CHINA’S ECONOMY IN 2006: A HIGH GROWTH PATH TOWARDS A ‘HARMONIOUS SOCIETY’

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Summary

2006 was the first year of China’s 11th Five-Year Plan, or 11th FYP, 2006—2010. It was also the last year of the five-year transitional period after China’s accession to the World Trade Organisation (WTO). The key policy initiatives of the 11th FYP are to reduce the dependency of growth on investment and energy consumption and to build a harmonious society. Some of these policy initiatives have produced significant effects, but the challenges and constraints remain tough.

China’s macro-economic performance in 2006 was impressive. Its gross domestic product (GDP) is predicted to exceed RMB 20 trillion, growing by 10.7% from the previous year. Measured in US dollars, per capita GDP will be close to US$ 2,000, thanks to domestic economic growth and the appreciation of RMB.

In 2006, China continued to attract a large volume of foreign direct investment (FDI), although the rate of growth slowed down considerably, reflecting the government’s efforts to improve the quality of FDI and to radically readjust its industrial structure. In the first eleven months, the total amount of FDI flowing into China was about US$ 53 billion.

Apparently, China’s high growth in 2006 was still fuelled by domestic investments and exports. Domestic demand depends significantly more on investment growth than domestic consumption, a pattern that has persisted for years. Investment growth was possible because of high domestic savings. In the first eleven months of 2006, fixed assets investment rose by 26.6%, but consumption only increased by 13.6%.

China’s international trade greatly outperformed its economic growth. The volume of trade reached US$ 1.8 trillion, an increase of 23.8% over 2005. China’s export boom continued in 2006 despite growing protectionism in the US and the EU against Chinese textile, garment and shoes. Both exports and imports soared, with the former growing much faster than the latter, enabling China to generate its highest trade surplus ever of US$ 177.5 billion, increasing by nearly 70% over the previous year. Since 2004, China has been the world’s third largest trading partner. At its current rate of growth, it will overtake Germany to become the world’s second largest trader by the end of 2007.

Due to its swelling trade surplus, China overtook Japan in holding the world’s largest foreign exchange reserves. The total amount of foreign exchange reserves was US$ 853.6 billion in February 2006, surpassing that of Japan’s, and continued to rise to US$ 1.07 trillion by the end of the year. China is pursuing its currency appreciation by following its principle of gradualism, despite continual – and strong – foreign pressures calling on China to accelerate the process. From July 2005 to the end of 2006, the Chinese RMB had appreciated by 5.7% against the US dollar.

The Chinese economy has been considered by many economists to be overheating since 2003. Fortunately, under such a persistently strong rate of growth, China managed to maintain a low inflation rate, and a low urban unemployment rate.

In 2006 China accelerated its financial reform, especially its banking and insurance industries. The largest state-owned commercial bank, Industry and Commercial Bank of China (ICBC), was listed in the Hong Kong and Shanghai stock exchanges in October 2006, following the initial public offerings (IPOs) of China Construction Bank and Bank of China in October 2005 and May 2006.
respectively. The share price of ICBC in Shanghai rocketed by more than 70% in two months from its IPO day to 27 December 2006. The share price of China’s largest insurance company, the People Life Insurance Company, was over 100% higher than its offer price on 11 January 2007, its first day of trading in the Shanghai Stock Exchange.

Restructuring of state-owned commercial banks and insurance companies was part of the government’s efforts to transform the state industries from state-owned enterprises into share-holding companies in order to improve their efficiency and competitiveness as China has become a widely open economy with WTO obligations. The government has also started to suppress the so-called ‘special interest groups’ in an effort to build a harmonious society. The present policies pursued by the Hu-Wen leadership also put an emphasis on making China a scientific and technological innovation state, on environmental protection, and on energy-material efficiency for economic growth.

In 2006, China continued to work hard on narrowing the urban-rural income gap. The leadership initiated the policy of ‘building a new countryside’ as part of its concept of a harmonious society. As essential parts of economic development, China made great efforts to reform its education and social security systems. Such reforms have shown some encouraging results but more efforts are certainly warranted in the following years to come.

In 2006, China maintained its strong growth momentum but started to alter its old extensive growth model to a more intensive one. The Chinese leadership has realised that China’s past development norm is physically unsustainable, and politically and socially undesirable. China has become an industrial power, but is still far from being a harmonious society. The road leading to such a goal is long and challenging. In Peter Nolan’s words, ‘China was at the crossroads’ in 2006.
China’s Economy in 2006:
A High Growth Path towards a ‘Harmonious Society’

Shujie Yao and Minjia Chen*

Another High Growth Year

1.1 2006 was the first year in China’s Eleventh Five-Year Plan, 11th FYP, 2006-2010, and also the last year of the five-year transitional period after China’s accession to the World Trade Organisation (WTO). The key policy initiatives of the 11th FYP are to reduce the dependency of growth on extensive capital investment and energy consumption; and to build a harmonious society with less income inequality and more social justice. Some of these policy initiatives have produced significant effects, but the challenges to, and constraints on, China’s next stage of economic development remain tough.

