BOFIT China Review
Yearbook 2004

A four-page monthly survey in English focusing exclusively in recent developments in the Chinese economy, public finances, and financial markets.

In addition to this regular coverage, each issue contains commentary from an expert.

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Economic Developments

GDP growth continued strong in first quarter

Preliminary statistics indicate China’s real GDP increased 9.8 % y-o-y in the first quarter of 2004. The pace of growth nearly matched 4Q03, when GDP was up 9.9 % y-o-y. Growth was driven by both domestic and external demand. On-year investment growth accelerated to 43 % and retail sales to 11 %. Export growth amounted to 34 %. The trade balance, however, turned negative as imports were up 42 %.

The “secondary sector,” which includes e.g. industrial production, construction and energy production, increased 12 % y-o-y. Industrial production was up 18 %. The service sector grew 8 %, while the share of primary sector (mainly agriculture) in GDP continued to decrease as the sector’s production increased only 5 % y-o-y. China’s relatively small service sector (32 % of GDP) is partly explained by various statistical problems, but few challenge the notion that China today is essentially an industrial economy still awaiting a services revolution.

Growth should hold up in the second quarter, given that the base figure for the 2Q03 was low due to the Sars epidemic. April provided a foretaste of high growth to come as retail sales growth accelerated to 13 % and industrial production rose 19 % y-o-y. For the whole of 2004, most analysts expect China’s GDP growth to exceed 8 %.

In urban areas, monthly real disposable income per capita rose 10 % y-o-y in 1Q04 to 880 yuan (85 euros) per month. Cash income in rural areas rose 9 % to 280 yuan. The government particularly welcomed the rise in rural income, since one of its priorities is to increase incomes in the countryside. The rise reflected higher food prices, increased transfers from migrants working in cities and lower taxes and fees. The ever-widening urban-rural earnings gap is actually larger than these figures indicate due to additional tax and fee burdens on rural residents.

Booming investment growth raises worries

Contrary to the hopes of the central government and many analysts, investment growth continued to accelerate during the first months of 2004. The high growth has led to scarcity of raw materials, energy and transport services and raised worries about future profitability of investments.

Moreover, despite government warnings last year about the threat of overinvestment in real estate, car manufacturing, steel, cement and aluminium production, investment into these sectors continued to increase fast in 1Q04. Now definitive signs of overcapacity are begging to appear in e.g. the car industry and manufacture of certain construction materials. Moreover, according to some estimates, some 70 % of these investments have been made by the state or publicly owned companies and no one has yet to clarify whether these investments are driven by the market or politics. In January-March, growth was unbalanced between sectors as investments increased 76 % in manufacturing, 38 % in the service sector, but less than 1 % in agriculture. The authorities invoked new measures in April to curtail investment in overheated sectors, but at the same time encouraged banks to lend more to energy and infrastructure projects (such investment is hoped to eliminate economic bottlenecks and decrease upward pressure on prices).

High raw material prices lead to lower profits

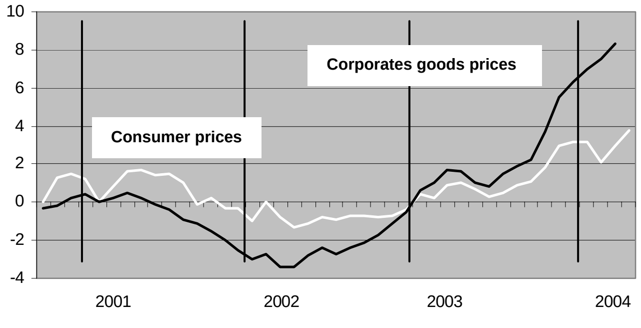
Investment growth has led to price hikes for raw material prices. For example, steel prices were up 41 % y-o-y in March. Consumer prices, in contrast, have risen more moderately. In April, they were up 3.8 % y-o-y, due mainly to a 10 % hike in food prices. The price rises in other product groups have been moderate. Prices for cars and certain electronic equipment continued to decline. The combination of price softness and expensive raw materials has rapidly shrunk profit margins in many sectors and increased worries about the investment profitability.

China’s official inflation target is 3 % this year. In coming months, however, inflation is likely to accelerate as prices were depressed in summer 2003 by the Sars outbreak.

Import growth widens trade deficit

In January-April, import growth (42 %) exceeded export growth (34 %), pushing the trade deficit to about 2 % of GDP. Trade increased rapidly with all major partners. The investment boom has increased demand for both raw material inputs and energy in China. The value of such imports increased 62 % y-o-y due both to higher volumes and higher prices. Strong growth in the processing sector increased imports of components and parts. In addition, foreign direct investment increased imports of machinery and equipment. Among export sectors, electrical machinery and equipment and related parts increased over 50 %. Growth was lower in textiles, clothing, footwear and toys.

Inflation rates, 12-month percentage change



Source: National statistical office and PBoC

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
GDP, y-o-y %-change	8.8	7.8	7.1	8.0	7.5	8.0	9.1	9.8	Q1/04
Industrial production, y-o-y %-change	11.3	8.9	8.5	9.8	8.7	10.0	17.0	18.2	1-4/04
Fixed investments, y-o-y %-change	8.8	13.9	5.1	10.3	13.0	16.9	29.4	43.0	1-3/04
Exports, CNY bn	1516	1522	1616	2063	2202	2695	3630	1347	1-4/04
Imports, CNY bn	1181	1163	1374	1864	2016	2443	3418	1437	1-4/04
Current account, % of GDP	4.1	3.3	2.1	1.9	1.5	2.8	3.3		

Source: People's Bank of China, National Bureau of Statistics of China, IMF, OECD.

A mountain of foreign exchange reserves

China's foreign currency reserves climbed to a record $440bn at the end of March. In the first quarter of this year, China's reserves grew by $37bn. Since end-March 2003, they were up by $120bn. Although China only publishes balance-of-payments statistics twice a year, preliminary figures indicate that surplus in the capital and financial accounts drove the increase in reserves. Foreign direct investment inflows were up 8 % y-o-y to about $14bn. According to many analysts, the financial account surplus was boosted by other capital flows that were driven largely by revaluation expectations.

Under China's implicit pegged exchange rate regime, the central bank must buy the excess supply of foreign currency from the market and issue 8.28 yuan for each US dollar. To restrict liquidity in the market, the PBoC has sterilised capital inflows by selling central bank bills to the banks.

When discussing the high investment rate, it is also important to remember that China's savings rate is so high that the country already possesses sufficient resources to finance its investments. External debt is fully covered by investments abroad, and, including investments in foreign exchange reserves, China is net exporter of capital.

Restrictions on credit growth

Growth rates of money supply and credit remain well above official targets, despite the fact that growth slowed slightly in the first months of 2004. In April, the annual growth rate of broad money (M2) was 19 %, while the credit stock of all financial institutions increased 21 % y-o-y to CNY 18,100bn (140 % of estimated GDP). Deposits increased 19 % y-o-y to CNY 23,400bn.

To curb credit growth, the PBoC has raised the reserve requirement three times since last autumn. On April 25, the reserve requirement was raised to 7.5 %. Despite these hikes, most banks enjoyed good liquidity as deposits have also increased rapidly. The authorities have also provided commercial banks with credit policy guidelines and have urged them to reduce their lending to overheating sectors. In addition, credit terms to these sectors have been tightened.

