

People's Republic of China

Supported by strong domestic and external demand, GDP growth reached a multiyear high in 2007. Inflation also quickened, a result of high global oil and grain prices, domestic price pressures on some foods, and excess liquidity in the banking system. The Government has taken more aggressive tightening measures which, combined with weaker external demand, are expected to slow economic growth in 2008 and 2009. Price pressures are seen easing somewhat later this year. A longer-term goal is to achieve a more balanced and inclusive economy.

Economic performance

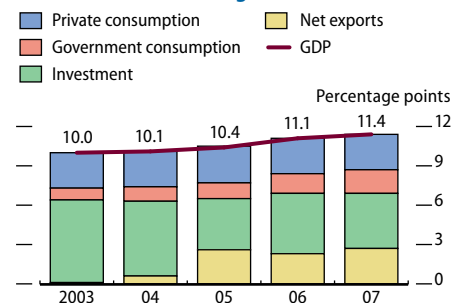
GDP growth reached 11.4% in 2007 in the People's Republic of China (PRC), a 13-year high and the fifth consecutive year of double-digit expansion. Fueled by buoyant exports and vigorous domestic demand, it accelerated from 11.1% in the first quarter to 11.9% in the second. To prevent overheating, the Government raised interest rates and banks' reserve requirements, abolished or cut export tax rebates on certain products, and imposed tariffs on some exports. As a result, GDP decelerated gradually to 11.5% in the third quarter and 11.2% in the fourth. Most of the slowing was caused by a reduced contribution from net exports.

It was hard to detect any signs of rebalancing away from industry-led growth. This sector contributed 7.5 percentage points to total growth, and services another 3.5 percentage points. Agriculture made a minor contribution. On the demand side, domestic consumption replaced investment to become the biggest driver of growth for the first time in 7 years, contributing 4.5 percentage points of GDP growth, compared with 4.2 percentage points from investment and 2.7 percentage points from net exports (Figure 3.9.1).

Rapid economic growth and government policies to promote employment helped create 12.0 million new jobs in urban areas in 2007, well above an official target of 9 million, though about 24 million new jobs were needed to absorb all newcomers to the labor market, according to the National Development and Reform Commission. The private sector and small and medium enterprises generated about 80% of the new jobs, although their share of total employment was only about 16% in 2007.

Wage increases lifted real urban incomes by 12.2% last year. Rural incomes in real terms grew by 9.5%, driven mainly by remittances of migrant farmers who moved to cities for better jobs (Box 3.9.1). Fueled by buoyant urban and rural incomes, private consumption rose by about 8%, continuing to grow at a rate below that of total GDP. Investment in some overheated sectors eased, but overall investment was again boosted by high industrial profitability, strong investment initiatives at

3.9.1 Contributions to growth (demand)



Sources: National Bureau of Statistics; staff estimates.

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3.9.1 Workforce in transition

The country faces three main challenges related to the workforce, and has started to address some of them.

Massive rural-to-urban migration

The scale of domestic movement of labor has been huge in the past two decades, reflecting both “push” and “pull” factors—rural poverty and underemployment push farmers to leave their homes, and higher-paying jobs pull them to cities. Migrant workers (defined as those having migrated for employment for at least 6 months in the previous year) are estimated at 140 million–200 million, and have helped fuel economic growth in urban areas.

The profile of rural-to-urban migrants has become younger, but remains dominated by unskilled and semiskilled workers. About two thirds have not received any job training. With a poor education and rarely any vocational skills, migrant workers seldom get good jobs in cities. They are also denied full access to basic public services away from their rural homes, such as education, health care, or social protection.

Shortage in semiskilled and skilled workers

While unemployment and underemployment among unskilled workers appears to be rising, a paucity of skilled workers has led to severe recruitment and retention problems for local and foreign firms. Recent studies have identified growing skill constraints in areas like English-language skills and research and development.

Despite an influx of nearly 5 million new university graduates annually, both domestic and foreign firms complain of job applicants' low employability. Only 10% of graduates meet the English-language requirements of foreign companies, which now account for more than 20% of all local job opportunities.

A rapidly aging population

The need to reengineer the PRC workforce is set against a backdrop of broader economic and social transitions, including an aging population. The old-age dependency ratio (the number of people at the retirement age and above divided by the number of people of working age) is forecast to double between 2005 and 2030 and the population over

60 to triple by 2050 relative to 2005. This transition will hit the PRC at a much lower per capita income level than most other countries, further straining health, insurance, and social protection systems.

