

People's Republic of China

Strong investment, supported by an expansion of private consumption and net exports, powered a return to double-digit growth. The authorities ended the fiscal stimulus program and, with inflation pressures building, tightened monetary policy. GDP growth is forecast to moderate both this year and next. Inflation will rise in 2011, then likely decelerate in 2012. Going beyond the next 2 years, the new 5-year plan puts more emphasis on consumption and services as drivers of growth and on reducing both income inequality and pollution.

Economic performance

Brighter than expected economic growth in the second half of 2010 lifted the full-year rate of expansion in the People's Republic of China (PRC) to 10.3% in a return to the pre-global recession double-digit pace. All sectors recorded solid growth, led by industry with a 12.2% increase that contributed about two-thirds of total GDP growth. Services expanded by 9.5% and agriculture by 4.3% (the grain harvest was good, despite harsh weather).

From the demand side, investment and consumption explained 92% of total growth, investment being the main contributor (Figure 3.9.1). Still, the winding back of the aggressive fiscal stimulus put through during the global recession slowed the growth of fixed asset investment in nominal terms from the very high 31.0% seen in 2009 to 24.4% in 2010.

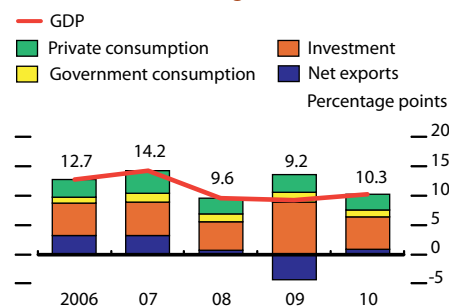
Private consumption grew by 11.0% in nominal terms (9.3% in real terms), supported by higher incomes. Sales of household appliances and furnishings benefited from heavy investment in housing, while sales of automobiles continued to surge. Despite several years of solid growth in private consumption, however, it remains low as a share of expenditure-based GDP at 34%.

Net exports contributed positively to GDP growth in 2010 (by 0.8 percentage points), unlike 2009 when net exports fell as global trade slumped.

Monetary policy supported growth, even as the authorities reined in the highly expansionary stance taken during the global recession. While broad money supply (M2) growth decelerated to 19.7% in 2010 from 27.7% in 2009, it was above the 17.0% target for 2010 of the People's Bank of China (the central bank).

Growth in bank credit at CNY8 trillion also exceeded its target, by CNY0.5 trillion, although it was well below 2009's outturn (Figure 3.9.2). This measure of credit is likely to understate the total as it excludes loans channeled through trust companies. Several

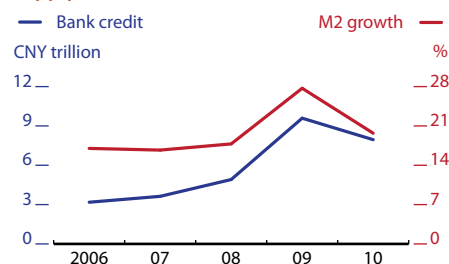
3.9.1 Contributions to growth (demand)



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

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3.9.2 Growth in bank credit and money supply (M2)



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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estimates suggest that these off-balance-sheet loans amounted to about CNY3.8 trillion in 2010.

Abundant liquidity, rising food prices, and higher costs of imported oil and commodities pushed up consumer prices during 2010 (Figure 3.9.3), when inflation averaged 3.3%.

The government changed some of the weights in the consumer price index basket in early 2011, lowering that for food and raising the one for housing. Yet despite this, the index is still seen as understating inflation because its composition and weights have not been significantly adjusted to reflect the major changes in consumption patterns in the last decade.

Moving to stem inflation, the central bank raised the reserve requirement for banks six times in 2010 and three times in the first quarter of 2011 (to 20.0% for large banks). It also lifted the benchmark interest rate twice in 2010 and once in the first quarter of 2011 (by a total of 75 basis points to 6.06%—Figure 3.9.4). The government imposed price controls on some food items and increased subsidies for low-income earners.

Prices of residential property in cities rose strongly, propelled by rising incomes, investment demand, and the abundant liquidity. Overall property prices climbed by an average of 10.0% in 70 major cities. Real estate investment surged by 33.5% in nominal terms, outpacing overall investment growth. Government actions to curb house prices included raising both mortgage interest rates and down payments as well as directing banks not to lend for purchases of third (or more) homes. These changes damped the rate of increase during the year (Figure 3.9.5).

