INTERNATIONAL MONETARY FUND

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PEOPLE'S REPUBLIC OF CHINA

2011 ARTICLE IV CONSULTATION

July 2011

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2011 Article IV consultation with China, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 9, 2011, with the officials of China on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 27, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Supplement to the Staff Report** of July 11, 2011 updating information on recent developments.
- **Informational Annex** to the Staff Report of June 27, 2011.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its July 15, 2011 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for China.

The document listed below will be separately released.

People's Republic of China: Spillover Report for the 2011 Article IV Consultation and Selected Issues

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

June 27, 2011

KEY POINTS

Focus. The consultation examined the macroeconomic outlook, the potential for a property price bubble, the risks to the banking system, and the policy measures underpinning the 12th Five-Year Plan. The mission drew on the work of the FSAP—to connect financial sector reform to macroeconomic rebalancing—and of the spillover team—to trace out the international implications of rebalancing in China.

Macroeconomic Policies. The ongoing withdrawal of monetary stimulus is fully appropriate but a greater weight should be given to the use of higher interest rates and nominal appreciation in tightening monetary conditions. A continued steady decline in the fiscal deficit is also warranted, accompanied by a reorienting of tax and expenditure policies to support consumption.

Risks. The main near-term domestic risks to the outlook are from higher-than-expected inflation (most likely from domestic food supply shocks), a property bubble that inflates and then bursts, or a decline in credit quality linked to the post-crisis expansion in lending.

Rebalancing. There has been much progress on a number of fronts and the 12th Five-Year Plan lays out a comprehensive strategy to advance the transformation of China's growth model. To achieve these goals, a range of measures will be needed including improvements in the social safety net, policies to raise household income, a liberalization of the financial system, a stronger currency, and increases in the costs of various factors of production. A successful rebalancing, with policy changes on all these fronts, will generate positive spillovers to the global economy.

Financial Liberalization. Financial reform holds significant promise in contributing to the needed transformation of the Chinese economy. Over the horizon of the 12th Five-Year Plan, reforms should seek to secure a more modern framework for monetary management, improve supervision and regulation, deepen the channels for financial intermediation, transition to market-determined deposit and loan rates, and open the capital account. In all of this, a stronger renminbi will be an important complement.

Approved By
Anoop Singh and Tamim Bayoumi

Discussions took place in Chengdu, Shanghai, and Beijing on May 23–June 9, 2011. The staff team comprised N. Chalk (Head), A. Ahuja, S. Barnett, N. Geng, M. Nabar, P. N'Diaye (all APD), S. Maziad (SPR), and I. Lee and M. Syed (resident representatives). The Acting Managing Director and Mr. Singh joined the mission for the concluding meetings with Vice Premier Wang, Minister of Finance Xie, and People's Bank of China Governor Zhou.

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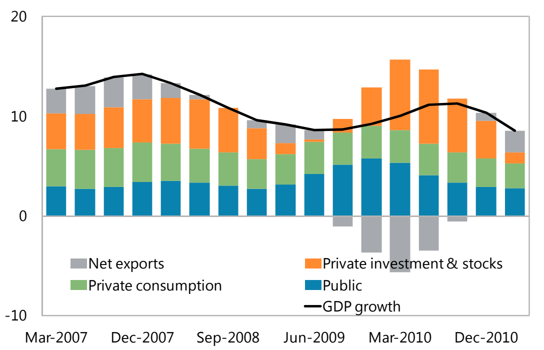
Figure 1. Toward Strong and Sustained Growth

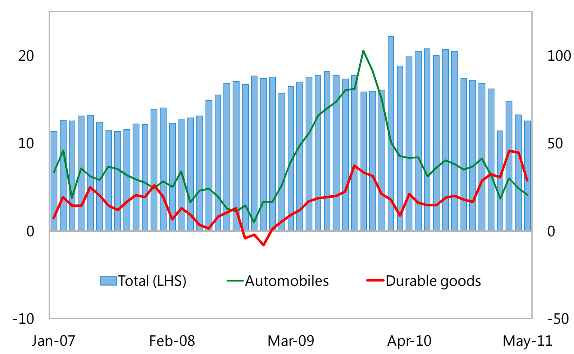
A broad-based recovery is well in train.

Contribution to GDP Growth
(In percent, annual average)



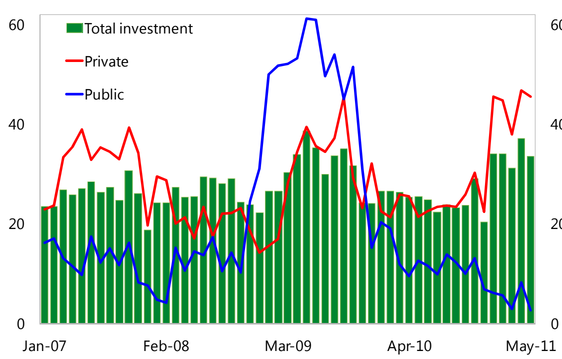
Consumption growth has slowed, but remains healthy…

Retail Sales
(In percent, year-on-year growth)



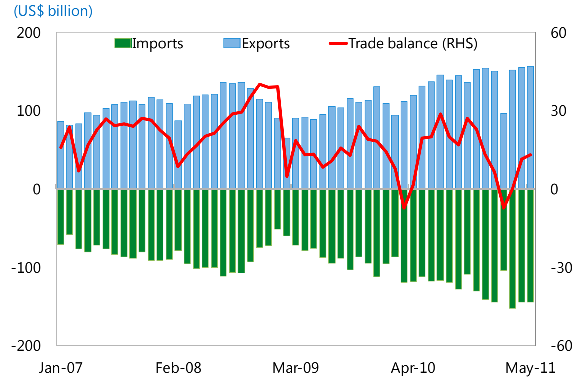
…and there has been a hand-off to private investment as the stimulus winds down.

Fixed Asset Investment
(In percent, year-on-year growth)



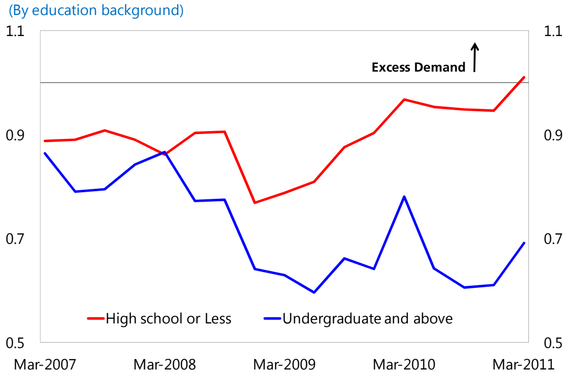
Exports have been solid, although overtaken by imports in the first part of this year.

Monthly Trade Balance
(US$ billion)



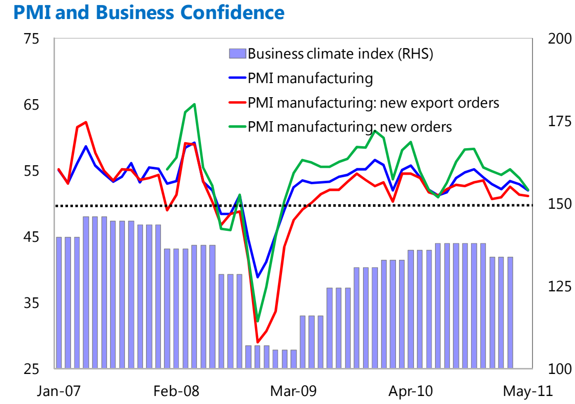
Labor demand, particularly for unskilled labor, is strong.

Ratio of Urban Labor Demand to Supply
(By education background)



Producers expect continued positive momentum going forward.

PMI and Business Confidence



Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

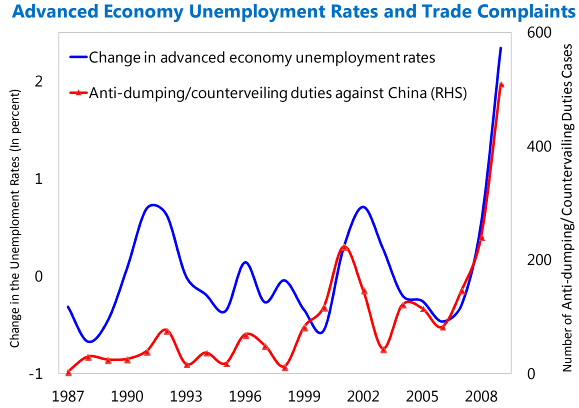
THE NEAR-TERM POLICY CHALLENGES

A. Overheating and Inflation

1. ***The global context***. The authorities indicated that they saw multiple downside risks to the global outlook. In particular, officials underlined the inward spillovers and risks to China arising from high levels of public debt in the United States, the United Kingdom, and elsewhere; the slow pace of recovery in many large industrial economies; and the increasing divergence across the European Union (particularly related to sovereign risks in the Euro periphery). They also reiterated their concerns about the scale of global liquidity and the potential for increased volatility in capital flows. Finally, they pointed to the counter-productive rise in trade protectionism in recent years, linking it to sub-par growth in the larger economies. It was against this global backdrop that the 12th Five-Year Plan had been prepared (Box 1) and macroeconomic and financial policies were being decided.

Trade frictions rose during the global recession

Advanced Economy Unemployment Rates and Trade Complaints



2. ***Growth.*** Despite the external risks, China's economy remains on a solid footing, propelled by vigorous domestic and external demand. Wage and employment increases have fueled consumption, the expansion in infrastructure and real estate construction has driven investment upward, and net exports are once again contributing positively to economic growth (Figure 1). There has been some sequential slowdown in activity in recent months, in part a result of policy tightening, but this had already been built into staff forecasts.

3. ***Inflation***. Over the past year, consumer price inflation has been a pressing social and economic issue. At end-May, inflation was 5½ percent with a broadening of price pressures beyond just fresh food (Figure 2). The authorities indicated that they have responded to the upswing in inflation with a range of policy measures including monetary tightening, efforts to increase food supply and deal with transportation bottlenecks, as well as the use of existing price controls on some items. It now looks as if the supply shocks that precipitated the recent inflationary upturn are dissipating and the policy measures taken to counter price pressures are having an impact. Barring further food price shocks, and assuming the ongoing tightening of monetary policy is continued, there was general agreement that inflation should soon peak although there were still upside risks to inflation, mostly from adverse weather conditions affecting food prices and from higher global commodity prices. Staff also noted that some part of current inflation was likely being suppressed by administrative measures. This may stifle the appropriate supply response to higher prices and could lead to the inflationary dynamic showing more inertia and persistence during this cycle.

Box 1. Highlights From China's 12th Five-Year Plan

Coverage. The 12th Five-Year Plan is a high level strategic document that outlines the directions for policy and reform in the coming years and sets specific targets on certain areas (such as growth, urbanization, energy use, and others). In many areas, though, the plan does not yet detail the concrete steps that will be put in place to achieve these social and economic goals.

Themes. Rebalancing growth from exports to consumption remains a central theme of the plan with an emphasis on "accelerating the transformation of the pattern of economic development" by enhancing productivity, supporting innovation, and investing in human capital. The priority has also shifted away from the absolute level of growth toward its quality and impact on "people's livelihood."

Internal balance. The government has promised increased support for agriculture and the service sector as well as a more balanced regional development by harnessing urbanization and supporting the relocation of industries to the interior.

Household income. To boost consumption, the plan targets a needed growth in disposable income—for both urban and rural residents—that outstrips that for the economy as a whole, reversing the secular decline in household income as a share of GDP.

Safety net. There are plans to further increase the coverage of the health and pension systems and provide low income housing for up to 20 percent of urban households.

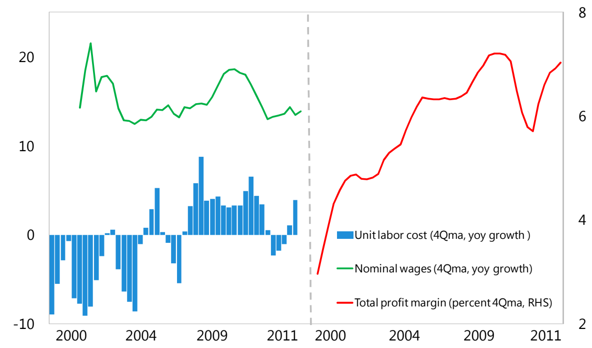
Technology and environment. The plan targets moving up the value chain in manufacturing through technological upgrade and promoting investment in strategic industries. There is also a continued emphasis on clean energy and increases in input costs to better price pollution externalities.

Financial reform. Over the next five years, the government intends to move toward more market-based interest rates and capital account convertibility.

4. ***Labor***. Official data shows double-digit increases in nominal wages and there are signs of labor mismatches, both geographically and skills-related. There is, however, significant heterogeneity across the labor market. Anecdotal indications are that jobs are migrating from the coastal regions into the interior provinces, in part due to demographic reasons, improved prospects in inland provinces, and frictions to labor mobility created by the household registration scheme. The premium for skilled or experienced labor is growing but unskilled labor has much less pricing power in the labor market. Unemployment among university graduates is becoming an important social issue with many college graduates ill-equipped for the workplace. At the same time, companies report being increasingly constrained by a lack of skilled labor. This growing skills gap is a pressing issue without a clear near-term solution and one that is feeding into growing income inequality.

Labor costs are growing broadly in line with productivity

China Unit Labor Cost and Industrial Profit Margin



5. ***Cost pressures***. There are some signs that higher wages and broader cost pressures could be starting to feed through the production chain, pushing up the prices of manufacturing exports. The authorities felt that the transition underway in the labor market was an important development and could represent a significant force in economic rebalancing. They argued that this change was likely to continue and accelerate, driven by demographic factors and policies to increase the minimum wage, improve the social safety net, and strengthen workers' rights. Staff agreed that there were some signs of a tightening labor market and rising cost pressures. Nevertheless, China continues to have a structural labor surplus with significant unemployment and underemployment. At an aggregate level, it still appears that wage pressures are mostly being absorbed by productivity gains; manufacturing unit labor costs are rising only slowly and corporate profit margins are not being compressed by rising costs. While changes in the labor market will help with rebalancing, this would be a gradual process and would need to be complemented with reforms in a range of other areas. In addition, while export prices were rising, this was also a feature of other Asian economies and may be driven more by a pass-through of rising global commodity prices than by country-specific cost pressures.

As in the rest of Asia, export prices have rebounded

Export Prices

(In percent, year-on-year 3mma growth)

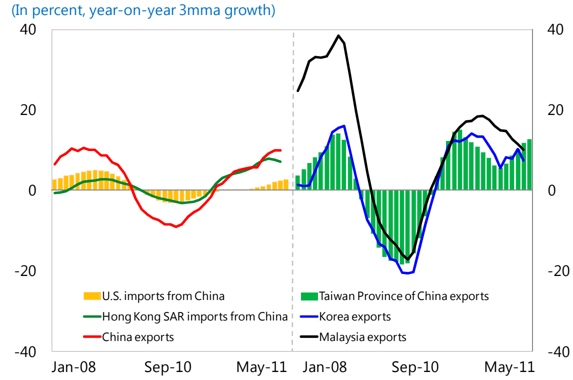
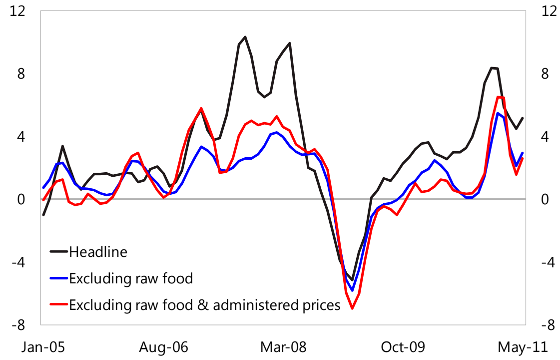


Figure 2. Prospects for China's Inflation

Starting in late 2010, price increases began to spill over from raw food to other items...

Inflation

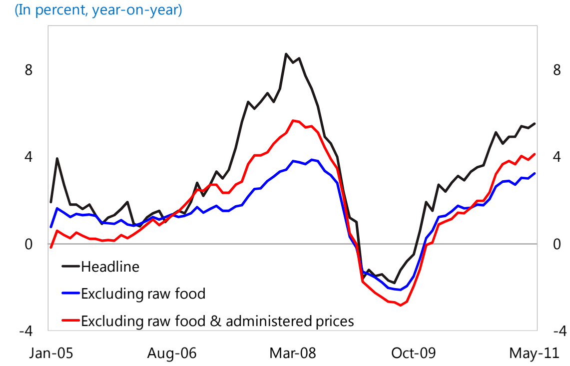
(3m-on-3m, saar, 3mma)



...and inflation has risen steadily over the past year.

Inflation

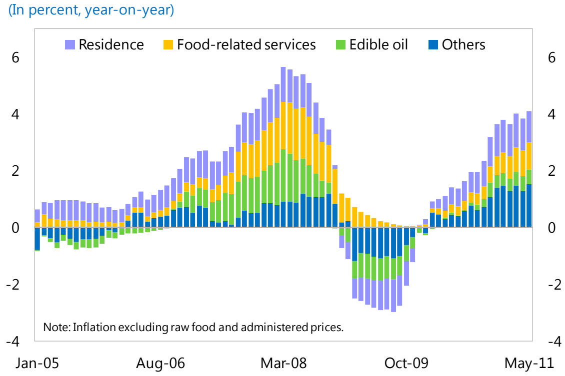
(In percent, year-on-year)



Underlying inflation—excluding raw food and administered prices—has been more broad-based than in 2007.

Contribution to Underlying Inflation

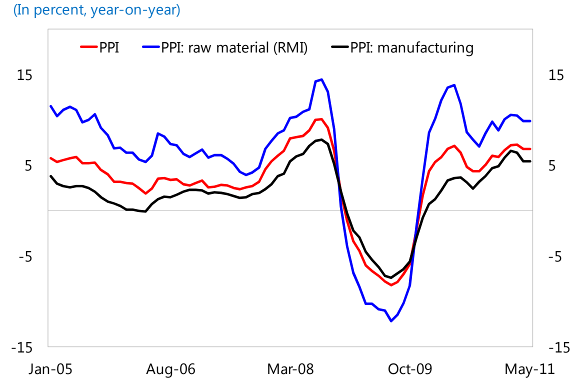
(In percent, year-on-year)



Input costs—particularly for commodities—have increased.

Producer Price Index

(In percent, year-on-year)



And households are clearly concerned about inflation.

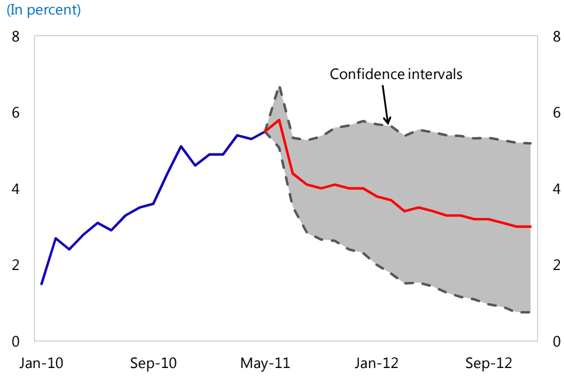
Urban Depository Survey

(Share of respondents)

Nevertheless, model-based forecasts indicate that inflation should soon peak.

Consumer Price Inflation

(In percent)



Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

B. Property Bubbles

6. ***Developments***. The government's efforts to slow the rapid pace of increase in property prices appear to be having the desired effect. In the first five months of this year, residential property prices on average rose 7 percent over those of the previous year and transaction volumes have been discretely lower. Market participants indicated that the restrictions on purchases of properties for investment purposes have had the biggest impact. There is also some evidence that people are shifting more into renting property with rents now catching up with prices in the larger cities. In addition, commercial real estate prices have been rising quickly, particularly in the larger coastal cities (Figure 3). Despite the slower rate of increase in house prices, real estate investment has held up well, in part bolstered by an ongoing expansion in the construction of housing for lower income groups (the government has a goal of building or refurbishing 10 million units of social housing this year).

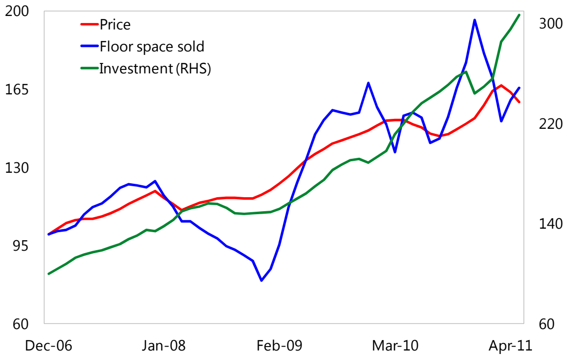
7. ***Assessment***. Despite some success in calming down the property market, prices are high as a share of household income, particularly in some of the larger cities, and staff remains concerned about the potential for a property price bubble in China. The property sector occupies a central position in the Chinese economy, directly making up 12 percent of GDP and is highly connected to upstream industries (like steel and cement) and downstream producers of appliances and other consumer durables. Direct lending to real estate (developers and household mortgages) makes up around 18 percent of banks' credit portfolio; property is a sizable component of household and corporate balance sheets; and for local governments—which account for 82 percent of public spending—property-related revenues (including budgetary funds) are important. A property bubble, therefore, would pose serious macroeconomic and financial stability risks.

8. ***Policies***. Staff did not see imminent risks of a material downturn in the property sector. However, with the slowdown in transaction volumes there could be stress on the balance sheets of some property developers; this could prompt consolidation in the sector. Staff maintained that as long as the cost of financing is low and other investment options are sparse, the propensity for property bubbles will remain and the government will have to take progressively tighter administrative measures to stem demand and dampen house price inflation. Decisively mitigating the risk of a property bubble will require a higher cost of capital, financial market development, and the introduction of a broad-based property tax. The authorities recognized the risks and also emphasized their concerns related to the impact of worsening housing affordability on inequality and social stability. There was broad agreement that the government will need to continue to provide affordable urban housing to lower-income households for many years to come.

Figure 3. Is There a Property Bubble in China?

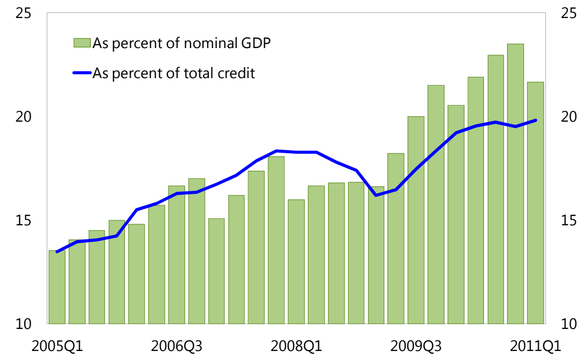
Government measures have cooled down the property market somewhat but investment remains solid.

Residential Housing
(Dec 2006 = 100, sa)



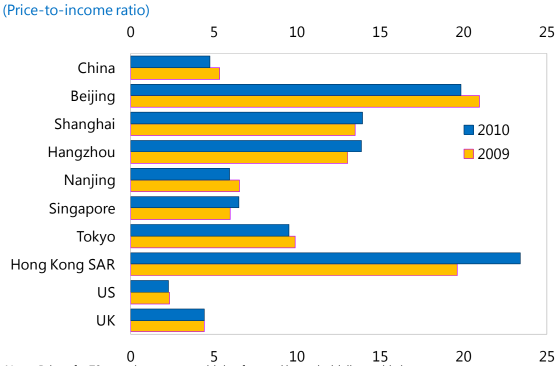
The share of bank credit going to the real estate sector has leveled off.

