

World Bank Office, Beijing

世界银行驻中国代表处

Quarterly Update

May 2006



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 and credit expansion in the first quarter of 2006 have surprised on the upside. GDP grew 10.2 percent, year on year (yoy), in the first quarter of 2006. Much of the growth surprise stemmed from stronger exports, whereas domestic demand grew in line with expectations. Investment continued to power ahead, though, partly due to an up tick in credit growth, with more new lending going into real estate development.

Prolonged strong foreign exchange inflows continue to complicate monetary policy. With the trade surplus, FDI up, and non-FDI inflows all up in the first quarter, foreign exchange reserves surged by US\$56 bln to US\$875 bln. The People's Bank of China's (PBC's) policy of keeping bank liquidity high, and thus inter-bank interest rates low, has so far succeeded in dealing with the exchange rate challenges. But the easy monetary stance sits oddly with concerns about too rapid credit and investment growth, including to real estate, and other measures to control credit and investment seem to have run out of steam. Although the risks for inflation remain limited, this development could lead to overcapacity and rising non-performing loans down the road.

Sustained rapid growth is expected to continue. Global conditions and growth prospects remain favorable. And while international commodity prices are still high, the rates of increase are coming down, although upward risks on commodity prices remain. In light of the strong first quarter, we revise up our GDP growth forecast for 2006 to 9.5 percent. This still implies a slowdown in the rest of the year and into 2007, assuming that a moderate policy tightening can keep investment growth in check. Inflation should on balance remain subdued, while the current account surplus may rise again this year.

More policy action is needed to keep credit and investment growth in check, mitigate external imbalances, and to entrench the rebalancing of growth patterns. Further monetary tightening, after the increase in benchmark bank lending rates of April 27, should include mopping up liquidity in the inter-bank market, possibly supported by measures to limit credit to risky sectors such as real estate. To limit renewed liquidity buildup from foreign exchange inflows triggered by higher domestic interest rates, the Government could choose to accelerate the planned gradual appreciation of the currency and take further measures to limit those inflows, or increase outflows. Accelerated appreciation would also help reducing current account surpluses and rebalancing growth towards consumption. Any adverse effect on vulnerable sectors of such a move could be mitigated by fiscal policy, whereas the risk of deflation could be addressed by speeding up administrative price reforms, including for energy and utilities.

In the medium term, rebalancing growth requires structural measures. Increasing domestic consumption and reducing the saving-investment surplus can be achieved by shifting government spending from investment to health, education, and the social safety net, more financial sector reform, and better corporate governance and dividend policies. Investment can be shifted into nontradables (services) by removing several subsidies for manufacturing stemming from the pricing of inputs (land, energy, water, utilities, and the environment) and through the tax system.

RECENT ECONOMIC DEVELOPMENTS

Economic growth in the first quarter of 2006 beat expectations. GDP growth was 10.2 percent year-on-year (yoy), after recording 9.9 percent in the fourth quarter of 2005 and 2005 as a whole (Figure 1). Growth was higher than the pre-release consensus forecast for 2006 of 9.1 percent.¹ Much of the upward surprise was due to stronger exports: net exports contributed more to GDP growth than in the fourth quarter of 2005, while domestic demand grew broadly as expected in the first quarter, broadly unchanged from the fourth quarter of 2005. Within domestic demand, fixed asset investment (FAI) again outpaced expectations while consumption, although robust, continued to lag FAI.²

Investment growth remains strong, particularly in the tradable sector. After rising 26 percent in 2005, nominal FAI grew by 28 percent (yoy) in the first 3 months of 2006, with growth of 32 percent in March (Figure 2).³ Rapid growth in investment in agriculture (47 percent (yoy) in the first quarter) matches the government's focus on agriculture and the countryside. However, agriculture did only 1 percent of FAI, and total rural investment rose by 18 percent (yoy) in the first quarter, compared to 30 percent in urban areas. FAI remained particularly strong in the tradable sector—manufacturing—with 36 percent increase in the first quarter, after 39 percent growth in 2005. FAI growth (yoy) was less buoyant in non-tradable sectors such as services (28 percent), including real estate (20 percent), and utilities (12 percent, in the first two months). Private enterprises did 68 percent of FAI in January-February, compared to 62 percent in 2005 and 59 percent in 2004. Retained earnings continued to be the main financing source for FAI in the first 2 months of 2006, financing half of total FAI (and 60 percent of identified financing). However, domestic credit became more important, financing 27 percent of FAI, compared to 19 percent in 2005. In real estate, financing by bank credit plays a larger role than in most other sectors.

Solid consumption still lags investment. While consumer credit has been subdued, continued robust urban wage growth and lower housing investment have sustained private consumption. Nominal retail sales grew at around 13 percent through the first quarter of 2006, as it has done since mid 2004, with low inflation allowing for brisk real retail sales growth (Figure 3). Real *per capita* living expenditure of urban households—a better proxy for consumption—rose 10 percent (yoy) in the first 2 months of 2006.

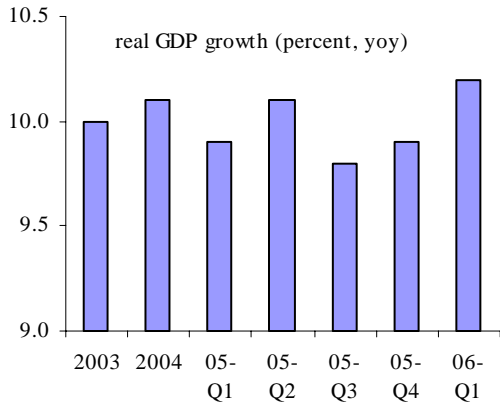
Stronger net trade drove higher growth. Fuelled by a rebound in March, first quarter exports grew by 27 percent (yoy) in US\$ terms (Figure 4). While an unexpected surge in high income countries' imports contributed to the export strength (see below), China continues to gain market share in foreign markets. US and European limitations on textiles, which are a small share of total exports, have had only limited impact on China's

¹ As in the April Asia Pacific Consensus Forecast.

² The monthly and quarterly data on domestic activity, including FAI and retail sales, cannot be easily compared to the national accounts equivalents gross fixed capital formation and consumption (see Quarterly Updates of August and November 2005). Moreover, there are no monthly and quarterly data on government consumption and investment in inventories.

