

# People's Republic of China

Economic growth sprinted ahead in the first 6 months of 2006, as fixed investment and exports again surged. This *Update* revises up the full-year growth forecast, made in *Asian Development Outlook 2006 (ADO 2006)* in April, to 10.4%. For 2007, it upgrades the growth forecast to 9.5%. To cool the economy, the authorities have raised the key interest rate and implemented administrative controls. However, the effectiveness of monetary and fiscal policy is constrained by institutional, social, and technical factors, and though administrative controls can be useful they are often difficult to fine-tune. New approaches, including greater flexibility in managing the exchange rate and capital flows, and a variety of structural reforms, are likely to be needed. Yet if the current investment boom continues and leads to chronic overcapacity, achieving balanced and sustainable long-term growth could become somewhat problematic.

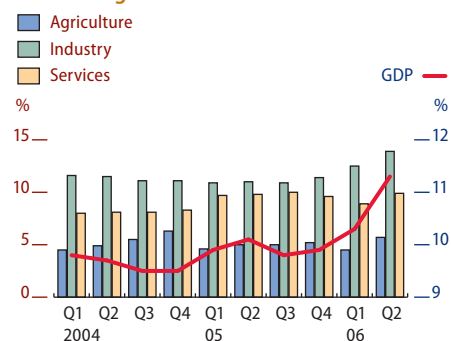
## Updated assessment

GDP grew by 10.9% in the first half of 2006 relative to the year-earlier period. Its 11.3% growth in the second quarter (Figure 2.2.1) was the fastest year-on-year rate since 1994. Investment again spearheaded GDP growth. Fixed asset investment surged by 29.8% in January–June, continuing the strong expansion seen in the second half of 2005, and even if down from its recent peak of early 2004, it is well above the official target of 18% (Figure 2.2.2). Gross capital formation is set to climb to nearly 46% of GDP in 2006, an increase of 10 percentage points over 4 years.

Direct estimates of consumption expenditure in the first half of 2006 are unavailable. Although retail sales grew strongly at 12.4% in real terms, overall consumption growth may be slower. Personal consumption growth has averaged 8% since the early 1990s, consistently lagging GDP growth by about 2 percentage points. Some of this gap is explained by a declining share of household disposable income in GDP and by the need for significant personal saving to finance education, health care costs, pensions, and purchases of expensive durable goods.

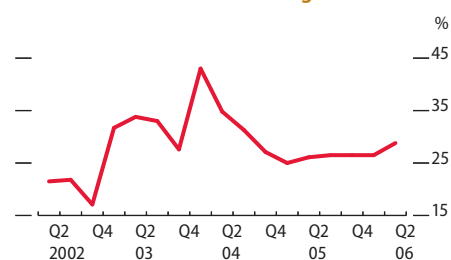
Favorable conditions in the global economy continue to support rapid expansion of merchandise trade, and net exports again contributed positively to growth in the first half of 2006. Exports and imports both grew rapidly, by 25.2% and 21.3%, respectively, resulting in a \$61.4 billion trade surplus for the first half of the year (Figure 2.2.3). Although the capital account remains in surplus, disbursed foreign direct investment fell slightly, perhaps a result of a more restrictive policy on property. The current account surplus is now expected to be around 7% of GDP in 2006, slightly below the record high of 7.2% in 2005.

### 2.2.1 GDP growth



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, various issues.

### 2.2.2 Fixed asset investment growth



Source: CEIC Data Company Ltd., downloaded 15 August 2006.

Despite rapid economic growth, consumer price inflation has remained tame. This reflects the supply-side nature of the current upswing and a rapid expansion of capacity. Indeed, output prices have been falling in some sectors even with increases in input costs. A good grain harvest has also helped keep consumer prices in check. The full-year rise in the consumer price index is now projected at just 1.6%, down from the 2.3% forecast in *ADO 2006* in April this year.

One area where prices are rising at a worrying rate is housing. Upward pressures come from easy liquidity (Figure 2.2.4), buoyant lending (Figure 2.2.5), and speculation. In an attempt to control the boom, the Government has imposed new restrictions on real estate development. For example, in April, the minimum downpayment on apartments larger than 90 square meters was increased from 20% to 30%, and a higher sales tax was applied on the sale of residential properties owned for less than 5 years. A 20% capital gains tax on residential property in force in some cities was extended nationwide. Additional restrictions on foreign investment in real estate were also imposed.

