

# China's Economic Growth Outlook and New Challenges

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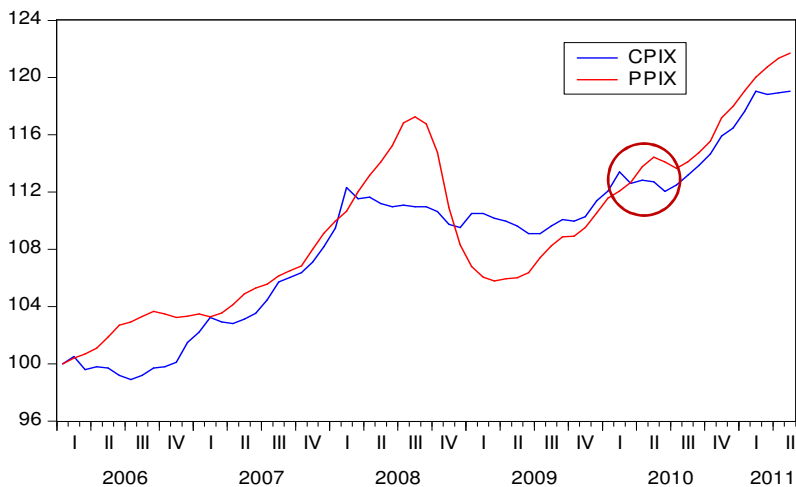
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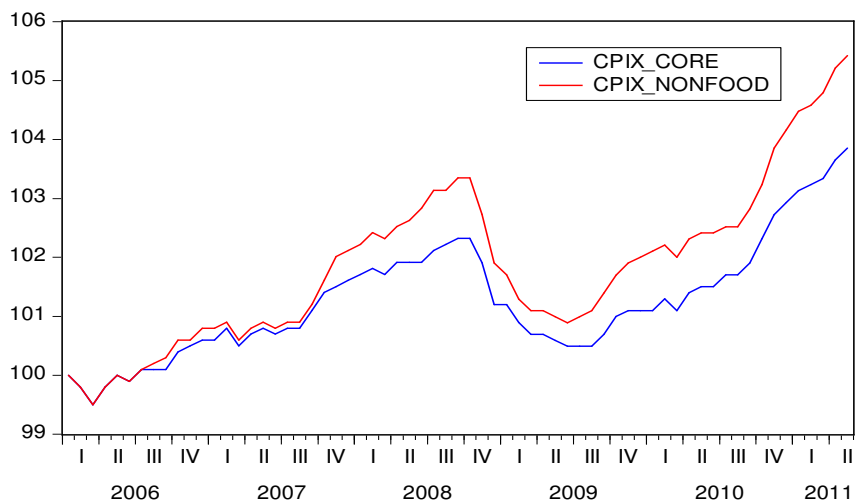
## Presentation Outline

- Fighting inflation remains a major challenge for the Chinese government
- However, the tightening measures are hitting the wrong targets
- When the growth slowdown becomes a major concern in the second half of this year, the government is likely to relax its control
- As a result, China's GDP growth rate will still be above 9% in 2011, but inflation will return in 2012 and be more difficult to control

### Inflation has been picking up (Jan. 2006 = 100)



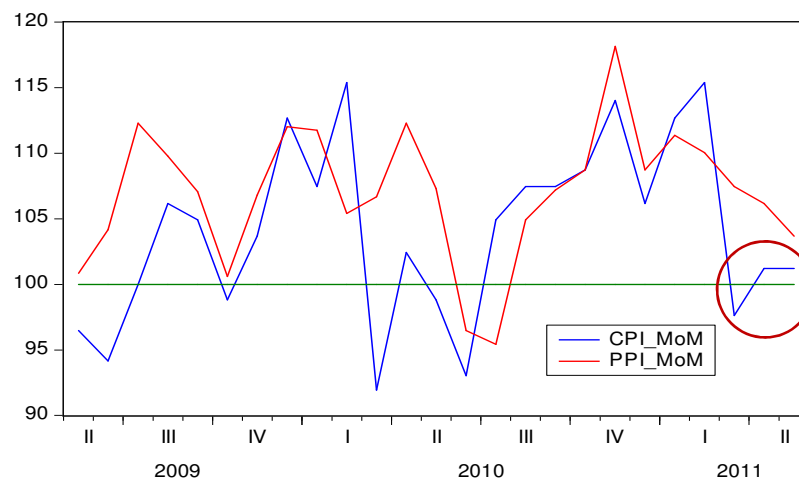
### Core inflation is also trending upward (Jan. 2006 = 100)



