



CHINA ECONOMIC OUTLOOK

A STAFF UPDATE

September 26, 2011

This document has been prepared by the IMF Resident Representative Office in Beijing. It updates staff projections of the main macroeconomic aggregates underlying the IMF's recently released World Economic Outlook Report. It also offers staff views on recent economic trends and their policy implications.

RECENT DEVELOPMENTS

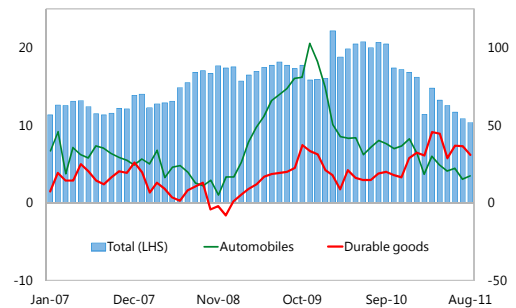
The economy is decelerating but still humming along at an enviable pace

1. **Growth is moderating.** The ongoing withdrawal of monetary stimulus and the scaling back of public spending are leading to a healthy slowdown. Growth in the second quarter was moderately below that seen earlier in the year and the handover from public sector demand appears to be steadily progressing. Labor market conditions are good, supporting household consumption. At the same time, private investment has compensated for waning public infrastructure outlays. Recent indicators—including retail sales, industrial production, fixed asset investment, and purchasing managers indices—point to the economy smoothly navigating toward a soft landing. The main risk on the horizon is, not surprisingly, from the broader downside risks to the global economy (see the IMF's latest World Economic Outlook, <http://www.imf.org/external/pubs/ft/weo/2011/02/index.htm>).

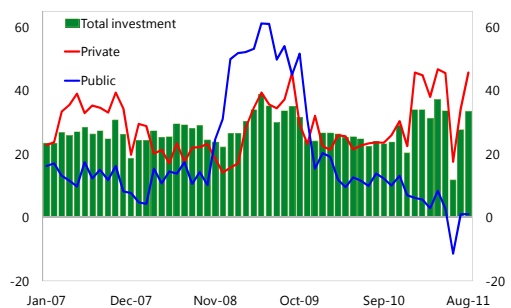
2. **Inflation has peaked but remains uncomfortably high.** Inflation ticked down to 6.2 percent in August from the three-year high

Food prices remain elevated as a new food supply shock—this time to pork—plays out

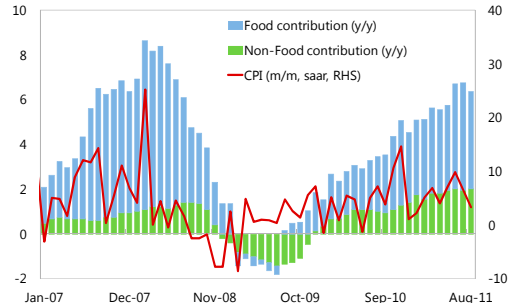
Retail Sales
(In percent, year-on-year growth)



Fixed Asset Investment
(In percent, year-on-year growth)



Inflation
(In percent)



of 6½ percent in July. Food remains the main driver, accounting for more than two-thirds of the rise. The earlier inflationary impulse from fruits, vegetables and grains is dissipating but a new driver has emerged in the form of high pork prices. Nevertheless, the overall momentum behind inflation is subsiding, as evidenced by the sharp drop in the month-on-month price increase since June.

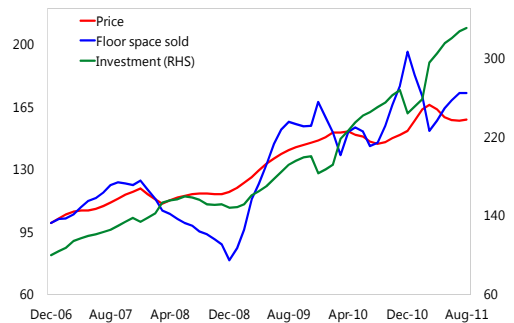
Government measures have been successful in steadily deflating the buoyant property market, although pressures remain

3. *The property market continues to cool.*

In mid-July, home purchase limits were expanded to cover smaller cities, adding to a succession of government measures that have been aimed at gradually slowing property price inflation and dissuading speculation. Both transaction volumes and price increases remain subdued. In July and August, for the first time in three years, prices in some of the largest Tier-1 cities—including Beijing, Shanghai, and Shenzhen—were flat on a monthly basis. Meanwhile, real estate investment has held up well, barely dampened by the slowdown in prices, in part due to an expansion in the construction of social housing. Nevertheless, the underlying fundamentals—notably low real interest rates, lack of financial instruments, and the low cost of carrying properties—leave China vulnerable to property bubbles and the propensity for a boom-bust property cycle remains an important domestic risk.

