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Quarterly Update

February 2007

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

OVERVIEW

Economic growth eased slightly in the second half of 2006, as strong external trade offset much of the impact of slower investment. Investment cooled in the second half in response to tightening measures introduced mid-2006. However, as exports continued to outpace imports by a wide margin, the impact on overall growth was largely offset and the external surplus reached new highs. As inward FDI also provided a steady stream of inflows, foreign reserve accumulation continued apace. Surging stock prices prompted government measures to slow the amount of new funds moving in the stock market.

Near term prospects remain broadly favorable. Chinese exporters and manufacturers have been affected by several recent policy measures to rebalance the economy, including tax measures and appreciation, and more such measures are likely to follow. However, continued productivity growth and a resilient world economy promise only a minor export slowdown. Domestically, the fundamental drivers of investment remain, and investment is therefore unlikely to slow drastically in 2007, while boosting consumption will remain challenging, particularly in rural areas. In all, our projection for GDP growth in 2007 remains unchanged at 9.6 percent. The external imbalance is unlikely to shrink much in the near term, and a significant surge in inflation seems unlikely.

China's internal macro challenges remain manageable, but the external imbalance is on the rise. Thus, policy measures that address domestic concerns could ideally also reduce the external imbalance. The government has already decided on a dividend policy for SOEs and a more rapid increase in spending on health and education, and has stepped up the pace of currency appreciation. These measures tend to reduce investment and increase consumption, and are thus steps in the right direction. Meanwhile, containing investment growth and inefficiency on a more sustainable basis calls for structural policies that address the underlying causes of inefficiency and excess investment.

While growth has been impressive in recent years, in the medium term China will increasingly rely on new sources of growth. China still has a vast potential for catching up in productivity, but China's industry, investment and export based growth has become problematic because of trade tensions and environmental and resource constraints. With a growth pattern that relies more on services, and more labor-intensive urban growth, more of growth could come from reallocation of labor out of agriculture. Growth along such rebalanced patterns could boost urban employment, wages and household incomes and reduce rural-urban disparities, while mitigating external imbalances.

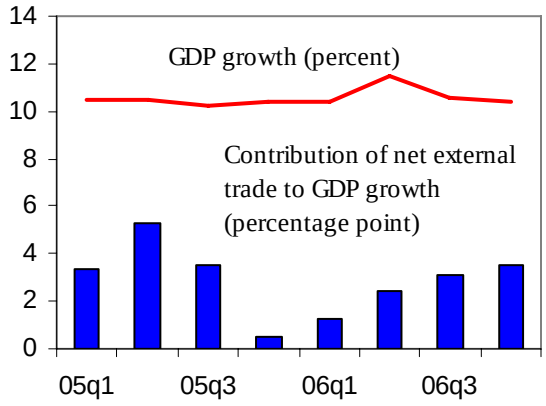
The third national financial work conference held in January set out directions for major financial sector reform. Key reforms discussed were in rural finance, foreign exchange management, and policy banks. On rural finance, it was decided to reduce the access thresholds for financial institutions to attract a more diverse set of providers and to continue the reforms of the Agricultural Bank of China. Looking ahead, rural finance would also benefit from interest rate liberalization and further reforms in existing providers. On foreign exchange reserve management, the meeting decided to explore ways to more actively manage the country's foreign exchange reserves.

RECENT ECONOMIC DEVELOPMENTS

Economic growth eased slightly in the fourth quarter of 2006. Real GDP growth was 10.4 percent (yoy), after 10.6 percent in the third quarter (Figure 1). This brought growth for 2006 as a whole to 10.7 percent, compared to an upwardly revised 10.4 percent in 2005.[1]

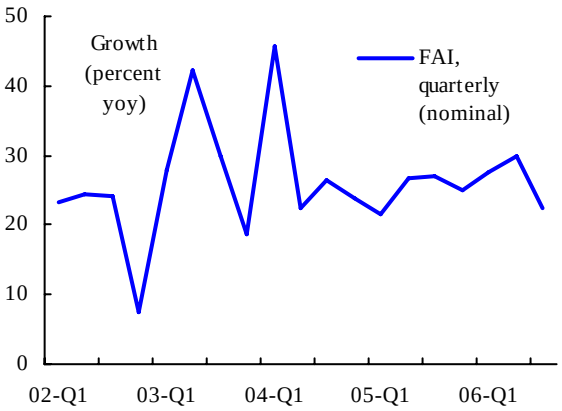
In the second half of 2006, investment cooled following policy measures. Nominal fixed asset investment (FAI) growth slowed to 22 percent in the third quarter (yoy), following a range of tightening measures introduced mid-2006 (Figure 2).[2] Monthly data on *urban* FAI suggests FAI slowed further in the fourth quarter, particularly in December. However, the monthly numbers can be volatile, particularly at the end of the year when decisions on when to complete projects can generate large swings.

Figure 1. GDP growth remains above 10 percent



Source: NBS, staff estimates.

Figure 2. Investment cools down



Source: NBS, staff calculation.

The impact on GDP growth was largely offset by net exports. As exports continued to outpace imports by a large margin, the trade surplus reached new record highs and the contribution of net trade to GDP growth increased from almost 2 percentage point in the first half to 3.3 percentage point in the second half (Figure 1).[3] We estimate that China's current account surplus has overtaken Japan's in 2006 to be the world's largest. Processing export growth trended down in 2006, in line with slowing global trade (Figure 3), but

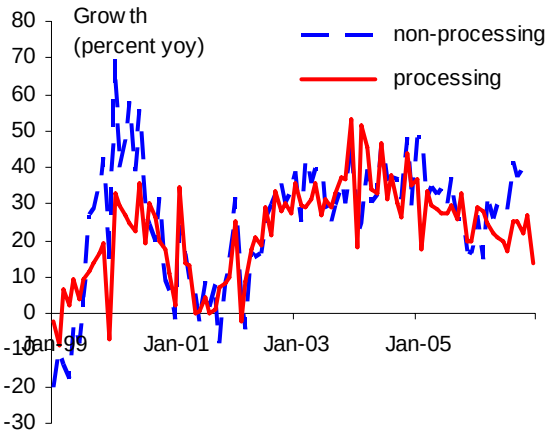
[1] The NBS now releases the national accounts data in 3 steps, with a preliminary estimate, a preliminary revision, and a final revision. The final revision of the 2005 data was released on January 23, 2007. The revision vis-à-vis the preliminary revision was explained by higher growth in the tertiary sector.

[2] The August 2006 Quarterly Update discusses these measures (pp 12-13).

[3] These estimates assume unchanged terms of trade. Factoring in declining terms of trade would increase the contribution of net trade to GDP growth.

