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Impact and Policy Responses People's Republic of China

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**Impact and Policy Responses
People's Republic of China (PRC)**

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Introduction and Summary

Financial and trade transmission mechanisms had increased the People Republic of China's (PRC) vulnerability to the global crisis. Despite this, the PRC has come through the global crisis in extraordinarily better shape than many forecasters had expected.

This remarkable resilience can be traced to a system which allows swift policy responses that are transmitted into the real economy with a relatively short time lag.

As a result, the signs point toward the PRC's economic growth surging very strongly next year. We believe that the risks to economic growth are now low. The greater risks that the PRC faces are now related to the unintended consequences of successful policy actions. Inflationary expectations could surge and distortions in the economy could intensify.

Macro-economic policy settings thus need to be reset as quickly as feasible. In particular, monetary policy stimulus needs to be withdrawn soon – monetary growth has to be reined in and the exchange rate should return to the path of gradual appreciation seen between July 2005 and mid-2008.

The PRC has also shown a remarkable determination to pursue longer term structural adjustments to ensure that its economy moves up the value chain and is more resilient to the vagaries of the global environment:

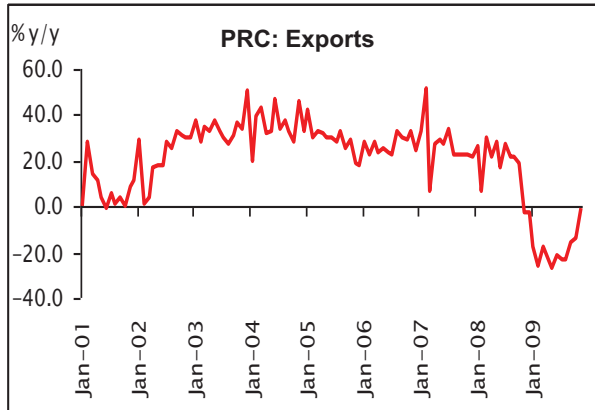
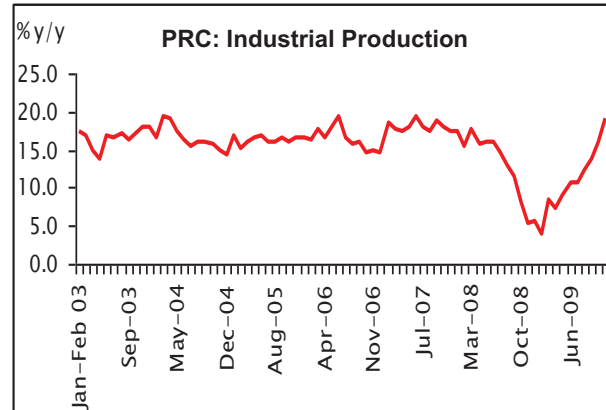
1. Where does the People's Republic of China (PRC) economy stand?

First, the crisis hit the PRC mainly through external demand and asset prices

The collapse in world demand badly dented the PRC's export sector. Exports plunged 52.6% from the pre-crisis September 2008 level – the steepest decline among Asian exports (Chart 1.1). Some 15% of export-oriented enterprises halted work or cut production by half¹ in late 2008. Industrial production decelerated sharply to expand just 3.8% y/y in January-February 2009² – the slowest pace since the series started in 1995 (Chart 1.2). An estimated 20 million migrant workers were forced to return home.

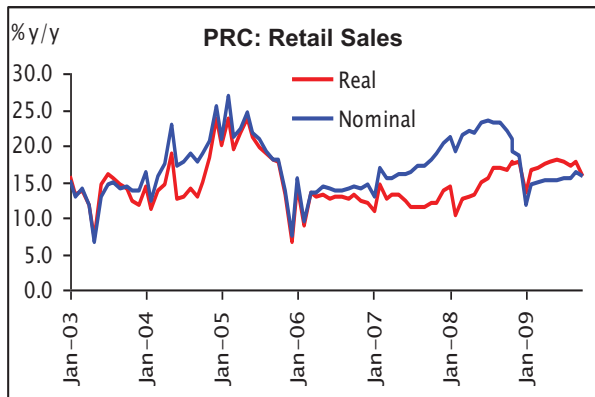
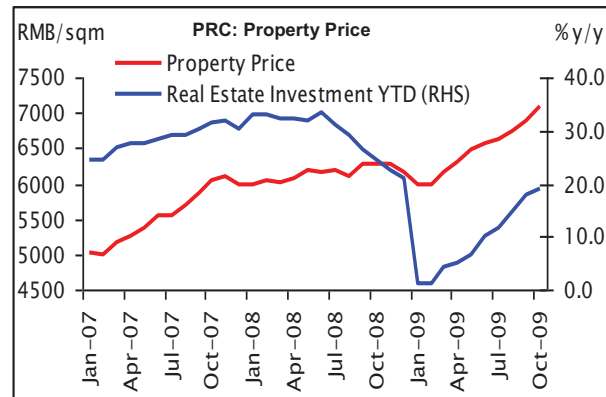
¹ The figure was quoted from Yao Jingyuan, chief economist at the National Bureau of Statistics.

² We look at January-February period as one data point to eliminate seasonal effects from the Lunar New Year.

Chart 1.1**Exports collapsed amid global crisis...****Chart 1.2****Industrial production decelerated sharply...**

Source: Collated by Centennial Group using CEIC Database.

