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The Chinese Economy: Risky Reporting

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Summary

- China is now a dominant force in the global economy, so it is not surprising that China-watching has also escalated – This trend is to be welcomed, but high standards of reporting and analysis must be encouraged. These are especially important given rising concern over economic trends and risks.
- The economy and currency were predicted to be on the verge of collapse in the late 1990s. This clearly did not happen. Now, many insist that the currency is grossly undervalued and GDP underestimated, with the economy still at risk of overheating. Is this misleading? How accurate are assessments of both the current data and likely risks?
- A specific example of concern over reporting has been the emphasis placed on the monthly investment data with little or no mention of how poor an indicator this may be: such details are important.
- Another recent example of reporting that did not clarify the facts was coverage of the GDP data for 2004 – most comments ignored the fact that the main ‘surprise’ was the surge in farm output, pushing GDP growth to 9.5% for 2004 instead of the figure of about 8.9% that would have been seen if crops had been ‘normal’ – so it was the farm economy, stupid ...
- Also, pause to recall that China is a developing economy for which annual GDP per capita has only just passed \$1000 (at current prices). Institutions, such as the banks, social services and tax policies will reflect this status. Opinion regarding risks to the growth outlook and the appropriateness of economic policy should take this into account.
- The need for improved data and reporting on China was recently highlighted at a Symposium held in Beijing (March 2005) – clearly the National Bureau of Statistics has an active programme for advancing the information available and is aware of the suggestions being voiced (e.g. by the World Bank).

Introduction

Not only is China's economy expanding rapidly; so too is the activity commonly referred to as 'China-watching'. From an international perspective, there has been a shift from a situation where China analysis was a rarefied academic subject to one in which comments on China's economic and business developments are commonplace. Widespread publicity concerning recent arguments about China's trade practices and the fairness of its fixed currency peg is an example of this.

Not surprisingly, this change in attitudes over China's newsworthiness has come at the same time as statistics have emerged illustrating the rapid development of the Chinese economy and its impact on the rest of the world, from soaring exports to a surge in oil and other raw material imports. The focus on the implications of China's high growth rates has rekindled speculation on topics such as when China will overtake the US as the world's largest economy – indeed this flush of enthusiasm has even created speculation over India also competing for such titles over the next 40–50 years. Yet just a few years ago much of the analysis being published about China, by (in many cases) long-time China-watchers, was relatively downbeat, disputing the statistics and the high growth rates reported in official data. Some even implied that China's economy might be on the verge of collapse.

How can these differing views of China be reconciled? Is the 'new view' right – or does it suffer from excess exuberance based on just a couple of years' stellar performance? Was the 'old view' completely mistaken? What is a realistic assessment of the prospects and risks for the Chinese economy?

To examine some of the questions raised, this paper presents a brief review of the history of China-watching, comparing the assessments put forward with the actual outcome, before turning to the current performance of the economy and risks to the outlook for continued steady economic growth.

A brief history of China-watching

Assessments of the performance of China's economy have passed through several distinct phases as the economy itself has emerged from virtual oblivion (pre-1980s), into a period of domestic reforms and high growth (in the 1980s), to being a rising exporter (mid-1990s) and then the major driver behind the recent spurt in growth in Japan and the rest of Asia (since 2001). Speculation about how soon China will overtake the US as the world's dominant economic force is now commonplace – although it should be pointed out that any expectation of this happening in the next 20 years very much depends on applying favourable purchasing power parity (PPP) adjustments to how GDP is measured (as indicated below).

Such a fast leap from 'zero to hero' is bound to invite observers to see China as an extraordinary phenomenon – and to be suspicious about the data. The unusual form of many of the statistics reported by China has only added to the bemusement, encouraging the impression that there is something fishy about the

data. Perhaps some indication of this quixotic view of China is the unusual fact that it became a subject for an opera, 'Nixon in China' (John Adams, 1987), based on President Nixon's ground-breaking trip in 1972.

Thus, for a number of reasons, the Chinese economy was, until quite recently, seen as a rarefied subject, treated mainly in studies by academics and the major international institutions (such as the World Bank and IMF). Indeed, given the operation of the economy in the period before the 1980s, and the problems of information, it was hardly considered amenable to economic analysis at all. Political events were occasionally reported but little else reached the world's daily news headlines.

The early years: use and abuse of statistics

Detailed investigations of the data were encouraged by China's arcane statistical methods and the very rapid growth rates reported through the 1980s. China has yet to establish all of its national accounts on the widely adopted SNA (System of National Accounts) basis. Its statistics are still influenced by the accounting system associated with the central planning regime of the first thirty to forty years of the PRC's history, the Material Product System (MPS). As a result it has effectively maintained a hybrid system of national accounts for many years. But neither the definition of gross value of output nor that of net material product is precisely compatible with the SNA measure of GDP. In addition, there are questions over the inflation estimates used and other factors, such as data coverage and collection techniques.

