Quarterly Update

March 2009

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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

China’s real economy has been hit hard by the global crisis, but has been holding up. Indeed, China has weathered the storm better than many other countries because it does not rely on external financing, its banks have been largely unscathed by the international financial turmoil and it has the fiscal and macroeconomic space to implement forceful stimulus measures. As the global crisis has intensified, however, China’s exports have declined sharply, and this is affecting market-based investment and sentiment, as well as employment, notably in the manufacturing sector.

Although China’s growth is set to decline, it is still likely to be higher than in most other countries. The forceful stimulus policies will help dampen the downturn by supporting domestic demand, production, and employment. Banks have been keen to expand credit, after having deleveraged in recent years. And private consumption has been fairly resilient so far and should be able to continue to grow significantly, while government-influenced investment is accelerating already thanks to the stimulus package.

However, the continued global crisis is bound to contain China’s growth in 2009 and 2010, especially via weaker exports and market-based investment. The World Bank has just downgraded sharply its projections for global GDP and imports in 2009. In this light, we expect China’s exports to shrink in 2009. Government influenced activity will support growth, but it makes up a modest share of the total. It therefore cannot and probably should not offset fully the downward pressures on market-based activity. We project GDP growth of 6.5 percent in 2009. This is significantly lower than potential growth, and spare capacity is likely to lead to weaker market-based investment, less job growth and migration, downward pressure on prices, redirection of exports to the domestic market, and import substitution in the coming years.

Nonetheless, China’s economic fundamentals are strong enough to allow policymakers to consider policies that will affect the economy well beyond 2009. So far, the policy response to the downturn has emphasized stimulating investment to help achieve the economic targets. Looking ahead, less focus on targeting short term GDP growth would allow for more emphasis on the rebalancing and reform agenda. Meanwhile, somewhat lower growth is not likely to jeopardize China’s economy or social stability, especially not if the adverse consequences of the downturn for employment and people’s livelihood can be limited via the social safety net, preferably combined with education.

There are useful synergies between China’s short and medium term policy objectives. The subdued prospects for the global economy—and thus for exports—increase the importance of boosting domestic demand and domestic consumption, which is also key for rebalancing. Thus, recent initiatives to stimulate consumption and improve people’s livelihood by expanding the government’s role and spending on health, education, and social safety are very welcome, and there is room to do more.

Financial sector reforms will help. They would help China manage the downturn and facilitate the transition to a more balanced economy.
The global financial and economic crisis intensified in the fall of 2008. Since September 2008, global financial market conditions have remained turbulent, with spreads in many funding markets still painfully high, despite wide-ranging policy measures to provide additional capital and reduce credit risks. Across the world, widespread disruptions of credit are affecting consumption, production, and trade. High levels of uncertainty and destruction of housing and equity wealth are affecting consumer and business confidence globally, with a strong negative impact on consumption and, notably, investment.

The adverse impact on output and trade is very large and geographically broad-based. Global industrial production declined by an estimated 4.5 percent in the fourth quarter of 2008, or 20 percent at a seasonally adjusted annualized rate (SAAR), with producers of capital goods especially hard hit. Overall GDP fell in the fourth quarter of 2008 in almost all of China’s main trade partners, to levels often significantly down on a year ago (Figure 1). Global GDP may have fallen by 5 percent (SAAR) in the fourth quarter, and a similar decline may occur in the first quarter of 2009. On the back of the record decline in industrial output, the growth of world trade fell rapidly through 2008 and turned negative in the final months of 2008.

Against this backdrop, China’s economy decelerated substantially. The international financial crisis has had limited direct impact on China’s financial system, but China’s open real economy has been affected significantly. Following mild overheating in 2006 and 2007, quarter on quarter (qoq) GDP growth declined steadily throughout 2008. This reflected the impact of the intensification of the global crisis—on exports, investment, and sentiment—as well as, domestically, the impact of policies to cool off the economy and housing market weakness (see our December Quarterly). On our estimates, GDP grew 2.5 percent (SAAR) in the fourth quarter, to a level 6.8 percent up on a year ago. This is a major slowdown, even if it compares favorably with data for other countries.

The intensification of the global crisis hit China’s exports hard. As the impact of the crisis deepened in the U.S. and Europe and started to hit demand in many emerging markets, China’s export volumes fell sharply in November (Figure 2). Falling further, they were down 21 percent (yoy) on average in the first 2 months of 2009, in US$ (Table 1). Exports were particularly weak in February, both processing and “normal”. Turning to imports, these had up to January been lagging, even though China’s economic growth
exceeds that in most other countries. One factor that depressed imports was destocking of raw materials. Raw material imports seem to have recovered in February, although it is too early to say whether this will be sustained. On the price front, sharply lower commodity prices push the import bill down. After averaging almost US$ 40 billion for 3 months, the trade surplus suddenly dropped to US$ 4.8 billion in February. This is however unlikely to be representative of underlying trends.

Figure 2. As elsewhere, China’s trade volumes declined sharply

Table 1. Recent trade data decomposed (percent change)

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th></th>
<th></th>
<th>2009</th>
<th></th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>Oct</td>
<td>Nov</td>
<td>Dec</td>
<td>Jan</td>
<td>Feb</td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>19.1</td>
<td>-2.2</td>
<td>-2.8</td>
<td>-17.5</td>
<td>-25.7</td>
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<tr>
<td>Volume</td>
<td>9.9</td>
<td>-7.3</td>
<td>-7.6</td>
<td>-19.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price</td>
<td>8.4</td>
<td>5.5</td>
<td>5.1</td>
<td>2.3</td>
<td></td>
<td></td>
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<tr>
<td>Imports</td>
<td>15.5</td>
<td>-17.9</td>
<td>-21.2</td>
<td>-42.9</td>
<td>-23.8</td>
<td></td>
</tr>
<tr>
<td>Volume</td>
<td>4.3</td>
<td>-19.5</td>
<td>-12.4</td>
<td>-36.2</td>
<td></td>
<td></td>
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<tr>
<td>Price</td>
<td>10.8</td>
<td>1.9</td>
<td>-10</td>
<td>-10.6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: China’s custom administration, staff estimates

Domestically, with a strong starting position providing space, stimulus policies dampen the downturn. China entered this downturn with solid macroeconomic fundamentals and a financial sector largely unscathed by the global turmoil. This gives the authorities scope to forcefully pursue expansionary policies. The end-2008 fiscal data indicate that the fiscal stimulus measures were executed quickly. The boost in fiscal spending that started in November of 2008, combined with revenue weakness, quickly helped turn the government balance into a small fiscal deficit for 2008 as a whole.¹ Leveraged by a boost in bank lending, the fiscal stimulus supports activity and sentiment. Table 5 in the fiscal policy section gives a breakdown of spending under the stimulus plan.

The relaxation of monetary policy is leading to more bank lending and support for economic activity. Following a major shift in the policy stance, bank lending increased rapidly. With new lending averaging RMB 1,345 billion per month in the first 2 months of 2009 (more than 4 percent of whole-year GDP), total outstanding credit rose 24.2 percent in the year to February (Figure 3). A significant amount of the new lending is short-term bill financing (40 percent in January). Some of this is meeting companies’ demand for short term lending after a period of tight financing conditions. Some of it seems to be “superficial”, based on arbitrage. In recent months, the bill financing rate has been very

¹ After the initial disbursement of RMB 100 billion in November 2008, the central government disbursed RMB 130 billion for projects under the RMB 4 trillion stimulus package in early 2009. The overall general government budget probably remained in surplus, because of surpluses in the social security funds.
low after the central bank dramatically increased liquidity. While still higher than the rate banks receive for reserves deposited at the central bank, for firms this rate is far lower than normal bank lending rate and even lower than short term bank deposit rates. The arbitrage-based financing is not associated with economic activity. But at least access to bank financing is no longer a systemic constraint on economic activity. At any rate, even excluding all bill financing, bank lending increased substantially, with (yoy) growth rising to 18.9 percent (yoy) in February. A substantial part of this is lending to infrastructure projects. However, presumably another reason for the rapid uptick in lending is that banks can quickly decide to finance pre-approved other projects that had been held up because of credit controls in place until October last year.

