

People's Republic of China

Driven by surging investment and exports, the economy grew by 9.9% in 2005. Very high investment levels have, though, caused overcapacity in some industries. In 2006–2007, growth is expected to remain vigorous, but to ease slightly from 2005's outcome. Inflation should remain low. Further out, growth is seen as converging on a more sustainable trajectory, but this will require a rebalancing of demand in favor of private consumption and better use of investment resources. Risks to the outlook include incomplete reforms in the financial system, labor market, and state enterprises; widening income inequalities; a deteriorating natural environment; and international trade frictions.

Economic performance

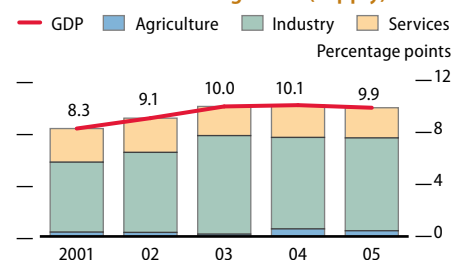
Buoyant domestic investment and exports resulted in gross domestic product (GDP) growth of 9.9% for the People's Republic of China (PRC) in 2005, extending to 4 years a run in excess of 9%. Since the new economic census of 2004 added \$284 billion to estimated 2004 GDP, growth is now measured from a larger base. The census also suggests that services are more important to the economy than previously thought. The phenomenal economic expansion has led to various structural weaknesses, including overcapacity in certain sectors, widening income inequalities, and environmental problems.

The strong economic performance of recent years has been anchored in export-oriented industrial production and powered by investment. In 2005, the industry sector, primarily manufacturing and construction, contributed 7.1 percentage points to the total GDP growth outturn (accounting for 71% of overall growth); the contribution of agriculture declined to 0.5 percentage points (6%); and that of services was little changed at 2.3 percentage points (23%) (Figure 2.8.1). On the demand side, vibrant investment again propelled growth, contributing 5.9 percentage points to total growth in 2005 (60% of overall growth); consumption contributed 3.2 percentage points (32%); and net exports just under 1 percentage point (8%) (Figure 2.8.2).

Having stabilized in the second part of 2004 and the first half of 2005, the investment rate (Figure 2.8.3) began to climb again. For the whole year, gross capital formation grew by 13%, and gross fixed capital formation increased by 16%, supported by expanding liquidity and credit. Investment in real estate development, which the Government has attempted to damp in recent years, still grew by 19.8% in 2005. Foreign direct investment fell a little relative to 2004, but with inflows of about \$60 billion it remained near record levels.

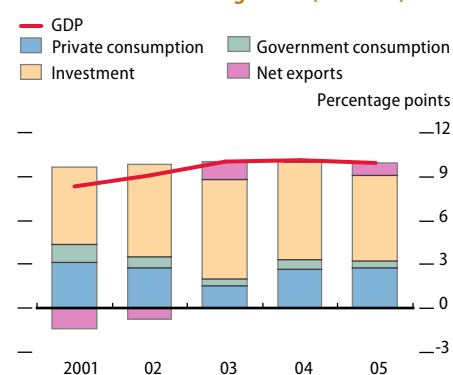
Rapid growth of merchandise exports (slightly below 30%) continued in 2005, but did not quite match the heady rate seen in 2004 (about 35%). Robust global demand, growing market penetration of PRC-manufactured goods in overseas markets, and the transfer of global

2.8.1 Contributions to growth (supply)



Sources: National Bureau of Statistics; staff estimates.

2.8.2 Contributions to growth (demand)



Sources: National Bureau of Statistics; staff estimates.

