



Highlights and Key Issues

- A turn in the domestic investment cycle has been coupled with a dramatic slowdown in external demand, leaving China weathering storms on both fronts. But with the government announcing an unprecedented fiscal package and with fewer structural problems to contend with than in earlier downturns, China is likely to fare better than in previous domestically-driven slowdowns such as in the early-1980s and 1990s.
- A sharp slowdown in industrial output and a dramatic drop in export growth confirmed that GDP growth is likely to slow further in the coming quarters. Net trade has added over 3% to growth over the past three years and this boost will fade next year. But strong public spending will help to offset the weakness in domestic investment.
- Consumption will be supported by higher real incomes, in turn boosted by a rise in government transfers and lower inflation. So while we now expect growth of just over 7% in 2009, it should gather pace in the second half of next year, rising above potential to 10% by end 2010.
- But there are downside risks. China could suffer a more serious slowdown if the fiscal package fails to keep investment growth from falling sharply and unemployment rises rapidly, which could lead to a slump in consumption and social tensions. With major trading partners falling into recession, many exporters will struggle, while the global credit crunch could trigger a more fundamental restructuring of the banking sector.

Forecast for China						
(Annual percentage changes unless specified)						
	2007	2008	2009	2010	2011	2012
Domestic Demand	12.0	9.4	7.2	10.0	10.3	10.4
Private Consumption	10.2	9.4	8.8	9.9	9.8	10.0
Fixed Investment	12.8	9.4	6.8	9.8	9.7	9.4
Government Consumption	11.2	10.8	11.4	10.1	9.5	9.2
Exports of Goods and Services	18.0	11.1	4.5	7.9	9.9	10.0
Imports of Goods and Services	13.6	9.7	5.9	8.3	11.6	12.5
GDP	11.9	9.0	7.2	9.8	10.0	9.8
Manufacturing (value-added)	18.5	13.0	9.1	12.2	12.8	11.7
Consumer Prices	4.8	5.8	1.0	2.9	3.0	2.9
Current Balance (% of GDP)	11.3	9.3	9.6	8.1	6.7	5.9
Government Budget (% of GDP)	0.7	1.1	-0.6	-0.8	-0.6	-0.5
Current Account (\$bn)	371.8	386.0	449.5	446.8	438.0	438.4
Total Trade Balance (\$bn)	261.8	290.4	362.0	367.1	365.7	373.0
Short-Term Interest Rates (%)	6.71	7.18	4.59	4.91	5.58	5.58
Exchange Rate (Per US\$)	7.61	6.95	6.66	6.35	6.13	6.06

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Overview

Sharp slowdown in output...

- October saw a sharp slowdown in industrial output growth to 8.2% from 11.4% in September, half the average growth rate of 16% seen in the last few years. Most of the slowdown was in heavy industry, and the processing of steel in particular. These figures confirm that the slowdown in overall GDP growth to 9.0% in Q3 (from close to 12% last year) is likely to accelerate in the next couple of quarters.
- Retail sales in October appeared to hold up quite well, growing by 22.0% (after 23.2% in September), but consumption growth is set to slow. House price inflation fell from a peak of 11.0% in 2008 Q1 to 5.3% in 2008 Q3 while the stock market has fallen over 60% since the beginning of the year. But the prospects for consumption will be driven mostly by how well employment holds up.