Bank Exposure to Real Estate Sector
(Quarterly)



Housing affordability remains a pressing social issue particularly in major cities.

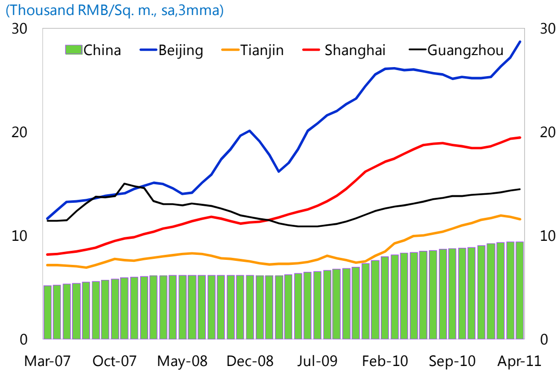
Housing Affordability
(Price-to-income ratio)



Note: Price of a 70 sq.m. home as a multiple of annual household disposable income.

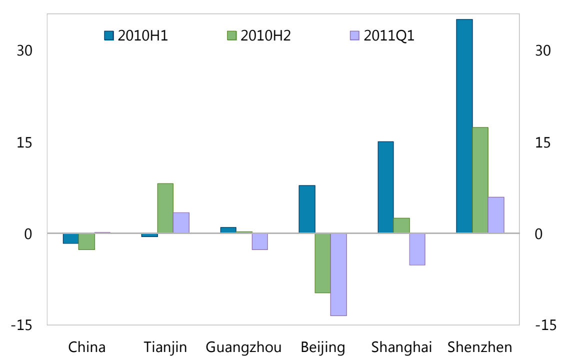
Property price increases have moderated in several Tier I cities.

China Property Prices
(Thousand RMB/Sq. m., sa,3mma)



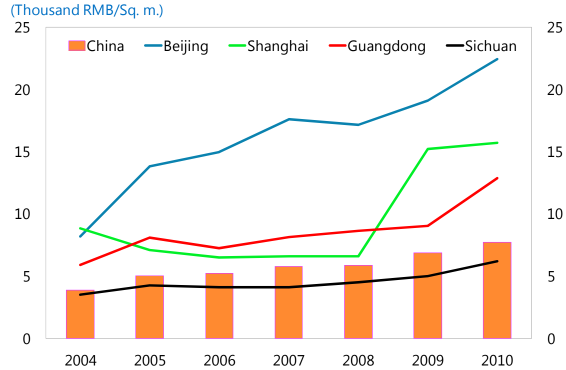
At the national level, prices do not appear out of line with fundamentals but certain cities still look "bubbly".

Deviation of Mass-market House Price from Benchmark
(Percent of benchmark price)



Commercial real estate markets have become increasingly buoyant particularly in a few eastern and southern provinces.

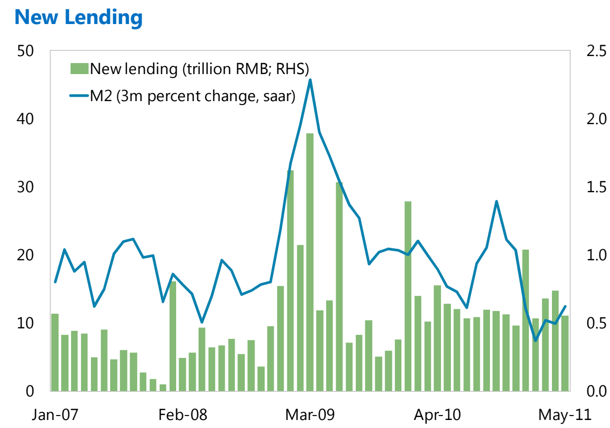
China Commercial Real Estate
(Thousand RMB/Sq. m.)



Sources: Bloomberg; CEIC Data Company Limited.; Centaline Property Agency Limited; and staff estimates. Benchmark house price is derived from a no-arbitrage condition equating rental to home-ownership costs.

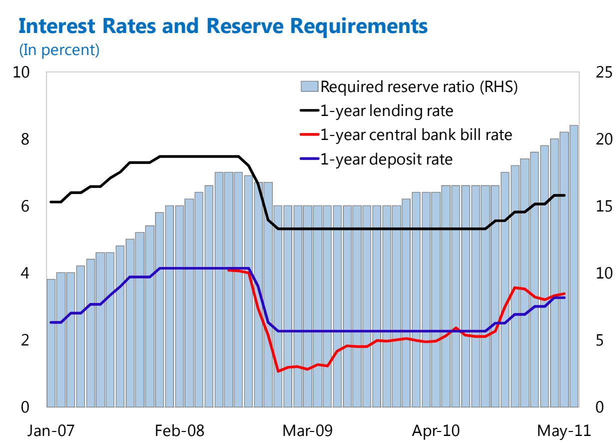
C. Credit and Banking Risks

The growth in bank lending has slowed



9. ***Developments***. Following the massive injection of credit stimulus in response to the global financial crisis, the central bank and the bank regulatory agency moved in 2010 to rein in loan growth. Despite this shift in policy, monetary and credit growth last year overshot their targets. In addition, off-balance sheet credit expanded (through trust funds, guarantees, and other means). However, since late 2010, there has been a renewed effort to tighten credit conditions and a steady, albeit moderate, increase in deposit and loan rates.

Interest rates and reserve requirements have moved higher



Selected Banking Indicators (in percent)

	2007	2008	2009	2010
All commercial banks				
Total CAR ratio	...	...	11.4	12.2
NPL ratio	6.1	2.4	1.6	1.1
Bank provisions to NPLs	41	117	153	218
Return on assets	0.9	1.1	1.0	1.1
Return on equity	16.7	19.5	18.0	19.2

Source: CBRC.

10. ***Assessment***. Stress tests—conducted by the authorities as part of the FSAP process—suggest that the banking system is generally capable of absorbing significant downside risks. However, given the large expansion in credit in the past 2½ years, a coordinated shock on multiple fronts (including lower growth, a sharp real estate downturn, and higher interest rates) would leave some of the smaller private banks with insufficient capital to meet regulatory requirements. The key risks to credit quality remain concentrated in loans to local government financing vehicles, off-balance sheet lending, and, to a lesser extent, credit to the property sector. A full assessment of these various risks is, however, hampered by serious data gaps, weaknesses in the information infrastructure, and constraints on the FSAP team's access to confidential data.

11. ***Policies***. To counter these credit risks, the bank regulatory agency indicated it is in the process of requiring that banks assess their credit portfolio in a downside scenario and ensure that lending to local government vehicles meets certain minimum collateral requirements. The authorities also said that efforts to catalog and determine the risks and potential contingent fiscal liabilities arising from the recent surge in lending to local government financing vehicles were nearing completion. Banks had been asked to raise the capital requirements and provisioning for such loans and significant time has been spent conducting on-site examinations and increasing the regulatory and supervisory scrutiny of credit risks. In addition, banks are now being required to bring much of their trust-related lending back on balance sheet by year-end. Despite these efforts, staff argued that credit quality risks remain, potentially implying significant contingent liabilities.

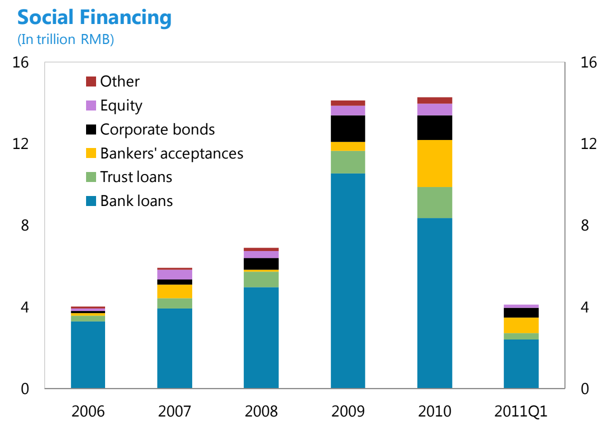
D. Near-Term Macroeconomic Policies

12. ***Fiscal policy***. The significant monetary and fiscal stimulus put in place in late 2008 has been effective in offsetting the growth impact of the collapse in external demand. There was broad agreement that with growth now self-sustaining, it is fully appropriate to gradually unwind the fiscal stimulus. Staff argued that the fiscal position should return to broad budget balance in the next one to two years, allowing fiscal policy to be modestly counter-cyclical. Should growth prospects deteriorate, a slower or delayed path of fiscal consolidation would be warranted. The authorities indicated that budget decisions would be taken on an annual basis at the time of the National People's Congress and would very much depend on the prevailing economic situation. They underlined their commitment to devote more resources to social expenditures and rural development and to raise the minimum threshold of the personal income tax. Even with a reduction in the deficit over the near-term, staff argued that there should still be ample scope to reallocate fiscal resources toward tax and spending policies that promote private consumption.

13. ***Monetary policy***. Given the cyclical outlook for the economy, evident price pressures, and the potential for a worsening of bank credit quality in the coming years, staff and the authorities agreed that monetary stimulus should be withdrawn and the target of 16 percent M2 growth by end-year (down from 19.7 percent at end-2010) represented a steady return to more normal monetary conditions that was well calibrated to the current macroeconomic environment. Achieving this goal would help mitigate the risks to bank balance sheets posed by the very rapid expansion of lending that had occurred over the past two years.

14. ***Monetary tools***. The central bank has used both reserve requirements and higher interest rates to slow credit but still relies heavily on direct administrative limits on loan growth. The central bank has also introduced a supplemental "dynamically differentiated reserve requirement," which varies across banks and through time based upon the pace of credit growth at the bank, the capital adequacy ratio, and other factors. Staff argued that this focus on quantity limits has limited the supply of bank credit but with little impact on the cost of capital or demand for new loans. In addition, with guaranteed loan-deposit rate margins, the banks still have strong incentives to expand lending. As a result, the control of monetary aggregates through direct limits on bank lending is already being disintermediated. There has been a significant rise in off-balance sheet provision of loans (e.g. through trust funds, leasing, bankers' acceptances, inter-corporate lending, and other means) and a growing intermediation of credit through nonbanks and fixed income markets. In addition, over the past several months, there have been large loan inflows from offshore entities recorded in the balance of payments (as Chinese companies go abroad to offset credit restrictions at home). Such avenues were already partially counteracting the impact and effectiveness of monetary tightening and that tendency was likely to increase in the coming years. The central bank indicated that it was

Bank loans have fallen as a share of total financing



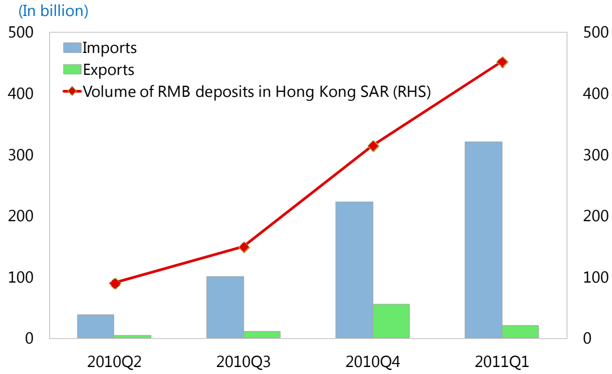
committed to moving gradually to more price-based tools of monetary policy, noting that loan and deposit rates had been increased four times since October. The central bank was also now monitoring a broader measure of "social financing"—which includes bank loans, off balance sheet lending, as well as funds raised in the equity and bond markets—in order to better judge financial conditions. They felt that the existing array of tools and the expanded scope of their surveillance would be sufficient to contain disintermediation risks. They also indicated that, to some degree, lending limits could be viewed as an effective microprudential device in a system where risk management and risk monitoring were still insufficiently developed.

E. Cross-Border Renminbi

15. ***Developments***. Over the past year, the offshore use of the renminbi has grown tremendously. With the expansion of renminbi trade settlement, monthly settlement volumes reached RMB 134 billion in April (or around 7 percent of total trade). At the same time, the volume of renminbi deposits in Hong Kong SAR stood at RMB 511 billion at end-April (representing 8 percent of the Hong Kong deposit base). Finally, the development of renminbi financial products offshore has moved quickly with a range of instruments, spot markets, and derivatives now available. This has included the issuance of around RMB 155 billion in renminbi bonds in Hong Kong SAR.

Offshore renminbi deposits and trade settlement have expanded rapidly

RMB Trade Settlement for Cross Border Trade
(In billion)



Note: Staff estimates for 2010Q4.

16. ***Assessment***. Despite the progress to date, the use of renminbi for trade settlement remains very one-sided, with 89 percent of settlement covering imports. Most issuance of financial instruments has been by Chinese entities with only limited use of the renminbi by nonresidents as a funding currency. In addition, the stock of available renminbi instruments is still small relative to the volume of renminbi that is building up offshore. As a result, much of the renminbi ends up being deposited at the Hong Kong clearing bank. The authorities recognized that progress in building the offshore market would need to be accompanied by a steady expansion in the avenues for those funds to flow back to the Mainland. In particular, they highlighted that they have already allowed around RMB 50 billion to be invested into onshore interbank bond markets and a similar amount to return as inward FDI. There are also discussions underway for a "mini-QFII" scheme that will allow, subject to quota, approved institutions to invest their renminbi in onshore capital markets.

17. ***Policies***. The one-sided growth in cross-border activity has led to further upward pressure on international reserves and revealed the tension between achieving a greater global role for the renminbi at the same time as the currency is undervalued. Despite the relatively small size of the offshore market (it now represents around 10 percent of China's monetary base or less than 1 percent of M2), there were already growing signs of two-way linkages between the onshore and offshore markets (Box 2). The authorities indicated that they were very closely monitoring the transactions taking place across the capital account—in both renminbi and foreign currency—and were ensuring that all cross-border flows were consistent with the regulations and were being used only to finance activity in the real economy. They also noted that, while the process of internationalization of the renminbi was demand driven, it was still being managed very carefully—in both the Mainland and Hong Kong SAR—to ensure stability.

Box 2. The Links Between Onshore and Offshore Renminbi Markets

The renminbi holds significant potential to become widely used internationally due to China's large economic size, diversified trade structure and network, and high growth rates. Yet, nonresident access to renminbi-denominated assets remains limited. Despite this, in a historically unprecedented process of market development, renminbi trade settlement with nonresidents has expanded rapidly and the issuance of renminbi-denominated assets in Hong Kong SAR is growing. This could have implications for the links between offshore and onshore markets even with binding capital controls in place.

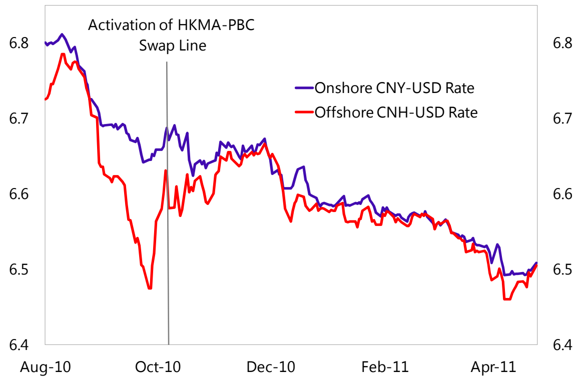
Using a multivariate GARCH model, the links between the offshore renminbi markets in Hong Kong SAR (CNH) and the onshore renminbi (CNY) spot and forward markets were examined. [1]

Results

The movements in CNH and CNY are highly correlated and the connection between the two markets was stabilized following the activation in October of the renminbi swap line between the People's Bank of China and the Hong Kong Monetary Authority.

- Developments in the onshore spot market exert an influence on the offshore spot market but the reverse is not true.

China Bilateral Exchange Rates



Summary of GARCH Results

From \ To		CNY Spot	CNY Forward	CNH Spot	CNH Forward
CNY					
	Spot	--	--	0.33*	0.19
	Forward	--	--	0.04	0.02
CNH					
	Spot	0	-0.37***	--	--
	Forward	-0.03	-0.37**	--	--

Values indicate change due to a 1 percent change in explanatory variable
*, **, *** indicate statistically significant coefficient with 10%, 5%, and 1% confidence level, respectively.

- Nevertheless, offshore forward markets do seem to move *ahead* of onshore forwards. In particular, today's CNH 3-month forward rate has a predictive impact on tomorrow's CNY forward rate but not vice versa. This could be due to either price discovery being faster in the Hong Kong markets (due to their full integration with global markets) or, potentially, that onshore market participants may be looking to the CNH market for pricing signals in setting onshore rates.
- There is also evidence of two-way volatility spillovers between CNY and CNH, especially in the forward markets.

The results suggest that the ongoing process of RMB internationalization is already leading to spillovers from offshore to onshore markets despite the wide-ranging capital controls. These linkages are only likely to grow as the market develops and liquidity improves.

[1] See J.S. Kang, S. Maziad and S. Roache, "Renminbi Internationalization: Offshore-Onshore Links," IMF Working Paper (forthcoming).

IS CHINA REBALANCING?

A. Social Safety Net

18. ***Developments***. Since the eruption of the global financial crisis commendable progress has been made in expanding China's social safety net with significant resources allocated to improving the pension, healthcare, and education systems. This will certainly help rebalance toward private consumption. In particular, a new rural social pension system has been introduced and now covers 60 percent of counties In addition, healthcare spending has been substantially increased to build health facilities, train personnel, and achieve near-universal coverage of basic health insurance. Finally, the government is about to expand the existing social pension scheme to include the urban unemployed with nationwide coverage expected by 2012.

Social Policies Already Taken To Promote Rebalancing

- Increases in the basic pension, social transfers, and unemployment benefits
- Launch of a new rural pension scheme
- Introduction of a new social pension system for urban residents
- Full portability of pension benefits
- Increased subsidies for health insurance and coverage of a core set of prescription drugs
- Significant investments in new hospitals, community health facilities, and the training of healthcare personnel
- Implementation of the Labor Contract Law and increases in minimum wages

19. ***Policies.*** Despite progress, gaps in the safety net still remain. The health system continues to create incentives for precautionary saving because of high out-of-pocket expenses and inadequate coverage for catastrophic illnesses. At the same time, there is a need to increase the generosity of social benefits, consolidate the complex and fragmented patchwork of various national, provincial, government and occupational pension schemes, and achieve universal pension coverage for urban, migrant, and rural workers.

B. Input Costs

20. ***Labor***. There was broad agreement that labor markets will continue to evolve in the coming years as the demography shifts and skills are increasingly in demand. This will be a potentially important, albeit slow-moving, force going forward. In particular, it should lead to labor gaining a stronger negotiating position, with higher wages and more of the gains from growth redistributed from the corporate sector to households. This is a positive development and will help with rebalancing. Indeed, for consumption to grow at a faster pace than output, there needs to be a sustained increase in nominal wages in

Staff Recommendations on Further Policies For Rebalancing 1/

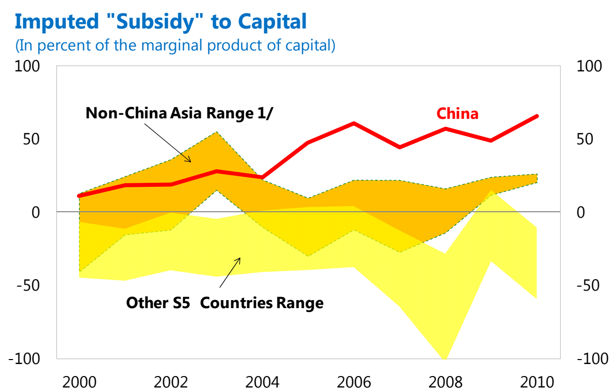
- Liberalizing the financial system and developing new markets and financial instruments.
- Further reducing the taxation of labor income through lower social contributions.
- Continuing to improve access to high quality healthcare, reduce out-of-pocket expenses and strengthen coverage for catastrophic illness.
- Raising the costs of various factor inputs such as land, energy, pollution, and capital.
- Appreciating the exchange rate.
- Reforming corporate governance, reducing monopoly power in key sectors, and boosting dividend payouts to the budget from state-owned corporations.
- Improving labor mobility by reforming the household registration system.

1/ See People's Republic of China—2010 Article IV Staff Report for details.

excess of nominal GDP. There was general agreement that attention should be paid to avoiding the growing skills gap, putting a particular prominence on improving the education system and vocational training. Staff argued that the government could further facilitate the increase in household income by significantly reducing social contribution rates (which can be in excess of 40 percent of wages) and replacing them with other forms of general revenue (for example, higher dividends from state corporations, an expansion in the VAT base to cover services, or increases in energy taxes). In addition, staff recommended that fundamental reform of the household registration scheme should be considered.

21. ***Other factors of production***. The staff and authorities agreed that there remain distortions in factor pricing in several areas (Box 3). The authorities underlined the steps already being taken to raise energy prices and link them more closely to global costs and agreed there was scope to raise the cost of many inputs to production in order to ensure a more efficient allocation of resources and a more appropriate pricing of externalities. Officials also noted that the latest Five-Year Plan places particular emphasis on protection of the environment and energy conservation and efforts would continue to dissuade pollution and excessive energy use through higher prices and greater taxation of resource use. Staff made the case that the cost of capital in China was also very cheap especially when compared with the returns that capital can generate. The authorities, though, believed assessing the appropriate cost of capital in China was exceedingly difficult, complicated by the other factor cost distortions that were in the system. Certainly, the productivity of

The cost of capital is well below its marginal product



1/ Includes Indonesia, Korea, Singapore, and Taiwan Province of China.
Source: Background Paper, "Competitiveness, Overcapacity, and Sustainability Risks."

capital was high but, in part, that was due to the underpricing of other factors of production (such as energy) and insufficient environmental protection. It may also be the case that the apparent high investment-GDP ratio—which has risen to close to 50 percent and some viewed as a sign that capital was too cheap—could be overstated due to the under-recording of both consumption and service sector output in the national accounts.

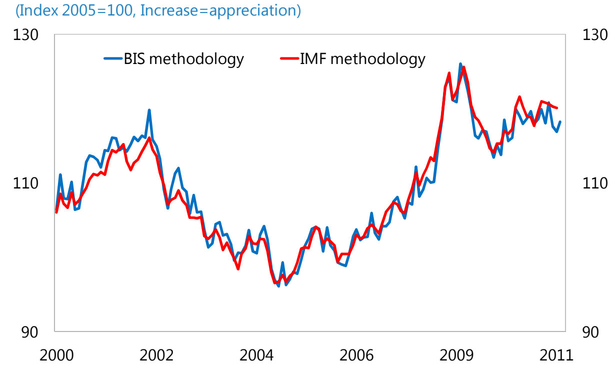
C. The Role of the Exchange Rate

22. ***Assessment***. Staff continues to believe that the renminbi remains substantially below the level consistent with medium-term fundamentals. At this point, there is little reason to change the assessment made during the 2010 Article IV consultation. Reserve accumulation has been significantly larger than foreseen at the last Article IV (reserve levels at end-March were already above what staff had previously forecast for end-2011 and are well above the level needed for precautionary purposes). Despite progress in appreciating against the U.S. dollar, the real effective exchange rate has depreciated over the past year.[1] Finally, despite the important progress made in many policy areas, staff does not yet see in place the critical mass of measures that will be needed to decisively change the incentives for saving and investment and achieve a lasting decline in the current account surplus (Box 4). Nonetheless, the low trade surpluses recorded in the first five months of this year could be an indication that this year's current account surplus will be smaller than expected.