Thus, domestic demand has held up better than foreign demand. This is confirmed by data that differentiate between these two, such as on industrial sales and the PMI.

Government-influenced investment is coming on stream while market-based investment is decelerating (Figure 4). Real estate investment continues to weaken in response to depressed housing sales, despite recent measures to boost the property market. Other market-based investment has also decelerated, notably in manufacturing, held back by subdued exports and profits and the emergence of spare capacity. However, government-influenced investment has accelerated impressively since end-2008.

Figure 3. Bank lending increased sharply

Figure 4. Government influenced investment accelerates while market based investment slows

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2 Key measures included more government spending on public housing, lower minimum down payments for mortgages and lower interest rates for several types of buyers, and lower own-capital requirements for bank lending to developers building cheap rentals.

3 Our government-influenced investment covers utilities, transport, scientific research, water and environment conservancy, education, health care, social security, culture, sport, and public administration.
The unwinding of involuntary stock building has subtracted from activity since November, but the stocks overhang does not appear very large. Since mid-2008, when the slowdown became visible, manufacturing firms started to reduce inventories of raw materials. On the other hand, for much of the second half of 2008, inventories of finished goods increased involuntary across China’s manufacturing sector (Figure 5). Surprised by a sudden demand shock, the deceleration in production lagged the one in industrial sales. This happened across sectors, notably in heavy industry sectors such as steel. For manufacturing as a whole, the size of this inventory build up (overhang) was not very large, however. Since December, the PMI shows a shift towards destocking of finished products across manufacturing, notably in heavy industries such as steel. This destocking means that production lags sales. However, the PMI data and sector specific data on steel suggest that that the period from the onset of the demand shock to the start of the destocking was not very long. Also, the increase in the ratio of inventories of finished products to (the 12 month moving average of) sales during this period (from 54.9 in January 2008 to 55.8 in November) was not very large. Thus, looking ahead, the drag on production from inventory overhang is likely to be modest. Indeed, the February PMI data suggests that the pace of destocking was declining.

Consumption is decelerating to still robust rates. The extraordinarily strong retail sales growth since early 2008 is probably not representative of underlying trends.\(^4\) Nonetheless, other indicators confirm that private consumption is holding up—decelerating in response to worsening economic and labor market prospects but to a still solid pace. Retail sales of large retailers decelerated to around 12 percent (yoy) in the fourth quarter in real terms, with the deceleration most pronounced in discretionary items such as cars and housing related items (Figure 6). Retail sales during the Chinese new year were 13 percent higher than a year ago in real terms. Income trends indicate a renewed widening of the urban-rural income gap, with implications for rural consumption. Real urban household disposable income growth accelerated in the fourth quarter of 2008 to 10.5 percent, due in large part to disinflation led by food prices. But rural per capita cash income growth decelerated in the fourth quarter, due to subdued farm output prices and rising job losses among migrants. Fiscal data suggest growth of government consumption—responsible for more than one-fourth of total consumption—picked up in late 2008.

Weaker labor demand is creating labor market pressure. The official urban unemployment rate rose by 0.2 percentage points to 4.2 percent in the year to the fourth quarter of 2008. However, with large sections of the working population (including migrants) not eligible to register as unemployed, this captures only a small part of the pressure. According to a survey held by the Ministry of Agriculture, before the Chinese new year festival 20 million migrants had lost their job (15 percent of the total). The Ministry of Human Resources and Social Security (MHRSS) estimates that, of the 70 million rural migrant workers who returned home for the Spring Festival, about 80 percent, or roughly 56 million, came back to urban areas after the Festival. Of this group, about 11 million had not yet found a job in early March.\(^5\)

\(^{4}\) This data suggests real retail sales growth rose to 17 percent in the fourth quarter of 2008 and was still 15.8 percent on average in January-February 2009.
The slowdown is adding further downward pressure on inflation. As the previous large price increases for food, oil, and raw materials are fading out, inflation is receding to low levels. Prices of raw materials are now much lower than a year ago and this is the main driver of downward pressure on PPI (factory gate) and CPI inflation, causing consumer prices to be 1.6 down on a year ago in February (Figure 7). In addition, attempts to redirect sales from foreign markets to domestic markets and to substitute for imports are reported to have started to add to downward pressure on prices.

Figure 7. Sharply lower raw material prices are driving down inflation

Figure 8. Profits in core manufacturing influenced by price gap between PPI and raw materials

China’s labor market data is very weak, so it is difficult to have a good picture of overall trends. This led the government to initiate more additional, comprehensive labor market surveys this year.
Profitability in the corporate sector deteriorated in the second half of 2008. After over 5 years of very rapid growth, profit growth in industry decelerated rapidly, notably in heavy industry, but also in the machinery and light industrial sectors. Margins in core manufacturing were hit as raw material prices increased much faster than PPI (factory gate) prices (Figure 8). In addition, the slowdown in demand has started to affect profitability. Looking ahead, the sharp fall in raw material prices more recently should help mitigate the impact of the downturn on profitability.

ECONOMIC PROSPECTS AND RISKS

Continued global turmoil and economic weakness is likely to contain growth in China in 2009 and 2010, notably via weaker exports and market-based investment. However, China is likely to continue to outgrow most other countries, because it does not rely on external financing for growth; its domestic banks are largely unscathed by the international financial turmoil and have deleveraged in recent years, enabling them to help finance growth; and there is space and willingness to use fiscal and monetary policy stimulus. Indeed, the policy stimulus has started to provide support to activity and sentiment.

Even so, China’s economy cannot escape the impact of the global weakness. Government influenced activity makes up a modest share of the total; it cannot and probably should not offset fully the downward pressures on market based activity. With growth in 2009 falling short of potential growth, increasing spare capacity is set to lead to weaker market-based investment, less job growth and migration, downward pressure on prices and profit margins, redirection of exports to the domestic market, and import substitution.

Global financial markets are likely to remain strained during 2009. Market conditions in the industrialized countries are likely to continue to be difficult pending the implementation of forceful policy action to restructure the financial sector, resolve the uncertainty about losses, and break the adverse feedback loop with the slowing real economy. In many emerging economies, financial conditions will likely remain tense for some time—especially for those that have relied on external financing for their growth.

Global growth prospects are very unfavorable and uncertain. Since end-November 2008, when we released our previous quarterly update, the global outlook has worsened strongly. The economic downturn is particularly severe because it is synchronized, affecting all major economies. Assuming that forceful, coordinated policy actions can normalize financial market conditions while fiscal and monetary stimulus can support activity, output in industrialized countries may start recovering in late 2009 or 2010. Emerging markets and developing countries are more robust now than during previous crises, because of better fundamentals. Nonetheless, their growth will decline substantially in 2009 because of the slowdown in export markets, lower commodity prices, and much tighter external financing conditions, especially for economies that depend on external

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5 Core manufacturing excludes petroleum and metal processing, chemicals, utilities, and food processing.

