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

People’s Republic of China

High growth and low inflation in 2012 are expected to continue in 2013. Growth slowed but continued to shine among large economies. Consumption outpaced investment to contribute the most to expansion. In line with the emphasis on domestic demand, the current account surplus continued to decline relative to GDP in a trend expected to continue in 2013 and 2014. The challenge is to implement ambitious reforms to restructure the economy toward domestic demand and inclusive growth.

Economic performance

Beset by a deteriorated external environment and a cooled real estate sector, economic growth in the People’s Republic of China (PRC) slowed from 9.3% in 2011 to 7.8% in 2012, the lowest rate in the past 13 years but still higher than the government’s target of 7.5%. Growth picked up late in 2012, boosted by stimulus measures adopted earlier in the year that included higher public spending, especially on infrastructure, and fiscal incentives. Economic activity—particularly manufacturing and other industry—started to rebound in September in a trend that has continued uninterrupted. Higher growth at 7.9% in the fourth quarter of 2012 ended deceleration that had persisted for 7 consecutive quarters. Higher salary and pension increases fueled real income growth—up by 9.5% in urban areas and by 10.7% in rural areas—lifting per capita income to $6,080 at the market exchange rate prevailing at the end of December.

Consumption expenditure growth slowed in 2012, reflecting lower economic dynamism, but nevertheless its contribution to growth surpassed that of investment (Figure 3.9.1). The slowdown in investment was due mainly to less-brisk growth of fixed asset investment, a major component of total investment (Figure 3.9.2), which in turn resulted from falling investment in real estate triggered by government restrictions on the purchase of investment property. A rebound in apartment sales since July 2012, driven by higher incomes and stable prices, suggests improved momentum in a key sector of the economy, which augurs well for higher growth in 2013.

Growth by economic sector varied from 8.1% in industry and services to 4.5% in agriculture. Growth in the industry sector—by far the largest component of GDP—declined by 2.2 percentage points year on year, contributing the most to GDP deceleration (Figure 3.9.3). Growth in services suffered less than industry, and growth in several high-end services including information, design, and creative industry outperformed traditional services, suggesting upward sophistication in the sector. Improved weather and government support to agro-services contributed to making agriculture the only sector in which growth accelerated.
Measured by the consumer price index (CPI), inflation gradually slowed in 2012 from 4.5% year on year in January to 2.5% in December (Figure 3.9.4). For the year as a whole, CPI inflation declined to 2.6% from 5.4% in 2011. Improved supplies of food, mainly pork, and better weather contained the rise in food prices, the largest category in the CPI basket. The stabilization of housing prices also contributed to the moderating trend.

Fiscal policy supported growth through consumption subsidies and more favorable fiscal treatment of the service sector and small and medium-sized enterprises. In 2012 the consolidated fiscal deficit was modest at 1.6% of GDP, and bank borrowing to cover it raised total domestic public debt, including local government debt, to 54% of GDP.

Fiscal expenditure grew by 15.1% and revenue by 12.8%. A gradual shift in focus toward social expenditure was reflected in higher support to education, up by 28.3%. On the revenue side, corporate income tax collection increased by 17.2% in line with improved enterprise profitability, while individual income tax revenue declined by about 4% following the late 2011 raise in the income threshold at which individuals pay taxes.

With taxation at the forefront of the reform agenda, the government announced plans to expand property taxes piloted in Shanghai and Chongqing to other cities and gradually establish a nationwide property tax system to keep real estate from overheating and provide a steady income to local governments. Similarly, the trial replacement of the business tax with a value-added tax was extended to new provinces and municipalities. The program covers telecommunications, rail transportation, construction, and business services.

Monetary stance was accommodative in 2012. Lower inflation and declining growth prompted the central bank to cut both the 1-year benchmark interest rate and the reserve requirement ratio twice in 2012 (Figure 3.9.5). Nevertheless, money supply (M2) grew by 13.8%, in line with the government’s target of 14.0%. Total social financing, a measure of liquidity outside M2, rose by 22.8% to CNY15.8 trillion at year-end, which is almost double the CNY8.2 trillion in new bank lending. The rise highlights the rapid development of such untraditional sources of liquidity as trust loans, bond issuances, entrusted loans, and bank acceptance bills, which do not fall easily under central bank control.