Independent assessments (e.g. those of Maddison, 1998 and Wu, 1997) examined issues such as the adjustments necessary to bring the reported data into line with practice elsewhere, and related questions such as how GDP growth could be explained using capital stock estimates and the simple growth accounting model. Maddison's estimates suggested that GDP growth in 1985–94 might have been more like 7% than the 10% reported, while other studies came to broadly similar conclusions though tending to indicate slightly higher growth rates. These were largely technical papers, aimed at an academic-style audience.

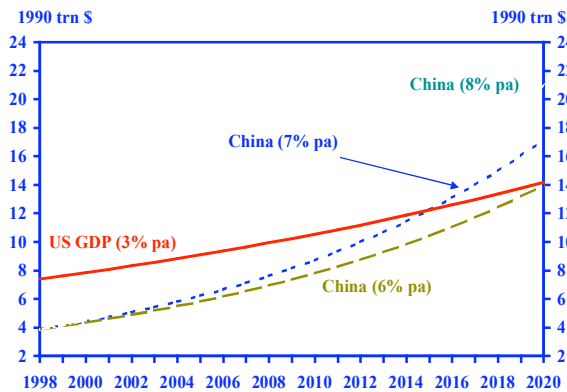
In addition to discussion of acceptable revisions to the historical data, another disputed point was how to adjust China's GDP data to produce an estimate at PPP. Scaling factors as high as three or four times the basic definition of GDP have been justified, pumping up the estimated GDP level to such a degree that forecasts of China's GDP surpassing that of the US by 2020 no longer looked unrealistic (see Figure 1).

Thus a variety of opinions emerged from these articles. Most suggested that criticisms of the data were warranted, thus promoting the view among casual observers that no China figures could be trusted and that the chances were that China's growth was largely a mirage. The latter was not necessarily the message of all the statistical reviews, but it gained credence. China was a problem for analysts – the economy was all smoke and mirrors.

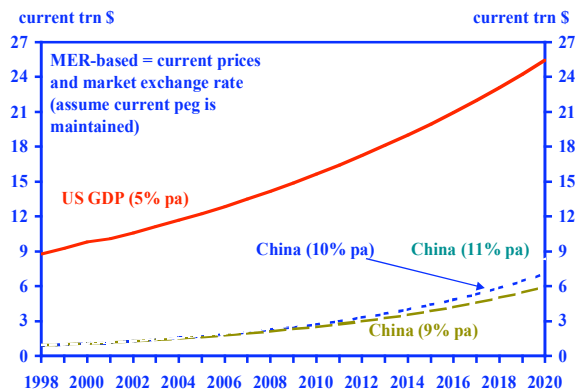
Nevertheless, as interest in Asia was growing along with the regional economy, and China started to see big gains in trade (data which were less disputed given

FIGURE 1: EXAMPLE GDP EXTRAPOLATIONS BASED ON ALTERNATIVE GDP ESTIMATES

China & US: GDP extrapolations (PPP-based)



China & US: GDP extrapolations (MER-based)



Source: OEF.

confirmation from trade partners), interest in China also escalated in the 1990s. Put together with the poor opinion of China's statistics, this was a recipe for commentaries straying into the realms of anecdotal evidence and speculation – which they did, sometimes with more dubious results than the official data.

For example, the basis of the widely quoted 'alternative GDP estimates' published by Rawski (2001 – see Table 1) was very poor, as other analysts (such as Lardy, 2002) pointed out, although Rawski (2002) maintained that his basic argument was still correct (i.e. that real growth was much weaker than reported). Rawski made use of employment statistics and short-term indicators such as energy output – but failed to acknowledge the possible distortions in these data themselves. In fact, some claims that GDP statistics, and particularly incomes and consumption, were much lower than the figures reported were based on anecdotal evidence only, following informal discussions.

It was still rare for China's economy to be the subject of news headlines or financial market analysis, although the number of China-watchers had started to grow and become more vocal and opinionated. Even the widespread view in the late 1990s that China

would have to devalue was – perhaps fortunately – given relatively low-level publicity.

The rise of the short-term trend watchers – and more reasons for caution

Comments on China's economic and business trends are now commonplace, and following every nuance of the China monthly statistics release is being elevated into an art form, much the same as the regular reading of the runes from the Fed and the US monthly data. Global variables such as oil and commodity prices (and the dollar and US interest rates) can be influenced by such interpretations of China's data.

