



# A Random Walk through China's Inflation Outlook

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*"The views expressed in this presentation are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management."*

# Tentative Takeaways

1. As in recent episodes, price pressures largely reflect narrow group of food items and imported inflation
2. Nonfood inflation remains moderate
3. Suggests more of a role for supply shocks (perhaps exacerbated by loose money)
4. Evidence for overheating is still weak at best
5. Looking ahead, rapid investment and excess capacity should keep core inflation in check
6. As external demand and global commodity prices moderate, inflation should subside post-spring
7. But could this time be different?

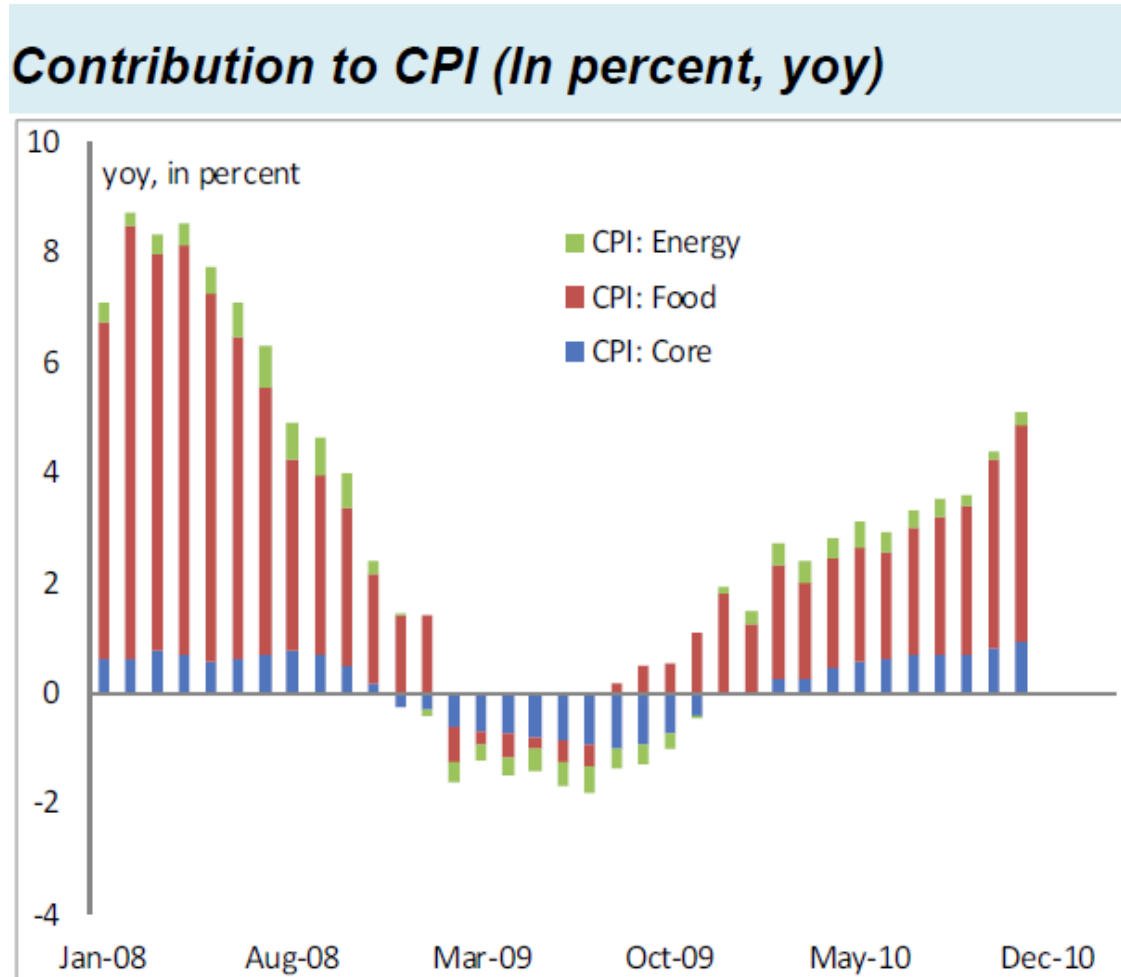
# Outline of Remarks

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1. Recent Inflation Trends
2. What Drives Inflation in China?
3. Outlook and Risks

