BOFIT Forecast for China
25.3.2009

BOFIT China Desk

# BOFIT Forecast for China 2009-2011

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*The global economic downturn has sharply reduced China's economic growth. As rapid redeployment of the freed-up capacity of export industries to the domestic market is unlikely, China must deal with the changed circumstances through broad monetary and fiscal stimulus measures geared to boosting domestic consumer demand and investment. Even with the stimulus, however, China's overall economic growth is likely to decline to around 5 % this year. Although the country could potentially sustain higher growth, the poor outlook for exports over the next two years severely limits any quick recovery. Given the exceptional frailty of the world's economy, the ongoing efforts of China's leaders to adjust economic policy and uncertainties related to Chinese statistical data, any prognosis at the moment inherently contains extraordinary risks. Thus, we find it prudent to concentrate on the trends rather than precise figures.*

The world economy was broadsided in the second half of last year by a crisis in the global financial system that spilled over quickly into the real economies of practically all countries. During the last months, it has become clear that economic forecasts everywhere needed to be revised downwards. Even China, with its strong monetary and fiscal position, has found itself staggered by a sudden loss of export demand.

In the first half of 2008, China's GDP growth was above 10 % y-o-y. Growth slowed sharply in the third quarter, and fell below 7 % y-o-y in the final quarter of the year. For 2008 overall, the country's GDP growth averaged 9 %, a far cry from the 13 % GDP growth posted in 2007.

China's economic development in coming years cannot be delinked from the hard times facing most of world's economy. In China's case, this largely means a deterioration of its export prospects. Thus, while the country has the fiscal and monetary resources to stimulate economic growth, it cannot completely offset the effects of lost export demand by boosting domestic demand. For 2009, we expect China's GDP growth to fall to 5 % and then slowly accelerate to 7 % by the end of 2011 as economic growth revives in Europe and North America.

## Massive stimulus package to deal with loss of export demand

Export volumes in 2009 will be lower than in 2008, but should recover slightly towards the end of the forecast period. Imports volumes this year will also be down sharply from last year with a decline in imports related to processing trade and lower demand on the part of Chinese industry for raw materials. China's imports should bounce back more quickly than its exports as efforts to prop up domestic demand kick in. In other words, the effect of net exports will slightly pull down overall GDP growth for the forecast period. This is quite unusual for China as even during the Asian financial crisis in the late 1990s the contribution of net exports to the GDP growth remained positive. Nevertheless, China will continue to run large, though decreasing, trade and current account surpluses.

Poor prospects for exporters hurt domestic demand as export industries hold back on planned investment and rising unemployment in export sector cuts private consumption. While growth in investment and domestic consumer demand should slow from the sizzling growth rates of recent years, domestic demand, boosted by monetary and fiscal stimulus measures, will remain relatively strong.

Inflation began to cool rapidly late last year. By February 2009, consumer prices were lower than 12 months earlier, signalling a shift to a deflationary environment. Thus, there is room for further monetary easing if considered appropriate. China's government last autumn began incremental reductions in benchmark interest rates and reserve requirements for commercial banks. Previous limits on bank lending have also been lifted. On the exchange rate front, a three-year-old policy of allowing the yuan's nominal exchange rate to appreciate gradually against the US dollar has been suspended for the time being. Since July 2008, the yuan-dollar rate has remained steady at 6.8 (USD 1 = CNY 6.8). However, the yuan's real trade-weighted exchange rate, a measure of the price competitiveness of Chinese firms, has continued to increase through December 2008, slightly eroding the price competitiveness of Chinese firms. The euro's rapid decline against the dollar last year returned some of the competitiveness European firms had lost to their Chinese counterparts in recent years.

The 4-trillion-yuan ($590 billion) stimulus package (13 % of 2008 nominal GDP) announced late last year is China's flagship effort to support domestic demand. Over the short-term, the essential elements in the stimulus package, which extend over a two-year period, are investment in housing and public infrastructure coupled with measures to boost consumer demand. At least initially, the central government, regional administrations, large state-owned enterprises and large commercial banks will all participate and share the costs of implementing the stimulus programme. If needed, the government has still plenty of latitude to exercise further monetary and fiscal policy stimulus measures. China's gross central government debt is under 20 % of GDP, with an almost negligible foreign debt component.

Compared to the rest of the world, China's forecasted 5 % GDP growth this year is downright blistering. Our forecast largely assumes that China's stimulus package manages to reinforce domestic demand and investment growth to cushion the effects of China's shrinking export demand. Our prognosis also suggests that China's foreign trade surplus will somewhat diminish, which will mitigate China-related global imbalances over the forecast period. However, given the recent collapse of foreign trade in Asia, it appears that China's import demand alone can provide only limited support to other economies.