1.2 China has accelerated its economic and financial reform process to prepare for more international competition as a standard WTO member. China’s GDP growth rate in 2006 reached 10.7%, making the GDP value to be RMB 20.94 trillion (about $2.72 trillion).1 It is a further upward shift from the 10.2% growth in 2005.2

1.3 The share of manufacturing and construction as a proportion of China’s total GDP increased from 41.6% in 1990 to about 50% in 2006, whereas agriculture’s share declined from 27.1% to 11% over the same period, about one percentage point per year.3 The share of the rural population and the share of agricultural labour in national totals have declined much more slowly than the share of agricultural value-added in GDP, causing significantly more urban-rural divide in both productivity and per capita income. Massive numbers of rural migrants working in the cities receive low wages and work extraordinarily long hours but their creation of value-added wealth, or GDP, has to remain in the cities and be enjoyed by the urban population. The government of Guangzhou announced that the per capita GDP of the city reached US$ 10,000 in 2006, but this calculation was based on an exaggerated nominator and a vastly deflated denominator, as several millions of rural workers creating Guangzhou’s GDP are not counted as its residents. Many of these people worked over 12 hours a day and 7 days a week The Lewis model of economic development has been vividly demonstrated and experimented in China.

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to the absolute disadvantage of agriculture, peasantry and rural society, whereas industrialisation and urbanisation have been developing in full steam, in the past, in 2006 and beyond.

1.4 China’s fast economic growth has been primarily propelled by industrial expansion, as shown in Figure 1. Rapid industrial growth has been quickly transmitted into GDP growth during the data period.

Figure 1: GDP & Industrial Production Growth (%), 1990-2006

![Graph showing GDP and industrial production growth from 1990 to 2006.](image)


1.5 It has been estimated that agricultural production in 2006 was about US$20 billion, an increase of 13% from the previous year.¹

**Strong Domestic Driving Forces**

2.1 China’s high growth has been fuelled by both domestic demand (consumption and investment, especially the latter) and foreign demand (exports). For a huge economy like China or the US, domestic consumption normally should constitute the mainstream of economic growth. China’s economic growth, however, has been mostly investment driven since the early 1990s. In the long run, high levels of domestic investment in China will not be sustainable. The Chinese government, since the previous premier Zhu Rongji’s era (from the late 1990s), has been trying to encourage domestic consumption to become a driving force of economic growth. Unfortunately, today, almost ten years later, the pattern of China’s economic growth has remained largely unchanged.

2.2 China’s growth rate of fixed assets investment has been persistently higher than the growth rate of its final consumption. Figure 2 shows the relationship between them. It shows that 2005’s 10.2% of GDP growth was primarily driven by a 27.8% rise in fixed assets investment but only a 12.9% rise in final consumption. China saw a 31.3% growth in urban fixed assets investment in the first half of 2006, the highest in the past three years. In the first eleven months of 2006, fixed assets investment increased at a hefty 26.6%, but final consumption rose only 13.6%. It

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can therefore be estimated that the economic growth pattern of China for 2006 should be quite similar to that in 2005.

Figure 2: Domestic Demand: Fixed Assets Investment & Final Consumption Growth (%)

* Data source: *China Statistic Yearbook*. Data for 2006 are from January to November. The final consumption uses Total Retail Sales of Consumer Goods as a proxy.

2.3 In order for the people to enjoy the fruits of fast economic growth it would be necessary for the economy to shift more resources towards the production of goods and services for domestic consumption, rather than for exports or investments. The continued high levels of investment in industries such as steel, which already showed signs of excess capacity, suggest that capital misallocation has been an obvious defect in the Chinese model of economic growth.

2.4 Statistical data show that total public and private consumption accounted for 51.1% of the country’s GDP in the first three quarters of 2006, down from 62% in the 1980s. The proportion of private consumption in GDP hit a record low in 2005, dropping to 38.2% from 48.8% in 1991. Investment accounted for 49.9% of GDP growth, while consumption contributed only 35.7% in the first three quarters in 2006. Too much of growth has been driven by trade and investment rather than consumption. Therefore, the Chinese government would continue to rein in investment and credit, focusing on the adjustment of investment structure and improving investment returns, and to tighten control on the real estate sector by both market mechanism and administrative intervention.

2.5 In China fixed assets investment mainly comprise infrastructure and industrial development. The key source of investment funds is domestic savings. Chinese people tend to save rather than borrow, resulting in an extraordinarily high rate of saving in recent years because of rapid income growth and the lack of alternative investment channels. From 1990 to 2005, China’s total household bank deposits rose from RMB 7,119 billion to RMB 14,115 billion, with an average annual growth of 22%. Savings were 46.4% and 51% of GDP in 2004 and 2005 respectively, whereas the global average rate was only 19.7% in 2005.5 Partly due to the bull stock markets in the second half of 2006, savings deposit growth in October decreased for the first time in five years.

