

**FOR
AGENDA**

SM/11/139

Correction 1

July 11, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Staff Report for the 2011 Article IV Consultation**

The attached corrections to SM/11/139 (6/28/11) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 9, right column, paragraph 8: for “Staff and the authorities did not see imminent risks” read “Staff did not see imminent risks”

Page 12, left column, paragraph 12, line 6: for “to unwind the fiscal stimulus” read “to gradually unwind the fiscal stimulus”

Page 17, right column, paragraph 21, line 2: for “there remain important distortions” read “there remain distortions”

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 5, right column, paragraph 3, line 11: for “the use of price controls for some items” read “the use of existing price controls on some items”

Page 6, Box 1, right column, second paragraph, line 4: for “of the urban population” read “of urban households”

Page 9, right column, line 1: for “(developers and mortgages)” read “(developers and household mortgages)”

Page 10, added to sources: “Benchmark house price is derived from a no-arbitrage condition equating rental to home-ownership costs.”

Page 11, left column, paragraph 9, line 3: for “the central bank” read “the central bank and the bank regulatory agency”

Page 12, left column, paragraph 12, line 21: for “to raise the minimum income threshold” read “to raise the minimum threshold”

Page 16:

left column, paragraph 18, line 9: for “a new rural social pension system has been introduced which will cover 60 percent of counties by end-year” read “a new rural social pension system has been introduced and now covers 60 percent of counties”

line 15: for “about to launch a new social pension scheme for the urban unemployed” read “about to expand the existing social pension scheme to include the urban unemployed”

right column, text box:

Bullet 3, line 2: for “for the urban unemployed” read “for urban residents”

Bullet 5, line 1: for “Expanded subsidies” read “Increased subsidies”

Page 24, Box 5, right column, second paragraph, line 9: for “smaller companies” read “small- and medium-size companies”

Page 29, Box 6, bullet 2, line 2: for “mandates for the regulatory agencies” read “mandates for the central bank and regulatory agencies”

Page 33: Text table updated

Pages 41–43, Tables 1–3: updated to correct factual errors

Pages 45–47, Tables 5–7: updated to correct factual errors

Page 50, Draft PIN, Table 1: updated to correct factual errors

Evident Ambiguity

Page 30, Box 7, left column:

Bullet 1, line 9: for “consider authorizing bank trading of bonds on the stock exchanges and allowing corporate bond issuers to decide” read “consider permanently authorizing bank trading of bonds on the stock exchanges and allowing corporate bond issuers that meet the appropriate (disclosure-based) listing standards to decide”

Bullet 2, line 5: for “able to rollover” read “able to automatically rollover”

Bullet 3, last line: for “should be addressed with the current free float of shares expanded” read “should be addressed and the current free float of shares in public companies expanded”

Typographical Error

Page 48, Draft Public Information Notice, Title: for “IMF Executive Board Concludes 2010 Article IV Consultation with China” read “IMF Executive Board Concludes 2011 Article IV Consultation with People’s Republic of China”

Questions may be referred to Mr. Chalk (ext. 38281), Mr. Barnett (ext. 34439), Mr. Ahuja (ext. 35464), Mr. N’Diaye (ext. 39751), Mr. Nabar (ext. 39024), and Ms. Geng (ext. 34097) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (20)

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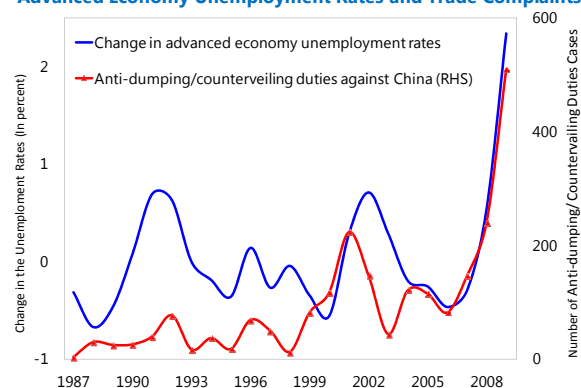
THE NEAR-TERM POLICY CHALLENGES

A. Overheating and Inflation

1. **The global context.** The authorities indicated that they saw multiple downside risks to the global outlook. In particular, officials underlined the inward spillovers and risks to China arising from high levels of public debt in the United States, the United Kingdom, and elsewhere; the slow pace of recovery in many large industrial economies; and the increasing divergence across the European Union (particularly related to sovereign risks in the Euro periphery). They also reiterated their concerns about the scale of global liquidity and the potential for increased volatility in capital flows. Finally, they pointed to the counter-productive rise in trade protectionism in recent years, linking it to sub-par growth in the larger economies. It was against this global backdrop that the 12th Five-Year Plan had been prepared (Box 1) and macroeconomic and financial policies were being decided.

Trade frictions rose during the global recession

Advanced Economy Unemployment Rates and Trade Complaints



2. **Growth.** Despite the external risks, China's economy remains on a solid footing,

propelled by vigorous domestic and external demand. Wage and employment increases have fueled consumption, the expansion in infrastructure and real estate construction has driven investment upward, and net exports are once again contributing positively to economic growth (Figure 1). There has been some sequential slowdown in activity in recent months, in part a result of policy tightening, but this had already been built into staff forecasts.

3. **Inflation.** Over the past year, consumer price inflation has been a pressing social and economic issue. At end-May, inflation was 5½ percent with a broadening of price pressures beyond just fresh food (Figure 2). The authorities indicated that they have responded to the upswing in inflation with a range of policy measures including monetary tightening, efforts to increase food supply and deal with transportation bottlenecks, as well as the use of existing price controls on some items. It now looks as if the supply shocks that precipitated the recent inflationary upturn are dissipating and the policy measures taken to counter price pressures are having an impact. Barring further food price shocks, and assuming the ongoing tightening of monetary policy is continued, there was general agreement that inflation should soon peak although there were still upside risks to inflation, mostly from adverse weather conditions affecting food prices and

from higher global commodity prices. Staff also noted that some part of current inflation was likely being suppressed by administrative measures. This may stifle the appropriate

supply response to higher prices and could lead to the inflationary dynamic showing more inertia and persistence during this cycle.

Box 1. Highlights From China's 12th Five-Year Plan

Coverage. The 12th Five-Year Plan is a high level strategic document that outlines the directions for policy and reform in the coming years and sets specific targets on certain areas (such as growth, urbanization, energy use, and others). In many areas, though, the plan does not yet detail the concrete steps that will be put in place to achieve these social and economic goals.

Themes. Rebalancing growth from exports to consumption remains a central theme of the plan with an emphasis on "accelerating the transformation of the pattern of economic development" by enhancing productivity, supporting innovation, and investing in human capital. The priority has also shifted away from the absolute level of growth toward its quality and impact on "people's livelihood."

Internal balance. The government has promised increased support for agriculture and the service sector as well as a more balanced regional development by harnessing urbanization and supporting the relocation of industries to the interior.

Household income. To boost consumption, the plan targets a needed growth in disposable income—for both urban and rural residents—that outstrips that for the economy as a whole, reversing the secular decline in household income as a share of GDP.

Safety net. There are plans to further increase the coverage of the health and pension systems and provide low income housing for up to 20 percent of urban households.

Technology and environment. The plan targets moving up the value chain in manufacturing through technological upgrade and promoting investment in strategic industries. There is also a continued emphasis on clean energy and increases in input costs to better price pollution externalities.

Financial reform. Over the next five years, the government intends to move toward more market-based interest rates and capital account convertibility.

4. **Labor.** Official data shows double-digit increases in nominal wages and there are signs of labor mismatches, both geographically and skills-related. There is, however, significant heterogeneity across the labor market. Anecdotal indications are that jobs are migrating from the coastal regions into the interior provinces, in part due to demographic reasons, improved prospects in inland provinces, and frictions to labor mobility created by the household registration scheme.

The premium for skilled or experienced labor is growing but unskilled labor has much less pricing power in the labor market. Unemployment among university graduates is becoming an important social issue with many college graduates ill-equipped for the workplace. At the same time, companies report being increasingly constrained by a lack of skilled labor. This growing skills gap is a pressing issue without a clear near-term

B. Property Bubbles

6. *Developments.* The government's efforts to slow the rapid pace of increase in property prices appear to be having the desired effect. In the first five months of this year, residential property prices on average rose 7 percent over those of the previous year and transaction volumes have been discretely lower. Market participants indicated that the restrictions on purchases of properties for investment purposes have had the biggest impact. There is also some evidence that people are shifting more into renting property with rents now catching up with prices in the larger cities. In addition, commercial real estate prices have been rising quickly, particularly in the larger coastal cities (Figure 3). Despite the slower rate of increase in house prices, real estate investment has held up well, in part bolstered by an ongoing expansion in the construction of housing for lower income groups (the government has a goal of building or refurbishing 10 million units of social housing this year).

7. *Assessment.* Despite some success in calming down the property market, prices are high as a share of household income, particularly in some of the larger cities, and staff remains concerned about the potential for a property price bubble in China. The property sector occupies a central position in the Chinese economy, directly making up 12 percent of GDP and is highly connected to upstream industries (like steel and cement) and downstream producers of appliances and other consumer durables. Direct lending to

real estate (developers and household mortgages) makes up around 18 percent of banks' credit portfolio; property is a sizable component of household and corporate balance sheets; and for local governments—which account for 82 percent of public spending—property-related revenues (including budgetary funds) are important. A property bubble, therefore, would pose serious macroeconomic and financial stability risks.

