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Quarterly Update

June 2009

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 economy has continued to feel the brunt of the global crisis. Global economic activity continued to decline in the first part of 2009, even as tentative signs of stabilization have emerged recently in several countries.

However, very expansionary fiscal and monetary policies have kept the economy growing respectably. Fiscal stimulus is centered on the infrastructure-oriented "RMB 4 trillion" stimulus plan and the monetary stimulus has led to a surge in new bank lending. Government-influenced investment has soared. Market-based investment has lagged, although positive signs have emerged in the real estate sector. Consumption has held up well. Very weak exports have continued to be the main drag on growth, but import volumes have recovered in the second quarter of 2009 as raw material imports rebounded.

Global growth prospects remain subdued even as signs of stabilization have emerged. Financial markets have become less strained and there are prospects for stabilization of activity. However, a rapid global recovery seems unlikely and uncertainty remains. The risk of global deflation seems low, although spare capacity will continue to put downward pressure on prices of manufactured goods. Monetary policymakers in major countries should in principle be able to prevent inflation from rising in the medium term, although risks remain, including political ones.

Growth in China should remain respectable this year and next, although it is too early to say there is a sustained recovery. Government influenced investment will strongly support growth in 2009. Nonetheless, there are limits to how much and how long China's growth can diverge from global growth based on government influenced spending, given that China's real economy is relatively integrated in the world economy. Meanwhile, market based investment is likely to continue to lag for a while because of the squeeze on margins amidst spare capacity in many manufacturing sectors. Prospects for real estate activity appear reasonably good, but consumption is unlikely to pick up speed. In all, China's growth is unlikely to rebound to very high single digit rates before the world economy recovers. We project GDP growth of 7.2 percent in 2009 and 7.7 percent in 2010.

China can have the confidence to emphasize forward looking policies and structural reforms. Based on our projections we think it is not necessary or appropriate to add more traditional stimulus in 2009. One reason is that the fiscal deficit is likely to be significantly higher than budgeted and additional stimulus now reduces the room for stimulus in 2010. Nonetheless, with subdued global demand and less export growth, China needs more growth from domestic demand—consumption in particular. Also, relative prices need to change, notably those of natural resources. The transition to more consumption-led, service sector-oriented, and labor-intensive growth requires policy adjustments that: (i) help channel resources to sectors that will grow in the new setting, instead of to sectors that have traditionally done well; and (ii) support thriving domestic markets and successful, permanent urbanization. Such reforms can be pursued more successfully if flanked by a well-functioning public finance system and social safety net.

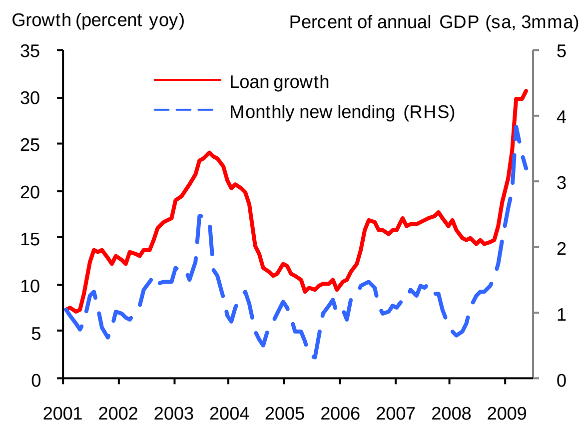
RECENT ECONOMIC DEVELOPMENTS

Internationally, economic activity continued to decline in the first part of 2009. Tensions on international financial markets have eased, equity markets have rallied, and some tentative signs of stabilization in the economies of key countries including the US have emerged recently. However, in the first 5 months of 2009, the impact of the crisis on the global economy has continued. GDP fell 5.7, 9.7 and 14.2 percent (at a seasonally adjusted annualized rate, or SAAR) in the first quarter in the US, the Euro zone, and Japan. In recent months, the decline in output continued, even though the rate of decline appears to have come down. The weak global environment has had a major impact on China's exports and the economy more generally.

In this setting, China's economy continued to slow down, but it received significant support from expansionary policies. Fiscal and monetary policy have been very expansionary since November 2008. Much of the fiscal stimulus is centered around the government's investment and infrastructure oriented "RMB 4 trillion" stimulus plan (see our March Quarterly Update (pp 17-21) for details). With the central government committing to 29 percent of the spending under the stimulus plan, its own spending is leveraged by complementary bank lending. This has been a key part of the impressive expansion of bank credit in the first 5 months of 2009.

Following a spectacular surge in the first quarter, lending moderated in the second quarter. In the first quarter, monthly new lending averaged a massive 5 percent of annual GDP, leading to some concerns among policymakers about the pace, the high share of bill financing, and credit flowing to financial markets rather than the real economy (Figure 1). Monthly new lending slowed in April-May, averaging 2 percent of annual GDP. The composition of lending also changed, with the share of bill financing and other short term lending declining. The share of lending to households also went up, in part due to higher housing sales. In any case, this massive monetary impulse will fuel economic growth in the coming quarters.

Figure 1. New lending has been massive



*Source:*CEIC, staff estimates

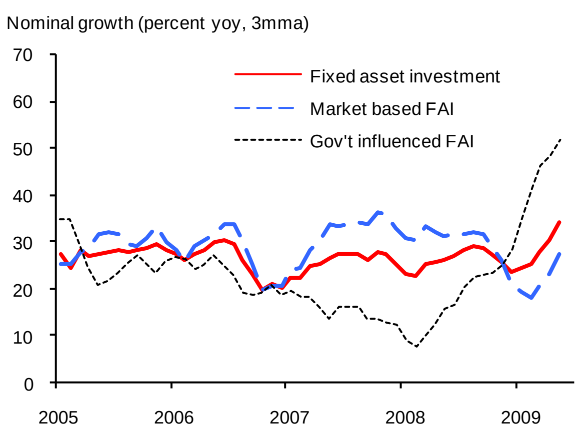
Government-influenced investment (GII) has soared (Figure 2). Boosted by the stimulus package, infrastructure and other government-influenced investment rose rapidly in the first five months (an estimated 39 percent (yoy) in the first four months in national accounts terms, up from an estimated 13 percent in 2008).[1]

[1] Our government-influenced investment covers utilities, transport, scientific research, water and environmental conservation, education, health care, social security, culture, sport, and public administration.

The stimulus has also supported some market-based sectors, but overall, market based investment (MBI) lags significantly. The monthly urban fixed asset investment (FAI) data suggest real MBI also rebounded, driven by commodity and specialized machinery industries that benefit from the stimulus spending. However, the FAI data over-estimate growth of fixed capital formation.[2] Moreover, in several key manufacturing sectors—notably those oriented on exports (textiles, clothes, furniture, computers, and IT)—FAI has continued to decelerate, reflecting subdued and uncertain prospects for exports and profits and substantial spare capacity. Nominal MBI rose by an estimated 12.6 percent (yoy) in the first four months in national account terms, compared to 20 percent in 2008.