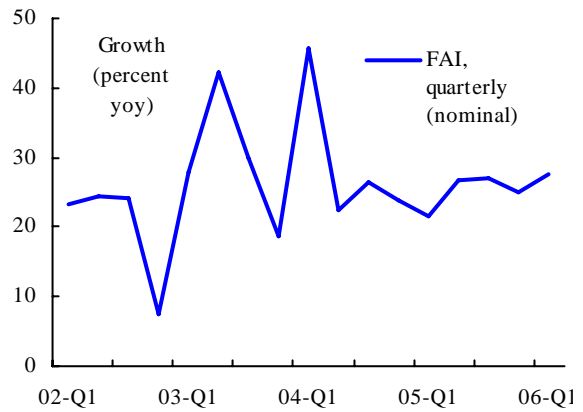
³ There is no data on the FAI deflator in the first quarter. Judging from developments in the PPI and prices of imports and real estate, average prices of investment goods have increased, but moderately (yoy).

Figure 1. Growth surprises on the upside



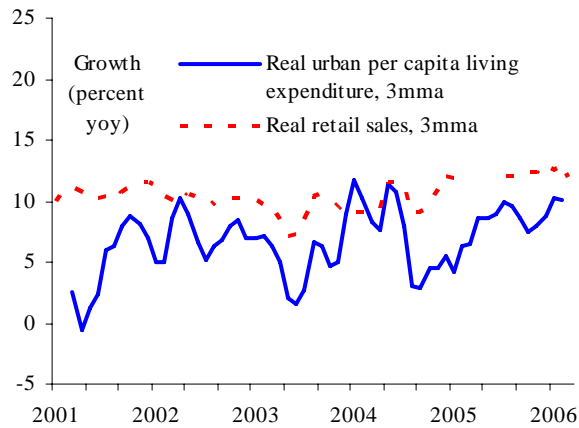
Source: NBS, staff calculation.

Figure 2. Investment continues to power ahead



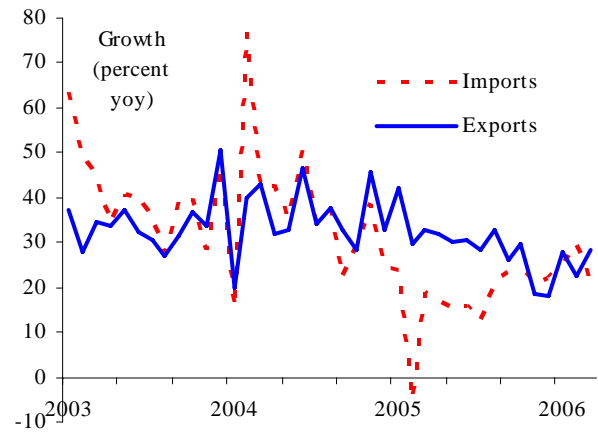
Source: NBS, staff calculation.

Figure 3. Household consumption grows steadily



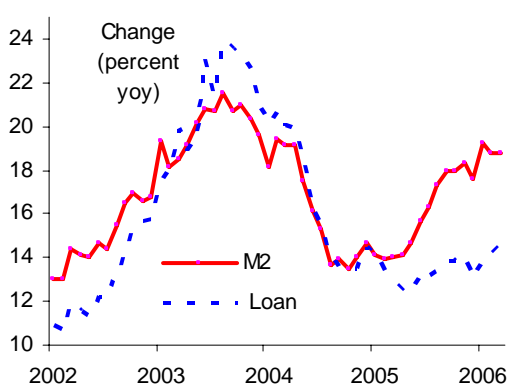
Source: NBS, and staff calculation.

Figure 4. Export growth rebounds



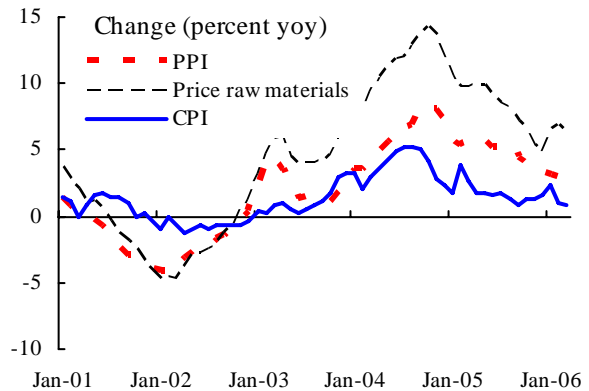
Source: NBS, staff calculation.

Figure 5. Monetary expansion is rapid



Source: NBS, CEIC.

Figure 6. Inflation remains subdued



Source: NBS, CEIC, and staff estimates.

exports thus far. First quarter imports grew by a strong 25 percent (yoy) in US\$ terms, but monthly data suggests that imports may have slowed month on month, recently. It is not clear how sustained the pickup in import growth momentum is that started in the second half of 2005. On a sectoral level, imports of metals and chemicals have been particularly weak, due to rapid increases in domestic production capacity. In all, the trade balance rose to US\$23.3 bln in the first quarter, compared to US\$16.5 bln a year ago, while the current account surplus was US\$ 161 bln in 2005, or 7.2 percent of GDP. With export prices nudging up (yoy) and import prices easing, net trade's contribution to *real* GDP growth was about 1 percentage point in the first quarter, which by and large accounts for the growth surprise.

Aside from the short-term trends, structural increases in export capacity drive exports. China's exports are being diversified and upgraded rapidly. Relative to other countries with similar factor endowments, in China more of the increase in exports stems from new product varieties, as opposed to existing ones. This enables China to continue its exports boom without suffering a worsening of the terms of trade, even in the face of the recent surges in international commodity prices (Box 1). On the import side, import substitution and broadening of supply chains also continue unabated. Indeed, more than in other emerging markets, a high and increasing share of foreign companies' sales in China are produced in China. These structural processes are associated with the buoyant investment in tradables discussed above (that is, they are both cause and effect of the investment strength). FDI into China grew 6.4 percent (yoy) to 14 billion in the first quarter. The trend increase in tradable production is a structural driver of the trade surplus. Its impact on the trade surplus can be offset by policies boosting domestic demand and consumption and policies changing the relative price of tradables.

The large trade surplus and continued FDI and non-FDI inflows resulted in a large overall balance of payments surplus. Non-FDI inflows, which had fallen in the fourth quarter of 2005, seem to have picked up again in the first quarter, to about \$15 billion, the same as a year ago. With the trade surplus and FDI flows also up (see above), foreign exchange reserves increased by US\$ 56 billion in the first quarter to US\$875 billion. The build-up of foreign exchange reserves continued complicating monetary policy.

