Focus: China

SEB

November 13, 2003

Huge opportunities - looming risks

This is a brief travel report from a recent trip to China. It covers mainly macro economic issues; but not such important topics as the legal system, intellectual property rights, foreign policy etc.

My overall conclusions are these: 1) The Chinese expansion will continue at breakneck speed – average annual growth rates of 7-9 per cent – at least until 2010. 2) The present overheating symptoms do not constitute any major danger, but will lead to credit restrictions and somewhat slower growth next year. 3) The long term structural challenges – not least those arising from demography and social tensions – are immense. They will eventually slow the economy as it matures.

Both the rewards and the risks are huge, but given the enormity of the Chinese economy and its future impact on the global economy, no major Western corporates can afford to stay away from China. They will have to increase their presence, not necessarily as a part of a "China strategy" but because it is an important ingredient of a global strategy.

Klas Eklund, Chief Economist

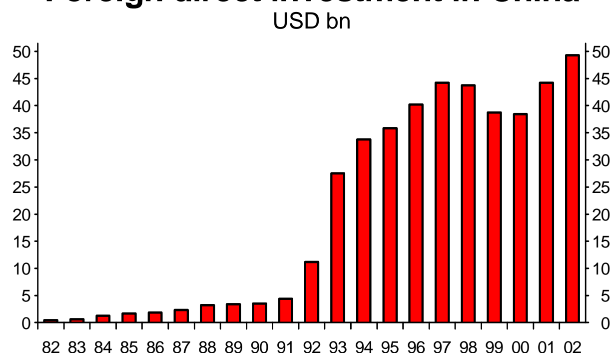
Rapid growth

Real GDP growth in 2003 seems set to surpass the official target of 8 per cent. It could actually surpass 10 per cent, once again making China the fastest growing of the large economies.[1] Growth stems from the following sources:

- A huge inflow of **foreign direct investments**. China is – as usual these years – the largest recipient of FDI in the world, surpassing even the US.
- A similar huge inflow of **extremely cheap labour** from the rural areas into the cities and industrial zones. Some 10-15 million new workers – at dirt-cheap wages – migrate into industry every year.

Foreign direct investment in China

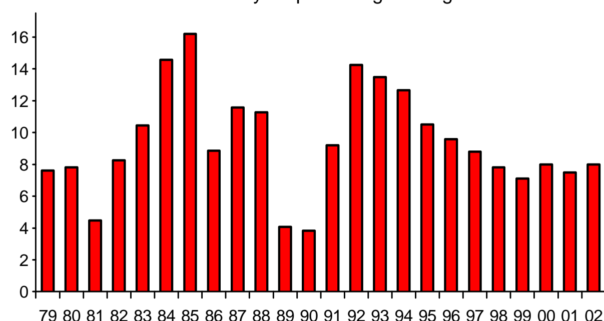
USD bn



Source: IMF

[1] Some years ago, an animated discussion was carried out among economists and statisticians about the quality and reliability of Chinese growth statistics. Firstly, there was a natural range of uncertainty as a large portion of the economy consisted of non-market activities and statistics were undeveloped. Secondly, there has been a suspicion that reporting often was thwarted for political reasons; that China was cooking the books, i.e exaggerating its performance. The present consensus among China watchers, however, is that transparency has increased and official statistics have become more reliable. To the extent that there is a problem, it is rather that China tries to "smooth" the numbers, to give an impression of more stability. Thus, while official numbers may exaggerate performance during "bad" years, they possibly underestimate performance during "good" years. Therefore, we should suspect that growth this year actually is a bit higher than reported. Several independent forecasters estimate actual growth to come in at 11 per cent, clearly higher than official numbers.

- A **growing number of well-educated and highly-skilled specialists**, large R&D efforts and immigration from overseas educated Chinese. It is well known that Chinese students make up a major part of students at American universities; these students are now starting to come back home in large numbers.
- Large **infrastructure investments** in roads, telecommunications and energy distribution.
- A rapid rise in **disposable income** and private consumption, primarily in the coastal regions. In the big cities, private consumption is probably growing by more than 20 per cent annually as a new middle class expands.



- Deregulation, privatisation and WTO entry **is spurring competition in more sectors and boosting productivity**. The old state-owned enterprises (SOE) are gradually being closed down and resources are being freed up for new, private business. Uncertain estimates claim that the value of production in the private sector has increased by no less than 70 per cent annually during the last decade.

