INTERNATIONAL MONETARY FUND

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PEOPLE'S REPUBLIC OF CHINA

2012 ARTICLE IV CONSULTATION

July 2012

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 2012 Article IV consultation with the People's Republic of China, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 8, 2012, with the officials of the People's Republic of China on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 6, 2012. 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.
- **Informational Annex** to the Staff Report of July 6, 2012.
- **Staff Statement** of July 20, 2012
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its July 20, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for the People's Republic of China.

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 2012 ARTICLE IV CONSULTATION

July 6, 2012

KEY ISSUES

Context. The economy seems to be undergoing a soft landing, though global headwinds are increasing. Growth is expected to moderate to around 8 percent this year and inflation to drop to 3½ percent. Meanwhile, a political transition is underway.

Focus. Near-term macroeconomic management challenges were a key focus of the consultation. The economy has been slowing partly as a result of policy action to moderate growth to a more sustainable pace, but a worsening of the euro area crisis poses a key risk to the outlook. The mission also discussed domestic risks related to the property sector, financial system, and local government finances. Another theme related to the medium-term priority of internally rebalancing the economy toward consumption. Finally, the mission also exchanged views on inward and outward spillovers, with particular attention to how China's investment impacts the rest of the world.

Macroeconomic policy advice. Policies should continue to be geared toward achieving this year's growth targets. In the event of a worsening of the external outlook, China has ample room to respond forcefully, using fiscal policy as the main line of defense and with emphasis on measures that support China's medium-term reform objectives.

Internal rebalancing. The significant reduction in the current account surplus since its peak in 2007 is welcome, but this external rebalancing has been achieved at the cost of rising internal imbalances. China's growth has become increasingly dependent on investment, a pattern that will be difficult to sustain. Therefore, there is a need to accelerate progress in transforming the economic growth model to be more reliant on consumer demand. Such a transformation would substantially boost living standards and make growth more balanced, inclusive, and sustainable.

External assessment. The renminbi is assessed to be moderately undervalued, reflecting a reassessment of the underlying current account, slower international reserves accumulation, and past real effective exchange rate appreciation.

Approved By
Anoop Singh and Tamim Bayoumi

Discussions took place in Wuhan, Shanghai, and Beijing during May 29–June 8, 2012. The staff team comprised M. Rodlauer (Head), A. Ahuja, S. Barnett, M. Nabar, P. N'Diaye (all APD), M. Das (RES), I. Lee and M. Syed (resident representatives in Beijing), and A. Meier (resident representative in Hong Kong SAR). Messrs. Zhang, Xia, and Tao (OED) joined meetings in Wuhan and Beijing. The First Deputy Managing Director joined the mission on June 7–8.

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NEAR-TERM MACROECONOMIC MANAGEMENT

A. Near-Term Outlook

1. ***Growth.*** Staff project growth to moderate to 8 percent this year—¼ percentage point lower than in the April WEO—the lowest in many years (Figure 1). This projection assumes that global activity is slightly weaker than envisaged in the April 2012 WEO and that the authorities continue to gear policies to achieving this year's fiscal and monetary targets. Growth is expected to bottom out in the second quarter, and then accelerate in the second half of the year. Growth next year is projected to be 8½ percent.

2. ***Inflation.*** Since peaking at 6½ percent last July, inflation has been on a downward path to 3 percent in May. Price pressures have eased across all major components of the CPI basket, led by declining food inflation that reflects the unwinding of agricultural supply shocks. Policy efforts to rein in the property sector have also helped to lower inflationary impulses from housing, and softer global commodity prices have contributed to lower production costs. Inflation in China remains driven primarily by food prices, and barring further shocks to agricultural supply, inflation should stay in the 3–3½ percent range this year and fall to 2½–3 percent in 2013.

3. ***Authorities' views.*** The authorities have been pursuing policies aimed at slowing the economy to a more sustainable pace. As a result, growth has been steadily moderating over the past five quarters. This managed slowdown, however, has run into stronger-than-anticipated headwinds from the worsening of the euro area crisis. Measures to support growth are now being given more prominence and the authorities are confident that growth will be at least 7½ percent this year. Regarding inflation, they noted that ongoing reforms to increase factor prices could push inflation above staff's 2013 forecast.

B. Macroeconomic Policies

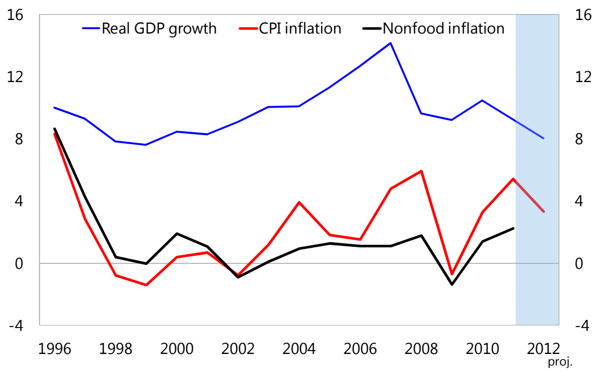
4. ***Fiscal policy.*** The 2012 budget strikes a balance between unwinding the 2009-10 fiscal stimulus and providing support to the slowing economy (Figure 2). The overall deficit is expected to be 1¼ percent of GDP, unchanged from last year in cyclically adjusted terms.[1] Although revenues have been subdued this year, the full-year revenue targets remain achievable, as activity is expected to pick up in the second half of this year. To help support activity, implementation

[1] This is based on staff definitions, which adjust the official figures for a few items, the main one being net transfers to the stabilization fund.

Figure 1. Growth Appears Headed Toward a Soft Landing

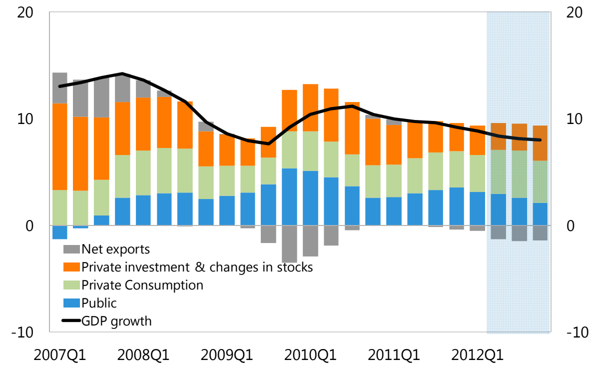
The economy appears to be undergoing a soft landing, with growth moderating and inflation easing.

CPI Inflation
(In percent, year-on-year)



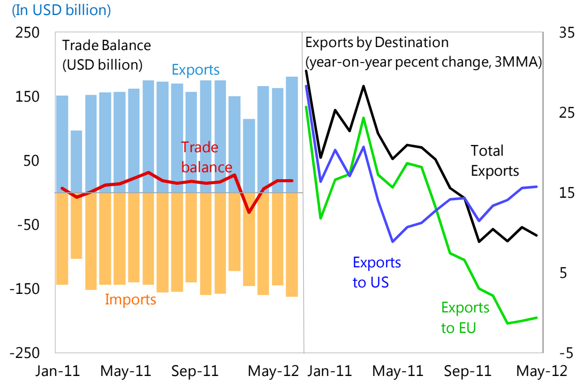
Growth remains healthy, supported by strong domestic demand...

Contribution to GDP Growth
(In percent, annual average)



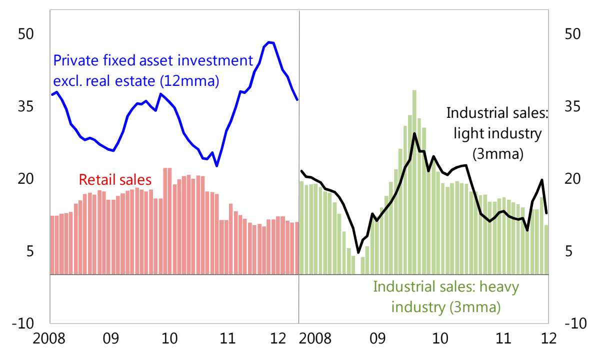
...even as the downdraft from slower external demand weighs on activity.

China: Trade Balance
(In USD billion)



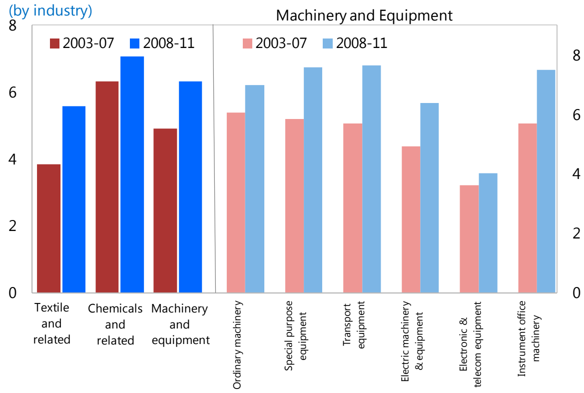
Industrial sales and fixed asset investment are buoyant...

FAI and Industrial Sales
(In percent, year-on-year growth, in real terms)



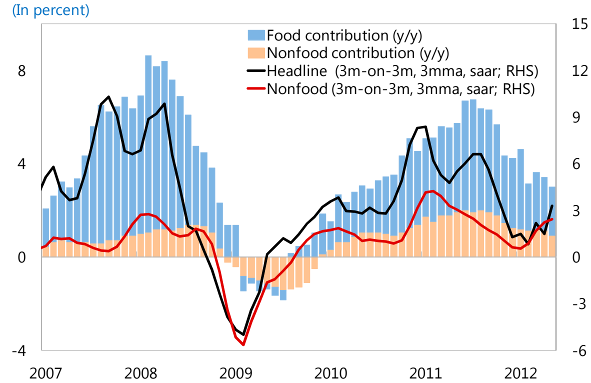
...supported by healthy profit ratios across a range of industries.

Profit Ratio
(by industry)



Inflationary pressures appear to be limited.

Inflation
(In percent)

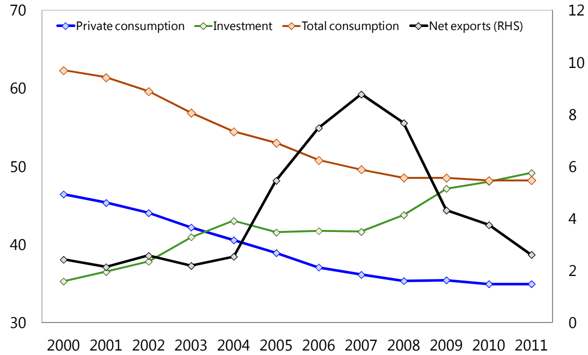


Sources: CEIC; Haver Analytics; WEO; and IMF staff calculations.

Figure 2. Lingering Effects of the Last Stimulus

The growth model continues to tilt toward investment...

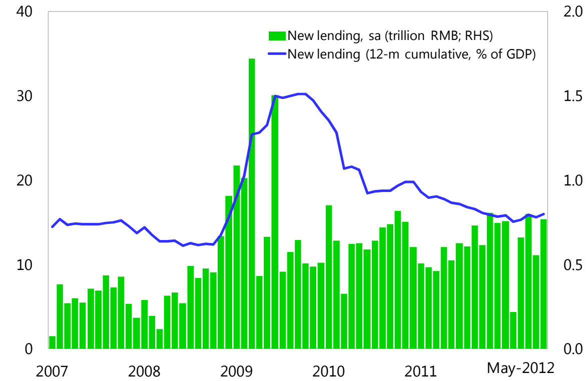
GDP Expenditure Components
(In percent of GDP*)



* Expenditure-based GDP.

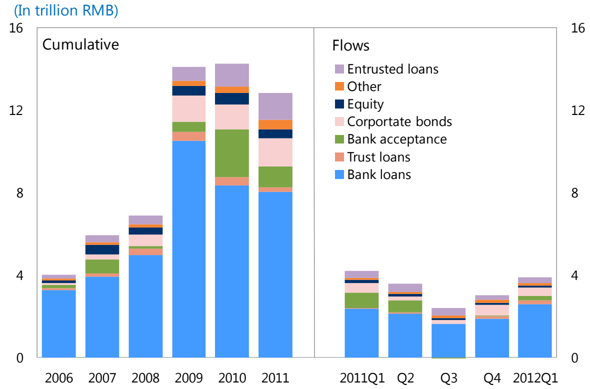
...supported by a large expansion of bank credit...

New Lending



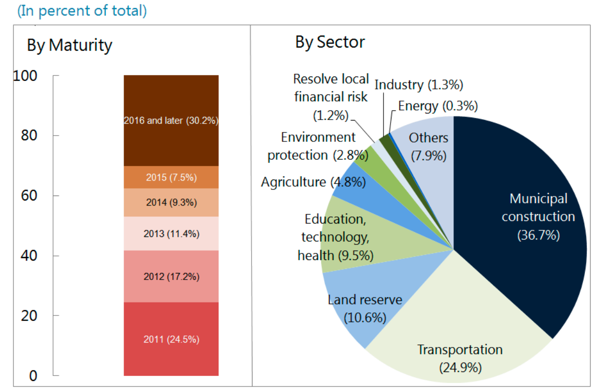
...and accompanied by financial innovation in nonbank channels of intermediation.

Social Financing
(In trillion RMB)



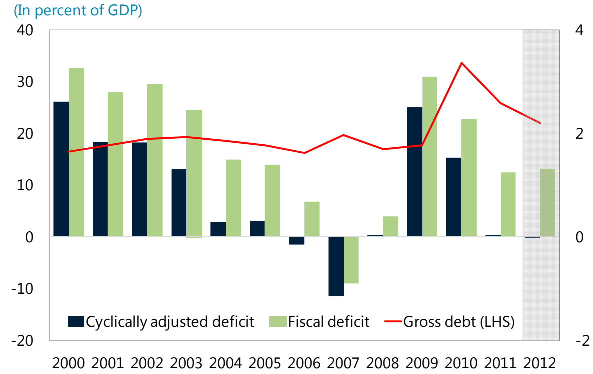
Much of the investment has been undertaken by local governments and is debt-financed.

Local Government Debt
(In percent of total)



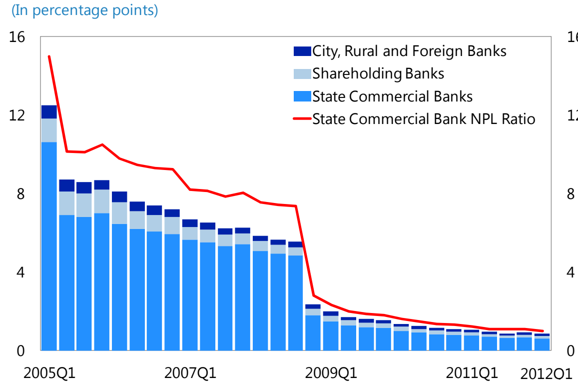
Despite the increase in local government borrowing, overall government debt remains at comfortable levels...

Gross Debt Position
(In percent of GDP)



...and the banking sector has some room to absorb a possible rise in NPLs tied to local government debt.

Contribution to Non-Performing Loan Ratio
(In percentage points)



Sources: CEIC; Haver Analytics; WEO; and IMF staff calculations.

of approved 2012 projects is being accelerated and some measures to support energy-efficient consumption have been implemented, all of which fit within the existing budget envelope.

5. ***Structural fiscal reforms.*** Ongoing fiscal reforms aim at facilitating China's economic transformation to a more consumer-based economy over the medium term, including by boosting household purchasing power and improving living standards. Recent progress includes reforms of the personal income tax to exclude more low-income workers from the tax net, increased social safety net payments, higher natural resource taxation, and a pilot reform to replace the business tax on services with the more efficient VAT. More broadly, staff highlighted that, in light of China's looming demographic changes (Box 1), it is important to ensure that the strengthening of the social security system is fiscally sustainable. In this context, the publication of well-defined medium-term fiscal plans would help anchor expectations and provide assurance that the planned fiscal reforms, including to social security, are affordable.

6. ***Monetary policy.*** The authorities are maintaining their 14 percent target for M2 growth this year. Credit growth has slowed significantly from a peak of 29 percent in early 2010 to 16 percent in May 2012, reflecting the authorities' policy efforts to slow the economy, with particular emphasis on reining in areas such as real estate development and local government financing vehicles (see section D below). Looking ahead, recent policy adjustments, including lower benchmark interest rates and an acceleration of investment projects already part of the 12th Five-Year Plan, are expected to support a moderate rebound of growth in the second half of the year, with a corresponding firming of credit demand. The reduction in foreign exchange intervention has lessened the need for sterilization, facilitating three cuts in banks' required reserve ratios since December. Going forward, staff advocated further reductions in reserve requirements and increased reliance on open market operations to manage liquidity.

7. ***Interest rates.*** To provide cyclical support to the economy, the authorities have lowered benchmark interest rates twice since early June (by a cumulative 0.56 percentage point on lending and 0.5 percentage point on deposits) . At the same time, they permitted banks to have more flexibility in setting interest rates (Box 2) under the administered benchmark interest rate system. By reducing the minimum margin between the deposit and lending rate, the recent reform will make banking more competitive over time with other types of intermediation. On the lending side, the majority of loans are already priced above the benchmark rate and, therefore, the near-term impact on average lending interest rates is unclear. Staff has long advised that price-based tools should play a stronger role in monetary policy, which would allow the central bank to rely less on administrative tools on bank lending to achieve its

Box 1. Demographics—Has China Reached the Lewis Turning Point?

An abundant supply of low-cost rural labor has been a key feature of China's economy. But do reports of wage inflation and labor shortages mean that this era is coming to an end? Staff analysis suggests not yet, but structural demographic factors indicate that China will approach the Lewis Turning Point (LTP) by the end of the decade.

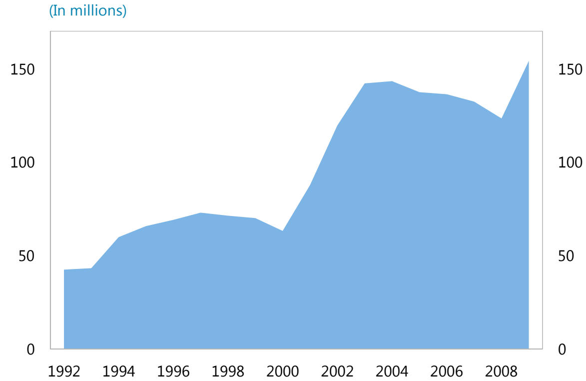
Demographics

China is experiencing a rapid demographic change. In addition to the projected decline in the labor force post-2015, the old-age dependency ratio is expected to increase at an almost unprecedented rate over the coming decades, from about 13½ percent in 2010 to around 20 percent in 2020 and around 28 percent in 2030. The rural old-age dependency ratio will rise to over 34 by 2030 (World Bank China 2030 Report).

Approach

A simultaneous equation disequilibrium model of the labor market is used to gauge the current level of excess labor supply.[1] The result is used to project the path of excess labor supply based on China's fundamentals (including demographics, household wealth, labor market characteristics, productivity, and external demand) and to determine the approximate period during which China will cross the LTP. Alternative assumptions are used to assess the impact of possible reforms.