Despite these measures, credit growth has not slowed. Many analysts have thus called for the central bank to raise interest rates, even though the possible effects of an interest-rate hike on China's strongly regulated financial sector are difficult to forecast. The PBoC has kept interest rates stable and the reference rate for one-year credit remains 5.31 %. The central bank has been reluctant to raise interest rates because higher rates could even increase foreign capital inflows to China. Moreover, higher interest rates could deteriorate the ability of companies to pay back their credits, increase non-performing loans and curb economic growth too sharply.

Non-performing loans still a problem

Recent official figures imply that the total amount of non-performing loans (NPLs) is nearly CNY 4,000bn, or over 30 % of GDP. The actual situation is probably worse, given that official figures likely understate the problem. Most NPLs are held by the big four state-owned banks, rural credit cooperatives or asset management companies set up in 1999 to clear NPLs from the big banks' balance sheets.

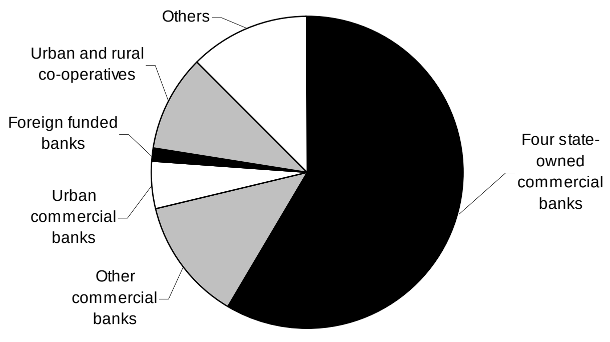
Half of all NPLs are held by the big four state-owned banks. As of end-March, these banks reduced their NPL ratios significantly to an average of 19 %. On the other hand, the value of their outstanding NPLs dropped only slightly and most of the lowering in their NPL ratios reflects the impact of new lending. The NPL ratio of the rural credit corporations may be over 30 % and their outstanding NPLs would amount to over CNY 500bn.

The share of NPLs is considerably lower at smaller commercial banks. At the end of March, the NPLs in these 11 banks amounted to CNY190bn or 7 % of total loans. In these banks, however, the amount of NPLs has risen in 2004. This raises concerns over the quality on new credit. If the same trend appears in the four big banks, the average NPL ratio may start rising sharply.

Two big banks under reconstruction

In March, the PBoC released a ten-point program for restructuring the healthiest two of the four major state-owned banks. The reforms should improve the corporate governance of banks and encourage them to operate according to market principles. The aim is to list Bank of China and China Construction Bank before the end of 2005 and to find strategic investors to buy stakes in these banks. Due to their size (total assets of both banks is around CNY4,000bn or €400bn) and large stocks of non-performing loans, however, it could ultimately prove difficult to find a strategic investor. In the first quarter of 2004, the profits of the two banks rose to CNY 33bn. At the same time, the NPL ratio dropped to 9 % for Construction Bank and to 15 % for Bank of China.

Asset distribution by financial institutions at the end of 2003



Source: PBoC

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
Inflation (CPI), 12-month, %	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.8	4/04
M2, y-o-y %-change	19.6	14.8	14.7	12.3	17.6	16.9	19.6	19.1	4/04
Average monthly disposable income in urban areas, CNY	430	452	488	523	572	642	708	880	Q1/04
Average monthly cash income in rural areas, CNY	178	180	184	200	211	226	244	278	Q1/04
Forex reserves, $ bn (end of period)	139.9	145.0	154.7	165.6	212.2	286.4	403.0	440.0	3/04
CNY/EUR (end of period)	9.205	9.714	8.318	7.702	7.294	8.68	10.453	9.892	4/04

Source: People's Bank of China, National Bureau of Statistics of China, IMF.

Wen stresses stability and sustainability

In his speech at the National People's Congress (NPC) annual meeting on March 5, premier Wen Jiabao emphasised sustainability and balance of future economic growth. Wen set China's GDP growth target for 2004 at 7 %. The government's goals included more balanced development between urban and rural areas, among regions, between people and the environment and between China and the outside world. The Chinese leader was particularly concerned about the slow growth of rural residents' incomes. He promised to lower the agricultural tax gradually and eliminate it within five years. He also promised to liberalise completely grain purchases and increase central government transfers and investments to rural areas.

The theme of equal and sustainable growth is a likely cornerstone of the next five-year plan. During 2006-2011, the government would shift its emphasis from high economic growth to improving living standards throughout China.

Constitutional changes lift private sector's status

The NPC approved several constitutional amendments on March 14. The most significant changes concern protection of private property rights and eminent domain, whereby the state must fairly compensate owners of land or other private property when a state taking occurs. This should particularly protect farmers and improve growth prospects in rural areas. As economic growth has increased the private property of individuals and enterprises, conflicts over property rights between individuals and the government have become more common. The constitutional changes are designed to provide a legal framework to deal with such conflicts.

China's constitution previously only acknowledged the existence of a private sector. Now it recognises the state's commitment to private sector development. The private sector is the most dynamic force in China's economic development, yet it still faces major obstacles. The private sector, for example, still has restricted access to financing from the largely state-owned banking sector, which favours public projects over private ones.

2004 budget approved in March

In March, the NPC passed the 2004 budget, which foresees the budget deficit shrinking slightly to 2.5 % of GDP in 2004 and puts an end to widening budget deficits. The total revenue of central and local budgets would amount to CNY 2,400bn (€230bn), or 18 % of estimated GDP. Expenditures would rise to CNY 2,670bn. Both revenues and expenditures would increase nearly 9 % from 2003. The budget is based on annual GDP growth of 7 %. It should be noted, however, that a large share of China's actual public revenue and expenditure occurs outside the budget.

The budget gives priority to development of rural areas and military spending. This year's military spending will amount to CNY 210bn, or 9 % of budgetary expenditures. Again, actual defence spending is considerably higher than the budgetary figure suggests.

The delegates also approved the 2004 national economic and social development plan. The plan aims at keeping urban unemployment below 4.7 % and creating 9 million new urban jobs. Farmers' incomes would rise 5 %. The inflation target is 3 %.

The right stuff for a soft landing?

Many analysts still declare that economic growth can be reined in and will converge to the growth trend of around 7 % without major difficulties. However, the government is confronted with a very difficult task. It calls for growth rates that are high enough to create jobs, but dampens growth so that some sectors do not get further overheated and inflation pressures do not get out of hand. In a strongly regulated and partly underdeveloped environment such as China's, this task is made even more challenging as such restrictive measures may hold unintended consequences. On the bright side, the central government's power is still substantial in most sectors.

The government already moved a year ago to cool down the economy by limiting loans for real estate. Since then the authorities have adopted administrative measures and monetary policies designed to diminish growth of the money supply and credit. Investment growth has been limited by lengthening the process of granting construction and investment permits. Public investments have been delayed and budget deficit is expected to decrease in 2004.

Nevertheless, growth has yet to slow. Public investments at the local level, in particular, have boomed. Some experts now openly worry that the central government is losing its influence at the local level. The rapid investment growth clearly suggests the efficacy of its current measures has diminished. Of course, the government has a number of political, fiscal and monetary measures it has yet to unleash to cool down the economy. It can affect decision-making at the local level e.g. through administrative changes, giving early warnings or implementing rules more strictly. One example of this tougher policy line was seen in April when the directors of a steel company were arrested for illegally building a plant. While the government in principle can use fiscal tightening to discourage further public investment, socio-political factors severely constrain its options. In addition, the government should have an influence on the lending policies of state-owned banks. Monetary measures include raising interest rates or changing an exchange rate policy that has kept the yuan constant against the US dollar for the past ten years (8.28 yuan = 1 dollar). Growing currency reserves have also raised discussion about China's fixed-rate approach. The PBoC has repeatedly said that it aims at greater exchange-rate flexibility in the long term and stable exchange rates in the short term.

