

People's Republic of China

Economic growth exceeded 10% for a fourth consecutive year, driven by strong investment. A gradual tightening in monetary policy and the use of administrative tools moderated investment growth in the second half of the year. In 2007 and 2008, softer external demand and policy curbs are expected to pull growth down gradually. In the short run, the Government is likely to restrict investment growth and cool the economy. In the medium to long-term, the aim is to achieve a more balanced and inclusive economy, dependent less on exports, investment, and industry, and more on private consumption and services. This evolution will probably mean lower GDP growth rates.

Economic performance

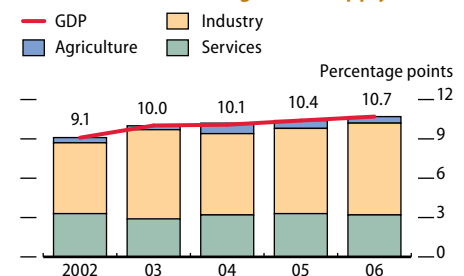
The People's Republic of China (PRC) recorded a strong economic performance in the first year of its 11th Five-Year Program. GDP in 2006 grew by 10.7%, a 10-year high and a fourth year of double-digit growth. Concerned about overheating in some sectors, the Government imposed restrictions that slowed growth modestly, from 11.5% in the second quarter to 10.4% in the fourth.

Industry, including manufacturing and construction, contributed 7.0 percentage points, or 65% of total GDP growth, and services another 3.2 percentage points, or 30% (Figure 2.8.1). Agriculture made a minor contribution. On the demand side, the economy continued to be driven by strong investment, which contributed 4.4 percentage points, or 41% of total GDP growth (Figure 2.8.2). As the contribution of net exports declined to 21% in 2006, that of total consumption edged up to 38%. Private consumption grew robustly, but by less than GDP growth.

Investment surged in the first half of 2006 as a result of accelerating urbanization, the drive of local governments (which have incentives to push growth through investment), and excess liquidity (which made access to credit easy for some firms). As the Government's efforts to cool the economy took effect, the growth of fixed asset investment slowed from about 30% in the first half of the year to 21% in the second (in nominal terms). Investment slowed sharply in industries that have built excess production capacity, such as textiles, coal mining, and electricity (Figure 2.8.3).

The relationship between investment and industry is key to understanding the PRC's growth acceleration. Certainly, growth was helped by economic reforms that made labor and capital more productive, and by a favorable global environment. However, the reinvestment of large profits into new industrial activity was perhaps the most important driver. Higher investment allows more capital deepening, which in turn increases labor productivity and potential GDP. Profits of industrial enterprises grew faster than industrial value added for much of last year, which indicates a decline in the share of wages in GDP. This, together

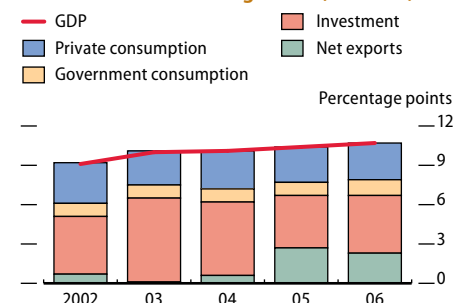
2.8.1 Contributions to growth (supply)



Sources: National Bureau of Statistics; staff estimates.

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2.8.2 Contributions to growth (demand)



Sources: National Bureau of Statistics; staff estimates.

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with low inflation and impressive productivity gains, helped keep the growth of unit labor costs under control. The gap between growth in nominal industrial profits and nominal industrial value added widened from 3.1 percentage points in the first 5 months of 2006 to 7.8 percentage points in the 11 months to November (Figure 2.8.4), encouraging companies to lift investment.

Faster growth in exports than imports (Figure 2.8.5) boosted the trade surplus by \$60 billion to \$194 billion in 2006. Bilateral surpluses with the United States (US) and European Union (EU) surged, while the deficit with the rest of Asia continued to widen. This is consistent with the growth of supply chains, where manufacturing plants in the PRC import intermediate inputs from the rest of Asia. (See also *Uncoupling Asia: Myth or reality* in Part 1.) Processing trade, which involves the assembly and export of imported intermediate items (with most inputs exempted from customs tariffs), is the largest contributor to the trade surplus (Figure 2.8.6).

