



China Report

The Vienna Institute for International Economic Studies (WIIW)

CHINESE ECONOMY DRAWN BY DOMESTIC AND EXTERNAL FORCES

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 2002

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In the first half of 2002, the Chinese economy developed better than expected. The downward trend prevailing in the second half of 2001, due to the downswing of the world economy, has reversed and GDP rose by 7.8% in the first six months of the year as compared to 7.3% over the whole year 2001. Growth was driven by exports as well as domestic demand, in particular investment. For the second half of the year we expect the positive development to continue and thus GDP growth over the whole year 2002 to be higher than last year, probably reaching 7.7%.

Key developments in the first two quarters 2002

GDP rose 7.6% in the first quarter and 8% in the second quarter of 2002, after only 6.6% in the last three months of 2001. The accelerating growth of the overall economy was largely supported by a surge in exports, due to the recovery of the world economy. Chinese *exports* increased by 9.9% in the first quarter and by 14% over the first half of the year – compared to only 6.8% over the whole year 2001. The *trade surplus* in June reached USD 13.6 billion, i.e. USD 5.4 billion more than in the same period a year earlier. Domestic demand too developed fast, with *investment* accelerating strongly and reaching a growth rate of 19.6% in the

first quarter and of 21.5% in the first six months of this year (compared to 15.1% in the first half of 2001). This was due to public investment mainly, but private investment took an important share as well. *Foreign direct investment* remained strong, striking USD 24.6 billion by the end of June 2002. *Retail trade turnover* as a proxy for consumer demand developed at a fast and quite stable pace, expanding at a rate of 10.2% in real terms (against 10.8% in the same period a year earlier).

On the supply side, *industrial production* and *services* benefited from the general revival of demand and value added in both sectors and accelerated significantly from the first to the second quarter of the year. However, the expansion of the services sector remained again below the growth rate of GDP, reflecting the structural weakness of that sector in China. Growth in the *primary sector* was higher in the first than in the second quarter when the output of summer grain fell below last year's level (-2.9%), due to unfavourable weather conditions.

Prospects for the second half of the year

As a matter of fact, GDP in the first half of the year expanded at a similar pace as in the first half of

2001 (7.8% compared to 7.9%). Regarding the second half of this year, we face a rather stable domestic demand but again a slow down of the global economy which, however, is expected milder than last year's slump and thus will have a less negative impact on the Chinese economy. We therefore expect GDP to grow at approximately 7.6% during the second half of the year (compared to only 6.7% in the second half of 2001). As a result, GDP for the whole year 2002 is expected to rise by 7.7%, considerably faster than last year.

Beginnings of a new investment cycle?

Total *investment in fixed assets* in the first half of 2002 reached yuan 1446.2 billion (USD 174.7 billion), up 22% year-on-year. Although public investment still took the lead, private investment showed great vigour, too, especially if compared to the very weak investment from this side in China for more than three years now. Among the total, the fixed asset investment completed by state-owned enterprises rose 24.4%, collective investment was up 15.8% and individual investment up 19.4%.¹ In the first half of 2001, public investment had expanded by 17.9% while collective and individual investment together had gone up 7.5% only.² In order to finance investment in infra-structure, which is considered an important instrument to support overall economic growth, the government has again issued treasury bonds worth yuan 150 billion (USD 18.1 billion), the same amount as last year, but yuan 30 billion more than in previous years, following the Asian Financial and Economic Crisis of 1997.

Regarding the target of investment³, similar to last year, investment in 'real estate development' increased fastest (32.9%). This was due to a large extent to the private housing market expanding rapidly since the reform of the 'welfare housing distribution system' in 1998.⁴ But contrary to 2001, investment in new projects ('capital construction investment') grew faster (23.0%) than investment in projects to modernize and replace existing assets ('technical updating and transformation', 16.1%). This points to the beginning of a new 'investment

cycle', independent of capital injections by the government – probably induced by China's entry into WTO and further acknowledgement of the private sector's position by the Chinese government.