The global crisis exacerbated the bust in the PRC equity markets, dragging the Shanghai Composite Index to as low as 1706.7 in November 2008 – 72% off its peak of 6092.1 in Oct 2007. Average property prices in 36 cities (collated by the Price Monitoring Centre under the National Development Reform Commission) fell about 5% in October 2008 through February 2009. Negative wealth effects coupled with dismal job prospects caused PRC households to curtail spending (Chart 1.3). Deteriorating sentiment amid fears of a property bust triggered a sharp pullback in real estate investment, which accounts for nearly a quarter of urban fixed asset investment in the country (Chart 1.4).

Chart 1.3**Retail sales decelerated, briefly...****Chart 1.4****Sharp pullback in real estate investment...**

Source: Collated by Centennial Group using CEIC Database.

As a result, the PRC's economic growth fell to 6.1% y/y in Q1 2009 – the lowest in 19 years (Chart 1.5). And for the first time in 13 years, net exports had an adverse impact on growth, knocking 3.6 percentage-points off headline GDP growth in Q3 2009 YTD (Chart 1.6).

Chart 1.5

Economic growth fell to a record low...

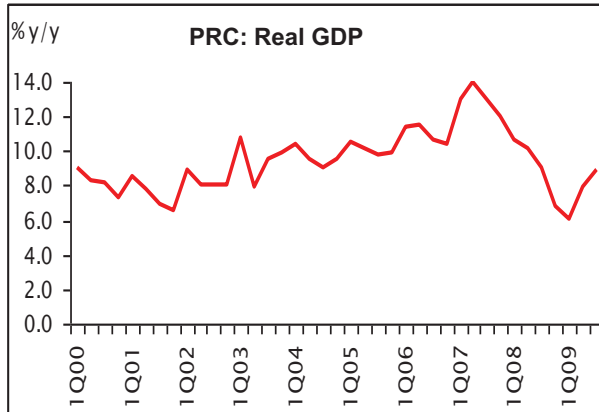
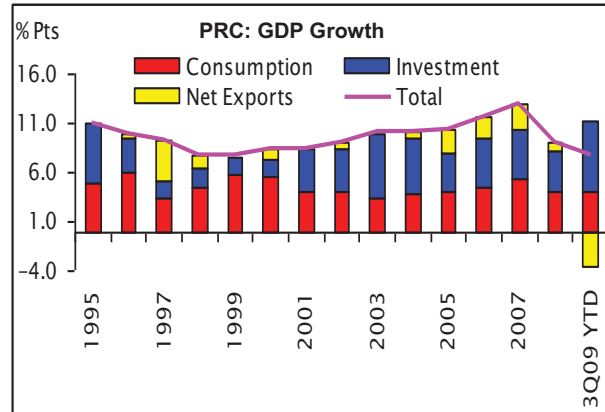


Chart 1.6

Net export had adverse impact on growth...



Source: Collated by Centennial Group using the PRC's NBS Database.

Second, swift and effective policy response turned the economy around much more quickly than anticipated

The PRC's remarkable resilience can be mainly attributed to swift, decisive and aggressive policy responses. Before the country's economic indicators could worsen further, the government conceived and implemented a range of stimulus measures (in late 2008 and early 2009) of unprecedented scale, which effectively arrested the economic deceleration and inspired a robust recovery.

- The centrepiece of policy response was a fiscal stimulus package worth RMB4tr aimed at boosting domestic demand (for 2009-2010), unveiled as early as November 2008. The size of the package stood at 12%-13% of the PRC's estimated 2009 GDP, well ahead of other major economies at that point in time (2.5% for the US, 4% for Japan and Germany). The scale of expansionary fiscal policy for 2009-10 was also unparalleled in the PRC history (Chart 1.7 and 1.8). More importantly, the fiscal stimulus was frontloaded at the start of 2009, pouring into infrastructure and development projects across the country.

Chart 1.7

Fiscal impulse of unprecedented scale

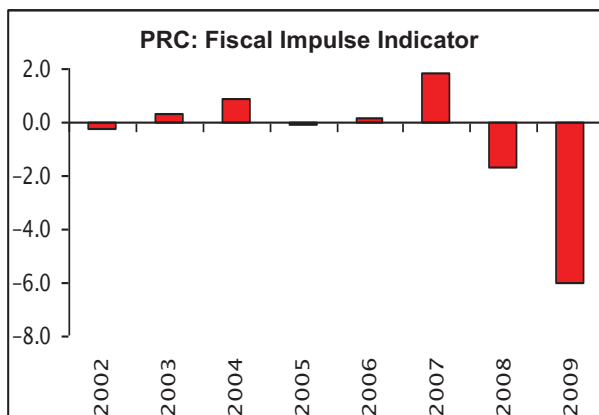
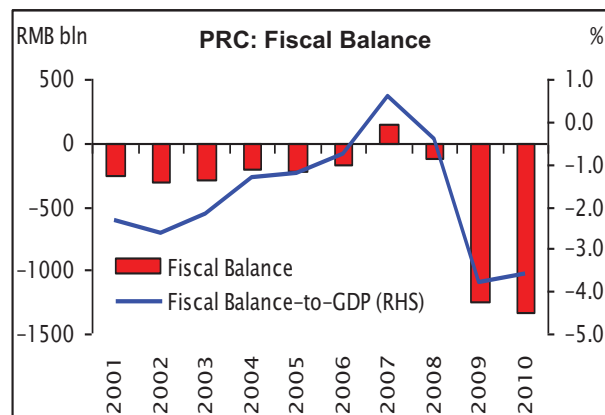


Chart 1.8

And planned over 2009-10



Source: Calculated by Centennial Group

- The People's Bank of China (PBOC) slashed its benchmark one-year working capital lending rate by 216 basis points to 5.31% from 7.47% in a short span of less than 4

months (15 September 2008 through 22 December 2008) as shown in Chart 1.9. Also, the one-year deposit rate was cut by 189 bps to 2.25% from 4.14%. Reserve requirement ratio for big banks was lowered by 200bps to 15.5% from 17.5%, and that for smaller banks was cut by 400bps to 13.5% from 17.5%. Lending quotas were scrapped. State-owned banks were asked to boost lending to help financially-distressed but viable companies, as well as to support public projects.

