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FOR AGENDA

SM/08/294

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September 8, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Staff Report for the 2008 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2008 Article IV consultation with the People's Republic of China, which is tentatively scheduled for discussion on **Friday, September 26, 2008**. 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. Dunaway (ext. 37343), Ms. Papi (ext. 36894), and Mr. Porter (ext. 37316) 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, September 16, 2008; 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.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the People's Republic of China

Approved by Steven Dunaway and Anthony R. Boote

September 5, 2008

- The 2008 Article IV discussions with China were held during May 10−25, 2007, December 12−18, 2007, February 14−15, 2008, and June 17−20, 2008.
- The staff team comprised Mr. Dunaway (Head), Messrs. Aziz, Aitken, Leigh, Porter, and Mss. Cui and Papi (all APD), Mr. Duenwald (PDR), and Mr. Podpiera (MCM). The team was assisted by Mr. Arora (Senior Resident Representative) and Mr. Feyzioğlu (Resident Representative). Mr. Huayong Ge, Mr. Jianxiong He, and Ms. Fang Yang (OED) participated in the discussions. Mr. Kato joined the mission on May 20−22, 2007. The Managing Director and Mr. Burton (APD) participated in the discussions in February 2008.
- The last Article IV consultation was concluded on July 31, 2006. (A summary of the Executive Board discussion can be found at http://www.imf.org/external/country/CHN/index.htm?pn=2). In recent years, the authorities and the IMF have generally agreed on policy priorities in a number of areas; however, in many areas the authorities have favored more measured and gradual steps than the IMF. For example, while improvements have been made in monetary policy operations, the authorities have relied relatively more on administrative measures and window guidance to contain investment and credit growth. In part, this reflects the authorities' more gradual approach to increasing exchange rate flexibility. The IMF has welcomed the July 2005 and subsequent changes to the exchange rate arrangement, but it has encouraged the authorities to utilize more fully the flexibility afforded by the new arrangement. At the same time, the IMF and the authorities have agreed on the pace of fiscal consolidation. There is also broad agreement on the structural reform strategy, including in the banking sector, the state owned enterprises, and dealing with rural-urban income disparities.
- 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 capital transactions.

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EXECUTIVE SUMMARY

Sustained strong economic performance has made China one of the world's largest economies and trading nations. These remarkable achievements reflect the government's policies and reforms, that have opened China up and made it increasingly market oriented, and a generally favorable external environment that aided China's integration into the world economy. While the current global downturn has affected China's growth, it remains very strong.

However, China's growth has been accompanied by growing macroeconomic imbalances. Growth has been driven mainly by investment and exports. With household consumption unable to keep pace with the increase in capacity created by the rise in investment, the excess has been reflected in rising exports and a growing trade surplus. The resulting sharp increase in official reserves has added to the already substantial liquidity in the banking system, threatening to touch off further surges in lending and investment growth. Added to these concerns is the pick up in food and commodity prices since mid-2007, which could spark rising wage demands and a shift in inflation expectations and risks igniting a generalized inflation process.

These concerns have increased the urgency of rebalancing growth away from its heavy reliance on investment and exports towards consumption. Encouraging rapid investment are distortions in key prices: the low cost of utilities, energy, land, and pollution abatement and, importantly, the low cost of capital and the substantial undervaluation of the exchange rate. The government has taken steps, such as raising some land and energy prices, and tightening environmental standards, but these efforts need to be strengthened.

To raise the cost of capital and curb inflation, a tight monetary policy needs to be maintained. Steps have been taken, including several increases in required reserves and in lending and deposit rates, but more needs to be done since large reserve accumulation continues to add to the ample liquidity in the banking system. To be able to effectively maintain the necessary tightness in monetary policy, there is a need for faster exchange rate appreciation sufficient to create a genuine risk of two-way movement in the exchange rate.

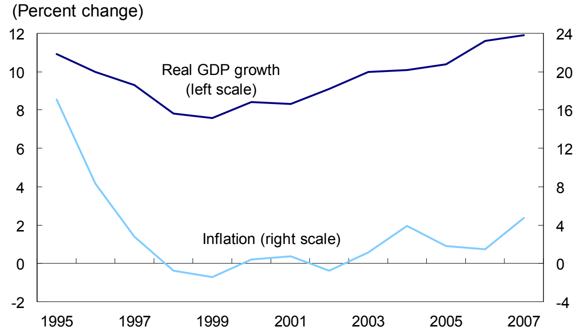
Despite its appreciation against the U.S. dollar this year, the renminbi is still judged by staff to be substantially undervalued. Moreover, China continues to heavily manage its exchange rate. Policies that the authorities have put in place to rebalance the economy, if fully implemented, could redress this situation over the medium term. To this end, it is particularly important that the exchange rate be allowed to appreciate significantly faster and that the renminbi's value rises in relation to a basket of currencies. Staff recommends an ad hoc consultation to discuss these issues further, with another discussion by the Board in about six months.

I. Background

1. **China's economic performance continues to be one of the strongest in the world, notwithstanding the recent modest slowdown in growth**. Sustained rapid growth has helped China to become one of the world's largest economies and trading nations and great strides have been made in reducing poverty. Much of this economic expansion has occurred in the context of a generally strong global environment over the last decade, accompanied by increasing integration of China into the world economy and a rapidly changing production structure. The current global downturn has affected China's economy, but growth has remained strong.

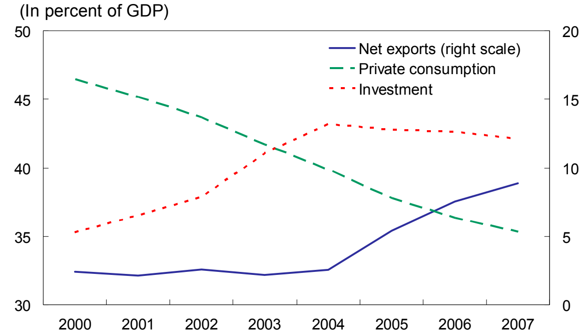
2. **But China's rapid growth has also been accompanied by widening macroeconomic imbalances**. While the government's economic policies and reforms have opened up the economy, both internally and externally, and made it increasingly market oriented, the source of growth has been increasingly biased towards investment and exports. With household consumption unable to keep pace with the increase in capacity created by the rise in investment, the excess has been reflected in rising exports and a generally growing trade surplus. At the same time, sharp increases in official reserves have added to the already substantial liquidity in the banking system, threatening to touch off further surges in lending and investment growth. Moreover, a sharp pickup in food and commodity prices since mid-2007 has raised concerns that high food price increases, should they persist, could raise inflation expectations and wage demands and set off a more generalized inflation process.

China's Growth and Inflation
(Percent change)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

China: GDP Components
(In percent of GDP)



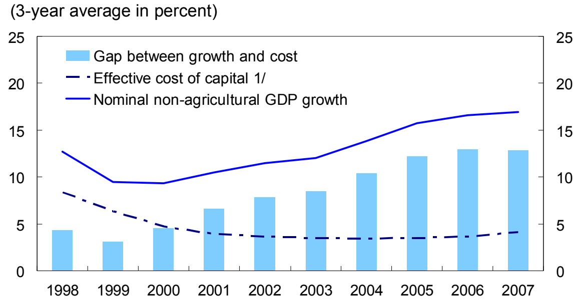
Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

3. **These imbalances have raised concerns about domestic and external stability and the sustainability of rapid growth**. There is a risk that the continued rapid expansion of capacity will eventually lead to price declines in certain sectors which will cut profits, increase loan defaults, and undermine confidence. While both the timing and the size of such an occurrence are uncertain, as the imbalances persist the odds increase of such an adverse outcome happening. The negative impact of the rise in capacity on prices would be worse if it coincides with a sharp global slowdown and increased competition from other countries,

making it that more difficult for China's firms to sell their products abroad. Added to that is the risk of rising protectionism in China's trading partners.

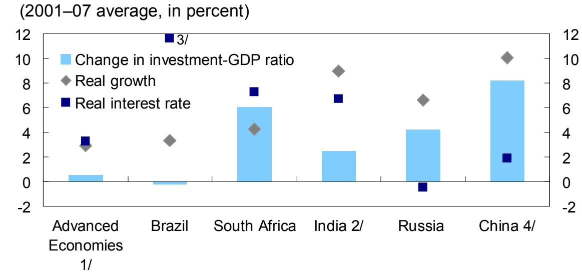
4. **Thus, the urgency of rebalancing growth away from heavy reliance on investment and exports towards consumption has increased**. At present, low prices of key inputs encourage rapid investment in many sectors. The government has raised some land and energy prices while strengthening environmental standards in recent years, but land, energy, water, and pollution abatement costs remain low. Most important is the low cost of capital.[1] The cost of capital is not only low in China, but the difference between the cost of capital and the average return on investments (proxied by GDP growth) has increased and is one of the largest in the world. The low cost of capital has also served to skew production towards more capital intensive technologies. As a result, job creation has been low despite China's abundant labor supply. In recent years, while in most comparator countries 3−4 percent GDP growth is associated with 2−3 percent employment growth, in China 10 percent GDP growth has generated only a little more than 1 percent growth in employment. The low value of the renminbi also has encouraged heavy investment in the production of tradable goods. In contrast to the rise in investment, since the early 1990s the share of private consumption in GDP has fallen by more than 10 percentage points to stand today at less than 40 percent of GDP, almost entirely because of a declining share of household income.[2] At the same time, the household saving rate has remained high reflecting poor financial intermediation, weak government provision of health care and education, and inadequate and uncertain pensions.

Growth and Cost of Capital
(3-year average in percent)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.
1/ Effective cost of capital is calculated as the weighted average of benchmark banking lending rate and opportunity costs of investing from retained earnings.

Growth-Interest Rate Gap and Investment
(2001–07 average, in percent)



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.
1/ The group of advanced countries is as defined by WEO.
2/ Average for India 2004–2007.
3/ Average real interest rate for Brazil was 46.5.
4/ Real cost of capital is substituted for interest rate.

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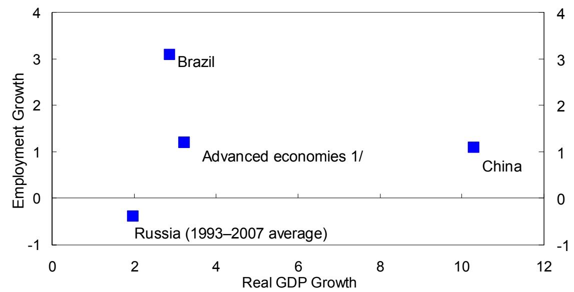
[1] Jahangir Aziz, 2006, "Rebalancing China's Economy: What Does Growth Theory Tell Us?," IMF Working Paper 06/291, describes how distortions in the price of capital may be quantitatively a major factor behind the rise in China's macroeconomic imbalances. Jahangir Aziz, 2008, "Real and Financial Sector Linkages in China and India," IMF Working Paper 08/95 finds that the investment wedge (which in turn is related to financial sector policies) is large and significant in explaining China's investment.

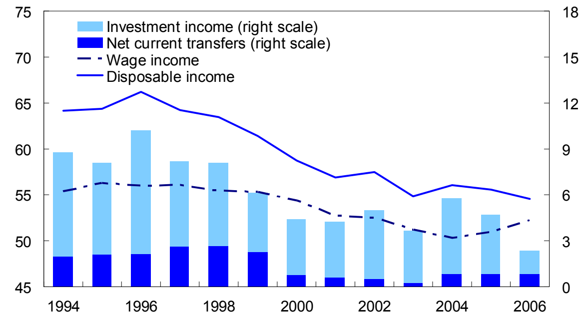
[2] While this decline has occurred across all categories of household income, most of it has come from lower investment income; see Jahangir Aziz and Li Cui, 2007, "Explaining China's Low Consumption: The Neglected Role of Household Income," IMF Working Paper 07/181.

Real GDP and Employment Growth
(In percent, 1991–2007 average unless otherwise noted)



Sources: IMF, *World Economic Outlook* (WEO); and IMF staff estimates.
1/ The group of advanced economies is as defined by WEO.

Components of Household Income
(In percent of GNP)

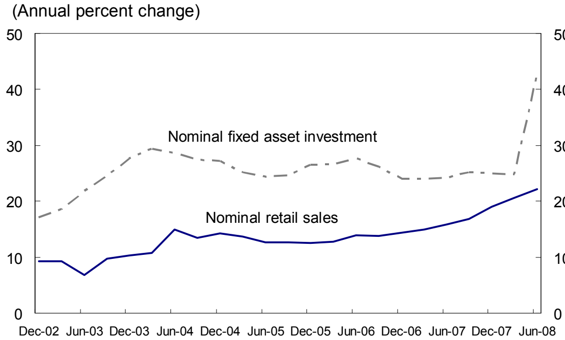


Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

II. Economic Developments

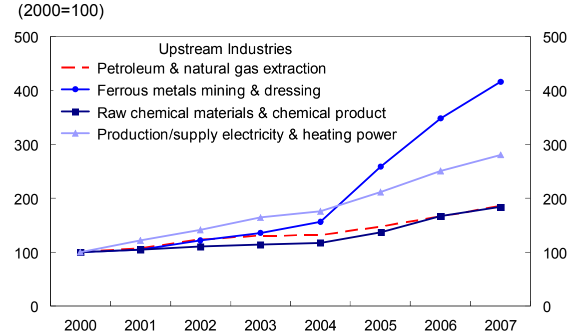
5. **The Chinese economy continued to grow rapidly in 2006−07, before slowing modestly in the first half of 2008**. Measured from the production side, real GDP grew by 11.6 percent in 2006 and 11.9 percent in 2007, compared to an average of 10¼ percent in 2003−05 (Table 1).[3] Growth moderated to 10.4 percent in the first half of 2008, as the impact of softer net exports was cushioned by robust domestic demand. Investment, in particular, has remained strong. Retail sales suggest that consumption growth also continued to be high.

Domestic Demand Indicators
(Annual percent change)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

Net Fixed Stocks in Selected Industries
(2000=100)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

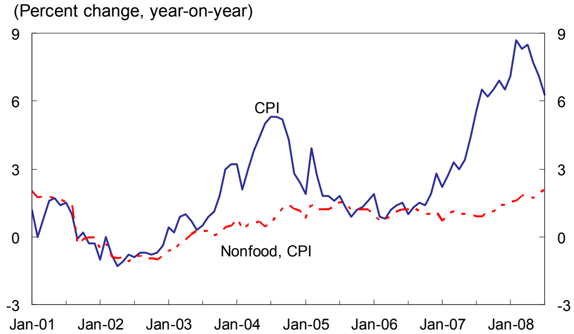
6. **The rate of inflation peaked in February of this year but has since retreated**. Inflation gathered pace in 2007, rising from under 2 percent in 2005−06 to 4.8 percent in 2007 and averaging over 8 percent (y/y) in the first four months of 2008. By July, however, inflation had come down to 6.3 percent. Food prices were the main factor driving the rise, reflecting some domestic supply shortages and, to a more limited extent, higher international agricultural commodity prices. Nonfood inflation edged up slightly to around 2 percent. With

[3] Indicators of aggregate demand suggest much higher growth rates.

producer price inflation also ratcheting up, concerns emerged that persistently elevated food inflation could spill over to wages and nonfood prices. In response, the State Council in January 2008 approved temporary subsidies and administrative controls over price increases for basic necessities and a temporary halt to administered price changes (mainly prices for utilities, oil products, and transportation).[4] The authorities have also introduced measures to limit exports of food and to subsidize key agricultural inputs, such as fertilizers.[5] Food inflation started to ease in the second quarter of 2008. In June 2008, administered fuel and electricity prices were raised by 17−18 percent and 5 percent, respectively, as international commodity prices continued to rise.