6 IMF World Economic Outlook Update, January 2009.
capital to finance growth. With world GDP down by 5 percent (saar) in the fourth quarter of 2008, and probably as well in the first quarter, world GDP would fall significantly in 2009 as a whole even with a modest rebound in late 2009. The World Bank now projects a decline of 1.5 percent (in market exchange rates), a full 2.5 percentage point markdown compared to November 2008 (Table 2). Moreover, the Bank now projects world imports to shrink 6 percent in 2009. In this context, we have further downgraded our projection for China’s exports. The one positive feature about this setting is that international prices of primary commodities including energy and metals have fallen sharply. The World Bank forecasts declines of over 50 and 30 percent for oil and non-oil commodities in 2009. This will help reduce cost pressures and support margins in manufacturing.

Table 2. The global environment

(Percent change, unless otherwise indicated)

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008(e)</th>
<th>2009(f) Nov-08</th>
<th>2009(f) Feb-09</th>
<th>2010(f) Nov-08</th>
<th>2010(f) Feb-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>World GDP (real)</td>
<td></td>
<td></td>
<td>3.7</td>
<td>2.6</td>
<td>1.0</td>
<td>-1.5</td>
</tr>
<tr>
<td>(market exchange rates)</td>
<td></td>
<td></td>
<td>9.8</td>
<td>5.8</td>
<td>-2.5</td>
<td>-6.0</td>
</tr>
<tr>
<td>World imports (volume)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity prices</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil ($/bbl)</td>
<td></td>
<td></td>
<td>71.0</td>
<td>97.0</td>
<td>47.8</td>
<td>52.7</td>
</tr>
<tr>
<td>Non oil commodities (%)</td>
<td></td>
<td></td>
<td>17.1</td>
<td>23.2</td>
<td>-30.5</td>
<td>-1.6</td>
</tr>
</tbody>
</table>

Source: World Bank (DEC, March 2009), staff estimates

Risks and uncertainty about the international outlook are unusually large. The scale and scope of the current financial crisis have taken the global economy in unfamiliar territory. The pernicious feedback loop between real activity and financial markets may intensify, leading to a deepened impact on global growth. Emerging market corporate sectors could be badly damaged by continued limited access to external finance. Markets may respond adversely to the sharp increases in public debt in many countries, with implications for currencies and interest rates. There are also risks of rising protectionism in trade and finance. An upside risk is that financial conditions improve faster than expected.

Domestically, on balance the outlook suggests support for activity. China’s growth can only rebound significantly and sustainably if the world economy recovers, and this does not seem likely to happen soon. Nonetheless, the policy stimulus provides support to activity and sentiment. There have at least been early signs of stabilization, although, given the international weakness, it is too early to expect a sustained rebound. In these circumstances, growth forecasts for China for 2009 have diverged (Box 1).

Spare capacity is emerging, and is starting to have several types of effects. With the pace of growth significantly below potential growth, unused capacity is emerging (Figure 9). This excess capacity is set to show up in: (i) weaker market based investment in the absence of a need to expand capacity; (ii) less job growth and migration; (iii) downward pressure on prices and profit margins as firms facing spare capacity try to redirect exports to the domestic market or substitute for imports. On the latter, we are now projecting lower
Box 1. The divergence of growth forecasts.

It is more difficult than usual to project China’s growth for 2009, and projections have diverged. The negative impact of the international financial turmoil and economic crisis is very large. This affects China’s real economy by means of lower exports, but also lower investment and even consumption. While there is broad agreement that the external situation will imply very subdued exports, opinions differ about the sensitivity of overall growth to export developments. At the same time, many believe China has some strengths in addressing this shock, including a substantial fiscal and monetary policy stimulus and a banking system with a relatively healthy balance sheet that is able to lend. The divergence of forecasts of GDP growth for 2009 for China is due to large differences in perception on how large and effective the offsetting impact from the policy stimulus is going to be, relative to the impact of the shock from the external weakness. How these two forces play out will also determine the “shape of the recovery” in 2009-10, another actively debated issue.

Box Figure. Growth forecasts for 2009 have diverged

GDP growth in 2009 (Percent yoy)

- Consensus forecast
- Consensus forecast mean
- World Bank forecast

Source: Consensus Economics, World Bank, staff estimates

imports in 2009 than in November. In addition to the impact of lower exports, this is only in small part because of lower domestic demand. It is more because there are indications that China’s industrial sector is more successful in import substitution than previously expected. As economic growth in China is projected to be significantly higher than in its trading partners, we still expect imports to hold up better than exports in 2009 (in volumes). However, we now project a somewhat smaller gap between the rate of change in imports and exports than in November.

Figure 9. Spare capacity is set to become substantial

- Potential GDP growth
- GDP growth
- Output gap (production-based)

Source: CEIC, staff estimates
1/ From Cobb Douglas production function.

With market based investment expected to retreat, government-influenced investment will be key (Table 3). Our analysis suggests that the downward pressure on profitability and the emergence of spare capacity tend to reduce investment growth in China, as would be expected in a market-based setting. Therefore, with these conditions
present, market-based investment is likely to be weak this year, after 2 years in which it contributed the bulk of overall fixed investment growth of around 10 percent. Sectors where sales slowed down the most, and that have the largest spare capacity, are steel and other heavy industries, as well as several export-oriented sectors. Meanwhile, foreign direct investment (FDI) will suffer from the reduced investment plans of foreign firms (FDI fell by 26 percent (yoy) (in US$) in the first two months of 2009. Real estate investment is likely to remain weak for much of 2009, given the still very weak real estate sales. As housing prices come down, and with mortgage interest rates down significantly as well, the affordability of housing and mortgages improves substantially, creating the conditions for an eventual recovery. Based on the government’s plans, including the stimulus packages, government-influenced investment will be strong in 2009 and 2010 (see fiscal section).

Table 3. Investment in 2009—illustrative breakdown

<table>
<thead>
<tr>
<th>Weight (share)</th>
<th>Growth (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross fixed capital formation</td>
<td>1</td>
</tr>
<tr>
<td>Government influenced</td>
<td>almost 1/3</td>
</tr>
<tr>
<td>Market based</td>
<td>2/3</td>
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<tr>
<td>Impacted by export</td>
<td>1/6</td>
</tr>
<tr>
<td>Not impacted by export</td>
<td>1/2</td>
</tr>
<tr>
<td>Real estate</td>
<td>1/6</td>
</tr>
<tr>
<td>Other</td>
<td>over 1/3</td>
</tr>
</tbody>
</table>

1/ Based on national accounts type of investment, not FAI (thus adjusted for the impact of asset sales).
Source: staff estimates

We expect private consumption growth to decelerate, but to remain significant (Table 4). In urban areas, growth of nominal wages and employment will slow, and consumer confidence has deteriorated (although it has not yet plunged as sharply as in many other countries). However, a few factors are likely to support consumption. Significantly lower inflation than in 2008 will help offset the lower wage growth. Public sector pensions are set to rise 10 percent in 2009 and 2010, and minimum living allowances are increased. Additional fiscal support comes in the form of somewhat higher transfers including higher government contributions to medical insurance and one-off payments or coupons to lower income households. Moreover, looser monetary policy after a tight stance for much of 2008 may stimulate consumer lending somewhat. With average nominal urban wage growth 4-5 percentage points (pp) lower this year than in 2008, urban employment growth much lower than the 3 percent in 2008, and some fiscal support for urban households, nominal urban disposable income growth may decline about 5 pp in 2009. However, with CPI inflation down 5 pp, real urban income growth may not be much lower than in 2008. Assuming some increase in household saving rates because of lower consumer confidence and more uncertain economic prospects, urban consumption growth would be lower than in 2008 but still significant.

Rural consumption is likely to lag behind. Rural incomes will benefit from the 13-16 percent increase in the minimum grain procurement price, although the average effective price increase may be lower because this minimum is often not binding. Other agricultural output prices are likely to be more subdued, given the outlook for international food prices.