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Financial data from the People’s Bank of China (PBC) indicated that October’s total savings balance was RMB 15.8 billion, at a monthly growth rate of 15.5%, which was the lowest since April 2006.

2.6 Investment-led growth is bound to lead to bias in resource allocation, in favour of capital, enterprises and government, causing, therefore, a relatively low weight of labour compared to capital. This in part explains the unstoppable rising trend of income inequality, urban-rural divide and industry-agriculture divide, aggravating China’s so-called ‘Three Nongs’ (agriculture, rural and peasant) problem, as resource allocation induced by the investment-led growth model has been heavily biased against agriculture, rural areas and peasants’ incomes. China’s social security deficiencies have led to its large household precautionary savings. The financial system reform faces severe difficulties and cannot channel domestic savings through the market mechanism into effective investment. The government dictates bank saving and lending rates, deliberately making investment capital cheap at the expense of savers, enabling commercial banks to earn easy interest incomes. Therefore, consumption growth is constantly lower than investment growth, pushing China onto a vicious track of ‘high investment and high savings’.

2.7 In 2006 China made substantial investment in its railway and highway system. During the first eleven months, the fixed investment in the railway system was US$ 21.19 billion, an 84% increase from the previous year, in which the investment in railway infrastructure was about US$ 16.65 billion, a 104.8% increase comparing with the same period of 2005. China built 1,928km of new railways in 2006, and another 6,289km are under construction. In April 2007 China will, for the sixth time, raise the overall speed of the railway system and start to build several additional expressways, connecting major cities. From January to November 2006 the investment in highway transportation was about US$ 68.37 billion, a 14.5% increase. In 2005 China built 49,000km of highways, of which 6,700km were motorways. By the end of 2005 China had built 41,000km of motorways, which was the world’s second longest motorway network. In 2006, another 4,460km of motorways were built, making the total length of the network 45,460 km, which was about five times that of the UK motorway system. The plan for 2007 is a further 5,000km.

2.8 In 2006 China built three more large seaports, in addition to the previous ten, with an annual capability of handling over 100 million tons of cargo. Shanghai Port handled 465 million tons of cargo in 2006, continuing to be the world’s largest in terms of handling capability. The overall capacity of cargo handling in China increased by 17.1% in 2006.

2.9 In 2006, China was the second biggest producer of electricity in the world after the US. In the first three quarters of 2006, China consumed 2075.8 billion kwh of electricity, a rise of 9.2% over the same period in 2005. During the 11th FYP period, China’s electricity generation capability would be expected to increase by 250 million kwh to reach a

6 Data source: Ministry of Railways.
9 China Power Sector Analysis Report (First Three Quarters, 2006).
total capability of 750 million kwh. As a main producer and the largest exporter of steel, China produced 339 million tons during the first three quarters in 2006, an increase of 23%. The total production in 2006 is expected to be over 400 million tons, or one-third of the world’s total output. Its consumption in the first three quarters reached 287 million tons, a 10% increase.\(^{10}\) China produced 1.06 billion tons of cement in 2005, which was 48% of the world production, and has been the world’s top producer for twenty-one consecutive years. In the first nine months of 2006, the production volume was 871.55 million tons, 20.7% up from the previous year.\(^{11}\) The total output of coal was estimated to be 2.3 billion tons in 2006.

2.10 China produced 7.28 million vehicles, and sold 7.22 million, in 2006. These two numbers suggest a growth of 27.32% and 25.13% respectively, making China the world’s third largest automobile producer, overtaking Germany, and the second largest consumer, surpassing Japan. Roughly every 5 seconds, there was one car sold in China.\(^{12}\)

2.11 2006 witnessed China’s stock market ending its four-year long bearish cycle and entering into a bullish one. According to the records of the last trading day of 2006, Shanghai and Shenzhen Stock Exchanges rose over 130%, compared with the first trading day of that year.

**Roaring Foreign Demand**

3.1 The export boom started in 2002, the first year after China joined the WTO, and continued in 2006 despite growing protectionism from the US and the EU against Chinese textile, garment and shoe manufacture. Figure 3 illustrates the rapid growth of exports from 2002. In 2006 China’s total imports and exports passed US$ 1.761 trillion, a 23.8% increase in growth compared with 2005. Exports in 2006 grew 27.2% to US$ 969.1 billion while imports grew by 20% to US$ 791.6 billion.\(^{13}\) They yielded a sizeable trade surplus of US$ 177.5 billion, compared to US$ 110 billion for 2005. Since 2004, China has been the world’s third largest trader after the US and Germany, and is expected to overtake Germany’s place in the world’s top two by the end of 2007. As imports into the US greatly exceed its exports, China may become the world’s largest exporter by the end of this decade, although its trade volume will continue to be less than that of the US well into the second decade of the twenty-first century.

