

World Bank Office, Beijing

www.worldbank.org/china

世界银行驻中国代表处

www.worldbank.org.cn

Quarterly Update

November 2009



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

OVERVIEW

Large fiscal and monetary stimulus has supported a recovery in China's economy. Falling exports amidst the global recession have been a major drag on growth. Nonetheless, real GDP growth rose to 8.9 percent year-on-year in the third quarter on the back of the stimulus. Although most of the stimulus has shown up in infrastructure-oriented government-led investment, some has been consumption-oriented and domestic demand growth has been broad based. Resurgent housing sales have started to feed through to construction activity. Investment in manufacturing is affected by spare capacity, but consumption has held up well. The strong domestic demand has buoyed import volumes and the current account surplus may fall to 5.5 percent of GDP this year even with import prices down sharply. The downturn has clearly affected the labor market, but the impact has been smaller than expected and the trough may have been past.

Growth is likely to remain robust in 2010, but the composition will change. With a larger than expected monetary stimulus, China is on track to meet the target of 8 percent GDP growth this year. We project 8.4 percent growth. Looking ahead, the global recovery is likely to be slow and subject to risk. Nonetheless, China's export growth is likely to resume, helped by strong fundamental competitiveness and the recent depreciation of the nominal effective exchange rate, and net exports are likely to stop being a drag on growth. Real estate investment is also bound to be stronger. However, the growth impact of the government stimulus is set to decline sharply next year and investment in parts of manufacturing is likely to remain under pressure from spare capacity in China and abroad. The global spare capacity is also expected to keep inflation pressures low. With exports and imports projected to grow at broadly the same pace next year and the terms of trade likely to deteriorate, the current account surplus may edge down further.

On policies, the costs and risks of sustaining the current expansionary policy stance will increase over time. In our view, macroeconomic conditions in the real economy do not yet call for a major tightening. However, risks of asset price bubbles and misallocation of resources amidst abundant liquidity need to be mitigated and the overall monetary stance will have to be tightened eventually. Given our economic projections, in 2010 an unchanged or only slightly higher fiscal deficit would fit best but flexibility is important and this includes allowing the automatic stabilizers to work, this year and in 2010.

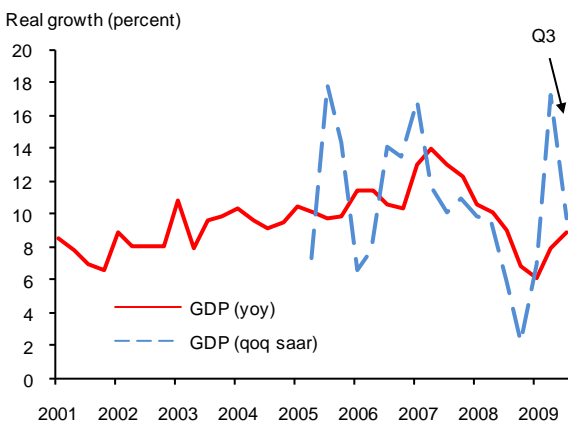
In the medium term, the recovery can only be sustained by successful rebalancing of the economy. Rebalancing and getting more growth out of the domestic economy call for more emphasis on consumption and services and less on investment and industry. Following on earlier initiatives, some further steps have been taken in recent months to rebalance and boost domestic demand, including increasing the presence of the government in health, education, and social safety; improving access to finance and SME development; and mitigating resource use and environmental damage. These are useful steps, but more policy measures will be needed to rebalance growth in China, given the strong underlying momentum of the traditional pattern. Structural reforms to unleash more growth and competition in the service sector and stimulate more successful, permanent migration would be particularly welcome.

RECENT ECONOMIC DEVELOPMENTS

In spite of a large drag on growth from exports amidst the global recession, China's economy continues to grow robustly because of expansionary fiscal and monetary policies (Figure 1). Infrastructure investment has been key but consumption has also held up well. More recently, real estate activity has been recovering as well.

In a difficult global climate, exports have been a major drag on growth. After a steep fall, global economic activity has turned the corner as financial conditions have improved. World industrial production grew 6 and 9 percent at a seasonally adjusted annualized rate (SAAR) in the second and third quarters of 2009, with especially rapid expansion in emerging markets. Nonetheless, this was from a low base in early 2009 and imports have remained weak in many parts of the world (Figure 2).¹ With processing exports particularly hard hit by the outbreak of the crisis, China's overall goods exports initially fell even faster than the imports of its trading partners. Processing trade subsequently recovered rapidly (Box 1). Nonetheless, total volumes of goods exports have remained weak and were still down 6.7 percent on a year ago in September. Net external trade withdrew 3.6 percentage points from GDP growth in the first 3 quarters.

Figure 1. China's economy has continued to grow robustly



Source: CEIC, World Bank staff estimates.

Figure 2. With world demand remaining weak, exports remain a drag



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

Nevertheless, overall growth held up very well through the third quarter, driven by domestic demand. After almost coming to a halt in late 2008, GDP rose 17 percent in the second quarter and 10 percent in the third (SAAR), to a level 8.9 percent up on a year ago.² Domestic demand grew 12 percent year on year (yoy) in the first three quarters, led by

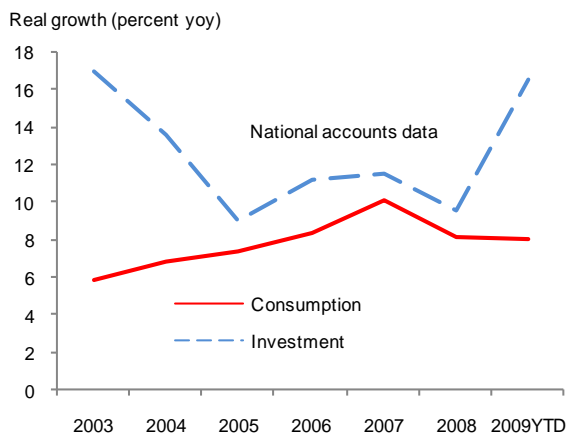
¹ Based on the CPB data on world trade, we estimate that imports into the world excluding China fell 19.3 percent in the first 8 months of 2009, compared to 17 percent for total world imports.

² The quarter on quarter growth numbers are our estimates. The NBS does not publish such data.

government-influenced investment (Figure 3). The acceleration in GDP growth during 2009 was reflected in stronger industrial and electricity production.

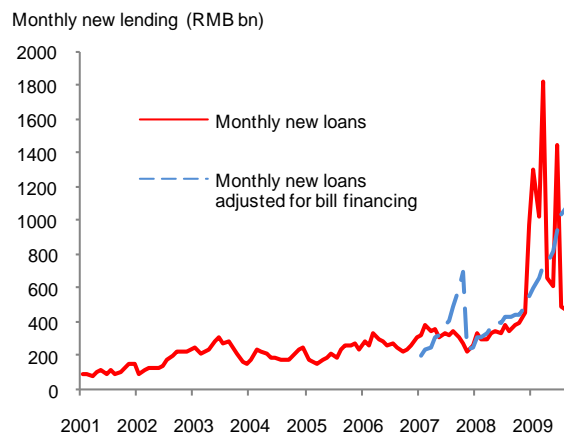
The domestic demand expansion has been fueled by very large fiscal and monetary stimulus. The government's own budget shows some of the surge in government-influenced spending. Fiscal expenditure rose 24 percent in the first 9 months of 2009 (in nominal terms). But, with the government contribution to the stimulus package investment being only around one-third, government-influenced investment is much larger than the budget suggests. Bank lending towards the stimulus projects leveraged by the government's contribution is a key part of the massive expansion of bank credit since November 2008. In the first half of 2009, new medium and long term lending to infrastructure rose 42 percent (yoy), contributing more than one-half of the total increase in credit. Headline new lending declined in the third quarter. However, this was because some of the bill financing that had taken place earlier expired. Excluding bill financing, underlying new lending actually rose to 6.5 percent of *annual* GDP in the third quarter, with mortgage lending growing particularly rapidly (Figure 4).

