FOR AGENDA

SM/02/220

CONTAINS CONFIDENTIAL INFORMATION

July 15, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Staff Report for the 2002 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2002 Article IV consultation with the People's Republic of China, which is tentatively scheduled for discussion on **Monday, August 5, 2002**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the People's Republic of China indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Rodlauer (ext. 38789), Mr. Feyzioğlu (ext. 37273), and Ms. T. Wang (ext. 36573) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 23, 2002; and to the Asian Development Bank, the European Commission, the European Investment Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation
with the People's Republic of China

Approved by Yusuke Horiguchi and Shigeo Kashiwagi

July 12, 2002

- The 2002 Article IV discussions with China were held in Beijing and Xi'an during May 13–28, 2002. The staff team comprised Mr. Dunaway (Head), Mr. Rodlauer, Mr. Aziz, Mr. Feyzioğlu, Ms. Wang (all APD), Mr. Karacadag (MAE), Mr. R. Singh (FAD), and Mr. Blancher (PDR). The team was assisted by Mr. Otani and Mr. Brooks (Resident Representatives' office). Mr. Wei, and Mr. Wang (OED) participated in the discussions. Mr. Sugisaki and Mr. Tweedie joined the team during May 24–27.

- The team met with Vice Premier Wen Jiabao, People's Bank of China (PBC) Governor Dai Xianglong, Vice Minister of Finance Jin Liqun, Shaanxi Province Governor Jia Zhibang, other senior officials, and representatives of the banking, business, and diplomatic communities. Staff from the World Bank and Asian Development Bank attended many of the meetings as observers.

- In concluding last year's Article IV consultation on July 23, 2001, Executive Directors noted China's favorable economic performance, with robust growth, easing deflationary pressures, and a strong external position. They viewed these developments as reflecting the continued transformation of the Chinese economy, supported by skillful macroeconomic management and continued structural reforms. However, Directors also noted the large unfinished reform agenda and welcomed the authorities' intention to accelerate reforms, with focus on the intertwined problems of the financial system and the state-owned enterprises (SOEs), while managing the social costs of the transition and ensuring that the benefits of globalization were broadly shared.

- China has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement; exchange controls continue to apply to most financial account transactions.

- Despite notable improvements in recent years, China's economic statistics remain weak in many important areas, including the national accounts, the fiscal sector, and the balance of payments. China has subscribed to the GDDS, with its metadata posted on the official website since mid-April 2002.

- The principal authors of this staff report are Markus Rodlauer and Jahangir Aziz, with contributions from other team members.

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LIST OF ABBREVIATIONS

AMCs	Asset Management Companies
AML	Anti-money Laundering
CAR	Capital adequacy ratio
CCB	China Construction Bank
CSRC	China Securities Regulatory Commission
FDI	Foreign direct investment
FFEs	Foreign-funded enterprises
FSAP	Financial sector assessment program
GDP	Gross domestic product
HIPCs	Heavily Indebted Poor Countries
ITICs	International trust and investment corporations
MOF	Ministry of Finance
NBFIs	Nonbank financial institutions
NDF	Nondeliverable forward exchange rate
NPLs	Nonperforming loans
OMOs	Open market operations
PBC	People's Bank of China
PIN	Public Information Notice
RCCs	Rural credit cooperatives
RCFs	Rural credit funds
RMB	Renminbi
SETC	State Economic and Trade Commission
SMEs	Small and medium-sized enterprises
SOEs	State-owned enterprises
SCBs	State commercial banks
TVEs	Township and village enterprises
VAT	Value-added tax
WTO	World Trade Organization
Y	Yuan

Executive Summary

Economic Setting:

- **Over the last five years, the Chinese economy has faced two external shocks—the Asian financial crisis of 1997–98 and last year's global economic slowdown.** Supported by appropriate macroeconomic policies and reforms, the economy weathered these shocks well, while continuing its transformation toward increased market orientation. Major challenges remain, especially in tackling the intertwined problems in the banking, state-owned enterprise, and fiscal sectors.

- **After last year's slowdown, growth has recovered in 2002.** The staff projects GDP growth of 7½ percent in 2002, based on a rebound in exports and continued strong investment growth. Although deflation re-emerged in late-2001, it is expected to fade later this year. The external position remains strong, with the current account in surplus and reserves rising sharply. Despite this favorable performance, social pressures (especially unemployment and the growing difference between urban and rural incomes) continue to be a major policy concern.

Policy Discussions:

- **The staff supported the current monetary policy stance.** Based on the present economic outlook, there was no pressing reason to change policy, although the staff noted that there was room to lower interest rates if prospects worsened significantly.

- **The staff continued to emphasize the need for greater exchange rate flexibility.** The authorities, while agreeing on the medium-term benefits of flexibility, said that at present the stability of the renminbi was important to China, as well as the region.

- **Fiscal policy should maintain the steady path of consolidation realized in recent years.** Given the improved economic outlook and medium-term constraints, the staff recommended that the authorities aim at reducing the budget deficit by ¼–½ percent of GDP a year in 2002 and over the next few years. The authorities agreed with the need for medium-term fiscal consolidation, but they did not envisage a reduction in the deficit this year because of lingering uncertainties regarding the economic outlook.

- **The government's focus on banking reforms has started to yield results, although much remains to be done.** The prudential framework has been strengthened, and the state-owned commercial banks have started to adjust their lending practices. Asset management companies also are making progress in resolving the nonperforming loans that they acquired from the banks. The staff welcomed these developments and offered specific suggestions to further strengthen the prudential regime, enhance incentives for sound banking practices, and restructure the large state-owned banks.

- **Among the wide range of state-owned enterprise reforms underway, the staff underscored the importance of hardening enterprise budget constraints.** The authorities agreed and noted the linkages between reforms in this area and the need to strengthen the social safety net, including the pension system, unemployment benefits, health care, and the minimum living standards allowance.

I. Background

A. Recent Developments

1. **Over the last five years, the Chinese economy has weathered two major external shocks—the Asian financial crisis of 1997–98 and last year's global economic slowdown.** Supported by appropriate macroeconomic policies and structural reforms, the economy was able to manage well the challenges posed by these shocks, while continuing its transformation toward increased market orientation. Growth averaged nearly 8 percent a year; the external position strengthened further; reforms advanced in the key financial and banking sectors; and external liberalization continued, culminating in China's accession to the WTO in December 2001.

2. **Economic activity in China slowed in the course of last year, before recovering in the first quarter of 2002 (Figure 1 and Table 1).** Export growth, after peaking at close to 40 percent (year-on-year) in early-2000, decelerated sharply throughout 2001 as external demand weakened. Import growth also declined but with a lag, and the contribution of net exports turned negative from late 2000 to the second half of 2001 (Figure 2). Domestic demand growth also decelerated, despite continued expansion of public sector fixed investment. As a result, GDP growth declined from 8 percent in 2000 to 7.3 percent in 2001. In the first quarter of 2002, a rebound in exports and surging public-sector fixed investment boosted GDP growth to 7.6 percent.[1] However, consumption growth appears to have moderated somewhat, with retail sales growth slowing to below 10 percent, from 12 percent in the fourth quarter of 2001.

3. **Deflation, which re-emerged in late 2001, has continued.** After prices fell in 1998–99 in the wake of the Asian crisis, they increased moderately by 1.1 percent (annual rate) through the third quarter of 2001. However, subsequently the CPI has declined by 1.1 percent (annual rate) through May 2002. Staff analysis suggests that the renewed deflation reflects both temporary factors, such as lower international commodity prices and WTO-related tariff cuts, as well as more long-term forces, such as continued excess supply conditions in certain sectors (Box 1).

4. **Despite last year's slowdown of export growth, China's external position strengthened further (Tables 2–4).** While the current account surplus narrowed slightly from 1.9 percent of GDP in 2000 to 1.5 percent of GDP in 2001, the financial account improved significantly. Foreign direct investment (FDI) surged ahead of China's entry into the WTO, and with the onshore-offshore interest rate differential turning positive because of declining U.S. rates, substantial deposit assets were repatriated, reversing the outflows of previous years. Official reserves rose by \$47 billion in 2001 (4½ percent of GDP) and a further \$26 billion in the first 5 months of 2002, reaching \$245 billion by end-April. External

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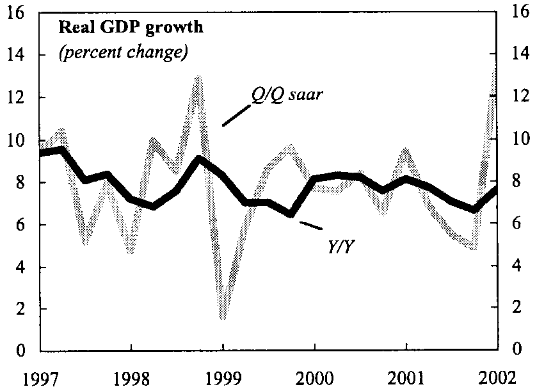
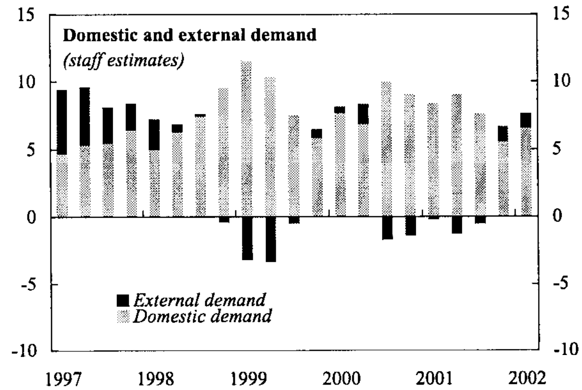
[1] Quarterly GDP data must be interpreted with particular caution because of data weaknesses (Annex II).

Figure 1. China: Growth and Demand Indicators

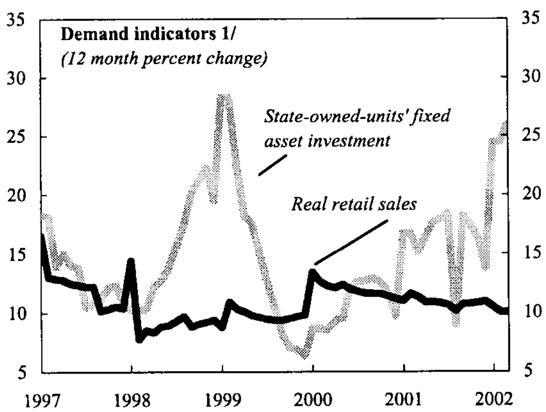
After declining last year, GDP growth rebounded in Q1 2002.



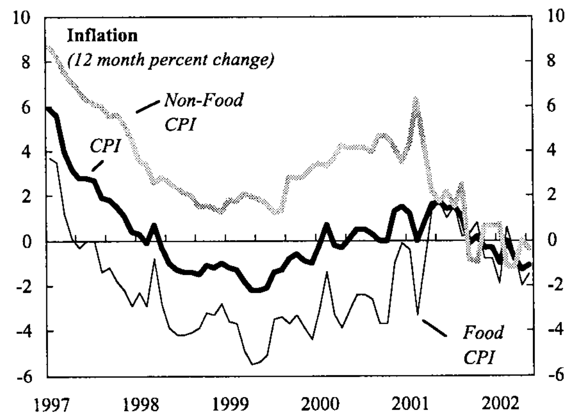
Both domestic and external demand slowed from late 2000, before recovering from late 2001.



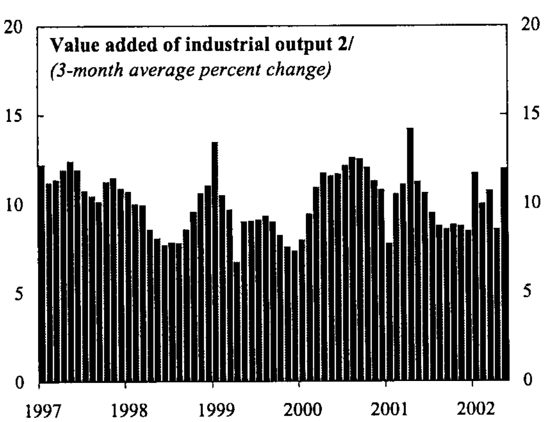
Domestic demand growth has been supported by strong public investment growth.



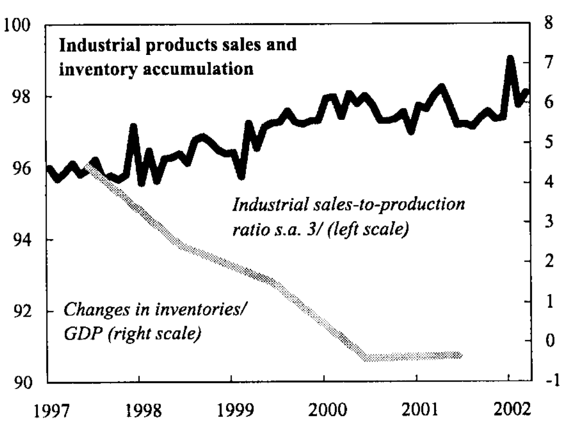
Deflation resurfaced in late 2001.



In recent months, industrial growth has recovered...



...as inventories have declined.



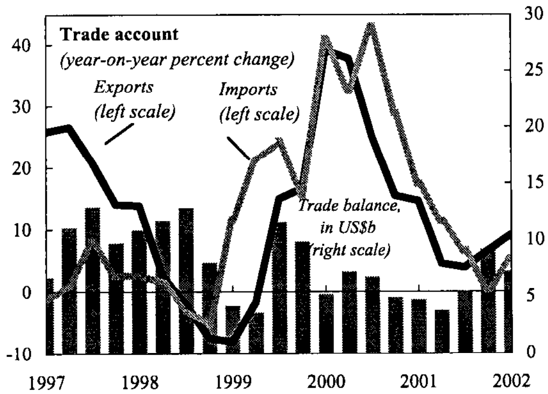
1/ Cumulative from beginning of year.

2/ Real value-added industrial production, percentage change over the previous year's month.

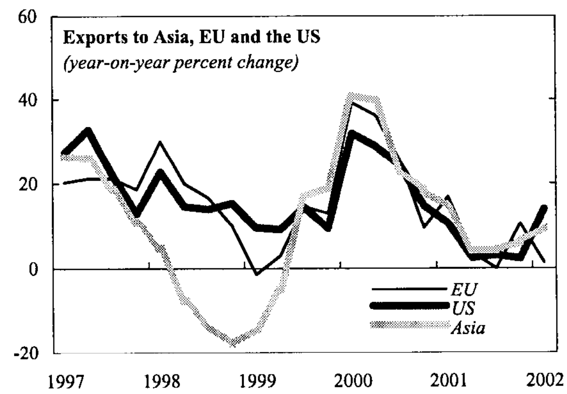
3/ Based on surveys of 5000 principal industrial enterprises.

Figure 2. China: External Indicators

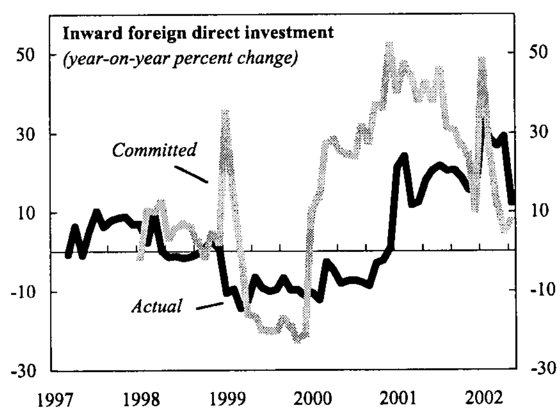
Export growth, after slowing sharply in 2001, has started to recover...



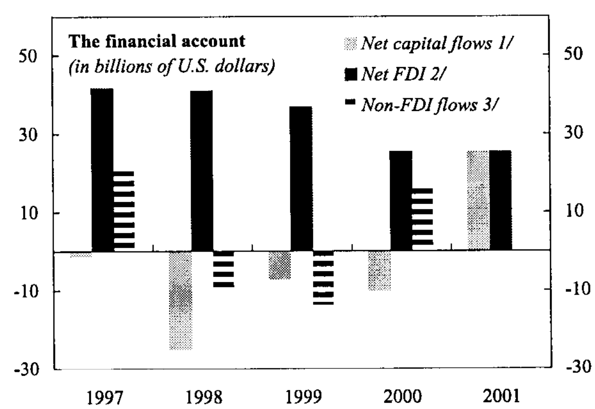
...particularly to the U.S.



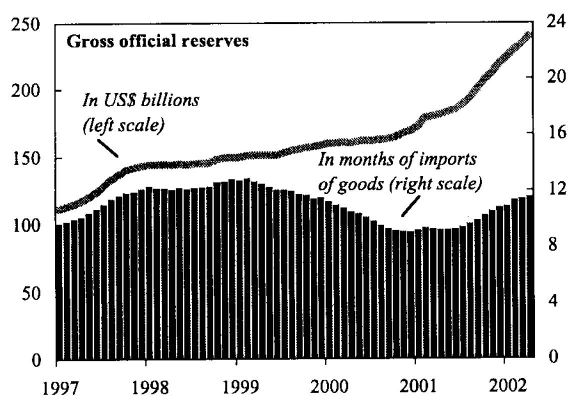
FDI inflows reached record levels in 2001...



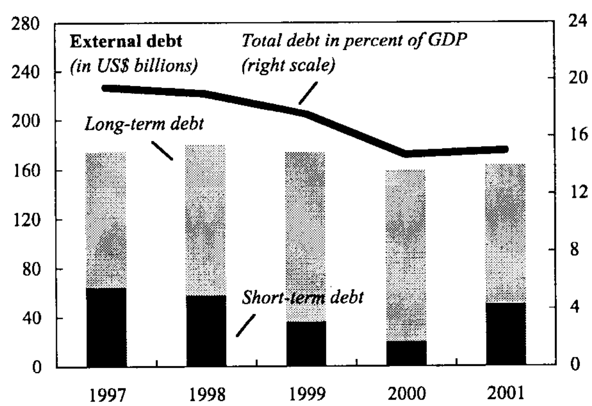
...helping the financial account move into surplus.



International reserves have continued to rise...



...while the explicit debt burden remains moderate 4/



1/ Change in reserves less current account balance.
2/ Balance of payments basis.
3/ Identified private flows (based on BIS data).
4/ In 2001, China's debt was reclassified including a shift from original to remaining maturity and inclusion of categores previously not covered.