Also, most interestingly, investment in the *primary sector* reversed the declining trend, showing an impressive increase of 25.6%; investment in the *secondary* and *tertiary industry* rose 25% and 23.8% respectively. With regard to the regional distribution of investment, in particular the *central provinces* showed a higher increase of investment (26.7%) than either the more advanced *eastern provinces* (22.9%) or the more backward *western regions* (20.9%),⁵ probably induced by both, a declining rate of return on investment in the advanced coastal provinces and the so-called 'Go West' strategy which is part of the Tenth Five-Year Plan 2001-2006, geared to improve the infrastructure and to support private investment in China's less developed hinterland.

For the reasons given above, we expect private and public investment to stay strong for the rest of the year 2002.

Foreign direct investment continues to rise strongly

The inflow of foreign direct investment (FDI) was 19% higher than in the first half of 2001. Contracted FDI rose even faster, by 31.5%, indicating a further strong increase of foreign capital inflow in the future. Noticeably, according to a survey of chief executives and chief financial officers conducted by the international consultancy AT Kearney, China has recently overtaken the US as the world's most appealing destination for foreign investment.⁶

The FDI inflow of the major investors (Hong Kong, the United States, Japan, EU) developed less dynamically than from some 'second-tier' investors such as Taiwan (+48%), Korea (+34%) or Singapore (23.9%). Also, investment coming from some, so far minor investors in the region such as the Philippines (40.4%) and Malaysia (74.9%) rose

very fast. Obviously, China is establishing itself as a centre of economic gravity in (South) East Asia, and WTO membership has probably also helped to foster investors' confidence.

The total stock of FDI (including reinvestment) reached USD 420 billion by the end of June 2002. Foreign affiliates in 2001 accounted for 23% of the country's total industrial value added, 18% of tax revenues and 48% of total exports.⁷

Foreign trade picking up fast

Exports expanded by 14.2% in the first six months of 2002, compared to only 8.8% in the same period a year earlier and 6.8% over the whole year of 2001. This surge was supported by the stronger than expected recovery of the world economy since the turn of the year, in particular of the US and some Asian countries, but probably to some extent by China's accession to the World Trade Organization (WTO) as well. Exports to the US expanded by 19.3%, to the ASEAN countries by 22.2% but to the EU by only 6.1%. Interestingly, exports to countries which have been minor trading partners of China so far has particularly surged, probably as a direct consequence of WTO membership: India (24.3%), Iran (33.5%), Turkey (29.9%), United Arab Emirates (33.9%) and Russia (25.9%).

Trade balance improved despite WTO entry

Contrary to the expectation of most economists, Chinese *imports* have risen *less than exports* since China's entry into WTO at the beginning of 2002, and the *trade balance* thus has improved instead of deteriorating. In the first six months, imports increased by 10.3%, which is also less than the rise of imports in the same period a year earlier (14.0%).⁸ Nevertheless, Chinese imports have accelerated during the first six months of 2002, reaching a growth rate of (only) 5.2% in the first quarter, and the upward trend still continues.⁹ Given the fact that a large proportion of Chinese exports consists of processed imports, we might

expect a continuation of the export boom in the second half of 2002. (In the first half of the year, among total exports, processing trade grew faster, +15%, than general trade, +12.5%).¹⁰ Machinery and electronic exports were rising particularly fast.

Beyond doubt, the surprisingly high trade surplus was a major factor behind the better than expected development of the Chinese economy in the first half of 2002.

The high trade surplus also pushed up the *current account* balance, which for the first six months showed an even higher surplus of USD 13.6 billion than for the same period a year earlier (USD 5.1 billion), again contrary to what most experts had expected at the beginning of the year.¹¹

Foreign reserves reach record height

Fuelled by the surplus on the current account and the large inflow of foreign direct investment, *foreign exchange reserves* have further increased to reach USD 242.8 billion by the end of June, up 34% year-on-year and worth nearly 12 months of imports now.

Deterioration of the global economy

However, the pace of recovery of the global economy has started to slow down by the middle of 2002 (except in the emerging markets in Asia) and since July the business outlook for the USA and Europe has deteriorated significantly. The recovery is still expected to continue, but global growth in the second half of the year will be weaker than anticipated. Yet, given the deep slump in the second half of 2001, year-to-year growth rates may still be substantial. In these circumstances and taking into consideration that Chinese imports, which represent a kind of forward-looking indicator for exports, are still on the rise, we may thus expect the growth of Chinese foreign trade to remain strong and the trade balance to widen further in the second half of the year.

