FOR AGENDA

SM/10/191

July 12, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Staff Report for the 2010 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2010 Article IV consultation with the People's Republic of China, which is tentatively scheduled for discussion on **Monday, July 26, 2010**. At the time of circulation of this paper to the Board, the authorities of the People's Republic of China have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Publication will only proceed upon the receipt by the Fund of the member's explicit consent. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Chalk (ext. 38281), Mr. Barnett (ext. 34439), Mr. N'Diaye (ext. 39751), Mr. Porter (ext. 37316), and Mr. Ahuja (ext. 35464) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 20, 2010; 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 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Article IV Consultation with the People's Republic of China

Approved by Anoop Singh and Tamim Bayoumi

July 9, 2010

Mission. A staff team consisting of N. Chalk (Head), A. Ahuja, S. Barnett, P. N'Diaye, N. Porter, M. Syed (APD), R. Duttagupta (SPR), I. Lee, and T. Feyzioğlu (Resident Representatives) visited Beijing, Lanzhou, and Shanghai from June 17 to July 1, 2010. Messrs. He and Zhang (OED) joined the mission and Mr. Shinohara and Mr. Singh participated in the senior policy meetings. The mission overlapped with a joint MCM-World Bank mission that began work on the Financial Sector Assessment Program for China.

Outlook. The recovery has taken hold and growth should be in the double digits this year. Barring further food supply shocks, inflation will peak by mid-year and then slowly decline. The current account surplus continues to fall and is now around one-half of its 2007 peak. However, over the medium-term, there is a potential for sizable current account surpluses to return as the policy stimulus is wound down and the global economy recovers.

Risks. The main risks facing the Chinese economy include a renewed weakening in the global recovery, a worsening of credit quality (notably from an expansion of lending to local governments), or a misstep in the government's response to rising property prices.

Rebalancing. A range of policies will be needed to ensure a sustained rebalancing of growth toward private consumption. These include measures to reform and liberalize the financial system, fiscal support for household consumption, an expansion of the social safety net, policies to capitalize on the ongoing process of urbanization, developing the service sector, structural changes to lower corporate savings, and an appreciation of the renminbi. There has been important progress in many of these areas but more remains to be done.

Past advice. The authorities broadly agree with the Fund's advice on the need to rebalance toward domestic sources of growth, but there have been different views on the appropriate pace of some reforms.

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EXECUTIVE SUMMARY

A strong fiscal response and an expansionary monetary policy have ensured that China has led the global recovery. At the same time, important progress has been made in a range of structural areas which will contribute to a rebalancing of the economy. The challenge now will be to sustain this strong growth performance while switching decisively to an economy that is powered by the Chinese consumer. Much has been done but, given the complexity of the task at hand, a broad agenda remains ahead and includes:

- Maintaining the fiscal stimulus through 2010 while, on the margin, reorienting further toward fiscal measures that will spur consumption. If the recovery continues as envisaged, begin gradually withdrawing fiscal stimulus in 2011 while continuing to expand near-term fiscal support for consumption.
- Continuing to withdraw monetary stimulus to return credit growth to more normal levels. In doing so, a greater role for interest rates, open market operations, and reserve requirements is warranted.
- Maintaining supervisory and regulatory vigilance to identify and manage any deterioration in credit quality that may arise from last year's credit expansion.
- Increasing the transparency and availability of information on local government financing vehicles. Strictly enforcing the existing prohibition of local government debt guarantees.
- Continuing to deploy prudential measures to counter unwarranted growth in real estate prices. Introducing a property tax and, over time, raising the cost of capital to lessen the propensity for property price bubbles.
- Using the flexibility in the current exchange rate regime to allow for an appreciation of the renminbi in real effective terms.
- Liberalizing the financial system with an eventual phase-out of deposit rate ceilings and of direct limits on credit growth.
- Developing a broader range of financial markets and investment products to raise household capital income, offer households alternative investment and insurance products, and lessen the demand for physical assets (such as housing) as a store of value.
- Sustaining the recent pace of progress in building out China's social safety net, particularly in health, education, and pensions.
- Capitalizing on urbanization as a force for growth and rebalancing. This would include reducing labor market rigidities, investing in urban infrastructure, rural land reform, and removing barriers to competition in the service economy.
- Tackling high corporate saving by raising the costs of factor inputs (including capital), widening corporate ownership, boosting dividend payouts, and increasing competition in domestic markets.

I. How has China Handled the Global Financial Crisis?

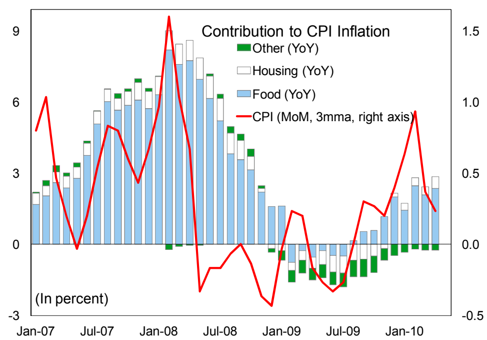
1. ***The crisis response***. China was hit hard by the global financial crisis, predominantly through trade channels. The policy response was quick, determined, and effective and comprised three broad strands:

- *A major fiscal stimulus.* The public stimulus was concentrated in infrastructure spending, drawing on the government's successful use of capital spending as a countercyclical tool during the Asian financial crisis. The government did, however, devote an estimated 2–3 percent of GDP to higher social spending and incentives—largely on the tax side—to support private consumption.
- *An extraordinary credit expansion*. Chinese banks extended new loans of 33 percent of GDP in 2009. This outturn was largely a result of the removal of limits on credit growth, supported by a relaxation of restrictions on property lending and a reduction in both interest rates and reserve requirements.
- *Re-pegging the renminbi to the U.S. dollar.* In July 2005, the central bank began to allow the renminbi to appreciate against the U.S. dollar, at its peak reaching a rate of appreciation of around 1 percent per month. However, in response to increasing volatility in the world economy and in global financial markets, the central bank returned to pegging the renminbi to the U.S. dollar in July 2008.

2. ***Outcomes***. This policy package was instrumental in mitigating the effects of the shock to external demand and in arresting the downward momentum to both activity and confidence (Figure 1).

- *Growth* began to pick up in the second quarter of 2009 and reached an average for the year of 9.1 percent, around half of which is estimated to be due to public spending.
- *Inflation* moved into negative territory for much of 2009 but has since registered a modest increase. The bulk of this inflation has been directly attributable to higher food prices.

Since late 2009 inflation has resumed



- The *balance of payments* saw an unprecedented and dramatic change. The current account fell quickly as export volumes slowed and imports surged. The terms of trade also moved against China, accentuating the decline in the trade surplus. On the capital account side, foreign direct investment fell, in line with global trends.
- Despite the lower current account and reduced FDI inflows, *reserve accumulation* continued to be rapid, reaching over US$40 billion per month in the year to March.

3. ***Spillovers***. China's recovery had significant positive trade spillovers to the region and the global economy, initially through increased demand for commodities—which contributed to an upswing in global commodity prices—and later through higher imports of capital goods (notably from Japan, Korea, Germany, and Taiwan Province of China).

4. ***Exit***. The government has started to unwind many of its crisis response measures (Figure 2). Credit growth is being slowed; prudential requirements related to property lending are being tightened; and the government announced it would return to the managed floating exchange rate regime that was in place from July 2005 to July 2008 (Box 1).

Box 1: Further Reform of the Renminbi Exchange Rate Regime

- On June 19, 2010 the People's Bank of China announced the return to a managed floating exchange rate regime that allows for movements in the exchange rate based upon market supply and demand and with reference to a basket of currencies.
- Under this regime, the U.S. dollar-renminbi exchange rate can move intraday ±0.5 percent from a central parity (that is determined at the opening of trading by a weighted average of primary dealers' offer rates). The central parity itself is able to move by up to ±0.5 percent each day.
- In the 3 weeks since the reform was announced, the currency has appreciated against the U.S. dollar by ¾ percent depreciating ¼ percent in nominal effective terms.

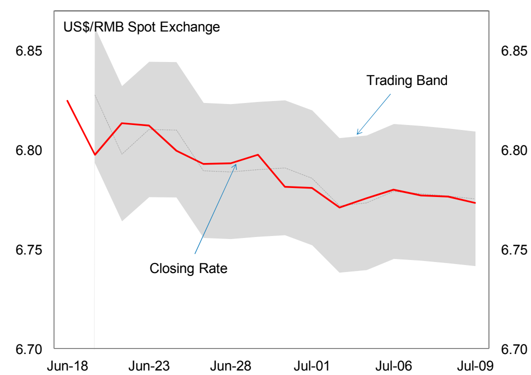
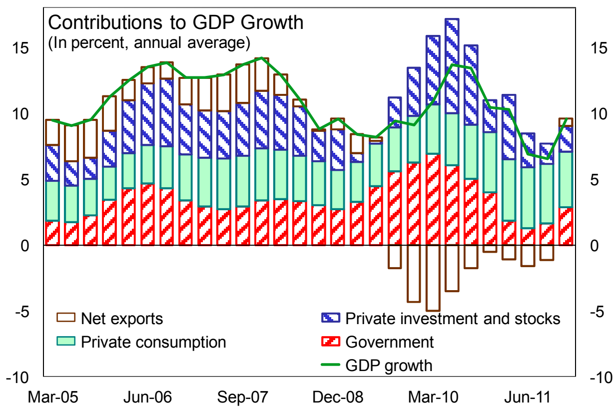


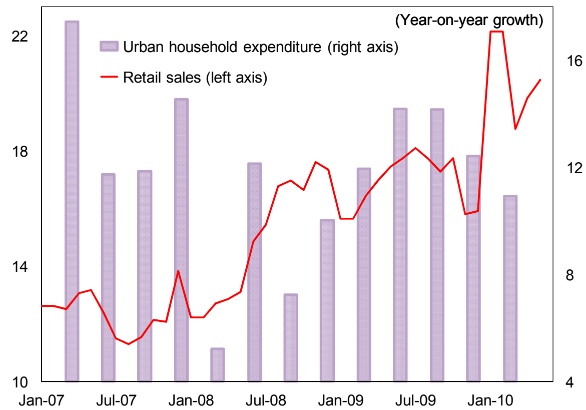
Figure 1. A Robust Recovery

Main Message: The recovery is well established with increasing signs of a transition from public stimulus to private sector-led growth.

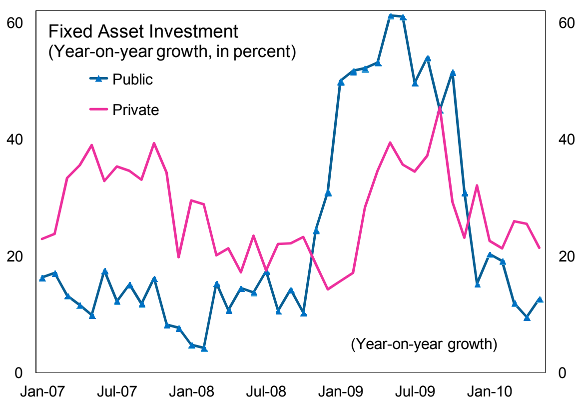
The economic recovery began early and has proceeded at a fast pace.



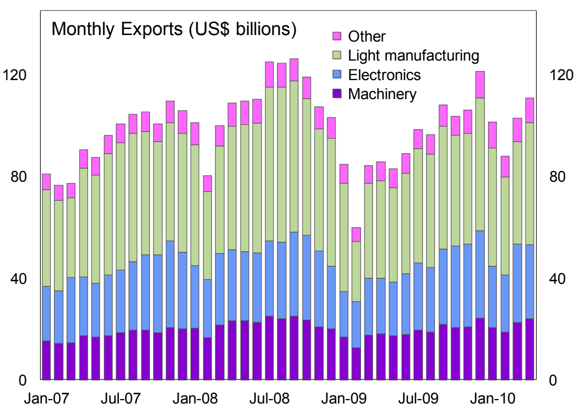
Consumption growth has been vigorous, helped by robust labor markets and government policies,…



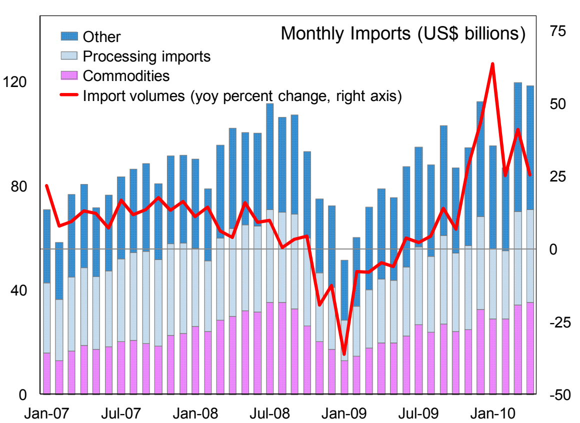
…while the surge in investment has been extraordinary.



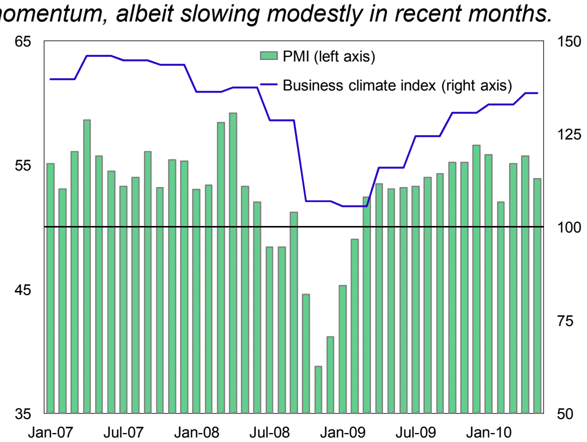
Exports are above their pre-crisis levels with particular strength in electronics and light manufacturing.



