

4 CHINA

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2004: ACCELERATING GROWTH

China's economy experienced accelerating growth in 2004. The GDP growth rate was up to 9.5% from 9.3% in 2003, driven by fixed asset investment (FAI). In the first quarter of 2004, GDP grew by 9.8% and FAI surged by 43%. Concerned at the over-investment resulting in economic overheating, the government introduced polices in April 2004 focusing on land control, credit control and stricter project approval. Reflecting the implementation of macro controls, the economy then decelerated gradually. GDP grew by 9.6%, 9.1% and 9.5% for the second quarter, third quarter and fourth quarters, respectively. The FAI growth rate was down to 22.5% by the fourth quarter.

FAI for the full year increased by 25.8%, 1.9 percentage points lower than in 2003, but still rather high. The FAI-to-GDP ratio was up to over 50% in 2004. The rapid investment growth was supported by local governments seeking rapid growth in their areas: projects under central government authority increased by 3.1%, while local projects surged by 31.5%. In addition, FDI recorded accelerating growth. Total actual FDI registered was US\$60.6 billion, a rise of 13.3%, or 11.9 percentage points higher than in 2003. Contracted foreign investment, an indicator of future trends, rose by 33.4% year-on-year to US\$153.5 billion.

Over the year, exports accelerated slightly, rising by 35.4%, 0.8 percentage points higher than that in 2003. The continued rapid growth was

attributed to global economic recovery, the renminbi's relative depreciation, and the increase in FDI. Foreign-funded enterprises have played a very important role in exports in recent years, accounting for 57% of total exports in 2004. The number of foreign-funded manufacturing enterprises accounts for 70% of the all foreign-funded enterprises. In 2004, the number of approved foreign-funded manufacturing enterprises accounted for 72% of the total, focusing on communication equipment, computers, electronic equipment, and general and special machinery.

Imports grew by 36% in 2004, down nearly 4 percentage points from 2003. The merchandise trade surplus swelled to US\$32 billion in 2004, rising by 25% compared with 2003. The import growth rate continued to outpace the export growth rate. Since China joined the WTO, tariffs have been cut gradually. The export VAT rebate rate was cut by 3 percentage points from an average 15% to 12% in 2004. In addition, domestic demand increased significantly. All these factors supported the import increase.

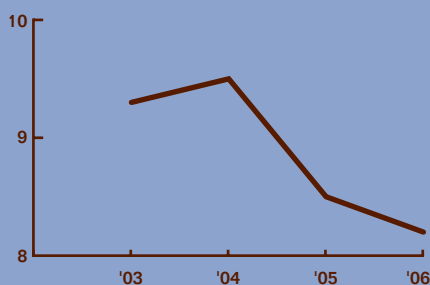
Consumption increased faster in 2004 than in 2003. Total retail sales grew by 13.3%, 4.2 percentage points higher than in 2003. Due to grain price rises, farm household per capita income increased by 6.8% in real terms, the highest since 1997, while urban household per capita disposable income increased by 7.7% in real terms. Those factors also supported the consumption growth.

China's CPI has risen rapidly since November 2003, as inflation pressure increased. CPI peaked at 5.3% year-on-year in July and August 2004. After August, it decreased gradually coming down to 2.3% in December 2004, due to the government's macro controls. Over the full year, CPI rose by 3.9% year-on-year, against 1.2% in 2003. The rapid CPI rise was due to soaring food prices – food prices rose by 9.9% in 2004, with grain prices up 26.4% and eggs up 20.2%. Residential prices rose by 5.4%. The summer grain harvest reduced the inflation pressure somewhat in the second half of the year. Due to over-investment, China's economy is suffering from shortages of energy and transportation, also increasing inflation pressures.

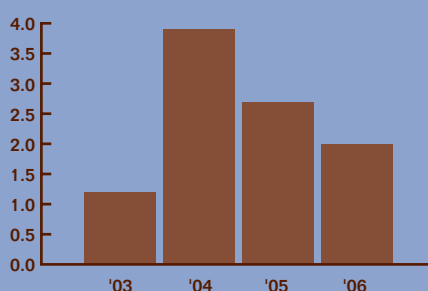
OUTLOOK FOR 2005 – 06

The government announced it would adopt neutral economic policies to achieve sustainable growth in 2005, ending years of expansionary policies. The target GDP growth rate for 2005 is 8%. It is estimated that the macroeconomic control measures taken in 2004 will continue to impact on the economy in 2005. We expect the economy to still keep growing rapidly in the next two years, but the growth rate will be lower than in 2004, at 8.5% in 2005 and 8.2% in 2006. The economy will make a gradual soft-landing. The positive factors for the forecast are FDI inflow, financial and state-owned enterprise reform, and rapid urbanization. The negative factors include the shortage of energy and transportation, and the government's neutral economic policies. Energy and

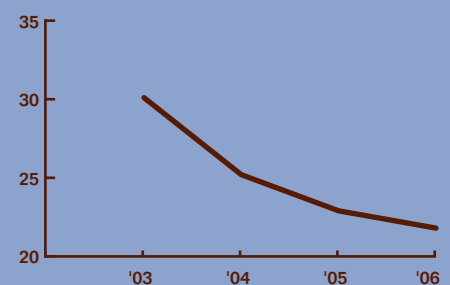
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)





transportation have become bottlenecks in the economy, which will not be eased in short term.

