May 6, 2020
Approval: 5/13/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/70-2

10:00 a.m., July 31, 2019

2. People's Republic of China—2019 Article IV Consultation

Documents: SM/19/189 and Correction 1; and Correction 2; and Supplement 1; and Supplement 1, Correction 1; SM/19/190; and Correction 1

Staff: Daniel, APD; Kang, APD; Koeva Books, SPR

Length: 1 hour, 31 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	Alternate Executive Directors
	O. Odonye (AE), Temporary
M. Raghani (AF)	
	J. Di Tata (AG)
N. Ray (AP)	
A. Tombini (BR)	
	P. Sun (CC)
L. Villar (CE)	
L. Levonian (CO)	
R. Kaya (EC)	
	A. Castets (FF)
S. Meyer (GR)	
	M. Siriwardana (IN)
D. Fanizza (IT)	
T. Tanaka (JA)	
	M. Daïri (MD)
	S. Geadah (MI)
A. De Lannoy (NE)	
	J. Sigurgeirsson (NO)
A. Mozhin (RU)	
M. Mouminah (SA)	
A. Mahasandana (ST)	
P. Inderbinen (SZ)	
S. Riach (UK)	
M. Rosen (US)	

C. McDonald, Acting Secretary
J. Morco, Summing Up Officer
R. Smith Yee, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
African Department: S. Jain-Chandra. Asia and Pacific Department: J. Daniel, S. Das, P. Deb, F. Han, S. Jahan, E. Jurzyk, J. Kang, K. Kang, E. Kvintradze, A. Schipke, J. Zhang, C. Zhou. Communications Department: P. Wang, T. Yan. European Central Bank: D. Rakitzis, R. Rueffer. Fiscal Affairs Department: B. Li. Legal Department: I. Carrington, K. Kwak, Y. Liu. Monetary and Capital Markets Department: M. Catalan, T. Kapan.

Strategy, Policy, and Review Department: P. Koeva Brooks, H. Lin, E. Van Heuvelen, S. Wang. Statistics Department: X. Zhao. World Bank Group: D. Mishra. Alternate Executive Director: R. Alkhareif (SA), N. Heo (AP), K. Merk (GR), L. Palei (RU), P. Rozan (FF), P. Trabinski (SZ). Senior Advisors to Executive Directors: A. Muslimin (ST), L. Johnson (AP), S. Keshava (SA), P. Pollard (US), S. Potapov (RU), J. Shin (AP), G. Vasishtha (CO). Advisors to Executive Directors: S. Bah (AF), O. Bayar (EC), D. Cools (NE), M. Mehmedi (EC), G. Nadali (MD), A. Park (AP), A. Srisongkram (ST), Y. Zhao (CC), F. Antunes (BR).

2. PEOPLE'S REPUBLIC OF CHINA—2019 ARTICLE IV CONSULTATION

The staff representative submitted the following statement:

This statement contains information that has become available since the staff report was circulated. This information does not alter the thrust of the staff appraisal.

Recent data releases are broadly in line with staff projections:

Q2 GDP growth was 6.2 percent (y/y), in line with staff projections and marginally lower than 6.4 percent in Q1. Growth was driven by rebalancing: services contributed more to growth than industry (3.6 percentage points vs industry's 2.3), and consumption more than investment (3.4 percentage points vs investment's 1.6); net exports remained a positive contributor to growth, at 1.2 percentage points, due to weak import growth. Nominal GDP growth accelerated to 8.2 percent (y/y) in Q2 from 7.8 percent in Q1.

High-frequency indicators suggest some strengthening in activity in June. Industrial value-added recovered to 6.3 percent (y/y) in June from 5.0 percent in May. Fixed asset investment growth picked up to 6.3 percent (y/y) in June from 4.3 percent in May. Total social financing growth increased to 10.9 percent (y/y) in June from 10.6 percent in May, driven by a slower contraction in shadow banking.

Headline CPI inflation remained at 2.7 percent (y/y) in June, with core CPI also steady at 1.6 percent (y/y); PPI inflation slowed to 0.0 percent (y/y).

Following the announcement in early July to accelerate financial sector opening, the Financial Stability and Development Committee announced eleven opening up measures. These improve foreign access to the bond market, asset management, insurance, securities, and ratings industries. Specifically, the measures will allow foreign financial institutions to: (1) rate domestic bonds; (2) establish and invest in wealth management subsidiaries of commercial banks; (3) establish controlling stakes in wealth management companies; (4) invest in pension management companies; (5) establish and participate in currency brokerage companies; (6) increase ownership in life insurance companies from 51 to 100 percent as of 2020 (advanced from 2021); (7) own more than 25 percent of the total shares of insurance asset management companies; (8) no longer be required to operate for over 30 years (for foreign-funded insurance companies); (9) own 100 percent of securities companies, fund management companies, and futures companies by 2020 (advanced from 2021); (10) obtain Class-A primary underwriting licenses in the interbank bond market; and (11) invest more easily in the interbank bond market.

Since the Staff Report was finalized on July 12th the RMB has been broadly stable, appreciating by 0.4 percent against the CFETS basket and depreciating by 0.1 percent against the US dollar; the equity market fell by ¼ percent; the 3-month central government bond yield rose by 15bps to 2.2 percent and the 5-year yield was essentially unchanged at 3.0 percent.

Mr. Jin, Mr. Sun and Ms. Liu submitted the following statement:

Our authorities would like to thank staff and management for the candid and constructive discussions during the Article IV consultation. The authorities broadly share staff's assessment. We value the Fund's recommendations, which are helpful for the authorities' policy deliberation. Given China's solid fundamentals and great potential, we are confident that the economy will overcome negative impacts of possible external shocks and will adapt to sustainable and quality growth.

Recent Developments

Recent data shows that the Chinese economy has maintained stable and high-quality growth resiliently, contributing substantially to the global economy. Although GDP growth slowed down from 6.4 percent in the first quarter to 6.2 percent in the second quarter—resulting in a 6.3 percent increase in the first half of this year—it is within the expected range and quite resilient, despite a more complex and challenging environment both externally and internally amid the recent escalating trade tensions. Supported by counter-cyclical macroeconomic policies, major economic indicators are within reasonable range. Inflation has remained stable, with CPI increasing by 2.2 percent in the first half. Employment has been stable with the surveyed urban unemployment rate at 5.1 percent in June. Imports and exports have increased moderately in the first half, and the trade structure continued to improve.

As a large economy, domestic demand has always been the dominant driving force for China's growth. Thanks to successful structural adjustments in the past decade, the contribution of consumption expenditure to GDP growth has been raised to more than 60 percent. The service sector's share has expanded steadily and become larger than the manufacturing sector's share.

Economic Outlook

We are confident that the economy has the potential to achieve sustainable growth within an expected range of 6 to 6.5 percent in 2019. We concur with staff that, in the medium to long term, China has the potential to maintain robust growth, given its early stage in productivity convergence. The Chinese economy has been undergoing a tremendous and sustained structural transformation. In recent years, the urbanization ratio has risen steadily. The once high housing inventory has declined to a new low. Despite high infrastructure investments in the past decades, China still has a large gap in density or per capita terms and has substantial potential for catching up with developed countries.

Against the backdrop of shrinking global FDI and the diversion effect of trade tensions between China and the U.S., new FDI inflow increased by 4 percent in 2018. China has remained the second largest FDI recipient in the world (World Investment Report 2019, UNCTAD). Firms' decision to relocate depend on many factors, including availability of a qualified labor force, comprehensive supply chain, convenient infrastructural network, and a stable and effective government. Recently, some exited firms returned to China after painful experiences elsewhere and enduring a comprehensive assessment. Although labor costs have risen significantly, China now has the largest pool of reasonably priced professional labor force such as engineers and technicians. The number of college graduates in 2018 reached a record high of 8.2 million, with science, technology, engineering and mathematics majors (STEM) accounting for more than 50 percent of total graduates. China's R&D expenditure accounts for 2.18 percent of GDP, which is higher than EMs average and close to OECD's average. Moreover, with significant improvements in transportation and communication infrastructure, the supply of efficient working time has been multiplied, and these infrastructures integrated the economy into a more accessible and more liquid single country market.

Fiscal Policy

China has continued with a proactive fiscal policy with greater intensity and enhanced performance, focusing on large cuts in taxes and fees, totaling nearly 2 trillion yuan (equivalent to US$280 billion), and more efficient fiscal resource allocation between the central and local governments. Major beneficiaries of the tax cuts are small- and medium-sized companies and R&D in the corporate sector. We concur with staff's suggestion that there is no need for a further large-scale fiscal stimulus since the effects of trade tensions have already been factored into this year's budget. We believe more positive results will be felt in the second half of the year.

Staff mentioned in Appendix I that the DSA results reflected worsening debt dynamics compared to that of last year, posing risks to debt sustainability. In our view, Staff has mismatched the concept of stock (debt) and flow (GDP) and can hardly provide a more relevant measurement of debt sustainability in China. We believe that a more accurate analysis of debt sustainability can be made based on the Debt Service/GDP ratio and Debt/National Wealth ratio.

Monetary Policy

Monetary policy remains prudent and policy adjustments have been more data dependent, relying mainly on both domestic and international economic developments as well as changes in price levels. A combination of monetary policy instruments has been used to keep liquidity at an appropriate level, and money supply has been reasonably sufficient. The People's Bank of China (PBC) will further deepen the market-based interest rate liberalization reform and enable its policy rates to better guide market rates. The PBC will further shift from a quantity-oriented monetary policy framework to a price-oriented one by improving the formation and transmission mechanism of the market-based policy rate. As staff noted in the report, the PBC has had little FX interventions in recent years.

Financial Risks

The authorities have attached great importance to safeguarding financial stability, and various measures have been taken to prevent and mitigate financial risks in the banking, securities, and insurance sectors. Leverage ratios in China have been stabilized, and the financial sector has generally performed well as reflected by various indicators. The regulatory authorities have required small- and medium-sized banks to raise more capital from markets.

In May of this year, the PBC and China Banking and Insurance Regulatory Commission (CBIRC) have jointly taken over Baoshang Bank, a medium-sized bank in northern China, and effectively contained spillover risks. This is an isolated but educational case. The Deposit Insurance Fund has provided a guarantee of principals and interests for all personal savings, as well as corporate deposits and interbank liabilities under RMB50 million, covering a total of 5.2 million depositors and 25,000 corporations and banking institutions. The takeover of Baoshang Bank is a market-oriented regulatory solution that could significantly reduce moral hazards in both deposit protection and bank failure bailout. This could also enhance the credit culture in China.

SOE and SMEs

China has been resolutely deepening the supply-side structural reform. 95 percent of central zombie firms have been disposed, while the remaining 5 percent will be tackled by the end of this year. Of the total disposed zombie firms, more than one-third have been disposed through bankruptcy, and the rest have been mainly disposed through mergers and acquisitions as well as internal restructuring. Recently, a new policy measure has been jointly released by the National Development and Reform Commission (NDRC) and 12 other ministries, making it easier for zombie SOEs to declare bankruptcy and exit the market. For those SOEs that can satisfy the criteria for bankruptcy, no parties should impede their exit from the market. Both central and local governments are prohibited from providing subsidies or loans to prop up the operation of non-viable SOEs.

Small- and medium-sized firms account for over 60 percent of GDP and over 80 percent of employment in China. Domestic private owned firms and foreign invested firms account for more than 90 percent of China's exports. Meanwhile, the authorities are committed to maintaining a level playing field for all types of companies, be it public or private, domestic or foreign, and implementing the principle of Competitive Neutrality in practice.

We welcome staff's SIP on Improving the Allocation of Corporate Credit in China. Caution should be exercised when making policy recommendations using the perception-based "implicit guarantee" concept. There is a risk of arbitrary judgment on implicit guarantees. Therefore, a more comprehensive cross-country study with an evenhanded approach is necessary to reach a fair conclusion.

Trade

Trade tensions need to be resolved through dialogue and consultation based on mutual respect, equality, and credibility. Striking a mutually beneficial and win-win agreement serves the best interest of China and the U.S., as well as the rest of the world.

Negative impacts of intensified trade tensions on the Chinese economy are inevitable but manageable. In terms of total retail sales, China has become the world's largest market. While some foreign investors are leaving China either to avoid higher tariffs imposed by the U.S. on Chinese exports, or to move their production to more cost-effective locations based on evolving comparative advantages, more foreign investments are also entering into China to avoid retaliated tariffs placed by China on U.S. exports and to take advantage of opportunities in the Chinese market. In addition, portfolio inflow also hit a record high in 2018. Being an increasingly open economy with an ever-improving business environment and IPR protection, China is a crucial market that major multinational companies would not risk losing to any third party.

In addition, some technology transfer barriers and embargoes could weigh on China's technological development and innovation in the short term. But the suppliers could also be affected, sometimes fatally affected. Moreover, China could be forced to make large-scale investment for import substitution, and that will offset the decline in external demand and boost economic growth.

That said, we concur with staff that China and its trading partners should work cooperatively and constructively to settle their disputes in a rules-based multilateral framework and make joint efforts to reform the WTO in a good faith and win-win approach. That is not only good for China and the U.S., but also for the international community as a whole.

Mr. Mahlinza and Mr. Nakunyada submitted the following statement:

We thank staff for a comprehensive report and Mr. Jin, Mr. Sun and Ms. Liu for their helpful buff Statement.

The Chinese economy slowed down in 2018, against the backdrop of financial regulatory strengthening, softening external demand, and tightening conditions for local government infrastructure funding. Looking ahead, growth is expected to moderate reflecting the shift in policy focus from high-speed to high-quality growth. Downside risks include uncertainty around renewed China-US trade tensions, elevated financial vulnerabilities, and impediments to private sector development. Accordingly, we reiterate the need for continued efforts to amicably resolve trade tensions, further regulatory tightening, and steadfast implementation of structural policies aimed to advance market reforms. We broadly share staff's appraisal and provide the following comments for emphasis.

The modernization of the macroeconomic policy framework remains essential to reduce reliance on administrative measures. We encourage the authorities to prioritize the transition to a price-based monetary policy framework including adoption of a single policy rate. In addition, the need for a more flexible exchange rate to absorb external shocks associated with the country's exposure to volatile capital flows and escalating trade tensions, cannot be over-stated. That said, we welcome the reduction in external imbalances in line with medium-term fundamentals and desirable policies but impress on the need to eliminate distortions that support excessive household savings. As such, fiscal structural reforms remain critical to strengthening the social safety net to lower precautionary savings and enhancing the progressivity of the tax system. Further, we welcome the progress made in fostering fiscal discipline through the tightening of debt contraction by local governments. That said, we emphasize the need to reduce misalignment of center-local fiscal responsibilities which could undermine rebalancing efforts. Could staff clarify the divergent views on the accuracy of the DSA as highlighted in the buff statement?

The implementation of the announced regulatory reforms including the 2019 FSAP recommendations would be important to contain financial sector vulnerabilities. In this vein, we commend the authorities for the progress made in successfully containing credit growth and corporate debt through regulatory reforms implemented to reduce arbitrage opportunities and strengthen financial supervision. Nevertheless, we note the resultant balance sheet strains in small and medium sized banks, and system-wide capital inadequacies. Accordingly, we urge the authorities to continue with the efforts to strengthen capital buffers for small and medium sized banks. We also encourage the authorities to enhance the financial framework by developing a clear resolution regime and boosting the macroprudential toolkit to contain vulnerabilities from rising household debt. At the same time, fintech supervisory oversight should be further strengthened and deficiencies in the AML/CFT framework should be addressed in line with FATF recommendations. We note the authorities' decision to shift from deleveraging back to supporting growth, while household and corporate indebtedness remains elevated. Could staff elaborate on the likely effects of this policy stance on financial sector stability?

We welcome the detailed assessment of the implications of trade tensions and the associated spillovers. In this context, we urge the authorities to work cooperatively and constructively with trading partners to address weaknesses in the international trade system to keep pace with the dynamic global environment. Specifically, we underscore the need for prompt resolution of trade tensions in a manner that supports and strengthens the international trading system without recourse to distortionary trade practices that have far-reaching repercussions on global growth and trade. At the same time, we emphasize the important role that the Chinese economy can play in advancing global cooperation in e-commerce and fintech, setting global standards on industry regulation, digital standards, and cybersecurity.

Structural reforms should be sustained to boost consumption, foster competition, raise productivity and promote durable and inclusive growth. In this regard, we welcome the progress made in opening-up the economy through tariff cuts, enactment of a new investment law to improve treatment of foreign firms and prohibit forced technology transfer. Could staff comment on the adequacy of the recent changes to the negative list and their potential impact on the Chinese economy? Further, we view the recent improvements in the doing business rankings, as a positive development. That said, we encourage further efforts to promote private sector development and reduce the dominance of SOEs. We are, however, concerned about the recent reforms that have reinforced the dominance of SOEs in accessing credit via implicit guarantees, despite fiscal risks emanating from their weak profitability, and rising liabilities. In this respect, the opening-up of non-strategic sectors to private and foreign participation and the unification of product markets across localities would be important to increase the role of market forces and boost competition. Could Staff comment on the effectiveness of the authorities' preferred strategy to reduce SOE leverage by setting alert thresholds to trigger stricter supervision of their liabilities to asset ratios?

Mr. Tombini, Mr. Saraiva and Ms. Hennings submitted the following statement:

We thank staff for the well-written, insightful report and Mr. Jin, Mr. Sun and Ms. Liu for their useful statement. The Chinese economy is undergoing a delicate, multi-dimensional transition, which entails rebalancing from external to domestic demand, from investment to consumption, from industry to services, while improving income distribution and the environmental friendliness of the economy. Compounding with the structural slowdown of growth – intrinsic to this transition –, the onset of trade tensions changed the baseline scenario, putting additional pressure to the sequence of reforms that were cautiously being implemented. Standing as the second largest economy in the world with widespread trade and investment connections, the nature of the policy response by the authorities will affect not only the path of the Chinese transition and its results, but also its trade partners, and the global economy at large.

A well-managed, soft slowdown that preserves the ongoing structural rebalancing of the Chinese economy is in the best interest of both China and the world. We welcome the fact that the growth rate in the range of 6 to 6.5 percent is consistent with Chinese fundamentals and has been supported by more targeted policy responses, avoiding unduly stimulating the shadow banking and the property sector. Accommodative monetary policy suited well the current situation and next movements should be data dependent. Inflation is still subdued, albeit subject to food and commodity prices pressures. We take note that staff has a mixed assessment of the appropriateness of the fiscal responses, with four out of seven measures being deemed as not consistent with medium-term goals. That said, staff and the authorities agree that, in the absence of further deterioration in the international environment, current policies should be maintained as they suffice to stabilize growth over the relevant period. Under an adverse scenario, staff proposes a set of fiscal measures in line with medium-term objectives to recalibrate the stimulus and avoid an abrupt slowdown. Has staff discussed with the authorities that range of more desirable policy options in case further escalation of trade tensions takes place? Are authorities' views well aligned with staff's on how to react in such a circumstance?

As part of the transition, households' savings rate in China is in a declining trend, although it is still high compared to peers. The rise in household income has been reflected, among other things, in the increase in outbound tourism, with remarkable impact on current account balance. Nevertheless, shortfalls in the social safety net still encourage high savings. Fortunately, the Chinese demography remains favorable to promoting wide-ranging reforms in the health and pension systems, which could incentivize a change in the consumers' behavior reducing precautionary savings. We note, however, that household indebtedness has been growing at a fast pace and could threaten consumption growth over the medium term. The excellent SIP on household debt dwells not only on macro-financial risks but on this potential impact of debt overhang on consumer behavior. It also presents a series of policy recommendations that we would encourage the Chinese authorities to consider carefully. Approaching the shift towards consumption from a different angle, we realize that measures to reduce regional and rural-urban inequality have had limited effect and that addressing this challenge should have relevant impact on income and consumption. Does staff have an estimate of how substantial the effects of furthering domestic intraregional trade in China would be?

Regulatory and supervisory reforms induced financial deleveraging and decreased interconnectedness between banks and non-banks, but debt is high and still grows at a fast pace. Encouragingly, the asset management industry is shrinking, and shadow banking contracted. Raising banks' capital, especially in small and medium banks, is still key to ensure the continuity of this trend. We commend the authorities' commitment to measures and reforms that can strengthen the financial system and encourage them to avoid any regulatory backtracking. Nevertheless, the economy still struggles to channel resources to micro and small enterprises and to some priority sectors. In addition, we note staff's assessment that credit has been crowded out by state-owned enterprises that are still perceived as benefiting from government implicit guarantee. Concerning the 2017 FSAP recommendations, we highlight the need to address data gaps and the compilation of granular supervisory data. Better statistics will allow for increasing transparency and improved quality of analysis and policies.

The successful rebalancing of the current account (CA) is a testimony to the structural transformations taking place in the Chinese economy. Effective reforms favored the substantial decline of CA surpluses since 2007. In 2018, CA surplus reached 0.4 percent of GDP, driven by strong import growth and tourism expenses. Global uncertainty and the challenging environment have increased capital flows volatility, with effects on exchange rate behavior. We welcome the authorities' commitment to increase FX flexibility and to continue promoting market-oriented reforms. Considering the potential for capital inflows driven by the inclusion of China's shares and bonds into international indices, we agree with staff's recommendation regarding macroprudential measures.

We particularly valued the insightful box on complementarity and sequencing of reforms. We appreciate the vast reform agenda that has been implemented at an intensive pace in the past several decades in China. We also understand that the remaining to-do list is still very long and covers multiple areas. Nonetheless, the transition that China has been undertaking in the past five years is extremely delicate. Hence, having the thoughtfulness to devise how to better cope with political economy constraints is essential to ensure the success of this complex endeavor. Relatedly, we take the opportunity to underscore the important improvements in business environment, reflected by the substantial upgrade in China's position in the Doing Business ranking.

China has made a remarkable progress in implementing the legal system and a comprehensive AML/CFT framework, although there remains an important agenda to be completed. We note as particularly positive the high degree of inter-agency coordination and the fact that the Financial Intelligence Unit (FIU) has the potential to produce intelligence to support the operational needs of competent authorities. However, current fragmented access to data within the institution undermines its effectiveness in analyzing and disseminating information. Also vital is improving the understanding of financial institutions about risks and effective ways to mitigate them.

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

We thank staff for the comprehensive and excellent set of reports and Mr. Jin, Mr. Sun, and Ms. Liu for their informative buff statement. Although economic activity is expected to moderate, China's continued solid economic growth in tandem with the ongoing rebalancing of the economy and financial deleveraging is commendable. We broadly agree with staff's assessments and recommendations and would like to offer the following remarks.

The authorities should avoid additional stimulus and relying on excessive credit growth. Growth is still expected to be robust as the economy moves toward a more sustainable growth path. Under this scenario, we agree that the planned stimulus is sufficient to stabilize growth despite the recent tariff incidents. We note that government debt is already elevated and rising rapidly, and should the projected developments materialize, China could end up with significantly higher debt levels and a worse fiscal position within a relatively short timeframe. Nonetheless, the outlook is particularly uncertain given the trade tensions and that risks remain tilted to the downside. Should growth prospects deteriorate significantly, we agree that easing primarily through fiscal measures would be warranted. We positively note that the authorities intend to refrain from excessive credit growth to support the economy.

On monetary policy, we agree that any further easing should be data dependent and balanced with the need to monitor and contain leverage. We believe that exchange rate flexibility should continue to increase to facilitate adjustment to the external environment, but FX interventions should continue to be limited to counter disorderly market conditions. We also share staff's view that policy frameworks should be further developed to be more market-oriented and transparent in order to manage the increasingly complex economy.

Addressing data gaps will help improve policymaking, credibility, and surveillance. We welcome the substantial steps in improving monetary policy and financial stability communication. However, there is still room for enhancing transparency and statistics. We fully agree with the recommendation that estimates of the general government deficit and debt should be improved following international standards and include off-budget borrowing. Also, the long-standing recommendation of improving national accounts data and labor market statistics is fully warranted.

Financial sector reform and deleveraging should continue. We note that the build-up of risks in the financial sector has been contained, but vulnerabilities remain elevated and credit growth has picked up in 2019. We encourage the authorities to press forward with structural regulatory reforms to reduce still-elevated vulnerabilities and to move promptly on the reforms recommended by the FSAP. Strengthening bank capital, especially for smaller banks, as both staff and authorities point out, will be critical. Enhancing macroprudential tools to address vulnerabilities from rising household debt would also contribute to the resilience of the financial sector.

Further progress in reforms to open up the economy and increase the role for market forces are key to boost long-term productivity growth. To this end, there is a strong need for prompt implementation of the SOE reforms that have been put off for years. Long-term growth would be supported by increasing the role of the private sector and levelling the playing field. With slowing growth and increased fiscal stimulus, together with extensively high growth targets, the role of the state in the economy could increase further. This would be a step in the wrong direction, reducing the future growth potential, and making the reforms needed in the future even more challenging. As SOEs enjoy better access to credit and lower costs than POEs, eliminating implicit guarantees and hardening SOE budget constraints, as well as identifying and making exit plans for zombie enterprises would be important.

We welcome the authorities’ commitment to cooperate towards strengthening the multilateral and rules-based trade system. We support Staff’s view that trade tensions between the US and China should be resolved through comprehensive agreements that tackle the underlying roots of the tensions and not through a discriminatory or “managed trade” deals that could have a substantial negative effect on third parties.

Mr. Geadah and Ms. Abdelati submitted the following statement:

China’s growth is stabilizing after the slowdown in 2018 due to financial deleveraging, tighter conditions for local government infrastructure funding, and a slowdown in external demand. We note some continued progress on rebalancing, which is becoming more challenging in a highly uncertain environment. We note the once large current account surplus has nearly almost disappeared, driven by strong import growth, and the external position is broadly in line with fundamentals. Structural reforms have continued in many areas. Sizable capital inflows are expected to continue after the inclusion of China A shares in the MSCI equity indices and of local currency bonds into the Bloomberg Global Aggregate Index. Clearly, the trade conflict with the U.S. presents a major challenge for China, leading to an uncertain environment that weighs on the near-term and longer-term outlooks, with potential negative spillovers globally.

We commend the authorities on the structural reforms that are helping to open the economy to foreign investors and increase the role of market forces (paragraph 13 and pages 76-79). The new investment law, and the strengthened intellectual property protections are especially noteworthy. Accordingly, China moved up 34 places in the World Bank's Doing Business Rankings to 46th place worldwide. We share the concern that total SOE debt has increased following mergers of zombie central SOEs with other SOEs, and that one-third of SOEs remain loss making. In addition, we note that the rebalancing scorecard on page 56 has a majority of green-coded indicators. We also note the large increase in the contribution of consumption to GDP in 2018. As shown in Figure 2, labor reallocation toward services is continuing and has not slowed, and services accounted for 59.7 percent of GDP in 2018. What does staff consider to be the desirable level and what is the scope for additional internal rebalancing towards services in the coming years?

In view of the uncertainties, we appreciate staff's resort to three policy scenarios depending on the outcome of trade tensions. We note the broad agreement between the authorities and staff on policy responses under each of the scenarios. We agree with the desirability of increasing the role of markets, further movement toward greater openness, and SOE reforms as they could significantly boost productivity. The already announced policy measures are sufficient to stabilize growth in 2019, and additional fiscal stimulus would be warranted if trade tensions escalate further. Like staff, we see an urgent need for trade tensions between the U.S. and China to be quickly resolved through a comprehensive agreement that avoids undermining the international trading system and not through trade compression.

We commend the progress achieved in reducing financial sector fragilities. The reforms aimed at curbing shadow credit have been successful in reducing leverage in the financial market, particularly in the asset management businesses, and banks continued to bring off-balance sheet assets onto their balance sheets. Nevertheless, staff express concern that vulnerabilities remain elevated and credit growth is picking up. We note that banks continue to favor SOEs over private enterprises and that lending to SMEs in particular was curtained. Another area of concern is the rapid increase in short-term credit to households to circumvent restrictions on mortgage lending. Further strengthening of regulation is therefore warranted, through fully implementing announced reforms, and strengthening bank capital. Rising household debt, and extreme-over-indebtedness need to be addressed through strengthened macroprudential tools. We also agree that it would help to remove the implicit guarantee for SOEs to improve credit allocation.

The authorities continue to improve policy frameworks and seem to agree with many of staff's policy recommendations. With respect to modernizing the fiscal framework, the authorities want to foster more balanced regional development by establishing a transparent budget system and implementing budget performance management. We would like to hear what were the authorities' reactions to staff recommendations on structural fiscal reforms summarized in paragraph 69? We agree with the need to further enhance the social safety net with a more progressive tax system to discourage excessive household savings. We also encourage China to continue to upgrade its external lending framework to ensure greater transparency and foster further coordination.