The export rebound has, however, been outstripped by import demand.



Forward-looking indicators show continued growth momentum, albeit slowing modestly in recent months.

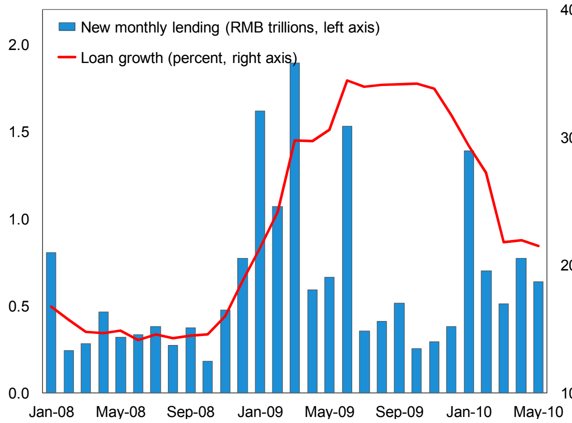


Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

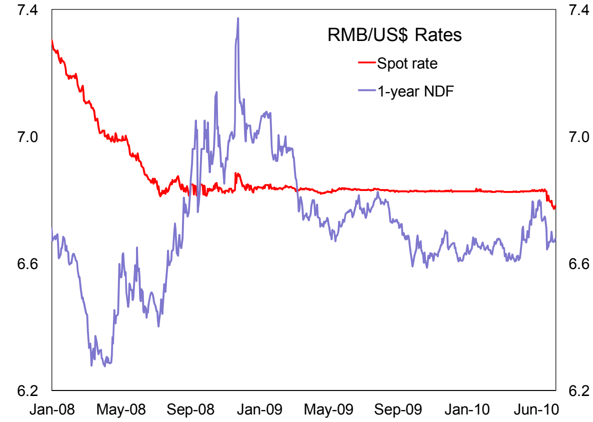
Figure 2. Macroeconomic Policies

Main Message: The policy challenge now is to correctly calibrate the pace and sequencing of exit from the extraordinary support that was given to the economy during the global financial crisis.

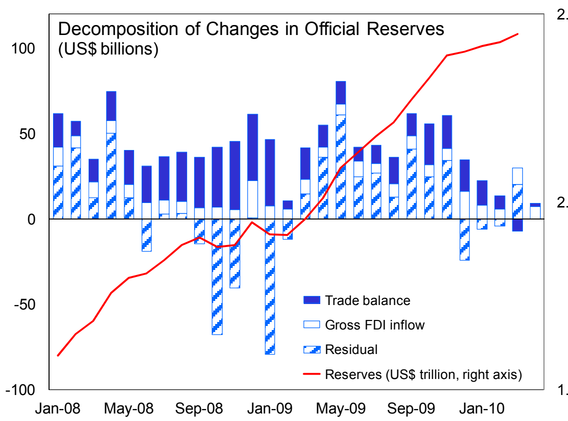
In late 2008, restrictions on loan growth were removed allowing the fiscal stimulus to be financed by bank credit.



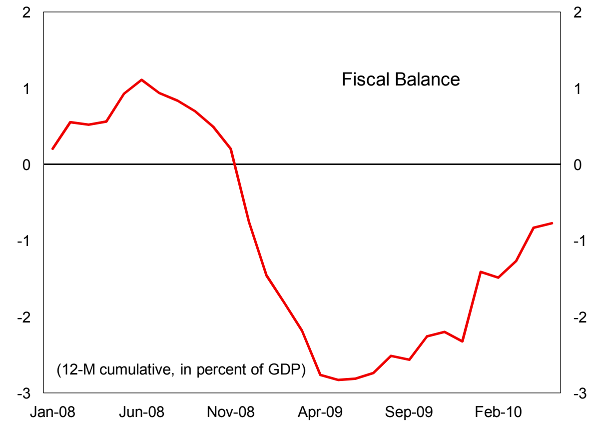
The renminbi was re-pegged to the US dollar…



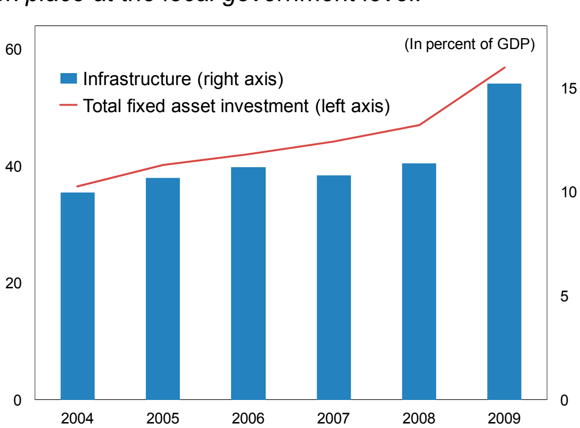
..supported by foreign currency intervention.



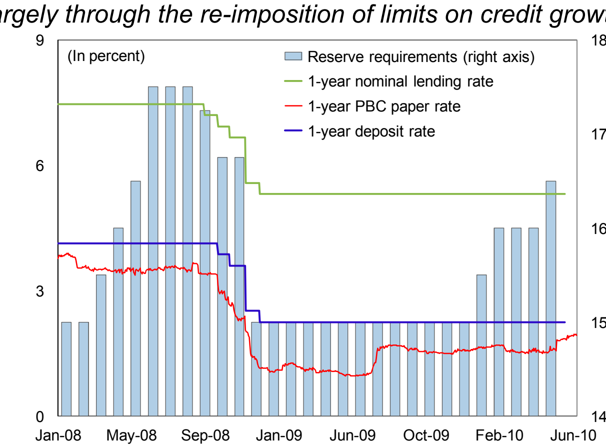
A significant fiscal stimulus was quickly put in place…



…driven by higher capital spending, a large part of which took place at the local government level.



The monetary expansion is now being steadily scaled back, largely through the re-imposition of limits on credit growth.



Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

5. ***Monetary policy***. The central bank's loosening of monetary policy in response to the economic crisis served to support growth and mobilize the resources needed to finance a surge in investment. However, the rapid expansion in credit has led to an increased risk of a worsening in credit quality. With China's economic recovery now firmly established, the need for monetary support has greatly diminished. The central bank is, therefore, targeting a reduction in M2 growth from 30 percent at end-2009 to 17 percent by end-2010. This will imply an increase in new lending of around Y7.5 trillion for the year as a whole. To achieve that goal, the central bank has increased reserve requirements three times this year (from 15 to 16½ percent). In addition, domestic liquidity conditions have been tightened through the stepped-up issuance of central bank bonds. However, benchmark interest rates have yet to move upwards and the government continues to rely on quantitative limits to slow credit growth. The targeted reduction in the pace of credit growth is fully appropriate. However, staff argued for a broader range of tools to be used with a greater reliance placed on interest rates, open market operations, and reserve requirements. Central bank officials indicated that they are fully committed to a greater use of indirect monetary policy instruments. They noted, however, that, with a benign inflation outlook, there was less need for higher nominal interest rates at this point. Also, as a secondary factor, they were concerned that higher interest rates could risk fueling capital inflows.

6. ***Fiscal policy.*** The 2010 budget targets a deficit of 3 percent of GDP, which should support a steady resumption of private demand. This fiscal stimulus has come through a combination of infrastructure spending, a reduction in the tax burden, and incentives to boost purchases of consumer durables and autos. In addition, pensions, social transfers, unemployment benefits, healthcare, and education spending have all been increased in an effort to support household income and improve people's livelihoods. Beyond the fiscal impulse evident in the higher general government deficit, a significant amount of support was also provided to the economy through capital spending by local government financing vehicles and state-owned enterprises. There was agreement that further mechanisms should be sought to continue to reorient spending toward measures that would boost household income and consumption, within the existing budget envelope. Staff noted that revenue performance had been strong in the first half of 2010 and that this should afford considerable scope for additional measures to encourage consumption while still staying within the deficit target for the year as a whole. For 2011, the authorities indicated they have yet to decide the fiscal stance but noted that any eventual withdrawal of

Measures to Boost Household Income and Consumption

- Increases in the basic pension, social transfers, and unemployment benefits.
- Consumption subsidies for the purchase of autos and home appliances.
- Incentives to trade-in autos and motorcycles for more energy efficient models.
- Lower tax rate on the purchase of smaller autos.
- Lower stamp duty for the purchase of smaller homes.
- Delayed payment of social security contributions.
- Skill training for the unemployed and migrant workers.
- Subsidized college tuition for rural students.

stimulus would be measured and gradual. On the other hand, if the global recovery falters, there was a shared view that China should turn once again to fiscal tools to offset the resultant shock to external demand. Over a longer horizon, the authorities' preference was to gravitate back toward budget balance, noting that China's strong fiscal position going into the global crisis had afforded it the space needed to respond forcefully to the shock to external demand. Staff agreed that such an approach to the setting of fiscal policy in the coming years was fully appropriate.

7. ***The exchange rate***. The authorities characterized their decision to return to a managed floating regime as part of an effort to overcome the temporary interruption to the reform process that was caused by the global financial crisis. They emphasized the market-determined nature of the exchange rate under the managed floating regime and indicated that they are prepared to allow the exchange rate to respond more to the forces of demand and supply. Staff agreed that the return to the pre-crisis regime would afford the central bank significant flexibility and greater monetary policy independence. Going forward, it would be important to allow movements in the exchange rate to assist in the ongoing tightening of monetary conditions.

8. ***External risks***. There was broad agreement that the principal near-term risk facing the Chinese recovery is the possibility of a renewed downswing in the global economy. The authorities indicated that events in Europe have increased concerns within China about the sustainability of the global recovery, inducing greater caution in the pace of exit from the government's crisis response measures. Over a longer horizon, they were also concerned that the process of fiscal consolidation in Europe, Japan, and the U.S. had the potential to lower global growth with longer-lasting negative spillovers to China. The authorities indicated they were watching carefully for a decisive approach to tackling the unsustainable sovereign debt trajectory in a range of countries and that they would also favor early publication of bank stress tests in Europe. Finally, they indicated their full support for the G-20 mutual assessment process—and the important role of the IMF—as a means to achieve a more coordinated approach to global economic policy.

II. HAS THE CRISIS RESPONSE EXACERBATED EXISTING VULNERABILITIES?

A. Has the Policy Stimulus Created a Risk of Overheating?

9. ***Context***. Monetary aggregates have been growing at a very fast pace. At the same time, the growth rebound has been rapid. This has raised concerns by some analysts that the output gap may now be closing in China and inflationary pressures may rise in the period ahead. Indeed, after a period of deflation in 2009, prices have moved on to an upward trajectory and inflation is now around 3 percent.

10. ***What drives inflation in China?*** Aside from periodic bouts of food inflation, prices in China have been remarkably stable since the end of the high inflation in the late 1990s.

This is despite rapid economic and monetary growth throughout that period. Empirical work suggests that the output gap is not a major predictor of inflation in China.[1] This finding is robust for several different measures of the output gap. Staff interpret this result as an indication that, over much of the past decade, China has been on the flatter part of the inflation-output trade-off, with the economy operating away from potential output. However, empirical work suggests that foreign demand and rising commodity prices do affect nonfood inflation. In particular, a 1 percent increase in foreign demand or a 20 percent increase in world commodity prices would each raise nonfood inflation by around ½ percent. Movements in food inflation, on the other hand, appear to be largely a result of supply shocks to agriculture.

11. ***What about wages?*** China has recently seen some high profile labor disputes that have been resolved with significant increases in nominal wages. At the same time, there are reports of labor shortages in some of the coastal areas. Discussions with the private sector indicated that while nominal wages were rising in the 10–15 percent range, this was a reasonably similar pattern to that of previous years and represented more an indication of the high level of productivity growth rather than tightness in the labor market. Indeed, historically, there appears to be relatively little pass-through from higher wages to domestic inflation with the costs being absorbed either through productivity gains or within companies' existing margins. In addition, facilitated by ongoing investments in infrastructure, jobs are continuing to move toward the interior of the country where wages are lower. This will be a structural force for some time to come that will help put downward pressure on average labor costs. The authorities agreed that labor market conditions were stable and that, for the nation as a whole, there was still an excess supply of labor (which would restrain wage pressures). There was broad agreement that steadily rising real wages were a healthy development that would ultimately boost household income and promote consumption, leading to a more balanced economy.

12. ***Outlook.*** Looking forward, the massive investment program put in place since late 2008, continued high levels of investment, and significant productivity growth will continue to neutralize demand pressures in the near term. Staff forecasts that inflation will soon peak and converge to a level of around 2–3 percent over the next few years, even after accounting for stronger external demand and the IMF's forecast for global commodity prices. In addition, producer price inflation should also begin to fall in the coming months. However, it is worth noting that, since the housing component in the CPI is linked to rental and actual mortgage costs, nonfood inflation does not fully capture the underlying cost of living associated with rising housing costs.

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[1] See N. Porter, "Inflation Dynamics in China," IMF Working Paper (forthcoming).

B. What are the Emerging Risks in the Property Sector?

13. ***Context***. The government's removal of constraints on lending to residential real estate was effective in fostering a turnaround in both construction and property prices (Figure 3). However, attention is now shifting to whether this policy response has created a situation where housing prices are rising faster than would be justified by underlying fundamentals. Housing affordability is also becoming an increasingly prominent social issue.

14. ***Is there a risk of a bubble?*** Low real returns on bank deposits and a lack of alternative investment vehicles mean that residential real estate presents an attractive destination for China's high domestic saving. Nonetheless, at a national level, it does not seem as if property prices are significantly above fundamentals (Box 2). However, a property bubble is beginning to inflate in some of the larger cities and there has been an uptick in credit to the real estate sector. As a result, preemptive action is warranted.