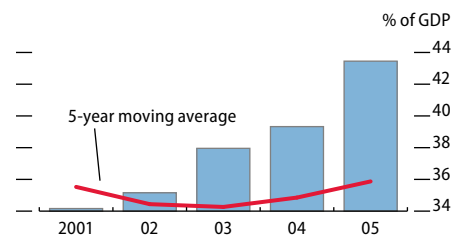
manufacturing capacity to the PRC over many years are underpinning this trend. On the other side of the account, the rise in merchandise imports fell by about half from the 2004 rate, to 17.6% (Figure 2.8.4). Softer import growth can be traced to growing domestic substitution for imports as new capacity comes on stream, and to a drawdown of inventories built up in earlier years. In the first half of 2005, speculation of a possible appreciation of the yuan may also have caused some importers to delay buying in the hope of a fall in the domestic currency price of imports. As a result of the gap between export and import growth, the trade surplus widened (according to customs data) to \$102 billion, triple the level of 2004. Large bilateral surpluses have led to trade frictions with the European Union (EU) and the United States (US), and in response the Government has undertaken several measures. In particular, it has cut most value-added tax (VAT) rebates for exports of iron and steel, aluminum, and some other products, and has agreed to temporary quotas on textile and clothing exports to the EU and US.

Despite strong economic expansion, consumer inflation eased to 1.8% in 2005. Food prices barely rose and productivity improvements helped insulate consumer goods prices from the rising costs of production materials and labor. Oversupply of some products and moderate demand intensified competition among producers, also discouraging price rises. Consumers have not yet felt the full impact of the rise in global oil prices because retail prices are subsidized. Average global oil prices rose by around 40% in 2005, but retail prices for the PRC's petroleum products rose by just 10–15%. As a result, oil refiners incurred losses of \$3.7 billion in 2005. Although the Government paid Sinopec \$1.2 billion in compensation, this failed to cover its refining losses. A more efficient use of energy will require a concerted shift to market-based pricing, and even to taxes on products that create a negative environmental impact.

The central and local governments' fiscal position in 2005 was broadly neutral. Revenues, buoyed by strong economic activity and more efficient tax collection, have brought the deficit down, but in 2005 it widened a little to about 1.6% of GDP (Figure 2.8.5). Priorities for public spending started to move toward rural development, education, health, and basic infrastructure. In an effort to stimulate domestic consumption, the tax authorities doubled the minimum tax-exemption level of personal income. However, planned reforms to unify corporate taxes on domestic and foreign-funded enterprises and to change the VAT system were postponed because of concerns about the possible erosion of revenues and adverse impact on foreign investment.

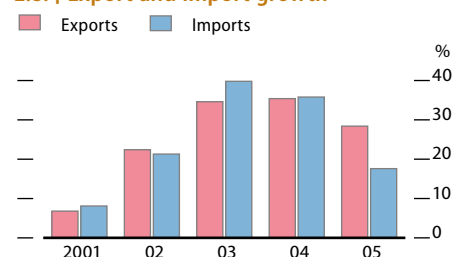
Capital inflows abated in 2005. Changes in the exchange rate regime in July 2005 appear to have tamed short-term capital inflows, but reserves still surged by \$208.9 billion (Figure 2.8.6), boosted both by a higher trade surplus and by stronger longer-term capital inflows. Large foreign exchange inflows led to a rapid increase in liquidity in the banking system, and funds flowing into the interbank market in 2005 drove the interbank rate to a historical low. In the second half of 2005, lending for infrastructure burgeoned while that for private consumption slowed, going against the Government's declared intention of stimulating consumption and moderating investment. Toward the end of the year,

2.8.3 Gross domestic investment



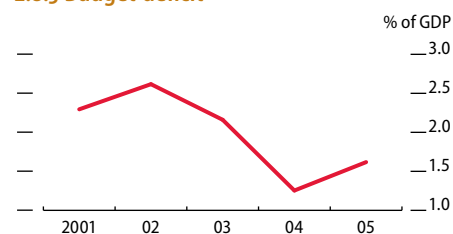
Sources: National Bureau of Statistics; staff estimates.

