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Cyclical growth rebound and secular consumption patterns

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THE YEAR OF UNCERTAINTY

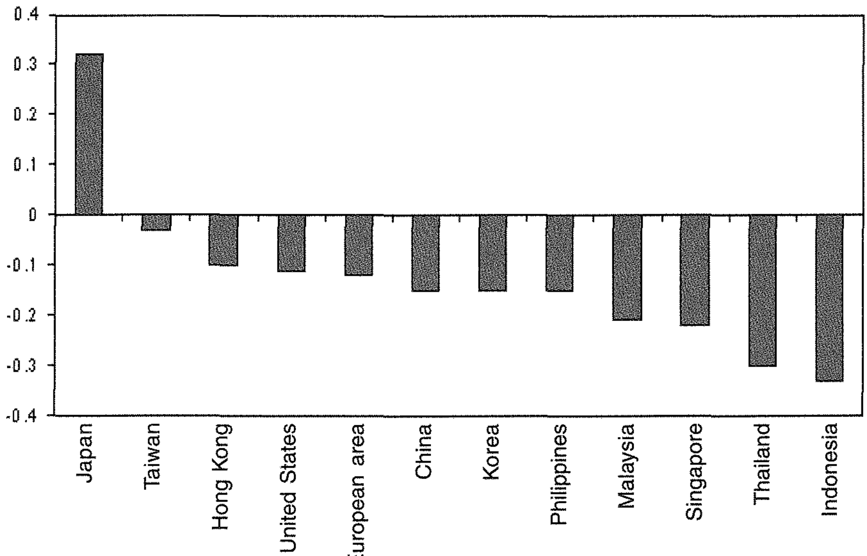
2002 is a critical year for the Chinese economy not only because the growth trajectory may reverse its trend but also because a number of key events will take place during the year.

First, the fourth generation of the leadership is ready to take over from the third at the forthcoming 16th Party Congress in September and the 10th National People's Congress in March 2003. The transition is likely to be smooth despite the inevitable power struggles and infighting. Candidates from the younger generation are similar to those that they will succeed, but tend to be better educated, more open-minded, and have a better understanding of Western-style economy and society. Uncertainties related to the leadership transition will be mainly reflected in the areas of policymaking and implementation. There are already signs that the current government intends to postpone some tough decisions for the next government. Most senior officials are currently busy seeking critical appointments in the next government rather than pushing through reforms now. As a consequence, there may be a vacuum in policy reforms over the next few months.

Second, China has already begun implementing WTO reforms since joining the organisation in early December 2001. The Chinese version of the WTO agreement was published just before Christmas—a delay which has caused difficulties for the public in gauging the implications of the WTO reforms accurately and for government officials in implementing these changes. An important area of reform is the financial sector. With foreign banks, insurance companies and asset management firms moving into China and expanding their scope there, serious doubts are emerging about whether the domestic financial institutions will be able to survive the competition. The financial policy conference in early February 2002 laid the groundwork for reforms, but much more needs to be done. The recently revealed Bank of China (BOC) scandals provide an illustration of the seriousness of the problems in the banking sector. Non-performing loans (NPLs) in the banks and the asset management companies (AMCs) are now believed to constitute nearly 50 per cent of total outstanding loans.

