

CHINA: RECENT TRENDS AND OUTLOOK – PART III

CONTRADICTIONS AND STUMBLING BLOCKS TO DEVELOPMENT

The spectacular development of the Chinese market and the country's position in the global economy obscure a number of contradictions, some of which are being felt today (financial sector, bureaucracy), and others that will materialize in the future (gap between rich and poor, unemployment).

Regional imbalance

While the coast is moving forward, the rest of the country is still languishing. The average gap between rich and poor between the industrialized East and rural West continues to widen, surpassing a ratio of 2.5, the same as between developed and third world countries. In many respects, it looks like East China is exploiting the West side's natural riches. Five hundred million peasants are ready to work 16 hours per day just to survive.

Despite Peking's desire to rebalance the country, the eastern provinces continue to absorb between 85% and 90% of foreign investment. It should be recalled that Chengdu, described in a previous bulletin, is an oasis in the interior, surrounded by some 350 million casualties of progress. Despite a preferential taxation policy, the province received only 2% of foreign direct investment in 2003, while China was the number one recipient of FDI.

Some observers see a threat to the country's cohesion, particularly since economic and social disparity is being further exacerbated by ethnic and cultural differences. In fact, in November 2004, tensions involving Muslim communities were reported in the west of the country.

An archaic financial system

The banking structures are not keeping pace with the country's development, and moreover, are not up to international standards. After years of extending loans to unprofitable state-owned enterprises, China's banks are in very bad shape. According to unofficial sources, the bad debts of the country's four largest banks represent 40% of their total loans. The typically optimistic state data puts the rate at 21.5%.

Few sources of financing are available to companies. At the end of 2003, China's stock market capitalization accounted for less than 40% of its GDP, a laughable figure when compared to its Asian neighbours (75% in South Korea, 130% in Taiwan) and the major stock markets in the West. Given the absence of a sufficiently large stock exchange or bond market, the banks always provide 90% of the financing. In fact, the Chinese stock exchange accounts for only 0.4% of the world's stock market capitalization, and consequently, China's largest companies list in Hong Kong or New York.

The Chinese government has promised the World Trade Organization (WTO) to open its stock market in 2006. It also recently announced that commercial banks

will soon be able to start equity and bond investment funds, which should facilitate the development of long-term financing and strengthen local financial markets.

China's monetary policy does not favour a transition to a market economy. In fact, the government has decided to keep the renminbi (RMB) pegged to the U.S. dollar at all costs, and in order to keep its currency from appreciating, the People's Bank of China has been buying U.S. dollars for years. The foreign exchange reserve has swelled 200% in five years, and, as a result, the country's money supply is growing much too quickly.

Companies with outdated structures

The transition to a market economy is also being hindered by the outdated structure of formerly state-owned enterprises. China has found itself with thousands of scattered factories with redundant, inefficient and outmoded operations. However, the situation is slowly changing. The state manufacturing sector, which employed 200 million people in 2002 (56% of manufacturing jobs), has shrunk to 72 million (29%). The private sector now fuels two thirds of the economy's growth, and more than 75% of public companies have been incorporated. Public enterprise reform is an overriding objective of the 10th 5-Year Plan (2001-2005), which also calls for creating some 50 competitive industrial groups capable of trading on the world's stock markets.

However, this reform will create immense social problems, as 2,500 small and mid-sized businesses close their doors and lay off 5 million people in a country with no unemployment benefits.

Heavy energy dependence

Despite its abundant raw material resources, China's exceptional growth in the last decade has made the country's energy dependence all too apparent. Indeed, China is now the world's second largest importer of crude oil.

According to estimates by the International Energy Agency, China's oil needs will double by 2025, from 5.5 to 11 million bpd, thereby raising its share of global oil consumption from 7% to 9%. The country's growth is therefore directly dependent on stable oil supply.

Inadequate health services and environmental stewardship

While China has become a scientific powerhouse, the SARS crisis in 2003 highlighted the country's inadequate health system.

And as for the environment, China is far from getting a handle on its severe pollution problem.