Figure 3. Domestic demand has been the key driver this year.



Source: CEIC, World Bank staff estimates.

Figure 4. Underlying lending to the real economy has remained strong



Source: CEIC, World Bank staff estimates.

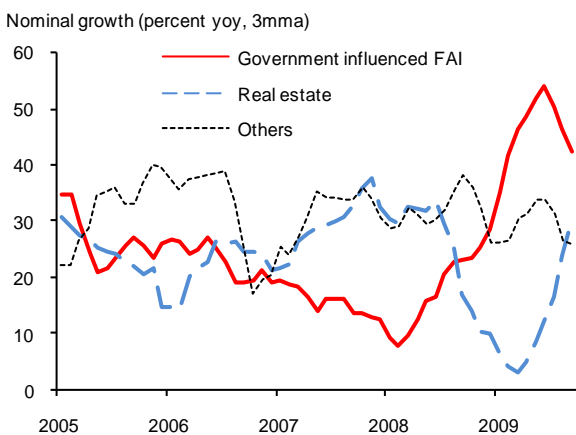
While much of the stimulus showed up in infrastructure-oriented government-influenced investment, the domestic demand surge has been more broad based.³ Government-influenced investment contributed almost half of total investment growth of 16.4 percent in the first 3 quarters (on national accounts definition) (Figure 5). But the domestic demand growth came from other sources as well.

Resurgent housing sales have started to feed through to construction activity. Following a recovery of property sales and completions earlier this year, growth of floor space started became positive in June and it reached 27 percent (yoy) in the third quarter, after languishing for a year (Figure 6). The rebound in construction activity is driven by (i)

³ Investment and GDP growth in the central and western region outpaced that in coastal areas.

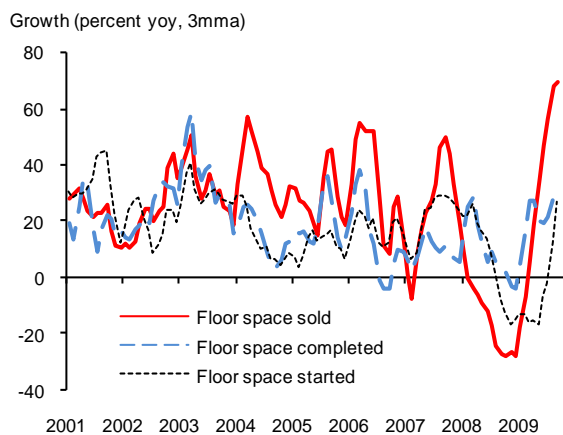
strong low-end and mass market housing construction, as part of the stimulus package; and (ii) a rebound in construction of higher-end and commercial properties, driven in part by stronger-than expected sales and the liquidity boom (bank lending to developers has rebounded, and mortgage lending has been increasing rapidly).

Figure 5. Surging government-influenced investment has been key



Source: CEIC, World Bank staff estimates.

Figure 6. Resurgent housing sales have fed through to construction activity



Source: CEIC.

Other market based investment in several sectors, notably manufacturing, has lagged, as excess capacity is limiting the incentive to invest (Figure 5). This is so even as profitability in industry is recovering, up 6.5 percent (yoy) in the third quarter. Concerns about excess capacity led the government to reinforce measures to prevent “overcapacity” in sectors including steel, cement, and aluminum and “redundant” investment in sectors including the manufacturing of wind power equipment (see below, footnote 6).

Consumption has held up, but lagged investment (Figure 3). Sales of discretionary items such as cars and electronic appliances have been particularly strong. Consumption has benefited from falling prices, which have boosted purchasing power, and government measures such as lower consumption taxes for small cars and subsidies for rural consumption of electronic appliances. Incomes and consumption have further been supported by strong increases in government transfers. However, weaker labor market conditions (see below) have dampened income growth. Nominal growth of “per capita wage income” in rural areas fell from 16 percent in 2008 to 10 percent in the first 3 quarters of 2009, with growth particularly low early in the year.⁴ In urban areas total per capita disposable income growth declined from 14.4 percent in 2008 to 9.3 percent in the first 3 quarters of 2009, with growth weakening through the third quarter.

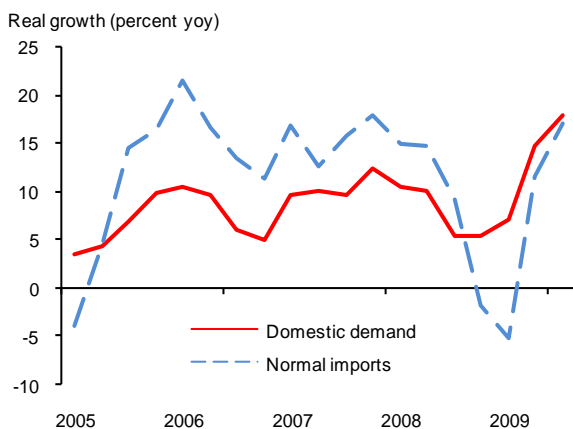
The surge in domestic demand fuelled imports. After falling sharply in the first quarter, imports recovered and import volumes (in constant prices) rose by 6.2 percent in the third

⁴ “Per capita wage income” in the household surveys includes the impact of both wages and employment.

quarter, even though large price declines have kept the value of imports in US\$ down substantially on a year ago (Box 1). In particular, “normal” import volumes (for the domestic market) have been fueled by the domestic demand surge (Figure 7).

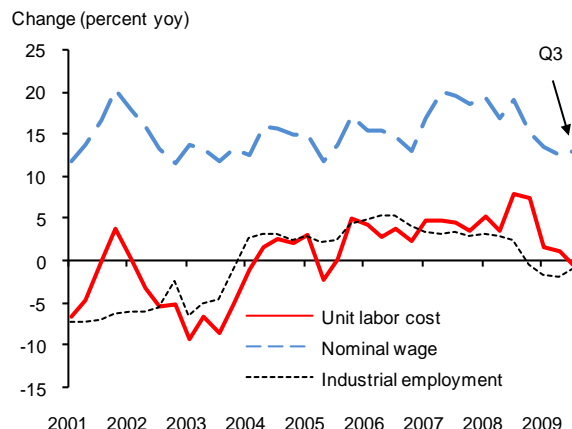
The slowdown has had a major impact on the labor market, but the worst may be over. Many jobs have been shed in export-oriented manufacturing sectors, and official industrial employment declined on a year ago (Figure 8). At the same time, new jobs have been created, largely in services, construction, and the public sector, and overall conditions on the labor market are not as bad as feared earlier this year, although significant numbers of people have had to accept lower wage jobs in the process. Nation-wide, employment and wage growth slowed substantially in the first half of 2009, but remained positive (according to the official labor market data and information on migrant wage income from the household survey). The labor market impact varies across regions. In export-oriented Guangdong, even total official employment was lower than a year ago in the first half of the year. These employment trends have put downward pressure on wage growth, particularly in the more flexible segments of the labor market. Migrant wage income growth slowed to 7.6 percent “per capita” in the first half of 2009, from rates more than twice as high in 2008 (see footnote 4). However, the trough may have been past. Both official wage growth and rural “per capita” wage income growth picked up again somewhat in the third quarter (Figure 8). Survey data on the balance between demand and supply on the labor market also suggests that the labor market has tightened again in the third quarter.

Figure 7. Surging domestic demand has lifted “normal” import volumes



Source: CEIC, World Bank staff estimates.