On the back of vigorous growth, fiscal revenue grew by 22% in the first 6 months of 2006; expenditure rose by 17.5% over the same period. Under the guidelines of the 11th Five-Year Program (2006–2010), one of the priorities is to increase spending on rural infrastructure and social welfare, especially education and health, and on lower-income groups in urban areas.

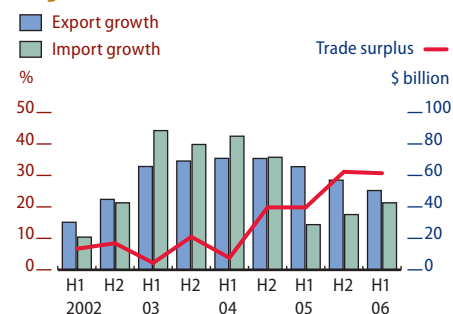
The acceleration of growth has heightened concerns about overcapacity and the possibility of a painful pullback in economic activity. The authorities have signaled their discomfort with the current pace of economic expansion, taking various tightening steps, including: two 27 basis point increases in the 1-year benchmark lending interest rate; increases in commercial bank reserve requirements effective July and August; and restrictions on investment in property. The People's Bank of China has also imposed direct controls on lending and adopted measures to absorb bank liquidity. It is now expected that the economy will expand by 10.4% in 2006, revised up from 9.5% in *ADO 2006*.

Statements by top leaders hint at more tightening measures to come. However, the actual likely magnitude and timing of the measures' impact are uncertain. In addition, their effectiveness, and the wider challenge of economic stabilization in the People's Republic of China (PRC), are complicated by a variety of factors.

First, economic incentives in the provinces are frequently at odds with those at the center. For example, provincial officials tend to attach higher priority to visible projects that support growth than to less tangible macroeconomic stabilization objectives. A senior regional leader and his deputies were recently publicly reprimanded for violating controls on investment. Administrative measures and exhortation may help moderate investment, but exercising close control across such a vast economy is not easy.

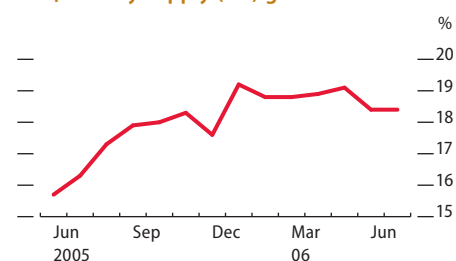
Second, the central Government is less able to exert direct control than formerly over investment decisions now that private investors, as well as local governments, play a more important role in investment. The funding of new projects has also diversified away from loans by state-owned banks, with enterprises' retained earnings an increasingly

### 2.2.3 Trade indicators



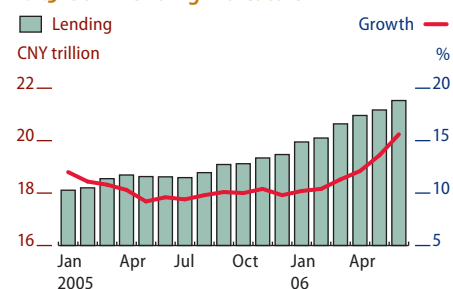
Source: National Bureau of Statistics, *China Monthly Economic Indicators*, various issues.

### 2.2.4 Money supply (M2) growth



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, July 2006.

### 2.2.5 Bank lending indicators



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, July 2006.

important source. In an effort to curb investment, the central authorities are pressing local officials to scrutinize new investment projects with a value of more than CNY100 million, to ensure that they are consistent with macroeconomic objectives.

Third, although the timeliness and reliability of statistics are improving, the central authorities must base some decisions on doubtful data from the regions. Moreover, available data may not be comprehensive, such that current economic developments can be subject to sharply different interpretations. For example, industrial profits were reported as rising by 28% in the first half of 2006, faster than a year earlier. For some, this suggests that the sector is performing well and making sound investment decisions. For others, these and other data imply that most of the profits were earned by a select group of favored state-owned industries that do not always base investment decisions on commercial grounds, given that many small and medium enterprises report a severe squeeze on profit margins.

