COUNTRY RISK ANALYSIS: CHINA

By Jesper Christensen

Introduction

The Chinese economy is facing many interesting macro- and micro level opportunities and restraints due to its accession to the WTO in December 2001.

Whether the economy will prosper in the light of the WTO obligations is very hard to say. However, this paper will focus on answering, whether the Chinese economy is ready for accession to the WTO or not.

I will mainly try to answer this question with regard to the last years’ developments in Gross Domestic Product (GDP) and the industrial policies surrounding the State Owned Enterprises and the Township and Village Enterprises. Furthermore, I will venture into a brief discussion of the credibility of the official GDP growth figures.

GDP Growth

The Chinese economy has been growing in terms of GDP since the first economic reforms were initiated in 1978. However, GDP levels have especially raised in the 1990’s with nominal growth rates reaching as high as 30% in certain years (with comprehensive inflation rates bringing real growth down to around 14%).

The growth has, not surprisingly, slowed down comprehensively as it is harder to change a large GDP by 30% than is the case with a very small GDP, as the one China had up through the late seventies and early eighties.

The picture is the same if we look towards the west and more developed countries that historically have experienced the same reduction in GDP growth. The same goes for GDP growth rates in other Asian latecomers of which a large number have seen the same slowdown. This is not unnerving, especially in the case of China, as she has actually been able to sustain a very high growth as compared to a world economy in recession. And not only has China been able to keep GDP growth high, she has also been able to keep it more or less stable over the last five years in real terms.
Table 1: Nom. GDP and real percent change.

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<tbody>
<tr>
<td>GDP and Major Components (percent change from previous year, except as noted)</td>
<td>Nominal GDP (billion US$)</td>
<td>601.1</td>
<td>540.9</td>
<td>697.65</td>
<td>816.9</td>
<td>903.0</td>
<td>960.9</td>
<td>991.1</td>
<td>1080</td>
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<tr>
<td>Real GDP</td>
<td>13.5</td>
<td>12.6</td>
<td>10.5</td>
<td>9.6</td>
<td>8.8</td>
<td>7.8</td>
<td>7.1</td>
<td>8.0</td>
<td>7.3</td>
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Source: APEC, 2002

Table 2: GDP per capita (US$).

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<tbody>
<tr>
<td>GDP per Capita US$</td>
<td>672</td>
<td>731</td>
<td>773</td>
<td>805</td>
<td>867</td>
<td>913</td>
<td>993</td>
<td>1147</td>
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Source: Salomon Smith Barney (CitiGroup) 2002

In this light, the economic developments that have taken place in China are impressive, and it must be acknowledged that a rise in GDP in real terms is a very positive sign of the economy as this indicates a rise in living standards as an indicator of ability to consume. The backbone of this rise in ability to consume must of course be a rise in output – caused by improvements in national production ability (with domestic or foreign investment and labor inputs).

When calculated in GDP, adjusted for Purchasing Power Parity (PPP), China has in fact surpassed Japan as the second largest economy by a staggering 48% and is in this sense by far the world’s second largest economy after the US, as illustrated in fig.1.

Fig.1: China, the US and Japan in nominal terms and adjusted by PPP.

Source: Skorburg, 2002
Distribution of Wealth

Another aspect that has to be taken into consideration, however, is the level of distribution of GDP. It is widely recognized that the eastern regions of China have been developing much faster than the western ones in terms of attracting investment and in terms of wage growth – especially in the urban areas. In this sense GDP per capita growth has mainly taken place in urban areas as the urban/rural per capita consumption ratio indicates in fig.2.

Fig. 2: Urban/rural consumption ratio 1978-1999.

[Graph showing the urban/rural consumption ratio from 1975 to 2000 with data points and a trend line indicating an increase over time.]

Source: Yao, 2002

For the urban households, as main derivers of GDP growth benefits, some very positive distributionary trends are mounting. It seems as if the middle class is, and has been, growing rapidly since the start 90’s. This indicates an ability to increase discretionary spending (however still on a small scale) for the middle class and is a main driver of domestic consumption.

Fig. 3: Income distribution in 1999 prices:

[Graph showing the income distribution with different years indicated by different colors and markers. The graph shows a skewed distribution with most households earning less than Rs. 50,000 per annum.]

Source: Asian Demographics Ltd., 2001
As fig.3 shows, the urban incomes are increasing rapidly. And the income distribution is becoming more leveled out over time.\(^1\) This does not imply that the Chinese political economy is becoming egalitarian, but it simply implies that China is becoming a country with a general higher living standard in the growing middle class in the urban areas.

