People's Republic of China

Domestic demand rather than exports was the driving force behind 2011's strong performance, with high investment and consumption. The outlook for 2012 and 2013, despite uncertain global prospects, is for only moderately slower growth. The economy is gradually diversifying, with imports rising rapidly and the trade surplus now much less as a percentage of economic output. Currency appreciation, rising wage rates, increasing income disparities, and environmental concerns underscore the need for modifying the country's growth model. With a strong fiscal position and declining inflation, the government is well positioned to implement the 12th Five-Year Plan, designed to further transform the economy.

Economic performance

GDP of the People's Republic of China (PRC) grew at 9.2% in 2011, despite subdued external demand for exports and the effects of domestic policy tightening. Although growth came in a full percentage point less than in 2010, it far exceeded that in most other countries, further consolidating the country's status as the world's second-largest economy. The main factors continuing to drive the economy were high domestic and foreign investment, brisk government expenditure, and increased domestic consumption.

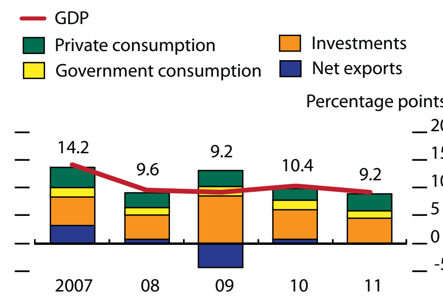
Investment and consumption accounted for all the growth in 2011 (Figure 3.9.1). Net exports were a marginally negative contributor, as real imports grew faster than real exports.

Fixed asset investment increased by almost 24%, slightly slower than in 2010 on the policy-induced slowdown in real estate investment to curb speculation (Figure 3.9.2). Local government expenditure on infrastructure also stayed strong, although again at a slower rate than in 2010.

Rising urban and rural per capita incomes (up 8.4% and 11.4% in real terms) bolstered consumption, reflecting wage and pension increases. Retail sales (a proxy for consumption) increased by 17% in nominal terms, somewhat slower than in 2010. Sales of furniture, household appliances, and audiovisual equipment registered the highest growth, while car sales grew much more slowly, showing the impacts of restricted licensing to control traffic congestion and of the end of subsidies and rebates.

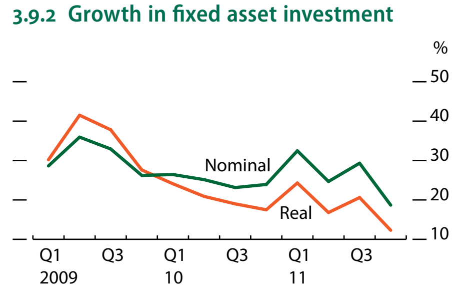
By sector, agricultural output benefited from an abundant grain harvest in the second half of the year and increased overall by 4.5%, slightly above the pace set in 2010. Slowing investment and exports caused growth of industrial output to slow to 10.6% from 12.3% the previous year; the sector was still the main contributor to growth (Figure 3.9.3). Services increased by 8.9%, slower than the 9.8% growth in 2010, driven by retail sales and financial services.

3.9.1 Contributions to growth (demand)



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

3.9.2 Growth in fixed asset investment



Source: ADB estimates based on data from CEIC Data Company (accessed 1 March 2012).

This chapter was written by Yolanda Fernandez Lommen, Niny Khor, and Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

Reflecting the turmoil in global markets, the bellwether Shanghai A-share stock index dropped by more than 20% in 2011. Investors, concerned about the international outlook and earnings prospects of listed companies, exited risk assets. Total market capitalization during 2011 fell by $486 billion, or to 31% of GDP from 45% in 2010.

Inflation—measured by the consumer price index—peaked at a 3-year high of 6.5% in July, falling to 4.1% by December (Figure 3.9.4). The second-half improvement reflected monetary tightening in the first half of the year, government measures to regulate the housing market, and favorable harvests in the autumn that curbed hikes in food prices. Still, the inflation rate in 2011 was 5.4%, up from 3.3% the prior year, reflecting primarily food and fuel prices and residential housing costs. Supply shocks, such as surging pork prices and supply shortfalls as a result of poor harvests in the first half of the year, accounted for much of the food inflation. Residential housing prices started to grow more slowly or fall marginally in some areas; transactions were fewer.

Fiscal policy was expansionary. Government expenditure grew by 24.7%, revenue by 26.7%, and the government incurred a fiscal deficit equal to 1.8% of GDP (including local government debt). At 44% of GDP, total public debt remains manageable. Increased budget shares were made in support of medical reform, educational programs for migrant workers' children in urban areas, and poverty relief. The government revised the poverty line from about $0.50 to $1 a day, thereby classifying another 100 million people as poor.