Fiscal policy was supportive of growth in 2010, although less so than in 2009 as the massive CNY4 trillion fiscal stimulus program launched in late 2008 came to an end. Fiscal revenue and expenditure rose by 21.3% and 17.4%, respectively, well above the government's traditionally conservative targets. The strong revenue performance was a consequence of the robust economic growth and higher prices. The budget deficit narrowed to the equivalent of 2.1% of GDP from 2.9% in 2009.

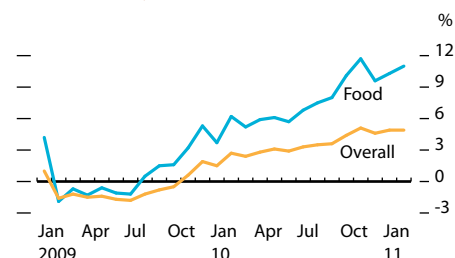
Global recovery in trade last year saw the country's trade flows soar by nearly 35% to about \$3 trillion. Merchandise exports in nominal US dollar terms rebounded by 31%. Imports rose even faster (Figure 3.9.6), reflecting strong demand and higher prices for oil, other commodities, and capital goods. The trade surplus at \$254 billion was little changed from 2009.

The PRC is diversifying its export markets in light of the slowdown in major industrial economies. It became Brazil's top trade partner in 2009 with bilateral trade showing a more than 12-fold increase in value since 2001. Some 85% of its exports to Brazil are manufactured products, while soybeans and minerals account for two-thirds of its imports.

Foreign direct investment (FDI) reached \$105.7 billion in 2010, up by 12.4% from the previous year. By sector, manufacturing, real estate, and services attracted the most FDI. The leading sources of FDI were (in order) Hong Kong, China; Taipei, China; Singapore; Japan; the United States; the Republic of Korea; and the United Kingdom.

The PRC's direct investment abroad increased by 23.4% to \$59 billion in 2010. It targeted energy, mining, and agriculture. Asia remained the top regional destination, although flows to South America and Africa

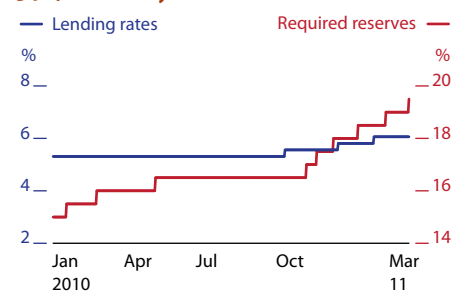
3.9.3 Monthly inflation



Source: CEIC Data Company (accessed 16 March 2011).

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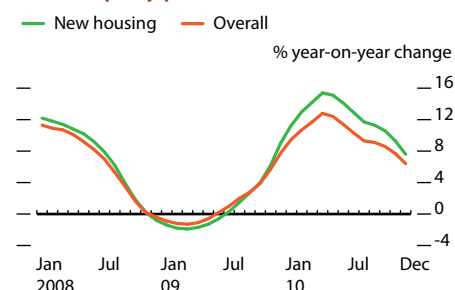
3.9.4 Monetary indicators



Source: CEIC Data Company (accessed 25 March 2011).

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3.9.5 Property prices



Note: Overall are both residential and nonresidential.

Source: CEIC Data Company (accessed 16 March 2011).

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picked up. Large investments in energy-related projects in some Central Asian countries have turned the PRC into the second-largest investor there, after the Russian Federation.

The PRC is also gaining prominence as a lender to developing countries: its lending in the past 2 years exceeded that from the World Bank (excluding the International Development Association, which makes grants and low-interest loans). These operations included loan-for-oil deals with Brazil, the Russian Federation, and Venezuela; power-related projects in India; and infrastructure investments in Argentina and Ghana.

The current account surplus increased to \$306.2 billion, but as a ratio to GDP it declined to 5.2%. This surplus, coupled with the FDI inflows and central bank purchases of foreign exchange to manage the exchange rate, pushed up foreign exchange reserves by 19% to \$2.85 trillion. The yuan appreciated against the US dollar by 3% in nominal terms during the year (Figure 3.9.7), after the authorities indicated in June 2010 that they would gradually allow greater flexibility in the exchange rate. In real effective terms the yuan appreciated by 4.2% in 2010.

Efforts to internationalize the currency resulted in much higher levels of yuan-denominated trade, estimated at CNY70 billion in 2010 compared with just CNY0.5 billion in 2009.