Mr. Fanizza and Ms. Collura submitted the following statement:

We thank staff for their high-quality set of papers and Mr. Jin, Mr. Sun and Ms. Liu for their comprehensive buff statement. The report well describes the challenges the Chinese authorities face to stabilize growth amid rising global uncertainty, while at the same time pushing the transition to high-quality growth forward. We welcome staff's effort to tailor their policy advice to different scenarios. We broadly share staff's policy recommendations and will comment on a few specific aspects.

External imbalances

Structural changes have reduced external imbalances substantially, thus contributing to global stability. The relevant Selected Issues Paper provides a good analysis of both the factors behind this adjustment and its implications going forward, including the likely higher volatility of financial flows. The latter requires policies towards more stable capital flows and the internationalization of the Renminbi (RMB), which we support; we share the staff’s call for more flexibility and transparency in the management of the RMB.

We concur with staff that policies should continue focusing on rebalancing by addressing distortions that lead to excessive household savings, e.g., limited social welfare. A stronger social safety net together with a more progressive income tax structure would help tackling inequality. We would appreciate if staff could clarify why they believe the recent increase of the taxable-income threshold reduces progressivity, which seems counterintuitive. Moreover, we note that advocating policies to boost consumption appears at odds with staff’s concerns about the high household debt as a source of financial vulnerabilities. Staff’s comments would we welcome.

Trade

A renewed multilateral system is necessary to promote open and stable trade. Staff provide an interesting analysis of the global distortive impacts of a possible “managed trade deal” among the US and China, including negative long-run productivity effects. In accordance with the Guidance Note on Surveillance, such a focus on outward spillovers seems very sensible, as well as the policy advice to work for an agreement based on market mechanisms and macroeconomic fundamentals. We are confident that the US-China trade negotiations could provide an opportunity for improving the overall quality and fairness of the global trade system.

The Belt and Road Initiative (BRI)

We believe the BRI constitutes a valuable promise for global development. Infrastructure upgrading will favor markets’ interconnectedness and deeper global value chains – by leveraging investment and trade. To fully seize these opportunities, we believe it is essential enhancing discipline in external lending, monitoring debt sustainability, and adhering to global standards.

The productivity outlook

We share staff’s view that wide-range reforms to enhance productivity and policy frameworks would support more sustainable growth. We welcome that there is broad agreement between the staff and the authorities on the needed reforms. Further opening up of markets and more competition would benefit both the Chinese and the global economy. In this regard, SOEs reforms are key to level the playing field and reduce market malfunctioning. The improved communication of monetary and financial-stability constitutes a favorable development that should be followed by improved transparency and statistics on fiscal accounts.

We believe that more analysis should be devoted to productivity trends, thus considering e.g., the heterogeneity respectively in services and industry, issues of measurements, the possible structural transformations that will occur in the economy, and how eventually total factor productivity (TFP) will evolve. We are not convinced by staff's view that the shift from industry to services would inevitably put sustained downward pressure on GDP growth (cfr. Box 1). In fact, looking at the impact that technological innovations have had on the productivity of certain services, we believe the traditional idea that services have lower productivity may have become obsolete. Furthermore, as the decline in the Chinese GDP growth in the last decade is mostly explained by a lower TFP trend, we wonder whether major focus should be put on factors that affect TFP. In this regard, while noting that progress on environmental rebalancing recently occurred, we would appreciate if staff could consider more analysis on the impact that environmentally-oriented policies may have on TFP.

Finally, with reference to the recent AML/CFT assessment, we encourage the authorities to continue making progress towards improving the legal system and the effectiveness of the measures taken.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written set of papers and Mr. Jin, Mr. Sun, and Ms. Liu for their helpful buff statement.

Facing external headwinds and an uncertain environment, China is making steady progress in its planned shift from high-speed to high-quality growth under the authorities' skillful economic management and sound policies. Growth in 2019 has moderated to a more sustainable level, with policy support partially offsetting the adverse impact of US tariff hike on Chinese exports; inflation is projected to rise marginally because of higher food prices; and unemployment is stable at around 5 percent. The external position is in line with fundamentals, reflecting China's commendable progress in reducing external imbalances over several years, and reserves remain adequate. The buildup of risks in the financial sector has been contained, although vulnerabilities remain elevated; and structural reforms have progressed in several areas, including in substantially improving the business environment as confirmed by the World Bank's 2019 Doing Business Rankings. The fiscal deficit, however, has widened further, and public debt is on an upward trajectory. Given downside risks to the outlook, including from further escalation of trade tensions, the authorities are encouraged to continue their efforts to modernize policy frameworks, strengthen financial sector regulation and supervision, and advance productivity-enhancing structural reforms to ensure a more balanced and sustainable growth over the medium term. We concur with the thrust of staff appraisal.

In the absence of further US bilateral tariff increase, we agree that fiscal policy should avoid additional stimulus in 2019 and 2020 and that gradual growth-friendly consolidation could resume, once trade tensions ease, to balance growth and adjustment concerns. Should downside risks materialize, however, fiscal expansion could be used to support growth. A more durable external and internal rebalancing requires discouraging excessive household savings, further boosting consumption, and closing socio-economic, urban-rural gap. Consideration should be given to limiting off-budget infrastructure outlays by local governments while increasing social spending and transfers by the central government to poorer households and regions, accelerating the introduction of a nationwide recurrent property tax, reducing the personal income tax and broadening the tax base, and introducing a coal tax. We see merit in enhancing fiscal governance and transparency and appreciate staff indication if the authorities are willing to produce a fiscal risk statement, given risks associated with quasi-fiscal operations of SOEs and extrabudgetary funds.

Anchored core inflation and inflation expectations and delays in transmission of earlier monetary easing argue for keeping the monetary policy unchanged and data-dependent, pending also the impact of fiscal loosening and recent credit growth acceleration on inflation. Should core inflation fall along with growth, further easing could be warranted. Monetary policy could become more effective by PBC's greater operational independence, developing a market-based loan pricing mechanism, and basing price and access to PBC's lending facilities on clearly defined collateral rules. We welcome a more flexible and market-determined exchange rate that plays a greater role in absorbing shocks and facilitating external adjustment.

We are reassured by the authorities' commitment to constructive bilateral negotiations as well as collaboration with other emerging markets and the OECD to modernize the international trade system. Commitment to free trade and payment systems should extend to resisting unfair unilateral restrictions imposed by any of China's trading partners against its other partners. We note the authorities' three immediate WTO reform priorities and appreciate staff elaboration on the abusive use of national security exemptions under the WTO rules.

Financial deleveraging, contraction of shadow banking, and reduced interconnectedness between banks and nonbanks have helped lower corporate debt-to-GDP ratio and contain financial stability risks. However, capital remains low for small and medium-sized banks, profitability is under pressure, credit allocation to private SMEs has declined, and household debt has risen rapidly. The first public bank (Baoshang) takeover in twenty years and the ensuing funding pressures on small banks highlight the still-elevated vulnerabilities in the financial sector and place a premium on pressing ahead with key FSAP recommendations. Corporate credit allocation should also be improved by limiting SOE use of preferential credit schemes and accepting alternative forms of collateral for SMEs.

Mutually-reinforcing and properly-sequenced structural reforms to strengthen the role of market forces, foster greater openness, and intensify SOE reforms are essential to increase competition, boost productivity and income convergence, and support strong and sustainable growth. Product markets should be unified across localities and labor market made more flexible. We welcome decreases in tariffs, passage of a new foreign investment law, and revisions to the negative list for foreign investment, and encourage further steps towards equal market access and opening up of the service sector to private and foreign enterprises. We are pleased to learn from Mr. Jin, Mr. Sun, and Ms. Liu that no subsidies or loans will be provided to prop up the operation of nonviable SOEs, and that the authorities are committed to maintaining a level playing field for all types of companies, be it public or private, domestic or foreign.

We wish the authorities continued success in their endeavors.

Mr. De Lannoy and Mr. Cools submitted the following statement:

We thank staff for the excellent set of papers and Mr. Jin, Mr. Sun, and Ms. Liu for the insightful buff statement. We agree with the thrust of the report and would like to add the following comments for emphasis.

Economic outlook and risks

We agree with staff on the near-term economic outlook and associated risks. Economic activity is set to moderate in 2019 and 2020 as domestic rebalancing and deleveraging needs are compounded with the trade dispute with the US. Risks are tilted to the downside, and the medium-term outcome depends critically on China's policy response, i.e. further structural reforms and opening up of the economy will be needed to boost productivity, enhance competitiveness and potential growth.

We share staff's view that the planned stimulus can stabilize growth in 2019 and 2020, but current stimulus measures may be less effective than in the past. The pick-up in credit growth and in real estate and infrastructure investment in recent months risks undermining the rebalancing of economic growth and de-risking of the financial sector. At the same time, the VAT and personal income tax reforms together with reduced taxation of smaller firms can contribute to the recovery of consumer and investor confidence dented by the high degree of uncertainty surrounding the trade dispute with the US.

We support staff's view that the US and China should work together on reaching a comprehensive trade agreement that tackles the underlying cause of the tensions instead of a discriminatory or "managed trade" deal that could have a substantial negative effect on third parties. We welcome in this respect the authorities' commitment to cooperate towards strengthening the multilateral and rules-based trade system.

Finally, while staff is right to focus on a negative scenario given the dynamics of the ongoing negotiations, it would be worthwhile to also look at the effects of a possible positive scenario in which China would address structural issues as part of a trade deal, the Chinese economy would open up significantly and the role of market forces would be increased. Can staff elaborate on what they expect will be the effects in such a scenario in terms of GDP, investment and trade volumes?

Fiscal policy

We agree with staff that further fiscal reforms are necessary to strengthen fiscal transparency and discipline at the local government level and improve the allocation of responsibilities between the central and local levels and the provision of public services. The current fiscal set-up favours large quasi-fiscal deficits which have gradually spilled into a rapidly rising "augmented" public debt, which staff estimates at 73 percent of GDP in 2018 and projects to exceed 100 percent of GDP in 2024. Against this background, the likely widening of the "augmented" general government deficit from 11.2 percent of GDP in 2018 to 12.7 percent of GDP in 2019 seems less benign in terms of policy space and sustainability. Under the baseline, gradual consolidation should thus be pursued once trade tensions ease, while continuing to encourage consumption and support inclusive growth through a comprehensive reform of the social security system and increasing progressivity in the tax system so as to address high levels of income inequality. Finally, regarding external lending frameworks, we fully agree with staff that the authorities should introduce frameworks based on global standards that promote transparent and sustainable lending practices, enhance capacity building, and foster cooperation between international organizations, borrowers and creditors.

Monetary policy

We agree with staff's assessment that financial conditions eased somewhat after loosening monetary policy. The monetary loosening was achieved mostly by cutting reserve requirement ratios (RRRs). Although the People's Bank of China (PBoC) has also injected more liquidity into the banking system, the growth in bank credit to the real economy has so far remained relatively stable. We agree that further monetary policy easing should be data-dependent and assessed in view of its effective transmission to credit growth and emphasize that it should be balanced with the need to contain leverage. New measures to support lending to small private companies were taken, but access to credit for these firms remains difficult. The previous deleveraging campaign obstructed their funding channels both from shadow-banks and banks which prefer companies with state back-up. We also share staff's view that the operating framework should be simplified in order to improve transparency and communication of monetary policy.

We encourage further progress with the reform of the monetary policy framework to a more competitive market-based system. We agree with staff' view that further efforts should be made to move to one key policy rate and phase out benchmark deposit and lending rates.

We believe that exchange rate flexibility should continue to increase, and FX intervention should be limited to counter disorderly market conditions. In this respect, we see the restoring of the reserve requirements for forex forward contracts and reintroducing the counter-cyclical factor in the USD-CNY fixing as slowing the progress of the yuan towards becoming a fully-convertible currency.

Financial sector

Strengthening bank capital, especially for smaller banks, as both staff and authorities point out, will be critical. Concerns about the soundness of small banks have been increasing after the Chinese banking regulator took over Baoshang Bank, a small city bank, which led to some stress in the interbank and corporate bond markets. We believe that the takeover underlines the need for developing a clear resolution and deposit guarantee regime, which would allow weak banks to exit the market orderly. We agree with staff that removing implicit guarantees for state-owned enterprises (SOEs) is one of the most important elements of the financial sector reform. Enhancing macro-prudential tools to contain vulnerabilities from rising household debt would also contribute to the resilience of the financial sector.

Structural reforms

We fully share staff's concerns about the significant decline in productivity growth since the Great Recession and their recommendations to accelerate the SOE reform to limit SOE's preferential access to credit and allow the exit of non-viable companies. Reducing subsidies and excess capacity in the SOE sector remain important concerns. Building on recent progress, the role of the market should be further strengthened by opening up non-strategic sectors, particularly services, to private and foreign companies and by increasing labour market flexibility. Reform complementarities and sequencing should be critically considered in order to limit short-term adjustment costs and maximise impact. We also recommend moderating the growth pace of infrastructure and real estate investment in favor of increased investments in health care and education aiming to further reduce poverty in rural areas. This would limit the allocation of resources to activities with diminishing returns while, at the same time, allow higher consumption and welfare levels for Chinese citizens. Investments should also contribute to enhancing environmental sustainability by ensuring that they are green, low-carbon and climate resilient. Finally, we welcome the recommendation to modernise policy frameworks and improve governance, including in financial supervision and regarding overall transparency and statistics.

Ms. Levonian, Ms. McKiernan and Mr. Weil submitted the following statement:

We thank staff for the very well written Report and Selected Issues Paper, and Mr. Jin, Mr. Sun and Ms. Liu for their buff statement. We support staff's overall assessment of mixed progress towards internal and external rebalancing against an uncertain outlook for the Chinese economy due to domestic challenges and difficult external conditions.

We agree with staff on the economic outlook and associated risks. Under the baseline, growth is expected to slow gradually while moving to a more sustainable path as domestic rebalancing and deleveraging take place. China's longer-term income convergence will depend on its ability to boost productivity by strengthening the role of the market, opening up the economy, and increasing competition. Risks are tilted toward the downside due to the ongoing trade dispute with the US, but also from domestic challenges. Given the uncertain environment we welcomed staff's decision to provide policy advice tailored to different trade outcomes.

The authorities should commit to free and fair trade and a rules-based multilateral economic order. Economic uncertainty from trade tensions result from US and Chinese trade actions. We encourage the authorities to continue negotiating with the US in good faith to reach a durable resolution to the ongoing dispute. We highlight the value of Box 2 on the spillovers from a potential managed trade agreement with the US and agree that a discriminatory or managed deal between the US and China would distort market-based trading and weaken the rules-based global trading system. The authorities should prioritize an agreement with the US that reinforces WTO rules, is non-discriminatory, is based on market mechanisms, and remains consistent with macroeconomic fundamentals. We note the authorities' WTO reform priorities and urge China to reverse its own use of unilateral trade actions for political ends.

The external position is now consistent with medium-term fundamentals, but sustained efforts are required to maintain external balance. We broadly agree with the staff assessment and recommendations toward achieving a durable external balance through continued progress in reducing excessive household savings and boosting consumption, including by enhancing the social safety net and making the tax system more progressive. The authorities should also prepare the financial system to handle greater volatility and larger capital flows by de-risking the financial system and improving FX management.

Fiscal policy should remain adaptable to a changing external environment and not lose sight of worsening debt dynamics. We support staff's overall view that under the baseline no further stimulus is required, and that spending should be re-directed towards health, education and transfers to poor households. While we agree that a gradual fiscal consolidation should wait until significant trade-related economic uncertainty abates, worsening augmented debt dynamics are a concern. In particular, augmented debt is expected to reach 101 percent of GDP by 2024 under the baseline, a trajectory that would require a massive 7 points increase in the primary balance to stabilise. We continue to strongly support staff's use of the 'augmented debt' concept to account for significant spending and debt, including off-budget debt, at the local government level. Staff are encouraged to provide greater information regarding the fiscal risks from SOE debt, particularly as the authorities' SOE categorisation project unfolds and there is greater transparency around SOE mandates. Reforms are also needed to strengthen fiscal transparency including by resolving fiscal data issues that are limiting the accuracy of the debt perimeter. This should be done as part of an overall effort to address longstanding statistical gaps.

We note progress on exchange rate flexibility and urge the authorities to continue their efforts. The use of capital controls and the counter-cyclical factor to manage potential capital outflows is slowing progress in this respect. FX intervention should be limited to countering disorderly market condition. The operating framework should be simplified in order to improve the transparency and communication of monetary policy. We encourage the authorities to continue moving towards a more market-based monetary policy framework and agree with the staff view that further efforts should be made to move to one key policy rate.

The authorities need to commit to achieving competitive neutrality. We strongly agree with the staff recommendations aimed at accelerating and intensifying SOE reform to reduce the role of the state in the economy. A first step is the publication of the State-Owned Assets Supervision and Administration Commission's classification of SOEs as social, strategic or competitive. This is essential to achieving competitive neutrality between 'competitive SOEs' and privately-owned enterprises by limiting SOE credit advantages and actively eliminating implicit guarantees, while managing fiscal and financial sector spillover risks. The authorities should seek to right-size the SOE footprint through a bottom-up assessment of the role of the state and the orderly exit of zombie companies, rather than strictly through amalgamations. We support measures that would strengthen the credit culture, such as more flexible collateral policies or the establishment of a credit bureau that could support financial institutions' credit analysis. We are not supportive of supply-side credit policies that would see state-owned banks directed to increase loans to SMEs or private firms as such policies risk further distorting credit allocation.

The impact of credit growth on household debt and the resilience of the banking sector need to be monitored closely. Deleveraging reduced financial system interconnectedness, improved supervision, and a reduction in shadow banking have helped to contain risks in the financial system. However, a recent pick-up in credit growth could exacerbate risks from rising household debt. There are also signs of stress in the small and medium banking sector. We note the difference of opinion between the authorities and staff as to whether the failure of Baoshang Bank was an "isolated but educational case" as outlined in the buff statement or indicative of broader banking sector vulnerabilities. Balance sheet vulnerabilities, lower tier 1 capital, and a reliance on tightening interbank funding by small and medium sized banks could justify concerns of a broader nature. We support staff's recommendations for the authorities to strengthen bank capital, develop a clear bank resolution regime to allow more orderly market exit, and strengthen macroprudential tools to contain vulnerabilities from rising household debt. Does the newly created People's Bank of China Macroprudential Policy Bureau have full macro prudential authority or does this authority remain dispersed?

The authorities should address the findings of the 2019 Fund staff-led assessment of China's AML/CFT system. The authorities should continue strengthening the integrity of the financial sector particularly as they were assessed as being insufficiently effective against 8 of 11 of the FATF's immediate outcomes for AML/CFT frameworks.

We would have welcomed an analysis of China's progress in reducing inequality and improving social outcomes. The staff report mostly touched on social spending through the lens of supporting consumption as part of a sustained external rebalancing. The report did not present poverty and inequality metrics as part of an overall assessment of the authorities' stated goal of eliminating absolute poverty in rural areas by 2020. The staff report was also silent on issues of gender equality. Could staff highlight any noteworthy developments in these areas?

We encourage the authorities to consent to the publication of the Selected Issues Paper.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for their rich and insightful report and Mr. Jin, Mr. Sun, and Ms. Liu for their useful buff statement. The Chinese economy continues to experience high GDP growth rates but is facing significant internal and external challenges. Reforming domestic institutions and curbing financial vulnerabilities through adequate macro-financial policies are necessary steps. While conscious of the difficulties to navigate in a complex environment, reforms and rebalancing measures should be pursued, to allow for a gradual slow-down of growth rates.

Chinese authorities have readjusted their macroeconomic policy stance since last year Article IV. While motivated by the deterioration of the external situation, these evolutions should be designed to safeguard the overall objective of the authorities to ensure sustainable and quality growth as mentioned in the buff statement. In this regard, we would like to offer the following comments:

Fiscal and monetary stimulus measures taken over the last months cast doubt on whether derisking and deleveraging of the Chinese economy remain the primary policy objectives. While the growth slowdown is partly a result of the trade dispute with the US, it is also a natural consequence of the derisking policy undertaken since 2016. Despite those derisking efforts, the authorities have maintained an expansionary fiscal policy for the last 4 years, monetary conditions are still loose and credit growth is still elevated. Against such a background, it is important to carefully design supportive measures, as recommended by staff, in order to avoid feeding medium-term risks. We notably wonder whether the natural growth rate of the economy (without the various stimulus measures undertaken over the last years) is not lower than the actual growth rate. Staff comments on the desirable level of macroeconomic stimulus and the level of the growth rate that would be entailed by a neutral macro-financial policy stance would be welcome.

Given the high public deficit and rapidly rising public debt, fiscal policy could be excessively expansionary. We thank staff for its detailed assessment of recent fiscal measures which is particularly informative. While we understand the authorities' intent to cushion the impact of external developments, we wonder whether the size of the stimulus as well as its composition might go beyond this purpose. Fiscal measures should be consistent with the medium-term goals of a balanced and sustainable economic model. As recommended by staff, measures should be targeted to support lower income households to maximize the multiplier effect and favor consumption rebalancing. Going forward, given the needed fiscal adjustment of 7 percent of GDP to stabilize public debt to GDP, the authorities should start to design a medium-term fiscal consolidation strategy, including a reduction of off-balance sheet spending. While we agree with the authorities that considering the asset side of public finances is useful to assess fiscal space, last Fall Fiscal Monitor on Public Wealth highlighted a decrease in China net worth since 2014 and called for a cautious approach to Chinese public assets valuation, notably concerning SOEs and public infrastructures at the local level. Moreover, we wonder how such valuations of public assets could evolve in case of a negative growth shock. Staff comments on the reliability of public asset valuations and potential evolutions in case of negative shocks are welcome.

Regarding financial and monetary conditions, we support staff call to focus policy efforts on credit allocation. While past measures aimed at financial derisking have somewhat slowed debt growth and the authorities are to be commended for the implementation of past staff recommendations on shadow banking products, we are concerned that it has been done at the cost of increase credit misallocation both in the corporate and households sectors. Moreover, recent stress on small and medium sized banks revealed the insufficient capitalization of these institutions. We fully support staff call to maintain a strong regulatory oversight, notably concerning household debt macroprudential measures, and to swiftly boost banks' capital.

We continue to welcome the significant adjustment of the current account over the last decade which has been one of the main contributors of the reduction of global imbalances. We note that staff estimates that the external position is broadly aligned with fundamentals and that foreign exchange interventions have been limited. Those are encouraging developments. As highlighted in the Selected Issues Papers, this rebalancing is the result of structural factors such as the normalization of the household saving rate but also of a still high level of investment. Going forward, this external rebalancing should remain consistent with internal rebalancing toward consumption and durable financial derisking as well as a gradual opening of the capital account.

We thank staff for its analysis of the convergence potential of China which provides a useful benchmark for future growth rates. However, we would insist that these estimations of potential growth should be seen as conditional on the implementation of sustainable macroeconomic policies and reforms to improve resources allocation. The economic literature has notably shown that past credit misallocation can durably weight on future productivity growth. In addition, we would be interested to have staff's assessment of the prospective evolution of employment, notably how employment and unemployment would react to slower growth rates.

In parallel to the rebalancing of macroeconomic policies, putting in place the conditions for a sustainable and inclusive growth model will require a broad structural reform agenda. While we agree with most of the recommendations made in the report, we would like to highlight a few points for emphasis:

Reforming SOEs and ensuring regulatory neutrality is key to ensure medium domestic productivity growth. While we recognize that Chinese SOEs have undeniably been a key factor explaining the impressive success of the last 40 years including the development of new utility networks, we think that the renewed increase in the share of SOEs debt in total corporate debt, their still high leverage and low profitability need to be tackled upfront. Without any bias on the best ownership structure of enterprises, we think it is important to ensure a proper level playing field between privately and public owned firms. In this regard, we thank staff for the quality and richness of its Selected Issues Paper on improving the allocation of corporate credit. We particularly value the attention given to reforms sequencing which makes staff recommendations operational and provides the authorities with concrete steps to promote debt and regulatory neutrality. We encourage the authorities to start implementing the preconditions necessary to eliminate implicit guarantees laid out in the SIP and staff to monitor the progress made on these reforms in future Article IV.

We encourage the authorities to further improve the transparency and quality of economic data. We regret that no improvements have been made to reconcile the authorities views on public finance data with international standards. We reiterate our call for Chinese authorities to adopt accounting practices aligned with agreed public finance accounting principles. Notably, we urge the authorities to adopt the accounting principles related to the private/public classification of spending which are based on economic substance rather than legal considerations. In the financial sector, we see the development of credit registries, both for corporates and households, as key investments to ensure the proper functioning of financial supervision.

France supports an open, transparent and rule-based international trade system and encourages the Chinese authorities to resolve existing trade tensions through non-discriminatory reforms and multilateral cooperation. SOEs and subsidies reforms, openness to foreign investments and protection of intellectual property are key areas where further progress is needed to ensure the proper functioning of the international trade system. Concerning the Belt and Road Initiative, we commend the authorities for the recent publication of a debt sustainability analysis framework. Could staff comment on how this DSA framework and the signal it sends will be used to guide lending decisions by Chinese lenders, elaborating on governance and accountability mechanisms?

We welcome the integration of inequality and environment into the rebalancing scoreboard presented in staff report. We note with regret the mixed results obtained in these two categories and we would welcome a more extensive discussion of potential policy remedies in future Article IV. As we highlighted last year, inequalities have strongly risen in China these last decades and the tax and transfer system largely fails to reduce market income inequality. There is a strong case for an ambitious reform package aiming at increasing both the level and progressivity of taxes and of social safety nets. On climate change, we would appreciate an update of the 2016 SIP on climate mitigation to better measure the progress made so far toward the commitment taken under the Paris agreement and discuss further policy challenges.

Mr. Merk and Ms. Kuhles submitted the following statement:

We thank staff for the well-written set of reports and Mr. Jin, Mr. Sun and Ms. Liu for their insightful buff statement. Growth in China has stabilized in the beginning of 2019 from a slowdown in 2018, before being hit by another trade shock this year. Business sentiment is encumbered by sluggish domestic as well as external demand, not least due to uncertainty surrounding trade tensions. Domestically, risks regarding accelerated debt accumulation and a potential downturn in the property market weigh on the outlook. To support the objective of moving from “high-speed” to “high-quality” growth, it is critical for the Chinese authorities to implement crucial reforms, opening up the economy and strengthening market forces, containing credit growth, strengthening financial regulation and supervision, moving towards a more progressive tax system, and modernizing policy frameworks. As regards the conjunctural outlook, we fully support staff’s assessment that no additional policy easing is needed in the baseline scenario. As we broadly concur with staff’s appraisal and recommendations, we would like to highlight a few distinct aspects:

The current trade tensions between the United States and China weigh on business confidence and create large uncertainties. The authorities should work towards a comprehensive resolution of the trade conflict that is in line with and supports the strengthening of the multilateral and rules-based international trade system. A bilateral agreement based on “managed trade” could have significant adverse economic impacts, including producing substantial spillovers for third parties through the diversion of trade, as also implied by staff’s research (Box 2).

Regarding China’s external lending, we call for higher transparency and increased debt sustainability monitoring. We agree with staff that China should continue upgrading is external lending framework and adhere to global standards that promote transparent and sustainable lending practices and greater coordination and cooperation among borrowers, creditors and international organizations. In this context, we would also be interested in staff's view on a recent study which suggests that about 50 percent of China's lending is "hidden" and not captured by the IMF or World Bank.[1] Staff comments would be welcome.

In light of loosened financial conditions and accelerated credit growth, the authorities need to remain vigilant in order to safeguard financial stability. We welcome the progress in financial deleveraging and the reduced interconnectedness between banks and non-banks. Nonetheless, credit growth has picked up again, along with worsened credit allocation. This is reflected in difficult access to credit for private, particularly smaller firms despite a decline in short-term interest rates. We therefore echo staff's call that credit should be allocated through a more market-based system to ensure the efficiency of credit allocation. To prevent growing financial vulnerabilities, we encourage the authorities to continue reform efforts, with special emphasis on a proper bankruptcy regime to tackle extreme over-indebtedness.

In addition, we concur with staff that further monetary policy easing is not recommended and that monetary policy should make further progress towards an interest rate-based system with one key policy rate. This should be complemented by greater operational independence and accountability of the PBC around a clear inflation objective. As regards the rise of digital money and its impact on financial stability, we wonder how the widespread use of payment services such as Alibaba's "Alipay" or Tencent's "WeChat Pay" impacts bank profitability and financial stability. To what extent has staff looked into the potential risks as well as chances of the increasing role of online payment providers?