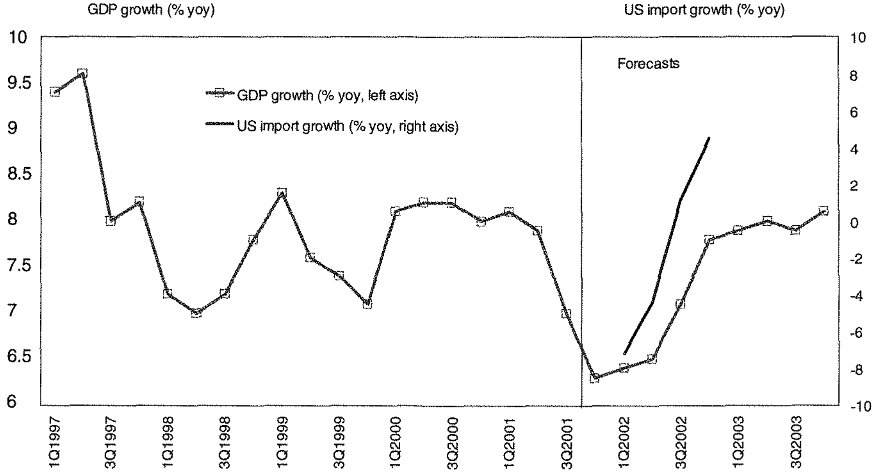
Finally, the pattern of global economic recovery will also affect the performance of the Chinese economy in 2002, particularly through trade links. It is now widely believed that the US economy will emerge from recession in 2002. But there is still a heated debate about the timing and extent of the recovery. A more critical factor is the future movement of the Japanese yen. The yen has weakened significantly since the end of 2001, stirring anxiety in the region as well as in China. However, the impact of yen depreciation on the Chinese economy is assessed as being limited. A weaker yen puts some pressure on China's export sector because Japan

FIGURE 2.1 **IMPACT ON GDP GROWTH OF A 10 PER CENT DEVALUATION IN THE YEN**



Source: Citigroup estimates applying the Oxford Macroeconomic Model.

FIGURE 2.2 **RAPID SLOWDOWN OF THE CHINESE ECONOMY**



Source: CEIC.

accounts for about 17 per cent of China's export market. This is particularly difficult at the moment because China's export companies have been severely affected by the global recession. China, however, does not compete directly with Japan in third export markets as export similarities from the two countries are quite low.

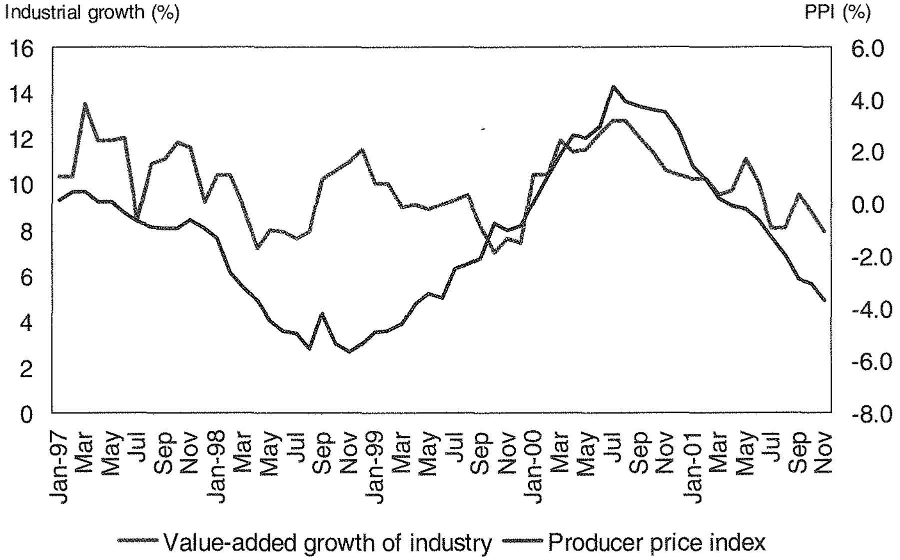
The Oxford macroeconomic model was applied to assess the impact of yen depreciation on Asian growth. A 10 per cent yen devaluation reduced China's GDP growth by 0.15 percentage points. This is rather small compared to 0.5 percentage gain in China's growth if US growth is lifted by one percentage point. The Chinese yuan will remain stable even if the exchange rate of the yen slides further.

GROWTH REBOUND

Growth of the Chinese economy slowed rapidly in 2001, from 8.1 per cent in the first quarter and 7.8 per cent in the second quarter to 7 per cent in third quarter and 6.3 per cent in the fourth quarter. The slowdown was mainly attributable to the recession of the global economy, and especially the US economy.

