People's Republic of China

China's economy in 1995 experienced its fourth year of double-digit growth, although at a slower rate than in 1994, in reflection of the lagged effects of the tight fiscal policies that have been in force since mid-1993. Fixed asset investment and public expenditure moderated considerably, imparting a contractionary impact on GDP growth. The easing of aggregate demand, in turn, helped to reduce inflationary pressure.

Wide-ranging reforms introduced in a phased manner since January 1994 have had a positive effect on the trade account, exchange rate stability, and household saving. Orderly conditions prevailed in the financial markets except for the quickly resolved disruption in the Shanghai bond market at the beginning of the year. The trade balance was in record surplus which, in turn, led to an increase in external reserves by more than 42 percent during 1995. Central Government finances, however, continued to be strained despite reforms in intergovernmental fiscal relations designed to improve revenue collection.

The reform agenda progressed reasonably well and led to the strengthening of the Central Bank and improvement of the investment climate. However, reform of the state-owned enterprise (SOE) sector progressed slowly.

Recent Trends and Prospects

Growth, Investment, and Employment. The continuing tight fiscal and monetary policies enforced by the Government during the year resulted in a contraction of economic growth from 11.8 percent in 1994 to the more sustainable rate of 10.2 percent in 1995, with a significant moderation of inflationary pressures. China's growth rate in 1995, however, remains one of the highest in the world.

The agriculture sector grew by 4.5 percent in 1995 compared with 4 percent in 1994. This improvement resulted both from good climatic conditions and from the incentives to production given by the adjustment in mid-1994 of the procurement price for grains and cotton by 40 percent and 60 percent, respectively. Grain production is estimated at a record of 460 million tons in 1995.

Industrial output growth contracted from 17.4 percent in 1994 to 13.6 percent in 1995, primarily because of slower aggregate demand growth and the lagged effect of slower investment by the SOEs. Even at this growth rate, there were strains on the supply of electric power, transport services, and communications facilities. Private companies recorded the highest increases in output at 18.1 percent, followed by collectively owned enterprises at 12.8 percent and the state sector at 8.1 percent.

The services sector grew by 8 percent in 1995 compared with 8.2 percent in 1994. Financial, accounting, legal, wholesaling, retailing, and other support services all expanded strongly. As is the case with most transitional economies, the services sector in China is not well developed; its share in GDP is only 28 percent compared to the average of 65 percent for Hong Kong, Korea, Singapore, and Taipei,China.

The Central Government continued to impose controls on the approval of new investment projects in an effort to cool down the economy and to maintain the budgetary deficit within manageable limits. As a result, growth in fixed asset investment was contained at 17 percent, somewhat lower than its growth rate of 34 percent in 1994. To increase agriculture output and reduce dependence on food imports, the Government also increased supportive infrastructure investment in the sector by 33.4 percent. Overall, gross domestic investment declined to 39.5 percent of GDP compared with 40 percent in 1994, while gross domestic saving increased to 42.2 percent of GDP from 41.4 percent in 1994. The resource surplus thus increased from 1.4 percent of GDP in 1994 to 2.7 percent in 1995. The sources of finance for fixed asset investments have changed radically since the reform process began in the late 1970s, with budgetary appropriations comprising 3 percent of the total in 1994 compared with 45 percent in 1980 (Figure 2.5).

The official unemployment rate remained low at 2.9 percent in 1995, marginally higher than the 1994 rate of 2.8 percent. Employment in primary industry grew by 14.4 million jobs in 1995, down by 463,000 compared with 1994, while employment in secondary industry grew by 35.4 million, 1.1 million less than in 1994. However, taking into account the 23 million redundant workers in the SOEs and the estimated 170 million migrant workers from the rural areas who may or may not be fully employed in the informal sector, the unemployment rate could be as high as 8–10 percent. Providing employment opportunities in the rural areas and, hence, reducing poverty is an important objective of the Government's Eight-Seven Poverty Reduction Plan (Box 2.1).

The gradual slowdown of the economy is expected to continue over the next two years with GDP growth receding to 8 percent in 1996 and 9 percent in 1997. The greater emphasis given to the agriculture sector is expected to enable its growth performance to be maintained at an average of 4.5 percent over the next two years. Barring bad weather, grain production is expected to increase by an average of 10 million tons per annum given the additional acreage that has been brought under cultivation and the limitations that have been imposed on converting agricultural land for industrial and other nonagricultural purposes.