Figure 8. The labor market has softened



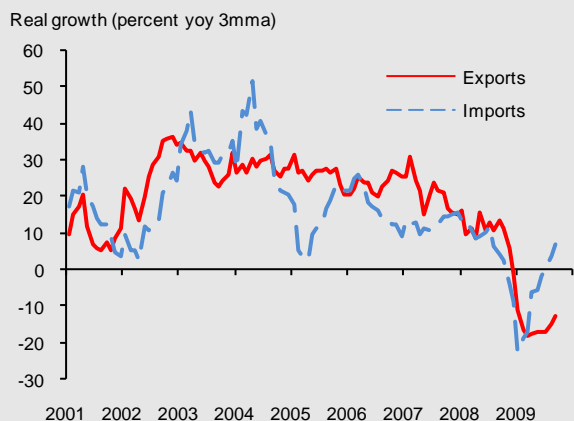
Source: CEIC, World Bank staff estimates.

Underlying inflationary pressures remain largely absent. Consumer prices were down 0.8 percent on a year ago in September, and producer prices (factory gate) 7 percent. Prices of food items including pork and grain have risen recently. However, given the subdued economic conditions globally and in China, with spare capacity in many manufacturing sectors, such developments are unlikely to cause sustained general inflation.

Box 1. Import developments in more detail.

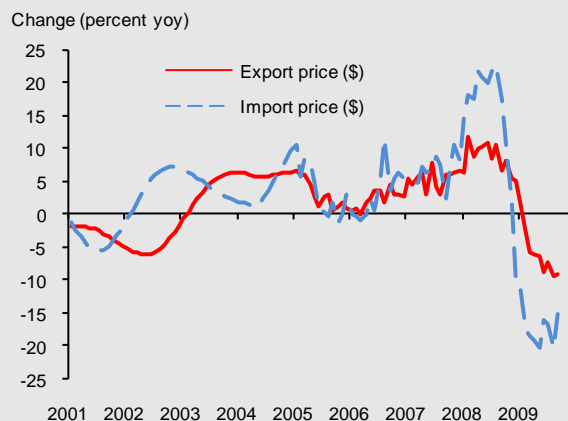
After collapsing together with exports, China’s imports recovered briskly (Box Figure 1). However, this recovery did not show up in the value of imports because of large falls in import prices, especially those of raw materials (Box Figure 2).

Box Figure 1. Imports have recovered strongly



Source: CEIC, World Bank staff estimates.

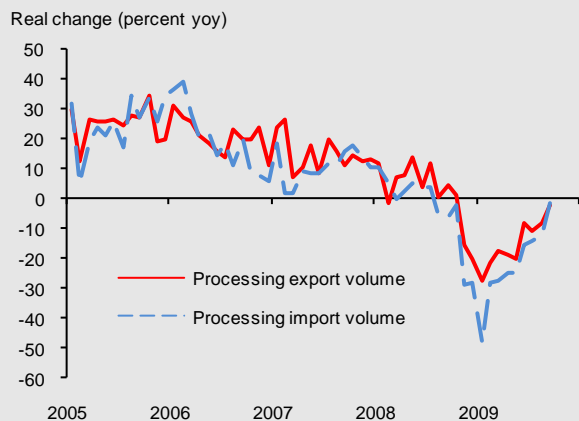
Box Figure 2. Import prices are down sharply



Source: CEIC, World Bank staff estimates.

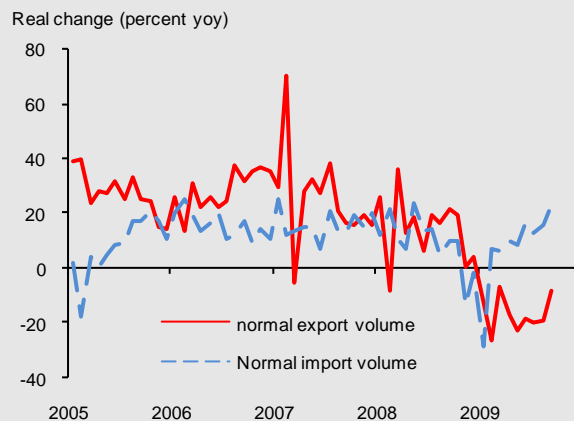
Imports used in the domestic economy grew particularly strongly. Volumes of processing imports remained very weak during the first half of 2009, after collapsing together with processing export volumes (Box Figure 3). Processing trade recovered briskly in June-September, partly in line with more favorable developments in global electronics trade. Meanwhile, “normal” (non-processing) import volumes (for the domestic market) had already rebounded strongly early in the year on the back of the surge in domestic demand and grew 17 percent (yoy) in the third quarter (Box Figure 4). Restocking of raw materials—which made up almost one-half of normal imports in 2008—has been key in the import surge so far this year. Given the scale of the restocking surge, raw material imports are unlikely to continue to expand at the pace registered so far this year. However, underlying demand for raw materials is likely to hold up and imports of machinery and equipment have also been strong.

Box Figure 3. Processing trade is recovering from a massive fall



Source: CEIC, World Bank staff estimates.

Box Figure 4. Surging domestic demand has lifted “normal” import volumes



Source: CEIC, World Bank staff estimates.

The RMB has been kept virtually pegged to the US dollar since mid 2008. Due to the depreciation of the US dollar, China's nominal effective exchange rate (NEER) has depreciated 7.6 percent since its peak early this year. This has reversed more than one-third of the appreciation since mid 2005 and the NEER is now back at the 2002 level (Figure 9).

The current account surplus has declined materially, but reserve accumulation has continued. The trade surplus has fallen because of the trade volume developments discussed above. However, large improvement in the terms of trade due to the sharp fall in raw commodity prices limited the decline to US\$ 45 billion in the first 9 months (and only US\$ 14 billion in the first half) on a year ago. The current account surplus, however, fell by US\$ 60 billion (yoy) in the first half to 6.4 percent of GDP. Additional factors behind this decline were (i) a lower services balance, as services exports fell alongside goods exports while the US\$ value of services imports lagged that of goods imports because prices of services imports did not fall nearly as much as those of goods imports; (ii) a strongly lower income balance; and (iii) lower net transfers. On the capital and financial account, after falling in the first 7 months (yoy), FDI showed positive yoy growth in August and September as financial conditions eased globally and China's economic prospects remained relatively favorable. On our estimates, other capital flows (after adjustment for valuation effects) turned from a large net outflow in the second half of 2008 to a small (US\$ 23 billion) net inflow in the first half of 2009. Foreign reserves accumulation speeded up in the third quarter, with the total reaching \$2.3 trillion in end-September, although a substantial part of that rise is due to valuation gains because of the depreciation of the US dollar against other major currencies.

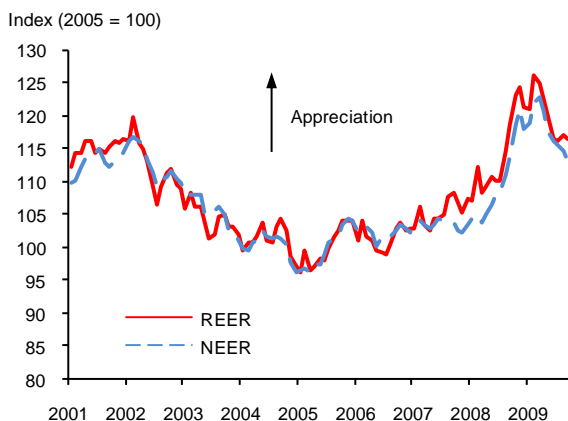
The stock market has declined since July, after having risen sharply earlier in 2009. A strong rebound in the stock market since late 2008 led the authorities in June to lift a ban on initial public share offerings imposed in October 2008. Since July, the market has declined again (Figure 10). There has been a lot of discussion and concern about large portions of the new bank lending flowing to the stock and housing markets instead of the real economy. Undoubtedly this has happened to some extent. However, it is not likely that a large share of the lending has flowed to these markets. With regard to the stock market, industry estimates are that net new inflows to the A share market in the first half of 2009 were around RMB 450 billion. This is equivalent to 6 percent of new lending in that period. However, 4/5th of these inflows came from individual investors and much of it is likely to have come out of existing deposits rather than from new lending.

