THE CHINESE ECONOMY AND ITS INTEGRATION IN THE WORLD ECONOMY*

*Carlos Martins***

1. INTRODUCTION

The growing importance of the Chinese economy is a striking feature of global economic developments in the last quarter of a century. This increasing importance translates into the higher contribution to world economic growth, the significant strengthening of China's weight in international trade flows and the significant amounts of foreign direct investment attracted by this country (Table 1). In 2004 the world economy grew by 5.1 per cent, around a quarter of that growth being attributable to China. On the other hand, growth in Chinese imports accounted for around 15% of the world trade expansion between 2000 and 2004. In 2004 China was the third largest recipient of foreign direct investment in the world.

The Chinese economy still has a high growth potential. China continues to be a relative poor country, where per capita GDP is far lower than in the main advanced economies or in other Asian economies. On the other hand, the process of structural reforms observed in China since the late 1970s is likely to continue, in particular in the context of the accession to the World Trade Organisation (WTO) in December 2001. Considering that China concentrates around 20 per cent of the world population, the maintenance of its economic growth and integration with the exterior process will naturally continue to influence significantly the world economy.

In this context, the objective of this paper is to present the key elements that characterise the Chinese economy and its integration in the international economy. Section 2 briefly describes economic growth factors and some structural changes seen since the launching of economic reforms in the late 1970s. Section 3 focuses on China's integration in the world economy, namely on its growing importance in international trade flows. These are largely related to the strong comparative advantage of China regarding the production and assembly of goods, where labour costs are decisive. Section 4 outlines recent macroeconomic developments, given that over the past few years concerns have arisen about an eventual "overheating" – and the consequent slowdown in the Chinese economy – and the possible impact of such developments on other economies. In turn, Section 5 presents the outlook for the Chinese economy and a number of economic policy challenges, namely as regards the financial situation of the banking and public sectors and the conduct of the monetary and foreign exchange policies. Finally, Section 6 concludes.

2. ECONOMIC GROWTH FACTORS

Since the beginning of the process of economic reforms in the late 1970s, economic growth in China has been remarkable (Table 2). Between 1980 and 2004, the annual average growth rate of the Gross Domestic Product (GDP), in real terms, was 9.5 per cent, i.e. much higher than world economic growth in the same period. Given that population growth was moderate, economic expansion translated into significant growth in per capi-

* The views expressed are those of the author and do not necessarily coincide with those of Banco de Portugal. The author thanks Nuno Alves, Ana Cristina Leal, Mário Centeno, João Sousa, Marta Abreu, Cristina Manteu and José Ferreira Machado for comments and suggestions.

** Economic Research Department.

Table 1

GROWING INFLUENCE OF THE CHINESE ECONOMY

	Unit	1980	1990	2000	2004
Population	Million	987	1143	1267	1300
Share in world population	Per cent	22.1	21.6	20.9	20.6[(a)]
Share in world GDP					
GDP at market exchange rates	Per cent	2.6	1.7	3.4	4.0
GDP measured in PPP	Per cent	3.2	5.7	10.9	13.2
Per capita GDP (United States = 100)					
At market exchange rates	Per cent	2.5	1.5	2.5	3.2
Measured in PPP	Per cent	3.5	5.8	11.2	14.3
Share in world trade (goods)					
Exports	Per cent	0.9	1.8	3.9	6.6
Imports	Per cent	1.0	1.5	3.4	6.0

		1980-89	1990-99	2000-04
Share in world FDI flows				
Total	Per cent	1.7	7.2	6.2
Directed to emerging market and developing economies	Per cent	9.8	25.7	26.7

Sources: International Monetary Fund and United Nations Conference on Trade and Development.
Note:
(a) Figures for 2003.

ta income. These developments, in parallel with the considerable improvement in other human development indicators, led to a substantial reduction in poverty indicators.

Based on a neoclassical growth model, several empirical studies have tried to identify the factors behind the rapid economic growth in China during the period of economic reforms (Table 3). In this approach, the GDP growth rate may be broken down into the contributions from the several factors of production - namely labour and capital - and from the growth in total factor productivity. The contribution from each factor depends on its growth rate and on the elasticity of output with respect to such factor. In turn, the contribution of total factor productivity to output growth is calculated as the difference between output growth and the contribution from the factors of production considered. The latter term includes the effects of technological progress and institutional changes namely due to economic reforms.

The results suggest that capital accumulation was the factor of production that most contributed to GDP growth in China between 1979 and 1998. This contribution is related to both the maintenance, over the last decades, of a significant pace of investment in physical capital and the high capital elasticity of output. The weight of fixed capital investment in GDP increased from around 29 per cent in 1980 to 44 per cent in 2004. Both studies shown in Table 3 estimate at around 65 per cent the capital elasticity of output. Assuming constant returns to scale, the labour elasticity of output shall only be 35 per cent. This seems to be related to the relative abundance of labour in China, where there are still very poor and low productivity regions. In this context, the contribution of the labour factor to economic growth was relatively low, although this factor recorded an annual average growth of 2.8 per cent between 1978 and 1998.

Despite the key role played by capital accumulation, the faster pace of growth of GDP from 1979 onwards is largely explained by the higher contribution of total factor productivity. The breakdown of this effect shows that, although the labour migration from the agricultural sector to sectors with higher productivity was a key factor, evidence seems to indicate that this was already observed prior to 1979. Therefore, the rise in the contribu-

Table 2

GROWTH OF THE CHINESE ECONOMY

	Unit	1980	1990	2000	2004
Real GDP (in RMB)	1980=100	100	243	637	889
Per capita GDP					
Real (in RMB)	1980=100	100	210	496	675
Nominal (at market exchange rates)	In USD	305	339	853	1272
Per capita GDP (United States = 100)					
At market exchange rates	Per cent	2.5	1.5	2.5	3.2
Measured in PPP	Per cent	3.5	5.8	11.2	14.3

Source: International Monetary Fund.