The surge in the trade surplus, coupled with higher tourism receipts and interest income on the large official foreign reserves, boosted the current account surplus to around \$227 billion, equivalent to 8.6% of GDP. Foreign direct investment for the year totaled \$69.5 billion. Besides these inflows, short-term speculative capital flowed into property and stock markets. Foreign exchange reserves reached \$1.07 trillion by year-end (Figure 2.8.7), prompting discussions on how to use reserves more efficiently, and calls from some trading partners for faster appreciation of the yuan. In a move to liberalize the capital account, a pilot program was introduced to allow PRC residents to purchase foreign securities through the Qualified Domestic Institutional Investors plan.

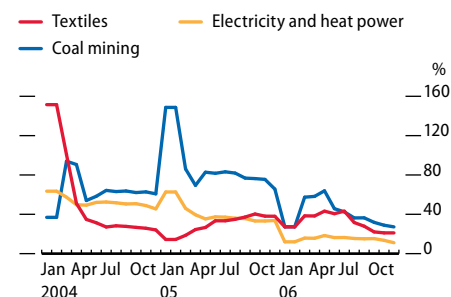
About 11.8 million new jobs were created in urban areas last year, well above target. The private sector and small and medium enterprises generated about 80% of these jobs, mainly in manufacturing, construction, and services. But millions of migrants from the countryside, new graduates, and laid-off workers still went without work. The National Development and Reform Commission estimated at the beginning of the year that urban areas needed about 25 million new jobs in 2006 to absorb all newcomers to the labor market.

The overall fiscal deficit narrowed to an estimated 0.4% of GDP. Revenues rose by 24.3%, helped by gains in incomes and rising corporate profits. Expenditures also rose rapidly, by 18.5%. Given buoyant private investment, the Government reduced its issuance of special treasury bonds used to finance public investment, from the equivalent of about \$10 billion in 2005 to \$7.4 billion in 2006.

As a result of the excess capacity in some industries and strong competition in manufactured products, inflation slowed to 1.5% in 2006. Late in the year, though, food prices accelerated, reflecting a sharp rise in global grain prices. Housing prices in several big cities grew rapidly because of excessive liquidity, speculation, and some structural imbalances in housing supply.

Worried about possible overheating, the Government took several steps to curb credit expansion and to slow investment. The People's Bank of China, the central bank, tightened credit five times, with increases in commercial banks' reserve-requirement ratio, beginning in mid-2006 and

2.8.3 Growth of investment, selected industries

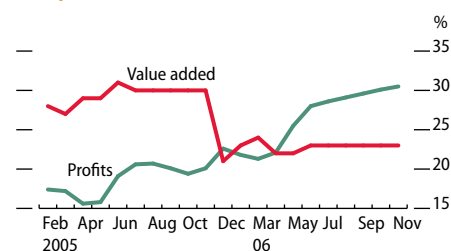


Note: Heat power refers to hot water and steam for city heating systems.

Sources: National Bureau of Statistics; staff estimates.

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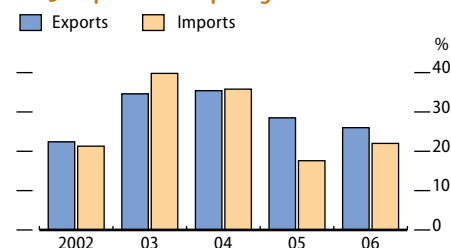
2.8.4 Growth of industrial value added and profits



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

2.8.5 Export and import growth



Sources: National Bureau of Statistics; staff estimates.

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running through February 2007, from 7.5% to 10.0% (Figure 2.8.8); and three hikes in the benchmark 1-year lending rate through March 2007, from 5.58% to 6.39% (Figure 2.8.9).

Commercial banks with the highest growth in lending were required to purchase special central bank bills at below market interest rates. These measures moderated growth in domestic credit, but actual lending and broad money increased faster than targets set by the central bank at the beginning of 2006. To ease upward pressure on the yuan from the surging trade surplus and strong capital inflows, the authorities allowed a slightly faster appreciation of the currency in nominal terms (2.4% against the US dollar in the second half compared with 0.9% in the first; Figure 2.8.10). The real effective exchange rate depreciated by 1.6% over the year, indicating that PRC goods became more price competitive.