2.8.4 Export and import growth



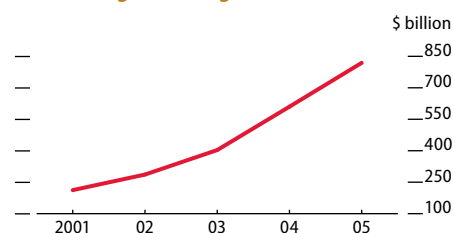
Source: People's Bank of China.

2.8.5 Budget deficit



Source: National Bureau of Statistics.

2.8.6 Foreign exchange reserves



Sources: People's Bank of China, available: www.pbc.gov.cn/english; CEIC Data Company Ltd., downloaded 3 March 2006.

the People's Bank of China, the central bank, stepped up sterilization operations to drain liquidity from the system.

Economic outlook

This is the first year of the 11th Five-Year Program. This new Program turns the spotlight on structural weaknesses. These are largely the by-product of a successful strategy of rapid industrialization and modernization. Signs of growing stress include significant overcapacity in some industries; widening income inequalities, particularly between rural and urban areas; and growing threats to the environment. The Program's goal is therefore to promote what it refers to as more balanced, equitable, and sustainable growth through strategies directed at boosting private consumption, and promoting income equality, rural development, and environmental protection (Box 2.8.1). It is expected that this new emphasis will influence the composition of aggregate demand and that the growth rate of output will slow to a more sustainable level in the long run.

Prospects for 2006 and 2007

GDP growth in 2006 is expected to be about 9.5% and 8.8% in 2007 (Figure 2.8.7). Assuming normal weather patterns, agriculture is forecast to expand by about 5.0–5.5%, supported by higher levels of infrastructure investment and other targeted development measures. Industrial growth is forecast to slow to 9–10% from about 11% in the past 2 years, as a consequence of significant oversupply in some sectors, moderation of investment expansion, and deceleration in export growth. The services sector is expected to grow by 9.5% in 2006, aided by the Government's efforts to promote private consumption and services. Notwithstanding the aim of rebalancing demand toward private consumption and an anticipated slowing of growth of capital spending in manufacturing and real estate, investment will remain the dominant driver of growth in 2006 and 2007. Indeed, in real terms, fixed investment may continue to increase its share in GDP, and could climb to about 50% in the near future. Unless investment loses this strong momentum, measures aimed at increasing private and government consumption are unlikely to significantly reorient the structure and sources of growth in the short run.

In 2006, merchandise export growth is likely to moderate to 20%, trimmed by voluntary restraint measures on selected exports, reductions in indirect subsidies, and higher labor costs (Box 2.8.2). Import growth is forecast at a similar rate, as demand for energy, basic materials, agricultural products, and intermediate industrial inputs will continue to expand rapidly. A rising merchandise trade surplus will be partly offset by a deficit on the services account. The current account surplus as a share of GDP is expected to be in the range of 5–7% in 2006–2007 (Figure 2.8.8).

Inflation is seen edging up in the next 2 years, to 2–3% (Figure 2.8.9). Increases are expected in administered prices of electricity, gas, water, and petroleum products, though the prices of some manufactured goods may fall. (Gasoline and diesel prices were raised slightly in March 2006.)

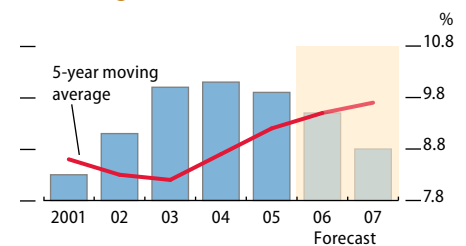
Fiscal policy, in the near term at least, is seen as offering little or no

2.8.1 Selected economic indicators

	2006	2007
GDP growth	9.5	8.8
Inflation	2.3	3.0
Current account balance (% of GDP)	6.7	5.7

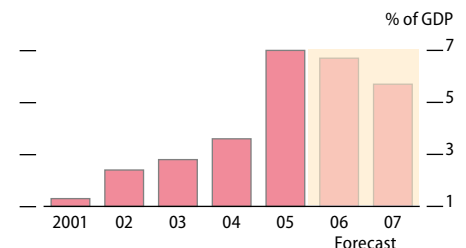
Source: Staff estimates.