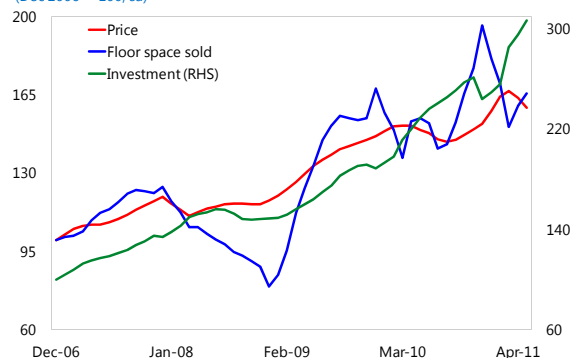
8. *Policies.* Staff did not see imminent risks of a material downturn in the property sector. However, with the slowdown in transaction volumes there could be stress on the balance sheets of some property developers; this could prompt consolidation in the sector. Staff maintained that as long as the cost of financing is low and other investment options are sparse, the propensity for property bubbles will remain and the government will have to take progressively tighter administrative measures to stem demand and dampen house price inflation. Decisively mitigating the risk of a property bubble will require a higher cost of capital, financial market development, and the introduction of a broad-based property tax. The authorities recognized the risks and also emphasized their concerns related to the impact of worsening housing affordability on inequality and social stability. There was broad agreement that the government will need to continue to provide affordable urban housing to lower-income households for many years to come.

Figure 3. Is There a Property Bubble in China?

Government measures have cooled down the property market somewhat but investment remains solid.

Residential Housing

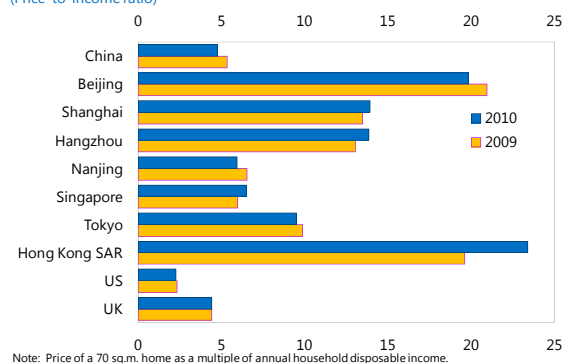
(Dec 2006 = 100, sa)



Housing affordability remains a pressing social issue particularly in major cities.

Housing Affordability

(Price-to-income ratio)

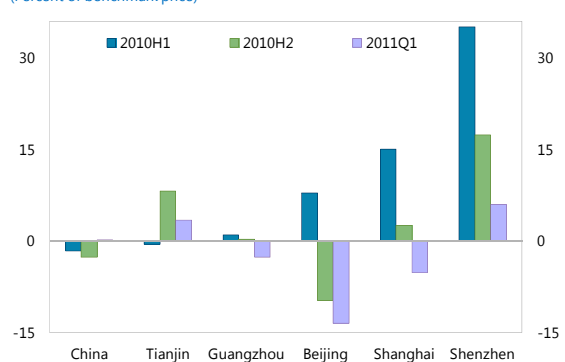


Note: Price of a 70 sq.m. home as a multiple of annual household disposable income.

At the national level, prices do not appear out of line with fundamentals but certain cities still look "bubbly".

Deviation of Mass-market House Price from Benchmark

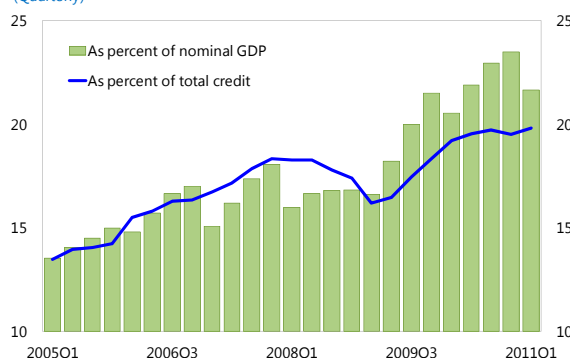
(Percent of benchmark price)



The share of bank credit going to the real estate sector has leveled off.

Bank Exposure to Real Estate Sector

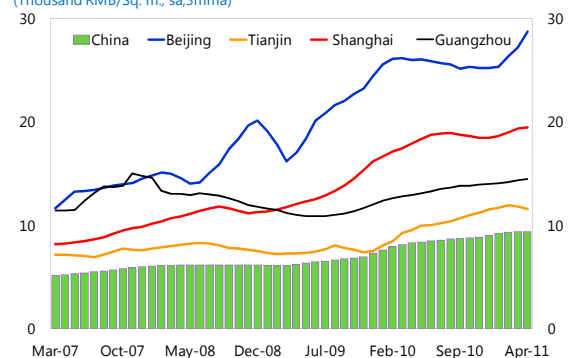
(Quarterly)



Property price increases have moderated in several Tier I cities.

China Property Prices

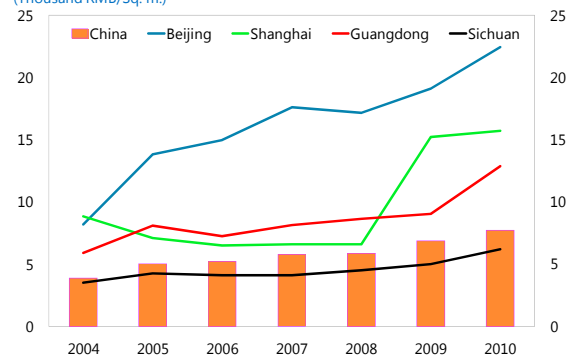
(Thousand RMB/Sq. m., sa, 3mma)



Commercial real estate markets have become increasingly buoyant particularly in a few eastern and southern provinces.

China Commercial Real Estate

(Thousand RMB/Sq. m.)

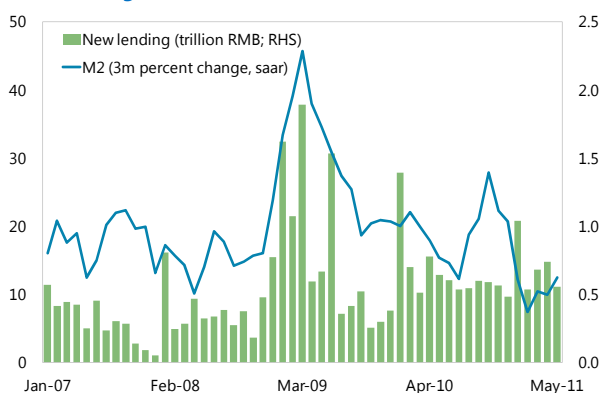


Sources: Bloomberg; CEIC Data Company Limited.; Centaline Property Agency Limited; and staff estimates. Benchmark house price is derived from a no-arbitrage condition equating rental to home-ownership costs.

C. Credit and Banking Risks

The growth in bank lending has slowed

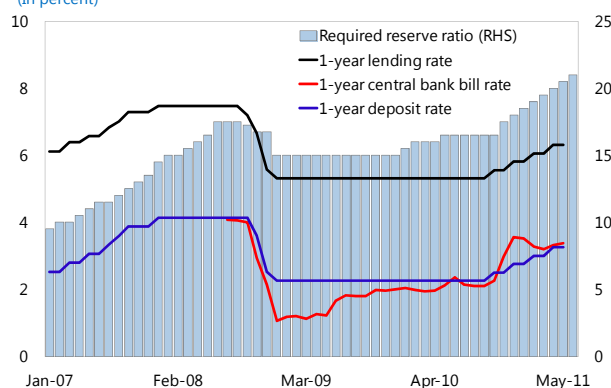
New Lending



9. *Developments.* Following the massive injection of credit stimulus in response to the global financial crisis, the central bank and the bank regulatory agency moved in 2010 to rein in loan growth. Despite this shift in policy, monetary and credit growth last year overshot their targets. In addition, off-balance sheet credit expanded (through trust funds, guarantees, and other means). However, since late 2010, there has been a renewed effort to tighten credit conditions and a steady, albeit moderate, increase in deposit and loan rates.

Interest rates and reserve requirements have moved higher

Interest Rates and Reserve Requirements
(In percent)



Selected Banking Indicators (in percent)

	2007	2008	2009	2010
<i>All commercial banks</i>				
Total CAR ratio	...	...	11.4	12.2
NPL ratio	6.1	2.4	1.6	1.1
Bank provisions to NPLs	41	117	153	218
Return on assets	0.9	1.1	1.0	1.1
Return on equity	16.7	19.5	18.0	19.2

Source: CBRC.

10. *Assessment.* Stress tests—conducted by the authorities as part of the FSAP process—suggest that the banking system is generally capable of absorbing significant downside risks. However, given the large expansion in credit in the past 2½ years, a coordinated shock on multiple fronts (including lower growth, a sharp real estate downturn, and higher interest rates) would leave some of the smaller private banks with insufficient capital to meet regulatory requirements. The key risks to credit quality remain concentrated in loans to local government financing vehicles, off-balance sheet lending, and, to a lesser extent, credit to the property sector. A full assessment of these various risks is, however, hampered by serious data gaps, weaknesses in the information infrastructure, and constraints on the FSAP team's access to confidential data.

