BOFIT Forecast for China
25.3.2010

BOFIT China Desk

BOFIT Forecast for China 2010–2012

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Although its GDP growth slowed substantially in the turbulance of the international financial crisis, China successfully implemented a package of stimulation measures to achieve nearly 9% growth last year. Robust (9%) growth is expected to continue in 2010 and 2011, and a slight slow down, to 8%, is projected for 2012. In the course of the forecast period, China's economic performance will come to depend increasingly on domestic consumption demand. The rapid growth of credit associated with the stimulation package has lowered the quality of commercial banks' loan portfolios and increased inflation pressure, which will complicate the conduct of economic policy during the forecast period.

Despite a sharp drop in China's GDP growth rate amid the turbulance of the international financial crisis, the economic outlook quickly improved in the late stages of last year. Real GDP increased 6% year-on-year in the first quarter, but the growth rate jumped to over 10% in the last quarter. For 2009 as a whole, the growth rate for real GDP was nearly 9%. The composition of the growth differed from that of recent years, as the international financial crisis dampened the demand for China's export products. The decline in foreign demand was offset by an extensive package of stimulation measures to boost primarily investment but also domestic consumption. As a result, investment demand posted exceptionally strong growth last year and consumption demand continued to expand at a rapid pace.

In the latter part of last year, China's economic performance was in all respects slightly better than anticipated in our previous forecast. For this reason, the predicted growth rate for real GDP in 2010 was raised by a percentage point to 9%. The prediction for 2011 was kept at 9%. For 2012, it is expected that growth will slow down moderately to 8%. China's economy is already as large as that of Japan and, as it continues to enlarge, growth rates in the region of 10% pa will be more and more difficult to achieve.

China's growth will increasingly depend on domestic consumption demand

The international financial crisis showed how vulnerable China's export-led economy is to external disturbances, and China's next five-year plan, for 2011–1015, will put much greater emphasis than before on the importance of domestic consumption as a driver of the economic growth. During the period 2010–2012, China's economic growth will become increasingly dependent on domestic consumption demand, which has expanded steadily in recent years in line with income. Although the rise in wages and salaries was modest last year, there are signs of a sharp pick-up this year. Moreover, minimum wage rates are being raised substantially andone of the aims of officials has been to raise the level of social security so as to reduce the need of individuals to save.

Over the next few years, urbanization will continue to have a major influence on investment activity in China. However, following the exceptionally rapid growth of investment last year, we will surely see a slowdown, as additional stimulation measures are not slated for this year and the stimulation program is set to wind down completely in 2011.

On the other hand, realizations of private-sector investment projects that were postponed during the crisis are expected to boost investment as the world economy continues to recover. The build-up of excess industrial capacity is limited to just a few sectors, and this is not expected to have a major impact on companies' investments. Although the growth rate of investment will slow down compared to last year, the investment ratio should remain very high relative to other countries throughout the forecast period.

In international trade, China is expected to maintain its position as the world's leading exporter despite a weakening of its main competitive advantage, as the level of production costs in China gradually rises. In the most labor-intensive production sectors, such as textiles and clothing, companies have already switched to countries with relatively low production costs. On the other hand, China is attracting higher-value-added areas of production. Not only exports but imports too will increase rapidly due to the fact that product assemblage carried out in China continues to be based largely on imported components, and China's need for imported raw materials will also increase. The current account surplus (6% of GDP in 2009) should remain large throughout the forecast period, although net exports are projected to have only a minor effect on economic growth during the period.

