Assessment of China’s Economic Cool-down Policy

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China’s Economic Overheating and Financial Risk

In the first quarter of 2004, China's gross domestic product (GDP) reached RMB 271.3 billion, up 9.8% year over year (yoy). In the same comparison period, retail sales of consumer goods rose 9.2% to RMB 128.3 billion; investment in fixed assets totaled RMB 879.9 billion, up 43.0%; and the consumer price index (CPI) rose by 2.8% yoy, an increase of growth rate of 2.3%. Two-way trade rose 38.2% to US$ 239.8 billion, resulting in a US$ 8.4 billion dollar deficit to China. Exports amounted to US$ 115.7 billion, up 34.1%, while imports surged 42.3% to US$ 124.1 billion.

Although China's economy has been growing at an extremely fast pace, the CPI in the first quarter this year rose by only 2.8%. Why then is Beijing so worried about an overheating economy that it has decided to adopt measures to cool down the economy?

The main source of concern over economic overheating is the overly rapid pace of investment in China. In the first quarter of 2004, investment there increased by 43% over the year before, compared with annual gains of 12.1%, 16.1%, and 26.7%, in the period from 2001 to 2003. In fact, the first quarter figure is nearly three times the average investment growth rate of 15% over the last 25 years. In the first two months of 2004, investment in 16 of 30 manufacturing sectors exceeded 100%. Increases were especially high in the steel industry (172.6%), construction materials sector (137.4%), and concrete industry (133%).

There are already signs that rapid investment growth is leading to overheating in certain industries. The CPI in 2002 fell by an average of 0.8%, compared with an increase of 3.8% in April 2004, representing a fluctuation of 4.6%. Although 3.8% is not high, it indicates that the overheating in certain industries is worsening. This trend is likely to create over-supply and a new round of deflation before long. For example, according to Chinese government statistics, China will be able to produce at least 330 million tons of steel a year after the completion of current steel plant construction projects at the end of 2005. However, demand is not expected to reach that level until 2010, putting capacity five years ahead of the market.

More important has been the rapid expansion of investment and its concentration in certain industries under the guidance of local governments, which can easily lead to blind investing and redundant construction. If investment is allowed to continue expanding at the current pace, it could fuel inflation or an asset price bubble. Moreover, if the economy slackens, investment in construction is likely to result in more non-performing loans (NPLs) and thus exacerbate the already serious financial risks in China.

At a press conference on March 15 this year, Chinese Premier Wen Jiabao admitted that the NPL ratio at state-owned banks is approaching 20%. If these banks had to compete in a fully liberalized financial market, this level of bad loans would be equivalent to a declaration of bankruptcy. Since China will fully open its financial sector to foreign investment in January 2007, Premier Wen believes that banking reform is a “do or die” task in which failure is not an alternative.

At present, however, there are no signs that the quality of loans made by state-owned banks is improving. Liu Mingkang, the head of the China Banking Regulatory Commission (CBRC), noted in mid-March that several large state-owned banks in China had reduced their accumulated NPL ratio by five percentage points to 18%, primarily through the issuance of new loans rather than by writing off old NPLs. Liu emphasized that resolving the NPL problem at state-owned banks remains a long and arduous job.

In view of the bubble economy and financial risk created by over-investment, Chinese President Hu Jintao clearly stated in his speech for the opening ceremony of the Boao Forum that although the growth prospects for China's economy are good, problems have emerged. He especially noted that blind investment in fixed assets has created serious shortages of coal, electricity and oil power resources and excessive growth in the money supply. Hu stressed that China would enforce “macro controls,” using economic, legal, and administrative levers to rein in development in certain industries and prevent the economy from overheating.

Premier Wen later emphasized that China needs “forceful and effective measures” to slow rapid economic growth. He said that China would adopt drastic measures to control credit and land utilization so as to ensure that the economy makes a “soft landing.” Premier Wen’s and President Hu's words reiterated Beijing's resolve to adopt an economic cool-down policy and mark the official launch of a series of measures to put this policy in force.