The exchange rate has depreciated in real effective terms over the past year

Real Effective Exchange Rate

(Index 2005=100, Increase=appreciation)



23. ***Policies***. Staff advocated a stronger exchange rate as a key ingredient to accelerate the transformation of China's economic growth model. The work of the spillover team would suggest that movement on the exchange rate alone may have only modest direct effects in addressing global imbalances. However, staff argued that this fails to take into account the fact that the undervaluation of the currency is holding back progress in other areas that would help safeguard against near-term risks and promote economic rebalancing. For example, the undervalued

[1] The current estimates of the IMF's Consultative Group on Exchange Rates indicate that the renminbi is undervalued by 3 percent (ERER approach), 17 percent (ES approach), and 23 percent (MB approach).

currency reduces the scope for running a more proactive and independent monetary policy with higher real interest rates. Similarly, the significant and sustained need to absorb liquidity from large-scale foreign currency intervention constrains the government's ability to move safely ahead with financial liberalization. The undervalued exchange rate also creates distortions in relative prices that act as a headwind to the government's efforts to raise household income and to develop the service sector. A faster pace of renminbi appreciation would open the way to move ahead in many areas that were highlighted in the 12th Five-Year Plan. This, in turn, would facilitate a decisive shift to a more balanced, equitable, and sustainable growth model.

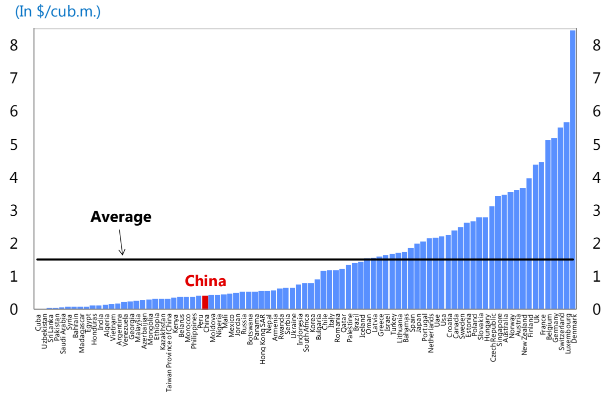
24. ***The authorities' view***. The authorities disagreed with the staff's exchange rate assessment. They underlined the progress that has been made in continuing to improve the mechanism for setting the exchange rate. At the same time, the trade outturns in the first five months of this year show that imbalances were clearly declining and in a sustained way. The authorities also argued that, despite recent improvements, the balance of payment statistics still under-recorded current account outflows from non-remitted income on nonresidents' investments in China. They also felt there was a generally weak relation between the movements in the current account and the level of the real exchange rate and so any assessment of the degree of undervaluation should not be based upon uncertain forecasts of the future current account. Instead, a broader view needed to be taken on the path of the real exchange rate. Relative prices were indeed adjusting in China, including through rising labor costs and increased enforcement of labor rights, demographic changes, higher energy costs, and enhanced environmental protection. Further, nontradable prices were moving higher, notably for housing. These developments were, perhaps, not fully reflected in CPI-based measures of the real exchange rate. Finally, the authorities underscored that the currency was converging toward its equilibrium and expected that this process would continue over the medium term.

Box 3. Are Factor Costs Too Low in China?

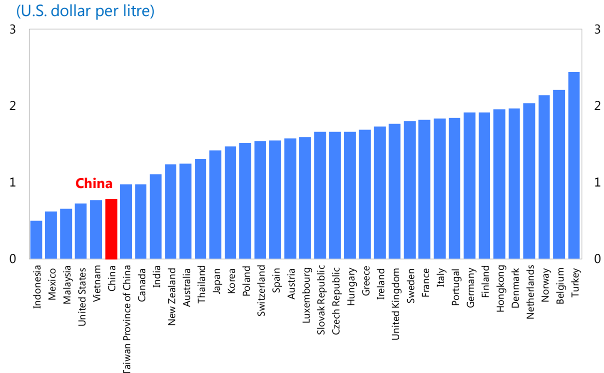
China's growth model relies on various low-cost factor inputs, including land, water, energy, labor, and capital. This offers Chinese firms a competitive edge and creates incentives for capital intensive means of production. Studies estimate the total value of China's factor market distortions could be almost 10 percent of GDP. [1]

Land and water. In China, all land belongs to the state and local governments have the discretion to sell industrial land use rights to companies for up to 50 years. In many cases industrial land is provided for free to enterprises to attract investment. For water, the price in China is about one third of the average of a sample of international comparators.

World Water Prices
(In $/cub.m.)



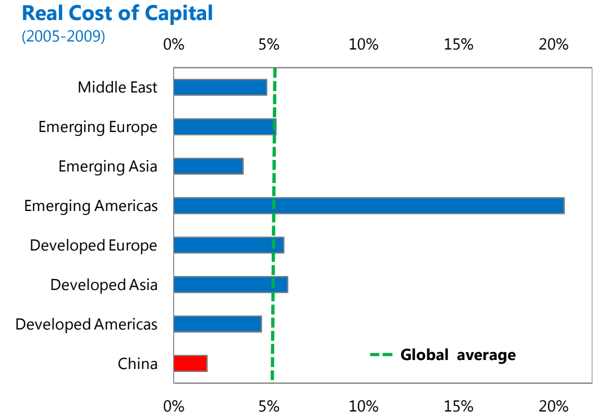
Intenational Comparison Retail Price of Gas
(U.S. dollar per litre)



Energy. Cross country data on the cost of energy shows that the price of gasoline in China is relatively low, although similar to that in the U.S. For electricity, the cost is also somewhat below the average of international comparators although discussions with private counterparts reveal that many companies are able to negotiate significant discounts to the regulated price. Having said this, China is making progress in bringing energy costs in line with international levels: oil product prices have been indexed to a weighted basket of international crude prices; natural gas prices were increased by 25 percent in May 2010; and preferential power tariffs for energy-intensive industries have been removed.

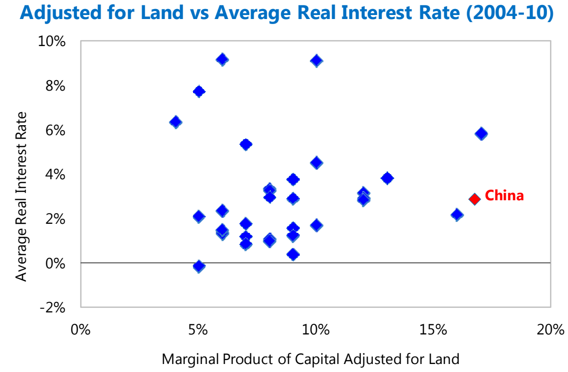
Capital. By various cross-country measures, the cost of capital appears low in China. Using data on 37,000 firms across 53 countries, staff estimates show that the real cost of capital—defined as a weighted average of the real cost of bank loans, bonds, and equity—faced by Chinese listed firms is below the global average. [2]

Real Cost of Capital
(2005-2009)



Capital looks especially cheap when compared to its high productivity in China. In particular country-specific estimates of the marginal product of reproducible capital (i.e., capital adjusted for land) show China as an outlier and well above the average real loan rate.

International Comparison: Marginal Product of Capital Adjusted for Land vs Average Real Interest Rate (2004-10)



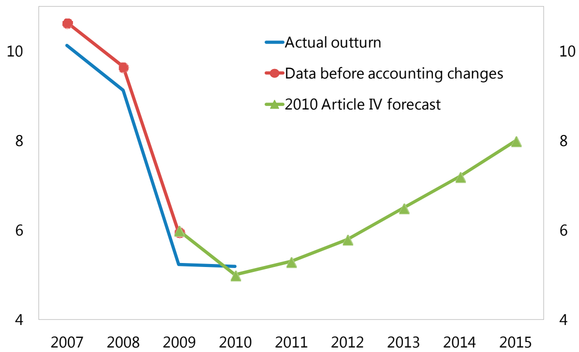
[1] See Y. Huang, "China's Great Ascendancy and Structural Risks: Consequences of Asymmetric Market Liberalization" (2010) and Y. Huang and K. Y. Tao, "Causes and Remedies of China's External Imbalances" (2010).

[2] See N. Geng and P. N'Diaye, "Determinants of Corporate Investment in China: Evidence from Cross Country Firm-level Data," 2011, IMF Working Paper (forthcoming).

Box 4. Prospects for the Current Account

Previous forecasts. At the time of the 2010 Article IV consultation staff had forecast that China's current account surplus would decline to 5 percent of GDP in 2010 (down from 6 percent of GDP in the previous year) and gradually rise to around 8 percent of GDP by 2015.

Current Account Balance: Forecast and Data Revisions
(In percent of GDP)



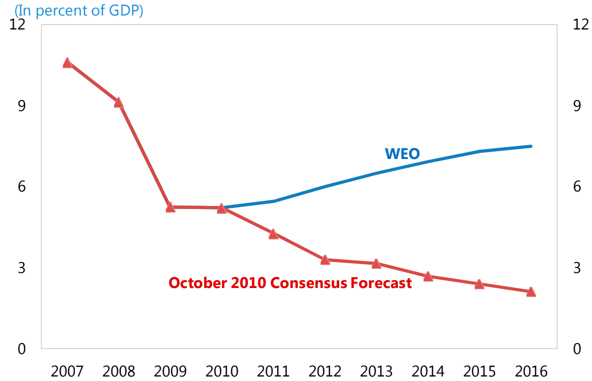
Outcomes. The balance of payments data for 2010 show that the current account surplus leveled off in 2010 at around 5¼ percent of GDP. The evolution of the current account surplus was dominated by two factors (i) a deterioration in the terms of trade and a ramp up in the volume of raw material imports; and (ii) a revision in the accounting for non-remitted income on FDI investments that lowered the current account by ¾ and ½ percent of GDP in 2009 and 2010, respectively. Despite these countervailing forces, the 2010 outturn was still ¼ percent of GDP higher than staff had forecasted a year ago.

The outlook. Looking ahead, the staff's forecast assumes a steady fiscal consolidation at the level of the general government, continued recovery in external demand, and, importantly, a real effective exchange rate that remains at current levels. In addition, the recent changes in accounting methodology have been incorporated into staff forecasts. The forecasts themselves are underpinned by various modeling techniques, including a Bayesian Vector Autoregression (BVAR) model, the Fund's Global Integrated Monetary and Fiscal (GIMF) model, and a time series model fitted to Chinese and global data (Figure 4).

- The BVAR model suggests a reversal of the current account surplus to 8½ percent of GDP over the next two years.
- GIMF simulations show that the combination of stronger global demand and steady fiscal consolidation could lift the current account surplus to around 7 percent of GDP by 2016.
- The staff's non-structural time series model shows that stronger demand for China's exports, the expected improvement in the terms of trade assumed under the latest World Economic Outlook, and a lack of exchange rate appreciation, would lift China's current account surplus to around 6¾ percent of GDP by 2016.

What do market analysts expect? The median long-range forecasts of private analysts show the current account will fall to below 3 percent of GDP by 2015. However, it is important to note that these forecasts assume, on average, a real effective appreciation of 23 percent over the next five years.

Medium-Term Current Account: Private Analysts Forecasts
(In percent of GDP)

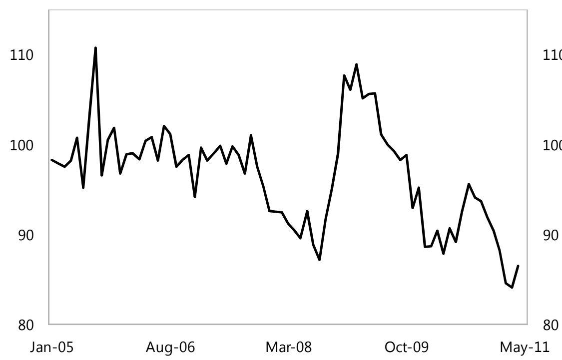


Current forecasts. Putting together all these inputs, staff now forecast that the current account surplus will reach 5½ percent of GDP this year and rise to 7½ percent of GDP over the medium term.

Figure 4. How is the Current Account Shaping Up?

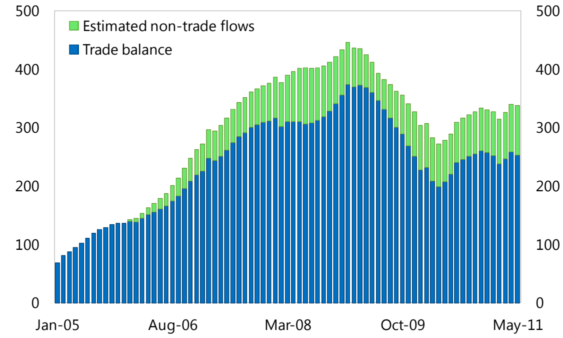
Despite a worsening in the terms of trade...

China Terms of Trade Index
(2004=100, sa)



...the current account surplus bottomed out in mid-2010.

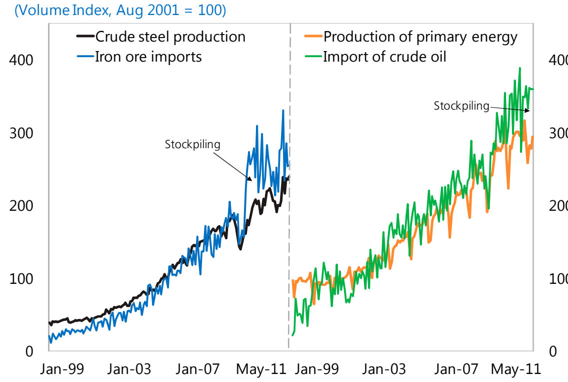
Current Account Balance
(12 month cumulative, US$ billions)



Note: Projected non-traded flows for May 2011.

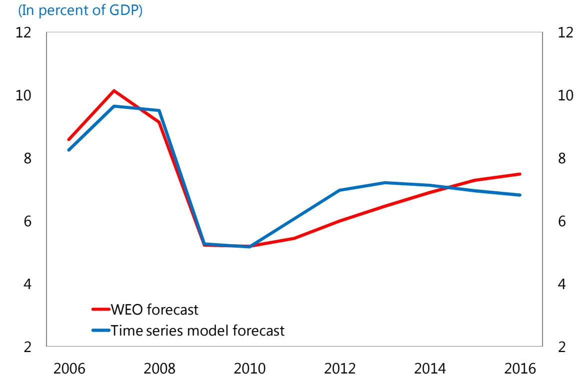
There has been a surge in imports of raw materials and an apparent build-up of inventories.

Imports vs Production
(Volume Index, Aug 2001 = 100)



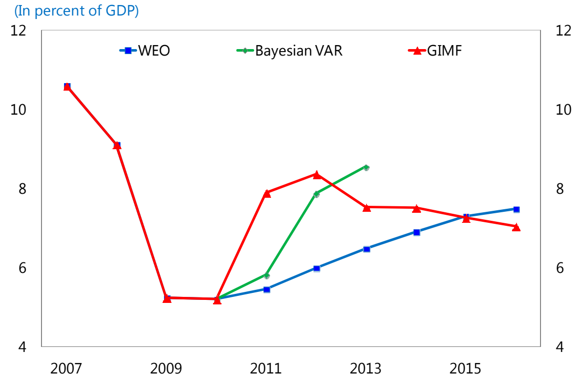
Staff forecasts continue to indicate that the current account surplus will reassert itself in the coming years.

Current Account Model Forecasts
(In percent of GDP)



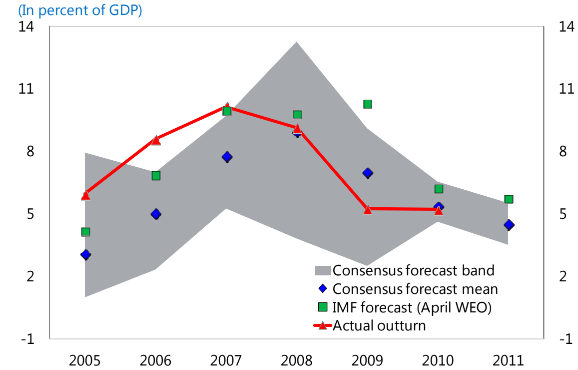
And this pattern is a common feature of several different modeling approaches.

Current Account Model Forecasts
(In percent of GDP)



Private analyst near-term forecasts, however, predict that the current account surplus will continue to decline.

Current Account Balance Projections
(In percent of GDP)



Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

FINANCIAL LIBERALIZATION AND REFORM

A. Motivation

25. ***Emerging tensions***. Much has already been done to reform China's financial system (Box 5). However, as touched upon earlier in this report, over the horizon of the 12th Five-Year Plan China will encounter a fundamental and structural shift in important aspects of its economic system. Demographic changes will mean the labor force will gradually start shrinking, leading to a steady rise in labor costs, a rising skills premium, and potentially altering inflationary dynamics. China will continue to face the risk of property bubbles, driven by low interest rates, robust growth prospects, and a lack of alternative investment vehicles. Finally, the ongoing process of financial innovation and disintermediation into non-bank areas will pose a growing and formidable challenge to China's ability to exert macroeconomic control through administrative means. This potential combination—of rising inflationary pressures, already-high prices in the property market, and a weakening of direct monetary control—poses significant risks to financial and macroeconomic stability. In addition, the current system for financial intermediation continues to hold back rebalancing and the development of the service sector, generating industrial overcapacity that could present negative implications for long-run growth prospects.

26. ***A time for action***. This argues for China to immediately move ahead with financial liberalization and reform, a position that is fully consistent with the 12th Five-Year Plan. This will be a complex, multi-year undertaking and starting now will ensure that the process can be largely completed within the horizon of the Five-Year Plan. Continuing to delay could mean that the financial system, instead, evolves in an uncoordinated and disorderly fashion, outpacing supervisory capabilities and revealing regulatory gaps. Indeed, the risk is high that developments proceed on a timetable driven not by careful, pre-emptive, and concerted policy planning but rather by the pace of market disintermediation and innovation. This would create liquidity stress, growing cross-border capital flows, and both asset price and macroeconomic volatility. Given the increasing complexity of China's financial system, an ad-hoc or poorly configured approach would be especially risky, for both China and the global economy.

Box 5. Recent Achievements In Financial Sector Reform

Over the last decade, China has made considerable progress in moving toward a more liberal and market-based financial system.

Bank Commercialization. Banks' internal risk management and accounting practices have been strengthened, with foreign strategic partners helping to implement international best practices. The main banks have been listed on foreign markets, helping to strengthen investor oversight and control and ensure compliance with international accounting standards. A large volume of bad loans—over 15 percent of GDP in 1999—was carved out and placed in asset management companies while the banks were recapitalized with government support.

Regulation and Supervision. The regulatory infrastructure has been significantly improved with the establishment of individual regulators for insurance, banking and securities markets. Within these agencies, capacities for supervision have been strengthened, and a regulatory infrastructure that meets international standards has been put in place. Laws on new companies, trusts, securities and investment funds have also been enacted, providing a modern framework for capital market development.

Fixed Income. Interest rates on a range of fixed income instruments have been allowed to be determined more by market forces. In addition, an interbank bond market was established to allow corporations to raise funds from securities markets, reducing their dependence on the banking system for credit.

Financial Centers. Shanghai has become a critical part of the global financial infrastructure. Best practices and state of the art trading platforms have been adopted in key markets and equity market liquidity increased by making a larger proportion of shares tradable. Shanghai's market capitalization now stands at around US$3 trillion, the sixth largest equity platform in the world. Shenzhen has also launched the Growth Enterprise Board giving small- and medium-size companies access to equity financing with streamlined listing procedures.

All these measures have bolstered the health and soundness of China's financial sector, helping it escape the global crisis relatively unscathed and enabling it to expand operations abroad. Nevertheless, as acknowledged in the 12th Five-Year Plan and outlined in the FSSA, a broad-ranging financial reform agenda still remains.

B. A Proposed Roadmap for Reform

27. ***Principles***. There is no optimal, pre-determined path that financial liberalization and reform should take in China and any plan should be flexible enough to adapt to unforeseen situations as reforms proceed. Nevertheless, international experience would suggest that certain key elements and a basic sequencing will be needed to mitigate the potential risks that will arise as the financial system becomes freer and more market-oriented. A broad roadmap—which includes appreciating the renminbi, absorbing liquidity and strengthening monetary management, improving regulation and supervision, developing financial markets and products, liberalizing interest rates, and finally opening up the capital account—is laid out below.

28. ***The exchange rate***. First, by allowing the exchange rate to appreciate there will be genuine, market-driven, two-way movement of the currency, reducing the pressure from capital inflows. This will provide greater scope for the People's Bank of China to exercise macroeconomic control through a more market-based and counter-cyclical monetary policy. A stronger renminbi will lessen the pace of foreign reserve build-up, translating into significantly less liquidity pressure in domestic markets and a diminished need to use higher and higher reserve requirements and issuance of central bank paper to absorb this liquidity. With structurally less liquidity generated by the balance of payments, financial reform can safely move ahead in various areas.

29. ***The monetary framework***. As appreciation continues, the central bank can begin to absorb the significant liquidity overhang that is currently present in the financial system. This will need to involve a steady increase in the entire structure of deposit, loan and interbank rates and a much more aggressive use of open market operations to reach a point where the central bank no longer needs to rely on administrative limits on new lending and, instead, credit can be allocated by price-based means. As liquidity conditions tighten, interbank and central bank paper rates should move well above the deposit rate and monetary policy can be conducted largely through indirect instruments. Tighter liquidity conditions will create incentives for banks to improve their internal liquidity management functions and focus more on assessing risk-return trade-offs in allocating loans. At the same time, the central bank should move to reserve averaging to ease liquidity management challenges faced by the banks and allow reserves to operate as an effective buffer in times of short-term stress. With a more flexible exchange rate and the likely instability in monetary aggregates as financial reform proceeds, China will have to adopt a new framework for monetary policy decision making. For an economy of China's size, importance, and complexity, the preferred alternative would be an institutional design that establishes objectives on growth, inflation and financial stability and uses a combination of monetary and macro-prudential tools to achieve those goals.

30. ***Regulation, supervision, and financial stability***. The government should continue to increase the commercial orientation of the banking system, bolster its crisis management capabilities, and strengthen supervision to identify and manage macro-financial vulnerabilities (Box 6). Supervisory and regulatory improvements will be needed to address the gaps that will inevitably emerge in a more liberalized setting. This should include routine stress testing, increased oversight for systemic institutions, an improved resolution framework, and better data quality and collection. Interagency regulatory and supervisory coordination should become more ongoing and systematic, including through the establishment of an interagency financial stability committee.

31. ***Financial market development***. Strengthening nonbank channels for financial intermediation will be an important objective to create competitive discipline on the banks, offer companies alternate avenues for project financing, and provide households with a broader range of financing and investment possibilities. Building on the significant progress made in the last several years, the FSSA outlines several areas to further expand nonbank financial intermediation (Box 7). A well-working fixed income market, in particular, will be essential in facilitating growth in pension, insurance, mutual funds, and other institutional investors. Expansion of nonbank areas of intermediation will, however, need to largely move in tandem with reform of bank-based intermediation. Failure to do so could create incentives for a migration of resources out of the banks (into bonds, equities, trusts, leasing, and wealth management products), with the accompanying supervision and regulatory challenges and the potential for destabilizing the banking system.

