THE PHENOMENAL GROWTH OF THE CHINESE ECONOMY: BOOMING OR OVERHEATING?

China has experienced phenomenal growth in the last few years, which has made its economy the planet’s main source of expansion since 2000. The boom has had an unmistakable effect on international markets where China is exerting its influence more and more, particularly on raw materials prices and in the area of international trade. However, the emergence of signs of overheating in several industry sectors are causing concern among many observers. In spite of certain restrictive measures, the economy is still roaring along at full tilt: will Chinese government authorities be able to bring about a soft landing of their economy?

The primary purpose of this Economic Viewpoint is to provide an answer to that question, which is so important to the world economy. All in all, we will show that, while present, the risks of a backslide are limited for the time being. To make our illustration, we discuss themes that are more general, and in the following order:

- China, a player of growing importance…
- …That increasingly exerts its influence
- The source of growth: an unprecedented investment boom
- Overheating = excess demand = inflation
- Controlling inflation: the key to China’s problems
- The explosion of international reserves
- The yuan: To revalue or not to revalue?

China, a player of growing importance…

The meteoric growth China has experienced over the last few years has enabled it to carve out a place for itself among the largest industrialized economies at a breathtaking speed. While the temptation might be strong to draw comparisons with other periods of expansion like those of Japan and other Asian countries, it is important to understand that China’s has been even more rapid. As we can see, at the pace at which things are going, China will need only about 20 years to go the same distance it took Japan 48 years to go.

Measured using exchange rate conversion, China is the sixth largest economy on the planet behind the United States, Japan, Germany, the UK and France. However, its size is even more eloquently illustrated when expressed in purchasing-power parity (PPP)—a theoretical rate of exchange that equalizes the purchasing power between countries, which is a much more accurate measure.

Based on PPP, the country’s economic weight has more than doubled, surging from 5.1% of world GDP in 1985 to 12.5% in 2003. This has enabled China to displace Japan as the world’s second biggest economy since 1995.
With its rivals now far behind it, China can hope to match the US economy shortly. It is noteworthy that with current industrialization, the growth potential of the Chinese economy is twice that of the United States, which matured long ago. According to the International Monetary Fund (IMF), to absorb the migration of workers from rural areas to the cities, the economy must grow by at least 7%, which is the growth needed to generate between 20 and 25 million new jobs per year (it is estimated that China has a surplus work force of 150 million people). At that rate, the size of the Chinese economy—measured at PPP—will outstrip the US economy between now and 2018. Of course, the breakneck advance of the last few years cannot be maintained indefinitely. We need point out only the demographic problems that China risks facing due to its “one child” policy. Consequently, Chinese real GDP could not exceed that of the United States for 30 to 40 years.

...That increasingly exerts its influence

In one way or another, China leaves no one untouched and can no longer be ignored. With an average advance of close to 8.5% between 2000 and 2004, China has contributed by more than a third to world economic growth, or significantly beyond the contributions of the Euro zone and Japan. Hence, it is due to China that the world’s economy did not sink into recession along with the US economy at the end of 2001.

With such an economic boom, it is not surprising that China has become a world leader in several industry sectors. It is already the world’s largest consumer and producer of steel and stands among the largest consumers of aluminum, zinc, copper and cement. In addition, its increasing energy needs moved it into second place for world oil consumption in 2003.

With China’s current industrialization, this trend is not about to reverse itself. The increase in the demand for current consumer goods, automobiles and housing, combined with the boom in corporate investment, will continue to sustain demand for raw materials over the next few years. The problem is that China’s need for natural resources will grow more rapidly than local production. For example, oil consumption has increased at an average of 8% per year since 2000, while production has risen by only 1.4% over the same period. The shortfall still has to be made up through imports.

1 We make the assumption here that the United States will grow at an annual rate of 3.2% over the same period, which is the current growth potential of the US economy according to the Congressional Budget Office (CBO), an independent American agency.
Source of growth: an unprecedented investment boom

Since its accession to the World Trade Organization in December 2001, China's opening to international trade has been extraordinary. Exports have undergone a constant increase to attain more than 35% in 2004, one of the main sources of growth of the Chinese economy.

Asia remains the leading market for total Chinese exports at nearly 50%, but that ratio has been decreasing year by year since 1995 in favour of exports to Europe and the United States, which have almost quadrupled over the same period. In particular, the weight of the US market has risen from 16% of total Chinese exports in 1995 to 21% in 2003.

On the flip side, China’s needs for raw materials mean that imports have become just as significant. When exports and imports are added together, the degree of openness amounts to about 60% of GDP, which makes China a very "open" economy that is much more oriented toward foreign trade than Japan or the United States: a real windfall for the Asian economy.

