

People's Republic of China

Softening external demand and the impact of policy tightening trimmed GDP growth to a still-rapid 10.4% in the first half of 2008. Private consumption remained robust because incomes generally outpaced inflation. This *Update* maintains the April growth forecast at 10.0% for this year and revises the 2009 forecast down slightly to 9.5%, on the expectation of a reduced trade surplus and slower investment growth. These developments are helping rebalance the structure of demand toward greater reliance on private consumption. The inflation projection is raised to 7.0% for this year and to 5.5% for 2009. Some policy easing is expected as the authorities focus on maintaining growth and creating employment.

Updated assessment

Although the rate of economic growth has eased in each of the past three quarters, GDP still expanded by a rapid 10.4% in the first half of 2008 (Figure 3.3.1). The slowing in the second quarter from the first reflected an easing in external demand, policy-tightening measures, and the impact of the Sichuan earthquake in May (Box 3.3.1).

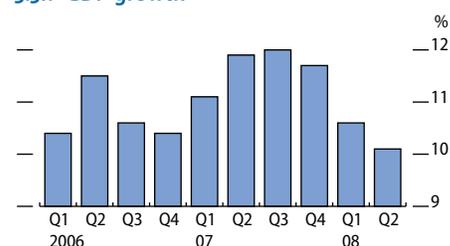
On the supply side, a slowdown in industrial output from 16.4% year on year in the first quarter to 15.9% in the second contributed the most to the deceleration in GDP. The production slowdown was mainly in consumer goods for export. Production of capital goods grew by about 17%, showing little sign of slowing due to strong, though declining, growth in domestic investment.

Weaker economic growth in industrial countries damped exports, as did a reduction in tax rebates on exports. Resilient demand from developing economies helped offset in part slower industrial-country export orders, so that overall export growth was a still-robust 22% in the first half (Figure 3.3.2), down 2 percentage points from the second half of 2007. Import growth of 30.6% outpaced that of exports, and the trade surplus fell by about 11% from a year earlier to \$99.7 billion. As a result, net exports are likely to contract and subtract from GDP growth in full-year 2008.

Fixed-asset investment grew by 26.3% in nominal terms in the first half, but after taking into account an acceleration in inflation, real investment growth slowed to around 15% from 22% (Figure 3.3.3). It was kept in check by rising prices for fuel, power, and raw materials (all rose by more than 10% in the first half), a halving in the nominal growth of industrial enterprise profits to about 20%; a slowdown in the property market owing to a tightening of credit; government directives to reduce fixed-asset investment in real estate, steel, cement, aluminum, and automobiles; and the softening in demand for exports. Foreign direct investment (FDI) picked up to average nearly \$9 billion a month.

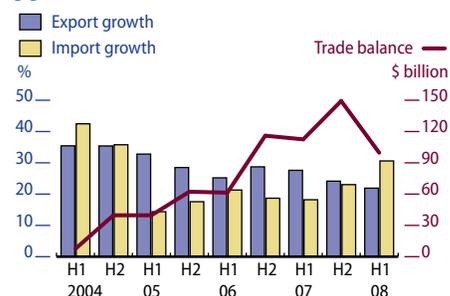
Private consumption was strong, despite accelerating price pressures.

3.3.1 GDP growth



Sources: Asian Development Outlook database; National Bureau of Statistics.

3.3.2 Trade indicators



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

3.3.1 Impact of Wenchuan earthquake on the economy

The massive earthquake in Wenchuan, Sichuan province on 12 May 2008 was the country's worst natural disaster in a generation. Although the most seriously affected areas are sparsely populated mountainous regions, the number of fatalities and people missing totaled more than 80,000. Many more were injured and 46 million left homeless.

The earthquake disrupted production, transportation, and communications in several counties of Sichuan and its neighboring Gansu and Shaanxi provinces. Given that the affected region is home to just 1% of the country's population and accounts for about 2% of national economic output, the destruction might lower GDP growth by 0.15–0.2 percentage points during the second and third quarters this year.

The loss in production will be

at least partly offset by increased investment for reconstruction in the second half of 2008 and in 2009. As a result, the overall reduction in 2008 GDP growth is expected to be less than 0.2 percentage points.

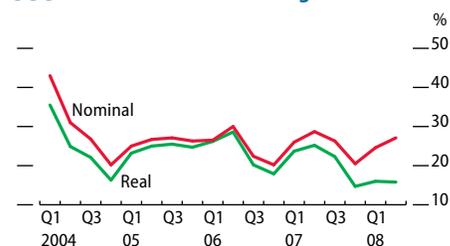
Some additional upward pressure was put on inflation by the loss of farm production, including that of pigs. The earthquake also destroyed an estimated 5.5 million buildings, and total property damage was put at more than CNY500 billion (\$72.1 billion). Few people had insurance.

