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CHINA: MACROECONOMIC DATA AND FORECASTS

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
Population (bn)	1.19	1.20	1.21	1.22	1.24	1.25	1.26	1.27	1.27	1.29	1.30	1.31
Nominal GDP (US$bn)	599	542	701	822	903	965	991	1,080	1,167	1,248	1,359	1,441
GDP per capita (US$)	505	452	578	672	731	773	787	853	917	971	1,046	1,098
Real GDP growth (%)	13.5	12.7	10.5	9.5	8.8	7.8	7.1	8.0	7.3	7.5	7.4	7.6
Oil production (mn b/d)	2.9	2.9	3.0	3.1	3.2	3.2	3.2	3.2	3.3	3.3	3.4	3.5
Consumer price inflation (an. avg %)	14.6	24.2	16.9	8.3	2.8	-0.8	-1.4	0.3	0.3	-0.5	1.8	3.5
Bank rate (% pa)	10.1	10.1	10.4	9.0	8.6	4.6	3.2	3.2	3.2	2.7	3.2	4.7
Deposit rate (% pa)	11.0	11.0	11.0	7.5	5.7	3.8	2.3	2.3	2.3	2.0	2.3	4.0
Lending rate (% pa)	11.0	11.0	12.1	10.1	8.6	6.4	5.9	5.9	5.9	5.3	5.9	7.9
CNY/US$ (eop)	5.8	8.4	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.4	9.0
CNY/US$ (period average)	5.8	8.6	8.4	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.7
Merchandise exports (US$bn)	91.0	121.0	148.8	151.2	182.9	183.6	195.2	249.3	266.2	310.6	341.7	392.9
Merchandise imports (cif, US$bn)	103.1	115.7	129.1	138.9	142.2	140.3	165.8	206.1	243.6	280.2	320.5	381.7
Trade balance (customs, US$bn)	-12.1	5.4	19.7	12.3	40.7	43.3	29.4	43.2	22.6	30.5	21.2	11.2
Current account (US$bn)	-11.6	6.9	1.6	7.2	37.0	31.5	21.1	20.5	17.4	23.2	12.5	1.5
Current account (% GDP)	-1.9	1.3	0.2	0.9	4.1	3.3	2.1	1.9	1.5	1.9	0.9	0.1
Foreign reserves (US$bn) *	22.4	52.9	75.4	107.0	142.8	149.2	157.7	168.3	215.6	260.5	270.0	263.5
Import cover (mths) **	2.7	5.7	6.7	8.3	10.4	10.9	9.9	8.1	9.2	9.7	8.8	7.3
External debt (US$bn)	83.6	92.8	110.4	116.3	131.0	146.0	151.8	145.7	170.1	180.0	190.0	198.6
External debt (% exports)	90.3	73.5	71.6	64.1	60.0	67.1	64.7	48.7	53.4	49.1	47.1	43.2
External debt (% GDP)	14.0	17.1	15.8	14.1	14.5	15.1	15.3	13.5	14.6	14.4	14.0	13.8

*f = BMI forecast, eop = end of period, * excluding gold; ** no. of months imports covered by FX reserves + gold. Sources: State Statistics Bureau/World Bank/BMI.*

BMI Ratings - China

The BMI Ratings can be used to rank emerging markets in terms of political risk, the economy and the quality of the business environment. There are four ratings: a composite rating, a political rating, an economy rating and a business environment rating. These ratings are reviewed every month and the results posted on BMI's online service **Emerging Markets Online** (www.businessmonitor.com). The political and economy ratings have short- and long-term components. The long-term ratings are designed to reflect more structural considerations and will not change greatly in the short term. The short-term ratings will change frequently in response to more transient influences. All ratings are expressed as a number between 1 and 100. A high rating is an indicator of lower risk.

RATINGS UPDATE – Economic Rating Falls Given Lingering Deflation

Our short-term political risk rating is static at 70.0 awaiting the outcome of the communist party congress scheduled for early November. A transparent and orderly transfer of power to vice-president Hu Jintao would likely result in a ratings increase. Our short-term economic rating has fallen to 83.0 (from 84.0) reflecting the recent downgrade to our inflation forecast with average annual inflation now expected to be in negative territory for 2002. Our business environment and composite ratings have fallen to 62.6 (from 62.8) and 76.2 (from 76.7) respectively, given the slight fall in our short-term economic rating.

BMI Risk Ratings – China

	Latest Rating*	Rank†	Previous Rating**	Trend	Region Avg	Emerg Mkts Avg
Composite Rating	76.2	4	76.7	⇩	64.8	59.4
L-T Political Rating	45.0~	45	45.0	⇔	51.6	56.9
S-T Political Rating	70.0	33	70.0	⇔	66.1	65.3
L-T Economic Rating	72.3	3	74.2	⇩	60.9	53.0
S-T Economic Rating	83.0	1	84.0	⇩	64.3	54.9
Business Environment Rating	62.6	15	62.8	⇩	59.8	55.7

*trend arrows reflect two consecutive months of movement in same direction. ~ indicates rating is below Emerg Mkts average † out of 64 emerging markets rated *13/09/02 **15/08/02*

POLITICAL RISK – Speculation Heats Up

Factors which influenced BMI's political ratings in September included:

■ With the Communist Party Congress now scheduled to begin on November 8, there has been increasing speculation over the likely outcome, although no details will be known until the congress is underway. A bid to cling to power by President Jiang Zemin would bode ill for foreign investor sentiment in China as this would indicate a lack of progress on political reforms with power still centred around people rather than institutions.

ECONOMIC RISK – Dragging Deflation

Factors which influenced BMI's economy ratings in September included:

■ Despite a prosperous economic outlook, China remains plagued by deflation. Consumer prices dropped -0.8% y-o-y during the first eight months of 2002 and there is little indication of any immediate inflationary pressures. Nevertheless, producer price deflation is easing gradually (in line with rising oil prices) and this should help to offset some of the structural deflation evident in the Chinese economy. Our 2002 and 2003 forecasts for consumer price inflation have been downgraded with this year set for annual inflation of -0.5%.

BUSINESS ENVIRONMENT RISK – Toyota Edges Into China

Factors which influenced BMI's business environment ratings in September included:

■ Japanese car maker **Toyota** is the latest foreign firm to get its foot into the Chinese market. In late August Toyota announced a joint venture with China's largest auto maker **First Automotive Works** (FAW). China's auto industry has seen a flurry of mergers and joint ventures over the past year, in line with the government's wish for significant consolidation within the industry. This latest joint venture should pave the way for further consolidation as the market becomes increasingly concentrated around a few key players.

BMI Risk Ratings – Asia Tables

	Composite	L-T Political	S-T Political	L-T Economy	S-T Economy	Business Environment
China	76.2	45.0	70.0	72.3	83.0	62.6
Hong Kong	71.0	51.7	80.0	63.2	63.0	84.4
India	60.0	55.0	59.0	58.1	61.0	50.6
Indonesia	55.5	41.7	55.0	51.0	56.0	48.3
Malaysia	69.4	51.7	74.0	65.8	65.0	62.4
Pakistan	43.6	37.5	38.0	44.5	50.0	45.8
Philippines	59.5	48.3	58.0	54.8	61.0	58.1
Singapore	83.9	74.2	87.0	82.6	81.0	86.9
South Korea	69.4	65.8	58.0	71.0	83.0	65.4
Sri Lanka	43.3	55.8	52.0	44.5	36.0	49.9
Taiwan	76.5	66.7	75.0	74.2	78.0	72.1
Thailand	71.0	43.3	72.0	53.5	70.0	56.2
Vietnam	63.0	34.2	81.0	56.1	49.0	35.3
Regional Averages	64.8	51.6	66.1	60.9	64.3	59.8
Emerging Market Averages	59.4	56.9	65.3	53.0	54.9	55.7

Countries rated on 20 September, 2002.