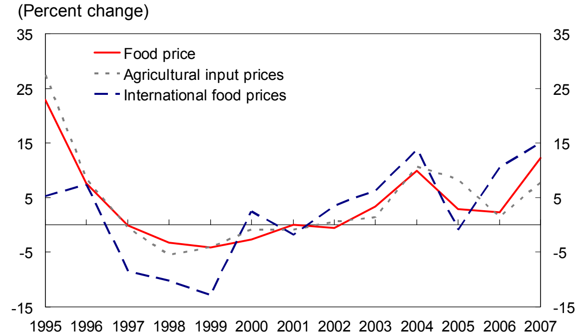
7. **On a national basis, the devastating earthquake that hit Sichuan Province in May 2008 is expected to have a limited economic impact**. Although it raised concerns about adding to existing inflationary pressures as it affected one of the main agricultural provinces, key food prices have not been affected. Its impact on growth for China as a whole is likely to be small as the most heavily affected area accounts for only a small share of the country's GDP and reconstruction efforts should boost economic activity.

Inflation
(Percent change, year-on-year)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

Food Prices, Agricultural Input Prices, and International Prices
(Percent change)



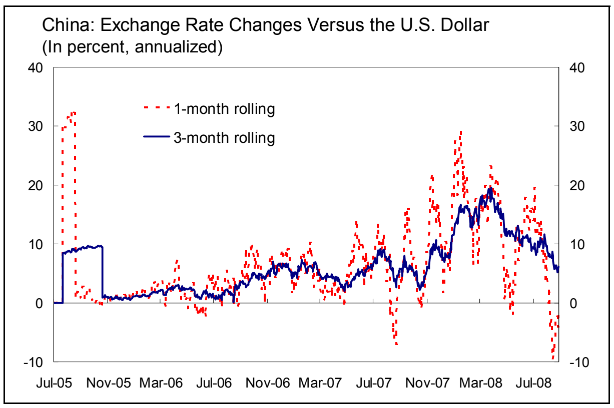
Sources: CEIC Data Co., Ltd.; IMF, *World Economic Outlook*; and IMF staff estimates.

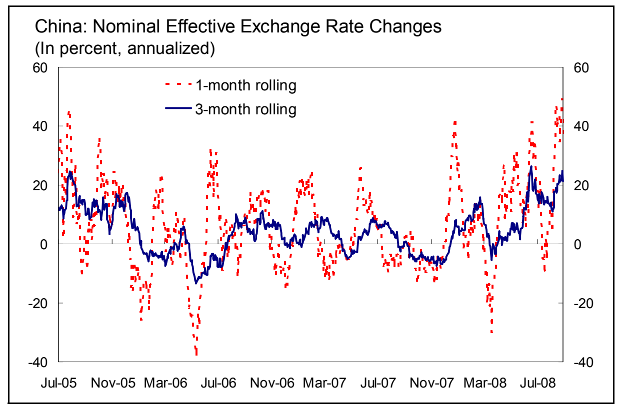
8. **The pace of appreciation of the renminbi versus the U.S. dollar picked up in the first half of 2008, but movements in the currency's value on a nominal effective basis were smaller**. The renminbi appreciated by roughly 7 percent against the U.S. dollar from the end of 2007 through June (21 percent since the exchange rate regime change in July 2005), following a 7 percent appreciation in 2007. The upward trend in the currency's movement against the U.S. dollar came to an end during July-August. On average, forward markets in

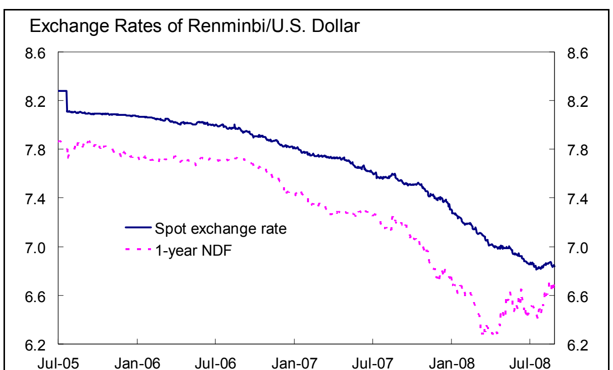
[4] These measures require large wholesalers and retailers to obtain government approval for raising prices of basic necessities by more than 4 percent at any one time, more than 6 percent within 10 days, and more than 10 percent in 30 days.

[5] Since late 2007, the authorities scrapped export tax rebates and imposed provisional export taxes on a range of grain products, and launched a quota and license management system for some grain exports. Also, they raised the minimum purchase price for grain producers and increased the export taxes on fertilizers.

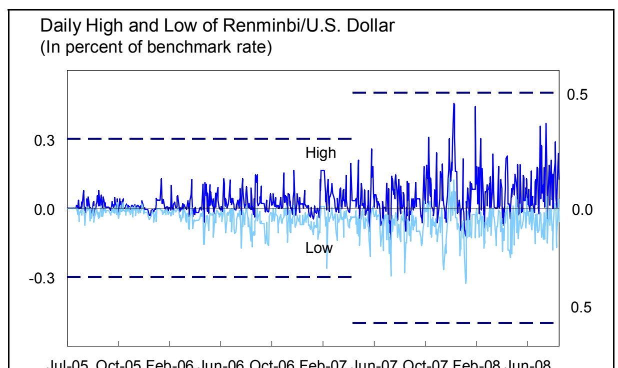
August 2008 priced a 2−4 percent appreciation of the renminbi against the U.S. dollar in the following twelve months. The average intraday fluctuation in the dollar-renminbi rate increased during 2007 and through August 2008, but it remained less than half of the 0.5 percent official limit on movements in either direction. On a nominal effective basis, the currency has appreciated by 7½ percent during the first eight months of 2008 (14 percent since the July 2005 exchange rate regime change). The rise in the real effective exchange rate has been larger owing to the relatively more rapid rise in Chinese consumer prices. The CPI-based real effective rate in July 2008 was 5 percent above its December 2007 level and 16 percent above its mid-2005 level; it remains slightly below its previous peak in February 2002.







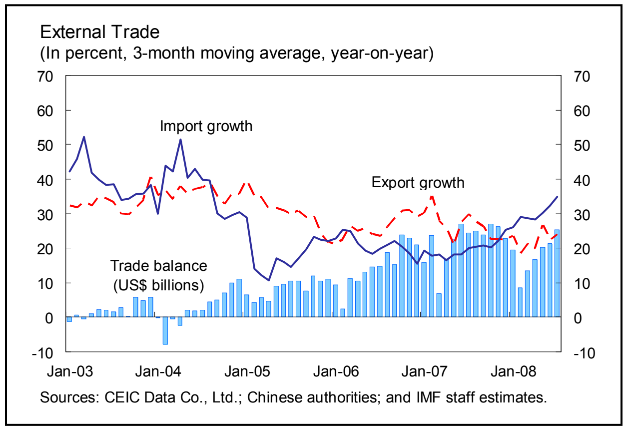
Source: Bloomberg L.P.



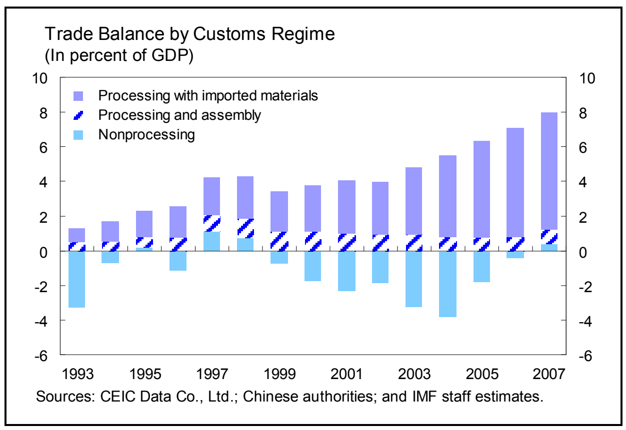
Sources: CEIC Data. Co. Ltd.; Chinese authorities; and IMF staff estimates.

9. **The trade surplus rose to $262 billion in 2007, but at $125 billion in the first seven months of 2008, it was smaller than in the same period in 2007**. Export growth averaged 26 percent in 2007 reflecting substantial increases in exports of machinery and transport equipment and intermediate products. It moderated in the latter part of 2007, and this

deceleration continued in the first part of 2008 as trading partners' economies slowed and the effect of lower export tax rebates and higher export taxes started being felt.[6] Exports to the U.S. led the slowdown, but export growth to the EU has also moderated this year. Import growth lagged that of exports for most of 2007, but has strengthened markedly since October 2007 and accounted for a large part of the decline in the trade surplus in the first half of 2008. Much of the rise in imports reflected increases in the prices and volumes of commodities, with a large increase in commodity imports from Africa. However, manufactured imports from Japan, emerging Asia and the EU have also accelerated, accounting for around one third of total Japanese export growth, one fifth of export growth in the rest of Asia, and 10 percent of EU export growth. Import growth from the United States, on the other hand, have slowed. Driven by the rising trade surplus, the current account surplus increased from about 9½ percent of GDP in 2006 to 11.3 percent of GDP in 2007 (Table 2).



10. **The increase in the trade surplus was partly driven by the shifting structure of China's trade.**[7] Large investments (including FDI) in recent years have expanded domestic production capacity, increased product sophistication, and enabled greater local sourcing of intermediate products. Consequently the domestic value added of exports has risen significantly. Processing trade remains important, but the contribution of traditional assembly-line processing trade has declined



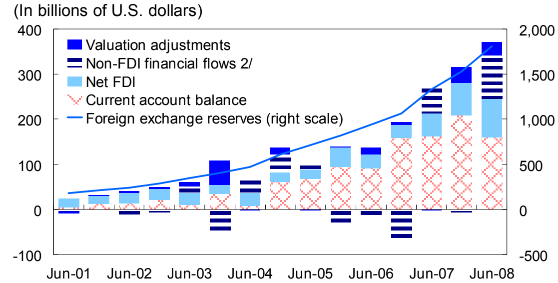
[6] Export tax rebates were reduced on a large number of steel products in April and July 2007, and export tariffs and duties were raised on several resource-intensive products in June 2007. Further increases in export taxes on products from resource-intensive industries have come into effect in 2008. In July 2008, however, export rebates on some products (e.g., textiles and garments) were increased.

[7] See Li Cui and Murtaza Syed, 2007, "The Shifting Structure of China's Trade and Production," IMF Working Paper 07/214.

to around 10 percent of the trade surplus. These changes imply that external demand fluctuations and exchange rate changes will likely play a larger role in determining the trade balance going forward.

11. **Foreign official reserves have continued to accumulate at a rapid pace**. Reserves rose by $462 billion in 2007 and another $281 billion in the first six months of 2008, bringing their level at end-June to $1.8 trillion. Capital flows have accounted for a larger share of reserve increases so far in 2008 compared to previous years, possibly reflecting the faster pace of appreciation of the currency. In response, the authorities lowered banks' foreign borrowing limits further, tightened the supervision of capital inflows, required exporters to deposit export proceeds in temporary accounts while the authorities verify that they are backed by genuine trade transactions, simplified rules for outward investment, and relieved trading firms of the requirement to repatriate their foreign currency earnings.

Change in Foreign Reserves and Balance of Payments Flows 1/
(In billions of U.S. dollars)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.
1/ Semiannual data.
2/ Calculated by subtracting the current account surplus and net FDI from the sum of the reserve accumulation (net of estimated valuation adjustments) and the change in other foreign assets of the PBC.

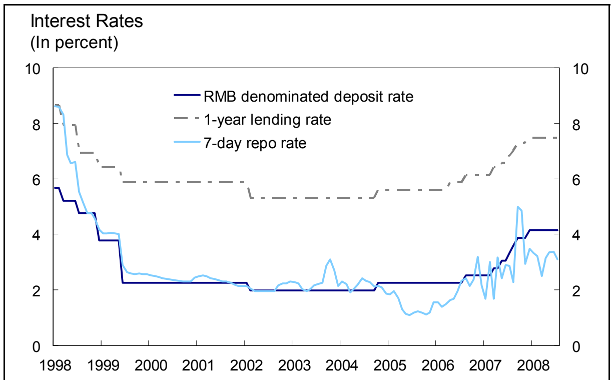
12. **The large reserves accumulation has been only partially sterilized, adding to the substantial liquidity in the banking system and fueling strong credit growth**. The PBC carried out open market operations and raised the required reserve ratio by 850 basis points in several steps between December 2006 and June 2008.[8] During 2007, it also raised the ceiling on bank deposit rates by a cumulative 162 basis points and base lending rates by 135 basis points. Nevertheless, with the sharp rise in the CPI and the PPI, interest rates on deposits, and even on loans, are below inflation. Credit growth picked up during 2007, but was held in check by the authorities exercising intensified window guidance, especially during the last few months of the year. Indicative quarterly targets were set for 2008 to try to maintain restraint on credit growth, which slowed to 15 percent (y/y) by June 2008.

China: Sterilization Efforts by the People's Bank of China

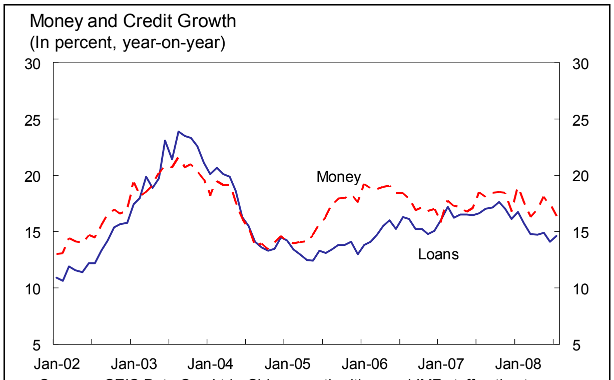
	2005	2006	2007	Mar-08	Apr-08	May-08	Jun-08
	(In billions of yuan)						
Change in the NFA of the PBC 1/	1,630	2,215	3,903	4,147	4,374	4,422	4,473
Sterilization operations 1/	1,009	1,562	2,975	2,898	2,885	2,882	2,949
Open market operations	1,009	1,084	923	739	693	649	472
Increased reserve requirement ratio	0	478	2,052	2,159	2,192	2,233	2,478
	(In percent of NFA change)						
Sterilization effort 1/	61.9	70.5	76.2	69.9	66.0	65.2	65.9

Sources: People's Bank of China; and staff estimates.
1/ Twelve-month rolling.

[8] Since August 2007, banks have been required to meet part of the increases in reserve requirements in foreign currency, which also served to reduce the PBC's accumulation of official reserves by an estimated $200 billion.



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

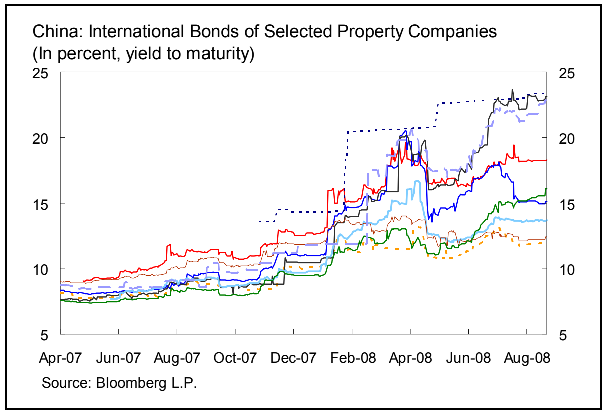
13. **The direct exposure of the Chinese financial system to U.S. structured credit products is reported to be low**. Banks' total exposure to such products is estimated at about $10 billion (about 0.1 percent of the banking system's assets). Bank of China (BOC) holds three quarters of this exposure, representing only 0.9 percent of its assets but 13 percent of its capital. Although no data on nonbank financial institutions are available, some analysts believe these institutions could have significant exposures, especially insurance companies. Also, banks could be adversely affected by lower values of other external assets, especially as they face a more challenging environment for liquidity management.[9] Major banks have increased provisions, but thus far this has not had a significant impact on the sector's profitability.

14. **After soaring since mid-2006, equity prices have fallen about 60 percent from their October 2007 peak**. The conversion of nontraded shares of listed companies to tradable shares, the reform of brokerage firms, and rising corporate profits restored investor confidence and led to a surge in stock prices. Equity prices rose more than five fold from end-2005 to their October 2007 peak. Overvaluation and concerns about a possible rise in the supply of securities coming into the market[10] have exerted downward pressures on equity prices since October, and these concerns were compounded by the global equity sell-off in 2008. In response to the decline, the authorities in April 2008 imposed limits on the sales of large blocks of stocks via the open market and reduced the stamp duty on equity transactions to 0.1 percent from 0.3 percent, reversing a May 2007 increase in this tax.