The pace of the growth deceleration surprised many market economists who argued that the Chinese economy would not be affected by external changes because of China's relatively small export sector and its aggressive counter-cyclical fiscal measures. Nonetheless, China still outperforms most of its East Asian neigbours. In 2001, Singapore, Hong Kong and Taiwan recorded negative GDP growth,

FIGURE 2.3 **DECLINE OF INDUSTRIAL PRODUCTION GROWTH AND PRODUCER PRICES**



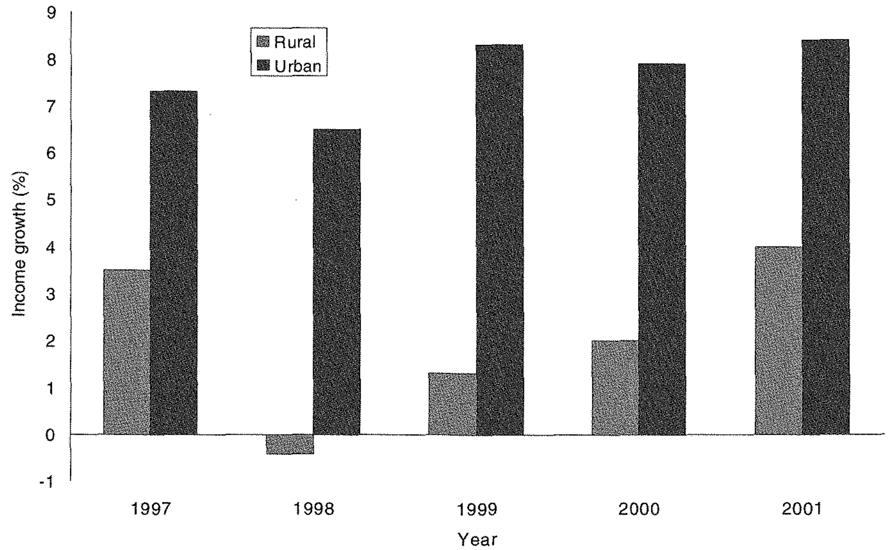
Source: CEIC.

while China achieved positive growth of 7.3 per cent.

China has felt the pain of global recession. After all, the export sector still accounts for 22 per cent of GDP according to official statistics, and export growth collapsed from 28 per cent in 2000 to 7 per cent in 2001. This had most visible impact on the coastal provinces, which happen to be the engine of the Chinese growth. As a result, growth of industrial production was dragged down.

The economy is likely to stay sluggish in the first half of 2002, but domestic demand is probably enough to support GDP growth of 6–7 per cent. WTO membership is likely to deliver significant benefits in a few sectors. Chinese growth will probably rebound in the second half of 2002. This prediction rests on the assumptions about the US economic recovery—although recent data suggest that a US recovery is already well underway, we believe a significant surge of imports into the United States will take place in the third and fourth quarters of 2002.

FIGURE 2.4 **RELATIVELY STRONG INCOME GROWTH**



Source: CEIC and Citigroup.