The Government earmarked CNY70 billion (\$10.1 billion) of its own funds for reconstruction and arranged for 19 provinces in the eastern and central regions to provide assistance to 18 counties in Sichuan and to severely affected areas in Gansu and Shaanxi provinces.

Retail sales in nominal terms grew by 22.2% in the April–June period (Figure 3.3.4). While higher prices accounted for part of this increase, real incomes continued to grow, underpinning rising consumption. Per capita urban incomes rose by 6.3% in real terms in the first half (slower than 14.2% growth a year earlier—Figure 3.3.5), and rural incomes rose by 10.3% (13.3% a year earlier). Greater government spending on social security, education, and health care might also be encouraging households to spend more, as their need to build savings to pay for these services diminishes. Employment generation continued at a high level, too, with 6.4 million new jobs in urban areas in the first half, slightly above 6.3 million in the same period of 2007. The continued strength in private consumption, combined with a slowing in investment and exports, is starting to achieve the authorities' sought-after rebalancing in the structure of demand.

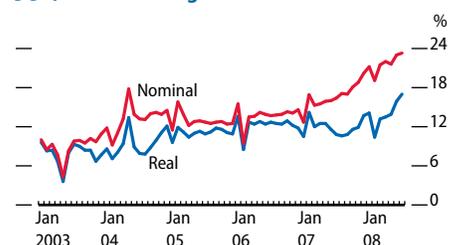
Inflation has been higher than was expected in *Asian Development Outlook 2008 (ADO 2008)* in April this year. The consumer price index (CPI) rose by 7.7% in the first 7 months, driven mainly by rising food prices (Figure 3.3.6) and, to a lesser degree, by increasing rents. The jump in food prices particularly hurt rural poor and low-income city residents (Box 3.3.2). Consumer inflation started to ease after April (from 8.5% in that month to 6.3% in July). The producer price index, however, continued to accelerate, from 8.2% in May to 10.0% in July, influenced by higher prices for imported oil and iron ore, and by stronger demand for

3.3.3 Fixed asset investment growth



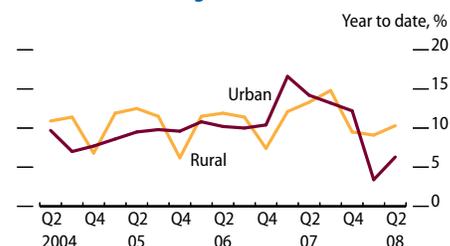
Sources: CEIC Data Company Ltd., downloaded 1 September 2008; staff estimates.

3.3.4 Retail sales growth



Source: CEIC Data Company Ltd., downloaded 1 September 2008.

3.3.5 Real income growth



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

3.3.2 Steps taken to reduce the impact of food price rises

Food prices in the People's Republic of China rose by 20.6% between July 2007 and June 2008, accounting for about 88% of the overall rise in consumer prices over that period. In contrast, nonfood consumer prices rose by 1.5%. The rise in food prices was concentrated in pork, which rose by about 70% because of shortages caused by a pig disease, and cooking oil, which rose by about 40%, reflecting global prices for this commodity. Pork prices started to decline from April 2008 as farmers replenished livestock numbers. Prices of other foods, including grain, rose moderately in the year to June.

Farmers who produce a surplus to their household needs can usually benefit from rising food prices because of the higher selling prices. But the poorest and most vulnerable rural residents—the elderly, chronically ill, disabled, and those with small or less productive plots of land—are worse off when food prices rise. The urban poor, who spend a high proportion of their incomes on food and have none to sell, also suffer, unless their

incomes rise to compensate. Higher prices lead some families to turn to cheaper food with lower nutritional quality, or they eat less.

Steps taken by the Government in the face of rising food prices included the sale of grain from reserves. About 13.5 million tons of rice and wheat was sold from grain reserves in 2007. Reserves remain high though, estimated by the Food and Agriculture Organization of the United Nations at 156 million tons of cereals in 2007, or 40% of annual consumption. Export taxes were imposed on some food products in January 2008 and the Government strengthened its price controls by requiring large producers of food to seek official permission to raise prices.

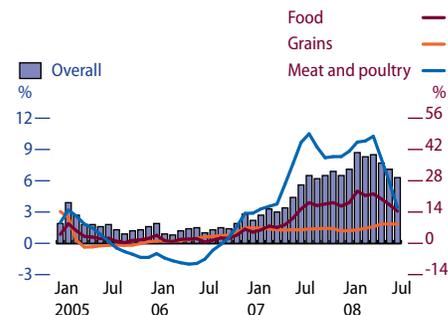
To directly help the poor cope with higher food prices, the Government has raised income support through programs for protecting minimum living standards known as *dibao*. In January 2008 and again in July, it raised the rural *dibao* by CNY10 a month and the urban *dibao* by CNY15 a month.

materials for earthquake reconstruction. Steps taken by the authorities to curb prices seem to have inhibited a spillover of price pressures into higher wages or into inflation expectations. Average salaries of urban employees rose by 18.0% in the first half of 2008, about the same rate of increase as the year-earlier period.

