

World Bank Office, Beijing

www.worldbank.org/china

世界银行驻华代表处

www.worldbank.org.cn

Quarterly Update

June 2010



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 (lil2@worldbank.org).

OVERVIEW

China's economy has continued to grow robustly, with some softening recently. So far in 2010, the slowdown in government-led investment (GLI) after last year's massive stimulus has partly been offset by strong real estate investment. Household consumption growth has held up well, reflecting a favorable labor market. Despite a rapid recovery of export volumes since the trough in early 2009, China's trade surplus has declined further due to surging import volumes and declining terms of trade. Inflation has picked up somewhat, but core inflation remains low. However, soaring property prices triggered tough property-specific measures. Leading indicators and industrial production data suggest some deceleration to a still rapid rate of growth.

China's economic outlook remains favorable. Despite concerns about fiscal risks in some high income countries, the global growth outlook remains favorable, in large part because of the strength in emerging markets. Nonetheless, risks around the global forecast are large. In China, after a rapid start to 2010, growth is likely to ease, mainly because of a partial normalization of the macro policy stance and the property measures. We project GDP growth of 9.5 percent for 2010 as a whole, and 8.5 percent for 2011, with risks both ways. Growth should be less investment-driven this year and benefit from more favorable external trade. Consumption is likely to remain supported by a strong labor market. The external surplus should decline somewhat further this year. Inflation is likely to remain contained this year by the absence of price pressures globally while a wage-price spiral is not likely.

Such prospects warrant further normalization of the macroeconomic stance, while keeping flexibility. Further consolidation of the overall monetary stance, as outlined, is needed to contain the key macroeconomic risks. Substantial uncertainty around a favorable baseline projection calls for policy flexibility rather than continued stimulus by default. The central authorities are rightly aiming to control lending by local government investment platforms. However, interest rates remain low. China could usefully let interest rates play a larger role in monetary policy. If policymakers remain concerned about capital flows, macro prudential regulation and more exchange rate flexibility would help.

Policy making needs to take into account several features of the medium term outlook. Considering the prospects for its key determinants, trend growth is on course to decline in 2010-20, but to a still respectable rate. The contributions from labor and TFP are likely to decelerate somewhat while, with some rebalancing expected, capital accumulation should also slow. In setting growth targets for the coming decade, the likely slowdown in potential growth needs to be acknowledged. The expected deceleration of potential growth also places a premium on policies that can increase sustained productivity growth, including via more reallocation of labor, enhanced human capital, and innovation.

Moreover, further reforms are needed to ensure economic growth remains sustainable socially and with regard to energy and the environment. Fiscal policy reforms in several areas are key in this effort. Additional reforms in social protection and labor market arrangements are important both to foster productivity growth and improve social outcomes. The government's intention to strengthen the role of private enterprises in the economy and remove barriers they face is welcome. In this connection, it would be useful to clarify the role that the government envisages SOEs to play in China's economy.

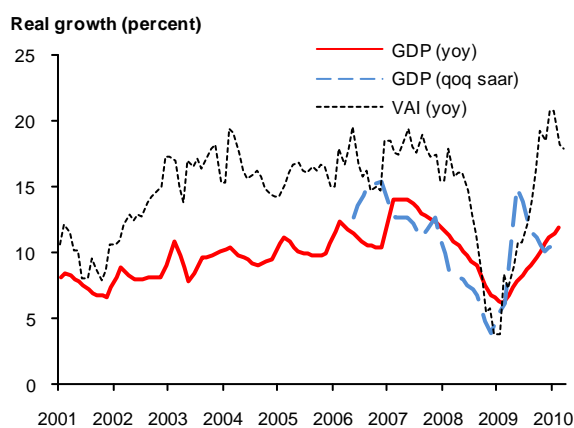
RECENT ECONOMIC DEVELOPMENTS

China’s economic growth has remained strong. After bottoming out in early 2009 amidst the global economic crisis, sequential GDP growth was strong on the back of massive domestic policy stimulus, pushing GDP up 11.9 percent on a year ago in the first quarter of 2010 (Figure 1). Leading indicators and industrial production data suggest some moderation (yoy) in the second quarter, to a still rapid pace.¹

Growth has continued to be supported by an expansionary macro policy stance. Headline fiscal policy has not been expansionary in the first 5 months of 2010 (see below, in the policy section). However, the monetary expansion remains large and this in part reflects quasi fiscal activity, notably via lending to local government investment platforms. After the 30 percent of GDP expansion of credit in 2009, outstanding loans rose another 7.6 percent of GDP in January-May (seasonally adjusted). In the first quarter of 2010 infrastructure construction and real estate received most of the new medium and long term (MLT) loans.

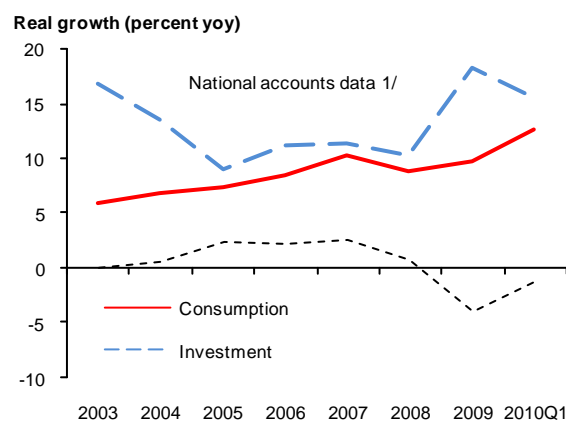
But growth has recently become more broad-based. In early 2009, exports collapsed and the massive stimulus effort boosted domestic demand, infrastructure investment in particular. More recently, net external trade has become less of a drag on growth as exports have accelerated alongside a rebounding world economy. Consumption growth has strengthened since 2008 while investment decelerated in the first quarter of this year, with government-led investment leading the slowdown (Figure 2). However, the stimulus measures led to some concerns about the role of SOEs in the economy (Box 1).

Figure 1. China’s growth has remained strong



Source: CEIC, World Bank staff estimates.

Figure 2. Growth becomes more broad based



Source: CEIC, World Bank staff estimates.

1/ Estimates using NBS data on contribution to growth.

¹ The “economic climate leading index” and the (seasonally adjusted) PMI have eased since early 2010.

Box 1. The role of SOEs in the economy.

Developments since the onset of the global crisis have triggered questions about the role of state-owned enterprises (SOEs) in the economy. There are concerns that “the state advances, and the private sector retreats,” that is, that SOEs have benefited disproportionately from the policy stimulus and are crowding out private enterprises.

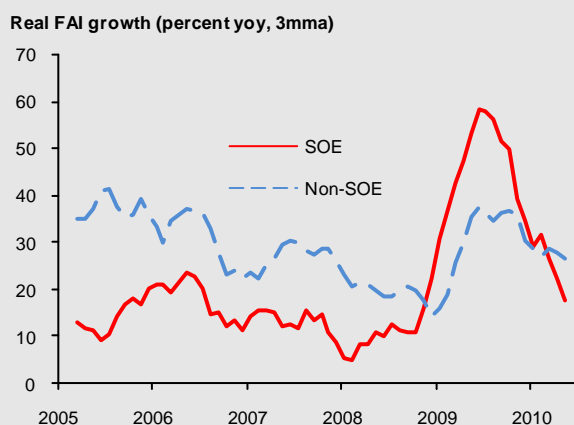
The weight of SOEs has increased recently, especially in investment (Box Figure 1). With its emphasis on construction and infrastructure, the stimulus has directly benefited SOEs more than non-SOEs. This is in part because of how state ownership is distributed over the economy. Most large construction companies and steel and cement companies supplying them are SOEs. And, having close relationships with the government and the banks, SOEs seem to have benefited strongly from the monetary stimulus. Moreover, the local government platforms carrying out the infrastructure construction that boosted investment in 2009 are classified as SOEs. Easy credit also led some SOEs to spend heavily on land amidst the property boom.