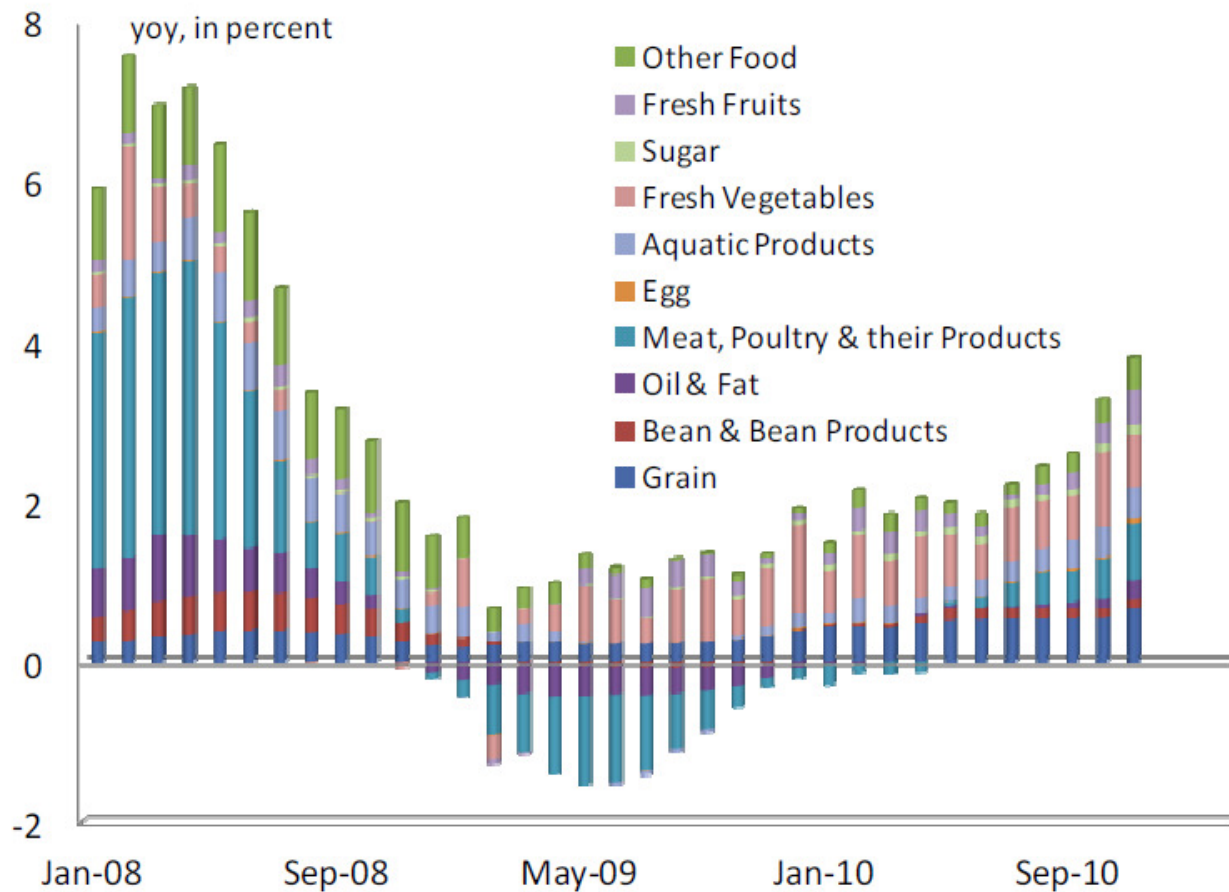
# 1. Recent Inflation Trends

# Headline inflation has risen sharply since mid-2010, mostly reflecting food prices...



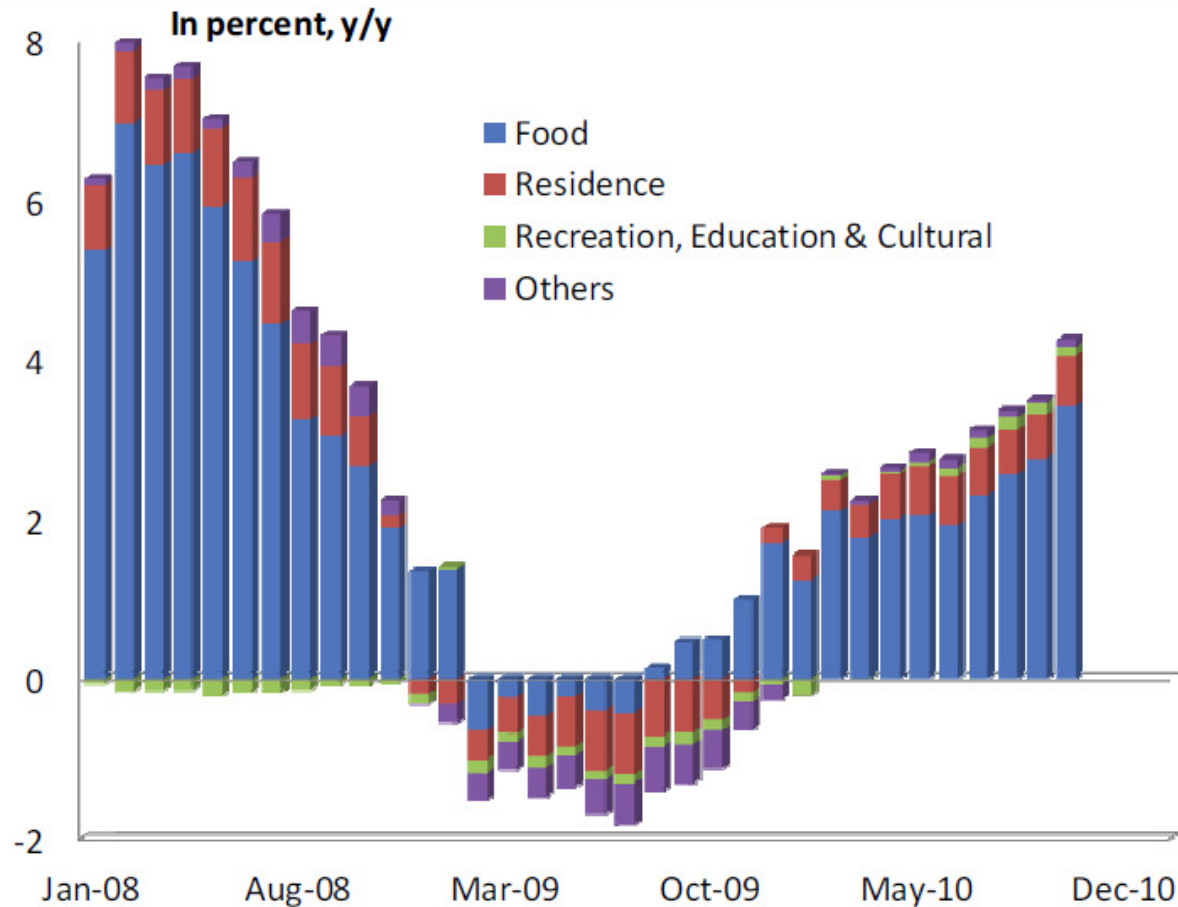
...particularly fresh fruits and vegetables; and more recently, pork.

**Contribution to Food (in percent, y/y)**



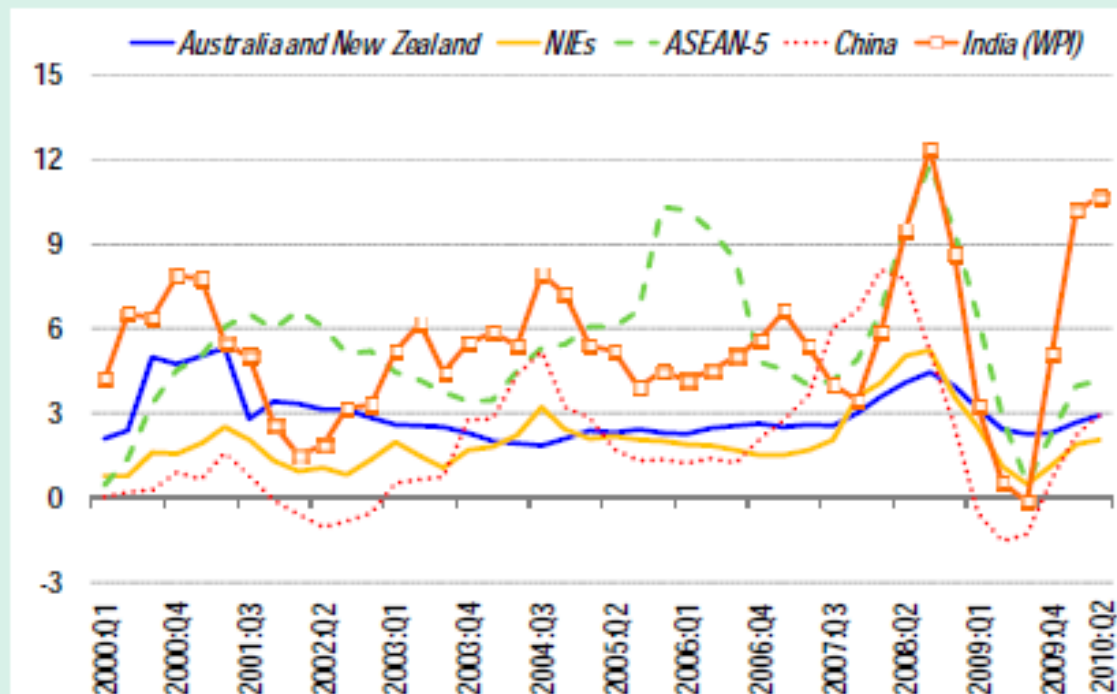
# Nonfood inflation has been more moderate, notwithstanding recent uptick in housing costs.