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8 According to an official estimate, this should lead to a rise in rural income of RMB 110 billion. That would be about 3.6 percent of rural disposable income.
Moreover, rural incomes will be significantly affected by the likely lower growth of migrant wages and employment. Several fiscal initiatives will support rural disposable incomes and consumption, including—as in urban areas—higher government contributions to medical insurance and one off payments or coupons to lower income households, as well as subsidies for spending on household appliances in rural areas. Nonetheless, this support may not be large enough to prevent a slowdown in rural real income growth. Indeed, looking further ahead, realistically, rural incomes are likely to continue to lag urban incomes, keeping up the pressure for fiscal support. Turning to public consumption, direct government consumption should grow substantially faster than GDP, reflecting the stimulus policies.

In all, due to substantial policy stimulus, China’s economy should continue to grow significantly in a very challenging external environment. Our forecast of 6.5 percent GDP growth for 2009 is 1 pp less than in end-November 2008, with the bulk of the downgrade due to the much weaker international outlook. In this scenario, government-influenced direct expenditure would contribute 4.9 pp to GDP growth, three-fourth of total growth, of which more than two-thirds from government-influenced investment and the rest from direct government consumption. There are both downside and upside risks to this GDP growth projection (see below).

China’s economy is likely to receive support from the expected global pick up if and when it occurs late in 2009 or in 2010. With China’s stimulus measures having effect earlier than in most countries, and the adverse impact of the global crisis on market based investment seemingly showing up later than in other countries, China may see less of an increase in growth in 2010 than some other emerging markets.

With raw material prices low and a significant output gap building up, inflationary pressure will be very low in 2009. Weak demand in many sectors, and the resulting spare capacity, is adding downward pressure. As some exporters redirect their sales to domestic markets, additional downward pressure on prices and profits may emerge.

Price pressure resulting from the slowdown drags down profitability. Looking ahead, the reversal of relative price trends, with raw material prices falling, is good for profits in manufacturing. On the other hand, downward pressure on margins from increased competition on the domestic market from the redirection of sales due to spare capacity is likely to intensify.

In this scenario, labor market weakness is set to continue. Between 2002 and 2008, non agricultural GDP grew impressively. Despite rapid productivity growth, this allowed non agricultural employment to grow 3.9 percent per year on average. Substantial migration contributed to a decline in agricultural employment of 16 percent during 2002-08. Our estimates suggest that every 1 percentage point less non-agricultural GDP growth means around 5.4 million lower non-agricultural employment. On a whole-year basis, GDP growth is likely to be about 3 percentage point lower than potential growth in 2009. But growth may be lower in the beginning of the year. This suggests about 16-17 million less non-agricultural employment because of weak growth for the year as a whole, peaking at
perhaps 20-25 million early in the year. These numbers are broadly consistent with the estimates of the MHRSS on the situation in early March.

### Table 4. China: Main Economic Indicators

<table>
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<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
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<tbody>
<tr>
<td>Real GDP growth (production side) (%)</td>
<td>10.4</td>
<td>11.6</td>
<td>11.9</td>
<td>9</td>
<td>6.5</td>
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<tr>
<td>Real GDP (expenditure side) 2/</td>
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<td>12.5</td>
<td>8.5</td>
<td>...</td>
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<tr>
<td>Consumption 2/</td>
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<td>8.4</td>
<td>10.1</td>
<td>8.0</td>
<td>7.8</td>
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<tr>
<td>Gross capital formation 2/</td>
<td>9.0</td>
<td>10.7</td>
<td>10.3</td>
<td>9.7</td>
<td>8.4</td>
</tr>
<tr>
<td>Fixed capital formation</td>
<td>11.0</td>
<td>13.0</td>
<td>11.4</td>
<td>8.8</td>
<td>7.7</td>
</tr>
<tr>
<td>Exports (goods and services) 3/</td>
<td>24.3</td>
<td>23.3</td>
<td>19.9</td>
<td>7.8</td>
<td>-6.0</td>
</tr>
<tr>
<td>Imports (goods and services) 3/</td>
<td>11.4</td>
<td>14.3</td>
<td>13.9</td>
<td>3.6</td>
<td>-4.0</td>
</tr>
<tr>
<td>Consumer price increases (period average)</td>
<td>1.8</td>
<td>1.5</td>
<td>4.8</td>
<td>5.9</td>
<td>0.5</td>
</tr>
<tr>
<td>GDP deflator</td>
<td>3.8</td>
<td>3.6</td>
<td>7.4</td>
<td>7.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Fiscal accounts (percent of GDP) 4/</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>-1.2</td>
<td>-0.8</td>
<td>0.7</td>
<td>-0.4</td>
<td>-3.2</td>
</tr>
<tr>
<td>Total revenue</td>
<td>17.3</td>
<td>18.3</td>
<td>20.6</td>
<td>20.4</td>
<td>19.7</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>18.5</td>
<td>19.1</td>
<td>19.9</td>
<td>20.7</td>
<td>22.9</td>
</tr>
<tr>
<td><strong>External account (US$ billions)</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Current account balance (US$ bln)</td>
<td>161</td>
<td>250</td>
<td>372</td>
<td>416</td>
<td>425</td>
</tr>
<tr>
<td>As share of GDP (%)</td>
<td>7.1</td>
<td>9.5</td>
<td>11.3</td>
<td>9.6</td>
<td>8.8</td>
</tr>
<tr>
<td>Capital account balance</td>
<td>47</td>
<td>-3</td>
<td>90</td>
<td>33</td>
<td>0</td>
</tr>
<tr>
<td>(including errors &amp; omissions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which: FDI (net)</td>
<td>68</td>
<td>60.3</td>
<td>122</td>
<td>92.4</td>
<td>60</td>
</tr>
<tr>
<td>Change in reserves (increase = +)</td>
<td>207</td>
<td>247</td>
<td>462</td>
<td>420</td>
<td>425</td>
</tr>
<tr>
<td>Foreign exchange reserves (US$ bln)</td>
<td>819</td>
<td>1066</td>
<td>1528</td>
<td>1951</td>
<td>2376</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Broad money growth (M2), e-o-p (%)</td>
<td>17.6</td>
<td>16.9</td>
<td>16.7</td>
<td>17.8</td>
<td>17.0</td>
</tr>
</tbody>
</table>

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

1/ World Bank projection.
2/ Estimations are based on the national account data (Table 2-20 in China Statistical Yearbook 2008).
3/ Estimates based on trade deflators for goods published by the Custom Administration.
4/ GFS basis; central and local governments, including all official external borrowing.

**Domestically, there are also several risks.** On the downside, although there are no signs of it, there is always a possibility that policymakers become complacent after the first signs of stabilization. Relatedly, market-based spending may weaken more after disappointment about the lack of a speedy rebound. The large amount of spare capacity poses risks of significant downward price pressures and company failure, although policymakers have some weapons to fight deflation. In the medium term, if the bulk of stimulus spending is oriented on investment instead of consumption, rebalancing may be postponed. On the upside, additional stimulus measures may support growth further, although, as argued below, this policy response may not necessarily be the most appropriate.
ECONOMIC POLICIES

As short and medium term policy objectives overlap, the medium term objective of rebalancing needs to shape economic policies as much as possible. Notably, the very weak prospects for the global economy—and thus for exports—increase the importance of boosting domestic demand and domestic consumption, which is also key for rebalancing. Less emphasis on targeting short term growth would allow for more focus on the reform agenda. Meanwhile, limiting the adverse consequences of the downturn can be done by using and expanding the social safety net, preferably combined with education and training.

