

# People's Republic of China

## Summary

**F**irst-half GDP growth in 2005 was faster than anticipated, reflecting expansion in net exports, strong investment, and accelerating consumption. Mainly on this basis, the *Update* revises upward the GDP growth forecast for 2005 to 9.2%. A good harvest has damped inflation, paving the way for the consumer price inflation forecast to fall to below 3% for 2005. The larger than expected trade surplus has led to an upward revision of the current account surplus relative to GDP.

For 2006, the growth projection remains at just below 9%. Trade surpluses will likely narrow as the export surge, trimmed by softer global trade growth, is tempered. Investment is expected to decelerate due to moderate credit expansion and deteriorating profitability.

In an exchange rate policy move with significant implications, the People's Bank of China in July announced that it would no longer peg the yuan to the US dollar but would manage the exchange rate based on market supply and demand and with reference to a basket of foreign currencies. The central bank also revalued the yuan.

Downside risks to the growth outlook are energy concerns, weaknesses in the banking system, overcapacity in some industries, and the possibility that rural incomes will come under pressure.

## Updated assessment

GDP data for the first half of 2005 showed little sign of the anticipated growth slowdown. The first-half rate was 9.5% year on year, similar to the rate for the whole of 2004. Underpinning growth in the first half of the year were surging

net exports, still-buoyant investment, and an acceleration of consumption. Continuing strong growth aided employment generation: about 6 million new jobs were created in this period, or some two thirds of the target for the whole year, mainly by the private sector.

Net external demand contributed significantly to GDP growth. Exports continued to power ahead, up by 32% in the first 7 months. Textile exports surged in the first quarter, supported by the abolition of textile quotas under the Multifibre Arrangement. The associated trade frictions and resultant agreements (with, for example, the European Union) led to a drag on textile expansion in the second quarter.

Total import growth, in contrast, slowed to 14% in the first 7 months, significantly less than the 35%-plus rate of the previous 2 years (Figure 2.2). Particularly affected were agricultural and mineral products, base metals, machinery and equipment, and motor vehicles and parts. A good harvest, slightly slower investment growth, a stronger competitive position for some domestic industries such as automobiles, and a drawdown in oil inventories were the main factors contributing to slower import growth.

The continued upsurge in exports, combined with decelerating imports, produced a trade surplus of \$39.7 billion in the first half, a turnaround from a trade deficit of \$7.6 billion in the same period of 2004. Expectations of a currency appreciation also played a role in the big trade surplus, as some companies brought forward exports and delayed imports.

Retail sales grew by 12.0% in real terms in the first half, 1.8 percentage points higher than the year-earlier period. Sales were boosted by rising household incomes. Real rural incomes grew



by 12.5%, 3 percentage points faster than urban incomes, following increased grain production and government efforts to assist farmers, including the abolition of the agricultural tax. Retail sales data suggest that overall consumption (public and private) is firm, but past evidence suggests that its growth may be somewhat more moderate.

Although the growth rate of fixed asset investment in the first half remained high at 25.4%, this was below the 28.6% posted a year earlier. Nominal fixed investment growth tends also to exaggerate that of real investment as measured in the national accounts.

Government policies to rein in investment in sectors that it considers overheated, particularly real-estate development, started to have an impact. Investment is expected to slow further in the second half because of tighter credit and reduced corporate investment resulting from a moderation in profit growth. This expected deceleration in the second half, together with a slowdown in export growth caused in part by recent steps to constrain exports of energy-intensive products such as aluminum and steel, will slightly cool GDP expansion from the first-half pace. However, the forecast for the whole of 2005 is revised to 9.2%, from 8.5% in *ADO 2005*. The 2005 current account surplus is now expected to be 4.7% of GDP, largely as a consequence of the increased trade surplus.

Consumer price inflation, which hit an 8-year high of 5.3% in July–August 2004, slowed to 2.3% in the first half of 2005, and is expected to remain low in the second. The consumer price index (CPI) rose by just 1.8% in April and May from a year earlier. Food prices, which account for about one third of the CPI basket, rose at a slower rate in the first half of 2005 than over 2004 because of a better harvest. Ex-factory prices rose by 5.6% in the first half, but this was not all passed onto consumers because of oversupply of many products. The CPI forecast for 2005 is revised to below 3% from 3.6% in *ADO 2005*.

