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DAILY BRIEFING

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State planner advocates more controlled growth, higher social spending, but no big change expected; US steps up trade pressure, one-off CNY move not ruled out

Leading state planner Ma Kai, head of the State Development and Reform Commission, has advocated slowing growth to a more controllable pace, with a greater emphasis on social spending, and implied that unbalanced fast growth has been the cause of some current social ills. His comments are part of an on-going policy debate and not a signal that China is about to change direction. A moderation in stimulatory fiscal and monetary policies is expected but the overall expansionary bias should remain in place, though some cases of excessive investment are likely to be tackled. An adjustment in policy settings is scarcely surprising given that the economy is currently powering ahead, with more very strong output and export data in October. The sharp jump in the October trade surplus partly reflects seasonal factors and the rush to get exports through before tax breaks are cut. On the other hand, there could be fresh deficits in early 2004 and a much smaller trade deficit is forecast for the full year. Beijing hopes this trend will quieten trade critics however the bilateral surplus with the US has gone up even as the overall surplus has slipped. Washington is duly stepping up trade pressure. China has so far been conciliatory but made no real concessions. A one-off CNY revaluation cannot be entirely ruled out but a floating exchange rate and capital account convertibility are not expected.

Planner advocates more controllable, sustainable pace of growth and social spending

This week has brought an interesting new contribution to the debate on policy priorities and risks of overheating (discussed in our briefing of 28 November). On 2 December the China Daily quoted Ma Kai, head of the State Development and Reform Commission, as saying that "Economic development is not everything for the government, and we should put more energy [into] other indicators such as education, health, environment and social welfare". Ma said that China will yet again set a GDP growth target of 7% for 2004, in line with the government's long-term goal of 'sustainable' average growth of 7% between 2001 and 2005. Of course, 7% was also originally the target for this year but was very soon honoured only in the breach and growth now looks likely to comfortably exceed 8% on the official measure, with an increasing number of independent economists, including some in China, saying that the 'true' rate of growth this year may be nearer 10%.

But the implication of Ma's comment is that Beijing should be ready to settle for growth nearer to 7% next year and not focus quite so much on ramping up output and activity, diverting some resources instead into social expenditure etc. Certainly, China's self-admitted failure to handle the SARS epidemic well, above all in the countryside, highlighted one area showed that much needs to be done in health provision. In this respect it was interesting and potentially significant that, also on 2 December, Premier Wen Jiabao shook hands and chatted with three AIDS patients in an unprecedented public show of concern about the disease, now finally recognised as a major public health challenge. The clear message in Wen's gesture was that the government acknowledges the problem and is starting to tackle it.

Less explicit in Ma's comments but potentially more important was the implied suggestion that very rapid growth may itself be a cause of social problems, above all widening and politically sensitive income disparities between the rural and urban dwellers and between poor and rich provinces. This issue is plainly of paramount concern to the leadership and has been raised equally by those less nervous about continued high growth than Ma. But he proffered a somewhat different perspective, commenting "I'm sure China can sustain a faster developing pace [than 7% GDP growth], but we must realise the challenge if we ignore the rule of sustainable development". These words arguably move him a little closer to those who contend that the current pattern of ultra-rapid, investment-driven, export-focused industrial growth is too unbalanced and liable to excess capacity shocks as well as being potentially socially divisive (especially if measures are not taken to redress the build up of regional disparities).

No big policy change seen but some slowing likely together with targeted measures

The fact that Ma, quite a senior figure, made such comments does not mean that the high growth strategy is about to be stopped. The evidence from most policy statements in recent weeks is that Beijing will follow broadly the same strategy next year as it did this, albeit fiscal and monetary/lending policies need not be quite as loose. The state press have already indicated that next year's issue of special treasury bonds to fund extra spending will be cut to CNY110bn (USD13bn) from CNY140bn this year and the central bank is now selectively tightening up on bank lending. Evidently, there is a debate going on about the possibility of rather greater changes, with a reallocation of expenditure away from some current developmental priorities. However, other major issues, such as the exchange rate and CNY convertibility, have increasingly been discussed in a fairly open fashion, without change following right away so this latest discussion need not have any immediate implications either.

A shift in macroeconomic policy could be seen in due course but probably not a lot over the coming year. We may expect increased social spending and more rural initiatives in 2004 but no big reorientation of overall policy.