China: Excess Supply of Labor Estimates
(In millions)

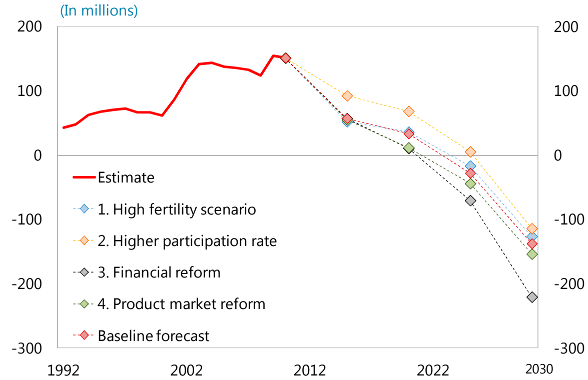


Results

- Excess supply of labor is strongly related to demographics (population, labor force, and participation), real wages, total factor productivity, household wealth, and the unemployment rate. The baseline estimates indicate that:

  - ➢ China will continue to benefit from excess supply of labor through 2020. Excess labor is estimated in the range of 150 million at the present time, and projected to fall to around 30 million in 2020.
  - ➢ China is poised to cross the LTP somewhere between 2020 and 2025.

Excess Labor: Baseline and Alternative Scenarios
(In millions)



- Higher fertility rates (such as by relaxing the one-child policy) would induce a positive, albeit small, delay in crossing the LTP, as it will translate into a larger labor force but only with a significant passage of time.
- Raising labor force participation rates (such as by granting migrant workers urban residency permits and easier access to subsidized housing, schooling, and healthcare in their city of residence) would move the LTP to after 2025, assuming a 4 percentage point rise in participation relative the 2010 rate.
- Financial sector reform could accelerate reaching the LTP. Interest rate liberalization that permanently lifts deposit rates would raise net household wealth and thus induce a reduction in the supply of labor as households find it less attractive to work.
- An increase in total factor productivity (by raising competition in the service sector and improving the efficiency of investment) would boost output, cause firms to demand more labor, and reduce the effective supply of labor.

[1] See Das, M. and P. N'Diaye, "Has China Crossed the Lewis Turning Point?" IMF working paper (forthcoming).

Box 2. Recent Interest Rate Reform

On June 7 and July 5, 2012, the People's Bank of China (PBC) announced (i) reductions in benchmark interest rates and (ii) changes to the margins around benchmark renminbi deposit and lending interest rates:

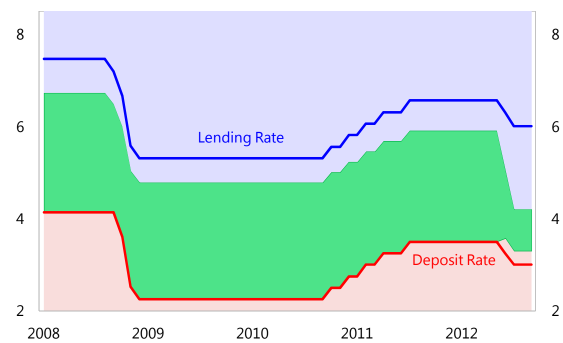
- ***Reduction of benchmark rates.*** The one-year benchmark deposit rate was lowered by a cumulative 50 basis points (to 3 percent), and the lending rate by 56 basis points (to 6 percent). These were the first reductions since the second half of 2008. Adjustments were also made to benchmark interest rates on deposits and loans of other maturities, as well as deposit and lending interest rates of the personal housing provident fund.

- ***New margin on deposit rate.*** The maximum deposit interest rate was allowed to be 10 percent above the benchmark rate, whereas previously it could not be set above the benchmark. As a result, the highest possible one-year deposit interest rate was reduced from 3.5 percent to 3.3 percent (10 percent above the new 3.0 percent benchmark).

- ***Larger reduction in minimum lending rate.*** The minimum lending interest rate, previously at 90 percent of the benchmark rate, was lowered to 70 percent. The minimum one-year lending interest rate therefore declined from 5.9 percent to 4.2 percent.

- ***Minimum margin considerably smaller.*** As a result, the margin between the minimum lending interest rate and the maximum deposit interest rate at the one-year tenor has been narrowed by 150 basis points, from 240 basis points to 90 basis points.

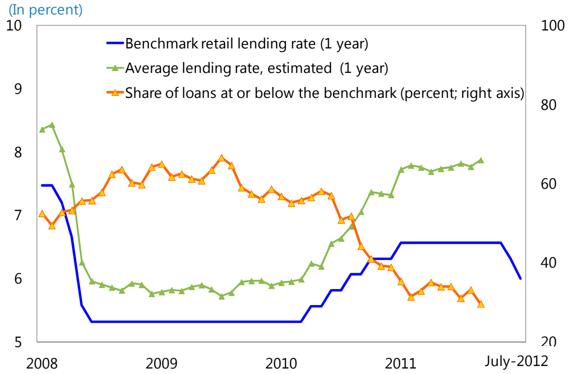
Benchmark Lending and Deposit Rate
(In percent pa; 1 year)



Sources: CEIC; and IMF staff calculations.

monetary goals. This goal is becoming more urgent as financial innovation is facilitating intermediation outside of the standard deposit-and-loan business.

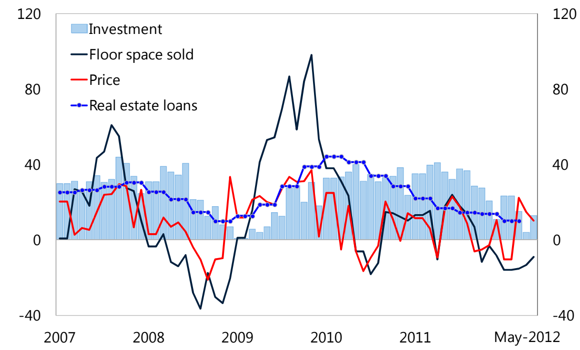
Nomimal Lending Rates
(In percent)



8. ***Authorities' views.*** On fiscal policy, the authorities were confident that there was space within the existing budget to continue to adjust policies to support growth. They continued to view their monetary targets as appropriate and noted that the recent cuts in benchmark interest rates would help ensure that these targets were achieved. Moreover, they highlighted that the recent announcements also include important further steps toward interest rate liberalization. They also considered that prices were already playing a key role in financial intermediation.

9. ***Property.*** The residential property market has cooled off in recent months, with nearly two-thirds of the 70 major cities tracked in the official index witnessing sustained price declines. In the larger tier 1 cities, price declines have mainly occurred in outlying areas and suburbs. Real estate investment has slowed, but continues to be supported by social housing construction. So far, the slowdown in the property sector appears to be relatively smooth and no major developer has been reported to experience serious financial distress. However, as in the last property cycle, the trough in investment is likely to come after property prices start to rise. Given the importance of the property sector in the Chinese economy and its extensive forward and backward linkages, the authorities are attaching high priority to carefully monitoring price and transactions developments and ensuring that they remain on a stable trajectory.

Residential Property Price and Activity, National
(In percent, yoy)



C. Global Risks

10. ***External risks.*** The main external risk continues to be spillovers to China from a worsening of the euro area crisis. Staff analysis indicates that China would feel the impact primarily through the trade channel. Assuming no policy response in China, growth could decline by as much as 4 percentage points in response to a 1¾ percentage point slowdown in global growth (as in the January WEO downside scenario).

11. ***Policy response.*** A record of fiscal discipline gives China ample space to respond to a heightened external shock using fiscal policy as the primary tool. In 2009–10, China's timely and large stimulus succeeded in supporting domestic growth, shielding China's population from the worst of the crisis, and helping the global recovery by providing a lift to world demand. However, the side effects of the largely credit-fueled stimulus are still being felt and its heavy reliance on investment has led to an increase in excess capacity, a heightened risk of future NPLs, and concerns about the financial health of local government financing vehicles. This underscores the importance of using on-budget fiscal measures as the principal tool of any future stimulus. Such measures should aim to boost consumption and support the medium-term objectives of transforming China's growth model. Options, many of which are already being pursued to some extent, include direct subsidies to consumption, incentives to reduce pollution and energy use, fiscal support to small enterprises, and higher social safety net spending. The response should be guided by the principle of accepting growth that is somewhat slower but better balanced.

12. ***Authorities' views.*** The authorities were concerned about the external outlook, especially the risk of a worsening of the euro area crisis and the lack, so far, of a sufficiently strong policy response within Europe. They noted that the euro area crisis was already weighing on exports, investment, and consumer sentiment in China. Weakening activity and potentially pro-cyclical fiscal policy in the United States were also cited as risks. The authorities agreed that, in the event of a worsening of the euro area crisis, they had ample room for a forceful policy response. They would aim to adopt a balanced approach between fiscal and monetary measures, designed to safeguard the official growth target of 7½ percent for 2012 while avoiding the build-up of future imbalances. They highlighted that rising real interest rates and the still-high reserve requirements provided space for a further monetary response. By ensuring healthy domestic consumption and investment growth, China would continue to contribute significantly to global economic stability.

D. Domestic Risks

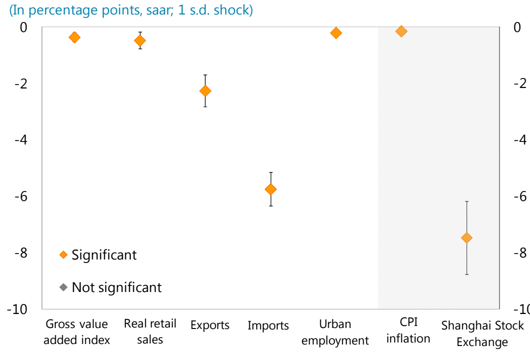
13. ***Weaker growth?*** The authorities' efforts to slow the economy entail the risk that growth could weaken too much. This is especially true against the backdrop of a worsening external environment. If activity softens further, there is scope to adjust macroeconomic policies. To avoid a repeat of the 2009–10 credit and investment stimulus (which would compromise the medium-term rebalancing agenda), fiscal policy should assume the lead role in this response, with monetary policy geared to achieving the existing targets.

14. ***Real estate risk.*** Staff raised the potential risk that measures to cool the real estate market could overshoot and lead to a sharper-than-anticipated decline, especially with a possibility of more severe external headwinds going forward. Staff spillover analysis suggests that a disorderly decline in real estate investment could have significant implications for growth in China and the global economy (Box 3). In the event the market contracts too much, there is space to accelerate the social housing program and selectively loosen some of the restrictions that hold back housing demand, notably those affecting first-time buyers, owner-occupied housing, and low-income groups. Staff emphasized, however, that mitigating China's inherent tendency for property bubbles would require addressing the underlying structural causes. This would include providing more outlets for household savings through

Box 3. The Spillover Effects of a Downturn in China's Real Estate Investment[1]

Real estate investment accounts for a quarter of total fixed asset investment in China. This box examines the spillover effects of an independent decline in China's real estate investment on a large set of macroeconomic, labor, financial, and trade indicators in China and its G20 trading partners as well as global commodity prices. The interaction between China and the rest of the G20 is captured by a two-region factor-augmented VAR (FAVAR), based on monthly data during 2000M1-2011M9.

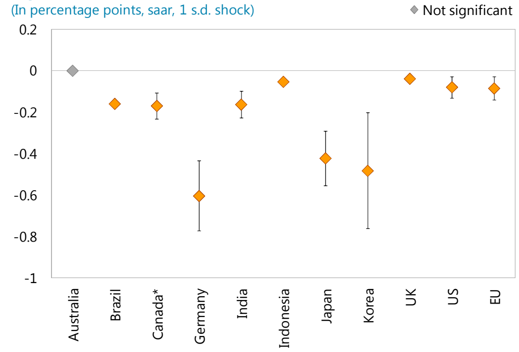
Fig. 1: China, Peak Impact on Macroeconomic Indicators
(In percentage points, saar; 1 s.d. shock)



Domestic Impacts. Following a decline in real estate investment, activity would fall in a broad range of sectors, given the real estate industry's strong backward linkages to other domestic industries (such as consumer durables, construction, light industry, electricity). Weakening domestic demand would depress China's imports and, in turn, impact trading partners' production, employment and domestic demand. As a (second-round) result, China's exports would weaken. The fall in China's imports reflects robust linkages of real estate activity to domestic industries that require inputs from abroad on top of a significant share of processing trade in total trade (see Fig. 1). Consumption would weaken as income and wealth decline. Total industrial value added and output would fall, with impact starting to dissipate after 4 quarters. The overall slowdown is reflected in the stock market as well as employment conditions. As demand conditions deteriorate, property transaction volume and price would also fall.

Global Spillover. Capital goods manufacturers that have sizable direct exposure to China, especially Korea and Japan, and those that are highly integrated with the rest of the G20—therefore sharing adverse feedback (second-round impact) from a negative shock in China with other trading partners, such as Germany and Japan—would experience a larger slowdown in industrial production and GDP (see Fig. 2). All in all, a 1-percent decline in China's real estate investment would shave about 0.2 percent off China's real GDP within the first year, with negative spillover impacts to China's G20 trading partners, which would result in global output loss of 0.06 percent. Trading partners face a direct impact on exports of machinery, equipment, and commodities following a downturn in China's real estate investment. This initial impact is further amplified through second-round effects on domestic demand.

Fig. 2: Peak Impact on Real GDP, implied
(In percentage points, saar, 1 s.d. shock)



Global trade activity would weaken, which implies that economies that derive significant benefit from global trade expansion and have indirect links with China via supply chain countries over the past decade, such as Germany and Japan, would be harder hit in the second round.

Table 1. Impacts one year after a 1-standard-deviation exogenous decline in China's real estate investment: Selected Commodity Prices

World Prices:	(In percent, year-on-year)
Metals	-2.7
Non-fueled primary commodities	-1.3
Zinc	-4.3
Nickel	-3.7
Lead	-3.2
Copper	-3.1
Iron ore	-1.6
Aluminum	-2.1
Rubber	-1.6
Silver	-1.5
Gold	-0.4

Remark: A one-standard-deviation decline in growth is equivalent to 2-percent decline in real estate investment levels from baseline

Worsened global growth prospects would be reflected in falling asset prices and sovereign bond spreads (except the United States, where the initial flattening of the yield curve is reversed after around two quarters, pointing to better recovery prospects compared to other G20 economies).

Global growth slowdown and a drop in China's demand for base metal imports would lead to a drop in the international prices of iron ore, aluminum, copper, lead, nickel, and zinc (see Table 1). The impact on overall metal prices could last 4 quarters, with up to 5–6 quarters for lead and zinc, possibly due to weaker supply response.

[1] See Ahuja, A. and A. Myrvoda, "The Spillover Effects of a Downturn in China's Real Estate Investment on G20 Economies and Global Commodity Prices," IMF Working Paper (forthcoming).

deepening local financial markets and eventually opening the capital account, and increasing the carrying cost of real estate by achieving, over time, structurally higher real interest rates and putting in place a broad-based property tax. This, however, will require a well developed registration and appraisal system.

15. ***Authorities' views.*** The authorities regarded the risk from policy over-tightening as low. On the real estate risk, they felt that current measures were sufficient to support the real estate market in the short run, and were also conducive to the long-term development of the housing market and the economy as a whole. They also noted that current policies were already aimed at encouraging first-time buyers' demand and that nonspeculative transactions should rebound once the property sector had cooled enough.

16. ***Local government finances.*** Local governments have direct responsibility for the delivery of social services, and therefore play an important role in distributing the benefits of growth to all parts of society. However, they lack adequate own-revenue sources and are prohibited from on-budget borrowing (except for a limited pilot in a few provinces; instead, many of them make recourse to borrowing by off-budget financing vehicles to fund investment projects). This has consequences for the provision of social services, the property market (given the strong incentive to use land sales as a source of financing), the banking system via lending to local government entities, and public debt dynamics. Addressing the problem of local government finances should be a priority, which will need to include clarifying expenditure assignments, ensuring that revenue sources are adequate to meet these assignments, and putting in place a system to closely monitor and control the risks related to borrowing by local entities, especially local government financing vehicles.

17. ***Authorities' views.*** The authorities agreed that reforming local government finances was a priority, including on the revenue, spending, and financing sides. They indicated that around 20 percent of the debt owed by local government and local government financing vehicles as of end-2010 had already been repaid during 2011, and local government financing vehicles had taken on a minimal amount of new debt during the same period.

E. Financial Sector

18. ***Bank asset quality.*** The side effects of the last stimulus are still winding their way through the economy. As a result, there is a clear risk of deterioration in bank asset quality, which would be amplified in a lower-growth scenario. As suggested by the Financial Sector Assessment Program (FSAP) stress tests, and corroborated by new stress tests conducted by the authorities at the end of 2011, the risk to the overall banking system appears manageable under most scenarios. Reported data indicate that bank balance sheets are generally healthy, with provisioning rates against gross loans at 2.5-3 percent (covering reported NPLs close to three times) for the largest banks. Also, the fiscal position is sustainable even under conservative assumptions about the ultimate fiscal costs of dealing with a rise in NPLs. Nevertheless, a substantial rise in NPLs would raise potentially difficult questions about burden sharing between banks and different levels of government. In this context, it is critical to put in place a crisis management framework that allows for the orderly exit of weak or failing financial institutions and clearly defines the roles of the state in providing fiscal support; and to adopt a formal deposit insurance scheme. Moreover, the China Banking Regulatory Commission (CBRC) should continue to ensure that banks fully account for the underlying risks of their loan portfolios with appropriate classification, provisioning, and risk weighting.

Selected Banking Indicators (in percent)

All commercial banks	2007	2008	2009	2010	2011
Total CAR ratio	...	...	11.4	12.2	12.7
NPL ratio	6.1	2.4	1.6	1.1	1.0
Substandard	1.0	1.1	0.7	0.4	0.4
Doubtful	2.2	1.0	0.7	0.5	0.4
Loss	2.8	0.2	0.2	0.2	0.2
Provision coverage ratio	41	117	153	218	278
Return on assets	0.9	1.1	1.0	1.1	1.3
Return on equity	16.7	19.5	18.0	19.2	20.4

Source: CBRC.

19. ***Off-balance sheet and nonbank financial intermediation.*** Financial activity outside of bank balance sheets has continued to grow at a rapid pace. This migration of resources into off-balance sheet activity and nonbank intermediation risks undermining the use of traditional monetary aggregates as policy targets, and potentially adds to vulnerabilities. While such activity reflects public demand for financial services and can benefit financial development in China, there is a risk that it could weaken monetary control and threaten financial stability. Addressing this risk requires the continued upgrading of regulatory and supervisory capacity. This includes further improving data collection on nonbank intermediation and strict oversight of nonbank risk management, especially in areas where short-term customer funds are channeled into longer-term risky investments. More broadly, these developments underscore the importance of strengthening the monitoring of systemic risk and pushing forward financial reform (in line with FSAP recommendations), including making monetary policy more reliant on price-based signals.

20. *Financial sector reform.* The last Article IV consultation and last year's FSAP (Box 4) focused on the importance of financial sector reform. International experience shows that while financial liberalization can foster long-term growth, careful sequencing, monitoring, and adjustments along the way as needed by changing circumstances, are important to avoid crises. Box 5 summarizes the progress made since last year's FSAP, including the widening of the renminbi trading band, the recent increase in interest rate flexibility, a stress testing exercise, and an implementation plan for adopting Basel III. Moreover, the trend toward making the renminbi a more international currency is positive and consistent with China's economic importance; to be successful, it needs to proceed in tandem with the gradual opening up of the existing capital control regime (Box 6).