Asia Ratings League Tables

Composite Rating

	Composite	Rank*	Trend
Singapore	83.9	1	⇔
Taiwan	76.5	3	⇧
China	76.2	4	⇩
Hong Kong	71.0	8	⇔
Thailand	71.0	8	⇔
South Korea	69.4	15	⇔
Malaysia	69.4	15	⇧
Vietnam	63.0	30	⇧
India	60.0	37	⇩
Philippines	59.5	38	⇔
Indonesia	55.5	44	⇔
Pakistan	43.6	58	⇔
Sri Lanka	43.3	60	⇔
Regional Averages	*64.8*		
Emerging Market Averages	*59.4*		

Business Environment Rating

	Business Environment	Rank*	Trend
Singapore	86.9	1	⇔
Hong Kong	84.4	2	⇔
Taiwan	72.1	5	⇧
South Korea	65.4	10	⇔
China	62.6	15	⇩
Malaysia	62.4	16	⇔
Philippines	58.1	24	⇔
Thailand	56.2	28	⇔
India	50.6	36	⇔
Sri Lanka	49.9	38	⇔
Indonesia	48.3	40	⇔
Pakistan	45.8	46	⇔
Vietnam	35.3	56	⇔
Regional Averages	*59.8*		
Emerging Market Averages	*55.7*		

Short-Term Political Rating

	S-T Political	Rank*	Trend
Singapore	87.0	1	⇔
Vietnam	81.0	7	⇔
Hong Kong	80.0	10	⇔
Taiwan	75.0	19	⇔
Malaysia	74.0	21	⇔
Thailand	72.0	27	⇔
China	70.0	33	⇔
India	59.0	43	⇔
South Korea	58.0	44	⇔
Philippines	58.0	44	⇔
Indonesia	55.0	48	⇔
Sri Lanka	52.0	50	⇔
Pakistan	38.0	60	⇔
Regional Averages	*66.1*		
Emerging Market Averages	*65.3*		

Long-Term Political Rating

	L-T Political	Rank*	Trend
Singapore	74.2	6	⇔
Taiwan	66.7	16	⇔
South Korea	65.8	18	⇔
Sri Lanka	55.8	28	⇔
India	55.0	30	⇔
Hong Kong	51.7	34	⇔
Malaysia	51.7	34	⇔
Philippines	48.3	40	⇔
China	45.0	45	⇔
Thailand	43.3	46	⇔
Indonesia	41.7	50	⇧
Pakistan	37.5	55	⇔
Vietnam	34.2	56	⇔
Regional Averages	*51.6*		
Emerging Market Averages	*56.9*		

Short-Term Economic Rating

	S-T Economic	Rank*	Trend
China	83.0	1	⇩
South Korea	83.0	1	⇔
Singapore	81.0	3	⇔
Taiwan	78.0	4	⇧
Thailand	70.0	8	⇔
Malaysia	65.0	13	⇔
Hong Kong	63.0	14	⇔
India	61.0	19	⇩
Philippines	61.0	19	⇔
Indonesia	56.0	31	⇔
Pakistan	50.0	42	⇔
Vietnam	49.0	44	⇧
Sri Lanka	36.0	59	⇔
Regional Averages	*64.3*		
Emerging Market Averages	*54.9*		

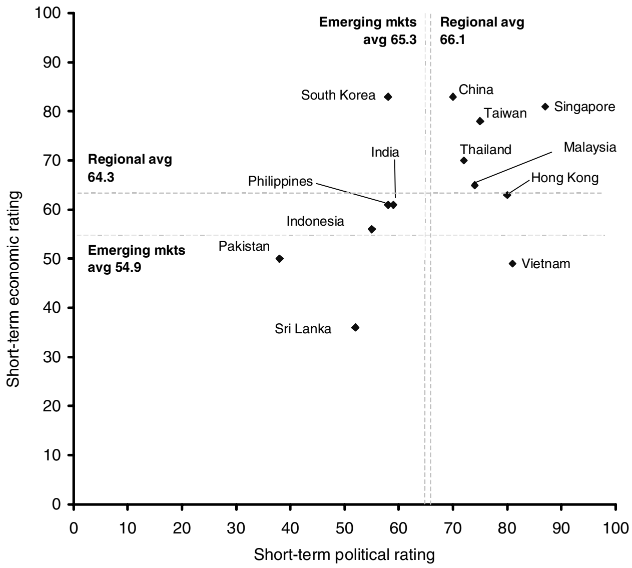
Long-Term Economic Rating

	L-T Economic	Rank*	Trend
Singapore	82.6	1	⇔
Taiwan	74.2	2	⇔
China	72.3	3	⇩
South Korea	71.0	4	⇔
Malaysia	65.8	7	⇔
Hong Kong	63.2	10	⇔
India	58.1	17	⇔
Vietnam	56.1	22	⇧
Philippines	54.8	26	⇔
Thailand	53.5	32	⇔
Indonesia	51.0	39	⇔
Pakistan	44.5	47	⇔
Sri Lanka	44.5	47	⇔
Regional Averages	*60.9*		
Emerging Market Averages	*53.0*		

trend arrows reflect two consecutive months of signficant movement in the same direction.
** out of 64 emerging markets rated*

Risk Interaction Diagram

BMI's **Risk Interaction Diagrams** give a more informative picture than the composite rating of the information conveyed jointly by the political and economy ratings. One problem with the composite, which is an unweighted geometric mean of the short-term political and short-term economy ratings, is that a misleading picture can be presented if the two components are widely different. In the Risk Interaction Diagram, the short-term political rating is plotted along the horizontal axis, the short-term economy rating along the vertical axis. The averages for all countries rated by **BMI** are indicated by horizontal and vertical broken lines. Countries in the top right quadrant, therefore, have above-average ratings. The more "equally balanced" countries appear along the diagonal of the quadrant.



BMI Ratings – Brief Methodology

Composite Rating

The composite rating is an unweighted geometric mean of the short-term political and short-term economy ratings, allowing a ranking of all countries in **BMI**'s emerging markets universe.

Political Ratings

The political ratings are an indicator of political stability, seen as a pre-requisite for a stable economy and business environment. The long-term political rating considers more structural elements such as: Is there a functioning democracy? Are there free and fair elections? Is there separation between party and state? Have recent governments pursued similar, enlightened policies amid a stable political environment? The short-term political rating considers more transient influences such as: Have there been recent large-scale demonstrations or strikes? To what extent have these threatened the political status quo? Is unemployment currently a potential source of political instability? What is the current position in the political cycle – to what extent is this contributing to political risk? Is the government having trouble passing legislation?

Economy Ratings

The economy ratings assess the degree to which the country approximates the ideal of non-inflationary growth with contained fiscal and external deficits and manageable debt ratios. The ratings use as raw material historical data and forecasts fed in from **BMI**'s country databases: as historical data is revised and forecasts change, so the ratings change. Factors in the long-term rating include GDP growth, unemployment, inflation, real interest rates, exchange rates, the fiscal balance, the current account balance and external debt. A number of other structural factors are also thrown into the equation, including dependence on the primary sector, reliance on commodity imports, reliance on a single export sector, and central bank independence. The factors included in the short-term rating are a subset of those in the long-term rating.

Business Environment Rating

The business environment rating is a broad indicator of the investment climate, for both domestic and foreign players. While areas such as competitiveness, finance, openness and environment comprise the bulk of the rating, there is also an important feed from the political and economy ratings. The factors considered include: the state of the national infrastructure, the education system, cronyism/ corruption, red tape, the legal framework, property rights, market access, and the corporate tax regime.

chapter 1 Political Outlook

Introduction

Leadership Speculation Rife

There is growing speculation over the new Chinese leadership, to be announced at the five-year Communist Party Congress due later on this year. Many had hoped that the changeover, which will usher in a "fourth generation" of leaders, would be orderly. This now looks in doubt. There have been widespread reports that President Jiang Zemin has been lobbying party members for support to stay on, despite the presence of an heir-apparent, Vice-President Hu Jintao. No details will be known until the congress is underway, and the opaque nature of Chinese Communist Party (CCP) politics means that the government may well attempt to cover up any internal struggle. A messy changeover could seriously dent foreign investor confidence and act as a restraint on the pace of economic reforms.

China's political scene has been dominated by speculation over an imminent leadership changeover, one of the biggest in China's history.

