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## **Quarterly Update**

**November 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 growth has moderated somewhat, with a shifting composition.** GDP growth declined from 10.6 % in the first half to a still surprisingly strong 9.6 % (yoy) in the third quarter. The domestic economy cooled as the stimulus impact is fading out and the monetary stance is being normalized. Investment and urban consumption have decelerated, and so have imports. Meanwhile, with exports strong, net external trade has contributed significantly to (yoy) growth and the external surplus is rising again.

**The global outlook is broadly favorable, but risks remain.** Despite an expected deceleration, global growth prospects are fairly favorable due to emerging market strength. But risks include a weaker outlook in high income countries and ample international liquidity as well as the global imbalances and possibly contentious policies triggered by them. Global price pressures remain contained by spare capacity in many countries. But there are upward inflation risks internationally.

**China's own economic prospects remain sound, with risks both ways.** Growth may ease further as global growth decelerates and the macro stance is normalized further. However, the expansion should remain supported by the traditional growth drivers and a robust labor market. We have edged up our GDP growth projection for 2010 to 10 % after the third quarter data. We see growth at 8.7 % in 2011 and easing somewhat further in the medium term. Pushed up by higher food prices, inflation may stay above the 3 % target for a while. It is unlikely to escalate as core inflation remains in check. However, raw commodity prices may rise further while sustained high wage growth is unlikely but cannot be ruled out. Given the fundamental drivers of property prices, they are unlikely to be contained for long. On current trends and policies, the external surplus is on course to rise in 2011 and the medium term.

**Further normalization of the macroeconomic stance is needed to guard against macro risks.** The key concerns are asset price increases, strained local finances and NPLs, while inflation risks cannot be ruled out. Two way risks call for policy flexibility. The authorities are broadly on track to normalize the overall monetary stance and meet the 2010 quantitative targets. They have also started to raise interest rates, although interest rates will need to rise further. International liquidity poses challenges to monetary policy, but these should be more manageable in China than in some other emerging markets. Nonetheless, measures can be taken to enhance protection against unwanted capital flows.

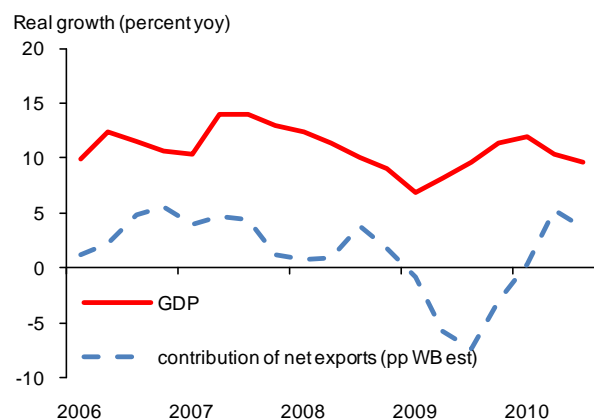
**The preparations for the 12<sup>th</sup> 5YP (2011-2015) call for focus on structural issues and reforms.** Changing the growth pattern is rightly a key target. The need to rebalance to more domestic demand led, service sector oriented growth seems stronger now than 5 years ago, in part because the international environment is less favorable. Rebalancing will not happen by itself—it will require significant policy adjustment. This Update also discusses policies that would help boost private sector development, focusing on opening up sectors and reducing entry barriers, addressing investment climate constraints, and supporting research and development and innovation by the private sector. Further progress in energy conservation and renewable energy calls for further rebalancing the pattern of growth, energy pricing reforms, more market-based mechanisms, lower cost of renewable energy, and accelerated development and diffusion of new energy technologies.

RECENT ECONOMIC DEVELOPMENTS

**China’s continued rapid growth during the global crisis reflected large scale stimulus and strong underlying growth drivers.** The stimulus package implemented since end-2008 gave a well-timed temporary domestic demand boost. The underlying growth drivers, in place since long, stem from sound fundamentals and a policy setting that stimulates industry-led, capital intensive growth.

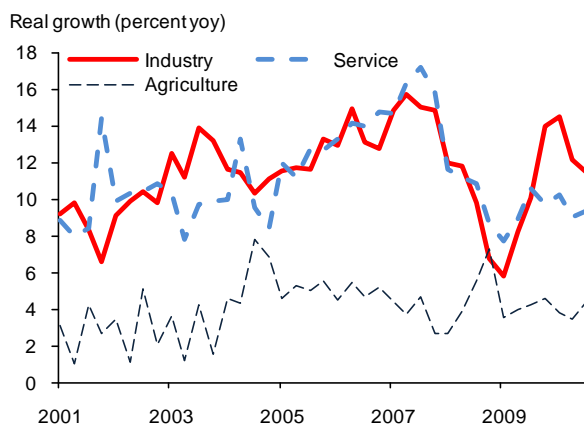
**Growth moderated to a still rapid pace of 9.6 % (yoy) in the third quarter of 2010, with a shifting composition (Figure 1).** The domestic economy cooled as the stimulus impact is fading out and the overall monetary stance is being normalized. Since August, measures to meet the 11<sup>th</sup> Five Year Plan’s energy efficiency targets may also have had some effect. Meanwhile, the (yoy) contribution of net external trade shifted from strongly negative in mid 2009 to strongly positive in mid 2010, reflecting a rebounding world economy and further global market share gains. Sequential GDP growth held up better than expected at 9.1 % in the third quarter at a seasonally adjusted annualized rate (SAAR). Production-wise, the slowdown was led by industry—heavy industry in particular— with the expansion in the service sector more steady (Figure 2).

Figure 1. Solid growth with shifting composition



Source: CEIC, World Bank staff estimates.

Figure 2. Some slowdown more recently



Source: CEIC, World Bank staff estimates.

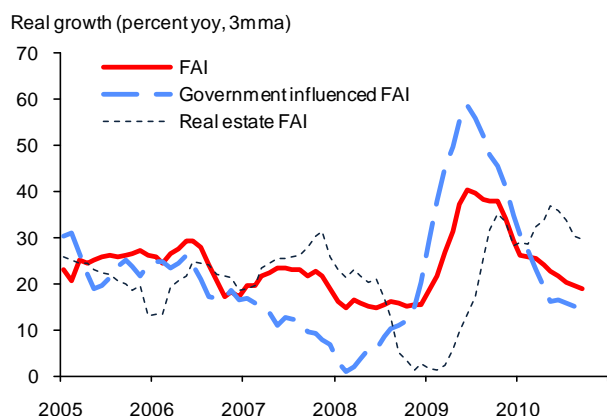
**So far, the growth moderation has been largely domestically-led.**

- **Investment continued to slow gradually through the third quarter (Figure 3).** After the surge, government-led investment has normalized in 2010, slightly lagging overall investment. Strong real estate investment has prevented a more abrupt slowdown in overall investment. In April, the government took measures to contain housing prices, including higher minimum down payments for mortgages, banning mortgage discounts, and restricting financing of developers.

However, because of the lead time, real estate construction and investment have not yet slowed significantly, even though sales initially weakened substantially (see below). Other market based investment, has continued to expand robustly.

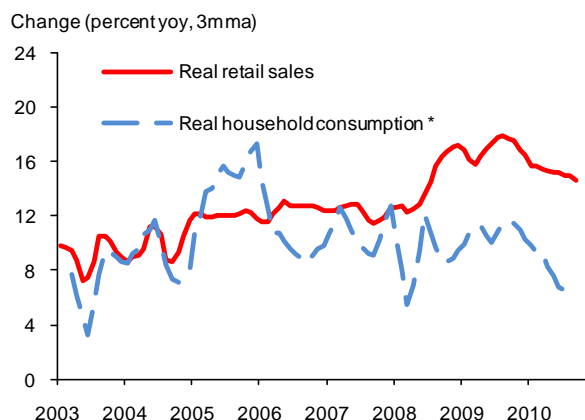
- Consumption growth has also softened, especially in urban areas.** With real urban income growth moderating in 2010 because of higher food-price driven inflation and slower housing sales (which trigger consumption spending on household items), urban consumption has decelerated significantly through the third quarter. In rural areas, slower “business income”—in part because of the supply shocks causing the higher food prices—was more than offset by strong increases in migrant wage income and government transfers. Rural cash consumption growth held up through the third quarter. However, overall consumption growth decelerated, because of the higher weight of urban spending. Retail sales also moderated slightly (Figure 4).