FROM EXTERNAL TO INTERNAL REBALANCING: TRANSFORMING CHINA'S GROWTH MODEL

A. Progress with Rebalancing

21. *Current account*. China's external imbalances have been reduced significantly (Figure 3). The current account surplus declined sharply from a peak of 10.1 percent of GDP in 2007 to 2.8 percent of GDP last year, due primarily to a reduction in the trade surplus. The decline reflects a variety of factors including a worsening of the terms of trade, as China is no longer a price taker in many markets; cyclically weak foreign demand knocking down exports; strong domestic investment driving up imports, especially of primary commodities; and the appreciation of the real exchange rate.[2] Since some of these factors are likely to continue putting downward pressure on China's external imbalance, the medium-term forecast has been significantly lowered to a surplus of some 4 to 4½ percent of GDP (well below the 7 to 8 percent of GDP previously expected). However, China's surplus would still rise as a share of global GDP from 0.2 percent in 2012 to 0.6 percent in 2017. The projection cautiously assumes that the terms of trade will continue to deteriorate steadily (at around ½ percent per year), investment as a share of GDP will stay close to the current level, fiscal consolidation will continue over the medium

[2] Ahuja, A., N. Chalk, M. Nabar, P. N'Diaye, and N. Porter, 2012, "An End to China's Imbalances?" IMF Working Paper 12/100 (Washington: International Monetary Fund).

Box 4. FSAP Follow Up: A Preliminary Assessment of Recent Reform Efforts and Pending Priorities

Last year's Financial System Stability Assessment (FSSA) noted significant progress in moving toward a commercially oriented financial system, but also identified several near-term risks, structural challenges, and policy-induced distortions.

The Chinese authorities welcomed the FSSA, and explained that time was needed to study its recommendations and decide upon implementation. They noted that the FSSA's reform proposals would be carefully considered as China continues to develop and safeguard its financial system under the 12th Five-Year Plan. However, since the FSAP was completed only last year, the authorities cautioned that it was still too early for a full-fledged assessment of the follow-up.

Significant progress has already been achieved in several areas. Key examples include:

- ***The widening of the renminbi intraday trading band in April***, which the PBC notes has been underpinned by sharply reduced foreign exchange market intervention. If sustained, such restraint would mark welcome progress toward a more market-based exchange rate system.

- ***The PBC's decision in early June to give banks more flexibility in setting deposit and lending rates***, which sharply reduced the minimum interest margin and created scope to enhance monetary control via prices rather than administrative guidance.

- ***A stress-testing exercise conducted in late 2011*** that built on earlier work undertaken during the FSAP. Establishing a regular stress testing cycle would underpin the authorities' efforts to ensure proactive, forward-looking oversight of evolving banking sector risks.

- ***Improved data collection***, including a dedicated statistical system for bank acceptance bills and a credit code system gathering data on beneficial ownership and control for institutional bank account holders. The CBRC is also enhancing its collection of offsite surveillance data on leverage ratios and cross-border exposure.

- ***Launch of an inter-agency mechanism to develop the corporate bond market***, led by the PBC and incorporating the National Development and Reform Commission and the China Securities Regulatory Commission. It aims to improve rules on issuance, trading, and information disclosure.

- ***Creation of a task force to help develop a new risk-based solvency framework for the insurance sector.*** The China Insurance Regulatory Commission has also set up a risk monitoring system for the insurance industry and clarified the rules governing exit from the market via portfolio transfers.

- ***Finalization of an implementation plan for Basel III***, which will introduce higher standards for capital adequacy to be phased in from January 1, 2013 onward.

Nonetheless, staff recommended further efforts in other areas, notably to upgrade the prudential framework to keep pace with the ongoing liberalization of the financial system. The FSSA underscored the need to develop a robust crisis management framework, establish a Financial Stability Committee to enhance the monitoring of systemic risk, and to introduce a formal deposit insurance scheme. The authorities noted some preparatory work in these areas and recognized that further efforts are desirable. Concrete progress will become increasingly important to ensure that the benefits of financial liberalization are not undermined by heightened risks to financial stability.

Box 5. Roadmap for Financial Sector Reform

Objective. Move to a more commercially oriented financial system that fosters stable and inclusive economic growth, facilitates internal rebalancing, and safeguards financial stability. The current system impedes rebalancing as it works as an implicit tax on household savings that is used to subsidize corporate investment and protect bank earnings.

Principles. There is no optimal and pre-determined path for financial sector reform, and plans should remain flexible and tuned to changing circumstances. Nonetheless, the complexity and interconnections between different aspects of the reform process—and the consequences of mistakes—underscore the importance of careful sequencing.

Exchange rate. Reaching exchange rate equilibrium with greater exchange rate flexibility will simplify monetary management by reducing the need to sterilize capital inflows and providing scope for a more independent monetary policy.

Monetary framework. Monetary policy should move toward price-based means instead of administrative controls on lending, which will require the absorption of excess liquidity to steer interest rates to an appropriate level. Implementing reserve averaging, targeting a short-term repo rate, and ensuring the PBC standing facilities operate immediately would help strengthen liquidity management and limit the volatility of money market rates. A new monetary policy framework could be put in place that focuses on growth, inflation, and financial stability.

Regulation and supervision. Improvements in supervision and regulation, as well as in systemic risk monitoring and the crisis management framework need to keep pace with increases in the commercial orientation and innovation of the financial system.

Financial market development. Strengthening nonbank financial intermediation will provide competitive discipline on banks, offer companies alternative avenues for finance, and provide households with a broader range of investment opportunities. Progress, however, needs to be calibrated with bank reforms to prevent a destabilizing rush away from bank-based intermediation.

Interest rate liberalization. As a strong system of prudential oversight is put in place, the central bank can move to liberalize the limits on loan and deposit rates and allow them to be market determined. It is critical, however, to ensure that this liberalization does not result in an unintended loosening of monetary conditions.

Capital account liberalization. Full liberalization—especially for short-term flows—should wait until the bulk of the reforms identified above are in place. The existing framework of qualified foreign institutional investor and qualified domestic institutional investor could be used to advance a gradual and controlled opening of the capital account.

Box 6. Renminbi Internationalization

The authorities are facilitating a gradual increase in the international use of the renminbi. This has involved allowing the settlement of cross-border trade in renminbi and the development of renminbi financial products in offshore markets. This has resulted in a growing share of trade invoiced in renminbi, a build-up in renminbi deposits in Hong Kong SAR, and an increase in issuance of renminbi-denominated "dim sum" bonds. More recently, and as the forward markets in Hong Kong SAR were pricing in depreciation of the renminbi against the U.S. dollar, the use of renminbi in Hong Kong SAR has leveled off as indicated by a flattening in the share of trade settled in renminbi and a modest dip of renminbi deposits. Market development has been helped by a selective relaxation of capital controls to allow offshore renminbi to flow back to the Mainland.

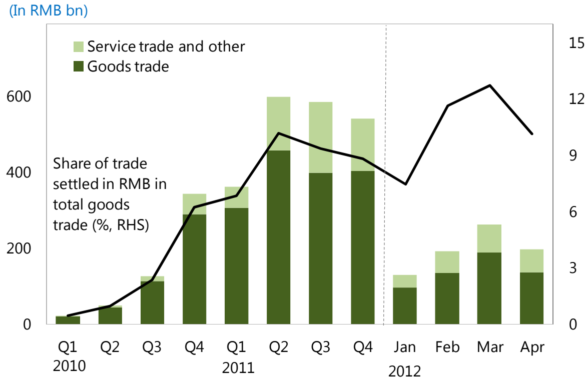
The expansion in the international use of the renminbi has occurred largely in Hong Kong SAR with its open capital account, highly regarded legal system, and strong regulatory oversight provided by the Hong Kong Monetary Authority. A payment infrastructure has been created, with the Bank of China as the clearing bank. Measures relaxing capital controls to support renminbi internationalization have been progressively implemented:

- Trade settlement in renminbi has been expanded to all Chinese corporations.
- Rules to remit offshore renminbi back to the Mainland as FDI have been simplified.
- A scheme has been put in place (renminbi-qualified foreign institutional investor) to allow offshore renminbi to be invested in Mainland interbank, bond, and stock markets (subject to a RMB 70 billion quota).
- Mainland banks and corporations have been allowed to issue "dim sum" bonds in Hong Kong SAR and repatriate the funds back to the Mainland.
- A renminbi swap facility with Hong Kong SAR can be used to provide renminbi liquidity offshore.

International use of the renminbi is also being promoted through bilateral agreements. China has established renminbi currency swap arrangements with 18 central banks totaling $260 billion. The China Development Bank has also arranged renminbi credit lines with other development banks and state enterprises in some emerging markets for renminbi trade settlements.

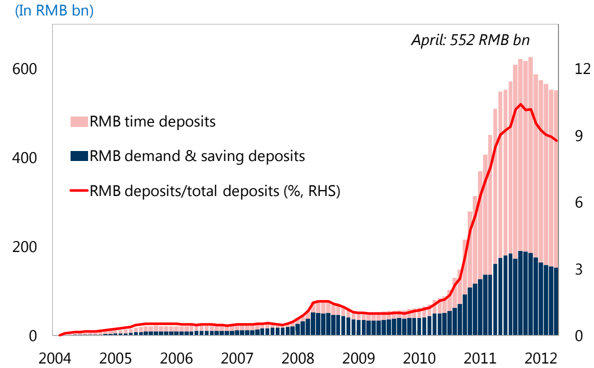
There are plans to expand the offshore renminbi business to other financial centers. Most recently, sales of renminbi financial products have been conducted in London.

RMB Cross-Border Settlement for Trade
(In RMB bn)



Sources: Bloomberg; CEIC; HKMA; PBoC; and IMF staff estimates.

RMB Deposits in Hong Kong SAR
(In RMB bn)

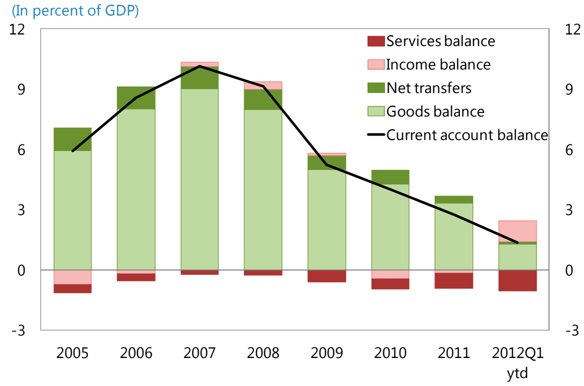


Sources: CEIC; HKMA; and IMF staff calculations.

Figure 3. Current Account: Recent Trends and Prospects

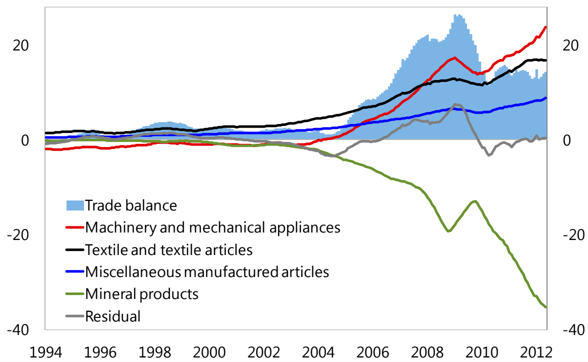
The decline in the current account has been larger and more durable than expected…

Current Account and Components
(In percent of GDP)



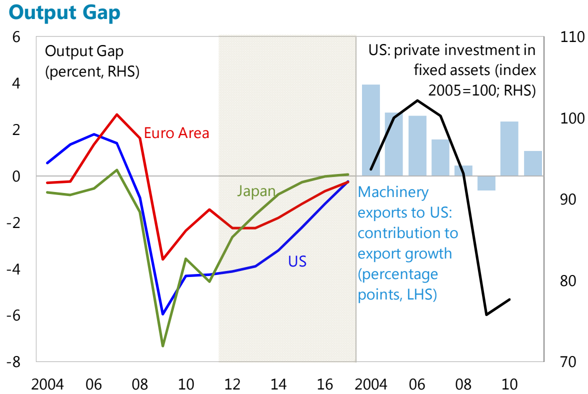
… largely due to a sustained compression in the trade surplus.

Trade Balance
(In billion USD; 12MMA)



The decline has taken place in the context of cyclically weak external demand…

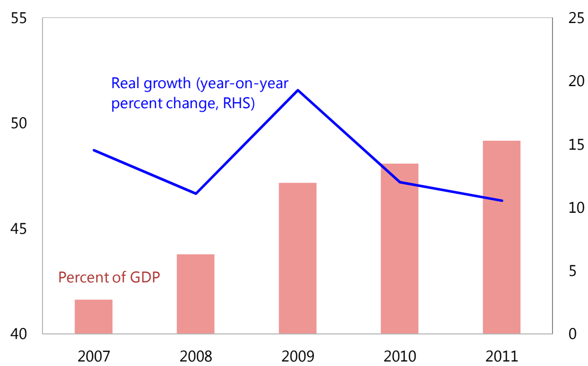
Output Gap



Source: WEO; and IMF staff calculations.

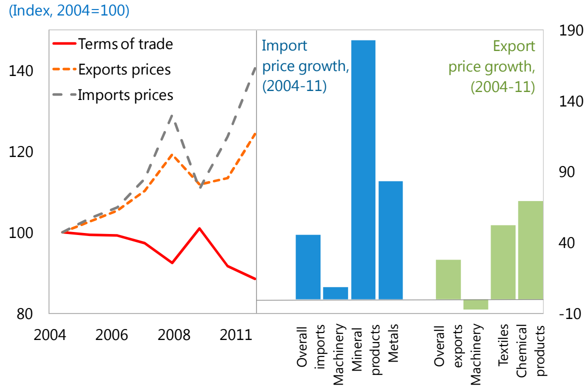
…but there are other, more long-lasting factors at work as well, particularly the steep increase in investment in China.

Total Investment
(In percent)



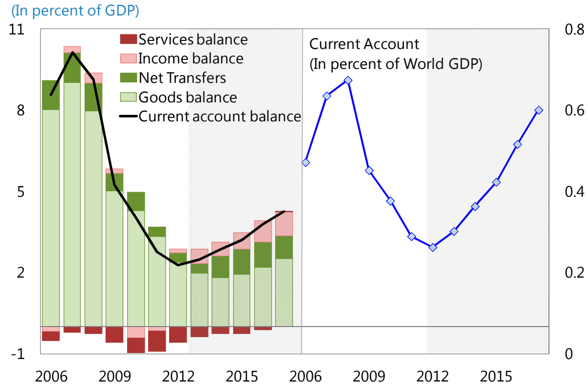
The higher investment, and the accompanying demand for commodities and capital goods, has reinforced the secular decline in China's terms of trade.

China Terms of Trade
(Index, 2004=100)



Over the medium term the surplus is expected to stay below pre-crisis ranges, although still rising as a share of world GDP.

Current Account and Components
(In percent of GDP)



Sources: CEIC; Haver Analytics; WEO; and IMF staff calculations.

term, advanced economies recover as envisaged in the April WEO, China will continue to gain global market share at the average pace seen over the past decade, and the standard staff assumption of a constant real effective exchange rate holds.

Table 1: Estimated Contributions to Decline in China's Current Account Surplus, 2007-11
(In percent of GDP)

	Estimated Trade Elasticities[1]	Reduced - Form Current Account Model
Actual 2007	10.1	10.1
Contributing factors:		
Terms of trade	1.6	3.0
Foreign demand	1.6	1.4
Investment	1.9	2.6
REER	2.6	1.3
Others	-0.2	-0.9
Actual 2011[2]	2.8	2.8

Source: IMF Staff calculations.
[1]Elasticities based on estimated calculations for exports and imports of goods.
[2]Preliminary actual.

22. ***Authorities' views on current account forecast.*** The authorities considered the underlying policy and related medium-term assumptions as too conservative and, consequently, the current account surplus forecast by staff in the medium term as too high. They expected demand from advanced economies to remain subdued for some time, and emphasized that the bulk of the decline in China's current account surplus was due to structural factors rather than cyclical ones, including reforms that have helped boost imports.

23. ***External assessment.*** The exchange rate assessment is based on a variety of inputs, including from the Consultative Group on Exchange Rate Issues (CGER), the new pilot External Balance Assessment (EBA), and other factors assessed by staff (Box 7 and Figure 4). Both CGER and EBA suggest that China's current account should be in a small surplus assuming output gaps in China and all other major economies were closed and, in the EBA framework, policies were at desired levels. This, together with the sharp decline in the current account surplus and related developments, convey that the undervaluation of the renminbi has been reduced. Overall, the renminbi is assessed to be moderately undervalued against a broad basket of currencies.

24. ***Authorities' views on external assessment.*** The authorities noted that prevailing foreign exchange market conditions were close to equilibrium. This, combined with the significant reduction in the current account surplus and renminbi appreciation, indicated in their view that the renminbi was now close to equilibrium or, at most, slightly undervalued. They appreciated the staff efforts to develop a new methodology for external assessments. However, they had significant reservations about the new model that was being piloted. They argued that more time was necessary before this approach was applied to China so as to better understand the model and allow for the needed vetting by the wider public. On the model itself, they expressed concerns that it was not evenhanded, as it focused on policy gaps in emerging markets, while missing key policy features of advanced economies that had contributed to the last crisis (such as

Box 7. Analysis of the External Sector

Staff's assessment is that the renminbi is moderately undervalued against a broad basket of currencies. As in the past, this assessment draws on a range of inputs.

- *Current account.* In addition to the multilateral model analysis discussed below, the current account surplus has declined sharply, from 10 percent of GDP in 2007 to less than 3 percent of GDP in 2011. Staff's medium-term forecast has also been revised down significantly.

- *Real exchange rate.* In addition to the multilateral model analysis discussed below, the real effective exchange rate has appreciated by some 30 percent since the 2005 exchange rate reform, and by 8 percent over the past year (end-April). The nondeliverable forward and onshore forward markets have been pricing in modest depreciation and spot market pressures are no longer one-sided.

- *International reserves.* The pace of international reserve accumulation has slowed considerably over the past 12 months (based on balance of payments data). It was especially low in the second half of 2011 before rebounding to US$75 billion in the first quarter of 2012—still below the post-2005 reform quarterly average of US$100 billion. Nevertheless, reserves are well above all standard metrics and the real effective exchange rate should be allowed to continue appreciating by reducing intervention and making it two-sided over the medium term.

- *Capital account.* China maintains a broad range of controls on capital inflows and outflows. Over the medium term, a carefully planned and sequenced loosening of capital controls that supports and reinforces domestic financial liberalization would be appropriate. It is not clear what effect liberalization would have on the direction of capital flows.

- *Net foreign assets.* Net foreign assets amount to 30 percent of GDP and have grown rapidly over the past several years. This reflects the persistent current account surpluses that peaked at 10 percent of GDP and years of strong FDI inflows. The composition of assets is dominated by foreign exchange reserves, which are around 50 percent of GDP, while liabilities are largely composed of FDI. International investment position vulnerabilities are low.