\(^{10}\) Data source: OECD China, ‘Steel Committee Market Prospect’.


\(^{13}\) Figures are from China Customs.
3.2 External demand for China’s exports is mainly for merchandise goods, partially due to its trade advantage in labour costs, and various government policies in favour of exporting industries. However, the contribution of external demand to China’s domestic growth is somehow ambiguous. Statistical data shows that China’s net export (the difference between exports and imports) contributes never more than 5% to its GDP growth.\textsuperscript{14} Over recent years, both exports and imports have soared, and exports have consistently grown faster than imports. China’s trade surplus keeps generating its historically high records. External demands are definitely contributing more to overall growth, although the absolute proportion should be relatively low, still.

3.3 The pattern of China’s direction of trade in 2006 showed some noticeable changes, especially on the import side. Compared with the situation a year earlier, most of China’s major export destinations remain the same, except that India entered the top ten for the first time (Figure 4). It may, in some way, reflect the Chinese leadership’s long term strategy with its large neighbour, another fast-growing economic giant. On the other hand, however, some countries which are the important natural resource exporters, such as Brazil, became China’s top import destinations. The trading volumes with Saudi Arabia, Russia and Australia have been significantly increasing. China has been desperately seeking for energy, natural resources and raw materials to fuel its rapidly expanding economy in recent years. The constant dispute between China and the US, and China and the EU, on the trade imbalance with them, has exerted pressure on China drastically to increase imports from both of them. Compared with the same period in 2005, in 2006 China increased its import volume from the US from US$ 39.78 billion to US$ 49.14 billion, a 23.53% increase, and from the EU from US$ 60.02 billion to US$ 73.59 billion, a 22.6% increase.\textsuperscript{15}

\textsuperscript{14} John Wong, ‘China’s Economy 2005: Growth and Its Problems (II).’ \textit{China Policy Institute Briefing Series}, Issue 5, January 2006, China Policy Institute, University of Nottingham, UK.

China’s trade surplus in 2006 reached a record level, triggering concern from the Chinese government as well as from China’s key trading partners, especially the US, which has typically contributed about half of China’s trade surplus. Rising trade surplus has fuelled a rapid rise in China’s foreign exchange reserves. By the end of 2006, the total foreign exchange reserves reached US$ 1.07 trillion, breaking the symbolic US$ 1 trillion record for the first time, after overtaking Japan to become the world’s largest holder of foreign exchanges in February 2006. Before 1979, China’s foreign exchange reserves never surpassed US$ 1 billion. In 1981, the total reserves were only US$ 2.7 billion. By the end of 1990, the total reserves broke the US$ 10 billion record, reaching US$ 11 billion. By the end of 1996, the US$ 100 billion record was broken. Before China joined the WTO in 2001, the reserves surpassed US$ 20 billion. It was only after China’s accession to the WTO that new records have been broken year after year. In the past five years, the total amount rose fivefold by the end of 2006, to surpass US$ 1 trillion and for China to comfortably become the world’s largest holder of foreign money. China’s policy on the management of its foreign exchange reserves has been controversial and frequently criticised by academics, and by foreign governments. China’s vast holding of US dollars has made the global markets highly sensitive to any decision that the PBC makes on its reserve assets, or information that it provides about them.

China is running a unique pattern of trade balance with its major trading partners. Figure 5 shows that, as in the previous few years, China in 2006 continued to run substantial trade deficits with East and Southeast Asian economies and those energy exporters. By contrast, it had a considerable surplus with the US, the EU and Hong Kong. China’s extensive trade deficit with its neighbouring economies also signifies that China has opened up its vast domestic market for their exports in both manufactured products and primary commodities. Therefore, China is operating as an engine for those economies’ growth. This will undoubtedly further raise China’s geo-political and geo-economic influence in the region, and even in Africa and Latin America, which are easy targets for China to forge political alliance. Africa used to be a neglected continent of economic growth, partly due to the ineffective economic policies forced on it by the World Bank and the International Monetary Fund. With China’s rise, there have been rising interests in

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16 People’s Daily overseas edition, 16/01/2007, p1, ‘China’s Foreign Exchange Reserves Pass the US$1 Trillion Level for the First Time’. 

* Data source: Ministry of Commerce of China.
Africa for China to seek for resources and markets, and for the western powers to struggle to maintain their dominant influence on the economic and political affairs of African states. As more and more African and Latin American countries are attracted to China, the western powers have begun to consider China not just as an economic competitor for their exports but also as a fierce competitor in international relations and diplomacy.

