

# BBL Seminar Handout

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December 6, 2011

"China: Economic Developments and Outlook"

Steven Barnett

<http://www.rieti.go.jp/jp/index.html>

# China Economy

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December 2011

These are the views of the presenter and not those of the IMF, its Executive Board, or its Management.



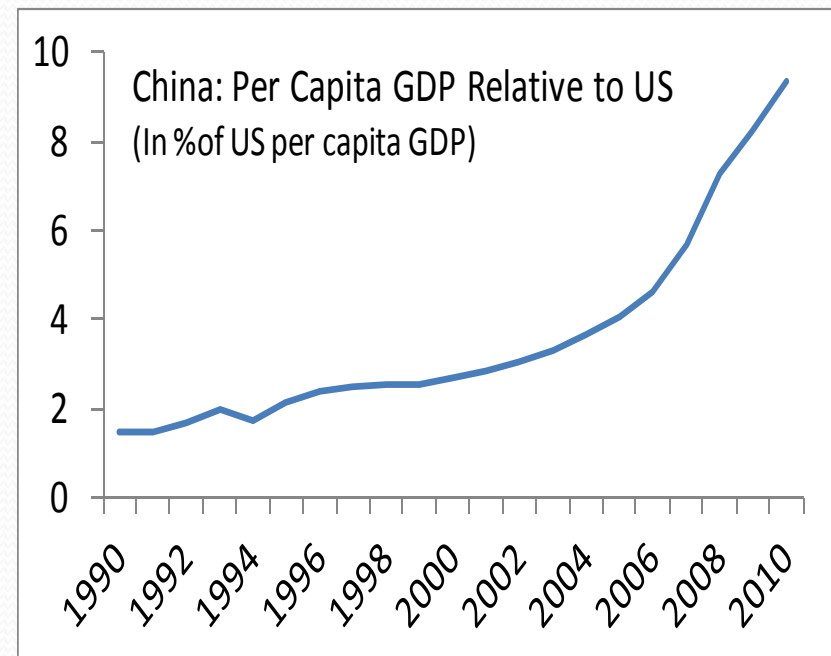
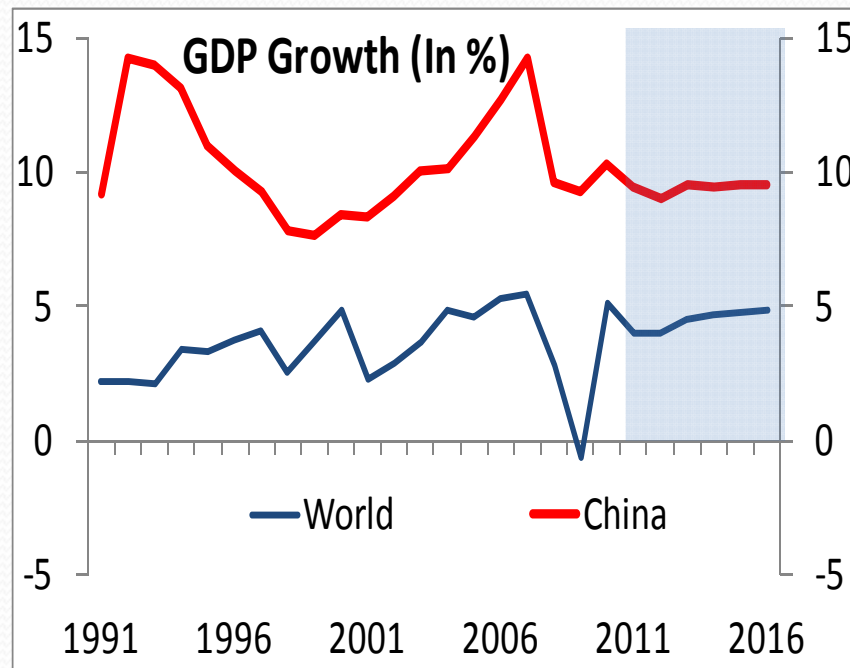
# Outline

- I. Historical and global perspective
- II. Developments and outlook
- III. Rebalancing
- IV. Spillovers
- V. Financial sector reform

# I. Historical and global perspective

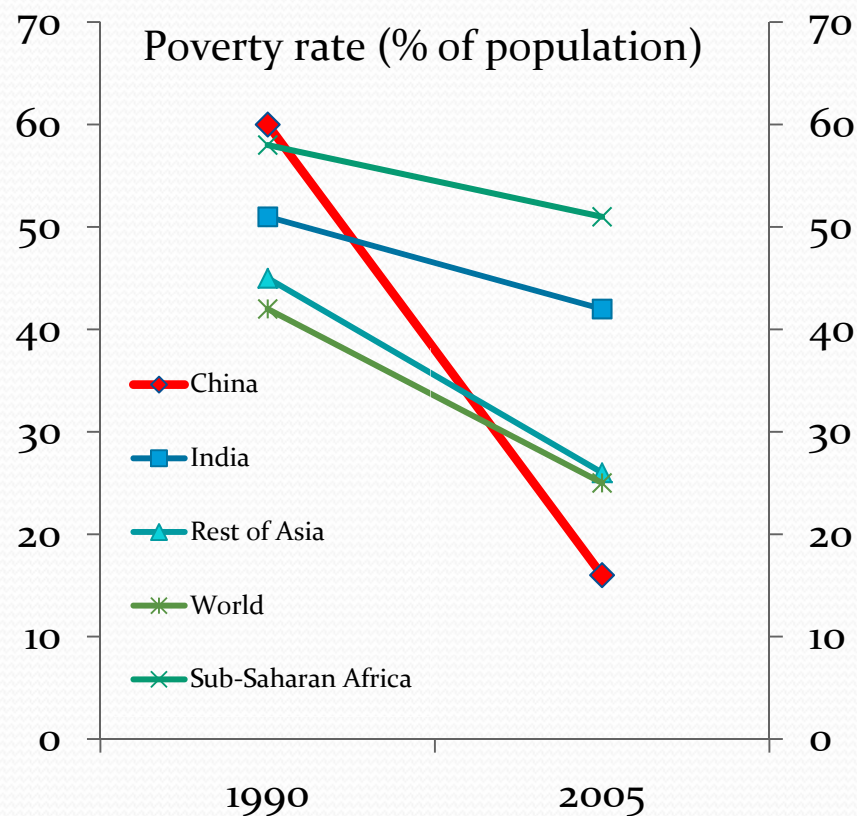
China has enjoyed rapid economic growth...

...boosting income per capita, which however is still much less than in US





# Substantial reduction in poverty



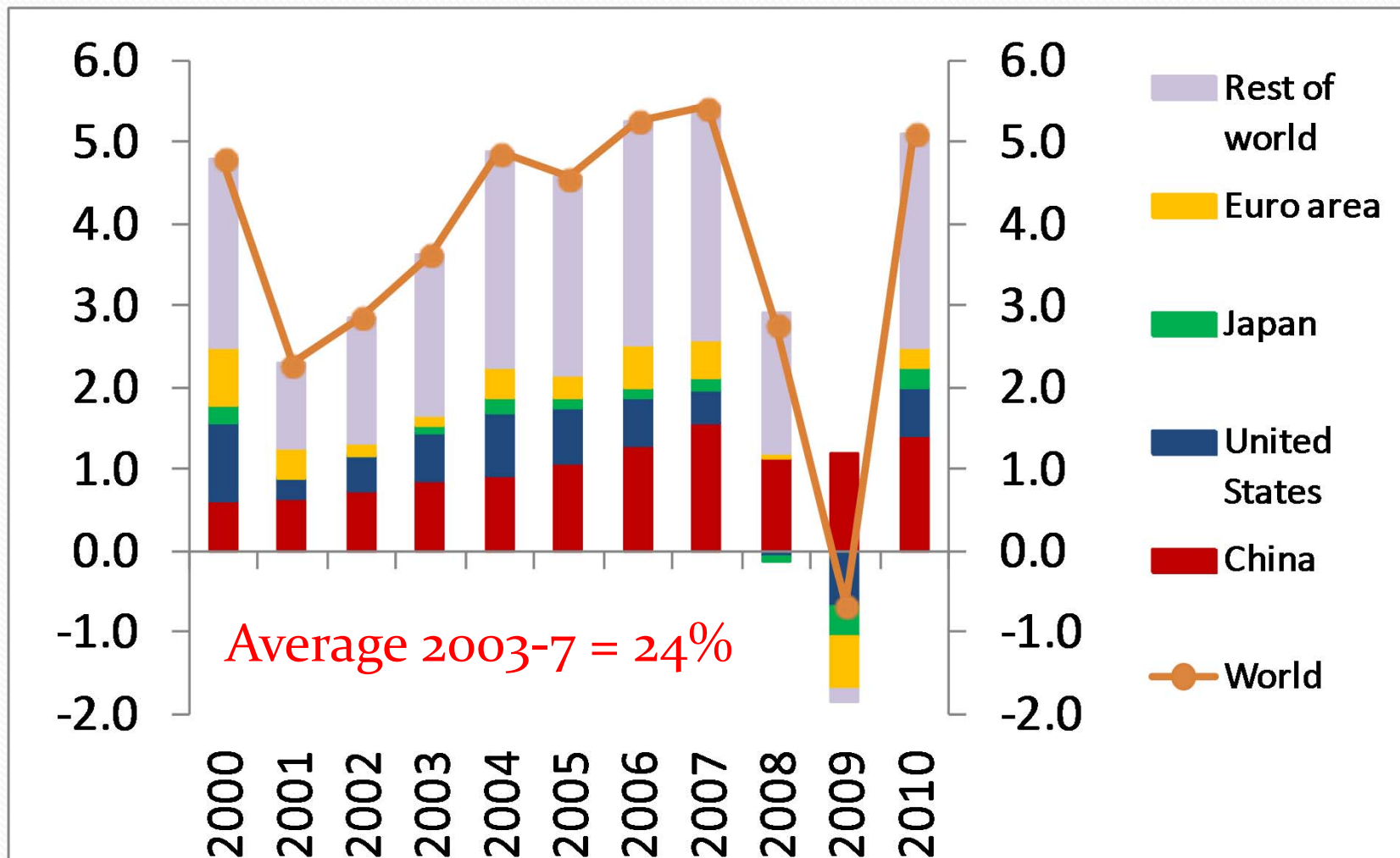
	Number Living in Poverty (millions) 1/		
	1990	2005	Change
World	1818	1374	-444
China	683	208	-475
India	436	456	20
Rest of Asia	333	248	-85
Sub-Saharan Africa	297	388	91
Rest of world	69	74	5

1/ Less than \$1.25 a day at 2005 purchasing power parity

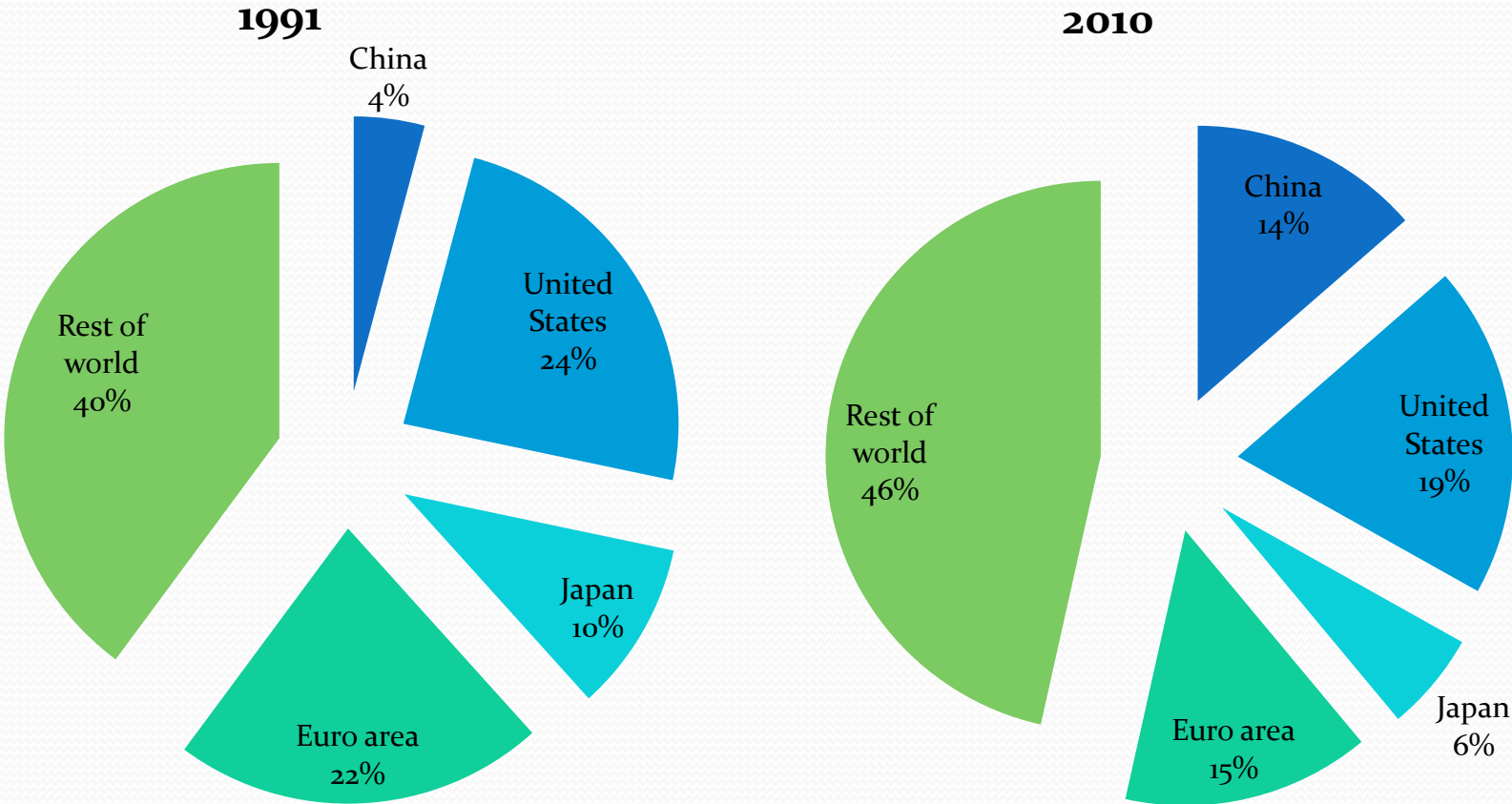
Source: APD REO, Sep. 2011 (Data from World Bank, *PovcalNet* database)

# China accounted for ¼ of global growth

Contributions to GDP Growth (In percentage points)

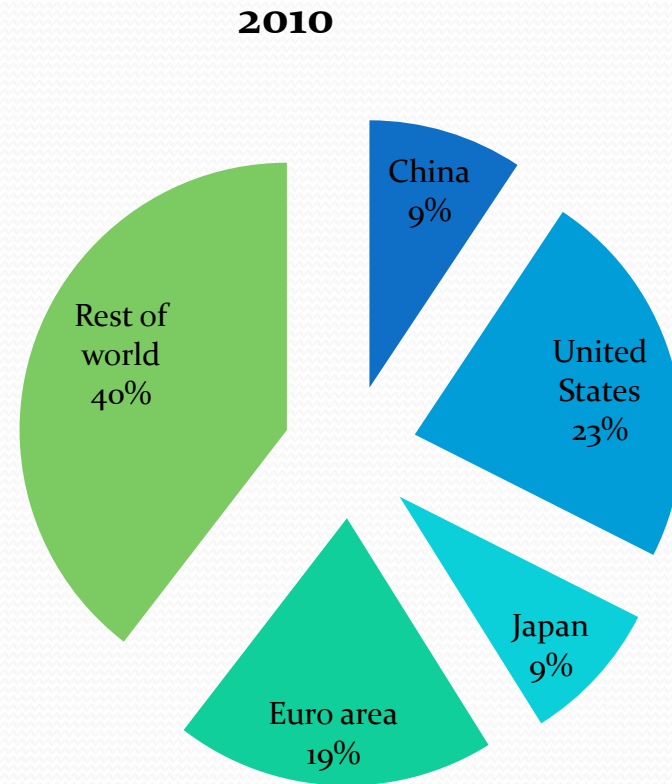
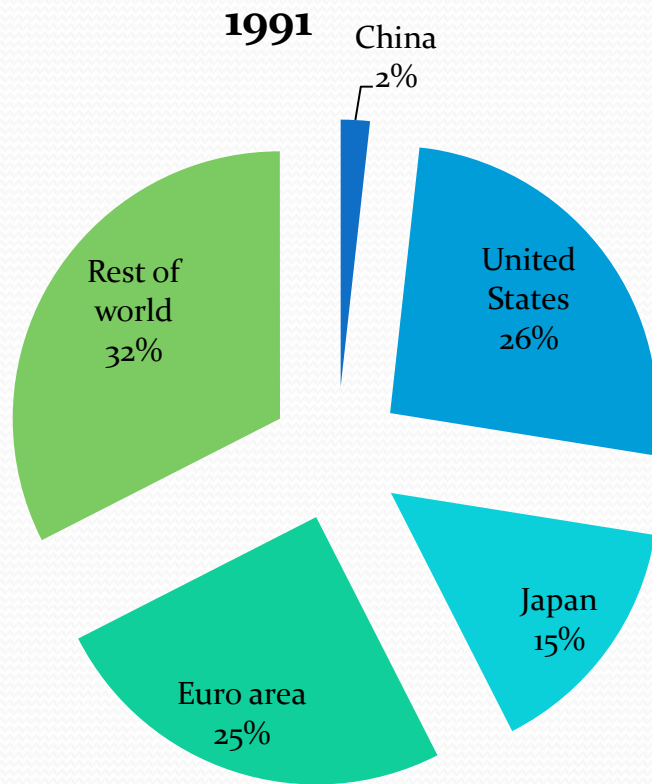


