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Economic Developments

Overcapacity looming in a number of sectors

There has been extensive discussion on the quality of Chinese statistics in recent months. Further worries about the accuracy of the figures have been fuelled by hasty data releases. China announced its preliminary GDP figures for the all of 2005 already on January 25 despite the ongoing statistical revision. As expected, strong economic growth continued last year; real GDP was up 9.9%. Production in the primary sector increased 5%. For the second year in a row, the grain harvest was good. Rapid investment growth continued apace, while industrial production (up 16% y-o-y) rose steadily throughout the year. In the service sector, growth remained steady at around 10% as it has done for the past decade. Although real growth in retail trade (12%) accelerated slightly from 2004, consumption has yet to become the main engine of economic growth. Meaningful analysis of the demand side of the economy must wait until further statistics are released.

The Chinese economy now seems somewhat more balanced than a year ago and economic growth is expected to slow only slightly. Positive news includes evidence of progress in banking reform, low inflation and the removal of bottlenecks in the energy and transport sectors. China's continuous inflow of foreign direct investment and efforts at capturing export markets shares reflect the country's high competitiveness in many sectors.

Some new difficulties, however, have appeared. Official statistics report that the number of public demonstrations in 2005 was higher than ever. Serious environmental problems have also entered the limelight. China's massive trade surpluses have put it on a more contentious basis with key trading partners. Government control over the economy has been tightened in some areas and the introduction of new limits is often erratic. For example, new rules have been put into place to cool the real estate market, banking reform is hindered by credit policies and retail energy prices continue to be strictly administered.

A big challenge is increasing domestic consumption to counteract the threat of overcapacity facing many industries. In December, officials identified overcapacity in e.g. the iron and steel, aluminium, coke and car industries. The danger lies in the fact that some capacity is already dormant in these industries, yet online projects will boost capacity even further. It is thus likely that investment growth will gradually slow. In addition, unprofitable investments already started to increase the non-performing loan stock in the second half of last year.

Prelude to large trade surpluses

China's trade surplus tripled to \$102 billion in 2005. Rapid export growth (28% y-o-y) continued, while growth in imports fell by half to 18%. In the final quarter of 2005, the trend reversed as export growth declined and import growth accelerated. The shift, however, was partly due to occasional factors. China's bilateral surpluses increased and deficits decreased with most trade partners. The biggest exceptions were Korea and Taiwan which widened their surpluses with China. The US again ran a huge deficit with China (over \$100 billion in January-November), while China's surplus with EU countries soared even faster.

In 2004, half of the increase in imports came from machinery and electronic products but import growth in this sector dropped to about 15% last year according to preliminary figures. The volume of crude oil imports rose just 3% y-o-y, while higher crude prices pushed the value of oil imports up 41%, the same rate as in 2004.

Although growth in many export sectors slowed from 2004, exports of machinery and electronic products, which cover half of all exports, increased rapidly. Growth in textiles (33% in January-November) decelerated in late 2005 due to quota restrictions with the US and EU.

China is now expected to run significant trade surpluses in coming years. Thanks to the competitiveness in many industrial sectors, China's market share has increased significantly in Europe and the US. If predictions are met of a high savings rate, a gradual slowing in investment growth and increasing self-sufficiency in parts and components, any substantial increase in import growth seems unlikely. Moreover, technological evolution, trade liberalisation, overcapacity and strong FDI inflows will increase exports, although export growth will probably slow down gradually.

Import and export growth (% y-o-y), trade balance (US\$ billion)



Source: General Administration of Customs

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP, y-o-y %-change	7.8	7.6	8.4	8.3	9.1	10.0	10.1	9.9	
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.4	
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	26.6	25.7	
Exports, US\$ billion	184	195	249	266	326	438	593	762	
Imports, US\$ billion	140	166	225	244	295	413	561	660	
Current account, % of GDP	3.1	1.9	1.7	1.3	2.4	2.8	3.6	8.1*	1H/05

* Preliminary figure

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

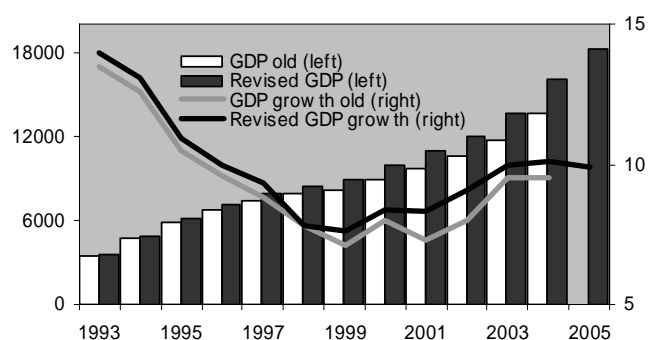
New census results boost GDP figure by a fifth

China put a lot of resources into conducting its first extensive economic census last year. The National Bureau of Statistics (NBS), under the supervision of the State Council, was the census' main organiser. It coordinated some 13 million supervisors, statisticians and accountants on the project. The census covered all companies, small businesses and self-employed individuals working in the industrial, construction and service sectors. The primary sector (agriculture and forestry) was not surveyed.

The census forced a major readjustment of China's GDP in 2004 to nearly CNY16 trillion (€1.6 trillion), a 17% increase from the earlier official figure. The census also changed the picture of the economy when it found that previous estimates grossly underestimated the size of the service sector. Indeed, over 90% of GDP adjustment was due to the service sector. The value-added produced in the service sector rose by almost 50% and its share of the overall economy was lifted from 32% to 41%. Within services, the largest gains came from transport and telecommunications, trade and real estate. Enterprises in these sectors are typically small, privately owned and evolving. They also seem to be in great abundance and China's statistical systems fail to capture their activities. The size of secondary sector (industry and construction) rose only slightly and its share of the economy dropped from 53% to 46%. As primary sector was excluded from the census, its size remained unchanged and its share of GDP declined from 15% to 13%.

The last time a service sector census was conducted was in 1992. Thus, as most of the increase in GDP came from services, China's statistical authorities decided to go back and revise GDP figures in the period 1993–2004. Growth rates for these years were lifted on average half a percentage point. The major exception was 1998. Growth was kept at 7.8% as the Asian crisis apparently affected the Chinese economy more than was shown in earlier statistics.

Old and revised growth figures (% change, y-o-y);
GDP in nominal terms (CNY billion)



Source: NBS

Do the new figures suggest a more balanced economy?

In nominal terms, the new figures show China displaced the UK last year as the fourth largest economy in the world. However, the revision was not enough to remove China from the low-middle income category. GDP per capita was still only about CNY 13,500 (€1,350) in 2005. With the relative shrinking of the importance of the industrial sector, China's economy looks now more balanced. Future growth prospects were also improved by the fact that the roles of the service sector and the private sector are apparently greater than was earlier believed.

The higher GDP figure has positive implications for the banking sector, which exceptionally large size is now smaller compared to the economy. Also the relative magnitude of the non-performing loan problem has slightly declined. The amount of foreign exchange reserves as a percentage of GDP dropped five percentage points at the end of 2004, although in nominal terms, its size and the effect on the global economy obviously remained unchanged. Some figures like the relative amount of resources used by the public sector on education or health care are even lower than before, especially by international comparison.

Revised data on the expenditure components of GDP are not yet available. Although it is widely believed that the significance of consumption should increase as most of GDP rise came from the service sector, it is still uncertain how much the boost in the real estate statistics will lift investment figures. Full assessment of the economic structure is thus impossible until these data are released.

While the census provides handy information about economic development, it also confirms that Chinese statistical data still suffers from serious shortcomings. As the statistical methods were partly developed to serve the planning process of a centrally planned economy, they fail to capture many of the new and more dynamic elements in the economy. It is difficult to make reliable conclusions about economic trends and short-term fluctuations before the whole statistical system is profoundly reformed.

Contributions of major sectors to GDP, %

	1993 old	1993 revised	2004 old	2004 revised
Agriculture and forestry	19.9	19.5	15.2	13.1
Industry, construction etc	47.4	46.6	52.9	46.2
Services	32.7	33.9	31.9	40.7

Source: NBS

Fiscal indicators (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005*	as of
Revenues	11.7	12.8	13.5	14.9	15.7	16.0	16.5	19.1	1-9/05
Expenditures	12.8	14.7	16.0	17.2	18.3	18.1	17.8	16.0	1-9/05
Balance	-1.1	-1.9	-2.5	-2.3	-2.6	-2.2	-1.3		
Government debt			20.0	21.0	22.0	22.1	20.2		

* Preliminary figures.

Sources: Budget – National Bureau of Statistics of China. Government debt – IMF.

Trade surplus boosted foreign exchange reserves

Chinese authorities still strictly control the yuan's exchange rate, meaning they have to buy extra foreign currency from the market. As a result, China's foreign exchange reserves ballooned from \$610 billion to \$819 billion (37 % of GDP) in 2005. Most of the foreign currency inflow was caused by the record \$102 billion trade surplus. Moreover, foreign direct investment into China amounted to \$60 billion, a decline of 0.5 % from 2004. Even ahead of publication of the balance-of-payments data, it seems likely that the inflow of speculative capital diminished from 2004 levels.

China's foreign debt increased steadily in the first nine months of 2005. As of end-September, the amount of foreign debt was 15 % higher than a year earlier. Despite the rather high share of short-term debt (over 50 % of total debt), the general level of foreign debt (12 % of GDP) is low by international standards, particularly when compared to the size of the country's foreign exchange reserves.

