

**CHINA'S ECONOMY IN 2007/8:
COPING WITH PROBLEMS
OF SECULAR HIGH GROWTH**

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Executive Summary

1. China's economy in 2007 experienced another year of super growth at 11.5% as disclosed by Premier Wen Jiabao in late November whilst visiting Singapore. But real growth may well be 11.6% after the usual statistical adjustment.
2. China's GDP in 2007 almost doubled the level of 2002 (when China joined the WTO) to reach US\$3.2 trillion at market exchange rate. China is about to displace Germany as the world's third largest economy. Indeed, China's economy in 2007 contributed slightly more to global GDP growth than the US.
3. China has sustained such sizzling double-digit rates of growth for five years in a row, quite unprecedented in world economic history. Such dynamic growth had even taken the Chinese leadership by surprise, who conceived the warranted growth rates to be around 8-9%.
4. Accordingly, the government was initially quite worried about a possible "hard landing" for the economy, which had nonetheless refused to cool, and had instead kept on growing and growing.
5. In reality, China's high growth has been propelled mainly by high levels of domestic investment which was matched by equally high levels of domestic savings. For the past five years, fixed assets investment grew at 26% a year, exports at 30% while domestic consumption also at the double-digit rate of 12%. This naturally translates into high GDP growth.
6. Even more remarkable is China's decade-long growth at 9-10% with annual inflation kept well below 3%. Economists attribute the difference to productivity growth. Indeed, many studies and anecdotal evidence have pointed to China's substantial productivity gains in its recent spurt of high growth.

7. All this, along with such real-world indicators as China's bulging foreign reserves, rising trade surplus, and extremely low domestic and external debt, serves to show that China's present prolonged economic boom is clearly not built on a house of cards, but on strong economic fundamentals.
8. But then, no economy can keep on expanding at such high speed year after year without overheating itself or running into other constraints. Cracks will show up sooner or later.
9. As indeed it is happening now. The consumer price index (CPI) shot up to 6.9% in November, the highest in a decade, with the annual inflation for 2007 likely to exceed 4.7%, well above the government's "comfort level" of 3%.
10. Though the "core inflation" rate (at about 1.5%), i.e. after excluding food items etc, is still not high for an economy growing at double-digit rates, it is sufficient to alarm China's top leadership into declaring that reducing economic overheating and curbing inflation would be the top policy priorities for 2008.
11. The government has the means to contain such cost-push inflation with appropriate price stabilization measures. But the more "tricky" part is in the tackling of the sources of inflation from the demand side as China's inflation is also a serious monetary phenomenon, fuelled by the rapid growth of money supply (M2 up by 18% in November) and the resultant excessive liquidity.
12. The root cause can be traced to the undervaluation of the *Renminbi* (and its inflexible exchange rate), which in turn is attributable to China's chronic external and internal macroeconomic imbalances.
13. Overall, China's present structural economic problems are the cumulative results of its secular high growth based on over-savings, over-investment and over-exports along with under-consumption.

14. The Chinese leadership is not oblivious of the basic problems, as it has time and again emphasized the need for a more balanced growth strategy. However, given its penchant for stability, the leadership is institutionally and politically incapable of undertaking bold and drastic remedial measures.
15. Still, the government's recent policy initiatives to battle inflation and overheating in 2008 will provide a much-needed breather for the economy under a long spell of high growth.
16. 2008 is likely to experience the continuation of high growth, at around 10% with inflation at 5-6%, despite the expected tighter macroeconomic control measures and the more adverse international economic environment. And the fundamental problems of the secular high growth will largely remain.