In this sense it should not be feared that Chinese policy is becoming a “sleeping pillow” for its citizens, as the above mentioned change in distribution is primarily stemming from a general rise in living standards rather than from governmental distribution through fiscal constraints.

As long as the Chinese economy is able to keep up the steam and grow with the pace seen in the previous years, social unrest can be kept at the door, even though the urban/rural consumption ratio should be sought brought down to avoid an intensified immigration to the major cities (which was 13 million people in 1995 and 16 million in 1998 – even though unofficial figures may be higher).\(^2\) But if GDP growth cannot absorb the many immigrants from rural zones, social unrest might be the unfortunate future scenario.

### Questioning Growth

Are the Chinese central government and its statistics reliable in terms of measuring GDP growth?

Even though application of the official GDP numbers is widespread (and applied in this paper as well), several authors question their reliability (Rawski, 2001: Smith, 2001: Wang & Meng, 2001; Premier Zhu, 2000).

Especially Rawski poses a very strong and logical critique of the GDP growth ratio as he measures it up against the energy use and employment rates of the domestic economy. And one must indeed admit that it seems as if major inconsistencies exist when comparing theses figures, as presented in table 3.

\(^1\) Assuming that annual real GDP growth is 5.1% for the 2010 estimate.

\(^2\) Yao, 2002; Wu & Yao, 2002.
Table 3: Official GDP figures compared to energy use and employment rates.

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<tbody>
<tr>
<td>Real GDP</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Official</td>
<td>7.8</td>
<td>7.1</td>
<td>8.0</td>
<td>7.9</td>
<td>34.5</td>
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<tr>
<td>Alternate</td>
<td>-2.0/+2.0</td>
<td>-2.5/+2.0</td>
<td>2.0/3.0</td>
<td>3.0/4.0</td>
<td>0.4/11.4⁴⁷</td>
</tr>
<tr>
<td>Energy use</td>
<td>-6.4</td>
<td>-7.8</td>
<td>1.1</td>
<td>1.1</td>
<td>-5.5</td>
</tr>
<tr>
<td>Urban formal employment</td>
<td>2.3</td>
<td>1.6</td>
<td>1.2</td>
<td>1.2</td>
<td>0.8</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>-0.8</td>
<td>-1.4</td>
<td>0.4</td>
<td>-0.5</td>
<td>-2.3</td>
</tr>
</tbody>
</table>

Source: Rawski, 2001

If there are no mistakes in the above mentioned figures, the Chinese industries have performed absolutely magnificent. And likely better than what is feasible to believe.

Let us take a look at the cumulative growth between 1998 and 2001. Does it seem likely that real GDP has grown 34.5% when compared to a 5.5% fall in energy use – and with formal employment only rising 0.8% in urban areas which so far have been the major receivers of investment?

It is to be acknowledged that the Chinese economy, in terms of growing TVE and SOE output, have performed well, but not much emphasis have been given to energy reduction, and with a real output rise of 34.5% in only four years it would be almost unbelievable that the Chinese industry would be able to cut energy use. Especially when taking into account that formal labor input only rose by 0.8% - and hereby did not substitute more energy consuming processes (machines – even though computer technology have reduced energy use).

However, the data in table 3 does point to the acknowledged fact that China is in a transition process and in this sense is shifting from energy-heavy and labor-intensive, primary production towards a more secondary industrial regime, where lighter manufacturing industries and high-technology mass-consumption products (much after the model of the South Korean chaebols) are in focus – even though this transition takes time and does not happen over four years, as indicated above.

Even with these transitions in mind it seems as if the figures stemming from the (Chinese) National Bureau of Statistics (NBS) are too good to be true, when compared to other economies in transition in earlier decades – even the Chinese itself.
In table 4 it becomes apparent that if the official GDP growth tells the truth, China has experienced a true industrial revolution, more powerful than anything seen before when taking resource consumption and labor input into consideration.

Other more qualitative data also questions the GDP rates reported. Starting in 1998, the NBS has rejected provincial data on economic growth, which it dismisses as “cooked local figures”. Despite recent efforts to create regional networks that bypass local and provincial governments, the NBS has not been able to collect data outside of its normal information channels, particularly since surveys remain subject to control of local government interference. This means that the NBS rely on data, which it can not support itself, pointing to quite an inconsistency.

