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Quarterly Update

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The World Bank quarterly update provides an update on recent economic and social developments and policies in China, and present findings from ongoing World Bank work on China. The update is produced by a team from the Beijing Office with support from the China country team. Questions and feedback can be addressed to Li Li (lli2@worldbank.org)

OVERVIEW

Growth reached record highs in the second quarter. China's economy expanded by almost 11 percent in the first half of 2006, with growth in the second quarter the highest in over a decade. Industry continues to outpace services on the supply side, and investment remained the main driver of demand. Export growth continued to outpace import growth, contributing to a record current account surplus. Monetary aggregates expanded beyond targets, although more recently M2 has slowed down somewhat.

The authorities have implemented a series of measures to cool down the economy in reaction to recent economic statistics. Measures include monetary tightening by absorbing liquidity in the interbank market; administrative measures to limit investment in real estate; reinforcement of controls and regulations on investment projects, including a re-evaluation of all large investment projects; and loosening controls on capital outflows.

The outlook for China's economy remains favorable. With production capacity continuing to expand in line with demand, inflation low, and the current account in surplus, the main policy concern is not general overheating. Rather, policymakers are worried that high investment could cause overcapacity in specific sectors, and may affect the banks because loans may turn bad in the future. The authorities can take some comfort from the fact that most investment is financed from profits rather than credit, and that the highest investment growth is taking place in largely commercialized sectors. But the continued investment boom warrants concerns about efficiency, making more moderate growth desirable. On the external side, key risks are a sharper than expected slowdown in the US economy and a disorderly resolution of global imbalances.

The authorities may stay the course on current measures, and await further evidence of their effects before initiating additional demand-reducing measures. A drastic slowdown alone would lower imports and boost the current account, creating more problems for monetary policy and trade relations. Continuing the recent strengthening of the Renminbi against the dollar may ameliorate part of this dilemma, as it would raise imports, reduce capital inflows, and switch investment to the non-tradables sector. Also, the latest data suggest that the recent measures have started to have some effect on monetary aggregates. Internationally, if the slowdown in the US starts to affect China's growth prospects, the authorities may need to reconsider the macroeconomic stance.

More policy focus can be put on rebalancing the economy. Although this is a medium term objective of the authorities, there are reasons to give it more prominence. First, many of the measures that can help rebalance the economy also support desirable macroeconomic adjustment. Second, the current investment boom may give rise to a capital stock that would no longer be viable once relative prices and standards better reflect the government's new priorities. The package of policies that would promote rebalancing include: (i) measures to stimulate domestic consumption, and increase the efficiency of investment; (ii) measures to increase the relative attractiveness of producing services (non tradables) over manufacturing production (tradables); and (iii) institutional reforms to give local decision makers stronger incentives and better tools to pursue rebalancing.

RECENT ECONOMIC DEVELOPMENTS

Economic growth again surprised on the upside and hit a ten-year high in the second quarter. GDP expanded by 10.9 percent in the first half of 2006, year-on-year (yoy). This implies second quarter growth of 11.3 percent, a pace not seen since 1996, and is compared to a July consensus forecast for the whole year of 9.7 percent.

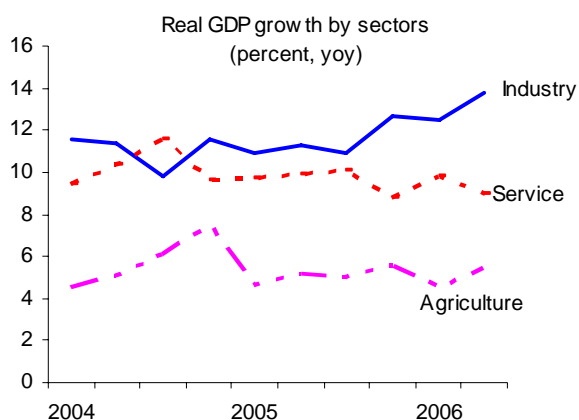
Growth continued to be along familiar—largely imbalanced—patterns. On the supply side, the government's objective to rebalance growth away from industry and towards services is yet to be achieved. Industry powered ahead, up 13.8 percent in the second quarter of 2006 (yoy), continuing an acceleration that started in mid-2005 (Figure 1). Services failed to take the lead, their growth down from last year's average of 9.6 percent to 9 percent in the second quarter. Harvests were good, but agricultural value added lagged far behind, up 5.5 percent on a year ago. While care remains required in interpreting the quarterly GDP data, the economic structure is unlikely to be significantly more balanced than the data suggests.¹ On the demand side, despite the government's aim to boost consumption, net exports and investment have remained the main growth drivers. The main surprise again came from trade. Exports continue to grow faster than imports, and net trade contributed a full 2½ percentage point to real GDP growth in the second quarter, the highest since the first quarter of 2005 (Figure 2).² Real fixed assets investment (FAI) rose an estimated 27.5 percent (yoy) (Figure 3), although this means considerably less growth in terms of national accounts-type fixed capital formation.

Investment maintained high growth despite measures to rein in growth. Concerns about excessive investment growth led to a new round of macro tightening starting in April, centered on monetary tightening and administrative measures (see policy section below). Fiscal spending also slowed in April-May, especially on "capital construction", although it is unclear whether that has been a deliberate policy. The measures had some effect on monetary aggregates in June (Figure 4), and may have contributed to the slowing of financing of investment by domestic credit and FDI in April-May. However, the monetary measures in particular will take time to affect the real economy and so far investment has not slowed. Nominal FAI growth rose to 31 percent (yoy) in the second quarter. Investment in the first half was particularly strong in industry (up 35 percent in January-May, yoy), especially in food processing, coal mining and textiles. It was less buoyant in services, including real estate (up 24 percent in the first half, yoy) and utilities. Geographically, some rebalancing is taking place, with the central and western regions taking the lead, with 39 and 32 percent growth in January-May, compared to 25 percent

¹ Since the revision of the annual production side data in early 2006, which increased the coverage, particularly of new branches and firms in services (see the February 2006 Quarterly Update Special Focus), the quarterly GDP data is still compiled using the old survey framework. However, the data is then adjusted, with the aim to make it consistent with the revised (annual) method and data.

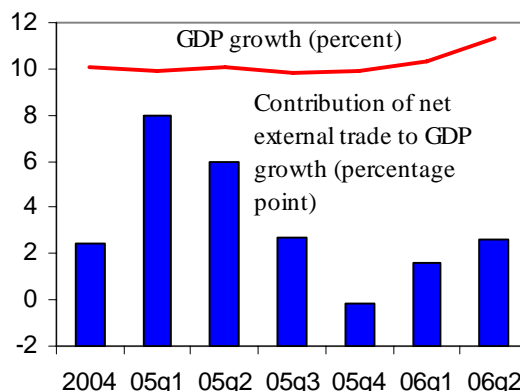
² The estimates on the contributions to growth are made using the published national accounts GDP data and the trade and current account data. Issues with this data would obviously affect the estimation. For instance, if the GDP data is accurate but the current account and trade data is biased upwards because of hidden capital inflows, and if these inflows increase, the contribution of trade to growth would be overestimated, while the contribution of domestic demand would be underestimated.