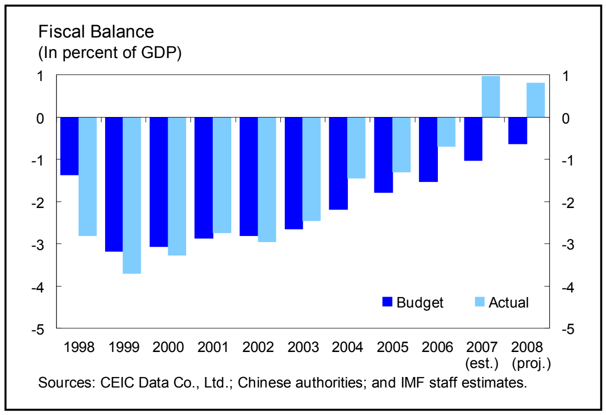
[9] At end-June 2008, Chinese entities directly held $470 billion of bonds issued by U.S. government sponsored enterprises; the bulk of these securities are held by SAFE as part of official reserves.

[10] Representing prospective sales by listed companies of the marketable shares that they hold, as lock-in periods limiting the sale of these shares expire.

15. **There are signs that the property market, especially in the large cities, is softening**. The authorities introduced regulatory measures in 2007, such as higher down payments and interest rates on mortgages for second houses, to cool property speculation. While property prices countrywide increased 7.0 percent (y/y) in July 2008, prices and sales volumes in some cities have fallen. In addition, property developers are facing greater difficulty in accessing credit and increasing financing costs, especially on their offshore borrowing in part as a result of the turmoil in international credit markets.



16. **The budget was in a surplus in 2007, reflecting strong revenue overperformance**. Revenue increased by over 30 percent in 2007, compared to a budget projection of half that rate, reflecting higher corporate income tax, stamp duty, and VAT receipts. With only part of the revenue overperformance spent, the outturn was a surplus of 1 percent of GDP (IMF definition), compared to a 2007 Budget projection of a 1 percent deficit. In the first seven months of 2008, revenue was 30 percent higher than in the same period of 2007 and the fiscal position again looks set to outperform budget forecasts.



III. Outlook and Risks

17. **The staff projects a moderation in growth in 2008**. Real GDP is projected to grow by 9¾ percent, reflecting a reduced contribution of net exports as trading partners' demand eases. As a result, the external current account surplus could temporarily decline to around 10 percent of GDP. With the cost of capital and other inputs in China still low and corporate profits high, investment demand should remain strong, while signs are that real consumption is picking up somewhat as incomes continue to rise, consumer credit facilities expand, and the government boosts spending on social programs. Inflation is likely to remain elevated for most of the year. Although food inflation is expected to continue to moderate as the supply of agricultural commodities improves, increases in fuel and energy prices will partly offset this decline. The average CPI inflation rate for 2008 is expected to be around 7 percent.

18. **The risk of spillovers from a sharper-than-envisaged slowdown in world demand is rising**. The authorities have become increasingly concerned about the effects on growth and employment of the slowdown in export growth that is already taking place and the possibility of a further weakening in external demand. In response, they have taken steps to boost exports by raising VAT rebates for some products and to ease credit restraints. With the domestic-value added of China's exports rising, China's economy is increasingly export-dependent and exposed to external demand fluctuations, providing little credence to the view held by some analysts that China may have "decoupled" from the economic cycles of its major trading partners.[11] Staff estimates that a 1 percent drop in U.S. growth would reduce China's growth by 0.5−1 percentage points, with larger effects if other major economies slowed at the same time or if the growth moderation was protracted.

19. **In the event the global downturn turns out to be more severe or its impact on China's domestic growth greater than expected, the authorities have room to take countercyclical fiscal measures**. Given the relatively sound fiscal position, if growth falters, it is likely the authorities will raise public spending to maintain GDP growth above 9 percent. Although China's final growth rate might be largely unchanged as a result, the change in the composition of China's aggregate demand is likely to have significantly different effects on other Asia and Pacific economies. Those providing China with capital equipment, raw materials, and primary commodities would be expected to be less affected than those economies for which China has become the major destination for their exports of intermediate products or those which face China as a major competitor for finished goods exports in third-country markets. A rise in protectionist sentiment in China's major trading partners is also an important risk, especially if it intensifies with the global downturn.[12]

20. **Inflation remains a significant risk**. The authorities are likely to adjust further some key administered prices, as a result of high world prices, which would influence prices of other goods. Moreover, delays in raising pork production or disruptions to grain supply could prevent a decline in food price inflation. Protracted elevated headline inflation, in turn, could ignite wage inflation and raise inflation expectations.

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[11] See Li Cui and Murtaza Syed, 2007, Ibid; and Jahangir Aziz and Xiangming Li, 2007, "China's Changing Trade Elasticities," IMF Working Paper 07/266, for more details.

[12] In February 2007, the United States requested formal consultations with China on export and import-substitution subsidies prohibited under the WTO. In April 2007, the United States imposed countervailing duties on glossy paper from China and lodged complaints with the WTO regarding China's enforcement of intellectual property rights and restrictions on imports of music, movies, and books. In July 2008, the WTO upheld an interim judgment against China with respect to EU, United States, and Canada complaints regarding automobile parts. In March 2008, the EU and the United States filed a joint complaint at the WTO against China's regulation on foreign financial information providers. In addition, various pieces of legislation calling for measures against Chinese imports have been introduced in the U.S. Congress.

21. **China's medium-term prospects are favorable, but entail risks in the absence of a significantly faster pace of implementation of planned policies and economic reforms**. The scenario presented in Table 8 based on WEO exchange rate and policy assumptions shows GDP growth averaging 10 percent per year over the medium term with moderate inflation.[13] This result could be achievable under the more gradual pace of policy change and structural reform that the authorities appear to envisage. However, in these circumstances the economy's imbalances would persist—the investment-to-GDP ratio would remain high and the consumption-to-GDP ratio would still be low, while large current account surpluses would add further to the reserve accumulation feeding liquidity in the banking system. Moreover, in the absence of faster exchange rate appreciation in the period immediately ahead, incentives would continue to favor investment in the traded goods industries, adding to productive capacity and pulling more resources into this sector. Consequently, vulnerability to external shocks and eventual adjustment costs would increase.[14] Thus, not only does the economy's dependence on investment and exports need to be rebalanced towards consumption, but within investment there needs to be a shift away from tradables to nontradables.

22. **Given these risks, a faster pace of policy change and reform is needed**. A stepped-up rate of currency appreciation and higher interest rates in the immediate future could entail some additional slowdown in near-term growth. In particular, a sharp drop off in investment growth would rob the economy of its main engine of growth. But much of the authorities' rebalancing measures and those suggested by staff are aimed at moderating, rather than substantially reducing investment growth. Better financial intermediation would boost investment and employment by increasing access to financing for small and medium-size enterprises, while an appreciation of the exchange rate would raise households' purchasing power and consumption. These factors would help to buffer the impact of a decline in investment. Moreover, this year's decline in the trade balance appears to be largely cyclical and the current account surplus is unlikely to be a temporary phenomenon. Attempts to shelter exporters from current difficulties would only delay the necessary adjustment, could stoke protectionist pressures in trading partners, and exacerbate medium-term risks related to the misallocation of resources. If growth were to slow down more sharply than anticipated, fiscal policy would be the most appropriate way to boost activity. The fact that

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[13] The WEO-based scenario presented in Table 8 assumes a constant real exchange rate at current levels over the medium term. It also assumes the continuation of present policies which would include the future effects of past policies and reforms, but no further policy changes or reforms.

[14] An alternative view is that investment will decline gradually as profitability falls and thus there is no need for significant corrective measures now. For a discussion of these two views see Jahangir Aziz and Steven Dunaway, "China's Rebalancing Act," *Finance and Development*, September 2007, pp. 27−31, and Jonathan Anderson, "Solving China's Rebalancing Puzzle," *Finance and Development*, September 2007, pp. 32−35.

reforms to increase consumption may take time to bear fruit only underscores the need to implement these changes quickly.

23. **The rebalancing of China's economy will affect world markets, including by helping to avoid a disruptive resolution of the global current account imbalance**. The exact impact would depend on the timing and size of the rebalancing. A rise in the consumption share of GDP, especially if it is accompanied by a more appreciated currency, would likely increase China's demand for imported goods and financial and retail services. At the same time, the Chinese authorities, as part of rebalancing efforts, are aiming for more efficient energy use, with a targeted 20 percent reduction in energy content per unit of GDP over the next five years. This could temper the growth in world demand for energy products, while increasing that of energy-conserving technologies.

IV. Policy Discussions

24. **The authorities and the staff agree on the basic assessment of the economy and on the broad reform agenda needed to rebalance growth and policies to strengthen macroeconomic management**. However, in the staff's view, without a faster pace of policy implementation, the imbalances in the economy would mount, leading to increasing external and domestic instability and raising the country's vulnerability to shocks. Against this background, discussions focused on areas where more rapid and substantial policy actions should be taken, such as containing investment, credit growth, and inflationary pressures more effectively through further monetary tightening along with greater currency appreciation; improving financial intermediation; and raising the provision of education, health care, and pensions through reforms and higher public spending in these areas.

25. **These policies and reforms are in line with the authorities' plans and their undertakings laid out in the first Multilateral Consultation**.[15] The Chinese authorities note that reducing the trade surplus is a major national objective and, in this connection, they intend to continue to pursue measures to boost domestic demand, raise rural incomes, reform the trade system, accelerate financial sector reform, and gradually increase exchange rate flexibility with attention paid to the value of the renminbi relative to a basket of currencies. Since the conclusion of the first Multilateral Consultation, the authorities have further streamlined and reduced export tax rebates and import tariffs, have begun to require state-owned enterprises to pay dividends to the budget, enhanced social programs, and advanced on their financial sector reform and development agenda (Appendix I). However, reflecting concerns about the impact of high commodity prices and declining external demand on exports, the authorities in July 2008 raised VAT rebates for some exports, including textiles and clothing, which had previously been cut. Moreover, the economy

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[15] Details of these undertakings can be found at http://www.imf.org/external/np/sec/pr/2007/pr0772.htm.

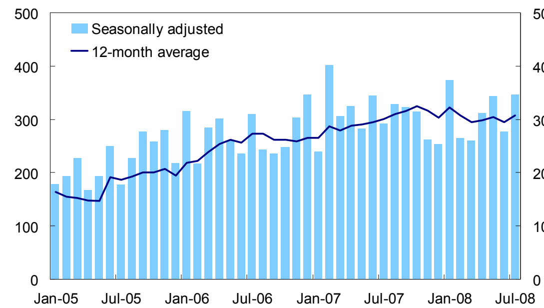
continues to be heavily dependent on investment and exports as the main drivers of growth, and external imbalances have increased in 2007. Reform efforts need to be accelerated in order to meet the authorities' medium-term objectives.

A. Reducing Reliance on Investment and Exports

Tight Monetary Policy with Faster Appreciation

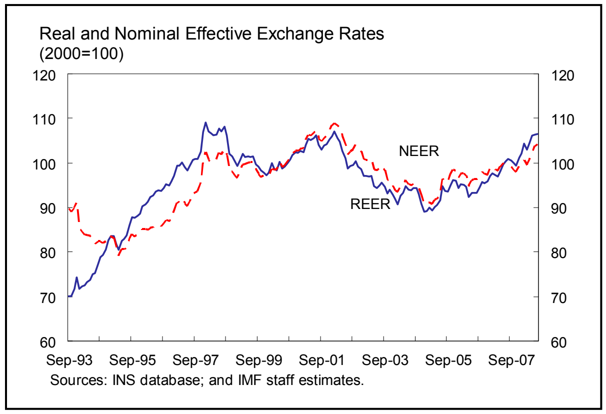
26. **Further actions will be needed to ensure that investment and credit growth are kept in check and inflationary pressures are curbed**. Efforts to limit investment and credit growth have preoccupied the policy agenda for the last four years, but the steps taken so far have not provided a lasting solution. While monetary tightening over the last year and a half has been welcome, further significant measures are needed to mop up liquidity and substantially raise the current low cost of capital. Tight monetary policy is also the most effective means of limiting the risk of a generalized inflation process developing. There are concerns, however, that more rapidly draining liquidity from the banking system could intensify capital inflows as domestic interest rates rise, especially now that the Federal Reserve has significantly lowered U.S. rates. These concerns only underscore the importance of tightening monetary conditions in conjunction with a faster pace of currency appreciation that would be sufficient for the currency to quite quickly reach a point where there was genuine risk of two-way movement in the exchange rate. Such appreciation would also contribute to reducing inflation pressures directly by lowering the cost of imported goods. The authorities agree on the potential dangers of continuing rapid credit and investment growth and inflation, but they note that monetary policy should continue to be complemented by sector-specific measures, including raising land and energy prices and tightening environmental standards to increase business costs, and restricting credit to high energy consuming sectors. They also pointed to flaws in the international monetary system, stressing that the dramatic easing of U.S. monetary policy since the beginning of 2008 has greatly complicated monetary management in the rest of the world, especially in China which has had to deal with the resulting rise in liquidity.

Increase in New Renminbi Loans
(In billions of renminbi)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

27. **Although it appreciated more rapidly against the U.S. dollar in the first half of 2008, the renminbi is judged by the staff to be substantially undervalued**. The currency's real effective rate as of July 2008 is still slightly below its previous peak in February 2002. At that time, the current account surplus was relatively small and stable, and there were no strong indications of undervaluation in the exchange rate. Since then, a number of factors—such as faster productivity growth relative to trading partners, increasing global market share, and large accumulation of net foreign assets—all point to substantial improvements in competitiveness and thus to a significant appreciation in China's equilibrium real exchange rate. During this period, the current account surplus has risen sharply from 2.4 percent of GDP in 2002 to 11.3 percent of GDP in 2007. Official reserves rose by more than $1.6 trillion to $1.8 trillion at end-June 2008, with about $1 trillion of this increase occurring since the July 2005 change in the exchange rate regime, reflecting the continued management of the currency's value. The staff considers this analysis, based on traditional indicators, to be indicative of substantial undervaluation. The tenor of model-based estimates too is consistent with this analysis.[16]



28. **The authorities have adopted policies that could correct the undervaluation of the renminbi over the medium term if they are fully implemented**. At this critical juncture, it is particularly important that there be a much more rapid pace of renminbi appreciation to help control inflation, to aid in the implementation of tighter monetary policy in the short term, to help achieve the authorities' stated objective of allowing the renminbi's value to rise against a basket of currencies, and to facilitate the rebalancing of the economy over the medium term.

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[16] The Spring 2008 CGER note estimates a range of undervaluation from 10 percent to 35 percent, with the lower end based on the reduced form equilibrium real exchange rate approach and the upper end corresponding to the macroeconomic balance approach.

China: Illustrative Alternative Scenario 1/

	2007	2008	2009	2010	2011	2012	2013
				(Percent change)			
Real GDP	11.9	9.7	8.7	9.0	9.0	9.0	9.0
Consumer prices (average)	4.8	7.0	5.0	4.7	4.0	3.6	3.6
				(In percent of GDP)			
Consumption	51.4	53.9	55.8	57.5	59.4	61.4	63.7
Private	37.1	38.9	40.1	40.6	41.4	42.5	43.7
Public	14.4	15.0	15.8	16.9	17.9	19.0	20.0
Gross investment	44.2	44.9	44.6	44.3	44.0	43.7	43.4
Current account balance	11.3	9.9	9.3	8.9	7.8	7.0	6.6

1/ This scenario incorporates different assumptions for the real effective exchange rate, and macroeconomic policies and reforms than under the WEO-based scenario. China's real effective exchange rate is assumed to appreciate at an average rate over the next five years equivalent to that during 2007, although the scenario assumes a faster pace of appreciation early in the period. The scenario also assumes that the authorities' policy plans and reforms will be fully implemented.