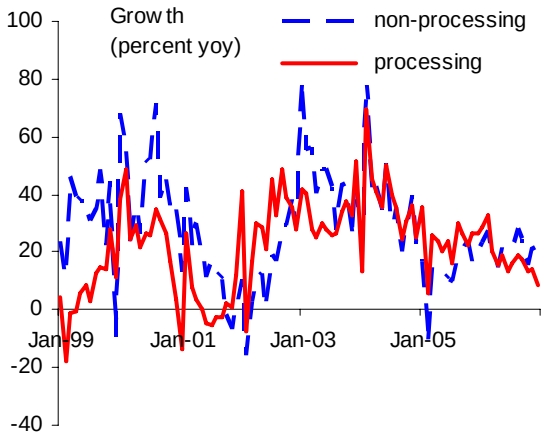
processing import growth declined even more (Figure 4).[4] As a result, the processing surplus increased and now accounts for all of the trade surplus. The balance of the other half of trade, non-processing trade, saw the deficit decline from US$ 73 billion in 2004 to US$8 billion in 2006, as non-processing exports powered ahead. The import slowdown in the second half of 2006 was led by machinery and equipment, consistent with the slowdown in FAI. However, overall non-processing import growth has held up quite well in late 2006 (Figure 4).

Figure 3. Non-processing exports power ahead



Source: NBS, staff estimates.

Figure 4. Non-processing imports hold up well



Source: NBS, staff calculation.

Foreign reserve accumulation continued apace. While the trade surplus and inward FDI has provided a steady stream of foreign exchange inflows, net non-FDI capital flows has been more volatile. In the third quarter of 2006 non-FDI capital flows were negative, led by domestic financial institutions, which some argue was done at the request of the authorities. In any case, in the last months of 2006, non-FDI capital flows seem to have been quite small on balance.

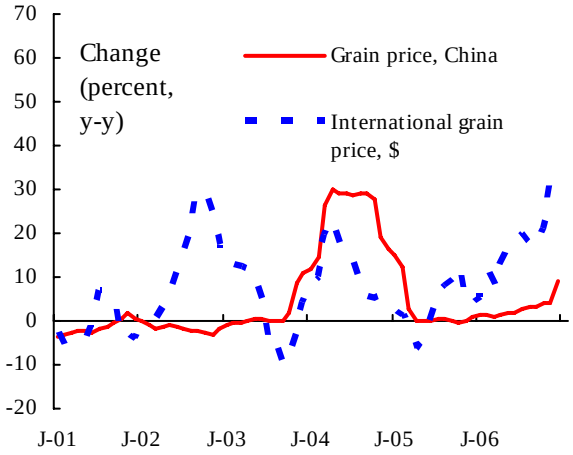
Consumption has continued to grow robustly, but still slower than overall GDP. Retail sales (in nominal terms) rose almost as much in rural areas as in urban areas in 2006, although rural retail sales in particular are not a good proxy for consumption because they include significant business expenditure. However, income developments indicate the challenge of further boosting demand in rural areas and offsetting urban-rural inequality on a sustained basis. The NBS reported that real per capita household income rose 7.4 percent in 2006 in rural areas, compared to 10.2 percent in urban areas.

Consumer price inflation has picked up recently, due to higher food prices. In December, consumer prices rose by 2.8 percent (yoy), led by higher food prices, especially grain. Since WTO accession, grain prices in China have been moving more in line with

[4] The import/export ratio in processing started to decline in 2005, after years of broad stability.

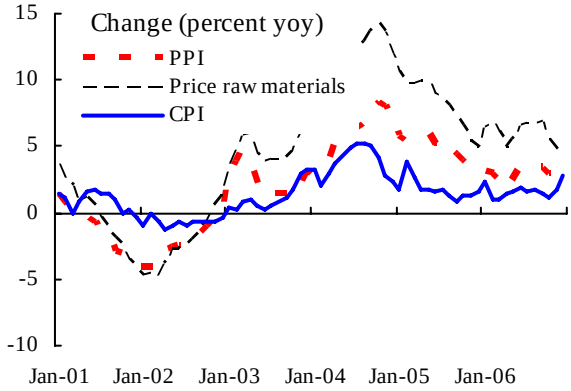
international prices (Figure 5). International grain prices rose sharply in late 2006, due to drought in Australia, as well as rising demand for grains for the production of bio fuel. Chinese grain prices have risen less than international prices, in part because the government has released grain on the market from its grain reserves.[5] Non-food consumer price inflation remains modest at around 1 percent. PPI inflation was about 3 percent in the fourth quarter, and raw material price inflation around 5 percent (y-y), having eased throughout the year (Figure 6).

Figure 5. Grain prices are up



Source: CEIC, World Bank, and staff estimates.

Figure 6. Consumer price inflation up



Source: NBS, staff calculation.

China's stock markets have risen sharply since mid-2006. Progress in equity market reform, notably a reduction in the overhang of non-tradable shares, has boosted stock prices. The rapid stock price increases have re-invigorated the public's enthusiasm for investment on the stock market, and the amount of funds flowing into mutual funds increased rapidly.[6] The government temporarily halted approval for new mutual funds in December and banned banks from extending loans for buying stocks in January. Observers are concerned that relatively relaxed monetary stance and ample liquidity in the banking system is fuelling the inflows. That may be the case. However, concerns about the impact of liquidity on the stock market should relate to the stock of M2 rather than the flow.

A medium-term perspective

Four good years. 2006 was the 4th year in a row with GDP growth exceeding 10 percent. Although this is not much different from the average during 1978-2005, what is impressive about the recent growth is that it has been stable at a very high level for a sustained period of time. What explains this performance?

[5] The PBC noted that the grain price rose 9.1 percent (yoy) in December.

[6] The State Information Center indicated that in the first 10 months of 2006, 49 new equity funds (among a total of 63 new funds) raised RMB 181 bln, exceeding the total stock of equity funds volume at end-2005.

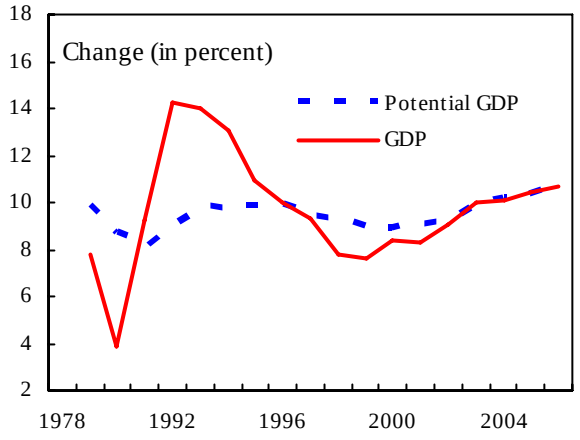
First, economic reforms continued to make China's labor and capital more productive. WTO accession in 2001, with its increased entry and competition on domestic markets and improved access to foreign markets, has provided a particular boost for trade, investment, and competition, factors that are associated with productivity increases around the world. This decade China also reaped the full benefits of the SOE reforms initiated in the mid-1990s. While restructuring may have moderated growth in the 1990s, the reallocation of labor and capital increased productivity in the economy as a whole, and also boosted the performance of SOEs in this decade.