32. ***Interest rate liberalization***. With the liquidity overhang absorbed, a robust market-based monetary framework in place, and a financial system that is less dependent on the banks, China will then be able to move away from the current system where loan and deposit rates are regulated by the central bank. It will be essential to ensure that, unlike in the unsuccessful cases of interest rate liberalization, this does not translate into an unintended loosening of monetary and credit conditions (Box 8). This will be complicated since the ongoing financial reform and liberalization will make money demand difficult to predict. In addition, it will be important to use regulatory and supervisory tools to ensure that the banks do not engage in overly aggressive competition or unsafe practices to attract deposits, expand lending, or compress margins to gain market share. The authorities should begin by gradually raising the ceiling on deposit rates. As deposit rates rise the floor on loan rates will steadily become less binding, increasing the cost of capital and allowing lending decisions to be determined more by market forces. Greater freedom to set loan and deposit rates will create incentives for the banks to better manage and price risk and make money market rates more representative of true financial conditions. At the same time, a market-determined system of interest rates will provide valuable price signals for macroeconomic policymaking, as well as strengthen the transmission mechanism for monetary policy.

33. ***Capital account liberalization***. With these various reforms in place, China could then proceed to dismantle the extensive system of controls on capital flows that is currently in place, fully internationalizing the renminbi, and moving the currency toward being "freely usable." The early stages of capital account liberalization should focus on removing restrictions on more stable, long-term sources of financing such as direct investment flows. Full liberalization—including short-term flows—should wait until the bulk of financial sector reforms, discussed above, have been implemented. The existing framework of QFII and QDII could provide a useful means to open up the capital account, with the quotas steadily expanded and judiciously targeted at particular asset classes. Eventually these quotas would become nonbinding and could then be removed altogether.

C. The Authorities' Views

34. ***Importance of reforms***. The authorities emphasized their commitment to continued financial liberalization and were in broad agreement with the scope of the reforms outlined by the mission. Indeed, they noted that the 12th Five-Year Plan highlighted many of these core areas including interest rate reform, improving the framework and transmission of monetary policy, strengthening regulation and supervision, developing alternatives to bank finance, reforming the exchange rate regime, and liberalizing the capital account. The authorities acknowledged the importance of sequencing and viewed the roadmap suggested by staff as a clear and helpful framework for organizing the wide-ranging reform process that China now faces. However, they indicated that the sequencing of reforms would follow a path determined by circumstances and progress in many areas could move in a complementary and parallel way. They indicated it would be difficult to design a definitive ordering of reforms ex ante and emphasized that reforms would take time and be preconditioned on a stable and supportive macroeconomic environment. The authorities did, however, underscore the risks of an uncoordinated approach to financial liberalization and were looking carefully to the experiences of other countries for potential lessons.

35. ***Monetary management.*** The absorption of liquidity, associated with large balance of payments inflows, was recognized as a key challenge to monetary management and healthy asset market development. The authorities agreed that revisions would be needed to the monetary framework in order to manage the complicated trade-offs between growth, inflation, financial stability and structural changes in the economy. Indeed, these trade-offs were likely to become more complex in the coming years. Over time, greater emphasis would be given to inflation as an end-goal and to short-term interest rates as a means to achieve that target. Macro-prudential tools would also be drawn upon, as needed, to manage financial risks.

36. ***Interest rate liberalization.*** The authorities recognized that ensuring banks face hard budget constraints would be an important prerequisite for a more commercially-oriented banking system that adequately prices risk and efficiently allocates credit. As interest rates are liberalized, preventing disorderly competition among banks for market share would be a priority. In this context, those banks with better-developed risk management capabilities could be allowed greater flexibility in determining deposit and lending rates at an early stage. In addition, bankruptcy laws and resolution mechanisms would need to be in place. Moral hazard issues would potentially be important given the systemic size of many banks and social importance of others (like the rural credit cooperatives). Care would also need to be taken not to precipitate potentially destabilizing capital inflows from higher interest rates.

37. ***Regulation and supervision.*** The authorities agreed that the capacity of the regulatory agencies to monitor and contain evolving risks will need to be bolstered, as will the crisis management framework. In particular, they highlighted that a deposit insurance scheme is a priority and that capacity was now being built to undertake a range of regular stress testing exercises with the banks. Both of these will help to strengthen the robustness of the financial system.

38. ***Capital account liberalization.*** The authorities recognized that full capital account convertibility will need to be handled carefully, particularly as managing the process successfully would hinge on other measures, such as continuing to reform the exchange rate setting mechanism and having more market-determined interest rates. They identified several pre-requisites, notably stable macroeconomic conditions, a strong regulatory and supervisory framework, and broad, deep and liquid financial markets. They were also receptive to the idea of phasing in the opening of the capital account based on the nature of flows, with longer-term capital such as FDI considered before shorter-term flows. Even as the capital account is liberalized, they stressed that some tools would still be needed to manage risks to financial stability, notably those associated with volatile short-term capital flows. Finally, while they viewed full convertibility of the capital account as an important goal, they noted that significant progress had already been made in the development of cross-border renminbi activity and that process would continue on a separate track.

Box 6. Key Financial Stability Reforms

The principal areas identified by the Financial System Stability Assessment (FSSA) to improve the framework for financial stability include:

- Establish a ***Financial Stability Committee*** to help coordinate across agencies on systemic risks and adapt to the changing perimeter for regulation as innovation reshapes the financial landscape and creates new channels of intermediation.
- Clarify the objectives and strengthen the mandates for the ***central bank and regulatory agencies*** with greater operational autonomy, improved accountability, adequate resources in terms of skilled staff and funding, and effective enforcement and resolution powers.
- Put in place a ***crisis management framework*** that allows for effective oversight, early intervention, and an orderly exit for weak or failing financial institutions (including systemically important institutions and financial conglomerates) and a clear definition of the role of the state in providing fiscal support.
- Transition to a formal ***deposit insurance*** scheme that will clearly define the limits of state support.
- Set clear limits on central bank ***emergency liquidity support*** that is restricted to solvent banks facing short-term liquidity problems.
- Ensure that the central bank's ***standing facilities*** operate immediately and automatically, with common conditions and collateral requirements, for all domestically incorporated institutions.

Box 7. Key Reforms to Deepen Financial Intermediation

The principal areas identified by the FSSA to develop and deepen intermediation include:

- ***Bonds***. The government should adapt its bond issuance strategy so as to help improve the existing market making activities across all maturities of the yield curve. Reforms should aim to increase the connectivity between the exchange-traded and interbank markets and ensure a coordinated regulatory approach between the two markets. The government could also consider permanently authorizing bank trading of bonds on the stock exchanges and allowing corporate bond issuers that meet the appropriate (disclosure-based) listing standards to decide whether to list on the interbank or exchange-traded bond market. Finally, creditworthy sub-national entities should be allowed to issue bonds to raise financing.

- ***Money markets***. The PBC should further upgrade the operational framework for the repo market to increase market liquidity. Operational restrictions that make instruments less efficient (such as not being able to automatically rollover open repo positions) should be re-considered. Leverage risk should be controlled through prudential regulations. Addressing tax and regulatory hurdles that limit the size of the outright repo market would also be important. The availability of suitable hedging tools should be encouraged to help market liquidity providers manage risk, with interest rate derivatives particularly important in the near-term.

- ***Equities***. The nature and scope of investable instruments should be broadened to create a more balanced institutional and retail investor base, improve liquidity, and strengthen price discovery. Residual legacy constraints and anomalies relating to nontradable, "A" and "B" shares should be addressed and the current free float of shares in public companies expanded. Building a smooth conduit between the private and public offer segments will be critical to sustainable funding for SMEs.

- ***Insurance***. The insurance sector is still a relatively small part of the financial system but is growing rapidly and most of the insurers licensed in the past decade continue to lose money. This growth, combined with the low returns available on insurance company assets, is putting strains on the sector's capital adequacy and solvency. Consolidation of the sector is needed with stronger solvency requirements, more comprehensive risk-based capital requirements, and clearer voluntary wind-up and exit rules. Insurers should be allowed to hedge asset-based market and credit risks, including through asset management companies. Subject to prudent risk management, quantitative limits on pension fund allocations could be relaxed to allow for a greater diversification away from bank deposits and toward bonds and equities. Stronger actuarial oversight of non-life claims provisioning is also needed.

- ***Mutual funds***. The scope of fixed-income instruments available to mutual funds could be broadened to include lower-rated issues (within prescribed parameters) and medium-term notes. This would broaden their appeal and enhance their competitiveness while supporting access of private companies to direct funding. There is also a need for an assessment of whether development of the mutual funds sector is being prejudiced by a more conservative regulatory approach than applied to the wealth management industry.

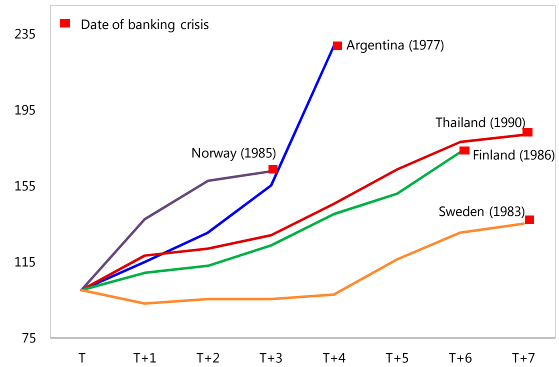
Box 8. Financial Liberalization and Reform: Lessons From International Experience

Experiences. Many countries have reformed their financial sectors in recent decades. While financial liberalization has generally helped spur long-term growth, inappropriate design of reforms has also resulted in disruption or even crises. There is no unique blue-print, but international experience suggests the need for a carefully-calibrated approach.[1]

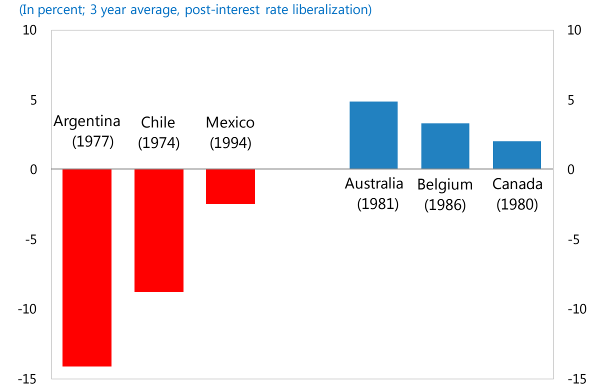
Key Lessons for China

- Significant financial sector fragilities should be addressed ahead of major liberalization, including recapitalization or restructuring of systemic institutions and corporate governance enhancements.
- Regulatory and supervisory frameworks need to be upgraded early and continuously. Virtually all post-liberalization crises can be traced to inadequate supervision or regulations not keeping up with changing financial landscapes.
- Liquidity must be absorbed, relative prices adjusted, and reliance on indirect monetary tools increased before interest rates are liberalized and quantitative lending restrictions are lifted.
- Monetary policy needs to guard against an excess supply of credit as interest rate constraints are removed. In successful cases of liberalization, credit expansion was mitigated by a deliberate containment of liquidity and increases in real interest rates.
- Interest rate liberalization is a key catalyst in achieving broader reform goals. Market based interest rates enhance competition, efficiency, and risk management. At the same time, implicit guarantees of financial institutions and borrowers should be withdrawn to prevent moral hazard.

Private Credit (percent of GDP)
(T = time of interest rate liberalization, normalized to equal 100)



Real Interest Rates
(In percent; 3 year average, post-interest rate liberalization)



- Strict regulation and proactive supervision is also needed to prevent banks from excessively focusing on building market share to the extent that it undermines their financial rates of return.
- Broader financial development must not run too far ahead of financial reform. This could serve to precipitate an erosion in monetary control and increased pressure on banks. That said, capital market development should not be left too late, as it serves to enhance competition, increase the efficiency of capital allocation, and promote longer-term capital flows.

[1] Staff examined the liberalization experience of several of China's G-20 peers—including Argentina, Australia, Canada, Indonesia, Japan, Korea, Mexico, Turkey and the U.S.—as well as that of the Nordic countries and other emerging markets. In addition, see Reinhart and Rogoff (2008), "Banking Crises: An Equal Opportunity Menace" and IMF (1999), "Sequencing Financial Sector Reforms: Country Experiences and Issues."

A TRANSFORMED GROWTH MODEL

39. ***An Alternative Scenario***. Many of the reforms assumed in this alternative scenario are outlined in the 12th Five-Year Plan. While detail is still lacking as to how such policies will be designed and implemented (particularly those related to financial and corporate sector reform, the medium term fiscal position, and the path for the exchange rate), if fully implemented in a coherent way, such reforms have the potential to successfully lead to a significant transformation in economic incentives and the structure of the Chinese economy. To summarize the potential impact these policy changes may have, an illustrative macroeconomic scenario is described below and quantified in the Table below.

40. ***Household Savings***. A strengthening of the pension and healthcare systems, over time, will lessen the precautionary motive for saving. Lower social contributions and reduced taxation of labor income, an expansion of employment (driven by a shift of production toward more labor and skills-intensive service industries), a more appreciated exchange rate, higher deposit rates, and access to a broader—and higher return—range of savings vehicles will combine to boost household income. As households obtain a larger share of the benefits from economic growth and reduce their need for self-insurance, consumption will begin to rise faster than output and household savings will fall (Box 9).

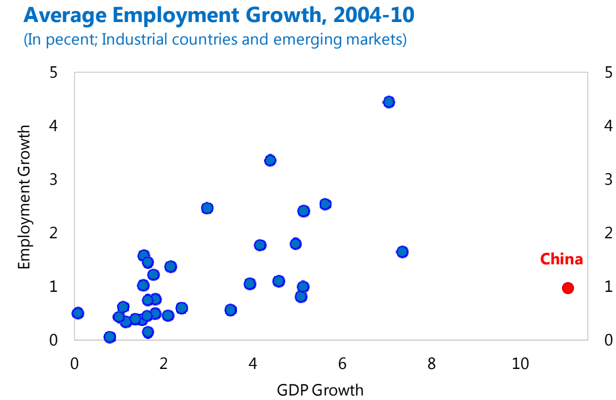
41. ***Corporate Savings***. A higher cost of borrowing, rising wages, a more appreciated currency, a weakening of the oligopoly power of firms in some sectors, and greater market discipline (leading to higher dividend payouts) will all reduce the excess rents currently accruing to firms and lessen corporate saving (Box 10). In addition, as financial development broadens the access to and predictability of corporate financing, smaller companies will reduce their need for precautionary saving to fund future investment projects.

42. ***Investment***. As the cost of capital rises to be more in line with the returns generated from investment, the overall level of capital formation will decline. Gross capital formation will be further lowered by an increase in various other factor costs. At the same time, a more appreciated exchange rate will provide the price incentives necessary to shift investment away from a continued expansion of export capacity and toward sectors that serve the domestic consumer. The net result would be a shift to a more labor-intensive means of production, focused on nontradables and services, with corresponding benefits in terms of lower energy usage, less excess capacity, lower pollution, and higher employment.

43. ***The external imbalance***. The net effect of reforms on the external accounts will imply a steady reduction of the current account surplus. As domestic consumption picks up, the demand for imports will rise and a greater proportion of China's production of tradable goods will be sold into the local market rather than sent abroad. The trade surplus will fall in U.S. dollar terms. In addition, the more appreciated exchange rate will, eventually, lessen the incentives for capital inflows and reduce the pace of reserve accumulation.

44. *Growth and employment*. Over a longer horizon, transformation of the economic model may lead to growth that is modestly lower than the historical performance. However, that growth will be more sustainable, inclusive, and have a bigger positive impact on people's livelihoods. Consumption possibilities will be enhanced, environmental degradation will fall, and the economy will generate far higher levels of job growth. Indeed, over the past decade, under the export-oriented model, employment growth in China has been disappointing relative to international comparators. Over the near term, the shift toward domestic consumption is likely to reduce growth somewhat as the economy adjusts to the various elements of reform and, in particular, as it takes some time to build productivity in the service industries to substitute for lost output in export industries. However, China has the resources and capacity to cope with the implications of such a near-term slowdown.

China's high growth has not been very job-intensive



Illustrative Rebalancing Scenario[1]

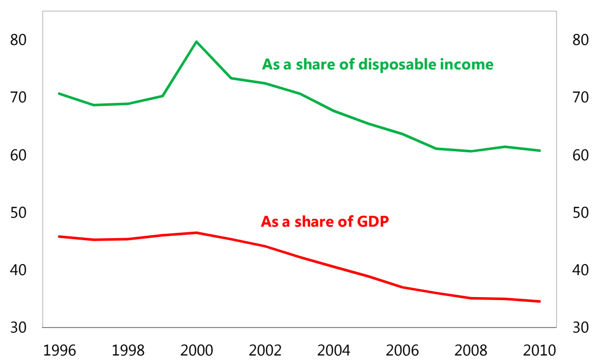
	2010	2011	2012	2013	2014	2015	2016
Real GDP (percent change)	10.3	9.6	9.0	8.4	8.1	8.2	8.5
Consumption (percent change)	8.1	9.5	11.3	13.0	13.7	13.0	12.7
Investment (percent change)	12.0	7.5	7.5	7.4	7.3	7.1	7.6
Net Exports (contribution to growth)	0.8	1.5	0.2	-1.3	-2.1	-2.0	-1.9
Fiscal balance (percent of GDP)	-2.2	-1.6	-1.0	-0.5	-0.4	-0.3	-0.3
Gross national savings (percent of GDP)	54.0	54.0	53.2	51.8	50.1	48.8	47.6
Total capital formation (percent of GDP)	48.8	48.5	47.7	46.9	46.1	45.2	44.5
Current account (percent of GDP)	5.2	5.5	5.5	4.9	4.1	3.6	3.1
International reserves (US$ trillion)	2.9	3.5	4.1	4.6	5.0	5.3	5.5

[1] As discussed in the text, assumes an appreciation of the exchange rate in line with long-run market consensus forecasts, a higher cost of capital, lower labor taxes, improvements in the social safety net, financial liberalization, and an increase in a range of factor costs.

Box 9. Interest Rate Liberalization and Household Saving Behavior

Context. China's urban household saving rate has been rising steadily from around 19 percent of disposable income in 1996 to close to 30 percent in recent years. To rebalance China's economy, it will be essential to arrest this upward trend and create incentives for households to save less. Financial reform and interest rate liberalization offer the potential to contribute to this effort.

Household Consumption
(In percent)

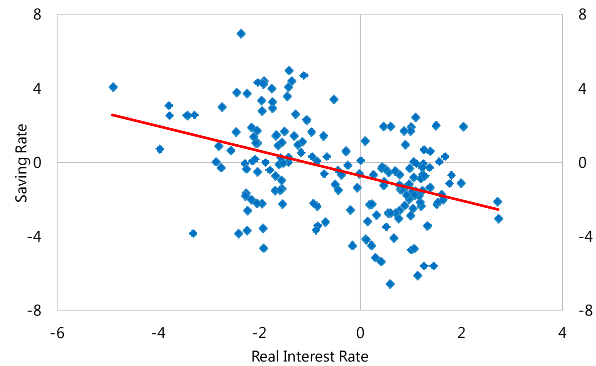


Methodology. To examine the potential impact that financial reform and a higher cost of capital could have on saving behavior, research was undertaken using data from 31 Chinese provinces over the period 1996-2009 to examine the impact of interest rate liberalization on urban household saving rates.[1]

Results. Key results from the analysis include:

- The figure shows the annual deviation of urban saving rates and real interest rates from their province-specific averages during 2003-2009. Urban saving rates tend to fall when real interest rates rise. A one percentage point increase in the real rate of return on bank deposits would lower the urban household saving rate by 0.6 percentage points with the income effect outweighing the substitution effect.
- The response to changes in the real rate of return on savings is largely driven by movements in the interest rates on bank deposits.
- The negative relationship between savings and interest rates has strengthened over the last several years.
- The relationship is robust to the inclusion of variables that proxy for other influences on saving such as life cycle considerations and self-insurance against income volatility.

Deviation from Provincial Average
(In percent, 2003-2009)



Conclusions. China's households save to meet a multiplicity of needs—pensions, health expenditures, purchase of durables and real estate, and to insure against income volatility. Research would suggest that individuals may well behave as if they are targeting a particular absolute level of savings. A rise in real interest rates increases the return on bank deposits and makes it easier for households to achieve this targeted level of savings accumulation. This leads higher deposit rates to reduce the share of disposable income that is saved. If an increase in real deposit rates is combined with other measures to raise household income and change incentives to save, the impact could be even larger.

[1] See M. Nabar, "Financial Development and Household Saving in China," IMF Working Paper (forthcoming).

Box 10. Corporate Investment, Savings, and Financial Reform

Using firm-level data for a panel of over 50 countries the impact of financial sector reform on corporate investment and savings was examined.[1] The results from the panel, cross-country, firm-level data were cross-checked using a similar model estimation but using a panel of cross-country macroeconomic data.

Corporate Investment

- ***Real interest rates*** have a negative impact on investment. At the aggregate level, a 100 basis points increase in real interest rates reduces corporate investment in China by about 0.4 percent of GDP. The effect for China is much larger than the average of the other 52 countries in the panel. The estimated impact of interest rates changes on corporate investment is about half as big when estimated using firm-level data. This could possibly reflect the smaller reliance of this sample (which are large, listed enterprises) on bank-intermediated financing.
- ***Exchange rate appreciation*** also lowers investment. A 10 percent appreciation would reduce total investment by around 1 percent of GDP. The large concentration of manufacturing companies in the firm-level sample means that the estimated impact of exchange rate appreciation from the firm-level data is much larger.
- Indicators of ***capital market development*** suggest more developed financial systems tend to promote higher investment, largely by easing the financing constraints faced by firms.

Estimated Impact on Corporate Investment 1/

	Cross Country	China
Based on Aggregate Panel Data		
Interest Rates	-0.05	-0.40
REER Appreciation	0.12	-0.13
Capital Market Development	+	+
Based on Firm Level Data		
Interest Rates	-2.40	-0.25
REER Appreciation	-0.41	-0.41
Capital Market Development	+	+

1/ Results are from GMM estimates using an unbalanced panel of 52 countries.

Corporate Savings

- At the firm-level, higher ***real interest rates*** appear to reduce corporate saving but there is no significant effect using aggregate data.
- ***Real appreciation*** tends to lower corporate savings in China; a 10 percent appreciation reduces corporate savings by 1 to 3 percent of GDP (depending on the model used).
- ***Capital market development*** appears to raise corporate savings for the listed firms perhaps because it increases profits due to a more efficient allocation of capital. This effect may, however, mask a negative impact that financial development can have on savings of companies that have little access to financing. For smaller firms, with little access to capital markets, financial development could reduce the need for precautionary savings and cash hoarding to finance investment, ultimately lowering savings.

Net Corporate Savings

- Overall, the empirical results suggest that ***financial sector reform***, including raising interest rates, appreciating the real effective exchange rate, and developing the domestic capital market, would lower both investment and corporate savings. An exercise looking at the net savings, though, would suggest that higher interest rates and currency appreciation would tend to reduce the imbalance between corporate savings and investment.

Estimated Impact on Corporate Savings 1/

	Cross Country	China
Based on Aggregate Panel Data		
Interest Rates	…	…
REER Appreciation	-0.03	-0.13
Capital Market Development	+	+
Based on Firm Level Data 2/		
Interest Rates	-3.90	-0.10
REER Appreciation	-1.13	-0.27
Capital Market Development	+	+
Based on Firm Level Data 3/		
Interest Rates	-6.89	-0.61
REER Appreciation	-1.58	-0.36
Capital Market Development	…	+

1/ Results are from GMM estimates using an unbalanced panel of 52 countries.
2/ Uses data on gross savings.
3/ Uses data on net savings.