Box 1. Deflation

China has experienced two periods of deflation in the last four years. After peaking at over 25 percent in 1994, inflation declined steadily as macroeconomic policies were tightened to cool the overheated economy. Prices began to fall in 1998 as the economy slowed further in the wake of the Asian crisis. A period of mild inflation in 2000–01 followed, before renewed deflation appeared in late 2001 and early 2002. While the first episode of deflation (1998–99) was led by food prices (with nonfood inflation being close to zero), the recent return of deflation reflected mainly falling nonfood prices.

The persistence of deflation has raised questions about its nature and origin, in particular whether it is mainly a product of transitory economic shocks or whether more longer-term structural forces are at work. Possible transitory factors include cyclical swings in output growth and changes in foreign prices, the exchange rate, and administrative prices. A possible (benign) structural explanation for deflation may be that declining production costs as a result of reforms (including external and domestic opening up to greater competition, adoption of new technologies, and SOE reforms) allowed firms to reduce prices. A less benign structural source of deflation may be an excess supply of goods, perpetuated by the continued loss-making operations of SOEs.

Staff analysis suggests that both transitory shocks and longer-term structural factors have played a role in China's inflation/deflation experience in recent years. A structural VAR model[1] estimated over the period 1995–2001 (using quarterly data) suggests that some 95 percent of changes in the price level during this period can be explained by aggregate demand shocks, foreign goods prices, and changes in government support prices for grains (transitory factors). A regression analysis over a longer period (1980–2000), using annual data, further suggests that longer-term structural changes have also played an important role in price changes. In particular, the ongoing reduction in tariff rates and the competition induced by the rapidly growing private sector appear to have had a significant dampening effect on prices. A plausible interpretation of these results is that more recent short-term fluctuations of inflation are well explained by cyclical and other temporary factors around a longer-term trend decline in inflation that is largely explained by structural factors.

Looking ahead, based on this analysis, deflation should give way to mild inflation as the transitory factors depressing prices in recent years fade. With growth recovering and external prices projected to rise moderately, deflationary pressures should ease during the course of the year. Also, further reductions in administered grain prices are unlikely, given the authorities' heightened concerns over stagnating rural incomes. However, with the continued presence of structural factors dampening price pressures, no major flare-up of inflation is expected in the near future.

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[1] Following the model developed in Danny Quah and Shaun P. Vahey, 1995, "Measuring Core Inflation," *The Economic Journal*, vol. 105, pp. 1130–1144.

debt remains low (15 percent of GDP), with short-term debt covered more than four times by reserves. Although the real effective exchange rate has risen by over 6 percent since end-1999 (with a nominal effective appreciation of close to 12 percent), China's external competitiveness has remained strong, as indicated by continued rising export market shares.

5. **Domestic equity prices underwent a correction last year (Figure 3)**. After peaking in May 2001, equity prices fell by over 30 percent, reflecting stepped-up regulatory investigations, oversupply concerns arising from privatization plans, and a correction in B-share prices to the overshooting that had followed the opening of the market to local investors with foreign currency accounts in February 2001. In mid-2002, the average price-earning ratio of China stocks was around 45–50, down from a peak of 50–60 a year earlier.

6. **Rapid revenue growth over the past two years has allowed moderate reductions in the fiscal deficit, while spending was boosted in support of domestic demand (Table 5)**. The overall budget deficit declined from 4 percent of GDP to 3.6 percent in 2000, and then to 3.2 percent in 2001 (IMF definition).[2] In both years, much faster-than-expected revenue growth more than offset sharp increases in spending to above budgeted levels, as the government sought to support domestic demand.

7. **Monetary policy was largely unchanged until a moderate easing in early 2002 (Table 7)**. Interest rates remained constant from late 1999 through early 2002. In February 2002, the uncertain economic outlook and renewed concerns about deflation prompted the PBC to cut deposit and lending rates by ¼ and ½ percentage point, respectively. Liquidity in the banking system has been high, with deposits continuing to grow rapidly, while banks have maintained large excess reserves, reflecting in part more cautious lending practices in response to ongoing reforms.

8. **Social pressures stemming from structural changes and the economic slowdown remain serious concerns**. Based on official data, the staff's definition of the urban unemployment rate declined slightly in 2001 (to 5.6 percent, from 6.1 percent in 2000).[3] Although the growth of rural incomes picked up somewhat in 2001 (to 4.2 percent in real terms), it remains significantly below that of urban income. As a result, the rural-urban income gap has continued to widen, which has also exacerbated the gap between the poorer western and interior provinces and the costal regions.

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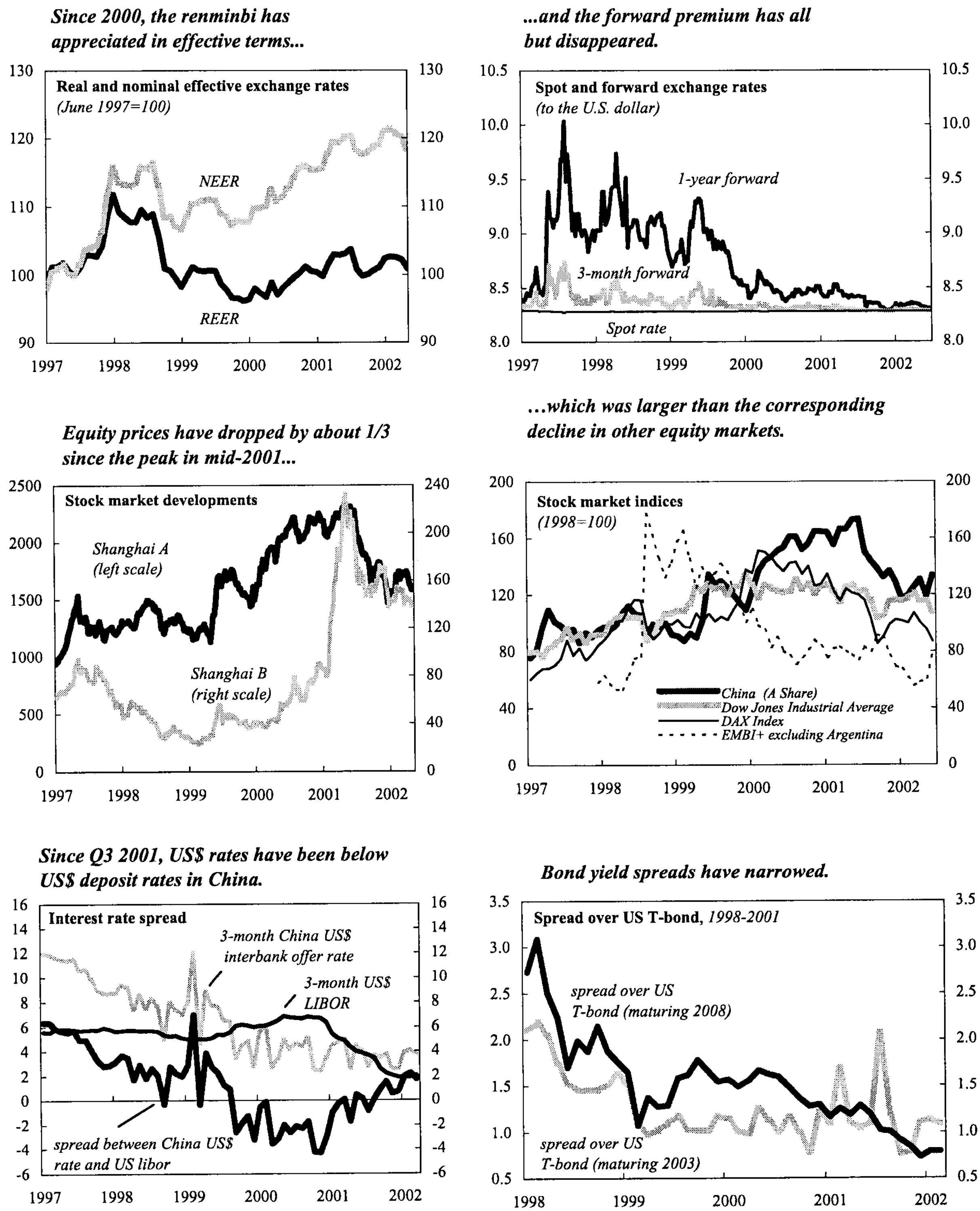
[2] Table 6 explains the difference between the authorities' and the IMF's definition of the fiscal balance (0.6 percent of GDP in 2001). The differences primarily reflect the treatment of privatization receipts and on-lending to local governments of funds borrowed by the central government.

[3] Included are registered urban unemployed and laid-off SOE workers. Analysts generally believe the unemployment rate to be higher, especially in cities with many SOEs. In addition, there is a large rural labor surplus, estimated at around 150 million (one-third of the rural work force).

Figure 3. China: Financial Indicators



B. Outlook and Risks

9. **Based on the strong first-quarter outcome and improved external conditions, the staff projects real GDP growth to reach 7½ percent in 2002 and sustain that pace in 2003**. Investment growth in 2002 is expected to remain high, reflecting the large public-sector investment program (although its rate of expansion should slow from the very rapid pace in the first quarter) and continued strong FDI inflows. Consumption growth is expected to strengthen modestly in the remainder of this year and to increase further in 2003, supported by rising incomes. While export growth should be sustained by the global recovery, imports are also expected to rise, partly due to WTO-related trade liberalization. As a result, the current account surplus is expected to remain unchanged at 1½ percent of GDP this year, before declining to 1 percent of GDP in 2003. Deflation should ease in the second half of 2002 as domestic demand picks up and world commodity prices rise, with inflation of about 1½ percent projected for 2003.

10. **The risks to the near-term outlook appear roughly balanced.** On the downside, external developments could be weaker than currently projected (with continued risks in Japan and uncertainty about the strength of recovery in the United States), while sluggish rural income growth and uncertain urban employment prospects associated with SOE reforms could dampen the anticipated recovery in domestic demand. On the other hand, more favorable external conditions could improve China's economic performance substantially, including by boosting business and consumer confidence.

11. **The medium-term outlook depends critically on the nature and pace of structural reforms and the impact of WTO accession**. If appropriate structural reforms are implemented and the commitments under WTO to further liberalize the economy are met, China should be able to achieve annual growth of 7–8 percent over the medium term (Table 8).[4] Excluding the cyclical recovery and the effect of quota elimination, trend growth is projected to slow somewhat to 7½ percent over the next few years from its average of near 8 percent in the last five years. This expected slowing reflects some output loss from SOE restructuring and the effects of increased WTO-related foreign competition, near-term costs of reform that should, over time, be more than offset by faster productivity and export gains. Inflation is projected to remain moderate, in part due to further reductions in tariffs. Continued strong FDI inflows and portfolio investment should keep the balance of payments in surplus, despite a reduction in the current account surplus due to increased imports of goods and services.

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[4] The elimination of quota restrictions on China's textile exports should also help to boost growth to 8 percent in 2005. However, China's WTO accession protocol provides for special textile safeguards until 2008, which, if imposed by partner countries, could delay the boost to exports.

II. Policy Discussions

12. **Against this background, the discussions focused on the appropriate stance of macroeconomic policies and important next steps in pushing ahead with structural reforms**. With growth prospects improving globally as well as in China, the macroeconomic policy discussions centered on the appropriate balance between supporting the recovery and the medium-term adjustment and reform requirements. The intertwined banking, SOE, and fiscal reforms were the focus of the discussions on structural reforms.

A. Monetary and Exchange Rate Policy

13. **Monetary policy remains accommodative**. The authorities explained that limiting the risk of continued deflation was the key near-term concern of monetary policy. Following the reduction of interest rates in February, the PBC in May raised its target for M2 growth in 2002 to 14 percent (from 13 percent originally). The authorities noted that, despite a slowdown in lending by state commercial banks (SCBs)[5], M2 growth so far was on track to meet this target owing to the boost to liquidity from the external sector and rapid credit growth by the smaller joint stock and city banks (Figure 4). Nonetheless, they were concerned that overall credit growth might slow further, exacerbating deflationary pressures. The staff observed that current growth and inflation prospects argued for leaving interest rates unchanged for the time being, although there was scope to lower them further if the outlook worsened significantly. Staff analysis suggests that with some of the temporary factors behind the recent decline of prices fading, deflation should give way to mild inflation during the second half of 2002 (see Box 1).

14. **The authorities expressed concern about reduced effectiveness of monetary policy**. In particular, they were concerned that a further slowdown of lending by SCBs might undermine the growth outlook and add to deflationary pressures. The staff observed that, to an important extent, the recent slowdown of SCB lending reflected the ongoing structural adjustment in the banking system, a welcome development overall. Fundamentally, the key factor impeding monetary transmission was banks' continuing inability to price risk appropriately (Box 2), which in turn reflects the existence of interest rate controls and ongoing problems for the SCBs in making lending decisions strictly on a commercial basis. Therefore, lifting the ceiling on lending rates and pressing ahead with bank and SOE reforms were crucial to strengthening monetary policy effectiveness on a sustained basis. In line with the staff's recommendations, the authorities said they were considering widening the band on lending rates and reducing the remuneration of excess reserves (to encourage more interbank lending).[6] They were also urging SCBs to develop plans to make full use of existing lending

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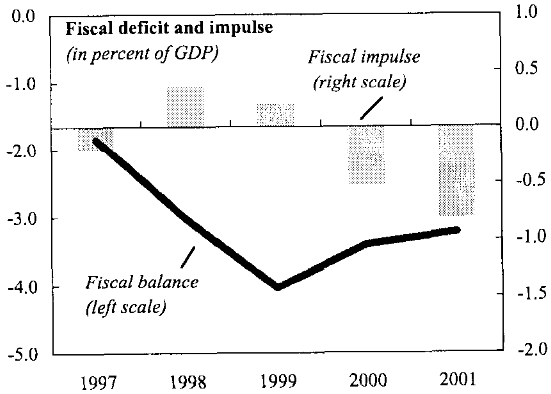
[5] SCBs in this report refer to China's four largest banks—Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China—which together account for two-thirds of banking sector assets.

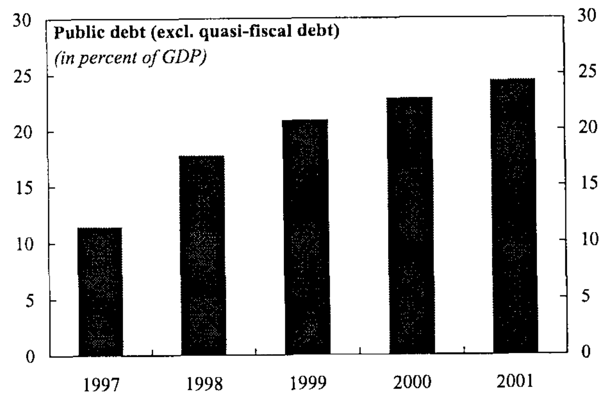
[6] Excess reserves are currently remunerated at a rate of 1.89 percent, compared to the ceiling on lending rates of 5½ percent.

Figure 4. China: Macroeconomic Policies

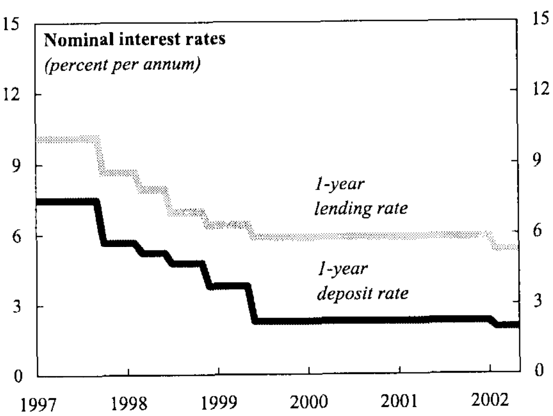
The fiscal deficit has been reduced in 2000-01...



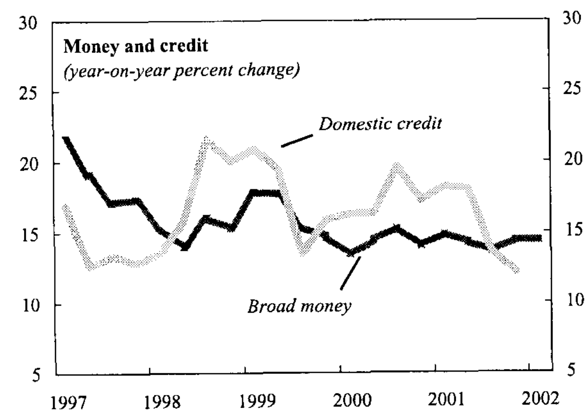
...slowing the growth of explicit public debt.



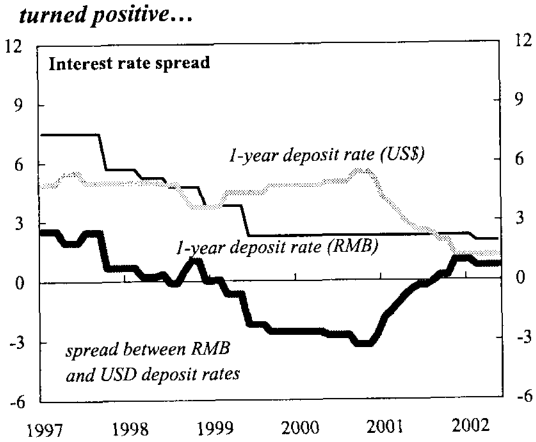
After no change for 2 1/2 years, domestic interest rates were lowered in February 2002.



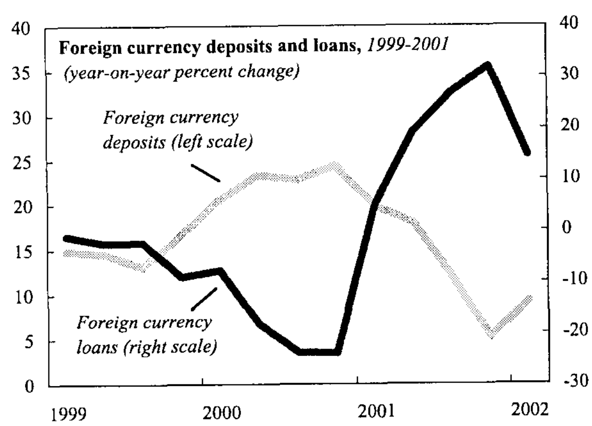
While broad money expanded in 2001, credit growth slowed.



The RMB-US dollar deposit rate differential has turned positive...



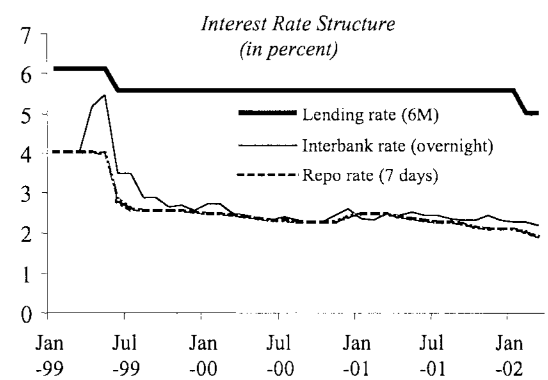
...slowing foreign currency deposit growth.



