World Bank Office, Beijing

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Quarterly Update

November 2005

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 and the Development Economics Department. Questions and feedback can be addressed to Li Li (lli2@worldbank.org)

OVERVIEW

Economic growth has been higher than expected, in part due to more rapid domestic demand growth. Reversing the pattern of the first half of 2005, domestic demand appears to have rebounded in the third quarter—reflecting both stronger investment and stronger consumption—while the contribution of net external trade declined. As a result, GDP growth slowed only slightly to 9.4 percent (yoy), after 9.5 percent in the first half of the year.

Recent developments point to a very slight moderation of growth in the coming year. Against a background of a favorable macro economic and financial setting, we project GDP growth of 9.3 percent in 2005 and 8.7 percent in 2006, low inflation, and—with domestic demand driving growth again—a decline in the current account surplus in 2006, after a projected record surplus of over 6 percent of GDP in 2005. However, a two-way risk is formed by considerable uncertainty about enterprises' investment behavior.

Under current circumstances, more rapid growth in credit and investment would be unwelcome. Stronger domestic demand from either consumption or investment would reduce the current account surplus that is complicating monetary policy and trade relations. However, investment is already considered too high—concerns about overinvestment had triggered the tightening measures in 2004. Recent indicators suggest that the renewed pick up in domestic demand is at least in part due to stronger investment, including in industries with downward price pressures due to over supply. Indeed, investment is likely to continue to grow faster than consumption into 2006, and policy measures may be required to dampen investment. Capital inflows appear to have eased in the wake of the change in the exchange rate regime in July, due in part to a PBC policy of allowing foreign surpluses to partly spill over in bank liquidity in order to drive down market interest rates. So far, the increased bank liquidity has not led to increased credit growth. But there is a risk that the additional liquidity could lead to another investment upturn.

Changing the pattern of growth is high on the agenda. The 5th plenary session of the 16th Central Committee of the CPC held in October discussed changing China's pattern of growth, moving to growth that is less resource-intensive, more "knowledge-driven" (that is, through higher efficiency), and more equally-shared. The pattern of growth can be transformed in this direction by rebalancing growth to sectors that require less capital, energy, and resources but generate more urban employment, while improving the efficiency of capital. This will require among others further financial sector reform, better corporate governance, a dividend policy for state enterprises, a larger role for private sector firms, and liberalizing restrictions hindering the development of the services industry and labor movements. These measures need to be flanked by public finance measures that strengthen the role of the government in education, health, and the social safety net—both to further a "harmonious society" and to boost household consumption—and use the tax system to adjust energy and resources use in line with scarcities and social preferences. With health sector reform key, this Quarterly Update has a Special Focus section on Reforming China's Health System.

RECENT ECONOMIC DEVELOPMENTS: DOMESTIC RESURGENCE?

High growth is holding up, supported by rebounding domestic demand. A recovery of domestic demand in the third quarter seems to reflect both stronger investment and stronger consumption. The resurgence in investment in part reflects a fading out of the impact of the slowdown triggered by the policy tightening since May 2004. The contribution of external trade to growth, while still substantial in the third quarter of 2005, dropped from the very high level in the first half of the year. The overall result was a milder-than-expected slowdown in GDP growth to 9.4 percent (yoy), after 9.5 percent in the first half. Domestic demand accounted for some 75 percent of growth in the third quarter, compared to 40 percent in the first half of the year (Figure 1).[1]

Fixed asset investment (FAI) has unexpectedly rebounded. Nominal FAI growth picked up to 28.5 percent (yoy) in the third quarter, from 26.4 percent in the first half (Figure 2), despite moderate credit growth and profit growth that is considerably below that of last year (Figure 3).[2] The rebound was led by investment in manufacturing, especially the consumer goods, natural resource processing, and export-oriented industries. Several indicators suggest that the construction sector picked up steam again since June, including floor space under construction and buildings completed and sold, as well as households' non-consumption expenditures. However, FAI in the real estate sector continued to slow through August. Industrial production has remained strong, growing 16.2 percent (yoy) in the third quarter, slightly less than in the second quarter.

Consumer spending became stronger, although not yet enough to take over growth momentum from investment. Nominal retail sales have been growing steadily at 12.5-14 percent (yoy) since May 2004, with declining consumer price inflation allowing for the pick up in real retail sales growth (Figure 4). Household survey data on "living expenditure" may be a better proxy for private consumption (see Box 2). Urban households' per capita "living expenditure", which had been affected by the policy tightening measures, recovered early this year and has been growing at around 10-11 percent (yoy) in recent months, slightly slower than per capita urban income (Figure 4). Large increases in rural household incomes boosted overall household incomes and consumption: nation-wide household incomes grew almost 16 percent (yoy), in nominal terms, in the first 9 months of 2005. Consistent with these developments, and some recovery in bank lending to households, car sales—which were also hit by the 2004 tightening measures—have rebounded sharply since early summer.

Recent trade patterns are in line with buoyant domestic activity. Export growth averaged over 30 percent in the first 8 months (yoy), in US$, but dropped to 26 percent in September, whereas import growth is on the rise (Figure 5). During the second half of

[1] A note of caution is that analysis of the direction of the economy is clouded by the caveats with China's macroeconomic data. A key issue is that the monthly indicators on domestic demand—retail sales and FAI—are not always consistent with trends derived from combining the GDP data with the trade data.

[2] As illustrated in Box 1 of the August 2005 Quarterly Update, while FAI data is indicative of investment trends, the internationally-comparable national account-based investment growth has in recent years been significantly lower than FAI growth. FAI deflators are published only semi-annually.

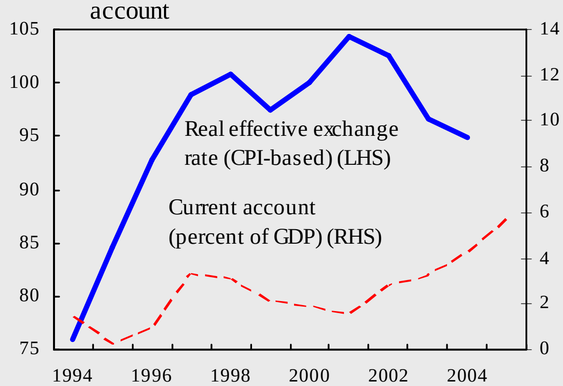
2004 and the first half of 2005, weakness in domestic demand triggered by the policy tightening had significantly affected imports, in particular steel, chemicals, and machinery and equipment. Recently, import growth recovered from 14 percent (yoy) in the first half to 24 percent in August-September. Steel imports—traditionally a good indicator for construction activity—also rebounded in September. These trade developments could mean that the surge in the trade surplus since 2004 has in part been cyclical (Box 1**),** but given the large gap between exports and imports it will take a sustained period of faster import growth relative to export growth to make a dent in the external surplus.