Table 3

GDP GROWTH FACTORS IN CHINA[a]

As a percentage of GDP[b]

	Chow (2002)			Heytens e Zebregs (2003)				
	1952-98	1952-78	1979-98	1971-78	1979-89		1990-98	
Actual growth	7.3	5.8	9.3	5.4	9.1		9.5	
Potential growth:	7.2	5.5	9.5	4.9	9.3		9.5	
Capital accumulation	5.1	4.6	5.8	4.8	5.7		6.4	
Labour-force growth	0.9	0.9	1.0	0.7	1.0		0.5	
Total factor productivity growth	1.2	0.0	2.7	-0.5	2.5		2.6	
				1971-78	1979-84	1985-89	1990-94	1995-98
Total factor productivity growth:				-0.5	2.8	2.1	2.8	2.3
Structural reforms[c]				0.4	0.9	0.8	0.8	0.4
Agricultural exodus				2.3	2.0	1.5	2.2	2.1
Exogenous trend[d]				-3.3	-0.2	-0.2	-0.2	-0.2

Sources: Chow (2002) and Heytens and Zebregs (2003).

Notes:

(a) Estimates are based on models with constant returns to scale. For example, Chow (2002) concludes that this hypothesis is plausible for the 1952-98 period.

(b) Period average.

(c) Measured on the basis of four indicators: the share of the industrial product resulting from the non-governmental sector, the ratio of total external trade to GDP, the level of urbanisation and the pace of capital accumulation.

(d) Residual, where technological progress is included.

tion of total factor productivity after 1978 was due to the higher contribution of the structural reforms and the residual component. The latter moved from a significantly negative value in the 1970s[(1)] to close to zero as from 1979, probably reflecting the technological progress and aspects of structural reforms not captured by the corresponding indicator used.

This should be seen in the light of the economic reforms made in China, which envisaged the establishment of a more decentralised and market-oriented economy, and an increasing external openness. Reforms included the diversification of land tenure, the encouragement of private business start-ups, incentives to profit and the easing of the State control over the various economic dimensions. At the same time, foreign trade was liberalised and conditions were created for foreign direct investment, which culminated in the acces-

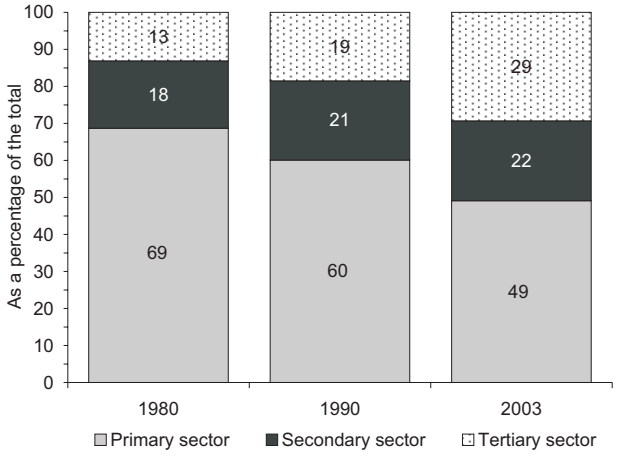
(1) This period was marked by serious disturbances due to the effects of the Cultural Revolution.

sion to the WTO in December 2001. The whole process was gradually implemented and led to extensive structural changes in the Chinese economy. Stress should be laid on the productivity gains resulting from a more efficient behaviour of economic agents, largely reflecting the implementation of decision-making autonomy in the agricultural and corporate sectors and the development of market mechanisms, as well as gains related to the allocation of economic resources, particularly due to the lower weight of the primary and the State industrial sectors and the higher weight of external-oriented sectors.

In the case of the agricultural sector, reforms boosted incentives to production and investment, which translated into a significant rise in productivity and living standards in this sector and into the relocation of workers to other sectors. It should be noted that between 1980 and 2003, agricultural productivity more than doubled and the share of employment in the primary sector decreased by around 20 percentage points, to around half of total employment (Chart 1). However, this outward migration from the agricultural sector was largely concentrated in rural areas. In particular, two legal and administrative restrictions discouraged the exodus from rural to urban areas. The first was the "hukou" system(2), which for many years prevented the rural population from seeking work in the cities. Some of these restrictions have already been abolished, but the access to education, health and other social services still continues to be subject to that system. The second was the agricultural land use system, which established that farmers leaving their rural dwelling for long periods would lose the right to use the land, which was their main guarantee of income in old age. In this context, around 60 per cent of the Chinese population continues to live in rural areas, although this figure includes workers moving between rural and urban areas and working mainly in the informal sectors of cities.

Reforms also translated into a decline in the role played by the State in the economy. In particular, the weight of State-owned enterprises in output declined, which as their name indicates, are fully held by the Chinese State. These developments reflected, at a first stage of reforms, up to the mid-1990s, the considerable expansion of collective enterprises, mainly in rural areas. Such enterprises have also a public character, though not State-owned, given that they are held by local communities. However, they developed mainly outside the central plan of the State and in a more market-oriented way, i.e. their management was closer to the private sector, which significantly contributed to increasing both the efficiency in terms of resource allocation and economic competition(3). At a later stage in the reforms, the development of private enterprises was boosted, including those with foreign participation. Despite these developments, State-controlled enterprises still accounted for around 40 per cent of total industrial production in 2003. In the services sector, their influence is even more significant and, for example, in the retail and wholesale trade subsectors such

Chart 1
CHINA - EMPLOYMENT BY SECTOR OF ACTIVITY



Source: China Statistical Yearbook 2004.

(2) Household registration system, according to which each citizen must live and work in a pre-defined location, usually set at birth. In particular, this system makes a distinction between rural and urban areas.