Second, increased profitability and a recovery in government revenues boosted already high savings and investment. Enterprise savings increased on the back of enterprise reforms, a shift towards more industrial activity and a more private economy, and gains in productivity and profitability more generally. Government savings increased after the 1994 fiscal reforms resulted in higher revenues of which a significant part was used to finance investment rather than current spending. China's high saving and investment allowed more capital deepening and infrastructure construction, which in turn increased labor productivity and potential GDP.

Third, better macroeconomic management has reduced economic volatility and risk. Actual GDP growth has remained much closer to potential GDP growth in this decade than in the decades before (Figure 7). More macroeconomic stability, desirable in its own right, also promotes growth by lengthening horizons of investors and reducing the probability of misallocation of investment.

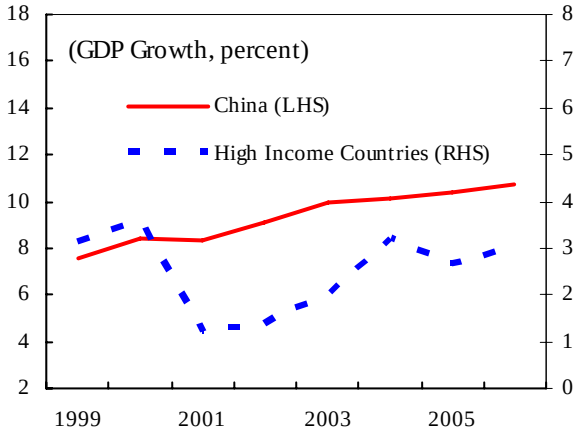
Fourth, the global environment has been very favorable. Global growth and trade have been high and there has been far less financial turmoil than in the 1990s (Figure 8). Global growth in the last five years has been remarkably resilient, and averaged around 4 percent, levels not seen since the late 1980s. World trade led the way, and created a very benevolent environment for China's exports, which grew on average with almost 30 percent per year.

Figure 7. GDP growth close to potential



Source: CEIC, World Bank, and staff estimates.
1/ estimated using a Cobb Douglas production function.

Figure 8. Benign global environment



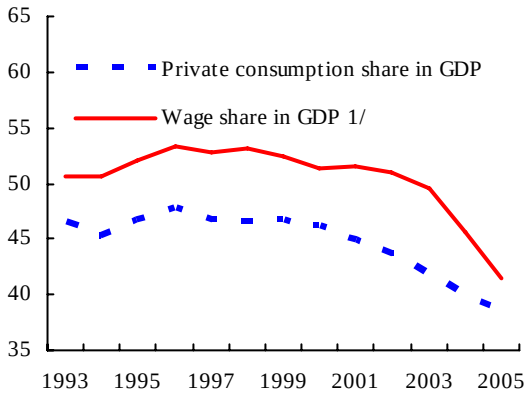
Source: NBS, staff calculation.

What are the growth prospects for China in the medium run? China still has a vast potential to catch up in productivity with more advanced countries. However, China's industry, investment and export based growth model has also become increasingly problematic because of the trade tensions and environmental and resource constraints it entails. Moreover, if driven by accumulation of capital alone, growth will in the end run out of steam. So the government is opting for growth that relies less on industry and investment.

What could be the sources of growth if not industry and investment? China's trade in goods is already very open, and further opening up may still be desirable, but is likely to generate less efficiency gains than in the past. In contrast, reallocation of capital still has some way to go: although the state's share in the economy is now below 40 percent, banks still lend predominantly to SOEs rather than private and notably smaller enterprises, which yield higher returns. So further financial sector reforms should be high on the agenda. Also, making labor more productive by increasing *human* rather than physical capital still has considerable growth potential: over the reform period, China has received only a modest 0.4 percentage point annual growth on average from more schooling. Further, 40 percent of China's labor force is still tied up in low productivity agriculture, where labor productivity is only around 1/6th of that in the rest of the economy. Reallocating more excess labor—which some estimate to be half of the agricultural labor force—to other sectors, in particular to labor intensive services, could vastly increase productivity and therefore growth. Increased competition in the services sector as a result of WTO accession will certainly help, but further reducing state monopolies and removing policies that bias development towards industry are key.

Growth along such rebalanced patterns would increase the share of wages and household incomes, and thus the share of consumption in GDP. The latter is one of the key objectives of rebalancing. The flipside of the increase in the share of profit and taxes mentioned above is that the share of wages and household income in the total economy has declined (Figure 9). Many discussions on how to boost consumption in China still center around household saving. However, most of the decline in the consumption to GDP ratio since the late 1990s can be explained by the decline in the share of wage income in the total economy rather than a change in household saving behavior. The share of wages in GDP declined from 53 percent in 1998 to 41.4 percent in 2005, which compares to 57 percent in the

Figure 9. The wage share has declined



Source: National Bureau of Statistics.
1/ From Statistical Yearbook. There is no data for 1995 and 2004.

US.[7] That is why rebalancing the pattern of growth, featuring prominently a move to a more labor intensive urban growth, will need to be a key part of an effort to boost the role of consumption in the economy and sustainably reduce the trade surplus. For details and the policies, see the November 2006 Quarterly Update (pp 15-17).

ECONOMIC PROSPECTS AND POLICIES FOR 2007

Economic prospects for 2007

Global prospects remain favorable, although risks remain. The world economy appears to be more resilient than previously thought (**Table 1**). Although the US housing market remains weak, the overall economy is holding up better than expected, in part because of declining oil prices, and a soft landing is now more likely. Meanwhile, economic recovery in Europe has become more broad- based, Japan's growth continues, while the expansion in the developing world remains strong. Major risks remain, notably disorderly adjustment of global imbalances, a sharper than expected slowdown in the US, and geo-political risks. But, largely because of better growth in the US, a halt in the rise of the US trade deficit, and lower oil prices, the risks are lower now than 3 months ago.

Table 1. Global conditions remain favorable.
(percent change, unless otherwise indicated)

	2005	2006	2007
World GDP 1/	3.5	3.9	3.2
World trade (volume)	7.7	9.7	7.5
Oil price ($/bbl)	54	64	56
Non-oil commodity prices	13.4	20.6	-4.5

Source: World Bank DEC Prospects Group (Jan 2007).
1/ Market exchange rates.

