CHINA'S ECONOMY 2010: CONTINUING STRONG GROWTH, WITH POSSIBLE SOFT LANDING FOR 2011

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Executive Summary

1. The Chinese economy has done much better during the global economic crisis than much of the rest of the world.

2. Robust recovery in 2009 was carried forward to 2010 to become strong growth, yielding a 10% growth for the year. But inflation has become a new worry, with the consumer price index (CPI) in November soaring to a 28-month high of 5.1% year-on-year.

3. The year 2010 was actually a good year for China, with its official statistics confirming that China's total nominal GDP has replaced Japan's as the world's second largest economy after the USA.

4. But problems cropped up on the external front. With bulging foreign reserves (US$2.7 trillion) and continuing trade surplus, China was under mounting international pressures for the *Renminbi* (RMB) to revalue while its exports were also subjected to increasing protectionist measures in developed country markets.

5. Inspite of US' accusation of it being a "currency manipulator", China stood fast on its exchange rate policy of gradual and discrete appreciation. But an open "currency war" was averted after the RMB went off the US dollar peg in June with a 2.3% revaluation.

6. In the post-crisis environment of fiscal expansion and loose monetary policy, China's rigid exchange rate regime is actually harmful to China. The undervalued RMB has attracted speculative capital inflows and generated excessive liquidity.

7. This has increased the risk of assets bubbles, as manifested in the overheating housing market, and lately, it has also stoked inflation, as evidenced by the rising CPI.

8. Besides, the undervalued RMB can also impede China's long-term policy of rebalancing its economic growth pattern towards more domestic consumption and less export dependency.

9. In 2009, with the collapse of China's export markets due to the financial crisis, exports turned up a negative contribution to GDP growth. However, with exports in 2010 staging rapid recovery, China's dependency on exports for growth has returned.

10. China's economic development strategy of restructuring its economic growth pattern, which is further reaffirmed in the newly adopted 12th Five-Year Development Programme (2011-2015), is destined to be a slow and difficult process.

11. For years, domestic investment (investment ratio at 48%) has been the major source of China's economic growth, with (household) consumption at about 36% always tailing behind. Hence low domestic consumption.

12. The major stumbling block for re-orienting China's growth pattern towards greater consumption is its disproportionately high saving (averaging 48% of GDP for 2000-2008). The other side of the coin for high saving is low consumption.

13. China's persistent trade surplus has aggravated global macroeconomic imbalance. Domestic high saving is again the culprit of China's trade surplus, which is just the mirror image of its net surplus of saving.

14. Domestic high saving, shaped by deeply entrenched socio-economic forces, cannot be easily changed in the short run. To accelerate economic adjustment, China should speed up its RMB revaluation so as to trigger off more fundamental economic forces for macroeconomic rebalance.

15. For 2011, China's economy is likely to come to a "soft landing". Economic growth is expected to moderate to slightly below 9% due to weaker domestic and external environment, and with inflation rising to 4.5% or more.

16. The government's single biggest concern in 2011 is rising inflation, which is actually low by the average standards of emerging economies. But China has a very low political and social tolerance towards inflation.

17. With all its available administrative means and monetary policy tools, the government is quite confident of containing inflation. But the challenge remains. A stronger RMB would certainly help the government's inflation-fighting efforts, especially to curb the inflationary expectation.

18. For 2011, the movement of the RMB (has since appreciated 3.6% from June, on top of the previous 21%) can be the most critical variable that will impact many domestic and external policies.