While some have pointed to a potential evaporation of the low-cost labor pool, arguably, this core challenge is again more of quality than of quantity. To maintain sustainable economic growth, the shrinking of the low-cost labor pool should be offset by an improvement of labor skills and productivity. Although the number of young workers (aged 15–24) is forecast to remain over 200 million until 2015 (declining gradually thereafter), the key question is whether sustainable but decelerating growth driven by human capital and technological progress can support an aging population.

The restructuring

Sweeping labor law reforms that came into effect in January 2008 represent a step forward in protecting the rights of workers and providing stronger stipulations in areas such as written labor contracts, handling labor disputes, payment of wages on time, and long-term job security. A long-term relationship between employers and employees will be helpful for workers to strengthen their on-the-job skills. In addition, the reforms provide incentives for employers to invest in vocational training. However, in the short term, the legislation might well cause some employers to cut staffing levels or even relocate.

Other reforms include a range of vocational training programs for rural-to-urban migrants and others to retrain laid-off workers. The challenge will be in enforcing these changes, in ensuring that the programs are adequately funded, and in involving the private sector and other stakeholders.

At a broader level, employer surveys and other evidence suggest a need to reorient education from a focus on rote and theory toward flexibility in learning and applied skills. Such a shift becomes increasingly important to more closely link the classroom to the labor market, which is in line with the rapid technological change and broader social transitions. (See also the chapter *Asia's skills crisis* in Part 2.) To address such interlinked challenges, the Government will need to continue reforms in education, training, and pensions, and to construct a stronger social safety net.

provincial level, a booming stock market, and still-low lending rates. Fixed asset investment in industry grew by 29% in 2007. About 60% of corporate investment is financed from firms' internal funds, mostly own capital and profits. Consequently, rising corporate profits tend to make domestic overinvestment in manufacturing, and growth in net exports, mutually reinforcing. This also made corporate investment less sensitive to increases in interest rates.

Government efforts to restructure investment seem to be having some impact. The policy to encourage innovation, save energy, and cut

pollution has led to accelerated investments in hi-tech machinery and in recycling while investment in overheated sectors such as steel, electricity, and heat power slowed modestly (Figure 3.9.2). In addition, policies to stimulate the rural economy pushed up investment in agriculture last year by 31.1%, faster than that in industry and services. Indeed, encouraged by the policies to promote development in remote areas and in old industrial areas, investment in western and central regions grew by about 30%, faster than in the east. As investment has grown faster than GDP (both in nominal terms) for several years, its share of GDP reached a high level of 44.5%, symptomatic of the economic imbalance.

An imbalance was also seen in a soaring trade surplus, with merchandise exports growing by 27.6%, much faster than import growth of 18.0%, in the first half of 2007 (Figure 3.9.3). To rein in the trade surplus, the Government launched a series of measures: an export tariff was imposed on 142 products in June and export tax rebates were reduced or abolished in July for 2,831 items; and import restrictions were abolished on 338 items. Export growth slowed to 24.7% in the second half of the year, when import growth picked up to 22.6%. Yet the trade surplus still climbed by 45% to \$316.6 billion for the year. The main contributor was processing trade, which involves the assembly of imported intermediate items and their export as final goods, often by manufacturers owned by foreign firms.

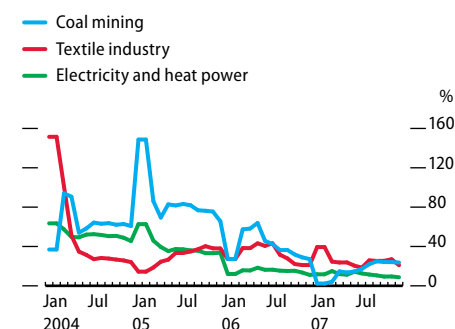
The surge in the trade surplus increased the current account surplus to an estimated \$353 billion, equivalent to 11% of GDP. Foreign direct investment inflows rose by 13.8% to \$82.7 billion. As well as these inflows, short-term speculative capital flowed into the booming real estate sector and stock markets. Foreign reserves reached \$1.53 trillion by year-end, the largest in the world. In October, the China Investment Corporation was established to invest part of the pool of reserves abroad.

