China Economic Outlook

February 6, 2012

Prepared by the IMF Resident Representative Office, People's Republic of China

China's economy is slowing, but remains a bright spot in an unpredictable global economy

- Growth is expected to stay above 8 percent in 2012-13
- Inflation is coming down to more comfortable levels
- The real estate market is deflating

A storm emanating from Europe would hit China hard

- China's growth rate would drop abruptly if the Euro area experiences a sharp recession
- But China has room for a countervailing fiscal response, and should use that space
- Unlike 2009–10, any stimulus should be executed through the budget rather than the banking system

The weak global outlook reinforces the importance of rebalancing China's economy

- This means more private consumption and a diminishing reliance on investment
- Financial and corporate sector reforms will be critical to achieving this economic transformation

The Baseline Outlook

1. **The global recovery is threatened by intensifying strains in the euro area and fragilities elsewhere.** The latest World Economic Outlook (WEO) projections forecast a deceleration in global activity to 3¼ percent in 2012. This represents a downward revision of about ¾ percentage points relative to the September 2011 WEO, largely a result of the euro area entering a mild recession, contracting by ½ percent in 2012. Growth in emerging and developing economies is expected to reach 5½ percent this year, ¾ percentage point less than forecasted in the September 2011 WEO.

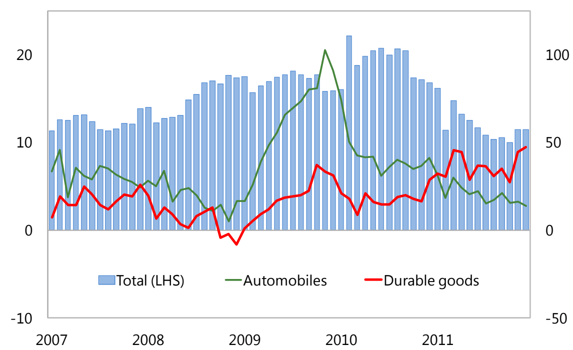
2. **This weaker global environment has led staff to lower their growth forecasts for China.** The Chinese economy has, once again, shown its resilience in the midst of a difficult external environment, buoyed by robust corporate profitability and rising household incomes (Figure 1). However, net exports will prove to be a significant drag on growth in the coming two years, with the current account surplus remaining at 3–4 percent of GDP. As a result, growth is expected to fall to 8¼ percent this year (from 9.2 percent in 2011), gathering speed in the latter part of this year and rising to 8¾ percent in 2013 (Table 1 and Figure 2).

3. **Inflation has peaked but will continue to be vulnerable to supply-driven food price increases.** Inflation fell to

FIGURE 1. RECENT DEVELOPMENTS

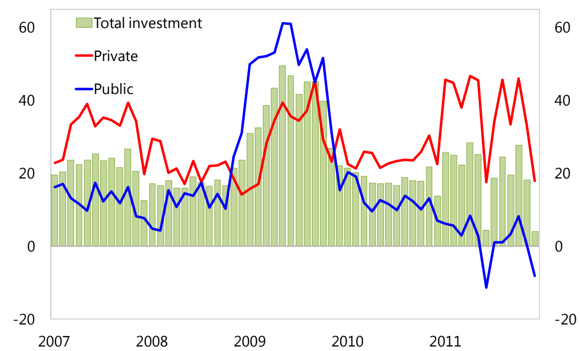
Domestic demand remains strong as stimulus is withdrawn. Household spending has moderated to pre-crisis levels…

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



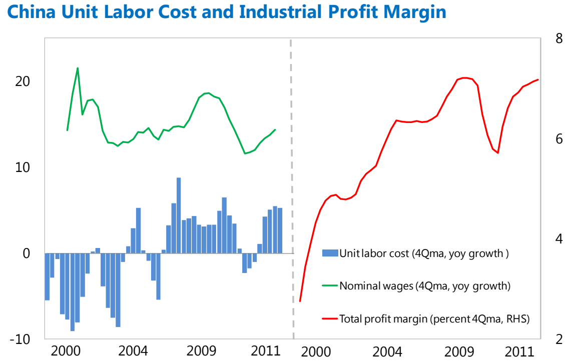
…and private investment has taken over from public stimulus…