Figure 5: China's Trade Balances with Its Top Partners, Jan-Oct 2005 & 2006

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>-6.6</td>
<td>-8.5</td>
</tr>
<tr>
<td>Angola</td>
<td>-4.8</td>
<td>-8.6</td>
</tr>
<tr>
<td>ASEAN</td>
<td>-15.0</td>
<td>-15.3</td>
</tr>
<tr>
<td>Japan</td>
<td>-12.4</td>
<td>-19.1</td>
</tr>
<tr>
<td>Korea</td>
<td>-46.4</td>
<td>-33.1</td>
</tr>
<tr>
<td>Taiwan</td>
<td>-54.1</td>
<td>-4.4</td>
</tr>
<tr>
<td>UAE</td>
<td>-4.1</td>
<td>-8.6</td>
</tr>
<tr>
<td>EU</td>
<td>5.4</td>
<td>6.8</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>52.0</td>
<td>71.7</td>
</tr>
<tr>
<td>USA</td>
<td>86.9</td>
<td>92.8</td>
</tr>
<tr>
<td>Japan</td>
<td>114.0</td>
<td>116.2</td>
</tr>
</tbody>
</table>

* Data source: Ministry of Commerce of China.

3.6 Most of China’s exports are processing trade, which took up 52.6% of total exports in the first ten months in 2006. In addition, about 58% of China’s exports during the same time were conducted by foreign-invested companies, particularly those from Japan, Korea, Taiwan and Hong Kong. China uses imports to supply for its exports and only earns an extremely low domestic value-added from the processed products. China’s foreign trade has become a critical link in the East Asian supply chains. China, now a true world manufacturer, obtains raw materials, parts and components, technology and even financial services from Asian economies or elsewhere, and converts the products from ‘Made in Asia’ into ‘Made in China’ to supply the world markets. In this sense, China’s trading and manufacturing industries not only operate as the engine of its own growth, but also as a channel for regional and global economic corporation.

3.7 To promote the country’s balance of international payments has become a priority for the Chinese leadership’s further economic work. Chinese leaders pledged to redouble efforts to vigorously expand imports and overseas investment, while maintaining rational export growth and use of foreign investment. It is one of the government’s objectives of macroeconomic regulation and control, which are aimed at maintaining macroeconomic stability. On one hand, it is to rebalance China’s trading position. On the other hand, it is to relieve the growing difficulty and risk of managing such enormous foreign reserve assets. In a recent meeting on foreign trade, China’s minister of commerce, Bo Xilai, suggested that the top priority in China’s foreign trade policy was to reduce trade surplus through the expansion of domestic consumption, although a

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balance had to be struck so that employment was not jeopardised as a result of a trade policy shift.\textsuperscript{18}

3.8 China is pursuing its currency appreciation following its principle of gradualism, despite continual and strong foreign pressures calling on China to accelerate the process. By the end of 2006 the RMB's exchange rate against the US dollar had appreciated by about 5.68\%, at about $:\text{RMB} = 1:7.81$, since July 2005 when the RMB was allowed to float. As the Chinese government repetitively highlighted, it can be believed that in the long run RMB's exchange rate will have an upward trend due to China’s economic strengthening, and in the short run sudden or large scale appreciation could not be expected. This is best reflected in the high-level meeting in Beijing at the end of 2006 between top US economic officials led by treasury secretary Henry Paulson and their Chinese counterparts led by Vice-Premier Wu Yi. The final outcome of the meeting clearly signalled that China had principally stood its own ground and did not behave simply according to the political demand of the US for a large measure revaluation of the RMB.

3.9 China is either the first or second largest world foreign direct investment (FDI) host country in recent years. Certainly, FDI is one of the most important explanatory variables for China’s growth in the past twenty years-plus. Yao and Wei (2007) estimate that FDI has contributed to more than one-third of China’s total factor productivity growth, which was about 3.5\% per year, over the data period 1980-2003.\textsuperscript{19} FDI contributes enormously to economic growth in general and to export industry in particular. In 2006 the growth rates of both contracted and utilised value of FDI decreased, reflecting China’s efforts to improve the quality of FDI. Figure 6 shows FDI as a percentage of China’s GDP from 1990. Since its reform and opening-up in the late 1970s, up to the end of September 2006, China had received over US$ 665 billion FDI from over 200 countries and territories. The accumulative number of foreign invested companies was over 570,000. Since the open door policy, China’s economy had been growing at an average rate of 9.7\%, of which about 2.7\% was contributed by utilising foreign investment. FDI also provided about 25 million direct employment opportunities, which was nearly 11\% of China’s total urban workforce. By the end of September 2006 foreign investors had established more than 800 research and development centres in China. The technology and organisational spill-over effects from foreign investment and companies have helped domestic industries to improve their efficiency and productivity.\textsuperscript{20}

\textsuperscript{18} People’s Daily overseas edition, 16/01/2007, ‘Bo Xilai Suggests that the Top Priority of China’s Foreign Trade Policy in 2007 is to Reduce Trade Surplus’.


\textsuperscript{20} Data are from Ministry of Commerce of China statistical data.
FDI, on the other hand, may have also caused various negative consequences in China, such as unfair competition between domestic and foreign firms, unbalanced development among industries, aggravation of regional disparity and environmental pollution. Further, large mergers and acquisitions of domestic enterprises by foreign investors raise concern about economic security issues, especially when some foreign commercial giants are suspected of monopoly, and abuse of their dominant market positions in certain important economic areas, and so on.