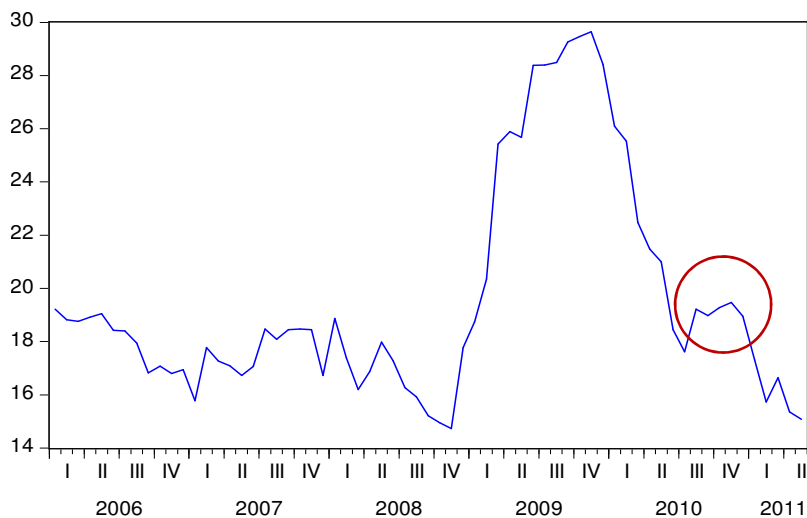
## Inflation has different impact on different income groups

- We did a simulation to find the impact of a 3% increase in CPI
- For the poorest 10% of urban households, CPI would increase by 4.1%, disposable income reduce by 6% and consumption 5.4%
- Similarly, for the poorest 20% of rural households, CPI would increase by 4.8%; net income reduce by 5.3% and consumption by 7.3%
- But for the richest 10% of urban households, CPI would increase by only 2.5%, disposable income reduce by 1.5% and consumption 1.1%

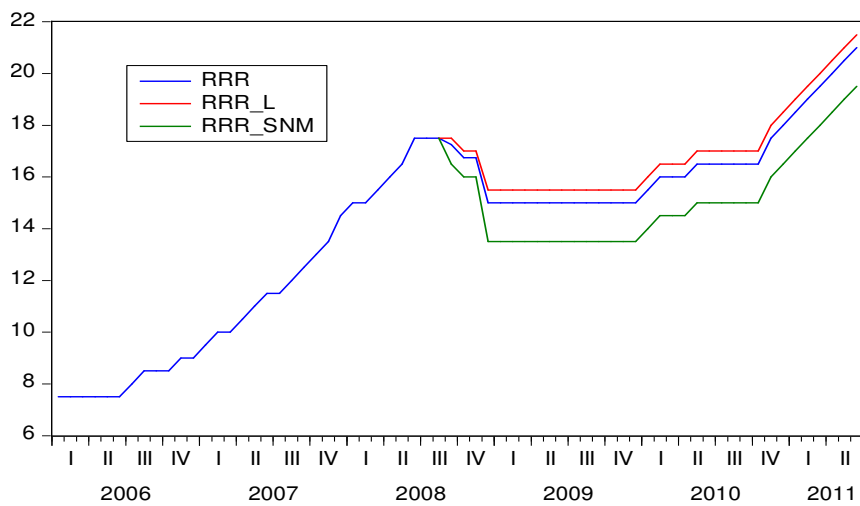
## But prices seem to be under control in recent months (MoM annualized)