Figure 3. Investment has slowed, led by government-influenced investment



Source: CEIC, CPB (Netherlands Bureau for Economic Policy Analysis), World Bank staff estimates.

Figure 4. Consumption has also eased, led by urban spending



Source: CEIC, World Bank staff estimates.  
\* Weighing up the household survey data

**With exports strong, domestic demand and imports easing, and a broadly unchanged growth pattern so far, the external surplus is increasing again.**

- China’s highly competitive exports have continued to outpace global imports.** Global import demand has slowed recently, after the post recession rebound, and import volumes (in constant prices) in the world outside China are still somewhat lower than a year ago (Figure 5). However, despite recent easing, China’s merchandise export volumes were up 9.6 % on 2 years ago in the third quarter, implying further market share gains.

- **The expansion of import volumes has slowed alongside investment.** After the stimulus-driven surge earlier on, slower investment and heavy industrial production caused imports to decelerate this year, particularly raw material imports (Figure 6). Imports of machinery and equipment have held up better and car imports have also remained strong. Overall merchandise import volumes were 22.6 % higher than 2 years ago in the third quarter.

Figure 5. Export growth has been strong



Source: CEIC, World Bank staff estimates.

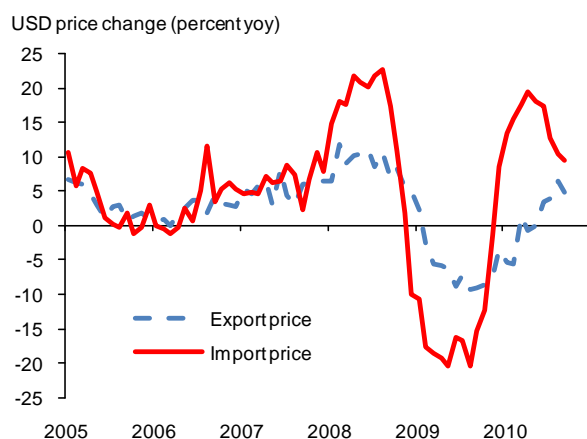
Figure 6. Imports are slowing after the earlier surge



Source: CEIC, World Bank staff estimates.

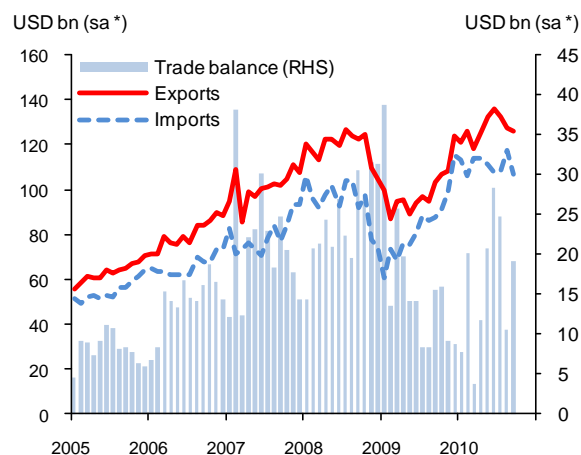
- **China's terms of trade (TOT) were unfavorable in the first half, but are turning around.** In the first half of 2010, the TOT were an estimated 15 % lower than a year ago as commodity prices were sharply higher while spare capacity in the manufacturing industry worldwide depressed China's export prices (Figure 7). However, as commodity price increases are moderating while export prices are recovering, the TOT are turning around again—in September they were down only 4.2 % on a year ago—, adding substantially to the current account surplus.
- **The trade surplus is rising again (Figure 8).** The trade surplus declined strongly in 2009 because China's domestic economy—and thus imports—kept on growing, supported successfully by massive stimulus, while the global crisis depressed China's exports. Now, with the impact of the stimulus fading out and imports slowing, little change so far in China's underlying pattern of growth, and the world economy recovering, the external surplus is rising again, even though this was masked in the first half by TOT effects. Thus, while in the first quarter of 2010 the trade surplus was US\$ 47.7 billion lower than a year ago, in the third quarter it was US\$ 26.5 billion higher than a year ago.

Figure 7. The terms of trade loss is fading out



Source: CEIC, World Bank staff estimates.

Figure 8. The trade surplus is on the rise again



Source: CEIC, World Bank staff estimates.

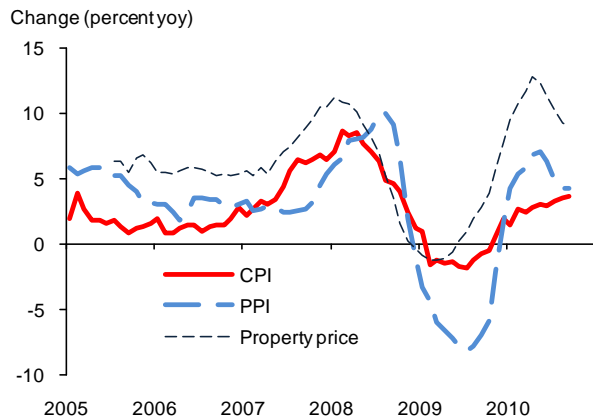
\*/ Our estimate of seasonally adjusted (SA) trade flows uses SA volumes and non-SA prices.

**Consumer price inflation has risen on higher food prices.** CPI inflation rose to 3.6 % (yoy) in September (Figure 9). About two-thirds is contributed by higher food prices, largely because of problematic weather domestically but with additional impact from higher international food prices.<sup>1</sup> Despite renewed increases in international prices for industrial raw materials, input prices in China are still falling month on month and the (yoy) PPI increases are moderating. Meanwhile, core inflation remains low as strong productivity growth in manufacturing has largely offset sizeable wage increases in recent years (Box 1). Nonetheless, after falling in 2009, unit labor costs in manufacturing rose significantly in the first 3 quarters of 2010 (yoy) because of the particularly high wage increases granted earlier this year (Figure 10).

**Property prices have hardly budged since April.** According to the NBS's 70 cities index, the most closely watched by policymakers, price rises were contained during June-August amidst weak housing sales. However, housing prices rose again by 0.5 % month on month in September as sales recovered. In response, the government added some measures in September, including by increasing the minimum down payment ratio for first mortgages to 30 %.

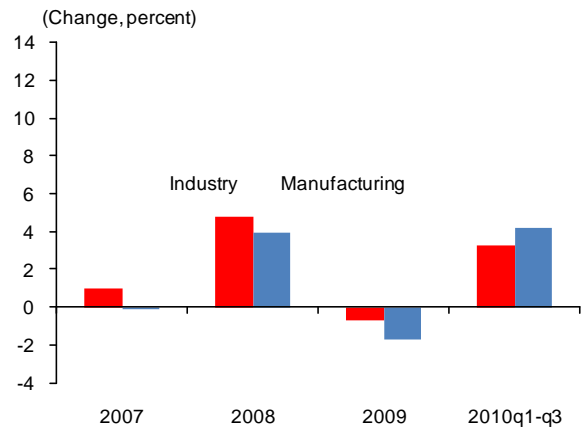
<sup>1</sup> Unlike in most other markets for raw materials in China, China's wheat and rice prices do not closely follow international prices. This is due to the active use of a large grain reserve and administratively set grain procurement prices. However, prices of corn and soybeans in China follow international prices more closely, and the higher prices for these products have helped driving up meat and egg prices..

Figure 9. CPI inflation rises as PPI inflation declines



Source: CEIC, World Bank staff estimates.