Figure 7 shows the utilised FDI source structure from January to November 2006. The investment from the top ten source countries and territories amounted to US$ 45.375 billion, accounting for 83.62% of the total utilised FDI in the same period. The pattern of FDI inflow had changed very little from that of recent years. Hong Kong took the biggest share, followed by British Virgin Islands, due to its special financial significance, Japan, Korea and the US, which were among China’s top trading partners. It was also consistent with the fact that foreign invested enterprises in China accounted for 56% of China’s total exports during the first ten months of 2006.\(^{21}\)

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\(^{21}\) Ibid.
**Stable Macroeconomic Conditions**

4.1 It is clear that China’s economy enjoyed another year of very strong growth. The high growth, mainly driven by fixed assets and infrastructure investment, continues to signal the risk of economic overheating since 2003. In particular, China’s economy surged year-on-year 10.9% growth in the first half of 2006, with an 11.3% for the second quarter alone, roaring ahead despite a slew of measures imposed by the central government to ease the blistering growth of investment. However, under such a persistent strong growth speed, China managed to maintain low inflation. Its consumer price index (CPI) for the first eleven months of 2006 was only 1.3%, at a healthily low level. In fact, China has been keeping a low inflation rate since the late 1990s. Figure 8 gives the relationship between China’s GDP growth rate and inflation rate, measured by CPI.

![Figure 8: China’s Economic Growth & Inflation (%), 1990-2006](image)

* Data source: *China Statistic Yearbook*. Data for 2006 are from January to November.

4.2 Since the early 1990s China’s urban registered unemployment rate had kept increasing for over ten years until 2003, when it hit 4.3%. From 2004 to the middle of 2006, it had been controlled to stabilise at around 4.2%. The recent ‘Eleventh Five-Year Plan for Labour and Social Security Sectors (2006–2010)’ issued by the Chinese Ministry of Labour and Social Security, stated that the urban unemployment target for the time period should be below 5%. To maintain a reasonable unemployment rate, the Chinese government has to keep its economy growing fast. The contradiction leaves the Chinese leadership in a dilemma: on one hand, the risk of economic overheating, and the enormous negative consequences of extensive growth, urge the development to slow down; on the other hand, the unemployment problem and its associated potential social instability issues force further acceleration of the engine of growth.

4.3 In 2006 the Chinese government made great efforts to address the potential economic overheating. It implemented a series of policies, such as investment project clearance, raising the central bank base rate, restrictions on the real estate sector, and putting an emphasis on energy

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efficiency, all of which are aimed at controlling investment, especially that by local governments. These methods, amongst others, certainly exert positive effects on the economy. The National Bureau of Statistics of China (NBS) claims that China's macro-economy has remained sound and stable, with the trend of overheating growth being reined in.\textsuperscript{24}

4.4 In recent years the Chinese government has achieved strong and rapidly growing fiscal revenues. In 2003, government revenue reached 2 trillion RMB. In 2004, it was more than 2.5 trillion RMB, rising to 3.5 trillion RMB in 2005, and is expected to reach 3.9 trillion RMB by the end of 2006.\textsuperscript{25} The healthy growth of government revenue is a fair reflection on the prosperity of China, which is certainly in its top gear of industrialisation.

4.5 In general, the three main powers of China’s economy, investment, trade and consumption, have all shown strong growth in 2006. China will continue to ensure stable monetary and fiscal policies, in order to optimise the ties between investment and consumption, and domestic and foreign demands, with the fundamental goal of encouraging domestic consumption demand. China is aiming at improving the income and consumption ability of low-income urban and rural citizens by further adjusting its income distribution system. Whilst maintaining rational growth of exports and FDI, China will actively expand imports and optimise the structure of import products, and systematically increase China's investment abroad. China expects to rapidly enlarge its consumption and alleviate its problem of unbalanced international payments.

\textbf{Economic Reform and Challenges Ahead}

5.1 With almost three decades of unrestrained growth, China’s economic growth process has inevitably created, and accumulated, quantities of socio-economic side effects. The starting year of the 11\textsuperscript{th} FYP, 2006, was the important time for Chinese policy makers to rebalance and reorient China’s development route.

5.2 2006 was the year in which China needed to fully open up its financial market to foreign competition under the agreement of China’s accession to WTO in 2001. China’s bank reform was under ever high pressure to improve commercial banks’ efficiency, since it is the key for domestic banks to survive in a liberalised environment. Without much success before, the last hope for raising bank efficiency is through ownership reform. A critical element of ownership reform was to restructure the Big Four\textsuperscript{26} state-owned as well as other commercial banks to enable them to be listed in the stock exchange markets, subjecting them to monitoring and control by share holders, rather than only by politicians.

