

Professor Arne Jon Isachsen  
September 2004

# WHAT IS HAPPENING IN CHINA?



Centre for Monetary Economics

# What is happening in China?

- Have you read "Wild Swans: Three daughters of China" by Jung Chang? If not – do it
- The Middle Kingdom's history stretches back 5-6000 years
- Today, 1.3 billion Chinese. GDP equal to that of France. Risen by a factor of seven since 1978
- 7 % growth and GDP doubles in 10 years



- Market economy is developing  
⇒ Free to choose
  - Tianamen Square 4 June 1989  
⇒ Political reforms are frozen. No choice
- ⇒ Are the two compatible in the long run?
- Legitimacy to the existing regime by delivering continued economic growth, benefitting most of the people most of the time



- Hu Jintao takes over for Jiang Zemin:
  - November 2002 as Party Chief
  - March 2003 as PresidentMr. Zemin is still supreme commander of armed forces
- Wen Jiabao is prime minister
- Hu and Wen have substituted political reform with bureaucratic reform
  - ⇒ Make government officials more accountable. But not politicians accountable to the people through democratic and free elections



## Will focus on:

- Corruption
- Rule of Law
- Banking
- Agriculture
- FDI
- Investment
- International Trade
- Exchange rate policy
- Relations with EU
- Consequences of WTO



## Corruption

As a consequence of One Party Rule. Not well developed Checks and Balances as in a democracy. Fighting corruption has high priority.

Rule of Law and predictability is in short supply.

December 2001 member of WTO.

⇒ External pressure to abide by the Rule of Law.



## Banking

- Four large State Owned Banks (SOBs). Lend primarily to State Owned Enterprises (SOEs). 55 % of credit supply from SOBs
- 35.000 Rural Credit Corporations (RCCs). 10 % of credit supply
- RCCs only source of credit in the countryside. Vulnerable to interference from local governments
- Deposits take in one township cannot be translated into loans in another
- Non-performing loans (NPLs) in China, 30-40 % of loans outstanding
- Excessive investments and lending in 2003-2004  
⇒ NPLs will increase in the downturn
- Loans considered as a form of "social welfare"
- SOBs are in a mess. Technically insolvent.



- Fred Hu (Goldman Sachs) on largest risk to the Chinese economy:  
”Banks continue their unsound lending and poor risk management”
- 2007: Big four SOBs will have to compete with foreign ones (WTO).
- 1999: 1/3 of 500 bill. dollars in bad loans transferred from SOBs to AMCAs, at face value. 35 % have been reclaimed, at 17 % of face value.
- Lending rates between 5 % and 9 %. Inflation on the increase. Will lending rates follow suit?
- 6 August 2004: HSBC buys 19,9 % of Bank of Communication (fifth largest bank) for 1.75 bill. USD. 2700 branches in 139 cities.
- Citibank, HSBC are allowed to do RMB-business with domestic firms in 13 cities, including Shanghai (WTO, again).



Agriculture is the dominant sector. Close to 50 % work the land, producing 15 % of GDP.

- 300 – 400 million surplus rural laborers
- 100 million migrants workers in China. 70 % of them are owed pay by their employers. Often paid once a year
- Unclear who bears the responsibility when wages are not paid
- Big challenge: Social justice
  
- People living in absolute poverty have declined from 200 mill. to 30 mill. in twenty years.

BUT: Difference between rich and poor is increasing

- Focus on better incentives in agriculture. Reduced taxes. Improved access to credit. Longer leases of land



# Foreign Direct Investments (FDIs)

- 2003, FDI in China
  - 4 bill. USD from the US
  - 4 bill. USD from EU
- Total FDI from the US is 40 bill. USD
- As much European investment in Texas alone as all US investment in Japan and China put together.
- 2003: USA invested
  - 4.1 bill. USD in Denmark
  - 1.5 bill. USD in India
  - 19.0 bill. USD in the Netherlands
  - 22.0 bill. USD in the whole of Asia



- Modest R&D in China. Need FDI to obtain access to new technology
- Car production and foreigner can only have 50 % ownership. Joint venture for exports, and this rule no longer applies

Honda-plant: 65 % Japanese. Also, requirement of 40 % locally produced parts is gone



# Investment

- 45 % of GDP allocated to real investment in 2003
  - Domestically financed
  - 21 % increase in bank lending
  - 70 % of real investment by state sector
  - Provincial governments keep increasing real investment
- Real danger: Excess capacity
- Wen Jiabao orders tightening of lending
  - Higher interest rate may attract foreign capital and put upward pressure on the exchange rate.

