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Quarterly Update

April 2011

The World Bank quarterly update provides an update on recent economic and social developments and policies in China, and present findings from ongoing World Bank work on China. The update is produced by a team from the Beijing Office with support from the China country team. Questions and feedback can be addressed to Li Li (lli2@worldbank.org).

OVERVIEW

China's economic growth has remained resilient as the macro stance moved towards normalization. Both fiscal and monetary policy contributed to the normalization. Consumption growth slowed in early 2011. But overall domestic demand held up well, supported by still strong investment growth. Real estate investment has so far remained robust to measures to contain housing prices—a policy focus. Reducing inflation is the other policy priority, after inflation rose to 5.4%, largely on higher food prices.

The economic outlook remains broadly favorable. The global growth outlook has so far been little affected by the higher raw commodity prices and the earthquake in Japan. Domestically, headwind from a normalized macroeconomic stance, inflation, and somewhat slower global growth is likely to be partly offset by solid corporate investment and a still robust labor market. An expected slowdown in mainstream housing construction should in part be compensated by the government's ambitious social housing construction plans. With a broadly neutral contribution of net trade, we now project China's real GDP growth at 9.3 percent in 2011 and 8.7 % in 2012. The surge in raw commodity prices means we expect another decline in the current account surplus this year. However, whether the trend towards a lower external surplus and lower dependence on external trade will be sustained remains to be seen.

A fully normalized macro policy stance is key to address the macro risks with respect to inflation and the housing market. With food price increases slowing, sequentially, and core inflation still in check, inflation should moderate eventually. However, much of the impact of the higher oil and industrial commodity prices is still in the pipeline, inflation expectations are high and there is little spare capacity in the economy, overall. To address the risks on inflation and the property market, macro policy is typically better placed than moral suasion and administrative measures. It is too early to stop the macro tightening. Two way risks are better dealt with by maintaining fiscal and monetary flexibility.

While the macro and financial risks on the property market require macroeconomic measures and reforms, social concerns require a different policy response. Macro and financial policy is supposed to prevent different types of risks from building up and make the economy and the financial system robust to a possible property downturn, rather than mainly focus on containing overall housing prices. If housing prices are considered systematically too high from a market perspective, macroeconomic levers are more obvious than administrative measures, especially locally administered ones. On the other hand, making housing more affordable for targeted groups requires sustainable rules-based arrangements, almost unavoidably explicitly subsidized by the government. The scaling up of social housing is in the right direction. However, finding a transparent, rules based financing model is key.

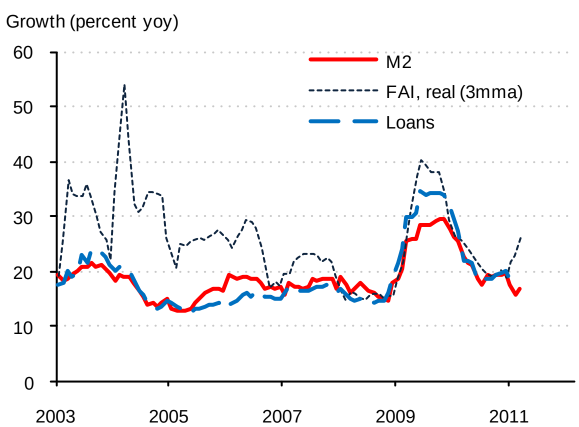
The 12th 5YP can provide direction for reform. Its two key overall objectives are rebalancing and industrial upgrading and moving up the value chain in manufacturing. Policy-wise, it is important to find the right balance between these two. With regard to the 5YP's growth targets, the challenge is to make them binding and consistent nationwide. The targeted 4 pp of GDP increase in the share of services is ambitious but supported by fruitful policy proposals. The targeting of wage growth at or above GDP growth is new. Reforms of inter-governmental fiscal relations will be crucial for achieving meaningful progress on a range of other policy priorities. Barriers to labor mobility may require more attention.

RECENT ECONOMIC DEVELOPMENTS

Economic growth remained resilient as the macro stance moved towards normalization. Sequential GDP growth eased from 10% in the last quarter of 2010 to 8.7% in the first quarter of 2011 at a seasonally adjusted annualized rate (SAAR), according to the new estimates of the National Bureau of Statistics (NBS), leaving output up 9.7% on a year ago; our estimates suggest somewhat faster sequential growth. The overall fiscal stance implies some withdrawal of stimulus in 2010 and 2011. The monetary stance was normalized through the first quarter of this year, with higher interest rates and reserve requirement ratios and, most importantly, re-inforced quantitative guidance on bank lending. As a result, credit and money (M2) growth slowed in early 2011, although overall financing conditions remained accomodative (Figure 1).

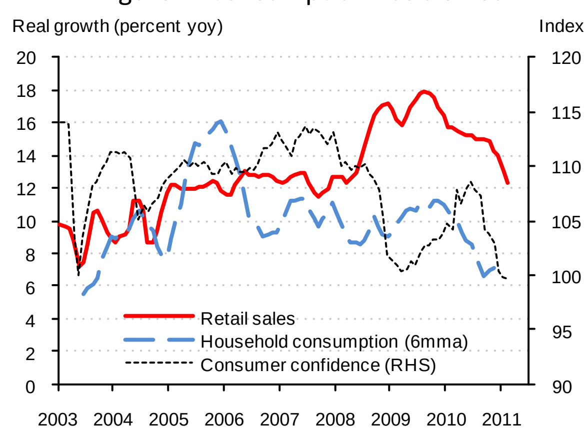
Domestic demand held up well in early 2011, supported by investment, even as consumption slowed. Reflecting the still accommodative financing conditions, reported real fixed asset investment growth rose to 25% in the first quarter (yoy) (Figure 1).[1] Real estate investment remained resilient to several rounds of measures to contain housing prices. Reflecting those measures, housing prices in large cities softened on average in the first quarter, according to data of the NDRC and Soufun.com. However, housing market activity remained buoyant in tier 2 and 3 cities, where nowadays the bulk of housing construction takes place and which have been less affected by the measures.[2] In the first quarter, economy-wide real estate investment, floor space under construction, housing starts, and property sales all still continued to post robust growth. However, retail sales decelerated in the first months of 2011 as inflation affected purchasing power and consumer confidence (Figure 2). Car sales decelerated particularly rapidly, after surging in recent years, as several incentives expired.

Figure 1. Investment has remained strong



Source: CEIC, World Bank staff estimates.

Figure 2. Consumption has slowed



Source: CEIC, World Bank staff estimates.

[1] In early 2011, the NBS increased the threshold of projects covered by the FAI data and expanded the coverage to FAI by rural enterprises and institutions. It noted these steps did not affect the estimation of investment growth.

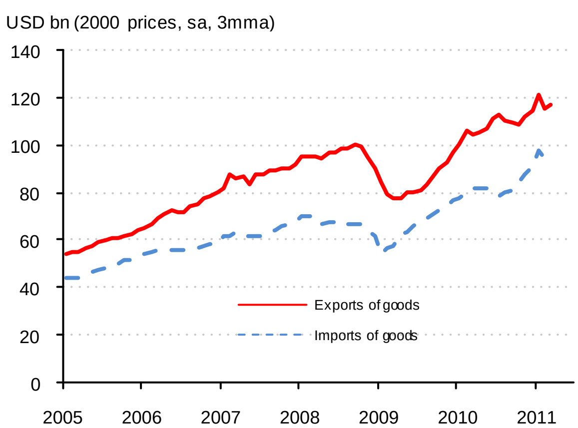
[2] The last round included a higher second home mortage down-payment ratio, higher transaction taxes, restrictions on the number of urban homes people can buy, and increased land supply for public housing.

Exports slowed down in late 2010 but continued to expand in early 2011. As world trade rebounded in the first half of 2010, China's exports surged 39% (SAAR) in real terms (Figure 3). In the second half, amidst slower world trade growth, exports rose only 7% on this sequential metric, but in the first quarter of 2011 they expanded 10.6% (SAAR), to a level up 11.4% on a year ago in real terms.