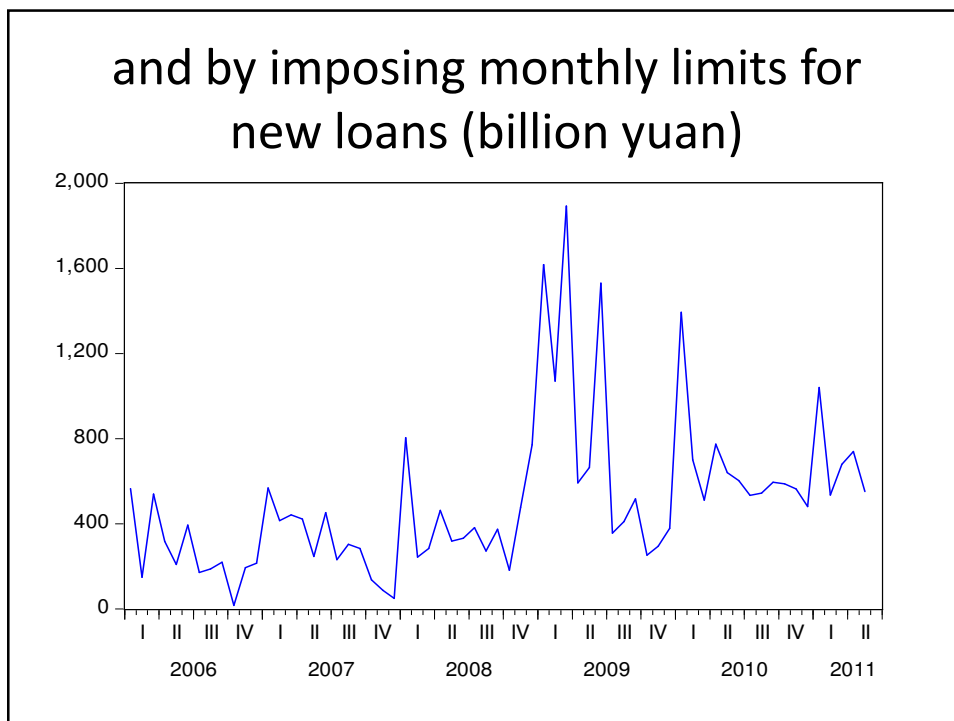
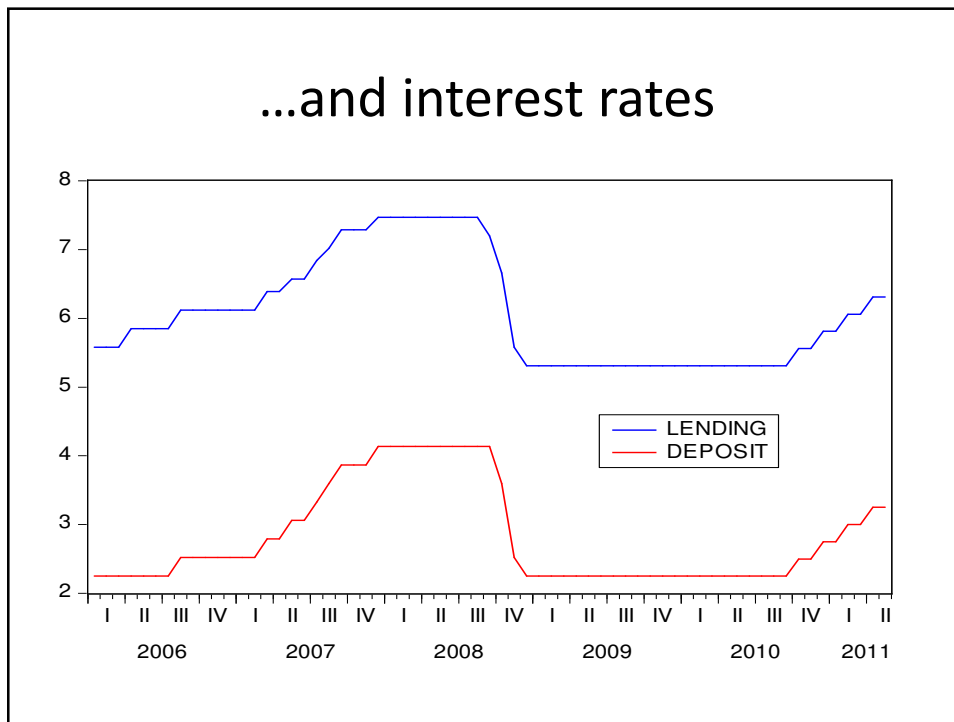