Stock and property markets have weakened, partly a reflection of tightened bank lending. The Shanghai A-share stock index (for shares accessible to domestic investors) plunged by about 60% between October 2007 and August 2008, after soaring throughout 2006 and most of 2007 (Figure 3.3.7). House price growth slowed in 70 cities in the first half of 2008 and sales, as measured by floor space, fell in big cities.

Rapidly growing FDI and speculative capital inflows boosted foreign exchange reserves by 36% to \$1.8 trillion in the 12 months to 30 June 2008 (Figure 3.3.8), even as the trade surplus fell. Non-FDI capital inflows contributed 46% to the buildup in foreign reserves, prompting concern among the authorities that speculators are betting on a faster appreciation of the yuan, and that the banking system could be jolted if the inflow of speculative capital is reversed.

3.3.6 Monthly inflation



Source: CEIC Company Data Ltd., downloaded 1 September 2008.

3.3.7 Shanghai stock exchange index, A-share



Source: CEIC Data Company Ltd., downloaded 31 August 2008.

3.3.8 Foreign exchange reserves and exchange rate



Source: CEIC Data Company Ltd., downloaded 1 September 2008.

The People's Bank of China, the central bank, is working to drain from the banking system excess liquidity created by the accumulation of foreign reserves. It has used increases in commercial bank reserve requirements as its major tool for managing liquidity, given that interest-rate increases might attract even stronger capital inflows. It raised these reserve requirements six times between end-2007 and July 2008, from 14.5% to 17.5%. In this manner, and by issuing more of its own bills, the central bank absorbed about CNY1.8 trillion (\$256.4 billion) of liquidity. These efforts have been combined with guidance to banks to adopt informal credit quotas to curb lending. The tightening measures slowed growth in bank lending to 15.5% in July 2008, from a recent high of 18.0% in October 2007 (Figure 3.3.9). Growth of broad money (M2) slowed slightly from 16.7% in December 2007 to 16.4% in July 2008 (Figure 3.3.10), still above the central bank's target of 16.0%.

The authorities allowed the yuan to appreciate by 7.3% against the US dollar in nominal terms between end-2007 and July 2008, a little faster than the 6.9% appreciation for all 2007 (Figure 3.3.8). Concerned that this might attract more speculative capital inflows and also harm small and medium exporting firms that employ a large portion of rural migrants, they tightened capital controls in August. The real effective exchange rate rose by 3.6% in the first 7 months of 2008.

After the Sichuan earthquake, the Government raised the forecast for the national budget deficit from 0.8% to 1.0% of GDP to fund reconstruction. (There was a fiscal surplus of 0.7% of GDP in 2007.) Revenues increased by 31.4% in the first half of 2008, well above the budgeted 14.0% increase for 2008, but a deceleration in corporate tax revenues and a cut in the tax on stock trading in April could slow revenue growth in the second half. Expenditures, which grew by 25.8% in the first half, are likely to accelerate further in the second, in order to rebuild earthquake-hit areas and to fund higher subsidies both for farmers and some transport operators following an increase in administered retail fuel prices in June 2008 (Box 3.3.3).

Prospects

The Government has indicated that it will put more emphasis on maintaining economic growth in the second half of 2008 and in 2009. This is likely to mean that some administrative controls on bank lending are loosened to assist smaller firms (which have been squeezed financially and may reduce employment otherwise). Fiscal policy is expected to remain slightly expansionary, with spending raised on reconstruction, agricultural development, and social sectors.

Rising production costs and softening external demand are forecast to trim export growth from 26% in 2007 to 20% in 2008 and 15% in 2009. At the same time, higher oil and commodity prices will push up import growth from 20% in 2007 to a projected 29% in 2008, before it eases to 21% in 2009, as global oil prices fall slightly. Faster growth of imports than exports will reduce the trade surplus from \$315 billion in 2007 to \$290 billion in 2008 and \$260 billion in 2009.

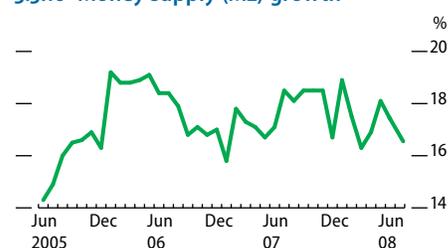
As for domestic demand, growth in real fixed-asset investment is projected at 13.0% this year, slowing from 20.1% in 2007 because of the

3.3.9 Bank lending



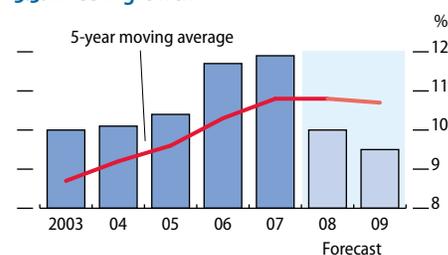
Source: CEIC Data Company Ltd., downloaded 30 August 2008.