Reflecting the still robust overall domestic demand, imports held up well early this year, especially those of manufactured goods. Overall import volumes rose 14% in the second half of 2010 (SAAR), with growth particularly strong in the fourth quarter (Figure 3). They broadly kept that pace in the first quarter, growing 13% (SAAR) to a level up 14.5% on a year ago. Processing imports volumes continued to track processing export volumes, while growth of "normal" imports—used in the domestic economy—slowed from 22% to a still solid 15% (yoy) in the first quarter, in real terms. As in most of 2010, manufactured goods imports outpaced raw material imports substantially (yoy), in real terms.

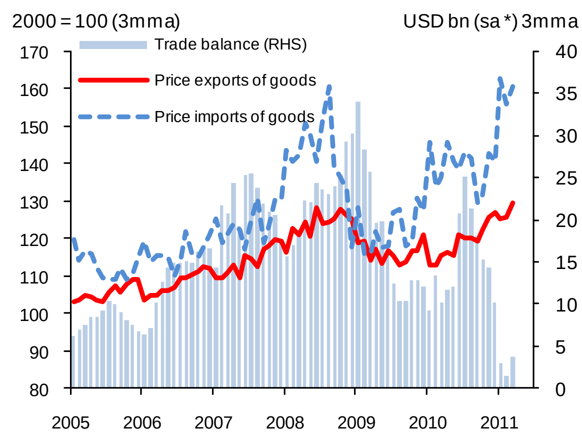
Falling external terms of trade combined with the volume developments to lower the trade surplus. For much of 2010, net external trade contributed positively to GDP growth. The NBS estimates this contribution at 0.8 percentage point (pp) for the whole year; our estimate is 2.5 pp (see Table 4 below). However, a large decline in the external terms of trade—as global commodity prices recovered much faster than those of manufactured goods—kept the trade surplus broadly unchanged in 2010, in US dollar terms (Figure 4). Nevertheless, the current account surplus rose, largely because of higher income on China's rapidly rising foreign assets.[3] In the first quarter of this year, with export volumes slowing more rapidly than import volumes, the contribution of net trade to real growth declined—we estimate it was slightly negative (yoy). On the back of further raw commodity price hikes in the first quarter, the terms of trade were down another 3.8% on a year ago and the (customs data based) trade balance shifted to a small deficit, although the seasonally adjusted trade balance remained positive.

Figure 3. Trade volumes have kept expanding



Source: CEIC, World Bank staff estimates.

Figure 4. Commodity price hikes reduce the surplus



Source: CEIC, World Bank staff estimates.
*/ Using SA volumes and non-SA prices.

[3] The current account balance has been revised downwards due to an upward revision of unrepatriated earnings on inward FDI back to 2005, with inward FDI revised up accordingly. In 2009 the revision was 0.7% of GDP.

Inflation has risen to a 32 month high on higher food and other raw commodity prices.[4] Consumer price inflation rose to 5.4% (yoy) in March, mainly driven by higher food prices caused by problematic weather domestically last year and hikes in international food prices (Box 1 discusses longer term trends in food prices). Vegetable prices, the key driver in 2010, have come down recently, sequentially, after peaking in February. Retail prices of other food products, such as meat, rose in the first quarter, probably driven by higher feed costs.[5] Grain retail prices have also risen, in line with adjustments in procurement prices. However, overall, pressure from food prices may have peaked for now, with sequential increases having slowed since early 2011. In the absence of significant spill-over into other prices and wages, underlying inflation pressures have so far remained low. Core inflation was 2.3 percent in March (yoy), although much of the impact of higher raw commodity prices is still in the pipeline.

The government has taken several steps to contain inflation. In addition to normalizing the overall macro policy stance it took some measures to boost food supply and reduce the cost of production and logistics, including releasing grain from China's large reserves, increasing subsidies to farmers, exempting transport of vegetables from road toll, and boosting food imports. More recently, this was followed by limiting the increase in domestic fuel prices arising from higher oil prices and applying moral suasion on manufacturers of food and consumer products. Also, after being de facto pegged for almost 2 years, since June 2010 the RMB has appreciated 4.6% against the US dollar, although it depreciated in nominal effective terms.

Foreign reserves continue rising rapidly. The rise in foreign reserves in 2010 was at US$ 448 billion broadly unchanged from 2009 as a higher current account surplus and higher net FDI were offset by a switch from valuation gains to valuation losses and lower net financial flows (which include "hot money" flows) (Table 1). The US$ 197 billion increase in foreign reserves in the first quarter, despite a trade deficit, suggests a surge in net financial commercial inflows and/or one-off transactions. Given that China's capital controls are considered to have been reasonably effective in recent years, a surge in net financial commercial inflows would be remarkable.[6]

Table 1. Sources foreign exchange build up (US$ billion)

	2009	2010
Headline FX increase	453	448
Valuation adjustment	71	-21
Sales other reserve assets	-16	-2
Current account balance	261	305
Net FDI	70	125
Net other flows	67	41

Source: SAFE, staff estimates

[4] Changes in the CPI weights in early 2011 did not change the estimate of inflation. The weight of food was lowered by 2.2 pp to an estimated 31%, and that of residence costs increased by 4.2 pp to an estimated 17.4%.

[5] China's wheat and rice prices do not closely follow international ones; they are set by policy. In contrast, China's prices of corn and soybeans do follow international prices fairly closely, and these are both used as feed.

[6] In its first report on capital flows monitoring, the State Administration of Foreign Exchange estimated "hot money" flows at a relatively moderate US$ 35.5 billion in 2010.

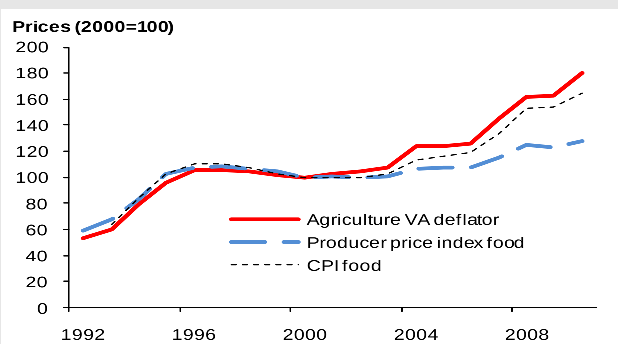
Box 1. Longer term trends in China's food prices.

Since the early 2000s, China's food prices have trended up (Box Figure 1). Agricultural prices have risen 8% per year on average since 2000, after falling during the second half of the 1990s. PPI food prices (factory gate) have risen much less because prices of other inputs into the food processing industry have gone up less and rapid productivity growth in food processing has dampened the transmission of higher raw food prices. However, food prices at the retail level have also risen rapidly. Many food products are not processed. Thus, much of the higher vegetable prices and, in 2007/8, higher pork prices, show up undampened in the CPI data. Consumer food prices are also driven up by wage and other cost pressures in the logistics and retail sector.

Supply factors are key in explaining China's food price increases. In agriculture productivity can typically not increase as easily as in manufacturing. Spectacular growth of China's manufacturing productivity and production has kept down manufacturing prices. Expanding agricultural production is constrained by the availability of land—a key production factor— and yields per hectare cannot be raised easily as productivity in manufacturing since they are already quite high (there is plenty of room for raising labor productivity in agriculture, but that largely entails people moving out of the sector). Thus, higher prices of energy and other costs increases in the 2000s drove up food prices substantially.

