

**World Bank Office, Beijing**

**世界银行驻中国代表处**

# **Quarterly Update**

**February 2006**



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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 and the Development Economics Department. Questions and feedback can be addressed to Li Li (lli2@worldbank.org)

## OVERVIEW

**China's GDP growth hardly slowed in 2005, with domestic demand firmly taking the lead over net trade in the second half.** GDP Growth was 9.9 percent in 2005, 0.2 percentage point lower than in 2004. Investment was supported by still-robust profit developments and a relaxed monetary policy. Consumption, although still lagging GDP growth, was supported by strong income growth, especially in urban areas, and increasing consumer credit. While China's trade surplus of over \$100 billion for the year grabbed the headlines, the contribution of net trade to growth had already turned negative by the end of last year. Although the build-up of foreign reserves was billion very large in 2005, lower non-FDI capital inflows in the second half of the year suggest that the new exchange rate regime should over time add to domestic stability.

**The outlook for China's economy remains benign.** China will benefit from solid export demand, while profit and credit developments suggest that investment remains robust. Consumption may not accelerate much in 2006, though, held back by subdued rural income prospects. Price pressures should remain limited with more moderate commodity price developments and strong increases in potential GDP. Internationally, risks include a disorderly adjustment in global imbalances and trade tensions, even though China's trade surpluses are likely to come down. The main domestic risk is that abundant liquidity will re-fuel credit and investment.

**For macroeconomic policy, this implies that the "prudent" stance announced last year is appropriate for this year as well.** Monetary policy could in the short run focus on absorbing some of the excess liquidity to reduce the risk of excessive credit growth. This task may be complicated somewhat by active financial innovation, whose impact should be closely watched. The overall fiscal stance needs little change for now, but a shift towards social spending is needed to redress China's macroeconomic and structural imbalances. Over time, with a rebalanced economy that relies more on services and consumption, tax revenues may come under pressure. That should be countered by reforms in the tax structure and administration, and medium-term expenditure restraint.

**The GDP revisions moderate, but do not substantially change, the perspective on China's main structural challenges.** China still shows a heavy reliance on industry and investment and a lower than normal share of services in GDP. Interestingly, 2/3<sup>rd</sup> of the GDP revision came from higher price increases, which implies that China's *real* exchange rate has appreciated by 10 percent more than previously thought.

**The Party's guidance for the 11<sup>th</sup> Five Year Plan signals a change to more balanced growth, with more attention to the environment and income distribution.** While local leaders' announcements fall in line with these national goals, local growth targets remain high. To achieve these high growth rates, local spending is likely to continue to be directed at investment rather than at the social services needed for a harmonious society and a more balanced economy. The targeted reduction in energy intensity of the economy by 20 percent over the next five years is very ambitious, and the announced industrial policy, instead of pricing policies, to realize the target raises some concerns.

## RECENT ECONOMIC DEVELOPMENTS

**Growth held up well in 2005, supported by rebounding domestic demand in the second half.** As the effects of policy tightening measures of 2004 and early 2005 faded, investment and consumption increased pace just as export growth started to ease. Although China's 2005 trade surplus grabbed the headlines, the contribution of external trade to GDP growth declined throughout 2005, to about zero in December. On the basis of newly revised GDP data, GDP grew 9.9 percent in the last quarter of 2005 and for the year as a whole, compared to 10.1 percent in 2004. According to the old data, GDP rose an estimated 9.4 percent in 2005 (Figure 1).

**Investment has remained strong.** Reflecting the fading impact of the tightening measures and still favorable financing conditions, nominal fixed asset investment (FAI) growth edged up throughout 2005, despite a slowdown in FAI in real estate (Figures 2 and 3). As a result, year-average nominal FAI growth was at 25.7 percent not much lower than in 2004.<sup>1</sup> Within industry, FAI was strong in all sectors except communication, computers and other electronics, where it may have been weaker because foreign direct investment leveled off in 2005. Investment in inventories appears to have recovered through 2005, after the apparent draw down of inventories in response to the policy tightening. The continued strength of investment has raised concern among policymakers, notably because of the potential for future over-capacity in some sectors, and the consequences this may have for prices and profits. While it is true that prices in some consumer goods sectors are under pressure, reported excess capacity may not always be cause for concern. For instance, average capacity utilization in US industry typically varies between 74 and 85 percent over the economic cycle.

**Consumer spending has grown solidly but continues to lag investment.** Household consumption is buoyed by solid income growth and consumer credit. Nominal retail sales have been growing steadily at 13-14 percent (yoy) since May 2004, with declining inflation allowing real retail sales growth to rise from 10.2 percent in 2004 to 12 percent in 2005 (Figure 4). Growth in real *per capita* living expenditure of urban households rose through 2005 and averaged over 8 percent in January-November 2005, compared to about 7 percent in 2004. Households added 11.8 percent of GDP to their savings deposits in 2005, more than in 2004, although less than in 2003. Lower household residential investment explains at least as much of the higher addition in 2005 as higher household saving does.<sup>2</sup>

**External trade developments confirm that domestic demand is taking over growth momentum from exports.** Exports seem on track to a more moderate pace, after a 3 year bout of over 30 percent growth (in US\$). Merchandise exports growth slowed to 25

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<sup>1</sup> The internationally-comparable national accounts-based investment growth has in recent years been significantly lower than FAI growth. In contrast to the annual FAI data, the monthly FAI data (used in Figure 2) include only urban investment above a certain scale (RMB 50,000 for real estate and private FAI, RMB 500,000 for other FAI).

<sup>2</sup> According to the 36 cities urban household survey, household expenditure not spent on "living expenditure", which should largely be residential investment, did not increase (yoy) in January-November 2005, despite robust income growth.

percent in the fourth quarter of 2005 (in US\$) from 35 percent in the first quarter (Figure 5). At the same time, reflecting stronger domestic demand, merchandise import growth rose from 12 percent in the first quarter (yoy) to 22 percent in the fourth. With imports outpacing exports in December, the contribution of net trade to (yoy) growth became negative in that month (in nominal terms) just as the international headlines reported a record trade surplus of US\$102 billion in 2005.

**Foreign reserves surged in 2005, although capital flows moderated.** Despite a 2.6 percent exchange rate strengthening in 2005 to 8.07 yuan/dollar, and strong competition from other Asian countries, inward FDI was US\$ 60 billion in 2005, only slightly lower than in 2004. Outward FDI—largely through acquisition of foreign enterprises, especially in natural resource industries—increased in 2005 to US\$6 billion, bringing the stock of outward FDI to over US\$50 billion, almost 10 percent of the stock of inward FDI. Although inward non-FDI flows eased considerably in 2005, the large trade surplus and steady FDI inflows made China’s foreign reserves increase US\$209 billion in 2005 to US\$819 billion.

**Despite abundant liquidity, consumer price inflation remained low.** Swelled by the foreign reserves purchases, which were only partly sterilized, M2 grew by 17.8 percent (yoy) by end-2005, 3 percentage points more than targeted at the start of the year. However, credit growth has been less fast (see the November 2005 Quarterly Update), and consumer price inflation has been falling through 2005 to 1.6 percent (yoy) in December because of falling food prices and decelerating raw material prices (Figure 6). Measured by the broader measure of the GDP deflator, inflation was 3.8 percent in 2005. So far there is little to suggest that the higher growth in liquidity will spill over in substantial inflation, although it may unduly fuel investment.

**The National Bureau of Statistics (NBS) released revised national accounts data in January.** The *special focus* section (at the back of this Update) discusses the GDP revision and its implications. The section finds that, compared with the old data, the new data provide better information on the economy, show several changes in the structure, and indicate significantly faster price increases during 1993-2004. Nonetheless, the section also finds that the new data do not fundamentally alter the picture of China’s economy, its growth pattern, and issues of concern for policy makers.