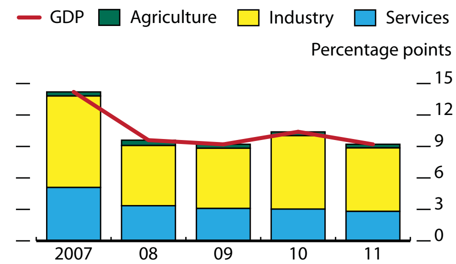
Monetary policy tightened in 2011 to dampen inflation pressures. The central bank increased the banks' reserve requirement ratio six times in the first half, to 21.5% for big lenders. It raised benchmark 1-year interest rates three times in the year, to 6.56%. As inflation pressures eased and the consumer price index fell, it started easing monetary policy first in December, by lowering the reserve requirement by 50 basis points and then by another 50 basis points in February (Figure 3.9.5). Money supply growth was 13.6% in 2011, below the government target of 16.0%. New credit amounted to CNY7.5 trillion ($1.2 trillion) in 2011, about the same increase as the year earlier.

Restricted access to credit, and persistent negative real interest rates (bank deposit rates were lower than the inflation rate), encouraged heavy off-balance sheet credit activities and informal lending. This undermined government efforts to stabilize liquidity and control inflation, prompting increased supervision by regulatory agencies. Of particular focus were macro-prudential measures to regulate rapidly expanding wealth management products.

As reported by the central bank, foreign exchange reserves increased to $3.18 trillion in 2011, compared with $2.85 trillion in 2010. In a break from the seemingly continuous increase in reserves, they declined (by $21 billion) in the fourth quarter of 2011 for the first time since 1998, due to increased repatriation of foreign capital, capital flight, and valuation losses. On the exchange rate, the yuan appreciated during 2011 by 4.7% against the United States (US) dollar, and by 7.9% against the euro.

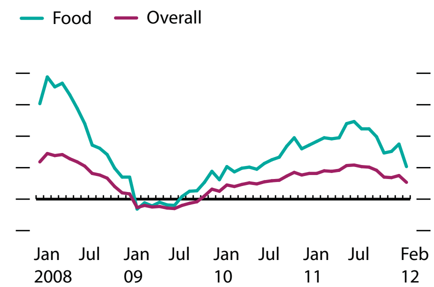
Due to the weak global economy, trade slowed: export growth decelerated to 20% from 31% and imports to 25% from 39% (Figure 3.9.6). The trade surplus on a customs basis narrowed to $158 billion from

3.9.3 Contributions to growth (supply)



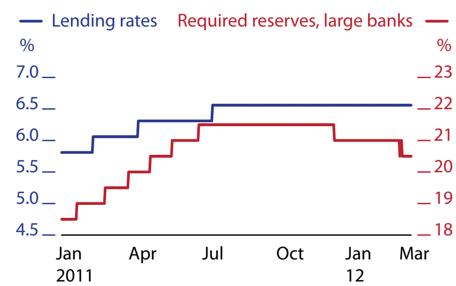
Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

3.9.4 Monthly inflation



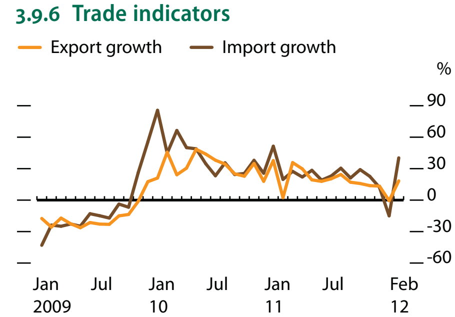
Source: CEIC Data Company (accessed 12 March 2012).

3.9.5 Interest rates and required reserves



Source: CEIC Data Company (accessed 12 March 2012).

3.9.6 Trade indicators



Source: CEIC Data Company (accessed 1 March 2012).

$181 billion (2.2% of GDP in 2011 versus 3.1% in 2010, and down from a high of 7.5% in 2007). The current account surplus fell to 2.8% of GDP in 2011. Foreign direct investment in the PRC increased, however, from $106 billion in 2010 to a record $116 billion. Declining investment by US and European Union investors were more than offset by increased inflows from Asia.

Economic prospects

The outlook assumes that the US economy will continue its slow recovery, that the eurozone sovereign debt crisis will not worsen, and that the PRC's policy stance will remain accommodative.