Figure 1. Industry again outpaces other sectors



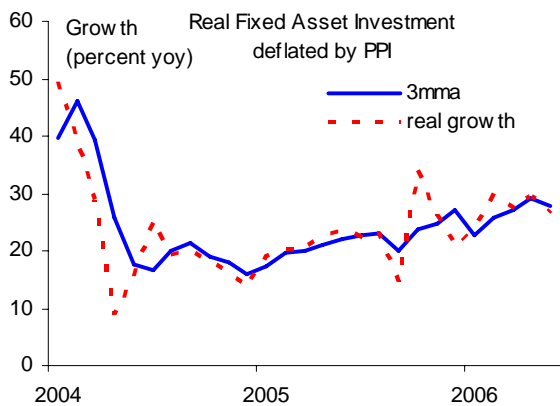
Source: NBS, staff calculation.

Figure 2. The contribution to growth of net trade is on the rise again



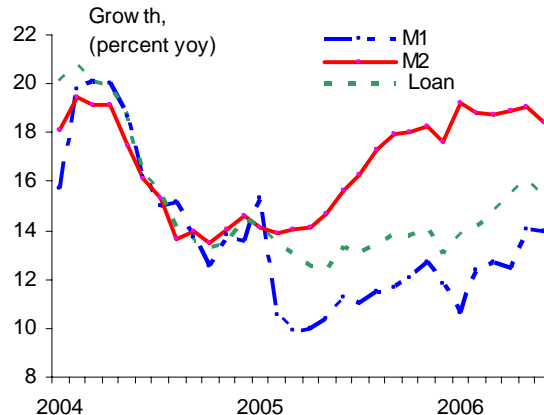
Source: NBS, staff calculation.

Figure 3. Investment continues to power ahead...



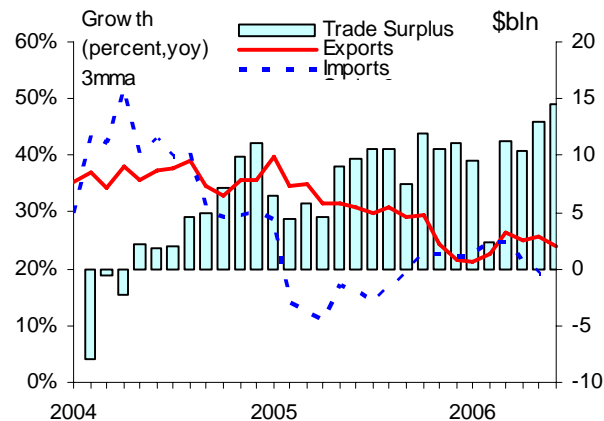
Source: NBS, and staff calculation.

Figure 4. ...Despite some monetary moderation



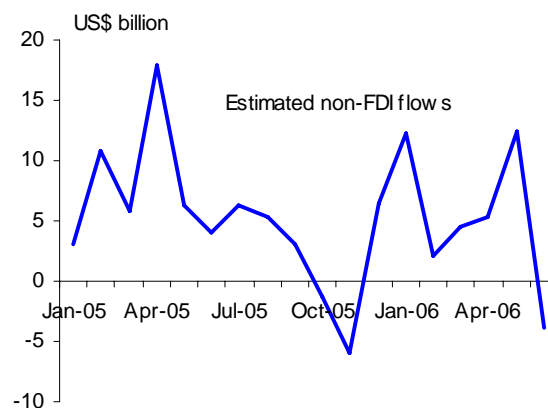
Source: NBS, staff calculation.

Figure 5. Trade surplus reaches new record



Source: NBS, CEIC.

Figure 6. Non-FDI inflows retreat in June



Source: NBS, CEIC, and staff estimates.

in the east. Railway investment surged by 88 percent (yoy), as rail links are improved to reduce transport costs and help the development of the interior regions.

Investment is supported by local government behavior. The recent measures have not affected the urge of local governments for investment. Between 10 and 20 percent of investment is carried out by local governments, in part financed by so-called “packaged loans” (Box 1). In addition, given current rules and institutions, local governments have incentives to stimulate enterprise investment. Key incentives include the criteria of local government officials’ performance, which are largely economic criteria including GDP growth and FDI, and the importance for local government finances of revenues from land sales related to investment projects as well as VAT revenues on the production of goods (as opposed to services, that are not covered by the VAT). Channels through which local governments can stimulate enterprise investment range from agreeing to favorable investment terms to using their leverage to secure bank loans for firms.

However, investment is increasingly driven by firms’ profits and profitability. This is because the private sector makes up an increasing share of the economy, and SOEs are commercializing. Indeed, one reason for the resilience of FAI to tightening measures is that profits, which finance over half of investment, picked up momentum. Total profits in industry rose by 28 percent (yoy) in the first half, 9 percentage points more than in the same period of last year. The findings presented in Box 2 suggest that FAI growth in the first half of 2006 tended to be higher in sectors with high profit growth and high profitability. Moreover, investment growth tended to be higher in sectors dominated by the private sector. These findings suggest that, in terms of identifying and addressing the causes of high investment growth, private sector incentives are likely to be as much at the core as local government behavior, even if private sector investment is often stimulated and backed by local government behavior.

Box 1. The rise and fall of “packaged loans” involving local governments.

Banks have financed a lot of urban construction through “packaged loans.” Packaged loans (or lines of credit) are usually borrowed by an Urban Construction and Investment Company, owned by a local government. Guaranteed by the local finance bureau, these loans are meant for a province or a city’s many infrastructure projects jointly. For example, the China Construction Bank (CCB) agreed to provide the Haikou Municipal Government with a RMB 30 billion credit support during the 11th five-year plan.

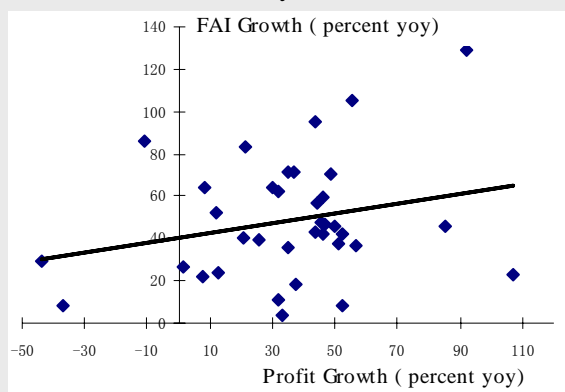
Banks consider packaged loans attractive. While local government indebtedness and its implications for their financial sustainability is an increasing concern (see February 2006 QU, Box 3), the risk of lending to local governments is perceived to be low because of their fixed revenue streams and the assumption that they would be bailed out by the central government if things go wrong. In addition, with risk management still a challenge for banks, the fact that packaged loans pool risk is considered an important advantage.

The central government has called on banks to stop providing packaged loans. As part of the measures to tighten investment, an April 25, 2006 decree that was jointly issued by different Ministries and public entities called on banks to stop signing packaged loans or credit cooperation agreements with local governments. The decree also invalidated all guarantees provided by local governments in violation of the Guarantee Law after January 26, 2005. It called on local governments to fulfill guarantees in violation of the Guarantee Law made before January 26, 2005.

Box 2. Why is enterprise investment so buoyant?