Fiscal indicators (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	as of
Revenues	11.6	12.6	13.9	15.0	16.8	18.0	18.5	1-11/03
Expenditures	12.4	13.8	16.1	17.8	19.4	21.0	17.7	1-11/03
Balance	-0.8	-1.2	-2.1	-2.8	-2.6	-3.0		

Source: National Bureau of Statistics of China.

Chinese stock market struggles to find its place in the SOE reform

by Andy G. Ji *

Paradoxical performance

The total capitalization of the Chinese stock market exceeded €400 billion at the end of 2003, putting it among the ten largest stock markets in the world. Market capitalization as share of domestic GDP had also climbed to 50 % in 2001, a rather impressive gain from a mere 1 % a decade ago.

Despite these numbers, the Chinese stock market appears to convey more historical significance than economic sense over a decade after its official inauguration. While GDP quadrupled from 1992 to 2002, the composite index of the Shanghai stock exchange gained only 75%. Moreover, listed firms reported a combined €65 billion loss for the period 1994–2001.

Soft budget constraints and monitoring problems

The Chinese stock market was established to facilitate the reform of state-owned enterprises (SOEs) at a time when the government found it increasingly costly to pursue its policy of lending, subsidizing, and otherwise giving preferential treatment to SOEs. These soft budget constraints inevitably led to incentive problems and permitted SOEs to lag far behind their private counterparts in both productivity and profitability without facing serious consequences. The present massive stock of non-performing loans in the banking sector testifies to just how badly things got out of hand.

Establishing a stock market was supposed to relieve budget pressure from China's exceptionally high individual savings rate and transfer the responsibility for SOE monitoring to more efficient institutions and individual investors. To convince wary investors its intentions were legitimate, the government committed to absorbing any default risk incurred by listed firms. It set forth a strict screening process and discretionary measures to sanction new listings. In the end, however, the government found itself further extending soft budget constraints to listed firms in order to make its promise credible to the investors. Indeed, despite their dreadful performances, only 14 of over 1,300 listed firms have ever been de-listed.

Given to the government's reluctance to privatize, most of China's listed firms have ownership structures where the state is the absolute majority shareholder and many individuals constitute the minority shareholders. Such an ownership structure makes it impossible for small investors to carry out efficient monitoring. Moreover, when trading in shares owned by the state is forbidden at the exchanges, it widens gap between majority shareholder's interests and those of individual investors (which is basically value maximization). The ineffective monitoring is further complicated by the lack of relevant laws and non-existence of a corporate control market. These deficiencies resulted into a market with severe agency problems between majority and minority shareholders.

The advent of gradualism

The role of government on the stock market remains controversial. Instead of setting rules and building institutions, the government constantly intervenes with measures that influence market supply and demand. As most such measures are discretionary, they actually tend to generate market risk or distort investor expectations.

While the gradualist approach has been hailed for allowing the government the possibility of maintaining stability in SOEs during the reform process, maintaining inefficient schemes involving soft budget constraints is clearly not the optimal path to a robust, advanced market economy. Moreover, China's much-touted gradualism implies reluctance on the government's part to implement privatization. It creates corporate ownership structures dominated by a single majority shareholder and obstructs the emergence of an efficient stock market. Despite attempts to associate China's social and economic achievements with gradualism, the experiences on the Chinese stock market offer an alternative basis for evaluating this policy.

Old wine?

The government's renewed intention to divest its entire ownership in listed firms now weighs heavily on the stock market. Such a move would triple the share supply at a time when investor interest is waning. Although the move is recognized by many as a necessary step toward better corporate governance, fundamental changes in the law, institutions, and the government's role arguably must come first.

Many have dismissed the Qualified Foreign Institutional Investor (QFII) scheme as little more than old wine in a new bottle. The scheme imposes the same fatal constraints as foreign investors already face on the B-share market. The ceilings on both the amount and the ownership that foreign investors can invest in listed firms through QFII will essentially eliminate the possibility of introducing control contests or subsequent improvements in corporate governance structures.

The listings of some of the best state-owned companies abroad even reflect the government's own frustration with the existing regulatory regime of the Chinese stock market.

Since no quick cure is in sight, investors in the Chinese stock market must face the possibility that their investments may well be written off as nonperforming "equities."

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Economic Developments

Few signs of slower growth in the second quarter...

According to preliminary statistics, China's real GDP grew 9.6 % y-o-y in the second quarter of 2004 and 9.7 % in the first half of 2004. The growth rate in the second quarter was lower than expected, partly due to revision of last year's figures. The GDP growth figure for the second quarter of 2003 was lifted from 6.7 % to 7.9 % after the National Bureau of Statistics (NBS) decided the negative impact of the Sars epidemic a year earlier had been overestimated.

Official measures to curb the investment boom seem to have worked; investment growth slowed in the second quarter. Fixed investments were up only 29 % y-o-y in the first half of 2004, although the growth in the first quarter was 43 %.

In many sectors, however, growth continued to be strong or even accelerated in the second quarter. Industrial production increased 18 % y-o-y and construction was up 12 %. Retail trade growth accelerated to 15 %. Exports rose 37 % and imports 43 % in the second quarter.

According to the survey by the People's Bank of China, the growth of inventories accelerated during the first half of 2004. In June, inventories were 22 % larger than a year earlier, putting the value of inventories at its highest level since 1996. This may hamper production growth in the coming months. Industries suffering from the slowdown of investments such as metallurgy, construction materials and car manufacture saw inventories increase. These industries also saw their profits hurt by increased competition and higher prices for raw materials and energy.

... and the general picture remained mixed in July

Growth of industrial output slowed to 16 % y-o-y in July. Government tightening of the credit market caused a cooling off in car production, which grew only 0.5 % in July. By comparison, the growth rate in car industry was still over 20 % in June.

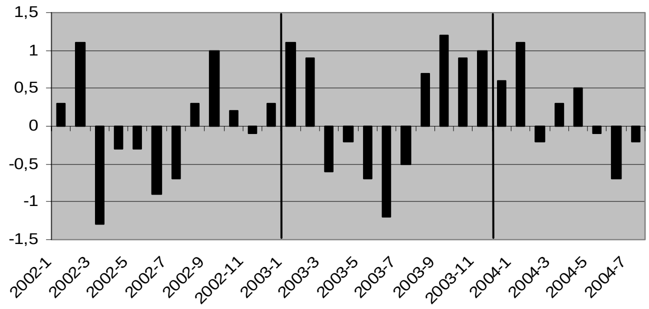
On the other hand, growth remained brisk in many other sectors. Retail trade increased 13 % and exports were up 34 % y-o-y. Investment growth rebounded with the growth rate for January-July rising to 31 %.

Most analysts agree that the "soft landing" hoped for by the government and central bank has yet to occur. The authorities have issued repeatedly warnings in recent weeks that the threat of overheating remains. They emphasise that it is important to continue with measures to curb growth. In keeping with this policy, the government suspended or cancelled nearly 4,000 infrastructure projects around the country.