Exchange rate considerations continue to constrain monetary policy. With continued large foreign exchange flows only partly sterilized, M2 growth has remained high, reaching almost 19 percent (yoy) in March 2006, compared to an year-end target of 16 percent (Figure 5). The relaxed monetary stance into the first part of 2006 kept inter-bank interest rates low, with the apparent aim to dampen non-FDI inflows and mitigate appreciation pressures. Despite stepped up sterilization in November and February, and some increase in inter-bank rates, the monetary stance remains loose. This policy was key to the so far broadly successful handling of the exchange rate challenges. However, high bank liquidity will eventually filter through in bank lending. In addition, the low inter-bank rates have led to a rapid expansion of short term bills issued. The popularity of these bills, which are basically priced from inter-bank rates, stems from a large gap between the inter-bank rates and the still existing floor on the lending rate.⁴ Their use has lowered

⁴ In principle priced from the PBC's rediscount rate, their interest rates are in practice even lower.

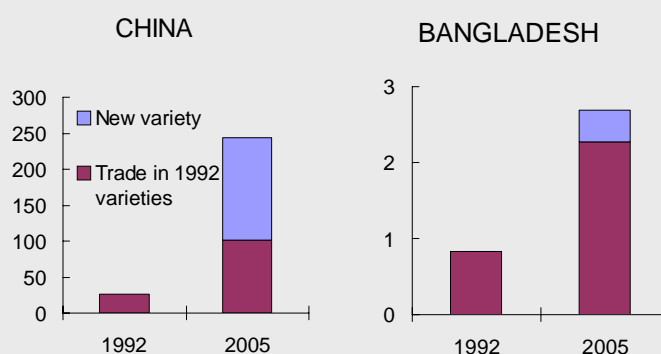
Box 1. China's export boom

Since 1978, China's exports have boomed, while the terms of trade have held up. From 1978 to 2005, the volume of Chinese merchandise exports has grown on average 17 percent per year. China's merchandise export share in the rest of the world's imports has risen from less than one percent in 1978 to an estimated 7.3 percent in 2005. While the import content of Chinese exports is fairly high, net exports have also risen fast. Taking into account the imports used as inputs in assembly, the share of net exports in total exports declined mildly, from 76 percent in 1993 to 71 percent in 2005. Importantly, the rapidly expanding export supply did not result in large declines in the terms of trade (the relative price of exports to imports). These have remained roughly unchanged since the early 1990s. How can we reconcile China's dizzying export growth with its relatively stable (or improving) terms-of-trade and export prices?

Extraordinary as it may seem, China's experience is not unique. Costa Rica, Israel, Japan, Korea, and Taiwan (China) have also enjoyed long export booms, often quadrupling their export volumes every ten years or less. In most cases the terms of trade were also relatively stable. Perhaps what makes China stand out most is its size.

Long export booms require continuous upgrading of the export package. On the supply side, such export booms are explained by a combination of steady increases in labor supply (often related to urbanization), rapid capital accumulation (on the basis of high domestic savings and/or FDI), and technological change. However, rather than increasing the supply of a fixed set of goods, what makes successful exporting countries stand out is that over time they produce and export better quality versions of the same products or new goods altogether. Studying Chinese and Bangladeshi exports to the United States at the 23,981 10 digit HS categories over the last 14 years reveals that both China and Bangladesh managed to double the number of exported varieties (from 581 in 1992 to 1,058 in 2005, compared to China's 6,602 and 12,698 respectively). However, in Bangladesh, many of these 'new' varieties are very similar to the old ones and almost all of them lie within the broad textiles sector. As a result, in Bangladesh the new varieties did not generate much additional export revenue. On the contrary, in China, the new varieties are in new groups and branches. Thus, China managed to enter whole new markets.¹ As a result, more than half of the increase in the value of China's exports from 1992 to 2005 is accounted for by exports of new products (see figure).

Export growth and new varieties
(US imports from China and Bangladesh, current US\$ billions)



What does this mean for the future? These experiences with export booms do not tell us how long they last, or which policies contribute to it (apart from trade and investment-friendly policies). But the experiences show that booms can last a very long time and that, aside from increases in labor supply and rapid capital accumulation, booms are likely to be accompanied by significant product diversification and upgrading of the export basket. As a large country, China cannot continue to grow exports at current rates indefinitely. But, its capacity to move into new markets should allow it to continue expanding its share of world imports to a while. As a comparison, the US's share of world exports peaked in the early 1990s at 14 percent, double China's current share.

^{1/} A more elaborate discussion will appear in a working paper on this subject.

borrowing cost for many enterprises, including in real estate. The bills allow in principle for a welcome diversification of financial sector instruments. But, with the current configuration of interest rates, their use has decreased the overall profitability of lending. Moreover, the increasing use of short term bills adds to banks' lending risks on traditional loans, since the bills have preferential status and the most creditworthy firms can issue bills.

Rapid money growth has started to boost credit. Underlying credit demand has been strong, fuelled by strong growth and confidence and low interest rates. Throughout 2005, though, credit growth had lagged, due in part to window guidance and possibly cautious bank behavior in the run up to IPOs and foreign participation. However, the amount of lending in the first quarter was half of the People's Bank of China's (PBC's) whole-year target, compared to about one-third of targeted and actual whole-year lending in 2005. While this reflects in part a fairly conservative target for credit growth in 2006 (equivalent to 12 percent), credit growth picked up to 14.7 percent (yoy) in March, compared to 12.8 percent in December 2005. Through February, new mid-to long term lending to households declined and corporate lending rose sharply, especially through short term bills, which made up 8.3 percent of the stock of bank credit to the private sector by end-2005, but 23 percent of new lending in the first 2 months of 2006.

A particularly large share of new lending in the first months of 2006 went to real estate developers. Lower household purchases of residences following the March 2005 measures to tighten mortgage lending are reflected in reduced mortgage lending. As a result, "deposits" and "advanced payments" now finance much less real estate development: 25 percent less in the first two months of 2006 (yoy). In contrast, bank credit for real estate development jumped, absorbing about half of the total credit growth in the first two months of 2006. Total real estate-related lending made up 20-30 percent of total lending for the large State-owned banks.⁵ This is not as high as the average exposure of banks in the US and some European countries of about 60 percent, or most Asian countries before the 1997 crisis (from 15-25 percent in Korea to 40-45 percent in Hong Kong). However, in developed countries, specialized instruments such as mortgage backed loans and refinance markets limit the risk of real-estate lending in the banking system. In China, maturity mismatch with the short term deposits that dominate banks' liabilities and undeveloped refinancing markets increase the financial risk of real estate lending. Urbanization and rapid urban income growth suggest strong fundamentals for real estate, but new housing construction in recent years may have outpaced demand. There are also indications that the real estate market does not function well (see the policy section below). At the same time, (physical) investment in real estate decelerated through 2005 into early 2006 along with weaker household purchases. Nominal FAI in real estate grew 20 percent in the first quarter of 2006, similar to the 2005 average.