In 2012, the central bank began implementing a multiyear financial reform plan to liberalize exchange and interest rates, gradually open the capital account, and move from quantity-based to price-based tools of monetary policy. A deposit insurance scheme will complement plans to liberalize interest rates. Moreover, a special zone in Shenzhen will pioneer a direct cross-border yuan-denominated lending pilot with Hong Kong, China. Terms and interest rates will be set independently in line with efforts toward instituting greater interest rate flexibility and full convertibility. This measure—together with the doubling of the currency trading band to 1% in 2012, which introduced more flexibility in the country’s exchange rate regime—will further boost the internationalization of the currency.

Reflecting the added flexibility, the renminbi appreciated in 2012 by an annual average of 2.4% against the US dollar and 10.6% against the euro.
In real effective terms the currency appreciated by 5.9% in 2012 and by 9% since 2010, which may have implications for competitiveness (Box 3.9.1). Trade flows grew more slowly in 2012, registering for the first time a slower increase than the government’s target: 6.2% vis-à-vis 10.0%. Weaker demand from major trading partners depressed export growth to 7.9% based on customs data, down from 20.3% in 2011 (Figure 3.9.6). Exports nevertheless performed better than imports—which grew by only 4.4%, compared with 24.9% in 2011—widening the trade surplus to $233 billion from $158 billion in 2011, or below 3% of GDP. The services account remained in deficit as payments for tourism, transportation, and insurance exceeded receipts. These developments shrank the current account surplus to 2.6% of GDP in 2012 from 2.8% in 2011 (Figure 3.9.7).

Owing to the attractiveness of the Chinese market, foreign direct investment inflows were less affected than trade by the unfavorable external environment, declining by only 3.7% from a year earlier and reaching $112 billion. Gross foreign exchange reserves grew by 3.1% to $3.3 trillion in 2012.

**Economic prospects**

The baseline outlook assumes that the US economy will continue its slow recovery, the euro area will avoid a worsening of the current crisis, and increased public spending in the PRC will improve living standards and boost consumption. Against this backdrop, and following the rebound in economic activity since September 2012, growth is expected to continue picking up in the first half of 2013 and stabilize for the remainder of the year, as the impact of stimulus implemented in mid-2012 fades.

Looking ahead, fixed asset investment will continue to drive growth, boosted by efforts to accelerate large infrastructure projects earmarked in the Twelfth Five-Year Plan, 2011–2015. Rising wages and pensions will support private consumption growth. The expected slow recovery of external demand suggests the contribution of net exports to growth will remain marginally negative in 2013 but turn modestly positive in 2014 as global trade picks up.

Export growth is projected at 10% in 2013, and import growth will reach 9% as domestic demand strengthens, commodity prices rebound, and the national currency continues to appreciate. The trade surplus will nevertheless be slimmer, narrowing the current account surplus to 2.5% of GDP in 2013 and 2.1% in 2014.

The accompanying policy stance will likely be supportive. Fiscal policy is expected to be more expansionary, with the overall fiscal deficit projected to widen to 2.2% of GDP in 2013 from 1.6% in 2012. The bias toward social expenditure will continue in accordance with government intentions to narrow the income gap and improve living standards through tax reform. Monetary policy will remain accommodative with broad money supply set to grow by 13% in 2013.

Under these assumptions, GDP growth is forecast at 8.2% in 2013. Greater efforts to comply with more stringent environmental targets, coupled with reforms to make growth more inclusive, will push growth down slightly to 8% in 2014 (Figure 3.9.8). Stable commodity prices will contain inflationary pressures in 2013, leaving the CPI up 3.2% on average,
slightly below the government target of 3.5%. However, higher labor costs and likely rises in food prices can be expected to drive the CPI up to 3.5% in 2014 (Figure 3.9.9).

The outlook is subject to several downside risks. First, in 2013 the economy will remain vulnerable to the sluggish global recovery, which could exacerbate weakness in external demand and hamper exports and employment. The main risk stems from the fragile economic outlook in the European Union, the PRC’s largest trading partner and the only major market to which PRC exports shrank in 2012 (Figure 3.9.10).

