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Quarterly Update

November 2006

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

Economic growth slowed in the third quarter, led by investment. GDP growth slowed to 10.4 percent in the third quarter, from 11.3 percent in the second quarter, after tightening measures reduced investment growth. Exports continue to outpace imports by a large margin, so slowing domestic demand was partly offset by rising contributions of trade to GDP growth, while the current account surplus reached new highs.

Macroeconomic prospects remain favorable for growth. Prospects for a soft landing of the world economy remain good, although risks remain, including from a sharper than expected slowdown in the US economy and disorderly resolution of global imbalances. China is relatively well-placed to deal with a mild global slowdown, which would tone down overall activity and reduce the current account surplus. Domestically, underlying conditions remain favorable to continued rapid growth. Upside risks remain as investment growth may rebound with abundant liquidity in the banking system and higher profit growth.

With supply growing broadly in line with demand, the main short term macro imbalance is the external one. Policymakers remain concerned about overinvestment that triggered the mid-year tightening measures. But the main short term macro imbalance is an external one: the surging trade surplus. The lower investment growth that the authorities aim for, which is desirable for efficiency reasons, could aggravate the external imbalance if achieved without more consumption growth. These considerations put a premium on measures to boost consumption alongside those already taken to reduce investment growth.

Continuing mopping up liquidity remains necessary. Although macroeconomic risks appear manageable, financial risks remain, and excessive credit expansion may lead to problems down the road. Abundant bank liquidity is at the core of rapid credit growth. The apparent receding of non-FDI inflows implies more room for monetary policy tightening, although these flows cannot be counted out. In addition to the liquidity creation stemming from foreign exchange purchases, structural changes are boosting M2 growth and may require additional central bank efforts while in the short run liquidity will also be boosted by higher government spending in the fourth quarter. The current policy of some exchange rate flexibility around an appreciating trend can bring about desirable expenditure switching and create welcome two-way risk that discourages speculative capital inflows.

China's key economic challenge is to rebalance the economy. The concerns about high investment and the pattern of growth have to be addressed by structural reforms. The underlying causes of high investment can be tackled through better pricing of energy, resources, land, and environmental damage; higher interest rates; limiting retained earnings by an SOE dividend policy; and moderating local government incentives to pursue growth. Rebalancing the economy means a shift in production from industry towards services, more reliance on domestic demand, more equally shared growth and more environmentally sustainable growth. Besides being desirable in their own right, measures that support rebalancing are also likely to address the surging trade surplus, China's main short term macro challenge.

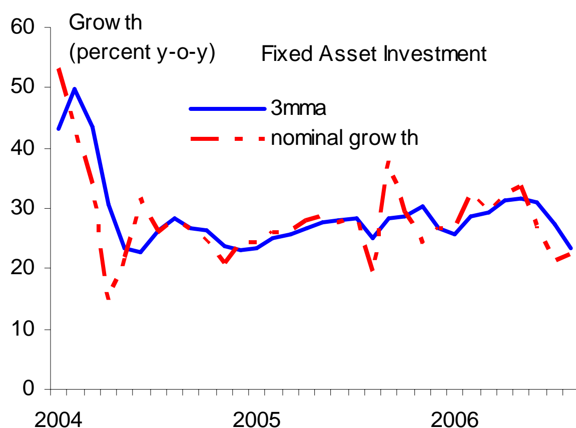
RECENT ECONOMIC DEVELOPMENTS

Economic growth slowed in the third quarter, led by investment. GDP growth eased to 10.4 percent from 11.3 percent in the second quarter, following a range of tightening measures introduced mid-year to reduce investment growth.[1] Nominal urban fixed asset investment (FAI) growth came down from 31 percent in the first half to 24 percent in the third quarter (Figure 1).

The slowdown in domestic demand was partly offset by a further increase in the contribution of trade to growth. As exports continued to outpace imports by a large margin, the contribution of net trade to GDP growth increased to almost 3 percentage points, after 1.2 percentage point in Q1 and 2.4 percentage points in Q2 (Figure 2). Consumption remained the most stable demand component, growing robustly but still lagging investment.

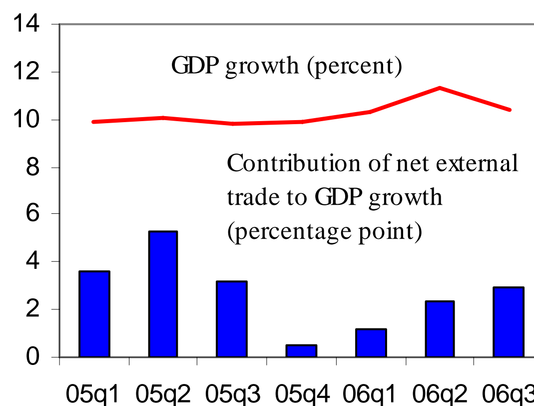
The investment-centered slowdown in domestic demand was reflected in industrial output developments. The secondary sector's value added growth slowed to 12.6 percent in the third quarter, down from 13.8 percent in the second, but still higher than overall GDP growth. Value added growth in the service sector picked up to 9.7 percent in the second quarter, while value added in agriculture remained subdued.

Figure 1. Investment growth moderates



Source: NBS, staff calculation.

Figure 2. Trade's contribution to growth rises



Source: NBS, staff calculation.

Monthly data suggests that investment and industrial activity have not undergone a drastic slowdown. As the tightening measures—particularly the reinforcement of regulations on investment projects and the outright suspension of some projects—sorted effect, lower growth of investment in new projects from July onwards contributed to the slowdown in total FAI. Nominal urban FAI growth declined from 30 percent in the first seven months to 21.5 percent in August, but rose to 23.7 percent in September. Similarly, real growth of industrial value-added fell from its peak of 19.5 percent in June to 16.7

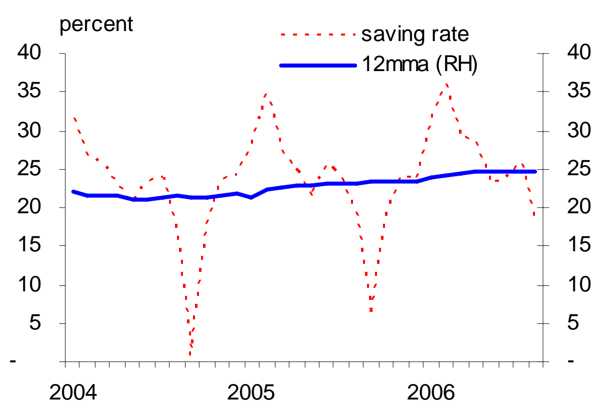
[1] The August Quarterly Update discusses these measures on pages 12 and 13.

percent in July and further to 15.7 percent in August before edging up to 16.1 percent in September (all yoy).[2] The pick-up seems to suggest that there is no need to fear a drastic slowdown in domestic demand, although it is too early to say from one month of data whether the September data indicates a rebound. FAI in real estate, a sector that has attracted a lot of attention and was the target of specific policy measures to slow investment, has somewhat surprisingly remained robust in the third quarter, with growth inching down from 24.2 percent in the first half of 2006 to 23.5 percent in July-August (yoy).