This has been achieved by tightening the money supply (M2 YoY growth rate)



By raising required reserve ratios...

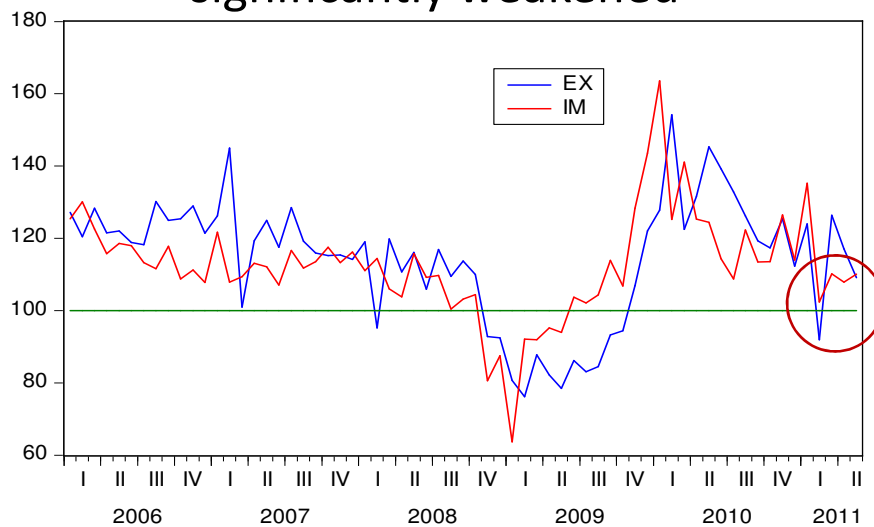




## As a result, GDP growth began to slowdown

	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1
GDP (YoY %)	11.9	10.3	9.6	9.8	9.7
GDP (QoQ seasonally adjusted annual rate)	8.9	8.3	10.2	10.0	8.7

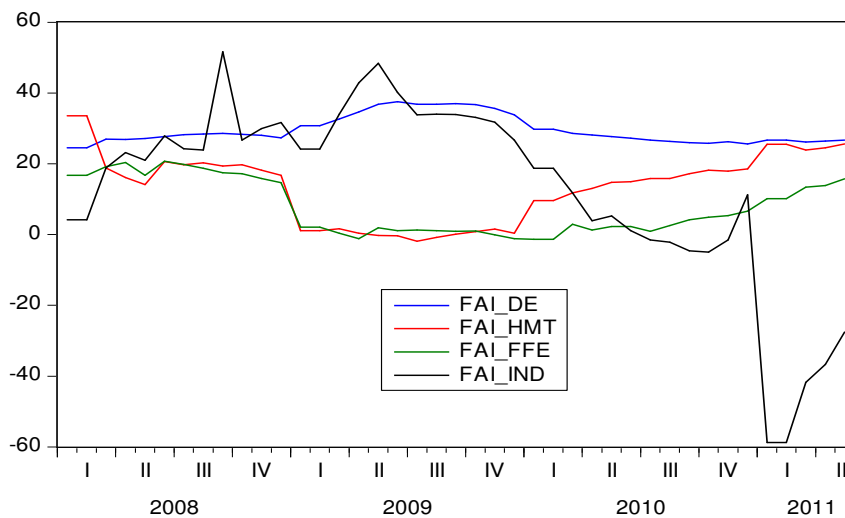
## Growth of export unstable, import significantly weakened