Inflation reaches seven-year high

The government is particularly worried over inflation, which continues to accelerate. In July, consumer prices were 5.3 % higher than 12 months earlier – the highest inflation rate since the beginning of 1997. The inflation picture, however, is mixed for several reasons. The negative monthly changes in consumer prices since May and simultaneous acceleration in annual inflation are the product of the Sars epidemic, which depressed prices in summer 2003. The impact of Sars will disappear from the on-year figures in the autumn. Additionally, the inflation figures are largely affected by food prices, which, due to small crops and price liberalisation, have risen briskly since autumn 2003. On the other hand, the prices for many durable consumer goods continue to decline. Although the central bank expects inflation to only begin to slow in the last quarter of 2004, it has not introduce any further measures to restrain inflation in the summer. Apparently, the PBoC is trying to get a clearer picture of the situation before it makes another move.

Consumer prices, monthly percentage changes



Source: NBS and PBoC

Rapid income growth in rural and urban areas

Higher food prices and an increased number of migrant workers have boosted income in rural areas significantly. In the first half of 2004, the monthly per capita cash income of rural residents amounted to 224 yuan (22 euro). Real incomes rose 8 % y-o-y. The increase was warmly greeted by the government, which has set raising rural incomes as a primary policy goal.

The gap between rural and urban incomes continued to widen as urban incomes climbed 9 % y-o-y. Per capita monthly disposable income of urban residents now exceeds CNY 800 (€80). The difference between rural and urban areas is even larger than these figures show, due e.g. to numerous extra taxes and fees charged in rural areas. To highlight the widening income disparity, the NBS reported that the number of poor people increased in 2003 for the first time since 1979. There are now 29 million people in China earning less than the government's official poverty threshold, CNY 637 (64 euro) per year. When measured by international standards, the number of poor people in China rises to 200 million.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
GDP, y-o-y %-change	8.8	7.8	7.1	8.0	7.5	8.0	9.1	9.7	H1/04
Industrial production, y-o-y %-change	11.3	8.9	8.5	9.8	8.7	10.0	17.0	17.3	1-7/04
Fixed investments, y-o-y %-change	8.8	13.9	5.1	10.3	13.0	16.9	29.4	28.6	H1/04
Exports, CNY bn	1516	1522	1616	2063	2202	2695	3630	2560	1-7/04
Imports, CNY bn	1181	1163	1374	1864	2016	2443	3418	2600	1-7/04
Current account, % of GDP	4.1	3.3	2.1	1.9	1.5	2.8	3.3		

Source: People's Bank of China, National Bureau of Statistics of China, IMF, OECD.

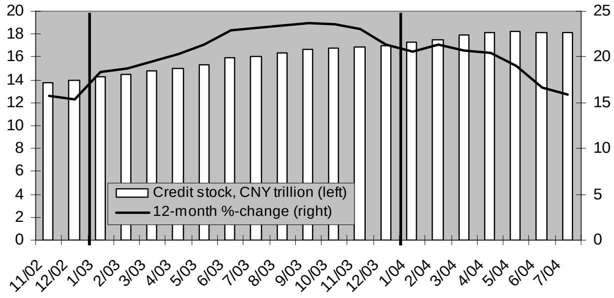
Credit growth cools

Government guidelines to curb the credit boom seem to have taken effect as growth in bank lending has slowed considerably from the beginning of 2004. Credit growth declined close to official targets as the credit stock increased 16 % y-o-y at the end of July. This figure, however, likely underestimates credit growth because banks took large write-offs on non-performing loans (NPLs) during the summer months. Actually, the selling on of NPL debts slightly reduced the stock of renminbi-denominated loans from June to July. A more convincing sign of the slowdown perhaps is that the amount of new loans granted in January-June was lower than in the same period last year.

Due to slower credit growth, money supply growth has also decelerated. As of end-July, broad money (M2) had expanded 15 % in the past twelve months, a rate well below the target of 17 % set by the central bank.

Despite the first signs of cooling off in the financial sector, the People's Bank of China warned that credit growth is still very strong and urged banks to curb the excessive growth of medium and long-term loans. In addition, the Banking Regulatory Commission has identified lending risks in five previously unmentioned sectors: power, transportation, utilities, education and hospitals.

Loans in local and foreign currencies in all financial institutions



Source: PBoC

Capital inflows continue strong

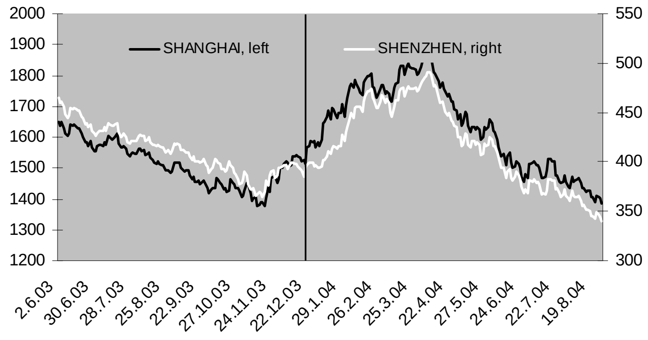
At the end of June, China’s foreign currency reserves stood at $471bn. Since the beginning of 2004, they were up by $67bn. The rise is partially explained by the increased inflow of foreign direct investment (FDI). In January-June, China received FDI worth of $34bn, 12 % more than in the corresponding period in 2003. Strong import growth, however, turned the trade balance negative by $7bn and made the recorded increase in foreign currency reserves somewhat enigmatic. The increase probably reflects higher capital inflows into China.

Downward stock market trend

In the first half of this year, the total capital raised through issuing shares reached a record CNY 86bn (€8.6bn), an increase of 130 % y-o-y. Capital raised through issuing A-shares rose 58 %. Capital raised through H-shares rose an astonishing 700 %, thanks to the large IPOs of China Telecom and Pin An Insurance. As of end-June, capital raised on the stock market constituted almost 5 % of total domestic finance (less than 2 % at the end of 2003). The frenzied issuing activity reflected rising share prices in the first four months this year. Profits surged for many listed firms during this period.

China’s stock market seldom moves in tandem with the real economy. The exceptional hand-in-hand rally of the stock markets and the economy in January-April reflects the magnitude of overheating in the state sector. Undoubtedly, listed firms were timing issuances to maximize their proceeds, so it is unlikely that the same breakneck pace in raising capital will continue. Indeed, the current economic tightening measures are already taking their toll on asset prices. As of end-June, the share indices of both the Shanghai and Shenzhen bourses had retreated to their starting point at the end of last year.

Composite indices of A-shares on Shanghai and Shenzhen exchanges



Different territories, familiar tales

Shenzhen Stock Exchange launched a new board for small end medium size enterprises (SMEs) in June. The highly anticipated board is expected to alleviate some of the difficulties SMEs face in acquiring adequate financing in China. However, the first trading days on the list experienced extremely volatile performance. After a mere ten days of trading, Jiangsu Qionghua, the second firm listed on the SME board, was rebuked by China’s Securities Regulatory Commision (CSRC) for serious disclosure irregularities.

In the same vein, China Life, once dubbed the world’s largest IPO in 2003 ($3.5bn in raised capital) was hit by an investor lawsuit alleging accounting and disclosure irregularities in its IPO process. The class-action lawsuit was brought by small investors in the US, where China Life’s ADRs are listed.

Nor are China Life or Jiangsu Qionghua the only “bad apples” hit by the recent wave of investigations and condemnations from the CSRC. The CRSC issued 26 rebukes during the 44 trading days in June and July.