The relationship of the FAI data with the national accounts data on investment is tenuous. In the absence of timely data on inventory and land transactions, it is hard to assess on the basis of FAI data the current pace of national accounts-type investment. A comparison of FAI data and national accounts data for recent years (Box 1) suggests that internationally-comparable investment has indeed grown rapidly in recent years, but far less rapidly than would appear from the FAI data. Moreover, this comparison suggests that investment has probably continued to increase as a share of GDP in the first half of 2006, but not nearly as much as would appear from the FAI data.

Consumption growth remained robust, but lagged behind investment. Fueled by still rapid wage increases, real urban per capita disposable income increased by 10 percent in the first three quarters of 2006 (yoy). Household survey data (from the 36 cities survey) suggests that the urban household saving rate edged up in 2006 (Figure 3), keeping consumption growth somewhat below income growth: per capita urban consumption grew 8.4 percent (yoy) in the first half.[3] Rural incomes are boosted by rapid overall economic growth, including through remittances by migrants, although growth in agriculture, which naturally lags behind the other sectors, constrains rural income growth. Real per capita rural cash income rose 11.4 percent (yoy) in the first three quarters, with real per capita rural cash expenditure growth a bit slower at 9.3 percent (yoy) in the first half of 2006. Real retail sales, also an imperfect proxy for consumption, grew 13 percent in the third quarter.

Figure 3. The urban household saving rate edges up *



Source: NBS, and staff calculations.
* Estimated with household survey data on income and "living expenditure" instead of national accounts data.

[2] The monthly data on industrial value added implies different quarterly average than the quarterly data show because of different coverage (the monthly data covers only larger enterprises).

[3] The national accounts show lower consumption growth than the household survey. In 2003-05, nominal consumption growth was 2-4 percentage point lower than the total implied by the household surveys.

Box 1. How to relate the FAI data to the national account data on investment?

Recently released national accounts data helps assessing the more timely FAI data. Estimates of national accounts type investment using recently released expenditure side GDP data shows a broadly similar trend for investment growth, but at very different levels of growth rates.[1/] Investment growth has been strong in recent years, with a further acceleration in 2005.

The national accounts data indicates some important caveats in interpreting the FAI data. First, nominal FAI has grown significantly faster than internationally-comparable gross fixed capital formation (GFCF). This is so especially for the "headline" urban FAI data. This is in large part because of difference in coverage and concepts. The monthly FAI series cover only large urban enterprises, while the national accounts data covers all enterprises. Moreover, the FAI data include spending on land transactions, which does not lead to capital formation. Second, the national accounts deflator has risen more rapidly than the "headline" FAI deflator. Together, the difference in growth rates adds up to some 10 percentage points: real GFCF grew by almost 15 percent in 2005, compared to estimated real urban FAI growth of more than 25 percent. Another interesting point is that total gross capital formation (GCF) rose significantly less rapid than GFCF in 2005, because the build-up of inventories was much lower in 2005 than in 2004. More generally, the fact that investment in inventories is not included in the FAI data results in another difference between FAI and GCF. According to the national accounts data, total GCF grew only slightly faster than GDP in 2005, and the difference with real total FAI growth (from the quarterly data) was almost 13 percentage points.

More timely estimates are needed on capital formation. With judgments on the speed of investment growth central to policymaking, the current gap between the FAI data and the national accounts data on investment hampers policymaking.

Table. Data on investment (growth, in percent)

	2004	2005	2006	
			Jan-Jun	Jul-Sep
FAI, quarterly data				
current prices	25.8	25.7	29.8	23.8
constant prices	19.1	23.7	28.6	
deflator	5.6	1.6	0.9	
Urban FAI, monthly data				
current prices	27.6	27.2	31.3	24.2
Gross fixed capital formation 1/				
current prices	21.7	19.0		
constant prices	11.6	14.8		
deflator	9.1	3.6		
Gross capital formation 1/				
current prices	23.6	15.0		
constant prices	13.4	10.9		
deflator	9.0	3.7		

Source: National Bureau of Statistics and staff estimates.
1/ National accounts

1/ The 2006 Statistical Yearbook (table 3-13) contains data on the contribution to GDP growth of different expenditure components in constant prices.

The trade surplus continued to increase as exports continued to outpace imports. Merchandise exports and imports grew by 29 percent and 22 percent (yoy, in dollar terms) in the third quarter, and the gap widened further in October, when import growth declined to 15 percent while export growth continued full speed ahead at 30 percent. Part of the export strength stems from new production capacity resulting from heavy investment in previous years, particularly in sectors such as steel and machinery. Heavy investment in steel plants turned China from being a net steel importer into a net exporter. In addition, in recent months, the policy-induced investment slowdown has amplified the trade surplus by reducing imports and diverting some production to export markets. In all, the trade surplus reached a record US$ 49 billion in the third quarter, up from US$ 29 billion in the third quarter of 2005, while the October surplus was double that of a year ago (Figure 4).

The export structure continues to evolve in several dimensions. China's exports become more diversified geographically. While North America and EU remain China's main export destinations, exports to Latin America, Africa and Eastern Europe are rising more rapidly. Total exports to the traditional three key destinations (US, EU and Japan) grew by 20 percent in January-August 2006 (yoy), while the exports to the rest of the world expanded by 32 percent. If continued, this diversification can reduce the exposure to downturns in particular markets, including the US. Further, ordinary trade has continued to outpace processing trade, with export-oriented enterprises increasing their local sourcing.

Buoyant foreign direct investment (FDI) added to the balance of payment surpluses. The State Administration of Foreign Exchange (SAFE) reported a 42 percent increase (yoy) in inward FDI to $37 billion in the first half of 2006 (Table 1). Inward FDI recorded by the Ministry of Commerce (MOFCOM) for the same period inched down by 0.5 percent. The large discrepancy between the two data sources seems in part a result of China's increased economic and financial integration with the rest of the World. The SAFE data seems to have been boosted by cross-border transactions between subsidiaries of MNCs across borders which may not all be included in MOFCOM's statistics.

Non-FDI capital inflows appear to have receded. This trend appears to have started since the change in the exchange rate regime in July 2005 (Figure 5).[4] From the second quarter of 2006 onwards, estimated non-FDI flows have turned into a net outflow. This observation is broadly consistent with the balance of payments data, which show a net outflow of $0.5 billion in the first half of 2006 compared to a net inflow of $10.7 billion in the same period of last year. Much of this turn-around in non-FDI flows appears to

Table 1. Balance of payments (US$ bln)

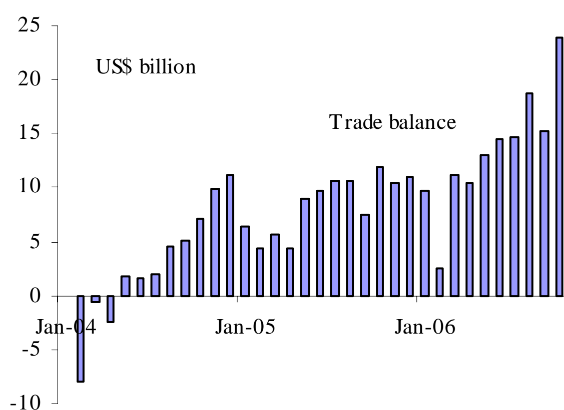
	2005H1	2006H1
Current account balance	67.3	91.6
o/w. trade balance	50.3	74.3
Capital and financial account[1]	33.2	30.5
Direct Investment	22.5	31
o/w. FDI in China	26.4	37.3
Portfolio investment	-1	-29.2
Other investment[1]	9.5	26.8
Overall Balance	-100.5	-122.1

source: SAFE
1/ Including errors and omissions

[4] We estimate monthly non-FDI flows by deducting the trade surplus, FDI, returns to reserves and, following Brad Setser of RGE, reserve assets valuation changes from the increase in foreign exchange reserves.