We believe that exchange rate flexibility should continue to increase and FX intervention should be limited to counter disorderly market conditions. In this respect, we see the restoring of the reserve requirements for forex forward contracts and reintroducing the counter-cyclical factor in the USD-CNY fixing as slowing the progress of the yuan towards becoming a fully-convertible currency.

We take positive note of the progress on reforms regarding financial sector opening and strengthened protection of intellectual property rights. This, however, came at the expense of dominance of SOEs. While we

[1] Horn, S. et. al. (2019): Kiel Working Paper, China's Overseas Lending, IfW Kiel Institute for the World Economy, No. 2132, June 2019.

appreciate that the business environment in China has improved, we would like to point out that SOE debt has increased and is relatively large, amid low profitability and a high share of loss-making SOEs. Increasing competition through strengthening the role of markets, while at the same time allowing for foreign market access, is key to lift productivity and potential growth.

China has successfully reduced external imbalances over the years, but partly at the expense of internal imbalances. A sustainable rebalancing requires a gradual reduction of expansionary policies and the implementation of structural reforms. Rebalancing of consumption vs. investment has progressed, even though household consumption remains very low compared to peers, due to high savings and persistent internal imbalances with regard to income distribution. As outlined in the 2019 External Sector Report, a high fiscal as well as domestic credit gap and a decline in reserves have contributed to a narrowing current account surplus. Yet, in light of prevailing domestic imbalances we would like to emphasize possible spillovers of a disorderly unwinding of domestic imbalances. Enhancing the social safety net and making the tax system more progressive, while containing credit growth, could address this issue. In this context, as accentuated by staff, the introduction of a recurrent property tax might have the additional benefit of curbing property speculation. Last but not least, environmental rebalancing has progressed, especially with regard to air pollution. However significant challenges remain, particularly concerning energy intensity, which could be addressed through a comprehensive mechanism of carbon pricing.

We note that according to staff high spatial and rural-urban inequality remains a challenge in China, also with significant macroeconomic implications. Staff's reasoning arguing in favor of accelerating the reform of the 'hukou' system, which could promote labor mobility and reduce inequity between migrant workers and other residents, seems reasonable. Reducing barriers in labor and product markets across regions and localities could also facilitate firm entry and boost competition. Moreover, reviewing federal fiscal relations in areas such as education and health could ensure a minimum level of service and reduce regional disparities.

Last but not least, we echo staff's call to make fiscal accounts more transparent and bring data more in line with international standards in order to improve policymaking and the credibility of China's G20 commitments. In this context, we strongly encourage the authorities to consent to the publication of this report. A timely release of the report can help the effectiveness of Fund surveillance.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for their well-written set of reports, and Mr. Jin, Mr. Sun and Ms. Liu for their informative buff statement. China’s strong economic progress over the last several decades and its substantial contribution as the engine of global growth has been remarkable. Consequent to the reforms undertaken to open-up, the Chinese economy has grown to become the second largest economy in the world. The employment and income levels have increased, and poverty has declined substantially. We commend the authorities for continuing reforms to further open-up the economy and allow a greater role for market forces in their economic rebalancing efforts towards consumption-led growth and high-quality development. Efforts to improve the transparency in many aspects of the macroeconomy is also noteworthy. We broadly concur with the thrust of the staffs’ appraisal and wish to make following remarks for emphasis.

The growth outlook indicates important trends. The developments in the Chinese economy and its spillovers to the global economy in the near to medium-term will largely depend on the outcome of the trade negotiations. In effectively facing these challenges, the modernization of the macroeconomic policy framework also remains a key requisite. The decades long high growth is projected to gradually converge to a more sustainable growth path by around 2030 highlighting the need for taking continued measures to improve productivity and enhance potential growth.

Fiscal policy has been more targeted to support domestic demand. Given the adequacy of planned stimulus, including large cuts in taxes and fees, staff does not see any need to provide additional stimulus to stabilize growth in 2019 and 2020 unless the trade tensions are escalated. We concur that the policy space should be effectively used to offset any negative impacts from needed structural reforms rather than taking efforts to achieve excessively high growth targets, which will also help improve the quality of the medium-term adjustment.

The current monetary policy of the People’s Bank of China (PBC) seems appropriate. Like staff, we note that further actions should be proactive and data dependent, taking the impact of fiscal loosening and credit growth into account. Modernization of the monetary policy framework will be important by eventually moving to a single policy rate. We commend the authorities for their commitment to increasing exchange rate flexibility and deepening market reforms. We positively note that the PBC has had little FX intervention recently and the foreign currency reserves of about US$ 3.2

trillion remain more than adequate to allow a continued transition to a floating exchange rate.

We commend the authorities for pressing ahead with financial regulatory reforms and deleveraging amidst external shocks. The reform efforts have been particularly successful in reigning credit growth. However, the lack of credit flows to SMEs, particularly the sharp decline in the lending to small and micro firms, and increased credit to SOEs remain as concerns. The significant increase in household debt, which now stands above the emerging market average, will call for further tightening of macro prudential measures. We encourage the authorities to implement reforms, including those were recommended by the FSAP, to address elevating vulnerabilities in the financial sector, and also to implement recently concluded FATF recommendations to strengthen the AML/CFT framework.

Trade tensions have had a significant impact on the Chinese economy. We welcome the detailed analysis in this regard and commend the continued policy measures implemented to open-up the economy, including the reduction of the effective tariff rate, as well as the prohibition of forced technology transfer, revision of the negative list for foreign investment to liberalize investment regime and protection of intellectual property rights. That said, we note the potential impact of trade tensions, particularly in terms of corporate investment and relocation of global supply chains. Could staff comment on the relocating or downsizing trends in response to declining demand, which could also fuel worries about layoffs, affecting employment and the potential increased entering of foreign investments that could offset such implications? We echo the authorities' view that trade tensions need to be resolved through dialogue and consultation based on mutual respect, equality and credibility, indicated in the buff. This should be complemented by constructive and collaborative work by China's international partners.

A noteworthy progress has been made in reducing the role of SOEs in the economy. We welcome the disposal of about 95 percent of zombie firms, as indicated in the buff. However, the majority has been disposed through mergers and acquisitions as well as internal restructuring. Meanwhile, staff has indicated that some of the recent reforms have increased the dominance of SOEs and worsened the environment for private businesses. Could staff comment on these developments in the context of addressing excess capacity, entity profitability and promoting private sector involvement in the economy?

We commend the substantial progress in implementing structural reforms. The significant improvement of the World Bank Doing Business ranking is particularly commendable. Going forward, we encourage the authorities to accelerate, deepen and broaden structural reforms while also focusing on environmental protection and social equality.

With these remarks, we wish Chinese authorities all the very best in their future endeavors.

Ms. Mahasandana and Ms. Yoe submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Jin, Mr. Sun and Ms. Liu for their insightful buff Statement.

China has made significant headways in transforming its economy, and its successful transition towards to a more balanced and sustainable growth model will not only bring long-term benefits to China but also to the global economy. In this regard, we welcome the authorities' continued efforts in pursuing high-quality growth and to further open up the economy. That said, further progress on rebalancing is needed, and the challenging task of reforming such a complex and systemic economy has become more difficult amid trade tensions and weak global demand. We encourage the authorities to push ahead with structural reforms and rebalancing to address financial vulnerabilities and to improve productivity, and avoid large-scale policy easing that would reverse the progress made.

Policy mix must be carefully calibrated to allow smooth transition to more balanced and sustainable growth while ensuring continued reform progress. The active fiscal policy undertaken by the authorities has helped to stabilize near-term growth, and we take positive note that the authorities are committed to implement prudent and carefully calibrated monetary and credit policies so as not to backtrack on deleveraging. We take comfort in that the authorities still have room for fiscal and monetary policy easing to stabilize growth if necessary in the event of a further escalation of trade tension, although both staff and the authorities assessed that there is no need for additional stimulus at this point. Even as the authorities undertake incremental policy easing to cushion the slowdown, the authorities should continue to deepen reforms and to stay the course on deleveraging and rebalancing.

While promoting sustainable growth over the medium term, China needs to continue its work on labor market reform, especially on human development and education to enhance labor productivity and ensure that its population continues to benefit from employment opportunities. Job creation is crucial to China's political and social stability, and policymakers in China have made employment one of the top policy priorities this year amid the slowing economy. Strong and sustained growth in the past decade has supported robust job creation for the Chinese economy. However, with growth expected to gradually fall below 6 percent over the medium term, we wonder about the implication to employment growth, labor force participation rate and unemployment rate and we welcome staff comments. We would also like staff to comment on whether the slower pace of growth would generate sufficient employment and particularly high-quality jobs to preserve social and economic stability?

China can play a central role in safeguarding multilateralism and advancing economic integration. We welcome the continued progress on structural reforms aimed at further opening up the Chinese economy and strengthening the role of market forces. These measures not only serve to boost China's economic competitiveness and vibrancy, but also signal China's commitment to free trade. The trade talks that are set to resume is an encouraging development. We hope that China and its trading partners will be able to resolve the trade disputes in a timely and decisive manner through constructive dialogues. The Belt and Road initiative has the potential to deepen connectivity and promote economic integration within our region. That said, BRI projects, if not well implemented, can pose risks to debt sustainability and green sustainability in China and in the recipient countries. We fully support staff's recommendation and the Chinese authorities' plans to strengthen its external lending framework and welcome the new BRI-Debt Sustainability Framework as a step in the right direction. Can staff provide further elaboration on the new framework and its implications to the BRI investment plan as well as the recipient countries?

We welcome the continued debt deleveraging and de-risking and would like to reiterate that these developments must be complemented with structural reforms to strengthen the SOE and corporate sector. While efforts at deleveraging has helped to contain the built-up of risks in the financial system, vulnerabilities remain elevated. We fully support staff's call for the authorities to avoid regulatory backtracking and to continue to strengthen the financial sector including through fully implementing the announced regulatory reforms and strengthening bank capital. Financial spillovers from China to the region have grown considerably, driven by greater trade and financial linkages. We underscore the importance of having a transparent and consistent framework for managing corporate defaults, so as not to trigger wider financial instability and negative spillovers to the region. On SOE reform, we welcome the authorities' decisive and resolute approach to tackling zombie SOEs. Further progress in strengthening the SOEs would facilitate the deleveraging process and maintain financial stability. Debt owned by SOEs is increasingly allowed to default, thereby breaking the implicit guarantee and improving market discipline. However even as the authorities try to foster competitive and debt neutrality, credit allocation remains skewed towards SOEs. We are unconvinced that the policy to remove implicit guarantee in the SIP (Improving the Allocation of Corporate Credit in China) would help improve credit allocation to private sector. We consider that it may be more effective to focus on policies to enhance access to credit by private owned enterprise (POEs) and SMEs as well as to strengthen the credit culture to improve lending decisions. Staff comments are welcome.

Finally, we commend the authorities for improving the monetary policy and financial stability communication, including through a new website in English, regular press conference and expanded Q&A. We encourage further progress to modernize the policy frameworks, including adoption of a single policy rate in the monetary policy framework and reducing the misalignment of center-local fiscal responsibilities, and to address longstanding data gaps to improve policymaking and surveillance.

Mr. Inderbinen and Ms. Wehrle submitted the following statement:

We thank staff for the very useful set of papers and Mr. Jin, Mr. Sun, and Ms. Liu for their informative buff statement. We broadly agree with staff's analysis of the outlook and risks and we note that the authorities broadly share staff's assessment. The excellent analysis of the spillovers and distortions arising from a potential managed trade deal with the US clearly shows the importance of a multilateral and rules-based approach for the benefit of the entire global economy. We welcome that the authorities agree on the need to cooperatively settle trades disputes.

We welcome the authorities' efforts to strengthen fiscal discipline, as well as the commitment to modernize the fiscal framework. The authorities should maintain a prudent fiscal stance and continue efforts to deleverage the economy. Debt ratios have started to increase again, as the authorities recently moved towards a more expansionary fiscal stance to counter the slowing economic growth. We support staff's view that the announced stimulus is sufficient to stabilize the economy in 2019. Going forward, we encourage the authorities to safeguard fiscal sustainability through tax reforms aimed at increasing progressivity, and to continue efforts to stabilize local government debt ratios. In this respect, curbing the inefficient allocation of credit, reducing off-budget borrowing, tackling the misalignment of fiscal responsibilities between the central and local governments, and strengthening fiscal governance more generally remain essential.

We welcome the continued good progress in reforming the monetary policy framework. The People's Bank of China (PBC) has made encouraging progress in interest rate liberalization and opening China's capital account over the past few years. The recent steps taken to strengthen monetary policy communication are welcome. We encourage the PBC to continue to enhance transparency and provide timely access to information for local and international market participants. We also see merit in staff's recommendation to implement a more price-based monetary policy framework by eventually moving to a single policy rate. We agree with staff that the CFMs should gradually be phased out over the medium term, in line with greater exchange rate flexibility. With respect to the current monetary policy conditions, the PBC has loosened its stance by further cutting reserve requirement ratios for banks. While the current stance appears appropriate amid slowing growth, we agree with staff that the PBC needs to strike a careful balance between stimulating growth and containing financial sector risks.

We encourage the authorities to continue progressing on strengthening financial sector stability. We take good note of the authorities' successful reduction of financial vulnerabilities and shadow banking risks, as well as their ongoing commitment to addressing leverage issues in the corporate sector and in state-owned enterprises. The announced regulatory reforms should be fully implemented to further reduce financial sector risks, and bank capital should be increased, especially in the smaller banks segment. Developing a bank resolution regime to facilitate the exit of weak institutions will also be crucial to improve long-term stability. In this regard, we take note of public takeover of Baoshang and would welcome staff's views on whether the takeover process struck the right balance between containing risks to the financial system and limiting moral hazard. Given the size of the financial sector, additional resources for supervision would enhance the authorities' ability to contain the build-up of risks. Moreover, we thank staff for its AML/CFT assessment and encourage the authorities to address weaknesses as described in Appendix III.

Lastly, we welcome the authorities' renewed commitment to opening up the economy. China has made considerable progress in improving the business environment for international market participants. The most recent announcements to fully open up foreign ownership of financial firms in 2020, one year ahead of schedule, reflects China's determination to progressively open the financial sector to foreign investors. Similarly, the latest announcements to improve intellectual property rights protection and increase support for small investors are welcome. We encourage the authorities to continue reducing barriers of entry, which will also support China's high-quality growth agenda by increasing productivity through greater competition and foreign technology.

Mr. Ray and Ms. Johnson submitted the following statement:

We thank staff for their frank discussion of the opportunities and challenges facing China's economy and thank Mr. Jin, Mr. Sun and Ms. Liu for their informative buff statement. China's authorities are navigating a complex set of transitions. Doing so successfully remains critical for the future wellbeing of the Chinese people. China's economic performance is critical for global growth. Trade tensions remain the biggest risk for China's short-term economic outlook and are increasing the complexity of China's longer-term transitions. We encourage China and its trading partners to continue to work constructively to resolve trade tensions. We underscore our support for the open, rules-based multilateral trade system.

We agree with staff's near-term outlook for the Chinese economy and acknowledge staff's view that China and its trading partners should work constructively towards an agreement that avoids undermining the international system. We note that the authorities broadly agree on the outlook – with their concerns focused on the external risks – but were more confident than staff on the domestic risks. We also acknowledge the authorities views that China is well placed to navigate increased uncertainties. Looking ahead, we note more fiscal stimulus may be required if trade tensions worsen. Could staff provide further detail on the analysis underlying the statement that 'no additional stimulus is needed as the planned stimulus is sufficient to stabilize growth'?

We agree with staff's assessment that implementation of targeted structural reforms to improve the social safety net – on healthcare, education and pensions – could help to boost consumption and reduce inequality.

We welcome staff's recognition of the many steps taken or announced by the authorities towards further liberalization of the economy. Nonetheless, we encourage the authorities to continue to pursue reforms – including the financial deleveraging agenda, targeted structural reforms and, over time, liberalization of the capital account – to support sustained economic growth that would benefit China and its trading partners.

We welcome staff's appraisal on the need to improve center-local fiscal responsibilities. We consider that tight local government financing is emerging as a risk that may set back progress authorities have achieved in reducing off-balance sheet debt accumulation. We note the difference of views between staff and authorities over the concept of augmented debt and deficit but continue to find this definition useful and encourage further work.

We welcome the emphasis on improving competition in the market and SOE reform by the staff and authorities' views. We are encouraged by this reform and note that the potential gains from these reforms largely depend on their continued implementation and enforcement.

We support the staff recommendation for continued strengthening of the financial sector through implementation of announced reforms. We note that small banks are likely to continue to face challenges, reaffirming the need for China to continue to progress its financial sector reforms.

We continue to support staff's assessment that China needs to make urgent progress to address remaining macroeconomic data gaps and improve communication to enhance policy making. We recognize, as the authorities note, that progress has been made, however significant gaps and inconsistencies persist, which can increase the complexities associated with well informed decision making and policy development.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written set of reports and Mr. Jin, Mr. Sun, and Ms. Liu for their insightful buff statement. We broadly share staff's analysis and policy recommendations and would limit our remarks to the following issues.

We welcome the robust performance of the Chinese economy. Growth in the first half of 2019 was around 6.3 percent and is expected for the year to be within the 6.0-6.5 percent target range, underpinned by the authorities' sound macroeconomic management. Inflation has remained low and the unemployment rate has been stable. We are also encouraged by the progress in financial deleveraging and reducing interconnectedness between banks and non-banks, which have helped contain the build-up of financial risks. The improvement in the business environment resulting in China moving up 34 places to 46th in the World Bank's 2019 Doing Business Rankings is also remarkable.

Looking ahead, we are encouraged by the favorable medium-term outlook with the authorities' focus on supply-side structural reforms, deepening market-oriented reforms, and accelerating opening-up to achieve high-quality development. Indeed, the stress on a decisive shift from high-speed to high-quality growth remains appropriate and, in this context, we take positive note of recent data, which continue to show progress toward rebalancing. The authorities' agenda of continued opening-up of economy is moving forward and, in this regard, we welcome the recent announcement of further opening up measures, as noted in the staff supplement. Over the medium term, growth is expected to remain strong, reflecting China's early stage in productivity convergence, although it will gradually slow to 5.5 percent with the economy moving towards a more sustainable growth path.

The authorities are rightly pursuing wide-ranging macroeconomic policies, including targeted fiscal measures, after the growth slowdown in 2018 and continuing their efforts to modernize the fiscal framework. We also take note of the staff's assessment that, under the baseline, no additional fiscal stimulus is needed as the planned stimulus is sufficient to stabilize growth in 2019 and 2020. The ongoing efforts to modernize the fiscal framework, including by reforming central-local fiscal relationship and moving toward a standardized and transparent budget system, are steps in the right direction. In this connection, we echo staff's recommendation for a shift in certain social welfare spending responsibilities, e.g., health and education, to the central government to address socio-economic gaps. Indeed, such a move would ensure a minimum level of service and reduce the large disparity between urban and rural public service provision. Here, we would welcome staff elaboration of the authorities' plans for the central government to take over these spending responsibilities and the likely timeframe for such a move. To further strengthen policy making, we agree with the staff's recommendation on establishing a macro-fiscal unit in the Ministry of Finance.

We welcome the continuation of structural reforms in a number of areas and the putting forward of the principle of "competitive neutrality". Indeed, the authorities should continue their efforts to foster greater openness, further advance SOE reform, and increase competition that would continue to improve resource allocation and facilitate entry of competitive private firms. The ongoing hukou reform will enhance labor market flexibility and we welcome the authorities' plan to expand the reform from medium-sized to mega cities in the future. To implement the principle of competitive neutrality, we take positive note in the buff statement of the authorities' commitment to maintain a level playing field for all types of companies whether public or private, domestic or foreign. Considering the importance of SMEs in the economy, including in providing employment, we agree on the need for proactive, market friendly measures to support SMEs to level the playing field and ensure adequate financing for this sector. On the authorities' view that credit allocation to SMEs could be improved by finding alternatives to collateral, including through using fintech to determine their creditworthiness, we would welcome staff comments on the way forward in using fintech, which would be of interest to many countries.

We agree that fully implementing the announced regulatory reforms, strengthening bank capital, especially for smaller banks, and enhancing macroprudential tools to address vulnerabilities from rising household debt remain important. While the report (¶20) underlines domestic risks arising from a deterioration in asset quality of financial institutions, especially among small and mid-sized banks, and funding stress facing banks and non-bank financial institutions, we did not find any mention of these risks in the Risk Assessment Matrix (Appendix II) that is referred to in the paragraph. Staff comments would be appreciated. The recent takeover of a non-systemic mid-size bank (Baoshang Bank) underscores the need for developing a well-functioning resolution regime to facilitate the exit of weak banks and we welcome the authorities' willingness to consider it. We would welcome staff elaboration on the reported partial takeover of Bank of Jinzhou by state-owned entities on July 28. In view of the need to contain vulnerabilities from rising household debt, the SIP provides useful analysis and policy recommendations that are useful for the authorities' policy deliberations. On AML/CFT, we welcome the progress towards improving the legal system and the effectiveness of the measures taken and look forward to the authorities' plan to address the issues identified in the FATF report.

Finally, the ongoing trade tensions need to be resolved in a manner that builds a stronger multilateral and rules-based trading system. In this context, we welcome the resumption of trade talks between China and the U.S. in June 2019. The SIP on "the spillover effects of the U.S.-China trade policies" is an important work since the outcome of trade talks between the two systemically important trading partners would have important implications for the rest of the world. In this connection, we concur with the staff's conclusion that the agreement should serve to reinforce WTO rules, be non-discriminatory, and be based on market mechanisms and macroeconomic fundamentals. Such an agreement will have immense beneficial impact on the global economy.

With these remarks, we wish the authorities continued success.

Mr. Rosen and Mr. Grohovsky submitted the following statement:

The Chinese economy slowed in 2018 and is projected to decelerate again in the second half of this year. Given efforts to rebalance the economy and slow credit growth, this slowing should not be viewed as negative event, but instead part of the necessary shift towards a service and consumption-driven economy. In light of this view, we encourage the authorities to avoid backsliding on efforts to open up the economy, shift from high levels of savings towards greater consumption, and continue efforts to reduce financial sector risks. Such efforts should be underpinned by market-based policies and a reduced role of the state in order to minimize distortions in both domestic and global markets. These reforms are necessary for shaping a positive path for both China and the global economy.

Growth, Openness, and the Role of the State

Given the fall in potential growth as the Chinese economy has developed, it is important that any stimulus be well-targeted and not backslide on the progress made so far to transition to more sustainable growth. Moreover, the policy priority should be on long-needed structural reforms rather than specific growth targets. Recalling the discussion of growth targets in last year's Article IV, we would have welcomed a greater focus again this year on de-emphasizing growth targets, which still seem to dominate policy actions and are hindering internal rebalancing.

Greater market openness and foreign competition are integral to successful internal and external rebalancing in China. Staff's analysis is helpful in emphasizing China's lack of openness compared to other G-20 emerging market economies and in showing the potential productivity gains from further opening. However, the analysis should have further underscored the urgency of implementing such reforms in the near term, given the distortive effects of China's current policies on global trade and investment. While China's recent announcements are welcome, given China's long history of market access barriers, implementation should be quick and result in actual liberalization, leading to a more market-based economy that benefits both Chinese citizens and the global economy. As China removes foreign investment restrictions, it must simultaneously adopt transparent and predictable regulatory and licensing practices so foreign investors can, in fact, benefit from greater market access. The Article IV's observations in paragraph 34 that China "may . . . accept more open investment regimes" and "can . . . benefit from further opening up and other structural reforms" are far too ambiguous. We would encourage staff to press China to liberalize with greater conviction and willingness. We did appreciate the bar graph of government support of the aluminum sector and would welcome further details on the methodology behind this calculation as well as the precise values.

Faster SOE reform and services sector opening would also boost productivity growth while eliminating inefficiencies and market distortions. In this regard, we continue to be concerned by the lack of meaningful SOE reform. We appreciate staff's detailed analysis of this issue, which constitutes the strongest section of this year's Article IV report. We would add that measures taken by the authorities in the years following the Global Financial Crisis have led to greater dominance of SOEs in the economy as opposed to less. Moreover, we are also concerned by the growing role of the state and Party in economic decision making, including in private firms. The authorities should instead reduce the role of public sector enterprises by removing implicit guarantees and ensuring that credit is allocated based on market forces.

External Sector

We found the report's coverage of external sector issues to be particularly weak compared to previous years. Given the size and impact of past external imbalances, there should be more attention to the policy reforms needed to firmly entrench external balance. The 2019 External Sector Report rightly highlighted that even as China's external position is assessed to be broadly in line with fundamentals, major offsetting policy distortions create risks of a resurgence of external imbalances. We would have welcomed if this staff report delved into more granular detail on the policies needed to tackle these distortions. In particular, the report would have benefited from greater focus on China's still-elevated national saving rate, including the multilateral challenges it poses for achieving strong and durable global growth. The report also focused too much on negative spillovers from a potential U.S.-China trade agreement due to managed trade in the highly speculative Box 2, while ignoring the structural reforms that have been prioritized in our discussions, as well as the significant potential benefits to China and the global economy from further liberalization of trade and investment barriers, which will benefit not only Chinese and U.S. companies but any entity investing and trading in China.

We are further concerned that the report put too much emphasis on the need for short-run exchange rate flexibility to counter trade shocks, without a discussion of the trade-offs entailed in further depreciation. Additionally, with staff assessing the RMB to be broadly in line with fundamentals, significant exchange rate movement would not appear to be warranted. We recall that last year's Article IV had a more appropriately nuanced approach, calling for greater two-way flexibility over the medium term, deepening of the foreign exchange market, and use of the central-parity mechanism transparently and mechanically.

However, we strongly support staff's call for greater transparency in China's exchange rate policies. The authorities' claim that their "disclosure of foreign exchange intervention data meets international standards since joining the IMF's SDDS" is not pertinent, since SDDS covers disclosure of foreign exchange reserves rather than intervention. China should disclose FX intervention promptly given its economic size and importance.

Financial Sector

Although the authorities have implemented significant financial reforms during the deleveraging campaign, we are concerned about the resumption of credit growth amidst elevated household and corporate debt levels. We urge the authorities to continue with their financial reform agenda in order to contain risks. The recent takeover of Baoshang Bank underscores the remaining vulnerabilities and moral hazard in a banking system with assets at a significant 300 percent of GDP, one of the highest for any large economy in the world. It is therefore critical that the authorities develop a strong resolution regime as part of a sequenced reform process to reduce implicit guarantees. Additionally, the authorities should heed staff's advice to improve system-wide capital, with considerable needs at both small and medium-sized banks. Other measures – such as a personal bankruptcy regime – could also help manage risks arising from household debt. Finally, as noted above, while we appreciate recent announcements about reducing constraints on foreign participation in the financial sector, the path forward on implementation remains unclear.

Fiscal Policy

While there has been some progress with deleveraging, we would have appreciated greater specificity in staff's recommendations for fiscal policy, particularly under the baseline scenario. Can staff comment on why the fiscal measures under an adverse scenario (in the table on page 18) – many of which align with structural reform priorities that can improve growth over the medium term – were not part of staff's baseline recommendations (presumably paired with additional offsetting measures to contain the augmented deficit)? The projection that the augmented debt level will not stabilize in the medium term highlights the importance of containing off-budget spending and reforming fiscal policies that are at odds with continued rebalancing. Any fiscal measures used to support near-term growth should be on-budget, consistent with deleveraging efforts, and designed to support rebalancing, rather than used to achieve growth targets.

Monetary Policy

We note that the authorities do not plan on taking additional monetary easing measures in 2019 and welcome their consideration of targeted stimulus for the private sector and SMEs. Modernizing the monetary policy framework by moving towards a single key policy rate and clear inflation target are important preconditions for the eventual opening of the capital account, which should be carefully sequenced and targeted.

Belt and Road Initiative (BRI)

As a global creditor, China should pursue projects in a manner that maximizes their benefits for recipient countries and meets international standards. China’s new Debt Sustainability Framework (DSF) is a positive first step, but it remains to be seen how the new DSF will be implemented. The Chinese DSF does differ from the IMF’s DSF in material ways (such as the discount rate), and it is unclear what would happen if the Chinese DSF and IMF DSF diverge. We urge the authorities to bring BRI lending practices in line with global standards, including the G-20 Principles for Quality Infrastructure Investment. Enhanced debt sustainability monitoring, open procurement, private sector participation and strong governance are necessary to mitigate the attendant risks: resource misallocation, the buildup of excessive debt, weakening of local institutions, and environmental damage. Further transparency is critical – six years since its announcement, there is still no reliable list of BRI projects, no disclosure of lending standards, nor even the amount that has actually been invested. We are disappointed that the authorities do not have plans at present to strengthen the oversight framework of the BRI.