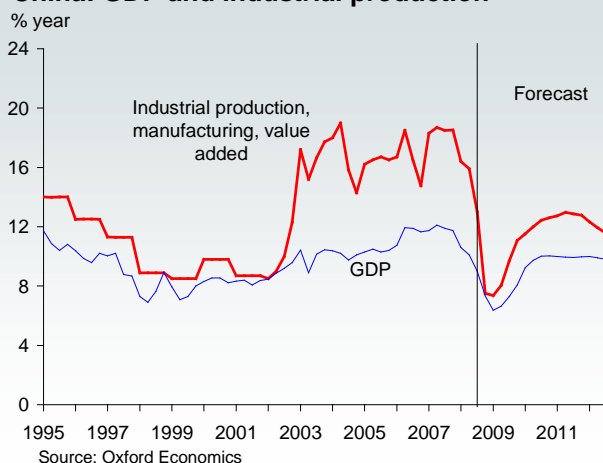
...prompts large policy stimulus

- The authorities, clearly alarmed by the speed of the weakening in the economic outlook, announced a massive fiscal package of CNY4 trillion (US\$568bn) on 9 November. While the headline package of close to 15% of GDP sounds enormous, only a proportion (we estimate around 25%) represents new spending. The majority of the spending will be on infrastructure with almost a half allocated to higher transport spending and a quarter to infrastructure. Other measures include increased provision of low-income housing, income support for rural households, environmental conservation and higher spending on health and education. The plan includes a welcome shift to rural areas through a lifting of restrictions on spending by local governments.
- The fiscal stimulus has been coupled with cuts in interest rates and a reduction in reserve requirements. Since September, the People's Bank of China has lowered the one-year lending rate by nearly 200bps to 5.58% (the latest cut of 108bps on November 26). The government is committed to 'moderately easy' monetary policy and, with inflation falling, this appears to suggest further cuts.

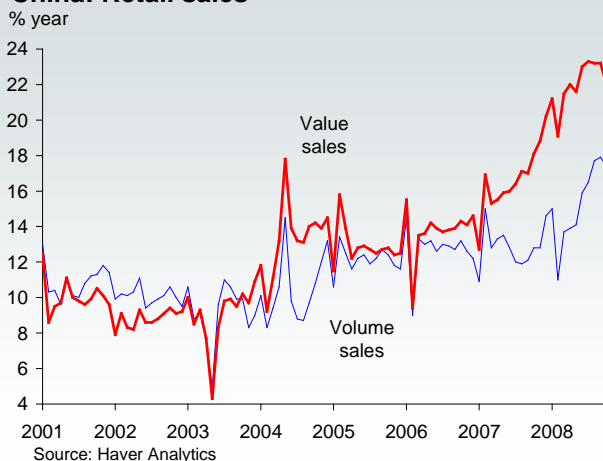
Dramatic falls in trade...

- Growth in exports in US\$ terms reversed sharply in November, falling by 2.2% compared with a rise of 19.2% in October. However, imports fell even faster