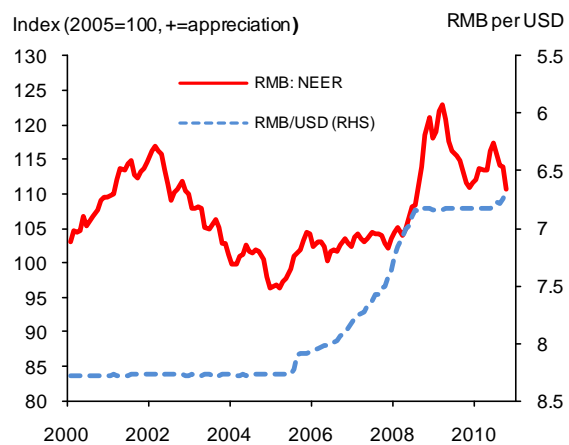
Figure 10. Will unit labor cost remain contained?



Source: CEIC, World Bank staff estimates.

**Despite some exchange rate appreciation against the US dollar, foreign exchange accumulation is accelerating again.** Between the end of the temporary peg in mid June and early November the RMB has appreciated 2.3 % against the US dollar. As the US dollar weakened substantially against many other currencies, in nominal effective terms the RMB has depreciated in this period, although the nominal effective exchange rate is still more appreciated now than in mid 2008, when the temporary peg was introduced (Figure 11). The foreign exchange purchases required to keep the RMB from appreciating more against the US dollar has gained speed again in the third quarter. Even after accounting for about US\$ 80 billion in valuation effects, the net inflow was US\$ 114 billion in the third quarter, due to a substantial trade surplus, more net FDI, and some net financial capital flows.

Figure 11. Some appreciation against the US dollar, although not in effective terms



Source: CEIC, Bank for International Settlements, World Bank staff estimates.

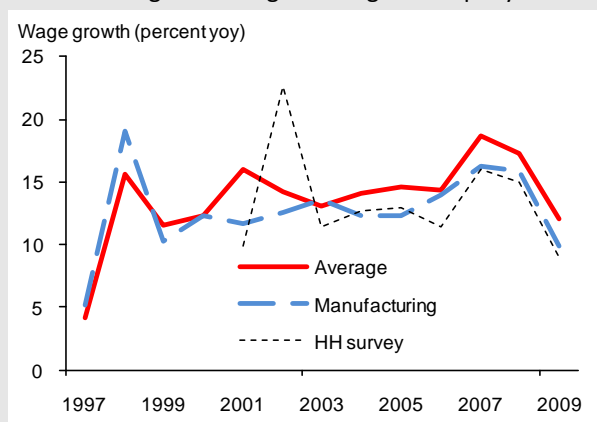
**Box 1. Have wage increases driven up costs in manufacturing?**

Concerns were raised earlier this year that high wage increases would drive up costs in China’s manufacturing sector. Weaknesses and gaps in the data call for caution. Nevertheless, sizeable wage increases in manufacturing over the last 10-15 years seem to have been offset by rapid productivity growth, also in recent years. As a result, unit labor costs fell between the mid 1990s and the mid 2000s and remained broadly unchanged since.

**In a booming economy, manufacturing wages have grown strongly in the last decade.** Amidst robust urban labor demand, average wages have risen rapidly since 2000, and in recent years wages at the lower end have also started to accelerate. Nominal wage growth picked up further in 2007, when the economy was booming and inflation rising (Box figure 1). However, it slowed substantially in 2009 due to the impact of the global crisis. Quarterly data clearly shows the recent deceleration and rebound (Box figure 2). Wages in the services sector decelerated less during the downturn and, conversely, have not seen the rapid acceleration seen in industry since end-2009.

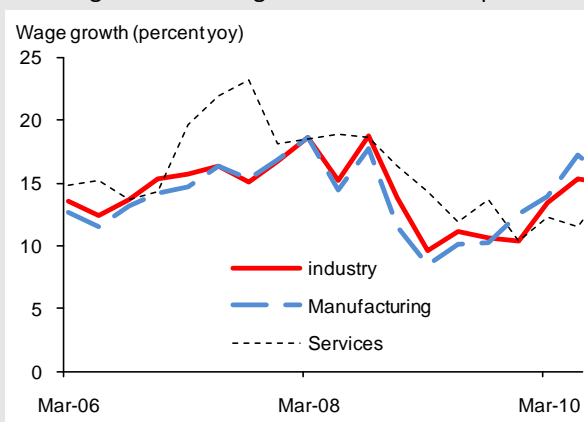
**Despite several problems, the wage data provides useful information.** The most widely used wage data—used in Box figures 1 and 2—largely only covers the urban economy and does not cover most private enterprises. This is in principle a major problem, since it may not be representative for the whole economy. However, surprisingly, this weakness appears not to distort the picture excessively. Separate, independent data from the household survey suggests lower average wage growth than the mainstream data (Box figure 1).<sup>2</sup> However, the household survey data shows a similar dynamic and the pace of wage growth is broadly similar to that in manufacturing in the mainstream data. This strengthens the case for using the mainstream data even as caution remains required.

Box figure 1. Wages have grown rapidly



Source: CEIC, World Bank staff estimates.

Box figure 2. Zooming in on recent developments



Source: CEIC, World Bank staff estimates.

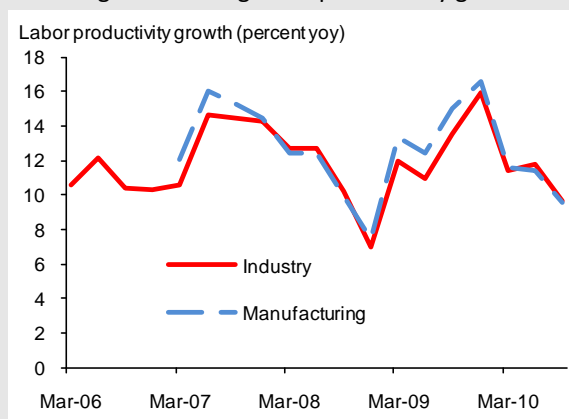
**Labor productivity in industry has also risen sharply in the last 15 years.** Value added in industry grew at around 9-10 % in 1997-2001. It then accelerated, boosted by WTO accession and a strong world economy. Moreover, labor productivity was boosted by labor shedding in SOEs: between 1997 and 2004 (when major job shedding had come to an end), some 43 million SOE jobs, or 40 %, were shed. According to our estimates, labor productivity growth in industry eased from 15-20 % in 1997-2003 to still very robust 10-12 % in post SOE job shedding 2005-2009 (Box figure 3).

<sup>2</sup> The household survey data from the urban and rural surveys is weighed up to obtain an economy-wide estimate.

## Box 1 (continued).

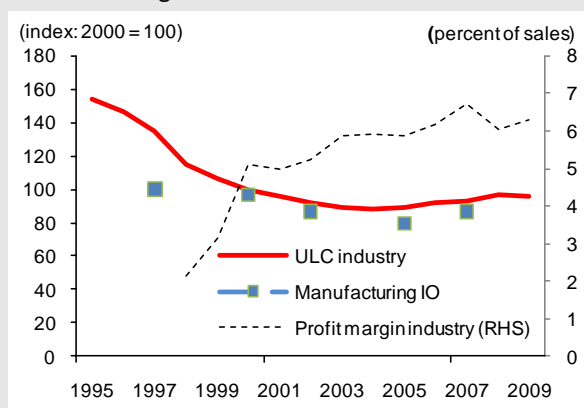
In all, unit labor costs (ULC) in industry seems to have bottomed out in recent years, after a steady decline since the mid-1990s. ULC measures the wage costs per unit of production. Putting together wage and productivity growth, ULC in industry first declined, then bottomed out around 2004, and have since edged up slightly. There are several potential caveats concerning this data. However, a ULC estimate from a different data source—the input output tables—gives a broadly similar picture for manufacturing, at least from 1999 onwards (Box figure 4).<sup>3</sup> The estimates are also consistent with a finding—on more detailed data—from van Ark, Erumban, Chen, and Kumar (2009)—that ULC in manufacturing fell on average 38 % between 1995 and 2004.<sup>4</sup> They found that within manufacturing ULC fell particularly rapidly in the machinery, transport and equipment, and electronics sectors, which saw particularly rapid labor productivity growth, and ULC fell less in textile and clothing, where labor productivity had risen less fast.