Data

Finally, we strongly encourage the authorities to address longstanding data gaps in national accounts data. Even though some preliminary steps have been taken, greater transparency and more frequent reporting of data is critical. In this spirit – and given China's economic importance – we strongly encourage the authorities to consent to publication of this report as well as the Selected Issues Paper, which was not published last year.

Ms. Riach, Mr. Ronicle and Mr. Hemingway submitted the following statement:

We thank staff for an excellent set of papers and Mr. Jin, Mr. Sun and Ms. Liu for their informative buff. We welcome the focus in the staff report on the key issues facing China.

Moderating growth reflects both positive developments and negative shocks. More positively, the rebalancing of the economy and lower credit growth has resulted in lower GDP growth in the short-term but should contribute to a more sustainable growth path going forwards. However, trade shocks have slowed growth further. The authorities have provided a significant fiscal stimulus in response. We note staff's comparison between this response and the 2015/16 stimulus and broadly agree that the shift towards greater use of traditional fiscal policy measures – notably through significant tax cuts – is welcome. However, we also note staff continue to find a large augmented fiscal deficit. Indeed, the debt-stabilizing primary balance is estimated to be 6.7p.p. of GDP stronger than the 2019 level (the government's preferred measure also implies a significant consolidation – 2.8p.p. of GDP – to stabilize debt). Given this, we expect balancing growth objectives against managing vulnerabilities to ensure long-term sustainability to remain a critical issue for the authorities.

Risks and vulnerabilities remain elevated. The rebalancing of the economy appears to have stalled and the level of credit remains high, in part as the authorities have shifted their emphasis from deleveraging back to supporting growth. We also note staff comments on the exposure of the Chinese economy to a downturn in the property market and the scope for a cyber-attack to result in significant economic costs. Maintaining reform momentum is critical to reducing vulnerabilities and managing these risks. We particularly emphasize the importance of reforms in the financial sector, including implementing those set out in the 2017 FSAP.

Trade tensions are rightly identified as the most important short-term risk and one with potentially significant consequences for the rest of the membership. Given this, we thank staff for their analysis in the Selected Issues Paper and summarized in the main report. We endorse staff messages: there are opportunities for China, and the world, from further opening up, supported by appropriate structural reforms; but there are substantial risks from the "wrong" type of deal. We fully support the staff view that any resolution to trade tensions should "serve to reinforce WTO rules, [be] non-discriminatory, and [be] based on market mechanisms and macroeconomic fundamentals."

China has taken action to drive global growth and support the international trading system but could go much further. We welcome the recent opening of the Chinese economy, including bringing the effective tariff rate down by 2 p.p., introducing a new foreign investment law and accelerating efforts to open up the financial sector. That said, barriers remain relatively high, so there is scope for further action in all these areas. Just as important are the steps staff outline through which China can support the international system and benefit itself from further opening up, such as collaborating with other countries in e-commerce – where China is a leader – to set global standards.

Regardless of short-term economic fluctuations, we thank staff for reminding us that China's scope for robust growth and productivity convergence remains very large. Indeed, staff highlight that, notwithstanding the rapid growth over the last two decades, productivity remains 70 percent below the frontier. China's potential remains enormous and we agree with staff that faster SOE reform and opening up of the service sector are key areas of focus to realize it. Competitive neutrality will have significant benefits for both China and the global economy, so we welcome the authorities' commitments to achieving this outlined in the buff.

In particular, SOE reform will be key to improving domestic productivity and reducing domestic and external imbalances. We broadly agree with the issues staff outline, including completing classification of SOEs, increasing competition and improving governance. We also welcome the detailed discussion of implicit guarantees for SOEs and the consequences for the financial sector. We are particularly conscious of the potential interaction between implicit guarantees, tighter financial conditions and risk aversion in the financial sector limiting credit to private firms, an issue highlighted by staff in paragraph 14. Indeed, the accompanying chart is particularly striking, highlighting a 6 p.p. increase in the SOE share of total liabilities in around a year. Do staff see this as evidence of significant credit misallocation within the financial system? If so, what are the macro-economic consequences? What further actions do staff advise the authorities take to decisively dispel the perception of guarantees for SOEs?

We thank staff for their balanced analysis on the Belt and Road Initiative (BRI). We join them in seeing enhanced debt sustainability monitoring using the new BRI-Debt Sustainability Framework as a positive step. We welcome the commitment of the authorities to the full implementation of this framework, noting that this will be key to achieving its stated aims. More generally, we agree with staff that BRI frameworks should look to adhere to global standards that promote transparent and sustainable lending practices.

Finally, we see publication of quality data and analysis as an important global public good. Therefore, we support staff calls to urgently address macroeconomic data gaps to further improve data credibility and policy making. We also note that the 2018 Selected Issues Papers were not published as the authorities withheld their consent. We encourage the authorities to consent to the publication of all papers this year and to consider allowing the 2018 papers to be released.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the well-written set of papers and Mr. Jin, Mr. Sun, and Ms. Lui for their informative buff statement. Growth of Chinese economy, while still robust, is marginally slowing down, from the average 6.7-6.9 percent in 2015-17 to a new level of 6.0-6.5 percent, reflecting deteriorating external environment and ongoing structural transformation. The authorities have responded to the slowdown by the counter-cyclical policy easing. Leading economic indicators attest to stable macroeconomic conditions. CPI inflation remains contained at about 2 percent, and unemployment is about 5 percent. The current account is practically balanced, and domestic demand is the main driver of growth. Exchange rate remains broadly stable, and China’s US$ 3.2 trillion foreign currency reserves provide solid support for external stability.

Rebalancing of the Chinese economy is proceeding steadily on almost all fronts, and the authorities should be commended for the uninterrupted structural reform momentum. The authorities’ policies are focused on transition from high-speed to high-quality growth, opening up the economy, and deepening the market-oriented, supply-side structural reforms. In 2018, China has moved up 34 places in World Bank’s Doing Business ranking to 46th position. Among the recent developments, we welcome the decision to frontload the opening-up of the China’s financial market to foreign investors, and the new Foreign Investment Law, which includes provisions of equal treatment of foreign and domestic firms and prohibiting forced technology transfers. We also note success in reducing the shadow banking sector and strengthening the financial regulation.

The accumulation of debt remains the main risk for macroeconomic stability. While overall debt growth has slowed down over the last two years, it has picked up again in the 1H 2019 against the backdrop of macroeconomic stimulus. Credit to the public sector and to households is the main driver of debt growth, while the corporate sector is deleveraging since 2017, as the shadow banking has been contained. Further tightening of macro-prudential policies may be necessary to rein in rapid increase in household debt. To address excessive borrowing by local governments and LGFVs, the authorities need to de-emphasize growth targets, reduce misalignment in center-local revenues and responsibilities, and strengthen fiscal discipline.

We note staff's special attention to the role of the state-owned enterprises (SOEs) in the economy, and of the state in general. "The increasing role of the state" in the economy is asserted several times in the report. Such developments would be in contrast with the overall direction of China's market-oriented reforms. Could staff elaborate in more details, why they suggest that the role of the state in the Chinese economy is increasing? We also believe that a detailed assessment of the size of the state in China, similar to the last year's working paper on Russia, could greatly benefit our discussion.

We welcome substantial progress achieved in improving efficiency of the SOE sector. 95 percent of central zombie firms have been disposed. However, the authorities have made only limited progress in addressing zombie SOEs at the local level. Our experience suggests that it is often difficult to tackle inefficient SOEs in small and remote towns, because the existence of the entire community often depends on a single enterprise. Could staff share their view on the main reasons for slow progress in dealing with SOE inefficiency at the local level in China?

China's growth remains heavily dependent on continued credit expansion, which reached very high level and need to be contained. Substantial share of credit to corporate sector is absorbed by SOEs, while private sector, especially small- and medium-size enterprises, were recently facing tightening credit conditions. Presumably, private sector might use credit resources more efficiently, achieving higher output with less credit. Therefore, staff advocate measures aimed at reducing attractiveness of SOEs, in order to create more level playing field. We note that the authorities are fully aware on the need to improve credit conditions for private companies and declare their commitment to maintain a level playing field for all types of companies. On the other hand, the abolition of “implicit guarantees”, recommended by staff, may prove to be difficult in practice. We, therefore, support further analysis of this issue, including a possible cross-country study.

We note that staff highlight the emerging issue of the social security system sustainability in the context of rapidly aging population. The shortfall in the pension system is growing despite relatively high social security contributions, and parametric pension reform could be necessary in order to keep the system healthy. In this regard, we note that the key staff recommendation to reduce China’s excessive household savings through enhanced social safety net is starting to look less convincing. Do staff see substantial fiscal space for increasing social safety net beyond the current level?

It is impossible to discuss China’s economy today without mentioning the ongoing trade conflict. We are deeply concerned about these trade tensions, which could have a profound impact not only on its direct participants, but on the entire world economy. China is one of the main pillars of the global economy and trade. China has made remarkable progress in opening-up its trade and foreign investment regime. The authorities continue reforms in these areas, and recently made additional important steps in reducing tariff rates, liberalizing foreign investment regime, opening up the financial sector and strengthening the intellectual property rights protection. We welcome the authorities’ commitment to stand by the rules of multilateral trade system and to support international cooperation. We agree that China and its trading partners should work cooperatively to settle their disputes and make joint efforts to reform the WTO.

With these remarks, we wish the authorities further success.

Mr. Kaya and Mr. Bayar submitted the following statement:

We thank staff for their comprehensive set of reports and Mr. Jin, Mr. Sun, and Ms. Liu for their insightful buff statement. Amidst a highly uncertain environment, epitomized by elevated trade tensions, the Chinese authorities continue to take strides in shifting from a `high-speed` to `high-quality` growth model, while at the same time gradually addressing financial sector vulnerabilities. Nevertheless, progress is uneven as the authorities’ renewed attention to growth outweighed other objectives – leading to a pause in deleveraging. Going forward, the authorities will need to strike a fine balance between accommodating a structural slowdown in the economy and countering the negative impact of trade tensions. In this respect, we appreciate staff's status-dependent policy advice which reflects the uncertainty and complexity of the challenges facing the Chinese economy. We agree with the thrust of the staff appraisal and would like to provide the following comments for emphasis.

The trade tensions between the US and China need to be resolved through a comprehensive agreement. We caution against undermining the international system through a discriminatory or "managed trade" deal that could create distortions in resource allocation at the global scale and have a significant negative impact on third parties. China's continued progress toward a more open trade and investment regime, enhanced transparency of industrial and trade policies, and stronger collaboration with other countries in setting global standards, including on fintech and digital economy, will help address some of the underlying roots of tensions. We welcome in this respect the authorities' commitment to cooperate toward strengthening the multilateral and rules-based trade system. Nonetheless, we note with concern that the authorities effectively ruled out staff's upside scenario (i.e. a reduction in trade tensions). Could staff provide further insights about the discussions with the authorities on this matter, as we tend to see this as a rather contradictory signal to the markets which have taken the resumption of trade talks after the G20 Summit as quite positive?

Further fiscal reforms are needed to improve fiscal transparency and discipline at the local government level. The authorities' `proactive` fiscal policy appears appropriate given the need to support growth against a challenging external backdrop. While we agree that consolidation should wait for greater clarity on the course of trade negotiations, the rapidly- rising "augmented" public debt, which staff projects to exceed 100 percent of GDP in 2024, calls for the authorities' closer attention. To increase the quality of medium-term adjustment, we support limiting the off-budget infrastructure spending, boosting progressive taxes as well as raising the share of health, education, and social expenditures.

Monetary policy should firmly focus on preserving price stability and further actions should be data-dependent. We support the ongoing shift from a quantity-oriented monetary policy framework to a price-oriented one by improving the formation and transmission mechanism of the market-based policy rate. We concur with staff that further efforts should be made to move toward a single policy rate and phase out benchmark deposit and lending rates. We agree that the recent acceleration in credit growth and the inefficiencies in credit allocation are sources of concern. We therefore encourage the authorities to take steps to moderate credit expansion toward nominal GDP growth, let market forces set the pricing of the credit as well as its allocation, and curtail the asymmetric advantages of the state-owned-enterprises in access to finance. We support the policies to promote lending to small- and medium-sized enterprises, which have also suffered from the previous efforts to deleverage. We believe that exchange rate flexibility should continue to be increased to facilitate adjustment to the new external environment, while interventions in the foreign exchange market should be limited to counter disorderly market conditions. We encourage the authorities to publish data on exchange rate intervention to improve the transparency and communication of their policy framework. We note in this regard the authorities' assessment that China's disclosure of foreign exchange intervention data meets international standards since joining the Fund' Special Data Dissemination Standards. Staff comments are welcome.

Sustained efforts to strengthen financial regulation, reduce regulatory arbitrage, and improve the supervisory framework are needed to reduce still-elevated vulnerabilities. Boosting bank capital, especially for smaller banks, will be critical to withstand heightened risk aversion and funding pressures following the first bank take-over (i.e. Baoshang Bank) in twenty years. We believe that this take-over operation underlines the need for developing a clear resolution regime, which allows weak banks to exit the market in an orderly fashion. Enhancing macro-prudential tools to contain vulnerabilities from rising household debt would also contribute to the resilience of the financial sector. To that effect, we encourage the authorities to advance the needed reforms, including those recommended by the last FSAP.

Finally, we reiterate our call on the authorities to intensify their efforts to address the data gaps in line with their G20 commitments. We welcome the recent improvements in data provision, with particular respect to monetary policy and financial regulation. Nevertheless, further improvements in the provision and quality of national accounts', fiscal accounts', and labor market data are essential for an informed policy dialogue and high-quality policy making.

Mr. Lopetegui, Mr. Di Tata and Ms. Moreno submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Jin, Mr. Sun, and Ms. Liu for their very helpful buff statement.

China’s growth moderated to 6.6 percent in 2018, reflecting financial regulatory strengthening and softening external demand. Core inflation remained moderate and the current account surplus continued to fall, driven by strong import growth. As economic activity slowed in the second half of 2018, the authorities shifted emphasis from deleveraging back to supporting growth by rebalancing macroeconomic policies. The “augmented” fiscal deficit was increased, monetary policy was loosened, and the pace of regulatory strengthening was relaxed. Real GDP growth stabilized in the first quarter of 2019, but indicators point to sluggish domestic and external demand because of the impact of renewed trade tensions. Assuming that the policy stimulus is maintained and trade tensions do not escalate, growth is projected to decline gradually to 5 ½ percent over the medium term as the economy continues to evolve from industrial production to lower-productivity services sectors. Economic prospects, however, remain uncertain, with external risks being more of a concern than domestic ones.

Although regulatory and supervisory reforms have led to financial deleveraging, reduced interconnectedness between banks and non-banks, and improved risk differentiation, staff notes that vulnerabilities remain elevated. Overall debt of the nonfinancial sector grew slowly in 2017-2018 reflecting corporate deleveraging but still reached 257 percent of GDP, and the recent policy easing has led to a further increase in debt accumulation, including by households and corporates. Moreover, credit growth has accelerated in 2019. Could staff elaborate on the risks to the baseline from the still elevated leverage and the recent pick up in credit growth? We would also appreciate staff’s comments on the adequacy of the administrative restrictions and macroprudential tools at the disposal of city governments to stabilize house prices.

As noted by staff, a sizable policy package has been adopted in 2019. On the fiscal side, the package includes tax cuts and higher infrastructure spending that would increase the “augmented” deficit by 1 ½ percentage points of GDP, to 12.7 percent of GDP in 2019. We note that the authorities continue to disagree with the “augmented” deficit concept used by staff. Could staff elaborate further on the main differences of views on this issue as well as on the size of off-budgetary items? We welcome ongoing efforts to foster balanced regional development by reforming the central-local government relationship through further sharing of responsibilities. On a related matter, how important is off-budgetary borrowing by local governments? Also, what are the prospects for introducing a nationwide recurrent property tax to provide an important source of revenue to these governments?

We broadly agree with the policy recommendations associated with the three scenarios (baseline, adverse, and upside) presented by staff in the report. Regarding the baseline scenario, we concur on the need to avoid additional stimulus and excessive credit growth. Going forward, fiscal consolidation should be gradual while the recent credit acceleration should be curtailed by reducing credit growth to SOEs and pricing credit appropriately. We also encourage the authorities to allow for greater exchange rate flexibility and improve transparency by publishing FX interventions. Further capital account opening should be carefully sequenced over the medium term. We share the view that an adverse scenario triggered by an escalation of trade tensions would warrant additional fiscal easing, and that any further monetary loosing should be modest and data dependent. We take note of the authorities' contingency plans consisting of pipeline projects that might be accelerated. Under the upside scenario, fiscal consolidation should proceed at a faster pace while monetary policy may need to be tightened moderately.

We welcome the authorities' willingness to work toward strengthening the multilateral and rules-based trade system. In this regard, we concur with staff that China should seek to limit spillovers from its policies and promote open and stable trade. The selected issues paper on the spillover effects of a potential US-China "managed trade deal" provides a useful quantification of the global effects due to trade diversion and disruptions in global value chains, which could be sizable. We also encourage the authorities to strengthen China 's external lending framework by promoting greater cooperation and transparency. We take positive note of the authorities' new BRI-Debt Sustainability Framework (DSF) to enhance discipline in external lending.

On the monetary front, we encourage the authorities to continue moving towards more market-based and transparent frameworks, relying less on administrative measures. We welcome the PBC's plans to deepen market-based interest rate liberalization, enable policy rates to better guide market rates, and shift from a quantity-oriented to a price-oriented monetary policy framework, including by improving the transmission mechanism. As noted by staff, this should be complemented by giving the PBC greater accountability and operational independence around a clear inflation objective.

Regarding the financial sector, we welcome ongoing efforts to strengthen financial regulation and supervision as well as the measures adopted recently to improve foreign access in several areas. Going forward, we agree that the priority should be to avoid regulatory backtracking and to continue with structural regulatory reforms to reduce still-high vulnerabilities. In this regard, we encourage the authorities to regulate the asset management sector, enhance macroprudential tools to address rising household debt, require small- and medium-sized banks to raise more capital, develop resolution regimes for banks, and strengthen the deposit insurance scheme. At the same time, the authorities should press ahead with their plans to formulate rules for fintech regulation and address identified shortcomings in the AML/CFT framework. Could staff elaborate further on how shadow banking has evolved in recent years and on the authorities' strategy to further downsize it?

We concur with staff on the need to improve credit allocation and efficiency through policies aimed at increasing lending to the private sector while reducing the share of credit to SOEs. To that end, it would be important to develop a medium-term plan to remove the implicit guarantees enjoyed by SOEs, improve access to bank and bond financing by private firms, encourage equity financing, and strengthen the overall credit culture. We notice that the recent takeover of a mid-size "zombie" bank by the government in May led to a tightening of interbank funding for some small banks and NBFIs. Although the PBC injected liquidity and market sentiment seems to have stabilized, situations like this should be monitored closely.

We welcome China's progress in reducing external imbalances in recent years. As indicated by staff, the external position is now broadly in line with medium-term fundamentals and desirable policies. Going forward, maintaining a durable balance in the external position requires addressing distortions that encourage excessive household savings and further stimulating consumption, including by enhancing the social safety net and making the tax system more progressive.

Staff notes that China's productivity growth has declined steadily since the global financial crisis due to decreasing returns on infrastructure investment and worsening resource misallocation related to the increasing role of the state in the economy. Is the abovementioned worsening related to the increased dominance of SOEs due to mergers and acquisitions referred to in paragraph 14? On this issue, we notice some difference of views with the buff statement, which suggests that more than a third of the total disposed zombie firms were disposed through bankruptcy and that recent policy measures will make it easier for zombie SOEs to declare bankruptcy and exit the market.

Going forward, we agree with staff on the need to implement a broad set of reforms with due attention to appropriate sequencing. Further efforts are needed to enhance labor flexibility and increase firm entry across sectors and regions; foster greater openness in the services sector and streamline approval of inward investments; accelerate SOE reform, including through a comprehensive amendment of the Enterprise Bankruptcy Law; and increase competition by opening non-strategic sectors. In this connection, we welcome the measures announced recently to relax hukou restrictions for medium-sized cities, the authorities' plans to further remove SOE's social responsibilities and improve their governance through mixed ownership, and the government's intention to lower market barriers for foreign firms and implement a level playing field for all companies. We also encourage the authorities to improve social security sustainability by considering parametric reforms.

Lastly, it would be important to address data gaps in the national accounts and sparse labor market data.

With these comments, we wish the Chinese authorities every success in their endeavors.

Mr. Raghani and Mr. N'Sonde submitted the following statement:

We thank staff for a set of comprehensive reports on People's Republic of China and Mr. Jin, Mr. Sun and Ms. Liu for their informative buff statement.

In a context of elevated trade tensions and global economic slowdown, Chinese growth has stabilized this year following modest moderation in 2018 resulting from financial regulatory reforms and reduced infrastructure funding at the local government level. Inflation figures, including headline inflation, remain under control while the housing market shows continued signs of downturn. The current account surplus has declined significantly owing mainly to rising imports. In this context, China's external buffers remain robust, with foreign currency reserves at a very comfortable level to pursue a smooth transition to greater exchange rate flexibility while capital continues to flow in.

The authorities should be commended for the progress towards a more open economy, an increased role of market forces and an improved business environment. As highlighted by Mr. Jin, Mr. Sun and Ms. Liu in their buff statement, external and internal rebalancing have advanced quite well. The macro policy response to the slowdown, focused on rebalancing, have started to bear fruit, with great impact expected on the 2019 growth. In this regard, we would appreciate staff elaborating on the medium-term growth impact of the fiscal stimulus detailed on page 11 of the main report.

Notwithstanding, while deleveraging has gained grounds and financial risks have been contained, vulnerabilities remain. These include fast-rising government and household debt; elevated corporate debt albeit on the decline; and strong credit growth to SOEs. In addition, global trade tensions pose an immediate risk to the outlook. Unless resolved in a way to preserve an open, fair and rules-based multilateral trading system, those tensions can have enduring adverse effects on the Chinese and global economies. We appreciate the insightful empirical results provided by the Selected Issues paper in this regard.

Against this backdrop, the authorities should pursue policies to further stabilize the economy, achieve balanced and durable growth, and support global growth. We broadly agree with the policy and reform priorities laid out in the report to cope with adverse external headwinds, enhance financial stability, support consumption, bolster productivity and buttress income convergence. We also concur with staff on the importance to strengthen policy frameworks and to leverage the weight of the Chinese economy to help improve the international system.

We encourage the authorities to remain steadfast with the current fiscal policy stance and allow multipliers to run their course. However, in the event of further escalation in trade tensions they should add sufficient fiscal pro-poor and rebalancing support to stabilize the economy. In this regard, efforts should be made in spending more on health, education and targeted transfers to the poor. In the absence of a negative shock, the authorities should endeavor to curb the rising public debt through gradual fiscal consolidation.

The current monetary policy stance should be maintained unless a negative shock occurs; in which case some monetary policy easing based in priority on further reduction of required reserve ratios should be introduced. We agree that such actions should be attentive of data developments, notably the effects of other accommodative measures on inflation. As regards foreign exchange policy, we note the authorities' renewed commitment to increase flexibility and press ahead with FX market reforms. We look forward to further progress in establishing a macroprudential regulation framework to manage cross-frontier capital flows.

Concerning the financial sector, we urge the authorities to uphold macroprudential policies to enhance financial stability. We encourage them to further promote lending by large state-owned banks to medium-sized private firms. The highly-leveraged household sector should be subject to an enhanced systemic risk assessment. There is room to further downsize shadow banking and enhance banking resilience notably by requiring banks to augment their capital. More broadly, we welcome the pursuit of the regulatory reform to tackle financial sector vulnerabilities and efforts to strengthen weak banks. We see merit in the ongoing efforts to design fintech regulation and oversight and address the AML/CFT framework based on recommendations of the FATF report.

On structural reforms, we agree on the need to further reduce external imbalances, foster productivity growth and achieve income convergence over the medium to long-term. We concur with staff that measures are needed to discourage excessive household savings notably through adequate social safety nets, and to further increase domestic consumption. In this regard, we welcome the authorities' reforms to reinforce the unemployment insurance framework and their progress on the property tax legislation. The authorities' long-term reform agenda should improve productivity, promote competition and modernize policy frameworks. The reform complementarities and sequencing presented in Box 3 provide a useful reform implementation guidance. Finally, we encourage staff and the authorities to reach an agreement on the definition of general government perimeter with a view to improving policy discussions.

With these remarks, we wish the authorities of the People's Republic of China every success in their endeavors.

Mr. Villar submitted the following statement:

We thank staff for its comprehensive and well-written report and Mr. Jin, Mr. Sun, and Ms. Liu for their helpful buff statement. Stability-oriented macroeconomic policies, correction in external imbalances and progress on supply-side structural reforms for high-quality growth bore fruits in early 2019: a resilient high GDP growth, low and well-anchored inflation, and stable unemployment, alongside with increased currency flexibility and reduced reliance on external demand. This notwithstanding, we concur with staff's outlook that trade tensions, coupled with high levels of indebtedness, embody noteworthy triggers towards a high uncertainty environment which should be managed. We broadly share staff's assessment and policy recommendations and provide the following comments for emphasis.

Proactive fiscal stimulus was activated against sluggish economic growth since the second half of 2018. According to staff calculations, fiscal-tax cuts and infrastructure spending expected to increase the deficit by 1½ percent of GDP in 2019. We take note that some fiscal measures were not consistent with staff's advice, namely the new personal income tax-threshold, tax support for MSEs and infrastructure bonds. Could staff expand on its view of the potential impacts of these measures? Still, fiscal consolidation should be warranted. We noticed staff's assessment that "augmented" debt is on an upward trajectory and is not projected to stabilize over the medium term. As mentioned in the buff statement, the administration disagrees with staff's debt sustainability analysis. We consider that continued monitoring of results will be key to assess these alternative views and the need for policy adjustments. In any case, we notice that the authorities concur with staff's suggestion that there is no need for a further large-scale fiscal stimulus since the effects of trade tensions have already been factored into this year's budget.

The monetary policy stance has helped to stabilize growth, yet further easing is not recommended under the baseline scenario—where there is no further escalation of trade tensions. We are glad to see in the buff statement that the authorities place high priority to the shift from a quantity-oriented monetary policy framework to a price-oriented one by improving the formation and transmission mechanism of the market-based policy rate. We also welcome the strengthening of the institutional framework of the Central Bank by supporting the flexibility of the exchange rate and reducing intervention in the FX market. In this vein, could staff provide its view on whether the recent measures to restore reserve requirements for FX forward contracts may affect the process of ensuring that the yuan becomes a fully-convertible currency? Looking ahead, we agree that publishing information on FX intervention would improve the transparency and communication of the framework.

We concur with staff's assessment that whereas the financial system has recently shown robust performance, medium-term risks are still building up and vulnerabilities are showing up, especially in small regional banks. We see merit in the continuous efforts to rein credit growth by stringent regulatory standards, scaling back bank lending and clamping down shadow banking. However, we noticed that credit growth has accelerated in 2019, raising concern against the high levels of debt over GDP. We concur that improvement of credit efficiency through a more market-based allocation and removal of implicit guarantees for state-owned enterprises is warranted. Fintech can play a key role in this agenda and, thereby, the comprehensive oversight plan of fintech firms is welcome. China is at the forefront of fintech development and we hope this experience will be useful for a better understanding of this topic globally.

Contingency policy actions should be prepared against the near-term uncertain macroeconomic outlook, mostly reliant on shifts in trade tensions. We observe staff's advice of additional stimulus in case of further escalation of trade tensions: fiscal expansion of 0.8 percentage points of GDP and modest monetary policy easing. We would appreciate if staff could expand on this scenario foresight and its potential impact on the external sector and financial system. We notice that staff considers authorities' vision more sanguine towards domestic risks and we wonder if the recent released data have altered this perspective. Staff comments are welcome.

We agree that People's Republic of China's footprint in the global economy has expanded dramatically and should play an important role in modernizing the international trade system and further opening. We welcome the progress made in opening structural reforms, including cutting tariffs, new foreign investment law and removal of the foreign ownership limit for banks. We also see room to build on recent progress in strengthening the role of the market by opening non-strategic sectors, particularly services, to private and foreign companies. As expressed before, we broadly agree that the global economy would benefit from a more open, stable, and transparent, rules-based international trade system. Thus, we encourage authorities to avoid further escalation on trade, which as shown in Box 2 affects not only US and China economies but could trigger a more severe global downturn and significant sectoral dislocation. In this regard, we share staff's view that US-China trade tensions should be resolved through a comprehensive agreement rather than through a discriminatory or "managed trade" deal that could have a substantial negative effect on third parties. Additionally, we concur that external lending frameworks should be strengthened to support their effectiveness for both partner countries and China. We agree that greater coordination, cooperation, and transparency would help maximize the benefits of China's external lending.