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



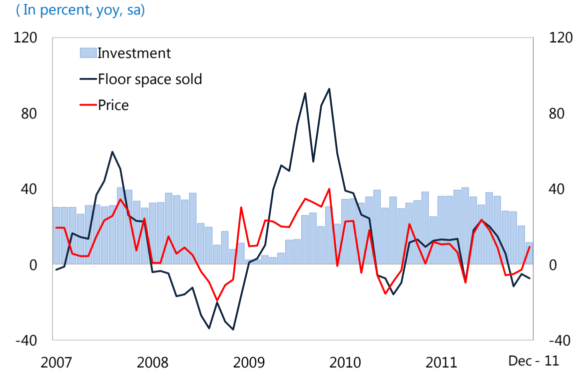
…supported by strong profitability. Rising labor costs appear so far to be largely matched by productivity gains.

China Unit Labor Cost and Industrial Profit Margin



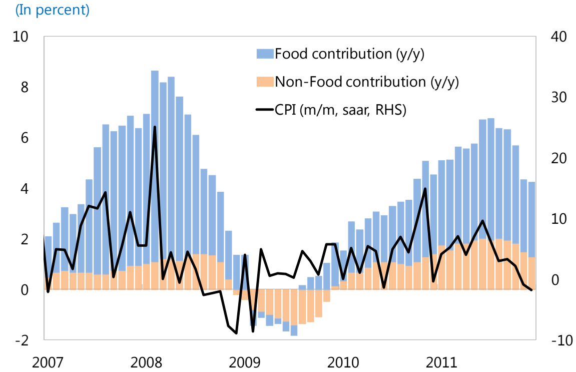
The government is successfully calming the property market, but underlying construction activity remains healthy.

Residential Property Price and Activity, National
(In percent, yoy, sa)



Inflation has peaked and is now declining…

Inflation
(In percent)



…while the trade surplus has continued to fall through the global crisis.

Current Account and Components
(In percent of GDP)

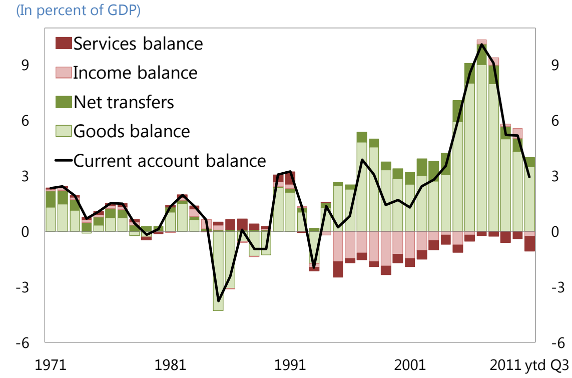


Table 1: Main Economic Indicators

	2011	2012	2013
(percent change, unless otherwise specified)			
Real GDP	9.2	8.2	8.8
Domestic Demand	10.3	9.5	9.3
Consumption	10.0	9.6	9.6
Investment	10.6	9.4	8.9
Net exports (contribution to growth)	-0.5	-0.9	-0.2
Inflation (average)	5.4	3.3	3.0
Current account (percent of GDP)[1]	3.3	3.2	3.8
General government balance (percent of GDP)[1]	-2.0	-2.0	-1.4

[1] Staff projections for 2011

4.1 percent at end-2011 and will continue to decline steadily in the first few months of this year. However, the tight supply-demand balance for domestically produced food will mean that even small shocks to supply—from adverse weather conditions or disease—will have a disproportionate effect on prices. A durable solution will require broad-based reforms to increase agricultural productivity, improve distribution networks, facilitate food imports, and generally raise the responsiveness of food supply to rising prices.

4. **The government's efforts to cool the property sector have been effective.** The market is beginning to deflate, with price growth slowing and transaction volumes down. Encouragingly, underlying investment remains healthy, in part due to the government's efforts to expand the supply of social housing. At present, there seems little reason to backpedal on the measures put in place to deflate the market. Indeed, a modest decline in property prices should be regarded as a welcome development, giving household income an opportunity to catch up with housing costs. Nevertheless, the reliance on administrative measures—to contain leverage and curtail purchases—carries its own risks and could become less effective over time. A more durable remedy to China's propensity for property bubbles has to be firmly rooted in policies that raise the cost of capital, provide a broader range of alternative investment vehicles for savers, and institute a broad-based property tax.