**Contribution to CPI Change (in percent, y/y)**



This pickup in headline inflation is also observed in other parts of Asia...

**Figure 2.1. Asia (excl. Japan): Headline Consumer Price Index**  
*(Year-on-year percent change)*

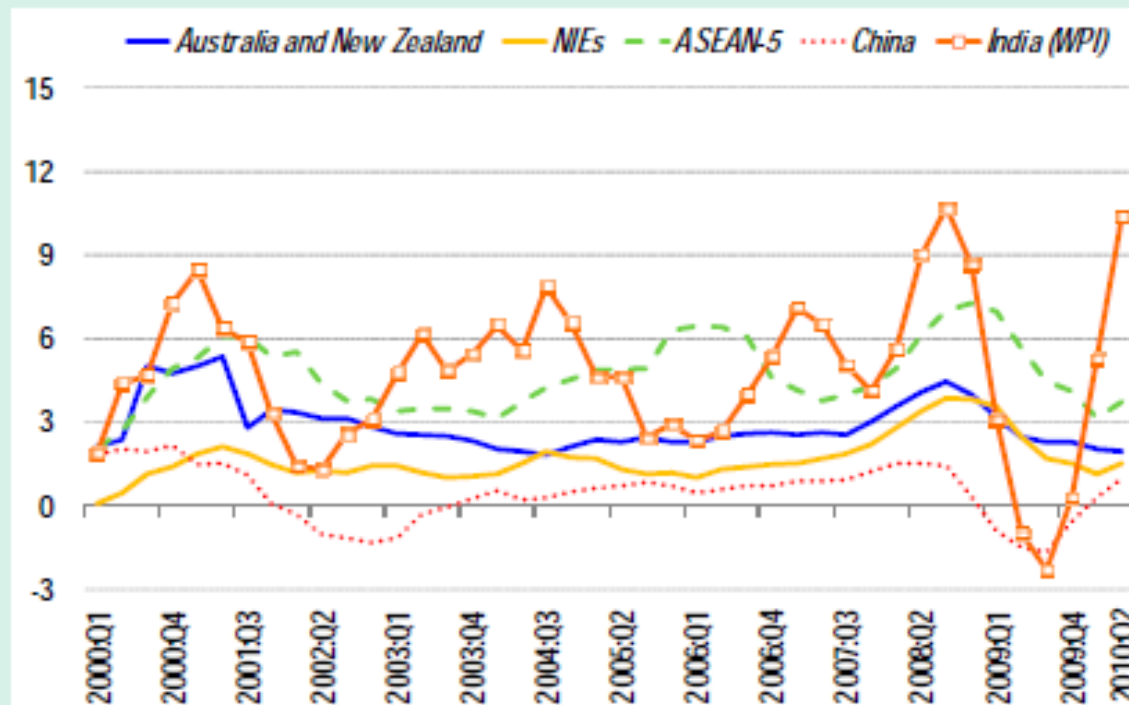


Sources: CEIC Data Company Ltd.; and IMF staff calculations.



...with core inflation also generally more muted.

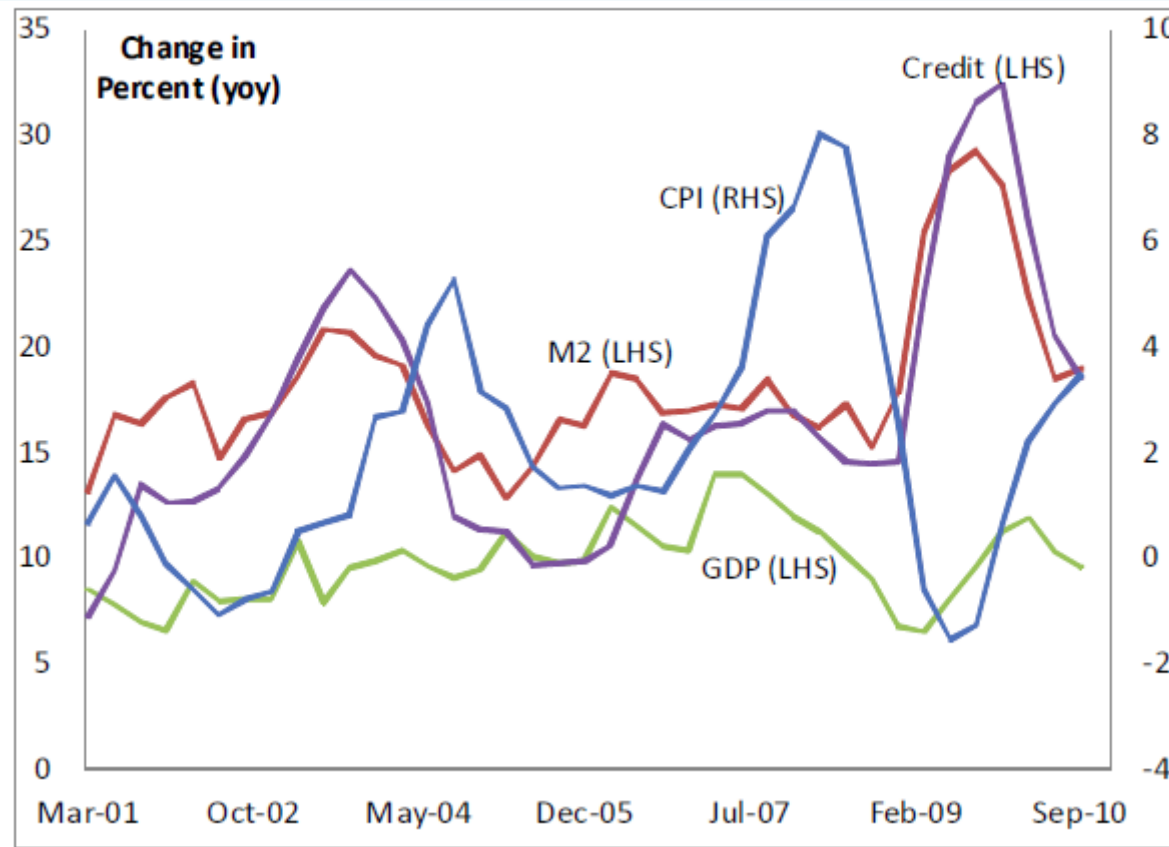
**Figure 2.2. Asia (excl. Japan): Core Consumer Price Index**  
*(Year-on-year percent change)*