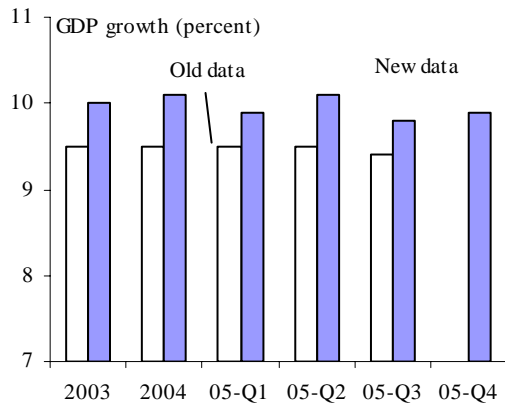
## ECONOMIC PROSPECTS AND POLICIES

**The Proposal for the 11<sup>th</sup> Five Year Plan (2006-2010) states policymakers’ key objectives.** It stresses that “economic development is the top priority”, but development should be “comprehensive, harmonious, and sustainable”. This implies “stable and relatively fast economic growth”, and the need to “step up the transformation of the economic growth pattern” towards growth that is less energy, resource and capital intensive, more knowledge and innovation-driven, and more equally shared.<sup>3</sup>

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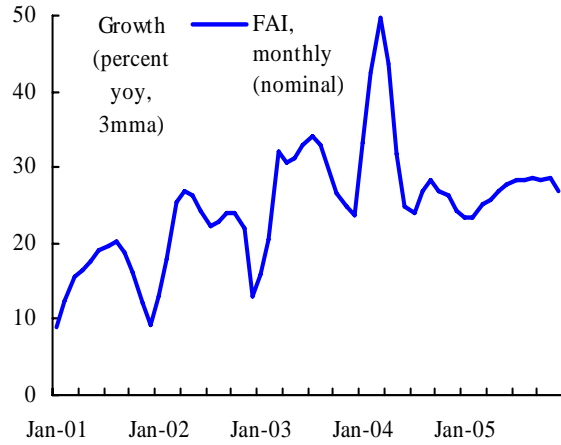
<sup>3</sup> Communiqué of the 5<sup>th</sup> plenary session of the 16<sup>th</sup> Central Committee of the CPC, October 11, 2005.

Figure 1. GDP growth remains high



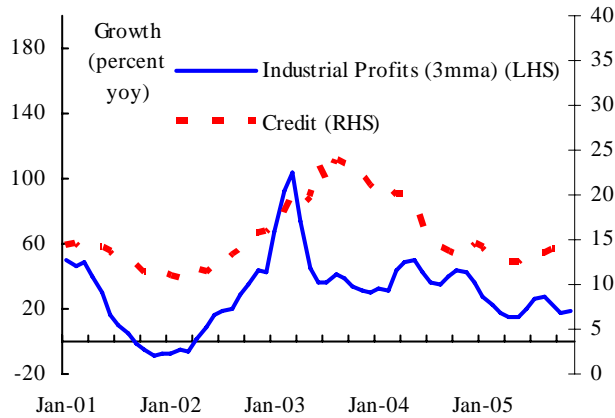
Source: NBS, staff calculation.

Figure 2. Fixed asset investment remains strong



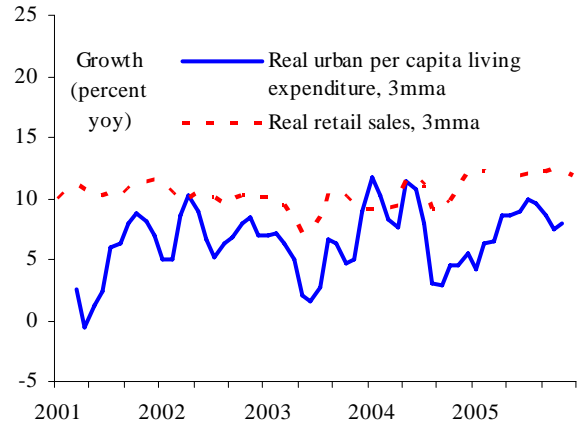
Source: NBS, staff calculation.

Figure 3. Investment funding keeps pace



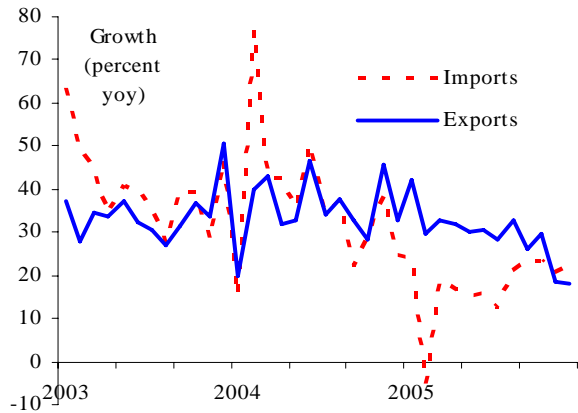
Source: NBS, and staff calculation.

Figure 4. Consumption strengthened in 2005



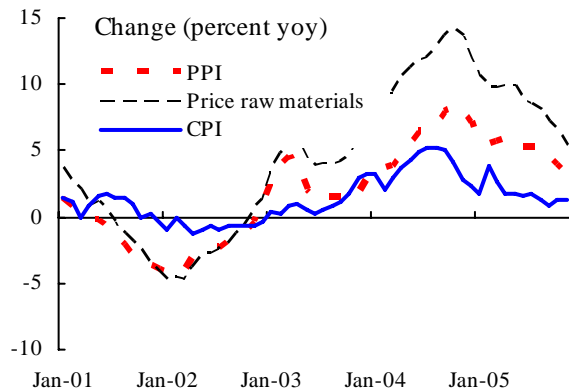
Source: NBS, staff calculation.

Figure 5. Imports are now outpacing exports



Source: NBS, CEIC.

Figure 6. Inflation pressures have declined



Source: NBS, CEIC, and staff estimates.

## I. THE OUTLOOK FOR 2006 AND MACROECONOMIC POLICIES

**How to maintain “stable, relatively fast growth”?** Policymakers would like to change the composition of demand, relying more on domestic demand and less on exports. Within domestic demand, they would like to boost consumption while keeping investment growth in check.

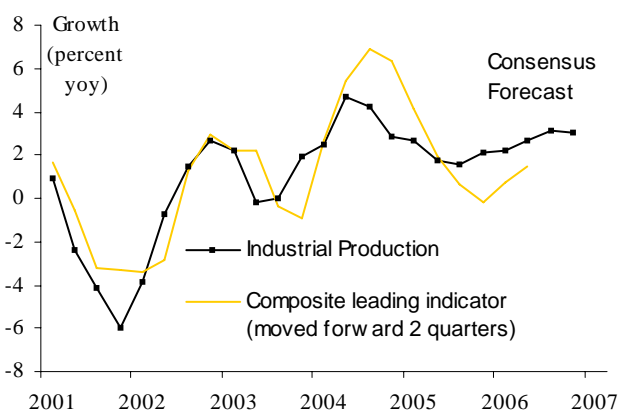
### The international setting is favorable.

After a good outcome for the world economy in 2005, forecasts for the US economy in 2006 remain positive, Europe’s growth prospects are strengthening somewhat, and in Japan domestic demand is perking up. Thus, external demand for China is expected to hold up well in 2006. This should prevent too abrupt a deceleration in exports stemming from negative domestic supply side effects—including a leveling off of FDI, some exchange rate appreciation, tax measures taken to discourage energy-intensive

exports, as well as a domestic demand recovery (Table 1 and Figure 7). On the price front, international energy prices, led by oil, have bounced back after falling at the end of 2005. The price of non-energy industrial commodities continued to surge, led by large gains in all major metals, apparently in part due to renewed demand strength in China. Nonetheless, the World Bank projects that international industrial commodities prices will ease in 2006. While there are upward risks to this

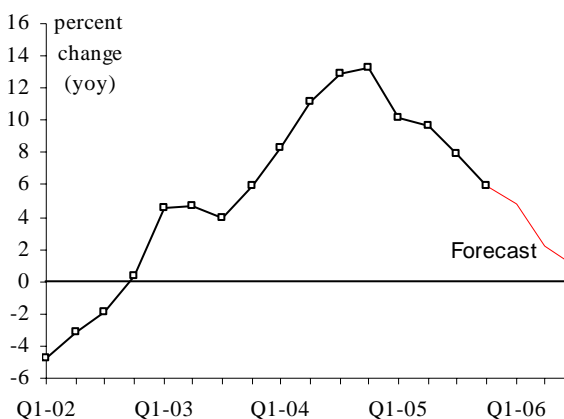
forecast (see below), the *rate of increase* should decline considerably, which—combined with a stronger exchange rate—is driving our projection that increases of China’s raw material prices should ease from 5.9 percent (yoy) in the fourth quarter to about 2 percent by mid-2006, which should mitigate inflationary pressures in China’s commodity-intensive economy (Figure 8).

Figure 7. China’s export markets grow steadily 1/



Source: OECD, National authorities, and World Bank estimates.  
1/ Indicators in advanced economies, weighted by their share in China’s total exports.

Figure 8. China’s raw material prices decelerate



Source: NBS and World Bank estimates.

