December 6, 2011

"China: Economic Developments and Outlook"

Steven Barnett

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

<table>
<thead>
<tr>
<th>Region</th>
<th>1990</th>
<th>2005</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>1818</td>
<td>1374</td>
<td>-444</td>
</tr>
<tr>
<td>China</td>
<td>683</td>
<td>208</td>
<td>-475</td>
</tr>
<tr>
<td>India</td>
<td>436</td>
<td>456</td>
<td>20</td>
</tr>
<tr>
<td>Rest of Asia</td>
<td>333</td>
<td>248</td>
<td>-85</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>297</td>
<td>388</td>
<td>91</td>
</tr>
<tr>
<td>Rest of world</td>
<td>69</td>
<td>74</td>
<td>5</td>
</tr>
</tbody>
</table>

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 $\frac{1}{4}$ of global growth

Contributions to GDP Growth (In percentage points)

Average 2003-7 = 24%
Rising Share of Global Output (GDP on PPP Basis)

1991
- China: 4%
- United States: 24%
- Japan: 10%
- Euro area: 22%
- Rest of world: 40%

2010
- China: 14%
- United States: 19%
- Japan: 6%
- Rest of world: 46%
- Euro area: 15%
Same trend but less dramatic when measured at market exchange rates

1991
- United States: 26%
- Japan: 15%
- Euro area: 25%
- Rest of world: 32%
- China: 2%

2010
- Rest of world: 40%
- United States: 23%
- Japan: 9%
- Euro area: 19%
- China: 9%
GDP Per Capita, 2010 (US$)

- China: 4,382
- United States: 46,860
- Japan: 42,783
- Euro area: 36,716
- World: 10,356
- Brazil: 10,816
- Russia: 9,239
- India: 1,371
- Thailand: 4,992
- Vietnam: 1,174
- Indonesia: 2,974
- Malaysia: 8,423
- Philippines: 2,123
- Mexico: 9,522
- United Kingdom: 36,164
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)*

![Graph showing downward revisions in growth forecasts since April 2011 WEO.](image)

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

<table>
<thead>
<tr>
<th>Country</th>
<th>2010</th>
<th>2011 (Proj.)</th>
<th>2012 (Proj.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>5.1</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Advanced economies</td>
<td>3.1</td>
<td>1.6</td>
<td>1.9</td>
</tr>
<tr>
<td>USA</td>
<td>3.0</td>
<td>1.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Euro area</td>
<td>1.8</td>
<td>1.6</td>
<td>1.1</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.4</td>
<td>1.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Japan</td>
<td>4.0</td>
<td>-0.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>
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 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)*

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

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

- 90 percent confidence interval
- 70 percent confidence interval
- 50 percent confidence interval
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

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

China Unit Labor Cost and Industrial Profit Margin

Producer Price Index
(In percent, year-on-year)
Overheating?

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

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

- *Food*
- *Nonfood*
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

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

![Pork Price](image)

![Consumer Price Inflation](image)
Credit growth

Headline credit growth is falling

Especially from the peaks reached during the stimulus
Credit growth

Monetary policy has been tightened

And borrowers are paying higher interest for bank loans
Credit growth: Social financing

Other forms of financing also have grown

But have slowed in the most recent data
Credit growth: real estate

Real estate lending grew but has stabilized

With most financing going to mortgages
A Property Bubble?
Property remains very expensive

But the gap between owning and renting is narrowing

Housing Affordability
(Price-to-income ratio)

Deviation of Mass-market House Price from Benchmark
(Percent of benchmark price)

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

Government measures have cooled down the property market and moderated the pace of growth in credit to real estate.
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
Latest trade data

Exports to EU slowing

Imports remain strong
More trade data

EU is the largest export destination outside of Asia

Imports are mainly commodities and machinery
External Outlook

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

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

Current Account Balance
(12 month cumulative, US$ billions)

Current Account Balance Projections
(In percent of GDP)