In China, domestic prices and costs will continue to be adjusted gradually, with impact on exports. In general, exporters have so far been able to absorb the recent currency appreciation—against the US$ and in trade-weighted terms—and rising costs of domestic inputs such as land and wages without reducing margins. This has been made possible by rapid productivity growth and some export price increases. Several recent policy measures that further rebalance also increase costs, including rising industrial-use land fees and taxes, lower VAT export rebates, and new export taxes on energy intensive products. More such measures are likely to come, as well as a further appreciation of the currency, but they are likely to be implemented gradually, so that they can be absorbed by productivity growth, and upgrading of the production structure. On the demand side, a resilient world economy means that export demand prospects remain good, although less buoyant than in 2006. Overall, taking into account continued capacity expansion, we project export growth to decline to 20 percent in 2007, in real terms, from 24 percent in 2006.

[7] Changes in methodology may complicate the interpretation of this data over time. But the trend is consistent with some other sources of data, and the data for 2005—based on recent methodology—can usefully be compared with other countries.

Domestic demand prospects remain solid. With rising profit growth (31 percent in the first 11 months of 2006 (yoy)) and ample liquidity in the banking system, the fundamental drivers of enterprise investment are still present. Thus, investment is unlikely to slow drastically in early 2007. Consumption should grow solidly, underpinned by income growth and to a lesser extent the shift in government spending towards health and education, but held back by food price increases. We keep our projection for GDP growth in 2007 unchanged at 9.6 percent (Table 2).

Table 2. China: Main Economic Indicators

	2003	2004	2005	2006	2007 1/
The real economy (change in percent)					
Real GDP (production side)	10.0	10.1	10.4	10.7	9.6
Real GDP (expenditure side) 2/	10.5	9.9	12.1	…	…
Consumption 2/	6.6	7.1	8.3	…	…
Gross capital formation 2/	17.2	13.4	10.9	…	…
Fixed capital formation	17.0	11.6	14.8	…	…
Exports (goods and services) 3/	26.8	28.4	23.6	24.3	19.8
Imports (goods and services) 3/	24.9	22.7	13.4	16.3	17.5
Consumer prices (period average)	1.2	3.9	1.8	1.5	2.5
GDP deflator	2.6	6.9	3.8	3.0	3.0
Fiscal accounts (percent of GDP) 4/					
Fiscal balance	-2.2	-1.3	-1.2	-1.0	-0.7
Total revenue	16.2	16.6	17.8	18.9	19.2
Total expenditure	18.3	18.0	19.0	19.9	19.9
External account (US$ billions)					
Current account balance	46	69	161	230	260
As share of GDP (%)	2.8	3.6	7.1	8.7	8.3
Capital account balance (including errors & ommissions)	71	138	47	17	8
of which: FDI (net)	47	53	68	63	52
Change in reserves (increase =+)	117	206	207	247	268
Foreign exchange reserves	403	610	819	1066	1334
Other					
Broad money growth (M2), e-o-p, in percent	19.6	14.6	17.6	16.9	16.0

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

1/ Projection.

2/ Estimations are based on the newly released national account data (Table 3-13 in China Statistical Yearbook 2006).

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

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

The external imbalance is unlikely to shrink in the near term. The trade surplus may flatten out eventually because the expansion of manufacturing capacity that underlies much

of it is likely to moderate.[8] Nevertheless, import projections need to take into account that imports have been growing more slowly than could be expected based on historical patterns for a few years now, in part because of continued deepening of supply chains within China. One sign of this is the steadily decline in the ratio of imports to exports in processing trade since early 2005. This phenomenon has few precedents, and the future trend is difficult to quantify. We interpret it as an upside risk for GDP growth and the external surplus, and with that proviso in mind project a current account surplus of 8.3 percent of GDP.

Although consumer price inflation has picked up, medium-term inflationary pressures remain moderate. The sharp increase in grain prices has pushed up headline inflation. Some of the cost pressures affecting manufacturing indicated above will also impinge on consumer prices. However, raw material prices have come down, with the oil price decline particularly notable, and the RMB's appreciation makes imports cheaper. From a medium-term perspective, with relatively good credibility of monetary policy, a strong currency, and excess labor, a significant surge in inflation seems unlikely.

Economic policies

While the short-term internal macro challenges remain manageable, the external imbalance has further intensified. The risk of too rapid investment growth remains, because the fundamental drivers remain in place. However, with FAI growth slowing, policymakers can be less concerned about "investment overheating" than a year ago. The uptick in inflation should be monitored but is unlikely to become a major policy challenge. In the meantime, the high trade surplus has grown further and has been put firmly on the government's agenda.[9] Much of the planned reduction in the trade balance will have to come from policies to rebalance the economy, including fiscal and pricing policies and a stronger exchange rate.

These circumstances have implications for the type of macro measures to be used to address domestic concerns. The preferred measures to lower investment growth would be those that strengthen consumption at the same time, so as not to aggravate the external imbalance. The preferred measures to counter possible inflation pressure would be those that also mitigate the external imbalance. In the mean time, containing investment growth sustainably and improving the efficiency of investment calls for structural policies that address the underlying causes of inefficient investment: adjusting prices of energy, resources, land, and the environment, further reforming financial markets, introducing—as planned—a dividend policy for SOEs, and addressing local government incentives. China is relatively well-placed to deal with a soft landing of the world economy. Policy should be

[8] See the discussion by Jonathan Anderson of UBS on market based rebalancing in *Rebalance This*, UBS Asian Focus of December 12, 2006.

[9] Minister of Commerce Bo Xilai noted in January that "China's excessive trade surplus is detrimental to both domestic economic development and foreign trade relations" and that reducing the trade surplus was the "top priority" of trade policy this year. http://news.xinhuanet.com/fortune/2007-01/15/content_5608411.htm

ready to act if the global economy turns out to be weaker than currently foreseen, but China's policymakers, especially fiscal, have sufficient leeway to boost demand if and when needed.

China's main challenge remains to rebalance the economy. The annual Central Economic Work Conference in December 2006 called for further progress in building a harmonious society, and "efforts…to restructure the economy and transform modes of growth, promote the conservation of energy and resources, and protect the environment." In terms of overall economic strategy, this means a relative shift in production from industry towards services and more labor-intensive urban growth. The November 2006 Quarterly Update discusses this rebalancing and policy options to tackle them more in-depth (pp 15-17).

Monetary and exchange rate policy

The People's Bank of China (PBC) announced monetary targets for 2007. The target for end-2007 M2 growth is 16 percent (yoy). On the basis of the government's projections—8 percent GDP growth, 3 percent CPI inflation—this would imply a larger decrease in velocity than the outcome in 2006.[10] However, using the market consensus projection for GDP growth of 9.6 percent, the M2 target would imply a decrease in velocity broadly similar to that in 2006. In contrast to previous years, the PBC did not set targets for M1 or credit growth, probably in recognition of the fact that targeting these aggregates has become more difficult in China's now more complex economy and rapidly changing financial system.

