

People's Republic of China

Fiscal and monetary stimulus, coupled with recovery in world trade, drove double-digit growth in the first half of 2010. As the stimulus phases down, GDP growth is seen easing in the second half. The full-year forecast is kept at the 9.6% given in April. GDP growth is anticipated to step down by a half percentage point in 2011 from 2010, assuming the absence of stimulus programs and subdued industrial-country growth. Lower than expected inflation this year has prompted a slight downward revision to the 2010 forecast. Looking further forward, rebalancing the sources of economic growth remains imperative.

Updated assessment

GDP growth moderated to 10.3% in the second quarter of 2010 from 11.9% in the first (Figure 3.3.1), putting the expansion in January–June at 11.1%. While investment and consumption continued to drive growth from the demand perspective, the contribution of net exports turned positive in the second quarter for the first time since the onset of the global recession.

With the impact of the government's aggressive fiscal and monetary stimulus programs starting to recede, growth in nominal fixed-asset investment pulled back to 24.8% in the first 8 months of 2010 from the very high rate of 33.0% in the prior-year period. Growth of industrial output eased to 16.0% in the second quarter from 19.6% in the first, reflected in a marked slowing of growth in power generation and the production of automobiles, cement, and steel (Figure 3.3.2). The purchasing managers' index for manufacturing output declined from 55.8 in January to 51.7 in August (Figure 3.3.3).

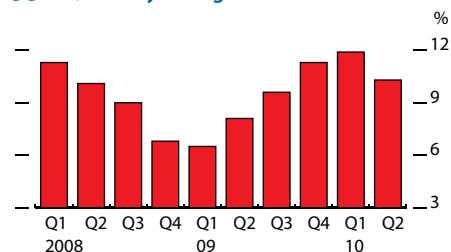
Retail sales, a proxy for consumption, held up well, increasing by 18.2% in nominal terms in the first 8 months from 15.1% a year earlier. Private consumption was supported by higher than expected employment generation and increased salaries and pensions, which lifted real incomes in urban and rural areas by 7.5% and 9.5%, respectively, from January to June. Sales of household appliances also benefited from government subsidies on these items.

By sector, industry grew by 13.2% and services by nearly 10% in the first half, both benefiting from the stimulus programs. However, drought in the south and northeast regions led to a decline in the summer harvest, so that agricultural output rose by a modest 3.6%.

Consumer prices, after falling for most of 2009, have edged higher this year (Figure 3.3.4), bumped up by low-base effects from the prior year, higher food prices caused by the bad weather, and excessive liquidity from the monetary stimulus. However, upward pressures were modest, and for the first 8 months of 2010 inflation averaged 2.8% year on year.

The government moved to curb sharp rises in prices of residential

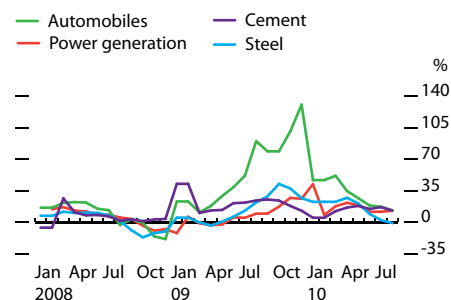
3.3.1 Quarterly GDP growth



Source: CEIC Data Company (accessed 16 September 2010).

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3.3.2 Growth in industrial production, selected sectors



Source: CEIC Data Company (accessed 16 September 2010).

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property spurred by investment demand and the expansionary monetary stance. Price increases for new housing in 70 major cities accelerated to 15% year on year in April. From May, though, policies to cool the market started to have an impact (Figure 3.3.5). Government actions included increasing downpayments on second homes (from 40% to 50%) and raising mortgage interest rates to at least 1.1 times the benchmark rate set by the central bank. In the main coastal cities, banks were encouraged to temporarily refuse loans for third homes.