SOEs’ weight in production has not risen recently and the long term trend is for it to decline. Private enterprises were substantially outgrowing SOEs before the crisis. Industrial production growth fell sharply across the board since end-2008 and then showed a V-shaped recovery in 2009. The SOE sector and private enterprises now grow at broadly similar rates (yoy). Taking a longer term perspective, the weight of SOEs has declined steadily in terms of both production and assets (Box Figure 2). The data used here covers large industrial companies. Other statistics suggest that these downward trends also hold for the overall economy. However, the decline has bottomed out in recent years.

The economic role of SOEs remains large, partly because of policies. In addition to favorable access to credit, SOEs pay very little dividend to the state. In some sectors, SOEs are granted monopolies or oligopolies, with private sector participation prevented by policy. And it is explicit policy to maintain a key role for SOEs in many sectors deemed to be “strategic” or “basic or pillar”.

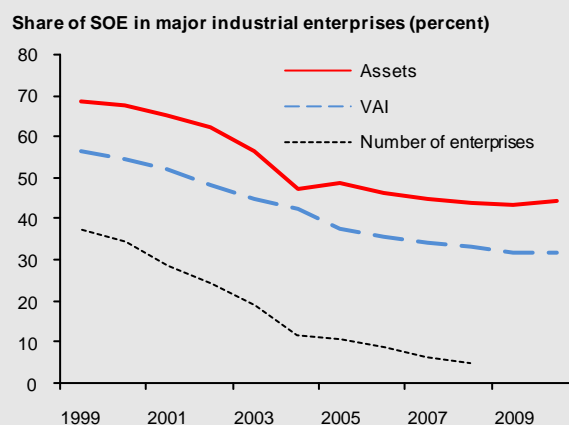
The government is rightly revisiting the policy stance towards the private sector. China could derive a lot of productivity gains by opening up various sectors further to private participation, particularly in the service sector. The government has listed developing the private economy and removing entry barriers to private investment among the key reform tasks for this year. It makes sense to reconsider the composition of the list of “strategic” and “basic or pillar” industries where state ownership is meant to play a key role. The current list includes the machinery, auto, IT, construction, steel, base metals, and chemicals industries. It is not obvious why state ownership is essential in these industries. Second, a lot of progress can still be made by reducing barriers to competition. The government could also usefully clarify the role it envisages SOEs to play in China’s economy.

Box Figure 1. SOE investment surged in 2009



Source: NBS, World Bank staff estimates.

Box Figure 2. The decline in the weight of SOEs may have halted

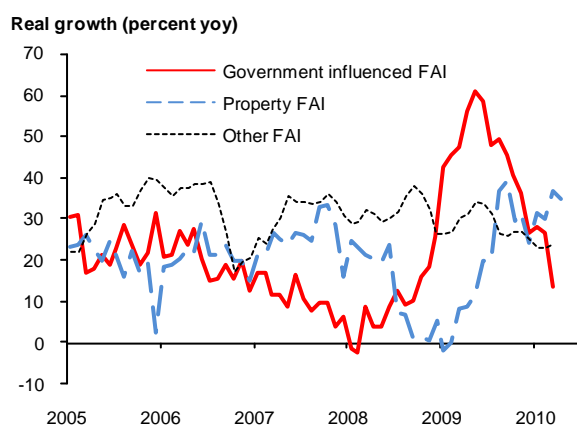


Source: CEIC, World Bank staff estimates.

The slowdown in government-led investment (GLI) has partly been offset by strong real estate investment. The deceleration of GLI reflects the gradual phasing out of the policy stimulus and the high base left by the boom in 2009 (Figure 3). But, a favorable policy stance and ample liquidity fueled housing prices sales since early 2009 and—with a lag—real estate investment. In mid April, the government took measures to contain the housing price increases (see below). These measures are likely to affect sales volumes and prices. But, given the time lag in construction, the impact on construction activity is not expected until later in the year.

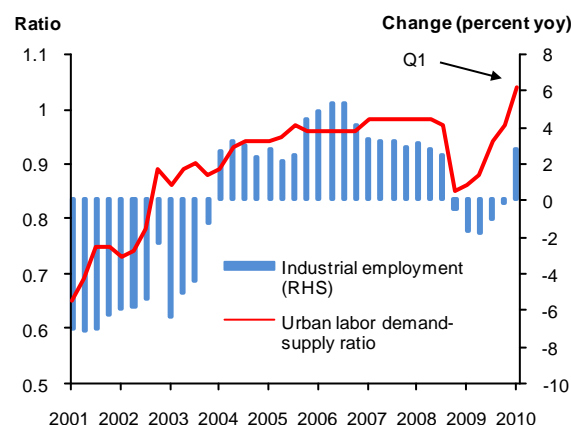
Household consumption growth has remained solid, in line with a favorable labor market. The recovery of consumer confidence and continued consumer spending growth since early 2009 are in large part fueled by a strong labor market (Figure 4). After bottoming out in early 2009, employment recovered on the back of the strong domestic economy. With the urban labor market survey indicating rising demand for labor, compared to supply, wage growth picked up again, at least for migrants.² Consumption is also fueled by strong sales of cars (accounting for around one-tenth of total retail sales) and housing, with the latter boosting sales of furniture, home appliances, and building materials.

Figure 3. Investment growth has varied



Source: CEIC, World Bank staff estimates.

Figure 4. Labor market conditions have improved



Source: CEIC, World Bank staff estimates.

Export volumes have recovered fast in the last 12 months, reflecting improved global demand and further market share gains. As the global economy recovered during 2009, China's export volumes

² While there is currently no recent data on migrant income available in the regular household surveys, per capita rural wage income growth, which includes the impact of both wage and employment developments, recovered since mid 2009 and was 16.4 percent (yoy) in the first quarter of 2010.

strongly outgrew external demand (Figure 5).³ In the first five months of 2010 they were an estimated 10 percent up on 2 years ago (before the crisis), even though global imports were still below pre-crisis levels then. The market share gains confirm that China’s exporters have continued to boost price competitiveness, upgrade products, and enter new markets. In turn, this is helped by strong productivity growth, which has cushioned the impact of downward price pressures for manufactured goods globally and wage increases. Indeed, profit margins in sectors that export a large share of output such as textiles and electronics now exceed pre-crisis levels, even though export prices are still down substantially.