29. **The authorities do not agree with the staff's view that the renminbi is substantially undervalued**. They contend that structural factors, such as the global relocation of industries to China because of the low costs of labor and pollution, are the key drivers of the rise in the current account surplus and not the exchange rate. They point to a need to take a longer-term view of the equilibrium value of the renminbi, which since the unification of the exchange rate in 1994 has appreciated by about 35 percent. They think it is important to recognize that faster appreciation of the renminbi since the change in the exchange rate regime in July 2005 is taking place in the context of dramatic changes in the exchange rates of major currencies, and this should have some bearing on the pace that the currency should reasonably be expected to increase, especially against a basket of currencies. In their view, adequate consideration also is not being given to other policy changes that China is enacting, such as more exacting labor and environmental standards, which will have significant effects on China's competitiveness in the period ahead. In addition, they argue that model-based estimates of the renminbi's equilibrium rate vary widely, which underscores the large uncertainties in applying such methodologies to China. In particular, these methodologies do not capture China-specific factors, such as the global relocation of industries and the high household precautionary savings. In addition, given the 100−150 million underemployed workers in the rural sector, the authorities are also skeptical whether it is logical to expect that productivity differentials with partner countries would be transmitted into renminbi appreciation as assumed in some of these model-based estimates. The authorities also argue that the current account surplus may be overstated, as it may mask some capital inflows that are circumventing capital controls. In light of these factors, the authorities conclude that there is reasonable doubt about the extent of renminbi undervaluation.

30. **The authorities also maintain that dealing with the imbalance in China's current account would require more than simply changing the exchange rate; addressing the global imbalance requires action also from other major countries**. They argue that the most effective way to handle the situation is through macroeconomic policy changes and structural reforms that aimed at rebalancing China's economy. To do this will take time. The authorities note that the necessary policies and reforms (including China's undertakings in the context of the first Multilateral Consultation) are already in train, and they will bring about an orderly rebalancing of China's economy. If the impact of these policies and reforms is factored in, there would be a significant medium-term decline in China's current account surplus. They expect that the current account surplus in 2008 will likely decline by more than envisaged in the staff's projections and will continue to fall in 2009. In their view, current account deficit countries also need to do more to increase their saving rate and make more of a contribution to narrowing global imbalances.

31. **The authorities agree that greater exchange rate flexibility is needed not only for its own sake, but also to support other policy changes and reforms aimed at efficiently rebalancing the economy by providing the right price signals**. However, they maintain that exchange rate appreciation needs to take place at a "self-initiated, controllable, and gradual" pace. They remain committed to allowing a greater role for market forces to determine the exchange rate, noting that several reforms have been implemented in this regard: the number of market makers in the exchange market has been increased; market infrastructure has been improved through a new electronic trading system; and forward and swap markets as well as the trading of currency derivatives have been introduced.[17] They also emphasize that China does not target a large trade surplus, but on the contrary seeks to reduce the external imbalance, and that they do not manipulate the currency to gain unfair competitive advantage.

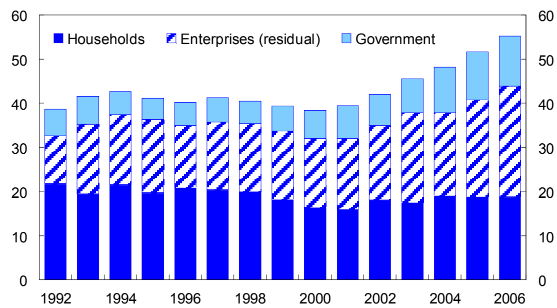
32. **The authorities remain concerned about the potential adverse impact a rapid, significant appreciation could have on macroeconomic and financial sector stability**. Reform of the banking sector is not fully completed, and there are questions about how well banks would cope with a large appreciation. They are also concerned about the adverse effects an abrupt appreciation could have on social stability if it led to large displacement of low-skilled workers. China employs a large number of rural migrant workers in low-margin, labor-intensive, high-volume exports of basic consumer goods, who work in such sectors to supplement their farm incomes. These are the sectors most likely to be affected by rapid appreciation of the currency, and indeed, a number of these firms have gone bankrupt in the past several months reflecting the impact of currency appreciation on top of other cost

[17] The authorities are looking into introducing more derivatives products, including options, but this would require introducing continuous trading along with other institutional changes.

pressures and slowing external demand. The authorities point out as well that, if faster appreciation were to slow the economy significantly, it could hamper world growth and trade, given China's growing global economic importance. They also cautioned that, with the effects of rising labor and environmental costs on competitiveness still unfolding, to push for faster appreciation would run the risk of significantly overshooting the exchange rate's medium-term value.

33. **The staff acknowledges the authorities' concerns and agrees that they have made progress in implementing many of the rebalancing policies and reforms that would help to eliminate the currency's undervaluation over time, but more needs to be done to increase the flexibility of the exchange rate**. In nominal effective terms, the renminbi has appreciated more rapidly since end-2007. However, the appreciation of the CPI-based real effective exchange rate during the past year is unlikely to suggest a significant reduction in China's competitiveness since the factors that have raised China's CPI inflation relative to its trading partners will not have a significant impact on production costs, at least in the near term. A faster pace of appreciation of the renminbi in the period immediately ahead is, therefore, essential in the staff's view. The exchange rate remains a key price for facilitating overall adjustment, and a more rapid appreciation would contribute to a sizable reduction in the current account surplus over the medium term. While globalization and high precautionary savings in China are important factors, they are unlikely to explain the nearly 9 percentage points rise in the current account surplus in the last five years. In fact, household savings over the last five years have remained largely stable, with much of the rise in the current account surplus being due to a similarly sized rise in corporate savings.

Domestic Savings By Sectors
(In percent of GDP)



Sources: CEIC Data Co., Ltd.; Chinese authorities; and IMF staff estimates.

34. **The staff also considers that the direct effects of a faster pace of exchange rate change on the banking system would be small and the impact on low-skilled workers would be manageable**. Banks' exposure to foreign currency risk is deemed relatively low, and in the staff's view, the current exchange rate regime is sufficiently flexible to allow faster appreciation without disrupting financial markets. While staff acknowledges that the initial impact of more rapid appreciation could be to slow GDP growth further and reduce employment in traded goods sectors of the economy, Chinese firms have proven to be adaptable and can be expected to take actions to cut costs, boost productivity, and move up the value-added chain in the products that they produce. At the same time, China's overall economy provides a favorable environment for alternative employment opportunities. Concerns about temporary unemployment could be mitigated through transitional income support from the budget. While such a measure is a second best option, it is less costly

compared to the distortions created by continuing to heavily manage the exchange rate. Although current economic circumstances may be less favorable than before, further delay will only exacerbate the imbalances, making the adjustment increasingly painful over time.

35. **In the staff's view, the current exchange rate regime is sufficiently flexible to allow faster appreciation**. There are no formal restrictions on changes in daily opening quotes (only on intraday changes after the central rate is fixed as an average of the opening quotes). To make the renminbi more flexible, apart from less intervention, it would be useful for the PBC to clarify to market makers that the daily opening quotes are not subject to the trading band. Current circumstances are not conducive to achieving the authorities' objective of appreciating at a "self-initiated, controllable, and gradual pace." To do so is likely to invite considerable speculative capital inflows. Although such inflows are unlikely to be eliminated entirely, a substantially quicker pace of appreciation in the period immediately ahead is needed to create genuine risk of two-way movement in the exchange rate and dampen incentives for short-term currency plays.

Raising the Cost of Capital: Increasing the Funding Cost of the Banks

36. **The staff recommends that the ceiling on bank deposit rates be raised significantly with a view towards its elimination in the period ahead, as it is a major factor in keeping the cost of capital low**. This ceiling has allowed the larger banks with their substantial deposits to enjoy a wide interest margin (the gap between the ceiling on deposit rates and the floor on lending rates has averaged around 300−400 basis points in recent years). The ability of the smaller banks to compete for deposits has been limited. Given the uneven distribution of deposits in the banking system, their ability to compete with the large banks also has been adversely affected by the large increases in reserve requirements that have taken place. Consequently, the large banks have had little incentive to develop the capacity to price risk and seek out a wider client base. Instead, lending rates have remained clustered around the base lending rate, and loans have been biased towards large, capital-intensive, state-owned enterprises. Moreover, the deposit rate ceiling has imposed a substantial cost on households by lowering returns on their savings and keeping household investment income very low. Recent interest rate decisions which raised deposit rates more than lending rates are steps in the right direction, but much more needs to be done and should be done quickly since real interest rates on deposits are highly negative.

37. **The authorities are uncertain about the impact of lifting the ceiling on deposit rates**. They acknowledge that the cap on the deposit rate plays a role in keeping the funding cost of banks low. However, the authorities are concerned that, based on past experience, lifting the cap on deposit rates in the near term would lead the banks to compete away their margins and profitability. They see removal of the cap on retail deposits as a later step in a process of banking development that should begin with establishing SHIBOR (the Shanghai interbank offer rate) as a benchmark for interest rates in China. Once this has happened, the

floor on lending rates could be removed, possibly in conjunction with lifting the cap on corporate deposits, while the cap on retail deposits would be lifted last. The staff argues that it is unlikely that banks would compete away their margins if the ceiling on deposit rates were lifted given the substantial liquidity currently in the system and strong loan demand. In these circumstances, deposit rates should not rise sharply, and the banks would have room to raise lending rates to maintain margins. In any event, the interest rate ceiling on deposits could be increased in steps to allow the authorities to observe banks' behavior and correct inappropriate actions. Staff also argued that an early removal of the cap on deposits rates was not inconsistent with the authorities' plans to develop SHIBOR. In fact, since deposits are the banks' main funding source, maintaining the deposit rate cap could hinder the development of SHIBOR, owing to the fact that such an interbank rate is heavily dependent on the cost of deposits. In addition, the authorities are not certain that increasing deposit rates would necessarily boost consumption by raising household income. On the contrary, it could well increase savings because in theory the impact of an increase in interest rates on savings is ambiguous. In the staff's view, a rise in deposit rates would likely boost consumption because precautionary savings would not tend to rise in proportion to the increase in household income and wealth. In addition, if more aggressive competition among banks led to increased access to loans by small- and medium-sized enterprises, corporate savings would also decline.[18]

Raising the Cost of Capital: SOE Profits and Tax Incentives

38. **The requirement that SOEs pay dividends to the budget should contribute to reducing investment growth**. Profits of SOEs—many of which enjoy monopoly positions—have grown rapidly in recent years and have been fully retained within firms and their holding groups since the 1994 SOE reforms. This has contributed to a rise in investment and has complicated demand management by generating pro-cyclical investment cycles. Starting in 2008, most SOEs will transfer 5−10 percent of their after tax profits to the budget. The staff welcomes this as an initial step in the right direction, but is concerned that the dividends likely to be transferred to the budget will be very small. It encourages the authorities to undertake an early review of the program with a view to increasing these payments. In particular, the staff recommends that SOE groups that have stock market listed companies should transfer almost all dividends paid by their listed affiliates to the budget. The authorities welcome the recommendation, but note the difficulty of reaching a consensus on higher dividend payments in the near term.

[18] One reason why China's enterprise savings are high, especially among SMEs, is because savings of these firms are used to compensate for the limited access many of them have to bank and capital market financing (see Aziz and Cui, 2007).

39. **The staff welcomes the government's unification of the enterprise income tax rate for domestic and foreign companies**. While this is a step in the right direction, transition arrangements are lengthy, and the tax system is still riddled with a plethora of tax incentives. Thus, there is still a need to simplify the tax system and eliminate incentives that keep the cost of capital low and contribute to its misallocation.

Improving Financial Intermediation: Bank Reforms

40. **Financial sector reform is key to rebalancing growth and, given their size, banks will play a major role**. Financial restructuring for three of the four major state-owned banks has been completed, while the sector has been fully opened to foreign competition.[19] With regard to the Agricultural Bank of China (ABC), several agencies are working to put together a final reform package, and provision has been made to finance the ABC's recapitalization through the China Investment Corporation. Although no specific timetable has been set for the bank's restructuring and recapitalization to be implemented, it is envisaged that further progress will be made in strengthening ABC's operations this year. In the meantime, the staff continues to recommend that, until ABC's reform is implemented, strict limits should be placed on the expansion of its assets and liabilities. The authorities note that financial soundness indicators for the banks, notably asset quality and profitability, have improved substantially over the past year. However, there is still a need to enhance governance and internal controls. The staff also suggests that China Banking Regulatory Commission (CBRC) closely monitor the flow of new NPLs to detect problems early. There are some concerns about credit quality, especially given the relatively fast pace of credit expansion in recent years and indications of overinvestment in some sectors. The staff notes that bank lending to property developers is one area of particular concern given declining demand and prices for housing in major cities. The authorities note that to deal with the increased risks the banks face the CBRC has stepped up its supervisory efforts, issuing notices on market risk and drafting stress testing guidelines.

41. **Premier Wen announced in February 2008 that China would participate in an FSAP**. The FSAP is expected to help take stock of the significant progress in financial sector reforms over the last few years and identify priorities for further reforms.[20] China is also taking part in the IWG, which aims at arriving at a generally accepted principles and practices for SWFs.

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[19] By the end of 2007, the authorities had approved the establishment of subsidiaries of over 20 foreign banks with unrestricted local currency services.

[20] In December 2007, MCM staff presented a workshop on the FSAP and financial stability analysis and helped the authorities in establishing a framework to conduct stress tests on a regular basis.

B. Reducing Savings and Increasing Consumption

Capital Market Development and Portfolio Diversification

42. **Deepening bond and equity markets will provide firms with alternative sources of financing and households with a broader range of financial assets in which to invest**. The result should be, over time, to reduce corporate savings and raise household income. Reforms in 2006 have revived the equity market, and corporate bond issuance is expected to increase as a result of the corporate bond issuance pilot scheme announced by the China Securities Regulatory Commission (CSRC) in August 2007. Under this new scheme for stock market listed companies, the quota on total bond issuance, the cap on interest rates, and the requirement of a bank guarantee on principal were eliminated. Shelf-registration and streamlined approval procedures (moving them closer to a disclosure-based system in line with staff's earlier recommendations) were introduced. In addition, the PBC in April 2008 expanded the commercial paper market to allow companies to issue securities with up to 5-year maturities. The staff welcomes these reforms, noting their potential to unlock an important new funding source for companies and increase competition in the financial sector. Staff also called for better coordination between the regulatory agencies and the PBC to remove potential impediments to expansion of the corporate securities market. In December 2007, the authorities announced a tripling of the quota for the Qualified Foreign Institutional Investor program to $30 billion and that foreign invested enterprises will be allowed to issue renminbi securities in China's capital markets. The quota of the Qualified Domestic Institutional Investor program also has been expanded to $64 billion.[21]

43. **The staff and the authorities agree that, given the still small role played by the stock market in the economy, the growth effects of a decline in stock prices are likely to be limited at present**.[22] Nonetheless, the stock markets' sharp decline since October 2007 prompted the authorities in April 2008 to impose restrictions on trading of large blocks of shares and to roll back the May 2007 increase in the stamp duty on equity transactions. Stock and property price declines, however, could have a significant impact on financial institutions. Data deficiencies make it difficult to quantify banks' exposure to property prices and their possible indirect exposure to equities, although insurance firms appear to be significantly exposed to equities and securities and fund management firms could also face substantial losses on their proprietary positions and reduced profitability. The authorities

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[21] The performance of QDII funds in 2007 was adversely affected by the global financial market turmoil and the appreciation of the renminbi, resulting in significant losses. This, in turn, has reduced the interest in these products. The current take-up of investments under QDII is around $40 billion.

[22] Less than 8 percent of the population is estimated to hold stocks and their value accounts for less than 25 percent of household financial assets (including real estate wealth would make this ratio even less).

maintain that capital markets supervision and governance in securities firms have been strengthened and they do not see threats to financial stability. They also believe that the fundamentals in the property market remain sound and a generalized real estate price drop is unlikely. Nevertheless, the authorities concur that the confluence of the slowdown, the global financial situation, and weak asset markets is likely to weaken financial institutions' asset quality somewhat and warrants heightened vigilance.

