



People's Republic of China

Economic Assessment

Growth in gross domestic product (GDP) slowed to 9.6% in the second quarter of 2004 from 9.8% in the first and 9.9% in the fourth quarter of 2003, largely as a result of government macroeconomic policy tightening. Growth for the first half of 2004 was 9.7%. On the supply side, the industry sector, including construction, grew by 11.9% in the first 6 months. Agricultural production expanded by 4.9%, better than expected in *Asian Development Outlook 2004 (ADO 2004)*, after a good summer grain harvest, and the services sector grew by 8.0%. Some caution is required in drawing conclusions from the data, though. For a start, the year-earlier production figures were depressed by the severe acute respiratory syndrome (SARS) epidemic. Also, the statistical system of the People's Republic of China (PRC) still has weaknesses. For example, the services sector and private sector are not well covered, although the National Bureau of Statistics is working to improve the accuracy, quality, and timely disclosure of data.

A surge in fixed asset investment and concerns about overheating in some subsectors prompted the Government to resort to a combination of monetary, fiscal, and administrative measures for damping the economy beginning in September 2003. Excessive investment was most evident in the aluminum, automobile, cement, real estate, and steel subsectors. Symptoms of overheating included steep price increases for raw materials and severe bottlenecks in power and transportation. For example, in the first half of 2004, 24 out of 31 provinces experienced power blackouts, while the railway system was unable to move all of the freight on time. The tightening measures had some impact, especially on those five subsectors, and the growth in fixed asset investment slowed from 43.0% in the first quarter of 2004 to 22.3% in the second. However,

investment growth in cement and steel remained very high in the first half of the year, at 54.7% and 56.5% year on year, respectively, though this was well below 2003's rates of 96% and 130%.

Retail sales in real terms grew by 10.2% in the first half—sales were particularly strong for telecommunications equipment (up 52.3%) and motor vehicles (up 43.7%)—with rising incomes fueling consumption. Urban disposable incomes rose by 11.9% and the average cash income of farmers by 16.1%, the latter representing the largest increase since 1997. The underlying reasons included reduced agricultural taxes, higher grain prices, and changes to the grain procurement system, as well as moves both to increase the incomes of rural migrants working in cities and to ensure they actually get paid for their work.

In contrast to the 2000–2003 period when deflation was a concern, inflation has become an issue in 2004. Overall, the consumer price index (CPI) rose by 3.6% in the first half of the year, at 3% in urban areas and 4.6% in rural areas. In July, the CPI rose at a year-on-year rate of 5.3%. Food prices rose in the first half from low year-earlier levels, despite the good harvest. Driven by the rapid growth of investment and industrial output, ex-factory prices for industrial products rose by 4.7%, and the cost of industrial inputs such as raw materials, fuels, and power jumped by 9.8%. Against these rises, prices fell for clothing, household appliances, communications, and transportation. The People's Bank of China (PBC) is closely monitoring inflation as it weighs the need for an increase in interest rates, which are expected to be raised if inflation exceeds 5% for an extended period.

External trade has soared. Exports in the first half of the year shot up by 35.7% to \$258.1 billion, but imports grew even faster, by 42.6% to \$264.9 billion. In contrast with previous years' healthy trade surpluses, the PRC posted a \$6.8 billion trade deficit in the first half. The PRC

Table 2.1 Selected Economic Indicators, People's Republic of China, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	8.3	8.8	8.2	8.0
Inflation (CPI)	3.0	3.4	2.7	4.9
Current account/GDP	1.3	-0.1	1.0	-1.4

Source: Staff estimates.

runs a large trade surplus with the US and EU, but a deficit with the rest of Asia, especially Japan, Republic of Korea, Singapore, and Thailand.

The policy tightening has had little effect so far on the inflow of foreign direct investment (FDI). Contracted FDI leaped 42.7% to \$72.7 billion in the first half of the year from a year earlier and actual FDI was 12.0% higher at \$33.9 billion. The PRC's accession to the World Trade Organization (WTO) allows foreign investors to become involved in more fields, such as telecommunications, banking, insurance, and securities markets. Foreign-funded enterprises accounted for 31% of the country's industrial production in 2003 and more than half of its exports.