The PBC faces medium and short term challenges. As economic development continues, the exchange rate becomes more flexible, and the capital market more open, the PBC will eventually need to adjust its framework for monetary policy away from quantitative targeting, probably with a more explicit role for an inflation benchmark. In the short term, irrespective of the framework and anchor, the operation of monetary policy will continue to focus on draining excess liquidity out of the banking system. More exchange rate flexibility will help in getting better control over the monetary stance, as it would reduce the balance of payment surpluses and provide more room for monetary policy to operate to mop up liquidity without triggering renewed capital inflows.

The case for tighter monetary policy and higher interest rates has strengthened. The PBC has expressed concern about the impact of balance of payment surpluses on property prices and the potential for asset market bubbles, and indicated that it would take steps to mop up liquidity.[11] Significant mopping up would tend to increase interbank rates, and traditionally the PBC has been reluctant to see interbank rates rise, for fear of attracting

[10] In 2006, end-year M2 growth was 16.9 percent, year average GDP growth 10.7 percent, and end-year CPI inflation 2.8 percent.

[11] According to an editorial in the Financial News, a newspaper published by the PBC. http://business.sohu.com/20061127/n246626576.shtml

non-FDI capital flows. However, with such flows having apparently dried up, the PBC may have become somewhat less reluctant to see interbank rates go up. A desire to dampen the relative attractiveness of stock markets over bank deposits would strengthen the case for both higher deposit and lending rates. Finally, the recent uptick in inflation, if sustained, would support the case for higher interest rates.

The case for further appreciation has strengthened. Reducing the trade surplus has become a firmer target of economic policy, and the exchange rate appreciation so far is perceived as not having hurt the economy much, mitigating concerns over further appreciation. Indeed, the pace of appreciation against the US$ has picked up since the summer to an annualized rate of about 5.3 percent in the 6 months to end-January. The recent increase in inflation provides an additional reason in favor of appreciation.

Fiscal and structural policies—steps towards rebalancing the economy

While overall fiscal policy is set to stay prudent, the government is targeting more spending on health and education. Finance Minister Jin Renqing in December noted that the fiscal deficit will be reduced further in 2007. Minister Jin also noted that "social services, especially in rural areas" will be a priority for government expenditure.[12] These services include education, medical care, and social security. In 2007, tuition fees will be waived for all 150 million rural children eligible for 9 year compulsory education.[13] More rural people will be covered by the co-operative health care insurance. The system will be tested in about half of China's rural areas. In 2008 it will be expanded to cover 80 percent of the rural population. The government's per person spending on the program will be increased from RMB 10 to RMB 20. Both programs have been accelerated compared to the target in the 11th 5 year plan.

Unification of corporate tax rates comes closer. End December, the government submitted to the National People's Congress' standing committee a draft new corporate tax law containing one unified tax rate for domestic and foreign funded enterprises (FFEs) and uniform treatment of tax deductibles and tax base. The new unified rate of 25 percent would imply a significant increase for FFEs operating in special economic zones, which now pay 15 percent (other FFEs now pay 24 percent). The new rate will be a decrease for domestic firm, which now pay a statutory rate of 33 percent. The move is likely to make investment in domestic enterprises—which are in general more oriented on the domestic market—more attractive. Also, it is likely to end the so-called "round tripping" of domestic capital disguised as foreign, and thus reduce measured FDI, although not genuine FDI.

As part of the broader effort to rebalance the economy, several additional measures have recently been announced or implemented. They include the following:

- The authorities have started a pilot with "full cost coal pricing" in Shanxi. By explicitly pricing in the costs of the resource, the environment, and workers' safety

[12] http://news.xinhuanet.com/politics/2006-12/19/content_5507946.htm

[13] The tuition fees of 50 million of these, in China's Western provinces, had already been exempted in 2006.

and welfare, this measure would raise the price of coal by RMB 50-70 per ton, or about 1/6th to 1/5th.

- The Chairman of the state-owned assets supervision and administration commission (SASAC) indicated that a proposal to reintroduce SOE dividend payments to the state would be approved by the State Council in early 2007.

- The government has set minimum prices for the sale of land for industrial use as of end December 2006. The rules aim to stop selling land below costs to attract investment. The minimum price on land sales for industrial use will range from RMB 60 to RMB 840 per square meter. However, local government are still allowed to make exceptions. In certain circumstances, the minimum price can be 60 percent of the floor price.

- In addition, land-use fees for construction projects will double, to between RMB 10 and RMB 140 per square meter. This fee is paid for construction on rural land.

- The SAT announced a profit tax on the real estate sector, per February. The move was apparently motivated by a desire to reduce the attractiveness of real estate investment, reviving a rule previously introduced in 1993 that had not been enforced.

While gasoline prices were reduced, the debate on the introduction of a fuel tax continues. The government used the drop in oil prices on the world market to reduce the price of gasoline, while leaving the price for diesel unchanged. With the move, gasoline prices at the pump are back to around 60 dollar cents per liter, some 20 percent lower than the US prices, about a third of prevailing European prices, and comparable to pump prices in major oil exporters such as Indonesia and Malaysia. Newspapers report that the long-standing proposal for a fuel tax is stuck on a debate on the use of the tax. Some see the fuel tax as a means of financing roads and road maintenance, and therefore want to earmark the revenues for that purpose while at the same time abolishing the road user fees. Part of a fuel tax could be indeed be used for road maintenance, and such a use would reflect to some extent the benefit principle of taxation. However, this will only be a small part. A proper fuel tax in China, like in other countries, is likely to raise considerable more revenues than needed for the roads sector. In Hainan, which has been experimenting with a fuel tax to replace the road maintenance fee, the tax was less than 2 Yuan per liter.

Irrespective, a fuel tax is the instrument of choice to limit car use, vehicle pollution and energy intensity in the economy. Proceeds from the tax could be used to promote the government's goals, or for reducing other taxes, for instance on labor, to promote growth and employment. Apart from these principal considerations, practical issues are also at stake. A fuel tax is easily administered because there are only few fuel producers, and taxation "at the source" is easy. However, because of the highly decentralized nature of government responsibility for roads in China, administrating a scheme that shares those revenues with all the jurisdictions involved may become administratively very complex. Meanwhile, the Government need not wait with a fuel tax before a road fund, if any, will

be ready. Instead, it can consider keeping the road maintenance tax for now while using the receipts of a fuel tax for other purposes. Once decisions on a road fund are made, the road maintenance fee can be abolished, and the fuel tax increased with an equivalent amount. The reason for moving now on the fuel tax is simple: a time of falling oil prices is a good time to consider introducing the tax: people are already used to higher fuel prices, and rather than passing on the reduction in oil prices on the world market to consumers, the government can introduce the tax without additional pain.