Box figure 3. Strong labor productivity growth.



Source: CEIC, World Bank staff estimates.

Box figure 4. ULC has been contained.



Source: CEIC, World Bank staff estimates.

The suggested broad absence of cost pressures from wage costs in the last 5 years after a decline earlier on is broadly consistent with data on profit margins in industry. This data, from the industrial survey, suggests that profit margins in industry trended up until 2004 and have remained at that relatively high level since then (Box Figure 4).

Internationally, ULC in manufacturing in several other countries nowadays also tends to be contained. For long, since the second world war, ULC in manufacturing trended upwards in the major industrialized countries. However, in recent decades that has not held anymore, because of lower inflation and, presumably, globalization. The OECD estimates that in 2000-09, ULC in manufacturing has declined by 2 % in the US and a full 25 % in Japan, although it rose by 12 % in the EU13 and 26 % in Mexico.

<sup>3</sup> The input output tables suggest only slightly higher increase in ULC for the whole economy during the recent decade, whereas the flow of funds data suggests a 20 % increase.

<sup>4</sup> "The Cost Competition of the Manufacturing Sector in China and India, an Industry and Regional Perspective," the Conference Board and Growth and Development Center of the University of Groningen, January 2009.

## ECONOMIC PROSPECTS

**The global economy is starting to slow again, particularly in high income countries (HICs).** This is because of an end to the inventory adjustment, implementation of exit strategies for stimulus policies, and sovereign stress in peripheral Euro zone countries and its potential impact on global financial markets. Prospects for growth in the US and Japan in 2010-11 are being revised downwards, which is also leading to further easing of monetary policy there, including by possible additional quantitative easing in the US. Global trade and industrial production are slowing down after the earlier bounce back (Table 1).

Table 1. The global environment

*(percent change, unless otherwise indicated)*

	2008	2009	2010		2011	
			Jan	Oct	Jan	Oct
World GDP growth 1/	1.6	-2.3	3.0	3.6	3.2	3.0
High income countries	0.3	-3.6	2.0	2.2	2.2	1.8
Developing countries	4.1	-0.1	4.8	6.0	5.2	5.3
World imports 2/	3	-11.2		11.5		6.8
World prices (US\$) 2/						
Oil (\$/bbl)	97	61.8		76.2		78.8
Non oil commodities	0.0	-21.6		16.8		-2.1
Manufactured export products	5.9	-4.9		3.1		1.4
\$ Libor interest rate (6 m percent per year)	3.0	1.1		0.6		0.8

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

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

2/ International Monetary Fund (WEO, October 2010).

**However, overall global growth prospects are supported by emerging market strength.** In the US and Europe, the apparent slowdown notwithstanding, mainstream forecasters do not expect a double dip, although the Japanese economy may struggle. Moreover, most emerging markets and developing countries should see continued robust growth. Their growth prospects are of course linked to those in HICs via trade and capital flows, and financial sector risks originating in HICs have global ramifications. However, domestic demand prospects are robust in most large emerging markets, while relatively sound macroeconomic fundamentals buoy the sustainability of their growth. In all, overall global growth prospects for 2010 have been upgraded since January 2010, although those for 2011 have been nudged down (Table 1).

**Nonetheless, the global growth outlook remains subject to large risks, both ways.** In HICs, households may remain reluctant to consume as they adjust to balance sheet losses and amidst high unemployment and uncertainty. There could also be feedback effects between high public debt burdens, unfavorable

growth dynamics, increased rollover risk, and linkages to the banking system. A few factors mitigate downside risks: private investment may not fall much more, given that it is already low, as a share of GDP, and amidst robust corporate profits; a renewed rundown of stocks is unlikely because inventories appear to be close to desired levels; and overall financial conditions have stabilized in OECD countries, making banks somewhat less reluctant to lend.

**The global imbalances and the tensions they create cast a shadow over the global outlook.** The combination of large current account surpluses in some countries, including China, and large current account deficits in other countries, notably the US, poses financial and economic risks, including from possible tension and contentious policy responses to them.

**Internationally, underlying price pressures seem to remain moderate, but there are risks.** Price pressure remains contained by slack in labor and product markets in HICs and parts of the developing world. In this setting, the prospects for raw commodity prices on international markets including oil and food are considered to remain subdued (Table 1). Discussions on possible renewed easing of monetary policy in HICs, notably the US, have led to concerns about global inflation pressures. However, the possible monetary easing would be in response to economic weakness. Combined, the associated changes to the outlook do then not obviously imply higher global inflation, although the easing could complicate the financial outlook, including by boosting global liquidity. However, substantial recent increases in many food and industrial commodity prices show how changes in market conditions can affect such prices quickly. More generally, inflationary pressures have resurfaced in several large emerging markets, which are much further advanced in the recovery than the HICs.

**In China, growth may ease in the short term, notwithstanding the surprisingly robust third quarter.** The expected slowdown in global growth and imports is likely to affect China's exports. Some additional impact stems from the normalization of the macro policy stance, the eventual impact of the measures introduced to contain property price rises, and some administrative measures to meet energy efficiency targets. Nonetheless, we revise up our GDP growth forecast for 2010 as a whole to 10 % after the stronger than expected third quarter outcome (Table 2).

**Growth is likely to moderate somewhat more in 2011 and the medium term to a still robust pace.** The expansion should continue to be supported by the traditional growth drivers and robust macroeconomic fundamentals. In early 2011, activity may also receive a fillip from the end of some temporary administrative measures to meet energy efficiency targets. New public investment programs are also likely to be started next year to accelerate urbanization in inland regions and promote strategic new sectors. However, these are unlikely to fully offset the impact of the end of the RMB 4 trillion stimulus package. In all, with export growth lower but consumption benefiting from a robust labor market and private sector investment assumed to hold up, we project GDP growth to moderate to 8.7 % next year. In the medium term growth should remain robust, although trend (potential) growth is likely to diminish. See our June 2010 Quarterly Update for a discussion of China's medium term outlook.

Table 2. Main Economic Indicators.

*(percent change, unless otherwise indicated)*

	2007	2008	2009	2010 f	2011 f	2012 f
<b>The real economy</b>						
Real GDP	14.2	9.6	9.1	10.0	8.7	8.4
Domestic demand 1/	12.3	9.6	13.8	8.1	8.7	8.4
Consumption 1/	10.8	8.5	8.5	7.6	8.7	8.6
Gross capital formation 1/	14.2	11.0	19.8	8.7	8.6	8.3
Contribution to GDP growth (pp)						
Domestic demand 1/	11.7	8.8	12.8	7.8	8.4	8.1
Net exports 1/	2.5	0.8	-3.7	2.2	0.4	0.2
Contribution net exports (WB, pp) 2/	3.4	1.8	-4.8	2.2	0.4	0.2
Exports (goods and services) 2/	20.0	8.6	-10.4	24.3	9.3	8.4
Imports (goods and services) 2/	14.2	5.1	4.3	19.0	9.1	8.7
Potential GDP growth	10.6	10.5	11.0	9.8	9.2	8.9
Output gap (pp)	4.3	3.4	1.5	1.6	1.1	0.6
CPI (year average)	4.8	5.9	-0.7	3.0	3.3	3.3
GDP deflator	7.6	7.8	-0.9	4.7	3.0	3.0
External terms of trade	-0.9	-4.3	8.6	-8.8	-0.1	1.1
<b>Fiscal accounts (percent of GDP)</b>						
Budget balance 3/	0.6	-0.4	-2.8	-1.8	-1.6	-1.6
Revenues	19.3	19.5	20.3	20.3	20.5	20.7
Expenditures	18.7	19.9	23.0	22.1	22.1	22.3
<b>External account (US\$ billions)</b>						
Trade balance (BOP)	315	361	250	247	273	314
Current account balance	372	426	297	320	356	442
Current account balance (% GDP)	10.6	9.4	6.0	5.5	5.3	5.7
Foreign exchange reserves	1529	1946	2400	2765	3143	3596
<b>Other</b>						
Broad money growth (M2), e-o-p (%)	16.7	17.8	27.0	...	...	...

