

PEOPLE'S REPUBLIC OF CHINA

The global economic slowdown has led to a sharp decline in demand for exports from the People's Republic of China, but a strong recovery in domestic demand has largely offset this. Although the 11 September terror attacks on the US have worsened the near-term external outlook, the economy is expected to maintain robust growth over the rest of 2001 and 2002. The Government's challenges are to manage the reform process after accession to the World Trade Organization and to reduce poverty by promoting development in the poorer provinces, as well as in the private sector.

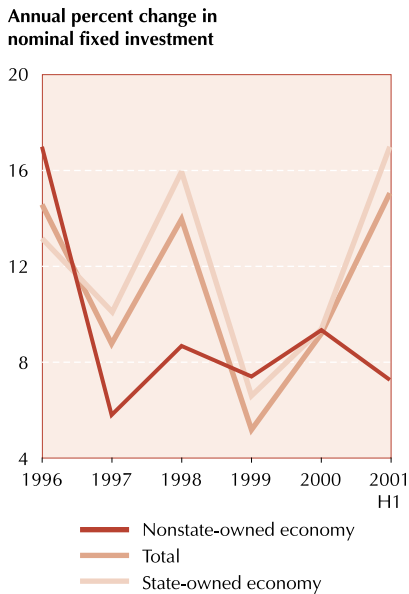
Economic Indicator (percent)	1998	1999	2000	2001		2002	
				Current	ADO 2001	Current	ADO 2001
GDP growth	7.8	7.1	8.0	7.3	7.3	7.0	7.5
Inflation rate	-0.8	-1.4	0.4	1.0	2.0	0.8	2.5
Current account/GDP	3.1	1.6	1.5	0.9	1.2	0.3	1.0

Economic Assessment. The sharper than expected global slowdown led to a steep decline in demand for exports from the People's Republic of China (PRC) during the first nine months of 2001, though this was largely offset by a strong recovery in investment and consumption. GDP growth declined somewhat to 7.6 percent over this period compared to 8.2 percent in the same period of 2000. The industry sector (including construction activity) expanded by 9.3 percent, led by strong domestic demand, with value added in heavy industry increasing faster than that of light industry. The services sector grew by 7.0 percent in this period, mainly due to rapid growth in the transport and telecommunications sectors. The agriculture sector expanded by only 2.4 percent, partly because more than 20 of the 31 provinces and municipalities were hit by serious drought. The yields of summer crops fell by 4.6 percent, following a 9.1 percent decline in total crop production in 2000.

During the first nine months of 2001, investment growth remained healthy due to increased public investment and FDI inflows. Reflecting the Government's "go west" policy, the investment growth rate in the western region was twice as high as that in the eastern and central regions. However, investment growth in the nonstate sector, including collective and privately owned businesses, declined, stemming from an underdeveloped base and the narrowness of the investment opportunities available to this sector. The Government is aware of these limitations, and has taken steps to encourage nonstate-sector investments, such as establishing a credit guarantee scheme for SMEs and reducing barriers to accessing credit for the nonstate sector.

Robust economic growth and imminent accession to WTO have made the PRC more attractive to foreign investors. Both contracted and actual FDI grew strongly in the first eight months of 2001. Contracted FDI was \$43.7 billion, a 31.6 percent increase compared to the first eight months of 2000. Actual FDI reached \$27.4 billion, a rise of 20.4 percent over the same

The first half of 2001 saw robust investment growth...



Source: National Bureau of Statistics

period of 2000. There are, however, some signs that, due to the rapid deterioration in the global corporate environment, FDI inflows into the PRC in July and August eased somewhat.

Consumption maintained its double-digit growth rate in the first nine months of 2001. Policies such as wage increases for civil servants and measures to facilitate the purchase of automobiles and housing have stimulated demand. However, income disparities between the rural and urban sectors widened in 2000: rural residents' incomes increased by only 2.1 percent compared to 6.4 percent for urban residents. Retail sales to rural residents in the first nine months of 2001 increased by 7.8 percent, whereas retail sales to urban residents increased by 11.5 percent. Moreover, the per capita cash income of rural residents increased by 5.2 percent in the first nine months of 2001 while the per capita disposable income of urban residents rose by 7.4 percent. Because the majority (64 percent) of the population live in rural areas, raising farmers' incomes has become a top priority for the Government. Recently, about 10 items of fees collected from farmers, including those relating to land use and farmers' dwellings, were eliminated. The Government is also conducting a fiscal reform experiment to reduce the tax burden on farmers by converting approved fees into an agricultural tax and abolishing other arbitrary forms of fees imposed on farmers. This policy reform will have a pro-poor impact because the system of imposing fees on poor farmers is a regressive method of taxation. It will also improve governance by bringing these funds into the budgetary framework. This will strengthen oversight and accountability for the management and expenditure of these funds.