FINANCIAL SECTOR POLICIES AND DEVELOPMENTS

The third national financial work conference concluded on January 20 set out directions for improving China's financial sector. This high level meeting, held every 5 years, has charted major new policies in the past, This year's meeting discussed a wide range of reforms including in rural finance, policy banks, and foreign exchange management. The meeting decided on broad direction of reforms, which over the coming months and years will become more detailed.

On *rural finance*, it was decided to reduce the access threshold for financial institutions into the rural market and to continue the shareholding reforms of the Agricultural Bank of China (ABC). Before the conference, the China Bank Regulatory Commission had already announced more detailed measures regarding increased access. They are a major step towards a more open and diverse rural financial market, which for decades has lagged behind developments in other parts of the financial sector. This is particularly true on the lending side. Other financial services such as depositing money and payments services are abundantly available. The net withdrawal of funds from the countryside, which is common around the world, is accentuated in China by insufficiently developed rural finance. Key factors hindering lending are constraints on entry, limits on lending rates, weak existing rural financial institutions, and an inadequate legal environment. These issues have taken central stage as better rural finance is an important building block for the new socialist countryside and harmonious society. Looking ahead (i) for rural finance to be sustainable it needs to be commercially viable, with interest rate caps removed; (ii) rural economies and finance would benefit from a more diversified field of providers; (iii) a more differentiated rural financial sector will require adjustments to the regulation and supervision framework; (iv) the government rightly is putting renewed emphasis on reforming the ABC; and (v) consolidation of reform of the Rural Credit Cooperatives (RCCs) is important. We will now elaborate on these issues.

For rural finance to be sustainable it needs to be commercially viable finance and to comprise a more diversified field of providers than is currently the case in China. This is shown by international experience from countries with successful rural finance such as Indonesia, Mexico, and Brazil. The government clearly has a role to play in creating the environment for such a diversified commercial financial sector; by allowing commercially viable interest rates; by sustaining sound prudential regulations and supervision and by supporting healthy competition among lenders to minimize risk and interest rates, and by supporting innovations in finance that promote better access in rural

areas. China has a long-standing limit on lending rates in rural areas. Government has limited lending rates in part because of a legitimate concern that the poor cannot afford the rates, and in part because it has used credit as a poverty alleviation tool. Although the lending limits have recently been increased, at 2.3 times the base lending rate they are still too low to make finance commercially viable in cases where the clients are remote and scattered and the loans are small and infrequent. For comparison, urban rates for micro and small enterprises with good credit prospects is at about 18-20 percent per year, and in countries such as Indonesia the lending rate for rural finance can be as high as 20-25 percent in real terms. The hard truth is that as a result of the lending rate limits rural credit is less than it should have been, and the poor are simply not creditworthy at the current rates. One way forward is to clearly separate the poverty alleviation goal from the financial sector, and shift government programs to help the poor to the government budget. The financial sector can still be an agent for the government—for a fee—and help distribute the money, but a commercial rural financial sector cannot be expected to take on credit risk in poverty alleviation programs. Once the poverty alleviation function is removed from the financial sector, interest rates can be further liberalized.

The increased entry that the new CBRC rules now allow should create more competition among financial institutions. This in turn would limit the possibility of excessive interest charged by banks and informal money lenders. The new rules vary the capital requirements for financial institutions from 100 percent (which means institutions that lend only from own capital) to 8 percent (banks). Options for more competition in rural finance include stronger rural credit cooperatives, domestic and foreign commercial banks, possibly a Postal Bank and other players such as credit cooperatives, the microcredit agencies that are currently being experimented with, and even currently informal money lenders.

It is the challenge for government to create regulation and supervision to allow such a more differentiated rural financial sector to emerge, while safeguarding people's deposits and trust in the system. One practical step is more staff in CBRC that needs to supervise more and more diverse organizations as well as encouraging further consolidation of the large number of existing, but weak RCCs. One option to consider is to spin off the responsibility of regulating and supervising rural commercial banks (RCBs) to those units in charge of joint-stock commercial banks (JSBs), because by nature the RCBs are no different from the JSBs, despite the word rural in their names. This will potentially release regulatory and supervisory resources for the increased demand for effective regulation and supervision of the numerous new entries as a result of the recent CBRC policies. A wider variety of institutions is likely to require more capacity in CBRC. The government's plans to implement an explicit deposit guarantee scheme (as opposed to the implicit one currently in place) could also help, if well designed. Key for supporting healthier rural finances is that the scheme reinforces rather than distracts from prudent behavior of financial institutions, including a mechanism to correct weak finances and in the end a mechanism for orderly exit for those that fail to meet prudential criteria.

The government is rightly putting renewed emphasis on reforming the ABC. The ABC is the only large state-owned bank that has yet to embark on major reforms, and it is

one of the more troubled banks, with an NPL ratio of 23 percent, three times higher than the industry average of 8 percent. At this stage ABC reforms are likely to matter less for rural reforms than some of the other announced reforms. The bank is no longer specialized in rural finance, having currently less than one fifth of its lending portfolio in agricultural credit, a share that has been steadily declining. Thus, reforms of this bank need no longer be constrained by its former role as a rural credit provider, and it is not a good idea to force ABC back to the rural areas as it has become an urban bank despite the name. More generally, tying financial service providers geographically or to certain groups of clients is a suboptimal solution to rural finance. Thus, financial institutions should not be required to serve specific clients. All the options used in the successful reform of the other State Commercial banks can be considered, including strategic investors, consolidation of branches and personnel, tightening of the internal governance structure and centralization of lending authority, and even divestiture of the remaining rural portfolio to banks eager to grow in rural areas.

More important for rural credit are the Rural Credit Cooperatives (RCCs). The critical issue here is to consolidate the results of the 2003 reform by (1) making the RCCs truly autonomous by returning the management power to the RCCs shareholders and their representatives at the board; (2) rationalizing the roles and functions of the provincial RCC Unions by making them service providers rather than managers for RCCs; (3) freeing the RCCs of policy-oriented functions such as agricultural loans at subsidized interest rates so as to put them on a commercial path; (4) subjecting RCCs to increasing competition from new entry and allow RCCs to be purchased or merged by foreign and domestic investors. In this connection the CBRC is to be commended for its recent policies to promote entry by lowering threshold coupled with enhanced regulation.