To maintain a gradual appreciation of the yuan's nominal exchange rate, the People's Bank of China, the central bank, has to drain excess liquidity created by the accumulation of foreign reserves. Since it cannot fully achieve this, excess liquidity is injected into the economy by an expansion of base money. As a result, broad money supply (M2) grew by 16.7% last year, above the central bank's target of 16%. Growth of bank lending was also strong at 16.1% by end-2007. The authorities allowed the yuan's appreciation against the United States (US) dollar to accelerate in nominal terms to 6.9% in 2007 from 3.4% in 2006. According to the Bank for International Settlements, the PRC's nominal and real effective exchange rates appreciated year on year by 1.6% and 4.1%, respectively, in 2007.

Inflation became a serious problem in 2007, caused mainly by rising prices for food (up 12.3%), and to a lesser degree housing and fuel. Inflation reached 6.9% in November 2007 (Figure 3.9.4), the highest since 1996, with a year-average rate of 4.8%. Underlying the hike in food prices were higher costs of imported grain and an outbreak of a pig disease that caused shortages and pushed up pork prices. The Government's response was to encourage pork production, introduce more price controls and quotas, and reduce exports of food.

Housing prices have accelerated in many cities because of rising demand encouraged by excess liquidity. Sales of new houses jumped by 42.1% in 2007 in terms of value.

3.9.2 Growth of investment, selected industries

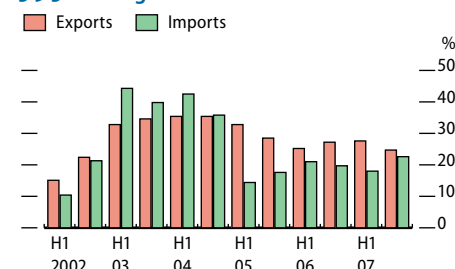


Note: Heat power refers to hot water and steam for city heating systems.

Sources: National Bureau of Statistics; staff estimates.

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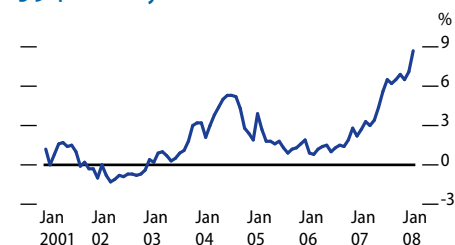
3.9.3 Trade growth



Sources: CEIC Data Company Ltd., downloaded 17 March 2008; staff estimates.

[Click here for figure data](#)

3.9.4 Monthly inflation



Source: CEIC Data Company Ltd., downloaded 13 March 2008.

[Click here for figure data](#)

Excessive liquidity in the financial system and relatively unattractive bank deposit interest rates spurred the stock market. The Shanghai A-share index (for shares available to domestic investors) nearly doubled in 2007, after a 131% leap in 2006. To curb market speculation, the authorities in May raised the stamp duty tax on stock transactions and brought in measures to curb the use of bank loans for stock market speculation. The stock market index reached a peak in October, and then declined.

Among its efforts to curtail liquidity and to fight inflation, the central bank tightened policy frequently in 2007, increasing its policy interest rate by 135 basis points and commercial banks' reserve-requirement ratio by 5.5 percentage points. The 1-year benchmark lending rate was raised to 7.47% and deposit rate to 4.14% (Figure 3.9.5). However, after taking inflation into account, the real deposit rate remained negative. Concerned about the weakening global economy and the possibility of more speculative capital inflows as the Federal Reserve cut US interest rates, the central bank in December raised the deposit rate by 27 basis points, well above the 18 basis point increase in lending rates. It also sold special bills to commercial banks six times to drain liquidity.

Fiscal revenues rose by 32.4%, reflecting rapid economic growth and buoyant corporate profits. Expenditures grew by 22.6%. The surge in receipts and a government-induced slowdown in public infrastructure spending helped produce a budget surplus equivalent to 0.7% of GDP in 2007, compared with a deficit (0.8% of GDP) in 2006.

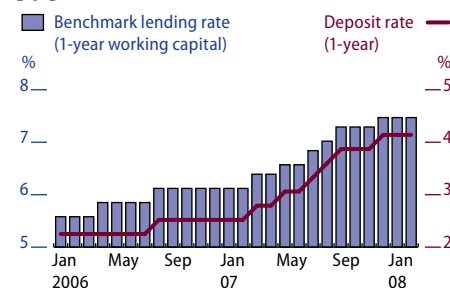
Economic prospects

The 2007 performance suggests strong momentum going further into 2008, maintaining a risk of overheating in some sectors and of inflation becoming more entrenched. The following forecasts rest on the assumptions that monetary conditions will tighten further; fiscal policy will be prudent; steps will be taken to improve energy efficiency and cut pollution; and the exchange rate against the US dollar will appreciate faster.