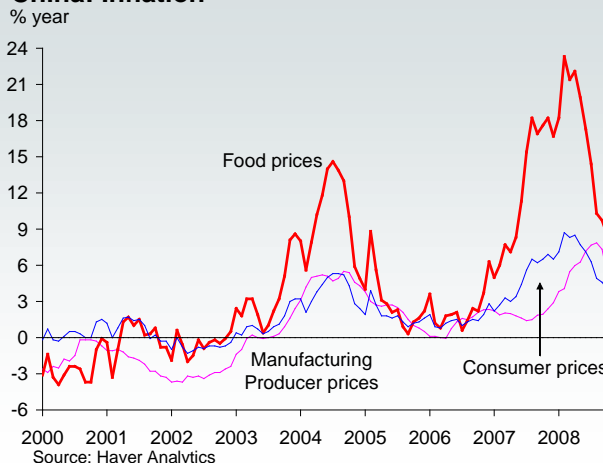
China: GDP and industrial production



China: Retail sales



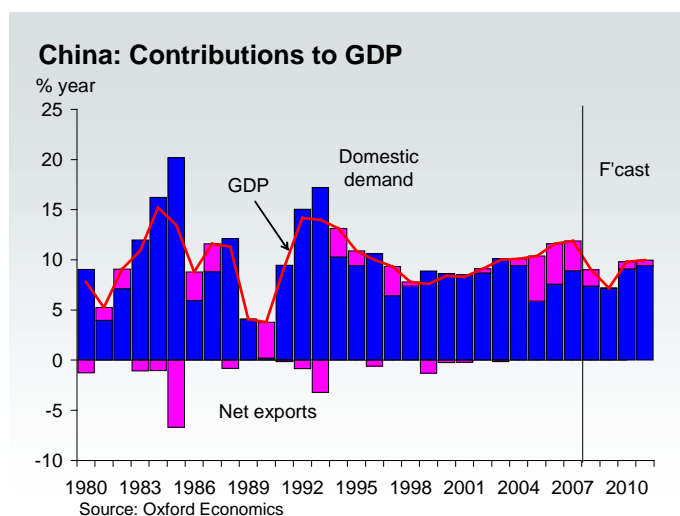
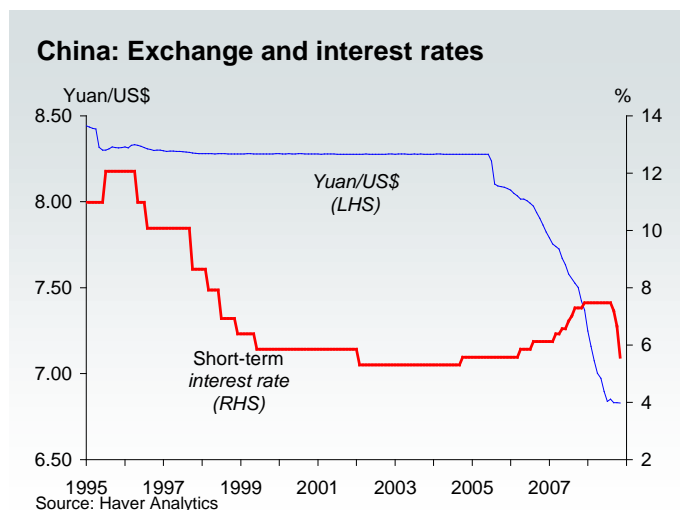
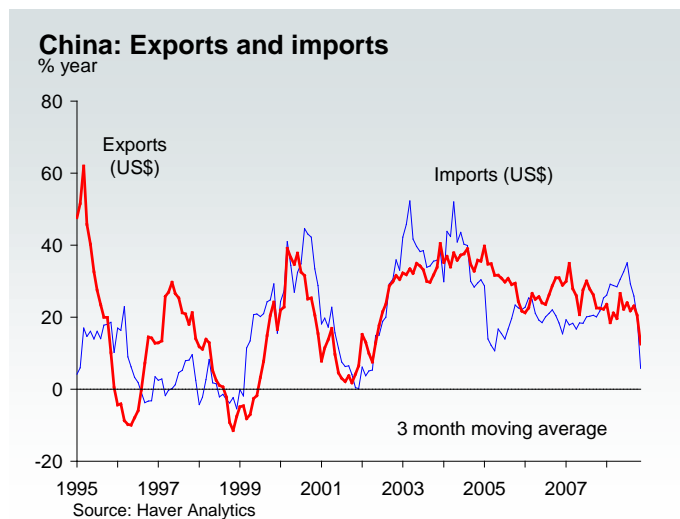
China: Inflation



in November, by nearly 18%. This is the largest contraction in exports since the slump in trade in the two years following the Asian crisis in 1997. While CNY appreciation against the euro and lower oil and commodity prices will have contributed to the fall, with demand falling away in China's trading partners, exports will continue to be hit. Meanwhile, import growth has not been this weak since the difficult period of adjustment in China in the late-1980s, suggesting that domestic demand has contracted sharply. Net trade contributed over 3% to GDP growth in the last few years and we expect this boost to disappear over the next two years.

...but can China weather storm?

