



Waltraut Urban

China: Economy fast on track

In the first quarter of 2010, the Chinese GDP expanded at a rate of 11.9%, after reaching 10.7% growth in the last quarter of 2009 and 8.7% for the year 2009 as a whole. Growth was mainly driven by investment, but consumption played a substantial role as well. Both were supported by continued stimulus measures of the Chinese government which have been part of the huge 'stimulus package' implemented in 2009 during the global financial and economic crisis. Foreign trade, which had started to grow again in December last year, recovered further, but as imports rose faster than exports China's trade surplus narrowed. After deflation had come to an end in December 2009, inflation picked up in the first months of 2010.

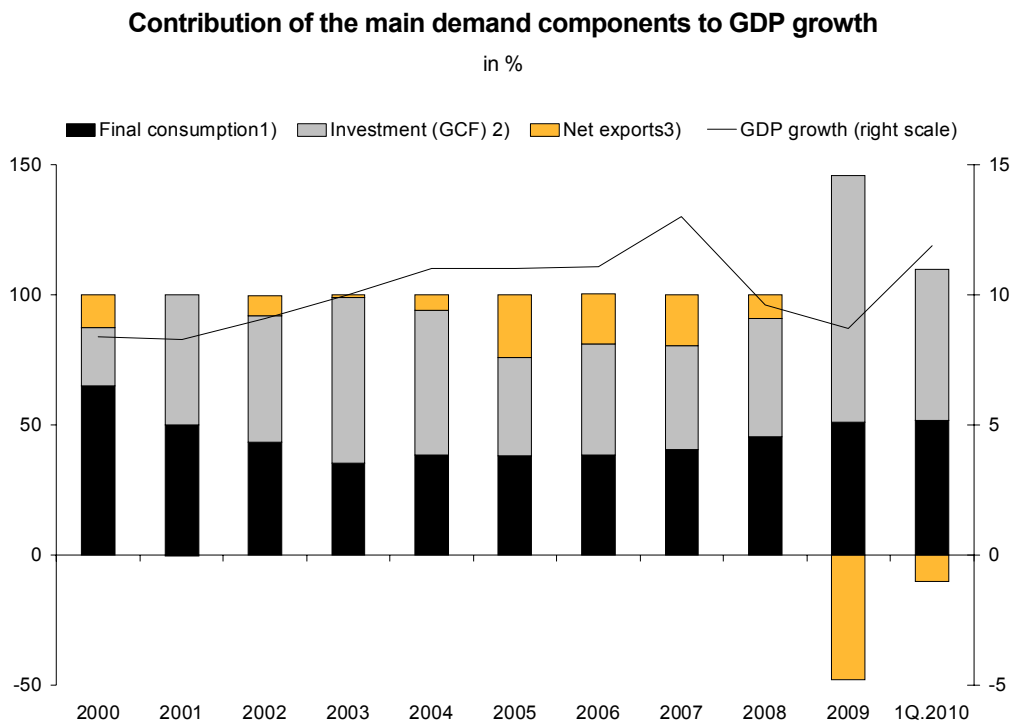
The very high GDP growth rate has to be seen in the light of the depressed year-earlier levels, when the economy hit the bottom of the crisis. But from the second quarter of 2009 onwards, the Chinese economy recovered rather quickly and because of that level effect the year-on-year growth rates for the rest of 2010 are expected to be lower than in the first quarter. Under the assumption of a prolonged pro-growth fiscal policy and a moderately tight monetary policy as pledged by the Chinese government in November last year, together with a continuous recovery of the world economy, we expect China's GDP to grow by 9.5% in 2010. This estimate is in line with current forecasts of the World Bank, the United Nations (both 9.5%) and the Asian Development Bank (9.6%), but lower than those of the IMF (10%) and the OECD (11%).¹ Recent estimates by Chinese researchers put GDP growth in a range between 9% and 10%. The biggest downward risks are a 'double-dip' recession of the world economy caused by sovereign debt risk, and an early budgetary consolidation in Europe as well as a still fragile recovery in the USA and Japan. As for the domestic economy, the biggest challenges come from the real estate market, rising inflation and the escalation of related labour disputes. For those reasons the Chinese