Statistical complaints and proposed adjustments have not disappeared but they seem to have become more practically oriented to the needs of short-term forecasting and analysis, and less concerned with long-term historical revisions to the data. Predictions of the imminent collapse of the Chinese economy have also been shelved, although they could be dusted off – or maybe resurface in a somewhat different guise – in the event of a sharp downturn.

Many people are aware of the flood of imports from China and the economic force this represents: for them, and for visitors to China's booming business

TABLE 1: THE 'RAWSKI' ASSESSMENT (2001): ANNUAL AND CUMULATIVE CHANGE IN GDP AND RELATED INDICATORS (% CHANGE)

	1998	1999	2000	2001 ^a	1998-2001 cumul. ^b
Energy use	-6.4	-7.8	1.1	1.1	-5.5
Urban employment	2.3	1.6	1.2	1.2	0.8
Consumer price index	-0.8	-1.4	0.4	-0.5	-2.3
Real GDP					
Official	7.8	7.1	8.0	7.9	34.5
Rawski's low estimate	-2.0	-2.5	2.0	3.0	0.4
Rawski's high estimate	2.0	2.0	3.0	4.0	11.4

Source: Rawski, 2001.

^a First two quarters only at the time of Rawski's assessment.

^b This is the 2001 estimate divided by 1997 data.

districts, the economy's growth has been authentic enough, whatever the 'real' figures may be after all the arguments have been taken into account. The main news reports now carry regular stories on China-related business and economic issues, from trade deals to currency views, and the number of human-interest stories has also grown. In contrast, politics is now accorded about the same proportion of attention as for any other country. This is a sign of how far China has come and how much the international perspective has changed.

However, the relatively rapid rise in the following of China's economic statistics is also a reason for caution about the opinions expressed. For example, the current debate about the direction of China's growth rate and underlying trends is somewhat complicated by the difficulties involved in tracking the Chinese economy and its statistics, which reflects potential inaccuracies not just in the data themselves but in the form in which they are released and how they are subsequently reported. Highly variable seasonal factors, poorly documented changes in data collection methods, the lack of reporting on the expenditure components of GDP and constant price data, and the absence of a typical monthly index for prices (reports are for growth rates only) all make interpretation of the figures more liable to error: there have been reporting errors in the units reported (mistaking the use of 100 million or 10,000 as units of account). Comments on the monthly China data can thus be misleading; a few particularly problematic issues will be mentioned later, as they concern the critical subject of interpreting the recent slowdown and investment trends.

While the move to 'China-watching' on such a detailed basis clearly indicates that China has taken a giant step forward, some of the previous doubts and uncertainties over its statistics must remain, albeit lurking in the more academic background. As indicated above, early assessments focused largely on more accurate measurements for GDP, GDP growth and capital stock. By the mid-1990s, additional work emerged on issues such as assessments of the potential scale of government debt and its link to the bad debt problems of the banks. Moreover, new studies looked at the likely impact of WTO entry; Hu's estimate (1999) that trade and investment would approximately double proved fairly accurate, although many observers saw this as wildly over-optimistic at the time. Many articles attempting to assess the impact of WTO entry became so embroiled in caveats and 'one hand/ other hand' arguments that they failed either to clarify the importance of the WTO or to provide any reasonable estimates of the likely outcome.

However, optimistic or pessimistic, these studies were preoccupied by the general direction of the Chinese economy in terms of what may be called 'the big picture', looking at policy problems, distortions in measurements and risks over the medium to long run. There was much less focus on examining the monthly numbers for signals and predictions regarding very short-term prospects. Expertise on this aspect of China-watching was hardly developed and, given widespread doubts over the main statistics, few would have placed

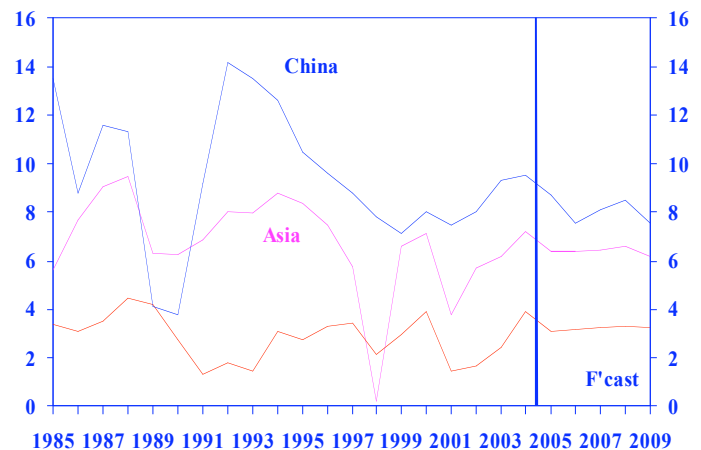
much confidence in short-term indicators and forecasts either. Now it seems as if many of the caveats about China data have been ignored in the haste to produce rapid assessments of trends. To some extent this reflects the growing importance of China but it may also reflect impatience at the poor medium-term forecasts made in the late 1990s. Nevertheless there are grounds for concern about recent assessments as well and scope to improve standards through more careful data analysis.