During the Annual Central Economic Work Conference in December 2011—a major economic policy forum—the government announced the main policy guidelines for 2012. These include a shift in emphasis from curbing inflation to maintaining stable and relatively fast economic growth, promoting restructuring, and managing inflation expectations. These objectives will be addressed through fiscal and financial reforms supporting domestic demand as well as emerging and strategic industries, and structural reform to rebalance the sources of growth, in line with the main guidelines of the 12th Five-Year Plan (2011–2015).

Fiscal policy is expected to remain broadly expansionary in the forecast period, with higher spending on education, health care, pensions, public housing, and other social security programs (including a 40% increase in the 2012 budget allocation for poverty relief). The overall fiscal deficit is expected to be 1.7% of GDP in 2012 and 2.0% in 2013. To ease the tax burden on consumers and small and medium-sized enterprises, the government may again raise the minimum income tax exemption level and replicate nationwide the Shanghai pilot tax reform of shifting from the business tax to a value-added tax (Box 3.9.1). Plans have also been announced for improved support of small businesses, including tax relief and easier access to capital markets.

Monetary policy will accommodate a continued high rate of economic growth. Money supply (M2) is set to grow by 14% in 2012, with new lending targeted at CNY8 trillion ($1.3 trillion) and a similar target for 2013. Financial sector reform will continue, including prudential regulation of off-balance sheet credit activities that could destabilize the real economy. A cornerstone reform in this context would be a more market-based approach to setting interest rates, leading to a more effective allocation of capital and savings.

In view of exchange rate movements in 2011 and earlier, and the effects of increased labor and other domestic costs on export competitiveness, continued appreciation of the yuan against the US dollar may slow.

Fixed asset investment is projected to remain the major engine of growth, increasing by 20% or more in 2012 and 2013. Investment in infrastructure (such as railways, rural irrigation, and urban public transport) is expected to continue at a high level. As part of the current five-year plan, 7 million housing units are to be constructed in 2012, which will partly offset the slowdown in real estate investment by the private sector. Consistent with government efforts to narrow regional

3.9.1 Tax reforms

The authorities introduced new tax policies in 2011. In a step designed to improve energy efficiency and strengthen local government finances, a national resource tax system was launched in November 2011. Following a trial period in Xinjiang Uygur Autonomous region, oil and gas producers now face a 5% tax on sales value. The reform does not cover coal, however—the source of about 70% of the country's total energy.

A trial program for the services sector began in January 2012, in Shanghai, to replace the business tax (on gross revenue) with a value-added tax (VAT).

The trial will focus on selected service providers and will be extended nationwide if effective. As part of the program, the Shanghai government announced new brackets of lower VAT rates for transport and certain service industries. The reform is expected to lower the tax burden for the service sector and support development of the country's modern service industry.

To bolster development of small and medium-sized enterprises (SMEs)—which employ a large proportion of the country's work force, especially in urban centers—the government raised the minimum threshold of the VAT and business tax for SMEs.

It also abolished the stamp tax on loan contracts between financial institutions and micro and small enterprises. Government departments have been requested to allocate at least 30% of their purchasing quota to SMEs.

disparities, the central and western provinces will continue to receive the highest rate of public investment growth.

Nominal private consumption is expected to grow by almost 12% in both 2012 and 2013, boosted by continued employment and wage growth as well as increased government social expenditure. Inclusive-growth measures under the five-year plan target the rural–urban income gap (see below). Exports and imports are expected to increase by around 15% and 18% in 2012, edging up in 2013. The contribution of net exports to GDP growth is projected to remain negative, and the trade surplus to continue narrowing. The current account surplus is set to fall to 2.1% and 1.7% of GDP in 2012 and 2013 (Figure 3.9.7). Factors weighing on these trade prospects include deteriorating terms of trade and a gloomy world economic outlook, particularly for the eurozone.

In a signal that it will accommodate somewhat slower growth in order to make it more inclusive and environmentally sustainable, the government announced that it has reduced the 2012 growth target from 8.0% to 7.5%. As in previous years, though, it is expected that actual growth will exceed this target. On the above estimates, GDP growth is forecast at 8.5% in 2012 (Figure 3.9.8) driven by robust investment and private consumption, and 8.7% in 2013, supported by stronger global growth momentum.

Inflation is forecast to decline to about 4.0% (Figure 3.9.9), as indicated by the combined annual rate of 3.9% for January and February. With world economic growth expected to remain modest, global commodity prices—except for oil—will likely moderate, easing pressures from imported inflation. Continued policy restraint on property markets will help control domestic inflation pressures, although bad weather or other setbacks could disproportionately affect inflation. Other inflation risks stem from rising labor costs and possible increases in energy and utility prices, reflecting the need for stringent compliance with the environmental targets of the current five-year plan.