Industrial production is expected to stabilize at a growth rate of 8.5-9 percent per annum

Table 2.5 Major Economic Indicators: People's Republic of China

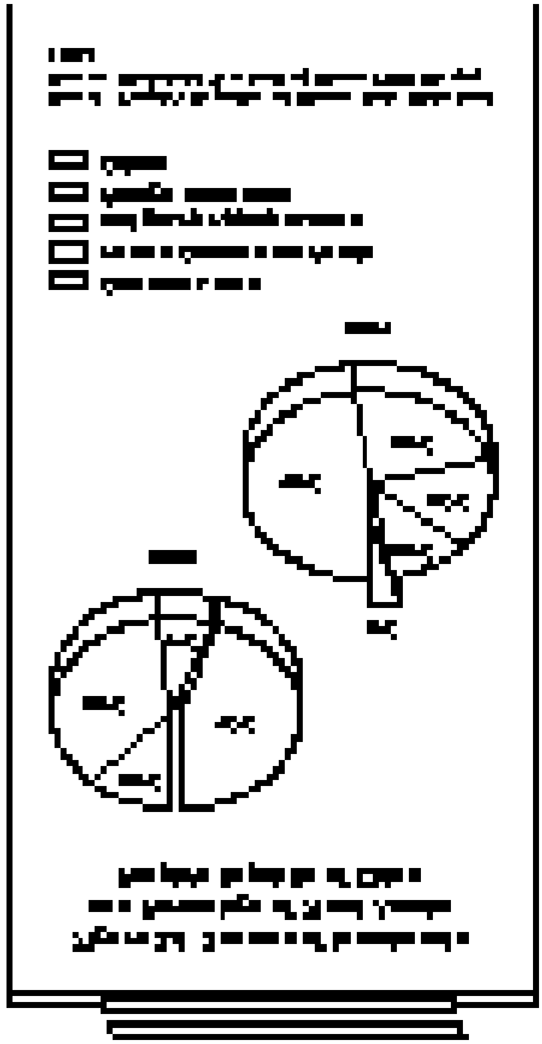
		1993	1994	1995	1996	1997
Gross Domestic Product	% change	13.5	11.8	10.2	8.0	9.0
Agriculture	% change	4.7	4.0	4.5	4.5	4.5
Industry	% change	20.7	17.4	13.6	8.5	8.9
Services	% change	9.5	8.2	8.0	10.0	12.0
Gross Domestic Investment	% of GDP	43.5	40.0	39.5	38.7	38.7
Gross Domestic Saving	% of GDP	41.5	41.4	42.2	40.2	39.2
Inflation Rate	% change in RPI	13.0	21.7	14.8	10.0	14.0
Money Supply Growth	% change	24.0	49.0	29.4	24.5	29.0
Merchandise Exports	$ billion	75.7	102.6	126.2	140.0	164.1
	% change	8.8	35.6	23.0	11.0	17.2
Merchandise Imports	$ billion	86.3	95.3	108.6	134.7	161.6
	% change	34.1	10.5	14.0	24.0	20.0
Current Account Balance	$ billion	-11.7	6.5	16.5	4.1	1.0
	% of GDP	-2.0	1.3	2.4	0.5	0.1
External Debt Outstanding	$ billion	84.2	100.5	110.6	125.6	140.6
Debt-Service Ratio	% of exports	11.2	8.9	9.1	9.3	9.1

Sources: People's Republic of China, State Statistical Bureau, *Statistical Yearbook of China 1995* (Beijing, 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996): World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); data collected from the State Statistical Bureau, People's Republic of China by EDRC for the Asian Development Bank *Annual Report 1995*; and staff estimates.

over the next two years in line with the Government's efforts to prevent economic overheating and to rationalize investment in the SOE sector in line with sustainable growth of the economy generally. The non-state sector will continue to increase its share in industrial output growth and employment generation. As enterprise reforms continue to deepen and the bankruptcy law is applied more widely, the share of the state sector in total industrial output will continue to decline from 44 percent in 1995 to below 40 percent by 1997. In the last quarter of 1995, a yuan (Y) 120 billion program to upgrade technology and enhance product quality in some 900 large- and medium-sized SOEs was launched. The program is scheduled for completion in 1997. When fully implemented, approximately 70 percent of the total amount under the program will have gone to projects in energy, raw materials, and the transport and communications industries, all of which have become bottlenecks in the way of sustaining the high growth rate of the economy.