Assessments of China's economic development and prospects

Ironically, the bout of pessimism in the 1990s was encouraged rather than discouraged by China's apparently robust economic performance, 'suspiciously' impervious even to shocks such as the Asian crisis (see Figure 2).

FIGURE 2: GDP GROWTH ACROSS EMERGING MARKETS

Official Chinese statistics indicated that in the ten years



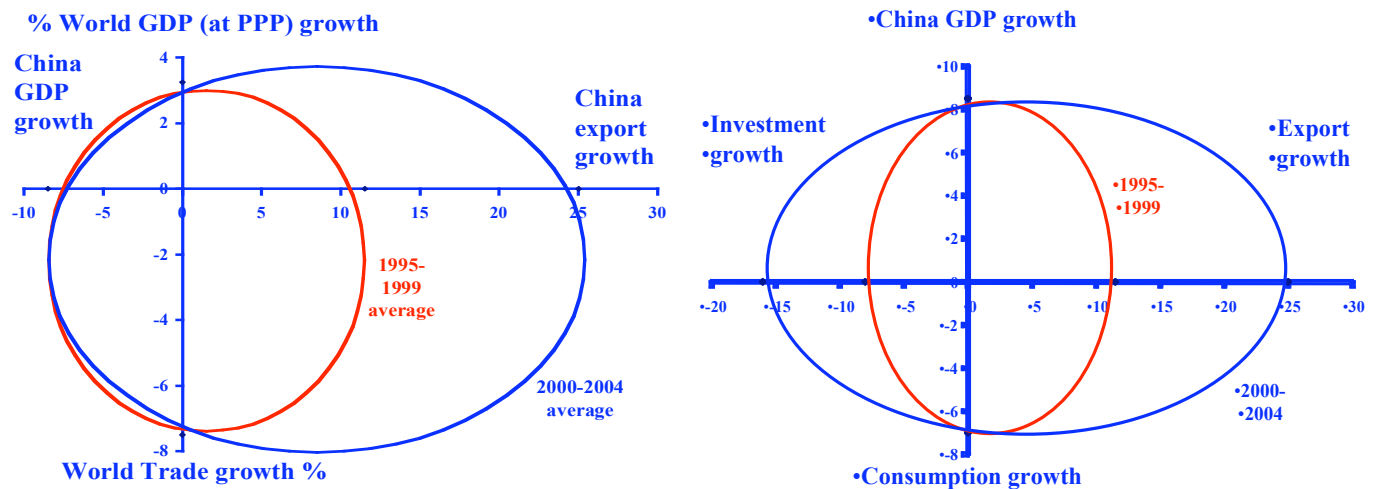
Source: OEF

to 2001 real GDP grew at an annualized rate of 9.9%. This compared with the 3.3% achieved in the US and a range of 5–7% for the other fast-growing economies of the Asia-Pacific region.

Exports, perhaps a clearer indicator of underlying improvements in both products and productivity, have grown even faster than reported GDP, from just \$22 billion per annum in the early 1980s to \$249 billion in 2000 and \$593 billion in 2004 (representing over 35% of GDP at current prices). China has overtaken Japan to become the world's third largest importer after Germany and the United States. And it is now the second largest oil consumer after the US, using about 6.5 million barrels/day.

Steady foreign direct investment (FDI) inflows of the order of \$50–60 billion per annum seem an obvious vote of confidence from the rest of the world. Driven by exports, the industrial sector has risen steadily, breaching 50% of GDP by 1997, while the share of agriculture has halved over 20 years, to about 15%. Although clearly lagging behind developments in

FIGURE 3: BALLOONING EXPORTS AND INVESTMENT DURING WTO ENTRY PERIOD



Source: OEF.