China has important short, medium, and long term challenges. The key short term challenge is to limit the adverse consequences of the downturn for employment and people’s livelihood. The medium and long term challenges are enshrined in the 11th Five Year Plan (5YP) that is now in the fourth year of implementation. The key medium term challenge is to rebalance the pattern of growth to make it more sustainable economically, socially, and environmentally (see our December Quarterly for a discussion and possible policies—page 13 and Box 3). The key long term challenge is to continue with reforms to raise productivity and living standards. The World Bank’s report on a mid term evaluation of progress in implementing the 5YP recently concluded that “significant progress has been made toward several of the major objectives of the 11th 5YP, but important challenges remain.”

With the short and medium term objectives overlapping, the medium term objectives need to shape economic policies in 2009. As emphasized by China’s leaders, the subdued prospects for the global economy—and thus for exports—increase the importance of boosting domestic demand and domestic consumption, which is also key for rebalancing. Thus, several measures needed for rebalancing are also good for stimulating growth in the short term. These include increasing the role and spending of the government in health, education, and social security and measures to sustainably boost household disposable income, particularly of lower income people. This is not true for all policies: some rebalancing policies will not stimulate growth in the short term and some policies to stimulate growth in the short term do not help rebalancing. However, China has strong economic fundamentals and the medium and long term objectives are important. Less emphasis on targeting short term GDP growth would allow for more emphasis on the reform agenda, and there is a premium on stimulus measures that fit well in the rebalancing agenda.


10 President Hu Jintao, in a speech to the Communist Party of China (CPC) Central Committee Political Bureau on February 24, stressed that in response to the global crisis, the government should “maintain the policy of giving top priority to increasing domestic demand while stabilizing external demand,” calling for “more powerful and efficient measures to increase domestic demand, consumer demand in particular.”
Looking ahead, measures other than new investment-oriented stimulus may be preferable. China’s traditional policy response to a downturn emphasizes stimulating investment to help achieve economic targets. This is done by large government-influenced projects, funded by both fiscal spending and bank lending. In the current downturn, the rapid policy response has been key in dampening the impact on growth. However, employment and people’s livelihood are equally important, and the number of jobs created by growth depends on not just the rate of growth but also the pattern. China’s growth has been capital intensive in the recent decade, meaning that a lot of new investment is needed to create new jobs. Also, since not all investment-oriented projects are in line with rebalancing needs, the quality of growth may deteriorate as a result of the traditional approach. Thus, the government has rightly added more consumption-oriented stimulus measures. There is room for a further shift in this direction. Also, somewhat lower overall growth is not likely to jeopardize China’s economy or social stability, especially not if the adverse consequences of dislocation and lay-offs are alleviated by using and expanding the social safety net. Thus, there is a case for maintaining the current level of short term policy stimulus and putting more emphasis on reform and rebalancing.

Box 2 discusses possible and recommended labor market policies to alleviate the labor market consequences of the downturn. It argues that using the social security system has advantages over several other labor market policies.

Financial sector and capital market reform could help rebalance the growth pattern. New investment in the coming years needs to be consistent with the desired kind of demand. Encouraging investment by providing financial incentives and subsidies runs the risk of generating backward-looking investment—investment that was successful under China’s traditional, capital intensive and industry heavy, export oriented growth model. However, for China to thrive in the medium and long run, new investment needs to be forward looking—that is successful under a rebalanced growth model. This consideration is relevant as stimulus measures are considered. It also suggests reforms in: (i) monetary policy and the banking system, to moving away from a traditional bias towards large traditional clients (such as industrial SOEs) (see below); (ii) the capital market, where more development would help increase the flow of capital from mature sectors to new growth sectors, and (iii) more significant dividend payments for SOEs.

Fiscal policy

The government was right to provide a forceful fiscal stimulus. Looking ahead, though, there may be limits to the amount of traditional, largely investment-oriented fiscal stimulus that can be spent efficiently. Consumption-oriented fiscal stimulus can be considered. However, the costs and benefits of additional overall stimulus and growth need to be weighed against those of using the social safety net, preferably combined with education and training. As additional fiscal measures are considered, it may not be obvious to cut taxes further. But, recent measures to expand the government’s role and spending in health, education, and social safety are very welcome, and there is room to do more.

11 While SOE dividend payments to the government (the main shareholder) have been introduced in 2008, the share of profit paid is modest for most, with estimates suggesting an average of 7-8 percent.
Box 2. Labor market policies to alleviate the consequences of the downturn.

As the global crisis has hit China’s real economy, its impact on employment becomes an increasing source of concern. While these effects have not yet appeared in the (unrepresentative) official statistics on urban unemployment, there is much anecdotal and survey evidence of rising joblessness, particularly among migrants (see main text). The authorities have also expressed concern about the impacts on other groups, including recent college graduates and urban youth with low educational attainment.

China’s central and local authorities have already responded by complementing their overall stimulus plans with more targeted initiatives. These include policies to allow certain firms to temporarily delay payment of workers’ social security contributions, greater (often subsidized) vocational and technical training opportunities for laid-off workers, programs aimed at creating jobs for recent graduates, and efforts to encourage SME development. Local governments have also been allowed to use unemployment insurance funds to temporarily subsidize jobs at struggling companies.

Three features of the current crisis can guide the design of further policy responses to its labor market impact. First, while not all sectors are affected equally, the crisis is first and foremost a large and general negative shock to labor demand. Second, some of China’s most affected groups are not well covered by the social safety net programs which are typically best placed to help alleviate the impact of shocks. Third, China will likely emerge from the crisis with a different economic growth model, driven by different sectors requiring different job market skills. This will place a premium on policies which facilitate rather than hamper the reallocation of labor, and which help supply citizens with the most highly demanded skills.

Policies to “create jobs” that may work in normal times can be too costly in the face of a large and generalized shock to labor demand. A firm facing much reduced demand for its products could require a substantial subsidy to hire new workers. Such spending could be wasteful, and its impacts unsustainable. Higher public sector employment or wages would also tend to help those who are already better off, and could be difficult to reverse in the future. While new high return public investments are a welcome part of the overall stimulus package, more artificial “public works” programs would create few permanently valuable skills and have a high non-wage component (and thus a high cost per job created). Job search programs, while not very costly, are also likely to be relatively ineffective at a time of low overall labor demand.

Various “job protection” policies can also have high indirect costs and may be unsustainable. Preventing or heavily discouraging firms from laying off workers could be bad for the business climate, could make firms less willing to hire new workers in the future, and ultimately fail if the company goes bankrupt as a result. Extensive bailouts of troubled firms would be very costly per ‘job saved’. Higher minimum wages could harm employment, because they increase labor costs in a low labor demand environment. However, voluntary “worksharing” schemes agreed within an enterprise could be encouraged, as these can help maintain overall employment levels and allow workers to share the impact of the crisis.

Using the social safety net is much more promising, with due attention paid to the ability of programs to reach the most affected groups. Given the need for speed, the immediate focus could be on expanding and/or reforming existing programs. In many countries, the focus is on expanding unemployment benefits (UB). However, in China, two groups of particular concern – migrant workers and recent graduates – are not well covered by the UB program targeted at urban formal sector workers with an employment history. Thus, it could make more sense to focus on other existing programs, such as the urban and rural dibao. The first priority will be ensuring adequate funding for the selected program(s) under existing rules in the face of a rising number of beneficiaries. For programs administered by local governments, this may also require increased transfers from the central budget. If funding constraints permit, the second priority would be adjusting the rules governing these programs to expand the coverage, level and/or duration of benefits. However, any such changes need to fit into long-term reform plans and avoid adverse incentive effects on work effort.
Expanded enrollment in high quality and demand-driven education and training programs is also promising. If “job creation” efforts are too costly in the face of a sharp drop in labor demand, it could be better to use the current moment to provide China’s citizens with additional skills, either by keeping students enrolled in school or by providing adult training. This would facilitate the movement of labor to the different and more sustainable jobs which will be in demand under China’s new growth model. Workers who had deferred training out of a reluctance to forego earning opportunities during a boom may now show greater interest in such offerings. These programs should be as much as possible demand driven, both in terms of the skills provided and the locations where they are offered (especially the urban areas with the best long-run growth potential). As many persons may not be able to afford temporary inactivity or the direct cost of training, the additional offerings may need to be complemented by targeted scholarships, stipends, or loan programs.