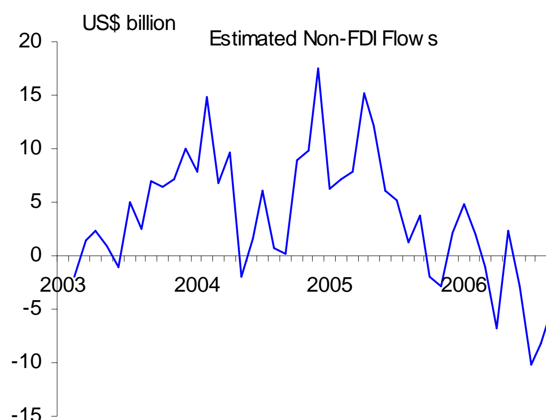
have been led by domestic financial institutions, which some argue was done at the request of the monetary authorities. According to SAFE, Chinese individuals and institutions bought $45 billion in foreign notes and bonds in the first half of 2006. Up to one third of this was likely done with funds collected from IPOs. The remainder is likely to be largely due to the second Qualified Domestic Investor Initiative (QDII) introduced in April 2006, which granted banks more leeway in investing in international capital markets on their own account. The jump in the monthly increase in banks' net foreign assets to RMB 400 billion in June from an average RMB 136 billion in the previous 4 months suggests that banks are using this leeway. Meanwhile, capital inflows through trade credit were much lower than in previous years, which is likely to be partly a result of diminished expectations of a sharp RMB appreciation. The authorities also made some progress in liberalizing individuals' overseas investment under the QDII mechanism, although QDII are only allowed to invest in overseas fixed income products, which at the moment are not very attractive because the yield differential with domestic instruments may not compensate for expected appreciation of the RMB. By end September, the approved QDII quota for individuals' investment totaled US$11 billion, but only a few billion was used.

Figure 4. The trade surplus continues to increase



Source: NBS, staff calculation.

Figure 5. Non-FDI flows recede



Source: NBS, staff calculation.

With China's foreign reserves around US$ 1 trillion, a lively debate has emerged on how to invest or "use" them better. With net non-FDI capital flows apparently substantially negative in the third quarter, the increase in foreign exchange reserves (US$47 billion) was lower than the trade surplus. With China's reserves at US$ 988 billion in end-September, many proposals have been made on using them differently, including capitalizing the social pension fund; cleaning up banks and restructuring SOEs; spending on infrastructure development; building up an oil reserve; and investing in higher-yield instruments such as stock, derivatives and private equity.[5] Senior central bank officials recently spoke out against using foreign reserves to capitalize the pension funds or to build a national oil reserve, but argued at the same time that Huijin, which was capitalized by

[5] Jonathan Anderson, January 2006, "How to Spend a Trillion", UBS Investment Research

using foreign exchange reserves, could be turned into an investment company similar to Singapore's Temasek.

Inflationary pressures in the goods market remain low, despite higher raw material prices. Producer prices are under upward pressure from hefty increases in international raw material prices, including non-ferrous metals like nickel and copper. Raw material (including fuel) price inflation was 6.9 percent in September (yoy). However, Chinese firms have generally been able to absorb the impact of rising raw material prices because of rapid labor productivity gains. With labor productivity in industry outpacing wage growth, wage costs have declined as a ratio of total value added, leaving a larger share for companies' profits. These productivity increases have kept margins intact and profit growth high in recent years even though producer ("factory gate") and consumer price increases have been significantly lower than raw material price increases.[6] PPI and CPI inflation were 3.5 and 1.5 percent (yoy) in September. After reaching record levels earlier this year, international oil prices fell to less than $60 per barrel in September. This will not have much immediate impact on local fuel prices, because these administratively controlled prices had not been raised in response to the higher prices. However, continued declines in international oil prices may set the stage for introducing a fuel tax—which could be introduced when international prices dip below domestic ones.

Asset prices have risen significantly. As in other countries, in part this has been because of easy financing and abundant liquidity. Moreover, in 2006, progress in equity market reforms, especially in reducing the overhang of non-tradable shares, has boosted stock prices. Housing price rises continue to elicit concerns. While official data suggests they are moderate, overall, compared to urban income growth and real estate price rises in other countries (residential property prices rose by 6.4 percent in China in the first half of 2006), there are concerns about the data and many believe actual price rises are significantly higher. Concerns about the affordability of housing to lower and middle income have put the role of the government in housing finance on the agenda. The Financial Sector Developments and Policies section below discusses housing finance issues.

ECONOMIC PROSPECTS AND POLICIES

Economic prospects

Prospects for a soft landing of the world economy remain in sight. On the international financial markets, volatility and interest rates have come down after turbulence earlier this year, as oil prices have receded from earlier highs. These conditions may moderate the anticipated cyclical slowdown in the world economy led by an anticipated US slowdown (Table 2). While prospects for a soft landing remain good, risks of a sharper correction also remain. The world economy benefits from recent vigor in Europe and Asia, where growth appears to have become less export-dependent and more led by domestic demand. However, Europe, Japan, and the rest of the world including China will be affected by the

[6] A more detailed discussion on corporate profitability trends is included in "A Note on Saving, Investment, and Profits of China's Enterprises", on www.worldbank.org/china, under "What's New".

slowdown in the US that seems increasingly in the making, and it remains to be seen how vigorous the world economy can grow without the US as an engine. An orderly soft landing in the US would mean lower inflation and interest rates in the US, and thus be good for financial stability around the world.

However, there are several global risks. On the economic front, disorderly adjustment of the still large "global imbalances"—large current account deficits in some countries, including the US, and large surpluses, including China and oil producer countries—remains a key risk. Other risk factors include a sharper-than-expected slowdown in the US. Additional risks stems from the possible escalation of several geo-political conflicts. Materialization of these risks may lead to financial turmoil and exchange rate volatility, tighter monetary conditions and higher world interest rates, and lower global growth.

Table 2. Global conditions remain favorable.

(change, in percent)

	2005	2006f	2007f
World GDP 1/	3.5	3.9	3.3
United States	3.2	3.3	2.4
Euro zone	1.4	2.3	1.9
Japan	2.6	2.9	2.4

Source: World Bank, GEP (October 2006).
1/ At market exchange rates.