About 11.7 million new jobs were generated in urban areas last year, above the official target but fewer than the average 24 million new job seekers who enter the labor market each year. Average minimum provincial wages rose by 24%, illustrating government efforts to raise living standards and foster consumption.

Economic prospects

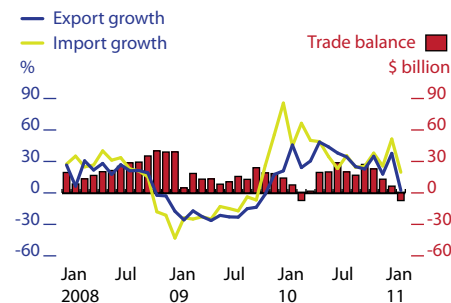
The 12th Five-Year Plan (2011–2015), approved in March 2011, seeks to rebalance the pattern of growth. Its targets indicate that the authorities are willing to forgo some speed of GDP growth to enhance its sustainability (see below).

Fixed asset investment is expected to remain the main driver of growth in 2011 and 2012, decelerating to 22% in 2011 and to 20% in 2012 (Figure 3.9.8). The expiration of the fiscal stimulus package in 2010 will reduce such investment by CNY2 trillion this year (or 7% of the total in 2010). Monetary tightening under way will also damp the high rates of investment. Further, the central government is scrutinizing local government finances and investment more closely.

Fiscal policy will be broadly expansionary, with a higher priority on education, health care, low-cost housing, and research and development. The overall budget deficit is projected to be little changed at about 2% of GDP.

Inflation pressures are prompting the authorities to tighten monetary policy, but their stance is expected to remain supportive of growth. They have trimmed the target for growth in M2 money supply to 16% for 2011; a similar rate is assumed for next year. For new lending, the central bank has opted not to provide an annual target ceiling on new bank loans for 2011. It will instead target a new measure of total credit, “total social financing,” which includes loans from trust companies, corporate bonds,

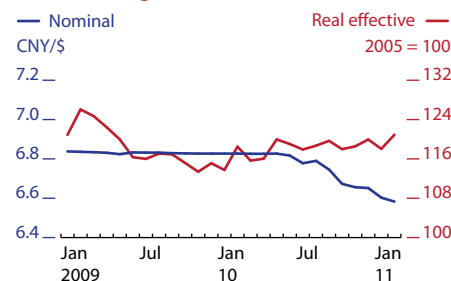
3.9.6 Trade indicators



Source: CEIC Data Company (accessed 16 March 2011).

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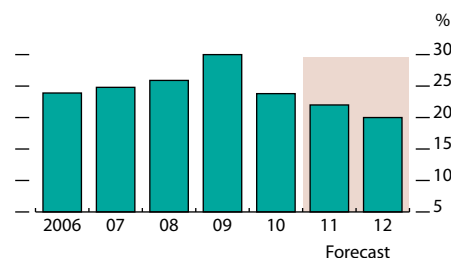
3.9.7 Exchange rates



Source: CEIC Data Company (accessed 16 March 2011).

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3.9.8 Fixed asset investment growth



Sources: CEIC Data Company (accessed 20 March 2011); ADB estimates.

[Click here for figure data](#)

and equities of nonfinancial companies. It has not yet disclosed the numerical target.

Private consumption growth is expected to accelerate to 12.6% this year in nominal terms, a consequence of rising incomes and expanding state provision of education, health care, and pensions.

The contribution of net exports to GDP growth will moderate from 2010 owing to the base effect, still subdued demand from major export markets, and the expiry of tax rebates on some PRC exports. The increase in merchandise exports is forecast to slow to about 20% in nominal terms this year and 18% in 2012, below the near 30% average pace seen in the 5 years before the global recession.

Based on these projections, GDP is forecast to grow by 9.6% in 2011, easing to 9.2% in 2012 (Figure 3.9.9) on expectations that industrial production and fixed investment will continue to moderate.

Industrial production is expected to slow over the 2 years owing to relatively soft external demand, overcapacity in some manufacturing subsectors, and government efforts to reduce carbon emissions and other environmental damage. Nevertheless, in the first 2 months of this year, industrial output grew by 14.1%, slightly above the rate in December 2010.

In further signs of a solid start to 2011, fixed asset investment rose by about 25%, investment in real estate surged by 35%, and retail sales increased by 16% in the first 2 months (all in nominal terms).

