

## OVERVIEW

**China's economy has continued to grow robustly, with some softening recently.** So far in 2010, the slowdown in government-led investment (GLI) after last year's massive stimulus has partly been offset by strong real estate investment. Household consumption growth has held up well, reflecting a favorable labor market. Despite a rapid recovery of export volumes since the trough in early 2009, China's trade surplus has declined further due to surging import volumes and declining terms of trade. Inflation has picked up somewhat, but core inflation remains low. However, soaring property prices triggered tough property-specific measures. Leading indicators and industrial production data suggest some deceleration to a still rapid rate of growth.

**China's economic outlook remains favorable.** Despite concerns about fiscal risks in some high income countries, the global growth outlook remains favorable, in large part because of the strength in emerging markets. Nonetheless, risks around the global forecast are large. In China, after a rapid start to 2010, growth is likely to ease, mainly because of a partial normalization of the macro policy stance and the property measures. We project GDP growth of 9.5 percent for 2010 as a whole, and 8.5 percent for 2011, with risks both ways. Growth should be less investment-driven this year and benefit from more favorable external trade. Consumption is likely to remain supported by a strong labor market. The external surplus should decline somewhat further this year. Inflation is likely to remain contained this year by the absence of price pressures globally while a wage-price spiral is not likely.

**Such prospects warrant further normalization of the macroeconomic stance, while keeping flexibility.** Further consolidation of the overall monetary stance, as outlined, is needed to contain the key macroeconomic risks. Substantial uncertainty around a favorable baseline projection calls for policy flexibility rather than continued stimulus by default. The central authorities are rightly aiming to control lending by local government investment platforms. However, interest rates remain low. China could usefully let interest rates play a larger role in monetary policy. If policymakers remain concerned about capital flows, macro prudential regulation and more exchange rate flexibility would help.

**Policy making needs to take into account several features of the medium term outlook.** Considering the prospects for its key determinants, trend growth is on course to decline in 2010-20, but to a still respectable rate. The contributions from labor and TFP are likely to decelerate somewhat while, with some rebalancing expected, capital accumulation should also slow. In setting growth targets for the coming decade, the likely slowdown in potential growth needs to be acknowledged. The expected deceleration of potential growth also places a premium on policies that can increase sustained productivity growth, including via more reallocation of labor, enhanced human capital, and innovation.

**Moreover, further reforms are needed to ensure economic growth remains sustainable socially and with regard to energy and the environment.** Fiscal policy reforms in several areas are key in this effort. Additional reforms in social protection and labor market arrangements are important both to foster productivity growth and improve social outcomes. The government's intention to strengthen the role of private enterprises in the economy and remove barriers they face is welcome. In this connection, it would be useful to clarify the role that the government envisages SOEs to play in China's economy.