As we can see, China has a trade surplus with the United States, but a deficit with the rest of Asia. That said, the lion’s share of the gains from exports is counterbalanced by a similar increase in imports, which leaves a marginal contribution to GDP growth by the foreign trade sector.

With the weight of consumer spending relatively stable over time, the frenetic growth of the Chinese economy over the last few years is due to the unprecedented boom in investment. Due to China’s industrialization, the flow of workers from rural areas moving into the cities means that the needs for new plants, the expansion of infrastructures and the construction of new housing are very high. Since 1999, growth in investment spending has progressed in double digits and, in spite of the restrictive measures, the pace slowed only to 25.8% in 2004, a slim decline of 1.9 percentage points compared to the preceding year. This means that the scale of investment has risen from 25% of GDP in 1995 to close to 42% in 2003 and probably more in 2004.

2 We are not referring here to foreign direct investment (FDI), which represents only 3% to 4% of GDP, but rather spending in corporate investment that originates-majoritarily-with government corporations.
Overheating = excess demand = inflation

The problem is that it appears overheating is developing in industry sectors where demand is extreme. Most of the time, overheating (that is excess demand) tends to cause inflation, which is never a good sign for economic growth. To fill that demand, investment then has a tendency to increase very rapidly—in fact, too rapidly.

In the past, increasing investment spending has often led to production overcapacity that, in turn, resulted in economic growth running out of steam. These swings in the economic cycle—from a boom to a bust in a very short span of time—have involved massive job losses in the government state owned enterprises and an increase in nonperforming bank loans. The problem in China is that out of the savings of the Chinese people (about 45% of income), nearly two-thirds is deposited in the four major state banks, which lend more than 60% of that to government corporations, often without regard for return or risk.

Controlling inflation: the key to China’s problems

The purpose of the restrictive measures is to keep overheating from turning into an upsurge in inflation. To succeed in this, the government is attempting to slow down the economy to bring it back in line with its growth potential (between 7 and 8%). For the time being, inflation is not too much of a concern but given the speed at which things tend to develop in China, as a measure of caution, the government is hoping to nip it in the bud.
The most recent data show that the annual variation of the consumer price index (CPI) has decreased since the summer, declining from 5.3% in July—an almost 7-year high—to only 2.4% last December. Still, inflation came in at 3.9% for 2004 overall, a net acceleration compared to 1.2% in 2003. Essentially, this reflects the climb in food prices during the summer and, more particularly, the price of grains, which jumped nearly 32% on average during the same period due to poor weather. That said, excluding food prices, inflation remains very low at less than 1.0%.

On the other hand, there is some pressure coming from producer price inflation (PPI) that, despite a first decline in December, has been showing a net upward trend for a year. The incidence of the increase in PPI on consumer prices remains weak for the time being, but the sustained rise in energy prices will sooner or later have an effect on consumer prices, equalling the extent to which China industrializes. For the moment, the lion’s share of consumption is focussed on food and housing but increases in wage earners’ incomes will stimulate demand for manufactured goods.

In the short term, it is expected that the annual variation of total CPI will continue its downturn due to the negative base effects linked to food. That said, there is nonetheless a risk of seeing inflation excluding food rising over the next few quarters. On the one hand, there are few concrete signs to date that the restrictive measures have succeeded in slowing the economy down. Contrary to consensus expectations, the growth of real GDP accelerated from 9.1% to 9.5% from the third to the fourth quarter of 2004 and investment spending slowed only marginally.

There are also wage pressures. For the last five years, real salaries of Chinese wage earners have undergone a dizzying rise of nearly 10% per year on average. This might seem a bit contradictory to the fact that the flow of workers from the countryside into the cities has a tendency to limit wage increases, but it must be noted that in its efforts to industrialize, China is having more and more difficulty finding qualified personnel. If we put growth in productivity at 7%, the increase in real wages, 12% in 2003, could mean an increase in the unit cost of labour of 5%: that is huge, and highly inflationary.
And then, there is the expansion of the supply of money. Of course the restrictive measures on credit have helped to slow down M2 growth from a high of more than 20% in August 2003 to a low of 13.6% in October 2004, but the supply of money remains difficult to control in the medium term. It must be noted that the massive flow of foreign capital into China over the last few years has pushed up the contribution of international reserves to the expansion of the money supply from under 1% in January 2001 to close to 10% at the end of 2004. According to the IMF, Chinese monetary authorities have succeeded in partially limiting the expansion of cash in circulation by sterilizing two-thirds of their purchases of international reserves. But at the rate China is building them up (monthly purchases were US$30B, on average, in the fourth quarter of 2004), pressure on the supply of money can go nowhere but up.