In comparisons of fixed asset investment (FAI) across industries, rapid profit growth tends to lead to stronger investment growth. In line with the findings on the importance of profits as a key source of financing of investment, sectors with higher profit growth in the first five months of 2006 seem to have invested more rapidly (Figure 1). For instance, sectors like transport equipment, ordinary machinery, and the textile industry, which were identified by the NDRC as having seen particularly rapid FAI growth, saw particularly high profit growth, and thus fit the relationship well. Of course, such relationships have outliers. The outliers are largely sectors outside of core manufacturing where government policies, including on pricing, have a large influence.^{1/}

Figure 1: Higher profit growth, more investment a/ (Jan-May, 2006)



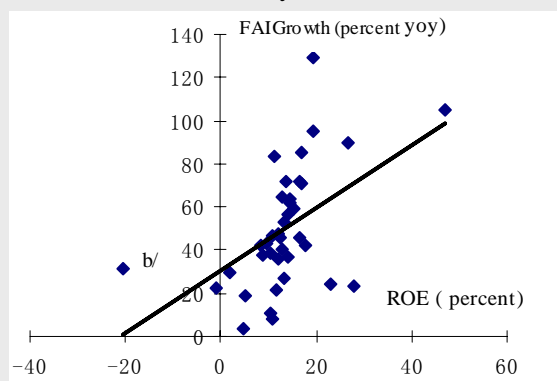
Source: CEIC, and staff calculation

a/ Sectors with extremely small or negative profits (other mining, petroleum processing & coking, and water), are not included.

More profitable industrial sectors see higher investment growth. In the first five months of 2006, the return on equity (ROE) in different sectors, measured by the ratio of net profit to owners' equity, showed a positive relationship with investment growth. This finding complies with what investment theory would predict for a market economy. As striking examples, most mining sectors are located in the upper-right region, while electricity & heating sectors are in the lower-left region (Figure 2).

Industries dominated by the private sector saw more rapid FAI growth than SOE-dominated ones. The importance of SOEs in industrial sectors, approximated by the ratio of total assets of state-owned and state-controlled industrial enterprises to the sum of assets of both state-owned enterprises and non-state-owned ones "above designated size", seems to have displayed a negative relationship with FAI growth. This suggests that private sector incentives also play an important role in explaining investment, next to local government behavior (Figure 3).

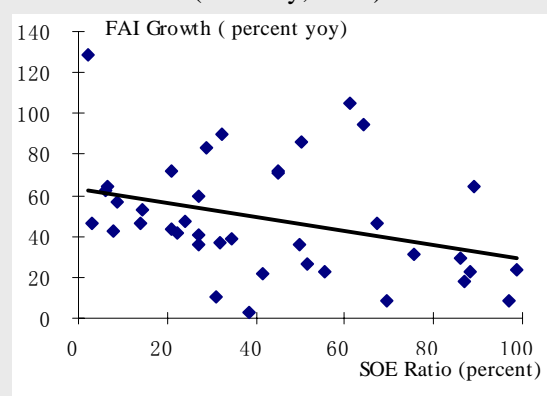
Figure 2: Higher profitability, more investment a/ (Jan-May, 2006)



Source: CEIC, and staff calculation

a/ Outliers (the petroleum & natural gas sector) are not included. b/ Petroleum Processing & Coking.

Figure 3: FAI grew less in SOE-dominated sectors (Jan-May, 2006)



Source: CEIC, and staff calculation

1/ Analysis of the sectoral structure of FAI in Jan-May 2006, NDRC website, July, 21, 2006.

Consumption expanded solidly as incomes rose, with rural spending growth more modest. Fueled by urban wage increases of 14.6 percent (yoy) in the first half of 2006, but with other income sources less buoyant, urban per capita disposable income rose by 11.6 percent in the year to the first half of 2006. Urban per capita consumption grew a bit less at 11 percent (yoy) in the first quarter. Rural incomes benefited from a 20 percent (yoy) increase in remittances from migrant workers and lower taxes, but income from farming lagged behind. Rural households' per capita cash income grew by 13.3 percent (yoy) in the first half. This is seemingly more rapid than urban incomes. However, this indicator overstates improvements in living standards and purchasing power, and is not used by the authorities in the annual analysis of living standards.³ Indeed, nominal rural per capita cash expenditure grew 9.2 percent (yoy) in the first quarter, significantly slower than cash income, and also less fast than urban consumption. Retail sales rose 13.3 percent in the year to the first half, broadly unchanged for 2 years in a row.

Buoyant net trade boosted growth and in July the trade surplus hit an all-time high. Exports continued to outpace imports, growing by 24 percent in dollar terms compared to 18 percent, in the second quarter. As a result, the trade surplus has continued to surge, with the surplus a record US\$14.5 billion in June and July (Figure 5). China's rising trade surplus reflects cyclical term as well as structural developments. In the short term, the trade surplus is boosted by buoyant demand from trading partners and some effective depreciation of the RMB over 2006. While the RMB continued its slow appreciation against the US\$ to 7.99 RMB per dollar at end-July, it depreciated together with the dollar against other currencies. On net, the nominal effective (trade-weighted) exchange rate has depreciated since end-2005 by a few percent.⁴ The large and rising trade surplus, and its effects on monetary policy and international economic relations, continues to feed market expectations of a more rapid appreciation of the RMB.

China's trade basket is diversifying and moving up-market. In addition to the plain expansion of trade surplus-generating processing trade, China's trade structure is upgraded rapidly. The impressive increase in exports stemming from new product varieties in China was highlighted in our May Quarterly Update (in Box 1).⁵ Other developments include rapid growth of exports by domestic private firms—up around 50 percent (yoy) in the first half—and import substitution and broadening of supply chains by foreign firms that previously sourced most inputs from abroad. As a result, the share of processing exports in total exports dropped from 54.7 percent in 2005 to 51 percent in the first six months of 2006. If this trend continues, external trade will benefit China not only by creating jobs, but also by generating more value added and profits. On the other hand, suppliers of intermediary inputs to China may experience slower export growth.

³ In 2005, rural per capita cash income rose by 21 percent. At the same time, cash expenditures on things other than consumption (“productive costs”) increased very rapidly (by over 30 percent). As a result, rural per capita net income used by the authorities to assess living standards grew by 10.9 percent to RMB 3255.

⁴ China's nominal effective exchange rate (NEER) as calculated by the IMF was in April about 1 1/2 percent weaker than in end-2005. Since April, with the euro appreciating about 2 percent vs. the dollar while the Yen remained roughly unchanged, China's NEER must have weakened somewhat further.

⁵ Indeed, Dani Rodrick, of Harvard University, finds that China's export basket is significantly more sophisticated than what would be normally expected for a country at its income level, in “What is so special about China's exports?” <http://ksgnotes1.harvard.edu/Research/wpaper.nsf/rwp/RWP06-001>

On the back of the surging trade surplus, China added US\$115 billion to its foreign exchange reserves in the first half. At end-June, foreign exchange reserves totaled US\$941 billion. While the trade surplus surged by over 50 percent to US\$62 billion in the first half, FDI remained at US\$28 billion roughly unchanged from last year's elevated level.⁶ After large net measured non-FDI capital inflows in the start of 2006, measured inflows are estimated to have reversed in June—perhaps in part due to measures to rein in inflows (see below)—turning from an estimated \$12.5 billion net inflow in May to a net outflow of \$3.8 billion in June (Figure 6).⁷

The high level of foreign reserves has sparked reform of capital controls. Newly released data confirm that China is a modest net creditor to the rest of the world, with net foreign assets larger than foreign liabilities (Box 3). It also shows that 2/3rd of foreign assets is in the form of foreign reserves, whereas 2/3rd of foreign liabilities is inward FDI. Holding a lot of foreign reserves is not very efficient because the foreign government bonds they are invested in, while safe, typically have a low return. In contrast, the return on foreign liabilities, particularly on FDI, is understood to be significantly higher.⁸ The relaxation of foreign exchange controls announced in May could improve the composition of and yield on foreign assets and reduce the pressure of foreign exchange reserves buildup on monetary policy. The reforms allow qualified domestic investment institutions (QDII) to invest in foreign equity and bonds. Prudential regulations on QDII are still in draft. By now only two insurance companies have been approved by the exchange authorities, with more applicants in the pipeline. Two of the six banks that got approval to invest in foreign fixed-income assets on behalf of clients have launched their fund. Controls on inflows have been tightened, with quotas reduced, offshore borrowing and FX loan conversion discouraged, and, most recently, foreign residents' ownership of real estate restricted.