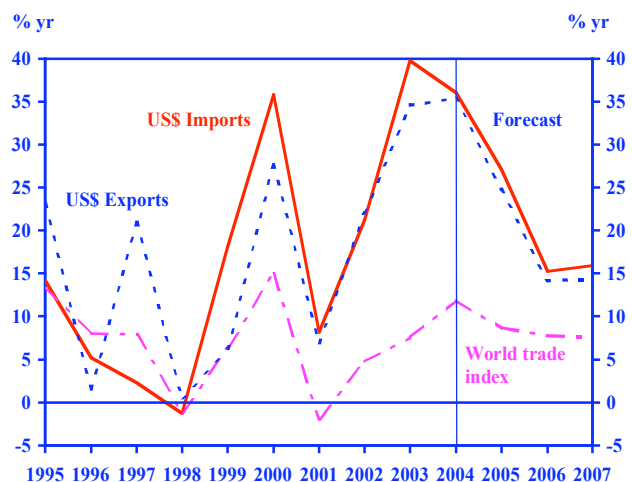
exports and investment (as illustrated in Figure 3), consumer spending has also grown rapidly, from about \$155 billion in the early 1980s to near \$650 billion in 2003 (from \$150 to \$500 on a per capita basis). And rural consumption, the supposed laggard, has risen from \$120 to \$350 per person.

In spite of the historical growth record, and the prospect of WTO entry to boost exports, the consensus view by the late 1990s was that China’s underlying potential growth rate was falling. Following double-digit growth in the early 1990s, reported GDP growth rates slowed to 7–8% in the late 1990s. Many expected this slowdown to continue steadily, with estimates in the 5–7% range for 2000–2010, the bias being towards the lower end of the range. Few expected a return to 10% growth, even in a cyclical upswing. Yet against these modest expectations, the last few years have seen China’s growth pick up sharply, and arguably it is now back into double digits. The average growth rate in the present decade looks likely to be closer to 8% than many believed possible according to the assessments of the late 1990s.

This upturn raises questions over the previous assessments for both medium- and long-term growth prospects. Pessimistic views were encouraged both by the short-term problems in the Asian and global economies and by the even more pessimistic prognoses of those China analysts who saw only the risks from bad debts, rising and hidden unemployment, misrepresentation of the economy’s performance, etc. It is difficult to avoid the effect of sentiment on forecasts, and forecasters, but the need to be even-handed and see the upside as well as downside risks should be obvious.

The latest phase of rapid growth has clearly been driven by the massive and prolonged trade boom resulting from WTO entry in 2002 (see Figure 4). This has been a heady growth period, reminiscent of the early 1990s, when a substantial expansion in investment, manufacturing and trade helped generate double-digit GDP growth (at that time, unification of the exchange rate and opening up of the current account in 1993–4 were important one-off factors

FIGURE 4: CHINA’S TRADE GROWTH OUTPERFORMS WORLD TRADE



Source: OEF.

stoking the boom). The stimulus from opening up to trade is also considered to be a key explanatory factor behind improved efficiency, as measured by sustained high growth rates in total factor productivity (TFP). Partly because such shocks entail long-term shifts in the sectoral composition and organization of an economy, the more subtle benefits from an opening up to trade may persist for some years.

Following specific measures that raise the share of trade in GDP (e.g. WTO entry), it is plausible to anticipate both rapid short-term changes and a lengthier period of enhanced GDP growth rates. Recent estimates by Oxford Economic Forecasting (OEF) suggest that TFP growth has probably remained high at around 4–5% pa, with rates arguably peaking at 6–7% in the mid-1990s. GDP growth in the period 2001–04 has been further boosted by a very substantial rise in investment and thus potential output. From 2000 to 2004, investment (and exports) more than doubled while GDP has risen a cumulative 40%.

TFP growth will need to remain fairly high (3–4%) to keep GDP growth rates at 6–8% by 2010–15, even if

TABLE 2: ACCOUNTING FOR GROWTH (OEF ESTIMATES, %)

	2000-04	2010-15
Labour supply growth	1	similar
Capital stock	9-10	8-10
GDP growth rate supported by the above	3.5-4	3-4
But adding		
TFP*	4-5	3-4
Overall potential output growth	7.5-8.5	6.5-7.5
Actual GDP growth	8-9	6.5-7.5

* Total factor productivity growth – estimates for average OECD rates are in the 1-2% range, with Korea about 2.5%.

that estimated GDP/capita of some \$4,200 in the Shanghai district for 2003 was about six times the average GDP/capita in the poor Southwest and West regions. Clearly it will require some considerable efforts to develop cities, infrastructure and industries to match regional aspirations for growth. Urbanization will need to develop very rapidly. This is an opportunity but also a huge challenge.

However, there is little evidence to suggest that even the more prosperous urban

investment growth remains at 'target' rates of about 10% (see Table 2). This investment must also be productive and efficiently allocated across sectors and regions. But the OEF estimates put forward are plausible given the results achieved so far, the scope for further catch-up and the experience of other regional developing economies.