Table 1.China: Main Economic Indicators

	2002	2003	2004	2005 1/	2006 2/
<b>The international setting (change in percent, unless otherwise indicated)</b>					
World GDP growth		2.5	3.8	3.2	3.2
Export market growth (high income countries)		4.4	10.4	6.5	6.6
Oil price (\$/bbl)		28.9	37.7	53.6	56.0
Price of non-oil commodities		10.2	17.5	11.9	-5.9
<b>The real economy (change in percent) 3/</b>					
Real GDP (production side - based on old data)	8.3	9.5	9.5	9.5	8.7
Real GDP (production side - based on new data)	9.1	10.0	10.1	9.9	9.2
Exports (goods and services) 4/	29.4	26.8	28.4	22.0	14.6
Imports (goods and services) 4/	27.4	24.9	22.7	13.5	16.5
Consumer prices (period average)	-0.8	1.2	3.9	1.8	1.8
GDP deflator	0.6	2.6	6.9	3.8	3.5
<b>Fiscal accounts (percent of GDP) 5/</b>					
Fiscal balance	-2.6	-2.2	-1.3	-1.1	-1.1
Total revenue	15.9	16.2	16.6	17.5	17.5
Total expenditure	18.5	18.3	18.0	18.7	18.6
<b>External account (US\$ billions)</b>					
Current account balance	35	46	69	129	117
Capital account balance	32	71	138	75	62
(including errors & omissions)					
of which: FDI (net)	47	47	53	50	50
Change in reserves (increase =+)	76	117	206	204	179
Foreign exchange reserves	286	403	610	819	998
<b>Other</b>					
Broad money growth (M2), e-o-p, in percent	16.8	19.6	14.6	17.6	15.0

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

1/ Estimate.

2/ Projection.

3/ Expenditure side components of GDP consistent with the new GDP data are not yet available. Estimation of these components requires many arbitrary assumptions, including on how the price deflators of these components changed during the revision.

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

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

**There are also international risks.** Key among them is a downturn in the US, possibly triggered by a correction of the US's large current account deficit that may include a weaker US dollar and rising international interest rates. Higher international interest rates stemming from other causes would also damage the international outlook. The benign forecast for international commodity prices is clearly subject to risk as well.

**Domestic economic conditions favor “stable, relatively fast growth”.** They include a favorable macroeconomic and financial setting and strong confidence. In this climate,

and given solid profit growth—20 percent (yoy) in the first 11 months of 2005, although slower outside mining—and ample liquidity in the banking system, investment growth should remain strong, although probably not as high as in 2005. We project GDP growth of 9.2 percent in 2006 (based on new data)<sup>4</sup> and moderate inflation, with headline inflation depending on the possible adjustment of administered prices for public utilities (e.g., electricity, water, gas) and fuel planned for 2006.<sup>5</sup> With export growth easing and domestic demand strong, the current account surplus should decline in 2006, although it will take a while before it declines substantially.

**Changing the composition of domestic demand may take time.** Household consumption will be supported by solid income growth, particularly in urban areas, some tax initiatives and other fiscal initiatives, including some further support for rural areas and an expected 15 percent wage increase for civil servants. But we do not see a dramatic pickup in consumption soon, largely because it is difficult to significantly boost rural income growth in China without much faster out-migration. Despite a favorable (one-off) impact of removing agricultural taxes and rural fees, real rural per capita income growth declined in 2005 to 6.2 percent, and compared to 9.6 percent in urban areas. Rebalancing the composition of demand will have to rely to a large extent on policies addressing structural issues, including public finance measures, financial sector reform, dividend policy and corporate governance, and these take time (see the November 2005 Quarterly Update). Probably the most effective way to change the composition of demand towards consumption is to move ahead on a dividend policy for SOEs and to ensure that the revenues go through the overall budgeting process, so that they can finance reforms in education, health, and social security (Box 1).

**The key macro policy debate centers on deflation and inflation.** Over-investment and over-supply have depressed prices in some industries. Looking ahead, unduly strong investment and a faster-than-expected deceleration of exports would exacerbate excess capacity and downward pressure on prices.<sup>6</sup> However, generalized deflation—properly measured—is not likely in China. At any rate, supply-side driven deflation cannot be alleviated by relaxing monetary policy and fiscal support along traditional lines. Traditional policy relaxation boosted investment rather than consumption. Thus, such policies would accentuate the problem. Rather, it requires rebalancing spending towards consumption and reigning in undue investment, including by strengthening the market mechanism in allocating capital. These policies could be flanked by opportunistic adjustment of administered prices. Some are concerned about significant inflation. However, inflationary pressures should remain moderate, even after the relaxed monetary conditions in the second half of 2005 and a pick up in services price increases, but depending a bit on the adjustment of administered prices. This is because of the benign outlook for international commodity prices, some currency strengthening, and rapid growth of potential GDP.

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<sup>4</sup> This implies an unchanged forecast of 8.7 percent based on the old data

<sup>5</sup> Currently most water companies are running losses, natural gas is priced at about half of the international price, and fuel prices are not aligned anymore with international prices.

<sup>6</sup> As concerns exports, this is actually only true if exports are slowing down due to demand factors.

**Box 1. SOE dividend payments: Why, How Much, and to Whom? <sup>1</sup>**

**China's increasingly profitable SOEs do traditionally not pay dividends to the government.** China's state-owned enterprises (SOEs) overseen by the central government's State-Owned Assets Supervision and Administration Commission (SASAC) made net profits of RMB 600 billion during 2005, representing 3.3 percent of GDP and equivalent to 1/5th percent of fiscal revenue. Yet, for historical reasons, no government entity receives any dividends from these SOEs, a pattern that mostly applies as well to locally-administered SOEs. This is in contrast to other countries, where the state, as key shareholder, receives dividends from SOEs, just like other shareholders.

**There are good reasons for having SOEs pay dividends to the state.** First, within-firm allocation of capital does not receive the same scrutiny as channeling via the financial sector, which may make the allocation less efficient. The lower a firm's growth and profitability prospects are, and the weaker corporate governance is, the more likely it is that retained profits are used inefficiently—for excessive investment, corporate perks, or non-economic diversification—and that pay-out of at least some of the profits to its shareholders improves efficiency. Keeping most profit in the firm may also lead to procyclical investment behavior of enterprises, making the economy prone to “boom and bust cycles”. These issues are of particular concern when corporate governance is weak. Second, it is reasonable for the State to receive some return on its assets, just like other shareholders. This argument has become all the more valid now that the State has borne most of the restructuring costs for enterprises: it has taken over social obligations such as schools and hospitals, and it has taken over much of the responsibility for costs associated with workers' unemployment and early retirement. Indeed, the shedding of these obligations played a big part in the rise in SOE profits. Finally, having SOEs pay dividends would be one of the most effective ways to shift the trade-off between consumption and investment to increase the role of consumption, currently a major objective of economic policy.

**SOE dividend policy is being discussed.** Following the establishment of SASACs at the central, provincial, and municipal levels during 2003-04, SOE dividend policy was brought to the government's reform agenda when the annual working conference of SASACs discussed the issue of a “state assets management budget” in January 2005. Central SASAC Chairman Li Rongrong indicated that his Commission would “work closely with the Ministry of Finance to try to start this reform this year following the strategy set by the State Council”. While there is fairly wide recognition of the rationale for a SOE dividend policy, practical implementation in China requires resolving further issues, including:

- **How much to pay?** International experience suggests it depends on a firm's growth prospects. In general, dividend policies for SOEs are similar to those for private firms, although in some countries dividend targets are set higher for SOEs, reflecting the idea that SOEs capital is a “public trust”.
- **Who to pay (i.e., what to do with the dividends)?** The issues brief (see footnote 1) discusses alternative arrangements, taking into account the institutional setting and the role of SASAC and the Ministry of Finance but emphasizing that SOE profits are public revenues and should be managed as such, with decisions on spending approved by the National People's Congress through the integrated budgeting process in order to better prioritize public spending across sectors.

1/ This box is an abstract of a World Bank issues brief that discusses in more detail the rationale for a dividend policy and considerations in developing and implementing such a policy. See <http://www.worldbank.org/china>, under “publications and reports”.

***Monetary policy—complicated by exchange rate issues and financial innovation***

**Exchange rate considerations determined monetary policy in 2005.** M2 was boosted by PBC purchases of foreign exchange (RMB 2000 billion), stemming from continued surpluses on the balance of payments which were only partly sterilized. The resulting liquidity drove down inter-bank rates to low levels in line with the goal of discouraging financial capital inflows. In addition to sterilizing less, the PBC also lowered the interest rate on excess reserves from 1.6 percent to just under 1 percent in February. This brought additional liquidity into the market, as banks tried to reduce excess reserves, and the result was further downward pressure on inter-bank interest rates. The trend of falling inter-bank rates was in sharp contrast to international rates, notably US rates, which moved upwards for most of the year. Combined with the introduction of some flexibility in the exchange rate, and the authorities' increasingly credible commitment not to pursue a second step-wise appreciation of the currency, this may have deterred capital inflows. Indeed, capital inflows seem to have receded and balance of payments surpluses are now largely determined by the current account rather than the capital account.