First, the net acceleration in exports at the end of the year spiked up the trade surplus to US$31.9B in 2004. To that must be added a net amount of about US$30B in transfers, revenues, services and omissions, which brings the current account surplus to more than US$62B. Then, there are the inflows into the capital account. China is the world’s largest recipient of foreign direct investment (FDI). In 2004, it received US$60.6B, an increase of 13% over 2003.

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\begin{align*}
\text{China: The foreign direct investments strongly increased in 2004} & \\
\text{Ann. var. in %} & \text{Ann. var. in %} \\
\text{Foreign direct investments} & 0 & 2 & 4 & 6 & 8 \\
\end{align*}
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Sources: National Bureau of Statistics and Desjardins, Economic Studies

So we see that China finds itself at the same time with a current account surplus and a capital account surplus (from which comes the obligation to accumulate international reserves, an outflow of capital that re-adjusts the identity of the balance of payments to zero).

That said, of the US$206B in reserves accumulated in 2004, only US$122.6 have been capitalized accordingly: a shortfall of US$83.4B. These unclassified inflows of capital originate essentially from a combination of higher
interest rates and speculation on a pending revaluation of the Chinese currency. As the following chart shows, non-deliverable forward contracts on the yuan indicate that investors expect a currency revaluation within a few months.

The yuan: To revalue or not to revalue?

For many, the accumulation of massive international reserves over two years (a reflection of the acceleration in the growth of exports and the record influx of foreign direct investment (FDI)), is in itself evidence of the undervaluation of the Chinese currency. According to some officials from the most industrialized countries, China is in large part responsible for the US current account deficit, and pressure is strong for the Chinese government to revalue is currency downward.

First, to be credible, a revaluation has to be substantial (a small revaluation, like a widening of the fluctuation range, would only encourage an acceleration of speculative movement on the currency). That said, with the efforts of the government to slow down the speed of investment, growth of the Chinese economy is more than ever oriented toward exports: a marked revaluation of the yuan would obviously be harmful to foreign trade.

A floating exchange rate is not a viable solution either: the banking system is still too fragile and the financial markets too underdeveloped to allow opening the capital account and allowing free access to foreign banks to convert yuans.

Matching to a basket of currencies (US$, euros, yen, A$ and other Asian currencies, for example) appears likely to be the most promising option. But at the moment, the financial markets are too underdeveloped. This means that firms engaged in trade cannot buy futures contracts on the yuan to cover exchange risks. In contrast, the current situation, in which the yuan is matched exclusively to the greenback, allows them to buy futures contracts in US dollars against the currencies of the countries they trade with.

That said, the desire by government authorities to steer China toward a market economy means that, from a political point of view, revaluation still remains likely within the next few years. Note that, due to the fixed exchange rate, the absolute yuan has depreciated parallel to the US dollar since February 2002, which only serves to benefit China’s international trade position. Additionally, a recent IMF study⁴ shows that, as the Chinese economy matures and becomes more closely correlated to the world economy, China will be more exposed to different types of macroeconomic shocks. At that point, it will be more advantageous for it to have greater exchange rate flexibility and, accordingly, a more independent monetary policy.

Conclusion

The acceleration of the Chinese economy in 2004 is both disconcerting and reassuring. On the one hand, the rise in real GDP in the fourth quarter suggests that there

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⁴ IMF Policy Discussion Paper, PDP/05/1 “Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China”.

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remains much work to be done to bring about a soft landing of the economy. On the other hand, while the efforts of government authorities are aimed primarily at slowing down growth in investments in overheated sectors, the improvement in net exports (US$11.1B) and the rise in household spending (14.5%) in December suggests that the economy is not heading for a hard landing. The continuing improvement in the conditions of households gives hope that consumer spending, combined with exports, will be able to take the place of investment over the next few years.

Consumer price inflation is contained for the time being, but some inflationary pressure is still being felt from producer prices and the accumulation of international reserves. Since controlling inflation is the key to sustainable growth in China, this suggests that government authorities will continue to apply measures intended to slow overinvestment in the overheated sectors.

Despite pressure from the Americans and some European countries, it would also be surprising if the Chinese government were to undertake a sudden revaluation of its currency. In the context where growth is more than ever oriented toward exports, China will certainly not want to lose its trade advantage—the most effective weapon in its arsenal.

Finally, although China’s future is promising, there remain nonetheless several risks in the short term. For one, China is still an emerging economy (its per capita GDP was only 1,100 in 2003). Since emerging economies are subject to volatility, the possibility of sagging growth after the rapid expansion of the last years cannot be ruled out. One of the reasons is that the underlying needs of democracy arising from the improvement in the standards of living could lead to political instability. Moreover, there is still a long way to go to achieve the transition from a planned economy to a market economy. The banking restructuration is far from finished and state owned enterprises are not efficient enough yet. Summing up, China promises to be a continued source of worry for the next several years, something the rest of the planet will have to deal with.

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