IMF Country Report No. 13/211

PEOPLE'S REPUBLIC OF CHINA

2013 ARTICLE IV CONSULTATION

July 2013

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 2013 Article IV consultation with China, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 29, 2013, with the officials of China on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 27, 2013. 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** prepared by the IMF.
- **Staff Supplement** of July 9, 2013 updating information on recent developments.
- **Press Release** summarizing the views of the Executive Board as expressed during its July 12, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for 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 2013 ARTICLE IV CONSULTATION

June 27, 2013

KEY ISSUES

Overview. China's economic performance over the past three decades has been remarkable, a testament to its ability to implement necessary but difficult reforms. Continued success now requires another round of decisive measures—in line with the new leadership's expressed intention to re-energize the reform effort.

Outlook and risks. Staff expect the economy to grow by 7¾ percent this year, although with downside risks from both external and domestic uncertainties. Since the global crisis, a mix of investment, credit, and fiscal stimulus has underpinned activity. This pattern of growth is not sustainable and is raising vulnerabilities. While China still has significant buffers to weather shocks, the margins of safety are diminishing.

Policies. To secure more balanced and sustainable growth, a package of reforms is needed to contain the growing risks while transitioning the economy to a more consumer-based, inclusive, and environmentally-friendly growth path.

- In the near term, a priority is to rein in broader credit growth and prevent a further build up of risks in the financial sector. Only if growth were to slow too sharply below the authorities' target, on-budget fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.
- Accelerated financial sector reforms are needed to secure a safe transition to a market-based financial system. This will combine allowing greater room for market forces (such as liberalizing interest rates in the 'traditional' banking industry) with strengthened oversight, governance, and investor accountability. While this will lead to higher borrowing costs for many firms, it is critical to reduce the large-scale regulatory arbitrage and moral hazard evident in the current system, and to improve the allocation of credit essential to future growth and sound finance.
- The post-2008 expansion in quasi-fiscal activity needs to be gradually unwound. Key reforms to this end should include a comprehensive revamp of local government finances, increasing SOE dividend payments to the budget, and continuing tax reforms allowing, inter alia, a shift in the tax burden away from regressive social contributions.
- A more market-based exchange rate, with reduced intervention, will facilitate further adjustment in the renminbi which staff assess as moderately undervalued against a broad-basket of currencies.
- A range of other structural reforms will support rebalancing and help unleash new sources of growth, such as opening markets to more competition, reforming resource prices, and gradually liberalizing the capital account.

Benefits. With a successful transition, China will grow at a healthy pace for years to come. Activity may be somewhat slower, a tradeoff worth making for the benefit of much higher income in the medium to long run—a growth trajectory that will also be good for the global economy.

Approved By
Anoop Singh and Kalpana Kochhar

Discussions took place in Guiyang, Anshun, Shanghai, and Beijing during May 15–29, 2013. The staff team comprised M. Rodlauer (Head), S. Barnett, P. N'Diaye, J. Walsh, M. Nabar, W. Liao, Y. Zhang (FAD), F. Ohnsorge (SPR), and M. Syed and A. Meier (MCM) (Resident Representatives). Mr. Lipton was in Beijing for meetings during May 27–29. Spillover team comprised I. Mateos y Lago (APD) and C. Christou (EUR).

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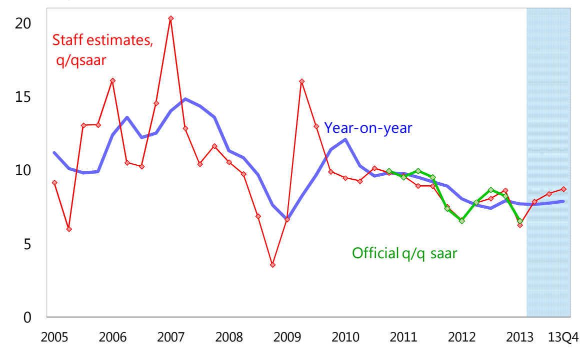
SETTING: OUTLOOK AND RISKS

1. Context. Three decades of rapid economic growth and much reduced poverty are a testament to China's success in implementing reforms. For the past few years, the difficult policy challenge has been to sustain activity in the face of adverse global conditions while achieving a smooth transition to a more consumer-based, inclusive, and sustainable growth path. While there has been unequivocal success on the first front—growth in China has been a solid anchor for the world economy in recent years—progress with rebalancing has been limited and is becoming increasingly urgent. Encouragingly, the new government—in office since March 2013—has announced a clear commitment to re-energizing the reform effort toward more balanced and environmentally friendly growth. Details are expected to be fleshed out in the coming months. Swift and steadfast implementation of the reform agenda will be critical to maintaining China's strong track record of economic development.

A. Macroeconomic Developments and Outlook

China: Real GDP Growth
(In percent)



Sources: CEIC; and IMF staff estimates.

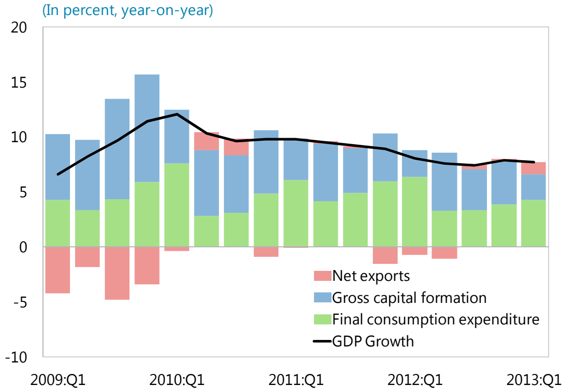
2. Growth. Despite weak and uncertain global conditions, the economy is expected to grow by around 7¾ percent this year. Although first-quarter GDP data were sluggish, the pace of the economy should pick up moderately in the second half of the year, as the lagged impact of recent strong growth in total social financing (a broad measure of credit)[1] takes hold and in line with a projected mild recovery in the global economy. High-frequency indicators have been mixed recently, with infrastructure spending and retail sales showing more resilience than exports and private nonresidential investment (Figure 1). Overall, the risks to the near-term outlook have moved more to the downside, as the expected rebound in the second half of the year may not materialize if, for example, external demand for China's exports remains subdued and/or the weaker activity in recent months spills over into investment and consumer demand going forward. On the upside, credit growth has traditionally been a leading indicator of economic activity, which has also typically seen an upswing following a leadership transition as new local officials ramp up investment spending.

[1] In addition to "traditional" bank credit, total social financing includes a range of other forms of credit, such as trust products, corporate bonds, and equity financing.

Figure 1. Message: Growth and inflation are stable

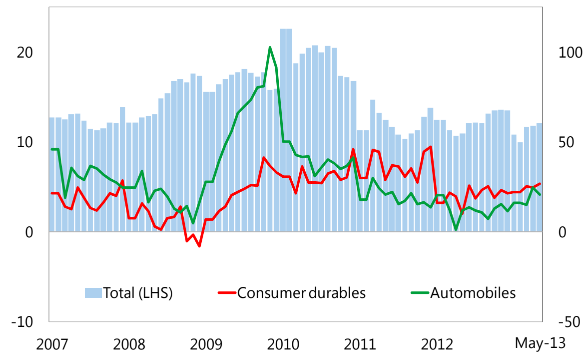
Growth in the first quarter was sluggish, with a strong contribution from consumption and weak capital formation…

Contribution to GDP Growth
(In percent, year-on-year)



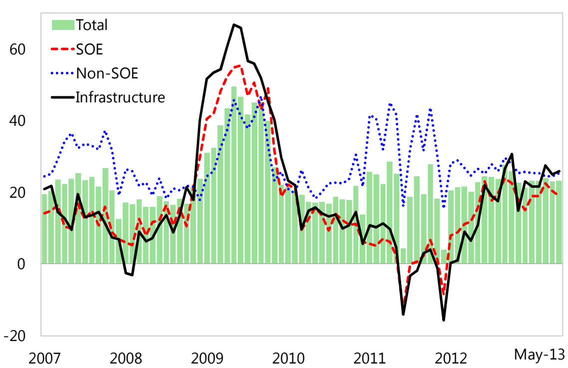
…which is somewhat at odds with the modest slowing in retail sales (though still growing at a healthy pace)…

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



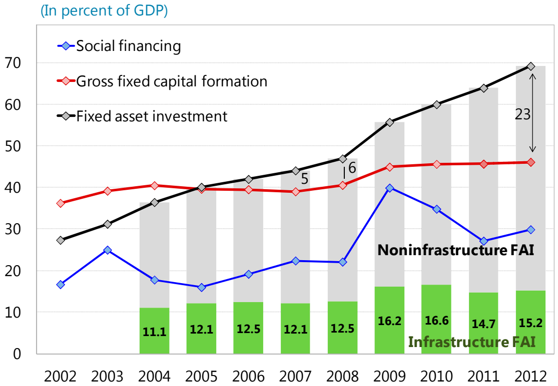
…while fixed asset investment (FAI), buoyed by infrastructure spending, has continued to grow at over 20 percent…

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



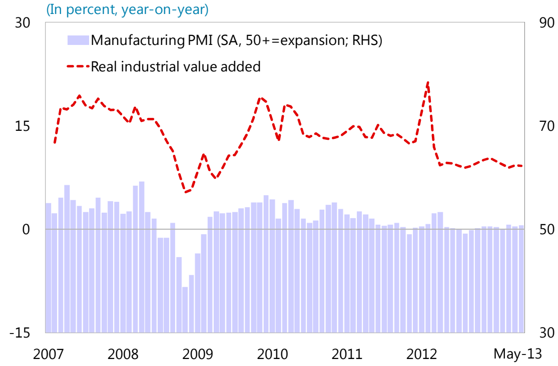
…though FAI and GFCF have for years shown different trends that are hard to explain. Total social financing (credit) has been supporting investment, but finances less than half of FAI.

Nominal Social Financing, Investment, and FAI
(In percent of GDP)



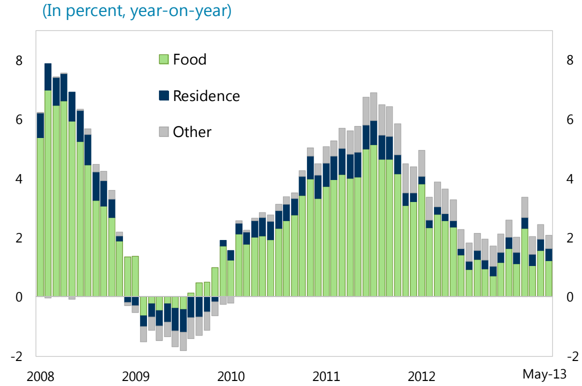
Supply-side indicators remained broadly in line with recent trends.

Industrial Value Added
(In percent, year-on-year)



Inflation is moderate, while volatility has been driven primarily by agricultural supply shocks effecting food prices.

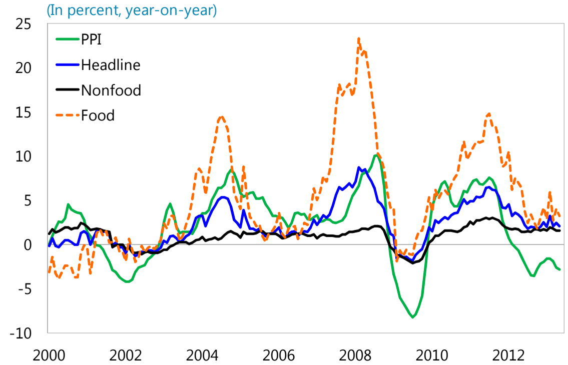
Contribution to Inflation
(In percent, year-on-year)



Sources: CEIC Data Company Ltd.; Haver Analytics; Bloomberg; WEO; and IMF staff calculations.

3. Inflation. Inflation is likely to remain moderate this year at around 3 percent. Nonfood prices, a proxy for core inflation, have been fairly stable for many years. Inflation has only been loosely linked to output fluctuations because surplus labor has helped prevent wage-price spirals and agricultural supply shocks have been the dominant driver of price volatility. With little sign of a renewed pick-up in food prices, inflationary pressures are likely to stay subdued. Moreover, persistently high investment has led to excess capacity in many sectors that tends to put downward pressure on prices.

Inflation
(In percent, year-on-year)



Sources: CEIC; and IMF staff calculations.

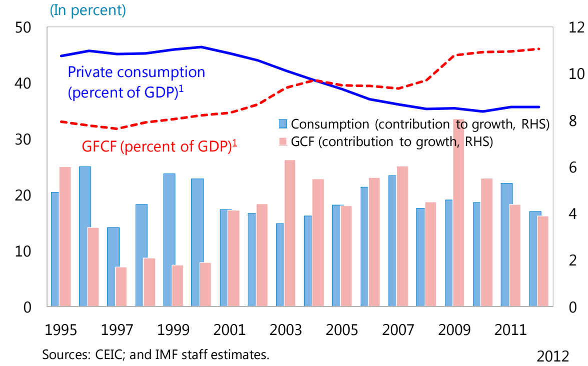
4. Balance of Payments. Last year, the surplus edged up to 2¼ percent of GDP, and it is expected to remain broadly unchanged this year (Figure 2). After years of net inflows, the capital and financial account posted a small net outflow in 2012, reflecting changed exchange rate expectations and a rise in global risk aversion. However, data through May 2013 indicate a resumption in net capital inflows. Purchase of foreign exchange reserves has also increased and amounted to US$157 billion in the first quarter of this year, compared to US$97 billion during all of 2012.

5. Authorities' views. The authorities saw the Chinese economy on a broadly stable—albeit lower—growth path, with inflation well contained. They were confident that growth would reach or slightly exceed their 7½ percent target for 2013, and viewed the slowdown since 2011 as appropriate and reflective of on-going structural changes in China as well as globally. They agreed that inflation would remain subdued, as food price inflation was low.

B. Rebalancing

6. Domestic rebalancing. Domestic imbalances remain large. Since 2009, investment—implemented through a mix of fiscal, quasi-fiscal, and state-owned enterprise spending—has been used to support domestic activity and offset the impact of external shocks. While this has had positive spillovers to global demand by increasing China's imports, it has exacerbated the domestic imbalance between investment and consumption. There are signs that these imbalances are no longer worsening, but a decisive shift toward a more consumer-based economy has yet to occur. In particular, last year investment rose while private consumption remained flat as a share of GDP, and the urban household saving rate increased (Figure 3).

Consumption and Investment
(In percent)

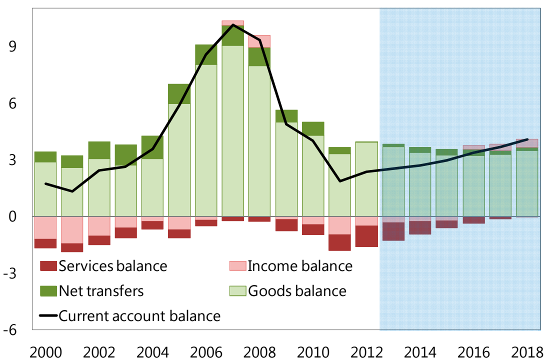


Sources: CEIC; and IMF staff estimates.
[1] Percent of expenditure-based GDP.

Figure 2. Message: After a reprieve in 2012 balance of payments pressures have resumed

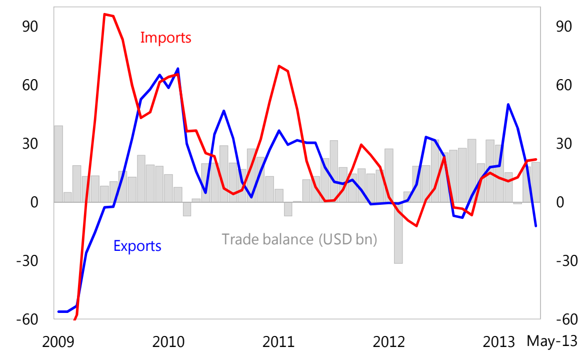
The current account surplus edged-up last year and staff forecast a gradual rise over the medium term.

Current Account and Components
(In percent of GDP)



Exports had accelerated strongly, raising questions about whether this is capturing hidden capital inflows.

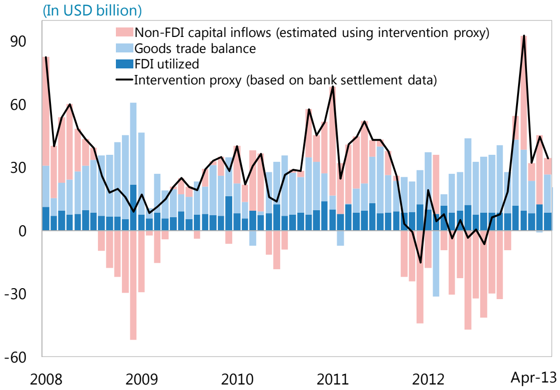
Trade Balance
(In percent, 3mma, 3m-on-3m, saar[1])



1/ Seasonally adjusted using X12 after averaging January and February data.

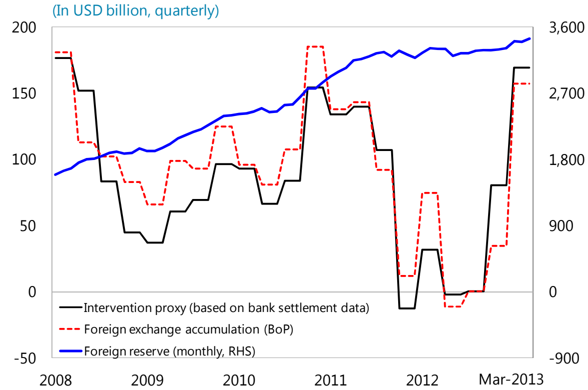
As non-FDI capital inflows have resumed recently, after registering net capital outflows last year...

Trade, FDI, and Foreign Exchange Intervention
(In USD billion)



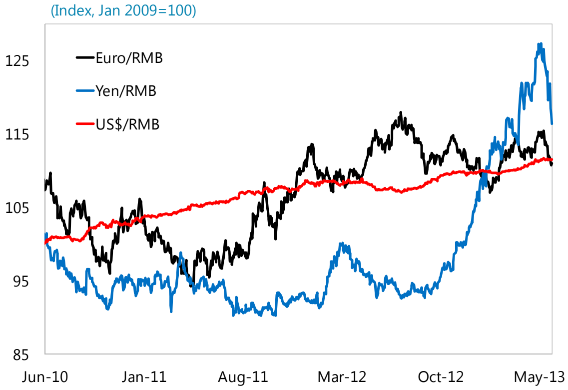
...and, after a lull in 2012, there has been a corresponding resumption in intervention.

Foreign Exchange Accumulation and Intervention
(In USD billion, quarterly)



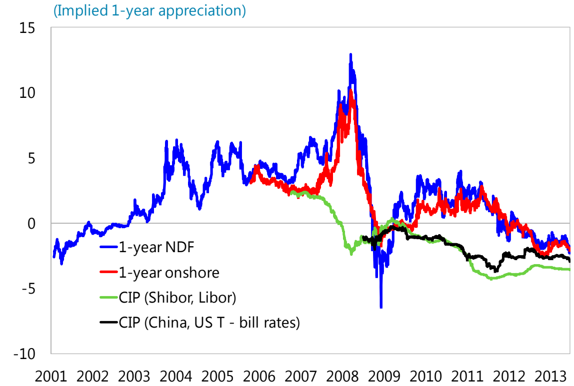
The renminbi has appreciated modestly against the U.S. dollar, and thus is up sharply against the yen.