Despite renewed pick up in raw material and oil prices, overall inflation pressures remain moderate. This is largely because China's production capacity continues to grow in line with demand. Raw material and fuel price rose 6.6 percent in the year to June, while PPI inflation reached 3.5 percent in June. CPI inflation edged up to 1.5 percent in June. Trade statistics suggest that higher raw material prices have been offset by lower prices for imported machinery, keeping down the overall import price increase. As in many other countries, asset prices have risen rapidly. In 2006, progress in equity market reforms, especially in reducing the overhang of non-tradable shares, has boosted stock prices. While real estate price increases continue to elicit concerns, overall they are moderate compared to urban income growth and real estate price rises in other countries. Overall real estate price increases eased nation-wide to 5.6 percent (yoy) in the first half, with residential real estate prices continuing to rise 2-3 percentage points faster than commercial real estate prices. In Shanghai, where real estate prices had risen rapidly for several years until mid-

⁶ The official data (from the Ministry of Commerce) on inbound FDI for 2005 has been revised up to US\$ 72.4 billion, to better reflect investment in the financial sector. When adding the reinvested earnings, the inbound FDI in 2005 totaled \$85.5 billion as SAFE reported in BOP statement.

⁷ Non-FDI capital flows are estimated as the increase of foreign exchange reserves net of the trade surplus and FDI. Capital flows disguised in the trade flows would thus not be captured.

⁸ The balance of payment data would suggest rather low returns on FDI in China, in part probably because of the treatment of income on FDI by foreign firms and/or China's statistics.

Box 3. China's International Investment Position.

Recent data confirms that China is a modest net creditor to the rest of the world.

The data on China's international investment position released recently by the State Administration of Foreign Exchange confirm that China has more foreign assets than foreign liabilities (Table). Foreign reserves made up 2/3rds of total assets at end-2005. However, net foreign assets, which indicate how much a country owes to or is owed by the rest of the world, are far less than foreign reserves. Other assets were outbound FDI (US\$ 64.5 billion), foreign notes and bonds (US\$ 117 billion), trade credit (US\$ 90 billion), loans (US\$ 72 billion), and deposits abroad (US\$ 43 billion). On the liabilities side, the stock of FDI reached \$610 billion at end-2005, 2/3rds of the total. The other major liabilities were portfolio investment (US\$77 billion), trade credit (US\$91 billion), external borrowing (US\$87 billion) and currency and deposits (US\$42 billion).

Table. China's International Investment Position (end-2005, US\$ billion)

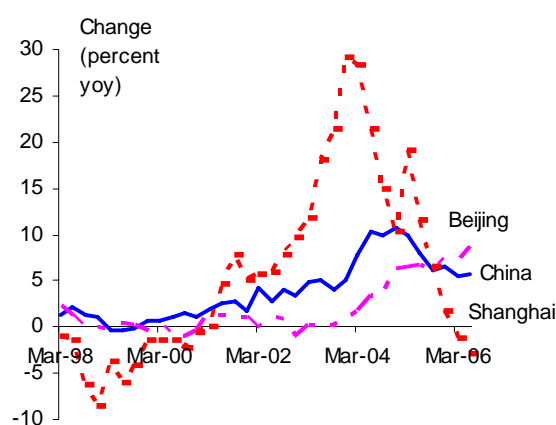
Net Foreign Assets	<u>287.5</u>
Gross Foreign Assets	<u>1218.5</u>
Equity	64.5
o.w. FDI	64.5
Debt	327.9
Reserves	825.7
Gross Foreign Liabilities	<u>930.7</u>
Equity	673.8
o.w. FDI	610.2
Debt	256.9

Source: State Administration of Foreign Exchange and World Bank estimates.

2005, prices were down on a year ago, whereas real estate price rises in Beijing were higher than the national average (Figure 7).

With growth still led by industry, investment, and exports, along most dimensions the rebalancing desired by the government is clearly not happening. A key objective of the 11th Five Year Plan (FYP) is to change China's pattern of growth, making growth more technology and knowledge-driven, less driven by resources and capital accumulation, more equal, and more environmentally friendly. In several dimensions, the developments in the first half of 2006 are at odds with these objectives. As discussed above, the share of industry in the economy has increased, as opposed to declined, and the share of services in the economy has declined, as opposed to increased. As also discussed, urban incomes appear to have grown faster than rural incomes, widening further the urban-rural income inequality. In the areas of environmental degradation, pollution, and resource use, data is not yet available. However, energy consumption per unit of GDP went up 0.8 percent in the first half, at odds with the plan to have it reduced by 4 percent this year, and 20 percent in the FYP period. With GDP growth

Figure 7. Real estate prices slow down



Source: NBS, and staff calculations.

also much higher than projected, total energy consumption was significantly higher than targeted/projected.

With economic growth very high, progress is made with urbanization and urban job creation. Urbanization in China is still low, compared to countries with similar income levels, and during the last five years the pace of urbanization and urban job creation is not as fast as it was in several other rapidly growing Asian countries when they had comparable income levels. Nevertheless, economic growth is currently so fast that urbanization and urban job creation has been significant. Between end-2000 and end-2005, the urban population increased by over 100 million to 562 million (or 43 percent of the total population), with much of the increase coming from rural-urban migration.⁹ During this period, urban employment rose by 42 million, or about 3.4 percent per year. Registered urban unemployment increased from 6 million in end-2000 to 8.4 million currently. However, this is largely due to labor shedding by SOEs, as opposed to migration. In the first half of 2006, 6 million urban jobs were created, 60 percent of the government's target for the year. The private sector created 5.9 million jobs in the first quarter, far more than the number of jobs shedded by state owned and collective enterprises, 2.6 million.

ECONOMIC PROSPECTS AND POLICIES

Global prospects remain broadly favorable, and more balanced across countries. Signs of slowing activity in the US, the most important export market for China, are becoming much more apparent. At the same time, European growth is accelerating modestly and Japanese growth remains firm. This picture is confirmed by recent readings of the OECD's leading indicator, a barometer for prospects in China's developed country trading partners—and thus important for export prospects. Such a shifting of growth could on the one hand ameliorate long-standing concerns about global imbalances and over-reliance on US demand, but a sharper than expected slowdown in the US could affect China's prospects as well as those of the rest of the world. Recent months have seen another oil price hike to levels that are, in real terms, unprecedented since the second half of the 1970s. Global economic growth has so far been resilient to higher oil prices, although concerns are that there are limits to this resilience. Non-oil commodity prices—for China equally, if not more important than oil prices—have been volatile, recently recovering from an earlier sell-off. Prices of some

Table 1. Global conditions remain favorable.

