

33. CHINA

Will China's growth model change?

An economic success story...

Following the start of economic liberalisation in 1978, the average growth rate in China has reached 10% per year, multiplying by close to the factor '10' the GDP per capita in only thirty years. Since the second wave of reforms initiated by DENG Xiaoping in 1992, China's growth model relied ever more on the urban, coastal, export-oriented provinces which were expected to pull the central and western provinces with them. Profound structural reforms were initiated in parallel, which allowed the country to embark on a strong growth path.

During the Asian financial crisis in 1997-98, China's favourable fiscal situation allowed the country to launch a first stimulus package aimed at improving infrastructure. In parallel, China for the first time acted as an anchor for regional economic stability by refusing to devalue its currency against the US dollar.

From 2001 onwards, the export-oriented growth model allowed the country to profit fully from the general acceleration in globalisation. With the Chinese currency continuing to be pegged to the US dollar at a competitive rate and exports growing by double digit rates, China started to accumulated exchange reserves to a degree never observed before. The suspension of the peg in July 2005 and the ensuing gradual appreciation against the US dollar did not change this trend, and provided the country with a valuable buffer during the current crisis.

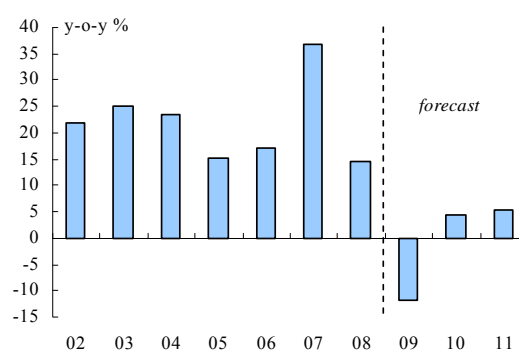
...not lastingly damaged by the Great Recession

With a GDP growth rate of 13% in 2007 – compared to the official target of 8% - economic policy was aimed at avoiding overheating and keeping inflation at bay. This restrictive policy was successful as it succeeded in reducing the growth rate in 2008 to 9% only.

The focus of economic policy only changed in summer 2008, when the RMB was again pegged to the US dollar at an exchange-rate of (around) RMB 6.83 to the US dollar and monetary policy stopped being restrictive.

Following the failure of Lehman Brothers on 15 September, the official line changed rapidly to 'fiscal stimulus and relatively loose monetary policy'. A vast fiscal stimulus programme for the years 2009 and 2010 – corresponding to around 15% of 2008 GDP – was announced in November 2008; its rapid implementation allowed China's economy to recover strongly after the trough in growth reached in the first quarter of 2009, when the GDP growth rate declined to 6.1% y-o-y, driven by a strong decline in exports (down by 23.5% in value terms in the first half of 2009 compared to the same period in 2008).

Graph II.33.1: China - Export volumes growth

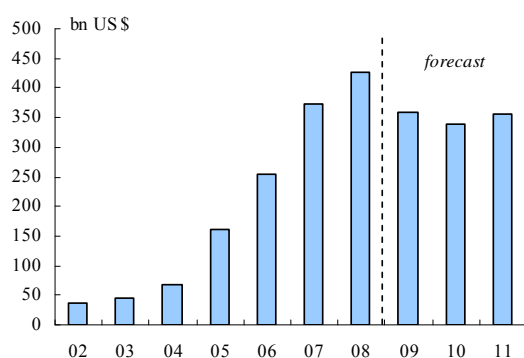


As the decline in exports was to a considerable degree due to the collapse of processing trade, the overall impact on value added in manufacturing has remained limited, but the effects on employment were considerable, with an estimated 20 million migrant workers (out of a total estimate of at least 150 million) losing their jobs and finding themselves without any social security support. As a consequence, the unemployment rate, estimated at 9% in September 2008 by the Chinese Academy of Social Sciences, is very likely to have reached a double digit figure early this year. With many of these unemployed migrant workers returning to their rural homes to celebrate Chinese New Year, the Chinese authorities reacted fast by promoting private consumption in particular in the countryside.

At the same time monetary policy turned decidedly expansionary, mostly through 'informal' instruments such as 'administrative guidance' to banks. As a consequence, in the first half of 2009 the supply of broad money M2 increased by 28.5%

on the year and new loans were up by RMB 7.4 trillion to RMB 37.7 billion. This monetary loosening combined with the fiscal stimulus programme led to a strong rise in fixed asset investments, which rose by more than 33% on the year in the first six months of 2009. Industrial production, which had 'only' risen by 5.1% in the first quarter accelerated to a growth rate of 9.1% in the second quarter (and 10.7% in June), confirming the early and strong recovery of the Chinese economy.

Graph II.33.2: China - Current account balance



Favourable short-term outlook...

Not surprisingly under these circumstances, GDP growth accelerated to 8.9% on the year in the second quarter, already higher than the official 8% growth target. Given the strong rise in loans, an improving external environment and the statistical base effect (due to a very weak fourth quarter 2008), the annual growth rate is likely to accelerate further in the last quarter of this year, bringing the overall growth rate for 2009 to more than 8.5%.

