

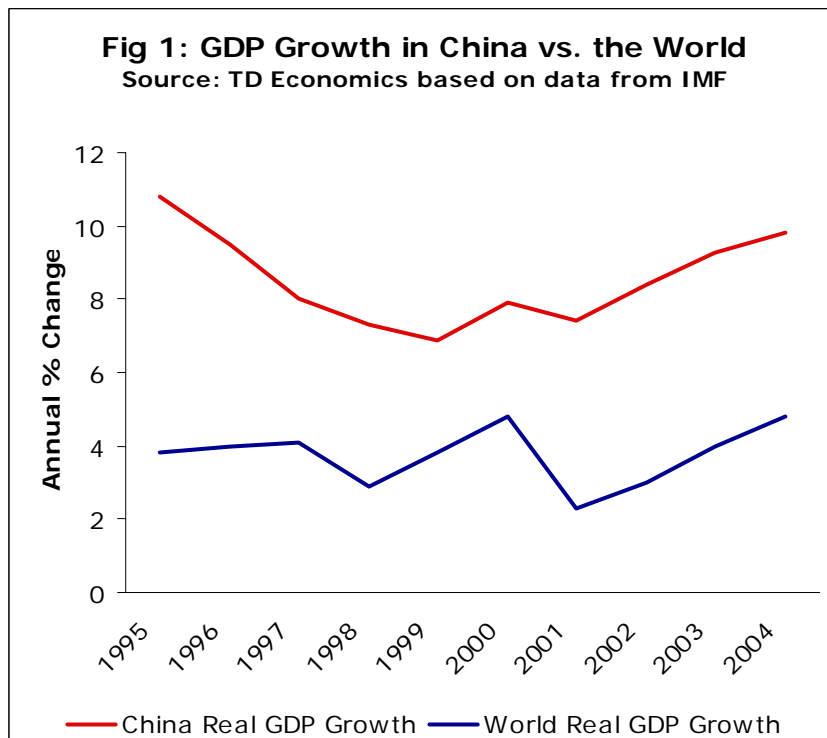
# **China: Can We Risk being Optimistic?**

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## **Introduction**

In recent years, emerging markets have gained more interest among investors and analysts across the globe. China's dramatic economic growth in recent years has captured the attention of many analysts monitoring global markets (See Fig. 1). Along with this rapid growth, China has enjoyed a number of socio-economic benefits and has become well integrated within the global economy. Resulting from recent economic reforms, private investors and market prices now play a significant role in production and trade in this formerly "state-owned" economy. However, despite this recent progress, some challenges still lie ahead. Notably, a firm framework for private sector business needs to be established; significant reforms are required in the financial sector; and a stable macroeconomic environment must be achieved.



## **Rapid Economic Growth**

China's economic growth is amongst the most rapid and sustained economic transformations in the world over the past 50 years, averaging about 9.5 percent over the past two decades.<sup>1</sup> Over the past decade, the average annual growth rate decreased slightly to just below 9 percent per year. However, this is still more than twice the average annual growth rate of real world GDP over this

<sup>1</sup> "Economic Survey of China, 2005", OECD, Sept. 2005

period (just under 4 percent).<sup>2</sup> Both the Organization for Economic Co-operation and Development (OECD)<sup>3</sup> and TD Bank analysts are predicting that China's economy will continue to grow at a rate of 7 percent over the next 10 years. Although this is slightly less than the average GDP growth of the last 20 years, it remains twice that of the US.<sup>4</sup>

China's GDP is now the sixth largest in the world<sup>5</sup> and exceeds that of many major European economies. In fact, China's GDP is currently only exceeded by 3 OECD member countries.<sup>6</sup>

Many of China's industries are now well integrated into global markets. As a result, China accounts for over 30 percent of the world's manufacturing output.<sup>7</sup> It is predicted that if current trends continue, China will be one of the world's top exporting countries by 2010.<sup>8</sup>

### **Policy Change for Growth**

#### *Free Market Reforms and a Growing Private Sector*

Since the late 1970's, China's rapid growth is largely attributable to evolving economic policies, which have served to improve efficiency in China's private sector industries. The government's economic policies have been changed to place greater emphasis on the free market. Initially targeted at the agricultural sector and later expanded to other industry sectors, these policies focused on the elimination of price controls, encouragement of private ownership, enforcing new competition laws, allowing foreign direct investment, reducing tariffs, abolishing the state-owned export trading monopoly, and ending multiple exchange rates.