2.8.7 GDP growth



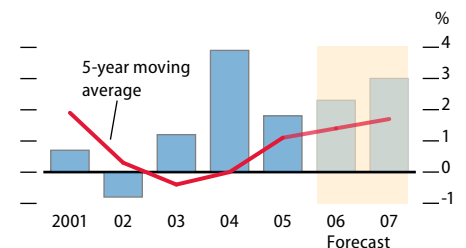
Sources: National Bureau of Statistics; staff estimates.

2.8.8 Current account surplus



Sources: National Bureau of Statistics; staff estimates.

2.8.9 Inflation



Sources: National Bureau of Statistics, available: www.stats.gov.cn/english/index.htm, downloaded 27 January 2006; staff estimates.

2.8.1 Change of emphasis in the 11th Five-Year Program

The National People's Congress in March 2006 endorsed the 11th Five-Year Program (2006–2010), which builds on a gradual shift in the Government's emphasis since 2003 toward policies aimed at achieving balanced, equitable, and sustainable development. This plan, officially called a "program," generally provides indicative targets, rather than fixed targets, and gives attention to standards of living and the environment as well as to the economy. Of 22 goals, just two relate to economic growth—total gross domestic product (GDP) and per capita GDP—and four to changes in economic structure—share of services in the economy and in employment, spending on research and development, and the urbanization rate. The other 16 relate to population growth, use of resources, the environment, and standards of living (box table). The primary economic target is an average GDP growth rate of 7.5% over the next 5 years (compared with actual average growth of 9.5% over the past 5). Key goals are to reduce both energy consumption and discharge of major pollutants.

There is a stronger emphasis on rural development. The Government pledges to raise farmers' incomes and promote

public services in the countryside. In addition to abolishing the agricultural tax at the start of this year, it will eliminate all tuition fees for 9 years of compulsory education in rural areas next year, and trim local government bureaucracies. It will increase subsidies for farmers who grow grain, and will continue to set prices for grain purchases as a support measure.

For industries, the focus is on strengthening their structure rather than on increasing their size. In the environmental area, the authorities will push industries to upgrade equipment and technology and eliminate processes that waste energy, water, and raw materials. They will also make efforts to expand the services sector. Recognizing a lack of technological innovation, the Government will invest \$8.9 billion in 2006 to encourage innovation, up nearly 20% from 2005. In education, the Government will expand the secondary vocational education system to around the same size as the general secondary education system; increase enrollment rates for senior secondary education and higher education to 80% and 25%, respectively; and extend the availability of 9 years of compulsory education to all regions.

Key indicators of economic and social development, to 2010

Item	Indicators	2005	2010	Target	Type of target
Economic growth	GDP (CNY trillion)	18.2	26.1	7.5%	Indicative
	Per capita GDP (CNY)	13,985	19,270	6.6%	Indicative
Economic structure	Share of services sector value added in GDP (%)	40.3	43.3	[3 pp]	Indicative
	Share of employment in services sector (%)	31.3	35.3	[4 pp]	Indicative
	Share of research and development spending in total GDP (%)	1.3	2	[0.7 pp]	Indicative
	Urbanization rate (%)	43	47	[4 pp]	Indicative
Population, resources, and environment	Population (billion)	1.308	1.360	<0.8%	Maximum
	Energy consumption per unit of GDP			[20%]	Reduction
	Water consumption per unit of industrial value added			[30%]	Reduction
	Coefficient of effective use of water for irrigation	0.45	0.5	[0.05]	Indicative
	Rate of use of solid industrial waste (%)	55.8	60	[4.2 pp]	Indicative
	Total area of cultivated land (100 million hectares)	1.22	1.2	-0.3	Minimum
	Total discharge of major pollutants			[10%]	Reduction
	Forest coverage (%)	18.2	20	[1.8 pp]	Minimum
Public services and standards of living	Years of education per capita	8.5	9	[0.5]	Indicative
	Coverage of urban basic old-age pension (100 million)	1.74	2.23	5.1	Minimum
	Coverage of rural cooperative medical care system (%)	23.5	>80	>[56.5]	Minimum
	New jobs created for urban residents (10,000)			[4,500]	Indicative
	Number of rural laborers transferred to nonagriculture sectors (10,000)			[4,500]	Indicative
	Urban registered unemployment rate (%)	4.2	5		Indicative
	Per capita disposable income of urban residents (CNY)	10,493	13,390	5%	Indicative
	Per capita net income of rural residents (CNY)	3,255	4,150	5%	Indicative