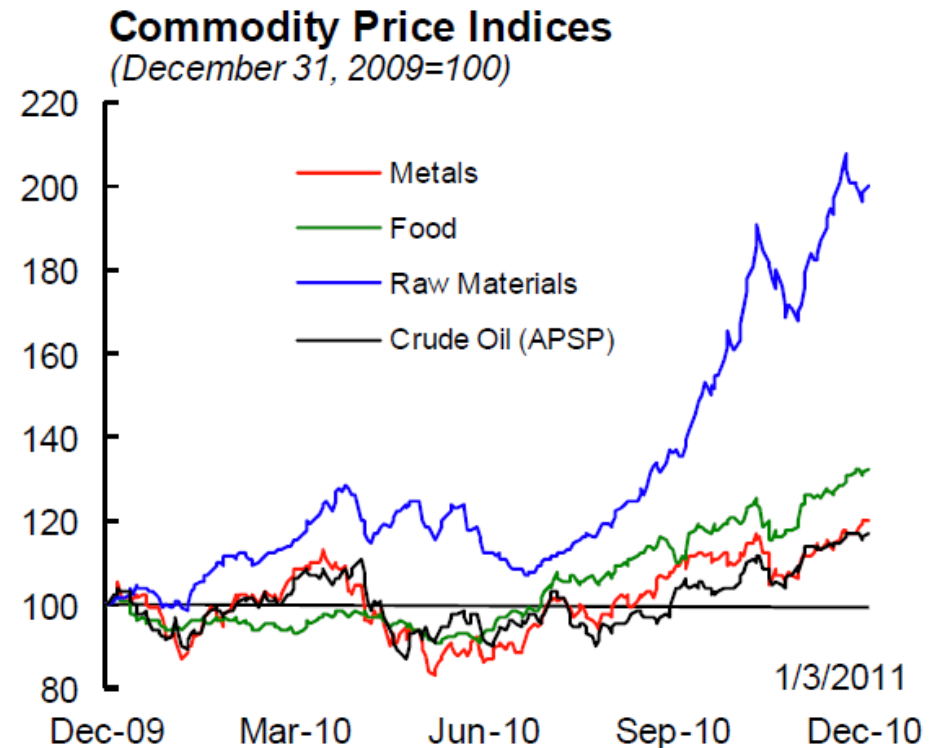
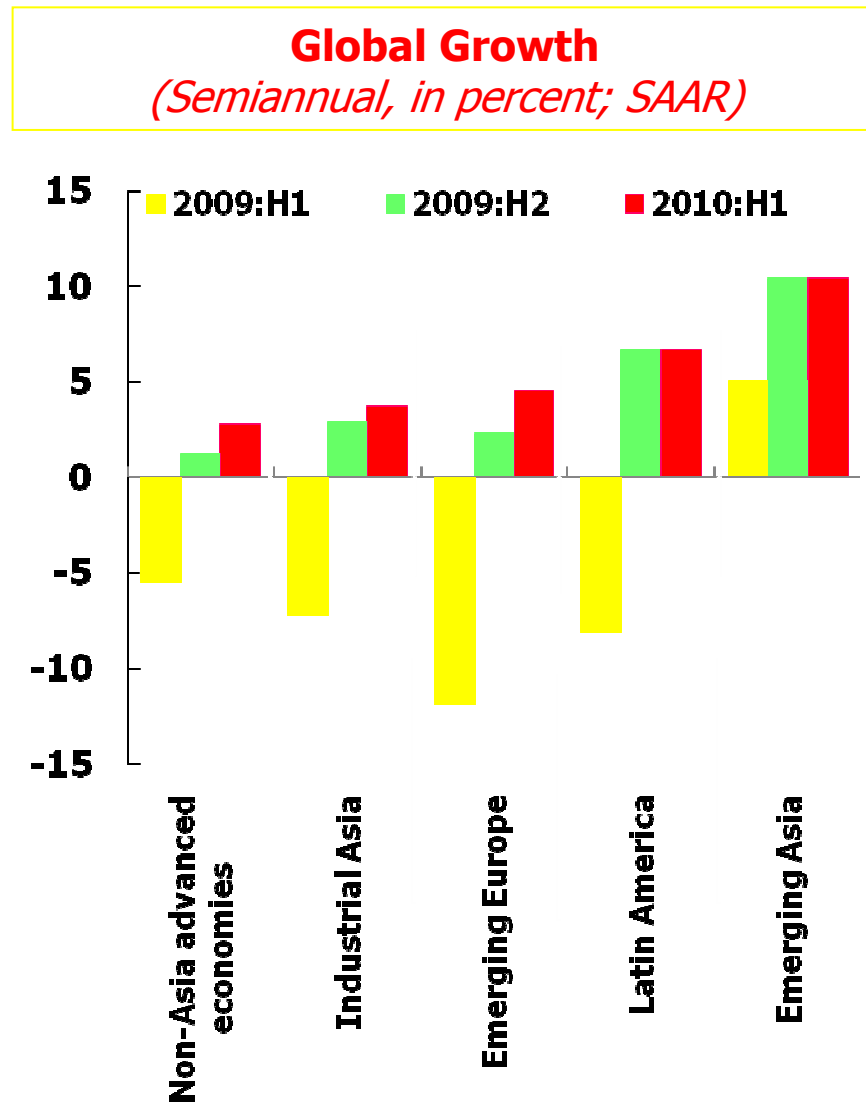
Sources: CEIC Data Company Ltd.; and IMF staff calculations

In China, the rise in inflation has accompanied robust growth and rapid credit expansion...

