People's Republic of China

GDP growth reached 11.5% in the first half of 2007, buoyed by exports, investment, and consumption. The authorities redoubled efforts to rein in investment and exports, such as increasing interest rates, banks' reserve requirements, and taxes on some exports, but to date, these steps have had limited impact. This *Update* raises the GDP growth forecast, made in *Asian Development Outlook 2007* (*ADO 2007*), to 11.2% for 2007, and 10.8% for 2008. Inflation has risen, mainly the result of a run-up in food prices. The inflation projection is lifted to 4.2% this year and 3.8% in 2008, but there is a risk that the actual outturn could be higher still.

Updated assessment

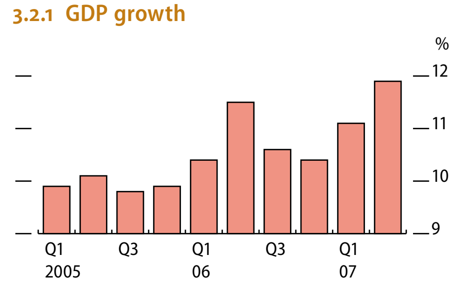
GDP growth accelerated in the People's Republic of China (PRC) from 11.1% in the first quarter of 2007 to 11.9% in the second (Figure 3.2.1), fueled by a widening trade surplus, by galloping investment across the board, and by buoyant private consumption. Growth of 11.5% in the first half of the year was at its fastest rate since 1994, despite measures by the authorities to constrain investment and exports. On the supply side, growth was again led by industry (especially heavy industry), where value added rose by 13.6% in the first half, faster than services' 10.6% and agriculture's 4.0%. Strong momentum in the real economy is underlined by an upward revision of 2006's GDP growth rate, which is now placed at 11.1%.

Underlying drivers of investment, including strong profitability, buoyant sales, and still-low lending rates, remained strong. With industrial profits improving by about 42% in the first 5 months of this year, growth in fixed asset investment accelerated to 28.7% in the second quarter from 26.0% in the first (Figure 3.2.2). Investment administered by local governments grew by 28.1% in January–June, nearly double the equivalent central government rate, suggesting that efforts by the center to tighten investment at the local level have as yet had little impact. Strong profit growth in industries such as steel, electricity, chemicals, and oil processing continues to encourage investment in these sectors. Factors underpinning profits are rising productivity in manufacturing and low, government-controlled prices for domestically produced energy and resources, with the costs of environmental degradation not being internalized by polluters.

Supported by government policies to boost the rural economy, investment in agriculture surged by 37.5% in the first 6 months, faster than that in industry (29.0%), and services (24.6%). Provincial governments have strong incentives to maintain rapid investment, partly since local fiscal revenue depends heavily on receipts of value-added tax, which are boosted by new investment projects.

Reflecting the pickup in consumption, retail sales grew by 15.4% in the first half, up from 13.4% in the year-earlier period (Figure 3.2.3). Two main factors are driving consumption growth. One is rising incomes,

3.2.1 GDP growth



Source: China.org.cn, available: http://www.china.org.cn/e-news/index.htm, downloaded 31 August 2007.

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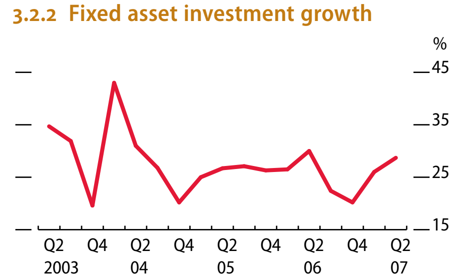
3.2.2 Fixed asset investment growth



Sources: CEIC Data Company Ltd., downloaded 31 August 2007; staff estimates.

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supported by enterprise profits, salary increases for civil servants, higher minimum wages for some employees, and policies to stimulate the economy in rural areas. Urban and rural incomes in real terms rose by 14.2% and 13.3%, respectively, in January–June (Figure 3.2.4). The second is that, as central and local governments pay more attention to social security and increase investment in education, health care, and low-cost housing, some households may be encouraged to release savings and spend more. Consumers stepped up spending on big-ticket items, such as housing and automobiles. Sales of automobiles jumped by 36.7% in the first 6 months of the year, albeit from what is still a low base.

