly four times as much as their rural counterparts. Falling agricultural prices and insufficient demand indicate that structural reform of the rural economy is urgently needed.

China's domestic prices for some agricultural products are around 10-30 percent higher than international prices. After China's WTO accession, imported foreign products are expected to rise steadily and certain prices will most likely fall. Many Chinese farmers will have difficulties in coping with this new development. Whether the limited government protection and subsidies can compensate for the shortfall is a big policy challenge. Moreover, China's rural residents bear a heavy fiscal burden. They have to support rural education, administration and infrastructure investment by themselves. In addition to paying agricultural taxes, they have to pay various extra fees to support rural governments.

Boosting the rural economy, which is heavily burdened by high poverty and illiteracy rates, is a daunting task. According to official figures, 26 million Chinese living under the poverty line (income less than USD 1 a day) are in rural areas. Many poor rural families cannot afford to pay for the education of their children. And in many rural areas, basic social services and security systems remain insufficient. More investment in rural infrastructure is not enough to reduce rural poverty; it needs a whole set of new policies, especially labour mobility and urbanisation policies.

With the relaxation of the household registration system, millions of rural residents will go to cities to find jobs. New urban areas are emerging and large metropolitan areas are expanding at a rapid speed. It is estimated that over 80 million farmers are now working in cities. With more people migrating to urban areas, the employment issue has posed a huge challenge to policymakers. In the past decade, some 30 million workers have been laid off by urban state-owned enterprises. Creating more jobs for rural migrant workers and unemployed urban workers is a key policy challenge, not only in order to maintain high growth, but also to reduce income disparity and hence social tension.

7 Prospects

China's authorities face a big challenge in maintaining high growth in the near future. The government hopes to achieve a growth rate of 7 per cent in 2002. The sluggish external demand has already put great pressure on net exports, investment, fiscal revenues and private consumption. Also the growth of domestic demand diminished substantially in the second half of 2001. China is certainly not immune to the global economic slowdown. Nevertheless, China still enjoys some room for domestic policies that support domestic demand and cushion the shortfall in external demand. Fiscal stimulus policy will continue, supporting high-level public investment. FDI is expected to maintain a strong momentum. The sustained high level of foreign capital inflow is essential for achieving the government target of economic growth in 2002.

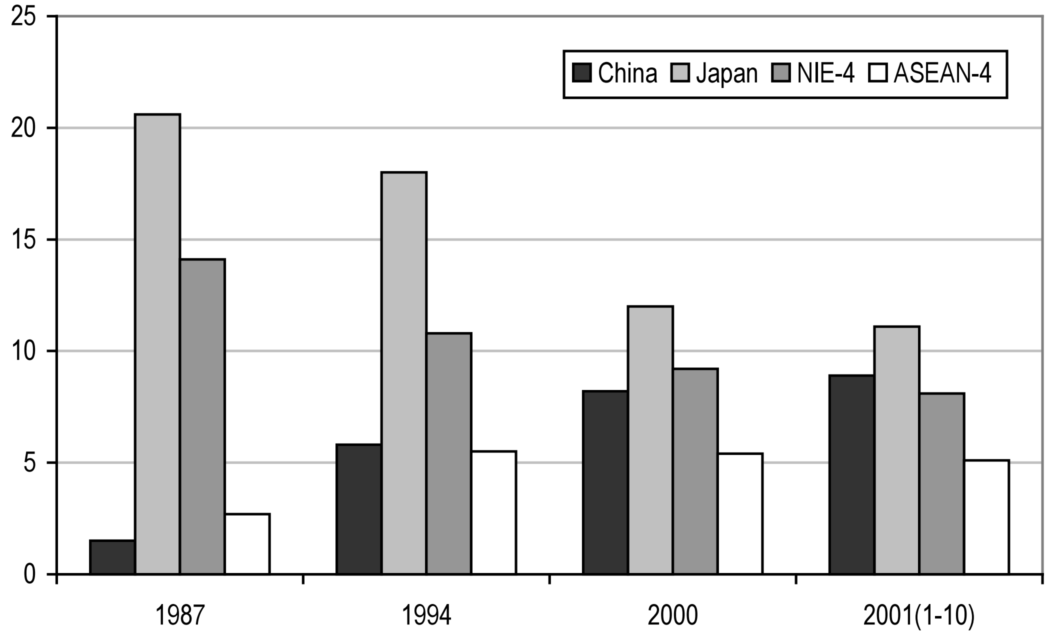
The risk to reach the government target of growth is mostly related to external demand. More than one-third of Chinese exports go to the US and Japan directly. If adding the indirect exports via Hong Kong, China's export-dependent ratio concerning these two destinations is much higher. With both countries facing an economic slowdown, if not outright recession, China will have difficulties in counting on exports. Already, China's external balance worsened considerably in the second half of 2001. As a result, economic growth in the second half of 2001 was slower than in the first half.

Despite short-term difficulties, the prospects for China's medium- to long-term growth remain favourable. China will benefit from the efficiency gains achieved in transforming the character of its economy from predominantly rural to industrialised, from centrally planned to market-oriented, and from closed to open. Foreign direct investment will be instrumental in transforming China into a global manufacturing base.

There has been a trend in recent years for China to become a global production powerhouse. China has unparalleled advantage in labour costs, which attracts global capital to build an export-oriented manufacturing power base, like Japan in the 1960s, and the newly industrialised economies in the 1970s. In addition, China enjoys a huge domestic market, abundant human capital and natural resources. Indeed, following the case of Hong Kong, the majority of Taiwan's industries are relocating production bases to China's coastal areas. This trend has intensified recently. According to official figures, there are 300,000 Taiwanese living on a continuous basis in Shanghai alone. Total Taiwanese investment in China amounts to USD 50-60 billion. To a lesser extent, Korean and Japanese firms are also relocating manufacturing bases to China.

The transfer of manufacturing bases from other East Asian countries to China is reflected in the US import pattern. In the US market, China's market share climbed even though China did not devaluate its currency during and after the Asian crisis. Cheap labour and productivity improvement are two powerful weapons for China to use in competing globally.

Figure 8. US imports from East Asia, % of total



Source: Morgan Stanley Dean Witter

Political stability and economic development are interdependent. China seems to possess all the necessary ingredients for an economic takeoff. The main risks to China's long-term sustainable growth are twofold: internally social and political stability and externally geopolitical considerations, particularly US policy towards China. China's status as a "strategic competitor" versus a "constructive partner" in its relations with the US will have big impacts on China's economic development.

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