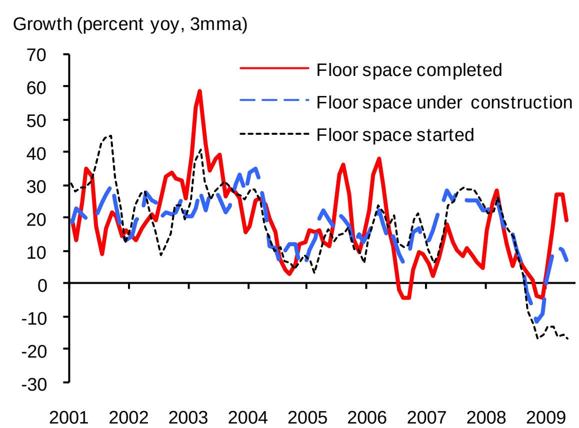
Housing sales have recovered in early 2009, but new real estate activity remained subdued so far. Sales had been falling throughout 2008. Amidst a more positive sentiment stemming in part from the stimulus package, sales have benefited from lower interest rates and taxes, as well as from an earlier easing of prices. Higher sales nudged up prices in April and May, but they are still down on a year ago. The completion of residential property projects has also risen sharply since early 2009 (Figure 3). To date this appears to be driven less by the recovery in sales than by a boom in property construction in 2007 and early 2008, when the amount of floor space under construction was growing much faster than that completed. Indeed, floor space started is still falling strongly (yoy). This may change if the positive recent developments gain momentum.

Figure 2. Market based investment lags government influenced investment



Source: CEIC, staff estimates.

Figure 3. Completion of residential property is up sharply, but starts not



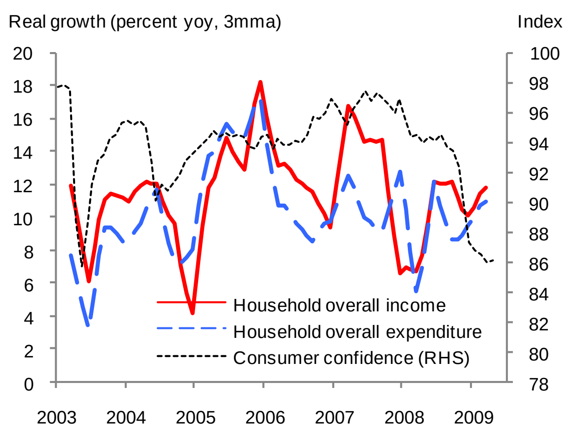
Source: CEIC.

[2] Besides including asset sales, there seem to be additional reasons why China's monthly data on urban FAI is not a good proxy for (national accounts type) gross fixed capital formation. The discrepancies are likely to be larger when the pace of investment is changing significantly, as is the case now. Interpreting the data is also more complicated when the rate of price rises is changing rapidly, as was the case in the first quarter (the rate of price rises changed from 8.9 percent (yoy) in 2008 to -1.2 percent (yoy) in the first quarter).

Consumption has held up well. It grew at an estimated 11 percent in real terms in the first quarter (yoy) (based on household survey data), even though reported consumer confidence has fallen to the low level registered at the time of SARS (Figure 4). Retail sales data for April and May indicate that consumption growth remained robust. Consumption has been supported as lower inflation buoyed real incomes even though nominal income growth came down in the first part of 2009. Rural income growth decelerated in the first quarter, due to subdued farm output prices and significantly less buoyant earnings of migrants.[3] Seemingly at odds with reported low consumer confidence, and following a pronounced deceleration in 2008, car sales rose 14 percent on a year ago in January-May. This is in part due to lower consumption taxes for small cars, but apparently also because expectations of lower car prices have diminished as concerns and uncertainty over China's prospects have subsided somewhat.

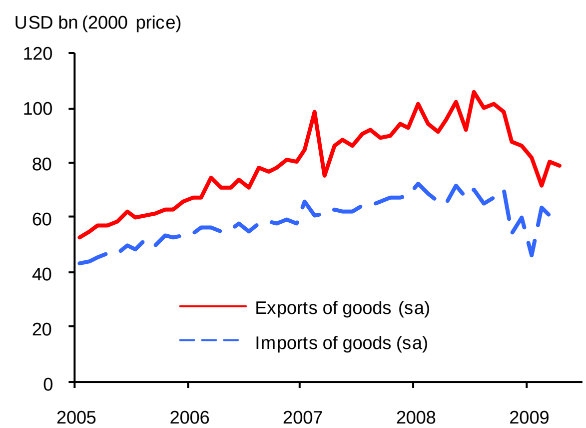
Exports have remained very weak while imports recovered (Figure 5). The export weakness since end 2008 has been across the board, in terms of type and destination, and export volumes were still down an estimated 20 percent on a year ago in April-May. Meanwhile, China's import volumes have picked up swiftly since March because of stimulus package-induced demand for raw materials. In April-May, total import volumes were down an estimated 6.8 percent on a year ago, with raw materials import volumes up strongly even as those of manufactured goods were still down sharply. Part of the strength of raw materials imports since March follows particular weakness earlier—China's manufacturing firms sharply curtailed inventories of raw materials in response to the crisis—and it may thus not fully reflect underlying patterns. Nonetheless, the impact of the import rebound dominated that of improved terms of trade due to lower raw material prices, and China's trade surplus was down on a year ago in April-May.

Figure 4. Consumption has held up well



Source: CEIC, staff estimates.

Figure 5. Export weakness has continued, but imports rebounded from the trough



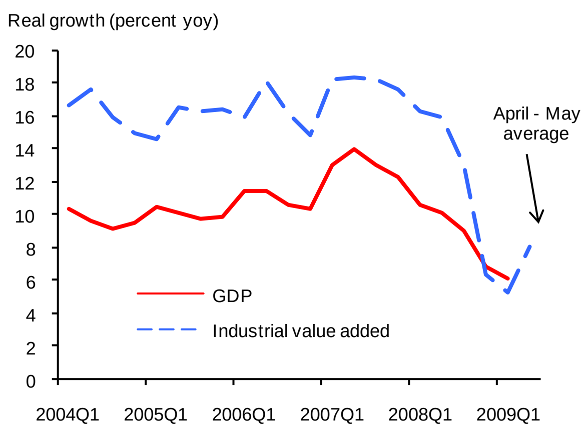
Source: CEIC, staff estimates.

[3] Wages of migrants have felt much more downward pressure than those of people in the formal sector, because migrants tend to work more in the private sector and in export oriented firms.

Overall, economic growth remained respectable in a very difficult global environment. GDP rose 6 percent (SAAR) in the first quarter, to a level 6.1 percent up on a year ago. Industrial production seems to have picked up pace somewhat recently, with (yoy) growth up from 5.3 percent in the first quarter to an average 8.1 percent in April-May (Figure 6), while fiscal revenues posted positive (yoy) growth in May for the first time this year.

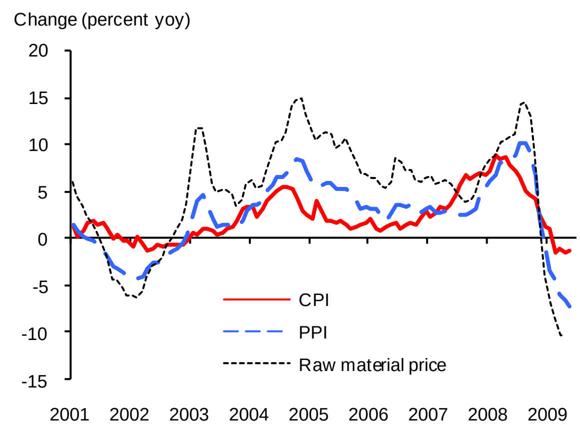
Downward pressure on inflation has continued. Prices of raw materials are now much lower than a year ago and this has driven PPI (factory gate) and CPI prices down from a year ago (Figure 7). In addition to these benign price pressures, substantial spare capacity in China and abroad is putting downward pressure on prices of manufactured goods.