New multilateral methodology. A new methodology, External Balance Assessment (EBA), is being piloted. Similar to the CGER,[1] it generates results for three different approaches, but aims to improve on CGER by more explicitly looking at the role of policies in contributing to external imbalances. The EBA also takes into account a much broader set of factors that may influence the current account or real effective exchange rate. The analogs to the CGER external sustainability and effective real exchange rate approaches, as well as the CGER macro balance approach, yield a moderate undervaluation. The analog to the CGER macro balance approach is expressed in terms of the current account balance. This approach suggests that China would have a small current account surplus after controlling for the effects of the business cycle (both in China and the rest of the world) and assuming that all countries put in place the desired policies for the social safety net, fiscal balance, capital controls, and foreign exchange intervention.[2] To achieve that position, the underlying current account would come down. The results are preliminary and the model estimates are subject to uncertainty.

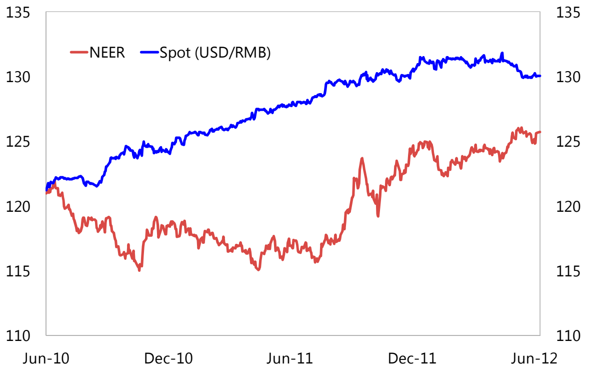
[1] Lee, J.; G.M. Milesi-Ferretti; J. Ostry; A. Prati; L.A. Ricci, 2008, "Exchange Rate Assessments: CGER Methodologies," IMF Occasional Paper No. 261 (Washington: International Monetary Fund).

[2] For more details on the methodology and preliminary results of this analysis, see the Pilot External Sector Report (forthcoming).

Figure 4. Exchange Rate

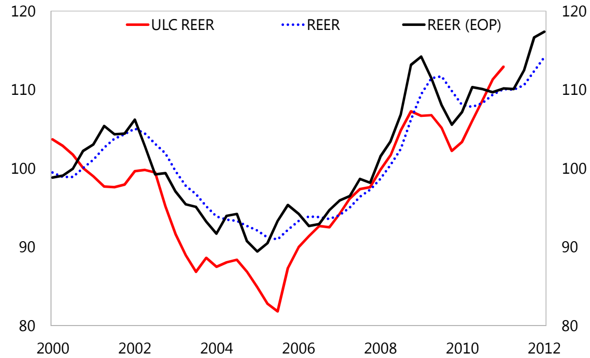
The renminbi has appreciated over 30 percent against the U.S. dollar and 25 percent in nominal effective terms since 2005…

Nominal Effective Exchange Rate
(Index; Jan 3, 2005=100)



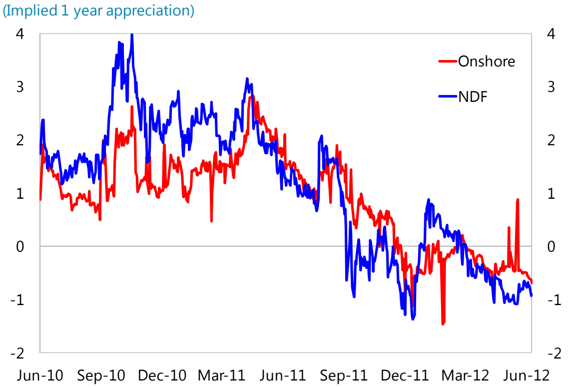
…which has contributed to the appreciation in the real exchange rate.

Real Effective Exchange Rate
(Index, 2000=100; 4QMA)



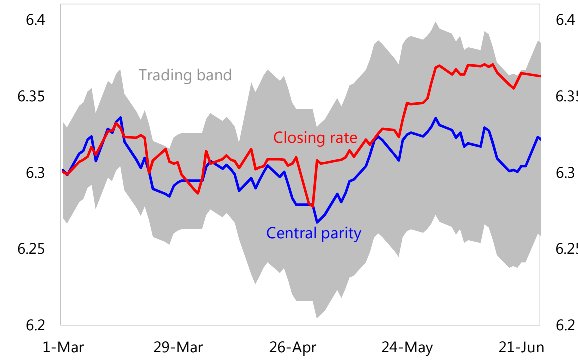
Forward markets have been anticipating greater two-way flexibility of the exchange rate for some months now…

Exchange Rate
(Implied 1 year appreciation)



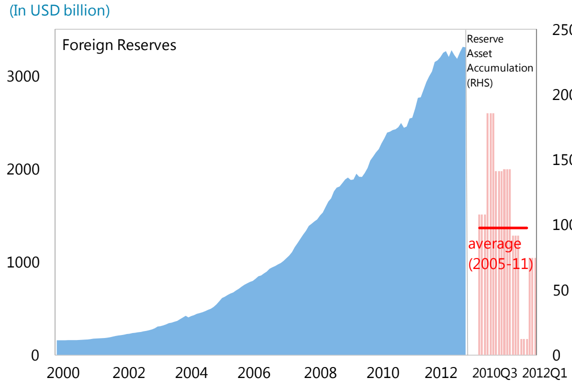
…and the widening of the trading band creates more room for market forces to influence the spot rate in both directions.

Spot Exchange Rate
(In USD/RMB; 1 March, 2012 - 25 June, 2012)



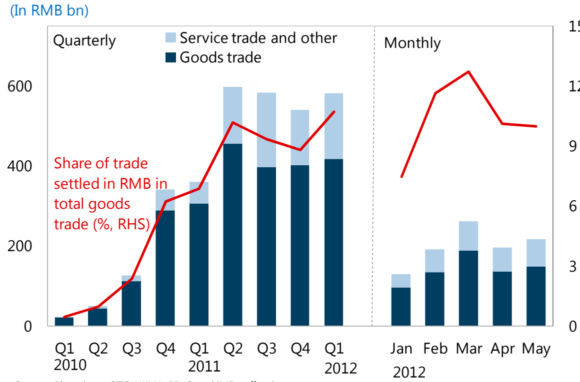
The pace of reserve build-up appears to be slowing…

Foreign Reserves
(In USD billion)



…and the renminbi has gained some traction as a settlement currency.

RMB Cross-Border Trade Settlement
(In RMB bn)



Sources: Bloomberg; CEIC; HKMA; PBoC; and IMF staff estimates.

Sources: PBC; Bloomberg; CEIC; Haver Analytics; OECD; IFS; INS; and IMF staff calculations.

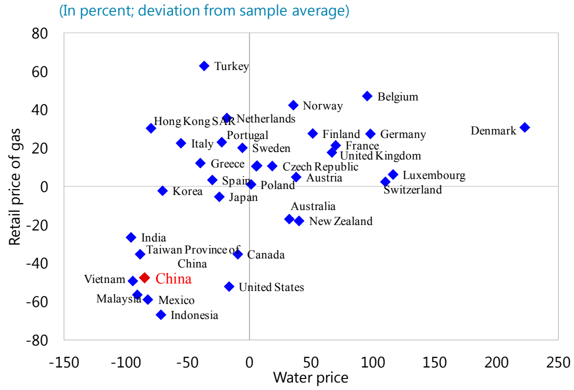
financial market supervision). They also disagreed strongly with the new focus on a desired current account balance and highlighted that previous China staff reports had never emphasized a current account target or norm.

25. ***Factor costs.*** In addition to the appreciation of China's nominal exchange rate, other factor costs in China have also been rising (such as labor, natural resources, and energy). Over time, these developments will further erode China's competitiveness and contribute to narrowing the undervaluation.

26. ***Energy and other inputs.*** Progress has been made to bring energy costs more in line with international levels. Oil product prices have been indexed to a weighted basket of international crude prices; natural gas prices have been steadily increased; and preferential power tariffs for energy intensive industries have been removed. Nevertheless, input costs remain significantly below most international comparators, and some users (such as those in the industrial zones) receive preferential pricing.

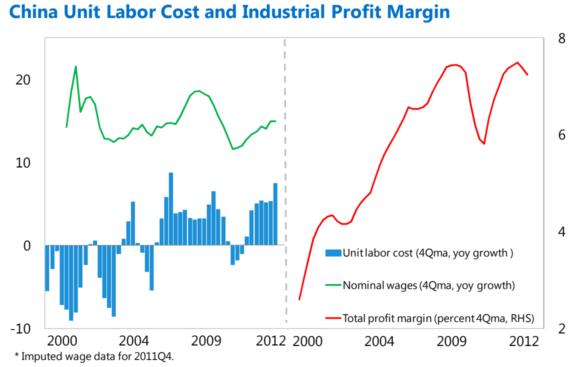
Water and Gas Prices

(In percent; deviation from sample average)



27. ***Labor cost.*** In the labor market, official data show wages growing at an average 15 percent over the past couple of years. Wages have been rising faster in inland provinces as more companies relocate there from the coast. However, the rise in aggregate wages has been only marginally above that of productivity, and the available data suggest that the household income to GDP ratio is not yet on a firm upward trend. Background work by the staff suggests that China still has untapped labor resources, and so has not yet reached the Lewis Turning Point (Box 1). The share of migrant workers in the labor force has risen from 23½ percent in 2008 to 26 percent in 2011. The recent rise in wages is thus mainly a result of increases in the minimum wage, efforts to improve workers' rights (including greater scrutiny of compensation and hours worked), and growing skill mismatches. However, demographic changes mean the labor force will gradually start to shrink after 2015, putting greater pressure on labor costs.

China Unit Labor Cost and Industrial Profit Margin



* Imputed wage data for 2011Q4.

28. ***Corporate profits.*** Rising factor input costs have, so far, not led to a visible erosion of industrial corporate profit margins or signs of broad-based corporate stress. Indeed, corporate profit ratios have been rising on average, and the share of loss-making enterprises has been declining. Geographical relocation, strong productivity, and modest increases in export prices are helping to defray cost pressures that firms may be facing. Recent data suggest that while profit margins may be weakening in some sectors, they continue to remain healthy on aggregate.

29. ***Rising domestic imbalances.*** While important progress has been made, the reduction in the current account surplus to date does not yet represent the "rebalancing" in China advocated by staff over the past several years. In particular, there is little evidence, as yet, of a decisive shift toward consumption and lower national savings as the main force behind the lower current account surplus. This raises concerns related to the sustainability of the recent decline in the current account surplus and the risk of growing domestic imbalances.

30. ***Authorities' views.*** The authorities considered that they had already turned the corner on domestic imbalances. Consumption, they noted, had already stopped declining as a share of GDP and would soon start to rise. Indeed, it had contributed significantly more to growth last year than in 2010. The authorities also felt that consumption was likely underestimated, and pointed to ongoing work to improve China's national accounts. Moreover, as discussed below, they had some reservations about characterizing China's investment rate as being excessive.

B. High Investment: Risks and Spillovers

31. ***High investment growth.*** The Chinese economy continues to face strong incentives to over-invest as the effective cost of capital and other key inputs remains too low. By most standards, including a cross-country comparison and the historical experience of other fast-growing economies, China's investment is very high. Approaching 50 percent of GDP, investment has been sustaining China's high growth and is creating large excess capacity in the economy, with the capacity utilization rate declining from just under 80 percent before the crisis to around 60 percent today, according to staff analysis. Consequently, the economy is likely operating below potential, as illustrated by staff estimates based on a structural model (Box 8). Closing this gap will require time and the pursuit of reforms to rebalance the economy.

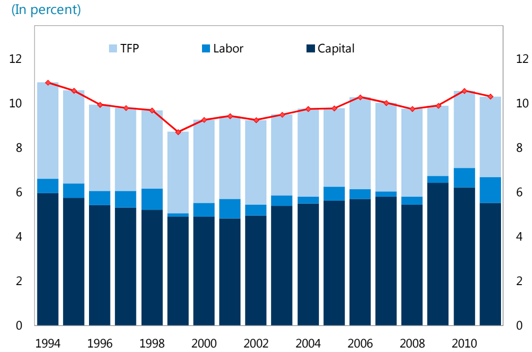
32. ***Demographics.*** Staff analysis suggests that about half of the recent increase in potential GDP has come from capital accumulation. This type of extensive growth can work as long as there is abundant supply of labor, so that firms can readily find low-skilled workers without driving up wages. However, demographic changes mean that in

Box 8. China's Rapid Investment, Capacity, and Output Gap

Measuring potential output in China is affected by significant uncertainty, given the large structural changes in the economy. Its growth model has relied on very high rates of investment; combined with surplus labor, this has created sizable and persistent excess capacity that will take time to close.

China has had a remarkable record of rapid growth and low inflation, which has helped lift more than 400 million people out of poverty. Since the last burst of inflation in 1996, real GDP growth has averaged 10 percent and nonfood inflation 1 percent. The growth model, however, is heavily dependent on investment, and capital accumulation has explained more than one-half of the increase in potential output (defined as the amount the economy could produce without generating inflation while fully utilizing available capacity and labor). A potential output estimation method that differs from standard filtering techniques explicitly models the use of capital and labor, as well as the relationship between output and inflation.[1]

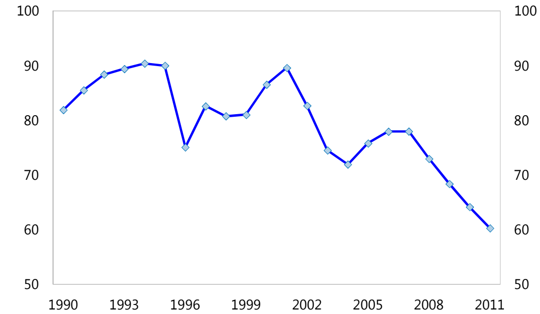
China: Potential Output Growth
(In percent)



Using this methodology suggests that, while GDP growth dropped to 9.2 percent at the onset of the global financial crisis, potential output continued to expand at about 10 percent as the government put in place a large stimulus package that further boosted investment. With investment increasing by 5 percent of GDP over the past three years, staff estimates show that capacity utilization has declined from just under 80 percent before the crisis to around 60 percent today. This low rate of capacity utilization, together with continued low core inflation, suggests that there is large excess capacity in the economy.

Unlike output gap estimates based on standard filtering techniques such as the Hodrick-Prescott filter, the structural modeling approach suggests the output gap was around 5 percent below potential at end-2011. However, given China's large structural changes, it is hard to pin down the output gap precisely, and other methodologies typically give different (smaller) values.

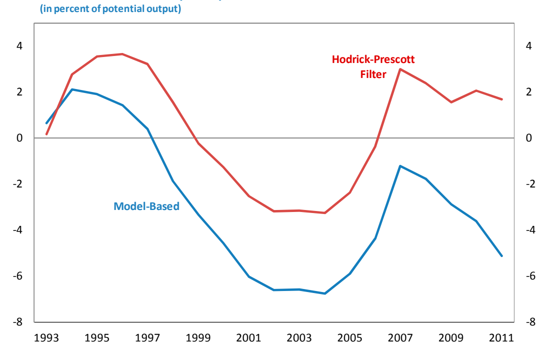
Average Capacity Utilization
(In percent)



Sources: IMF staff calculations.

The estimates also show that China has had excess capacity for most of the past decade. The gap was closing in the run-up to the financial crisis, but did so based on an unsustainable level of external demand. Even in 2007, when growth exceeded 14 percent, nonfood inflation was low and stable, suggesting the economy was still operating below capacity. Then, in 2008, the government put in place a large investment stimulus that propped up growth and built out capacity in a range of areas. Filtering techniques which impose a cycle on the data would point to a negative output gap since 2007 even while price pressures were virtually nonexistent and excess capacity was growing.

Estimates of China's Output Gap
(in percent of potential output)



Eliminating China's excess capacity will take time and cannot quickly or persistently be achieved with standard demand management tools without building imbalances. Rather than aim to do this with short-run stimulus measures, a package of structural reforms should be put in place to rebalance the economy away from investment and toward consumption as a driver of demand growth. This would translate into slower but higher-quality growth over the medium term.

[1]The methodology is based on a structural model that incorporates information about the level of investment and excess labor supply through a production function framework. It is estimated using a system of four basic structural equations: an aggregate production function, a Phillips curve, an equation to estimate the NAIRU, and an Okun's law relationship relating the unemployment gap to the output gap.

the coming years the labor force will gradually start to shrink. Extensive growth will therefore cease to be an option, and sustaining growth will hinge on investing less, but in better and more productive capital, and consuming more. Achieving this transformation will require a comprehensive package of reforms as described below.

33. ***Risks.*** Maintaining high investment will add to overcapacity and thereby create problems over the medium term. Staff highlighted the risk that persistent overcapacity could lead to deflationary pressure, a rise in bankruptcies, and large financial losses. It could also drive up exports and depress prices to maintain high global market shares in a range of products, which could trigger retaliatory trade action. Eventually, under this scenario, a sharp correction in investment would become inevitable, with significant negative implications for growth and employment.

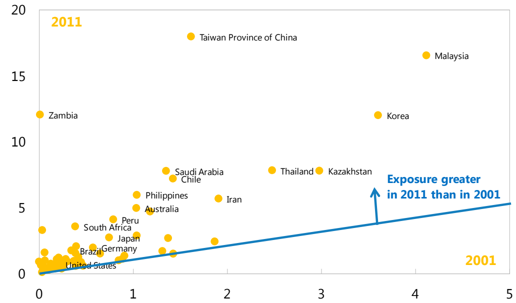
34. ***Spillovers.*** Should domestic rebalancing fail to take place in an orderly fashion, staff analysis suggests that the alternative of a sharp decline of China's investment would have a significant impact on trading partners' growth and global commodity prices (Boxes 3 and 9). The combination of China's reliance on investment for growth and its growing footprint of commodities and capital goods imports leave several economies exposed to a slowdown in China's fixed-asset investment. The growth impact would be significant for G20 economies such as Japan, Germany, Canada, and Brazil. It would also be considerable for those economies within China's supply chain of electronics and machinery exports, such as Taiwan Province of China, Malaysia, and Korea, and the primary suppliers of key minerals and natural gas. A sharp slowdown in China's investment growth would also lead to a decline in financial asset prices abroad, as well as base metal prices (particularly zinc, nickel, copper, lead, aluminum, and iron ore), the prices of agricultural raw materials, and nonfuel primary commodities in general. This would result in a deterioration in the terms of trade for commodity exporters (see Box 3 for more details). A fuller discussion of these spillovers is contained in the 2012 Spillover Report.

35. ***Authorities' views on investment.*** The authorities agreed with the need to rebalance the economy to be based more on consumption. However, they considered that the questions of whether China had been over-investing and whether China's investment level was too high remained open to further in-depth study. This should take into account, for instance, China's stage of development, geographic size, regional disparities, demographics, and fast urbanization from a low base. In recent years, capacity utilization

Box 9. Investment-Led Growth in China: Global Spillovers[1]

Over the past decade, China's growth model has become more reliant on investment and its importance to trading partners in its supply chain has grown substantially. The ratio of exports to China relative to trading partner GDP has, on average, quadrupled across the decade. This box quantifies potential global spillovers from an investment slowdown in China.