15. ***Policy implications***. The Chinese authorities are acutely aware of the underlying risks of asset price inflation, not least due to the lessons learned from Japan's experience in the 1980s (Box 3). The government has, therefore, deployed a range of regulatory tools to contain unwarranted inflation in asset markets. These have included increases in transaction taxes, stricter regulatory controls on lending (including lower loan-to-value ratios for non-owner occupied residences), and increases in mortgage interest rates for non-owner occupied residences. Staff argued that, while recent measures are treating the underlying symptoms, they have not tackled the fundamental causes of property price inflation. These are inextricably linked to a low cost of capital, prospects for capital appreciation (linked to urbanization and broader economic growth), and a lack of alternative savings vehicles. The authorities indicated that the measures taken in April to lessen speculative activity in the real estate markets had been effective, lowering transaction volumes and leading to a leveling off in prices. In addition, the government would expand its investments in low income housing in the coming years. They also pointed out that deposit rates in China were still well above those in many other industrial countries. Nevertheless, the government will evaluate the impact of these measures over time and further enhance them, as needed, to ensure stability in the housing market. They indicated that, while a property tax was under consideration, no decision had yet been made on either its design or the timing of its introduction.

Real interest rates are well below the growth rate.

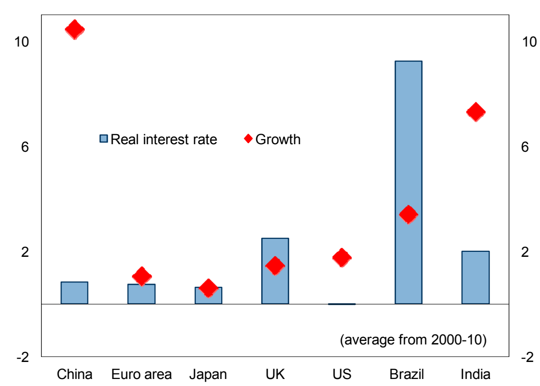
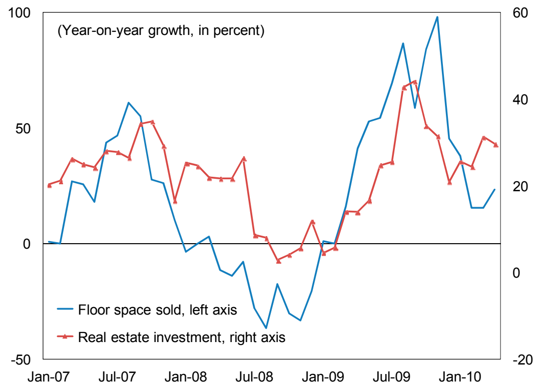


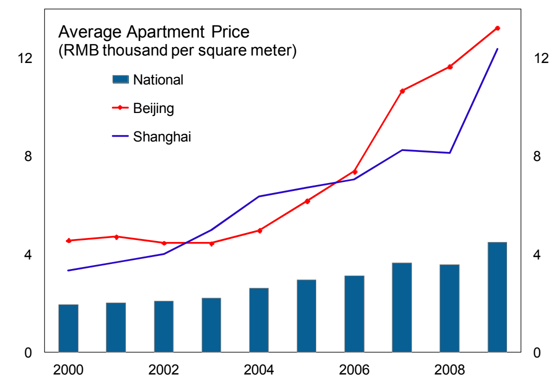
Figure 3. The Residential Real Estate Market

Main Message: A property price bubble is beginning to inflate in some urban areas but the authorities are acting preemptively to prevent a boom-bust cycle in asset prices from taking hold.

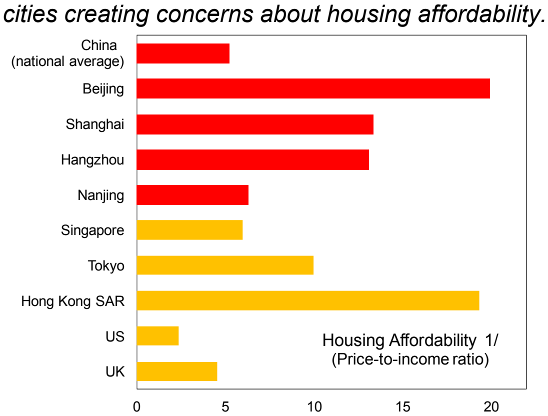
Real estate investment has returned to previous growth rates.



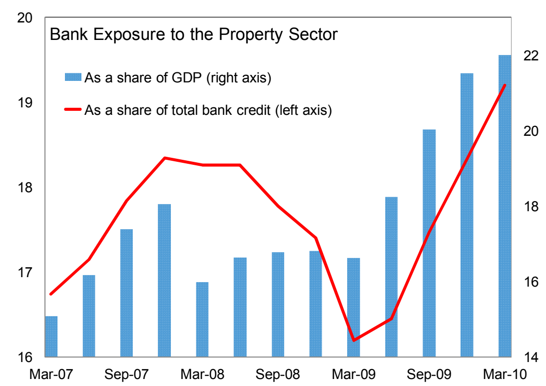
But the level of property price inflation, particularly in larger cities, has raised concerns of an asset price bubble



Prices are already high, as a ratio of household income, in some cities creating concerns about housing affordability.



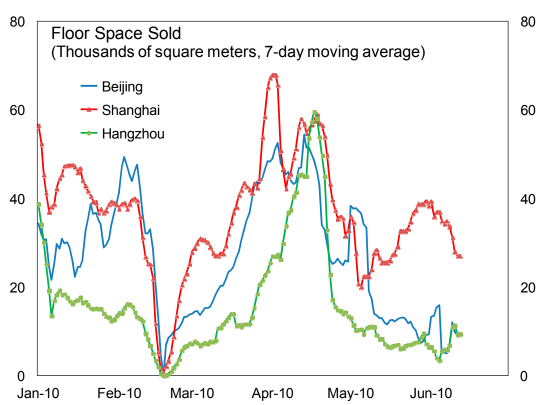
Lending to real estate has bounced back but remains a relatively small part of bank lending.



The government has responded with a graduated tightening of regulatory requirements.

March 2010	♦ 20 percent downpayment required from property developers
April 2010	♦ "discounts" on mortgage rates reduced ♦ downpayment for >90 square meter homes increased to 30 percent ♦ downpayment of 50 percent required for second homes ♦ higher mortgage rates on second homes ♦ mortgages for third homes discouraged, particularly in selected high price areas ♦ state enterprises, whose core business is not in property, requested to exit the market

Precipitating a decline in transaction volumes and dampening expectations for further rapid price increases.



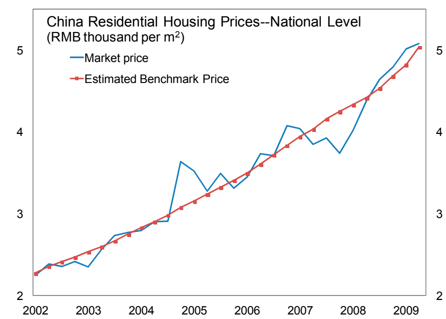
1/ For China, Tokyo, Hong Kong SAR, and Singapore the price of a 70 square meter apartment as a multiple of annual household disposable income. For the US and UK, median house price as a multiple of annual household personal disposable income.

Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

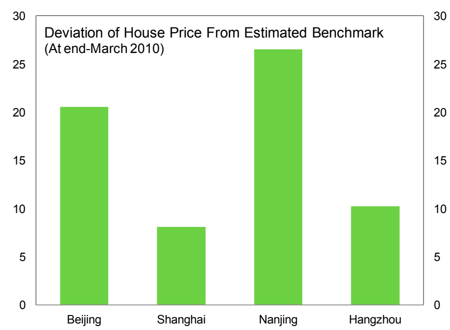
Box 2: China's Residential Real Estate Market[1]

An empirical model is used to link housing prices—in China and a set of comparator countries—to a set of key fundamentals. An estimated benchmark housing price is then derived. The fundamental explanatory variables include rents, real interest rates, property tax payments, the degree of mortgage tax deductibility, maintenance costs, a proxy for expected capital gains, and an additional risk premium between owning and renting a home.

Estimates indicate that, for China as a whole, the deviation between the current price and underlying fundamentals is relatively small. The same model does, however, show large deviations from fundamentals in those countries in the sample that were subsequently found to have had a significant property price bubble prior to the onset of the global financial crisis.



However, the picture differs greatly across China's cities. In particular, the deviation of housing prices from the estimated benchmark is larger in some, but not all, of the Tier-1 cities. Interestingly, despite rapid price inflation in Shanghai, the deviation of the current price from the benchmark is more modest. This is largely because rents in Shanghai have more closely tracked house price inflation than elsewhere in China.



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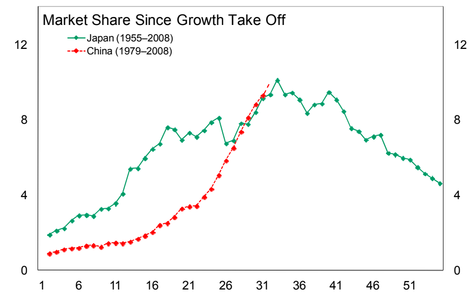
[1] See A. Ahuja and N. Porter, "Are House Prices Rising too Fast in China?" IMF Working Paper (forthcoming).

Box 3: Key Lessons from Recent Japanese History[1]

China's economy today faces the difficult task of shifting its sources of growth away from exports and investment and toward private consumption. This is a similar challenge to that which confronted Japan in the 1980s. During that period, Japan's growing share of the global export market inflamed protectionist sentiments, eventually resulting in the Plaza and Louvre accords. As part of these accords, Japan agreed to appreciate the yen, implement fiscal policies to support domestic demand, promote private sector development, and conduct monetary policy in a flexible manner with due attention to the exchange rate. Analysis of this history provides the following lessons:



- ***There are limits to export-oriented growth***. At its peak, Japan occupied around 10 percent of global exports and, by the mid-1980s, was beginning to find it increasingly difficult to push its share in global markets higher.

- ***An incomplete package of measures will be unable to achieve sustained rebalancing***. Shifting toward a greater reliance on the service sector requires a real appreciation of the exchange rate, supportive macroeconomic policies, and structural reforms to develop nontradable sectors. Japan's experience shows that without all the components in place and working in concert the risk of incomplete rebalancing and economic stagnation is high.

- ***The growth and employment impact of exchange rate appreciation can be alleviated with supportive macroeconomic policies.*** The appreciation of the yen that followed the Plaza accord led to slower growth and higher unemployment. However, these trends were subsequently reversed by a looser monetary stance and supportive fiscal measures.

- ***However, such supportive macroeconomic policies, if maintained for too long, can inflate asset bubbles.*** Maintaining loose monetary policy for too long combined with incentives to boost consumer and mortgage credit fueled a rapid rise in equity and land prices in Japan. The subsequent protracted adjustment in goods and asset markets and the deleveraging in household, bank, and non-financial corporate balance sheets contributed to Japan's "lost decade" of deflation, public debt accumulation, and stagnation.

- ***Financial liberalization has to be carefully managed.*** Liberalizing interest rates in the context of a banking system with excess liquidity has the potential to lead to a significant decline in deposit rates, fueling asset price inflation. An early shift toward greater reliance on indirect monetary instruments can help to maintain control over monetary aggregates following liberalization but, even with this, the stance of monetary policy still needs to be correctly calibrated.

[1] See P. N'Diaye, "Lessons for China from Japan's Experience in the 1980s," IMF Working Paper (forthcoming). For a broader perspective on the lessons from episodes of current account surplus reversals see World Economic Outlook, April 2010, "Getting the Balance Right: Transitioning out of Sustained Current Account Surpluses."

C. What are the Vulnerabilities in Local Governments' Fiscal Positions?

16. ***Context***. Despite legal restrictions prohibiting subnational borrowing, it has been common practice for a number of years for local governments to establish corporate vehicles (capitalized by transfers of money, land, equity, or other government assets), which are then used to borrow. In addition to their publicly provided capital, these financing platforms regularly receive implicit or explicit guarantees from the local government to underwrite their borrowing. In 2008–09, as restrictions on credit growth were removed and the central government actively encouraged infrastructure investment to offset the shock to external demand, local governments significantly increased their recourse to such vehicles.

17. ***Risks***. Information on the activities of these entities (and their underlying financial condition) is sparse, making it exceedingly difficult to assess the risks they imply for the banking system. Indeed, officials indicated they were only now putting in place systems to identify and measure the level of recourse to these financing arrangements. Some part of the expansion in this quasi-fiscal lending will end up as nonperforming loans with negative implications for both local government finances, bank balance sheets, or, potentially, central government finances. The ongoing Financial Sector Assessment Program (FSAP) will carefully assess the underlying vulnerabilities associated with such lending.

18. ***Policies***. It was generally agreed that many of the investments being made at the subnational level were needed and were in projects that would ultimately improve the livelihoods of the Chinese people. Lowering the potential risks from such lending, however, will need to involve better information in the operations of local government financing platforms; work is already underway within the government to collect such data. Officials underlined their commitment to more strictly enforce the existing prohibition on local government borrowing and the use of explicit (or implicit) local government guarantees. They particularly pointed to the recent instruction by the State Council, reaffirming that local governments cannot borrow or issue debt guarantees and, if they do, any such guarantees will be deemed invalid. To contain credit risks, the China Banking Regulatory Commission (CBRC) has instructed banks to reappraise all lending to local government vehicles and, if needed, return to the borrowers to request additional collateral to back such lending, particularly for those projects where the underlying cashflows are weak or insufficient. Staff argued that some consideration could also be given to formalizing local government financing (for example through establishing a municipal bond market), accompanied by appropriate prudential controls. Any such change, however, would need to weigh carefully the broader consequences for fiscal federal relations and fiscal stability going forward. In addition, staff indicated that the introduction of a property tax would benefit local government finances and lessen local governments' reliance on land sales as a source of revenue.

