

BOFIT Forecast for China
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BOFIT China Desk

BOFIT Forecast
for China 2008-2010



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Although the Chinese economy steamed ahead in 2007 a slight moderation of growth is expected over the next few years. While dimmer prospects for the world economy will restrain China's export growth, domestic demand remains firm. In addition to uncertainties about the world economy, one of China's biggest challenges for the forecast period is the need to curb inflation.

China's economy continues to grow at a robust pace. Investment is still increasing rapidly, as urbanisation and expanding infrastructural requirements have boosted construction activity and enticing growth prospects have spurred industrial investments. Increasing incomes and rising employment have added to households' purchasing power, and higher tax revenues have enabled a higher level of public spending. As a result of strong competitiveness, Chinese exports continued on a steep upward path in 2007. A slowing of the growth of exports to the United States was offset by a marked pick-up in exports to eg oil producing countries. The contribution of net exports in economic growth did however decline notably towards the end of the year, as imports accelerated.

The rapid growth is expected to continue at nearly the pace foreseen in last summer's BOFIT forecast. Although the diminished outlook for the world economy will have a negative impact on exports, the underlying support for aggregate domestic demand remains firm. While the role of investment in China's economic growth is still substantial, the importance of consumption is gradually expanding. Consumption growth, along with a growing need for energy and raw materials, will increase China's need for imports, whereas any decrease in exports would reduce the need for imports of parts and components for use in the assembly sectors. The centre of gravity of China's foreign trade is gradually shifting away from processing activities.

Because the 11.4% economic growth in 2007 led to an acceleration of wages and other production costs, it was probably running ahead of long-term potential output growth. Consequently, the growth rate in 2008 is expected to ease to about 10%, and the coming years will see a further slowing, to about 9% per annum by the end of the forecast period. Over the longer term, worsening environmental problems, for example, will place additional constraints on economic growth.

Inflation poses a challenge for monetary policy

At present, the major challenge for Chinese economic policy is to maintain price stability. In December consumer prices were 6.5% higher than in the year-earlier period. Although the rise in the price level was largely due to food products (other prices were up by just 1.4%), rising inflation cannot continue to be ascribed solely to production hitches in agriculture. Part of the inflation problem resides in loose monetary policy, and the return to a low inflation setting will take some time. According to a survey, inflation expectations

have risen, which puts upward pressure on wages and prices. Wage inflation picked up considerably already in 2007.

Asset prices are also surging. For example, prices of land and dwellings have accelerated. Abundant liquidity and now-negative real interest rates on deposits have boosted investment in the stock market. As a result, share prices doubled in the course of last year. And, in recent months, share-price volatility has increased.

It is clear that one factor behind the loose monetary policy is the October party conference at which the present Government renewed its position by citing high growth numbers, nor was any notable slowing of growth deemed wise. On the other hand, the market-oriented tools of monetary policy – hikes in interest rates and reserve requirements – have not sufficed to restrain growth at a time when the yuan's exchange rate has been allowed to appreciate only gradually against the US dollar. Growth of broad money in 2007 exceeded the authorities' target. At the end of 2007 the conduct of monetary policy was relying increasingly on administrative tools such as limits on credit and on price increases. The central bank has announced that it will tighten monetary policy in 2008.

In order to prevent inflation, the yuan, towards the end of 2007, was allowed to appreciate faster against the dollar. In fact, due to the dollar's pronounced weakening against euro the yuan depreciated against the euro in the past year. The yuan is expected to continue to appreciate in dollar terms during 2008. One would assume that, in the longer term, China will gradually loosen its exchange rate policy dependency on the dollar.

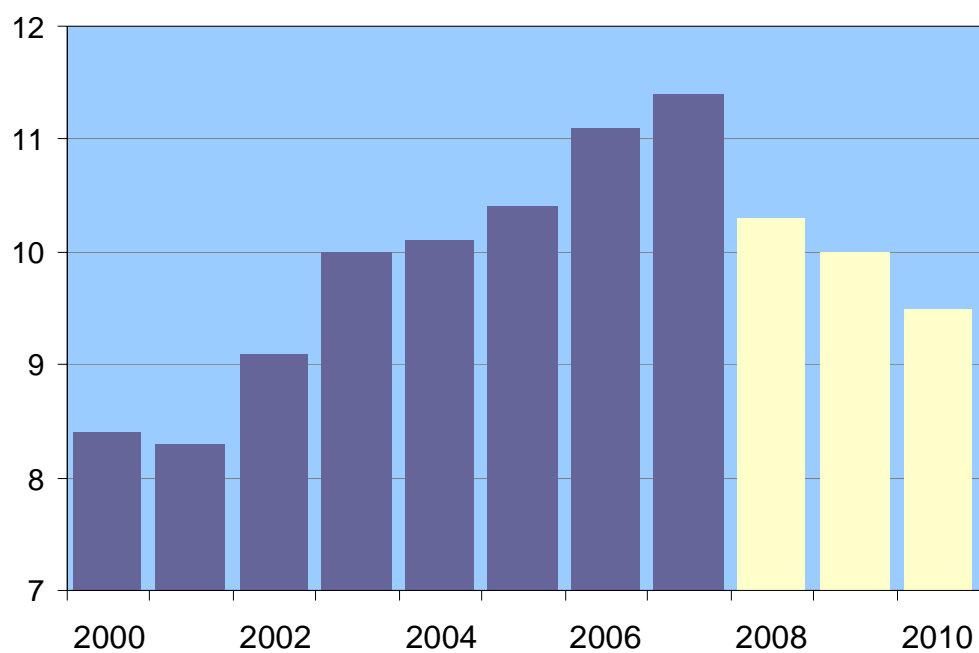
Risks on the rise

The risks for the forecast – downside risks - have increased in magnitude since the last summer forecast. In particular, the weakening growth outlook for the United States could spread widely across the world economy, which could have a sizeable and quick negative impact on China's export prospects. Thus China's economic growth – still quite dependent on exports – could slow down to a greater extent than in our forecast.

Another important risk factor is the possible lateness of the authorities' anti-inflation measures. Tightening actions taken in fear of high inflation numbers can be oversized and thus cause, in particular, an abrupt stemming of investment growth. With China's exceptionally high investment-to-GDP ratio of 43%, any cyclical swings in that variable will reverberate across the economy.

Share-price valuations are still high by international standards, and pronounced gyrations are likely to continue. An interesting additional consideration is that, once the positive stimulus from the August Olympic Games subsides, there could be more uncertainty. On the other hand, many observers feel that even a sizeable decline in share prices may not have a notable dampening effect on domestic demand.

Growth of real GDP, y-o-y %



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