# Rising Share of Global Output (GDP on PPP Basis)



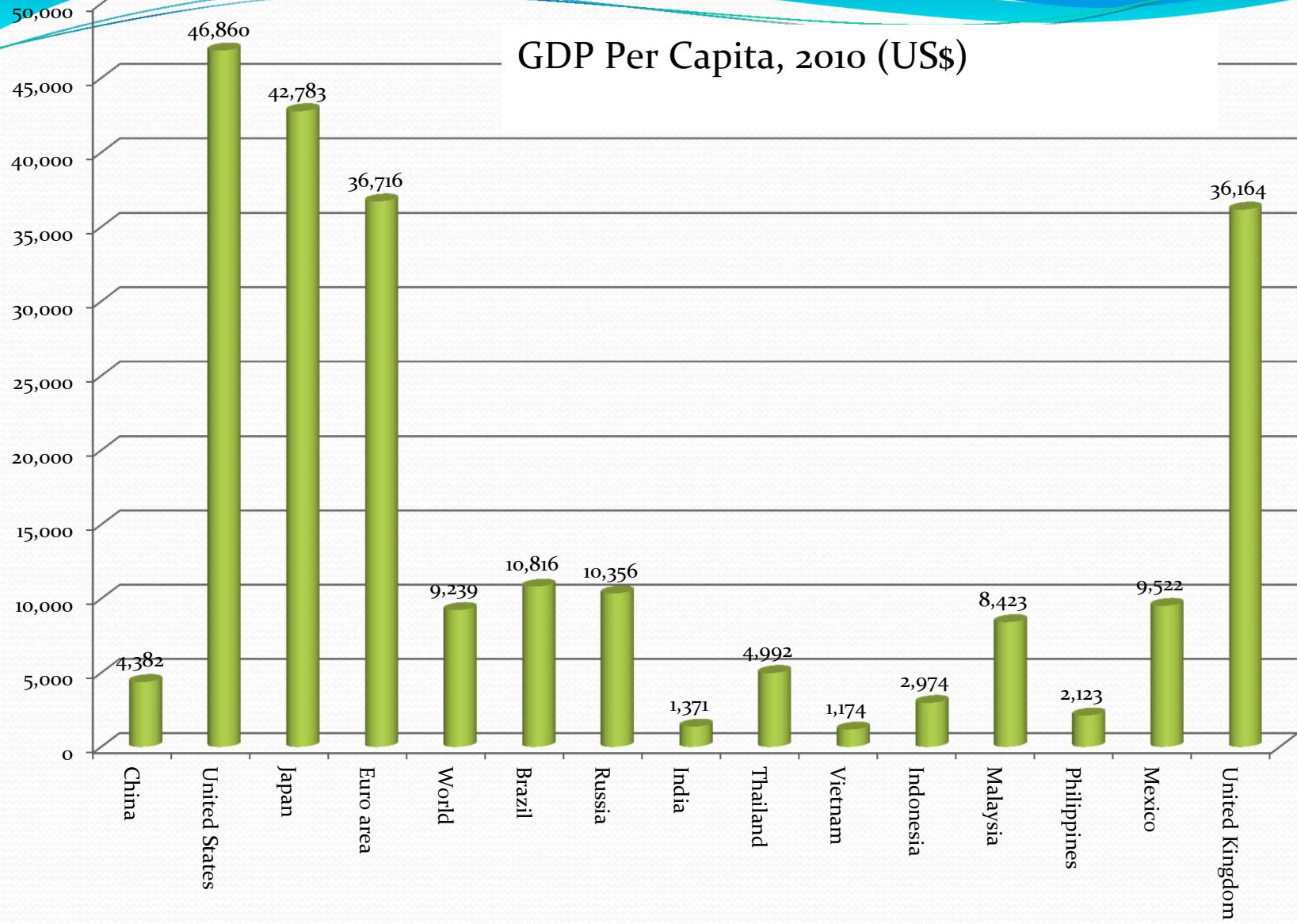


# Same trend but less dramatic when measured at market exchange rates

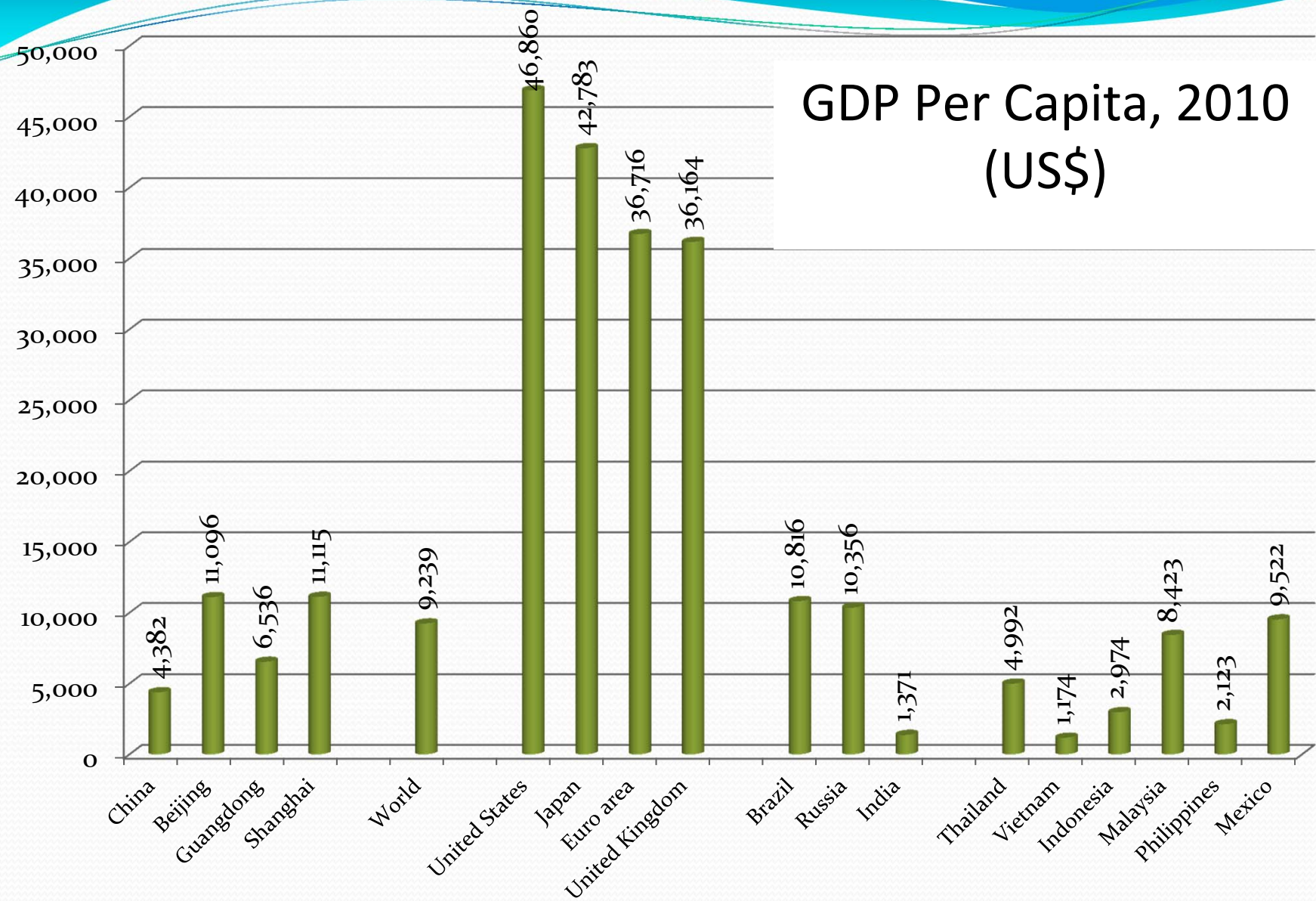




GDP Per Capita, 2010 (US\$)

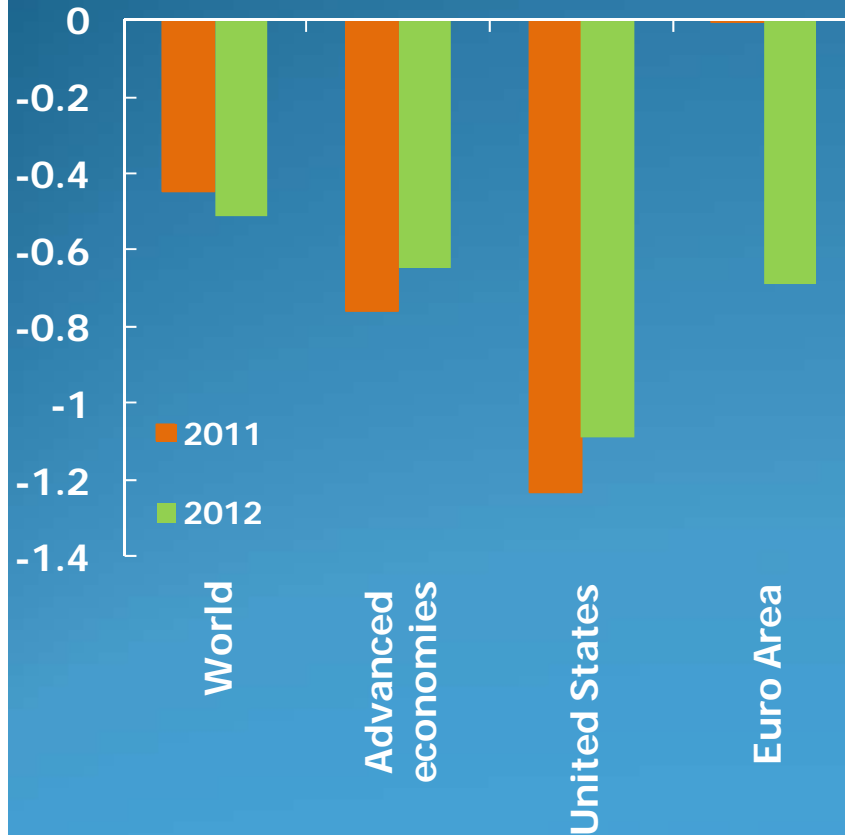


# GDP Per Capita, 2010 (US\$)



# Global Outlook: Global growth has been revised down

**Downward Revisions in Growth Forecasts since April 2011 *WEO***  
(In percentage points)



**World GDP Growth**  
(Year-over-year; in percent)

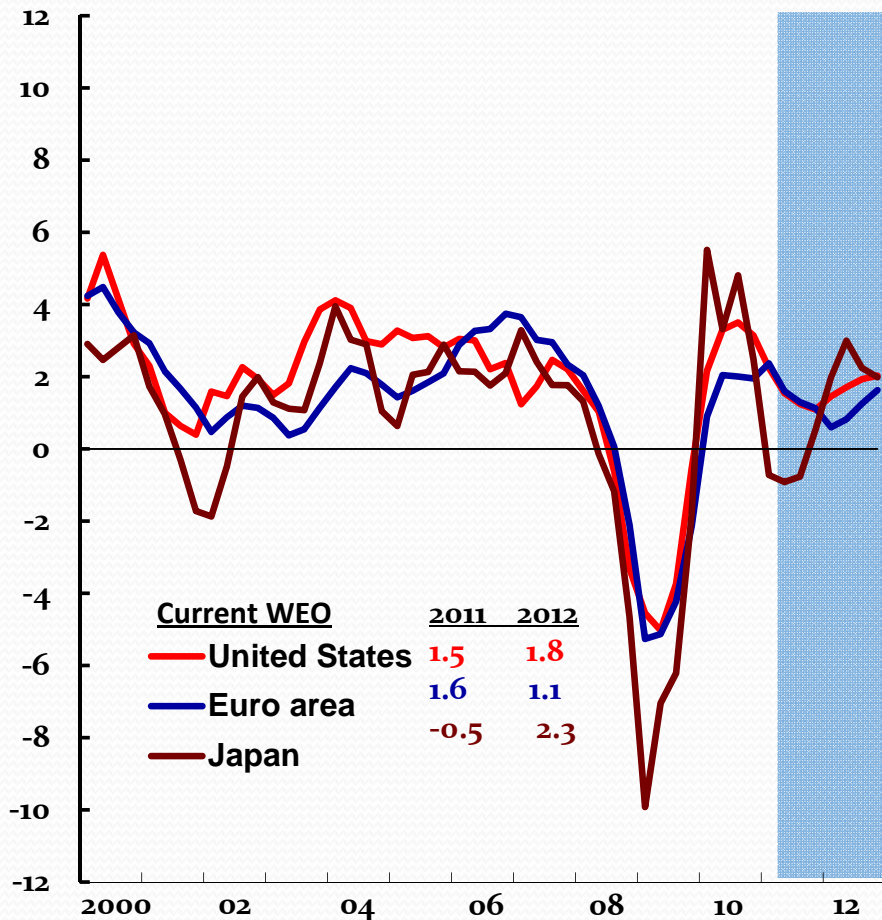
	2010	2011 (Proj.)	2012 (Proj.)
<b>World</b>	<b>5.1</b>	<b>4.0</b>	<b>4.0</b>
Advanced economies	3.1	1.6	1.9
USA	3.0	1.5	1.8
Euro area	1.8	1.6	1.1
United Kingdom	1.4	1.1	1.6
Japan	4.0	-0.5	2.3



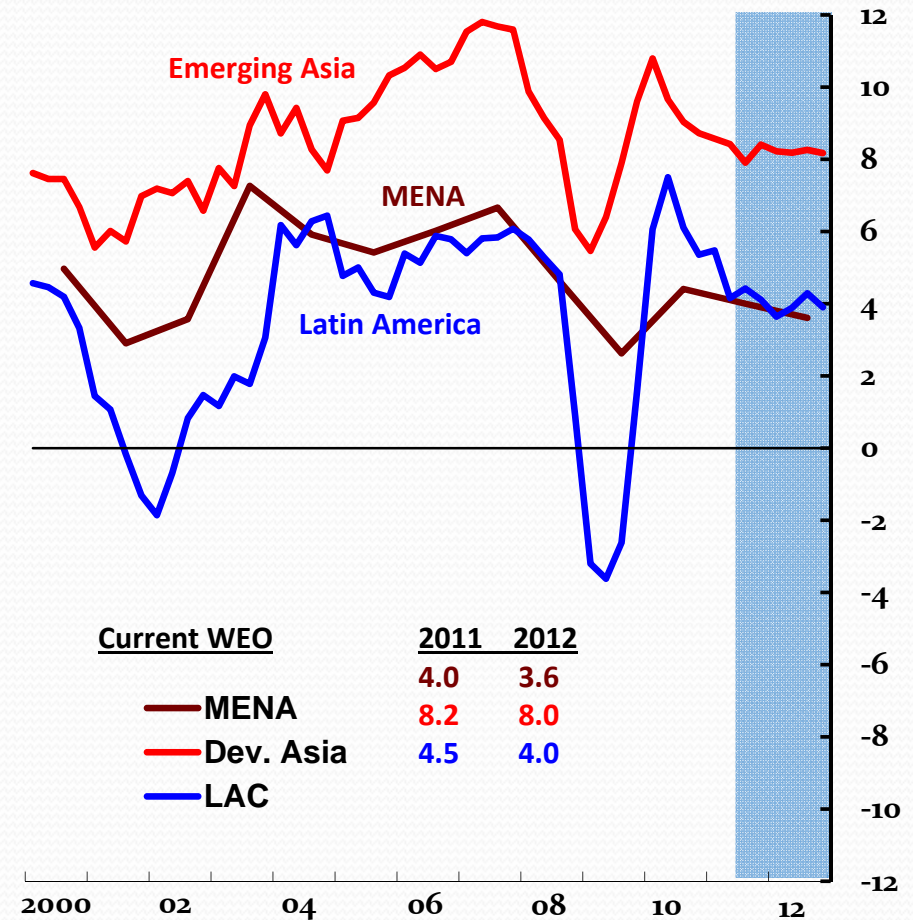
**The baseline forecast is for more uneven recovery:  
 > 6 percent growth in EM, < 2 percent growth in AE  
 = 4 percent global growth.**

**Real GDP Growth**  
*(percent change from a year earlier)*

**Advanced Economies**

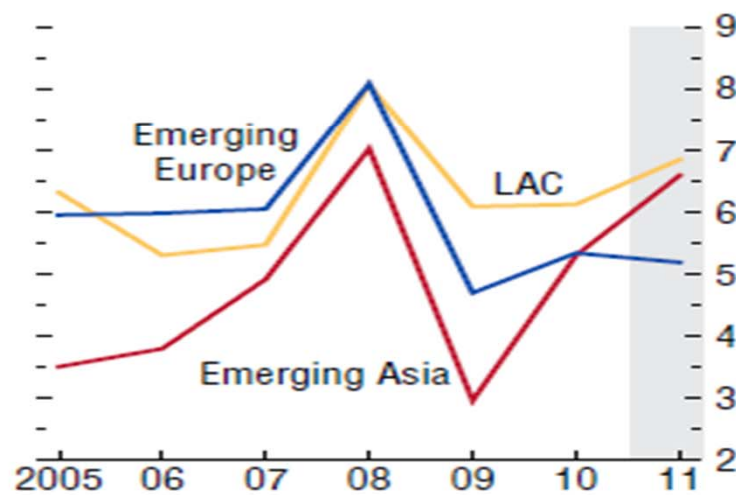
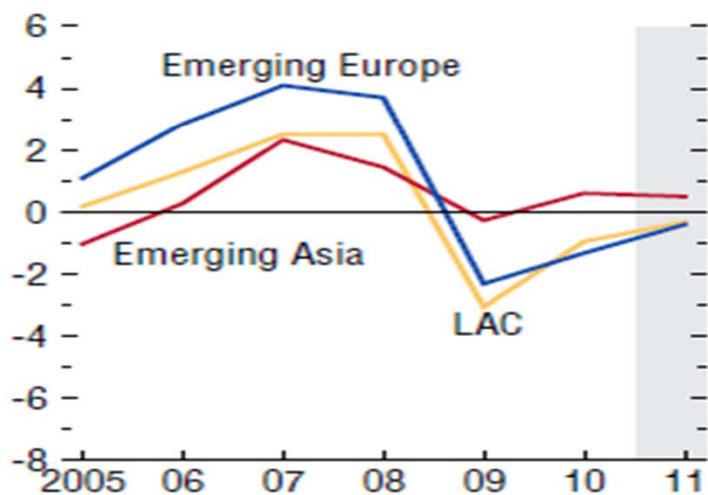
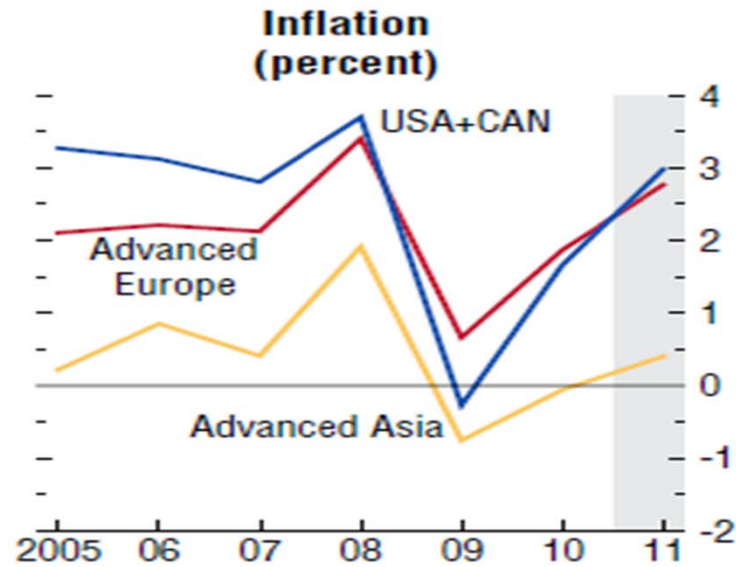
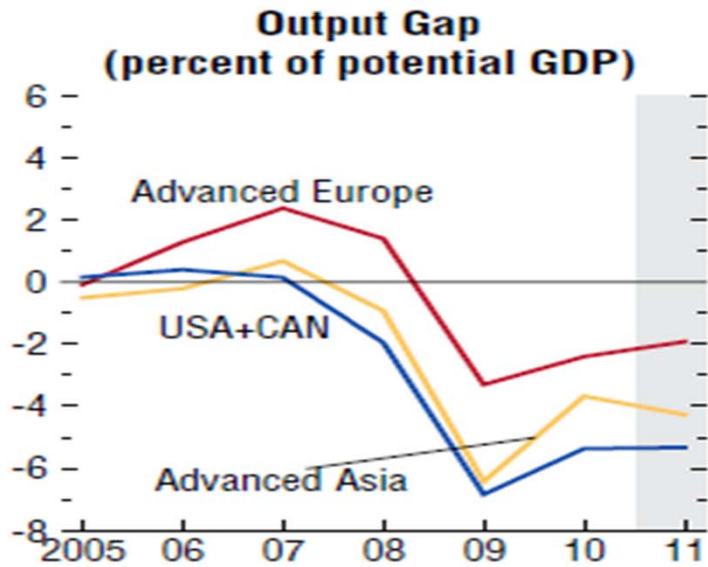


**Emerging Economies**





# Advanced economy GDP not yet recovered



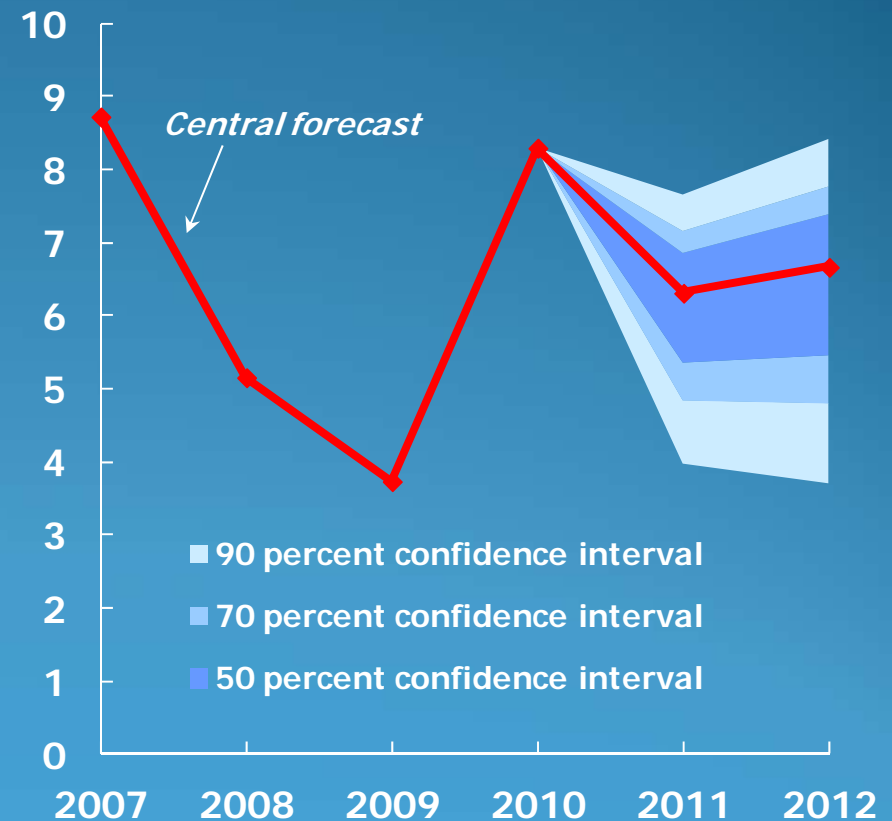


# Growth in emerging Asia moderating But risks tilted decidedly to the downside

**Asia: Projected GDP Growth**  
*(in percent; year over year)*

	Actual data and latest projections			Difference from April 2011	
	2010	2011	2012	2011	2012
<b>Emerging Asia</b>	<b>9.5</b>	<b>7.9</b>	<b>7.7</b>	<b>-0.2</b>	<b>-0.3</b>
China	10.3	9.5	9.0	-0.1	-0.5
Hong Kong SAR	7.0	6.0	4.3	0.6	0.1
Korea	6.2	4.0	4.4	-0.5	0.2
Taiwan Province of China	10.9	5.2	5.0	-0.2	-0.2
India	10.1	7.8	7.5	-0.4	-0.3
Indonesia	6.1	6.4	6.3	0.2	-0.2
Malaysia	7.2	5.2	5.1	-0.3	-0.1
Philippines	7.6	4.7	4.9	-0.3	-0.1
Singapore	14.5	5.3	4.3	0.1	-0.1
Thailand	7.8	3.5	4.8	-0.4	0.3
Vietnam	6.8	5.8	6.3	-0.5	-0.5

