

CHINA

China's economic growth was strong in 2007, with some slowdown in the second half. GDP grew 11.4 percent in 2007, making it the fifth year in a row with double-digit growth. On a quarterly basis, GDP growth slowed from 11.9 percent in the second quarter year-on-year (yoy) to 11.2 percent in the fourth quarter.

The slowdown was due to a lower contribution of external trade to growth, offset partly by a higher contribution of domestic demand. In the second half of 2007, in particular, import growth picked up because of brisk domestic demand while export growth declined as demand from other countries, especially the United States, eased. Imports outpaced exports in the last 3 months of 2007 and the first 2 months of 2008. As a result, the contribution of net trade to growth fell, particularly in the fourth quarter. Most of the impact on overall GDP growth was offset by a rebound in domestic demand, which became more pronounced toward the end of 2007.

Inflation rose throughout 2007 and into 2008 due to higher food prices. Pork prices increased because of shortfalls in supply, in part due to the outbreak of disease. Another factor was the increase in the price of food products in international markets. Food price inflation has been 17 percent–18 percent (yoy) since August 2007, increasing to 23 percent in February. This factor has raised headline inflation from 2.2 percent in January 2007 to 8.7 percent in February 2008.¹ With households spending on average more than one-third of their incomes on food, the food price hikes have affected purchasing power, particularly of the urban poor and some rural groups, although higher food prices benefit net food producers in rural areas. In addition, international prices of energy, industrial materials, and agricultural products continue to rise and will gradually exert their influence on domestic prices.

So far, few signs are evident of excess demand, but there is little spare capacity in the economy. Non-food inflation has remained low despite high economic growth because potential output growth has broadly kept up with actual output growth. Potential output growth has been supported by high investment and rapid productivity growth, although there is evidence that the economy is near full capacity. There are some signs that real wage growth is already on the rise, especially in manufacturing. Policy-makers have been keen to prevent any acceleration in inflation arising from excess demand pressures, including by raising interest rates and introducing specific price freezes. The objectives of the latter are to temporarily dampen price rises, keep basic goods affordable, and manage expectations. Ultimately, these price freezes will need to be replaced by targeted subsidies, which are affordable given China's strong fiscal position.

These price and cost developments take place against a backdrop of large balance of payment surpluses that boost liquidity. Such liquidity could lead to demand-led inflation. China's external surpluses stem from very large current account surpluses and capital inflows under its relatively fixed exchange rate regime. Since July 2005, the RMB has appreciated at 6.6 percent a year against the US dollar. In contrast, the trade-weighted nominal effective exchange rate

¹ Sharp increases in global prices of industrial commodities (mainly metals) in recent years have driven up China's raw material prices and, to a lesser extent, producer prices. However, their impact on consumer prices was modest. International oil prices also soared, but this hike was only partly reflected in China's prices because of domestic price controls on fuels.

strengthened on average by only 2.1 percent per year. In 2007, with a current account surplus estimated at US\$359 billion, incoming FDI of US\$83 billion (partly offset by rising FDI outflows), and large net portfolio inflows, official foreign reserves surged to US\$1.5 trillion.² The PBC is issuing central bank bills and hiking reserve rates to sterilize the impact on liquidity. In addition, window guidance has been relatively successful in reducing credit expansion. M2 growth of 16.7 percent (yoy) at the end of 2007 was lower than nominal GDP growth of 20 percent in the fourth quarter, although it rebounded to 18.9 percent (yoy) in January.

So far, the increased liquidity seems to have affected share and house prices but not prices of goods. The massive increase in share prices in 2006 and 2007 has been influenced by low deposit rates. A key reason that deposit rates are low is that the authorities are reluctant to raise domestic interest rates for fear of attracting portfolio capital inflows. Although the rise in real estate prices is low by international standards, the liquidity is contributing to housing market increases.

While the uncertain global outlook may slow China's exports, the country's growth is expected to remain robust, and the authorities are well positioned to stimulate demand if needed. Growth is projected at around 9.5 percent for 2008, a significant 2 percentage points slower than in 2007 but still rapid by international standards. This still solid growth forecast reflects not only the ability of Chinese exporters to seek alternative export markets but also the growing role of domestic demand. If the global slowdown becomes more pronounced, the authorities could stimulate demand by easing fiscal policy, although current inflation concerns make lowering interest rates or relaxing liquidity management less obvious.

² This excludes foreign exchange reserves "offloaded" to other institutions and commercial banks.