(change, in percent, unless otherwise indicated)

	2004	2005	2006f
World GDP (market exchange rates)	4.1	3.6	3.7
High income countries	3.3	2.8	3.0
Developing countries	7.1	6.4	6.3
World trade (volume)	12	9	11
Consumer prices G7 countries	1.7	2.2	2.0
Non-oil commodity Prices (US\$)	17	13	6
Oil Price (US\$ per barrel)	38	53	64
US\$ interest rate, 6 month (%)	1.7	3.6	5.1

Source: World Bank DEC Prospects Group (July 2006).

⁹ The population data is from the census. The employment data is from the employment statistics.

commodities have reached new highs. However, overall the rate of price change has diminished over time, and the World Bank expects this to hold for 2006 as a whole (Table 1). Overall price pressures in developed countries have remained modest to date. But expectations are for some increase in price pressures, which would lead to some global liquidity tightening, after years of accommodative monetary conditions.

However, the number of sources of global risks has increased. On the economic front, disorderly adjustment of the “global imbalances”—large current account deficits in some countries, including the US, and large surpluses, including China and oil producer countries—remains a key risk. Other risks factors include a sharper-than-expected slowdown in the US and even higher oil prices. In addition, there are risks that any of the several political and military conflicts, including in the Middle East, could escalate further. Materialization of these risks may lead to financial turmoil and exchange rate volatility, tighter monetary conditions and higher world interest rates than expected, and lower global growth.

In China, the economy is likely to slow down somewhat in the second half of 2006, provided that the recent cooling measures will be effective. Favorable domestic economic conditions include a sound macroeconomic and financial setting and strong investor confidence.¹⁰ With profit growth picking up and still ample liquidity in the banking system, investment growth will remain strong, although it should weaken from the high growth rates in the first half of 2006 as a result of the tightening measures already taken. Consumption should continue to benefit from rising incomes, particularly in urban areas, and should be more robust than investment to the tightening measures. Taken together, we expect domestic demand growth in the rest of the year to retain the pace of the first half. With the gradual slowdown in exports projected to continue, we expect the contribution of net trade to growth to diminish. This scenario would imply a slight slowdown in GDP growth to under 10 percent at the end of 2006, resulting in growth of 10.4 percent for the year as a whole, and 9.3 percent in 2007 (Table 2). Inflation should on balance remain subdued, and we expect another large increase in the current account surplus in 2006.

China’s policymakers face short term and long term challenges. In the short-term, the rapid growth of credit and investment since early 2006 has intensified concerns about a too relaxed monetary stance and the risk of a future rise in non-performing loans that such a stance entails. Regarding the real economy, concerns are voiced on overcapacity and “overheating” of certain sectors, including real estate, although the economy does not show the symptoms of generalized overheating. However, the surging trade surplus, which is leading to trade tension with major trade partners, cannot be ignored, and lower investment growth without more consumption growth would result in even higher surpluses. Since end-April the authorities have implemented a series of measures to reduce banking system liquidity and contain investment (see below). A key question going forward is what their impact will be on investment and the trade surplus. From a longer-term perspective,

¹⁰ Standards and Poor’s cited strong macroeconomic conditions and a good record of reform as the key reasons behind the end-July upgrade of its rating for China’s long-term sovereign debt from A- to A.

Table 2. China: Main Economic Indicators

	2003	2004	2005	2006 1/	2007 1/
The real economy (change in percent) 2/					
Real GDP (production side)	10.0	10.1	9.9	10.4	9.3
Exports (goods and services) 3/	26.8	28.4	24.8	20.8	15.5
Imports (goods and services) 3/	24.9	22.7	12.8	18.4	18.2
Consumer prices (period average)	1.2	3.9	1.8	1.9	2.1
GDP deflator	2.6	6.9	3.8	3.3	3.0
Fiscal accounts (percent of GDP) 4/					
Fiscal balance	-2.2	-1.3	-1.2	-0.9	-0.8
Total revenue	16.2	16.6	17.8	18.3	18.5
Total expenditure	18.3	18.0	19.0	19.2	19.3
External account (US\$ billions)					
Current account balance	46	69	161	220	193
As share of GDP (%)	2.8	3.6	7.1	8.3	6.3
Capital account balance (including errors & omissions)	71	138	47	42	40
of which: FDI (net)	47	53	68	65	60
Change in reserves (increase =+)	117	206	207	262	234
Foreign exchange reserves	403	610	819	1081	1315
Other					
Broad money growth (M2), e-o-p, in percent	19.6	14.6	17.6	17.0	15.0

Sources: NBS, PBC, Ministry of Finance, and staff estimates.

1/ Projection.

2/ Revised expenditure side components of GDP are not yet available. Estimation of these components require many arbitrary assumptions, including on how the price deflators changed.

3/ Estimates based on trade deflators for goods published by the Custom Administration.

4/ GFS basis; central and local governments, including all official external borrowing. The data are not adjusted for accumulation of arrears in tax rebates to exporters during 2000-2002, and the repayment of these arrears in 2004 and 2005. Such an adjustment would increase the deficit in 2000-02 and lower it in 2004-05.

the challenge remains how to bring about the desired rebalancing of the pattern of growth. The desired shift in production from industry towards services, more reliance on domestic demand, more equally shared growth and more environmentally sustainable growth that are aimed for in the 11th FYP is yet to begin. Box 4 (below) discusses ways of measuring sustainability in China.

The challenges need to be addressed by a combination of monetary and exchange rate policy, fiscal policy, as well as institutional reform. In the short term, reining in credit, investment, and the trade surplus calls for a key role of monetary and exchange rate policy. There may not be much of a role of fiscal policy in short-term demand management. Administrative measures remain part of the authorities' toolkit. However, their impact is likely to be larger in the short term than in the long term. Indeed, with investment

increasingly from commercialized companies, market-based measures are likely to become more potent over time, and thus more important. With regard to the longer-term challenges, the role of fiscal policy in rebalancing the economy and striving to a harmonious society is so prominent and demanding that it deserves to be the sole focus of fiscal policy making. In the area of monetary and exchange rate policy the government's longer term strategy includes a more flexible exchange rate, which will allow monetary policy to be geared to domestic considerations, and financial market reform.

The package of policies that would promote a rebalancing of the economy includes several types of measures. First, measures to stimulate domestic consumption, reduce the saving-investment surplus, and increase the efficiency of investment. Second, measures to increase the relative attractiveness of producing services (non tradables) over manufacturing production (tradables). And third, institutional reforms to give local decision makers the incentives to actually pursue a rebalancing of the economy.

There is overlap between the short and long term challenges and synergy between the impact of different policies. Shifting the composition of growth away from investment and exports towards consumption would help address the short term challenges. Indeed, some elements of the long-term rebalancing package are also useful in containing investment now, including shifting the composition of fiscal spending away from capital spending towards education, health, and social security. In all, the sooner the rebalancing starts, the better, also for dealing with the short term challenges.

Macro management—a key role for monetary and exchange rate policy

The authorities have taken a series of steps to contain liquidity in the banking system and contain credit growth. At the end of April, the PBC raised lending rates by 27 basis points and tightened measures to guide banks' credit policies. To reinforce this "window guidance," low-interest rate "penalty bonds" have been issued to banks that were considered not to have followed the window guidance, a measure that seems at odds with the authorities' aim to commercialize the banking system.¹¹ Meanwhile, the PBC stepped up sterilization of the liquidity inflow from the balances of payments via issuance of central bank bills. Net issuance (gross issuance net of maturing paper) in the first half was around RMB 860 billion, compared with about RMB 680 billion in the first half of 2005, and compared to around RMB 920 billion increase from the balance of payment. This kept base money growth down to around 8 percent (yoy) in February-May. Moreover, effective on July 5, the PBC further mopped up RMB 150 billion by raising the required reserve ratio 0.5 percentage points. And on July 21 it announced it will raise the required reserve ratio by another 0.5 percentage point effective on August 15.