Chart 1.9

Steep cuts in interest rates...

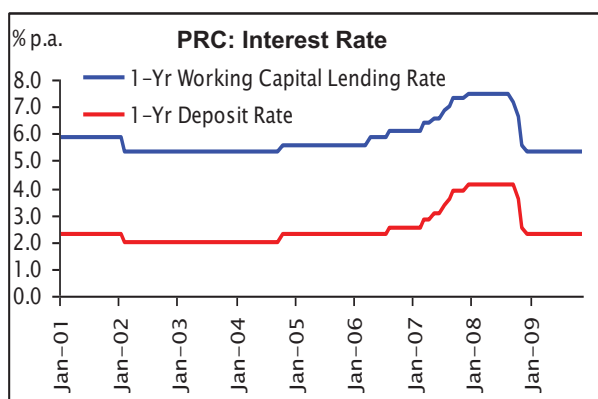
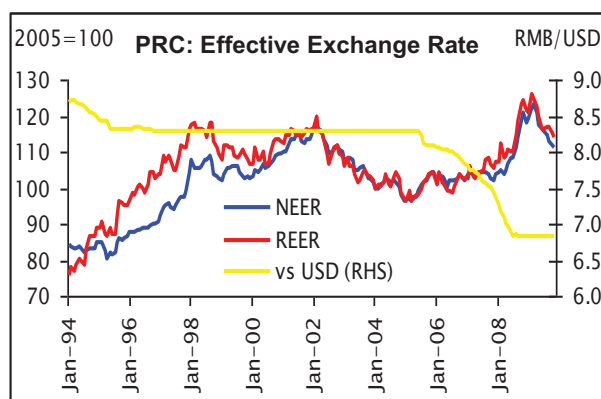


Chart 1.10

...plus depreciating exchange rate...



Source: Collated by Centennial Group using CEIC Database.

- The PRC halted the appreciation of the RMB. By virtually pegging the domestic currency to the US\$, the PRC's real effective exchange rate depreciated nearly 10% in the period February 2009 through November 2009 as the US\$ weakened (Chart 1.10). This, plus a series of export tax rebates - also an implicit form of currency depreciation - helped PRC exporters to weather the global downturn.
- There were other administrative measures to tackle specific problems. Measures to support the real estate market included cutting the lock-up period beyond which individuals can resell property without paying a business tax to 2 years from 5 years, scrapping the stamp tax for property transactions, charging VAT for sellers, charging urban property tax for foreign firms and individuals, etc. Measures to support the capital markets include abolishing the 5% withholding tax on interest income, scrapping the stamp tax for purchases of equities, instructing Central Huijin to buy shares of listed PRC firms, etc. In order to boost domestic consumption, the government introduced a rebate scheme nationwide for home appliances, ramped up subsidies for car replacement, allowed the set up of consumer financing firms and embarked upon unprecedented low-income housing programmes. Landmark economic restructuring measures such as the massive 3-year health care reform and the introduction of pension schemes in rural areas were implemented to inject the necessary ingredients for a higher rate of domestic consumption.

All in all, the PRC implemented a comprehensive stimulus policy package aimed at all parts of the economy, which has proven to be effective. Loan growth spiked (Chart 1.11). Urban fixed asset investment rose by 32.1% y/y in November 2009 YTD, compared with an expansion of 26.2% in 2008 (Chart 1.12). The property market was revived, and real estate activity becomes an important driver of growth. The Shanghai Composite Index was the best performer in Asia so far in 2009. Consumption held up remarkably well, contributing 4 percentage-points to the 7.7% GDP growth in Q3 2009 YTD. Investment was the main cause for the strong economic rebound, contributing 7.3 percentage-points to economic growth in Q3 2009 YTD.

Chart 1.11

Stimulus package inspired a lending frenzy...

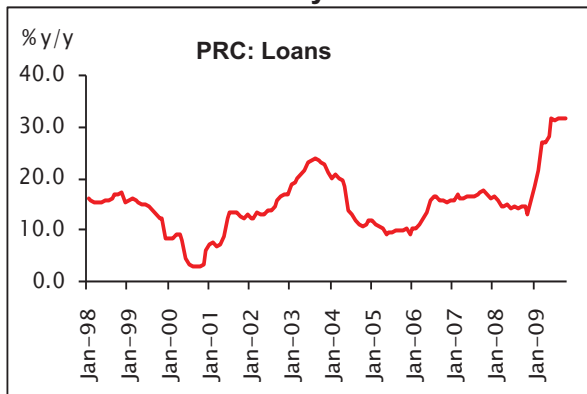
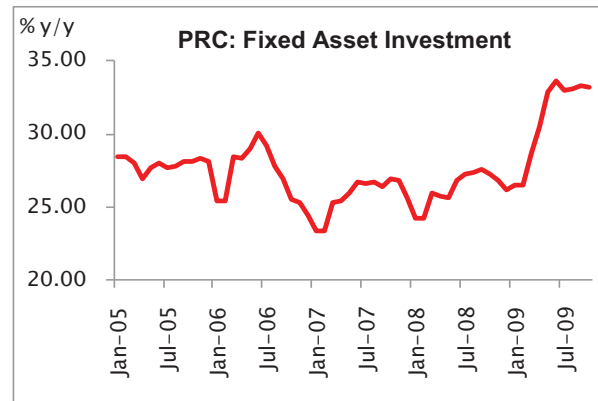


Chart 1.12

...driving up fixed asset investment...