- Both consumer and producer price inflation have continued to slow. CPI inflation slowed to 2.4% in November from 4.0% in October and we expect it to average just 1.0% in 2009 after 5.8% this year. This will provide a boost to real incomes and, coupled with a rise in government transfers, should help to support consumption growth next year.
- We expect investment growth to slow sharply over the next six months, though the boost from higher government investment will offset the weaker recovery in private investment in 2010. Strong government consumption will help to keep overall GDP growth above 7% next year and growth will rapidly recover to above-trend levels in 2010 at close to 10% as the full effects of the policy stimulus feed through and world trade recovers.
- But there are downside risks. China could suffer a more serious downturn if the fiscal package fails to keep overall investment growth from falling sharply and unemployment rises rapidly, which could lead to a slump in consumption and social tensions. With its major trading partners falling into recession, many Chinese exporters will struggle, while the global credit crunch could trigger a more fundamental restructuring of the banking sector.
- With China being hit on both fronts with a collapse in external demand just as the effects of a domestic slowdown are rapidly taking their toll, the scope for policy intervention is now much greater compared with previous slowdowns. And the fruits of earlier financial sector reform and state-owned enterprise restructuring also mean that the economy is now better placed to weather storms.



Key Indicators: China

Percentage changes on a year earlier unless otherwise stated

	Industrial value added	CPI	Food Prices	RPI	Exports US\$ %	Imports US\$ %	Trade balance (US\$ mn)	Retail sales
Nov	17.3	6.9	18.2	6.0	22.7	25.1	26321	18.8
Dec	17.4	6.5	16.7	5.6	21.6	25.6	22605	20.2
2008								
Jan	15.4	7.1	18.2	6.2	26.5	27.6	19354	21.2
Feb	15.4	8.7	23.3	8.1	6.3	35.6	8194	19.1
Mar	17.8	8.3	21.4	7.8	30.3	24.9	13137	21.5
Apr	15.7	8.5	22.1	8.1	21.8	26.7	16361	22.0
May	16.0	7.7	19.9	7.5	28.1	40.7	19747	21.6
Jun	16.0	7.1	17.3	7.1	17.2	31.4	20691	23.0
Jul	14.7	6.3	14.4	6.8	26.8	33.8	25126	23.3
Aug	12.8	4.9	10.3	5.5	21.0	23.0	28778	23.2
Sep	11.4	4.6	9.7	5.3	21.5	21.3	29366	23.2
Oct	8.2	4.0	8.5	4.6	19.2	15.6	35239	22.0
Nov	–	2.4	5.9	–	-2.2	-17.9	40090	–

Financial Indicators: China

Percentage changes on a year earlier unless otherwise stated

	Loans rate %	Savings Rate %	Exchange rate Yuan/€ avg.	Exchange rate Yuan/\$ avg.	Exchange rate Yuan/100Yen	Share price Shanghai A	Reserves US\$ Bn	Imports Cover
Nov	7.29	3.87	5.06	7.42	6.67	5514	1496.9	16.4
Dec	7.47	4.14	5.06	7.37	6.55	5320	1528.3	16.7
2008								
Jan	7.47	4.14	4.92	7.24	6.72	5296	1589.8	17.6
Feb	7.47	4.14	4.85	7.17	6.69	4672	1647.1	20.8
Mar	7.47	4.14	4.56	7.07	7.02	4108	1682.2	17.6
Apr	7.47	4.14	4.44	7.00	6.82	3565	1756.7	17.2
May	7.47	4.14	4.48	6.97	6.68	3727	1797.0	17.8
Jun	7.47	4.14	4.43	6.90	6.45	3143	1808.8	18.0
Jul	7.47	4.14	4.34	6.84	6.40	2940	1845.2	16.6
Aug	7.47	4.14	4.58	6.85	6.27	2620	1884.2	17.8
Sep	7.20	4.14	4.77	6.84	6.41	2272	1905.6	17.8
Oct	6.66	3.60	5.15	6.83	6.83	2031	–	–
Nov	5.58	2.52	5.36	6.83	7.04	1971	–	–