¹ World Bank, Quarterly Assessment of the Chinese Economy (17 March 2010); Asian Development Bank, Asian Development Outlook 2010 (13 April 2010); United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), Economic and Social Survey (May 2010); IMF, World Economic Outlook (April 2010); OECD Economic Outlook (May 2010).

government is still hesitant to phase out its support measures while fighting overheating in certain sectors and trying to restrain the real estate market.

Taking into account the above-mentioned risks, we expect the Chinese economy to grow by 9.5% in 2011 and 10% in 2012. But if the Chinese government takes its goal to switch from quantitative to more qualitative growth more seriously in the upcoming Five Year Plan 2011-2015, growth rates may be even lower.

Figure 1



Notes: 1) Private consumption and government consumption. - 2) Gross capital formation, including fixed capital formation and change in inventories. - 3) Net exports of goods and services

Source: China Statistical Yearbook, 2009; *China Daily*, 16 April 2010.

As illustrated in Figure 1, investment was again the most important driver of GDP growth in the first quarter of 2010, but lost relative importance compared to last year when it was heavily pushed by the government.² This development is also reflected in Figure 2 which shows declining growth rates of (urban) fixed asset investment. In contrast, investment in

² In 2009, the foreign sector's contribution to GDP growth was negative, for the first time since 1993, due to the global financial and economic crisis. Exports fell by 11% and imports by 6%. As a consequence, the trade balance shrank from EUR 202 billion to EUR 141 billion.

real estate has strongly accelerated after a deep slump in the first quarter of 2009. A certain slowdown at the beginning of this year is due to several government measures taken to contain the overheated real estate market.

Fighting the real estate bubble

The real estate market in China is driven by excessive demand and property prices are reported to have skyrocketed by about 80% year-on-year in many big cities such as Shanghai and Beijing. This prompted consumer complaints and heightened concerns that an asset bubble was building up, driven by excess liquidity and speculation. An eventual bursting of such a bubble could substantially harm the Chinese economy given the fact that real estate investment comes up to one quarter of fixed asset investment which takes an average share of 40% of GDP. Accounting for some 10% of GDP, the sector is also an important employer and has a significant impact on many upstream (cement, steel, glass etc.) as well as downstream industries (furniture, home appliances, etc.). Besides, land (-use) sales are a primary source of fiscal revenue for local governments and affordable housing is considered an important element of social stability in China's current phase of rapid urbanization. The government has therefore introduced a number of measures to contain real estate demand already at the end of last year,³ but has released further regulations on 16 April this year. Such measures include more stringent downpayment requirements for mortgage loans, higher loan rates, a temporary ban on lending for third or above home purchases and tighter scrutiny of developers financing. Local governments can adjust these basic rules according to the specific situation. Further on, the People's Bank of China (PBOC) has raised the reserve requirement for banks three times this year already to rein in excess liquidity, and the approval of stock issue plans of real estate companies will be handled with more care. For the future, the introduction of a property tax is discussed.

As a consequence, property sales in China's major cities dropped significantly in May this year, yet records on price developments are ambiguous with prices falling in some cities but still rising in others, where prices will probably adjust later in the year. However, many experts find especially the policies to tighten third and above home purchase difficult to implement due to the independence of China's housing registration and bank credit systems and the fact that housing systems in different cities are not linked with each other. But there is also a minority fraction which fears that house prices may fall very strongly (20-30%) and may set in motion a downward spiral. Then even high-quality mortgage loans

³ See W. Urban, 'China: On the cusp of double-digit growth', *wiiw Current Analyses and Forecasts*, No. 5, February 2010, p. 144.

would face limitations and 'contract violation' cases would increase markedly. Also, when housing prices plunge, demand usually hibernates and buying is suspended, which in turn will intensify the over-capacity of industries relying on property development. In this case the end of 2010 and the beginning of 2011 may see a sluggish real estate market similar to what happened in late 2008 and early 2009.⁴ The measures to cool down the real estate market have already triggered a decline in the stock market (Figure 3). The shares of China Vanke Co., the county's biggest listed property developer, has reached the lowest value since March 2009.