Consumer price inflation has slowed to 0.9 percent (yoy) in September, largely due to lower food prices. Core consumer price inflation remains low. PPI inflation has declined to 4.5 percent (yoy) in September, led by declining raw material price rises (Figure 6).

Box 1. The surge in the trade balance: exchange-rate based, structural, or cyclical?

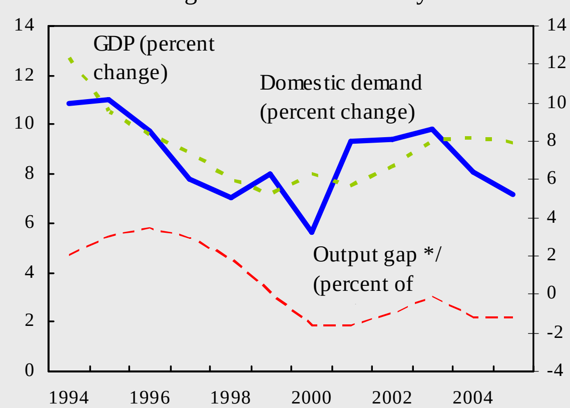
There are three factors behind the increase in China's trade balance in recent years. First, the depreciation of the real effective exchange rate since 2001, due largely to a weaker US$, to which the RMB was pegged (Figure 1). Second, a structural element: China's WTO entry has made the country more attractive to FDI, and at the same time, its more developed economy may be capable of sourcing a higher share of exports domestically. In addition, structural factors in China's economy may discourage consumption. To the extent that the surge is structural, it will continue and continue to complicate external relations and monetary policy. Third, a cyclical element. The decline in domestic demand that followed the tightening measures of 2004 decreased imports and stimulated companies to export goods for which domestic demand had fallen. Economists who emphasize the cyclical factor point to a precedent in 1997-98 when China's large current account surpluses coincided with very low growth of domestic demand after the previous boom (Figure 2).[1/] This view is supported by the observed rapid reduction in the contribution of (net) external trade to GDP growth in the third quarter of 2005 (see main text).

Figure 1. Exchange rate and current account



Sources: NBS, IMF IFS, and staff estimates

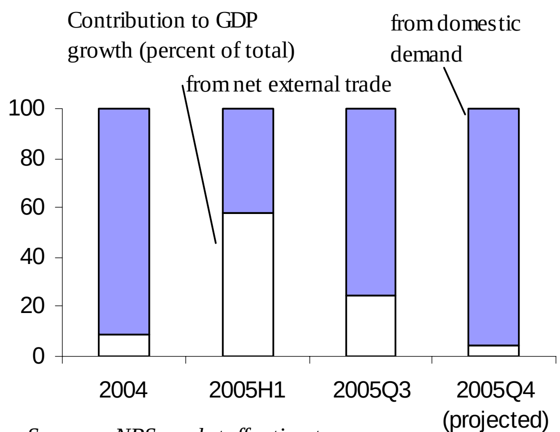
Figure 2. The domestic cycle



Sources: NBS, and staff estimates.
**/ Estimated using expenditure*

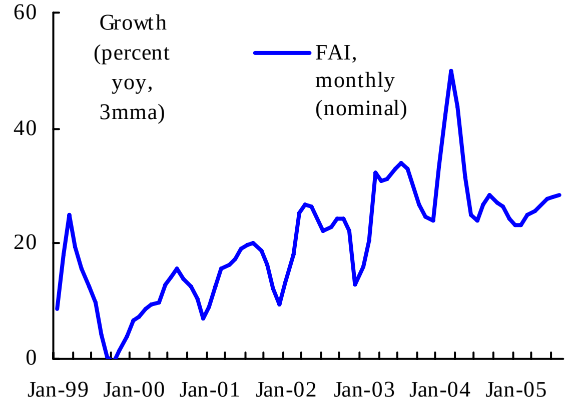
1/ The dip in domestic demand in 2000, apparently caused by an inventories correction, may have been too short to drive a large external trade response.

Figure 1. Domestic demand drives growth again



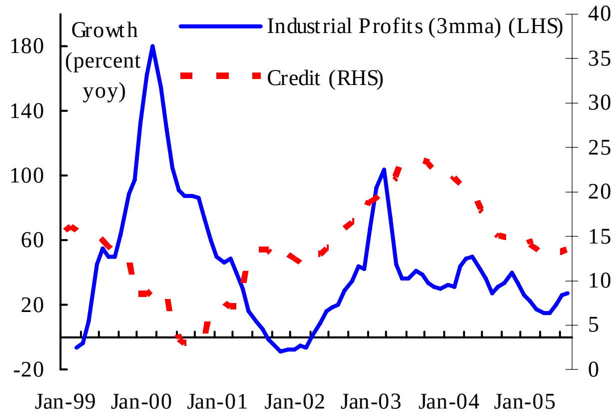
Sources: NBS, and staff estimates.

Figure. 2. Fixed asset investment rebounding



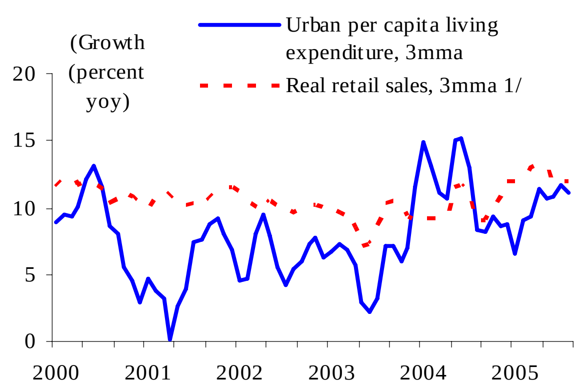
Source: NBS, staff calculation.

Figure 3. Investment funding eased to robust pace



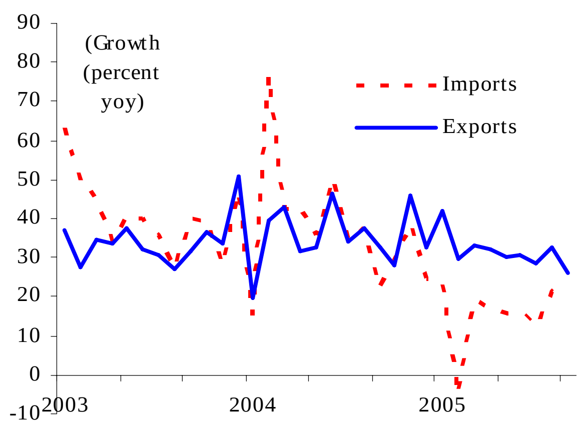
Source: Customs, staff calculation.