Prospects for the Chinese economy remain robust. Looking ahead, underlying domestic economic conditions remain favorable to rapid growth. With profitability largely still good, profit growth picking up to 30 percent in the first 3 quarters of 2006 (yoy), and still ample liquidity in the banking system, the fundamental drivers of enterprise investment growth are still present. Government-led investment in "bottleneck" infrastructure, including transport and energy, is also likely to remain buoyant. The measures aimed at bringing down investment growth have already shown significant impact. But the September data indicate that it is not likely for investment growth to decline drastically. Consumption should continue to benefit from rising incomes, particularly in urban areas. Taken together, we expect domestic demand growth in the fourth quarter of 2006 and into 2007 not to be materially lower than in the third quarter, and maybe higher.

Economic growth is likely to continue to ease somewhat in the rest of 2006 and early 2007. We eventually expect a decline in the contribution of net trade to growth from its very high level in the third quarter. The anticipated slowdown in the world economy is likely to affect Chinese exports, as will some appreciation, reductions in tax rebates (including for coal, steel, and non-ferrous metals), and introduction of some export taxes. Import growth may come under further downward pressure from continuing import substitution and the investment slowdown. On balance, we expect the contribution of net trade to growth to remain significant but to eventually diminish. Overall, our scenario includes a slight slowdown in GDP growth to just under 10 percent at the end of 2006, resulting in growth of 10.4 percent for the year as a whole, and 9.6 percent in 2007 (Table 3).[7] Inflation should remain subdued. We expect the current account surplus to level off in 2007, after reaching a record 8-9 percent of GDP in 2006.

[7] Our GDP growth forecast is broadly similar to recent forecasts from the Chinese Academy of Social Science and the State Information Council.

Table 3. China: Main Economic Indicators

	2003	2004	2005	2006 1/	2007 1/
The real economy (change in percent)					
Real GDP (production side)	10.0	10.1	10.2	10.4	9.6
Real GDP (expenditure side) 2/	10.5	9.9	12.1	…	…
Consumption 2/	6.6	7.1	8.3	…	…
Gross capital formation 2/	17.2	13.4	10.9	…	…
Fixed capital formation	17.0	11.6	14.8	…	…
Exports (goods and services) 3/	26.8	28.4	24.8	21.3	15.5
Imports (goods and services) 3/	24.9	22.7	12.8	13.6	18.7
Consumer prices (period average)	1.2	3.9	1.8	1.7	2.1
GDP deflator	2.6	6.9	3.8	4.3	2.7
Fiscal accounts (percent of GDP) 4/					
Fiscal balance	-2.2	-1.3	-1.2	-1.0	-0.7
Total revenue	16.2	16.6	17.8	17.4	14.9
Total expenditure	18.3	18.0	19.0	15.2	13.3
External account (US$ billions)					
Current account balance	46	69	161	222	228
As share of GDP (%)	2.8	3.6	7.1	8.5	7.5
Capital account balance (including errors & ommissions)	71	138	47	55	22
of which: FDI (net)	47	53	68	65	52
Change in reserves (increase =+)	117	206	207	227	250
Foreign exchange reserves	403	610	819	1099	1349
Other					
Broad money growth (M2), e-o-p, in percent	19.6	14.6	17.6	16.0	15.0

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

1/ Projection.

2/ Estimations are based on the newly released national account data (Table 3-13 in China Statistical Yearbook 2006).

3/ Estimates based on trade deflators for goods published by the Custom Administration.

4/ GFS basis; central and local governments, including all official external borrowing. The data are not adjusted for accumulation of arrears in tax rebates to exporters during 2000-2002, and the repayment of these arrears in 2004 and 2005. Such an adjustment would increase the deficit in 2000-02 and lower it in 2004-05.

Economic policies

Short-term internal macro challenges remain manageable. Policymakers' concerns about too rapid investment growth have not been fully alleviated. However, with tightening measures still in effect and after the observed slowdown in the third quarter, these concerns should have diminished from 3 months ago. Moreover, although growth is rapid, as before there are no signs that overall demand is running way ahead of overall capacity, which suggests there is no sign of a significant internal short-term macro

imbalance. The main short-term macro imbalance is an external one: the surging trade surplus. The lower investment growth that the authorities aim for, that is desirable for efficiency reasons, could aggravate the external imbalance if achieved without more consumption growth. These considerations put a premium on measures to boost consumption alongside those already taken to reduce investment. Irrespective, the favorable short-term macro situation should allow policy makers to devote more attention to China's major structural and long-term challenges and the policies to address them.

Structural issues remain prominent. China's key economic problems are structural in nature, and the main challenge is to rebalance the economy. The legitimate concerns about too rapid investment growth, its consequences for efficiency, and the pattern of growth have to be addressed by structural reforms. In particular, containing investment growth sustainably calls for policies addressing the underlying causes of unwelcome investment: underpricing of energy, resources, land, and the environment, low interest rates, large retained earnings of some SOEs, and local government incentives. The broader long-term challenge of rebalancing the economy and striving for a harmonious society has been put firmer on the government's agenda during the 6th plenum of the Communist Party of China (CPC) central committee in October. It means a shift in production from industry towards services, more reliance on domestic demand, more equally shared growth and more environmentally sustainable growth. Besides being desirable in their own right, measures that support rebalancing are also likely to address the surging trade surplus, China's main short term macro challenge.

MACRO MANAGEMENT

New macro tightening measures—beyond the ones already in place—seem unwarranted. The mid-year tightening measures appear to have led to a slowdown in investment, M2, and credit in the third quarter. The concerns that triggered the measures—too rapid investment growth, overcapacity and "overheating" of certain sectors, including real estate, a too relaxed monetary stance, and the potential for non-performing loans—have not fully been alleviated. That is why the State Council has stressed the need to hold on to the controls on land and credit and why, perhaps in response to the tentative rebound in FAI growth in September, investigation missions were sent by the central authorities to 12 provinces to ensure adherence of newly started projects to regulations and standards.[8] However, the concerns are lower now than 3 months ago. At the same time, the surging trade surplus, which is complicating monetary policy and leading to trade tension with trade partners, cannot be ignored, and lower investment growth without more consumption growth would result in even higher surpluses. These considerations seem to make significant new macro tightening measures—over and above the ones in place—undesirable, if not flanked by measures to boost consumption. The current measures

[8] A State Council meeting on October 18 chaired by Premier Wen Jiabao noted that it was still too early to conclude that the investment slowdown had already become a trend and that, as a result, curbs on credit and land supply will stay in place for the rest of the year.

include mopping up liquidity in the banking system, and actively mopping up liquidity remains of course essential.

Supply is keeping up with demand in China's economy—instead, China's problems are structural. China's rapid growth in demand is matched by a rapid expansion of the capacity to produce. As a result, China does not experience the problems usually associated with excess demand: high inflation, high current account deficits, and widespread bottlenecks in the economy.[9] China's economic problems are structural in nature. The legitimate concerns about the pace and efficiency of investment and the pattern of growth have to be addressed by structural reforms.