Figure 6. Overall growth remains respectable



Source: CEIC.

Figure 7. Falling raw material prices drag down headline prices

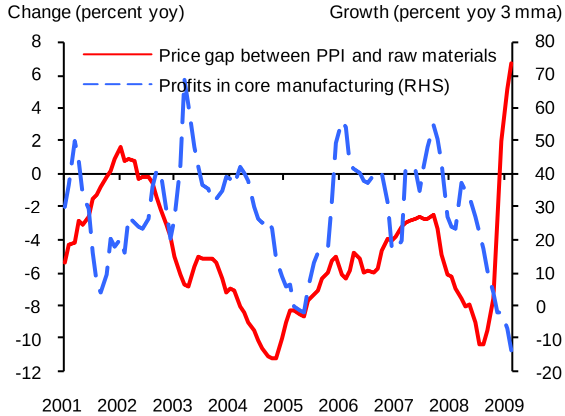


Source: CEIC.

Profitability in industry deteriorated further in early 2009. In 2008, margins in industry were compressed by a surge in raw material prices (Figure 8). This pressure has reversed as raw material prices have fallen. Moreover, with wage growth coming down, unit labor cost growth is diminishing (Figure 9). However, margins are squeezed by the impact of spare capacity on PPI (factory gate) prices and the impact of slow or negative sales growth in the face of fixed costs, notably of financing. The impact of lower output prices and extent of the slowdown and its impact in the face of fixed costs are particularly high in heavy industry. Thus, profits in heavy industry fell 43 percent (yoy) in February, while those in light industry dropped only 10 percent (yoy).[4]

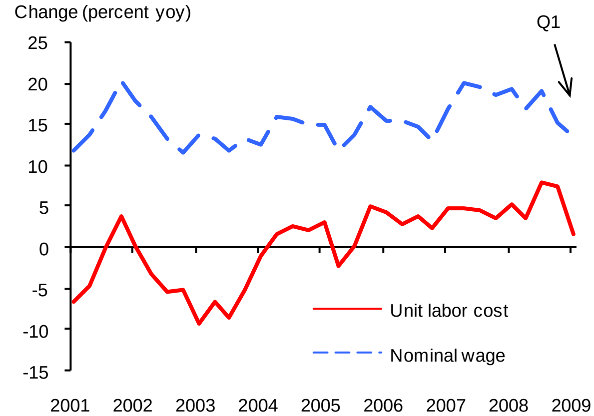
[4] The petroleum extraction sector, which saw its output price falling by 55 percent (yoy) in February, contributed the lion's share of the overall industrial profit decline.

Figure 8. Pressure on profits remains



Source: CEIC, staff estimates.

Figure 9. Wage growth is falling



Source: CEIC, estimates.

China's foreign exchange reserve accumulation has slowed. In the first part of 2009, the trade surplus and FDI inflows both remained sizable, despite some decline in FDI from early 2009 onward and in the trade balance from April onward (Table 1). The main reason behind the slower pace of reserve accumulation in the past 9 months (to about US$ 2 trillion) is a sizable apparent net financial outflow, while valuation adjustments due to appreciation of the US dollar against other major currencies also dragged down the headline number.[5] Both of these factors are unlikely to be sustained over long periods. Recent indications are that China continues to be a significant net buyer of US bonds, mainly treasuries, despite expressions of concern about the financial security of such investments by senior Chinese leaders (see the Special Focus on global prices).

Table 1. Foreign reserves accumulation (US$ billion)

	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
FX reserve increase	154	127	97	40	8
Trade balance	41	57	84	115	62
Gross FDI inflows	27	25	22	34	22
Interest earnings	14	15	17	15	13
Valuation adjustments	76	-23	-41	66	-57
Other flows	-3	54	15	-189	-32

*Source:*CEIC, World Bank staff estimates

China's stock market rallied in early 2009. With sentiment on the economy improving since the beginning of 2009 and liquidity in the domestic financial market up substantially due to the easy monetary stance, the Shanghai composite index (of A shares) has risen more than 50 percent since end 2008, led by cyclical sectors such as materials. Rising share prices have re-ignited interests from investors, and turnover has increased in volume terms, even surpassing levels of early 2007.

[5] This residual category is sometimes called "hot money" in China, but it comprises various types of financial flows, as well as earnings on inward FDI, divestiture of inward FDI, outward FDI and losses on foreign assets. Moreover, data on headline foreign exchange reserves has been subject to undisclosed one-off transactions, for instance between the PBC and other financial institutions. As a result, the estimation of underlying financial capital flows is subject to a lot of uncertainty.

ECONOMIC PROSPECTS

Globally, there are signs of stabilization in financial markets, where the current crisis started. Financial markets in industrialized countries have become less strained since early 2009, with tension in inter-bank markets receding and equity markets having rallied. However, markets have not stabilized fully. Risk aversion is still high, reflected in reluctance among banks to lend. International capital flows in particular are still very subdued, and the corporate sector in many developing countries has difficulties getting access to finance. Moreover, additional shocks originating in the financial system cannot be ruled out.

There are also some tentative signs of stabilization in parts of the global economy. Although global output has continued to decline in the first quarter of 2009, there are signs of sequential (month on month) moderation in the *rate of decline* and possible prospects of stabilization of activity. Some "green shoots" have been observed in the US, including in retail sales, home sales and factory orders. Recently business sentiment in the US and Europe has also improved, although most business surveys are not yet indicating sequential growth. And, globally, orders have rebounded sequentially.[6] Several East Asian countries have seen output rising recently, grounded in part in a sharp acceleration in high tech manufacturing.

But a rapid global economic recovery seems unlikely and a lot of uncertainty remains. Prospects for 2009 for global growth and trade have again been downscaled, compared to three months ago, in large part because of a sharper than expected decline in the end of 2008 and early 2009 (Table 2). In this light, eventual sequential stabilization of activity does not necessarily presage a rapid, sustained recovery. Morever, in most developing countries and emerging markets outside of East Asia there are no strong signs yet of improvements in the economy. That is because much deteriorated access to external financing and a smaller or less effective policy stimulus than in many industrialized countries are constraining domestic demand. The world excluding China is now expected to shrink by 3 percent in 2009, before posting moderate growth in 2010 (weighted by the geographical composition of China's exports, projected world growth looks slightly better, because of East Asia's relatively good prospects).

Global price prospects are receiving a lot of attention. Prices of most raw commodities have come off earlier lows in international markets, with some, including the oil price, having risen significantly recently. However, they are still much lower than their peaks of mid-2008. Forecasters do not expect commodity prices to rise significantly from current levels in the coming one and a half year (Table 2). As to global headline prices, the combination of large global downturn and very aggressive policy responses in many countries, notably the US, has incited concerns of both global deflation and inflation, also among China's policy makers. The Special Focus discusses the issues and concludes that the risk of deflation is considered low. Monetary policy makers should in principle also be

[6] Markit's global "order to inventories ratio" index rose sharply in March.

able to manage the challenges associated with preventing inflation from rising too much. This is also what financial markets think. But risks remain, including political risks.

