China

Economic growth remains rapid and the trade surplus continued to widen into the third quarter, under an unchanged pattern of growth. Boosted by a continued strong contribution of external trade and an investment driven recovery in domestic demand, GDP growth reached a particularly high 11.5 percent (yoy) in the first half of 2007 and 11.9 percent in the second quarter. The soaring trade surplus, which so far seems little affected by measures to contain export growth, constitutes the bulk of the rising balance of payment surplus. This surplus is adding to domestic liquidity and contributing to steady asset price increases, share prices in particular.

Consumer price inflation rose to a decade high because of higher food prices. This is in part due to high pork prices, which have shown regular spikes in the past, and which may be affected this year by a pig disease as well. However, prices of many other food items have risen in line with higher international food prices. So far, the price pressures have been confined to food. Indeed, producer price inflation has come down as industrial commodity price rises have moderated. China's raw material prices are overall affected by international ones. This means that the recent moderation in international commodity price increases, if continued, should help reduce domestic price pressures. Asset prices are still rising steadily, though, and the stock market indices are constantly setting new records.

The recent international financial market turmoil may affect China's economy, but China is well-placed to absorb the impact. The impact via losses of Chinese financial institutions holding overseas assets and, as evidenced by the continued challenge to mop up liquidity in the financial system, the transmission of financial turmoil to China's markets seems to be limited. The main impact of the international turmoil is likely to run via the real economy. Although the world economy still retains momentum, China will be affected more than most other large emerging markets by an economic slowdown in key markets, because of the large weight of exports in China's economy. At the same time, China is better placed than many countries to deal with the impact. A moderate global slowdown would mitigate pressures of concern to policymakers on overall growth, inflation, and the trade surplus, while China's strong macroeconomic position provides room to adjust the domestic policy stance, if necessary.

There are no indications that cost pressures are significantly affecting the competitiveness of China's exports. High international commodity prices have pushed up prices of manufacturing goods across the world, including in China, and China's industry has also faced domestic cost pressures. As a result, prices of China's exports are now rising in US dollar terms, but they are still rising by less than those of other countries.. In other words, China is still gaining competitiveness. Indeed, export volume growth has remained strong and profit margins in industry have continued to rise in 2007.

China's macroeconomic prospects generally remain good. Domestically, prospects remain buoyant. With profit and credit growth strong, investment is likely to continue to expand strongly. Consumption is expected to remain solid as well, although high consumer price inflation constrains real consumption growth. We now project GDP growth of 11.3 percent in 2007 and 10.8 percent in 2008. With international food price increases expected to remain substantial but producer price rises to moderate, we expect CPI inflation to gradually ease from later in 2007 onwards, although upward risks remain. We now project a current account of around 12 percent of GDP.

The external balance remains China's main macroeconomic issue. While there are no serious demand and price pressures yet, the very strong growth risks eventually outpacing supply. Thus, the authorities are rightly aiming at avoiding excess demand and the spillover of high food prices into generalized inflation, and mopping up liquidity and raising interest rates will continue to be needed. However, the main macroeconomic task remains to contain the rising trade surplus, and a stronger real exchange rate is the most obvious tool. Indeed, reducing the external imbalance may become an important contribution from China to world growth, if a sharper than expected US slowdown was to occur. The government has taken some—largely tax-based—measures to slow export growth. However, given the size of the surplus and the drivers behind the surplus, significantly more policy action is likely to be needed.

In the long term, the key challenge remains to rebalance the economy. The package of policies to deal with these challenges would include real exchange appreciation, with, over time, more exchange rate flexibility; monetary policies that tighten liquidity and increase interest rates; a change in the composition of fiscal spending, with more spending on health and education; further financial sector reforms; structural policies that change the relative attractiveness of manufacturing versus services; and removal of remaining obstacles to rural-urban migration.

While continued rapid growth would eventually lead to a drying up of surplus labor, there are several reasons to think that China may not yet be close to a labor shortage. These are discussed in the Special Focus of the September 2007 China Quarterly Update. Most analysts on the issue focus on demographics, and note that there are fewer under-thirty educated rural agricultural workers left, which are the ones most likely to migrate to cities. However, in addition to demographics, policies and individual choices also affect labor supply. In preparing for less labor abundance, it is therefore important to take into account the impact of policies, including those on vocational education, rural land and pensions, on the labor supply.