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
Inflation (CPI), 12-month, %	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2	5.3	7/04
M2, y-o-y %-change	19.6	14.8	14.7	12.3	17.6	16.9	19.6	15.3	7/04
Average monthly disposable income in urban areas, CNY	430	452	488	523	572	642	708	803	H1/04
Average monthly cash income in rural areas, CNY	178	180	184	200	211	226	244	224	H1/04
Forex reserves, $ bn (end of period)	139.9	145.0	154.7	165.6	212.2	286.4	403.0	470.6	6/04
CNY/EUR (end of period)	9.205	9.714	8.318	7.702	7.294	8.68	10.453	9.968	7/04

Source: People's Bank of China, National Bureau of Statistics of China, IMF.

Discussion over trade policies rising

During the last 25 years, China has become an important player in the world market. Its share of world trade reached 6 % in 2003 and the growth rate of China's foreign trade is among the fastest in the world. Although China's trade surplus has been modest (less than 2 % of GDP in 2003), the country's role as a processor has spectacularly widened its bilateral trade surpluses, particularly with the US and the EU. These surpluses appear even larger using data from China's trade partners (partly because China classifies its trade with other countries as trade with Hong Kong if the goods pass through Hong Kong ports). This has provoked discussion among China's trade partners China's trade policies.

Trade balances with major trading partners, USD billion

	China's statistics			Partners' statistics		
	2001	2002	2003	2001	2002	2003
EU	5.3	9.6	19.1	36.1	40.6	54.8
Japan	20.4	-5.0	-14.7	26.8	21.8	9.1
US	28.1	42.8	58.7	90.2	111.4	134.8
Korea	-10.9	-13.1	-23.0	-4.9	-6.4	-17.1
ASEAN	-	-7.6	-27.4	4.0	5.9	-4.6

Source: IMF, Direction of Trade Statistics

Since joining the WTO in December 2001, China's implementation of its membership commitments has been monitored through a special review mechanism. It is widely recognised that China has made impressive progress in reducing tariffs and adjusting its laws to WTO requirements. However, the monitoring reports and the general discussion have become increasingly critical over the last couple of years of China's efforts to meet its WTO commitments. For example, new laws in China are said to lack transparency and little seems to have been done to systematically protect property rights. Foreign companies are upset about recent Chinese measures that deny them access to business opportunities. While such actions are nominally consistent with the WTO regulations, they harm development of economic relations. A typical example of such measures is the capital requirement China imposes on the banking sector, which will be opened up to foreign banks at the end of 2006. Although the recent regulations will substantially lower the requirements from the beginning of September, many analysts fear that the requirements will discourage foreign banks from entering the market. Similar restrictions exist e.g. in the construction sector.

Last spring, China and the EU had a major row over coking coal, with the EU accusing China of restricting coke exports. The dispute was temporarily resolved but permanent solution has not been found. The US, which runs the largest trade deficit with China, is the loudest critic of China's trade policies. The debate also has a national dimension, as it has become a talking point in the presidential campaign. Last March, the US became the first country to file a complaint against China with the WTO. The complaint alleged inconsistent value-added tax treatment of imported and domestic semi-conductors in China. The US seems to have won the dispute; China announced in July it was ending preferential tax treatment for domestic semi-conductors.

Many countries fear China will increase its dominance of the textile and clothing sector after the WTO agreement removes import quotas in the sector at the beginning of 2005. China is already the world's largest exporter of textiles and clothing, and some analysts estimate its share of the sector rise even further.

Anti-dumping and market economy status

China has become the favourite target of anti-dumping measures. In 2003, 45 anti-dumping initiatives, or 21 % of all such initiatives, concerned Chinese products. Currently, the US has around 50, and the EU around 30, anti-dumping measures in force against Chinese products. The actual share of Chinese exports subject to these measures, however, remains quite small.

On the other hand, China increasingly relies on anti-dumping measures to protect its own trading interests. In 2003, China made 22 antidumping initiatives. It also revised its anti-dumping legislation to make it more effective.

Only a few minor trading partners, such as New Zealand, Singapore and Thailand, have granted China market economy status (MES), which should improve China's position in anti-dumping cases. In June, the European Commission concluded that China had yet to fully meet MES criteria regarding state influence, corporate governance, property and bankruptcy law and the financial sector.

Amended foreign trade law effective on July 1

The revised law is more consistent with China's WTO commitments and allows individuals engage in foreign trade. Under the new rules, registration is sufficient to conduct foreign trade and government approval no longer needed. The new law should also enhance protection of intellectual property rights.

Five other new laws also took effect at the beginning of July, including the Administrative Licensing Law, which is designed to reduce red tape and bureaucracy. The law aims to restrict government power and reduce corruption by eliminating many licensing procedures. The law is also expected to give individuals and enterprises access to markets outside their home area, and thus should reduce local protectionism. Overall, it should enhance the role of market mechanisms in the economy and help China meet its WTO commitments.

The National People's Congress has also begun discussing of a new bankruptcy law. The old law applies only to the state-owned enterprises. The new law would improve the status of creditors and promote equal treatment of all kinds of enterprises. The law would enter into force at earliest in summer 2005. An anti-monopoly law is also under preparation.

Fiscal indicators (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	as of
Revenues	11.6	12.6	13.9	15.0	16.8	18.0	18.6	24.4	1-5/04
Expenditures	12.4	13.8	16.1	17.8	19.4	21.0	21.1	17.0	1-5/04
Balance	-0.8	-1.2	-2.1	-2.8	-2.6	-3.0	-2.6		

Source: National Bureau of Statistics of China.

Monetary regulation in a changing China

by Tapio Korhonen *

Financing still administratively regulated

China's financial system is caught up in a slow evolution from command to market-based system. While the state has for the most part abandoned overall planning of the economy, strong interests still dictate how credit is distributed. The party and the government continue to set the monetary policy guidelines and let the People's Bank of China work out the details. In their recent struggles to prevent economic overheating, Chinese authorities have also relied heavily on regulatory measures.

Increasing market flexibility, however, has diminished the potency of centralised regulatory approaches and exposed the inefficiencies of administered regulation. China's banking sector is nevertheless large by international standards, so official policies are likely to have major economic repercussions. The Chinese are also diligent savers. Inflation has not consumed the value of their savings, and, thanks to regulation, their savings have remained in the country. Unfortunately, regulation has also guided investment of this money, often into unprofitable ventures, saddling banks with a massive stock of non-performing loans.

Foreign finance and foreign exchange policy

The regulatory regime matters most in formulating monetary and foreign exchange policy. Despite the diminishing effectiveness of foreign exchange regulation, its impact is apparent (e.g. in yuan forward markets outside China, where the exchange rate is not set according to the difference between domestic and foreign interest rates).

Capital movements are essentially unrestricted only for direct investments in Chinese industry. Foreign direct investment in China has helped boost foreign exchange reserves and the money supply in recent years. Similarly, large inflows of speculative capital have recently increased domestic liquidity.

Interestingly, swings in China's current account balance have apparently been moderated by the regulation of foreign capital movements. Due to restrictions on capital exports, savings have to be used inside China. As a result, investments and imports have increased rapidly.

Broad restrictions on foreign exchange operations affect China's foreign exchange policy. Because each official regulatory decision constitutes a de facto foreign exchange intervention, the yuan cannot float freely. China has so far resisted experimentation with a flexible foreign exchange regime by retaining its peg of the yuan to the US dollar. This fixed peg, however, is becoming increasingly difficult to preserve as the economy evolves to a point where capital movements are largely unregulated.