At the same time, the government increased the availability of land for residential purposes and the supply of low-income housing. Further, the authorities directed 78 enterprises that are owned by the central government and whose core business is not property focused to stop participating in the property market. Their privileged access to bank loans under the stimulus package apparently was adding to land and housing price pressures.

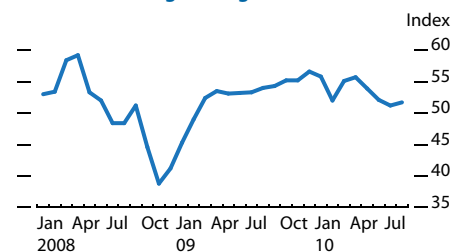
Merchandise trade has staged a vigorous recovery (Figure 3.3.6), after diving at the start of the global recession. Exports in nominal terms rose by 35.4% in the first 8 months of 2010, and imports by 45.8%. Imports decelerated in April–July, reflecting a slowdown in the fiscal stimulus and fewer infrastructure project startups. The trade surplus of \$104.5 billion for the first 8 months was considerably less than for the same period in 2009. Net exports made a slight contribution to GDP growth in the second quarter.

Foreign direct investment (FDI) in the first 7 months increased by about 20% to \$58.4 billion, illustrating the continued appeal of the burgeoning economy to international companies. Reflecting official efforts to combat pollution, new guidelines to encourage investment in what the government considers to be environmentally sound projects (such as high-tech industries, certain services, and energy-efficient technologies) have been written. A ban was imposed on foreign investment in polluting and energy-intensive projects, and in sectors suffering from overcapacity. Outbound investment, primarily directed at manufacturing and mining, increased by about 24% to \$5.65 billion.

After 2 years of a de facto peg of the yuan to the US dollar, the central bank (the People's Bank of China) in June 2010 said that it would gradually allow greater flexibility in the exchange rate against a basket of currencies for the PRC's main trading partners. By mid-September, the yuan had appreciated by 1.5% against the US dollar from the start of 2010 (Figure 3.3.7). The real effective exchange rate appreciated by 2.4% in the first 7 months of the year. Foreign reserves rose to \$2.45 trillion at end-June, the pace of reserves accumulation slowing mainly as a consequence of the smaller trade surplus.

Monetary officials started to rein in the very expansionary monetary stance adopted during the global recession, in view of the strong economic growth, sharp rise in property prices, and risks that funds would be diverted into unproductive purposes. The target for new lending in 2010 was pared back to CNY7.5 trillion (actual lending in 2009 totaled an exceptional CNY9.6 trillion), and the authorities set monthly credit quotas for banks. New bank lending decelerated to CNY5.7 trillion in the first 8 months of this year (still well above levels in 2007 and 2008—Figure 3.3.8) from CNY8.2 trillion in the prior-year period.

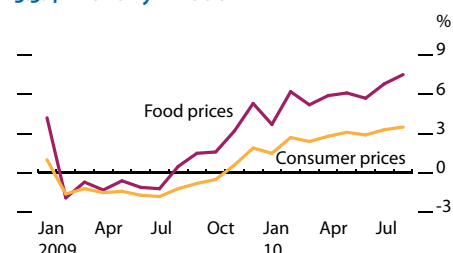
3.3.3 Purchasing Managers' Index



Source: CEIC Data Company (accessed 16 September 2010).

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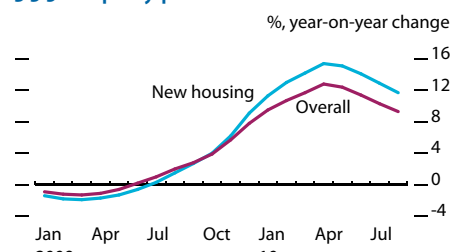
3.3.4 Monthly inflation



Source: CEIC Data Company (accessed 16 September 2010).