Enormous challenges remain to realign the institutional framework consistent with the rebalancing of the Chinese economy. We take note of the mixed progress in 2018: internal rebalancing towards consumption accelerated, while credit efficiency did not improve further and progress on internal balance towards services slowed down. Remarkably, this agenda has supported an economy increasingly reliant on domestic demand—as opposed to exports and foreign investments—and has helped rebalance the Chinese trade position. Although still high, the year annual growth in the second quarter of 6.2 percent—the weakest in nearly three decades—raised the flag to speed up this agenda. We support staff's call for further structural reforms, with a focus on increasing the role of market forces and reforming the labor market, as well as a shift from infrastructure and real estate investment towards investment in healthcare and education. It is well known that China's reform started in agriculture land-use through the dual-track pricing mechanism that provided farmers market incentives, becoming one of the main drivers for high-growth rates. In this context, we support the call for improved governance in administering land fees.

We strongly support a robust agenda for improving transparency and statistics. We notice that there is still disagreement between authorities and staff on the difference between the size of the official fiscal general government deficit. We consider that data should be brought more in line with international standards. Also, we concur with staff's recommendations to strengthen governance through improving anti-corruption legislation, and the assessment of the AML/CFT national risk.

Mr. Tanaka, Mr. Harada and Mr. Nagase submitted the following statement:

We thank staff for the set of informative papers and Mr. Jin, Mr. Sun, and Ms. Liu for their useful statement. China's Q2 GDP growth slowed to 6.2 percent, its weakest pace in at least 27 years. In this regard, we welcome the staff's evaluation that the Chinese economy has been stabilized by their policy support in 2019 after slowing in 2018.

In order to realize sustainable growth under uncertain environment, the focus of the growth policy needs to shift from high-speed to high-quality, while taking measures to respond to shocks as necessary. Keeping economic trends in mind, we encourage the authorities to implement macroeonomic policies following the staff's recommendation; fiscal policy to further boost consumption and reduce income inequality; structural reforms to increase the role of the market mechanism; and monetary policy to curb rapid credit growth. In addition, we strongly agree with staff's view that the global economy would benefit from a more open, stable, and transparent, rules based international trade system, thus we encourage further efforts of the authorities to address shortcomings in the trading system. To this end, we would like to point out following three key points;

First, to realize the high-quality economic growth, as staff repeatedly mention in the report, it is indispensable to increase transparency of all the policy area, including fiscal policy, structural reforms, monetary policy and trade policy. All efforts to make fair-minded rules, disclose information and ensure ex-post verification will improve the predictability of the stakeholders such as relevant countries, businesses and investors, and will certainly contribute to the continuous vitalization of the China's economy.

Secondly, the speed of the reforms should be controlled in an appropriate manner. As mentioned above, we expect the authorities to steadily implement necessary policies. However, under recent highly uncertain circumstances, the overly rapid reforms in China may cause unexpected negative impact in the short-run not only on China itself, but also on the global economy. In this context, while we recognize that timeline was roughly showed in the Box.3 of the report, could the staff elaborate desirable modality for future reforms?

Thirdly, in general, policies should be properly and transparently enforced all over the country. From this point of view, we strongly expect that the policy intentions of the Chinese central government will be permeated. Especially, policy enforcement criteria among the local governments should be standardized and the equal footing between state-owned enterprises (SOEs) and private companies needs to be ensured.

As we agree with the thrust of the staff's appraisal, we will make the following comments:

Fiscal Policy

Local government borrowing would be a risk for the Chinese economy. In this regard, we welcome the authorities' efforts to ensure transparency and to strengthen fiscal discipline. Our understanding is that the gap between local government revenues and expenditures has resulted from demographic change, including population aging and centralization of population in urban areas. This is important issue, as discussed in the G20 meeting this year. We encourage the authorities to accelerate the following policies recommended by staff. We believe that these policies enhance well-functioning and fiscally sustainable social safety net with due consideration to intra- and inter-generational equity, corresponding to policies to be considered in the Communiqué of the G20 Finance Ministers and Central bank Governors Meeting in June.

On the expenditure side, the authorities should reduce misalignment of center-local fiscal responsibilities, including those related to pensions, employment insurance, health, and education.

On the revenue side, to enable local government to secure necessary tax revenue, the authorities should consider the introduction of a new tax such as a recurrent property tax.

Regarding debt management, the authorities should try to reduce off-budget local government liabilities and local government guaranteed debt. The special purpose bonds as an infrastructure financing tool must be recognized as liabilities in an appropriate manner and be managed properly. It would be highly important to disclose sufficient information and therby ensure transparency.

We support the staff's view that targeted structural fiscal reforms are needed to contain external imbalances, help boost consumption and reduce inequality. In addition, we agree with the staff recommendations that utilizing social welfare spending including healthcare, pension and education to tackle with these problems. On the other hand, we would like to point out that the authorities should pay attention on the balance between the growth of these expenditures and securing the sustainability of the social security system as rapid aging is expected in China. Furthermore, we take note that staff propose to reform the personal income tax system again to widen the tax base and make the system more progressive. We would like to hear staff's views on the appropriate design and level of the personal income tax more in detail.

According to the report, the impact of VAT cuts and Social security contribution cuts, which became effective from this April and May, on 2019 growth were estimated as 0.15 percent and 0.1 percent respectively. Although we recognized these reforms were aimed at reducing the burden of businesses including small and medium-sized enterprises (SMEs), could staff evaluate the real effect of those reforms and who were benefited so far?

We note that staff propose to the authorities that they should impose a substantial carbon or coal tax to tackle air pollution and climate change and to generate revenue to offset higher social spending sequentially last year. We would appreciate it if staff could explain more concrete views on the plan for the new tax. In addition, although staff introduced that China launched a nationwide carbon emissions trading system in 2017 last year's report, could staff elaborate the outcome of the system?

Structural Reform

We welcome that China has made progress in reducing external imbalances over several years. In addition, we support staff’s view that the authorities should further advance comprehensive domestic reforms including tackling income inequality and reducing inefficiency of SOEs.

Especially, we agree with staff that to boost productivity and potential growth over the medium-term, the continuous expansion of the role of markets aided by greater openness, along with meaningful SOE reform is needed. In this regard, as we understand that privileges of SOEs are causing the overcapacity problem, including steel and aluminum capacity, we support the recommendation of staff to remove the implicit guarantees and harden the budget constraints for SOEs. In addition, Chinese oversupply of steel and aluminum spells trouble for China and the world economy, thus we would like to point out the importance of the steady implementation of the structural supply-side reform to reduce the excess production facilities, which was announced in the 13th five-year plan. To this end, we would like staff to closely monitor the gap between the public statistics and their actual conditions. It is also important to increase the transparency of the management of SOEs and to allow exit of zombie SOEs to release resources to the private sector. We note that bank lending to the corporate sector continued to expand strongly, but banks favored SOEs over private enterprises, and lending to SMEs was curtailed in particular. On this point, we would like to hear how staff evaluate the role of SMEs in present Chinese economy and the impact of the curtailment on them. We encourage the authorities to take corrective action to solve the discriminatory treatment between SOEs and private enterprises. In addition, we would like to invite staff’s comments on how to secure a stable means of financing for SMEs.

Monetary and Financial Sector Policy

We support staff’s recommendations that financial sector reform and deleveraging should be continued to prevent financial risk. We take note that the total nonfinancial sector debt is estimated to increase and reach 295 percent in 2024. Regarding this point, we would like staff to elaborate the view on the desirable time frame of deleveraging.

Although we understand the authorities’ decision to take over the Baoshang Bank, we note that interbank funding tightened for some small banks and non-bank financial institutions, as negotiable certificate of deposit issuance, fell sharply while funding costs for many NBFIs rose significantly after the event. Staff recommend enhancing the financial framework by developing resolution regimes and strengthening the deposit insurance system. We would welcome further elaboration from staff on the outline of current systems and problems of them. In addition, we would like to hear staff's view on the possibility of a management risk of small banks and a systemic risk caused by the impact on money market.

On anti-money laundering and countering-financing of terrorism (AML/CFT), we welcome the authorities' recent attitude to address shortcomings identified in the FATF chaired by China and its report published on April 2019. We encourage the authorities to steadily implement the related policies recommended by staff, including the measures to increase the transparency of beneficial owners of legal entities operating in China.

Exchange Rate Policy and Capital Flow Management Measures

We agree with the staff's view that exchange rate should remain flexible and market-determined. We welcome the authorities' continuous efforts to open up the economy, including the enactment of a new foreign investment law. We encourage the authorities to make the spirit of the law universally known by the policy implementers and ensure the free economic activities of foreign companies in China, including liberalization of overseas remittance.

We support staff that CFMs should not be used to actively manage the capital flow cycle and should be gradually phased out in a sequence consistent with greater exchange rate flexibility and other supporting reforms. While China has continued its efforts to liberalize market, further easing of restrictions is needed to ensure an open market. In addition, CFMs should be targeted and transparent, and should be phased out as supporting reforms increase the economy's ability to handle greater capital flow volatility. In this regard, we welcome the staff's views on whether the capital outflow risk in China is still high or not.

The Belt and Road Initiative

As staff point out, creditors should strengthen their external lending frameworks to "global standards" and should provide financing to borrowers in a transparent and sustainable manner by fostering cooperation among borrowers, creditors and international organizations in line with such standards. It is expected for China to closely monitor its lending operations to ensure debt sustainability of the partner countries in accordance with the global standards. Efforts by China, as one of major creditors, to enhance debt transparency by managing its lending operations even more prudently would also be welcomed.

The authorities' new Belt and Road Initiative - Debt Sustainability Framework (BRI-DSF) should be implemented transparently and consistently with the DSF of IMF and World Bank, given that DSAs produced under the latter are widely accessed and used as the global standard by various stakeholders in the international community. The guidance of the IMF-WB DSAs should not be undermined as a result of the introduction and application of the BRI-DSF in BRI countries. In this regard, we encourage the authorities to closely cooperate with IMF and World Bank staff and make available to the international community details of operational policies to implement the BRI-DSF. We particularly note that the assessment of debt sustainability will be significantly affected by some critical elements, such as a discount rate and macro economic assumptions and projections. Regarding staff's view in the report that the IMF values the BRI-DSF as a positive step, we would like to know to what extent staff have been informed from the authorities about the details of the framework as the basis of this judgment.

Mr. Tombini made the following statement:

I have issued a gray statement, and I will make brief remarks on four topics.

First, a well-managed transition of China's economy is in the best interests not only of China, but the entire global economy. China has played a key role in shaping the global economy in the past few decades, becoming a more open and integrated economy and increasingly more market-based. Ensuring sustainability and avoiding a sharp slowdown requires skillful macroeconomic management and persistence in implementing a vast reform agenda. I am glad to see that the policy response to the slowdown this year has been more consistent with the strategic goals and avoided undue stimulation of shadow banking and property markets. Hence, I encourage the authorities to persevere on this approach.

Second, I greatly appreciate Box 3 of the staff report on the reform complementarity and sequencing. This is a good example of a thoughtful analytical effort to prioritize and sequence reforms in a mutually reinforcing and consistent way. I would encourage the staff to follow up on this approach and deepen the analysis further, which I believe provides a useful framework for policy discussions with the Chinese authorities.

Third, one of the pillars of the reform agenda, and a sensitive one, is the opening of the capital account and further integration of factors. In this regard, I took note that the staff representative's statement mentioned that 11 measures to accelerate financial sector opening were taken recently. I will ask staff to assess the reach and the depth of those measures.

One issue that deserves great attention from the authorities when opening the capital account is the need to have markets and instruments developed for the provision of a hedge to debtors, especially the corporate sector, that have borrowed in foreign currency. That hedging may be crucial to avoid or cope with disruptive market behavior in situations of stress. For once, it allows foreign exchange hedging to take place in derivative markets with no immediate impact on the level of reserves.

Regarding the continuation of financial opening, including the capital account, what role does staff see for the development of derivative markets and the use of derivatives in foreign exchange hedging in China?

Finally, we note that the escalation of trade tensions has been a major factor disturbing the Chinese economy with worldwide repercussions. With this in mind, I encourage the Chinese authorities to pursue an agreement that is consistent with the rules-based multilateral framework, which would be beneficial for both parties but also for the world economy as a whole. I wish the authorities success in their future policy initiatives.

Mr. De Lannoy made the following statement:

We have issued an extensive gray statement, so I will limit my comments to a few points.

First, on the structure of the report, we liked the way the policy section of the report was organized around five guiding points, rather than sector per sector. It allows for a more integrated discussion of China's policy frameworks. Second, on the content of the report, on the rebalancing of the Chinese economy, we recognize that significant external rebalancing efforts have been made while further efforts to internally rebalance the Chinese economy are paramount. We support Ms. Levonian's and Ms. McKiernan's point that an analysis of China's progress in reducing inequality and improving social outcomes would have been welcome. At the same time, we appreciate that the rebalancing scorecard includes an environment and income distribution component. Going forward, we support Mr. de Villeroché's call for a discussion on potential policy remedies in these areas in next year's Article IV report.

The fiscal picture, and particularly worsening debt dynamics, are a cause for concern. Medium-term fiscal consolidation should be geared toward making the Chinese economy more balanced and toward reducing infrastructure spending. In particular, off-balance infrastructure spending should be addressed. That said, we recognize that there are important regional differences and needs across China. We would be interested in hearing staff's views on whether the general advice on reducing infrastructure spending needs to be differentiated depending on the region.

On trade, the report makes it clear why the Fund should remain a staunch advocate for free trade within a multilateral rules-based system, including clear and enforceable rules on intellectual property. On lending practices, we welcome the newly developed data sustainability framework. This is a welcome first step, but we note major differences with international standards and best practices. We invite staff to work with the authorities to enhance Belt and Road Initiative (BRI) lending practices in line with international standards and best practices.

Finally, we invite the authorities to publish the entire set of papers, including the selected issues papers, as the Fund's thinking on China is relevant for market participants across the global.

Ms. Levonian made the following statement:

We support staff's appraisal, and like Mr. De Lannoy, we liked the innovation of approaching the policy discussion in the form of five key questions, and we think they were the right questions. We also very much appreciated staff providing policy advice that is tailored to different trade outcomes. The boxes were also very well done. Having box 2 on the knock-on impacts of a managed trade deal with the US and the dislocations that might be created may fit nicely in an analytical chapter in the World Economic Outlook (WEO). And like Mr. Tombini, we felt that Box 3, on reform complementarities and sequencing, was valuable given the scope of the reform agenda.

As China transitions to a more sustainable growth path, it is critical that they do so carefully. Policy missteps in such a systemic economy would have global ramifications. Prevailing trade tensions are not helping the authorities focus on the task of rebalancing, but they will be part of any solution. We encourage the authorities to work constructively to resolve trade tensions as part of a broader commitment to a rules-based international economic system.

China's external position is now in line with medium-term fundamentals and desirable policies, but they did not necessarily get there in the most sustainable way. The authorities should address domestic vulnerabilities associated with the external rebalancing, including excessive credit growth. We support the recommendations in the baseline to avoid further fiscal stimulus and for fiscal consolidation to be gradual. However, like Mr. de Villeroché, we did wonder whether fiscal policy might be too expansionary in light of the worsening augmented debt dynamics.

With respect to the management of capital investment, the authorities should be commended for the development of the Belt and Road Debt Sustainability Framework. This is an important step toward ensuring that Chinese infrastructure investment is sustainable.

On the financial sector side, we urge the authorities to press forward with regulatory reforms to reduce still-elevated vulnerabilities, including from household debt. This includes seeing through important recommendations from the 2017 Financial Sector Assessment Program (FSAP). We would highlight the need for a credible bank resolution regime, and like Mr. Rosen, we underscore the moral hazard implications of the recent decision to take over Baoshang Bank.

Ultimately, China's long-term income convergence prospects hinge on increasing productivity by reducing the footprint of the state and opening up the economy. In that respect, we were encouraged by China moving up 34 places in the World Bank's Doing Business ranking. We encourage the authorities to continue pressing forward to achieve competitive neutrality. Perhaps staff can use the next Article IV consultation to undertake a comprehensive stock-taking of efforts in this regard with emphasis on state-owned enterprise (SOE) reform.

And lastly and importantly, we thank staff for the answers to our questions regarding social outcomes and encourage staff to give this issue more prominence in the future. With that, we wish the authorities well.

Mr. Castets made the following statement:

We thank Mr. Jin, Mr. Sun, and Ms. Liu for their informative buff statement, and we would like to reiterate our appreciation for the high-quality work done by staff on this Article IV and more generally for the very high-quality of the work done by the Fund on the Chinese economy. Since the level of internal and external challenges remain quite elevated for China, we feel that the close engagement of the Fund with the authorities has great value.

As stated in our gray statement, we noticed a significant readjustment of macrofinancial policies in China over the last year, and we are reassured by the comment made in the buff statement on the commitment of the authorities to high-quality and sustainable growth and further internal rebalancing. But we also notice that the accumulation of new measures could go in the opposite direction, depending on the magnitude and the design of these measures. As underlined by other Directors in their gray statements, we encourage the authorities to make sure that those measures remain consistent with the internal rebalancing and financial derisking.

It could be that these measures will entail a lower growth rate in the short run, but this lower growth rate, as advocated by staff many times, could be necessary to avoid a more disruptive adaptation in the medium-term.

In addition to these general comments, I would like to emphasize a number of points. The first one is on SOE reform. Staff advocates strongly in favor of these reforms. We would like to highlight that SOEs have played quite an important role in China’s development over the recent years and decades, and they have helped to develop a network, notably for utilities. We should not have any ideological bias regarding their role in the economy. Nonetheless, we strongly support staff’s call for leveling the playing field between SOEs and non-SOEs in the Chinese economy, since it is needed to ensure further income convergence and also to ensure that FDI will continue to support the Chinese economy’s modernization.

Second, we encourage the Chinese economy to continue to build transparent and effective policy institutions. This means further improving the decision making process and the articulation between central and local levels, and we also encourage the authorities to further advance data transparency and quality, and we definitely see a need for further engagement with staff.

Also related to the fiscal side, we note staff’s answers on the valuation of public assets, and in the public balance sheet assessment, we note the fact that there is no modeling of the valuation impact in case of a shock. We wonder whether there should not be more work done on that front.

Third, on a point made already by Ms. Levonian and Mr. De Lannoy, we see tackling inequalities and reducing the carbon footprint of the economy as quite challenging moving forward, so we would reiterate our call for staff to systematically cover those dimensions in further reviews.

Finally, on the trade dispute between the United States and China, we would strongly reiterate our call for non-discriminatory exclusions to be found. In our view, managed trade, as also well illustrated by staff's analysis in the report, will be detrimental to China's main trade partners, and one has to consider what could be the reaction of those trade partners if a solution would be found that will be strongly detrimental to their own interests. Trade disputes should be settled within an open and rules-based trade system and we believe that the World Trade Organization (WTO) is the best forum to do so.

Finally, we commend the authorities for publishing last year's Article IV report in English and Chinese, and we encourage the authorities to continue this good practice, including for the selected issues papers that bring great value to the analysis of the Chinese economy.

Ms. Riach made the following statement:

Staff rightly identified trade tensions as the most important short-term risk for the Chinese economy and one that potentially has significant consequences for the rest of the membership. As others have said, an open, transparent, and rules-based international trade system is essential for all our economies, so we fully endorse the staff view that resolution to trade tensions should serve to reinforce WTO rules, be non-discriminatory, and be based on market mechanisms and macroeconomic fundamentals.

Looking at the macro picture in China, the potential trade risks sit on top of a wider long-term set of vulnerabilities, notably the need to rebalance growth. Our reading of the staff report is that the combination of these factors has limited the authorities' degree of policy freedom, meaning that the fiscal expansion is the least bad policy option. I would be interested in whether that is an accurate reflection of staff views and, if so, whether changes in the policy framework, such as more use of macroprudential policy, could give the authorities more options to respond.

More generally, we agree with the basic message that decisions focused on short-term demand management should be mindful of their impact on the long-term challenges China faces. Staff do an admirable job highlighting both the long-term potential and the risks around achieving it.

We found the idea of competitive neutrality an interesting framework for thinking about the broad set of reforms needed to drive further productivity growth and to support the rebalancing of the Chinese economy. It also speaks to the potential spillovers from China achieving this for the rest of the membership and the risks of getting it wrong, leading to costly distortions across the global economy.

While the potential reforms are broad, the two urgent aspects appear to be continuing to open the Chinese economy and SOE reform. On the first, we recognize that significant progress has been made by the authorities, but as we note in our gray statement, there remains scope to go further.

The second, SOE reform, features heavily in the staff report and in many of the gray statements. We also note the difference of views between the authorities and staff on this issue. As several Directors noted in their gray statements, the political economy of dealing with the perceived guarantees will be hard. However, I appreciate staff's answer to our question that clearly sets out both the economic and fiscal costs of failing to tackle credit misallocation linked to the implicit guarantee of SOEs and some practical steps the authorities could consider to mitigate that perception. With this, I wish the authorities all the best.

Mr. Di Tata made the following statement:

We issued a detailed gray statement and wish to express our appreciation to staff for the responses to our questions. We would like to emphasize some points and raise a few additional issues.

First, we broadly agree with the policy recommendations associated with the three scenarios presented in the report. Although regulatory and supervisory reform have led to financial deleveraging, the overall debt of the non-financial sector remains elevated. Against this backdrop, we concur that under the baseline scenario, the authorities should proceed with gradual fiscal consolidation while reducing credit growth to SOEs and pricing credit appropriately.

Second, on the monetary front, we encourage the authorities to continue moving toward more market-based and transparent frameworks. In this regard, we welcome the People's Bank of China's (PBOC) plans to deepen market-based interest rate liberalization and shift from a quantity-oriented to a price-oriented monetary policy framework. As noted by staff, this should be complemented by giving the PBOC greater accountability and operational independence.

Regarding the financial sector, the priority should be to avoid regulatory backtracking and continue with structural regulatory reforms to reduce still-high vulnerabilities.

Third, we agree with staff on the need to move ahead with a broad set of structural reforms, paying due attention to appropriate sequencing. Further efforts are particularly needed to enhance labor flexibility, increase firm entry across sectors and regions, facilitate inward investment, and accelerate the reform of the SOEs.

Fourth, we welcome China's progress in reducing external imbalances in recent years. As noted in the report, the external current account surplus declined from about 10 percent of GDP in 2008 to 0.4 percent in 2018 and is expected to remain at about that level under the baseline scenario. However, the savings investment imbalances of the public and private sector remain very large, with the public sector's negative net savings (as measured by the large augmented fiscal deficit), being more than offset by sizeable positive net savings by the private sector. We agree with staff that the fiscal deficit of such magnitude should be reduced in a gradual but steadfast manner to address debt sustainability concerns. Could staff elaborate further on the timeframe and policies being envisaged by the authorities to address simultaneously these large imbalances of opposite signs? We also would have appreciated more information on how the augmented fiscal deficit is being financed.

Lastly, we note from Figure 2 in the selected issues paper on China's shrinking current account surplus that the share of imports of consumer goods relative to total imports has changed relatively little since 2008 and remains low at only 5 percent. We would appreciate staff comments on this issue. With these comments, we wish the Chinese authorities every success in their endeavors.

Ms. Mahasandana made the following statement:

We thank staff for the comprehensive set of reports. The detailed analysis on policy options in response to trade tensions is insightful. It shows that the staff have given thought and rigorous consideration to the policy tradeoff and complex challenges facing China. We also very much enjoyed the selected issues paper which delved deeper into the issues that are permanent to the Chinese economy, including the household indebtedness and credit allocations. We have issued a gray statement, and we have two quick comments to add to our gray statements.

First, we strongly support staff's call for the United States and China to quickly resolve trade tensions through a comprehensive agreement, not through a managed trade agreement. The recent economic data and the Fund's analysis provide clear evidence that the trade tensions between the two giant economies has taken a toll on the global economy with no clear benefit to the United States nor China. This underscores the urgency for the United States and China to come to a solution on trade. As we still have hope for resolution of the trade tensions, we agree with staff that it is important for an agreement between the United States and China to reinforce WTO rules. In this regard, we welcome the analysis in Box 2, which highlights that the U.S.-China managed trade agreement would introduce distortions and negative spillovers.

Second, we underscore the importance for China to manage its policy tradeoffs carefully so as to minimize spillover to the rest of Asia and the global economy. China faced a trilemma of having to manage a structural slowdown, address financial vulnerabilities, and implement ambitious structural reform. We appreciate the authorities' readiness to provide additional target stimulus in the event of further escalation of trade tensions, but as noted in the staff's written responses to technical questions, it is important for the authorities to avoid achieving a given growth target at all costs, including unsustainable credit and investment stimulus.

We trust that the authorities remain committed to deleveraging and financial derisking and will stay on course on rebalancing. Financial linkages between China and Asia have deepened over years. As China proceeds to modernize its monetary policy framework and move toward exchange rate flexibility, we encourage the authorities to continue to enhance policy communications and transparency so as to minimize market volatilities in the regions.

China also plays an increasingly important role in helping many of our economies in infrastructure development through the BRI. In this regard, we welcome further progress to enhance project selection as well as strengthen oversight so as to maximize the benefits of the BRI project for China and the recipient countries. With these remarks, we wish China's authorities the very best.

Mr. Sigurgeirsson made the following statement:

We have issued a gray statement, but in addition, I would like to highlight three topics. First, we fully agree with staff that the external lending framework should be strengthened to support the effectiveness for both partner countries and for China. The BRI has the potential to bring significant benefits to all partners. However, a framework that promotes greater transparency would serve to maximize the benefits of the BRI. We therefore agree with the statements by some of our Board colleagues and staff that enhanced monitoring using the new BRI Debt Sustainability Framework is a positive first step to enhancing discipline in external lending, and it is important that the BRI framework should adhere to global standards that promote transparent and sustainable lending practices.

Second, I would especially like to thank staff for the informative selected issues paper on trade spillovers, although it was somewhat disconcerting. A new trade war agreement that involves China purchasing U.S. goods to reduce the trade balance will bring significant trade diversion effects. We found the export-at-risk analysis particularly innovative, indicating that the impact can be significant for many advanced and emerging economies. This underscores the importance of resolving trade tensions through agreements that tackle the underlying roots of tensions and not through managed deals that could potentially have negative effects on third parties. Like Mr. Castets mentioned, it will be hard to predict the impact from third parties.

Last but not least, tensions between the United States and China have broadened beyond trade of goods to include the tech sector, and while they are intertwined, a tech war is very different from a trade war, and much more difficult to predict its outcome. One thing is clear, that normalizing tech transfer relationships will be the lifeblood for sustaining long-term growth in China. Perhaps some direction could be found in the idiom from the Middle Kingdom: Refraining oneself in the moment leads to a calming down, and one step of concession may take you to a higher flight.

Mr. Merk made the following statement:

As we broadly concur with staff's appraisal and recommendations, we would like to highlight a few distinct aspects.

The current trade tensions weigh on business confidence and create large uncertainties. Like many other Directors, we encourage the authorities to work toward a comprehensive resolution of the trade conflict that is in line with and supports the strengthening of the multilateral and rules-based international trade system. Regarding China's external lending, we agree that China should continue upgrading its external lending framework and adhere to global standards that promote transparent and sustainable lending practices and create a coordination and cooperation among borrowers, creditors, and international organizations.

We welcome the progress in financial deleveraging and the reduced interconnectedness between banks and non-banks. Nonetheless, credit growth has picked up again along with worsened credit allocations. Consequently, the authorities need to remain vigilant in order to safeguard financial stability. We echo staff's call that credit should be allocated through a more market-based system to ensure the efficiency of credit allocation.

Lastly, we encourage the authorities to make fiscal accounts more transparent and bring data more in line with international standards.

Mr. Tanaka made the following statement:

We thank staff for the informative and comprehensive papers and high-quality consultation process. We welcome the staff's evaluation that the Chinese economy has been stabilized in 2019 after struggling in 2018.

We strongly agree with staff's view that the global economy would benefit from a more open, transparent, and rules-based international trade system, toward which we encourage the authorities to address further measures.