The impact of changes in food demand on food prices in the 2000s is less obvious. It is often argued that increased demand for food and changes in diets in emerging and developing economies and resulting pressure on scarce resources such as land are key drivers of higher food prices. However, in China the changes in diet and resulting pressure on scarce resources were much more rapid in 1990-2000, when food price increases were subdued, than in 2000-2009. Per capita daily calorie intake rose steadily from 1960 until 2000 but then it reached a ceiling broadly at the level of high income Asian neighbors such as Japan and South Korea. The resulting changes in the composition of the usage of farmland were also more rapid in 1980-2000 than in 2000-09. The main trend during 1980-2009 in this regard has been a rise in the amount of land used for products other than grain, particularly vegetables and fruit. However, this shift was much more pronounced before 1990 than since then (Box table 1).

Box Figure 1. Food prices have risen since 2004



Source: CEIC, World Bank staff estimates.

Box Table 1.Usage arable land

(change, as share *total* amount at start of decade, %)

	1980-1990	1990-2000	2000-2009
Total	1.4	5.5	1.6
Grain	-2.6	-3.4	0.4
Non grain, *o/w:*	3.9	8.9	1.3
Vegetables	2.2	6.1	2.2
Fruits	2.3	2.6	1.5

Source: CEIC.

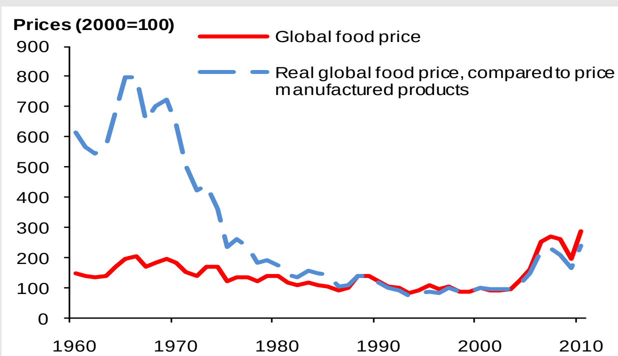
China's food prices are also influenced by global markets and globally supply factors have also been key, as have been biofuels. Many of China's food prices follow international ones, with wheat and rice prices as the big exceptions. Since 2004, international food prices have outpaced manufacturing prices substantially. However, for most of the post war period, global food prices did not increase much and, relative to manufacturing prices, they declined strongly until the early 1990s (Box Figure 2).

Box 1 (continued).

Several factors contributed to the rise in global food prices since 2004 (Mitchell (2008) and Alexandratos (2008)).* First, sharply higher oil prices increased the production costs of agriculture, notably via higher fertilizer prices (the WB estimates that the energy intensity of agriculture is 4.4 times that of manufacturing, globally). Higher oil prices also stimulated biofuel related demand for cereals, diverting a rapidly growing share of cereals away from food consumption. Second, global grain stocks had shrunk during 1997-2003, when consumption continued to grow while low prices kept global grain production stagnant. Thus, by around 2004, global stocks were relatively low. Third, supply shocks from weather induced crop failures in key producing countries.

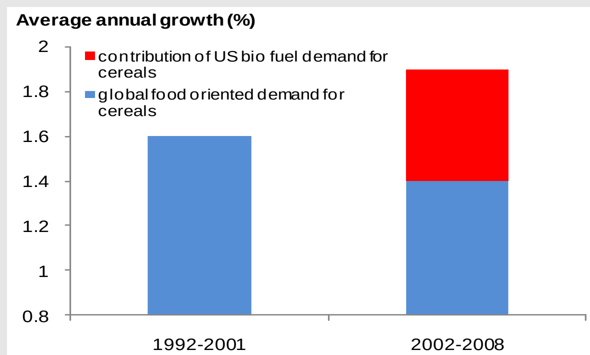
Again, the role of food demand is less obvious. Growth in global demand for cereals (rice, wheat, and course grains) rose from 1.6% per year in 1992-2001 to 1.9% per year in 2002-08. However, the acceleration was because of bio fuel demand. Excluding US bio-fuel related corn demand, global cereal demand growth actually slowed to 1.4% per year in 2002-2008, continuing its gradual deceleration (Box Figure 3). Adding biofuel related cereal demand in other countries would further reduce the measured growth of global food oriented cereal demand.

Box Figure 2. Internationally, food prices rose since 2004, after languishing for a long time



Source: CEIC, World Bank staff estimates.

Box Figure 3. Global growth in demand for cereals continued slowed down since 2001



Source: Alexandratos (2008).

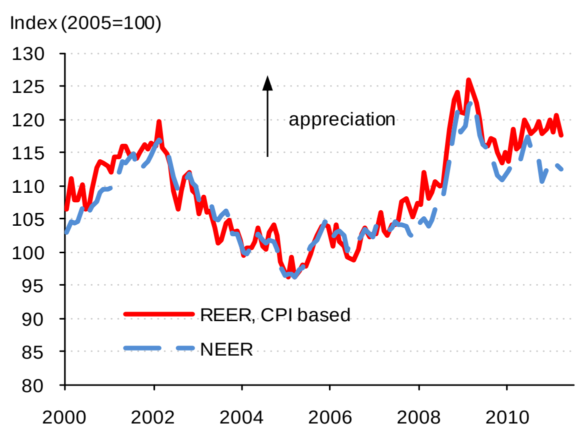
Looking ahead, several of the features that have emerged are likely to remain part of the medium term outlook. Domestically, the supply side effects described above are likely to continue to operate. On the demand side, consumers are likely to continue to shift to higher quality foods and increased variety. The scope for such shifts has bounds, though; average per capita daily calory intake and the overall composition of diets in China is broadly already quite similar to that in Japan and Korea. At the retail level, the non tradable component of food is large. Thus, with continued rapid overall economic growth, wage increases and Balassa- Samuelson effects, the price of food at the retail level is likely to continue to outpace prices of manufactured goods strongly. Internationally, the impact of energy prices on food prices is likely to remain strong. And the impact of global prices on many of China's food prices is also likely to remain strong, even though the volatility of international grain prices in recent years has probably made China's policymakers more keen to retain the controls on grain prices. Indeed, China recently announced a price control scheme for cotton. Most experts continue to think that food prices will eventually stop increasing as additional capacity comes on line. However, even in a benign medium term scenario price volatility along the way could well remain high, possibly accentuated by climate change, as it perhaps is already.

* Mitchell, D., "A Note on Rising Food Prices", Policy Research Working Paper 4682, World Bank and
http://www.fao.org/fileadmin/templates/esa/Global_persepctives/Long_term_papers/FoodPriceSurges-Alexandratos.pdf

Some medium term trends

With strong real growth and substantial real appreciation, China's share in the world economy has surged in recent years. China's continued strong growth in 2008-2010 contrasts with weak or no growth in other parts of the world. In addition, with substantial price increases and some nominal exchange rate appreciation, in the last 5 years China's prices rose faster than elsewhere, measured in common currency (Figure 5). This is especially so for the GDP deflator (Table 2).[7] GDP deflator-based real appreciation against the US dollar averaged 6.6% per year in 2005-10 and annual (trade-weighted*)* *effective* real appreciation on this basis averaged an estimated 5.5%. It is not fully clear what the main reasons are behind these rapid relative price increases and whether they will be sustained. Nonetheless, they have been a major factor in China's catch up in recent years. China's share of global GDP rose from 6.3% in 2007 to an estimated 9.5% in 2010, in current prices and market exchange rates, with around one third coming from higher relative prices.

Figure 5. The effective exchange rate has trended up



Source: CEIC, World Bank staff estimates.