Fiscal policy in 2009 is likely to lead to a sizable but manageable increase in the government deficit. Our scenario for 2009 sees government-influenced direct expenditure contributing a massive 4.9 pp to GDP growth, or three-fourth of the total, but only part of government-influenced investment is financed by the central and local governments. In terms of the government budget, we estimate that the combined effect of the expenditure increases, the discretionary reduction in revenues because of tax rate reductions and increases in VAT rebates to exporters (including the whole-year impact of tax changes introduced in 2008), and some impact on revenues from weaker growth is an increase in the government deficit to 3.2 percent of GDP in 2009. This is a little higher than in the Ministry of Finance’s budget presented to the NPC, which is based on somewhat higher GDP growth and inflation.

How strongly should fiscal policy respond if the growth target for 2009 is in danger, and how? If economic growth falls short of the target, one response would be to add more fiscal policy stimulus along traditional (investment-oriented) lines. As noted above, this would require a lot of additional spending, and there may be limits to how much such stimulus measures can be expanded efficiently. This downside of investment-oriented stimulus may be less of a concern with consumption-oriented measures. Nonetheless, a second reason for capping the overall fiscal stimulus in 2009 is that the global slowdown may well extend to 2010 or longer. This would require additional fiscal stimulus (increase in the deficit) in 2010. Since there are limits to how high fiscal deficits can and should be, it would be prudent to preserve room to increase the deficit further in 2010, if needed.

The consequences of the downturn can also be alleviated by expanding and using the social safety net, preferably combined with training (Box 2). The private sector now plays a much larger role than in 1998, when China used fiscal stimulus to counter the impact of the Asian crisis. Thus, there may be a different trade off between the costs and benefits of boosting growth by overall government spending and those of improving and using the social safety net. Using the social safety net would surely be less costly for the government. As a very crude calculation, using overall (fiscal and bank-financed) spending to create enough growth for 20 million extra non-agricultural jobs requires additional spending of 3.5 percent of GDP, based on China’s current pattern of growth, which is not
labor intensive.\textsuperscript{12} Even assuming that the government needs to finance only one-third of that, this would mean a fiscal cost of over 1 percent of GDP. Providing living assistance to 20 million people at twice the poverty rate would require only around 0.2 percent of GDP.

\textbf{Spending under the 10 point stimulus plan is taking place.} The plan has an emphasis on infrastructure and other investment, although of a different nature than 10 years ago, with many projects geared to broad long term development needs and improving living standards instead of to the needs of industry (see our December Quarterly Update for more detail). The central government has committed RMB 1.18 trillion out of the total RMB 4 trillion, with the rest coming from local government financing, bond issuance by local entities affiliated with local governments, and, notably, bank lending. After spending RMB 104 billion at the end of 2008, the central government plans to spend RMB 487.5 billion (1.4 percent of GDP) on the 10 point plan in 2009 (the central government plans to spend RMB 908 billion in total on investment this year). In the Work Document presented to the NPC in early March, the government showed an adjusted breakdown (Table 5).

\textbf{As part of the 10 point plan, the government has announced 10 sector specific plans.} Several of these largely investment oriented plans have an environmental and/or energy efficiency element.\textsuperscript{13} For instance, in the case of the petrochemical sector, RMB 500 billion (1.4 percent of 2009 GDP) is meant to be spent in 2009-10 on upgrading of refineries and improving the quality of fuel to reduce emissions.

\textbf{Other recent fiscal policy initiatives have focused on stimulating consumption and improving people’s livelihood.} The following initiatives are in addition to sizeable proposed increases in public sector pensions. The magnitude of consumption-oriented stimulus spending has so far been modest compared to investment-oriented spending. However, central government spending on health, education, and social safety is set to increase by 38, 24, and 22 percent in 2009. Looking ahead, there is room for more medium term oriented initiatives in these areas.

\textbf{First, the government recently announced the outlines of a health care reform plan.} Under the plan, RMB 850 billion would be spent in 2009-2011 (about 0.8 percent of 2009 GDP per year) to increase medical insurance coverage and payments, improve equality in accessing public health facilities and care, and “establish an efficient public health and medical system.” (Box 3) This is moving in the right direction, although many specifics are still unknown, including on the role of local governments in financing it.

\textbf{Second, steps are taken to improve the social safety net.} The draft of China’s first Social Insurance Law was released in late 2008 for public consultation. It specifies a common right for citizens, urban and rural, to social insurance for medical care, unemployment, work injuries, and childbirth, although it is not yet clear what the immediate impact of the introduction of the law would be. Also, the government

\textsuperscript{12} This assumes a fiscal multiplier of 1.

\textsuperscript{13} For instance, the car industry plan contains subsidies for auto makers that upgrade their technology and develop alternative-energy vehicles, a reduction in the consumption tax for small (energy friendly) cars, and subsidies for farmers who opt to replace three-wheeled vehicles or outdated trucks with new, small vehicles.
distributed about RMB 9.7 billion to 74 million poor people before the Chinese New Year. While one-off, the initiative is noteworthy because it tested the capacity of the social safety net to target the most needy and transfer payments to them. In addition, several local governments have made one off payments or distributed coupons.

Table 5: The 10 point plan

<table>
<thead>
<tr>
<th></th>
<th>Total 2008q4–2010 overall financing</th>
<th>First 2 batches—central government financing</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>First</td>
</tr>
<tr>
<td>Public housing</td>
<td>4,000</td>
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<tr>
<td>Rural infrastructure (electricity, water, and roads)</td>
<td>400</td>
<td>10</td>
</tr>
<tr>
<td>Transport (rail, airports, and roads)</td>
<td>370</td>
<td>34</td>
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<tr>
<td>Health and education</td>
<td>1,500</td>
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</tr>
<tr>
<td>(including building schools and hospitals)</td>
<td>150</td>
<td>13</td>
</tr>
<tr>
<td>Energy and the environment</td>
<td>210</td>
<td>12</td>
</tr>
<tr>
<td>(incl. water and sanitation, sewage, and restoration)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technological innovation</td>
<td>370</td>
<td>6</td>
</tr>
<tr>
<td>Post earth quake reconstruction</td>
<td>1,000</td>
<td>...</td>
</tr>
</tbody>
</table>

Source: NDRC.

Third, the government sees great potential to boost rural consumption and has taken initiatives to achieve this objective. The key challenge is to raise labor productivity in agriculture and thereby per capita incomes. In this context, our December 2008 Quarterly Update had a box on land reform. In the meantime, the government has rolled out nationwide a scheme through which it provides a subsidy of 13 percent for consumption of specific electronic items by rural people. An earlier pilot scheme launched in December 2007 in 4 provinces was considered successful, with rural sales of the products of the four major product categories (color TVs, refrigerators, washing machines, cell phones) in those provinces up 30 percent in 2008—significantly more than in other provinces. The new program will last 4 year and includes additional products (motor cycles, PCs, air conditioners, microwave ovens, and water heaters) at the discretion of local governments. The central and provincial governments will provide 80 and 20 percent of the funding. Other measures to stimulate rural consumption include a government program to increase the number of stores and distribution centers in rural areas and to renovate, standardize, and upgrade rural food markets.