On the foreign policy front, relations with Taiwan have taken another nosedive, but strengthening economic links means the fate of the two nations is becoming increasingly intertwined. The Chinese economy is emerging as a major trading partner around the world and this is increasing China's diplomatic clout, often at the expense of Taiwan. Despite the independence rhetoric from Taiwanese President Chen Shui-ban over the past few months and resulting hostilities with China, economic, if not political, integration is real. It remains on course to continue.

Domestic Political Outlook

Jiang Set To Cling To Power

China's domestic political environment has been dominated by speculation over the leadership changes of the ruling CCP due during the next six months. The changeover will be one of the biggest in China's history with around half of the 340 full and alternate members of the Central Committee set to step down, along with five of the seven-man politburo standing committee, China's top policy-making body. China's economy has undergone significant reform in the past two decades (and is currently facing huge challenges as it moves towards a more market-based economy) but there has been little political reform. This may prove to be a major hurdle in the way of continued economic liberalisation.

The outcome of the Communist Party Congress, set to begin in November, holds major significance for the likely pace of political reform over the coming decade in China. It could also have a significant bearing on future economic reforms.

The majority of the speculation has centred around President Jiang Zemin, number one in the government, party and military as China's head of state, general secretary of the CCP and chairman of the Central Military Commission. Initially Jiang had been expected to hand over his position of party secretary to Vice-President Hu Jintao at the party congress, although no formal announcement had actually been made. The role of state president is usually transferred at the National People's Congress scheduled for March 2003. However, it has been widely rumoured that Jiang wants to hold on to his power, a move that could well pave the way for other key figures to follow suit, throwing the whole transition into disarray. The new leadership line-up should be announced at the five-year Communist Party Congress, scheduled to begin on November 8. This is later than in previous years, presumably so as to allow Jiang to hold all the key posts in Chinese politics when he attends two key meetings in late October. Jiang is scheduled to meet US President George W Bush at his ranch in Texas and then attend an Asia-Pacific Economic Cooperation (Apec) leadership meeting in Mexico. The meeting with Bush is seen as a key opportunity to discuss issues such as weapons proliferation, US-Taiwan relations and human rights, all sticking points in US-China relations in the past.

THE STATE COUNCIL AND OTHER KEY POSTS (AS OF SEPTEMBER 2002)	
President	Jiang Zemin
Prime Minister	Zhu Rongji
Vice premiers	Li Lanqing, Qian Qichen, Wu Bangguo, Wen Jiabao
State Councillors	Luo Gan, Chi Haotian, Wu Yi, Ismail Amat, Wang Zhongyu
Secretary-general of the State Council	Wang Zhongyu
Key Ministers	
Ministry of Agriculture	Du Qinglin
Ministry of Civil Affairs	Doje Cering
Ministry of Communications	Huang Zhendong
Ministry of Construction	Yu Zhengsheng
Ministry of Culture	Sun Jiazheng
Ministry of Defence	Chi Haotian
Ministry of Education	Chen Zhili
Ministry of Finance	Xiang Huaicheng
Ministry of Foreign Affairs	Tang Jiaxuan
Ministry of Foreign Trade and Economic Cooperation (MOFTEC)	Shi Guangsheng
Ministry of Health	Zhang Wenkang
Ministry of Information Industry	Wu Jichuan
Ministry of Labour and Social Security	Zhang Zuoji
Ministry of Land and Resources	Zhou Yongkang
Ministry of Personnel	Zhang Xuezhong
Ministry of Public Security	Jia Chunwang
Ministry of Railways	Fu Zhihuan
Ministry of Science and Technology	Zhu Lilan
Ministry of State Security	Xu Yongyue
Ministry of Supervision	He Yong
Ministry of Water Resources	Wang Shucheng
Commission of Science, Technology and Industry for National Defence	Liu Jibin
Governor of the People's Bank of China	Dai Xianglong
State Development Planning Commission (SDPC)	Zeng Peiyan
State Economic and Trade Commission	Sheng Huaren
State Ethnic Affairs Commission	Li Dezhu
State Family Planning Commission	Zhang Weiqing

Source: United States Central Intelligence Agency.

In August China's leading politicians headed for the seaside resort of Beidaihe where the annual communist party gathering takes place. The meetings were expected to shape the details of the changes to be announced at the party congress. Up until then it seemed certain that Vice-President Hu Jintao was set to take over, especially after he was sent on an official visit to the US in late April. But since the meetings in Beidaihe, rumours of Jiang's desire to remain in the top spot have been frequent. This could create problems on many fronts.

As Jiang is now 76 years old, he is unable to stand again as general secretary of the CCP under an informal agreement not to pursue party office after the age of 70. However, rumours have surfaced that Jiang has been lobbying party leaders for their support for him to retain this position. Such a move could well muddle the whole leadership change as this may cause other important figures such as premier Zhu Rongji and parliament chief, Li Peng, (both aged 73) to hold on to their posts too. This could also scupper many provincial party appointments around the country. A clause in China's constitution limits the position of state president to two five-year terms. As Jiang has now reached this limit, he is not expected to hold on to this post. Power should be transferred to current vice-president, Hu Jintao, at the National People's Congress early next year. But this will be of little consequence if the other posts remain under Jiang's control.

Five Places Free At The Top

Politburo Standing Committee

Current	Likely Successor
Jiang Zemin	Zeng Qinghong
Li Peng	Luo Gan
Zhu Rongji	Wen Jiabao
Li Ruihuan	remain
Hu Jintao	remain
Wei Jianxing	unknown
Li Lanqing	unknown

Source: Reuters.

Jiang could well hold onto his post of head of the Central Military Commission, a tactic used by Jiang's predecessor, Deng Xiaoping. As this post gives him direct control over the world's largest military operations, Jiang would retain significant influence over national security and foreign policy issues. China's latest spat with Taiwan (see *Foreign Policy*) may have secured Jiang's claim over this position, especially as Hu has very little experience within the military.

Welcoming The Capitalists

Aside from the change of manpower in China, rumours of a possible change in CCP thinking have come to the forefront.

Two other important announcements may be made at the party congress. Firstly Jiang's theory known as the "Three Represents" is likely to be bound into the party constitution. The merits of this theory have been widely pushed over the past few months, as Jiang tries to make his mark as a great thinker along with China's former leaders, Mao Zedong and Deng Xiaoping. The theory talks of representing advanced forces of production, advanced culture and the interests of the entire population. While these are sufficiently vague to ensure that China's leadership will be able to encompass these in its future endeavours, it is significant because it suggests a move away from solely representing the working class. Moreover, it is in direct contrast to the previous policy of actively excluding and punishing private entrepreneurs. In addition, there have been reports that prominent businessmen may be invited to become members of China's core policy-making body, the central committee.

This signals an important shift away from the past but towards a situation that could make it extremely difficult for the Communist Party to maintain its power base. As state-owned enterprises continue to be scaled down and private businesses become an increasingly important part of the Chinese economy, the current political structure is likely to come under pressure. This could lead to political instability in the years ahead.

The economic benefits of an orderly leadership changeover could be vast. With foreign direct investment set to top US$50mn this year there is significant foreign interest in the political transition. A smooth changeover, free from unexpected events, will help to put the minds of foreign investors at ease and confirm that the power base lies within established institutions and not individuals.

Foreign Policy Outlook

Private Sector Lead Cross-Strait Links

Although Beijing's "one China" policy continues to prevent an improvement in diplomatic relations with Taiwan, the private sector has made significant progress in establishing economic links.

The foreign-policy spotlight has been centred around issues regarding neighbouring Taiwan. Although diplomatic ties have come under intense pressure, both Taiwan and China have made concrete moves during the last few months to increase economic links. After fleeing from a civil war in the mainland in 1949, Taiwan's government banned direct links forcing all travel, communications and business to go through an intermediate port, commonly Hong Kong. As both countries are now members of the World Trade Organisation (WTO), they are bound by a commitment to "provide non-discriminatory treatment to all WTO members". But Beijing's insistence that Taiwan agrees to its "one China" policy before any negotiations take place has been stalling the process for many years as this policy would commit Taiwan to eventual reunification with the mainland – a policy that goes against the wishes of Taiwan's nationalist-leaning government. Nevertheless, substantial economic progress has been made over the past few months with the key factor being the involvement of the private sector in negotiations. But while economic links are becoming easier to establish, political relations between the two sides are still far from amicable.