11. *Policies.* To counter these credit risks, the bank regulatory agency indicated it is in the process of requiring that banks assess their credit portfolio in a downside scenario and ensure that lending to local government vehicles meets certain minimum collateral requirements. The authorities also said that

efforts to catalog and determine the risks and potential contingent fiscal liabilities arising from the recent surge in lending to local government financing vehicles were nearing completion. Banks had been asked to raise the capital requirements and provisioning for such loans and significant time has been spent conducting on-site examinations and

increasing the regulatory and supervisory scrutiny of credit risks. In addition, banks are now being required to bring much of their trust-related lending back on balance sheet by year-end. Despite these efforts, staff argued that credit quality risks remain, potentially implying significant contingent liabilities.

D. Near-Term Macroeconomic Policies

12. *Fiscal policy.* The significant monetary and fiscal stimulus put in place in late 2008 has been effective in offsetting the growth impact of the collapse in external demand. There was broad agreement that with growth now self-sustaining, it is fully appropriate to gradually unwind the fiscal stimulus. Staff argued that the fiscal position should return to broad budget balance in the next one to two years, allowing fiscal policy to be modestly counter-cyclical. Should growth prospects deteriorate, a slower or delayed path of fiscal consolidation would be warranted. The authorities indicated that budget decisions would be taken on an annual basis at the time of the National People's Congress and would very much depend on the prevailing economic situation. They underlined their commitment to devote more resources to social expenditures and rural development and to raise the minimum threshold of the personal income tax. Even with a reduction in the deficit over the near-term, staff argued that there should still be ample scope to reallocate fiscal resources

toward tax and spending policies that promote private consumption.

13. *Monetary policy.* Given the cyclical outlook for the economy, evident price pressures, and the potential for a worsening of bank credit quality in the coming years, staff and the authorities agreed that monetary stimulus should be withdrawn and the target of 16 percent M2 growth by end-year (down from 19.7 percent at end-2010) represented a steady return to more normal monetary conditions that was well calibrated to the current macroeconomic environment. Achieving this goal would help mitigate the risks to bank balance sheets posed by the very rapid expansion of lending that had occurred over the past two years.

14. *Monetary tools.* The central bank has used both reserve requirements and higher interest rates to slow credit but still relies heavily on direct administrative limits on loan growth. The central bank has also introduced a supplemental "dynamically differentiated reserve requirement," which varies across

Box 2. The Links Between Onshore and Offshore Renminbi Markets

The renminbi holds significant potential to become widely used internationally due to China's large economic size, diversified trade structure and network, and high growth rates. Yet, nonresident access to renminbi-denominated assets remains limited. Despite this, in a historically unprecedented process of market development, renminbi trade settlement with nonresidents has expanded rapidly and the issuance of renminbi-denominated assets in Hong Kong SAR is growing. This could have implications for the links between offshore and onshore markets even with binding capital controls in place.

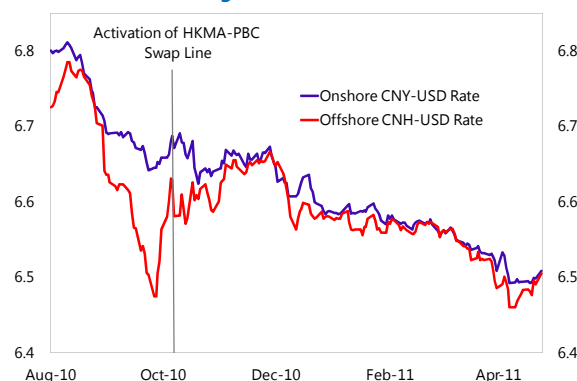
Using a multivariate GARCH model, the links between the offshore renminbi markets in Hong Kong SAR (CNH) and the onshore renminbi (CNY) spot and forward markets were examined.¹

Results

The movements in CNH and CNY are highly correlated and the connection between the two markets was stabilized following the activation in October of the renminbi swap line between the People's Bank of China and the Hong Kong Monetary Authority.

- Developments in the onshore spot market exert an influence on the offshore spot market but the reverse is not true.

China Bilateral Exchange Rates



¹ See J.S. Kang, S. Maziad and S. Roache, "Renminbi Internationalization: Offshore-Onshore Links," IMF Working Paper (forthcoming).

Summary of GARCH Results

	To	CNY		CNH	
		Spot	Forward	Spot	Forward
From					
CNY	Spot	--	--	0.33*	0.19
	Forward	--	--	0.04	0.02
CNH	Spot	0	-0.37***	--	--
	Forward	-0.03	-0.37**	--	--

Values indicate change due to a 1 percent change in explanatory variable
*, **, *** indicate statistically significant coefficient with 10%, 5%, and 1% confidence level, respectively.

- Nevertheless, offshore forward markets do seem to move *ahead* of onshore forwards. In particular, today's CNH 3-month forward rate has a predictive impact on tomorrow's CNY forward rate but not vice versa. This could be due to either price discovery being faster in the Hong Kong markets (due to their full integration with global markets) or, potentially, that onshore market participants may be looking to the CNH market for pricing signals in setting onshore rates.
- There is also evidence of two-way volatility spillovers between CNY and CNH, especially in the forward markets.

The results suggest that the ongoing process of RMB internationalization is already leading to spillovers from offshore to onshore markets despite the wide-ranging capital controls. These linkages are only likely to grow as the market develops and liquidity improves.

IS CHINA REBALANCING?

A. Social Safety Net

18. *Developments.* Since the eruption of the global financial crisis commendable progress has been made in expanding China's social safety net with significant resources allocated to improving the pension, healthcare, and education systems. This will certainly help rebalance toward private consumption. In particular, a new rural social pension system has been introduced and now covers 60 percent of counties. In addition, healthcare spending has been substantially increased to build health facilities, train personnel, and achieve near-universal coverage of basic health insurance. Finally, the government is about to expand the existing social pension scheme to include the urban unemployed with nationwide coverage expected by 2012.

19. *Policies.* Despite progress, gaps in the safety net still remain. The health system continues to create incentives for precautionary saving because of high out-of-pocket expenses and inadequate coverage for

Social Policies Already Taken To Promote Rebalancing

- Increases in the basic pension, social transfers, and unemployment benefits
- Launch of a new rural pension scheme
- Introduction of a new social pension system for urban residents
- Full portability of pension benefits
- Increased subsidies for health insurance and coverage of a core set of prescription drugs
- Significant investments in new hospitals, community health facilities, and the training of healthcare personnel
- Implementation of the Labor Contract Law and increases in minimum wages

catastrophic illnesses. At the same time, there is a need to increase the generosity of social benefits, consolidate the complex and fragmented patchwork of various national, provincial, government and occupational pension schemes, and achieve universal pension coverage for urban, migrant, and rural workers.

B. Input Costs

20. *Labor.* There was broad agreement that labor markets will continue to evolve in the coming years as the demography shifts and skills are increasingly in demand. This will be a potentially important, albeit slow-moving, force going forward. In particular, it should lead to labor gaining a stronger negotiating

position, with higher wages and more of the gains from growth redistributed from the corporate sector to households. This is a positive development and will help with rebalancing. Indeed, for consumption to grow at a faster pace than output, there needs to be a sustained increase in nominal wages in

Staff Recommendations on Further Policies For Rebalancing 1/

- Liberalizing the financial system and developing new markets and financial instruments.
- Further reducing the taxation of labor income through lower social contributions.
- Continuing to improve access to high quality healthcare, reduce out-of-pocket expenses and strengthen coverage for catastrophic illness.
- Raising the costs of various factor inputs such as land, energy, pollution, and capital.
- Appreciating the exchange rate.
- Reforming corporate governance, reducing monopoly power in key sectors, and boosting dividend payouts to the budget from state-owned corporations.
- Improving labor mobility by reforming the household registration system.

1/ See People's Republic of China—2010 Article IV Staff Report for details.

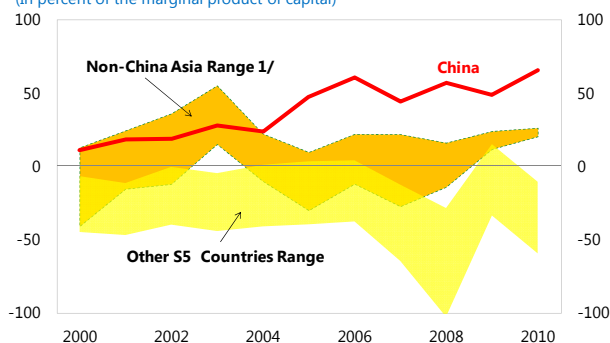
excess of nominal GDP. There was general agreement that attention should be paid to avoiding the growing skills gap, putting a particular prominence on improving the education system and vocational training. Staff argued that the government could further facilitate the increase in household income by significantly reducing social contribution rates (which can be in excess of 40 percent of wages) and replacing them with other forms of general revenue (for example, higher dividends from state corporations, an expansion in the VAT base to cover services, or increases in energy taxes). In addition, staff recommended that fundamental reform of the household registration scheme should be considered.