CHINA

TABLE 1 SUMMARY ITEMS

Annual Percentage Changes, Unless Otherwise Specified

	CONSUMERS EXPENDITURE (C)	TOTAL FINAL EXPENDITURE (TFE)	TOTAL FIXED INVESTMENT (FI)	GROSS DOMESTIC PRODUCT (GDP)	INDUSTRIAL PRODUCTION (GROSS) (IPVA)	TOTAL EMPLOYMENT (ET)	AVERAGE EARNINGS (ER)	WHOLE ECONOMY PRODUCTIVITY (GDP/ET)	COMPETITIVENS (2000=100) (WCR)	CONSUMER PRICE INDEX (CPI)	RETAIL PRICE INDEX (RPI)
YEARS BEGINNING Q1											
2006	9.60	14.09	12.76	11.61	16.59	0.79	13.07	10.74	137.52	1.76	1.03
2007	10.18	13.70	12.77	11.87	18.51	0.77	14.26	11.02	150.16	4.79	3.80
2008	9.37	9.88	9.41	9.03	13.02	1.18	14.01	7.75	168.55	5.76	6.14
2009	8.78	6.43	6.76	7.21	9.08	0.46	13.38	6.72	190.81	0.98	2.09
2010	9.89	9.42	9.82	9.80	12.16	0.45	11.95	9.32	200.75	2.89	2.94
2011	9.80	10.22	9.66	9.96	12.84	0.68	11.39	9.22	209.73	2.99	3.20
2012	10.01	10.31	9.38	9.81	11.74	0.68	11.44	9.07	215.16	2.90	3.02
2006											
I	8.71	13.42	11.75	10.75	16.70	0.81	13.15	9.86	134.52	1.53	0.53
II	9.75	13.75	13.43	11.95	18.50	0.80	13.04	11.06	134.83	1.81	0.97
III	9.65	15.06	13.18	11.90	16.50	0.78	12.95	11.04	138.54	1.71	0.93
IV	10.20	14.05	12.57	11.65	14.77	0.76	13.13	10.81	142.19	1.99	1.67
2007											
I	8.45	13.11	12.35	11.75	18.30	0.76	13.83	10.91	145.12	2.78	2.07
II	9.32	13.80	12.75	12.10	18.70	0.77	14.10	11.25	148.02	3.51	2.60
III	10.29	14.02	12.83	11.90	18.50	0.77	14.36	11.05	152.69	6.13	4.83
IV	12.30	13.76	13.01	11.75	18.51	0.77	14.61	10.89	154.80	6.74	5.63
2008											
I	10.42	11.35	11.92	10.60	16.40	1.17	14.11	9.33	159.82	8.08	7.37
II	10.33	11.39	10.95	10.10	15.90	1.20	14.03	8.80	163.08	7.80	7.60
III	9.03	11.57	9.26	9.00	13.00	1.21	13.96	7.70	171.31	5.28	5.90
IV	7.99	6.10	6.88	7.33	7.51	1.16	13.96	6.11	180.01	2.05	3.80
2009											
I	8.04	5.41	5.30	6.38	7.36	0.66	14.00	5.68	182.79	0.53	2.84
II	8.17	5.77	6.31	6.64	8.05	0.52	13.64	6.09	188.09	0.65	1.89
III	8.94	6.55	7.05	7.31	9.70	0.37	13.29	6.91	194.74	1.07	1.78
IV	9.79	7.67	7.80	8.08	11.08	0.32	12.83	7.74	197.63	1.67	1.87
2010											
I	10.04	8.47	8.92	9.24	11.54	0.32	12.33	8.89	198.36	2.43	2.36
II	10.17	9.36	9.88	9.74	11.99	0.38	12.12	9.32	198.23	2.81	2.89
III	9.95	9.74	10.14	10.01	12.44	0.50	11.85	9.47	201.94	3.04	3.15
IV	9.48	9.90	10.08	10.04	12.60	0.58	11.61	9.40	204.47	3.27	3.35
2011											
I	9.39	9.95	9.97	9.99	12.73	0.66	11.41	9.27	205.85	3.18	3.33
II	9.67	10.22	9.66	9.95	12.98	0.69	11.38	9.20	207.30	3.05	3.22
III	9.99	10.36	9.57	9.92	12.85	0.69	11.39	9.17	211.86	2.90	3.15
IV	10.10	10.29	9.53	9.98	12.77	0.69	11.39	9.23	213.90	2.82	3.09
2012											
I	10.04	10.34	9.54	9.99	12.33	0.68	11.42	9.25	213.93	2.87	3.07
II	9.97	10.44	9.44	9.90	11.93	0.68	11.43	9.15	213.29	2.89	3.01
III	10.04	10.42	9.36	9.79	11.56	0.67	11.45	9.05	216.01	2.88	3.00
IV	9.98	10.09	9.25	9.64	11.24	0.67	11.46	8.92	217.42	2.97	3.00