Exports to China, 2001 and 2011
(in percent of national GDP)

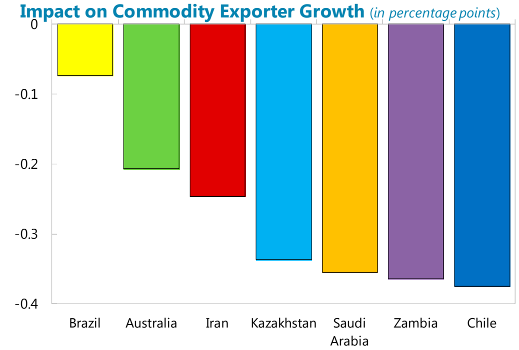


The effect of the spillover from China on trading partner growth is estimated using a panel of 64 economies exposed to China through the export channel. The sample covers the period of China's membership in the WTO (2002–11) and includes the full set of OECD economies, emerging markets classified under the MSCI index, and key commodity producers.

Economies within China's supply chain are increasingly exposed to the risks from a deceleration in investment in China. Aggregating across all economies in the sample (weighted by their PPP shares), the current impact on global growth of a one percentage point slowdown in investment in China is just under one-tenth of a percentage point. The impact is about five times larger than in 2002. The most heavily exposed economies are those that lie within the Asian regional supply chain such as Taiwan Province of China, Korea, and Malaysia. If investment growth declines by 1 percentage point in China, GDP growth in Taiwan Province of China, for example, falls by slightly over nine-tenths of a percentage point. Among the advanced economy exporters of capital goods, Japan suffers a decline of just over one-tenth of a percentage point in response, while growth in Germany declines by a slightly smaller amount. Among commodity exporters, the impact of a slowdown in investment growth in China is likely to be largest on mineral ore exporters with relatively less diversified economic structures and a higher concentration of exports to China. In response to a 1 percentage point slowdown in investment growth in China, the estimated effect on Chile's growth is a reduction of close to two-fifths of a percentage point. By contrast, the larger commodity exporters such as Australia and Brazil with more diversified economies suffer relatively smaller declines in growth.

China Investment Slowdown (1 percentage point)
Impact on Trading Partner Growth *(in percentage points)*

China Investment Slowdown (1 percentage point)
Impact on Commodity Exporter Growth *(in percentage points)*



A complementary approach based on FAVAR shows that the spillover effects from an investment slowdown in China would register strongly across a range of macroeconomic, trade and financial variables among G20 trading partners, as well as world commodity prices. The results are broadly similar to those reported in Box 3, which examines the spillover impacts from China's real estate investment slowdown.

[1] See Nabar, Malhar and Ashvin Ahuja, "Investment-Led Growth in China: Global Spillovers," IMF Working Paper (forthcoming).

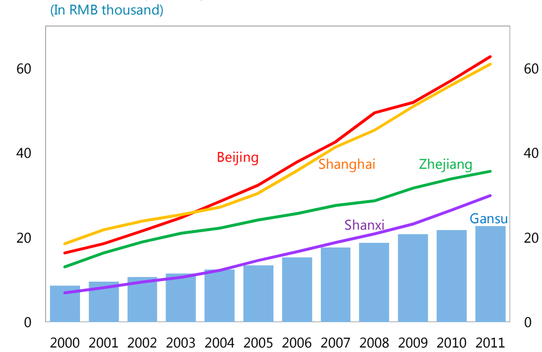
rates appeared to have been falling because external demand had been weak, although there could also be overcapacity in some sectors. More fundamentally, they considered that China's capital stock was still too low and, therefore, there was much room for further productive investment. In the future, the authorities expected investment growth to recede to a lower and stable level as China moved up the value chain and developed its service sector further.

36. ***Authorities' views on spillovers.*** The authorities considered the probability of a sharp decline in investment as remote. Implementation of their structural reform agenda would help ensure a smooth transformation of the economy. They highlighted that investment devoted to updating and improving the efficiency of the capital stock in recent years would not translate into overcapacity. Moreover, successful rebalancing would help ensure that capacity was absorbed domestically. Rather, they indicated that the more likely source of an unanticipated decline in investment was the weak global economy. The authorities also emphasized that steady, albeit somewhat slower, investment growth and continued capital stock upgrading were not only necessary for China's long-term sustainable development, but also for more balanced and sustained global growth.

C. Toward Higher-Quality Growth

37. ***Reform package.*** A package of reforms is needed to achieve the authorities' goal of quality growth that is less reliant on investment and more on consumption, and that addresses rising inequalities, especially between coastal and inland regions, by promoting inclusive growth. With growing excess capacity and demographic shifts around the corner, time is running out on the current growth model. Implementing the needed policies, however, will take time and it is therefore urgent to accelerate the process to avoid a further build-up of risks and help ensure a smooth and controlled adjustment to a more consumer-based economy. Delay could prove costly, and a disorderly unwinding of China's domestic imbalances poses an important risk for the domestic and global economy.

Real Average Wages: Dispersion Across Provinces
(In RMB thousand)



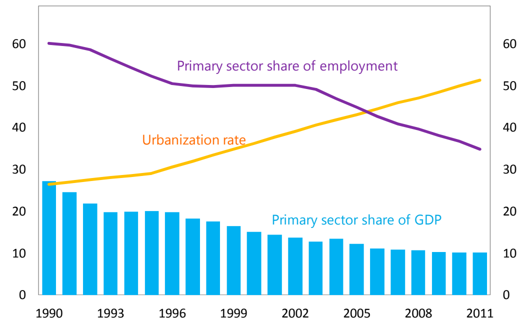
38. ***Saving, Investment, and Incomes.*** Internal rebalancing hinges on reducing household saving, increasing household real disposable income, and reducing incentives to over-invest. Key reforms to achieve this include:

- ***Improve the social safety net.*** China has made significant progress in this area, which has helped improve the welfare and living standards for both urban and rural households (Box 10). A continuation of reforms to the pension, health, and education systems would also help boost consumption by reducing precautionary savings and over time improving labor productivity.

- ***Lower social security contributions.*** Very high contribution rates—the combined employee and employer share exceeds 40 percent in many cases—are an impediment to internal rebalancing. Reducing contributions would help boost employment and also directly increase household disposable income. Moreover, lower-income households would get the biggest benefit (given the regressive nature of social security contributions), which would help foster more inclusive growth and provide a relatively larger boost to consumption (since low-income households have a higher marginal propensity to consume). However, a reduction in social security revenue needs to be accompanied with other reforms (including coverage, benefits, and financing) to safeguard the financial viability of the system.

- ***Expand the service sector.*** Although the labor share of employment in the primary sector has declined markedly over the past decade to about 35 percent in 2011 from 50 percent in 2002, it remains high when compared to other countries and after taking into account China's fundamentals. There continues to be scope to absorb more labor into the services sector, which would help boost labor's share of income. This could be done by opening up domestic sectors to competition and raising productivity in sectors such as utilities, banking, and telecommunications.

Urbanization Rate, Primary Sector Share of Employment and GDP
(In percent)



Box 10. Social Safety Net

China has made significant progress in developing its social safety net in recent years, which has provided substantial social benefits. It should also help reduce household savings and boost private consumption. To meet the government's targets, additional resources may be needed in the coming years and several lingering issues will have to be resolved.

Pensions

Targets. The government is aiming for comprehensive coverage of the pension system by 2020. It has established principles for reforming the urban pension system: "broad coverage, protect at the basic level, multi-layered, and sustainable." Principles for the rural system are identical.

Recent achievements. Complementing the existing urban workers pension insurance scheme, a rural pension pilot was launched in September 2009 and a pension pilot for urban residents (for informal workers) in 2011. Since 2010, the urban workers scheme, in principle, allows workers changing jobs to transfer both their accumulated individual accounts and social pooling rights to other jurisdictions.

Key remaining priorities

Broadening coverage. Based on World Bank estimates, around 30 percent of China's labor force contributes to a pension scheme in 2008. Among migrants, participation in the urban system doubled between 2005 and 2010, but remained low at around one-quarter, compared to 80 percent for local workers.

Raising replacement rates. According to the World Bank, for instance, gross replacement rates for the urban old age insurance system are about 45-55 percent, compared to the OECD median of over 70 percent in 2008.

Increasing portability. Despite the significant progress in improving portability, lack of portability of pension rights across urban pension subsystems or between rural and urban systems remains an issue. In addition, practical barriers constrain reliable and timely transfer of pensions even within provinces, including from incompatible information systems.

Reducing fragmentation, both across space and schemes. Across space, funds could be pooled at higher levels to increase efficiency and reduce risks, first at the provincial level and ultimately at the national level. Across programs, international best practice suggests integrating the various urban schemes—including the public sector unit, civil servant, and urban workers' schemes—and eventually merging the rural and urban residents' schemes.

Healthcare

Targets. The government intends to provide safe, affordable and effective health care to all citizens by 2020, notably by raising health insurance coverage, formulating a national essential drug program, improving basic medical services for screening and prevention, and reforming the management of public hospitals.

Recent achievements. According to the OECD, 95 percent of the population is now covered by basic health insurance and the private share of health expenditures (including out-of-pocket expenses) has declined to around 35 percent, from 60 percent in 2001. In addition to the urban employee basic medical insurance scheme, two new ones have been recently introduced: urban residents scheme targeting nonworkers and the new rural cooperative scheme.

Key remaining priorities

Curbing out-of-pocket expenses. Benefit levels are still fairly low and cost-sharing requirements high. For instance, the rural scheme pays out $50 per person per year and reimburses 50 percent of the cost of in-patient care.

Increasing coverage of catastrophic diseases. Health benefits are capped and those covered by insurance are not always protected against catastrophic health expenditure, leaving patients uncovered for the worst crises and providing incentives for pre-cautionary saving. Pilots of enhanced coverage for some limited catastrophic diseases have begun, but need to be significantly bolstered.

Reforming public hospitals and pricing. Financing and managing public hospitals are areas where reforms have lagged. In addition, their heavy dependence on revenues from selling medicines fuels inefficient use of hospital services and contributes to inflated pharmaceutical prices.

Reducing fragmentation. Contributions required and benefits provided vary significantly between China's health insurance schemes. Fragmentation has especially hurt the effective coverage of migrants. Typically enrolled in the rural scheme, they can face higher out-of-pocket expense and must claim in their home county, with much lower reimbursement rates and long lags.

Financing. More resources will likely be needed over the medium term to meet China's social security targets, ensure the sustainability of the systems, and deal with legacy pension costs. Currently, public expenditure on health, pensions, and other forms of social protection only amounts to 5.7 percent of GDP in China. On average, economies at similar levels of development spend more than twice as much.

- ***Boost state-owned enterprise (SOE) dividend payments.*** Requiring SOEs to increase dividend payments to the budget would reduce self-financed investment and increase budget revenue that, in turn, could be used to finance fiscal and social security reforms. This should include steps to ensure that dividends from profit-making enterprises to a parent company are not used to finance investment in loss-making ones at the expense of budget revenue.

- ***Structurally higher real interest rates.*** This would help improve the allocation of investment by reducing reliance on administrative credit controls (which typically favor large state-owned enterprises, at the expense of smaller, private firms), increase household interest income, and reduce household saving (because the income effect on consumption dominates the substitution effect).[3]

- ***Increase cost of factor inputs.*** China has made progress in increasing the cost of energy, land, water, and pollution, all of which will help reduce the incentives to over-invest and improve its efficiency. Still, many investments are profitable only because input costs are kept artificially low. This creates a large wedge between the cost of capital and the marginal product of capital.[4] Pricing factor inputs at the right cost will make many existing investment plans not profitable and therefore reduce firms' incentives to invest. This will also ensure a better pricing of externalities. The recent hike in resources taxes are a good example and reforms in this area should continue.

39. ***Stronger renminbi.*** Currency appreciation continues to be an important component of the package of reforms needed to transform China's economy. A stronger renminbi would increase household purchasing power, help expand the service and other nontradable sectors, boost the labor share of income, and facilitate financial sector reform. The recent widening of the intraday trading band is an important step in this regard, as it will allow the market to play a stronger role in determining the exchange rate. Using this increased flexibility would also have the benefit of allowing for a more independent monetary policy. As reserves are well above all standard metrics and the currency is moderately undervalued, the real effective exchange rate should be allowed to

[3] Staff analysis shows that a one percentage point increase in real interest rates is associated with a reduction in urban household saving rates of 0.5 percent of disposable income. See Nabar, M., 2011, "Targets, Interest Rates, and Household Savings in Urban China," IMF Working Paper 11/223 (Washington: International Monetary Fund).

[4] See Geng, N. and P. N'Diaye, "Determinants of Corporate Investment in China: Evidence from Cross-Country Firm Level Data." IMF Working Paper 12/80. (Washington: International Monetary Fund).

continue appreciating by reducing intervention over the medium term.

40. ***Authorities' views.*** The above priorities are shared by the authorities and all feature in the 12th Five-Year Plan. The authorities had several comments on specific aspects of the agenda. Regarding the renminbi, the authorities considered that the market was already basically in equilibrium. As for lowering social security contributions, they were open to exploring this option but underscored that it had to be done in the context of a comprehensive reform of the social security system to ensure its actuarial and financial soundness. Finally, on SOE dividends they noted that these were paid in accordance with existing laws and that consideration could be given to gradually increasing the payments that flow to the budget.

STAFF APPRAISAL

41. ***Outlook.*** The authorities' plan to target slower growth is appropriate. In line with this objective, the economy is slowing and growth is projected to moderate to 8 percent this year. However, intensifying strains in Europe have increased the downside risks to this outlook. Inflation peaked a year ago, is on a downward trajectory, and, barring further shocks to food supply or global commodities, is expected to remain below the authorities' target of 4 percent.

42. ***Fiscal policy.*** The 2012 fiscal stance strikes a balance between unwinding of past stimulus and supporting the slowing economy. The efforts to calibrate fiscal policy to support growth, within the existing budget envelope, are appropriate. Fiscal reforms, meanwhile, should continue to be oriented to facilitating the transformation of the economy to a more consumer-based one, including through ongoing efforts to ensure appropriate costs of resource use, expand the VAT to services to replace the business tax, and improve the livelihood of lower-income households through tax reductions and social safety net improvements. In addition, the publication of well-defined medium-term fiscal plans would help anchor expectations and provide assurance that the reform agenda is fiscally sustainable.

43. ***Monetary policy.*** This year's 14 percent M2 growth target is consistent with projected growth without exacerbating the risks from the credit overhang. Recent cuts in required reserve ratios and benchmark interest rates will help achieve this year's economic objectives and increase the market orientation of monetary policy. In particular, the recent steps to allow banks more flexibility in setting interest rates will allow prices to play a greater role in clearing the capital market, which is becoming increasingly important as financial innovation leads to more intermediation taking place outside of standard bank deposits and loans. Meanwhile, sustained reduction in foreign exchange purchases by the central bank would lessen the need for sterilization, create welcome space to further lower banks' reserve requirements, and allow the central bank to increasingly rely on open market operations to absorb liquidity.

44. ***Domestic risks to growth.*** The authorities appear to be succeeding in slowing the economy. Assuming the global environment does not deteriorate precipitously, the current stance of policies should support growth at around 8 percent. The deliberate cooling of the real estate market has been a key factor, given the property sector's important role in the economy through its significant linkages to other sectors. Staff spillover analysis suggests that real estate investment also has a sizeable impact on the global economy, underscoring the importance of ensuring healthy development in this sector. In the event the market cools too much, there is space to further accelerate the social housing program and selectively loosen some of the restrictions that hold back housing demand. However, mitigating the propensity for property bubbles requires a range of reforms to make housing relatively less attractive as a vehicle for financial investment by providing more alternatives and raising the carrying costs.

45. ***External risk.*** The chief external risk continues to be spillovers to China from a worsening of the euro area sovereign debt crisis. A history of fiscal prudence has made China well placed to respond forcefully to an adverse external shock using fiscal policy as the primary tool. The authorities' strong response to the last crisis helped maintain robust growth in China and provided needed support to the global economy. It also relied heavily on a large expansion in bank credit—especially to local government financing vehicles—which is now raising concerns about bank asset quality, the size and efficiency of investment, and the financial health of some local government entities. Given the lingering risks from the last stimulus, future measures should be implemented mainly through the budget, which would help safeguard the banking system, promote more efficient use of the stimulus funds, and allow for a stronger emphasis on reforms that promote the desired transformation of the economic growth model. There is ample fiscal space for the response to be commensurate with the size of the shock, finding the right balance between tolerating somewhat slower growth, emphasizing reforms consistent with medium-term objectives, and protecting people's livelihoods.

46. ***Financial sector.*** The rapid increase in lending during the last stimulus poses a risk to bank asset quality, especially if growth slows considerably. The risk to the overall banking system appears manageable under most scenarios as reported data indicate that bank balance sheets are generally healthy and there is adequate fiscal space to deal with any problems. Nonetheless, a substantial rise in NPLs would raise potentially difficult questions about burden sharing between banks and different levels of government. In this context, it is important to strengthen the crisis management framework, adopt a formal deposit insurance scheme, and ensure that banks fully account for the underlying risks of their loan portfolios. Meanwhile, financial innovation is resulting in more intermediation taking place outside of traditional bank deposit and lending activity. This is a positive step in financial development; but unless it develops in an orderly and supervised way, it could weaken monetary control and threaten financial stability. Addressing this risk requires the continued upgrading of regulatory and supervisory capacity to keep pace with innovation, strengthening the monitoring of systemic risk, and pushing forward financial sector reform, especially to increase the reliance on price-based instruments.

47. ***Current account.*** The sharp decline in China's external imbalances is a welcome development, especially the significant reduction in the current account surplus. The decline reflects both structural and cyclical factors, and staff has accordingly lowered the medium-term current account forecast to a surplus of some 4–4½ percent of GDP.

48. ***External assessment.*** The sharp decline in the current account surplus and the recent appreciation in the real effective exchange rate suggest that the undervaluation of the renminbi has been reduced. The renminbi is assessed as moderately undervalued against a broad basket of currencies. Many reforms underway, such as strengthening the social safety net, reducing intervention, and moving toward a more open capital account, will further help achieve the desired external rebalancing.

49. ***Internal rebalancing.*** China has relied heavily on investment as a driver of growth. This has pushed up investment to the point where it accounts for nearly half of GDP, which is unusually high by international and historical standards. It is also leading to excess capacity that could result in problems down the road if domestic and global markets are unable to absorb the output, leading potentially to trade frictions, price declines, bankruptcies, and a worsening of bank asset quality. This model, therefore, is not sustainable.

50. ***Spillovers.*** China is now the world's second largest economy and its domestic developments have significant spillovers to the rest of the world. It is clear that China's success in maintaining robust growth since the onset of the global financial crisis in 2008 has provided a welcome lift to global demand. The rapid growth in investment, moreover, had particularly strong benefits for primary commodity producers and exporters of machinery and equipment. Going forward, it will be important to ensure that investment returns gradually to a more sustainable level. Otherwise, there is a risk of a sharp and disorderly reduction in investment, which would have significant adverse domestic and global repercussions.

51. ***Reform package.*** It is well recognized that a broad package of reforms is needed to achieve quality growth that relies less on investment and more on consumption, and is inclusive and environment-friendly. As implementation will take time, the reform process should go faster to avoid a further build-up of risks and ensure smooth adjustment. The key elements of the reform are opening up the service sector, raising factor costs, allowing for a continued gradual appreciation of the renminbi, improving the social security system, and implementing a comprehensive financial sector reform program that is continually calibrated in line with evolving conditions.