Table 2. Prices and exchange rates (average annual change, %)

	2000-05	2005-10
Prices		
CPI	1.4	3.0
GDP deflator	3.2	4.9
Nominal exchange rate		
v-a-v US	0.2	3.9
NEER	-1.2	2.7
Real exchange rate, v-a-v US		
CPI based	-1.0	4.7
GDP deflator based	0.9	6.6
Real effective exchange rate		
CPI based	-1.9	3.4
GDP deflator based 1/	0.2	5.5

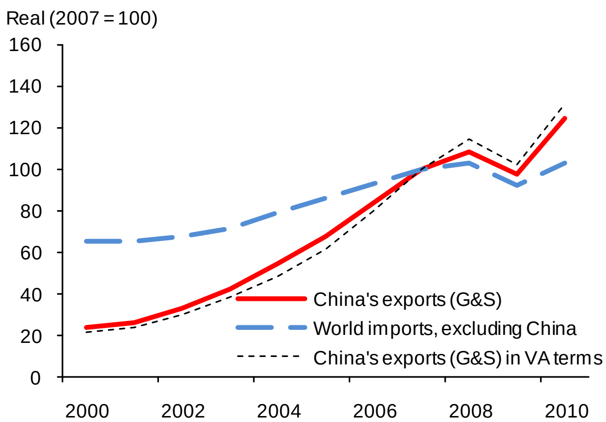
Source: CEIC, World Bank staff estimates.
1/ Estimate.

During this time, China's exports rose rapidly. They strongly outpaced partner countries' imports on the basis of rising competitiveness in an increasing array of manufacturing sectors, and their global market share rose from 7.4% in 2007 to an estimated 9.6% in 2010 (Figure 6). Moreover, the value added content of exports continued to rise because of (i) deeper supply chains in the processing sector that raised the value added content of processing exports from 40% in 2007 to 43% in 2010; and (ii) a rising share of normal (non processing) exports, which have a higher value added content. Thus, in terms of value added, export growth was even somewhat faster than headline export growth (Figure 6).

[7] A key reason behind the particularly rapid increase in the GDP deflator is that both the investment deflator and the overall consumption deflator have outpaced the CPI index; the latter largely because of the impact of rapidly rising government wages on the deflator for government consumption.

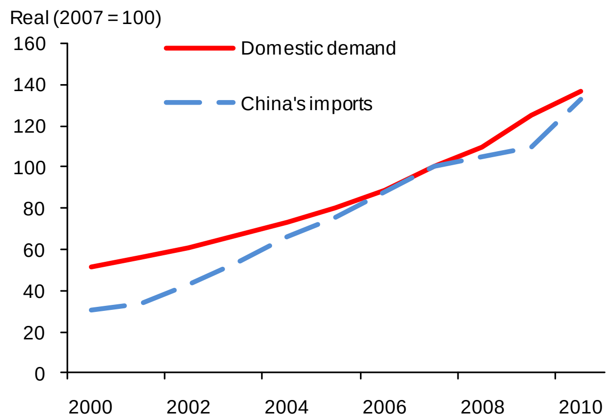
Nonetheless, because of strong domestic demand and relative price changes, the relative importance of external trade has declined. China's domestic economy grew even faster than exports in those 3 years and China's imports surged alongside domestic demand—outpacing exports, in real terms (Figure 7). This lowered the current account surplus from 10.1% of GDP in 2007 to 5.1% in 2010, leading to some external rebalancing simply because China grew much faster than the rest of the world.[8] At the same time, the relative importance of exports in the economy declined because of these trends and the fact that domestic prices rose much faster than export prices. Having peaked at 39 percent in 2006, the share of exports in GDP was an estimated 29 percent in 2010 (in value added terms the reduction was somewhat less). These developments are of course influenced by the global crisis, which depressed global demand and led China's government to implement a large and effective stimulus. Looking ahead, whether these trends will be sustained depends on China's policies, including the progress with rebalancing, and other developments domestically and globally.

Figure 6. Exports have powered ahead since 2007, especially in value added terms



Source: CEIC, World Bank staff estimates.

Figure 7. However, domestic demand and imports rose even faster



Source: CEIC, World Bank staff estimates.

ECONOMIC PROSPECTS

The global growth outlook remains broadly favorable despite recent shocks. After a period of upgrades to growth forecasts in 2010, the global outlook has recently been challenged by high prices of oil and other raw commodities and the terrible earth quake and tsunami in Japan. Overall, though, global growth prospects remain robust. Recent downward revisions to growth have generally been modest and the April Consensus Forecasts suggest global GDP growth of 3.4% this year, after 3.8% in 2010, at market exchange rates (Table 3). This incorporates a downward revision of the forecast for Japan's GDP growth by 0.9 pp, with the forecast for next year up by 0.8 pp, although the damage to society and physical assets is of course much larger than those numbers suggest. Although the oil price has continued to rise since early March, in large part because of turmoil in the Middle East and resulting supply concerns,

[8] In 2007-10 the terms of trade worsened in total around 4%, which had a modest impact on the change in the current account.

most of the oil price increase since early 2010 took place before the outbreak of that turmoil, apparently largely because of improved global demand prospects instead of supply concerns.

International raw commodity prices more generally have risen. Since early summer 2010, international raw commodity prices have risen strongly across the board, largely because of strengthened global demand prospects but also, such as in the case of food, because of supply factors. More recently, international prices of most raw commodities, including oil, metals, and food, have halted their ascent, sequentially, presumably in large part because global demand prospects have stopped improving. However, the higher raw commodity price levels are pushing up (yoy) inflation, especially in emerging markets, and much of the higher raw commodity prices still needs to feed through into consumer prices, globally. At the same time, low core inflation in high income countries, especially the US, mean it is likely to take a while before global interest rates will rise substantially.

Table 3. The global environment *(% change, unless otherwise indicated)*

				projections		Differences from Jan projections	
	2008	2009	2010	2011	2012	2011	2012
World GDP growth 1/	1.6	-2.5	3.8	3.4	3.7	-0.1	0.1
High income countries	0.3	-3.7	2.4	2.0	2.5	-0.2	0.1
US	0.4	-2.6	2.8	2.9	3.3	-0.3	0.0
EU	0.6	-4.0	1.7	1.7	1.7	0.2	0.1
Japan	-1.2	-6.3	3.9	0.3	2.7	-0.9	0.8
Developing countries	4.1	-0.3	6.0	5.8	5.8	0.0	0.0
Asia ex Japan ex China	3.8	1.6	7.1	5.3	5.8	-0.1	0.2
World trade 2/	4.2	-10.9	12.4	7.4	6.9	0.3	0.1
World prices (US$) 2/							
Oil ($/bbl)	97	62	79	107	108	22	1
Non oil commodities	0.0	-15.8	26.3	25.1	-4.3	14.1	1.3
of which: food	23.3	-13.1	11.7	24.1	-4.6	…	…
Manufactured exports	6.6	-6.3	3.0	5.5	1.1	…	…
$ Libor interest rate (6 m % per yr)	3.0	1.1	0.5	0.6	0.9	-0.1	0.0

Source: Consensus Economics, International Monetary Fund, and staff estimates.
1/ Consensus Economics (April 2011), using 2009 weights and market exchange rates.
2/ International Monetary Fund, WEO April 2011.

Risks to the global growth outlook remain. In high income countries, high public debts and weak real estate markets continue to pose risks, especially in some euro area countries, while financial risks stem from high funding requirements of banks and sovereigns. In emerging markets, risks include overheating and booming asset markets. Also, raw commodity prices including oil may rise still further.

Domestically, growth is likely to ease somewhat this year and next to a still healthy rate. This year, headwind from a normalized macroeconomic stance, inflation, and somewhat slower global growth should be partly offset by solid corporate investment and a still robust labor market.

- **Investment growth is likely to slow down somewhat.** It should be affected by the monetary policy normalization. Overall financing conditions should remain reasonably supportive because of robust financing via the capital market and generally healthy profit prospects and balance sheets in the corporate sector. This is so even though higher commodity prices may put downward pressure on profits in sectors that find it difficult to pass on higher input costs because of strong competition, such as in core manufacturing, or administratively-set output prices. However, the rapid expansion of infrastructure investment in recent years reduces the room for it to further drive investment growth.[9] This is even though investment should benefit from the start of the 12th 5YP, including through its emphasis on "industrial upgrading". Real estate investment is also expected to slow down in response to several rounds of property tightening measures, although the government's ambitious plans for social housing construction are likely to keep overall property construction growing this year. In all, despite significant stock building, we project growth in gross capital formation to come down from an estimated 11.6% last year to 10.7% this year and 9% next year (Table 4).