¹¹ The bonds were issued to those banks that had the highest credit growth. Provided that prudential standards were met by these banks, they were the most successful in a commercializing environment, but are now punished. In contrast, an increase in the reserve requirement, as was also implemented, affects all banks in equal measures. Further, the interest rate on the penalty bonds is below market prices: for instance, the interest rate on the latest earmarked bill issued to Bank of China was about half percentage point lower than that of other central bank bills.

These measures were supplemented by administrative measures targeting the real estate sector and new investment projects. The measures in the real estate sector target speculation rather than the overall real estate market and include: (i) a higher down payment ratio for the purchase of second houses; (ii) a 20 percent capital gains-type income tax on the sale of second-hand property, as well as a 5.5 percent transaction tax on the sale of second-hand property within five years of purchase; (iii) more transparency in the real estate market by requiring local governments to release sales information; (iv) restrictions on the purchase of property by foreigners: foreign nationals can now only buy a house for self-occupancy after residing in China for a year, whereas before no such restriction existed; and (v) an increase in the capital requirement for large projects (over US\$ 10 million) of overseas' developers from 30 to 50 percent of total investment. The measures targeting new investment projects include: (i) reinforcement of existing controls and regulations, including, prominently, by asking local governments to re-examine new projects to ensure that projects strictly adhere to all standards and criteria and to postpone or cancel those that fail one of the criteria;¹² (ii) higher standards, particularly environment standards; (iii) tighter land supply policy; (iv) creation of regional inspection bureaus to ensure enforcement of national land use regulations; and (v) redefinition of revenues from the transfer of land use as part of local government budgets, as opposed to local land departments' extrabudgetary funds.

The measures seem to have started to affect monetary aggregates and centrally-monitored projects. M2 growth declined from 19.1 percent (yoy) in May to 18.4 percent in June and July, although credit growth remained firm through July.¹³ The lower liquidity, as well as the resumption of IPOs in the A-share market, drove up the interest rate on one-year central bank bills from 1.9 percent at the start of the year to about 2.7 percent currently. The higher interbank rates are likely to do more to reduce credit than the increase in lending rates, which makes it more profitable for banks to lend. Nevertheless, after a prolonged period of easy monetary policy, it will take time for the monetary measures to have an impact. With abundant bank liquidity at the core of rapid credit growth, continuing mopping up liquidity remains necessary. This is important because, even if the real economy concerns seem manageable, financial risks remain, especially in real estate, and excessive credit expansion may lead to problems down the road. There are indications that the administrative controls have started to bite, and some centrally-monitored investment projects have been cancelled or postponed recently.

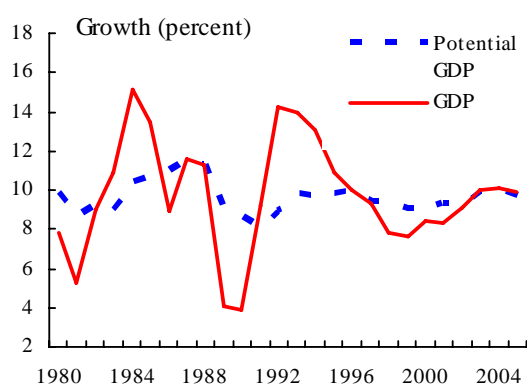
The authorities may decide to await further evidence of the effectiveness of recent measures before deploying more expenditure-reducing measures. There are several reasons for such a stance. First, while growth is very fast, China does not experience problems usually associated with "overheating": high inflation, high current account deficits, and widespread bottlenecks in the economy. China's rapid growth in demand is matched by a rapid expansion of the capacity to produce (Figure 8). Relatedly, rapid

¹² The circular issued by the NDRC, jointly with 4 other ministries, in early August lists the criteria: industrial policy, approval rules, land policy, environmental impact, and credit policy. It applies to all investment projects of RMB 100 million or more, with lower thresholds in specific sectors.

¹³ The impact of window guidance can perhaps be observed from the low share in June lending of the 4 large state-owned banks, whose credit policies are easier guided than those of smaller banks.

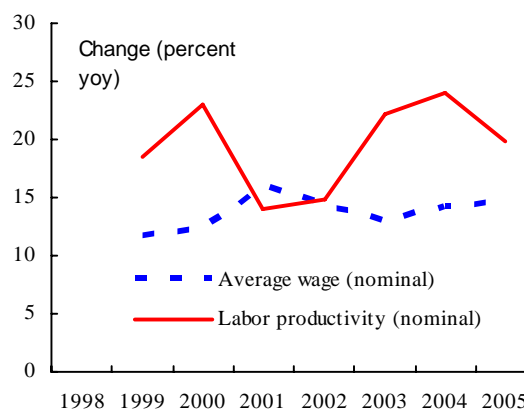
productivity growth sustains profitability in industry (Figure 9). Thus, from a macroeconomic perspective, the need to slow down the real economy significantly is not clear-cut.¹⁴ Rather, the blistering pace of investment increases concerns about its efficiency, future non-performing loans in the banking system and the lack of rebalancing. Second, the external current account surplus is very high and rising. This is complicating monetary policy and may create trade tensions internationally. Significant tightening of domestic demand without rebalancing growth would aggravate the external imbalance.

Figure 8. GDP grows in line with potential



Source: NBS, staff calculation.

Figure 9. Productivity in industry outpaces wages



Source: NBS, staff calculation.

The recent exchange rate strengthening against the dollar, if continued, would bring about desirable *expenditure switching*. A stronger exchange rate dampens domestic growth somewhat and addresses the current account surplus at the same time. A stronger exchange rate would also raise the attractiveness of investing in the non-tradables sector, thus helping rebalancing. Further, a stronger exchange rate would, by lowering expected future appreciation, likely mitigate capital inflows. While these inflows dropped sharply in June, the fear of them continues to be a major constraint on monetary policy. While domestic considerations call for less abundant bank liquidity, the PBC appears to remain reluctant to let interbank interest rates rise above the current level of 2.8 percent, although the interest sensitivity of these non-FDI inflows may be lower than commonly assumed.¹⁵

A change in the overall fiscal stance is currently less obvious. The fiscal position was consolidated further in the first half of the year. Tax revenues (excluding tariff, agriculture land occupation tax and deed tax) were up 22 percent as a result of strong economic growth. Corporate income taxes were particularly buoyant. Expenditure growth declined from 21 percent (yoy) in the first quarter to 17 percent in the first 5 months of 2006, with capital construction spending down (yoy) in April and May. With fiscal revenue outpaces

¹⁴ Also, there may be less overcapacity and overproduction in China than is often suggested (see our May Quarterly Update (Box 2)).