Regulation of domestic financing

The state has recently slashed the investment plans of state companies. China's Banking Regulatory Commission has also issued regulations on bank lending, while the PBoC has promulgated detailed lending guidelines for banks and tried to limit expansion of the money supply with market-based approaches such as higher reserve deposits and reliance on open-market operations.

The effectiveness of these moves lies partly in the fact that China's four largest banks are still state owned. In contrast, the combined holdings of local, private and foreign-owned banks represent less than a quarter of deposits. Monetary policy is complicated by the massive stock of non-performing loans (official figures claim a fifth of the loan stock). In the conditions of a state- driven financial system, however, the problem is unlikely to evolve into a full-blown crisis unless China encounters a major depression. Nevertheless, the non-performing-loan mess will have to be cleaned up before the banking system is deregulated.

Chinese interest rates have nominally been quite stable for years. Banks have seen a gradual widening of the range from which they can depart from reference rates on credits and deposits. The reference rate on a one-year loan is 5.31 %, while deposits pay 1.98 %. Lending rates have been relatively high in recent years given the deflationary climate, and have yet to become negative in real terms.

Presumably, China's passive interest-rate policies will continue as long as access to financing is restricted and real interest rates stay positive. Of course, the impact of interest rates in a regulated environment may be different than in a free market. Higher interest rates, by encouraging saving, can actually worsen economic overheating as new credit is made available to the investment sector. An interest-rate hike would also increase non-regulated capital imports.

Final market deregulation still years off

The rapid integration of the Chinese economy into the world economy has committed China to ongoing liberalisation of its financial and foreign exchange markets. China's WTO agreement includes a promise to open up the banking sector to foreign competition by 2007. Meanwhile, great efforts are underway to restore the balance sheets of two of the four large state-owned banks in preparation for privatisation.

Rapid modernisation of the financial system and the rise of free markets will undoubtedly be stressful for both banks and their clients, so the authorities will probably refrain from ending regulation and introducing a free-floating exchange rate for several years.

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Economic Developments

Brisk GDP growth continues

China's real GDP increased 9.5 % y-o-y in January-September. Growth slowed only slightly in the third quarter, when GDP was up 9.1 % y-o-y. Despite signs that measures to curb growth in some sectors have started to take effect, analysts still disagree on whether the somewhat lower figures herald the hoped-for "soft landing" or merely represent statistical discrepancies. Growth accelerated to 6 % y-o-y in agriculture and 9 % in the service sector during the first three quarters of 2004. Industrial growth (11 % in Jan-Sept) declined slightly from the first half of the year.

The rebound in investment growth in July slowed in August-September. In January-September, fixed investments increased 28 % y-o-y, slightly off the 29 % pace of the first half of the year. Restraining measures really seem to be working in some industries. In the aluminium industry, for example, investment fell 7 % in January-September (down from growth of 39 % y-o-y in the first quarter of 2004). Investment growth in the steel and cement industries, as well as real estate, has also slowed considerably since the beginning of the year.

In line with government objectives, domestic consumption has begun to play a greater role in driving economic growth. In September, annual growth of retail trade accelerated to 14 %. During the first nine months of 2004, retail trade was up 13 % y-o-y in nominal terms and 10 % in real terms. Consumption, however, remains unequally distributed between urban and rural areas. Urban retail sales increased 15 % y-o-y in nominal terms, while growth in rural areas remained under 10 %. This trend could soon change, however, if income growth in rural areas continues strong. In January-September, per capita disposable income in urban areas rose 7 % y-o-y (9 % in the first half of 2004), while income growth in rural areas accelerated from 8 % to 11 %.

Manufacturing growth has slowed only slightly from the beginning of 2004. In January-September, the value-added of industrial production was up 17 % y-o-y (18 % in the first half of 2004). Growth figures in many industries have been all over the map. Growth of heavy industry dropped significantly to 19 % for the first three quarters, while light-industry increased 15 %. Car manufacturing, for example, has been hit by a dramatic slowdown in demand growth. Following last year's very high growth rates in passenger car production, growth this year declined and ultimately turned negative in September, when production was 8 % lower than in September 2003. The reasons for the drop in demand include restrictions on loan growth and the announcement of lower import duties in coming years. In addition, declining car prices have encouraged many shoppers to delay their purchases.

Inflation begins to plateau

In September, consumer prices were 5.2 % higher than a year ago. Annual inflation was 5.3 % in August. The rise in food prices slightly moderated in September, when food was 11 % more expensive than a year earlier. In August, the increase was still 14 %. On the other hand, housing prices have started to take off. In September, they were up by 4 % y-o-y. Price cuts in clothing, household goods and services continued.

Somewhat alarmingly, the rise in producer prices continued to accelerate. In September, producer prices were up 7.9 % y-o-y, compared to 6.4 % in June. They were mainly driven by price rises for raw and processed materials and fuel.

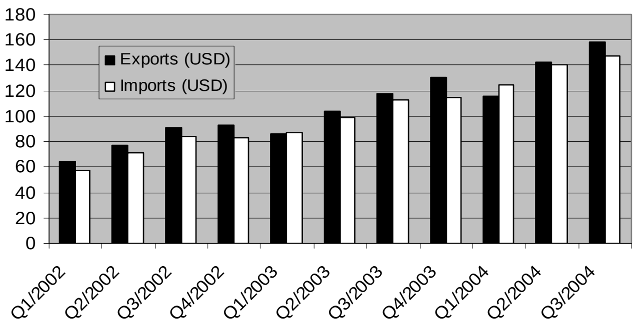
Demand for Chinese exports remains strong

In the third quarter, exports increased 35 % y-o-y while import growth slowed down to 31 %. Trade was almost in balance, trade surplus amounted to $11bn, $4bn in January-September.

During the first three quarters, exports increased 35 % from the corresponding period of last year. Exports of machinery, as well as electrical appliances increased almost 50 % y-o-y and their total share of all exports was around 40 %. Exports of high-tech products (e.g. computers, mobile phones and digital cameras) soared 54 % – and accounting for 27 % of all exports. Exports of clothing and textiles increased 20 % and represented 17 % of total exports.

Imports were up 38 % y-o-y in the first nine months of 2004. The value of imported raw materials soared 60 % y-o-y and the volume of imported crude oil was up 34 %. In September, growth in both these categories slowed substantially. It is nevertheless too early to say whether the slowing trend will continue in coming months. As a result of government measures, steel imports declined 15 % y-o-y in January-September.

Foreign trade, US$ billion



Source: Ministry of Commerce

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
GDP, y-o-y %-change	8.8	7.8	7.1	8.0	7.5	8.0	9.3	9.5	Q1-Q3/04
Industrial production, y-o-y %-change	11.3	8.9	8.5	9.8	8.7	12.6	17.0	17.0	1-9/04
Fixed investments, y-o-y %-change	8.8	13.9	5.1	10.3	13.0	16.9	27.7	27.7	Q1-Q3/04
Exports, CNY bn	1516	1522	1616	2063	2202	2695	3629	3449	1-9/04
Imports, CNY bn	1181	1163	1374	1864	2016	2443	3420	3414	1-9/04
Current account, % of GDP	4.1	3.3	2.1	1.9	1.5	2.8	3.2	1.0	H1/04

Source: People's Bank of China, National Bureau of Statistics of China, IMF, OECD.