BOX 2. THE MONETARY TRANSMISSION MECHANISM

The objective of monetary policy in China is price stability, while ensuring high GDP growth. Consistent with this objective, the People's Bank of China (PBC) sets growth targets for M2 and M1, and uses a range of monetary policy instruments to influence liquidity in the banking system and credit growth. In 1995, the People's Bank of China (PBC) officially abolished directed lending and started to make greater use of indirect monetary instruments, such as open market operations (OMOs) and rediscount lending. The pursuit of a domestic monetary policy goal while maintaining a *de facto* fixed exchange rate regime is possible given China's extensive system of capital controls.

Despite improvements, shortcomings remain in China's institutional framework, which reduce the effectiveness of indirect monetary instruments. In particular, the use of indirect instruments is hampered by the system of administered interest rates, an underdeveloped interbank market, inefficiencies in the payment system, and the shortage of financial instruments suitable for rediscount lending and OMOs.



Bank credit is the most important channel through which monetary policy affects the real economy, but the link is weak. Weaknesses appear at various stages in the chain:

- Changes in the cost of funding—which the PBC targets mainly by influencing the 7-day repo rate in the interbank market—are not reflected in lending rates, which are largely fixed. For example, at present the benchmark one-year lending rate is 5.3 percent, with a margin of +10/-10 percent—that is +/-0.5 percentage point—within which banks can set rates freely (+30/-10 percent for SMEs in urban areas, and +50/-10 percent for SMEs in rural areas).
- The link between bank reserves and credit growth is inhibited by the interest rate controls, weak lending practices of banks, and soft budget constraints of SOEs. Although banks have begun to operate more on commercial principles, they are still unable to price risk appropriately (because of the ceilings on lending rates, their limited experience with commercial loan appraisals, and the distorting effect from unreformed SOEs with soft budget constraints). The problems in the SOE sector and the burden of nonperforming loans have made banks more cautious in their lending practices and, as a result, they have preferred to place funds in safe assets (such as deposits at the PBC or government bonds) rather than extend credit.
- Credit growth and real activity are not strongly correlated, since SOEs (still the main recipients of bank credit) account for only 35 percent of industrial production.
- Despite recent improvements, the interbank market remains underdeveloped. It is dominated by the large banks, with limited participation by nonbank financial institutions and a paucity of suitable instruments, especially at the short end. Interbank activity has slowed further recently reflecting the banks' increasingly cautious lending policies.
- Inefficiencies in the payment system and remuneration of excess reserves by the PBC at rates above deposit rates have caused banks to maintain a high level of excess reserves.

opportunities, especially for small and medium-sized enterprises. The staff cautioned the authorities against using policy guidelines to induce the banks to increase lending, as this would undo some of the structural adjustment taking place in the banking system.

15. **The authorities continued to express an interest in moving toward greater exchange rate flexibility**. As in previous consultations, the staff emphasized the importance of greater exchange rate flexibility for China given the major structural changes underway, existing factor market rigidities, and the country's growing integration into the world economy.[7] The strong external position and favorable growth outlook at present would allow such a move to take place from a position of strength. While the authorities recognized the longer-term benefits of greater flexibility, they considered that at the current juncture continued stability of the renminbi was important to China as well as the region. The authorities indicated that they were working to improve the functioning of the exchange market (Box 3). The staff noted that such improvements were needed for the market to better reflect the supply and demand of foreign exchange in the economy and should be an integral part of a move toward greater exchange rate flexibility. The authorities welcomed the staff's suggestions in this area, based on previous technical assistance, including steps to deepen the foreign exchange market, remove trading restrictions, and strengthening market infrastructure and supervision.

B. Fiscal Policy

16. **After two years of deficit reduction, the budget for 2002 targets a broadly unchanged deficit (3.3 percent of GDP)**. Revenue is projected to increase by 10 percent and spending by 11 percent. The budgeted revenue growth is substantially less than the 21 percent realized in 2001, reflecting some tax reductions (such as tariff cuts in line with WTO commitments and lower business tax on banks) and conservative assumptions about the underlying buoyancy of revenues.[8] Spending increases are focused on social, military, and investment outlays. A further increase also is planned in basic civil service salaries, while other budget items, including subsidies, were largely kept at their 2001 levels. In the first five months of 2002, expenditure rose by 19 percent (year-on-year), mainly due to a boost in public investment spending, while revenue grew by 9 percent.

17. **The authorities explained that the policy stance adopted in the 2002 Budget largely reflected their concerns about near-term growth**. They recognized, however, that spending had to be reined in from the high levels in the first part of the year in order to meet the 2002 budget target. The staff suggested that, in light of improved growth prospects since

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[7] A forthcoming selected issues paper discusses exchange rate policy and exchange market issues.

[8] Over the past years, the buoyancy of revenues (the ratio of the change in revenues to the change in GDP) have averaged 2.6. Estimates in the budget for 2002, adjusting for tax changes, imply a buoyancy of 1.7.

Box 3. China's Foreign Exchange Market

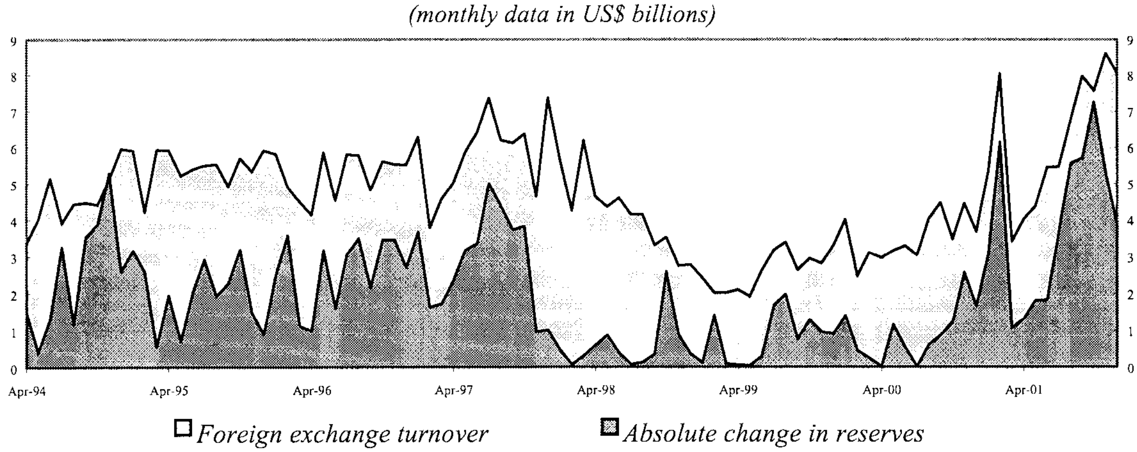
The Shanghai-based *China Foreign Exchange Trading System* (CFETS) was established in January 1994, as a nationally integrated system for interbank foreign exchange trading. The People's Bank of China and the State Administration of Foreign Exchange are the government authorities responsible for the exchange rate, regulating the supply and demand of foreign exchange, and supervising the market. On each business day, the PBC announces the rate of exchange between the renminbi and major foreign currencies[1] based on the previous day's reference rate (a weighted average of the previous day's CFETS transactions). The PBC also specifies a range (typically less than 1 percent) within which the market rate used for commercial transactions may deviate from the announced rate. In practice, the market rate has fluctuated within a narrow band against the dollar (+/-0.3 percent), and an even smaller range (+/-0.02 percent) since the Asian crisis, though small deviations outside this latter range (mostly on the appreciated side) have been allowed in the last two years. In the current centralized system, the CFETS is the counterpart for settlement for each foreign exchange transaction. In situations where the supply and demand in the market do not reach an equilibrium within the desired exchange rate range, the PBC steps in as needed to absorb the excess supply or demand.

Trading in the foreign exchange market has been constrained by many factors. Only "designated foreign exchange banks" are allowed to trade in the market. Domestic enterprises are required to surrender their foreign exchange and conduct all foreign exchange transactions through one bank selected among the banks authorized to perform such transactions. The freedom to transact is further circumscribed by China's foreign exchange control regime (especially the extensive system of capital controls). In practice, market trading is dominated by a few domestic and foreign financial institutions, which are "designated foreign exchange banks". Since these banks accumulate buy and sell orders and send only the residual net position to the CFETS for execution, many transactions never reach the foreign exchange market. The market does not provide for independent position taking and direct dealing between banks, and market-making (two-way quotations) is not possible. While forward instruments were introduced in the late 1990s, trading of such instruments has remained very limited. This reflects not only the overall stability of the renminbi (which reduces the incentives for hedging), but also regulatory impediments, such as the need for the forward cover to be provided only by the Bank of China (one of the four large state commercial banks) and to be linked to an underlying transaction.

Official intervention has been the largest source of foreign exchange trading activity. China's strong external position in recent years has led to an excess supply of foreign exchange at the prevailing exchange rate, which the PBC has absorbed through intervention. Such official foreign exchange purchases have dominated market turnover, which otherwise remains relatively thin (average monthly turnover of around US$8 billion).

China: Foreign Exchange Reserves and Turnover, 1994-2001

(monthly data in US$ billions)



[1] The U.S. dollar, Hong Kong dollar, Japanese yen, and the euro. U.S. dollar trading dominates the system.

the Budget was announced and medium-term constraints, the authorities should maintain the pace of consolidation achieved in recent years and reduce the deficit in 2002 by about ¼–½ percent of GDP. The authorities responded that economic prospects remained uncertain and that there was a limit to how much spending could be rolled back owing in part to the need to complete a number of ongoing infrastructure investment projects.

18. **The medium-term fiscal outlook remains an important source of vulnerability (Box 4)**. While China's explicit budget deficit and debt are modest, the outlook is burdened by large quasi-fiscal liabilities in the banking system associated with nonperforming loans (NPLs) and future costs of social security (especially pension) payments, infrastructure, and other social needs.[9] The authorities and the staff agreed that precise measurement of the quasi-fiscal liabilities was not possible because the ultimate size, disposition, and impact on the explicit state budget of these quasi-fiscal liabilities will depend on reforms implemented and other policy actions taken (including asset sales). Reflecting these considerations, the staff suggested that annual reductions in the fiscal deficit of ¼–½ percent of GDP over the next few years would be a reasonable objective and help ensure the longer-term viability of the fiscal position. This adjustment path would have to be reevaluated periodically to reflect the implementation of reform policies and economic developments. The authorities emphasized that potential demands on the state finances could be less burdensome and might be met to a large extent by a combination of factors including higher growth and recovery rates on NPLs and asset sales. They added that reforms would aim at limiting the impact of quasi-fiscal and other contingent liabilities on the budget.

19. **The authorities noted the importance of pension reforms currently underway**. The authorities have initiated a move to a three-pillar nationwide pension system, including a public minimum pension for all (non-rural) workers, mandatory funded individual accounts, and a supplementary voluntary tier. They have started a provincial pilot project and established a National Social Security Fund to help meet future pension obligations (especially in poorer provinces). Originally, this fund was to be financed by selling gradually through the stock market the state's shareholdings, but this initiative (started in June 2001) was subsequently cancelled because of concerns about its dampening effects on stock prices (see paragraph 30). The staff noted that, given the medium-term fiscal constraints, pension reform would also have to involve significant cost saving measures (such as raising the retirement age and indexing pensions to prices instead of wages), and encouraged the authorities to resume asset sales to help finance pension reform.

20. **The staff welcomed the ongoing efforts to strengthen tax revenue and public expenditure management (areas where the Fund is providing significant technical assistance).** The strong rise in the revenue-to-GDP ratio in recent years is partly attributable to the major efforts made to strengthen tax administration. In particular, computerization is proceeding and increased collaboration between the different agencies involved has reduced

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[9] Staff estimates suggest that non-recoverable NPLs of the SCBs could amount to 45–70 percent of GDP (see Paragraph 23).

Box 4. Medium-term Fiscal Sustainability

At first glance, fiscal sustainability may not appear to be a pressing issue for China. The official debt stock is low and the state budget deficit modest. Official data show that the stock of explicit government debt stood at 25 percent of GDP at end-2001, including bonds issued to recapitalize the four state-owned commercial banks in 1998 and bonds used for on-lending to local governments. Four-fifths of the debt was domestic.

However, including the government's quasi-fiscal liabilities, the public debt-to-GDP ratio would be significantly larger. Although a precise estimate of these liabilities is constrained by data limitations, the debt stock including estimated potential loan losses in the banking sector could be on the order of 70–95 percent of GDP. Moreover, substantial additional public spending needs will arise in the coming years as China will have to increase its expenditure on health, education, infrastructure, and the environment to meet its stated development goals.

To gauge the order of magnitude of the adjustment needed to stabilize the fiscal outlook, the staff conducted a range of illustrative scenarios. The scenarios were derived from simple accounting relations and assumptions about the evolution of broad macroeconomic and fiscal variables. They do not take into account the impact of additional reforms and policies adopted to deal with the problems in the SOE and the banking sectors, which could substantially reduce budget costs. The scenarios do not incorporate significant asset sales, which also could reduce the need for fiscal resources. Consequently, the scenarios need to be treated as being illustrative and will need to be re-evaluated over time in light of more information on reforms and other policy actions and their impact on the required fiscal adjustment.

In a scenario of unchanged fiscal policy, accommodating the above needs would increase the debt-to-GDP ratio from 70 percent of GDP in 2001 (the lower bound of the estimated range) to 95 percent by 2010. The main assumptions driving this result are that (i) the expenditure/GDP ratio rises from 20.5 percent in 2001 to 24.2 percent in 2010, while the revenue/GDP ratio increases at a slower pace from 17.2 percent to 19.0 percent over this period—as a result, the explicit fiscal deficit increases from 3.2 percent of GDP to 5.0 percent; (ii) the rate at which new nonperforming loans occur decreases steadily from the current estimated level of 22 percent of total new loans to 13 percent by 2010; (iii) real GDP growth averages 7–8 percent a year; and (iv) the average real interest rate on domestic debt increases gradually to 3 percent by 2010.

China: Adjustment in the Primary Balance
(in percent of GDP)

Annual fiscal adjustment needed to achieve a debt/GDP ratio of:	by:	2005	2010	2015	2020
50		2.5	0.8	0.4	0.3
60		1.5	0.5	0.3	0.2
80		--	0.1	0.1	0.1
Stock of total debt/GDP					
Unchanged policy		78	95	116	143
Adjustment in NPLs only		74	82	88	96

Stabilizing the debt-to-GDP ratio under these assumptions would require fiscal adjustment, the amount of which would depend on the target debt-to-GDP ratio and the terminal year chosen (see tabulation). Sharply reducing the annual rate of increase in new NPLs alone would not be sufficient to stabilize the debt-to-GDP ratio owing to the large stock of existing NPLs. If the flow of new NPLs were reduced from the present rate of 22 percent of new loans to 2 percent by 2010, the overall debt-to-GDP would still continue to rise to just under 90 percent by 2015. Combined with such a reduction in NPLs, the needed reduction in the explicit deficit ranges from 2.5 percent of GDP per year, if the target debt-to-GDP ratio is 50 percent and the terminal year is 2005, to no reduction if the aim is to stabilize the debt-to-GDP ratio at 80 percent by 2010. For intermediate targets and terminal dates, the reduction in the explicit deficit would be on the order of ¼ to ½ percent of GDP per year. Obviously, if the macroeconomic assumptions underlying the scenarios turn out to be less favorable, a stronger adjustment path would be needed.

The total stock of quasi-fiscal liabilities is significantly larger than the stock of NPLs, also including the potential costs of restructuring SOEs and China's pension system. Consequently, the needed fiscal adjustment could be substantially larger than envisaged in the scenarios presented above. SOE reforms will require additional government resources, as the social responsibilities carried out by these entities will have to be taken up by the government. Moreover, the current pension system would require increasing government support in the long run as the ratio of contributors to beneficiaries declines, unless cost-saving reforms are implemented. There is, however, a fair degree of uncertainty surrounding estimates of the government's financial involvement in these reforms. The government's contribution will depend on how the SOEs are restructured and the specific parameter and institutional changes made to the pension system. Part of the needed fiscal adjustment could come from asset sales, including the sale of state shares as part of the SOE restructuring process.

evasion and fraud. The tax-for-fees reform has been extended to 20 provinces, simplifying the rural tax system and reducing farmers' tax burden.[10] The authorities are also planning to extend the VAT to services and shift it to a consumption basis,[11] as well as to unify the corporate income tax rate for foreign and domestically funded enterprises. In the area of expenditure management, treasury reforms have been accelerated, and progress is being made in strengthening budget preparation (to date, extra-budgetary revenues of five departments have been incorporated in the budget). A new budgetary classification scheme is being phased in and should be fully implemented in 2004.

21. **The system of intergovernmental fiscal relations needs to be strengthened (Box 5)**. Local governments in the poorer regions have encountered serious problems in meeting their spending obligations and maintaining minimum standards of public services. A new sharing formula for income taxes introduced in 2002 will provide for additional transfers to poorer regions.[12] The staff recommended that the authorities undertake a more comprehensive reform, including examining intergovernmental spending and revenue assignments, as well as the transfer system, and allowing for the uneven fiscal impact of structural reforms across provinces and regions.[13] The authorities agreed that reform was needed, and they welcomed planned IMF technical assistance on this issue later in 2002.

C. Structural Reforms

Banking sector

22. **Strengthening the banking sector tops the authorities' reform agenda.** Recognizing that banking sector soundness is key to China's sustained rapid economic growth and financial stability, the authorities have pushed ahead with a broad-based reform effort:

- ***Improved prudential and regulatory framework.*** The PBC in early 2002 implemented new loan classification and provisioning requirements, consistent with

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[10] The tax-for-fees reform is to replace a number of fees and charges in rural areas by a single surcharge on the agriculture tax (with an intended net reduction in the tax burden on farmers).

[11] By allowing VAT on capital goods to be credited.

[12] The 2002 budget introduced a new sharing formula for the personal and corporate income taxes, according to which all proceeds from these taxes above the 2001 level will be shared between the center and the provinces on the basis of a 50-50 ratio (60-40 in 2003). The share received by the center will be used for transfers to poorer provinces.

[13] A forthcoming selected issues paper discusses intergovernmental fiscal relations.