The stock market expanded significantly in 2006, with major domestic banks among companies to sell shares to the public. Share prices climbed (Figure 2.8.11), underpinned by strong economic expansion, high liquidity levels, and the conversion of nontradable, state-owned shares into tradable shares.

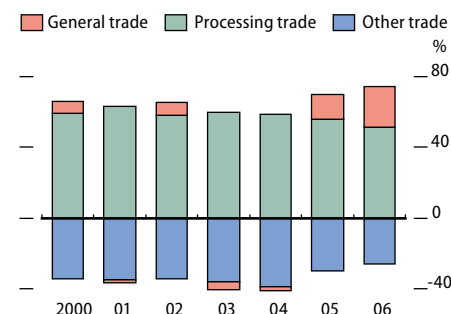
Economic prospects

Rapid GDP growth in 2006 set a high starting point for the 11th Five-Year Program (2006–2010), which has an indicative average annual growth of 7.5% for the period. This implies that overall macroeconomic policy should tighten in 2007. The projections assume that the authorities will keep the fiscal deficit below 1.0% of GDP. Also, it is assumed that the central bank will continue its current monetary policy stance by using interest rates, the reserve ratio, and open-market operations. Likewise, with rising profit growth and ample liquidity in the system, it is assumed that investment will again grow at a fast rate (although not at the 2006 pace) and will remain the main driver of growth. In the meantime, reforms will be implemented that, in the medium to long term, may have an impact on the structure of the economy.

Economic growth is projected to moderate in 2007 and in 2008, but will remain close to 10%, far from the indicative program target (Figure 2.8.12). Industrial growth is forecast to slow to 11.0% in 2007 and to 10.8% in 2008, from about 12% in the past 2 years, because of: significant oversupply in some sectors; slower growth in investment as a result of the tightening measures; and easing export growth caused by softer external markets. Agriculture is expected to benefit from a new official emphasis on rural development. Assuming no serious weather problems, agricultural production is projected to increase by 5.2–5.4% in the next 2 years, accelerating from an average of about 4% growth over the past half decade. Services are expected to grow by 10.4–10.5% (10.3% last year), supported by government efforts to promote consumption as well as expenditures associated with the Olympic Games in 2008.

Responding to various restrictions, especially those targeted at energy use and pollution, and others curbing property speculation, fixed investment growth is projected to moderate to 20%. It will be important that efforts be made to improve the efficiency of investment, so that a

2.8.6 Shares of trade

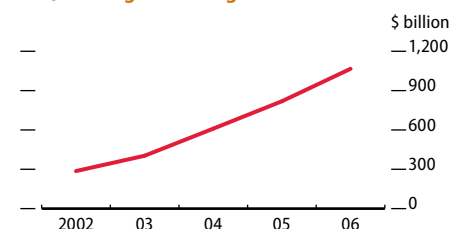


Note: General trade refers to the import or export of goods by enterprises with import-export rights.

Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

2.8.7 Foreign exchange reserves



Source: National Bureau of Statistics.

[Click here for figure data](#)

2.8.1 Selected economic indicators

	2007	2008
GDP growth	10.0	9.8
Inflation	1.8	2.2
Current account balance (% of GDP)	8.8	8.9

Source: Staff estimates.

given investment share can translate into a higher growth rate of capital accumulation.

Public investment will increase in priority areas including agriculture, education, and health: rural areas will get a larger share of infrastructure spending; schools fees will be eliminated up to the end of junior high school; and spending on health care will increase this year by 87%, and a medical insurance program launched in 2003 is expected to be extended to cover 80% of rural areas. These measures should support rural development and stimulate services. Private consumption will grow, reflecting projected increases in both urban and rural incomes, the latter assisted by government spending in rural areas and grain price guarantees. Retail sales have already risen by 14.7% in the first 2 months of 2007, up from a 12.5% pace in the year-earlier period, a sign of stronger consumer demand.