### *Inflation Pressures: GDP, M2 and Credit*



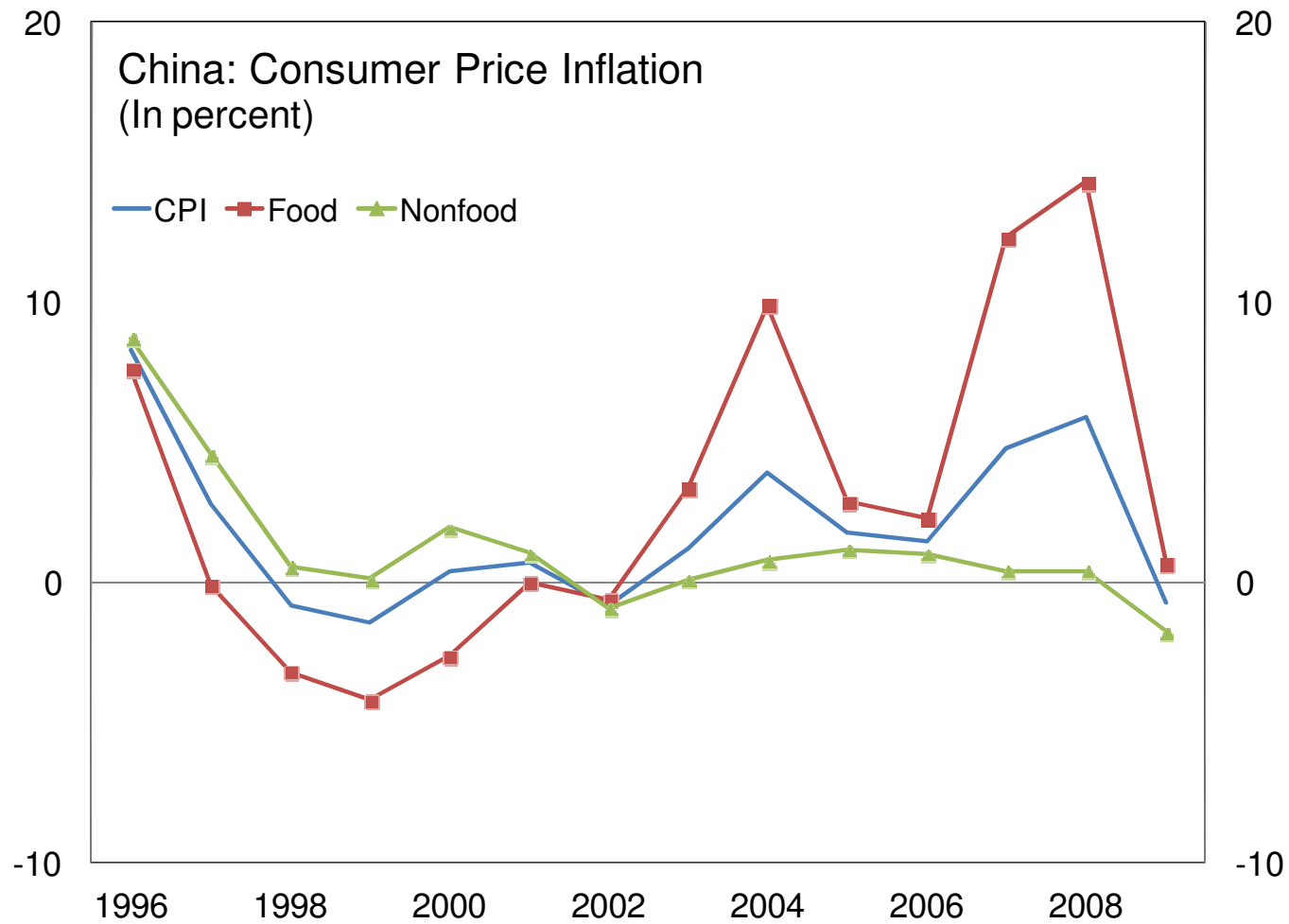
# ...and a pickup in external demand and global commodity prices.



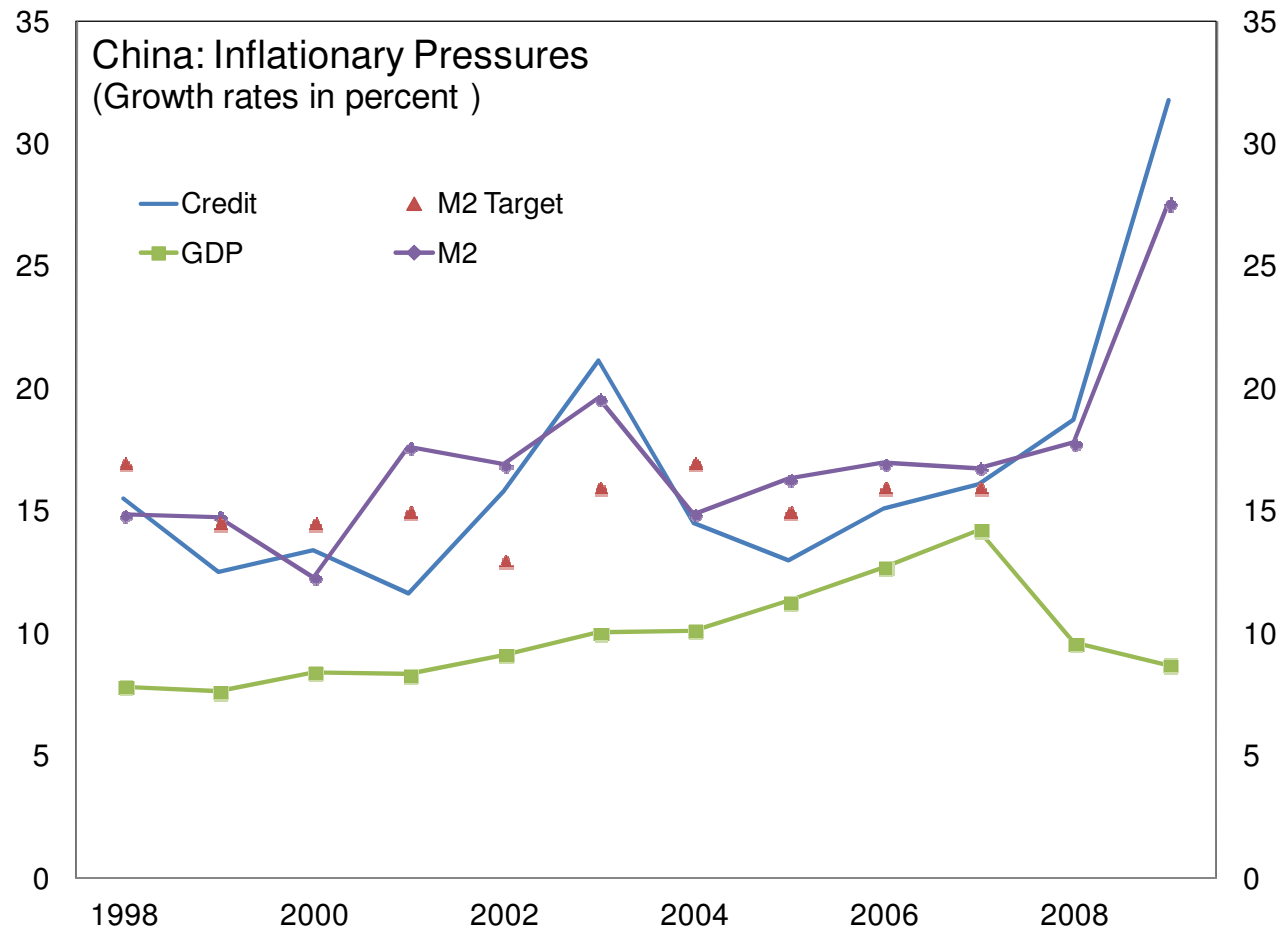
## 2. What Drives Inflation in China? <sup>1/</sup>