Interest rates are expected to trend up in 2008, before easing in 2009 when inflation is seen moderating. The central bank is also likely to further raise banks' reserve requirements, issue bills to sterilize liquidity inflows, and strengthen its so-called "window guidance" in an effort to reduce bank lending to overheated industries. In fact, it hoisted the reserve-requirement ratio from 9.0% to 14.5%, a 20-year high, in 2007, and in the first quarter of 2008 has raised this ratio twice more, by a total of 1.0 percentage point, to 15.5% (Figure 3.9.6). The accumulative impact of monetary tightening is expected to have greater effect this year. As the rising trade surplus and surging foreign capital inflows contribute to excess liquidity, the authorities are expected to permit faster appreciation of the yuan against the US dollar.

The fiscal position will be strengthened by higher stamp duty on share transactions, the reduction of export tax rebates, and the introduction of a requirement that central government-owned enterprises pay dividends. On the last point, the Government required state enterprises to pay dividends from October 2007, as a trial. Firms in the petroleum and petrochemicals, telecommunications, coal, electricity, and tobacco industries will pay dividends of 10% of their after-tax profits, and those

3.9.5 Interest rates



Source: CEIC Data Company Ltd., downloaded 13 March 2008.

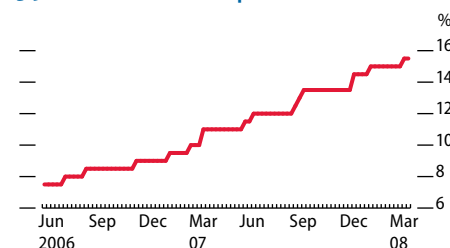
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3.9.1 Selected economic indicators

	2008	2009
GDP growth	10.0	9.8
Inflation	5.5	5.0
Current account balance (% of GDP)	9.9	8.6

Source: Staff estimates.

3.9.6 Bank reserve-requirement ratio



Source: People's Bank of China.

[Click here for figure data](#)

in other sectors will pay 5%. (State enterprises in military industries and institutions involved in scientific research are excluded from any dividend requirement.)

On the expenditure side, the Government's goals of creating a "harmonious society" and stimulating growth of private consumption call for more spending on rural development, education, health care, and other social programs. As the authorities will also reduce spending on infrastructure, fiscal policy will play a more important role in structural adjustment. The fiscal balance this year and next is projected to show a small deficit of about 1% of GDP, suggesting policy will be slightly expansionary if these projections are realized. If the global economic situation deteriorates to a greater degree than expected, the authorities could change to a more expansionary stance.

Two important targets of 11th Five-Year Plan (2006–2010) are to cut energy consumption per unit of GDP by 20% and reduce major pollutants by 10% by 2010. In the forecast period, the Government is expected to be more active in taking steps to achieve these goals by, among other moves, increasing outlays on energy saving and environment protection, imposing new taxes on energy and natural resource consumption as well as on environmental pollution, and by tougher implementation of regulations on energy saving and pollution reduction. Official figures show energy consumption per CNY10,000 of GDP fell by 3.3% last year, following a 1.2% reduction in 2006. Sulfur dioxide emission was reduced by 4.7% and chemical oxygen demand cut by 3.1% in 2007.

Investment will continue to underpin the expansion of GDP in 2008 and 2009, with many of the drivers still in place: low cost of borrowing for state-owned companies, buoyant profits, and strong incentives for local governments to pursue high rates of growth.

The China Banking Regulatory Commission has strengthened the supervision of mortgage loans and raised the share of down payment for purchasing a second house from 30% to 40%, which should constrain credit for real estate developers and housing buyers (and speculators). The authorities also announced measures to force suppliers of housing to build on land rather than keep it vacant.

Domestic consumption will remain firm, supported by government spending on social and rural development and a new labor contract law that came into force in January 2008 that gives greater security to many employees. Furthermore, the threshold for paying individual income tax was raised from March, in effect lowering taxes. The summer Olympics are expected to give retail sales a fillip. (Nominal retail sales rose by 20.2% in the first 2 months of 2008, accelerating from the year-earlier pace of 14.7% as consumer demand remained strong and prices increased.)