BOX 5. INTERGOVERNMENTAL FISCAL RELATIONS

Intergovernmental fiscal relations over the last 20 years have evolved in two broad phases, decentralization in the early 1980s and recentralization since the mid-1990s. The 1980 fiscal reforms decentralized the revenue sharing system, contributing to a sharp decline in the central government's share of revenue (from 39 percent in 1985 to 22 percent in 1993). By the early 1990s, the authorities considered central government revenue to be seriously inadequate, prompting a new round of reforms toward recentralization by changing the revenue sharing rules and increasing the role of transfers. These reforms helped to more than double the central government's share of total revenue (to 52 percent by 2001).

In recent years, regional disparities in public service delivery have increased. Local governments' revenue sources are limited, while their expenditure responsibilities are substantial, including health, education, unemployment insurance, social security, and infrastructure. Transfers have been largely regressive, in the sense that richer provinces have received most of the money and local governments have been left to rely primarily on their own revenues. This has increased regional disparities with poorer regions often having difficulties meeting minimum standards of public services. It has also led to increased reliance on off-budget revenue, which has raised the burden on farmers and distorted local government finances and service delivery.

Current Arrangements

Revenue:

- Central government revenue includes 75 percent of VAT; excise and trade-related taxes; and a small but increasing share of income taxes (50 percent—60 percent from 2003—of collections above the 2001 level).
- Local government revenue includes 25 percent of the VAT; the business tax; and the remaining (large but declining) share of income taxes.

Transfers:

- Revenue returned gives each province 30 percent of the increase in VAT and excise tax it collects over the 1993 base. Although declining, it still represents 40 percent of total transfers.
- Specific purpose grants are earmarked and allocated on an ad-hoc basis. They have grown recently to about one third of total transfers.

Central to Local Government Transfers, 1997–2001

	1997	2001	1997	2001
	in percent of GDP		in percent of total transfers	
Total transfers	3.8	5.8	100	100
Revenue returned	2.7	2.3	70.5	38.9
Subsidy 1/	0.5	1.5	11.4	26.5
Specific purpose	0.7	2.0	18.1	34.6

Sources: National authorities; and staff estimates.
1/ Includes transfers for income equilization and a small fixed subsidy.

- Subsidy transfers are meant to help equalize the resources of provinces. They are rules-based and depend on variables such as provincial GDP or student-teacher ratios (they also include a small fixed subsidy designed to ensure that each province has revenues no lower than in 1993).

international best practice.[14] Banks are publicly reporting more accurate financial statements, and recently issued guidelines on bank disclosure will push this trend further.

- ***SCBs are focused on reducing NPLs and improving lending practices.*** Stricter prudential regulations, reduced government interference, and improving corporate governance in SCBs have induced improvements in risk management and loan assessments. Some SCBs also have established specialized work-out departments to deal with NPLs. As a result, average NPL ratios of SCBs declined slightly in 2001;[15] their credit growth slowed to 9 percent (year-on-year, from an average 15 percent per annum in 1997-2000); and the composition of new loans shifted to lower-risk housing and consumer loans and, among corporate loans, to more creditworthy clients in the coastal regions.

- ***AMCs are making progress in asset disposal.*** Through end-2001, AMCs disposed of 13 percent of their assets, achieving a cash recovery rate of 21 percent.[16] The legal framework for AMC operations has improved, including through new regulations for foreign investor participation, although deficiencies remain (such as uncertainties over the tax treatment of foreign investors and difficulties in exercising creditor rights).

23. **Despite the progress made, the financial condition of the banking system remains weak**. Even after the transfer of bad loans to AMCs, reported NPL ratios of SCBs remain high (30 percent), with an additional sizable portion (16–20 percent) classified as "special mention". The composition of NPLs suggests a high loss content, with over three-quarters classified as doubtful or loss, and 80-90 percent resulting from loans more than five

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[14] The new classification system has five tiers: pass, special mention, substandard, doubtful, and loss, with the latter three considered as nonperforming. A loan with interest or principal past-due by more than 90 days must be classified as nonperforming. General provisions of one percent of total loans are required, and specific provisions are as follows: two percent of special mention, 20–30 percent of substandard, 40–60 percent of doubtful, and 100 percent of loss loans. Banks are expected to fully comply with these requirements by end-2005.

[15] Reported NPL ratios of SCBs fell to an average 30.4 percent at end-2001, from 30.6 percent at end-2000. The underlying improvement was somewhat larger, taking into account the shift to a new classification system which resulted in upward revisions in reported NPL ratios of two SCBs (by 3–4 percentage points).

[16] The AMCs in 1999–2000 received Y 1.4 trillion of bad loans from the SCBs and one policy bank (14 percent of total loans, or 15½ percent of GDP). Recovery rates are likely to decline as disposal moves to lower-quality assets.

years old. The staff estimates potential loan losses in the banking sector in the range of 45–70 percent of GDP.[17]

24. **Much therefore remains to be done to improve the soundness of the banking sector**. In particular, the staff suggested:

- ***Further strengthening of the prudential regime and enhancing incentives for sound banking.*** Banks' adherence to prudential rules should be strictly enforced, based on close monitoring and a clear set of corrective actions and penalties. Use of external audits to help monitor regulatory compliance and trends in asset quality should be expanded. To enable banks to build loan loss reserves and meet capital requirements, full tax deductibility of specific provisions should be allowed and the tax burden on the banking sector reduced further beyond the scheduled reduction in the business tax rate to 5 percent in 2003 (this issue will be addressed by an IMF technical assistance mission later this year). Lifting the cap on lending rates would also help boost bank profitability and enhance banks' ability to price credit risk.

- ***Restructuring of bank internal operations and ownership***. Steps should be taken toward completing corporatization of the SCBs and improving the banks' credit risk management, internal controls, and accounting and management information systems. The ability of banks to resolve distressed debts[18] needs to be improved, including creditor rights, foreclosure rules, and bankruptcy procedures. Specialized NPL resolution units should be further developed and this practice adopted by all SCBs. The staff also recommended that the authorities adopt clear plans to gradually transfer ownership and management control of the SCBs to the private sector, including strategic investors. Any further capital injections by the state should be made strictly conditional on measurable improvements in operational efficiency and financial performance.

- ***Focusing AMCs on rapid asset disposal***. The early experience with China's AMCs, in line with cross-country experience, suggests that asset management companies are more effective in disposing of assets than in enterprise restructuring. Accordingly, the AMCs should focus their efforts on rapid and effective asset disposal, and their capacity for this would be enhanced by strengthening creditor rights, and giving AMCs full latitude for market-based asset disposal (unconstrained by any administrative targets for recovery rates). In this context, the staff suggested that

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[17] The estimate is based on NPLs reported by SCBs and selected other commercial banks, and on qualitative information for credit cooperatives, policy banks, and trust and investment corporations. It further assumes lower and upper bound recovery rates on NPLs of 10 and 20 percent, respectively, based on the experience of AMCs with asset sales and the relatively old age of NPLs (which suggests substantial impairment of their value).

[18] A forthcoming selected issues paper is devoted to the issue of NPL resolution.

consideration be given to granting the AMCs special legal powers to more easily seize and dispose of collateral and other assets owned by nonperforming debtors.

25. **The authorities agreed with the staff on the need to further improve the prudential regime, enhance incentives for sound banking, and strengthen the SCBs.** They had set a target for SCBs to cut their NPL ratios by about half (to an average 15 percent) by 2005. Even though asset recoveries might still be hamstrung by constraints, the authorities considered that the AMCs had achieved reasonable results and that the banks' own efforts and skills in debt resolution were improving. They expected the SCBs to strengthen their capital base from various sources, including increasing profits, issuance of subordinated debt, possible further NPL transfers to AMCs, private capital infusion through eventual listing on the stock exchange, and possible direct government recapitalization. The authorities agreed with the staff on the importance of continued improvements in prudential oversight, and noted the possible further widening of the band on bank lending rates in the near future. They also saw a need to closely monitor the fast growth in lending by other commercial banks to prevent excessive risk-taking, while noting that gains in market share by these banks represented an intended consequence of reforms.

26. **The staff, once again, encouraged the authorities to consider positively China's participation in FSAP**. The authorities, however, considered an FSAP for China as premature at this stage, given the ongoing reforms of the banking sector and its regulation and supervision.

SOE reforms

27. **SOE profitability has remained weak**. Operating margins and return on assets of SOEs actually declined during the second half of the 1990s, before receiving a boost in 2000 that was mainly due to higher oil prices and lower interest payments resulting from debt-equity swaps.[19] With oil prices falling, industrial SOE profits declined slightly in 2001, and shrank by a further 13 percent (year-on-year) in the first five months of 2002. The authorities explained that recent financial results of SOEs were also affected by payments for laid-off workers and overdue wages and pensions and WTO-related tariff cuts.

28. **While progress has been made in reforming China's SOE sector, the authorities recognized that deep-seated problems remain**. Key steps to improve SOE performance would include: (i) accelerating the establishment of modern management structures and systems; (ii) reforming the management appointment system and establishing appropriate incentives for managers to perform well; (iii) reducing the state's shareholding in SOEs; (iv) increasing competition (including by continued breaking-up of large state utilities and monopolies and following through on WTO-related liberalization); and (v) strengthening the social safety net, especially the pension and unemployment insurance systems (as SOE

[19] See WP/01/82 (C. Karacadag, "An Attempt to Profile the Finances of China's Enterprise Sector").

reforms typically involve laying off redundant workers and relieving enterprises of their social responsibilities). In addition, the staff noted the importance of basing all new lending to SOEs on a strictly commercial basis. For SOEs unable to raise sufficient operating capital, the government would need to decide which ones to support directly from the budget, while expediting their restructuring or exit from the market.

29. **The authorities pointed to the wide range of reforms underway, designed to transform SOEs into globally competitive entities**. They explained that the basic reform strategy remained to "corporatize" the large enterprises (by introducing shareholding and modern management systems) while "releasing" the smaller ones (through merger, bankruptcy, leasing, sales, or closure), to increase competition through progressive external and domestic liberalization, and to improve the social safety net to help cushion the impact of reforms. The authorities emphasized that managing the social pressure of SOE reform was a key motivation behind their efforts to improve the pension system, unemployment benefits, health care, and the minimum living standards allowance. They also noted the increasingly restrained lending by SCBs as evidence of hardening budget constraints, and explained that the process of corporatization was being more closely supervised to ensure meaningful enterprise restructuring.

Capital market development

30. **The authorities' efforts to strengthen China's equity and bond markets continue**. Although the stock markets have developed rapidly since their inception in 1990,[20] they remain dominated by state controlled companies (about 90 percent of all listed companies), market segmentation (with about two-thirds of all shares held by state entities and not traded), absence of institutional investors, and weak transparency and market irregularities. Over the past two years, the authorities have tightened market oversight to crack down on fraud and market manipulation, strengthened listing and delisting rules, and taken steps to raise corporate governance in listed companies. The authorities and the staff agreed that it was important in the longer run to increase the number of private listed companies and reduce the amount of shares held by the state. However, the authorities also emphasized the importance of strengthening the quality of listed firms and preventing a sharp decline in stock prices. In order to preserve the integrity of the market, they would continue to limit new listings. Moreover, while they retained the objective of eventually disposing of the shares held by the state, the state share sales program was suspended in October 2001 and terminated in June 2002. In the future, such sales would have to be done in a way that would prevent major market disruptions (for example, through negotiated sales).

31. **Efforts are also needed to develop the bond market**. Although the primary bond market has grown rapidly in recent years, it remains illiquid and corporate issues have been few. To improve market infrastructure and liquidity, the staff recommended unifying bond

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[20] For a summary description of China's stock markets, see SM/01/206, Box 1.

trading on the interbank and stock markets,[21] developing more liquid benchmarks for government bonds, and unifying bond market supervision. The authorities generally agreed with these suggestions and indicated that some work in this area was already being done.

Labor market and distributional issues

32. **The labor market has become more market-oriented over the past 20 years, and the main challenge now is to create the conditions for further rapid and high-quality job growth in the private sector.**[22] Workers now can seek jobs for themselves, enterprises have much greater autonomy in hiring decisions and over wage levels, and a large share of employees has shifted to employment contracts. The private sector has become the main engine of job growth in recent years, while state-owned and collective units reduced their workforce from a peak of about 145 million in the early 1990s to less than 90 million in 2001. Strong job growth will be needed to absorb both the existing labor surplus and the 10–11 million new workers entering the labor force each year.

33. **The authorities intend to address labor market pressures by encouraging private sector job growth, reducing barriers to migration, developing worker skills, and facilitating job search.** A number of steps have been taken to foster private sector development, including by formally elevating its role to parity with the state sector (in a 1999 amendment to the Constitution), continued external and domestic liberalization, and facilitating access to credit. However, further efforts are needed to improve private sector access to capital (including through stock market listing) and reduce barriers to entry (in particular, by breaking up state monopolies and eliminating or modifying licensing requirements in line with WTO commitments). To encourage greater labor mobility, restrictions on internal migration have been reduced, but a further liberalization of the "hukou" system of residency permits will likely be needed to encourage surplus rural workers to move to the cities.[23] In order to enhance workers' employment prospects, the authorities are promoting education and training (with assistance from the ILO), although funding of education in poorer provinces will need to be improved to achieve the goal of nine-year universal basic education by 2010. In addition, the authorities are enhancing access to information on job opportunities and are fostering the establishment of private employment agencies.

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[21] China's bond market transactions currently take place in the interbank and stock exchanges, with different instruments, investors, and trading mechanisms. Banks trade solely in the interbank market, while individual investors are mainly confined to the stock exchange; securities houses and investment funds can trade in both markets, but with only a few bonds being traded in both markets, arbitrage is difficult.

[22] A Selected Issues Paper addresses the outlook and reforms in China's labor market.

[23] The "hukou" system was set up in the mid-1950s to control the movement of the population; an urban houkou designation was needed for an individual to reside in cities and for access to city services, such as education, health, and social security.

34. **Addressing the rural-urban and regional income divide has become a major policy concern**. Partly related to the lagging growth in farmers' incomes, growth in the poorer western and central provinces has been much slower than in the coastal regions. To address this increasing gap and the resulting social tensions in the countryside, the authorities are pursuing a two-pronged strategy that includes intensified efforts to "Develop the West" and a comprehensive program to promote rural incomes. The "Develop the West" initiative has directed a substantial amount of resources for infrastructure investments, technological upgrading, and training and education to the poorer provinces. The 10th Five-Year Plan (2001–05) has set a goal of 5 percent annual growth in farmers' income, by promoting higher-value-added agricultural activities, encouraging nonfarm businesses, and reducing the fiscal burden on farmers through the tax-for-fees reform.

Trade policy, debt relief, anti-money laundering, and statistical issues

35. **The authorities said that the implementation of China's WTO commitments was broadly on schedule (Box 6)**. They explained that, notwithstanding minor technical delays (for example, in allocating tariff quotas for agricultural imports), overall progress was in line with China's WTO commitments. In particular, they noted that the average import tariff rate was cut by about 3 percentage points in early 2002,[24] and that a wide range of laws and regulations had already been adapted to WTO requirements (including on foreign investment, customs valuation, and the protection of intellectual property rights). At the same time, they voiced concern about recent steps taken by trading partners to limit imports from China, such as anti-dumping measures. They feared that proliferation of such measures could significantly weaken the gains from WTO accession.

36. **China has given debt relief to several Heavily Indebted Poor Countries (HIPCs)**. Under China's African initiative for debt relief announced in 2000, the authorities have deemed 32 countries eligible for debt relief. To date, memoranda of debt relief have been signed with 31 of those countries. The total amount of debt relief under the initiative is about US$1.2 billion.

37. **Although China does not have a separate anti-money laundering (AML) framework, relevant rules are contained in various other laws**. The Criminal Code defines money laundering and the financing of terrorism as offences. There is no single body that is responsible for implementing and enforcing AML-related laws and regulations. The State Council, the People's Bank of China, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission are all responsible for AML matters in the context of their supervisory roles and duties.

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[24] Import tariffs were reduced from 15.3 percent to 12.0 percent (unweighted average), or from 9.1 percent to 6.4 percent (weighted average), in early 2002.

BOX 6. THE TERMS OF CHINA'S WTO ACCESSION

China's WTO accession in December 2001 represents a significant move to further open its economy and a signal of its commitment to domestic reforms. Over the next few years, China will lower further its external tariffs, phase out quantitative import restrictions, and grant substantial market access to foreign service providers. China has also agreed to comply with WTO rules and requirements, including in the areas of safeguards and antidumping. Specifically:

Market access:

1. **Goods markets**—all tariffs on imported goods are to be eliminated or reduced, mostly by 2004:
    - *Industrial* goods—tariffs will be reduced to an average of 9 percent; tariff "peaks" will be very significantly reduced; import quotas will be removed by 2005;
    - *Agricultural* goods—tariffs will be decreased to 15 percent on average.

2. **Services sectors**—foreign providers' access is to be ensured through transparent and automatic licensing procedures in various sectors, including insurance, legal and other professional services, telecommunications, tourism and, importantly:
    - *Right to Trade and Distribution*—within three years after accession, all firms will have the right to import and export all goods except those subject to state trading monopolies (e.g., oil or fertilizers). Within five years, foreign firms will be allowed to distribute virtually all goods domestically.
    - *Banking*—foreign financial institutions will be permitted to provide services without client restrictions for foreign currency business upon accession; local currency services to Chinese companies within two years; and services to all Chinese clients within five years.

Other provisions

1. **Trading and investment regimes**. China will ensure that its trade and investment regimes are compatible with WTO principles:
    - *National treatment/non-discrimination*—Measures and practices that discriminate against imported products or foreign companies will be removed.
    - *Export subsidies*—Upon accession, all forms of export subsidies inconsistent with WTO rules, including grants and tax breaks linked to export performance, were eliminated.
    - *Trade-Related Investment Measures (TRIMs)*—Foreign investment approvals will no longer be subject to mandatory requirements (e.g., technology transfer or local content requirements).
    - *Trade-Related Aspects of Intellectual Property Rights (TRIPs)*—China will enforce the rights protecting intellectual property within China.

2. **Safeguards by trading partners**. These provisions could potentially constrain China's export market gains from WTO accession in the coming years:
    - *Anti-dumping and countervailing* safeguards allowing the determination of dumping and subsidies based on the "non-market economy" criterion (up to 15 years after China's accession for antidumping).
    - Transitional *product-specific* safeguards against imports from China, based on a "market disruption" rather than "serious-injury" criterion as under normal WTO rules (for up to 12 years).
    - A special *textiles and clothing* safeguard until the end of 2008 (instead of 2004 for other WTO members) is provided under the *Agreement on Textiles and Clothing*.