The official estimate of urban unemployment at the end of 2000 was 6 million, about 3.1 percent of the urban labor force. However, the estimate does not cover urban *xiagang* workers, who are unemployed but are not registered with the Ministry of Labor and Social Security. There are still about 9 million *xiagang* workers who were laid off as part of the SOE reforms at the end of 2000. Including these *xiagang* workers, urban unemployment stood at about 15 million, or some 8.2 percent of the urban labor force, at the end of 2000.

The CPI rose by 1.0 percent in the first nine months of 2001 from 0.4 percent for the whole of 2000. Housing and services prices rose moderately, while food and traded goods prices declined. In relation to traded goods, due to weak foreign demand, manufacturers have been cutting prices and diverting stocks intended for exports to the domestic market.

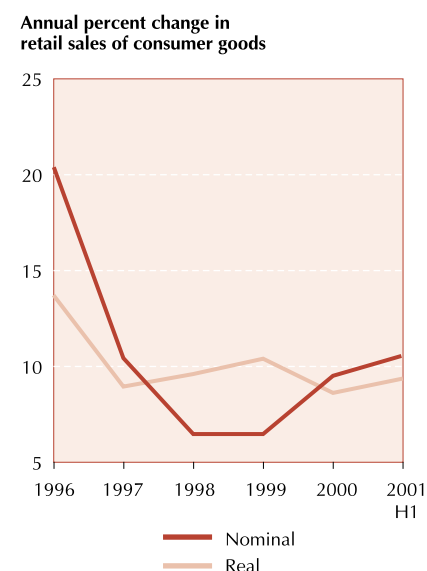
From January to September 2001, export and import growth decelerated to 7.0 percent and 11.2 percent, respectively, from 33.1 percent and 38.7 percent in the corresponding period of the previous year. While slower export expansion mirrored the slowdown in world trade, the import-dependent nature of exports meant that import growth also decelerated during this period, notwithstanding relatively high imports of investment and consumption goods. As a result, the trade surplus narrowed marginally to \$13.6 billion, from \$14.0 billion in the corresponding period of 2000.

Economic Management Issues. In the wake of sharply slower export growth, monetary policy remained accommodative to stimulate domestic demand and boost GDP. By the end of September 2001, outstanding broad money (M2), narrow money (M1), and money in circulation (M0) were higher by 13.6 percent, 12.3 percent, and 8.4 percent, respectively, over September 2000 levels. The aggregate loan balance of all financial institutions at end-September 2001 was also 12.3 percent higher than 12 months earlier. The increase in loans in 2001 consisted mainly of consumer credit and agriculture loans. Interest rates remained stable in the first nine months of 2001, after seven reductions in rates beginning in May 1996. The domestic one-year bank deposit rate was 2.25 percent and the prime lending rate of financial institutions was 5.85 percent. Some liberalization of foreign lending and deposit rates has taken place, marking the early steps in reform of the administrative system for setting interest rates that began in September 2000. Liberalization of domestic currency lending rates will follow, and the freeing up of domestic currency deposit rates will be the last stage of this reform.

The expansionary fiscal policy that was begun in 1998 in the wake of the Asian financial crisis is being gradually phased out. Although an additional Y150 billion in bonds will be issued in 2001—with Y50 billion for the central government budget, Y50 billion for on-lending to local governments, and Y50 billion to support the Government’s “go west” policy—the fiscal deficit for 2001 was originally planned at 2.7 percent of GDP as against 2.8 percent of GDP in 2000. Better than expected revenue collection in the first half of 2001 suggests that the actual fiscal deficit will be lower than the planned budget figure. During the first six months of 2001, tax revenue increased by 27 percent over the same period in 2000. Revenue from VAT and consumption tax rose by more than 40 percent, while revenue from individual income tax and enterprise income tax, taken together, improved by 36.2 percent.