44. **In 2007, the government established the China Investment Corporation (CIC) to invest part of its international reserves to earn a higher return**. CIC has an initial capital of $200 billion, which in effect was taken from China's official reserves. About one third of these funds has been used to purchase Central Huijin (a PBC-owned company that holds the government's stake in the three major state-owned commercial banks that have been restructured and some securities firms). Roughly, another third of CIC's capital is reserved to fund the recapitalizations of ABC, China Development Bank (CDB), and a few other financial firms.[23] The remainder (roughly $70 billion) will be redeployed in offshore assets yielding higher returns than official reserves. CIC has hired external fund managers, and the authorities intend, at least initially, to have these managers handle the investment of most of these funds to be placed abroad, in line with staff's suggestions. Staff has underscored the need to keep the agency's purpose simple and its operations transparent, and to keep its focus on raising asset returns subject to appropriate risk considerations. An arms-length approach to investments would help to shield the agency from undue influence from various domestic interest groups and alleviate potential foreign government concerns regarding the agency's investments.

Role of Fiscal Policy

45. **The 2008 budget envisages a 0.8 percent of GDP deficit, with a continuing shift in spending composition towards social programs**. After rising by about 33 percent in 2007, overall social spending (including education and health care) is budgeted to increase substantially in 2008. The central government plans to increase its own share of social spending by almost 30 percent, and it will increase transfers to local governments at the same time. The authorities plan to extend nationwide the free provision of compulsory school education that was initiated in rural areas in 2006, cover all rural households under the rural health insurance scheme (up from 80 percent coverage in 2007), and expand the pilot program for urban health insurance. As in previous years, budget estimates for revenue are conservative, suggesting that the 2008 outcome is likely to be better than budgeted. Earthquake-related spending (about ½ percentage point of GDP) is expected to be largely financed within the existing budget ceilings.

[23] A $20 billion recapitalization of CDB took place in December 2007.

46. **The authorities and the staff agree that better provision of education and health care services is essential to help reduce households' high precautionary savings**. The higher spending on social needs in 2007 and that planned for 2008 is consistent with their overall strategy. The authorities point to the difficulty of setting up a comprehensive system for improving the provision of social services given wide variations in income distribution, especially between rural and urban areas, and competing funding needs between education, health care, and pensions. The authorities and staff agree that increases in social spending should be in line with the development of comprehensive reform plans for the delivery of these services and with implementation capacity. The staff encourages the authorities to further enhance implementation capacity to expand these programs faster. Given the difficulties of local authorities in funding some of their expenditure mandates, especially in these areas, the staff continues to stress the need for a review of intergovernmental fiscal transfers and tax assignments.

Pension Reforms

47. **Apart from weak public provision of education and health care, the uncertainty over pensions and the upcoming aging of the population have also kept savings high**. Pension reforms launched in 1997 are focused on developing a comprehensive pension plan for all workers in urban enterprises. Uneven economic development both within and across provinces has given rise to disagreements among local governments and with the central government over who should bear the legacy costs of the previous enterprise-based pension system and has substantially inhibited the pooling of pension assets and liabilities from local governments up to provincial levels and eventually to the national level. Coverage of the system is also expanding very slowly. In any event, the fiscal costs of the system are rising. To jump start pension reform and reduce the longer-term fiscal burden, the staff proposes that the authorities consider dealing with the problems of the current system separately and proceed immediately to establish a new nationwide pension system covering both urban and rural workers.[24] This proposed new pension system could be fully funded and would begin paying benefits in 15−20 years, when the aging of the population rises significantly. The authorities, however, point to the difficulties of establishing a comprehensive pension system, especially because of the disparities between urban and rural areas.

V. Other Issues

48. **The authorities are pushing ahead with the implementation of China's WTO commitments**. They also remain fully committed to multilateral trade liberalization and see regional and bilateral free trade agreements as supplementary to multilateral agreements.

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[24] For details see Steven Dunaway and Vivek Arora, "Pension Reform in China: The Need for a New Approach," IMF Working Paper 109/07.

They consider successful completion of the Doha round a critical step in further liberalizing the international trade regime.

49. **China was assessed against the Financial Action Task Force (FATF) Recommendations in 2007 and is now a FATF member**. China adopted a new Anti-Money Laundering Law in 2006 and implementing regulations came into effect in 2007. In June 2008, China informed the FATF of the steps it has taken to address the shortcomings identified in the 2007 evaluation report and confirmed its commitment to make further progress in the fight against money laundering and the financing of terrorism.

50. **China continues to provide large financial support to low-income countries (LICs)**. China has provided debt relief to many heavily indebted poor countries (HIPCs), although not always on HIPC Initiative comparable terms according to available information. Staff welcomes China's increasing provision of financial assistance to LICs and the authorities' willingness to have a dialogue with Fund and World Bank staffs on how to maintain debt sustainability in these countries and more generally with the international community on the coordination and harmonization of aid to LICs. Staff encourages the authorities to produce and disseminate more information on China's assistance to LICs, to provide debt relief to all eligible countries on HIPC Initiative comparable terms, and to ensure that their lending activities are consistent with debt sustainability.[25]

51. **The authorities have made improvements in the quality of economic statistics**. The 2007 revised budget classification system will improve fiscal analysis, while the publication of a quarterly statistical bulletin by the PBC will enhance timing and coverage of monetary data. China's economic statistics are adequate for surveillance purposes, but improvements can be made in many areas: publication of annual and quarterly real GDP on expenditure basis; better measures of inventories, employment, and hours worked; publication of quarterly balance of payments data; and more details on financial soundness indicators.

VI. Staff Appraisal

52. **Sustained strong economic performance has made China one of the world's largest economies and trading nations, while making great strides in reducing poverty over the past two decades**. These are remarkable achievements and much of the credit for them is owed to the government's economic policies and reforms that have opened up the

[25] A joint Bank-Fund meeting with Chinese officials on LIC debt sustainability issues was held in Beijing in May 2007. The workshop focused on the need to enhance the exchange of information on China's aid to LICs and to raise awareness on the importance of taking into account debt sustainability issues when lending to LICs. Separately, in February 2008, the Fund signed a Memorandum of Understanding with China Development Bank to enhance cooperation in low-income country activities.

economy, both internally and externally, and made it increasingly market oriented. While the economy has slowed in 2008 due to weaker external demand, growth remains rapid.

53. **The strong economic performance, however, has been accompanied by growing macroeconomic imbalances**. Growth continues to be led primarily by investment, and efforts to curb rapid loan and investment growth over the last four years have not provided a lasting solution. With household consumption unable to keep pace with the increase in capacity created by the rise in investment, the excess has been reflected in rising exports and a generally growing trade surplus. At the same time, sharp increases in official reserves have substantially increased liquidity in the banking system, potentially fueling further surges in lending and investment growth. In addition, the large food and commodity price increases over the past year could spill over into wages and spark a rise in inflation expectations, leading to a more generalized inflation process.

54. **These mounting imbalances have increased the urgency to rebalance growth away from heavy reliance on investment and exports towards consumption**. Encouraging rapid investment are distortions in the prices of utilities, energy, and land and the cost of pollution abatement. Even more important, the low cost of capital and the substantial undervaluation of the exchange rate have continued to encourage investment, especially in the tradable goods sector.

55. **In the period ahead, tight monetary policy needs to be maintained**. Monetary tightening measures introduced during 2007 and early 2008 are significant, but more will have to be done because large reserve accumulation continues to add to the already ample liquidity in the banking system. Any concern that more rapidly draining liquidity from the banking system would attract further capital inflows underscores the importance of taking liquidity out of the banking system in conjunction with allowing faster currency appreciation, sufficient to create genuine risk of two-way movement in the exchange rate.

56. **Despite its appreciation during the course of this year, the renminbi is still judged by the staff to be substantially undervalued**. Moreover, China continues to heavily manage its exchange rate. Traditional indicators—such as the four-fold increase in the current account surplus, the five-fold increase in official reserves in the last five years, and the fact that the real effective exchange rate is still slightly below its previous peak in February 2002 despite significant improvements in China's competitiveness since then—all point to a substantial undervaluation of the currency. Model-based estimates of the equilibrium real effective exchange rate support this assessment. Policies that the authorities have put in place, if fully implemented, could redress this situation over the medium term. To this end, it is particularly important that the exchange rate be allowed to appreciate significantly faster and that the renminbi's value rises in relation to a basket of currencies.

57. **A more appreciated renminbi would not only help to sustain high growth in China, but also contribute to an orderly unwinding of global imbalances**. As long as there remains a widely held view that the pace of appreciation will be modest, substantial investment in the tradable goods sector will continue, but in time much of this investment may prove unviable. A stronger renminbi will help to discourage such investments, while boosting household purchasing power and consumption. At the same time, such a rebalancing of demand in China would contribute to the orderly unwinding of the global current account imbalance. The potential adverse impact of a faster appreciation on low-skilled workers is manageable. Transitional income support from the budget could be provided to ease the adjustment of those affected by the exchange rate change. Income support is a second best measure and would need to overcome some design hurdles, but it would be less costly compared to the distortions created by continuing to tightly manage the exchange rate. Undoubtedly, current economic conditions are less favorable than before, but further delay in undertaking the necessary adjustment will only exacerbate the economy's imbalances, ultimately making the adjustment more costly.

58. **The staff agrees with the authorities' focus on financial sector reforms as one of the keys to rebalancing growth**. Progress has been made in financially restructuring banks. Building on these steps, banks need to continue to improve risk management, internal controls, and governance. Early adoption and implementation of a reform plan for the Agricultural Bank of China is also needed to help maintain banking system stability and reduce moral hazard. The efficiency of the banking system would be further enhanced if the cap on deposit interest rates is lifted, allowing for greater competition for funding among the banks. This measure would also greatly aid the rebalancing of the economy by raising the cost of capital and household investment income.

59. **Deepening bond and equity markets will provide firms with alternative sources of financing and provide households with a broader range of financial assets in which to invest**. Progress has been made in reviving the stock market, expanding the corporate bills market, and establishing a new framework for corporate bond issuance by stock market listed companies. However, for the bond and equity markets to reach their full potential, issuance should be moved even closer to a disclosure-based system.

60. **Improving the provision of education, health care, and pensions should reduce households' high precautionary savings**. The government's successful efforts over the last few years in budget consolidation have created the space to step up education and health care spending as envisaged in this year's budget. The authorities should continue increasing spending in line with the expansion of implementation capacity and the establishment of reform plans for the provision of these services. The 2008 Budget strikes the appropriate balance in this regard. However, in the event the global downturn slows Chinese growth by more than currently expected, the authorities would have sufficient room to take countercyclical fiscal measures. The importance of expanding social spending to contribute to

rebalancing underscores the urgency of formulating and implementing these reform plans more rapidly and further enhancing implementation capacity. The substantial aging of the population in the next 20 years lends urgency to efforts to reform the pension system. The authorities should consider a new approach to pension reform, whereby they could deal separately with the problems of the existing pension system, while at the same time, moving ahead quickly to establish a new nationwide pension system covering all urban and rural workers.

61. **The unification of income tax rates for domestic and foreign companies and the requirement that state enterprises pay dividends to the budget will help to improve the efficiency of investment**. This is also an opportunity to simplify the tax system further and ensure that incentives, which have kept the cost of investment low and contributed to the misallocation of capital, are eliminated. The decision by the government to require profitable state-owned enterprises to pay dividends to the budget is a welcome step. An early review of the program aimed at raising dividends transferred to the budget is desirable. As a general principle, SOE groups that have stock market listed companies should be asked to transfer almost all dividends paid by their listed affiliates to the budget.

62. **China's announcement that it will participate in the IMF's Financial Sector Assessment Program (FSAP) is welcome**. This will help take stock of the significant progress made in reforming the financial sector and identify priorities for further reform.

63. As noted above, staff considers that the real exchange rate is substantially undervalued, and sees a possibility that exchange rate policies might significantly contribute to external instability. Staff has significant concerns in this regard but is not yet making a determination regarding specific findings under the 2007 Surveillance Decision.[26] Staff recommends an ad hoc consultation to discuss these issues further, with another discussion by the Board in about six months. It is proposed that the next regular Article IV consultation with China take place on the standard 12-month cycle.

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[26] See *Guidance on Operational Aspects of the 2007 Surveillance Decision* (SM/08/236, Revision 1, 8/4/08) paragraph 2 and Attachment I regarding fundamental misalignment and nonobservance of a Principle for the Guidance of Members' Exchange Rate Policies.

Table 1. China: Summary Indicators

Nominal GDP (2007): US$3,259 billion
Population (2007): 1.321 billion
GDP per capita (2007): US$2,483
Poverty headcount ratio at $1 a day at PPP (2004) : 10 percent of the population
Quota: SDR 8,090 million
Main products and exports: Manufacturing goods (95 percent of merchandise exports)
Unemployment rate (urban area, 2007): 4.10 percent
FDI (2007): $121 billion
Public debt (2007): 20.9 percent of GDP
Foreign-currency denominated public debt (2006): 1.9 percent of total public debt

	2003	2004	2005	2006	2007	2008 Proj.	2009 Proj.
				(Change in percent)			
Real GDP (production)	10.0	10.1	10.4	11.6	11.9	9.7	9.8
Consumer prices (period average)	1.2	3.9	1.8	1.5	4.8	7.0	4.9
Registered unemployment rate in urban areas (in percent)	4.3	4.2	4.2	4.1	4.0	...	...
				(In percent of GDP)			
Total capital formation	41	43	44	45	44	45	46
Of which : fixed capital formation	39	41	42	43	42	43	44
Gross national saving	44	47	51	54	56	55	56
External current account	2.8	3.6	7.2	9.4	11.3	9.9	10.5
Overall budget balance, IMF basis 1/	-2.4	-1.5	-1.3	-0.7	1.0	0.8	-0.6
Revenue	16.2	16.6	17.4	18.6	21.1	23.1	22.9
Expenditure (including net lending)	18.6	18.1	18.7	19.3	20.1	22.3	23.5
Overall budget balance, authorities' definition (in billions of yuan)	-293	-209	-208	-166	151	189	-231
Overall budget balance, authorities' definition	-2.2	-1.3	-1.1	-0.8	0.6	0.6	-0.7
Government gross debt (in percent of GDP)	19.2	18.5	17.8	16.5	20.9	…	…
				(Change in percent; end of period)			
Banking system's net domestic assets 2/	19.7	7.7	12.6	9.9	8.6	…	…
Of which : domestic credit 2/ 3/	19.6	10.9	13.6	16.3	17.6	…	…
Broad money 2/	19.6	14.6	17.6	17.0	16.7	…	…
Reserve money	17.1	11.4	9.3	20.8	30.6	…	…
Interest rate (one-year time deposits, year-end)	2.0	2.0	2.3	2.5	4.1	…	…
				(In billions of U.S. dollars)			
Current account balance	46	69	161	250	372	401	483
Of which : exports	438	593	762	970	1,220	1,507	1,755
imports	394	534	628	752	905	1,167	1,356
Capital and financial account balance	53	111	63	10	74	269	17
Of which : direct investment inflows (net)	47	53	68	60	121	173	130
Errors and omissions	18	27	-17	-13	16	…	…
Change in net international reserves (increase -)	-117	-206	-207	-247	-462	-670	-500
Gross international reserves 4/	412	619	826	1,073	1,534	2,204	2,704
In months of imports of goods and nonfactor services	8.2	10.4	11.6	12.4	13.9	17.1	17.7
As a percent of short-term external debt 5/	535	502	529	584	697	…	…
External debt 5/	209	248	281	323	374	…	…
Of which : short-term debt 5/	92	123	156	184	220	…	…
Debt-service ratio (in percent of exports) 5/	20.0	19.6	19.3	17.8	16.8	…	…
Exchange rate at end-period (yuan per U.S. dollar)	8.28	8.28	8.07	7.81	7.30	…	…
Nominal effective exchange rate 6/	98.6	94.2	94.3	96.8	99.0	…	…
Real effective exchange rate 6/	95.2	92.7	92.5	94.4	99.1	…	…
Memorandum items:							
Nominal GDP (in billions of yuan)	13,582	15,988	18,322	21,192	24,953	29,289	33,721
Exports growth (value terms, in percent)	34.6	35.4	28.5	27.2	25.8	23.5	16.5
Imports growth (value terms, in percent)	39.8	35.8	17.6	19.7	20.3	29.0	16.2
Net imports of oil (in billions of U.S. dollars)	21	39	50	73	87	147	163
(In percent of GDP)	1.3	2.0	2.2	2.7	2.6	3.6	3.6
Real GDP growth of trading partners (in percent)	2.2	4.5	3.7	4.1	3.7	2.4	2.3

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

1/ Central and local governments, including all official external borrowing.
2/ Banking survey.
3/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.
4/ Includes gold, SDR holdings, and reserve position in the Fund.
5/ Official data sources. The coverage and classification of official external debt data were modified in 2001. Categories of debt previously not covered are now included. Trade credit data since 2001 was revised in 2005.
6/ Annual averages (2000 = 100).