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TABLE 2 SUMMARY TABLE

	TRADE BALANCE (US\$ BN)	CURRENT ACCOUNT (US\$ BN)	CURRENT ACCOUNT (% OF GDP)	GOVT. FINANCIAL DEFICIT (YUAN BN)	GOVT. FINANCIAL DEFICIT (% OF GDP)	SHORT TERM INTEREST RATE	SPREAD OVER US SHORT TERM RATE	REAL INTEREST RATE	EQUILIBRIUM EXCHANGE RATE PER US DOLLAR (RXEQUIL)	DOLLAR EXCHANGE RATE (RXD)
	(BVIS/ 1000)	(BCU/ 1000)	(BCU*100 /GDP\$)	(-GB)	(-GB*100 /GDP)	(RSH)	(RSH-RSH US)	(%) (Note 2)		
YEARS BEGINNING Q1										
2006	217.7	249.9	9.4	166.3	0.8	5.9	0.7	4.1	5.55	7.97
2007	315.4	371.8	11.3	-175.7	-0.7	6.7	1.4	1.9	4.61	7.61
2008	330.4	386.0	9.3	-328.8	-1.1	7.2	4.3	1.4	4.13	6.95
2009	402.0	449.5	9.6	195.4	0.6	4.6	3.7	3.6	4.35	6.66
2010	407.1	446.8	8.1	265.3	0.8	4.9	3.4	2.0	4.64	6.35
2011	405.7	438.0	6.7	239.0	0.6	5.6	1.8	2.6	5.12	6.13
2012	413.0	438.4	5.9	218.5	0.5	5.6	-0.2	2.7	5.46	6.06
2006										
I	40.0	62.3	12.3	40.1	1.0	5.6	0.8	4.1	5.97	8.05
II	58.6	62.4	10.1	39.2	0.8	5.9	0.6	4.0	5.70	8.01
III	63.7	62.5	9.6	40.6	0.8	6.0	0.6	4.3	5.42	7.97
IV	55.5	62.6	7.2	46.4	0.7	6.1	0.8	4.1	5.10	7.86
2007										
I	59.4	92.7	14.9	-41.7	-0.9	6.2	0.8	3.4	5.00	7.76
II	84.0	92.9	12.2	-41.1	-0.7	6.5	1.1	3.0	4.73	7.68
III	90.4	93.0	11.5	-42.9	-0.7	6.9	1.5	0.8	4.53	7.56
IV	81.6	93.2	8.5	-50.0	-0.6	7.3	2.3	0.6	4.20	7.43
2008										
I	51.4	84.6	10.5	-144.0	-2.5	7.5	4.2	-0.6	4.25	7.16
II	67.3	76.1	7.6	-97.5	-1.4	7.5	4.7	-0.3	4.17	6.96
III	92.7	95.2	9.2	-75.7	-1.1	7.4	4.5	2.2	4.09	6.84
IV	119.0	130.1	10.0	-11.5	-0.1	6.4	3.6	4.3	3.98	6.85
2009										
I	76.2	106.4	11.7	-36.5	-0.6	4.9	3.6	4.3	4.18	6.81
II	88.1	95.7	8.6	53.5	0.7	4.5	3.5	3.9	4.37	6.69
III	109.5	111.1	9.6	65.7	0.9	4.5	3.8	3.4	4.50	6.61
IV	128.2	136.3	9.1	112.8	1.2	4.5	3.7	2.8	4.35	6.54
2010										
I	76.8	103.1	9.6	24.9	0.4	4.5	3.6	2.1	4.53	6.45
II	86.7	92.9	7.0	75.1	0.9	4.8	3.6	2.0	4.63	6.39
III	110.1	111.1	8.1	60.1	0.7	5.0	3.4	2.0	4.72	6.32
IV	133.4	139.7	7.9	105.2	0.9	5.3	3.2	2.0	4.69	6.27
2011										
I	73.8	96.4	7.6	6.5	0.1	5.6	3.0	2.4	4.96	6.20
II	83.9	88.7	5.7	70.8	0.7	5.6	2.2	2.5	5.13	6.14
III	109.5	109.7	6.8	49.9	0.5	5.6	1.5	2.7	5.23	6.09
IV	138.6	143.1	6.9	111.8	0.9	5.6	0.7	2.8	5.15	6.08
2012										
I	70.8	90.1	6.2	-12.2	-0.1	5.6	0.2	2.7	5.38	6.06
II	81.1	84.8	4.8	66.7	0.6	5.6	-0.3	2.7	5.49	6.06
III	111.2	110.9	6.1	47.7	0.4	5.6	-0.3	2.7	5.55	6.06
IV	149.8	152.5	6.5	116.3	0.8	5.6	-0.3	2.6	5.40	6.06