**The relaxed monetary policy seems to have come to an end as of the fourth quarter.**

The relaxed monetary policy was at odds with the already strong economic growth and concerns about high investment, even though credit grew much less than M2. The PBC has stepped up its issuance of central bank bills at the end of 2005, and inter-bank interest rates are now on the rise. However, inter-bank rates are still much lower than banks' lending rates—which did not change in 2005—and therefore it remains more attractive for enterprises (at least those who have access) to issue corporate notes rather than take normal loans from the banks. Between May and December 2005, companies issued corporate notes equivalent to RMB 142 billion, which was a significant contributor to total bank lending.

**Financial innovation, while largely welcome, will complicate monetary policy.**

The PBC's monetary targets for 2006 reflect a somewhat tighter stance than the outcomes for 2005, although not compared to the targets for last year. The announced growth in M2 of 16 percent, M1 of 14 percent, and credit of 12 percent imply a further decline in the loan over deposit rate, and a further decline in velocity of money. Given past trends in monetary velocity, these targets would be consistent with inflation of below 2 percent. However, the active financial innovation, the introduction of, among others, short term corporate notes, asset-backed securities, and financial bonds, is likely to complicate monetary policy, because they have opened up more channels of credit to the real sector and are changing the nature of the transmission of monetary policy. This comes at a time when the new exchange rate regime requires the authorities to formulate new principles and practice of monetary policy.

**In the longer term, financial sector reforms should allow interest rates to rise.** This would be consistent with the financial sector gaining the capacity to reach underserved parts of the economy with more productive investment.

*Fiscal policy—how to support consumption under prudent fiscal policy?*

**Fiscal developments in 2005 continued to benefit from favorable—but not everlasting—economic trends.** Tax revenues are estimated to have risen 18 percent, with total revenues up even somewhat faster.<sup>7</sup> All major taxes are projected to have increased more than 18 percent except for “Consumption tax and VAT on imports”, which grew only 14 percent in the face of slow imports for much of 2005. These strong revenues allowed the fiscal deficit to decline to about 1 percent of (revised) GDP even though expenditure grew an estimated 17 percent, compared to a budgeted 13.5 percent.<sup>8</sup> It is not easy to verify to what extent the government is succeeding in shifting the composition of spending “from physical infrastructure towards social infrastructure”, in part because of weaknesses in the current expenditure classification. Progress here, and on transparency in general, would improve the effectiveness of fiscal policy. Judged with the conventional tools of analysis, the fiscal stance was mildly contractionary in 2005, in line with the spirit of prudent fiscal policy (Box 2). However, the favorable economic trends that have boosted revenues—and which are not captured in the conventional analysis of the fiscal stance—may not last. In particular, efforts to rebalance the economy away from reliance on capital and industry towards more reliance on labor and services—welcome by themselves—may affect the buoyancy of fiscal revenues in the medium term.

**Prudent fiscal policy may therefore call for more moderate expenditure growth in the medium term.** Additional considerations are: (i) “contingent liabilities”, including from the financial sector, the pension system, and local governments (Box 3); and (ii) concerns about the efficiency of spending, given the weak administrative capacity in many local governments. All this does not mean that there is no room for increasing spending in the medium term on reform of social security, health, and education. In particular, scope will remain for adjusting the composition of spending, reducing capital spending, including capital transfers.

**The government targets a prudent fiscal policy in 2006 and wants to adjust the composition of spending.** The Minister of Finance indicated that the deficit target for 2006 would be a little lower than the RMB 336 billion targeted in 2005, implying some increase compared to the estimated 2005 outcome. He also indicated that “the country would adjust and optimize the structure of government spending”, with priority given to rural construction, science, education, medical care, social security, energy saving, ecological construction, environmental protection and western development. The government will also adjust and regulate income distribution to propel growth of consumer spending.”

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<sup>7</sup> Based on the new GDP data, the revenue to GDP ratio looks less good than it did based on the old data, although, by the same token, the debt to GDP ratios look better.

<sup>8</sup> The fiscal data may not measure all local government spending (see also Box 3). On the other hand, it may also not measure unspent local government revenues.

### Box 2. Assessing the fiscal stance

**Fiscal developments have been favorable in recent years.** Tax revenues grew from a trough of 9.9 percent of GDP in 1995 to 12.7 percent of GDP in 2000 and an estimated 15.9 percent of GDP in 2005, and total revenues rose even faster. Expenditures grew in line with revenue—that is, also significantly faster than nominal GDP. The resulting measured (official) deficit has been modest. Around 1 percent of GDP in the second half of the 1990s, it rose as a result of the “proactive” fiscal policy initiated after the Asian crisis, and came down again in recent years.

**A standard assessment would suggest fiscal policy has been prudent since 2003.** Adjustments to the government deficit for cyclical developments are small, since the estimated output gap has been small and relatively stable since 1999 (Table). However, the accumulation of arrears in tax rebates to exporters during 2000-2002, and the repayment of these arrears in 2004 and 2005, affect the correct measurement of the fiscal stance. Adjusted for the changes in arrears, the deficit was higher in 2000-2002 and lower in 2004 and 2005. The accordingly adjusted fiscal impulse measurement suggests that the fiscal stance has been neutral in 2001-02, and tight in 2003-05 (Table). A caveat is that local government fiscal developments are not fully reflected in these numbers. On the one hand, in recent years many local governments ran surpluses that are not fully reflected in the fiscal accounts. On the other hand, off budget local government borrowing has led to spending and deficits also not reflected in these numbers. These practices reduces the control of the Ministry of finance over fiscal policy and the information content of fiscal data. Box 3 discusses local government debt issues.

**The standard assessment of the fiscal stance do not tell the whole story, since a changing economic structure explains most of the favorable tax revenue developments.** Tax revenues have benefited from the shift in economic activity from agriculture to industry and services and from the rising share of imports in GDP. The tax to GDP ratio increased 3.2 percentage point between 2000 and 2005. This is fully accounted for by taxes whose tax base developed particularly favorably. The increase in corporate income tax, up by 1.3 percentage points of GDP, is more than fully explained by the increase in profits during this period. Taxes on imports (“Consumption tax and VAT on imports”), up by 0.8 percentage points of GDP, is fully explained by higher imports. And, business taxes and personal income taxes, both up by 0.5 percentage point of GDP in 2000-2005, have benefited from rapidly growing private sector activity and wages. In other words, fiscal deficits developed favorably, even as expenditures rose rapidly, because of changes in the economic structure boosting tax revenues, rather than due to tight fiscal policy as suggested by the standard assessment. Indeed, looking forward, the government cannot count on these trends continuing. In particular, efforts to rebalance the economy away from reliance on capital and industry towards more reliance on labor and services—welcome by themselves—may affect fiscal revenues.

**Table. China's fiscal developments.**

	2000	2001	2002	2003	2004	2005 (estimated)
Revenues	13.8	15.2	15.9	16.2	16.6	17.6
Tax Revenues	12.7	14.0	14.7	14.7	15.1	15.9
Nontax Revenue	1.1	1.3	1.3	1.4	1.5	1.7
Expenditure 1/	16.3	17.5	18.5	18.3	18.0	18.7
of which: Subsidies to Loss-making Enterprises	0.3	0.3	0.2	0.2	0.1	0.0
Balance	-2.5	-2.3	-2.6	-2.2	-1.3	-1.1
Balance (adjusted for tax rebate arrears)	-2.9	-3.4	-3.4	-2.2	-0.8	-0.2
Cyclically adjusted balance 2/	-2.4	-2.0	-2.3	-1.8	-1.0	-0.7
Cyclically adjusted balance, adjusted for tax rebate arrears	-2.8	-3.1	-3.1	-1.8	-0.4	0.2
Fiscal impulse (percent of GDP)						
Adjusted for the cycle and for tax rebate arrears	na	0.3	0.0	-1.2	-1.4	-0.6
<i>Memorandum item:</i>						
Estimated output gap (percent of GDP)	-0.5	-1.5	-1.7	-1.5	-1.4	-1.4

Source: Ministry of Finance and staff estimates.

1/ Expenditures may not include all local government spending.

2/ Assuming a tax elasticity with respect to GDP of 1.5, with no impact on expenditures.

**Box 3. How to manage local government debt?**

**Fiscal risks stemming from local government borrowing are an increasing concern.** In China's very decentralized government system, sub-national governments are responsible for about 70 percent of total government expenditure, including for health, education, and much of social security. Mismatches between expenditure assignments and revenues of local governments, as well as overspending, especially on investment and salaries, mean that many local governments are short of revenues to meet their expenditure obligations. As a result, ad hoc, often *off-record* borrowing by local governments has been prevalent, even though under current provisions local governments are forbidden from borrowing unless explicitly approved by the State Council. World Bank staff estimates that the *increase* in *on-record* county-level (including township-level) debt in 2004 was quite significant compared to local GDP and to China's total government expenditure, even though most of the debt is *off-record*. Against this background, an active debate has ensued on options in improving local government debt management.