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

China: Risk Assessment Matrix

		Up/Downside	Risk	Impact	Staff Recommended Policy Response
Strong intensification of the Euro Area sovereign debt crisis.	A	↓	**Medium**	**High** Main impact would be through lower export demand.	Deploy fiscal stimulus.
A protracted spike in oil prices.	B	↓	**Low**	**Low** Higher global oil prices could depress global growth and impact demand for China's exports.	Provide targeted support to the needy.
Local government finances.	C	↓	**Low**	**Low** Impact on banks balance sheets, credit, and government debt.	Revamp intergovernmental fiscal relations, allow local governments to issue bonds, and improve monitoring.
Sharp slowdown in investment.	D	↓	**Low**	**High** Lower domestic demand, including consumption, China's imports from the rest of the world, and credit.	Accelerate reforms to rebalance growth.
Downturn in property market, deterioration in bank asset quality, and rise in NPLs from local government financing vehicles.	E	↓	**Low**	**High** Lower domestic demand, including consumption, China's imports from the rest of the world, and credit.	Removal of distortions that hold back housing demand, acceleration of social housing, and greater reliance on price based instruments of monetary control. Ensure that bank lending standards and risk management practices are sound, while deploying countervailing macroprudential measures (e.g. lower loan-to-value ratios).
Combined shocks (A,D,E).		↓	**Low**	**High** Lower external and domestic demand as well as credit.	Deploy on-budget fiscal stimulus (mainly to support consumption), remove distortions that hold back housing demand, accelerate social housing, and rely more on price-based instruments of monetary control. Recapitalize banks as needed and, to the extent it is feasible without undermining prudent risk management or eroding necessary capital buffers, consider a gradual easing of bank lending conditions (e.g., through reductions in risk weights on viable new lending or an increase in loan-to-value ceilings).
Rebalancing.	F	↑	**Medium**	**High** More sustainable growth with higher share of consumption and lower share of investment in GDP.	Faster internal rebalancing by accelerating implementation of staff recommended reforms (e.g. social security, financial sector reform, higher cost of capital, develop service sector, renminbi appreciation) and ensure inclusive growth.

Table 1. China: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013
	(Annual percentage change, unless otherwise specified)							
National accounts and employment								
Real GDP	12.7	14.2	9.6	9.2	10.4	9.2	8.0	8.5
Total domestic demand	11.4	12.6	9.7	14.0	10.6	10.1	9.4	9.0
Consumption	9.8	11.1	8.5	9.4	9.2	9.7	10.1	9.7
Investment	13.4	14.5	11.1	19.3	12.0	10.5	8.8	8.2
Fixed	12.6	13.3	9.7	22.9	11.4	9.5	9.3	8.7
Inventories 1/	0.6	0.8	0.8	-0.8	0.5	0.7	0.0	0.0
Net exports 1/	2.1	2.6	0.9	-3.5	0.4	-0.4	-1.0	-0.2
Consumer prices								
End of period	2.8	6.5	1.2	1.9	4.6	4.1	3.5	2.5
Average	1.5	4.8	5.9	-0.7	3.3	5.4	3.3	3.0
Unemployment rate (annual average)	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1
	(In percent of GDP)							
External debt and balance of payments								
Current account	8.6	10.1	9.1	5.2	4.0	2.8	2.3	2.5
Trade balance	8.0	9.0	8.0	5.0	4.3	3.3	2.4	2.0
Exports of goods	35.7	34.9	31.7	24.1	26.7	26.1	24.3	23.9
Imports of goods	27.7	25.9	23.8	19.1	22.4	22.7	21.9	21.9
Gross external debt	12.5	11.1	8.6	8.6	9.3	10.4	11.4	12.3
Saving and investment								
Gross domestic investment	43.0	41.7	44.0	48.2	48.2	48.6	48.5	48.2
National saving	51.6	51.9	53.2	53.5	52.2	51.3	50.8	50.7
Public sector finance								
General government gross debt	16.2	19.6	17.0	17.7	33.5	25.8	22.0	19.4
General government balance	-0.7	0.9	-0.7	-3.1	-1.5	-1.2	-1.3	-1.0
	(Annual percentage change)							
Real effective exchange rate								
Annual average	1.6	3.9	9.2	3.4	-0.5	2.7	...	...
End of period	-0.9	4.8	12.5	-4.9	4.5	6.0	...	...

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

Table 2. China: Balance of Payments

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

	2007	2008	2009	2010	2011	2012	2013
Current account balance	353.9	412.4	261.0	237.7	201.6	187.6	225.1
Trade balance	315.4	360.7	249.5	254.2	243.5	196.9	179.6
Exports	1,220.0	1,434.6	1,203.8	1,581.4	1,903.8	2,006.0	2,171.8
Imports (BOP basis)	904.6	1,073.9	954.3	1,327.2	1,660.3	1,809.1	1,992.3
Services	-7.9	-11.8	-29.4	-31.1	-55.3	-48.5	-34.5
Income	7.8	17.7	7.2	-26.0	-11.9	10.2	48.0
Current transfers	38.6	45.8	33.7	40.6	25.3	29.0	32.1
Capital and financial account balance	95.2	46.3	180.9	286.7	220.8	204.9	189.4
Capital account	3.1	3.0	4.0	4.6	5.4	3.6	3.6
Financial account	92.1	43.3	176.9	282.1	215.4	201.2	185.8
Net foreign direct investment	143.1	121.6	70.3	185.7	170.4	156.5	144.2
Portfolio investment	18.7	42.6	38.7	24.1	19.5	20.3	21.3
Other investment	-69.7	-120.9	67.9	72.3	25.5	24.4	20.3
Errors and omissions 1/	11.6	20.8	-43.5	-52.7	-34.6	0.0	0.0
Overall balance	460.7	479.5	398.4	471.7	387.8	392.5	414.5
Reserve assets	-460.7	-479.5	-398.4	-471.7	-387.8	-392.5	-414.5
Memorandum items:							
Current account, as percent of GDP	10.1	9.1	5.2	4.0	2.8	2.3	2.5
Export growth (value terms)	25.8	17.6	-16.1	31.4	20.4	5.4	8.3
Import growth (value terms)	20.3	18.7	-11.1	39.1	25.1	9.0	10.1
FDI (inward), as a percent of GDP	4.6	3.9	2.3	4.1	3.0	2.5	2.2
External debt 2/	389.2	390.2	428.7	548.9	757.1	944.2	1,114.0
As a percent of GDP	11.1	8.6	8.6	9.3	10.4	11.4	12.3
Short-term external debt (remaining maturity) 2/	235.7	226.3	259.3	375.7	498.5	655.2	793.8
Gross reserves 3/	1,534.4	1,953.3	2,425.9	2,875.9	3,263.7	3,656.2	4,070.7
As a percent of ST debt by remaining maturity	651.0	863.2	935.7	765.5	654.6	558.0	512.8
Real effective exchange rate (1990 = 100)	105.6	115.3	119.2	118.7	121.9	...	...
Net international investment position	1,188.1	1,493.8	1,490.5	1,688.0	1,774.7	...	...
In percent of GDP	34.0	33.0	29.9	28.5	24.3	...	...
Nominal GDP	3,494.2	4,520.0	4,990.5	5,930.4	7,298.1	8,270.1	9,079.4

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

	2005	2006	2007	2008	2009	2010	2011
Monetary and financial indicators							
General government debt (official data; in percent of GDP)	17.6	16.2	19.6	17.0	17.7	33.5	25.8
Broad money (M2: annual percentage change)	16.3	17.0	16.7	17.8	28.4	18.9	17.3
Foreign currency deposits to broad money (percent)	4.4	3.6	2.9	2.6	2.3	2.1	2.1
Credit (annual percentage change)	13.0	15.1	16.1	18.7	31.7	19.9	15.8
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/	1,221	2,815	5,521	1,912	3,437	2,940	2,304
Stock exchange capitalization (percent of GDP)	24.5	48.9	130.2	46.0	81.1	76.7	56.2
Number of listed companies (A-share)	1,355	1,398	1,507	1,581	1,678	2,041	2,320
Balance of payments indicators							
Exports (annual percentage change, U.S. dollars)	28.5	27.2	25.8	17.6	-16.1	31.4	20.4
Imports (annual percentage change, U.S. dollars)	-17.6	-19.7	-20.3	-18.7	11.1	-39.1	-25.1
Current account balance (percent of GDP)	5.9	8.6	10.1	9.1	5.2	4.0	2.8
Capital and financial account balance (percent of GDP)	4.5	1.9	2.7	1.0	3.6	4.8	3.0
Of which : gross foreign direct investment inflows	5.2	4.6	4.6	3.9	2.3	4.1	3.0
Reserve indicators							
Gross reserves (billions of U.S. dollars) 3/	825.6	1,072.6	1,534.4	1,953.3	2,425.9	2,875.9	3,263.7
Gross reserves to imports of GNFS (months)	11.6	12.4	14.9	21.1	19.1	18.2	18.9
Gross reserves to broad money (M2) (percent)	22.9	24.7	28.9	28.6	27.2	26.8	24.8
Gross reserves to short-term external debt by remaining maturity (percent)	481.0	538.4	651.0	863.2	935.7	765.5	654.6
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)	13.1	12.5	11.1	8.6	8.6	9.3	10.4
Total external debt (billions of U.S. dollars) 2/	296.6	338.6	389.2	390.2	428.7	548.9	757.1
Of which : public and publicly guaranteed debt 5/	33.0	34.4	34.9	33.3	36.9	38.8	37.4
Banking sector debt	101.9	120.0	126.6	126.3	132.4	183.5	266.0
Short-term external debt by original maturity (billions of U.S. dollars)	171.6	199.2	235.7	226.3	259.3	375.7	498.5
Net foreign assets of banking sector (billions of U.S. dollars)	85.5	108.2	161.4	251.0	204.5	171.3	...
Total debt to exports of GNFS (percent)	35.4	31.9	29.0	24.7	32.1	31.5	36.3
Total debt service to exports of GNFS (percent) 6/	21.1	19.3	17.9	14.6	19.8	21.8	24.3
Of which : Interest payments to exports of GNFS (percent) 6/	0.6	0.5	0.4	0.3	0.4	0.3	0.2
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 LT sovereign bond ratings (eop)							
Moody's	A2	A2	A1	A1	A1	Aa3	Aa3
Standard and Poor's	A-	A	A	A+	A+	AA-	AA-
Memorandum items:							
International investment position	407.7	640.2	1,188.1	1,493.8	1,490.5	1,688.0	1,774.7
Nominal GDP (billions of U.S. dollars)	2,256.9	2,712.9	3,494.2	4,520.0	4,990.5	5,930.4	7,298.1
Exports of GNFS (billions of U.S. dollars)	836.9	1,061.7	1,342.2	1,581.7	1,333.3	1,743.6	2,086.6
Real effective exchange rate (annual percentage change)	-1.1	1.6	3.9	9.2	3.4	-0.5	2.7

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	2012				
						Jan	Feb	Mar	Apr	May
Net foreign assets	13,775	17,897	19,853	22,604	25,164	25,369	25,552	25,807	25,898	...
Net domestic assets	26,569	29,620	41,169	49,981	59,995	60,221	61,165	63,750	63,063	...
Domestic credit 1/	33,966	37,938	49,589	58,732	68,797	69,121	70,032	72,203	71,889	...
Net credit to government	2,821	2,943	3,229	3,460	4,236	3,949	3,854	4,212	3,842	...
Credit to non-government	31,145	34,994	46,360	55,272	64,561	65,173	66,178	67,991	68,047	...
Other items, net 1/	1,128	767	107	-1,188	-3,306	-3,295	-3,758	-4,559	-4,425	...
Broad money	40,344	47,517	61,022	72,585	85,159	85,590	86,717	89,557	88,960	90,004
Reserve money	10,155	12,922	14,399	18,531	22,464	23,739	22,334	22,668	22,437	...
Of which:										
Excess reserves	1,400	2,575	1,708	1,386	462	646	384	311	175	...
Net foreign assets of PBC	12,388	16,181	18,457	21,470	23,520	23,693	23,769	23,885	23,805	...
Net domestic assets of PBC	-2,233	-3,259	-4,059	-2,939	-1,056	47	-1,435	-1,216	-1,368	...
Net foreign assets 2/	10.7	10.2	4.1	4.5	3.5	3.3	3.3	3.0	2.9	...
Net domestic assets	8.6	11.5	39.0	21.4	20.0	19.4	21.2	21.9	21.2	...
Domestic credit 3/	17.6	11.7	30.7	18.4	17.1	16.3	16.9	18.2	17.7	...
Of which: loans	19.3	14.0	34.2	19.4	15.1	14.8	15.1	16.0	15.3	...
Other items, net 2/ 3/	5.3	-0.9	-1.4	-2.1	-2.9	-2.2	-3.1	-2.8	-2.6	...
Broad money 4/	16.7	17.8	27.7	19.7	13.6	12.4	13.0	13.4	12.8	13.2
Including foreign currency deposits	15.9	17.4	27.3	19.4	17.3	16.8	18.1	18.5	18.1	...
M1 4/	21.0	9.1	32.4	21.2	7.9	3.2	4.3	4.4	3.1	3.5
M0 4/	12.1	12.7	11.8	16.7	13.8	3.0	8.8	10.6	10.4	10.0
Quasi money	14.3	23.2	25.2	18.9	16.8	17.2	17.5	18.0	17.7	18.2
Reserve money	30.6	27.3	11.4	28.7	21.2	22.3	16.8	17.7	16.1	...
Net foreign assets of PBC 5/	50.2	37.4	17.6	20.9	11.1	10.7	10.3	8.9	7.3	...
Net domestic assets of PBC 5/	-19.6	-10.1	-6.2	7.8	10.2	11.6	6.5	8.8	8.8	...
Reserve ratios 6/										
Required reserves	14.5	15.0	15.0	18.0	20.5	20.5	20.0	20.0	20.0	19.5
Excess reserves	3.3	5.1	3.1	2.0	2.3	2.2	2.2	2.2	...	...
Memorandum items:										
Money multiplier	4.0	3.7	4.2	3.9	3.8	3.6	3.9	4.0	4.0	...
Forex deposits of residents (US$ billion)	159.9	179.1	208.9	228.7	275.1	289.9	316.9	341.8	364.5	377.6
In percent of total deposits	2.9	2.6	2.3	2.1	2.1	2.2	2.4	2.5	2.6	2.7
Forex loans of residents (US$ billion)	219.8	243.7	379.5	453.4	538.7	536.1	544.4	559.5	561.0	565.8

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/ Anualized contribution to reserve money growth, percent.

6/ In percent of total bank deposits.

Table 5. China: General Government Budgetary Operations

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					(In billions of RMB)						
Revenue	5,255	6,172	6,882	8,555	10,683	12,153	13,586	15,154	16,951	18,885	20,974
Tax revenue	4,562	5,422	5,952	7,321	8,972	11,103	12,419	13,858	15,514	17,291	19,208
Taxes on income and profits	1,196	1,490	1,549	1,768	2,281	2,697	3,173	3,654	4,196	4,652	5,154
Taxes on goods and services	2,426	2,819	3,226	3,832	4,488	5,153	5,903	6,686	7,487	8,380	9,374
Other taxes (residual)	745	784	905	1,202	1,511	2,379	2,254	2,179	2,201	2,294	2,326
Nontax revenue (residual)	693	750	930	1,234	1,711	1,050	1,167	1,296	1,437	1,594	1,766
Expenditure	5,023	6,404	7,925	9,168	11,270	12,835	14,149	15,554	17,041	18,624	20,302
Primary	4,917	6,274	7,776	8,984	11,031	12,468	13,801	15,214	16,707	18,302	20,000
Interest	105	131	149	185	239	366	348	341	334	322	302
Overall balance	233	-232	-1,044	-613	-587	-682	-564	-400	-90	261	671
Financing	-233	232	1,044	613	587	682	564	400	90	-261	-671
Domestic	-233	232	1,044	613	587	682	564	400	90	-261	-671
External	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
Memo: Authorities' definition											
Revenue	5,132	6,243	6,902	8,320	10,524	11,630	13,566	15,134	16,931	18,865	20,954
Revenue (Budget)	5,132	6,133	6,852	8,310	10,374	11,360	13,566	15,134	16,931	18,865	20,954
Withdrawal from Stabilization Fund	0	110	51	10	150	270	0	0	0	0	0
Expenditure	5,081	6,278	7,852	9,348	11,374	12,430	14,114	15,519	17,006	18,589	20,267
Expenditure (Budget)	4,978	6,259	7,630	8,987	10,893	12,430	14,114	15,519	17,006	18,589	20,267
Contribution to Stabilization Fund	103	19	10	225	289	0	0	0	0	0	0
Other adjustment to expenditure	0	0	212	136	192	0	0	0	0	0	0
Fiscal Balance on budget	154	-126	-778	-677	-519	-1,070	-549	-385	-75	276	686
Overall balance 1/	51	-35	-950	-1,028	-850	-800	-549	-385	-75	276	686
					(In percent of GDP)						
Revenue	19.8	19.7	20.2	21.3	22.7	23.2	23.3	23.4	23.6	23.7	23.8
Tax revenue	17.2	17.3	17.5	18.2	19.0	21.2	21.3	21.4	21.6	21.7	21.8
Taxes on income and profits	4.5	4.7	4.5	4.4	4.8	5.1	5.4	5.6	5.8	5.8	5.8
Taxes on goods and services	9.1	9.0	9.5	9.5	9.5	9.8	10.1	10.3	10.4	10.5	10.6
Other taxes (residual)	2.8	2.5	2.7	3.0	3.2	4.5	3.9	3.4	3.1	2.9	2.6
Nontax revenue (residual)	2.6	2.4	2.7	3.1	3.6	2.0	2.0	2.0	2.0	2.0	2.0
Expenditure	18.9	20.4	23.2	22.8	23.9	24.5	24.3	24.0	23.7	23.4	23.0
Primary	18.5	20.0	22.8	22.4	23.4	23.8	23.7	23.5	23.2	23.0	22.7
Interest	0.4	0.4	0.4	0.5	0.5	0.7	0.6	0.5	0.5	0.4	0.3
Overall balance	0.9	-0.7	-3.1	-1.5	-1.2	-1.3	-1.0	-0.6	-0.1	0.3	0.8
Financing	-0.9	0.7	3.1	1.5	1.2	1.3	1.0	0.6	0.1	-0.3	-0.8
Domestic	-0.9	0.7	3.1	1.5	1.2	1.3	1.0	0.6	0.1	-0.3	-0.8
External	0.0	0.0	0.0	0.0	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	0.0	0.0	0.0	0.0
Net Lending / Borrowing	-0.9	0.7	3.1	1.5	1.2	1.3	1.0	0.6	0.1	-0.3	-0.8
Change in Debt	0.1	2.9	3.0	2.6	1.9	1.8	1.5	1.1	0.6	0.2	-0.3
Change in Deposits	1.0	2.2	0.0	1.1	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Other flows / valuation changes	6.3	-2.6	-1.0	15.9	-4.6	-3.0	-1.9	-1.5	-1.2	-1.0	-1.0
Memorandum items:											
Debt	19.6	17.0	17.7	33.5	25.8	22.0	19.4	17.2	14.9	12.6	10.1
Domestic	19.4	16.8	17.5	33.4	25.7	21.9	19.3	17.1	14.8	12.5	10.1
External	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Cyclically adjusted balance (percent of potential GDP)	1.1	-0.4	-2.4	-0.7	0.0	0.0	0.2	0.3	0.5	0.7	0.8
Nominal GDP (RMB billion)	26,581	31,405	34,090	40,151	47,156	52,484	58,346	64,802	71,874	79,680	88,285

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

1/ Includes net allocations to stabilization fund and other adjustments to expenditure.