High savings rate boosts deposits

Monetary growth accelerated again in the second half of last year. At the end of December, the broad money supply was up almost 18 % y-o-y. After targeting for annual growth rate at 15 % at the beginning of 2005, the People's Bank of China later revised its forecast for the year upwards. The central bank apparently loosened its monetary stance in the summer, probably in reaction to lower inflation. While the central bank sterilised almost the entire inflow of foreign currency in the first half of 2005, it relaxed its position in the third quarter. Starting from December, the PBoC again boosted its sales of central bank bills to commercial banks.

The PBoC left untouched the benchmark interest rates for yuan-denominated deposits and loans in 2005. While strong liquidity pushed interest rates down in the interbank market, the average interest rate for a one-year yuan credit was still 6.8 % in the third quarter of 2005. Perhaps reflecting progress in banking reform and improved skills of credit risk management, banks have increased flexibility in setting lending rates, so the share of loans above the benchmark interest rate has started to rise.

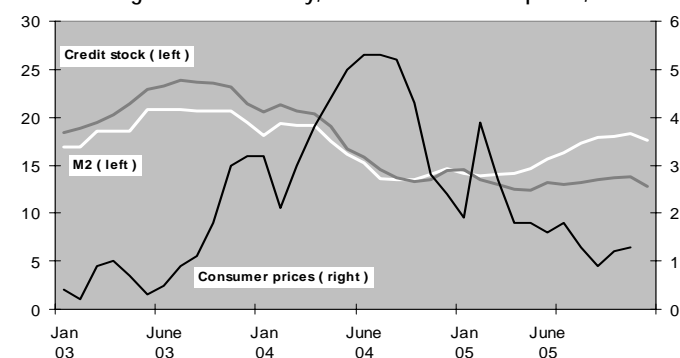
Credit growth remained below the targeted level; the credit stock was up 13 % y-o-y at the end of December, when the credit stock stood at CNY 20,700 billion (€2,100bn) or 115 % of GDP. Growth in consumer credit slowed last year due e.g. to cooling of the real estate market and banks' stricter control of car loans. The authorities, however, have encouraged banks to give more credit to households in order to increase consumption. For example, the PBoC launched a nationwide personal credit database in January to decrease commercial banks' financial risks.

The deposit stock grew faster than the credit stock. At year's end, it was 18 % larger than a year earlier, possibly indicating savings rate to remain high. The increase was

greatest for household deposits, but non-financial corporate deposits also accumulated rapidly. In December, the PBoC governor Zhou Xiaochuan gave a speech encouraging companies to distribute dividends to owners. To date, state-owned companies in particular have been reluctant to pay dividends, preferring instead increased bank deposits and additional investment projects.

Weak development in the stock exchanges continued. The main indices of both the Shanghai and Shenzhen bourses decreased in 2005.

Annual changes in broad money, credit and consumer prices, %



Source: NBS, People's Bank of China

Low inflation and financial sector reforms continue

Despite rapid monetary growth, consumer price inflation was low in the last quarter of 2005. In December, consumer prices were just 1.6 % higher than a year earlier. Prices of textiles and electronic products continued to decline. Prices of services were 2.2 % higher and housing expenditures rose by 5.4 % y-o-y. Producer prices continued to rise faster than consumer prices. In December, prices for raw materials, fuel and power were up 5.0 % y-o-y.

Hard competition and last year's good grain harvest are expected to subdue consumer price inflation this year. Administered retail prices for fuel and energy may be raised, but their weighting in the consumer price index is still modest. The PBoC this month announced monetary targets for 2006 that are essentially the same as last year's. Growth in broad money should slow to 16 %, while yuan-denominated loans should increase by around 13 %. Reforms in the currency market and banking sector are generally expected to continue. In the beginning of 2006, the forex market witnessed the launch of over-the-counter trading and market-maker systems on the spot market. The changes are considered mainly technical and not expected to have strong effects on the yuan's exchange rate. The authorities have also launched initiatives to encourage investment outflows (mainly direct investment) in order to restrict the accumulation of foreign exchange reserves and reduce appreciation pressures on the yuan.

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Inflation (CPI), 12-month, % (year average)	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	
M2, y-o-y %-change (end of period)	14.8	14.7	12.3	17.6	16.9	19.5	14.6	17.6	
Average disposable income in urban areas, y-o-y %-change	5.1	8.0	7.2	9.4	12.2	10.0	11.2	11.4	
Average net income in rural areas, y-o-y %-change	1.1	2.2	3.3	4.8	4.6	6.3	11.9	11.5	Q1-3/05
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	818.9	
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	9.580	

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

Hard data vs. sentiment indicators

– Do they give the same picture of the Chinese economy?

by Aaron Mehrotra and Jouko Rautava*

The increasing importance of China for the world economy implies a growing demand for information on its macroeconomic developments. Besides basic economic statistics, policymakers and enterprises use various business climate and confidence indicators to assess the current situation and the future outlook. Unfortunately, China's rapidly evolving economic environment and its underdeveloped statistical system with often-short time series limit the availability of relevant indicators.

Problems with basic output and price data

From the standpoint of economic monitoring and research, major problems concerning basic economic statistics persist. This is evident in the context of the recently announced upward revision of GDP by 17% in light of improved information on the role of the service sector in China's booming economy. Moreover, even with the improvements in GDP data, their usefulness is still hampered by the fact that there are no quarterly series on GDP components in real terms. On the expenditure side of GDP, the problems are even more pronounced. Thus, quarterly consumption and investment data are only available in the form of cumulative nominal data that do not permit computation of actual quarterly figures.

While one could in principle use some other indicator as a proxy for the national account item, there is also a lack of satisfactory proxies. For example, it has been argued that the monthly indicator on retail sales poorly captures trends in household consumption. The same applies to capital formation, as investment data published on a monthly basis (fixed asset investment) differs conceptually from the internationally comparable national account measure (gross fixed capital formation). Besides problems with real sector data, the lack of proper price indices also hinders the evaluation of actual developments.

Various survey indicators are available

To deal with concerns about the reliability of output data, various survey indicators can be used to gain insights into current developments in the real economy. For example, survey indicators that measure the judgements of economic agents on future prospects rather than prevailing conditions may provide valuable indications of possible turning points in the business cycle and, hence, serve as leading indicators with respect to economic developments. The National Bureau of Statistics (NBS) and the People's Bank of China (PBoC) currently publish a number of survey indicators for the consumer and business sectors.

To evaluate the utility of such indicators, we consider two regularly reported indices.

For the consumer side, the NBS publishes its monthly consumer confidence (expectation) index (CCI). The CCI has been available since the beginning of 1999; its purpose is to identify changes in consumer attitudes to consumption, income and general economic conditions. Notwithstanding a short-lived collapse in April 2003 and a slight slump in spring 2004, the CCI has overall indicated a robust economic situation throughout the current decade. The negative measures coincide with the emergence of the SARS epidemic and later concerns about official responses to deal with economic overheating. The CCI does not, however, appear to help with understanding actual retail sales developments. While a formal statistical test for causality gives some evidence that the CCI may serve as a leading indicator for retail sales, experiments with various lags and modifications of the series reveal very low correlation between the two series.

The PBoC has published diffusion indices for the 5,000 largest industrial enterprises since 1992. These quarterly series reflect judgements on developments experienced in the recent past, the current situation and prospects for the next few months. The diffusion index for general business conditions (BCI) has been able to track the impact of the Asian crisis and the ever-improving economic situation of the current decade. Moreover, it seems that the BCI can be considered a leading indicator for industrial production and GDP. The BCI series with one or two lags is highly correlated (coefficients above 0.8) with the latter series, although formal tests for causality do not always confirm this conclusion. The PBoC's other business condition indices (e.g. lending attitude of banks, profitability of firms) yield similar results.

Actual picture remains vague

The analyzed survey and actual output data provide broadly similar pictures of the macroeconomy – especially when movements in the BCI and industrial production are compared. Given the short and perhaps exceptional time period, none of the measures provide strong evidence of traditional business cycle fluctuation. This may diminish the usefulness of survey data for indicating possible turning points. Further, uncertainty about the quality of the actual output data makes problematic any study of the leading indicator aspects of sentiment indicators. Consequently, new survey indicators, such as the Purchasing Manager Index introduced in summer 2005, may help enrich our views of Chinese economic developments. Still, they are no substitute for basic real sector statistics of good quality.

* *The authors are economists at BOFIT.*

Economic Developments

Rapid growth continues

China's GDP growth retains the structure and pace of last year. Officially, real GDP increased 10.2 % y-o-y in the first quarter. In the main production sectors, growth remained highest in manufacturing, which continued to profit from stable growth in both domestic demand and exports. In January-March, exports increased 26 % y-o-y. Although import growth (25 %) accelerated from 2005, the foreign trade surplus increased to \$23 billion (\$17 billion in 1Q05). Strong growth continued in most export sectors, while development was uneven among imports. For example, the value of crude oil imports nearly doubled due to rapid increases in volumes and world market prices. Imports of many other raw materials, motor vehicles and car parts also boomed. The well-performing export sector also had an increased need for electronic parts and components. Higher domestic production decreased the need for imports of rolled steel.