ECONOMIC PROSPECTS

Short term global prospects have improved. But the global recovery is likely to be slow and subject to risk. China itself is on course to meet its growth target in 2009. In 2010, the composition of growth is likely to change, after the remarkable developments in 2009. Exports will probably stop being a drag on growth from end-2009 onwards and real estate investment looks set to be stronger. However, the government stimulus to growth is set to decline sharply next year, and market based investment and consumption may continue to

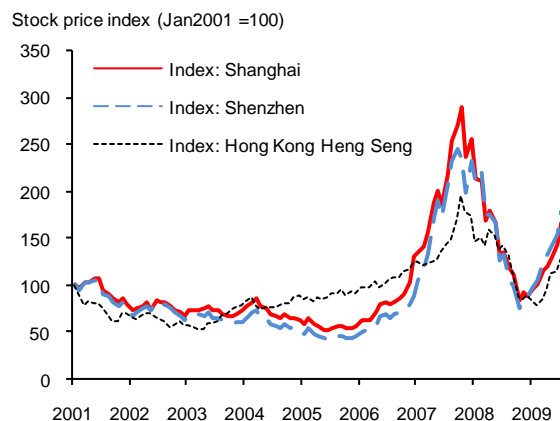
feel pressure. In all, we expect GDP growth to rise somewhat in 2010, with risks evenly balanced.

Figure 9. The exchange rate has depreciated substantially in 2009



Source: CEIC, World Bank staff estimates.

Figure 10. The stock market declined in recent months



Source: CEIC, World Bank staff estimates.

Global economic activity seems to be recovering. After the steepest decline in 7 decades, global financial and economic developments have largely been positive recently. Government intervention across the world has led to large improvements in financial market conditions and stabilization in the real economy. Global activity is expanding again, buoyed by restocking, government stimulus and strong growth in Asian economies.

However, there are several challenges to overcome, and the global recovery is likely to be slow and subject to risks. Banks, households and businesses in several high income countries still have a long way to go to repair their balance sheets and that will contain demand. The policy stimulus that is currently driving the recovery in high income countries will have to be reversed at some point, and restocking is also a temporary boost. Thus, in the coming quarters, the strength and pace of recovery in high income countries remains a major risk, although risks are not only on the downside. In 2010, the sustainability of the global recovery depends on several factors which all imply risks: the return of bank credit and further normalization of financial markets; effectively communicated and appropriately phased withdrawal of fiscal and monetary stimulus; and overcoming the negative impact from sustained low capacity utilization and high unemployment. Moreover, for the global recovery to be sustainable, the global imbalances will have to be reduced. This means that surplus countries such as China will have to reduce structurally their current account surplus by having domestic demand grow faster than production capacity, while deficit countries such as the US will have to reduce their current account deficit. The latest Consensus Forecast sees the world excluding China growing 2.3 percent next year, after a decline of 2.8 percent this year—with growth holding up somewhat better if weighted by China’s export composition (Table 1).

Table 1. The global environment
(percent change, unless otherwise indicated)

	2007	2008	2009		2010	
			Jun-09	Oct-09	Jun-09	Oct-09
World growth excluding China 1/						
unweighted			-3.0	-2.8	1.6	2.3
weighted by China's export composition			-2.4	-1.9	2.2	2.9
Imports, world excluding China (volume) 2/	6.8	2.9		-12.8		2.0
Output gap high income countries 3/	1.7	0.3		-5.3		-5.8
World prices (US\$)						
Oil (\$/bbl) 2/	71.0	97.0	52.0	61.5	62.5	76.5
Non oil commodities 2/	14.0	7.5		-20.3		2.4
Manufactured products 2/	9.0	8.6	-8.9	-9.2	1.7	3.1

Source: World Bank (DEC), IMF, Consensus Economics, OECD, and staff estimates.

1/ Consensus Economics (October 2009).

2/ International Monetary Fund (WEO, October 2009).

3/ OECD (Economic Outlook 85, September 2009).

Against this light, global price pressures are expected to remain modest next year.

After the recent commodity price increases, the international financial institutions expect the oil price to rise somewhat more, implying significant (yoy) increases. Non-oil commodity prices are expected to be somewhat higher next year. Prices of manufactured goods are expected to rise by 3 percent, after falling 9 percent this year (in US dollar terms). With world growth now squarely led by emerging markets such as China, where growth tends to be more intensive in raw commodities than in high income countries, over time raw material prices are likely to outpace those of manufacturing products, resuming a trend decline in China's terms of trade that was temporarily reversed in 2009.

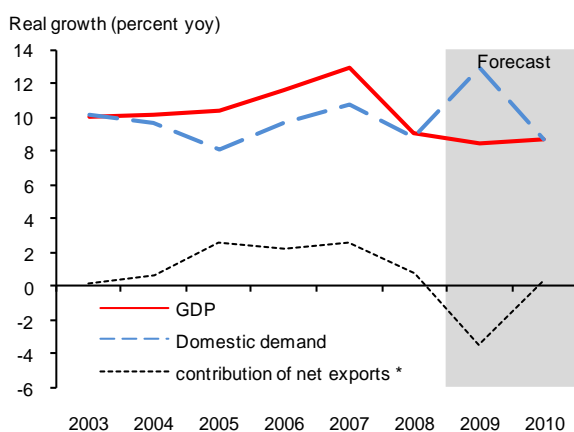
In this setting, China's exports should resume growth in 2010, but global demand is likely to remain subdued.

Based on IMF WEO projections, but adjusted for China's own imports, imports of the world excluding China are expected to increase 2 percent, after falling 12.8 percent in 2009, in constant prices. Compared to the expected rebound in GDP next year, much less of this year's decline in imports is projected to be recouped. This is presumably because of relatively weak investment in machinery and equipment globally (which is import-intensive) and relatively strong investment in infrastructure (which is not import-intensive). China's exports benefit from the strong and increasing fundamental competitiveness of its manufacturing industry. In fact, while most of the current investment boom—focused on infrastructure—does not directly benefit manufacturing, it does strengthen its broader setting. The recent depreciation of the (nominal effective) exchange rate provides further support. China is likely to continue increasing global market share in 2010 and beyond, but in a more difficult global environment than before and the medium term outlook for global demand and exports is subdued compared to the recent decade (see Box 1 in our June 2009 China Quarterly Update).

China is on track to meet the government’s target of 8 percent GDP growth this year (Table 2). This is led by a projected contribution of domestic demand of almost 12 percent point and despite an expected drag on growth from net trade of 3.4 percentage points. Growth is higher than expected earlier because of larger-than-expected macroeconomic stimulus. Our forecast of 8.4 percent GDP growth for 2009 assumes an increase of 6.8 percent in the fourth quarter (SAAR), which is within reach given current trends.

We project growth to increase somewhat in 2010, with a marked shift in the (expenditure) composition. The expected turn-around in exports allows for a halt of the negative contribution of net trade (Figure 11, Table 2). In addition, with housing starts rebounding swiftly, real estate investment is set to add significantly more to growth than in 2009. However, government- influenced investment, the key driver of growth this year, is bound to decelerate. Spending under the stimulus package may rise somewhat in 2010. However, this implies a large deceleration after the spectacular growth this year. Moreover, market based investment is likely to continue to feel negative pressure from spare capacity in several manufacturing sectors.⁵ In all, we project overall investment growth in 2010 to be around half of the projected rate for this year, in real terms (and on national accounts definition) (Figure 12).

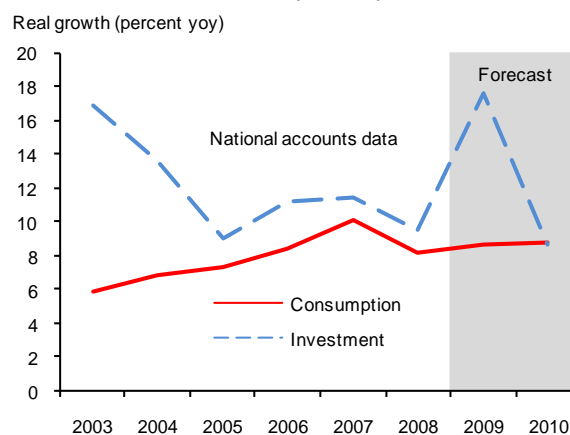
Figure 11. The composition of growth is likely to shift markedly in 2010



Source: NBS, World Bank staff estimates.