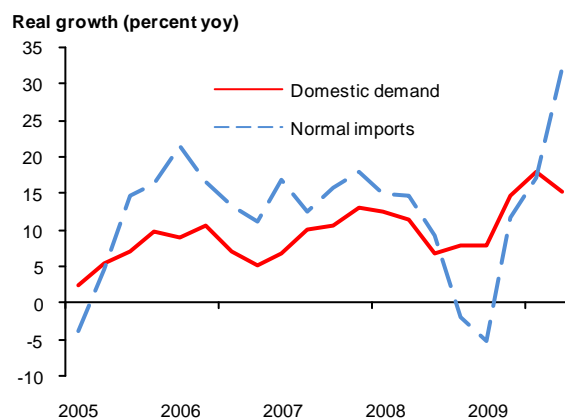
In spite of this, China’s trade surplus has declined sharply since 2008 due to surging import volumes and declining terms of trade. In the first 5 months of 2010, the trade surplus was down more than 50 percent compared to the same period in 2008. Import volumes have surged across the board, including “normal” imports used in the domestic economy. Boosted by strong domestic demand, their particularly rapid growth at the end of 2009 and start of 2010 (yoy) is in part—but not fully—because of base effects (Figure 6).⁴ In any case, given the outlook for domestic demand, this pace of “normal” import growth cannot be expected to last. Import data for the second quarter confirms a deceleration.

Figure 5. Export volumes have surged amidst a recovering global economy



Source: CEIC, Centraal Plan Bureau (NL), WB estimates.

Figure 6. Normal imports have soared but are bound to slow down



Source: CEIC, World Bank staff estimates.

China’s terms of trade have deteriorated substantially up until recently. China’s terms of trade have been volatile in recent years. Between early 2009 and April 2010 they fell and in the first 5 months of

³ China’s exports are very sensitive to changes in the global trade cycle because of the role of processing trade. Thus, some—although not all—of the steep recovery in 2009 was following a very sharp drop earlier on.

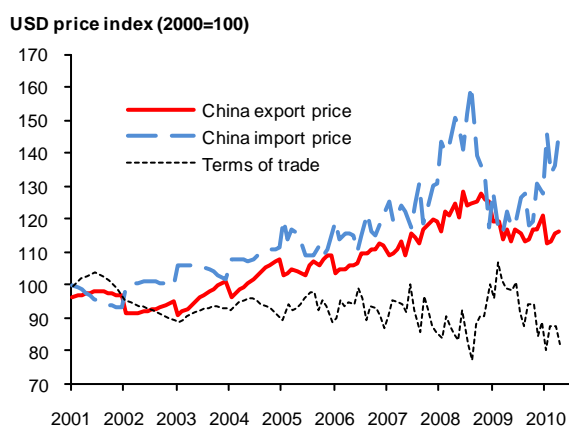
⁴ China’s “normal” import volumes were unusually weak in end-2008 and early 2009, compared to real estimated domestic demand, presumably because of destocking (Figure 6).

2010, they were still down on 2 years ago (Figure 7). The recent terms of trade loss is in part because of a surge in raw commodity prices. In addition, since early 2009, prices of China’s exports, which are almost all manufactured goods, have fallen more and risen less than prices of manufactured goods imports, whereas normally these move in line. In all, almost one-third of the decline in the trade balance in the 2 years to the first 5 months of 2010 was due to the worsened terms of trade. With the trade surplus traditionally the key driver of foreign reserves accumulation, its decline has somewhat slowed the accumulation of reserves, even though net financial flows were positive in the first quarter.

The peg of the RMB to the US dollar transmits swings in the US dollar to China’s exchange rate. The US dollar rose almost 15 percent against the euro between November 2009 and Mid July this year, amidst the euro zone sovereign debt turmoil. This has translated into a similar appreciation of the RMB against the Euro zone, China’s largest trade partner. As only about one-fifth of China’s foreign trade is with the US, such US dollar movements affect China’s exchange rate with the bulk of its trading partners.

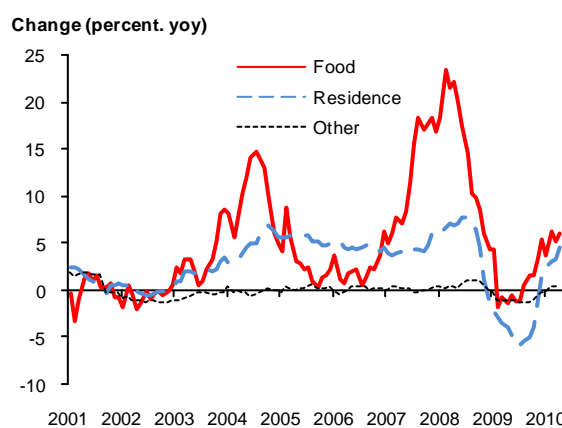
Inflation has picked up somewhat because of higher food prices, but core inflation remains low. Consumer price inflation reached 3.1 percent (yoy) in May, driven mainly by higher food prices and somewhat by higher “residence” items (housing costs) (Figure 8).⁵ PPI inflation rose from -8 percent (yoy) in mid 2009 to 7.1 percent in May. However, the sequential increase in the PPI index has declined since March as raw commodity prices have stopped increasing (see below). Moreover, estimated unit labor cost has been constant in recent quarters, consistent with low core inflation and suggesting no wage-inflation spiral, despite the expansionary monetary stance.

Figure 7. China’s terms of trade have declined



Source: CEIC, World Bank staff estimates.

Figure 8. Core inflation remains low



Source: CEIC, World Bank staff estimates.

⁵ Food accounts for about one third of the CPI basket and “residence” for 10 percent.

However, property prices have surged on the back of the expansionary monetary stance and have triggered measures. Ample liquidity and low interest rates have boosted property prices, especially in large cities, where they were up 12.4 percent on a year ago on average in May, according to the official NBS data. The government took measures in mid April aimed at containing the price increases rather than at curbing real estate construction. They included raising minimum mortgage down payment and mortgage interest rates,⁶ virtually banning lending for people buying their third home, and asking local governments to increase land supply for and accelerate construction of “mass market and low-end housing.” The measures have already impacted sales volumes. They are likely to also affect housing prices and—with a lag—construction activity.

Stock prices have declined on concerns about policy tightening. Share prices have received support from the recovering economy. However, concerns about the impact of policy tightening have weighed strongly on equity valuation. As a result, stock prices have moved up and down several times in the last 12 months. The mid-April property related policies had a particularly large impact because they reduced profit prospects in the real estate sector and increased concerns about further policy tightening. The A share market has fallen by 19 percent since mid-April and 22 percent since the start of this year.

ECONOMIC PROSPECTS

Growth prospects in many high income countries are subdued and fragile. Their recoveries were kick started by unusually expansionary monetary and fiscal policies. But, in many of them, growth is held back by high unemployment and weak household balance sheets and bank credit, and it remains dependent on macroeconomic policy support. Meanwhile, high government deficits have led to rising sovereign risk premiums and more ambitious fiscal consolidation plans in several European countries as well as some renewed stress in the global banking system. Thus, the recovery is likely to be relatively slow in many high income countries.

However, the outlook for overall global growth is better now than it was in early this year. The global recovery has evolved better than expected. After the world economy shrunk in 2009, the Consensus Forecasts suggest that global GDP (excluding China) expands 3.0 percent this year and 3.0 percent in 2011 (Table 1 and 2). Many emerging markets and developing countries have returned to solid growth, with Asia in the lead and Eastern Europe lagging behind. Overall, global

Table 1. Recent changes in global growth forecast

	Global GDP excluding China 1/	
	2010	2011
January 2010	2.6	2.9
April 2010	2.8	2.9
May 2010	3.0	3.0

Sources: Consensus Economics, WB estimate.
1/ WB estimate based on Consensus Forecasts.