**China currently does not have a nationwide regulatory framework and a coherent local debt management system.** Local governments' foreign loans, state bonds, and central bank loans for addressing local financial risks are well-monitored, and their servicing is enforced. The Ministry of Finance (MoF) makes deductions from fiscal transfers if a local government does not service those debts. However, these debts form a small part of total local debt. The MoF also requires that provincial finance bureaus submit debt reporting tables annually and that sub national governments establish a debt repayment fund (amounting to 3 to 8 percent of direct explicit outstanding debt—the appropriateness of the size is subject to debate). However, the implementation of these measures has been uneven and ineffective. Moreover, the majority of local debt is unrecorded and not subject to any regulation.

**A range of reforms is necessary to manage current debts and risks, and prevent undue new debts and risks.** Revising the current legal provisions to allow local borrowing is a sensible policy choice, as is establishing a new legal framework for local borrowing. This is a complex task though. A carefully-designed and well-sequenced reform package could include the following elements. First, strengthening the debt reporting information system and improve local governments' financial management capacities. A reliable, standardized and consistent local debt information system is the prerequisite for a meaningful local debt management system. Second, establishing a local debt management system. Countries around the world have introduced various types of systems, from heavily regulated ones (Brazil, Bolivia) to market-based ones (Finland). In a non market-based system, quantitative borrowing limits have to be established, with rules on access to borrowing (and how) and under what conditions. Third, developing a debt workout plan to help heavily indebted local governments. Immediate options include debt rescheduling, revenue mobilization and expenditure reduction. Fourth, fundamentally, fixing the intergovernmental fiscal system. Realigning expenditure and revenue assignments is critical, so is improving the transfer payment system to make it more transparent and consolidated, and more incentive-compatible.

**II. STRUCTURAL AND SOCIAL POLICIES**

**The 11<sup>th</sup> Five-Year Plan (FYP) constitutes a policy shift.** The 5<sup>th</sup> Plenum of the Central Committee of the 16<sup>th</sup> Party Congress of the CCP was held in October, 2005 to adopt a

CCP Proposal for the upcoming 11<sup>th</sup> FYP (for 2006-10) to be reviewed and approved by the NPC session in March 2006. The November Quarterly Update briefly reported on this, but this guiding document for the next five years deserves more attention. Indeed, the guidance for the plan is a major departure from past plans that largely focused on growth as the key objective. Although rapid growth remains a key objective, the “Harmonious Society” with the “Five balances” to be achieved through a “Scientific Approach to Development” has taken center stage. These concepts, which have entered the vocabulary since the 3<sup>rd</sup> plenum of the Central Committee of the 16<sup>th</sup> Party Congress in 2003, together promise a different approach to development, one that emphasizes more equitable development and more care for the environment.

**The Plan will have key guidelines and benchmarks.** The Proposal itself had only 2 quantitative *targets*: “doubling per capita GDP of 2000 by 2010” and “reducing energy intensity by 20 percent”. Together with 2 other key objectives, “construction of a new socialist countryside” and “structural upgrading of the economy through self-innovation”, these are discussed below. Other *benchmarks* considered by policymakers are: (i) increasing urbanization to 48 percent; (ii) raising real per capita incomes by 5 percent per year in both urban and rural areas; (iii) substantially increasing the share of rural people with health insurance coverage; and (iv) reducing “over pollution by 5 percent. Officials of the National Development and Reform Commission (NDRC) have indicated that, with China increasingly becoming a market economy, most quantitative *benchmarks* should not be seen as strict government targets.

**“Doubling the per capita GDP of 2000 by 2010” should not be difficult.** With average

growth of 9.5 percent over the 10<sup>th</sup> Five Year Plan period, and modest population growth in the years ahead, the target will only require GDP growth of under 7 percent for the next 5 years. Interestingly, all of the local governments that have announced their growth goal for the 11<sup>th</sup> Plan are far more ambitious (Table 2). This discrepancy may not be immaterial. There are three issues here. The first is one of consistency of planning. Central government planning decisions on items such as large infrastructure and budget projections for revenues and spending may

**Table 2: All above average**  
(Announced local growth targets)

Beijing	9%
Shanghai	9%
Guangdong	9%
Shangdong	10%
Hebei	11%
Liaoning	11%
Tianjin	12%
Inner Mongolia	13%
<i>Memorandum Item</i>	
Necessary GDP growth to double income per capita	<7%

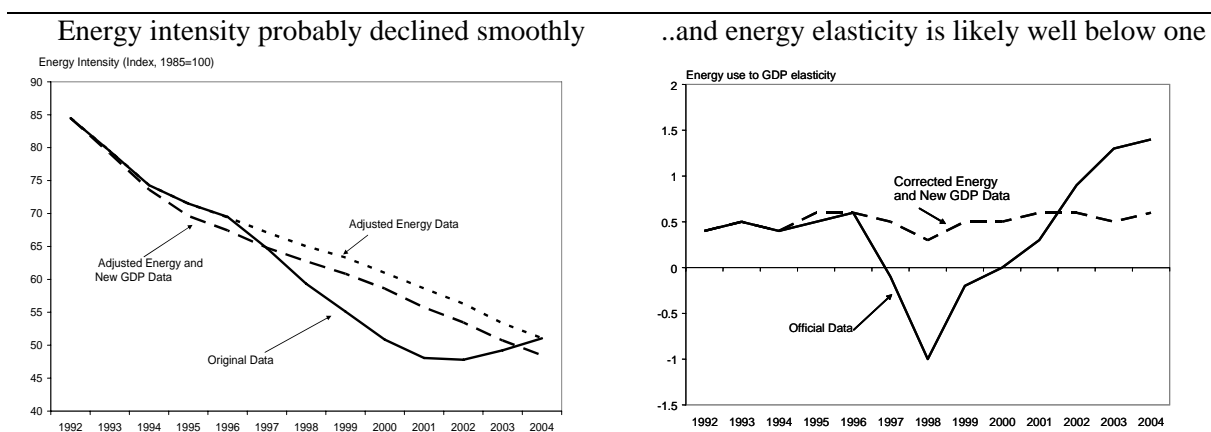
Source: Various Media Reports

well be based on the more modest central target. In finalizing the 11<sup>th</sup> FYP at central and local government level, it may be worthwhile to revisit the growth numbers to ensure internal consistency. The second one is one concerning rebalancing of the economy: if local governments, which control 70 percent of fiscal spending, want to achieve their planned—high—growth rate, they will have to again heavily invest in infrastructure, leaving insufficient fiscal space for the social spending needed to rebalance the pattern of economic growth. Thus, the growth target does influence the composition of growth. The third one concerns local government debt and the associated fiscal risks. The high local

growth targets and spending needs stimulate ad hoc local borrowing (see Box 3). For these reasons, more moderate growth targets at the local level would be desirable.

**“Reducing energy intensity of the economy by 20 percent” will be more ambitious.** According to the official energy statistics, this would be near-impossible. The reason is that according to these statistics energy use has skyrocketed in recent years: the energy intensity of the economy, after years of strong decline, shot up in the period 2001–2004, and the GDP elasticity of energy use (how much extra energy was used to produce extra GDP) came, for the first time since the reform period, above one (Figure 9). However, as others have pointed out,<sup>9</sup> energy data since the mid-1990s are likely to be misleading, induced by policies of the late 1990s that aimed at closing small coal mines. Most likely, rather than being closed, the mines disappeared from the statistics. A rough correction for the deficient coal statistics as done by Jonathan Anderson of UBS changes the picture considerably (Figure 9). The energy intensity, rather than rapidly declining in the late 1990s and spiking in recent years, saw a smooth, gradual decline over the whole period since the mid-1990s. With the new GDP data, this decline becomes even steeper.