China’s Economic Cool-down Policy

In order to slow the economy and reduce financial risk, Beijing has been toning down its active fiscal policy in 2004. The level of fiscal deficit as a percentage of GDP was reduced from 2.9% in 2003 to 2.5% in 2004. The government has also been using monetary levers to cool down economic growth. The People's Bank of China (PBoC) raised the deposit reserve ratio by one percentage point in September 2003, and announced an additional increase of half a percentage point in April 2004, bringing the deposit reserve rate to 7.5%.

In fact, there are three reasons that the Chinese government hopes to use mainly administrative means rather than financial or monetary policy to chill the overheating economy. First, the government worries that an economic slowdown resulting from an overall increase in interest rates will increase unemployment.

Second, China currently faces a serious problem of investment imbalance across industrial sectors. Some sectors are receiving excessive levels of investments, but around 80% of the commodities in China are in excess supply. Raising interest rates would have a blanket affect on all industries and exacerbate deflationary pressure on most industries.

Thirdly, even though investment in fixed assets increased at an annual rate of 43.5% in the first quarter this year, the level of new investment in the farming, fishing, husbandry and forestry industries inched up by only 0.4% and was in fact negative in the first two months of the year. Higher interest rates would make it difficult for the farming industry to get loans, worsening problems in this sector and the situation among farming villages and families. Beijing has therefore opted for macro controls that can at once cool overheating sectors while stimulating lagging industries. This task was significantly harder than simply downshifting the economy overall.

Since this March, Beijing has relied mainly on the following six levers to rein in growth. First, it has tightened lending controls on banks. The CBRC has asked banks to more closely manage their lending and to suspend lending in areas of blind investment, low-level expansion, and areas which are not in accord with national industrial policy or those that have not been examined and approved according to regulatory procedures. Moreover, China's National Development and Reform Commission (NDRC) has singled out the real estate, steel, concrete, electrolyzed aluminum, electricity, urban development and chemical industries as the main over-heating sectors. It has forbidden financial institutions from financing new construction or expansions by companies in these sectors unless they meet specified conditions. Furthermore, the PBoC has directed the head offices of four major state-owned banks to rein in lending to several major industries with over-investment and to those sectors which have been designated by t he government for a comprehensive reduction in lending.

The second lever applied by Beijing is to limit land development. The State Council has demanded a stop to the misappropriation of land and required more rigorous examination and management of construction land so as to preserve a basic level of farmland and dampen excessive investment in fixed assets. The State Council has also ordered a 62% reduction in the number of development zones, from 6,015 down to 3,763. Premier Wen personally ordered Jiangsu Tieben Steel & Iron Co. to stop all work on its $RMB10.6 billion steel plant project and censured the company for illegally obtaining land and financing for the project.

In addition, the Ministry of Land and Resources (MLR) has stopped approving the rezoning of agricultural land for industrial development, suspended the shift of county land to city jurisdiction, and temporarily halted the re-planning of land in basic farmland preservation areas. The Ministry of Construction and MLR have also jointly reorganized land development. The former has demanded that local governments submit reports on the regulatory compliance of planned or ongoing construction of steel, electrolyzed aluminum, and cement plants, golf courses, and large-scale shopping centers. The MLR, in turn, has been making all out efforts to sort out projects involving unapproved land development, land requested but not used, misappropriated land, and haphazard land rezoning.

A third dampening measure is to increase the required reserve ratio for certain industries. The State Council has raised the capital reserve ratios for fixed asset investment in the steel industry from 25% to over 40%, and in the electrolyzed aluminum, cement and real estate sectors from 20% to over 35%.

A fourth lever is to comprehensively sort out investments. The State Council has ordered various localities and units to thoroughly put in order ongoing or planned investments in fixed assets within a six-week period, including investments in the steel, electrolyzed aluminum, and cement sectors, and office building and shopping center development. It has also stopped approving new investment in the steel, electrolyzed aluminum, and cement sectors.