Finally, interest rates and credit risks do not have the same pull on credit demand and allocation in the PRC as they do in a full market economy. Nonmarket considerations still play a significant, if declining, role. Even administrative controls are handicapped by a fragmented banking system. In addition, rising foreign reserves and capital inflows can undermine the impact of higher interest rates. Difficulties in constraining domestic credit expansion would be eased by allowing greater flexibility of the exchange rate and by relaxing controls on capital outflows. From just before the central bank's adoption of the managed exchange rate regime in July 2005, i.e., including the initial revaluation, to end-July 2006, the yuan appreciated by only 3.8% against the US dollar (Figure 2.2.6).

## Prospects

Although the Government would like to slow economic growth, it does not want to risk a disruptive, sudden deceleration. Creating jobs and reducing the widening income gap remain high priorities (Box 2.2.1), and require sustained growth. There are some forces that could even push up growth in the short term, risking more painful adjustments later on. Most immediately, fiscal spending is likely to increase in 2007 ahead of the 17th Communist Party Congress that year and in the lead-up to the 2008 Olympic Games in Beijing.

It may also be difficult to control credit expansion if large capital inflows continue. In these circumstances, it would become increasingly difficult to insulate the domestic monetary base, and to prevent liquidity from spilling over into investment. On the supply side, power supply and transportation bottlenecks, which in the past held back output, have eased following significant investments. Considering these factors against the tightening measures that have already been taken as well as the possibility of further restraints, the baseline forecast for GDP growth in 2007 is revised to 9.5% (Figure 2.2.7), but with significant uncertainty around this estimate.

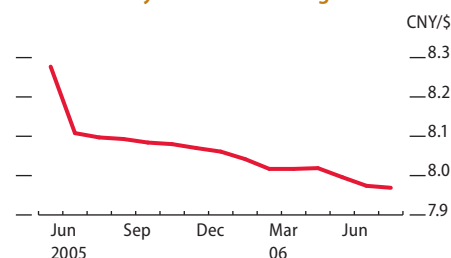
The rate of increase in the trade surplus is projected to moderate next year as export growth slows alongside somewhat softer conditions in the

### 2.2.1 Selected economic indicators, %

	2006		2007	
	ADO 2006	Update	ADO 2006	Update
GDP growth	9.5	10.4	8.8	9.5
Inflation	2.3	1.6	3.0	1.8
Current acct. bal. (share of GDP)	6.7	7.0	5.7	6.8

Source: Staff estimates.

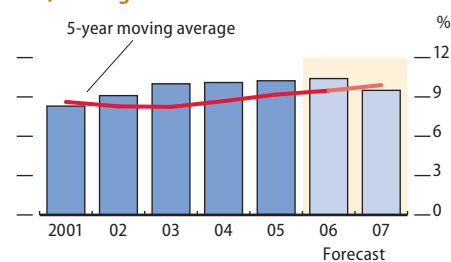
### 2.2.6 Monthly nominal exchange rate



Note: August data are for the first 3 weeks.

Sources: CEIC Data Company Ltd., downloaded 17 August 2006; Datastream, downloaded 22 August 2006.

### 2.2.7 GDP growth



Sources: National Bureau of Statistics; staff estimates.

### 2.2.1 Widening income gaps

Inequality in incomes has widened rapidly in the PRC in recent years. The Gini coefficient for the country, used as a measure of income inequality, increased from 0.30 in 1981 to more than 0.40 in 2005 (zero equals perfect equality and income distribution becomes more unequal as the coefficient approaches 1, its maximum value).

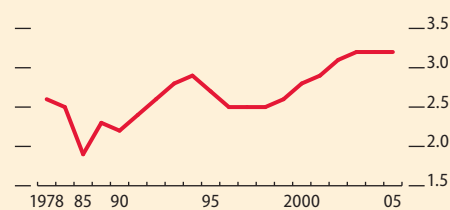
While some deterioration in income distribution is inevitable as the PRC moves from a largely agrarian and centrally planned economy to an urban-based, industrialized market economy, the degree to which the gap has opened is a concern. Unequal opportunities for education, health care, and migration of workers and their families from the countryside to cities are major reasons for the widening rift.

Since the PRC started opening up in 1978, the ratio between urban and rural incomes has risen from 2.6:1 to 3.2:1 (box figure). Typifying the uneven development between coastal and inland regions, the ratio between per capita GDP in Shanghai and Guizhou province in 2005 was 9.9:1. To some extent, this reflects growing divergence among different sectors of the economy. Looking at various jobs, the average wage in the highest-earning occupation in 2000 was 4.7 times that of the lowest-earning. This ratio had widened to 7.5:1 in 2004. Intragroup inequality has also widened. During

2000–2003, the ratio between the highest and the lowest rural income groups rose from 6.5:1 to 7.3:1, and the Gini coefficient in rural areas from 0.36 to 0.38. In the same period, the ratio between the highest and lowest urban income groups rose from 3.6:1 to 5.7:1, and the Gini coefficient in urban areas from 0.33 to 0.37.