At some point, China will find that it has picked all the low-hanging fruit. It will be more difficult to grow rapidly. To take an extreme example, once the urban population reaches the productivity levels of, say, Korea today, then growth will slow to the 4-6% range fairly quickly. Essentially, catch-up effects become exhausted and thus TFP growth slows.

If the overall growth rate for China is to stay at 7-8%, then the poorer, rural areas will have to generate growth of at least 8-10% on their own. Although this poses a challenge, it is not impossible – and is one of the reasons for continued optimism about long-term growth prospects.

Both urban and rural incomes have about doubled in the last decade, however, with rural wages approximately a third of urban pay rates. This may imply that it will take another 15-20 years of high growth for rural pay simply to reach the level of today's urban worker. These averages obscure the fact

hubs have exhausted their potential productivity gains yet. GDP/capita is still well below most of Northeast Asia (see Table 3). And in terms of key products, such as consumer durables, output/capita is also much lower than for Korea (see Table 4).

Risks to the outlook

In spite of the scope for sustaining high rates of growth over the longer run, the economy faces a number of serious risks over the next few years – some old, such as rising non-performing loans (NPLs) and a potential collapse in investment, and some new, such as the increasing sensitivity to world trade cycles (and indeed, the increasing sensitivity of the world to China). These downside scenarios have the potential to slash GDP growth into the 5-6% range or less.

Growing risks linked to world trade

As the Chinese economy has expanded, largely driven by exports, a new risk factor has emerged. This is the extent of China's dependence on the world economy. Given the scale of China's exports, and the production and employment that lie behind the trade data (both

TABLE 3: GDP/CAPITA COMPARISONS FOR 2003 (OEF ESTIMATES, CURRENT US\$)

	India	Hong Kong	Korea	Malaysia	Thailand	China
Population (millions)	1050	6.8	48	25	62	1290
GDP/capita (US\$)	550	24000	11000	4100	2500	1100
China	Urban	Rural	Mid-coast	Shanghai Province	West & Southwest	
Population (millions)	515	775	370	16.5	190	
GDP/capita (US\$)	2100	420	1600	4000-4500	700	

TABLE 4: SAMPLE OF INDUSTRY STATISTICS FOR CHINA'S OUTPUT PER CAPITA AS % OF KOREA'S AVERAGE

	Output/capita as % Korea's				Stock/capita as % Korea's	
	Cement	Beer	Fridges	Washing machines	Cars	Personal computers
1993	24.5	29.1	26.8	11.8	0.6	1.7
1998	42.6	52.6	37.8	17.0	1.1	5.0
2003	54.1	52.4	45.5	18.3	3.5	5.7
2008	79.5	64.0	68.9	31.7	8.7	17.8
2013	99.0	73.1	89.3	40.1	18.5	37.6

Korean level = 100

Source: OEF.

for exports and imports), it looks increasingly unlikely that China can ride out world trade cycles the way it has in the past. The 'WTO entry' boost cannot be repeated and is probably starting to fade. Although this year's export growth looks set to be as high as ever, China's export growth is likely to be more closely aligned with world trade growth in the future – and more sensitive to global cycles. The choice between stabilizing the economy with counter-cyclical spending programmes and allowing it to be buffeted by global shocks will pose an increasing challenge for policy-makers.

The vulnerability to trade shocks can be demonstrated by some simple calculations. Broadly speaking, the share of exports in GDP indicates the sensitivity of the economy to very generalized trade shocks.

Using the data in Table 5, a 'back of the envelope' estimate for the first-round, direct impact of a 5% world trade (export) loss suggests that China's loss in GDP might have been about 0.5% in 1985. But this estimated loss rises to 1% for 2000 (other things being equal), and losses could be as much as 2% by 2010 as the share of exports in GDP roughly doubles to 40%.

TABLE 5: MERCHANDISE TRADE AS % OF GDP

	China		US		Korea		Taiwan		Thailand	
	Export	Import	Export	Import	Export	Import	Export	Import	Export	Import
1985	8.3	12.6	5.3	8.1	32.6	33.5	70.4	56.6	18.1	21.6
1990	13.3	11.0	6.9	8.8	25.5	27.4	41.9	34.2	26.7	34.6
1995	18.3	15.7	7.9	10.2	25.5	27.6	42.0	39.1	33.8	42.1
2000	23.1	19.9	8.0	12.7	37.3	34.8	47.8	45.2	56.7	50.6
2003	31.3	28.1	6.6	11.6	37.2	34.2	50.1	44.3	55.3	51.8
2005	34.9	33.0	7.4	11.9	40.4	39.2	54.2	50.0	52.6	51.2
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2010	40.4	38.3	10.0	13.3	46.6	46.2	60.4	57.7	57.6	55.0

Source: OEF.

