China

Economic growth eased slightly in the second half of 2006, as strong external trade offset much of the impact of slower investment. Real GDP growth was 10.5 percent (yoy) in the second half of 2006, which brought growth for 2006 as a whole to 10.7 percent, compared to an upwardly revised 10.4 percent in 2005. Preliminary data suggests growth remained very strong in early 2007. Investment cooled in the second half of 2006 in response to tightening measures introduced mid-2006. Consumption has continued to grow robustly, but still slower than overall GDP.

Exports continued to outpace imports by a wide margin through February 2007, and in the second half of 2006 external demand largely offset the growth impact of the investment slowdown. The external surplus reached new highs: we estimate that China's current account surplus has overtaken Japan's in 2006 to be the world's largest. Processing export growth, which is predominantly done by foreign-invested firms, trended down in 2006 following slower global trade, but processing import growth declined even more. As a result, the processing surplus increased and now accounts for all of the trade surplus. China's deficit in non-processing trade declined from US$73 billion in 2004 to US$8 billion in 2006, as non-processing exports powered ahead. In addition to the current account surplus, inward FDI also provided a steady stream of inflows, and foreign exchange reserve accumulation continued apace. Surging stock prices prompted government measures to slow the amount of new funds moving in the stock market.

Consumer price inflation has picked up recently, led by higher food prices, especially grain. Since WTO accession, grain prices in China have been moving more in line with international prices, which rose sharply in late 2006. Chinese grain prices have recently risen less than international prices, though, in part because the government released grain on the market from its grain reserves. Non-food consumer price inflation remains modest at around 1 percent.

China's stock markets have risen sharply since mid-2006, although a correction took place end February. Besides continued strong profit growth, progress in equity market reform, notably the reduction in the overhang of non-tradable shares, has boosted stock prices. The rapid stock price increases have re-ignited the public's enthusiasm for investment on the stock market, and the amount of funds flowing into mutual funds increased rapidly. The government temporarily halted approval for new mutual funds in December and banned banks from extending loans for buying stocks in January. The end-February sell off of Chinese stocks seemingly triggered, for the first time, a global sell off. Chinese equity markets remain volatile, as do markets in other countries.

Near term economic prospects remain favorable. Chinese exporters and manufacturers have been affected by several recent policy measures to rebalance the economy, including tax measures and appreciation, and more such measures are likely to follow. However, continued productivity growth and a resilient world economy promise only a minor export slowdown. Indeed, export growth remained very strong in early 2007. Domestically, the fundamental drivers of investment growth remain in place, and investment is therefore unlikely to slow drastically in 2007, while boosting consumption will remain challenging, particularly in rural areas. In all, our projection for GDP growth in 2007 remains unchanged at 9.6 percent. The external imbalance is unlikely to shrink much in the near term, and a significant surge in inflation seems unlikely. Measures to rebalance the economy as announced by government could temporarily slow growth further in 2008.

China's internal macro challenges remain manageable, but the external imbalance is on the rise. Thus, the preferred policy measures to address domestic concerns are those that also reduce the external imbalance. The government has already decided on a dividend policy for SOEs and a more rapid increase in spending on health and education, and stepped up the pace of currency appreciation. These measures tend to reduce investment and increase consumption, and are thus steps in the right direction. Meanwhile, containing investment growth and inefficiency on a more sustainable basis calls for structural policies that address the underlying causes of inefficiency and excess investment.

At the annual session of the National People's Congress in March, the government presented its Work Plan for 2007, which includes several initiatives to rebalance the pattern of economic growth. Rebalancing aims to make growth less intensive in resources and energy, less damaging for the environment, more evenly distributed and more led by domestic demand and domestic consumption.

In terms of the overall economic strategy, rebalancing involves a shift in the pattern of growth. This shift means more growth of the services sector instead of industry and a larger role for consumption instead of investment and exports. This would meet the aim to make growth less intensive in energy, raw materials, and resources and less tough on the environment. It would also make growth less capital intensive, allowing China to grow with lower saving, and more consumption. Moreover, it would mean more labor intensive urban growth, and thus less excess labor in agriculture and the related poverty and urban-rural inequality. Finally, it would ameliorate the pressures for overproduction of goods and current account surpluses.

Several rebalancing policies were discussed at the March meetings. They include unification of the corporate income tax (between foreign and domestic enterprises); a property law; significant increases in government spending on education, health, and agriculture, farmers, and rural areas.[1]

The third national financial work conference held in January set out directions for major financial sector reform. Key reforms discussed were in rural finance, foreign exchange management, and policy banks. On rural finance, it was decided to reduce the access thresholds for financial institutions to attract a more diverse set of providers and to continue the reforms of the Agricultural Bank of China. Looking ahead, rural finance would also benefit from interest rate liberalization and further reforms in existing providers. On foreign exchange reserve management, the meeting decided to explore ways to more actively manage part of the country's foreign exchange reserves.

[1] A package of potential rebalancing policies can be found in the World Bank's November 2006 China Quarterly Update (pp 15-17).