¹⁵ In early August, the PBC appears to have signaled this by conducting its first “volume auction” of central bank bills since 2004, with a pre-set fixed interest of just below 2.8 percent.

expenditure, the fiscal deficit for year 2006 would, on current trends, further narrow from last year's 1.5 percent of GDP. In current circumstances, there is no clear case for either tightening or expanding fiscal policy. Tighter fiscal policy may, if well-targeted, help reduce domestic demand. But by itself this would increase the current account surplus, which is, in current circumstances not desirable.¹⁶ Moreover, using fiscal policy for this purpose is difficult—relying on good fiscal information and strong control over total fiscal spending by the Ministry of Finance—which is why policymakers may decide against it. Indeed, Ministry of Finance officials have said that fiscal policy will not be used to cool the economy, leaving that to monetary policy. Whatever decisions are made on the fiscal policy stance, it is essential to coordinate them closely with monetary policy. On the other hand, if the external environment, and notably the US economy, deteriorates, China would have sufficient macroeconomic stability and fiscal flexibility to boost domestic demand when needed.

Rebalancing—a key role for fiscal policy

Changing the composition of expenditures is on the agenda. A recent round table on Public Finance for a Harmonious Society agreed with the government that rebalancing the composition of spending towards health, education, and social spending is important for attaining a harmonious society (Box 5). More of the government budget has been spent on pensions and social relief (up by 27 percent in January-May (yoy)) and innovation (up 26 percent yoy), while expenditure for capital construction increased only 8 percent (yoy). In contrast, expenditures on education and health grew 15 percent (yoy) in the first five months, lagging total expenditures. The recently released reform strategy on income distribution made progress in suggestion introducing incentive mechanisms for the public and quasi-public sectors and providing more finance support to vulnerable groups, and there have also been discussion on reining in wages in monopoly industries such as electricity. However, the reform strategy emphasized public sector salary issues and did not address issues of overall income distribution and inequality, urban-rural inequality, and access to public goods and services, particularly education and health care. On the tax side, the reduction of the VAT export rebates for energy intensive products such as steel and aluminum supports rebalancing by making investing in such industries less attractive. At the same time, this measure brings new distortions, and, unlike an excise tax, leaves production of energy-intensive goods for the domestic market unaffected. Finally, the measure to include land revenues in the local government budget, rather than as part of the extrabudgetary funds managed by the land bureau, could improve the governance of these funds and reduce the incentive to pursue a land-intensive development pattern.

Several further fiscal measures would support rebalancing. These include: (i) unifying the domestic and foreign enterprise income tax, which would eliminate the tax advantages of export-oriented, predominantly foreign-financed industries; (ii) establishing a dividend policy for State-Owned Enterprises to reduce their abundant investment capital; (iii) increasing the prices of and taxes on inputs into manufacturing—land, energy, water,

¹⁶ On the other hand, while it may under certain circumstances be helpful to flank a monetary tightening and/or exchange rate appreciation with a fiscal easing, a fiscal easing on its own may not be appropriate now, in circumstances of concerns about too rapid growth.

utilities, and the environment—aligning them with relative scarcities and social costs and (iv) expanding the VAT to the services sector. The latter measure seemingly contradicts the government's efforts to promote services as a source of growth. However, because most economic decisions are influenced by local rather than central government, it is important to provide local governments with a fiscal incentive to promote this sector—namely the local share in VAT revenues.

Other structural policies are also on the agenda. Beyond fiscal policies, further financial sector reform, which will improve the allocation and productivity of capital, would support rebalancing, and would maintain growth with less investment. In addition, some of the drivers of the current mode of growth and investment, including local government behavior, have institutional roots and can only be addressed by institutional reform. Central to these is the performance evaluation of local officials, which is currently under debate. Evaluation criteria were until now fairly narrowly focused on growth, but recent experiments, among others in Zhejiang province, have started to reform the system to include criteria more related to a rebalanced economy.¹⁷ In Zhejiang, the provincial authorities have included the goal of reducing the energy intensity of the economy in the performance of local officials. While laudable, there is some issue as to whether the local officials have control over such a variable, or, indeed, the policy levers to influence such a variable. Because energy pricing and energy taxation is controlled by the central government, local officials can only avail themselves of planning tools and the investment approval system to achieve the energy intensity targets, and this may not always be optimal.

FINANCIAL SECTOR POLICIES AND DEVELOPMENTS

The recent progress on credit reporting systems (CRSs) is welcome, given how important CRSs are to the functioning of the financial system. They provide rapid access to accurate and reliable standardized information on potential borrowers (individuals or corporate), and are key in enhancing the risk management capacity of financial institutions while extending credits to private sectors, especially SMEs. The first phase of the development of the credit reporting system was completed in June 2006 with the launching of a corporate credit information database (CID) by the PBC. This follows a pilot consumer CID, also initiated by the PBC, involving 15 nation-wide commercial banks and 8 city commercial banks located in Shanghai, Tianjin, Zhejiang Province and Fuzhou. In May 2006, the PBC agreed with utilities companies for them to share payment information of utilities in major cities. So far, the public registry on consumers includes information on bank loans, credit cards, motor finance, telecom and utilities, and insurance.

Legal and regulatory backing is necessary to improve the effectiveness of the credit reporting system in China. The operation of consumer credit reporting database is now guided by a “Provisional Measure” issued by the PBC in August 2005. However, this

¹⁷ Traditionally, performance criteria have been economic growth, FDI, unemployment, social stability and population control.

provisional directive will not provide the legal and regulatory power needed for the Central Bank to effectively regulate and supervise the Credit Reporting industry, which is yet to be developed, in China. A higher level law or regulation on Credit Reporting needs to be developed in China to specify the rules on protection of personal information, credit information disclosure, power and function of the supervisory authority, rights and obligations of the members of credit bureau and the rights of access by borrowers, etc. International evidence shows that the legal and regulatory framework for data protection and credit reporting has an enormous impact on how a credit reporting industry develops.

CORPORATE SECTOR POLICIES AND DEVELOPMENTS

There is progress in reforming corporate governance of large SOE groups. The State Assets Supervision and Administration Commission (SASAC), the shareholder agency of the State Council, has allowed 16 wholly state-owned and state-controlled enterprises (SOEs) to experiment with creating boards of directors, and 7 of them have put in place 25 external directors in their boards. SASAC seems prepared to delegate some decision making power to boards of directors that follow its guidelines and are regarded as well functioning (*guifan*). A SASAC Decree issued in end-June, which requires all state owned and control enterprises under its supervision to submit annual investment plans for review and record, those that have set up well-functioning boards are differentiated from others.¹⁸ SASAC's focus on board of directors is commendable. Improving the efficiency of large strategic SOEs by strengthening state ownership function and improving corporate governance will only succeed if these enterprise are managed as modern companies by strong and well-functioning boards of directors. SASAC's caution in delegating power is well justified as a way to avoid failure, but delegation is the right way forward.

A proposal of amendments to the Partnership Enterprise Law was submitted to the National People's Congress (NPC) for review in April. One of the key amendments was an addition of limited partnership as one more form of partnership enterprise. This is intended to promote the development of venture capital industry in China. Limited partnership allows a differentiated allocation of risks, returns and power among two categories of investors, those who contribute expertise in fund management together with money, and those who contribute only money. It provides a standardized contract for them to collaborate. NPC's approval of this amendment would surely broaden the stage for potential entrepreneurs and investors. Its impact would be fully realized if improvements of the investment climate in many other aspects are also achieved.