Increasing income inequality has added to social tensions in recent years. Consequently, measures that lift rural incomes and improve the quality of life in the countryside should help ease such pressures. To address other aspects of inequality, the Government needs to direct more public resources toward the provision of affordable safety nets and other social protection mechanisms for those who cannot protect themselves against shocks and risks.

**Income ratio between urban and rural residents**



Source: National Bureau of Statistics, *China Statistical Abstract 2006*.

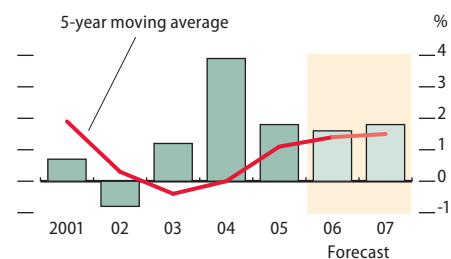
world economy. Government efforts to slow exports of resource-intensive products should also have an effect. In addition, the opening of more areas in the services sector, as a result of the PRC's commitments to the World Trade Organization, should stimulate imports by that sector. The current account surplus is forecast to decline to 6.8% of GDP in 2007.

Consumer price inflation is projected to be little changed next year (Figure 2.2.8). Low food price inflation and manufacturing overcapacity will maintain downward pressure on prices, but increases in public sector wages and in state-controlled prices of water, power, and oil products, as well as the easy credit conditions, will lift some consumer prices.

Risks to the outlook are finely balanced. If the investment momentum does not slow, growth in 2007 could again surprise on the upside, raising the possibility of more difficult adjustments later. Burgeoning excess capacity would increase the probability of a profit crunch, bankruptcies, bad loans, and consumer price deflation. But if the authorities brake too hard, GDP growth could fall by more than forecast. This happened in 1989–1990, when the Government stopped approving all new investment projects and GDP growth slumped from about 12% to 4% (Figure 2.2.9). In contrast, in the late 1990s, the Government successfully engineered a soft landing, with growth slowing from above 12% to 7–8%.

Structural weaknesses contribute to risks. Despite ongoing strengthening within the financial sector, significant vulnerabilities remain. Nonperforming loans have probably declined in recent years, though significant value would likely be at risk in the event

**2.2.8 Annual inflation**

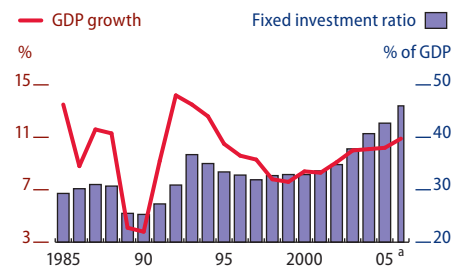


Sources: National Bureau of Statistics, *China Statistical Abstract 2006*; staff estimates.

of an economic downturn. To improve efficiency and mitigate risks, commercial banks need to further strengthen their capital positions and credit risk management functions. Rural households, meanwhile, lack access to formal financial services, and many rural credit cooperatives operate at a loss and carry a high proportion of nonperforming loans. The arrival of foreign banks and relaxation of restrictions on their activities should help improve overall banking system efficiency and safety. Already in July, Standard & Poor's raised the PRC's long-term sovereign credit rating to A from A-minus, citing among other reasons "persistent efforts to strengthen the banking sector."

Other growing concerns are environmental degradation and low energy efficiency. The PRC's economic boom is being driven largely by the development of heavy industry, and has come at a high cost in terms of pollution. In 2005, the country consumed 1.2 tons of coal equivalent for every CNY10,000 (\$1,234) of GDP, about three times that of the US and 10 times that of Japan, and one of the main targets of the new Five-Year Program is to lower energy intensity by 20% by 2010. But in the first half of this year, this ratio actually rose by 0.8%. Among other elements, cleaner energy technology and stricter monitoring are required to tackle the problem.

### 2.2.9 GDP and fixed investment



<sup>a</sup> First half 2006.

Sources: National Bureau of Statistics, *China Statistical Yearbook 2005*; staff estimates.