Diplomatic Relations With Taiwan Remain Under Strain

China has continued to disrupt Taiwan's foreign relations, enticing provocative comments from Taiwan's president and further souring relations.

In late July China established diplomatic links with the South Pacific island of Nauru. This was a direct switch of loyalties as Nauru previously recognised Taiwan. This was particularly embarrassing for Taiwan as the announcement coincided with president Chen Shui-bian's inauguration as chairman of the ruling Democratic Progressive Party, a move which was intended to strengthen the party's position. Chen reacted by stating "we will have to seriously consider walking our own road", a statement that angered Chinese officials. A short time later Chen enflamed the situation further by announcing in Japan that China and Taiwan were "one country on each side" of the Taiwan Strait, and that holding a referendum on independence was a "basic human right". This sparked further warnings from China, with its Taiwan Affairs Office stating that this could "lead Taiwan to disaster".

China has considerable influence over Taiwan's foreign relations given the mainland's military and economic might, and its importance as a major trading partner. China managed to complicate the travel arrangements of Chen's tour of Africa in July when the South African government refused landing rights to the Taiwanese delegation due to "diplomatic considerations". On a recent trip to Indonesia, Taiwan's vice-president, Annette Lue, was not allowed to enter Jakarta at the beginning of her trip. Divisions among Taiwan's politicians are also making it easier for China to flex its diplomatic muscle. Taiwanese officials rushed to insist that its China policy remained unchanged after Chen's pro-independence remarks. Taiwan's latest comments have proved useful to China in that they have clarified any doubts that China had over US loyalties. The US confirmed its adherence to the "one China" policy after the Taiwan remarks, and Jiang's upcoming trip to the US should allay any other fears China may have, in particular over US arms sales to Taiwan.

Economic issues are also working in China's favour as foreign firms are rushing to invest in China. Business opportunities have increased as restrictions have eased in line with China's commitments to the WTO, and the continued uncertainty over global prospects has encouraged many producers to locate in China to take advantage of the cheap labour costs. China recorded a huge trade surplus with the US during the first half of 2002 as US companies set up in China to cut costs. A similar story is true in Japan. Chinese goods accounted for 17.8% of Japanese imports in the first six months of 2002, only slightly behind the 18.2% share from the US, according the China's Ministry of Foreign Trade and Economic Cooperation. As a major trade partner with the world's two largest economies, China's diplomatic weight may well increase further.

Relations With The US Still Rocky

While the US has restated its support for China, several grievances remain, in particular China's commitment to the US war on terrorism. This topic is like to dominate Jiang's visit to the US in October as there has been increasing evidence that China is continuing to sell arms to countries on the US watch list. The US imposed sanctions on nine Chinese firms in July on the basis that they were assisting weapons proliferation in Iran. As China has crossed the US several times on the issue since the terrorist attacks on the US on September 11, the US may well push China to comply. Chine now appears to be going to great lengths to keep the US on side. In late August China announced new rules on missile exports, a move which should ease US concerns.

China's commitment to the US war on terrorism remains a sticking point between the two nations. Nevertheless, advances are being made.

But even still, weapons proliferation is likely to remain a major sticking point in US-China relations. In late July the pentagon released a report suggesting that China's military spending could be as much as US$65bn, significantly higher than the official US$20bn miliary budget. This sparked concern over China's military intentions, particularly towards Taiwan, and the US will wish to avoid a significant arms build-up anywhere around the globe.

chapter 2 Economic Outlook

Introduction

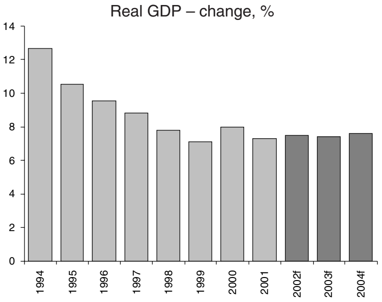
Another Robust Quarter Of Growth Ahead

Significant government investment and buoyant exports helped ensure another robust quarter of growth in Q2 2002. Nevertheless, risks remain that could prove to be a serious drag on future growth.

The Chinese economy continues to perform better than expected. Real GDP growth accelerated to 7.8% year on year (y-o-y) in the first half of 2002 (8.0% in Q2), after expanding 7.3% in 2001. **BMI** has now revised upwards its forecast for 2002 real GDP growth to 7.5% (from 7.2%). Heavy state spending combined with strong demand for Chinese goods is keeping the economy afloat despite rising unemployment and a deceleration in consumer spending. Ongoing uncertainties in the global environment have increased China's attractiveness as a low-cost producer as firms increase outsourcing to cut costs. China remains one of the top destinations in the world for foreign direct investment. It ranked sixth in 2001 for world foreign direct investment inflows at US$46.8bn, as accession to the World Trade Organisation (WTO) in December 2001 opens up opportunities for foreign firms. While the liberalisation process is gradual, domestic industries are currently attempting to modernise so to compete with more profitable foreign firms in the future. Industrial output growth has been particularly buoyant so far this year. This could well be the result of increased efficiency at state firms as significant layoffs have reduced costs.

Growth Still Booming

Real GDP – change, %



f = BMI forecast; Sources: State Statistical Bureau/BMI.

But while many areas of the Chinese economy appear to be booming, serious concerns remain regarding the financial strength of China's 1.3bn consumers. Savings have reached record levels as uncertainties intensify over job prospects. Annual price inflation has not been positive since October 2001. Excess capacity and overproduction are the main drag on prices indicating that deflation could well continue for some time, tempting consumers to postpone consumption even further. So while China is on course to be the fastest-growing economy in Asia this year, serious economic challenges remain as China moves towards a more market-based economy. China has the added problem that an imminent change in political leadership means the government is both under pressure to produce results and reluctant to push through any significant policy changes in the short term, as stability is the main priority over the transition period. This is a tricky combination, particularly given the current environment of WTO-related trade and investment liberalisation.

GDP, OUTPUT & POPULATION

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
Population (bn)	1.19	1.20	1.21	1.22	1.24	1.25	1.26	1.27	1.27	1.29	1.30	1.31
Real GDP growth (% y/y)	13.5	12.7	10.5	9.5	8.8	7.8	7.1	8.0	7.3	7.5	7.4	7.6
Industrial output (% y/y)	-	21.4	16.1	15.1	13.2	9.6	9.8	11.2	9.9	10.0	11.0	13.0
Urban unemployment rate (%)	2.6	2.8	2.9	3.0	3.1	3.1	3.1	3.1	3.6	4.5	4.7	4.9

f = BMI forecast; Sources: IMF, Reuters, official press reports.

Economic Activity

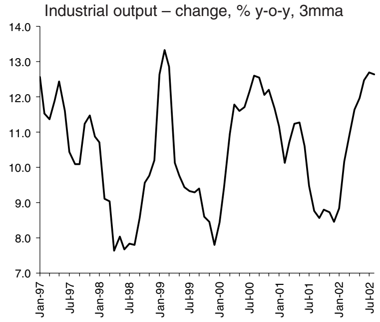
An External Boost To Growth

China's economy expanded 8.0% year on year (y-o-y) in the second quarter boosted by strong state spending and robust external demand. Government investment expanded 24.4%, the biggest increase in eight years, bringing the overall increase in investment to 21.5%. This investment was directed at a variety of infrastructure projects and reform of state enterprises. As a result of this, industrial output growth has been particularly buoyant. Q2 output expanded 12.5% y-o-y and there is no sign of this easing, with August output up 12.7%. This improvement is also likely to be due to increased profitability. Total industry profits increased 8.1% y-o-y to CNY275.7bn (US$33.3bn) during the first seven months of 2002, a marked turnaround from the fall of 9.1% in Q1 2002. Producers of transport equipment (including cars) were one of the most profitable sectors, as WTO entry has brought about significant consolidation of firms and an increase in foreign alliances. Profits at state-owned enterprises continued to fall, although the rate of decline is decelerating. Profits fell 6.7% y-o-y to CNY129.3bn during the January-July period, a modest improvement from the double-digit falls witnessed during the first six months of 2002. The increasing presence of foreign firms in China should help industrial profits to improve as firms continue to push for efficiency gains and new production techniques are learnt from foreign firms.