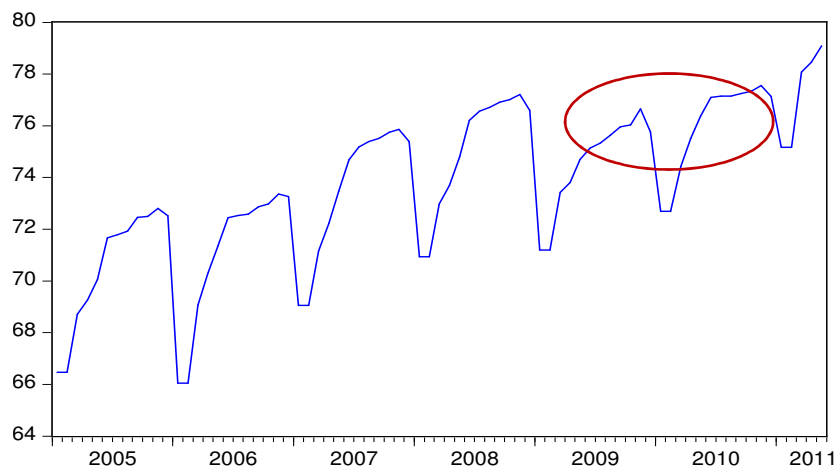
## Growth of Industry VA also unstable

	Feb. 2011	Mar. 2011	Apr. 2011	May 2011
VA of Industry (YoY, %)	14.9	14.8	13.4	13.3
VA of Industry (MoM, seasonally adjusted annual rate)	-10.7	14.4	-10.5	13.1

## Fixed asset investment by SMEs has plunged



## The share of FAI financed by self-raised and other funds keeps increasing



## Tight monetary policy is hitting the wrong targets

- China's banking sector has excess liquidity which cannot be absorbed by raising Required Reserve Ratio or issuing central bank papers
- Raising interest rates is not considered a useful option because of it would attract inflows of hot money
- Administrative measures such as monthly credit ceilings had to be imposed
- When bank credits are rationed, local government projects will still be supported, but private firms and SMEs will be squeezed out of the formal financial markets



## Can RMB appreciation help curb inflation?

- As a continental economy, prices of imported goods have only limited influence on China's domestic prices, so RMB appreciation is unlikely to reduce inflation significantly
- Our simulation study has found that currency appreciation also cannot result in a significant reduction in net export. This is because when China's export decreases, so is processing import
- RMB appreciation will force China to rely even more on investment for GDP growth

## Growth Prospects

- GDP growth in Q2 2011 is likely to be below 9% (seasonally adjusted annual rate)
- This will prompt the authority to relax the monetary policy in Q3 and Q4 of 2011
- The policy shift has strong political support because:
  - This is the first year of 12<sup>th</sup> 5-year plan period
  - This is the year before the 18<sup>th</sup> national congress of CCP, good economic performance this year is crucial for many local leaders who wish to be promoted at the party congress
- However, the premature exit from the tight monetary policy will make it more difficult to control inflation next year as inflation expectations become more entrenched and harder to manage

## Conclusion

- If the tight monetary policy can be carried out as planned (which is to keep M2 growth rate between 14% and 15% for the whole year), inflation would be under firm control by Q4 although CPI would still be around 5% for 2011, which is above the official target of 4%
- However, monetary easing can be expected in Q3 given the political conditions, and the GDP growth would bounce back to near 10% for the second half of this year
- When that happens, inflation would become more persistent, and the probability of an economic hard landing in 2012-2013 would be much higher

Thank you for your attention