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Kontakt/Contact:

Dr. Kathrin Rübberdt

Tel. ++49 (0) 69 / 75 64 - 2 77

Fax ++49 (0) 69 / 75 64 - 2 72

e-Mail: presse@dechema.de

Trend Report : The State of the Chinese Economy: Maintaining growth without overheating

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- China's economy appears to have weathered the crisis without serious effect
- Government stimulus programs compensate for fall in exports
- Structural changes in the economy continue to create attractive opportunities for investment and collaboration

Many observers around the world are focusing their attention on China. Politicians, business leaders and the media are looking for signs of a recovery which could signal a turnaround in the world economy. Countries like Germany that are large exporters hope that China and other emerging countries will stimulate growth in their domestic economies.

China's economy appears to have weathered the crisis without serious effect. According to figures released by the Chinese government, the economy expanded by 8.7% during 2009, which was significantly better than predicted. China became the world's largest exporter at the end of the year. After 14 consecutive months of decline, exports increased by 18% in December. However, domestic demand was the real factor which stimulated growth. The Chinese economy expanded by 7.7% during the first three quarters of 2009, with an increase in domestic consumption providing a boost of 4 percentage points. Investment also contributed 7.3 percentage point, but this rise was offset to some extent by a negative impact of 3.6 percentage points caused by the decline in exports. Import levels are another indication that domestic demand is now playing a more significant role than in the past. Imports rose by 56% in December 2009. Instead of being a mere extension of the world's manufacturing base, China is now becoming an increasingly attractive sales market. The Chinese economy is having a stabilizing effect on the European and worldwide economy. In the second quarter of 2009, German exports to China were 3.4% higher than in the previous quarter. Exports to China compensate to some extent for a sharp fall in German exports to other Asian countries.

The figures show that investment is not the only factor that is driving sales in China. The consumer market is also rapidly expanding. Car sales were up by more than 52% to 10.3 million vehicles, making China the world's biggest automobile market ahead of the US. According to figures provided by the Chinese National Bureau of Statistics, retail sales during the first nine months of 2009 also rose by 15.9% year-on-year. Experts point out however that Chinese consumers have a long way to go before their importance for the

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economy is comparable to the situation in other countries. Private consumption increased by 8% over the last years, but national product expanded by 12%. Consumption accounted for 35.5% of economic output. By way of comparison, the figure was 70.1% for the US during the same period and 54.7% for India (an emerging nation).

Economic stimulus from the government on a large scale in recent months is the reason behind the apparent immunity of the Chinese economy to the financial crisis. The 4 trillion RMB (€428 billion) which the government has decided to pump into the economy is one of the largest stimulus packages worldwide during the current crisis. Following a few revisions and modifications, the Director of the National Development and Reform Commission Zhang Ping outlined at a press conference in March how these funds will be allocated. 1.5 trillion RMB (€160 billion) is earmarked for infrastructure projects. Highway construction, airport expansion/modernization and continued development of the railway network will give a boost to the somewhat underdeveloped Chinese logistics industry. In addition to the transportation network projects, this section of the economic stimulus package includes water management and other projects.

Another 1 trillion RMB (€107 billion) will be spent to repair earthquake damage and carry out reconstruction work in the Sichuan region. 400 billion RMB (€43 billion) has been allocated to projects which directly benefit the people such as construction of social housing. 370 billion RMB (€40 billion) will be made available for rural development. 150 billion RMB (€16 billion) has been set aside for health, education and culture. 210 billion RMB (€22 billion) of funding will be provided for measures to save energy. Finally, 370 billion RMB (€43 billion) will be available to promote the development of new technologies and carry out industrial restructuring programs. In addition to direct funding, low-interest loans will be available for future technologies within the framework of 10 industry-specific "revitalization and support programs". The financing will be provided by the central government and by regional government agencies which are authorized to issue bonds to raise the funds. Mr Zhang explained that individual projects could be adjusted flexibly if general conditions changed, but the intention is to retain the overall structure of the stimulus package.

However, increasing concern has been raised in recent months. Back at the end of September 2009, the International Monetary Fund (IMF) urged the Chinese government to stimulate domestic demand and reduce the reliance on exports in order to avoid the risk of overcapacity, inflation and a decline in the quality of bank credit. The inflation rate increased 1.9% in December 2009 compared to 0.6% in the previous month. Given the growth rate during the last quarter of 2009, an increasing number of experts are warning against a continuation of stimulus measures and above all the extension of credit at the levels we have seen in recent months. Around 600 billion RMB (€64 billion) of credit was granted during the first calendar week of 2010 alone. Experts are concerned about the possibility of a bubble in the real estate market. In January, the Financial Times quoted an

article from the China Securities Journal which was written by two researchers at the Academy of Social Science: "If the government continues with the same strength of macro-economic stimulus as in 2009, there will be notable economic overheating in 2010."

The government has already reacted to overcapacity in certain industries which have expanded rapidly in recent years, and it is attempting to reduce the problem. Steel as well as solar and wind energy are the primary areas of concern. No investment is planned in the steel industry for a period of three years.

The chemical industry has also begun to react to recent events. Worldwide demand for chemicals fell sharply in 2008, and this had a significant effect on Chinese chemical exports. Average capacity utilization fell from 85% to 55%. Production and export volumes decreased sharply between the fourth quarter of 2008 and the first quarter of 2009. Production rose only 2.5% year-on-year during the first nine months of 2009, ranging between -6.9% in basic chemicals to +11.4% in the special chemicals sector. Chemical production is expected to increase by 8% to \$600 billion for the full year.