Rising contribution of final consumption to GDP growth

In the longer-term perspective, China is trying to gradually rebalance its growth pattern away from excessive investment and exports towards domestic consumption, to make the economy less sensitive to external shocks. The current development seems to be in line with this goal as illustrated in Figure 1. Retail trade as a proxy for private consumption showed high and persistent growth throughout the crisis and in the first five months of this year as well (see Figure 4). This development is backed by the relatively fast rise of incomes but also supported by 'consumer subsidies' to the rural population for the purchase of household appliances and by various measures to promote car sales. These measures were introduced last year in order to compensate for the shortfall of external demand. In the first quarter, sales of household appliances and audio-video equipment rose by 30% and sales of motor vehicles by 40%. Consumer subsidies are expected to phase out at the end of this year, thus incomes will become the major driver of consumption again.

Will the strike at China's Honda factory trigger a nation-wide wage race?

In May this year, 1900 workers at the Honda Auto Parts Manufacturing Co. in Foshan, Guangdong province, went on strike for higher pay, putting Honda's four assembly plants in China to a halt as well. The action was primarily triggered by rising inflation. Workers were demanding that monthly salaries be raised from 1000-1500 yuan to 2000-2500 yuan.⁵ The strike lasted for about three weeks and was the largest industrial action ever reported in China. Finally, the management agreed to raise wages by 600 yuan (67 euro) per month (about 24% on average), which represents a substantial increase particularly for low-wage earners, mainly migrant workers. The bargain is becoming a catalyst for wage

⁴ See *China Daily*, 17 May 2010.

⁵ From 112-168 euro to 225-280 euro. Currently, the minimum wage in Foshan comes up to 920 yuan (103 euro) per month.