D. How has the Credit Expansion Affected the Banks?

19. ***Context***. The scale of the expansion in credit has been unprecedented. Experience, in both China and abroad, would suggest that this should soon be accompanied by a worsening in average credit quality. The government is conscious of this risk and has tightened prudential regulations by building up reserves (through higher provisioning for nonperforming loans), more stringent capital adequacy standards, placing limits on bank guarantees for corporate bonds, and tightening liquidity and concentration ratios. In addition, banks have been strongly encouraged to raise new capital and, indeed, many have done so in recent months.

Banking System Indicators (In percent)

Liquid assets/liquid liabilities 1/	41.1
NPL (share of loans) 1/	1.4
Provisioning (share of NPLs) 1/	170.2
CAR 2/	11.4
Tier 1 Capital 2/	8.6
ROE 3/	24.6
ROA 3/	1.4

1/ March 2010.
2/ Share of risk-weighted assets, December 2009.
3/ December 2009

20. ***Implications***. A detailed assessment of risks will be provided by the ongoing FSAP. At this point, the banking system looks well-placed to withstand a significant deterioration in credit quality. Profitability is solid, most banks meet the regulatory requirements of being well capitalized, large banks are subject to a capital surcharge, and provisioning levels are being increased. The authorities noted that, in addition to their proactive regulatory response, the limits on loan and deposit rates—and the resulting guaranteed loan-deposit rate margin—would also provide some protection to the banking system going forward. Nevertheless, they would continue to scrutinize carefully banks' risk management practices and adapt China's regulatory framework as international standards evolve.

III. Where is the Chinese Economy Heading Over a Longer Horizon?

A. Will the Decline in the Current Account Surplus Endure?

21. ***Prospects***. In the past two years, the current account surplus has almost halved as global demand collapsed and China's demand for commodities and capital goods imports picked up. Indeed, import volume growth has well outpaced export growth for more than a year and the current account surplus is still falling (Figure 4). However, as external demand recovers and the fiscal position moves back to budget balance (and assuming current policies and a constant real exchange rate) there is a potential for larger current account surpluses to reassert themselves (Box 4). The accumulation of net foreign assets will also put upward pressure on the current account through its impact on income flows, particularly as global interest rates return to more normal levels. The authorities disagreed with this assessment. Instead, they anticipate that the current account surplus will settle at about 4 percent of GDP over the medium term. Ongoing structural reforms, rising wages, and the recent appreciation of the currency will combine to boost consumption. At the same time, continued fast growth will shrink the current account surplus as a share of GDP. They underlined the important progress that had already been made in lowering the current account imbalance and expected that policies would continue to be calibrated to ensure that large surpluses do not return,

recognizing that the high level of the trade surplus witnessed in 2007 was simply not sustainable.

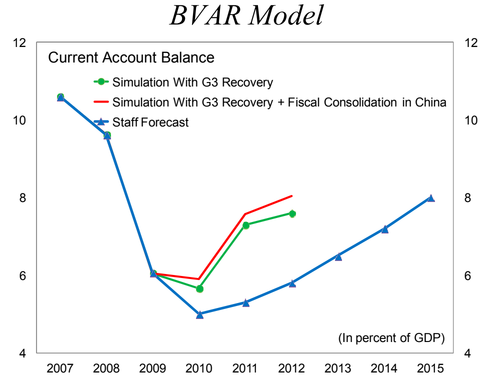
Box 4: Prospects for the Current Account Surplus

A Time Series Approach. Staff simulations—using a Bayesian Vector Autoregression model (BVAR) estimated on quarterly data—suggest that the recent decline in the current account surplus may be partially reversed in the coming years. The model was fitted to historical data and used to forecast assuming:

- a steady fiscal consolidation in China;
- a recovery in the global economy along the path forecasted in the current World Economic Outlook;
- constant real exchange rates.

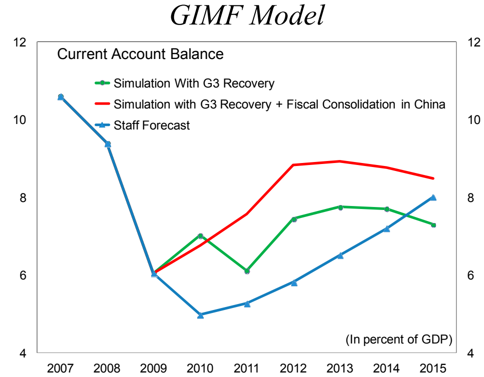
Under this out-of-sample simulation, beginning from end-2009, the current account surplus rises to around 8½ percent of GDP over a two-year horizon. Most of the impact is due to the pace of recovery in the global economy with little apparently attributable to the change in fiscal stance.

BVAR Model



A Structural Modeling Approach. Simulations using the Global Integrated Monetary and Fiscal model (GIMF) show that the combination of stronger global demand and a lower fiscal deficit will increase the current account surplus to around 8–9 percent of GDP. However, compared to the BVAR results, the simulations based on this calibrated global structural model indicate a much larger impact of fiscal consolidation but a more modest effect from stronger global output.

GIMF Model

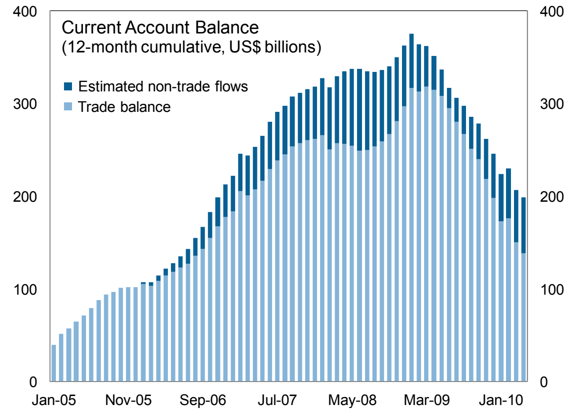


Staff's current account forecasts take these results as a guide but assume a more moderate increase in the current account than would be predicted by model simulations alone, using some degree of judgment to adjust for the impact of the policies put in place in 2009–10.

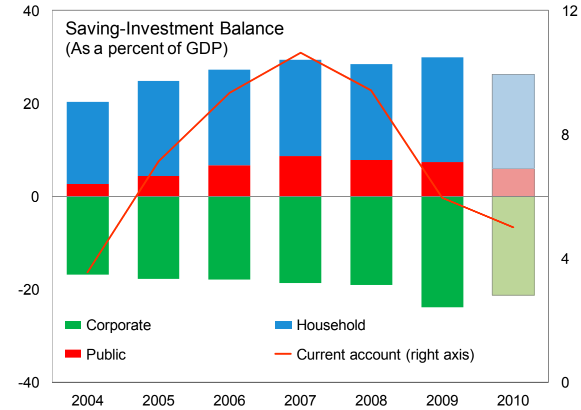
Figure 4. The Decline in the Current Account Surplus

Main Message: While progress has been made in lessening imbalances, the recent downturn in the current account has the potential to be temporary and cyclical in nature.

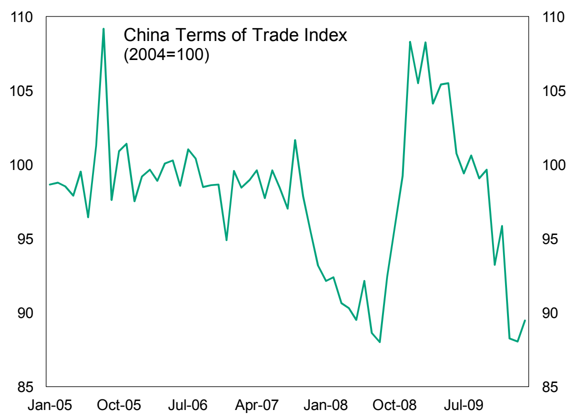
The current account surplus has been almost cut in half over the past two years…



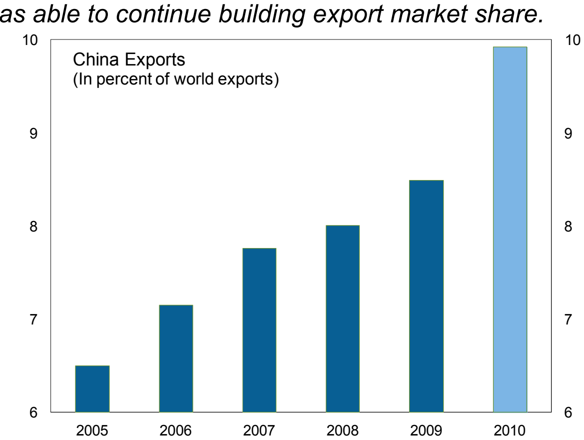
…reflecting a shift to fiscal deficits, stronger household consumption, and a surge in investment.



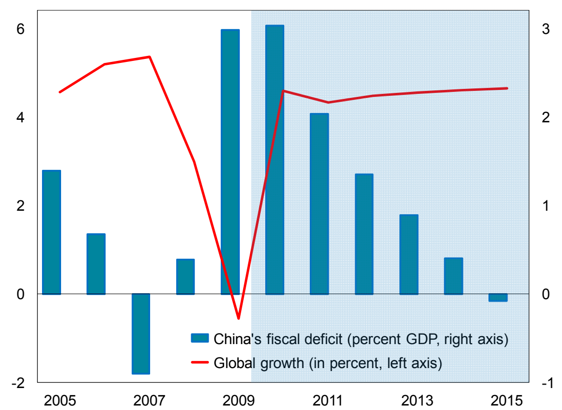
The terms of trade have also moved against China.



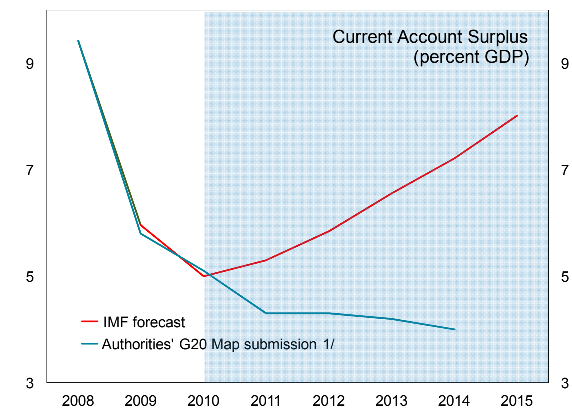
Nevertheless, even during this global downturn, China was able to continue building export market share.



As the world economy recovers and China's fiscal stimulus is unwound…



…staff see a potential for the current account surplus to reassert itself. The authorities, however, are confident the decline is a structural break that will be sustained.



1/ Based on academic forecasts.

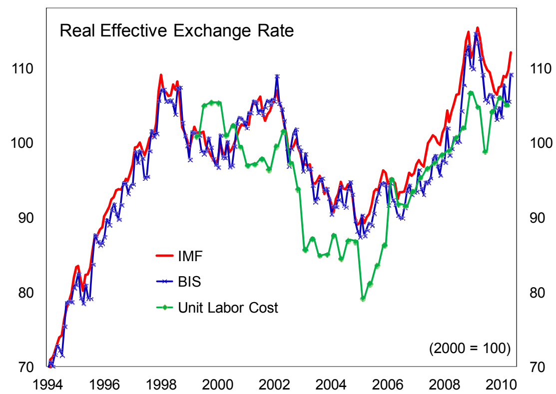
Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

22. ***What does this imply for the exchange rate?*** Staff believe that the renminbi remains substantially below the level that is consistent with medium-term fundamentals. This assessment is based upon three broad arguments:

- *The pace of accumulation of international reserves continues to be rapid*. The authorities did not view this as compelling evidence of a meaningful undervaluation of the currency. In particular, they argued that the recent accumulation of international reserves was more a product of the unprecedented expansion of global liquidity, a result of monetary policy decisions in the large industrial economies.

- *The current level of the real exchange rate is close to the level it was at in the late 1990s even though, in the interim, China has had significantly higher productivity than its trading partners*. The authorities regarded it as arbitrary to judge the current level of the exchange rate by referencing a particular point in time when the currency may or may not have been in equilibrium. In particular, they noted that the currency was currently more than 50 percent stronger than when the exchange rate was unified in 1994 and 22 percent more appreciated than at its recent low point in 2005. They also made the broader point that the real exchange rate had been very flexible over the past decade, moving significantly in both directions. Staff agreed that comparison to any one point in time could indeed be deceptive. However, the real exchange rate was now back to the average level of 1999–2003, a period when there did not appear to be any decisive imbalance in the external accounts. In the interim, cumulative productivity differentials had been substantial.

The real exchange rate is now around the level of a decade ago.