⁵ Average exposure of the banking sector to the real estate market via loans to property developers and mortgages was around 15 percent of total loans in 2005, of which two-thirds on mortgages. The exposure of the large state-owned banks is higher, ranging from 17 to 22 percent. Moreover, banks have additional exposure to the real estate market via loans to the "construction" sector. Finally, a significant, but unknown share of short term bills (which comprised 8.3 percent of total lending at end-2005) is also lent to the real estate sector. All in all, for the large banks, 20-30 percent of lending is somehow related to real estate.

Inflation pressures remain limited. This is in large part because China's high investment rate expands production capacity in line with growing demand and imported inflation has stabilized. Fuel price hikes in March of 5-7 percent and higher service price inflation stemming from buoyant urban wage growth have not fully offset a decline in food price inflation. Consumer price inflation slowed to 0.8 percent (yoy) in March, and producer price (PPI) inflation to 2.5 percent (Figure 6). However, increases in raw material prices picked up from 5 percent (yoy) in December 2005 to 6.2 percent in March 2006, mainly driven by oil and power prices. After large increases in domestic capacity, the steel and chemical industries saw downward pressures for much of 2005. In late 2005, however, steel and chemicals prices started to recover. In March, the raw material purchasing price index for steel was 3 percent down on a year ago, while that for chemical prices was up 0.8 percent.

The exchange rate may yet again gain the limelight in the coming weeks. The semi-annual United States (US) Treasury report required by the 1988 Omnibus Trade Act on currency manipulation is expected to be released soon. If China is dubbed a manipulator, the law only requires dialogue with the country, something the USA is already doing. But the report could reignite votes on the Schumer-Graham (S-G) or the Grassley-Baucus (G-B) bill. The S-G bill calls for a 27.5 percent tariff on all US imports from China if the US Treasury finds that China is manipulating its currency. The tariffs would most likely be found against WTO rules, but until such a determination is made, much damage could be done. The G-B bill has a lower threshold than "manipulation": the bill calls for (non-trade) sanctions for countries that have a "fundamental misalignment" of their currency. Sanctions would include voting against loans and grants by international organizations, opposing extension of voting power in international organizations, retaining non-market economy status, and denying government-sponsored trade and investment insurance. Undersecretary of the US Treasury Adams has called this "a novel approach that would help us," which might suggest the forthcoming Treasury Report may declare misalignment rather than manipulation. In addition to the actions called for by the Omnibus Trade Act or the pending bills, the US could also appeal to the WTO, asserting that China's "undervalued" currency constitutes a subsidy to its export sector.⁶

ECONOMIC PROSPECTS AND POLICIES

Global economic prospects remain favorable. Global conditions in terms of growth, prices, and interest rates remain broadly favorable (Table 1). Prices of oil and other primary commodities have risen strongly. But this has been largely because of the strong world economy, rather than supply issues. Looking ahead, growth prospects remain good, despite higher US policy interest rates and slightly higher long-term bond yields. Growth

⁶ See: Congressional Research Service (2006), "*China, The United States and the IMF: Negotiating Exchange Rate Adjustment*," Washington DC, March 13. The WTO and IMF have an agreement that exchange rate issues which arise in WTO deliberations shall be referred to the IMF. Special consultations between IMF management and countries have occurred twice previously in response to formal complaints by another country about currency manipulation. In the 1990s, the United States made a complaint about Korea and Germany filed a complaint about Sweden (CRS, 2006).

is now more diversified beyond the US, and Japan and Europe have started to contribute more to global growth. Consensus forecasts suggest higher growth in high income countries from 2.8 percent in 2005 to 3 percent in 2006, and the OECD leading indicator points in the same direction.⁷ International commodity prices rebounded again in the first quarter of 2006, led by large gains in all major metals, in part because of stronger growth, worldwide and in China. For 2006 as a whole, we expect China's import-weighted energy and industrial commodity prices to rise by 17 and 9 percent, after 40 and 17 percent rises in 2005 in US\$ terms (Figure 7). Imported food and beverage prices, on the other hand, are expected to fall slightly.

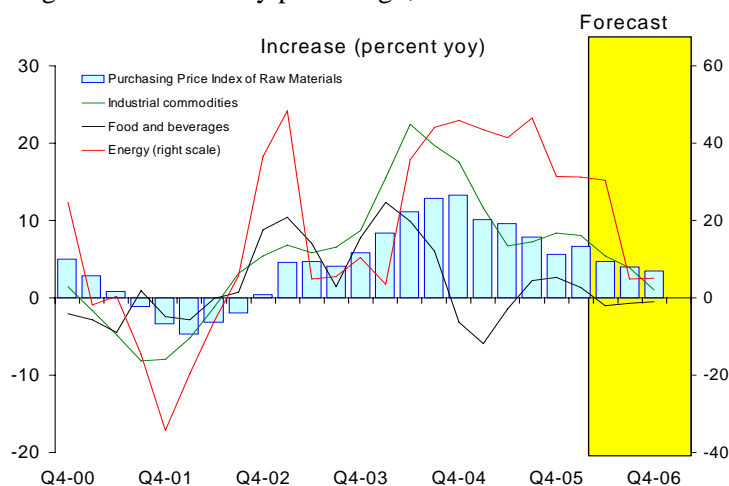
Table 1. Global conditions favorable.

	2003	2004	2005	2006f
(change, in percent, unless otherwise indicated)				
World GDP (market exchange rates)	2.8	4.1	3.6	3.7
High income countries	2.1	3.3	2.8	3.0
Developing countries	5.6	7.1	6.4	6.2
World Trade Volume	7.7	12.0	8.7	9.0
Consumer Prices G7 countries	1.5	1.7	2.2	2.0
Non-oil commodity Prices (USD)	10.2	17.3	13.4	5.4
Oil Price (US\$ per barrel)	28.9	37.7	53.4	59.0
Interest Rates				
\$, 6-month (percent)	1.2	1.7	3.6	5.2
€, 6-month (percent)	2.3	2.1	2.3	2.5

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

International risks remain. Large current account surpluses in some countries, including China, are mirrored in large deficits in others, including the US. A disorderly adjustment of these “global imbalances” may entail a large depreciation of the US dollar and rising international interest rates. Higher international interest rates, whatever the cause, would slow economic growth world-wide and in the past tended to channel financial capital back to high income countries. The commodity price projections remain subject to upward risks as markets remain tight, stocks are low, and supply issues remain.