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3.3.5 Property prices

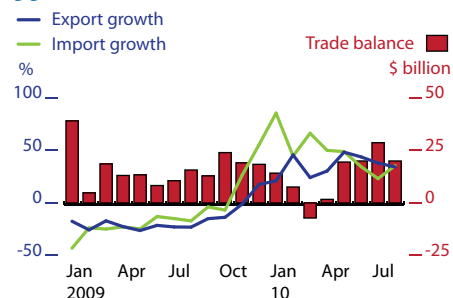


Note: Overall property prices cover both residential and nonresidential buildings.

Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

3.3.6 Trade indicators



Source: CEIC Data Company (accessed 16 September 2010).

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Tightening measures also included 3 half-percentage point increases in the banks' reserve requirement ratio (to 17% for large banks) and open-market operations by the central bank to absorb liquidity. M2 money supply growth moderated to 19.2% in August from 27.7% at end-2009 (Figure 3.3.9).

Share prices have declined, partly because of the clampdown on the property market and concerns over possible further tightening measures. The Shanghai Composite Index fell by nearly 20% in the 8 months through August. However, the market's decline did not stop Agricultural Bank of China from raising almost \$22 billion in August through an initial public offering in Hong Kong, China and in Shanghai, the largest in the world to date.

Fiscal stimulus, too, is phasing down. Total government spending in 2010 is budgeted to increase by 11%, about half the pace seen in 2009. An 8% budgeted increase in revenue looks conservative, and the fiscal deficit for this year will likely be narrower than 2.8% of GDP, the official target.

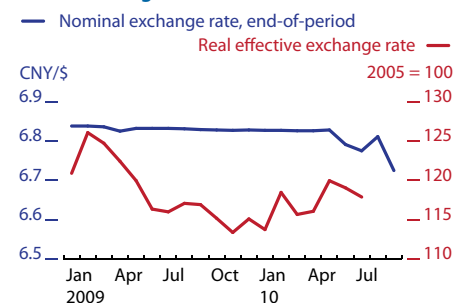
Local governments have used their off-budget investment arms to tap into the flood of bank lending unleashed during the stimulus programs, and have channeled those funds into local infrastructure projects, not all based on solid commercial foundations. An investigation of this practice by bank regulators found that, of CNY7.7 trillion disbursed by banks to local government investment arms, perhaps one-fifth is at risk of becoming bad loans. The regulators, while tightening guidelines for such lending, maintained that the banking sector is secure because the ratio of nonperforming loans was just 1.3% at midyear and the average provisioning ratio was 186%.

Another outcome of the massive stimulus programs that have been conducted mainly through state-controlled banks and enterprises has been to increase state ownership and control of the economy. The government has issued guidelines that, it has said, are aimed at redressing this development, opening to private investment some previously closed industries, including public utilities, rural financial services, telecommunications, low-income housing, and science and technology ventures.

Rapid economic growth generated 6.4 million new jobs in urban areas in the first half, and more than 3 million laid-off workers were rehired. The national jobs-to-applicants ratio exceeds 1, signaling more vacancies than job-seekers. The stimulus programs fostered employment in central and western regions, attracting back a large number of migrant workers from coastal cities. The tightness of the labor market prompted higher wages and, in some cases, better working conditions (as well as a few strikes), contributing to the increase in consumer spending.

Senior government officials have highlighted the benefits of urbanization as a means to strengthen domestic demand, enhance services delivery, and reduce income inequality. In this connection, a new residence permit system has been adopted in 10 cities to reform the household registration (*hukou*) system and foster urbanization. The new permit grants to migrant workers the same social benefits as to those registered in the cities. Permit holders can later apply for the urban *hukou* if they meet certain conditions. The system is expected to result in migrant workers progressively becoming permanent urban residents,

3.3.7 Exchange rates

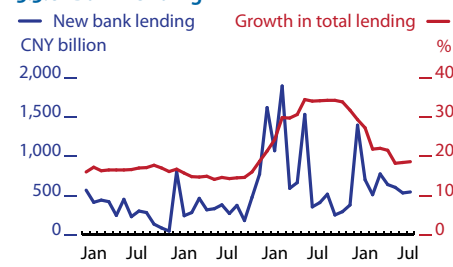


Note: Latest data for nominal exchange rate are as of 15 September and for real effective exchange rate as of end-July.