[1] See N. Geng and P. N'Diaye, "Financial Development, Corporate Investment and Savings in China," IMF Working Paper (forthcoming).

SPILLOVERS TO THE GLOBAL ECONOMY

45. ***Rebalancing***. If China were to successfully transform its economy, giving greater prominence to private consumption and services, there would undoubtedly be significant positive external spillovers to the rest of the world. Staff analysis suggests that currency appreciation alone would yield only limited benefits. A more comprehensive transformation—as described in the scenario above where appreciation is accompanied by significant systemic reform—would increase output especially for those countries within China's supply chain (mainly emerging Asia) and commodity exporters. There would be a more limited effect, though still positive, on the large advanced economies.

Growth Impact (In percent)

	20 percent RMB appreciation	20 percent RMB appreciation plus other reforms for rebalancing
China	-8.8 to -2.0	-2.0 to 1.0
U.S.	0.05 to 0.07	< 0.15
Euro Area	< 0.12	<0.21
Japan	0.07 to 0.30	0.10 to 0.30
U.K.	< 0.5	< 0.1
EM Asia	0.25 to 0.33	0.25 to 1.0
Commodity producers	< 0.3	< 0.3

Based on input-output model, GVAR, and GIMF

Current Account Impact (In percent of GDP)

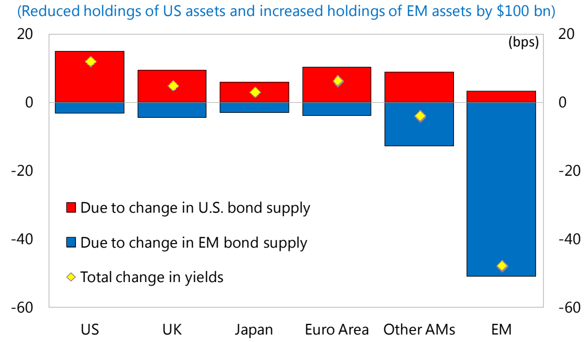
	20 percent RMB appreciation	20 percent RMB appreciation plus other reforms for rebalancing
China	-0.7 to -2.9	-0.7 to -5.2
U.S.	0.02 to 0.08	0.02 to 0.25
Euro Area	0.05 to 0.1	0.10 to 0.19
Japan	0.04 to 0.11	0.04 to 0.11
U.K.	0.05	0.11
EM Asia	-0.31 to 0.30	-0.76 to 0.31
Commodity producers	-0.2 to 0.11	-0.01 to 0.31

Based on input-output model, and GIMF

46. ***Continuing the existing model***. On the other hand, failing to rebalance China's economy could lead to excess capacity in many of China's industries. This would necessitate that China continues to build global market share in a range of products in order to maintain its high growth rates and deploy its growing capacity in heavy industry and manufacturing. Such unprecedented gains in global market share would inflame concerns that China's comparative advantage unfairly rests on low and distorted cost structures, inviting trade tensions. It may also increase the risks of a disruption in China itself with significant negative spillover effects to the rest of the world. If such a disruption were realized, the resulting sharp slowdown in China would significantly reduce prices for a range of commodities, (especially metals, raw materials, and energy) and have negative consequences for the global economy.

47. ***Financial spillovers***. Despite its closed capital account, China does have an impact on global asset prices and flows. China's rising foreign exchange holdings—which are expected to continue to increase in both the baseline and rebalancing scenarios—support the prices of reserve currency assets. China's impact on global financial markets will certainly change as financial reform proceeds, the currency is internationalized, and financial opening gives rise to two-way, non-official capital flows. Even a gradual portfolio shift by China, away from U.S. Treasuries to emerging market assets, would raise long term yields in the U.S. and other advanced countries and sharply reduce emerging market yields.

Impact on Yields of Portfolio Reallocation in China
(Reduced holdings of US assets and increased holdings of EM assets by $100 bn)



Source: Background paper, "Potential Impact on Global Bond Markets of Reallocating China's International Reserves"

STAFF APPRAISAL

48. ***Outlook***. As the government stimulus winds down, there is an ongoing hand-off to private sector-led activity. Staff continues to forecast near-term growth in the 9–10 percent range. At the same time, staff expect CPI inflation, on a year-on-year basis, to fall to around 4 percent by end-year, albeit with some upside risk to this forecast.

49. ***Risks***. Aside from the global environment and the potential for domestic supply shocks that reinvigorate food price inflation, China also faces important domestic risks. First, the fundamental drivers of rising house prices remain in place. Second, the expansion in bank lending over the past few years is likely to lead to a decline in credit quality that will need to be handled proactively and carefully. Third, the rise in nonbank intermediation and the increasing sophistication of local capital markets has the potential to undermine China's levers for macroeconomic control.

50. ***Property***. Vigorous growth, low returns on bank deposits, and an ongoing process of urbanization will all support demand for housing. Administrative measures to slow property price inflation have helped but any durable solution that prevents property price bubbles in China will need to involve a significantly higher cost of capital, the development of financial instruments and markets (to deepen the availability of alternative household savings vehicles), and an increase in the carrying cost for property through higher real estate taxation.

51. ***Local government financing vehicles***. The expansion in lending to local governments represents a tangible near-term risk. The accounting for these liabilities should be quickly brought to a close with comprehensive disclosure and transparency on the scale and nature of such lending. Banks should fully account for the underlying risks of such loans, with appropriate provisioning and risk weighting.

52. ***Monetary policy***. While the central bank's monetary goals are the right ones, the means by which these targets are being achieved is moving in the wrong direction, relying on an increasingly complicated array of tools and administrative controls that will be difficult to effectively sustain. The dynamically differentiated reserve requirement adds to the complexity of the current monetary framework and moves away from a more market-based system for monetary policy. The central bank should, instead, rely more on higher interest rates and open market operations. This would improve the monetary transmission mechanism, simplify policies, simultaneously influence the cost of both bank and nonbank financing alike, and create fewer incentives for disintermediation. Such a policy shift would lay the groundwork for broader financial market liberalization and reform.

53. ***Exchange rate***. A stronger renminbi is in China's own interest and an important component in accelerating the transformation of China's economic growth model toward one that is more reliant on private consumption. An appreciation of the exchange rate will facilitate progress in a number of other areas including financial sector reform, a more independent monetary policy, increasing household disposable income, and developing the service sector.

54. ***Cross-border renminbi***. The expansion in renminbi trade settlement and the growing pace of development of renminbi markets and financial products in Hong Kong SAR are impressive achievements. The trend toward a more international renminbi is a positive one and a natural direction given China's economic importance. However, the current trajectory remains extremely one-sided. As this process evolves, it will be important to ensure that the expansion of cross-border renminbi does not prematurely undermine the capital control regime or create arbitrage opportunities between onshore and offshore markets before China is ready to move to greater capital account convertibility.

55. ***Imbalances***. Despite the commendable efforts to strengthen the social safety net, raise disposable income, and realign some factor costs, the post-crisis decline in the current account surplus has moved into reverse. This is a product of both the recovery in the global economy and a slowing of China's infrastructure stimulus. Under current policies and assuming a constant real exchange rate, the current account surplus is expected to rise to around 7½ percent of GDP over the medium-term.

56. ***Economic transformation***. The key policy challenge ahead, therefore, will be to accelerate the ongoing transformation of China's economic model to one of more inclusive growth, more linked to domestic consumption, and less reliant on exports and high levels of investment. The 12th Five-Year Plan recognizes that such a transformation will require efforts in multiple areas and outlines a high-level strategy to achieve those goals. All the essential ingredients for reform are included in this plan and, if successfully and expeditiously implemented, this policy platform has the potential to address the imbalances and tensions in China's current growth model.

57. ***Financial reform***. Financial reform will be indispensable in this economic transformation. The current system of financial intermediation poses an obstacle to the goals of ensuring a smooth rebalancing of the economic growth model and building a more inclusive economy that is focused on improving people's livelihoods. The financial system works as an implicit tax on household savings which is then used to subsidize corporate investment and sterilized intervention. A carefully designed approach to financial liberalization and reform would serve to increase household income, lessen both corporate and household savings, and improve the efficiency of investment. In addition, financial reform will help mitigate the risk of asset bubbles and enhance monetary policy transmission.

58. ***Policies***. Financial liberalization and reform will require several elements. The current framework for monetary and exchange rate management will need to be changed, and at an early stage, and the liquidity overhang currently in the financial system will need to be absorbed. This should be accompanied by a strengthening of regulation and supervision, improved financial stability monitoring, and proper development of non-bank channels for financial intermediation. Once such reforms are well advanced, China will be able to fully liberalize deposit and loan rates and move to a system where all interest rates and asset prices are market-determined and achieve capital market clearing. This would facilitate China's full integration into global capital markets, with the capital account open and the renminbi made fully convertible.

59. ***Final thoughts***. Successfully designing and implementing the broad set of policies discussed in this report—to strengthen the social safety net, raise household income, liberalize the financial system, appreciate the exchange rate, and increase the costs of various inputs to production—will have a sweeping impact on the Chinese economy. This will pave the way to improved living standards and a better distribution of economic gains. Such a reform program is very much in line with China's own policy goals and will have a positive impact on China's trading partners, constituting China's critical contribution toward strong, sustained, and balanced global growth.

60. It is proposed that the next Article IV Consultation with China takes place on the standard 12-month cycle.

Table 1. China: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	12.7	14.2	9.6	9.2	10.3	9.6	9.5
Total domestic demand	11.5	12.7	9.7	14.2	10.0	8.5	9.0
Consumption	9.8	11.1	8.6	8.4	8.1	9.5	9.6
Investment	13.6	14.7	11.0	20.8	12.0	7.5	8.3
Fixed	12.8	13.5	9.7	24.5	11.8	7.9	8.7
Inventories 1/	0.6	0.8	0.8	-0.8	0.3	0.0	0.0
Net exports 1/	2.0	2.5	0.8	-3.7	0.8	1.5	1.1
Consumer prices							
End of period	2.0	6.6	2.5	0.7	4.7	4.0	3.0
Average	1.5	4.8	5.9	-0.7	3.3	4.7	3.3
Unemployment rate (annual average)	4.1	4.0	4.2	4.3	4.1	4.0	4.0
	(In percent of GDP)						
External debt and balance of payments							
Current account	8.6	10.1	9.1	5.2	5.2	5.5	6.0
Trade balance	8.0	9.0	8.0	5.0	4.3	4.6	5.1
Exports of goods	35.7	34.9	31.7	24.1	26.9	30.2	31.8
Imports of goods	27.7	25.9	23.8	19.1	22.6	25.5	26.7
Gross external debt	12.5	11.1	8.6	8.6	9.3	10.1	11.5
Saving and investment							
Gross domestic investment	43.0	41.7	44.0	48.2	48.8	48.5	48.5
National saving	51.6	51.9	53.2	53.5	54.0	54.0	54.5
Government	7.7	8.8	8.4	6.2	6.9	6.5	7.3
Non-government	43.9	43.0	44.8	47.3	47.1	47.5	47.2
Public sector finance							
Central government gross debt	16.2	19.6	17.0	17.7	17.0	16.5	15.4
General government balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7
	(Annual percentage change)						
Real effective exchange rate 2/	1.6	4.0	9.2	3.3	-0.5	...	...

Sources: CEIC Data Co., Ltd.; and staff estimates and projections.
1/ Contribution to annual growth in percent.
2/ Percentage change of annual average.

Table 2. China: Balance of Payments

(In billions of U.S. dollars, unless otherwise noted)

	2006	2007	2008	2009	2010	2011	2012
Current account balance	232.8	353.9	412.4	261.0	305.3	376.9	455.5
Trade balance	217.8	315.4	360.7	249.5	254.2	317.3	388.9
Exports	969.7	1,220.0	1,434.6	1,203.8	1,581.4	2,066.1	2,414.3
Imports (BOP basis)	751.9	904.6	1,073.9	954.3	1,327.2	1,748.8	2,025.4
Services	-8.8	-7.9	-11.8	-29.4	-22.1	-31.0	-33.6
Income	-5.4	7.8	17.7	7.2	30.3	40.6	44.7
Current transfers	29.2	38.6	45.8	33.7	42.9	50.0	55.4
Capital and financial account balance	52.8	95.2	46.3	180.9	225.9	228.7	200.8
Capital account	4.0	3.1	3.0	4.0	4.6	3.6	3.6
Financial account	48.8	92.1	43.3	176.9	221.3	225.0	197.2
Net foreign direct investment	102.9	143.1	121.6	70.3	124.9	125.7	112.0
Portfolio investment	-67.5	18.7	42.6	38.7	24.1	25.1	26.3
Other investment	13.4	-69.7	-120.9	67.9	72.3	74.2	58.9
Errors and omissions 1/	-0.8	11.6	20.8	-43.5	-59.5	0.0	0.0
Overall balance	284.8	460.7	479.5	398.4	471.7	605.6	656.3
Reserve assets	-284.8	-460.7	-479.5	-398.4	-471.7	-605.6	-656.3
Memorandum items:							
Current account, as percent of GDP	8.6	10.1	9.1	5.2	5.2	5.5	6.0
Export growth (value terms)	27.2	25.8	17.6	-16.1	31.4	30.6	16.9
Import growth (value terms)	19.7	20.3	18.7	-11.1	39.1	31.8	15.8
FDI (inward), as a percent of GDP	4.6	4.6	3.9	2.3	3.1	2.8	2.4
External debt 2/	338.6	389.2	390.2	428.7	548.9	693.8	873.2
As a percent of GDP	12.5	11.1	8.6	8.6	9.3	10.1	11.5
Short-term external debt (remaining maturity) 2/	199.2	235.7	226.3	259.3	375.7	498.5	655.2
Gross reserves 3/	1,072.6	1,534.4	1,953.3	2,425.9	2,875.9	3,481.5	4,137.7
As a percent of ST debt by remaining maturity	538.4	651.0	863.2	935.7	765.5	698.3	631.5
Real effective exchange rate (1990 = 100)	92.0	95.7	104.5	107.9	107.4	...	...
Net international investment position	640.2	1,188.1	1,493.8	1,510.7	1,790.7	...	...
In percent of GDP	23.6	34.0	33.0	30.3	30.5	...	...
Nominal GDP	2,712.9	3,494.2	4,520.0	4,990.5	5,878.3	6,850.3	7,585.5

Sources: CEIC Data Co., Ltd.; and IMF staff estimates.
1/ Includes counterpart transaction to valuation changes.
2/ Data provided by the Chinese authorities unless otherwise indicated.
3/ Includes gold.

Table 3. China: Indicators of External Vulnerability

	2004	2005	2006	2007	2008	2009	2010
Monetary and financial indicators							
Central government debt (official data; in percent of GDP)	18.5	17.6	16.2	19.6	17.0	17.7	17.0
Broad money (M2: annual percentage change)	14.9	16.3	17.0	16.7	17.8	28.4	18.9
Foreign currency deposits to broad money (percent)	5.0	4.4	3.6	2.9	2.6	2.3	2.1
Credit (annual percentage change)	14.5	13.0	15.1	16.1	18.7	31.7	19.9
Foreign currency loans to credit to the economy (in percent)	...	...	4.5	4.7	4.4	5.2	5.1
Stock exchange index (end-of-period, December 19, 1990 = 100) 1/	1,330	1,221	2,815	5,521	1,912	3,437	2,940
Stock exchange capitalization (percent of GDP)	23.4	24.5	48.9	130.2	46.0	81.1	77.4
Number of listed companies (A-share)	1,349	1,355	1,398	1,507	1,581	1,678	2,041
Balance of payments indicators							
Exports (annual percentage change, U.S. dollars)	35.4	28.5	27.2	25.8	17.6	-16.1	31.4
Imports (annual percentage change, U.S. dollars)	-35.8	-17.6	-19.7	-20.3	-18.7	11.1	-39.1
Current account balance (percent of GDP)	3.6	5.9	8.6	10.1	9.1	5.2	5.2
Capital and financial account balance (percent of GDP)	5.7	4.5	1.9	2.7	1.0	3.6	3.8
Of which : gross foreign direct investment inflows	2.8	5.2	4.6	4.6	3.9	2.3	3.1
Reserve indicators							
Gross reserves (billions of U.S. dollars) 3/	618.6	825.6	1,072.6	1,534.4	1,953.3	2,425.9	2,875.9
Gross reserves to imports of GNFS (months)	10.4	11.6	12.4	14.9	21.1	19.1	17.2
Gross reserves to broad money (M2) (percent)	20.1	22.9	24.7	28.9	28.6	27.3	29.4
Gross reserves to short-term external debt by remaining maturity (percent)	445.9	481.0	538.4	651.0	863.2	935.7	765.5
Gross reserves to proposed new IMF metric (percent) 4/	140.2	155.2	165.3	190.5	200.1	208.2	200.9
External debt and balance sheet indicators							
Total external debt (percent of GDP)	13.6	13.1	12.5	11.1	8.6	8.6	9.3
Total external debt (billions of U.S. dollars) 2/	263.0	296.6	338.6	389.2	390.2	428.7	548.9
Of which : public and publicly guaranteed debt 5/	33.6	33.0	34.4	34.9	33.3	36.9	38.8
Banking sector debt	97.6	101.9	120.0	126.6	126.3	132.4	183.5
Short-term external debt by original maturity (billions of U.S. dollars)	138.7	171.6	199.2	235.7	226.3	259.3	375.7
Net foreign assets of banking sector (billions of U.S. dollars)	85.5	108.2	161.4	190.1	251.0	204.5	171.3
Total debt to exports of GNFS (percent)	40.1	35.4	31.9	29.0	24.7	32.1	31.3
Total debt service to exports of GNFS (percent) 6/	21.9	21.1	19.3	17.9	14.6	19.8	21.7
Of which : Interest payments to exports of GNFS (percent) 6/	0.8	0.6	0.5	0.4	0.3	0.4	0.3
Bond spread (EMBI China, end of period, basis points)	58.0	57.0	68.0	51.0	120.0	228.0	64.0
Foreign-currency sovereign bond ratings							
Moody's	A2	A2	A2	A2	A1	A1	A1
Standard and Poor's	BBB	BBB+	A-	A	A	A	A
Memorandum items:							
International investment position	276.4	407.7	640.2	1,188.1	1,493.8	1,510.7	1,790.7
Nominal GDP (billions of U.S. dollars)	1,931.6	2,256.9	2,712.9	3,494.2	4,520.0	4,990.5	5,878.3
Exports of GNFS (billions of U.S. dollars)	655.8	836.9	1,061.7	1,342.2	1,581.7	1,333.3	1,752.6
Real effective exchange rate (annual percentage change)	-3.1	-1.0	1.6	4.0	9.2	3.3	-0.5

Sources: CEIC Data Co.; and IMF staff estimates.
1/ Shanghai Stock Exchange, A-share.
2/ Data provided by the Chinese authorities.
3/ Includes gold.
4/ Metric proposed in "Assessing Reserve Adequacy," IMF Policy Paper (February 2011); the suggested adequacy range is 100-150 percent.
5/ Debt of banking sector not included.
6/ IMF staff estimates.

Table 4. China: Monetary Developments

	2007	2008	2009	2010	2011			
					Jan	Feb	Mar	Apr
Net foreign assets	13,775	17,897	19,853	22,604	22,968	23,152	23,526	23,709
Net domestic assets	26,569	29,620	40,769	49,981	...	...	...	...
Domestic credit 1/	33,966	37,938	49,589	58,732	59,422	59,917	61,106	61,089
Net credit to government	2,821	2,943	3,229	3,460	3,242	2,959	3,190	2,802
Credit to non-government	31,145	34,994	46,360	...	56,180	56,958	...	...
Other items, net 1/	1,128	767	107	-1,188	-1,709	-1,450	-2,437	-2,431
Broad money	40,344	47,517	61,022	72,585	73,388	73,613	75,813	75,738
Reserve money	10,155	12,922	14,399	18,531	19,408	19,123	19,257	19,331
Of which:								
Required reserves	5,409	6,614	8,520	12,262	...	...	...	...
Excess reserves	1,432	2,596	1,723	1,404	...	...	...	...
Net foreign assets of PBC	12,388	16,181	18,457	21,470	21,608	21,807	22,170	22,401
Net domestic assets of PBC	-2,233	-3,259	-4,059	-2,939	...	...	...	...
Net foreign assets 2/	10.7	10.2	4.1	...	5.0	5.0	...	...
Net domestic assets	8.6	11.5	37.6	...	...	...	...	...
Domestic credit 3/	17.6	11.7	30.7	...	18.0	16.9	...	...
Of which: loans	19.3	14.0	34.2	19.4	...	...	...	...
Other items, net 2/ 3/	5.3	-0.9	-1.4	...	-0.9	-0.4	...	...
Broad money 4/	16.7	17.8	27.7	19.7	17.2	15.7	16.6	15.3
Including foreign currency deposits	15.9	17.4	27.3	...	...	...	...	...
M1 4/	21.0	9.1	32.4	21.2	13.6	14.5	15.0	12.9
M0 4/	12.1	12.7	11.8	16.7	42.5	10.3	14.8	14.7
Quasi money	14.3	23.2	25.2	18.9	19.3	16.4	17.5	16.7
Reserve money	30.6	27.3	11.4	28.7	4.7	-1.5	0.7	0.4
Net foreign assets of PBC 5/	45.5	30.2	14.0	16.2	2.1	1.1	1.7	1.3
Net domestic assets of PBC 5/	-215.1	-45.9	-24.5	27.6	...	...	...	...
Reserve ratios 6/								
Required reserves	14.5	15.0	15.0	18.0	18.5	19.0	19.5	20.0
Excess reserves	3.3	5.1	3.1	2.0	...	...	...	...
Memorandum items:								
Money multiplier	4.0	3.7	4.2	3.9	3.8	3.8	...	...
Forex deposits of residents (US$ billion)	159.9	179.1	208.9	228.7	225.0	228.6	236.9	238.0
In percent of total deposits	2.9	2.6	2.3	...	...	...	...	...
Forex loans of residents (US$ billion)	219.8	243.7	379.5	453.4	463.6	468.8	477.5	485.1

Sources: CEIC Data Co., Ltd.; and IMF staff calculations.
1/ Includes foreign currency operations of domestic financial institutions and domestic operations of foreign banks. In addition, some items were moved from "other items net" to "net credit to government."
2/ Twelve-month change as percent of beginning-period stock of monetary liabilities.
3/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.
4/ The growth rates are based on official announcements, which correct for the definitional changes in the series.
5/ Twelve-month change as a percent of beginning-period reserve money stock.
6/ In percent of total bank deposits.