Figure 7. Commodity prices high, but rates of increase down



Source: World Bank estimates.

In China, rapid economic growth is expected to continue. In light of the stronger-than-expected GDP growth in the first quarter and impact of the first quarter's credit expansion still to come, we revise up our forecast of GDP growth in 2006 to 9.5 percent, from 9.2 percent (Table

⁷ Japan's imports grew by 14.7 percent, yoy, in the first two months of 2006, compared with 7.3 percent in the last two months of 2005. Euro zone imports grew 16.4 percent, yoy, in January, from 1.7 percent in the last two months of 2005. US imports accelerated somewhat, from 15.7 to 18 percent yoy.

2). This still implies a slowdown in the rest of the year and continuing into 2007, assuming that a moderate policy tightening will keep investment growth in check and export growth eases somewhat later in 2006. Inflation should on balance remain subdued. Although imports are expected to outpace exports in the rest of the 2006 in real terms, the current account surplus may rise in 2006, even though it should decline as a share of GDP.

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	9.5	8.5
Exports (goods and services) 3/	26.8	28.4	27.6	20.3	15.1
Imports (goods and services) 3/	24.9	22.7	17.4	22.9	17.6
Consumer prices (period average)	1.2	3.9	1.8	2.0	1.8
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	-1.1	-0.8
Total revenue	16.2	16.6	17.5	17.8	18.7
Total expenditure	18.3	18.0	18.7	18.9	19.5
External account (US\$ billions)					
Current account balance	46	69	161	175	153
As share of GDP (%)	2.8	3.6	7.2	6.6	5.1
Capital account balance	71	138	46	43	29
(including errors & omissions)					
of which: FDI (net)	47	53	68	63	58
Change in reserves (increase =+)	117	206	207	218	182
Foreign exchange reserves	403	610	819	1037	1219
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.

More policy action is required to achieve the government's goals for containing credit and investment growth, mitigating external imbalances, and rebalancing growth patterns. The rapid credit growth in the first quarter makes it harder for the PBC to meet its monetary targets for 2006 and has intensified concerns about too rapid investment growth, possible surplus capacity, and financial risks, including in real estate. At the same time, stronger exports add to the trade surplus and foreign reserves

accumulation, thereby complicating monetary policy and international economic relations alike. From a medium-term perspective, the desired rebalancing of growth patterns, with less reliance on exports and investment and a larger role for consumption, is clearly not yet in the making.⁸

A consistent policy stance would entail several elements. It would include measures to tighten liquidity, perhaps supplemented by measures to limit credit to risky sectors such as real estate. To limit renewed liquidity buildup from foreign exchange inflows triggered by higher domestic interest rates, the Government could choose to accelerate the planned gradual appreciation of the currency as well as take further measures to limit those inflows, or increase outflows. Accelerated appreciation would also help reducing current account surpluses and rebalancing growth towards consumption. Any adverse effect on vulnerable sectors of such a move could be mitigated by fiscal policy. Over time, fiscal policy should also play a major role in rebalancing the economy, which would further reduce current account surpluses and stimulate domestic consumption.

The mix and magnitude of the different policies need to carefully balanced. A few considerations warrant caution. First, there may be less overcapacity and overproduction in China than is often suggested (Box 2), while the pace of credit and investment is now lower than in 2004, when the previous set of “macro control” measures was introduced. This suggests there is no need for drastic tightening measures. Second, now more of the investment is in manufacturing and done by the private sector than in early 2004. This may suggest different policies, with more emphasis on indirect (monetary) measures, and less emphasis on administrative measures. Third, the external current account surplus is now much higher than in 2004, and is creating more international tension, and significant tightening without rebalancing growth would aggravate the external imbalance.

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

Tighter monetary policy would reduce bank liquidity and help keeping in check credit and investment growth. There are various instruments available for tightening, each with somewhat different impact: (i) raising the cost of borrowing and return on saving by increasing benchmark lending and deposit rates; (ii) mopping up bank liquidity and raising inter-bank rates by larger open market operations (OMOs) or raising reserve requirement ratios; (iii) exchange rate strengthening; and (iv) affecting credit by window guidance. The PBC on April 27 already raised lending rates by 27 basis points and published a press release on a “window guidance” meeting it held with banks.⁹ The rate rise was an important signal about the commitment to reign in credit growth, and should

⁸ In this context, on April 14 the State Council concluded that FAI and M2 had grown excessively in the first quarter, while the “foreign trade sector is still troubled by structural problems.” It announced measures including “curbing new production capacity”, curbing exports of “energy-intensive, highly polluting products”, and “stepping up reforms in rural areas, SOEs, financial and tax systems, while encouraging the creation and the development of welfare systems.”

⁹ The press release noted that the PBC had called on the banks to contain credit growth, especially to “overly invested sectors”, but also to provide sufficient credit to small and medium-sized enterprises.

Box 2. How to think about overcapacity and overproduction in China?

There has been a rich debate and a dearth of data about overcapacity and overproduction in China. Regularly the issue emerges and motivates policy responses, either economy-wide or targeted at specific industries. Most recently, the fear of overcapacity in sectors such as steel, chemicals, and cement has come to the forefront, and calls for investment restrictions in those sectors have emerged. The authorities seem to have access to data on capacity and capacity utilization, because they are regularly referred to in the media, but no official data are published, so for many economists, this important macroeconomic variable remains guesswork.

One way to guess is at the macroeconomic level. Overall capacity and capacity utilization of the economy can be approximated by estimating *potential* GDP, and comparing it with actual GDP. Potential GDP (capacity) can be estimated by means of a production function, with labor inputs derived from labor market statistics, capital inputs from investment numbers, and productivity increases from past trends. According to this methodology, potential GDP grows about 10 percent per year at present, pretty much in line with actual GDP, so on aggregate there seems to be no excess capacity building up in China. Systemic overproduction would show up in build up of inventories and lack of profits. However, while there is no authoritative data on inventories, industrial profits are on average still growing with some 20 percent, and average rates of return on equity in China are respectable (see Figure 9 in the main text).