**Asia: GDP Growth**  
*(Central forecast and selected confidence intervals; in percent)*



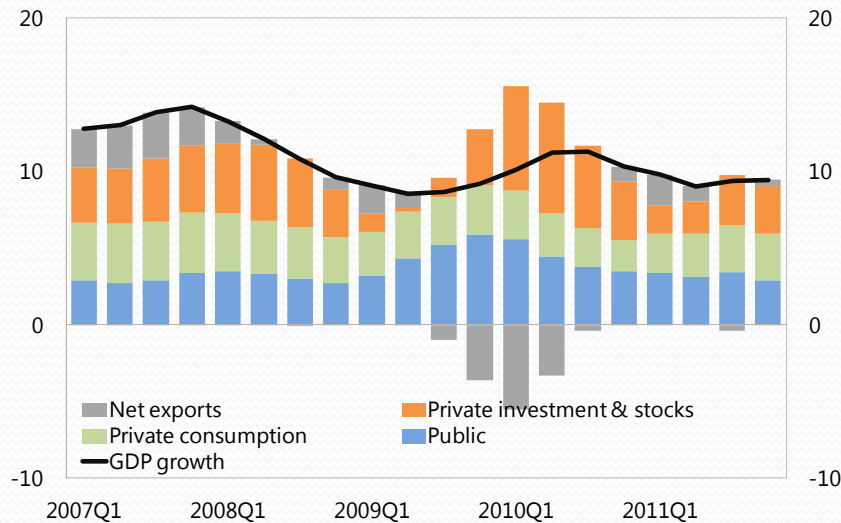
# II. Developments and outlook

● The economy is doing just fine

● Consumption has moderated but is still healthy

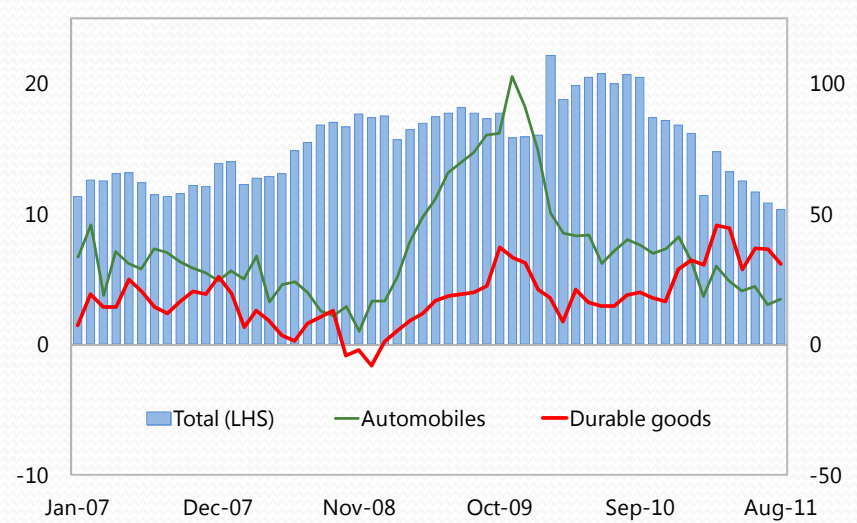
**Contribution to GDP Growth**

(In percent, annual average)



**Retail Sales**

(In percent, year-on-year growth)

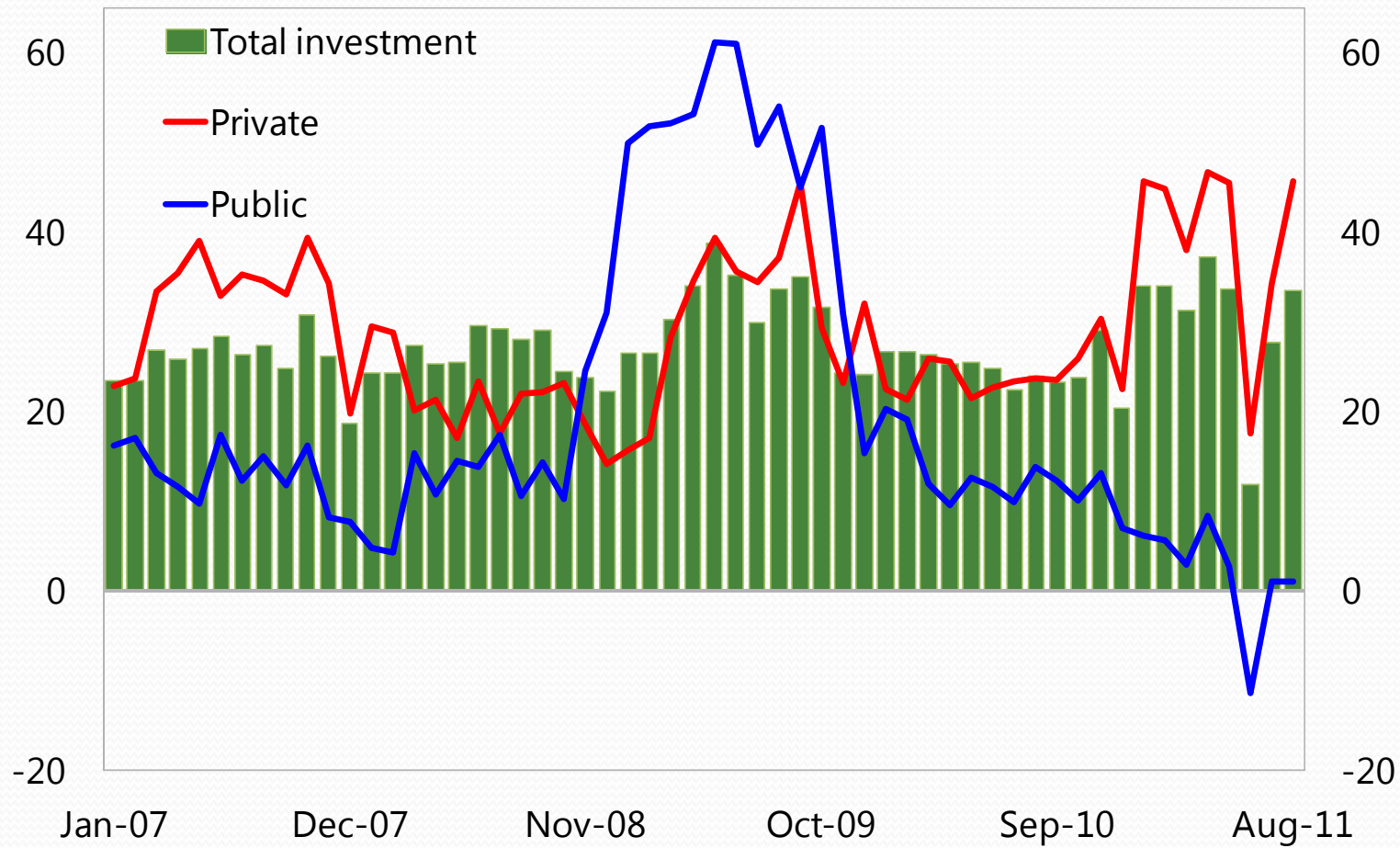




There's an ongoing hand-off from public to private drivers

## Fixed Asset Investment

(In percent, year-on-year growth)

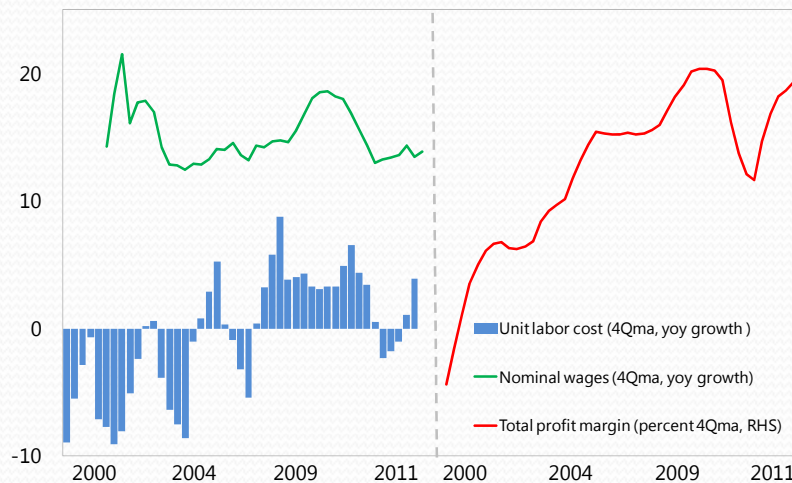




# Overheating?

Wages are rising quickly but remain in line with productivity

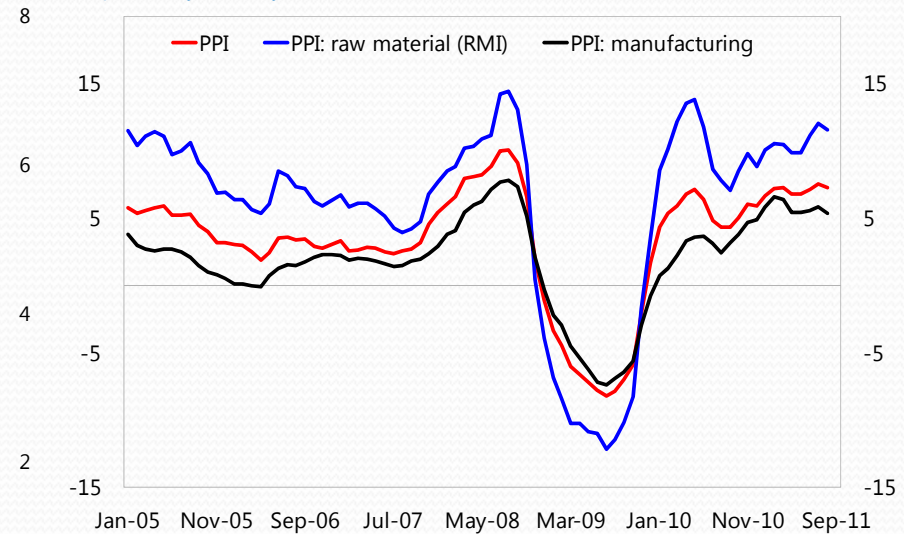
China Unit Labor Cost and Industrial Profit Margin



Input costs, particularly for commodities, are adding to price pressures

Producer Price Index

(In percent, year-on-year)

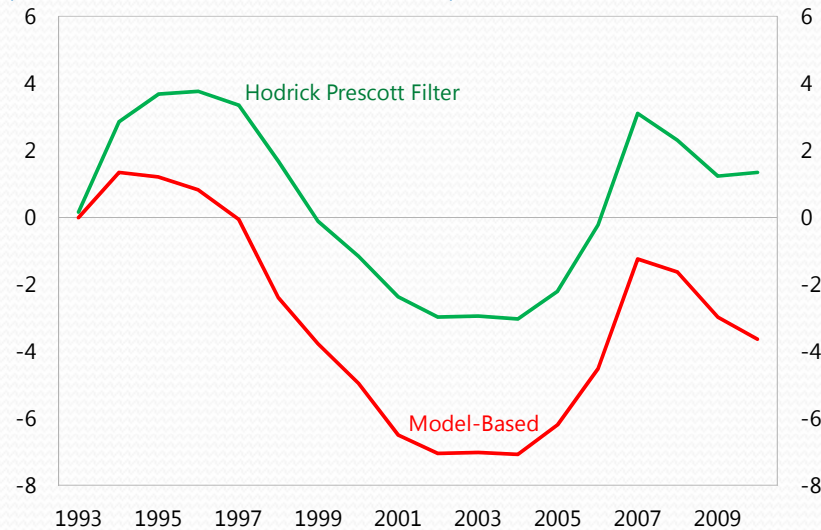


# Overheating?

Unused capacity has increased as a result of the surge in investment

## China Output Gap

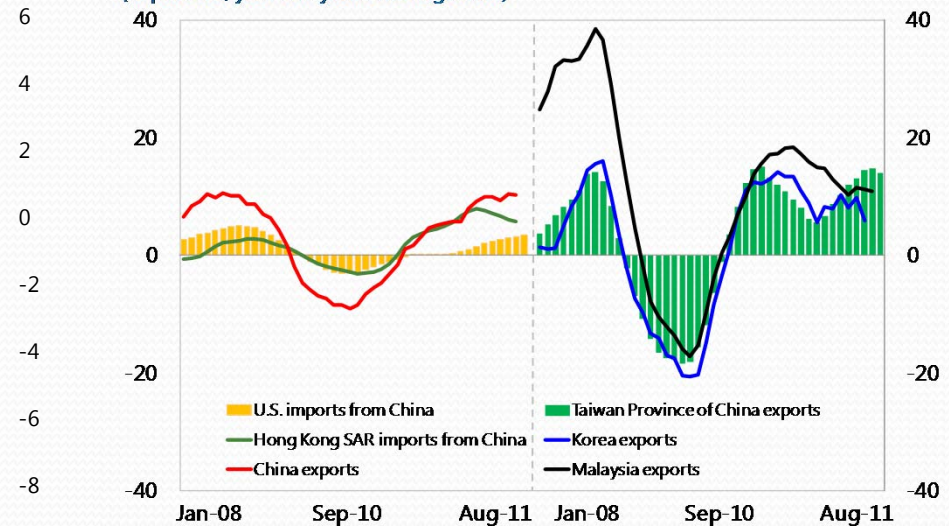
(Hodrick Prescott Filter vs. More Model Based)



Rising China costs are not leading to China exporting inflation to the rest of the world

## Export Prices

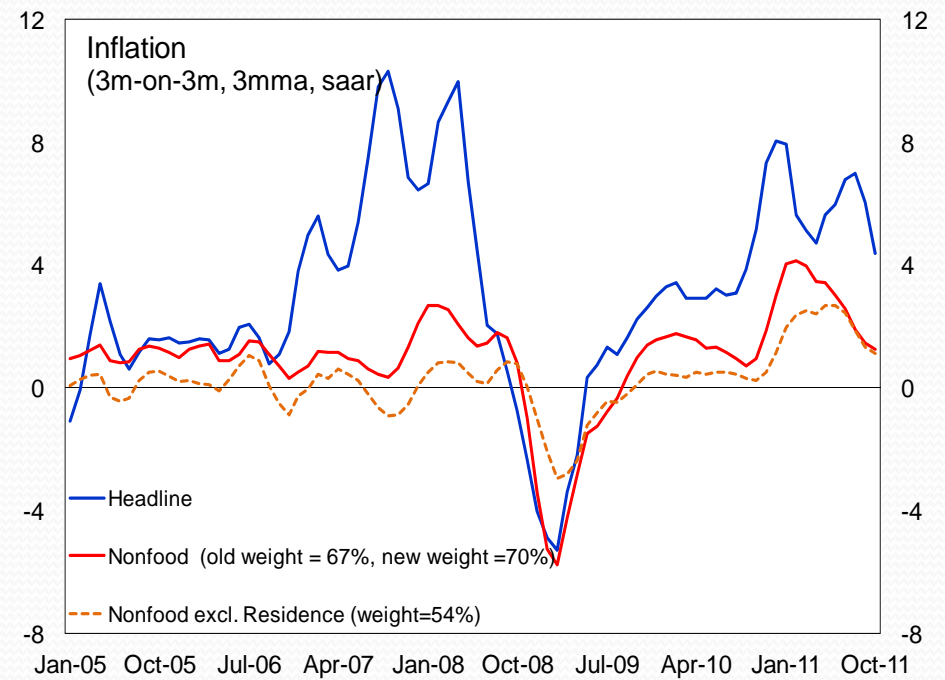
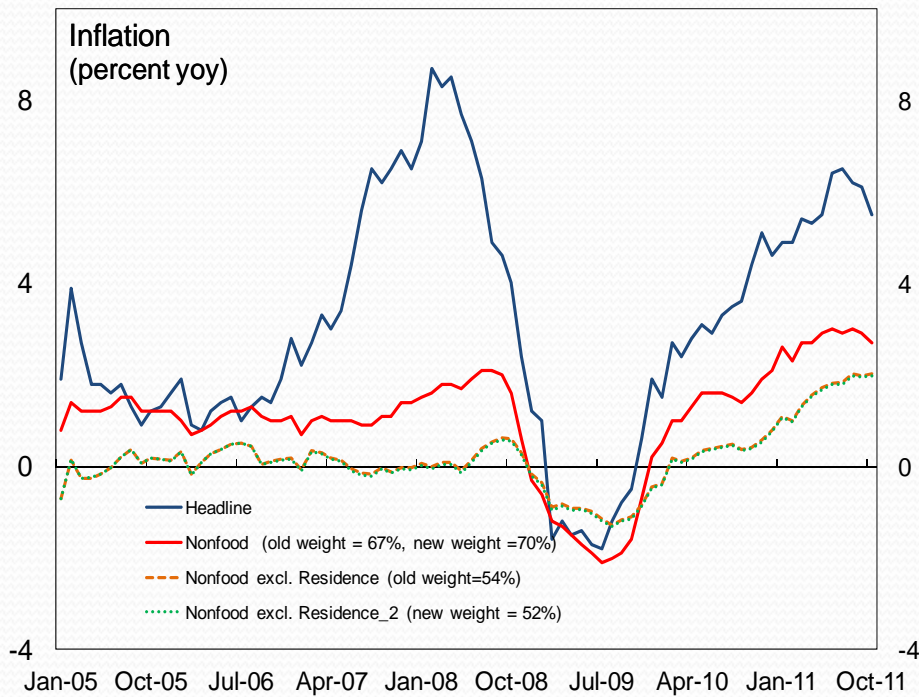
(In percent, year-on-year 3mma growth)





# Inflation

- Inflation seems to have peaked in a year-on-year basis
- And sequential momentum is also slowing

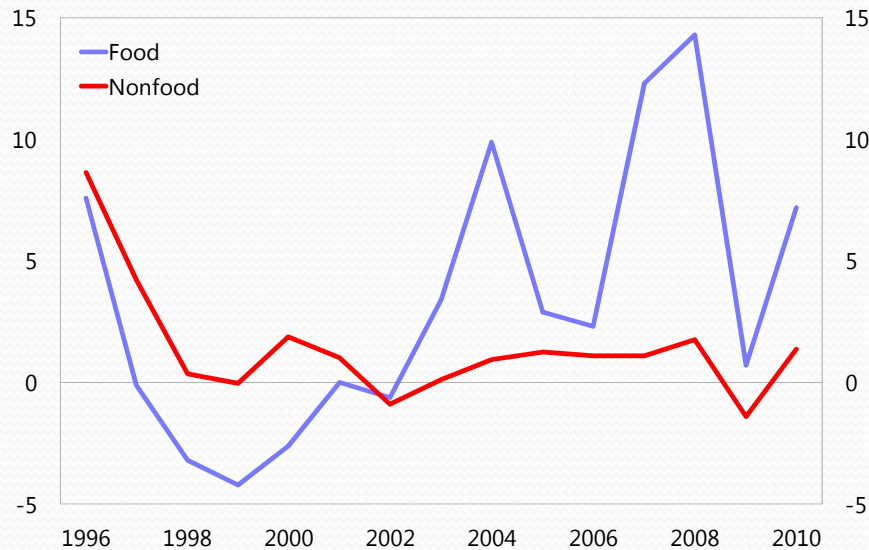


# Inflation

- However, nonfood inflation has essentially been absent for a decade
- With inflation driven instead entirely by food supply shocks

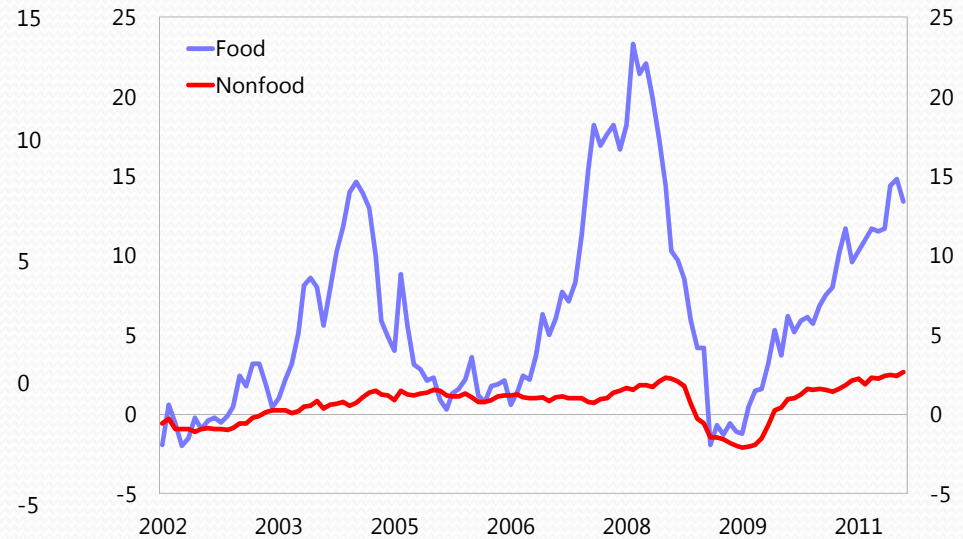
**Consumer Price Inflation**

(In percent)



**Consumer Price Inflation**

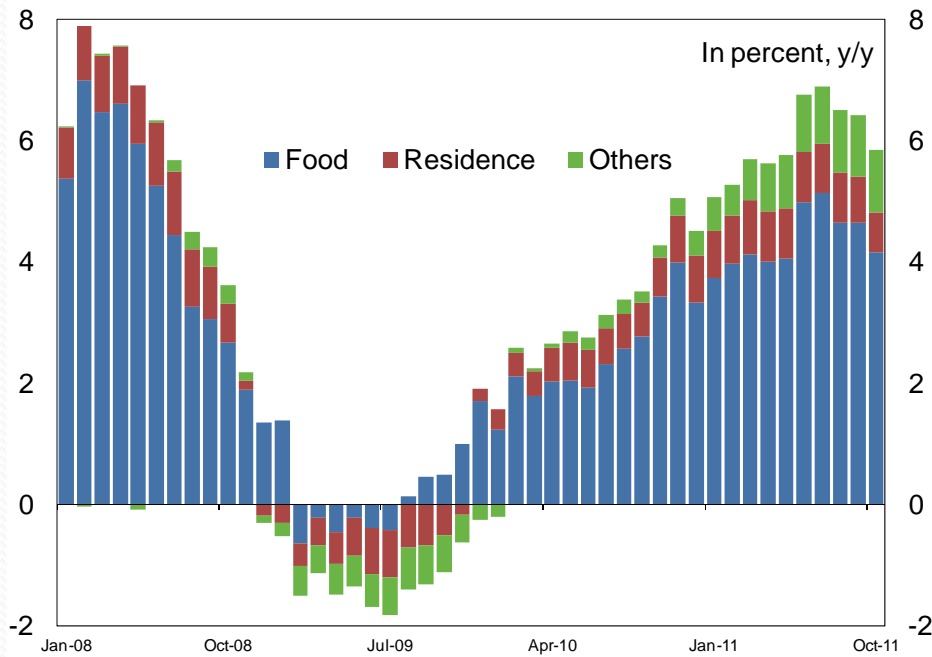
(In percent)