Table 2. The global environment
(percent change, unless otherwise indicated)

	2007	2008	2009(f)		2010(f)	
			Mar-09	Jun-09	Mar-09	Jun-09
World excluding China 1/						
unweighted			-2.1	-3.0	1.7	1.6
weighted by weights in China's exports			-1.6	-2.4	2.1	2.2
World imports (volume) 2/	7.2	3.3	…	-11.0	…	0.6
World prices (US$)						
Oil ($/bbl) 2/	71.0	97.0	…	52.0	…	62.5
Non oil commodities 3/	17.1	21.0	…	-30.2	…	-2.1
Manufacturing products 2/	8.8	9.6	…	-8.9	…	1.7

Source: World Bank (DEC), International Monetary Fund, Consensus Economics (June 2009), and staff estimates.
1/ Consensus Economics.
2/ International Monetary Fund (WEO, April 2009).
3/ World Bank (DEC).

It is too early to say that there is a sustained recovery in China. The policy stimulus allows China to continue to grow in this weak global setting. Nonetheless, there is a limit to how much and how long China's growth can diverge from global growth, given that China's real economy is relatively integrated in the world economy. Government influenced spending only makes up one-third of domestic demand. The current surge in government influenced investment is welcome, and more domestic demand in China is helpful for the world economy. However, it is unlikely to lead to a rapid, broad based recovery in China, given the current global environment and the subdued short term prospects for market based investment. China's economic growth is unlikely to rebound to a high single digit pace before the world economy recovers to solid growth.

In our view, overall growth prospects for 2009 have improved somewhat, compared to 3 months ago, but with little carry-over into 2010. The downward revision of export prospects is offset by a more favorable domestic growth outlook. Developments in the real economy have been somewhat better than expected 3 months ago. More importantly, bank lending in the first part of 2009 has been much larger than expected. After such an expansion, it is likely and appropriate that new lending will moderate during the rest of the year. Nevertheless, the massive monetary impulse of the first 5 months will support economic growth in the coming quarters. Government expenditure has also substantially outpaced expectations in the first 5 months.

In this light, we forecast GDP growth of 7.2 percent in 2009 (Table 3). A full 6 percentage point of growth is estimated to be contributed by government-influenced expenditure, with additional stimulus from lower tax revenues. We expect growth to pickup somewhat in 2010, but not as much as in many other countries, largely because China already saw a large fiscal policy stimulus in 2009, whereas many other countries will see much of it in end 2009 and 2010. Moreover, it appears that many companies still have to fully adjust investment plans to the subdued prospects in several manufacturing sectors.

Table 3. China: Main Economic Indicators

	2006	2007	2008	2009 1/
Real GDP growth (production side) (%)	11.6	13.0	9.0	7.2
Real GDP (expenditure side) 2/	11.7	12.5	8.5	…
Consumption 2/	8.4	10.1	8.2	8.4
Gross capital formation 2/	10.7	10.3	9.5	12.6
Fixed capital formation	13.0	11.4	8.8	12.0
Exports (goods and services) 3/	23.3	19.9	8.4	-10.1
Imports (goods and services) 3/	14.3	13.9	3.9	-4.7
Consumer price increases (period average)	1.5	4.8	5.9	0.5
GDP deflator	3.6	7.4	7.2	1.2
Fiscal accounts (percent of GDP) 4/				
Fiscal balance	-0.8	0.7	-0.4	-4.9
Total revenue	18.3	20.6	20.4	18.6
Total expenditure	19.1	19.9	20.8	23.4
External account (US$ billions)				
Current account balance (US$ bln)	250	372	426	388
As share of GDP (%)	9.5	11.3	9.8	8.0
Capital account balance	-3	90	-7	-170
(including errors & ommissions)				
of which: FDI (net)	60.3	122	94	40
Change in reserves (increase =+)	247	462	419	218
Foreign exchange reserves (US$ bln)	1066	1528	1950	2168
Other				
Broad money growth (M2), e-o-p (%)	16.9	16.7	17.8	19.0

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

1/ World Bank projection.

2/ Estimations are based on the national account data (Table 2-20 in China Statistical Yearbook

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.

On the specific expenditure components:

- **Strong government influenced investment will support growth in 2009, but market based investment is likely to continue to lag.** The prospects for market based investment in several sectors are not very favorable. Economic growth prospects remain uncertain, while large spare capacity in China and globally is putting serious downward pressure on output prices (the PPI) and profits, even as lower commodity prices help. Thus, market based investment may remain subdued for a while, particularly in manufacturing, where foreign sales make up between one-fourth and one-third of the total. In the real estate sector, medium term sales prospects are reasonably good. A large stock of unfinished housing expected to be completed may contain new high end housing projects. However, mass market and low-end construction should expand as a result of government measures.

- **Consumption is likely to be resilient but is expected to slow.**[7] Growth of nominal wages and employment is likely to decline further. Real income should continue to be supported by very low inflation and fiscal support. However, urban consumption has started to lag urban incomes, indicating some increase in the household saving rate, consistent with relatively low reported consumer confidence. Improvements in the housing sector would support consumption, because of wealth effects stemming from higher housing prices and the consumption related to home improvement. Assuming some further increase in household saving rates, urban consumption would slow this year (compared to 2008), although it would remain robust. Rural income prospects are more subdued, due to subdued agricultural output prices and migrant wages and employment. Fiscal support will stimulate rural incomes and consumption—including via more government subsidies to medical insurance and spending on household appliances (see our March Quarterly Update, p. 18). However, this is unlikely to be large enough to prevent a slowdown in rural real income and consumption, and keeping up rural income and consumption growth remains a challenge.

- **Net trade is likely to subtract from growth this year.** The PMIs suggest new export orders are up sharply, signaling that exports should recover from the current trough. However, while China's competitiveness remains good, exports are likely to continue to face headwinds from the weak global economy. Even if part of the relative import strength in March-May may not last, as it was because of restocking of raw materials following earlier destocking, imports should decline less than exports in 2009, given that growth in China is so much higher than that abroad.

In the coming 10 years exports are likely to grow significantly less than in the previous 10 years. This shaves off around 2 percentage point of GDP growth in our illustrative scenario (Box 1). This is significant but not catastrophic.

There are risks to the growth projections. Key short term growth risks are longer and more severe export weakness; lower market based investment, in light of spare capacity and weak profit prospects in many sectors; and lower consumption. There are also upside risks to the growth forecast, notably higher government influenced spending, perhaps also higher market based investment—if we are too pessimistic on profit prospects—and lower imports (because of more import substitution). Key medium term risks are that global imbalances are not resolved and, domestically, that potential output growth is lower because of slow progress with rebalancing.

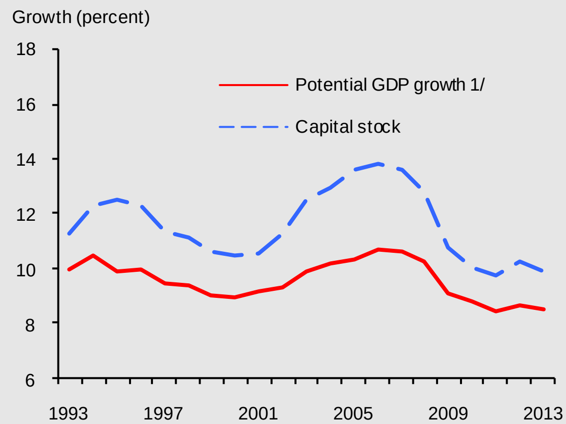
[7] Incomes and consumption (as in the household expenditure data] have benefited from a low base effect in the first quarter. They are likely to slow down later in the year.