Table 5. China: General Government Budgetary Operations

	2006	2007	2008	2009	2010	2011	2012
			(In billions of RMB)				
Revenue	3,944	5,262	6,173	6,821	8,103	9,449	11,075
Tax revenue	3,480	4,562	5,422	5,952	7,320	8,543	10,057
Taxes on income and profits	954	1,196	1,490	1,549	1,768	2,148	2,566
Taxes on goods and services	1,980	2,426	2,819	3,226	3,832	4,452	5,155
Other taxes (residual)	424	745	784	905	1,201	1,354	1,623
Nontax revenue (residual)	464	700	750	869	783	906	1,018
Expenditure	4,090	5,023	6,294	7,875	8,993	10,163	11,448
Primary	3,993	4,917	6,164	7,726	8,808	9,960	11,224
Interest	98	105	131	149	185	203	224
Overall balance	-146	239	-122	-1,054	-889	-714	-373
Financing	146	-239	122	1,054	889	714	373
Domestic	153	-239	122	1,054	889	714	373
External	-6	0	0	0	0	0	0
Privatization and other	0	0	0	0	0	0	0
Memo: Authorities' definition							
Revenue	3,876	5,132	6,133	6,852	8,308	9,429	11,055
Expenditure	4,042	4,978	6,259	7,630	8,958	10,128	11,413
Overall balance 1/	-216	51	-35	-950	-1,000	-699	-358
			(In percent of GDP)				
Revenue	18.2	19.8	19.7	20.0	20.4	20.9	21.8
Tax revenue	16.1	17.2	17.3	17.5	18.4	18.9	19.8
Taxes on income and profits	4.4	4.5	4.7	4.5	4.4	4.7	5.0
Taxes on goods and services	9.2	9.1	9.0	9.5	9.6	9.8	10.1
Other taxes (residual)	2.0	2.8	2.5	2.7	3.0	3.0	3.2
Nontax revenue (residual)	2.1	2.6	2.4	2.5	2.0	2.0	2.0
Expenditure	18.9	18.9	20.0	23.1	22.6	22.4	22.5
Primary	18.5	18.5	19.6	22.7	22.1	22.0	22.1
Interest	0.5	0.4	0.4	0.4	0.5	0.4	0.4
Overall balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7
Financing	0.7	-0.9	0.4	3.1	2.2	1.6	0.7
Domestic	0.7	-0.9	0.4	3.1	2.2	1.6	0.7
External	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization and other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Lending / Borrowing	0.7	-0.9	0.4	3.1	2.2	1.6	0.7
Change in Debt	1.9	1.7	0.3	4.3	3.0	2.3	1.4
Change in Deposits	1.2	2.6	-0.1	1.3	0.8	0.7	0.7
Other flows / valuation changes	-0.8	4.7	0.0	-2.3	-1.2	-0.7	-0.7
Memorandum items:							
Debt 2/	16.2	19.6	17.0	17.7	17.0	16.5	15.4
Domestic	15.9	19.4	16.8	17.5	16.8	16.4	15.3
External	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Cyclically adjusted balance							
(percent of potential GDP)	-0.6	0.3	-0.9	-3.4	-2.5	-1.8	-0.8
Nominal GDP (RMB billion)	21,631	26,581	31,405	34,090	39,798	45,297	50,894

Sources: CEIC Data Co., Ltd.; and IMF staff estimates.
1/ Includes net allocations to stabilization fund.
2/ Central government.

Table 6. China: Illustrative Medium-Term Scenario 1/

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
					(Percent change)						
Real GDP	12.7	14.2	9.6	9.2	10.3	9.6	9.5	9.5	9.5	9.5	9.5
Total domestic demand	11.5	12.7	9.7	14.2	10.0	8.5	9.0	8.9	8.9	8.8	8.9
Consumption	9.8	11.1	8.6	8.4	8.1	9.5	9.6	9.6	9.5	9.4	9.4
Investment	13.6	14.7	11.0	20.8	12.0	7.5	8.3	8.2	8.2	8.2	8.2
Fixed	12.8	13.5	9.7	24.5	11.8	7.9	8.7	8.6	8.5	8.5	8.5
Inventories 2/	0.6	0.8	0.8	-0.8	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 2/	2.0	2.5	0.8	-3.7	0.8	1.5	1.1	1.2	1.3	1.3	1.3
Consumer prices (average)	1.5	4.8	5.9	-0.7	3.3	4.7	3.3	3.0	3.0	3.0	3.0
					(In percent of GDP)						
Total capital formation	43	41.7	44.0	48.2	48.8	48.5	48.5	47.9	47.4	47.0	46.6
Gross national saving	52	51.9	53.2	53.5	54.0	54.0	54.5	54.4	54.2	54.2	54.1
Fiscal balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7	0.0	0.1	0.2	0.2
Revenue	18.2	19.8	19.7	20.0	20.4	20.9	21.8	22.5	22.6	22.7	22.7
Expenditure	18.9	18.9	20.0	23.1	22.6	22.4	22.5	22.5	22.5	22.5	22.5
Current account balance	8.6	10.1	9.1	5.2	5.2	5.5	6.0	6.5	6.9	7.3	7.5
					(In billions of U.S. dollars)						
Current account balance	233	354	412	261	305	377	455	545	644	758	865
Trade balance	218	315	361	250	254	317	389	447	539	614	701
Exports	970	1,220	1,435	1,204	1,581	2,066	2,414	2,775	3,206	3,677	4,221
(Percent change)	27	26	18	-16	31	31	17	15	16	15	15
Imports	752	905	1,074	954	1,327	1,749	2,025	2,327	2,667	3,063	3,520
(Percent change)	20	20	19	-11	39	32	16	15	15	15	15
Capital and financial account, net	53	95	46	181	226	229	201	171	144	122	105
Capital account	4	3	3	4	5	4	4	4	4	4	4
Direct investment, net	103	143	122	70	125	126	112	99	86	73	60
Portfolio investment, net	-68	19	43	39	24	25	26	27	28	30	32
Other investment, net	13	-70	-121	68	72	74	59	41	26	15	9
Errors and omissions	-1	12	21	-44	-60	0	0	0	0	0	0
Change in reserves (- indicates increase)	-285	-461	-480	-398	-472	-606	-656	-716	-788	-880	-970
Memorandum item:											
Nominal GDP (in billions of yuan)	21,631	26,581	31,405	34,090	39,798	45,297	50,894	57,301	64,540	72,487	81,391
GDP Deflator (2010 = 100)	84	88	95	96	100	104	107	110	113	116	119
Gross reserves (USD billion)	1,073	1,534	1,953	2,426	2,876	3,481	4,138	4,854	5,642	6,522	7,492

Sources: CEIC Data Co., Ltd.; and IMF staff estimates and projections.

1/ Following convention, the scenario assumes a constant real exchange rate and a continuation of the current policy framework.

2/ Contribution to annual growth in percent.

Table 7. China: Public Sector Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	2007	2008	2009	2010			2011	2012	2013	2014	2015	2016
							I. Baseline Projections					
Public sector debt 1/	19.6	17.0	17.7	17.0			16.5	15.4	13.7	12.1	10.6	9.3
Of which: foreign-currency denominated	0.2	0.2	0.1	0.1			0.1	0.1	0.1	0.1	0.1	0.1
Change in public sector debt	3.4	-2.6	0.7	-0.7			-0.5	-1.1	-1.7	-1.6	-1.5	-1.3
Identified debt-creating flows (4+7+12)	-3.9	-2.6	1.8	-0.3			-0.5	-1.1	-1.7	-1.6	-1.5	-1.3
Primary deficit	-1.3	0.0	2.7	1.8			1.1	0.3	-0.4	-0.4	-0.5	-0.5
Revenue and grants	19.8	19.7	20.0	20.4			20.9	21.8	22.5	22.6	22.7	22.7
Primary (noninterest) expenditure	18.5	19.6	22.7	22.1			22.0	22.1	22.1	22.2	22.2	22.2
Automatic debt dynamics 2/	-2.6	-2.6	-0.9	-2.1			-1.6	-1.4	-1.3	-1.2	-1.0	-0.9
Contribution from interest rate/growth differential 3/	-2.6	-2.6	-0.9	-2.1			-1.6	-1.4	-1.3	-1.2	-1.0	-0.9
Of which: contribution from real interest rate	-0.7	-1.0	0.5	-0.5			-0.2	0.0	0.0	0.0	0.0	0.0
Of which: contribution from real GDP growth	-1.9	-1.6	-1.4	-1.6			-1.4	-1.4	-1.3	-1.2	-1.0	-0.9
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Denominator = 1+g+p+gp	1.2	1.2	1.1	1.2			1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2–3)	7.3	0.0	-1.0	-0.4			0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	99	86	88	83			79	71	61	54	47	41
Gross financing need 5/	1.2	2.6	5.3	4.3			3.6	2.7	1.8	1.5	1.2	1.0
In billions of U.S. dollars	43	117	263	255			249	205	154	143	129	122
					10-Year Historical Average	10-Year Standard Deviation						
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	14.2	9.6	9.2	10.3	10.9	2.1	9.6	9.5	9.5	9.5	9.5	9.5
Average nominal interest rate on public debt (in percent) 6/	3.0	2.5	2.8	3.1	3.4	1.2	3.0	3.0	3.0	3.0	3.0	3.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.6	-5.3	3.4	-2.8	-0.3	3.9	-0.9	0.4	0.2	0.2	0.4	0.4
Inflation rate (GDP deflator, in percent)	7.6	7.8	-0.6	5.8	3.7	3.3	3.9	2.6	2.8	2.8	2.6	2.6
Growth of real primary spending (deflated by GDP deflator, in percent)	14.5	16.3	26.1	7.7	14.4	5.1	8.9	9.9	9.8	9.8	9.7	9.6
Primary deficit	-1.3	0.0	2.7	1.8	1.1	1.2	1.1	0.3	-0.4	-0.4	-0.5	-0.5
							II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios												
A1. Key variables are at their historical averages in 2011–16 7/							16.4	15.9	15.4	15.0	14.7	14.3
A2. No policy change (constant primary balance) in 2011–16							17.1	17.5	17.8	18.0	18.3	18.5
A3. Contingent debt recognized in 2011 8/							84.6	76.0	67.5	59.9	53.2	47.2
B. Bound tests												
B1. Real interest rate is at baseline plus one standard deviations							16.8	16.0	14.5	13.1	11.7	10.5
B2. Real GDP growth is at baseline minus one-half standard deviation							16.8	16.3	15.3	14.6	14.1	13.9
B3. Primary balance is at baseline minus one-half standard deviation							17.1	16.6	15.4	14.3	13.2	12.3
B4. Combination of B1-B3 using one-quarter standard deviation shocks							17.0	16.4	15.2	13.9	12.8	11.7
B5. One time 30 percent real depreciation in 2011 9/							16.6	15.5	13.8	12.2	10.7	9.3
B6. 10 percent of GDP increase in other debt-creating flows in 2011							26.5	24.6	22.1	19.8	17.6	15.7

1/ Coverage of public sector refers to gross debt of the budgetary central government.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Coverage of public sector refers to gross debt of the budgetary central government and contingent liabilities. The latter includes estimated current and future losses related to NPLs, unfunded pension liabilities, and AMC losses. All outstanding and future contingent liabilities are assumed to be recognized in 2011 (the NPV of this contingent debt is added to the 2011 debt stock as a one-time adjustment; no additional losses are built into the forecast horizon).
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

July 11, 2011

Supplementary Information

Approved By
Anoop Singh and Tamim Bayoumi

Prepared by
Asia and Pacific Department

The following information has become available since the preparation of the staff report. This does not alter the thrust of the staff appraisal.

1. Inflation. Consumer prices rose in June largely owing to higher food prices, in particular pork. The June outturn is in line with staff forecasts. However, if this strong momentum in pork prices is sustained, inflation could end the year modestly above staff forecasts.

Inflation (y/y, in percent)

	2009	2010	2011 May	2011 June
CPI	0.7	4.7	5.5	6.4
PPI	-2.1	5.7	6.8	7.1

2. Trade. The trade surplus rebounded in June to a seven-month high (US$22 billion). Both exports and imports were below staff's June forecast although the trade surplus was modestly higher.

3. Monetary Policy. The People's Bank of China increased loan and deposit rates by 25 basis points effective July 7, the third such increase this year.

4. Tax Reform. In an effort to raise household income, the government increased the personal income tax threshold to RMB 3,500 (up from RMB 2,000) effective September 1. The tax rate for those with incomes between RMB 3,500 to RMB 4,500 will decline to 3 percent (compared with 5 percent previously). This new threshold will reduce the number of households paying income tax by 60 million (to 24 million).

5. Local Government Debt. The National Audit Office published data showing at end-2010 local government debts were RMB 10.7 trillion (or 27 percent of 2010 GDP). Around one-half of these debts were incurred by local government financing vehicles (LGFVs) and used to finance activities in the construction and transportation sectors and acquire land.

Local Government (LG) Debt (end-2010)

	Total	Borrowed	Guaranteed	LG-related institutions
		(In RMB trillions)		
LG debt	10.7	6.7	2.3	1.7
o/w LGFVs	5.0	3.1	0.8	1.0
		(In percent of GDP)		
LG debt	27.0	16.9	5.8	4.3
o/w LGFVs	12.5	7.9	2.1	2.5

Source: National Audit Office report; and staff calculations.

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 27, 2011

Prepared By

The Asia and Pacific Department
(In consultation with other departments)

CONTENTS

ANNEX I. FUND RELATIONS

(As of April 30, 2011)

I. Membership Status: Joined 12/27/45; Article VIII (December 1, 1996)

II. General Resources Account:

	SDR Million	% Quota
Quota	9,525.90	100.00
Fund holdings of currency	7,143.55	74.99
Reserve position in Fund	2,382.40	25.01
Lending to the Fund		
New Arrangements to Borrow	3,700.00	

III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	6,989.67	100.00
Holdings	7880.35	112.74

IV. Outstanding Purchases and Loans:

None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	11/12/86	11/11/87	597.73	597.73

VI. Projected Payments to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.00	0.09	0.09	0.09	0.09
Total	0.00	0.09	0.09	0.09	0.09

VII. Exchange Arrangements:

China's exchange rate regime has been classified as a crawl-like arrangement since June 21, 2010. De jure classification of the exchange rate is managed floating. On July 21, 2005, the People's Bank of China (PBC) announced that the exchange rate of the renminbi against the U.S. dollar would be revalued upward by about 2.1 percent (from RMB 8.28/US$ to RMB 8.11/US$) and the exchange rate regime would move to a managed float in which renminbi's value is set with reference to a basket of currencies. The stated intention of the Chinese authorities was to increase the flexibility of the renminbi's exchange rate. The authorities indicated that they will not publish the currencies in the reference basket and their relative weight. The PBC indicated that it would adjust the exchange rate trading band as necessary to reflect market developments and financial and economic conditions. Under the new regime, the band around the daily trading price of the U.S. dollar against the renminbi was kept at ± 0.3 percent around the central parity published by the PBC while the trade prices of the non-U.S. dollar currencies against the renminbi were allowed to move within a certain band announced by PBC, which was initially set at ±1.5 percent and increased to ±3 percent in September 2005. In

August 2005, the governor of PBC revealed that U.S. dollars, Euro, Japanese yen, and Korean won were the main currencies included in the basket, and U.K. pound, the Thai baht, and the Russian ruble were among other currencies included in the basket. In May 2007, the band around the daily trading price of the U.S. dollar against the renminbi was widened to ± 0.5 percent. After maintaining the renminbi closely linked to the U.S. dollar between July 2008 and June 2010, the PBC announced on June 19, 2010 a return to the managed floating exchange rate regime prevailing prior the global financial crisis with the exchange rate allowed to move up to ±0.5 percent from a central parity rate to enhance the effectiveness of monetary policy. As a result, the renminbi has gradually appreciated against the dollar (by 4.7% until end-April 2011), while the rate has remained in a 2% crawling band. Accordingly, the de facto exchange rate arrangement has been reclassified to a crawl-like arrangement from a stabilized arrangement. The trading prices for the renminbi against the euro, yen, Hong Kong dollar, and pound sterling on the one hand and against the ringgit and the ruble on the other hand float within a 3% and a 5% range of the day's middle exchange rates of the renminbi against these currencies, respectively.

On January 4, 2006, over-the-counter (OTC) trading of spot foreign exchange was introduced with 13 banks initially designated as market makers.The number of market makers has since risen to 44 with 26 banks approved as spot market makers, and 18 approved as forward and swap trading market makers. The centralized spot foreign exchange trading system (CFETS) remains operative, but its central parity rate (renminbi against the U.S. dollar) is now based on a weighted average of CFETS and OTC transactions. Under the new system, CFETS first inquires prices from all market makers before the opening of the market on each business day, exclude the highest and lowest offers, and then calculates the weighted average of the remaining prices in the sample as the central parity for the renminbi against the U.S. dollar for the day. The weights for the market makers, which remain undisclosed, are determined by the CFETS in line with the transaction volumes of the respective market makers in the market. The method for determining is as follows: The CFETS determines the middle rate for the renminbi against the ringgit and the ruble similarly. The middle exchange rates of the renminbi against the euro, yen, Hong Kong dollar, and pound sterling, respectively, are determined through cross rates by the CFETS based on the day's foreign exchange middle rate for the renminbi against the U.S. dollar and the exchange rates for the U.S. dollar against the euro, yen, Hong Kong dollar, and pound sterling on international foreign exchange markets.

China accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement on December 1, 1996. There are repatriation requirements on proceeds from exports and from invisible transactions and current transfers. Starting on August 13, 2007, all enterprises (domestic institutions) having foreign exchange revenue from foreign operation or from current accounts may keep foreign exchange receipts according to their operational needs in their current account foreign exchange accounts. Domestic institutions that had no current account foreign exchange revenue may purchase foreign exchange for imports in advance based on documentary proof of the payment and deposit the funds into their foreign exchange accounts. Individuals may, also open foreign exchange savings accounts and deposit foreign exchange purchased in accordance with the relavant regulations. There are no measures currently in force that have been determined to be exchange restrictions subject to Fund jurisdiction. However, China has notified measures to the Fund, pursuant to procedures under the Executive Board Decision 144-(52/51), which apply to measures imposed solely for national or international security reasons.

Exchange controls continue to apply to most capital transactions. Effective on July 1, 2006, quotas on foreign exchange purchases for foreign direct investment (FDI) were abolished, and domestic investors were allowed to purchase foreign exchange to finance pre-FDI activities. Since December 1, 2002, qualified foreign institutional investors (QFIIs) have been allowed to invest domestically in A shares, subject to certain restrictions, and all nonresidents have been allowed to purchase B shares, which are denominated in U.S. dollars or Hong Kong dollars. The overall QFII quota was increased to US$30 billion in December 2007 from US$10 billion. By the end of December 2010 there were 106 QFIIs of which 97 had an approved investment quota of $19.72 billion. The Qualified Domestic Institutional Investor (QDII) scheme was introduced in 2004, and measures have since been taken to promote its development. Since May 1, 2006, residents can purchase up to US$20,000 foreign exchange for depositing in banks or for current account transactions and this limit was raised to US$50,000 in September 2006. Beyond the quota, purchases require relevant documents. In May 2007, the QDII scheme was expanded to allow qualified banks to invest retail funds in foreign equities. Effective July 5, 2007 the China Securities and Regulatory Commission extended QDII to securities and fund-management companies. The firms have to meet certain capital and other requirements. From April 2006, qualified insurance companies were also allowed to invest their own foreign exchange externally under the QDII scheme up to 15 percent of their total assets. QDIIs may also invest in foreign derivative instruments.

The use of renminbi in international transactions has been expanded. In 2010, international financial institutions were approved to raise funds domestically in renminbi for use offshore. Other nonresidents are still not permitted to issue capital or money market securities in the domestic market. Since June 17, 2010, trade transactions between 20 provinces and cities in the Mainland with other countries may be settled in renminbi (Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Chongqing, Sichuan, Yunnan, Jilin, Heilongjiang, Xizang and Xinjiang). Since August 17, 2010, eligible foreign institutions may invest in the interbank bond market in renminbi. The eligible institutions include foreign banks engaged in cross-border trade settlements in renminbi, the Hong Kong and Macao region renminbi clearing banks, and foreign central banks and monetary authorities. These investments are subject to limits, but there is no minimum holding period. Starting from January 6, 2011, resident enterprises in 20 provinces and cities in the Mainland may use renminbi for outward FDI in those countries which accept such settlement.

External borrowing remains subject to permission by the respective authority except for FFEs which may borrow abroad within the difference between the enterprise's total investment and registered capital. Lending abroad generally requires approval, but domestic associated enterprises of multinational corporations may directly lend to offshore associated enterprises.

VIII. Article IV Consultation:

China is on the standard 12-month consultation cycle. The 2010 Article IV mission was concluded on July 26, 2010 and the staff report was published on July 29, 2010.

IX. Technical Assistance:

Technical assistance provided in 2000 through May 2011 is summarized in Annex V.

X. Resident Representative:

The resident representative office in Beijing was opened in October 1991. Mr. Il Houng Lee is the Senior Resident Representative and Mr. Murtaza Syed is the Resident Representative.

ANNEX II. WORLD BANK–IMF COLLABORATION

(As of June 8, 2011)

1. **Building on consultations between Mr. Rohland (World Bank Country Director) and Mr. Chalk (IMF Mission Chief) on June 30, 2010, the Bank and Fund country teams met** on September 28, 2010, to identify macro-critical structural reforms and coordinate the two teams' work for the period September 2010-August 2011.

2. **The teams agreed on China's main macroeconomic challenges.** These are to maintain macroeconomic and financial stability, sustain growth while implementing reforms to decisively rebalance the economy toward domestic demand, and reform the financial sector to support the new growth model.

3. **Based on this shared assessment, the teams identified four structural reform areas as macro-critical**, in view of their central role in rebalancing the economy and placing China on an internally and globally more sustainable growth path: (1) ***further liberalizing and developing the financial sector***, in line with the recommendations from the ongoing FSAP being jointly conducted by the IMF and World Bank; (2) ***strengthening the social safety net***, notably pensions and healthcare; (3) ***reforming the SOE sector***, including dividend and corporate governance policies; and (4) ***reforming public finance,*** including local government financing, intergovernmental fiscal relations, and taxation policy. Annex 1 details the specific activities planned by the two country teams, along with their expected deliveries.

4. **The teams confirmed their commitment to continue to provide information for their counterparts on the following areas:**

- The Fund team to be informed of progress in analytical work, in particular on work related to the reform of social protection, financial sector reform, public financial management, and inter-governmental fiscal relations. Timing: when milestones are reached (and at least semi-annually).

- The Bank team to be kept informed of the Fund's assessments of macroeconomic policies and prospects, and on TA or analytical work on social protection, financial sector reform, public financial management, and inter-governmental fiscal relations. Timing: in the context of Article IV and other missions (and at least semi-annually).

5. **No disagreement among the teams emerged on either the key issues, challenges or on the program of specific tasks to tackle these.** It was agreed that further details on collaboration, as necessary, will be agreed at the technical level as work progresses.