Source: Collated by Centennial Group using CEIC Database.

Third, the PRC's resilience goes beyond just the policy response. Prior era reforms had improved a range of factors that contributed to resilience

Table 1.1 breaks down the various components of the PRC's resilience.

Table 1.1: Analysis of the PRC's Resilience

Component/Indicator	2000	2008	Comments
Export Diversity			
Average coefficient of variation for top 10 exports and destinations	0.9	0.7	<i>The more diversified your export base, the more resilient the economy is.</i> Export diversity is quite high, ranging from electronics to apparel
Demand Diversity			
C + I + G (% of GDP)	96.6	90.8	<i>The greater the dependence on exports and less exposure to domestic demand, the less resilient the economy is likely to be.</i> The PRC enjoys a higher ratio of domestic demand to GDP than many other Asian exporting nations, lending it relatively greater resilience.
Automatic Stabilisers			
10 year average of change in tax revenue/change in GDP	1.5	1.9	<i>Tax revenues automatically adjust as economy accelerates or decelerates, providing a natural automatic stabiliser or shock absorber in the economy.</i> Improved tax buoyancy acts as an automatic stabiliser even though the PRC does not have the automatic stabilisers on the expenditure side such as national welfare payments that one finds in developed economies.
Capacity for swift and effective policy response			
Fiscal - Public Debt (% of GDP)	16.3	15.9	<i>Higher public debt imposes a constraint on use of fiscal tools.</i> Public debt is low, allowing the PRC considerably greater latitude than many other Asian economies in responding with fiscal stimulus to an external shock.

Component/Indicator	2000	2008	Comments
Monetary - G7-Country Inflation over 8 yrs (%/y)	-7.3	0.0	<i>The greater the credibility the central bank has built up by controlling inflation not too different from major countries' inflation, the more latitude central bank has to ease monetary conditions in a slowdown.</i> Inflation management has improved considerably from 2000 (though it is still a concern) and the PBOC has emerged as one of the most credible and respected central banks in the emerging economies.
External Financial Vulnerability			
Financially mobile capital (% of foreign exchange reserves)	27.2	19.1	<i>High financially mobile capital in relation to FX reserves and high current account deficit/GDP signify reduced resilience.</i> Significantly lower external vulnerability due to fall in financially mobile capital and large increase in current account surplus. The PRC also has an array of capital controls that help provide some insulation, though it should also be noted that the high level of errors and omissions suggests that these capital controls are not wholly effective.
Domestic Financial Vulnerability			
NPL Ratio	40.0	2.0	<i>A stronger banking sector with low non-performing loans is less likely to amplify an external shock by cutting lending drastically.</i> The financial sector has matured, somewhat, with a hugely improved NPL ratio.
Vulnerability to oil prices			
Average excess production of energy (% of GDP)	-1.1	-1.1	<i>Country is more resilient if it is a net producer of energy.</i> The energy gap ³ in the PRC remained significant despite an accelerated pace of domestic energy production since 2007, implying that the country's dependence on energy imports (particularly oil imports) remains high.
Political Stability			
Index of Stability	5.0	5.1	<i>Country with political stability is more resilient.</i> The PRC enjoys both political stability and a strong and effective administrative structure. However, there is little transparency in the political and regulatory framework and this creates difficulties.

2. Economy is now poised for a strong recovery

2.1 Forward looking indicators are rising

The PRC's economy looks poised for an accelerating recovery going forward.

³ Excess energy consumption over domestic energy production, which stood at 15.8% of energy production in 2008.

- The OECD lead indicator for the PRC is looking up (Chart 2.13). In addition, the official purchasing manager index (PMI) rebounded strongly since March 2009, with forward looking components such as new orders rising (Chart 2.14).

Chart 2.13

OECD CLI for the PRC is looking up...

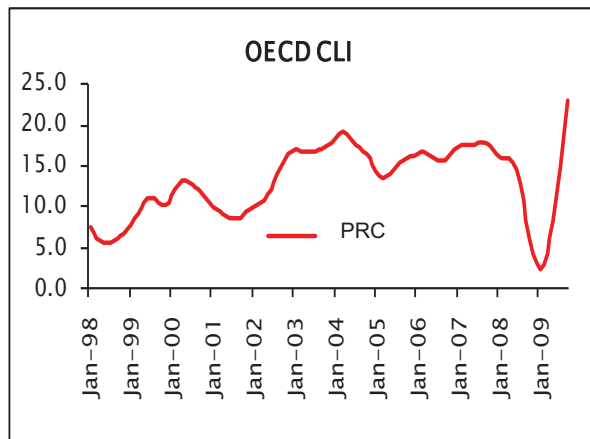
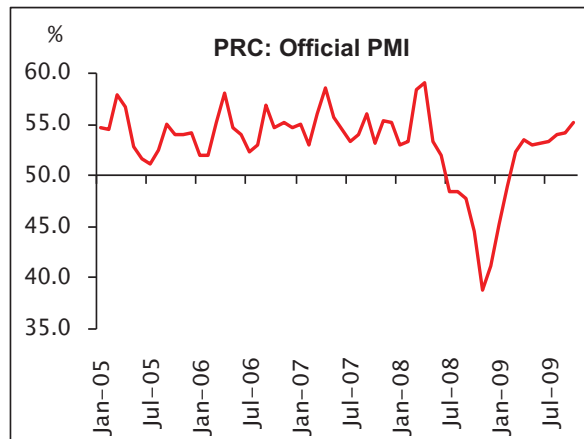


Chart 2.14

...and PMI looks promising...