⁶ The minimum down payment rates were raised from 20 to 30 percent for first time buyers for homes larger than 90 m² and from 40 to 50 percent for second homes. The mortgage interest rate was increased from discounts before to premiums over the benchmark interest rate.

growth prospects remain quite good, in large part because of the strength in emerging markets. Indeed, recent Consensus Forecasts suggest stronger global growth prospects for this year and next than those done earlier this year.

Table 2. The global environment

(percent change, unless otherwise indicated)

	2008	2009	2010	2011
World GDP growth 1/	2.0	-1.9	3.4	3.3
World GDP growth excluding China 1/	1.5	-2.6	3.0	3.0
World imports 2/	3.2	-11.7	6.3	6.7
World prices (US\$) 2/				
Oil (\$/bbl)	97	61.8	78.1	74.6
Non oil commodities	0.0	-21.6	16.8	-4.0
Manufactured export products	5.9	-4.9	0.0	-3.7
\$ Libor interest rate (6 m percent per year)	3.2	1.2	0.8	2.2

Source: World Bank, Consensus Economics, and staff estimates.

1/ Consensus Economics (May 2010), weighed using 2007 weights.

2/ World Bank DECPG (GEP, May 2010).

Nonetheless, the uncertainties and risks around the central global forecast are large. The rapid increase in government debt in many high income countries has become a major source of risk. Market concerns about sovereign liquidity and solvency in the euro zone periphery or elsewhere could turn into a real and contagious sovereign debt crisis. More generally, there is a risk that the room for policy discretion in many high income economies has been sharply reduced, leaving the fragile recoveries exposed to new shocks. Most of the markets' attention has so far been on Europe. However, the US fiscal outlook is also precarious. Additional downside risk stems from bank exposure to real estate, mainly in the United States and parts of Europe, while prospects of regulatory reforms in the US could cause rating downgrades of large banks and raise borrowing costs.

With spare capacity in many industries, globally, price pressures are likely to remain subdued. After rising in most of February-April because of an improving global outlook, international raw commodity prices fell steeply again since end April, presumably on the back of the euro zone turmoil and signs that China's economy may be cooling. The spare capacity in many sectors, internationally, is set to continue

to dampen pressures on prices of both manufactured goods and raw commodities including oil in the coming years.⁷

In China, growth is likely to ease somewhat. The first quarter outcome was modestly stronger than we expected in March. However, we now envisage a somewhat more pronounced deceleration in the rest of the year, reflecting the impact of the move towards normalization of the overall macro policy stance and the recent measures with respect to the real estate sector as well as the headwinds from Europe. In all, we leave our GDP growth forecast unchanged at 9.5 percent for this year and reduce that for 2011 slightly to 8.5 percent (Table 3).

In 2010, growth should be less investment-driven and benefit from more favorable external trade.

- **Investment growth is likely to moderate this year.** Government-led investment is decelerating, after the spectacular growth in 2009. Real estate investment is set to contribute significantly to growth most of 2010.⁸ However, later in the year the impact of the recent property tightening measures should kick in. Given the sharply increased importance of mortgage financing since early 2009, in flow terms, the mortgage-related measures are likely to affect housing sales and presumably housing prices substantially.⁹ The impact on construction activity is expected later in the year, given the inherent lags. The government aims to offset the impact on construction activity by increasing the supply of lower and middle income housing. However, given the modest share of such kind of housing and underperformance of targets in this area in recent years, it may be difficult to achieve this.¹⁰ Investment in the services industry should remain solid, supported by the healthy outlook for domestic consumption. The outlook for manufacturing investment is less clear.
- **Consumption should continue to grow solidly.** Amidst favorable labor market conditions, income growth should remain robust. Moreover, despite some pick up in inflation, consumer sentiment is recovering.
- **We expect net external trade to make a small positive contribution to real growth in 2010 and 2011.** Following the rapid recovery so far, export volumes are likely to slow, sequentially, because of an eventual end to the inventory adjustment in partner countries and lower final

⁷ According to the World Bank, energy and metal prices are likely to be contained in the coming years by the large inventory overhang and agricultural markets should continue to be “well supplied” (Global Commodity Markets, companion to the January 2010 Global Economic Prospects).

⁸ New housing starts were up 87 percent on a year ago in March-May 2010.

⁹ The share of housing sales value financed by mortgages rose from 40 percent in 2006-08 to 60 percent in early 2010.

¹⁰ The share of “*economic housing*” in total market housing has declined over time to 6 percent (in terms of floor space) in 2008. In 2009, about 2 million units of *public housing* were provided, about two-thirds of the target and about 8 percent of total sales.

demand growth, especially in Europe, China's largest trading partner. However, for the year as a whole that still implies rapid growth. We expect import volumes to outgrow export volumes somewhat, with a similar pattern—slowing sequentially in the rest of the year as investment slows (investment is relatively import sensitive in China). However, because exports were larger than imports last year, that still implies a mildly positive contribution of net external trade to growth.

Table 3. China: Main Economic Indicators
(percent change, unless otherwise indicated)

	2007	2008	2009	2010 f	2011 f
The real economy					
Real GDP	13.0	9.6	8.7	9.5	8.5
Domestic demand 1/	10.8	9.4	13.8	9.6	8.5
Consumption 1/	10.2	8.8	9.7	9.5	9.1
Gross capital formation 1/	11.4	10.2	18.3	9.7	8.0
Contribution to GDP growth (pp)					
Domestic demand 1/	10.4	8.8	12.7	9.1	8.3
Net exports 1/	2.6	0.8	-4.0	0.4	0.3
Contribution net exports (WB, pp) 2/	3.5	1.8	-4.8	0.4	0.3
Exports (goods and services) 2/	20.0	8.6	-10.4	23.0	8.9
Imports (goods and services) 2/	14.2	5.1	4.3	26.4	9.0
Potential GDP growth	10.4	10.1	10.0	9.3	8.8
Output gap (pp)	2.4	1.9	0.5	0.7	0.5
CPI increases (period average) (%)	4.8	5.9	-0.7	3.7	2.8
GDP deflator	7.4	11.4	-2.1	3.7	2.6
External terms of trade	-0.9	-4.3	8.6	-6.4	-0.1
Fiscal accounts (percent of GDP)					
Budget balance 3/	0.6	-0.4	-2.8	-2.8	-2.5
Revenues	19.9	19.5	20.6	19.5	19.7
Expenditures	19.3	19.9	23.4	22.2	22.2
External account (US\$ billions)					
Current account balance (US\$ bln)	372	426	297	260	300
Current account balance (% GDP)	11.0	9.4	6.1	4.7	4.7
Foreign exchange reserves (US\$ bln)	1529	1946	2400	2705	3028
Other					
Broad money growth (M2), e-o-p (%)	16.7	17.8	27.0	17.0	...

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

1/ WB estimations using contribution to growth data (Table 2-20 in NBS Stat. Yearbook).

