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Assessing China's Recent Economic Development: Economic Imbalance, Financial Risks, and Exchange Rate

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I. The First Quarter of 2004

China's GDP for the first quarter of 2004 reached 2.71 trillion yuan, up by 9.7 percent from the same period last year. Primary industries have grown by 4.5 percent, secondary industries by 11.6 percent, and tertiary industries have shown an increase of 7.7 percent. In the same quarter, capital investment in fixed assets, estimated at 879.9 billion yuan, saw 43 percent growth. Retail sales of consumer goods came to 128.31 billion yuan, reflecting actual growth of 9.2 percent and the CPI rose to 2.8 percent. Urban incomes reached 2,639 yuan, an increase of 9.8 percent, while rural incomes reached 834 yuan, an increase of 9.2 percent.

Looking at external trade and investment for the first quarter, imports and exports totaled US$239.8 billion, an increase of 38.2 percent; however there was also a trade deficit of US$8.4 billion. Export figures show an increase of 34.1 percent, with exports holding at US$115.7 billion, while import figures increased by 42.3 percent, with imports at US$124.1 billion. Up by 49.2 percent, contracted foreign direct investment (FDI) reached a new high of US$34.3 billion while utilized investment came to US$14.1 billion, which is an increase of 7.5 percent. At the end of March foreign exchange reserves had surged to US$439.8 billion, showing an increase of US$36.6 billion compared to the end of 2003. This reflects an average monthly increase of US$ 12.2 billion.

II. Economic Imbalances and Financial Risks

With regard to economic trends in China, China's National Bureau of Statistics has recently pinpointed several areas of concern. In particular, overinvestment in fixed assets is rampant, and certain industries and regions have seen blind investment and low-level duplicated construction, which as yet remains unchecked. This situation has in turn caused major gluts in the supply of raw materials, power resources and transportation, thereby further exacerbating inflationary pressures. In mid-March, Chinese Premier, Wen Jiabao even went so far as to caution that solving China's deep rooted economic problems will prove an even greater test than that of SARS. He further remarked on the seriousness of the situation, for without applying the right adjustments, China's economy could indeed suffer a major setback. Moreover, the National Bureau of Statistics reiterated this view when commenting, "Fighting SARS is of utmost concern but it is the success or failure of macroeconomic management that will have a direct impact on the economy." It is thus becoming more and more evident that China's current economic climate is not overly optimistic.

Currently, the overall investment growth rate stands at 43 percent – almost three times that of the average investment growth rate (15 percent) over the past 25 years. In fact, in the first two months of 2004, amongst the 30 manufacturing sectors, investment exceeded 100 percent in 16 sectors. In particular, the iron and steel industry saw increases of 172.6 percent; the construction industry saw increases of 137.4 percent, while increases in the cement industry were equivalent to 133 percent. By the end of the first quarter, investment in manufacturing alone has shown a sustained growth of 75.8 percent. As the People's Bank of China stated when raising the deposit reserve ratio in mid-April, the rampant expansion of investment could possibly set off inflation or an asset price bubble. In the end, this will only mean a new round of non-performing loans (NPLs) as well as added financial risks.

Compared to the present CPI of 2.8 percent, the average CPI for 2002 stood at 0.8 percent, reflecting a disparity of around 3.6 percent. Although 2.8 percent is by no means high, it is indicative of overheating in the economy and before long China's local industries will likely see a situation of supply exceeding demand – only kicking off a new wave of deflation. According to the survey of the second half of 2003 by the Chinese National Business Information Center, supply balanced demand in only 127 categories out of the 600 different product categories listed, which equates to only 21.2 percent of product categories. In other words, while the overwhelming majority of industry is in a deflationary situation, there are a small number of rapidly expanding industries that are causing serious imbalances in economic development.

More importantly, since it is local bureaucrats that are guiding the rapid rise in investments and the concentration of investments in certain sectors, overinvestment and duplication of construction are therefore highly likely. For instance, based on the Chinese official estimates, if all the present iron and steel projects are completed, then China will have an output of at least 3.3 hundred million tons of steel by the end of 2005. Yet it is not until 2010 that demand for steel will match an output of 3.3 hundred million tons and investment in the steel industry has already surpassed estimates for the next five years. Once economic growth slows, these investment projects could quite easily become non-performing loans, which would only further aggravate an already highly critical financial predicament.

During a press conference on the 15th of March, Premier Wen acknowledged that the NPL ratio of state-owned banks amounted to around 20 percent and if the government were to completely open its financial markets to competition, because of these high NPL ratios, it would be equivalent to announcing their bankruptcy. Since China intends to open its markets to the foreign banking sector by January of 2007, Premier Wen regards banking sector reform as a "final battle" and one that must be won at all costs.

