A 'Macroeconomic Engineering' Challenge

Among the IMF's recommendations to the Chinese government:

- Allow the country's currency, the yuan, to strengthen beyond its undervalued position against the U.S. dollar.
- Rebalance growth toward domestic consumption.
- Put forward measures such as allowing higher and more market-driven interest rates.
- Lower taxes to encourage consumption.
- Speed up urbanization by reducing restrictions on migration.
- Raise the current low prices -- set by the government -- for energy and raw materials.
- Expand the existing social safety net, with improved health-care coverage, pensions and education.
- Monitor and manage any red flags indicating a deterioration in credit quality.
- Contain threats to the banking sector as well as continued risks of a bubble in the real-estate market.

Source: International Monetary Fund

Using productivity calculations contained in the IMF report, Mr. Prasad said, resulted in a 23.5%
IMF Report Urges China to Consume More

The debate over currency policy is only part of the discussion over the broad direction of the Chinese economy, which both the IMF and China's government agree still depends too much on exports. Supporting domestic consumption instead "will reduce China's reliance on external demand and better insulate the economy from shocks in overseas markets," the IMF said.

China gave domestic demand an enormous boost with its stimulus program to combat the effects of the financial crisis, resulting in a surge in imports of raw materials and equipment to feed a construction boom. As a result, China's current account surplus—the broadest measure of its trade balance—fell sharply, reaching 4.5% of gross domestic product in the first quarter of this year, less than half the peak level of nearly 11% of GDP in 2007.

For China to ensure that its trade surplus continues to decline will be "an exceptionally complicated exercise in macroeconomic engineering" that "will require concerted action on multiple fronts," the IMF said. Although China has taken some steps in the right direction, including the recent loosening of its currency's link to the U.S. dollar, the IMF said, "The critical mass of policy reforms that will be needed to realize this goal is not yet fully in place."

Achieving a shift toward lower trade surpluses in nations such as China, and smaller trade deficits in nations such as the U.S., should help global economic growth to be faster and more broad-based, the leaders of the Group of 20 major economies agreed at their summit meeting last month.

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The IMF's focus on medium-term structural issues reflects its view that the Chinese economy's recovery is now solidly established, with little danger of high inflation. The fund expects China's headline inflation rate to fall in the second half of this year and hover around 2% to 3% annually in coming years.

The IMF noted that China worries that efforts to cut budget deficits in Europe, the U.S. and Japan could weaken global growth, while China itself has room for more stimulus if needed. However, it said that after the lending binge that resulted from the previous stimulus plan, China also needs to deal with risks to the banking sector as well as continued risks of a bubble in the real-estate market.

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