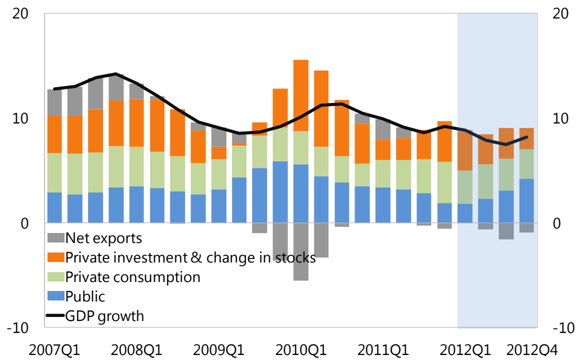
5. **Upward pressures on the currency have diminished recently.** The renminbi appreciated by around 6 percent in real effective terms in 2011. At the same time, the pace of reserve accumulation has fallen due to multiple factors including a smaller trade surplus, higher global risk aversion, and valuation effects associated with a stronger U.S. dollar. However, given the current account still has a sizable surplus in U.S. dollars and FDI remains strong, the pace of reserves accumulation should resume this year.

6. **Monetary conditions should be fine-tuned to allow for some modest additional credit to the economy**. Following a tight third quarter last year and a slowing of foreign inflows, M2 growth ended the year at 13.6 percent. In the last few months, the authorities have allowed for a modest increase in liquidity, including through a 50 basis point reduction in reserve requirements in December. This year, an M2 growth target of 14 percent would be prudent and would strike the right

FIGURE 2. OUTLOOK AND RISKS

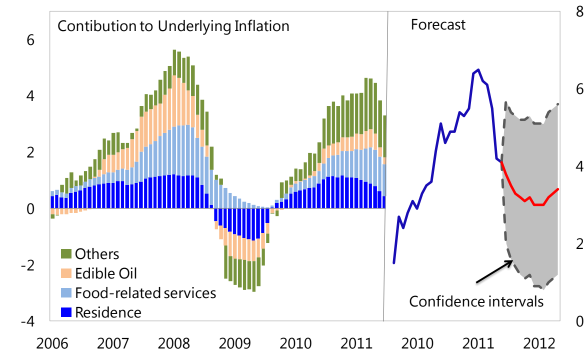
Growth is likely to moderate but will still be at healthy levels.

Contribution to GDP Growth
(In percent, annual average)



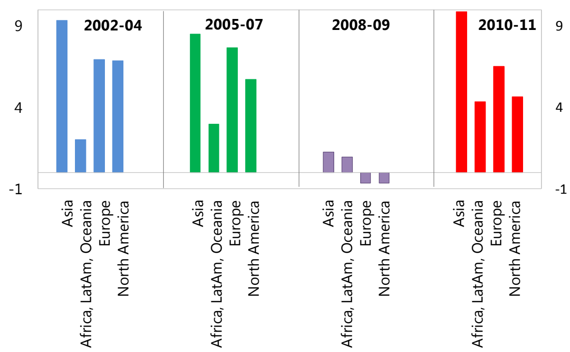
Inflation will fall although volatile food prices remain a significant vulnerability.

Consumer Price Inflation
(In percent)



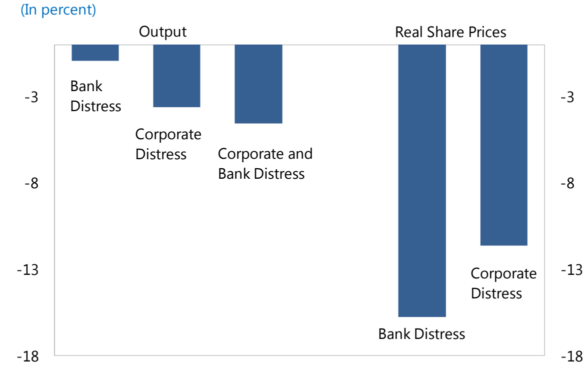
As in 2008–09, a severe recession in advanced economies would hit China hard through lower exports.