Real GDP growth is expected to slow slightly in H2 2002 given accelerating imports and a front-loading of state investment in H1.

Industry Leads The Way

Industrial output – change, % y-o-y, 3mma



Sources: State Statistical Bureau/Reuters.

While quarterly volume trade figures are not available, monthly merchandise trade figures suggest that external demand was also a significant boost to growth in the second quarter. US dollar exports expanded 17.9% y-o-y in Q2, up from 10.4% in Q1 and significantly faster than the Southeast Asian average of 6.0%. The trade balance widened to US$18.0bn during the January-August period, nearly double the US$9.9bn during the same period in 2001. China's trade surplus with the US has reached record levels and China is set to overtake the US as Japan's number-one market. While there are still concerns over the strength of domestic demand in these markets (especially as the current turmoil in global financial markets is likely to weigh on consumer confidence for some time), this appears to be benefiting China as foreign firms increase outsourcing to China to take advantage of cheap labour costs. WTO accession has also made this easier as foreign firms now have greater access to the Chinese market.

With real GDP growing at 7.8% in the first half of 2002, our forecast of 7.5% for 2002 implies growth will slow to around 7.2% in H2. State investment growth is expected to slow given restrictions on the government's budget and a significant front-loading in H1. The boost from exports may also be less pronounced in the second half of 2002 given the recent acceleration in imports (Q2 merchandise imports expanded 15.0% y-o-y compared with just 5.9% in Q1). In addition, unemployment is set to rise, implying more benefit claims on government funds. Urban unemployment rose to 3.8% in H1 from 3.6% at end-2001 according to the State Statistical Bureau. While unemployment is widely regarded as underestimated, the rise in joblessness is likely to continue as state-owned firms are forced to shed excess labour as industry is faced with more efficient foreign competition.

Consumers Reluctant To Spend

Workers are becoming increasingly concerned about job prospects, breeding a more risk-averse consumer. Retail-sales growth is slowing and savings have reached record levels. There is a serious risk of slower GDP growth.

Rising unemployment is a key factor weighing down on private consumption. Monthly retail sales growth (a proxy for private-consumption) suggests that consumer spending is slowing, a trend that could prove to be a serious drag on growth. Retail sales expanded 8.6% y-o-y during the first eight months of 2002 (after rising 10.1% in 2001), making the government's 2002 target of 10.0% growth unlikely to be achieved. Rural sales have continued to lag those in urban areas with H1 growth at 6.7% y-o-y and 9.7% respectively. Savings have soared, reaching record levels this year. Household savings reached CNY8.3trn in July (US$1tn) an increase of 18.4% from July 2001 indicating consumers are increasingly reluctant to spend. Savings are also likely to have risen in line with increased uncertainties over job prospects as state-owned firms slash jobs in an effort to improve profitability. Rising costs for education and healthcare are also putting an extra burden on consumers.

Vice-minister in charge of the State Development Planning Commission, Wang Chunzheng, in August announced policies intended to stimulate private consumption. New policies included reducing charges on education, expanding construction of low-cost housing and promoting the purchase of cars. While these policies will likely boost consumption, particularly in urban areas, this will probably require additional government financing to be effective. Given the government's current fiscal woes (see *Fiscal Policy*), significant additional financing is not likely. In addition, these measures are unlikely to ease the burden on China's rural workforce (around 60-70% of China's population lives in rural areas, with 50% of the total labour force working in agriculture, a very low value-added sector). Instead of allocating funds towards encouraging purchases of cars, a more lasting solution would be to concentrate efforts to move labour into cities to eliminate the current discriminatory policies towards migrant workers.

Monetary Policy

Policy Changes Unlikely

Interest rates were left unchanged at the monetary policy meeting in July, with the longer-term goal of liberalisation of the financial system cited as the central bank's key objective.

The Chinese central bank, the People's Bank of China, left interest rates unchanged at its quarterly monetary policy meeting in July, despite calls for a reduction in rates to end deflation and boost lending. The central bank indicated that its key priority was the longer-term goal of liberalisation of the financial sector and that interest rates were likely to remain unchanged in the short term. Interest-rate liberalisation and widening of the trading band of the exchange rate are key tasks that the central bank faces in the coming years. As the banking sector confronts increasing foreign competition, banks must be allowed to set interest rates to provide a more efficient indication of risk, allowing banks to compete fully.

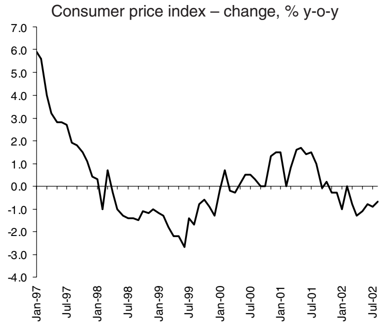
The Chinese economy has been plagued by deflation since late 2001. Consumer prices dropped 0.8% y-o-y during the first eight months of 2002, with producer prices down 3.3% during the January-July period. Even if the central bank had bowed to pressure and reduced rates, this would have been unlikely to spark much upward price pressure, as China's deflation is largely the result of supply-side pressures such as overproduction. China's state-owned enterprises still operate with significant excess labour. This means that goods are overproduced (particularly within the agricultural sector) causing fierce competition and falling prices. Widespread redundancies are gradually improving the situation of excess labour, although this is leading to increased efficiency and lower costs. This too is being passed onto consumers aggravating the problem of deflation. Nevertheless, urban incomes are rising indicating that falling prices are not being passed onto workers in the form of lower wages. This will help to contain the deflation and suggests that once the bulk of the economic restructuring is complete, prices should again begin to rise.

In addition, there should be some weakening of the deflationary presures given the slowdown in producer price deflation in 2002, a trend that is probably being helped by the increase in domestic oil prices. Spot prices of Chinese Daqing oil rose 42.8% during January-August 2002, slightly sharper than the 36.4% rise in the price of the basket of oil from the Organisation of Petroleum Exporting Countries (Opec). The **BMI** forecast for the 2002 average Opec basket has been revised to US$23.5/b (from US$22.0/b) indicating prices should remain around US$26.0/b for the remaining four months of 2002. This should provide much-needed respite to Chinese oil producers and help producer price inflation nearer neutral territory. **BMI** has revised its 2002 and 2003 inflation forecasts. Annual price inflation is expected to average -0.5% in 2002 and then pick up pace in 2003 and 2004 with inflation expected to average 1.8% and 3.5% respectively.

Deposit and lending rates are expected to remain at their current levels of 1.98% and 5.31% respectively for the rest of the year. Rates are then expected to increase from 2003 as inflation moves back into positive territory. The deposit and lending rates are expected to end 2003 at 2.25% and 5.85% respectively, reversing the cuts made in early 2002. The expected widening of the renminbi's trading band (see *Exchange Rate Policy*) will likely require interest rates to move up sharply in 2004 so as to ensure limited currency outflows.

Excess Supply Weighs On Prices

Consumer price index – change, % y-o-y



Sources: IMF/BMI.

INTEREST RATES & INFLATION												
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
Deposit rate (local currency, % eop)	11.0	11.0	11.0	7.5	5.7	3.8	2.3	2.3	2.3	2.0	2.3	4.0
Lending rate (local currency, % eop)	11.0	11.0	12.1	10.1	8.6	6.4	5.9	5.9	5.9	5.3	5.9	7.9
Consumer price inflation (% an. avg)	14.6	24.2	16.9	8.3	2.8	-0.8	-1.4	0.3	0.3	-0.5	1.8	3.5

f = BMI forecast; eop = end of period; Sources: BMI, IMF.