Inflation is forecast to accelerate to 4.6% on average in 2011 (Figure 3.9.10), a result of higher global prices for food and oil, rising wages, and robust domestic demand. For the first 2 months of this year it averaged 4.9%, exceeding the full-year official target of 4.0%. The pace is expected to ease later in 2011 mainly because of the base effect.

In 2012, inflation is projected to ebb to 4.2% owing to the anticipated leveling off of global oil and commodity prices as well as tighter domestic monetary policy. Although the authorities are tightening to address inflation, they face difficulties in controlling bank liquidity and in managing inflation expectations without a nominal inflation anchor (Box 3.9.1).

Imports are expected to increase faster than exports during the forecast period, largely owing to high prices for imported energy and commodities. The current account surplus is projected to fall to 4.6% of GDP this year and 4.2% next, continuing a decline from a recent peak of 10.6% in 2007 (Figure 3.9.11) brought about mainly by faster growth in the value of imports than exports.

Downside risks to the economic outlook relate mainly to the fragility of external demand (exacerbated by the modest recovery in the United States), fiscal and debt concerns in the European Union (the PRC's largest trading partner), and now Japan. Although data are inadequate at present to assess the impact of the massive earthquake and tsunami on the PRC economy, they may have a short-term effect on bilateral trade, to a degree because Japanese companies in the PRC rely on spare parts and materials imported from Japan.

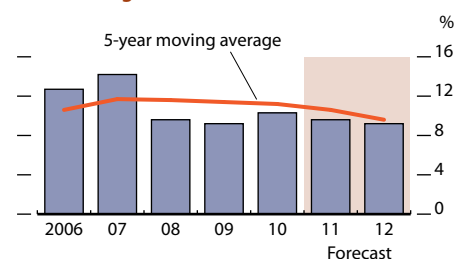
The rapid increase in local government debt to an estimated CNY7.6 trillion, stemming from the stimulus program begun in late 2008, is likely to lead to some rise in nonperforming loans at banks, given that about one-third of the debt is estimated to be at risk. This risk is, though,

3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	9.6	9.2
Inflation	4.6	4.2
Current account balance (share of GDP)	4.6	4.2

Source: ADB estimates.

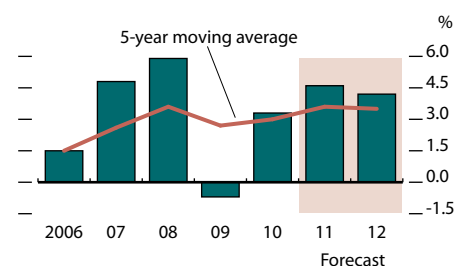
3.9.9 GDP growth



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

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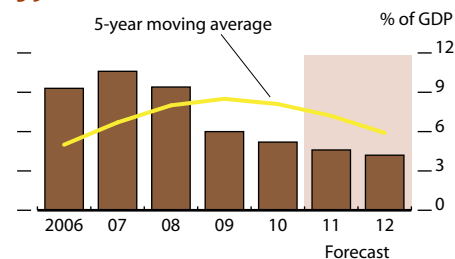
3.9.10 Inflation



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

[Click here for figure data](#)

3.9.11 Current account



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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mitigated by the current moderate level of nonperforming loans (1.1% of total lending), larger provisions for bad loans, and more stringent bank capital-adequacy requirements in recent years.

Failure to decisively implement the government's agenda to rebalance the economy risks jeopardizing the sustainability of growth in the longer term. Rapid growth over three decades has allowed for transition from a low- to a middle-income country, but has also generated imbalances such as heavy reliance on investment, relatively low levels of private consumption, underdeveloped services, widespread environmental damage, and expanding income gaps.

Development challenges

Implementing the 12th Five-Year Plan will be a major challenge. Its main policy directions include the following: a better balance in the drivers of growth among investment, consumption, and exports, with services playing a more important role; a stronger emphasis on improving living standards and narrowing income inequalities; newly designated strategic industries—a modern energy industry, a comprehensive transport system, information-based industries, and biotechnology—to promote innovation; and plans to combat global warming and reduce carbon intensity, including ambitious emission-reduction targets, a carbon tax, new indicators for pollutants, and carbon-trading programs.

The plan sets quantitative targets on key economic, social, and environmental indicators. It trims the GDP growth target of 7.0% for 2011–2015 from 7.5% in the previous plan, a move aimed to signal the government's willingness to sacrifice speed of growth for the sake of sustainability (actual GDP growth in the previous plan was 11.2%).