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

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

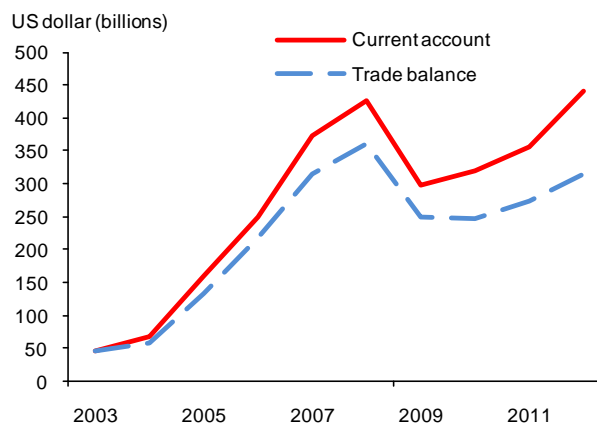
3/ For 2009 and 2010 this is in line with the commitment data presented to the NPC.

**Inflation is unlikely to escalate but it will be difficult to contain housing prices for long.** Inflation may remain above the 3 % target for a while, although the food price increases should eventually decelerate (the domestic supply side factors driving them up are considered largely temporary). Looking further ahead, the inflation outlook benefits from the subdued projections for international prices for oil, industrial commodities and food, recent increases notwithstanding, although China's domestic staple grain prices are not influenced much by international prices. Despite the large wage increases in part of

the manufacturing industry earlier this year, core inflation is unlikely to escalate, because China’s labor market is flexible and the manufacturing sector appears able to absorb substantial wage increases (Box 1).<sup>5</sup> However, given the fundamental drivers of property prices—rapid urbanization, sizeable income growth, and low interest rates—they are unlikely to remain flat for long.

**The external surplus is on course to rise again.** Taking into account the recent trends in trade volumes, normal seasonal patterns in export and import volumes, and the turnaround in the international terms of trade, the whole-year trade surplus may be broadly unchanged from 2009, because of the low reading in the first half.<sup>6</sup> However, on current policies and trends, the trade surplus is likely to continue to rise in 2011 and the medium term, in US\$ terms (Figure 12). The current account surplus should rise faster than the trade surplus because the net income on China’s rapidly growing net foreign asset position is likely to grow significantly in the coming years. The upward revision in our current account surplus forecast compared to our June forecast is largely because of stronger than expected export volumes and weaker than expected import volumes.

Figure 12. The external surplus is likely to rise again



Source: CEIC, World Bank staff estimates.

**There are of course risks to this outlook.** In current circumstances, with the world economy at an inflection point, there are in principle many sources of risk. On growth, the global risks discussed above, including those with respect to global imbalances and possible policy responses, are probably the key ones for China. In this connection, a lack of success in rebalancing China’s growth pattern would be among the more serious medium term risks, for China and the world economy. Upside risks with respect to inflation could arise from further shocks affecting raw commodity prices or from sustained high wage increases driving up core inflation.

<sup>5</sup> These large wage increases reflected a strong rebound in the labor market after an earlier downturn last year when wage growth slowed. Looked at over a 2 year horizon, wage growth is not far from historical norms.

<sup>6</sup> Seasonal patterns suggest export volumes and the trade surplus tend to be substantially higher in the fourth quarter. Our forecast for 2010 simply assumes that, in seasonally adjusted terms, export volumes decline 1 % per month in the fourth quarter and import volumes rise 1 % per month on this basis. On prices, we project a deterioration in the TOT of 4 % in the second half, compared to 15 % in the first half, as commodity price increases have slowed while export prices have recovered somewhat.

## ECONOMIC POLICIES

**China's favorable growth outlook warrants further normalization of the macroeconomic stance.** After the large stimulus, the key macroeconomic concerns remain asset price increases, strained local government finances, and NPLs. While the inflation outlook does not seem worrisome, the upward risks call for vigilance and managing inflation expectations. Notwithstanding the slack and unemployment in many HICs, China's economy is operating close to full capacity and the growth outlook is favorable. Thus, further consolidation of the overall macroeconomic stance is needed to contain these risks.

**Two way risks to growth make it important to be able to respond flexibly to changes in circumstances.** This can be done by ensuring flexibility in the design and implementation of policymaking. Over time, changes to the monetary and exchange rate regime, to increase the leeway to use monetary policy to pursue domestic objectives, would help dealing with the divergence in the cyclical position vis a vis the US and financial capital inflows amidst ample international liquidity.

**The preparations for the 12<sup>th</sup> 5YP (2011-2015) call for focus on structural issues and reforms.** After the Fifth Session of the 17<sup>th</sup> Communist Party of China Central Committee (CPCCC) in mid October, the CPCCC issued its proposal on Formulating the 12<sup>th</sup> 5YP. This sets out the broad direction for policy making in the coming years. The major targets proposed include stable and relatively fast economic growth, major economic restructuring, raising people's income relatively fast, and deepening reform and opening up. The principles, targets, and tasks and strategic priorities are broadly in line with the overall challenges and objectives we discussed in our March 2010 China Quarterly (pp19-22) (Box 2).

### Box 2. The key challenges and objectives during the 12<sup>th</sup> 5YP.<sup>1/</sup>

Two overall challenges:

- Achieving sustained rapid growth and development; and
- Improving the quality of growth, making growth more people oriented, improving the quality of life; reducing environmental degradation; containing energy demand; and reducing the external imbalance.

Five main objectives:

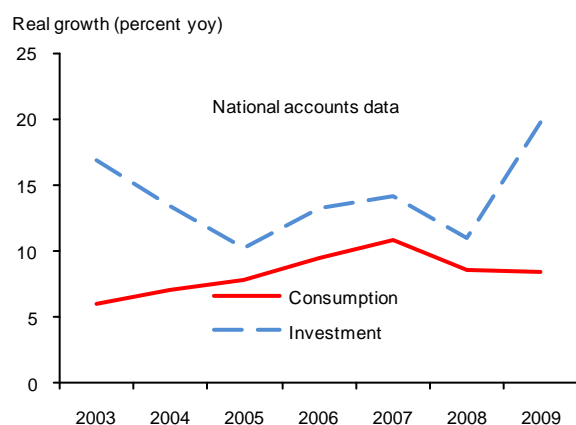
- Changing the economic growth pattern; more focus on services and consumption and less on industry and investment;
- Boosting efficiency, notably by innovation and upgrading and increasing the role of the private sector;
- Pursuing sustainable spatial transformation, by successful urbanization and regional development;
- Changing the role of the state in the economy, with less direct control when markets function well and more involvement in areas such as health and education where markets often do not function well; and
- Taking account of China's changing interaction with the rest of the world.

1/ For a discussion, see our March 2010 Quarterly Update (pp. 19-22).

The Plan itself should have more specifics on the planned policy reforms and associated quantitative targets. In the June 2010 Quarterly we looked at the key role of the public finances and the crucial need for reform of the intergovernmental fiscal system, and fiscal reforms are likely to be introduced. Below we discuss 2 important policy areas in more detail: private sector development and energy.