Changes in circumstances may require an adjustment of the policy stance. Looking ahead, if the external environment, and notably the US economy, deteriorates, China would have sufficient macroeconomic stability and fiscal flexibility to boost domestic demand when needed. In fact, in China's circumstances, a US slowdown may be helpful. It would tone down overall activity and reduce the external imbalance at the same time, although the downside would be that lower US interest rates that would follow a weaker US economy reduce the perceived room to increase interest rates in China.

Better quality and more transparent economic statistics are needed. The frequently published FAI data are not a good proxy for true investment that comes out with a lag. A similar problem pertains to consumption data. This puts policymakers, who are concerned about the development of investment as well as people's living standards, at risk of being put on the wrong foot because of misleading information. Thus, improving the relationship between timely indicators and underlying variables would greatly benefit policymaking.

Monetary and exchange rate policy

Monetary expansion has slowed but bank liquidity remains high. Between end-April and August, the authorities introduced a range of policies, including moral suasion, increases in reserve requirements and interest rates, and sterilization to contain investment and credit growth. In response to the tightening measures, the pace of M2 and credit growth slowed. M2 growth eased from over 19 percent in May (yoy) to less than 17 percent in September (Figure 6). Credit growth declined by from 15.5 percent in August to 14.6 percent in September (yoy). Despite significant liquidity absorption, net liquidity creation remained significant, adding further to the ample liquidity in the banking system that is at the core of rapid credit growth. As a result, the excess reserve ratio remained high[10] and the 1-week inter-bank market interest rate fell from 2.5 percent in August to 2.3 by end-September. Following another rise in reserve requirement ratio in early November,

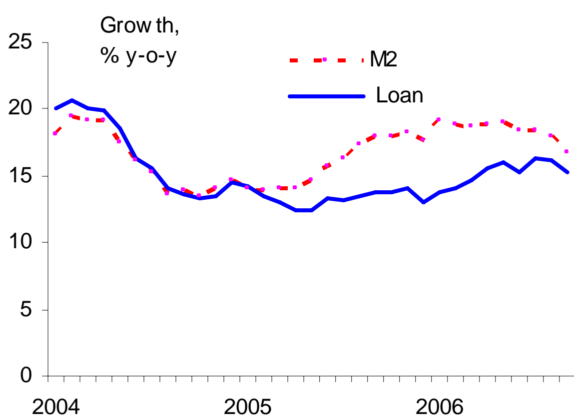
[9] Traditionally, economists call an economy *overheated* if, from the short-term macro perspective, supply cannot keep up with demand. In China the term overheating is often used to describe different things, including too rapid investment and overcapacity.

[10] Our estimate based on data from reported in the IMF's *International Finance Statistics* is that bank reserves at the central bank were some 13 percent of deposits at end-June. This implies excess reserves of some 5.5 percent of deposits. Market participants often quote lower data, which may be due to different definitions and data sources used.

continuing mopping up liquidity remains necessary for the central bank. This is important because, even if the real economy concerns seem manageable, financial risks remain, especially in real estate, and excessive credit expansion may lead to problems down the road.

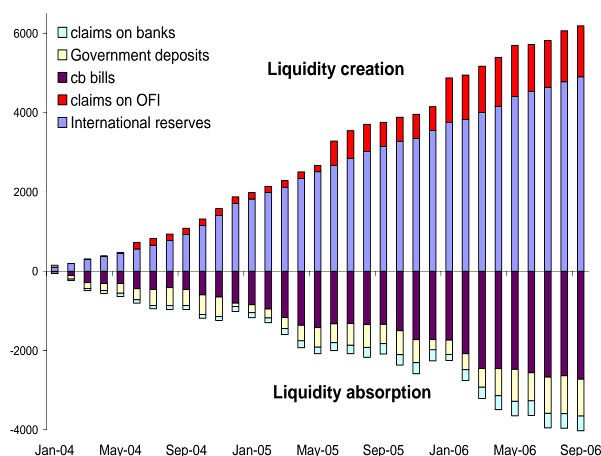
Structural changes boosting M2 growth may need to be countered by the central bank. Reserve money growth has trended down from a peak of more than 18 percent in mid-2004 to 9-10 percent (yoy) now, as large sterilization operations, the build-up of government deposits, and to a lesser extent lower central bank loans to banks partly offset the impact of the bulging foreign exchange increases and the increased liquidity resulting from central bank lending to non-bank financial institutions (Figure 7).[11] However, M2 growth has been much higher than reserve money growth, because innovations in the payments system and a change in bank and household behavior have driven up the money multiplier (Box 2). In the short term, the central bank will likely need to step up bonds issuance just to contain reserve money. The reason is government spending, which always picks up at the end of the year and which will drive down government deposits. In the longer run, the central bank may need to step up its efforts even more, not just because of the balance of payment surpluses, but also because the structural changes that are driving up M2 growth are, in light of international experience, likely to continue for quite some time.

Figure 6. Monetary expansion slows



Source: NBS, staff calculation.

Figure 7. Liquidity creation exceeds absorption
(Cumulative since 2004Q1, RMB bln)



Source: NBS, staff calculation.

[11] Lending to financial institutions by the central bank is a bit of a puzzle. Loans outstanding to banks have been clearly on the decline since the start of the decade, but in recent years lending to non-bank financial institutions has rapidly increased. In part this likely reflects central bank bailouts of various financial institutions such as trust companies and securities firms. In part this may also reflect central bank lending for social policies such as grain procurement. And the increase could also be partially ascribed to accounting changes on the balance sheet. Irrespective, the increase is large enough to note, and to potentially have a significant effect on base money growth, even if not all lending to financial institutions leads to reserve money increases.

Why is M2 growing so much faster than reserve money?

The short answer is that the money multiplier has been increasing steadily over the last decade or so (Figure 1). Why has that happened? It seems to be a combination of innovations in the payments system and more commercial operations of the banks. The money multiplier increases if people prefer to hold deposits rather than cash, and if the banks hold a lower share of deposits in reserves at the central bank.[1/]

Over the last decade, Chinese people and enterprises have held an increasing share of broad money in the form of deposits rather than cash (Figure 2). This may have been because of better banking services such as debit and credit cards, because they get higher returns on deposits (for most of the 1990s real interest rates on deposits were negative), or because they are saving towards down payment of larger expenditures such as housing, or save more for retirement. Irrespective, the ratio of currency over deposits *halved* over the last decade (Figure 2), implying that more of the currency issued by the central bank ends up in deposits, and becomes available for credit.

Banks are also more likely to lend the deposits they receive. The share of deposits held at the central bank dropped from some 20 percent on average in the mid-1990s to less than 10 at end-2003, only to bounce back under the influence of "window guidance" which compelled the banks to lend less than they could. Again, a better payment system may have played a role: as interbank clearing could take several days in the 1990s, holding more reserves at the central bank was a necessity for meeting a bank's obligation in the interbank market. With more efficient clearance, less excess reserves are needed. Banks may also be more commercially minded—keen to lend out any deposit they get in. And finally, lending pays more now than it did in the past: the spread between what a bank earns on holding excess reserves in the central bank and what it minimally earns on loans has steadily increased since the 1990s.

