

OVERVIEW

China's economy has continued to feel the brunt of the global crisis. Global economic activity continued to decline in the first part of 2009, even as tentative signs of stabilization have emerged recently in several countries.

However, very expansionary fiscal and monetary policies have kept the economy growing respectably. Fiscal stimulus is centered on the infrastructure-oriented “RMB 4 trillion” stimulus plan and the monetary stimulus has led to a surge in new bank lending. Government-influenced investment has soared. Market-based investment has lagged, although positive signs have emerged in the real estate sector. Consumption has held up well. Very weak exports have continued to be the main drag on growth, but import volumes have recovered in the second quarter of 2009 as raw material imports rebounded.

Global growth prospects remain subdued even as signs of stabilization have emerged. Financial markets have become less strained and there are prospects for stabilization of activity. However, a rapid global recovery seems unlikely and uncertainty remains. The risk of global deflation seems low, although spare capacity will continue to put downward pressure on prices of manufactured goods. Monetary policymakers in major countries should in principle be able to prevent inflation from rising in the medium term, although risks remain, including political ones.

Growth in China should remain respectable this year and next, although it is too early to say there is a sustained recovery. Government influenced investment will strongly support growth in 2009. Nonetheless, there are limits to how much and how long China's growth can diverge from global growth based on government influenced spending, given that China's real economy is relatively integrated in the world economy. Meanwhile, market based investment is likely to continue to lag for a while because of the squeeze on margins amidst spare capacity in many manufacturing sectors. Prospects for real estate activity appear reasonably good, but consumption is unlikely to pick up speed. In all, China's growth is unlikely to rebound to very high single digit rates before the world economy recovers. We project GDP growth of 7.2 percent in 2009 and 7.7 percent in 2010.

China can have the confidence to emphasize forward looking policies and structural reforms. Based on our projections we think it is not necessary or appropriate to add more traditional stimulus in 2009. One reason is that the fiscal deficit is likely to be significantly higher than budgeted and additional stimulus now reduces the room for stimulus in 2010. Nonetheless, with subdued global demand and less export growth, China needs more growth from domestic demand—consumption in particular. Also, relative prices need to change, notably those of natural resources. The transition to more consumption-led, service sector-oriented, and labor-intensive growth requires policy adjustments that: (i) help channel resources to sectors that will grow in the new setting, instead of to sectors that have traditionally done well; and (ii) support thriving domestic markets and successful, permanent urbanization. Such reforms can be pursued more successfully if flanked by a well-functioning public finance system and social safety net.