1/ Drawn from IMF Working Paper 10/221 “Price Dynamics in China” (Nathan Porter).

## Over the last decade, inflation has been generally moderate in China...



... despite rapid economic and credit growth.



# Nonfood inflation is persistent and more affected by foreign cost pressures and expectations than output gap

**Table 2.2: China: NKPC–Baseline GMM Estimates with Nonfood Inflation<sup>1</sup>**

Variable	Coefficients	t-statistic
Constant	-0.002 **	-1.81
Foreign price gap	0.31 *	15.74
Expected inflation	0.12 *	2.69
Output gap <sup>2</sup>	0.02	0.93
Lagged inflation	0.63 *	21.38

*R*-squared = 0.84, adjusted *R*-squared = 0.75

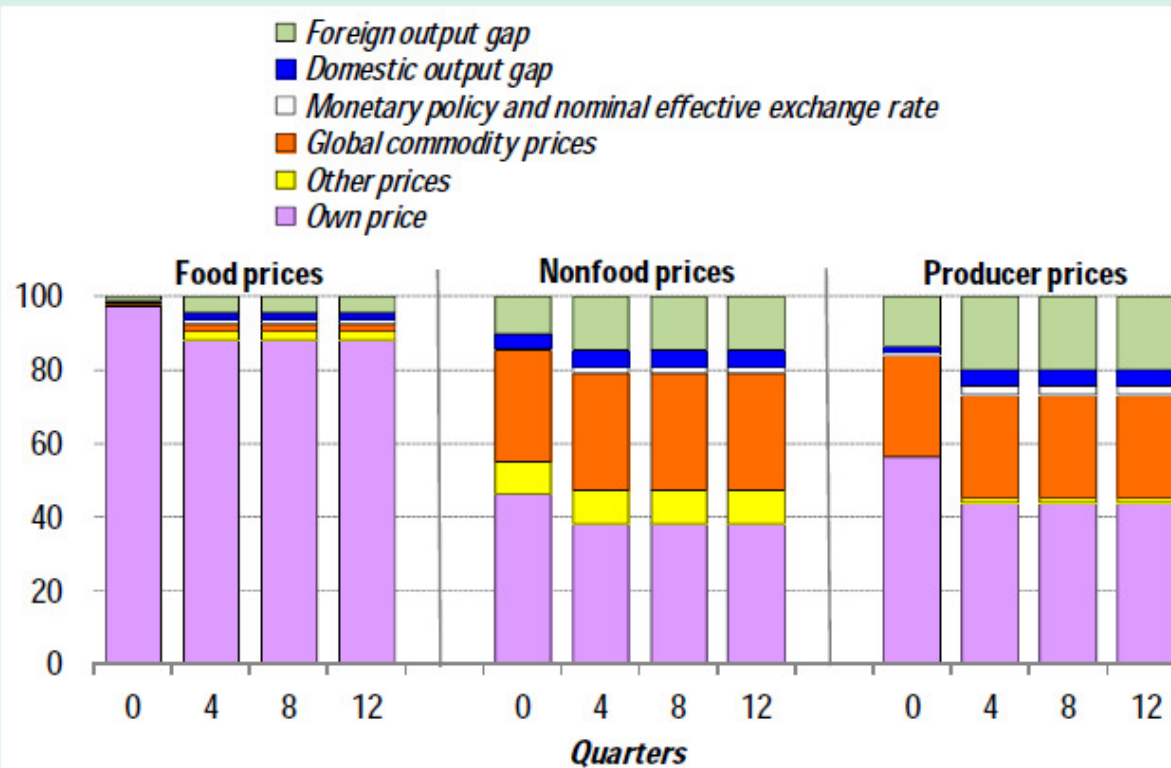
Source: IMF staff estimates.

<sup>1</sup> The sample period is 1996–2008. \* and \*\* denote significance at 5 and 10 percent levels, respectively.

<sup>2</sup> Output gap is estimated through a growth accounting model.

Foreign demand also important for nonfood prices, while food prices related to supply shocks.