The reform of policy banks was also on the NFC agenda. This is a good time for China to reconsider and realign the role of policy banks, for several reasons. Some of these policy banks have increasingly entered in largely commercial operations. For others part of their mandates have become obsolete, as in the case of Agricultural Development Bank of China with the reform in the procurement of agricultural commodities. There are areas where the policy banks can play a role in enhancing commercial finance. An example is Mexico's rural finance system, which created development agencies to serve as apex institutions to leverage greater scale of funding to rural areas through commercial financial institutions. Such a government development agency can focus on evaluation and selection of the commercial financial institution, and in so doing provide incentives to improve their governance and performance. The development agencies provide technical assistance and wholesale funding to the private FIs to build up their capacity and to meet their funding needs especially in cases where the PFIs do not have access to retail deposits. Similar cases can be found in Brazil, India and Ghana. China may wish to study these practices and decide whether this is a useful route to take in pursuing the "commercialization" of development banks.

The third major area of debate at the meeting was foreign exchange reserve management. The meeting decided to further explore ways to more actively manage the country's foreign exchange reserves. Even with more rapid implementation of the

economic policies that could lead to more balanced growth, the current external imbalances are unlikely to disappear overnight. Further managed opening up the capital account for outward investment may also help to slow the inflow in foreign exchange, although for now only limited use has been made of the expanded QDII scheme, in part because under QDII domestic investors are only allowed to invest in overseas fixed income products, which at the moment are not very attractive because the yield differential with domestic instruments may not compensate for expected appreciation of the RMB. So, with full exchange rate flexibility still quite far away, on current policies, the foreign exchange inflow is likely to persist for some time to come. This means that China's international reserves—with more than $1 trillion already the largest in the world—are set for further increases.

Given this size, managing these reserves well is an important issue. Furthermore, the current arrangement, in which the PBC buys part of the foreign exchange as part of its role as manager of the exchange rate, causes domestic liquidity to increase. Some increase is fine: a growing economy such as China needs more reserve money, and the 9 percent growth in reserve money that China targets for the year means that balance of payments surpluses in the order of $60-70 billion, or 3 percent of GDP can easily be absorbed. But inflows beyond that need to be absorbed by issuance of central bank bills or bonds to prevent too much liquidity spilling over in domestic credit. This sterilization may affect the balance sheet of the central bank and also brings a lot of relatively short term paper on the market, which end up on the balance sheets of financial institutions, some of which would be better off with longer term paper.

Various options have been under debate on how to better manage the foreign exchange reserves, and what institutional arrangements are needed to do so. One option is simply to leave the institutional arrangements the same and have SAFE invest in a more diverse set of overseas assets. According to market sources, this is what has already been happening to some extent, and some part of China's reserves have been invested in investments not usually considered as typical for a central bank—although "typical" is a relative word in a world in which central bank reserves have been swelling in many parts of the world. Another option discussed has been to use an entity like *Huijin* to redirect parts of the foreign reserves for other purposes like bank recapitalization or pension fund top-ups. This has a precedent—part of the international reserves was used to capitalize *Huijin*, which in turn invested in state banks after the government's capital was written down against NPLs. A third option discussed is an investment vehicle like Singapore's Government Investment Corporation. Such a government corporation could either buy foreign exchange from the People's Bank or buy it from the market by issuing bonds or in exchange for other assets, and invest it abroad. As Jonathan Anderson of UBS, an investment bank, argues, such a corporation could invest in a broader set of assets better aligned with China's strategic priorities rather than just in assets suitable as reserve instruments.[14] Further, if financed by government bonds or by government surpluses or cash from the banking system, this would withdraw liquidity from the monetary system,

[14] See "UBS Asian Economic Comment - China: The Financial Work Conference and FX reserves" of January 23, 2007.

and could thus support the central bank's monetary policy goals. Some newspapers reported that decisions had already been taken regarding future institutional arrangements. However, no official announcement has been made thus far, and whether to pursue an alternative, and if so which one, will no doubt be seriously debated in the coming months.

Housing Provident Funds (HPFs)

In the November Quarterly Update, we discussed the operations of Housing Provident Funds (HPFs) in the context of the government's desire to make housing finance more affordable for lower and middle income people. This is a topic of great interest to China's policymakers and public, as evidenced by the number of responses, and clearly needs more research and policy follow up.

The government is considering options for housing finance system development and the role of HPFs. In the context of the government's objective of giving lower and middle income people better access to housing finance, using HPFs as an important vehicle has been proposed as an option. It was in this context that we discussed the operations of HPFs. We are well aware of the important role HPFs have played in moving away from the enterprise housing system. As many have pointed out, HPFs were not set up with the objective of targeting lending to lower and middle income people. Nevertheless, as the government considers the options for facilitating better access to housing finance for middle and lower income people, it needs to consider what, if any, role the HPFs should play. Moreover, HPFs may benefit from reform in other aspects. In the November quarterly (pp 18-19), we touched on options for reform and adjustment to the mandate, operations, and supervision of HPFs.

Some disagreed with some of our conclusions. In particular, some disagreed with our finding that so far only a moderate part of HPF housing lending has gone to lower and middle income households. In part this seems to be because those who disagree use a different definition of what is a middle income.[15] If anything, this discussion underscores the need for more information and transparency about the finances of these publicly-owned institutions and on how they operate as a source of housing finance subsidies.

There are some key principles that should guide housing finance and the government's support for it. Best international practice calls for financial institutions that channel savings and provide financing for both developers and individual buyers under commercial market conditions using effective tools for financial risk management. Government institutions that provide subsidies should ensure that subsidies are allocated as equitably and efficiently as possible. Given a review of the limited data that is available,

[15] We define middle income in the same way that China's census does: households that fall in the third quintile of the national income distribution (40-60 percent). Others use a significantly higher benchmark for middle income. Correspondingly, they find that more of the housing lending by HPFs goes to middle income people. Our judgment on the allocation of HPFs housing finance also considered that HPFs are only accessible to those with formal employment. Thus, they are not accessible to the majority of those earning less than the median income.

and of the literature on China's HPFs, it seems apparent that China would benefit from substantial reform of the HPF system. [16]

Looking ahead, the role and mandate of HPFs should be consistent with the current and expected future financial system and overall housing finance policy. HPFs should be evaluated in terms of their efficiency as financial institutions, the return they offer on savings, and the access to mortgage lending that they provide. HPFs have played an important role in China's housing reforms, and have provided mortgages to millions of households. We also recognize that HPFs were not specifically set up as a poverty alleviation tool. Nevertheless, development and reform has changed the landscape. Commercial banks have become the major provider of mortgage loans and appear to have some comparative advantages over HPFs in mortgage lending (in terms of funding sources, credit assessment and loan supervision, internal control and economy of scale). [17] Moreover, HPFs do not appear to have supplied mortgages on the scale of the savings that they have accumulated, for instance by providing loans for all creditworthy members that request one. In the meantime, tension between the different objectives and some weakness of HPFs have emerged. In these circumstances, it is necessary to re-assess the strengths and weaknesses of HPFs, review their positioning and supervision and enhance their efficiency in the context of housing finance system development in China. This is in line with the objectives of the Chinese government to promote sustainable housing supply and housing finance and for the benefit of the society.

