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New challenges for China
Rural growth in focus

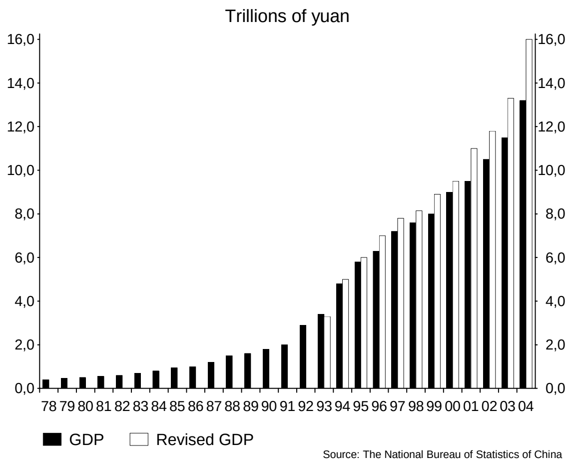
This is a personal travel report from a week-long visit in Beijing and Shanghai, on the eve of the Peoples' Congress and the new five-year plan.

- **The Chinese juggernaut keeps rolling along. Economic growth and trade are breaking records, while inflation remains low.**
- **The challenge now is increase the *quality* of growth – i.e. to make it more environmentally friendly and to spread its rewards to backward areas of the country.**
- **This is the main goal of the new Five Year Plan.**

A visit to the Middle Kingdom always leaves me dazzled. The breakneck speed, the vitality, the immensity of the challenges – every time I go back to Sweden I feel small and humbled. In particular, Shanghai is becoming strikingly more attractive, with the patching-up of city parks, planting of trees, new fascinating high-rises and spectacular projects, the latest being the construction of the world's largest deep-sea port, connected to Pudong via (of course) the world's longest trans-oceanic bridge.

To an SEB employee, Shanghai's attractiveness is further increased by our brand-new branch office on the 31st floor of a smart skyscraper with spectacular views of the city, just above the People's Park, with the city hall, the concert hall, the Shanghai museum and the urban exhibition hall just beneath the panoramic windows. And on the other side of the office, a small, beautiful park with lively throngs of elderly Chinese singing and playing games is flanked by a new Porsche store and by a big sign asking the visitors (literally) "kindly not to urinate or shit" in the park. China remains a country of glaring contrasts…

Graph 1: GDP level
GDP according to old and new national accounts, CNY trillion



Continued rapid growth
Some years ago, pessimists claimed China was in for a hard landing because of over-

investment. I didn't believe it then, and by now it is obvious that this gloomy prediction was totally wrong. If anything, **the economy seems more balanced now**. Domestic demand is playing a larger role than before, and the service sector is a growing part of the economy. Inflation is low.

Last year, a new system of national accounts revised the GDP level in 2004 upward by 17 per cent. Growth in previous years had clearly been understated. In 2004, growth now seems to have been above 10 per cent, and the preliminary estimate for 2005 is almost as high. One obvious conclusion is that the **potential annual growth rate for the past 5-10 years has been 9 per cent** rather than the previously assumed 8. The brunt of the revision fell on the service sector, which increased its share of GDP. But anyone who has been to China and seen the bustling small commerce in the streets surely must be convinced that the new numbers also fail to fully account for the informal sector in the Chinese economy.

I am positive that China can maintain its rapid pace of growth for at least a few more years. A mild cyclical slowdown is likely in 2007, but infrastructure projects, private consumption, net exports and investment all indicate continued strong growth. To a visitor, infrastructure growth is the most astounding change, with high-speed trains, freeways and telecom networks sprawling ever further inland.

A financial dwarf

Of course there are problems. The financial sector remains an unproductive dwarf. The stock exchange remains illiquid, with two thirds of listed companies being state-owned with meagre liquidity. The bond market is still in its infancy. The banks are still plagued by non-performing loans and a poor credit culture. The currency remains pegged and non-convertible. Interest rates are artificially low, which means that capital costs are too low and capital waste, consequently, is rampant.

But **the financial sector is gradually being reformed**. The total amount of non-performing loans is coming down in the big banks, while foreign (minority) ownership and IPOs are levers which the authorities are using in order to put pressure on management to modernise. Pension reforms and pension funds are on their way – and with them a bond market. And more and more loopholes are being opened up for trade in foreign exchange markets as authorities test the waters – in quite clever ways – for a freer future currency market.