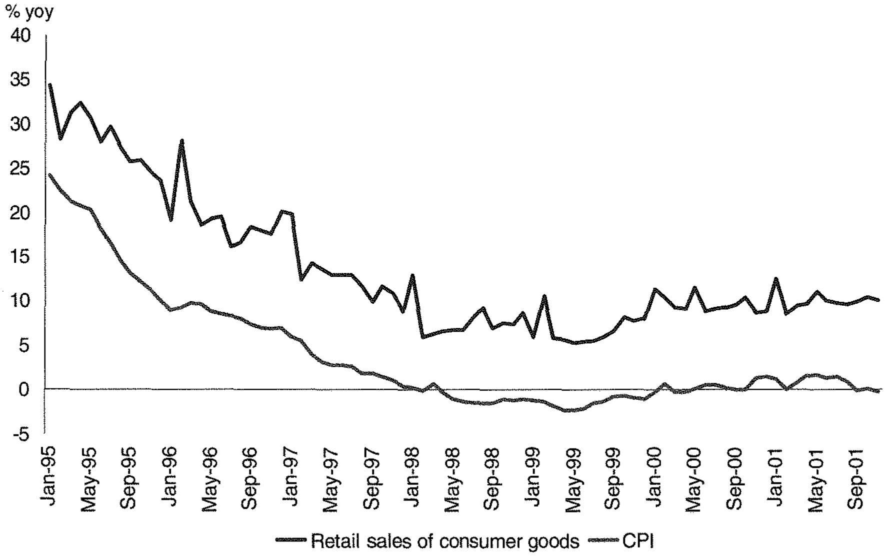
CONSUMPTION PATTERNS

Before an export-led rebound takes place, Chinese growth in the first couple of quarters in 2002 will have to be supported by domestic demand. This will be influenced by relatively strong urban consumption alongside a weakening investment trend.

The stability of consumer confidence in recent months has been underpinned by rapid income growth. In 2001, urban per capita income increased by 8.4 per cent and rural disposable income was up by 4 per cent. Both rates of growth were higher than in the previous year, although GDP growth was slower. The rapid growth in urban incomes was caused by the government's pay rise policy—a 30 per cent increase in base salary plus year-end bonus equivalent to one month's salary.

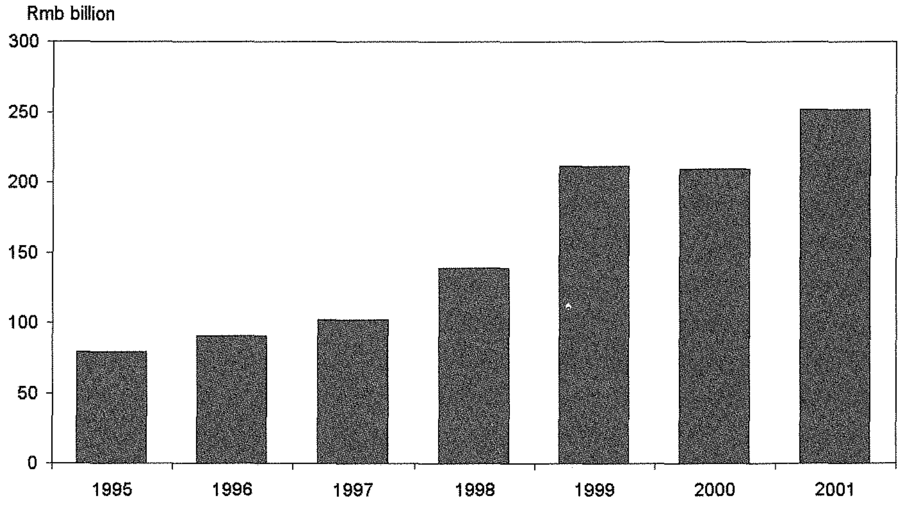
Growth in incomes drove consumer spending strongly. Retail sales consistently grew by more than 9.5 per cent every month in 2001, except February (which was

FIGURE 2.5 RELATIVELY STRONG CONSUMER SPENDING



Source: CEIC and Citigroup.

FIGURE 2.6 GOVERNMENT SPENDING ON CAPITAL CONSTRUCTION



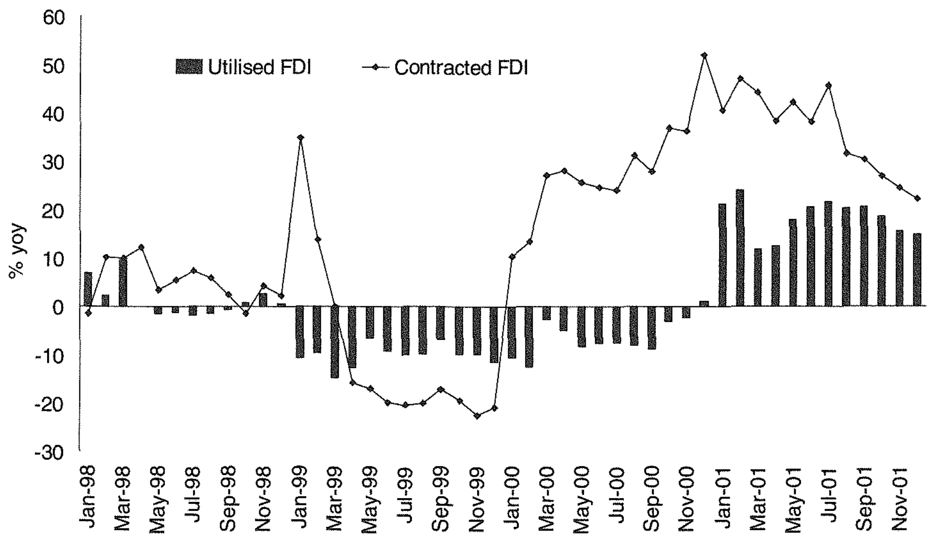
Source: CEIC and Citigroup.