Bilateral Exchange Rate
(Index, Jan 2009=100)



Forward rates show depreciation, though the amount is broadly in line with the interest differential.

Exchange Rate
(Implied 1-year appreciation)

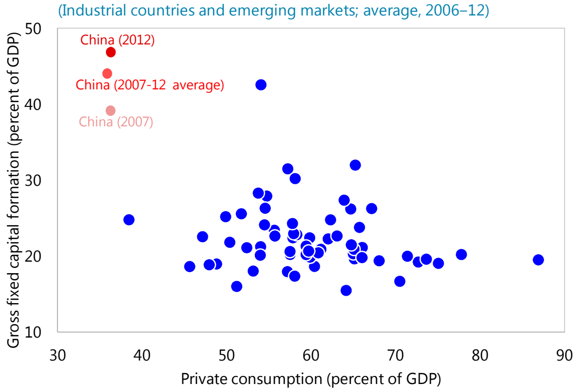


Sources: CEIC Data Company Ltd.; Haver Analytics; Bloomberg; WEO; and IMF staff calculations.

Figure 3. Message: More progress is needed on domestic rebalancing

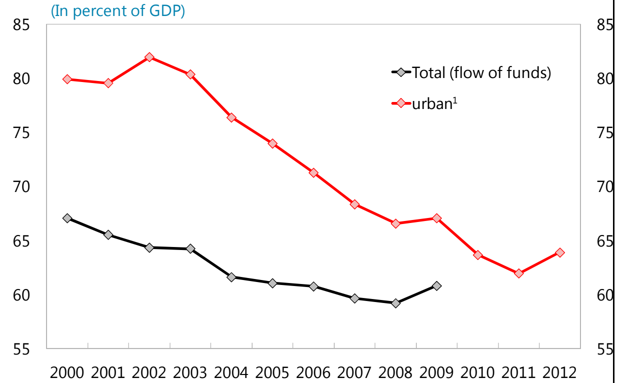
China remains an outlier, with investment higher and consumption lower than other countries.

Private Consumption and Investment
(Industrial countries and emerging markets; average, 2006–12)



Per capita household income increased last year, after declining for much of the previous decade...

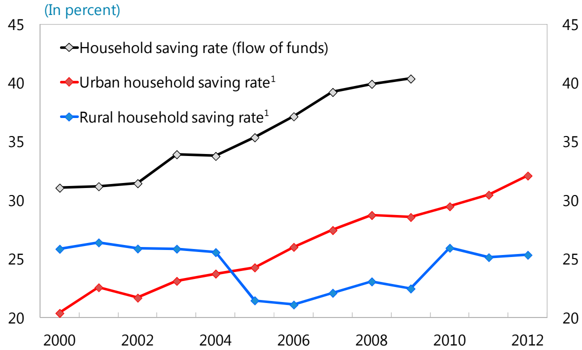
Household Disposable Income
(In percent of GDP)



[1] Per capita as a share of per capita GDP; household survey.

...but the urban household saving rate continued to rise.

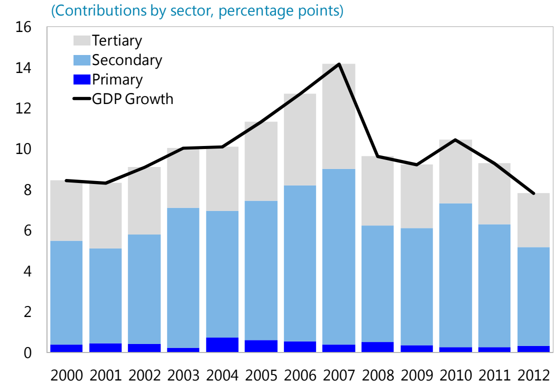
Household Saving Rate
(In percent)



[1] Rural household saving rate =(net income - living expenditure)/net income, percent; urban household saving rate = (disposable income-consumption)/disposable income, percent; household survey.

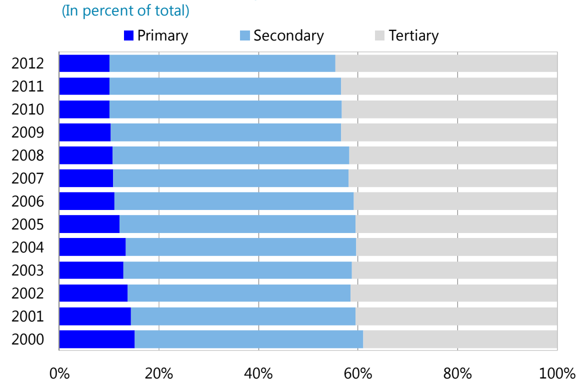
The secondary sector has been the main driver of growth over the past decade...

China: GDP Growth
(Contributions by sector, percentage points)



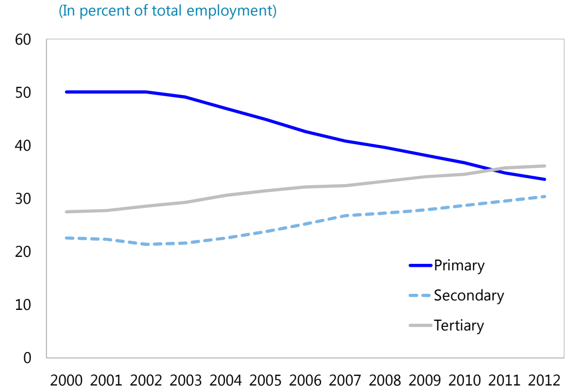
...and there has been only a modest increase in services share of GDP...

China: GDP Shares by Sector
(In percent of total)



...although the tertiary share of employment has now inched up past the primary.

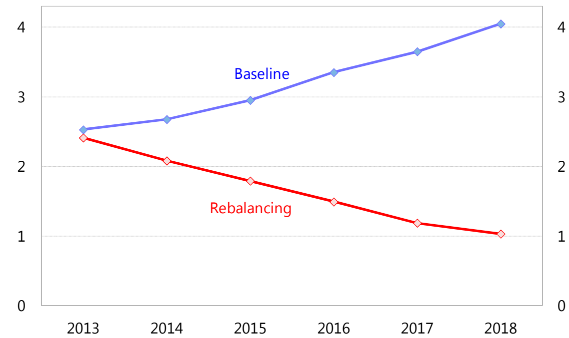
China: Employment Shares by Sector
(In percent of total employment)



Sources: CEIC Data Company Ltd.; Haver Analytics; Bloomberg; WEO; and IMF staff calculations.

7. External sector. In contrast to domestic rebalancing, substantial progress has been made in external rebalancing, and the current account surplus remains well below the 2007 peak of 10 percent of GDP. In the staff's baseline scenario, the current account surplus gradually rises to about 4 percent of GDP by 2018. This assumes a gradual recovery in global demand (consistent with the WEO projection), a constant real effective exchange rate (REER), and limited progress on domestic rebalancing in China. By contrast, in a scenario that assumes good progress on rebalancing and continued moderate REER appreciation, China's current account surplus would decline to around 1 percent of GDP by 2018 (see rebalancing scenario below). This reduction (compared with the increase in the baseline) would reflect mainly lower private savings, while investment would also decline, albeit by less than savings.

Current Account
(In percent of GDP)



Source: IMF staff estimates.

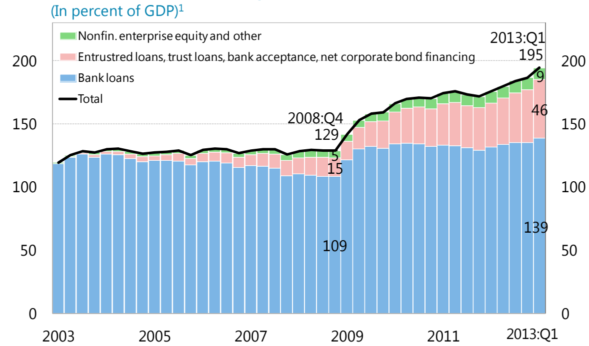
8. Authorities' views. The authorities emphasized the progress in external rebalancing, which they saw largely as the result of the structural (and thus lasting) changes in the Chinese economy and the global environment. They were confident that a sizable rebound in the current account surplus (in percent of GDP) was highly unlikely in the medium term, citing higher input costs, such as for labor and from tighter environmental protections, which would rein in export growth. At the same time, the services deficit would continue to rise as rebalancing shifts the economy toward consumption. They considered the staff's current account projections in the rebalancing scenario as reasonable, but strongly disagreed with the baseline scenario that showed a 4 percent of GDP surplus in 2018. They argued that the baseline continued to use unrealistic assumptions, including about the REER, and did not give enough weight to ongoing and planned reforms.

9. On domestic rebalancing, the authorities pointed to the inherent challenges in shifting the structure of a large and diverse economy. Nevertheless, supply-side and geographic rebalancing had moved forward: they pointed to the higher contribution to growth from real consumption than from real gross fixed capital formation over the past two years, strong growth of services relative to manufacturing, rapid increases in urban and rural household incomes, and growth in central and western provinces outstripping that in the more affluent coastal provinces. They were confident that continuing reforms would achieve the desired rebalancing to a more consumer-based economy.

C. Risks

10. Domestic risks. China has maintained robust growth since the global crisis, but the heavy reliance on credit and investment to sustain activity is raising vulnerabilities. The consequence is a steady build-up of leverage that is eroding the strength of financial sector, local government, and corporate balance sheets. This is most apparent in the continued rapid expansion in total social financing. After years of remaining broadly constant as a share of GDP, the stock of total social financing has increased sharply since 2009 (rising by 60 percent of GDP in just four years).

China: Social Financing Stock
(In percent of GDP)[1]



Sources: CEIC; and IMF staff calculations.
[1] In percent of 4Q rolling sum of quarterly GDP.

- **Financial system**. While the development of nontraditional finance marks a shift to more market-based intermediation, the migration of activity to less regulated parts of the system poses risks to financial stability (Figure 4). The rapid growth in some areas, notably the trust company and corporate bond sectors, raises questions about the adequacy of supervision and regulation, quality of underwriting standards, and pricing of risk. Moreover, the proliferation in alternative wealth management products (WMPs), managed by banks and securities companies, raises concerns as the composition of underlying asset pools is often opaque, maturity mismatches create liquidity risk, and investors perceive that most WMPs are implicitly guaranteed. Recent regulatory tightening, if strictly implemented, will reduce some of these risks, but does not fully address concerns about weak disclosure and moral hazard. Thus, WMPs and Trust products could over time evolve into a systemic threat to financial stability, especially if a sudden loss of confidence were to trigger a run. A related risk is that the boom in nontraditional sources of credit will entail a worsening of asset quality that could eventually lead to a severe credit crunch and heavy fiscal burden. Banks would not be immune in this scenario, as they remain closely linked to the development of nontraditional finance. Based on reported data, bank balance sheets appear healthy and loan books show only a modest deterioration in asset quality. However, banks remain vulnerable to a sharper worsening of corporate sector financial performance.

Selected Banking Indicators
(In percent)

All commercial banks	2007	2008	2009	2010	2011	2012
Total CAR ratio	8.4	12.0	11.4	12.2	12.7	13.3
NPL ratio	6.1	2.4	1.6	1.1	1.0	1.0
Substandard	1.0	1.1	0.7	0.4	0.4	0.4
Doubtful	2.2	1.0	0.7	0.5	0.4	0.4
Loss	2.8	0.2	0.2	0.2	0.2	0.1
Provision coverage ratio	41	117	153	218	278	296
Return on assets	0.9	1.1	1.0	1.1	1.3	1.3
Return on equity	16.7	19.5	18.0	19.2	20.4	19.8

Sources: CEIC; CBRC.

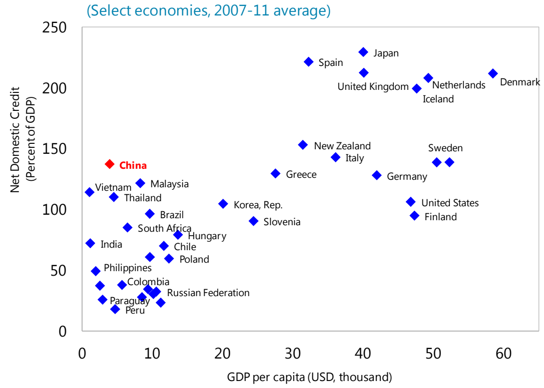
- **Local government finances**. There is considerable off-budget and quasi-fiscal activity in China, primarily at the local government level, which has been ratcheted up as a means of supporting the economy during the global crisis. Faced with revenue sources that do not match expenditure mandates and a general prohibition on borrowing, local governments have made recourse to

Figure 4. Financial Sector Risks

China's stock of credit is among the highest in the world at its level of income…

Net Domestic Credit and GDP per Capita

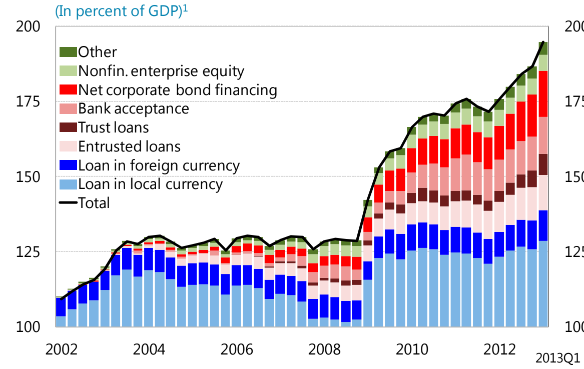
(Select economies, 2007-11 average)



..and is growing fast.

China: Social Financing Outstanding

(In percent of GDP)[1]

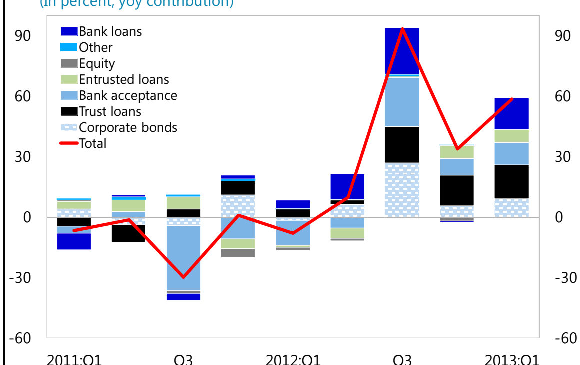


[1] In percent of 4Q rolling sum of quarterly GDP.

Nonbank intermediation has grown particularly rapidly, albeit from a small base…

Growth in Social Financing Flows

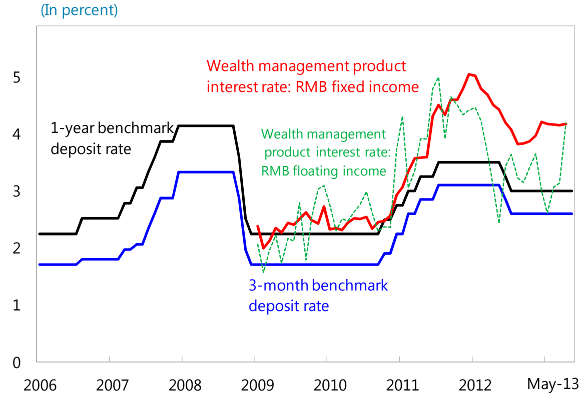
(In percent, yoy contribution)



…as alternative investment products offer more attractive yields, compared to traditional bank deposits.

Interest Rates

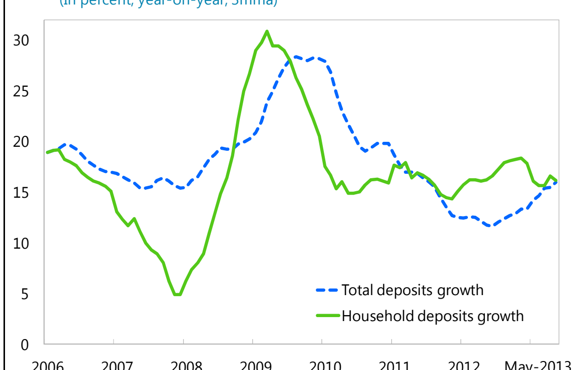
(In percent)



Although there has been a slight pick-up in recent months, deposit growth appears to be slowing.

Total Deposits and Household Deposits Growth

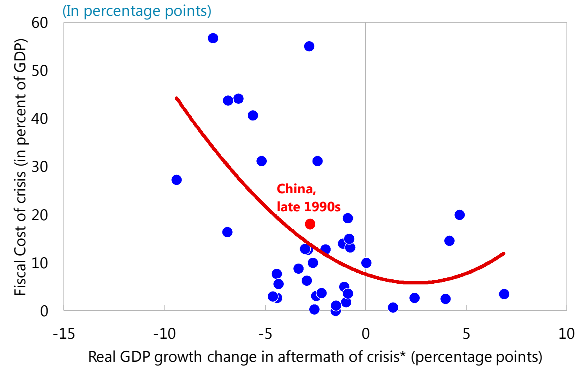
(In percent, year-on-year, 3mma)



While risks appear manageable for now, history suggests credit expansions of this kind often entail costly clean-ups.

Crisis Fiscal Cost and Change in Real GDP Growth

(In percentage points)



* Change in 5-year averages of real GDP growth before and after crises. Sources: WEO, IMF working paper by Laeven, Valencia, 2012.

Sources: CEIC Data Company Ltd.; Haver Analytics; Bloomberg; WEO; WDI; and IMF staff calculations.

off-budget activity, including land sales, to help finance social and infrastructure spending. In particular, borrowing by local government finance vehicles (LGFVs) has increased significantly since 2009. Expanding the definition of government to include LGFVs and off-budget funds, staff estimates that in 2012 "augmented" government debt was 45 percent of GDP and the "augmented" fiscal deficit was around 10 percent of GDP (Box 1). Based on these augmented government estimates, fiscal space is considerably more limited than headline data suggest. The large augmented fiscal deficits also raise questions about local governments' ability to continue financing the current level of spending and service their debts, which has implications for financial system asset quality and the potential need for central government support. While the size of augmented government debt and overall government resources suggests that such problems would still be manageable, further rapid growth of debts would raise the risk of a disorderly adjustment in local government spending. This would drag down growth, with adverse global spillovers, and potentially lead to disruptions in the provision of social spending since most of education, health, and welfare spending is implemented by local governments.

- **Real estate**. The real estate market remains an important source of growth and employment (Figure 5). However, existing distortions make the market susceptible to large cyclical swings. On the supply side, local governments' reliance on land sales for financing and real estate development for growth can lead to excess supply. On the demand side, the market is prone to bubbles since housing represents a uniquely appealing investment opportunity given real deposit interest rates that are close to zero, significant capital account restrictions, a history of robust capital gains, and favorable tax treatment. The measures put in place to limit real estate credit and speculative demand have helped, although price growth has picked-up again recently. An expansion in social housing, meanwhile, has helped sustain investment and address the need for low-cost housing. Over the medium term, however, real estate development will need to slow to a more sustainable pace as the market matures, which will act as a drag to economic growth. The challenge is to avoid excess supply or policy missteps that could trigger an abrupt investment decline and/or a sharp price correction.