The Government's efforts to encourage the growth of the services sector to absorb the rapidly expanding labor force, and to meet new demands for the types of services generated by the increasingly market-oriented economy, will lead to the continued expansion of this sector over the medium term. The sector is expected to grow by 10 percent in 1996 and 12 percent in 1997. Recent measures to open up the financial sector, particularly banking and insurance and the retail and wholesale trades, to foreign investment, as well as rapid expansion in transport and communications services, will help sustain the near-term growth of services.

Budget, Money, and Prices. Despite the fiscal reforms introduced since March 1994 to improve revenue collection and control expenditure on nonpriority items, the budgetary balance remained strained in 1995. The planned budget deficit of Y66.7 billion was exceeded by 5.3 percent to reach Y70 billion. Part of the problem is that fiscal reforms depend critically on the progress of SOE and financial sector reforms. Although the planned budget deficit was a mere 1.2 percent of GDP, this underestimates actual spending by the State. Taking hidden subsidies into consideration, the total budget deficit is estimated at 8 percent of GDP in 1995.



Government revenue as a proportion of GDP has declined in recent years owing to the reduced profitability of SOEs and the poor revenue buoyancy of indirect taxes, especially the VAT. The amount collected from the consumption tax and VAT – the main sources of revenue for the Government – was 6 percent below the target for the year, largely because of SOE tax arrears. As the newly established National Tax Service matures and provincial level capacity to enforce the tax codes correctly is improved, it is expected that revenue buoyancy will be improved.

Despite pressures from the SOEs and the faster-growing provinces, monetary policy remained tight during 1995 in line with the stance of bringing the overheated economy to a soft landing. The main factor influencing domestic money supply growth since mid-1994 has been the large external surplus, which is gradually being reduced. Broad money supply (M2) grew by 29.4 percent in 1995 compared with 49 percent in 1994 while narrow money (M1) grew by 18 percent compared with 10 percent. Currency in circulation rose by the more modest rate of 14 percent, attributed to the efforts of the Central Bank to promote the use of checks. Although the deceleration in money supply growth is encouraging, M2 growth was still well above the official target of 24 percent for the year.

With the slowdown in money supply growth, inflation fell sharply in 1995; the increase in the national retail price index (RPI) dropped from 21.7 percent to 14.8 percent in 1995, slightly below the targeted rate of 15 percent announced at the beginning of the year. The increase in the broader consumer price index (CPI), which includes services as well as retail goods, remained slightly higher at around 17 percent. Various administrative measures were taken to restrain the rate of increase of prices, including improving food supplies by increasing the use of subsidized agricultural inputs, controlling fixed asset investments, temporarily reimposing price controls, freezing price reforms, and clamping down on unfair trade practices. However, the Government recognizes that none of these measures are permanent remedies for controlling inflation. Reimposition of price controls has delayed the one-time impact of liberalizations on inflation and created longer-term macroeconomic management problems. Furthermore, subsidizing interest rates on bank deposits has been a costly way of encouraging saving during periods of high inflation. Nevertheless, indirect instruments of monetary policy are gradually being put in place and, when completed, should result in better control of inflation without distorting factor markets.

The fiscal situation of the Central Government over the next two years depends on the performance of revenue and the extent to which SOE reforms are implemented. As new tax measures and the tax collection system become more entrenched, revenue buoyancy is expected to improve and, consequently, the tax/GDP ratio will rise. Expediting SOE reforms will also significantly reduce subsidies channeled to them through the budget. The Government's consolidated budget deficit is expected to fall significantly below that in 1995 mainly because of reduced support to the loss-making SOEs expected over the next two years and stricter implementation of the Budget Law and Auditing Law enacted in 1994 which limit recourse to Central Bank credit.

With the tight monetary policies having yielded the intended results of restraining inflation, there have been pressures for the easing of credit supply. These pressures have come from the SOEs, which have been deprived of investment and working capital under the austerity program, and the local governments, which are faced with escalating social security expenses and falling enterprise tax revenues. However, it is unlikely that the Central Bank will move aggressively in the near term to restimulate the economy, given the painful memories of the 1993 inflation blowout and how long it has taken to stabilize the economy. At the same time, the sweeping trade reforms scheduled for 1996 will also deter the authorities from acting aggressively; the combination of loose monetary policy and a deep cut in tariffs could seriously undermine China's external balance and cause currency market instability. The improved inflation outlook and the slower money supply growth will prompt the monetary authorities to selectively ease monetary policy from mid-1996. Despite this, money supply (M2) growth is projected to slow further to 24.5 percent in 1996 before rising again to 29 percent in 1997.