External demand was strong, too, in the first half. Merchandise exports rose by 27.6%, much faster than import growth of 18.2%, lifting the trade surplus to $112.5 billion (Figure 3.2.5). Temporary factors probably helped boost exports, including decisions by many firms to bring forward export shipments to before the imposition of midyear government measures to help limit the trade surplus. Import growth was damped by high global prices for commodities such as oil and agricultural products.

The growth rate for some exports could slow in the second half: from 1 June 2007, an export tariff was imposed on 142 products, while export tax rebates were reduced or abolished in July for 2,831 items. The aim is to rein back the growing trade surplus and at the same time ease strains on the environment by reducing goods production that requires high inputs of energy and natural resources, and that causes high levels of pollution. Accordingly, the Government has taken steps to curtail lending to polluting industries. Exports are forecast to grow by 20% and imports by 16% in the second half of 2007, resulting in a record full-year trade surplus of around $300 billion, up more than 60% from 2006.

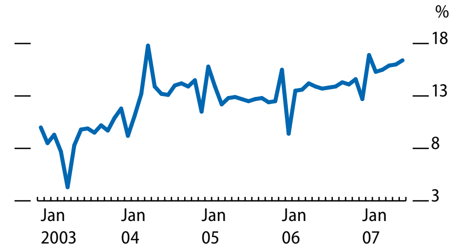
Based on the updated assessment of domestic and external demand, the full-year 2007 GDP growth forecast is revised to 11.2%, from 10.0% in *ADO 2007*. The current account surplus is now expected to swell to 10.9% of GDP, revised up from 8.8%.

Rapid economic growth in the first 6 months of 2007 helped create 6.3 million jobs in urban areas, 70% of the year's urban employment goal. The Government has introduced free training and subsidized job-search services, and plans to revitalize efforts to find work for laid-off workers, retired armed forces personnel, and others who find it difficult to integrate into the formal job market.

An upturn in inflation, mainly caused by food price increases, is raising concerns. The consumer price index rose by 3.9% in the January–August period from a year earlier, exceeding the 3.0% target set by the central bank for all of 2007. In August, inflation reached 6.5%. Rising global grain prices was one reason for the spike in food prices. Another is an outbreak in the PRC of a pig disease that caused shortages, and pushed up prices, of pork. The producer price index rose by 2.4% in the first 6 months, well below the pace of consumer prices, since despite high international prices for oil and other raw materials, many of their domestic prices are controlled by the Government. The net effect of the higher than expected food prices has led to a revision in the full-year inflation forecast to 4.2% from 1.8% in *ADO 2007*.

Rising stock and property values also pose challenges: these markets

3.2.3 Retail sales growth



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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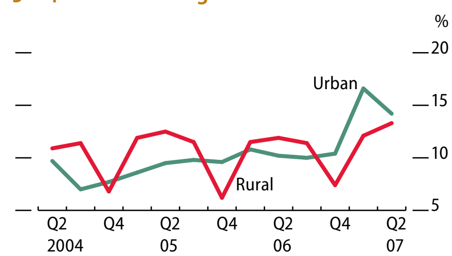
3.2.4 Real income growth



Sources: National Bureau of Statistics, *China Statistical Abstract 2007*, and *China Monthly Economic Indicators*, various years.

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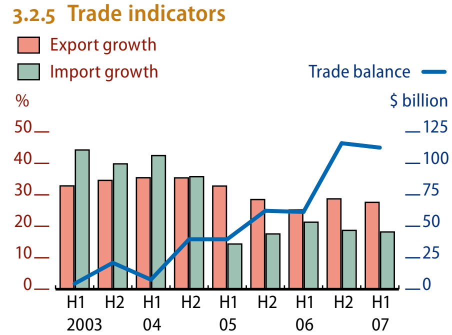
3.2.5 Trade indicators



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, various years.