38. **Considerable progress has been made in upgrading China's economic statistics, but further improvements are needed (Annex II).** Progress has been made especially in the areas of external debt, monetary statistics, and the financial condition of SCBs. In April 2002, China subscribed to the Fund's GDDS, providing comprehensive documentation and establishing a framework for further improvements. The staff urged the authorities to work especially toward presenting quarterly real GDP data on an expenditure basis, more comprehensive labor and price statistics, and fiscal accounts on the standard GFS basis. In the external area, the staff encouraged the authorities to strengthen monitoring of capital flows and data provision to the IMF on reserves and external debt, in line with the benchmarks established for surveillance purposes.

III. STAFF APPRAISAL

39. **China's economic performance continues to be impressive**. Although growth slowed in the course of last year, it remained much faster than in most other parts of the world. This performance reflects policies and structural reforms that allowed the economy, once again, to weather a sizable external shock while continuing its transformation toward increased market orientation. The near-term outlook is also favorable; with improved external conditions, real GDP growth should reach 7½ percent in 2002 and sustain that pace in 2003.

40. **The continued implementation of sound macroeconomic policies will establish a stable foundation for economic development; at the same time, it is essential to sustain the momentum in reforming the structure of the economy**. The authorities are fully aware that, while short-term vulnerabilities are limited, the medium-term outlook depends on completing the unfinished reform agenda. Top on this agenda remains the need to address the intertwined problems in the banking, SOE, and fiscal sectors in order to ensure that rapid growth and financial stability can be sustained and the social costs of the transition managed successfully.

41. **The staff supports the current stance of monetary policy**. The present growth and inflation outlook argues for leaving renminbi interest rates unchanged. Nevertheless, the authorities should be prepared to change the policy stance as required, and there is some scope to lower interest rates in the event economic prospects worsen significantly. To improve the effectiveness of monetary policy, the staff recommends early progress in liberalizing lending rates, and lowering the remuneration of excess reserves at the central bank. At the same time, the staff cautions the authorities on the use of policy guidelines to encourage SCBs to increase their lending as this could undo some of the gains made in recent years toward commercializing the operations of the banks.

42. **The staff's advice remains for China to move gradually toward greater exchange rate flexibility**. Greater exchange rate flexibility is important to facilitate adjustment to the major structural changes underway and China's increasing integration into the world economy. The strong external position and favorable growth outlook would allow a move from a position of strength. As an integral part of any move to greater flexibility, the

exchange market needs to be substantially improved to more fully and directly reflect the supply and demand for foreign exchange in the economy.

43. **Fiscal policy should maintain the steady path of consolidation realized in recent years**. Medium-term constraints increasingly limit the scope for expansionary fiscal policy to support domestic demand, and the need for such support has diminished with the improvement in growth prospects. Hence, the staff recommends that the authorities aim to reduce the fiscal deficit in 2002 by about ¼–½ percent of GDP from last year's outcome, and continue this pace of consolidation in the next few years. In particular, spending growth has to be reined in from the high levels realized in early 2002.

44. **The medium-term fiscal outlook remains a source of vulnerability**. While the explicit public debt is relatively low, the outlook is burdened by large quasi-fiscal liabilities in the banking system and future costs of pension reform, infrastructure, and other social needs. The ultimate impact of these contingent liabilities on the budget will depend importantly on structural reforms implemented and other policy actions taken, including asset sales. Nonetheless, substantial demands can be expected to be placed on the state finances. To meet these demands without putting public debt on an unsustainable path will require that the explicit state budget deficit be reduced further over the next few years.

45. **The staff welcomes the broad range of ongoing fiscal reforms**. Progress in strengthening tax administration and the budget process is particularly commendable. The staff encourages the efforts toward a broader pooling of pension contributions and to enhance the funding of the pension system; these efforts will have to be accompanied by cost-containing measures to ensure the long-term viability of the pension system. The staff also urges an early revamp of the system of intergovernmental fiscal relations to ensure that local governments in poorer provinces can meet minimum standards of public services and to facilitate key structural reforms.

46. **The staff commends recent progress in banking reforms, and urges continued forceful action to strengthen the prudential regime and enhance incentives for sound banking**. The new loan classification system and corresponding provisioning requirements are welcome, and there is evidence of improving risk management and asset recovery by SCBs. The new prudential rules should be strictly enforced, including through increased use of external audits. The staff recommends that the authorities allow tax deductibility of specific loan loss provisions and further reduce the tax burden on the banking sector. These measures, along with the removal of lending rate ceilings, should help raise bank profits and aid in improving their capital base. The PBC is encouraged to further strengthen its supervisory capabilities and, in particular, to closely monitor fast-growing banks to mitigate the risk of future NPLs. The staff encourages China's early participation in the FSAP to take stock of the ongoing reforms and identify vulnerabilities and priorities for future development.

47. **Restructuring of bank ownership and internal operations needs to be accelerated**. The staff recommends early corporatization of SCBs and continued efforts to improve their risk management and controls, retrain staff, and upgrade legal and accounting

standards. The ability of banks to resolve distressed debts needs to be strengthened, including by improving the legal framework of creditor rights, foreclosure, and bankruptcy. Specialized NPL resolution units established by some banks should be further developed, and this practice adopted by other banks. Any further capital injections by the state should be made strictly conditional on measurable improvements in banks' performance, and the authorities should adopt a clear plan to gradually transfer ownership and management control of the SCBs to the private sector, including strategic investors.

48. **Rapid asset disposal should remain the top priority of China's asset management companies (AMCs)**. The staff welcomes the progress made by AMCs in disposing assets, supported by improvements in the regulatory environment and the use of foreign expertise. To further enhance the AMCs' capacity for effective asset disposal, creditor rights need to be strengthened, remaining legal uncertainties over the taxation of capital gains should be addressed, and specific targets for recovery rates should not impede speedy and market-based asset disposal. The authorities may also consider granting AMCs special legal powers to more easily seize and dispose of collateral and other assets of nonperforming debtors.

49. **Among the wide range of SOE reforms underway, the staff underscores the importance of hardening enterprise budget constraints**. All new lending to SOEs should be on a strictly commercial basis; SOEs that are unable to raise sufficient operating capital should be either supported directly from the budget—with appropriate restructuring—or forced to exit from the market. In addition, the staff urges accelerated efforts at establishing modern enterprise management systems, including reforms to the management appointment and incentives system; reducing the state's shareholding in SOEs; and increasing competition, including by breaking up large state utilities and monopolies.

50. **Unemployment remains a pressing issue as the economy adjusts to the effects of SOE reforms and WTO accession**. To mitigate these pressures, job growth in the private sector should be fostered by improving access to capital, reducing barriers to entry, and further reforms to the "hukou" system of residency permits to allow freer movement of labor. The staff also encourages the government's efforts to upgrade education and training, and welcomes the progress being made in strengthening the social safety net, including the pension system, unemployment insurance, health care, and the minimum living standard allowance.

51. **The staff supports the measures being taken to develop the stock and bond markets**. Ongoing efforts to improve market oversight, rationalize listing and delisting rules, improve accounting and disclosure standards, and upgrade corporate governance are welcome and should continue. The staff also recommends that further steps be taken to bring more private companies to the market, develop institutional investors, improve the initial-public-offering process, and strengthen bond market liquidity and infrastructure.

52. **Considerable progress has been made in upgrading China's economic statistics, but further improvements are need**. The staff welcomes China's recent participation in the GDDS, and urges the authorities to follow through with the full implementation of the plans

for improvement contained in the GDDS. The staff also notes that, although data provision to the Fund has improved, there remains substantial room for improvement in a number of areas important to IMF surveillance.

53. **The staff recommends that the next Article IV consultation with China take place on the standard 12-month cycle.**

Table 1. China: Summary Indicators

Nominal GDP (2001): US$1,159 billion
Population (2001): 1.276 billion
GDP per capita (2001): US$908
Quota: SDR 6,369.2 million

	1998	1999	2000	2001 Est.	2002 Proj.	2003 Proj.
			(Change in percent)			
Real GDP	7.8	7.1	8.0	7.3	7.5	7.5
Real domestic demand	8.5	8.8	8.0	8.6	7.7	7.8
Consumer prices (period average)	-0.8	-1.4	0.4	0.7	-0.1	1.5
			(In percent of GDP)			
Gross domestic investment	37.7	37.2	37.3	37.9	37.0	37.0
Gross national saving	41.0	38.7	39.2	39.4	38.5	38.0
External current account	3.3	1.6	1.9	1.5	1.5	1.0
Overall budget balance 1/	-3.0	-4.0	-3.6	-3.2	-3.3	-2.7
Revenue	13.0	14.3	15.3	17.2	17.8	18.4
Expenditure (including net lending)	16.1	18.3	18.9	20.4	21.1	21.1
			(Change in percent; end of period)			
Banking system's net domestic assets 2/	15.7	15.0	10.8	12.3	...	...
Of which : Domestic credit 2/	20.0	15.9	17.2	12.1	...	...
Broad money 2/	15.3	14.7	12.3	14.4	...	...
Reserve money	2.3	7.2	8.5	9.2	...	...
Interest rate (one-year time deposits, in percent)	3.8	2.3	2.3	2.3	...	...
			(In billions of U.S. dollars)			
Current account balance	31.5	15.7	20.5	17.4	18.9	13.4
Of which: Exports	183.6	194.9	249.2	266.1	292.8	324.7
Imports	136.9	158.5	214.7	232.1	257.1	289.2
Capital and financial account balance	-6.3	7.6	1.9	34.8	28.0	21.6
Of which : Direct investment inflows (net)	41.1	37.0	37.5	37.4	41.0	41.0
Errors and omissions	-18.7	-14.8	-11.9	-4.9	-5.0	-5.0
Change in net international reserves (increase -)	-6.4	-8.5	-10.6	-47.4	-41.9	-30.0
Gross international reserves 3/	149.8	158.3	168.9	216.3	258.2	288.1
In months of imports of goods and nonfactor services (in percent)	11.0	10.0	8.1	9.6	10.4	9.9
As a percent of short-term external debt 4/	864	1,042	1,291	376	420	433
External debt 4/	146.0	151.8	145.7	170.1	178.9	199.9
Of which : Short-term debt 4/	17.3	15.2	13.1	50.6	61.5	66.5
Debt-service ratio (in percent of exports) 4/	8.0	9.1	7.3	7.1	7.4	7.1
Exchange rate at end-period (Rmb per US$) 5/	8.3	8.3	8.3	8.3	...	...
Nominal effective exchange rate 5/	73.2	70.8	72.8	76.7	...	...
Real effective exchange rate 5/	100.0	92.9	92.5	95.2	...	...

Sources: Data provided by the Chinese authorities; and staff estimates and projections.

1/ Central and local governments, IMF definition (see Table 6).
2/ Banking survey.
3/ Includes gold, SDR holdings, and reserve position in the Fund.
4/ Official data sources. The coverage and classification of official external debt data were modified in 2001. Since then categories of debt previously not covered have been included, especially under short-term debt, whose measure is on a remaining maturity basis (and on an original maturity basis between 1996 and 2000).
5/ Annual averages (1990 = 100), using revised weights.

Table 2. China: Balance of Payments
(In billions of U.S. dollars)

	1997	1998	1999	2000	2001	2001				2002
						Q1	Q2	Q3	Q4	Q1
Merchandise Trade 1/										
Exports	182.9	183.6	194.9	249.2	266.1	59.3	65.7	70.4	71.3	64.7
Imports, customs value	142.2	140.3	165.7	225.1	243.5	54.5	61.9	65.0	62.1	57.4
Trade balance, customs basis	40.7	43.3	29.2	24.1	22.6	4.8	3.8	5.5	9.2	7.3
Trade balance, BOP basis 2/	46.2	46.6	36.2	34.5	34.0	7.2	6.2	8.5	12.0	...
Services, income, & current transfers balance 2/	-11.5	-14.0	-20.5	-14.0	-16.6	-1.2	-7.1	-3.5	-4.7	...
Current account balance 2/	37.0	31.5	15.7	20.5	17.4	6.0	-0.9	5.0	7.3	...
(in percent of GDP)	4.1	3.3	1.6	1.9	1.5	...	...	...	...	...
Foreign direct investment (net, BOP basis) 2/	41.7	41.1	37.0	37.5	37.4	7.2	11.1	10.7	8.4	...
Inward investment credits 1/	45.3	45.6	40.4	40.8	46.8	8.0	12.7	11.5	14.6	10.1
Identified non-FDI private capital inflows 3/	20.6	-9.3	-13.9	15.7	-1.1	-0.1	3.3	-3.9	-0.2	...
BIS Bank Claims on China	9.5	-9.2	-17.1	-5.3	-3.6	-1.8	1.5	-2.7	-0.6	...
BIS Equity Issues	9.2	1.1	3.3	21.1	3.1	1.8	0.5	0.2	0.8	0.2
BIS Securities	1.9	-1.2	-0.1	-0.1	-0.6	-0.2	1.3	-1.4	-0.3	-0.1
Other capital flows 4/	-41.3	-38.1	-15.5	-51.3	-1.5	-1.3	-1.2	2.8	-2.0	...
Capital and financial account (BOP basis) 2/	21.0	-6.3	7.6	1.9	34.8	5.8	13.2	9.6	6.2	...
Change in stock of foreign exchange 2/	34.9	5.1	9.7	10.9	46.6	10.2	5.0	15.0	16.4	15.4
Change in China's accounts with the IMF 5/	0.9	1.4	-1.2	-0.3	0.7	0.3	0.0	0.5	-0.1	0.2
Change in stocks of reserve assets	35.8	6.5	8.5	10.5	47.4	10.6	5.0	15.5	16.3	15.6
Residual: Other flows (non-BOP data) 6/	-67.1	-61.4	-33.7	-66.5	-15.8	-2.1	-14.8	2.4	-7.3	...
Of which: errors and omissions 2/	-22.3	-18.7	-14.8	-11.9	-4.9	-1.2	-7.3	0.4	3.2	...

Sources: Data from the Chinese authorities; Bank for International Settlements; and staff calculations.

1/ Trade and FDI inflows data are official data from the Ministry of Foreign Trade and Economic Cooperation.
2/ Official Chinese balance of payments statistics.
3/ Based on Bank for International Settlements data.
4/ Capital and financial account less FDI (BOP basis) and other identified private flows (BIS data).
5/ IMF Treasurer's Department.
6/ The sum of the current account balance, FDI inflows, and identified non-FDI flows from BIS data less reserve accumulation.

Table 3. External Debt
(In billions of U.S. dollars) 1/

	1997	1998	1999	2000	2001
Debt to Commercial Banks	51.9	55.8	53.4	46.2	46.5
Foreign Financial Institutions	40.3	42.8	39.6	32.9	33.5
Buyer's credit	11.6	13.0	13.8	13.2	13.1
Debt to Official Creditors	40.0	45.4	51.7	51.0	51.3
Bilateral official creditors	20.8	22.4	26.6	24.6	23.7
Multilateral creditors	19.2	23.0	25.1	26.3	27.6
Bonds Issued Abroad	12.9	12.4	12.0	12.3	12.7
Debt to other creditors	26.2	32.5	34.8	36.3	59.6
Of which:					
Loans from other non-bank sources	13.8	17.4	20.2	22.8	23.5
Trade credit	1.5	1.7	2.0	1.6	24.4
International financial leasing	10.5	13.1	12.3	11.9	10.1
Total debt	131.0	146.0	151.8	145.7	170.1
Of which:					
Short-term debt (original maturity) 1/	18.1	17.3	15.2	13.1	...
Short-term debt (remaining maturity) 1/	...	...	...	...	50.6
Memorandum items:					
Debt to Commercial Banks from BIS Data	82.4	77.1	62.1	52.2	46.3
Difference between BIS and official data	29.4	21.3	8.7	6.0	-0.3
Debt to Offical Creditors from OECD data	51.5	55.5	62.6	56.8	56.7
Difference between OECD and official data	11.5	10.1	10.9	5.8	5.4
Bonds Issued Abroad from OECD data	14.5	14.6	14.2	13.8	12.8
Difference between OECD and official data	1.6	2.1	2.2	1.5	0.2
Total Debt adjusted for creditor source differences	174.6	179.6	173.6	147.1	173.8
Subtotal: all adjustments	42.6	33.5	21.7	1.3	3.7
Short-term debt (remaining maturity, from BIS data)	63.1	58.6	36.2	19.8	20.1

Sources: Chinese authorities; Bank for International Settlements; Organisation for Economic Cooperation and Development; and Fund Staff calculations.

1/ Significant changes in coverage and classification of official external debt data were made in 2001 and are reflected in the 2001 data only. Categories of debt previously not covered are now included, especially under short-term debt (e.g., trade credit), whose measure for 2001 is now provided only on a remaining maturity basis.

Table 4. China: Indicators of External Vulnerability

	1998	1999	2000	2001	2002	2003	2004	2005
					Projection			
Monetary and Financial indicators								
Public sector domestic debt (official data; in percent of GDP)	13.4	16.1	18.3	20.1	21.9	...	...	...
Broad money (M2; annual percentage change)	15.3	14.7	14.0	14.4	...	...	...	...
Foreign currency deposits to broad money (in percent)	7.0	7.1	7.9	7.0	...	...	...	...
Credit to nonstate sectors (annual percentage change)	16.3	15.6	18.1	8.5	...	...	...	...
Foreign currency loans to credit to the economy (in percent)	...	5.9	3.9	5.2	...	...	...	...
Stock Exchange Index (end of period, Dec. 19, 1990 = 100) 1/	1,147	1,367	2,073	1,646	...	...	...	...
Stock Exchange capitalization (percent of GDP)	1	1.8	3.0	2.9	...	...	...	...
Number of listed companies	438	484	572	646	...	...	...	...
Balance of payments indicators								
Exports (annual percentage change, U.S. dollars)	0.5	6.1	27.9	6.8	10.0	10.9	11.4	16.1
Imports (annual percentage change, U.S. dollars)	0.3	15.8	35.4	8.1	10.8	12.5	12.9	16.8
Current account balance (percent of GDP)	3.3	1.6	1.9	1.5	1.5	1.0	0.7	0.6
Capital and financial account balance (percent of GDP)	-0.7	0.8	0.2	3.0	2.3	1.6	1.3	1.2
Of which:								
Gross foreign direct investment inflows	4.8	4.1	3.8	4.0	3.9	3.5	3.3	3.0
Unidentified capital flows 2/	-6.5	-3.4	-6.2	-1.4	0.0	0.0	0.0	0.0
Reserve indicators								
Gross reserves (billions of U.S. dollars)	150	158	169	216	258	288	312	337
Gross reserves to imports of GNFS (months)	11.0	10.0	8.1	9.6	10.5	10.3	9.9	9.1
Gross reserves to broad money (M2) (in percent)	11.9	10.9	10.4	11.6	...	...	...	...
Gross reserves to short-term external debt (in percent) 3/	256	438	852	427	...	...	...	...
External debt and balance sheet indicators 4/								
Total external debt	146.0	151.8	145.7	170.1	178.9	199.9	221.4	243.4
Of which: Public and publicly guaranteed debt 5/	41.6	47.3	49.0	49.8	...	...	...	...
Banking sector debt 6/	34.0	34.4	29.8	30.1	...	...	...	...
Short-term external debt by original maturity	17.3	15.2	13.1	...	...	...	...	...
Short-term external debt by remaining maturity	...	...	...	50.6	...	...	...	...
Short-term external debt by remaining maturity based on BIS data	58.6	36.2	19.8	20.1	...	...	...	...
Net foreign assets of banking sector	24.3	36.6	70.0	88.6	...	...	...	...
Total external debt (percent of GDP)	15.4	15.3	13.5	14.7	14.4	14.7	14.9	14.8
Total debt to exports of GNFS (in percent)	70.4	69.5	52.1	56.8	54.8	55.2	54.9	51.9
Total debt service to exports of GNFS (in percent)	8.0	9.1	7.3	7.1	7.4	7.1	7.1	6.8
Of which: Interest payments to exports of GNFS (in percent)	3.0	3.8	2.9	3.2	3.2	3.1	3.1	3.0
Bond spread (benchmark bond, end of period, basis points)	273	162	162	101	...	...	...	...
Foreign-Currency Sovereign Bond Ratings								
Moody's	A3	A3	A3	A3	A3	...	...	...
Standard and Poor's	BBB+	BBB	BBB	BBB	BBB	...	...	...
Memorandum items:								
Nominal GDP (US$ billions)	946	991	1,080	1,159	1,244	1,358	1,489	1,640
Exports of GNFS (US$ billions)	207	218	280	299	326	362	403	469
Real effective exchange rate (end of period, percentage change)	-8.6	-3.4	4.6	0.6	...	...	...	...