Contribution to Export Growth
(Percent of total)



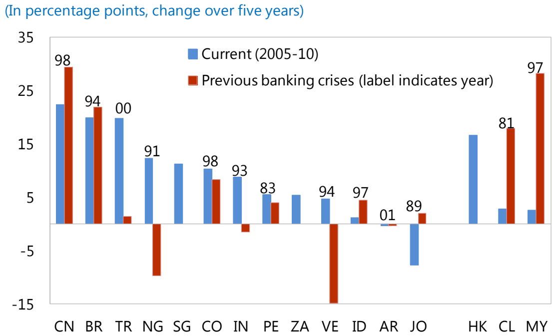
The real estate market presents the biggest domestic risk.[1]

China: Potential Effects on Property Downturn
(In percent)



Historical and international experience would indicate the large credit stimulus of 2009–10 has increased the risks in the banking system...

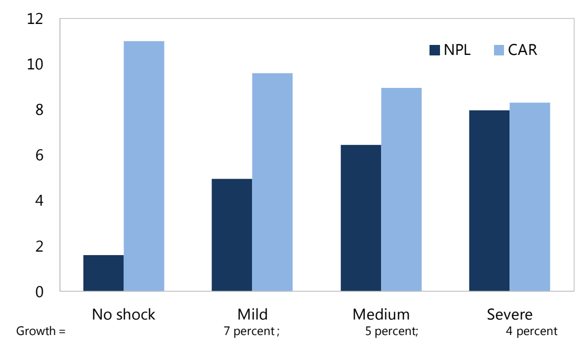
Credit/GDP
(In percentage points, change over five years)



AR: Argentina; BR: Brazil; CL: Chile; CN: China; CO: Colombia; HK: Hong Kong SAR; ID: Indonesia; IN: India; JO: Jordan; MY: Malaysia; NG: Nigeria; PE: Peru; SG: Singapore; TR: Turkey; VE: Venezuela; ZA: South Africa. Figure shows bank credit to the private sector. For Argentina, calculations are based on official GDP and CPI data. Right scale.

...and could hit bank balance sheets hard in the face of a significant growth and real estate downturn.

China: Macro-Scenario Results
(In percent, end-2009)



Source: PBC/CBRC

[1] In this scenario, a downturn of the property market causes a sizable portion of credit to local government financial platforms, the real estate sector, and small and medium enterprises to become impaired.

balance between the need to provide modest support to a slowing economy while being conscious of the credit overhang and risks to the banks created by the post-crisis credit stimulus. In particular, a McCallum rule would suggest that an M2 growth target of around 14 percent would be consistent with staff's forecast for growth and inflation. Over the next couple of months, liquidity conditions should be fine-tuned through open market operations. However, if foreign inflows remain subdued, reserve requirements could also be lowered. Meanwhile, the ongoing decline in inflation should be viewed as an opportunity to raise real loan and deposit rates in order to move the cost of capital closer to equilibrium and increase household financial income. Allowing prices to play more of a role in clearing the capital market would enable the central bank to rely less on administrative limits on credit to achieve its monetary goals.

7. **Given the uncertain global outlook, some modest fiscal support to the economy is warranted.** In particular, for 2012, plans for fiscal consolidation should be deferred and a general government deficit of around 2 percent of GDP should be targeted. Given very buoyant tax receipts, this could be achieved even with a lowering of social contributions and consumption taxes, an increase in social transfers (particularly to the poor and unemployed), and an acceleration of the ongoing public investments in social housing.

A Clear and Present Danger Emanating from Europe

8. **As identified in the latest WEO and Global Financial Stability Report Updates, the global economy is at a precarious stage and downside risks have risen sharply**. The most salient risk is from an intensification of feedback loops between sovereign and bank funding pressures in the euro area, resulting in more protracted bank deleveraging and sizable contractions in credit and output in both Europe and elsewhere.