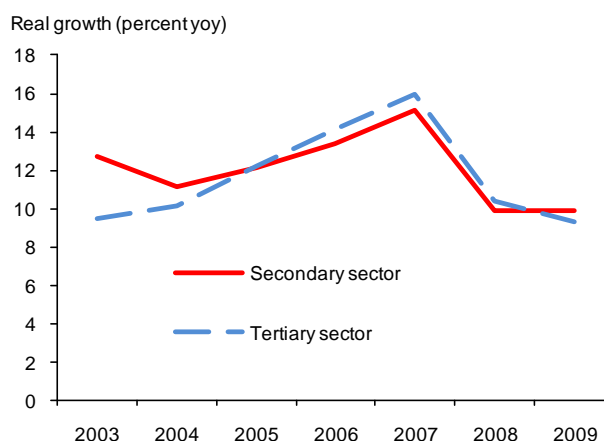
**Key among the objectives is changing the growth pattern.** This adjustment—towards more services and consumption, away from the emphasis on industry and investment—is in order to address China’s social, environmental and external imbalances. It was already a key objective of the 11<sup>th</sup> 5YP. Progress has been made in several specific areas. However, there has been limited progress with the overall rebalancing. On the expenditure side, consumption has so far substantially lagged investment (Figure 13). On the production side, the tertiary sector has broadly kept pace with the secondary (largely industrial) sector but not grown faster, in real terms (Figure 14).

Figure 13. Evolution of the economic structure—the expenditure side



Source: CEIC, World Bank staff estimates.

Figure 14. Evolution of the economic structure—the production side



Source: CEIC, World Bank staff estimates.

**The need to transform the economic growth pattern may be stronger now than 5 years ago.** This is in part because the external dimension has become more pronounced. Prospects for exports are less good now. Moreover, China’s economy, its role in the world economy, and its external surplus are now substantially larger than 5 years ago. On current trends and policies, the current account surplus is rising again. Some have suggested that “endogenous” rebalancing may occur: that surplus labor is drying up and that, thus, wage increases will be substantially higher in the years ahead, automatically driving up the share of wages and household income and thus raising the share of consumption and reducing the external surplus. However, in our view, the drying up of surplus labor is a slow process with still a long way to go. In any case, there are still various distortions in China’s policy setting that need to be addressed, including in the prices of capital, labor and resources, as well as access to markets and

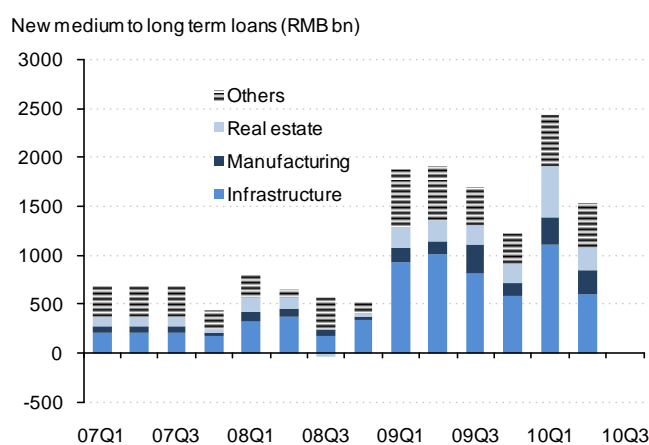
finance. Removing the distortions is a key part of the required policy adjustment. Thus, in our view rebalancing to more domestic demand led, service sector oriented growth is unlikely without significant policy adjustment and it is appropriate to have it as a major objective of the 12<sup>th</sup> 5YP.

### Fiscal and monetary policy

**China’s headline fiscal position remains sound, which helps to provide policy space.** Despite the massive fiscal expansion, the headline fiscal deficit reached only 2.8 % of GDP in 2009, as much of the expansion was financed by bank lending. In the first 3 quarters of this year, headline expenditure rose 20.6 %, with fairly even growth of spending across different categories. Revenues increased 22.4 % in this period, with indirect taxes rising faster than direct taxes. These trends suggest a further reduction in the headline fiscal deficit, although such trends may not necessarily be a good predictor of the whole-year balance.<sup>7</sup> China’s official government debt was a modest 17.5 % of GDP at end 2009.

**Quasi fiscal spending is being contained, after the surge that has reduced the overall macro policy space.** A significant share of the surge in lending to local government investment platforms (LCIPs) since end 2008 may go bad. After an investigation, the China Banking Regulatory Commission estimated in July that of the RMB 7.7 trillion in lending to LGIPs, about RMB 1.54 trillion, or around 20 %, faces default risk. Given China’s solid macroeconomic and fiscal position, and the reported capital cushion of most banks, the local finance problems are unlikely to cause systemic stress fiscally or for the banking sector. Nonetheless, the flow of new lending to the platforms during the stimulus was unsustainable and, overall, China now has less macro policy space than in 2008. The measures taken by the government earlier this year to stem the flow seem to have achieved results. Medium and long term lending to infrastructure—which overlaps with lending to LGIPs—declined from RMB 1111.2 billion (up 19 % on a year ago) in the first quarter of 2010 to RMB 607.5 billion (down 40 % on a year ago) in the second quarter (Figure 15). It is important to keep this flow contained and reinforce prudential regulation with regard to this type of lending. It would also be very useful to improve its transparency.

Figure 15. Lending to infrastructure is coming down



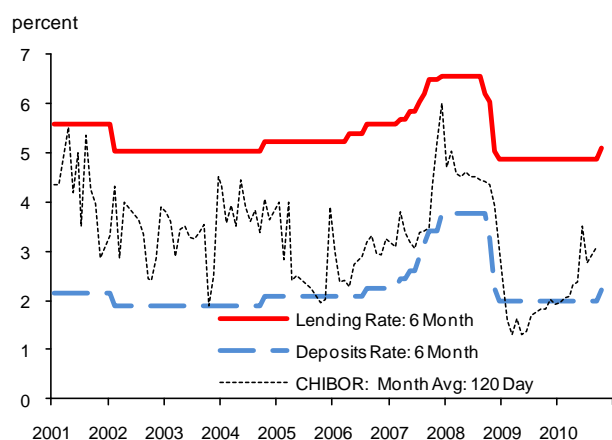
Source: CEIC, World Bank staff estimates.

<sup>7</sup> In January-September 2010, the surplus was 2.3 % of GDP. But the average surplus in the first 9 months was 3.4 % of GDP in 2007-09, while the whole-year balance ranged from +0.6 % of GDP in 2007 to -2.8 % of GDP in 2009.

**The overall monetary stance needs to be normalized to contain the associated risks.** In addition to strained local finances, the most important macroeconomic risks are NPLs and prices of housing, equity, and possibly other assets. Moreover, while the inflation outlook does not seem worrisome, the risks to inflation call for vigilance, managing inflation expectations, and monetary policy leeway. With the economy operating close to full capacity overall and the growth outlook robust, further consolidation of the monetary stance is needed.

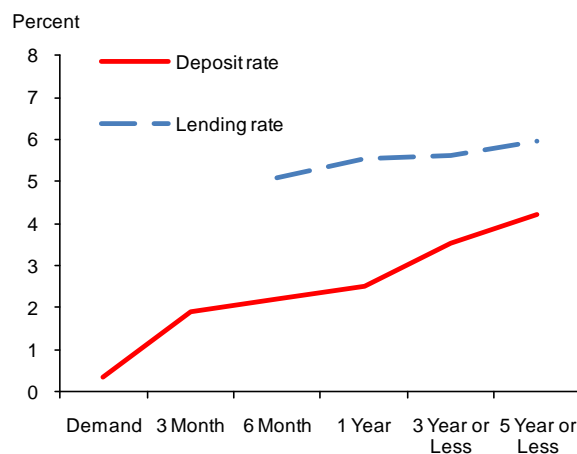
**The authorities are broadly on track to meet the 2010 monetary targets and have started to normalize interest rates.** Mainstream credit growth decelerated from 33.8 % in end 2009 to 18.5 % in September (yoy) and the 2010 target for new lending of RMB 7.5 trillion is broadly in reach. Meeting that target should help manage inflation expectations. However, the case for relying more on interest rates in conducting monetary policy is strong. Off balance sheet credit-type products have grown rapidly recently, in part because of ample liquidity and low interest rates. Reining in such financial activity, and more generally tightening overall monetary conditions, requires higher interest rates as well as containing liquidity in the financial system. In mid October the PBC raised benchmark 1 year lending and deposit rates by 25 bp (Figure 16).<sup>8</sup> The PBC raised longer-term deposits rates by a higher margin, in part to make deposits more attractive relative to alternatives (Figure 17). Longer-term lending rates were raised by a smaller margin. Further normalization of interests rates is needed, as lending and deposit rates are still low relative to historical levels and the buoyancy of the economy.