*/ in percent point

Figure 12. Investment growth is bound to slow substantially next year



Source: NBS, World Bank staff estimates.

Consumption may feel some headwind. In China, consumption growth is closely correlated to income growth. Continued significant increases in government transfers are likely to support income growth somewhat in 2010, including the 10 percent rise in pensions already committed to. However, the more subdued labor market may continue to put pressure on nominal income and consumption growth, even though migrant wage

⁵ The stimulus package may have postponed the incorporation of the new, more subdued environment in investment plans of the corporate sector. Thus, some of the impact may still come.

income growth appears to have troughed already. Moreover, in much of 2009, households benefited from negative inflation, which boosted their purchasing power. This will change next year as inflation is likely to turn positive again. In all, key domestic risks in the short term—both downward and upward—are market based investment and the pace of income and thus consumption growth.

Table 2. China: Main Economic Indicators
(percent change, unless otherwise indicated)

	2006	2007	2008	2009 f	2010 f
<i>The real economy</i>					
Real GDP	11.6	12.9	9.0	8.4	8.7
Domestic demand 1/	9.7	10.7	8.8	12.9	8.7
Consumption 1/	8.4	10.1	8.2	8.7	8.8
Gross capital formation 1/	11.1	11.4	9.5	17.6	8.6
Contribution to GDP growth (pp)					
Domestic demand 1/	9.4	10.4	8.2	11.9	8.2
Net exports 1/	2.2	2.6	0.8	-3.4	0.4
<i>Memorandum items:</i>					
Contribution net exports (WB, pp) 2/	3.8	3.4	1.8	-4.4	0.3
Exports (goods and services) 2/	23.8	19.9	8.6	-12.4	9.9
Imports (goods and services) 2/	15.9	14.0	5.1	-0.7	10.4
CPI increases (period average) (%)	1.5	4.8	5.9	-0.8	2.0
GDP deflator	3.6	7.5	7.2	-2.6	1.5
External terms of trade	-0.8	-0.9	-4.2	5.4	-4.9
<i>Fiscal accounts (percent of GDP)</i>					
Fiscal balance	-0.8	0.7	-0.4	-3.3	-4.1
Total revenue	18.3	20.6	20.4	20.0	20.0
Total expenditure	19.1	19.9	20.8	23.4	24.1
<i>External account (US\$ billions)</i>					
Current account balance (US\$ bln)	250	372	426	261	213
As share of GDP (%)	9.4	11.0	9.8	5.6	4.1
Foreign exchange reserves (US\$ bln)	1066	1528	1950	2392	...
<i>Other</i>					
Broad money growth (M2), e-o-p (%)	16.9	16.7	17.8	27.0	17.0

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

1/ Estimations using national account data (Table 2-20 in China 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.

Inflation is likely to remain subdued. If the government allows the oil product price mechanism to function, as the recent adjustments suggest, (yoy) oil product price increases will be significant in end 2009. However, these pressures are likely to moderate in 2010. Moreover, we think underlying inflation pressures will remain low because of the large spare capacity in China and other countries.

China's external surplus is set to shrink sharply this year, and only rise somewhat in 2010. We expect import volumes to continue outpacing exports by a large margin in the rest of 2009. Moreover, the terms of trade gain—from import prices falling much more than export prices (yoy)—is expected to come down, compared to the first half of the year. As a result, we expect the decline in the trade surplus to accelerate in the second half of 2009 and it could fall from 8.3 percent of GDP in 2008 to less than 5 percent of GDP in 2009 as a whole. The decline in the trade surplus is compounded by changes in other current account flows (see above). We expect that, as in the first half, in 2009 as a whole the current account surplus will fall more than the trade surplus. In 2010, with domestic demand expected to remain robust and processing trade recovering, overall imports should grow solidly. In our scenario exports and imports broadly grow at the same rate in 2010. However, the expected deterioration in the terms of trade would lead to some further decline in the external surplus. Over the medium term, with the gap between domestic growth in China and the rest of the world expected to diminish, we expect the external surplus to rise again, even with moderately successful rebalancing in China.

Medium term growth prospects are less favorable than recent experience, but rebalancing could buoy sustained growth. China's medium-term prospects continue to be supported by pro-growth economic policies and institutions. However, insufficient progress in rebalancing the pattern of growth and getting more growth out of the domestic economy would contain growth. Our medium term projections suggest “potential” or “trend” GDP growth of about 8 percent in the coming 5 years on current trends and policies, some 2 percentage points lower than in the previous 5 years due to the weaker export prospects (see Box 1 of our June 2009 Quarterly Update). Conversely, more progress with rebalancing would help raise potential GDP growth through more reallocation of labor, more human capital accumulation, and more service sector growth. However, this would only happen with bolder structural reform, including in difficult areas such as opening up several service sectors to private sector participation and reforming the intergovernmental fiscal system to make more permanent migration possible.

ECONOMIC POLICIES

The government has expressed its intentions to keep the overall macroeconomic policy stance broadly unchanged for now. Senior leaders have acknowledged the “consolidation” of China's recovery and the need to “balance the relationship between boosting growth, rebalancing the economy and managing inflation expectations.” However, emphasizing that downside risks to growth remain and that inflation is not yet a major source of concern, the government has for now decided to keep fiscal policy “proactive” and monetary policy “moderately loose,” relying largely on administrative measures to contain the risks of asset price increases and worsening asset quality.⁶

⁶ In line with this approach, the government in end-August announced reinforcement of existing administrative measures to curb overcapacity in the steel and cement sectors and “redundant projects” in sectors including wind power equipment. The measures include strict controls on market access, reinforced environmental supervision, tougher controls over land use, and ordering banks to conduct lending to these

In our view, macroeconomic conditions in the real economy do not yet call for a major overall tightening. Even though short term prospects for China appear relatively favorable, risks and uncertainties in the world economy are indeed high. Moreover, our projections do not see growth significantly exceeding potential growth in 2010 and it will take time to undo the spare capacity in several key manufacturing sectors. Thus, underlying inflation is not a concern for now. A somewhat supportive policy stance is appropriate, and it is particularly important to have flexibility to add or subtract support if needed.

However, the costs and risks of sustaining the current expansionary policy stance increase over time. With our projections indicating continued respectable growth in 2010 even without significant fiscal stimulus (large further increases in the fiscal deficit), we think the focus is best placed on measures with lasting effect on rebalancing and getting more growth out of the domestic economy.

- **In the monetary sphere, risks of asset price bubbles and misallocation of resources amidst abundant liquidity need to be addressed.** Thus, one of the key policy challenges is how best to do this when inflation is not yet much of a concern. With risks largely financial instead of inflation-related, monetary policy tightening is more obvious than fiscal tightening. While administrative measures can help mitigate pressures, in the end, general monetary tightening will be the most effective and least distortive approach.
- **Significant additional fiscal stimulus does not seem warranted, although flexibility is.** While China's government debt is still modest compared to many other countries, it is higher, and increasing more rapidly, than the headline official numbers suggest. Given our economic projections, a neutral or mildly supportive fiscal stance in 2010—meaning a constant or only slightly higher deficit—would fit best. The need for flexibility calls for contingency plans and letting automatic stabilizers work, this year and next.
- **In the medium term, the recovery can only be sustained by successful rebalancing of the economy.** Rebalancing and getting more growth out of the domestic economy call for more emphasis on consumption and services and less on investment and industry. While the government-led investment boom is not necessarily directly adding heavily to manufacturing capacity, the reliance on infrastructure investment is not sustainable and its contribution to rebalancing is limited.