- **Consumption should remain supported by a robust labor market, but inflation creates headwind.** Household income should benefit from solidly rising wages and employment, although this is likely to continue to be tempered, especially in the second and third quarter, by substantial inflation which reduces real income growth and consumer confidence.[10] We expect total consumption (including government consumption) to grow 8% this year, as in 2010.

- **Net trade should be broadly neutral with respect to growth.** With global imports expected to rise 7.4% in 2011, in real terms, and global market share gains expected to moderate, we project China's exports to rise 12.4% this year, in real terms. With domestic demand growth remaining steady, we expect imports to outpace exports somewhat, growing 13.2% in real terms.

- **In all, we project real GDP growth to slow to 9.3 percent in 2011 and 8.7% in 2012.** The upgrade to the 2011 forecast, compared to November 2010 and March of this year, is on the back of the stronger than expected outcomes in the fourth and first quarter.

[9] For instance, after the massive expansion in recent years, railway infrastructure investment is envisaged to be broadly constant this year.

[10] As an indication of expected wage dynamics, relative to recent years, according to a survey by Aon Hewitt, a human capital consulting firm, average salaries covered "across all major industries" should rise 9.1% this year, compared to 8.4% in 2010 and 5.8% in 2009.

Table 4. China: Main Economic Indicators
(percent change, unless otherwise indicated)

	2008	2009	2010	2011 f	2012 f
The real economy					
Real GDP	9.6	9.1	10.3	9.3	8.7
Domestic demand 1/	9.6	13.8	9.8	9.4	8.7
Consumption 1/	8.5	8.5	8.0	8.0	8.4
Gross capital formation 1/	11.0	19.8	11.6	10.7	9.0
Contribution to GDP growth (pp)					
Domestic demand 1/	8.8	12.8	9.5	9.0	8.5
Net exports 1/	0.8	-3.7	0.8	0.3	0.1
Contribution net exports (WB, pp) 2/	1.8	-4.8	2.5	0.3	0.1
Exports (goods and services) 2/	8.6	-10.4	27.6	12.4	11.1
Imports (goods and services) 2/	5.1	4.3	21.8	13.2	11.5
CPI (year average)	5.9	-0.7	3.3	5.0	3.4
GDP deflator	7.8	-1.0	5.8	6.0	4.0
External terms of trade	-4.3	8.6	-8.4	-5.5	0.9
Fiscal accounts (percent of GDP) 3/					
Budget balance 4/	-0.8	-2.0	-2.3	-1.5	…
Revenues	19.5	20.1	20.9	19.5	…
Expenditures	19.9	22.4	22.5	21.7	…
External account (US$ billions)					
Trade balance (BOP)	361	250	254	198	233
Current account balance	412	261	305	264	323
Current account balance (% GDP)	9.1	5.2	5.1	3.6	3.8
Foreign exchange reserves	1946	2399	2850	3291	3694
Other					
Broad money growth (M2), e-o-p (%)	17.8	27.6	19.7	…	…

Sources: CEIC, NBS, PBC, Ministry of Finance, and staff estimates.

1/ WB estimations using contribution to growth data from the NBS.

2/ WB staff estimates based on trade data for goods from the Custom Administration, adjusted for estimated difference in price development for services trade.

3/ For 2011, this is the budget as presented in March, and discussed in the text below.

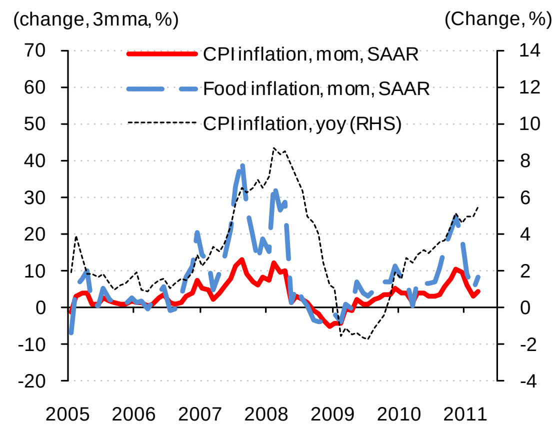
4/ The balance differs from the net of revenues and expenditure because of Adjustment Fund transactions. Also, for 2009 and 2010 the balance differs from the commitment budget. RMB 260 bln in government spending from the 2009 budget was actually spent in 2010.

Inflation is unlikely to escalate but there are risks. Food price increases seem to have slowed for now, sequentially, and the (yoy) rate of increase in food prices is likely to diminish later in the year (Figure 8). Upstream price pressures may continue to build because of the hikes in oil and industrial commodity prices. Importantly, however, so far core inflation pressures remain in check. Based on the above global price outlook, we expect the moderation in food price inflation in the coming 12 months to more than offset the rise in non-food inflation, resulting in a slowdown in headline CPI inflation, with the pace of deceleration in part depending on factors such as the possible adjustment of some utility prices.

Meanwhile, we have revised downwards our projection for the current account surplus because of the higher commodity prices, which affect China's terms of trade substantially.

Domestic risks add to the global ones noted above. Downside risks to growth stem from possibly weaker corporate sector investment or household consumption. However, both also carry upward risk. Higher raw commodity prices pose a risk to the inflation outlook.

Figure 8. Sequential pace of inflation has diminished for now



Source: CEIC, World Bank staff estimates.

The property market is a particular source of risk. With tension between the underlying upward housing price pressure and the policy objective to contain price rises, interaction between the market and policy measures could lead to a more abrupt than planned downturn in the real estate market. In the medium term, the widespread use of property as investment vehicle and the role of local governments add to the risks. Property construction is an important part of the economy, directly and in terms of impact on large sectors such as steel and cement. Thus, shocks to the property sector that would slow down construction significantly could have a large impact on the economy and on bank balance sheets, taking into account bank exposure to construction and other sectors dependent on the real estate market. Moreover, a property downturn could affect the finances of local governments, which do a lot of the infrastructure investment and are important clients of the banking system.

Looking further ahead, whether the recent trend towards a lower external surplus and lower dependence on external trade will be sustained remains to be seen. The fall in the external surplus and the relative importance of exports since 2007 was in no small part because of the global crisis. Whether the domestic economy and imports will outpace exports in the coming five years depends on China's policies, including progress with rebalancing, and other domestic and international developments. If China's domestic demand growth remains much stronger than elsewhere and significant rebalancing takes place, the external surplus may remain contained and the economy may continue to become less dependent on exports. The importance of exports may decline especially if domestic prices continue to rise much faster than tradable prices, as in 2005-10. This would over time change the nature of China's economy, making it increasingly domestic demand driven. It would also facilitate a broadly benign further integration of China's economy in the global economy. However, the tentative results on the pattern of investment across sectors discussed in Box 2 suggest such a scenario is not yet entrenched. With less progress on rebalancing, less benign scenarios are also possible.

Economic policies

The macro stance needs to be normalized fully to address macro risks including on inflation and the property market. Even though our baseline inflation projections are not particularly worrying, the risks, including from further global commodity price shocks, call for vigilance. Also, inflation expectations are high, and there is little spare capacity in the economy, overall. Macroeconomic policy remains key in limiting the spill-over of higher prices of food and other raw commodities into other prices and wages and containing other risks, including in the property market and with respect to bank balance sheets. To address such macro risks, macroeconomic policy is typically better placed than moral suasion and administrative measures.

Recent economic policy has largely been moving in this direction. Fiscal policy appears not to provide stimulus anymore and the monetary stance has moved towards normalization. The government has recently also limited the transmission of higher oil prices in domestic fuel prices used moral suasion.[11] Such measures could create distortions and are unlikely to be effective for a long time. With the central inflation outlook manageable, it may not be necessary for concerns about inflation to hold up for long price changes needed for the transformation of the growth pattern such as price increases for resources and utilities.