Exchange Rate Policy

Stability Remains Key

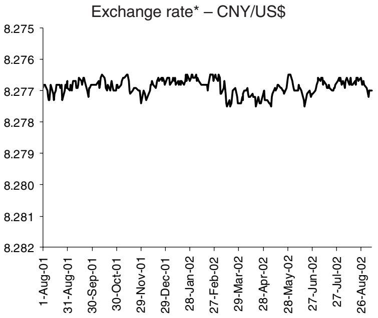
The depreciation of the US dollar against the world's major currencies has boosted China's competitiveness thanks to the fact that China's currency is effectively fixed to the US dollar. This has lead to increasing calls for a widening of the renminbi's trading band.

A drop in the value of the US dollar against the yen and the euro this year has caused friction between China and neighbouring Asian economies. The Chinese yuan trades in a tight band of CNY8.267-8.280/US$, although, in effect, is operating according to a peg of CNY8.277/US$. The depreciation of the US dollar has meant Chinese exports have become even more competitive compared with those of say Thailand or Indonesia, both of which are major export competitors in terms of labour-intensive products. Moreover, China's efforts to diversify its export base, through increasing its presence of hi-tech industries, has raised concern from economies such as Taiwan and Singapore.

Many hoped that China's entry to the WTO would speed up the need for China to change its exchange rate policy as surging imports would lead to an outflow of dollars such that the central bank would find the current peg unsustainable. So far the reverse is true. China's exports have soared resulting in a build-up of reserves. Foreign exchange reserves amounted to US$246.5bn at end-July (an increase of US$34.3bn since January 2002 according to the State Development Planning Commission), a quantity that is surpassed only by Japan. While the Chinese government had stated its intention to widen the yuan's trading band given the expected swing in the balance of payments position, no time frame or concrete steps have been announced. In early September, Chinese finance minister, Xiang Huaicheng, stated that although it would be impossible to liberalise the exchange rate in the "foreseeable future" given the current draft of economic reforms, full liberalisation remains nevertheless a longer-term objective.

No Hurry To Widen

Exchange rate* – CNY/US$



*inverted scale; Sources: Reuters/BMI.

Moreover, an upcoming leadership change means politicians will be reluctant to make any significant policy changes over the next six to 12 months, especially as the economy is currently performing well with GDP growth set to outpace the government's 7.0% target. In addition, given the strength of demand for Chinese goods and the ongoing boom in investment, a widening of the trading band would likely see the yuan appreciate against the US dollar. The Chinese authorities are unlikely to be in favour of such an outcome as this could weaken the country's competitive position and thus export growth, one of the economy's key growth engines. An appreciating currency may also deepen the current deflationary environment, as imported goods become cheaper and domestic suppliers are forced to cut prices to compete.

Assuming that the leadership changes proceed as planned (see *Domestic Political Outlook*), a fourth generation of leaders should be in place by March 2003. But even in the best-case scenario, the current leaders are likely to maintain some power over policy from behind the

EXCHANGE RATES & FOREIGN EXCHANGE RESERVES

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
CNY/US$ (an. avg)	5.76	8.62	8.35	8.31	8.29	8.28	8.28	8.28	8.28	8.28	8.30	8.70
CNY/US$ (eop)	5.80	8.45	8.32	8.30	8.30	8.28	8.28	8.28	8.28	8.28	8.45	9.00
Foreign exchange reserves (US$bn)	22.4	52.9	75.4	107.0	142.8	149.2	157.7	168.3	215.6	260.5	270.0	263.5

f = BMI forecast; eop = end of period. Sources: IMF, BMI.

scenes. So in terms of the timing of a change in exchange rate policy, **BMI** believes that any widening of the yuan's trading band would take place around end-2003 at the earliest. Our forecast for the end-period exchange rate in CNY8.45/US$ for 2003, depreciating further to CNY9.00/US4 by end-2004, implying a 6% depreciation over the next two years.

Fiscal Policy

Pressure To Spend

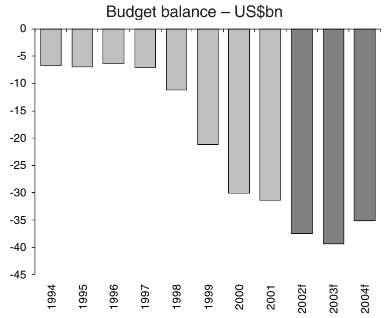
China is now in its fifth year of expansionary fiscal policy with the deficit set to reach CNY310bn this year (3% of nominal GDP), almost 20% more than the shortfall in 2001. The government is under increasing pressure to keep spending so as to ensure the economy continues to expand around the target rate of 7%. Last year's accession to the WTO will exacerbate an already troublesome situation. The expected increase in competition will mean significant job losses, particularly at state-owned enterprises, resulting in an increase in social-security obligations, and WTO commitments to reduce import tariffs will mean a reduction in government revenues.

The government's finances are under increasing pressure as unemployment rises and tariff revenues fall in line with WTO commitments. Nevertheless, the government appears to be making concrete steps to rein in its revenues.

Despite doubts over the government's ability to meet this year's budget target, the deficit remains on track. H1 government expenditure expanded 17.8% y-o-y, significantly faster than the 9.2% expansion in revenue, but leaving the government comfortably within its 2002 deficit target. However, the current deficit is misleading as it does not include items such as pension obligations or the vast level of non-performing loans at state banks, both of which would add significantly to the total. So while the budget deficit is sustainable in the short term, a situation that called on the government to foot the bill for its unaccounted liabilities (such as having to bail out the banking system from crisis) would put an unsustainable strain on government finances. Moreover, the scale of these problems is so huge that the current measures to rein in the fiscal deficit would make little difference. Nevertheless, as long as China is not called upon to finance these claims, (as the government surely hopes), then its current measures to boost tax revenues are a step in the right direction.

An Increasing Shortfall

Budget balance – US$bn



f = BMI forecast; Sources: IMF/BMI.

The government has enforced a crackdown on personal income-tax evasion with the high profile arrest of Beijing actress Lui Xiaoqing. The finances of China's wealthiest individuals are to be probed in order to offset the reduction in import tariffs lost through WTO commitments. The most significant development so far has been the announcement by vice-premier, Li Lanqing, of establishing a nation-wide computer network for taxation purposes. CNY9bn is to go towards a computerised tax information system that should allow officials to share data across China therefore curbing rampant tax evasion.

GOVERNMENT FINANCE (CNYBN)

	1993	1994	1995	1996	1997	1998	1999	2000	2001e	2002f	2003f	2004f
Total revenue	435	522	624	741	865	988	1,144	1,340	1,640	1,935	2,322	2,740
Total expenditure	464	579	682	794	923	1,080	1,319	1,589	1,880	2,245	2,649	3,046
Budget balance	-29	-57	-58	-53	-58	-92	-174	-249	-240	-310	-327	-306
Budget balance (% of GDP)	-0.9	-1.2	-1.0	-0.8	-0.8	-1.2	-2.1	-2.8	-2.7	-3.0	-2.9	-2.4

e/f = BMI estimate/forecast; Sources: IMF, BMI.

Given the current pressure on the government to prop up the economy through public spending and investment, a gradual reduction in the deficit will prove difficult, although not impossible, especially as under WTO commitments, foreign firms will no longer enjoy favourable tax advantages after 2003. **BMI** expects the deficit to come in on target in 2002, particularly given the leadership change. The shortfall will likely widen in 2003 to CNY327bn as unemployment continues to rise and further tariff reductions are introduced.

Balance Of Payments

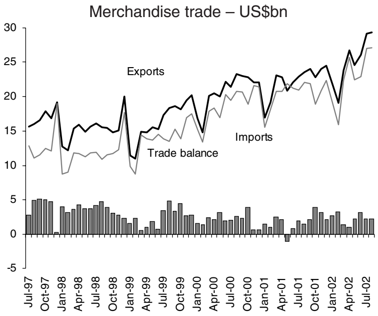
China Becomes A World Heavyweight

China's January-July trade surplus is almost double the level a year earlier. Import growth is now beginning to catch up but the 2002 current account surplus is now expected to be wider than in 2001 at US$23.2bn.