High investment growth raises worries

Investment growth remains high, and, from the positive point of view, the structure of investment seems to be improving given the large differences in growth rates among sectors. For example, widespread overcapacity and administrative control measures have restrained investment in smelting and pressing of ferrous metals at last year's levels, while investment in the service sector and infrastructural bottlenecks (e.g. railways) has increased rapidly.

Even so, the consensus among high-level officials is that the rate of investment growth is too high and government agencies need to apply further measures to control growth. Following the example from the steel sector last year, the authorities have issued plans on how to decrease overcapacity in the cement, coal, aluminium and coke industries. Plans to reintroduce limitations on land use are also under consideration.

One of the bad examples comes from the real estate sector. In 2005, nearly a quarter of all investment went to real estate development and the same trend has continued this year. Although the big trends of urbanisation and accumulation of wealth justify large investments in the sector, the latest figures suggest that the amount of unsold real estate was up as much as 24 % y-o-y at the end of March. Moreover, the glut of unsold properties may already well exceed levels that set off bubble alarms elsewhere. The problem of oversupply seems to exist mainly in the residential sector, but problems with commercial space may also be emerging. If growth in the real estate sector suddenly slows,

it is likely to worsen oversupply problems in steel and other building material industries.

Declining profits in certain sectors may also signal excessive investment growth. While at the aggregate level companies tend to benefit from robust economic growth and profits overall increase, losses also appear to be snowballing for particular industries, due e.g. to oversupply problems. Huge drops have been seen in the profits of steel and cement producers, and some car manufacturers have experienced significant erosion of their bottom lines. Smaller profits may also indicate increased competition in these sectors.

Households continue to save despite strong income growth

Income growth has been strong both in rural and urban areas in recent years. In rural households, per capita gross income rose from 2,930 yuan in 2003 to 3,915 yuan (€390) in 2005. Most of the increase was the result of larger grain harvests and higher producer price for farm products. The share of wages of rural income declined to below 30 % as the increase in wage income has been rather slow. The share of transfers from family members working in cities now represents about 5 % of total rural income.

Wages are obviously the most important source of income in urban areas, where the average annual disposable income was 10,500 yuan in 2005. While the official statistics only report steadily increasing average wages, wage trends seem to be diverging according to level of education and job requirements. A number of surveys and other studies suggest wages for educated and experienced workers may be rising more than 10 % a year. Although wages for unskilled persons have hardly budged in real terms since the early 1990s (due largely to a continuous flow of migrant workers from the countryside), there are signs that this situation is now changing in the developed coastal areas. In these areas, some factories have begun to complain about a lack of cheap labour. For example, the city of Shenzhen recently released plans to raise the minimum wage from 690 yuan to 900 yuan to attract new labour to the region.

Despite strong income growth, households continue to save aggressively. This only adds extra fuel to the investment boom. An urban household survey conducted in February found that households are increasingly reluctant to consume. The major reason for the accumulation of savings is uncertainty over future spending. This forces households to save for their children's educations, pensions, buying an apartment and precautionary savings for catastrophic illness or injury. The surveys findings were reflected in a 19 % y-o-y rise in household deposits in March.

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, y-o-y %-change	7.8	7.6	8.4	8.3	9.1	10.0	10.1	9.9	10.2	Q1/06
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.4	16.7	1-3/06
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	26.6	25.7	27.7	Q1/06
Exports, US\$ billion	184	195	249	266	326	438	593	762	197	1-3/06
Imports, US\$ billion	140	166	225	244	295	413	561	660	174	1-3/06
Current account, % of GDP	3.1	1.9	1.7	1.3	2.4	2.8	3.6	7.2		

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

Tax revenues profited from rapid economic growth in 2005

China was able to increase fiscal revenues and decrease its public deficit in 2005. Total revenues at the local and central administrative levels increased nearly 20 % y-o-y. Although expenditures climbed 18 %, the budget deficit was a mere 1.1 % of GDP – less than budgeted.

There are several reasons for the higher-than-expected revenues. First, VAT and business tax revenues increased as a result of rapid economic growth that kept raw material prices high and the real estate sector booming. The favourable economic climate, in turn, boosted revenues from corporate income tax 39 % y-o-y as profits rolled in. Improvements in tax collection also raised government revenues.

Official figures apparently underestimate the true size of China's public sector. Extra-budgetary expenditures, financed by unauthorised fees and charges, are estimated to constitute 4 % of GDP. The OECD calculates that when summing up the basic budgetary data, extra-budgetary expenditures and subsidies to state-owned enterprises, the size of the public sector in 2004 increased to nearly 24 % of GDP, even when the basic figure was less than 18 %. On the other hand, the budget deficit situation remains essentially unchanged.

The amount of public debt on-record remains small

According to preliminary statistics, the debt of the central government amounted to less than 18 % of GDP at the end of 2005. In other words, the level of debt continued to decrease last year and remains low by international standards. However, there are estimates that put the actual amount of public sector debt considerably higher. One reason is a reluctance to report debt particularly in the local level. Under the law, for example, a local government needs approval from the State Council to issue debt. In practice, local governments sidestep this law by accumulating payment arrears or borrowing money for companies they own. These amounts are not registered, so it is difficult to estimate the actual amount of debt of local governments. A recent OECD publication on China's public spending suggests the actual amount of local debt is likely in the range of 2–10 % of GDP. There are implicit commitments that raise the estimates for debt even further. For example, the stock of non-performing loans and liabilities originating from the restructure of state-owned enterprises pushes up the amount of contingent liabilities. The pension fund deficit, already huge, continues to grow every year. Thus, even though the fiscal situation looks stable on paper, China clearly faces big challenges in the coming years in keeping public debt under control.

No big changes to fiscal policy expected this year

The National People's Congress (NPC) approved the budget for 2006 in the beginning of March. The budget is in line with the fiscal policy of recent years and no major changes are expected. Both revenues and expenditures are budgeted to increase rapidly (12 % and 14 %, respectively). When central and local government budgets are combined, expenditures exceed revenues by CNY 295 billion (€30 billion), which is less than 1.5 % of forecast GDP. Typically, the actual deficit has been considerably smaller than the budgeted deficit, so it is not unreasonable to expect the deficit to remain small in 2006. In any case, the official figure for public debt should remain at a low level.

In his speeches at the NPC, prime minister Wen Jiabao placed priority on spending for agriculture, education, employment, social security and public health. Overall, he wants to the fruit of economic development to be more fairly distributed. However, these emphases are hard to notice in the approved budget; spending increases steadily in nearly all budgetary categories. The allocations to defence increase 15 %, and, even if not explicitly stated, the share of administration expenditures remains high.

The funds channelled to the development of the "New Social Countryside" initiative would increase 14 % y-o-y, although their share of total expenditures barely increases, and, when calculated on a per capita basis, the increase in spending is just 50 yuan (5 euro). Perhaps the most important reforms are related to the medium-term targets in the medical care system and education in rural areas. Currently, both sectors are in a poor condition and lack resources. China will expand the trial of a new medical care system to cover 40 % of rural areas this year. However, the subsidy from the public sector is a mere 10-20 yuan (1-2 euro) per participant, so real effects from the trial are likely to be modest. A trial to make rural compulsory education free in Western China will be launched this year and free education should be available nationwide by 2007. For this purpose, the budgetary resources will be considerably higher, CNY 44 billion a year during the years 2006–2010. Although the share of these expenditures in the whole budget is only around 1 %, the effects from the reform are expected to be remarkable.

On the revenue side, no major changes are expected in 2006. The effects from the elimination of agricultural tax at the beginning of this year, the on-going trials with the VAT system and expected decreases in tariff rates should also be quite minor. The most important change in the tax system will come from the doubling of the income tax exemption from 800 yuan to 1,600 yuan from the beginning of this year. Since the change, about 50 % of all Chinese are exempt from any income tax.

Fiscal indicators (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
Revenues	11.7	12.8	13.5	14.9	15.7	16.0	16.5	17.3		
Expenditures	12.8	14.7	16	17.2	18.3	18.1	17.8	18.5		
Balance	-1.1	-1.9	-2.5	-2.3	-2.6	-2.2	-1.3	-1.1		
Government debt			20.0	21.0	22.0	22.1	20.2			

Sources: Budget – National Bureau of Statistics of China. Government debt – IMF.

World's biggest foreign currency reserves

China has only permitted the renminbi to strengthen less than 1 % against the dollar since the beginning of the year. Meanwhile, the bulging trade surplus and foreign direct investment have sustained strong foreign currency inflows into China. As a result, China's foreign currency reserves surpassed those of Japan in February, making China the largest holder of forex reserves.

The foreign exchange market interventions of the Chinese authorities have increased the domestic money supply. Although China sterilised about half of its interventions by selling central bank bills to commercial banks during January-March, the level of liquidity in the banks remains high. The excess liquidity and looser lending policies have contributed to accelerated credit growth. In the first quarter of 2006, banks granted 70 % more new loans than in the corresponding period last year. Most loans went to enterprises, while growth in household consumption loans was moderate. This situation, combined with high investment growth, raises questions about the sustainability of credit growth. Some observers see the acceleration of loan growth linked to the real estate market. They have warned that the unwillingness of the local governments to see declining housing prices could have encouraged banks to increase loans to real estate developers to tide them over the difficult market situation.