Box 1. Medium term growth trends—an illustrative scenario.

More subdued exports are likely to lower GDP growth, although not dramatically. From 1998 to 2008, world imports grew 6.6 percent on average and China's exports 19.7 percent, in real terms. In the coming decade, exports will grow less. How rapidly depends on world import growth, China's competitiveness, and possible limits to its global market share. In an illustrative scenario, on the basis of mainstream projections for world imports and assuming a continued increase in market share reflecting strong competitiveness, the growth rate of China's exports could average 9 percent in the coming decade— 10 percentage point (pp) less than in the previous decade.[1/] China's global market share would be 12 percent in 2018. As a comparison, the US share peaked at 14 percent in the early 1990s. The value added contribution of exports to GDP now is estimated at almost 20 percent.[2/] Thus, as a rough, illustrative estimate, GDP growth could be (0.1*0.2=) 2 pps lower in the coming decade because of lower export growth. This is significant, but not dramatic, compared to average GDP growth of 10 percent in the previous decade.

A slowdown in potential output is likely to largely reflect lower capital stock growth. China's potential output has grown fast in the previous decades, driven by rapid capital accumulation and TFP growth (Figure). Several factors will contain potential output growth in the coming years, largely affecting the capital stock. First, most importantly, investment is likely to be subdued in the coming years, especially in manufacturing, given the outlook for exports, spare capacity, and profits. Second, the composition of investment is changing now, with more government influenced investment (GII) and less market based investment (MBI). GII is likely to contribute less to narrow GDP growth than MBI in the medium term, largely because the economic returns of investment in infrastructure are spread out over a longer period than those of investment in equipment. GII is also likely to be less efficient.[3/] Third, some of the current capital stock in sectors facing particularly large spare capacity will have to be written off. In all, on reasonable assumptions, China's capital stock would rise by 10 percent in the coming 5 years, compared to 13.3 percent in the previous 5 years. Potential output growth would be about 2 pp lower in the coming 5 years than in the previous 5 years.

Figure. Potential output growth is likely to decline



Source: CEIC, staff estimates.
1/ From Cobb Douglas production function.

Succesful rebalancing could help boost growth. In the transition to a new setting, TFP growth may be lower because of less migration out of agriculture and policies that channel resources to less efficient activities and firms. More progress with rebalancing would help offsetting this by generating more reallocation of labor from agriculture, more education, and more service sector productivity.

1/ We believe that, reflecting strong competitiveness, China will continue to gain market share, but at a slower pace, assuming that exports outpace world trade by 4 percentage points (pp), compared to 13 pps in the previous decade.

2/ He and Zhang (2008) (HKMA Working Paper 14/2008) use input output tables and estimate that the share in value added was 17.5 percent in 2007. In gross terms, exports of goods were 20 percent of gross industrial output in 2008.

3/ Assuming that GII is 40 percent less efficient in the medium term, potential growth would be 0.2 pp lower.

China is unlikely to get into deflation; policy measures can help mitigate the risk. As discussed, globally, the risk of malign deflation seems low. In this context, outright deflation in China is also unlikely, but downward pressure on inflation is likely to continue. The risks of deflation could be mitigated by increasing administrative prices opportunistically and preventing excessive investment in sectors that may have done well traditionally but may do less well in the future (with a different composition of demand and relative prices).

ECONOMIC POLICIES

On current projections it is not necessary, and probably not appropriate, to add more traditional fiscal stimulus in 2009. [8] First, while growth may not exactly reach the government's target this year, it will be very respectable, given the global setting, because of the the forceful stimulus. Indeed, China is likely to avoid malign deflation or other major downturn-induced problems. Second, it would be good to retain room for fiscal policy stimulus in 2010, given the uncertainty about the global recovery. China's public finances are quite sound. Nonetheless, the current stimulus is already set to increase China's government deficit substantially, and the higher the fiscal deficit in 2009 is, the less room there is for an additional increase in 2010, given limits on the size of deficits.[9] Third, there are limits to how much additional infrastructure-oriented stimulus can be spent effectively and efficiently. If policymakers are concerned about the adverse consequences of the downturn for households, it is less costly to address these by using and beefing up the social safety net. This would also fit well with China's medium and long term objectives. Some of the short term measures to boost consumption also seem relatively effective, even if they will have little medium and long term impact.

In responding to the global crisis, China should have the confidence to emphasize forward looking policies and structural reforms. The economic setting is likely to look different in the coming decade from what it looked in the previous decade. With global demand more subdued, China needs to get more growth from domestic demand—consumption in particular. Also, the government's rebalancing objectives call for changes in relative prices—notably higher prices for resources and environmental impact. The pattern of growth emerging in this setting would be driven more by the service sector (and other relatively clean, energy efficient, and labor-intensive activities), and less by industry (especially environmentally damaging, energy consuming, and capital-intensive heavy industry).

[8] Our March Quarterly Update discusses the various elements of and considerations on China's fiscal policy, including under the stimulus package (pp 17-21).

[9] While some of the stimulus-related spending will show up immediately on the government's balance sheet, some is likely to show up only later, such as in the case of government commitments to co-finance the repayment of bank lending or subsidies to cover operating costs of projects that are otherwise not financially sustainable.

Fiscal and structural policies

The transition to such a pattern of growth would be easier and more successful with fiscal and structural policy adjustments that:

- **Help channel resources to sectors that should grow in the new setting, instead of to sectors that have traditionally been favored and done well.** This calls for reforms to encourage competition and remove barriers to private sector participation in several key services sectors currently reserved for SOEs, as well as in financial sector policy, natural resource pricing and taxation,[10] and SOE dividend policy. [11]

- **Support thriving domestic markets and successful, permanent urbanization.** In addition to service sector liberalization, key policies to make this happen include land reform, further liberalization of the Hukou system, and reform of the inter-governmental fiscal system that make it possible for local governments to fund the public services without which migration cannot be successful and permanent. With more succesful, permanent migration and thriving service sector-oriented urban activity, wage and household income, and thus consumption, can rise as a share of the economy.

Such reforms could be pursued all the more boldly and successfully if they are flanked by a well-functioning public finance system and social safety net. In addition to the essential reforms of the intergovernmental fiscal system, the following are important:

- A well functioning social safety net that can deal with the adverse consequences of economic shocks such as the current one and possible temporary or sectoral impact of reforms.

- More equal and less segmented institutions and arrangements for social insurance and social safety nets. This would strengthen them and also increase economic efficiency and mobility. In particular, more pooling and portability and less segmentation of schemes would facilitate domestic market integration and labor mobility.

[10] The new fuel pricing mechanism announced in May is a welcome step in this regard. Under this mechanism, prices would be adjusted if global crude prices fluctuate more than 4 % over 22 straight working days, although the NDRC noted that "to prevent speculative trading, we will not adjust oil prices exactly in line with the benchmarks set in the regulation." In any case, benchmark prices of gasoline and diesel were raised by 7-8 percent on June 1. In a step in the opposite direction, the government recently lowered the cost of converting land for industrial use. Rebalancing considerations had earlier led the government to an increase in the minimum price of land for such conversion.