Reform of HPFs could deliver more mortgage finance to a broader portion of the population. A range of themes can be explored. An important starting point would be to institute international best practice for management and corporate governance, such as risk-based pricing, public financial reporting, and adherence to international bank capital standards. In the meantime, As financial institutions, HPFs should be held to the same standards as commercial banks.

Although HPFs were modeled on the housing part of the Central Provident Fund (CPF) of Singapore, there are important departures from the Singapore model. The government should consider whether they are appropriate in China's current circumstances. Singapore's CPF is used to help households save and invest for retirement, housing, and general purposes. The savings from individuals in Singapore's CPF are used

[16] See for instance, Burrell, Matias, "China's Housing Provident Fund: Its Success and Limitations," Housing Finance International March, 2006; Liu Zhifeng, "Strengthen the Management of Housing Provident Funds," Speech, 2001, as cited in Burrell; Buttimer, Richard, Anthony Yanxiang Gu and Tyler Yang, "The Chinese Housing Provident Fund", International Real Estate Review 2004 Vol. 7 No. 1: pp. 1 – 30; Sato, Hiroshi "Housing Inequality and Housing Poverty in Urban China in the Late 1990s," China Economic Review 17 (2003) 37-50.

[17] China's HPFs are similar to the closed circuits for housing finance that were once prevalent in Europe and the United States, but have since been opened as financial markets have been liberalized. These types of systems featured specialized institutions with government backing or legal privileges to overcome some kind of market imperfection. These structures were not used to target housing finance to lower and middle income people. While these structures have been eliminated, mortgage lending in Europe and the United States has grown dramatically.

for their own mortgage payments, but not for subsidized lending to others. Moreover, Singapore does not use the CPF to provide subsidized housing finance to lower and middle income people. Singapore's Housing Development Board (HDB) develops, finances, and manages housing for targeted populations. The HDB provides subsidized mortgage loans for targeted lower income households only, recognizing the scarcity of government resources. First time buyers and married households with children receive priority. Subsidized loans are financed by loans from the Ministry of Finance. As of 2003, the Housing Development Board stopped providing market rate loans – households that are able to pay market terms are expected to borrow from commercial banks. The separation of subsidized and market rate lending is important. In Singapore, the subsidized and market rate lending sectors are substantially separate and for the most part do not compete for customers.

CORPORATE SECTOR POLICIES AND DEVELOPMENTS

The government has provided guiding principles on the role of state ownership in China's economy. The State Council General Office distributed on Dec. 5, 2006 a document of "guiding opinions" prepared by SASAC and approved by the State Council. The document is meant to be a guideline for restructuring the "layout" of state ownership among sectors and enterprises. It calls for a further concentration of state ownership in a narrower scope, defined as "important sectors and key areas that are crucial to national security and national economy". Relevant departments are expected to put together a specific catalogue of such sectors and areas. According to media reports, Li Rongrong, the head of SASAC, has indicated what type of sectors and areas are considered. He indicated that "state capital of central SOEs will move to concentrate in seven sectors--military industry, power grid and generation, oil and petrochemical, telecommunication, coal, civil aviation, shipment--as well as backbone enterprises in sectors such as equipment manufacturing, automobile, electronic and information, construction steel, etc.." [18]

This represents a renewed effort of the government in specifying the boundary for state control in terms of industrial sectors and enterprises. Ever since China embraced the notion of "co-existence of multiple ownerships" as a defining feature of the socialist market economy, there has been a question about the scope of the state ownership in terms of sectors and enterprises. The principle of "control the big and let go the small" was introduced in the mid-1990s. In 1999, a CPC "Decision" further specified sectors and enterprises as primary targets for state control.[19] In terms of sectors, there were three kinds: those that are related to national security, natural monopolies, and those that provide important public goods and services. In terms of enterprises, the Decision mentioned backbone enterprises in pillar industries and hi- and new-tech industries as primary targets for state control.[20]

[18] Reported by the Shanghai Securities News: http://finance.sina.com.cn/g/20070120/03143265505.shtml

[19] "*Decision on Some Major Issues Concerning the Reform and Development of State-Owned Enterprises*"
[20] See article by Wu Bangguo. http://www.qsjournal.com.cn/qs/19991101/GB/qs^274^0^19992109.htm

The State Council approved document is only about the reallocation of state ownership among sectors and enterprises. It says nothing about whether those sectors that are selected for state control will also be open to non-state participation. However, for those sectors and enterprises that are not deemed as "important sectors and key areas", the withdrawal of state ownership has been clearly set as a guiding principle.

Recently released World Bank studies on China:

- ***The international financial integration of China and India***
  World Bank Policy Research Working Paper (WPS) No. 4132
  by Philip R. Lane, IIIS, Trinity College Dublin and CEPR, Sergio L. Schmukler, World Bank
  The goal of this paper is to assess how the increasing economic prominence of China and India is reshaping the international financial system. It elaborates three main features that characterize the international financial integration of China and India. Full text of this report is available at: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2007/02/05/000016406_20070205094817/Rendered/PDF/wps4132.pdf

- ***Reform of the intergovernmental transfer system in China (WPS 4100)***
  by Anwar Shah and Chunli Shen, World Bank
  This paper examines the incentives associated with the design of central-to-subnational transfers and their implications for the efficiency and equity of public service provision and accountable local governance in China. Full text of this report is available at: http://www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000016406_20061220115722&searchMenuPK=64187283&theSitePK=523679

- ***Are there lasting impacts of aid to poor areas? Evidence from rural China (WPS 4084)***
  by Shaohua Chen, Ren Mu and Martin Ravallion, World Bank
  The paper revisits the site of a large, World Bank-financed, rural development program in China 10 years after it began and four years after disbursements ended. The program emphasized community participation in multi-sectoral interventions including farming, animal husbandry, infrastructure and social services). Full text of this report is available at: http://www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000016406_20061206153200&searchMenuPK=64187283&theSitePK=523679

- ***Partially awakened giants: uneven growth in China and India (WPS 4069)***
  by Shubham Chauhuri and Martin Ravallion, World Bank
  The paper examines the ways in which recent economic growth has been uneven in China and India and what this has meant for inequality and poverty. It also examines why growth was uneven and why this should be of concern. Full text of this report is available at: http://www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000016406_20061117113609&searchMenuPK=64187283&theSitePK=523679

- ***The fiscal framework and urban infrastructure finance in China (WPS 4051)***
  by Ming Su and Quanhou Zhao, World Bank
  The report analyzes two problems in the decentralized fiscal management in terms of urban infrastructure in China's development strategy and proposes the way-out. Full text of this report is available at: http://www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000016406_20061026113712&searchMenuPK=64187283&theSitePK=523679