The anticipated further contraction of money supply growth in 1996, the continued strict control over fixed asset investment, and the weakening of consumption demand has prompted the Government to set an inflation target of 10 percent for 1996, which is achievable given the aggregate supply and demand conditions that will most likely prevail in the economy during that year. With the expected easing of monetary policy and the implementation of projects under the Ninth Plan beginning in earnest to break supply bottlenecks in infrastructure, inflation is projected to pick up moderately in 1997 to 14 percent.

External Trade and Payments. With sustained external demand and continued progress in trade and foreign exchange reforms within China, total trade expanded strongly again in 1995. Exports rose by 23 percent to $126 billion while imports grew by 14 percent to $109 billion. The merchandise trade surplus thus increased to $17.5 billion in 1995 from $7.3 billion in 1994. Manufactured goods comprise the bulk of China's exports, with their share having risen over the past decade

Box 2.1 China's Eight-Seven Poverty Reduction Plan

The Government's approach to poverty alleviation took a new turn with the launching of the Eight-Seven Poverty Reduction Plan (ESPRP) in July 1993, shifting from providing relief assistance and transfer payments to creating more opportunities for the poor to engage in income-earning opportunities and to achieve self-reliance. The basic objective of the ESPRP, which is to run from 1994 to 2000, is to lift the incomes of all people living below the poverty line through targeted interventions.

The specific aim is to raise annual per capita incomes in 592 designated poverty areas to at least Y500 (in constant 1990 prices) by the turn of the century. This will be done by increasing the income-earning opportunities of the poor, building infrastructure in poor areas, and increasing expenditure on human resource development (HRD). High-yielding farmland for cash crop and livestock production is being made available and at least one member of each poor household is being provided with the opportunity to work in a township or village enterprise or in an urban center. Infrastructure development is aimed at increasing access to potable water, building farm-to-market roads, and ensuring that all designated poverty townships have access to electricity. HRD includes providing compulsory primary education, providing vocational and technical education to adult workers, improving the delivery of rural health care services, and promoting family planning practices.

Public funds and credit for poverty reduction have been progressively increased. Between 1986 and 1990, budgetary allocations for poverty reduction were Y5 billion a year. In July 1993, the amount was increased to Y9 billion; an additional Y2 billion was later added for work relief programs and for interest subsidies.

Beginning in 1994, all existing credit funds to assist the poor previously held by the People's Bank of China and specialized banks came under the unified control of the newly established Agricultural Development Bank of China. Fund allocation has also been revised. Since ESPRP began, half of the Central Government's funds used to assist the needy in the more economically developed coastal provinces have been diverted to assist the poor in the more impoverished regions in the central and western parts of the country. From 1996, developed provinces will be responsible for assisting their poor, with the Central Government's poverty allocation being used entirely for the most impoverished provinces and autonomous regions. A two-pronged strategy will be used in the distribution of these funds: for development projects capable of producing economic returns, assistance will be provided through loans with subsidized interest rates; and for projects that have significant social benefits but no immediate financial benefits, grant assistance will be available.

Since the ESPRP began, an estimated 10 million people have been brought out of absolute poverty. At this rate, the Central Government's current strategy should help raise the incomes of between 35 million and 40 million people to above the poverty line by the end of the century.

from 50 percent to 85 percent of total exports. Labor-intensive products are predominant. The trade of foreign-funded enterprises accounted for about 28 percent of China's total trade value, reflecting the growing importance of the non-state sector in both exports and imports. Of the 235,000 foreign-funded enterprises approved to the end of 1995, more than 110,000 have begun operations, employing 15 million workers. Industrial products accounted for 90 percent of total exports. Japan remained China's biggest trading partner in 1995, with the total value of trade between the two countries reaching $53 billion for the year.