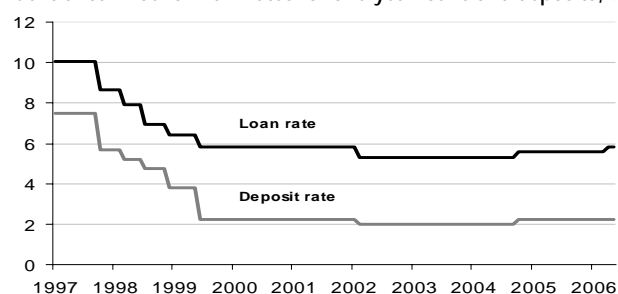
Interest rate hike and new rules to tackle imbalances

The rapid expansion on lending has raised questions about the effectiveness of China's monetary policy in the current circumstances. As a part of a larger plan to keep credit and investment growth under control, the People's Bank of China raised its benchmark one-year lending rate on May 28 by 0.27 percentage points from 5.58 % to 5.85 %. The benchmark rate for deposits was kept unchanged. In addition, the central bank invited commercial banks to "a window guidance" meeting on April, 27. Authorities called banks to control the speed of credit growth and exercise strict control on sectors suffering from overcapacity.

The authorities have also gradually relaxed controls on taking money out of China. In mid-April, the central bank released its qualified domestic institutional investor (QDII) procedure. The QDII allows certain Chinese financial institutions to make investments in foreign financial markets. The first step includes bank investments in foreign bond markets, as well as insurance company investment in foreign stocks. QDII transactions still require a licence from the authorities, who set the final investment quotas for each investor. In principle, the reform could have major effects on the Chinese financial sector and cause considerable out-

flows of foreign currency. However, it is still uncertain how big the quotas will be. It is more likely that China will proceed cautiously in this new reform. China will also seek to limit foreign currency liquidity by raising the maximum amount of foreign currency that private Chinese individuals can purchase from \$8,000 to \$20,000 starting from May. In addition, China remains keen to reform domestic investment possibilities so that part of savings would be directed out of the banking sector to more efficient purposes. For example, the on-going reform in the stock market to modify the ownership structure should increase interest in stocks. There are also moves to develop China's corporate bond market.

Central bank benchmark rates for one-year loans and deposits, %



Source: People's Bank of China

Rapid monetary growth still not reflected in inflation

Despite surging monetary growth, consumer price inflation has remained low. In March, consumer prices were only 0.8 % higher than a year ago. Food prices have been nearly stagnant for the last 12 months and prices of some durable goods have continued to decline. Prices for telecommunications services fell 18 %, while services generally were up 1.6 % y-o-y. Despite a small rise in fuel prices in March, prices for oil products remained strictly regulated and are still far below levels of current world market oil prices.

Producer price inflation has slowed considerably. In March, producer prices were only 2.5 % higher than in March 2005. While high oil prices have somewhat increased production costs, prices of products in oversupply (e.g. steel) have dropped significantly.

Although the link between monetary growth and consumer price inflation takes a rather long time to materialise even in the market economies, it appears the link operates somewhat differently in China. While in China, excess liquidity can easily lead to an investment boom that causes overcapacity in certain sectors, private consumption may not increase as fast. This is likely due to the tendency of Chinese households to save and moreover the huge labour force reserve hinders the possibilities for rapid run-ups in wages. Slow growth in private consumption is further reflected in the anaemic growth of household borrowing.

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
Inflation (CPI), 12-month, % (year average)	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	0.8	3/06
M2, y-o-y %-change (end of period)	14.8	14.7	12.3	17.6	16.9	19.5	14.6	17.6	18.8	3/06
Average disposable income in urban areas, y-o-y %-change	5.1	8.0	7.2	9.4	12.2	10.0	11.2	11.4	10.8	1Q/06
Average net income in rural areas, y-o-y %-change	1.1	2.2	3.3	4.8	4.6	6.3	11.9	11.5*	11.5	1Q/06
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	818.9	875.2	3/06
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	9.58	10.05	4/06

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

*) Data from January-September 2005.

Total factor productivity projections cloud China's long-term growth prospects

by Juuso Kaarevirta*

China's technological development has been a hot topic for years. In particular, the question remains unresolved whether China has achieved its spectacular GDP growth over the past ten years through true productivity gains or by piling up production factors, mainly physical capital (factories, roads, etc.) and labour force.

Developing countries have lower technology levels than developed countries, so they can readily import more advanced technologies from abroad. This makes it easy for them to achieve high productivity growth on paper. Progress in technological development, essential for the long-term growth of any country, is tricky to assess, as it cannot be measured directly. One way to get a clearer picture of technological development at the macro level is to evaluate technological change with the growth accounting method. This involves calculating to which extent changes in production factors contribute to GDP growth. The residual of contributions, generally designated as total factor productivity (TFP), are interpreted as an improvement in technology. The most commonly used production factors to calculate TFP are physical capital stock and labour force. Human capital (education, etc.), exports and foreign direct investment are often mentioned as having significant impacts China's economic growth, yet their shares are actually quite small compared to physical capital stock and labour force.

The literature is somewhat mixed on total factor productivity growth in China. Many studies suggest that productivity growth has been important factor behind GDP growth since the reforms in the late 1970s. More recent studies, however, point out that the trend of TFP growth has been declining and the growth rate is quite low. For example, the OECD's Economic Survey of China published last year suggests that the role of the total factor productivity growth has declined since the mid-1990s, although average growth level remained quite high in 2003 (about 3% y-o-y). The OECD further estimates, however, that the structural change in labour force (i.e. the shift from agriculture to manufacturing and the service sector) obscures about a percentage point of TFP growth.

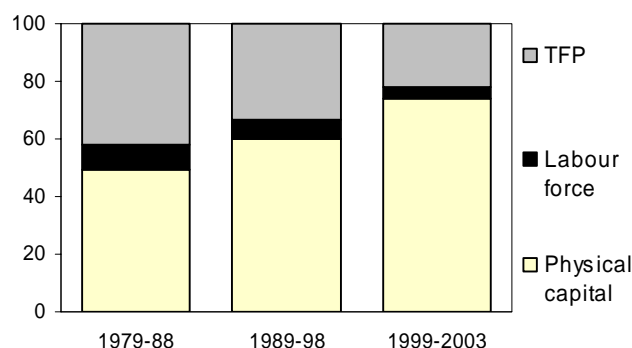
Total factor productivity growth has slowed

In line with many other studies, our estimates suggest total factor productivity growth slowed during an observation period of 1979–2003. We estimate that TFP growth declined from the high rates of the 1980s to just 1.6% y-o-y in 2003. If structural change in the labour force is taken into account, TFP growth rate fall to as low as 0.9% y-o-y in 2003. The growth rate is quite low for an emerging country like China; even in the developed US, TFP growth is estimated to have been around 1% y-o-y in recent years. India's TFP growth has been averaging around 3%.

We further note that high growth of the physical capital stock has been the main driver of the economic growth in China. This, in turn, is partly the result of restrictions on capital exports and an astronomical saving rate. China's saving rate presently exceeds 40% of the GDP, compared to just 20% for Europe and even less for the US.

China's investment habits also differ from western countries; for example, domestic companies commonly reinvest the bulk of their profits. Labour force growth only made a minor contribution to economic growth throughout our 1979–2003 research period.

China's GDP growth sources, % of GDP growth



Source: author's calculations

Does a slowdown in TFP growth really matter?

The problem with TFP is that it is not a pure indicator for technological development – it contains many factors. Arguably then, slowing TFP growth does not really reflect a slowdown technological development at all, but merely changes in other factors included in the TFP estimate (e.g. lower returns on investments due to overinvestment). Moreover, statistical errors are likely due to the vagueness of some physical capital stock assumptions. Moreover, China's labour force data are famously flawed. Finally, TFP growth figures are sensitive to the weights used in calculating production factor contributions to GDP. A higher weight for physical capital stock, for example, translates almost directly to lower TFP growth rates, which partly explains difference between our and OECD's estimation results. However, the TFP growth trend appears not to be sensitive to changes in weights.

As China's labour force growth and growth of physical capital stock are likely to slow, it seems inevitable that economic growth will also slow in the long run if productivity growth remains as low as TFP estimates suggest. In addition to low TFP growth rate, its declining trend also raises concerns about sustainable growth in China.

* The author is economist at BOFIT.

Economic Developments

Investment boom continues

Investment growth exceeded expectations in January-July as fixed investment in urban areas increased 31% from the corresponding period last year. Investment growth was strong in nearly all sectors. Almost a third of investment was channelled to manufacturing and investment in infrastructure; roads, railways, power production and public facilities accounted for 27 % of total investment. A quarter of investment went to real estate development, while much smaller amounts were directed to mining and service industries.

The authorities are worried over runaway investment growth in certain sectors. To restrain growth, the central government has ordered stricter rules for land supply and limited construction of new factories for some sectors. In particular, the restrictive measures have been directed to the real estate sector, where the amount of unsold property is increasing. Authorities have limited construction of luxury housing and foreign capital inflows into the sector. Stricter tax procedures have also been imposed to decrease speculation in the real estate market.

Compared to the previous investment boom in 2004, it appears that the central authorities are having a harder time restricting investment growth. Growth figures in recent months show little response to restrictive measures introduced since April. Although most effects only appear after a lag, the differences between the current Chinese economy and the situation in 2004 are quite apparent. First, the share of private sector has increased, making it harder to control investment growth through administrative measures. Second, the weak links between central and local governments seem to limit the enforcement of policy measures more than earlier. For example, local governments have ignored restrictions on land development and most of land transactions in recent years have been illegally executed by local authorities. Third, bottlenecks in energy supply and transportation capacity that restricted growth a couple of years ago have been partly removed, although some areas still suffer from power shortages. Finally, corporate profits have rapidly increased in recent years, so a large share of investment is now financed out of pocket. This has made limitations on bank lending a relatively inefficient tool for restricting investment.