Source: Collated by Centennial Group using CEIC Database.

- New loans for productive real sector activities are surging. The ratio of medium-and-long-term new loans to total new loans rose from 35.5% in February 2009 to over 100% in recent months, suggesting that the banks were converting their shorter-term loans (which were widely suspected to be used for speculative purposes in the stock market) to longer-term loans that would be used to finance real corporate investment (Chart 2.15). Policy makers have voiced concerns about a significant proportion (around 20% according to industry sources) of short-term bill financing being channelled into the stock and property markets in 1H09, leading the China Banking Regulatory Commission (CBRC) to put in place various measures to strictly monitor and control the use of loans.

Chart 2.15

Loans shifting to the real sector...

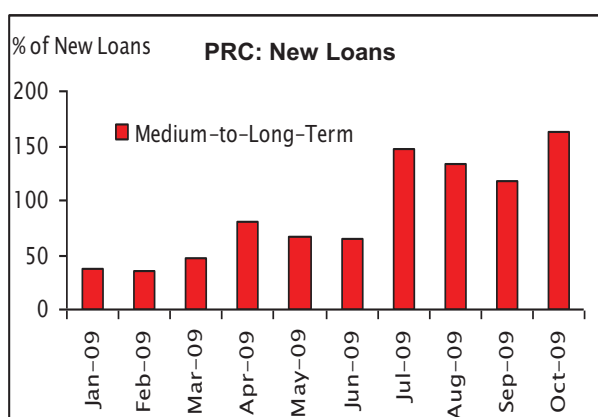
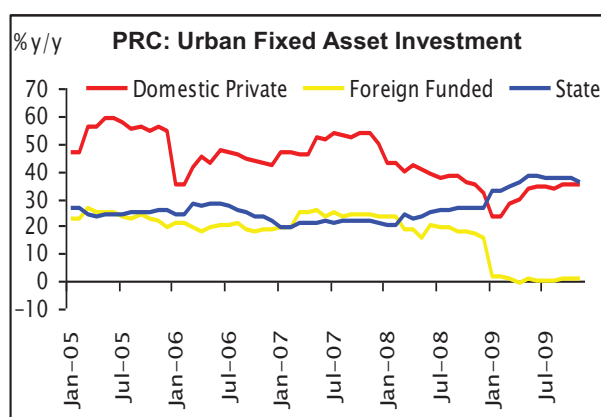


Chart 2.16

Private investment picking up...



Source: Collated by Centennial Group using CEIC Database

- Indicators of corporate capital spending activity are also picking up, as seen in the rise in urban fixed asset investment from domestic private enterprises (Chart 2.16). This will help ensure a sustainable recovery when the effects of government-led spending wane. It is striking how urban fixed asset investment is rising in sectors as varied as real estate,

mining, transport, storage services and other tertiary sectors. This suggests that the recovery in investment sentiment is spreading across industries.

Chart 2.17

External environment slowly recovering...

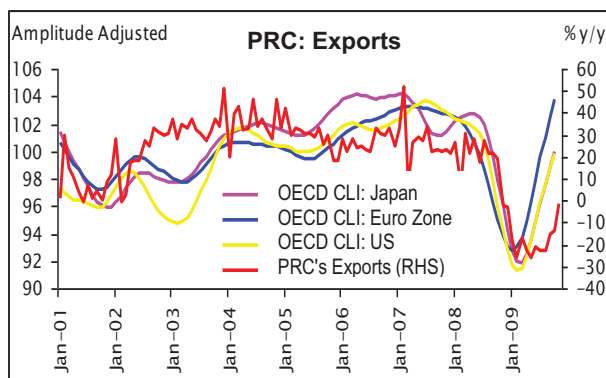
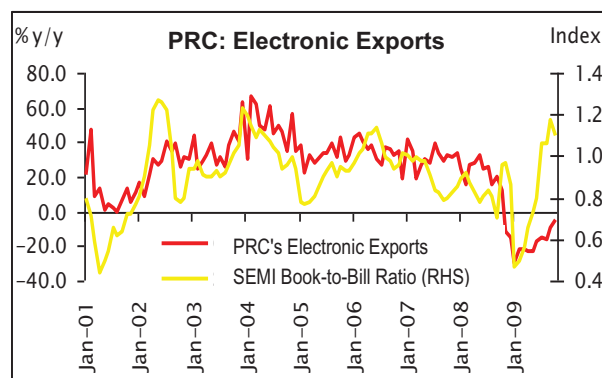


Chart 2.18

...and global tech rebound would help...



Source: Collated by Centennial Group using CEIC Database

- Export growth is stabilising. More importantly, OECD lead indicators points to improving economic conditions in the G3 countries (US, Euro-zone and Japan) – which consume a majority 41.2% of total PRC exports in 2008, suggesting that external demand for the PRC exports could soon become a positive driver of growth (2.17). A global tech rebound will provide a boost for the PRC's electronic exports – some 30% of total PRC exports (2.18).

2.2 Transmission mechanisms suggest that risks in global environment are manageable

Table 2.2 summarises the transmission mechanisms for the PRC economy in 2009-10.