21. Other factors of production. The staff and authorities agreed that there remain distortions in factor pricing in several areas (Box 3). The authorities underlined the steps already being taken to raise energy prices and link them more closely to global costs and agreed there was scope to raise the cost of many inputs to production in order to ensure a more efficient allocation of resources and a more appropriate pricing of externalities. Officials also noted that the latest Five-Year Plan places particular emphasis on protection of the environment and energy conservation and efforts would continue to dissuade pollution and excessive energy use through higher prices and greater taxation of resource use. Staff made the case that the cost of capital in China was also very cheap especially when compared with the returns that capital can generate. The authorities, though, believed assessing the appropriate cost of capital in China was exceedingly difficult, complicated by the other factor cost distortions that were in the system. Certainly, the productivity of

The cost of capital is well below its marginal product

Imputed "Subsidy" to Capital

(In percent of the marginal product of capital)



1/ Includes Indonesia, Korea, Singapore, and Taiwan Province of China.
Source: Background Paper, "Competitiveness, Overcapacity, and Sustainability Risks."

capital was high but, in part, that was due to the underpricing of other factors of production (such as energy) and insufficient environmental protection. It may also be the case that the apparent high investment-GDP ratio—which

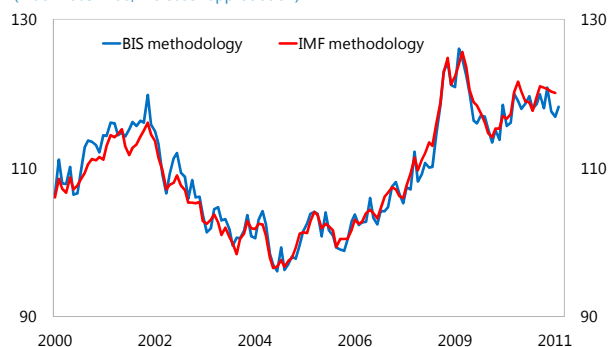
has risen to close to 50 percent and some viewed as a sign that capital was too cheap—could be overstated due to the under-recording of both consumption and service sector output in the national accounts.

C. The Role of the Exchange Rate

22. *Assessment.* Staff continues to believe that the renminbi remains substantially below the level consistent with medium-term fundamentals. At this point, there is little reason to change the assessment made during the 2010 Article IV consultation. Reserve accumulation has been significantly larger than foreseen at the last Article IV (reserve levels at end-March were already above what staff had previously forecast for end-2011 and are well above the level needed for precautionary purposes). Despite progress in appreciating against the U.S. dollar, the real effective exchange rate has depreciated over the past year.¹ Finally, despite the important progress made in many policy areas, staff does not yet see in place the critical mass of measures that will be needed to decisively change the incentives for saving and investment and achieve a lasting decline in the current account surplus (Box 4). Nonetheless, the low trade surpluses recorded in the first five months of

The exchange rate has depreciated in real effective terms over the past year

Real Effective Exchange Rate
(Index 2005=100, Increase=appreciation)



this year could be an indication that this year's current account surplus will be smaller than expected.

23. *Policies.* Staff advocated a stronger exchange rate as a key ingredient to accelerate the transformation of China's economic growth model. The work of the spillover team would suggest that movement on the exchange rate alone may have only modest direct effects in addressing global imbalances. However, staff argued that this fails to take into account the fact that the undervaluation of the currency is holding back progress in other areas that would help safeguard against

¹ The current estimates of the IMF's Consultative Group on Exchange Rates indicate that the renminbi is undervalued by 3 percent (ERER approach), 17 percent (ES approach), and 23 percent (MB approach).

FINANCIAL LIBERALIZATION AND REFORM

A. Motivation

25. *Emerging tensions.* Much has already been done to reform China's financial system (Box 5). However, as touched upon earlier in this report, over the horizon of the 12th Five-Year Plan China will encounter a fundamental and structural shift in important aspects of its economic system. Demographic changes will mean the labor force will gradually start shrinking, leading to a steady rise in labor costs, a rising skills premium, and potentially altering inflationary dynamics. China will continue to face the risk of property bubbles, driven by low interest rates, robust growth prospects, and a lack of alternative investment vehicles. Finally, the ongoing process of financial innovation and disintermediation into non-bank areas will pose a growing and formidable challenge to China's ability to exert macroeconomic control through administrative means. This potential combination—of rising inflationary pressures, already-high prices in the property market, and a weakening of direct monetary control—poses significant risks to financial and macroeconomic stability. In addition, the current system for financial intermediation continues to hold back rebalancing and the development of the service sector, generating

industrial overcapacity that could present negative implications for long-run growth prospects.

26. *A time for action.* This argues for China to immediately move ahead with financial liberalization and reform, a position that is fully consistent with the 12th Five-Year Plan. This will be a complex, multi-year undertaking and starting now will ensure that the process can be largely completed within the horizon of the Five-Year Plan. Continuing to delay could mean that the financial system, instead, evolves in an uncoordinated and disorderly fashion, outpacing supervisory capabilities and revealing regulatory gaps. Indeed, the risk is high that developments proceed on a timetable driven not by careful, pre-emptive, and concerted policy planning but rather by the pace of market disintermediation and innovation. This would create liquidity stress, growing cross-border capital flows, and both asset price and macroeconomic volatility. Given the increasing complexity of China's financial system, an ad-hoc or poorly configured approach would be especially risky, for both China and the global economy.

Box 5. Recent Achievements In Financial Sector Reform

Over the last decade, China has made considerable progress in moving toward a more liberal and market-based financial system.

Bank Commercialization. Banks' internal risk management and accounting practices have been strengthened, with foreign strategic partners helping to implement international best practices. The main banks have been listed on foreign markets, helping to strengthen investor oversight and control and ensure compliance with international accounting standards. A large volume of bad loans—over 15 percent of GDP in 1999—was carved out and placed in asset management companies while the banks were recapitalized with government support.

Regulation and Supervision. The regulatory infrastructure has been significantly improved with the establishment of individual regulators for insurance, banking and securities markets. Within these agencies, capacities for supervision have been strengthened, and a regulatory infrastructure that meets international standards has been put in place. Laws on new companies, trusts, securities and investment funds have also been enacted, providing a modern framework for capital market development.

Fixed Income. Interest rates on a range of fixed income instruments have been allowed to be determined more by market forces. In addition, an interbank bond market was established to allow corporations to raise funds from securities markets, reducing their dependence on the banking system for credit.

Financial Centers. Shanghai has become a critical part of the global financial infrastructure. Best practices and state of the art trading platforms have been adopted in key markets and equity market liquidity increased by making a larger proportion of shares tradable. Shanghai's market capitalization now stands at around US\$3 trillion, the sixth largest equity platform in the world. Shenzhen has also launched the Growth Enterprise Board giving small- and medium-size companies access to equity financing with streamlined listing procedures.

All these measures have bolstered the health and soundness of China's financial sector, helping it escape the global crisis relatively unscathed and enabling it to expand operations abroad. Nevertheless, as acknowledged in the 12th Five-Year Plan and outlined in the FSSA, a broad-ranging financial reform agenda still remains.

B. A Proposed Roadmap for Reform

27. Principles. There is no optimal, pre-determined path that financial liberalization and reform should take in China and any plan should be flexible enough to adapt to unforeseen situations as reforms proceed. Nevertheless, international experience would suggest that certain key elements and a basic sequencing will be needed to mitigate the potential risks that will arise as the financial system becomes freer and more market-oriented. A broad roadmap—which includes

appreciating the renminbi, absorbing liquidity and strengthening monetary management, improving regulation and supervision, developing financial markets and products, liberalizing interest rates, and finally opening up the capital account—is laid out below.

28. The exchange rate. First, by allowing the exchange rate to appreciate there will be genuine, market-driven, two-way movement of the currency, reducing the pressure from

Box 6. Key Financial Stability Reforms

The principal areas identified by the Financial System Stability Assessment (FSSA) to improve the framework for financial stability include:

- Establish a **Financial Stability Committee** to help coordinate across agencies on systemic risks and adapt to the changing perimeter for regulation as innovation reshapes the financial landscape and creates new channels of intermediation.
- Clarify the objectives and strengthen the mandates for the **central bank and regulatory agencies** with greater operational autonomy, improved accountability, adequate resources in terms of skilled staff and funding, and effective enforcement and resolution powers.
- Put in place a **crisis management framework** that allows for effective oversight, early intervention, and an orderly exit for weak or failing financial institutions (including systemically important institutions and financial conglomerates) and a clear definition of the role of the state in providing fiscal support.
- Transition to a formal **deposit insurance** scheme that will clearly define the limits of state support.
- Set clear limits on central bank **emergency liquidity support** that is restricted to solvent banks facing short-term liquidity problems.
- Ensure that the central bank's **standing facilities** operate immediately and automatically, with common conditions and collateral requirements, for all domestically incorporated institutions.