Taken together, China's economy gets "more M2 out of every RMB" in reserve money issued by the central bank. It may also mean that, if these trends persist, the central bank will have to absorb more liquidity than before in order to get the same effect on M2 growth. International experience suggests that this trend is indeed likely to persist (Figure 3): as countries grow, the money multiplier tends to increase to levels well beyond where China's multiplier is right now.

Figure 1: Reserve money, M2,and money multiplier

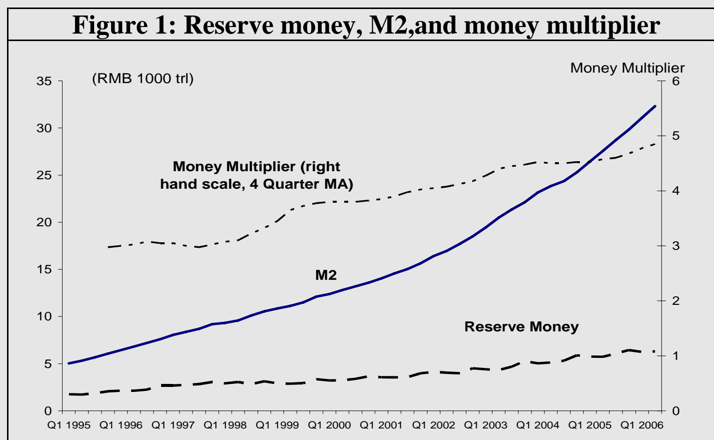


Figure 2: Currency and reserves over deposits

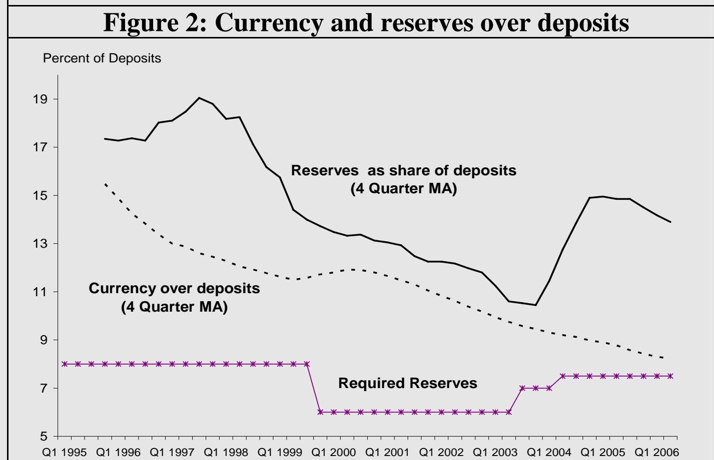
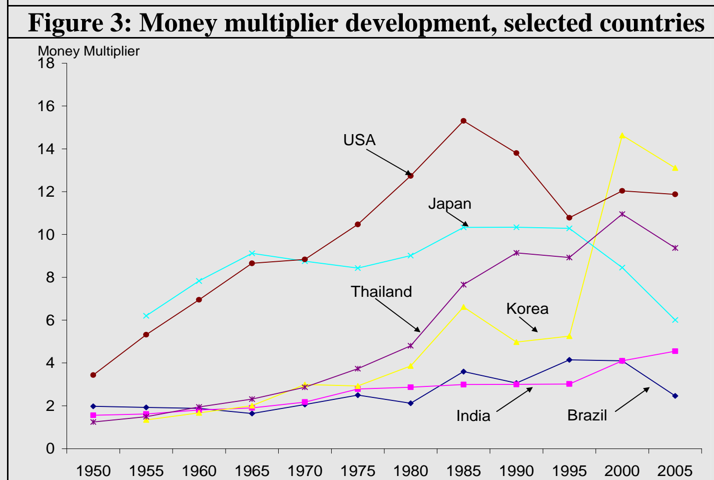


Figure 3: Money multiplier development, selected countries



Source: International Financial Statistics, IMF, and staff calculations.

[1/] Formally, M={(1+*cd*)/(*rd*+*cd*)}*H, where M is M2, *cd* is the ratio of cash over deposits, and *rd* is the reserve ratio.

Lower non-FDI inflows would increase leeway for monetary policy. With concerns about them easing among the authorities, the traditional constraint on domestic monetary policy stemming from the foreign exchange market considerations—higher interest rates would attract more unwelcome non-FDI inflows—has eased somewhat. The apparent reduction in non-FDI flows may in part be because of the recent gradual appreciation of the RMB against the US dollar, which takes some wind out of the expectations for a further sharp appreciation of the currency. And it may have resulted from the way in which the exchange rate appreciated—with higher volatility around an appreciating trend.[12] Thus, that part of capital inflows that was looking for a "quick win" is likely to have been disappointed. This also means there is more room for mopping up liquidity and higher inter-bank interest rates, if needed. However, the factors underlying the apparent decline are not well-understood, and such inflows cannot be counted out.

A stronger exchange rate helps bring about desirable *expenditure switching*. RMB appreciation against the dollar accelerated somewhat in the third quarter, to 1.1 percent. This brings the total appreciation against the dollar since the 2.1 percent appreciation against the dollar in July 2005 to 2.5 percent. However, this appreciation has been by and large offset by the dollar's depreciation against other major currencies. A stronger exchange rate could dampen domestic growth and addresses the current account surplus at the same time, although exchange rate adjustments by themselves will not be enough to permanently lower the current account surplus since price elasticities of trade are generally found to be fairly low, for China as well as in the rest of the world. In addition, however, a stronger exchange rate would also raise the attractiveness of investing in the non-tradables sector, thus helping rebalancing of the economy. Moreover, a stronger exchange rate would, by lowering expected further appreciation, likely mitigate capital inflows. Finally, more exchange rate flexibility would, by generating two-way risk with regard to exchange rate changes, discourage non-FDI inflows.

Fiscal policy

Fiscal policy is mildly contractionary. So far in 2006, fiscal revenue has outpaced expenditure to a considerable extent, and both have outpaced budgetary targets by a wide margin. Tax revenue rose 23 percent (yoy) in the first eight months of 2006 (yoy), while expenditures increased 16 percent (yoy) in this period. This compares with planned increases of 11.7 percent in revenues and 9.7 percent in expenditures for the year as a whole. On current trends, the fiscal deficit for 2006 would further narrow substantially from last year's 1.2 percent of GDP, implying that fiscal policy is withdrawing stimulus from the economy. While this is consistent with the announced "prudent" fiscal policy, current circumstances provide no clear case for tighter fiscal policy. Tighter fiscal policy reduces domestic demand, but our analysis suggests it is not obvious that domestic demand is currently too high compared to supply. At the same time, tighter fiscal policy tends to increase the current account surplus, which is currently not desirable.

[12] The standard deviation of the daily rate change rose from 0.06 percent in the second quarter to 0.09 percent in the third. The rate once approached the 0.3 percent band in August, which sparked market expectation that the central bank might widen the band.