Reasons for Growth

Even though questions remain in the case of the official real GDP growth figures, I will move on to discuss how such growth figures could arise. In other words, I will try to answer how the Chinese growth has been achieved (should the official figures tell the truth).

The Chinese experience confirms a well-known point in the economic development literature: the economic liberalization of an autarkic, over-regulated developing economy would raise its growth rate. Economic liberalization integrates a developing economy into

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the international trade and financial systems, and allows it to reap the benefits of increased output due to competition and specialization.

The path towards a socialist market economy has not been an easy road for the Chinese economy to follow. It has been an ongoing struggle between conservatives and liberals in the Chinese Communist Party (CCP) – and one may definitely argue that the reforms have often not been whole-hearted or, perhaps more correctly, incremental. In the later years, however, the liberal parts of the CCP have had the power to take the final steps towards an open market economy, as China entered the WTO in late 2001. In the following I give a short summary of the periods of different political economy settings since reforms began in China.4

<table>
<thead>
<tr>
<th>Period</th>
<th>Desired Endpoint upon Completion of Reform</th>
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<tbody>
<tr>
<td>Pre-1979:</td>
<td>A planned economy under the law of exchange value.</td>
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<td>1979 to Oct.1984:</td>
<td>A</td>
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It is by nature not an easy task to give a quantitative analysis of the contributors to growth in a country. Therefore I will have to point to the developments that I find to be the most important in a more qualitative manner.

One thing that has definitely contributed to the growth of the Chinese economy is the increasing interaction with the rest of the world, as the PRC has run a consistent trade surplus since 1994, enabling the Chinese economy in general to prosper and guaranteeing new market opportunities for the national production. More importantly, the Chinese economy can reap the benefits of introducing better priced or better quality products to business and private consumption to further increase output and satisfy demand.

Table 5: Export, import and trade balance (in million US$)

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<tbody>
<tr>
<td>Export</td>
<td>71843</td>
<td>84940</td>
<td>91744</td>
<td>121006</td>
<td>148780</td>
<td>151048</td>
<td>182792</td>
<td>183809</td>
<td>194931</td>
<td>249203</td>
</tr>
<tr>
<td>Import</td>
<td>63791</td>
<td>80585</td>
<td>103959</td>
<td>115614</td>
<td>132084</td>
<td>138833</td>
<td>142370</td>
<td>140237</td>
<td>165699</td>
<td>225094</td>
</tr>
<tr>
<td>Trade balance</td>
<td>8052</td>
<td>4355</td>
<td>-12215</td>
<td>5392</td>
<td>16696</td>
<td>12215</td>
<td>40422</td>
<td>43572</td>
<td>29232</td>
<td>24109</td>
</tr>
</tbody>
</table>

Source: Asian Development Bank

Another important effect of the opening of the Chinese economy is the possibility of FDI to the industries in the form of pure investment and technological and/or managerial expertise. Especially the latter is a very important part – not exclusively in the understanding of the already recorded growth - but especially of the future ability to compete in the light of WTO accession.

There is a very narrow coherence between FDI injection and foreign trade in China as fig.4 shows. And the share is in fact rising. This could point to the fact that Chinese enterprises need foreign expertise and investment in order to compete on the world market.

Fig.4: Foreign invested enterprises dominate trade

Source: Morgan Stanley Research, 2002

However, other components than foreign trade needs to be examined to give the full picture of the growth rate of the Chinese economy, as the economy is still highly driven by domestic demand. When comparing table 1 and 3 it becomes apparent that only around 25% of GDP is exported – the greatest upsurge in GDP is in this sense to be found in a higher domestic demand and in the ability of Chinese industry to satisfy this growing demand in the light of economic reform.

Two main components have in this sense spurred the GDP growth; Rise of productivity in:

- State Owned Enterprises (SOE’s)
• Township and Village Enterprises (TVE’s).

Let me first turn my attention to the SOE’s. These major corporations were a result of industrial policies attempting to ripe the benefits of economies of scale with Japan as the role model (but of course not on the same terms, politically).

The SOE’s has in certain ways been a success as they have contributed greatly to the overall growth of the Chinese economy with annual output growth rates of around 13% p.a. from the early 80s till the late 90s. Many of these major corporations have furthermore successfully implemented modern technology, “learned how to compete in the marketplace, substantially upgraded the technical level of their employees, learned wide-ranging managerial skills and gained a thorough understanding of foreign financial markets.”