Looking ahead, it is too early to stop the macro tightening, while, with risks both ways, fiscal and monetary flexibility is key. The strong recent growth has shown the resilience of the economy to the policy normalization. If the slowdown materializes and inflation eases, the case for further overall monetary tightening weakens. However, even then room remains for interest rates to play a larger role, relative to quantitative targeting.

On the property market, market-related risks require one set of policies and social concerns another. After the 2008-09 stimulus, the authorities rightly reined in liquidity, flanked by specific measures, to stop housing prices from surging. However, in general, given robust income growth and urbanization, housing prices should rise over time and empirical research is inconclusive as to what extent prices are systemically out of line with fundamentals. The role of economic and financial policy is to prevent different types of economic and financial risks from building up in the housing sector, including those discussed above, and to make the economy and the financial system robust to a potential property downturn, rather than focusing mainly on containing overall prices. In any case, if overall prices are considered to be systematically too high from a market perspective, macroeconomic levers are most obvious; administrative measures are less obvious, especially locally administered ones.[12]

[11] The NDRC said March 31 it will send inspectors to consumer goods manufacturers to investigate the reasons for price increases and indicated that "some manufacturers will be invited to have talks with the NDRC".

[12] The central government required municipal governments to release targets for housing price increases in 2011 and holds them accountable for their achievement. By the deadline of March 31, most of the cities that had released them targeted price increases of around 10-15%.

Box 2. The evolution of China's pattern of growth—what do investment patterns suggest?

During the 11th Five Year Plan period, some modest progress was made with rebalancing towards more services and domestic consumption. On the production side, the secondary (industrial) sector grew broadly as fast as the services sector, in real terms. The share of the service sector in GDP increased because of more rapid price increases in the services sector and a fall in the share of agriculture. However, industry clearly remains very important. On the expenditure side, consumption has so far substantially lagged investment, which in 2010 made up more than 46% of GDP.

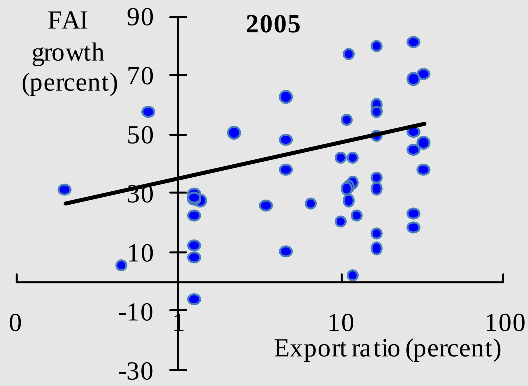
Looking forward, the pattern of investment across sectors matters. Channeling resources to new sectors and activities is a key element of transforming the growth pattern.

Traditionally, investment growth was particularly strong in the tradable sector. As Box Figure 1 shows for 2005, in 2004-07 sectors with a higher ratio of exports to (gross) output on average saw more rapid growth of fixed asset investment (FAI).

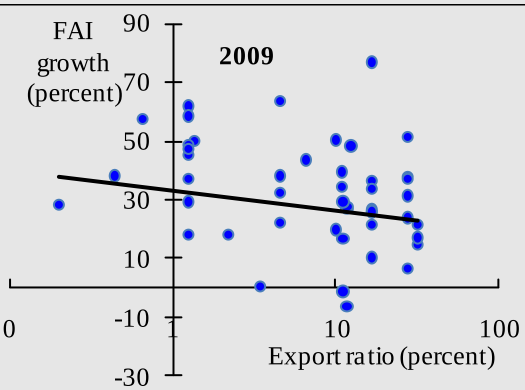
When the global crisis broke out, this pattern changed. Investment in export oriented manufacturing was affected by the global slump and emergence of spare capacity. For instance, in the textile sector—the sector with the highest export ratio—investment slowed down sharply in 2008 and growth remained subdued in 2009. Moreover, China's stimulus boosted investment in non tradable sectors, notably in infrastructure. Thus, as indicated in Box figure 2, in 2009, investment growth was on average higher in more domestically-oriented sectors.

However, it is too early to say that this rebalanced pattern of investment will be sustained. Box figure 3 suggests that the traditional pattern seems to have re-emerged itself in 2010 (and the first months of 2011). This is possibly temporary, after the turmoil in 2008-09. However, at a minimum rebalancing is not yet on course.

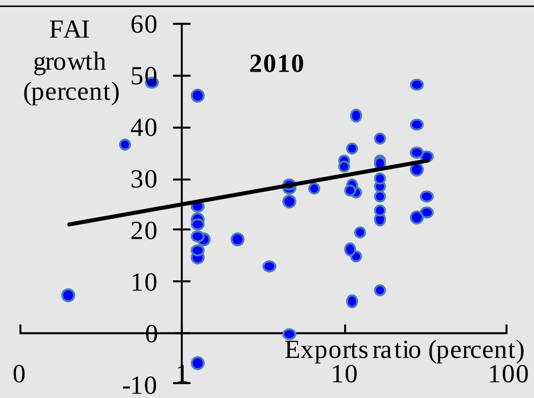
Box Figure 1. Traditionally—investment particularly strong in tradable sector



Box Figure 2. Global crisis and stimulus—investment particularly strong in the non tradable sector



Box Figure 3: post crisis—back to traditional patterns?



Source: CEIC, and staff calculations.

On the other hand, making housing more affordable for targeted groups requires sustainable rules-based arrangements, almost unavoidably explicitly subsidized by the government. The planned scaling up of social housing discussed below is in this direction. As elaborated below, a transpartant, rules based, financing model is key.

What will be the focus of structural reforms? The 12th 5YP discussed below has 2 overall objectives: transforming the pattern of growth towards more emphasis on consumption and services and moving up the value chain in manufacturing. What the 12th 5YP implies for the way China will grow in the medium term will in part depend on the relative emphasis on these 2 objectives.

FISCAL POLICY AND PUBLIC FINANCE

The overall fiscal stance in 2010 probably withdrew stimulus. The commitment budget deficit for the national (central and local) government was 1.6% of GDP, down from 2.8% of GDP in 2009. However, with 0.7% of 2010 GDP in local government spending carried over from 2009 into 2010, the cash deficit was 2.3% of GDP last year, compared to 2.0% in 2009. As in 2009, the social security funds ran a surplus of around 1% of GDP. Their operations did thus not affect the fiscal stance. Data on infrastructure lending in the first 9 months of 2010 suggests that quasi fiscal activity financed by bank lending withdrew stimulus in 2010, likely more than offsetting the small increase in the cash budget deficit.

Among budgetary expenditures, priority areas saw significant increases in 2010. As usual, budgetary revenues grew much faster than assumed in the budget prepared in early 2010, with overall tax revenues rising 23% and indirect taxes increasing particularly rapidly.[13] Overall budgetary expenditures rose 17.4%, somewhat faster than assumed in the budget. Following substantial increases in earlier years, budgetary spending on education, health, and social security—a focus of policy—rose 18.5% in 2010, reaching 6.6% of GDP, 1.1 pp of GDP more than in 2007 (Table 5). Spending on pensions, health, and unemployment by social security funds and budgetary spending on the environment, agriculture, and “other social welfare” also rose as a share of GDP in 2007-10, while expenditure on social housing increased especially rapidly last year, from a low level.

The 2011 budget is cautious. It sees tax revenues growing at 8.3%, which implies a large buffer according to our revenue growth projection, which is twice as high. Budgetary expenditure is envisaged to rise 12% this year, with spending on education, health, and social security up 14%, less than (our projection for) nominal GDP growth. The broadly unchanged allocation for social housing, with respect to 2010, is surprising, given the drastic increase envisaged in the scale of social housing construction (see below). The budget deficit of 1.5% of GDP (using our GDP forecast), compared to 2.3% of GDP in 2010, appropriately suggests some withdrawal of fiscal stimulus, with the low estimate of tax revenues providing a buffer and thus some flexibility.