Selected data on China, 2007-2010

Figure 2

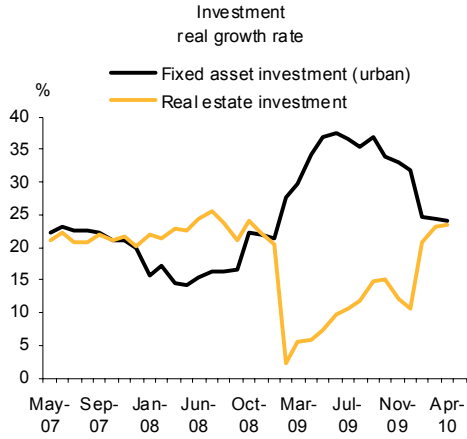


Figure 3

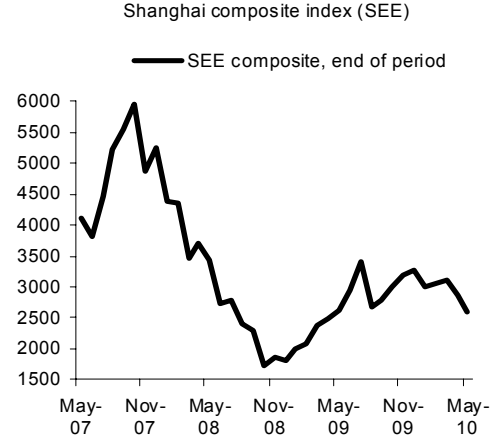


Figure 4

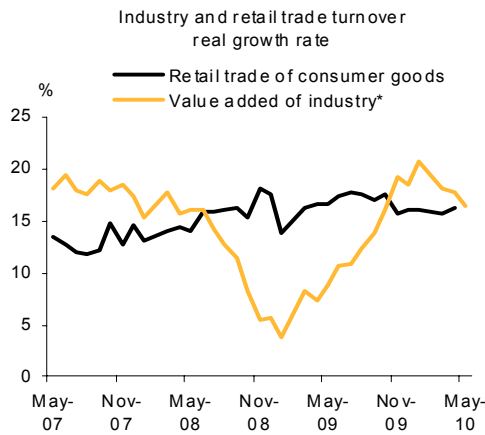


Figure 5

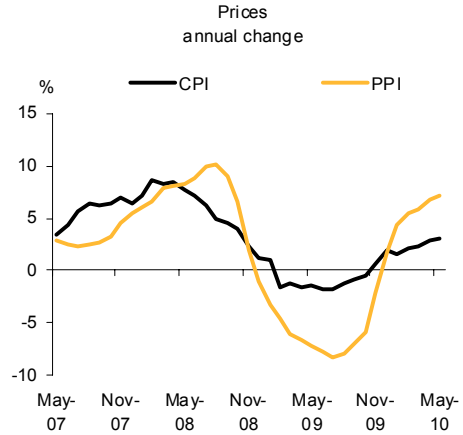
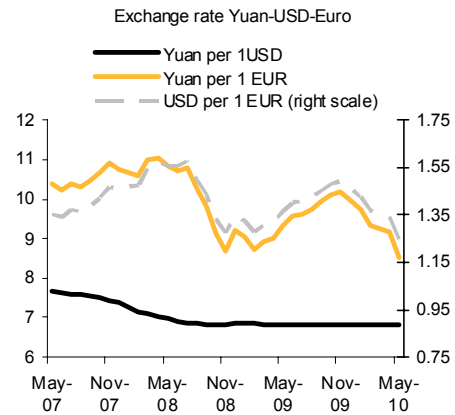


Figure 6



Figure 7



Note: * Includes only enterprises with annual sales revenue of over yuan 5 million (euro 560,000).

Source: National Bureau of Statistics, China Monthly Statistics, iiw calculations.

increases in other companies of the branch, as automakers and suppliers have similar wages nationwide and profits in China's auto industry are relatively high compared to mature markets, leaving a certain room for increasing workers' benefits. Further on, the quest for higher wages is already spreading to other sectors, as the Chinese labour market is currently dried up in the industrial hubs of eastern China, for skilled as well as unskilled personnel. In the first week of June, for instance, Foxconn, a large Taiwan-funded contract electronics manufacturer, which has been in the news recently because of a string of suicides among its workers, raised wages by 30% and announced it would give its labourers in Shenzhen a second pay rise in October this year, which would push up wages by 65% altogether. Immediately after hearing about the Foxconn pay rise, thousands of workers from another big Taiwan-based electronics factory, Merry Electronics, in Shenzhen went on strike for higher pay as well. Similar walkouts have been reported in the provinces of Yunnan, Henan, Gansu, Shandong, Jiangsu and Shanghai over the past few weeks.⁶

The Honda strike was a landmark event also from a political point of view. It was extensively covered in the official media and the wage negotiations took place directly between the Honda management and elected workers' representatives, circumventing official trade union representatives (independent trade unions are forbidden in China), which is a sign of the government's support of the action. One reason for this could be the government's increasing awareness that low-paid workers, in particular second-generation migrant workers, represent a major potential source of social unrest, which could be partly mitigated by adequate pay rises. But higher wages are also an important step towards a more consumer-driven economy. Further on, there are certain signs that collective bargaining, which is stipulated in China's new Labour Law of 2008, will become more common now. The era of a declining proportion of GDP going to wages, which began more than 20 years ago, is probably coming to end now.⁷

For foreign investment enterprises targeting the global market, increasing wages translate into rising production costs and could become a reason to leave China (e.g. for Vietnam, Bangladesh, Laos), particularly in branches where margins are already very low as in apparel and footwear. But companies producing for the Chinese market, such as automotives, will be compensated and attracted respectively by the larger market potential. Judging from provisional data on foreign direct investment in the first quarter of this year, based on investments in the non-financial sector only, the inflow of FDI rose by about 8%

⁶ See *China Daily*, 3 June 2010.