The new party and state leadership shows no signs of abating or weakening in its drive to modernise the country. On the contrary, all give the same impression of a **clear determination to stay the course**. The overall ambition – repeated by all – is to build a "well-to-do Chinese society", which in quantitative terms is translated into a **quadrupling of GDP by 2020**. To do this, China needs to continue to unleash entrepreneurial activity; something which is underlined by both ideology and political reforms. One example is that former President Jiang Zemin's theory of the "three represents" is to be written into the constitution. This means that **the Communist party accepts private property** and that capitalists are accepted as party members.

All in all, there is a good chance that China will **continue to grow by an average rate of 7-9 per cent annually** for the foreseeable future.[2] There will be cyclical swings, but around a trajectory of rapid long-term growth. Furthermore, there is no doubt that the government will do its utmost to propel rapid growth at least until two giant showcases have taken place – the summer Olympic games in Beijing in 2008 and the world exposition in Shanghai in 2010. Any major hangovers will have to wait until thereafter.

Short-term strains

Growth does not come without strains. In the present 9-10 per cent growth environment these are visible in several ways.

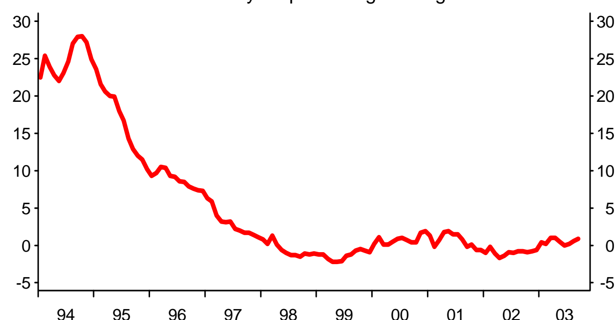
- There are **over-investments** in several sectors. Total investments increased by more than 30 per cent in the first three quarters of this year. Capacity is growing more rapidly than production in industry, not least due to many foreign companies setting up large-scale production facilities for export. The glut is most clearly visible in auto production. China is now the world's third largest car manufacturer (after the US and Japan – bigger than Germany); VW is the dominant producer but now also domestic brands are starting to grow. There is probably 30-40 per cent

[2] Most economists seem to believe this is the potential growth rate. Growth below 7 per cent normally results in deflationary strains, while growth above 9 per cent causes some inflation. If growth, for some reason, were to dip to 3-4 per cent for a couple of years, unemployment and social problems would rise rapidly.

overcapacity in the auto industry.[3]

- There are clear indications of **local bubbles in real estate**. Construction is going bananas, not only in the coastal cities, but a lot of office space and even some private homes and condominiums are vacant. Prices seem to have peaked in this cycle, but at such a high level that many households moving into new homes have to become heavily indebted. The market is looking increasingly bifurcated. There are no signs of prices going down at the top end of the market: Occupancy rate in the best office buildings in Shanghai is above 90 per cent.
- Credit expansion is swift at about a 10 per cent annual rate.[4] An ominous sign is that the troubled state banks (see below) recently have started expanding their lending again – both to real estate and industry – probably adding to their oversized portfolio of non-performing loans. This indicates that the banking system is **inept in handling credit risks**.
- **Inflation** is crawling upwards, albeit from a very low level. Commodities prices are being lifted globally as a result of growing Chinese demand. As regards consumer prices, the CPI is rising at around 1-2 per cent annually, but could shoot up; historically, price levels have been known to fluctuate wildly.

All in all, there are signs of over-heating in the coastal regions. Personally, though, I don't see them as dangerous enough to lead to any drastic retrenchment or any sharp setbacks. My best guess is that the **government will tighten macro policy next year**, through credit rationing from the central bank and via a less expansionary fiscal policy. This means that **GDP growth will slow down somewhat in 2004**, mainly as a result of a more restrained credit growth.



Medium-term structural problems

While the short-term cyclical problems seem manageable, there are much more difficult medium-term structural problems, not least in financial markets. These problems arise both from the difficulties of building a modern financial services sector to cope with the rapidly modernising industrial sector – while inheriting huge problems from the old, planned state banking sector.

1. The banking crisis

Foremost among these problems is the banking crisis. The Chinese banking sector is dominated by four large state banks. These are saddled with bad loans given to the decrepit state-owned enterprises. This, in turn, is a result both of the old planned economy – with state and local party organs ordering the state banks to lend cheaply to state production – and corruption, as many of these loans were the result of scratch-my-back-I-scratch-your-back deals.