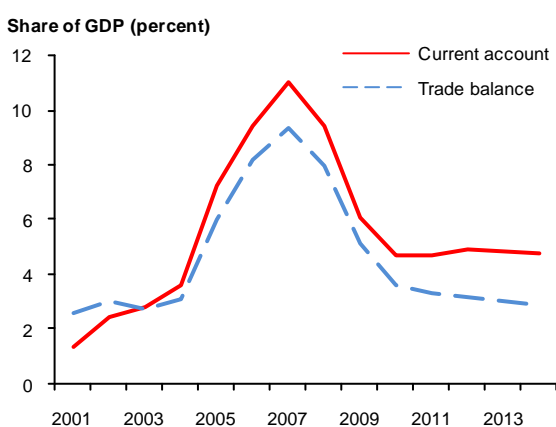
2/ WB staff estimates based on trade data for goods from the Custom Administration, adjusted for estimated difference in price development for services trade.

3/ For 2009 and 2010 this is in line with the commitment data presented to the NPC.

The external surplus should ease down somewhat this year. In the first 4 months of 2010, international raw material prices recovered much more than prices of manufactured goods and China’s terms of trade declined again. However, raw material prices fell sharply in May. Taking into account the global context and assuming they broadly stay at their May level the rest of 2010, the external surplus would decline this year in US dollar terms and as a share of GDP (Figure 9).¹¹

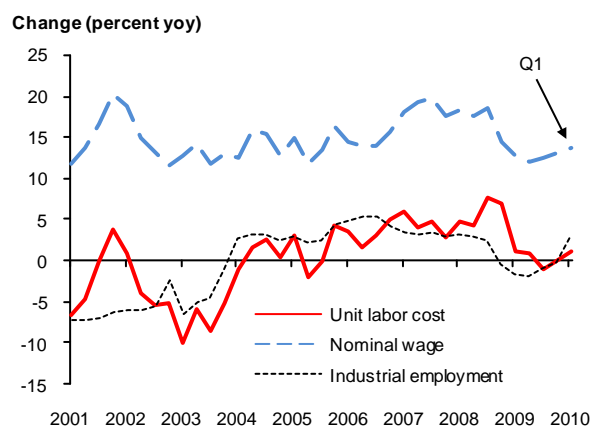
Inflation is likely to remain contained this year. The expansionary monetary stance since end 2008 has increased inflation expectations. However, inflation is basically determined by supply and demand for goods and services and China’s prices are strongly influenced by global prices. Higher food prices and imputed rent are exerting some upward price pressure. However, the envisaged global context moderates China’s inflation prospects, including via the absence of upward pressure on commodity and food prices. The China-specific factors behind high food prices are also not likely to be sustained. Moreover, continued low core inflation reflects the influence of China’s pattern of growth, with large increases in the supply of goods and services, compared to increases in demand. Wage growth at the lower end of the income distribution may increase as a result of some widely published labor disputes and increases in factory-specific and minimum wages. This is in part a cyclical issue, reflecting the strong rebound in the labor market after an earlier downturn when wage growth slowed (Figure 10). Viewed over a two year horizon, these increases are within historical norms. The adjustment of individual companies to these pressures will vary. However, given the flexibility of China’s labor market and the track record of China’s overall manufacturing sector in absorbing wage increases and keeping unit labor cost growth down, this is unlikely to set in motion an unwarranted wage-inflation spiral.

Figure 9. The external surplus



Source: CEIC, World Bank staff estimates.

Figure 10. Unit labor costs



Source: CEIC, World Bank staff estimates.

¹¹ If raw material prices would be 10 percent higher in the remaining 7 months of 2010, with manufactured goods prices and all else unchanged, the current account surplus would be 0.5 % of GDP lower.

Risks are two way and balanced. The renewed increase in risks to the global economy matters for China. However, sound macroeconomic fundamentals, absence of dependence on foreign capital flows and still binding capital controls mean that the impact of any potential global turmoil on China is likely limited to real economic impact via weaker trade. Domestically, the dynamics between economic developments and policy responses imply substantial risks and uncertainties, amplified by the types of instruments used, including with regard to the real estate sector. But, overall growth prospects remain solid and much less uncertain than a year ago. The risks related to rapidly rising housing prices have subsided because of the recent property tightening. Nonetheless, probably the most serious macroeconomic and financial risks are still those stemming from the monetary stimulus, including underlying pressure on asset prices, strains on local government finances, and NPLs. Goods price inflation may rise if actual output continues to outgrow potential output.

Medium term projections

With China and the world economy recovering from the global crisis, and some rebalancing taking place in China, it is useful to revisit medium and long term prospects. This section summarizes the key conclusions of a recent medium term scenario building exercise. This exercise was conducted to get a sense of how the pace and composition of growth may develop, both from the production (or supply) side and the expenditure (or demand) side; what the key implications are; and how China's living standards and the size of the overall economy may compare internationally in 2020. For more detail and discussion see World Bank China Research Paper No. 9.¹²

Considering the prospects for its 3 key determinants, trend growth is on course to decline in 2010-20, but to a still respectable rate. Our growth accounting exercise suggests that potential GDP gradually declines to 7 percent in 2016-20 as a result of the following factors (Table 4).

Table 4. Growth accounting (1978-2020)*; change, in percent

	1978-94	1995-2009	2010-15	2016-20
Potential GDP growth	9.9	9.6	8.4	7.0
Employment growth	3.3	1.0	0.2	-0.5
Labor productivity growth	6.4	8.6	8.2	7.5
From TFP growth	3.0	2.7	2.3	2.3
From higher H/L	0.5	0.3	0.5	0.6
From higher K/L ratio	2.9	5.5 **	5.4 ***	4.6
Memorandum items (in percent)				
Investment/GDP ratio (period average)	30.0	37.3	41.1	39.1

Source: NBS, and staff estimates.

* Methodology as in Kuijs and Wang (2006), but with human capital.

** The contribution from higher K/L is much higher in 2000-09 than in 1994-99.

*** This is influenced by the dramatic increase in investment in 2009.

¹² http://siteresources.worldbank.org/CHINAEXTN/Resources/318949-1268688634523/medium_term_scenario.pdf

- The working population is on course to decelerate because of demographic developments. We expect overall employment to shrink somewhat in 2015-20.
- Total factor productivity (TFP) growth may also decline somewhat. This tends to happen as catch up proceeds. We expect the deceleration to be particularly noticeable in the coming years. In the recent 15 years, SOE restructuring, WTO accession, and very successful integration of China's manufacturing sector in a rapidly growing economy have boosted TFP growth to a remarkably high rate, including via large economies of scale. The contribution from these factors is likely to diminish somewhat in the coming decade.
- With a mild easing of the ratio of investment to GDP from 2011 onwards because of modest rebalancing, growth of the capital stock slows materially in 2010-20.

Looking ahead via the expenditure perspective, this scenario has several features (Table 5).

- Actual GDP would continue to grow broadly as fast as potential GDP, continuing the track record since the late 1990s.
- With some—but no drastic—further rebalancing expected, the share of consumption is likely to bottom out and to rise somewhat through 2015. The ratios of investment and saving in GDP edge down gradually.
- With economic growth in China likely to continue to be robust, import growth remains solid. Meanwhile, given the outlook for the world economy and exports, exports are not expected to outgrow domestic activity in 2010-2015 in our scenario despite good competitiveness and further market gains. Thus, with export price increases assumed to lag domestic inflation, the export to GDP ratio should continue to diminish.
- The external surplus would rise in US dollar terms, not as a share of GDP. This scenario uses fairly benign medium term projections for raw material prices from the World Bank. On this basis, combined with the volume developments discussed above, the trade surplus would edge up in US dollar terms but gradually decline as a share of GDP, from 5.1 percent in 2009 to 2.7 percent in 2015. The current account surplus would rise substantially in US dollar terms and hold up, as a share of GDP, because of rising income on growing foreign assets.