I will make the following comments. First, as to the fiscal policy area, local government borrowing would be one of the risks for the Chinese economy. The gap between the local government revenues and expenditures has resulted from demographic change, including population aging, and centralization of population in urban areas. In this regard, as discussed in the G20 meeting communiqué this year under the Japanese presidency, it is important to enhance the efficiency of public spending and to provide a well-functioning social net, along with due consideration to intra- and intergovernmental equity. On the expenditure side, we encourage the authorities to reduce misalignment of fiscal responsibilities between central and local governments. We would like to point out that the authorities would pay attention to the balance between the growth of these expenditures and securing sustainability of social security system, as rapid aging is expected in China. On the revenue side, to enable the local government to secure necessary tax revenue, the authorities could consider the introduction of a new source of taxation. Regarding the debt management, reducing off-budget local government liabilities, including guaranteed debt, is required. It will be highly important to disclose such information and thereby ensure transparency.

Second, I will move on to structural reform. We welcome that China has made progress in reducing external imbalances over several years. In addition, I recognize the authorities would further advance comprehensive domestic reforms, including tackling income inequality and reducing inefficiency of SOEs. Especially on SOEs, we agree with staff that the continuous expansion of the role of the market is needed to enhance productivity and potential growth over medium term. In this regard, as we understand the privileges of SOEs are causing overcapacity, including for steel and aluminum, we support the staff's recommendation to remove the implicit guarantees and harden the budget constraints for SOEs. We would like to point out the importance of the steady implementation of structural supply-side reform to reduce excess production facilities. Under the BRI, China as one of the main creditors should strengthen the external lending framework to global standards and should provide financing to borrowers in a transparent and sustainable manner by fostering cooperation among borrowers, creditors, and international organizations. The authorities' new BRI Debt Sustainability Framework should be implemented transparently and consistently with the assistance of Fund and the World Bank. In this regard, we encourage the authorities to closely cooperate with the Fund and the World Bank and make available to the international community details of operational policies to implement the BRI Debt Sustainability Framework.

Finally, concerning monetary and financial sector matters, we support staff's recommendation that the financial sector reform and deleveraging should be continued to prevent fiscal risk. We take note that the total non-financial sector debt is estimated to increase and reach less than 300 percent in 2024.

As to the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) issue, we welcome the authorities' recent policy action to address the Financial Action Task Force (FATF) requirement, which is chaired by China. I wish all the best for the authorities.

Mr. Inderbinen made the following statement:

We welcome the authorities' continued implementation of the structural reform agenda and China's continued progress toward an open and market-based economy.

We encourage the authorities to maintain the good reform momentum which is evidenced, among other things, by the notable gains in the Doing Business rankings. Nonetheless, moving to high-quality growth could be further supported by efforts to deleverage the economy further and to address remaining inefficiencies. We welcome the efforts to modernize the fiscal framework and encourage the authorities to enhance fiscal governance and transparency at all levels. This includes better aligning central and local fiscal responsibilities, enhancing the controls and transparency with respect to the collection of land fees, and limiting the use of off-budget borrowing.

Reforming SOEs clearly bears great potential in ensuring a more efficient allocation of credit across the economy, and we see merit in strengthening the governance, removing implicit guarantees of SOEs, and reducing their privileged access to credit.

Like Ms. Levonian, we note the moral hazard risks that are associated with the recent interventions in the financial sector, notably at Baoshang Bank. We also note the differences in the approach that the authorities have chosen to take in the more recent case of the Bank of Jinzhou, as the staff reports in the written answers. We would encourage the authorities to develop a consistent framework for the resolution of financial institutions as would be in line with the recent FSAP recommendations.

Finally, like Mr. Tanaka, we encourage the authorities to continue strengthening the monitoring and transparency of external lending practices and ensure that they adhere to global best practices for sustainable lending. We take good note of the potential of the BRI Debt Sustainability Framework in helping to strengthen discipline in external lending and note the importance of the assumptions underlying the Debt Sustainability Assessment (DSA), including the macroeconomic model and the discount rates that are used.

Finally, we join Mr. De Lannoy and Mr. Castets in encouraging the authorities to again consent to the publication of the documentation for today.

Mr. Kaya made the following statement:

In addition to our gray statement, I would like to follow-up with two brief comments.

First, the advances the Chinese authorities have made in reorienting their growth model from high speed to high quality are obviously accompanied by difficult policy tradeoffs between long-term benefits and short-term risks and social impacts. The authorities therefore need to strike a fine balance in their policy choices to appropriately distinguish a healthy level of growth moderation that reflects the much-needed rebalancing of the Chinese economy, from the short-term pressures emanating from the elevated trade tensions. Defending growth at all costs would risk amplifying the structural challenges facing the Chinese economy. From the buff statement, as well as the authorities' views expressed in the staff report, we note that the authorities are well aware of the broad picture and are carefully calibrating their policies to address the conflux of challenges. We look forward to a further modernization of the authorities' policy framework in tandem with the increasing size and complexity of the Chinese economy.

Second, as rightly emphasized throughout the staff report, trade tensions between the United States and China continue to have a defining impact not only on the Chinese economic outlook but also on the global scale. Like many other Directors, we welcome staff's advocacy for a comprehensive resolution of these disputes within the parameters of the rules-based international trade system. It is critical to refrain from discriminatory and managed trade deals which are very distortive at the global scale and have significant negative effects on third countries. Here both sides of the dispute have a role to play to diffuse the tensions. We are pleased to see the authorities' commitments on their part and very much hope that a fair and globally beneficial resolution will be reached. With these remarks, we wish the authorities success.

Mr. Mouminah made the following statement:

We issued a detailed gray statement. I would therefore limit my remarks to a few issues.

First, we take positive note that growth has stabilized and is driven by rebalancing. To achieve a decisive shift to high-quality growth, the authorities are rightly focusing on deepening market-oriented reforms and accelerating opening up. In this regard, we welcome the recent announcement of measures to improve foreign access to the bond market, and the wealth management, insurance, securities, and rating industries. Given the large size of the Chinese economy, we encourage staff to further strengthen analysis of the outward spillovers from the rebalancing.

Looking ahead, the authorities should continue to implement key reforms to foster greater openness, advance SOE reforms, and increase competition, which will help in boosting productivity and potential growth. The authorities should also build upon progress with deleveraging.

Second, on trade, we join others on underlining the importance of resolving the ongoing trade tensions in a manner that builds a strong multilateral and rules-based trading system. Box 2 of the report and the chapter in the selected issues paper provide a good analysis of the implications for the rest of the world. I agree with Ms. Levonian that this should be included in the WEO report. In this connection, we concur with staff on the importance of supporting a multilateral trade system.

Third, on the financial sector, fully implementing the announced regulatory reforms, strengthening the bank buffers, especially for smaller banks, and developing additional macroprudential tools where needed to address excessive risk-taking remain important. Notably, as other Directors highlighted, the recent events underscore the need for developing a well-functioning, transparent resolution regime to facilitate the exit of weak banks. Moreover, we note disparity of the strong credit expansion for mortgages. The NPL ratio remains low. We would appreciate staff elaboration on the key steps taken by the authorities to ensure low NPLs.

On AML/CFT, we welcome the progress toward improving the legal system and the effectiveness of the measures taken. We also look forward to the authorities' plan to address the weakness identified on the FATF report.

Fourth, on inequality, the staff's report brings attention to the challenges of still-high inequality. Like Ms. Levonian, Mr. De Lannoy, and Mr. Castets, and other Directors, we encourage the authorities to continue their efforts to address it. In this context, we welcome the plans to eliminate absolute poverty and improve public health and education services, including for low-income groups.

Finally, I would like to raise a point about the staff's judgment and perception. I was surprised to read in paragraph 12 that the mission's visit to the villages in Guizhou Province provided evidence of inequality. Although I strongly support the call to further address inequality, I disagree with the approach and urge staff to remain cautious in representing firm conclusions in the formal staff report based on short field trips. With these remarks, we wish the authorities continued success.

Mr. Ray made the following statement:

Like other Directors, I thank staff for an excellent set of papers, also for the outreach, and I might also take the opportunity to thank the resident representative and his team in Beijing as well because I know they do an outstanding job as well, and also I thank Mr. Jin, Mr. Sun, and Ms. Liu for an interesting buff statement.

Like others, I quite liked the five key questions approach, and we appreciated some of the analysis, particularly around managed trade. China's experience over the past few decades has been absolutely extraordinary, and we tend at times to focus on the policy challenges that they currently face, which remain daunting, but given where they have come, we should not underestimate where they are going to go. That said, the rebalancing that they are engineering, the opening of the capital account and SOE reform remain the most important things for the future, and they are difficult things to do. The staff's work is supporting the authorities, and I encourage them to continue to do that. In that sense, the trade tensions must be a bit of a distraction. The analysis in Box 2 is very helpful, although I do think it is probably a bit of a worst-case scenario. As I have mentioned to staff privately, I would encourage you before publication to look at the labeling, because I am sure Australia does not export that many pearls to China.

This analysis in the selected issues paper, that we actually saw in the Regional Economic Outlook (REO) as well, shows why it is so important that the authorities work toward an outcome on trade that would further strengthen the multilateral rules-based and open and transparent trading system rather than go down a different route.

The area of the staff report that is quite important is this question around enhancing the social safety net because that would lower the need for precautionary saving in China, which is going to have important macroeconomic effects. I did wonder about the recommendation to shift spending from local to center. That is not the traditional approach to these things where the subsidiarity principle tends to hold. I personally have always been a bit suspect of subsidiarity because I come from a central government. But because it is not the normal recommendation, I would encourage staff to think about how they analyze that question. I would also think that it would be helpful if we could help China to avoid the problems the rest of us have made with splits of responsibilities—for example, in the health system—between the central level and a lower tier level. That would be a helpful thing to do to help China avoid our mistakes.

Like others, we think China has come quite a way on financial system reform, and has a way to go. Consistent application and implementation is going to be the challenge.

One last comment on the staff paper is that the concept that China needs to think about macro-fiscal issues is incredibly important, but I did wonder about the micro recommendation that they have a unit in the Ministry of Finance. I wonder whether that is really what we should be doing, and whether we should be just suggesting the direction and then letting the authorities work out how to do it.

Mr. Raghani made the following statement:

We have issued an extensive gray statement, so I will limit my remarks to three broad points.

First, China has made good progress toward a strong and open economy, as well as more balanced growth, even though more remains to be done. The macroeconomic policy response to the slowdown is also bearing fruit with a positive impact on 2019 growth. We understand that it is hard to estimate long-term impact and we appreciate staff’s answers to this inquiry. We welcome the consistency of fiscal measures listed on page 11 of the report with supporting potential growth.

Second, on a broader perspective, we appreciate the authorities’ reform priorities to cope with the adverse external environment, enhance financial stability, and bolster productivity. We encourage them to build on progress made to reinforce their policy frameworks, notably in financial regulations and AML/CFT.

Finally, while we acknowledge China’s desire to help maintain an open, fair and rules-based international trading system, we encourage further efforts from all to achieve this mutually beneficial objective. With this, we wish the Chinese authorities success in their reform endeavors.

Mr. Rosen made the following statement:

Though the Chinese economy is slowing, there has been an important shift toward the service sector and greater consumption, and this is a trend we fully support. However, as Mr. Castets pointed out, recent actions have contributed to slowing this progress, particularly in the areas of deleveraging and reducing credit growth, and the role of the state in the economy is again increasing, so we strongly encourage the authorities to redouble their efforts to open up the economy and undertake reforms that will continue the rebalancing toward consumption.

I wanted to focus my comments on trade, external, and financial sector issues in fiscal policy. First, on trade, the report focuses mainly on a managed trade deal related to the purchases of goods, particularly agricultural products. However, the overwhelming U.S. emphasis of a potential U.S.-China trade deal is on the structural changes that would be part of the agreement. As Mr. De Lannoy noted in his gray statement, a positive scenario which creates a more open and market-based trading and investment environment would generate significant benefits to China, and we would add that the structural reforms in a U.S.-China trade agreement would also accrue to all countries that do business in China.

On the external sector, although China’s current account surplus has narrowed, there is a risk of a return to larger surpluses due to excessively high savings, especially if consumption fails to rise due to the higher household debt, and we would welcome greater attention on these distortions in next year’s Article IV report.

We also want to reiterate our comments on a greater transparency in China’s exchange rate policies. For an economy of China’s size, foreign exchange intervention reporting is critical. We note that foreign exchange interventions do not appear to be significant in recent years, but it is impossible to know the extent of the interventions without accurate data, and we hope the authorities will take steps to publish this information soon.

Additionally, as a growing creditor internationally, China should pursue lending projects that maximize their benefits for the receiving countries and meet standards of transparency and good governance. We agree with Ms. Levonian in welcoming the new debt sustainability framework that

China has adopted. However, we urge the authorities to bring lending practices under the BRI in line with international standards, such as the G20 Principles for Quality Infrastructure Investment, and prioritize open procurement, private sector participation, and strong oversight. We support the comments from Mr. Tanaka and Mr. Inderbinen on this subject.

In the financial sector, while some past Article IV reports and the 2017 FSAP dealt with issues of leverage in the financial system, this Article IV report did not focus on the issue as much. Given that the banking sector assets are at 300 percent of GDP compared to other large economies, which are between 100 to 200 percent, this is an issue that should feature prominently in future reports and is a financial stability risk for China and the broader global economy. One area where this topic was touched on was the selected issues paper, which dealt with the allocation of corporate credit in China. We think the issue of implicit guarantees with credit allocations skewed toward less-efficient SOEs given their government backing, is an important topic for staff to investigate, and we support both staff's work and Mr. Castets's comments on this today. We encourage the authorities to consent to publication of this selected issues paper even if they disagree with the analysis.

Finally, we note that debt dynamics have deteriorated compared to last year, with a sharp increase in household and corporate debt in the first quarter and non-financial sector debt projected to rise by 10 percent of GDP this year. We agree with the statement by Ms. Levonian welcoming the use of augmented debt concept to account for significant spending and debt at the local government level. As staff note, the projected difference between the narrow definition of debt and the augmented measure is 51 percent of GDP versus 101 percent in 2024, a very substantial difference. We also welcome the statement by Mr. de Villeroché and others on the need to align public financial data with international standards.

Mr. Fanizza made the following statement:

Like many of my colleagues, I should say that I really enjoyed reading the documents. I found them well done. There is a but, and it is on a light note on this somber day. As many of you know, this chair has been arguing against age discrimination. I could not read some of the graphs, even with my reading glasses and magnifying lenses. Please, next time, use bigger fonts. That is important. I am getting older.

That said, the report was good. I thank staff for the answers. Let me get to the main point. I am not convinced about the staff's answer on the fact that increasing the personal income tax threshold is a regressive measure. It goes against what I have believed all my life and all my career at the Fund. It is not like that. Ceteris paribus, it goes in the opposite direction, and this is one standard recommendation of the Fund for many years, so I do not understand why we are changing.

On the idea of increasing consumption of China while reducing savings, how is it possible that we say we want measures to reduce savings and then we point to the fact that household indebtedness is a significant source of vulnerability. The two things are not consistent, so I would like an explanation.

On this idea of the shift to services, they are welcome, as Mr. Rosen was saying before, and we need to go in that direction. I am not convinced by the stance that the staff takes. The report highlights the adverse impact of this shift would have on growth prospective. However, technological change is affecting mainly services. The reason why services tends to have lower productivity is because they are not traded, but technological changes have made services much more tradeable than they used to be. Yesterday I was looking at the drafts for a book that I am published with Springer. It was edited in India, so that is services. This idea that services are lower productivity than traditional industry is a bit of an obsolete point and does not go in the right direction of making it easier for the Chinese economy to transition.

Mr. Mozhin made the following statement:

We have issued our written statement, and I will make only a few additional comments. The main piece of news from the report is that China's current account is now in balance and that the exchange rate is aligned with fundamentals. This is a testament to many years of very strong efforts by the Chinese authorities to address the issue of their current account imbalance. Let me recall what happened about five years ago during the time of the so-called taper tantrum, when the Chinese authorities sold about US$1 trillion from their reserves in a massive effort to prevent a significant depreciation of the Chinese currency and by doing that effectively saved the world economy from a massive deflationary shock, demonstrating their sense of responsibility for the development of the global economic developments.

On the footprint of the state, there are 100,000 SOEs, and the bulk of those are small enterprises belonging to local authorities and many of them performing effectively social functions, and it will take time to address this situation. I am encouraged by what I read in the statement of Mr. Jin that the authorities are mindful of this deficiency and are planning significant efforts to address it, but obviously this will take time.

The implicit guarantee is another important matter, and it is not uncommon to many countries. In every country, large companies, public or private, enjoy this implicit guarantee and benefit from better lending, better borrowing terms. We have had many discussions about the too big to fail issue. This is just another name for the same type of problem. Again, I think it is important that the Chinese authorities recognize this issue.

On trade tensions, I am fully in agreement of what is written in the report, that the objective should be an enhancement of rules-based multilateral system rather than managing bilateral trade on the basis of bilateral agreements. Protection of intellectual property rights is an important matter, but the irony is that historically the Chinese have invented more or less everything, from paper and printing to gunpowder and silk and you name it. For many centuries, foreigners have been stealing industrial secrets from China all the way until as late of the 19th century when tea plants were smuggled out of China, and this gave the rise of this worldwide tea culture. I agree that it is important to strengthen intellectual property rights protection but this has to be placed in the historical context. I welcome significant progress in structural reforms, which is reflected in Chinese progress in the World Bank Doing Business Indicators. My final point is that I am joining others in encouraging the Chinese authorities to publish the reports. This will benefit the authorities themselves.

The staff representative from the Asia and Pacific Department (Mr. Daniel), in response to questions and comments from Executive Directors, made the following additional statement: [2]

Responding to a few of the questions that were raised, on the depth of the recent opening up, what we have seen is that the reform of the financial sector is perhaps at the forefront, and what we are seeing here is a further increase in the pace of opening up on the financial sector in line with the authorities' commitments. We would especially welcome the opening up of

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

the wealth management sector, which is huge in China, and also the domestic bond ratings, which are a critical gap in China's financial system. I would stress that there is often a big gap between statements and reality on the ground, and the proof of the pudding is in the eating, so we would also encourage the authorities to quickly put this into implementation, so it can change reality on the ground.

Should infrastructure spending vary by region? Very much so, yes. We did not flag that, and we are not experts, but there is a wide gap in infrastructure amongst Chinese regions, and in fact, the difference seems to be more between rural provinces and the urban provinces, and we definitely would say that there should be better targeting of infrastructure spending but within an overall smaller envelope.

On fiscal response being the least bad response to countercyclical shocks, exogenous shocks, yes, this fits into our bigger perspective on China. They do not have yet the policy frameworks where they have much choice. Were they to have a monetary transmission mechanism that was fully functioning; were they to have a fully-fledged macroprudential system and, indeed, the buffers which they could then draw down as necessary; were the exchange rate to be more fully flexible and markets more able to respond to that in a balanced measure, then the policy recommendations would be different, and I think that is what China is aiming for as well.

On the other hand, there is a medium-term agenda that can be met, a two-birds-one-stone angle, which we thought we would try and exploit. On what the authorities are doing to address the savings investment gaps, the two things that stand out is the huge amount of public infrastructure investment and the huge amount of private savings. On public infrastructure investment, and perhaps to speak more in the authorities' defense, we make a big deal about the augmented balance and the increase in infrastructure spending, but the authorities are aware of this issue and are trying to tackle it mainly through a legal approach to tell local governments that they cannot do stuff off balance sheet and it will not be guaranteed, so they are aware of these issues and are trying to take it forward but more through a legal approach.

On private savings, it comes back to a previous conversation. The authorities are rolling out a bigger social safety net and are liberalizing the imports of consumer goods as well as reducing tariffs. Our point is it goes in the right direction, but we would like to see it done more rapidly.

How is this big augmented deficit financed? It is basically through the bonds and bank borrowing of these local government financing vehicles. These are 100 percent SOEs doing what seems to us to be public infrastructure investment, and they borrow from banks, and they issue bonds and usually at very tight spreads to government debt, and that is how it is mainly financed.

Why are consumer imports so low in China? They are remarkably low, quite true. To a certain extent you would think that is partly understandable given that China is the consumer goods producer for the world, but it also reflects the pattern of development in China, the big increase in investment spending that has brought down the current account, and the still-high private savings.

On the point about social spending being shifted to the local governments, perhaps was not the best phrasing that we used. We used take over. Our point is that we need to recognize there is a big diversity of experience around the world, and many different ways can work. Our point more is about taking over the financing of some of these spending items. For provinces that have very high aging needs or poverty-reduction needs or employment support needs, it does not seem to be ideal that they should also bear the entire burden of financing it, and perhaps we could have phrased that better.

On why increasing the income tax allowance is regressive, I agree. I have also been in the Fund a long time, including in the Fiscal Affairs Department, and this is the first time I have criticized such an increase. Our point is that pretty much nobody pays personal income tax in China. The ratio of the allowance to the average earnings is very high. To push it even higher means you are basically undermining the revenue source for one of the few progressive taxes in China. Already in China the outcomes of the fiscal spending and revenue system do not change inequality. In most countries around the world, the Gini coefficient before and after fiscal action is very different. In China it is identical, and that is because of the absence of these progressive taxes. We thought that on aggregate, reducing the role of the personal income tax within the overall revenue scheme of China was regressive, and perhaps we could have explained that better.

On household debt and private savings, it is weird that we say household debt is rising too fast, and we want you to spend more. I get that. It is a little contradictory, but perhaps some aspects of the Chinese situation might help. The bulk of household borrowing is not for spending or consumption. It is to buy houses, another form of savings, which is also reflective of the credit situation, the lack of assets, and the macroprudential issue. By addressing the housing market and the housing prices head on, you still can be consistent with raising private consumption, which can also be supported by government support to the social safety net.

The staff representative from the Asia and Pacific Department (Mr. Kang), in response to questions and comments from Executive Directors, made the following statement:

I will address the question on the state of the foreign exchange hedging markets in China. You are right to point to the low demand for foreign exchange hedging in China currently, but that situation is changing given that the policymakers have allowed for a much greater two-way flexibility in the exchange rate recently. But also looking ahead, the trends do suggest that demand will increase. Chinese households and corporates, as aging continues, will look to diversify their large pool of savings, including overseas. At the same time, China's next phase of integration is financial integration. The team put out a book recently on the future of China's bond market, which highlights that foreign ownership of Chinese bonds is very low at about 2 percent, so there is tremendous potential for further global integration of Chinese financial markets, and foreign exchange hedging instruments and derivatives would be an important part of that overall strategy. The authorities have taken steps in this direction. In April, they allowed for Chinese bonds and equities to be included in certain global indices, which should encourage inflows in the coming years, and they have also accelerated plans to further open up the financial system, which will also provide more demand for derivatives and other foreign exchange hedging instruments.

In the staff report, we have highlighted a few areas where China can take measures to facilitate this transition, including by allowing for greater two-way flexibility in the exchange rate to allow for further opening up of the financial sector; as well as continuing with interest rate liberalization, shifting away from a central bank benchmark rate to a more market-based instrument to allow for the pricing of these derivatives based on market conditions.

Mr. Daïri made the following statement:

We would like to recognize and commend the authorities for their excellent stewardship of the economy. It is not an easy task for a country of the size of China, which is not only in the process of a huge social and economic transition but also which is faced with unfavorable external environment. I appreciate that they are looking at the impact of the reforms on the rest of the world.

I am a bit surprised or even disappointed by the assessment that the rebalancing effort of China is mixed. I do not think it pays sufficient tribute to what they are doing, and I hope that the summing up will not repeat these words, this concern. They have done a lot in terms of rebalancing. Mr. Mozhin just mentioned some of them. In many other countries, we would be applauding very loudly such accomplishments. We should not refrain from doing so because it is China. China deserves also to be applauded for what they have done. Nobody says that the task is complete. Nobody says that there are not distortions, including maybe new ones. This happens in all countries. We should recognize, we should give the right message that they are doing a lot, but there are things that need to be done maybe more quickly, and also that maybe we should refrain from undoing what they have done before. A clear message from the Board in this area would be extremely important and ensure giving credit and justice to what China is doing.

Mr. Castets made the following statement:

I have a point I had no time to make in my first intervention on the BRI. We fully share the assessment made by some Directors that the adoption of the Debt Sustainability Framework is a very positive step, and the authorities have to be commended for that. We also encourage the authorities to apply it consistently and in close cooperation with the Fund and the World Bank going forward.

Also, I have a follow-up question on my first question on the public assets valuation and how we should work on modeling of both liquidity and valuation in a scenario of shock. We feel it is an important question because when we look at the balance sheet analysis that was presented in the Fiscal Monitor last spring, a large part of those public assets are SOE assets, and it is difficult work but it goes beyond the Chinese case. We also had the discussion of this issue for Canada several times and for other countries, so we would appreciate if staff could indicate whether work is ongoing on that front.

Mr. Fanizza made the following statement:

I just wanted to second the point made by Mr. Daïri. The point is that the road toward transformation is a bumpy one. We cannot expect that things proceed smoothly and in a seamless way. It is true there are areas where there has been less progress than somewhere else, but that is part of life and part of any reform process that we have ever seen. Thank God it is like that, because the idea of doing things completely smoothly and without problems, it is something different from market economy. In a situation like China, where actually you do a huge transformation, you cannot expect that everything goes well. It is just a question of the tone of the presentation.

The staff representative from the Asia and Pacific Department (Mr. Daniel)) responded that he believed that the Fiscal Affairs Department was working on the issues raised by Mr. Castets.

Mr. Jin made the following concluding statement:

I would like to first thank my colleagues in the Board for your constructive and insightful comments, which will be faithfully conveyed to my authorities.

Regarding the macro economy in China, given China's solid fundamentals and still large productivity gap, we are confident that the economy will overcome the negative impacts of external shocks and adapt to a sustainable and quality growth.

Regarding the debt issue, we think that the recent rise in the debt ratio is a short-term response rather than a long-term trend. The authorities are committed to stabilizing the overall leverage in the short and medium term. The debt issue should be examined in the context of the high savings rates in China. The high savings rate indicates the level of domestic resource mobilization that has enabled China's intertemporal resource allocation and capital formation to be more independent of external financing, and this is also consistent with the need to maintain external balance.

On financial stability, the recent takeover of Baoshang Bank and the participation of strategic investors in Jinzhou Bank have reflected the continuation of the authorities' efforts to clean up, consolidate, and strengthen some of the small- and medium-sized banks. In the past few years, the majority of small- and medium-sized banks have been strengthened by aggressive efforts to raise capital, dispose of bad debt, and sharply increase provisioning, which is consistent with FSAP recommendations.

On SOEs' explicit versus implicit guarantee, the Chinese authorities have committed to maintaining a level playing field for all types of companies and have started to implement the principle of competitive neutrality in practice. We welcome the staff's selected issues paper on improving the allocation of corporate credit in China and appreciate staff's reference to some countries' experiences in offsetting SOEs' low borrowing cost associated with explicit guarantees. But caution should be exercised when staff define and quantify a new perception-based concept of implicit guarantee. Chinese authorities clearly prohibit any unauthorized guarantees to companies. As recognized in the staff report, quite a lot of SOE bonds in China have defaulted in recent years, and in certain periods, the number of defaults in SOE bonds is higher than that of publicly-owned enterprise bonds. This contradicts staff's assumption that there widely exists implicit guarantees. Staff has sent out a message that the lower financing cost of SOEs is equivalent to quantified implicit guarantees. There is a big risk of oversimplification and arbitrary judgment here. We encourage staff to conduct a comprehensive study and cross-country comparison to test the robustness of the concept of implicit guarantee and apply it to member countries in an evenhanded approach. Staff may need to study whether the low financing cost of some big financial institutions and automakers in developed countries bailed out by their government during financial crisis or partially owned by the government has reflected implicit guarantees. I doubt whether we can quantify this type of implicit guarantee with great confidence. We hope staff can incorporate much more evidence we provided to enrich cross-country comparisons and make the conclusion and the policy proposal more pertinent and robust.

Regarding trade, we fully understand staff's and many Directors' concerns with the managed trade that is characterized by discrimination and distortion. We share the view of the Fund that trade balance should be examined from a multilateral rather than bilateral perspective. In fact, the managed trade described by staff is proposed by negotiators of China's counterparty. It is more appropriate to discuss this issue with those who proposed it.

In the past year, China has already cut its effective tariff rate, liberalized market entry for foreign investors in many sectors, and further strengthened intellectual property protection. This progress is related but not conditional on a final U.S. trade agreement. China would like to resolve economic and trade divergences with its trade partners based on mutual respect, mutual benefit, and mutual trust. Any trade agreement that China could reach with its trade partners will both promote bilateral trade and be WTO-consistent. It will be implemented on decisions made by independent market players based on market conditions.