Nonetheless, if we take a look at China's state-owned banks it would appear that the quality of credit has not improved. In mid-March, the chairman of the China Banking Regulatory Commission, Liu Mingkang indicated that many of China's state-owned banks had reduced the NPL ratio by 18 percent, a decrease of 5 percent compared to last year, however the main mechanism to achieve this is through expanding new loans rather than by eliminating past NPLs. Chairman Liu Mingkang emphasized that resolving the NPL burden in China's state-owned banks is both a long-term and a potentially arduous task. In this context, the continued expansion of banking credit is only likely to create more bad loans and could in fact lead to a financial crisis.

In order to dampen the overheated economy and reduce financial risk, China's government prohibited loans for overheated industries mainly through administrative measures. China's State Development and Reform Commission has already identified real estate, iron and steel, cement, electrolytic aluminum, electricity, urban construction and chemical engineering as the main culprits contributing to the overheating and has requested that financial institutions do not give out loans to new or reconstruction projects when and where conditions are not met. At the same time, any construction projects that do not meet the Government's industrial policy or that do not conform to market opening standards will not be permitted the use of the land.

A more direct approach was to raise the deposit reserve ratios, but so far, Beijing has been unwilling to raise the interest rates. After raising the deposit reserve ratio by 1 percent last September, in April of this year, the People's Bank of China decided to raise it by 0.5 percent, from 7 percent to 7.5 percent.

III. Evaluating China's Economic Trends

One of the fundamental sources of China's current economic imbalances and its overheated economy lies with the money supply and the overextension of credit. Brought on by soaring foreign exchange reserves, the money supply has seen sharp rises since 2003. In fact, foreign exchange for 2003 accounted for 91.5 percent of the increase in base currency. From this year onwards the

People’s Bank of China has no choice but to throw in over 100 billion yuan in base currency each month to purchase the unimpeded flow of foreign exchange into China. This is also one of the main contributing factors to the loosening of the M2 money supply at the end of March – at an increase of 19.1 percent. The capital contraction, achieved by raising the deposit reserve ratio, seemed insignificant, because this figure was much lower than the released domestic capital attributing to China’s constant accumulation of foreign exchange reserves.

In meeting its goal of lowering the money supply, there are basically two means available to China: lifting interest rates and revaluating the Renminbi (RMB). Ironically, not only does the raising of interest rates have negative impacts on investment and consumption but there is also the added drawback of further stimulating the speculative capital inflows into China. If this occurs, the effort to check the money supply will have become fruitless. Perhaps more importantly, aside from jeopardizing robust investment, cutting the interest rates in one fell swoop will not necessarily correct the economic imbalances. Thus China must really deal with the problem directly: the undervalued RMB, which is like a magnet for short-term capital inflows or what has been termed: “hot money.” Otherwise China will find it difficult to deal with the current economic imbalances and may even see a worsening of the situation.

Ever since 2002, hot money has been flowing into China from all around the globe. The very basis of this flow is simple: speculation over an undervalued RMB. In 2003, international hot money inflows were estimated at US$50 billion. For the first quarter of this year, China’s trade deficit came to 8.4 billion, while the actual direct foreign capital amounted to US$14.1 billion, and yet foreign exchange reserves had increased by US$36.6 billion. The unexplained portion of foreign exchange reserves thus amounts to 30.9 billion (36.6+8.4-14.1), which is an increase of 25.6 percent. With this in mind, it is foreseeable that hot money inflows for this year are unlikely to lag behind those of last year.

If international hot money flows continue pouring into China, and if the money supply and credit continues along the same track domestically, what is currently an overheated economy could instead head towards a full blown financial crisis. Thus at the present time, it would seem that the appreciation of the yuan and the adjustment of the currency exchange rate regime presents the most effective approach to the problems of hot money and an overheated economy.

IV. Impacts upon Taiwan

If the current economic malice in China continues unabated, Taiwan must face the fact that China's economy may be in for a hard landing. Looking ahead, there are four main scenarios that China's future economic development may take:

1. If China chooses to lift its interest rates, there is the possibility that overseas speculative inflows will continue and may even show a large increase. In this scenario, neither the economic imbalances nor the overheated economy will show any benefit and could instead worsen as a result. What is more, China would have to increasingly rely on ad hoc, short-term administrative measures to dampen the overheated economy and yet the prospects after having done so are not overly bright. On the contrary, the economy may have to face a hard landing in the end.

2. If China opts to move ahead slowly with a minor revaluation of the yuan, we might expect to see a prolonged international inflow of hot money into China. Once again this will not solve China's immediate economic problems and may instead worsen them. In the meantime, it is foreseeable that the speculative foreign capital inflows into China and the upward pressures on the yuan will likely continue for some years into the future.

3. China intends to open its financial markets by January of 2007. If by that time, the Chinese government has still not been able to solve the problems of an overheated and imbalanced economy, there is a relatively high probability that a local financial crisis may occur.

4. If China makes one-time adjustment to revalue the RMB by 10-15 percent, re-pegs the RMB to a basket of several currencies, and expands the floating band of the exchange rate, China's economic imbalances and the overheated domestic economy will be improved significantly.

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