The fifth measure adopted by Beijing has been to require price controls by local governments. In order to prevent inflation on a national level, the NDRC has ordered local governments to suspend price increases on transport, utility and other fees when inflation exceeds a certain limit so as to reduce inflationary pressure and cool the economy.

The sixth lever is to control the overly rapid growth of credit. On May 11 this year, the PBoC released its monetary policy report for the first quarter of 2004, in which it stated that China would adopt an “appropriately tight” monetary policy to rein in liquidity in the financial system and control excessive credit expansion.

The Effects of China’s Economic Cool-down Policy

During the first half of 2004, China’s GDP amounted to RMB 5,877.3 billion, an increase of 9.7% yoy. In the first and second quarter of 2004, China's GDP increased by 9.8% and 9.6%, respectively. In the first half of 2004, fixed asset investment in China amounted to RMB 2,608.2 billion, an increase of 28.6% yoy. China's total retail sales of consumer goods amounted to RMB 2,524.9 billion, an increase of 12.8% yoy. The CPI in China increased by 3.6% yoy; the CPI in urban areas increased by 3%, whereas that of rural areas increased by 4.6%.

China's total trade volume, during the first six months, amounted to US$ 523 billion, an increase of 39.1% yoy. Of the total, exports amounted to US$ 258.1 billion, an increase of 35.7%, whereas imports amounted to US$ 264.9 billion, an increase of 42.6%. China's trade deficits amounted to US$ 6.8 billion. Contractual foreign investment amounted to US$ 72.7 billion, an increase of 42.7% yoy, whereas the realized amount was US$ 33.9 billion, an increase of 12.0%. At the end of June, China's foreign exchange reserves amounted to US$ 470.6 billion, an increase of 35.8% yoy, or an increase of US$ 67.3 billion compared to the beginning of this year. The average monthly increase was US$ 11.4 billion.

The cool-down policy focuses heavily on the industries that are overheated, such as iron and steel, electrolytic aluminum, cement, and real estate. In fact, the rapid growth of real estate investment first led to the rapid expansion of investment in China, further spurring the growth of other industries. In the beginning of this year, real estate investment accounted for 30% of fixed asset investment in China. Due to the economic cool-down measures employed, such as credit crunch, restricted land use, and stringent procedures for approval, in 2004, the growth of real estate investment dropped from 43.6% in the first two months to 30.2% in the first five months. Following the dramatic decrease of real estate investment, the expansion of fixed-asset investment in China reduced from 53.0% to 34.8%.

During the first quarter of 2004, fixed-asset investment in China increased by 43.0% yoy. During the first half of this year, fixed-asset investment in China only increased by 28.6% yoy, a decrease of growth rate by 14.4% compared to the first quarter. In particular, the number of new started projects increased by 5.9% yoy in April and decrease by 15.7% yoy in May, significantly dropping from that of the first quarter of 2004 (an increase of 31% yoy). All the data listed above are solid indicators of the effectiveness of the economic cool-down policy.

China's Unfinished Mission and Long-term Strategy

As far as we are concerned, China's economic cool-down policy seems to be very effective. Nevertheless, the Chinese government needs to appropriately adjust the interest rate and the exchange rate of the Renminbi (RMB). In the long run, the Chinese government also needs to undertake fundamental reforms in its investment and financing system to sustain rapid economic growth and to avoid possible financial crises.

First, since 1995, China's decreasing interest rates have led to constant credit expansion. From 1995 to 2003, the ratio of China's credit to GDP almost doubled, from 87.1% to 166.2%. In particular, the current one-year deposit rate in China stands at 1.98%, whereas the one-year lending rate stands at 5.31%. In June 2004, China's CPI increased to 5%. The distorted interest rate policy resulted in an extremely low lending rate in China, which will most likely go down below zero in the near future. This low lending rate contributes to the huge loaning investment and economic bubbles in China's real estate industry, while the banking system bears the enormous risks of a huge amount of bad debts. The transformation of the incentive structure of enterprises' excessive investments can be achieved only by adjusting interest rates, rather than undertaking transitory macroeconomic adjustment and control measures.