Figure 4. Consumption still trails investment



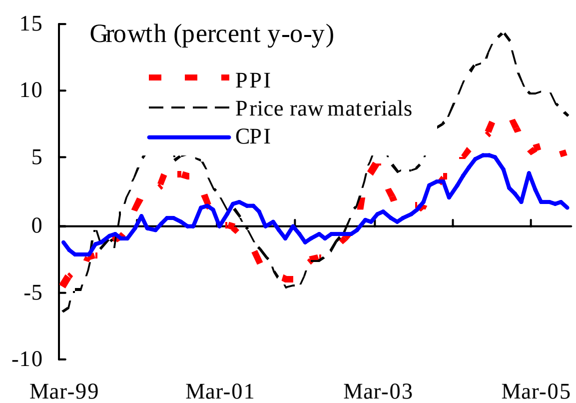
Source: Customs, staff calculation.

Figure 5. Net trade's contribution is coming down



Source:NBS, CEIC.

Figure 6. Inflation pressures have declined



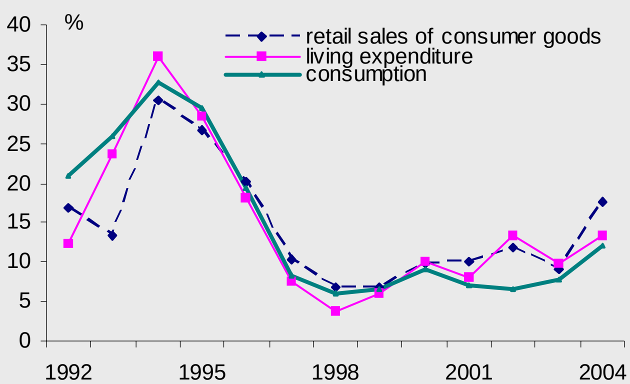
Source: NBS, CEIC, and staff estimates.

Box 2. The Household Survey: a better measure of consumption trends?

Retail sales are widely used as the key recent indicator for household consumption trends but they are not a very good proxy for household consumption (see August Quarterly, Box 1). The surveys on household living expenditure may provide a better one. The NBS publishes household survey data on household income and expenditure. The 36 cities urban household survey data are published monthly, and the rural household survey data are published quarterly. The national urban household survey data are published only yearly.

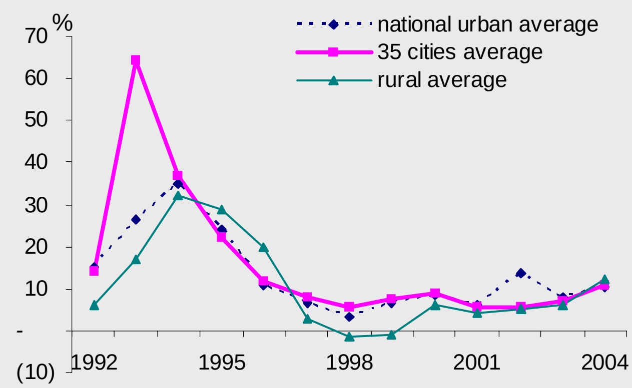
World Bank estimates suggest that in 2004 total national living expenditure was only 6 percent below household consumption expenditure in the national accounts, compared to an 8.6 percent gap for retail sales.[1/] More importantly, growth of total living expenditure has been a better proxy for household consumption growth (Figure 1). In principle, the usefulness of the household survey data is constrained by the fact the rural survey data is only available on a quarterly basis. However, in practice, the consumption measures from the three household expenditure survey series have grown at remarkably similar rates in recent years (Figure 2), which strengthens the case for using the monthly 35 cities survey for monitoring consumption.

Figure 1. Growth rate of household consumption



Data source: CEIC and staff estimation

Figure 2. Growth Rate of living expenditure per capita



Data source: CEIC

The treatment of housing services is the one key difference in data definition between the different surveys (Table). In national accounts it includes both the paid-in rent and the imputed rent of owner-occupied housing, but excludes housing purchases (which are treated as financial transactions). In the urban household survey it only includes the actually-paid rent, with the purchase of a house included in the non-living expenditure and no "imputed" (market) rent. In the rural household survey it includes paid-in rent and purchase of residence, but excludes imputed rent.

Table. Treatment of housing service

	Household consumption expenditure: National accounts	Living expenditure: Urban household survey	Living expenditure: Rural household survey
Paid rent	Yes	Yes	Yes
Imputed rent	Yes	No	No
Purchase of house	No	No	Yes

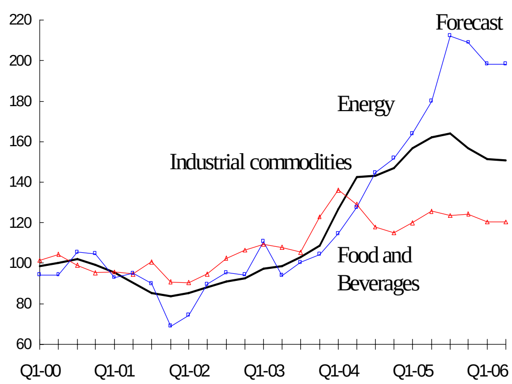
1/ Estimated combining the per capita data with population data.

THE ECONOMIC OUTLOOK REMAINS GOOD

The macroeconomic outlook remains favorable, with some export-led slowdown, and limited price pressures. We project GDP growth of 9.3 percent in 2005 and 8.7 percent in 2006, continued low inflation, and a decline in the current account surplus in 2006, after a projected record surplus of over 6 percent of GDP in 2005 (Table 1).

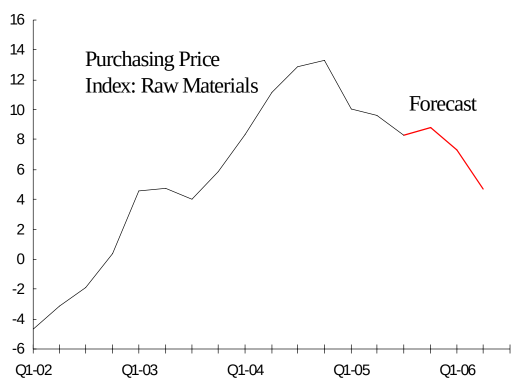
The international outlook is favorable, despite the oil price increases. Available indicators (of industrial production) suggest that the global slowdown is bottoming out, and consensus forecasts imply a moderate acceleration of global activity in the latter part of 2005 reaching trend growth of about 3 percent by mid-2006 in real terms. Nonetheless, China's exports should decelerate due to domestic *supply-side* effects including a leveling off of FDI, some exchange rate appreciation, tax measures taken to discourage energy-intensive exports, as well as a domestic demand recovery. The steep rise in key international commodity prices is projected to come to a halt (Figure 7)**.** On this basis, we project lower increases in China's raw materials purchasing price index, from 8.3 percent (yoy) in the third quarter to less than 5 percent by mid-2006 (Figure 8). Favorable commodity prices could provide a boost to China's resource-intensive economy, reversing the pressure on profit growth from the combination of rapidly rising commodity prices and very low "downstream" price increases.[3]

Figure 7. Commodity prices expected to have peaked (indices, 2000=100)



Sources: World Bank.
Note: Indices of primary commodities and iron and steel. Calculated using Chinese import weights for 2000.