**Figure 2.19. China: Variance Decomposition of Inflation**  
(In percent)

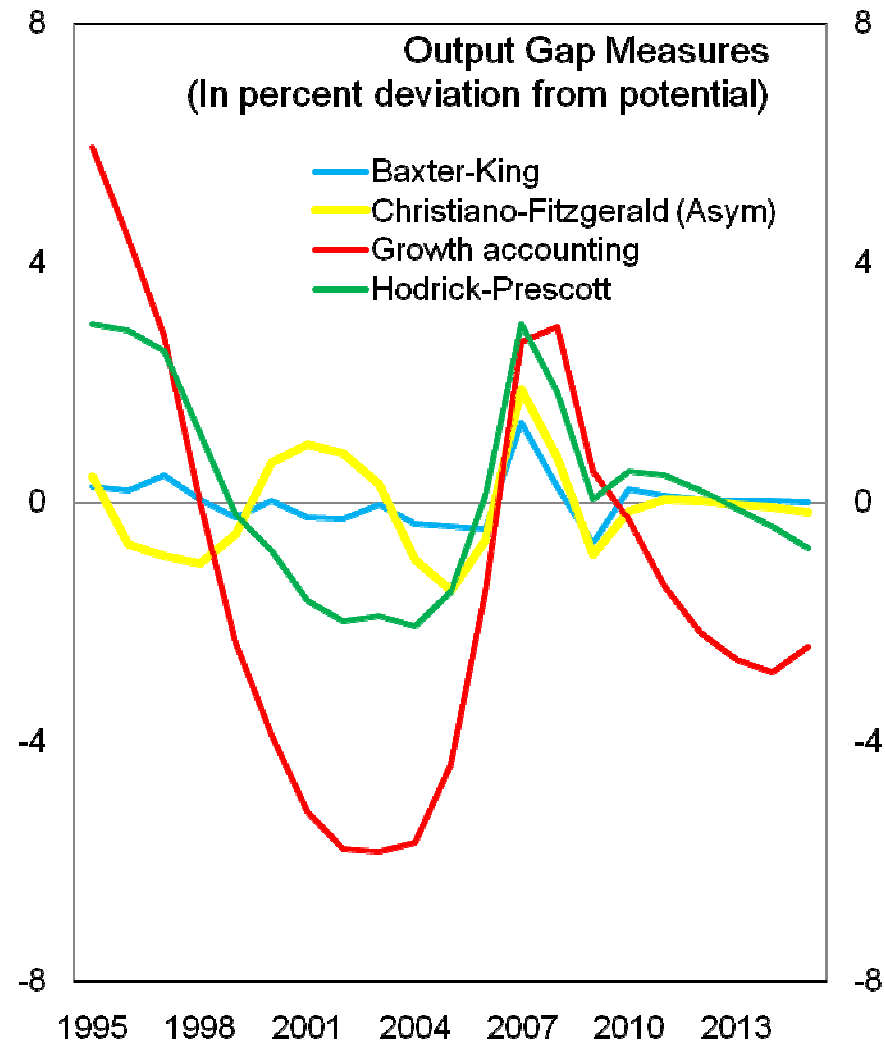


Source: IMF staff estimates.

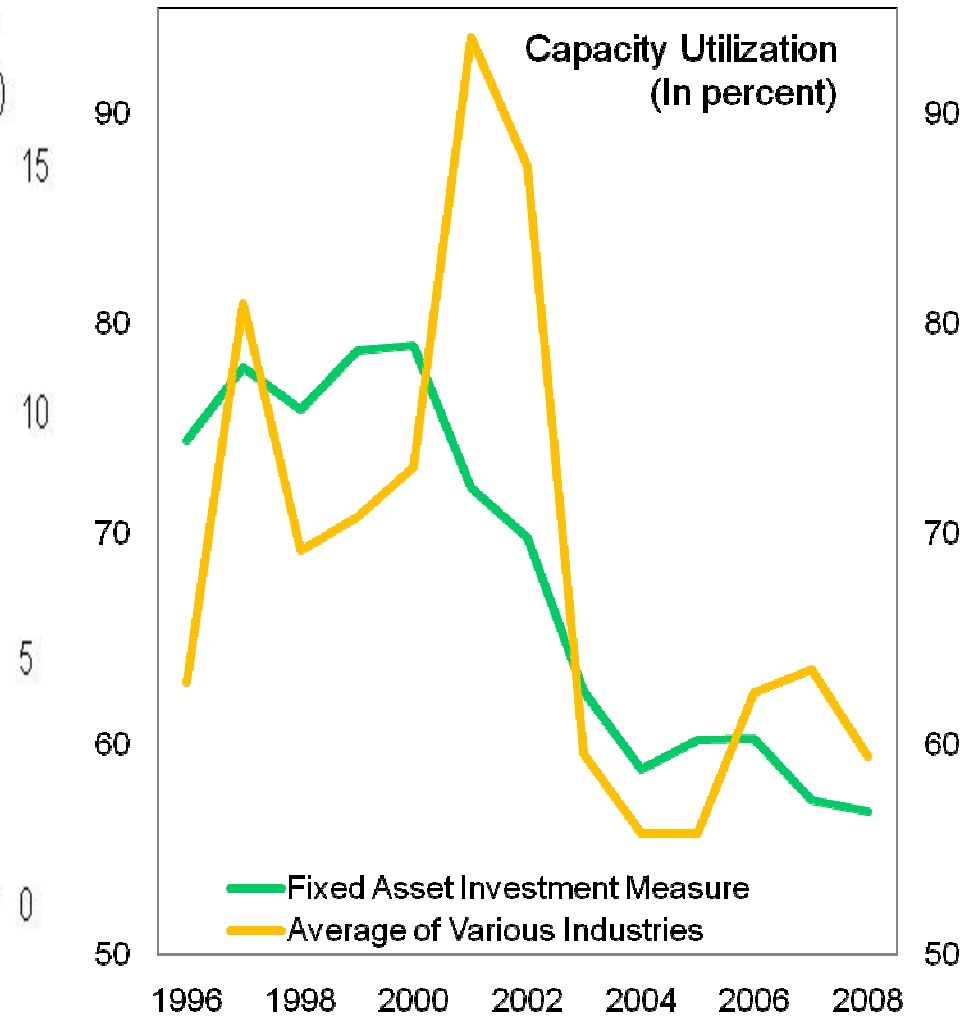
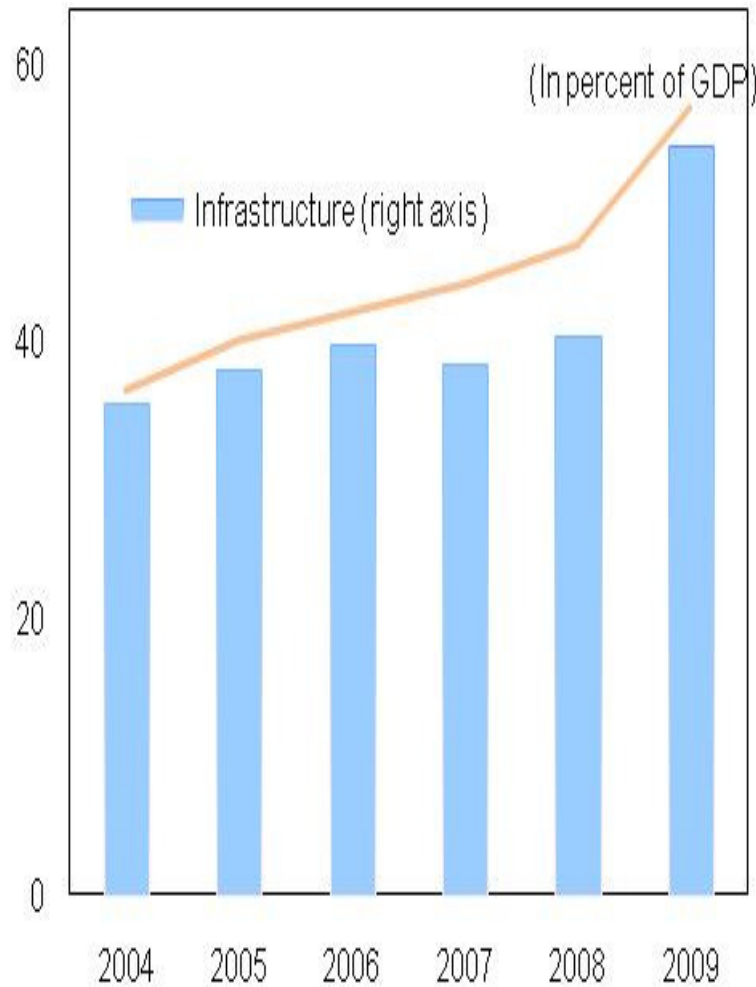