On overseas lending, the authorities have made great efforts to improve monitoring, coordination, and transparency. The Debt Sustainability Framework under the BRI has borrowed a lot from the Fund's methodology and benefited from staff's consultation and advice. Based on staff's monitoring and the Board discussion, we issued early warning to creditors in China for their potential risks, and these efforts have yielded concrete positive results.

Finally, I would like to thank Acting Managing Director Lipton for his leadership and thank the mission chief, Mr. Kang, for his candid and successful policy dialogue with the authorities. Our thanks also go to the entire China team for their arduous and professional work, and Chang Yong Rhee and James Daniel for their advice and guidance.

The Acting Chair (Mr. Lipton) noted that the People's Republic of China is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' recent reform progress, in particular, in reducing financial sector fragilities and continuing opening up of the economy. They noted the highly uncertain external environment and emphasized that successfully shifting from high-speed to high-quality growth requires continuing with deleveraging and strengthening rebalancing efforts while adjusting macroeconomic policies to respond to rising trade tensions.

Directors agreed that the announced policy measures are sufficient to stabilize growth in 2019 provided there are no further increases in tariffs, and that additional stimulus and excessive credit growth should be avoided. In this context, a few Directors reiterated the need to de-emphasize growth objectives. Directors agreed that if trade tensions escalate further, putting at risk economic and financial stability, additional stimulus, mainly fiscal, would be warranted and should be targeted. Directors underscored the importance of structural fiscal reforms that can enhance medium-term growth.

Directors welcomed the authorities' commitment to multilateralism and a rules-based trading system. In this regard, they saw scope for China to work constructively with trading partners to better address shortcomings in the international trading system. Directors agreed that tensions between China and the United States should be quickly resolved through a comprehensive agreement that avoids undermining the international system. Directors also emphasized that China has an important role to play and would benefit from further opening up of the economy and other reforms that enhance competition.

Directors stressed the importance of staying the course on deleveraging and financial de-risking. They concurred that continuing financial regulatory reforms while strengthening bank capital, developing a clear resolution regime for banks, and containing vulnerabilities from rising household debt would help deliver a more sustainable growth path. To improve credit allocation, most Directors agreed that a plan to reduce implicit guarantees for state-owned enterprises would be important.

Directors welcomed the progress on reducing external imbalances over several years and noted staff's assessment that the external position in 2018 was broadly in line with fundamentals and desirable policies. They emphasized that achieving a durable balance in the external position requires continued progress in addressing distortions that encourage excessive household savings. In this regard, to help boost consumption and reduce inequality, Directors urged continued progress on reforms to enhance the social safety net and make the tax system more progressive. Directors concurred that greater exchange rate flexibility and deeper and better functioning FX markets would help the financial system prepare for greater capital flow volatility. Greater exchange rate policy transparency would also be important. Some Directors also called for disclosure of FX interventions. Directors agreed that China should continue to upgrade its external lending framework to foster greater coordination and cooperation, and to ensure transparency and debt sustainability.

Directors underscored that a broad set of reforms are needed to boost productivity and longer-term income convergence. They stressed the need to increase the role of the market and reduce the dominance of the public sector in many industries by ensuring fair competition, accelerating opening up to the private sector, and intensifying reform of state-owned enterprises. They also highlighted the need to continue to modernize policy frameworks, including by moving to a more price-based monetary policy framework, and addressing the misalignment of center-local fiscal responsibilities. They stressed the urgent need to address China's macroeconomic data gaps to further improve data credibility and policy making.

It is expected that the next Article IV consultation with the People's Republic of China will be held on the standard 12-month cycle.

APPROVAL: May 13, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

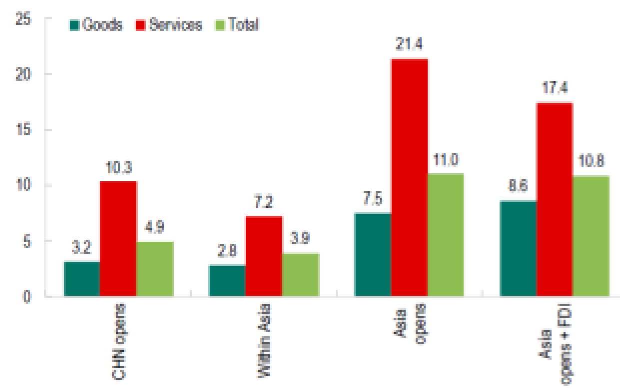
Outlook and Risks

1. It would be worthwhile to also look at the effects of a possible positive scenario in which China would address structural issues as part of a trade deal, the Chinese economy would open up significantly and the role of market forces would be increased. Can staff elaborate on what they expect will be the effects in such a scenario in terms of GDP, investment and trade volumes?

- Given the lack of detail on what a deal may entail, staff analysis has covered various potential components separately. For example:
- *Opening up*. Staff's analysis finds that if China were to unilaterally eliminate tariffs on goods imports and reduces nontariff barriers on services for all trading partners, this could increase China's real GDP level by about 3 percent and world trade (goods and services) by about 5 percent in the long term. Liberalizing FDI could increase GDP by a further 6 percent (see IMF Asia and Pacific Regional Economic Outlook, Oct 2018, and background paper no 1, "The Evolving Role of Trade in Asia: Opening a New Chapter").

Figure 23. World Trade Rises: Goods 9 Percent, Services 17 Percent

(World trade; change from baseline in percent)



Source: IMF staff estimates.
Note: Asia = Australia, China, India, Indonesia, Japan, Korea, and Taiwan Province of China.

- *SOE reform/role of market forces*. Staff analysis finds that a combination of SOE reform and resolving zombies would increase productivity and boost long-term growth by about 0.7-1.2 percentage points a year (see Lam et al, 2017, "Resolving China's Zombies: Tackling Debt and Raising Productivity," IMF working paper)

2. Has staff discussed with the authorities that range of more desirable policy options in case further escalation of trade tensions takes place? Are authorities' views well aligned with staff's on how to react in such a circumstance?

- Staff has discussed its recommended fiscal measures in the event of a further escalation of trade tensions with the authorities. While the authorities noted their continued efforts on reform to promote high quality development and decrease inequality—such as their plans to eliminate absolute poverty, support infrastructure in under-developed areas, and improve public health and education services for lower-income earners—their specific points on the appropriate policy response to a further escalation has been to:

- o note that they have adequate monetary room to deal with a worsening external environment
- o point that they have identified certain pipeline projects that could be accelerated
- o strengthen unemployment insurance, which overlap with staff's recommendations.

3. The staff report was also silent on issues of gender equality. Could staff highlight any noteworthy developments in these areas?

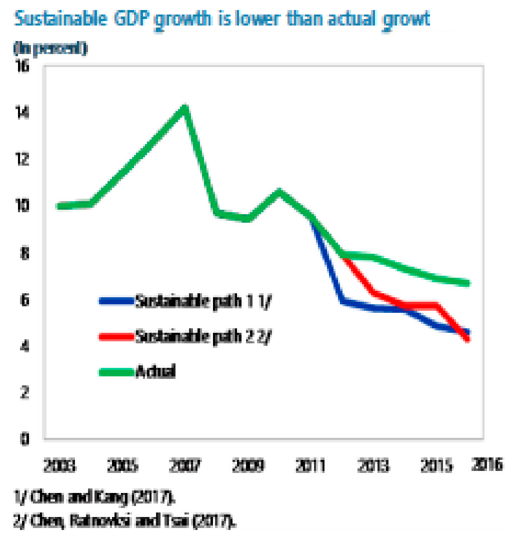
- While staff have looked an inequality issues recently (eg S. Jain-Chandra et. al, June 2018, "Inequality in China - Trends, Drivers and Policy Remedies"), staff have indeed not looked in depth at gender inequality, which could be a topic for future research.
- That said, female labor force participation does not appear to be macro-critical for China, as the female labor force participation rate is still relatively high compared to other countries in the region, and in the range of many advanced economies. While it has fallen over the past decade, from 70 percent to around 60 percent in 2018, reflecting structural change in the economy, it remains higher than the female labor force participation rate in G7 economies (estimated at 54 percent in 2018 by the ILO).

4. What does staff consider to be the desirable level and what is the scope for additional internal rebalancing towards services in the coming years?

- We do not have an optimal level of the services share of GDP in mind. However, productivity convergence in services has been slower than in industry over the last twenty years (see Box 1 of the staff report), reflecting both the non-tradeable nature of certain services and less opening up of the services sector in China. As part of this analysis of the potential for future productivity convergence, staff finds that the shift from industry to services is expected to continue, with the service share of GDP rising to 65 percent in 2030 (which is still low compared to many advanced countries which have shares of 70-80 percent).
- Opening-up of the state-dominated services sector should bring greater private sector participation and thereby contribute to greater services share in employment and value-added.

5. We notably wonder whether the natural growth rate of the economy (without the various stimulus measures undertaken over the last years) is not lower than the actual growth rate. Staff comments on the desirable level of macroeconomic stimulus and the level of the growth rate that would be entailed by a neutral macro-financial policy stance would be welcome.

- Staff agrees that the growth rate of the economy would have been lower in recent years without easing measures, in both China and in other economies. As an historical illustration, staff has analyzed "sustainable" growth—growth in the absence of excess credit—and estimated that the growth rate would have been about 5½ percent between 2012-16, absent faster reform, to have kept credit growth on a sustainable path (rather than 7¼ percent actual) (see Chen and Kang, 2018, "Credit Booms—Is China Different?", IMF working paper).



- Note that the sustainable growth rate for China depends on reform progress. Faster reform as outlined in the Staff Report could deliver sustainable growth of about 6 percent in the medium term, though staff recognize considerable uncertainty around this estimate. While in the case of slow reform, sustainable growth would need to be significantly lower to avoid a further rapid buildup of credit.
- While we do not recommend growth targets, we would expect a somewhat lower growth rate for the next few years to be sustainable, especially if credit allocation is improved. It is important for the authorities to have a policy setting that accommodates deviations from their growth target, given the large uncertainties attached to the impact of reforms and to focus on productivity-enhancing reforms over the medium term (rather than doing "whatever it takes", including through unsustainable credit and investment stimulus to achieve a given growth target).

6. In addition, we would be interested to have staff's assessment of the prospective evolution of employment, notably how employment and unemployment would react to slower growth rates.

- The box on potential growth provides a baseline scenario forecast where the authorities continue the current reform pace to improve the efficiency of credit allocation, which would be key to ensure further convergence.
- On employment, as the economy shifts from industry to services, growth has become more labor intensive, hence new job creation has been robust despite slowing growth. On the supply side, working age population is shrinking due to population aging.
- Overall, the impact of slower growth on the labor market is expected to be contained (as indeed it has been since the GFC, with employment growth remaining strong despite much slower rates of GDP growth). That said, trade tensions and potential large-scale application of AI may pose downside risks.

7. We wonder about the implication to employment growth, labor force participation rate and unemployment rate and we welcome staff comments. We would also like staff to comment on whether the slower pace of growth would generate sufficient employment and particularly high-quality jobs to preserve social and economic stability?

- Labor market condition have been holding up well in recent years, despite lower growth. The monthly survey-based urban unemployment rate has been fairly stable around 5 percent in the past few years, average wages have grown in line with nominal GDP, and newly created urban jobs exceeded 13 million in each year from 2013 onwards (start of this data series) and reached 13.6 million in 2018.
- Structural trends will support labor market resilience (see detailed staff analysis on China's labor market in Lam et al, 2015, "China's Labor Market in the "New Normal", IMF working paper). China is at a demographic turning point, part of which includes a decline in surplus rural labor, which could dampen the negative pressures on employment as economic growth slows. At the same time, an expansion of the more labor-intensive services sector is generating more jobs.
- Steady implementation of reforms will facilitate structural trends and flows of migrant labor, which in turn will help generate jobs and urban employment in the medium term. Key reforms are the opening up the services sector and reforming "hukou" (household registration) regulations to enhance labor market flexibility. At the same time, fiscal reforms on taxation, pension portability, and higher social spending will help narrow the urban–rural income gap and contribute to social stability.

8. Could staff provide further detail on the analysis underlying the statement that 'no additional stimulus is needed as the planned stimulus is sufficient to stabilize growth'?

- Staff does not recommend further fiscal expansion in the baseline scenario – where the current tariffs stay in place and there is no further escalation of trade tensions. This is because the sizeable fiscal stimulus measures in 2019 (outlined in the "Fiscal Measures in the Baseline" table on page 11 of the staff report), which amount to a 1.5 percent of GDP fiscal impulse on staff's "augmented" (broadly-defined) definition, are estimated to have a sufficient positive impact (0.8 percentage points) on growth to avoid a sharp slowdown in 2019 and 2020.

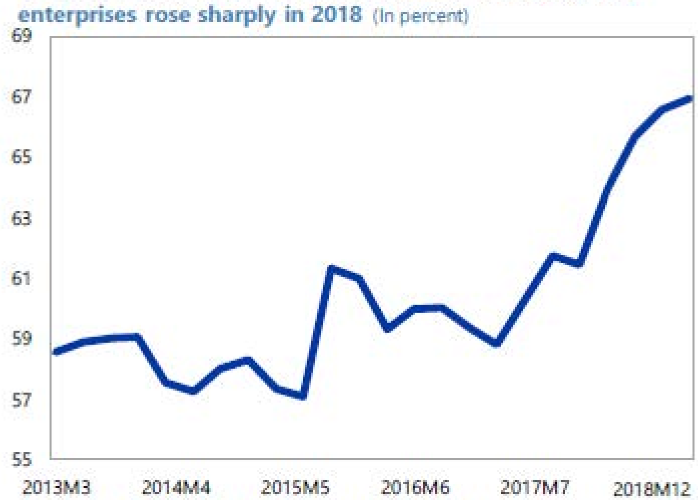
9. While the report (¶20) underlines domestic risks arising from a deterioration in asset quality of financial institutions, especially among small and mid-sized banks, and funding stress facing banks and non-bank financial institutions, we did not find any mention of these risks in the Risk Assessment Matrix (Appendix II) that is referred to in the paragraph. Staff comments would be appreciated.

- While we acknowledge that greater emphasis could have been given to the financial risks in the RAM, we highlight that there could be financial stress though multiple channels including through the downturn in the property market. We recommend several policy options in the RAM and in the staff report that would support financial stability including, (1) staying the course on rebalancing and deleveraging, (2) improving credit allocation to the private sector, and (3) using macro-prudential tools to curb excessive risk taking, and (4) strengthening bank capital buffers, especially among smaller banks.

10. Could staff elaborate in more details, why they suggest that the role of the state in the Chinese economy is increasing?

- The increasing role of state mainly reflects two aspects:
  - The increasing dominance of SOEs in the economy, e.g. SOE debt as a share of total enterprise debt also rose sharply in 2018 and the share of SOEs in industrial sales has risen from 21 percent in 2016 to 27 percent in 2018.
  - The role of the Party has been strengthened and institutionalized in both state-owned and private companies (eg the securities regulator recently required listed companies to establish Party units and strengthen Party-building activities).

SOE liabilities as a share of total liabilities of nonfinancial enterprises rose sharply in 2018 (In percent)



Source: PBOC, MoF, Wind, CNBS and IMF staff estimates.

11. Nonetheless, we note with concern that the authorities effectively ruled out staff's upside scenario (i.e. a reduction in trade tensions). Could staff provide further insights about the discussions with the authorities on this matter, as we tend to see this as a rather contradictory signal to the markets which have taken the resumption of trade talks after the G20 Summit as quite positive?

- The text of the report saying that "the authorities were less focused on an upside scenario but noted that policy implementation and increasing efficiency are key" (para 30) has been corrected, and now reads "the authorities also noted that policy implementation and increasing efficiency are key even in an upside scenario." Even in the original version, staff did not intend to suggest that the authorities had ruled out the upside scenario of a reduction in trade tensions.

- Rather, the focus of that paragraph was the macroeconomic response to alternative trade scenarios, and reflected the authorities' views that the macroeconomic effects of a trade agreement are expected to be positive. Instead of specifying which measures they would scale back, the authorities simply indicated that they would continue to improve policy implementation and economic efficiency.

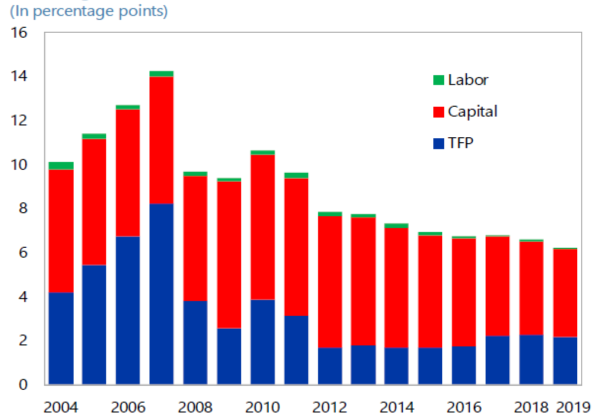
12. Could staff elaborate on the risks to the baseline from the still elevated leverage and the recent pick up in credit growth?

- The financial sector reforms implemented by the authorities in 2018-19 have strengthened the financial system, and helped curb credit growth and leverage, especially among private sector companies. Staff is of the view that the risk of a rapid growth deceleration or a financial crisis due to high levels of debt remains low in the short-term given the sizable buffers and available policy space. The recent pick-up in credit growth has also been modest.
- That said, under the baseline, debt/GDP remains very high and does not stabilize in the medium-term under current policies, pointing to the need to further strengthen the financial sector, improve allocation of credit, and contain household sector vulnerabilities, to increase productivity, reduce credit dependence, and avoid a disruptive adjustment.

13. Is the abovementioned worsening related to the increased dominance of SOEs due to mergers and acquisitions referred to in paragraph 14?

- No. The TFP growth slowdown in 2012-2015 was mainly driven by overinvestment and credit misallocation, while the M&A activities largely took place after 2016 during the overcapacity cut.
- The point staff would make is that the modest TFP pick up since 2015 could have been larger (and would be going forward) if SOE reform and zombie exit were to be intensified.

Declining contribution of TFP to real GDP Growth
(In percentage points)



Source: CEIC and IMF staff estimates.

14. We observe staff's advice of additional stimulus in case of further escalation of trade tensions: fiscal expansion of 0.8 percentage points of GDP and modest monetary policy easing. We would appreciate if staff could expand on this scenario foresight and its potential impact on the external sector and financial system.

- Escalating trade tensions under an adverse scenario could trigger depreciation pressures and potential capital outflows. This would call for clear public communication and possible FX intervention to counter disorderly market conditions. In case FX market pressures persist and lead to herding and financial system stress, tightening existing CFMs in a transparent and temporary manner may be appropriate, as part of a broader policy package to stabilize the economy and markets. The impact on the current account is unclear, though opposing forces (depreciation and less domestic demand versus lower export demand from the US) could largely offset.
- Bank profitability would likely decline under an adverse scenario. First, slower economic growth would increase NPL ratios and exacerbate credit losses. Second, funding pressures would intensify, particularly for medium and small banks with weak fundamentals. Third, securities prices (particularly those issued by the corporate sector) could decline. As a result, banks will seek to delever and credit growth will slow. The process of shadow bank downsizing and formal bank reintermediation observed over the past two years—whereby banks bring credit intermediated in the shadow system back onto their own balance sheets—could stall.
- Hence staff's advice is for some fiscal stimulus, exchange rate flexibility, and potentially some monetary easing.

15. We notice that staff considers authorities' vision more sanguine towards domestic risks and we wonder if the recent released data have altered this perspective. Staff comments are welcome.

- Compared to staff assessment, the authorities (1) are less concerned about high credit growth, debt accumulation, and the consequences of worsening credit allocation, in part due to the progress they made on deleveraging in 2018 and also because they have recently take measures to improve credit access of micro and small enterprises, and (2) view a sharp downturn in the property market as unlikely as they expect house prices to continue increasing due to still-strong growth, strong income growth, and continued rapid and large-scale urbanization.
- Recent high frequency data does not alter staff's perspective. GDP growth in Q2 slowed as expected and credit growth continued to increase, supporting staff's concerns about the path of debt and the need for stronger reforms to improve the allocation of credit.

16. We take note that the total nonfinancial sector debt is estimated to increase and reach 295 percent in 2024. Regarding this point, we would like staff to elaborate the view on the desirable time frame of deleveraging.

- We do not have a strong view on exactly when debt/GDP should start decreasing. However, it seems desirable that the ratio should eventually stop increasing, and with reforms, it seems realistic for this to occur in the medium term (e.g. 5 years). It also seems desirable to ensure that credit growth stay on a downward trend in the meantime.

Fiscal Policy

17. Could staff clarify the divergent views on the accuracy of the DSA as highlighted in the buff statement?

- Staff took the Fund debt sustainability analysis (DSA) framework for market-access countries when assessing fiscal risks for China (reflected in our DSA annex). Although the BUFF suggested that it might be worth looking into additional dimensions of fiscal risks, e.g. debt service-to-GDP ratio and debt-to-national wealth ratio, the current DSA annex of the Staff Report has been consistent with other countries following the market-access DSA framework.
- Recognizing the long-standing disagreement between staff and the authorities on the definition of the general government perimeter, and the estimated nature of the broader approach, we provided the DSA on both narrow (budgetary) and broad (augmented) definitions.
- Staff remains of the view that the augmented approach is the more appropriate definition of general government for China, and thus the DSA using this approach is the more relevant one.

18. We would like to hear what were the authorities' reactions to staff recommendations on structural fiscal reforms summarized in paragraph 69?

- We did not receive a specific response to all our detailed recommendations in this consultation. However, on the four listed in para 69, we understand the authorities do not agree with recommendations #1 on the PIT, #2 on the minimum social security contributions, and #4 for a carbon/coal tax, but do agree with #3 for a recurrent property tax.

19. We would appreciate if staff could clarify why they believe the recent increase of the taxable-income threshold reduces progressivity, which seems counterintuitive. Moreover, we note that advocating policies to boost consumption appears at odds with staff's concerns about the high household debt as a source of financial vulnerabilities. Staff's comments would we welcome.

- While the PIT schedule itself is progressive, the recent increased taxable personal income threshold reduces the overall progressivity of the PIT as those on higher incomes benefit more with a higher threshold, and the overall progressivity of the tax system is reduced as the amount of revenue from PIT (a progressive tax) is reduced.

Also, while some new PIT deductions may benefit those on lower incomes, other deductions have negative impacts (for example, the mortgage interest deduction is likely regressive and encourages debt finance and, along with the deduction for rental expenses, distort consumption choices toward housing).

- The policies staff recommends are focused on lowering the comparatively high household savings in China, largely through greater public funding of the social safety net. For example, increasing government spending on healthcare and education and improving access to social services would allow households to re-orient their spending on these items to other types of consumption without increasing household debt.

20. We see merit in enhancing fiscal governance and transparency and appreciate staff indication if the authorities are willing to produce a fiscal risk statement, given risks associated with quasi-fiscal operations of SOEs and extrabudgetary funds.

- While agreeing on the need to continue strengthen local government budget constraints, the authorities continued to disagree with staff's definition of the general government perimeter (augmented concept) which includes the off-budgetary items of the general government. The authorities argued that under the 2014 Budget Law, local governments did not bear any responsibility for the financial obligations of Local Government Financing Vehicles, government-guided funds, or special construction funds. Hence, staff would not expect the authorities to be willing to produce a fiscal risk statement. That said, the authorities have in the past published reports, for example by the National Audit Office, on quasi-fiscal debt.

21. Here, we would welcome staff elaboration of the authorities' plans for the central government to take over these spending responsibilities and the likely timeframe for such a move.

- The authorities have made continuous efforts to implement the new intergovernmental framework. In recent years, the State Council announced reforms to further adjust central-local government responsibilities, improve inter-governmental transfers, and reduce the regional disparity of pensions. These reforms gave central government more expenditure responsibilities, especially in education, healthcare, and social security, and are intended to be completed by 2020. The reforms should also facilitate budgetary and accounting reforms and enhance the supervision of local government performance.

22. Staff comments on the reliability of public asset valuations and potential evolutions in case of negative shocks are welcome.

- China's net financial worth has declined over the last decade—from 23 percent of GDP in 2009 to 11 percent of GDP in 2017 (still above the average for emerging market economies)—as the rise in general government debt outstripped the increase in the general government's financial assets.
- Nonfinancial infrastructure assets have also risen, but valuation of these assets is difficult, notably given limited information on investment returns. As discussed in the Spring Fiscal Monitor, the gap between government asset returns—along with those on nonfinancial infrastructure assets—and the interest rate on debt widened, with an estimated shortfall of 1.5-2 percentage points during 2013–15, partly driven by low profitability among SOEs.
- Should the economy be hit by a substantial negative shock, asset valuation, both financial and non-financial, would likely fall, though staff have not modelled this process.

23. Can staff comment on why the fiscal measures under an adverse scenario (in the table on page 18) – many of which align with structural reform priorities that can improve growth over the medium term – were not part of staff's baseline recommendations (presumably paired with additional offsetting measures to contain the augmented deficit)?

- The recommended fiscal measures in the adverse scenario do overlap with the general direction of fiscal advice under the baseline. The measures in the adverse are more specific/quantified than in the baseline as they are to respond to a specific shock and are designed to give immediate, actionable, measures for the authorities. For example, the baseline advice is to increase spending on social welfare (para 46) and in the adverse scenario, the specific recommendation is for a package that increase such spending by 0.5-0.6 percent of GDP.

24. Do staff see substantial fiscal space for increasing social safety net beyond the current level?

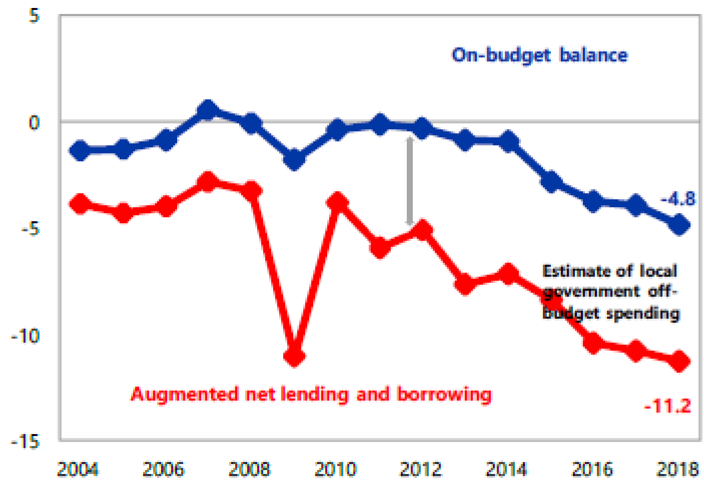
- Yes. China still has in general some further fiscal space (high savings, low borrowing costs, high growth, strong public assets and positive net financial worth), there are growth-friendly/progressive revenue sources that should be more fully exploited, and the longer-term challenge of social security sustainability requires changes to parameters (eg retirement age).

25. Could staff elaborate further on the main differences of views on this issue as well as on the size of off-budgetary items?

- Staff introduced the concept of "augmented" balance/debt in the 2013 Staff Report and have used it since. It adds to official government data staff estimates of off-budget infrastructure spending, mainly financed by local government financing vehicles (LGFVs), resulting in substantially larger deficits/debt. The government audited LGFV borrowing in 2014, recognized about two-thirds of it, reiterated that any new off-budget borrowing was illegal and would not be considered as government debt, and allowed local governments to issue bonds. Since 2016, the central government has issued a wide range of regulations and taken action against some "non-compliant" borrowing.

- Staff has argued that the "augmented" approach remains valid based on the economic behavior of local governments and their LGFVs. In particular, their activities— given the impact on the economy (fiscal impulse, public debt)—should be treated as part of general government, consistent with the Government Finance Statistics manual (GFSM) 2014 (see Rui and Stokoe WP 17/272 "Reassessing the Perimeter of Government Accounts in China"). While recognizing reform progress, staff argued that the "augmented" concept remains warranted—albeit with a larger uncertainty on "augmented" debt becoming an explicit government liability.
- The authorities, however, see it largely as a legal issue—legally, LGFVs are not part of government, hence their debt is not government debt unless the government recognizes or guarantees it, both of which are outlawed.
- In terms of size of off-budget items, the augmented balance was 6.4 percent of GDP larger than the on-budget balance (see Table 5 and figure 4).

Government balance under different definitions
(In percent of GDP)



Source: CEIC and IMF staff estimates.

26. What are the prospects for introducing a nationwide recurrent property tax to provide an important source of revenue to these governments?

- We understand preparations for a nationwide recurrent property tax are underway but there is no timetable.