Source: CEIC Data Company (accessed 16 September 2010).

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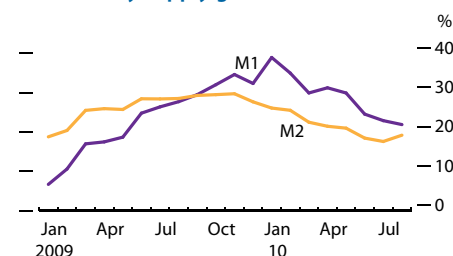
3.3.8 Bank lending



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

3.3.9 Money supply growth



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

enhancing mobility of labor and raising migrant workers' disposable incomes.

Addressing the issue of environmental damage inflicted by decades of heavy investment in industry and the economy's low-energy efficiency, the government plans to include low-carbon targets in the Twelfth Five-Year Plan (2011–2015). It is drawing up fiscal incentives and supportive policies to promote the use of renewable energy (wind, solar, biomass, and geothermal), and to increase the use of nuclear power. New anti-pollution taxes, too, have been proposed and, if approved, will likely be tried in one or two provinces later this year.

Prospects

The forecasts assume that the planned fiscal stimulus programs will be fully disbursed through the second half of 2010, and that no new stimulus measures will be introduced. As noted above, the fiscal deficit in 2010 is likely to be narrower than the budgeted deficit of 2.8% of GDP, mainly because of stronger than projected growth in revenue. In 2011, fiscal policy is assumed to be less stimulatory than 2010 and the deficit will narrow further from this year's level in relation to GDP.

On monetary policy, the outlook assumes that tightening measures taken this year to stem the flood of bank lending will rein in money supply and credit growth toward government targets.

Growth in fixed-asset investment has pulled back steadily this year (Figure 3.3.10) and is expected to moderate further as the impact of the fiscal and monetary stimulus wanes. This deceleration will temper demand for industrial products, such as cement, during the forecast period. A government plan to cut excess production capacity in the steel industry, by as much as 300 million tons, or about half 2009's steel output, will also cool growth in the industry sector. Furthermore, determined efforts to reduce carbon emissions and other environmental damage will likely crimp growth in some industries. The PRC has become the world's largest energy consumer, which adds some urgency to efforts to raise energy efficiency and reduce polluting emissions.

Private consumption is projected to remain brisk, underpinned by growth in employment and incomes, which in turn is helped by a trend to relocate labor-intensive industries to central and western areas and by policies to improve conditions for migrant workers. Government incentives to buy automobiles and household electrical appliances also favor consumption growth. Consumer confidence has continued to recover from low levels in the first half of 2009 (Figure 3.3.11).

Growth in merchandise exports is expected to decelerate in the second half of 2010, owing to the base effect as exports moved higher in the prior-year period, more subdued demand from some export markets, and the expiration of PRC tax rebates. Import growth, too, will soften, given the high import component of PRC exports (about 50%) and more restrained industrial production. The central bank's June adjustment to exchange rate policy is unlikely to have much of an impact on trade flows in the near term.

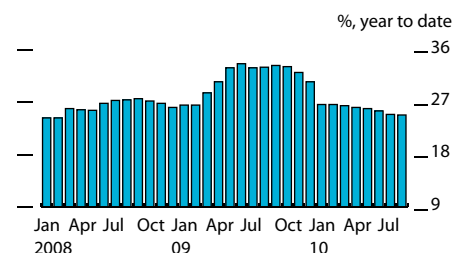
GDP growth is forecast to step down to about 9% in the third quarter of 2010 and to 8% in the fourth, so that full-year growth is 9.6%

3.3.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	Update	ADO 2010	Update
GDP growth	9.6	9.6	9.1	9.1
Inflation	3.6	3.2	3.2	3.2
Current acct. bal. (share of GDP)	5.7	5.6	5.3	5.2

Source: ADB estimates.