Another way is through industry level surveys. In the United States, the Federal Reserve Board (FED) releases particularly comprehensive data on capacity utilization. They use a detailed industry survey on capacity and capacity utilization done by the US census bureau, spanning 50 SITC classes, and covering over 17,000 firms. These firms are asked once a year to assess their current production and maximum capacity under normal circumstances, and under "national emergency" circumstances (interpreted as the absolute maximum). The FED combines the annual survey based capacity numbers with the more regular industrial production numbers to estimate capacity utilization. After a period of rapid growth, overall capacity utilization in Industry was 81 percent in March 2005, up from a low of 74 percent in 2001-2.

A World Bank survey done in 2005 can shed some light on the issue. In China, no industry surveys on capacity and overcapacity are published. But the Bank's Investment Climate Survey, fielded in 120 cities, and covering more than 12,000 enterprises, included questions on capacity utilization. Overall, at least until 2004, capacity utilization was rising, including for sectors such as steel, which is considered by some as a sector with overcapacity. And, although the method is different, the capacity utilization found for China does not differ that much from that found in the US. Of course, 20 percent excess capacity in China, which grows 10 percent per year, is relatively less than 20 percent overcapacity in the US, which grows by only 3 percent per year. There is little variation among the sub-industries: in 2004, the highest capacity utilization was in textiles, garments, leather, etc. with 87 percent, and the lowest in food processing, beverage, and tobacco with 78 percent. Weighted by sales, these numbers would be even higher. Noteworthy is also that steel pretty much followed the trend in capacity utilization as a whole, and at least in 2004 showed no sign of overcapacity. What is striking, however, is that even in 2004, a boom year, some steel firms ran at only *fifteen* percent capacity. In other countries, such a firm, for which it is impossible to make a profit, would exit the market or would be forced to exit by its creditors.

China Manufacturing Industry Capacity Utilization (in percent)

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Manufacturing Industry (12,360 firms)	77	80	83
o/w Steel (486 firms)	75	79	82

It seems unlikely that the economy as a whole, or even the majority of sectors, now have significant overcapacity. Of course, since 2004 things have changed, and a lot of investment has taken place since then. However, demand has increased rapidly as well. While some industries have seen price decreases at times, what is key for a judgment on overcapacity and overproduction is profitability in the medium term. For steel, capacity may have been expanding more rapidly than demand. But prices are recovering again. Also, Fitch, a rating agency, just rated two major steel companies as investment grade, and Tongshan Steel, China's second largest steel company, is looking for an expansion of its capacity from 18 million tons to 30 million tons by 2010. Perhaps they see the overcapacity and overproduction issue different than some industry sources. But we will not know until the authorities produce and publish a regular survey on capacity utilization. Such a survey would not just serve an economist's curiosity, but may well also guide investment decisions in industry, and that by itself would cause less overcapacity to arise.

have some impact on credit demand, since much of bank lending is still at rates less than or equal to the benchmark rate. However, the overhang of bank liquidity, inter-bank rates, as well as deposit rates remain unchanged. Unchanged deposit rates mean banks' margins on lending have increased, making lending a more attractive proposition for banks.

In current circumstances, effective monetary tightening should include mopping up liquidity. The associated increase in inter-bank rates would have an impact on lending.

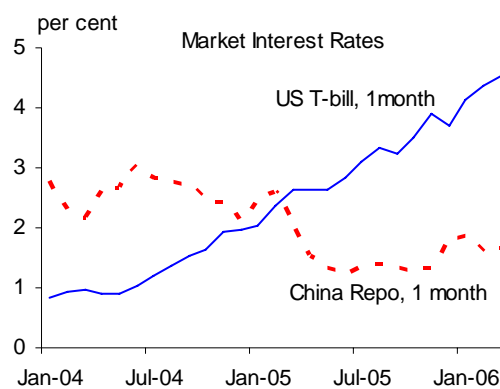
Furthermore, the growing importance of the short term bills market is likely to have boosted the direct impact of a rise in inter-bank rates on the real economy.

¹⁰ Moreover, the increases in US interest rates have provided some scope for further rises without too much effect on non-FDI capital flows (Figure 8). Reducing excess liquidity by 1 percentage point from their current level of over 4 percent (of deposits) would entail additional withdrawal of liquidity of about RMB 280 bln, equivalent to almost 4 times the monthly average liquidity withdrawal

through OMOs in 2005. As to the specific instrument, a rise in the reserve requirement ratio would be less costly for the PBC than open market operations. This is because the interest rate on required reserves is much lower than yields on central bank bills. However, forcing more bank assets in low yielding required reserves seems at odds with calls for the large state-owned banks to become more commercial, and effectively is a tax on the banking system. Thus, OMOs may be a less distortive instrument.

The government is currently debating the use of administrative measures to keep investment in check, although these may not be effective in the long run. Such measures are considered in part because the majority of investment is not credit-financed. Specific measures in consideration are tighter controls on investment approval and land supply. Given China's stage in the reform process, such controls still have an impact, especially in the short term. This is so even if tighter control on land supply is not always strictly adhered to and may only bite with a lag, given that there is a significant "stock" of already approved land. In general, however, administrative measures tend to lose their effect over time if the fundamental factors driving investment are not addressed. These include (i) local government's urge to invest, stemming from weaknesses in the inter-governmental fiscal system and evaluation criteria for government officials; (ii) a relatively low interest rate; (iii) subsidization of investment in manufacturing stemming, among others, from the price and tax system (see below). Addressing these issues is important to ensure macroeconomic stability in the longer run. Measures recently announced by the National Development and Reform Commission (NDRC) to restructure

Figure 8. China's inter-bank rates remain low



Source: CEIC.

¹⁰ Higher inter-bank rates should discourage bill discounting, and only with inter-bank rates sufficiently close to the lending rate floor can the latter become binding again.

several industries (see below) may also have an impact on these industries. However, their economy-wide impact will be limited.

An acceleration of the gradual exchange rate strengthening would reduce pressures on monetary policy as well as help rebalance the economy. The authorities have announced their intention to continue with a gradual strengthening of the RMB and a gradual move towards more exchange rate flexibility. On a trade weighted basis, the RMB already appreciated some 9 percent in the year until April, in part because of a stronger dollar. However, with the recent weakness in the dollar, and the apparently still tight link with the dollar, the RMB actually depreciated on a trade weighted basis recently, a move that seems to go against the government's expressed policy direction. Accelerating the policy for a stronger RMB would reduce the pressures on monetary policy from the balance of payments. Moreover, a stronger real exchange rate would encourage investment in non-tradable sectors such as services rather than in tradables (manufacturing). This would therefore contribute to the desired rebalancing of the economy and lower current account surpluses.