Click here for figure data

continued to boom in the first half of the year. After several years of dull performance, stock prices started to soar in 2006 when a long-standing issue concerning the future of state-owned nontradable shares was resolved in a way that eased market concerns. Excessive liquidity in the financial system and relatively unattractive bank deposit interest rates have also been key factors. The Shanghai A-share index (for shares available to domestic investors) nearly doubled in the first 8 months of 2007, after a 130% leap last year (Figure 3.2.6). To curb market speculation, the authorities in May raised the stamp duty on stock transactions and brought in measures to curb the use of bank loans for stock market speculation. These steps had limited impact. After an initial decline, the A-share index rebounded to reach a new record high by end-July, and was largely impervious to August's turbulence in global credit and equity markets.

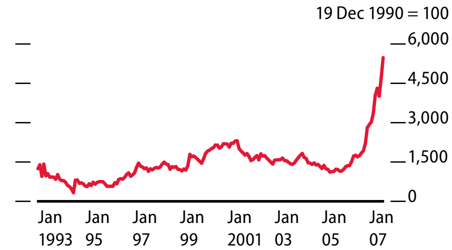
Housing prices have accelerated in many cities this year (and rose at double-digit rates in some, including Beijing and Nanjing) due to excessive liquidity and a surge in demand. Sales of new houses nationwide jumped by 22.5% in the first half.

Persistently high trade surpluses and capital inflows have further boosted foreign exchange reserves, complicating monetary policy. Reserves reached $1.3 trillion by end-June, up by $266 billion in 6 months (Figure 3.2.7). The trade surplus ($122.5 billion) and actual foreign direct investment (FDI) (up 12.2% to $31.9 billion), accounted for 54% of the total foreign exchange accumulation in the first half of 2007, while non-FDI capital inflows contributed 46% (against just 3.0% in 2006). The main reason for much higher non-FDI inflows was repatriation of the substantial proceeds from initial public offerings of shares by PRC banks and companies launched mainly in the Hong Kong, China stock market. The authorities are concerned that capital inflows are being used to speculate in domestic stock and property markets, and on a greater appreciation of the yuan.

The People's Bank of China, the central bank, has continued to drain excess liquidity from the banking system but has not completely offset capital inflows. Broad money supply (M2) grew by 18.5% in July from a year earlier (Figure 3.2.8), above the central bank's target of 16.0%. Bank lending also is strong: loan growth was 16.5% at end-July (Figure 3.2.9). The authorities allowed the yuan's appreciation against the US dollar to accelerate slightly in nominal terms to 4.4% in the second quarter of 2007 (year on year), from 3.7% in the first and 2.8% in all of 2006 (Figure 3.2.10).

Among its efforts to curtail liquidity and to tame investment, the Government took several financial measures in the first 9 months of 2007, including further increases in interest rates (the 1-year benchmark lending rate was raised from 6.12% to 7.02%; Figure 3.2.11.) and in the commercial banks' reserve-requirement ratio (from 9.5% to 12.5%; Figure 3.2.12), in addition to the imposition of export tariffs and the cuts in export tax rebates. These measures built on successive steps taken over recent years. But the effectiveness of interest rate rises in cooling demand is hindered by seepages into liquidity of rising foreign exchange reserves and by the fact that the economy is still not fully market-based. Incentives, particularly at the local level, to build more production plants and real

3.2.6 Shanghai stock exchange index, A-share



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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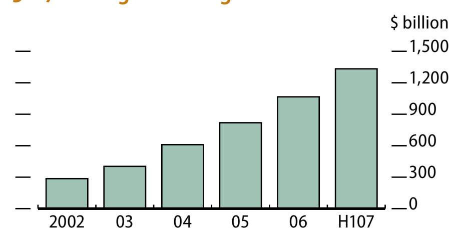
3.2.7 Foreign exchange reserves



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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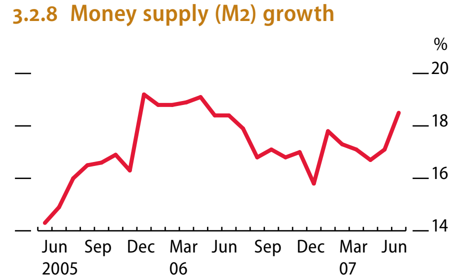
3.2.8 Money supply (M2) growth



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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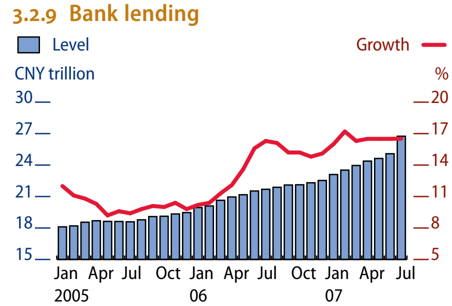
3.2.9 Bank lending



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, various years.