Figure 8. China's raw material prices should decelerate (yoy growth, in percent)



Sources: NBS and World Bank estimates.

Domestically, key indicators suggest more moderate but still robust investment growth into 2006, with consumption likely to continue to lag investment. Overall credit growth—the key monetary variable for the real economy—has remained

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[3] Historically, the negative correlation between "upstream" prices (or the gap between upsteam and downsteam prices) and profits/profitability developments is weaker than often assumed, perhaps because both prices and profits are endogenous variables that increase in an upturn.

Table 1.China: Main Economic Indicators

	2002	2003	2004	2005 1/	2006 1/
The international setting (change in percent)					
World GDP growth		2.5	3.8	3.1	3.1
Export market growth (high income countries)		4.4	10.4	5.9	7.1
The real economy (change in percent) 2/					
Real GDP (production side)	8.3	9.5	9.5	9.3	8.7
Consumption	7.4	6.1	6.4	7.0	7.3
Gross capital formation	13.2	19.1	14.3	13.6	15.5
Fixed capital formation	14.1	19.9	16.8	14.8	13.0
Exports (goods and services) 3/	29.4	26.8	26.7	23.6	15.5
Imports (goods and services) 3/	27.5	24.8	25.2	15.5	19.9
Consumer prices (period average)	-0.8	1.2	3.9	2.0	2.0
Fiscal accounts (percent of GDP) 4/					
Fiscal balance	-3.4	-2.8	-1.7	-1.5	-1.0
Total revenue	18.2	18.7	20.5	20.0	20.9
Total expenditure	21.6	21.5	22.0	21.5	21.9
External account (US$ billions)					
Current account balance	35	46	69	123	105
Capital account balance	32	71	138	72	77
(including errors & ommissions)					
of which: FDI (net)	47	47	53	50	50
Change in reserves (increase =+)	76	117	206	195	182
Foreign exchange reserves	286	403	610	810	992
Other					
Broad money growth (M2), e-o-p, in percent	16.8	19.6	14.6	17.9	15.0

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

1/ Projection.

2/ The growth rates of the expenditure components of GDP are estimates and need not match to overall GDP growth rates, due to statistical discrepancies between the data from the expenditure and production sides.

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

4/ GFS basis; central and local governments, including all official external borrowing. The data includes repayment of arrears on VAT rebates. In 2004 these were RMB 127.5 bln (0.9 percent of GDP). Treating this as a "below the line" transaction would reduce the deficit--in 2004 by 0.9 percent of GDP.

unchanged at 13-14 percent (yoy) since end-2004, and credit to the corporate sector—key for investment—increased at a broadly similar pace, even though M2 growth has picked up (see below).[4] Industrial profit growth has come down from 38 percent in 2004, but has been stable at a respectable 20 percent (yoy) since June. Together, these developments suggest an easing of investment over time to a more sustainable but robust pace.

[4] Corporate financing via the short-term bonds market that opened in May has—on an annualized basis—been roughly equivalent to 1 percentage point additional credit growth. Corporate deposits continued to grow broadly in line with credit through September, suggesting that deposits drawdown has not been a financing channel.

Household consumption will be supported by recent high income growth. In addition, several tax initiatives (see below) should support household after-tax incomes in 2006. However, although rural peoples' non-farm income can continue growing rapidly, it may be difficult to sustain the recent speed of rural income growth because of the one-off nature of the impact of removing agricultural taxes and rural fees and increases in agricultural prices. Private consumption will probably not yet outpace GDP, whereas government consumption will almost certainly not. Policy measures to strengthen social safety nets, pension reform and health insurance could boost consumption, but implementing them will take time.

International risks are largely on the downside while domestic risks are upwards, on balance. Key international risks are potential weakness in US activity; impact on global activity from sustained high oil prices; and unexpectedly higher commodity prices, in part because of the impact of a stronger Chinese economy than currently expected on the international markets. Domestic risks are largely centered on corporate behavior. The risk that a profit squeeze would trigger a pronounced slowdown in investment and a wider economic slowdown seems small, given the stable macroeconomic environment, underlying growth potential, and favorable financial conditions. A perhaps larger risk is that investment would not be reigned in sufficiently in industries facing potential excess supply. A build-up of liquidity in the banking system amplifies this risk (see below). With enterprises sometimes more market share-oriented than profit-oriented, there is a risk of further pressure on prices, corporate sector balance sheet problems, and a new round of non-performing loans. A welcome upside risk is stronger-than-expected household consumption, while *avian influenza* represents a downward risk.

ECONOMIC POLICIES

The 5th plenary session of the 16th Central Committee of the CPC held in October confirmed that the communist party continues to be of the view that "economic development is the top priority", but wants development to be "comprehensive, harmonious, and sustainable".[5] This implies "stable and relatively fast economic growth", and the need to "step up the transformation of the economic growth pattern" towards growth that is less energy, resource and capital intensive, more knowledge and innovation-driven, and more equally shared among the population.[6] What does this mean for macroeconomic and structural policies?

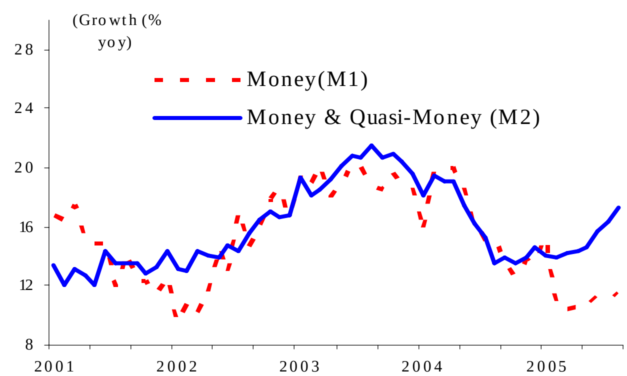
MACROECONOMIC POLICIES: HOW TO KEEP GROWTH RAPID AND STABLE?

Domestic demand and its composition are at the core of several policy debates. The recent rise in the external surplus—the balance between saving and investment—that is complicating international relations and monetary policy is due to high national saving,

[5] Communiqué of the 5th plenary session of the 16th Central Committee of the CPC, October 11, 2005.
[6] The official goal of the party guidance for the 11th five year plan is to have growth high enough to double per capita income between 2000 and 2010. Given the high growth over the last 5 years, doubling real GDP per capita will only require GDP growth of a little under 7 percent for the next 5 year plan.

rather than low investment.[7] Moreover, a tendency for over investment and over supply has led to downward price pressures in some industries, although generalized deflation is not likely in China.[8] If the renewed pick up in domestic demand signaled above were due to stronger consumption, it would by and large be welcome. However, recent indicators suggest that the renewed pickup is at least in part due to stronger investment, and new policy measures may be required to dampen investment.