Private consumption stable, household savings increasing strongly

In nominal terms, the expansion of *retail trade turnover* as a proxy for consumer demand was significantly slower in the first six months of 2002 (8.6%) than in the same period a year earlier (10.3%). But as the deflationary pressure in retail trade has worsened since last year, *real* consumer demand increased at a rather similar pace in both periods (10.8% and 10.2% respectively).

Price *deflation*, which is typically linked to a low or negative growth of the overall economy, is a very obstinate phenomenon plaguing the country for more than four years now, despite China being probably the world's fastest growing economy. It is due mainly to an oversupply of light industrial products (electrical appliances, clothing etc.) probably because of delayed restructuring. (Prices for services, for instance, rose by 1.4%.) A certain pressure also came from low oil prices and lower prices for raw materials as a consequence of WTO membership. On the demand side, however, rising income inequalities and a cautious consumer attitude in view of various economic and social uncertainties hamper sales. In the first half of the year, the income gap between urban and rural households has further widened, with rural per capita incomes now reaching 28% of urban per capita incomes only (yuan 1123 and yuan 3942 per year, respectively). The rural population comprises two thirds of the total but rural consumption accounts for one third of consumption only.¹² Surprisingly, the stepwise increase of low salaries of government employees and the substantial rise of the average wage level in public enterprises of 16.7% nominally in the first half of the year, had no significant stimulating effect on the turnover of retail trade, and price deflation even accelerated. One explanation is the strong rise of household savings (17.4%) now reaching more than yuan 8 billion (USD 1 billion). Another reason could be that a growing share of incomes is spent on (private) housing, due to the housing reform, which is also reflected in the real estate boom mentioned earlier.

So far the declining trend of prices is expected to continue for a period of time – unless interrupted by a sharp increase in world oil prices.

In order to stimulate spending (especially for cars and housing), the People's Bank of China (PBO) has reduced the refinancing rate from 3.2% to 2.7% in February 2002.

Industrial production expanding strongly, SOEs catching up

Driven by increases in investment, exports and consumption, value added of the industrial sector accelerated and rose significantly faster than overall GDP, with state-owned enterprises taking a rising share. A breakdown of the growth rates according to ownership for the first six months of the year, only available for enterprises with annual sales of more than yuan 5 million, shows the following picture: state-owned enterprises (SOEs): 10.8%, collective-owned enterprises: 8.3%, partnership and joint ventures: 10.8%, share holding enterprises: 13.0%, foreign invested enterprises (FIEs): 12.2%. Although FIEs and share holding enterprises are still growing faster than SOEs, the gap has significantly narrowed throughout this year.¹³ Probably the SOE reform is now beginning to bear fruits. There is also some indication that the employment decline in SOEs starts to stabilize: According to official figures, the number of laid-off workers stood at 4.64 million in June, a drop of 510,000 from the beginning of this year. But unemployment is still the biggest unresolved and most serious problem in China. However, no reliable data exist in this field. The official unemployment rate of 3.6% refers to *registered urban unemployment*, which is known to be a small fraction of the actual overall unemployment rate only. Moreover, 'hidden unemployment' or 'underemployment' in the agricultural sector reaches significant levels as well.

Given the size of the Chinese economy and the rather stable domestic demand, we conclude that

the expected slowdown of the global economy will only have a moderate dampening impact on the overall economic development in China in the second half of 2002. However, lower profits, declining orders for exports and negative expectations may lead to weaker private investment and production growth in the first half of 2003.

