Waltraut Urban

China: how to curb inflation while sustaining growth?

In the first quarter of 2008, the Chinese GDP expanded at a rate of 10.6%, less than in the same quarter of last year (11.1%) and in 2007 on average (11.9%), but still faster than expected. The deceleration of foreign demand was largely compensated by accelerated growth of domestic demand, consumption as well as investment in fixed assets. Probably, the slowing down of the global economy will have a significant impact on the Chinese economy only in the months to come. Rapidly rising consumer and producer prices in China are raising concern and call for action. China’s decision makers must now balance inflationary pressures against the weakening global economic outlook.

Taking into account the recent upward revision of GDP growth in 2007 (from 11.4% to 11.9%) and assuming a certain decoupling of Asia from the US-led global economic downturn, we expect the Chinese economy to expand at a rate of 10% in 2008, 9.7% in 2009 and resuming growth of about 10% in 2010, in line with the expected recovery of the world economy.

Limited impact of natural disasters on overall growth

In January and February, the southern part of China including the province of Guangdong, an industrial and export hub as well as an important supplier of fruit and vegetables, was hit by unprecedented low temperatures and winter storms; this has contributed to the slowing down of the overall economy in the first quarter to a certain extent. In May, a disastrous earthquake killed more than 80,000 people and destroyed the homes of about 5 million inhabitants as well as important infrastructure in the central province of Sichuan. The loss of output as a consequence of the disaster, however, is negligible from an overall point of view – Sichuan being one of the poor and industrially less developed provinces of China, taking a share of only 4% in total GDP; and output and reconstruction of infrastructure will even boost investment and thus economic growth to a certain extent. The impact of the heavy rainfalls starting in June in the South of China as well as in the Yellow River area cannot yet be assessed.

Strong domestic demand compensating slowdown of external demand

Investment in fixed assets rose by 24.6% (in nominal terms) in the first quarter of this year, 0.9 percentage points faster than in the same period of 2007, despite several administrative measures to cool down investment in place for more than a year now. A major driver of investment is investment in real estate and infrastructure associated with urbanization. But also investment growth in rural areas picked up, reaching 18.3%, a rise of 1.6 percentage points. However, as profits
declined sharply in the first quarter of 2008 and less loans will be available for the rest of the year, investment growth may decelerate in the months to come.

Retail trade turnover as a proxy for private consumption increased by 20.6% (in nominal terms), much faster than in the same period of 2007 (14.9%), due to rising prices but faster rising incomes as well. Measured in real terms, the growth of private consumption reached 13.2%, up 0.4 percentage points from the same period of last year.

**Food prices driving inflation, but upstream price pressure on the rise**

Retail prices rose by 7.4% and the consumer price index increased by 8.0% in the first three months of 2008. This was the highest price rise in the last 11 years and is causing concerns for consumers as well as policy makers in China. The major drivers of inflation were food prices, rising by 21% and contributing 6.8 percentage points to the overall price hike. Increasing costs for housing contributed another percentage point, prices for other categories of commodities witnessed slight rises or drops. After reaching a peak in February (8.7%), consumer price inflation has somewhat eased because of a deceleration of food prices and the inflation rate came down to 7.7% in May. But in the meantime, producer prices have accelerated due to soaring energy and raw material costs and in May the rise of the producer price index hit 8.2%, which can be expected to spill over at least partly to consumer prices, after a certain lag. Thus inflation may well reach 7% for the year 2008 as a whole.

So far, despite price hikes, real per capita incomes have risen very fast, although somewhat less than last year in urban areas (by 12%, down from 14.2%), but much stronger in rural areas (by 19%, up from 13.5%), due to rising prices for agricultural products. However, real wage increases in export-oriented industries, which are under double pressure from the weakening of external demand and the continuous revaluation of the yuan against the US dollar, were significantly lower than last year. Also, poor families, which still take a significant proportion of China’s population, were hit over-proportionately by inflation because of the large share of food expenditures in their incomes.

**Government policies to curb inflation**

Government measures to contain inflation include administrative price caps on the one hand and attempts to absorb liquidity on the other. The central government controls the prices of public utilities and fuels such as gasoline and diesel and has also put pressure on local governments to control the price rise of agricultural products. To absorb excess liquidity and constrain the expansion of bank lending, the Chinese central bank has raised the reserve requirement ratio for commercial banks 5 times in this year already; by the end of June the ratio will stand at 17.5%, which is very high by

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Prices for gasoline and diesel were kept constant since November last year despite soaring international crude oil prices, causing a big loss for Chinese refineries. Their losses were partly compensated by state subsidies, but especially smaller oil refineries cut down or even halted production which led to severe shortages of refined petroleum products. Therefore, on 20 June, the government raised prices for gasoline and diesel by 16% and 18% respectively. Electricity prices will go up by 4.7% for commercial units. Certain compensations were notified for producers of grain and for taxi drivers. The retail price for 93-octane gasoline is now 6.09 yuan (57 euro cents) per litre, which is still low by international standards.
international standards. Notably, the reference interest rate was left untouched to avoid an additional spread of the interest levels between China and the USA, which may attract more ‘hot money’ and thus liquidity despite existing capital controls. Therefore, real interest rates on deposits in China remain clearly negative and real lending rates are still quite low. To curb the expansion of loans, the government uses lending quotas and a number of regulatory measures rather. The total quota for new loans in 2008 is yuan 4.1 trillion (EUR 381 million) of which 44% have already been taken in the first four month of the year, indicating a certain slowing down of credit growth and thus of domestic demand in the second half of the year.