Table 2.2: Transmission Mechanisms

Scenario for 2009/10		Risks/Upsides
Capital flows	<ul style="list-style-type: none"> ▪ Capital controls prevent much capital inflows and outflows. ▪ However, within the current structure, we expect a large increase in speculative and unregulated inflows as speculation over the RMB's appreciation intensify. 	<p>Risks</p> <ul style="list-style-type: none"> ▪ The risks to the outlook are linked to the PBOC's response to RMB appreciation pressures. In case of a one-time revaluation, we expect some capital to exit the country but this will not destabilize the balance of payments.
Trade	<ul style="list-style-type: none"> ▪ Exports will continue contracting until early 2010 when base effects start disappearing. After that, the recovery in exports is likely to be very large given the favourable base effects. ▪ It is unlikely that export growth will recover to pre-crisis level. 	<p>Risks</p> <ul style="list-style-type: none"> ▪ A double dip would hurt the export prospects for most emerging market economies, but more so for the PRC. ▪ This is because it has built excess capacity in 2008 to serve exports and its domestic demand. But domestic demand will not be able to absorb the capacity alone creating concerns about waste and additional costs.

Scenario for 2009/10		Risks/Upsides
Tourism	<ul style="list-style-type: none"> ▪ No signs of recovery in 2009/10 as of now. ▪ More tourist flows within Asia should be expected. 	
FDI	<ul style="list-style-type: none"> ▪ FDI inflows picked up sharply in Nov 09: we expect this to accelerate into 2010. 	
Commodity Prices	<ul style="list-style-type: none"> ▪ Among traded commodities, steel and food are critical to the PRC. 	<ul style="list-style-type: none"> ▪ Food prices will be of special concern as they affect consumer welfare and the PRC government will want to avoid an escalation in prices.

2.3 Stimulus Boosted 2009 Growth but could it Cause Excesses in 2010-11?

The PRC's impressive policy actions to tackle the crisis have produced remarkable results. The policy response has secured a swift and creditable turnaround in economic growth in 2009. The question for policy makers is now over the pace and timing of monetary and fiscal policies. This question will be settled according to the balance of risks: most pertinently, between how well policies have limited the downside risks to economic growth in 2010-11 and how much the current policy stance might produce unintended costs or raise other risks such as inflation.

The forward-looking indicators and assessments of possible scenarios discussed above point to the diminishing risks of a double-dip slowdown in the PRC. Thus, the remaining question is over the degree to which the risks of continued loose policies are rising. Because monetary policy operates with long lags, we need to look beyond current data and understand how economic agents are behaving in response to policy settings: if their behaviour suggests that policy is creating incentives for economic decisions that raise risks, then there is a potential problem. In fact, there are warning signs that the stimulus programme might be producing rising risks.

First, there are increasing signs of overcapacity

The signs of rising over-capacity are proliferating. What is significant about this rising risk of over-capacity is what it tells us about economic agents. Economic agents respond to the incentives in their environment: if they are raising capital expenditure to the point where over-capacity with all its downsides threatens, it tells us that the cost of capital is probably too low.

The State Council itself has highlighted six problem areas where overcapacity could pose serious problems, namely steel, cement, glass, coal, chemical, poly-crystalline silicon and wind power.

- Shipbuilding in the PRC, where 70% of its demand is export-related, is expecting overcapacity to spill into 2011.
- The production of flat glass, where the PRC provides half the world's supply, has over 30 production lines still under construction and a stagnant demand outlook.
- A sum of RMB140 billion was invested in the PRC steel industry in 1H09 - currently 58 million tons of new capacity is under construction in the PRC. At same time, the outlook

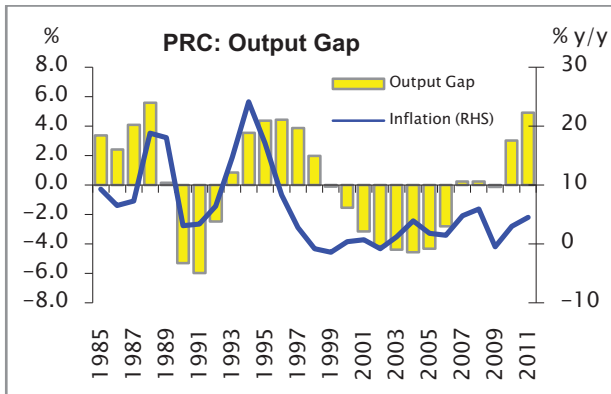
for global steel demand remains bleak with a 36.6% y/y decline in the US and a 14.9% y/y decline globally in 2009.

High household and corporate savings combined with local government protectionism and self-interest are major contributing factors to the push for fixed-asset accumulation. However, the 2008 fiscal stimulus and easy liquidity, boosted by an exceedingly large 2009 lending programme, have added immensely to this capacity build-up at a time of falling global demand. With the PRC now far more integrated into the global economy than in the 1990s, the problem of overcapacity in the PRC adds to the risks of trade tensions as price effects from overcapacity induces anti-dumping measures by its global trading partners.

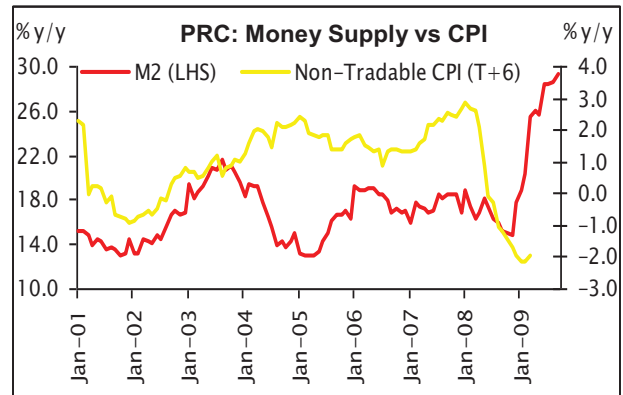
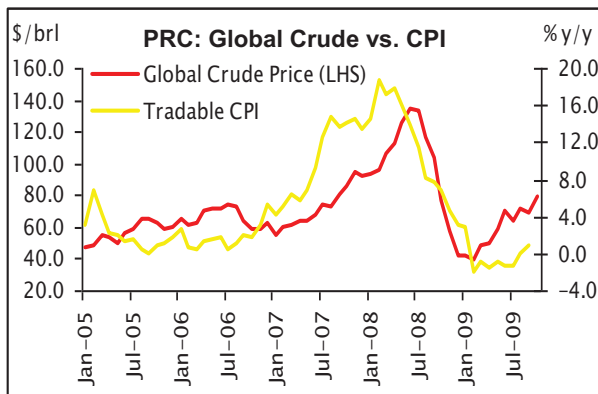
Second, the sharp surge in monetary growth increases inflationary and other risks