1 USD = 8,28 RMB since 1994



- 2003: China produced 4 % of world GDP.  
China consumed 40 % of world concrete and 27 % of world steel
- Thailand 1996: 43 % investment rate  
35 % savings rate.  
⇒ Had to borrow abroad. Excess capacity developed  
2 July 1997: Had to abandon the exchange rate
- Will China engineer a soft landing? Or will something similar to the Thai experience materialize?
- Why don't the Chinese consume more?  
65% of GDP to private consumption in the 1980s.  
Only 54 % in 2003



- People feel insecure and save
  - One-child policy
    - Save for education of child
    - Save for own old age
  - 100 mill. workers stripped for social security in SOEs
  - Banks are broke, and future taxes may have to increase
  - Health and education increasingly privatized



International trade on the increase. Last five years exports up by 140 %, total production by 60 %.

- Export as a share of GDP from 20 % to 29 %.
- Trade equally much with
  - Japan
  - USA
  - EU
- Huge surpluses against the US (124 bill. USD in 2003) matched by deficits towards rest of the world
- Expect small trade deficit in 2004



- Chinese companies can now retain 30 – 50 % of export revenue. Until May 2004, only 20 %
- Unfair trade?
  - Non-performing loans
  - Too weak currency
  - Low wages



- Exchange rate policy heavily criticized by Mr. John Snow, US secretary of the Treasury. He wants:
  - Floating exchange rate
  - Free capital mobility

BUT:

The RMB could depreciate if many Chinese want to diversify their portfolios

Nicolas Lardy: 1 USD = 7 RMB and 40 – 50 bill. USD in reduced deficit

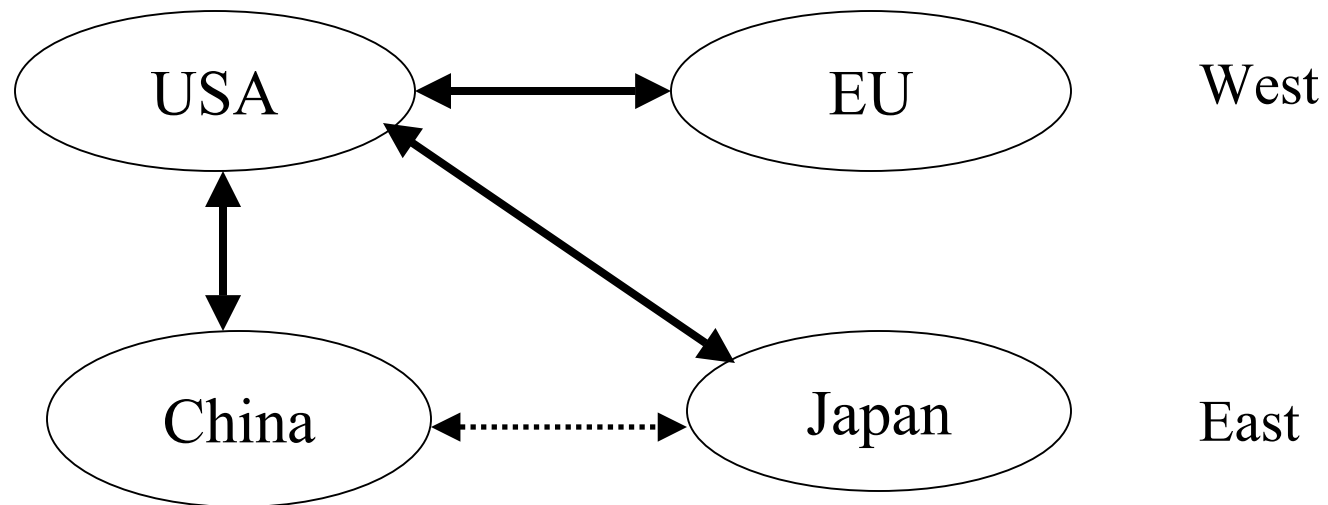
Ronald McKinnon: Not the case, because Americans do not want to save

$$\text{Current Account} = \text{Private savings} - \text{Private Real Investment} \\ + \text{Surplus on Government Budget}$$



Higher consume prices } Eased pressure to revalue  
Trade deficit } RMB

Figure 1: China is increasingly important to the West.



Relation with EU is steadily improving. Trade will soon surpass that with the US

- Politically EU and China share concerns about American unilateralism
- EU's arms embargo of 1989 may be lifted (France). Will leave Taiwan more exposed. Not in the interest of the US
- China wants to diversify arms' purchase away from Russia
- January 2004: Year of China in France. Jacques Chirac welcomed Hu Jintao



# Consequences of WTO

- March towards a full fledged market economy will continue
  - Outside pressure brought to bear upon SOBs and SOEs, so as to make them perform better
  - Challenges
    - Combine market solution with fair distribution
    - Clamp down on corruption
    - Develop democracy, Chinese style
  - China's political system suppresses horizontal networking and reinforces vertical relationships
  - Rules constantly shifting and manipulated by government official
- ⇒ Need for WTO to level the playing field and make business climate more stable and predictable