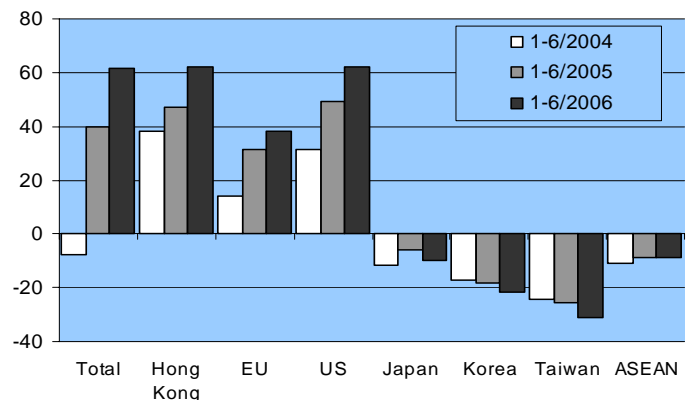
Trade surplus hits record high

China's trade surplus continues to balloon. In January-July, the surplus reached \$75 billion – up \$25 billion from the corresponding period in 2005. China made share gains in virtually all markets. Total exports increased 25 % y-o-y in January-July. Exports to the two biggest markets, the EU and

the US, increased 21 % and 25 %, respectively. Export growth to Japan, however, slowed to 7 %. Although foreign-funded companies still account for nearly 60 % of all exports, growth was fastest in exports originating from domestic privately and collectively owned companies.

Import growth was driven by raw materials, components and energy. The volume of crude oil imports increased 13 % and refined petroleum products 21 % y-o-y in January-July. The value gains, however, were considerably higher. The share of crude oil and refined petroleum products rose to 11 % of all imports. Overall, import growth (21 % y-o-y in January-July) was slower than export growth.

China's trade balance with selected trade partners, US\$ billion



Source: General Administration of Customs

Forecasts revised upwards

Besides strong investment and export growth, economic development was also supported by domestic demand. In January-July, retail trade increased 13 % in nominal terms and government expenditures increased 18 % y-o-y in the first half of this year, slightly faster than a year ago.

Investment and export growth have driven growth mainly in the industrial sector, while the service sector has benefited from increase in household consumption. Out of the major production sectors, growth has been slowest in primary industry, especially agriculture, where production was up just 5 % y-o-y in the first half.

Due to higher-than-expected investment growth in the first half of 2006, many GDP forecasts have been revised upwards to around 10 % for all 2006. On the other hand, worries over the sustainability of rapid investment growth in coming years have increased. Because the share of investment in the whole GDP is close to 50 %, fluctuations in investment rates are felt throughout the economy.

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, y-o-y %-change	7.8	7.6	8.4	8.3	9.1	10.0	10.1	9.9	10.9	H1/06
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.4	17.6	1-7/06
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	26.6	25.7	29.8	H1/06
Exports, US\$ billion	184	195	249	266	326	438	593	762	509	1-7/06
Imports, US\$ billion	140	166	225	244	295	413	561	660	433	1-7/06
Current account, % of GDP	3.1	1.9	1.7	1.3	2.4	2.8	3.6	7.2		

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

Foreign acquisitions raise concerns in China

Most foreign direct investment (FDI) in China has been in the form of either greenfield projects, joint ventures, re-investment in existing ventures, or buying minority stakes in Chinese companies, foremost in the big state banks. Until recently, China has seen relatively few outright foreign acquisitions of key domestic companies. The pace has noticeably quickened lately with private equity groups, industrial buyers and big banks all going on a buying spree. However, several announced deals have either stalled or been blocked. Numerous Chinese government officials, industry leaders and research institutes have come out strongly against allowing foreign multinationals to acquire key local companies or to create local monopolies through acquisitions. A national mood that has turned more critical towards foreign involvement in the economy has prompted high-ranking EU and American trade officials to voice their concerns that China is poised to push the brakes on further economic opening.

Chinese authorities have signalled that they are taking a closer look at foreign acquisitions. In August, six ministries and other government agencies jointly issued comprehensive regulations on foreign mergers and acquisitions (M&A). Henceforth, all bigger acquisitions have to be approved by the authorities. Notably, the regulations set a low threshold for governmental review without specifying clear criteria for when acquisitions are permissible and when not.

Acquisition troubles galore

A spate of foreign acquisitions encountering problems indicates that the Chinese government is not keen on allowing foreign acquisitions of key local companies. Several acquisitions have stalled in the administrative process, possibly pending a clarification of review and approval procedures.

Bids by a Citigroup-led consortium and Société Générale to acquire a large stake in troubled Guangdong Development Bank, and Carlyle's and Caterpillar's attempts to acquire local machinery makers, all stumbled on administrative obstacles. Citigroup's offer defied existing rules limiting foreign ownership to below 25 % of a Chinese bank and a single foreign investor's ownership to below 20 %. The Chinese authorities have indicated that they have no intention of making an exception to the rule. Related to the Carlyle and Caterpillar cases, the National Development and Reform Commission (NDRC) issued peculiarly well-timed guidelines for the development of the domestic heavy equipment manufacturing industry, which encourage state-owned enterprises to drive industry restructuring. Key enterprises within the sector now need to seek approval from the State Council before transferring ownership control.

Other foreign companies have stumbled on local government manoeuvring to thwart acquisitions through semi-forced mergers of local champions. Steel giant Arcelor ran into such a hurdle in its attempt to purchase a 38 % stake in Shandong province based Laiwu Steel. Provincial officials

rapidly pushed through a semi-forced alliance between Laiwu and another local steel company. Last year, China published a steel policy paper banning foreign control of Chinese steelmakers. Meanwhile, French Danone ran into a similar protectionist tactic when trying to raise its stake in a local dairy company.

Other deals have been cancelled at a late stage. A bid by a Citigroup-backed consortium called CVC Asia Pacific to acquire a controlling stake in Chenming Paper, China's biggest paper and pulp producer, had been agreed to in May, but in late July the Chinese counterpart suddenly cancelled the deal. Chenming had invited the offer in order to fund expansion plans. Instead, it now intends to rely partly on a generous credit line from China Development Bank (CDB), a major policy bank. While both parties deny that the deal floundered on governmental pressure, CDB credit support—usually given to state-owned companies key to national security—suggests otherwise. Similarly, a takeover by German Schaeffler of state-owned machinery company Luoyang, agreed to in May, now faces an ad hoc government inquiry.

Policy and legislative developments affecting M&A activity

China publishes an intermittently revised official catalogue on FDI that outlines in which industries investments are prohibited, restricted or encouraged. Some of the stalled acquisitions are in formally approved industries, a fact that has taken foreign investors aback. A new round of investment guideline revision is apparently currently under way. In addition, a separate and more detailed list of industries in which foreign ownership is restricted and industry-specific M&A policy guidelines are under preparation. Industries in which foreign control is forbidden will include steel, shipbuilding, and most energy-related and heavy equipment. China has also recently raised the requirements on foreign investors in the real estate, retail, paper, auto and insurance industries.

The heated internal debate on the role of foreign and private interests in the Chinese economy will probably affect several impending laws. For example, the draft anti-monopoly law, long in preparation and now under review, includes a section on mergers and acquisitions in line with international standards. In so far as enterprise mergers could result in monopolies forming they have to be reported to and examined by the authorities. However, according to media reports a controversial section on administrative monopolies—internationally unusual in legislation against monopolies—has been watered down. Administrative monopolies are mainly maintained by Chinese companies in collusion with local governments, whereas monopolies formed through the market and M&A include many foreign companies.

Already, over 60 % of Chinese exports are produced by foreign, Taiwanese and Hong Kong companies. The Chinese government appears to be taking a time-out on allowing foreigners to gain larger control also of those parts of the economy now dominated by domestic enterprises.

Fiscal indicators (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006*	as of
Revenues	11.7	12.8	13.5	14.9	15.7	16.0	16.5	17.3	21.9	1-6/06
Expenditures	12.8	14.7	16	17.2	18.3	18.1	17.8	18.5	16.0	1-6/06
Balance	-1.1	-1.9	-2.5	-2.3	-2.6	-2.2	-1.3	-1.1		
Government debt			20.0	21.0	22.0	22.1	20.2			

Sources: Budget – National Bureau of Statistics of China. Government debt – IMF.

*) Preliminary figures

Further attempts to restrain monetary growth

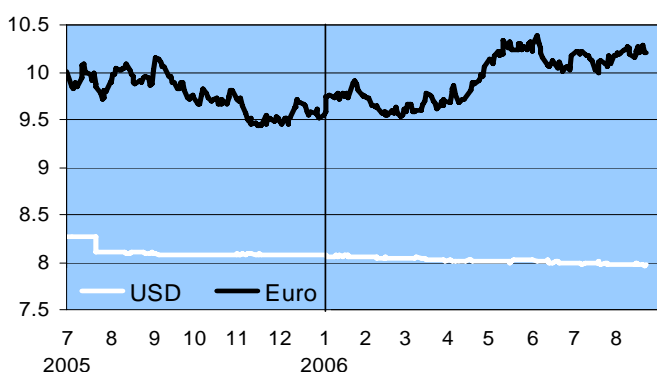
A record trade surplus and strong inflow of foreign direct investment have increased monetary growth beyond the central bank target. As of end-July, broad money (M2) was up 18 % y-o-y, ripping through the 16 % official target for all of 2006. The volume of new loans granted also increased rapidly compared to the January-July period in 2005, and nearly filling the central bank's target for all of this year.