mainly caused by the special effect of the Chinese New Year). The government has recently committed to continuing the pay rise policy in 2001. Urban consumer spending will remain steady, but the strength of rural consumption has been questionable for some time.

Investment may be relatively weak. We examine three types of investment activities—public investment, foreign direct investment (FDI) and corporate sector investment. Government spending has been a major driver for GDP growth in the last couple of years, and the spending program has concentrated mainly on infrastructure projects in western provinces. But the proportion of government spending on capital construction in GDP stabilised during the period 1999–2001. In 2002, the government committed another 150 billion yuan to infrastructure projects, exactly the same amount as in 2000 and 2001. This means that the contribution of the spending program to economic growth will probably be smaller this year.

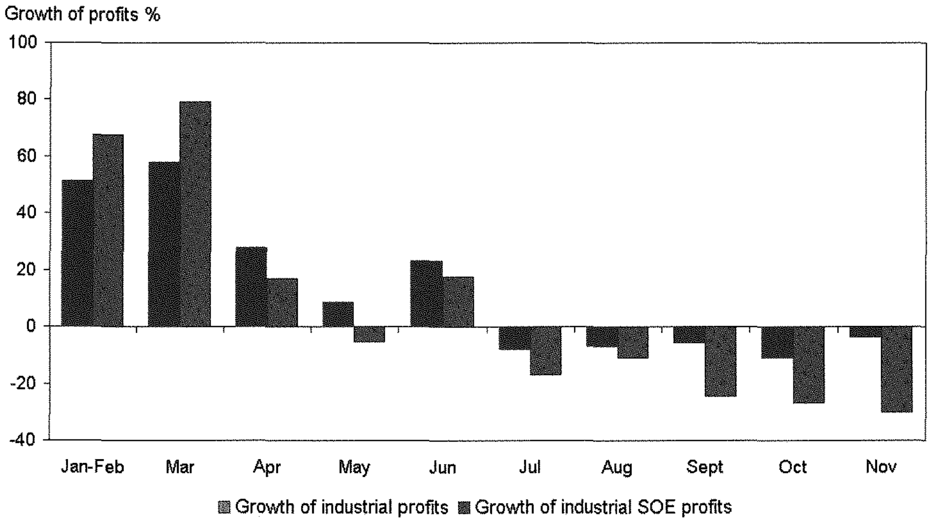
The inflow of FDI surged in 2001, growing by 15 per cent, owing to China's expected accession to the WTO. On average, FDI contributed about 0.6 percentage points to GDP growth. In 2002, strong capital inflow is likely to continue but the