CNY = yuan; pp = percentage points.

Notes: (i) GDP, per capita disposable income of urban residents, and per capita net income of rural residents are at 2005 prices; (ii) changes in [] refer to cumulative figures for 2006–2010; (iii) major pollutants refer to sulfur dioxide and chemical oxygen demand.

2.8.2 Trade in textiles and clothing

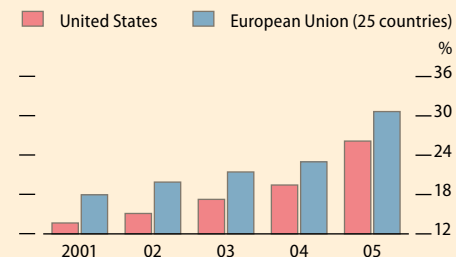
Textiles and clothing are long-standing, internationally competitive industries in the People's Republic of China (PRC), accounting for nearly 18% of total exports in 2001–2005 and providing employment for around 10 million people. The Multifibre Arrangement, established in 1974, introduced limits on exports of these items. Following the establishment of the World Trade Organization (WTO) in 1994, these quantitative restrictions were phased out over a 10-year period, ending on 31 December 2004. However, when the country's exports of textiles and clothing shot up in the first quarter of 2005, the EU and US took steps to invoke a "safeguard clause"—as allowed for in the PRC's 2001 WTO commitment—to again control the increase in such exports (box figure). In subsequent agreements, the PRC agreed to limit export growth of 10 categories of textile products to the EU to a range of 8–12.5% in 2005–2007. The agreement with the US limits export growth of 21 categories of textile products to a range of 10–15% in 2006, 12.5–16% in 2007, and 15–17% in 2008. Because of the safeguard clause, over 2005–2008, and based on an extrapolation of their annual growth momentum in 2002–2004, annual growth in exports of textiles and clothing may well be lower than it would have been if the clause had not been invoked.

Clothing will feel the impact of these new restrictions more than textiles, as about 70% of the restricted exports

are clothing products (the rest are textiles). This increases the impact of the export controls on employment creation since clothing is the more labor intensive.

The prospects for the PRC's exports in textiles and clothing are not rosy. Although the new agreements have helped ease potential trade conflicts with major trading partners, the PRC will most likely become the target of antidumping actions and other special trade safeguards in other countries. Other WTO members can initiate product-specific safeguard measures for imports from the PRC until 2013, and can treat the PRC as a nonmarket economy requiring antidumping and surveillance actions until 2016.

Market shares of PRC textile and clothing exports in the United States and European Union



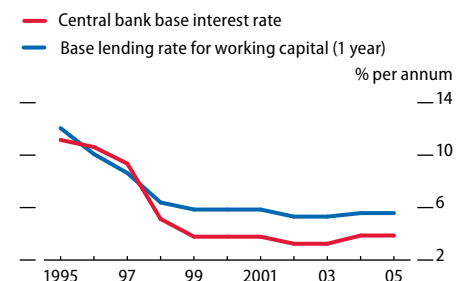
Source: US Census Bureau, available: <http://www.census.gov/foreign-trade/statistics>; Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1090,30070682,1090_30298591&_dad=portal&_schema=PORTAL, downloaded 13 February 2006.

impetus to growth, but the structure of expenditure is planned to shift in favor of rural areas and the social sector. It is also expected that the Government will raise civil service salaries and take other measures to stimulate private consumption.