[11] Our November 2008 Quarterly has a more comprehensive overview of the policies needed to rebalance the pattern of growth (in Box 3).

On current trends, the fiscal deficit is likely to be substantially higher than budgeted. The 2009 budget foresaw revenue rising by 8 percent and expenditure by 22 percent, leading to a budget deficit of 3 percent of GDP (excluding the balances of the social security and extra-budgetary funds). In the first five months of the year, tax revenues fell 9.4 percent on a year ago, and total revenues 6.7 percent, with particularly large declines in corporate tax revenues and large increases in VAT rebates to exporters. A sizeable portion of the decline is because of policy changes and one-off effects, notably the change in VAT treatment of investment, higher VAT rebates to exporters, and fluctuating stamp taxes on stocks. Expenditures rose 27.8 percent (yoy) in the first five months, with particularly large increases in transportation, agriculture, and environmental protection. Revenue forecasts are very difficult to make at the moment. Nonetheless, on the basis of our current economic forecasts and broad estimates of the whole year effect of policy changes, we estimate that revenues may decline somewhat in 2009 as a whole. Our illustrative scenario assumes that expenditure growth in the remainder of the year will come down substantially from the pace of the first 5 months so that expenditures grow 22 percent for the year as a whole, as budgeted (Table 4). This would lead to a budget deficit of almost 5 percent of GDP. Almost one-third of the increase in the deficit in 2009 would be the whole year effect of the discretionary revenue measures, including measures taken only recently such as 2 new rounds of increases in VAT rebate rates. These projections are only tentative, and China's fiscal postion is strong enough to deal with such an increase in the deficit. However, these projections underline the trade off between more general fiscal stimulus in 2009 and having room for stimulus in 2010.

Table 4. Fiscal developments
(percent of GDP)

	2007	2008	2009 1/
Budgetary revenue	19.9	20.4	18.6
Budgetary expenditure	19.3	20.8	23.4
Budgetary balance 2/	0.6	-0.4	-4.9

*Source:*CEIC, staff estimates
1/ Illustrative scenario. See text for assumptions.
2/ Excluding social security and extra-budgetary funds.

The implementation of the stimulus package and other fiscal initiatives is hampered by longstanding problems with China's intergovernmental fiscal system. Sub-national governments in China are responsible for a much larger share of spending than in most other countries. However, China does not have institutional arrangements that channel substantial amounts of resources from rich to poor areas on the basis of rules guaranteeing minimum levels of public services. As a result, despite transfers from the central government, local governments in poor areas tend to be financially strained. Local governments are legally not allowed to borrow, although for infrastructure spending this constraint has long been by-passed by having SOE type entities that are part of the local governments do the borrowing. Nonetheless, there are large disparities in the provision of public services that amplify regional income inequality.[12]

[12] As an example, some pilot programs currently aim at extending the urban public pension plan to rural citizens. The pilots typically include a fairly generous subsidy, with contributions from the municipal government and required matching funds from the lower level government. However, often only in the relatively well-off areas do the lower level governments have the capacity to contribute. In the poorer areas,

In the case of the projects under the stimulus plan, many local governments have difficulty providing the matching funds. For the first 2 phases of the stimulus plan, local governments were supposed to provide RMB 170 billion, matching the central government's commitment of RMB 230 billion.[13] The Ministry of Finance found that as of end April local governments had allocated only RMB 88 billion. Partial short term relief is coming from additional borrowing on behalf of local governments. Since the start of this year the government is operating a pilot whereby the Ministry of Finance issues bonds on behalf of local governments. The scheme is meant to emphasize poorer provinces. To address such problems structurally, China's intergovernmental fiscal system will have to be adjusted.

Monetary policy

Large liquidity injections are supporting the surge in bank lending. In the last months of 2008, the PBC injected large amounts of liquidity into the banking system, in addition to lifting the credit quotas that had constrained bank lending. In large part the injection came about because of lower required reserve ratios (from 17.5 percent to 14-15 percent). Base money has stabilized in March, but the liquidity injection is still working its way through the financial system. With lending growth continuing at a rapid pace, banks' excess reserve ratio has declined.

A sharp increase in the share of bill financing caused concerns, but may be less worrisome than it appears. The concerns include that bill financing does not lead to economic activity but to arbitrage and asset transactions. However, there are reasons not to be too worried about the increased share of bill financing. Bill financing largely crowded out other short term credit. The total share of short term lending inched up only moderately, to 52.2 percent at end March, and is still lower than in early 2007. Moreover, from the perspective of the banks, replacing other open credit with bill financing was a rational response to a combination of sharply increased liquidity, and thus lower cost of funds, and increased risk aversion because of the downturn (unlike other forms of short term credit, bill financing is backed by receivables as collateral).

The high pace of lending is not sustainable. As the backlog of projects gets cleared, banks' excess reserves come down because of all the lending, and government-related projects receive their financing, new bank lending is expected to come down later in 2009. Even so, credit is likely to outpace nominal activity by a very large margin this year, and this implies risks.

- **The risk of inflation seem low.** Some worry that the rapid growth of money and credit will lead to inflation. However, with a lot of space capacity in China and

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where the local government cannot contribute, rural people do not have access to the scheme and the subsidy. This makes the schemes regressive.

[13] See Table 5 (p. 18) of our March 2009 Quarterly Update for the composition.

world-wide putting downward pressure on prices and raw material prices unlikely to soar soon, substantial generalized price pressures seem unlikely any time soon.[14] The Special Focus looks into risks of global deflation and policy-induced inflation.

- **However, the rapid credit expansion can have consequences other than inflation and the authorities are right in being cautious and vigilant.**

  - **Abundant liquidity in an environment of subdued demand could lead to unwarranted asset market inflation.** In principle, asset transactions are a function of portfolio decisions, and these will eventually be consistent with economic outcomes and expectations. However, given the large liquidity shock, the still immature financial system, and with capital controls making capital outflows difficult, unwarranted flows and processes could happen along the way.

  - **It also increases the risk of misallocation of credit, and thus of resources, as well as NPLs.** Amidst concerns about the impact of the credit surge on the quality of banks' loan portfolios, the CBRC raised its loan-loss coverage ratio to 150 percent.

China's government has taken several initiatives recently to boost the role of the RMB in international trade and finance. These include (i) agreeing currency swaps worth RMB 650 billion (US$ 95 billion) with several economies (including Argentina, Malaysia, South Korea, Hong Kong, Belarus, and Indonesia) that will allow foreign importers to pay with RMB for imports from China; (ii) allowing 2 foreign banks to launch international bonds denominated in RMB; and (iii) allowing exporters and importers in 5 Chinese cities to settle cross-border trade deals in RMB. The government is also studying a proposal to extend financial aid to developing countries in RMB instead of in US dollars and then allow beneficiary nations to trade RMB reserves in Hong Kong.

It may take time before the RMB becomes a major reserve currency. International experience suggests that several conditions need to be in place, including open capital markets; deep, liquid foreign exchange markets; well developed bond markets; and a more or less flexible exchange rate. It will take time before China has achieved these benchmarks.

[14] The relationship between monetary aggregates and inflation is complex. That is why central banks in mature market economies have largely abandoned using money as a guiding variable for inflation projections, giving priority to output gaps.