Disbursed foreign direct investment (FDI) fell by 3.2% in the first half of 2005, compared with 12.0% growth in the year-earlier period. Since FDI commitments rose strongly in 2004 and increased by 19.0% in the first 6 months of 2005, disbursed FDI is expected to pick up in the second half of the year. Reduced FDI inflows did not curb the rise in foreign exchange reserves, though. By midyear, they had soared by 51% from a year earlier to \$711 billion, supported by the growing current account surplus and greater inflows of short-term capital, possibly in anticipation of a yuan appreciation. The monetary authorities continued to sterilize foreign capital inflows to limit the impact of reserves accumulation on monetary growth and domestic credit expansion.

In the financial sector, the authorities moved to control a surge in house prices and excessive investment in the real-estate sector by raising mortgage rates and by introducing a tax on housing transactions. Although growth rates of loans and broad money supply (M2) showed a modest acceleration in June and July, the monetary authorities are not expected to significantly relax monetary and credit policies.

According to a survey by the People's Bank of China, between the second quarters of 2004 and of 2005, the weighted average 1-year lending rate rose by almost 200 basis points, while the benchmark lending rate went up by only 27 basis points. This sharp rise in the average lending rate followed the removal of upper limits on lending rates by the central bank in October 2004, and reflected pressure from the China Banking Regulatory Commission on commercial banks to tighten credit risk management and to enforce more stringent capital-adequacy requirements.

**Table 2.2 Selected economic indicators, People's Republic of China, 2005–2006, %**

Item	2005		2006	
	ADO 2005 Update	ADO 2005 Update	ADO 2005 Update	ADO 2005 Update
GDP growth	8.5	9.2	8.7	8.8
Inflation (CPI)	3.6	2.5	3.3	2.6
Current account/GDP	1.2	4.7	0.4	3.6

Source: Staff estimates.

In a move with significant implications, on 21 July the central bank adopted a managed exchange rate with reference to a basket of foreign currencies, dominated by the US dollar, euro, yen, and won, in what would appear to be a first step toward greater exchange rate flexibility (Box 2.1). The yuan was revalued by 2.1% to CNY8.11/\$1.

Reform of the banking system continued. In April, the Government injected \$15 billion of foreign reserves as new capital into the state-

owned Industrial and Commercial Bank of China (ICBC), the country's largest bank in terms of assets. Strengthening of the capital base is in preparation for a public offering of stock. ICBC also disposed of CNY459 billion of nonperforming loans to asset management companies. The total nonperforming loan ratio of the four large state-owned commercial banks declined to 10.1% by the end of June from 15.6% at the start of 2005, largely because of ICBC's disposal of such loans.

The tightening of fiscal policy, expected in *ADO 2005*, appears to be on track. Revenues and expenditures both rose by about 15% in the first half of the year, with revenues rising faster than expected. The fiscal deficit is expected to narrow to 0.9% of GDP over the full year, from 1.5% in 2004. As part of its move to phase out preferential policies for foreign-funded enterprises, the Government is considering a uniform corporate tax rate for both foreign and domestic enterprises. In other policy developments, the Government

### Box 2.1 Implications of the new exchange-rate policy

The People's Bank of China announced on 21 July that it would no longer peg the yuan to the US dollar—a practice followed since 1997—but would manage the exchange rate based on market supply and demand and with reference to a basket of foreign currencies. Dominant currencies in the basket include the US dollar, euro, yen, and won, but their weights have not been made public. The central bank also revalued the yuan by 2.1% to CNY8.11/\$1.

According to the central bank, the demand for foreign-exchange hedging services and risk-management tools is now increasing because of the new exchange rate mechanism. Reflecting this, it took steps in August to establish a foreign exchange forwards business and launch currency and interest-rate swaps.

It is too early to assess the full impact of these steps toward

greater exchange rate flexibility but, although the immediate effects are limited, they will likely have the following longer-term implications:

- A moderating impact on exports and therefore on investment in export industries.
- An improvement in the PRC's terms of trade, providing some relief from rising global prices for oil and raw materials.
- A possible reduction in speculative capital inflows into the PRC because of the two-way risk in the yuan's movements. In the near term, though, speculative inflows may increase on expectations of further currency appreciation.
- Some weakening of inflationary pressures if the need to sterilize capital inflows is reduced, giving the central bank more control over the money supply.