That the non-performing loans are given by state banks to state companies means both heaven and hell. In theory it's a simple operation to solve the problem in one swift transfer from one side of the state balance sheet to the other. But that is in theory. In practice it is extremely difficult to sort out the mess: Since the NPLs result from deals which

[3] Before the reader gets too agitated from this number, please remember that underlying market expansion is very rapid: Car sales grew by over 80 per cent in H1 2003. Thus, although capacity utilisation at present is low, it should rise as a natural effect of the growing economy.

[4] This number is not totally compatible with Western statistics, since Chinese capital markets are undeveloped.

were not priced properly on a functioning market, the value of the debts/assets is extremely hard to assess.

The official estimate is that NPLs amount to some 22 per cent of outstanding debt. Private analysts, however, claim that the total number – also including the assets transferred to the newly founded asset management companies (AMC, i.e. bad banks, similar to Sweden's Securum) – probably is **close to 40 per cent**.[5] The real cost of sorting out the crisis is impossible to know. Western estimates range from 25 per cent of GDP to 50.[6] For comparison, the cost in Sweden amounted to 4 per cent of GDP.[7]

The obvious conclusion is that **it will take a long time to solve the banking crisis** – during which the banking system will be fragile. However, the government has pursued a reasonable strategy, first experimenting with different tools, and then setting up the four AMCs (one for every large bank). Most probably, the banking sector will muddle through with a slow and gradual resolution of the NPL problem. It is probable that minor financial crises will erupt from time to time, especially at the local level, bringing down clusters of companies with them. Still, few economists fear that the banking problems are severe enough to put a halt to the entire growth process. Should the unlikely happen and a major financial crisis triggers a deep recession, government will no doubt bail out depositors and quite brutally chop up and close down the worst-performing banks. I doubt that they will drag their feet like the Japanese.

2. Immature capital markets

The banking crisis is only one aspect of the lack of maturity on financial markets. Small mom-and-pop investors dominate the nascent **stock market**, stock prices are manipulated and volatility is huge. Furthermore, there have been several types of shares traded on different markets, which has served to keep foreign investors out. Also, ratings and corporate analyses are conspicuous in their absence. Here we are talking **Wild East casino**!

The situation will gradually improve, though. The artificial boundaries between share types are about to be dismantled. Ratings and transparency will improve over time – but don't expect this process to be swift!

Bond markets are even less developed. As a result, domestic companies have been dependent on bank borrowing or financing through profits. Also here, we can expect improvements in the future, albeit gradual.

3. The currency

The fragile state of the banks and the undeveloped nature of the Chinese capital markets are important reasons why the currency will not be liberalised in the near future. At present, the renminbi[8] is pegged to the dollar: USD 1 = 8.28 yuan, with a narrow fluctuation band of 0.3 per cent. Transactions on the capital account are not convertible. To move to a fully convertible currency with a floating exchange rate (possibly after merging the renminbi with the Hong Kong dollar) is stated as a long-term goal. But as long as capital markets are undeveloped and banks fragile, this cannot be done. A fully convertible, floating currency may trigger large capital flows which destabilise the financial system.[9]

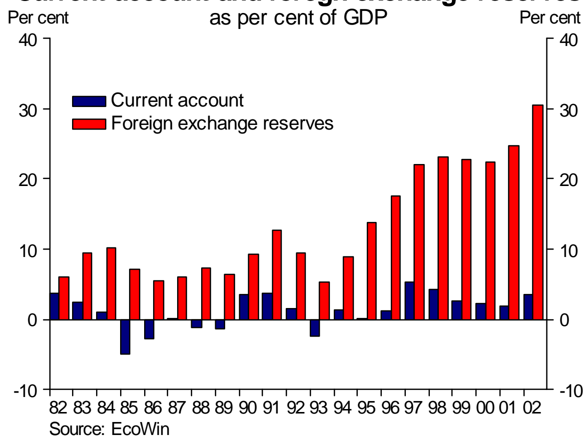
[5] This could be compared to the Swedish banking crisis, in which NPLs peaked at 11 per cent.

[6] The latter number is the estimate of S&P.

[7] This "real" cost should not be interpreted as an assessment of necessary GDP reduction. Rather it is the amount of public money that must be injected into the banking system.

[8] The currency's name is Renminbi, which literally means "the people's currency". Its basic unit is called yuan.