One other thing to watch for, however, is some fresh attempt to rein in certain provinces and major cities where the authorities have not so much facilitated high growth as attempted to lead it by hot-housing key industries with cheap loans and preferential treatment, at times -- it would appear -- almost for status-seeking reasons. Thus, Beijing can be expected to target 'over-investment' in some areas in industries such as autos, steel and cement, but not with the aim of checking underlying industrial growth. In fact, the latest data have been seen by some as indicating that this process is getting underway in the auto sector, yet output growth is still accelerating.

October output growth rebounds to 8-month high, autos slow a bit

The State Statistical Bureau (SSB) said on 11 November that "value added industrial output" rose by 17.2% year-on-year in October, up from 16.3% in September, and the highest growth figure since 19.8% in February (and seasonal distortions probably added to this). The strong October figure lifted output growth over the first ten months to 16.7% year-on-year. The SSB stated that, "Looking at pillar sectors, the three major industries of telecommunications equipment, machinery and metallurgy ... were major forces driving industrial output growth in the month". It also said that personal computer output in October was double that of the corresponding month a year earlier while production of other kinds of computers rose by almost 58%. Output of home appliances "such as ovens and microwaves" also rose by more than 50% on the year. Steel production was up by some 25%. However, there was some slowing in the auto sector, from the record high figures seen in September; autos output was up 36.8% to 427,600 units, within which sedans were up 70% to 190,000. In October, sedan production was 168,000, a more modest 52% rise on the year, and we see this rate falling quite a lot further. The SSB noted some knock-on effects, stating "Feeling the effects of slower automobile output, makers of transportation equipment saw their contribution to industrial output growth fall".

The headlong growth in industrial output this year has been driven above all by foreign-invested and export-oriented firms, often one in the same thing. The biggest single change over the last year and more has probably been the build up in Taiwanese-owned plants which are taking over much of the direct exporting from their Taiwanese parents, who now increasingly supply components to the mainland for assembly, with quite a clear effect on Taiwan's overall pattern of trade. However, there is also a great deal of new, part foreign-funded production going to serve the domestic market in China. On the whole such industries are run on a realistic accounting basis with profits in view, nevertheless -- as the repeated comments about parts of the autos, cement and steel sectors indicate -- there are still many state-linked plants that are not necessarily economic, even though they are still pushing up output.

October trade surplus soars as imports dip for seasonal reasons

The bullish rise in October output paralleled another surge in exports. The commerce ministry announced on 13 November that exports rose by 36.7% on the year in October to USD40.93bn, the fastest growth rate in five months and the second highest export figure ever behind, the September total of USD41.9bn, a 31.3% rise on the year. The September-October export totals were well up on earlier months, the previous best being a 30.6% rise to USD38.11bn in July. On the other side of the trade account, October imports rose by 39.7% to USD35.19bn, a similar increase but not a similar total to September, when imports rose 39.6% on the year to an all-time high (by a wide margin) of USD41.6bn. As the data indicate there was a similar month-on-month fall in the imports total in October last year. This is partly a seasonal phenomenon, evident in data for earlier years and related to the long public holiday in October.

The result of the import dip was that the trade surplus soared to USD5.74bn in October, easily the highest figure this year (indeed more than the surplus for the whole of the first half) and dramatically up from the surplus of just USD290m in September. It was also up

20.8% on the year from USD4.75bn in October 2002, itself the largest surplus last year. The October surplus bumped the cumulative ten month trade surplus up to USD14.87bn but that was still 40.1% down on the year, with much of the difference arising from the run of deficits in the first quarter of this year when import growth stormed ahead of exports (albeit exports were up by more than 30% year-on-year). Over the first ten months of 2003, exports rose by 32.8% to USD348.6bn and imports were up by 40.4% to USD333.7bn.

On the basis of previous years and indeed the sheer strength of domestic demand, imports can be expected to pick up again in November, so the deficit may well narrow significantly this month. The same will be true in December, though there is some possibility of an additional push by exporters to cash in on tax rebates that are being reduced, or in some cases phased out, from the start of next year (see 21 October briefing on overhaul of exporter tax rebates). The full year trade surplus could therefore be anywhere between USD2-10bn up on the ten-month figure, but even at the top of that range it would not approach the USD30.35bn surplus notched up in 2002 on the back of export growth of 22.3% and import growth of 21.2%.