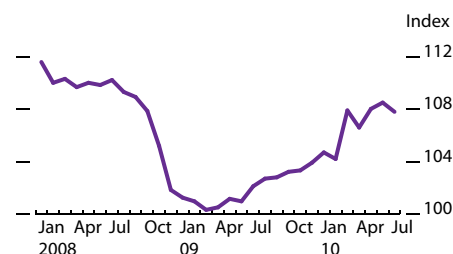
3.3.10 Growth in fixed asset investment



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

3.3.11 Consumer confidence



Source: CEIC Data Company (accessed 16 September 2010).

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(unchanged from the *Asian Development Outlook 2010* forecast in April). Taking into account the phasing out of stimulus policies in 2010 and expected subdued growth in industrial economies next year, the GDP growth forecast for the PRC in 2011 is maintained at 9.1% (Figure 3.3.12). Sizable current account surpluses are still projected—5.6% of GDP for this year and 5.2% for 2011.

Flooding in the summer raised prices of food and some other items, though this effect is expected to be temporary. Price increases that were anticipated this year for water, natural gas, and electricity have been postponed until next year. Average inflation for 2010 is forecast at 3.2%, trimmed from April, in light of lower than expected price pressures in the first half. Inflation in 2011 is forecast to be the same as this year's average (Figure 3.3.13).

Downside risks to the outlook mainly relate to the fragility of external demand, exacerbated by European fiscal and debt concerns this year. A weakening of the euro could exert appreciation pressures on the yuan's real effective exchange rate, hurting exports to the European Union, the PRC's largest trading partner. There is a risk of a worse than expected deterioration in PRC bank asset quality, a consequence of the flood of bank lending that in some cases has been diverted into unproductive purposes. That risk would be heightened if measures to cool the property market have a more severe impact than currently anticipated.

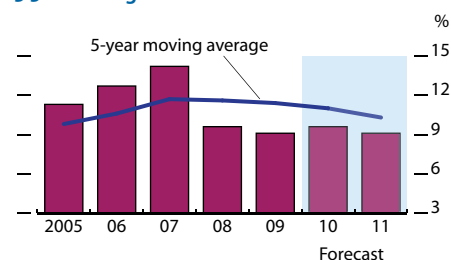
GDP growth would be more rapid than forecast if the domestic slowdown prompts the authorities to implement new fiscal or monetary stimulus. A stronger economic recovery in Europe that caused the euro to appreciate would likely spur PRC exports and GDP growth.

Longer term, failure to decisively implement the agenda to rebalance the PRC economy risks jeopardizing the sustainability of growth. A greater emphasis on private consumption demand, as against the current investment-driven economic growth model, would promote longer-term growth and raise living standards. Growth in consumption has been limited by the declining share of household income in total income, while the shares of enterprises and the government have increased.

From the production perspective, services have huge potential to contribute toward sustainable growth, since they account for only a relatively small proportion of GDP.

Finally, fiscal policy can play an important role in promoting a more consumption-driven and services-oriented economic model, particularly if it is complemented by other mutually supportive and consistent policies (Box 3.3.1).

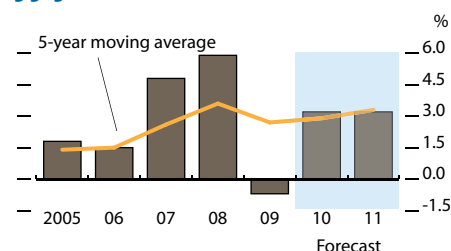
3.3.12 GDP growth



Sources: National Bureau of Statistics of China; ADB estimates.

[Click here for figure data](#)

3.3.13 Inflation



Sources: National Bureau of Statistics of China; ADB estimates.

[Click here for figure data](#)

3.3.1 Fiscal policy's role in rebalancing the economy

The following fiscal goals could be pursued, within a broader overall policy environment, to support rebalancing and income redistribution.