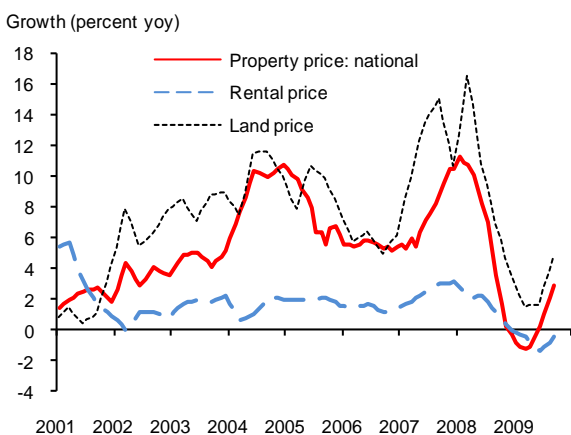
sectors in strict accordance with present industrial policies. The government also wants to provide better information to market participants about capacity, demand, and government policies.

Monetary and exchange rate policy

Serious asset price bubbles are unlikely to be imminent. In the housing market, some cities have seen major price increases in recent months and years. However, nation-wide, price rises have not exceeded income growth significantly (Figure 13). Affordability is now also supported by lower interest rates. However, there is a lack of clarity about affordability. The real estate market and policymaking towards it would benefit strongly from better (more representative) data on property prices and how they compare to incomes. Stock markets are up significantly this year, but this is after a sharp fall earlier on and share prices are still down strongly from their peak in 2007 (Figure 10).

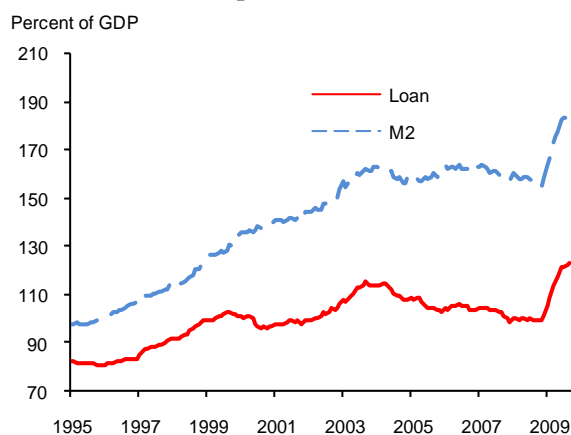
However, risks of misallocation of credit and bad loans are real and it pays to be proactive. These risks may be rising now because of the sheer overall volume of new lending—projected to be a massive 30 percent of GDP this year—and the particularly rapid growth of lending by smaller banks (city banks and rural credit cooperatives), with possibly weaker risk management systems (Figure 14). The recent global financial crisis has shown the dangers of neglecting asset price increase and misallocation of credit in monetary and financial policy making. With monetary policy in key high income countries traditionally geared only towards inflation, monetary policy remained loose for too long, even as asset prices rose to levels deemed worrisome by many.

Figure 13. Property price increases are modest



Source: CEIC, World Bank staff estimates.

Figure 14. The current lending burst is unprecedented

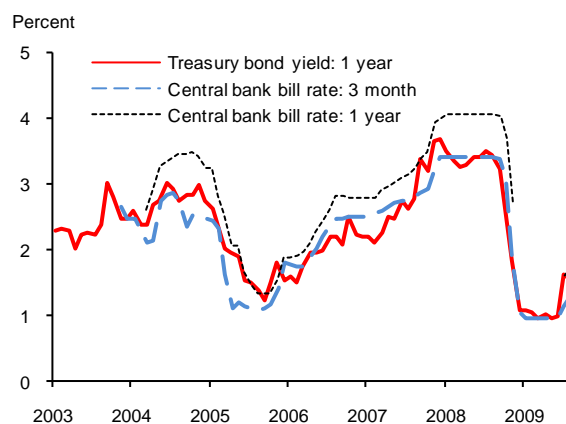


Source: CEIC, World Bank staff estimates.

China’s exposure to asset price risks differs from that of most other countries. The impact of sharp negative corrections in asset prices on households would be relatively limited as their exposure to the stock market and leverage is still relatively low. However, many firms and banks are exposed considerably to asset prices because of the large share of property in their portfolio. Moreover, local governments would be affected strongly, as land transactions are a key source of their revenues and these would be impacted significantly. Also, given the property sector’s importance for the economy, a housing sector slowdown would affect the overall economy.

The authorities have taken several steps recently in an effort to mitigate these risks. Monetary conditions have tightened somewhat since July (Figure 15). In addition, the loan-loss coverage ratio was increased; banks with particularly large loan expansions have had to buy low yielding central bank bills; the CBRC has urged banks to ensure that loans for “real” investment are not diverted to the property or stock market; and the minimum down payment for a second house was raised to 40 percent. On the supply side, on the equity market, IPOs are allowed again, after having been frozen for a year.

Figure 15. Monetary conditions have tightened somewhat



Source: CEIC, World Bank staff estimates.

Eventually, general monetary tightening will be required to dampen these risks. Under China’s current (not-flexible) exchange rate regime, policymakers consider their ability to increase interest rates to be constrained by their fear of capital inflows. Thus, monetary tightening has tended to rely on administrative measures, including credit quotas. These have in the past been effective in affecting the overall volume of credit. However, such instruments are distortive and sit oddly with efforts to make banks more commercially oriented. Over time, more exchange rate flexibility would make monetary policy more independent, giving it the leeway to raise interest when warranted domestically even though interest rates in high income countries remain low.

Several types of financial market policies could enhance financial stability and reduce risks on asset prices and quality. First, increasing the availability of financial titles would allow diversification of investors’ portfolios, and could reduce stock market volatility. Building on the re-introduction of IPOs, further financial sector deepening would be useful, including in the bond market. Second, easing the interest ceiling on bank deposits, encouraging financial institutions to develop more long-term contractual savings instruments, and increasing interest rates on longer term deposits could tie up more liquidity in the banking system, and prevent it from flowing to the stock and property markets. A credible regulatory and supervisory regime needs to be set up for those instruments so that the public has the confidence to invest in them. Third, the introduction of a capital gains tax on equity could be considered.⁷ Finally, further opening up the capital account in a controlled fashion could help increase capital outflows.

The government has continued with steps to increase the role of the RMB in international finance and trade (see our June Quarterly Update for earlier steps). A pilot scheme will let “qualified” Chinese companies in selected Chinese cities settle cross-

⁷ In general, any change in the taxation system can best be motivated in line with the goals of that system rather than as a measure to address a short-term phenomenon such as a stock market surge.

border trades in RMB with counterparts in Hong Kong, Macao, and the 10 ASEAN countries. The scheme allows lenders in these economies to buy or borrow in RMB from mainland lenders to settle trades and mainland lenders to provide trade finance to overseas firms. To support the development of the RMB-denominated financial and bond markets in Hong Kong, China's MOF and the China Development Bank have issued RMB-denominated bonds in Hong Kong.

Fiscal policy

Remarkably strong revenues in the third quarter limit the increase in the deficit. After steep (y-y) declines in the first 4 months of 2009, government revenues rose 26 percent in the third quarter and 5.3 percent in the first 3 quarters (yoy). Fiscal expenditure rose 24 percent in the first 3 quarters. Since the summer, revenues have grown much faster than the underlying tax base, apparently in part because of strong efforts to meet the 8 percent fiscal revenue growth target. It is appropriate to strengthen tax collection. However, an all-out effort to meet a revenue target that was set with a significantly higher projection for nominal GDP growth in mind may not be consistent with a pro-active fiscal stance.⁸ A pro-active fiscal policy should probably imply letting the automatic stabilizers work.