Modest current account surplus, strong capital inflows

The State Administration for Foreign Exchange released China's current account statistics for the first half of 2004 at the beginning of September. For 1H04, China's current account surplus was $7.5bn or 1.0 % of GDP. This was substantially lower than in 1H03, when the surplus exceeded $11bn. The narrowing surplus reflected a decrease in the trade surplus from $14bn to less than $6bn. The services balance, as usual, was negative ($6bn).

Financial inflows into China stayed strong, with the financial account surplus rising 50 % y-o-y to $67bn in January-June. The net inflow of foreign direct investment was $31bn. As of end-June, China's foreign exchange reserves were $471bn, up $67bn from the end of 2003. Surprisingly, the net errors and omissions item in the balance of payments turned $7bn negative. It had been strongly positive since 2002, probably due to illegal speculative inflows driven by yuan revaluation expectations.

In the third quarter of 2004, foreign exchange reserves continued to grow. At the end of September, reserves amounted to $515bn (worth 10 months of imports). In 3Q/04, China received foreign direct investment worth of $17bn.

Slowing banking sector growth

Credit growth continued to slow down in the third quarter of 2004. At the end of September, the loan stock had grown 14 % y-o-y. Although the relatively low figure may partly reflect write-offs of non-performing loans (NPLs), the amount of new loans also dropped from last year.

Deposit growth has slowed as well. At the end of September, deposits were up 15 % y-o-y. In the first months of 2004, the annual growth of deposits was still nearly 20 %. In addition to increased consumption, the slowing also reflects low interest rates on deposits. The People's Bank of China has held its reference rate for one-year deposits at 1.98 %, while the real interest rate has turned negative due to accelerating inflation. Negative real deposit rates and lower credit growth rates, combined with continuing strong investment growth, have led some analysts to sound alarms of an emerging black financial market.

NPL ratios drop

The amount of bad loans held by major commercial banks continued to decline in the first half of 2004. In China's fifteen largest banks (i.e. the four giant state-owned banks and the eleven joint stock commercial banks), the official non-performing loan (NPL) ratio had dropped to 13 % as of end-June. At the beginning of 2004, the ratio was still nearly 18 %. The decline was partly the result of credit growth, but several banks also wrote off substantial amounts of NPLs from their balance sheets.

Bank of China (BOC) and China Construction Bank (CCB), the large state-owned banks recapitalised at the end of 2003 and now undergoing major reform, have decreased their NPL ratios most. In June, these banks transferred bad loans totalling almost CNY 280 billion (€28bn) via auction to Cinda Asset Management Corporation, a specially created state-owned asset management company. In a new approach, the bad loans were not transferred at book value, but rather discounted 50 %. As a result of this and some other transfers, NPL ratio of CCB fell to 3 % at the end of June, and that of the BOC to 5 % at the end of September. The NPL ratios of the other two large state-owned banks remain much higher. The NPL ratio of the eleven commercial banks stood at 5 % at the end of June.

Further reduction of the NPL stock, however, is by no means guaranteed. Banking supervisors have warned that a possible wave of new bad loans from the current investment boom could hit in next few years. In September, China's Banking Regulatory Commission (CBRC) warned that the general NPL ratio could rise 2 percentage points by the second half of 2005. Naturally, one has to bear in mind that international agencies' estimates on bad loans are much higher than China's official figures.

Capital adequacy gets high priority

The emphasis of banking sector reform has shifted from reducing NPL ratios to improving capital adequacy ratios. This may mark an important policy shift from simply accumulating banks' loan portfolio as an aim to decrease the NPL ratio to a more sophisticated banking system where risks are taken into account more than before.

According to new CBRC rules issued in February, a bank must have a minimum capital adequacy ratio (capital as a percentage of risk-weighted assets) of at least 8 % by the end of 2006. Currently, most Chinese banks have very low capital adequacy ratios. To improve the figure some banks have issued subordinated debt. For example, BOC and CCB have issued subordinated debt worth totally nearly CNY 30bn. The BOC's capital adequacy ratio currently stands at 8.3 %; that of the CCB at around 7.0 %.

Despite an immediate positive impact on bank balance sheets, these debt issues could lead to future problems because banks hold significant amounts of each other's debt. The yields of these issues have been set artificially low and they have increased systemic risk in the banking system. To limit exposure, the PBoC declared a new limit on the maximum amount of subordinated debt banks are allowed to hold. Under the new rule, a commercial bank cannot hold subordinated debt of another bank in excess of 20 % of its core capital.

As part of the reform process, the large state-owned banks will eventually be listed on the stock market. The BOC and CCB have already been reformatted as joint-stock commercial banks and their listings are planned for next year. Before listing, both banks would also like to sell stakes to strategic foreign partners. Nevertheless, it may turn out to be hard to find suitable partners, as estimating the true value of the banks is difficult.

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
Inflation (CPI), 12-month, %	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2	5.2	9/04
M2, y-o-y %-change	19.6	14.8	14.7	12.3	17.6	16.9	19.6	13.9	9/04
Average monthly disposable income in urban areas, CNY	430	452	488	523	572	642	706	786	Q1-Q3/04
Average monthly cash income in rural areas, CNY	178	180	184	200	211	226	244	234	Q1-Q3/04
Forex reserves, $ bn (end of period)	139.9	145.0	154.7	165.6	212.2	286.4	403.0	514.5	9/04
CNY/EUR (end of period)	9.205	9.714	8.318	7.702	7.294	8.68	10.453	10.275	9/04

Source: People's Bank of China, National Bureau of Statistics of China, IMF.

Rising rural incomes decrease migration to factories

A report from the Ministry of Labour and Social Security claims the Pearl River Delta region suffered a labour shortage of two million migrant workers in September. The southern region is a focus of foreign direct investment and home to many export-oriented processing plants.

The lack of suitable labour is somewhat surprising; most economists treat China's labour force as a near-infinite supply. On the other hand, there are good reasons for the declining flow of migrants to the factories.

Incomes in rural areas have risen briskly this year. Rising prices, government subsidies and tax cuts have helped boost farmers' incomes substantially. Average real cash income in rural areas was up 11 % y-o-y in January-September. In contrast, living costs in many cities have risen considerably, while wage levels in processing factories have stagnated. Basic wages have held at around CNY 700 (€70) per month for the past decade. The low wage level was made possible by the flow of low-skilled labour from the countryside to the Pearl River Delta. Today, other regions compete for these migrant workers, and thanks to mobile phones and Internet access, newcomers are rather well-informed on wage levels offered at specific factories.

The current undersupply of employees is not expected to last permanently. Many of China's nearly 800 million rural inhabitants are underemployed. However, it is also a rudimentary economic principle that wage levels cannot remain flat when factories want to attract labour from the rural areas. For educated workers, there is already intense competition among employers and their salaries have risen significantly in recent years.

Factories could also be forced to give up their strict requirements on migrant employees. So far, many factories have exclusively hired young female workers. However, this type of labour force is limited as a result of one-child policies and demographic changes. The legal and social status of migrant employees also needs to improve to attract workers to the coastal regions. News of an employer failing to pay salaries spreads rather easily nowadays.

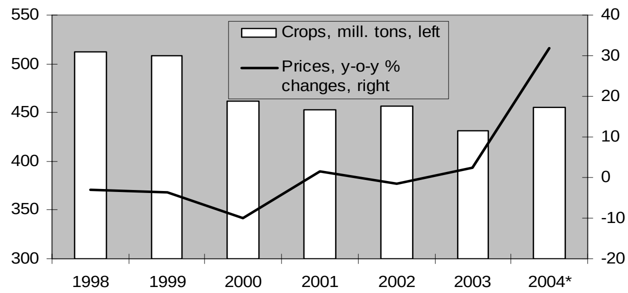
Some factories will likely have to relocate in more western regions as the search for cheap labour intensifies. This would favour balanced regional development in China and probably has the government's blessing.