Since monetary policy operates with long lags, the current state of very low inflation does not mean that the current policy stance is not raising inflation risks in the longer term. A confluence of several factors highlights the risk that inflation could rise to uncomfortable levels by late 2010 or 2011:

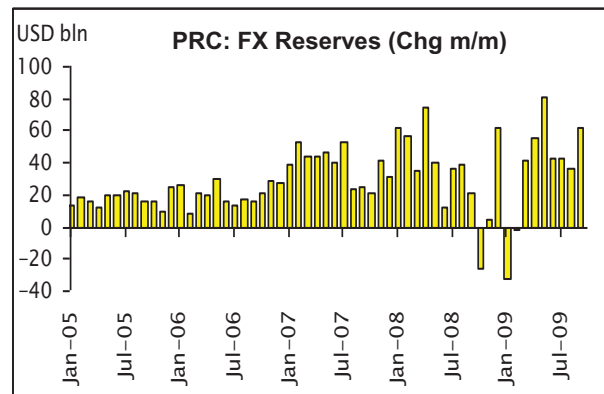
- First, the deflationary gap has narrowed considerably through the year (Chart 2.19). Our estimates suggest that the PRC is set to see a widening inflationary gap going forward.
- Second, this is a particular concern given the sharpness with which monetary variables are rising: The amount of new loans totalled RMB9.3 trillion in January-November 2009, almost twice the government's target of RMB5 trillion and money supply M2 surged 29.7% y/y in November 2009 (Chart 2.20). 2009 – overshooting the central bank's target growth of 17% for 2009 which was set when the stimulus package was announced. For such a sharp surge to occur in such a short period of time would raise risks in any economic system – and all the more so in a developing economy where the financial sector is still maturing.
- Third, rising international commodities prices would push up imported inflation. Particularly, the PRC's new market-based fuel-pricing mechanism will raise the vulnerability of the PRC's economy to imported inflation risks, as compared with the past (Chart 2.21).

Chart 2.19**... Inflationary gap set to widen fast**

Source: Collated by Centennial Group using CEIC Database.

Chart 2.20**Surging money supply; non-tradable inflation****Chart 2.21****Rising oil price to push up imported inflation...**

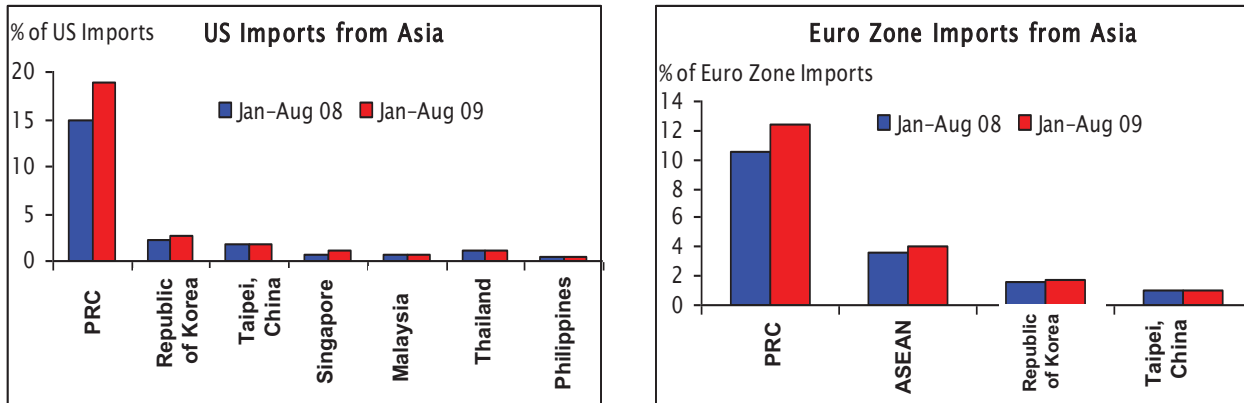
Source: Collated by Centennial Group using CEIC Database.

Chart 2.22**Rapid pace of FX reserves accumulation...****Third, the exchange rate regime may be adding to risks in the long term**

The PRC has been accumulating foreign exchange reserves on a massive scale, suggesting substantial intervention in the currency markets to stem the appreciation of the RMB (Chart 2.22). The fact that the PRC exports are gaining market shares in the US and the Eurozone (Chart 2.23) suggests a possible misalignment in the country's exchange rate.

Chart 2.23

PRC exports gaining shares in global markets...



Source: Collated by Centennial Group using CEIC Database.

3. Implications for policy

No country has responded as effectively and as resolutely to the crisis as the PRC has.

With the global economy now recovering and with the PRC's growth now surging, the determinants of optimal policy are also evolving rapidly. This suggests a need to change policy settings in some important ways. Most critically, we believe that the greater risk for the PRC is now from maintaining the extraordinary high level of policy stimulus than from having insufficient stimulus. At the same time, the PRC needs to continue addressing structural issues in its economy so as to smoothen its transition to a higher-value added economy that is more resilient to the vagaries of the global environment.