Box 7. Key Reforms to Deepen Financial Intermediation

The principal areas identified by the FSSA to develop and deepen intermediation include:

- **Bonds.** The government should adapt its bond issuance strategy so as to help improve the existing market making activities across all maturities of the yield curve. Reforms should aim to increase the connectivity between the exchange-traded and interbank markets and ensure a coordinated regulatory approach between the two markets. The government could also consider permanently authorizing bank trading of bonds on the stock exchanges and allowing corporate bond issuers that meet the appropriate (disclosure-based) listing standards to decide whether to list on the interbank or exchange-traded bond market. Finally, creditworthy sub-national entities should be allowed to issue bonds to raise financing.
- **Money markets.** The PBC should further upgrade the operational framework for the repo market to increase market liquidity. Operational restrictions that make instruments less efficient (such as not being able to automatically rollover open repo positions) should be re-considered. Leverage risk should be controlled through prudential regulations. Addressing tax and regulatory hurdles that limit the size of the outright repo market would also be important. The availability of suitable hedging tools should be encouraged to help market liquidity providers manage risk, with interest rate derivatives particularly important in the near-term.
- **Equities.** The nature and scope of investable instruments should be broadened to create a more balanced institutional and retail investor base, improve liquidity, and strengthen price discovery. Residual legacy constraints and anomalies relating to nontradable, "A" and "B" shares should be addressed and the current free float of shares in public companies expanded. Building a smooth conduit between the private and public offer segments will be critical to sustainable funding for SMEs.
- **Insurance.** The insurance sector is still a relatively small part of the financial system but is growing rapidly and most of the insurers licensed in the past decade continue to lose money. This growth, combined with the low returns available on insurance company assets, is putting strains on the sector's capital adequacy and solvency. Consolidation of the sector is needed with stronger solvency requirements, more comprehensive risk-based capital requirements, and clearer voluntary wind-up and exit rules. Insurers should be allowed to hedge asset-based market and credit risks, including through asset management companies. Subject to prudent risk management, quantitative limits on pension fund allocations could be relaxed to allow for a greater diversification away from bank deposits and toward bonds and equities. Stronger actuarial oversight of non-life claims provisioning is also needed.
- **Mutual funds.** The scope of fixed-income instruments available to mutual funds could be broadened to include lower-rated issues (within prescribed parameters) and medium-term notes. This would broaden their appeal and enhance their competitiveness while supporting access of private companies to direct funding. There is also a need for an assessment of whether development of the mutual funds sector is being prejudiced by a more conservative regulatory approach than applied to the wealth management industry.

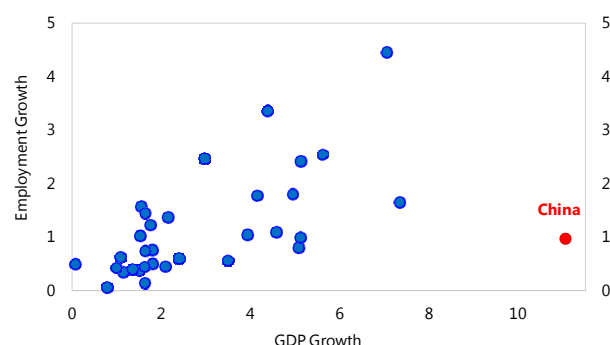
account surplus. As domestic consumption picks up, the demand for imports will rise and a greater proportion of China's production of tradable goods will be sold into the local market rather than sent abroad. The trade surplus will fall in U.S. dollar terms. In addition, the more appreciated exchange rate will, eventually, lessen the incentives for capital inflows and reduce the pace of reserve accumulation.

44. Growth and employment. Over a longer horizon, transformation of the economic model may lead to growth that is modestly lower than the historical performance. However, that growth will be more sustainable, inclusive, and have a bigger positive impact on people's livelihoods. Consumption possibilities will be enhanced, environmental degradation will fall, and the economy will generate far higher levels of job growth. Indeed, over the past decade, under the export-oriented model, employment

China's high growth has not been very job-intensive

Average Employment Growth, 2004-10

(In percent; Industrial countries and emerging markets)



growth in China has been disappointing relative to international comparators. Over the near term, the shift toward domestic consumption is likely to reduce growth somewhat as the economy adjusts to the various elements of reform and, in particular, as it takes some time to build productivity in the service industries to substitute for lost output in export industries. However, China has the resources and capacity to cope with the implications of such a near-term slowdown.

Illustrative Rebalancing Scenario¹

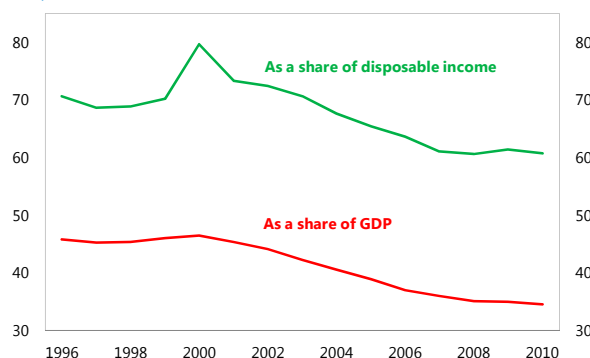
	2010	2011	2012	2013	2014	2015	2016
Real GDP (percent change)	10.3	9.6	9.0	8.4	8.1	8.2	8.5
Consumption (percent change)	8.1	9.5	11.3	13.0	13.7	13.0	12.7
Investment (percent change)	12.0	7.5	7.5	7.4	7.3	7.1	7.6
Net Exports (contribution to growth)	0.8	1.5	0.2	-1.3	-2.1	-2.0	-1.9
Fiscal balance (percent of GDP)	-2.2	-1.6	-1.0	-0.5	-0.4	-0.3	-0.3
Gross national savings (percent of GDP)	54.0	54.0	53.2	51.8	50.1	48.8	47.6
Total capital formation (percent of GDP)	48.8	48.5	47.7	46.9	46.1	45.2	44.5
Current account (percent of GDP)	5.2	5.5	5.5	4.9	4.1	3.6	3.1
International reserves (US\$ trillion)	2.9	3.5	4.1	4.6	5.0	5.3	5.5

¹ As discussed in the text, assumes an appreciation of the exchange rate in line with long-run market consensus forecasts, a higher cost of capital, lower labor taxes, improvements in the social safety net, financial liberalization, and an increase in a range of factor costs.

Box 9. Interest Rate Liberalization and Household Saving Behavior

Context. China's urban household saving rate has been rising steadily from around 19 percent of disposable income in 1996 to close to 30 percent in recent years. To rebalance China's economy, it will be essential to arrest this upward trend and create incentives for households to save less. Financial reform and interest rate liberalization offer the potential to contribute to this effort.

Household Consumption
(In percent)



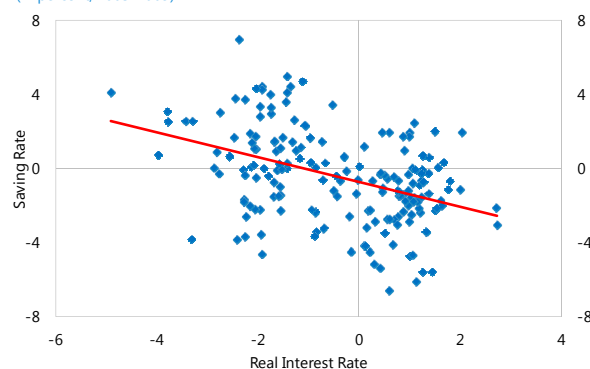
Methodology. To examine the potential impact that financial reform and a higher cost of capital could have on saving behavior, research was undertaken using data from 31 Chinese provinces over the period 1996–2009 to examine the impact of interest rate liberalization on urban household saving rates.¹

Results. Key results from the analysis include:

- The figure shows the annual deviation of urban saving rates and real interest rates from their province-specific averages during 2003–2009. Urban saving rates tend to fall when real interest rates rise. A one percentage point increase in the real rate of return on bank deposits would lower the urban household saving rate by 0.6 percentage points with the income effect outweighing the substitution effect.

- The response to changes in the real rate of return on savings is largely driven by movements in the interest rates on bank deposits.
- The negative relationship between savings and interest rates has strengthened over the last several years.
- The relationship is robust to the inclusion of variables that proxy for other influences on saving such as life cycle considerations and self-insurance against income volatility.

Deviation from Provincial Average
(In percent, 2003–2009)



Conclusions. China's households save to meet a multiplicity of needs—pensions, health expenditures, purchase of durables and real estate, and to insure against income volatility. Research would suggest that individuals may well behave as if they are targeting a particular absolute level of savings. A rise in real interest rates increases the return on bank deposits and makes it easier for households to achieve this targeted level of savings accumulation. This leads higher deposit rates to reduce the share of disposable income that is saved. If an increase in real deposit rates is combined with other measures to raise household income and change incentives to save, the impact could be even larger.

¹ See M. Nabar, "Financial Development and Household Saving in China," IMF Working Paper (forthcoming).