Speculation on a sharp appreciation of the yuan has faded since the new exchange rate regime was introduced. The new mechanism offers the authorities more flexibility in setting monetary policy. It is envisaged that interest rates will remain low (Figure 2.8.10) and that the authorities will allow the yuan to appreciate gradually in 2006 and beyond (Figure 2.8.11). In late 2005, the central bank conducted a swap transaction with commercial banks, the pricing of which implied that the yuan may appreciate by 3% this year.

As a result of fast growth in the labor supply and a decline in the amount of employment for every percentage point of GDP growth, urban unemployment and underemployment have become a serious concern for policy makers (Figure 2.8.12). According to the National Development and Reform Commission, urban areas will need to create around 25 million jobs in 2006 to soak up newcomers to the labor market. Of these 25 million people, about 9 million will be joining the labor market for the first time (including some 4 million new graduates), 3 million will be migrants who have recently moved to cities, and the remaining 13 million will be workers made redundant by their employers, mainly state enterprises. It is worrying

2.8.10 Interest rates



Source: CEIC Data Company, Ltd., downloaded 14 March 2006.

that the Commission's estimates suggest that the economy will be able to create only about 11 million jobs for these workers. Fast growth will be needed to create jobs and to minimize the social risks that a growing number of unemployed and underemployed workers could present.

Medium-term outlook

After decades of central planning, the PRC is abandoning most numerical economic targets and intends to allow the market to play a greater role. With this in mind, the average growth rate for 2006–2010 is expected to be about 9%. Although the authorities recognize the necessity to continue growth at a fast pace, they also acknowledge the problems that the strategy of rapid industrialization and modernization has generated. Three main structural weaknesses have surfaced. First is the existence of significant overcapacity in some industries. Second are widening income inequalities, particularly between rural and urban areas. Third are growing threats to the environment.

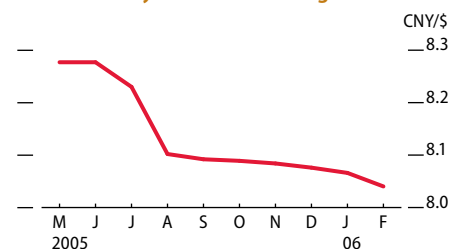
For decades, many implemented policies induced an imbalance between private consumption and investment. Many of the mechanisms used to promote investment in the past need to adapt to today's changed circumstances. In this context, there is an issue as to whether it is optimal for the PRC to devote such a large share of income to capital formation and so forgo current consumption (Box 2.8.3). Very high levels of investment have led to industrial overcapacity, which in turn has brought about rising inventories and declining prices in sectors that have invested excessively over the last few years, including aluminum, automobiles, cement, and steel.

Despite overcapacity, further expansion is still under way. Steel capacity, for example, is already 120 million tons greater than demand, but capacity of an additional 70 million tons is being built. In addition, more than a quarter of the nation's 10.3 million tons of aluminum capacity was idle in early 2006. The concern is that as supply outstrips demand, prices may fall. Poor returns on new projects in industries that are already oversupplied could put a financial strain on the enterprises involved as well, and, by extension, on their creditor banks.

Several factors have contributed to overinvestment and inefficiency, including directed lending by banks, subsidies to some inputs such as energy, and incentives geared to inputs (like capital investment) rather than outputs. Local governments, which control 70% of fiscal spending, also contribute to the investment drive by spending on new factories and "trophy" projects in their areas, often regardless of whether expansion is warranted on economic grounds. Incentives and rewards at local government level are often still linked to physical growth targets rather than to more meaningful economic and social objectives. Likewise, state enterprises face incentives that are biased toward investment. They do not pay dividends and direct their retained profits (estimated at more than \$70 billion in 2005) toward capital expansion that may not satisfy basic economic tests. In a context of investment-led growth, investors' expectations may have exacerbated difficulties. In lifting short-run output and income, high investment rates may have provided unreliable signals of the longer-term viability of capital spending.