Sources: The Chinese authorities; and Fund staff estimates and projections.

1/ Composite index based on A- and B-shares.
2/ The sum of the current account, FDI inflows, and identified non-FDI flows from BIS data less reserve accumulation.
3/ Short-term debt on remaining maturity basis, based on BIS debt data until 2000 and on official data from 2001 onward.
4/ In billions of U.S. dollars and based on official debt data, unless otherwise indicated.
5/ Does not include external debt of state-owned banks.
6/ Does not include foreign-funded financial institutions.

Table 5. China: State Budgetary Operations 1/

	1997 Actual	1998 Actual	1999 Actual	2000 Actual	2001 Budget	2001 Actual	2002 Budget
			(In billions of yuan)				
Total revenue	902.0	1,020.9	1,173.4	1,365.9	1,502.0	1,654.8	1,830.5
Tax	823.4	926.3	1,068.3	1,257.1	1,380.6	1,529.2	1,689.6
Nontax	78.6	94.7	105.2	108.8	121.4	125.7	140.9
Total expenditure and net lending	1,039.5	1,258.6	1,505.3	1,690.9	1,805.9	1,958.4	2,169.5
Current	857.4	985.8	1,123.8	1,316.1	1,447.9	1,563.6	1,737.9
Of which:							
Subsidies	90.7	104.6	98.5	132.9	114.1	104.0	105.8
Interest 2/	59.2	72.9	59.6	72.7	80.1	79.4	68.5
Capital	162.0	200.3	283.5	299.7	313.9	350.7	402.2
Unrecorded expenditures	20.1	72.6	97.9	75.1	44.1	44.1	29.4
Overall balance	-137.5	-237.7	-331.8	-325.0	-303.9	-303.6	-339.0
Financing	137.5	237.7	331.8	325.0	303.9	303.6	339.0
Domestic (net, residual)	116.7	190.8	285.0	311.2	296.9	296.5	331.1
Foreign (net)	20.8	46.9	46.8	13.8	7.1	7.1	7.9
			(In percent of GDP)				
Total revenue	12.1	13.0	14.3	15.3	15.7	17.2	17.8
Tax	11.1	11.8	13.0	14.1	14.4	15.9	16.4
Nontax	1.1	1.2	1.3	1.2	1.3	1.3	1.4
Total expenditure and net lending	14.0	16.1	18.3	18.9	18.8	20.4	21.1
Current	11.5	12.6	13.7	14.7	15.1	16.3	16.9
Of which:							
Subsidies	1.2	1.3	1.2	1.5	1.2	1.1	1.0
Interest 2/	0.8	0.9	0.7	0.8	0.8	0.8	0.7
Capital	2.2	2.6	3.5	3.4	3.3	3.7	3.9
Unrecorded expenditures	0.3	0.9	1.2	0.8	0.5	0.5	0.3
Overall balance	-1.8	-3.0	-4.0	-3.6	-3.2	-3.2	-3.3
Financing	1.8	3.0	4.0	3.6	3.2	3.2	3.3
Domestic (net)	1.6	2.4	3.5	3.5	3.1	3.1	3.2
Foreign (net)	0.3	0.6	0.6	0.2	0.1	0.1	0.1
Memorandum items:							
Unrecorded expenditures (in billions of yuan)	20.1	72.6	97.9	75.1	44.1	44.1	29.4
Of which:							
External borrowing excluded from budget	...	42.8	51.7	13.1	4.1	4.1	4.4
Unbudgeted fiscal "stimulus" spending	...	29.8	46.2	62.0	40.0	40.0	25.0
Primary balance (percent of GDP)	-1.1	-2.1	-3.3	-2.8	-2.3	-2.3	-2.6
Balance including policy bank lending	...	...	-5.8	-5.1	...	...	...
Government debt	11.4	17.8	20.9	22.8	24.5	24.4	26.0
Domestic	7.4	13.4	16.1	18.3	20.2	20.1	21.9
External	4.0	4.4	4.8	4.5	4.3	4.3	4.1
Budget balance (government definition)	-0.8	-1.2	-2.1	-2.8	-2.7	-2.6	-3.0

Sources: Ministry of Finance; People's Bank of China; State Statistical Bureau; and staff calculations.

1/ The coverage is central government, provinces, municipalities and counties, IMF definition (see Table 6).

2/ Interest payments on external debt and on recapitalization bonds are not included.

Table 6. China: Official and IMF Budget Definitions

	1999	2000 Prel.	2001 Prel.	2002 Budget
	(In billions of yuan)			
Revenue (official definition)	1,144.4	1,338.0	1,637.1	1,801.4
Plus:				
Subsidies to loss-making SOEs 1/	29.0	27.9	29.9	29.1
Minus:				
Privatization proceeds	0.0	0.0	12.2	0.0
Revenue (IMF definition)	1,173.4	1,365.9	1,654.8	1,830.5
Expenditure (official definition)	1,318.8	1,587.9	1,884.4	2,111.0
Plus:				
Subsidies to loss-making SOEs 1/	29.0	27.9	29.9	29.1
Interest payments (foreign and domestic) 2/	59.6	...	...	...
On-lending associated with official external financing	51.7	13.1	4.1	4.4
Unrecorded fiscal stimulus spending (onlending to local governments)	46.2	62.0	40.0	25.0
Expenditure (IMF definition)	1,505.3	1,690.9	1,958.4	2,169.5
Balance (official definition) 2/	-174.4	-249.9	-247.3	-309.6
Balance (IMF definition)	-331.8	-325.0	-303.6	-339.0
	(In percent of GDP)			
Revenue (official definition)	13.9	15.0	17.1	17.5
Revenue (IMF definition)	14.3	15.3	17.2	17.8
Expenditure (official definition)	16.1	17.8	19.6	20.5
Expenditure (IMF definition)	18.3	18.9	20.4	21.1
Balance (official definition)	-2.1	-2.8	-2.6	-3.0
Balance (IMF definition)	-4.0	-3.6	-3.2	-3.3
Memorandum item:				
Nominal GDP (in billions of yuan)	8,207	8,940	9,593	10,303

Sources: Ministry of Finance; and IMF staff calculations.

1/ From 2000 onward, official definition of expenditure includes interest payments.
2/ The official definition includes this item as negative revenue.

Table 7. China: Monetary Developments

	1998	1999	2000	2001 Mar.	2001 Jun.	2001 Sep.	2001 Dec.	2002 Mar.
				(In billions of yuan)				
Net foreign assets	1,504	1,703	2,058	2,198	2,326	2,433	2,642	2,656
Net domestic assets	8,946	10,287	11,403	11,677	12,455	12,731	12,808	13,751
Domestic credit 1/	9,446	10,584	11,731	12,061	12,519	12,774	13,301	15,703
Net credit to government	484	581	588	893	896	907	1,102	1,091
Credit to non-government	8,962	10,004	11,143	11,167	11,623	11,867	12,200	14,611
Other items, net	-501	-298	-328	-384	-65	-43	-494	-1,952
Broad money	10,450	11,990	13,461	13,874	14,781	15,164	15,450	16,407
Reserve money	3,134	3,359	3,646	3,562	3,557	3,571	3,983	4,123
Of which : Required reserves	746	639	720	746	803	819	833	891
Excess reserves	728	834	882	760	717	565	876	885
Net foreign assets of PBC	1,356	1,446	1,519	1,531	1,651	1,777	1,935	1,917
Net domestic assets of PBC	1,778	1,913	2,127	2,030	1,907	1,794	2,048	2,206
				(Twelve-month percentage change)				
Net foreign assets 2/	1.5	1.9	3.0	3.3	3.7	3.7	4.3	3.3
Net domestic assets	15.7	15.0	10.8	11.6	15.3	14.8	12.3	17.8
Domestic credit 3/ 4/	20.0	15.9	17.2	18.2	18.1	13.6	12.1	13.9
Of which : Credit to non-government 3/ 4/	16.3	15.6	18.1	15.7	15.3	11.1	8.5	13.2
Other items, net 2/ 3/ 4/	-4.0	-1.5	-6.4	-6.6	-3.3	-0.1	-1.1	2.9
Broad money 5/	15.3	14.7	12.3	13.2	13.5	13.6	14.4	14.4
Including foreign currency deposits	...	14.9	13.1	13.6	16.8	15.9	14.1	...
M1 5/	11.9	17.7	16.0	17.4	14.9	12.3	12.7	10.1
M0 5/	10.1	20.1	9.0	8.5	7.2	8.4	7.0	8.2
Quasi money 3/	16.7	13.0	10.0	10.7	17.9	19.0	19.1	17.0
Reserve money	2.3	7.2	8.5	10.4	9.7	5.6	9.2	15.8
Net foreign assets of PBC 6/	1.1	2.9	2.2	2.1	5.4	8.9	11.4	10.8
Net domestic assets of PBC 6/	1.2	4.3	6.4	8.4	4.3	-3.3	-2.2	4.9
Reserve ratios: 7/								
Required reserves	8.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Excess reserves	7.8	7.8	7.4	6.1	5.4	4.1	6.3	6.0
Memorandum items:								
Money multiplier	3.3	3.6	3.7	3.9	4.2	4.2	3.9	4.0
Forex deposits of residents (US$ billion)	88.5	103.2	128.3	129.3	134.0	134.8	134.9	141.2
In percent of total deposits	7.9	8.0	8.9	8.6	8.3	8.2	8.0	7.9
Forex loans of residents (US$ billion)	88.6	80.5	61.2	83.6	83.2	82.5	80.7	95.8

Sources: The People's Bank of China; and staff calculations.

1/ Starting 2002, includes foreign currency operations of domestic financial institutions, domestic operations of foreign banks, and some items previously classified under other items net.

2/ Twelve-month change as a percent of beginning-period stock of monetary liabilities.

3/ 2002 growth rates exclude the revisions made in 2002 (see footnote 1).

4/ 1999-2001 growth rates are corrected for the transfer of NPLs from banks to the AMCs.

5/ Since there are breaks in the series, the growth rates are based on official announcements.

6/ Twelve-month change as a percent of beginning-period reserve money stock.

7/ In percent of total bank deposits.

Table 8. China: Medium-Term Scenario

	1999	2000	2001	2002	2003	2004	2005	2006	2007
			Est.	Projections					
	(Percent change)								
Real GDP	7.1	8.0	7.3	7.5	7.5	7.5	8.0	7.5	7.5
Real domestic demand	9.2	7.4	7.9	7.7	7.8	7.9	7.7	7.6	7.7
Consumer prices (average)	-1.4	0.4	0.7	-0.1	1.5	2.0	2.0	2.0	2.0
	(In percent of GDP)								
Gross domestic investment	37.2	37.3	37.9	37.0	37.0	37.0	37.0	36.8	36.5
Gross national saving	38.7	39.2	39.4	38.5	38.0	37.7	37.6	37.3	36.9
Fiscal deficit	-4.0	-3.6	-3.2	-3.3	-2.7	-2.3	-1.9	-1.5	-1.2
Expenditure	18.3	18.9	20.4	21.1	21.1	21.4	21.8	22.1	22.4
Revenue	14.3	15.3	17.2	17.8	18.4	19.2	19.9	20.6	21.3
Current account balance	1.6	1.9	1.5	1.5	1.0	0.7	0.6	0.5	0.4
	(In billions of U.S. dollars)								
Current account balance	15.7	20.5	17.4	18.9	13.4	10.0	10.1	9.6	7.9
Trade balance	36.2	34.5	34.0	35.7	35.5	35.2	38.9	41.4	43.6
Exports	194.9	249.2	266.1	292.8	324.7	361.8	420.2	483.0	551.4
(Percent change)	6.1	27.9	6.8	10.0	10.9	11.4	16.1	14.9	14.2
Imports	158.5	214.7	232.1	257.1	289.2	326.6	381.3	441.6	507.7
(Percent change)	15.8	35.4	8.1	10.8	12.5	12.9	16.8	15.8	15.0
Net services and transfers	-20.5	-14.0	-16.6	-16.8	-22.1	-25.3	-28.8	-31.8	-35.7
Of which : net investment income	-18.0	-14.7	-19.2	-19.0	-19.9	-20.8	-21.3	-22.1	-22.6
Capital and financial account, net	7.6	1.9	34.8	28.0	21.6	19.0	20.0	20.5	20.0
Direct investment, net	37.0	37.5	37.4	41.0	41.0	42.0	42.0	42.0	41.0
Portfolio investment, net	-11.2	-4.0	-19.4	-10.0	-12.0	-11.0	-10.0	-9.5	-9.0
Other investment, net	-18.1	-31.5	16.9	-3.0	-7.4	-12.0	-12.0	-12.0	-12.0
Errors and omissions	-14.8	-11.9	-4.9	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Change in reserves (- indicates increase)	-8.5	-10.6	-47.4	-41.9	-30.0	-24.0	-25.1	-25.1	-22.9
Memorandum items:									
International reserves	158.3	168.9	216.3	258.2	288.1	312.1	337.2	362.4	385.2
In months of imports of goods and nonfactor services (in percent)	10.0	8.1	9.6	10.4	10.3	9.9	9.1	8.5	7.8
External debt (official definition) 1/	151.8	145.7	170.1	178.9	199.9	221.4	243.4	265.4	287.4
In percent of GDP	15.3	13.5	14.7	14.4	14.7	14.9	14.8	14.8	14.6
Debt-service ratio (official definition)	9.1	7.3	7.1	7.4	7.1	7.1	6.8	6.4	6.2

Sources: The Chinese authorities; and staff projections.

1/ The coverage and classification of official external debt data were modified in 2001. Categories of debt previously not covered were included, and short-term debt was based on a remaining -maturity basis (short-term debt data through 2000 were on a original-maturity basis).

China—Fund Relations
As of May 31, 2002

I. Membership Status: Joined 12/27/45; Article VIII (December 1, 1996)

II. General Resources Account:

	SDR Million	% Quota
Quota	6,369.20	100.00
Fund holdings of currency	4,420.42	69.40
Reserve position in Fund	1,948.83	30.60
Financial Transaction Plan transfers (net)	185.00	

III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	236.80	100.00
Holdings	703.30	297.00

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	11/12/86	11/11/87	597.73	597.73
Stand-by	3/02/81	12/31/81	450.00	450.00

VI. Projected Obligations to Fund: None

VII. Exchange Arrangements:

1. On January 1, 1994 the Chinese authorities introduced a unified exchange rate system. Under the new system, domestic enterprises are required to sell their foreign exchange to designated banks and can freely purchase foreign exchange from banks for trade and trade-related transactions with the necessary import documentation. Although the authorities formally adopted a "managed float" system, the renminbi has in practice been tightly linked to the U.S. dollar, especially since the Asian crisis. The PBC has limited movement of the renminbi against the U.S. dollar to +/-0.3 percent around a reference rate, through purchases and sales of foreign exchange in the interbank market. Since the Asian crisis, the renminbi has been kept within a range of +/-0.2 percent, although more recently it

has been allowed to move slightly outside this narower range (mostly on the appreciated side). On June 17, 2002 the exchange rate was Y 8.3 per U.S. dollar.

2. China accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement on December 1, 1996. There are repatriation and surrender requirements on proceeds from exports and from invisible transactions and current transfers. As of April 2, 2002, qualifying domestic enterprises are allowed to retain 30 percent of the value of their foreign trade (exports plus imports) of the previous year. In December 2001, requirements to qualify were relaxed to include those domestically-funded enterprises that have annual export receipts of more than \$2 million, have annual foreign currency expenses of more than \$0.2 million, have export and import rights, have sound financial situation, and do not violate foreign exchange regulations. Foreign-funded enterprises (FFEs) may retain their export earnings provided these earnings do not exceed the maximum amount allowed for a foreign exchange surrender account as prescribed by the State Administration of Foreign Exchange (SAFE); otherwise, if any, earnings must be sold to authorized banks or to the market. Importers must provide valid proof and commercial bills to obtain foreign exchange. There are no measures currently in force that have been determined to be exchange restrictions subject to Fund jurisdiction.

3. In 1998, new requirements expanded the scope of documentation required for most forms of current transactions and required prior verification of the underlying transactions in some instances (e.g., the customs service must certify the value of imports before banks can provide foreign exchange for payment). Following China's WTO accession, regulations reducing the scope for domestically-funded entities to conduct business with foreign banks operating in China are to be fully eliminated by end-2003.