Developments in 2010 are likely to remain favourable, as the fiscal stimulus will be maintained and the external environment is expected to improve further. The likely tightening of monetary policy and the announced reduction in overcapacities in some sectors like steel, however, should lead to slightly lower growth rates in the second half of 2010. With growth in the US forecast to accelerate again in 2011, the running out of the domestic stimulus package should be at least partly compensated for by a more favourable external environment, not least due to a clear recovery in processing trade. However, because of overall strong domestic demand, import growth should be higher than the growth rate of exports both in 2010 and 2011.

All in all, GDP growth in 2010 and 2011 is forecast to reach 9.6% and 9.5% respectively, still implying a relative underperformance compared to the average rate observed since 1978. However, demand by China should give a bottom to global prices of raw materials including petrol.

The growth rate of consumer prices, which is likely to be slightly negative in the current year, is expected to turn positive in 2010 and rise further in 2011.

Data on general government finance is not easily available, but on current trends it appears likely that the general government deficit will be only somewhat higher than the official target of 3% of GDP, in spite of the considerable volume of the fiscal stimulus package.

China's GDP valued at market exchange rates is likely to be the second highest in the world as early as next year and China's contribution to world growth will continue to be the single most important one, far ahead of any other country or region.

...but how about medium to long-term imbalances?

The focus of the stimulus package on infrastructure investment, welcome as it may be in the short term, not least to mitigate the impact of the slowdown on unemployment, has however contributed to increase the existing domestic imbalances of the Chinese economy. Even with real consumption likely to grow by more than 8% in the current year, the extremely high growth rate of fixed asset investment implies that the already low share of private consumption in overall GDP will decline further. In addition, the fiscal stimulus package has allowed some sectors like steel to maintain capacities, which might turn out to be idle if external demand does not return to the growth rates observed in the pre-crisis years.

While the Chinese authorities have announced their intention to cut down on potential overcapacities in these sectors, it remains unclear if and when they will implement this announcement. Furthermore, the expansionary monetary policy is likely to lead to a considerable misallocation of resources, which would not only fuel the growth of non-performing loans in the banking sector, but might even create new overcapacities.

One of the counterparts of this domestic imbalance is the external imbalance. While the huge current account surplus, 11% of GDP in 2007, is likely to continue to decline, as was already observed in 2008, it will remain sizeable in absolute terms (around USD 350 billion in both 2010 and 2011), the decline in terms of GDP being primarily due to the ongoing strong rise in China's nominal GDP figure.

Reducing both domestic and external imbalances appears to be the crucial challenge facing the Chinese economy in the medium to longer term. Under current policies, China risks to see its monetary policy having less and less traction, as speculative capital inflows are likely to rise again, obliging the central bank to intervene via the compulsory purchases of bonds by Chinese banks, which impacts negatively on bank profitability. The assumption of no-policy-change behind this forecast also assumes that the Chinese renminbi de facto remains pegged to the US dollar throughout the forecast horizon.

Table II.33.1:

Main features of country forecast - CHINA

	2008			Annual percentage change						
	bn CNY	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	30067.0	100.0		10.2	11.7	13.0	9.7	8.7	9.6	9.5
Private consumption	10839.2	36.1		-	-	-	-	-	-	-
Public consumption	4072.0	13.5		-	-	-	-	-	-	-
Gross fixed capital formation (1)	111417.4	43.3		-	-	-	-	-	-	-
of which : equipment	-	-		-	-	-	-	-	-	-
Change in stocks as % of GDP	-	-		-	-	-	-	-	-	-
Exports (goods and services)	14306.9	47.6		-	17.1	34.3	8.2	-11.4	4.5	5.1
Final demand	-	-		-	-	-	-	-	-	-
Imports (goods and services)	9559.5	31.8		-	16.4	11.7	6.5	-6.8	5.9	5.1
GNI (GDP deflator)	-	-		-	-	-	-	-	-	-
Contribution to GDP growth :		Domestic demand		-	-	-	-	-	-	-
		Stockbuilding		-	-	-	-	-	-	-
		Foreign balance		-	-	-	-	-	-	-
Employment				1.1	0.8	0.8	0.6			
Unemployment (a)				3.3	4.1	4.0	4.2			
Compensation of employees/head				-	-	-	-	-	-	-
Unit labour costs				-	-	-	-	-	-	-
Real unit labour costs				-	-	-	-	-	-	-
Savings rate of households				-	-	-	-	-	-	-
GDP deflator				-	3.6	7.4	6.5	1.5	3.0	3.0
Private consumption deflator				-	-	-	-	-	-	-
Index of consumer prices (c)				5.6	1.5	4.8	5.9			
Trade balance (b)				2.7	8.2	9.3	8.3	6.5	4.8	4.3
Current account balance (b)				2.1	9.5	11.0	9.8	7.3	6.1	5.6
Net lending(+) or borrowing(-) vis-à-vis ROW (b)				-	-	-	-	-	-	-
General government balance (b)				-1.5	-0.8	0.6	-	-	-	-
General government gross debt (b)				-	-	-	-	-	-	-

(a) urban unemployment, as % of labour force. (b) as a percentage of GDP. (c) national indicator.

(1) 2007