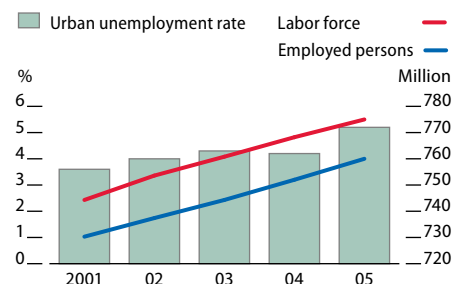
Income inequalities form the second structural weakness. For

2.8.11 Monthly nominal exchange rate



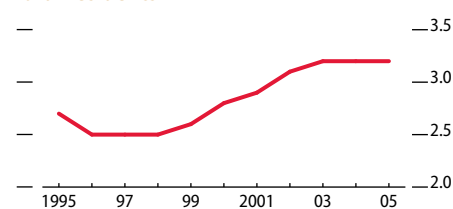
Source: International Monetary Fund, International Financial Statistics online database, available at: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>, downloaded 3 March 2006; CEIC Data Company Ltd., downloaded 21 March 2006.

2.8.12 Labor indicators



Source: National Bureau of Statistics.

2.8.13 Income ratio between urban and rural residents



Source: National Bureau of Statistics, *China Statistical Yearbook 2005*.

2.8.3 Consumption-investment imbalance in the PRC economy

The 11th Five-Year Program calls for a rebalancing of the economy. In this context, a recent debate has arisen about the need to shift the contributions of private consumption and investment in aggregate demand, especially with a view to increasing the role of the former. There are two important issues to consider in evaluating the likelihood of significant rebalancing in a relatively short period of time.

The first is that, as Box figure 1 shows, the shares of private consumption and investment in GDP have moved in opposite directions for many years, with the share of investment increasing from an average of about 20% in the 1950s and early 1960s to about 45% recently. In contrast, the share of private consumption has decreased from an average of about 60% of GDP during the earlier period, also to about 45%. A relatively low consumption ratio is one factor in the country's widening trade surplus and buildup of foreign exchange reserves.

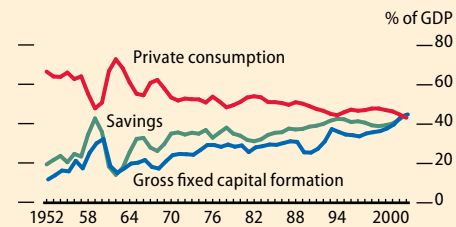
A high level of domestic investment has been supported by an even higher rate of savings. For many households, lack of reliable social welfare (e.g., old-age pensions, medical insurance, and unemployment protection) and rising costs of education and housing compel saving and constrain consumption spending. Bank lending has leaned largely toward industry and infrastructure. Eventually, bank credit allocation practices will need to be guided by commercial and risk considerations. If state enterprises are required to pay dividends instead of reinvesting all profits, their government owners will have an additional source of funds to channel toward social development and consumption. Credit services for consumers (e.g., mortgages, credit cards, and financing for household appliances and cars) are rarely available outside major cities, and even there, market penetration is limited.

This large transfer of resources from consumption into investment was in part the result of a conscious

effort by economic managers, whose main objective was to maximize growth. Reversing this trend will be a considerable challenge.

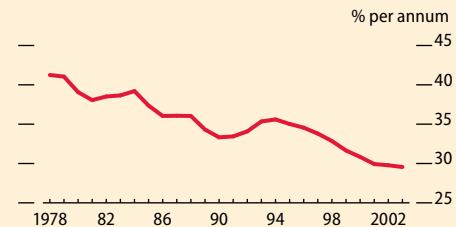
The second issue is that, having lifted investment over a protracted period, the economy is now faced with declining capital productivity (Box figure 2). Without improved allocation and greater efficiency of capital, a greater rate of investment will, paradoxically, be needed to underpin the capital accumulation required to create jobs. This would be better achieved through emphasizing the quality and efficiency of investment rather than its quantity.