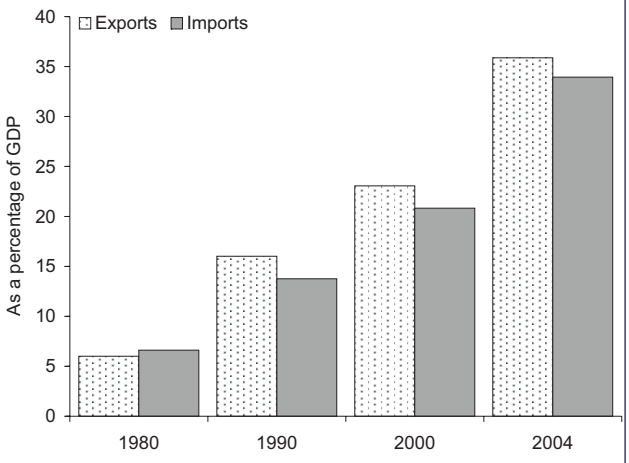
(3) Such enterprises were created in rural areas in the early 1970s, in an attempt of the government to mechanise agriculture. With the economic reforms, these enterprises were naturally tailored to meet the demand for new investments in agriculture, and local government found in them the solution to absorb the excess labour force of the agricultural sector. Moreover, such enterprises, which were mainly small and medium-sized, benefited from both the availability of raw materials and new markets in terms of State-owned enterprises, which resulted from the easing of resource allocation mechanisms in the economy.

enterprises accounted for around 75 per cent of total revenue in 2001.

On the other hand, reforms were accompanied by an increasing external openness of the Chinese economy. This opening-up process started relatively slowly in the 1980s, with the abolition of a number of controls over exports and imports, and intensified during the following decades, due to foreign direct investment flows and the significant reduction of customs tariffs. Between 1993 and 2002, tariffs declined from 38 to 6 per cent, on weighted average. Stress should be laid on the very strong expansion of the Chinese external trade, with a nominal average growth of 15 per cent between 1980 and 2004, which compares with an average change of 7 per cent in the world trade. As a consequence, the degree of external openness of the Chinese economy, as measured by the ratio of average exports and imports of goods to GDP, increased from 6.3 to 34.9 per cent between 1980 and 2004 (Chart 2). This value is close to the one observed currently in other Asian economies, for example in Korea, but exceeds to a large extent that of other major world economies. In 2004, this ratio stood at around 14 per cent for the euro area and the United States and at around 10 per cent for Japan. On the other hand, the Chinese economy has attracted significant amounts of foreign direct investment since the early 1990s, accounting on average for around 4 per cent of GDP in China (Chart 3). Investment has been mainly concentrated in the industrial sector, namely in export-oriented enterprises. It should be noted that in 2003 enterprises with foreign participation accounted for around 30 per cent of industrial production and more than half of Chinese exports.

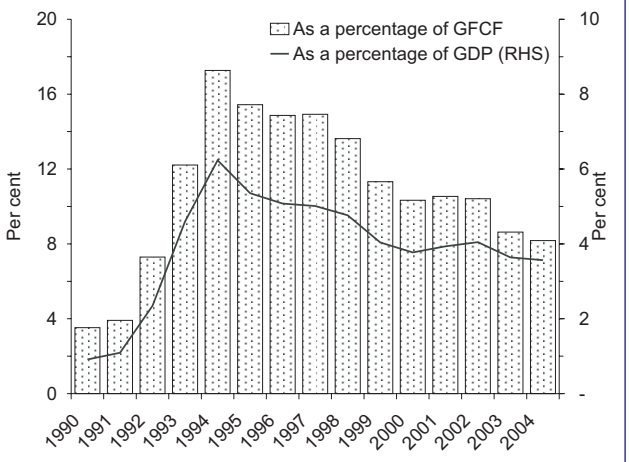
Overall, the financial system in China was not efficient in promoting productive investment and economic growth, despite the high increase in financial intermediation both in terms of deposits and loans. Significant reforms were introduced in the financial system, in particular in the banking sector, which evolved from a situation where there was only one bank, in the mid-1980s, to a legal framework now closer to those of modern financial systems. In line with the high savings rate in the economy, the banking sector grew amid conditions of ample liquidity and loans amounted to around 130 per cent of GDP at the end of 2004. However, the sector's structure is still strongly

Chart 2
CHINA - EXTERNAL OPENNESS
Trade of goods as a percentage of GDP



Sources: International Monetary Fund and CEIC.

Chart 3
CHINA - FOREIGN DIRECT INVESTMENT
Net inflows



Sources: CEIC and UNCTAD.

dominated by State banks, which have an inadequate commercial market orientation. As a rule, credit decisions are not made on the basis of an adequate risk and profitability assessment. It should be noted that over the past few years bank credit has been mainly channelled to State-owned enterprises, to the detriment of more buoyant economic sectors. On the other hand, the performance of the financial sector was also affected by the low development of the capital and securities markets, which due to various limitations were rather constrained and had weak liquidity. At the end of

2004, total capitalisation in stock markets stood at around 27 per cent of GDP, although only around one third of this value is negotiable, while the amount of Treasury securities and corporate bonds issued amounted to only 5.1 and 0.2 per cent of GDP respectively.

In sum, the results of several studies carried out seem to show that the main factors behind Chinese GDP growth have been, to a large extent, physical capital accumulation and the increased efficiency of the economy, due namely to the agricultural exodus and the structural reforms implemented since 1978. In this context, the continued urbanisation process, significant savings and investment levels and the ongoing process of structural reforms point to the maintenance of the high pace of growth of the Chinese economy.

3. THE INTEGRATION OF CHINA IN THE WORLD ECONOMY

There has been a growing integration of China in the world economy. Between 1980 and 2004, the weight of Chinese exports and imports of goods in the world total increased from around 1 per cent to 6.6 and 6.0 per cent respectively. In 2004 China was the world third largest exporter and importer. Moreover, since the early 1990s the Chinese economy received around one quarter of the world foreign direct investment channelled to emerging market economies (Table 1).

Therefore, China has become over the years an important export market for the main industrialised economies (Table 4). This is particularly noticeable in the case of Japan, as well as in the case of other Asian economies such as Hong Kong, Taiwan and Korea, to which China became the main destination of exports. These developments partly reflect an increasing degree of vertical integration of the production process in Asia, in which China functions as an assembly centre and export platform for finished goods. This has translated into a significant rise in intra-regional trade flows, with China importing growing volumes of semi-processed goods from other Asian economies and exporting finished goods to the rest of the world. Sales from the euro area and the United States to the Chinese market have also increased considerably, although the weight of China in total exports of these economies is less significant.