Despite fears of surging imports after entry into the WTO, China's trade position has actually strengthened. China's importance as an economic heavyweight is becoming increasingly apparent and Asian economies are rushing to find their place in this changing environment. China is soon to overtake the US as Japan's main import source, according to Japanese officials, while statistics from the US show its biggest trade deficit is with China, at US$43.1bn, followed by Japan at US$33.1bn (during the January-July period). This has left the smaller economies of East Asia eager to carve a niche within the Chinese market.

Exports Continue To Soar

Merchandise trade – US$bn



Sources: IMF/Reuters/BMI.

Merchandise exports expanded 17.3% y-o-y during the January-August period, compared with growth of 7.2% during the same period in 2001. Imports have also accelerated sharper than expected with growth of 14.4% during the first eight months of the year. **BMI** has now revised its forecast for merchandise trade, with growth now forecast at 16.7% and 15.0% for exports and imports respectively. While current-account data are not yet available for Q2, the improved outlook for exports suggests the surplus will be larger than previously expected. The upgrade of our trade forecast means our current account forecast for 2002 has now increased to US$23.2bn, an improvement from the US$17.4bn in 2001. This means that our forecasts for 2003 and 2004 have increased, with the current account surplus expected to narrow to US$12.5bn in 2003 and US$1.5bn in 2004 largely on the back of strengthening imports.

BALANCE OF PAYMENTS (US$BN)

	1993	1994	1995	1996	1997	1998	1999	2000	2001e	2002f	2003f	2004f
Merchandise exports (fob)	91.0	121.0	148.8	151.2	182.9	183.6	195.2	249.3	266.2	310.6	341.7	392.9
Merchandise imports (fob)	103.1	115.7	129.1	138.9	142.2	140.3	165.8	206.1	243.6	280.2	320.5	381.7
Trade balance	-12.1	5.4	19.7	12.3	40.7	43.3	29.4	43.2	22.6	30.5	21.2	11.2
Current account balance	-11.6	6.9	1.6	7.2	37.0	31.5	21.1	20.5	17.4	23.2	12.5	1.5
Current account (% of GDP)	-1.9	1.3	0.2	0.9	4.1	3.3	2.1	1.9	1.5	1.9	0.9	0.1

e/f = BMI estimate/forecast. Sources: IMF, BMI.

chapter 3 Key Economic Sectors

Introduction

WTO Effects Begin To Emerge

Accession to the World Trade Organisation means that domestic firms will face increasing foreign competition over the next five years. In order to compete after full liberalisation, local firms are attempting to shape-up now.

By joining the World Trade Organisation (WTO) in late 2001, China committed itself to full investment and trade liberalisation. This process involves the reduction of tariffs and quotas, in addition to other protectionist policies such as licences and tendering requirements. Liberalisation of trading practises is also required, allowing foreign firms access to the very sheltered Chinese market. Some tariffs were scrapped on accession and many more were reduced. Several thousand laws covering trade and investment rules have also been amended in line with WTO regulations. In most industries, China has approximately five years to prepare domestic firms for full liberalisation. Nevertheless, Chinese producers are already stepping up efforts to improve profitability. Cost cutting and improved management and corporate-governance techniques are high on the agenda, as are attempts to establish brand loyalty by expanding distribution networks and focusing on customer care. This is in order to establish a presence as a dominant market player and to ensure survival once foreign firms are allowed to compete directly. Foreign firms already operate (under restrictions) within key Chinese markets, and local firms have been increasingly anxious to gather expertise.

The effect of WTO entry on the automobile sector is perhaps the most evident so far. Tariffs dropped to around 45% from 80-100% after accession, with a commitment to cut to 25% by mid-2006. Despite a flurry of mergers and foreign alliances, this sector still has more than 100 producers, with overproduction and competition pushing prices downward. Last year the government announced plans to consolidate the industry around three main firms in order to compete with cheaper foreign imports. One of these firms was China largest auto producer **First Automotive Works** (FAW) which has a joint venture with Germany's **Volkswagen AG**. In June FAW announced a merger with the forth-largest producer, **Tianjin Automotive Industry Corp** (TAIC), in a move that should provide a precedent for further consolidation of the industry. About 75% of Tianjin's 60,000-strong workforce is to be sacked in a bid to cut costs, and it is hoped that this merger will stem competition within the sector, easing the pressure on producers from falling prices. Consumers have also benefited from industry restructuring as falling prices mean cars are now more affordable. Passenger car sales rose 36.2% during the first six months of 2002, and China's expanding rich are also benefiting from increased imports of luxury cars.

Adverse Weather Deepens Agricultural Problems

Severe flooding is causing problems throughout the Chinese economy. Infrastructure has been damaged and people have been forced to leave their homes. The biggest impact has been on the agriculture sector. However, the flooding is unlikely to weigh down on overall GDP growth.

China's agriculture sector was often cited as one of the biggest potential losers from WTO entry. Massive overproduction combined with small-scale and largely inefficient farming means costs are relatively high and fierce competition ensures prices are low. The government's scheme to transfer labour off the land and into cities is a slow process and is faced with a barrage of discriminatory problems such as housing costs and benefit allocation. One of the biggest concerns was that cheaper foreign imports would force farmers to reduce prices or simply go out of business, aggravating the problem of rising unemployment and lagging rural incomes.

But problems within the agriculture sector have been deepened by adverse weather conditions this year. Heavy rains in southern China have affected around 100mn people, with almost 1,000 people losing their lives by September. Crops have been destroyed and infrastructure has suffered. A section of the Beijing-Guangzhou railway has been destroyed, and many schools, motorways, bridges and other public buildings have been damaged. An estimated 1.8mn people have been forced to leave their homes, mainly those living in rural areas. Around 8mn hectares of agricultural land has been destroyed so far this year, and the summer harvest was 2.9% lower than in 2001, according to the State Statistical Bureau. Although the majority of Chinese provinces have been adversely affected, among the worst affected areas were Shaanxi, Fujian, Hunan, Sichuan, Hubei and Chongquing. China's second largest lake, Dongting lake, has also reached dangerous levels and more bad weather is expected. If this causes the huge Yangtze river to burst (as happened in 1998 claiming the lives of 4,000 citizens and destroying vast amounts of crops) another 10mn people could be affected. To make matters worse, growth in the agricultural sector is also being hampered by a drought affecting northern China. Crops and livestock are suffering as land becomes parched, and reservoirs are running low posing serious concerns for the rural population in affected areas.

Despite the severe flooding (and drought), overall GDP growth is expected to be largely unaffected. The extent of the oversupply within the agricultural industry is such that a reduction in output should not pose any significant burden on prices or supply. Moreover, industrial output has surged throughout 2002 indicating that the damage to infrastructure has not proved to be too much of a burden on the economy. But as around half of the population are employed within the primary sector and an even greater proportion resident in rural areas, the social costs are likely to be much higher than any direct economic impact.

Banking

A Five-Year Head Start

China's banking sector has five years to prepare for full liberalisation. By 2006 foreign banks will be permitted to compete for local-currency business with Chinese consumers and businesses, opening up a huge untapped market. The reform process is now in its third decade, but a greater urgency has taken hold due to last year's accession to the WTO. This has highlighted the scale of the problems within the banking sector, and as such, acted as a catalyst to the reform process. Reform of the banking sector is vital as a more efficient allocation of China's vast savings would have benefits for the longer-term development of the economy.

China's unprofitable banking sector must transform itself in order to compete with efficient foreign banks in five years' time. However, it is unlikely that foreign banks will pose any serious threat to domestic banks for some time given the structure of the Chinese industry.

Major concerns have been raised over the potentially disastrous implications that the liberalisation process could have on the Chinese banking system. Banks are burdened with huge non-performing loans (NPLs), inadequate regulatory and credit-control systems, and insufficient capital on which to operate, resulting in very low profitability. Four state-owned commercial banks (SOCBs), known as the four "big banks", dominate the market with around 70% of total loans and 80% of deposits. According to the Chinese central bank, the People's Bank of China, the average NPL ratio for the four SOCBs was 25% at end-2001, although many analysts estimate this ratio much higher (ratings agency **Standard and Poor's** estimated the true level of NPLs at around 50%). Since profits are extremely weak, deposits are vital to ensure ample liquidity in the banking system. Fears have arisen that if enough deposits are attracted by foreign banks, the major domestic banks will lose this liquidity and the true insolvency of the banking system could become evident. To avoid such an outcome, the government is attempting to break up the monopoly of the state banks, transforming them into profitable commercial enterprises to ensure they can compete with their foreign cousins. This is an onerous task, but one that the entry of foreign banks will not exacerbate. It is unlikely that foreign banks will manage to corner a sufficient proportion of deposits (or skilled staff) to force the collapse of the Chinese banking system as they will be unable to establish much more than a limited presence in the market. This leaves the burden of the restructuring firmly in the hands of domestic banks.