The background paper also explores various ways to compare China's living standards and the size of the economy with that of other countries in the future, focusing on the key role of real exchange rate appreciation in catch up.

Table 5. China: Main Economic Indicators (*percent change, unless otherwise indicated*)

	2009	2010 f	2011 f	2012 f	2013 f	2014 f	2015 f
Real GDP	8.7	9.5	8.5	8.2	8.0	7.9	7.9
Domestic demand 1/	13.8	9.6	8.5	8.3	8.2	8.1	8.0
Consumption 1/	9.7	9.5	9.1	9.1	8.9	8.9	8.9
Gross capital formation 1/	18.3	9.7	8.0	7.6	7.4	7.2	7.0
Contribution to GDP growth (pp)							
Domestic demand 1/	12.7	9.1	8.3	8.1	7.9	7.8	7.7
Net exports 1/	-4.0	0.4	0.3	0.1	0.1	0.1	0.1
Contribution net exports (WB, pp) 2/	-4.8	0.4	0.3	0.1	0.1	0.1	0.1
Exports (goods and services) 2/	-10.4	23.0	8.9	7.9	7.9	7.9	7.9
Imports (goods and services) 2/	4.3	26.4	9.0	8.6	8.4	8.4	8.4
Potential GDP growth	10.0	9.3	8.8	8.5	8.2	8.0	7.8
Output gap (pp)	0.5	0.7	0.5	0.2	0.0	0.0	0.1
External terms of trade	8.6	-6.4	-0.1	1.1	0.7	0.7	0.7
Gross national saving (% GDP)	51.4	51.1	50.9	50.8	50.4	50.0	49.6
Gross capital formation (% GDP)	45.4	46.4	46.2	45.9	45.6	45.3	44.9
Current account balance (% GDP)	6.1	4.7	4.7	4.9	4.8	4.7	4.7
Foreign exchange reserves (US\$ bln)	2400	2705	3028	3395	3798	4247	4745

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

1/ WB estimations using contribution to growth data (Table 2-20 in NBS Stat. Yearbook).

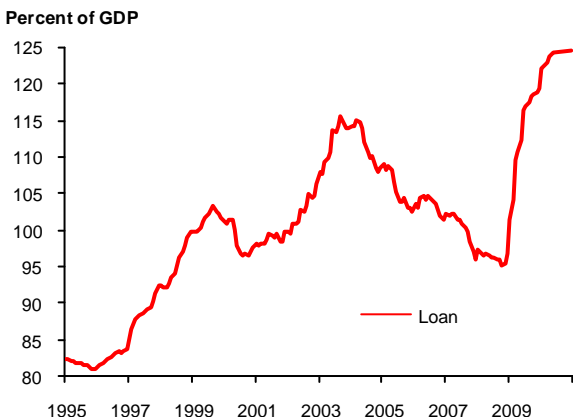
2/ WB staff estimates based on trade data for goods from the Custom Administration, adjusted for estimated difference in price development for services trade.

ECONOMIC POLICIES

China's baseline macro prospects warrant a normalization of the overall macroeconomic stance. So far, the property-related measures notwithstanding, China's overall macro stance has remained quite expansionary, the monetary stance in particular (Figure 11). Looking ahead, despite some renewed uncertainty globally and the measures towards the property market, overall growth prospects for this year and next remain good in the central scenario—broadly as fast as potential growth—while the economy is now operating close to full capacity (Figure 12). Against the backdrop of the large monetary expansion since late 2008, the key macroeconomic risks relate to asset price movements, local government finances, and NPLs. This outlook calls for normalization of the overall macro stance, notably the monetary stance. A less accommodative overall monetary stance would also reduce the need for tough property-related measures, particularly if higher interest rates would be allowed to reduce the fundamental drivers of rapid housing price increases.

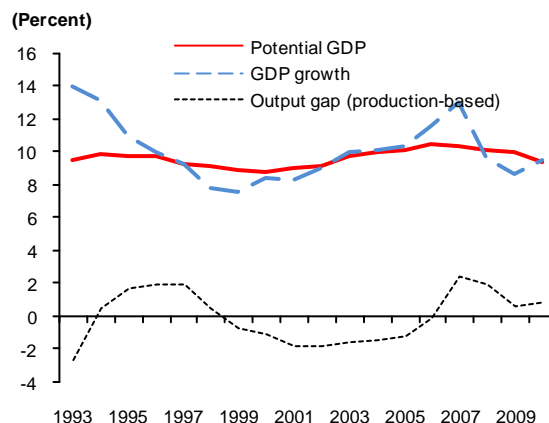
Heightened uncertainty calls for policy flexibility rather than continued stimulus by default. Preparing for the uncertainties and risks around these favorable baseline projections by ensuring flexibility in the design and implementation of policymaking is preferable to deciding now to provide added stimulus to be sure growth will exceed a certain rate. This is all the more so since the risks to growth are two-way.

Figure 11. Monetary aggregates have grown rapidly



Source: CEIC, World Bank staff estimates.

Figure 12. Spare capacity is limited



Source: CEIC, World Bank staff estimates.

Policy making needs to take into account several features from the medium and long term outlook.

- In setting growth targets for the coming years, the likely slowdown in potential growth needs to be incorporated. To avoid macroeconomic stress, growth targets should be set in line with potential GDP growth that is projected in a plausible and sustainable scenario. In principle, downward pressure on potential growth from demographics and TFP growth could be mitigated by boosting investment and thus capital accumulation. However, boosting the already very high investment to GDP ratio would contradict the government’s aim to rebalance the pattern of growth towards one that is less dependent on investment. Moreover, a delay of rebalancing may diminish the associated efficiency gains.
- Given the downward pressure on potential growth, there is a premium on policies that can increase TFP growth, including via more reallocation of labor, enhanced human capital, and innovation.

Fiscal policy

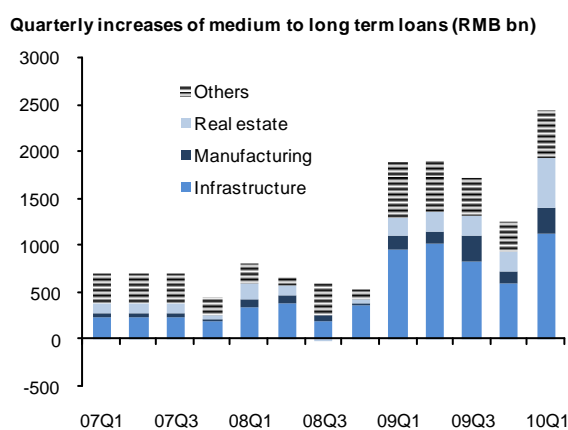
The headline budget deficit rightly implies broadly neutral fiscal policy, although the broader fiscal stance is not clear. The 2010 budget foresees a broadly unchanged budget deficit, compared to 2009. With robust economic growth and surging imports boosting revenues from VAT and import taxes, budget revenue grew 40 percent (yoy) in the first 5 months of 2010, from a low base. Meanwhile, budget expenditure growth declined to about 10 percent in that period (yoy), from 20 percent in late 2009. As a result, the 12 month rolling budget deficit shrunk to about 1 percent of GDP in May. However, the broader fiscal stance is hard to know. Taking into account off-budget government-led spending, notably that by local government investment platforms (LGIPs), the stance may still be

expansionary. The monetary data suggests that in the first quarter of 2010 a large share of lending still went to LGIPs (Figure 13).