11. Diminishing space. As of now, the authorities still have sufficient tools and fiscal space to address potential shocks, which reduces the likelihood of significant macroeconomic instability in the near term. However, maintaining rapid and unbalanced growth would further strain financial sector, government, and corporate balance sheets. Failure to change course and accelerate reforms—as assumed in the staff's baseline scenario—would thus increase the risk of an accident or shock that could trigger an adverse feedback loop. For example, financial distress would lead to a contraction in credit, a fall in domestic demand, and lower growth, which would make it more difficult for highly-leveraged borrowers to grow out of their debt. The timing and coincidence of events that would trigger such an adverse feedback loop are difficult to predict, and the staff's baseline scenario assumes that it would occur sometime after the initial five-year projection period.

Box 1. Debt and Deficits with a Broader Definition of Government

A significant amount of activity that is fiscal in nature, such as a majority of local government infrastructure spending, is not included in China's general government data. Since the financial crisis, such off-budget infrastructure spending has become an important countercyclical tool. To better assess the contribution of fiscal policy to stabilizing output and the concomitant rise in indebtedness, staff constructed augmented fiscal data by expanding the perimeter of government to include off-budget infrastructure spending. The main findings are that the augmented fiscal debt has risen to above 45 percent of GDP as the augmented fiscal deficit has been both much higher and more countercyclical than the headline government deficit. Because of data gaps the augmented fiscal data estimates rely partly on assumptions, and thus need to be read with caution and can only serve as a complement, not a substitute, to the standard fiscal definitions used in China (see Appendix III).

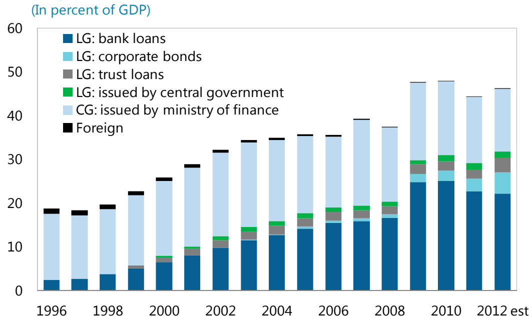
Augmented fiscal debt. The augmented fiscal debt rises to above 45 percent of GDP in 2012. The staff estimate is within in the range—though on the low-side—of estimates published by many academics and researchers. For example, staff of the Development Research Center (DRC), the research wing and advisory body of the China's State Council, recently published a similar estimate.[1]

Augmented borrowing is general government net lending/borrowing plus the market financing of local government infrastructure (such as LGFV borrowing through banks, bonds, and trusts) and net withdrawal of government cash deposits, data on which are incomplete and filled in using staff estimates. This measure captures transactions in financial liabilities—that is, debt creating flows and thus closely corresponds to the change in augmented fiscal debt.

Augmented fiscal deficit is augmented net borrowing plus financing from land sales (net of costs such as land development and compensation for relocation). Land sales are treated as a financing item akin to privatization, but do not contribute to debt accumulation. This is an analytical concept well-suited to capturing the overall impact of fiscal policy on aggregate demand. The augmented fiscal deficit increased sharply in 2009 and more modestly in 2012, underscoring how off-budget spending has contributed to stabilizing output.

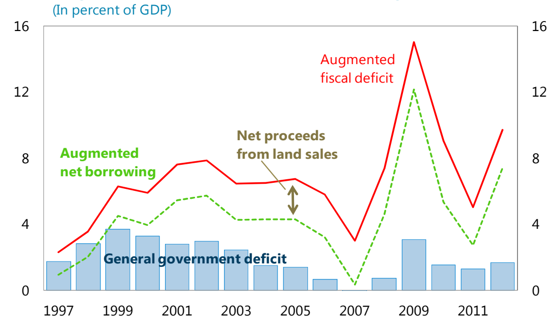
Further considerations. Estimating the augmented fiscal data involves numerous assumptions and the uncertainty around the estimates suggests some caution in interpreting the results. Nonetheless, it is clear that China has considerably less fiscal space than indicated by conventional general government data. Moreover, the augmented fiscal data only capture some aspects of fiscal risk and vulnerability. Additional sources of vulnerability include possible contingent liabilities related to the financial sector, SOEs, and actuarial shortfalls in the pension system. However, a comprehensive assessment would also include the government's holding of financial and nonfinancial assets, such as the China Investment Corporation, National Pension Fund, and the equity stake in SOEs.

Augmented Public Debt Level
(In percent of GDP)



Sources: CEIC, Chinabond, EUROSTAT, China Citic Press, China Trustee Association, NAO, and the Ministry of Finance; and IMF staff estimates.

Augmented Deficits and Net Borrowings
(In percent of GDP)



Sources: CEIC, Chinabond, EUROSTAT, China Citic Press, China Trustee Association, NAO, and the Ministry of Finance, Zhang and Barnett (2013).

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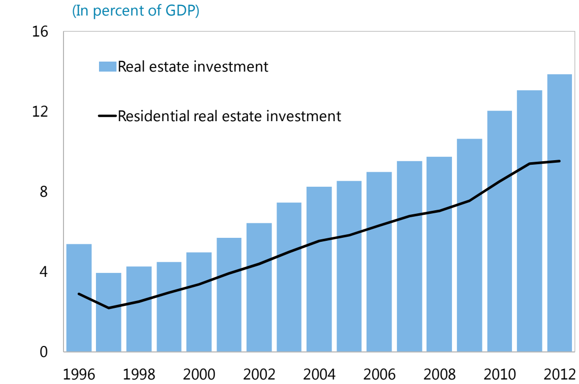
[1] Yu and Wei (2012), A Study on China's Fiscal and Financial Risks, DRC Research Series. Their estimate was 59 percent of GDP, but refers to the end of 2010 and includes items not in the staff definition (asset management companies, pension funds, and ministry of railway.

Figure 5. Message: Real estate has rebounded

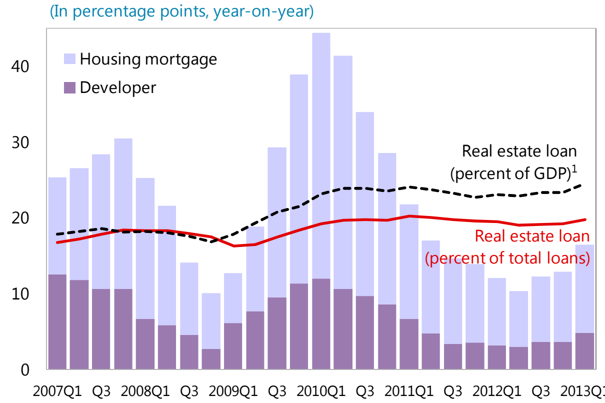
Real estate investment in 2012 accounted for 12½ percent of China's GDP, 14 percent of total urban employment, and rising share of FAI.

Lending to real estate is primarily for household mortgages and has slowed recently.

Real Estate Investment
(In percent of GDP)



Contribution to Real Estate Loan Growth
(In percentage points, year-on-year)

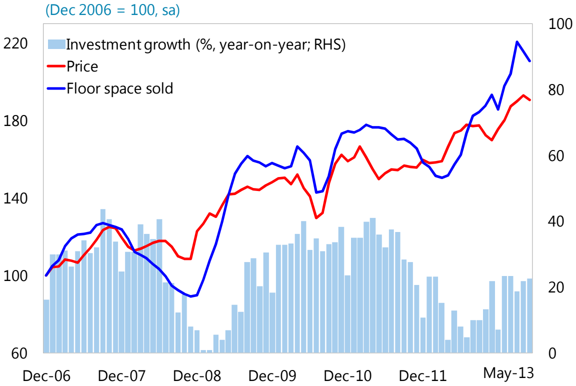


[1] In percent of 4Q rolling sum of quarterly GDP.

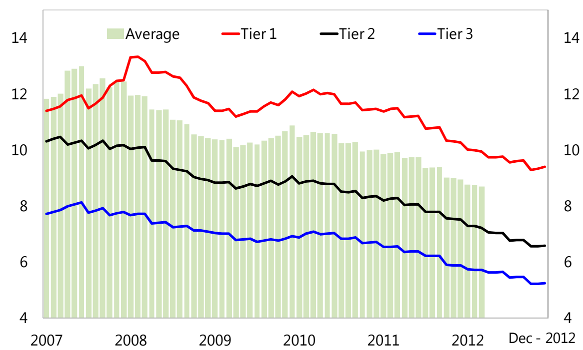
The real estate market has shown signs of a recovery lately, with moderate growth in prices, investment, and sales…

…and affordability indices have been improving…

Residential Housing
(Dec 2006 = 100, sa)



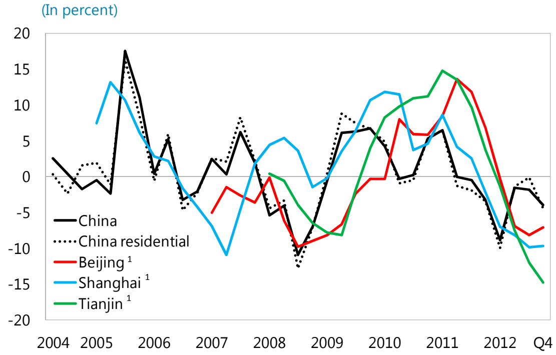
Residential Property Price to Household Disposable Income (SA, per 90 Sq. m. apartment)



…and prices now seem to be broadly in line or even below fundamentals nationwide and in major cities.

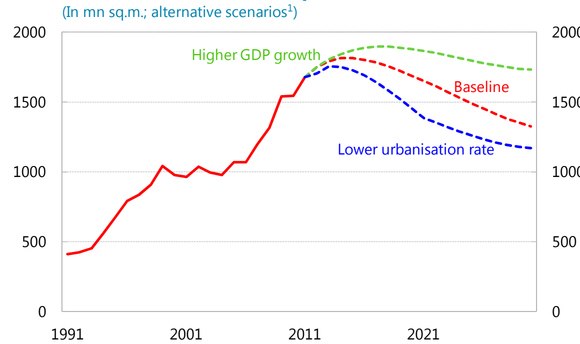
Over the medium term, residential construction is likely to slow as the market matures.

Deviation from Benchmark
(In percent)



[1]Average price of traded second-hand housing (WIND).
Sources: CEIC; WIND Info; Ahuja and others (2010); and IMF staff calculations.

Urban Residential Floor Space Construction
(In mn sq.m.; alternative scenarios[1])



Sources: CEIC; RBA, updated from Berkelmans and Wang (2012).
[1]Dashes indicate projections.

Sources: CEIC Data Company Ltd.; Haver Analytics; Bloomberg; WIND Info; and IMF *World Economic Outlook* and staff calculations.

12. Authorities' views. The authorities recognized the importance of containing risks and continuing reforms to change the course of economic growth, but were confident that vulnerabilities were well under control with the countervailing measures already put in place. On the financial side, they considered the rapid growth in trust, WMP, and corporate bond activity as important shifts toward more market-based intermediation. They acknowledged that this process involved risks, but viewed these as manageable, especially as they were actively committed to improving supervisory oversight. While reported NPLs had been rising in some industries, they remained low and Chinese banks had some of the highest capital and provisioning ratios in the world. The authorities continued to closely monitor the real estate market, and would fine-tune policies, as necessary, to ensure the stable development of the market, including for low-income housing. At the same time, they acknowledged that rapid growth had helped mask some of the problems in the past, but with growth slowing, they were being especially vigilant, particularly with respect to risks in the fiscal and financial sectors.

13. The authorities noted staff's focus on the augmented fiscal data. They emphasized that the staff's estimates involved several simplifying assumptions, and, the actual augmented position could be stronger. Moreover, they emphasized that some LGFVs generated operational revenue and would be able to service part of their own debt and a significant portion of LGFV spending was for the acquisition of fixed assets. Regarding land sales, they considered this to be a viable source of financing for many years to come and questioned why it was included as a financing item in the augmented fiscal deficit, rather than focusing on debt-creating net borrowing requirements. Nonetheless, they acknowledged that local government debt had become a pressing issue in some jurisdictions, and they were thus considering further strengthening of local debt management, including the creation of a monitoring system to contain risks. Overall, they emphasized that banks appeared comfortable with their exposures and the underlying health of projects they had financed. The authorities noted, however, that those projects without cash flows would be transferred to the government budget.

14. External risks. The main external risks to China are renewed financial distress in the euro area, a protracted period of slower euro area growth, and the risks associated with unwinding of unconventional monetary policy in major advanced economies (see Risk Assessment Matrix). Should any of these risks materialize, the spillovers to China would be significant given its dependence on demand from the euro area and the United States, which together account for around 30 percent of China's exports. In addition, a prolonged slowdown in advanced economies or a reappraisal of U.S. or Japanese sovereign risk could have a strong negative impact on China. At the same time, continued reforms to the Chinese financial and services sectors, as well as further exchange rate liberalization, would be part of a global package that could lead to higher and more stable growth worldwide. A fuller discussion of these spillovers is contained in the 2013 Spillover Report.

15. Authorities' views. The authorities remained concerned about the impact of continued slow growth in major advanced economies (AE), which was depressing export growth in China and other emerging market and developing economies. They also noted that unconventional monetary policy (UMP) in several advanced economies created adverse spillovers and policy challenges elsewhere. Besides the well-know channels of trade, capital flows, and exchange rates, these policies in their view created significant uncertainties for investors and consumers worldwide. They also were concerned that UMP risked allowing AE governments to continue postponing the necessary structural reforms critical to long-term growth.

POLICIES

A. The Challenge

16. The challenge for China now is to accelerate its transition to a more balanced and sustainable growth path, while maintaining adequate domestic growth and stability in a global environment that is likely to remain difficult for some time. Successful transition will require a decisive new round of reforms that will combine to unleash new sources of growth, address the growing risks in various parts of the economy, and make growth more inclusive and environmentally sustainable (Box 2; Figure 6; Box3). At a strategic level, the reform agenda will need to (1) give a greater role to market forces through continued liberalization and reduced government involvement; (2) embed strong governance in lower-level state or state-related economic institutions, especially banks, state-owned enterprises, and local governments; and (3) boost household incomes and consumption. In terms of economic policies, the agenda includes a broad set of fiscal, financial sector, exchange rate, and other structural measures. Many of these reform directions and policy objectives have been outlined in the authorities' recent announcements; timely and focused implementation will be crucial for success. The necessary focus on managing risks and structural change will likely entail somewhat slower growth in the short run, but this is not a reason to delay as vulnerabilities are rising and, even in the best of cases, the necessary restructuring of supply and demand will take time to implement. Moreover, looming demographic changes (Box 4) add urgency to reforms that make growth less dependent on factor accumulation, and more on productivity gains (Box 5).

17. **Authorities' views**. The authorities recognized the challenges, and pointed out that the new government had already announced a set of reforms for 2013 to address them. They emphasized their intention to embark on a comprehensive reform agenda at all levels of government and to give market forces the primary role in resource allocation, while strengthening the framework of regulation, oversight, and incentives to ensure the proper functioning of markets. They also noted their commitment to address the environmental challenges and to ensure that the benefits of growth would be shared more equitably among all parts of society.

B. Demand Management

18. **Policy stance**. Near-term policies should focus on containing the build-up of risks and advancing the structural reform agenda, while providing support to activity if needed to prevent an unduly sharp slowdown of growth. The rapid growth in total social financing needs to be reined in through a coordinated effort that includes tighter supervision, prudential measures, and

Box 2. The Nexus between Inclusive Growth and Rebalancing[1]

Since its reform and opening up period, China has made remarkable strides in lifting people's incomes and reducing poverty (Figure 6). In 1981, nearly 85 percent of its population lived on less than $1.25 a day, the fifth largest poverty incidence in the world. By 2008, this proportion had fallen to 13 percent, well below the developing country average.

However, inequality has increased sharply. According to the World Bank, China's Gini index increased from 0.29 in 1981 to over 0.42 in 2005, higher than in the United States. Notwithstanding a downtick since 2009, official estimates report a Gini of over 0.47 in 2012. Many unofficial estimates are even higher.[2] These data suggest that China's growth has been less inclusive than in most other developing regions, including Latin America and a number of its Asian peers.

In many ways, inequality has been an inevitable by-product of China's investment and export-led growth model. The capital stock was largely utilized to support the growth of the manufacturing sector, increasingly to meet export demand; wages were low in large part due to the large labor dividend; and the East coast developed first for geographical reasons, benefitting from trade and FDI.

The unbalanced nature of growth has propagated income gaps based on skills, sectors, and geography. Between Chinese households, the most important factors explaining income inequality are education, access to health insurance, and labor market variables, including sector of employment and enterprise size. Across China's provinces, divergences in per capita incomes are driven by the relative level of urbanization, financial access, reforms, and capital-intensity. Importantly, the public sector can play a role in dampening geographic disparities, as it has done since the "Go-West" Policy of 2000. In addition, excess liquidity has exacerbated inequality in the last decade, with the wealth gap from asset price inflation further differentiating the income of the rich from the poor. This includes rising property prices, which also raise issues of affordability.

Based on these findings and international experiences, a number of policies could help broaden the benefits of growth in China. These include prudent monetary policy, a fairer fiscal tax and expenditure system, higher public spending on health and education, deregulation and reforms to increase competition, measures to raise labor incomes and assist vulnerable workers, and better access to finance for both households and SMEs, including in rural areas. These policies are also in line with recent recommendations by the World Bank and Asian Development Bank.[3]

In fact, many of these measures are already being put in place by the authorities in an effort to rebalance the economy. Indeed, the change in China's growth model envisaged in the 12th Five Year Plan would go a long way toward facilitating the needed reduction in inequality. The income distribution plan recently approved by the State Council further identifies many supportive reforms, including minimum wage increases, improving the tax system, and strengthening social security.

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[1] Based on Lee, Syed, and Xin (forthcoming), IMF Working Paper: "Two Sides of the Same Coin: Rebalancing and Inclusive Growth in China."

[2] For instance, a recent study by the Southwestern University of Finance and Economics estimated a Gini of 0.61 in 2010.

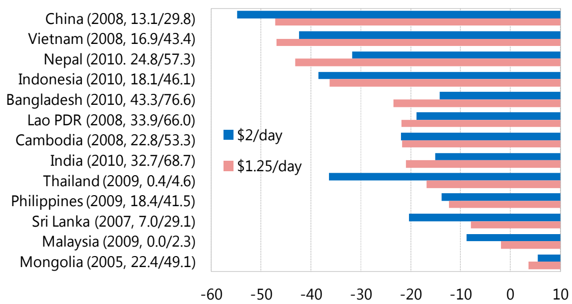
[3] See Development Research Center and World Bank (2013), "China 2030 Report: Building a Modern, Harmonious, and Creative Society;" and Asian Development 2012 Outlook Report.