Table 2. China: Balance of Payments

(In billions of U.S. dollars, unless otherwise noted)

	2003	2004	2005	2006	2007		
					H1	H2	Year
Current account balance	45.9	68.6	160.8	249.9	162.9	209.0	371.8
Trade balance	44.7	59.0	134.2	217.7	135.7	179.7	315.4
Exports	438.3	593.4	762.5	969.7	547.2	672.8	1,220.0
Imports (BOP basis)	393.6	534.4	628.3	751.9	411.5	493.1	904.6
Services	-8.6	-9.7	-9.4	-8.8	-3.1	-4.8	-7.9
Credit	46.7	62.4	74.4	92.0	55.9	66.3	122.2
Debit	-55.3	-72.1	83.8	100.8	59.0	71.1	130.1
Income	-7.8	-3.5	10.6	11.8	12.9	12.8	25.7
Current transfers	17.6	22.9	25.4	29.2	17.4	21.3	38.7
Capital and financial account balance	52.7	110.7	63.0	10.0	90.2	-16.7	73.5
Capital account	0.0	-0.1	4.1	4.0	1.5	1.6	3.1
Financial account	52.8	110.7	58.9	6.0	88.7	-18.3	70.4
Net foreign direct investment	47.2	53.1	67.8	60.3	50.9	70.5	121.4
Inward investment (net)	47.1	54.9	79.1	78.1	58.3	80.1	138.4
Abroad	0.2	-1.8	-11.3	-17.8	-7.4	-9.6	-17.0
Portfolio investment	11.4	19.7	-4.9	-67.6	-4.8	23.5	18.7
Assets	3.0	6.5	-26.2	-110.4	-15.1	12.8	-2.3
Liabilities	8.4	13.2	21.2	42.9	10.3	10.7	21.0
Other investment	-5.9	37.9	-4.0	13.3	42.6	-112.3	-69.7
Assets 1/	-17.9	2.0	-48.9	-31.8	17.1	-168.6	-151.5
Liabilities	12.0	32.3	44.9	45.1	25.5	56.3	81.8
Errors and omissions 2/	18.4	27.1	-16.7	-12.9	13.1	3.3	16.4
Overall balance	117.0	206.4	207.0	247.0	266.1	195.6	461.7
Reserve assets	-117.0	-206.1	-207.0	-247.0	-266.1	-195.6	-461.7
Memorandum items:							
Current account, as percent of GDP	2.8	3.6	7.2	9.4	…	…	11.3
Export growth (value terms)	34.6	35.4	28.5	27.2	27.6	24.4	25.8
Import growth (value terms)	39.8	35.8	17.6	19.7	18.0	22.3	20.3
FDI (inward), as a percent of GDP	2.9	2.8	3.5	2.9	…	…	4.2
External debt	208.8	247.5	281.0	323.0	…	…	373.6
As a percent of GDP	12.7	12.8	12.6	12.2	…	…	11.4
Short-term external debt (remaining maturity)	92.2	123.2	156.1	183.6	184.9	220.1	220.1
Gross reserves	412.2	618.6	825.6	1,072.6	1,338.7	1,534.4	1,534.4
As a percent of ST debt by remaining maturity	447.2	502.1	528.8	584.1	724.2	697.2	697.2
Net international investment position	…	292.8	422.6	611.4	…	…	1,022.0
In percent of GDP	…	15.2	18.9	23.0	…	…	31.2
Nominal GDP	1,641.0	1,931.6	2,235.8	2,657.8	…	…	3,280.2

Sources: Data provided by the Chinese authorities; CEIC Data Co., Ltd.; and IMF staff estimates.

1/ 2003 figure includes the counterpart transaction to the US$45 billion of foreign exchange reserves used for bank recapitalization. 2005 include bank capitalization and foreign exchange swap, estimated at $28.8 billion.

2/ Includes counterpart transaction to valuation changes.

Table 3. China: External Debt
(In billions of U.S. dollars)

	2003	2004	2005	2006	2007
By debtor	208.8	247.5	281.0	323.0	373.6
Government and government agencies	34.1	33.6	33.0	34.4	34.9
Domestic entities	64.3	72.3	65.9	74.2	85.3
Chinese enterprises	7.6	6.0	4.6	3.5	4.7
Chinese banks	56.3	66.0	61.1	70.4	80.3
Chinese nonbank financial institutions	0.3	0.3	0.3	0.3	0.3
Foreign-funded entities	58.7	76.2	91.3	110.5	120.3
Foreign-funded enterprises	37.8	44.6	50.5	60.8	74.0
Foreign-funded banks	20.9	31.6	40.8	49.6	46.3
Trade credit	51.7	65.4	90.8	104.0	133.1
Other	0	0	0	0	0
By creditor	208.8	247.5	281.0	323.0	373.6
Official creditors	51.9	57.3	54.0	55.5	58.4
Multilateral	26.5	25.1	26.8	27.8	28.4
Bilateral	25.4	32.2	27.2	27.7	30.1
Commercial banks	53.7	55.6	58.5	67.5	62.1
Foreign banks and financial institutions	42.4	43.8	49.2	58.5	54.6
Suppliers (buyer's credit)	11.3	11.9	9.3	9.0	7.5
Bonds	11.2	13.3	13.0	14.2	16.3
Other	92.1	121.2	155.6	185.8	236.7
Loans from nonbank financial sources	28.9	34.7	39.6	47.6	60.1
International financial leasing	7.7	7.3	6.7	7.0	6.7
Trade credits	51.7	65.4	90.8	104.0	133.1
Deferred payments	1.2	9.6	13.3	20.1	25.3
Deposits from overseas	2.5	4.2	5.2	7.1	11.4
By maturity					
Medium- and long-term debt	116.6	124.3	124.9	139.4	153.5
Short-term debt (original maturity basis)	88.1	115.8	148.3	173.4	203.7
Short-term debt (remaining maturity basis)	92.2	123.2	156.1	183.6	220.1
Memorandum item:					
Gross international reserves	412.2	618.6	825.6	1,072.6	1,534.4

Sources: Data provided by the Chinese authorities; CEIC Data Co., Ltd.; and IMF staff estimates.

1/ The breakdown of debt by debtor and coverage of entities was changed in 2001. In addition, loans from foreign governments to policy banks are moved from debt of government category to debt of Chinese-funded financial institutions from end-2003 onward. The adjustment was $15.2 billion at end-2003. In 2001, trade credits and loans borrowed by foreign-funded financial institutions are included. Their stock at end-2001 was $38.7 billion. In 2005, switching to sample based estimation increased trade credit for 2001 onwards and by $14.7 billion for 2001 compared with methods used previously.

Table 4. China: Indicators of External Vulnerability

	2003	2004	2005	2006	2007
Monetary and financial indicators					
General government domestic debt (official data; in percent of GDP)	19.2	18.5	17.8	16.5	20.9
Broad money (M2: annual percentage change)	19.6	14.6	17.6	17.0	16.7
Foreign currency deposits to broad money (percent)	5.6	5.0	4.4	3.6	2.9
Credit (annual percentage change)	21.1	14.5	13.0	15.1	16.1
Foreign currency loans to credit to the economy (in percent)	5.4	5.1	4.9	4.5	4.8
Stock exchange index (end-of-period, December 19, 1990 = 100) 1/	1,569.1	1,330.2	1,220.9	2,815.1	5,521.5
Stock exchange capitalization (percent of GDP)	31.4	23.4	24.8	42.1	131.3
Number of listed companies (A-share)	1,269.0	1,341.0	1,361.0	1,383.0	1,507.0
Balance of payments indicators					
Exports (annual percentage change, U.S. dollars)	34.6	35.4	28.5	27.2	25.8
Imports (annual percentage change, U.S. dollars)	39.8	35.8	17.6	19.7	20.3
Current account balance (percent of GDP)	2.8	3.6	7.2	9.4	11.3
Capital and financial account balance (percent of GDP)	3.7	5.7	2.8	0.4	2.2
Of which : gross foreign direct investment inflows	2.9	2.8	3.5	2.9	4.2
Reserve indicators					
Gross reserves (billions of U.S. dollars)	412.2	618.6	825.6	1,072.6	1,534.4
Gross reserves to imports of GNFS (months)	8.2	10.4	11.6	12.6	14.0
Gross reserves to broad money (M2) (percent)	15.4	20.1	22.3	24.1	27.7
Gross reserves to short-term external debt by remaining maturity (percent)	447.2	502.1	528.8	584.1	697.2
External debt and balance sheet indicators 2/					
Total external debt (percent of GDP)	12.7	12.8	12.6	12.2	11.4
Total external debt (billions of U.S. dollars)	208.8	247.5	281.0	323.0	373.6
Of which : public and publicly guaranteed debt 3/	34.1	33.6	33.0	34.4	34.9
Banking sector debt	77.3	97.6	101.9	120.0	126.6
Short-term external debt by remaining maturity (billions of U.S. dollars)	92.2	123.2	156.1	183.6	220.1
Net foreign assets of banking sector (billions of U.S. dollars)	85.5	108.2	161.4	205.1	189.9
Total debt to exports of GNFS (percent)	43.0	37.7	33.6	30.4	27.8
Total debt service to exports of GNFS (percent) 4/	20.0	19.6	19.3	17.8	16.8
Of which : Interest payments to exports of GNFS (percent) 4/	1.0	0.8	0.6	0.5	0.4
Bond spread (EMBI China, end of period, basis points)	58.0	57.0	68.0	51.0	120.0
Foreign-currency sovereign bond ratings					
Moody's	A2	A2	A2	A2	A1
Standard and Poor's	BBB	BBB+	A-	A	A
Memorandum items:					
International investment position	…	292.8	422.6	611.4	1,022.0
Nominal GDP (billions of U.S. dollars)	1,641.0	1,931.6	2,235.8	2,657.8	3,280.2
Exports of GNFS (billions of U.S. dollars)	485.0	655.8	836.9	1,061.7	1,342.2
Real effective exchange rate (annual percentage change)	-6.6	-2.6	-0.2	2.1	5.0

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

1/ Shanghai Stock Exchange, A-share.
2/ Based on official debt data unless otherwise indicated.
3/ Debt of banking sector not included.
4/ IMF staff estimates.

Table 5. China: Monetary Developments

	2002	2003	2004	2005	2006	2007	2008 Jan	2008 Feb	2008 Mar	2008 Apr	2008 May	2008 Jun
	(In billions of yuan)											
Net foreign assets	3,175	3,773	5,535	7,570	10,086	13,775	14,253	14,593	15,097	15,656	16,095	16,327
Net domestic assets	15,326	18,349	19,770	22,268	24,474	26,569	27,529	27,511	27,209	27,275	27,528	27,987
Domestic credit 1/	17,262	20,628	22,428	24,837	28,874	33,966	34,516	34,754	34,838	35,040	35,118	35,397
Net credit to government	1,333	1,318	1,550	1,520	1,535	2,821	2,538	2,503	2,427	2,142	1,964	1,890
Credit to non-government	15,929	19,311	20,878	23,317	27,339	31,145	31,979	32,251	32,411	32,898	33,154	33,507
Other items, net 1/	-1,936	-2,279	-2,658	-2,568	-694	1,128	668	814	1,103	1,094	894	662
Broad money	18,501	22,122	25,305	29,838	34,560	40,344	41,782	42,104	42,305	42,931	43,622	44,314
Reserve money	4,514	5,284	5,886	6,434	7,776	10,155	10,948	10,704	10,422	10,647	10,862	11,535
Of which:												
Required reserves	1,006	1,410	1,738	2,060	2,867	5,409	5,717	5,829	6,086	6,376	6,700	7,227
Excess reserves	907	845	987	953	1,979	1,432	1,225	1,321	993	928	879	1,001
Net foreign assets of PBC	2,282	3,066	4,640	6,270	8,485	12,388	12,990	13,285	13,649	14,187	14,544	14,868
Net domestic assets of PBC	2,232	2,218	1,246	154	-709	-2,233	-2,043	-2,581	-3,226	-3,540	-3,682	-3,332
	(Twelve-month percentage change)											
Net foreign assets 2/	3.4	3.2	8.0	8.0	8.4	10.7	10.7	10.6	11.2	11.8	12.2	11.7
Net domestic assets	16.2	19.7	7.7	12.6	9.9	8.6	11.7	9.7	7.2	7.3	8.5	8.1
Domestic credit 3/ 4/	30.7	19.6	10.9	13.6	16.3	17.6	18.2	17.2	15.6	15.3	15.0	12.9
Of which: loans	15.4	21.1	14.5	13	26.6	15.7	20.4	19.3	17.7	17.9	17.5	15.4
Other items, net 2/ 3/ 4/	-10.9	-3.1	-4.4	-3.2	6.3	5.3	4.3	4.7	5.1	4.5	3.7	2.4
Broad money 5/	16.8	19.6	14.6	17.6	17.0	16.7	18.9	17.4	16.2	16.9	18.0	17.3
Including foreign currency deposits	16.3	18.2	13.8	17.2	16.1	15.9	17.6	16.2	-97.1	-97.0	-97.1	-97.1
M1 5/	16.8	18.7	13.6	11.8	17.5	21.0	20.5	18.9	18.0	18.8	17.7	14.0
M0 5/	10.1	14.3	8.7	11.9	12.6	12.2	31.2	6.0	11.1	10.7	12.9	12.3
Quasi money	16.8	20.1	14.7	21.8	16.3	14.3	17.9	16.5	15.2	15.8	18.1	19.1
Reserve money	13.3	17.1	11.4	9.3	20.8	30.6	49.2	32.4	35.4	38.6	39.5	39.5
Net foreign assets of PBC 6/	8.7	17.4	29.8	27.9	35.1	46.0	46.7	44.6	43.6	44.6	43.7	43.0
Net domestic assets of PBC 6/	4.6	-0.3	-18.4	-18.5	-13.6	-19.6	-7.2	-18.3	-18.5	-18.3	-17.3	-14.6
Reserve ratios: 7/												
Required reserves	6	7	7.5	7.5	9.0	14.5	15.0	15.0	15.5	16.0	16.5	17.5
Excess reserves	5.4	5.4	5.3	4.2	4.8	3.3	…	…	…	…	…	…
Memorandum items:												
Money multiplier	4.1	4.2	4.3	4.6	4.4	4.0	3.8	3.9	4.1	4.0	4.0	3.8
Forex deposits of residents (US$ billion)	151	149	153	162	161	160	152	154	155	164	162	164
In percent of total deposits	6.9	5.8	5.2	4.5	3.6	2.9	2.7	2.6	2.6	2.6	2.5	2.5
Forex loans of residents (US$ billion)	103	131	135	151	166	220	237	258	269	271	274	275

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

1/ Starting 2002, includes foreign currency operations of domestic financial institutiojns and domestic operations of foreign banks. In addition, some items were moved from "other items net" to "net credit to government."
2/ Twelve-month change as percent of beginning -period stock of monetary liabilities.
3/ 2002 growth rates are based on data that exclude the revisions made in 2002 (see footnote 1).
4/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.
5/ The growth rates are based on official announcements, which correct for the definitional changes in the series.
6/ Twelve-month change as a percent of beginning-period reserve money stock.
7/ In percent of total bank deposits.