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estate projects also frustrate efforts to limit investment growth. Measures to liberalize investment from the PRC in the Hong Kong, China stock market could help curb rises in foreign exchange reserves, and form a stepping stone to broader liberalization of capital account outflows.

The rapid economic growth and buoyant corporate profits helped boost fiscal revenue by 30.6% in the first half of 2007, when fiscal expenditure grew by 22.7%. The surge in receipts and a slowdown in public infrastructure spending should help keep the budget deficit this year to less than 1% of GDP. Reflecting changes in spending priorities, outlays on rural development, education, social security, and health care all rose by 28–36% during January–June. The Government announced in March that it is developing a plan for state-owned companies to pay dividends (instead of reinvesting profits, one reason for the rapid growth in investment).

Prospects

The faster than expected growth momentum built up this year is expected to carry into 2008. Further steps to cool the rapid investment expansion are likely and the Government will put more emphasis on improving energy efficiency and on cutting pollution. But top priorities remain the creation of jobs for nearly 8 million rural surplus workers migrating to cities each year, and on lifting income growth in lagging regions. Moreover, fiscal spending looks set to increase in 2008 with more public investment slated for education, health care, and rural development.

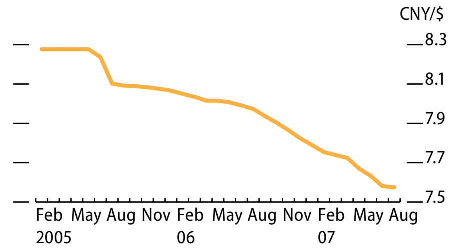
On the demand side, rising incomes and improvements to the social security system are projected to underpin growth in consumption. Investment will stay high, supported by local governments that want to generate employment and develop their cities, by banks willing to lend, and by enterprises eager to expand and maintain earnings growth. The gap between export and import growth will probably close a little as the changes to export tariffs and export tax rebates take effect.

GDP growth for 2008 is revised to 10.8% (Figure 3.2.13), up 1 percentage point from the *ADO 2007* forecast. The current account surplus is put at 10.5% of GDP (Figure 3.2.14), revised up because of a sustained high merchandise trade surplus and a narrower deficit in services trade. On the production side, agriculture should be strengthened by policies to lift rural incomes and to improve rural infrastructure, and services will be supported by the summer Olympics. But industry is again expected to contribute the lion's share (about two thirds) of GDP growth in 2008.

The sharp increases in food prices seen in 2007 are assumed to ease next year. This would open the way to carry out planned reforms in the pricing of state-controlled sectors such as water, power, and natural gas, which will probably mean tariff increases by these utilities. On this basis, the inflation forecast for 2008 is raised from 2.2% to 3.8% (Figure 3.2.15).

Significantly higher inflation than forecast would, however, pose a risk to the outlook. Adverse weather would lower domestic grain production, at a time that imported grain prices are high. Furthermore, the pig disease might not be brought under control as quickly as the forecast assumes. Finally, the increases in the consumer charges from changes

3.2.10 Monthly yuan-dollar exchange rate



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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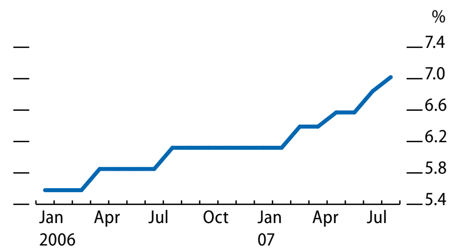
3.2.11 Benchmark lending rate (1 year)



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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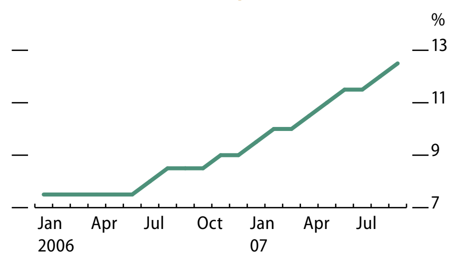
3.2.12 Bank reserve-requirement ratio



Source: People's Bank of China, available: http://www.pbc.gov.cn/english/, downloaded 31 August 2007.