Chinese policy makers are starting to see the fruit of their labors, particularly in the area of foreign direct investment. Since 1992, foreign direct investment increased by almost five times.<sup>9</sup>

In addition, foreign portfolio investment in China has also risen significantly. Foreigners do not yet have access to all shares traded on Chinese exchanges. Only local Chinese may purchase A shares, however foreigners have access to B shares on the Shanghai and Shenzhen exchanges. These shares can now be traded directly on the exchanges, whereas previously they had to be traded

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<sup>2</sup> "Pressure on China could Delay Appreciation of Chinese Currency", TD Economics, Apr. 2005

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<sup>5</sup> "Profiting from China's Economic Boom", TD Economics, Apr. 2004.

<sup>6</sup> "Economic Survey of China, 2005", OECD, Sept. 2005

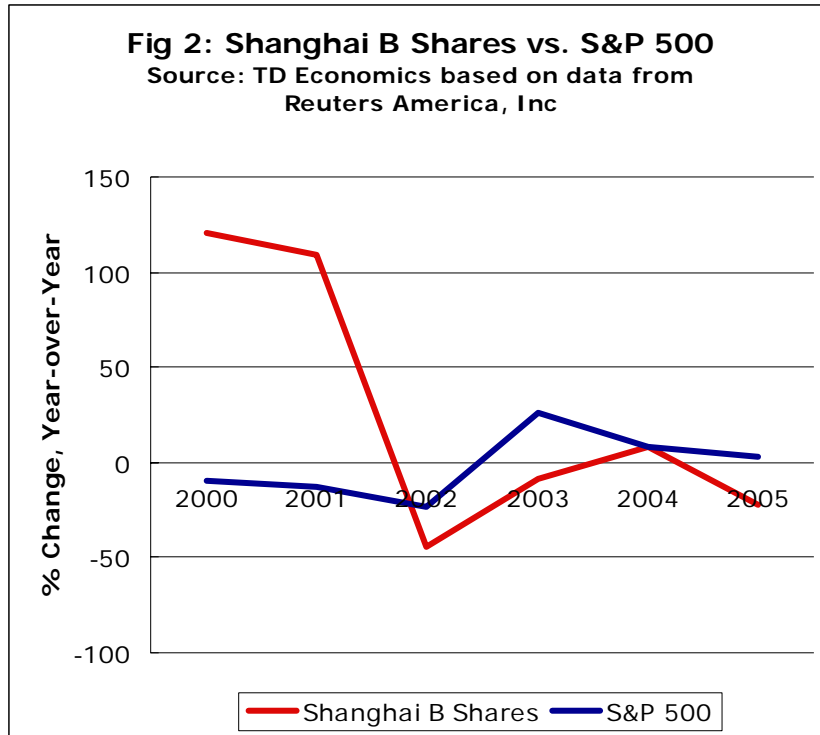
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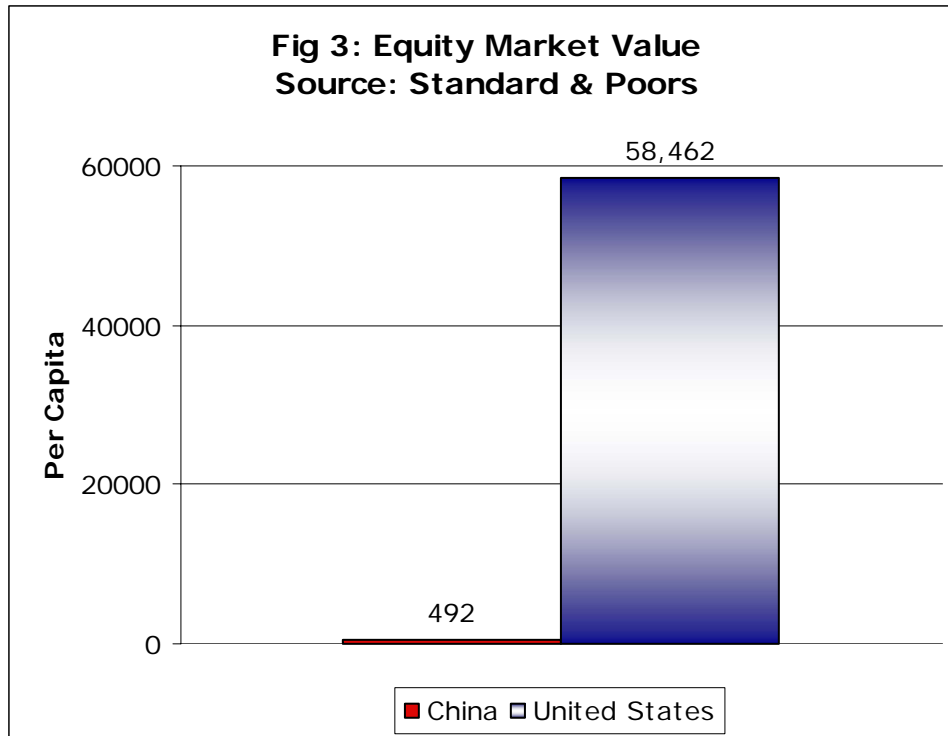
through local brokerages. Between 2000 and 2005, Chinese equities listed on the Shanghai B exchange have had a total return greater than 150 percent. This compares with losses on US equities, as represented by the S&P 500.