Table 6. China: State Budgetary Operations 1/

	2003	2004	2005	2006	2007	2008	
					Est.	Budget	Proj.
				(In billions of yuan)			
Total revenue	2,194	2,661	3,182	3,949	5,264	5,932	6,774
Tax revenue 2/	2,002	2,414	2,878	3,428	4,561	...	6,113
Taxes on income and profits	476	593	749	949	1,196	...	2,060
Taxes on goods and services	1,299	1,535	1,807	2,476	3,041	...	3,112
Other taxes	227	287	321	2	325	...	941
Nontax revenue	192	247	305	522	703	...	660
Total expenditure	2,527	2,899	3,421	4,096	5,024	6,117	6,540
Current expenditure, *of which:*	1,950	2,300	2,729	3,300	4,302	...	...
Administration and defense	655	766	888	1,012	1,218	...	...
Culture, education, public health, and science	471	537	637	878	1,171	...	...
Pensions and social welfare relief	266	309	365	413	540	...	...
Capital expenditure	537	570	663	766	722	...	...
Unrecorded expenditures 3/	39	29	29	30	30	...	30
Overall balance	-332	-238	-239	-146	240	-185	234
Financing	332	238	239	146	-240	185	-234
Domestic (net, residual)	328	236	245	146	-240	185	-234
Foreign (net)	5	2	-6	…	…	...	...
				(In percent of GDP)			
Total revenue	16.2	16.6	17.4	18.6	21.1	20.3	23.1
Tax revenue 2/	14.7	15.1	15.7	16.2	18.3	...	20.9
Taxes on income and profits	3.5	3.7	4.1	4.5	4.8	...	7.0
Taxes on goods and services	9.6	9.6	9.9	11.7	12.2	...	10.6
Other taxes	1.7	1.8	1.8	0.0	1.3	...	3.2
Nontax revenue	1.4	1.5	1.7	2.5	2.8	...	2.3
Total expenditure	18.6	18.1	18.7	19.3	20.1	20.9	22.3
Current expenditure, *of which:*	14.4	14.4	14.9	15.6	17.2	...	...
Administration and defense	4.8	4.8	4.8	4.8	4.9	...	...
Culture, education, public health, and science	3.5	3.4	3.5	4.1	4.7	...	...
Pensions and social welfare relief	2.0	1.9	2.0	1.9	2.2	...	...
Capital expenditure	4.0	3.6	3.6	3.6	2.9	...	...
Unrecorded expenditures 3/	0.3	0.2	0.2	0.1	0.1	...	0.1
Overall balance	-2.4	-1.5	-1.3	-0.7	1.0	-0.6	0.8
Financing	2.4	1.5	1.3	0.7	-1.0	0.6	-0.8
Domestic (net, residual)	2.4	1.5	1.3	0.7	-1.0	0.6	-0.8
Foreign (net)	0.0	0.0	0.0	…	…	…	…
Memorandum items:							
Government debt	19.2	18.5	17.8	16.5	20.9	...	17.0
Domestic	18.6	18.0	17.4	16.2	20.2	...	16.4
External	0.6	0.5	0.4	0.3	0.7	...	0.6
Budget balance (authorities' definition)	-2.2	-1.3	-1.1	-0.8	0.6	-0.8	0.6
Nominal GDP (in billions of yuan)	13,582	15,988	18,322	21,192	24,953	29,289	29,289

Sources: Ministry of Finance; People's Bank of China; National Bureau of Statistics; and IMF staff estimates.

1/ The coverage is central government, provinces, municipalities, and counties. Revenues and expenditure data for 2006 and 2007 including social spending are based on the revised budget classification. The authorities have not yet released the data for 2005 and before based on the revised budget classification.

2/ Tax revenues are net of refunds for VAT paid on inputs. The IMF definition is not adjusted for tax refund arrears in the absence of adequate data.

3/ Includes external borrowing excluded from the budget and unbudgeted "fiscal stimulus" spending (see Table 7).

Table 7. China: Official and IMF Budget Definitions

	2003	2004	2005	2006	2007 Budget	2007 Est.	2008 Budget	2008 Proj.
				(In billions of yuan)				
Revenue (official definition) 1/	2,172	2,640	3,163	3,876	4,406	5,127	5,849	6,690
Revenue (IMF definition) 1/	2,194	2,661	3,182	3,949	4,440	5,264	5,932	6,774
Expenditure (official definition) 2/	2,465	2,849	3,371	4,042	4,651	4,976	6,079	6,501
Expenditure (IMF definition) 2/	2,527	2,899	3,421	4,096	4,695	5,024	6,117	6,540
Balance (official definition)	-293	-209	-208	-166	-245	151	-230	189
Balance (IMF definition)	-332	-238	-239	-146	-255	240	-185	234
				(In percent of GDP)				
Revenue (official definition)	16.0	16.5	17.3	18.3	17.7	20.5	20.0	22.8
Revenue (IMF definition)	16.2	16.6	17.4	18.6	17.8	21.1	20.3	23.1
Expenditure (official definition)	18.1	17.8	18.4	19.1	18.6	19.9	20.8	22.2
Expenditure (IMF definition)	18.6	18.1	18.7	19.3	18.8	20.1	20.9	22.3
Balance (official definition)	-2.2	-1.3	-1.1	-0.8	-1.0	0.6	-0.8	0.6
Balance (IMF definition)	-2.4	-1.5	-1.3	-0.7	-1.0	1.0	-0.6	0.8
Memorandum item:								
Nominal GDP (in billions of yuan)	13,582	15,988	18,322	21,192	24,953	24,953	29,289	29,289

1.3

Sources: Ministry of Finance; and IMF staff estimates. -0.5

1/ Tax revenues are net of refunds for VAT paid on inputs. As of end-2005, refunds amounting to roughly RMB 260 billion claimed but not paid. In 2007, the IMF definition incorporates the RMB 103 billion put into a revenue fund and is not adjusted for tax refund arrears in the absence of adequate data.

2/ Authorities' definition excludes subsidies to loss-making enterprises and unrecorded fiscal stimulus spending including onlending to local governments.

Table 8. China: Illustrative Medium-Term Scenario 1/

						Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(Percent change)										
Real GDP	10.0	10.1	10.4	11.6	11.9	9.7	9.8	10.0	10.0	10.0	10.0
Consumer prices (average)	1.2	3.9	1.8	1.5	4.8	7.0	4.9	4.4	4.0	3.9	3.9
	(In percent of GDP)										
Total capital formation	41	43	44	45	44	45	46	45	45	45	45
Gross national saving	44	47	51	54	56	55	56	57	57	56	56
Fiscal balance	-2.4	-1.5	-1.3	-0.7	1.0	0.8	-0.6	-0.7	-0.7	-0.7	-0.7
Revenue	16.2	16.6	17.4	18.6	21.1	23.1	22.9	23.0	23.1	23.1	23.1
Expenditure	18.6	18.1	18.7	19.3	20.1	22.3	23.5	23.8	23.8	23.8	23.8
Current account balance	2.8	3.6	7.2	9.4	11.3	9.9	10.5	11.5	11.3	11.2	11.1
	(In billions of U.S. dollars)										
Current account balance	46	69	161	250	372	401	483	592	653	724	808
Trade balance	45	59	134	218	315	340	399	454	502	564	644
Exports	438	593	762	970	1,220	1,507	1,755	2,062	2,409	2,812	3,291
(In percent change)	35	35	28	27	26	24	17	18	17	17	17
Imports	394	534	628	752	905	1,167	1,356	1,608	1,907	2,249	2,647
(In percent change)	40	36	18	20	20	29	16	19	19	18	18
Capital and financial account, net 2/	53	111	63	10	74	269	17	-92	-153	-224	-294
Capital account	0	0	4	4	3	0	0	0	0	0	0
Direct investment, net	47	53	68	60	121	173	130	103	98	92	85
Portfolio investment, net	11	20	-5	-68	19	39	-61	-125	-190	-243	-313
Other investment, net	-6	38	-4	13	-70	57	-51	-70	-60	-73	-66
Errors and omissions	18	27	-17	-13	16	…	…	…	…	…	…
Change in reserves (- indicates increase)	-117	-206	-207	-247	-462	-670	-500	-500	-500	-500	-500
Memorandum items:											
Nominal GDP (in billions of yuan)	13,582	15,988	18,322	21,192	24,953	29,289	33,721	38,732	44,296	50,610	57,824

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

1/ Following convention, the scenario assumes a constant real exchange rate and a continuation of the current policy framework including fiscal policy.
2/ The coverage and classification of official external debt data were modified in 2001. Categories of debt previously not covered have since been included.

Table 9. China: Millennium Development Goals
(In percent, unless otherwise specified)

	1990	1995	2001	2002	2003	2004	2005	2006	2007
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates								
Population below US$1 a day	0.0	...	...	0.0	...	...	...	...	...
Poverty gap at US$1 a day	8.9	...	3.9	...	...	0.0	...	...	...
Share of income or consumption held by poorest 20 percent	...	...	4.7	...	...	4.3	...	...	...
Prevalence of child malnutrition (percent of children under 5)	17.4	12.9	10.0	6.8	...	...	...	...	...
Share of population below minimum level of dietary energy consumption	16.0	...	9.0	...	12.0	12.0	...	...	...
2 Achieve universal primary education	2015 target = net enrollment to 100								
Net primary enrollment ratio (percent of relevant age group)	97.4	97.9	93.2	...	...	...	...	...	...
Percentage of cohort reaching grade 5	86.0	93.8	...	...	...	...	...	...	...
Youth literacy rate (ages 15–24)	94.3	96.5	98.9	98.9	...	98.9	...	...	...
3 Promote gender equality	2005 target = education ratio to 100								
Ratio of girls to boys in primary and secondary education	87.0	87.3	99.1	...	98.6	...	...	99.9	...
Ratio of young literate females to males (ages 15–24)	91.5	97.0	99.3	99.3	...	...	...	...	...
Share of women employed in the nonagricultural sector	37.7	38.7	38.7	38.8	37.9	39.2	...	...	...
Proportion of seats held by women in national parliament	21.0	21.0	22.0	22.0	22.0	20.0	20.3	20.3	20.3
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds								
Under 5 mortality rate (per 1,000)	45.4	43.8	36.6	36.4	37.0	31.0	25.4	23.7	...
Infant mortality rate (per 1,000 live births)	36.3	35.1	31.0	30.0	30.0	26.0	21.4	20.1	...
Immunization, measles (percent of children under 12 months)	98.0	80.0	85.0	85.0	85.0	86.0	86.0	93.0	...
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths								
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	60.0	...	...	...	...	...		
Births attended by skilled health staff (percent of total)	50.3	...	70.0	97.0	95.9	97.3	97.8	...	...
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.								
Prevalence of HIV, female (ages 15–24)	...	...	0.1	...	0.1	...	0.1	...	...
Contraceptive prevalence rate (of women ages 15–49)	84.6	90.4	86.9	...	...	...	...	...	...
Number of children orphaned by HIV/AIDS	...	...	76,000.0	...	...	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	116.5	110.8	104.4	103.3	102.3	101.3	100.3	99.3	...
Tuberculosis cases detected under DOTS	...	15.0	30.8	30.1	43.1	63.5	79.8	79.4	...
7 Ensure environmental sustainability	2015 target = various 1/								
Forest area (percent of total land area)	16.8	...	19.0	...	...	...	21.2	...	...
Nationally protected areas (percent of total land area)	...	6.4	6.4	7.8	7.8	...	14.9	15.9	16.9
GDP per unit of energy use (PPP $ per kg. oil equivalent)	1.5	2.1	3.3	3.3	3.2	3.1	3.1	...	...
CO2 emissions (metric tons per capita)	2.1	2.7	2.7	2.8	3.3	3.9	...	...	...
Access to an improved water source (percent of population)	70.0	...	76.0	76.0	...	77.0	...	...	...
Access to improved sanitation (percent of population)	23.0	32.0	41.0	44.0	...	44.0	...	...	...
8 Develop a global partnership for development	2015 target = various 2/								
Youth unemployment rate (percent of total labor force ages 15–24)	0.0	2.9	3.1	...	...	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Personal computers (per 1,000 people)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General indicators									
Population (in billions)	1.1	1.2	1.3	1.3	1.3	1.3	1.3	1.3	...
Gross national income (US$ trillion)	0.4	0.7	1.3	1.4	1.6	1.9	2.3	2.7	...
GNI per capita (US$)	320.0	530.0	1,000.0	1,100.0	1,270.0	1,500.0	1,740.0	2,000.0	...
Adult literacy rate (percent of people ages 15 and over)	77.8	81.9	85.8	86.4	...	90.9	...	...	...
Total fertility rate (births per woman)	2.1	1.9	1.9	1.9	1.9	1.9	1.8	1.8	...
Life expectancy at birth (years)	68.9	69.4	70.3	70.7	70.8	71.4	71.8	72.0	...

Sources: *World Development Indicators database*. In some cases, the data are for earlier or later years than those stated.

1/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.

2/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the special needs of the least developed countries. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Appendix I: China—Structural Reforms and Multilateral Consultation Undertakings

(Reforms undertaken since the end of the Multilateral Consultation and announced before end-July 2008)

Area	Government Plans	Timeframe
I. Boosting Domestic Demand		
Taxes	Threshold for personal income tax planned to be raised to RMB 2,000 from RMB 1,600 Tax on bank interest income reduced from 20 percent to 5 percent	March 2008 August 2007
Social programs	Roll-out of rural cooperative health system to be extended to all counties Rural compulsory education now provided entirely free of charge Several social security programs were enhanced, e.g., subsistence allowance in rural areas, pensions for ex-SOEs employees	FY 2008
SOEs	SOEs required to pay dividends to the budget (5 percent competitive industries; 10 percent resource-based industries)	December 2007
Private property rights	Property rights law	October 2007
Labor market	New labor law	January 2008
II. Promoting Balanced External Sector Development		
Import tariffs	Tariffs on imports of several raw materials and agricultural products were reduced	December 2007
Export taxes	Export taxes on several products from energy-intensive industries were raised (e.g., steel and coke)	December 2007
Export tax rebates	Export taxes rebates were slashed on some products in July 2007. However, in July 2008, VAT rebates on some products (such as textiles), which had previously been cut, were raised (from 11 percent to 13 percent for textiles).	July 2007-July 2008
Taxes	Unification of corporate tax rate for domestic and foreign-funded firms to 25 percent (from 33 percent and 15 percent, respectively)	January 2008
III. Financial Sector Reform		
Capital markets	Bond issuance by listed companies under CSRC only, interest rate market determined, no quota, more disclosure based Foreign-funded enterprises will be allowed to issue bonds and equities in China Companies were allowed to issue commercial paper with up to 5-year maturity.	August 2007 December 2007 April 2008
China Development Bank	CIC provided $20 billion for recapitalization	December 2007
Agricultural Bank of China	CIC to provide funds for recapitalization, but restructuring plans not yet announced	2008
QDII	Expanded during 2007 and 2008, the quotas reached US$64.5 billion in June 2008	
QFII	Expanded to $30 billion from $10 billion	December 2007
Domestic institutional investors	Restrictions on foreign participation in domestic securities companies eased (now up to 25 percent, with 20 percent for individual owner)	December 2007
IV. Exchange Rate Regime		
	The surrender requirement on firms' foreign currency earnings obtained from current account transactions was abolished	August 2007
	Foreign exchange (FX) products were enhanced: e.g., FX swap trading launched Diversified and increased the number of FX market participants	December 2007 2007

APPENDIX II: CHINA—DEBT SUSTAINABILITY ANALYSIS

1. An analysis of the sustainability of China's government debt (based on the Fund's standard framework) suggests that there will not be major difficulties over the medium term. China's official government debt is low, around 21 percent of GDP at end-2007.[1] Going forward, large quasi-fiscal liabilities related to nonperforming assets of the financial sector and pension liabilities, and rising expenditure pressures (some of which may relate to demographic changes) may give rise to potential fiscal vulnerabilities over the longer term, which will fall outside of the medium-term horizon covered here. However, it is not feasible to extend the analysis to a longer-term horizon given the considerable uncertainties about the magnitude of these potential pressures.

2. The debt sustainability analysis is based on the staff's macroeconomic projections and on the authorities' medium-term fiscal framework. The main assumptions include:

- Real GDP growth is projected to average around 10 percent a year through 2013.
- The government deficit is assumed to be around ¾ percent of GDP over the medium term, largely reflecting increased social spending.
- The average domestic real interest rate increases gradually to around 2½ percent over the medium term, reflecting gradual liberalization of the financial sector.