Figure 9. M2 growth increases.



Source: PBC, CEIC.

M2 growth has increased significantly. M2 growth increased from around 14 percent (yoy) in early 2005 to 17.9 percent in September (Figure 9). In part this is because in July-September the PBC allowed its continued large foreign exchange purchases to affect the domestic money supply. The purchases stem from China's large balance of payment surpluses, caused by continued current account surpluses and capital inflows. In recent months, the PBC sterilized significantly less than the increase in foreign exchange reserves. The resulting increase in liquidity in the banking system has driven down market interest rates to very low levels, in line with the goal of discouraging capital flows.[9] While the balance of payment surpluses continued after the change in exchange rate regime on July 21, there are signs that non-FDI inflows decreased in recent months, with a rough estimate suggesting a drop from over US$8 billion per month in the first half of 2005 to less than half that in the third quarter.[10] Given the current domestic context, it may be difficult, though, to rely too long on this policy. The low money market rate used to stave off capital inflows does not seem consistent with strong economic growth and concerns about high investment. In addition to the policy-determined factors, increased demand for money may also have played a role in the uptick in M2 growth.

Increased M2 growth may result in a pick up in bank lending. Historically, M2 and credit growth moved broadly hand in hand. However, this time, credit growth—the key monetary variable for the real economy—has so far not picked up from the 13-14 percent (yoy) pace registered since end-2004, which, in the face of increasing bank liquidity, could imply one (or a combination) of three things: (i) credit demand is weak; (ii) the large banks are reluctant to expand lending during the ownership reform process and ahead of international public offerings (IPOs); or (iii) other policies, perhaps including

[7] Measured by national account data, investment was 45 percent of GDP in 2004.

[8] Supply side driven deflation cannot be alleviated by easing monetary policy and/or fiscal support along traditional lines, which would tend to encourage investment rather than consumption, thus potentially accentuating the problem. Rather, it requires a rebalancing of spending towards consumption.

[9] The interest rate differential with US short-term rates has turned from slightly positive in early 2005 to a negative 250 basis points now, with a similar turnaround to about 150 basis points for bond yields.

[10] The August Quarterly discusses the regime change and the potential impact of a stronger exchange rate.

window guidance, are keeping bank lending down. Weak credit demand would be difficult to square with the booming economy. At any rate, the increased liquidity and potential for new lending and investment that it represents require careful monitoring, and perhaps corrective measures.

Since the exchange rate regime change of July 21, further reforms have been implemented. Wider interbank market spreads allow the banks more room to price risk; wider spreads vis-à-vis clients allow the development of 2-way quotes; and wider trading bands vis-à-vis currencies other than the US$ remove unhelpful arbitrage. The PBC has also accelerated foreign exchange market reform. Introduction of derivative products including forwards allow banks and firms to manage their exchange rate risks, and an RMB swap market is also planned to be introduced this year. Market makers are allowed in the forward exchange market and in market trading between foreign currencies, and restrictions on banks' open foreign exchange positions have been relaxed.

Fiscal policy is appropriately prudent. Tax revenues are growing significantly faster than budgeted. The Ministry of Finance's policy is to keep expenditures to the budgeted amounts, with the exception of disaster funds.

STRUCTURAL AND SOCIAL POLICIES: HOW TO STEP UP THE TRANSFORMATION OF THE ECONOMIC GROWTH PATTERN?

Making growth less intensive in energy, resources, and capital, more driven by knowledge and innovation, and more equally shared among the population requires a rebalancing of polices, away from those favoring capital-intensive, industry-based growth, flanked by public finance measures. Since poverty and inequality are fundamentally caused by insufficient availability of productive jobs and differences in productivity between agriculture and other sectors, policies rebalancing growth patterns will have to be the driving force in reducing inequality, while among public finance measures expenditure reforms are more effective in promoting equity than tax measures. Indeed, using the tax system to reduce income inequality needs to be handled with care, as there may be trade-offs between equality and growth.

China's government wants to make growth less based on investment and more on consumption. By saving and investing a lot, China is foregoing current consumption, keeping living standards lower than necessary, which is why policy makers would like consumption to play a larger role.[11] Looking further ahead, it will not be feasible to generate the ever-increasing saving required to sustain the current pattern of growth. Rebalancing away from the relatively volatile export and investment-based growth to consumption-based growth may also make growth more stable. Public finance measures can help increase consumption's share in GDP (see below).

Combining lower investment with a better allocation of capital could rebalance growth. In the current institutional and policy setting, lower investment alone will just

[11] Concerns about the quality of China's macroeconomic data warrant caution. For instance, the size of the services industry and consumption may not be as small as the official data indicate.

mean lower growth, which may be perceived as inconsistent with China's development goals, which feature GDP growth prominently. Thus, the lower investment needs to be accompanied by higher efficiency and better allocation of capital, and/or a redirection of growth in the direction of sectors that require less capital. Measures towards this objective include financial sector reforms, better corporate governance, a dividend policy for state enterprises, a larger role for the private sector in the economy, and liberalizing restrictions and regulations hindering the development of the services industry.[12] Rebalancing growth away from industry towards services would also help making growth less energy and resource intensive. It is also worth discussing how important GDP growth should be, as an objective, compared to other objectives. If the ultimate goal is creating urban jobs and getting people out of (largely rural) poverty, a somewhat lower, but more labor-intensive growth may be more sustainable and more in line with other objectives.[13]

PUBLIC FINANCES

The public finances are key to increase the role of consumption and can help achieve growth that is less resource intensive, more knowledge-driven, and more equally shared. Shifting government spending from investment to spending on health and education ("from construction of physical infrastructure to social infrastructure") would directly reduce national saving and investment in favor of consumption, while supporting the drive to a harmonious society. Particularly fruitful areas of reform are pensions (to improve its financial sustainability), the health sector, and clarifying the government's role in financing of education. Household savings appear to be affected by uncertainty about future pensions and costs of health care and education. Removing this uncertainty and providing more insurance would support private consumption. The government intends to take more responsibility in these areas. For instance, the government has recently committed to free compulsory education for children in rural areas before 2010. As highlighted in our Special Focus section below, there is an urgent need for health sector reform. As the government is taking new spending commitments, it will have to identify areas where expenditure can be cut, perhaps including investment, so as to keep total expenditure in check.

On the revenue side, several tax reform initiatives towards more equality and lower energy intensity are in preparation. The Standing Committee of the National People's Congress in end-October approved a doubling of the personal income tax threshold to RMB 1600 which will reduce the tax burden and exempt many income earners from paying income tax.[14] More importantly, in terms of the equity and efficiency of the tax system, the national unified tax collection network in preparation—with all tax payers

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[12] The OECD Survey on China (2005) presents empirical results showing that private sector companies use capital more efficiently than SOEs.