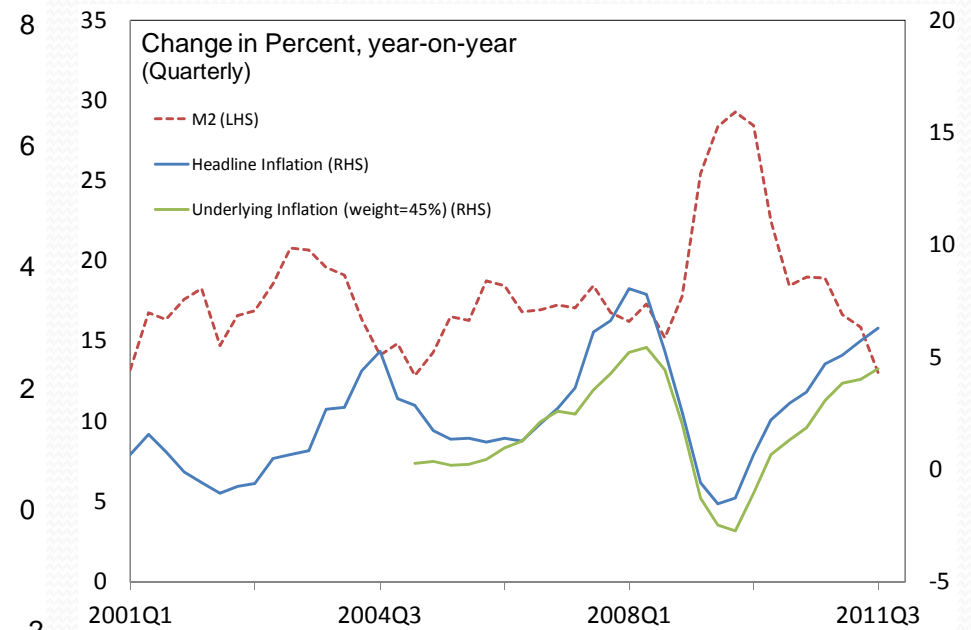


# Inflation

## Food prices drive the CPI (Contribution to Inflation)



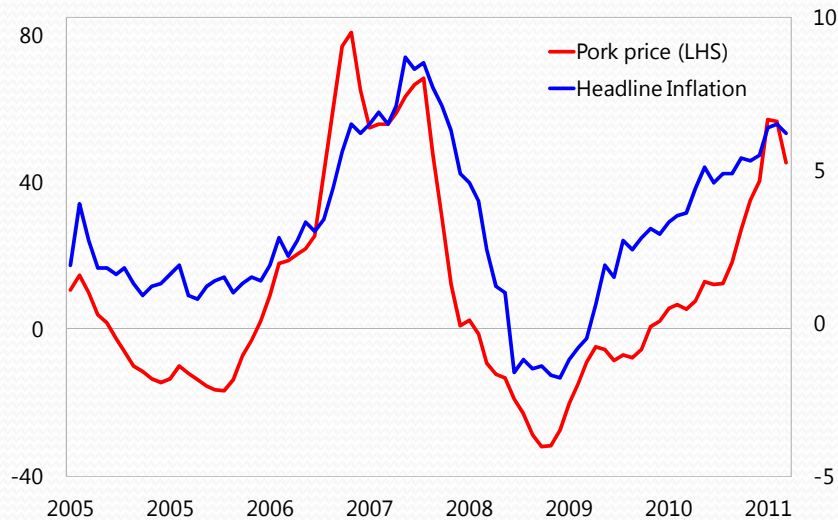
## And there is no obvious correlation with money supply



# Inflation

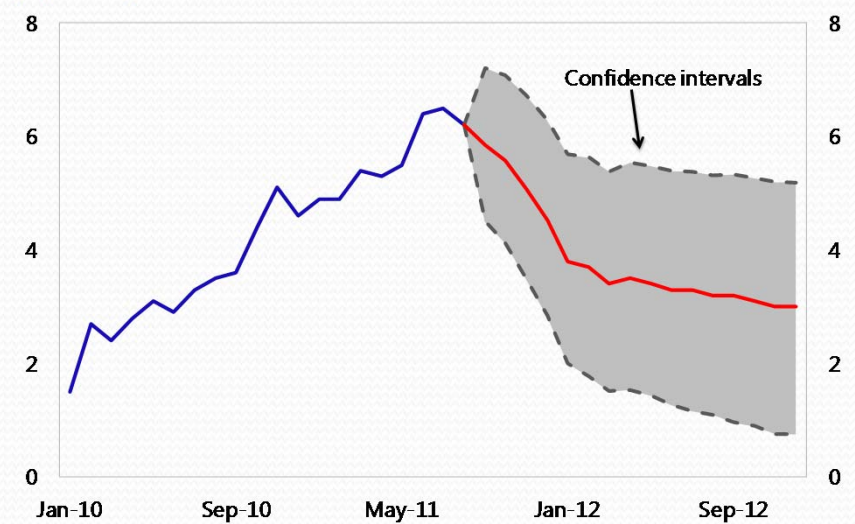
- **The food cycle is starting up again with recent return of pork inflation**

**Pork Price**  
(In percent, year-on-year)



- **Nevertheless, we think inflation has peaked and should now start to recede**

**Consumer Price Inflation**  
(In percent)

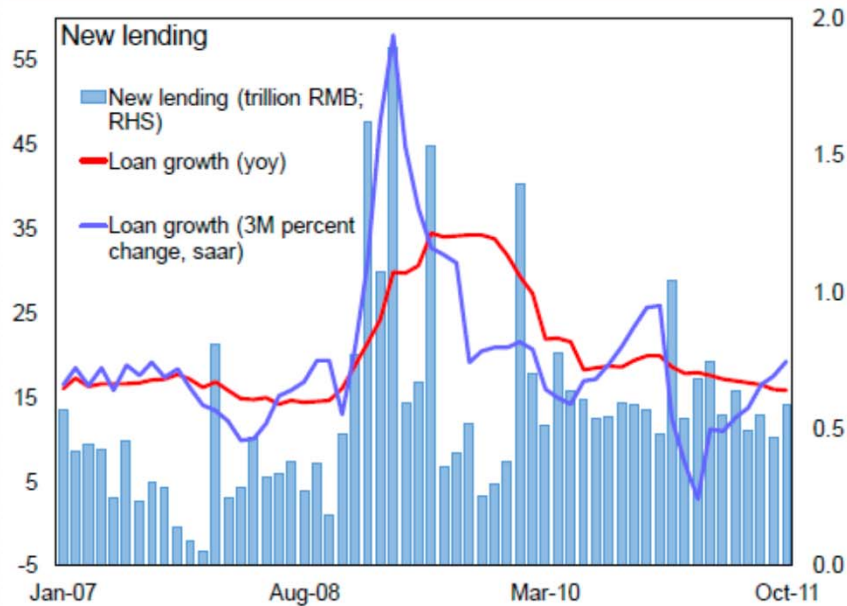


# Credit growth

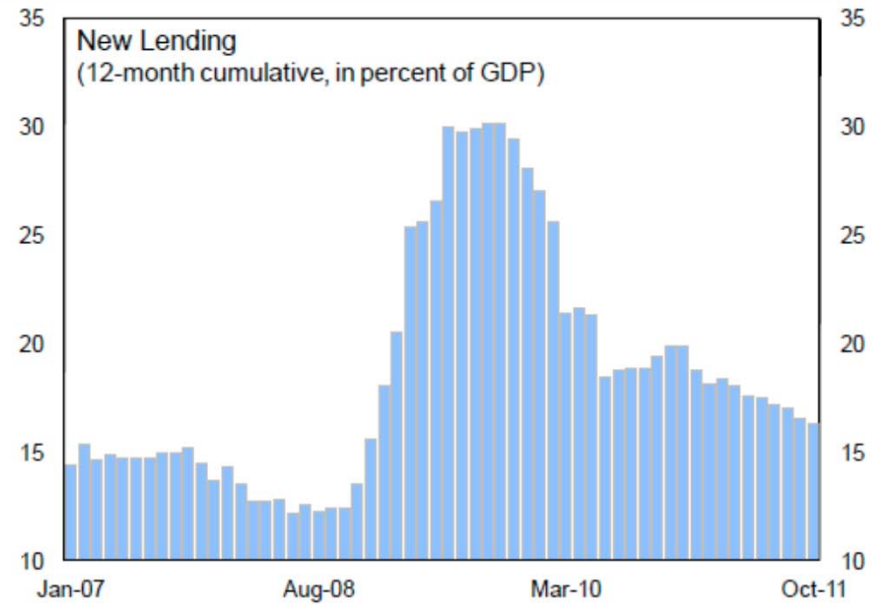
Headline credit growth is falling

Especially from the peaks reached during the stimulus

New lending (flows and growth)



New lending (%GDP)



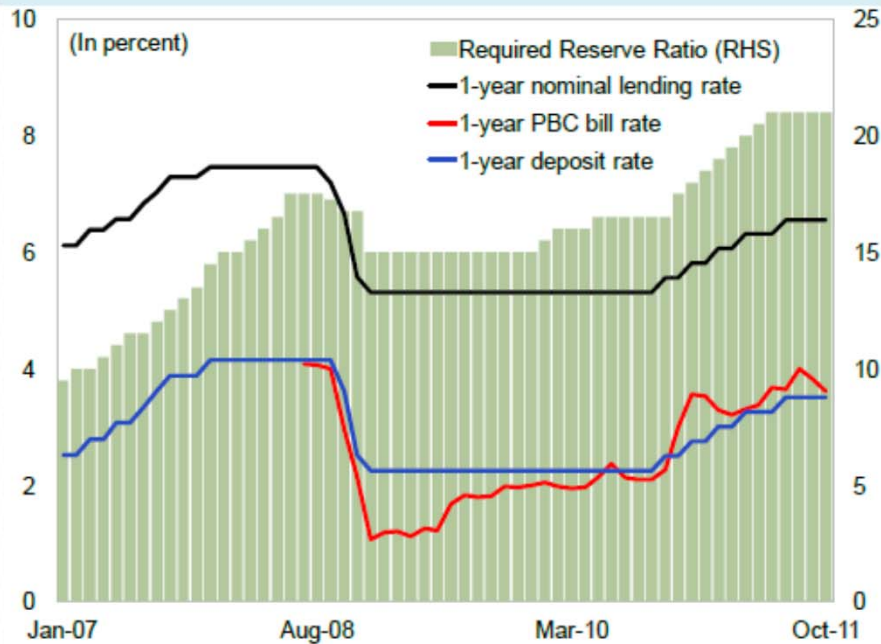


# Credit growth

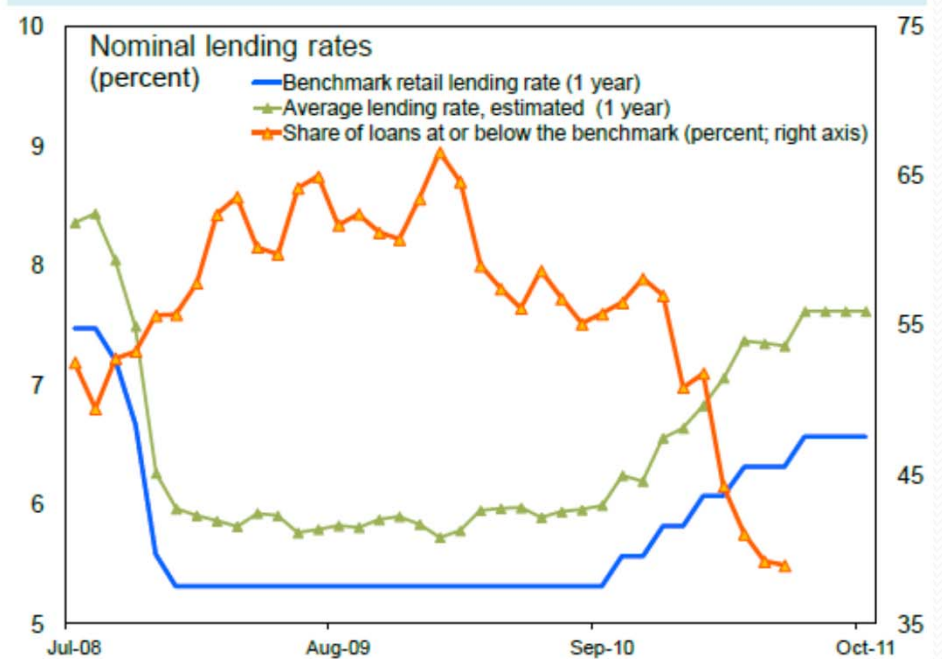
Monetary policy has been tightened

And borrowers are paying higher interest for bank loans

Short-term interest rates



Nominal lending rates



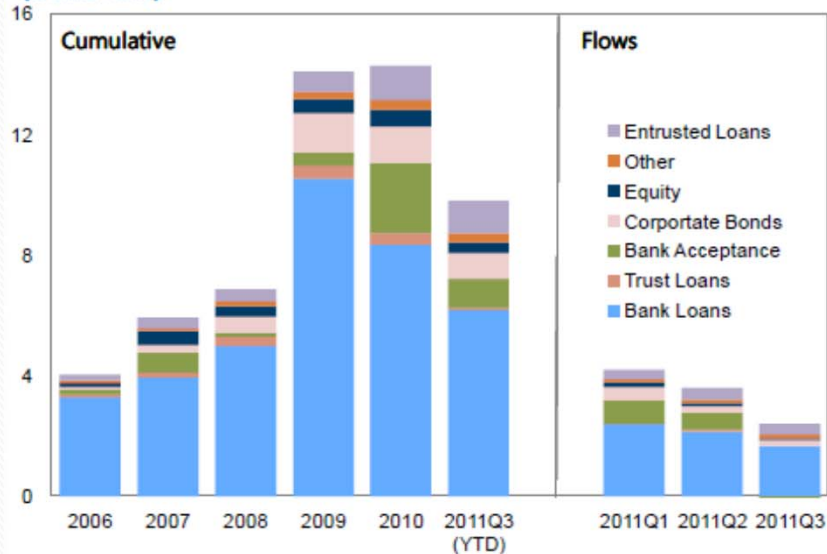
# Credit growth: Social financing

Other forms of financing also have grown

But have slowed in the most recent data

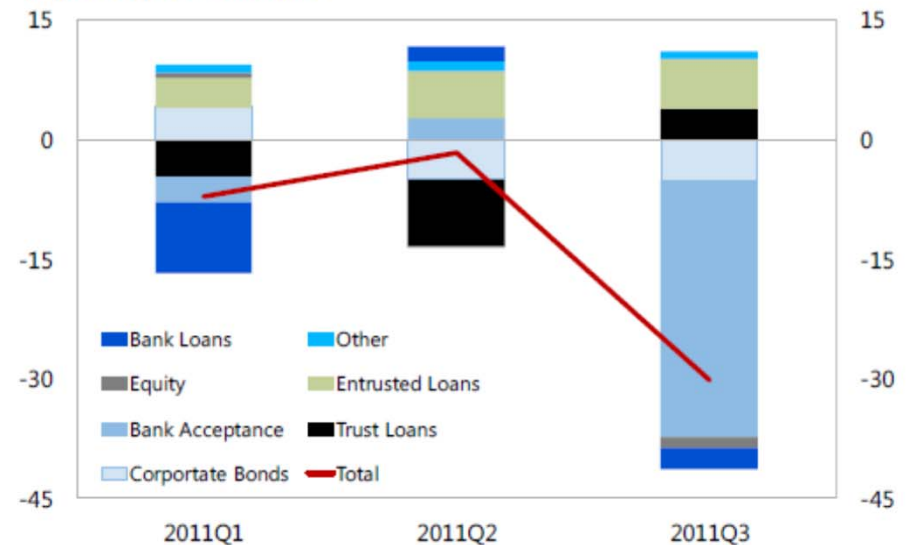
## Social Financing

**Social Financing**  
(In trillion RMB)



## Social Financing

**Social Financing**  
(In percent, yoy contribution)

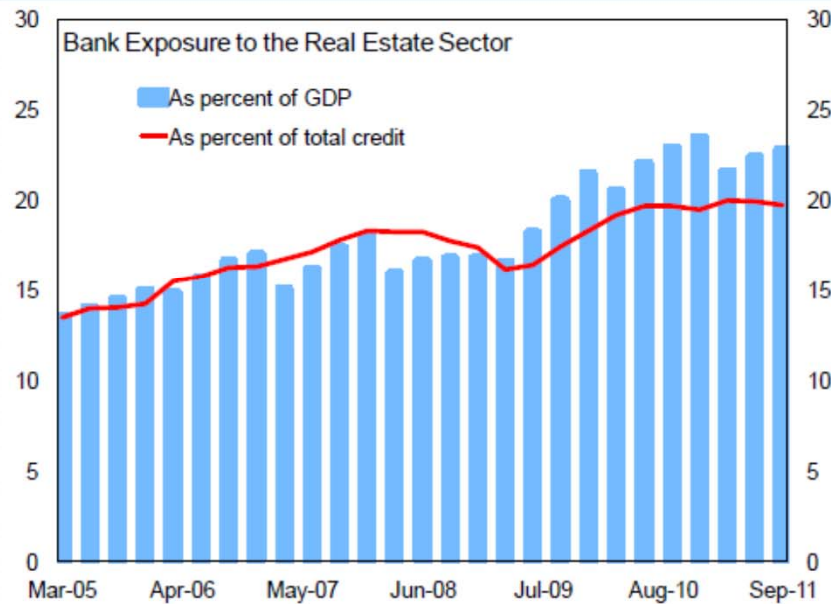


# Credit growth: real estate

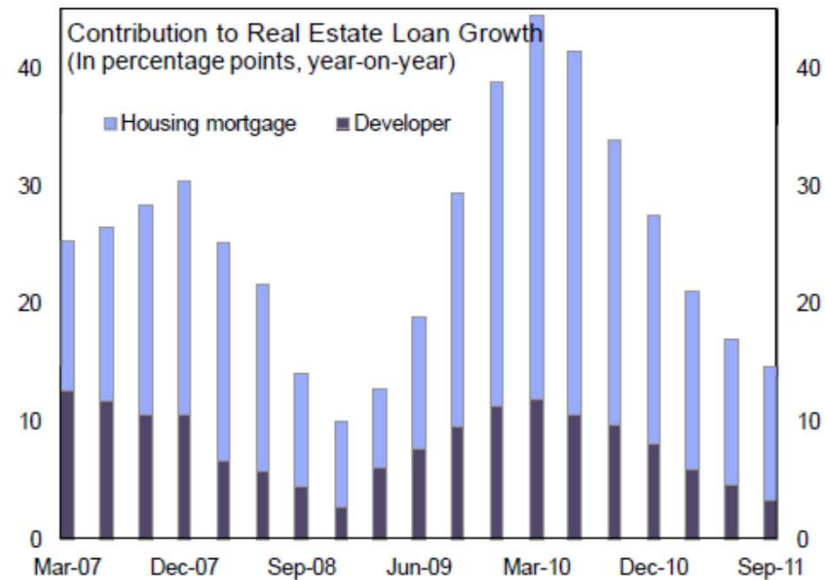
Real estate lending grew but has stabilized

With most financing going to mortgages

Bank exposure to real estate



Contribution to real estate loan growth





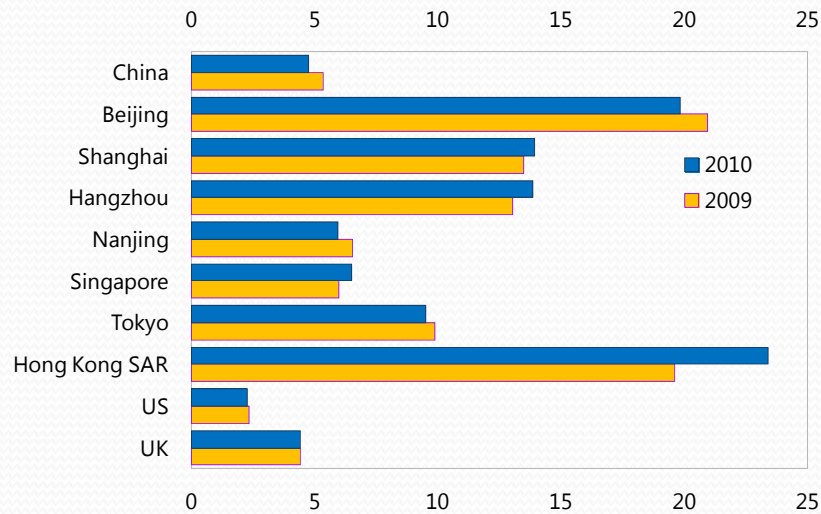
# A Property Bubble?