Table 1. China: Selected Economic Indicators							
	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	12.7	14.2	9.6	9.2	10.3	9.6	9.5
Total domestic demand	11.5	12.7	9.7	14.2	10.0	8.5	9.0
Consumption	9.8	11.1	8.6	8.4	8.1	9.5	9.6
Investment	13.6	14.7	11.0	20.8	12.0	7.5	8.3
Fixed	12.8	13.5	9.7	24.5	11.8	7.9	8.7
Inventories 1/	0.6	0.8	0.8	-0.8	0.3	0.0	0.0
Net exports 1/	2.0	2.5	0.8	-3.7	0.8	1.5	1.1
Consumer prices							
End of period	2.0	6.6	2.5	0.7	4.7	4.0	3.0
Average	1.5	4.8	5.9	-0.7	3.3	4.7	3.3
Unemployment rate (annual average)	4.1	4.0	4.2	4.3	4.1	4.0	4.0
	(In percent of GDP)						
External debt and balance of payments							
Current account	8.6	10.1	9.1	5.2	5.2	5.5	6.0
Trade balance	8.0	9.0	8.0	5.0	4.3	4.6	5.1
Exports of goods	35.7	34.9	31.7	24.1	26.9	30.2	31.8
Imports of goods	27.7	25.9	23.8	19.1	22.6	25.5	26.7
Gross external debt	12.5	11.1	8.6	8.6	9.3	10.1	11.5
Saving and investment							
Gross domestic investment	43.0	41.7	44.0	48.2	48.8	48.5	48.5
National saving	51.6	51.9	53.2	53.5	54.0	54.0	54.5
Government	7.7	8.8	8.4	6.2	6.9	6.5	7.3
Non-government	43.9	43.0	44.8	47.3	47.1	47.5	47.2
Public sector finance							
Central government gross debt	16.2	19.6	17.0	17.7	17.0	16.5	15.4
General government balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7
	(Annual percentage change)						
Real effective exchange rate 2/	1.6	4.0	9.2	3.3	-0.5	...	...
Sources: CEIC Data Co., Ltd.; and staff estimates and projections.							
1/ Contribution to annual growth in percent.							
2/ Percentage change of annual average.							

Table 2. China: Balance of Payments							
(In billions of U.S. dollars, unless otherwise noted)							
	2006	2007	2008	2009	2010	2011	2012
Current account balance	232.8	353.9	412.4	261.0	305.3	376.9	455.5
Trade balance	217.8	315.4	360.7	249.5	254.2	317.3	388.9
Exports	969.7	1,220.0	1,434.6	1,203.8	1,581.4	2,066.1	2,414.3
Imports (BOP basis)	751.9	904.6	1,073.9	954.3	1,327.2	1,748.8	2,025.4
Services	-8.8	-7.9	-11.8	-29.4	-22.1	-31.0	-33.6
Income	-5.4	7.8	17.7	7.2	30.3	40.6	44.7
Current transfers	29.2	38.6	45.8	33.7	42.9	50.0	55.4
Capital and financial account balance	52.8	95.2	46.3	180.9	225.9	228.7	200.8
Capital account	4.0	3.1	3.0	4.0	4.6	3.6	3.6
Financial account	48.8	92.1	43.3	176.9	221.3	225.0	197.2
Net foreign direct investment	102.9	143.1	121.6	70.3	124.9	125.7	112.0
Portfolio investment	-67.5	18.7	42.6	38.7	24.1	25.1	26.3
Other investment	13.4	-69.7	-120.9	67.9	72.3	74.2	58.9
Errors and omissions 1/	-0.8	11.6	20.8	-43.5	-59.5	0.0	0.0
Overall balance	284.8	460.7	479.5	398.4	471.7	605.6	656.3
Reserve assets	-284.8	-460.7	-479.5	-398.4	-471.7	-605.6	-656.3
Memorandum items:							
Current account, as percent of GDP	8.6	10.1	9.1	5.2	5.2	5.5	6.0
Export growth (value terms)	27.2	25.8	17.6	-16.1	31.4	30.6	16.9
Import growth (value terms)	19.7	20.3	18.7	-11.1	39.1	31.8	15.8
FDI (inward), as a percent of GDP	4.6	4.6	3.9	2.3	3.1	2.8	2.4
External debt 2/	338.6	389.2	390.2	428.7	548.9	693.8	873.2
As a percent of GDP	12.5	11.1	8.6	8.6	9.3	10.1	11.5
Short-term external debt (remaining maturity) 2/	199.2	235.7	226.3	259.3	375.7	498.5	655.2
Gross reserves 3/	1,072.6	1,534.4	1,953.3	2,425.9	2,875.9	3,481.5	4,137.7
As a percent of ST debt by remaining maturity	538.4	651.0	863.2	935.7	765.5	698.3	631.5
Real effective exchange rate (1990 = 100)	92.0	95.7	104.5	107.9	107.4	...	...
Net international investment position	640.2	1,188.1	1,493.8	1,510.7	1,790.7	...	...
In percent of GDP	23.6	34.0	33.0	30.3	30.5	...	...
Nominal GDP	2,712.9	3,494.2	4,520.0	4,990.5	5,878.3	6,850.3	7,585.5
Sources: CEIC Data Co., Ltd.; and IMF staff estimates.							
1/ Includes counterpart transaction to valuation changes.							
2/ Data provided by the Chinese authorities unless otherwise indicated.							
3/ Includes gold.							

Table 3. China: Indicators of External Vulnerability

	2004	2005	2006	2007	2008	2009	2010
Monetary and financial indicators							
Central government debt (official data; in percent of GDP)	18.5	17.6	16.2	19.6	17.0	17.7	17.0
Broad money (M2: annual percentage change)	14.9	16.3	17.0	16.7	17.8	28.4	18.9
Foreign currency deposits to broad money (percent)	5.0	4.4	3.6	2.9	2.6	2.3	2.1
Credit (annual percentage change)	14.5	13.0	15.1	16.1	18.7	31.7	19.9
Foreign currency loans to credit to the economy (in percent)	...	...	4.5	4.7	4.4	5.2	5.1
Stock exchange index (end-of-period, December 19, 1990 = 100) 1/	1,330	1,221	2,815	5,521	1,912	3,437	2,940
Stock exchange capitalization (percent of GDP)	23.4	24.5	48.9	130.2	46.0	81.1	77.4
Number of listed companies (A-share)	1,349	1,355	1,398	1,507	1,581	1,678	2,041
Balance of payments indicators							
Exports (annual percentage change, U.S. dollars)	35.4	28.5	27.2	25.8	17.6	-16.1	31.4
Imports (annual percentage change, U.S. dollars)	-35.8	-17.6	-19.7	-20.3	-18.7	11.1	-39.1
Current account balance (percent of GDP)	3.6	5.9	8.6	10.1	9.1	5.2	5.2
Capital and financial account balance (percent of GDP)	5.7	4.5	1.9	2.7	1.0	3.6	3.8
Of which : gross foreign direct investment inflows	2.8	5.2	4.6	4.6	3.9	2.3	3.1
Reserve indicators							
Gross reserves (billions of U.S. dollars) 3/	618.6	825.6	1,072.6	1,534.4	1,953.3	2,425.9	2,875.9
Gross reserves to imports of GNFS (months)	10.4	11.6	12.4	14.9	21.1	19.1	17.2
Gross reserves to broad money (M2) (percent)	20.1	22.9	24.7	28.9	28.6	27.3	29.4
Gross reserves to short-term external debt by remaining maturity (percent)	445.9	481.0	538.4	651.0	863.2	935.7	765.5
Gross reserves to proposed new IMF metric (percent) 4/	140.2	155.2	165.3	190.5	200.1	208.2	200.9
External debt and balance sheet indicators							
Total external debt (percent of GDP)	13.6	13.1	12.5	11.1	8.6	8.6	9.3
Total external debt (billions of U.S. dollars) 2/	263.0	296.6	338.6	389.2	390.2	428.7	548.9
Of which : public and publicly guaranteed debt 5/	33.6	33.0	34.4	34.9	33.3	36.9	38.8
Banking sector debt	97.6	101.9	120.0	126.6	126.3	132.4	183.5
Short-term external debt by original maturity (billions of U.S. dollars)	138.7	171.6	199.2	235.7	226.3	259.3	375.7
Net foreign assets of banking sector (billions of U.S. dollars)	85.5	108.2	161.4	190.1	251.0	204.5	171.3
Total debt to exports of GNFS (percent)	40.1	35.4	31.9	29.0	24.7	32.1	31.3
Total debt service to exports of GNFS (percent) 6/	21.9	21.1	19.3	17.9	14.6	19.8	21.7
Of which : Interest payments to exports of GNFS (percent) 6/	0.8	0.6	0.5	0.4	0.3	0.4	0.3
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	1,510.7	1,790.7
Nominal GDP (billions of U.S. dollars)	1,931.6	2,256.9	2,712.9	3,494.2	4,520.0	4,990.5	5,878.3
Exports of GNFS (billions of U.S. dollars)	655.8	836.9	1,061.7	1,342.2	1,581.7	1,333.3	1,752.6
Real effective exchange rate (annual percentage change)	-3.1	-1.0	1.6	4.0	9.2	3.3	-0.5
Sources: CEIC Data Co.; and IMF staff estimates.							
1/ Shanghai Stock Exchange, A-share.							
2/ Data provided by the Chinese authorities.							
3/ Includes gold.							
4/ Metric proposed in "Assessing Reserve Adequacy," IMF Policy Paper (February 2011); the suggested adequacy range is 100-150 percent.							
5/ Debt of banking sector not included.							
6/ IMF staff estimates.							