Table 4

IMPORTANCE OF CHINA IN EXPORTS OF MAIN INDUSTRIALISED ECONOMIES

Weight in the total, per cent

	1990	1995	2000	2004
Euro area	1.8	1.9	2.1	3.5
US	1.2	2.0	2.1	4.3
Japan	2.1	5.0	6.3	13.1
South Korea	0.9	7.3	10.7	19.6
Hong Kong	25.6	34.2	34.3	44.0
Taiwan	-	0.3	2.9	19.7

Sources: European Commission, US Department of Commerce, Japan Tariff Association and CEIC.

Moreover, China has also been gaining increasing importance in terms of the world demand for oil and other raw materials such as iron, steel and copper, thus contributing to upward pressures on the prices of these commodities in international markets over the past few years. In particular, the weight of China in the world demand for oil increased from 3.4 to 7.7 per cent between 1990 and 2004.

The penetration of manufactured goods from China is currently significant as regards imports of the main world economies (Table 5). This increase in China's share reflects the strong comparative advantage of this economy in terms of the production and assembly of goods where labour costs are a key factor. However, Chinese exports have been characterised by a growing diversification (Table 6). For example, the weight of textiles, clothing and footwear in total exports declined from around 34 per cent in 1994 to around 19 per cent in

Table 5

IMPORTANCE OF CHINA IN IMPORTS OF MAIN INDUSTRALISED ECONOMIES

Weight in the total, per cent

	1990	1995	2000	2004
Euro area	4.4	4.7	5.2	8.6
US	3.1	6.1	8.2	13.4
Japan	5.1	10.7	14.5	20.7
South Korea	3.5	5.9	7.4	11.6
Hong Kong	36.8	36.2	43.1	43.5
Taiwan	-	3.0	4.4	10.0

Sources: European Commission, US Department of Commerce, Japan Tariff Association and CEIC.

Table 6

CHINA'S EXPORT STRUCTURE BY GROUPS OF PRODUCTS

Weight in total nominal exports (per cent)

	1994	1999	2004
Food and live animals; Beverages and tobacco	9.1	5.8	3.4
Crude materials, inedible, except fuels; Mineral fuels, lubricants and related products; Animal and vegetable oils, fats and waxes	7.0	4.5	3.4
Chemicals and related products, n.e. s.	5.2	5.3	4.4
Manufactured goods classified chiefly by material	19.2	17.0	17.0
Textiles	9.8	6.7	5.6
Machinery and transport equipment	18.1	30.3	45.2
Office machines and automatic data processing equipment	2.2	6.9	14.7
Telecommunications and sound recording and reproducing apparatus and equipment	5.6	6.7	11.5
Machinery and electrical equipment, n.e.s., and parts	4.9	9.2	10.0
Other machinery	3.3	4.3	5.5
Miscellaneous manufactured articles	41.3	37.2	26.4
Apparel and clothing accessories	19.6	15.4	10.4
Footwear	5.0	4.5	2.6
Other	0.0	0.1	0.2

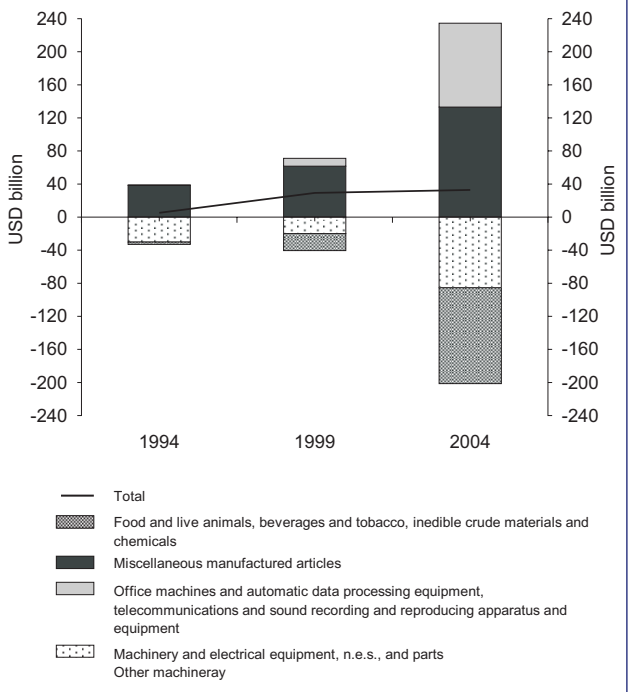
Source: CEIC.

2004. In contrast, over the same period, the weight of machinery increased from 16 to over 40 per cent of total exports. China has maintained a relatively stable trade surplus over the past few years, reflecting the strong comparative advantage of the economy in terms of the production of labour intensive goods. Net exports of this type of goods are counterbalanced by the need to import raw materials and capital goods (Chart 4). At the same time, the geographical structure of the balance has been evolving in line with changes in the location of production processes at the global level. In this context, China has been recording a growing trade surplus with the euro area and the United States, while it switched to a deficit with other Asian countries.

The strong increase in the Chinese external trade is associated with the significant amount of foreign direct investment that the Chinese economy has been attracting since the early 1990s. A significant share of these investments emanate from Asia itself. Investment has been mainly focused on the industrial sector, namely in export-oriented enterprises. A large share of this investment has been made by Asian multinationals, which relocate the final assembly stage, in order to take advantage of the low labour costs in China, but which continue to import from their countries of origin most of the components used in production. The motivation underlying foreign direct investment is likely to be also associated with the size and growth potential of the Chinese domestic market.

Chart 4

TRADE BALANCE OF CHINA AND NET EXPORTS BY TYPE OF PRODUCT



Source: CEIC.