Critical among the objectives is changing the growth pattern toward a model oriented more to services and consumption from the past emphasis on industry and capital investment. Economic rebalancing was an objective in the previous plan, and indeed some progress was made in, for example, curbing energy consumption and pollutants and expanding the coverage of urban and rural health care.

Yet there was limited progress on major rebalancing targets. Consumption, for instance, substantially lagged investment (with average contributions of 41% and 54% to annual GDP growth in the past 5 years). On the production side, services' share of GDP is relatively low at about 43% (Figure 3.9.12).

The need to transform the pattern of economic growth is stronger now than in 2006 both because the external imbalances have become more pronounced, and because the recent global recession highlighted the risks of the export-led growth paradigm. Moreover, the implications of population aging in the PRC threaten the sustainability of growth and complicate the reform agenda.

Rebalancing is, however, unlikely to occur without significant policy adjustments, including shifting the emphasis of public spending from investment to public services, liberalizing the finance sector, developing capital markets to help small and medium-sized enterprises and the self-employed to access credit, and facilitating a greater role for private players in the economy.

3.9.1 Anchoring inflation expectations

Climbing consumer and asset prices in the country risk raising inflation expectations, and so encouraging new rounds of price increases that further heighten expectations. Such spirals have occurred in the past, leading to 20% inflation in 1988.

International experience suggests that the best way to control inflation expectations is to anchor them, preferably with inflation targeting rather than monetary targeting.

Inflation targeting allows the monetary authorities to use all available information, not just monetary variables, to determine monetary policy settings.

It is also transparent and readily understood by the public, increases central bank accountability (because its performance can be measured against a clearly defined target), and can help focus the political debate on the main role of the central bank in the long run (controlling inflation instead of boosting economic growth).

A central bank's credibility is indispensable in inflation targeting, so as to keep expectations well anchored.

In the People's Republic of China at the moment, accelerating inflation and difficulties of managing the high levels of bank liquidity suggest that some anchoring of expectations might now be appropriate. And although it would be premature for the central bank to adopt formal inflation targeting—given its limited independence and government controls on interest rates—it could consider some features of an anchoring system, such as announcing an explicit inflation objective or target range, and committing to achieve it for several years.

To increase the central bank's credibility, it would need full control over managing its reserves, more leeway to liberalize interest rates, and greater exchange rate flexibility. Managing inflation expectations would also require it to more clearly flag its monetary intentions to financial markets.

As the new plan reflects these reforms to some degree, the key challenge lies in how to successfully carry them out in a period of political transition to a new generation of leaders in 2012–2013. Moreover the intended reforms, although necessary, are not risk free, and might create or exacerbate policy-making trade-offs.

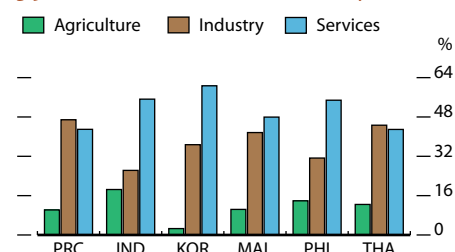
For instance, promoting services as a source of growth and employment may entail short-term side effects such as increased unemployment (until the full benefits unfold in the medium to longer term, when excess labor is absorbed through implementation of adequate supportive policy measures, including education and training).

Further, promoting consumption as a driver of growth would require larger salary increases, as supported in the plan, which could generate a wage-price spiral in the economy, trapping policy makers in a difficult choice between rebalancing and price stability.

Closing the income gaps is another major challenge. The benefits of rapid growth in the PRC have not been evenly distributed among regions, resulting in a skewed distribution of income in favor of coastal cities and urban citizens. The Gini coefficient, a measure of income inequality (zero indicates perfect equality and 1 absolute inequality) has worsened from 0.16 in 1978 to the current 0.47.

The PRC's rapid development has also come at a significant environmental cost. Heavy dependency on coal as an energy source has led to high levels of air and water pollution. The additional tens of millions of new automobiles on the roads in the past few years have taken carbon dioxide emissions to alarming levels. Against this background, government plans to accelerate urbanization—as stated in the new plan—require greater efforts to facilitate a sustainable process of urbanization in the framework of a low-carbon economy.

3.9.12 Sector shares in current GDP, 2010



PRC = People's Rep. of China; IND = India; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; THA = Thailand.

Note: Data for India are based on advance estimates. Data for the Republic of Korea refer to 2009.

Source: Asian Development Outlook database.

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