Residential Housing

(Dec 2006 = 100, sa)

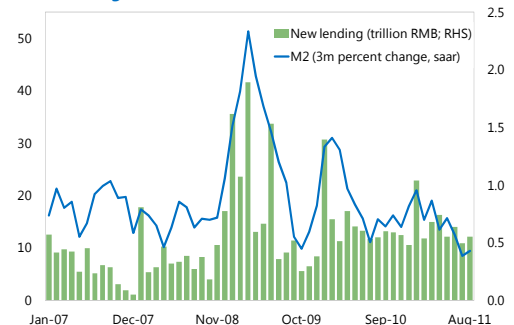


Monetary policy is being tightened but other forms of financing are assuming a greater role in intermediation

4. *Bank lending has moderated but other sources of credit remain active.*

M2 growth slowed to 13½ percent in August and reserve requirements were raised by a further 50 basis points from June 20th. While deposit rates remain negative in real terms, banks are taking advantage of the tighter credit environment to boost profitability by pushing up the cost of loans. Smaller property developers and SMEs are reportedly bearing the brunt of this credit slowdown, although increased non-bank and offshore funding is providing some safety valve for those companies that are rationed out of bank credit. In an effort to lessen the incentives for off-balance sheet loans, the People's Bank of China recently announced that the base for calculating required reserves would be extended to cover margin deposits, including those connected to banks' commercial bill acceptances, letters of credit, and guarantees.

New Lending



Downside risks to the global recovery have increased markedly

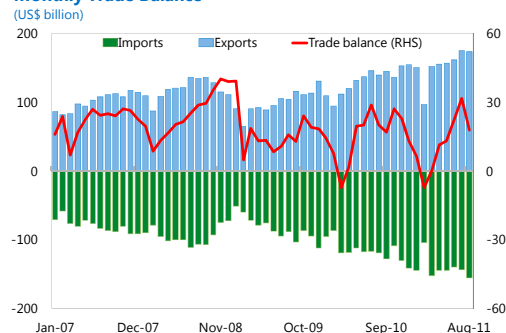
5. *The external environment has entered a dangerous new phase.* As indicated in the IMF's World Economic Outlook, the global economy has slowed, financial volatility and risk aversion have sharply increased, and performance remains uneven across regions. Emerging and developing economies continue to expand, a few at rates that are well above pre-crisis averages. By contrast, activity in the advanced economies is anemic, with the handover from public to private demand having stalled. Weak growth and the lack of a credible medium-term fiscal plan to reduce debt are draining confidence in the United States. In much of advanced Europe, growth is weighed down by high public deficits, lower potential output, and market tensions about the interconnected banking sector and sovereign debt risks linked to the Euro area periphery. The baseline outlook for these economies is for a continuing, but weak and bumpy, expansion. However, risks are clearly to the downside, stemming mainly from a potential escalation in global financial market volatility¹, a failure to contain the crisis in the Euro area periphery, and further blows to the U.S. recovery, including from a political impasse over fiscal consolidation or a weak housing market.

But in China, both exports and imports have been strong, with a rising trade surplus in recent months

6. *Despite this, China's trade performance continues to hold up well.*

Despite the heightened uncertainty in the United States and Europe, exports have maintained a strong sequential momentum. Indeed, export growth surprised on the upside in August, growing 25 percent from a year earlier. China is also increasingly diversifying export destinations toward other emerging markets. Import growth has also been very strong, led by both commodities and capital goods. Foreign exchange reserves continue to climb, growing by a further US\$153 billion in the second quarter to US\$3.2 trillion. The renminbi has continued to move steadily upward versus the U.S. dollar but has moved little over the past year in real effective terms.

Monthly Trade Balance



¹ See the IMF's latest Global Financial Stability Report, <http://www.imf.org/external/pubs/ft/gfsr/2011/02/index.htm>.

THE OUTLOOK

7. *The weaker external environment has led to a modest lowering of our growth forecast.* The

United States and Euro area are now expected to grow more slowly in both 2011 and 2012, with average growth projections lowered by ½ to 1 percentage point. China's large tradable sector will undoubtedly be hampered by this more tepid demand in industrial countries and, as a result, growth for 2012 has been lowered to 9 percent (from 9½ percent expected a few months ago). In addition, the near-term trade and current account

surplus are expected to be somewhat smaller than previously anticipated. Offsetting the bleaker outlook for net exports is a still remarkably good outlook for domestic demand, supported by rising real wages and a healthy job market. Despite this slightly slower pace, China's growth will continue to propel the world economy forward, contributing one-quarter of the overall global growth of 4 percent.

8. *Inflation has now peaked and will steadily decline in the latter half of the year.* With the effects of last year's weather-induced food supply shocks easing and the PBC's tighter monetary stance having an impact, inflation has peaked and should gradually fall back toward 4½ percent by the end of the year. There is some uncertainty in the timing and size of the pass-through of recent rises in pork prices to headline inflation, which complicates near-term forecasting. However, barring further shocks to food supply, inflation should continue on a downward path, reaching 3 percent by end-2012.