⁷ 14 Provinces and regions have already raised minimum wages this year, with the highest by more than 20%.

(measured in USD) compared to the same period of last year, after remaining more or less constant in 2009.

Inflation – a rising concern

After a period of deflation, prices started to rise at the end of last year. During the first months of 2010, inflation accelerated significantly and in May consumer prices were 3.1% higher than in the same period of 2009. Producer prices increased even faster, to 7.1% above the previous year's level, hinting at further price rises for final goods in the future (see Figure 5). One major factor behind this development are soaring food prices because of an extreme drought in the southwest of China, but rising costs for housing, raw materials (oil!) and wages as well. There is also widespread concern that the official CPI underestimates the actual rise in living costs.

Foreign trade above pre-crisis levels again

After expanding vigorously, Chinese exports have surpassed pre-crisis levels already in December 2009 and then again in May this year (see Figure 6). Imports rose even faster, and in March 2010 China reported a monthly trade deficit for the first time in years. In the first quarter of this year, exports rose by 21% and imports by 55% as against the same period last year. However, in April and May, the growth rates of exports and imports converged and the trade deficit turned into a substantial surplus again. Nevertheless, because of the much faster growth of the Chinese economy compared to those of its major trading partners, we expect the trade surplus and the current account surplus to be significantly smaller than last year and in the years prior to the crisis. The recent restrictions by the Chinese government on exports of highly energy-intensive and polluting products such as steel plates, aluminium products and fertilizers will have a certain dampening effect as well.

More flexibility for the yuan's exchange rate

On 19 June 2010, the People's Bank of China (PBOC) announced that it will enhance the flexibility of China's currency by abandoning the dollar peg. The announcement came one week in advance of the G20 meeting in Canada, where global imbalances and also the role of the Chinese currency in this context should be discussed. However, the PBOC ruled out a one-off revaluation of the yuan and advocates a system of managed float similar to that in the period between mid-2005 and mid-2008, reflecting market supply with reference to a basket of currencies, but moving within a narrow band ($\pm 0.5\%$ per day). Between 2005 and 2008, the yuan had appreciated at about 20% in terms of US dollar.

The system would also allow greater flexibility of the yuan's exchange rate to the euro, which has fluctuated strongly in recent times because of the dollar peg (see Figure 7). The expected gradual revaluation of the yuan will have only a moderate impact on the development of the Chinese economy in the short run. By making Chinese exports more expensive and imports relatively cheaper, it could reduce China's current account surplus and dampen GDP growth and employment to a certain extent and will at the same time help to curb inflation and rein in excess liquidity. But the impact on the current account is not certain due to the high import content of Chinese exports and will partly depend on price elasticities and the price policy of Chinese exporters. In a longer-term view, it will reduce the country's reliance on external demand, support the upgrading of the country's industry and make Chinese investments abroad easier.

Strong growth of industrial production

In the first quarter of this year, industrial value-added expanded at a rate of 14.5% as comparable to the boom year 2007. But comparisons in the first quarter are flattered by depressed year-earlier levels. We therefore expect the growth rates to decline in the months to come and the average growth rate for 2010 to reach about 9.5%. A certain deceleration of growth is already visible in Figure 4, presenting growth rates of value-added for large enterprises until May 2010.