Table 4. China: Monetary Developments

	2007	2008	2009	2010	2011			
					Jan	Feb	Mar	Apr
Net foreign assets	13,775	17,897	19,853	22,604	22,968	23,152	23,526	23,709
Net domestic assets	26,569	29,620	40,769	49,981	...	...	...	...
Domestic credit 1/	33,966	37,938	49,589	58,732	59,422	59,917	61,106	61,089
Net credit to government	2,821	2,943	3,229	3,460	3,242	2,959	3,190	2,802
Credit to non-government	31,145	34,994	46,360	...	56,180	56,958	...	...
Other items, net 1/	1,128	767	107	-1,188	-1,709	-1,450	-2,437	-2,431
Broad money	40,344	47,517	61,022	72,585	73,388	73,613	75,813	75,738
Reserve money	10,155	12,922	14,399	18,531	19,408	19,123	19,257	19,331
<i>Of which:</i>								
Required reserves	5,409	6,614	8,520	12,262	...	...	...	...
Excess reserves	1,432	2,596	1,723	1,404	...	...	...	...
Net foreign assets of PBC	12,388	16,181	18,457	21,470	21,608	21,807	22,170	22,401
Net domestic assets of PBC	-2,233	-3,259	-4,059	-2,939	...	...	...	...
Net foreign assets 2/	10.7	10.2	4.1	...	5.0	5.0	...	...
Net domestic assets	8.6	11.5	37.6	...	...	...	...	...
Domestic credit 3/	17.6	11.7	30.7	...	18.0	16.9	...	...
<i>Of which:</i> loans	19.3	14.0	34.2	19.4	...	...	...	...
Other items, net 2/ 3/	5.3	-0.9	-1.4	...	-0.9	-0.4	...	...
Broad money 4/	16.7	17.8	27.7	19.7	17.2	15.7	16.6	15.3
Including foreign currency deposits	15.9	17.4	27.3	...	...	...	...	...
M1 4/	21.0	9.1	32.4	21.2	13.6	14.5	15.0	12.9
M0 4/	12.1	12.7	11.8	16.7	42.5	10.3	14.8	14.7
Quasi money	14.3	23.2	25.2	18.9	19.3	16.4	17.5	16.7
Reserve money	30.6	27.3	11.4	28.7	4.7	-1.5	0.7	0.4
Net foreign assets of PBC 5/	45.5	30.2	14.0	16.2	2.1	1.1	1.7	1.3
Net domestic assets of PBC 5/	-215.1	-45.9	-24.5	27.6	...	...	...	...
Reserve ratios 6/								
Required reserves	14.5	15.0	15.0	18.0	18.5	19.0	19.5	20.0
Excess reserves	3.3	5.1	3.1	2.0	...	...	...	...
Memorandum items:								
Money multiplier	4.0	3.7	4.2	3.9	3.8	3.8	...	...
Forex deposits of residents (US\$ billion)	159.9	179.1	208.9	228.7	225.0	228.6	236.9	238.0
In percent of total deposits	2.9	2.6	2.3	...	...	...	...	...
Forex loans of residents (US\$ billion)	219.8	243.7	379.5	453.4	463.6	468.8	477.5	485.1

Sources: CEIC Data Co., Ltd.; and IMF staff calculations.

1/ Includes foreign currency operations of domestic financial institutions 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

	2006	2007	2008	2009	2010	2011	2012
(In billions of RMB)							
Revenue	3,944	5,262	6,173	6,821	8,103	9,449	11,075
Tax revenue	3,480	4,562	5,422	5,952	7,320	8,543	10,057
Taxes on income and profits	954	1,196	1,490	1,549	1,768	2,148	2,566
Taxes on goods and services	1,980	2,426	2,819	3,226	3,832	4,452	5,155
Other taxes (residual)	424	745	784	905	1,201	1,354	1,623
Nontax revenue (residual)	464	700	750	869	783	906	1,018
Expenditure	4,090	5,023	6,294	7,875	8,993	10,163	11,448
Primary	3,993	4,917	6,164	7,726	8,808	9,960	11,224
Interest	98	105	131	149	185	203	224
Overall balance	-146	239	-122	-1,054	-889	-714	-373
Financing	146	-239	122	1,054	889	714	373
Domestic	153	-239	122	1,054	889	714	373
External	-6	0	0	0	0	0	0
Privatization and other	0	0	0	0	0	0	0
Memo: Authorities' definition							
Revenue	3,876	5,132	6,133	6,852	8,308	9,429	11,055
Expenditure	4,042	4,978	6,259	7,630	8,958	10,128	11,413
Overall balance 1/	-216	51	-35	-950	-1,000	-699	-358
(In percent of GDP)							
Revenue	18.2	19.8	19.7	20.0	20.4	20.9	21.8
Tax revenue	16.1	17.2	17.3	17.5	18.4	18.9	19.8
Taxes on income and profits	4.4	4.5	4.7	4.5	4.4	4.7	5.0
Taxes on goods and services	9.2	9.1	9.0	9.5	9.6	9.8	10.1
Other taxes (residual)	2.0	2.8	2.5	2.7	3.0	3.0	3.2
Nontax revenue (residual)	2.1	2.6	2.4	2.5	2.0	2.0	2.0
Expenditure	18.9	18.9	20.0	23.1	22.6	22.4	22.5
Primary	18.5	18.5	19.6	22.7	22.1	22.0	22.1
Interest	0.5	0.4	0.4	0.4	0.5	0.4	0.4
Overall balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7
Financing	0.7	-0.9	0.4	3.1	2.2	1.6	0.7
Domestic	0.7	-0.9	0.4	3.1	2.2	1.6	0.7
External	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization and other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Lending / Borrowing	0.7	-0.9	0.4	3.1	2.2	1.6	0.7
Change in Debt	1.9	1.7	0.3	4.3	3.0	2.3	1.4
Change in Deposits	1.2	2.6	-0.1	1.3	0.8	0.7	0.7
Other flows / valuation changes	-0.8	4.7	0.0	-2.3	-1.2	-0.7	-0.7
Memorandum items:							
Debt 2/	16.2	19.6	17.0	17.7	17.0	16.5	15.4
Domestic	15.9	19.4	16.8	17.5	16.8	16.4	15.3
External	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Cyclically adjusted balance							
(percent of potential GDP)	-0.6	0.3	-0.9	-3.4	-2.5	-1.8	-0.8
Nominal GDP (RMB billion)	21,631	26,581	31,405	34,090	39,798	45,297	50,894

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

1/ Includes net allocations to stabilization fund.

2/ Central government.

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

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
	(Percent change)										
Real GDP	12.7	14.2	9.6	9.2	10.3	9.6	9.5	9.5	9.5	9.5	9.5
Total domestic demand	11.5	12.7	9.7	14.2	10.0	8.5	9.0	8.9	8.9	8.8	8.9
Consumption	9.8	11.1	8.6	8.4	8.1	9.5	9.6	9.6	9.5	9.4	9.4
Investment	13.6	14.7	11.0	20.8	12.0	7.5	8.3	8.2	8.2	8.2	8.2
Fixed	12.8	13.5	9.7	24.5	11.8	7.9	8.7	8.6	8.5	8.5	8.5
Inventories 2/	0.6	0.8	0.8	-0.8	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 2/	2.0	2.5	0.8	-3.7	0.8	1.5	1.1	1.2	1.3	1.3	1.3
Consumer prices (average)	1.5	4.8	5.9	-0.7	3.3	4.7	3.3	3.0	3.0	3.0	3.0
	(In percent of GDP)										
Total capital formation	43	41.7	44.0	48.2	48.8	48.5	48.5	47.9	47.4	47.0	46.6
Gross national saving	52	51.9	53.2	53.5	54.0	54.0	54.5	54.4	54.2	54.2	54.1
Fiscal balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7	0.0	0.1	0.2	0.2
Revenue	18.2	19.8	19.7	20.0	20.4	20.9	21.8	22.5	22.6	22.7	22.7
Expenditure	18.9	18.9	20.0	23.1	22.6	22.4	22.5	22.5	22.5	22.5	22.5
Current account balance	8.6	10.1	9.1	5.2	5.2	5.5	6.0	6.5	6.9	7.3	7.5
	(In billions of U.S. dollars)										
Current account balance	233	354	412	261	305	377	455	545	644	758	865
Trade balance	218	315	361	250	254	317	389	447	539	614	701
Exports	970	1,220	1,435	1,204	1,581	2,066	2,414	2,775	3,206	3,677	4,221
(Percent change)	27	26	18	-16	31	31	17	15	16	15	15
Imports	752	905	1,074	954	1,327	1,749	2,025	2,327	2,667	3,063	3,520
(Percent change)	20	20	19	-11	39	32	16	15	15	15	15
Capital and financial account, net	53	95	46	181	226	229	201	171	144	122	105
Capital account	4	3	3	4	5	4	4	4	4	4	4
Direct investment, net	103	143	122	70	125	126	112	99	86	73	60
Portfolio investment, net	-68	19	43	39	24	25	26	27	28	30	32
Other investment, net	13	-70	-121	68	72	74	59	41	26	15	9
Errors and omissions	-1	12	21	-44	-60	0	0	0	0	0	0
Change in reserves (- indicates increase)	-285	-461	-480	-398	-472	-606	-656	-716	-788	-880	-970
Memorandum item:											
Nominal GDP (in billions of yuan)	21,631	26,581	31,405	34,090	39,798	45,297	50,894	57,301	64,540	72,487	81,391
GDP Deflator (2010 = 100)	84	88	95	96	100	104	107	110	113	116	119
Gross reserves (USD billion)	1,073	1,534	1,953	2,426	2,876	3,481	4,138	4,854	5,642	6,522	7,492