Note 2 : REAL INTEREST RATES = Nominal interest rate (RWL or RSV) - % change in CPI

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Background:

- Although not formally a member of G8 meetings, China is now typically invited to sit at the top table in world economic affairs due to its meteoric rise as an economic power. China became a member of the WTO in 2001 and has long been a nuclear power and a member of the UN Security Council, having a high status in political and military terms. China has more recently promoted its space research with manned flights as well as operating an active satellite programme and, more contentiously, developing missile capabilities.
- From a minor economy with little trade with the outside world in the 1970s and 1980s, China has transformed itself to overtake Japan and become the world's third largest trading nation after the US and Germany and it is now the second largest oil consumer after the US. GDP passed the \$2 trillion mark in 2005 – indeed, at PPP rates, the economy has already overtaken Japan (over \$6 trillion). Recent upward revisions to the national accounts show that GDP growth has been running at 10% since 2003, with high rates also recorded before then.
- However, with a population of 1.3bn, China is still a very poor country with GDP per capita of just over \$2400, above India and Indonesia (since the Asian crisis damaged Indonesia's growth performance) but less than countries such as Thailand and Malaysia and far below the rates of Korea, Taiwan, Hong Kong and Singapore. Income disparities have grown, although even in Beijing and Shanghai average salaries are still well below rates in Korea and Hong Kong.
- In the early period of emergence from the isolation of the 1960s and 1970s, and set in train by the reforms instituted by Deng after the death of Mao, agricultural reform and the growth of village enterprises initiated a period of strong GDP performance in the 1980s, which was quickly followed by improvements in manufacturing and services. By 1990, the economy started to open up and this process rapidly accelerated through the 1990s, helped by reforms such as the unification of the currency rates and opening up of the current account, fuel price liberalisation and then food price liberalisation in the period 1993-95. In the mid-1990's boom, GDP grew at double-digit rates but also inflation started to soar – largely due to the impact of price reforms - threatening to stoke up a wage-price spiral. The authorities clamped down on wages and prices and the economy cooled down rapidly – at about the same time as the Asian crisis also hit the region. However, throughout this period China still achieved high rates of GDP growth (in the 6-8% range), drawing critical comments about the basis of its GDP measurement, although the actual figures may have been fairly close to the official data and other GDP figures quoted by critics do not hold up to scrutiny anyway. China also refused to bow to pressure to devalue the RMB during the Asian crisis – although it has also refused to adopt a large revaluation in recent years when sentiment has swung in the opposite direction, fuelled by China's rising trade surplus.
- Emerging from the Asian crisis period, China also prepared for WTO entry, which was finalised in December 2001. This was the catalyst for the substantial surge in trade – and investment – that has propelled China into its current pole position in world trade, especially in goods such as toys and textiles and other light manufactures, but also assisting a rise in its share of trade in equipment such as office machinery and computer accessories.
- Imports have also risen sharply but with a strong focus on raw materials (metals, cotton etc) and oil along with investment equipment – less than 10% of China's imports are consumer goods. This skewed nature of trade has led to the massive rise in China's trade surplus versus its key export partners, the US and also the EU, causing trade disputes about specific items (mostly textiles) as well as the general pattern of trade. China runs a deficit with oil producers and some Asian trade partners, where measurement is complicated by trade via Hong Kong.
- Investment is largely domestically financed out of profits, reflecting a high domestic savings (reinvestment) rate. The average household savings ratio is estimated to be in the 25-30% range and investment represented almost 50% of GDP in 2005, even when based on the revised national accounts (that boosted the role of consumption). FDI played a significant role in the early stages of the 1990's boom. FDI shot up to about 10% of total investment funds in the early-1990s although it is now down to only 5-6%. It was, and remains, an important part of investment in manufacturing for export markets and, more recently, the share of FDI going to financial services (eg stakes in Chinese banks) has increased. About half of FDI now goes to "greenfield" investment and the rest to M&A type activity. A poor track record for banks' bad debts is one of the key financial sector concerns.