Figure 9. Energy Intensity and GDP Elasticity of Energy Use



Source: NBS, UBS, and staff estimates

Source: NBS, UBS, and staff estimates

**Even with the new numbers, though, the 20 percent reduction in energy intensity within only five years will be hard to meet.** Such a reduction, assuming a 7.5 percent growth rate (more than enough to double income between 2000 and 2010), requires an elasticity of 0.34 (for every 10 percent increase in GDP energy use increases by 3.4 percent), whereas over the last 5 years that elasticity has been 0.5, and in 2004 it was 0.6.<sup>10</sup> This suggests that considerable policy action will be required to meet the energy

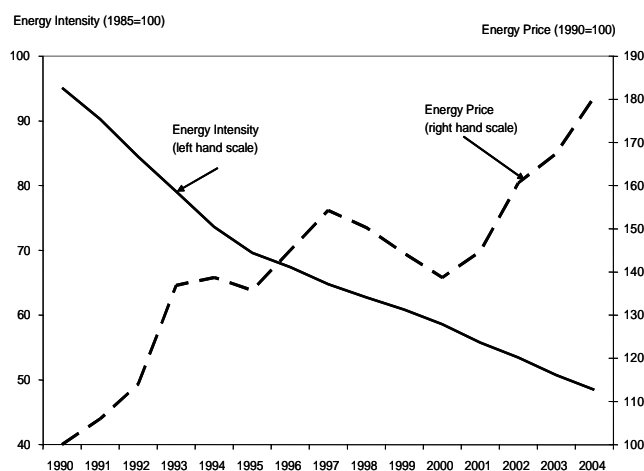
<sup>9</sup> The discussion on statistics is in part based on Jonathan Anderson, *The Great China Energy Debate*, UBS, *Asia Focus*, December 15, 2005. See also Jonathan Stinton, *Accuracy and Reliability of China's Energy Statistics*, *China Economic Review* 12 (2001) 373–381 and Barry Naughton, *China Leadership Monitor*, No. 16.

<sup>10</sup> Ironically, the higher growth will be, the higher the elasticity of energy use can be to achieve the 20 percent reduction in energy intensity. For instance, with 9 percent growth, the energy elasticity needed is 0.43. The reason for this is that the elasticity measures *additional* energy use in relation to *additional*

efficiency goal of the Plan. Perhaps for this reason the NDRC recently announced a far-reaching industrial policy to achieve energy efficiency, the *Provisional Regulation for Industrial Structure Adjustment*. The policy declares 399 industrial sub-sectors to be “banned”, 190 sub-sectors to be “restricted,” and 599 to be “encouraged. With this policy the NDRC hopes to achieve a less energy intensive structure of the economy, although it remains to be seen what the operational implications of the announced policy are.

**More emphasis on pricing of energy could help in reducing the energy intensity.** Indeed, China’s own past performance in reducing energy intensity suggests that higher prices have played a substantial role in the recorded savings (Figure 10). Throughout the 1990s energy prices rose much faster than overall prices, as prices of coal and oil were rapidly aligned to international market prices—a policy which was suspended with the recent price increases on the international energy market. A first step would be to align prices again with international prices. This would have the additional beneficial effect that the occasional shortage of gasoline and gas that has occurred in recent months will likely disappear. But for the planned savings to occur, China will probably have to start taxing energy to incorporate the costs of environmental degradation and energy security. How this should be done, and how to protect vulnerable groups such as farmers, is a challenge that would need to be tackled sooner rather than later. Indeed, the rapid growth in car ownership suggests that resistance to appropriate pricing of fuels will only increase over time.

Figure 10. Energy Pricing Works



Source: NBS, Staff Estimates

Note: “Energy price” is proxied by the price of output of the coal industry relative to the GDP deflator. Coal was on average 70 percent of China’s energy use.

In addition to these two quantitative targets, two other goals stand out.

**First, the “Construction of the new socialist countryside” largely focuses on improving agricultural productivity.** The government wants to improve service delivery and infrastructure, reduce production and transportation costs; speed up technological progress, including higher crop yields; improve administrative, financial and other institutions in rural areas; reduce farmers’ tax burden; and finance compulsory education.

GDP. Existing GDP is relatively energy inefficient, but “new” GDP is much more efficient, so the more “new” GDP, i.e. the higher the growth rate, the easier it is to achieve the desired energy intensity.

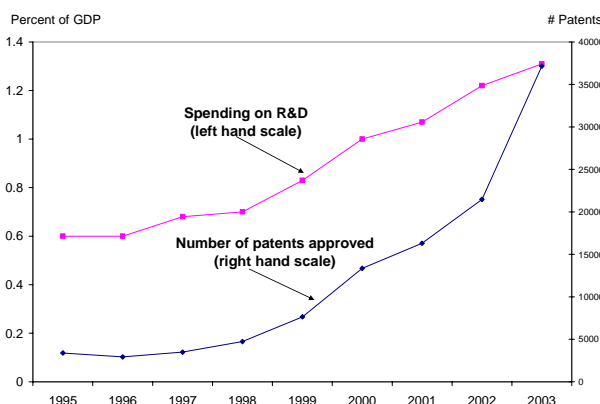
**Much of the progress in farmers' income relies on better infrastructure, crop shifts to higher value added products, and fewer agricultural workers through out-migration.** That is because agricultural yields per *mu* are already very high in China, prices have by and large reached international prices, and the agricultural taxes and most fees on farmers have already been abolished. The alternative, ever-increasing subsidies for agriculture, may not be desirable, not just from a fiscal point of view, but also because the subsidies may lead to over-production and a drop in market prices. Progress in the Doha round could also help, as liberalization in agriculture, notably in heavily protected markets in some of China's neighbors, supports world market prices.

**The government's plans for more social spending, notably on basic education, and to expand the health insurance system may be the best option for raising living standards in rural areas—as opposed to income improvement.** The reason is that these measures, apart from resulting in better educated, healthier people in rural areas, would also increase freely disposable income and reduce precautionary savings by households. China's household saving in general is high although not exceptional for East Asia. What is exceptional is that even among the poor the savings rate is high. This means that poverty measured by the World Bank standard of the number of people who *consume* less than \$1/day, which is some 10 percent of the population, is almost double that of *income* poverty at \$1/day. Experience in other countries has shown that a credible health insurance could add significantly to people's consumption. In Vietnam, for instance, the increase in the consumption share of the poor after introduction of a health insurance was some eight percent of income. An added benefit of this higher consumption is that China's macroeconomic imbalances would be reduced.

**Second, “structural upgrading of the economy through technological self-innovation” seems feasible.**

Although technological renovation has long been a government goal, the guidelines for the plan for the first time emphasize *self* innovation. Presumably this means more emphasis on home-grown technological progress, rather than the imported variety that, through FDI and adoption by domestic enterprises, has played a major role thus far in China's transformation. Over the last decade, government and enterprises in China have spent an increasing share of GDP on R&D, and with about 1.3 percent of GDP in spending, China now compares well with other lower middle-income countries and some OECD countries (Figure 11).<sup>11</sup> This spending seems to start paying off in terms of patents granted. While the majority of these patents are still granted to

Figure 11. Tech spending paying off



Source: China Science and Technology Statistics, 2003, and SIPO.

<sup>11</sup> Canada spends 1.6 percent of GDP on R&D, Spain and Mexico some 0.9 percent, Brazil 2.1 percent and the United States 2.7 percent of GDP.

non-residents, the share of patents awarded to residents (“self-innovation”) is rising. And there is likely more to come: in a recent UNCTAD survey among multinational companies, China topped the list of countries where those companies were likely to establish an R&D facility.<sup>12</sup> A key reason for the choice of location is China’s large pool of university-educated scientists and engineers.

**With this enthusiasm for R&D in China, additional policy incentives need careful consideration.** The proliferating “technology zones,” which have proven to be less successful in other countries, may be an unnecessary drag on revenues and land. And time will tell whether China’s effort to develop domestic technology standards in competition with already accepted standards from abroad will be successful. More important than fiscal incentives are the availability of private venture capital to fund innovations beyond the research stage and better protection of the property rights for would-be inventors.

**Many of the proposals for the 11<sup>th</sup> FYP are reflected in the policy agenda for 2006.** The Central Economic Working Conference held in early December concluded with an agenda of 8 points for 2006: (i) stabilizing macroeconomic policy; (ii) constructing a “Socialist New Countryside”; (iii) strengthening capacity of innovation to promote structural adjustment; (iv) saving energy, resources and promoting environmental friendly society; (v) promoting beneficial interactions among eastern, central and western regions; (vi) speeding up reform to remove institutional obstacles to the implementation of the “Scientific Development Concept”, including: administrative system reform focusing on transformation of government functions, deepening enterprise reform focusing on property rights, deepening fiscal and taxation reform focusing on the public finance system, financial sector reform focusing on strengthening corporate governance and internal control, and building market systems focusing on perfecting functions of markets; (vii) implementing a win-win strategy of opening up; (viii) promoting a harmonious society, by solving issues that have the most direct and immediate relevance to people and they are most concerned with, including employment, social security, legal protection of migrant workers, income distribution, free compulsory education in rural areas, urban community health system, rural new cooperative medical insurance.