Foreign exchange reserves continued to rise in the first 6 months of 2004, by \$67.3 billion to \$470.6 billion (and from \$346.5 billion in the year-earlier period), and required the central bank to undertake sterilization measures to help reduce inflationary pressures.

Fiscal revenues grew by 30.6% year on year in the first half, faster than expenditures that increased by 11.8%. As a result, the fiscal surplus in the period reached CNY350.4 billion. However, if off-budget obligations, such as the implicit pension debt and costs related to nonperforming loans (NPLs) are included, the Government's contingent liability remains substantial. The growth of money supply moderated, reflecting the macroeconomic tightening, with broad money supply (M2) up by 16.2% at end-June, down from 20.9% a year earlier. Total bank deposits grew by 18.2% and total loans by 16.3%. There are some concerns that rapid growth in loans in the last quarter of 2003 and the first quarter of 2004 may eventually result in an increase in NPLs.

Economic growth continues to create jobs

in the PRC, but not enough of them. Between 15 million and 20 million new jobs are needed each year to employ people entering the workforce and those being laid off by state-owned enterprises (SOEs), as well as to provide off-farm work for some of the 150 million surplus rural workers. Since most jobs will likely be created in the private sector, building an environment that allows private enterprises to flourish should be a government priority. For all of 2004, the Government has set a target of employing 9 million people in new jobs; by midyear, 5.9 million jobs had been created. Official statistics, which significantly underestimate the problem, put the number of registered unemployed at midyear at 8.3 million, or 4.3% of the urban workforce, similar to the figure 12 months earlier.

Policy Developments

The Government has used monetary and fiscal policies and administrative measures to slow the growth of overheated sectors. However, the incomplete nature of the economic reforms limits the impact of monetary policy instruments and inhibits the central bank's ability to conduct monetary policy through interest rate changes and open-market operations. Anticipated interest rate rises will also raise the cost of servicing SOE and government debt. As a result, changes in banks' reserve requirement ratio, rather than interest rate rises, have been used to slow activity.

The goal of the Government is not only to slow investment in the overheated subsectors, but also to spur growth in the lagging sectors, such as agriculture, services, and small and medium enterprises (SMEs), as well as in poorer provinces in the central, western, and northeastern parts of the country.

Among the tightening steps taken were the following:

- In April 2004, PBC raised the reserve requirement ratio from 7.0% to 7.5% for most banks and to 8.0% for banks considered inadequately capitalized.
- Also in April, ministries and local governments were ordered to curb credit expansion and investment in the aluminum, cement, real estate, and steel subsectors.

- In late April, the State Council raised the lending criteria for aluminum, cement, real estate, and steel projects by requiring more equity investment. The minimum equity ratio for steel was increased from 25% to 40% and for aluminum, cement, and real estate from 20% to 35%. The list of sectors for which investment was prohibited or restricted was expanded to include machinery, petrochemicals, pharmaceuticals, printing, and textiles.
- In May, to encourage energy conservation, electricity prices were raised by 2.8% and the electricity tariff restructured so that those industries using electricity heavily are charged higher prices.

Fiscal policy, too, has been tightened. Keeping in mind that the proceeds of government bond issues are often used to finance investment in fixed assets, the Ministry of Finance in March reduced the planned bond issuance for 2004 from CNY140 billion in 2003 to CNY110 billion. The focus of public investment switched from production-related investment to education, health, science, and technology, with priority given to rural areas.

The Government accelerated the progress of agricultural tax reform in 13 provinces where grain production accounts for a substantial part of their economy. Jilin and Heilongjiang provinces were exempted entirely from agricultural taxes and the tax rate was lowered from 8.4% to 5.4% in the other 11 provinces.

A pilot value-added tax (VAT) reform was announced for the provinces of Jilin, Heilongjiang, and Liaoning in the northeast. To reduce the tax burden on investors, the current production-based VAT regime is to be changed to a consumer VAT system for eight industries, including chemicals, oil, and automobile manufacturing. This reform may cut tax revenue in the short term, but in the long term it should expand the tax base, strengthen collection, and lift revenues. Other planned fiscal reforms include unifying the corporate tax of domestic and foreign-funded enterprises and reforming the personal income tax system.