The central authorities are rightly aiming to control lending by LGIPs.

Since long a core feature of China’s development strategy, lending to such platforms has soared since end 2008 (see our March 2010 Quarterly Update for more discussion and details). The China Banking Regulatory Commission (CBRC) estimates that total local government debt was RMB 8 trillion at end 2009, of which LGIP debt constituted RMB 7.4 trillion. This lending may in various localities cause problems for the local governments and lead to NPLs. Given China’s solid macroeconomic and fiscal position, the local finance problems are unlikely to cause systemic stress. Nonetheless, the flow of new lending to the platforms needs to be contained. It is not clear to what extent the central authorities are able to do this amidst still large overall credit creation.¹³

Figure 13. Lending to infrastructure has remained high



Source: PBC.

In current circumstances, it is important to have flexibility in fiscal policy implementation. This calls for a contingency plan and, importantly, for allowing the automatic stabilizers to work. That is, to accept deviations in tax revenues and the budget balance if economic conditions are different than expected at the time of the budget. The low fiscal deficit currently provides room for fiscal expansion if circumstances require that. This is so even though fiscal policy continues to be more expansionary than the on-budget fiscal activity suggests.

Fiscal policy and public finance reforms are key in keeping growth sustainable and rebalancing the economy. Reforms in the following areas are particularly opportune. In several areas, reforms are already discussed or underway.

- Continue to increase government spending on social protection, health, and education, both for the direct benefits of such spending and to increase household disposable income and consumption.

¹³ Aiming to control fiscal and financial risks, in directives issued end May and mid June the State Council called on local governments to strengthen the regulation and management of LGIPs and their activities, demanding a halt to lending to financing vehicles that mainly rely on fiscal revenues for debt servicing. It called on banks to also tighten their management of loans to LGIPs and called on local governments to stick to the rules prohibiting them from providing guarantees. This follows earlier moves by the CBRC to strengthen the regulation and monitoring of the LGIP loans.

- Further policy priorities in social security include putting the pension system on a financially sustainable footing; reducing segmentation, increasing pooling and portability; and responding to the implications of demographic changes. Box 2 discusses social protection and labor market policy achievements and challenges.
- Use the public finances to increase household disposable incomes, for instance by lowering social security contributions in a financially sustainable way.
- Expand the dividend policy for SOEs in coverage and level and improve corporate governance to remove the over-investment bias, especially in large, industrial SOEs. Further reforms in this area are pending.
- Remove the underpricing of industrial inputs—land, energy, water, natural resources, and the environment—through price increases and tax measures, to reflect the full cost of supply, including environmental and depletion costs. Recent adjustments in domestic fuel and water prices, the pilot with an ad valorem resource tax on oil and gas in Xinjiang, and plans to gradually end subsidized electricity prices for energy-intensive industries, are steps in the right direction.
- Remove remaining distortions in the tax system that stimulate manufacturing. Expanding the VAT system to the service sector and levying VAT at the location of consumption instead of production would help reduce current distortions.
- Consider a capital gains tax on equity to reduce distortions and make the tax system more equal.

Many of the government’s objectives are not possible without reform of the system of fiscal relations.

The key challenges are aligning incentives of local governments with the central government’s policy objectives, improving the consistency of revenue assignments and expenditure responsibilities of local governments and reducing the inequality in public spending.

- The incentives of local governments to be “on board” with the rebalancing agenda need to be strengthened. In addition to reforming the performance evaluation system for local officials, local taxes would reduce the dependence of local governments on land revenues and allow local governments to benefit from those economic activities that the central government wants to promote, including consumption, service sector activity, and full migration (of whole families). In this connection, property tax proposals are being discussed and likely to be piloted.

Box 2. Reform of Social Protection and Labor Market Policies

Social protection and labor market policies and programs have taken on sharply increased importance in China in recent years. During the 11th Five Year Plan (5YP) period, the scope and pace of social protection (SP) reform has in many areas exceeded the Government's already ambitious targets. This has included development of framework laws on social insurance and social assistance; a major rural pension reform initiative; ongoing efforts to reform the urban pension system; and introduction and rapid expansion of nationwide coverage of rural social assistance. SP measures also featured in the country's response to the global financial crisis. In parallel, China has reformed labor laws and regulations to protect labor rights and improve labor market flexibility. SP and labor market (LM) reforms are linked to pilot reforms of the household registration ("hukou") system and are part of policies to promote rural-urban integration.

Despite these major strides, a number of challenges remain which will need to be addressed during the 12th 5YP period and beyond. Some are areas for further policy reform and development, others relate to increasing the coherence of an SP system which has undergone such rapid recent change, while still others relate to the critical area of implementing recent reforms. Each of these challenges will also be affected by ongoing reforms outside the SP system, but to which it is closely linked, in particular "hukou" reform. Three key themes in this evolution of SP and LM policy and systems stand out:

1) Enhancing coherence and extending coverage. While the policy framework for SP and LM programs is increasingly in place, there remains much fragmentation across programs, space and people. As a result, the system is still more an accumulation of programs rather than a coherent SP system. The most striking example is the urban pension system. Furthermore, while coverage of SP programs has been increasing, they remain heavily focused on the urban formal sector. Expanding coverage to the rural population, self-employees and the growing urban informal sector (which accounts for just under one-third of the urban labor force) remains a major challenge, though the national rural pension pilot and localized initiatives on urban residents' pension programs have begun to address it.

In the area of *pensions*, possible elements of reform include: (i) establishing a universal "social pension" for urban and rural people; (ii) expanding a reformed contribution-based urban scheme to cover all segments of the urban labor force; and (iii) deepening the ongoing scale up of voluntary rural pensions. In the area of *social assistance*, reforms could include: (i) costed first steps to cover rural migrants who are long-term urban residents in urban minimum living standard guarantee ("dibao") schemes; (ii) exploring more systematic and inclusive processes for identifying the poorest in urban and rural dibao schemes; (iii) further increases in dibao funding to support reductions in exclusion errors; and (iv) expanding piloting and evaluating experience of social support for the "near poor".

2) Establishing appropriate financing arrangements. Three challenges stand out. First, how to ensure financial *sustainability* in a setting of high "legacy costs" of the urban pension system, expanding programs and a rapidly ageing population? Second, in a highly decentralized environment, how to define financing roles for central, provincial and local governments to promote greater *equity* while also striking a balance between spatial redistribution and incentives for local financing effort?¹⁴ Third, how to strike the proper balance between protection and labor *competitiveness*? While overall expenditure on social protection as a percent of GDP remains low for a country at China's level of development, the current very high contribution rates place heavy burdens on employers and workers, while also encouraging informalization of the labor market and under-reporting of wages.

¹⁴ At present, there are wide variations in benefit levels and coverage rates in several SP programs, with the classic situation of decentralized systems that areas with the greatest needs are often those with the least fiscal capacity.