POLICY PRIORITIES

9. *Monetary policy should continue to steadily slow the pace of credit growth.* The monetary tightening intended for this year should proceed as planned, in light of continued asset price pressures and the potential worsening of credit quality in coming years. However, the means by which this normalization of monetary conditions is achieved should rely more on higher interest rates rather than credit quotas or increases in reserve

Main Economic Indicators		
	2011	2012
(percent change, unless otherwise specified)		
Real GDP	9.5	9.0
Domestic Demand	9.6	8.8
Consumption	8.9	9.0
Investment	10.3	8.5
Net exports ¹	0.4	0.7
Inflation (end of period)	4.5	3.0
Current account (USD billion)	361	432
Current account (percent of GDP)	5.2	5.6
Export growth	21	15
Import growth	21	14
General government balance (percent of GDP)	-1.6	-0.8

¹ Contribution to annual growth, in percent

China will not be immune to sluggish global conditions, but should still see healthy growth

Price pressures should further recede in the next few months

Monetary conditions should continue to return to a more neutral stance

requirements. Such a shift to more price-based instruments would help more effectively allocate capital and strengthen the effectiveness of monetary policy.

10. ***The fiscal position should steadily head back toward budget balance.*** Revenue growth has been robust, which allows considerable flexibility in allocating fiscal resources while still gradually scaling back the multi-year fiscal expansion that was put in place in 2008 in response to the unfolding global economic crisis. This puts China in the enviable position of being able to direct more fiscal resources to supporting domestic demand—particularly private consumption—while still reducing this year’s fiscal deficit. In particular, China has scope to continue to build out its pension system, pursue the comprehensive healthcare reform begun in 2009, and increase spending in areas that boost productivity in agriculture and non-tradable sectors.

Fiscal tools should be reoriented toward supporting consumption

11. ***The weak global outlook underlines the importance of accelerating the transformation of China’s economic growth model.*** As outlined in the latest Article IV Staff Report², successfully transforming China’s growth model requires action on a number of fronts, including improvements in the social safety net, policies to raise household income, a liberalization of the financial system, a stronger currency, and increases in the costs of various factors of production. A balanced economy that relies more on domestic consumption and directs more resources to nontradable sectors (such as retail, health, education, and other service industries) would have several advantages. First, it would make China less reliant on demand from trading partners in advanced economies, reducing the impact of the mid-cycle global slowdown on China’s economic performance. Second, in the event of downside risks materializing (see below), China would be able to adapt more easily by capitalizing on an already ongoing shift toward domestic drivers of growth. Third, a more balanced economy—particularly with investments in social support systems and measures to raise household income—would lessen income inequalities and increase the inclusiveness of China’s growth model. Fourth, transforming the growth model would make it less energy and capital intensive, more environmentally friendly and, over time, would add to the pace of job creation. Finally, more vigorous domestic demand in China would help support the global economy, including by absorbing more imports, with positive spillovers to much of the rest of the world.³

Progress in transforming the economic growth model should be accelerated and will require a broad range of measures

² People’s Republic of China, 2011 Article IV Report, www.imf.org/external/pubs/ft/scr/2011/cr11192.pdf.

³ See the 2011 Spillover Report on China www.imf.org/external/pubs/ft/scr/2011/cr11193.pdf.

12. *If external downside vulnerabilities materialize, policies will have to respond to support the domestic economy.* The IMF's recent World Economic Outlook outlines a global downside risk scenario—involving major financial turbulence in the Euro area, a marked downscaling of U.S. medium-term growth prospects, and real-estate related financial stress in emerging Asia—which would plunge most advanced economies back into recession. If such a scenario is realized, the approach to policies in China would have to change. While domestic price pressures and the hangover from the large monetary stimulus of the last two years partially constrain options this time around, China still has significant room for maneuver. However, the nature of the response would need to differ from that pursued in 2008-09. Fiscal policy should be the first line of defence. With a debt-to-GDP ratio of around 35 percent (including local government debt), China's fiscal position remains healthy and staff estimates suggest that it would remain sustainable even under extreme scenarios. Therefore, China has ample scope to quickly move fiscal consolidation into reverse to support the domestic economy. Rather than focusing the crisis-response stimulus on infrastructure investment, as in 2009, a greater portion of fiscal resources should be devoted to boosting consumption and raising household incomes. This could involve a reduction in consumption taxes, direct subsidies to consumption (particularly for lower income groups), social transfers (to assist displaced workers), or lowering social contributions to raise labor's take home pay. In addition, there could be an acceleration of China's social housing program. This reorientation would help assuage concerns about the productivity and efficiency of another round of infrastructure expansion while contributing to a more structural transformation of the economic growth model. Moreover, this fiscal stimulus should be on-budget and financed by government borrowing, rather than executed through the banking system. Even under an adverse external scenario, currency appreciation—in both nominal and real effective terms—should continue as a means to support domestic demand and the broader rebalancing effort. Given ongoing concerns about credit quality and bank balance sheets, any monetary policy response should be modest.

Policies will need to remain flexible. The risk of a severe external slowdown would necessitate a rapid shift in policy orientation, with fiscal policy as the first line of defense