[13] A 2009 tax reform reduced corporate income tax revenue growth.

Table 5. Headline government spending (% of GDP)

	2005	2007	2010	2011 1/
Government expenditure 2/	24.1	24.0	27.5	…
Budgetary, *of which*	18.3	18.7	22.5	21.7
Education, health, and social security	4.7	5.5	6.6	6.5
Environment, agriculture and other social welfare	…	2.9	4.1	4.1
Extra budgetary	2.8	2.3	1.3	…
Social security funds	2.9	3.0	3.7	…

Source: CEIC, World Bank staff estimates.

1/ As in the budget presented in March, but using our GDP forecast.

2/ Excluding quasi fiscal spending financed by bank lending.

The government has indicated some plans for public finance reforms to support the transformation of the pattern of growth. The Government Work Report for 2011 mentions: a pilot to impose VAT on some producer services industries while reducing the sales tax on them; extending the coverage of the property, resource, and consumption taxes; reforming the pricing of electricity and water; and reducing and simplifying the personal income tax (PIT) by raising the tax exemption threshold, reducing the number of brackets and regularly indexing the structure to inflation. The Report also suggested giving provincial level governments more leeway in setting local taxes to "align better their revenues with their expenditure responsibilities." Most of these would be welcome steps.[14] However, for some of them it is not clear how concrete the plans are and what the time schedule for their implementation is.

Scaling up social housing is rightly used to help transform the economic growth pattern and improve people's livelihood. Social housing construction started along with China's housing reform in the late 1990s.[15] But it declined in importance during the last decade. However, the building of subsidized rental housing and renovation of industrial and mining shantytowns was scaled up in recent years as part of the stimulus policies. One objective of the 12th 5YP is to construct 36 mln units of social housing (including shantytowns renovation) in 2011-15, to give access 20% of urban households by 2015, compared to about 7% now. The plan is frontloaded, envisaging the construction of 10 million units in 2011, compared to an estimated 3.7 million units in 2010.

Successful, sustainable social housing requires strong institutions and clear rules, including on a sustainable financing model and the funding of the subsidy element. Local governments have so far typically not had strong incentives or means to build a lot of social housing. This time the increased prominence of the plans and the central government's emphasis provide an incentive. However, the large scale and time pressure, and already stretched finances of some local governments, suggests that

[14] PIT is paid by a modest share of the labor force, and by the higher echelons of the (taxable part of) the income distribution. If boosting wage earners' disposable incomes and reducing income inequality are the objectives, reducing social security charges—which are paid by many more people—may be a more obvious measure.

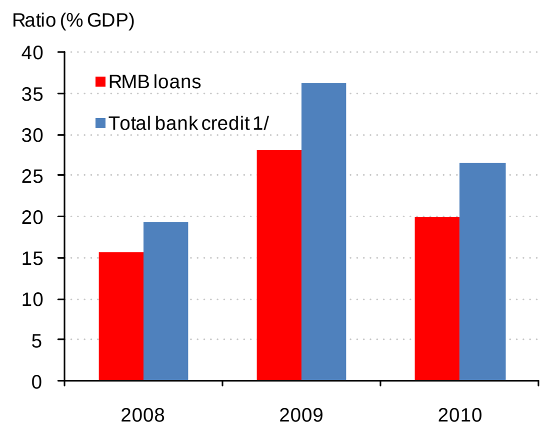
[15] Social housing includes "economic housing" and apartments sold below market prices, subsidized rental housing, and the renovation of shantytown housing.

the execution may not be straightforward. As the related policies are rolled out, it will be important to define "low income" and carefully identify the targeted beneficiaries, cost out the policies, apportion the financing in a sustainable and transparent fashion, and work out implementation details. The success of these policies will be determined by such details. In the government's plans, of the RMB 1.4 trillion in overall investment required this year, RMB 800 bln would come from the owners (end users or companies involved in shantytown renovation) and around RMB 100 bln from the central government. The rest will need to be generated by local governments via various channels, including land revenues, housing provident funds, and bank lending. The exact structuring of the financing will be hugely important for sustainability and efficiency.

MONETARY, FINANCIAL, AND EXCHANGE RATE POLICY

Monetary conditions have tightened recently as monetary policy moved towards normalization. Since October 2010 the government has raised benchmark interest rates 4 times and RRRs 7 times. Most importantly, quantitative guidance on bank credit, traditionally the backbone of monetary policy tightening, began to be reinforced, especially in early 2011. As a result, M2 growth came down from 19.5% in the fourth quarter to 16.6% on average in the first quarter, close to the target for the end of 2011, with a similar slowdown in bank lending. In recent years, total bank credit extention has been significantly larger than headline data suggests as banks expanded the use of credit instruments such as designated loans, trust loans and corporate paper, financed in part by trust and wealth management products that are not counted as deposits and are not part of M2, in order to evade lending quotas, capital requirements and RRRs (Figure 9). This remained the case in the first quarter. Nonetheless, and regardless of the coverage, banking credit extention was tightened in the first quarter of this year (Figure 10).[16] Also, reflecting tighter monetary conditions overall, interest rates on the interbank market have risen since end 2010 (Figure 11).

Figure 9. Total bank credit extention has been larger than headline data suggests



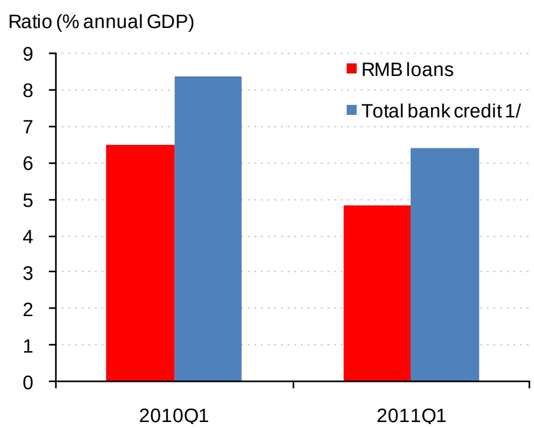
Source: CEIC, World Bank staff estimates.
1/ Includes FX loans and trust loans, designated loans, corporate paper and medium term notes.

[16] There has been a methodological change in early 2011 that affected the monetary statistics. However, in contrast to some reports, this did not affect the measurement of M2 growth. The way that designated deposits and loans are booked changed for non bank financial institutions, which reduced the measured amount of both deposits and loans. However, the (yoy) growth rates reported for deposits and loans are adjusted for the methodological change and thus correct.

Recent changes in the operation of monetary policy and a new concept do not imply a change in approach. In early 2011, the PBC introduced differentiated RRRs; so far they are largely differentiated between large and small banks. There is no official overall lending target anymore. However, the PBC still has an implicit target and this change does not imply a major shift in approach. The PBC also introduced the concept of "Total Social Financing" to map the different sources of financing of investment (and to show that containing bank lending does not necessarily imply investment weakness). In addition to headline bank lending it includes the other types of credit mentioned above as well as direct financing through equity and bond issuance. It should be interpreted with care, though. Items such as equity and bond issuance are not new liquidity creation. Also, Total Social Financing would not lend itself well to quantitative targeting.

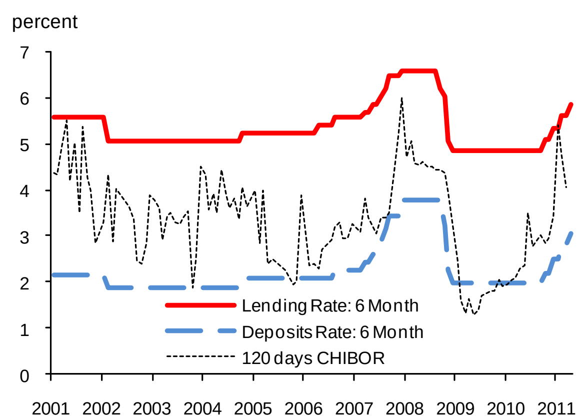
Over time, a larger role for interest rates could make the conduct of monetary policy more effective and less distortive. As underscored by the proliferation of non mainstream credit extention, it is increasingly difficult to effectively lower credit growth using quantitative guidance in the increasingly sophisticated and complex financial system.