Second, weather-induced food-price volatility, higher labor costs arising from tight market conditions, and planned measures to liberalize administered prices for utilities may generate inflationary pressures, albeit within government targets.

Third, local governments are under growing pressure to embark on large infrastructure projects to foster growth and employment. The trend may intensify as there is a historic pattern of investment growth accelerating during the second and third years of 5-year plans. This pattern, if repeated now, could rapidly expand local government indebtedness. Moreover, over half of the debt contracted by local government through investment platforms under the fiscal stimulus in 2009–2010 will mature in 2013. These factors could undermine debt sustainability for local governments and saddle banks with more nonperforming loans. However, systemic risk is unlikely to emerge in the banking sector. Not only is the current volume of nonperforming loans manageable at 1% (Figure 3.9.11), but overall loan-to-deposit and capital-adequacy ratios are within regulatory requirements. Further, effective banking supervision and more stringent regulations on untraditional lending channels are expected to be implemented as needed.

Fourth, the rapid aging of the population is taking its toll on the labor market, causing the size of the working-age population to decline in 2012 for the first time. Diminishing labor supply could create pressure to raise wages. Unless compensated by labor productivity growth, higher wages would erode the economy’s competitiveness and growth potential, hampering government development plans.

These downside risks make 2013 a challenging year of transition for the new leadership. The new leaders have indicated their intention to focus on quality, efficiency, and the sustainability of economic growth, replacing the previous pursuit of fast-track growth. This welcome approach will help to rebalance over time the PRC’s sources of growth in favor of domestic demand and shrink the income gap. However, in implementing its program, the new government will be challenged by the risks enumerated above and by the complexity of the reforms needed for the PRC to successfully raise incomes, as highlighted in the next section.

Policy challenge—fiscal reform for inclusive growth

The greatest challenge arising from the new leaders’ reform agenda is stepping up efforts to restructure the economy toward domestic demand and making growth more inclusive. Against this background, the new
leadership has announced a reform plan with three pillars: financial market reform to liberalize interest rates and accelerate bond market developments, fiscal reform to support economic restructuring and narrow the income gap, and deregulation to support greater private sector participation in the economy. Among the three, the fiscal component stands as the most crucial and challenging reform to be addressed in the coming years.

In its transition toward a market-oriented economy, the PRC introduced only limited taxation, and central government transfers for education, health, housing, and pensions declined. A wide income gap and low consumption resulted, constraining the enormous potential of domestic demand as an engine of growth. In recent years, the government has adopted a range of measures to reverse the trend. In particular, social spending has increased. Even so, it remains low, with government expenditure on education and health care amounting to only 5.5% of GDP (Figure 3.9.12), less than half of the average of 12.5% allocated by countries in the Organisation for Economic Co-operation and Development. Moreover, reforms have focused on expanding benefit coverage rather than revamping the benefits themselves.

Recent income tax changes have reduced the number of individual tax payers to less than 3% of the population and their payments to 6% of fiscal revenue. The narrow base leaves policy makers with no powerful tool with which to improve income distribution. The direct income tax base can be broadened by shifting the informal sector into the formal economy, strengthening tax administration, and curtailing tax evasion.

The regressive bias of the taxation system needs to be corrected. It would be more equitable to move away from the current emphasis on indirect taxation, which is highly regressive, toward a progressive tax system that shifts the tax burden from low-income households to high earners. Taxing capital gains and property would also help to improve income distribution. Property tax is a potentially significant source of stable tax revenue for local governments, allowing them to mitigate their heavy reliance on revenue from land sales and improve their provision of basic social services.

A shift in public spending away from investment and toward social transfers would allow people to save less against an uncertain future and consume more now. Similarly, higher provisions for education and pensions would reduce life-cycle savings and free up household resources for consumption. Improving tax collection, further liberalizing energy and resource prices, introducing environmental taxes, and channeling state-owned enterprises’ dividends into social expenditure would allow higher spending without straining public finances.