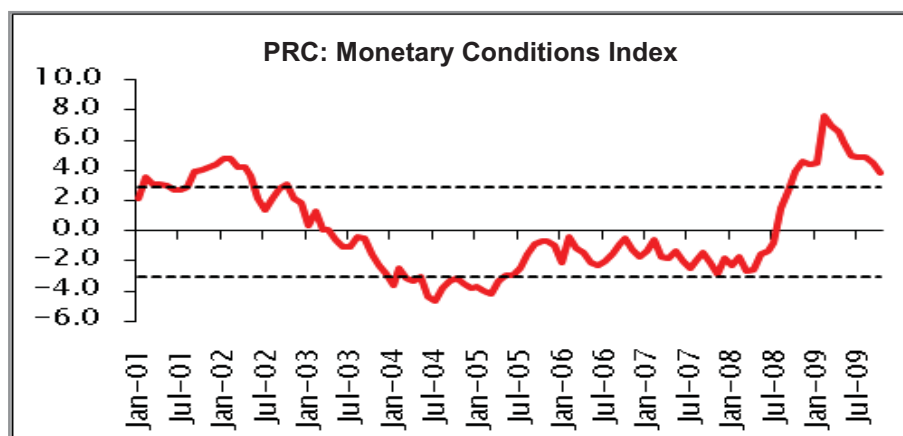
First, monetary tightening is needed sooner rather than later. The focus should be on reining in lending and raising the actual cost of funds

First, monetary growth needs to be slowed. Monetary conditions in the PRC look unduly loose and, more importantly (Chart 3.24), could ease further due to (1) the PRC's real effective exchange rate is set to depreciate further as long as the RMB continues to be pegged to a weakening US\$ and; (2) Inflationary expectations are likely to worsen, driving down real interest rates as a result. Notably, negative real interest rates would inspire PRC consumers to invest their money in the property or stock market in order to hedge against the erosion of their purchasing power. In fact, a PBOC survey conducted in Nov 09 found inflationary expectations rising - the portion of urban respondents finding inflation as 'unacceptable' rose in 4Q09 to 46.8%, up from an already high 45.2% in 3Q09. The same survey found that an increasing number of respondents were looking to hedge this inflation by purchasing property.

The fact that the PRC authorities have already begun a range of tightening measures in reflects their growing concerns over possible asset bubbles and other distortions, emphasising the use of administrative measures. For example, CBRC has asked small and medium sized banks to maintain a capital adequacy ratio of at least 10%. The CBRC asked big banks to raise their minimum capital adequacy ratio to 11%, to lower the risk of an increase in bad loans. A range of measures have also been employed to cool the rising property market – the use of the home sales tax has been widened, there has been a crackdown on land hoarding, developers are now required to make at least 50% down payment on land purchases and pay the remainder within 12 months and the Ministry of

Housing and Urban–Rural Development is stepping up efforts to provide affordable housing which will now be sold not only to low income but also to mid-to-low income earners. The Ministry will also build 1.8 million low-rent flats and 1.3 million affordable flats in 2010.

Chart 3.24



Source: Collated by Centennial Group using CEIC Database.

Second, the exchange rate is probably under-valued and should be allowed to appreciate gradually within a new exchange rate framework that acts as a monetary anchor

The scale of the foreign exchange reserve build-up and the rise in the PRC's market share in global exports make it difficult to argue against an under-valuation of the currency. A shift to a gradual appreciation of the exchange rate anchored in a new exchange rate regime such as the "basket-band-crawl" regime adopted by countries such as Singapore might be more appropriate.

Third, structural changes already being planned or implemented should be expanded to reorient demand towards consumption and away from excessive dependence on investment or exports

The roots of the low consumption to GDP ratio in the PRC run deep. So it is not realistic to expect the PRC to achieve a swift increase in the role that consumption plays in the economy. The root of the problem is not simply an excessive dependence on exports as many argue – the excessive dependence is on both exports and investment. We believe that this imbalance can at least partly be explained by distortions in key relative prices that need to be addressed by sustained policy action particularly in the following three areas:

- **Wages.** Restrictions on labour mobility between rural and urban areas lead to a segmented labour market in which rural migrants are paid considerably less than urban workers, effectively reducing real labour costs below what is likely to be optimal for the economy in the longer term. The PRC has begun to liberalise these restrictions – this liberalisation needs to be accelerated. Although reform of the hukou system started as early as 1992, it has yet to yield a satisfactory conclusion due to complicated policies attached to it (such as concerns about slums springing up throughout the country). Nonetheless, according to a 2007/08 survey by the Chinese Academy of Social Sciences (CASS), 26.5% of the rural migrants gained urban hukou status in Shenzhen, Huhhot, Qingdao and Kunming (cities in four different directions across the country) since hukou controls were weakened in 2001.

- **Cost of capital.** The cost of capital that state enterprises in particular face is probably too low given the preference that state owned banks show to state enterprises. The consequence is capital-intensive strategies that boost investment and eventually the returns on capital which then boosts the profit share of GDP. If the share of profits in GDP is high and very little of that profit share is re-cycled back into the household sector through dividends or through taxation and government spending, then household consumption as a proportion of GDP will obviously be low.
- **An under-valued exchange rate reinforces this.** When the exchange rate is under-valued, the incentive is clearly to favour export-oriented production which raises the economy's dependence on exports.

Report 4

Impact and Policy Responses
People's Republic of China

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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