The softening in export markets and a reduction in PRC tax rebates for exports are expected to reduce the growth of merchandise exports to 18% in 2007, from 26% last year. Import growth will ease to about 18% (versus 22%) as investment decelerates. The large export base and the moderation in import growth suggest that the trade surplus in goods will climb to about \$257 billion by 2008. Trade in services will remain in deficit, but the surplus in the income account is likely to increase sharply, reflecting earnings from accumulating foreign exchange reserves. Consequently, the current account surplus will rise further (Figure 2.8.13).

The acceleration in food prices late last year is not expected to continue through 2007, in part because the push on rural development is encouraging the planting of grain. Inflation will pick up, though, to about 1.8% in 2007 and 2.2% in 2008 (Figure 2.8.14), because of expected rises in labor costs (as a result of substantial productivity increases) and higher prices of water, electricity, and fuel. In the first 2 months of this year the consumer price index rose by 2.4%.

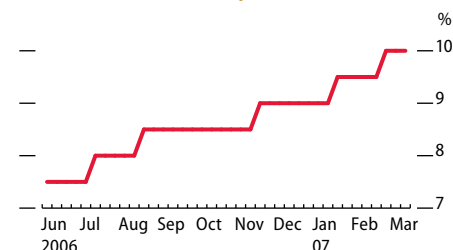
Domestic risks and uncertainties stem from two sources. First, if local governments do not fully respond to the central Government's restrictive measures—and they have not done in the past several years—GDP growth could surpass the above forecasts. (Urban fixed asset investment rose by 23.4% in the first 2 months of 2007, down slightly from the year-earlier pace.) Should investment continue to run at more than 20% a year, what has been a source of growth for many years could turn out to be a curse, if it leads to a further buildup in excess capacity and deflation.

Indeed, the combination of sometimes inefficient investment, overcapacity, and falling prices would erode profitability. To prevent this, the Government would need to step up its use of administrative measures to curb investment. Conversely, if all the measures to rein in growth are successfully implemented, GDP growth in 2007–2008 could slow more sharply, to about 9%. The main risk on inflation is that the Government may increase prices for administered utilities and services at a faster pace than anticipated, which would push inflation above forecast levels.

Over the medium term (2007–2011), GDP growth is expected to average about 9%. Inflation during this period will be higher than it is now, but probably less than 3% on average.

Several factors underpin the medium-term projections. The PRC will

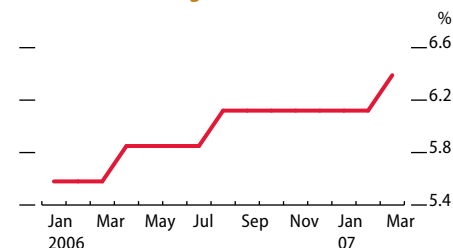
2.8.8 Bank reserve-requirement ratio



Source: People's Bank of China.

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2.8.9 Base lending rate

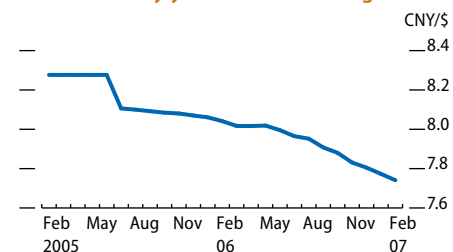


Note: One year rate for working capital.

Source: CEIC Data Company Ltd., downloaded 20 March 2007.

[Click here for figure data](#)

2.8.10 Monthly yuan-dollar exchange rate



Source: CEIC Data Company Ltd., downloaded 8 March 2007.

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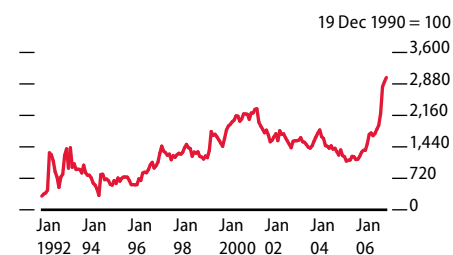
be industrializing rapidly for some time to come, so that investment will continue to support high levels of growth. The trend toward urbanization will also continue, which requires rapid development of urban infrastructure and housing. In the context of wide gaps in incomes and in development between urban and rural areas, the Government plans to promote the laggards rather than hinder the leaders. Moreover, large numbers of unemployed and underemployed people mean that pressure will be maintained on the authorities for many years to generate jobs, which requires high rates of economic growth. Finally, rising imports of technology, improved domestic productivity, and flows of foreign direct investment and other capital, support these imperatives for rapid economic expansion.