[13] For a discussion of China's historical pattern of growth and the benefits of rebalancing policies and growth patterns, see Kuijs and Wang: "China's Pattern of Growth: Moving to Sustainability and Reducing Inequality", World Bank China Office Research Working Paper No. 2 (October 2005), http://www.worldbank.org.cn/english/content/WBOB_Research_oct2005.pdf, and Bert Hofman: "Issues for China's 11th five year plan", a paper presented at Stanford Center for International Development on China's Policy Reforms (October 29-31, 2005); http://scid.stanford.edu/events/China2005/index.html.

[14] The Ministry of Finance's original proposal suggested RMB 1500.

identified by a single taxpayer number—could pave the way for a global income tax. This would mean moving away from the current system where only the salary and wage income are subject to the progressive tax rate, while other income are taxed separately subject to a flat rate. Since July 2005, the income from stock options is taxed. To encourage energy saving, since September a modest "fuel consumption tax" is levied on refineries and producers, with taxes between RMB 0.1-0.2 per liter. Plans to substantially raise the automobile tax for large cars and SUVs are expected to be enacted in 2006. A fuel tax has long been discussed. Despite consensus of its importance, its introduction has been complicated by the difficulties in finding agreement on a revenue assignment arrangement between the central and provincial governments. China's system of fuel pricing and taxation, and options for reform are discussed in Box 3.

As mentioned, financial and corporate sector reforms are key to improve the allocation and efficiency of capital that will support rebalancing of the growth pattern.

FINANCIAL SECTOR POLICIES AND DEVELOPMENTS

Equity participation by foreign banks in 3 of the 4 State-owned commercial Banks (SCBs) is seen as a vote of confidence in the Chinese banking sector. This increasing participation follows recapitalization of the 3 SCBs, and major operational restructuring of the banks slated for IPOs. Second-tier banks also attract increasing foreign interest, and new capital requirements from the China Banking Regulation Commission (CBRC) have increased the incentives on those banks to seek new capital. CCB was the first SCB to float its IPO in October in Hong Kong, raising some US$8 billion from issuing 12 percent of its enlarged share capital. This puts its hypothetical market value at $67 billion, making it Asia's third largest in terms of market capitalization. .Despite the foreign interest, many challenges remain. The nomination of a director on the board by the foreign investors may improve corporate governance. Nonetheless, it remains to be seen whether their shares—restricted to a total of 25 percent, and 20 percent for a single investor—are large enough for them to operate as a strategic investor. The inclusion of protective and exit clauses in several transactions, which, if triggered, would exempt the foreign strategic investors from hidden losses may reduce diligence of foreign investors. Corporate governance remains a major challenge, as illustrated by continued occurrence of fraud cases and continued increases in (underlying) non-performing loans.[15] It is understood that foreign investment and oversight by foreign regulators and authorities in connection to the offshore IPOs planned for the 3 SCBs will add pressure to improve corporate governance. The entry of foreign banks in second-tier banks has been accelerated by intensified efforts to replenish capital in response to (CBRC) regulations.

The performance of the 4 traditional asset management companies (AMCs) could be improved. The AMCs disposed slightly more than half of the NPLs they had received from the 4 parent SCBs by mid-2005. Cash recovery, at around 20 percent is already less

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[15] CBRC statistics show a decline in NPLs of the SCBs in the quarter to June 2005 of RMB536 bn. However, correcting for the RMB 634 bn carve-out of NPLs form ICBC, total NPLs in SCBs actually increased.

Box 3. The Price of Oil

In 10 years China has moved from being self-sufficient in oil to becoming one of the world's major oil importers. Last year, China imported almost 40 percent of its oil consumption, imports increased some 30 percent, and more than one third of additional global demand for oil came from China. Indeed, the oil price increases over the last year cost China more than 0.5 percent of GDP in higher oil import costs. China is thus clearly an oil-scarce country, and on current trends with rapidly rising demand from automobiles and power, will be more so in the future. But go to any gas station in the country, and you would never know. Whereas oil prices on the international market jumped by almost 50 percent since 2004,[1] China's retail prices only nudged upwards 10-15 percent depending on the product. Pump prices in China are now one third lower than in the USA, and barely a third of the prices in some countries in Europe. What is going on?

China suspended its automatic price adjustment mechanism. In 1998, China adopted a cost-based pricing mechanism for fuel prices at the pump, linking them to international prices.[2]/ When the formula implied a gap between the pump prices and the benchmark of 8 percent, retail prices were adjusted. However, the fear of negative impact on economic development of a rapid price increase led the authorities to suspend the price adjustment mechanism. Policymakers are particular concerned about farmers and taxi drivers—indeed several cities now subsidize every cabdriver with some 300 Yuan per month to compensate for the fuel price increases. Since last year, retail prices were only adjusted irregularly, and prices are now well below costs.

Who is paying for this implicit subsidy? The subsidy is paid for out of the profits of the oil companies. The oil and gas sector in China is dominated by three state owned oil companies: China National Petroleum Company (CNPC), China Oil and Petrochemicals Company (SINOPEC), and China National Offshore Oil Company (CNOOC). These companies still make a hefty profit as widely reported, but less than they would have made if prices would have followed the market. The profits are made on domestic oil production, whereas the companies make a loss on refinery and domestic sales. The impact of the below-costs price on the three companies varies in degree. CNPC has a large domestic oil production and a small refining capacity, and is therefore doing well. For SINOPEC, the opposite holds, and its profits are under pressure. CNOOC, which has lots of off-shore production, is still doing well, in fact so well that it could bid $18 billion dollars for Unocal, an American oil company. Aside from their effects on profits, low domestic fuel prices had another effect: China's oil companies preferred to export oil rather than sell it domestically, and indeed, exports of oil from China, even though small, was up in the first half of the year. This has caused supply shortage in some cities, and in reaction, the tax authorities suspended VAT rebate on fuel export, and later exports were banned altogether.

In most countries, governments limit the revenue of oil companies through a resource tax, sometimes linked to international prices. In China, the oil resource tax in China is very low: it currently varies between RMB 16-30 per ton crude oil produced (US2-3.75/ton), depending on the oil field. The argument is that the profits of the companies go to the State in any case. Maybe so, but this runs the risk that the oil companies inflate their costs to reduce profit remittance to the state. In addition to resources taxes, countries often have a consumption tax on fuel tax. Currently, China levies only a RMB 0.20/liter sales tax for leaded gas, and RMB 0.28 for unleaded gas, lower than the USA which has the lowest tax of any developed country. The idea of levying a proper fuel tax has already been accepted by the State Council a few years ago, and once oil prices start to ease, the time is ripe to introduce one.