In particular, China's real estate market is a monopolized market, producing exorbitant profits. Local governments have strong incentives to interfere in investment activities in real estate development, which offers a low-risk, high-reward profit-making approach for financial institutions. A mutually beneficiary and co-existent relationship has been established between local governments, developers, and banks in China. Thus, local governments are generally hesitant towards the current economic cool-down policy. Some local governments even strongly requested the central government to adjust the economic cool-down policy. Once the cool-down policy is relieved, economic overheating may re-emerge.

Huge market demand and economic benefits are partly to blame for economic overheating. In early March 2004, the price of steel surged by 50% yoy. Higher steel prices have, in turn, attracted a large increase in investment in the steel industry. In the first two months this year, the steel industry invested RMB 16.9 billion, more than twice the level of the same period last year. Since 2000, China has doubled steel output, making it the biggest steel producer in the world. From 2002 to 2003, the pace of new steel plant construction increased threefold and steel output is forecast to double again in the next three years.

In the real estate market, prices increased 7.7% nationally in the first quarter of 2004, compared with the same period last year, and rose 2.6% from the fourth quarter of 2003, these statistics are based on an official survey of 35 large and mid-sized cities. Price increases surpassed 10% in nine of the cities surveyed, with the biggest gains seen in Shanghai (up 28.3%) and Shenyang (19.6%). As a result, realized profits in the construction industry totaled RMB 3.5 billion in the first quarter of 2004, up 59.1% from the same period a year earlier.

Since profits are so high in overheating industries, banks are naturally happy to lend to these sectors. Such lending can reduce their NPL ratio and improve their profitability in the short term. In the first quarter of 2004, bank profits rose 52.8% from the same period a year earlier. The top four state-run banks improved their earnings by 43% and stock-limited commercial banks saw profit gains of 74.2%. Consequently, overheating industries and banks form a mutually beneficial relationship.

Furthermore, with the current economic cool-down policy, many well-managed small and medium private enterprises cannot receive sufficient loans necessary for business operation, because state-owned banks in China give the majority of their loans to large-scale and state-owned enterprises. This results in stringent liquidity supply and dramatic expansion of usury. The annual interest rate of private lending in Wenzhou stands above 15%, and in some places, the figure even reaches as high as 40%. Instead of maintaining low interest rates to subsidize the operation of state-owned enterprises, the Chinese government should create an environment of fair competition, with a view of sustainable economic development.

Second, since the start of 2002, hot money has been flowing into China in the speculation of the RMB exchange rate. In 2003, such inflows were estimated at US$ 50-60 billion. At the end of June 2004, China’s foreign exchange reserves amounted to US$ 470.6 billion, an increase of 35.8% yoy. Because Beijing insists on pegging the RMB yuan to the U.S. dollar, the PBoC has been forced to increase the monetary base by over 100 billion yuan each month this year to mop up the influx of foreign capital. In 2003, China’s purchasing foreign exchange contributed to 91.5% of the increase of base money supply, which significantly contributed to over-development in certain industries. This has been fueling an economic bubble, and heightening financial risk in China. At this point, the best way to stem the flow of hot money into China and slow the economy is to appropriately revalue the RMB.

Finally, the incremental capital-output ratio (ICOR) indicates extremely low efficiency of China’s investment, which would jeopardize the sustainability of rapid economic growth in China. During their rapid development periods, the ICORs of Japan (1961-1970), South Korea (1981-1990) and Taiwan (1981-1990) stood between 2.7 and 3.2. In comparison, China’s ICOR increased from 3.4 during 1991-1995, to 4.5 during 1996-2000, and 5.1 during 2001-2003. On average, China's ICOR stood at 4.1 during 1991-2003. That is, China's efficiency of investment is much lower than that of Japan, South Korea, and Taiwan at the similar stage of economic development. Furthermore, by itself, China's efficiency of investment keeps deteriorating. As a result, China needs to undertake fundamental reforms in its investment and financing system to sustain rapid economic growth and to avoid possible financial crises.