The composition of budget spending shows modest results on the rebalancing agenda. The modest growth in "capital construction" (10 percent) and pick up in social security spending (the sum of "pensions, social and relief funds" and "subsidies to social security"; 23 percent) in the first 8 months of 2006 are in line with the government's aim to shift the composition of spending "from physical infrastructure to social infrastructure". However, below average growth in spending on "culture, education and health" (14 percent) is not. Growth in spending on "science and technology promotion" (10 percent—against a planned 19 percent increase) was also below average, despite the objective to support upgrading of the production structure.

REBALANCING THE ECONOMY

The longer-term structural challenge remains how to rebalance the economy. The communiqué of the sixth Plenum of the 16th CPC Central Committee held during October 8-11 confirmed that rebalancing the economy and striving to a harmonious society have now firmly become key economic policy objectives. While the communiqué stated that rapid economic growth remains important, it also confirmed the objective of improving the quality of economic growth, rebalancing the growth pattern, and striving to a harmonious society.

During the October plenum, the objective of a harmonious society was concreticized with targets for 2020. These targets include: narrowing the urban-rural and regional development gaps; improving the income distribution; increasing employment; establishing a social safety network covering both urban and rural regions; increasing the quality and quantity of public goods and services; strengthening the innovation capacity; enhancing the efficiency of resource utilization and improving the environment; and achieving a well-off society. Fiscal policy is likely to play a key role in meeting these targets, with more spending on health, education, social security, and innovation promotion.

In terms of the overall economic strategy, rebalancing means a shift in the pattern of growth. This shift means, on the production side, more growth of the services sector instead of industry and, on the demand side, a larger role for consumption instead of investment and exports. Such a shift in the economic structure would address many concerns. It would make growth less intensive in energy, raw materials, and resources, and less tough on the environment. It would also make growth less capital intensive, allowing China to grow with lower saving. Moreover, it would mean more labor intensive growth, with more urban employment creation. Urban job creation is the key to reducing excess labor in agriculture and the related poverty and urban-rural inequality. Finally, it would ameliorate the pressures for overproduction of goods and current account surpluses.

Broadly, 5 types of policies would help rebalancing. In many of these areas, policy plans and/or proposals are in the pipeline. That does not guarantee that they will be introduced soon, as it is difficult to implement policies with short-term costs to segments of the population. International experience suggests that an opportunistic approach can be

effective, packaging unpopular but necessary measures with popular measures or favorable developments.

First, several macroeconomic measures—largely fiscal—to stimulate domestic consumption, reduce saving, and stimulate the services sector:

- Shifting government spending from investment to health, education, and social safety. The government plans to raise the ratio of fiscal spending on education to GDP to 4 percent. Specific policies include the central government's commitment on funding to gradually ensure free 9 years compulsory education in rural areas. In health, the government decided in October to reform medical insurance to ensure access to *primary* health care for everyone, including rural people, before embarking on the more complex overhaul of the health system.

- Speed up financial market opening and reform, to improve the efficiency of the allocation of capital—thus keeping growth up with less investment—and increase the role of consumption. In end-2006, China's banking sector will open up to foreign competition.

- Establish a dividend policy for State Owned Enterprises (SOEs) and improve corporate governance, to remove an over-investment bias. Discussions on an SOE dividend policy are underway.

Second, several price and tax measures would help rebalancing by readjusting the relative attractiveness of manufacturing production (tradables) over producing services (non tradables):

- Increasingly allow the exchange rate to move in response to underlying pressures, which at moment imply an appreciation;

- Adjust the price of inputs into manufacturing—including land, energy, water, utilities, natural resources, and the environment—getting them in line with relative scarcities and social preferences. In the area of energy, China has in recent decades had major success with using price increases to improve energy efficiency. Looking ahead, the resolution of the October plenum notes that "industrial policies, fiscal and taxation policies and pricing policies shall be amended to encourage environmental protection." At the technical level, plans to introduce a fuel tax are much-advanced. Falling prices on international markets make this more feasible. Reduction of VAT export rebates for energy intensive products such as steel and aluminum and the recently implemented export taxes on energy and resource-intensive products supports rebalancing by making investing in such industries less attractive. At the same time, these measures bring new distortions, and, unlike an excise tax, leave production of energy-intensive goods for the domestic market unaffected.

- Remove distortions in the tax system subsidizing and stimulating manufacturing, including from the VAT system and preferential tax treatment of FDI, notably on corporate taxes, and the VAT system. Concrete examples include the long expected unification of corporate tax rates for domestic and foreign companies and introducing a VAT for services.[13] Removal of other preferential treatment of FDI may also be appropriate.

- Remove remaining restrictions on the development of a thriving services industry. Addressing, as planned, monopolies and oligopolies would be important, as is removing other barriers including by vigorously implementing WTO agreements.

Third, further relax restrictions on the movement of labor and land transactions to facilitate rural-urban migration and mitigate rural poverty. Further, the fiscal system could be improved to provide host cities with more incentives to deliver social services to incoming migrants.

Fourth, introduce institutional reforms that give local decision makers stronger incentives and better tools to pursue rebalancing.[14] Central here is the performance evaluation of local officials. The recent measure to include land revenues in the local government budget, rather than as part of the extrabudgetary funds managed by the land bureau, could improve the governance of these funds and reduce the incentive to pursue a land-intensive development pattern.

Fifth, introduce policies to help upgrade the production structure and promote the "knowledge economy", including well-targeted government support for R&D and improving access to financing ("venture capital") for innovators.

In addition to these reforms, many important sector-specific policies are under discussion and/or preparation, including on reforming the health care system and strengthening energy and environmental standards.[15]

FINANCIAL SECTOR POLICIES AND DEVELOPMENTS

In October, China Industrial and Commercial Bank (ICBC) successfully listed simultaneously on the Hong Kong (HK) and Shanghai Stock Exchanges. ICBC was the last of the 4 large State-owned banks to be listed. The heavily oversubscribed IPO raised almost US$ 22 billion, the biggest amount ever. ICBC's market capitalization has become China's largest, and the fifth largest bank in the world. Investor's enthusiasm is in part a

[13] This measure may seemingly contradict the government's efforts to promote services as a source of growth. However, because most economic decisions are influenced by local rather than central government, it is important to provide local governments with a fiscal incentive to promote this sector—namely the local share in VAT revenues.

[14] As an indication that rebalancing is not yet top on the agenda of all local governments, the city of Harbin was recently attracting investors with preferential treatment in several areas, including land (China Daily, end October).

[15] Our November 2005 Quarterly Update contained a special on Reforming China's Health Care System.

vote of confidence in China's banking sector. However, the large banks still have a lot of restructuring ahead, and investor's enthusiasm is in large part due to China's good overall economic prospects. While subscription prices in HK and mainland were the same, prices in these two markets diverged on the day of public listing, implying almost 9 percent difference in valuation between the two markets. Factors that may account for the difference include expectations of RMB appreciation; mainland investors having better knowledge about the bank, which makes them less optimistic about the bank's performance; and better perceived investor protection in HK than in China.

Housing finance

The government's desire to make housing more affordable for lower and middle income people has directed attention to the Housing Provident Funds (HPFs). Several government measures have recently focused on adjusting the housing supply towards the needs and budgets of lower and middle income families.[16] Measures to develop complimentary financing for the housing needs of these groups seem to be lagging behind. In this context, the housing provident funds (HPFs) operating in Chinese cities are being considered as possible vehicles to develop affordable housing finance for these groups. However, reforms would be needed.