Figure 6. Inclusive Growth

China's rapid growth has translated into a significant reduction in poverty …

Asia: Change in Poverty Headcount, Last Two Decades[1]

(in percentage points since 1990)

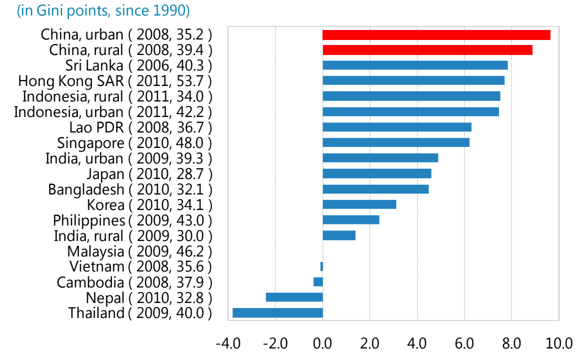


Sources: World Bank; and IMF staff calculations.
[1] At 2005 PPP prices. In parentheses, the latest available year and corresponding poverty headcount ratios at $1.25 and $2 per day, respectively.

… but inequality has increased markedly over the last two decades…

Asia: Change in Gini Index, Last Two Decades[1]

(in Gini points, since 1990)

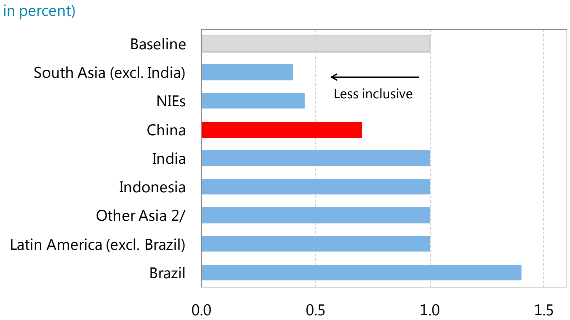


Sources: World Bank; national authorities and IMF staff calculations.
[1] In parentheses, the latest available year and corresponding Gini coefficients.

…making China's recent growth less inclusive than in a number of comparator economies.

Degree of Inclusiveness of Growth[1]

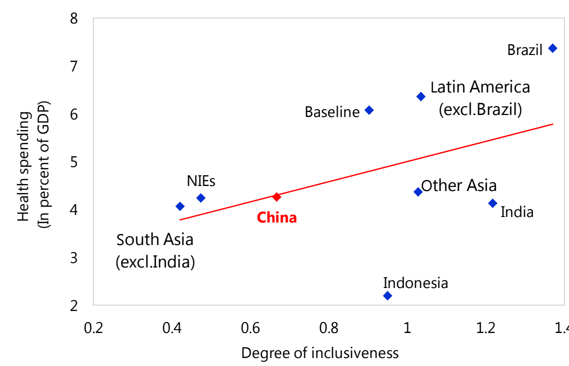
(impact on income of bottom quintile of a 1 percent increase in per capita income; in percent)



Source: IMF Asia and Pacific Regional Economic Outlook (October 2011).
[1] The elasticity is set to 1 when null of a significant difference cannot be rejected.
[2] Includes Cambodia, Malaysia, Philippines, Thailand and Vietnam.

China's relatively low social expenditures, both in terms of health…

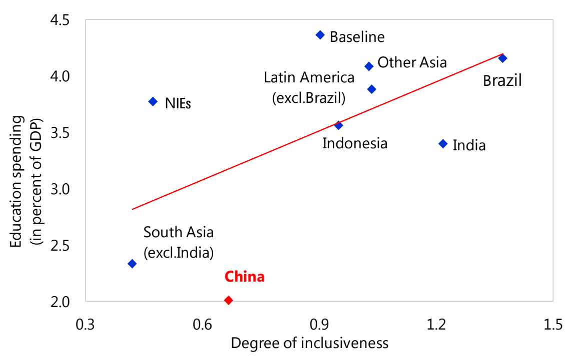
Health and Inclusiveness



Source: IMF Asia and Pacific Regional Economic Outlook (October 2011).

…and education, to play an important role, together with…

Education and Inclusiveness

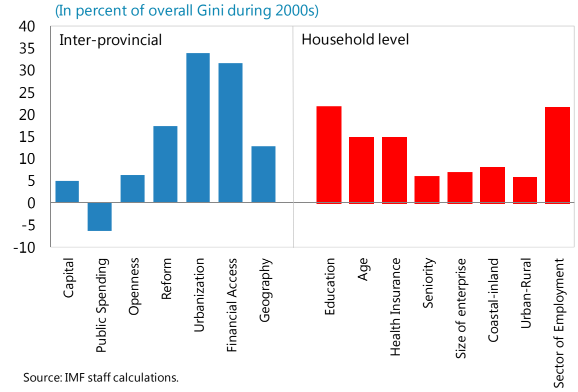


Source: IMF Asia and Pacific *Regional Economic Outlook* (October 2011).

…disparities in urbanization, financial access, reforms, capital, and labor markets related to China's growth model.

Inequality in China: Contribution of Factors

(In percent of overall Gini during 2000s)



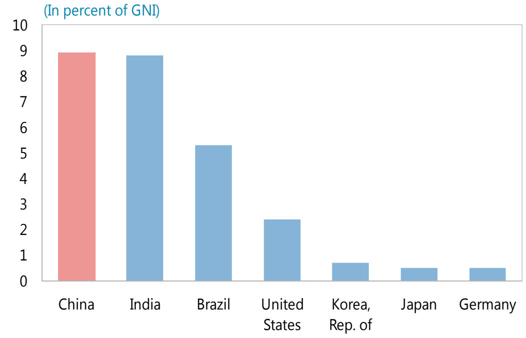
Source: IMF staff calculations.

Box 3. China: The Environment and Planned Reforms

While China's rapid economic development has been remarkable, it has also resulted in a notable deterioration in the environment. The World Bank estimates China is home to 16 of the world's most polluted cities. Air pollution, water quality and supply, and resources are pressing issues that have health, social, economic, and even global implications. This note describes some of these challenges and the policy response.

Air quality. The Chinese Academy of Environmental Planning estimated that environmental damage in 2010 cost the equivalent of 3½ percent of GDP. *China 2030* (2013) puts the cost higher and well above other countries. In Beijing, the Air Quality Index (AQI) and small particulates concentrations (PM2.5) often far exceed international standards—and though Beijing attracts the most media attention, it ranks ninth in the list of most polluted cities in China. Since 2005, China has been the largest emitter of greenhouse gases and emissions of sulfur dioxide exceed that of the United States and European Union combined. The burning of coal is the main source of air pollution, accounting for 19 percent, while vehicle emissions contribute 6 percent.

Environmental and Natural Resource Degradation and Depletion
(In percent of GNI)



Source: World Bank and DRC *China 2030* report.

Water. China faces the twin challenges of water shortage and pollution. One-third of major river systems, 85 percent of lakes, and 57 percent of underground water in monitoring sites are polluted. Nearly 300 million rural residents lack access to clean drinking water and some major rivers have become too polluted to supply drinking water.

Natural resources. Nearly 70 percent of China's energy consumption comes from coal, which is the biggest source of manmade carbon dioxide emissions and poses the greatest threat to the climate. According to the OECD (2007).[1] China's energy consumption per unit of GDP is about 20 percent higher than the OECD average. Desertification is also a problem, due in large part to overgrazing, and leads to the loss of about 5,800 square miles of grasslands every year. In addition, 31 percent of national land area experiences soil erosion and 85 percent of the total grassland area is degraded.

Policy response. The authorities have made improving the environment a priority. They have introduced measures to reduce car emissions in some cities (by restricting use to alternate days) and planted trees to combat desertification. To improve monitoring, the authorities have established a nationwide air and water quality monitoring network, which was recently strengthened; set a new standard for air quality monitoring in 74 cities, and will extend it to 190 cities by the end of the year; and report weekly water quality data from 131 monitor sites on the nation's major river systems. Regulations aimed at raising environmental standards have been passed and enforcement efforts stepped up. However, the OECD (2012) highlights that enforcement remains a key challenge because it is mainly delegated to local governments that lack sufficient capacity; fines are too small to act as an effective deterrent; and criminal charges, while possible, are difficult in practice and rarely used.[2]

Plans. The 12th Five-Year Plan for Environmental Protection (2011–15) sets out a blueprint with seven major targets to achieve by 2015, with a special emphasis on improving water and air quality and protecting ecosystems. Progress reports, including to the public, are due this year and 2015. The 12th Five Year Economic Plan also promotes environmentally-friendly growth, as three out of seven priority industries are aimed at cleaner and more sustainable growth. It also calls for advancement of environmental protection tax reform and improvement in waste disposal fees. Resource tax reforms have been piloted in some regions since 2010 and, in 2011; taxes on crude oil and natural gas were raised (and converted to an ad-valorem basis). A comprehensive environmental protection tax plan has been submitted to the State Council this year, which covers water ,solid waste, emissions, and noise. Price signals could be better used to promote the efficient allocation of resources and, more broadly, achieving the desired domestic rebalancing would help reduce the strain on the environment by shifting activity away from manufacturing to the less resource intensive and less polluting service sector.

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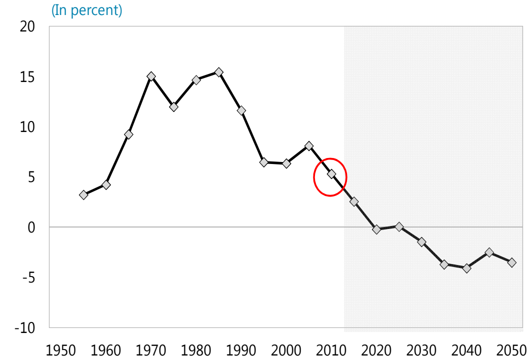
[1] OECD (2007), "OECD Environmental Performance Reviews: China 2007."
[2] OECD (2012), "China in Focus: Lessons and Challenges," http://www.oecd.org/china, htttp://www.oecdchina.org.

Box 4. China's Looming Demographic Changes

China is at the dawn of a demographic shift as the economy will soon start to be weighed down by a shrinking workforce and aging population. The working-age (15–64) population will start to fall in less than a decade due to declining fertility, reflecting the one-child policy. The cohort of 25–39 year olds—the core industrial workers—will shrink even faster, with implications for the pattern of growth reliant on building new factories and finding a ready supply of workers. The dependency ratio (population younger than 15 and older than 64 as a share of the working-age population), which declined for decades, is projected to increase from 13½ percent in 2010 to around 30 percent by 2030.

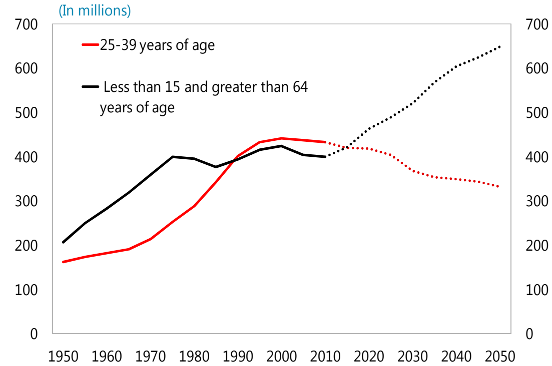
These demographic changes imply that China will meet the Lewis Turning Point—when the supply of plentiful low-cost labor is exhausted—toward the end of the decade.[1] As the surplus labor dwindles, labor cost will rise, which would affect prices, incomes, and corporate profits in China and would have implications for trade, employment, and price developments in key trading partners. For China, this transformation makes it even more important to switch from an extensive to an intensive growth model.

Growth of Working-Age Population
(In percent)



Source: IMF staff estimates.

Demographic Pressures
(In millions)



Sources: UN Population Database; and IMF staff estimates.

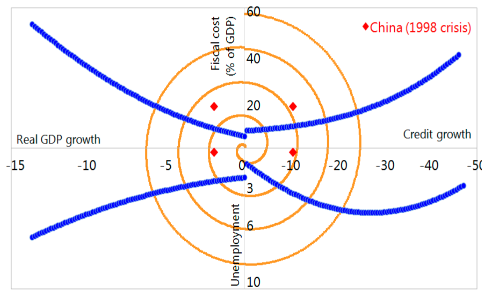
[1] See Das and N'Diaye (2013), "Chronicles of a Decline Foretold: Has China Reached the Lewis Turning Point," IMF Working Paper 13/26.

Box 5. Toward Intensive Growth

Time is running out on the current model which has relied on extensive growth—factor accumulation and relocation of labor from the countryside to factories. Without accelerating reform, vulnerabilities will increase as will the probability that China's convergence process stalls. Moving to high-income status will require transitioning to a growth model that is more reliant on total factor productivity ("intensive" growth).

Context. Growth has moderated, even as investment has risen and reliance on credit has increased, pointing to diminishing returns to the current model (which has depended heavily on factor accumulation). High investment has resulted in excess capacity and the return on investment has continued to decline to around 16 percent, down from 25 percent in the early 1990s.

Adverse Feedback Loop During Crises
(In percentage points)[1]

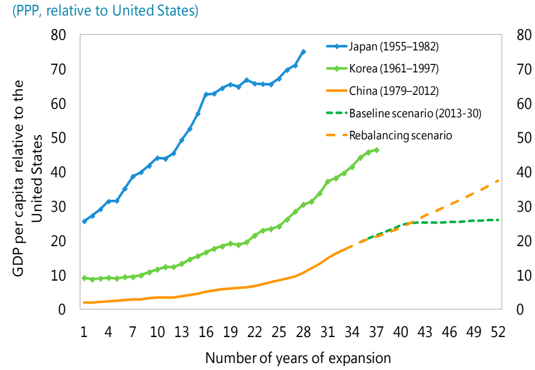


Sources: WEO, WDI, IMF staff calculations; and Laeven (2012), IMF working paper.
[1] Change in three-year averages of real GDP growth, credit by banking sector growth, and unemployment rates before and after crises.

An extension of the baseline scenario beyond 2018 illustrates the consequences of continuing the current growth model. The scenario assumes a further build-up of excess capacity and misallocation of resources. With demographic trends implying a decline in the labor force after 2015 and exhaustion of surplus labor around 2020, the returns on investment would be progressively lower than envisaged, which would cause bankruptcies and financial losses. China's own and cross-country experience suggests that the outcomes could be costly not just in terms of direct fiscal cost of clean-up, but also because the financial losses and deleveraging would in turn generate an adverse feedback loop that hampers employment and growth. The convergence process would stall, with the economy slowing to around 4 percent, and GDP per capita would remain about a quarter of that of the United States through 2030.

Moving to high-income status requires changing the growth model to be more reliant on total factor productivity (TFP) and less on factor accumulation. Factor accumulation has helped develop lower- and middle-income provinces, which have made modest gains catching up to the richest province in terms of average income. However, they have fallen further behind in TFP. This illustrates both the past reliance on capital accumulation, as well as the scope for the less developed provinces to improve TFP going forward, which would help drive China's growth and convergence to high-income status.

Convergence Process of Per Capita GDP: China, Japan, Korea
(PPP, relative to United States)



Source: IMF staff estimates.

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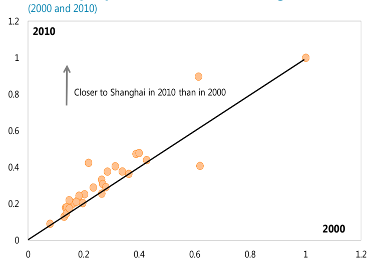
[1] Nabar and N'Diaye (forthcoming), IMF Working Paper: "China's Medium-Term Growth Prospects: The Path to a High-Income Economy."

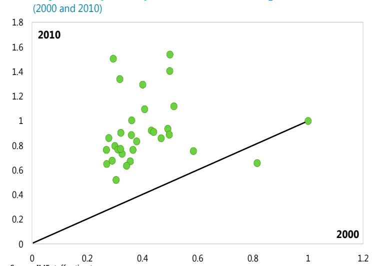
Box 5. Toward Intensive Growth *(concluded)*

Real Output per Worker Relative to Shanghai
(2000 and 2010)



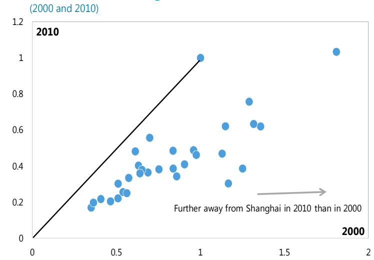
Source: IMF staff estimates.

Physical Capital Input Relative to Shanghai
(2000 and 2010)



Source: IMF staff estimates.

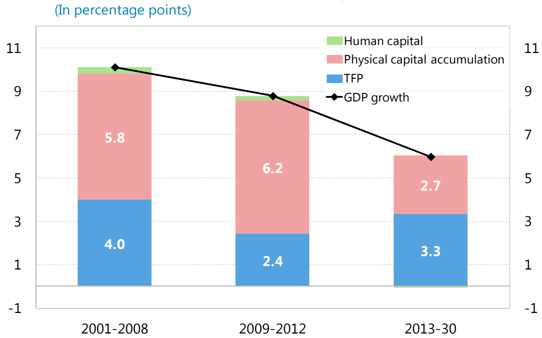
TFP Relative to Shanghai
(2000 and 2010)



Source: IMF staff estimates.

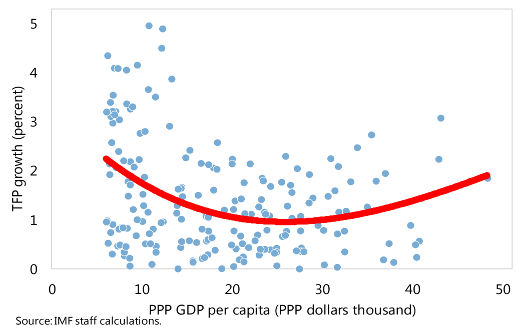
The transition from middle-to high-income status will be accompanied with slower growth. Average TFP growth is likely to fall below its pre-crisis level, consistent with the typical slowdown in TFP growth most countries go through during their transition from middle to high income. This, together with a declining labor force and more moderate pace of investment, means average GDP growth could fall to around 6 percent during 2013–30 (down from a pre-crisis average GDP growth rate of 10 percent). At such a pace China's per capita GDP would be about 40 percent of that of the United States by 2030.

China: Contribution to Growth by Input
(In percentage points)



Source: IMF staff estimates.

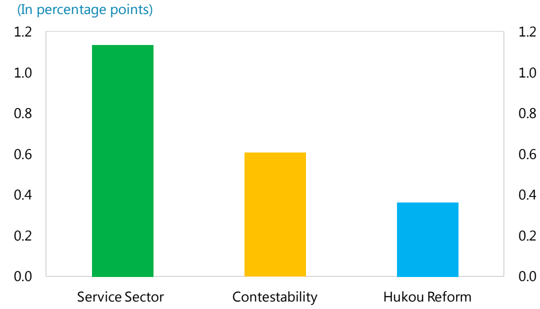
TFP and PPP GDP per Capita
(Five-year averages)



Source: IMF staff calculations.

Accelerating the pace of structural and financial reforms would help China limit the typical TFP growth slowdown that occurs during the transition to high-income status. Regression analysis using provincial data suggest that *greater contestability* of markets could increase productivity. *Service sector reform* (deregulation and increasing the share of labor employed in services) would also lift productivity growth. *Hukou reform* would support the urbanization process and boost productivity by enabling knowledge spillovers and specialization.