Productivity Differentials (2000-08)

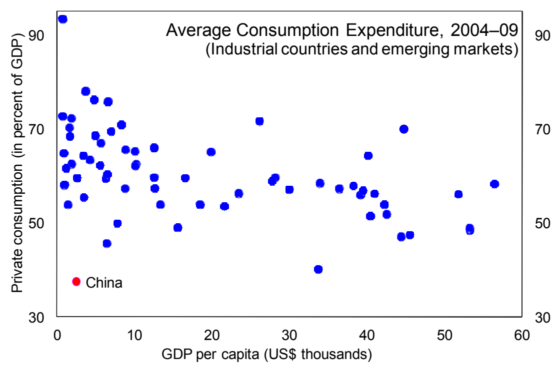
	Average Productivity China	Average Productivity Trading Partners	Cumulative Difference
TFP growth	2.8	1.2	14.9
Labor productivity			
Tradable sectors	9.3	2.3	62.7
Nontradable sectors	4.7	0.6	36.4
Real effective exchange rate			2.8

- *China's current account is set to return to a position of sizable surplus in the coming years*. The authorities refuted this view, indicating that the reforms put in place over the past several years—including the appreciation of the real exchange rate, improvements in health, education, and pension systems, and others—are already resulting in a structural change in saving and investment behavior in China. They viewed the level of the renminbi right now as much closer to equilibrium than at any time before. In addition, they argued that China was at a stage of development where, going forward, the share of imports in domestic demand was likely to become an increasingly important factor. In addition, the trend processes of urbanization, demographic change, and rural reform will all work to lower the current account surplus. Therefore, the authorities believed that the current account surplus would continue to decline modestly in the coming months, leveling off at around 4 percent of GDP by end-2010, a level that was regarded as appropriate for China. If this forecast proves accurate, the resulting undervaluation (as measured by standard methodologies) would be negligible.[2]

B. How can Recent Gains in Consumption Growth be Sustained?

23. ***Context***. The Chinese government has emphasized boosting consumption for more than a decade. During that period, China's consumption growth has indeed been among the strongest of any country (growing on average by more than 8 percent per year). Nevertheless, China has still seen a secular decline in its consumption-output ratio due to rising rates of precautionary saving and a rate of growth of household income that has not kept up with GDP. Last year saw the beginnings of a reversal of this trend and the challenge now will be to sustain and strengthen that dynamic.

Consumption is low as a share of GDP.



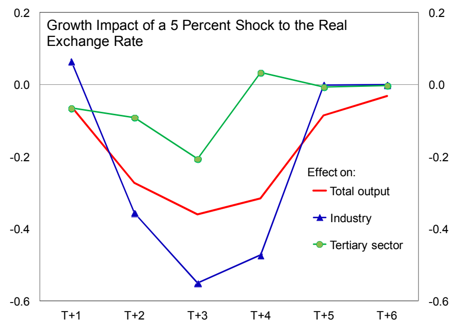
24. ***What does this mean for policies?*** To achieve a sustained rebalancing of the economy, continued progress will be needed in a range of areas:

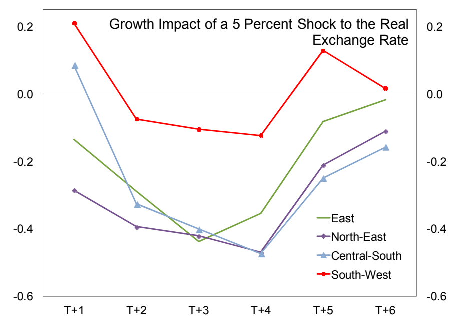
- ***A stronger currency***. An appreciation of the real exchange rate needs to be a key component of the government's medium-term strategy to rebalance toward higher private consumption. The current undervaluation is counterproductive and acts as a headwind to increasing private consumption. A stronger currency will help increase the purchasing power of households, raise the labor share of income, and reorient investment toward those sectors that serve the domestic market. There may be some negative short-term impact on growth and employment (Box 5) but, over time, job gains in the service sector should offset losses in tradable goods industries. The authorities noted that significant progress had already been made in strengthening the currency since 2005. Their expectation was that conditions were already in place for a decisive and permanent shift from external to domestic demand.

[2] In contrast, the current estimates of the IMF's Consultative Group on Exchange Rates are that the renminbi is undervalued by 5 percent (ERER approach), 15 percent (ES approach), and 27 percent (MB approach).

Box 5: The Inter-Provincial Impact of Exchange Rate Changes[1]

Panel data on Chinese provinces was used to examine the impact of exchange rate changes. The database provides for considerable cross-provincial economic diversity in growth, the movement in the real exchange rate (due to cross-province inflation differentials), and in structural factors. This heterogeneity allows for an examination of the different effects of currency movements across regions but also provides useful information on the impact on growth and employment for the economy as a whole.





- An appreciation of the currency in real effective terms has an impact on growth. In particular, a 5 percent appreciation of the exchange rate shaves a cumulative 1 percentage point off of headline growth. The effect lasts for around 2–3 years and then tapers off over time. Those provinces that have had a higher degree of appreciation, all else being equal, have seen slightly lower growth outturns.

- There are considerable geographical disparities in growth responses to a movement in the real exchange rate. For example, Western provinces are much less affected by movements in the exchange rate than the coastal provinces. This, in part, reflects a relatively lower dependence on tradables in the Western provinces than elsewhere. More generally, across provinces, those with a large service sector or greater labor market flexibility appears to be less affected by currency appreciation.

- A real appreciation also effects employment; a 5 percent appreciation lowers employment growth by around ¾ percent.

- The bulk of the adjustment to exchange rate changes is borne by primary and manufacturing industries; there is a relatively little impact on the service sector.

- Not surprisingly, a stronger external environment can help offset the growth impact of movements in the currency.

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[1]See R. Duttagupta, "Are China's Provinces Ready for a Stronger Currency," IMF Working Paper (forthcoming). Similar work can be found in R. Chen and M. Dao, "The Real Exchange Rate and Employment in China," IMF Working Paper (forthcoming).

- ***Financial liberalization***. Important progress has been made in recent years in developing a more market-based financial system in China. Many fixed income markets have been liberalized, including rates on interbank transactions, central bank paper, and repo instruments. In addition, a SHIBOR reference yield curve has been established and markets for corporate bills and bonds continue to expand. Nevertheless, China still uses certain non-market means in order to maintain macroeconomic stability and conduct monetary policy. These include regulated ceilings on deposit rates as well as direct limits on the quantity of new bank lending. This has led to a financial system where the cost of capital is relatively low, credit allocation is sometimes determined by non-price means, and market prices have the potential to become disconnected from underlying fundamentals. Gradually moving to a system where there is an even greater role for markets in the setting of interest rates and determining the pace of loan growth would yield a more efficient allocation of capital, create incentives to favor labor over capital in the means of production, raise household income, and lessen the underlying propensity for asset price bubbles. Doing so, however, would need to be accompanied by continued improvements in banks' risk management systems and strong supervision.

- ***Financial development***. There was broad agreement that continued development of equity markets and corporate bond markets will be an important ingredient to achieving a rebalanced economy. Considerable efforts have been made in this direction in recent years including the introduction of short selling and margin trading, the creation of traded index futures, and further expanding the markets for listing smaller corporations (with the creation of the Growth Enterprise Board last October). There was a common view that further steps could include the promotion of wider share ownership, a simplification of regulatory oversight in various markets, and mechanisms to increase liquidity in a range of markets. In addition, increased availability of a range of financial products—including mutual funds, exchange traded funds, annuities and other insurance products—would be beneficial.

- ***Fiscal support for consumption***. The authorities emphasized that they had already deployed multiple fiscal tools to boost consumption. Staff agreed that these measures had demonstrated significant effects on the economy and encouraged the authorities to go still further. For example, lowering the VAT rate and expanding its base would help increase the marginal incentives to consume. A similar effect could be achieved by reducing the burden of other consumption taxes or by further expanding the system of consumption incentives and subsidies.

- ***Raising household income***. Staff argued that there was also significant scope to reduce the taxation of labor income. To do so would necessarily imply a reduction in social contributions (since personal income tax has only limited coverage). Staff pointed out that social contributions were high (in excess of 40 percent of wages) and regressive. A lower level of contributions would boost household disposable income, lessen inequality, and foster job growth. However, this would also need to be accompanied by greater reliance on other revenue sources to ensure continued financing of social spending. Further increases in transfers to lower income groups and the unemployed could also be considered.

- ***Healthcare.*** China has achieved significant progress over the past several years with near universal coverage of health insurance in urban areas and significantly expanded coverage for rural residents. The government has increased its subsidies to cover health insurance premia, devoted significant resources to build hospitals and community health centers, and has plans already underway to expand the number of healthcare workers through training and other programs. Finally, the government has also introduced coverage for a core set of essential drugs. From 2009–11, through a budgetary investment of Y850 billion (around 2¼ percent of annual GDP), the government aims to achieve universal coverage of basic health services and to reduce the costs borne by patients. These efforts have been important but the authorities indicated there was still a very uneven quality of service delivery and funding across regions, particularly between rural and urban areas. They noted that lessening regional disparities in benefits and the quality of service would require further increases in fiscal resources, particularly to poorer regions. There was general agreement that, going forward, priorities should be to continue to pursue universal healthcare coverage (particularly of rural and migrant workers) and to reduce out-of-pocket expenses through higher reimbursement rates. Other goals were to reduce the medical system's heavy reliance on revenue from drug sales and user fees as well as increasing investments in primary care and community health facilities. Staff also advocated an expansion of benefits to cover catastrophic and chronic illness.

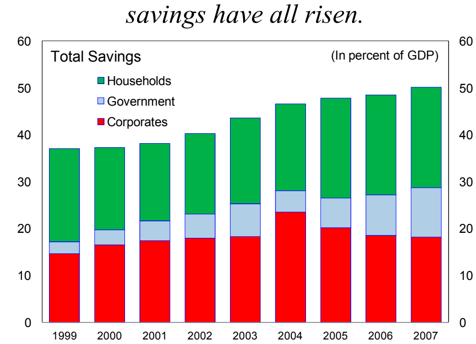
- ***Pensions***. In 2009 the government launched its plan to introduce a new rural pension scheme, financed by the central government, and began pilots in 10 percent of rural counties. By end-2010 it is expected that 23 percent of rural counties will be covered with universal coverage by 2020. Valuable efforts have also been made to increase the regional pooling of pension funds, unify key policy parameters at the provincial level, expand funded individual accounts, and increase the portability of urban pensions. Nonetheless, the pension system remains fragmented with multiple occupational systems that overlay the national rural and urban pension systems. This complexity will prove to be a constraint to a more dynamic labor market. The authorities agreed that reforms would need to focus on continuing to expand coverage to rural and migrant workers, increasing the uniformity of benefits, and putting in place an effective mechanism for intergovernmental transfers to facilitate increased portability. Staff indicated that it would also be important to realize (and deal with) the legacy costs from the current pension system and move toward greater pooling of risks at the national level.

- ***Education***. Despite a relatively low level of public spending on education, China has achieved near universal enrollment and full public funding up to junior secondary education. Staff argued that the next steps could focus on ensuring universal publicly funded education up to the senior secondary school level and improving the quality of and access to education (particularly in poorer areas and to children of migrant workers).

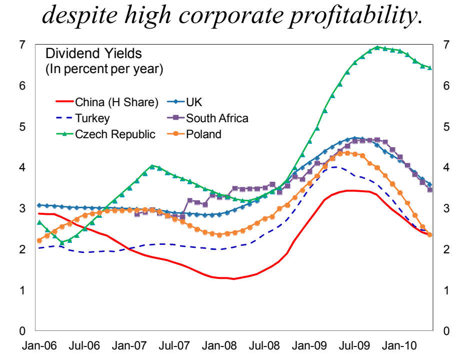
- ***Urbanization***. In China, 18 million people migrate to urban areas each year. Urban areas have less than one-half the population but generate over ¾ of China's consumption. The process of urbanization creates a steadily expanding flow demand for housing, services, and higher productivity jobs. The Chinese government has recognized the tremendous promise that continued urbanization holds for rebalancing the economy, developing the service sector, and maintaining the strong productivity performance that has underpinned China's spectacular growth. The authorities indicated the challenge ahead will be to generate sufficient urban employment to meet the inflows of new workers, to provide affordable housing and public infrastructure in a range of areas (sanitation, transportation, and others), and to tackle the environmental and energy use hurdles associated with a greater urban population. They emphasized the need for careful urban planning and a balanced approach to prioritizing and investing in urban infrastructure. Staff argued for greater efforts to foster labor mobility, including through improvements to the household registration system. There was broad agreement that labor mobility would also be facilitated by greater portability of entitlements and increased national uniformity of social protection schemes.

- ***Tackling high corporate saving***. Corporate savings in China are high. This has been a critical factor in the large current account surpluses of recent years. The reasons for this are multifarious. In part, they are linked to low costs for various factor inputs (including capital, energy, and pollution). This has particularly benefitted highly capital and energy intensive industries in tradable sectors. Market structure is also important with some firms enjoying oligopoly positions in domestic markets. For some smaller companies, uncertain access to future financing has created incentives for precautionary saving to ensure that the resources are on hand to fund profitable projects. Finally, corporations are not subject to the same contestability of ownership that is seen in other systems. This may lead firms to have less incentive to distribute profits in the form of dividends, resulting in higher corporate savings.

Corporate, household, and government savings have all risen.



Average dividend yields in China are low despite high corporate profitability.



25. ***The authorities' view***. The authorities expressed general agreement with the thrust of the structural agenda outlined by staff. They emphasized, and staff agreed, that remarkable changes had taken place in many of these areas over the past few years. Officials underlined the full commitment of the government to make China less reliant on exports and driven more by private consumption. They noted this was a dynamic reform process and certainly not all the reforms had yet been fully deployed; further measures were, nonetheless, being carefully studied. The authorities also noted that China's performance should be judged in an international context. They believed that China had moved at a much faster pace toward strong, sustained, and balanced growth than others in recent years, in part due to the difficult short-term economic and social situation in many of the industrial countries.