Box 2 (continued).

Possible reform elements include: (i) hiving off the “legacy costs” in urban pensions (for separate resolution) to allow lower contribution rates; (ii) sustaining recent initiatives to standardize management of social security funds and bring them within full budgetary oversight; (iii) extending provincial level pooling to all provinces (preferably with a common approach to pooling);¹⁵ (iv) developing more systematic approaches to indexation; and (v) pursuing a more fundamental reform of inter-governmental fiscal relations and systems (including to lessen the discretionary dimension of local level budgeting). Many of these reforms affect a wide range of agencies, and would thus need to be driven through a government-wide approach.

3) Reforms to facilitate rural-urban integration and development of a competitive labor market. The spatial transformation of economic activity and employment will remain a central feature of China’s development and a continued source of economic growth. Sustained urbanization will be coupled with large migration flows. Deeper rural-urban integration will shape the job opportunities in particular regions. Continued industrial upgrading and a “rebalanced” growth model will further shift the structure of activity within and across locations and sectors. The success of these deep transformations will require significant labor mobility and labor market flexibility. Furthermore, there is a strong equity case for such reforms.

Possible reforms to support a more mobile and flexible labor force include: (i) building on recent guidance from the national level, making further efforts (beyond provincial level pooling) to operationalize the portability of pension, health and other social insurance entitlements; (ii) establishment of supportive administrative systems which can handle the required flows of information, services and finances; and (iii) continued expansion and improvement of options for migrant workers to acquire skills demanded in the market. In addition, there is a need to further coordinate policies for social assistance to ensure that migrants do not fall into “policy gaps”.

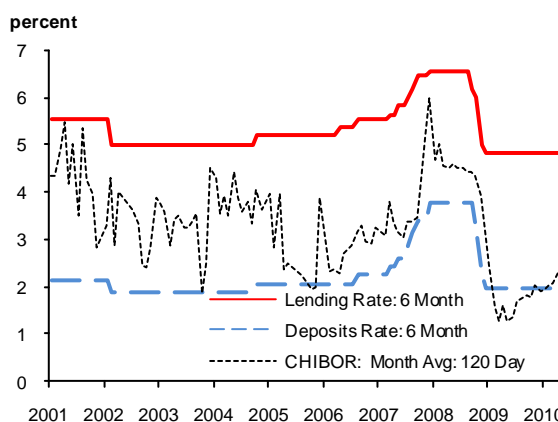
- The problems with local governments’ budgets—with normal budgets heavily constrained and supplementary off budget spending, notably on infrastructure— underscore the need for reform of the intergovernmental fiscal system, making urban development and infrastructure spending more transparent and better integrated in the overall public finances.
- Another aim of intergovernmental system reform should be to improve the fiscal capacity of poor regions so that they can fund a minimum level of public services determined by the central government. In the absence of significant net transfers from rich to poor regions or other revenue sources, large disparities in spending per person on public services will unavoidably persist. Transfers have increased. However, it is key to make transfers rules-based, so that local governments can base their future plans and policies on them.
- In addition, building on the pilot in Xinjiang, China could consider additional revenue sources that benefit poor regions. This would make them less dependent on fiscal transfers.

¹⁵ While even higher level pooling is a clear goal of policy, urban systems remain a considerable way from achieving even harmonized provincial level pooling at this point.

Monetary policy

The authorities have outlined a less expansionary overall monetary policy stance and taken some steps towards achieving that. New credit expansion is targeted at RMB 7.5 trillion this year, which would mean 18 percent yoy growth in end December. While substantially less than the 30 percent in 2009, this is still rather accommodative, pushing up the credit to GDP ratio to unprecedented levels. To help anchor price expectations and ensure financial stability, it is important to ensure that the credit target is met. Monthly credit quotas are employed to keep lending growth in check and credit through May was broadly consistent with the target. The reserve requirement ratio has been raised three times to withdraw liquidity. Although technically a substitute for open market operations, it seems to be a useful signaling device. As discussed, the authorities have also taken some administrative measures and adjusted prudential regulation to mitigate risks in the property sector and with respect to local government finance. However, interest rates have remained low. This is true for the benchmark lending and deposit rates as well as for the interbank rates (Figure 14).

Figure 14. Interest rates have remained low



Source: CEIC, World Bank staff estimates.

The gains from letting interest rates play a larger role in monetary policy are likely higher than the costs. Interest rates are substantially lower than expected rates of return on property and physical investment. This gap is a fundamental driver of overinvestment and real estate speculation, which are very difficult to contain without higher interest rates. The fear that high interest rates will attract massive capital inflows that could dominate liquidity developments seems overdone. So far, the role of interest-sensitive capital inflows in fueling liquidity has been fairly small, compared to domestic liquidity creation. This is because China's capital controls are relatively effective in containing financial capital inflows. Furthermore, such flows into China are not likely to be very interest sensitive, since they appear to be largely attracted by the equity and, especially, the property market. A recent State Administration of Foreign Exchange (SAFE) investigation concluded that there have so far not been large scale "hot money" inflows into China. The alternative to interest rate adjustments, quantitative and administrative measures such as credit quotas, tend to create volatility and uncertainty on financial markets, are distortive and sit oddly with efforts to make banks more commercially oriented.

If policymakers remain concerned about capital flows, macro prudential regulation and more exchange rate flexibility would help. SAFE recently tightened regulations on overseas lending and borrowing via domestic banks and both SAFE and the People's Bank of China announced they would

more strictly monitor capital flows. More exchange rate flexibility would make monetary policy more independent. By introducing useful two way risk on the foreign exchange market, such flexibility gives monetary policy more room to be in line with domestic needs and to raise interest rates even when interest rates in high income countries remain low. This feature of exchange rate flexibility will become increasingly important if China's cyclical conditions will diverge more often from those in the US, since then US monetary conditions (the interest rate) are not appropriate for China. With regard to the level of the exchange rate, a stronger currency helps reducing inflation pressures by lowering the price of imports and toning down demand. It also helps rebalancing China's pattern of growth towards more services and consumption and less industry and investment.

The following papers are available from World Bank's *Documents & Reports* website:

[Http://www-wds.worldbank.org](http://www-wds.worldbank.org),

China's Export Growth and the China Safeguard: Threats to the World Trading System?

Authors: Chad P. Bown, Meredith A. Cowley

Report nr. WPS5291

The authors examine this question by drawing on a newly constructed data set of U.S. and EU product-level import restrictions on Chinese trade imposed between 1992 and 2001 and estimate their impact on Chinese exports to 38 alternative markets. There is no systematic evidence that the import restrictions imposed during this period resulted in Chinese exports surging to such alternate destinations. To the contrary, there is weak evidence of a chilling effect on China's exports to third markets.

China's Investment in African Special Economic Zones: Prospects, Challenges and Opportunities

Authors: Deborah Brautigam, Thomas Farole, Xiaoyang Tang

Report nr. 53682

China's recent moves to establish special economic zones (SEZs) in several African countries can make a significant contribution to industrialization in Africa. But the success of these projects is by no means guaranteed. Meeting the objectives of both China and African countries will require an active partnership and a framework for collaboration that includes engagement from host governments, processes for phasing-in local control, communication and enforcement of standards, and support for integration with local economies.