#### ***FINANCIAL SECTOR POLICIES AND DEVELOPMENTS***

**China’s bond market expanded and developed rapidly in 2005.** Issuance volumes for T-bonds, central bank papers, policy banks’ bonds, and enterprise bonds increased rapidly (Table 3). In addition, several new products were introduced, including asset-backed securitizations (ABSs), mortgage-backed securitizations (MBSs), Panda Bonds issued by international financial institutions, financial bonds for commercial banks and finance companies, and short-term financing bills for enterprises on the inter-bank bond market. The PBC drove much of the expansion. The PBC introduced the new products on the inter-bank bond market and new trading procedures, including the disclosure-based approval process for issuance on the inter-bank bond market. In contrast to these

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<sup>12</sup> Source: UNCTAD World Investment Report 2005.

developments, bond issuance on the stock market was limited to modest volumes of T-bonds, enterprise bonds, and convertible bonds. Stock market activity was affected by the major restructuring of A shares in 2005, as the China Security Regulation Commission (CSRC) suspended new issuance for listed companies.

**Table 3. Fixed Income Securities Issuance 2000-2005 (in billion RMB)**

	2000	2001	2002	2003	2004	2005
T-Bond	457	488	593	628	692	704
Central bank papers			194	723	1704	2746
Financial sector bonds	165	269	318	452	520	685
Policy banks' financial bonds	165	269	318	452	435	605
Commercial banks'					75	77
Central bank financial bonds						3
Security firms' bonds					11	n.a.
Corporate Bonds (with guarantee)	8	15	33	36	33	120
Short-term financing bill						142
Securities Financing Bill						
ABS and MBS						8
Panda Bonds (RMB bonds by IFIs)						2
<b>Total</b>	<b>630</b>	<b>772</b>	<b>1137</b>	<b>1839</b>	<b>2949</b>	<b>4407</b>

Source: Chinabond.com.cn, CSRC.

### **The dynamic development on China's financial markets challenges regulators.**

China's bond market is supervised by several different regulatory authorities. The issuance of government debt is supervised by the MoF and the PBC; that of corporate bonds by the NDRC; that of financial bonds and short-term financing bills by the PBC; bonds traded in stock exchanges by the CSRC and those listed in the inter-bank market by the PBC. Staying “ahead of the game” requires, amongst others, that these authorities coordinate supervision approaches and results.

### **CORPORATE SECTOR POLICIES AND DEVELOPMENTS**

**Corporate sector reform continues apace.** Previous Quarterly Updates have highlighted the increasingly important role of independent directors and public shareholders in reviewing major transactions, the restructuring of some parent company-subsidary relationships, and the conversion of non-tradable shares into tradable ones.

**Revisions to China's company law have enhanced corporate governance and business-entry.** The revised law, approved by the National People's Congress in October 2005, reinforces the fiduciary duties of directors and other corporate insiders and enhances public shareholder rights and access to information. While the revised law also allows for cumulative voting for directors, experience from other countries suggests that this is likely to have minimal impact. New mechanisms for “piercing the corporate veil” may enhance protections for creditors in cases where a dominant shareholder abuses its shareholder rights and causes damage to a creditor (Box 4).

**In addition, forming a new business has become easier.** The revised law sets lower

minimum capital standards for limited liability and joint stock companies; allows for a domestic private business to establish itself as a single-person limited liability company, and reduces the “lock up” period during which the promoters, directors, or senior management of a new joint stock company may not sell their shares.

#### **Box 4. Selected Amendments to China’s Company Law**

##### Corporate Governance:

- A controlling shareholder, director, or senior manager who takes advantage of his/her affiliation and impairs a company’s interest, may be liable for damages.
- The revised law introduces a mechanism to “pierce the corporate veil” to protect creditors interests. Henceforth, “if any shareholder of a company causes any losses to the company or any other shareholder as a result of abuse of its shareholder’s rights, it shall make compensation for such losses.”
- A shareholder may ask the court to set aside board or shareholder resolutions that violate any law, regulation, or the company’s articles of association.
- A shareholders’ meeting may be called by shareholders who, in the case of a joint stock company, hold 10 percent or more of a company’s total shares for 90 consecutive days.
- Shareholders have a right to examine and copy articles of association, minutes of shareholders meetings, board resolutions, and financial and accounting reports.
- The revised law requires that employee representatives account for at least one-third of the board of supervisors.

##### Company Formation:

- The revised law reduces the minimum required capital for a limited liability company to RMB 30,000. The previous minimum had been RMB 100,000-500,000, depending on type of business.
- Minimum capital required for a joint stock company is reduced from RMB 10 million to RMB 5 million.
- Previously, the promoters, directors, and senior management of a new joint stock company were prohibited from transferring their shares within three years of establishment. Under the revised law, this “lock up” period is reduced to one year.
- The revised law allows for a domestic private firm to be organized as a single-person limited liability company with minimum capital of RMB 100,000. Previously, only foreign-invested or state-owned enterprises could adopt this form.

Source: O’Melveny & Myers LLP

## **Special Focus: GDP revisions--What has changed and what has remained the same?**

**The National Bureau of Statistics (NBS) recently released revised national accounts data.** This followed China's first Economic Census conducted in 2004. The revisions include a 16.8 percent upward adjustment of (production side) GDP for 2004, as well as historical adjustments back to 1993 and higher growth rates over 1993-2004 (Table). Although it is not uncommon that rapidly growing countries revise their GDP data, it is the first time that China makes such large official revisions, reflecting the significant progress that the NBS has made in improving its data production process. The new data provide better information on the current economic situation as well as on structural trends. The revisions are very timely indeed: many policy issues that the government wants to tackle in the forthcoming 11<sup>th</sup> Five Year Plan require accurate data for those issues to be assessed correctly.

**The new data shows several differences. First, the economy is much larger than previously estimated.** The revised data made China pass Italy to become the World's 6<sup>th</sup> largest economy in US\$ terms in 2004, and China should have overtaken France and Britain to be the World's 4<sup>th</sup> largest in 2005—although of course with over 20 times as many people as these countries. Economic growth during 1993-2004 was also somewhat higher than estimated previously.

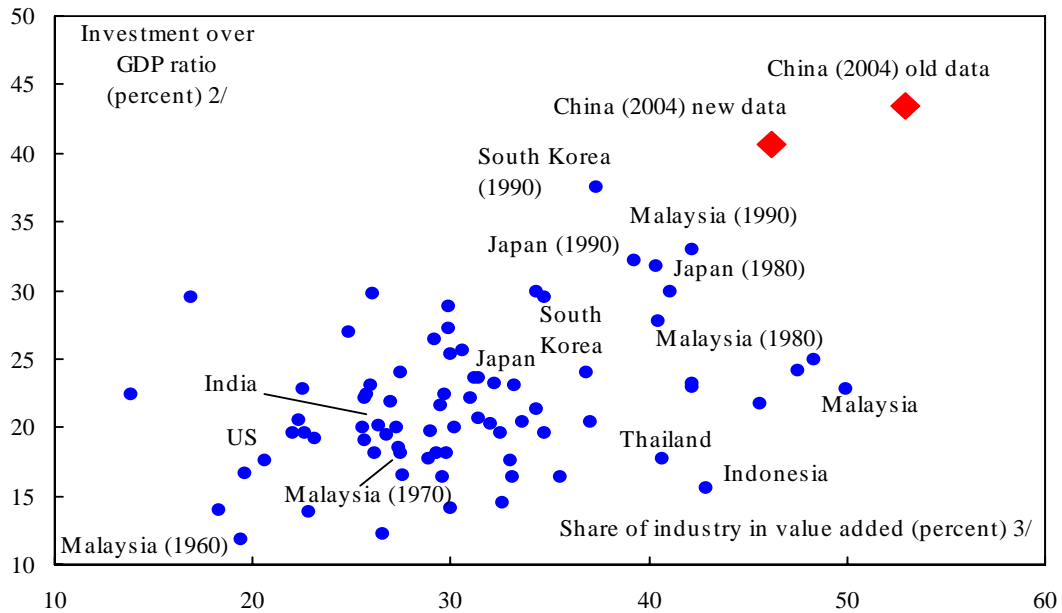
**Second, the structure of the economy looks less extraordinary in several dimensions.** Mainly, as suspected by many, China's services sector had been underestimated. A full 93 percent of the upward revision in GDP came from a revision of value added in services, as new firms and activities are now better captured. As a result, the share of services in GDP in 2004 was revised up 8.8 percentage points to 40.7 percent, while the shares of primary and secondary sectors declined by 2.2 and 6.6 percent, respectively.

**Third, price rises make up two-thirds of the revision to GDP.** This is because of the larger share of services in GDP, combined with higher price increases in services than in other sectors. According to the new data, China has faced 10 percentage points more real exchange rate appreciation than previously estimated (based on GDP deflators). This partly resolves an issue that had previously puzzled us, as typically rapidly growing countries experience real exchange rate appreciation because the relative prices of services tends to rise as a result of lagging productivity increases compared to industry.