FIGURE 2.7 **GROWTH OF FDI INFLOW**



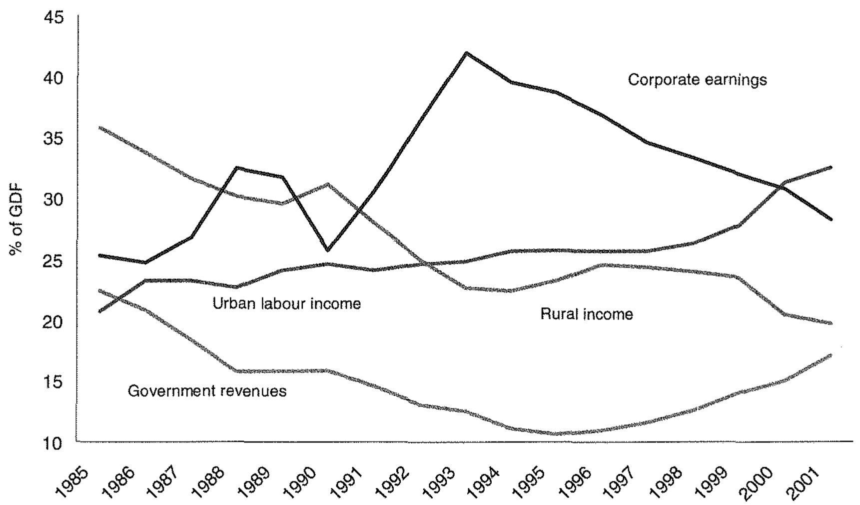
Source: CEIC and Citigroup.

FIGURE 2.8 **GROWTH OF INDUSTRIAL PROFITS**



Source: CEIC.

FIGURE 2.9 **CHANGING COMPOSITION OF GDP**



Source: CEIC and Citigroup.

growth rate of FDI will probably fall, mainly because global FDI is likely to fall due to recession.

Corporate sector investment may also weaken somewhat. Total industrial profits have been declining since mid 2001, probably because of three key factors—increased competition triggered by weakening export demand and illustrated by a rapid fall in producer prices; increases in the collection of government revenue; and a rapid rise in household income caused by the pay rise policy. Meanwhile, the real interest rate in China is rising again because the government has not changed its nominal interest rate since June 1999 but price deflation has also re-emerged. A combination of declining profits and rising real interest rates does not imply a bullish outlook for corporate investment in the short term.

Of course, the investment outlook, especially that of FDI and corporate sector investment, may improve significantly once an overall macroeconomic upturn starts. The outlook could be further improved by two possible policy changes currently under consideration—the interest rate cut in late February 2002, and expected reduction of corporate tax from 33 per cent to 25 per cent.

But the changing composition of GDP overall does not favor investment activity. Since the mid 1990s, the proportions of corporate earnings and rural income have been squeezed by those of government revenues and urban income. Such changes were driven by government policies to raise urban income and increase government revenue, but they could be bad news for investors, both direct investors and share holders in the Chinese companies.

Efforts to raise urban income are partly aimed at stimulating domestic demand after the East Asian crisis but are also partly a characteristic of China's gradual reform approach. Because reform is gradual, continuous compromises have to be made in order to keep the reform process alive. It is thus important to win the support of politically important constituencies or at least reduce their opposition. At present, this means raising urban incomes. Increases in government revenue are also a response to the declining government influence experienced during the early stages of reform as a result of decentralisation and liberalisation. Revenue growth in recent years has been realised through better collection of taxes, especially personal income tax and private sector tax, rather than increases in tax rates.

Over the longer term, even stronger consumer spending expansion can be expected. The foremost reason for optimism is the expected strong income growth. The government has estimated that the total size of the middle-class population

TABLE 2.1 **CHINA'S CONTINGENT LIABILITIES, END OF 2000**

	Amount (billion yuan)	Share in GDP (%)
Accumulated public debt	1367	15.3
Debt for recapitalisation in 1998	270	3.0
Costs on policy bank bonds	154	1.7
Bank restructuring	4467	50.0
External debt US$145.7 billion	1210	13.5
Total	7468	83.5

Source: Citigroup estimate.

may rise to 200 million by 2010. Improvements in investment efficiency will also make more resources available for consumption. With the further reforms and liberalisation prompted by WTO accession, a steady improvement in productivity is expected. China's demographic transition will also accelerate in the coming decade because of the one-child policy. According to the World Bank, the proportion of young workers in the Chinese population will fall from 61 per cent in 1990 to 45 per cent in 2010, while the proportion of aged population will rise from 9 per cent to 11 per cent during the same period. Population aging usually results in a decline of the saving ratio (which is currently around 40 per cent in China).