Appendix 1. China: Bank and Fund Planned Activities in Macro-Critical structural Reform Areas,

(September 2010–December 2011)

	Products	Expected Delivery Date
Bank Work Program	• China: Towards a High Income and Harmonious Society • China Economic Reform Implementation Project (umbrella TA project, including various sub-projects with MOF, PBoC, and provincial finance bureaus). • China Quarterly Update • "Just-in-time" policy notes for MOF • Policy note on local government finance and debt • China: A Vision for Pension Policy Reform • TA report on Statistical Master Plan	• December 2011 • Ongoing • Ongoing • Delivered on demand • April 2011 • June 2011 • June 2011

Fund Work Program	• December Staff visit aide memoire
	• Article IV Consultation Notes
	• Article IV Staff Report
	• Possible Working Papers on issues addressed during the Article IV mission
	  • Corporate investment in China: Determinants from cross country firm-level;
	  • Financial development and corporate sector investment
	  • Financial development and household saving
	  • How large are the potential gains from reforms toward free enterprise?
	  • RMB internationalization
	• Tax policy
	• Tax administration
	• Public financial management
	• Intergovernmental fiscal relations
	• Statistics
	• Financial stability and sequencing
		• Feb 2011
		• May/Jun 2011
		• Jul 2011
		• Jul/Dec 2011
		• Ongoing
		• Ongoing
		• Ongoing
		• Ongoing
		• Ongoing
		• Ongoing

Joint Work Program	FSAP	FSAP Report in July 2011

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

1. The Asian Development Bank's (ADB) partnership with the People's Republic of China (PRC) has grown in many ways since the PRC became a member of ADB in March 1986. The PRC is ADB's second largest shareholder among regional members and the third largest overall, as well as an important middle-income country client. By the end of 2010, the PRC's cumulative borrowing from ADB reached $23.5 billion with 171 loans for public sector projects. Of the total public sector loans, 55% was allocated to the transport sector, followed by water and other municipal infrastructure services (12%) and energy (12%), agriculture and natural resources (8%), industry and trade (3%), finance (2%), and multisector (7%). Over the past 24 years, ADB has helped finance 26 private sector projects in the PRC totaling $2.5 billion.

2. ADB also funds Technical Assistance for the PRC. By the end of 2010, ADB had provided a total of $357 million in grants for 637 technical assistance projects, consisting of $109 million for preparing projects and $248 million for policy advice and capacity development.

3. Overall, the PRC has demonstrated strong capabilities in implementing projects. The good performance shows the strong sense of project ownership among agencies involved in the design, implementation, and management of projects, as well as the rigorous screening process for development projects, particularly those proposed for external financing. Loan disbursement and contract award performance is good.

4. The PRC has demonstrated its strong partnership with ADB by contributing $35 million to the Asian Development Fund, establishing the $20 million PRC Poverty Reduction and Regional Cooperation Fund (the PRC Fund), and replenishing another $20 million to the PRC Fund. The PRC Fund—the first fund established in ADB by a developing member country—providing technical assistance projects mainly in the Greater Mekong Subregion and in Central Asia.

5. The Asian Development Bank is preparing its new "Country Partnership Strategy" (CPS) for the PRC, covering 2011 to 2015. The new CPS will be formulated in line with the priorities of the 12th Five Year Plan (FYP) that intersect with the strategic priorities of Strategy 2020, particularly PRC's redoubling of efforts to promote environmentally sustainable and socially inclusive development. The CPS preparation offers a unique opportunity for stocktaking and forging an even stronger and more innovative partnership

[1] Prepared by Asian Development Bank staff.

to promote greener and more inclusive development as well as South-South cooperation for knowledge sharing.

6. Projected public sector lending in 2011-2013 will total about $5.5 billion, of which 42% will support transport infrastructure; 17% for agriculture, rural development, and natural resource management; 29% for urban development, water supply, and sanitation improvement; and 12% for the energy sector. With about 90% of the projects located in the western, central and northeastern regions and all projects having an environmental focus, the pipeline closely follows the strategic pillars of the CPS, particularly its emphasis on inclusive growth and environmental protection.

The ADB's lending program will continue to be supported by technical assistance. Grants for technical assistance program are expected to be $15 million to $20 million annually. To enhance the strategic focus of ADB operations, better meet the goals of the 12th 5-Year Plan, and address pressing concerns on environmental protection and energy preservation, several advisory technical assistance projects are directly related to resource efficiency, environment protection, and climate change initiatives.

Table III.1. China: ADB's Commitments and Disbursements
(Public Sector Loans), 1993–2010
(In millions of U.S. dollars)

Year	Commitments 1/	Disbursements 2/
1993	1,031	371
1994	1,618	492
1995	2,304	558
1996	3,282	707
1997	4,033	715
1998	4,518	818
1999	5,337	792
2000	6,159	832
2001	6,748	1,313
2002	7,563	782
2003	8,075	705
2004	8,733	636
2005	11,060	892
2006	11,794	988
2007	13,214	1,190
2008	14,519	1,234
2009	15,623	1,342
2010	16,964	1,342

1/ Refers to cumulative contract awards.
2/ Refers to disbursements for the year.

ANNEX IV. STATISTICAL ISSUES

1. While economic statistics are adequate for surveillance purposes, weakness remain in the quality of the data, including coverage, frequency, and timeliness. Nevertheless, China has made significant strides in bringing its economic and financial statistics into line with international good practice. In April 2002, China began participation in the Fund's GDDS, and it updated the metadata posted on the Fund's DSBB (the most comprehensive documentation of economic and financial statistics available in English), in early 2009 (with the exception of financial sector and social demographic sector, which were certified in 2006). The technical assistance (TA) and training evaluation mission in March 2009 concluded that STA's TA and training missions to China were highly appreciated by all recipient agencies.

Real Sector Statistics

2. The National Bureau of Statistics (NBS) compiles and disseminates annual GDP by activity in current and constant prices (2005). The techniques for deriving volume measures of GDP are not sound and need to be improved. GDP by expenditure is compiled at current and constant 2000 prices, but the constant price estimates are not published. Quarterly GDP estimates are compiled in cumulative form, with minimal revisions, making it difficult to assess quarterly developments accurately or to make seasonal adjustments. Data on the expenditure components of GDP are not available on a quarterly basis. Nevertheless, the NBS has made a number of improvements to the range and quality of national accounts data, the most important being improving the exhaustiveness of the GDP estimates by activity. Further improvements are intended, including the adoption of the *1993 System of National Accounts*, and further improvements to quarterly GDP estimates. However, no target dates have been set. As in other countries, rapid economic change, including the expansion of the private sector, presents new problems for data collection and compilation. The ability to change the data collection systems is restricted by the decentralized nature of the statistical system. Extensive technical assistance has been provided from multilateral and bilateral institutions.

3. Monthly industrial production, retail sales, and fixed investment indices are compiled with the corresponding month of the previous year as a base period. However, no chain-linked time series are produced. Data revisions tend to be made without publishing the entire revised series.

4. Labor market statistics—including employment and wage data—are not comprehensive, and are only available on an annual basis, with considerable lag.

5. In January 2001, the NBS began to publish a Laspeyres price index that provides a time series for each January to December (with January each year = 100) but does not allow for year-to-year comparisons. This more accurately reflects consumer spending patterns (e.g., the weight of services increased, while the weight of food declined). The number of survey items has been expanded to around 700. The most recent weights of the major CPI components were provided to the staff in 2006. Prior to 2001, the index was compiled and disseminated on a month to month and year to year basis using current year weights for most items. The data for the weights for this index are for the period 1978–2000.

Government Finance Statistics

6. Serious data shortcomings continue to hamper fiscal analysis. Budgetary data exclude spending associated with domestic bond proceeds on-lent to local governments and official external borrowing. Also, data on the social and extra budgetary funds are only provided annually and with a long lag. Expenditure classification remains poor, mainly because data are not classified by economic type. The authorities have indicated an intention to begin collecting these data and to develop accrual based measures of fiscal performance over the medium term while also strengthening the compilation of cash based GFS.

7. China has reported general government cash-based budget data for 2003–2008 following the *GFSM 2001* methodology for publication in the 2009 *GFS Yearbook*. However, these data are limited, with no data provided on government transactions in assets and liabilities. The revenue classification does not fully distinguish between revenue and grants, tax and nontax revenue, and current and capital revenue. The presentation of expenditure by function is largely aligned with international best practice. In May 2011, STA conducted a two-week seminar on the *GFSM 2001* that was attended by staff from the PBC, the Ministry of Finance, and other agencies involved in compiling data on the fiscal operations of the government. The seminar emphasized the need for interagency cooperation in the compilation of GFS. Improved transactions coverage may result.

8. Owing to source data issues, the authorities have not yet been able to report a *GFSM 2001* Statement of Sources and Uses of Cash for the budgetary central government accounts on a subannual basis. As a result, there are no fiscal data for China on the Principal Global Indicators website.

Monetary and Financial Statistics

9. In recent years, improvements have been made by the PBC in monetary and financial statistics. The most notable progress made by the PBC are as follows: (1) expanding the coverage of financial institutions; (2) adjusting the sectorization of financial corporations; (3) improving the "all accounts" reporting system; and (4) improving data dissemination following the GDDS recommendations, such as disseminating advance release calendars on the PBC's websites. However, the monetary and banking surveys lack sufficient detail with regard to bank claims on the government, hampering the estimation of the fiscal deficit from the financing side. The reported net foreign assets position of PBC does not include exchange rate valuation effects and interest earnings on foreign reserves. The PBC has also ceased to report separate data on central government deposits in its balance sheet since April 2005 because the MOF no longer distinguishes between central and other government deposit accounts. This change has led to breaks in data series of monetary base and monetary aggregates. In addition, detailed breakdowns of bank credit by industry, and by borrower (including by the various elements of the state and nonstate sectors), are not publicly available.

10. On financial soundness indicators (FSIs), China began in May 2011 reporting of annual data on core FSIs to the Fund for publication. However, the FSIs data currently posted on IMF's website are for 2010 only and no historical data series will be provided.

11. Due to the restructuring of the banking sector, new statistical issues have arisen, such as how to record the transfer of nonperforming loans to asset management companies, and how to sectorize these companies in the banking survey. The monetary and financial statistics mission that visited Beijing in 2009 and 2010 made recommendations for addressing these issues with a view to facilitating PBC's implementation of Standardized Report Forms (SRF) for reporting monetary statistics. These missions also assisted the authorities in addressing issues related to compilation and reporting of FSIs data and metadata using the standard templates.

12. In response to a request from the authorities, a financial statistics mission has been scheduled to take place during FY2012. The mission will assist the authorities in advancing their work in addressing issues related to compilation of data on other financial corporations in the format of SRFs.

External Sector Statistics

13. The State Administration of Foreign Exchange (SAFE) relies on an International Transactions Reporting System (ITRS) which produces data derived from information on foreign exchange transactions conducted by banks. To supplement the ITRS, data on travel credits and trade credits are collected through periodic sample surveys, while additional data are collected from other government agencies and reports on balance sheet information from financial institutions and data on portfolio investment and direct investment.

14. The data are compiled (in U.S. dollars) largely in accordance with the fifth edition of the *Balance of Payments Manual* (*BPM5*). In 2011 the authorities began publishing quarterly estimates of the balance of payments—a significant step forward in the dissemination of timely external sector statistics. Within the current account, component detail is available on goods, services, income, and transfers. Data on the financial account, with significant component detail for functional categories, and data on the capital account are also available. Data on China's international investment position (IIP) are published for the period 2004-2010.

15. The authorities continue their efforts to improve the coverage of direct investment transactions in the balance of payments and IIP statistics, and progress is being made in developing these statistics. Data on transactions for the nonfinancial sector, received mainly from the Ministry of Commerce (formerly Ministry of Foreign Trade and Cooperation), apparently do not cover all required elements such as disinvestments. In 2007, inward direct investment stock data of the nonfinancial sector were based on new source data collected through the "Joint Annual Review and Evaluation of Overall Performance on China's Inward FDI," a joint government department effort to collect performance data from foreign-funded enterprises. Since ITRS is the major data source for BOP, in order to ensure its smooth operation, regular training programs for staff in the provincial offices of SAFE were recommended. An upgraded version of the ITRS has been used since 2009.

16. The Fund has provided extensive technical assistance and training to improve balance of payments and IIP statistics. At the Joint China-IMF Training Program in Dalian, STA conducted a specialized seminar on Cross-border Stocks and Flows in June 2006 and a Balance of Payments and IIP course in June 2007. Following China's agreement to participate in the Coordinated Direct Investment Survey (CDIS), STA visited Beijing in April 2008 to conduct an interagency meeting on the CDIS. At the request of SAFE, STA also conducted a one-week seminar on the new draft *Balance of Payments and International Investment Position Manual (BPM6)* in Kunming, China. In addition, STA conducted a course in *BPM6* in June 2009, a seminar on services statistics in November 2009, a seminar on financial derivatives and a workshop on direct investment and external debt in September 2010, and a balance of payments and IIP course in June 2011

17. The Fund has also provided technical assistance on the coverage, timeliness, and periodicity of data on official reserves, reserves-related liabilities, as well as on other external assets and liabilities, financial derivative activities, and other contingent and potential liabilities. Despite an ostensibly modest level of external vulnerability, there remains a need to strengthen external debt monitoring and compilation. STA conducted a seminar on external debt statistics in August 2005 as part of the China Training Program. In January 2010, China started submitting total and public external debt data for the Quarterly External Debt Statistics (QEDS) database, a notable step forward.

Data Reporting to STA for Publications

18. Despite improvements in reporting a number of breaks remain in the series, and comparable historical data are not available. Reporting of data to STA for *IFS* has, in the past, tended to be sporadic and with a considerable time lag. Following the introduction of new reporting arrangements, the timeliness of consumer price, industrial production, trade value, and total GDP data in *IFS* has improved substantially. No long-term time series are available for the consumer and producer price indexes and industrial production; rather the comparison is made each period with the same period of the previous year. However, the range of information is relatively limited, with no data published on wages, trade volumes, or prices/unit values. The authorities have resumed reporting data on international reserves for *IFS*. However, the monthly time series is now submitted every three months, instead of every month.

Data Dissemination to the Public

19. The publication of a quarterly statistical bulletin by the PBC has significantly improved the timing and coverage of publicly available data on the monetary accounts and the main real sector indicators. However, the monthly statistical publications do not contain many time series (e.g., unemployment) or the disaggregation necessary for analysis. Moreover, several important time series, particularly on the main fiscal variables, are not released in a systematic and timely manner. Extensive annual economic data are available in various statistical yearbooks, but these are published nine months or more after the end of the year.

China: Table of Common Indicators Required for Surveillance

(As of June 17, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[9]	Frequency of Reporting[9]	Frequency of Publication[9]
Exchange rates	05/11	6/1/11	D	M[9]	D
International reserve assets and reserve liabilities of the monetary authorities[1]	05/11	06/11	M	M	M
Reserve/base money	04/11	05/11	Q, M	Q, M	Q, M
Broad money	04/11	05/11	M	M	M
Central bank balance sheet	04/11	05/11	M	M	M
Consolidated balance sheet of the banking system	04/11	05/11	M	M	M
Interest rates[2]	04/11	05/24/11	[10]	[10]	[10]
Consumer price index[3]	04/11	05/17/11	M	M	M
Revenue, expenditure, balance and composition of financing[4] – general government[5]	12/09	06/10	A	A	A
Revenue, expenditure, balance and composition of financing[4] – central government	05/10	06/14/10	M	M	M
Stocks of central government and central government-guaranteed debt[6]	12/09	06/10	Q	Q	Q
External current account balance	Q4/10	05/11	Q	A, S[11]	A, S[11]
Exports and imports of goods and services[7]	Q4/10	05/11	M	M	M
GDP/GNP[8]	Q4/10	05/11	A, Q (cumulative)	A, Q (cumulative)	A, Q (cumulative)
Gross external debt	12/09	06/10	A, Q	A, Q	A, Q
International investment position	2010	06/11	A	A	A

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Only 12-month growth rates are reported (price indices are not available).
[4] Data on financing (foreign, domestic bank, and domestic nonbank financing) is not available.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] Data on the exports and imports of goods are provided monthly. Services trade data is provided semi-annually and released with the current account statistics.
[8] For real GDP, level data are available only on an annual basis (growth rates are available on a quarterly, cumulative basis).
[9] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[10] Interest rates change only infrequently; these changes are publicly announced.
[11] Data provided semi-annually.

ANNEX V. TECHNICAL ASSISTANCE

Table V.1. China: Summary of Technical Assistance, 2001–11

Department	Purpose	Date
Tax System Reform		
FAD	Mission on VAT and inheritance tax	April 2001
FAD	Mission on tax preference	September 2001
FAD	Mission on financial sector taxation	Aug/Sep 2002
FAD	Mission on personal income tax reform	November 2003
FAD	Mission on VAT treatment of financial services	April 2006
FAD	Mission on estimation of VAT gap and capacity	June 2009
Tax Administration Reform		
FAD	Five missions on computerizations	June 2000–Oct. 2002
FAD	Two missions on strategic planning	Nov. 2001–Aug. 2002
FAD	Seminar on Strategic Planning in Washington	October 2002
FAD	Mission on revenue administration	November 2003
FAD	Review of computerization project	September 2004
FAD	Mission on business process reengineering pilot	November 2005
FAD	Mission on IT modernization	June 2006
FAD	Mission on strategic planning, risk management, and taxpayer services	September 2006
FAD	Mission on VAT invoice cross-checking and other administration issues	March 2007
FAD	Mission on business process re-engineering and Golden Tax Project 3	August 2007
FAD	Seminar on Strategic Planning and Management	January 2008
FAD	Mission on VAT on Services, Resource Tax Policy	October 2009
FAD	Mission on project management Golden Tax Project 3	June 2010
FAD	Expert Visit on Strategic Planning	October 2010
FAD	Mission on Tax Administration: Large Taxpayers	October 2010
FAD	Peripatetic Expert Visit on Tax Administration	October 2010
Public Financial Management		
FAD	Workshop on Government Fiscal Management Information System	February 2001
FAD	Mission on treasury/accounting reform; macrofiscal coordination	November 2001
FAD	Mission on budget preparation, classification, and treasury reform	June 2002
FAD	Mission on budget classification	March 2003
FAD	Workshop on Budget and Treasury Modernization in Washington	October 2003
FAD	Mission on treasury and accounting reforms	November 2003
FAD	Mission on Budget Law I	March 2004
FAD	Mission on cash management	April 2006
FAD	Mission on Budget Law II	September 2007
FAD	Discuss FAD's PFM program with authorities	September 2007
FAD/STA	Mission on Accrual Accounting	September 2007
FAD	Seminar on Local Government Cash management	December 2009
FAD	Presentation of the Budget Institutions Paper	May 2010
Intergovernmental Fiscal Relations		
FAD	Mission intergovernmental relations	November 2002
FAD	Mission on subnational fiscal risks	November 2003
FAD	Conference on Reforming Assignments and Next Steps in Intergovernmental Reforms	November 2007
Statistics		
STA	Seminar on General Data Dissemination System	April 2001
STA	Missions on trade price statistics	Jun. 2001–Jan. 2002

Table V.1. China: Summary of Technical Assistance, 2001–11

Department	Purpose	Date
STA	Mission on GDDS	Feb./Mar. 2002
STA	Seminar on GDDS/SDDS in Washington	September 2002
STA	GDDS Review	December 2003
STA	Mission on government financial statistics	January 2005
STA	Mission on monetary and financial statistic	Feb./Mar. 2005
STA	Seminar on International Investment Position	April 2005
STA	Seminar on IIP Statistics	April 2005
STA	Seminar on External Debt Statistics	August 2005
STA	Macroeconomic statistics	May 2006
STA	Balance of Payments and IIP Course	June 2007
STA	Mission on monetary and financial statistics	August 2007
STA	Seminar on *Balance of Payments and International Investment Position Manual,* sixth edition (*BPM6*)	April 2008
STA	*BPM6* course	June2009
STA	Seminar on Services Statistics	November 2009
STA	Seminar on financial derivates, direct investment and external debt	September 2010
STA	Balance of Payments and IIP Course	June 2011
STA	Government Finance Statistics	September 2008
STA	Financial Soundness Indicators	June 2009
STA	Monetary and Financial Statistics	October 2010
STA	Workshop on Special Data Dissemination Standard	April 2011
STA	Government Finance Statistics	May 2011
Monetary Policy and Bank Supervision		
MFD	Missions on banking supervision	October 2003
MFD	Bank Restructuring	April 2004
MFD	AML/CFT Issues	September 2003
MFD	AML/CFT Training for PBC Officials	February 2005
MFD/LEG	Mission on AML/CFT	April 2005
LEG	AML/CFT Symposia	May 2005
MFD	AML/CFT Symposia	September 2005
MFD	AML/CFT and Internal Control Workshop	November 2005
LEG/MFD	AML/CFT Workshop	December 2005
LEG/MFD	Mission on AML/CFT	April 2006
LEG	Workshop on Information Management Technology for China's AML	June 2006
LEG	Mission on AML/CFT	July 2006
LEG	AML/CFT Workshop	August 2006
LEG	Mission on AML/CFT	September 2006
LEG	Mission on AML/CFT	October 2006
LEG	AML/CFT Symposia	November 2006
LEG	AML/CFT Financial Sector Workshop	May 2008
LEG	AML/CFT Financial Analysis Workshop	November 2008
LEG	AML/CFT Financial Institutions Inspection STX advice mission, Macao SAR	December 2008
LEG	AML/CFT Financial Analysis Workshop	November 2009
LEG	AML/CFT Future Cooperation in TA	November 2009
LEG	AML/CFT Financial intelligence Unit procedural improvements, Macao SAR	March 2010
LEG	AML/CFT Financial Analysis Workshop	April 2010
LEG	AML/CFT Legislative Drafting Mission	July 2010
LEG	AML/CFT Financial Analysis Workshop	September 2010
LEG	AML/CFT Legislative Drafting Mission	March 2011

Table V.1. China: Summary of Technical Assistance, 2001–11

Department	Purpose	Date
Review of Technical Assistance		
FAD	Visit to review UNDP/IMF/China fiscal reform TA program	February 2001
FAD/TAS	Two missions for tripartite review of the UNDP/IMF/China fiscal reform TA program	Jan. 2002/Feb. 2003
MFD	Mission on TA needs in banking sector reform	July 2002
MFD	Mission on TA needs in financial sector	October 2003
FAD	Participation in UNDP/DFID fiscal reform workshop	February 2004
FAD	Visit to discuss TA needs under UNDP/DFID fiscal reform project	December 2004
Training		
INS	Courses on Financial Programming and Policies (3)	July 2000–June 2002
INS	Course on Banking Supervision	June 2001
INS	High-Level Seminar on Banking Reform	March 2001
STA	Seminar on Money and Banking Statistics	April 2001
MFD	Course on Banking Supervision (On-Site and Off-Site)	July 2001
MFD	Banking Risk Management	July 2001
INS	Course on Financial Programming and Policies	August 2001
MFD	Seminar on Capital Account Convertibility	October 2001
FAD	Course on Public Sector Expenditure Management	June/July 2002
STA	Seminar on Balance of Payments and IIP Statistics	August 2002
STA	Course on Government Financial Statistics	September 2002
INS	Course on Banking Supervision	September 2002
MFD	Central Bank Accounting	November 2002
STA	Course on Government Financial Statistics	September 2003
INS	Course on Financial Programming and Policies	October 2003
MFD	Course on Assessing Financial Systems	November 2003
INS	Course on Advanced Financial Programming (Washington)	November 2003
STA	Course on Monetary and Financial Statistics	Nov./Dec. 2003
FAD	International Experience with Budget Law and Budget Law Reform	March 2004
INS	High-Level Seminar on Monetary Policy Transmission	April 2004
INS	High-Level Seminar on China's Foreign Exchange System	May 2004
STA	Seminar on Coordinated Portfolio Investment Survey	April 2004
INS	Course on Financial Market Analysis	June 2004
MFD	Workshop on Ex and Balance of Payments Issues	June 2004
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2004
STA	Seminar on Quarterly National Accounts	September 2004
INS	Course on Financial Programming and Policies	October 2004
STA	High Level Seminar on Macroeconomic Statistics	January 2005
MFD	Workshop on Monetary Strategy and Operation	May 2005
INS	Course on Financial Programming and Policies	June 2005
INS	Course on Macroeconomic Management and Fiscal Issues	June 2005
LEG	National IT Symposium	July 2005
LEG	AML/CFT Workshop	July 2005
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2005
STA	Course on External Debt Statistics	August 2005
STA	Course on Monetary and Financial Statistics	September 2005
LEG	Advanced Training on ML and TF Typologies and STRs	December 2005
MFD	Course on Foreign Exchange Operations	March 2006
INS	Course on Macroeconomic Management and Financial Sector Issues	May 2006
LEG	AML/CFT Workshop	June 2006
MFD	Course on Determining the Intermediate Target for Monetary Policy	June 2006