In the area of banking reforms, the legal framework for banks has been improved with the adoption of the Central Bank Law, Commercial Bank Law, and Bank Supervision Law in

December 2003. In addition, the China Banking Regulatory Commission (CBRC) is strengthening its capacity for bank supervision. The Government is also planning to amend the Negotiable Instruments Law, the Securities Law, and the Companies Law. These amendments are expected to significantly improve the development of the financial sector. Improvements that still need to be made include the adoption of an antimoney laundering law, a law to provide a legal framework for audit bureaus, a bankruptcy law, and regulations to wind up insolvent financial institutions.

According to official statistics, NPLs at the PRC's major banks—the four state-owned commercial banks and 11 joint-stock banks—dropped by 4.4 percentage points from end-2003 to 13.3% of their total loan portfolio by mid-2004. Some observers estimate that NPLs are higher than these levels. The decline in the official figures was related largely to the disposal of bad loans at the Bank of China, China Construction Bank, and Bank of Communications, which are being restructured. Bank of China and China Construction Bank were selected for a pilot bank reform and received a combined \$45 billion for recapitalization in early 2004. These two banks also sold nearly CNY280 billion (\$33.7 billion) of NPLs to asset management companies in June 2004. Despite these huge NPL disposals, the task of reducing NPLs further remains challenging, given that they may rise this year both because of 2003's rapid growth in lending and as an unintended consequence of macroeconomic tightening.

To improve capital adequacy, PBC and CBRC will allow commercial banks that meet the following criteria to issue subordinated bonds: (i) core capital adequacy ratios of not less than 5%, (ii) sufficient provisions for loan losses, (iii) sound corporate governance mechanisms, and (iv) no violations of laws and regulations within the past 3 years.

Under the current banking system, state-owned commercial banks, which account for 70–80% of total credit, make few loans to SMEs or to the private sector. Also, the PRC's capital market has been concentrated at the securities exchanges in Shanghai and Shenzhen, which were designed to meet the financing needs of large SOEs. To widen financial access for the private sector and SMEs, a new SME board was opened

at the Shenzhen Stock Exchange in May. Eight private companies were listed on the market on the opening day. Other measures that have been launched to help private sector and SME development include establishing SME development funds, improving SME service and support policies, and strengthening SME credit guarantee systems.

Although the Government has been attempting to cool some areas of fixed asset investment, it also has liberalized the approval system for those investments that have generally required government clearance. In July, it issued the Decision on the Reform of the Investment System, which aims to relax administrative control over investment by enterprises. Investments are classified into three categories: government-financed, large-scale and restricted, and other investment. Now, only government-financed investments need official administrative approval. Large-scale and restricted investments will be checked by the authorities, but other investments need to be registered only for statistical purposes.

The State Environmental Protection Administration called for the use of a “green” GDP methodology to reflect the relationship between environmental damage and economic growth. It said that average annual GDP growth from 1985 to 2000 would be 2 percentage points lower if environmental costs were reflected in the GDP estimates. The PRC still experiences considerable air and water pollution and land degradation. In addition to increasing investment in environmental protection, the Government needs to improve the regulatory system as well as strengthen compliance and enforcement, and make greater use of market-based instruments to put a financial cost on environmental damage.

The PRC has achieved the Millennium Development Goal (MDG) of reducing by half the number of people living on \$1 a day from the 1990 level (from 280 million in 1990 to 138 million in 1996 and 97 million in 1999). However, official statistics revealed that in 2003 the country recorded its first increase, to 29 million, in the number of people living in absolute poverty in 25 years. Some 800,000 people, mostly farmers, fell below this line, which stands at an annual per capita income of CNY637 (or \$77, well below the international norm of

\$1 a day). This was partly because of floods and drought but also because of the SARS outbreak. This increase suggests decreasing effectiveness of the Government’s poverty reduction program. Despite the fact that, by end-2003, the program had delivered special subsidized poverty reduction loans totaling CNY147 billion, poor targeting, low repayments, and corruption have led to a fall in the share of loans reaching the poor, from 70% in the mid-1980s to about 20% in 2003.

The PRC has made progress in achieving most of the nonincome MDGs, including providing access to basic education and reducing maternal mortality. However, more progress is needed to achieve the MDGs related to gender issues, HIV/AIDS, safe drinking water in rural areas, child mortality, and environmental damage.