9. **Should such a tail risk of financial volatility emanating from Europe be realized, it would drag China's growth lower**. The channels of contagion would be felt mainly through trade, with knock-on effects to domestic demand. In the downside scenario outlined in the WEO Update—which would see global growth falling by 1¾ percentage points relative to the baseline—China's growth would fall by around 4 percentage points (Box 1). The risks to China from Europe are, therefore, both large and tangible.

10. **In the unfortunate event such a downside scenario becomes reality, China should respond with a significant fiscal package, executed through central and local government budgets** (Figure 3). At a time when much of the rest of the globe would fall into recession, China should be prepared to tolerate modestly lower growth in the near term while cushioning the impact on the most vulnerable through targeted transfers and unemployment

BOX 1. BRACING FOR THE STORM: HOW WOULD CHINA FARE IF THE EURO AREA FALTERS?

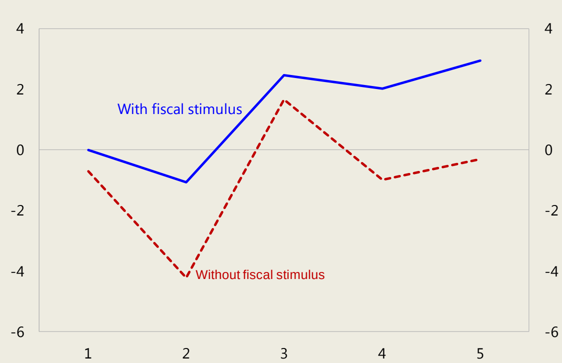
The WEO update envisages a global downside scenario under which intensification in adverse feedback loops between sovereign and bank funding pressures in the euro area results in sizeable contractions in credit and output. It assumes that sovereign spreads temporarily rise and increased concerns about fiscal sustainability force a more front-loaded fiscal consolidation, depressing near-term demand and growth. Bank asset quality deteriorates by more than in the WEO baseline, owing to higher losses on sovereign debt holdings and on loans to the private sector. Private investment contracts by 1¾ percentage points of GDP and euro area activity is reduced by about 4 percent relative to the WEO forecast. Assuming that financial contagion to the rest of the world is more intense than in the baseline (but weaker than following the collapse of Lehman Brothers in 2008), global activity would be lower by about 2 percent.

China's closed capital account would provide some protection from financial spillovers. Foreign banks' claims on Chinese banks are less than 1 percent of Chinese bank liabilities, while foreign assets of Chinese banks—including sovereign debt—represent only 2 percent of their total assets. In addition, given the large deposit base, Chinese banks do not depend on wholesale funding and Chinese non-financial corporations have minimal reliance on external funding. That said, a sharp fall in European and other advanced economies equity markets could affect sentiment, feeding through to China's equity markets, and may also create disruptions in the availability of trade credit.

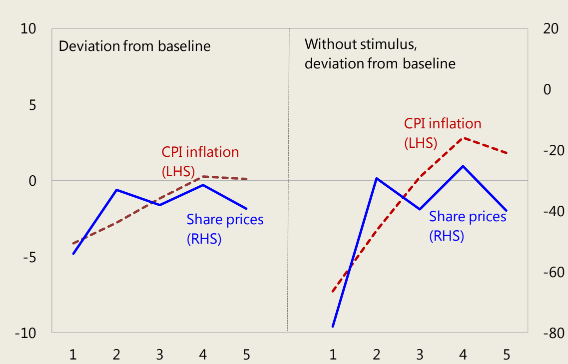
China would be highly exposed through trade linkages. Europe and the United States together account for nearly half of China's total exports. Lower global demand would, therefore, feed back negatively to corporate and financial sector balance sheets, hampering the performance of firms in the tradable sector (where excess capacity is already prevalent), increasing NPLs, and potentially prompting banks to deleverage. This would further reduce investment, employment and growth and could trigger a decline in China's property market. *In the absence of a domestic policy response*, China's growth could decline by as much as 4 percentage points relative to the baseline projections leading to broad-based consumer and asset price deflation. China's vulnerability to external shocks was highlighted in the global financial crisis, when global growth fell by around 6½ percent. In China, even after a huge credit and fiscal stimulus response, which boosted growth by at least 6 percentage points, growth still fell by 5 percentage points.