Further support will come from efforts being made to create the legal and regulatory structure that underpins development of a market-based economy. The third national financial work conference, held in January 2007, outlined a raft of financial reforms. To increase access to finance in rural areas, the China Banking Regulatory Commission issued rules to encourage private sector participation in rural finance, a change that will be first tried in five provinces. This move aims to address funding restrictions faced by farmers, who have little access to bank loans and generate only 15% of total bank loans and deposits. The conference also set plans for the PRC's three policy banks to open commercial operations so that they base lending decisions on commercial grounds. And it discussed management of the country's huge foreign exchange reserves.

In March, the Ministry of Finance announced that a foreign exchange investment corporation would be established to allocate a portion for strategic investments (e.g., international equity markets, natural resources, and as foreign direct investment). Although the portion of the reserves that could be managed this way was not determined, initial estimates indicate that a sizable amount could be transferred to the new corporation in phases. More active management of the reserves aims to increase returns. Independent estimates put at about 3% the central bank's return in 2006 on its reserves (the majority of which is invested in dollar-denominated instruments, mostly US treasury bonds). (See also Box 1.1.2 in Part 1.)

In other policy developments early in 2007, the Government decided to unify corporate tax rates paid by local and overseas enterprises, at a 25% rate from January 2008. Previously, domestic firms were taxed at up to 33% while foreign companies paid 15%. The National People's Congress in March passed a new property law (to come into effect in October 2007), following a change in the PRC constitution in 2004 to protect private property rights. The new law reassures the growing middle class that its assets (mainly houses) are secure. However, it does not give small farmers marketable ownership rights, nor does it allow them to use land as collateral to borrow and invest, which is what would help boost productivity in the countryside. Moreover, the state retains the right to appropriate farm land. Farmers do, though, get the right to renew land-use leases as they expire. (Rural land is "collectively owned" in the PRC and farmers are given 30-year leases.)

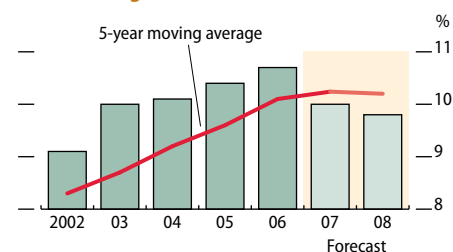
2.8.11 Shanghai stock exchange index, A-share



Source: CEIC Data Company Ltd., downloaded 8 March 2007.

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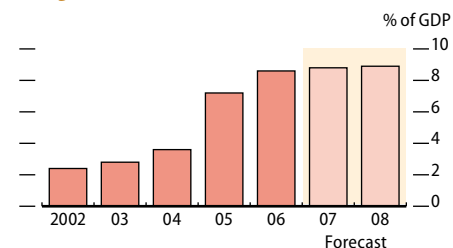
2.8.12 GDP growth



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

2.8.13 Current account balance



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

Development challenges

Four years of double-digit growth, rising government revenues, low inflation, and a manageable public deficit would be cause for celebration in most countries. In the PRC, this record has raised some concerns. The authorities believe that the economy can continue growing, but are aware that a number of corrections are necessary, in particular an overheated investment sector.

Efforts to cool the economy in the past 3 years have relied heavily on increases in bank reserve requirements and some increases in interest rates. But monetary policy, and in general the use of macro stabilization instruments, does not have the same impact in this economy as in a full market economy. Much of the PRC's bank lending is in the hands of autonomous local bank branches.

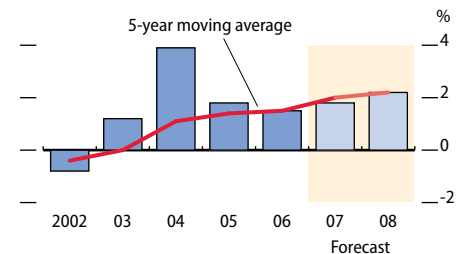
The most direct way for the authorities to control investment is by deciding what investments to approve on a case-by-case basis. Thus, while central planners were finally able to reduce the growth of investment toward end-2006, bank lending still grew at a rapid rate. This has resulted in an excess of bank-funded liquidity that is spilling over into the financial system. Under current methods, the only mechanism available is to continue using administrative measures, and perhaps extend them to the financial system to deal with excesses.