27. We take note that some fiscal measures were not consistent with staff's advice, namely the new personal income tax-threshold, tax support for MSEs and infrastructure bonds. Could staff expand on its view of the potential impacts of these measures?

- The policy response has been tax cuts on the revenue side, and infrastructure investment financed by special purpose bonds on the expenditure side. The augmented deficit is expected to widen by about 1.5 percent of GDP in 2019, fairly evenly distributed between revenue and expenditure measures.

- VAT refund on exports was increased, an improvement that will reduce production costs. The personal income tax (PIT) reform should support consumption, though it may be offset by greater collection efficiency from the tax administration reform. VAT cuts on SMEs and manufacturing sectors and social security cuts may support the growth in some industries. VAT cuts are also expected to have some price-pass through on the related industries. The overall revenue side measure amounts to 0.8 percent of GDP, and lead to about 0.45 percent of GDP growth impact.
- The expenditure through special purpose bonds is about an additional 0.7 percent of GDP, for an estimated 0.35 percent of GDP growth impact in 2019.

28. We would like to hear staff's views on the appropriate design and level of the personal income tax more in detail.

- In staff's view, the PIT is one of the few progressive taxes and its revenue (which is low by international standards as in practice very few taxpayers pay any PIT) should be increased by reducing the threshold and broadening the base. Lowering the current high basic personal allowance, transforming it into a tax credit, and redesigning tax brackets would ensure that middle and high income households with more ability to pay contribute more to financing the national budget and the provision of public goods. We also recommend a targeted tax credit for children, and do not recommend the mortgage interest deduction and rental expense deduction. Provinces could usefully be allowed to impose a surcharge within a range.

29. Although we recognized these reforms were aimed at reducing the burden of businesses including small and medium-sized enterprises (SMEs), could staff evaluate the real effect of those reforms and who were benefited so far?

- We have not examined this issue in detail, in part due to lack of data.
- In general, VAT cuts on SMEs and manufacturing sectors and social security cuts would support the growth in the related industries. In theory, the extent and timing of VAT cut impacts and price pass-through are not clear. The degree of pass-through may be less than complete (for example, due to substitution or general equilibrium effects such as the impact on consumers' spending power), or more than complete (for example, with imperfect competition). Likewise on timing, consumers may delay/increase spending ahead of announced VAT cuts/increases, but menu costs may mean a sluggish response. Pass-through is also likely to depend on the goods being taxed, consumption preferences and income elasticities, with broad-based VAT changes more likely to be passed on than narrow-based changes. International experience suggests a close to full price pass-through.

30. ***We would appreciate it if staff could explain more concrete views on the plan for the new tax. In addition, although staff introduced that China launched a nationwide carbon emissions trading system in 2017 last year's report, could staff elaborate the outcome of the system?***

- Staff's advice to introduce a carbon or coal tax is explained in the 2016 staff report and Working Paper (WP 16/148 "Climate Mitigation in China: What Policies are Most Effective" by Parry, Shang, Wingender, Vernon, and Narasimhan), including why a carbon/coal tax would be preferential to a trading system.
- We are unable to provide an update on the authorities' trading system at this time.

31. ***In this regard, we would appreciate staff elaborating on the medium-term growth impact of the fiscal stimulus detailed on page 11 of the main report.***

- We expect a growth impact of about 0.8 percent of GDP in 2019. The fiscal measures (in table, page 11) would have different impacts, and we note the consistency with the MT goals. Longer-term impacts are very hard to estimate, but those that are consistent with staff's medium-term recommendations would be likely to support potential growth.

Monetary and Exchange Rate policy

32. ***Does the newly created People's Bank of China Macroprudential Policy Bureau have full macro prudential authority or does this authority remain dispersed?***

- No. The ultimate decision-making authority rests with the Financial Stability and Development Committee (FSDC) with inputs from various agencies. The newly created Macroprudential Policy Bureau at the PBC takes the lead in establishing the macroprudential policy framework and basic principles. It can also submit specific policy "recommendations" based on its own analysis (e.g. activation of the counter-cyclical capital buffer) to the FSDC, which considers inputs from other agencies to make decisions (e.g. the PBC's Financial Markets Department and CBIRC provide inputs on LTV limits to FSDC).

33. ***We note in this regard the authorities' assessment that China's disclosure of foreign exchange intervention data meets international standards since joining the Fund' Special Data Dissemination Standards. Staff comments are welcome.***

- Publication of exchange rate intervention data is currently not a requirement under the Fund's Special Data Dissemination Standards (SDDS). However, staff have encouraged countries to publish this data in order to improve transparency and enhance communication.

34. In this vein, could staff provide its view on whether the recent measures to restore reserve requirements for FX forward contracts may affect the process of ensuring that the yuan becomes a fully-convertible currency?

- A 20 percent reserve requirement on FX forwards, which staff classify as a CFM, was reintroduced in 2018. While the authorities consider the measures necessary to counter speculation and ensure the stability of the capital account, they generate costs and hinder efficiency of individual corporate treasury management. Staff recommend that this requirement be phased out and CFMs not be used to actively manage the capital flow cycle and substitute for warranted macroeconomic adjustment and exchange rate flexibility. Phasing out such measures would also help the Yuan become a fully-convertible currency, though that remains far off and not necessarily the authorities' objective.

Financial Sector

35. We note the authorities' decision to shift from deleveraging back to supporting growth, while household and corporate indebtedness remains elevated. Could staff elaborate on the likely effects of this policy stance on financial sector stability?

- Staff sees financial sector vulnerabilities and risks as remaining elevated. However, we don't envisage an increase in systemic risks under the baseline scenario, in the absence of regulatory backtracking.
- Continued implementation of announced regulatory reforms such as the new asset management rules—which are being gradually phased-in over a transitional period—along with recommended actions to boost capital in smaller banks, strict application of microprudential regulations, and close supervision, should keep risks in check and prevent excessive credit growth to households and corporates.
- More broadly, expansionary fiscal policies based on local government borrowing could delay the deleveraging process (a short-term temporary effect) but financial sector de-risking will continue if staff recommendations are implemented and the macroeconomic environment remains (somewhat) supportive.

36. As regards the rise of digital money and its impact on financial stability, we wonder how the widespread use of payment services such as Alibaba's "Alipay" or Tencent's "WeChat Pay" impacts bank profitability and financial stability. To what extent has staff looked into the potential risks as well as chances of the increasing role of online payment providers?

- The impact of digital payment on bank profitability has been relatively limited, but pose financial stability risks. Online payment service providers operate in the shadow banking system; they pool cash from banks, invest in interbank CDs or micro loans, resulting in credit and maturity transformation. Actual fund flows are difficult to monitor as these payment providers operate outside of the purview of regulatory supervision.

- Significant policy efforts have been made to address such loopholes, e.g. the money market fund Yuebao is now captured in the PBC's money supply statistics; non-bank payments companies such as Alipay and WeChat Pay have been required to place 100 percent of their customer deposit funds under centralized, interest-free accounts in PBC since January 2019; money flow in the third-party payment system will now also be captured by Wanglian, the newly established central clearing system. Still, the current system does not offer a clear framework for jurisdictions over data ownership, or data sharing between different market participants and regulators.
- Some of these issues are examined in a recent staff working paper ("China's Digital Economy: Opportunities and Risks, WP 19/16, Longmei Zhang and Sally Chen).

37. In this regard, we take note of public takeover of Baoshang and would welcome staff's views on whether the takeover process struck the right balance between containing risks to the financial system and limiting moral hazard.

- Without full details it is hard to make a full assessment.
- The fact that authorities were willing to impose some losses on the creditors of the bank with claims above 50 million RMB (about 7 million USD) is a positive step that has helped mitigate the perception of implicit guarantees and moral hazard. The tightening of funding conditions among relatively weak and small banks after the takeover of Baoshang proves that market discipline has been enhanced by the modality of intervention. On the other hand, the spread of risk and contagion has remained under control.
- One could perhaps argue that more depositors should have suffered losses, particularly given that deposit insurance is supposed to cover deposits up to 500,000 RMB (about 70,000 USD)—so many "unprotected" creditors ended up recovering their investment in full. It is quite plausible, however, that contagion and knock on effects under more restrictive creditor protections would have triggered more significant contagion. This policy risk may well not have been worth taking at the current juncture, given that vulnerabilities and risks as well as opacity and complexity in the system remain elevated, and capital buffers in many banks need still to be strengthened.

38. We would welcome staff elaboration on the reported partial takeover of Bank of Jinzhou by state-owned entities on July 28.

- As we lack information on the bank, we can only use what is publicly reported and our assessment is thus constricted.

- Jinzhou received PBC-arranged support (in the form of warrants) for its short-term NCDs a couple of months ago, suggesting that it was already facing extreme pressure in funding its balance sheet, and "strategic" investments – i.e. below book value – from some state-affiliated institutions. More broadly, since the government's takeover of Baoshang in late May, interbank funding stress continued for the smaller/weaker banks; these banks may well face ongoing pressure raising deposit funding while paying more for other sources of funds.
- In sharp contrast to the case of Baoshang, Jinzhou creditors do not seem likely to bear any losses, raising issues of consistency and underlining the absence of a single and formal framework for the intervention and workout of medium/small banks. Historically, a case-by-case (ad hoc) approach has been followed to deal with failing banks. As we recommend in the report, developing a clear and transparent framework for intervention/resolution will ensure consistent treatment of creditors across all cases of bank failures. Such a framework will help remove the perception of implicit guarantees and boost depositor/market discipline in the system, improving resource allocation.

39. We would also appreciate staff's comments on the adequacy of the administrative restrictions and macroprudential tools at the disposal of city governments to stabilize house prices.

- City governments have full control over administrative restrictions on house purchases and sales. However, city governments need the approval from provincial PBC offices in order to change city-level macroprudential measures such as LTV limits.
- Staff recommends that the government should gradually reduce the reliance on administrative restrictions. This is because these restrictions can have an excessively abrupt impact, resulting in more distortions and circumvention compared to macroprudential measures (see Ding, et al. 2017).
- However, it may be difficult for city governments to use purely macroprudential policies to stabilize local house prices at this stage, because (1) they do not have full control over macroprudential policies, (2) they may not have risk assessment capacity, and (3) the risks remain of significant spillovers from macroprudential policies in neighbor and peer cities. Hence, staff recommends standardizing property market policies that are decentralized and implemented at the city level (see China FSAP, 2017). Also, staff recommends using the limit on debt-service-to-income ratio as a macroprudential measure and more actively, with a reduced limit more in line with international norm of 30-50 percent.

40. Could staff elaborate further on how shadow banking has evolved in recent years and on the authorities' strategy to further downsize it?

- In response to rising risks and vulnerabilities in the Chinese financial system, the authorities launched a sequence of comprehensive regulatory reforms starting in the summer of 2016 (see Table below). The regulatory reforms are closely aligned with FSAP recommendations and are helping to downsize the shadow banking sector and unwind the complex web of interconnections that characterizes the system. In particular, they are aimed at closing regulatory loopholes that facilitated arbitrage and the growth of shadow banking activities. Due to long phase-in periods in some cases, the implementation of the reforms is still ongoing.

Reform	Time	Main Measures
1	January 2017	**MPA framework implemented**
2	March-April 2017	**Measures to limit the growth of WMPs**
3	July 2017	**Creation of FSDC**
4	August 2017	**Measures to reduce bank reliance on NCDs**
5	September-October 2017	**Creation of new local AMCs**
6	November 2017	**Draft guidance on asset management operations of financial institutions**
7	December 2017	**Draft guidelines on managing liquidity risk at commercial banks**
8	January 2018	**Measures to strengthen risk management on entrusted loans**
9	January 2018	**Measures to broaden and tighten regulation of large exposures**
10	February 2018	**Announcement that Chinese G-SIBs are set to start implementing TLAC (total loss-absorbing capacity)**
11	March 2018	**Licensing of first non-state-owned consumer credit bureau**
12	March 2018	**New evaluation framework for insurance companies**
13	March 2018	**Revision to loan loss provision framework to encourage NPL recognition**
14	March 2018	**Institutional reorganization**

- The new asset management rules were particularly important to reduce the size of wealth management products (WMPs) (most of them issued by sponsoring banks through the use of special purpose vehicles). The “channel business” consisted in providing credit funded by issuance of wealth management products through a multi-layer system that comprised “trusts” and other NBFIs. As noted in the FSAP, this was a notoriously opaque and fragile part of the system—as credit provision was relatively risky (non-standard assets) and disruptions or liquidity problems in wealth management business could generate contingent losses for the sponsoring banks. The regulatory reforms were effective in downsizing this part of the system—particularly as a share of total intermediation (the amount of bank sponsored WMPs was about 30 trillion RMB as of 2017, and it is now appx. 22 trillion RMB; as the overall financial system grows at above 10 percent per year, the downsizing in relative terms has been significant).

- In addition, due to the asset management rules, other shadow banking activities have declined sharply (entrusted loans, overall intermediation by trust companies, etc.) and complexity has been reduced (e.g. a reduced number of non-bank intermediation layers mitigates opacity and cumulative leverage).

41. We would welcome further elaboration from staff on the outline of current systems and problems of them. In addition, we would like to hear staff's view on the possibility of a management risk of small banks and a systemic risk caused by the impact on money market.

- Balance sheet challenges of Baoshang bank were seen in many other small and regional banks as they have been particularly reliant on wholesale funding and held a large share of assets in opaque shadow products. These products also tend to use repo funding for NCD purchases, introducing a circularity in banks, non-bank financial institutions (NBFIs) and investment products to which the financial system is vulnerable.
- The interbank funding chain became clogged after the government's takeover of Baoshang bank. As investors began to question the creditworthiness of smaller banks and NBFIs, the recent liquidity squeeze could increase pressure for them to raise funding in the interbank markets despite generous liquidity support and administrative guidance from the authorities. At the same time, given relatively-weak capital and profitability, these banks face a trade-off between improving resilience and maintaining credit growth.
- The recommended course of action on small and medium banks includes the following: (1) require timely publication of audited financial reports (informational asymmetry tends to cause overreactions in markets); (2) boost capitalization through higher retention of earnings and external capital injections—transparency would also help promote access to external equity sources; (3) reduce dependence of small banks on wholesale funding sources—liquidity regulations and even application of stress tests should encourage banks to tap more stable funding sources; (4) facilitate consolidation in the system by allowing mergers and acquisitions of weak banks (if market-driven and efficient).

Structural Reforms

42. Could staff comment on the adequacy of the recent changes to the negative list and their potential impact on the Chinese economy?

- In the latest revision, China has revised down the negative list from 48 to 40 items for non-FTZs and from 45 to 37 items for FTZs. Notably, access to service sectors has been eased, in particular in transport, infrastructure, culture, and value-added telecommunications. These opening up measures, once fully implemented, could have a significant impact on service productivity in China, where convergence is lagging compared to the industrial sector.
- That said, as per last year's staff report, "while China has made progress in improving its trade and foreign investment regime, and this progress accelerated recently, it still appears relatively less open than other G20 EM countries on service sector trade and investment."

43. Could Staff comment on the effectiveness of the authorities' preferred strategy to reduce SOE leverage by setting alert thresholds to trigger stricter supervision of their liabilities to asset ratios?

- The authorities have proactively implemented several policies to curb SOE leverage. For example, they have put in place a target of reducing central SOEs' liability-to-asset ratio by 2 percentage points during 2018-20. The authorities have had success in reducing leverage as the liability-to-asset ratio has steadily declined since 2016.
- While welcoming this development, we also encourage reducing the liability-to-asset ratio by reducing liabilities rather than increasing assets (which could crowd out the private sector and may not be as productive). Furthermore, we also encourage the authorities to reduce leverage by reducing the debt-to-GDP ratio.

44. Does staff have an estimate of how substantial the effects of furthering domestic intraregional trade in China would be?

- Indeed, differences between rural and urban areas have been found to be a key driver of rising income inequality in China (from the late 1990s to about 2008) and the most important determinant of the level of inequality.
- Staff analysis also finds that rural-urban gap explains a large share of inequality and its trends, but that the contribution of regional disparities has been declining. Spatial drivers of inequality comprise two main dimensions – rural-urban and provincial differences (see Jain-Chandra et al, 2018, "Inequality in China – Trends, Drivers and Policy Remedies", IMF working paper):

- o The share of total inequality explained by provincial differences has come down from 35 percent in 1995 to 11 percent in 2013.
- o The share of total income inequality accounted for by the rural-urban gap has come down from 44 percent in 1995 to 34 percent in 2013.
- Other literature suggests that the decline in the urban-rural income gap since around 2008 is due to both rapid urbanization and government policies.
- Staff has not recently analyzed the potential gains from increased intraregional trade in China. However, forthcoming analysis by staff, which studies the impact of trade on growth in China and using both city and household-level data, finds that income increased more in cities with higher exposure to (foreign) trade (see Bin Grace Li et al, 2018, "Trade, Growth and Inequality: Evidence from China").

45. Could staff comment on these developments in the context of addressing excess capacity, entity profitability and promoting private sector involvement in the economy?

- The overcapacity cut has been accompanied with significant consolidation in the steel and coal industry, with increasing concentration of market power. Many small and weaker firms exited, which tend to be private firms. In the deleveraging campaign, shadow banking has contracted sharply, which was an important venue for private firms to borrow. For bank lending, private firms were also more affected as banks often prefer lending to SOEs reflecting perceived implicit guarantees. In response to the tightening of financial conditions for private firms, the government has announced a series of measures to promote lending, including setting hard targets for banks' lending growth and targeted RR cut. The recent opening up measures in the service sector also aim to increase the role of private sector in the economy.

46. We consider that it may be more effective to focus on policies to enhance access to credit by private owned enterprise (POEs) and SMEs as well as to strengthen the credit culture to improve lending decisions. Staff comments are welcome.

- Improving the allocation of credit away from the SOEs to the more productive and efficient POEs will require a multi-pronged approach. First, policies to enhance access to credit by POEs and SMEs will undoubtably play a strong role in improving credit allocation. For example, by reducing POEs' barrier to entry will increase their demand for credit, thereby allowing credit to flow freely to the most profitable firms.
- Similarly, a general improvement in the credit culture either through improving credit ratings, strengthening credit registries, or promoting risk-based lending will also encourage better allocation of credit. In addition, the perception that SOEs are less credit-risky solely due to implicit guarantees has to be rectified, otherwise POEs/SMEs will not be able to fairly compete for limited funding resources.

- And given the need to reduce credit growth generally, increasing POE credit growth needs to be accompanied by lower SOE credit growth.

47. On the authorities' view that credit allocation to SMEs could be improved by finding alternatives to collateral, including through using fintech to determine their creditworthiness, we would welcome staff comments on the way forward in using fintech, which would be of interest to many countries.

- Fintech played, and will likely continue to play, an important role in expanding financial inclusion in China. Digital platforms – including P2P lenders – get their funding primarily from retail investors and act as information intermediaries where they gather information, evaluate credit, facilitate information exchange and match borrowers and lenders. Micro lending from internet banks has also flourished, including financing for online store operators such as loans from Ant Financial to Taobao store owners, and small loans to households, particularly agricultural households facing financing constraints. These lenders – P2P and internet banks – focus mainly on small loans and are able to leverage big data gathered from e-commerce platforms for operations and credit risk assessment to reduce costs and expand lending to untapped customers. In this regard, the high degree of adaptation of digital platforms among consumers in China offer these lenders a unique advantage as they assess borrower credit and tailor lending decisions accordingly.

48. Do staff see this as evidence of significant credit misallocation within the financial system? If so, what are the macro-economic consequences? What further actions do staff advise the authorities take to decisively dispel the perception of guarantees for SOEs?

- Despite SOEs' lower profitability and weaker balance sheets, the majority of banks loans reportedly still flow to SOEs. The macroeconomic consequence of credit misallocation is (1) the growth potential of the economy may not be realized as credit is not channeled to its most productive use; (2) credit growth could be excessive resulting in a sharp growth slowdown or financial crisis, or both (3) the state can incur a loss as an owner if the SOEs do not make a commercial rate of return; and (4) there could be fiscal costs associated with allowing zombie firms to operate.
- There are several measures through which authorities can decisively dispel the perception of implicit guarantees for SOEs, which include: (1) greater tolerance of default events, as only market-based defaults could lead investors properly price credit risks and the government be able to establish a reputation for allowing market force to work; (2) rationalizing subsidies by not providing subsidies to loss-making firms only because of their continued support of government policies; and (3) implementing the principles of competitive neutrality that will ensure that the SOEs do not receive special advantages over the POEs.

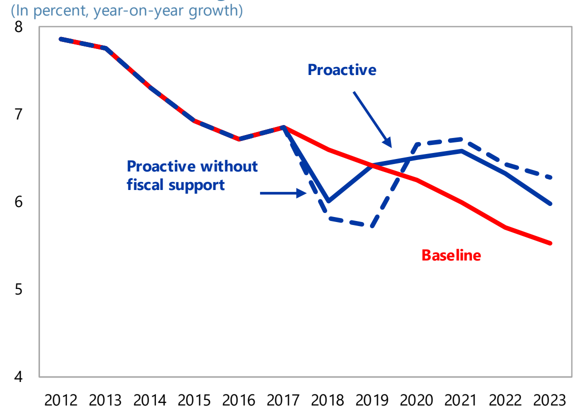
49. Could staff share their view on the main reasons for slow progress in dealing with SOE inefficiency at the local level in China?

- Local governments often depend on local SOEs to generate tax revenue and employment, in particular for less developed regions where alternative employment opportunity is limited. So, exit of local SOEs can be challenging, which hinders progress in dealing with SOE inefficiency.
- Reforms of the local SOEs cannot occur before putting in place the building blocks to address these issues. For example, reforming the local SOEs may require resettling labor which may only be possible by introducing changes to the hukou system to ensure greater labor mobility. Another option would be to reduce the local government's reliance on local SOEs for economic and social spending. This could be accomplished through encouraging greater private sector participation. Local governments may also need to receive greater funding to cover the short-term costs.

50. In this context, while we recognize that timeline was roughly showed in the Box 3 of the report, could the staff elaborate desirable modality for future reforms?

- Staff would agree that certain structural reforms can have negative impacts in the short term, and Box 3 focuses on how to conduct and sequence reforms in a manner that would improve their effectiveness and minimize such negative impacts. For example, studies have shown that reforms to increase labor market flexibility could be most usefully done along with and/or after product market reforms as the increased competition and firm entry that results from product market reforms lead to job creation that offsets layoffs that can accompany increased labor market flexibility (e.g. Blanchard and Giavazzi, 2001, "Macroeconomic Effects of Regulation and Deregulation in Goods and Labor Markets" for Europe; Anand and Khera, 2016, "Macroeconomic Impact of Product and Labor Market Reforms on Informality and Unemployment in India," IMF Working Paper for India, etc.).
- Moreover, in previous Article IV consultation staff reports, staff has illustrated a "pro-active" reform scenario where faster reform progress, particularly SOE reform and resolving zombie firms, leads to growth slowing in the near term due to labor displacement, but rebounding in the medium term on the back of faster TFP growth. Staff noted that a temporary fiscal stimulus package

Faster reform progress could pave the way for higher and more sustainable GDP growth
(In percent, year-on-year growth)



Sources: CEIC and IMF staff estimates and projections.

with resources to support rebalancing could help cushion the near-term adverse impact.

51. On this point, we would like to hear how staff evaluate the role of SMEs in present Chinese economy and the impact of the curtailment on them.

- SMEs contribute to 80 percent employment, 60 percent of value added, and 50 percent of tax revenues. The tightening of financing conditions for SMEs has had a significant impact on employment, as we have seen the labor market softened with survey unemployment rate rising from 4.8 percent last year to 5.1 percent.

52. In addition, we would like to invite staff's comments on how to secure a stable means of financing for SMEs.

- The key to promote lending to SMEs is to remove the implicit guarantee of SOEs by allowing orderly default of SOEs, and further liberalize interest rate to allow banks to charge a lending rate commensurate with the risk profile of SMEs. Fintech and the use of big data in credit analysis could also help lending to SMEs by alleviating the collateral constraint.
- Another option to alleviate collateral constraint is by improving credit reporting mechanisms such as credit bureaus (CB) and public credit registries - for example, a specialized CB could be introduced to run credit ratings for small enterprises. The specialized CBs can leverage different sources of credit information (e.g., credit card sales slips, telephone/electricity bills, online shopping, various commercial transactions, information from fintech lenders) for SMEs without collateral or guarantees.

- Greater use of movable collateral (such as machinery and accounts receivables) can also help to access credit.

External Sector and Trade

53. Could staff comment on the relocating or downsizing trends in response to declining demand, which could also fuel worries about layoffs, affecting employment and the potential increased entering of foreign investments that could offset such implications?

- The impact of trade tensions on corporate investment and relocation of global supply chains is unclear in the data available thus far. While survey evidence does point to such concerns, there are anecdotal/individual examples, and investment has been weak, yet FDI in the first half of 2019 has been robust and it is hard to disentangle from existing trends (eg of lower-value added firms relocating as Chinese labor costs rise).

54. We did appreciate the bar graph of government support of the aluminum sector, and would welcome further details on the methodology behind this calculation as well as the precise values.

- The chart is based on data from the 2019 OECD report: "Measuring distortions in international markets: the aluminum value chain", OECD Trade Policy Papers, No. 218, OECD Publishing, Paris. http://dx.doi.org/10.1787/c82911ab-en. In brief, the authors study trade distortions and government support in the aluminum industry, examining a range of measures including: export bans, export taxes, and incomplete VAT rebates on exports; import tariffs; energy subsidies; budgetary support and tax concessions; as well as loans provided on preferential terms and below-market returns on equity. The report collects data on individual firms along the aluminum value chain, selected for their economic significance in the sector and to ensure geographical balance.
- The chart aggregated the firm-level data up to the country level. These numbers can be found in "Table A A.2. Total government support over the period 2013-17, by firm and country" (page 120) of the report.

55. In this regard, we welcome the staff's views on whether the capital outflow risk in China is still high or not.

- Capital outflow pressures have remained subdued, despite pressures on the US-RMB bilateral exchange rate during the second half of 2018 and escalation in trade tensions in the first half of 2019. The inclusion of China in international bond indices have generated additional demand for Chinese assets and are expected to result in relatively stable capital inflows. There are currently no substantial net outflow pressures, although such pressures may resurface, particularly if the RMB comes under sustained depreciation pressures, as the private sector seeks to diversify and accumulate foreign assets faster than non-residents accumulate Chinese assets.

Belt and Road Initiative

56. In this context, we would also be interested in staff's view on a recent study which suggests that about 50 percent of China's lending is "hidden" and not captured by the IMF or World Bank. Staff comments would be welcome.

- The recently published paper on S. Horn, C. Reinhart, and C. Trebesch on "China's Overseas Lending" claims that Chinese overseas lending is much higher than what can be inferred from official data.

- While any research that helps shed light on debt vulnerabilities is welcome, staff have some concerns about the reliability of the new database and its possible misinterpretation as identifying "missing debts." For instance, the database records loans on commitment rather than disbursement basis, thus potentially inflating the loan stock, and comparisons with World Bank and BIS data may be misleading due to different loan coverage and the fact that China often routes its lending through financial centers, especially Hong Kong SAR.
- Staff is actively engaging with the authors in order to better understand the data. Staff is also well aware of the debt transparency problems: since identifying them in the March 2018 LIDC report, staff has been implementing a multi-pronged work program, jointly with the World Bank, to address the issue.

57. Could staff comment on how this DSA framework and the signal it sends will be used to guide lending decisions by Chinese lenders, elaborating on governance and accountability mechanisms?

- The Ministry of Finance recognizes that debt sustainability is critical to the success of the BRI, and is in the process of developing the debt sustainability framework (announced by President Xi in his speech to the Belt and Road Forum in April), with technical advice from the IMF and the World Bank. Currently the authorities are focused on capacity building within the Ministry of Finance and other agencies, and on data gathering. Initially, the DSF will likely be deployed on a voluntary basis. The Fund continues to cooperate closely with the authorities on this issue.

58. Can staff provide further elaboration on the new framework and its implications to the BRI investment plan as well as the recipient countries?

- See above

59. Regarding staff's view in the report that the IMF values the BRI-DSF as a positive step, we would like to know to what extent staff have been informed from the authorities about the details of the framework as the basis of this judgment.

- The Chinese authorities have consulted staff during the process of preparing their own Debt Sustainability Framework. In the Spring, staff held a two-week workshop in China with participants from key ministries, where the officials learned how to use the LIC-DSF including under a large scale-up investment program and adverse macro scenarios. Staff also presented the Fund's policies on debt limits, lending frameworks, resolving unsustainable debt and debt restructurings, lending into arrears, and financing assurances. Staff stands ready to continue these discussions.