Special Focus: Global prices—the risks of short term deflation and medium term policy-induced inflation

The steep global economic contraction has raised fears of deflation. Headline prices are under downward pressure now because of falling raw material prices. On balance, though, the risk of deflation is low, in large part because of a forceful policy response in most major economies. At the same time, the uncommonly forceful response of fiscal and monetary policy in major industrialized countries is raising concerns, including among China's policymakers, that inflation may emerge in those countries once their economies recover, and that this may weaken their currencies. The risk of such policy-induced inflation depends on the ability of central banks in major industrialized countries to reverse the recent liquidity injections, balance sheet expansions, and monetary policy loosening. So far, most experts and the financial markets expect the major central banks to be able to do this, although it cannot be ruled out that central banks err on the side of supporting a recovery at the risk of higher inflation.

With headline prices lower than a year ago in the US and Japan amidst a global recession, there are fears of deflation. Real, malign deflation is a persistent and generalized decline in prices across a wide array of products and services, with the price declines generating expectations that prices will continue to fall. The current situation does not constitute global deflation, as headline prices are down because of lower raw commodity prices, especially energy (Figure 10); core inflation is on course to remain positive in the US and the euro zone, although perhaps not in Japan. Nonetheless, vigilance is required. A key reason why real deflation can be dangerous is that, with prices falling persistently, central banks cannot stimulate the economy by pushing interest rates below inflation. In fact, the more deflation, the higher real interest rates are, further hampering economic activity.

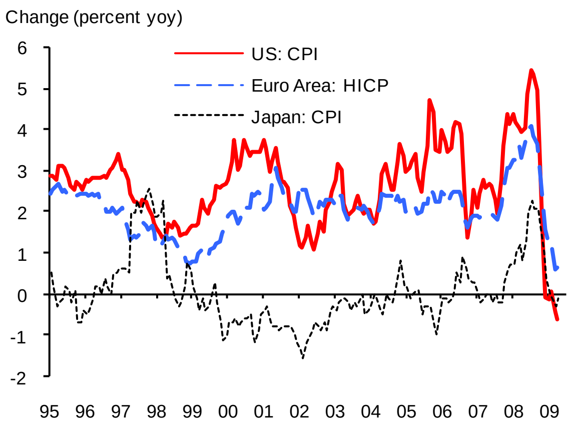
The global policy response to the recession makes sustained deflation unlikely, although it cannot be ruled out. Decressin and Laxton (2009), in an IMF "staff position note", find that spare capacity world wide has historically led to downward pressure on inflation.[15] Thus, in the short term, the severe recession and large amount of unused capacity will create deflationary pressures. However, the global policy reaction to the financial crisis has been so aggressive and determined that it is likely that deflation is avoided. Current consensus forecasts for inflation in the US and the Euro zone show that experts do not expect prices to continue to fall (Figure 11).[16] They do expect prices to fall in Japan, but that has happened frequently in the last decade. Current 10 year government bond yields in the US and Germany (3.7 and 3.5 percent) show the same for financial markets. Decressin and Laxton conclude that, while the risks for sustained deflation are appreciably larger than in 2002-3, the previous period with downward pressure on inflation, the most likely outcome is that sustained deflation will be avoided. Their model

[15] *Gauging Risks for Deflation*, IMF Staff Position Note, January 2009 (SPN/09/01).

[16] Headline consumer price inflation is expected to be negative this year in the US but not in the Euro zone because of the larger impact that oil price fluctuations have in the US than in Europe (where gasoline taxes are much higher).

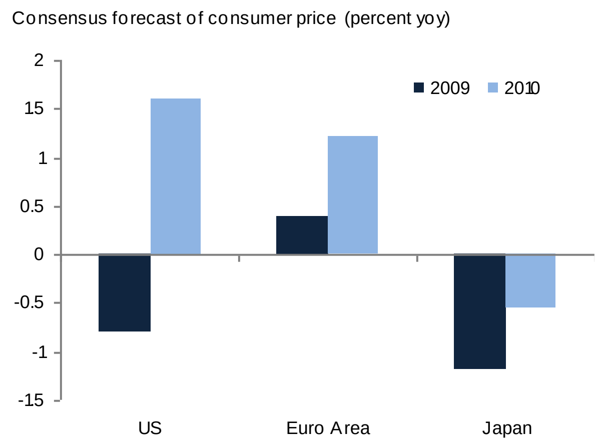
based analysis also suggested that, on the assumption that the financial distress is gradually resolved, the most likely outcome is that the global economy will stay clear of sustained deflation. However, they note that if financial sector problems are not remedied or further shocks add to current stresses, there is a significant probability of more negative deflationary outcomes, with a deeper and more prolonged recession.

Figure 10. Inflation has declined sharply, globally



Source: CEIC.

Figure 11. Experts do not foresee deflation



Source: Consensus Economics (June 2009).

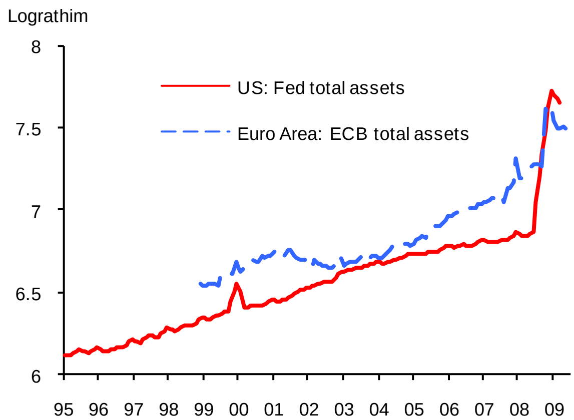
In fact, the aggressive policy response in key industrialized countries has led some to worry about inflation in the medium term. There is a reasonably widespread consensus among economists that lowering interest rates alongside substantial fiscal expansion was the right response to the current downturn in the short term. Indeed, there are few who expect inflation any time soon. However, the response of several key central banks to the crisis has been aggressive compared to historical benchmarks and it has included additional unorthodox measures that could potentially lead to inflation in the medium and long term. Many worry about the large fiscal deficits that will result from the forceful fiscal policy response in major industrialized countries, notably the US. In a country such as the US, where the government can issue interest bearing debt, whether large fiscal deficits lead to inflation depends on monetary policy. If the central bank "accommodates" the fiscal deficits by letting them lead to higher money supply, higher total demand and inflation may follow. If the central bank prevents the money supply from rising, higher short term interest rates will contain the rise in total demand and inflation. This puts the onus on monetary policy. Several prominent economists have expressed worries about the ability and willingness of policymakers to successfully reduce the size of central banks' balance sheets and tighten monetary policy more generally.[17]

The balance sheets of key central banks have expanded sharply. They have done this by boosting base money (the liabilities of the central bank) via standard injections of liquidity; pursuing quantitative easing by buying long maturity government bonds; and, in

[17] Martin Feldstein (Financial Times (FT), April 19) and John Taylor, quoted by Martin Wolf (FT, May 6).