5.3 The first bank of the Big Four being listed was China Construction Bank (CCB), whose initial public offering (IPO) in the Hong Kong Stock Exchange in October 2005 raised US$ 8 billion. It was followed by Bank

\textsuperscript{26} They are Industrial and Commercial Bank of China (ICBC), Bank of China (BoC), China Construction Bank (CCB) and Agricultural Bank of China (ABC).
of China (BOC), which was listed in both Hong Kong and Shanghai Stock Exchanges in May 2006, raising US$ 11.2 billion. The IPO of the Industrial and Commercial Bank of China (ICBC) in October 2006 in Hong Kong and Shanghai raised US$ 21.9 billion, setting a new world record.

5.4 The most recent restructuring of commercial banks shows the determination of the Chinese government to fundamentally reform the banking sector. Not only are the domestic banks being transformed from state-owned to share-holding companies, foreign banks are also allowed to buy shares of these banks, as well as setting up their branches in China. From 11 December 2006, foreign banks and their subsidiaries have had no business or geographical restrictions on their services for Chinese customers. The successful IPOs indicate that the government has achieved its first goal of ownership reform with foreign competition after WTO accession. Yao and Han (2007) estimate that the large Chinese commercial banks have been supported by the state to drastically reduce non-performing loans and improve total factor productivity at the rate of 5.6% per year during 1998-2005.27 The listing of China’s largest commercial bank, ICBC, was received with extraordinary enthusiasm by investors. In two months, from its listing on 27 October 2006 to 27 December 2006, its share price in the Shanghai Stock Exchange rose about 70%. This partly reflected the significant support by the government and investors’ positive perception of China’s future economic prospects. Of course, it needs to be stressed that investors in China may be far too speculative in the market, and the rapid rise of share prices can pose a risk for any future financial crisis. A similar and even more extraordinary story can be told from the IPO of China Life Insurance Co., whose share price on the first day of trade on 11 January 2007 gave initial investors a quick premium of over 100%. The offer price was about RMB 18 a share, but the market price on the first day of trading reached as high as RMB 40 a share.

5.5 Many problems associated with China’s development process, such as inadequate social security, widening of the income gap, excessive resource and environmental pressure, and one-sided pursuit of growth rate by local governments etc., are attributable to China’s lack of institutional mechanisms to effectively redistribute the fruits of growth. The Chinese leadership has realised this and continued to carry out reforms in 2006 to put in place an effective institutional framework, to regulate or guide the operation of the market. Without effective institutional safeguards, the market tends to work for ‘efficiency’ at the expense of social equity.

5.6 In 2006 China promoted state-owned capital to focus on the key areas and industries related to national security and economic lifelines. In December 2006, the State-owned Assets Supervision and Administration Commission (SASAC) specified seven such areas and industries, including the military industry, electricity and its grid, oil and the petrochemical industry, telecommunications, coal, civil aviation and shipping.28 The SASAC has been trying to speed up the shareholding system reform in the state owned enterprises (SOE), to improve the corporate governance

27 Yao, Shujie and Han, Zhongwei (2007), Ownership Reform, Foreign Competition and Efficiency of China’s Commercial Banks, forthcoming, Discussion Paper, China Policy Institute, School of Contemporary Chinese Studies, University of Nottingham.
structure, and to encourage enterprises to optimise the allocation of resources.

5.7 China has made efforts to regulate its state-owned monopoly industries, especially some high profit firms’ income distribution system, which have been recurrently criticised for their unreasonably high pay. In the sixth plenum of the Sixteenth Party Congress in October 2006, the Chinese leadership raised a proposal to suppress the ‘special interest groups’. The so-called ‘special interest groups’ have some common economic benefits, political purposes or social background. In order to maximise their common interests and achieve their common goals, these groups or individuals form an alliance. In the Chinese context, they are normally a monopoly, exclusive and parochial. To achieve their own interests, they would undermine fairness and justice and social harmony.

5.8 China has been the fourth largest economy in the world since 2005. To achieve the economic growth target set by the 11th FYP, China only needs to maintain an average annual growth rate of 7.5%. However, to achieve the overall development goal, China has to dramatically reduce energy consumption and waste emission, transform its growth model, optimise its industrial structure and enhance the ability of independent innovation (innovations made solely by Chinese researchers and institutions), all of which still has a long way to go.

5.9 Since Hu-Wen’s leadership came into power, China has dedicated itself to adjusting its growth model to be a balanced process, with an emphasis on environmental issues, especially on energy consumption. The 11th FYP includes a pledge to reduce energy consumption per unit of output in the next five years. The Chinese premier Wen Jiabao further specified in early 2006 in his working report that China should try to reduce its energy consumption per unit GDP by 4%. However, since the cumulative problems associated with the old growth model could not be solved promptly, during the first half of 2006 energy consumption per unit GDP, instead of decreasing, continued to increase by 0.8%, and many major indexes of pollutants emission also increased. 2006 has been a bleak year for China’s environmental situation. Pan Yue, Vice-Minister of the State Environmental Protection Agency, admitted that the target for cutting energy use and also emissions had not been met. Nevertheless, it would not affect the central government’s determination to achieve the goal of altering China’s growth pattern to be environmentally friendly and sustainable. According to the aims articulated by the 11th FYP, by 2010 China has to reduce its energy consumption per unit GDP by about 20%, and its major pollutants emission by 10%.