4. Exchange controls continue to apply to most capital transactions. In general, a capital account transaction requires the approval of the SAFE. Equity purchases in China by nonresidents are limited to special shares denominated in U.S. dollars or Hong Kong dollars ("B" shares). Nonresidents are not permitted to issue capital or money market securities in the domestic market. Purchases of capital and money market instruments abroad by residents are restricted to a few financial institutions and enterprises, as are foreign stock and bond issues which also require prior approval. In 2001, domestic investors were allowed to purchase B shares and measures were introduced to ease the restrictions of purchase of foreign exchange with RMB for the advance repayment of foreign debts, foreign exchange on-lending and domestic foreign exchange loans. Prior approval from the SAFE is needed for licensed commercial banks to convert foreign exchange into yuan for capital investment purposes. However, in December 2001, this approval process was eliminated under a pilot project in some provinces. Also, since December 2001, FFEs no longer need SAFE approval to convert foreign currency into yuan for capital investments, and commercial banks are now responsible for verifying the related documents.

5. An annual foreign borrowing plan sets mandatory ceilings for all medium- and long-term borrowing by government departments and enterprises (except FFEs which are subject to individual limits negotiated in the investment approval process). The State Development

and Planning Commission determines the ceilings, while the SAFE is responsible for the approval of each issue and management of external borrowing (pre-approval investigation covers the financial situation of the enterprise, the need for the loan, and whether the terms of the loan are consistent with the use of the proceeds). For short-term borrowing by financial institutions (less than a year), the amount of borrowing is subject to an overall limit determined by the SAFE on an annual basis (there are also enterprise-specific limits); financial institutions can conduct business within this limit without explicit approval, but must register the borrowing with the SAFE.

6. Regulations on guarantees by residents to nonresidents have the following key features. First, guarantees consist of collateral and pledges in addition to what are commonly known as guarantees. Second, prior SAFE approval is required for financing guarantees provided by banks and all guarantees provided by other institutions (with the exception of FFEs). Prior approval is not required for nonfinancing guarantees. Third, both domestic and foreign-currency-denominated guarantees are covered by the regulations. Fourth, the approval process for guarantees is based on prospective guarantors' profits, assets to liabilities, and asset-quality-ratio requirements.

7. China maintains controls on FDI, although it has generally pursued an "open door" policy toward inward FDI. In the case of outward FDI, foreign exchange is provided after a SAFE review of sources of foreign exchange funds and an assessment of the investment risk involved, approval by the Ministry of Foreign Trade and Cooperation (MOFTEC), and registration with SAFE. In the case of inward direct investment, nonresidents can invest in China subject to meeting certain regulations and MOFTEC approval. On April 1, 2002, a new four-tier classification system for foreign investment was introduced, defining activities where foreign investment is encouraged, permitted, restricted or banned. In effect, this resulted in the opening up of many industries previously closed to foreign investment, particularly in the services sectors, consistent with China's WTO-related commitments.

8. Domestic financial institutions and firms cannot enter derivative such transactions for speculation. However, transactions designed to hedge interest rate or exchange rate risk are possible. All transactions involving derivative instruments under foreign debt items must be registered with SAFE, except those undertaken by FFEs. With respect to the development of a forward foreign exchange market for the renminbi, the Bank of China has been permitted, as part of a pilot project, to offer forward transactions involving the renminbi, but the market remains small and proof of an underlying current transaction is required for access to forward cover.

VIII. Article IV Consultation:

9. Discussions for the 2001 Article IV consultation took place during May 15–29, 2001. The staff report (SM/01/206) was discussed by the Executive Board on July 23, 2001 (SUR/01/82). China is on the standard 12–month consultation cycle.

IX. Technical Assistance:

10. Technical assistance provided in 1998 through March 2002 is summarized in Annex V.

X. Other Visits:

11. The Managing Director, Mr. Köhler, visited China in June 2000 and September 2001. The Deputy Managing Director, Mr. Sugisaki, visited China in May 2001. The Deputy Managing Director, Mr. Aninat, visited China in January 2001. A midterm staff visit was held in December 2001.

XI. Resident Representative:

12. The resident representative office in Beijing was opened in October 1991. Mr. Ichiro Otani is the Senior Resident Representative and Mr. Ray Brooks is the Resident Representative.

China—Statistical Issues

Data weaknesses

1. **China has made significant strides in bringing its statistics into line with international good practice.** In April 2002, China subscribed to the Fund's GDDS, where the metadata provides the most comprehensive documentation available in English. However, weaknesses in the quality of the data, including coverage, frequency and timeliness, remain and continue to complicate the analysis of macroeconomic developments.

The main statistical issues and weaknesses are:

Real sector

2. According to GDDS metadata in the Internet, China follows the framework of *SNA93*. However, data on the production and expenditure components of GDP are not available on a quarterly basis; nor are deflators for the expenditure components—either on a quarterly or annual basis. The data are produced in cumulative form, with minimal revisions of previous data, making it difficult to assess quarterly developments accurately or to make seasonal adjustments. Constant price measures of GDP are also suspect because of deficiencies with the price indices used for deflating and their application. Nevertheless, the National Bureau of Statistics has made a number of improvements to the range and quality of national accounts data, including quarterly estimates of GDP by industry and estimates of GDP by type of expenditure. Further improvements are intended, including further development of income and expenditure data, and improvements to quarterly GDP estimates. However, no dates have been set. As in other countries, rapid economic change, including the expansion of the nonstate sector, present new problems for data compilation. The ability to change the collection of data is restricted by the decentralized nature of the statistical system. Extensive technical assistance has been provided from multilateral and bilateral institutions.

3. Monthly industrial production, retail sales, and fixed investment data also have a shifting base that does not allow a consistent time series. Data revisions tend to be made without publishing the entire revised series. Retail sales and fixed investment data are published only in nominal, not real, terms.

4. Labor market statistics—including employment and wage data—are not comprehensive, and are only available on an annual basis, with considerable lag.

5. Prior to December 2000, the consumer price index was not produced in a time series format, as there were only comparisons between the current month and the previous month, and the current month with the same month of the previous year. For most items, the weights were for the previous year's expenditures with the other weights being updated each month. Technical assistance missions in September 1991, April 1995, and June 1997 dealt with the concepts and methodology of internationally used index formulae. The authorities have received technical assistance and training on price index methodology under a cooperative program with Statistics Canada. A technical assistance mission in August 1999 reviewed the

methodology to compile fixed-base price indices in test projects in four provinces and found that only in one province the index was adequate. In January 2001, the NBS began to publish a new fixed base CPI, which more accurately reflects consumer spending patterns (e.g., the weight of services increased, while the weight of food declined). The number of survey items has been expanded to more than 550 from the previous 325. The weights of the major CPI components were provided to the staff during the 2001 Article IV mission.

Government finance

6. Serious data shortcomings continue to hamper fiscal analysis. Budgetary data exclude spending associated with domestic bond proceeds on-lent to local governments and official external borrowing. Also, data on the social and extra budgetary funds are only provided annually and with a long lag. Expenditure classification remains very poor, though this should start to improve this year with the introduction, on a pilot basis, of the new budget classification system.

7. China is a regular reporter of budgetary central government and local government data for publication in the *GFS Yearbook*. The latest published data are for 1999. No data are provided on expenditure by economic type or government debt. The data also exclude government social security and extrabudgetary operations.

Monetary accounts

8. In recent years, improvements have been made in the classification of accounts of the monetary authorities and the banking institutions. Continuing with this trend, in 2002 further revisions were made to the monetary survey, including extending the statistical coverage to foreign currency operations of domestic financial institutions. However, the monetary survey lacks sufficient detail with regard to bank claims on the government, which hampers the estimation of the fiscal deficit from the financing side.

9. Detailed breakdowns of bank credit extended by industry (e.g., manufacturing, property, etc.), and by borrower (e.g., the various elements of the state and nonstate sectors) are very important for economic policymakers, and are available in many countries. The staff continues to encourage the authorities to prepare information of this nature for analytical purposes.

10. Due to the restructuring of the banking sector new statistical issues have arisen, such as how to record the transfer of nonperforming loans to the asset management companies. In addition, data on the asset management companies are still not compiled on a regular basis..

Balance of payments

11. In January 1996, the SAFE launched an "international transactions reporting system" (ITRS) which started producing data of sufficient quality within one year. This system utilizes information on foreign exchange transactions conducted by banks to derive data on

China's international transactions. To supplement the ITRS, since early 1997 SAFE has used four periodic surveys to collect data on financial flows pertaining to travel, to gather balance sheet information from financial institutions, and to obtain data on portfolio investment and direct investment.

12. The new system has improved the coverage and timeliness of China's balance of payments accounts. Currently, the data are compiled in accordance with the fifth edition of the *Balance of Payments Manual* (*BPM5*), and they are disseminated on an annual basis within six months of the close of the reference period. It appears that the authorities are close to being able to publish quarterly estimates of the balance of payments. Within the current account, component detail is available on goods, services, income, and transfers. Data on the financial account are also available with significant component detail for functional categories, but with limited sectoral breakdown. The Chinese data are being compiled in U.S. dollars. The authorities have indicated that they have initiated the work on compiling international investment position (IIP) statistics in 2000. However, data collection procedures and the compilation system for IIP statistics need to be improved, and therefore no data have been published so far.

13. The Fund has provided extensive technical assistance (TA) for China to improve balance of payments statistics. The coverage of direct investment transactions remains a particularly problematic issue in the Chinese balance of payments and international investment position statistics. The data received from Ministry of Foreign Trade and Cooperation (MOFTEC) which represent the main data source for these transactions, apparently do not cover investments in the form of services, reinvested earnings, and disinvestments. The direct investment survey developed by SAFE on the other hand has not performed sufficiently well to allow the use of any of the data collected. Another issue that has to be addressed urgently by the authorities is to extend verification and auditing programs to reduce the measurement errors and ensure the long-term performance of the ITRS. For this purpose regular training programs for staff in the provincial offices of SAFE were recommended by TA missions.

14. As part of the work of the Fund Task Force on External Debt and Reserves, a Fund mission visited China during April--May, 1998 to discuss with the authorities the coverage, timeliness, and periodicity of China's data on official reserves, reserves-related liabilities, as well as those on other external assets and liabilities, financial derivative activities, and other contingent and potential liabilities. In early 2002, the authorities indicated that the compilation of the template on international reserves and foreign currency liquidity for China was almost complete. Data on external debt are compiled monthly but published, and provided to the staff, only on a semi-annual basis. In 2001, the authorities revised substantially the classification and coverage of official external debt data. This led to significant improvements in the quality of the data, which are now more consistent with data available from external sources (e.g., BIS, OECD). Short-term debt data have, in particular, benefited from a more comprehensive coverage of trade credit, but they are now provided only on a *remaining* maturity basis (i.e. not on an *original* maturity basis as in previous years).

Data reporting to STA for publications

15. In June 1999, the PBC resumed reporting monthly monetary data and has agreed to their publication in *IFS*. These improvements in reporting notwithstanding, a number of breaks remain in the series, and comparable historical data are not available.

16. Since 1994, China's Ministry of Finance (MOF) has regularly reported annual GFS data for publication in the *GFS Yearbook*. The GFS database currently includes data on the central government budget for 1990-97, and on provincial and local governments for 1995-97. However, the data still exclude social security and most extrabudgetary operations. In GFS terms, the revenue classification does not fully distinguish between revenue and grants, tax and nontax revenue, and current and capital revenue. The presentation of expenditure is by function only and lacks an economic classification. The MOF also reports annual GFS data for publication in *IFS*. Data, through 1998, relate to revenue, expenditure, and the deficit/surplus of the central, provincial, county-level, and municipal governments' budgets. These data are provided with substantial delays. The latest published data are estimates for 2000.

17. Reporting of data to STA for *IFS* has, in the past, tended to be sporadic and with a considerable time lag. Following the introduction of new reporting arrangements, the timeliness of consumer price, industrial production, trade value, and total GDP data in *IFS* has improved substantially. However, the range of information is relatively limited, with no data published on producer prices, wages, and trade volumes and prices/unit values.

Data dissemination to the public

18. The publication of a quarterly statistical bulletin by the PBC has significantly improved the timing and coverage of publicly available data on the monetary accounts and the main real sector indicators. However, the monthly statistical publications do not contain many time series or the disaggregation necessary for analysis. Moreover, several important time series, particularly on the main fiscal variables, are not released in a systematic and timely manner. Extensive annual economic data are available in various statistical yearbooks, but these are published nine months or more after the end of the year.

China: Core Statistical Indicators

(As of June 27, 2002)

	Exchange rates	International reserves	Reserve/base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index 1/	Exports/ Imports	Current account balance	Overall government balance	GDP/ GNP 2/	External debt
Date of latest observation	June 27, 2002	April 2002	April 2002	April 2002	May 2002	June 27, 2002	May 2002	May 2002	Dec. 2001	April 2002	Mar. 2002	Dec. 2001
Date received	June 27, 2002	June 5, 2002	June 14, 2002	June 14, 2002	June 14, 2002	June 27, 2002	June 13, 2002	June 11, 2002	May 13, 2002	May 29, 2002	April 16, 2002	April 23, 2002
Frequency of data	D	M	Q, M	M	M	... 3/	M	M	A,Q 7/	A,M	A, Q (cumulative)	A 7/
Frequency of reporting	M 4/	M	Q, M	M	M	... 3/	M	M	A,Q 7/	A,M	A, Q (cumulative)	A 7/
Frequency of publication	D	M	Q, M	M	M	... 3/	M	M	A,Q	A,M 5/	A, Q (cumulative)	A
Source of data	C	C,A,N	C,A,N	C,A,N	C,A,N	C,N	C,N	C,N	C,A	C,A,N	C,N	A
Mode of reporting	E	E,M	E,M	E,M	E,M	E,M	E,M	E	E,M	E,M	E,M	M
Confidentiality	C	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/

1/ Only 12-month growth rates are reported (price indices are not available).
2/ For real GDP, level data are available only on an annual basis (growth rates are available on a quarterly, cumulative basis).
3/ Interest rates change only infrequently; these changes are publicly announced.
4/ While officially transmitted on a monthly basis, these data are available from news sources on a daily basis.
5/ Data on interest expense not published.
6/ Restricted until publication.
7/ Data provided semi-annually.

Explanation of codes is as follows:
Frequency of data: D - daily, M - monthly, Q - quarterly, A - annually.
Frequency of reporting: D - daily, M - monthly, Q - quarterly, A - annually.
Source of data: A - direct reporting by the authorities, C - commercial electronic data provider, N - official publication.
Mode of reporting: E - electronic data transfer, M - mail.
Confidentiality: C - unrestricted use, D - embargoed for a specific period, and for unrestricted use thereafter.

China—Relations With The World Bank[1]

1. The World Bank has been active in China since 1980. Over the years, the relationship between China and the World Bank Group has grown into a mature and significant partnership for development. World Bank commitments to China as of April 30, 2002 totaled about $35.26 billion for 237 projects. About half of these projects are still under implementation, making China's portfolio by far the largest in the Bank. World Bank-supported projects are found in almost all parts of China and in many sectors of the economy, with infrastructure (transport, energy, industry, urban development) accounting for more than half of the total portfolio and agriculture, social sectors (health, education, social protection), environment and water supply and sanitation comprising the remainder.

2. In FY2001, lending totaled $787 million in IBRD loans for eight projects. Given the increased availability of domestic financing—as a result of China's fiscal stimulus policy—and a shift of the government's development program to the central and western areas, the focus of the World Bank's assistance program is now on the poorer and institutionally weaker inland provinces. As a consequence, the amount of lending per project has been scaled back to suit the absorptive capacity of those provinces, leading to a lower lending level compared with previous years. Of the projects approved in FY 2001, two supported urban transportation improvements in Inner Mongolia and Hebei Provinces, one benefited rural development, two assisted highway and inland waterways development, and two targeted pollution control. A summary of Bank commitments and disbursement to China is given in Table 1. Details of the sectoral breakdown of past lending can be found in Table 2.

3. Over the next two years, lending is expected to total around $2 billion, with support provided to development of health, education, agriculture and infrastructure in the interior provinces, and for urban management and the environment largely in the more developed eastern areas. Since China is no longer borrowing IDA funds, the Bank, in collaboration with the government and the United Kingdom's Department for International Development (DFID), has developed a mechanism to blend grant resources with IBRD loans, resulting in more concessional loans (at an interest rate of about 2 percent) for the social sectors and poverty reduction. Use of this blending mechanism with other development partners is envisioned.

4. The current World Bank Group assistance strategy, covering both lending and non-lending activities, is designed to assist China meet its objectives in three key areas of the country's development agenda: (i) improving the investment climate and building the institutions that will release the full productive forces of a well-functioning and knowledge-based market economy; (ii) addressing the remaining pockets of extreme poverty and reducing widening inequalities between the coastal areas and lagging interior, thereby helping to maintain social cohesion and ameliorate pressures to migrate; and (iii) facilitating a more environmentally

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[1]Prepared by World Bank staff.

sustainable development process by, *inter alia*, assisting China to improve management of its natural resource base and strengthen urban environmental services.

5. In addition to financial assistance the provision of non-financial services in the form of technical assistance, policy advice, seminars and training is an essential part of the cooperation program. The government has strongly endorsed Bank efforts to make its non-lending activities more responsive to the country's evolving needs, by having a better balance between detailed studies of issues requiring lengthy technical analysis and quick delivery of briefer policy notes, supplemented by other forms of collaboration like senior-level workshops. Some of our recent or upcoming outputs include policy and technical notes on pension reform, fiscal issues at both the national and sub-national levels, selected financial sector issues, power sector reform, recommendations for a knowledge strategy for China, services sector liberalization, major sector reports on the environment and water management—both critical to the development process, corporate governance, an urban sector assessment, and thematic notes on China's plan to develop its lagging western regions. Some of the same themes will be explored in the coming fiscal year, with a particular emphasis on development of the lagging regions, the impact of China's WTO accession on macroeconomic management, sustainable development of infrastructure, and macroeconomic management, including a major economic report.

Representation:	The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.
Capital Subscription:	China holds 4,480 million shares or 2.85 percent of the total authorized capital of the IBRD. Currently, China is fully subscribed.
Technical Assistance:	A technical assistance loan to the People's Bank of China to enhance the central bank's supervision, research, and clearing capabilities was approved in FY 1993. A second technical assistance project, approved in the same year, is financing reform-supportive studies and economic research, the strengthening of core agencies responsible for macroeconomic management and local training institutions, and preinvestment support. Technical assistance for economic law reform was approved in FY 1995. Fiscal technical assistance, also approved in FY 1995, supported the implementation of fiscal reforms by developing and establishing a new National Tax Administration, and by developing an intergovernmental grants scheme and improved budgetary practices. Assistance in bond market development has been provided recently. In FY 1999, technical assistance projects were approved for reform of accounting, pension and enterprise systems. Further technical assistance support for economic research and preinvestment was also provided in FY 1999. A

supplemental loan for financial sector technical assistance was approved in FY 2001.