Table V.1. China: Summary of Technical Assistance, 2001–11

Department	Purpose	Date
STA	Seminar on Banking Statistics on Cross-Border Flows	June 2006
INS	Course on Advanced Financial Programming	July 2006
INS	Course on Macroeconomic Management and Financial Issues	July 2006
LEG	National Workshop on IT for FIUs	September 2006
LEG	Workshop for APC Countries	December 2006
LEG	AML/CFT Workshop	May 2007
LEG	AML/CFT Training for Supervisors	May 2007
INS	Course on Financial Programming and Policies	May 2007
STA	Course on Balance of Payments Statistics	June/July 2007
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2007
LEG	AML/CFT Training for Supervisors	October 2007
STA	Course on Monetary and Financial Statistics	October 2007
MCM	Workshop on FSAP and Financial Stability	December 2007
MCM	Workshop on Stress Testing	December 2007
LEG	AML/CFT Risks in the Casino Sector	December 2007
FAD	Seminar on Revenue Forecasting	March 2008
LEG	AML/CFT Workshop	January 2008
FAD	Seminar on Revenue Forecasting	March 2008
INS	Course on Financial Programming and Policies	April 2008
LEG	AML Supervision Workshop	May 2008
INS	Course on External Vulnerabilities	June 2008
STA	Course on Government Finance Statistics	September 2008
STA	Seminar on Financial Soundness Indicators and Money and Banking Statistics	September 2008
INS	Course on Macroeconomic Management and Financial Sector Issues	October 2008
LEG	AML/CFT Financial Analysis and Survey	November 2008
INS	Course on External Vulnerabilities Analysis	February 2009
INS	Course on Financial Programming and Policies	May 2009
STA	Course on Balance of Payments and International Position Statistics	June 2009
INS	Course on Macroeconomic Management and Financial Sector Issues	November 2009
LEG	AML/CFT Financial Analysis and Survey	November 2009
INS	Course on Financial Programming and Policies	January 2010
STA	Course on Monetary and Financial Statistics	March 2010
INS	Course on Macroeconomic Management and Financial Sector Issues	May 2010
STA	Seminar on Financial Soundness Indicators Reporting and Disseminating	September 2010
STA	Seminar on Balance of Payments Statistics	September 2010
MCM	Financial Regulation Workshop	October 2010
INS	Course on Macroeconomic Management and Financial Sector Issues	March 2011
INS	Course on Macroeconomic Forecasting	April 2011
STA	Course on Government Finance Statistics	May 2011

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/94
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July 20, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with People's Republic of China

On July 15, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with China.[1]

Background

China's economy remains on a solid footing, propelled by vigorous domestic and external demand. Wage and employment increases have fueled consumption, the expansion in infrastructure and real estate construction has driven investment upward, and net exports are once again contributing positively to economic growth. Consumer price inflation has been a pressing social and economic issue, rising to 5½ percent by end-May. However, barring further food price shocks, and assuming the ongoing tightening of monetary policy is continued, inflation should soon peak and begin to decline in the second half of this year.

The improving cyclical outlook for the economy, price pressures, and the potential for a worsening of bank credit quality in the coming years, has led to a withdrawal of monetary stimulus (with a target of 16 percent M2 growth by end-year). The fiscal stimulus has also begun to be unwound with a 1 percent of GDP decline in the general government deficit targeted for this year. In addition, fiscal resources are being reoriented toward supporting social expenditures, rural development and policies that promote private consumption. Over the past year the currency has appreciated by 5½ percent against the U.S. dollar but has depreciated in both nominal and real effective terms. International reserves now stand at over US$3 trillion.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The policy measures outlined in the Twelfth Five-Year Plan are directed at shifting toward a consumer-based growth model through a range of reforms that will strengthen the social safety net, raise household income, enhance productivity, and invest in human capital. Financial reform is highlighted as an important element of this reform package. A successful implementation of such reforms, and the accompanying transformation of China's economic growth model, would have significant positive spillovers to the global economy.

Executive Board Assessment

Executive Directors noted that China's near-term growth prospects continue to be vigorous and are increasingly self-sustained, underpinned by structural adjustment. While inflation is expected to subside reflecting ongoing monetary policy tightening, upside risks remain, in particular from higher food and commodity prices. Asset price developments and continued rapid credit growth, coupled with global liquidity conditions, pose policy challenges. Directors agreed that the current environment calls for a further tightening of macroeconomic policies. The acceleration of China's economic transformation toward a more inclusive and balanced growth model as envisaged under the Twelfth Five-Year Plan will improve the welfare of the Chinese people and contribute to sustained and balanced global growth.

Directors welcomed steps to cool down property price inflation. They emphasized that any durable solution to property bubbles would need to involve a significantly higher cost of capital, financial development, and higher real estate taxation.

Directors noted heightened risks to credit quality associated with lending to the real estate sector and local government financing vehicles, with the potential for contingent fiscal liabilities. They welcomed steps to improve public disclosure of the scale and nature of these liabilities, and encouraged continued efforts to ensure that banks fully account for the underlying risks with appropriate provisioning, capital requirements, and risk weighting.

Directors welcomed the authorities' commitment to move gradually to more price-based tools of monetary policy, and to continue to improve the monetary policy framework and the interest rate structure. They saw room for a further tightening of monetary conditions through greater reliance on interest rates and nominal exchange rate appreciation, while taking care to safeguard financial system stability.

Directors generally agreed that, over the medium term, a stronger renminbi would be an important component in rebalancing the economy toward domestic demand, and a number of them saw this as a prerequisite for reforms to strengthen the macroeconomic policy framework and promote financial liberalization. Directors stressed that the appreciation of the exchange rate would need to be supported by wide-ranging reforms to bring about a transformation of China's economic growth model.

Directors supported the policy directions laid out in the Twelfth Five-Year Plan, which, if fully implemented, would lay a strong foundation for a new growth model. They welcomed in particular the focus on further improvements in the social safety net, measures to raise household income, and the role of market forces in resource allocation. Directors encouraged the government to flesh out detailed steps for the expeditious initiation of the various reform measures.

Directors welcomed China's participation in the Financial Sector Assessment Program, and underlined the importance of well-sequenced financial liberalization and reform as an integral part of China's rebalancing strategy. They commended the authorities for the considerable progress in moving toward a more market-based financial system and improving the regulatory and supervisory framework. Directors encouraged further efforts to absorb the liquidity overhang currently resident in the financial system, deepen the channels for financial intermediation, enhance supervision and regulation, establish a deposit insurance scheme, and strengthen the framework for resolution and crisis management. They looked forward to meaningful progress in these areas to help pave the way for full liberalization of deposit and loan rates, an opening of the capital account, and a convertible renminbi.

Directors welcomed the spillover analysis for providing a useful multilateral perspective to the Fund's policy advice to China, and encouraged further refinement of such analysis. They agreed that expansionary policies in China during the crisis had played an important role in bolstering global stability and growth, and expected China's positive externalities to continue, especially for regional economies. Directors generally noted that a major disruption in China's so-far-steady growth would have material adverse consequences for the rest of the world. They emphasized that a combination of currency appreciation and reforms to rebalance the growth model, together, would yield substantial benefits for both China and other countries. Several Directors also noted the potential effects of China's reserve accumulation and capital account policies on capital flows and global asset prices, although a few others saw no clear evidence that these policies have significant effects on emerging market capital flows.

Directors welcomed China's generous contributions to low-income countries in both financial and technical assistance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with China is also available.

China: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	12.7	14.2	9.6	9.2	10.3	9.6	9.5
Total domestic demand	11.5	12.7	9.7	14.2	10.0	8.5	9.0
Consumption	9.8	11.1	8.6	8.4	8.1	9.5	9.6
Investment	13.6	14.7	11.0	20.8	12.0	7.5	8.3
Fixed	12.8	13.5	9.7	24.5	11.8	7.9	8.7
Inventories 1/	0.6	0.8	0.8	-0.8	0.3	0.0	0.0
Net exports 1/	2.0	2.5	0.8	-3.7	0.8	1.5	1.1
Consumer prices							
End of period	2.0	6.6	2.5	0.7	4.7	4.0	3.0
Average	1.5	4.8	5.9	-0.7	3.3	4.7	3.3
Unemployment rate (annual average)	4.1	4.0	4.2	4.3	4.1	4.0	4.0
	(In percent of GDP)						
External debt and balance of payments							
Current account	8.6	10.1	9.1	5.2	5.2	5.5	6.0
Trade balance	8.0	9.0	8.0	5.0	4.3	4.6	5.1
Exports of goods	35.7	34.9	31.7	24.1	26.9	30.2	31.8
Imports of goods	27.7	25.9	23.8	19.1	22.6	25.5	26.7
Gross external debt	12.5	11.1	8.6	8.6	9.3	10.1	11.5
Saving and investment							
Gross domestic investment	43.0	41.7	44.0	48.2	48.8	48.5	48.5
National saving	51.6	51.9	53.2	53.5	54.0	54.0	54.5
Government	7.7	8.8	8.4	6.2	6.9	6.5	7.3
Non-government	43.9	43.0	44.8	47.3	47.1	47.5	47.2
Public sector finance							
Central government gross debt	16.2	19.6	17.0	17.7	17.0	16.5	15.4
General government balance	-0.7	0.9	-0.4	-3.1	-2.2	-1.6	-0.7
	(Annual percentage change)						
Real effective exchange rate 2/	1.6	4.0	9.2	3.3	-0.5	...	...

Sources: CEIC Data Co., Ltd.; and staff estimates and projections.

1/ Contribution to annual growth in percent.

2/ Percentage change of annual average.

Statement by Jianxiong He, Executive Director for People's Republic of China and Zhengxin Zhang, Senior Advisor to the Executive Director
July 15, 2011

The Chinese economy has continued to show resilience, reflecting strong consumption and investment, and further progress in structural adjustment. The key challenge is to balance the need for containing inflation, sustaining strong growth, and accelerating the transformation of the growth model. The task is complicated by the difficult external environment, which acutely constrains macroeconomic policy options and rebalancing efforts.

I. Recent economic developments and policies

Despite the weak recovery, continued financial market fragility and heightened sovereign risks in the developed economies, the growth in China has remained strong and continued to rebalance in favor of domestic demand, thanks to the package of comprehensive reform measures. Retail sales grew by 18.4 percent in 2010 and 16.6 percent in the first five months of 2011, driven by the household income growth (urban household per capita disposable income rose 11.3 percent in 2010, and rural household net per capita income by 14.9 percent), while fixed asset investment growth moderated to a more sustainable rate of 23.8 percent. With import growth outpacing that of export growth by 3.6 percentage points, the trade balance further narrowed from 4 percent of GDP in 2009 to 3.1 percent in 2010, followed by another 18.2 percent reduction in the first half of 2011. Current account surplus as a share of GDP continued to decline from the precrisis double digits to 5.2 percent in 2010 and 2.04 percent in the first quarter of 2011.

Inflation pressure has intensified, reflecting the sharp food price increase and the abundant domestic and global liquidity, and the associated surge in global commodity prices. It also reflects longer-term changes, such as the structural increase in labor, land, as well as environmental protection costs. Last year saw an average minimum wage increase of 22.8 percent across the country.

As the staff rightly noted, our authorities began to withdraw the monetary stimulus as soon as the recovery took hold. Since early 2010, the People's Bank of China (PBC) has raised reserve requirements on 12 occasions and policy rates on 5 occasions. Surprisingly, the staff reports have missed the significant constraint of the external environment on the monetary policy options. For example, the frequent tightening steps were interrupted for about two quarters of the year by the heightened sovereign risks in Europe. And more importantly, the near-zero policy rates in major advanced economies have limited the room for the PBC to rely on interest rate adjustments, as the higher domestic rate, combined with appreciation expectations, would not only fuel speculative flows but also fail to address the challenges arising from the sectoral differences and the fast-evolving financial system. The monetary policy mix may be better assessed in such a setting. In addition to the reserve requirement and policy rate adjustments, as well as the flexible use of open market operations, the PBC has adopted "aggregate financing" as a key indicator for gauging monetary and financial conditions. It has also introduced transparent and rules-based dynamically differentiated reserve requirement ratios to provide incentives for the individual institutions to respond to the need for capital buffer as it fluctuates with business cycles. They believe that the configuration of the price-based instruments with macroprudential tools suits the present external and domestic context.

Given the strong economic growth and revenue performance, the fiscal policy will focus on improving expenditure composition, particularly increasing social spending to encourage consumption while ensuring fiscal sustainability. The government will continue tax reform and structural tax reduction to facilitate rebalancing. The recent amendment to the income tax law simplified the tax structure, raised the exemption threshold by 75 percent, and revised the tax rate for the lowest bracket from 5 percent to 3 percent. Our authorities are well aware of the risks associated with the accumulation of local government debt—a legacy associated with the crisis response measures. Although such debt is small relative to GDP, and has been largely used to finance fixed asset investment and expected to generate cash flows, our authorities have taken preemptive actions, including introducing an effective monitoring and risk warning system, and standardizing local government debt management.

To address the risk of potential property bubbles, both demand and supply side actions were taken, including differentiated lending standards, larger supply of land, and affordable housing. The stress tests by commercial banks indicate that the real estate sector credit risks remain manageable.

II. Transformation of the growth model

China's far-reaching rebalancing efforts have yielded remarkable results. The multi-prong measures have resulted in an average 9.7 percent real annual increase in urban household per capita disposable income in the last five years, and 8.9 percent real increase in rural household net per capita income. During the same period, retail sales grew at an average annual rate of 18.1 percent, while the weight of the service sector edged up 2.7 percentage points. There has been a leap forward in strengthening the social safety net. The health insurance has covered 1.26 billion participants. The rural participation rate has reached 96 percent, with 836 million covered by the new rural medical insurance introduced in 2009. The government contribution to the health insurance increased 66.7 percent in 2010 on top of the 50 percent rise in 2009. The reimbursement ratio has reached 60 percent. The new rural pension scheme introduced in 2009 has already attracted 190 million participants. More than 50 million have begun to benefit from the scheme. The energy saving and environmental protection measures, which resulted in a 19.1 percent reduction in energy consumption per unit of GDP in the last five years, are also conducive to rebalancing. To encourage import, tariffs were significantly reduced on 33 tariff items covering energy, raw materials, and consumer products effective July 1, following the application of lower duties on over 600 items early this year. As a result, the contribution of domestic demand to GDP growth increased from 81.9 percent in 2007 to 91 percent in 2008 and 139 percent in 2009, before stabilizing at 92.1 percent in 2010. Since 2005, the domestic share of aggregate demand has also edged up by 2.9 percentage points to 97.4 percent.

Our authorities are fully aware of the enormous challenges to their rebalancing efforts, including the need for creating 25 million jobs for the new urban labor force each year in the Plan period. As the population begins to age, the demand for social protection will be more acute. The "Twelfth Five-Year Plan" on economic and social development illustrates our authorities' determination to transform the growth model by accelerating structural reforms with a strategic focus on expanding consumer demand. It sets out policy guidance in 10 areas, including accelerating growth in household income, providing lasting incentives to expand consumption, and allowing market forces to play a key role in resource allocation. The Plan has been the most comprehensive and elaborate policy framework to rebalance demand that G20 members have ever put forward. It is legally binding and embodies a monitoring and evaluation mechanism. We wish to highlight a few relevant elements.

1. **Expanding employment and improving income distribution to increase consumption**

   While increasing public service for employment, expanding training, and encouraging entrepreneurship, measures will be taken to accelerate income distribution reforms to raise the labor share of national income. The Plan envisages a real annual growth of over 7 percent in per capita household disposable income (faster than the projected real GDP growth), and an annual minimum wage growth over 13 percent. This will also reinforce the relative factor cost changes under way. According to the U.S. Bureau of Labor Statistics, during 2002–2008, manufacturing sector real wages doubled in China, compared to 20 percent in the United States.

2. **Strengthening the social safety net to reduce precautionary saving**

   Over the Plan period, out-of-pocket expenses will be further reduced for health insurance participants. The pension insurance system is expected to have all the urban and rural population covered by end-2012. About 36 million units of affordable housing will be provided.

3. **Allowing market forces to play a basic role in resource allocation and strengthening environmental protection**

   The Plan envisages 30 percent reduction in water consumption per unit of industrial value added, a further 16 percent reduction in energy consumption per unit of GDP, and other targets for emission reduction of major pollutants. The price reforms involving natural resources, including refined oil, natural gas, water, and electricity will be front-loaded as priority agenda for 2011.

4. Promoting the development of service and nontrade sectors

The Plan aims at a 4 percentage-point increase in the service sector share of GDP, particularly by promoting financial, logistics, and tourism services.

The structural measures, especially those aimed at promoting consumption and nontradable sectors, together with the relatively faster increase in factor costs, are expected to help narrow the current account surplus and bring the RMB exchange rate even closer to its equilibrium. We disagree with staff assessment that the RMB remains substantially below the level consistent with medium-term fundamentals, which is based on reserve changes, the most recent REER movement, and the shaky medium-term current account projections.

First, under the current international monetary system, the exceptionally loose monetary policy in major reserve-issuing economies had important implications for reserve changes in other countries. The factors underlying changes in reserves and key assumptions for staff medium-term current account projections, which have shown persistently large errors, certainly deserve further examination. Second, the REER-related assessment should be based on longer-term trend than what the staff paper seems to focus on. The movement in the past year has been complicated by the large fluctuations among the major currencies. Since 1994, the year the RMB exchange rates were unified, both the BIS and IMF have recorded RMB REER appreciation of over 50 percent, with 21 percent appreciation since mid-2005. Furthermore, structural changes, such as the increasing cost of labor and capital and the convergence of domestic and international metropolitan property prices, will fundamentally affect China's competitiveness.

Staff's exchange rate assessment, which is derived from medium-term current account projections based on the assumption of unchanged policies and constant exchange rate, ignores the trend exchange rate movement and the far-reaching legally-binding rebalancing measures that will be implemented in the medium term.

III. Financial reform and FSAP

China's precrisis financial reforms have been an important buffer against the global crisis. With a combination of quantitative and price instruments, the monetary policy framework, which aims at maintaining not only price stability, but also sustaining growth, has enabled the economy to weather multiple shocks including food price fueled inflation, domestic natural disasters, and the constraints by zero-rate policies in the advanced economies to the withdrawal of stimulus. The strengthened financial regulation and supervision, as well as the corporate governance, risk controls, and strong capital buffer of the financial institutions put in place before the global crisis have also enabled the financial system to respond effectively to the shocks.

The banking sector is generally healthy, with the completion of restructuring and public offering of all major commercial banks. Banks are profitable and well-capitalized, with NPLs at historical low levels. Hard financial constraints are being put in place. The rapid development of financial markets has facilitated the diversification of financing. The nonfinancial corporate sector saw a 122.9 percent increase in its funding from the equity market in 2010. The bond market has become the sixth largest in the world. The development of the financial markets has also improved conditions for interest rate marketization, better resource allocations, and financial innovation.

The new Five-Year Plan calls for deepening financial reforms, including further reforming financial institutions, accelerating the development of a multi-layer financial market, and strengthening financial regulation and supervision. Among many detailed actions, it envisages the establishment of a deposit insurance system, a countercyclical macroprudential framework, and a resolution mechanism for systemic financial risks; further interest rate marketization; further improving the exchange rate regime; phasing out restriction on the cross-border use of the renminbi; and progress toward capital account convertibility.

Our authorities attach great importance to the FSAP exercise as a comprehensive health check for the financial system. As for the four near-term risks mentioned in the FSSA, we would like to emphasize that both the NPL level and volume have been dropping steadily. The off-balance sheet exposures are small relative to bank balance sheets.

As the FSAP results confirm the general health of China's financial system, the exercise focused on further financial sector reform. We note that the FSAP recommendations were largely consistent with what has been laid out in the Plan. Some recommended actions are already being put in place. A subtle difference was that staff preferred a clear reform sequence and road map, while our authorities believe that, although it is important to have a clear direction and an integrated and coordinated approach to reform design, predetermined timing, sequencing, and pace could complicate and even slow down implementation. Flexibility for responding to unforeseen shocks is critical. For example, the progress in promoting capital account convertibility and exchange rate regime reform was interrupted twice by external financial crises. Each time, renewed efforts were needed to rebuild consensus.

IV. Spillover effect

The current spillover analyses were largely a summary and attempted verification of some third-party concerns. We would have benefited from an independent analytical framework by staff.

On the inward spillover, the reports fail to capture the significant shocks to the authorities' decision-making, firm and household behavior, and the progress in rebalancing. First, the prolonged massive unconventional easing by the major central banks not only fueled inflation pressures but also constrained the options regarding policy mix, as well as the timing, path, and pace of the monetary policy normalization in emerging market economies. Even those with floating regimes were also forced to resort to capital controls. Without the external shocks, China's monetary stimulus withdrawal would have experienced a different pace and would have relied more on price instruments. Second, the global crisis and recession negatively affected the fiscal performance and expenditure composition of the emerging market economies. Third, more profoundly, the external shocks caused major interruptions to reforms in China, particularly the exchange rate reform. Fourth, the spillover slowed the progress of rebalancing. As noted in the FSSA, the Lehman collapse marked a sudden surge in China's household and corporate savings, undoing much of the rebalancing efforts in China. The household deposits growth jumped from 1 trillion yuan in 2007 to an average of more than 4.3 trillion yuan in the three years after the subprime shock, while corporate deposit growth surged from 2 trillion yuan in 2008 to 6 trillion yuan in the following year. We find the real shock from the U.S. subprime crisis much stronger than suggested in the staff spillover reports. It caused China's exports to plunge for 13 consecutive months, with a 52 percentage-point drop in export growth and a sharp decline in FDI inflow. It has significant impact on business activity, employment, and fiscal performance.

On the outward spillover, we would like to highlight a few points. First, the report fails to mention China's role as an important source of global stability and growth. China has resisted the pressure for depreciation during the recent major episodes of large downward exchange rate movement in many other emerging market economies. While focusing on the rising export share (which is, as a matter of fact, not out of line with its share in global GDP), staff ignores the sharp rise in China's import share (from 6.1 percent in 2005 to 9.1 percent in 2010). Second, contrary to the view that China's capital controls diverted flows to other EMEs, since the outbreak of the crisis, China has been easing rather than tightening its restrictions and remains one of largest net capital recipient. Third, as a large and diversified importer and exporter as well as FDI destination, by facilitating the completion of the production chain, it helps the economies at the higher end of the value chain to relocate uncompetitive operations to China, and LICs to participate in the global division of labor. Fourth, as China raises its living standard, it frees up development financing for other low-income countries and contributes to the global efforts to achieve the millennium goal.