

OVERVIEW

In spite of the global recession, China's economy grew 8.7 percent in 2009. Massive investment-led stimulus was key, but real estate investment gained prominence more recently and household consumption growth has held up very well. The domestic growth momentum continued in the first months of 2010. Exports declined in 2009 as a whole, even as China gained global market share. With imports strong, external trade was a major drag on growth in 2009 and the external current account surplus declined sharply. Exports rebounded strongly through 2009, though, and exceeded the pre-crisis level in early 2010. In a heated real estate market, surging property prices triggered policy measures to expand supply and curb speculation.

We project 9.5 percent GDP growth for this year, with a shift in the composition. Government-led investment is bound to decelerate. But, exports are likely to continue to recover amidst a pick up in the global economy and real estate activity is likely to grow strongly this year. Consumption growth should remain solid. Inflation is on course to be significant in 2010, after being negative in 2009. But, with global price pressures likely to be subdued amidst large spare capacity internationally, China's inflation is unlikely to reach high rates in 2010. We expect the external surplus to remain broadly unchanged this year.

The macroeconomic policy stance needs to be tighter than in 2009. Unlike in most other countries, overall output in China is close to potential. Thus, China needs a different macro stance than most other countries. Macroeconomic risks include a property bubble and strained local government finances. The 2010 budget rightly implies a broadly neutral fiscal stance. Given the remaining uncertainty about the world economy, flexibility in its implementation is important. Inflation expectations can be contained by a tighter monetary stance and a stronger exchange rate, while monetary policy also has a key role to play in containing risks of asset price bubbles. The case for a larger role for interest rates in monetary policy is strong. If policymakers remain concerned about interest rate sensitive capital flows, more exchange rate flexibility would help.

Ensuring economic and financial stability includes mitigating risks of a property bubble and strains on local government finances. With regard to the property market, stability calls for an appropriate macro stance and improving the functioning of markets. Concerns about the affordability of housing for lower income people would be best addressed by a long term government support framework. The central authorities have rightly increased vigilance over lending by local government investment platforms. Given China's solid macroeconomic position, the local finance problems are unlikely to cause systemic stress. But the flow of new lending to the platforms needs to be contained and local government revenues need to become less dependent on land transaction revenues.

In the presentations to the NPC, the government emphasized the need for structural reforms. As China is preparing for the 12th Five Year Plan, the key overall objectives are making further progress in "rebalancing" the economy, enhancing efficiency gains, moving to a more sustainable spatial transformation of economic activity and employment, further changing the role of the state in the economy, and taking account of China's interaction with the rest of the world.