1/ The average 2005 increase of the price of oil has been less—about 25 percent over the average of 2004.
2/ The formula is: *Retail prices = average oil product prices in Singapore, New York and Rotterdam + sea transportation costs + tax and duties + distribution costs + sales tax.*

than rates achieved by Indonesia's IBRA and Malaysia' s Danaharta after the Asian crisis, which reached 25-30 percent. However, the recovery of China's AMCs is likely to decline in future years as most of the easy-to-recover assets have already been exhausted. Indeed, the performance of the Chinese AMCs remains unsatisfactory, in part because they have been constrained by a legal framework that is not conducive to enforcing creditor rights, by the original quality of the assets taken over, and by their weak corporate governance.

In rural finance, a pilot to reform the rural credit cooperations RCCs is now covering 29 provinces/municipalities. Under the pilot the central government, through the PBC, will fund 50 percent of the historical losses and managerial authority is turned over to the provincial governments from the central government, to remove the conflicting dual functions of ownership and regulation by the central authorities and to align the interests of provincial governments with those of the RCCs. It remains to be seen whether the implemented reforms can put the RCCs on a path of sound development. The establishment of RCC unions at the provincial level has rapidly increased administrative costs as new positions were created. Concerns also remain about insider control and a tendency to continue to lean on government support. Indeed, many RCCs continue to rely on central bank lending as a major source of funding. In order to foster a more competititive rural financial market and commercially sustainable microfinance, pilots are in preparation where credit-only MCIs, with participation of private capital, would be licensed to operate on commercial basis.

The reform plan to separate the postal savings bank from the postal administration may improve access to finance small businesses. As part of the move to independence, approved by the State Council in July, the subsidy on postal savings deposits (financed by the PBC) will be cancelled in August 2006. Thus the Postal Savings faces the daunting task of restructuring while needing to dispose of the large amounts of savings deposits that come in daily. So far it has been lending to financial institutions including RCCs. It will continue to do so for practical reasons. However, a banking license promised by the bank regulatory authority will enable the Postal Savings to engage in retail lending as well as full-fledged financial services.

CORPORATE SECTOR POLICIES AND DEVELOPMENTS

State-owned enterprises remain important in China's economy. Varying conclusions have been drawn recently about the importance of SOEs in China.[16] A look across different dimensions of data on manufacturing enterprises reveals some interesting patterns. The importance of SOEs has diminished in terms of numbers and sales volume; they now make up 12 percent of the total and conduct only 37 percent of total sales (Table 2**).** However, SOEs are dominant in most capital intensive industries, including heavy industry and utilities, which have seen rapid expansion in recent years. As a result, SOEs still do 58 percent of all fixed asset investment. With profits tending to be a large

[16] For instance, compare conclusions of CLSA ("China's capitalists", Special report, September 2005) and the OECD ("China Economic Review", 2005) on the one hand with that of UBS ("China's marginal private sector", Global Equity Research, September 15, 2005)).

share of value added in capital-intensive industries, SOEs also still generate half of total profits in industry.

Table 2. Relative size of China's manufacturers, by ownership (in percent)

	Mid-2003					Mid-2005				
	#	*Sales*	*Profits*	*Fixed Assets*	*Liabilities*	*#*	*Sales*	*Profits*	*Fixed Assets*	*Liabilities*
State-Owned	20	44	51	65	59	12	37	49	58	50
Collective	13	7	6	4	5	7	4	4	2	3
Foreign-invested	20	29	32	21	21	21	31	28	23	25
Domestic-private	47	20	11	10	15	60	28	19	17	22

Key policy developments so far in 2005 include the following:

- **Chongqing's Yufu assets management company (AMC) may, if successful be a useful benchmark.** Yufu, owned by the Chongqing SASAC and using loans from China Development Bank, acquired RMB 10.7 billion in debt owed to Industrial and Commercial Bank of China (ICBC) by 667 local enterprises at the discounted price of RMB 2.2 billion. If this AMC is able to undertake a successful operational and financial restructuring and ownership transformation of these enterprises, the "Yufu model" could serve to guide the restructuring, resolution, and transformation of many distressed SOEs in Northeast China.
- **In a series of pilots, the public shareholders of major state-majority listed companies have agreed to convert non-tradable State shares into tradable shares.** On average, about 70 percent of the shares of the 1100 or so listed companies have been non-tradable State shares. This "overhang" of non-tradable shares has depressed China's stock markets since 2002. The success of recent proposals to convert non-tradable shares into tradable, in which public shareholders have accepted dilution in return for compensation (e.g., warrants or additional shares) and commitments by State shareholders to "lock up" newly converted tradable shares for several years appears promising. In late August, the authorities required the conversion of all non-tradable shares and encouraged negotiation with listed shareholders over compensation.
- **The National Peoples Congress has still not passed a new market-oriented enterprise bankruptcy law.** The sticking point remains whether or not to give priority to worker claims over secured creditors. Consideration of OECD and middle-income country experience shows, however, that the global trend is moving *away from* worker claims having a priority over secured creditors *and toward* protecting previously-negotiated commercial contracts with secured creditors.

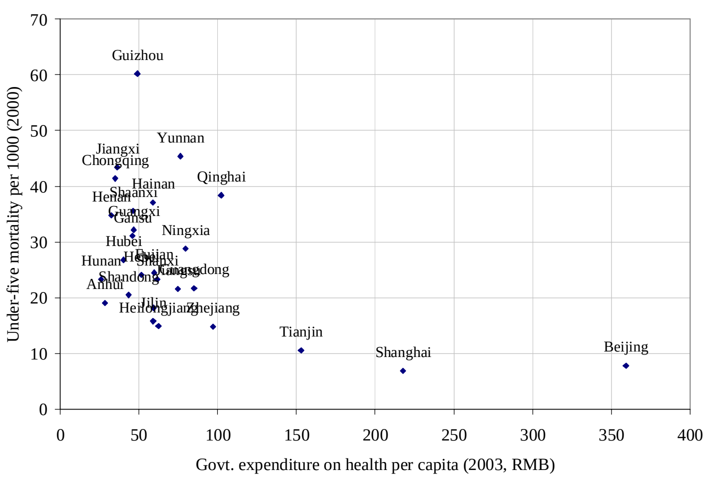
Special Focus: Reforming China's Health System[17]

China's health system has been hotly debated in recent months. The system—once admired by health specialists the world over—is now widely recognized to be in need of reform, and its deficiencies have been widely publicized. Beyond agreeing on this, the participants in the debate share little common ground—especially on the appropriate role for government.

Governments intervene in the health sector to promote equity and to address so-called 'market failures'—instances where a free market would produce socially inefficient outcomes. Relevant market failures in the health sector include: externalities and public goods, which together provide the economic rationale for public health programs, and information asymmetries between consumers and suppliers in the health care and health insurance 'markets'. In promoting equity and addressing each type of market failure, a government can choose between several alternative policies. In doing so, it needs to balance the costs involved (including the government spending implications) and the benefits (how well the policy ameliorates the market failure in question).