Shift the emphasis of public spending from investment to public services and redistribute more corporate profits to social spending. Public expenditure on education, health, and social security combined amounts to only 6% of GDP, compared with an average of 28% in industrial economies. Allocating more fiscal resources to public services would raise the disposable income of households and thus reduce precautionary savings and encourage consumption. Further, strengthening the social safety net to protect the poor and the vulnerable promotes consumption (as well as equity), since those groups tend to spend more and save less. Rising profits earned by state-owned enterprises are generally not redistributed to the community because these enterprises seldom pay dividends to the state. A dividend stream from state enterprises to the government could fund additional social spending without straining public finances.

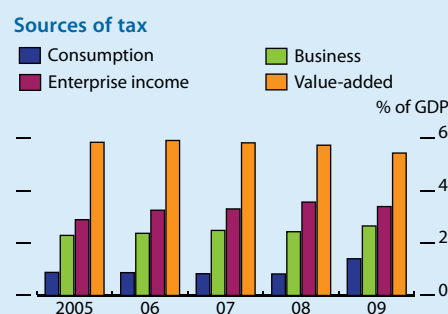
Strengthen automatic stabilizers. These mechanisms are taxes and transfers that adjust automatically to temper business cycles. For example, the amount paid out on unemployment benefits automatically increases in a recession when the labor market weakens, and such transfers contract as the economy turns up. Further, developing automatic stabilizers in the PRC would mitigate the risk and uncertainty households face in economic downturns, and thus encourage private consumption.

Increase the supply of low-income housing. Expanding such housing would increase the disposable income of poorer households. The government could establish municipal housing authorities to construct low-income housing and introduce fiscal incentives to attract private sector developers into this less profitable segment of the market. On the demand side, consumers could benefit from tax exemptions, cash subsidies or housing allowances, and capital grants on low-income housing. Further, provision of state guarantees or public mortgages, or both, would mitigate credit rationing that makes it difficult for poorer households to obtain housing finance.

Introduce property taxes. The government plans to pilot-test a property tax targeted at luxury residences in four cities, as part of its aim to curb property speculation. The expansion of the tax to all houses in urban areas, based on their value, could provide a substantial and steady source of revenue to fund public goods and services. This would in turn reduce precautionary saving and enhance consumption, contributing to rebalancing.

Subject services to value-added tax (VAT). VAT is the single largest source of tax revenue in the PRC, amounting

to just over 5% of GDP in 2009 (Box figure). The central government gets 75% of the revenue and provincial governments 25%. VAT is levied only on manufacturing, while services are subject to a business tax that raises a much smaller amount. Given local governments' heavy dependence on VAT revenue, they have a strong incentive to promote manufacturing rather than services. Rebalancing the economy could thus be advanced by including services in the VAT base, a measure that likely would also raise the revenue of local governments, increasing their capacity to provide public services.



Source: CEIC Data Company (accessed 16 September 2010).

[Click here for figure data](#)

Strengthen fiscal transfers to provinces. In both magnitude and timing, the flow of fiscal transfers from the central government to the provinces is unpredictable, constraining the capacity of local governments to provide public services. One approach would be to transfer a larger share of tax revenue, such as VAT, to provinces. Alternatively, the central government, while maintaining its decentralized arrangement for provision of social services, could increase its share in their financing. This could be achieved through redistributive and equalizing mechanisms to support poorer provinces. Otherwise, interprovincial disparities in social spending per person will remain, constraining consumption in the central and western provinces.

In this regard, a 5% resources tax on oil and gas has been introduced in Xinjiang Uygur Autonomous Region as part of a pilot project. It is expected to increase the region's revenue by the equivalent of 25% of its total 2009 revenue. This approach is intended to promote the efficient use of natural resources, as well as to bolster finances in less developed provinces, so reducing regional disparities.

Source

Donghyun Park and Yolanda Fernandez Lommen. 2010. The Role of Fiscal Policy in Rebalancing the People's Republic of China. *ADB Briefs*. Asian Development Bank, Manila.