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					(Percent change)					
Real GDP	9.6	9.2	10.4	9.2	8.0	8.5	8.5	8.5	8.5	8.5
Total domestic demand	9.7	14.0	10.6	10.1	9.4	9.0	8.6	8.1	7.9	7.7
Consumption	8.5	9.4	9.2	9.7	10.1	9.7	9.3	9.1	9.0	9.0
Investment	11.1	19.3	12.0	10.5	8.8	8.2	7.9	7.0	6.7	6.4
Fixed	9.7	22.9	11.4	9.5	9.3	8.7	8.3	7.4	7.0	6.7
Inventories 2/	0.8	-0.8	0.5	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 2/	0.9	-3.5	0.4	-0.4	-1.0	-0.2	0.1	0.7	0.9	1.0
Consumer prices (average)	5.9	-0.7	3.3	5.4	3.3	3.0	3.0	3.0	3.0	3.0
					(In percent of GDP)					
Total capital formation	44.0	48.2	48.2	48.6	48.5	48.2	47.7	46.9	46.0	45.1
Gross national saving	53.2	53.5	52.2	51.3	50.8	50.7	50.6	50.1	49.8	49.3
Fiscal balance	-0.7	-3.1	-1.5	-1.2	-1.3	-1.0	-0.6	-0.1	0.3	0.8
Revenue	19.7	20.2	21.3	22.7	23.2	23.3	23.4	23.6	23.7	23.8
Expenditure	20.4	23.2	22.8	23.9	24.5	24.3	24.0	23.7	23.4	23.0
Current account balance	9.1	5.2	4.0	2.8	2.3	2.5	2.9	3.2	3.8	4.3
					(In billions of U.S. dollars)					
Current account balance	412	261	238	202	188	225	285	351	454	560
Trade balance	361	250	254	244	197	180	180	212	261	329
Trade balance (in percent of GDP)	8.0	5.0	4.3	3.3	2.4	2.0	1.8	1.9	2.2	2.5
Exports	1,435	1,204	1,581	1,904	2,006	2,172	2,421	2,713	3,051	3,451
(Percent change)	18	-16	31	20	5	8	11	12	12	13
Imports	1,074	954	1,327	1,660	1,809	1,992	2,241	2,502	2,790	3,121
(Percent change)	19	-11	39	25	9	10	12	12	12	12
Capital and financial account, net	46	181	287	221	205	189	176	161	144	131
Capital account	3	4	5	5	4	4	4	4	4	4
Direct investment, net	122	70	186	170	157	144	132	119	106	94
Portfolio investment, net	43	39	24	20	20	21	22	23	24	26
Other investment, net	-121	68	72	26	24	20	19	15	9	7
Errors and omissions	21	-44	-53	-35	0	0	0	0	0	0
Change in reserves (- indicates increase)	-480	-398	-472	-388	-392	-415	-461	-512	-597	-690
Memorandum item:										
Nominal GDP (in billions of yuan)	31,405	34,090	40,151	47,156	52,484	58,346	64,802	71,874	79,680	88,285
GDP Deflator (2010 = 100)	89	90	94	100	103	106	108	110	113	115
Gross reserves (USD billion)	1,953	2,426	2,876	3,264	3,656	4,071	4,532	5,044	5,642	6,332

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	2017
								I. Baseline Projections					
Public sector debt 1/	19.6	17.0	17.7	33.5	25.8			22.0	19.4	17.2	14.9	12.6	10.1
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	0.1
Change in public sector debt	3.4	-2.6	0.7	15.9	-7.7			-3.8	-2.6	-2.3	-2.3	-2.3	-2.5
Identified debt-creating flows (4+7+12)	-3.9	-2.3	1.7	-1.1	-3.8			-1.3	-1.2	-1.3	-1.6	-1.8	-2.0
Primary deficit	-1.3	0.3	2.6	1.1	0.7			0.6	0.4	0.1	-0.3	-0.7	-1.1
Revenue and grants	19.8	19.7	20.2	21.3	22.7			23.2	23.3	23.4	23.6	23.7	23.8
Primary (noninterest) expenditure	18.5	20.0	22.8	22.4	23.4			23.8	23.7	23.5	23.2	23.0	22.7
Automatic debt dynamics 2/	-2.6	-2.6	-0.9	-2.2	-4.5			-1.9	-1.6	-1.4	-1.2	-1.1	-0.9
Contribution from interest rate/growth differential 3/	-2.6	-2.6	-0.9	-2.2	-4.5			-1.9	-1.6	-1.4	-1.2	-1.1	-0.9
Of which : contribution from real interest rate	-0.8	-1.0	0.5	-0.6	-1.8			-0.1	0.1	0.1	0.1	0.1	0.1
Of which : contribution from real GDP growth	-1.9	-1.6	-1.4	-1.6	-2.6			-1.9	-1.7	-1.5	-1.3	-1.1	-1.0
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	0.0
Denominator = 1+g+p+gp	1.2	1.2	1.1	1.2	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	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	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	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	0.0
Residual, including asset changes (2–3)	7.3	-0.3	-1.0	17.0	-3.9			-2.5	-1.4	-1.0	-0.7	-0.5	-0.5
Public sector debt-to-revenue ratio 1/	99	86	88	157	114			95	83	73	63	53	43
Gross financing need 5/	1.3	2.9	5.2	4.7	7.1			5.7	4.2	3.3	2.5	1.7	1.0
In billions of U.S. dollars	44	133	262	280	522			471	381	333	269	198	126
						10-Year Historical Average	10-Year Standard Deviation						
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	14.2	9.6	9.2	10.4	9.2	11.0	2.0	8.0	8.5	8.5	8.5	8.5	8.5
Average nominal interest rate on public debt (in percent) 6/	3.0	2.5	2.8	3.1	1.8	3.0	0.6	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	-3.6	-5.7	-1.4	4.0	0.0	0.5	0.7	0.8	0.9	0.9
Inflation rate (GDP deflator, in percent)	7.6	7.8	-0.6	6.6	7.5	4.3	3.5	3.0	2.5	2.3	2.2	2.1	2.1
Growth of real primary spending (deflated by GDP deflator, in percent)	14.4	18.4	24.7	8.3	14.2	14.6	4.8	9.7	8.0	7.7	7.5	7.3	7.0
Primary deficit	-1.3	0.3	2.6	1.1	0.7	1.0	1.1	0.6	0.4	0.1	-0.3	-0.7	-1.1
								II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios													
A1. Key variables are at their historical averages in 2012–17 7/								21.5	18.8	16.8	15.3	14.1	13.1
A2. No policy change (constant primary balance) in 2012–17								22.2	19.9	18.3	17.0	16.0	15.2
A3. Contingent debt recognized in 2012 8/								93.2	83.4	74.8	66.8	59.4	52.4
B. Bound tests													
B1. Real interest rate is at baseline plus one-half standard deviation								22.5	20.3	18.3	16.3	14.2	11.9
B2. Real GDP growth is at baseline minus one-half standard deviation								22.5	20.4	18.9	17.5	16.2	14.9
B3. Primary balance is at baseline minus one-half standard deviation								22.6	20.5	18.7	16.9	15.0	13.0
B4. Combination of B1-B3 using one-quarter standard deviation shocks								22.7	20.6	18.7	16.9	14.9	12.8
B5. One time 30 percent real depreciation in 2012 9/								22.2	19.5	17.3	15.0	12.7	10.2
B6. 10 percent of GDP increase in other debt-creating flows in 2012								32.0	28.7	25.7	22.9	20.0	17.0

1/ Coverage of public sector refers to gross debt of the budgetary general 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 general 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 2012 (the NPV of this contingent debt is added to the 2012 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

July 6, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

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

CONTENTS

ANNEX I. FUND RELATIONS

(As of May 31, 2012)

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	7,394.87	77.63
Reserve position in Fund	2,131.08	22.37
Lending to the Fund		
New Arrangements to Borrow	3,667.50	

III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	6,989.67	100.00
Holdings	7,796.62	111.54

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				
	2012	2013	2014	2015	2016
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.00	0.08	0.08	0.08	0.08
Total	0.00	0.08	0.08	0.08	0.08

VII. Exchange Arrangements:

China's de facto 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. dollar, 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. Further, on April 14, 2012, the PBC announced a widening of the renminbi's trading band against the U.S. dollar in the interbank foreign exchange market. As of today, the band has been widened from ½ to 1 percent, allowing daily fluctuations of up to twice the previously permissible amount relative to the central parity rate. 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 percent and a 5 percent 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 20 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 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 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 2011, a cumulative total of 110 QFIIs had been approved, with a total investment limit of US$21.64 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. Since August 2011, trade transactions between all provinces and cities in the Mainland with other countries may be settled in renminbi. 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. In August 2011, a new pilot scheme was announced to allow up to RMB 20 billion in portfolio flows into the securities markets (through a renminbi Qualified Foreign Institutional Investor scheme), and in October, rules were published to allow overseas firms to invest renminbi raised offshore in the Mainland as foreign direct investment.

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 2011 Article IV mission was concluded on June 9, 2011 and the staff report was published on July 20, 2011.

IX. Technical Assistance:

Technical assistance provided from 2000 through April 2012 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,

	Products	Expected Delivery Date
Bank Work Program	• 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 • TA on Mid-term Macro-Fiscal Framework • Sub-national Inter-governmental Fiscal Relationship • Municipal Financing and Local Debt Management • Inclusive Innovation • Promoting Inclusive Finance • Financial Consumer Protection • Interest Rate Liberalization • Capital Market Development • Corporate Governance and Financial Stability • TA report on Statistical Master Plan	• December 2012 • Ongoing • Delivered on demand • June 2013 • June 2013 • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing • June 2012

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 2011, the PRC's cumulative borrowing from ADB reached $24.9 billion with 181 loans for public sector projects. Of the total public sector loans, 53 percent was allocated to the transport sector, followed by water and other municipal infrastructure services (13 percent) and energy (12 percent), agriculture and natural resources (9 percent), industry and trade (3 percent), finance (2 percent), and multisector (7 percent). Over the past 25 years, ADB has helped finance 30 private sector projects in the PRC totaling $3.0 billion.

2. ADB also funds Technical Assistance for the PRC. By the end of 2011, ADB had provided a total of $380 million in grants for 665 technical assistance projects, consisting of $119 million for preparing projects and $261 million for policy advice and capacity development.

[1] Prepared by Asian Development Bank staff.

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 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 to support subregional cooperation initiatives, particularly Central Asia Regional Economic Cooperation (CAREC) and Greater Mekong Subregion (GMS) programs.

5. The Asian Development Bank's preparation of the new "Country Partnership Strategy" (CPS) for the PRC, covering 2011 to 2015 is nearly completion. The new CPS has been 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 renewed emphasis on regionally balanced development and environmental sustainability including low-carbon development. ADB will support four priority sector duing the new CPS period: (i) energy, (ii) natural resources and agricylture, (iii) transport, and (iv) urban development. Emphasis on selectivity within each priority sector is a highlight of the new CPS and marks major progress in the ongoing dialogue to reposition each sector through the lens of innovation and value addition, and synergy with regional cooperation and intergration programs.

6. Projected public sector lending in 2012-2014 will total about $4.41 billion, of which 39 percent will support transport infrastructure; 22 percent for agriculture, rural development, and natural resource management; 26 percent for urban development, water supply, and sanitation improvement; and 13 percent for the energy sector. About 90 percent of the projects are located in the western, central and northeastern regions in lined with the CPS's priorities of promoting inclusive growth and environmentally sustainable growth.

7. ADB's technical assistance will complement the lending program to improve the sector policy environment, support governance and capacity development, and strengthen the knowledge base and innovative features of lending operations.

Table III.1. China: ADB's Commitments and Disbursements (Public Sector Loans), 1993–2011
(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
2011	18,244	1,580

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

ANNEX IV. STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

1. Data provision has some shortcomings, but is broadly adequate for surveillance. Most affected areas are: national accounts and government finance statistics.

Real Sector Statistics

2. The National Bureau of Statistics (NBS) compiles and disseminates annual GDP by activity in current and constant prices (2005) and quarterly estimates of GDP. Both the annual accounts and quarterly accounts are based on the *System of National Accounts*, 1993 *(1993 SNA)*. 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 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 for both the annual and quarterly accounts, 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.

3. Monthly industrial production, retail sales, and fixed investment indices are compiled with the corresponding month of the previous year as a base period but, 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.

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 2003–2009 following the *GFSM 2001* methodology for publication in the 2011 *GFS Yearbook*. However, these data are limited, with no data provided on government transactions in expense, 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.

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 in monetary and financial statistics. The most notable progress made by the PBC are as follows: (1) expanding the coverage of depository corporations; (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. The April 2012 monetary and financial statistics mission established procedures for regular reporting to the Fund of data on the central bank and other depository corporations in the format of standardized report forms (SRFs) beginning in December 2012.

The FSIs data currently posted on IMF's website are available only for core indicators for 2010 and 2011 and no historical data series have been provided. The April 2012 mission encouraged the authorities to compile and report the FSI data with quarterly periodicity. The authorities agreed with the improved periodicity for their FSI data, but indicated that they would prefer to move to semiannual reporting prior to compiling the quarterly data. The mission also discussed with the authorities the possibility of expanding the data scope to include encouraged FSIs for deposit-takers. The authorities indicated that the work on the compilation of the encouraged FSI data is at an early stage and, furthermore, they are working on adopting the Basel III at this stage and agreed to consider the mission's recommendations after the developmental work is completed for collecting data under the Basel III.

External Sector Statistics

10. 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.

11. 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 balance of payments and international investment position (IIP) data—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 IIP are published for the period 2004-2010 on an annual basis and for 2011 on a quarterly basis.

12. 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. Since ITRS is the major data source for balance of payments (BOP) statistics, in order to ensure its smooth operation, regular training programs for staff in the provincial offices of SAFE have been recommended. In 2011, China commenced participation in the Coordinated Direct Investment Survey (CDIS).

13. Despite an ostensibly modest level of external vulnerability, there remains a need to strengthen external debt monitoring and compilation. China started submitting total and public external debt data for the Quarterly External Debt Statistics (QEDS) database, a notable step forward.

II. Data Standards and Quality

14. China has participated in the General Data Dissemination System since April 2002, and the metadata posted on the Fund's Dissemination

Standards Bulletin Board (DSBB) are regularly updated.

III. Data Reporting to STA for Publications

15. 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* have 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. With regards to BOP and IIP data, the authorities recently started submitting quarterly data to STA for *IFS* (BOP data are available on a quarterly basis starting in 2010 and IIP starting in 2011). Additionally, China participates in the CDIS and data on inward investments are available for 2009 and 2010.

Data Dissemination to the Public

16. 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. Nevertheless, in the case of BOP and quarterly external debt data disseminated in QEDS, time lag is around four to seven months (BOP data are available for the third quarter of 2011 and external debt data are available for end 2011)

China: Table of Common Indicators Required for Surveillance

(As of June 19, 2012)

	Date of Latest Observation	Date Received	Frequency of Data[9]	Frequency of Reporting[9]	Frequency of Publication[9]
Exchange rates	05/12	06/12	D	M[9]	D
International reserve assets and reserve liabilities of the monetary authorities[1]	03/12	04/12	M	M	M
Reserve/base money	05/12	06/12	Q, M	Q, M	Q, M
Broad money	05/12	06/12	M	M	M
Central bank balance sheet	05/12	06/12	M	M	M
Consolidated balance sheet of the banking system	05/12	06/12	M	M	M
Interest rates[2]	05/12	06/12	[10]	[10]	[10]
Consumer price index[3]	05/12	06/12	M	M	M
Revenue, expenditure, balance and composition of financing[4] – general government[5]	2011	06/12	A	A	A
Revenue, expenditure, balance and composition of financing[4]– central government	05/12	06/12	M	M	M
Stocks of central government and central government-guaranteed debt[6]	Q4/11	06/12	Q	Q	Q
External current account balance	Q1/12	06/12	Q	A, S[11]	A, S[11]
Exports and imports of goods and services[7]	Q1/12	06/12	M	M	M
GDP/GNP[8]	Q1/12	06/12	A, Q (cumulative)	A, Q (cumulative)	A, Q (cumulative)
Gross external debt	Q4/11	06/12	A, Q	A, Q	A, Q
International investment position	Q4/11	04/12	A, Q	A, Q	A, Q

[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
LEG	Seminar on basic tax law	December 2005
FAD	Mission on VAT treatment of financial services	April 2006
FAD	Mission on estimation of VAT gap and capacity	June 2009
FAD	Mission on VAT treatment of financial services	June 2010
FAD	Mission on tax gap analysis	September 2011
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
FAD	Tax Policy and Administration	September 2011
FAD	Tax Administration (Peripatetic Expert Visit 4 of 5)	October 2011
FAD	Tas Administration (Peripatetic Expert Visit 5 of 5)	October 2011
FAD	Large Taxpayer Compliance	October 2011
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

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

Department	Purpose	Date
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
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
STA	Monetary and Financial Statistics	April 2012
Monetary Policy, Bank Supervision and AML/CFT		
MFD	Missions on banking supervision	October 2003
MFD	Bank Restructuring	April 2004
MFD	AML/CFT Issues	September 2003
MFD	AML/CFT Supervision	March 2004
MFD/LEG	AML/CFT advisory mission	January 2005
MFD/LEG	AML/CFT Issues	April 2005
LEG/MFD	AML/CFT Issues	April 2006
LEG	AML/CFT mission to discuss TA to the Monetary Authority of Macao SAR	July 2006
LEG	AML/CFT Legislative Drafting	July 2006
LEG	AML/CFT Legislative Drafting	August 2006
LEG	AML/CFT Legislative Drafting	September 2006
LEG	AML/CFT Legislative Drafting TA to the Monetary Authority of Macao SAR	September 2006
LEG	AML/CFT Financial Institutions Inspection STX advice mission, Macao SAR	December 2008

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

Department	Purpose	Date
LEG	AML/CFT Financial intelligence Unit procedural improvements, Macao SAR	March 2010
LEG	AML/CFT Legislative Drafting	July 2010
LEG	AML/CFT Legislative Drafting	March 2011
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
LEG	AML/CFT Mission to discuss future cooperation and TA	November 2009
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
LEG/MFD	AML/CFT Workshop	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	AML/CFT Training for PBC Officials	February 2005
LEG	AML/CFT Symposium	May 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

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

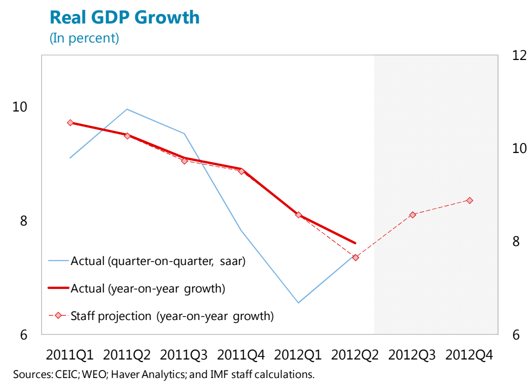
Department	Purpose	Date
LEG	National IT Symposium	July 2005
LEG	AML/CFT Workshop	July 2005
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2005
STA	Course on External Debt Statistics	August 2005
STA	Course on Monetary and Financial Statistics	September 2005
MFD	AML/CFT Symposium	September 2005
MFD	AML/CFT and Internal Control Workshop	November 2005
LEG/MFD	Advanced Training on ML and TF Typologies and STRs	December 2005
LEG	AML/CFT Workshop	January 2006
MFD	Course on Foreign Exchange Operations	March 2006
INS	Course on Macroeconomic Management and Financial Sector Issues	May 2006
LEG	AML/CFT Workshop on Information Management Technology	June 2006
MFD	Course on Determining the Intermediate Target for Monetary Policy	June 2006
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	AML/CFT Workshop on Mutual Evaluation Process	October 2006
LEG	AML/CFT Symposium	November 2006
LEG	Workshop for APC Countries	December 2006
LEG	AML/CFT Workshop	May 2007
LEG	AML/CFT Training for Supervisors	May 2007
LEG	AML/CFT Training for Macao SAR 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 Insurance and Securities Sectors 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 Legislative Drafting Workshop	January 2008
FAD	Seminar on Revenue Forecasting	March 2008
INS	Course on Financial Programming and Policies	April 2008
LEG	AML/CFT 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 Risk-Based Supervision Workshop	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 Risk-Based Supervision Workshop	November 2009
INS	Course on Financial Programming and Policies	January 2010
STA	Course on Monetary and Financial Statistics	March 2010

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

Department	Purpose	Date
LEG	AML/CFT Risk-Based Supervision Workshop	April 2010
INS	Course on Macroeconomic Management and Financial Sector Issues	May 2010
LEG	AML/CFT Legislative Drafting Mission	July 2010
LEG	AML/CFT Risk-Based Supervision Workshop	September 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
LEG	AML/CFT Legislative Drafting Mission	March 2011
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
STA	STA Balance of Payments and IIP Course	June 2011

Statement by the IMF Staff Representative
July 20, 2012

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



1. **Growth.** Real GDP growth was 7.6 percent (year-on-year) in the second quarter. This was broadly in line with market expectations and slightly stronger than the staff projection. The seasonally adjusted data suggest a slight pick-up in momentum. Staff continues to forecast growth to be 8 percent this year and 8½ percent next year.