China Reform Payoffs: Potential Increase in Average TFP Growth[1]
(In percentage points)



Source: IMF staff estimates.
[1] Reforms envisage moving the national average of service sector employment share, contestability, and nonagricultural hukou share of population to the level of Shanghai in 2010.

market discipline, which would lead to higher interest rates for many borrowers. These policies are likely to dampen activity in the near term, but will do so in a way that supports the transition to a more sustainable growth path. If growth were to slow too sharply below this year's target, then on-budget fiscal stimulus could be used. Such stimulus, however, should focus on measures that support domestic rebalancing, such as reductions in social contributions, subsidies to consumption, or targeted social safety net spending. Using on-budget stimulus would improve transparency, prevent a further build-up of risks in the financial sector, allow spending to be allocated more in line with social and economic priorities, and lower financing costs by replacing more expensive commercial financing with government debt.

19. Authorities' views. The authorities considered the current mix of prudent monetary and proactive fiscal policy to be appropriate. They noted that growth, employment, and inflation were progressing broadly as expected, and hence saw little need to alter the macroeconomic policy stance at this point. If necessary, they agreed with the relative benefits of on-budget fiscal stimulus. While growth in monetary aggregates this year had so far exceeded forecasts, the central bank would take measures to ensure appropriate growth for money and credit. Policy fine-tuning would continue to draw on a variety of measures, including open-market operations, macroprudential measures, and window guidance.

Financial Sector

20. Priorities. Accelerating financial sector reform is key for preventing a further build-up of risks and tapping new sources of growth. The priorities are to:

- liberalize interest rates, to allow market-pricing of deposits and lending by the banks and reduce regulatory arbitrage;
- strengthen regulation and supervisory oversight, especially in areas exhibiting rapid growth such as trusts and wealth management products;
- improve the institutional setting by introducing explicit deposit insurance, improving the resolution framework for financial institutions, and removing the moral hazard stemming from the perception that all interest-bearing assets are implicitly guaranteed; and
- move to using interest rates as the primary tool of monetary policy (Box 6).

Addressing the moral hazard problem is especially critical. With China's financial markets developing rapidly, effective pricing of risk requires tolerance for occasional losses or haircuts on interest-bearing financial instruments, such as corporate bonds or wealth management products without a formal principal guarantee. Routinely shielding investors from such losses, by contrast, perpetuates the perception of implicit guarantees and artificially depresses risk premia, and contributes to excessive growth in credit and investment.

Box 6. Priorities for Financial Sector Reform

Further steps toward a more commercially oriented financial system and market-based monetary policy framework will improve the allocation of resources, facilitate internal rebalancing, and safeguard financial stability. The priorities are:

- **Interest rate liberalization.** Notable progress has already been made with interest rate liberalization, including the greater flexibility introduced in mid-2012. As the next step, the maximum deposit rate should be raised further, for example, by increasing the upward float to 30 percent to match the downward flexibility in lending rates. This will reduce regulatory arbitrage that currently favors wealth management products over bank deposits.

- **Supervision and regulation.** As financial reform progresses and interest rates are liberalized, close monitoring and effective supervision of banks, particularly smaller institutions, are critical to guard against the risk of destabilizing competition. At the same time, a continued upgrading in the regulation and supervision of non-bank and off-balance sheet intermediation is needed to ensure that risks are properly disclosed, institutions hold adequate buffers against potential losses, markets operate transparently, and the pace of credit creation does not result in systemic risks. In this regard, the recent steps to tighten the rules for banks' wealth management products are welcome.

- **Institutional setting.** Introducing deposit insurance and improving the resolution framework as soon as possible is key to allow for an orderly exit of weak or failing financial institutions. Similarly, investors must be allowed to suffer principal losses on nonguaranteed products, including corporate bonds and trust products, to promote risk-awareness and prevent the perception that all financial investments are implicitly guaranteed.

- **Use interest rates as primary instrument of monetary policy.** Given the increasing complexity of the financial system, administrative controls on bank credit are losing effectiveness and should be progressively replaced by money market interest rates as the primary tool of monetary policy.[1] Specifically, the central bank should begin by establishing a stable short-term interest rate (seven-day or overnight interbank repo) as a precursor toward instituting a policy rate. The recent introduction of the standing liquidity operations will over time facilitate this effort by reducing interest rate volatility.

Progress also needs to continue in improving the commercial orientation of banks, with particular emphasis on prudent credit allocation and timely recognition of problem loans. Strong risk management and vigilant oversight by the authorities are indispensable for the success of financial reform, and indeed for opening up the capital account without the risk of major domestic financial instability or adverse spillovers.

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[1] See Liao and Tapsoba (forthcoming), IMF Working Paper: "Financial Liberalization, Innovation, and Money Demand Function Instability: Implications for China."

21. Reform and Stability. In many countries, financial liberalization was followed by an unintended loosening of financial conditions that ultimately led to systemic financial distress.[2] As the move to a more market-based system accelerates, implementation needs to safeguard financial stability, including through appropriately tight overall liquidity conditions and steps to reduce moral hazard to ensure that banks do not engage in potentially destabilizing competition. Even so, there will likely be some financial stress in individual firms and banks, which is normal (and necessary) in market-based systems. Weaknesses will need to be monitored carefully and resolved transparently. It will also be important to ensure adequate provisioning and transparent recognition of asset quality problems in the broader financial system. At any rate, the risks of delay are prohibitive, as accelerated arbitrage from traditional into new forms of intermediation, lack of proper pricing of risk, and continued 'dual-track' financial development would escalate the imbalances and associated risks. The authorities have taken measures to help contain risks, including in recent months, asking banks to monitor lending to certain sectors, control lending to LGFVs and property developers, and tighten rules on WMPs. In addition, continued progress in implementing the recommendations from the 2011 Financial Sector Stability Assessment would facilitate the move to a more liberalized financial system (Appendix II).

22. Authorities' views. The authorities' agreed with the thrust of the staff advice and are committed to accelerating financial sector reform. A priority for this year is to make further progress on interest rate liberalization and, as recently announced by the central bank, conditions are broadly in place to introduce deposit insurance. The central bank intends to continue to gradually move toward greater reliance on market-based methods for the implementation of monetary policy. Meanwhile, the various regulatory agencies expressed their commitment to continue improving prudential oversight, with particular focus on the rapidly growing nonbank finance.

Fiscal Policy

23. Medium-term adjustment. The augmented fiscal deficit estimates indicate that fiscal policy—especially local government off-budget and LGFV activity—has played a significant role in supporting demand since the global crisis. As a result, the augmented fiscal position has deteriorated significantly. Though the augmented debt is still at a manageable level (see Debt Sustainability Analysis: Tables 7–8), the augmented government deficit should be gradually reduced to a more comfortable level. Staff's baseline assumes a gradual unwinding of stimulus through a decline in the budget deficit and reduction in local government infrastructure spending (consistent with the retrenchment in 2010–11). Development of a medium-term fiscal plan that outlines the path for government revenues, spending, deficits and debts over a rolling (annually updated) multiyear horizon would facilitate adjustment. This should also include all local government operations and thus help curb projects with low economic or social returns.

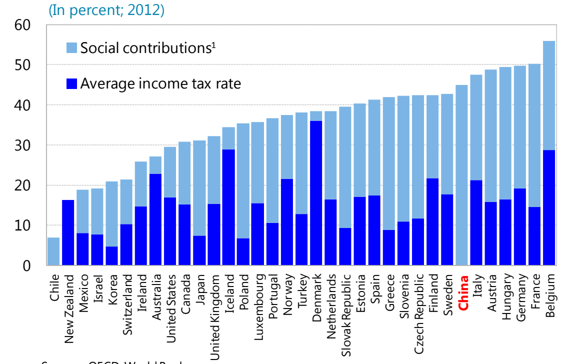
24. Local government finances. To ensure China's fiscal soundness, a top priority is to strengthen the management, transparency, and overall governance framework of local government finances. One element is ensuring that local governments have adequate resources to deliver the necessary social and infrastructure spending, by aligning revenue responsibilities with expenditure mandates. Options to

[2] See IMF Country Report No. 11/192, Box 8.

achieve this include giving local governments more control over revenue items, adjusting revenue sharing arrangements, and reducing expenditure mandates. Another challenge is to mitigate risk by strengthening fiscal management. This can be achieved by: (i) establishing and enforcing an institutional framework that limits government debt, contingent liabilities, and off-budget borrowing (such as a fiscal responsibility law); (ii) integrating government and LGFV investment spending into an overall public investment strategy; and (iii) improving data and transparency on off-budget fiscal operations, fiscal risks, and contingent liabilities.

25. Social security contributions. High social security contribution rates are a headwind to domestic rebalancing. Combined employee and employer contributions are around 40 percent for an urban worker earning the average wage, which is high by international standards. The contribution system reduces household disposable income, raises the cost of labor, encourages informality and evasion, and exacerbates inequality (as it is highly regressive). It also raises substantially more revenue—about 5 percent of GDP—than the personal income tax (1 percent of GDP). Social contributions are mandatory for most urban workers, though only around 85 percent contribute, whereas just 3 percent of workers pay income tax on labor income. Shifting the tax burden away from regressive social contributions would help boost consumption, reduce inequality, and facilitate rebalancing. Staff recommends that an initial step toward lowering social contributions could be made now, while continuing with the needed comprehensive social security reform to further improve coverage and ensure actuarial soundness. The budget should compensate the social security funds for the lost revenue, while ensuring deficit neutrality by taking offsetting fiscal measures that are more efficient, progressive, and supportive of rebalancing. Moreover, a strong case could be made for shifting the legacy costs of pension reform as well as the welfare components of the pension system to the budget. With offsetting budget measures to ensure fiscal sustainability, this would make room for a significant reduction in social contributions, which would cover only the insurance aspects of the system.

Average Tax Wedge
(In percent; 2012)



Sources: OECD, World Bank.
[1]Social contributions taken as difference between average tax wedge and income tax rates.

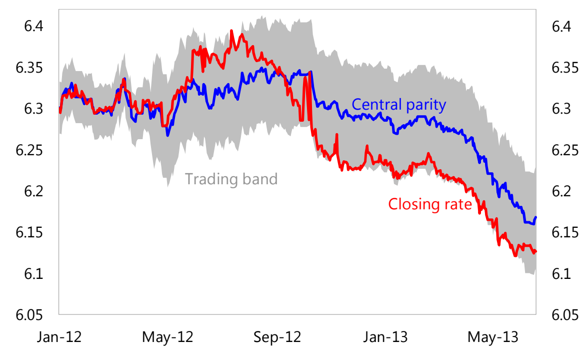
26. Other tax reforms. Other tax reforms that support rebalancing and promote efficiency should continue to be implemented. These include replacing the specific business taxes with the VAT, which will help broaden the tax base, minimize cascading, and reduce evasion. At the same time, expanding the property tax pilot will help contain speculation in the real estate sector and boost local government revenues (the pilot covers Chongqing and Shanghai and has a narrow base—for example, in Shanghai existing homeowners were grandfathered and in a sample of new purchases about 20 percent were subject to the property tax).

27. Authorities' views. The authorities were committed to ensuring medium-term fiscal sustainability, and they agreed on the importance of strengthening the fiscal framework to better manage local government finances. They favored allowing limited, transparent, and well-regulated local government borrowing, and considered development of a municipal bond market as part of the solution to the challenges facing local governments. They agreed with the benefits of lowering social contributions, but were concerned about the cost and financial implications for the social security system. They would consider the possibility as part of a comprehensive social security reform. They were committed to continuing tax reforms, especially replacing the specific business tax with the VAT. They were also considering other taxes that could be well-suited to collection and control by local governments, including broadening the pilot property tax program.

External Sector

28. Exchange rate system. Continuing to move to a more market-based exchange rate system is a key part of the rebalancing package. This means reducing intervention and allowing the exchange rate to move more in line with market forces. Staff suggested that the next steps should be to further widen the daily band and make the central parity better reflect market conditions, with larger day-to-day fluctuations in the central parity. A more flexible exchange rate will strengthen liquidity management by reducing the need to sterilize reserve purchases, facilitate further gradual capital account opening, and help ensure that investment decisions pay due regard to exchange rate risk. A number of quantitative models and indicators are used to assess the external position (Box 7). Overall, staff considers that the renminbi remains moderately undervalued against a broad basket of currencies. Given the assessment of the renminbi as moderately undervalued, greater flexibility is likely to result in some further real appreciation of the renminbi over time, which will help with domestic rebalancing by making investment in nontradables more attractive and boosting household purchasing power.

Spot Exchange Rate
(In USD/RMB)



Sources: Haver Analytics; Bloomberg; and IMF staff calculations.

29. Capital account. Staff supports the authorities' intention to further open the capital account (Box 8). A gradual liberalization will reinforce financial sector reform, improve the efficiency of investment, and ease overheating pressures in the domestic property market by providing opportunities for portfolio diversification. However, capital account opening must be carefully timed and sequenced with other reforms, especially as regards the financial sector—which needs to be able to effectively intermediate large and potentially volatile cross-border flows—and the exchange rate regime—which needs to be flexible to serve as a shock absorber.

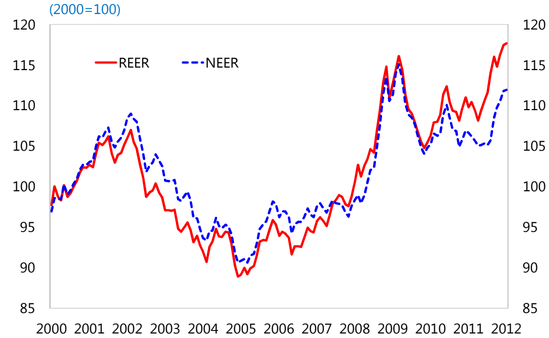
30. Outward spillovers. Staff research suggests that capital account opening in China would prompt sizable portfolio stock adjustments resulting in large gross flows in both directions. On balance, this stock adjustment could initially result in net capital outflows as China's large pool of savings is diversified internationally (Box 9). Over the longer term, the direction and size of net

Box 7. External Sector Assessment

Staff's assessment is that the external position appears moderately stronger and the currency moderately undervalued compared with the level consistent with medium-term fundamentals and desirable policy settings.

Recent balance of payments developments. The current account surplus is projected to rise slightly this year and further over the medium term to about 4 percent of GDP. While capital flows turned negative in the second half of last year, on the back of changed exchange rate expectations (from one-way appreciation to more balanced expectations), this has been reversed in recent months with renewed inflows and appreciation pressures. Overall, these developments suggest that the external position has remained broadly unchanged over the past year.

Real Effective Exchange Rate
(2000=100)



Sources: IMF, Information Notice System; and IMF staff calculations.

International reserves and NFA. Reserve accumulation in the second half of 2012 was around zero, a significant change from a decade of large increases. In recent months, however, the pace of reserve accumulation has picked up again, and China's reserves continue to be considerably above all standard metrics. With large net foreign assets (around 30 percent of GDP) China's international investment position vulnerabilities are low.

External Balance Assessment (EBA)

- In this year's EBA, the methodology has been refined, some data revised, and the assessment period shifted to 2012 from 2011. The current account balance approach estimates that China's 2012 current account surplus, adjusted for cyclical factors, is 1.8 percent of GDP above the level consistent with fundamentals and desirable policies (compared with 2.6 percent of GDP in last year's EBA). Consistent with the approach in last year's ESR (which applied some rounding and a range of +/- 1 percent to the current account point estimate reflecting uncertainty about the output gap), this implies a current account gap of about 1–3 percent of GDP—equivalent to RMB undervaluation of about 4–12 percent.

- The 2013 EBA's REER approach indicates that the renminbi is 17 percent weaker than consistent with fundamentals and desirable policies. However, the EBA estimate for China's REER is surrounded by large uncertainty, with the unexplained residual accounting for 8 percentage points of the estimated undervaluation.

- Estimates using CGER methodology indicate an undervaluation of 15 percent for the current account approach, and an overvaluation of 7 percent for the REER approach. The external sustainability approach indicates the renminbi is 9 percent below the level consistent with unchanged NFA.

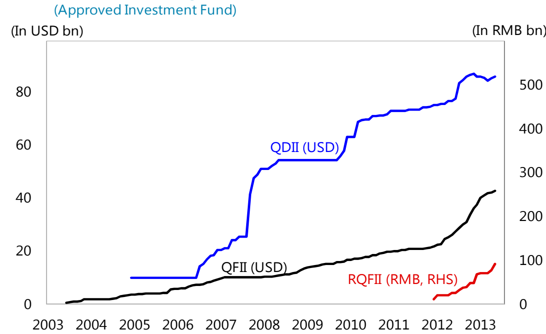
On balance, recent developments and available quantitative estimates suggest that the renminbi remains moderately undervalued by 5-10 percent relative to a level consistent with fundamentals and desired policies.

Box 8. Current Status of Capital Account Liberalization

China has gradually widened the scope for capital flows, but the non-FDI capital account remains subject to considerable restrictions. Specifically:

- **Portfolio investment** is controlled by quotas. Inward investment is channeled through 207 Qualified Foreign Institutional Investors (QFII) and subject to at least a 3-month lock-in period for most shares and an overall ceiling of USD 80 billion. In 2011, an R-QFII scheme was introduced that allows qualified firms to invest offshore renminbi back into China, subject to an overall ceiling that was raised to RMB 270 billion by end-2012. Before March 2013, only Hong Kong subsidiaries of eligible fund management and securities companies were allowed to participate in the R-QIII scheme. Outward portfolio investment—for foreign securities purchased by residents—is channeled through Qualified Domestic Institutional Investors (QDII), subject to a ceiling of USD 90 billion by end-2012. Cross-border issuance of securities requires approval.

Qualified Foreign & Domestic Institutional Investor
(Approved Investment Fund)



Sources: CEIC; and IMF staff calculations.

- **Other investment**. Foreign borrowing is subject to a ceiling (for short-term borrowing) or approval requirements (for long-term borrowing), but lending abroad by banks and affiliated companies is largely unrestricted. The holding of cross-border accounts requires SAFE approval.

Despite pervasive capital controls, capital flows have been considerable. While portfolio flows remain well below those of other emerging markets, other investment flows—both assets and liabilities—are on par with economies that have more open capital accounts. In particular, inflows and outflows of short-term borrowing have each been on the order of 10 percent of GDP (though largely offsetting).

Capital Flows, Average 2005–10[1]
(Percent of GDP)

	China	Malaysia	Korea	Brazil	India	Poland	Australia	Russia	Indonesia	Turkey
Financial account	3.0	8.0	0.0	2.9	4.2	5.4	-5.1	0.8	0.9	5.3
Overall non-FDI capital account	-0.2	6.5	1.3	1.6	3.2	3.5	-3.9	1.0	0.0	2.9
Net FDI	3.2	1.5	-1.4	1.3	1.0	1.9	-1.3	-0.2	0.9	2.4
Inflow	4.0	4.7	0.3	2.1	2.2	3.0	1.3	3.0	1.8	-0.3
Outflow	-0.8	3.2	-1.7	-0.8	-1.2	-1.1	2.6	3.2	-0.8	1.0
Net portfolio investment	-0.1	0.4	0.8	1.8	1.3	1.3	-4.2	0.3	1.3	0.0
Equity	0.5	2.3	-1.9	1.2	...	...	0.8	-0.1	...	0.0
Bonds	-0.5	-0.5	1.8	0.7	...	...	-5.0	0.4	...	0.4
Net other investment	-0.1	6.2	0.6	-0.3	1.9	2.2	0.3	0.7	-1.3	2.9
Liabilities	1.8	1.1	1.5	0.9	1.0	-0.1	-1.9	-3.6	...	2.9
Assets	-1.9	4.9	-0.9	-1.1	0.9	2.3	2.2	4.3	...	0.0
International investment position: Pprtfolio and other investment										
Assets	15	30	21	6	1	9	47	17	4	10
Liabilities	16	64	60	33	24	54	95	36	32	46

Sources: Haver Analytics; IMF IFS; and IMF staff estimates.