Although the indirect and second-round effects are more complicated, requiring use of econometric model estimates such as those calculated by OEF, this simple calculation demonstrates the reason for growing concern over risks from trade-linked shocks. Basically, GDP losses from world trade shocks double up as exports double their share in GDP; growth in exports offers

rewards but also creates risks of volatility.

While it would have been relatively easy to offset the scale of loss linked to trade cycles in the 1980s and 1990s through policies such as fiscal spending, a loss of 2% of GDP is less easily offset. In addition, after a long period of sustained increases embedded within the structure of production and demand, it is likely that by 2010 imports will be slower to fall in response to any shortfall in export demand, making balance-of-payments volatility an increasing threat on top of enlarged GDP losses.

Moreover, China's pattern of exports is significantly skewed, with exports to the US accounting for almost 40% of the total during the last few years. As most of these goods are consumer-oriented, China is particularly vulnerable to a US consumer-led recession – or to any deterioration in US–China trade relations, such as the introduction of protectionist measures by the United States. For example, using the same 'back of the envelope' methodology, if the United States were to cut its imports from China by 20% in 2006, then China could easily see GDP growth fall by 2–3% (perhaps to as little as 5–6%). Job losses in the key export industries clustered in regions such as Shanghai and Guangdong would have knock-on impacts on services and other regional activities and jobs.

The rapid growth of China's exports relative to world trade over the last few years also implies that China's share of world markets for particular products has steadily risen. Indeed, even before the latest surge, China was already the dominant global supplier of some goods (toys) and a leading supplier of others (such as clothing and textiles). More recently, its penetration in office machinery, consumer electronics and telecoms equipment has grown very quickly and this trend looks set to continue. As China's shares become larger, so too must there be an increased risk of serious losses if there were to be a fall in specific product demand, such as a general consumer switch away from Chinese-produced toys or clothing.

Concerns over investment, credit growth and non-performing loans

Given its weight in GDP (over 50% using the reported data) and the scale of its growth over the last two years (near 30% per annum), it is strictly investment, not exports, that has contributed most to GDP growth (although exports may be considered a key driving factor behind this investment performance). Funds have been flowing in, primarily from domestic credit growth as banks cut cash reserves and boosted loans in 2003 (see Figure 5). This process was driven chiefly by inflows of domestic savings into deposit accounts and not, as many seem to suggest, by FDI and the impact of the central bank's rising forex reserves.

The increase in bank loans has been truly massive: almost \$400 billion in new loans in 2003 alone, a rise of 22% (which helped fund investment totalling some \$670bn). Domestic deposits also rose by \$400 billion and by another \$450 billion in 2004. However, 2004's credit expansion cooled down (to under \$300 billion) although investment still rose by almost 30%, to \$850 billion. Total bank lending reached some \$2.5 trillion at the end of 2004, versus deposits of \$2.9 trillion and GDP of \$1.6 trillion.

While there is a case to be made for investment being overestimated (many believe it could be overstated by as much as 20–25%), it is not clear that this makes the position more comforting. The most optimistic interpretation is that some investment is

actually consumption, and this interpretation would be consistent with the low reported consumption figures (which appear weak even against retail sales data, especially since 2001).