Figure 16. Interest rates remain low



Source: CEIC, World Bank staff estimates.

Figure 17. Interest rates vary with maturity



Source: CEIC, World Bank staff estimates.

<sup>8</sup> This is the first adjustment to interest rates since December 2008, when they were cut as part of the stimulus package.

**Pressure from international capital flows may challenge the conduct of monetary policy, but these challenges should be more manageable in China than in some other countries.** The abundant liquidity internationally created by loose monetary policy amidst weak growth in developed countries is likely to be attracted by the strong growth in this region, notably China. Such flows will add to the upward pressure on the RMB. However, in China such flows may be less of a problem than is sometimes thought and they should not be a reason not to raise interest rates. The amount of net financial inflows is still quite modest, compared to other flows and domestic credit creation because China's controls on unwanted financial inflows have been rather effective. More than 100 % of the increase in foreign reserves in 2006-09 was driven by the current account surplus and net FDI while in 2009, the first year with positive net financial inflows since 2004, such net inflows were equivalent to around 4% of domestic credit creation.

**Measures can be taken to further shore up protection against unwanted capital flows.** In current circumstances it makes sense to continue to effectively apply the controls on financial capital flows and also to consider tightening regulation. Earlier this year, State Administration of Foreign Exchange (SAFE) 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. There would likely be more room for further tightening of micro and macro prudential regulation. In addition, more exchange rate flexibility may help in deterring capital inflows, although the recent experience in other large emerging markets shows that flexible exchange rates by themselves may not deter such inflows sufficiently. 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.

### **Private Sector Development**

**The private sector will remain critical for achieving China's development objectives over the 12th 5YP period and beyond.** Private sector firms are more productive than SOEs and are crucial for job creation.<sup>9</sup> Expanding the role of the private sector has been part of China's reform strategy. However, there is a feeling among many that in recent years the policy stance has favored SOEs over the private sector (see Box in our June 2010 Quarterly Update). At any rate, there is wide agreement that a vibrant private sector is key for raising productivity and for China's further development and growth.

In order to boost the strength of the private sector, in the next 5 years, China could address the following 3 challenges:

**First, opening up to private enterprises sectors so far dominated by state-owned firms.** In 2005, the government expounded the principle of allowing private firms to enter some industries previously reserved for SOEs and called for the equal treatment of SOEs and private companies. In practice, the

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<sup>9</sup> OECD Economic Survey: China 2010.

principle proved hard to implement and progress was limited. Earlier this year, the government issued guidelines which reiterated the desire to stimulate the private sector and remove entry barriers to private investment.<sup>10</sup> The objective is to encourage private investment in sectors such as infrastructure, utilities, financial services, logistics, and defense. Specific measures are still pending.

**In this connection, the government could usefully clarify the role it envisages SOEs to play in China's economy.** Without a clear, specific policy framework and support, such guidelines may not be very effective, since traditional habits among local governments, enterprises, and banks are sometimes hard to change. Moreover, the guidelines seem to conflict with other explicit principles emphasizing the need for a strong role for SOEs, as codified in a list of "strategic" and "basic or pillar" industries where state owned companies are meant to play a key role. The current list of "basic and pillar" sectors in industry includes machinery, autos, IT, construction, steel, base metals, and chemicals. If the aim is to stimulate the private sector, it would be useful to reconsider the composition of this list. In addition, there is ample room to open several services sectors to private sector participation.

**Second, continuing to address investment climate constraints.** During the 11th 5YP, the overall investment climate for the private sector has improved, notably through the reforms of the regulatory environment to encourage new entry. However, some remaining institutional and policy constraints that hamper the development of the non-public sector could be tackled during the 12th 5YP. These include:

- ***Making access to finance more equal and developing capital markets.*** Despite improvements in the capital market, especially the establishment of the Small and Medium-sized Enterprise (SME) Board and the New Ventures Board, many private firms still have difficulties accessing bank loans and the capital market. This is particularly so for micro, small and medium-sized enterprises (MSMEs) in the central and western regions, where the relevant financial markets and products are relatively underdeveloped. Thus, an important task during the 12th 5YP is to strengthen financial services to MSMEs, especially those in the interior regions.
- ***Adjusting the role of the government and reducing "red tape."*** Local governments often maintain tight control of economic development, including selecting industries and planning industrial transfer. As part of the process to change the role of the state, the government—including at the local level—could increasingly withdraw from direct intervention in the economy. In this way red tape could also be reduced.
- ***Reducing further regulatory barriers to entry.*** Despite the encouragement of private sector development, many sectors still have unnecessarily high barriers. These include unduly high levels for required registered capital and fixed assets.

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<sup>10</sup> "Several Opinions on Encouraging and Guiding the Healthy Development of Private Investment."

**Third, supporting the research and development (R&D) and innovation capacity of the private sector.**

During the 11th 5YP period, the overall innovation climate for China's private sector has improved and some very innovative private firms have emerged. However, most R&D in China is still conducted by large and medium-sized SOES, with private firms, particularly small ones, playing a small role. The government can further strengthen the private sector's innovation capacity through: (i) better protection of intellectual property rights; (ii) helping improve the skills of private sector workers; (iii) strengthening interactions between the private sector and knowledge institutions; and (iv) providing supportive services.

**Reducing energy intensity—challenges and policies**

**China will get close to meeting the energy intensity (EI) target of the 11<sup>th</sup> 5YP.** The plan included a target to reduce the amount of energy per unit of real GDP by 20 % between 2005 and 2010. Using the most recent energy consumption and GDP data, EI was reduced by 15.6 % in 2005-9. Given developments so far in 2010, it will be difficult to meet the 20 % target exactly, barring further data revisions.<sup>11</sup> Nonetheless, China will get close, thus decidedly reversing an earlier upward trend in energy intensity (Figure 18). Moreover, the adoption of a binding target has clearly established energy conservation as a top priority at all levels.

**More generally, China has made impressive achievements in energy conservation and renewable energy during the 11th 5YP period.** Several reforms have taken place, including in pricing and taxation. Many inefficient coal-fired power plants and energy-intensive factories have been closed. Since the Renewable Energy Law of 2006, wind power capacity has been doubling every year and China has transformed itself into a world leader in renewable energy.<sup>12</sup> These developments have shifted the economy towards a more sustainable energy path.

**Looking forward, China will continue to face (local and global) environmental sustainability challenges to meet the energy needs arising from rapid economic development.** China's energy use per unit of GDP in 2009 was around 3.6 times as large as in the US and 7.3 times as high as in Japan if GDP is measured at market exchange rates (Figure 19). If GDP is measured at PPP, China's energy intensity in 2009 was around 1.5 times as high as the US level.