¹⁸ <http://www.sasac.gov.cn/gzjg/zcfg/200607060137.htm>

Box 4. Measuring sustainability in China

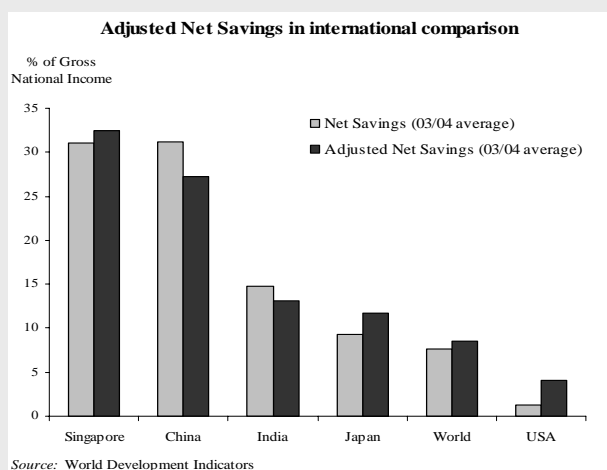
Defining and measuring sustainability is challenging but fundamental. Subsequent to the Brundtland Commission's path-breaking work on sustainability back in 1987, researchers have proposed various approaches to assess the sustainability of a country's development. These indicators suggest different conclusions on China's performance, depending on which aspects of sustainability are emphasized.

The Environmental Sustainability Index (ESI) 2005, focusing on the environmental component of sustainability, ranks China 133rd of 146 included countries. This index, developed by Yale and Columbia University, ranks countries based on indices comprising numerous indicators related to the environment, not including economic and social aspects. It finds China is relatively weak in the sustainability of water use, air pollution, and emission of acid rain and greenhouse causing gases, as well as in resource and waste management, and environmental governance. The areas where China is found to be weak have been identified by others and China's low overall rank could be interpreted as an alarming indication of the country's environmentally unsustainable development.



The World Bank's indicator of adjusted net savings, augmenting economic sustainability with resource depletion, environmental degradation, and human capital formation, gives a more favorable rating.² The indicator links sustainability with changes in net economic wealth (saving), broadly defined and adjusted. High positive adjusted net saving rates are seen as indicating sustainable growth, one that does not compromise future generations' well-being.³ China has since the early 1970s had high financial saving, which has boosted economic growth to the benefit of following generations. Until the early 1990s, energy depletion implied much lower adjusted net saving, in part because of high international energy prices (see Figure).⁴ As energy efficiency improved, the negative adjustment shrank over time (also affected by lower energy prices after the peak in the early 1980s, until recently).

As a result, China now ranks 3rd in international comparisons. However, energy depletion levels are still relatively high. Moreover, public education expenditures are low. Thus, whereas in most developed countries adjusted saving is higher than unadjusted saving, in China, as in many other developing countries, this is the other way around (Bar chart). This measurement indicates that China's economic growth pattern is less sustainable than suggested by the narrowly defined national saving. It also suggests that further decreases in energy (and other) resource depletion and emission, and increases in public spending on education, will help to improve the sustainability of China's growth.



¹ The full report including all data can be found at <http://www.yale.edu/esi/>

² Hamilton (2003) – *Accounting for Sustainability* (www.oecd.org/dataoecd/18/53/2713847.doc) provides an overview on sustainability indicators with an introduction into the adjusted net savings measure. The conceptual framework appears in Hamilton and Clemens (1999) – *Genuine Savings Rates in Developing Countries*

³ Adjusted net saving (Net changes in wealth) = Net domestic savings – energy depletion – mineral depletion – net forest depletion – particulate emissions – CO₂ damage + public education expenditure.

⁴ Resource depletion is monetized by valuating quantities with the “total resource rent”, the difference between world prices and the domestic cost of production. This makes the saving adjustment quite sensitive to the world prices of resources.

Box 5. Public Finance for a Harmonious Society

On June 26 and 27 2006, domestic and international experts debated the implications for Public Finances of creating a Harmonious Society at the Diaoyutai State Guesthouse. The meeting acknowledged that over the last decade China has made considerable progress in shoring up public finances, which were in a precarious state in the mid-1990s. The 1994 fiscal reforms have reversed the unsustainable trend of ever lower budget revenues and an ever lower share of the central government in those revenues. Indeed, including extra budgetary and social security funds China's government spending is now some 25 percent of GDP, comparable to the lower income OECD countries, and higher than most East Asian countries.

The role of the state is likely to further evolve in pursuit of the Harmonious Society. Public Finances are a reflection of the role of the state in society. The Harmonious Society will still see rapid economic growth, but growth that is more balanced, more equitable, and more environmentally sustainable. The Harmonious Society therefore requires a government that is less focused on investment and growth per se, and more concerned about the quality of growth and how growth benefits various parts of the population. The meeting debated the appropriate size of government in the Harmonious Society. Some argued that China's government, with 25 percent of GDP in fiscal resources, is already large enough. Others noted that only budgetary resources, amounting to 18 percent of GDP, should be considered as available for allocation and that therefore more tax revenues are needed over time. In deciding on the size of government it should be considered that any revenue raised has opportunity costs, and bring distortions into the economy, which, if too high, could slow down growth.

China's revenue structure can be better aligned with the goals of the Harmonious Society. This is irrespective of whether China needs more fiscal resources. Broadly, taxing more pollutants, natural resources, and services could realign incentives to create more balanced growth that is less resource intensive. Merging the foreign and domestic enterprise income tax and levying dividends on State-Owned Enterprises (SOEs) would slow unbridled investment, and would increase incentives for investment catering to the domestic economy.

Reallocating resources towards more social spending was considered to be important. Budgetary spending on health and education is relatively low in China: the budget only allocates 0.6 percent of GDP on health, and 2.8 percent of GDP on education. The average OECD government spends 6 percent of GDP on health, while East Asian countries such as Japan and Korea spend 6.4 percent and 2.8 percent of GDP. The average OECD government spends 4.5 percent of GDP on education, and Japan and Korea 6 percent and 4.2 percent of GDP. The meeting agreed that higher allocations to health and education would promote growth based more on human capital than on physical capital and avoid excessive income inequality. However, higher spending would only result in better outcomes with sound sector policies and strong institutions in place.

The meeting debated the role of public finance in income distribution and social security. Much of the difference between China and OECD countries in the size and composition of government lies in social security. China should make its own choices as to the design of a social security system and safety net, and how redistributive this should be. Lessons from the experience in OECD countries include: (i) a social security system should be able to withstand downturns in the economy as well as good times, and financial sustainability should be on the policymakers' mind from the onset of such a system; (ii) *marginal* rates of taxation and social security contribution should not be so high as to discourage work effort—be it by the better off, or by those receiving benefits; (iii) a social security system should not discourage the mobility of people from one job to the other nor from one region to the other. There was broad agreement that social security can best be managed by the province or center, rather than by the county or municipality as done currently.

There was consensus that sectoral or regional reallocation of public finances would only lead to better services with stronger institutions and accountability. Improving institutions and accountability is probably one of the most difficult challenges in establishing the Harmonious Society, and goes well beyond the fiscal system. Options to increase accountability and transparency that were discussed include: (i) more fiscal reporting and transparency at all levels of governments; (ii) clearer assignment of responsibility to all levels of government. (iii) use of conditional grants as an instrument to improve local government accountability to higher levels of government; (iv) benchmarking local governments—comparing performance across local governments to inform people and businesses on which government does well, and which does not. (v) public participation in budget processes, hearings on budget, and community participation in village based projects; and (vi) better financial management and accountability at all levels of government.

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* These studies are available online at <http://www.worldbank.org/china>.