Property remains very expensive

But the gap between owning and renting is narrowing

## Housing Affordability

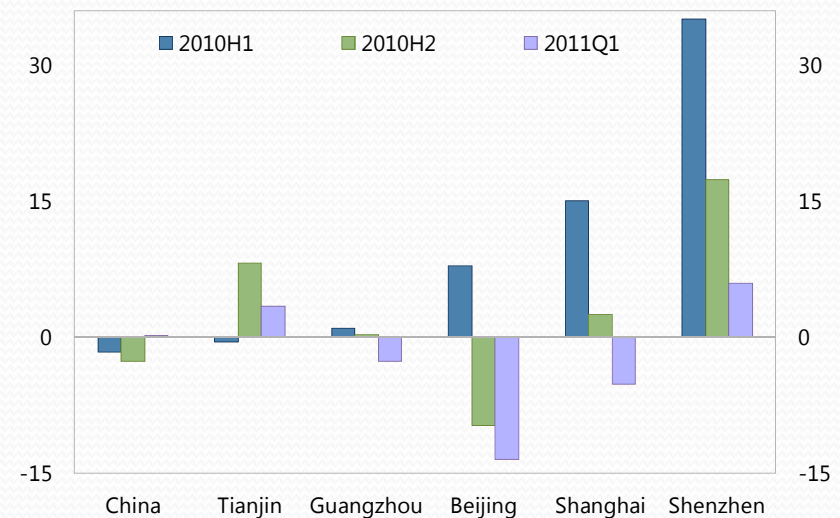
(Price-to-income ratio)



Note: Price of a 70 sq.m. home as a multiple of annual household disposable income.

## Deviation of Mass-market House Price from Benchmark

(Percent of benchmark price)



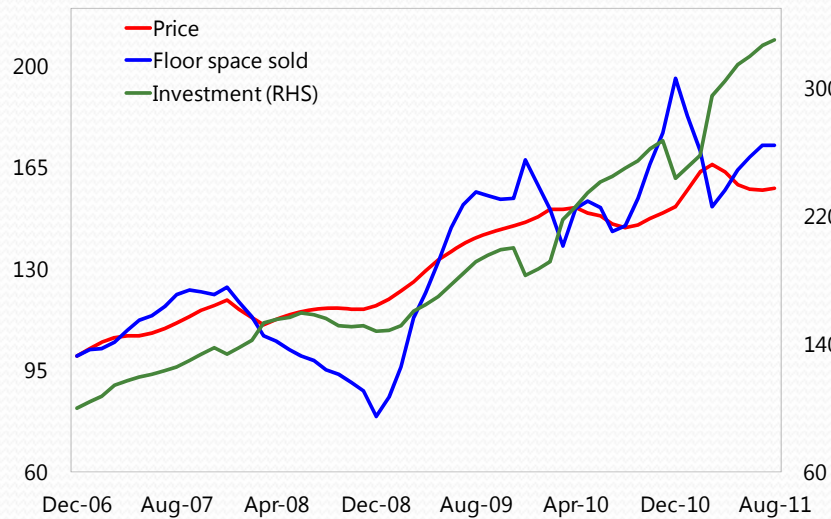
# A Property Bubble?

Government measures have cooled down the property market

And moderated the pace of growth in credit to real estate

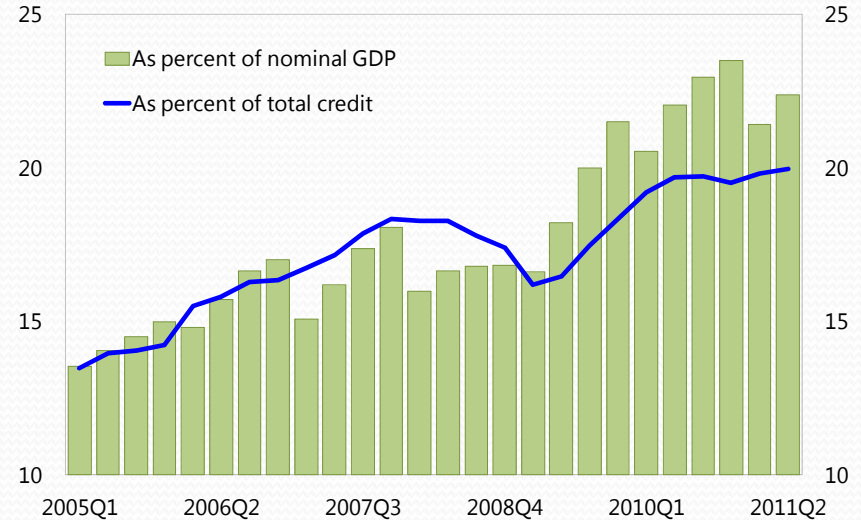
## Residential Housing

(Dec 2006 = 100, sa)



## Bank Exposure to Real Estate Sector

(Quarterly)





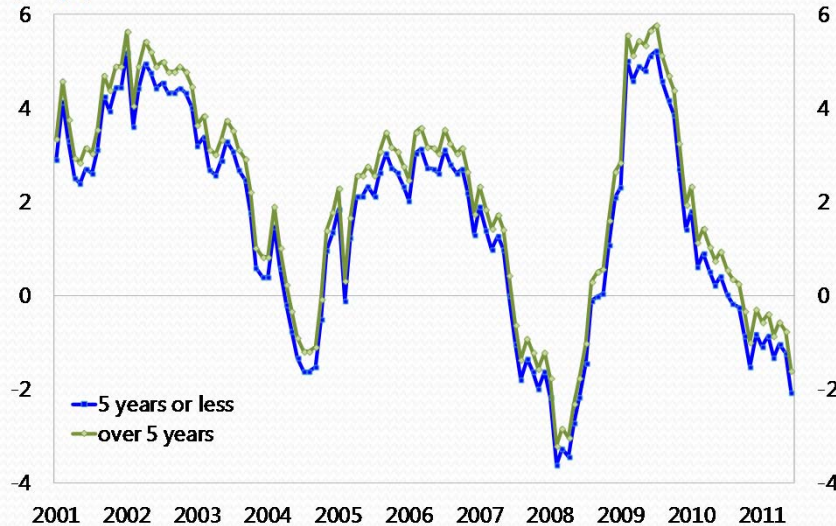
# A Property Bubble?

Nevertheless, with a low cost of financing and a lack of investment alternatives, ...

...the propensity for property bubbles remains an important domestic risk

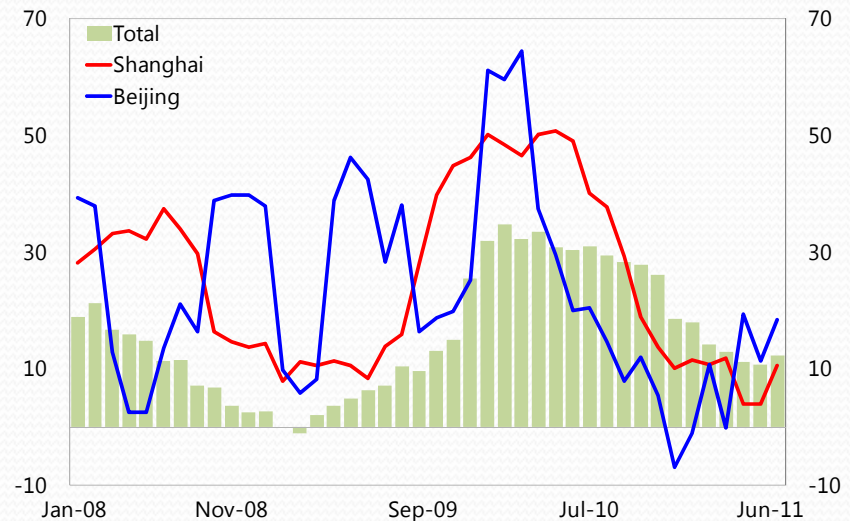
**Housing Loan: Real Lending Rates**

(in %pa)



**China Property Prices**

(In percent, year-on-year)



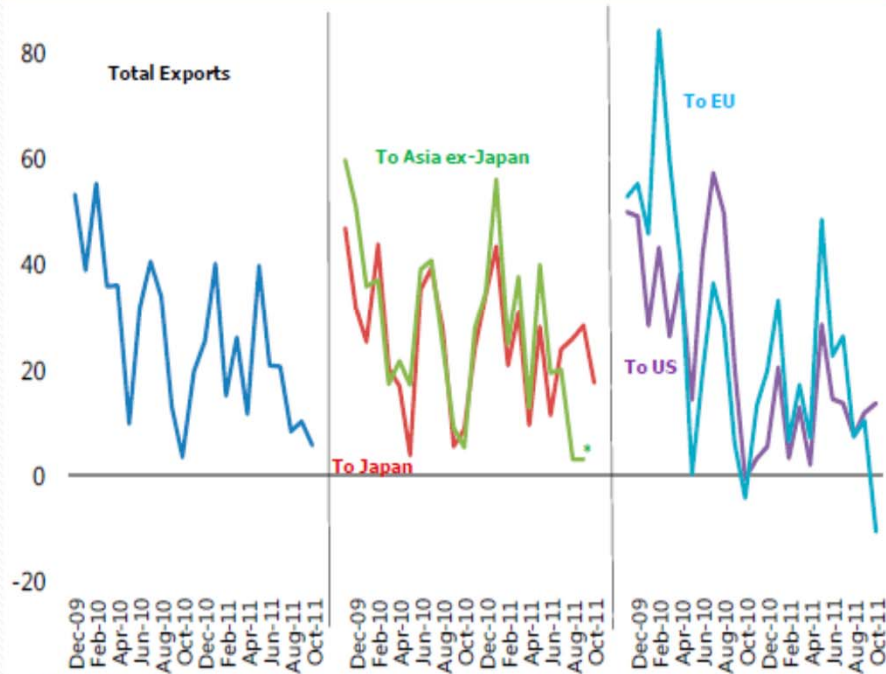


# Latest trade data

## Exports to EU slowing

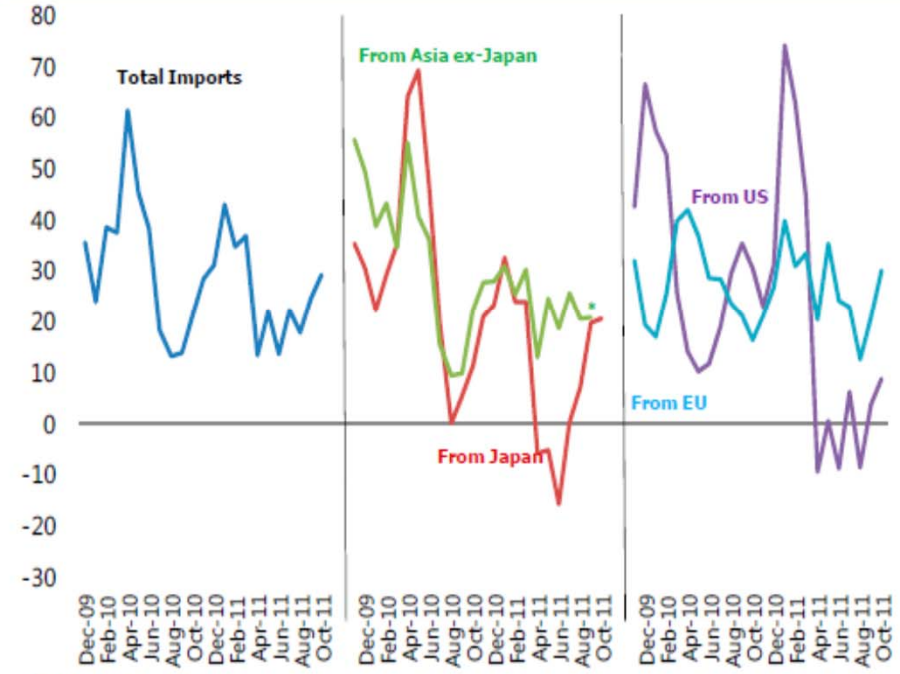
## Imports remain strong

Exports (3m percent change of 3mma, saar)



\* Through September 2011

Imports (3m percent change of 3mma, saar)



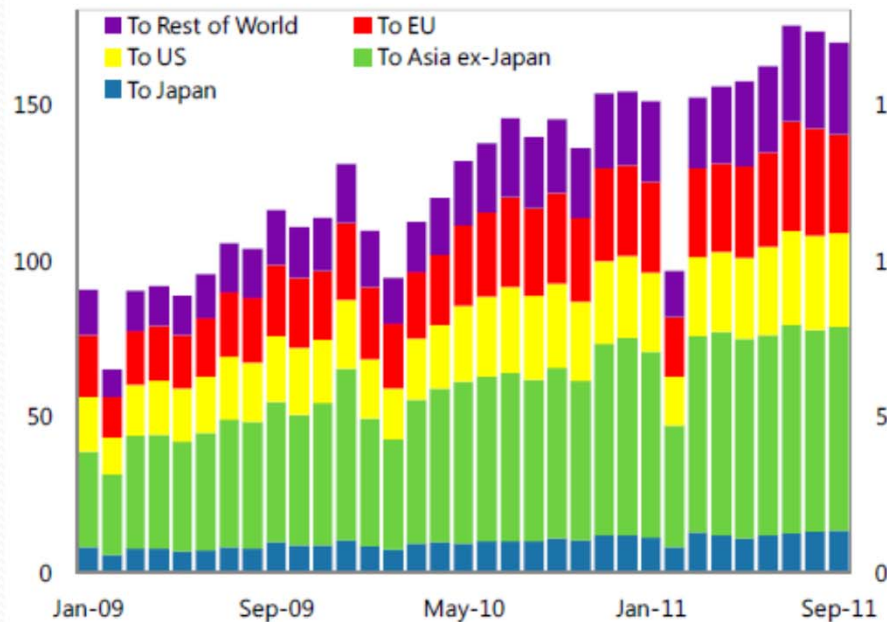
\* Through September 2011

# More trade data

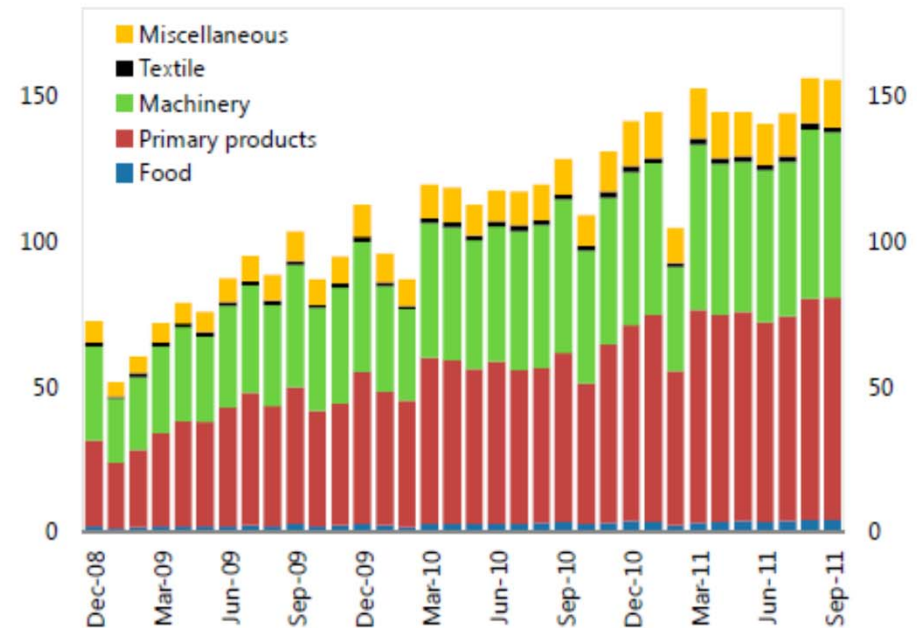
EU is the largest export destination outside of Asia

Imports are mainly commodities and machinery

Exports by Destination (USD billion)



Imports Composition (USD billion)



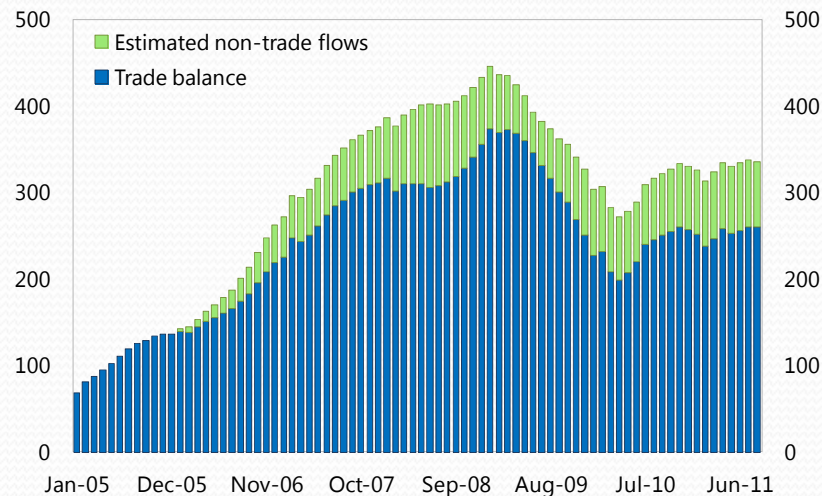


# External Outlook

The post-crisis fall in the current account surplus has moved into reverse

## Current Account Balance

(12 month cumulative, US\$ billions)

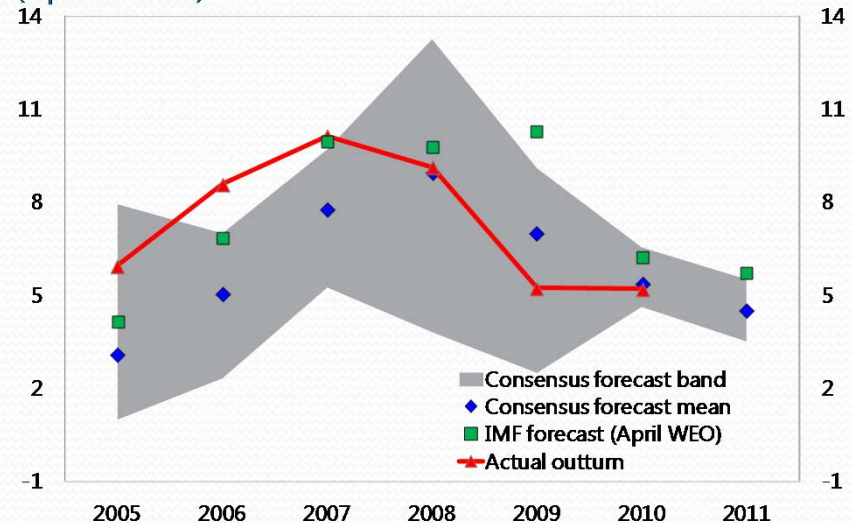


Note: Projected non-traded flows for 2011Q3.

But private analysts predict a continued fall in the current account surplus

## Current Account Balance Projections

(In percent of GDP)



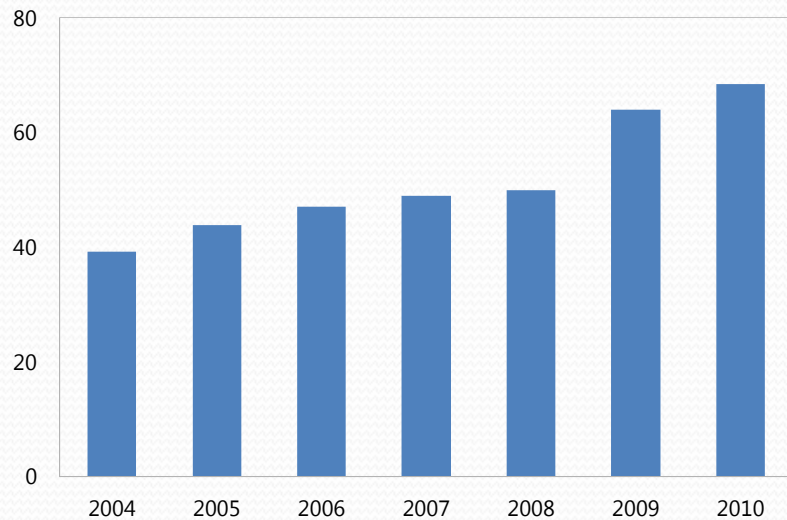


# External Outlook

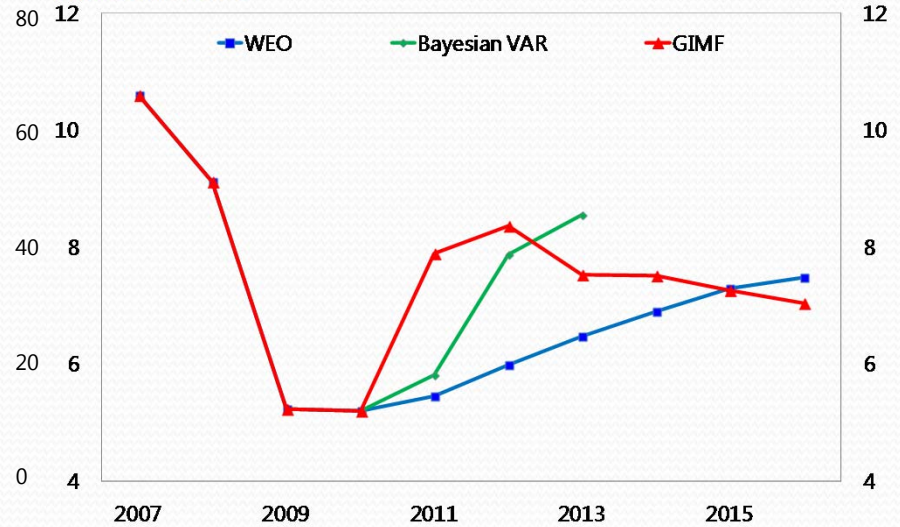
Could there be rebalancing through investment?

Or is it predominantly cyclical?