**Specifically, China's energy needs will be shaped by its response to three overarching challenges.**

These are: (i) maintaining rapid economic growth while rebalancing the country's economic structure and moving towards a less energy- and carbon-intensive economy; (ii) achieving rapid urbanization

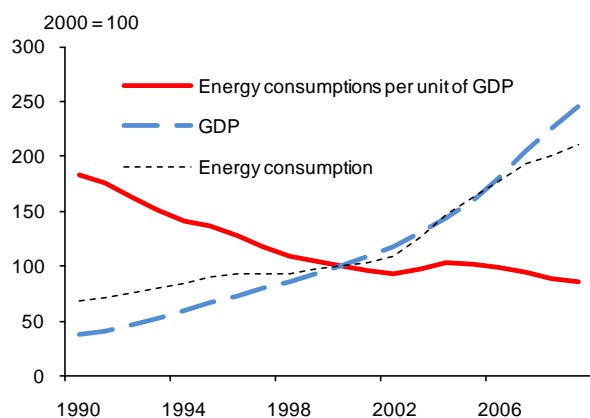
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<sup>11</sup> The government announced that in the first half of 2010, the EI rose by 0.9 %, compared to a year ago. Achieving the 5.2 % reduction in 2010 that is necessary to meet the 20 % of the 11<sup>th</sup> 5YP would require a 10 % reduction in the second half, compared to a year ago.

<sup>12</sup> In 2009, China added 14,000 MW of new wind power generation capacity, the largest increase in the world. Total installed capacity is expected to reach 30,000 MW in 2010, second to the US.

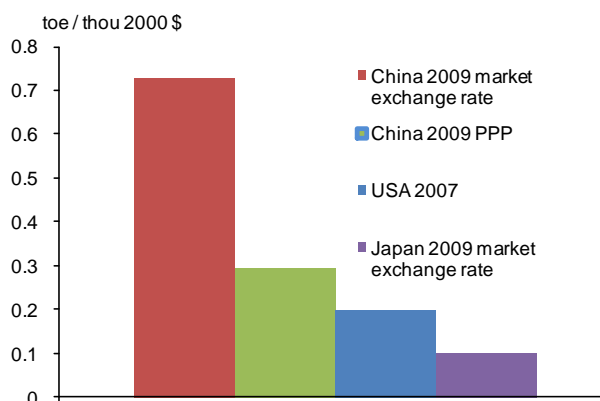
while shifting towards less energy- and carbon-intensive cities; and (iii) improving the quality of life while shifting to a less energy-intensive and more sustainable lifestyle. It is essential to meet these challenges to avoid being locked into a highly energy-intensive structure and to contribute to a sustainable energy development path both locally and globally.

Figure 18. The energy intensity is being reduced



Source: CEIC, World Bank staff estimates.

Figure 19. The energy intensity is still high



Source: CEIC, IEA, World Bank staff estimates.

In addition to economy-wide reforms to promote rebalancing, meeting these challenges will require actions in four key dimensions of the energy sector:

**First, continuing energy pricing reforms.** Passing the full economic cost of energy supply to consumers and gradually internalizing environmental costs in energy prices can help increasing energy efficiency, discourage energy waste, and encourage clean fuels. The pricing of coal and oil products now reflects developments in international oil prices in a relatively transparent way. However, fuel prices in particular are still low. The strong international evidence on the link between prices and energy intensity shows China can reduce the energy intensity by raising energy prices further. Pricing reforms are also still needed for natural gas and electric power, building on the welcome recent electricity pricing reform for residential electricity tariffs. Furthermore, introducing meters in district heating would help since the current tariffs are set based on the amount of floor area, which weakens incentives to conserve energy. Prices should also increasingly take account of environmental externalities. To that end, local (and even global) environmental costs can be incorporated in energy pricing through an additional fossil fuel tax and/or a carbon tax.

**Second, complementing administrative measures with market-based mechanisms to further reduce energy intensity.** Sustaining the reduction of energy intensity achieved under the 11th 5YP will require: (i) increasing the use of market-based mechanisms and financial incentives while strengthening the

implementation of administrative measures; (ii) continued structural reforms towards a less energy-intensive economy while pursuing technical and managerial energy conservation measures; and (iii) strengthening energy conservation in urban buildings and transport while consolidating efforts on large state-owned enterprises and expanding to other enterprises. Enhanced market based mechanisms, such as piloting energy saving certificates trading, developing market-based financing mechanisms, and scaling up the energy efficiency service industry, can also motivate enterprises to implement energy efficiency measures and allow government agencies to play a more indirect supervision role. To this end, the energy intensity reduction target for the 12th 5YP could be made more customized than the current one (which called for a similar reduction for all parts of the economy). This target can be complemented by a range of investments in human capacity, strengthening incentives, financial innovation, transparent supervision, data collection, reporting and verification methods.

**Third, reducing cost and improving performance of renewable energy.** Currently, power consumers pay an average of about 0.4 fen/kWh for the higher costs of renewable energy. With the rising share of renewable energy in the power mix, in the absence of a government subsidy, a continued increase in the surcharge for renewable energy may create financial burdens on consumers. In addition, a large share of wind power cannot get onto the grids, biomass development has run into fuel supply issues, and solar PV is still costly. Sustainable growth of China's renewable energy industry would need to focus more on driving down costs while promoting high efficiency and high quality. To address some of these issues, the government has already revised the Renewable Energy Law. Further reforms during the 12th 5YP period could include: (i) improving renewable energy planning, allocation of mandatory quota, and piloting renewable energy certificate trading; (ii) strengthening feed-in tariff schemes; (iii) resolving the grid integration bottleneck to wind and solar development; (iv) developing policies for distributed generation and integrating renewable energy into power sector reform; (v) accelerating hydropower development; and (vi) improving the performance and reducing the costs for wind and solar PV.

**Fourth, accelerating development and diffusion of new energy technologies.** Deploying advanced technologies on a large scale requires accelerated and enhanced research, development, and demonstration, coupled with an adequate carbon price. The clean technology revolution offers an opportunity for China to leapfrog to the next generation of new technologies, such as Integrated Gasification Combined Cycle (IGCC), carbon capture and storage (CCS), electric vehicles, energy storage, distributed generation, and smart grids. Coupling a technology push (e.g. increasing R&D) with demand pull (e.g. increasing economies of scale) is critical to drive substantial cost reductions of advanced technologies. This also provides an opportunity for China to create local manufacturing industries and drive down costs to becoming global technology leaders. China already has three of the top ten global solar manufacturers and its wind manufacturing industry is also on its way to become a global leader. The largest barrier is the high incremental costs between these technologies and conventional options.

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**Authors: Gallina Andronova Vincelette, Alvaro Manoel, Ardo Hansson, Louis Kuijs**

This paper explores how the ongoing crisis, the policy responses to it, and the post-crisis global economy will impact China's medium-term prospects for growth, poverty reduction, and development.

***Environmental Performance Rating and Disclosure: An Empirical Investigation of China Green Watch Program (Report nr. WPS5420)***

**Authors: Yanhong Jin, Hua Wang, David Wheeler**

This paper investigates the impact of a Chinese performance rating and disclosure program, Green Watch, which has been operating for 10 years.

***The Impact of Environmental Performance Rating and Disclosure: An Empirical Analysis of Perceptions by Polluting Firms' Managers in China (Report nr. WPS5419)***

**Authors: Yanhong Jin, Hua Wang, David Wheeler**

Using data from China's Green Watch program, this study extends previous research on performance rating and disclosure by considering firms' perceptions of public and market responses to their ratings.

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**Authors: Aaditya Mattoo, Arvind Subramanian;** This paper presents an analytical framework to encompass contributions to the literature on equity in climate change, and highlights the consequences

***China through 2020: A Macroeconomic Scenario (Report nr. 55132)***

**Author: Louis Kuijs;** This paper sketches a macroeconomic scenario for China for 2010-20, using a growth accounting framework. It also tries to assess how the size of China's economy may evolve compared to the US.

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**Authors: Monica Das Gupta, Avraham Ebenstein, Ethan Jennings Sharygin**

This paper shows that historically China has had nearly-universal marriage for women and a very competitive market for men. The authors examine the anticipated effects of this combination of bride shortage and hypergamy, for different regions of China.