There are also several tax policy changes. The reform to allow capital spending to be deducted from the VAT was rolled out nation-wide early this year. The consumption tax

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14 These are people on minimum living allowance (62.8 million), unemployed or receiving assistance from local governments (5.3 million) or the central government (6.4 million). Rural people received RMB 100 and urban people RMB 150.
on fuel was raised. With regard to foreign trade taxation, many rebate rates of VAT on exports were raised, the VAT rate on some imported mineral goods was raised, and the export tax on some products including steel products and fertilizers was lowered.\textsuperscript{15}

\textbf{Additional tax cuts are also discussed, but may not be desirable.} The combined package of recent tax cuts is already substantial, and comes on the heels of the earlier unification of corporate taxes at a lower combined effective rate. Also, tax revenues are already affected by the downturn. Finally, many tax cuts will also benefit people that are less affected and/or have a lower propensity to consume, eroding their effectiveness in raising domestic demand or protecting the most vulnerable.

\textbf{If tax cuts are considered, several points are worth noting.} First, further increases in the minimum threshold for paying personal income tax (PIT) would not be desirable. As a result of previous increases in this threshold (to RMB 2000/month), only an estimated 26 million persons still pay this tax.\textsuperscript{16} Were the threshold to be further increased to RMB 3000/month, this estimated number could fall further to only about 6 million, and it would benefit high income earners as much or more than middle income earners. If the aim is to cut labor taxation, it may be more effective to cut the social security charges that fund social protection programs, since over 200 million people pay these. Such cuts could be complemented by offsetting measures to protect the revenue base of these funds. Second, given the need to promote rebalancing, it would be unwise to consider further cuts in the corporate tax rate (CIT), as the corporate sector has already benefited disproportionately from the noted recent tax cuts, and given the current distortions affecting the distribution of income.

\textbf{Finally, to support rebalancing, further tax increases to improve the energy efficiency and environmental friendliness of economic activity in China should be considered.}

\textbf{Spending of many local governments may be particularly constrained this year.} Local governments traditionally carry much of the responsibility for spending on health, education, and social security. They are also expected to play a role in the financing of the 10 point plan package. However, many local governments do not have sufficient fiscal capacity, especially those in poorer areas. Moreover, the weakness in the real estate market has accentuated the financial problems of many local governments, because revenues from land sales are a key source of income. According to the Ministry of Land and Resources, local governments’ income from land transfers fell 20 percent to RMB 960 billion in 2008. Continued real estate market weakness is likely to contain such revenues, although the investment projects under the stimulus plan should increase land transfers. The pilot to allow some local governments to officially issue debt will help some. But it will not help the local governments with the weakest financial position, since the pilot is likely to include richer local governments with a strong capacity to repay. Pending more comprehensive reforms of intergovernmental relations, it may be necessary to increase ad hoc transfers to lower levels to fund key programs.

\textsuperscript{15} Policies towards the textile sector also include preferential loans and exempting the import tax on inputs.

\textsuperscript{16} Nicholas Lardy, presentation at World Bank-MOF Policy Seminar in Beijing, January 9 2009.
Box 3. Health care sector reform.

China’s health care system is widely recognized to be in need of reform. Recent years have seen a number of important policy initiatives, including in the areas of medical insurance and medical assistance. Building on these efforts, an Inter-ministerial Committee for Health Reform established in August 2006 has been working on a comprehensive health system reform plan for China.

An overall health care reform plan was formulated in consultation with and with input from different stakeholders, interest groups and experts. As part of the exercise, 8 institutions (including research centers, universities and international organizations (the World Bank and the WHO)) were invited to contribute a reform plan. The resulting draft outline of the government was put on its website last October to collect public feedback. This process in preparing the health reform plan has set an unprecedented model in China in the formulation of major national reform policy.

The plan sets out the government’s approach. The overall objective is to ensure universal coverage of basic health services through the establishment of a “basic health care system” which includes a public health system, a basic medical service delivery system; an essential drug supply system; and a health protection system. The health protection system is meant to consists of three main health insurance programs—basic medical insurance (BMI) for the urban formal sector, urban residents basic medical insurance (URBMI), the new rural cooperative medical system (NRCMS)—and a Medical Assistance (MA) program to subsidize health care premium and costs for the very poor.

The plan has five reform priorities. They are (i) scaling up basic health protection; (ii) a national essential drug system; (iii) better basic medical service delivery; (iv) more equal basic public health services; and (v) reform of public hospitals. To support the reform on these five priorities, the government plans to spend RMB 850 billion in 2009-2011, although the details, including on financing arrangements, are not yet know.

In “lower level” service delivery, the focus will be on revitalizing rural health services and building up community health service delivery systems. This includes building Community health centers (CHC), township health centers (THC), county hospitals and village clinics and training of health professionals working at the lower level. The central government will take on considerably more responsibility for the financing of lower level service providers. For CHC and THC, the government will finance or subsidize facility construction, equipment, staff salary and recurrent cost of the public health service. The profit markup of selling drugs will be abolished, although the financial implications still need to be worked out.

In the area of health protection, the focus is on scaling up the current schemes and improving the management. Enrollment rate is targeted at 90 percent by 2010 and the government subsidy to URBMI and NRCMS will be increased to RMB 120 per person by 2010, from RMB 80 now. This will imply roughly RMB 120 billion per year. The government’s subsidy to the MA program is expected to increase to RMB 6 billion per year. The government also subsidizes the BMI premium for the employees and retirees from bankrupted enterprises or enterprises with hardship, requiring RMB 30-50 billion per year.

1/ The details of the plan are yet to be published. The final reform plan is expected to be formally released in late March after the National People’s Congress’s annual meeting.
Box 3 (continued).

The national health reform plan is clearly moving in the right direction with the right focus. The government’s commitment to universal access to basic health care is encouraging. The five work priorities are also rightly identified. The plan has an appropriate focus on ensuring access to health services, reducing inequity in access between regions and between cities and the countryside, and better targeting towards basic services and disadvantaged population groups such as farmers, low-income urban residents, and senior citizens. In implementing the reform plan, several important issues need to be dealt with, including on the implementation approaches and incentive structures.

The government needs to ensure sufficient funding for the reform. Out of the total RMB 850 billion spending plan, about RMB 330 billion will be from the central government and the remainder is meant to come from local governments. This will pose major challenges for local governments in poor areas, where spending on health is constrained by weak revenues. The current slowdown may accentuate these pressures. There might be a need for the central government to focus its support to cash-strapped provinces and counties or to establish a central solidarity fund at the provincial level or even the national level to cross-finance the reform at the local level.

A rigorous monitoring and evaluation (M&E) system is of great importance. Considering the large financial commitment, the scope, the complexity and the depth of the forthcoming national reform, a rigorous M&E system is necessary to monitor progress, measure results, and evaluate the impact to ensure that the reform meets its intended objectives. China has a welcome tradition of doing pilots before introducing any significant policy reforms. However, there is a strong need also for evaluation of policies that is prospective, rigorous and well designed, to inform what worked and what did not. The current health reform needs to be closely monitored and its impact on out-of-pocket costs, poverty, quality of health care, and health status improvement should be evaluated so that any issues which emerge can be solved in a timely fashion.

Monetary policy

With inflation prospects subdued, there is further scope for expansionary monetary policy. Deflation is a risk, but policymakers have some weapons to fight it. Policymakers do not need to worry about a reduced pace of reserves accumulation. In the medium term, reform of monetary and exchange rate policy and in the financial sector can contribute to more equal access to credit.