**Fixed Asset Investment**  
(In percent of GDP)



**Current Account Model Forecasts**  
(In percent of GDP)

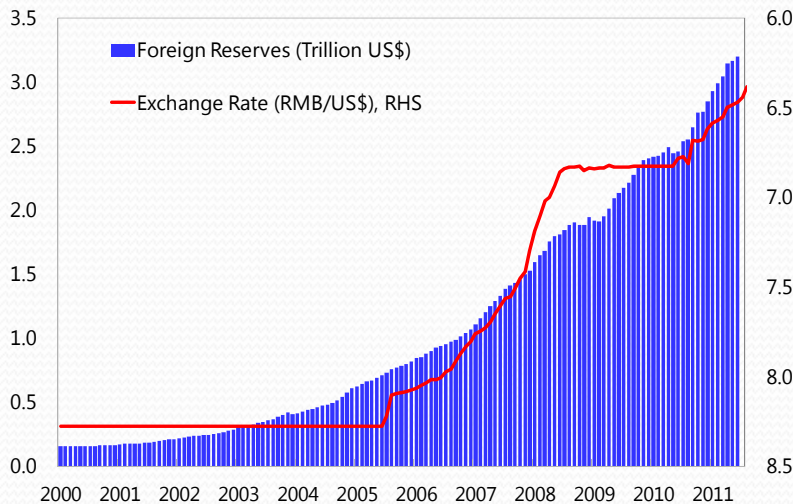


# External Outlook

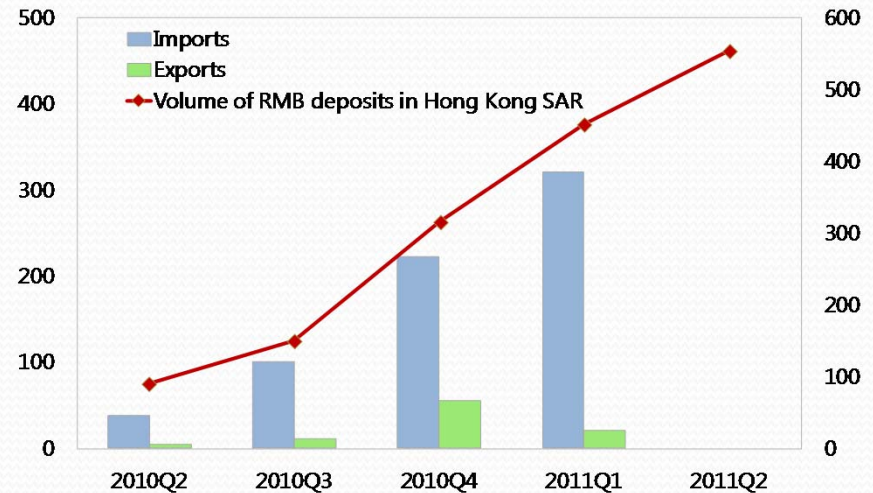
Reserve growth has been accelerating

And the one-sided nature of renminbi internationalization is adding to that pace

Exchange Rate & Foreign Reserves



RMB Trade Settlement for Cross Border Trade  
(In billion)



Note: Staff estimates for 2010Q4.

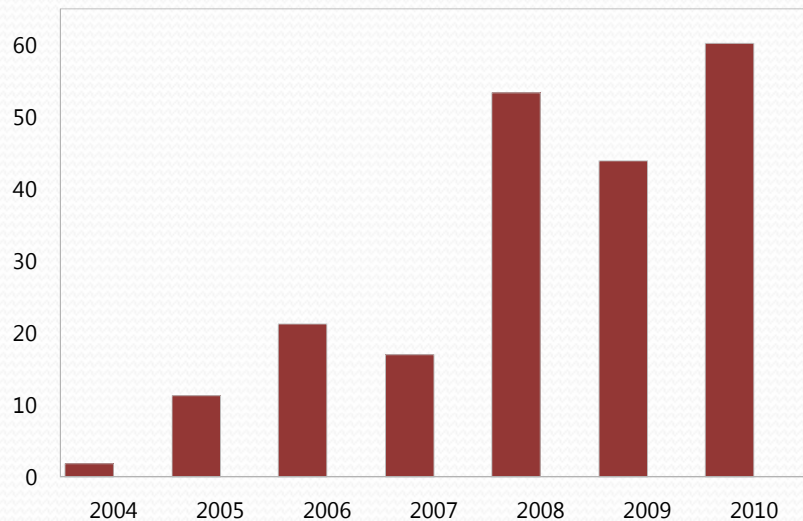


# External Outlook

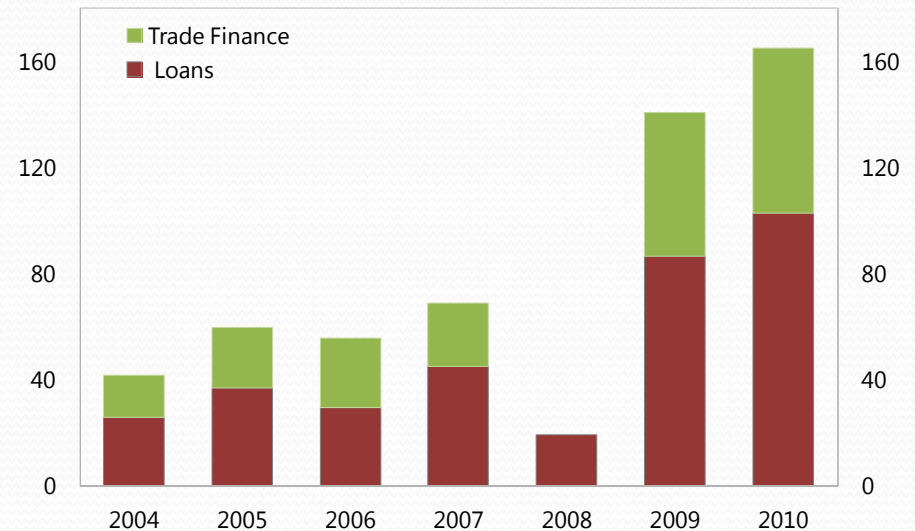
This is despite gross FDI outflows...

... and outward lending having picked up

**Outward FDI**  
(US\$ billions)



**Outward Loans & Trade Finance**  
(US\$ billions)

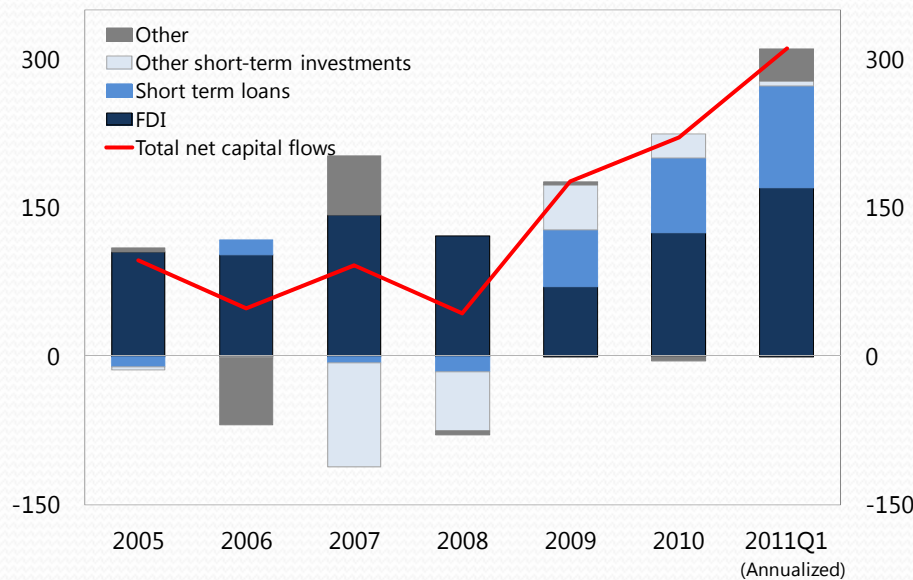




# External Outlook

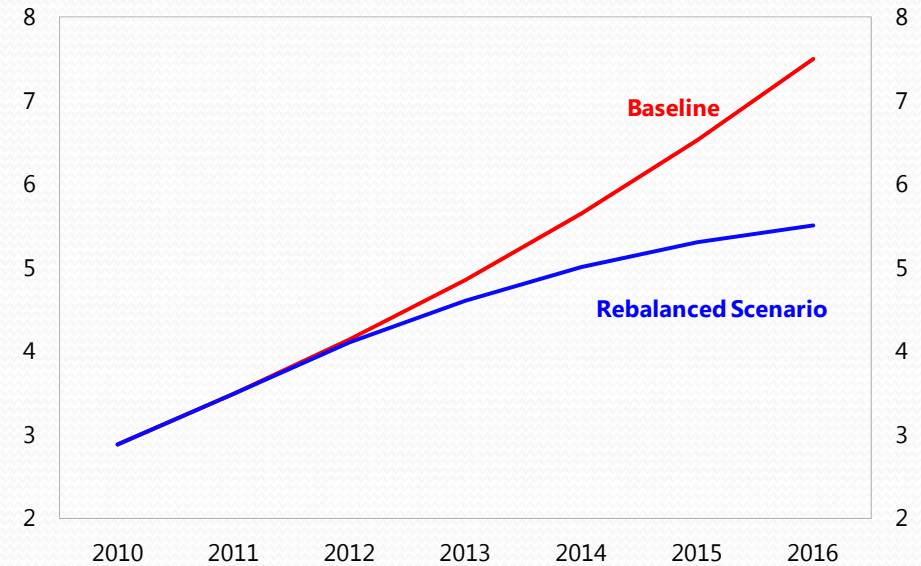
Despite the large gross outflows, the net inflows have accelerated

**Capital Flows**  
(US\$ billions)

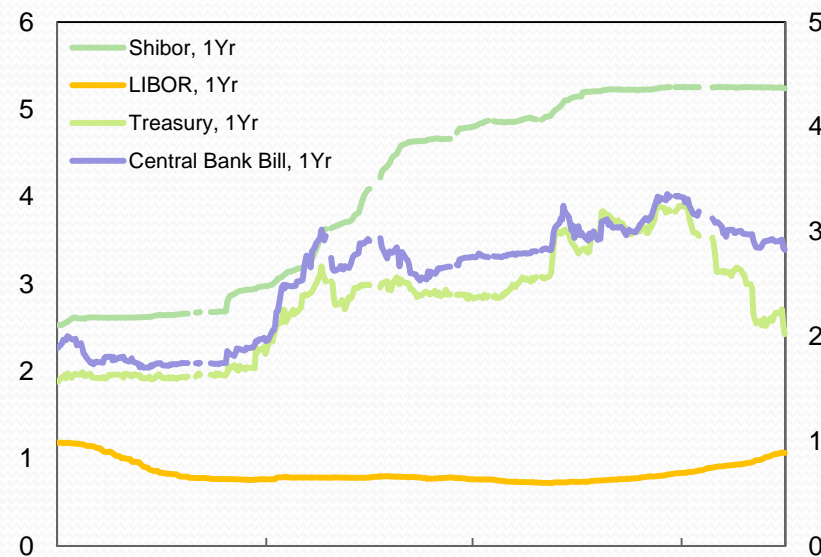
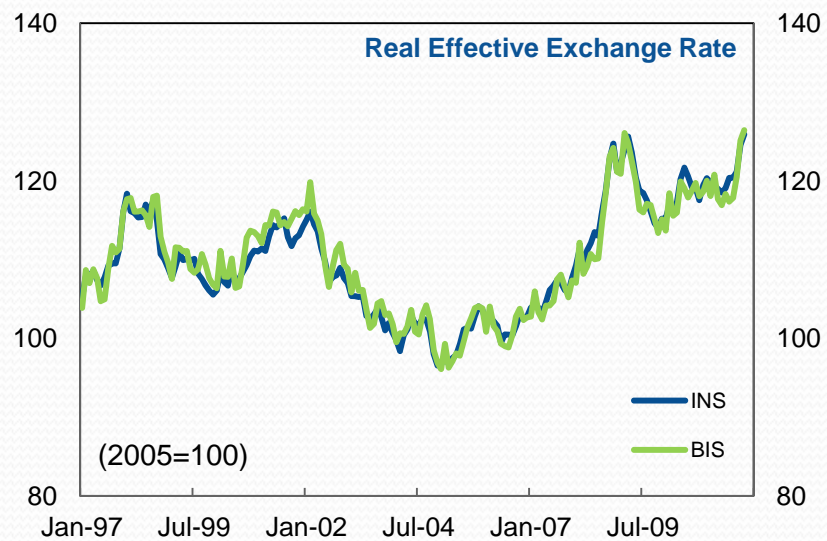
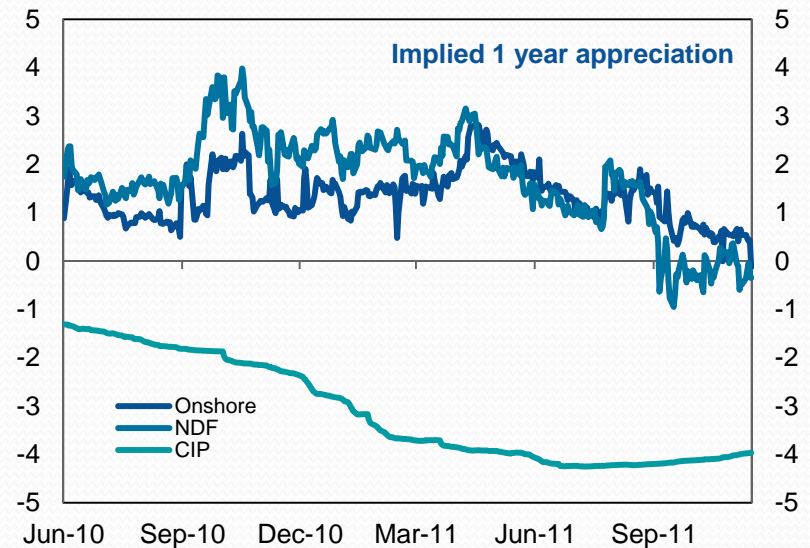
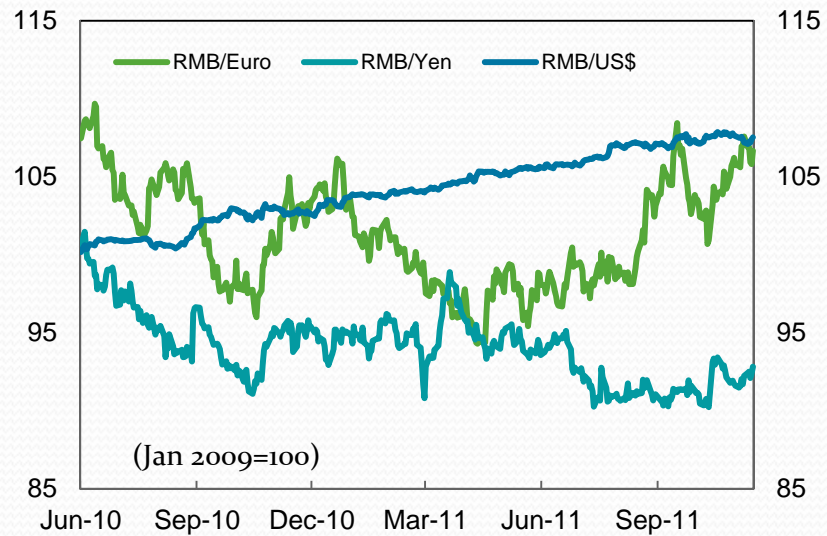


Leading us to believe that rapid reserve accumulation will continue

**Reserve Forecasts**  
(US\$ trillion)



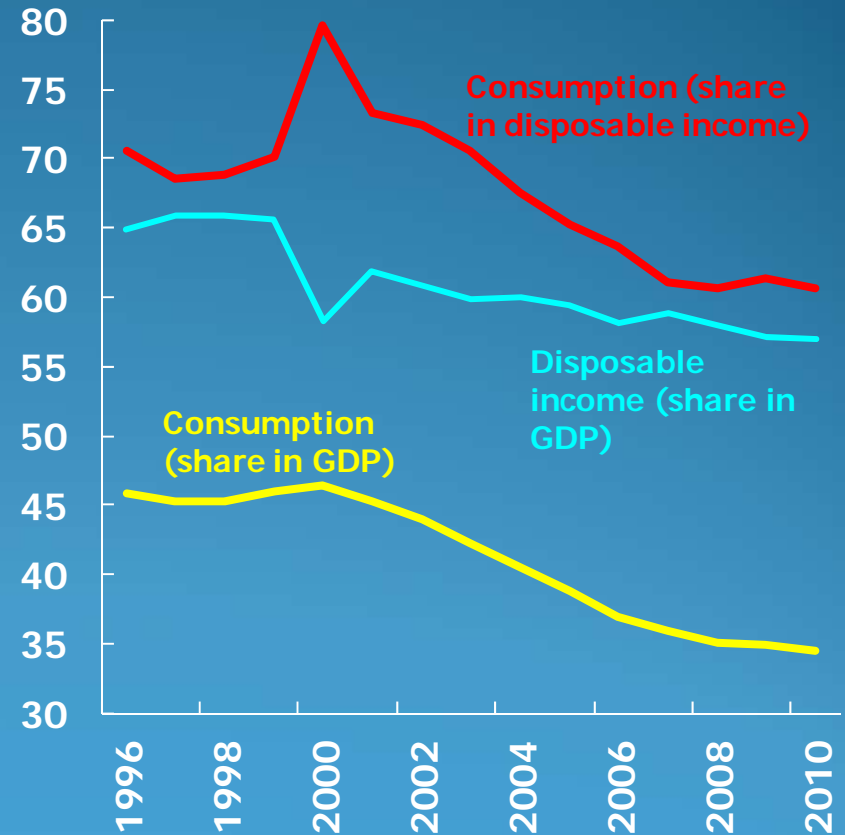
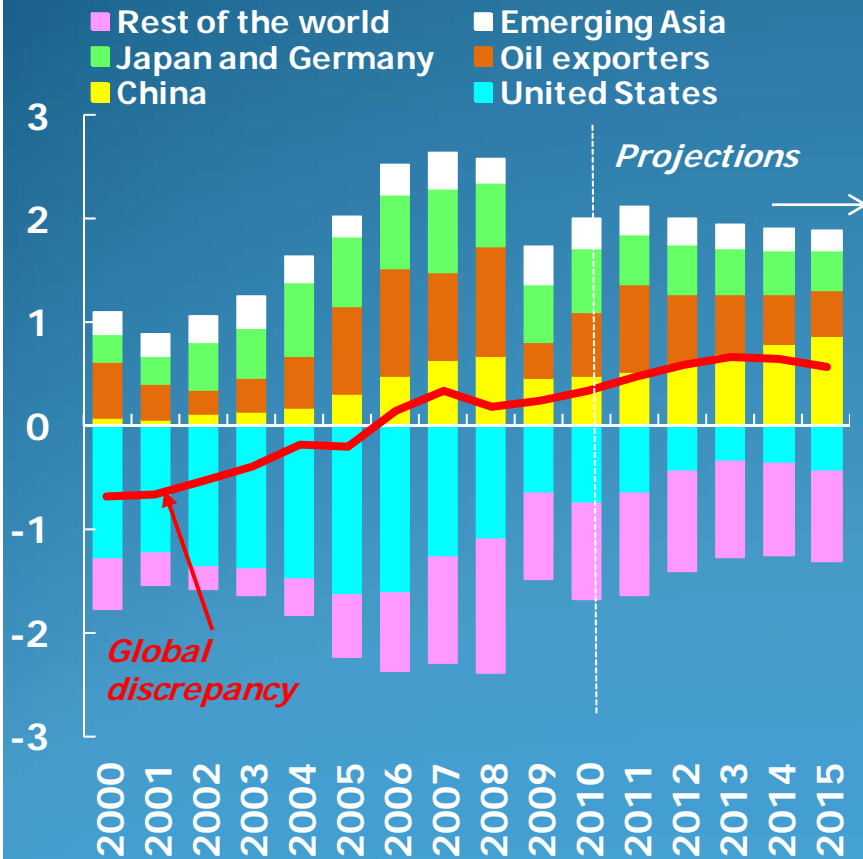
# Exchange rate