- Changes in export patterns and in FDI, which could lead to frictional unemployment.
- Possible greater flexibility in exchange rates among other Asian economies without risk of a loss of competitiveness to the PRC, so helping reduce global imbalances.

In a wider context, financial reforms that would complement the currency mechanism, some of which are now under way, include deepening the currency market through allowing a broader range of participants, permitting market forces to have a significant impact on the exchange rate, liberalizing domestic interest rates, and, eventually, liberalizing capital controls.

A stronger banking system is also essential if the risks of a more flexible exchange rate system are to be managed successfully.

issued a document in February aimed at stimulating private sector development. More of the areas that are currently dominated by state-owned enterprises (SOEs) will be opened to private investment, including public utilities, infrastructure, financial services, and social sectors such as education, health, culture, and sports.

## Prospects

This *Update* forecasts GDP growth of just below 9% for 2006. This figure is up a little from the *ADO 2005* projection. It is expected that high economic growth will be supported by rising incomes and consumption, though the deceleration of investment and net exports expected from the second half of 2005 is likely to bring GDP growth down a little from the peak levels of recent years.

Consumer inflation is expected to be just under 3% in 2006, since excess capacity in manufacturing and expected increased grain production will likely diminish upward pressure from higher production costs, including rises in wages and benefits and in international oil prices.

The trade surplus is forecast to narrow gradually in 2006 on an expected moderation in export growth, which will be influenced by softer growth of world trade and by some export self-restraint stemming from pressures from industrial trading partners. More sectors of the economy are scheduled to be opened to foreign competitors under World Trade Organization commitments, which will support import growth. The current account surplus is forecast to fall to 3.6% of GDP in 2006.

The fiscal deficit is projected to narrow further, to 0.7% of GDP in 2006. However, there is a risk that the fiscal position could be jolted by factors such as off-budget expenditures and contingent liabilities of SOEs. In addition, still-substantial nonperforming loans in the state-owned commercial banks and unfunded pension requirements could weaken the fiscal position. Money supply is expected to grow broadly in line with nominal GDP growth. M2 growth is projected at 14–15% next year, almost the same as in 2004 and 2005.

As a consequence of rapid economic growth over many years, the PRC has become the second-

biggest consumer of oil and one of the largest oil importers in the world. More than 40% of the economy's oil requirements are imported. Until 1993 the country was a net oil exporter.

The thirst for oil has been abetted by a more than 20% annual average increase in private vehicles over the past 3 years. Moreover, the economy does not use energy efficiently (see Part 3). In addition, the domestic oil pricing system is not fully market based. For example, while global oil prices rose by 30% in the first 7 months of this year, the PRC retail price of gasoline rose by only 15%, causing losses for the oil companies caught in this squeeze. Price controls have aggravated a shortage of gasoline in some cities, particularly in the Pearl River Delta, in part because oil companies can earn more by exporting the fuel. Reforms to the pricing system are now being considered. The PRC may face increasing energy bottlenecks in the future unless pricing becomes more responsive to market requirements, and energy conservation and efficiency are encouraged.

These energy concerns pose some risk to the growth forecast for 2006. Other downside risks emanate from weaknesses in the banking system, overcapacity in some industrial products, and potential problems for rural incomes.

With regard to banking weaknesses, the state-owned commercial banks need to improve their services and strengthen their capital structures and management if they are to withstand the competition that will follow the lifting in 2006 of geographic and customer restrictions on foreign banks under the PRC's World Trade Organization commitments. With regard to overcapacity, this has resulted from heavy investment, particularly in the steel, aluminum, cement, and automobile industries. If this is not reined in sufficiently, oversupply and subsequent lower prices could lead to deflationary pressures that seriously weaken producers' profitability and balance sheets, causing further problems both for their lenders and for growth more widely. Finally, rural incomes have risen faster than urban incomes in recent quarters, but could come under pressure as farm production costs look likely to rise faster than prices of farm products. Additional government measures to assist rural communities are required to maintain the growth in rural incomes.