[9] The Chinese leadership and the Central bank closely studied the Asian crisis in 1997-98 and drew the conclusion that "hot money" flows should be avoided. The turmoil in other countries only strengthened their resolve to sort out the banking crisis before liberalising the capital account.

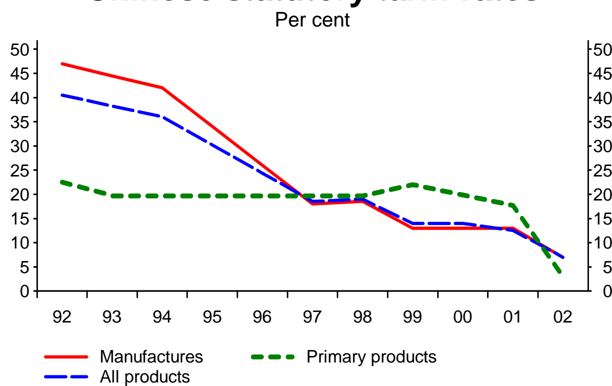


Here, the message we received was unequivocal: China will not alter its currency system. **Stability** is the foremost ambition. Thus – no large revaluation, no floating currency, and several years of preparation for full convertibility.

Nevertheless, I believe that there will be a **gradual liberalisation** of the present rigid peg, because that would be in line with moving towards the long-term goal; secondly because China may want to seem to "give" something to the US, either to show good will or to help the US save face. The price as regards currency changes does not have to be high, though. Firstly, China will also make trade deals and barters with the US, promising to buy auto parts, aircraft etc from the US. Secondly, the Chinese negotiating position is strong, since China sits on vast amounts of US treasuries.

There are two options:

- Gradually **widen the fluctuation band**, e.g to +/- 3 per cent, and let the yuan rise to the ceiling within the band (that would result in a USD/CNY rate of 8). Then, slowly widen the band, while keeping full control (i.e don't make the renminbi convertible). This would allow the yuan to appreciate slowly, say by some 3-5 per cent annually in the next couple of years.[10]
- Move from a dollar peg to a **currency basket peg** (such a basket could be weighted in different ways but it would certainly include the euro, the yen, the won etc). This would actually entail greater one-off consequences for international currency markets than the first option, as China may have to rebalance its currency reserves, selling USD and buying EUR. Such a transition would consequently have to be gradual and closely monitored in order to avoid sharp market reactions.
- Of course, it is also possible to do both, i.e move to a basket and then let the yuan gradually appreciate against that basket.



Personally, I don't believe the Chinese government and the central bank have yet decided what to do or when; they are at present assessing the options. My own guess is that they will go for the first option, i.e to **widen the present fluctuation band** some time during late 2004 or in 2005. This implies that two years from now, the yuan will be some 5 per cent stronger vs the USD than it is today. The process will not be dramatic. **Nor will it have any great impact on the trade balance between China and the US:** The labour cost in Chinese industry is about 4 per cent of that in the US, and even after taking the productivity differences into

[10] Longer term, such an appreciation could be formalised and made into a "crawling peg" which targets the appreciation rate.

account most analysts estimate that the Chinese competitiveness can cope with a revaluation of 20 per cent without problems.

Long-term challenges

The long-term challenges for the Chinese economy are huge. The most important concerns the interplay between demography, productivity, reallocation of labour – and inequality.

- In the next couple of decades, some **400 million farmers** (more than the total population of the current EU) will be made redundant as productivity in agriculture increases. They will move from the rural areas to cities, becoming industrial workers or seeking work in the service sector. This is the largest reallocation of workers in the history of mankind, and an immensely challenging task.
- Will it be possible for these millions to **find work** – or will they become unemployed? At present, there are some 150 million in the so called "floating population", i.e farmers who work in the cities but still are able to use a strip of land back in their home villages. The government wants to proceed slowly with further land reform (privatising all communal land), since these small cultivated patches function as a sort of unemployment insurance. Politically, from the government's point of view it is safer to have disgruntled peasants staying in their villages surviving on subsistence level through small farming, than to have them unemployed and starving in the cities.
- The vast pool of underemployed farmers will continue to **press down wages** for uneducated workers for decades to come. This will ensure China's competitiveness in low-cost industries, but it will also widen the income gap even further. And this situation is already threatening to turn explosive. In just two decades, China has moved from being one of the most egalitarian societies on earth to one of the least egalitarian. During the first years of reform, in the early 1980s, rural income rose relative to urban, but since the late 1980s the urban middle class has raised its standard way above that of the peasants. The Gini coefficient[11] is now close to 45, and approaches levels seen only in Latin America – levels which the IMF and the World Bank have deemed unsustainable.
- There is no real **social security system** – unemployment insurance, health insurance etc – to take care of the poor who are moving in from the countryside. Previously, the local village commune cared for its members in the rural areas, while the big SOEs cared for industrial workers (also giving them housing and health care). That system is now breaking down, and no new comprehensive system has been put in its place. In combination with the rising income inequality mentioned above, this results in a widening gulf also as regards health and access to medical care.
- In the long run, China – like most countries – faces the costs of an **ageing population**. The danger threshold has not been reached yet, but within two decades the Chinese age structure will change more rapidly than in any other country. This is due to the fact that life expectancy is rising swiftly, while the policy of one child per family has been largely effective. This will put strains on pensions and health care.