[1] Colors reflect the quartile of absolute values in each row, with red the lowest quartile and yellow the highest quartile. Data for Australia, Russia, and Malaysia are based on BPM6. For all others, based on BPM5.

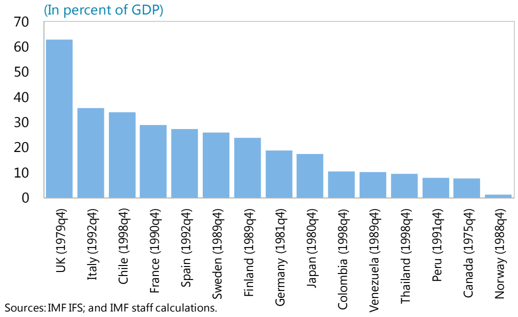
Nonetheless, the capital controls appear to be binding. One indication of this is the presence of arbitrage opportunities between on- and off-shore markets for spot and forward renminbi as well as between forward rates and interest differentials. Despite rapid growth since 2009, the offshore market remains small with RMB-denominated offshore deposits accounting for 0.7 percent of one-shore deposits and RMB-denominated offshore ("Dim Sum") outstanding debt for about 1 percent of on-shore outstanding debt.

Box 9. Potential Spillovers from Capital Account Liberalization in China

Approaches. Two complementary approaches are used to provide some indications for possible capital flows resulting from capital account liberalization in China: (i) the experience during episodes of capital account liberalization in advanced or emerging economies since the 1970s, and (ii) a cross-country regression analysis of bilateral portfolio exposures.

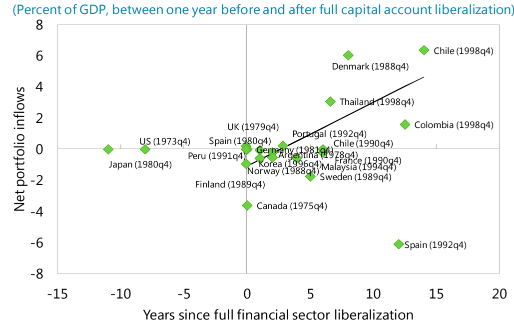
Historical precedents. Past episodes of capital account liberalization were followed by sharp increases in gross international assets but ambiguous changes in net capital flows. Kaminsky and Schmukler (2003) date capital account liberalization episodes in about 20 advanced and emerging markets since the 1970s.[1] In the five years following capital account liberalization, *gross* foreign assets on average increased by 19 percent of GDP. The increase in *net* capital flows depended on many factors: the global and domestic business cycle, growth prospects, and—importantly for the comparison with China—the interaction with financial sector liberalization. When capital account opening took place soon after financial sector liberalization, then the net inflows in portfolio and other investment were smaller and often negative. Net capital inflows in portfolio and other investment did not respond significantly to capital account liberalization in the two countries in the sample (U.S. and Japan) in which financial sector liberalization was only undertaken later.

Increase in Gross International Assets During Five Years Following Capital Account Liberalization[1]
(In percent of GDP)



Sources: IMF IFS; and IMF staff calculations.
[1] Data for the United Kingdom available only for year after capital account liberalization.

Change in Net Portfolio Investment Inflows
(Percent of GDP, between one year before and after full capital account liberalization)



Source: IMF staff estimates.
[1] Trend line excludes outliers United States, Japan, and Spain.

Cross-country regression. A panel regression for all global bilateral portfolio exposures is estimated based on the model in Forbes (2010),[2] focusing on portfolio equity and debt assets (the most restricted capital flows into and out of China). The results suggest that capital controls in the source country of international assets significantly restrict the buildup of international portfolio assets. In the extreme, and assuming no offsetting changes in the macrofinancial environment, the regression coefficients suggest that full capital account liberalization in China could prompt a one-off adjustment—although likely phased over several years—in the stock of Chinese resident assets held abroad of up to 25 percent of GDP and in the stock of nonresident assets in China of just under 10 percent of GDP. This would imply an increase in China's net international portfolio assets around 15 percent of GDP. (This is in contrast with India, where the model would predict net inflows.) The estimated direction of capital flows is broadly in line with other estimates, even if the magnitude is larger, and with the historical experience of liberalization in countries with a short history of financial sector liberalization. Based on data from the April 2013 Global Financial Stability Report, gross flows in the estimated magnitude would be equivalent to 1 percent of global debt markets and 2–3 percent of global stock market capitalization.

Predicted Change in Porfolio Investment
(Percent of GDP)

	Assets	Liabilities	Net Assets
Ohnsorge (2013)	15.4–24.9	1.7–9.9	10.7–18.1
He and others (2012)	21	16	5
Sedik and Sun (2011)[1]	3.25	2	1.25

Sources: Bayoumi and Ohnsorge (forthcoming), "Capital Account Liberalization in China" IMF Working Paper; He, Cheung, and Zhang, and Wu (2012), "How Would Capital Account Liberalization Affect China's Capital Flows and the Renminbi Real Exchange Rate?" HKIMR Working Paper No. 09/2012; Sedik and Sun (2012), "Effects of Capital Flow Liberalization—What is the Evidence from Recent Experiences of Emerging Market Economies?" IMF Working Paper No. 12/275.
[1] Estimate applies to the aggregate of FDI, portfolio, and other investment flows.

[1]Kaminsky and Schmukler (2003), "Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization."
[2]Forbes (2010), "Why Do Foreigners Invest in the United States?"

capital flows with an open capital account will depend on fundamental drivers such as real interest rates, saving, and growth prospects, which generally point to net capital flows toward fast-growing developing and emerging market economies like China.

31. Authorities' views. Regarding the external sector assessment, the authorities continued to express strong reservations about the quantitative models. They considered that the exchange rate was close to its equilibrium value. The authorities remain committed to moving to a more market-based exchange rate, including a further widening of the exchange rate band. They noted that with trend reserve accumulation having declined, recent intervention is an anomaly triggered in part by unconventional monetary policies in advanced economies. Regarding capital account liberalization, they emphasized that liberalization would continue at a measured pace consistent with fostering domestic stability and avoiding disruptions to external markets.

Other Structural Reforms

32. A wide range of additional reforms will support the transformation to more balanced, inclusive, and sustainable growth. These include:

- **Opening markets.** Many markets are considered strategic and still largely reserved for big SOEs. These include many service sector and upstream industries, which has an impact throughout the supply chain. Allowing more domestic and foreign competition in these sectors will help generate the total factor productivity gains needed to sustain growth.[3] Moreover, these sectors are often labor-intensive, and making them more competitive will help boost household income.

- **Resource pricing.** The progress already made in raising resource prices is welcome, but more needs to be done. Raising factor input costs (such as energy, land, and water), including through taxation, will help rationalize investment, especially in energy-intensive sectors, and help protect the environment.[4] Moreover, stronger enforcement of environmental regulations—and higher fines as existing ones often provide little deterrent—will promote more environmentally friendly development.

- **SOE dividends.** The SOE sector in China is highly profitable (mainly due to large profits in industries where entry and competition is limited), yet only a fraction of profits are transferred to the budget. In 2011, central government SOEs earned profits of RMB 913 billion, but paid only RMB 77 billion in dividends, of which just RMB 4 billion went to the budget (0.4 percent of profits). Instead, most of the profits are used to finance investment, as the opportunity cost of these funds is extremely low; transferred among subsidiaries of state holding companies (dividends are paid on the basis of holding company net profits); or held as retained earnings. Increasing the dividends SOEs pay to the budget will rationalize investment, improve financial discipline, and provide welcome additional fiscal revenue.

[3] See Ahuja (2012) "De-monopolization Toward Long-Term Prosperity in China," Working Paper No. 12/75.

[4] See IMF Country Report No. 11/192, Box 3; and Geng and N'Diaye (2012) "Determinants of Corporate Investment in China: Evidence from Cross-Country Firm Level Data," Working Paper No. 12/80

33. Data. Staff welcomes the progress that has been made in recent years in improving statistics. China, however, remains one of only two G-20 members that do not subscribe to the Special Data Dissemination Standards (SDDS) and participate in the Coordinated Portfolio Investment Survey (CPIS). Staff encourages the authorities to graduate from the General Data Dissemination Standards (GDDS) to the SDDS and participate in the CPIS as soon as possible.

34. Authorities' views. The authorities noted that they plan to improve further the pricing of natural resources. Over the near term, the pricing of electricity, oil and other raw materials will be moved toward a more market-determined basis. On SOE dividends, the authorities noted that collections were already high, especially for banks, but allowed that there was room for improvement in the area of holding companies and subsidiaries. On data provision, the authorities will continue to explore ways to collaborate with the Fund.

The Dividends of Reform, at Home and Globally

35. Sustainable Growth. The current growth model is showing diminishing returns and needs to adapt (Box 6). Reforms are urgent and intended by the authorities. This is critical to avoid a sharp correction later on, and to lift China onto a new growth path. The package of reforms described above will likely entail slower growth than projected in the staff baseline scenario as the economy adjusts to the new path (see rebalancing scenario in Table 6). However, this is a tradeoff worth making, because it comes with the benefit of more durable and sustainable long-term growth and higher consumption. The result will be an economy that distributes prosperity more broadly, better protects the environment, and delivers substantially higher living standards.

36. Spillovers. Ensuring better-quality and sustainable growth in China will undoubtedly benefit the rest of the world. The benefits are likely to materialize over the medium to long term as payoffs from reforms materialize. In particular, stronger demand from China will generally support trading partners' exports. At the same time, ensuring stable and sustainable growth in China will reduce tail risks and provide further support to global growth. In the short to medium term, the spillovers to the global economy from slower growth in China can be mitigated if the rest of world, especially the most systemic economies, implements the fiscal, financial, and structural policies needed in their own economies. Implementing reforms in a global and coordinated manner will reduce the likelihood of downside risks and lift global output significantly over the long term.

37. Authorities' views. The authorities agreed with the thrust of the staff analysis on the impact of rebalancing. It was important, they added, that the global community understand that reform in China would entail somewhat slower growth than in the past, but with the benefit of sustained income gains over the medium to long run—an outcome that would provide lasting benefits to the global economy.

STAFF APPRAISAL

38. Overview. A history of bold economic reforms has helped China generate three decades of rapid growth and lift more than 500 million citizens out of poverty. Since the global crisis, the resilience of China's economy has also provided a welcome boost to global demand, and substantial progress has been made with external rebalancing as the current account surplus has been sharply reduced. However, China's pattern of growth has become too reliant on investment and an unsustainable surge in credit, resulting in rising domestic vulnerabilities. Thus, the transformation of the economy is not complete, and continued success now requires a decisive new round of reforms. The Chinese authorities have announced the broad direction of economic reforms as well as policy priorities for 2013 that are intended to rebalance growth and reduce risks. Turning these plans into specific policies and actions that are successfully implemented will achieve the goal of transitioning to a more balanced and sustainable growth path that relies more on consumption, is more inclusive, and better safeguards the environment.

39. Outlook and risks. This year, China's economy is projected to maintain growth around 7¾ percent, with downside risks; inflation is expected to remain subdued. From the external side, the risk of slower global growth or renewed stress in world financial markets continues to weigh on the outlook. On the domestic front, vulnerabilities have increased in the financial, government, and real estate sector sectors. Rapid financial innovation is compounding the risks, as more lightly regulated entities account for a growing share of new lending, while implicit guarantees on all interest-bearing assets undercut market discipline. While China has the resources and capacity to maintain stability even in the face of an adverse shock, the margins of safety are narrowing. Continuing down this path leaves China vulnerable to the risk of a sharp downturn in growth, with significant adverse spillovers to the rest of the world.

40. Balancing reforms and near-term growth. The near-term challenge is to contain the build-up of risks and advance structural reforms. Activity has become too reliant on an unsustainable growth in total social financing and investment, especially local government infrastructure spending. It is necessary, therefore, to rein in broad credit growth, as the threat to financial stability dominates the short-term benefit of shoring-up growth. If growth were to slow too much below the authorities' 7½ percent target, then on-budget fiscal stimulus should be used to support activity, with an emphasis on measures that support rebalancing and protect vulnerable households.

41. Monetary and financial policies. A more commercially-oriented and liberalized financial system is critical to prevent a further build-up of risks, foster a more efficient allocation of investment, and boost household capital income. The priorities are to liberalize interest rates; strengthen regulation and supervisory oversight; establish a robust and transparent framework for resolving bad debts and troubled financial institutions; and move to using interest rates as the primary tool of monetary policy. Ensuring the effective pricing of risk is essential, and requires resolving the moral hazard problem rooted in the perception of widespread implicit guarantees. Interest rates will need to play an increasingly stronger role in managing monetary conditions, especially with more intermediation taking place outside traditional bank lending. In transitioning to a more market-based financial system, care should be taken to safeguard financial stability.

42. Fiscal policy. Off-budget and quasi-fiscal activity, especially at the local government level, has played a significant role in supporting demand since the global financial crisis. This support should be gradually unwound over the medium term. Containing the risks from rising local government debts while protecting priority social and infrastructure spending requires strengthening the management, transparency, and overall governance framework of local government finances. Shifting the tax burden away from regressive social contributions to more progressive and efficient forms of taxation would help boost consumption, reduce inequality, and promote rebalancing.

43. External sector. As in the past, the staff's assessment of China's external position and exchange rate uses a broad range of inputs, including recent developments in the external accounts, medium-term balance of payments projections, and quantitative models of the current account and the real effective exchange rate. Overall, staff assess the external position as moderately stronger and the currency moderately undervalued compared with the level consistent with medium-term fundamentals and desirable policy settings. A more market-based exchange rate system, with reduced intervention, would support rebalancing by allowing the renminbi to appreciate over time.

44. Structural reforms. A range of additional reforms will help strengthening governance, liberalizing the economy, and rebalancing domestic demand. A gradual opening of the capital account, appropriately sequenced with financial sector and exchange rate reforms, will support other aspects of the reform agenda. Other priorities include opening markets to more domestic and foreign competition, especially service sectors and upstream industries currently reserved for SOEs; raising resource prices and taxes, which will help rationalize investment and protect the environment; and increasing the dividends SOEs pay to the budget.

45. Reform dividends. Accelerating the reform process is critical to lift China onto a new growth path and avoid a sharp correction later on. The package of reforms described above will likely entail a moderate slowdown in growth as the economy adjusts to the new path. However, this is a tradeoff worth making, because it comes with the benefit of more durable and sustainable long-term growth. The result will be an economy that distributes prosperity broadly, better protects the environment, and delivers substantially higher living standards. Moreover, the benefits would spread beyond China and help foster robust and sustainable global growth.

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

Table 1. China: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013	2014
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	9.6	9.2	10.4	9.3	7.8	7.8	7.7
Total domestic demand	9.6	13.9	10.6	10.2	8.4	8.3	8.0
Consumption	8.6	9.4	9.2	11.0	8.4	8.5	8.1
Investment	10.8	19.2	12.0	9.5	8.4	8.1	7.9
Fixed	9.5	22.8	11.4	9.1	10.0	8.4	8.2
Inventories 1/	0.8	-0.8	0.5	0.4	-0.5	0.0	0.0
Net exports 1/	0.9	-3.5	0.4	-0.4	-0.2	-0.2	-0.1
Consumer prices							
End of period	1.2	1.9	4.6	4.1	2.5	3.1	3.0
Average	5.9	-0.7	3.3	5.4	2.6	3.0	3.0
Unemployment rate (annual average)	4.2	4.3	4.1	4.1	4.1	4.1	4.1
	(In percent of GDP)						
External debt and balance of payments							
Current account	9.3	4.9	4.0	1.9	2.3	2.5	2.7
Trade balance	8.0	5.0	4.3	3.3	3.9	3.7	3.4
Exports of goods	31.7	24.1	26.7	26.0	25.0	24.6	24.7
Imports of goods	23.8	19.1	22.4	22.7	21.1	20.9	21.3
Gross external debt	8.6	8.6	9.3	9.5	9.0	9.8	10.3
Saving and investment							
Gross domestic investment	44.0	48.2	48.2	48.3	48.8	48.8	49.0
National saving	53.4	53.1	52.2	50.1	51.2	51.4	51.6
Public sector finance							
General government gross debt	17.0	17.7	33.5	28.7	26.1	22.4	19.9
General government balance	-0.7	-3.1	-1.5	-1.3	-2.2	-2.1	-1.8
	(Annual percentage change)						
Real effective exchange rate							
Annual average	9.2	3.4	-0.4	2.7	5.7	...	...
End of period	12.4	-5.0	5.3	5.9	1.1	...	...