Owing to lack of data, this debt sustainability analysis only includes estimated losses from reported NPLs and small transition costs of shifting to a viable pension system.[2] Contingent liabilities include nonperforming loans (NPLs) in the banking system and the related cost of

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[1] On a gross basis, the debt level could be significantly larger if quasi-fiscal liabilities were included, while on a net basis it could be smaller if China used its substantial stock of state assets to net out government debt obligations. The estimated debt stock includes regular issues of bonds to finance the central government's budget deficits, as well as the bonds issued to recapitalize the four state-owned commercial banks in 1998, bonds issued to capitalize the China Investment Corporation in 2007, and bonds used for onlending to local governments.

[2] Based on the authorities' data, the stock of NPLs is estimated to amount to about 8.5 percent of GDP at end-2007 (which includes NPLs worth 5.1 percent of GDP on the balance sheets of banks, and the estimated stock of NPLs—3.3 percent of GDP—held by the AMCs; the stock of NPLs held by AMCs at end-2005 was estimated at around 13 percent of GDP). In the DSA exercise shown in Table II.1, it is assumed that AMCs will deal with around one third of their NPL stock each year, achieving a recovery rate of about 20 percent; for the projections of future NPLs, it is assumed that 7 percent of new loans will eventually become nonperforming and banks recover 20 percent of these. The unrecovered amounts from the assets dealt with by the AMCs and banks' NPLs are assumed to become fiscal liabilities. It is also assumed that further bank restructuring results in additional NPLs (around Y 800 billion) being transferred to AMCs in 2009. Unfunded pension liabilities (as part of a transition) equivalent to 5 percent of GDP are assumed to be covered each year by the budget in 2008−10; interest will also be paid on these and the bonds issued to cover NPLs.

recapitalization, unfunded pension obligations, and external borrowings by state-owned enterprises (SOEs). However, potential data weaknesses and the slow progress in making improvements in the banks' risk management and internal controls suggest that the scale of problem loans may be larger. Credit quality remains a key concern in the banking sector going forward. Although the reported performance of loans extended since 2000 has improved dramatically and despite some shift away from the pure policy lending of the early 1990s, the fall in reported NPLs also reflects the effect of a booming economy. Hence, when the economy slows, a significant amount of new nonperforming loans is likely to appear. Transition costs of the pension reform could also be considerably higher, depending on the magnitude of changes to the pension parameters. Liabilities, direct and contingent, of local governments are not included, as no information is available.[3]

3. Under these assumptions, the debt-to-GDP ratio would increase steadily over the next few years, peaking around 44 percent of GDP in 2011, before gradually declining over the remaining projection period (Figure II.1 and Table II.1). The sensitivity analysis suggests that fiscal sustainability may not be a major concern over the next few years, provided that structural reforms continue to be implemented. To take into account the uncertainties about future macroeconomic conditions, spending needs, and the actual level of contingent liabilities, the effects of maintaining an unchanged primary position and all the key variables at their historical levels, several shocks and a historical scenario were simulated. In all cases, the debt-to-GDP ratio would increase, but only under the historical scenario would debt stabilize around a significantly higher level reflecting the high historical real interest rate. Isolated or combined temporary adverse shocks on key macroeconomic variables would only increase the debt-to-GDP ratio in the short run (Figure II.1). Specifically:

- *Individual temporary shocks*. A temporarily lower GDP growth rate would increase the debt-to-GDP ratio marginally to about 46 percent in 2011 with a slightly larger effect produced by a higher real interest rate.[4]

- *Combined temporary shocks*. Should GDP growth be slower, the real interest rate and public spending higher (by one standard deviation), the debt ratio would increase to about 46 percent of GDP in 2011 before declining to around 44 percent in 2013.

- *Higher initial public debt stock*. If debt-creating flows were to be 10 percentage points of GDP higher in 2008, the debt-to-GDP ratio would reach about 52 percent in 2011, but then gradually fall over the medium term.

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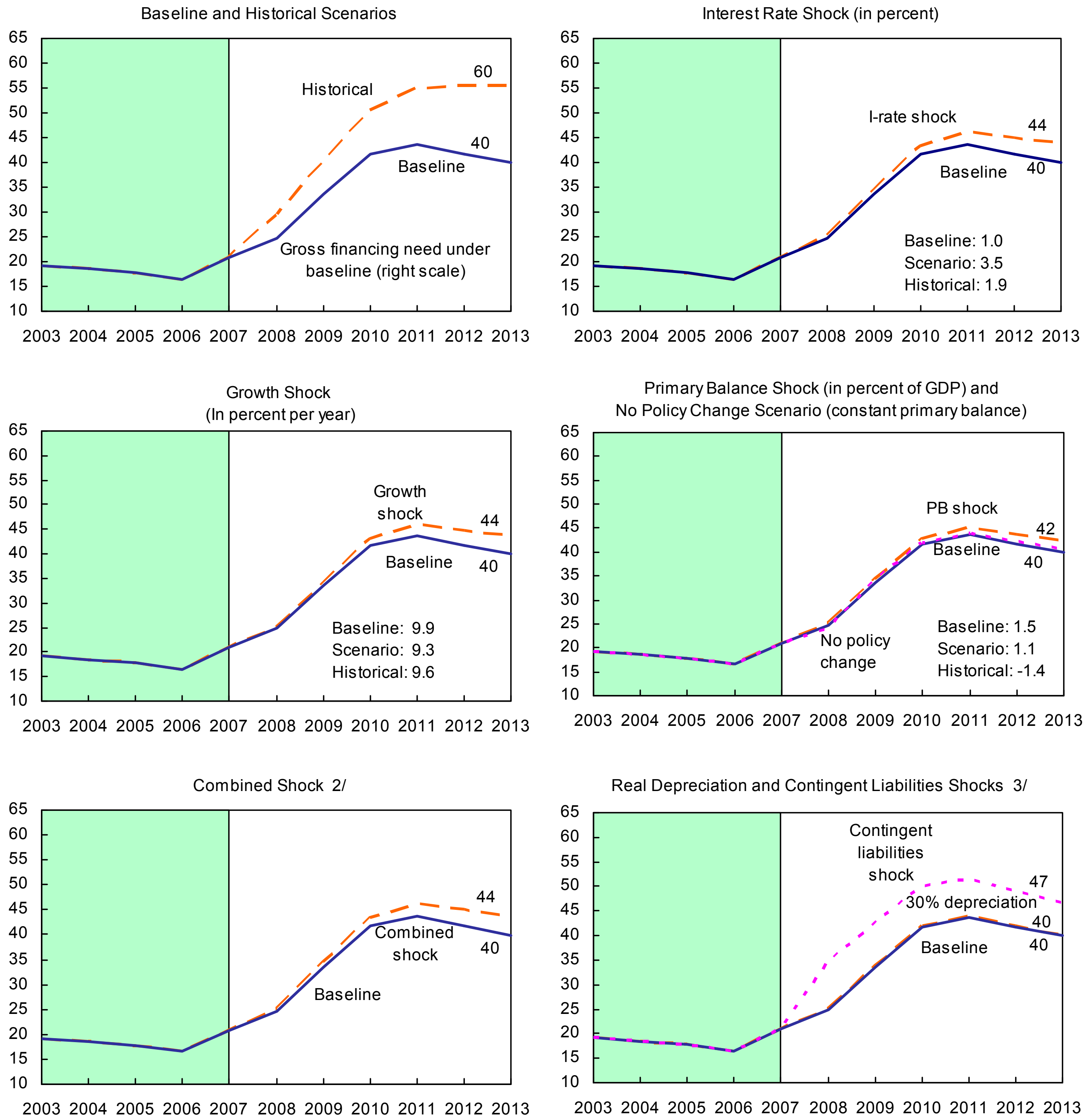
[3] Under the existing budget law, local governments are not allowed to borrow directly, however they have indirect access to borrowing through onlending from the central government, and through public enterprises, especially to fund infrastructure projects. This indirect financing (for which estimates are not available) carries fiscal risks for the local governments and, ultimately, the central government.

[4] The standard deviations and means for all variables have been calculated on the basis of the last 10 years.

Figure II.1. China: Public Sector Debt Sustainability: Bound Tests 1/
(Public debt, in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline scenario. Ten-year historical average for the variable is also
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table II.1. China: Public Sector Debt Sustainability Framework, 2004–2013

(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	2004	2005	2006	2007			2008	2009	2010	2011	2012	2013
							I. Baseline Projections					
Public sector debt 1/	18.5	17.8	16.5	20.9			24.8	33.5	41.7	43.6	41.8	39.9
Of which : foreign-currency denominated	0.5	0.4	0.4	0.3			0.6	0.5	0.4	0.4	0.3	0.3
Change in public sector debt	-0.7	-0.7	-1.3	4.3			3.9	8.7	8.2	2.0	-1.9	-1.9
Identified debt-creating flows (4+7+12)	-1.4	-1.1	-1.7	-3.5			3.0	8.7	8.2	2.0	-1.9	-1.9
Primary deficit	1.0	0.9	0.2	-1.5			-2.5	-0.6	-1.0	-1.6	-1.8	-1.7
Revenue and grants	16.6	17.4	18.6	21.1			23.1	20.4	20.5	20.6	21.0	21
Primary (noninterest) expenditure	17.7	18.2	18.9	19.6			20.6	19.8	19.5	18.9	19.2	19.3
Automatic debt dynamics 2/	-2.4	-1.9	-2.0	-1.9			-2.2	-2.1	-2.6	-2.9	-3.0	-2.8
Contribution from interest rate/growth differential 3/	-2.4	-1.9	-1.9	-1.9			-2.2	-2.1	-2.6	-2.9	-3.0	-2.9
Of which : contribution from real interest rate	-0.8	-0.2	-0.2	-0.3			-0.4	0.0	0.3	0.7	0.8	0.8
Of which : contribution from real GDP growth	-1.7	-1.7	-1.8	-1.7			-1.7	-2.1	-2.9	-3.6	-3.8	-3.7
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Other identified debt-creating flows	0.0	0.0	0.0	0.0			7.8	11.4	11.8	6.5	2.9	2.6
Privatization receipts (negative)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			7.8	11.4	11.8	6.5	2.9	2.6
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2–3)	0.7	0.3	0.5	7.8			0.8	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	111.3	102.5	88.7	98.9			107.1	164.6	203.7	212.3	198.9	190.0
Gross financing need 5/	3.8	3.5	3.8	1.3			0.8	2.0	2.1	1.9	1.8	1.6
In billions of U.S. dollars	73.1	78.5	102.4	45.2	10-Year	10-Year	32.4	95.6	110.7	115.5	118.2	124.0
				0.0	Historical	Standard						
				0.0	Average	Deviation						
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	10.1	10.4	11.6	11.9	9.6	1.3	9.7	9.8	10.0	10.0	10.0	10.0
Average nominal interest rate on public debt (in percent) 6/	2.8	2.7	3.0	4.0	4.7	2.9	5.2	5.2	5.9	6.4	6.4	6.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.1	-1.1	-0.6	-1.2	1.9	5.0	-1.8	0.3	1.5	2.4	2.6	2.6
Exchange rate (LC per U.S. dollar)	8.3	8.2	8.0	7.6	8.2	0.1	7.3	7.4	7.5	7.7	7.8	7.9
Nominal depreciation of local currency (LC per dollar)	0.0	-1.0	-2.7	-4.6	-0.8	0.9	-4.5	1.3	2.4	1.8	1.8	1.8
Exchange rate (U.S. dollar per LC)	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.0	1.0	2.8	4.8	0.8	0.9	4.7	-1.3	-2.3	-1.8	-1.7	-1.7
Inflation rate (GDP deflator, in percent)	6.9	3.8	3.6	5.2	2.3	2.4	7.0	4.9	4.4	4.0	3.9	3.9
Growth of real primary spending (deflated by GDP deflator, in percent)	8.6	13.9	15.5	16.1	14.9	5.3	15.4	5.5	8.2	6.8	11.8	10.8
Primary deficit	1.0	0.9	0.2	-1.5	1.4	0.9	-2.5	-0.6	-1.0	-1.6	-1.8	-1.7
							II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios												
A1. Key variables are at their historical averages in 2008–13 7/							29.4	40.2	50.6	55.0	55.4	55.6
A2. No policy change (constant primary balance) in 2008–13							24.2	34.2	41.8	43.9	42.3	40.5
B. Bound tests												
B1. Real interest rate is at baseline plus one standard deviations							25.2	34.4	43.3	46.1	45.1	43.9
B2. Real GDP growth is at baseline minus one-half standard deviation							25.1	34.3	43.1	45.8	44.7	43.7
B3. Primary balance is at baseline minus one-half standard deviation							25.2	34.3	42.9	45.2	43.7	42.1
B4. Combination of B1-B3 using one-quarter standard deviation shocks							25.3	34.6	43.5	46.2	45.1	43.9
B5. One time 30 percent real depreciation in 2008 9/							25.0	33.7	41.9	43.8	42.0	40.1
B6. 10 percent of GDP increase in other debt-creating flows in 2008							34.8	42.6	50.1	51.5	49.1	46.7

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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Appendix III: IMF Executive Board Concludes 2008 Article IV Consultation with the People's Republic of China

On September 26, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the 2008 Article IV consultation with the People's Republic of China.[1]

Background

Real GDP grew by 11.9 percent in 2007, before moderating to 10.4 percent in the first half of 2008. Investment and exports remained major drivers of growth; private consumption picked up during the period, but its growth rate continued to lag that of GDP. Inflation gathered pace in 2007, rising from under 2 percent in 2005−06 to 4.8 percent in 2007 and reaching an average rate of 8 percent (y/y) in the first six months of 2008. Food prices were the main factor driving the rise, reflecting some domestic supply shortages and higher international agricultural commodity prices. However, inflation has moderated as food price increases have slowed and was 6.3 percent in July. On a national basis, the devastating earthquake that hit Sichuan Province in May 2008 is expected to have a limited economic impact.

The trade surplus rose to $262 billion in 2007, but at $125 billion in the first seven months of 2008, it was smaller than in the same period in 2007. Export growth averaged 26 percent in 2007 reflecting substantial increases in exports of machinery and transport equipment and intermediate products. It moderated in the latter part of 2007, and this continued in the first part of 2008 as trading partners' economies slowed and the effect of lower export tax rebates and higher export taxes started being felt. Import growth lagged that of exports for most of 2007, but has strengthened since October 2007, reflecting

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[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.

high commodity prices. Driven by the rising trade surplus, the current account surplus increased from about 9½ percent of GDP in 2006 to 11¼ percent in 2007. Foreign official reserves have continued to rise at a rapid pace. Reserves rose by $462 billion in 2007 and a further $281 billion in the first half of 2008, bringing the level at end-June to $1.8 trillion.

The pace of appreciation of the renminbi versus the U.S. dollar picked in the first half of 2008, but has since slowed. The renminbi appreciated by roughly 7 percent against the U.S. dollar from the end of 2007 through June (21 percent since the exchange rate regime change in July 2005), following a 7 percent appreciation in 2007 but the upward trend against the U.S. dollar stopped in July and August. On a nominal effective basis, the currency has appreciated by 7½ percent during the first eight months of 2008 (14 percent since the July 2005 exchange rate regime change). The rise in the real effective exchange rate has been larger than that on a nominal basis owing to the relatively more rapid rise in Chinese consumer prices. The real effective rate in July 2008 was 5 percent above its December 2007 level and 16 percent above its mid-2005 level; it was slightly below its previous peak in February 2002.

The effects of the large reserves accumulation on liquidity in the domestic banking system has been only partially sterilized through monetary policy actions. In addition to open market operations, the People's Bank of China (PBC) raised benchmark lending rates by a cumulative 135 basis points in 2007, and it has raised the required reserve ratio by 850 basis points in several steps since December 2006. In addition, the authorities have used window guidance to dampen lending growth.

The fiscal position was significantly better than projected. The budget was in surplus in 2007 by 1 percent of GDP, compared to a projection in the 2007 Budget of a 1 percent deficit. This more favorable outturn reflected continuing strong revenue overperformance. Revenue increased by over 30 percent in 2007, compared to a budget projection of half that rate, owing to higher corporate income tax, stamp duty, and VAT receipts. Only part of this revenue overperformance resulted in an increase government spending. In the first seven months of 2008, revenue was 30 percent higher than in the same period of 2007.

Executive Board Assessment

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