Despite these relatively high returns, high market volatility has affected the consistency of annual returns over the period. Chinese equities delivered annual returns greater than 100 percent in 2000 and 2001, but dropped by a staggering 44 percent in 2002.<sup>10</sup> (See Fig. 2)



Despite recent growth, the equity market in China is still relatively small by global standards. In 2004, China's equity market value per capita was only \$492, in comparison with \$58,462 in the United States for the same period. As such, China is still far from reaching its full potential, and tremendous growth opportunities still exist. (See Fig. 3)

<sup>10</sup> "Profiting from China's Economic Boom", TD Economics, Apr. 2004.



As a result of the economic policy reforms, China is becoming an economy more heavily based on free market principles. This is exacerbated further by China's membership in the World Trade Organization, with the goal of further reductions in tariffs and other barriers to trade.

#### *Constitutional Changes*

In addition to economic policy changes, fundamental changes were made to the Chinese constitution in 2004, emphasizing the role of the private sector in the economy. This has been achieved through promoting business activity and protecting private property from arbitrary seizure which has led to the overall growth and development of a new strong private sector. This can be seen, as the private sector now produces over half of the GDP and a growing share of China's exports.<sup>11</sup>

#### *State Owned Sector Reforms*

The Chinese government has also introduced a number of reforms in the state-owned sector, which formerly dominated the economy. For instance, in the 1990's, the Chinese government started to allow state-owned corporations to be restructured and trade publicly on stock exchanges. As a result, the number of state-controlled enterprises fell by over 50 percent in 5 years.<sup>12</sup> In addition, allowing for more flexibility in employment contracts had resulted in a significant loss of jobs in the state-owned sector of over 14 million since 1998.

<sup>11</sup> "Economic Survey of China, 2005", OECD, Sept. 2005

<sup>12</sup> "Economic Survey of China, 2005", OECD, Sept. 2005

The government has also created policy initiatives to free the urban labor market. This includes allowing wages for educated staff to rise, in accordance with free market forces. Now, private companies generate most new jobs and, in turn, are improving the productivity and profitability of the economy.

Despite the reforms mentioned above, a large part of the state-owned sector remains to be restructured. The performance of the business sector could be further improved through continuing this modernization of the business framework and better enforcement of corporate laws.

### *Educational Reforms*

In the spirit of preparing for a more knowledge-based future economy, China has also undertaken a strategy of education reform to ensure that they have the human capital necessary to meet the future labor market demands. One such reform is the new minimum requirement of nine years of education for all children. This requirement extends across all regions of the country, including remote rural areas.

In addition, policy initiatives were taken to provide incentives to attain higher levels of education. Since these initiatives were implemented, enrollment in higher education courses has risen by approximately 3.5 times between since 1998. The result here is a more educated labor force, with new entrants entering with more than 3 times the number of years of schooling as those retiring.

### **Currency Revaluation**

China's monetary policy has been volatile with regard to inflation. Many analysts have noted that greater exchange rate flexibility would allow the authorities to guard against further increases in inflation, increase China's presence in the global export market, and allow market forces to have a greater influence on bank interest rates.