Note: Projected non-traded flows for 2011Q3.
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

![Graph showing foreign reserves and exchange rate]

**Exchange Rate & Foreign Reserves**
- Foreign Reserves (Trillion US$)
- Exchange Rate (RMB/US$), RHS

![Graph showing RMB trade settlement for cross border trade]

**RMB Trade Settlement for Cross Border Trade**
- Imports
- Exports
- Volume of RMB deposits in Hong Kong SAR

Note: Staff estimates for 2010Q4.
External Outlook
This is despite gross FDI outflows...
... and outward lending having picked up
External Outlook

Despite the large gross outflows, the net inflows have accelerated,
Leading us to believe that rapid reserve accumulation will continue.
III. Rebalancing

Global Current Account Balances
(in percent of world GDP)

China: Household Consumption and Income
(in percent)

Rest of the world
Emerging Asia
Japan and Germany
Oil exporters
China
United States

Consumption (share in disposable income)
Disposable income (share in GDP)
"We are keenly aware that we still have a serious problem in that our development is not yet well balanced, coordinated or sustainable."

“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.”

“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

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

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.
“...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

(Percents deviation from baseline scenario)

- Japan
- China
- Emerging Asia (excl. China)
- Australia

Source: IMF staff estimates.

1 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

(Percents deviation from baseline scenario)

- Investment
- Noncommodity exports
- Terms of trade

Source: IMF staff estimates.

1 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

*In percentage points*

- **1-year**
- **2-year**

Source: IMF staff estimates.

1 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.
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)

<table>
<thead>
<tr>
<th></th>
<th>20% Real Appreciation</th>
<th>20% Real Appreciation and Other Reforms for Rebalancing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Near term (I-O, GVAR)</td>
<td>Medium term (GIMF) 1/</td>
</tr>
<tr>
<td>China</td>
<td>-2.0 to -3.1</td>
<td>-8.8</td>
</tr>
<tr>
<td>U.S.</td>
<td>&lt; 0.05</td>
<td>0.07</td>
</tr>
<tr>
<td>Euro Area</td>
<td>&lt; 0.10</td>
<td>0.12</td>
</tr>
<tr>
<td>Japan</td>
<td>0.10 to 0.30</td>
<td>0.07</td>
</tr>
<tr>
<td>U.K.</td>
<td>&lt; 0.50</td>
<td>...</td>
</tr>
<tr>
<td>EM Asia</td>
<td>0.25</td>
<td>0.33</td>
</tr>
<tr>
<td>Commodity</td>
<td>&lt; 0.30</td>
<td>0.09</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>20% Real Appreciation</th>
<th>20% Real Appreciation and Other Reforms for Rebalancing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Near term (I-O)</td>
<td>Medium term (GIMF) 1/</td>
</tr>
<tr>
<td>China</td>
<td>-0.69</td>
<td>-2.91</td>
</tr>
<tr>
<td>U.S.</td>
<td>0.02</td>
<td>0.08</td>
</tr>
<tr>
<td>Euro Area</td>
<td>0.10</td>
<td>0.05</td>
</tr>
<tr>
<td>Japan</td>
<td>0.11</td>
<td>0.04</td>
</tr>
<tr>
<td>U.K.</td>
<td>0.05</td>
<td>...</td>
</tr>
<tr>
<td>EM Asia</td>
<td>0.30</td>
<td>-0.31</td>
</tr>
<tr>
<td>Commodity</td>
<td>-0.02</td>
<td>0.11</td>
</tr>
</tbody>
</table>

1/ Cumulative effect at peak

1/ 5-years.
V. Financial sector reform

Liberalization often led to credit boom and crisis

And low real interest rates
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
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.
The End

- WWW Information
  - http://www.imf.org/external/country/CHN/index.htm

- Publications
  - Article IV Report
  - Economic Outlook, Sep-11 (See second link above)
  - Spillover Report
  - FSAP