### 3. Outlook and Risks

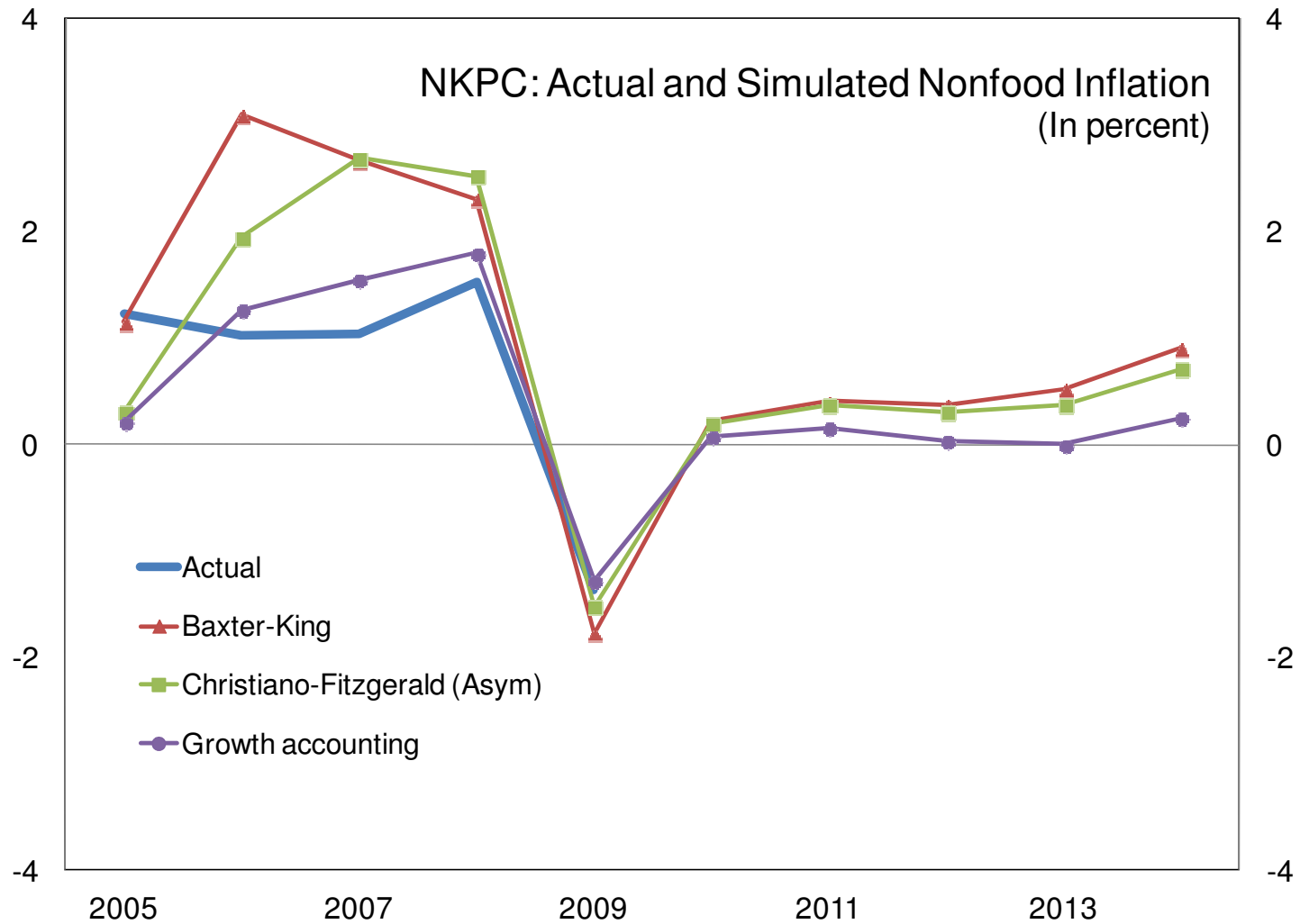
# For moment, evidence of overheating remains weak...



...including high levels of investment and still-low capacity utilization rates.



# History suggests little near-term pressure, with nonfood inflation falling through this year...



...on back of moderating foreign demand and commodity prices (and monetary tightening).

**World GDP Growth Projection**  
*(Year-on-year, in percent)*

	2010	2011
<b>World</b>	<b>4.8</b>	<b>4.2</b>
<b>Advanced economies</b>	<b>2.7</b>	<b>2.2</b>
<b>Emerging and Developing economies</b>	<b>7.1</b>	<b>6.4</b>
<b>Asia</b>	<b>8.0</b>	<b>6.8</b>

**World Price Projections**  
*(Year-on-year, in percent)*

	2010	2011
<b>Fuel</b>	<b>23.3</b>	<b>3.3</b>
<b>Nonfuel commodities</b>	<b>16.8</b>	<b>-2.0</b>
<b>Advanced economy CPI</b>	<b>1.4</b>	<b>1.3</b>
<b>Emerging and Developing economies CPI</b>	<b>6.2</b>	<b>5.2</b>

## But could this time be different?

- Has recent investment surge really boosted productive capacity?
- Could inflation expectations become unanchored?
- How much excess liquidity has rapid credit expansion created?
- How significant are wealth effects from sharp run-up in housing prices?
- Have wage increases been excessive?