Investment will continue to be the major driving force of the economy. The FAI growth rate will be around 16% in 2005, lower than in 2004. The positive factors behind this forecast include the low real interest rate, strong FDI inflow, and the government's policies to encourage private investment. Private investment increased by 51% in 2004, while state-owned investment rose only 14.5%. FDI increased by 10.7% in the first month of 2005 compared to the same period of 2004. The negative factors include the macroeconomic controls implemented in 2004 and the neutral fiscal and monetary policy adopted for 2005 to prevent investment growth rebounding.

Consumption demand will keep growing steadily in 2005 and 2006, with the growth rate of total retail sales 9% in nominal terms. Although interest rates have been raised, the real interest rate is still negative. In addition, consumption patterns have been changing, with demand for goods such as private cars growing rapidly in recent years; expenditure on building decoration materials has also increased significantly, due to the increase in private house purchases. All these factors will stimulate consumption growth.

We expect China's export growth to remain strong. Merchandise exports grew by 36.6% in the first two months of 2005, against 28.7% in the same period of 2004. The export growth rate should be 30% for the whole of 2005. This forecast is supported by global economic growth in 2005, the continuing effects of WTO entry, and US dollar depreciation. It is estimated that the US dollar (to which the Rmb is pegged) will depreciate continually in 2005, and the Rmb/US\$ exchange rate will remain stable. This will benefit China's exports. The

negative factor is the change in the policy on the export VAT rebate. The export VAT rebate for some products will be cancelled, and some export commodities will be taxed in 2005.

It is estimated that China's import of goods will grow by 29% in 2005, slightly lower than the growth rate of exports. Import growth is supported by domestic demand, which will ease in 2005. Statistics show that China's imports of goods grew by only 8.3% in the first two months of 2005, much lower than for exports, and the trade surplus reached US\$11.1 billion. It is estimated that China's foreign trade will maintain this trend for the whole year. According to the conditions of WTO entry, the average tariff level will decrease to 10.1% in 2005, with the average tariff on industrial products down to 9.3%, and agricultural products down to 15.6%. These factors will benefit imports.

China's CPI should rise by 2.7% in 2005 and 2% in 2006, 1.2 percentage points and 1.9 percentage points lower than that in 2004, respectively. It is expected that the economic growth rate in 2005 will be lower than in 2004, due to the government's neutral macroeconomic policies, which will reduce domestic demand. Statistics show that CPI rose by 2.9% for the first two months of 2005, which seems to indicate a slow decrease in inflation. Due to the rapid CPI rise in 2004, many local governments have delayed the adjustment of residential charges including water, electricity and fuel etc. These charges will probably be raised in 2005. All these factors support the forecast.

Preventing inflation and maintaining sustainable growth are still the main tasks for China's economic managers. The government has said it will implement neutral fiscal and monetary policies in 2005. The amount of special treasury

bonds will be reduced to Rmb80 billion in 2005 from Rmb110 billion in 2004. The deficit will be cut by Rmb19.8 billion, and the ratio of deficit-to-GDP will be down to 2% from 2.5% in 2004. Concerned about inflation and investment rebounding, the central bank announced that the target of money supply growth is 15% in 2005, 0.4 percentage points lower than that in 2004. It is believed that interest rates will be raised again, if inflation pressure increases in 2005. As for the foreign exchange rate, the central bank has announced it will reform the exchange rate system step by step, while keeping the exchange rate stable in 2005.

UNCERTAINTIES

It is expected that the global economy will keep growing in 2005. But, there are still some uncertainties – including external trade conflicts, oil prices, US dollar depreciation – that would impact on China's economic growth.

The depreciation of the US dollar will cause the depreciation of the Rmb relative to other currencies, which will strengthen the competitiveness of Chinese-made goods. This will benefit China's export growth. However, US dollar depreciation would also have some negative impacts on China's economy. Firstly, the export growth flowing from depreciation of the US dollar will intensify trade conflicts. Secondly, owing to robust FDI inflows and a large trade surplus for many years, China's foreign reserves accumulated quickly, reaching US\$600 billion at the end of 2004, most of which are in US-dollar assets. Rapid export growth would cause foreign reserves to increase further. The depreciation of the dollar will have a negative impact on the security of the foreign reserves. Thirdly, the foreign reserve increase will result in the an increase in base money, which would impact on monetary policy.