2. **Inflation.** Inflation fell to 2.2 percent in June, a drop of 0.8 percentage points from May. The decline, which was larger than expected, was due in large part to a reduction in pork prices. Nonfood inflation remained unchanged from May at 1.4 percent.

3. **Trade.** The trade surplus widened in June as growth slowed more in imports than exports. From May to June, import growth fell from 12 to 6 percent, and export growth from 15 to 11 percent. Declining global commodity prices are contributing to slowing import growth.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/86
FOR IMMEDIATE RELEASE
July 24, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with People's Republic of China

On July 20, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with China.[1]

Background

China's economy seems to be undergoing a soft landing, though global headwinds are increasing. GDP growth is expected to moderate to about 8 percent this year and then rise slightly to 8½ percent in 2013. Since peaking at 6½ percent in July 2011, inflation has been on a downward path to 2¼ percent in June. Price pressures have eased across all major components of the CPI basket, led by declining food inflation. Barring further shocks to agricultural supply, inflation should stay in the 3–3½ percent range this year and fall to 2½-3 percent in 2013.

The authorities' macroeconomic policies are geared to slowing growth to a more sustainable pace, and continue to be adjusted in line with evolving conditions. The 2012 fiscal stance aims to balance the unwinding of past stimulus and supporting the slowing economy. The overall deficit is expected to be 1¼ percent of GDP, unchanged from last year in cyclically adjusted

[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.

terms.[2] To help support activity, implementation of approved projects is being accelerated and some measures to support energy-efficient consumption have been implemented, all of which fit within the existing budget envelope. The 14 percent M2 growth target is within reach and consistent with the authorities' economic objectives. Monetary policy has been eased by the three cuts in banks' reserves requirements and the June interest rate reform, which lowered benchmark interest rates and gave banks more flexibility to set interest rates. The currency has appreciated, in the year through June, by about 1¾ percent against the U.S. dollar, 7½ percent in nominal effective terms, and about 8½ percent in real effective terms (in the year through May). International reserves now stand at US$3.3 trillion.

China's external imbalances have been reduced significantly. The current account surplus declined from a peak of 10.1 percent of GDP in 2007 to 2.8 percent of GDP last year, reflecting primarily a reduction in the trade surplus. The decline in the current account surplus has had positive spillovers to the global economy. Looking ahead, implementation of the 12th Five-Year Plan transition toward a more balanced, inclusive, and sustainable growth model will substantially boost living standards in China and contribute significantly to strong, sustained, and balanced global growth.

Executive Board Assessment

Executive Directors commended China for its robust growth that has provided an important lift to world demand during the global financial crisis. However, they noted that the pace of activity has slowed and downside risks are significant. Accordingly, Directors agreed that the key challenge for China's policymakers in the period ahead will be to achieve a soft landing for the economy while pushing ahead with reforms for a more balanced and sustainable expansion.

Directors considered the current fiscal stance as appropriate. They welcomed the authorities' effort to reorient the current budget to support growth, within the overall fiscal target. More broadly, Directors noted that China is well placed to respond forcefully, if needed, to a deterioration of the external environment, in particular through fiscal policy. They encouraged the authorities to direct fiscal reforms toward spurring private consumption, including through tax reforms and a stronger social safety net. Framing these policies in clear medium-term fiscal plans would help anchor expectations and ensure that the reform agenda is fiscally sustainable. Strengthening the finances of local governments should also be a priority in fiscal reform.

Directors considered the current stance of monetary policy to be consistent with the authorities' economic objectives. They welcomed the steps taken to allow interest rates to be more

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[2] This is based on staff definitions, which adjust the official figures for a few items; the main one being net transfers to the stabilization fund.

market-determined, and encouraged further deployment of market-based policy instruments. Directors took note of the staff's assessment that, notwithstanding an appreciation in real effective terms, the renminbi remains moderately undervalued against a broad basket of currencies.

Directors welcomed the progress in financial sector reforms, including on the recommendations of last year's Financial System Stability Assessment. They stressed, nonetheless, that a large agenda remains, including strengthening the crisis management framework, adopting a formal deposit insurance scheme, and promoting the commercial orientation of banks. Directors noted the risks from rapid growth of bank credit, off-balance-sheet transactions, and nonbank financial intermediation, and encouraged continued upgrading of regulation, supervision, and monitoring of systemic risk. Reforms, including capital account liberalization, should be carefully sequenced in order to safeguard financial stability. Directors also welcomed the authorities' efforts to cool the real estate market, and noted that eliminating the potential for property bubbles requires reforms to channel household savings away from housing and toward other financial assets.

Directors welcomed the decline in China's external imbalances evidenced, in particular, by the lower current account surplus. However, this decline has been accompanied by rising domestic imbalances, reflected in a further rise in China's already elevated level of investment. While acknowledging China's large investment needs, most Directors expressed concerns about the sustainability of such a high level of investment in the context of weak external demand and excess capacity. These Directors underscored the urgency of reforms to rebalance the economy toward more consumption-led growth.

Directors encouraged the authorities to accelerate the transformation of China's economy as envisaged under the 12th Five-Year Plan. Directors considered that the agenda should include further financial sector liberalization, expanding the services sector, strengthening the social safety net, raising factor prices, and exchange rate flexibility. Together, this reform package will raise living standards, achieve the desired rebalancing of growth, and distribute its benefits more widely.

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 People's Republic of China is also available.

Table 1. China: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013
	(Annual percentage change, unless otherwise specified)							
National accounts and employment								
Real GDP	12.7	14.2	9.6	9.2	10.4	9.2	8.0	8.5
Total domestic demand	11.4	12.6	9.7	14.0	10.6	10.1	9.4	9.0
Consumption	9.8	11.1	8.5	9.4	9.2	9.7	10.1	9.7
Investment	13.4	14.5	11.1	19.3	12.0	10.5	8.8	8.2
Fixed	12.6	13.3	9.7	22.9	11.4	9.5	9.3	8.7
Inventories 1/	0.6	0.8	0.8	-0.8	0.5	0.7	0.0	0.0
Net exports 1/	2.1	2.6	0.9	-3.5	0.4	-0.4	-1.0	-0.2
Consumer prices								
End of period	2.8	6.5	1.2	1.9	4.6	4.1	3.5	2.5
Average	1.5	4.8	5.9	-0.7	3.3	5.4	3.3	3.0
Unemployment rate (annual average)	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1
	(In percent of GDP)							
External debt and balance of payments								
Current account	8.6	10.1	9.1	5.2	4.0	2.8	2.3	2.5
Trade balance	8.0	9.0	8.0	5.0	4.3	3.3	2.4	2.0
Exports of goods	35.7	34.9	31.7	24.1	26.7	26.1	24.3	23.9
Imports of goods	27.7	25.9	23.8	19.1	22.4	22.7	21.9	21.9
Gross external debt	12.5	11.1	8.6	8.6	9.3	10.4	11.4	12.3
Saving and investment								
Gross domestic investment	43.0	41.7	44.0	48.2	48.2	48.6	48.5	48.2
National saving	51.6	51.9	53.2	53.5	52.2	51.3	50.8	50.7
Public sector finance								
General government gross debt	16.2	19.6	17.0	17.7	33.5	25.8	22.0	19.4
General government balance	-0.7	0.9	-0.7	-3.1	-1.5	-1.2	-1.3	-1.0
	(Annual percentage change)							
Real effective exchange rate								
Annual average	1.6	3.9	9.2	3.4	-0.5	2.7	...	...
End of period	-0.9	4.8	12.5	-4.9	4.5	6.0	...	...

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

1/ Contribution to annual growth in percent.

Statement by Mr. Tao Zhang, IMF Executive Director, at the Conclusion of the 2012 Article IV Consultation with People's Republic of China
July 20, 2012

I thank staff for the constructive discussions held with my authorities. My authorities appreciated the staff's candid advice and continue to attach great value to this annual engagement with the Fund.

Since the global financial crisis, the Chinese economy has maintained strong growth and provided crucial support to the global recovery. At the same time, the economy is undergoing structural changes, reflected in part by the substantial decline of the current account surplus, which has, in turn, contributed to a narrowing of global imbalances. Recent economic data on the Chinese economy point to a slower but still robust pace of growth, reflecting weaker external demand as a result of the soft global recovery, as well as my authorities' efforts to rebalance the economy toward domestic demand. The pace of growth remains consistent with my authorities' target of 7.5 percent for 2012 and the economic fundamentals remain sound.

My authorities will continue to consolidate the achievements made in transforming the pattern of economic development and set the stage for further progress under the Twelfth Five-Year Plan. Efforts are being made to maintain steady and strong growth while accelerating structural adjustments and managing inflation expectations. However, the external environment, including a weak global recovery, the heightened stress in the Euro Area, volatile commodity prices, and rising trade protectionism continue to pose significant challenges.

Recent economic developments

China's GDP grew 7.8 percent year-on-year in the first half of 2012. While retail sales continued to grow at a robust rate of 14.4 percent, the growth of fixed asset investment has moderated to 20.4 percent, or 5.2 percentage points lower than the same period of 2011. Growth in property investment has further decelerated to a rate of 16.6 percent. The per capita disposable income of urban residents and the per capita net income of rural residents rose in nominal terms by 13.3 percent and 16.1 percent, respectively, with higher growth for rural residents. Exports and imports grew 9.2 percent and 6.7 percent, respectively, in the first half of 2012, further narrowing the trade balance as a share of GDP to 1.9 percent.

Inflation continued on its downward trajectory, following the adoption of an appropriate policy mix. In the first half of 2012, CPI inflation was 3.3 percent year-on-year, or 2.1 percentage points lower than the same period of 2011. The key challenges to maintaining price stability point to high and volatile commodity prices, rising domestic factor costs, and frequent shortage of a few categories of agricultural products. As the 2012 Report on the

Work of the Government stated, price stability is a key objective of government policies, which included using monetary policy tools to regulate the supply of money and credit, increasing production to ensure the supply of major agricultural products, improving the distribution network, and strengthening the supervision of market operations. My authorities' projection of CPI inflation for 2012 is around 4 percent, which has taken into account the aggregate domestic demand as well as the impact of international commodity prices, and the effect of reforming the regulated prices.

Fiscal policy

My authorities continued to implement a proactive fiscal policy. The 2012 budget projected a deficit of 800 billion yuan, or 1.5 percent of GDP. Fiscal revenues for the first half of the year grew 12.2 percent year-on-year to about 6.4 trillion yuan, with tax revenues growing 9.8 percent year-on-year to 5.5 trillion yuan. The deceleration in the growth of fiscal revenues can be mainly attributed to the weaker economic growth, lower inflation, the declining profits of enterprises, and tax reduction. Budgetary expenditure totaled 5.39 trillion yuan in the first half, up 21.3 percent from a year ago. The expenditure structure continued to give priority to education, culture, medical and health care, employment, social security, low-income housing projects, while further reducing administrative costs. Outstanding government debt to GDP is lower than 20 percent, supported by the low level of fiscal deficit in the past years. This provides the government with ample room for the implementation of proactive fiscal policy should downside risks materialize.

Monetary policy

My authorities' monetary policy continued to aim to promote steady and robust economic development, maintain stable prices, and guard against financial risks. As of end-June 2012, broad money supply increased by 13.6 percent and credit expansion stood at 15.9 percent, in line with my authorities' expectations at the beginning of the year. The People's Bank of China (PBC) announced an asymmetric cut in the one-year benchmark lending and deposit rates, reducing the lending rate by 31 basis points to 6 percent and the deposit rate by 25 basis points to 3 percent, effective from July 6. In addition, the PBC has allowed banks more flexibility to set interest rates, with the ceiling on deposit rates increased to 110 percent of the benchmark rate and the floor on lending rates reduced to 70 percent of the benchmark rate. The adjustment of the band represents an incremental yet significant step in the direction of further developing a market-oriented interest rate system. The PBC also cut the reserve requirement ratio three times since last November in response to the liquidity condition in the banking system and moderating economic growth. The monetary stance will continue to rein in inflation expectations, enhance the flow of credit to support the real economy, and strengthen services to boost demand and the development of small enterprises.

Financial sector

My authorities continue to attach great importance to guarding against latent risks which exist in the banking and public finance sectors. The banking sector remains healthy, with strong asset quality and capital adequacy. The result of stress tests conducted by the CBRC (China Banking Regulatory Commission) on 17 large commercial banks confirmed the banks' adequate capital position in dealing with macroeconomic shocks and their capacity to operate under market stress. Risks in off-balance sheet exposures are relatively small and nonbank financial intermediation is under close surveillance. The Central Government also strengthened its supervision of local government debts. Local governments are prohibited from providing guarantees for financing companies. The repayment of the debts and the provision of additional funding for ongoing projects are being actively but prudently addressed, while new local government debts are strictly limited. Overall, local government debts in China are now at a controllable and secure level.

Strengthening domestic demand

The rebalancing toward domestic demand is in progress, in line with the implementation of the Twelfth Five-Year Plan. The contribution of consumption to GDP growth has increased to 50.8 percent in 2011 from 43.1 percent in 2010. The expansion of private consumption and the lowering of the household savings rate is an adjustment process that has to be accomplished over time. My authorities are committed to accelerate improvements to the social security system and it is planned that by the end of 2012, there will be full coverage of the new old-age pension system for rural residents and the old-age pension system for nonworking urban residents. My authorities will also promote the development and reform of medical and healthcare services. These improvements will help further boost private consumption. Meanwhile, progress has been made on the move toward a higher value-added industrial structure and on promoting regional development. In the first half of 2012, the value-added of high-technology industry grew 12.3 percent year-on-year, or 1.8 percentage points higher than the growth rate observed for total industrial value-added; and economic activity in the central-western and northeastern regions registered faster growth than the economy as a whole.

Domestic demand in China has maintained a relatively high rate of growth in the past 10 years, but the pace of investment growth has been even faster, leading to an increasing share of investment in GDP. China's high investment has to be seen in the context of ongoing industrialization, urbanization, and technological upgrading in China and the trend is consistent with some other countries' experiences, such as Japan and Korea, in their respective economic takeoff periods. Investment in China is very unlikely to experience a rapid deceleration, a risk highlighted by the staff as it is well supported by fundamentals, and there is also adequate room for the implementation of supportive macroeconomic policies. From a longer-term perspective, the gradual deceleration in the growth of investment in line with the rebalancing of the structure of the Chinese economy would not only benefit the sustainable development of China but the sustainable development of the global economy.

Measures undertaken by my authorities in the property market are aimed at fostering the stable development of the market in the longer term. Recent data show that the measures have resulted in the intended outcome. In the first half of 2012, speculative activity has dampened and property prices have continued on a path of decelerated growth. Meanwhile, my authorities would continue to expand the supply of subsidized housing and housing for low-income families to address the housing needs of families in need. Investment in real estate moderated to a still-robust 16.6 percent year-on-year in the first half of 2012. My authorities will seek to prevent large swings in property prices to facilitate stable and sustainable economic growth.

External sector

China's current account surplus has declined substantially from 10.1 percent of GDP in 2007 to 2.8 percent of GDP in 2011, reflecting partly cyclical factors but primarily structural factors, including significant appreciation of the real exchange rate, substantial expansion of the social safety nets, reform of factor prices, and more stringent environmental standards. Staff's past projections of the current account have consistently pointed to a higher current account surplus than what eventually transpired, and there is a risk that this tendency has continued in the forthcoming staff report. As China makes further progress toward raising domestic demand, my authorities view the staff's projection of China's current account surplus at 4-4.5 percent of GDP in the medium term as leaning on the high side. Instead, they see a high possibility for China's current account surplus to be roughly maintained at the current level or to narrow further in the medium term. As the structural adjustment continues, the change in labor costs, the urbanization process, the demographic structure, and exchange rate movements are expected to have a lagged effect on resource allocation, subsequently bringing about a decline in the savings rate and an increase in domestic consumption. Also, it is expected that the negative impact of the Euro Area crisis will continue to weigh on China's exports performance.

Staff's assessment of the renminbi exchange rate is that it is moderately undervalued against a broad basket of currencies. This assessment, in my authorities' view, is not consistent with the reality. The sharp decline in the current account surplus and the recent two-way movements in the renminbi suggest that the currency is roughly in equilibrium. Other indicators, such as the forward rates in the onshore and offshore foreign exchange markets, also point to a close-to-equilibrium exchange rate.

My authorities widened the trading band of the renminbi against the U.S. dollar in April 2012. This move further increased the two-way flexibility of the renminbi exchange rate, facilitating the move of the exchange rate toward its equilibrium. My authorities remain committed to allow market forces to play a larger role in determining movements in the renminbi, and will continue to reform its exchange rate regime in this direction.