Inflation has remained low despite rapid monetary growth. Although the very small annual rise of consumer prices in July (1.0 %) was due to some temporary factors, the forecasts for consumer price inflation for the rest of 2006 remain low.

The Chinese authorities have launched a selection of restrictive measures to maintain stable growth in the financial sector and avoid upward trends in inflation. First, the liquidity in the money market has been decreased by selling a record amount of central bank bills to the commercial banks. In some cases, the bills have served as a penalty for banks that have doled out too much credit. Second, the central bank raised the commercial bank reserve requirement twice this summer. The hikes totalled 1 percentage point; for most banks the requirement is now at 8.5 %. Third, the central bank has raised interest rates twice. Since the last rise on August 18, the one-year benchmark lending rate is 6.12 % and deposit rate 2.52 %. Fourth, the monetary authorities have encouraged foreign currency outflows by granting to a few commercial banks permission to invest in fixed-income instruments abroad. Although the allowances have been moderate, they constitute an important step in liberalising capital flows. Besides these rather market-oriented measures, authorities have also continued to give administrative orders and limitations to restrain lending.

So far, the influence from the tightening measures has remained limited. While most measures will take effect only after a lag, the possibility to use a more flexible exchange rate as a tool to correct balance of payments imbalances has been increasingly discussed. However, renminbi's strengthening against dollar has continued at slow pace.

Renminbi exchange rate against dollar and euro



Source: People's Bank of China

Development in the stock market

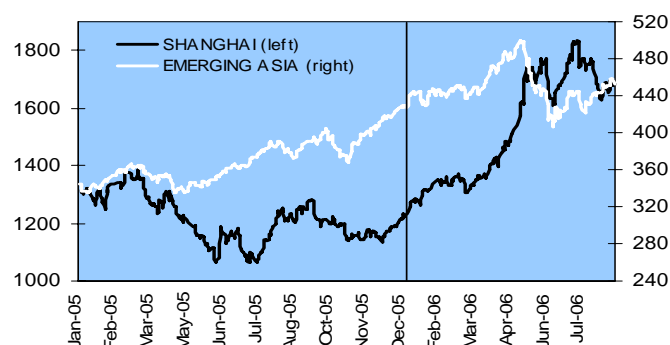
The development of Chinese stock prices has not generally reflected major international trends, and has proved quite resilient this year to the dips experienced in emerging market bourses. A-share prices in the Shanghai and Shenzhen exchanges are up about 40 % since the start of the year.

In May, the authorities lifted their year-long IPO moratorium. Revised listing rules were introduced, requiring firms to show a substantial profit for the three years prior to the listing and the existence of independent board members. Some observers doubt the new regulations will markedly improve corporate performance, especially where the enforcement of legal contracts remains weak. The listings have varied in success. The Bank of China IPO in July was heavily oversubscribed, while Air China scaled back its flotation in August ahead of lower-than-expected demand. Increasing uncertainty, a formal inquiry on a recent medium-sized IPO was opened over concerns of possible share price manipulation. On the positive side, the share of majority private-owned firms applying for listings seems to have increased.

The ban on IPOs was originally introduced in connection with the conversion of previously non-tradable state-owned shares to tradable shares. Trade in the newly tradable shares was launched in June, and the conversion process is scheduled to be completed by the end of 2006. The flood of new shares through IPOs and newly tradable shares may depress prices, but also encourage business restructuring and the channelling of household deposits to equity financing. Some reports suggest listed companies' profitability has declined in early 2006. The rules regarding foreign strategic investors have been relaxed, and their opportunities to invest in Chinese A-shares have increased. Similarly, media reports suggest Mainland insurers will be allowed to invest larger proportions of assets in stocks, possibly boosting prices.

Stock market uncertainty generally has increased in the past eight weeks following macroeconomic cooling measures – especially a tightening of the monetary policy stance – by the authorities. Some observers also fear listing restrictions may be reintroduced.

Stock markets; Shanghai A index and Morgan Stanley Emerging Markets Asia



Source: Bloomberg

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
Inflation (CPI), 12-month, % (year average)	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	1.0	7/06
M2, y-o-y %-change (end of period)	14.8	14.7	12.3	17.6	16.9	19.5	14.6	17.6	18.4	7/06
Average monthly disposable income in urban areas, CNY	452	488	523	572	642	706	785	874	999	H1/06
Average monthly net income in rural areas, CNY	180	184	200	211	226	244	270	326	300	H1/06
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	818.9	941.1	6/06
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	9.58	10.18	7/06

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

Improving Banking Supervision

by David G Mayes, Liisa Halme and Aarno Liuksila *

Our book, 'Improving Banking Supervision', has recently been published in Chinese by the China Renmin University Press (ISBN 7-300-07038-8). While it might not be correct to infer that this reflects a feeling in China that the supervision of the banking system needs improvement, the timing is opportune. Not only has the economy been developing rapidly but the sophistication of financial markets is increasing. Currently domestic savings run ahead of domestic investment, facilitated by insufficient financial intermediation. There is thus wide scope for financial institutions to enter areas in which they have limited experience. Coupled with a substantial existing stock of non-performing loans, variously estimated between €130bn and €700bn, the financial system is facing conditions where other countries have found that a sudden downward shock leads to substantial financial instability.

Our book sets out a framework that should maximise the chance of maintaining financial stability in these conditions by providing a network of interlocking incentives for prudence. We argue that it is those running banks who are best placed to act prudently and avoid building up the risks that can lead to problems. They need the incentive to act in this manner through, for example, a remuneration system that rewards them for good performance over the medium-term – i.e. there is significant lag between their actions and the judgement over what extra remuneration they should receive – and personal legal responsibility for their actions, with penalties such as imprisonment, which will deter richer people. Most of all they need an environment where there is extensive public disclosure so that their reputation will be ruined by poor performance. Self-discipline should thus be the main force governing the operation of banks.

Backing this up, the second source of discipline should come from the market in the widest sense, where it includes a whole range of the stakeholders in the bank: depositors, creditors, owners, borrowers and counterparties. For this market discipline to be exercised, there needs to be not just extensive disclosure of the performance and risk management strategies of the bank but a ready market in which the stakeholders can express their views – by selling their shares, finding jobs with other banks, increasing the price at which they are prepared to lend, withdrawing their deposits etc. There are some difficulties in achieving this in China, starting with the state ownership of banks. A key incentive to stakeholders comes from the fear of loss. If the owners of claims in the bank think it unlikely that they will lose in the event of failure, because the state will step in, market discipline will not work. Similarly managers will feel able to take greater risks and be subsidised to do so, as the lower risk reduces their borrowing costs – a typical 'moral hazard'.

This leaves regulation and supervision as the remaining source of discipline. Despite their ability to conduct on-site inspections and require disclosure of private information, regulators tend to be among the last to find out when something is going wrong in banks, often only when the bank itself asks for help. Nevertheless they can perform an important role in detecting adverse trends and seeing problems in the market as a whole from the concentration of risk by the independent actions of the banks, say, for example, if banks simultaneously target the retail car sector or housing.

Where the supervisor's role is most effective is as a deterrent for most of the stakeholders and as a safety net for the ordinary depositor, who will be ill-informed and readily panicked if they hear there are problems. The deterrent role stems from what the authorities are compelled to do if they discover there is a problem with a bank. Using a form of Structured Early Intervention and Resolution, the authorities are mandated to impose a range of ever tougher measures as a bank becomes undercapitalised up to the point that they withdraw its licence, take it away from its owners and step in to run it (or close it down). Even if the state is the owner the supervisor could still take over the management of the organisation. If these measures are not mandatory there are strong pressures on supervisors to exercise forbearance, because bank failure is easily equated with regulatory failure.

The managers and owners of the bank thus have every incentive to try to find a prompt solution to the problem (what is labelled Prompt Corrective Action in the jargon of the literature) as any means they can find to recapitalise the bank, halt the losses, or find a buyer are likely to have a less adverse effect than what will happen when the state steps in. Owners and managers are likely to lose everything and junior creditors may face substantial losses. However, the state itself has to have a clear failsafe set of powers so that it can indeed step in, stop new losses and give the ordinary policy uninterrupted access to their funds.

It needs to be somebody's responsibility to minimise the loss (to the state) and they need to know they will be held to account after the event for this incentive to work. It is not clear that any of these disciplining mechanisms works well in China, as the objectives, responsibilities and information are often opaque. However, China is not alone in this, or we would not have bothered to write the book. It also applies in Finland and the EU in general. However, there is no comfort in numbers – far from it. If there is a banking problem in China, foreign investors will also be vulnerable as, given the global imbalances prevailing at present, they will also be hit in their home market.