1 Private consumption, savings, and investment



Source: CEIC Data Company Ltd, downloaded 10 March 2006; Asian Development Bank, *Key Indicators 2005*.

2 Capital productivity



Source: http://cama.anu.edu.au/Working%20Papers/Papers/Fan_Felipe_222005.pdf.

example, the income ratio between urban and rural residents widened from 2.9:1 in 2001 to 3.2:1 in 2005 (Figure 2.8.13). To some extent, inequalities reflect the uneven geographic distribution of economic advantages, but these have been magnified by underinvestment in poor rural areas and restrictions on emigration of workers and their families from the countryside to the cities through the *hukou* (or residential registration) system. Although the growth of rural income outpaced that of urban areas in 2004, this was abnormal and 2005 saw a reversion to the pattern of previous years, as weaker grain prices and rising costs of agricultural inputs became a drag on rural incomes. The impact of new support measures, including the abolition of agricultural tax from 1 January 2006, will increase fiscal transfers to the rural sector, and larger

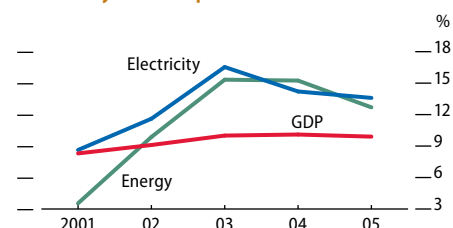
investments in rural infrastructure will also help. Inequality, together with the poverty and human suffering that it breeds, is one of the major challenges facing the PRC.

Although income disparities cannot be eliminated, more needs to be done to connect poor areas to more vibrant parts of the economy. This will require policies designed to improve rural productivity and social infrastructure. Policies that “tax” agricultural and poor regions and tilt the terms of trade in favor of urban areas aggravate inequalities. The movement of resources from the rural to the urban economy will continue, but better conditions and opportunities in the countryside will facilitate a smoother transition.

Fast growth and high investment rates have taken their toll on the environment—the third structural weakness. Annual average energy consumption rose faster than GDP in 2001–2005 (Figure 2.8.14) and, since coal is the primary energy source, fossil-fuel burning has caused widespread air pollution. It is estimated that about two thirds of urban residents are now living in a medium or seriously polluted environment. Threats to water resources and to land appear to be as serious. More generally, growth that favors industry and infrastructure has been relatively resource intensive, drawing heavily on energy and other commodities. For many years, the environmental impacts of industrialization have been exacerbated by the underpricing of land, energy, and water, which has encouraged overuse; by minimal investment in environmental infrastructure; and by weak enforcement of regulations governing the environment.

Risks and uncertainties to the above medium-term growth scenario stem from five main sources. First are incomplete reforms in banking, capital markets, social security, protection of private property rights, and state enterprises. If the economy is to make the transition to one that is better balanced and efficient, these support structures for a modern market economy must be fully constructed. High rates of growth will be in jeopardy without further improvements in these areas. Second is the unquantifiable but potentially serious impact of avian flu. Since an estimated 70% of the poultry stock is raised on small farms, with animals and humans in close proximity, lower-income farmers are the most vulnerable to both the economic and health impacts of further outbreaks. Third, as the November 2005 leakage from the Jilin chemical factory proved, an environmental catastrophe can have damaging consequences for the economy. Fourth are growing supply shortages in natural resources, especially energy. These could lead to pronounced price rises that could seriously affect economic performance. Finally, trade protectionism pressures in the EU and US may yet crimp the potential for export growth.

2.8.14 Growth rates of energy and electricity consumption and of GDP



Source: CEIC Data Company, Ltd., downloaded 14 March 2006.