Sources: CEIC Data Co., Ltd.; 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							
	2007	2008	2009	2010			2011	2012	2013	2014	2015	2016
I. Baseline Projections												
Public sector debt 1/	19.6	17.0	17.7	17.0			16.5	15.4	13.7	12.1	10.6	9.3
Of which : foreign-currency denominated	0.2	0.2	0.1	0.1			0.1	0.1	0.1	0.1	0.1	0.1
Change in public sector debt	3.4	-2.6	0.7	-0.7			-0.5	-1.1	-1.7	-1.6	-1.5	-1.3
Identified debt-creating flows (4+7+12)	-3.9	-2.6	1.8	-0.3			-0.5	-1.1	-1.7	-1.6	-1.5	-1.3
Primary deficit	-1.3	0.0	2.7	1.8			1.1	0.3	-0.4	-0.4	-0.5	-0.5
Revenue and grants	19.8	19.7	20.0	20.4			20.9	21.8	22.5	22.6	22.7	22.7
Primary (noninterest) expenditure	18.5	19.6	22.7	22.1			22.0	22.1	22.1	22.2	22.2	22.2
Automatic debt dynamics 2/	-2.6	-2.6	-0.9	-2.1			-1.6	-1.4	-1.3	-1.2	-1.0	-0.9
Contribution from interest rate/growth differential 3/	-2.6	-2.6	-0.9	-2.1			-1.6	-1.4	-1.3	-1.2	-1.0	-0.9
Of which : contribution from real interest rate	-0.7	-1.0	0.5	-0.5			-0.2	0.0	0.0	0.0	0.0	0.0
Of which : contribution from real GDP growth	-1.9	-1.6	-1.4	-1.6			-1.4	-1.4	-1.3	-1.2	-1.0	-0.9
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Denominator = 1+g+p+gp	1.2	1.2	1.1	1.2			1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
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			0.0	0.0	0.0	0.0	0.0	0.0
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)	7.3	0.0	-1.0	-0.4			0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	99	86	88	83			79	71	61	54	47	41
Gross financing need 5/	1.2	2.6	5.3	4.3			3.6	2.7	1.8	1.5	1.2	1.0
In billions of U.S. dollars	43	117	263	255	10-Year Historical Average	10-Year Standard Deviation	249	205	154	143	129	122
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	14.2	9.6	9.2	10.3	10.9	2.1	9.6	9.5	9.5	9.5	9.5	9.5
Average nominal interest rate on public debt (in percent) 6/	3.0	2.5	2.8	3.1	3.4	1.2	3.0	3.0	3.0	3.0	3.0	3.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.6	-5.3	3.4	-2.8	-0.3	3.9	-0.9	0.4	0.2	0.2	0.4	0.4
Inflation rate (GDP deflator, in percent)	7.6	7.8	-0.6	5.8	3.7	3.3	3.9	2.6	2.8	2.8	2.6	2.6
Growth of real primary spending (deflated by GDP deflator, in percent)	14.5	16.3	26.1	7.7	14.4	5.1	8.9	9.9	9.8	9.8	9.7	9.6
Primary deficit	-1.3	0.0	2.7	1.8	1.1	1.2	1.1	0.3	-0.4	-0.4	-0.5	-0.5
II. Stress Tests for Public Debt Ratio												
A. Alternative scenarios												
A1. Key variables are at their historical averages in 2011-16 7/							16.4	15.9	15.4	15.0	14.7	14.3
A2. No policy change (constant primary balance) in 2011-16							17.1	17.5	17.8	18.0	18.3	18.5
A3. Contingent debt recognized in 2011 8/							84.6	76.0	67.5	59.9	53.2	47.2
B. Bound tests												
B1. Real interest rate is at baseline plus one standard deviations							16.8	16.0	14.5	13.1	11.7	10.5
B2. Real GDP growth is at baseline minus one-half standard deviation							16.8	16.3	15.3	14.6	14.1	13.9
B3. Primary balance is at baseline minus one-half standard deviation							17.1	16.6	15.4	14.3	13.2	12.3
B4. Combination of B1-B3 using one-quarter standard deviation shocks							17.0	16.4	15.2	13.9	12.8	11.7
B5. One time 30 percent real depreciation in 2011 9/							16.6	15.5	13.8	12.2	10.7	9.3
B6. 10 percent of GDP increase in other debt-creating flows in 2011							26.5	24.6	22.1	19.8	17.6	15.7
1/ Coverage of public sector refers to gross debt of the budgetary central government.												
2/ Derived as [(r - p(1+g) - g + ae(1+r))/(1+g+p+gp)] times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).												
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.												
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).												
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.												
6/ Derived as nominal interest expenditure divided by previous period debt stock.												
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.												
8/ Coverage of public sector refers to gross debt of the budgetary central government and contingent liabilities. The latter includes estimated current and future losses related to NPLs, unfunded pension liabilities, and AMC losses. All outstanding and future contingent liabilities are assumed to be recognized in 2011 (the NPV of this contingent debt is added to the 2011 debt stock as a one-time adjustment; no additional losses are built into the forecast horizon).												
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).												



INTERNATIONAL MONETARY FUND

*Public Information Notice*EXTERNAL
RELATIONS
DEPARTMENT**Appendix I. Draft Public Information Notice**

Public Information Notice (PIN) No. [xx]/[xx]
FOR IMMEDIATE RELEASE
July [], 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with People's Republic of China

On July 15, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with China.¹

Background

China's economy remains on a solid footing, propelled by vigorous domestic and external demand. Wage and employment increases have fueled consumption, the expansion in infrastructure and real estate construction has driven investment upward, and net exports are once again contributing positively to economic growth. Consumer price inflation has been a pressing social and economic issue, rising to 5½ percent by end-May. However, barring further food price shocks, and assuming the ongoing tightening of monetary policy is continued, inflation should soon peak and begin to decline in the second half of this year.

The improving cyclical outlook for the economy, price pressures, and the potential for a worsening of bank credit quality in the coming years has led to a withdrawal of monetary stimulus (with a target of 16 percent M2 growth by end-year). The fiscal stimulus has also begun to be unwound with a 1 percent of GDP decline in the general government deficit targeted for this year. In addition, fiscal resources are being reoriented toward supporting social expenditures, rural development and policies that promote private consumption. Over the past year the currency has appreciated by 5½ percent against the U.S. dollar but has depreciated in both nominal and real effective terms. International reserves now stand at over US\$ 3 trillion.

The policy measures outlined in the 12th Five-Year Plan are directed at shifting toward a consumer-based growth model through a range of reforms that will strengthen the social

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.

safety net, raise household income, enhance productivity, and invest in human capital. Financial reform is highlighted as an important element of this reform package. A successful implementation of such reforms, and the accompanying transformation of China's economic growth model, would have significant positive spillovers to the global economy.

Executive Board Assessment

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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							
	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	12.7	14.2	9.6	9.2	10.3	9.6	9.5
Total domestic demand	11.5	12.7	9.7	14.2	10.0	8.5	9.0
Consumption	9.8	11.1	8.6	8.4	8.1	9.5	9.6
Investment	13.6	14.7	11.0	20.8	12.0	7.5	8.3
Fixed	12.8	13.5	9.7	24.5	11.8	7.9	8.7
Inventories 1/	0.6	0.8	0.8	-0.8	0.3	0.0	0.0
Net exports 1/	2.0	2.5	0.8	-3.7	0.8	1.5	1.1
Consumer prices							
End of period	2.0	6.6	2.5	0.7	4.7	4.0	3.0
Average	1.5	4.8	5.9	-0.7	3.3	4.7	3.3
Unemployment rate (annual average)	4.1	4.0	4.2	4.3	4.1	4.0	4.0
	(In percent of GDP)						
External debt and balance of payments							
Current account	8.6	10.1	9.1	5.2	5.2	5.5	6.0
Trade balance	8.0	9.0	8.0	5.0	4.3	4.6	5.1
Exports of goods	35.7	34.9	31.7	24.1	26.9	30.2	31.8
Imports of goods	27.7	25.9	23.8	19.1	22.6	25.5	26.7
Gross external debt	12.5	11.1	8.6	8.6	9.3	10.1	11.5
Saving and investment							
Gross domestic investment	43.0	41.7	44.0	48.2	48.8	48.5	48.5
National saving	51.6	51.9	53.2	53.5	54.0	54.0	54.5
Government	7.7	8.8	8.4	6.2	6.9	6.5	7.3
Non-government	43.9	43.0	44.8	47.3	47.1	47.5	47.2
Public sector finance							
Central government gross debt	16.2	19.6	17.0	17.7	17.0	16.5	15.4
General government balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7
	(Annual percentage change)						
Real effective exchange rate 2/	1.6	4.0	9.2	3.3	-0.5	...	...
Sources: CEIC Data Co., Ltd.; and staff estimates and projections.							
1/ Contribution to annual growth in percent.							
2/ Percentage change of annual average.							