**The revised data qualifies but in most cases does not fundamentally alter the picture of the Chinese economy, its growth pattern, and the key concerns.** Comparing China to other countries, the following characterizations remain true:

**The role of industry in China remains relatively large, and that of the services sector relatively small** (Figures 1 and 2). Nevertheless, according to the new data, the importance of industry in China is not as extraordinary as the old data suggested. With the revisions to growth in the services sector particularly large in recent years, the contribution of the secondary sector (that is industry plus

Figure 1. Investment and industry remain important 1/



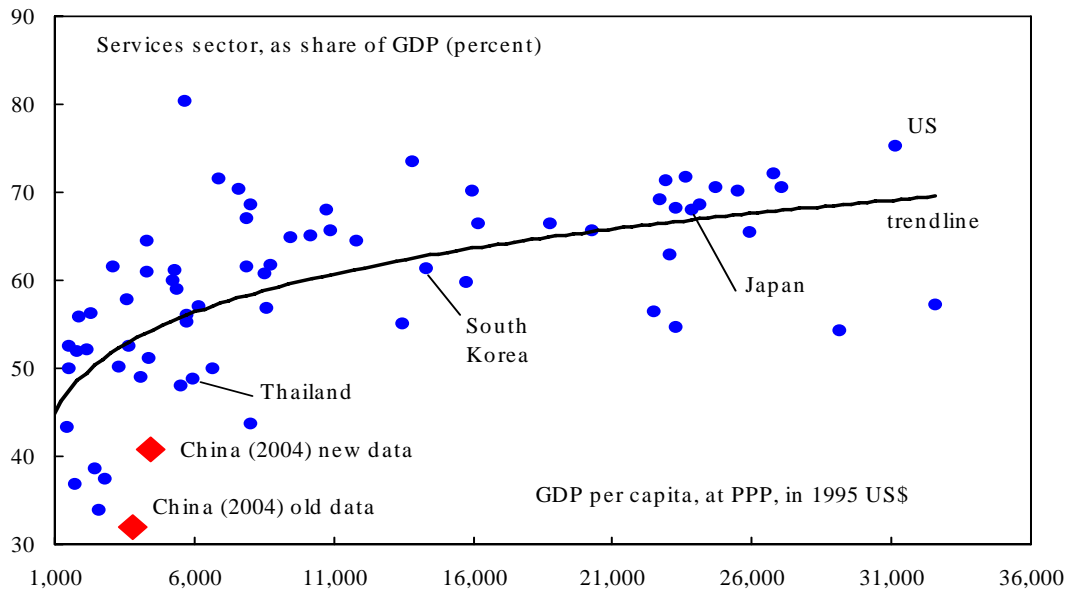
Sources: World Development Indicators, NBS (for China), and staff estimates.

1/ Using data in current prices. Data for 2001, unless otherwise indicated.

2/ Assuming that, of the revision of GDP, 85 percent is contributed by consumption, and 15 percent by investment.

3/ Including construction, as is the case in most countries.

Figure 2. China's services sector remains modest 1/



Sources: World Development Indicators and NBS (for China).

1/ Using data in current prices. Data for 2001, unless otherwise indicated.

construction) to total GDP growth has been lower than estimated previously. For instance, in 2004 it was 62 percent instead of 68 percent.

**Investment remains relatively high.** While corresponding revised GDP data from the expenditure side are yet to be released, economists expect that most of the increase in GDP will be attributed to consumption, as much of the revisions are found in the service sector. Assuming that only 15 percent of the increase in GDP is contributed by investment, China's investment to GDP ratio was 41 percent in 2004, compared to 45 percent according to the old data. This remains rather high compared to most other countries at different stages of their development, including Asian countries (Figure 1). The capital-output ratio is estimated to have increased from 2.3 in the early 1990s to 2.7 in 2004 with the new data (in constant prices), little different from the estimate based on the old data. Indeed, the new data does not lower the growth of gross fixed capital formation, which in 1993-2004 was 175 percent, compared to 88 percent in India and 75 percent in lower middle income countries, doubling China's share in total world investment.

**Capital accumulation has still been the key driver of economic growth.** Redoing a growth accounting exercise for 1993-2004 with the new GDP data, using the assumption made above on the contribution of investment to the revision of GDP, suggests that the contribution of capital accumulation to GDP growth would change from 61 to 58 percent, while TFP growth would change from 2.7 to 3 percent.<sup>13</sup>

**The judgment on other, often related, characteristics and ratios does not change materially.** These include high energy intensity, high resources consumption, large and growing urban-rural income inequality, largely driven by large and growing productivity differentials between agriculture and the rest of the economy.<sup>14</sup>

**Revised expenditure side data is now needed.** In all, the need to rebalance policies to make growth less energy and resource intensive, more knowledge-based, and more equally shared—in other words, more sustainable—remains and the government is right to keep this as a key policy objective. In this connection, after the considerable progress that the NBS has made in improving and expanding its national accounts in last decades, revised expenditure side data are now urgently needed for policymaking and analysis. In its absence, it is difficult to assess with certainty to what extent concerns over ratios including investment to GDP and consumption to GDP are alleviated with the new data.<sup>15</sup>

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<sup>13</sup> The original exercise, and the assumptions made, are in Kuijs and Wang (2005), "China's Pattern of Growth: Moving to Sustainability and Reducing Inequality", World Bank Policy Research Working Paper 3767, <http://econ.worldbank.org>.

<sup>14</sup> Also, with the revised GDP data, tax revenue and government expenditure on social spending, education, and health care are even lower, as a share of GDP, than previously estimated.

<sup>15</sup> In national accounts, production side GDP is estimated by summing up value added in all economic sectors while the expenditure side GDP is the sum of total investment, total consumption, and the trade balance. Theoretically, the two should be the same. However, in practice they are not because of statistical

Table. China's GDP revision

## New data

	Growth (percent)			Composition of GDP (percent)				
	Nominal GDP	real GDP	GDP deflator	Primary	Secondary		Tertiary	
					Industry	Construction		
1993	32.6	14.0	16.4	19.5	46.6	40.2	6.4	33.9
1994	36.4	13.1	20.6	19.7	46.6	40.4	6.2	33.7
1995	26.1	10.9	13.7	19.8	47.2	41.1	6.1	33.0
1996	17.1	10.0	6.4	19.5	47.5	41.3	6.2	33.0
1997	11.0	9.3	1.5	18.1	47.5	41.7	5.8	34.4
1998	6.9	7.8	-0.9	17.3	46.2	40.3	5.9	36.5
1999	6.2	7.6	-1.3	16.2	45.8	40.0	5.8	38.0
2000	10.6	8.4	2.1	14.8	45.9	40.3	5.6	39.3
2001	10.5	8.3	2.1	14.1	45.2	39.8	5.4	40.7
2002	9.7	9.1	0.6	13.5	44.8	39.4	5.4	41.7
2003	12.9	10.0	2.6	12.5	46.0	40.5	5.5	41.5
2004	17.7	10.1	6.9	13.1	46.2	40.8	5.4	40.7
2005	14.1	9.9	3.8	12.5	47.3	...	...	40.2

Accumulated difference 1992-2004 new-old (percent)

16.8      5.4      10.8

## Old data

	Growth (percent)			Composition of GDP (percent)				
	Nominal GDP	real GDP	GDP deflator	Primary	Secondary		Tertiary	
					Industry	Construction		
1993	30.0	13.5	14.6	19.9	47.4	40.8	6.6	32.7
1994	35.0	12.6	19.9	20.3	47.8	41.4	6.4	31.9
1995	25.1	10.5	13.2	20.5	48.8	42.3	6.5	30.7
1996	16.1	9.6	5.9	20.4	49.5	42.8	6.7	30.1
1997	9.7	8.8	0.8	19.1	50.0	43.5	6.5	30.9
1998	5.2	7.8	-2.4	18.6	49.3	42.6	6.7	32.1
1999	4.8	7.1	-2.2	17.6	49.5	42.8	6.7	32.9
2000	9.0	8.0	0.9	16.4	50.2	43.6	6.6	33.4
2001	8.8	7.5	1.2	15.8	50.1	43.5	6.6	34.1
2002	8.1	8.3	-0.2	15.3	50.4	43.7	6.7	34.3
2003	11.6	9.5	1.9	14.4	52.2	45.2	7.0	33.4
2004	16.6	9.5	6.5	15.2	52.9	45.9	7.0	31.9

Source: NBS, and staff estimates.

discrepancies. In China, the discrepancies had increased in recent years, with the expenditure side GDP 4 percent larger than the production side number, compared to a gap of 0.1 percent in 1995.