Other measures would reduce foreign exchange inflows and promote outflows, thereby reducing official reserves build-up. The PBC recently announced measures promoting outflows, including raising the cap on individual's purchase of foreign exchange for current account transactions, facilitating payments for trade in services, raising the cap on firm's foreign exchange accounts, allowing qualified financial institutions to invest abroad, and allowing individuals to invest abroad through designated financial institutions. Liberalizing capital flows in this way may add to macroeconomic and financial risk, particularly with the exchange rate not yet fully flexible. However, given the limits and quotas on these possible outflows, risks should be containable, although they should be monitored closely. Additional measures to promote outflows and reduce inflows would include prepaying foreign debt, allowing reputable foreign financial institutions to raise money on the domestic market, reducing pay-in requirements for FDI, giving foreign firms access to the domestic financial markets.

The real estate sector may require specific attention and measures. Short term bills are particularly common in financing real estate. Concerns about too much lending to the real estate sector may by itself be a reason to drive up inter-bank rates. Also, significant price increases seem accompanied by high and rising vacancy rates and significant new supply. If true, this situation suggests that the market is not functioning properly. Unfortunately, data on the real estate market is particularly poor.¹¹ For the purposes of financial and macroeconomic stability, the government should focus on monitoring and regulating the financial market aspect of housing finance—including the development of instruments such as mortgage-backed loans and the refinancing market—and making the housing market function better. Key measures to make the housing market function better

¹¹ Affordability (house prices as a ratio of household income) is an often-used indicator of the potential for negative price corrections. Movements over time in this indicator do not look particularly worrying, with urban wage growth since the end-1990s in most cities not significantly lower than average house price increases. However, it is difficult to judge whether the level of the ratio is appropriate, due to the data issues and China's unequal income distribution.

are improving the quality and consistency of data on prices and vacancies and defining property rights more clearly. On the latter, unclear property rights prevent the rental market and the secondary housing market from developing. On the other hand, the government should not focus on, or try to influence, the housing price. Concerns about the affordability of houses for lower and middle income people should be dealt with by predictable, rule-based government support (for instance, via subsidies), and not by intervention in the market.

Structural measures to rebalance growth

The 11th Five Year Plan (2006-10) approved by the National People's Congress in March was in line with the proposals. Key objectives include a change in the pattern of growth, making growth cleaner, more technology and less resource-driven, and more equal.¹² On the macroeconomic side, the government would like to change the composition of demand, relying more on domestic demand and less on exports and investment. Two types of measures are needed.

First, several measures need to be taken to stimulate domestic consumption and reduce the saving-investment surplus. These measures include: (i) shifting government spending from investment to spending on health, education, and social safety; (ii) speeding up financial market opening and reform; and (iii) strengthening corporate governance and dividend policies (see previous Quarterly Updates for more detail).

Second, measures are needed to readjust the relative attractiveness of manufacturing production (tradables) over producing services (non tradables). Investments in China's manufacturing industries drawn by cheap labor and good infrastructure are welcome. But if investments are attracted by subsidized inputs, they may not be in China's interest. By increasing the price of these inputs, the government can change the relative price of tradables (manufacturing) to non-tradables (services), over and above the impact of the strengthening of the nominal exchange rate, thereby rebalancing the attractiveness of production in these sectors. This means:

- *Increasing the price of inputs into manufacturing, getting them in line with relative scarcities and social preferences.* These inputs include land, energy, water, utilities, and the environment.
- *Removing distortion in the tax system subsidizing manufacturing.* These include preferential treatment of FDI, including from the corporate tax system, and the VAT system.
- *Removing remaining restrictions on the development of a services industry.*

The NDRC in end-April announced measures to facilitate structural adjustment in the cement, aluminum, and coke sectors. The aim is to rationalize the industries and upgrade the production structure. In cement and coke, the aim is to concentrate production in fewer, larger, more efficient firms and to contain overall capacity. In

¹² The Five Year Plan and associated policies are discussed in the November 2005 and February 2006 Quarterly Updates.

aluminum, the aim is to cut capacity by 25 percent by 2010. The NDRC noted it will restrict access to new entrants and “eliminate” non-profitable producers with low capacity.

Fiscal policy

In the first two months of 2006, government revenue and expenditure both outperformed the budgeted growth. The Ministry of Finance planned 12 percent revenue growth and 13.8 percent expenditure growth in the budget for 2006, with a fiscal deficit of RMB 295 billion, or 1.2 percent of GDP. However, in the first 2 months, revenue and expenditure increased by 22 percent and 25 percent (yoy). Tax revenue increased by 18.9 percent (yoy) in the first quarter. The government’s finances would in principle allow for fiscal support to ease the impact on specific groups of other policies or developments, or to help boost domestic consumption. However, such spending should be controlled (administratively) and monitored well, and take place in the context of a long-term framework, as opposed to ad hoc measures.

Several tax measures were taken recently. To encourage resource and energy saving, the MOF imposed consumption taxes on several items and adjusted the consumption tax rate for automobiles. China also imposed an internationally common windfall tax on the production of domestic crude oil. The level of taxation is linked to the oil price, kicking in at an oil price of \$40 per barrel with a maximum of 40 percent. The government intends to use the revenue to finance new subsidies for groups that the government intends to shield from the impact of higher oil prices.

FINANCIAL SECTOR POLICIES AND DEVELOPMENTS

The People’s Bank of China (PBC) is taking the lead in developing a strategy to expand housing finance. Buying a house is considered not affordable for most lower and middle income families in China’s urban areas. The PBC is considering standardization of the primary mortgage market and a mortgage insurance and guarantee scheme. These are important reforms, also from the perspective of macroeconomic and financial stability. A framework of government support will be necessary to support housing for lower and middle income families in a meaningful way on a sustainable basis. As in other financial markets, policy coordination in housing finance will be a major challenge, as there are at least four government agencies involved.

Currently, the lack of development of financial markets means that much of the real estate risk lies with banks. Lending is dominated by commercial banks in China, which are funded by short-term deposits, raising potential future liquidity risk. There is very little product diversification in mortgage products. Banks still largely offer variable-rate mortgage loans at the same rate, although a few banks started to offer fixed-rate mortgage in late 2005.