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; and IMF 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)

	2008	2009	2010	2011	2012	2013	2014
Current account balance	420.6	243.3	237.6	136.0	193.0	228.3	266.0
Trade balance	360.6	249.5	254.2	243.5	321.6	332.4	335.1
Exports	1,434.7	1,203.8	1,581.4	1,903.8	2,056.9	2,222.6	2,451.4
Imports (BOP basis)	1,074.1	954.3	1,327.2	1,660.3	1,735.3	1,890.2	2,116.3
Services	-11.8	-29.4	-31.2	-61.7	-89.8	-83.9	-67.1
Income	28.6	-8.5	-26.0	-70.3	-42.2	-30.7	-27.8
Current transfers	43.2	31.7	40.6	24.5	3.4	10.6	25.7
Capital and financial account balance	40.1	198.6	286.7	265.4	-16.8	202.2	108.3
Capital account	3.1	3.9	4.6	5.4	4.2	3.6	3.6
Financial account	37.1	194.6	282.1	260.0	-21.0	198.5	104.7
Net foreign direct investment	114.8	87.2	185.7	231.7	191.1	140.5	128.9
Portfolio investment	34.9	27.1	24.1	19.6	47.8	19.7	16.1
Other investment	-112.6	80.4	72.3	8.7	-259.9	38.4	-40.3
Errors and omissions 1/	18.8	-41.5	-52.6	-13.6	-79.6	0.0	0.0
Overall balance	479.5	400.3	471.7	387.8	96.6	430.5	374.3
Reserve assets	-479.5	-400.3	-471.7	-387.8	-96.6	-430.5	-374.3
Memorandum items:							
Current account, as percent of GDP	9.3	4.9	4.0	1.9	2.3	2.5	2.7
Export growth (value terms)	17.6	-16.1	31.4	20.4	8.0	8.1	10.3
Import growth (value terms)	18.8	-11.2	39.1	25.1	4.5	8.9	12.0
FDI (inward), as a percent of GDP	3.8	2.6	4.1	3.8	3.1	2.3	2.0
External debt 2/	390.2	428.6	548.9	695.0	737.0	885.9	1,019.5
As a percent of GDP	8.6	8.6	9.3	9.5	9.0	9.8	10.3
Short-term external debt (remaining maturity) 2/	226.3	259.3	375.7	500.9	540.9	644.8	735.7
Gross reserves 3/	1,953.3	2,425.9	2,875.9	3,263.7	3,360.3	3,790.8	4,165.1
As a percent of ST debt by remaining maturity	863.2	935.7	765.5	651.6	621.2	587.9	566.2
Real effective exchange rate (2005 = 100)	115.3	119.2	118.7	121.9	128.9	...	...
Net international investment position	1,493.8	1,490.5	1,688.1	1,688.4	1,736.4	...	...
In percent of GDP	33.0	29.9	28.5	23.1	21.1	...	...
Nominal GDP	4,520.0	4,990.5	5,930.4	7,322.0	8,227.0	9,025.7	9,932.3

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; 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

	2006	2007	2008	2009	2010	2011	2012	2013
Monetary and financial indicators								
General government debt (official data; in percent of GDP)	16.2	19.6	17.0	17.7	33.5	28.7	26.1	22.4
Broad money (M2: annual percentage change)	17.0	16.7	17.8	28.4	18.9	17.3	14.4	...
Foreign currency deposits to broad money (percent)	3.6	2.9	2.6	2.3	2.1	2.0	2.6	...
Credit (annual percentage change)	15.1	16.1	18.7	31.7	19.9	15.8	15.0	...
Foreign currency loans to credit to the economy (in percent)	4.5	4.8	4.4	5.2	5.1	5.0	5.3	...
Stock exchange index (end-of-period, December 19, 1990 = 100) 1/	2,815	5,521	1,912	3,437	2,940	2,304	2,376	...
Stock exchange capitalization (percent of GDP)	48.9	130.2	46.0	81.1	76.7	56.1	55.6	...
Number of listed companies (A-share)	1,398	1,507	1,581	1,678	2,041	2,320	2,472	...
Balance of payments indicators								
Exports (annual percentage change, U.S. dollars)	27.2	25.8	17.6	-16.1	31.4	20.4	8.0	8.1
Imports (annual percentage change, U.S. dollars)	-19.7	-20.2	-18.8	11.2	-39.1	-25.1	-4.5	-8.9
Current account balance (percent of GDP)	8.5	10.1	9.3	4.9	4.0	1.9	2.3	2.5
Capital and financial account balance (percent of GDP)	1.8	2.7	0.9	4.0	4.8	3.6	-0.2	2.2
Of which : gross foreign direct investment inflows	4.6	4.5	3.8	2.6	4.1	3.8	3.1	2.3
Reserve indicators								
Gross reserves (billions of U.S. dollars) 3/	1,073	1,534	1,953	2,426	2,876	3,264	3,360	3,791
Gross reserves to imports of GNFS (months)	12.4	14.9	21.1	19.1	18.1	19.4	18.4	18.5
Gross reserves to broad money (M2) (percent)	24.7	28.9	28.6	27.2	26.8	24.8	21.8	...
Gross reserves to short-term external debt by remaining maturity (percent)	538.4	651.0	863.2	935.7	765.5	651.6	621.2	587.9
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)	12.5	11.1	8.6	8.6	9.3	9.5	9.0	9.8
Total external debt (billions of U.S. dollars) 2/	338.6	389.2	390.2	428.6	548.9	695.0	737.0	885.9
Of which : public and publicly guaranteed debt 5/	34.4	34.9	33.3	36.9	38.8	37.4	36.6	...
Banking sector debt	120.0	126.6	126.3	132.4	183.5	266.0	256.6	...
Short-term external debt by original maturity (billions of U.S. dollars)	199.2	235.7	226.3	259.3	375.7	500.9	540.9	644.8
Net foreign assets of banking sector (billions of U.S. dollars)	204.7	188.3	250.8	204.5	170.6	259.9	300.4	...
Total debt to exports of GNFS (percent)	31.9	29.0	24.7	32.2	31.5	33.3	32.8	36.2
Total debt service to exports of GNFS (percent) 6/	19.3	17.9	14.6	19.8	21.8	24.2	24.3	...
Of which : Interest payments to exports of GNFS (percent) 6/	0.5	0.4	0.3	0.4	0.3	0.2	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	A1	A1	A1	Aa3	Aa3	Aa3	...
Standard and Poor's	A	A	A+	A+	AA-	AA-	AA-	...
Memorandum items:								
International investment position	640.2	1,188.1	1,493.8	1,490.5	1,688.1	1,688.4	1,736.4	...
Nominal GDP (billions of U.S. dollars)	2,713	3,494	4,520	4,991	5,930	7,322	8,227	9,026
Exports of GNFS (billions of U.S. dollars)	1,062	1,342	1,582	1,333	1,744	2,090	2,248	2,445
Real effective exchange rate (annual percentage change)	1.6	3.9	9.2	3.4	-0.4	2.7	5.7	...

Sources: CEIC Data Co.; Bloomberg; IMF, Information Notice System; 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

	2008	2009	2010	2011	2012	2013				
						Jan	Feb	Mar	Apr	May
Net foreign assets	17,897	19,853	22,604	25,164	25,885	26,491	26,686	26,948	27,184	...
Net domestic assets	29,620	41,169	49,981	59,995	71,530	72,722	73,174	76,638	76,071	...
Domestic credit 1/	37,938	49,589	58,732	68,797	80,559	81,435	82,000	84,643	84,531	...
Net credit to government	2,943	3,229	3,460	4,236	5,068	4,748	4,667	4,855	4,477	...
Credit to nongovernment	34,994	46,360	55,272	64,561	75,491					
Other items, net 1/	767	107	-1,188	-3,306	-5,742	-6,118	-6,108	-7,360	-7,037	...
Broad money	47,517	61,022	72,585	85,159	97,415	99,213	99,860	103,586	103,255	104,209
Reserve money	12,922	14,399	18,531	22,464	25,235	25,294	25,197	25,365	25,151	...
Of which:										
Excess reserves	2,382	1,871	1,436	1,862	3,028	1,859	1,874	1,959	...	...
Net foreign assets of PBC	16,181	18,457	21,470	23,520	23,995	24,727	25,020	25,283	25,565	...
Net domestic assets of PBC	-3,259	-4,059	-2,939	-1,056	1,239	568	176	82	-413	...
Net foreign assets 2/	10.2	4.1	4.5	3.5	0.8	1.3	1.3	1.3	1.4	...
Net domestic assets growth (percent)	11.5	39.0	21.4	20.0	19.2	20.8	19.6	20.2	20.6	...
Domestic credit 3/	11.7	30.7	18.4	17.1	17.1	17.8	17.1	17.2	17.6	...
Of which: loans	14.0	34.2	19.4	15.1	15.6	16.2	15.9	16.0	16.5	...
Other items, net 2/ 3/	-0.9	-1.4	-2.1	-2.9	-2.9	-3.3	-2.7	-3.1	-2.9	...
Broad money 4/	17.8	27.7	19.7	13.6	13.8	15.9	15.2	15.7	16.1	15.8
Including foreign currency deposits	17.4	27.3	19.4	17.3	15.0	16.4	15.5	16.0	16.2	...
M1 4/	9.1	32.4	21.2	7.9	6.5	15.3	9.5	11.8	11.9	11.3
M0 4/	12.7	11.8	16.7	13.8	7.7	4.4	17.2	11.8	10.8	10.8
Quasi money 4/	23.2	25.2	18.9	16.8	17.6	16.2	17.7	17.4	17.9	17.8
Reserve money growth (percent)	27.3	11.4	28.7	21.2	12.3	6.6	12.8	11.9	12.1	...
Net foreign assets of PBC 5/	37.4	17.6	20.9	11.1	2.1	4.4	5.6	6.2	7.8	...
Net domestic assets of PBC 5/	-10.1	-6.2	7.8	10.2	10.2	2.2	7.2	5.7	4.3	...
Reserve ratios 6/										
Required reserves	15.0	15.0	18.0	20.5	19.5	19.5	19.5	19.5	19.5	19.5
Excess reserves	5.1	3.1	2.0	2.3	3.3	2.0	2.0	2.0	...	...
Memorandum items:										
Money multiplier	3.7	4.2	3.9	3.8	3.9	3.9	4.0	4.1	4.1	...
Forex deposits of residents (US$ billion)	179.1	208.9	228.7	275.1	406.5	410.3	417.9	441.6	443.1	440.8
In percent of total deposits	2.6	2.3	2.1	2.1	2.7	2.7	2.7	2.7	2.7	2.7
Forex loans of residents (US$ billion)	243.7	379.5	453.4	538.7	683.6	712.0	730.3	754.3	767.9	773.7

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

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/ Annualized contribution to reserve money growth, percent.

6/ In percent of total bank deposits.

Table 5. China: General Government Budgetary Operations

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Proj.					
					(In billions of RMB)						
Revenue	6,172	6,882	8,555	10,697	11,759	12,733	14,231	16,064	18,015	20,219	22,668
Tax revenue	5,422	5,952	7,321	8,974	10,060	11,578	12,952	14,646	16,446	18,480	20,744
Taxes on income and profits	1,490	1,549	1,768	2,282	2,547	3,005	3,456	3,974	4,399	4,873	5,394
Taxes on goods and services	2,819	3,226	3,832	4,488	5,004	5,735	6,480	7,257	8,111	9,072	10,138
Other taxes (residual)	784	905	1,202	1,512	1,766	1,896	1,844	1,974	2,185	2,420	2,679
Nontax revenue (residual)	750	930	1,234	1,723	1,699	1,155	1,279	1,418	1,570	1,739	1,925
Expenditure	6,404	7,925	9,168	11,302	12,878	13,960	15,361	16,878	18,457	20,157	21,960
Primary	6,274	7,792	9,018	10,897	12,469	13,552	14,973	16,495	18,074	19,779	21,598
Interest	131	133	151	405	409	407	388	383	383	378	361
Overall balance	-232	-1,044	-613	-605	-1,118	-1,227	-1,130	-814	-442	61	709
Financing	232	1,044	613	605	1,118	1,227	1,130	814	442	-61	-709
Domestic	232	1,044	613	605	1,118	1,227	1,130	814	442	-61	-709
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	6,243	6,902	8,320	10,537	11,991	12,763	14,211	16,044	17,995	20,199	22,648
Revenue (budget)	6,133	6,852	8,310	10,387	11,721	12,663	14,211	16,044	17,995	20,199	22,648
Withdrawal from stabilization fund	110	51	10	150	270	100	0	0	0	0	0
Expenditure	.	7,852	9,348	11,406	12,591	13,875	15,326	16,843	18,422	20,122	21,925
Expenditure (budget)	6,259	7,630	8,987	10,925	12,571	13,825	15,326	16,843	18,422	20,122	21,925
Contribution to stabilization fund	19	10	225	289	18	50	0	0	0	0	0
Other adjustment to expenditure	...	212	136	192	1	0	0	0	0	0	0
Fiscal balance on budget	-126	-778	-677	-537	-850	-1,162	-1,115	-799	-427	76	724
Overall balance 1/	-35	-950	-1,028	-868	-800	-1,250	-1,115	-799	-427	76	724
					(In percent of GDP)						
Revenue	19.7	20.2	21.3	22.6	22.6	22.1	22.3	22.7	23.0	23.3	23.6
Tax revenue	17.3	17.5	18.2	19.0	19.4	20.1	20.3	20.7	21.0	21.3	21.6
Taxes on income and profits	4.7	4.5	4.4	4.8	4.9	5.2	5.4	5.6	5.6	5.6	5.6
Taxes on goods and services	9.0	9.5	9.5	9.5	9.6	9.9	10.1	10.2	10.3	10.4	10.5
Other taxes (residual)	2.5	2.7	3.0	3.2	3.4	3.3	2.9	2.8	2.8	2.8	2.8
Nontax revenue (residual)	2.4	2.7	3.1	3.6	3.3	2.0	2.0	2.0	2.0	2.0	2.0
Expenditure	20.4	23.2	22.8	23.9	24.8	24.2	24.0	23.8	23.5	23.2	22.8
Primary	20.0	22.9	22.5	23.0	24.0	23.5	23.4	23.3	23.0	22.7	22.4
Interest	0.4	0.4	0.4	0.9	0.8	0.7	0.6	0.5	0.5	0.4	0.4
Overall balance	-0.7	-3.1	-1.5	-1.3	-2.2	-2.1	-1.8	-1.1	-0.6	0.1	0.7
Financing	0.7	3.1	1.5	1.3	2.2	2.1	1.8	1.1	0.6	-0.1	-0.7
Domestic	0.7	3.1	1.5	1.3	2.2	2.1	1.8	1.1	0.6	-0.1	-0.7
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	0.7	3.1	1.5	1.3	2.2	2.1	1.8	1.1	0.6	-0.1	-0.7
Change in debt	1.6	5.1	1.5	2.2	2.7	2.6	2.2	1.6	1.0	0.4	-0.3
Change in deposits	0.9	2.0	0.0	0.9	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Other flows / valuation changes	-1.2	-3.0	17.0	-1.9	-2.8	-3.7	-2.5	-1.6	-1.2	-1.0	-0.9
Memorandum items:											
General Government Debt	17.0	17.7	33.5	28.7	26.1	22.4	19.9	18.0	16.0	13.8	11.3
Domestic	16.8	17.5	33.4	28.6	25.9	22.2	19.8	17.9	15.9	13.7	11.2
External	0.2	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Cyclically adjusted balance											
(percent of potential GDP)	-0.5	-2.6	-0.9	-0.2	-0.9	-0.9	-0.7	-0.2	0.1	0.4	0.7
Nominal GDP (RMB billion)	31,405	34,090	40,151	47,310	51,932	57,732	63,943	70,904	78,479	86,942	96,234
Central Government Debt 2/	17.1	17.8	17.0	15.4	14.4	15.1	15.4	15.0	14.2	12.7	10.7
Augmented Government Debt 2/	37.4	47.6	47.9	44.4	46.2	42.9	43.9	45.0	45.4	44.6	42.9
Augmented Net Lending / Borrowing 2/	-4.6	-12.1	-5.3	-2.7	-7.4	-4.9	-4.4	-3.9	-3.5	-3.1	-2.8
Augmented Fiscal Deficit 3/	-7.4	-15.0	-9.0	-5.0	-9.7	-7.2	-6.7	-6.2	-5.8	-5.4	-5.1

Sources: CEIC Data Co., Ltd.; and IMF staff estimates.
1/ Includes net allocations to stabilization fund and other adjustments to expenditure.
2/ Augmented fiscal data expand the perimeter of government to include local government financing vehicles and other off-budget activity.
3/ Augmented net lending / borrowing adjusted to treat net proceeds from land sales as a financing item, akin to privatization.

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

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
(Percent change)										
Real GDP	9.2	10.4	9.3	7.8	7.8	7.7	7.6	7.5	7.5	7.5
Total domestic demand	13.9	10.6	10.2	8.4	8.3	8.0	7.6	7.3	7.2	7.0
Consumption	9.4	9.2	11.0	8.4	8.5	8.1	7.9	7.6	7.6	7.4
Investment	19.2	12.0	9.5	8.4	8.1	7.9	7.3	6.9	6.8	6.5
Fixed	22.8	11.4	9.1	10.0	8.4	8.2	7.5	7.2	7.0	6.7
Inventories 2/	-0.8	0.5	0.4	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 2/	-3.5	0.4	-0.4	-0.2	-0.2	-0.1	0.2	0.4	0.5	0.8
Consumer prices (average)	-0.7	3.3	5.4	2.6	3.0	3.0	3.0	3.0	3.0	3.0
(In percent of GDP)										
Total capital formation	48.2	48.2	48.3	48.8	48.8	49.0	49.1	49.0	49.0	48.9
Gross national saving	53.1	52.2	50.1	51.2	51.4	51.6	52.0	52.4	52.6	52.9
Current account balance	4.9	4.0	1.9	2.3	2.5	2.7	3.0	3.4	3.7	4.1
(In billions of U.S. dollars)										
Current account balance	243.3	237.6	136.0	193.0	228.3	266.0	322.7	402.3	481.8	586.9
Trade balance	249.5	254.2	243.5	321.6	332.4	335.1	353.0	386.2	433.0	502.8
Exports	1,204	1,581	1,904	2,057	2,223	2,451	2,726	3,052	3,422	3,859
(Percent change)	-16.1	31.4	20.4	8.0	8.1	10.3	11.2	11.9	12.1	12.8
Imports	954	1,327	1,660	1,735	1,890	2,116	2,373	2,665	2,989	3,357
(Percent change)	-11.2	39.1	25.1	4.5	8.9	12.0	12.1	12.3	12.2	12.3
Capital and financial account, net	198.6	286.7	265.4	-16.8	202.2	108.3	103.4	98.8	90.2	81.1
Capital account	3.9	4.6	5.4	4.2	3.6	3.6	3.6	3.6	3.6	3.6
Direct investment, net	87.2	185.7	231.7	191.1	140.5	128.9	117.0	104.3	91.4	78.1
Portfolio investment, net	27.1	24.1	19.6	47.8	19.7	16.1	13.2	10.5	8.0	5.7
Other investment, net	80.4	72.3	8.7	-259.9	38.4	-40.3	-30.4	-19.7	-12.8	-6.4
Errors and omissions	-41.5	-52.6	-13.6	-79.6	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- indicates increase)	-400.3	-471.7	-387.8	-96.6	-430.5	-374.3	-426.1	-501.1	-572.0	-668.0
Gross reserves	2,426	2,876	3,264	3,360	3,791	4,165	4,591	5,092	5,664	6,332
(In percent of GDP)										
Fiscal balance	-3.1	-1.5	-1.3	-2.2	-2.1	-1.8	-1.1	-0.6	0.1	0.7
Revenue	20.2	21.3	22.6	22.6	22.1	22.3	22.7	23.0	23.3	23.6
Expenditure	23.2	22.8	23.9	24.8	24.2	24.0	23.8	23.5	23.2	22.8
General government debt	17.7	33.5	28.7	26.1	22.4	19.9	18.0	16.0	13.8	11.3
General government structural balance	-2.6	-0.9	-0.2	-0.9	-0.9	-0.7	-0.2	0.1	0.4	0.7
Memorandum item:										
Nominal GDP (in billions of yuan)	34,090	40,151	47,310	51,932	57,732	63,943	70,904	78,479	86,942	96,234
GDP Deflator (2012 = 100)	86.0	90.0	96.6	100.0	103.2	106.1	109.4	112.7	116.1	119.5
Real effective exchange rate growth rate										
Annual average	3.4	-0.4	2.7	5.7	...	...	...	...	...	...
End of period	-5.0	5.3	5.9	1.1	...	...	...	...	...	...
Terms of trade 3/	8.5	-10.0	-3.5	2.8	0.5	-0.5	-0.6	-0.6	-0.5	-0.5
Alternative rebalancing scenario										
Real GDP growth (percent change)	9.2	10.4	9.3	7.8	7.8	7.0	6.9	6.7	6.8	7.0
Total capital formation (percent of GDP)	48.2	48.2	48.3	48.8	48.8	48.8	48.5	48.0	47.4	46.7
Total consumption (percent of GDP)	49.7	48.3	49.1	50.0	50.2	50.7	51.3	52.1	53.1	54.1
Consumer prices (percent change)	-0.7	3.3	5.4	2.6	3.0	3.0	3.3	3.5	3.8	4.0
Current account (percent of GDP)	4.9	4.0	1.9	2.3	2.4	2.1	1.8	1.5	1.2	1.0

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; 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.