Resident Mission:	A resident IBRD office in Beijing has been in operation since October 1985. In October 1997, responsibility for managing the Bank's total program for China was decentralized to the Beijing office.
International Finance Corporation (IFC):	IFC commitments held as of April 30, 2002 total about $457.7 million in loans and $185.4 million in equity,. A resident IFC office in Beijing has been in operation since 1992. In July 2000, a joint IFC/World Bank regional office for private sector development was established in Hong Kong SAR, with management of this program decentralized to that office.
	IFC's activities in China focus on the following six areas: (i) catalyzing investment through limited-recourse financing; (ii) promoting development of the indigenous private sector; (iii) promoting liberalization and modernization of the financial sector; (iv) emphasizing investment in China's interior regions; (v) encouraging private sector participation in infrastructure; and (vi) supporting transformation of state-owned enterprises.

Table 1. China: IBRD-IDA Lending Activities, FY 1981–01 1/

(In millions of U.S. dollars)

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
1981	100.0	100.0	0.0	0.0
1982	60.0	0.0	0.1	0.0
1983	146.7	392.2	32.6	0.6
1984	4442.4	600.5	133.6	20.2
1985	554.9	573.3	146.2	235.7
1986	530.7	668.6	251.9	352.2
1987	587.6	863.5	361.3	317.8
1988	618.0	1,038.4	399.2	302.2
1989	534.7	831.0	549.4	684.5
1990	618.5	0.0	556.5	568.6
1991	988.6	448.1	493.6	620.3
1992	959.4	1,576.6	752.9	617.8
1993	989.5	2,113.3	762.9	812.5
1994	925.0	2,145.0	868.5	1,057.0
1995	630.0	2,369.5	659.3	1,554.9
1996	480.0	2,042.3	890.9	1,328.2
1997	325.0	2,490.0	722.9	1,405.3
1998	293.4	2,323.0	596.4	1,497.2
1999	422.6	1,661.1	614.4	1,411.7
2000	0 2/	1,672.5	420.1	1,407.7
2001	0	787.5	344.6	1,475.7
Total	10,206.9	24,696.3	9,886.1	16,702.5

1/ The financial year (FY) runs from July through June.
2/ As of July 1, 1999, China no longer borrowed IDA financing.

Table 2. Distribution of Lending, FY 1980–01

Sector	US$ mn.	Percent	No. of Projects
Rural devt./poverty alleviation	9,662.21	28	61
Industry and energy	9,174.25	26	51
Industry/corporate reform	2,844.95		20
Energy/renewable energy	6,329.30		31
Transport	8,430.79	24	45
Human resources	2,533.34	7	28
Education	1,697.34		18
Health	836.00		10
Environment and urban	4,641.48	13	34
Environment	2,353.36		17
Urban development	1,461.57		10
Water supply	826.55		7
Technical assistance/public sector	461.20	2	15
Total	34,903.27	100	234

China—Relations with the Asian Development Bank[1]

1. Asian Development Bank (AsDB) operations in China have focused on three strategic objectives: (i) economic efficiency enhancement; (ii) promotion of growth to reduce poverty in poor inland provinces; and (iii) environmental protection and natural resource management. These three broad objectives will help maximize employment generation, further eliminate factor market distortions, and address market failures of rapid growth by spreading the benefits of growth more evenly, and minimizing environmental degradation. In line with the Government's priority to stimulate the development of the Western Region through allocating an increased share of Government sources and the AsDB's overarching objective of poverty reduction, the 2001-2003 country assistance program will emphasize investment in basic infrastructure and agricultural development in the Western Region and less developed areas in the Central Region. In addition, support for projects addressing environment protection, natural resources management and urban poverty reduction in the Coastal Region and relatively developed areas in the Central Region will be continued.

2. Since China became a member of the AsDB in 1986, 85 public sector loans totaling $10,297.5 million (see table 1) have been approved as of 31 December 2000. In addition, AsDB has approved one line of equity for $3 million, four equity investments totaling $44.3 million, three loans of $116.5 million to the private sector without government guarantee, and 352 technical assistance projects amounting to $182.6 million.

3. The 2001 lending program is at $1.2 billion for nine projects. These are: Efficient Utilization of Agricultural Wastes for Sustainable Rural Development ($30 million); Ningxia Shapoutou Water Resources and Irrigation Development ($35 million); Songhua River Basin Flood, Wetlands, and Biodiversity Management ($150 million); Yellow River Flood Management ($150 million); Acid Rain Control and Environment Improvement ($150 million); Shen-Da Power Transmission and Grid Rehabilitation ($100 million); Ganzhou-Longyan Railway (Jiangxi-Fujian) ($200 million); Guangxi Road Development ($150 million); and Shaanxi Roads Development ($250 million). In addition, the technical assistance core program included 20 projects totaling $12 million. The lending program mix will reflect the recommendation made in the AsDB Poverty Reduction Strategy, which calls for increasing public sector lending to poverty interventions. Three of the 9 projects in the 2001 program, accounting for $380 million or 31 percent of projected lending, are categorized as poverty interventions.

4. The AsDB's proposed program in the next few years will address two other major issues: growing income disparities and environmental degradation. Particular emphasis is placed on ensuring that environmental issues are addressed and that the project

[1]Prepared by the staff of the Asian Development Bank.

beneficiaries include the poor. The strategic thrust of projects in AsDB's major project areas has now shifted to the inland provinces. About 65 percent (by number and 76 percent by amount) of the proposed projects in AsDB's operational program for 2001–2003 are located in inland provinces as compared with 40 percent during the 1987–96 period.

5. The AsDB's lending program will continue to be supported by a technical assistance program giving priorities to Project Preparatory TAs and Advisory TAs which maximize AsDB's strategic impact. Three key themes in the 2001-2003 TA program are poverty reduction, improved environmental management and improved governance. AsDB will continue to support for the development of the capital markets, the use of equity investments to mobilize international funds for investment in China, and arranging for cofinancing with commercial banks.

6. Overall, China has demonstrated a strong project implementation capability. The good performance reflects the strong sense of project ownership among agencies involved in the design, implementation, and management of projects, as well as the rigorous screening process for development projects, particularly those proposed for external assistance. Loan disbursement and contract award performance is good (see Table 2). Of the 85 loan projects approved as of 31 December 2000. 37 are fully disbursed and closed and 48 remained active as of end 2000.

7. The establishment of the China Resident Mission (CHINARM) in Beijing on 16 June 2000 will foster closer intereactions with stakeholders, including government officials, NGOs, private sector and other donors, and enhance AsDB's local knowledge. AsDB's presence in Beijing will increase development impact and contribute to improving portfolio management and project administration.

8. AsDB is playing a leading role in two ongoing regional programs that include China, the Greater Mekong Subregion (GMS) and the Central Asia Region. Through Yunnan Province, China is an active participant in AsDB-supported regional program to promote economic cooperation in GMS. One project in the transport sector with important subregional linkages, the Southern Yunnan Road Development Project, was approved in 1999. This Project was prepared under a regional technical assistance (RETA No. 5728: Chiang Rai-Kunming Road Improvement).

9. AsDB is also pursuing cooperation in the Central Asian Republics (Kazakhstan, Kyrgyz Republic, Tajikistan and Uzbekistan) and Xinjiang Uygur Autonomous Region in China. A series of RETAs are helping the countries identify and prioritize development projects that increase and diversify trade and other economic activities in three sectors: (i) energy, (ii) transport and communications, and (iii) regional payments and trade. Two projects in the transport sector with important subregional linkages include: (i) Kashgar-Torugart Railway Project, and (ii) Rail Crossing Improvements at the Druzba-Ala Pass (Kazakhstan-China Border). In the energy sector, one possible project has been identified: Facilitation of Kyrgyz Electricity Exports to China, which has been studied

under RETA No. 5663: Kyrgyz Republic and Xinjiang Uygur Autonomous Region Power Development Study.

10. In addition, AsDB launched a new initiative for economic cooperation between China and Mongolia (RETA No. 5969: Strategic Study on Development Options for Economic Cooperation between China and Mongolia). RETA will help the governments of the two countries prioritize investment programs for the RETA area (which covers the eastern part of Inner Mongolia Autonomous Region, China and Mongolia), and identify the most appropriate transportation modes to integrate the local economies with markets elsewhere.

Table 1. China: AsDB Distribution of Lending, 1986–2000

Sector	Approved Loan Amount	Percent of Total	No. of Projects
Agriculture and agro-industry	513.9	5.0	8
Energy	1,866.3	18.1	17
Industry (non-agriculture)	686.8	6.7	5
Transport and communications	4,968.0	48.2	35
Social infrastructure	846.5	8.2	7
Finance	530.0	5.1	6
Multisector	730.0	7.1	6
Others	156.0	1.5	1
Total	10,297.5	100.0	85

Table 2. China: AsDB's Commitments and Disbursements, 1986–2000

Year	Commitments 1/	Disbursements 2/
1986	-	-
1987	-	-
1988	254.00	2.70
1989	107.97	52.00
1990	180.75	55.40
1991	111.04	172.70
1992	588.64	178.50
1993	1,030.99	421.30
1994	1,617.68	492.09
1995	2,304.42	558.27
1996	3,282.32	707.19
1997	4,032.85	714.68
1998	4,517.55	831.33
1999	5,336.67	819.01
2000	6,158.90	847.50

1/ Refers to cumulative contract awards.

2/ Refers to disbursements for the year.

China—Summary of Technical Assistance

Department	Purpose	Date
Tax system reform		
FAD	Mission and seminar on tax policy	May 1998
FAD	Mission on tax policy and administration	November 1998
FAD	Seminar on tax administration	February-March 1999
FAD	Seminar on tax capacity, revenue, and fees	June-July 1999
FAD	Mission on VAT and inheritance tax	April 2001
FAD	Mission on tax preference	September 2001
Tax administration reform		
LEG	Workshop on security transaction taxation	May 1998
LEG	Seminar on tax law	July 1998
LEG	Workshop on tax law	December 1998
FAD	Mission on computerization	June 2000
FAD	Mission on computerization: follow-up	August-September 2000
FAD	Mission on strategic management, reorganization, risk management	September 2000
FAD	Mission on computerization: follow-up	May 2001
FAD	Mission on computerization: follow-up	August 2001
FAD	Mission on computerization: follow –up	November 2001
FAD	Mission on strategic planning	November 2001
Budget reform		
FAD	Workshop on budget classification	November-December 1999
FAD	Workshop on budget classification (continuation)	February-March 2000
FAD	Mission on review of budget classification	June 2000
FAD	Mission on public expenditure management	July-August 2000
FAD	Workshop on treasury, government fiscal management information system	February 2001
FAD	Mission on budget classification, tresury single account, macro-fiscal coordination, budget preparation	November 2001
Monetary, banking, and foreign exchange system reforms		
MAE	Workshop on monetary research and analysis	June 1998
MAE	Workshop on base money programming	October 1998
MAE	JVI seminar on capital account liberalization	December 1998
MAE	Mission on bank soundness issues	March-April 1999
MAE	JVI seminar on capital account liberalization	April 1999
MAE	Seminar on central bank accounting	May 1999

China—Summary of Technical Assistance

Department	Purpose	Date
MAE	Workshop on current account management	December 1999
MAE	Seminar on international accounting system	October 2000
MAE	Course on foreign exchange operations	October 2000
MAE	Seminar on monetary operations	May 2001
INS	Course on Banking Supervision	June 2001
MAE	Workshop on Banking Supervision (On-site & Off-site)	July 2001
MAE	Course on International Capital flows and Capital Account Convertibility	October 2001
Statistics		
STA	Mission on balance of payments statistics	January 1998
STA	Mission on balance of payments statistics	April-May 1998
STA	Mission on multisector statistics	September 1998
STA	Mission on money and banking statistics	April-May 1999
STA	Mission on consumer prices	August 1999
STA, BTS and RES	Mission on BOP statistics, information technology and economic crisis modeling	April 2000
STA	International meeting on technical cooperation with China	May 2000
STA	Mission on money and banking statistics	June-July 2000
STA	Seminar on macroeconomic statistics for users	August 2000
STA	Seminar on General Data Dissemination System	April 2001
STA	Seminar on money and banking statistics	April 2001
STA	Mission on trade statistics	June 2001
STA	Mission on trade statistics: follow-up	January 2002
STA	Mission on GDDS	Feb./March 2002
Review of TA		
MAE	Review of TA projects for the PBC and the SAFE (together with TAS)	April 1998
OIA	Review of TA	October 1998
FAD	Visit to assess TA needs in the fiscal area	April 1999
FAD	Mission to identify TA needs for budget/treasury reform	August 1999
FAD	Mission to identify TA needs for tax administration/ policy reform	November 1999
STA	Review of TA progress and needs in statistics areas	November 1999
FAD	Visit to prepare UNDP/IMF/China project document	January 2000

China—Summary of Technical Assistance

Department	Purpose	Date
FAD	Visit to review and reschedule UNDP/IMF/China fiscal reform TA activities	February 2001
FAD/TAS	Mission for tripartite review of the UNDP/IMF/China fiscal reform TA activities	January 2002
Training in economic analysis and policy		
INS	Course on financial programming	November 1998
INS	Visit to prepare Joint PBC-IMF training program	August 1999 and February 2000
INS	Course on financial programming	November 1999
INS	Course on macroeconomic impact of the budget and current issues in tax policy	June 2000
INS	Course on financial programming and policy	July-August 2000
INS	High-level seminar on banking reform	March 2001
INS	Course on Financial Programming and Policies	August 2001

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with the People's Republic of China

On August 5, 2002, the International Monetary Fund's (IMF) Executive Board concluded the Article IV consultation with China.[1]

Background

Over the last five years, the Chinese economy has weathered two major external shocks—the Asian financial crisis of 1997-98 and last year's global economic slowdown. Supported by appropriate macroeconomic policies and structural reforms, the economy was able to manage the challenges posed by these shocks well, while continuing its transformation toward increased market orientation. Growth averaged nearly 8 percent a year; the external position strengthened further; reforms advanced in the key financial and banking sectors; and external liberalization continued, culminating in China's accession to the WTO in December 2001.

Economic activity in China slowed in the course of 2001, before recovering in early 2002. Export growth, which had peaked at close to 40 percent (year-on-year) in early-2000, decelerated sharply throughout 2001 as external demand weakened. Import growth also declined but with a lag. Domestic demand growth slowed as well, despite continued expansion of public sector fixed investment. As a result, GDP growth declined from 8 percent in 2001 to 7.3 percent in 2001. In the first quarter of 2002, a rebound in exports and surging public-sector fixed investment boosted GDP growth to 7.6 percent. However, consumption growth appears to have moderated, with retail sales growth slowing somewhat. Deflation re-emerged in late 2001 and continued in early 2002, reflecting both temporary factors, such as lower international commodity prices and WTO-related tariff cuts, as well as longer-term factors, such as continued excess supply conditions in certain sectors. Unemployment continues to be

[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August, 4, 2002 Executive Board discussion based on the staff report.

a pressing issue, and despite a pick up in the growth of rural incomes in 2001, it continued to lag urban income growth, exacerbating regional income disparity.

Despite last year's slowdown of export growth, China's external position has strengthened further. While the current account surplus narrowed slightly in 2001, to 1.5 percent of GDP, the financial account improved significantly, including from surging foreign direct investment ahead of China's entry into the WTO. Official reserves rose by $47 billion in 2001, and a further $26 billion in the first 5 months of 2002, reaching $245 billion by end-May, more than four times the level of short-term external debt. Although the real effective exchange rate has risen by over 6 percent since end-1999, China's external competitiveness has remained strong, as indicated by continued rising export market shares.

Based on the strong first-quarter outcome and improved external conditions, GDP growth is expected to reach 7½ percent in 2002 and sustain that pace in 2003. Deflationary pressures should ease beginning in the second half of 2002 as domestic demand picks up and world commodity prices rise. While export growth should be sustained by the global recovery, imports are also expected to rise, partly due to WTO-related trade liberalization. As a result, the current account surplus is expected to remain unchanged at about 1½ percent of GDP this year, before declining to 1 percent of GDP in 2003.

Progress has continued in addressing the intertwined problems in the banking and state-owned enterprise sectors, although a large unfinished reform agenda remains. In the banking sector, stricter prudential regulations, reduced government interference, and improving corporate governance in state-owned commercial banks appear to have induced a reversal of the long-standing deterioration in asset quality as a result of improving lending practices. The prudential framework was strengthened further in early 2002 with the introduction of new loan classification and provisioning requirements, consistent with international best practice. The asset management companies have started to dispose the nonperforming loans they acquired from the banks in 1999-2000; through end-2001, they have sold about 13 percent of those assets, with an average cash recovery rate of 21 percent. In the state-owned enterprises, the government's reform strategy continues to focus on "corporatizing" the large enterprises (by introducing the shareholding and modern management systems) while "letting go" of the smaller enterprises (mainly through privatization, mergers, or closure); increasing competition through further external and domestic liberalization; and strengthening the social safety net to help cushion the social impact of reforms.

Executive Board Assessment

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

People's Republic of China: Selected Economic and Financial Indicators 1/

	1998	1999	2000	2001	2002 IMF Staff Projections
			(Change in percent)		
Domestic economy					
Real GDP	7.8	7.1	8.0	7.3	7.5
Consumer prices (period average)	-0.8	-1.4	0.4	0.7	-0.1
			(In billions of U.S. dollars)		
External economy					
Exports	183.5	194.7	249.1	266.1	292.8
Imports	-136.9	-158.7	-214.7	-233.1	-257.1
Current account balance	31.5	15.7	20.5	17.4	18.9
Capital and financial account balance 2/	-6.3	7.6	1.9	34.8	28.0
Of which: Foreign direct investment, net	41.1	37.0	37.5	37.4	41.0
Gross official reserves 3/	149.8	158.3	168.9	216.3	258.2
Current account balance (in percent of GDP)	3.3	1.6	1.9	1.5	1.5
			(In percent of GDP)		
Public finance 4/					
Overall budgetary balance	-3.0	-4.0	-3.6	-3.2	-3.3
Revenue	13.0	14.3	15.3	17.2	17.8
Expenditures	16.1	18.3	18.9	20.4	21.1
			(Change in percent)		
Money and interest rates					
Broad money (M2) 5/	15.3	14.7	12.3	14.4	...
Interest rate 6/	3.8	2.3	2.3	2.3	...

Sources: Chinese authorities; and IMF staff estimates.

1/ As of July 23, 2002.

2/ Excluding errors and omissions.

3/ Includes gold, SDR holdings, and reserve position in the Fund.

4/ Central and local governments. Data include all expenditure financed by official external borrowing, interest payments on government debt, and unbudgeted expenditures in 1998-2000 related to the fiscal stimulus program.

5/ Banking survey.

6/ One-year time deposits, year-end.