BOFIT Forecast for China
11.9.2008

BOFIT China Desk

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China's economic growth slowed in the first half of 2008 as expected. Growth in the foreign trade surplus came to a halt and investment growth showed the first signs of easing. In contrast, domestic consumption continues to grow strongly. Since the Bank of Finland's previous forecast, the outlook for the world economy has deteriorated further, and therefore we have made a slight downward adjustment in the growth forecast for China for 2008 and 2009. The Chinese economy nevertheless continues to grow strongly.

China's real GDP grew in January–June 2008 by 10.4% year-on-year, ie nearly two percentage points less than in the same period a year earlier. In industry and construction as well as in the services sector growth slowed fairly significantly, whereas in primary production the growth rate remained relatively stable.

The slower pace of growth was expected, and the overall picture has not changed significantly from the Bank of Finland's previous forecast. Weaker developments in several other countries have slowed growth in demand for Chinese products, and even though foreign trade is still making a positive contribution to economic growth, the contribution is notably smaller than last year. The tightening of monetary policy at the turn of the year has slowed real growth in investments as hoped, whereas domestic consumption demand has remained buoyant. The stock market crash does not appear to have had a major impact on economic developments in the first half of 2008.

The forecast for GDP growth in 2008 has been adjusted slightly downwards, to 10% (previous forecast 10.3%), due to the deteriorated outlook for the world economy. Growth is expected to slow further in 2009, to 9.5% (10%). The forecast for 2010 has not been adjusted, as the pace of GDP growth is expected to remain unchanged from 2009. Thus, all indicators suggest the Chinese economy will continue to grow at a rapid pace.

Domestic demand increasingly important

Over the past three years, economic growth in China has been exceptionally dependent on foreign demand. The growth contribution of net exports was nearly 3 percentage points in 2007. Over the forecast period, the contribution of foreign trade is, however, expected to decrease substantially, due to the slowing of world economic growth. In addition, strong domestic demand in China is boosting imports, which will contribute to a smaller surplus on goods.

The importance of domestic demand as the engine for growth is thus expected to increase over the next few years. Higher employment and wages in cities and higher agricultural income in the countryside will sustain consumer demand. Public consumption is also expected to pick up.

The Chinese economy's vulnerability to cyclical fluctuations is heightened by the exceptionally high investment-to-GDP ratio. Over the forecast period, corporate willingness to invest may be eroded slightly by slowing growth in profits and deteriorating export prospects. In particular, growth in real estate investments may slow, as costs have risen and sales of new properties have been sluggish, with real estate prices in some cities taking a downturn. However, the situation in the real estate sector varies considerably across regions. In the long term, structural changes in the economy and the associated massive construction activities will ensure continued growth in investments far into the future.

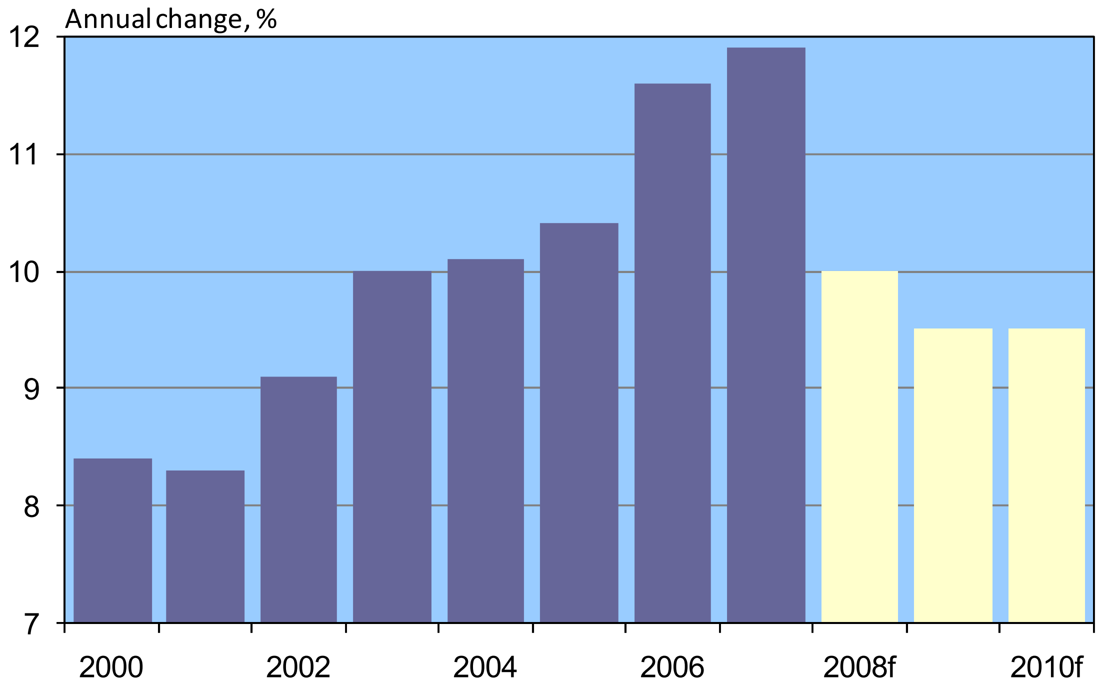
Parallel to extensive growth based on material investments, productivity will have to continue to rise rapidly in the future, too, if economic growth is to be sustained and employment secured. Those are the major objectives of the Chinese government. In comparison with the United States and Europe, labour productivity remains low in China, even though it is estimated to have increased recently by some 8–10%, per annum. Improving the overall efficiency of production is also a prerequisite for getting some sort of grip on China's enormous environmental problems.

As inflation concerns ease, economic policy can be supportive of growth

Developments over the forecast period are also dependent on the economic policy pursued, and particularly on whether the Chinese government considers high inflation or slowing economic growth the bigger threat. The government has traditionally been very active in steering the economy, and now, too, it has ample room for manoeuvre in economic policy due to the sound state of the public finances. Over the past two years, rising inflation has forced the Chinese government to tighten its monetary policy considerably, but there are now signs that the policy focus is shifting from curbing inflation to supporting growth and employment. In August, the government increased the quotas for bank lending to small and medium-sized enterprises and reintroduced tax concessions for the textiles industry, with the aim of boosting the profitability of exports. The possibility of raising the lower limit of taxable income and increasing public investment has also been discussed.

The weakening of growth prospects will probably also affect the Chinese government's willingness to let the yuan appreciate. Despite the evident slowing of economic growth, the threat of rising inflation has not completely disappeared because, despite the downward turn in consumer price increases, the growth rate of producer prices has accelerated in recent months. Raw material and energy prices, in particular, have risen, while at the same time the available data suggests wages are also growing at an extremely rapid pace. High inflation is a politically dangerous factor: to counterbalance the lack of social security, households have large savings, but an acceleration of inflation often turns the real deposit interest rates negative. The most significant risk over the forecast period is that growing uncertainties and rising costs will have a larger than anticipated impact on investments or household consumption while the inflation outlook simultaneously limits the use of expansionary policies.

Growth of real GDP, y-o-y %



Sources: China National Bureau of Statistics, BOFIT 2008–2010 forecast