Also needed are reforms to make central government transfers to poorer provinces larger and more effective toward achieving more equitable delivery of local public services. Although transfer payments from the central government have increased, the capacity of local governments to provide public services has not improved in tandem, and fiscal and institutional capacity disparities remain large in governments at the sub-provincial level. In this context, revenue and expenditure responsibilities need to be better shared between the central and local governments.

To ensure fiscal sustainability and efficiency, the PRC should further strengthen fiscal management by consolidating central and
local government budgets, the social security budget, and income and expenditure associated with state-owned assets. It should adopt multiyear budgeting to better align longer-term expenditure needs with development goals.

Finally, to highlight the importance of the environmental challenge, the PRC should accelerate its introduction of green taxes. The PRC’s rapid development has come at significant environmental cost. Notwithstanding the authorities’ commendable efforts already undertaken to combat climate change, additional actions are required to improve energy efficiency and the management of water and land.

3.9.1 Wages and competitiveness in the People’s Republic of China

In recent years the spotlight in the PRC has been on employment generation and economic competitiveness in light of concerns over the rapid increase in unit labor costs, stemming partly from dramatic increases in minimum wages. A major structural transformation of the labor market has amplified wage gains, causing them to outstrip labor productivity growth. Higher labor costs challenge the PRC’s competitiveness and the ability of its economy to generate adequate jobs.

Structural changes in the PRC’s labor market have occurred at a speed unprecedented in history. As recently as 1990, more than 80% of urban workers were still employed by state-owned enterprises and other collectives. Today, the private sector is the main provider and creator of jobs in urban areas, such that state-owned and collective units accounted for only 45% of all urban jobs in 2010. In rural areas, the changes are no less striking. Most rural employment is no longer agricultural, and legions of rural workers have migrated to urban areas.

During this period of structural transformation, labor productivity in the PRC has been growing more quickly than in the rest of the world, but it nevertheless remains low. In the most recent years for which data are available, annual labor productivity in the PRC was $3,700 per worker in 2005 dollars adjusted for purchasing power parity, far below the Republic of Korea’s $27,800 and Singapore’s $51,200.

At the same time, even after adjusting for inflation, average real wages for urban workers more than tripled in a decade. Minimum wages grew even more quickly than average wages, increasing by an average of 17% across the country in 2011 alone. In addition, nonwage costs such as for hiring and firing have increased with the introduction in 2008 of the Labor Contract Law. The impetus for higher wages has also come from the shrinking labor pool. In 2012, the working-age population aged 15–59 years old contracted by 3.5 million. In coastal areas, the decline is even more pronounced, as the inflow of migrant workers diminishes with rising standards of living and higher expectations among potential migrants in areas away from the coast. This trend is exacerbated by limitations long imposed on workers’ mobility through household registration (hukou) restrictions.

There are signs that these developments and the appreciation of the real exchange rate have eroded the competitiveness of the economy. Low-cost and labor-intensive manufacturers have been relocating to cheaper locales, helping Southeast Asia in particular realize a sharply increased share of global investment. Moreover, the most recent ranking of global competitiveness reported by the World Economic Forum in September 2012 saw the PRC’s ranking slip for the first time in 7 years, from 26th to 29th. According to the report, the PRC has become globally less competitive with respect to the goods market, firm-level technological readiness, the availability of on-the-job training services, flexibility in wage determination, hiring and firing practices, and redundancy costs. Improved competitiveness in these areas is essential to sustaining growth in the future.

Looking ahead, a number of measures are needed to keep competitiveness from eroding further. First, the authorities should ensure that increases in the minimum wage do not outpace productivity growth or, to avoid hindering job creation, the absorptive capacity of the labor market. Second, the public goal of reducing the income gap should entail transfers to low-income households. Third, productivity growth should be fostered through on-the-job training initiatives and by government incentives for firms to invest in new technologies. Finally, to improve market flexibility and job matching, steps are needed to reduce migration and transaction costs in the labor market. Key to reducing labor rigidity is reforming the hukou system, coupled with school subsidies in areas that are the main sources of migrant workers to reduce dropout rates as unskilled wages rise. These steps matter most in rural and less-developed areas, where improvements in human capital are indispensable to future growth.