Notes

- ¹ *China Monthly Statistics*, 6/2002, p. 2 of the 'Report'.
- ² *China Monthly Statistics*, 6/2001, p. 1 of the 'Report'. No breakdown in collective and private enterprises is given.
- ³ The more detailed data quoted below refer to investment excluding urban and rural collectives and individuals, which reached yuan 1110 billion (USD 134 billion) in the first half of 2002, increasing by 24.4%, somewhat faster than total investment.
- ⁴ For details see 'Private housing a key factor of consumer demand', *WIIW China Report*, 2001/1, pp. 4 and 5.
- ⁵ Coastal provinces: Liaoning, Beijing, Tianjin, Hebei, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong, Guangxi, Hainan. Central provinces: Shanxi, Inner Mongolia, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan. Western provinces: Xinjiang, Qinghai, Gansu, Ningxia, Shaanxi, Yunnan, Guizhou, Sichuan, Tibet (Xizang).
- ⁶ *China Economic Review*, October 2002, p. 1.
- ⁷ Foreign Trade Statistics published by the Chinese Ministry of Foreign Trade and Economic Co-operation (MOFTEC), quoted in: United Nations Conference on Trade and Development, *World Investment Report 2002*, p. 56.
- ⁸ In particular the experts' expectations that imports of agricultural products would rise rapidly and harm the agricultural sector in China, have not materialized. In the first five months of 2002, exports of farm produce rose by 6% year-on-year, and imports dropped by 6% on a year-on-year basis (*China Daily*, 19-20 October 2002, p. 4).
- ⁹ Nevertheless, imports of certain product groups shot up when tariffs went down as a result of China's WTO entry, e.g. automobiles. According to the China Trading Center for Automobile Imports, 39,405 vehicles were imported during the first five months of 2002, compared to 72,000 in the whole year 2001.
- ¹⁰ *China Monthly Statistics*, /6/2002, p. 2 of the 'Report'.
- ¹¹ *China Daily*, 18 October 2002. Starting with last year, China's Current Account is published twice a year by the State Administration of Foreign Exchange (SAFE).
- ¹² In fact, rural incomes rose somewhat faster than in the last couple of years, probably as a result of the 'tax for fees' reform implemented by the central government to curb the widespread exploitation of farmers by the local authorities. However, in addition to the low incomes in rural areas, the backwardness of the infrastructure, the high prices for electricity and the low quality of telecommunication facilities are holding back consumption. In the first six months of 2002, urban retail sales rose by 9.7%, rural sales by 6.7% (in nominal terms).
- ¹³ In the first half of the year 2000, value added of SOEs increased by 9.8%, that of FIEs by 14.6%. In 2001 the respective growth rates were 9.5% and 13.5%. (*China Monthly Statistics*, various issues)