3.3.10 Money supply (M2) growth



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

3.3.11 GDP growth



Sources: National Bureau of Statistics; staff estimates.

3.3.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	Update	ADO 2008	Update
GDP growth	10.0	10.0	9.8	9.5
Inflation	5.5	7.0	5.0	5.5
Current acct. bal. (share of GDP)	9.9	8.3	8.6	6.1

Source: Staff estimates.

factors listed above. Next year, investment growth is likely to ease to about 12%, on weakening external demand and slowing domestic sales growth in industries such as cement and steel. Private consumption growth, in contrast, is projected to step up to 12.0% in 2009 from 11.0% this year and 9.6% in 2007, supported by rising incomes and public investment in education, health care, and social security.

Based on the above projections, the GDP growth forecast for 2008 is maintained at the 10.0% made in *ADO 2008*, in April this year. The forecast for 2009 is revised down to 9.5% from 9.8% because of smaller trade surpluses and slower investment (Figure 3.3.11 above). On the basis of the lower merchandise trade surplus, as well as a continuing deficit in services trade, the forecast for the current account surplus is revised down to 8.3% of GDP in 2008 and to 6.1% in 2009.

Grain harvests this summer were better than expected and pork production is recovering, a result of steps taken that included increases in credit to pig farmers. Food price inflation has been easing since May 2008, and is expected to decline to single-digit levels late in the year. That should bring down overall inflation, since food constitutes a third of the CPI. However, as food inflation eases the Government is expected to further raise administered prices of fuel and electricity (their prices were increased in January–August). Based on higher than expected inflation in the first half, the inflation forecast for 2008 is revised up to 7.0% from 5.5%, above the 4.8% target set by the Government in March 2008 and the highest inflation rate since 1996. The further increases in fuel and electricity costs, and some likely spillover of rising production costs into consumer prices, lift the 2009 inflation forecast to 5.5% from 5.0%, keeping inflation well above the average 2.6% rate recorded in 2003–2007.

Growth of 9.5% in 2009 would bring GDP expansion into the 9–10% range considered by various studies to be the economy's potential rate of growth, without putting undue strains on energy, natural resources, the environment, and inflation. Reaching the Government's inflation target, though, is likely to require a further rise in interest rates (the last was in December 2007). Measures taken so far in 2008 to rein in price pressures have included the increases in bank reserve requirements (Figure 3.3.12); quotas for commercial bank lending; freezing prices for some goods and services and requiring official approval to raise other prices; scrapping tax rebates for grain exports and levying export taxes on some types of grain; and allowing the yuan to continue to appreciate against the US dollar.

The main risks for the 2009 forecast involve any sharper than expected deceleration in exports because of weakness in overseas markets or double-digit inflation that would require an aggressive tightening of monetary policy. Bad weather for agriculture or a new outbreak of livestock disease could reverse the easing in food price inflation and erode consumption growth. A hard landing for the economy (defined as GDP growth below 7%) is unlikely in 2009, although growth could decelerate to 7–8% if these risk factors materialize. In this unlikely event, the Government has the fiscal resources to spur consumption; for example, it could raise the income threshold at which personal income taxes start, provide more assistance to low-income groups, and further increase social sector spending.

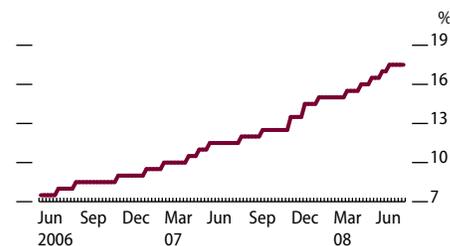
3.3.3 Hikes in energy prices and subsidies

Fuel prices in the PRC are kept relatively low (some studies show retail prices are 40% lower than the global average) by government subsidies to oil companies. These were equivalent to about 0.2% of GDP in 2007 and could reach 1.0% this year.

To reduce the cost of subsidies, and to ease a fuel supply shortage in some coastal provinces caused by the relatively low prices, the National Development and Reform Commission in June 2008 raised benchmark gasoline and diesel retail prices by 16–18% and aviation kerosene by 25%, the first increases since October 2007.

The reduction in outlays on fuel subsidies allowed the authorities to use part of the savings as assistance for those hurt most by higher retail fuel prices: low-income families, grain producers, and taxi and bus operators. The increases in urban and rural *dibao* were also intended to help the poor cope with higher fuel prices.

3.3.12 Bank reserve requirement ratio



Source: People's Bank of China.