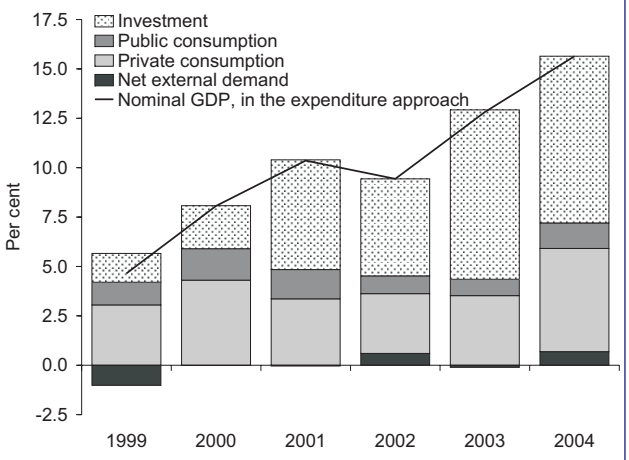
Excluding foreign direct investment, capital inflows and outflows in China are still considerably

controlled. Authorities continue to support a cautious approach with regard to the liberalisation of capital movements, given the delicate situation of the Chinese financial system and the Asian financial and foreign exchange crisis of 1997-98. Existing legislation significantly limits the access of foreign investors to Chinese stock and securities markets, which is either not possible or unattractive. On the other hand, Chinese portfolio investment abroad is also strongly restricted. In parallel, external corporate indebtedness, including that of companies with foreign participation, and the indebtedness of Chinese government agencies are subject to annual ceilings and repayment rules. Nevertheless, international trade growth and the financial and technological sophistication have led to less and less efficient controls and some steps have been taken towards the gradual liberalisation of capital movements, namely through the implementation of institutional investor programmes, both foreign and Chinese[4].

4. RECENT MACROECONOMIC DEVELOPMENTS

The pace of growth of GDP has followed an upward trend since 2002. The annual growth rate of real GDP reached 9.5 per cent in 2004. The growth pattern of activity has largely benefited the industrial sector. This sector's production increased, in real terms, by around 11 per cent in the past three years. The production of the agricultural sector increased at a very weak pace over the same period (despite having accelerated in 2004, following the implementation by the government of a series of support measures to agriculture), while the services sector increased slightly less than GDP. It should be noted that, in 2004, the services sector accounted for around 32 per cent of total value added, while industry and agriculture accounted for around 53 and 15 per cent respectively. This relatively low weight of services may be related to a number of methodological difficulties in the Chinese national accounts, namely the significant vertical integration of many enterprises or the inadequate coverage of services sectors with a higher pace of growth, namely where public property has lost importance or which are characterised by smaller producers.

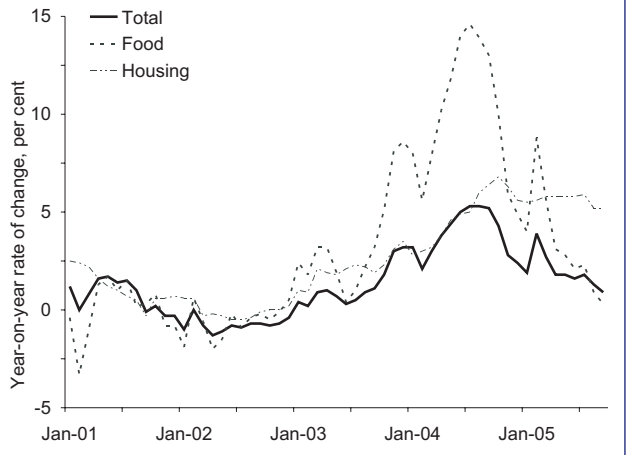
Chart 5
CHINA - CONTRIBUTION OF EXPENDITURE COMPONENTS TO NOMINAL GDP GROWTH



Source: CEIC.

Note: The Chinese national accounts in the expenditure approach are disclosed on an annual basis and only at current prices.

Chart 6
CHINA - CONSUMER PRICES



Source: CEIC.

On the demand side, the increase in GDP has largely reflected the strong incentives to investment, which has contrasted with the more moderate behaviour of private consumption. On the other hand, both exports and imports increased considerably, so the net contribution of external demand to GDP growth is likely to have remained low (Chart 5).

Inflation remained at a relatively moderate level, despite having fluctuated somewhat (Chart

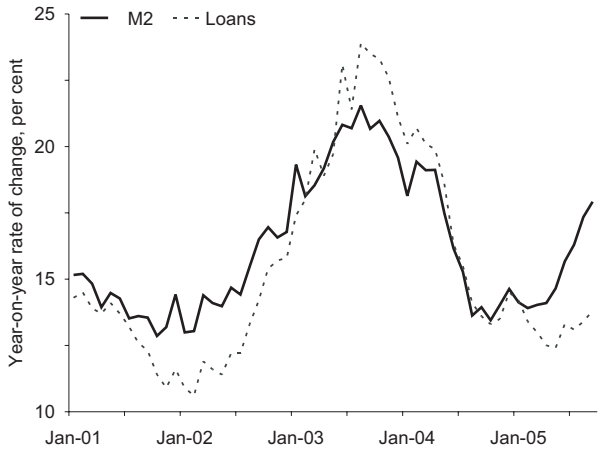
(4) For a detailed description of restrictions to capital inflows and outflows in China, see Prasad and Wei (2005).

6). In annual average terms, the economy moved from a fall in consumer prices in 2002 to moderate inflation in 2004 (3.9 per cent). As from end-2004, inflation showed signs of slowing down. These developments were largely due to the behaviour of food prices and, to a lesser extent, of housing costs.

In the context of accelerating activity and prices in 2003 and 2004, authorities decided to take macroeconomic measures, mainly of administrative character. The measures focused, for example, on the control of licensing of new investment projects. On the other hand, the monetary authority raised bank reserve requirements and put pressure on banks to restrict lending to certain sectors. As a consequence, the pace of growth of monetary aggregates and credit slowed down in 2004. The annual change in M2 and total bank loans stood at around 14.5 per cent at the end of 2004, compared with 19.6 and 21.1 per cent respectively at the end of the previous year (Chart 7). It should be noted that the authorities' behaviour concentrated, to a large extent, on the control of the excess buoyancy in certain sectors, to the detriment of more comprehensive solutions that would affect the overall growth of the economy.