However, strong evidence suggests that these corporations to a large extent may still not be able to compete as China enters the world economy fully within the next five years, which is the deadline for the last implementations of the WTO agreements.

Nolan (2001) suggests through his case studies of the Chinese SOE’s over ten years, in a comparative perspective, that these corporations are not able to compete with their global rivals. Furthermore he forecasts that the SOE’s have been left behind for good. Not due to a lack of willingness to reform of their ways of conducting business (as stated above, these corporations have increased production capability immensely and implemented high technology in their business processes), but due to a change in the global business world. Chinese SOE’s have tried to catch up with its foreign competitors, but has almost every time lost pace comparatively as the game has been changing even more rapidly outside the protected markets of the PRC with the globalization process, large-scale mergers and the IT revolution creating different, more vigorous terms of trade. Others argue that the Chinese corporations have a leading edge over their foreign competitors, as they are known to their domestic customers, who serve as a major market. But in terms of profitability and mere size, the SOE’s still have major battles to fight.

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This is especially true if the structure of the SOE’s is examined, as most of the major corporations are not specialized, but in fact consist of a large number of smaller sub-companies and hereby are not able to ripe the benefits of economies of scale as they initially were intended to.

And if we look at how the SOE’s have been financed over the years, we see even bigger problems arising. All major SOE’s have received preferential loans from government banks, often regardless of their ability to honor the obligations. This has been limiting private enterprises in access to funds just as the return to capital has diminished. In other words, the whole financial market has been distorted as scarce financial capital has not been allocated to investments with the highest return to capital (which must have hindered and not created growth). Furthermore, China is facing a massive domestic debt issue encompassing a extremely high ratios of non-performing loan (NPL’s), which affect the financial sector greatly (as 3.3 trillion Yuan is estimated to reside in the banks as NPL’s and account for round 30% of the debt portfolio - even though the ratio would be even higher (probably round 45%) had the state not shifted part of the burden to four asset management companies).

One major advantage that the Chinese corporations can still benefit from is the very low cost of labor compared to its competitors. Furthermore the labor resources are abundant (and can hereby wage-wise be kept down) as agricultural reforms raise output to labor units.

Another part of the Chinese industries are the TVE’s. These are smaller enterprises that are sought privatized through shares sold to stakeholders. The TVE’s have certain advantages over the SOE’s as they have not received government loans, just as well as they have been able to absorb a great number of surplus agricultural workers. The employment in these enterprises rose from 28.3 million workers in 1978 to 127 million in 1999 and is in this sense the most contributing sector to GDP growth along with the SOE’s and the agricultural sector (which still need major reforms).

Several constraints surround the TVE’s as well. Even though large scale production has not always proved to be the way forward, as the case with respect to the SOE’s show, small scale production of local products may satisfy some domestic needs,
but does not contribute to future growth, as the innovative potential seems highly limited and export is not a possibility.

Even though the enterprises may face serious problems as international competition is unleashed with WTO accession, certain key elements does point to improvements in competitiveness. As already described, GDP growth points to major increases in output, but also the deflationary pressures on the economy show that FDI, along with improvements in the domestically owned firms, have lowered consumer and retail prices. In fact, the Chinese economy has been in an almost constant deflationary state since Jan.1998 (deflation rates at the moment around 0.7%).

In this sense China’s impact on the world economy is increasing as the pace of FDI is still expanding, due to higher price sensitivity in world markets as an effect of world recession and lower production costs in China. In this way China is actually exporting deflation to the world economy.

The Chinese ability to compete is strengthened as input prices fall. But adverse effects may of course be seen in the long-term investment markets, as inflation does not make it favorable to speculatively invest in e.g. real-estate (even though price of capital in terms of interest rates is also very low) as well as real cost of foreign debt increases.

\footnote{Morgan Stanley: Equity Research, Asia-Pacific Region, Oct. 2002.}
China in the WTO

The negotiated agreement that was reached in late 2001 at first glance looks to be very much in favor of the existing WTO countries, as China in almost all aspects opens up its domestic industries to foreign competition and investment, even though the agreement has several implementation phases stretching from day one to five years into the agreement - based on the industry in focus.

China wanted to be accepted as a developing country in order to gain greater flexibility in tariff setting. The Chinese negotiators succeeded with regard to very few economic sectors indeed. In the agricultural and chemical sector China managed to gain concessions to protect domestic industries, but only minor ones. In most other industries China have to change its industrial policies of tariffs, limited foreign access to marketing channels, requirements of technology transfer, sub-contracting to local firms with FDI, ownership regulations and preferential bank loans.