IV. Staff Appraisal

26. ***Growth***. The government's policy response to the global financial crisis has been proactive, speedy, and resolute. Its success can be clearly seen in the robust outturn in 2009, where growth exceeded 9 percent despite an over 4 percent of GDP drag on the economy from net external demand. The recovery is well established and a transition from public stimulus to private sector-led growth is underway. Staff projects growth will reach into the double digits this year, decelerating modestly in 2011 as fiscal and monetary stimulus are wound down. These achievements further reinforce China's position as a central driver of global growth.

27. ***Inflation***. At this point in the recovery, there is little evidence that the upswing in inflation is coming from either binding capacity constraints, rapid growth in broad monetary aggregates, or demand pressures. Barring an unforeseen supply shock to food prices, consumer price inflation should peak in mid-year and begin falling in the second half of 2010.

28. ***Monetary policy***. The authorities' target for broad money growth for this year balances well the need to provide continued support to the economy on the one hand and to safeguard the health of bank balance sheets on the other. To achieve the targeted withdrawal of monetary stimulus, benchmark interest rates could be moved higher, liquidity can be absorbed through greater issuance of central bank paper and repo operations, and reserve requirements could be further increased. A more flexible exchange rate will also serve to support this withdrawal of monetary stimulus. Over a longer horizon, the government should consider moving toward the full use of indirect instruments for monetary policy and the phase-out of direct limits on new lending.

29. ***Fiscal policy***. The stimulus package initiated in 2008 has provided essential support to the economy. Fiscal stimulus from the state budget ought to be maintained over the near term but further reoriented, insofar as is possible, away from capital investment and toward measures to raise household income, lessen income inequality, improve the social safety net, and boost consumption. While such measures may not be as fast-acting or with as large a multiplier as infrastructure spending, they are likely to provide more enduring social and

economic benefits, helping to facilitate a rebalancing toward private consumption. In 2011, presuming the current trajectory for the economy is maintained, fiscal stimulus could begin to be gradually phased out and spending on capital projects (both in the budget and through local government financing platforms) can be wound down.

30. ***The exchange rate***. The central bank's recent decision to return to the managed floating regime that was in place prior to the global financial crisis is extremely welcome. This decision affords the central bank considerable flexibility to tighten monetary conditions through an appreciation of the exchange rate. Going forward, the central bank will need to avoid having movements in the real effective exchange rate determined by the relative strength or weakness of the U.S. dollar, particularly given the very different cyclical conditions in the two economies. In addition, unlike in 2005, there is now significantly more liquidity in the global financial system. As China begins to appreciate the renminbi, it will have to confront the prospect of a surge in inflows aiming to circumvent the existing capital control regime. Macroeconomic and prudential policies will need to be attentive to ensuring that such capital flows do not feed rapid price increases in key asset markets or undermine the steady progress made over the past several years to improve the health of the financial system.

Handling near-term risks

31. ***The global context***. The principal near-term risk facing China arises from a renewed downturn in the global economy. If such downsides were realized, China has the flexibility and room to return to an expansionary fiscal stance to offset the shock to external demand. In doing so, a larger weight could be put on budgetary measures to boost private consumption rather than further increases in public infrastructure spending. Over time, medium-term reforms to rebalance the economy toward private consumption will reduce China's reliance on external demand and better insulate the economy from shocks in overseas markets.

32. ***The property sector***. It is probably too early to say that, on a national level, property prices are significantly above fundamentals. However, prices in an increasing number of the larger cities have been rising rapidly and a property bubble is beginning to inflate. Unfettered, this dynamic risks leading to an acceleration of property price inflation followed by a crash in the real estate market. Such a path has been seen repeatedly in other countries. Therefore, the pragmatic deployment of a range of countervailing prudential measures has been fully warranted. Nonetheless, calibrating such a policy response is complicated and carries with it a risk of both over- and under-reaction. The government will have to carefully fine-tune these measures in order to avoid excessively driving down prices or curtailing real estate investment. Recent price increases are, however, a symptom of a deeper, structural problem. In spite of the government's efforts, the propensity for property price inflation and concerns about bubbles will persist. A lasting solution will need to include a combination of structurally higher real interest rates, the introduction of a meaningful property tax to raise the carrying costs of real estate, and broader financial market development to provide

alternative destinations for China's high savings. A property tax would also serve to strengthen local governments' financial positions and lessen their reliance on land sales as a source of revenue.

33. ***Local government finances***. The recent increase in the use of local government investment platforms to finance infrastructure and other projects has been extraordinary. Given the low levels of transparency for many of these operations, the heterogeneous nature of their activities, and the weak fiscal situation of many local governments, inevitably some share of the lending associated with these financing platforms will go bad. It is, however, exceedingly difficult to quantify the risks that such lending could imply for bank balance sheets. Greater transparency is needed. Going forward, all such entities should be required to publish annual, audited financial statements. It is also fully appropriate that the Ministry of Finance, together with the People's Bank of China and CBRC, are now working to build a comprehensive database to better understand these operations. Once available, that data could also be published.

34. ***Credit quality***. Last year's rapid expansion in credit, over time, will likely translate into weaker credit quality and an eventual increase in nonperforming loans; the international history in this context is compelling. Recent efforts to tighten prudential requirements will provide important protection to the banking system. In addition, the apparent financial health of the principal banks should allow them to absorb losses associated with this increased lending. Nonetheless, the expected rise in nonperforming loans will still place strains on bank balance sheets in the coming years. These will need to be closely monitored, particularly for some of the smaller, regional banks.

Rebalancing

35. ***Current account***. The recent decline in the current account surplus has been dramatic. However, international experience indicates that for reversals of current account surpluses to be sustained, there typically needs to be a combination of a real effective appreciation of the currency, macroeconomic policies to support demand, and in some cases, structural reforms to develop the nontradable sectors of the economy. Under currently announced policies and assuming a constant real exchange rate, there is a potential for significant current account surpluses to reappear over the medium term, albeit not of a scale that was seen in 2007.

36. ***A sustained rebalancing***. To achieve and sustain the government's predicted decline in the current account surplus will be an exceptionally complicated exercise in macroeconomic engineering. At this point, the critical mass of policy reforms that will be needed to realize this goal is not yet fully in place. In addition to the commendable efforts already underway, a sustained decline in the current account surplus will require concerted action on multiple fronts.

37. ***A stronger currency***. A stronger renminbi is needed and the recent reform of the exchange rate regime affords the flexibility necessary to undertake this appreciation. It is

possible that shifting resources from the export sector to industries that are more geared toward domestic markets will take time and, in the interim, growth and employment could be moderately lower than would otherwise be the case. This is a valid concern. Nevertheless, given international experience and staff analysis, we are convinced that, over time, job gains, particularly in the service sector, will outweigh near-term losses and the benefits to the Chinese people from a stronger currency will far outweigh the costs.

38. ***Financial liberalization***. Notwithstanding the significant progress made in financial market liberalization, China should work toward an eventual removal of ceilings on deposit rates, to make them more market-determined and responsive to forces of demand and supply. At the same time, the government should move toward a greater reliance on indirect instruments in exercising monetary control, giving up the use of direct limits on bank lending. Unwinding the complex system of controls that are currently in place will take time and will need to be carefully sequenced as well as closely supervised and regulated. It will be particularly critical that, as interest rates are liberalized, this does not translate into an unintended loosening of monetary conditions. Rather, such reforms should be designed carefully in order to lead to a structural increase in real interest rates.

39. ***Financial development***. Moving to a fully market-based system of financial intermediation will need to be accompanied by the development of a broader array of financial markets and instruments. This would offer households alternate investment and insurance products, increase household capital income, and lessen the demand for physical assets—such as housing—as a store of value. Such reforms would support consumption, lower corporate saving, increase employment, improve the allocation of capital, and lessen the likelihood of asset price bubbles. The ongoing FSAP will provide valuable input in articulating a clear roadmap for financial development in the coming years. That assessment will form an integral part of next year's Article IV consultation.

40. ***Fiscal support for consumption***. The recent efforts to provide budgetary incentives to raise household income, lower income inequality, and boost consumption have been effective. However, the underlying momentum in catalyzing consumption needs to be maintained and deepened. To do this, the government could examine ways to lower further the tax burden on both consumption and labor income and further increase transfers to lower income households and the unemployed. Such a reorientation of fiscal policy would have to be designed within the broader context of ensuring a medium-term downward path for the fiscal deficit. As such, supporting consumption and boosting household income may require offsetting actions to raise other revenue sources (for example, from property taxes) and reduce other spending items.

41. ***Social safety nets***. Over the past year, there has been admirable progress in building a more effective system of social insurance in China. Recent efforts to expand pension coverage to rural residents, improve the portability of urban pensions, and increase the quality and availability of health care will be indispensable in lessening household-specific

risk and lowering the motivation for precautionary saving. Further steps could include greater access to high quality health care, particularly for rural residents and migrant workers, an expansion of benefits to cover catastrophic and chronic illness, and a reduction in out-of-pocket expenses for the insured. The government is also right to continue to move toward its goals of universal coverage of the basic pension, with a particular focus on covering rural residents and migrant workers, greater pooling at the national level, and full portability of pension benefits.

42. ***Urbanization***. Fully capitalizing on the potential that urbanization holds will require a range of reforms. Over time, there will need to be a removal of various barriers to labor mobility, an improvement in the household registration system, continued rural land reform, measures to ensure uniform access to education and social protection for all urban residents (particularly migrant workers), and a reexamination of the intergovernmental fiscal system. Effective urbanization also means that the government will need to continue to seek out ways to ensure the availability of affordable housing in urban areas and to prioritize large investments in a range of urban infrastructure. Finally, greater urbanization will bring with it an increased demand for a range of services that has the potential to generate a significant number of jobs. To ensure that a service economy fully develops, barriers to competition and private participation in service industries will need to be sought out and removed.

43. ***Lessening corporate savings***. Realigning relative prices of various factor inputs through increases in the cost of capital, land, electricity, gas, water, and pollution will lower corporate savings, particularly in capital and energy intensive industries. This would be fully in line with the government's own priorities to conserve energy, reduce emissions, and protect the environment. There has already been progress in this direction as domestic petroleum product prices are now more closely linked to global price movements. However, recent moves to reduce VAT rebates to select industries are distortionary and counterproductive. Instead, it would be better for the VAT to be zero-rated for all exports with the objectives of dissuading energy intensive and polluting industries achieved through other means. The government may also wish to consider expanding its program of having state owned enterprises pay dividends to the budget, and ensure that these dividends are used to finance general budget spending (rather than being recycled back into the corporate sector through various means). Efforts ought to be made to ensure there is sufficient competition in domestic markets to avoid companies leveraging their oligopoly positions to generate excess rents. Finally, increasing households' stake in the corporate sector through wider share ownership—both directly and via institutional investors—will allow high corporate saving to translate into increased household wealth. This, in turn, will facilitate higher household consumption.

44. ***Conclusion***. The government's macroeconomic policy response to the crisis has delivered very positive results and mitigated the impact of the global downturn on China's economy. China has also made significant progress in many of the policy areas that have been highlighted in the G-20 Mutual Assessment Process. In doing so, China is contributing

greatly toward ensuring strong, sustained, and balanced global growth. The challenge now lies in calibrating the pace of exit from these crisis measures, particularly in the context of a very uncertain global environment. In addition, there is a broad structural agenda to be accomplished if China is to realize its own goal of making private consumption a central driving force behind growth in the coming years. In achieving that outcome, no policy tool should be left untapped. A stronger currency will be needed but should be viewed not in isolation but rather as a part of the broader package of measures described above.

45. It is proposed that the next Article IV consultation with China takes place on the standard 12-month cycle.

Table 1. China: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010	2011
						Proj.	
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	11.3	12.7	14.2	9.6	9.1	10.5	9.6
Total domestic demand	9.2	11.5	12.7	9.7	14.8	11.5	9.4
Consumption	8.1	9.8	11.1	8.6	9.9	13.2	11.0
Investment	10.6	13.6	14.7	11.0	20.4	9.7	7.6
Fixed	11.9	12.8	13.4	9.7	24.6	10.1	7.9
Inventories 1/	-0.3	0.6	0.8	0.8	-1.0	0.0	0.0
Net exports 1/	2.6	2.0	2.5	0.8	-4.3	-0.5	0.6
Consumer prices							
End of period	1.4	2.0	6.6	2.5	0.7	3.5	2.7
Average	1.8	1.5	4.8	5.9	-0.7	3.5	2.7
Unemployment rate (annual average)	4.2	4.1	4.0	4.2	4.3	4.1	4.0
	(In percent of GDP)						
External debt and balance of payments							
Current account	7.1	9.3	10.6	9.4	6.0	5.0	5.3
Trade balance	5.9	8.0	9.0	8.0	5.0	4.0	4.5
Exports of goods	33.8	35.7	34.9	31.7	24.1	30.3	32.9
Imports of goods	27.8	27.7	25.9	23.8	19.1	26.3	28.5
Gross external debt	12.5	11.9	10.7	8.3	8.6	8.9	8.7
Saving and investment							
Gross domestic investment	42.1	43.0	41.7	44.0	47.7	50.0	49.2
National saving	49.2	52.3	52.4	53.5	53.6	55.0	54.5
Government	6.3	8.7	10.5	9.9	9.9	8.8	9.1
Non-Government	42.9	43.6	41.9	43.6	43.7	46.2	45.5
Public sector finance							
General government gross debt	17.6	16.5	19.8	16.8	18.6	20.1	19.9
General government balance	-1.4	-0.7	0.9	-0.4	-3.0	-3.0	-2.0
	(Annual percentage change)						
Real effective exchange rate	-0.3	2.2	5.0	8.5	2.7	…	…

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

1/ Contribution to annual growth in percent.