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5.10 In 2006 particular importance was attached to independent innovation. In January 2006 China’s National Science and Technology Conference set the aim of building China into an innovative state by 2020. China’s State Council issued the National Mid- and Long-Term Scientific and Technological Development Plan Guideline (2006—2020) and its Complementary Policies. The Chinese Ministry of Finance supplied RMB 71.6 billion for science and technology development in 2006 (about 3.3% of GDP), an increase of 19.2% compared with the year before. China maintains its advantage in many areas such as manned spaceflight, high-performance computers, biotechnology, energy, new materials, etc. Independent innovation is a long process, and China has just begun its first steps in this long march. The encouraging achievements so far, and the development trends and requirements, will enhance the government’s determination to build an innovative country.

5.11 ‘Building a new countryside’ is an important part of Hu Jintao’s ‘harmonious society’ policy. The 11th FYP published in early 2006 listed ‘developing modern agriculture’ and ‘developing agricultural productivity’ as the priorities of ‘building a socialist new countryside’. The most significant decision for the rural development that the Chinese government made was to abolish the agricultural tax, effective from 1 January 2006, as a preferential policy in favour of peasants and rural areas. From then on, agricultural tax with a 2,600 year history in China has, for the first time, been abolished. China is at the stage of transition from traditional to modern agriculture. The government has been taking advantage of high economic growth and abundant fiscal income in recent years to boost investment in rural areas, focusing on upgrading agricultural technology, and on modern equipment and training for the peasants. The main target of ‘building a new countryside’ is to narrow the urban and rural income gap. The sixth plenum of the Sixteenth Party Congress in 2006 proposed the main tasks as being, essentially, to establish a social security system covering both urban and rural residences and to improve the basic public service system by 2020.

5.12 High investment in the real estate industry, resulting in extraordinarily high prices, especially in the rich coastal big cities, has been a main concern for a potential economic bubble. In 2006 the central Chinese government made great efforts to regulate the development of the sector, restricting the development of luxury residential properties in particular, and subsidising housing for people on medium and low incomes. However, the effects of those new regulations have not become fully apparent in the economy. The steep increase in housing prices shows some slowing, but its upward trend does not change. The government will definitely continue to direct and control this sector effectively.

5.13 The government explains that improving people’s living standards is the aim of China’s economic and social development and is the base for a harmonious society. Specifically, the government is working on improving the equitable income distribution system by direct supervision and tax adjustment, improving employment conditions, providing available and affordable education and a social security system including health

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services. There have been frequent complaints in the socio-economic sector about 'the difficulty of going to school and the difficulty of seeing doctors'. China's education reform has dramatically improved education availability, especially higher education. However, the tuition fee system reform and commercialisation have to some extent, made education unaffordable for many low-income families. The rapid expansion of higher education also causes employment problems for graduates, since society does not generate new employment opportunities as quickly as the number of new graduates increases. Chinese officials admitted that China’s health service reform during the past two decades was generally unsuccessful. Neither the patients nor the hospitals, and neither the rich and the middle classes, nor the poor, are satisfied with the current system. To provide affordable education and health services according to different levels of people’s needs is still a challenge for the Chinese government.

5.14 In 2006, China maintained its high growth momentum, but started to alter its old extensive growth pattern to a more intensive one. China spent great effort in many economic, social and political realms, in pursuing the course of building a harmonious society. However, the effects of those government policies have not yet become apparent. China's immense domestic achievements are associated with social tensions and excessive foreign pressures. At China's current development stage, economic growth is still the hard truth. It would be difficult for many policy initiatives to fundamentally change the situation. Government investment (including the investment made by SOEs and other affiliated bodies), which already account for a large proportion of the overall investment, will be highly likely to continue to increase, rather than to slow down. In the near future the Chinese government will indisputably continue with macroeconomic control and adjustment, following the principles of the 11th FYP. China has developed into an industrial power, but is still far from being a developed society. The road leading to such a goal is necessarily long and rough. The reform of the financial markets, especially making state-owned commercial banks and insurance firms become share-holding companies, is bold but important. Making these banks and insurance companies really competitive and profit-making is equally challenging. If managed well, China’s next round of growth will still be high, and the quality of growth will be better. Managed poorly, the potential damaging consequences caused by any revised failure of these financial institutions can easily subject China to an unprecedented financial crisis. This paper ends here with a cautious but yet positive note on the future of economic growth, as China has accumulated many years of positive experiences in tackling difficult economic, social and political problems. China’s gradual and pragmatic approach to reform remains an exemplum for other less developed economies to follow.