Table CN

China: Selected Economic Indicators

	1990	1995	1998	1999	2000	2001 ¹⁾	2001 Jan-Jun	2002 Jan-Mar	2002 ¹⁾ Jan-Jun	2002 forecast
Population, mn pers., end of period	1143.3	1211.2	1248.1	1259.1	1265.8 ²⁾	1277.3				
Gross domestic product, CNY bn, nom.	1854.8	5847.8	7834.5	8191.1	8940.4	9593.3	4294.2	2102.0	4553.6	
annual change in % (real)	3.8	10.5	7.8	7.1	8.0	7.3	7.9	7.6	7.8	7.7
GDP/capita (USD at exchange rate)	339.1	578.2	758.1	785.7	853.0	907.1				
GDP/capita (USD at PPP - WIIW)	1307.8	2638.2	3447.0	3717.5	4082.6	4444.25				
Industrial value added										
annual change in % (real)	3.2	13.9	9.2	8.8	9.9	8.9	9.7	9.3	9.6	
Agricultural value added										
annual change in % (real)	7.3	5.0	3.5	2.8	2.4	2.5	2.4	3.3	2.6	
Services value added										
annual change in % (real)	2.3	8.4	7.6	6.9	7.8	7.0	7.0	6.2	6.6	
Goods transport, bn t-km	2620.7	3573.0	3804.6	4049.6	4445.2	4535.8	2226.3	1102.1	2319.7	
Total investment in fixed assets, CNY bn ³⁾	451.7	2001.9	2840.6	2985.5	3291.8	3689.8	1189.9	467.2	1446	
annual change in % (nominal)	2.4	17.5	13.9	5.1	10.3	12.1	15.1	19.6	21.5	
Construction output, CNY bn	194.8	950.5	1374.1	1515.1	1678.1					
annual change in % (nominal)	-10.2	23.6	10.3	10.3	10.8					
Employment total, mn pers., end of period	567.4	679.5	699.6	705.9	711.5					
annual change in %	2.6	1.1	0.5	0.9	1.0					
Unemployed (urban) reg., th, end of period	3832	5196	5710	5750	5950.0					
Unemployment rate (urban) in %, end of per. ⁴⁾	2.5	2.9	3.1	3.1	3.1	3.6				
Average gross annual wages, CNY ⁵⁾	2140	5500	7479	8346	9371	10962	9511	11158	11103	
annual change in % (real) ⁶⁾	9.2	3.8	7.2	13.1	11.1					
Retail trade turnover, CNY bn	725.0	2062.0	2915.3	3113.4	3415.3	3759.5	1791.5	1003.5	1944.84	
annual change in % (real)	0.4	12.0	9.4	10.1	11.1	10.9	10.8	10.0	10.2	
Retail prices, % p.a.	2.1	14.8	-2.6	-3.0	-1.5	-0.8	-0.5	-1.6	-1.6	
Consumer prices, % p.a.	3.1	17.1	-0.8	-1.4	0.4	0.7	1.1	-0.6	-0.8	
General government budget, CNY bn										
Revenues	293.7	624.2	987.6	1144.4	1339.5	1637.1				
Expenditures	308.4	682.4	1079.8	1318.8	1588.6	1884.4				
Deficit (-) / surplus (+)	-14.6	-58.2	-92.2	-174.4	-249.1	-247.3				
Money supply, CNY bn, end of period										
M0, Currency outside banks	264.1	788.5	1120.4	1345.6	1465.3	1568.9	1394.3	1554.5	1509.74	
M2, Money + quasi money	1468.2	5823.0	10449.9	11989.8	13461.0	15830.2	14781.0	16406.5	16960.1	
Refinancing rate of NB % p.a., end of period ⁷⁾	7.9	10.4	4.6	3.2	3.2	3.2	3.2	2.7	2.7	
Current account, USD bn	12.0	1.6	31.5	15.7	20.5	17.4	5.1		13.6	
Official forex reserves excl. gold, USD bn	11.1	73.6	145.0	154.7	165.6	212.2	180.8	227.6	242.8	
Gross debt, USD bn	52.5	106.6	146.0	151.8	145.7	170.1				
Foreign direct investment, USD bn	3.5	37.5	45.5	40.3	40.7	46.9	20.7	10.1	24.6	52.0
Exports total, USD bn	62.1	148.8	183.8	194.9	249.2	266.2	124.6	64.7	142.1	
annual change in %	18.2	22.9	0.5	6.1	27.8	6.8	8.8	9.9	14.2	
Imports total, USD bn	53.4	132.1	140.2	165.8	225.1	243.61	116.4	57.4	128.5	
annual change in %	-9.8	14.2	-1.5	18.2	35.8	8.2	14.0	5.2	10.3	
Trade Balance, USD bn	8.7	16.7	43.6	29.1	24.1	22.5	8.2	7.3	13.6	
Average exchange rate CNY/USD	4.78	8.35	8.28	8.28	8.28	8.28	8.28	8.28	8.28	8.28
PPP (CNY/USD), WIIW ⁸⁾	1.24	1.83	1.82	1.75	1.73	1.69				

CNY: ISO-Code for the Chinese yuan.

Notes: 1) Preliminary. - 2) Census results from 1 Nov. 2000. - 3) 1990 excluding projects with a value of 20,000-50,000 yuan which are not listed in the state plan. - 4) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 5) Average gross annual wages of staff and workers, defined as: total wages of staff and workers per average number of staff and workers; since 1998: 'staff on duty' only. - 6) Staff and workers cost of living index is used as deflator for calculating real wage. - 7) Overnight rate. - 8) Purchasing power parity, ICP-method; see Ren Ruoan, 'The size of the Chinese economy', *The Vienna Institute Monthly Report*, 1996/2.

Sources: China Statistical Yearbook; International Financial Statistics; Economic Statistics Communiqué for 1995 of the State Statistical Bureau of the PR China; China Financial Outlook of the People's Bank of China; China Monthly Statistics; China Daily.

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