The current account surplus in 1995 was $16.5 billion, equivalent to 2.4 percent of GDP, compared with $6.5 billion or 1.3 percent of GDP in 1994. The services account remained in deficit, reflecting the underdeveloped state of this sector particularly in those services associated with international trade. Inflows of FDI remained strong in 1995, with realized FDI totaling $37 billion, a growth of 11 percent compared with inflows in 1994. Infrastructure, technology, and capital-intensive projects accounted for the largest proportion of total realized FDI, although in terms of absolute numbers they were small compared with light industrial projects, most of which were investments from Hong Kong; Macao; Singapore; Taipei,China; and Thailand. Investments from Japan and the US were generally in higher technology production. Total foreign exchange reserves increased by over 42 percent in 1995, reaching $73.5 billion by the end of the year.

Total external debt reached $110.6 billion at the end of 1995, an increase of 9.5 percent over the level in 1994. The debt-service ratio rose to 9.1 percent compared with 8.9 percent in 1994, reflecting the slower growth of exports of goods and services. The debt ratio fell to 16 percent of GDP in 1995 compared with 19.3 percent in 1994. Exports are projected to grow at a more moderate rate of 11 percent in 1996, accelerating somewhat to 17.2 percent in 1997. The primary factor for the slowing of export growth is the reduction in VAT export refunds from 14 percent to 9 percent beginning 1 January 1996. Other factors include the stricter enforcement of copyright and patent laws by the authorities and continuing trade problems with major trading partners such as the US, Japan, and the EU. The expected easing of credit from mid-1996 and the pickup in retail sales from the continued increase in disposable incomes is also expected to divert some exports to domestic consumption.

Imports are expected to grow by 24 percent in 1996 and at a slightly lower rate of 20 percent in 1997 mainly because of sweeping customs duty reductions and the strong domestic demand for advanced technology items needed for improving infrastructure and for technological renovation in the state-owned sector. In addition, strong inflows of FDI will be accompanied by increased imports of machinery and equipment. A 30 percent tariff cut on more than 4,000 items in 1996 will reduce the average tariff to 23 percent from 36 percent; and further tariff cuts planned for 1997 will reduce the average tariff to 15 percent. In addition, a policy decision was made to move to full convertibility of the yuan by the end of 1997. These reforms are expected to give a strong impetus to China's external trade.

Given the projections for exports and imports over the next two years, the very large merchandise trade balance achieved in 1995 will sharply decline to $5.4 billion in 1996 or 0.7 percent of GDP and $2.5 billion or 0.3 percent of GDP in 1997.

External debt outstanding is forecast to increase by an average of $15 billion over the next two years with a sizeable portion of this debt being attributable to the Three Gorges Project along the Yangtze River. The debt-service ratio as a percentage of GDP is projected to increase slightly to 9.3 percent in 1996 before declining to 9.1 percent in 1997.

Policy and Development Issues

The broad thrust of the planned reform program and the way in which reforms have been sequenced to date provide grounds for optimism regarding the future. While much progress has been made in introducing commercially oriented management practices in the SOEs, efforts to reform the enterprises are generally perceived to be slow with inadequate progress being made in reducing the drain on the budget and retarding improvements in the efficiency of the economy. SOE reform remains incomplete because of the Government's concern with balancing the twin objectives of economic and social stability. Further reforms can only be implemented when alternative social safety nets are well in place and incentives for labor mobility increased. Infrastructure bottlenecks generated by rapid economic growth also need to be addressed. The funds required to finance China's infrastructure needs exceed the amount available through traditional sources of financing. New methods of financing infrastructure, including mobilizing private long-term finance, need to be explored and developed. A number of perceived risks – such as the absence of a clear legal and regulatory framework to cover issues such as the convertibility of yuan revenues for foreign debt-service obligations and profit repatriation, transparency, and competition – have deterred both domestic and private investors from investing in long gestation projects in China. Unless an enabling environment for private sector investment in infrastructure can be created, it will be difficult for China to mobilize the resources necessary to finance planned infrastructure development.

Rural development and agricultural growth and productivity also need to be accelerated. Slower economic development in rural areas has contributed to widening rural-urban income disparities and widespread rural-urban migration, which is estimated to reach 200 million by the year 2000. Job creation has been insufficient to absorb this surplus rural labor. Also, urban infrastructure has been placed under tremendous pressure.

Finally, revenue collection and administration need to be strengthened to restore the ability of the Central Government to conduct effective fiscal policy. Revenue sharing and fiscal equalization would help to improve the provision of social services in poor areas.