However, a track record of fiscal discipline has given China ample room to respond to such an external shock. A sizable fiscal stimulus could mitigate, but not fully offset, the decline in its output. In particular, a front-loaded fiscal stimulus of around 3 percent of GDP spread out over 2012–13 would limit the growth decline to around 1 percent, cushioning the adverse effects on employment and people's livelihoods.

Effect on China Output



Effect on China Assets and Consumer Prices



(Effects shown in charts represent the impact of the downside scenario in the WEO update on China's output, consumer and asset prices, relative to the WEO baseline) benefits. A fiscal package—of around 3 percent of GDP—should be the principal line of defense. Stimulative measures could include further reductions in social contributions or consumption taxes, direct subsidies to the purchase of consumer durables, corporate incentives to expand investments that reduce pollution and energy use, fiscal support for smaller enterprises, advancing plans for social housing, and scaling up investments in the social safety net. Unlike in 2008, the stimulus package—including transfers to the subnational level to support their spending—should pass through the budget and not be reliant upon a public infrastructure package that is routed through the banking system, state enterprises, and local government financing vehicles. Residual concerns about credit quality and bank balance sheets from the 2009–10 stimulus would mean that any monetary response to an unfolding European crisis should be limited.

11. **The weak external outlook underscores the importance of accelerating the transformation of China's economy to reduce its vulnerability to the vagaries of global demand.** China has taken a number of encouraging steps, including appreciating the renminbi, making substantial investments in the social safety net, expanding pension and health care coverage, raising the minimum wage, and beginning to raise the cost of inputs to production (particularly energy). Greater efforts are now needed to raise household income and shift the growth structure from exports and investment toward consumption. As outlined in the 2011 IMF Staff Report on China, this requires measures in a number of areas, including financial and corporate sector reforms that would pave the way for China's citizens to share more fully in the dividends from high and sustained growth.

Lingering Domestic Risks

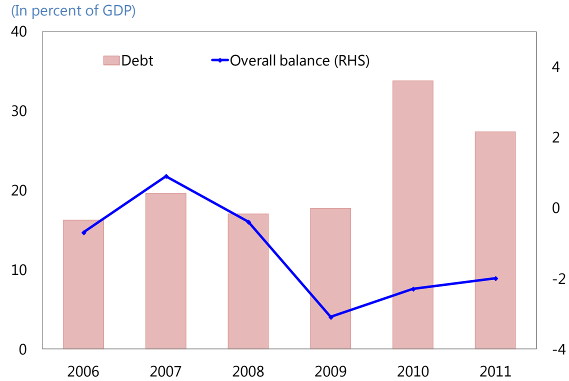
12. **China still has a long way to go to digest the side effects of the surge of credit unleashed in the wake of the global crisis**. In particular, there are balance sheet risks from the slowing real estate and export sectors, as well as possible losses on lending to local government financing vehicles. On their own, the potential costs from these problems appear manageable and could be absorbed without significantly derailing growth. However, this requires that bank regulation and supervision be attuned to proactively identifying and managing these risks.

13. **A large external shock would bring many of these domestic risks more forcefully to the forefront.** The biggest concern would be a coinciding, self-reinforcing slump in both the tradable and property sectors. This could precipitate a steeper than anticipated decline in prices, transaction volumes, and property-related investment. The appropriate response would be to boost property demand through the government purchasing homes directly for social housing purposes and selectively relaxing some of the administrative purchase restrictions for

FIGURE 3. POLICY PRIORITIES

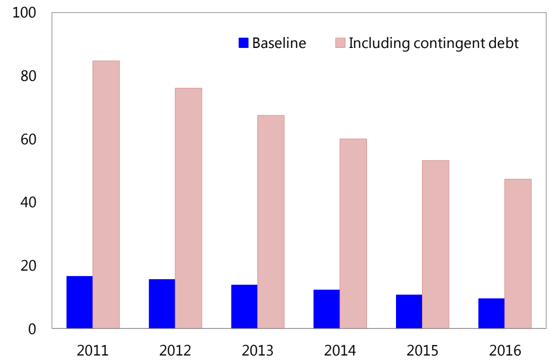
Fiscal consolidation should be deferred to provide support to the slowing economy. Fiscal stimulus should also be the main line of defense if downside risks materialize.