Outlook for 2004–2005

The Government will continue its macroeconomic tightening measures and, in an attempt to avoid a “hard landing,” encourage growth in lagging sectors. GDP is now forecast to rise by 8.8% in 2004, up from the *ADO 2004* figure of 8.3%, and growth in 2005 has been revised down slightly to 8.0% from 8.2%.

The rapid pace of investment growth is slowing, reflecting the gradual impact of the measures. However, the large amount of construction in progress means that growth in investment will remain high at 25% this year and 21% in 2005. In the longer term, such high levels of investment cannot sustainably be relied on to drive economic growth. Consumption is expected to expand by 13% a year in 2004–2005, supported by increased urban and rural incomes and a strengthened social security system.

The PRC’s exports are forecast to rise by 22.0% in 2004 and 16.0% in 2005, based on expectations that the world economy will achieve higher than expected growth in 2004 and more moderate growth in 2005, and that the PRC will remain the leading destination for global FDI. (Foreign investment will continue to stimulate exports because foreign-invested firms produce over half of all PRC exports.) Imports are likely to outpace exports, increasing by 30.0% in 2004 and 20.0% in 2005, due to the country’s growing appetite for a wide range of imports and its lower

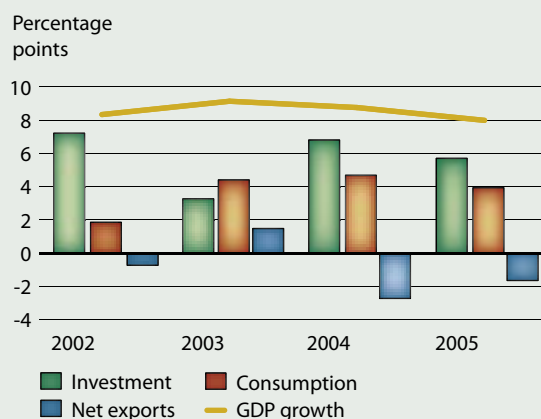
tariff and import barriers associated with WTO membership. The current account will turn from a surplus to a small deficit of about 0.1% of GDP in 2004 and 1.4% of GDP in 2005, for the first time since 1993.

In 2003, consumption, investment, and net exports all contributed to growth in GDP, at 4.4, 3.3, and 1.5 percentage points, respectively. The shares now are less balanced, with investment likely to account for 6.8 percentage points of GDP growth in 2004 and 5.7 percentage points in 2005. Consumption is forecast to contribute 4.7 and 3.9 percentage points, respectively, and net exports will subtract from growth (Figure 2.1).

Inflation will moderate in the second half from July's pace. The larger grain harvest in the first half will help lower inflation, which is now forecast at 3.4% in 2004 and 4.9% in 2005, both revised up from *ADO 2004*.

Higher global oil prices have introduced new uncertainties to the country's economic prospects for 2005. An extra \$10 a barrel for all of 2005 could translate into a decline in the GDP growth rate in 2005 of 0.8 percentage points and in the trade balance as a share of GDP of 0.1 percentage points, and a rise in the inflation of 0.5 percentage points. (Oil scenarios are discussed further in Part 3.) The PRC's demand for oil grew by 9% in 2003 to about 270 million tons, or double the 1992 level. Net oil imports in 2003, at 91 million tons, were more than twice the 1998 level. With continued economic growth and a rapidly growing number of motor vehicles, the demand for oil will continue its upward spiral. At the

Figure 2.1 Contribution to GDP Growth, People's Republic of China, 2002–2005



Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2003*; staff estimates.

same time, production from the nation's aging oil fields will decline. Some observers estimate that oil consumption could reach 600 million tons by 2020, with 400 million tons imported.

As it becomes more dependent on the international oil market, the Government is attempting to diversify both its sources of supply for its imported energy needs, as well as its types of supply, such as liquefied natural gas. A related issue for policy makers is the energy intensiveness of the economy, since its industries use over three quarters of a barrel of oil to produce \$1,000-worth of GDP, about double the average of other Asian countries. Increased efforts are needed in the areas of energy efficiency and energy conservation.