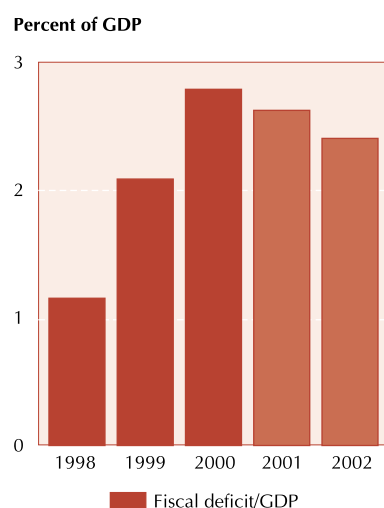
The main external risk facing the PRC relates to the prospects for recovery in the US economy, the country’s largest export market. Although it is anticipated that the US may gradually recover toward the end of the first half of 2002, the speed of this recovery remains uncertain—an uncertainty increased by the 11 September attacks on the US. The PRC’s exports will likely see a more pronounced contraction and the growth rate of foreign tourists may drop somewhat in the next few months. Further volatility in the stock market, which declined sharply in the aftermath of the 11 September attacks, cannot be excluded as events unfold. There is also concern over the economic slowdown in Asia and the pace of recovery. To minimize the adverse impact of the sharper and more protracted slowdown in the global economy, the Government recently adopted several measures to encourage exports, such as speeding up export-tax refunds and customs procedures, and granting permission to nonstate-owned companies to conduct external trade. Such trade was previously limited to government-approved medium and large SOEs. Despite these measures, the Government needs to make more effort to increase trade with countries that are less dependent on the US economy. If the external conditions deteriorate further, it will have to place greater emphasis on targeting a proactive fiscal and monetary policy for private sector activity in

...while consumption demand was relatively stable



Source: National Bureau of Statistics

Expansionary fiscal policy is gradually being phased out



Sources: National Bureau of Statistics, staff estimates

general and small and medium enterprises in particular. There is also a need for improving the business environment. This will require better governance to improve the legal regulatory framework, increase transparency and disclosure, strengthen auditing and accounting, protect intellectual property rights, reduce corruption, and ensure that contracts can be enforced.

The country's fight against poverty, in spite of significant achievements, has a long way to go. A Ten-Year Poverty Reduction Strategy (2000-2010) was formally announced in June 2001. A "key county" poverty system will be used to focus assistance for the remaining 30 million rural people with incomes under the official poverty line of Y625 per capita annual income. Poor villages in non-key counties will also be eligible for national poverty funding. Given that almost all the poor live in the central and western parts of the country, the Government will have to mobilize more resources to promote development there. And since a dynamic private sector will be an engine for economic growth and employment generation, it must also work to create a pro-business environment that provides the private sector with the same access to markets, finance, and land, and enforcement of property rights, as the public sector.

Accession to WTO will result in consumers having a wider choice of products while some goods and services will be sold at lower prices. Even though the welfare effects of WTO membership are positive in the long run, adjustments to be made in the short term will have social costs. WTO accession is likely to produce significant competitive pressure on the agriculture sector, as well as on the telecommunications and automobile industries. New studies show that the PRC's banking sector, one of the most protected in the country, is particularly vulnerable. In the short to medium term, local banks' net interest margins will narrow and profitability will be squeezed. Weak banks with low capital bases and poor asset quality may have to exit the market, possibly upsetting the stability of the domestic banking system. Consequently, to face the challenges from international banks after WTO accession, finance sector reform must be accelerated. The key challenge for the Government is to strengthen domestic banks by tackling the problem of nonperforming loans and to establish an effective corporate governance system. Domestic financial institutions must work to develop new areas of business and improve economic efficiency. Better human resources management systems, more generous compensation and incentive packages, and more appropriate staff training and career development, are also required.

Forecast. The 11 September attacks on the US, in the context of an already weakening global economy, have worsened the near-term external environment for the PRC. The country is, however, likely to be less affected by these events than many other countries in the region due to its relatively low dependence on exports and its strong domestic demand. GDP growth is now expected to grow by 7.3 percent and 7.0 percent in 2001 and 2002, respectively. Although economic growth is likely to slow during the remainder of this year, rising domestic consumption and investment will for the most part make up for the negative impact of slower export growth. Investment will likely remain strong due to the large public investment program and the

consolidation of FDI inflows at a high level. Consumption growth will also remain buoyant, due to rising incomes, including civil servants' salary increases. With inflation subdued, the Government is likely to maintain an accommodative monetary policy during the remainder of 2001 and 2002.

Export growth is forecast to fall to 6.0 percent for the whole of this year before declining further to 4.0 percent in 2002 due to a more prolonged global slump and softer rebound in 2002 than previously anticipated. Imports will also grow more slowly in 2001 and 2002 but faster than exports due to WTO accession and the liberalization of trade policies. Tourism is also likely to be affected for the rest of 2001 due to heightened security concerns. As a result, the current account surplus will come down to 0.9 percent of GDP in 2001 before narrowing further to 0.3 percent in 2002. However, this decline will be offset by foreign investment inflows, as the economy opens up further to foreign participation to fulfill WTO commitments. Official foreign exchange reserves will be about \$195 billion and \$210 billion in 2001 and 2002, respectively. With strong domestic consumption growth, there will be some pressure on prices, but given significant excess capacity in many industry subsectors, large unutilized supply potential in agriculture, and imports of cheap goods due to WTO-associated tariff liberalization, inflation is forecast to average 1.0 percent in 2001 before declining marginally to 0.8 percent in 2002.