On top of these immense economic tasks comes a socio-psychological challenge, stemming from a **growing chasm between old and young**. Older people have personal experiences of the planned economy, starvation (after the "Great Leap Forward" of the late 50s) and the chaos during the Cultural Revolution. They were brought up in an extremely ideological society. The generation

[11] A measurement of inequality. An index of 0 means that all inhabitants receive exactly the same income; 100 means that only one person receives the nation's total income. Sweden's Gini coefficient is 29.

growing up after the reform process started in 1978, on the other hand, has seen only the increasing influence of the market economy, rapidly growing income gaps and pragmatic, non-ideological governments. Most of them have also been the only child – meaning they have been pampered to an extent unheard of for their parents and ancestors. These generations have totally different mindsets, and it is impossible to know what strains on social cohesion might arise as a result. Nonetheless, it is a long-term factor that ought not to be ignored.

Finally, of course, there are inevitable **political tensions** arising from all of the above – i.e the unrelenting pressure from the new urban generation, the entrepreneurs and the increasing influences from abroad for China to gradually build a pluralistic, democratic society. At present, there are tendencies that express a shift towards more openness and responsiveness to such pressures, e.g more open elections of village and city officials. Personally, I believe this process will continue in an orderly fashion in the near future. Nonetheless, there are long-term risks that the contradiction between modernisers and party traditionalists once again could become violent. Only 14 years have passed since Tienanmen Square…

Concluding remarks

This has been a rambling essay, covering a number of macro economic topics from currency reform to demographics. What has been glaringly lacking is commentary on foreign policy and the important issue of how to do business in China (legal problems, intellectual property right, corruption etc). Nonetheless, it is possible to draw some general conclusions.

- China today is witnessing **the greatest economic transformation in the history of mankind**. Just as a comparison: During the industrial revolution in the West in the mid-18th century some 100 million people lived in regions (mainly England and parts of France) which started growing by one per cent annually (after have stood still for centuries). In China and parts of India today, one billion people live in regions that are growing by 10 per cent or more per year. Thus, the market expansion in large portions of the East today is at least 100 times larger than during the Industrial Revolution in the West.
- This growth spurt will change not only these economies – it will **change the world**. China is already the world's second largest exporter of goods and the third largest economy in terms of total GDP,[12] and the present rapid growth numbers will vault China even higher. Its political influence will increase with its economic strength, as will its military potential. No doubt the dominant global foreign policy issue in the decades to come will be Sino-US relations.
- But while the potential is huge, the risks are also huge. It will not be possible for China to grow for decades at today's breakneck speed and with today's ultra-capitalistic methods. That would wreck the environment and cause social upheaval. More resources must be set aside for environmental protection as well as new social security systems. This will **eventually slow growth** – my guess is that this slowdown will be quite obvious 10-15 years from now.
- For Western companies ogling China, both opportunities and risks are high. The Chinese market is booming and production costs are low. But **competition from Chinese companies is only yet in its infancy and is bound to stiffen** – not only in China but also on global markets; not

[12] Measured by purchasing power, i.e taking the low price level into account. If GDP is measured by current prices, China is number five.

only on low-cost markets but to an increasing extent also higher up the value-chain ladder. The lessons from Japan and the other tigers should not be forgotten – and this time the new player is much, much bigger.

Thus, large Western companies have no choice. They must have a **presence in China**, not necessarily a part of a "China strategy", but because it's a necessary part of their global strategy. And they should be prepared for a mounting Chinese challenge on their own home markets.

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