With international and domestic growth prospects weaker and inflation projections revised down sharply, monetary policy was rightly loosened. The large scale injection of liquidity by the PBC made base money surge and is still keeping interbank and bill financing interest rates low (Figures 10 and 11). The reversal of quantitative policy, from credit controls to active encouragement, has played a particularly large role in boosting bank lending. Banks seem to have been keen to lend to the infrastructure projects under the stimulus plan. Looking forward, though, it is not clear that, once banks have finished with the pre-approved backlog projects and stimulus projects, bank lending will continue to grow rapidly. Banks’ balance sheets are not highly leveraged and thus not a constraint on further lending. However, until uncertainty has been reduced and there are stronger signs of a rebound, banks may be cautious in expanding lending to the private sector. Meanwhile, enterprises and households may also be reluctant to invest and borrow.
Subdued inflation prospects imply space for continued expansionary monetary policy. With raw material prices low and significant output gaps emerging internationally as well as in China, inflation is set to be low in 2009, and inflationary pressures are unlikely any time soon. If, despite these considerations, China's policymakers remain concerned about the impact of liquidity injections and other policy measures on inflation in industrialized countries, increasing the independence of monetary policy—via more exchange rate flexibility—would insulate China from inflationary dangers in the industrialized countries.

Deflation is a risk, but in China the government has some tools to fight it. In February, consumer prices were 1.6 percent lower than a year ago, and China will continue to see consumer prices down on a year ago for a while this year. However, this does not necessarily constitute the kind of deflation that is a problematic, with core prices and wages, as well as output, declining in tandem. Nonetheless, given the global economic weakness and likely significant spare capacity in the coming years, problematic deflation is a risk. To cushion this risk, it is a good time for the government to remove remaining price controls on some industrial inputs—energy, water, utilities, natural resources, and the environment—through price increases, tax measures and/or pollution charges, and allow the prices to reflect the full costs of supply, including environmental and depletion costs. Such measures would contribute to rebalancing the pattern of growth. Initiatives such as the significant increase in public pensions announced for 2009 and 2010 also mitigate deflation pressures, and more such steps could be considered if needed.

Policymakers do not need to worry about a somewhat reduced pace of reserves accumulation. In early 2008, large apparent non-FDI inflows fueled the accumulation of foreign reserves and became a concern for policymakers. In the second part of 2008, China’s accumulation of foreign reserves slowed. This was despite a renewed ballooning of the trade surplus to unprecedented levels, suggesting a reduction or even reversal of non-FDI capital flows. In the current context, some capital outflow need not be a source of concern. Unlike in many other emerging markets, the recent massive build up of foreign reserves stemmed from large current account surpluses instead of capital flows. China’s
current account surplus will continue to be very large in the years to come—even though from a global balance perspectives it clearly needs to come down. Even if FDI were to disappear completely, China’s “basic balance” is likely to remain significantly larger than reasonable estimates of potential outflows of “hot money”. Moreover, reserves are so large that, even if, as is unlikely, a few hundred billion dollars of non-FDI capital were to leave China, that would not be a major concern.

In the medium term, China’s exchange rate will continue to be supported by the large current account surplus. Looking at prospective balance of payment and relative productivity trends, the RMB is likely to strengthen in the coming decade in real effective terms. In the shorter term, the nominal exchange rate is determined by policy. While depreciation is sometimes suggested as a way to revive exports, when world demand falls away, it is unlikely that export demand can be stimulated by depreciating the currency. Depreciation would also be unhelpful for boosting consumption. Some of the confusion about exchange rate issues and policy in China is caused by an unuseful focus on the bilateral US$ exchange rate. The RMB has stopped its gradual appreciation against the US dollar since the early fall of 2008. But it has appreciated by an impressive amount in effective terms since then.

Also in the medium term, reform of monetary and exchange rate policy can contribute to more equal access to credit. China’s highly managed exchange rate regime compromises monetary independence. In the recent past, when policy was aimed at cooling the economy, concerns about the impact of interest rate increases on capital inflows led the authorities to impose credit controls instead. However, credit controls created distortions. In particular, they accentuated a bias in bank lending towards preferred, traditional customers, the large and/or state-owned companies. They have reduced access to credit by the newer and smaller enterprises which will need to play a prominent role in the future. Further reform and opening up, as well as the need to support SMEs would benefit from a larger role for the interest rate in monetary policy. This, in turn, would call for more exchange rate flexibility.

Financial sector policies

Impact of the Economic Slowdown on the Financial System

It is important to monitor the effect of the slowdown on the banking system. As Chinese banks had little direct exposure to the toxic assets that ignited the financial crisis and China has a relatively closed capital account, the direct effect of the global financial crisis has been limited. However, the indirect impact via the real economy will be much larger. As some of the recent investment in the export and real estate sectors goes bad, there will be an inevitable rise in non-performing loans (NPLs). Some of the smaller and newer banks may be particularly vulnerable. It would be helpful to speed up the reform of the bank insolvency resolution system in anticipation of potentially rising insolvencies.
Banks should not be pressured to ramp up lending beyond prudent levels. This would risk creating new NPLs, and thus greater risks of insolvency. It would also be seen as rolling back significant recent progress in moving to more market-based allocation of credit. Fortunately, the approach of the banking regulatory authority has so far been balanced. While noting that it encouraged commercial banks to support the government’s stimulus plan, it also stressed that they should perform strictly in line with the prudential requirements, such as concentration ratio, provisioning coverage ratio, and other best practices of risk management.

**Financial Sector Reforms to Support Rebalancing**

A well-functioning financial system can help China manage the slowdown and make the transition to a rebalanced growth model. The traditional growth model based on industry, construction, and exports was one that was well suited to a “big bank” financial system. China’s growth has been relatively capital intensive, and the banks could facilitate this – lending for real estate and manufacturing while holding as collateral the buildings and machinery. China’s banks have not been as effective providing finance to the smaller firms and to service industries that have fewer tangible assets. But these are exactly the firms that will play a more important role in the future and where most/many jobs will be created.

**Thus, further structural reforms can increase finance for micro and small enterprises and the service and rural sectors.** While micro and small firms may not have many tangible assets, successful ones often have good cash flow and receivables. Structural measures can help improve the flow of finance to such firms. Further liberalization of interest rates in rural areas and entry of institutions serving small or even micro enterprises will enhance their access to finance. Artificially low interest rates do not help micro and small firms; they simply cannot get credit. Such firms would benefit from greater access to credit, even if at higher rates than big firms pay. Scaling up the consumer credit information reporting system is also important: both for consumer lending and for lending to rural households and micro firms. Other innovations that could help smaller firms get access to credit include development of the leasing industry, micro-leasing, factoring, and reverse-factoring. Such structural reforms can also promote the formalization of “underground credit”, which should reduce the cost and lengthen the maturity of loans to small private sector borrowers.
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**Abstract:** This report reviews China's water scarcity situation, assesses the policy and institutional requirements for addressing it, and recommends key areas for strengthening and reform.

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**Author:** Zhao Jianping ; David Creedy  
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**Effects of Privatization and Ownership in Transition Economies**  
**Author:** Saul Estrin; Jan Hanousek; Evzen Kocenda; Jan Svejnar  
**Report No.:** WPS4811  
**Abstract:** The paper evaluates the effects of privatization in the post-communist economies and China. In post-communist economies privatization to foreign owners results in a rapid improvement in performance of firms, while performance effects of privatization to domestic owners are less impressive and vary across regions, coinciding with differences in policies and institutional development.