In 2010, continued large fiscal stimulus does not seem warranted, although being able to flexibly respond to further shocks is important. It would be good to retain room for fiscal policy stimulus in later years, given the global uncertainty. China's government debt is still low compared to many other countries. But it is higher, and rising more rapidly, than the headline official numbers suggest, in particular if debts accumulated by SOE type entities under the local governments that develop infrastructure are included. These local debts are estimated to be sizeable already.⁹ The current large-scale new lending is adding to them. While some of the stimulus spending will show up immediately on the government's balance sheet, some is likely to show up later, such as in the case of government commitments to co-finance the repayment of bank lending or subsidies to cover operating costs of projects that are otherwise not financially sustainable. Moreover, as the stimulus continues, it becomes more difficult to identify infrastructure projects with high social returns. There is still significant room for further measures to stimulate consumption. However, with growth expected to be respectable, structural measures with permanent effect are much preferable to measures without lasting effect. Overall, our economic projections call for a neutral or only mildly supportive fiscal stance in 2010 (with unchanged or slightly higher deficit, compared to 2009). The ability to flexibly respond to changing economic prospects calls for a contingency plan and for allowing the automatic stabilizers to work, that is to accept deviations in tax revenues and the budget

⁸Local governments have had difficulties funding their share of stimulus projects. This pressure apparently increased demand for loans by local governments related entities, according to the People's Daily (October 9, 2009). The MOF recently also allowed them to fund their share with proceeds of land transactions.

⁹The Research Institute of Fiscal Science under the Ministry of Finance, recently estimated these to exceed RMB 4 trillion (21st Century Economics Report, March 14, 2009).

balance from those budgeted if economic conditions are different than expected at the time of the budget.

Structural measures and rebalancing

In considering further policy initiatives, the key to sustained recovery and growth will be successful rebalancing of the economy, from one led by investment and industry to one led more by consumption and services.

The government has recently reconfirmed its commitment to rebalancing. In a presentation to the 10th session of the Standing Committee of the 11th National People's Congress in August, Zhang Ping, the Chairman of the National Development and Reform Commission (NDRC), stressed the need for economic restructuring and said "China would (i) accelerate reform of the income distribution, pricing of resource products, and fiscal and tax systems; (ii) in evaluating officials, put more weight on increasing people's living standards and ensuring the quality of growth; (iii) continue to conserve energy and curb emissions and pollutants; and (iv) reduce the income gap between urban and rural residents and between western and eastern regions in a bid to expand domestic demand."

Some further steps have been taken in recently months to rebalance and boost domestic demand. These follow on earlier initiatives, including progress with land reform (see our December 2008 Quarterly Update), the announcement of a health care reform plan (see our March 2009 Quarterly Update), and other initiatives increasing the presence of the government in health, education, social safety and rural areas (see Chapters 5 and 6 of our Mid Term Evaluation of China's 11th Five Year Plan).¹⁰ More recent steps included (i) increasing further the presence of the government in health, education, and social safety; (ii) improving access to finance in rural areas and for SMEs and SME development more generally; and (iii) mitigating resource use and environmental damage. Regionally, poorer regions away from the coast receive emphasis in government-led investment (Box 2). The remainder of this report discusses the recent reforms, as well as key challenges in their implementation, in greater detail. In all, the measures taken and announced so far are substantial. However, as concluded in our Mid Term Evaluation, significantly more rebalancing measures are needed to shift the course of China's overall pattern of growth, given the strong momentum of the existing pattern.

I. Increasing the presence of the government in health, education, and social safety

A rural pension program was introduced more widely this year. The three pillar system resembles the urban pension system and had been launched in some areas since 2003. Under the first pillar, the central and local government provide a basic pension at the level of the minimum living allowance (RMB 55 per month). Under the second pillar, individual contributions (4-8 percent of average local rural income) accumulate in

¹⁰ <http://www-wds.worldbank.org>, report nr. 46355

individual accounts. Under the third pillar, voluntary individual accounts are held at the National Social Security Fund. The government has targeted coverage of 10 percent of China's counties by end-2009 and 100 percent by 2020. Challenges include ensuring the transferability of accounts across regions in China's segmented system, integrating the rural scheme in the existing pension scheme, and overcoming the difficulty faced by many local governments in poor areas in making their contribution.

An additional rural pension program for currently older farmers was piloted in August. After paying a one-off fee (of around 1.5 times annual income), farmers over 62 are meant to receive a life time pension. The scheme is subsidized by the central and local governments. The coverage targets are similar as for the first scheme. Challenges include ensuring the financial sustainability, given the fairly large subsidy element, particularly in poorer regions. During the pilot, many people also said they cannot afford the one-off fee.

Progress is being made in implementing the health care reform plan that aims to make health care more accessible and affordable (see our June 2009 Quarterly). Enrollment in medical insurance programs increased to 337 and 830 million urban and rural people by end-June, up 19 and 160 million from end-2008, respectively. The aim is to cover more than 90 percent of the population by 2011. The Ministry of Health recently issued a list of 307 essential drugs as part of an effort to improve people's access to essential drugs and cut their medical costs. Free provision of basic health care is expanding, including of free hepatitis B vaccinations for certain cohorts. Progress has also been made with (i) building and upgrading township hospitals, community health centers and stations and (ii) setting up health files for the rural population to improve their quality of health care. The MOH also intends to speed up reimbursement under the rural cooperative medical insurance system. Health care assistance will be expanded over the next 3 years by helping more needy families in both rural and urban areas.

These measures in health are important steps, but more is needed. They increase health care provision in rural areas and improve medical insurance coverage. They could have a significant impact on out-of-pocket healthcare spending and could help reduce precautionary saving. However, most out-patient services and medicines are not covered by the insurance. Another remaining challenge is to ensure portability of benefits. Proper and flexible implementation of the strategy will be critical to changing the deep-rooted distortions and achieving the goals. As part of this, monitoring and evaluation will be critical to track what is and is not working.

In all, spending in health, education, and social security has been rising significantly in recent years (Table 3). Commitments made by the government, notably on expanding systems and initiatives in health care, medical insurance, and pension insurance imply further spending increases in the future.

II. Improving access to finance in rural areas and for SMEs and providing other support to SMEs

The China Banking Regulation Commission (CBRC) is seeking to encourage the establishment of additional financial institutions in rural areas. To boost rural

development it is also studying the possibility and desirability of preferential tax policies to encourage rural financial services.

Table 3. Government spending on Education, health care and social security (% of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009
Total	7.8	7.6	7.5	7.7	8.0	8.7	9.5	10.3
Education	2.2	2.2	2.1	2.2	2.3	2.8	3.0	3.2 1/
Medical and Health Care	0.5	0.6	0.5	0.6	0.6	0.8	0.9	1.2 1/
Social Security and Employment	2.2	2.0	1.9	2.0	2.1	2.1	2.3	2.5 1/
Spending from Social Security Funds	2.9	3.0	2.9	2.9	3.1	3.1	3.3	3.4

Source: Ministry of Finance

1/ Assuming growth in 2009 will be as in the first 8 months.

Steps have also been taken to improve access to finance for SMEs. The CBRC has been pushing for special SME divisions at banks in order to overcome traditional difficulties SMEs have in obtaining finance because of a lack of collateral and credible accounting records, higher lending risk and default rates, and smaller loan sizes. By end-June, the five large State-owned commercial banks and 12 shareholding commercial banks had such divisions. The specialized divisions are meant to speed up SME lending, and to ensure better risk control and higher efficiency. The authorities are also trying to encourage smaller commercial banks to expand into regions with lower bank density, such as western and northeastern China. The CBRC also raised the permitted non-performing loan ratio in SME lending and eased requirements on SMEs for loan applications while the government is planning to subsidize banks for the higher risk of lending to SMEs.

In September 2009, China also launched other measures to support SMEs. For very small SMEs, the government will lower the income tax rate and give a one-year exemption on contributions to the Social Security Fund, although this may be difficult to implement.¹¹ In addition, the government pledged to: assist with technology upgrades, help develop new markets, improve the quality of infrastructure support, help improve management expertise among small enterprises, strengthen the government's leadership role, and generally improve the macro environment for SME development.