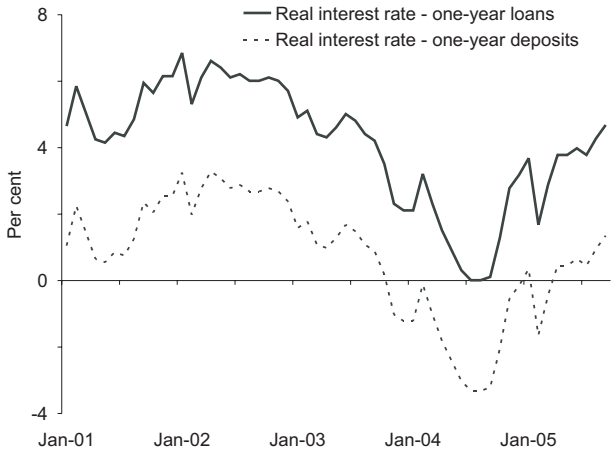
The monetary policy stance seemed to remain expansionary. Nominal interest rates remained broadly unchanged (with only a slight increase in October 2004), probably reflecting the authorities' fears of the effects of a more rapid rise in interest rates on the financial situation of State-owned enterprises and capital inflows. In the context of increasing inflation up to the third quarter of 2004, real interest rates reached very low levels (Chart 8). On the other hand, the real effective exchange rate of the renmimbi (RMB) recorded a real effective depreciation of around 11 per cent between end-2001 and mid-2005, largely reflecting international developments in the US dollar (USD) (Chart 9). It should be noted that, over this period, the exchange rate regime in China relied on a fixed exchange rate of the RMB against the USD, permitting the fluctuation against other currencies. Therefore, in order to maintain the target for the exchange rate against the USD, the monetary authority bought significant amounts of foreign currency, giving rise to high liquidity in the banking system. This situation is emphasised by high excess reserves of banks and low interbank market

Chart 7
CHINA - MONETARY INDICATORS



Source: CEIC.

Chart 8
CHINA - REAL INTEREST RATES

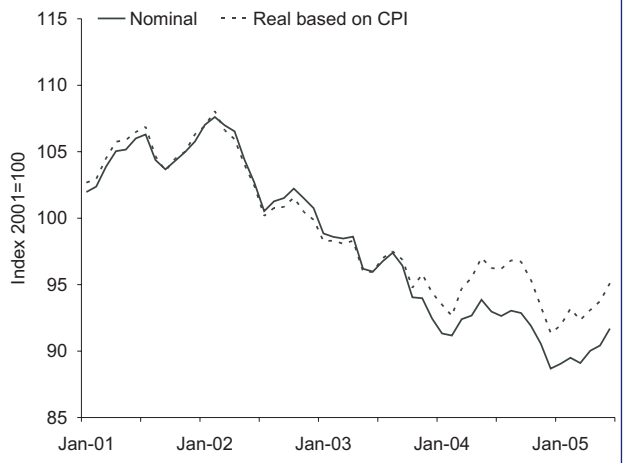


Source: CEIC.
Note: Nominal interest rates deflated by the year-on-year rate of change in consumer prices.

rates. As from end-2002, market expectations point to an appreciation of the RMB against the US dollar (Chart 10). In July 2005, the monetary authority announced a slight appreciation of the RMB against the USD (2 per cent). At the same time, the RMB was pegged to a currency basket that will act as a reference for the RMB exchange rate. The peg to the USD ended, and the RMB/USD is now subject to a daily fluctuation band of up to 0.3 per cent. However, in the following months, the flexibility allowed by the new system was scarcely used.

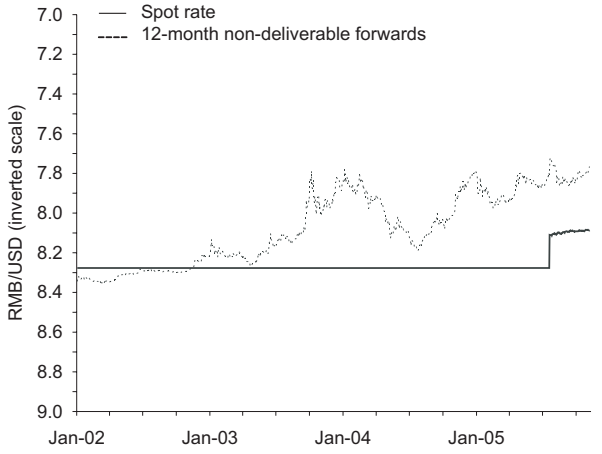
On the other hand, the fiscal policy has been going through a consolidation process in the past

Chart 9
CHINA - EFFECTIVE EXCHANGE RATE



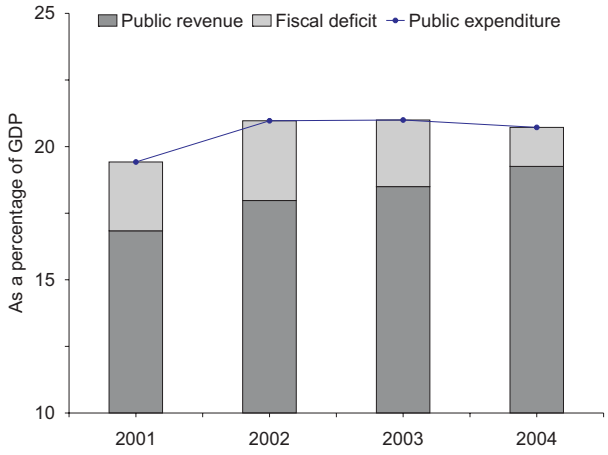
Source: IMF.