Net exports will be hit by a combination of weaker external demand, domestic policies to restrict some exports, currency appreciation, and rising local costs for labor and land. The growth of merchandise exports is expected to slow to 19% this year and further to 18% next year, from 26% in 2007. The European Union, Japan, and the United States bought nearly half the PRC's total exports last year, and all three markets are expected to weaken this year. In contrast, import growth is likely to remain at around 20%, influenced by the appreciating currency, declining import tariffs, and introduction of other pro-import policies.

These forces are forecast to moderate GDP growth to 10.0% in 2008 and 9.8% in 2009 (Figure 3.9.7). The contribution to growth of investment is expected to decline slightly and that of consumption to rise moderately. As the contribution from the external side falls, GDP growth will be pulled down. Growth in the trade surplus is expected to decelerate but tourism-related inflows linked to the Olympics will narrow the services deficit in 2008. The surplus on the income account will continue to rise this year and next, reflecting higher earnings from the PRC's foreign-exchange reserves and income from overseas investment. The current account surplus is forecast to fall as a share of GDP to 9.9% in 2008 and to 8.6% in 2009 (Figure 3.9.8).

Inflation was propelled to an average of 7.9% in the first 2 months of 2008 when bad weather hit 21 provinces, damaging fruit and vegetable production and blocking transportation routes. Food prices are expected to stay at high levels until the third quarter, when supplies of pork and grain are likely to pick up. The Government in early 2008 froze prices temporarily for some goods and services and required official approval to raise other prices. The Government also scrapped tax rebates for grain exports and instead indicated that it would levy export taxes on grain, apparently to ease upward pressure on grain prices. Overall, inflation this year is forecast to average 5.5%, and 5% in 2009 (Figure 3.9.9).

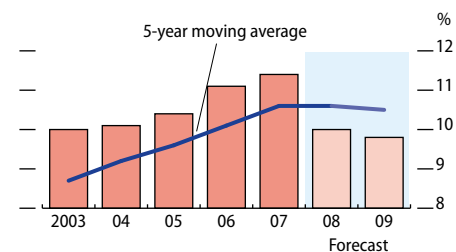
Those measures should reduce the risk that the public comes to expect rapid inflation, which would likely mean further upward pressure on wages and prices. However, if price controls are maintained too long, they may reduce incentives to increase production and so have an unintended upward impact on inflation in the medium term.

If food inflation eases as forecast, the temporary price controls might be ended. At that stage, though, the authorities are expected to consider price reforms for water, electricity, and fuel, which would likely lead to price increases for these items.

There are three major downside risks to this outlook. A more severe than expected deterioration in the global economic and financial position would cause a deeper erosion of PRC exports and economic growth. A major downturn in PRC property and stock markets could damage banks' balance sheets, leading them to tighten credit. Moreover, the resulting negative wealth effect for households could hamper private consumption, at least in cities. Lastly, an acceleration of inflation from current high level would likely prompt a more aggressive tightening of credit, potentially causing a drop in investment. If all three negative scenarios play out, economic growth could fall to perhaps 7%. In such circumstances, the Government would, though, have room to raise spending on welfare and urban infrastructure programs, as well as to relax its grip on monetary policy.

The National People's Congress in March approved a restructuring of government departments aimed at strengthening the central Government's ability to manage the economy. Five new "super ministries" were established for industry and information, human resources and social security, environmental protection, housing and urban-rural construction, and transport. A national energy commission was also established and the Ministry of Health was empowered to oversee food and drug safety.

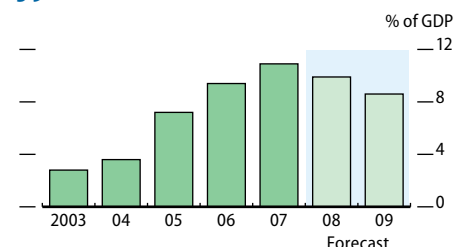
3.9.7 GDP growth



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

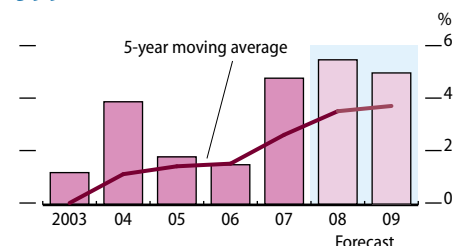
3.9.8 Current account balance



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

3.9.9 Inflation



Sources: National Bureau of Statistics; staff estimates.