HPFs collect mandatory savings from members and provide housing loans to some of them. The members are mostly working in government or for state-owned enterprises, but are also in the formal private sector. The housing loans are made at preferential rates to HPF members. The modest subsidy to borrowers is financed by paying below-market interest rates to savers. The mandatory saving is meant to contribute to retirement savings as well. By the end of 2005, HPFs had collected savings of RMB 626 billion from 63.3 million members. While some perform better than other, overall their performance as housing lenders remains weak. Only 45 percent of collected savings has been channeled to housing loans and only 17 percent of savers are borrowers. Although regulated by the Ministry of Construction, at the local level HPF Councils, with representation from local governments, determine policies in association with HPF Management Centers.

HPF lending has mainly benefited upper-income households. Because HPFs are employment-based, they are not accessible for the majority of lower and middle income people who are informally employed or unemployed. Further, many lower income members are unable to use their HPF funds due to affordability constraints. Thus the actual potential beneficiary pool is a modest subset of the urban population. Moreover, many members will never be able to obtain a loan and are forced to save at below market rates (for retirement), subsidizing the higher income households who are able to obtain mortgages.

Additional policy issues are in the areas of risk pooling and regulation. The loan portfolios of HPFs are not sufficiently diversified as most of their assets are in real estate loans from a particular area, usually a single city. To reduce the vulnerability to shocks, the

[16] These measures have been through regulation and administration. In the absence of financial incentives for the developers, their effectiveness will depend on monitoring and enforcement of the regulation.

Funds' loan portfolios would need to become more diversified geographically, which in turn would imply more consolidation. In the area of regulation, the Ministry of Construction lacks the expertise in financial institution regulation. There may also be a potential conflict of interest between the desire to develop housing as opposed to safe and sound lending. Therefore it may be preferable to have HPFs be regulated by a qualified financial regulator. There is also a need to improve their governance and transparency.

Reforms could make HPFs more effective. In its current form, the HPF system is not well suited to be the key vehicle of a policy framework to stimulate housing finance for lower and middle income people. If the government wishes to use this system for public policy, loans need to be better targeted to those with limited access to the banking system, such as first time buyers or lower income households. If the system is retained, its reach could be expanded by separating the functions of subsidy and finance, allowing HPFs to lend at market rates with lower income households receiving subsidies from the state or local government budgets.

There are ways to alleviate portfolio concentration of HPFs. These include mortgage default insurance (MI), securitization and portfolio sales, and the consolidation of separate HPFs. If a well-capitalized national MI provider was available, it could offer MI to HPFs. Such a product would encourage HPFs to develop standardized origination and collections procedures and market pricing to compensate for the risk incurred.

Combining separate HPFs into a single, large lender could have important benefits, but only with the right mandate and institutions. A combined entity could be categorized as a bank and regulated by the CBRC. In principle, such a combined entity could achieve diversification and standardization. However, national state-owned lenders also pose risks. In many countries they have distorted primary markets and hindered the development of housing finance. A combined entity would need a legal mandate to complement market institutions rather than to replace them. It should have clear targets such as addressing the needs of low-income individuals. It should have a governance structure that contributes to the implementation of its legal mission, and prevents its accumulation of undue market share or market privileges that would distort financial markets. Its prudential regulation should be as a bank, conducted by the banking regulator.

More choices should be provided to HPF members. If HPFs are viewed as important to the housing finance system, it would make sense to provide individuals with the opportunity to choose the HPF with which they affiliate. If individuals are able to move among HPFs, the separate funds would have a greater incentive to offer competitive rates of return on deposits and to offer a greater range of mortgage products. To enable such a change, it would be important to have the HPFs be regulated by a financial sector supervisor.

CORPORATE SECTOR POLICIES AND DEVELOPMENTS

The National People's Congress in August adopted a new Corporate Bankruptcy Law (CBL). It came 20 years after the passage of a trial CBL. While the 1986 trial law covered

only SOEs, the CBL covers all "enterprise legal persons (*qiye faren*)" or enterprises with limited liabilities. Regarding financial institutions, the CBL requires the State Council to put forward detailed rules of enforcement. The CBL provides three procedures for insolvent enterprises: reorganization, reconciliation and liquidation. The reorganization procedure, which was absent in the 1986 trial law, is a major contribution to putting in place a modern insolvency regime. The principles of China's CBL are broadly comparable to other modern CBLs, although China's CBL is sometimes more ambiguous, leaving more discretion to the court.

The new CBL has clarified the treatment of employee claims vis-a-vis secured claims. Until the mid-1990s, the 1986 trial law was hardly used, largely because settling claims and entitlements of employees of SOEs was difficult. Starting in 1994, the State Council launched an SOE bankruptcy pilot, later known as "policy-oriented bankruptcy", to enforce the law. The key "policy" in the pilot is a priority granted to employees' claims and entitlements over unsecured and secured creditors. Whether or not to incorporate this "policy" into the law has been a subject of discussion since the start of the drafting in 1994. Now the adopted CBL has resolved this issue in a pragmatic way with a combination of three articles. Article 109 grants priority to secured claims with regard to the properties that have been set as collaterals. Article 113 puts a bundle of employees' claims (including employer's social insurance contributions to employees' individual accounts) before all other unpaid contributions to social insurance schemes and tax arrears, as well ordinary (unsecured) claims. Article 132 creates a grandfathering rule: if the bundle of employees' claims occurred before the date of adoption of the CBL (i.e., Aug. 27, 2006), and they do not receive full repayment under Article 113, the remainder shall be repaid with properties that are collaterals under Article 109 before secured creditors are repaid. As the new law takes effect on June 1, 2007, the "policy-oriented bankruptcy" program operated by SASAC will be phased out over time. Except for the 2116 SOEs that were already slated by the State Council in February 2006, no more SOEs will be added to this program. Instead, they will be governed by the same set of rules as all other enterprises.

The new CBL has substantially strengthened the protection of creditors against abusive and fraudulent transactions prior to bankruptcy filing. For a group of abusive transactions that already appeared in the 1986 trial law, Article 31 of the CBL extended the period of retrospective protection from half year to one year before the court's acceptance of the case. They include the debtor's giving away properties for free, conducting transactions at prices that are clearly unfair, providing security to debt that has not been secured previously, and repaying debt that was not due. In addition, Article 32 and 33 list other abusive and fraudulent transactions, including repayment of one creditor within half year of bankruptcy filing when the debtor was already unable to repay debt that was due, and hiding or transferring properties to escape from repayment obligation. These provisions clearly reflect lessons from the past ten years, when lack of regulation over such behavior made bankruptcy a temptation instead of a threat to debtors, as found by a World Bank study in 2001.

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The full text is available at: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2006/11/01/000016406_20061101152515/Rendered/PDF/wps4057.pdf

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On the WB's China country site: http://www.worldbank.org/china, under "What's New" (October 17, 2006)

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