Chart 10
CHINA - EXPECTATIONS OF AN APPRECIATION OF THE RMB AGAINST THE USD



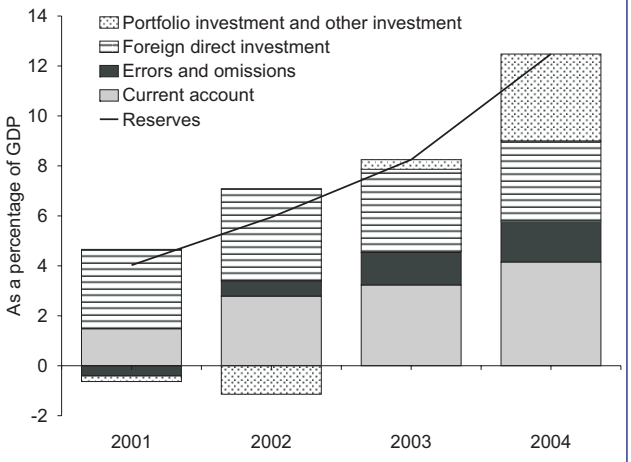
Source: Bloomberg.

Chart 11
CHINA - PUBLIC SECTOR



Source: CEIC.

Chart 12
CHINA - BALANCE OF PAYMENTS



Source: CEIC.

two years. The general government deficit declined by around 1.5 p.p. between 2002 and 2004, to 1.5 per cent of GDP (Chart 11). Public revenue has evolved favourably, in line with an improvement in activity and external trade. With regard to public expenditure, authorities have adopted, to a large extent, a cautious approach, in particular to make up for future irrecoverable debt in the banking system or for the increase in social expenditure. Government's priorities are now more balanced, given that there is a smaller emphasis on industrial public investment and a purpose of strengthening support to welfare policies and agriculture.

In the context of exchange rate stability against the USD, the current and financial accounts have posted growing surpluses, leading to a significant accumulation of foreign exchange reserves (Chart 12). The current account balance reached 4.2 per cent of GDP in 2004, reflecting the high savings rate of the Chinese economy. Over the same year, the financial account balance amounted to 6.7 per cent of GDP, due to constant inflows of foreign direct investment, together with a recent increase in net portfolio investment inflows. In 2004, the increase in portfolio investment inflows was, to a great extent, likely motivated by expectations of RMB appreciation against the US dollar, given

that, compared with the previous year, the differential between Chinese and US interest rates remained relatively stable in the first half of the year and even declined later on. International reserves amounted to around 37 per cent of GDP in 2004, corresponding to more than twelve months of imports.

5. ECONOMIC POLICY OUTLOOK AND CHALLENGES

The most likely scenario for the Chinese economy, which is common to the projections of international organisations, points to a gradual deceleration of activity and to the maintenance of inflation at a low level (Table 7). The acceleration in activity and prices over the past few years, together with significant monetary growth, raised concerns regarding a possible "overheating" of the economy and a consequent slowdown. It should be noted that, although the pace of growth of GDP in 2003 and 2004 corresponded approximately to the annual average growth level seen since 1980, it is currently estimated that the potential growth of the Chinese economy is somewhat lower. For example, there are signs that investment has not been done in an efficient way, given the existing bottlenecks in certain sectors, such as transportation and supply of energy and other commodities, as well as excessive investment in other sectors. On the other hand, given the significant expansion in the past few years, the weight of investment in GDP currently stands at a maximum level in historical terms, around 44 per cent. In this context, the evolution in activity will likely comprise a decline in the pace of growth of investment and an increase in exports and private consumption.

However, given the difficult challenges that China will face in the future some risks obviously persist, namely those regarding the financial robustness of the banking system in China. The inadequate market orientation of the banking system resulted in a rise in non-performing loans, which together with a heavy operational structure, namely of the four major State Commercial banks, contributed to the low profitability and decapitalisation of the banking system. It should be noted that although the four major State Commercial banks are among the 40 major banks of the world in terms of the size of their assets, only one is among the first 500 in terms of asset profitability[5]. On the other hand, the level of 8 per cent for the capital adequacy ratio required by the Basel Capital Accord is not generally complied with.

In the future, the challenge will be related to the reform of the financial system, expected to occur in parallel with the market liberalisation, which within the framework of the WTO membership is projected for the end of 2006. Recently, there seem to be signs of progress in these reforms. Non-performing loans have declined, although some uncertainty persists, given that over time some inconsistency in data releases has been observed. At the end of 2004, it is estimated that the weight of non-performing loans in the financial system, and taking into account banks and asset management companies, may have amounted to around 25 per cent of GDP. Moreover, State Commercial banks have been subject to high recapitalisation operations, namely using the State foreign exchange reserves. In contrast, the recent expansion of credit raises the possibility that part

(5) The Banker (2005).

Table 7

MACROECONOMIC PROJECTIONS FOR THE CHINESE ECONOMY

	IMF September 2005			Consensus Forecasts October 2005		
	2004	2005	2006	2004	2005	2006
Real GDP, rate of change, per cent	9.5	9.0	8.2	9.5	9.2	8.1
Consumer prices, rate of change, per cent	3.9	3.0	3.8	3.9	2.4	2.5
General government balance, as a percentage of GDP	-1.7	-1.7	-1.5	n.a.	n.a.	n.a.
Current account, as a percentage of GDP	4.2	6.1	5.6	n.a.	n.a.	n.a.

Sources: IMF and Consensus Economics.

of the new credit shall be considered irrecoverable, given the speculative nature of some of the associated investments, namely in the real estate sector, and the excess capacity in a number of sectors. It should be noted that, in the past few years, around 20 per cent of investment in fixed assets has been financed by bank loans.