The main downside risk is uncertainty over external demand, including the slow recovery in the US, fiscal and debt concerns in the European Union, and Japan's economic setbacks—among the country's largest trading partners. Nevertheless, progress in diversifying its export markets, and in rebalancing the sources of growth toward domestic demand, should help maintain economic momentum.

Potential increases in nonperforming loans of local government could be a domestic risk, stemming from large debt issues during implementation of the stimulus program introduced in 2009 to counter the effects of the global financial crisis. The concern relates to the mismatch between short- and medium-term maturity (over 50% of debt will mature within the next 3 years) and the long-term nature and limited profitability of most of the infrastructure projects undertaken as part of the stimulus program. However, this risk is unlikely to cause major disturbances to the economy given the overall soundness of the financial sector.

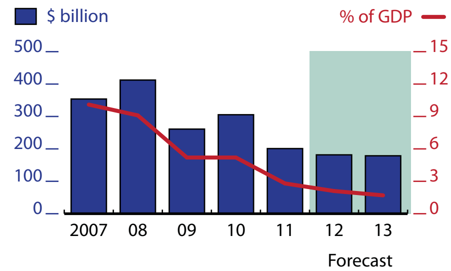
In October 2011, the Ministry of Finance announced a trial program to allow four local authorities—including the city governments of Shanghai and Shenzhen—to sell bonds directly, a move to help local governments repay loans of more than $1 trillion.

3.9.1 Selected economic indicators (%)

	2012	2013
GDP growth	8.5	8.7
Inflation	4.0	4.0
Current account balance (share of GDP)	2.1	1.7

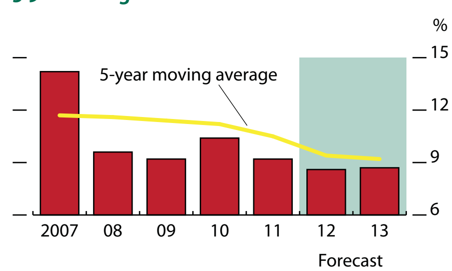
Source: ADB estimates.

3.9.7 Current account balance



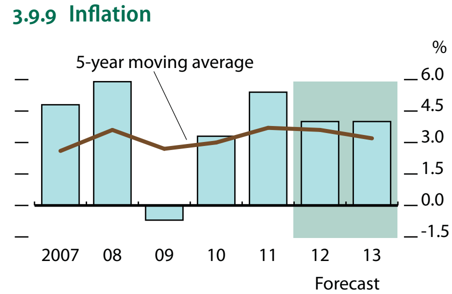
Sources: CEIC Data Company (accessed 5 March 2012); ADB estimates.

3.9.8 GDP growth



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

3.9.9 Inflation



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

Another domestic consideration is the transition to a new generation of political leaders. The 12th plan focus on deemphasizing exports in favor of domestic demand will require strong leadership and consensus. Further, new impetus is needed for inclusive growth and environmental sustainability.

Policy challenge—tackling income inequality

In the transition to a more market-based economy, 3 decades of rapid growth have lifted hundreds of millions out of poverty, but more than a hundred million are still severely poor, and income inequality has sharply widened. As acknowledged in the 12th plan, such inequality will hinder future growth as it undermines consumption, constrains development in poorer regions, and generates social tensions.

Different measures show how much income inequality has risen. The widely used Gini coefficient worsened (on a scale of 0–100) from around 25 in the mid-1980s to 41 in 2000, the last year the government published findings. Since then, several independent PRC scholars, using various methods and data, have placed the coefficient in a range of 45 to more than 50—among the highest in the world.

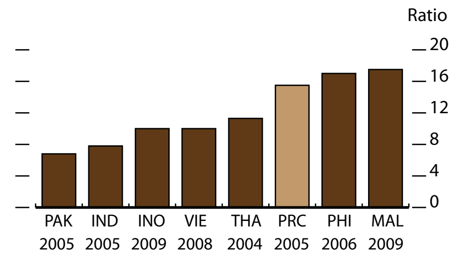
Other research suggests that the income of the top 10% of households relative to the bottom 10% in 2005 was 15.5 times, against 7.3 times in 1998. In contrast, the ratio was 10 or less for Indonesia, India, Pakistan, and Viet Nam in 2005 or more recent years (Figure 3.9.10).