Key Facts

Politics

Head of state: President HU Jintao
 Head of government: Premier WEN Jiabao
 Political system: Communist state
 Date of next presidential election: 2013
 Date of next legislative election: 2013
 Currency: Yuan (CNY) also called Renminbi (RMB)

Long-term economic & social development

	1975	1985	1995	2006*
GDP per capita (US\$)	176	290	604	2006
Inflation (%)	0.5	9.5	16.8	1.8
Population (mn)	928	1067	1214	1321
Urban population (% of total)	17.0	23.0	31.0	42.0
Life expectancy (years)	-	68.0	69.0	72.0

Source : Oxford Economics & World Bank

Structure of GDP by output

	2007
Agriculture	0.0%
Industry	0.0%
Services	0.0%

Source : World Bank

* 2006 or latest available year

Structural economic indicators

	1990	1995	2000	2006*
Current account (US\$ billion)	12.0	1.6	20.5	249.9
Trade balance (US\$ billion)	9.2	18.1	34.5	217.7
FDI (US\$ billion)	2.7	33.8	37.5	56.9
Debt service (US\$ billion)	7.1	15.1	27.1	27.9
Debt service (% of exports)	11.7	9.9	9.3	2.9
External debt (% of GDP)	15.6	16.2	12.2	11.9
Oil production (000 bpd)	2774	2990	3249	3673
Oil consumption (000 bpd)	2296	3363	4796	7273

Source : Oxford Economics / World Bank / EIA

Destination of goods' exports (2006)

United States	21.0%
European Union (27)	19.6%
Hong Kong, China	16.0%
Japan	9.5%
Korea, Republic of	4.6%

Source : WTO



Source : CIA Factbook

Location : Eastern Asia, bordering the East China Sea, Korea Bay, Yellow Sea and South China Sea, between North Korea and Vietnam (CIA Factbook)

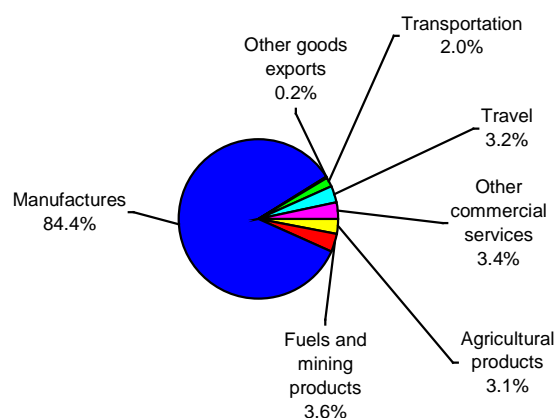
Corruption perceptions index 2008

	Score
Developed economies (average)	7.73
Emerging economies (average)	3.44
China	3.60
Emerging Asia	3.28

Source: Transparency International

Scoring system 10 = highly clean, 0 = highly corrupt

Composition of goods & services exports, 2006



Source : WTO