The increase in public sector liabilities in the future is a second risk factor. The public accounts situation is apparently comfortable: in the past few years, the value of the deficit as a percentage of GDP has been declining and the public debt-to-GDP ratio stands at around 25 per cent, being largely comprised of domestic debt (external debt amounts to around 4 per cent of GDP). Albeit moderate, these figures must be assessed in view of several factors. First, general government revenue in China as a percentage of GDP is relatively low, which means that the debt coverage capacity is lower than anticipated. Second, this low government revenue obviously imposes restrictions to expenditure, so that, until recently, public enterprises were responsible for a large share of social expenditure, namely that related to education, health, unemployment or retirement pensions. In the context of decreasing employment in the rural areas and ongoing corporate reforms, the current levels of public expenditure may not be sustainable in the future. The government will likely need to increase public expenditure in the wide range of the social areas referred to above. Moreover, some investments, which are important to overcome problems related to the environment or to regional disparities in terms of economic developments, shall need to be sponsored by the State. Third, great uncertainty persists regarding the magnitude of responsibilities not yet explicitly taken up by the government, which are still risk factors to the public accounts situation in the future. Such responsibilities may include restructuring and recapitalisation costs for State banks and enterprises, the financing of the pension system, which is in a transitional phase from a pay-as-you-go system to a capitalisation system, or the assumption of debt indirectly contracted by local government, in a context where revenue transfers to these services seem to be insufficient to fulfil their responsibilities.

However, future pressure on public accounts may be moderate if the pace of growth of the economy remains high or if appropriate reforms occur, e.g. reforms preventing the emergence of new non-performing loans or changes in the pension system rules. On the other hand, there is room for an increase in tax revenue. These developments may occur both in State-owned enterprises, as these recover their profits, due to the reforms made in such enterprises, and in the sectors where tax evasion has been significant, namely non-State-owned enterprises (particularly in the services sector) and households. Moreover, the State holds a large volume of assets, namely State-owned enterprises, urban property or natural resources, which may be sold in order to meet any responsibilities to be taken up in the future.

Finally, the maintenance of the RMB exchange rate against the USD has increasingly hindered the conduct of monetary policy in China and caused some friction at international level. In order to control the ample liquidity in the economy, the central bank has been seeking to sterilise the impact of its foreign exchange interventions on money supply, through the issuance of securities to be placed in the interbank market. The perpetuation of this situation may entail additional costs to the monetary authority, considering in particular the need to increase the interest rate of such central bank securities. Moreover, international interest rate hikes in the context of the business cycle may translate into a decline in securities prices which, together with a possible appreciation of the RMB, may imply considerable losses for the Chinese central bank. At the external level, the value of the RMB has been under international pressure, in order to make it more flexible against the US dollar and to allow for a possible appreciation. These developments could facilitate the correction of macroeconomic imbalances at the global level, namely the US external deficit, contributing for example to a greater flexibility in other Asian currencies.

In this context, it is crucial that exchange rate flexibility increases gradually in the future, namely in order to ensure the conduct of monetary policy in China. In financial terms, risks to companies and banks are not likely to be significant, given the weak exchange rate exposure. On the other hand, this may contribute to developments in the foreign exchange market and exchange rate risk management mechanisms. The

need for greater flexibility has been recognised by Chinese authorities, although it still depends on the progress of other economic reforms. In particular, there are concerns regarding possible effects of an eventual exchange rate appreciation on economic growth, namely on exports. However, it should be noted that although recent developments in the Chinese balance of payments point to an eventual appreciation of the RMB, it is extremely difficult to determine the situation of the real effective exchange rate of the RMB with regard to its "equilibrium" level in the context of ongoing economic reforms. For instance, the liberalisation of the services sector in the context of WTO membership and the gradual liberalisation of capital outflows, still strongly conditioned by the success of reforms in the enterprises and banking sectors and developments in financial markets. Recently, several studies aimed at estimating the "equilibrium" level of the RMB using different methodologies, although great uncertainty persists due to the large variety of results.

6. CONCLUSION

In the past 25 years, China showed impressive economic growth and an increasing integration in the world economy. Such growth levels of the economy and trade flows are not unprecedented. During similar stages of the economic development process, comparable paces of growth were observed in other economies, such as Japan (after the World War II) and the newly industrialised Asian economies (as from the end-1960s)[6]. However, various factors indicate that the impact of the growth and integration process of China on world economy is much more significant than in the case of other economies and that it will likely be observed over several years. On the one hand, there is the size of China, which concentrates around 20 per cent of the world population. Despite the significant increase seen in the last quarter of a century, the Chinese per capita GDP, as measured by purchasing power parity, is still far lower than in the main advanced economies (in 2004, it amounted to 14.3 per cent of the level seen in the United States) or in the newly industrialised Asian economies (between 18 and 26 per cent). This income gap points to high growth potential, whose materialisation is likely to be supported by favourable macroeconomic developments and the continuation of the structural reform process of the economy. Currently, this is confirmed, for example, by international organisations' projections regarding developments in the current business cycle. However, there is an urgent need for the further implementation of reform measures, enabling the control of a number of risk factors, related to the banking and public sectors or to the conduct of macroeconomic policies.

On the other hand, the ongoing liberalisation should continue to contribute both to economic growth in China and an increase in its economic importance and integration in the world. For example, the abolition of textiles and clothing import quotas imposed by WTO is likely to give a further boost to Chinese exports over the next few years and will pose additional challenges to the economies specialised in this type of products. In turn, China's commitments concerning the gradual abolition of restrictions to foreign direct investment over the next few years – in particular, in the trade and financial sectors – will mirror a significant openness of the Chinese domestic market and suggest that the involvement of international investors in the economy will remain considerable, with positive implications on productivity growth and technological innovation.

China's integration process in the world economy should have an overall positive impact, given that it will allow for a greater specialisation of the international trade, which in turn gives rise to efficiency gains in production and direct benefits for consumers, both in China and the rest of the world. It should be noted that, as far as the Asian economies are concerned, such effects have significantly boosted trade and economic activity in the region over the past few years, which have grown at a more robust pace than in the rest of the world. However, effects on individual countries may be positive or negative, and will tend to evolve over time, largely depending on the degree of complementarity between their pattern of trade and China's. The countries that tend to benefit more from China's trade expansion include exporters relatively specialised in equipment goods

(6) The newly industrialised Asian economies include Hong Kong, Singapore, Taiwan and South Korea.

or semi-processed goods with higher value added. Recent experience has shown that commodity exporters will also tend to benefit from the effects of the increased demand for this type of goods by China. On the other hand, countries relatively specialised in the export of goods similar to those produced in China, where labour costs are decisive, will tend to suffer losses in the markets of those products.

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