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Development challenges

Over the past 5 years, the economy has moved to a high-growth, high-investment, and high net export structure, which appears to be self-reinforcing. Yet three major imbalances in the economy indicate that the current growth model is not sustainable. The first is between internal and external demand. The large and rising current account surpluses have aggravated relations with major trade partners, while domestically the accumulation of foreign exchange reserves causes excess liquidity and signifies a suboptimal allocation of resources. Since 2003, the Government has been trying to restructure the economy toward a sustainable growth model by promoting consumption growth. But the share of consumption in GDP has continued to fall, while the share of capital formation and net exports has increased (Figure 3.9.10).

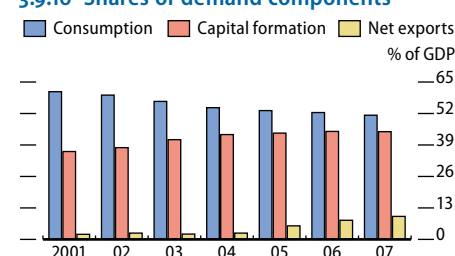
The second imbalance comes from energy and environmental strains. The country's heavy reliance on industry for growth has put increasing strains on energy supplies and the environment. The PRC improved the efficiency of energy use between 1978 and 2002 but the trend was subsequently reversed for a few years. The energy intensity of PRC industry is 1.5 to 2 times as high as in advanced economies and the current growth model results in steeply rising consumption of fuels and increasing imports of petroleum, triggering concerns about energy security. Heavy industry-dominated growth has also caused environmental problems. Reliance on coal for 70% of the total energy consumption and a rapid increase in the number of vehicles is intensifying air pollution and "greenhouse gas" emissions.

The third imbalance is rising income inequality. Whether measured in terms of the urban-rural income gap (Figure 3.9.11), differences between the top income groups and the bottom groups, or coastal versus interior regions, social inequality is worsening. Accumulation of capital in urban industry has led to large income inequalities.

To address these imbalances, the Government has launched a raft of new policies and programs since 2003, many of them aimed at helping the rural sector and giving stricter environmental protection. However, rebalancing faces several constraints. First, investment is still very much encouraged by high savings rates and local governments' incentives to pursue growth. A high level of domestic investment has been supported by an even higher savings rate. More important, the increase in savings did not come from households but mainly from enterprises, so that raising consumption might not solve the imbalance. Enterprise savings have soared in the past decade because state-owned enterprises have laid off excess staff and reduced their social functions at the same time as a rapid increase in the number of foreign and private firms has raised productivity. The decision to require central government-owned enterprises to pay dividends was an important step. However, considering that the share of these dividends in total enterprises' profits is small (5–10%) and that the dividends will be used for further reforms of state enterprises rather than for social programs, the policy looks unlikely to help remedy the investment-consumption imbalance.

Second, the evaluation system for local officials impedes rebalancing. Although the central Government has adopted a so-called "scientific approach to development," which emphasizes a balance between

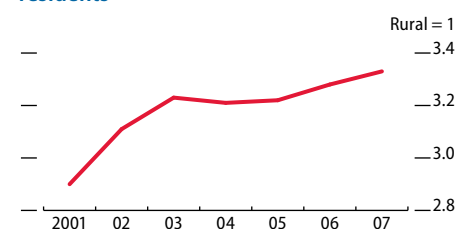
3.9.10 Shares of demand components



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

3.9.11 Income ratio of urban to rural residents



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

economic development and social and environmental sustainability, local officials sometimes still place GDP growth over more intangible social and environmental indicators because that is how their predecessors usually achieved promotion. This is likely to continue until local decision makers perceive stronger incentives to do otherwise.

Third, low energy prices and weak pollution-abatement measures hamper energy saving and pollution reduction. The authorities, concerned that higher energy prices and strict pollution control would push up inflation and raise costs for exporters, are reluctant to raise taxes on energy consumption and crack down heavily on pollution. But if they are to realize targets on energy efficiency and pollution reduction by 2010, it is likely that energy prices will have to be raised, taxes imposed on energy and natural resources, and the monitoring and evaluation systems strengthened.

Fourth, certain regulations such as the household registration (or *hukou*) system—which hinders the free movement of farm workers leaving their homes and seeking higher-paid jobs in cities—constrain rebalancing. Income inequality between urban and rural areas is the major contributor to widening national income discrepancies. One way to address this would be to allow more flexible movement of labor, especially farmers migrating to cities, which would require reforms to the *hukou* system.