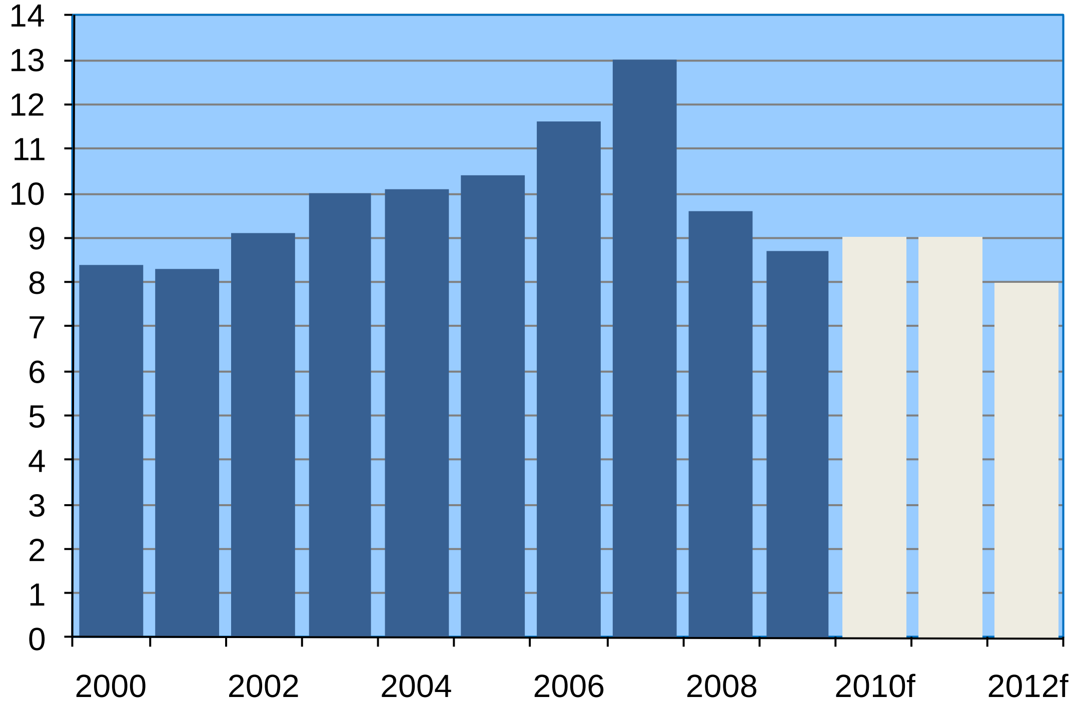
Growing inflation pressure is affecting economic policy

China's economic stimulation package announced in autumn 2008 includes support for commercial-bank lending. Because of a burst of lending, the broad money supply at yearend was about 30% larger than a year earlier, in contrast to prior years when officials kept the growth rate below 20%. With the rapid increase in lending, there is some concern about a potential accumulation of nonperforming assets over the next few years and that the central government would in the end have to foot the bill. A tightening of taxation could lead to a reduction in aggregate purchasing power and slow the growth of consumption. But the state's finances are sound; the debt is relatively small, even if local-level public extra budget debts are added on. The central government's financial deficit amounted to 3% of GDP last year and a similar result is budgeted for this year.

The rapid money growth has led to increasing prices of consumer goods and assets in China. Prices of exchange-traded shares rose 75% last year, which was not exceptional among the developing countries. However, house prices have been sharply on the rise. Even though officials have tried to rein in the price rise eg by encouraging people to hold on to their homes longer and by raising the minimum down payment for second-home buyers, it is possible that a bubble is in the making. The possibility of a sudden fall in house prices could produce a bulge in banks' nonperforming assets and a decrease in construction investment. Less construction would in turn lead to a substantially higher unemployment among migrant workers, which could foment some unrest.

Despite the increase in inflation pressure, the Chinese Government continues to focus on economic growth and preservation of jobs and has so far only slightly tightened its monetary policy. There has been strong pressure to revalue the Yuan, which would ease the domestic pressure on prices and reduce the likelihood of a trade dispute. As inflation heats up, the Chinese Government will have to consider raising reference interest rates in order to preserve the value of a the abundant savings of the Chinese people, even though this would restrain the growth of investment and induce further speculative capital inflows from abroad.

Chart. China's annual growth of real GDP and BOFIT forecast 2010–2012, %



Sources: Chinese statistics office and BOFIT forecast 2010–2012.

China's GDP and import volume 2009 and BOFIT forecast 2010–2012, annual %-change

	2009	2010f	2011f	2012f
GDP	8.7	9	9	8
Imports	3*	12	10	10

* Estimate

Sources: Chinese statistics office and BOFIT forecast 2010–2012.