Figure 10. Bank credit extention was contained in the first quarter



Source: CEIC, World Bank staff estimates.
1/ Includes FX loans and trust loans, designated loans, corporate paper and medium term notes.

Figure 11. Interbank rates confirm monetary conditions have tightened.



Source: CEIC, World Bank staff estimates.

The 12th 5YP (2011-15) was launched earlier this year. It is in line with the proposal circulated in October 2010 that was discussed in our November 2010 China Quarterly Update. In terms of strategic direction and reforms, 2 areas of emphasis stand out:

- **Rebalancing**. The government wants to transform the pattern of growth towards more emphasis on consumption and services to address imbalances with regard to the income distribution, the consumption share, the environment, energy consumption, and external balance. It also focuses on livelihood issues and regional rebalancing, with more emphasis on urbanization in inland regions and smaller cities. Such rebalancing obviously requires strong policy effort.[17]

- **Industrial upgrading and moving up the value chain in manufacturing.** The emphasis is on technological upgrading, investment in "new strategic industries", and innovation. The Plan discusses the role of the government in leading the industrial upgrading and promoting the development of new industries. However, in most market economies, the role of the government in pursuing such objectives would largely be to provide an enabling framework. Enterprises will have to do most of the upgrading and innovation. In any case, given the track record of China's industrial sector over the last decade, industrial upgrading is likely to continue.

Policy-wise, it is important to find the right balance between these 2 areas of emphasis. By itself, **i**ndustrial upgrading would boost investment and industry. If government policy emphasizes industrial upgrading rather than rebalancing, there might be little change in the pattern of growth, keeping it investment and industry driven, with limited progress towards a higher household income share, a larger role of consumption, and a lower external surplus.

With regard to the 5YP's growth targets, the challenge is to make them binding and consistent nationwide. The target of 7% average growth during the 12th 5YP period seems appropriate, allowing for relatively rapid growth while creating space for meaningful progress on restructuring. However, under past 5YPs GDP growth far exceeded the targets while no obvious attempts were made to meet them. Also, nearly all provincial governments have set much higher growth targets for their own 12th 5YPs. The challenge now is to make the announced growth rates the true targets behind future policies, and to achieve greater consistency between the policy stances at central and sub-national levels.

The targeted 4 pp of GDP increase in the share of services is ambitious but supported by policy proposals. Welcome proposals include establishing fair, regulated and transparent market access rules; breaking up sector segmentation, regional blocks and industrial monopolies; opening more service sectors to private and foreign investors; and establishing an integrated, open, competitive and orderly services market. Other policy measures proposed in the Plan include extending the VAT to services, allowing services firms to enjoy the same utility prices as manufacturing firms, and improving the service sector's access to land and finance.

The targeting of wage growth at or above GDP growth is new. Its motivation is welcome: to halt the decline in the shares of labor compensation in primary income and household disposable income in GDP. It is not obvious whether and how the government should directly influence wages in a market economy. However, pursuing more labor intensive growth and more permanent urbanization would boost these shares in an economically sustainable way.

[17] For an elaboration of the reform agenda for rebalancing, see the World Bank China Quarterly Updates of June 2009, March 2010, and November 2010.

Reforms of inter-governmental fiscal relations will be crucial for achieving meaningful progress on a range of other policy priorities. China's sub-national governments are responsible for the bulk of spending on public services and infrastructure. Local governments in poor areas tend to be financially strained and there are large disparities in the provision of public services that amplify regional income inequality. During the 11th 5YP, general transfers to poor provinces have increased, and this has reduced the disparity in public expenditure across provinces. The 12th 5YP shifts the focus to the sub-provincial level and proposes to increase provincial governments' fiscal transfers to county governments. However, it does not propose specific measures on how to reform inter-governmental fiscal relations, including on the role of the central government at the sub-provincial level. In addition, it would be good to bring the off-budget borrowing by local governments onto their budgets and set up more transparent modes of financing of local government deficits.

Barriers to labor mobility may require more attention. The Plan rightly identifies increasing non-farm income as key in raising rural incomes. It also proposes to relax the barriers for rural migrants to obtain an urban hukou in medium and small towns. However, it does not fully address the removal of barriers to labor mobility otherwise. Also, while the Plan rightly discusses enhancing pension and health insurance to rural people, the continued separation of rural pension and health insurance schemes from urban ones add barriers to labor mobility. Finally, among the recent measures aiming at containing housing prices, in many cities the purchase of property by people that have worked or lived there less than a certain amount of time was banned. This has not been helpful to labor mobility.

The following papers are available from World Bank's ***Documents & Reports*** website:

Http://www-wds.worldbank.org,

Market Integration in China, Qingqing Chen, Chor-Ching Goh, Bo Sun, Lixin Colin Xu (Report nr. WPS5630). This paper argues that China's economic production needs to be spatially concentrated, and its social services need to be spread out to the interior to ensure harmonious development and domestic integration.

How Do Special Economic Zones and Industrial Clusters Drive China's Rapid Development, Douglas Zhihua Zeng (Report nr. WPS5583). This study briefly summarizes the development experiences of China's special economic zones and industrial clusters, in an attempt to benefit other developing countries as well as the broader development community.

China and the Knowledge Economy: Challenges and Opportunities, Douglas Zjihua Zeng, Shuilin Wang (Report nr. WPS4223). This paper provides an analysis of the strengths, weaknesses, opportunities, and challenges to China's knowledge economy.

Early Childhood Development and Education in China: Breaking the Cycle of Poverty and Improving Future Competitiveness, Kin Bing Wu (Report nr. 53746). The report focuses on early childhood development and education and advocates a two-pronged, pro-poor approach in the 12th Five Year Plan (2011-2015).

Equity and Public Governance in Health System Reform: Challenges and Opportunities for China, Hana Brixi, Yan Mu, Beatrice Targa, David Hipgravei (Report nr. WPS5530). This paper explores whether the government's actual expenditure on health across levels support China's health system reform objectives.

Reducing Inequality for Shared Growth in China: Strategy and Policy Options for Guangdong Province, Xiaoqing Yu, Chunlin Zhang (Report nr. 58846). This is a joint study with the Guangdong Provincial Government to aim at reducing the urban-rural disparity in the Guangdong Province.

Can China's Rural Elderly Count on Support from Adult Children: Implications of Rural-to-Urban Migration, John Giles, Dewen Wang, Changbao Zhao (Report nr. WPS5510). This paper shows that support from the family continues to be an important source of support for the rural elderly, particularly the rural elderly over 70 years of age.

Catastrophe Insurance Policy for China, Jun Wang (Report nr. 52953). This paper shows that the current property insurance market in China is dwarfed by the nation's need for catastrophe risk protection. China's insurance industry cannot provide significant compensation for large natural hazards losses.

Did Higher Inequality Impede Growth in Rural China?, Dwayne Benjamin, Loren Brandt, John Giles (Report nr. WPS5483). This paper estimates the relationship between initial village inequality and subsequent household income growth for a large sample of households in rural China.

On the Road to Prosperity? The Economic Geography of China's National Expressway Network, Mark Roberts, Uwe Deichman, Bernard Fingleton, Tuo Shi (Report nr. WPS5479). This paper evaluates the aggregate and spatial economic impacts of China's newly constructed National Expressway Network.

It Is Not Too Late: Preparing for Asia's Next Big Earthquake - with Emphasis on the Philippines, Indonesia, and China, Peter I Yanev (Report nr. 57683). Strong earthquakes strike frequently countries in East Asia and the Pacific. This paper aims at delivering the best science, risk analysis, and engineering available.