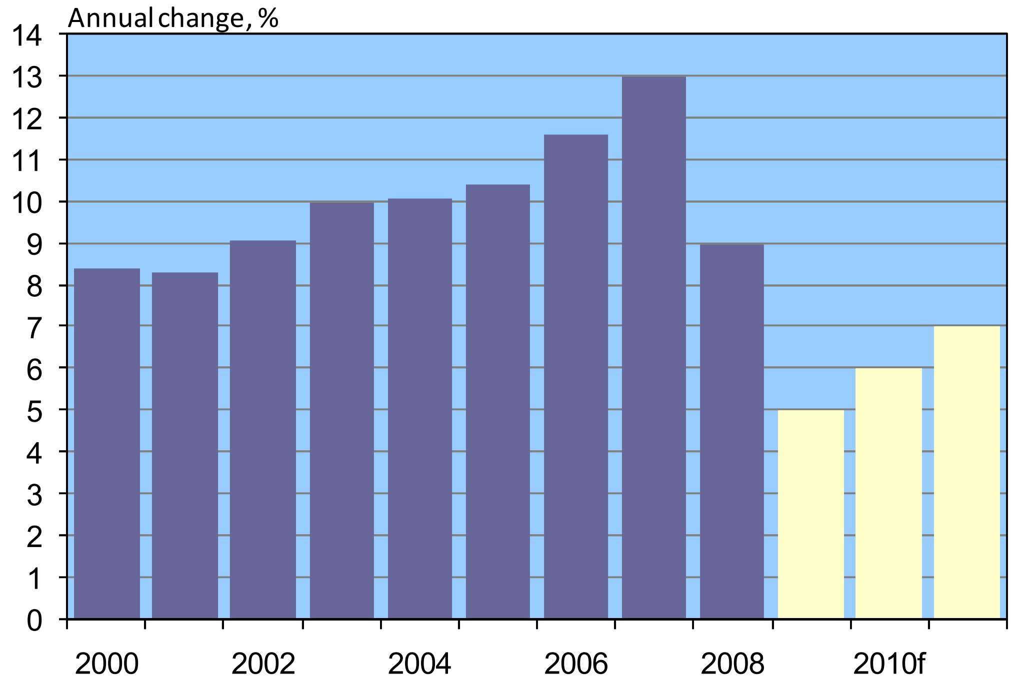
## Stimulus policy carries risks

The government appears ready to do just about anything to avoid undershooting its official 2009 GDP growth target of 8 %. In addition to its measures contained in the basic stimulus package, we have begun to see other measures ranging from local governments buying up unsold apartments to cities distributing consumer coupons redeemable for specific goods and services. Of course, vast stimulus measures may lead to waste of money and the lack of transparency invites outright abuse. Doubts have been raised that the recent acceleration of the already fast growth of bank lending is not on a firm basis as part of new lending seems to be feeding the rise in share prices on Chinese stock exchanges. In the absence of genuine investment demand, China's rapid expansion of credit could descend into misdirected investments, higher stocks of non-performing loans and longer-run price pressures.

News of the loss of 20 million jobs in export industries and demonstrations by dismissed workers indicate the delicacy of China's situation. While the country's labour markets are extremely flexible, reductions of wages are unlikely to help exporters to deal with the loss of demand, but could well dampen domestic demand further.

China has great potential demand in its domestic markets and the rapid ongoing urbanization of the population continues to support long-term economic growth. Whether the social risks from widespread unemployment materialise depends on how well China manages to repurpose its export sector overcapacity and resources to serving the domestic consumer, and how successful it is in helping those who could not be employed immediately. However, current crisis is not simply about replacing lost export demand with domestic demand; China must also consider how the structure of domestic consumption best corresponds to its long-term needs. In this respect, the current stimulus package does little to answer this long-term challenge as it focuses on infrastructure investments, while additional money for social security, health care and education would perhaps better serve China's development goals.

China's real GDP growth, %




*Sources: China National Bureau of Statistics, BOFIT 2009–2011 forecast*

China's real GDP and import volumes 2008 – 2011, y-o-y change, %

| | 2008 | 2009f | 2010f | 2011f |
|---|---|---|---|---|
| GDP | 9.0 | 5.0 | 6.0 | 7.0 |
| Imports | 7.0* | -10.0 | 5.0 | 10.0 |

* estimate

*Sources: National Bureau of Statistics, BOFIT Forecast 2009–2011*