Smaller crops behind higher grain prices

The acceleration of inflation (5.2 % in September) over the past twelve months has been mainly driven by higher food prices. Food still accounts for about a third of China's CPI.

Grain product prices (e.g. wheat, rice and maize) have risen most, up 32 % y-o-y in August. The rebound in grain prices was expected, as they declined for years prior to 2003. The price rise also reflects shrinking grain harvests since 1998, when the grain crop exceeded 510 million tonnes. In 2003, the grain harvest was just 430 million tonnes.

Grain production and prices, 1998-2004*



* Current 2004 forecast, August prices
Source: NBS

Smaller harvests partly reflect the reduction in cultivated land in China. The area under cultivation declined by nearly 4 million hectares to 152 million hectares between 1998 and 2003. This was mainly due to increased construction, industrial expansion and natural disasters. The most obvious factor, however, has simply been the decline of the share of grain in relation to total cultivated area. From 1998 to 2003, the share of land dedicated to grain production fell from 73 % to 65 %.

The shift in agriculture has been towards increased production of vegetables and fruits. These products are more profitable and offer better export opportunities, thanks to China's WTO membership. Overall, horticulture better suits China's conditions; it requires less farmland and is more labour intense.

Policies to support domestic grain production

This year, the government has moved to support grain farmers in many ways, including raising the grain purchasing price and allocating nearly CNY 12 billion in subsidies to grain growers. As a result of these support measures, officials expect the grain harvest to increase by 20 million tonnes to around 455 million tonnes this year. Although this is still below forecast consumption 490 million tonnes, further price hikes this year are expected to be more modest.

While supporting measures mainly concern stimulation of growth in the countryside, they are also linked to the ongoing discussion in China on food self-sufficiency. The fundamental question is whether the country should be self-sufficient in grain products or whether farmers should specialise in more profitable products and provide more welfare to the countryside. So far, China has been able to produce most of the grain consumed domestically. In 2003, consumption of grain exceeded domestic production by 55 million tonnes. China covered part of this gap by dipping into its grain reserves, which kept grain imports at a moderate level. The United States Department of Agriculture (USDA) expects Chinese imports of wheat, rice and maize to increase gradually, and does not see any dramatic leap in imports of grain in coming years.

Fiscal indicators (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	as of
Revenues	11.6	12.6	13.9	15.0	16.8	18.0	18.5	22.6	1-8/04
Expenditures	12.4	13.8	16.1	17.8	19.4	21.0	21.0	18.0	1-8/04
Balance	-0.8	-1.2	-2.1	-2.8	-2.6	-3.0	-2.5		

Source: National Bureau of Statistics of China.

Trade effects of Taiwanese investment in Mainland China

by Mikael Mattlin*

Taiwanese investment on the mainland

After Hong Kong, Taiwan is the most important source of external investment in Mainland China (PRC). This is not reflected in official statistics, however. Due to Taiwan (ROC) government restrictions and tax benefits, Taiwanese investment in China is often routed through third countries. Because official PRC statistics for foreign direct investment report immediate origin instead of original source, the British Virgin Islands currently rank as China's second largest source of FDI.

The ROC government has allowed indirect investment in Mainland China in 1990, and direct investment since 2002. However, it maintains restrictive policies on certain investments, including semiconductor foundries. Although indirect investment in Mainland China approved by the ROC government since 1991 amounts just to $38bn, actual Taiwanese investment is commonly believed to exceed $100bn. The bulk of approved investments have gone to Jiangsu (43%) and Guangdong (29%) provinces.

Relocation of processing and trade chaining

Taiwanese investors in China are particularly active in IT, consumer electronics and traditional manufacturing industries. More than half of Taiwan's IT hardware manufacturing – the backbone of the island's economy – takes place on the mainland. An estimated 68,100 Taiwanese companies operated on the mainland in 2003, roughly a third of all externally invested companies.

The mode of operation currently favored by electronics manufacturers has significant trade effects through trade chaining. Taiwanese and foreign manufacturers have relocated processing and assembly to Mainland China. Many intermediate products and raw materials for these operations are imported from Taiwan; final products, in turn, are re-exported from China to end customers in developed markets. Taiwan's exports to the US and Japan fell 26 % in absolute terms in 2000–2003, while its exports to Mainland China and Hong Kong grew 40 %. Processing trade last year accounted for over $40bn of Taiwan-China trade volume.

The biggest category of Taiwanese exports to China is integrated circuits and microcomponents. Taiwan's strong semiconductor industry remains mainly in Taiwan, while China is still unable to produce advanced semiconductors. Consequently, Taiwan ranks as third most important source of China's high-tech imports, after Japan and ASEAN.

Effects of Taiwanese investments on China's trade

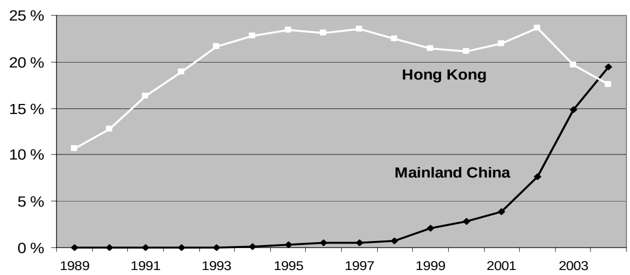
In just a few years, China has emerged as a major trading nation. Notably, 57 % of Mainland China's exports are produced by externally invested companies. Foreign companies have tended to target the local market, while Taiwanese and Hong Kong manufacturers have used the mainland as a cheap manufacturing base for export.

The allowing of indirect investment in 1990 boosted Taiwan-China trade, which was initially conducted through Hong Kong. The value of Taiwan exports to Hong Kong more than doubled in 1989–1992, while imports declined. 1998 saw the opening of a regular container transshipment route between Kaohsiung Harbour in Taiwan and two ports on the mainland. Registered "trial" direct trade has exploded since 2001, thanks to relaxation of investment and trade restrictions and the ramping up of production in mainland-based factories. Direct trade now substitutes indirect trade via Hong Kong.

In 2003, China's three biggest exporting companies were all subsidiaries of Taiwanese electronics/IT manufacturers. The Shenzhen manufacturing base of the Foxconn Group alone accounted for $6.42bn exports in 2003, roughly 1.5 % of China's total exports. It is estimated Taiwanese companies now produce 50–70 % of China's IT exports.

The share of Chinese imports from Taiwan is currently 11.5 %, about the same as the EU's share. Moreover, as China exports little to Taiwan, it runs its biggest trade deficit with Taiwan (projected to be $50bn this year). Roughly 75 % of this is due to processing trade.

Share of Taiwan's exports



Source: ROC Ministry of Economic Affairs

Trade enhancing and offsetting imbalances

Taiwan-China trade and China's trade deficit with the island continue to soar. The relocation of processing to China has a trade-enhancing effect, significantly increasing both China's exports of final products to developed markets and imports of production inputs (especially from other East Asian economies).

As long as China is unable to produce parts required by manufacturers, the trade deficit is likely to persist. However, this deficit is offset by increased trade surpluses with end markets due to Taiwanese companies' re-exports. With the present production structure, any interruption in processing input imports from Taiwan would hurt Chinese exports.

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