In July 2005, China announced a change in exchange rate arrangements. The renminbi's fixed peg to the US dollar has now been abolished and a managed floating exchange rate has been adopted. The new floating rate is anchored to a basket of currencies and will be allowed to fluctuate against these currencies within a band. Resulting from this revaluation, the renminbi immediately increased in value from 8.27 RMB/ USD, to 8.11 RMB/ USD.<sup>13</sup>

This change in exchange rate policy serves a number of economic and political objectives:

- 1) Allowing more market influence on the value of the renminbi will serve to make China a growing player in the global export market.

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<sup>13</sup> "China Revalues the Remnibi", TD Economics, July, 2005.

- 2) Abolishing the peg with the US dollar serves to make the country's currency somewhat of a more difficult target for speculators.
- 3) A more flexible exchange rate regime serves to combat protectionist sentiment in the US, which has accused China of unfair trade practices, possibly avoiding an increase in tariffs on Chinese exports to the US.

China's currency revaluation is a positive step in terms of maintaining a growing and vibrant export sector. In turn, this will further serve to increase foreign investment and create a great deal of optimism for the future.

### **Financial Sector and Governance Issues**

Throughout recent history, there has been significant global concern with regard to the capacity of Chinese financial institutions to make sound lending decisions. This was predominantly due to the fact that, until 1995, Chinese banks paid considerable attention to national priorities in determining the allocation of loans. As a result, lending policies led to the accumulation of a large quantity of bad loans. However, over the past five years, more than two thirds of the Chinese banking sector has been recapitalized, working to eliminate this burden.

A number of reforms have improved the capacity of banks to make market based lending decisions. As a result, new loans since 2000 have been observed to be of much higher quality. Banks are now using better risk weightings, which have been introduced by the regulator; more realistic classification systems for non-performing loans have been adopted; and foreign investors may now acquire shares in a number of second tier banks.

Although significant progress has been made, further advancement is desirable with a focus on improving governance, increasing private ownership and expanding and deregulating capital markets to minimize systemic risk. In particular, the rural credit co-op sector is made up of a number of small institutions with significant problems. This sector would need to face recapitalization. Progress has already started in this sector, where a number of these smaller institutions have been converted into commercial banks.

Aside from recapitalization, governance remains a significant concern for the banking sector. Policy aimed at improving governance should introduce a transparent process for appointments to senior management. In addition, the banking regulator must continue to ensure that adequate risk management tools are put into place in light of new technology and financial innovation.

### **Outlook for the Future**

To say that China's economy is currently in an expansionary phase would be an understatement. With low labor costs, we can expect to see foreign direct investment continue to rise. This will be complemented by further economic

policy reforms to reduce the restrictions on foreign ownership. Moreover, rising earnings and profit growth will continue to attract foreign investment.

Chinese policy makers have been concerned that the growth may be too explosive and difficult to sustain. The concern is that this may lead to the formation of an investment bubble. The Chinese central bank has already tightened monetary policy to temper economic growth and avoid the cycle of economic expansion, ultimately leading to a burst.

Despite the fact that investors should be wary of the risks inherent in this volatile economy, the outlook for investment in this emerging market is positive. Market analysts are predicting that China's economy will continue to grow at rates, well above that of the US and the global economy.

Although China may still face a number of obstacles with regard to governance and recapitalization of the financial sector, government policy is headed in the right direction to ultimately achieve sustainable economic growth. If the government achieves its goals in these areas, China will show abundant returns on capital in the years to come.

### **How You Can Invest in China**

There are a number of investment options available for individuals interested in investing in China. For instance, an ETF (Exchange Traded Fund) with the symbol FXI is trading at the American Stock Exchange, as well as several mutual funds are offered to the public ([click here](#) to view them). Potential investors should be aware that China is a very small market (by market capitalization) and all investment decisions should be made based on a personal investment profile and within the context of the entire portfolio.

Daniel Padro holds an MBA from York University and an MA in economics from McGill University. Daniel has previously held the position of Senior Analyst at various public and private sector policy-making institutions in North America. His areas of interest include financial sector policy, regulatory harmonization of the financial sector, and strategic management of financial institutions. Daniel has recently returned from a 1½ year trip around the world that combined both work and leisure.

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