The need to rebalance the economy by reducing the emphasis on investment and export-led growth while lifting private consumption is embraced by the 11th Five-Year Program. Policy makers view economic rebalancing as not just an economic objective, but as part of an overall strategy to achieve "social justice." Since 2004, the Government has advanced a series of strategies to build what it describes as a "harmonious society." This involves achieving "five balances"—between rural and urban development, interior and coastal development, economic and social development, people and nature, and domestic and international development. The political leadership decided in 2004 to change the growth pattern from investment- and export-led to more consumption-led growth. During 2005 and 2006, policy makers reiterated that improving the quality of economic growth and rebalancing the economy would be a priority in the medium and long term.

Rebalancing implies altering the model followed for decades. This entails, on the demand side, reduced reliance on exports and investment for growth, in favor of private consumption; and on the production side, a shift from industry-led growth to more services-led growth. Policy measures taken in the past 3 years in pursuit of these goals have included raising minimum wages, reducing income taxes, increasing public spending, as well as taking the steps needed to contain rapid growth in investment and promote consumption.

The scorecard shows that limited progress has been made on most fronts. The dependence on external demand for growth is still high. Since the PRC joined the World Trade Organization in 2001, its foreign trade has grown annually at an average rate of more than 20%. External trade as a proportion of GDP rose from about 42% in 2002 to 66% in 2006 (Figure 2.8.15). Large bilateral trade surpluses have sparked more trade friction with the US and EU. Further, the huge trade surpluses, combined with growing surpluses in the capital account, have created a surge in

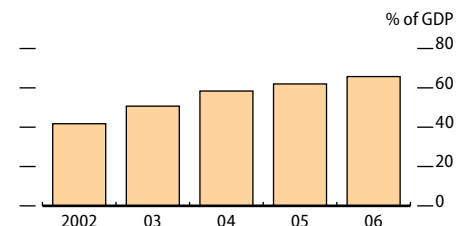
2.8.14 Inflation



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

2.8.15 External trade



Source: National Bureau of Statistics.

[Click here for figure data](#)

foreign exchange reserves that complicates monetary policy operations and puts pressure on the yuan to appreciate. Currently, the PRC needs to conduct extensive sterilization operations to drain liquidity and prevent the extra money from fueling inflation.

The surge in investment and commercial bank lending has not yet been brought under control. Aside from monetary tightening, the Government has taken administrative steps to restrain investment. These include raising downpayment requirements for housing purchases to curb speculation and sending inspection teams to provinces to check if new investment projects violate land-use and environmental regulations.

But key targets were not met in 2006: fixed asset investment growth was 24% (Figure 2.8.16), while the target was for growth below 18%; broad money (M2) grew by 16.9% (target below 16%); and bank loans rose by CNY3.1 trillion (target less than CNY2.5 trillion). In a further sign of a lack of rebalancing, the share of gross capital formation in expenditure-based GDP rose from 36.3% in 2001 to 45.0% in 2006, while that of consumption (private and public) fell from 61.0% to 51.9% (Figure 2.8.17).

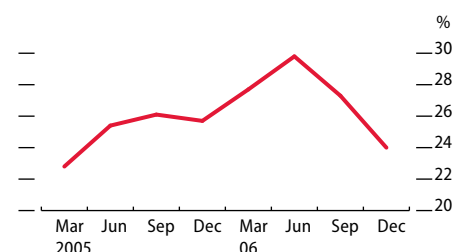
Environmental protection targets were not met either. The Government wanted to reduce energy consumption per unit of GDP by 4% in 2006. The outcome was a decline of just 1.2%. Similarly, there was slippage in achieving an emission reduction target. For example, sulfur dioxide emissions increased by 1.8%. Energy consumption (Figure 2.8.18) and pollution have increased and could become constraints on growth. Although the Government tried to induce local governments and enterprises to improve energy efficiency and cut pollution, these targets were not met.