China successfully listed a Hong Kong subsidiary of one of the four major state-owned banks in July this year, **Bank of China**. As the first listing of a SOCB, the continued success of this venture is vital to encourage future share offerings. But while this sale was successful, it was not without scandal. A New York listing was abandoned after Bank of China was fined US$20mn earlier in the year after discrepancies within the New York branch, and US$500mn was discovered missing from a branch in southern China in March

SELECTED BANKING INDICATORS

	1994	1995	1996	1997	1998	1999	2000
Stock market capitalisation (US$bn)	43.5	42.1	113.8	206.4	231.3	330.7	581.0
Stock market capitalisation (% GDP)	8.0	6.0	13.9	23.0	24.4	33.4	53.8
Banks liquid-reserves-to-assets ratio	16.7	18.0	19.9	19.7	15.0	14.3	12.7
Domestic credit provided by banking sector (% GDP)	92.2	91.2	97.8	106.8	121.8	130.3	132.7

Source: World Development Indicators.

this year. Nevertheless, this should set the stage for further share offerings, improving the balance sheets of the SOCBs. But these are unlikely to move along at any great pace. Even as the most profitable SOCB (and the Hong Kong subsidiary the most profitable entity within the bank), the slightly precarious financial position of the Bank of China meant that some housekeeping was necessary. NPLs were transferred to an asset management company (owned by the parent company) in order for the subsidiary to look more attractive to foreign investors. This still left the NPL ratio at 11.0%, more than twice the industry average of 4.5%. Given the much lower profitability of the other SOCBs, it is unlikely to be as easy for them to convince investors of their merits. Improved profitability is therefore essential from the outset to enable bad loan write-offs, and a chance of success in an initial public offering (IPO). A successful IPO is beneficial in that it raises funds that will strengthen bank balance sheets, and should force improved accountability and disclosure of the financial position of banks, a procedure that has often been lacking in the Chinese industry. But in order to take advantage of this, Chinese banks must first improve domestic profitability. Focusing restructuring on the development of funding to the private sector would be one possible way to achieve this.

Lending to the private sector (non-state enterprises) is a key growth area, given the ongoing rationalisation of state-owned enterprises (following increased competition from WTO entry) and the growing proportion of non-state output. Private firms currently receive around a 30% share of total lending (just half of their contribution to total output) as SOCBs are less willing to lend to the private sector as any unpaid loans cannot be attributed to the government. Domestic banks have significant advantages over foreign banks to expand this line of business, and the government's attempt to shift away from policy-directed lending may make this easier. Established branch networks and access to funds are the main advantages as foreign banks will continue to face limited access to local-currency funding (a regulation that is not covered by China's commitments to the WTO) making it difficult and probably expensive to raise funds to extend to private businesses.

The consumer market also has vast growth potential and offers significant opportunities to domestic banks. The extensive domestic branch network allows access to Chinese consumers that foreign banks will be unable to match. The consumer credit market, while still in its infancy in China, offers opportunities for domestic banks, and with a minimum of a five-year head start, Chinese banks would do well to exploit the opportunity. The potential for expansion here is again dependent on the wider reforms in the economy, as burgeoning unemployment or declining property prices would act as a brake on growth.

The only area where foreign banks have the potential to assist in the reform of Chinese banks in the medium term would be for domestic-foreign alliances. But even within the joint-stock and city commercial banks, NPL ratios remain high and banks are once again unattractive to potential foreign partners because of profitability concerns. Such alliances would allow Chinese banks to acquire essential skills and become viable competitors to foreign counterparts. The more likely outcome is that the benefits of the current banking reform will not become evident until around 10 years' time when foreign banks have managed to establish enough of a presence to allow domestic banks to imitate practices and thus significantly improve the efficiency of the system.

Textiles

Positive Benefits From Liberalisation

China's textiles sector was expected to fall victim to the trade liberalisation imposed by last year's entry into the World Trade Organisation. But the export performance during the first six months of 2002 suggests that better times may be in store.

In the run-up to China's entry to the World Trade Organisation (WTO) in December 2001, the textile sector was often cited as one of the biggest potential losers from trade liberalisation. This was in spite of textiles being one of China's main exports items (and as such will gradually enjoy wider market access as quota restrictions are phased out by 2005). The catalyst to this demise comes from the fact that the Chinese textiles industry is dominated by unprofitable state-owned enterprises (SOEs), coupled with a significant import content, particularly within the higher value-added end of the market. But the relatively robust export growth during the first six months of 2002 and ongoing push towards reform suggests that more favourable fortunes should be in store for the textiles sector.

As the world's largest textile exporter (with a 15% share of total world textile exports and 20% of total Chinese exports), China's success in boosting its share of the global market has implications for both the domestic and global industry. China's textile industry is still getting to grips with its role as a competitive and efficient sector. After continued losses during the mid-1990s, the industry returned to profit in 1999 as reforms transformed this unprofitable and underdeveloped sector into a competitive industry. Some 1.2mn jobs were cut and outdated machinery was replaced in an effort to bring the industry up to a more capital-intensive and therefore profitable base. The number of private enterprises has expanded bringing in additional capital and expertise, and encouraged competition within the SOEs. After profits fell 11.6% to US$2.7bn in 2001, concerns were raised regarding over-investment in the industry, and the potential for the tariff and quota reductions from WTO to force inefficient Chinese producers out of the market.

Even though China will be gradually permitted to export to previously closed markets, the worry was that this would not be enough to offset the negative effects from cheaper imports from abroad. China's State Economic and Trade Commission indicated that restricted markets account for just 23% of total export quotas and so end-markets such as Japan and the US will continue to play a key role. Despite weakness in consumer demand in many key end-markets, China's textile exports expanded 6.8% y-o-y in H1 2002 and domestic sales expanded 10%. This leaves the industry on track to beat expectations of 3% export growth for the year. During the first six months of the year Chinese exports to the US rose 19.3% y-o-y, slightly faster than the overall export growth of 14.2% with textiles benefiting

TEXTILES INDUSTRY (AS % OF TOTAL INDUSTRY)

	1998	1999	2000
Number of industrial enterprises	6.83	6.78	6.73
Gross industrial output value	6.46	6.23	6.01
Value-added of industry	5.24	5.18	5.01
Total assets	5.41	5.02	4.69
Sales Revenue	6.02	5.94	5.72
Textile exports	22.0	21.2	19.8

Source: China Statistical Yearbook.

favourably. In the dressing gown, robes, etc, category – one of the categories that received immediate quota liberalisation – imports to the US surged by over 300% during the January-April period, leaving China as the number one trading partner in this category and top partner in the wider textiles sector. A key indication of improving efficiency in China's textile industry is the expansion in profits. Profits increased slightly faster than exports in H1, up 7.0% y-o-y. This suggests that producers may have benefited as cheaper imports cut down costs, allowing producers to keep prices in check and therefore improve competitiveness.

Currently China's competitive benefits are likely to be restricted to the low value-added section of the textiles industry. China imports vast quantities of high-quality textiles thus exploiting its advantage in labour-intensive production. A move up the value-added chain would force the industry to keep up with improvements in technology while boosting export revenue and allowing some self-sufficiency in high-quality textiles. This may also provide scope for expansion in China's small but profitable clothing industry. Indeed the clothing industry was one of just a few industries thought to benefit from WTO entry due to its more competitive nature.

In the six months since partial liberalisation, the Chinese textile industry has benefited from the tariff and quota reductions through increased volumes and profits. This should encourage producers to continue to develop products, and keep the industry on track to benefit from the increased liberalisation over the coming years.