A Consumer Credit Reporting System (CRS), piloted in 2005, has been deployed at the national level in January 2006. This is an important part of the financial infrastructure, as it should help banks pricing risk better. The system is expected to connect all major commercial banks and rural credit cooperatives by mid year 2006. As of the end of 2005, the CRS mainly contained information about the 4.52 million corporates that borrowed RMB 1.736 billion from financial institutions in 2005.

CORPORATE SECTOR POLICIES AND DEVELOPMENTS

Notable recent corporate sector developments include the government's new program to spur innovation and continued fine-tuning its arrangements for state-owned enterprises (SOEs).

Enterprises – including small and medium enterprises (SMEs) – are expected to play the central role in innovation. One of the key goals of the 11th Five Year Plan is to achieve “structural upgrading of the economy through self-innovation” (see the February Quarterly Update). Priority areas include energy, natural resources, environmental protection, agriculture, and information technology. Innovation in enterprises is meant to be guided by the market and supported by collaboration among industry and research institutions. Various supporting policies have been announced, including increased research budgets, tax incentives, improved financial services for high-tech sectors, innovation-oriented government procurement, better protection of intellectual property rights, education reforms and incentives, investment in “innovation bases,” and international cooperation.

Fine-tuning the government's role and proper alignment of incentives will be key. The efficiency with which China seeks to transform itself into an “innovation nation” will depend, in part on appropriate fine-tuning of the government's role and achieving an alignment of incentives among industry, research institutes, and government that leads to commercially-viable innovation. The experience of OECD nations, which include more efficient and less efficient government programs to promote innovation, warrants careful consideration.

The central administrator for large SOEs, the State-Owned Assets Supervision and Administration Commission (SASAC) continues to explore modalities for enhancing SOE governance and “ownership transformation.” A World Bank policy note on dividend policy¹³ triggered intensive media discussion and general agreement that SOE profits should be treated as public financial revenues to be managed within the government's overall budget. SASAC recently indicated that some SOEs would be included in a pilot “state assets management budget” in 2006. But neither the nature of a state assets management budget nor the Ministry of Finance's views have been made public.

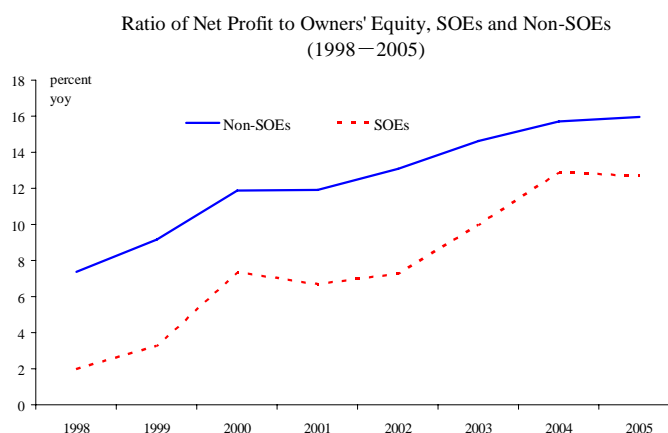
¹³ See <http://www.worldbank.org/china>, under “publications and reports”.

The benefits of establishing “second tier” “state assets management companies” (SAMCs) are unclear. It has been reported that SASAC may create a new SAMC in addition to China Chengtong and State Development Investment Company. Such SAMCs are expected to represent SASAC in such transactions as mergers and acquisitions (M&A) and public share offerings to achieve greater ownership diversification. Since central SASAC has organized its portfolio into a relatively manageable number of about 170 SOE groups, the benefits of establishing such “second tier” SAMCs is unclear. Such SAMCs may – at best – simply add a redundant layer of bureaucracy and – at worst – risk financial distress if implementation of a “state assets management budget” allows for debt-financing of M&A. While there are some successful examples of “second tier” state shareholding funds (e.g., Singapore’s Temasek), problematic examples in OECD and other middle-income countries should raise warning flags for SASAC.

Regarding SOE “ownership transformation” (privatization), SASAC is attempting to fine-tune controls over management buy-outs (MBOs) without necessarily banning MBOs. To some extent, SASAC is caught between public concerns about “loss of state assets” and desires to maintain momentum in the ownership transformation of small and medium SOEs.

Firms’ profitability has increased significantly since the end-1990s. The return on capital has increased steadily over time for both SOEs and non-SOEs. Non-SOEs have higher rates of return. The return on equity, measured by the ratio of net profit to owners’ equity, has increased from 2 percent in 1998 to 12.7 percent in 2005 for SOEs, and 7.4 percent to 16 percent for non-SOEs (Figure 9). Returns on total assets, approximated by the ratio of the sum of net profit and interest expenses to total assets, are lower, but show a similar increase over time. The findings on the relative performance of SOEs are not adjusted for the fact that capital intensity differs between sectors and SOEs traditionally play a larger role in more capital intensive industries. Nevertheless, Zhang’s (2004)¹⁴ findings suggest that this is also true adjusted for the sector. The pace of profitability improvement has slowed down in 2005.

Figure 9. Firms’ profitability has increased over time



Source: NBS and World Bank estimates.

¹⁴ Chunlin Zhang (2004), “Restructuring the State-Owned Enterprise Sector in China: Efforts, Effects and Remaining Challenges, *Journal of Restructuring Finance*, Vol. 1, No. 2 (2004).

Recently released World Bank studies on China:

- ***Revitalizing the Northeast: Towards a Development Strategy***
- ***Facilitating Investment and Innovation: A Market-Oriented Approach to Northeast Revitalization***

Northeast development would benefit from a shift in emphasis from direct government intervention to greater reliance on private sector investment, for instance through withdrawal of the state from small and medium sized enterprises and improvement of the local investment climate.

- ***SOE Dividends: How Much and To Whom?***

Most large SOEs should be expected to pay dividends, which should be treated as normal public revenues and subject to normal budget processes.

- ***China's Compliance with Food Safety Requirements for Fruits and Vegetables— Promoting Food Safety, Competitiveness, and Poverty Reduction***

Effective public sector actions can improve China's food safety compliance for fruits and vegetables, contribute to the competitiveness of the sector, and reduce poverty.

*The above studies are available on the World Bank China website:
<http://www.worldbank.org/china>*

- ***Reducing Poverty on a Global Scale: Learning and Innovating for Development***

Over 100 case studies of poverty reduction worldwide prepared for the Global Learning Process and Conference on Scaling Up Poverty Reduction held in Shanghai in 2004 show that reducing poverty significantly depends on several factors including leadership and commitment, institutional innovation, learning and experimentation, external catalysts such as donor assistance and sometimes even economic shocks.