** The authors are Advisor to the Board at the Bank of Finland, Deputy Director General of the Finnish Financial Supervisory Authority and, formerly General Legal Counsel International Monetary Fund.*

Economic Developments

Investment and exports fuel high growth

The pace of Chinese economic growth barely slowed in the third quarter as real GDP was up 10.4 % from the corresponding period last year. Of the three main sectors of the economy, *industry* led with an increase of 13 % y-o-y in January-September. The boom in construction stoked production in related industries such as steel, aluminium and cement. Electronics and textile industries benefited from continuous flow of foreign direct investment and higher exports. Growth in both *services* (up 10 % y-o-y) and *agriculture* (up 5 %) remained steady in the first nine months of 2006. Within the service sector, retail trade, catering and hotel services displayed high growth. The outlook for agriculture was also positive, with the early summer crop up 7 % from last year and prospects for harvests of major crops this year generally encouraging.

Strong growth of fixed investment has fuelled Chinese demand this year. China publishes demand-side data just once a year, but preliminary figures suggest investment continues to be the main engine of GDP growth. The trade surplus ballooned as exports benefited from favourable developments in the world economy and the ongoing transfer of production capacity to China. Growth in both private and public consumption has remained steady, although preliminary data shows slightly lower figures than expected.

Fast growth expected to continue in 2007

All major research agencies have recently boosted their growth forecasts for next year as downside risks have been seen as waning. While investment growth is expected to slow down, steady growth in domestic consumption should continue. Fears remain, however, of a sharper than expected slowdown in the world economy and its impact on China. Expected lower growth in the US and Europe is likely to bring down China's export growth figures in 2007. However, lower export growth is likely to dampen import growth as well, because the export will need fewer parts and components. Thus China's large trade surplus should persist in coming years, even if its contribution to GDP growth might decrease. Also the leaking effects from lower export growth to the other sectors of the economy are estimated to be significant.

From 2000 to 2005, the share of consumption in GDP dropped from 61 % to 52 % according to the official statistics. Although both private and public consumption has steadily increased, growth of other demand components (fixed asset investment and net foreign trade) has decreased

the role of consumption in the economy. If China wants to keep up with high economic growth rates, many analysts believe increasing the domestic consumption is a major medium-term structural challenge facing China. The investment rate is unlikely to remain at the current exceptionally high level forever and many of China's main trading partners have grown impatient with China's ongoing massive trade surplus.

Strong growth of employment, wages and rural income, as well as improved access to bank credit, have laid the groundwork for a substantial expansion in household consumption in coming years. Nevertheless, it will remain a challenge to encourage Chinese households to consume more and save less as long as the public sector fails to provide sufficient education, health care and pension systems. In the aftermath of the Asian crisis, China's public spending increased more rapidly than revenues; the opposite trend has been true since 2003. Budgetary revenues, which have skyrocketed in recent years, in principle should allow China to dedicate more money to public services. However, higher-than-anticipated economic growth rates have probably decreased the central government's willingness to fuel the growth further by its own expenditure. In addition, as the increase in budgetary revenues has been partly due to one-time factors such as improvements in tax collection, the government is unwilling to put the money in use immediately as long as it is uncertain about the permanence of revenue growth.

The inflation outlook for next year remains low. The continuous flow of cheap labour from the countryside, improved prospects of agricultural production, rising industrial production capacity and continuous productivity gains have apparently convinced many analysts that we will continue to see low inflation also in the coming years. Even so, others worry about rapidly rising wages for highly-educated labour and the impacts of high real estate, energy and raw material prices on certain products.

GDP growth and CPI forecasts, annual % change

	GDP		CPI	
	2006	2007	2006	2007
ADB	10.4	9.5	1.6	1.8
IMF	10.0	10.0	1.5	2.2
World Bank	10.4	9.3	1.9	2.1

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, y-o-y %-change	7.8	7.6	8.4	8.3	9.1	10.0	10.1	9.9	10.7	1-3Q/06
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.4	17.2	1-9/06
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	26.6	25.7	27.3	1-3Q/06
Exports, US\$ billion	184	195	249	266	326	438	593	762	779	1-10/06
Imports, US\$ billion	140	166	225	244	295	413	561	660	646	1-10/06
Current account, % of GDP	3.1	1.9	1.7	1.3	2.4	2.8	3.6	7.2	8.0	1H/06

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

Five years of China's WTO membership

The WTO-mandated transition periods for most sectors of the Chinese economy are over. Since entering the WTO in 2001, China's foreign trade has nearly tripled and its trade structure has changed considerably. The present export emphasis is more on high-end goods and nearly 60 % of exports are produced by foreign-owned firms. China's manufacturing dominance has generated a number of trade disputes, with the largest resulting from soaring Chinese textile and garment exports following the global abolition of quotas in January 2005. Many of China's trade partners responded to the flood of textiles with safeguard measures, which, according to the rules governing WTO member countries, can only be used to protect domestic textile and garment manufacturing sectors through 2008.

China has already implemented most of its WTO commitments. It has lowered practically all customs tariffs on industrial products and reduced the average tariff to 8.9 %, the level agreed in 2001. Certain chemical tariffs must still be lowered. Tariffs on agricultural products are down to the agreed 15 % and according to Chinese authorities, all import quotas have been eliminated.

China has also already fulfilled most of its WTO commitments for the service sector, i.e. permit distribution and retail sales of most products, and allowing foreign participation in many sectors, including insurance and telecom. On December 11, China will further open its banking sector to global players but many restrictions on foreign banks will remain in place. Oil product distribution will also open to foreign investors next month. Next year, geographical restrictions of foreign travel agencies will be removed and fully foreign-owned enterprises will gain entry into some minor sectors. China's WTO commitments call for no further service sector reforms after 2007.

Trade partners get tough on China

China's largest trading partners – the EU and the US – complain loudly about China's failure to meet some of its WTO commitments. The EU recently released a policy paper on EU-China trade and investment, stating that it will closely monitor China's compliance with its WTO obligations and actively pursue Chinese violations of WTO rules. The EU would like to see China open its markets beyond what is called for under its WTO commitments.

Most importantly, trade partners claim that China is not making sufficient efforts to protect intellectual property rights (IPR) nor reducing barriers on market access. While Chinese Premier Wen Jiabao has given assurances China is striving to improve IPR enforcement, the EU and the US are not convinced. China ran several anti-piracy campaigns last summer, but even Chinese officials admit little progress. A US-China Business Council survey found that just a third of the US companies operating in China note any improvement

in IPR enforcement from last year and that most companies consider the situation unchanged. Many observers believe IPR enforcement will only improve after Chinese companies own something that needs protection. The US is preparing a complaint about the issue to the WTO. Trading partners also blame China for erecting barriers to foreign enterprises trying to enter Chinese markets. China has many of its own standards that differ greatly from international conventions. The EU also notes that China heavily subsidises certain sectors.

China's largest trading partners have yet to give China market economy status, which would help China protect itself better from dumping charges. As of end-2005, there were totally 338 anti-dumping duties in force on Chinese exports. While the duties to date have been implemented on small segments of trade, larger cases are on the horizon. In October, the EU imposed anti-dumping duties on Chinese leather footwear for two years. The EU, backed by the US and Canada, also last month took Chinese import practices on car parts to the WTO. Unlike international practise, China currently treats foreign-manufactured doors, roofs and the six key engine parts as a complete imported car. Car parts have 15 percentage-point lower tariffs than complete cars. This was the first time that a trade dispute with China has gone so far as to require a WTO investigation. China and its trade partners previously have been resolved trade disputes through bilateral consultations. China has also been active in using anti-dumping measures to protect its own domestic production. In the end of 2005, China had 68 anti-dumping duties in force.

The US seems to have changed their trade policy somewhat with China since Henry Paulson took over the US treasury secretary post last summer. The US discussion no longer centres on the yuan's exchange rate, but rather larger issues such as reform of the financial sector. Senators Lindsey Graham and Charles Schumer also dropped their bill to apply punitive import tariffs on China if it failed to revalue its currency. However, a pending bill sponsored by senator Max Baucus would permit the US to take measures against countries with exchange rates "fundamentally misaligned" with the dollar.

The WTO has criticised China for not putting enough effort into the Doha Round and instead concentrating on bilateral free trade agreements (FTAs). China made FTAs with ASEAN countries last year and Chile this autumn. China is also negotiating FTAs with New Zealand, the South Africa Customs Union and the Persian Gulf Cooperation Council. Negotiations with Australia will begin in December. China's largest trade partners also want to see China to take more responsibility in global trade matters.

Fiscal indicators (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006*	as of
Revenues	11.7	12.8	13.5	14.9	15.7	16.0	16.5	17.3	21.9	1-6/06
Expenditures	12.8	14.7	16	17.2	18.3	18.1	17.8	18.5	16.0	1-6/06
Balance	-1.1	-1.9	-2.5	-2.3	-2.6	-2.2	-1.3	-1.1		
Government debt					18.9	19.2	18.5	17.9*		

Sources: Budget – National Bureau of Statistics of China. Government debt – IMF.