Furthermore, the share of services in total GDP remains low—it actually fell from 41.7% in 2002 to 39.5% in 2006, lower than in other countries in Asia (Figure 2.8.19). The contribution of services to GDP growth fell from 38.7% in 2001 to 29.7% in 2006, while the contribution of industry rose from 56.3% to 65.2%. The concern is that continued industry-led growth requires more energy and natural resources and puts a heavy burden on the environment, so it may not be sustainable in the longer term.

Income inequalities have worsened. The ratio between urban and rural nominal per capita incomes rose from 2.9:1 in 2001 to 3.3:1 in 2006. Real per capita household income rose by 7.4% in rural areas in 2006, against 10.4% in urban areas. Increasing income inequality impedes the growth of private consumption and adds to social tensions. Unemployment and underemployment have become serious concerns for policy makers.

Restrictive measures involving energy consumption, the environment, and land use are expected to have a greater impact in 2007 and 2008. In this regard, the Ministry of Land and Resources plans to crack down on the use of arable land for construction of buildings, especially for luxury housing and golf courses. Policies on energy conservation and environmental protection have been toughened. The State Environmental Protection Administration (SEPA) has decided to suspend project approvals for any region, sector, or large enterprise if the project violates SEPA's standards on energy consumption and pollution, until action is taken to meet the standards. In the first 2 months of 2007, SEPA

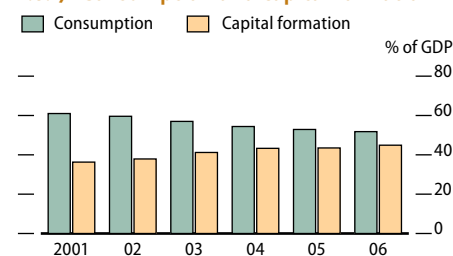
2.8.16 Growth of fixed asset investment



Source: CEIC Data Company Ltd., downloaded 20 March 2007.

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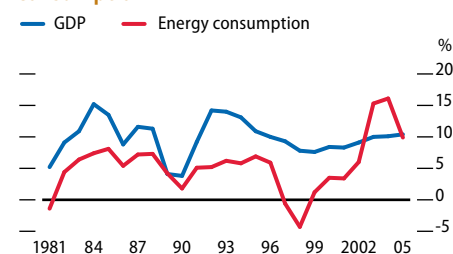
2.8.17 Consumption and capital formation



Sources: National Bureau of Statistics; staff estimates.

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2.8.18 Growth in GDP and energy consumption



Sources: National Bureau of Statistics; staff estimates.

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suspended more than 80 construction projects and four cities' rights to approve new projects.

Steps to be taken during the next few years toward rebalancing the economy involve reforms to the social security system—including establishing a minimum living standard in rural areas, similar to that in urban areas. This aims to eradicate absolute poverty (i.e., poor people who live below the official poverty line) in rural areas and help diminish the income gap between rural and urban areas. The Government will spend more on rural areas and less-developed regions.

The authorities have already increased salaries for civil servants, in late 2006, which lifted their purchasing power. Importantly, a plan is being drafted for state-owned enterprises to pay dividends to the state rather than reinvest all their retained earnings. This should impel enterprises to be more selective with their investments and, at the same time, provide financial resources to the state for development of social infrastructure and the social safety net, which is likely to lead to gradually increased consumption spending.

Rebalancing the economy is not easy from the point of view of policy design, implementation, or consequences. It will most likely be associated with lower rates of economic growth over the longer term. An increase in the share of wages in GDP will lead to higher private consumption; but as the increase in the share of wages is mirrored in a decline in the share of profits, this will eventually lead to a decline in investment (potentially larger than the increase in consumption) and, as a consequence, in employment.

A transformation to a more services-oriented economy may bring benefits from the point of view of employment creation (e.g., labor-intensive urban jobs), but services are likely to deliver lower GDP growth rates. The PRC cannot afford this in the short run. One source of growth that should play a more important role in the future is the relocation of labor out of agriculture into activities of higher labor productivity. Given that the share of employment in manufacturing has been decreasing, the services sector will likely have to play a key role in this between-sector transfer. At the same time, growth rates of about 10%, fueled by investment that is leading to overcapacity, and by substantial and growing liquidity in the banking system, pose serious threats to macroeconomic management.

2.8.19 Share of services in GDP



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)