# III. Rebalancing

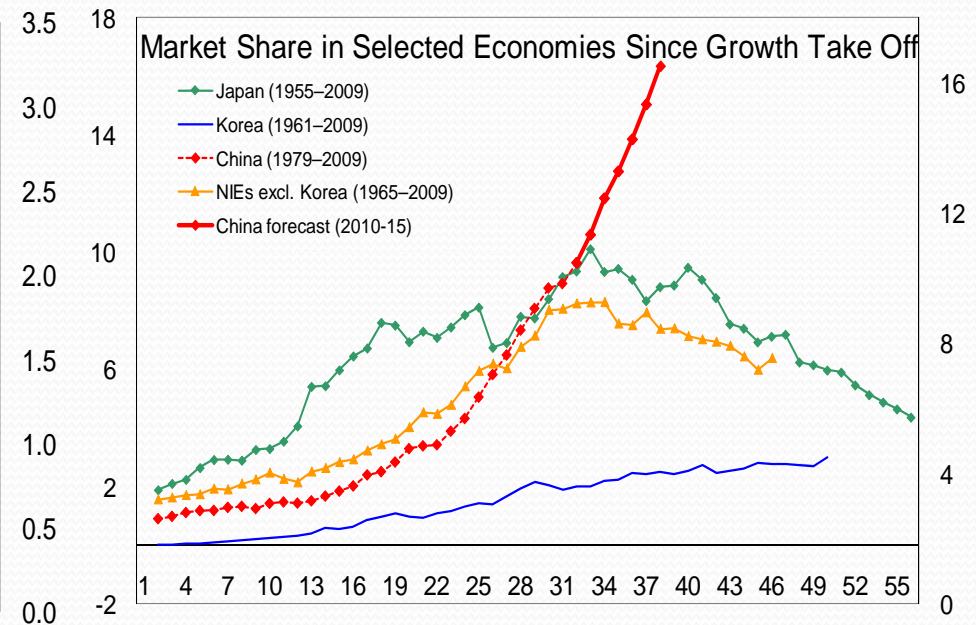
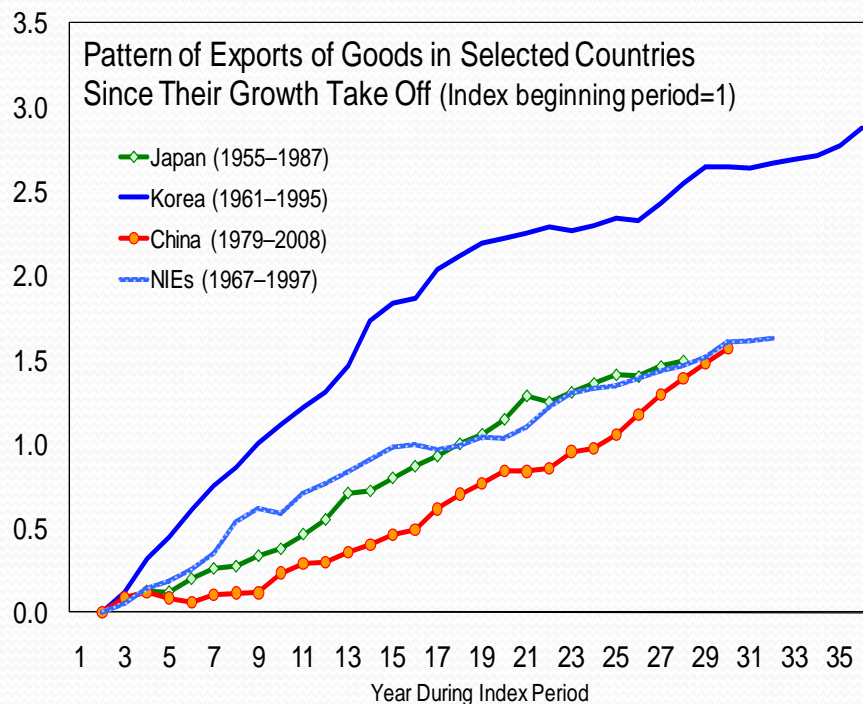
**Global Current Account Balances**  
(in percent of world GDP)

**China: Household Consumption and Income**  
(in percent)





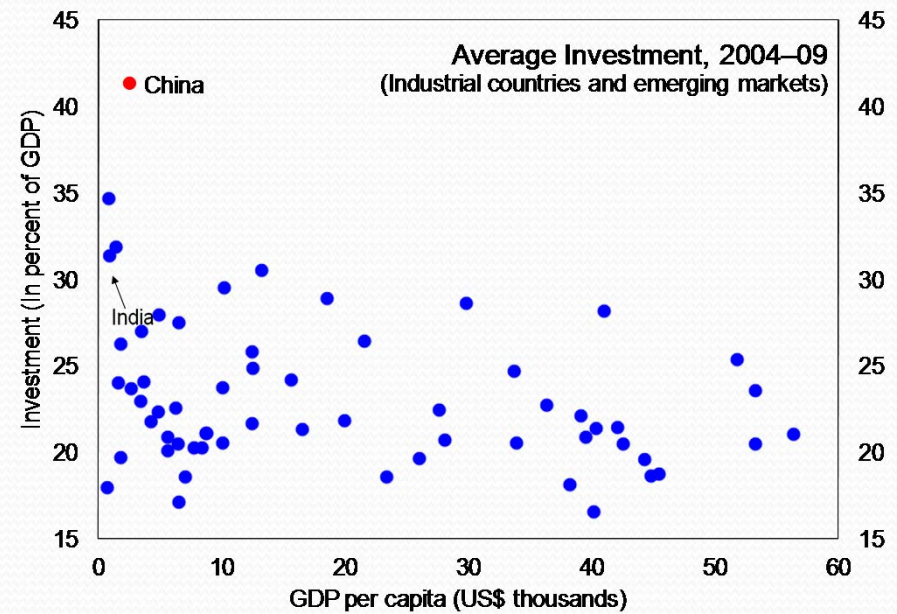
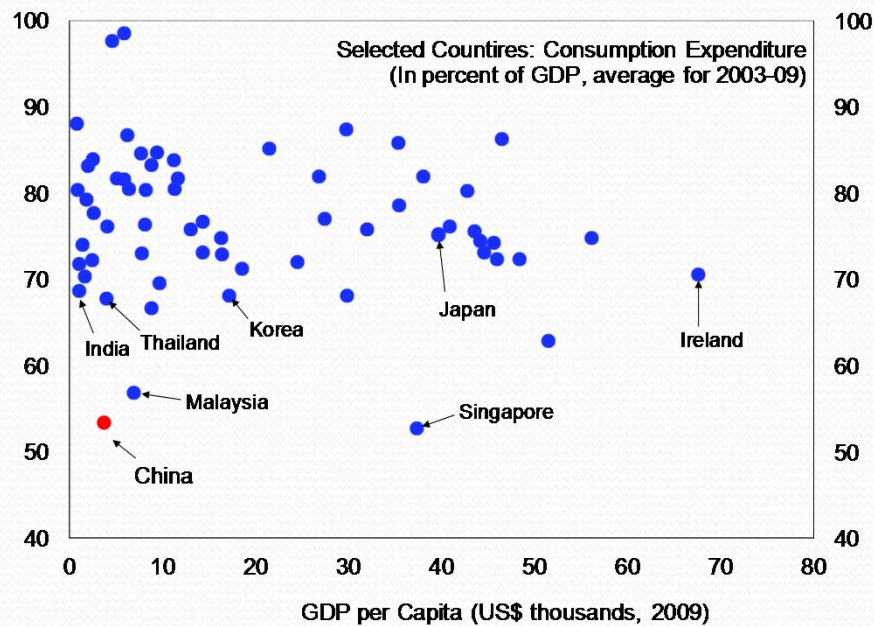
“We are keenly aware that we still have a serious problem in that our development is not yet well balanced, coordinated or sustainable.”



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

From: Guo and N'Diaye, *Is China's Export-Oriented Growth Sustainable*; in "Rebalancing Growth in Asia: Economic Dimensions for China," (2011).

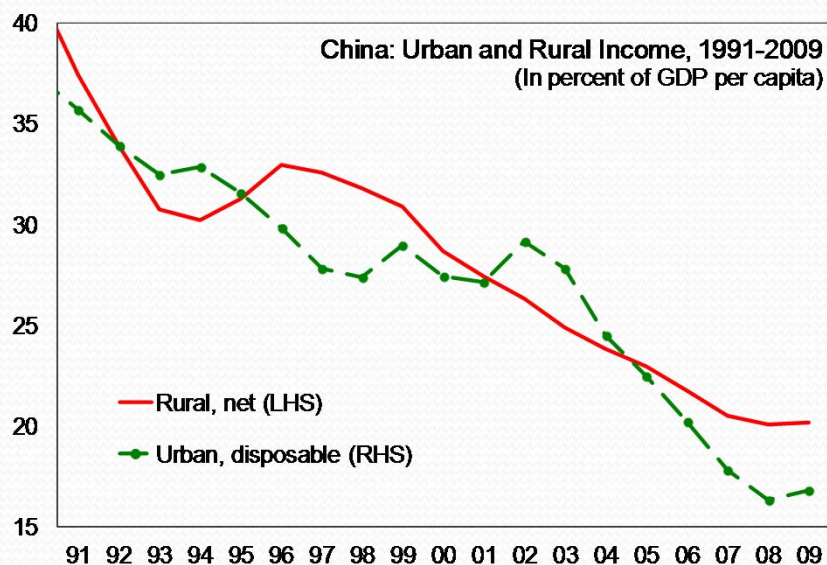
“This manifests itself mainly in...[list]...imbalance between investment and consumption...”



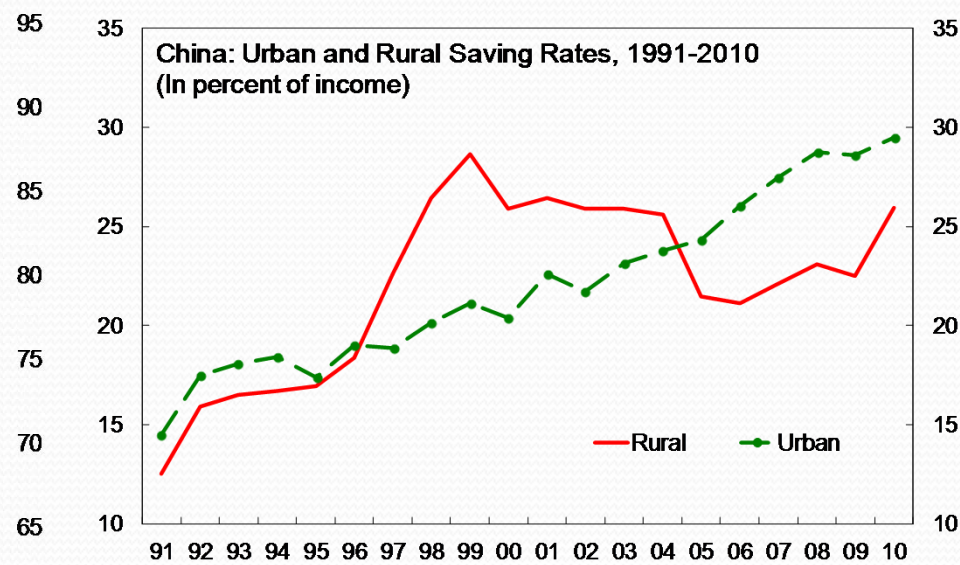
Source: Staff estimates



“We will more quickly improve the social security system, and continue to raise social security benefits. The basic pension insurance and basic medical insurance systems will cover all urban and rural residents.”



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.  
 Note: Left and right axis each span 25 percentage points, so slopes are comparable.



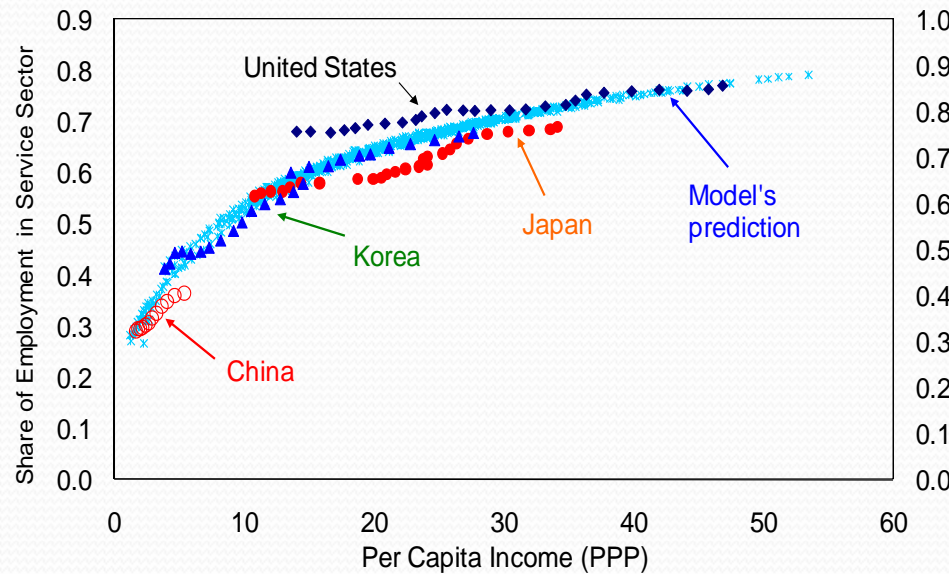
Sources: CEIC; and IMF staff calculations.

From: Barnett and Brooks, *Does Government Spending on Health and Education Raise Consumption*; in “Rebalancing Growth in Asia: Economic Dimensions for China,” (2011).



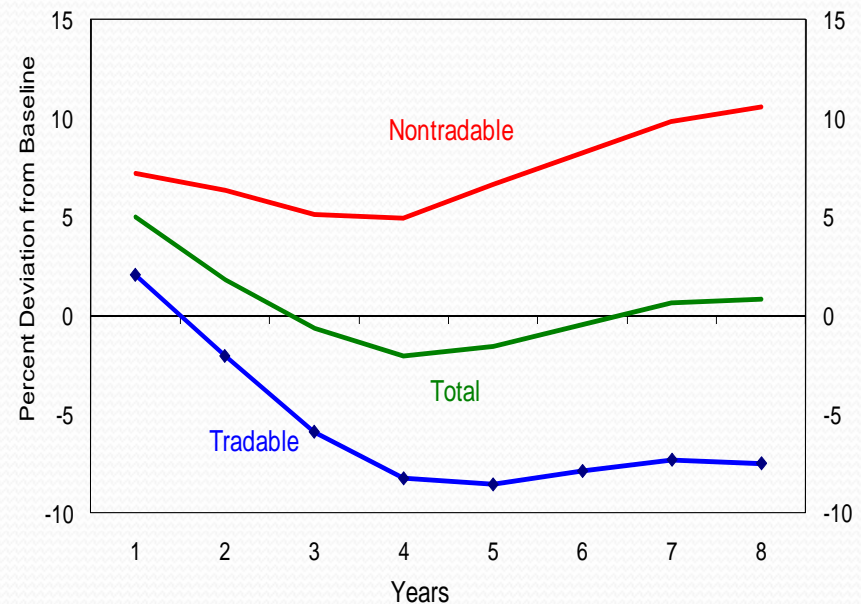
“We will accelerate the development of the service sector and raise its value-added contribution to GDP by 4 percentage points.”

Services Share of Employment, Model's Prediction vs. Actual for Selected Countries



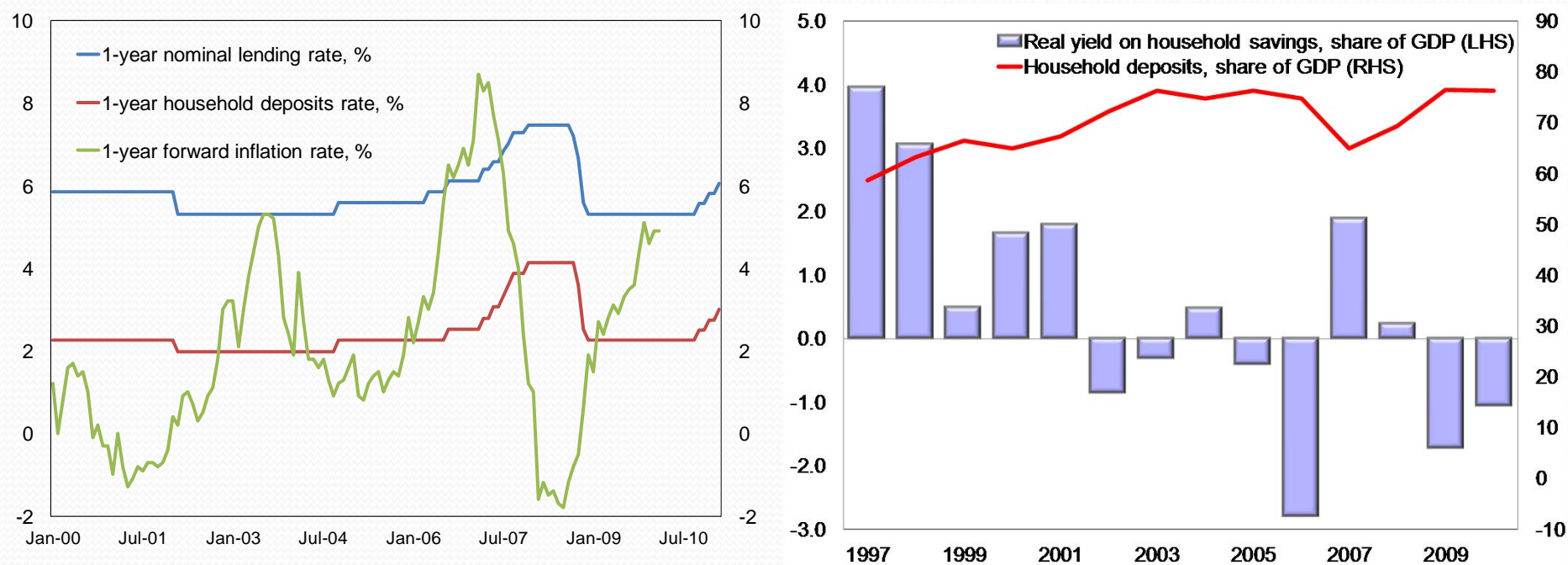
Source: IMF staff estimates.

China: Illustrative Employment Effects From Shift toward Nontradable Sector and Lower Saving Rate



From: Guo and N'Diaye, *Employment Effects of Growth Rebalancing in China*; in “Rebalancing Growth in Asia: Economic Dimensions for China,” (2011).

We will...develop a financial system that is comprised of diverse organizations, provides efficient service, exercises prudent oversight, and keeps risks within bounds.”



Sources: CEIC Data Co. Ltd; and staff estimates.



# Rebalancing Closing Thoughts

“...Further expanding domestic demand, especially consumer demand.

Expanding domestic demand is a long-term strategic principle and basic standpoint of China's economic development as well as a fundamental means and an internal requirement for promoting balanced economic development.

We will actively boost consumer demand...”

This and other quotes in this section from Premier Wen Jiabao's “Report on the Work of the Government” (March 5, 2011).



# IV. Spillovers

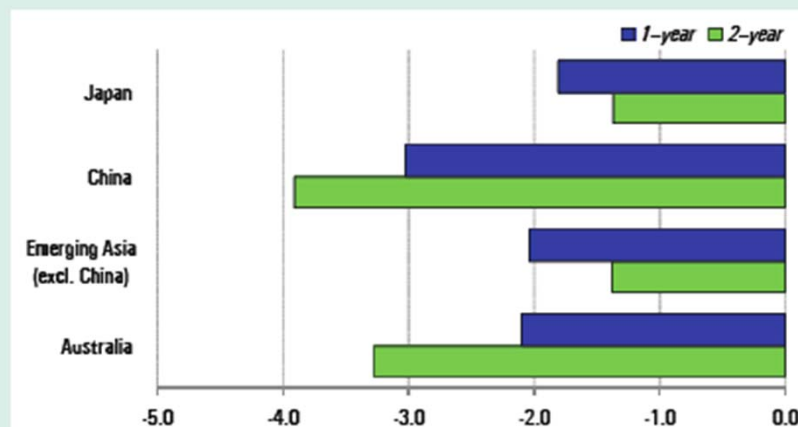
## Asia not immune from a global shock

Growth in the region would slow sharply

Through a variety of channels

**Figure 1.16. Selected Asia: Impact of Severe Global Slowdown on Real GDP Growth<sup>1</sup>**

*(Percent deviation from baseline scenario)*

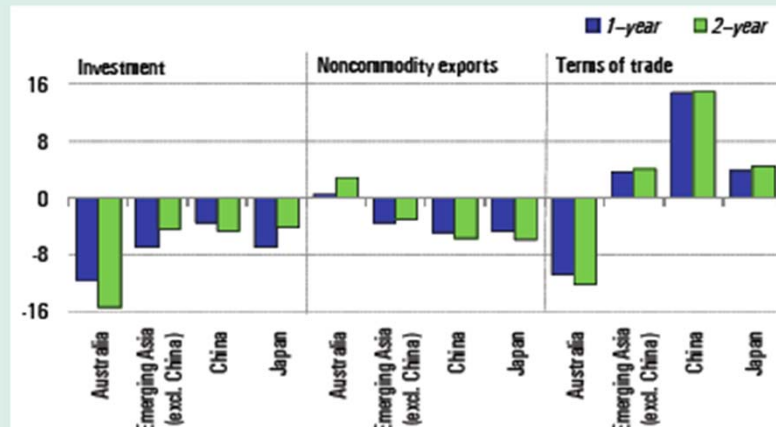


Source: IMF staff estimates.

<sup>1</sup> Based on the Global Integrated Monetary and Fiscal (GIMF) model imposing a -3.5 percent shock to output in Europe and -1 percent in the United States for two years. Assumes no discretionary policy response.

**Figure 1.17. Selected Asia: Impact of Severe Global Slowdown on Selected Indicators<sup>1</sup>**

*(Percent deviation from baseline scenario)*



Source: IMF staff estimates.

<sup>1</sup> Based on the Global Integrated Monetary and Fiscal (GIMF) model imposing a -3.5 percent shock to output in Europe and -1 percent in the United States for two years. Assumes no discretionary policy response.