The chemical industry regained momentum at the end of 2009, but the situation remains critical in some sectors. The fall in oil prices means that many projects that had appeared attractive are no longer economically viable. The coal-to-liquid (CTL) sector has been particularly hard hit. With only a few exceptions, CTL projects that were in the planning phase have been terminated. Cutbacks are also planned in chlorine-alkali electrolysis, fertilizer production and some other sectors to stabilize prices. In contrast, the State Council unveiled a stimulus plan for the petrochemical industry in the spring of 2009. The plan is to increase oil refinery capacity from 342 million metric tons per annum to 405 million metric tons per annum between 2008 and 2011. Refinery consolidation is on the horizon. New refineries will have capacities greater than 10 million metric tons per annum (MMTPA), and production centers will provide capacity for up to 20 MMTPA. Refineries with capacities below 1 MMTPA will be shut down, and refineries that can produce between 1 and 2 MMTPA will be amalgamated or shut down. Ethylene production capacity will be ramped up to 15.5 MMTPA by 2012. Observers have warned against a further increase the production of chemicals like ethyl acetate, as there is already overcapacity and adding capacity could create problems in the future.

The general level of investment in the chemical industry remains high however. Investment during the first three quarters of 2009 rose 21% to 825 million RMB, which is an indication of confidence in the Chinese market. The pharmaceutical industry, where investment rose by 37%, has played a major role. In its March 2009 forecast, market research firm IMS Health predicted that worldwide sales in the pharmaceutical industry will grow to \$155-185 billion by 2013. The authors expect that the volume of the Chinese market will be in the \$68-\$78 billion range. China's share of the market would rise to 43% compared to 27% in 2008. The prospect of this happening is attracting foreign investors. The Swiss

pharmaceutical maker Novartis has announced its intention to invest \$1 billion to expand its R&D activities in China over the next five years.

The mechanical engineering industry is also benefitting from the stimulus programs. According to a report published by German Trade and Invest (gtai) in July 2009, it appears that the Chinese machinery manufacturing industry was already starting to recover from the world economic crisis at the time the report was released. This is not the case in all segments of the industry however. The effects of the crisis were most drastic in the textile machinery sector. Following a 10.4% decline during the first eleven months of 2008, the situation deteriorated even further in 2009. Revenue was down 19% in the first two months compared to the previous year. The same is true of the consumer-related sector which is heavily dependent on exports. In contrast, there was significant growth in the following sectors during the first 11 months of 2008: construction and mining machinery, brazing, welding and foundry machinery, drive systems, pumps, valves and compressors. Business in these sectors was driven by the booming car industry among others. Steel and plastics also appear to have turned the corner in 2009, at least for the time being. The market for machinery and systems used in the chemical industry expanded by 8% during the first four months, which was somewhat less than the comparable figure for the booming agricultural, construction and mining machinery industries.

China is now not merely an importer. Machinery made in China is generating increasing interest in the global marketplace. Chinese machinery exports rose by 36.1 % in 2008 to \$10.7 billion. Japan held top spot in the import rankings at \$26.5 billion followed by Germany at \$19.7 billion and the US at \$11.5 billion. Metalworking machinery, compressors and construction machinery accounted for the major share of imports. Following a period of strong growth, Chinese imports fell (-16.1%) during the first 4 months of 2009. This was the first time in many years that imports have declined. Exports were also down 16.3 %. There are however major differences between the various sectors. Imports of valves and fittings grew by 9.8%.

Domestic demand is providing impetus to the instrumentation and control market. Following a weak first quarter in 2009, the market is expanding again. According to China Chemical Industry News, the China Instrument Manufacturers Association has forecast a 10% increase in production and sales for the full 12 months of 2009, although earnings will only rise by 5%. 4,322 companies in the instrumentation and control industry employed about 850,000 persons at the end of 2008 in China. Goods worth around \$16 billion were imported from the US, Japan, Germany, Korea and France into China in 2008. About 17% of these imported products are used to analyze physical and chemical properties.

Investors, producers and purchasers are seeing quite a diverse situation in the country. Over the past few years, the momentum provided by exports, which was one of the major forces driving the Chinese economy, has been lost to some extent. However so far, the Chinese government has been largely able to compensate for the loss. All of this is having

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very divergent effects on different industries, and it is important to take a close look at each sector. There are still very significant opportunities. According to German Trade and Invest (gtai), German companies are still taking advantage of brisk investment activity. According to the summary report on economic trends in China which was published in the middle of 2009, companies saw a significant level of interest at the China International Machinery Exhibition in April 2009. German companies submitted successful bids for railway contracts during the initial phase of the economic stimulus program. Chinese customers are interested in core components and leading-edge technology which cannot be produced locally.

Exhibitors at AchemAsia can expect to experience a similar level of interest. The international exhibition and congress on chemical engineering and biotechnology will be held on June 1st – 4th, 2010 in Beijing. There will be ample opportunity during the event to find out more about economic developments in China, explore opportunities for collaboration and make new business contacts.

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(This trend report was put together by a team of experts and international trade journalists on behalf of DECHEMA. DECHEMA does not accept any responsibility for incomplete or incorrect information.)