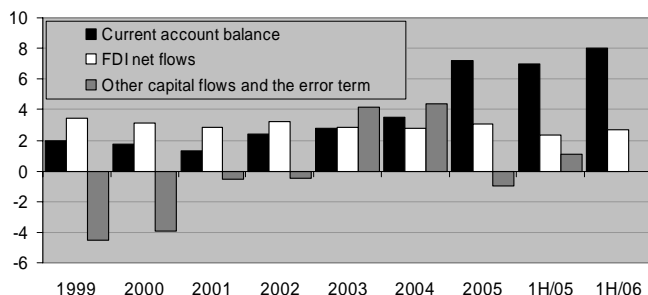
*) Preliminary figures

Current account surplus continues ballooning

China's foreign exchange reserves increased by \$122 billion in the first half of 2006. The biggest part of the rise was a ballooning current account surplus (\$92 billion) which increased 36 % from the first half of 2005. The \$39-billion surplus in the capital and financial account was largely foreign direct investment (net inflow \$31 billion) while net inflows of shorter-term capital decreased from the first half of 2005. The net capital inflow seems to have declined also in the third quarter of 2006 as growth in foreign exchange reserves slowed down despite a record trade surplus. Taken also into account the negative errors-and-omissions term in the balance-of-payments data, increasing outward dividend and interest remittances by foreign companies and current pricing of non-deliverable forward contracts, one could make a fairly cogent case that expectations on renminbi fast revaluation are diminishing.

It makes the lack of interest in investing abroad through the qualified domestic institutional investor (QDII) channel all the more surprising. While a number of banks have been granted QDII status and are allowed to invest Chinese funds overseas in fixed-return bonds, these banks have had difficulties in finding enough interested Chinese investors to fill their quotas. Obviously, the rather low yields on these instruments may partly explain investors' weak enthusiasm.

Currency flows into and out of China, % of GDP



Sources: China's State Administration of Foreign Exchange, BOFIT

Monetary growth slowing to meet target

As of end-September, growth in broad money (M2) had slowed to below 17 % from 19 % in May. While some of the slowdown was due to reduced foreign currency inflows, it also reflects the central bank's unwavering efforts to siphon liquidity from the market. The commercial bank reserve ratio has been hiked for the third time this year to 9.0 %, effective November 15. The central bank also continues to sterilise its currency interventions by selling central bank bills to the commercial banks. In the third quarter of 2006, the central bank sterilised nearly two-thirds of the increase in foreign exchange reserves. Although the low yield on central bank bills is good news for the central bank, the growing share of the low-return bills in commercial banks' portfolios could delay reforms in the banking sector.

WTO commitments encourage banking reform

As an important part of the banking sector reform, commercial banks must attain a capital adequacy ratio (CAR) of 8 % by the end of this year. While some banks have improved their figures through issuing subordinated debt or stock market listings, it is estimated that there are still banks trying to find ways to meet the requirement by the end of the year.

The reforms in a number of banks have continued. One of China's four big state banks, Industrial and Commercial Bank of China (ICBC), listed on both the Hong Kong and Shanghai stock exchanges in October. It was the biggest-ever listing worldwide, and piled up \$21 billion in cash. The ICBC was the third of the four big state banks to go public. The state-owned investment company China SAFE Investments Ltd. last month announced plans to inject CNY 20 billion (€2bn) into ailing China Everbright Bank. China Everbright Bank wants to attract foreign strategic investors and list on the stock market next year. Everbright Bank's pre-injection CAR was estimated at a mere 2 %. Citic Bank and Bank of Shanghai are also considering listings next year. The Agricultural Bank of China (ABC), the most troubled of the four big state banks, still suffers from a high proportion of non-performing loans (presently estimated to be more than 20 % of all loans). In October, state media reported that the central government has plans to inject capital worth of €80 billion to the ABC. The total stock of non-performing loans (NPLs) held by commercial banks continues to decline slowly. Mainly thanks to credit growth, as of end-June, the share of NPLs of all credit had dropped to 7.5 % from 8.7 % a year ago.

Despite the improved figures, China's banking sector is still vulnerable. For example, the amount of non-performing car loans, a relatively new credit product, has already climbed to CNY 100 billion (€10bn). Also the continuously large number of fraud cases reflects the weak level of corporate governance in the sector. As the credit growth has been slower than deposit growth in 2006, competition among banks seems to be accelerating. Banks are particularly keen on granting mortgages – a financial instrument they find secure and profitable. However, given China's rising real estate prices and the introduction of new products with for example lower cash payment requirements, the low-risk nature of the business seems to have reduced.

China is expected to open its banking sector in December to international competition under its WTO commitments. Due to a number of restrictions and requirements that will stay in place after that date, however, competition coming from the foreign-owned banks will remain restricted. High capital requirements for each branch mean that building up an extensive branch network requires substantial resources. Banks are also required to show two years of profitability before receiving a renminbi license to serve households. Under new draft rules, China will also restrict the possibilities of those foreign-banks that do not set up a subsidiary in China to engage in local currency business with individual clients.

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
Inflation (CPI), 12-month, % (year average)	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	1.5	9/06
M2, y-o-y %-change (end of period)	14.8	14.7	12.3	17.6	16.9	19.5	14.6	17.6	16.8	9/06
Average monthly disposable income in urban areas, CNY	452	488	523	572	642	706	785	874	978	1-3Q/06
Average monthly net income in rural areas, CNY	180	184	200	211	226	244	270	326	307	1-3Q/06
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	818.9	987.9	9/06
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	9.58	10.01	9/06

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

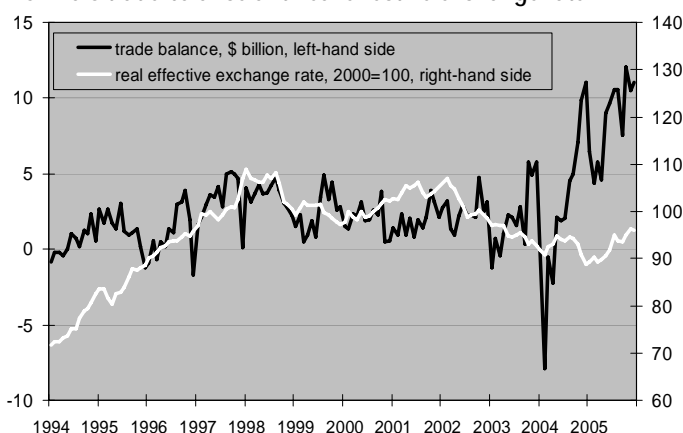
Can exchange rate policy reduce China's trade surplus?

by Alicia Garcia-Herrero and Tuuli Koivu*

China's trade surplus, which has swelled in recent years, will this year likely exceed \$160 billion, or roughly 6 % of GDP. The surplus has not only increased monetary liquidity in China and complicated conduct of monetary policy but it also has important implications for the rest of the world.

While a number of politicians have discussed extensively the potential undervaluation of the renminbi, surprisingly little academic research has occurred on the reasons behind the increasing trade surplus. While in political discussion the undervaluation has been closely tied to the increase in trade surplus, the actual causal relationships might be much more complicated due to China's specific role as a part of the global supply chain.

China's trade balance and real effective exchange rate



Source: IFS

Revaluation would decrease both exports and imports

In our forthcoming paper, we estimate export and import equations for China for 1994–2005 to get a better empirical understanding of the link between the exchange rate and foreign trade. Given the importance of processing goods in China's production structure, we separate equations for ordinary and processing exports and imports. To isolate the impact of the exchange rate on exports, we control for other export-affecting factors such as world demand, the role of foreign-owned companies in China, China's export oriented policies, production capacity and overall productivity gains in China's export sector. As one would expect, our study finds evidence that a renminbi revaluation leads to a decline in both ordinary and processed exports.

On the import side, our findings are more interesting. Controlling for trends in economic activity in China, the role of foreign companies and reductions in Chinese import tariffs, we find that real appreciation of the renminbi reduces China's imports. It may be that falling processing imports are explained by their extreme sensitivity to related exports, but further analysis is needed to confirm this hypothesis, particu-

larly as both processed and ordinary imports fall with a revaluation.

China's specific role in global production

In order to illuminate the dynamics behind the unexpected results from the import equations, we estimate bilateral export and import equations for China's ten largest trade partners. The findings for exports are again as expected: a renminbi revaluation reduces exports to all major trade partners.

On the import side, we can divide countries basically into three groups according to the composition of their exports to China. First, many Asian countries export parts and components to China's processing sector. We find evidence that these exports are negatively affected by a renminbi revaluation that harms China's processing industry. Countries in the second group export to China not only parts and components but also products that do not compete with Chinese domestic products. For example, US exports to China include parts and components, as well as aircraft and soybeans. For such countries, the renminbi revaluation effect, while negative, is statistically insignificant. The third category of countries exports goods mainly for China's domestic market. German exports to China, for example, consist of machinery, cars and electronics – products that serve domestic investment and consumption. Many of these products face competition from China's domestic industrial production, so a revalued renminbi would improve the competitiveness of foreign products. Thus, for the exports from this group of countries, a revaluation of the renminbi would be beneficial.

Net effects on the trade balance would be rather small

In sum, due to China's role as a part of the global supply chain, the net effect of a renminbi revaluation on China's trade surplus can be expected to be rather moderate. Although a revaluation would lead to a decline in the Chinese exports, also the need for imported parts and components would decline. Only those import products that are directed to China's domestic market and compete with China's domestic production would benefit from the revaluation.

According to our simple calculations, a 10 % appreciation of the renminbi real effective exchange rate would have decreased China's trade surplus by some 20 % in 2005. China's substantial trade surpluses would, thus, persist even in a case of moderate revaluation.

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Garcia-Herrero, Alicia and Koivu, Tuuli, "Can the Chinese Trade Surplus Be Reduced with the Exchange Rate Policy?" BOFIT Discussion Paper, forthcoming.