Table CN

China: Selected Economic Indicators

| | 2006 | 2007 | 2008 | 2009 ¹⁾ | 2009 1st quarter | 2010 1st quarter | 2010 | 2011 | 2012 |
|---|---------|---------|---------|--------------------|---------------------|---------------------|----------|-------|-------|
| | | | | | | | Forecast | | |
| Population, mn pers., end of period | 1314.5 | 1321.3 | 1328.0 | 1335.0 | . | . | 1342 | 1349 | 1356 |
| Gross domestic product, CNY bn, nom. | 21192.4 | 25730.6 | 31405.0 | 33535.3 | 6574.0 | 8057.7 | 38000 | 42900 | 48100 |
| annual change in % (real) | 11.6 | 13.0 | 9.6 | 8.7 | 6.1 | 11.9 | 9.5 | 9.5 | 10 |
| GDP/capita (EUR at exchange rate) | 1600 | 1900 | 2300 | 2600 | . | . | . | . | . |
| GDP/capita (EUR at PPP - wiiw) | 3900 | 4500 | 4900 | 5200 | . | . | . | . | . |
| Retail trade turnover, CNY bn | 7641.0 | 8921.0 | 10848.8 | 12534.3 | 2939.0 | 3637.0 | . | . | . |
| annual change in % (real) | 13.8 | 13.0 | 15.7 | 16.7 | 15.8 | 15.7 | 17.5 | 17 | 16 |
| Total investment in fixed assets, CNY bn | 10999.8 | 13732.4 | 17282.8 | 22500 | 2812.9 | 3532.0 | . | . | . |
| annual change in % (nominal) | 23.9 | 24.8 | 25.9 | 30.1 | 28.8 | 25.6 | 25 | 23 | 20 |
| Industrial value added | | | | | | | | | |
| annual change in % (real) | 12.9 | 14.9 | 9.5 | 9.5 | 5.3 | 14.5 | 9.5 | 10 | 11 |
| Agricultural value added | | | | | | | | | |
| annual change in % (real) | 5.0 | 3.7 | 5.5 | 4.2 | 3.5 | 3.8 | . | . | . |
| Construction value added | | | | | | | | | |
| annual change in % (real) | 13.7 | 12.8 | 7.1 | 9.5 | . | . | . | . | . |
| Employment total -reg., mn, end of period | 764.0 | 769.9 | 774.8 | 767.0 | . | . | 770 | 778 | 784 |
| annual change in % | 0.8 | 0.8 | 0.6 | -1.0 | . | . | 0.3 | 1.0 | 0.8 |
| Staff and workers, mn, end of period ²⁾ | 111.6 | 114.3 | 115.2 | 115.1 | 113.6 | . | . | . | . |
| annual change in % | 2.9 | 2.4 | 0.8 | 0.4 | 0.6 | . | . | . | . |
| Reg. unemploy.rate (urban), in %, end of per. ³⁾ | 4.1 | 4.0 | 4.2 | 4.3 | . | . | 4.3 | 4.2 | 4.2 |
| Average gross annual wages, CNY ⁴⁾ | 21001 | 24932 | 29229 | 33029 | 29800 | . | . | . | . |
| annual change in % (real) ⁵⁾ | 12.7 | 13.6 | 11.0 | 14.1 | 14.0 | . | . | . | . |
| Consumer prices, % p.a. | 1.5 | 4.8 | 5.9 | -0.7 | -0.6 | 2.2 | 3.5 | 3 | 2 |
| Producer prices in industry, % p.a. | 3.0 | 3.1 | 6.9 | -6.4 | -4.6 | 5.2 | . | . | . |
| General government budget, nat.def., % GDP | | | | | | | | | |
| Revenues | 18.3 | 19.9 | 19.5 | 19.8 | . | . | . | . | . |
| Expenditures | 19.1 | 19.3 | 19.9 | 22.8 | . | . | . | . | . |
| Deficit (-) / surplus (+) | -0.8 | 0.6 | -0.4 | -3.0 | . | . | -2.8 | -2.0 | -1.0 |
| Public debt, nat.def., in % of GDP ⁶⁾ | 16.5 | 20.2 | 16.9 | 24 | . | . | . | . | . |
| Base rate of NB % p.a., end of period ⁷⁾ | 3.3 | 3.3 | 2.8 | 2.8 | 2.8 | 2.8 | . | . | . |