A **deep financial crisis thus seems more unlikely now** than only a couple of years back. But even if such a crisis were to come, it is difficult to see it leading to major disruptions in the real economy. Firstly, a depositors' guarantee protects households and should prevent a run on the banks, and secondly – if worse comes to worst – the government is sitting on a huge pile of cash (FX reserves are getting close to USD 1,000 billion) which gives them sufficient means to bail out any bank problem.

Not a level playing field

No, there are other – worse – problems. I found it striking this time to hear Western companies complaining more – not less – than before about red tape and unfair practices. **The business climate does not seem to be improving** at the pace envisaged by Western companies or promised in the WTO treaty.

The graph below is from a recent study made by the Swedish Embassy in Beijing and the Swedish Chamber of Commerce in China. More companies were represented in this survey, their number of employees had increased by almost 20 per cent since the previous year, and revenues had grown sharply – by almost 40 per cent in one year. All this reflects the strength of the Chinese economy and the successes of Swedish companies in China. Nevertheless, Swedish complaints about unfair business practices in China also increased.

Table 1: Trade and investment complaints from Swedish companies in China, 2004
Share of companies that have complaints

	Per cent
Trade procedures	38
Trading rights	33
Intransparent government	31
Payment delays	29
Intellectual property rights	25
Tariffs	24
Local standards	23
Distribution regulations	22
Unfair competition	21

Source: Swedish Embassy, Beijing

Complicated and time-consuming import-export procedures have become an even greater barrier to expansion in China. Authorities are viewed as bureaucratic and slow – and some European business people I met actually suspected that this treatment by the authorities was deliberate, so as to put foreign companies at a disadvantage. Also, problems with **trading rights** seem to have worsened, which means that China is not adhering to its promised timetable of WTO reforms. According to the European Chamber of Commerce in China (where I gave a presentation), **lack of transparency in the legal and regulatory arena** is not uncommonly experienced by European companies in China. **Payment delays** are frequent – some people I met said that invoices are normally a month or more overdue when finally paid.

It is noticeable that all these day-to-day problems are at least as much of a nuisance as the more talked-about **abuse of intellectual property rights.**

So doing business in China is not a tea party, to paraphrase Chairman Mao.

A snapshot from the ground

Nevertheless, the foreign direct investments keep flowing in. The reasons have been examined at aggregate levels by scores of analysts – with McKinsey's conclusion speaking for itself: The average manufacturer in the US or Western Europe can normally boost profitability by some 50 per cent by moving assembly to China, and by more if the indirect effects on costs at home are included.

This time, I saw this general experience driven home more forcefully during a factory visit. I visited a Swedish client's production facility west of Shanghai. There – from an anonymous shop floor – emerges a more concrete picture of why China is so attractive, despite all the red tape:

- Granted, labour productivity in this particular plant is only about one third of productivity in its Swedish sister plant. But workers' wages are only 5-10 per cent of Swedish wages (even though all workers receive two extra months pay as a bonus). As a result, **unit labour costs are clearly lower** than in Sweden.

- Productivity is increasing rapidly, as the workforce becomes better educated.
- Wage differentials are abominably large to a Swede, but in China they create enormous incentives for workers. A worker may double his wage by improving his skills. If he becomes a foreman he can quadruple it. If he becomes the manager of a shift, his wage may increase by a factor of eight. This means that just about everybody is eager to learn new skills.
- Machinery is more often bought locally now: A Chinese-made machine for this plant typically costs about one quarter of what machines from the previous main supplier (in Germany) cost. They are not quite as reliable, but the plant engineers nowadays have become adapt at tweaking the machines to boost performance.
- Environmental regulations are now gradually being tightened, but so far they have been less strict than in Sweden.
- Taxes on income are extremely low – but payroll taxes are almost as high as in Sweden. Corporate taxes are somewhat lower.
- Transport is cheap. The local market is huge and growing rapidly – but this sector is almost impossible to penetrate for a company located outside China.