An obvious qualification for the bullish consumption story is rural income. As the government focuses increasingly on the urbanisation program, however, rural productivity and income may start to pick up again.

FISCAL SUSTAINABILITY A KEY CHALLENGE

China will be a main source of growth in the global economy in the coming decades. Even after another two decades of rapid growth, China's official per capita income level will probably still be around US$4000–US$5000. The gap between China and the advanced economies will be significant and the potential for further catch up will be huge. But China is already the world's sixth largest economy in the world, because of its vast population. In 20–30 years, China will definitely become the third or even second largest economy.

Growth sustainability is dependent on effective control of some of the key problems in the economy and society, including unemployment, the non-performing loans, corruption, regional disparities. The most significant challenge, however, is the maintenance of fiscal sustainability.

TABLE 2.2 **RISING FRAGILITY OF CHINA'S BANKING SECTOR**

	end 1996	end 1998	end 2001
Proportion of NPLs (%)			
Big four banks	40.0	48.0	35.0
Ten joint-stock banks	-	13.5	15.5
Average CAR (%)	4.4	8.0	6.6

Notes: NPLs: non-performing loans; CAR: capital adequacy ratio. Proportion of non-performing loans for the four major banks for 1996 and 1998 are re-estimated based on new information made available at the beginning of 2001. The proportion for 2001 excluded the Rmb1.4 trillion transferred to the Asset Management Companies in the previous year.
Source: Citigroup estimates.

Current fiscal programs do not pose serious problems as fiscal deficits have ranged between 2.5 per cent and 2.8 per cent of GDP in recent years. Government's massive spending on infrastructure to stimulate economic growth caused some side effects because most of those projects were implemented inefficiently by the SOEs and public spending crowded out more efficient private investment. But active fiscal policies during the past years still do not add up to significant fiscal risks. Public debts currently account for a little over 15 per cent of GDP. However, if all the contingent liabilities are counted, they already amount to nearly 84 per cent of GDP. This is already quite high. If the rising trend of contingent liabilities is not contained quickly, then the chances of fiscal crisis will increase quickly.

The key to averting a fiscal crisis lies in the effective control of the banking problems and the successful development of the pension fund. The newly established pension fund suffers from significant and growing deficits, rising from Rmb30 billion in 2000 to Rmb70 billion in 2001. It is estimated to reach around Rmb200 billion in five years. These shortfalls are not counted in the calculation of the contingent liabilities as the government as already decided to finance the pension fund by selling State shares in stockmarkets. However, this policy has not yet developed as speculation about sales of State shares has already led to a significant downward correction of the market. Should stockmarkets fail to come up with the needed funds, then the state budget will have to shoulder pension fund shortfalls.

Problems in the banking sector are more serious. The average proportion of non performing loans (NPLs) of the big four banks is around 35 per cent while their average capital adequacy ratio is about 6.6 per cent. What is even more worrisome is that there is limited evidence of improvement in the banking sector, even after several years of reform. Although the proportion of NPLs declined from its record high at 48 per cent in 1998, the reduction was mainly because the transfer of the NPLs to Asset Management Companies (AMCs). The majority of that portion of NPLs still needs to be disposed of, and is thus still the responsibility of the banks or the Ministry of Finance. Worse still, most of the problem SOEs stay with the parent banks and continue to create new NPLs. This is the reason the quality of banking assets has deteriorated rapidly during past years, with the capital adequacy ratio falling from above 8 per cent in late 1998 to around 6.6 per cent. Banks are in need of another round of recapitalisation.

The pace of China's banking reforms has accelerated recently. This is partly because China committed to open up the banking system completely within five years of joining the WTO. The Central Financial Works Conference in early February 2002 called for significant improvement in bank supervision through both reorganisation of the central bank and capacity building. It also confirmed a three-step reform approach for the banks—improvement of internal management system, corporatisation and public listing. The authorities now also permit foreign strategic investors to take equity interests in domestic banks. All these are positive and important steps toward eventual resolution of the banking problems. With the reform tasks lying ahead the Chinese government is anxious to avoid a fiscal crisis.