Government health spending in China has risen in real terms throughout the 1980s and 1990s. But it is becoming increasingly clear that it could have been used more effectively—both in promoting equity and addressing market failures. Surprisingly, perhaps, government health spending in China actually disproportionately benefits the better off, being largely focused on urban health insurance schemes and on subsidies to city hospitals. The inequalities generated are reinforced by the substantial inequalities in government health spending between poorer and better-off provinces (Figure 1). These inequalities reflect the low share of central government health spending in the national total (just 3 percent), and China's intergovernmental fiscal system that does relatively little to break the link between a province's per capita income and the resources that its government has available for health and other social sector programs.

Fig 1: Government health expenditure is lower in poorer provinces



Sources: NBS (Statistical Yearbook) and Ministry of Health.

In addressing market failures, too, government approach could be improved. Unlike in other 'markets', the consumer in the health care 'market' is at a substantial informational disadvantage compared to the supplier. This creates scope for the supplier to abuse his position by

[17] This is a summary of findings reported in more detail in a series of Briefing Notes and Critical Review Papers. They are available on our website (http://www.worldbank.org/china), under "publications and reports, "China Rural Health Briefing Note".

administering unnecessary—but profitable—care, or by skimping on quality. The shift in China since 1980 towards private practice at the village and township levels, and the 'hardening' of financial incentives in government-owned facilities, is believed to have increased the likelihood of supplier-induced demand. One study of village clinics found that less than one per cent of drug prescriptions were reasonable. Another found that 20 percent of expenditures associated with the treatment of appendicitis and pneumonia were unnecessary. China's extensive supplier-induced demand cannot all be blamed on the growth of the private sector and the sharper financial incentives in the public sector. A contributory factor is the government's well-intentioned but ultimately flawed approach to price-setting in the sector. In an attempt to ensure that basic care is affordable to everyone, the government sets prices at levels that result in providers making a loss on basic care but a considerable profit on drugs and high-tech care. Providers have exploited their informational advantage and have shifted demand from low-tech care to drugs and high-tech care.

In health insurance, too, it is debatable whether the government's policies to date have been the right ones to tackle the relevant market failures. One is adverse selection: a voluntary scheme with community-rating (everyone paying the same premium) risks unraveling as 'good' risks leave it, deciding (rationally) that their riskiness does not warrant paying the flat-rate premium. The risk of this happening is even greater if premiums or contributions are linked to income. One approach common in other countries—making insurance compulsory—has, in fact, been adopted by government in the case of urban health insurance. However, it seems likely that the low rates of coverage reflect noncompliance by some enterprises, presumably those with a young healthy workforce. In its new rural scheme (the new cooperative medical scheme or NCMS), the government has deliberately not made enrollment compulsory, worrying that it would make the program seem like a new tax or 'fee' just at the time when the government is trying to reduce the fiscal burden on rural households. It is possible that the generous subsidies to households that enroll in NCMS will be enough to prevent adverse selection. Time will tell.

The verdict on the government's approach to tackling the other classic type of market failure in health insurance markets—moral hazard—seems less likely to be positive. In an attempt to curb over-use of services by the insured, the government has focused on demand-side cost-sharing: getting patients to pay a sizeable fraction of the cost of care out of their own pocket, through a complex system of medical savings accounts. These seem to have done little to deter use, as patients have relied heavily on providers for information on what care they need. What they do seem to have done is to cause widespread financial hardship by severely limiting the amount the scheme will reimburse. A more promising development has been the government's limited attempts to introduce supply-side cost-sharing: paying providers a pre-agreed sum per case depending on the diagnosis, rather than letting them simply bill the insurer for whatever tests and care they decide to provide.

In the final area of market failure in the health sector—externalities and public goods—the government's approach has also come under fire. An ever smaller share of the incomes of public health institutions (PHIs) is being financed by government and an ever larger share by household out-of-pocket payments. Encouraging PHIs to generate business incomes and allowing them to charge for core public health activities has impacted negatively on coverage rates for key personal public health interventions. This, coupled with fiscal decentralization, has also hindered the development of public-good type programs, such as surveillance, especially in poor areas.

With regards to equity and market failures, the government's approach could be improved. Some recent changes are definitely a move in the right direction. The central government is spending more, and much of the extra spending is being used to subsidize NCMS enrolment in the poorer western and central provinces. The poor—wherever they live—are also being assisted with

NCMS contributions and medical expenses through a Ministry of Civil Affairs program. Both will help improve equity, but neither will be anything like enough to make China's government health spending pro-poor. That will require tighter targeting of central government spending, and gradually shifting government spending in general away from the urban health insurance program to the rural program, away from supply-side subsidies to city hospitals to demand-side subsidies (especially for NCMS), and away from the richer eastern provinces to the poorer western and central provinces. A health insurance solidarity fund is a vehicle that would facilitate such a transition.

To reduce the potential negative effects of the informational asymmetry between patient and provider, perhaps the most effective strategy is to encourage insurers to become better purchasers of health services on behalf of their clients. Care packages for different diagnoses would be standardized through common quality standards and payments linked to diagnosis rather than to services rendered. The purchaser approach, combined with appropriate regulatory mechanisms governing health providers, would go a long way to tackling supplier-induced demand and bringing health sector inflation down. Demand-side cost-sharing could be scaled back and medical savings accounts done away with. The advantage is that further changes in ownership (some argue for privatization, others for re-nationalization) are likely to be unnecessary, and would distract from other more pressing reforms.

Reform in the public health area is urgent. It is likely to require a mix of both financing and delivery reforms. The government could usefully commit to financing public health activities in full, but could also usefully explore ways of lessening and ultimately eliminating the link between local public health spending and local resources. Otherwise, the risk is that epidemics will continue to develop disproportionately in poor areas where the public health infrastructure is weak, and migrate to richer areas. A public heath equalization fund would facilitate such a transition. The government might consider replacing the largely autonomous provincial centers of disease control by a national public health agency with local offices, and make this responsible for the delivery of public health activities of a public-good type, such as surveillance. Whether national or not, the agency's activities should be fully financed by government, although there is scope for linking payment to successful discharging of agreed core functions and activities. Personal public health interventions, such as immunization, can be delivered by regular health institutions, but their delivery would need to be compensated in full by government, most obviously through a pre-agreed fee schedule, as in other countries.

In the 1960s and 1970s, China was an innovator in the health sector, coupling universal insurance coverage with a delivery system that was tailored to local needs. China's health system of the future will inevitably look quite different from its old one, not least because the financing and organizational bases of the old system have long disappeared. But there is no reason why, over the course of the next five years or so, China should not build a successful modern health system that will, like its old one, be admired the world over.