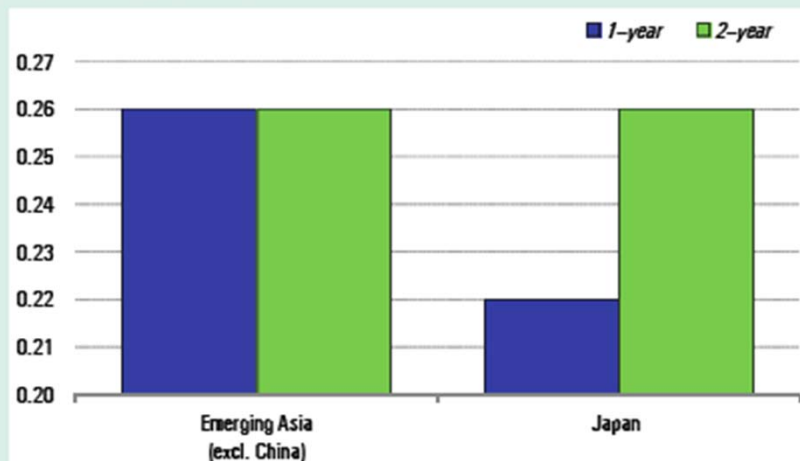
# China Stimulus Helps the Region

It boosts growth in emerging and advanced

More dependent on China final demand = higher growth

**Figure 1.18. Selected Asia: Impact on Real GDP Growth of Discretionary Fiscal Spending in China<sup>1</sup>**

(In percentage points)

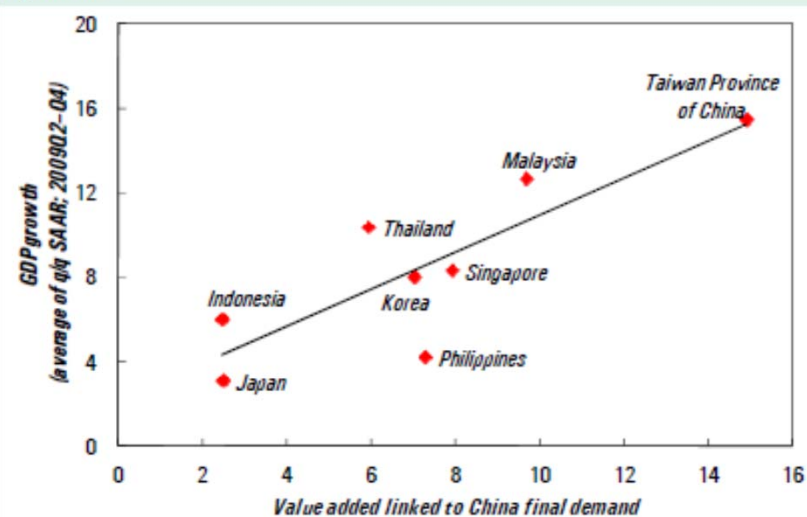


Source: IMF staff estimates.

<sup>1</sup> Based on the Global Integrated Monetary and Fiscal (GIMF) model assuming a 2 percent of GDP increase in discretionary fiscal spending by China.

**Figure 1.16 Selected Asia: GDP Growth and Value Added Linked to China Final Demand**

(In percent)



Source: IMF staff estimates.

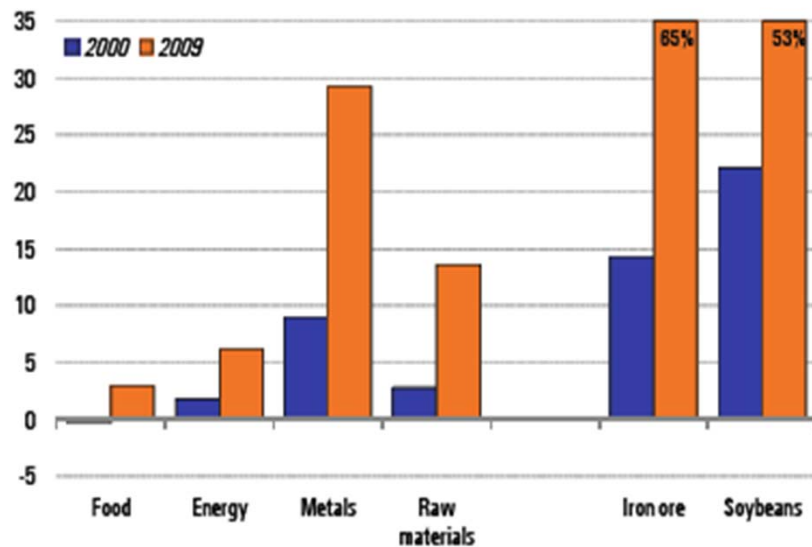
# Commodities

China share of imports increased sharply

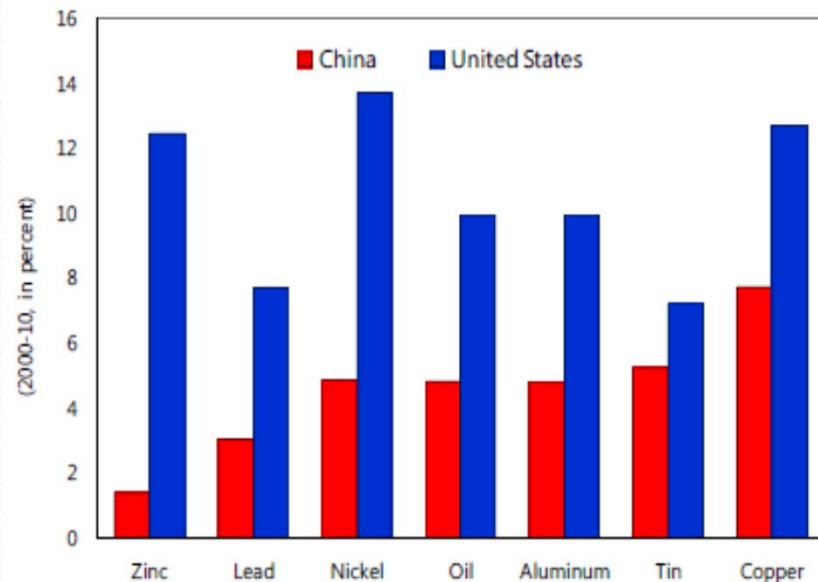
As has its influence on prices.

## China: Share of Global Commodity Trade

(Net imports in percent of world imports)



Source: IMF staff calculations.



Note: 4-quarter variance decomposition to 1 standard deviation shock in industrial output  
Source: Background paper, "China Spillovers: Global Commodity Markets"



# Real appreciation

Has positive impact on growth, especially if done as package of reforms

And, similarly on current account, but impact is small

**Table 2. GDP Impact of Appreciation and Rebalancing (in percent)**

	20% Real Appreciation		20% Real Appreciation and Other Reforms for Rebalancing	
	Near term (I-O, GVAR)	Medium term (GIMF) 1/	Near term (I-O, GVAR)	Medium term (GIMF) 1/
China	-2.0 to -3.1	-8.8	-2.0 to -2.3	1.0
U.S.	< 0.05	0.07	< 0.05	0.15
Euro Area	< 0.10	0.12	< 0.10	0.21
Japan	0.10 to 0.30	0.07	0.10 to 0.30	0.22
U.K.	< 0.50	...	< 0.10	...
EM Asia	0.25	0.33	0.25 to 0.30	1.0
Commodity	< 0.30	0.09	< 0.30	0.20

1/ Cumulative effect at peak

**Table 3. Current Account Impact of Appreciation and Rebalancing (in percent of GDP)**

	20% Real Appreciation		20% Real Appreciation and Other Reforms for Rebalancing	
	Near term (I-O)	Medium term (GIMF) 1/	Near term (I-O)	Medium term (GIMF) 1/
China	-0.69	-2.91	-0.70	-5.17
U.S.	0.02	0.08	0.02	0.25
Euro Area	0.10	0.05	0.10	0.19
Japan	0.11	0.04	0.11	0.04
U.K.	0.05	...	0.11	...
EM Asia	0.30	-0.31	0.31	-0.76
Commodity	-0.02	0.11	-0.01	0.31

1/ 5-years.

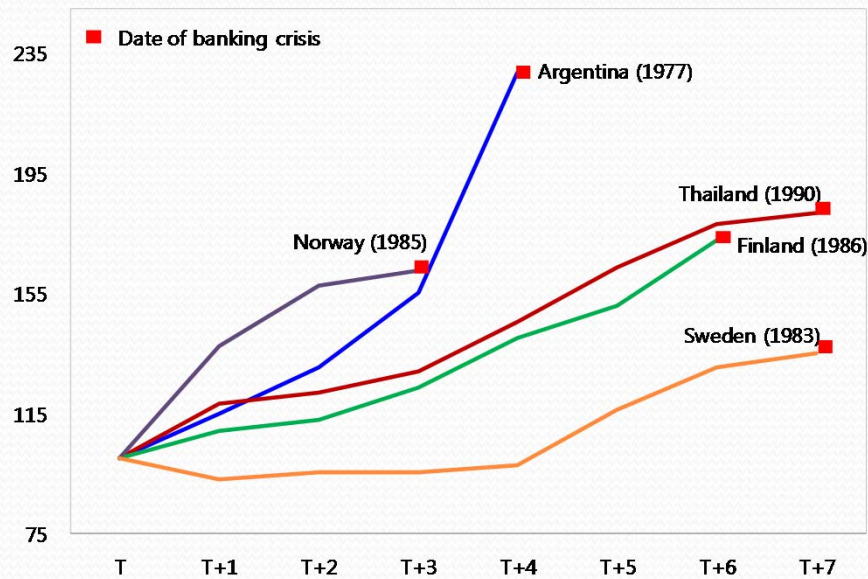
# V. Financial sector reform

Liberalization often led to credit boom and crisis

And low real interest rates

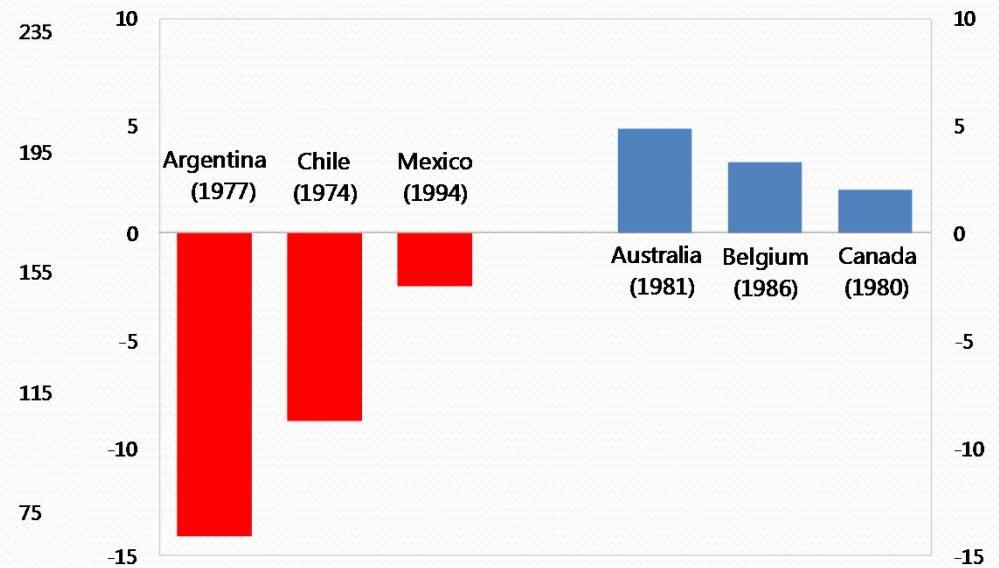
## Private Credit (percent of GDP)

(T = time of interest rate liberalization, normalized to equal 100)



## Real Interest Rates

(In percent; 3 year average, post-interest rate liberalization)





# Progress

## Institutions

- Splitting out the regulatory functions into CBRC, CSRC, CIRC
- Strengthening regulatory oversight and supervisory practices
- Moving toward international standards in a range of areas

## The Banks

- Stripping out bad loans from the banks
- Strategic foreign investors to improve internal practices
- Move to international accounting standards
- Listing on foreign exchanges



# Progress

## Markets

- Developing corporate bond markets
- Creating a range of futures, swap, and options markets
- Establishing interbank corporate bond market with NAFMII oversight
- Deepening equity markets, increasing liquidity, tackling nontraded shares

## Monetary Operations

- Building out central bank bond market
- Establishing SHIBOR reference curve
- Creating interbank and repo markets
- Building a well-functioning foreign currency market

# But There's More To Be Done

- It is a long list but I want to focus on a subset

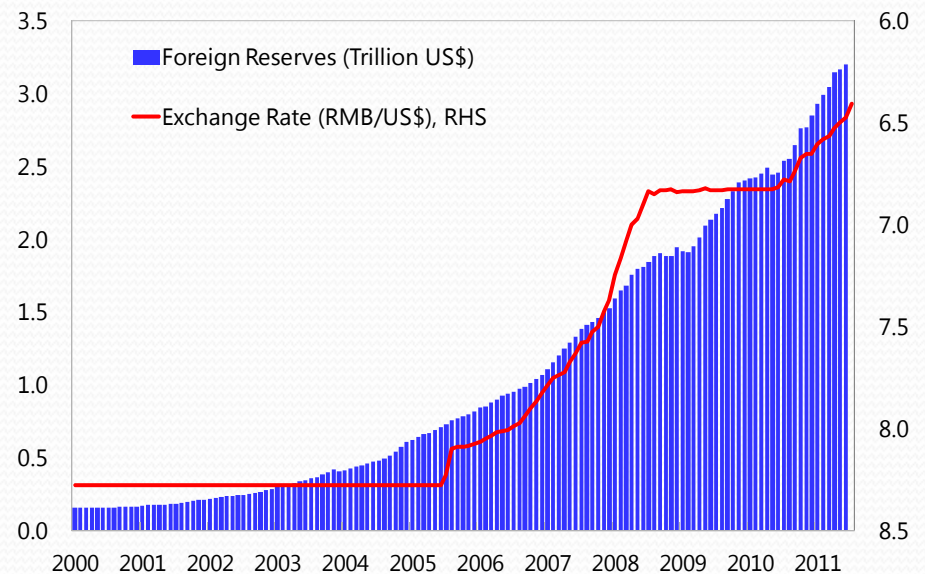
1. A stronger exchange rate
2. Rethinking the monetary framework
3. Improved regulation and supervision
4. Market development
5. Liberalizing interest rates
6. Opening up the capital account



# 1. A Stronger Exchange Rate

- There is a need for currency appreciation to...
  - Reduce the scale of BOP inflows
  - Lower FX intervention
  - Have the flexibility to use reserve requirements not merely as a sterilization tool
  - Greater scope for an independent monetary policy

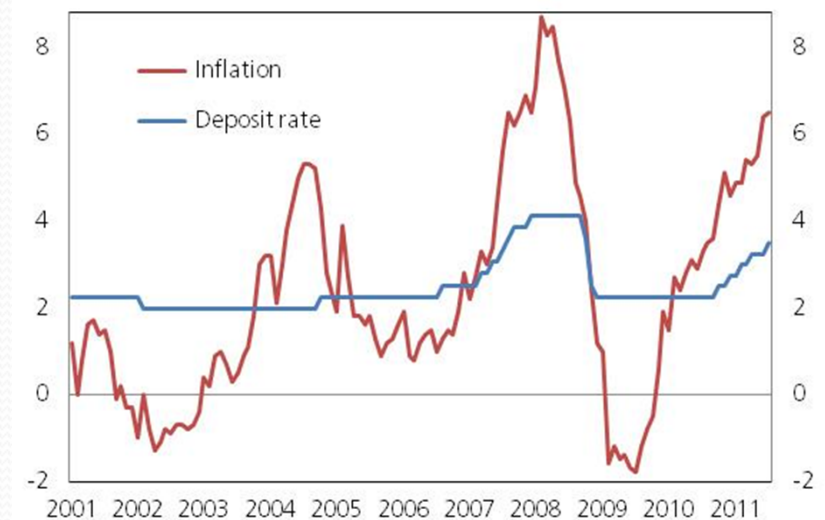
Exchange Rate & Foreign Reserves





## 2. Rethinking The Monetary Framework

- Absorb the excess liquidity in the financial system and move to a point where interest rates clear the credit market, not quantity controls
- Shift to a framework that establishes clear objectives on growth, inflation, and financial stability and deploys a combination of monetary and macro-prudential tools to achieve these objectives
- A greater reliance on indirect instruments as intermediate targets (perhaps the 7-day repo)
- Operational autonomy for the central bank



# 3. Improving Regulation and Supervision

## Regulation and Supervision

- Establish a coordinating regulatory body (Financial Stability Committee)
- Operational autonomy for regulatory agencies
- Increased staffing and funding
- Effective enforcement and resolution powers
- Tackle data quality and collection
- Continued progress in regular stress testing

## Crisis Management Framework

- Procedures for intervention and orderly exit of weak institutions
- Clear definition of the scope of fiscal support
- Deposit insurance scheme
- Limits on emergency liquidity support to solvent banks facing short-term liquidity problems
- Standing facilities should operate automatically with common conditions to provide liquidity support to all domestically incorporated institutions



# 4. Market Development

## Financial Markets

### Bonds

- Bond issuance strategy of government
- Increase connectivity between markets
- Disclosure-based listing

### Money Markets

- Increase repo market liquidity
- Remove tax and regulatory hurdles
- Interest rate hedging tools

### Equities

- Legacy issues related to nontradable, A and B shares
- Expand free float of shares of public companies

## Non-bank Intermediation

### Insurance

- Consolidation
- More comprehensive risk-based capital requirements
- Clearer voluntary exit rules
- Asset allocation limits
- Stronger actuarial oversight

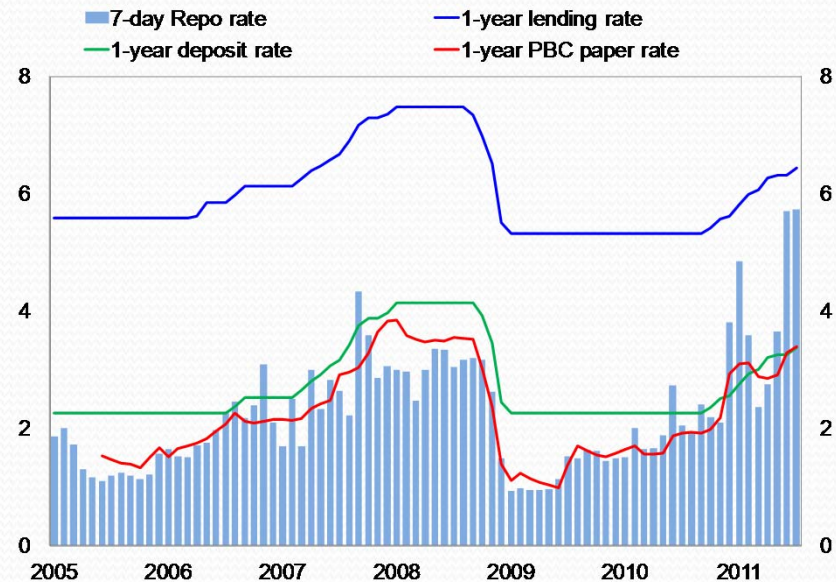
### Mutual Funds

- Expand scope of investments to lower-rated fixed income products and medium-term notes
- Assess the regulatory approach



## 5. Liberalizing Interest Rates

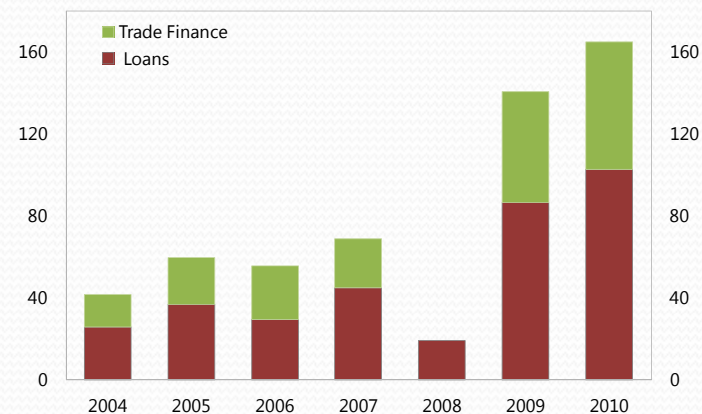
- Once liquidity has been absorbed and monetary policy is conducted by indirect instruments, then the PBC can move to liberalize interest rates
- Raise deposit rate ceiling first, making the loan rate floor more binding
- Need to ensure banks do not “over-compete”, eroding their margins and creating financial stability risks
- Will also need to calibrate monetary policy as interest rate regulations become less binding in order to prevent a surge in credit



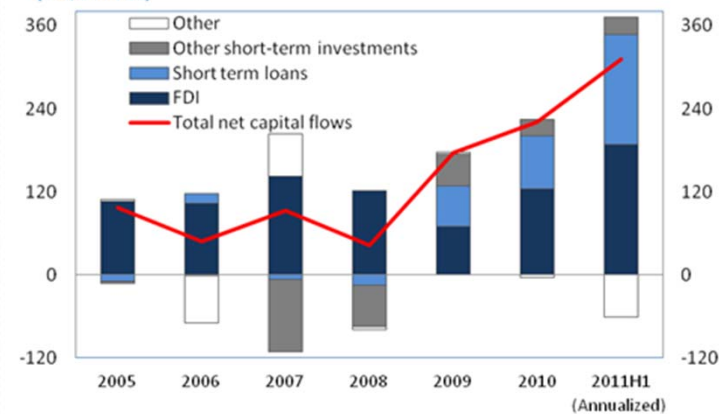
## 6. Opening Up The Capital Account

- It would be extremely risky to begin opening to international flows before addressing distortions in the domestic system
- Can make some progress along the way in opening up to outward flows and longer-term inward flows
- QDII and QFII are ideal tools for this
- Shorter term portfolio flows will have to wait for progress on currency and liberalizing interest rates
- Renminbi internationalization can be a part of this process but will move on a separate track

**Outward Loans & Trade Finance**  
(US\$ billions)



**Capital flows**  
(US\$ billions)





# The End

- WWW Information
  - <http://www.imf.org/external/country/CHN/index.htm>
  - <http://www.imf.org/external/country/chn/rr/index.htm>
- Publications
  - Article IV Report
    - <http://www.imf.org/external/pubs/cat/longres.aspx?sk=25066.0>
  - Economic Outlook, Sep-11 (See second link above)
  - Spillover Report
    - <http://www.imf.org/external/pubs/cat/longres.aspx?sk=25068.0>
  - FSAP
    - <http://www.imf.org/external/pubs/cat/longres.aspx?sk=25350.0>