Click here for figure data

3.2.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	10.0	11.2	9.8	10.8
Inflation	1.8	4.2	2.2	3.8
Current acct. bal. (share of GDP)	8.8	10.9	8.9	10.5

Source: Staff estimates.

to utilities' tariffs could turn out to be larger than currently expected, although these effects would likely be temporary and price liberalization would bring lasting benefits to the economy.

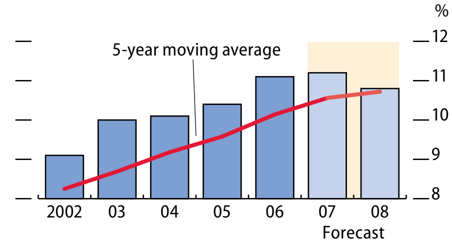
Another risk comes from the booming stock market. A major downturn in stock prices would likely damage bank balance sheets if borrowers faced major losses in stocks and could not service their bank loans. No official data are available on exposure, but it seems that some bank loans to households and enterprises have been used to speculate in stocks. Banks faced with rising nonperforming loan ratios would likely tighten lending, with impacts on the broader economy. A drop in stock prices that reduced household wealth would crimp private consumption, at least in urban areas, given the wider spread of stock ownership in recent years (more than 30 million new stock-trading accounts were opened in January–July 2007 alone).

The authorities face the important challenge of making progress with the plan to rebalance the economy, by reducing its reliance on exports and on investment for growth in favor of private consumption. Such a switch could lessen vulnerability to external shocks and ease environmental strains caused by the emphasis on export- and investment-led heavy industry. Yet policy measures taken over the past few years in this direction have so far achieved only modest rebalancing. Indeed, growth in the trade surplus and in investment outpaced growth in retail sales in the first half of 2007.

From a structural perspective, it seems that any substantial change in the current growth pattern is unlikely as long as the savings rate remains so high. Further, several studies of the country's flow-of-funds tables show that the increase in the national savings rate between 1992 and 2003 came mainly from rising government and enterprise saving; household saving, in contrast, fell by 3% as a share of total disposable income in those years. This drop occurred mainly because the household share of national disposable income declined during the same period, from 69% to 63%, while the government and enterprise shares rose, respectively, from 19% to 22% and from 12% to 15%. Available data since 2003 suggest that this trend has continued. Household incomes have grown in the past decade, but not as fast as enterprise profits and government revenues.

Therefore, lifting the share of total income going to households appears to be needed to achieve the economic rebalancing. Options to stimulate incomes include strengthening the implementation of minimum wages, further improvements to the social safety net, increasing public spending in education and health, and developing the capital market and the banking system to provide more avenues for consumer finance.

3.2.13 GDP growth



Sources: National Bureau of Statistics; staff estimates.
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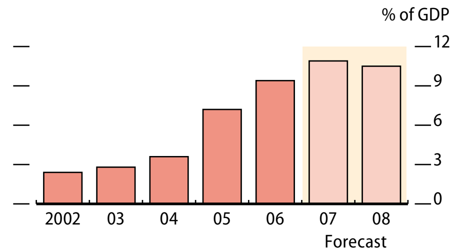
3.2.14 Current account balance



Sources: National Bureau of Statistics; staff estimates.
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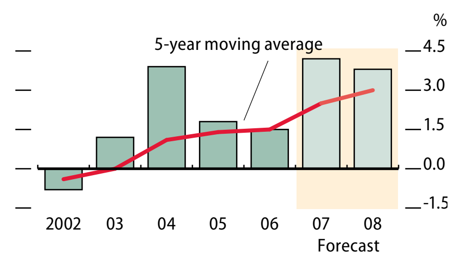
3.2.15 Inflation



Sources: National Bureau of Statistics; staff estimates.
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