China: General Government
(In percent of GDP)



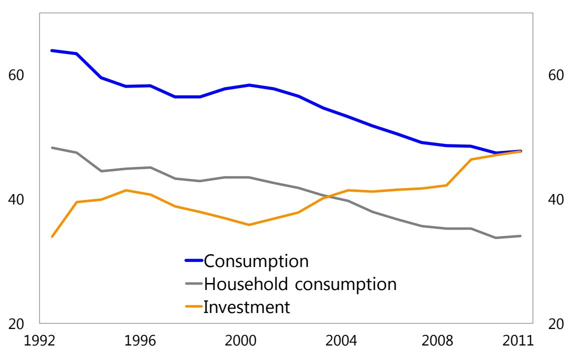
Government debt is projected to remain sustainable even under extreme circumstances.

China: Central Government Debt
(In percent of GDP)



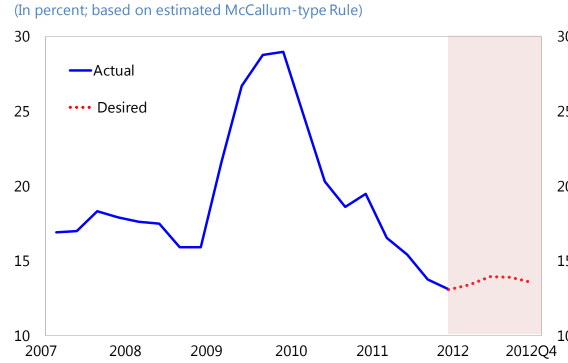
Unlike in 2008-10, stimulus should be focused less on investment and more on raising consumption and household income….

Domestic Demand
(In percent of GDP)



… with monetary policy continuing to normalize, to contain the balance sheet risks associated with the 2009–10 credit surge.

M2 Growth
(In percent; based on estimated McCallum-type Rule)



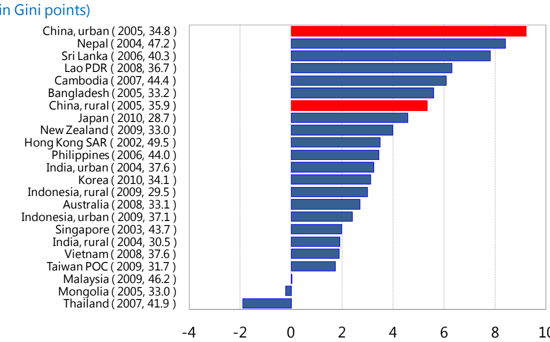
A property slump could be contained by selectively loosening some purchase restrictions—for first time buyers, lower income groups, and those seeking to purchase social housing—and accelerating social housing construction...

Selected purchase restrictions

- Minimum downpayment for homes larger than 90 m² increased to 30 percent
- Minimum downpayment for second homes increased to 60 percent
- Mortgage loans for third or more homes banned nationwide
- Buyers without at least 1 year of local tax or social security records treated as second home buyers

...while stepping up rebalancing efforts in order to sustain China's growth and make it more inclusive.

Asia: Change in Gini Index, Last Two Decades[1]
(in Gini points)



Sources: CEIC Data Company Ltd.; World Bank, PovcalNet database; WIDER income inequality database; Milanovic (2010); national authorities and IMF staff calculations.
[1] In parentheses, the latest available year and corresponding Gini coefficients.

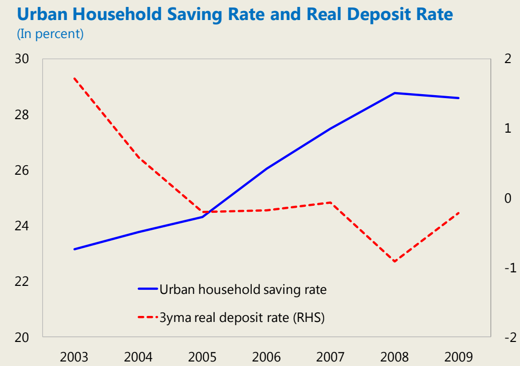
first time buyers, lower income groups, and those seeking to purchase social housing. Limits on lending to property (such as loan-to-value ratios), however, should be maintained to protect the financial system from the impact of a property downturn.