Much smaller trade surplus seen in 2004, run of monthly deficits possible

Early next year, especially if there has been a big end year export push in 2003, export growth could falter while imports remain buoyant. As total exports would again be overtaken by imports, then there is the distinct possibility of a run of monthly trade deficits. The reduction and withdrawal of exporter tax rebates will affect margins on exports as against domestic sales and could dampen export growth somewhat next year. At the same time, growing shortages of some domestic inputs as industrial growth outstrips supply growth in primary industries, will oblige China to import more. In some cases, tariff reductions will also encourage greater imports. Against this background, and with the Chinese economy continuing to outpace all other major economies in the coming year, we would expect a significant reduction in the trade surplus in 2004, probably below USD10bn, possibly much lower. However, it has to be said that the trade account has consistently been one of the most unpredictable of all the main economic forecasts for China. What happens beyond 2004 will be even more uncertain but a run of deficits in 2004 will tend to promote the expectation that deficits would continue, perhaps even deteriorate, in 2005. What this does to other expectations (eg over the Yuan) will be interesting, the more so because the dip into overall trade deficit may well happen alongside a rising bilateral trade surplus with the US. Suppliers of imports to China would gain but these countries have been less of a headline target for US trade complaints.

Dai Genyou, head of the credit information division of the central People's Bank of China said on 27 November that "China's trade surplus has shown a declining trend in recent years and successive annual trade deficits may occur" in coming years, on soaring imports into China and lower export incentives. Dai went on to say that "There are inappropriate expectations of a renminbi (CNY) appreciation, but such expectations will change when they clearly see the trend of trade deficit". This was the point of his comments really, since China's is engaged in a deepening trade dispute with the US, in which one of Washington's main lines of attack is that the CNY (pegged to the USD at 8.28 since 1995) is now significantly undervalued, giving China an unfair trading advantage.

Might China revalue without a float or capital account convertibility?

It remains our view (see 18 September and 21 October briefings) that, while China has opened room for some debate on exchange rate reform, and might in some circumstances consider some form of revaluation to what would amount a new parity, it does not want to move any time soon to convertibility on the capital account and fully flexible exchange rates. This incidentally was broadly the view taken by international ratings agency Fitch in comments by Brian Coulton, the head of Asian sovereign ratings, on 2 December, when he said that "We think revaluation of the exchange rate without changing the regime in terms of openness of the capital account, keeping it relatively closed, is a policy option that is becoming increasingly attractive to them".

The main reason for this caution on opening the capital account is the potential risk to the heavily-indebted and largely unrestructured banking sector. The banks are currently the focus of renewed reform efforts but are likely to remain vulnerable for some time to come. On the other hand, there are problems with maintaining the current exchange rate regime, not least the upward pressure on domestic money supply and lending arising from speculative inflows and the related lack of manoeuvrability in managing -- specifically raising -- interest rates. It was in this wider context that Dai said "It's a wise choice to keep the renminbi stable", a formula which in our view may rule out an open-ended appreciation but not necessarily some revaluation.

US deficit with China at record high, China sees structural cause

The exact size of the bilateral trade gap between China and the US is strongly disputed by the two sides. The US recently announced that its September trade deficit with China set a new monthly record of USD12.7bn, as imports from China hit USD14.8bn. As a result the trade deficit with China over the first nine months of 2003 totalled USD89.7bn and should comfortably top the 2002 record of USD103bn, possibly hitting USD120bn. These figures go a long way to explaining current trade tensions. Although China disputes these totals it certainly agrees that the trade gap is rising. But Beijing argues that this is largely because of structural factors, notably the sort of transfer of capacity very evident in the case of Taiwan but also apparent with other countries such as Japan and South Korea. This typically results in a rise in China's imports from these countries, in the form of first plant and then components, at the same time as a rise in China's exports to key end markets.

Hence, Dai made the point that "As China's trade surplus with the US has widened, its deficit with neighbouring countries has also widened". This point, however, tends to get pushed to one side in the US attack on China though it obviously has some validity. The other side of the equation is why US exports to China are not doing better, helping to offset the rise in imports from China. Part of the reason is again structural. The US is not a mainstream supplier of most of the components and the primary goods being sought by Chinese industry. The US’s strength in some consumer areas and above all services serves it less well in China than in more developed, consumer-oriented economies. Notably, of course, there have been deals struck by China to specifically raise imports of items such as aircraft from US suppliers. But these gains will not be large enough to make a serious dent in the overall bilateral balance given the relatively low level of US exports to China versus US imports from China.