Table 2. China: Balance of Payments

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

	2005	2006	2007	2008	2009	2010	2011
						Proj.	
Current account balance	160.8	253.3	371.8	426.1	297.1	265.8	313.1
Trade balance	134.2	217.7	315.4	360.7	249.5	211.7	265.6
Exports	762.5	969.7	1,220.0	1,434.6	1,203.8	1,610.4	1,947.7
Imports (BOP basis)	628.3	751.9	904.6	1,073.9	954.3	1,398.8	1,682.1
Services	-9.4	-8.8	-7.9	-11.8	-29.4	-56.5	-66.7
Income	10.6	15.2	25.7	31.4	43.3	54.3	51.6
Current transfers	25.4	29.2	38.7	45.8	33.7	56.4	62.7
Capital and financial account balance	63.0	6.7	73.5	19.0	144.8	45.1	-20.2
Capital account	4.1	4.0	3.1	3.1	4.0	3.7	3.7
Financial account	58.9	2.6	70.4	15.9	140.8	41.5	-23.8
Net foreign direct investment	67.8	56.9	121.4	94.3	34.3	12.7	-2.0
Inward investment (net)	79.1	78.1	138.4	147.8	78.2	66.5	59.8
Abroad	-11.3	-21.2	-17.0	-53.5	-43.9	-53.7	-61.8
Portfolio investment	-4.9	-67.6	18.7	42.7	38.7	-11.4	-11.4
Assets	-26.2	-110.4	-2.3	32.7	9.9	-20.1	-20.1
Liabilities	21.2	42.9	21.0	9.9	28.8	8.7	8.7
Other investment	-4.0	13.3	-69.7	-121.1	67.8	40.2	-10.4
Assets 1/	-48.9	-31.9	-151.5	-106.1	9.4	4.7	-45.9
Liabilities	44.9	45.1	81.8	-15.0	58.4	35.5	35.5
Errors and omissions 2/	26.9	24.8	15.4	34.5	-43.4	0.0	0.0
Overall balance	250.6	284.8	460.7	479.5	398.5	311.0	293.0
Reserve assets	-250.6	-284.8	-460.7	-479.5	-398.5	-311.0	-293.0
Memorandum items:							
Current account, as percent of GDP	7.1	9.3	10.6	9.4	6.0	5.0	5.3
Export growth (value terms)	28.5	27.2	25.8	17.6	-16.1	33.8	20.9
Import growth (value terms)	17.6	19.7	20.3	18.7	-11.1	46.6	20.3
FDI (inward), as a percent of GDP	3.5	2.9	4.0	3.3	1.6	1.3	1.0
External debt	281.1	323.0	373.6	374.7	428.6	472.7	516.8
As a percent of GDP	12.5	11.9	10.7	8.3	8.6	8.9	8.7
Short-term external debt (remaining maturity)	156.1	183.6	220.1	210.8	259.3	291.2	323.2
Gross reserves	825.6	1,110.4	1,571.1	2,050.6	2,449.1	2,760.1	3,053.0
As a percent of ST debt by remaining maturity	528.7	604.7	713.8	972.8	944.7	947.8	944.7
Real effective exchange rate (1990 = 100)	92.4	94.5	99.2	107.5	110.4	…	…
Net international investment position	407.7	640.2	1,188.1	1,493.8	1,821.9	…	…
In percent of GDP	18.1	23.6	34.0	33.0	36.5	…	…
Nominal GDP	2,256.9	2,712.9	3,494.2	4,520.0	4,984.7	5,317.6	5,911.2

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

1/ 2005 include bank capitalization and foreign exchange swap, estimated at US$28.8 billion.
2/ Includes counterpart transaction to valuation changes.

Table 3. China: Indicators of External Vulnerability

	2003	2004	2005	2006	2007	2008	2009
Monetary and financial indicators							
General government domestic debt (official data; in percent of GDP)	19.2	18.5	17.6	16.2	19.6	17.0	17.7
Broad money (M2: annual percentage change)	19.6	14.9	16.3	17.0	16.7	17.8	27.6
Foreign currency deposits to broad money (percent)	5.6	5.0	4.4	3.6	2.9	2.6	2.4
Credit (annual percentage change)	21.1	14.5	13.0	15.1	16.1	18.7	31.7
Foreign currency loans to credit to the economy (in percent)	5.2	5.0	4.9	4.5	4.7	4.4	5.2
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	1,911.8	3,437.5
Stock exchange capitalization (percent of GDP)	31.4	23.4	24.5	48.9	130.2	46.0	82.4
Number of listed companies (A-share)	1,261.0	1,349.0	1,355.0	1,398.0	1,507.0	1,581.0	1,678.0
Balance of payments indicators							
Exports (annual percentage change, U.S. dollars)	34.6	35.4	28.5	27.2	25.8	17.6	-16.1
Imports (annual percentage change, U.S. dollars)	-39.8	-35.8	-17.6	-19.7	-20.3	-18.7	11.1
Current account balance (percent of GDP)	2.8	3.6	7.1	9.3	10.6	9.4	6.0
Capital and financial account balance (percent of GDP)	3.2	5.7	2.8	0.2	2.1	0.4	2.9
Of which: gross foreign direct investment inflows	2.9	2.8	3.5	2.9	4.0	3.3	1.6
Unidentified capital flows 2/	…	…	…	…	…	…	…
Reserve indicators							
Gross reserves (billions of U.S. dollars)	412.2	618.6	825.6	1,110.4	1,571.1	2,050.6	2,449.1
Gross reserves to imports of GNFS (months)	8.2	10.4	11.6	12.9	15.3	22.1	18.0
Gross reserves to broad money (M2) (percent)	15.4	20.1	22.9	25.6	29.6	30.0	27.6
Gross reserves to short-term external debt by remaining maturity (percent)	447.6	502.1	528.7	604.7	713.8	972.8	944.7
External debt and balance sheet indicators 2/							
Total external debt (percent of GDP)	12.7	12.8	12.5	11.9	10.7	8.3	8.6
Total external debt (billions of U.S. dollars)	208.7	247.5	281.1	323.0	373.6	374.7	428.6
Of which: public and publicly guaranteed debt 3/	52.8	33.6	33.0	34.4	34.9	33.3	36.9
Banking sector debt	58.6	97.6	101.9	120.0	126.6	126.3	132.4
Short-term external debt by original maturity (billions of U.S. dollars)	92.2	123.2	156.1	183.6	220.1	210.8	259.3
Net foreign assets of banking sector (billions of U.S. dollars)	85.5	108.2	161.4	205.2	190.1	251.0	204.5
Total debt to exports of GNFS (percent)	43.0	37.7	33.6	30.4	27.8	23.7	32.1
Total debt service to exports of GNFS (percent) 4/	17.0	19.6	19.3	17.8	16.8	13.7	19.8
Of which: Interest payments to exports of GNFS (percent) 4/	1.1	0.8	0.6	0.5	0.4	0.3	0.4
Bond spread (EMBI China, end of period, basis points)	58.0	57.0	68.0	51.0	120.0	228.0	64.0
Foreign-currency sovereign bond ratings							
Moody's	A2	A2	A2	A2	A1	A1	A1
Standard and Poor's	BBB	BBB+	A-	A	A	A	A
Memorandum items:							
International investment position	….	276.4	407.7	640.2	1,188.1	1,493.8	1,821.9
Nominal GDP (billions of U.S. dollars)	1,641.0	1,931.6	2,256.9	2,712.9	3,494.2	4,520.0	4,984.7
Exports of GNFS (billions of U.S. dollars)	485.0	655.8	836.9	1,061.7	1,342.2	1,581.7	1,333.3
Real effective exchange rate (annual percentage change)	-6.6	-2.7	-0.3	2.2	5.0	8.5	2.7

Sources: CEIC Data Co.; 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 4. China: Monetary Developments

	2005	2006	2007	2008	2009	2010		
						Jan	Feb	Mar
				(In billions of yuan)				
Net foreign assets	7,570.0	10,086.5	13,775.1	17,897.1	19,853.2	19,866.2	20,002.4	20,228.0
Net domestic assets	22,268.0	24,473.9	26,569.1	29,619.6	40,769.3	42,694.8	43,604.8	44,766.7
Domestic credit 1/	24,837.0	28,873.8	33,965.9	37,937.9	49,588.9	50,345.1	51,244.9	52,101.8
Net credit to government	1,520.0	1,535.0	2,820.8	2,943.5	3,229.0	2,770.0	2,922.6	2,931.8
Credit to non-government	23,317.0	27,338.7	31,145.1	34,994.4	46,359.9	47,575.1	48,322.3	49,169.9
Other items, net 1/	-2,568.0	-693.8	1,128.1	766.6	106.8	-1,132.6	-1,208.1	-1,598.2
Broad money	29,838.0	34,560.4	40,344.2	47,516.7	60,622.5	62,560.9	63,607.2	64,994.7
Reserve money	6,434.3	7,775.8	10,154.5	12,922.2	14,398.5	14,282.0	15,262.9	15,003.3
Of which:								
Required reserves	2,040.1	2,866.8	5,409.5	6,614.2	8,519.7	9,065.2	9,491.3	9,773.9
Excess reserves	1,799.1	1,979.1	1,432.1	2,596.4	1,723.2	781.9	952.9	945.8
Net foreign assets of PBC	6,269.8	8,484.6	12,387.8	16,181.1	18,457.1	18,727.5	18,881.2	19,137.2
Net domestic assets of PBC	154.0	-708.8	-2,233.3	-3,258.9	-4,058.6	-4,445.5	-3,618.2	-4,133.9
				(Twelve-month percentage change)				
Net foreign assets 2/	8.0	8.4	10.7	10.2	4.1	3.9	3.8	3.8
Net domestic assets	12.6	9.9	8.6	11.5	37.6	34.8	33.9	28.4
Domestic credit 3/	10.7	16.3	17.6	11.7	30.7	27.4	26.2	21.9
Of which: loans	13.0	26.6	19.3	14.0	34.2	31.0	29.7	24.8
Other items, net 2/ 3/	-3.2	6.3	5.3	-0.9	-1.4	-3.0	-3.3	-3.5
Broad money 4/	17.9	15.8	16.7	17.8	27.6	26.1	25.5	22.5
Including foreign currency deposits	17.2	15.0	15.9	17.4	27.3	25.6	25.1	22.1
M1 4/	11.8	17.5	21.0	9.0	32.4	39.0	35.0	29.9
M0 4/	11.9	12.6	12.2	12.7	11.8	-0.8	22.0	15.8
Quasi money	21.8	16.3	14.3	23.1	25.0	19.7	20.9	18.8
Reserve money	9.3	20.8	30.6	27.3	11.4	10.2	21.7	20.7
Net foreign assets of PBC 5/	36.5	35.4	45.5	30.2	14.0	14.8	14.8	15.7
Net domestic assets of PBC 5/	-17.7	-11.2	-15.0	-7.9	-5.6	-7.8	1.8	-0.2
Reserve ratios 6/								
Required reserves	7.5	9.0	14.5	15.0	15.0	15.5	16.0	16.0
Excess reserves	4.2	4.8	3.3	5.1	…	…	…	…
Memorandum items:								
Money multiplier	4.6	4.4	4.0	3.7	4.2	4.4	4.2	4.3
Forex deposits of residents (US$ billion)	161.6	161.1	159.9	179.1	208.9	209.3	211.8	213.4
In percent of total deposits	4.3	3.6	2.9	2.6	2.3	2.3	2.3	2.2
Forex loans of residents (US$ billion)	150.5	166.4	219.8	243.7	379.5	388.8	398.6	408.3

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

1/ 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/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.
4/ The growth rates are based on official announcements, which correct for the definitional changes in the series.
5/ Twelve-month change as a percent of beginning-period reserve money stock.
6/ In percent of total bank deposits.