What led China to accept this agreement, under the assumption that the Chinese would only accept an accession agreement that would bring greater gains?

Politically, China was at a crossroad as it had to decide whether it should take the final step to open up the economy. In this sense the liberals in the CCP (including Premier Zhu and Jiang Zemin) needed external pressure to push forth the domestic economic reforms.

Whether China will gain from its membership of the WTO is very much a question of beliefs and assumptions, as I see it.

In the short run, the membership of the WTO will inevitably hurt the Chinese economy as many sectors are still non-competitive, state-driven monopolies. In this sense China is not really ready for membership on the terms that was negotiated. However, the paradox of the negotiations, from a Chinese pro-WTO perspective, lies in the fact that domestic economic reforms (necessary for improving competitiveness further) would be very hard to carry out without external pressure from the WTO, as domestic conservative forces are strongly vested in the Chinese political climate.

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8 For highlights of the US-Sino negotiated agreement, see: http://www.uschina.org/public/991115a.html
In this perspective the year of 2001 for WTO accession was as good a time as any in order to carry on the incremental market reforms put on track in 1978. Attempts have been made to analyze the China WTO negotiation outcome from a game theoretic perspective in terms of negotiations with or without the most favored nation principle as being guiding.⁹

Most game theory with its focus on NASH Equilibriums carries the assumption that the pie is fixed, thus claiming that the negotiation process is a question of winners and losers. I do not agree with this assumption as the world GDP has expanded and we have seen a general improvement in living standards (especially true for the industrialized, developed countries of course) during the last decades and especially since the creation of international organizations after World War II, such as the GATT (and the later WTO). The fact that world resources are scarce definitely plays a major role in the WTO accession negotiations, but the whole idea behind the expansion of the WTO area is that resources can be allocated more effectively and that the pie in this sense is not fixed - but rather flexible and expandable. However, this is an assumption questioned widely as economists argue over the effect of greater integration of trade allowing not only economic determinants (but also social and cultural costs) in the equation leading to the outcome of world prosperity.

**Conclusion**

Uncertainty remains as the determination of the negotiated outcome for China has to be seen in a long term perspective. It is the long term ability of the Chinese industries and financial sectors to restructure and become internationally competitive that will decide whether the WTO membership will deliver the promised prosperity. However, the last decade have shown significant growth in terms of FDI and production due to greater openness and more liberal market conditions and the emergence of stronger international competition as well as improvement in management and technology (not least through inclusion of non-party managers on the boards of the major SOE’s). In this sense the Chinese industries are improving rapidly – but whether the global industries are changing

even faster (as Nolan suggests) is a question to keep in mind. However, as I stated earlier, the Chinese economy has an advantage in its abundant, cheap labor force.

When looking at the other side of the coin for the economy, several problems are eminent as well. The financial sector is weak and very much under control of central and regional governments still (see: the Heritage Foundation’s 2003 Index over Economic Freedom). This leads to major distortions in the financial markets and has lead to decreasing returns to capital, as underperforming SOE’s have absorbed capital on a large scale (hindering private businesses without FDI to bloom). Further, banks have accepted bad loan risks (with government support) creating major NPL ratios for the banks to deal with in the years to come – and making a bank-sector meltdown likely, does the central government not step in to take on the burden of NPL’s before full-blown global competition opens up in 2006.

For China, the next five years will show whether the economy can persist the pressures that will definitely occur in the form of foreign competition. This period of time will also show whether the required reforms where actually brought about.

In terms of the industries, the Chinese government will have to remove the barriers that have been a major contributor to the distortions in the industries. In this sense several SOE’s must be expected to bow under to external pressure from more efficient competitors, leading to possible social unrests.

The FDI inflow in this way symbolizes both the threats and the opportunities of the WTO accession for China.

On the one hand, the FDI inflow acts as a positive driving force for the Chinese economy as it ensures the competencies needed to transform local industries and to create new jobs – as well as it acts as a driver of economic reform.

On the other hand, the FDI promises to cut inefficient parts of the economy off, posing the threat of major lay-offs in the SOE’s, social unrest and probably a loss of domestic control over many industries.
The Chinese economy may not have been ready for WTO accession in 2001. But the question to be posed is rather whether it ever would have been ready, had the external pressure of the negotiated agreement not pushed market reform forth and ensured changes in the financial and industrial sectors.

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Jesper Christensen, December 3\textsuperscript{rd} 2002.
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