US steps up trade offensive, more to come, China conciliatory so far

The background to the trade imbalance has been discussed in several previous briefings, which all emphasised the point that, alongside the exchange rate argument, the US might seek to prise open more markets in China through heavy lobbying and attempt to restrict some specific Chinese exports. Since then, with electoral concerns looming ever larger in Washington, the US administration has indeed gone on to the offensive, with restrictions imposed on a number of Chinese exports. The main attraction of this approach is that it appears to directly answer popular, or at least union, concerns in the US that 'American jobs are being lost to cheap Chinese imports'. The validity of this view is clearly questionable as the US is no longer a major producer in many of the product sectors where Chinese exports have been most successful – indeed many analysts acknowledge that some restrictions may even hurt the overall position of US industry.

Nevertheless, over the last two weeks, the US started the ball rolling by imposing quotas on various Chinese textiles (notably dressing gowns, bras and knitted fabrics) citing a clause in a US-China trade pact that allows Washington to set "safeguards" against import surges of specific goods. US commerce secretary Don Evans also warned China that "We're not going to sit around and tolerate 50% of your enterprises being state-owned, which means they're state subsidised. We're not going to tolerate 90% cent of our intellectual property being stolen", referring in particular to the illicit copying and resale of music, films and software. Last week the US commerce department ruled that televisions are being sold “at less than fair value” in the US by four Chinese firms and announced provisional duties of 28-46% on the sets.

China's reaction has been angry but relatively restrained. Days after the textile move, Beijing announced it would raise duties on some US goods, though it linked this to US steel tariffs imposed a year and a half ago. China also cancelled soybean, cotton and wheat-buying trips to the US. The rising rhetoric and strong possibility of further moves to come ahead of the US elections prompted expressions of concern from various quarters, including the IMF and non-administration figures in the US, about the risks of rising protectionism and bilateral trade conflicts though equally several observers (for example Japanese trade and industry minister Shoichi Nakagawa) made the point that both sides would lose if there were tit-for-tat trade restrictions and that much of the argument appeared to be posturing.

China, which had announced plans for US plane and indeed auto purchases just ahead of the textile move, has so far been relatively conciliatory. Thus for instance a senior Chinese government official has recently stressed that China is not looking to build up big trade surpluses with the rest of the world and indeed would now be happy with just a rough balance between imports and exports. Premier Wen Jiabao, who travels to Washington this month, is likewise expected to take a fairly conciliatory line on bilateral trade policy. Whether China will flag big trade deals or want to offer concessions, including any move on the CNY, while under such direct pressure is not clear but it is likely to remain fairly stoical. China certainly recognises that there is a medium-term political horizon fixed by next year's US elections ahead of which rhetoric is likely to rise and some further sanctions can be expected. It also knows that there are some big potential gains a little further ahead, notably the lifting of global quotas in the textile sector from 2005, which could offer substantial gains for China.

Industrial output in 2002 and 2003 (% year-on-year change) is as follows:

2002	Jan	Feb	Mar	Apr	May	Jun	
	9.9	12.6	10.9	12.1	12.9	12.4	
	Jul	Aug	Sep	Oct	Nov	Dec	2002
	12.8	12.7	13.8	14.2	14.5	14.9	12.6
2003	Jan	Feb	Mar	Apr	May	Jun	H1
	14.8	19.8	16.7	14.9	13.7	16.9	16.2
	Jul	Aug	Sep	Oct	Jan-Oct		
	16.5	17.1	16.3	17.2	16.7		

Trade figures on monthly basis in 2003 (USDm with % change on year) are as follows:

2003:	January		February		March	
Exports	29770	37.3	24460	27.8	32080	34.7
Imports	31020	63.4	23780	49.4	32540	45.1
Balance	-1250	n/a	680	-78.3	-459	n/a
	April		May		June	
Exports	35620	33.3	33840	37.3	34480	32.6
Imports	34600	34.34	31610	40.9	32340	40.1
Balance	1020	5.2	2230	1.3	2140	26.7
2003:	July		August		September	
Exports	38110	30.6	37400	27.2	41900	31.3
Imports	36510	35.3	34600	27.3	41600	39.6
Balance	1600	-27.6	2790	26.0	290	-86.3
	October		Jan-Jun		Jan-Oct	
Exports	40930	36.7	190300	34.0	348600	32.8
Imports	35190	39.7	185800	44.5	333730	40.4
Balance	5740	20.8	4500	-66.5	14870	-40.1