Urban–rural income differences are very large: urban households' incomes are on average almost three and a half times as high than rural households' (Figure 3.9.11). The gap persists for two main reasons. First, rural areas have much less investment in physical and human capital. Second, the return on investment and assets is typically much lower in rural areas. Other overlapping factors include special economic zones concentrated in coastal areas, decentralization of public services provision to local government without a corresponding increase in fiscal resources, and regressive taxes. Further, the social support network was set up initially for urban households—a rural pension system only started in 2009. Finally, fiscal disparities are steep: per capita public spending in the richest county is 48 times that in the poorest.

The first reason is the dominating factor in the PRC. The consequences of underinvestment in rural areas are strikingly illustrated in the returns to education. In 1988, education and individual characteristics (other than age) explained little of the variation in income among workers. Some 20 years later, household and individual characteristics accounted for 50% of the urban–rural income gap, and education alone for about 25% of that gap. Urban–rural income disparities are likely to further widen.

Income redistribution and social security thus need to be strengthened for inclusive and sustainable growth. A comprehensive social security system would help reduce income inequality. Although the PRC's social policies have made great strides in recent years—including the long-awaited Social Insurance Law in July 2011—further social security reform is vital. The social security framework is still segmented, operating through a complex system of insufficiently coordinated schemes

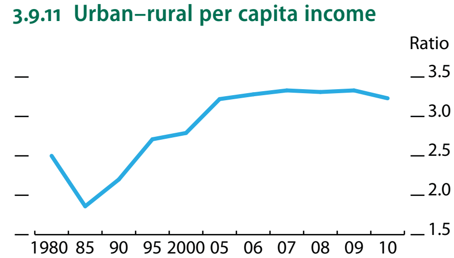
3.9.10 Income share, top 10% to bottom 10%



PAK = Pakistan; IND = India; INO = Indonesia; VIE = Viet Nam; THA = Thailand; PRC = People's Republic of China; PHI = Philippines; MAL = Malaysia.

Source: ADB estimates based on data from World Bank, World Development Indicators (accessed 14 February 2012).

3.9.11 Urban–rural per capita income



Source: ADB estimates using data from *China Statistical Yearbook 2011* (Table 10.2, p.330).

that result in inadequate coverage of benefits and beneficiaries. Further, its dual nature—parallel rural and urban programs—resulting from the household registration system or hukou, is no longer suitable. A much more unified system, as envisaged under the Social Insurance Law, is required to address the needs arising from increased labor mobility (including those of migrant workers), the challenges of accelerated urbanization, and the implications of a rapidly aging population.

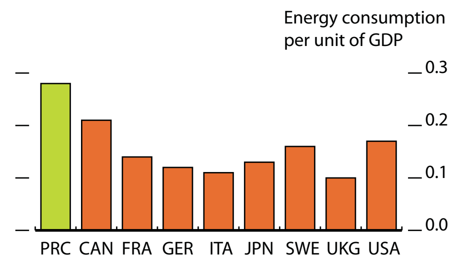
Central–local fiscal arrangements must also be strengthened. Although transfer payments from the central government have been increased, the capacity of local governments to provide public services has not improved in tandem. Equally, revenue sharing and expenditure responsibilities between the central and local governments need to be better aligned.

Beyond challenges of inclusive growth and income inequality are many others, notably water resource management and energy use. The country needs to manage its water better, as water scarcity and pollution are threatening the agricultural base. (The 12th plan aims to reduce water consumption per unit of industrial value added by 30%.)

The PRC is now the world's biggest energy consumer and since 2007 the largest source of energy-related greenhouse gas emissions; its energy intensity (energy consumption per unit of GDP) is nearly double the average of countries in the Organisation for Economic Co-operation and Development (Figure 3.9.12). (The 12th plan has set a target of cutting energy intensity by 17%.)

As the world's second-largest economy, the PRC will increasingly influence the rate and manner of world economic growth. Global interdependence requires the eurozone crisis to be resolved, a repeat recession in industrial countries to be avoided, trade protectionism to be rejected, and international consensus to be secured on actions on climate change and other issues. The PRC's growth in 2012 and 2013 is heavily dependent on the global context, as are its longer-term prospects.

3.9.12 Energy intensity



PRC = People's Republic of China; CAN = Canada; FRA = France; GER = Germany; ITA = Italy; JPN = Japan; SWE = Sweden; UKG = United Kingdom; USA = United States.

Source: Enerdata. Global Energy Statistical Yearbook. http://yearbook.enerdata.net (accessed 5 March 2012).