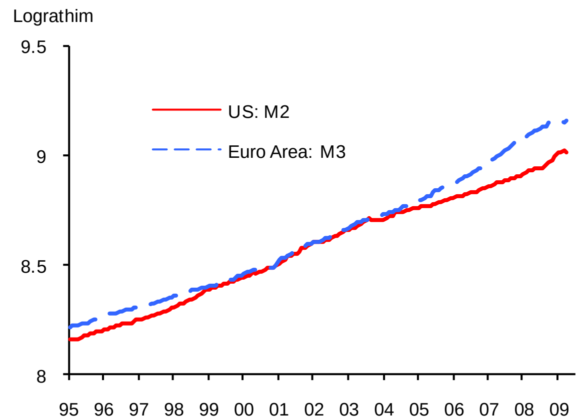
the case of the FED, providing direct credit to private borrowers. As a result, the balance sheets of central banks are now much larger than they normally are (Figure 12). If things go wrong, this potentially could threaten monetary stability. To date, these liquidity injections have led to a much more moderate increase in overall monetary aggregates in the US and, especially, Europe (Figure 13). So far, banks in the developed countries have used the additional base money to restore their required reserves and built up excess reserves (some US$ 700 billion the case of the US). In the face of the global recession and very weak demand for loans, banks have actually slowed lending (the "money multiplier" has dropped dramatically in the US and Europe) (Figure 14).[18] Once the financial system stabilizes and bank lending eventually comes on stream again, banks could lend out multiples of the hoarded reserves (the money multiplier could rise). What will happen to monetary aggregates depends on the "exit strategy" of central banks.

Figure 12. A large expansion of central banks' balance sheets



*Source:*IMF IFS.

Figure 13. A much more moderate expansion of broad money



Source: CEIC.

While there are no disagreements over what needs to be done to avoid inflation in the medium and long term, some fear that central banks are not able to do this. To avoid inflation in the medium and long term, central banks need to eventually withdraw much of the high powered money they created and bring the size of their balance sheets back to normal. In principle, there are no disagreements over the need to do this. However, there are some concerns over how easy this is going to be, technically and politically. On the technical side, for instance, many of the new assets on the balances sheets of central banks are illiquid. In the case of the US, Feldstein notes that commercial banks may not want to exchange their reserves for the "mountain of debt" that the FED is holding and the FED lacks enough treasury bonds to conduct ordinary open market operations. These technical concerns are countered by FED president Bernanke (2009).[19] He argues the FED has sufficient ability to soak up the liquidity, including because (i) much of the FED lending (up to US$ 1 trillion) is short-term and thus could be wound down relatively quickly; (ii)

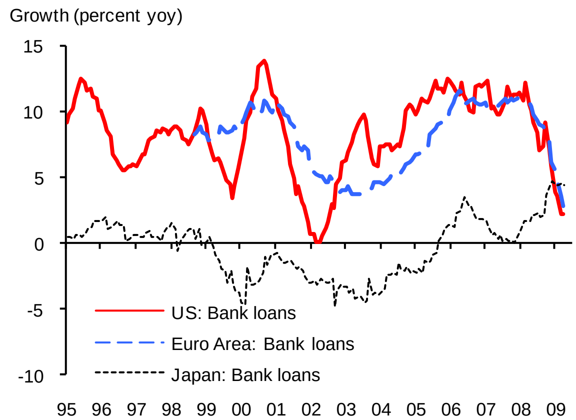
[18] Monetary aggregates such as M2 can be seen as a function of the monetary base and the money multiplier.

[19] *The Federal Reserve's Balance Sheet*, Ben Bernanke (2009).

the FED can conduct reverse repo agreements against its long-term securities holdings to drain bank reserves.

There may also be political constraints in soaking up the liquidity and tightening monetary policy swiftly. It may be politically difficult to tighten monetary policy at a time when the economic recovery is not yet in full swing. Moreover, government debt is set to rise substantially in the coming years in several countries. Some fear that this may lead to political pressure on central banks to keep interest rates low. This may lead to weakening of currencies. In addition, "when the time comes to sell its large holdings of mortgage debt, the FED may face resistance from the housing lobby of the US" (the Economist, April 25). Indeed, some say that the real risk is not "uncontrollabe" inflation, but rather a preference for inflation over deflation.

Figure 14. Bank lending is slowing rapidly in the US and the Euro zone



*Source:*CEIC.

Policy makers should be able to manage these challenges—this is also what financial markets think—but risks remain. It is not clear that the technical difficulties are really problematic. However, there is a risk that central banks err on the side of supporting a recovery at the risk of higher inflation. Given that monetary policy has lost some credibility, independent central banks may feel the need to show independence and strengthen their credentials, thus erring on the side of caution, and policy makers have some time to develop instruments and mechanisms to deal with possible problems. The potential risks may be more significant. So far, judging from inflation forecasts and bond yields, experts and investors do not expect significant post crisis inflation. But this cannot be ruled out.

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From Poor Area to Poor People: China' Evolving Poverty Reduction Agenda – an Assessment of poverty and inequality in China

Report No.: 47349

Abstract: China's progress in poverty reduction over the last 25 years is enviable. One cannot fail to be impressed by what this vast nation of 1.3 billion people has achieved in so little time. Between 1981 and 2004, the fraction of the population consuming below this poverty line fell from 65 percent to 10 percent, and the absolute number of poor fell from 652 million to 135 million, a decline of over half a billion people. The most rapid declines in poverty, in both the poverty rate and the number of poor, occurred during the 6th, 8th, and 10th plans. During the 7th plan period the number of poor actually rose, while in the 9th plan period, the poverty rate declined only marginally. But the pace of poverty reduction resumed between 2001 and 2004 and there are indications that during the first couple of years of the 11th plan poverty has continued to decline rapidly. The most recent official estimate of rural poverty in China for 2007 puts the number of poor at 14.79 million, or less than 2 percent of the rural population. While there is no official urban poverty line, estimates by others have found poverty levels in urban areas to be negligible using an urban poverty line that is comparable to the official poverty line for rural areas. These estimates thus suggest that only about 1 percent of China's population is currently in extreme poverty. Notwithstanding this tremendous success, the central thesis of this report is that the task of poverty reduction in many ways continues and in some respects has become more demanding.

Promoting enterprise-led innovation in China

Report No.: 48333

Abstract: China has made remarkable gains in industrialization and development. Over the past three decades, it has maintained gross domestic product (GDP) growth of about 9 percent per year and lifted hundreds of millions of people out of poverty. Entering the 21st century, China is determined to ensure the sustainability of its economic and social development, to which the innovativeness of business enterprises is critical. In 2006, the government of China laid out a strategy of enterprise-led indigenous innovation. In implementing this strategy, Chinese enterprises must cope with two severe challenges arising from the current stage of development. First, they must derive their competitiveness increasingly from innovativeness. Second, while they are innovating, they must also create jobs to keep the Chinese labor force employed. The realization of China's vision to promote enterprise-led innovation will entail concerted actions by government, the corporate sector, and the financial sector. What can the government do? The four basic recommendations of this report are to pursue a balanced strategy, to create the right incentives, to build the capacity of the private sector, and to strengthen the ecosystem for the venture capital (VC) industry.

Including financial services in preferential trade agreements: lessons of international experience for China

Author: Stephanou, Constantinos

Report No.: WPS4898

Abstract: The objective of this paper is to address the main considerations for China of including financial services in its preferential trade agreements. The paper briefly reviews China's financial liberalization process and the state of its domestic financial system, discusses the main considerations of including financial services in China's preferential trade agreements, compares and contrasts the different 'architectural' approaches that have been used by countries to include financial services in such agreements, and identifies good practices in preparing for financial services negotiations. Particular emphasis is placed on lessons from Latin American preferential trade agreements, given their more frequent and extensive coverage of financial services compared with other regions.