Table 5. China: General Government Budgetary Operations

	2005	2006	2007	2008	2009	2010	2011
						Proj.	
			(In billions of yuan)				
Revenue	3,184	3,944	5,262	6,173	6,817	7,438	8,580
Tax revenue	2,878	3,480	4,562	5,422	5,952	6,695	7,744
Taxes on income and profits	750	954	1,196	1,490	1,548	1,746	2,007
Taxes on goods and services	1,666	1,980	2,426	2,819	3,226	3,845	4,369
Other taxes (residual)	339	424	745	784	905	770	992
Nontax revenue (residual)	306	464	700	750	866	743	836
Expenditure	3,441	4,090	5,023	6,294	7,832	8,546	9,408
Primary	3,360	3,993	4,917	6,138	7,672	8,364	9,194
Interest	82	98	105	157	160	181	214
Overall balance	-257	-146	239	-122	-1,015	-1,108	-828
Financing	257	146	-239	122	2,041	1,108	828
Domestic	255	153	-239	122	2,041	1,108	828
External	2	-6	0	0	0	0	0
Privatization and other	0	0	0	0	0	0	0
Memo: Authorities' definition							
Revenue	3,165	3,876	5,132	6,133	6,848	7,469	8,560
Expenditure	3,393	4,042	4,978	6,259	7,587	8,311	9,373
Overall balance	-228	-166	154	-126	-740	-842	-813
			(In percent of GDP)				
Revenue	17.2	18.2	19.8	19.7	20.0	20.0	20.5
Tax revenue	15.6	16.1	17.2	17.3	17.5	18.0	18.5
Taxes on income and profits	4.1	4.4	4.5	4.7	4.5	4.7	4.8
Taxes on goods and services	9.0	9.2	9.1	9.0	9.5	10.3	10.4
Other taxes (residual)	1.8	2.0	2.8	2.5	2.7	2.1	2.4
Nontax revenue (residual)	1.7	2.1	2.6	2.4	2.5	2.0	2.0
Expenditure	18.6	18.9	18.9	20.0	23.0	23.0	22.5
Primary	18.2	18.5	18.5	19.5	22.5	22.5	22.0
Interest	0.4	0.5	0.4	0.5	0.5	0.5	0.5
Overall balance	-1.4	-0.7	0.9	-0.4	-3.0	-3.0	-2.0
Financing	1.4	0.7	-0.9	0.4	6.0	3.0	2.0
Domestic	1.4	0.7	-0.9	0.4	6.0	3.0	2.0
External	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Debt	17.6	16.2	19.6	17.0	17.7	19.2	19.0
Domestic	17.2	15.9	19.4	16.8	17.5	19.1	18.9
External	0.4	0.3	0.2	0.2	0.1	0.1	0.1
Cyclically adjusted balance							
(percent of potential GDP)	-1.0	-0.6	0.3	-0.9	-3.2	-3.3	-2.2
Nominal GDP (yuan billions)	18,494	21,631	26,581	31,405	34,051	37,151	41,811
Authorities' definition							
Revenue	17.1	17.9	19.3	19.5	20.1	20.1	20.5
Expenditure	18.3	18.7	18.7	19.9	22.3	22.4	22.4
Overall balance	-1.2	-0.8	0.6	-0.4	-2.2	-2.3	-1.9

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

Table 6. China: Illustrative Medium-Term Scenario 1/

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
					Projections					
					(Percent change)					
Real GDP	12.7	14.2	9.6	9.1	10.5	9.6	9.5	9.5	9.5	9.5
Total domestic demand	11.5	12.7	9.7	14.8	11.5	9.4	9.1	9.0	8.9	8.9
Consumption	9.8	11.1	8.6	9.9	13.2	11.0	10.9	10.7	10.4	10.3
Investment	13.6	14.7	11.0	20.4	9.7	7.6	7.1	7.1	7.1	7.2
Fixed	12.8	13.4	9.7	24.6	10.1	7.9	7.4	7.3	7.3	7.4
Inventories 2/	0.6	0.8	0.8	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 2/	2.0	2.5	0.8	-4.3	-0.5	0.6	0.8	0.8	0.9	1.0
Consumer prices (average)	1.5	4.8	5.9	-0.7	3.5	2.7	2.0	2.0	2.0	2.0
					(In percent of GDP)					
Total capital formation	43.0	41.7	44.0	47.7	50.0	49.2	48.3	47.4	46.5	45.6
Gross national saving	52.3	52.4	53.5	53.6	55.0	54.5	54.2	53.9	53.7	53.6
Fiscal balance	-0.7	0.9	-0.4	-3.0	-3.0	-2.0	-1.3	-0.9	-0.4	0.1
Revenue	18.2	19.8	19.7	20.0	20.4	20.9	21.6	22.1	22.6	23.2
Expenditure	18.9	18.9	20.0	23.0	23.4	22.9	23.0	23.0	23.1	23.1
Current account balance	9.3	10.6	9.4	6.0	5.0	5.3	5.8	6.5	7.2	8.0
					(In billions of U.S. dollars)					
Current account balance	253	372	426	297	266	313	386	482	594	736
Trade balance	218	315	361	250	212	266	331	409	511	643
Exports	970	1,220	1,435	1,204	1,610	1,948	2,268	2,644	3,099	3,645
(Percent change)	27	26	18	-16	34	21	16	17	17	18
Imports	752	905	1,074	954	1,399	1,682	1,936	2,235	2,587	3,003
(Percent change)	20	20	19	-11	47	20	15	15	16	16
Capital and financial account, net	7	74	19	145	45	-20	-131	-192	-284	-348
Capital account	4	3	3	4	4	4	4	4	4	4
Direct investment, net	57	121	94	34	13	-2	-17	-33	-50	-64
Portfolio investment, net	-68	19	43	39	-11	-11	-56	-101	-176	-226
Other investment, net	13	-70	-121	68	40	-10	-61	-61	-61	-61
Errors and omissions	25	15	34	-43	0	0	0	0	0	0
Change in reserves (- indicates increase)	-285	-461	-480	-399	-311	-293	-255	-290	-309	-388
Memorandum item:										
Nominal GDP (in billions of yuan)	21,631	26,581	31,405	34,051	37,151	41,811	46,849	52,364	58,533	65,391

Sources: Data provided by the Chinese authorities; CEIC Data Co.; 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.
2/ Contribution to annual growth in percent.

Table 7. China: Public Sector Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	2006	2007	2008	2009			2010	2011	2012	2013	2014	2015
							I. Baseline Projections					
Public sector debt 1/	16.2	19.6	17.0	17.7			36.0	42.9	48.5	53.4	57.5	61.0
Of which : foreign-currency denominated	0.3	0.2	0.2	0.1			0.1	0.1	0.1	0.1	0.1	0.1
Change in public sector debt	-1.4	3.4	-2.6	0.7			18.3	6.9	5.6	4.9	4.1	3.5
Identified debt-creating flows (4+7+12)	-2.4	-4.7	-3.4	1.7			17.9	7.0	5.7	4.9	3.3	2.6
Primary deficit	0.2	-1.3	-0.1	2.5			2.1	0.8	0.0	-0.7	-1.3	-2.0
Revenue and grants	18.2	19.8	19.7	20.0			20.0	20.5	21.2	21.7	22.2	22.72
Primary (noninterest) expenditure	18.5	18.5	19.5	22.5			22.1	21.3	21.2	21.0	20.9	20.7
Automatic debt dynamics 2/	-2.6	-3.5	-3.3	-0.9			-1.0	-2.7	-3.1	-3.5	-4.7	-5.0
Contribution from interest rate/growth differential 3/	-2.1	-2.6	-2.5	-0.8			-1.0	-2.8	-3.3	-3.5	-3.9	-4.1
Of which : contribution from real interest rate	-0.2	-0.7	-0.9	0.6			0.7	0.3	0.4	0.6	0.7	0.8
Of which : contribution from real GDP growth	-1.9	-1.9	-1.6	-1.4			-1.7	-3.1	-3.7	-4.1	-4.5	-4.9
Contribution from exchange rate depreciation 4/	-0.5	-0.8	-0.8	0.0			0.0	0.1	0.1	0.1	-0.8	-0.9
Other identified debt-creating flows	0.0	0.0	0.0	0.0			16.8	9.0	8.9	9.1	9.3	9.6
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			16.8	9.0	8.9	9.1	9.3	9.6
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)	1.0	8.2	0.7	-0.9			0.4	-0.1	-0.1	-0.1	0.8	1.0
Public sector debt-to-revenue ratio 1/	88.8	99.0	86.3	88.4			179.7	209.2	228.7	245.8	258.7	268.6
Gross financing need 5/	3.7	1.2	2.6	5.2			5.3	4.4	3.7	3.1	2.5	1.8
In billions of U.S. dollars	99.2	43.5	117.1	257.5			289.0	266.3	250.2	236.3	214.6	173.8
					10-Year Historical Average	10-Year Standard Deviation						
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	12.7	14.2	9.6	9.1	10.4	2.4	10.5	9.6	9.5	9.5	9.5	9.5
Average nominal interest rate on public debt (in percent) 6/	3.0	3.0	3.0	3.0	3.8	1.4	3.0	3.8	3.6	3.6	3.7	3.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.8	-4.6	-4.8	3.6	0.1	4.1	4.2	1.1	1.3	1.5	1.6	1.7
Exchange rate (LC per U.S. dollar)	7.8	7.3	6.8	6.8	7.9	0.5	6.8	6.8	6.9	6.9	6.7	6.7
Nominal depreciation of local currency (LC per dollar)	-3.2	-6.5	-6.4	-0.1	-1.7	2.7	-0.2	0.2	0.4	0.2	-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)	3.3	6.9	6.9	0.1	1.8	2.9	0.2	-0.2	-0.4	-0.2	1.8	1.8
Inflation rate (GDP deflator, in percent)	3.8	7.6	7.8	-0.6	2.9	3.4	-1.2	2.7	2.3	2.1	2.1	2.1
Growth of real primary spending (deflated by GDP deflator, in percent)	14.5	14.4	15.8	25.8	15.3	4.1	8.5	5.4	9.1	8.6	8.7	8.7
Primary deficit	0.2	-1.3	-0.1	2.5	1.4	1.4	2.1	0.8	0.0	-0.7	-1.3	-2.0
							II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios												
A1. Key variables are at their historical averages in 2010–15 7/							34.6	41.6	47.8	53.6	59.0	65.0
A2. No policy change (constant primary balance) in 2010–15							33.5	45.4	53.3	61.1	68.3	76.5
B. Bound tests												
B1. Real interest rate is at baseline plus one standard deviations							36.3	43.9	50.2	55.9	60.8	66.1
B2. Real GDP growth is at baseline minus one-half standard deviation							36.6	44.5	51.5	58.0	64.1	70.9
B3. Primary balance is at baseline minus one-half standard deviation							36.7	44.2	50.4	55.8	60.4	65.3
B4. Combination of B1-B3 using one-quarter standard deviation shocks							36.7	44.5	51.1	57.1	62.3	68.0
B5. One time 30 percent real depreciation in 2010 8/							42.2	48.7	53.9	58.4	62.0	65.2
B6. 10 percent of GDP increase in other debt-creating flows in 2010							46.0	52.2	57.1	61.3	64.7	68.7

1/ Coverage of public sector refers to gross debt of the budgetary general government. Official NPLs on bank's balance sheets were about 1.5 percent of GDP at end 2009, although this does not include the Y820 billion (2½ percent of GDP) carved out during the 2008 reform of the Agricultural Bank of China, and the unknown residual losses still held by the AMCs on their legacy loans. It is assumed around one third of the NPL stock each year is resolved, achieving a recovery rate of about 20 percent, with the resulting loss added to public debt in the forecast period. Future NPLs are conservatively assumed to be higher from lending in 2009 and 2010, of which 20 percent is eventually recovered. Unfunded pension liabilities (as part of a transition) are assumed to be covered each year by the budget in 2010−15; interest will also be paid on these and the bonds issued to cover NPLs.

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 $r - \pi (1+g)$ 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/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

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APPENDIX: DRAFT PUBLIC INFORMATION NOTICE

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IMF Executive Board Concludes 2010 Article IV Consultation with China

On July 26, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with China.[1]

Background

China was hit hard by the global financial crisis. However, the authorities quick, determined, and effective policy response has helped mitigate the impact on the economy and ensured that China has led the global recovery.

Public infrastructure spending was quickly increased, taxes were lowered, the government put in place incentives to boost purchases of consumer durables, and pensions, social transfers, healthcare and education spending were all raised. At the same time, interest rates and reserve requirements were lowered and limits on credit growth were removed, leading to an extraordinary surge in bank lending.

[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.

These policies were instrumental in arresting the downward momentum to both activity and confidence. Growth began to pick up in the second quarter of 2009 and reached an average for the year of 9.1 percent. Inflation moved into negative territory for much of 2009 but has since registered a modest increase, the bulk of which has been directly attributable to higher food prices. In the 12 months to May, the nominal effective exchange rate has depreciated by 1¼ percent while the real effective exchange rate has depreciated by 0.1 percent.

China's recovery had significant positive spillovers to the region and the global economy, initially through increased demand for commodities—contributing to an upswing in global commodity prices—and later through higher imports of capital goods. The balance of payments saw a dramatic shift with the current account falling quickly as exports slowed and imports surged. Despite the lower current account, reserve accumulation has continued to be rapid.

With the recovery becoming increasingly well established, the government has begun to unwind some of its crisis response measures. Credit growth has been slowed, reserve requirements were modestly increased, and prudential requirements related to property lending were tightened. The government also announced that it was returning to the managed floating regime that had been in place from July 2005 to July 2008. Fiscal policy, however, continues to provide important support to the economy.

Executive Board Assessment

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. China: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010 Proj.
	(Annual percentage change, unless otherwise specified)					
National accounts and employment						
Real GDP	11.3	12.7	14.2	9.6	9.1	10.5
Total domestic demand	9.2	11.5	12.7	9.7	14.8	11.5
Consumption	8.1	9.8	11.1	8.6	9.9	13.2
Investment	10.6	13.6	14.7	11.0	20.4	9.7
Fixed	11.9	12.8	13.4	9.7	24.6	10.1
Inventories 1/	-0.3	0.6	0.8	0.8	-1.0	0.0
Net exports 1/	2.6	2.0	2.5	0.8	-4.3	-0.5
Consumer prices						
End of period	1.4	2.0	6.6	2.5	0.7	3.5
Average	1.8	1.5	4.8	5.9	-0.7	3.5
Unemployment rate (annual average)	4.2	4.1	4.0	4.2	4.3	4.1
	(In percent of GDP)					
External debt and balance of payments						
Current account	7.1	9.3	10.6	9.4	6.0	5.0
Trade balance	5.9	8.0	9.0	8.0	5.0	4.0
Exports of goods	33.8	35.7	34.9	31.7	24.1	30.3
Imports of goods	27.8	27.7	25.9	23.8	19.1	26.3
Gross external debt	12.5	11.9	10.7	8.3	8.6	8.9
Saving and investment						
Gross domestic investment	42.1	43.0	41.7	44.0	47.7	50.0
National saving	49.2	52.3	52.4	53.5	53.6	55.0
Government	6.3	8.7	10.5	9.9	9.9	8.8
Non-Government	42.9	43.6	41.9	43.6	43.7	46.2
Public sector finance						
General government gross debt	17.6	16.5	19.8	16.8	18.6	20.1
General government balance	-1.4	-0.7	0.9	-0.4	-3.0	-3.0
	(Annual percentage change)					
Real effective exchange rate	-0.3	2.2	5.0	8.5	2.7	…

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

1/ Contribution to annual growth in percent.