Weakening demand from the USA and Europe

In the first three months of 2008, export growth in US dollar terms weakened moderately compared to the same period of last year (from 27.8% to 21.4%) and import growth accelerated strongly (from 18.2% to 41.4%), resulting in a significantly lower trade surplus (USD 41.4 billion, -11%) and thus a smaller contribution of net exports to GDP growth than last year. Due to the strong devaluation of the US dollar versus the euro, Chinese exports in euro terms dropped more dramatically, import growth declined as well and the trade surplus showed a significantly stronger reduction (EUR 27.9 billion, -21%). So far, most of China’s trade is denominated in US dollar, but recently denomination in euro is gaining importance. The following structural data refer to trade in dollar terms:

The growth of Chinese exports to the USA declined strongly, rising only 5.4% in the first quarter of 2008, compared to 20.4% in the same period a year earlier. But exports to the EU decelerated significantly as well, reaching 24.2%, ten percentage points less than last year when exports had expanded particularly fast. Together, these two regions make up 37% of China’s total exports. By contrast, export growth to Asia (including Japan), Africa, Latin America and Oceania remained largely stable, supporting the idea that a ‘decoupling’ of the emerging markets from the downturn of the established economies is possible to a certain degree. From the Chinese side, export restrictions on grain, certain energy-intensive products (e.g. steel), reduced tax refunds for exports, intensified quality controls and the continued revaluation of the Chinese currency versus the US dollar dampened export growth. In the first three months of this year, the yuan appreciated by 4% versus the US dollar, but depreciated by 3.1% versus the euro. For the rest of the year, a continued and even stronger appreciation of the yuan against the US dollar is expected.

The acceleration of import growth was driven by rising prices for raw materials including agricultural products and the increased import of refined petroleum products because of shortages of these products on the domestic markets. Both tendencies – deceleration of exports and acceleration of imports – will continue, thus the contribution of net exports to GDP growth in 2008 will be significantly smaller than last year.

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2 According to official estimates, the five increases of the reserve ratios since the beginning of this year have frozen more than 1000 billion yuan of funds, equivalent to one quarter of new loans issued in China in 2007 (China Daily, June 11 2008)
Soaring foreign direct investment despite new regulations

The inflow of foreign direct investment during the first quarter of 2008 amounted to EUR 18.2 billion (USD 27.4 billion), up 40% (61% in US dollar terms), despite various regulations taking effect in 2008 putting foreign investors in a less favourable position than before. On 1 January, a new tax law and a new labour law entered into force. By the new tax law, a unified corporate tax rate of 25% is stipulated for all enterprises (formerly the rate for foreign investment enterprises had been 15% while that for Chinese enterprises 33%). The new Labour Contract Law may raise labour costs due to increased severance payments and extended labour standards and minimum wage regulations. However, the actual fear is that the law will be enforced more strictly on foreign enterprises, thereby putting them in a less competitive position as compared to local entrepreneurs. Nevertheless, the growth potential and profit expectations still seem to outweigh these deteriorations of the business climate, respectively, they are compensated by other improvements such as reported progress in the protection of property rights.

Manufacturing industry loses steam

The slowing down of foreign demand had a moderate but distinct impact on industrial production. Value-added of industry (including construction) expanded at a rate of 11.5% in the first quarter of 2008, compared to 13.2% in the same period a year earlier; value-added of industrial enterprises above a designated size, excluding construction, expanded at a rate of 16.4% (compared to 18.3%). Fears that the appreciation of the yuan would drive out a large number of producers of low value-added standardized products such as clothing, shoes, toys etc. have not materialized on a large scale, notwithstanding several shutdowns and corresponding job losses, in particular in the South of China. Under the assumption of a further slowing down of the global economy, growth of the industrial sector in China will continue to decelerate.
Table CN

China: Selected Economic Indicators

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<td>Population, mn pers., end of period</td>
<td>1299.9</td>
<td>1307.6</td>
<td>1314.5</td>
<td>1321.3</td>
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<td>Gross domestic product, CNY bn, nom.</td>
<td>15987.9</td>
<td>18386.8</td>
<td>21087.1</td>
<td>24953.9</td>
<td>5028.7</td>
<td>6149.9</td>
<td>29200</td>
<td>33600</td>
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<tr>
<td>GDP/capita (EUR at exchange rate)</td>
<td>10.1</td>
<td>10.4</td>
<td>11.1</td>
<td>11.9</td>
<td>11.1</td>
<td>10.6</td>
<td>10</td>
<td>9.7</td>
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<tr>
<td>GDP/capita (EUR at PPP - wiiw)</td>
<td>1094.1</td>
<td>1374.6</td>
<td>1606.1</td>
<td>1816.1</td>
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<td>1st quarter Forecast</td>
<td>3040</td>
<td>3460</td>
<td>3920</td>
<td>4490</td>
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1) Preliminary and wiiw estimates. - 2) Including construction. - 3) Staff and workers (on duty) refer to persons who work in state-owned enterprises, urban collectives, shareholding ownership and foreign invested enterprises. - 4) Ratio of registered urban unemployed in % of urban employed and unemployed. - 5) Average gross annual wages of staff and workers, defined as: total wages of staff and workers on duty per average number of staff and workers on duty. - 6) Staff and workers cost of living index is used as deflator for calculating real wage (for 2007 and 2008, the consumer price index was used as a deflator instead). - 7) Overnight rate. - 8) Annual data are net investments drawn from the Chinese balance of payments. 2007 data are gross investments given by the Chinese Ministry of Commerce. - 9) According to customs statistics. - 10) wiiw estimates based on the 2005 International Comparison Project benchmark (World Bank). - 11) wiiw estimates based on the 2005 International Comparison Project benchmark (World Bank).

Source: China Statistical Yearbook; China Monthly Statistics; China Daily etc.; wiiw forecasts.

Note: CNY: ISO code for the Chinese yuan.