This is the reality for many manufacturers. Small wonder they keep pouring in. And with a couple of hundred million Chinese peasants waiting to leave the countryside during the next decade or so, any tendency towards rapidly rising wage costs or severe bottlenecks in Shanghai and Guangzhou can be offset by **moving more production inland.** The flood of migrants to the cities is not likely to abate soon; even if the lowest industrial wage is a mere 5 per cent of that in the West, a poor peasant in the countryside often earns less than a quarter as much as an industrial worker.

The new challenge: The quality of growth

So China will, no doubt, continue to grow rapidly. And it needs to grow. With productivity rising, supplying new city jobs to all peasants who are moving away from their villages is no easy thing. That is why **we will see China continuing to keep the yuan cheap** – I believe the revaluation against the USD will be slow, only some 5 per cent annually. It is also why we will see China reaching out even to rogue states in its quest for long-term energy supply contracts. And it is why we will see only a slow increase in real interest rates.

But the great challenge these days is not only to produce growth at any cost. It is to create growth of higher "quality", i.e. **"greener" growth, more evenly distributed.** This is badly needed. According to new domestic studies in China, the Gini coefficient (measuring inequality of income) has exploded in recent years. China is now one of the most unequal countries in the world, rapidly closing the gap even to such notoriously inequitable countries as Brazil.

The **number of "mass incidents"** including protests against unemployment and robber barons reached 87,000 last year. This is mainly farmers protesting against unscrupulous businessmen or local authorities robbing them of their land at excessively cheap prices. Among young people, there have actually been stirrings of a Maoist revival – not the hard-line Maoism of the Cultural Revolution, of course, but rather more nostalgic dreams about a society with narrower chasms between rich and poor. The numbers of such dissidents is small – the vast majority of people still put income growth and material prosperity at the forefront of their aspirations. But the signs of a future shift are visible for those can read the writing on the wall.

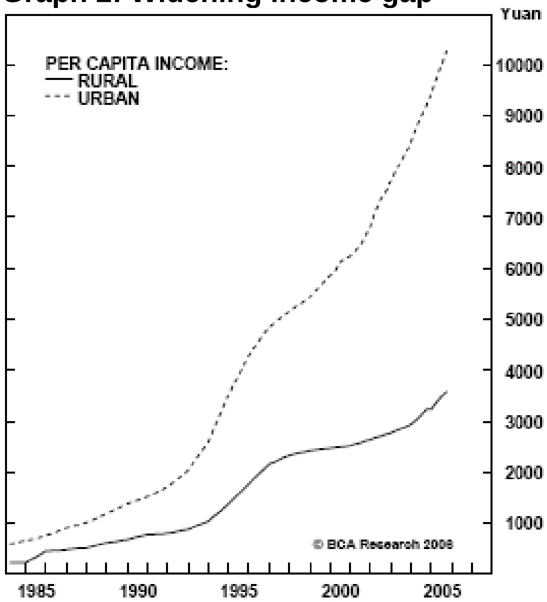
The new Five Year Plan

The task of improving quality of life in the countryside is **the focus of the Chinese People's Political Consultative Congress (CPPCC)** – the top advisory forum to the party leadership meeting now in Beijing and of the country's **new (11th) Five Year Plan**.

Indeed, recently the party leadership has sounded almost like Western European social democrats, pledging its commitment to a "well-off, well-rounded society" with equal opportunity for all. One of the slogans to be discussed at the CPPCC meeting is the creation of a **"new socialist countryside"**. The means to be used are subsidised infrastructure projects, more resources for health care, lower school fees and lower taxes on farmers.

On the eve of the opening of the CPPCC, I attended a small dinner in Beijing with some prominent, high-ranking Chinese economists. I was struck by how openly they discussed both actual problems and possible remedies. Important new sources of information are also being produced, for example the new UNDP report analyzing Chinese living standards, mainly written by Chinese researchers. This report clearly demonstrates glaring deficiencies in numerous areas from health care to pensions, especially in the poor rural areas.

Graph 2: Widening income gap



Source: Bank Credit Analyst

For foreign companies, the conclusion is clear: **China will start to build a social security system,** including a system for collecting tax revenues and fees to pay for it. There will be no Chinese "welfare state", but **foreign companies should be prepared for gradually higher taxes** – both at the corporate and personal level – as well as **tighter health and environmental regulations.** The process will be slow, perhaps erratic. But gradually China is bound to mature from the "Wild East" mentality that has dominated in the last decade.

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