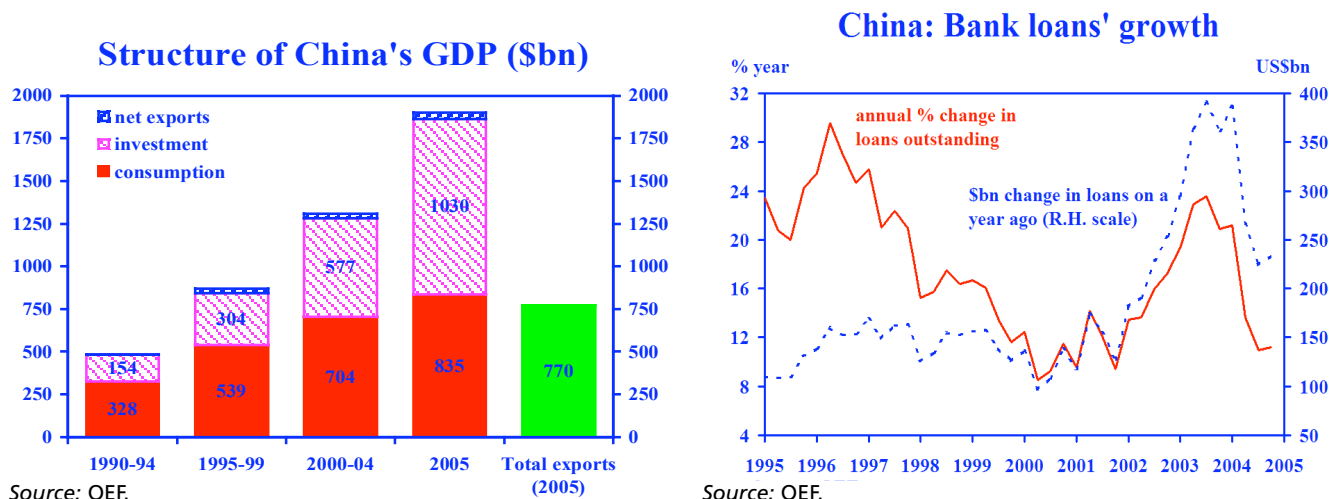
Whether or not the investment data are adjusted slightly, the high level of investment remains a cause for concern for at least two reasons. First, such high rates of investment will drive down returns to the point where investment growth will fall, possibly very sharply, dragging down GDP as well (a threat reminiscent of the Asian crash of 1997–8). Other demand components may be unable to take up the slack. Secondly, and linked to the first point, as investments turn sour then bad debts rise and this hits the banks in the form of NPLs – and ultimately the government in the form of yet another round of bail-outs on top of the assistance provided in recent years.

The crash in bank credit and investment that many feared in the late 1990s may simply have been postponed – the economy could plunge into recession and/or enter a prolonged low growth phase.

Another threatening aspect of the problem of rising bad debts is the potentially volatile market reaction that could stem from a perceived turn for the worse. China has seen its risk premium in international markets tumble in the last few years (to about 75 basis points) and the currency has been under pressure to revalue. A sudden change in view might turn this picture around, leading to higher domestic interest rates, a higher risk premium on foreign debt and massive capital flight.

Concerns over excess investment and potential NPLs did indeed surface in 2004 and were a motivating factor behind the policies implemented to curb bank lending and particular investment sectors over which fears of overheating (property) or excess capacity (steel) were most rife. However, the data on investment made interpreting the scale and speed of the slowdown difficult and thus opinions on the success of the policies and slowdown varied considerably through the last year. It is in this respect that the monthly investment report assumed such a prominent role – in spite of the shortcomings in using these data as a reliable indicator.

FIGURE 5: CHINA'S SURGING INVESTMENT AND BANK LOANS



This brings us back to our initial point: there are many pitfalls involved in data interpretation and the quality of many commentaries on China's economy is uncertain, especially from those unfamiliar with the nuances of the data and driven by short-term sentiments.

First, it should have been clear that the monthly data series offers only partial coverage of total investment (probably about 75–85% – the basis has changed somewhat over time). Secondly, about 70% of China's investment is recorded in the second half of the year; thus the first half is 'low' and not very representative of the outcome for the full year. The use of the first-quarter data as an example of investment trends can be particularly misleading as these statistics typically cover less than 10% of the total and are relatively volatile (as are many early-year statistics, partly because of the sizeable impact of China's New Year holidays, which vary between January and February). Even looking at the year-on-year comparisons (to avoid seasonal factors) is not reliable in this instance as the various distortions may be large relative to the 'low' level of the data.

It was certainly prudent to see the 'high' early 2004 growth rates quoted for investment as a hazard warning, but they should not have been taken too literally as indicating trends for the year. Credit growth proved a better guide in this respect, confirming fairly

high investment growth rates that have eased back from about 30% to 25% (the year average was much the same as for 2003, at about 27%). Unfortunately a great deal has been said about the monthly investment growth rates with virtually no mention of the caveats and other indicators.

In spite of the now visible cooling off in credit and investment, the risks have not necessarily been eliminated. The damage may already have been done in terms of potential NPLs emerging later on. The risks posed by the investment and loans build-up cannot be dismissed so quickly. Certainly, until there is visible and definite proof that banks have indeed improved their NPL record and 'learned to lend', the risk to the outlook from alternating credit binges and credit crunches cannot be eliminated.

Even if boom–bust scenarios can be avoided through careful policy intervention and support, this does not guarantee that the underlying problem is resolved. A legacy of poor credit and investment decisions, the persistent misallocation of investment funds is not necessarily visible in the short term but erodes real long-term growth prospects. Addressing this issue is more difficult and it is not a problem specific to China. As the assessment of long-term growth prospects was highlighted above, investment growth alone is insufficient to raise potential output: investment must also be productive and efficient.

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