14. **The ongoing migration of resources into nonbank means of financial intermediation casts a widening shadow on monetary control and financial stability.** Over the past year, the government has restricted bank lending through administrative means, creating incentives to shift resources into a less transparent and perhaps less well regulated nonbank financial system. In turn, this growing pace of financial innovation is complicating macroeconomic policy and undermining the effectiveness of using monetary aggregates as a policy target. It is also increasing liquidity pressures for smaller banks. While unlikely to create a systemic risk in the short term, left unaddressed, vulnerabilities could steadily build up over time. This underlines the urgency of undertaking a broad rethink of the monetary policy framework, strengthening regulatory oversight of nonbank forms of intermediation, and accelerating progress toward financial liberalization—along the lines proposed in the 2011 IMF Staff Report.

15. **Finally, continuation of the current, very high levels of investment may, over time, undermine bank and corporate balance sheets.** Much of the decline in the external surplus, at least so far, has been achieved through very strong investment growth, rather than the more desirable boost to consumption as a share of output. Such a decline in the external surplus due to higher investment would be undesirable, shifting concerns to a growing internal imbalance that could ultimately undermine the sustainability of China's growth by aggravating excess capacity, lowering productivity, and generating bad loans. A key measure to address these concerns, and shift to a more consumption-led economy, would be to raise the artificially low cost of capital in China (Box 2).

BOX 2. WHY MORE IS LESS: FINANCIAL REFORM AND HOUSEHOLD SAVINGS IN CHINA [1]

In the mid-1990s, urban households in China saved 19 percent of their disposable income on average. By 2009, their saving rate had increased to 30 percent. This increase is puzzling since it occurred during a time when the economy grew rapidly, urbanization proceeded at a relatively rapid pace, and household earnings prospects improved. Such influences could have been expected to dampen savings impulses, rather than trigger them. Although a similar decline in the consumption-GDP ratio has been seen during other economies' development, China's consumption started at a relatively low level and has fallen further over the past two decades. Rebalancing China's economy back toward consumption will require, among other policies, measures that raise household income and induce people to save less and consume more.



The evidence indicates that financial reform—in particular interest rate liberalization and an increase in real deposit rates—can contribute to boosting consumption. Since a large portion of household savings is placed in banks, the return on bank deposits has the potential to have a large impact on saving behavior. With deposit rates that are well below the rate of inflation in recent years, the real return on bank deposits has declined steadily. As real interest rates have declined, urban saving rates have moved in the other direction.

Examining the data across China's 31 provinces, it is clear that households save to meet multiple needs—self-insurance, retirement, meeting the downpayment to purchase a home—and appear to behave as though they have a target level of savings in mind. The data suggests that when the return to saving falls, households have a tougher time meeting their target savings and react by increasing the share of their disposable income that they save. Higher interest rates work in the opposite direction, leading households to reduce their savings. Higher real interest rates, therefore, hold significant promise in boosting private consumption.

Financial reform and interest rate liberalization should be a key part of accelerating China's economic transformation toward a consumption-based growth model. Building on the steps taken in recent years to strengthen China's financial system, the next stage of financial reform will need to be sequenced appropriately to minimize the risks of a disorderly liberalization.[2] A broad roadmap for reform would include adopting a new monetary policy framework; raising real interest rates; strengthening and expanding regulatory coverage of the financial system; putting in place a broad set of tools for crisis management; developing financial markets and alternative means of intermediation and new instruments for saving; deregulating interest rates; and, eventually, opening up the capital account. Progress is being made in many of these areas and should be accelerated through the course of the 12th Five Year Plan.

With higher real interest rates and more market-determined pricing of capital, the returns to household savings will increase. Empirical work would suggest that such a sustained increase in the interest rates on bank deposits and wider access to alternative investment opportunities will induce households to spend more, accelerating the transition to consumption-led growth in China.

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[1] See Nabar, M. (2011), "Targets, Interest Rates, and Household Saving in Urban China," IMF Working Paper 11/223.

[2] For details on sequencing, see People's Republic of China: Staff Report for the 2011 Article IV Consultation.