| Current account, EUR bn | 198.8 | 271.4 | 289.5 | 213.1 | . | . | 150 | 250 | 300 |
| Current account in % of GDP | 9.4 | 11.0 | 9.4 | 6.1 | . | . | 3.7 | 5.2 | 5.2 |
| Exports of goods total, EUR bn ⁸⁾ | 771.0 | 888.9 | 971.9 | 864.9 | 188.1 | 228.3 | 950 | 1140 | 1330 |
| annual change in % | 26.5 | 15.3 | 9.3 | -11.0 | -7.7 | 21.3 | 10 | 20 | 17 |
| Imports of goods total, EUR bn ⁸⁾ | 629.7 | 697.8 | 769.4 | 724.3 | 140.4 | 217.8 | 820 | 990 | 1130 |
| annual change in % | 19.3 | 10.8 | 10.3 | -5.9 | -20.2 | 55.2 | 13 | 21 | 14 |
| Trade balance of goods, EUR bn ⁸⁾ | 141.2 | 191.1 | 202.5 | 140.6 | 47.8 | 10.5 | 130 | 150 | 200 |
| Exports of services, BOP, EUR bn | 73.2 | 89.2 | 99.9 | 88.6 | . | . | . | . | . |
| annual growth rate in % | 23.0 | 21.9 | 12.0 | -11.4 | . | . | . | . | . |
| Imports of services, BOP, EUR bn | 80.2 | 95.0 | 108.0 | 101.2 | . | . | . | . | . |
| annual growth rate in % | 19.7 | 18.4 | 13.7 | -6.3 | . | . | . | . | . |
| FDI inflow, EUR bn ⁹⁾ | 62.1 | 101.0 | 100.4 | 65 | 16.7 | 16.9 | 71 | . | . |
| FDI outflow, EUR bn ⁹⁾ | 16.8 | 12.4 | 36.3 | 43 | . | . | . | . | . |
| Gross reserves of NB excl. gold, EUR bn | 810.0 | 1038.2 | 1384.0 | 1665.2 | 1468.6 | 1815.7 | . | . | . |
| Gross external debt, EUR bn | 245.4 | 253.8 | 266.5 | 268.5 | . | . | . | . | . |
| Gross external debt in % of GDP | 12.1 | 11.0 | 8.3 | 7.9 | . | . | . | . | . |
| Average exchange rate CNY/USD | 7.972 | 7.604 | 6.945 | 6.831 | 6.836 | 6.827 | 6.6 | 6.4 | 6 |
| Average exchange rate CNY/EUR | 10.019 | 10.418 | 10.223 | 9.526 | 8.923 | 9.457 | 9.2 | 9.0 | 8.4 |
| Purchasing power parity CNY/USD, wiiw ¹⁰⁾ | 3.462 | 3.615 | 3.943 | 3.828 | . | . | . | . | . |
| Purchasing power parity CNY/EUR, wiiw ¹⁰⁾ | 4.149 | 4.348 | 4.820 | 4.808 | . | . | . | . | . |

Note: CNY: ISO code for the Chinese yuan.

1) Preliminary. - 2) Staff and workers (on duty) refer to all persons working in government agencies, political and party organizations, social organizations, enterprises and institutions. - 3) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 4) Average gross annual wages of staff and workers, defined as: total wages of staff and workers on duty per average number of staff and workers on duty. - 5) Staff and workers cost of living index is used as a deflator for calculating real wage. For 2009 the consumer price index was used as a deflator. - 6) Central government debt only. - 7) Overnight rate. - 8) According to customs statistics. - 9) Net investments drawn from the Chinese balance of payments. Data for 2009 and 2010 are gross equity investments in the non-financial sector as given by the Chinese Ministry of Commerce. - 10) wiiw estimates based on the 2005 International Comparison Project benchmark (World Bank).

Source: National statistics (National Bureau of Statistics, Central Bank, China Daily etc.). Forecasts by wiiw.