However, some other recent policy initiatives were unfavorable to SMEs. For example, in Shanxi province, private coal mining firms producing less than 300,000 tons per year were to be nationalized or merged into larger firms. Also, the newly adopted Postal Law grants the state-owned China Post a monopoly on delivery of mail weighing less than 50g in the same city and 100g inter-city.

¹¹ Initially a temporary measure, companies with an annual taxable income up to RMB 30,000 can enjoy a temporary 50 percent reduction on their taxable income. As such firms typically do not have good records, it may in practice be difficult to make this measure effective.

III. Mitigating resource use and environmental damage

Some progress has been made in reforming resource pricing. First, after having been constant since 2003 in many areas, water prices have now been raised in many cities, to stimulate water conservation and allow for enhanced cost recovery of water utilities.¹² Second, China's fuel prices now more closely reflect global oil prices.¹³ On September 2, 2009, the government raised the prices of gasoline and diesel for the seventh time since introducing the new mechanism. Third, the NDRC is considering a pilot to raise hydropower electricity prices to the level of coal-fired power. Electricity from hydropower plants is currently cheaper than electricity from coal-fired power plants. Such price differentials are meant to reflect differences in operational costs of various power plants and a reasonable profit margin. More general increases in electricity tariffs are also under discussion. China also shut down small coal-fuelled power plants with a total capacity of 54 million kilowatts from 2006 to the end of June this year. Because of the closures, the average coal consumption by plants has fallen by 30 grams to 340 grams a kilowatt.

¹² Shanghai, Zhengzhou, and Nanjing raised residential water prices by 25, 25, and 12 percent in recent months. The first two cities said they plan more rises in the future, but Nanjing also introduced subsidies to reduce the impact on low-income households.

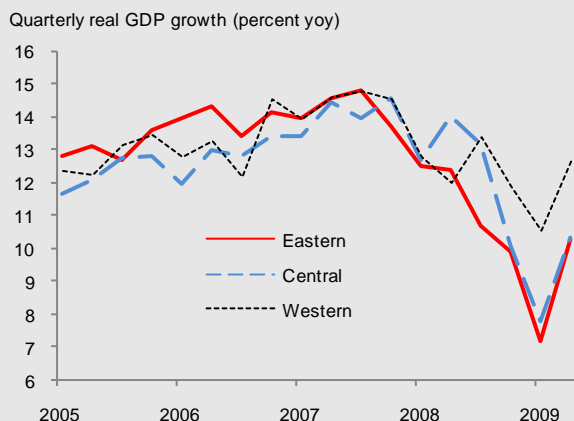
¹³ Under a new mechanism introduced in January, the NDRC will consider changing benchmark oil product prices when the 22 working days moving average of the international crude price rises or falls by 4 percent.

Box 2. Regional developments—what explains recent growth developments across regions?

The fall in exports has been across all regions. Since the intensification of the global financial and economic crisis late last year, exports declined dramatically. The Eastern region accounts for about 90 percent of China’s total exports. However, all parts of China saw exports fall by more than 20 percent.

The overall economy has also slowed in all parts of China, although less so in the Western region. In the Eastern region, the economy is much more directly exposed to the world economy, and thus to the global crisis, than in the other parts of the country. In the Eastern region, exports were more than 50 percent of GDP in 2008, compared to less than 10 percent in the rest of the country. However, the Western and Central regions are not isolated from the outside world. Most of China’s provincial economies are increasingly integrated with each other—although less so in case of the Western region. Moreover, the central region, with its high dependency on heavy industry, was also hit by the real estate weakness that kicked in in mid-2008. Thus, the export slowdown and real estate weakness lowered growth in the Western and, in particular, the Central regions (Box Figure 1).

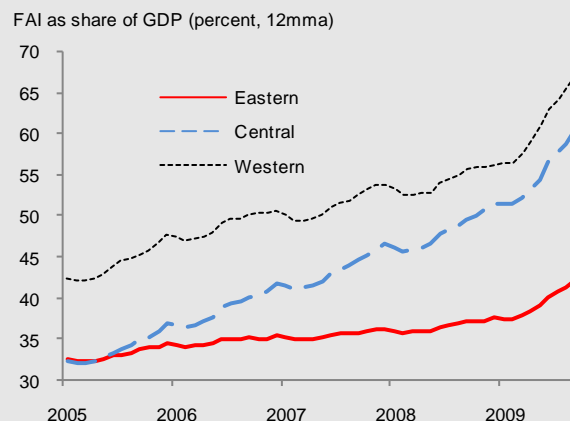
Box Figure 1. Led by the Eastern region, GDP growth slowed amidst the global crisis



Source: CEIC, World Bank staff estimates.

1/ Due to discrepancies, the average is higher than the nation-wide number.

Box Figure 2. The weight of investment is much higher in the Western and Central regions



Source: CEIC, World Bank staff estimates.

Variation in the role of government-influenced investment is another reason for differences in the intensity of the slowdown across regions. In line with China’s policy of regional rebalancing, government-led investment is tilted towards the Western and Central regions (Box Figure 2). Fixed asset investment growth in the Western region jumped to about 50 percent (yoy) in the early of this year, probably reflecting earth quake zone reconstruction efforts. In all, in the Western region, the direct exposure to the global economy is low, integration with other regions relatively modest, and the weight of rapidly growing public investment is high, in part because of regional rebalancing efforts. As a result, GDP growth has been less affected. In the central region, the direct exposure to the global economy is also low. However, this region is more integrated with the eastern region, was more exposed to the real estate weakness, and the weight of government-led investment is smaller here than in the Western region. Therefore, GDP growth came down quickly during 2008.

The following papers are available from World Bank's *Documents & Reports* website:
<http://www-wds.worldbank.org>,

World Development Report 2010: Development and Climate Change

Developing countries can shift to lower-carbon paths while promoting development and reducing poverty, but this depends on financial and technical assistance from high-income countries.

China in regional trade agreements: Lessons for China (Report nr. 51316)

This report draws on lessons for China on the three issues in regional trade agreement negotiation: competition, environment and labor mobility.

Growth through innovation: an industrial strategy for Shanghai (Report nr. 50208)

Shanghai's future performance and that of a handful of other urban regions will determine China's economic fortunes in the coming decades.

China: urban services and governance (Report nr. WPS5030)

This study addresses governance challenges in public service delivery in China. It builds on the citizen scorecard survey conducted in five Chinese cities in 2006 to gauge citizens experience with public services, and demonstrates the usefulness of citizens feedback for policy development and implementation.

China - Road traffic safety: the achievements, the challenges, and the way ahead (Report nr. 49562)

Road traffic injuries are a major but neglected global public health problem. On current trends, by 2020, road traffic injuries are likely to be the third leading cause of years lost. This report looks at ways to improve road safety.

Reforming China's rural health system (Report nr. 49049)

This book provides an analytical framework for explaining what happened in China's rural health system and why and presents a global perspective on the options for further strengthening the sector. This book can provide a useful reference for policy makers in the next phase of health reform and beyond.

A comparative perspective on poverty reduction in Brazil, China and India (Martin Ravallion) (Report nr. WPS5080)

Brazil, China and India have seen falling poverty in their reform periods, but to varying degrees and for different reasons. All three countries have learned how important macroeconomic stability is to poverty reduction

Implications of the growth of China and India for the other Asian giant: Russia (Elena Ianchovichina; Maros Ivanic ; Will Martin) (Report nr. WPS5075)

A major source of benefit to Russia is likely to be terms-of-trade improvements associated with higher energy prices - a quite different channel of effect from that for many developing countries that benefit primarily through expanded opportunities to trade directly with these emerging giants

The pattern of growth and poverty reduction in China (Jose Montalvo and Martin Ravallion) (Report No.: WPS5069)

This paper tests whether the pattern of China's growth mattered to poverty reduction using a new provincial panel data set constructed for this purpose.