3/ Percentage change of annual average.

Table 7. China: Public Sector Debt Sustainability Framework

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018
								I. Baseline Projections					
Public sector debt 1/	17.0	17.7	33.5	28.7	26.1			22.4	19.9	18.0	16.0	13.8	11.3
Of which : foreign-currency denominated	0.2	0.1	0.1	0.1	0.2			0.1	0.1	0.1	0.1	0.1	0.1
Change in public sector debt	-2.6	0.7	15.9	-4.8	-2.6			-3.7	-2.4	-1.9	-2.0	-2.2	-2.5
Identified debt-creating flows (4+7+12)	-2.3	1.7	-1.1	-3.8	-0.4			-0.5	-0.4	-0.8	-1.2	-1.6	-2.1
Primary deficit	0.3	2.7	1.2	0.4	1.4			1.4	1.2	0.6	0.1	-0.5	-1.1
Revenue and grants	19.7	20.2	21.3	22.6	22.6			22.1	22.3	22.7	23.0	23.3	23.6
Primary (noninterest) expenditure	20.0	22.9	22.5	23.0	24.0			23.5	23.4	23.3	23.0	22.7	22.4
Automatic debt dynamics 2/	-2.6	-0.9	-2.3	-4.2	-1.8			-1.9	-1.6	-1.4	-1.2	-1.1	-1.0
Contribution from interest rate/growth differential 3/	-2.6	-0.9	-2.3	-4.2	-1.8			-1.9	-1.6	-1.4	-1.2	-1.1	-1.0
Of which : contribution from real interest rate	-1.0	0.5	-0.7	-1.6	0.3			-0.1	0.0	-0.1	0.0	0.0	0.0
Of which : contribution from real GDP growth	-1.6	-1.4	-1.6	-2.6	-2.0			-1.8	-1.5	-1.4	-1.2	-1.1	-0.9
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Denominator = 1+g+p+gp	1.2	1.1	1.2	1.2	1.1			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)	-0.3	-1.0	17.0	-1.0	-2.2			-3.2	-2.0	-1.1	-0.8	-0.6	-0.4
Public sector debt-to-revenue ratio 1/	86	88	157	127	115			101	90	79	70	59	48
Gross financing need 5/	2.9	5.2	4.7	3.2	4.1			7.4	5.9	4.3	3.3	2.3	1.3
In billions of U.S. dollars	133	262	280	234	337	10-Year Historical Average	10-Year Standard Deviation	666	583	472	396	302	182
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	9.6	9.2	10.4	9.3	7.8	10.5	1.8	7.8	7.7	7.6	7.5	7.5	7.5
Average nominal interest rate on public debt (in percent) 6/	2.5	2.5	2.5	3.0	3.0	2.9	0.5	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)	-5.3	3.1	-4.1	-4.8	1.2	-1.9	3.1	-0.2	0.1	-0.1	0.1	0.0	0.0
Inflation rate (GDP deflator, in percent)	7.8	-0.6	6.6	7.8	1.8	4.8	3.0	3.2	2.9	3.1	3.0	3.1	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	18.4	25.0	8.5	12.1	12.4	13.6	5.2	5.3	7.4	6.9	6.4	6.2	6.1
Primary deficit	0.3	2.7	1.2	0.4	1.4	0.9	1.0	1.4	1.2	0.6	0.1	-0.5	-1.1
								II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios													
A1. Key variables are at their historical averages in 2013–18 7/								20.9	17.5	15.4	13.8	12.6	11.7
A2. No policy change (constant primary balance) in 2013–18								22.3	20.1	18.9	18.2	17.7	17.4
A3. Augmented government debt recognized in 2013 8/								51.0	45.8	41.3	37.1	32.9	28.5
B. Bound tests													
B1. Real interest rate is at baseline plus one-half standard deviation								22.7	20.6	18.9	17.1	15.1	12.7
B2. Real GDP growth is at baseline minus one-half standard deviation								22.7	20.8	19.6	18.4	17.2	15.8
B3. Primary balance is at baseline minus one-half standard deviation								22.9	20.9	19.4	17.9	16.1	14.0
B4. Combination of B1-B3 using one-quarter standard deviation shocks								22.9	20.9	19.4	17.8	15.9	13.7
B5. One time 30 percent real depreciation in 2013 9/								22.5	20.0	18.1	16.1	13.9	11.4
B6. 10 percent of GDP increase in other debt-creating flows in 2013								32.4	29.2	26.6	24.1	21.3	18.3

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/ The augmented government debt is based on staff estimate, which includes off-budget borrowing by local governments.

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).

Table 8. China: Public Sector Debt Sustainability Framework with Augmented Debt and Deficit

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018
								I. Baseline Projections					
Public sector debt 1/	37.4	47.6	47.9	44.4	46.2			42.9	43.9	45.0	45.4	44.6	42.9
Of which : foreign-currency denominated	0.2	0.1	0.1	0.1	0.2			0.1	0.1	0.1	0.1	0.1	0.1
Change in public sector debt	-1.8	10.2	0.3	-3.5	1.8			-3.3	1.0	1.1	0.3	-0.7	-1.7
Identified debt-creating flows (4+7+12)	-1.4	9.2	-1.9	-4.5	3.4			0.2	1.8	0.8	0.0	-0.9	-1.5
Primary deficit	6.5	14.2	8.0	3.8	8.5			5.9	7.1	6.2	5.4	4.6	3.9
Automatic debt dynamics 2/	-5.2	-2.1	-6.2	-6.0	-2.7			-3.4	-3.0	-3.1	-3.1	-3.2	-3.1
Contribution from interest rate/growth differential 3/	-5.2	-2.1	-6.2	-6.0	-2.7			-3.4	-3.0	-3.1	-3.1	-3.2	-3.1
Of which : contribution from real interest rate	-2.0	1.1	-2.0	-2.2	0.4			-0.2	0.0	-0.1	-0.1	-0.1	-0.1
Of which : contribution from real GDP growth	-3.2	-3.2	-4.2	-3.8	-3.2			-3.2	-3.0	-3.0	-3.1	-3.1	-3.0
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	1.1	1.2	1.2	1.1			1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows	-2.8	-2.9	-3.7	-2.3	-2.3			-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
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
Net land sales and others	-2.8	-2.9	-3.7	-2.3	-2.3			-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Residual, including asset changes (2–3)	-0.4	1.0	2.1	1.1	-1.6			-3.5	-0.8	0.4	0.4	0.1	-0.2
Gross financing need 5/	9.6	17.2	12.2	7.0	11.7			15.1	13.1	10.4	9.1	7.9	6.8
In billions of U.S. dollars	433	859	724	509	958	10-Year Historical Average	10-Year Standard Deviation	1366	1302	1139	1090	1043	988
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	9.6	9.2	10.4	9.3	7.8	10.5	1.8	7.8	7.7	7.6	7.5	7.5	7.5
Average nominal interest rate on public debt (in percent) 6/	2.5	2.5	2.5	3.0	3.0	2.9	0.5	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)	-5.3	3.1	-4.1	-4.8	1.2	-1.9	3.1	-0.2	0.1	-0.1	0.1	0.0	0.0
Inflation rate (GDP deflator, in percent)	7.8	-0.6	6.6	7.8	1.8	4.8	3.0	3.2	2.9	3.1	3.0	3.1	3.0
Primary deficit	6.5	14.2	8.0	3.8	8.5	6.5	3.3	5.9	7.1	6.2	5.4	4.6	3.9
								II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios													
A1. Key variables are at their historical averages in 2013–18 7/								41.8	40.6	40.6	40.6	40.4	39.9
A2. No policy change (constant primary balance) in 2013–18								45.5	47.7	50.9	53.9	56.5	58.5
B. Bound tests													
B1. Real interest rate is at baseline plus one-half standard deviation								43.6	45.1	46.8	47.6	47.4	46.1
B2. Real GDP growth is at baseline minus one-half standard deviation								43.3	44.5	45.9	46.5	45.9	44.3
B3. Primary balance is at baseline minus one-half standard deviation								44.6	47.1	49.6	51.3	51.7	51.1
B4. Combination of B1-B3 using one-quarter standard deviation shocks								44.2	46.4	48.7	50.0	50.3	49.5
B5. One time 30 percent real depreciation in 2013 8/								43.1	44.1	45.2	45.5	44.8	43.0
B6. 10 percent of GDP increase in other debt-creating flows in 2013								52.9	53.2	53.7	53.4	52.1	49.8
B7. Narrowing Interest rate-growth differential 9/								43.3	44.6	46.3	47.3	47.6	47.0

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/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
9/ The scenario assumes r-g converges to -4.3 percent by 2018, in line with the pace of convergence identified in April 2013 Fiscal Monitor.

Appendix I. China: Risk Assessment Matrix

Main Sources of Risks		Overall Level of Concern	
		Likelihood (Over next one to five years)	**Impact and Policy Response**
Global	**Financial stress in the euro area re-emerges**	**Medium** Financial stress in the euro area could re-emerge and bank-sovereign-real economy links could re-intensify as a result of stalled or incomplete delivery of policy commitments at the national or euro area level (e.g., Banking Union), or adverse developments in some peripheral countries. The consequences would include further financial fragmentation and continued impairment of credit transmission, strains in cost of market access of peripheral sovereigns and negative shocks to growth that could lead to a protracted period of slow growth in the medium *term.	**Medium** Main impact would be through lower export demand. GDP growth would slow relative to baseline by close to ¾ percentage points. *Policy response:* If growth were to slow too sharply below the authorities' target, on-budget fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.
	Protracted period of slower European growth	**High** The adverse impact of public and private sector debt and deleveraging on the real economy may be larger than currently expected, leaving large output gaps and potentially spurring debt-deflation dynamics. Financial market fragmentation becomes entrenched. Structural reforms are delayed, unemployment remains high, and investment subdued, reducing potential output. Core economies weaken due to trade links and confidence effects, reducing growth in the euro area to around ¼ percent over the medium-term. (spring 2013 WEO scenario).	**High** Capacity utilization rates in export sectors would decline, leading to a fall in profitability, rising unemployment, and diminished ability to service corporate debt. Bank asset quality would deteriorate and tighter financing conditions would further slow investment and growth. *Policy response*: Advance structural reforms to accelerate the transition to domestic consumption-based growth.
	Advanced bond market stress	**Medium** Though the fiscal outlook is different in the United States and Japan, bond market stress in both countries would materialize through an increased sovereign risk premium, and higher government bond yields in the medium-term. Such developments could undermine the recovery of private domestic demand and have severe global financial market repercussions. The sovereign risk premium could increase by 200 bp (spring 2013 WEO scenario).	**High** Main impact would be through lower export demand. *Policy response*: If growth were to slow too sharply below the authorities' target, on-budget fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.
	Distortions from unconventional monetary policy	**High** *Mispricing of risk assets followed by a broad-based correction in valuations.* High asset valuations and low volatility may increasingly reflect excessive risk-taking and divergence from fundamentals (of particular concern is possible mispricing of credit risk). If confidence cracks, market reversal could be material, with high volatility. *Side effects from exit modalities.* Market volatility and higher-than-expected increases in long-term rates could occur as a result of changes in monetary policy stances and operations, and would be compounded by policy mistakes (tightening too early or too late). In the worst case, this could lead to a sudden fall in asset prices and sharp reversal of capital flows, stalling the global economic recovery.	**Medium** The fallout from a large asset price correction would depress demand for Chinese exports, hurting economic growth. Financial linkages would also be significant, as rising risk aversion could hurt inflows, while financial market volatility would complicate progressive financial liberalization in China (e.g., capital account liberalization). *Policy response*: If growth were to slow too sharply below the authorities' target, on-budget fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.

Appendix I. China: Risk Assessment Matrix *(concluded)*

Main Sources of Risks		Overall Level of Concern	
		Likelihood (Over next one to five years)	**Impact and Policy Response**
Domestic	➢ **Renewed run-up in China's property prices followed by sharp correction in property market**	**Low** The authorities' array of macro-control measures to cool the real estate market and promote affordable housing have been largely successful in moderating the market, but the focus on administrative/control does not address the underlying propensity to real estate boom-bust cycles and carries the risk that policies either underperform or overshoot.	**High** Employment in construction and related sectors would fall. Domestic demand, including consumption, would decline. Financial losses and deteriorating asset quality would restrict subsequent credit growth and investment. This would lower China's imports from the rest of the world. *Policy response*: Removal of distortions that create excessive real estate investment and hold back demand for housing in urban areas, 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 continuing to deploy countervailing macroprudential measures (such as lower loan-to-value ratios).
	➢ **Financial stress / deteriorating asset quality in China's financial system related to rapid growth in alternative financial instruments.**	**Low** The combination of slower growth, higher investment, and the growing importance of credit raises concerns about the efficiency of credit allocation.	**High** Disruptions in credit intermediation would lead to employment losses, declining domestic demand, and further adverse feedback on the financial system. *Policy response*: Accelerate financial reform. Elements include: further interest rate liberalization, stronger regulation including of off-balance sheet and nonbank financial products, proper development of capital markets and nonbank channels of intermediation, and ultimately capital account liberalization.
	➢ **Financial stress related to credit exposures on local government financing vehicles.**	**Low** Local governments' large quasi-fiscal and off-budget activities raise questions about their ability to service their debts, with implications for financial system asset quality, and to finance continued spending at current levels.	**Medium** Bank balance sheets would worsen, constricting credit growth and investment. *Policy response*: Revamp intergovernmental fiscal relations, improve monitoring and control of local government fiscal activity, and ensure that local governments have sufficient resources to provide needed social spending and infrastructure.
	➢ **Failure to rebalance/prop up growth with continuing credit growth**	**Medium** Investment could continue to outstrip both external and domestic demand, leading to a further build-up of excess capacity and increased misallocation of resources.	**High** The returns on investment would be much lower than envisaged, which would cause bankruptcies and large financial losses. Such financial losses would in turn hamper employment and growth. *Policy response*: Decisive, comprehensive reforms to rebalance the economy.

Appendix II. China: Progress on Key Recommendations in Table 1 of the FSAP, 2011, CR 11/321

Recommendations	Priority	Time-Frame	Progress
Improving commercialization			
1. Continue to advance the process of interest rate and exchange rate reform (¶8, 11, 50, 51, 52, 68, 79),while ensuring that appropriate credit risk management practices in financial institutions are in place.(¶5, 8, 11, 50, 51, 57, 58, 79)	High	MT	• On June 8, 2012 and July 6, the PBC adjusted deposit interest rate upper limit of the financial institutions from the benchmark interest rate to 1.1 times the benchmark interest rate, and adjusted the floor on lending rates from 0.9 times the benchmark interest rate to 0.7 times gradually. • Expanded the number of banks operating in the Shanghai interbank offered rate (Shibor) system. • Since April 16, 2012, the PBC has widened the trading band of RMB against the U.S. dollar in the interbank spot foreign exchange market from 0.5 percent to 1 percent.
2. Clearly delineate the roles and functioning of policy financial institutions from commercial financial institutions. (¶6, 8, 12, 15, 55)	Medium	MT	N/A
3. Transform the four Asset Management Companies (AMCs) into commercial entities and, as a first step, require them to publish periodic financial statements and management reports. (¶49)	Medium	MT	• China Cinda and China Huarong have completed their shareholding reforms and were formally incorporated in 2010 and 2012 respectively. They have published partial financial statements and management reports.
Increasing efficiency of the institutional, regulatory, and supervisory framework			
4. Empower the PBC and three supervisory commissions with focused mandates, operational autonomy and flexibility, increased resources and skilled personnel, and strengthen interagency coordination to meet the challenges of a rapidly evolving financial sector. (¶5, 6, 39, 53, 54)	High	MT	• PBC, CBRC, CIRC and CSRC have strengthened cooperation in policy-making, cross-industry access approval, cross-industry joint inspection, information sharing. • They have also increased the coordination of cross-industry regulatory policies and the coordination between regulatory policy and monetary policy.
5. Develop a framework for regulation and supervision of financial holding companies (FHCs), financial conglomerates, and informal financial firms (¶54). In the interim, acquisition of a regulated institution should be approved by the regulatory commission responsible for the underlying financial institution. (¶54)	Medium	NT	• PBC is developing the regulatory rules for financial holding companies, including deciding the supervision agency, improving corporate governance, regulating internal transactions, strengthening the regulation for capital adequacy ratio and risk concentration. These measures aim to widen the regulatory perimeter, prevent regulatory arbitrage, enhance supervision effectiveness, and contain transmission of risk across industry and market segments.

Notes: NT (Near Term) means implementation completed within three years; MT (Medium Term) means implementation completed in three to five years. Paragraph numbers in parentheses attached to recommendations refer to CR 11/321—People's Republic of China: Financial System Stability Analysis.

6. Introduce a more forward-looking assessment of credit risk in the China Banking Regulatory Commission (CBRC) risk rating system and eliminate deviations from the capital framework for credit and market risk. (¶56)	Medium	NT	• CBRC is revising guidelines for regulating and rating commercial banks. In January 2013, the Regulation Governing Capital of Commercial Banks (Provisional) began to be implemented.
7. Introduce a formal program whereby the China Securities Regulatory Commission (CSRC) conducts regular comprehensive on-site inspections of the exchanges to improve oversight. (¶60)	Medium	NT	• CSRC has organized experts to perform regular comprehensive on-site inspections into the information system of the stock exchange, and created a full set of forms and regime for on-site inspection.
8. Introduce a risk-based capital (RBC) solvency regime for insurance firms with suitable transition period and restrict new businesses by insurance companies operating below the 100 percent solvency level. (¶61)	Medium	MT	• In May 2013, the CIRC issued the Overall Framework of the 2nd Generation Solvency Supervision System of China, now formally named China Risk Oriented Solvency System (CROSS).
9. Develop explicit and clear regulation for facilitating the exit of insurance companies from the market via run off or portfolio transfers. (¶61)	Medium	NT	• In October 2011, Tentative Measures for Administration of the Transfer of Insurance Business began to be implemented.
10. Enact a payment system law to give full protection to payments, derivatives and securities settlement finality. (¶63)	Medium	MT	• PBC has completed the first draft of regulations on payment and settlement system administration.
11. Ensure that beneficial ownership and control information of legal persons is adequate, accurate, and readily accessible to competent authorities. (¶67)	High	MT	N/A
12. Improve information sharing and coordination arrangements among the PBC and other agencies on anti-money laundering (AML) and other supervisory issues. (¶39, 53, 54, 67)	High	MT	• Since July 2012, PBC has held regular meetings on anti-money laundering analysis.
Upgrading the framework for financial stability, systemic risk monitoring, systemic liquidity, and crisis management			
13. Establish a permanent committee of financial stability, with the PBC as its secretariat. (¶6, 39)	High	MT	N/A

14. Upgrade data collection on financial institutions including their leverage, contingent liabilities, off balance sheet positions, unregulated products, and cross-border and sectoral exposures. (¶40)	Medium	NT	• CBRC has introduced monitoring indicators in its off-site system, including leverage ratio, liquidity coverage ratio, and net stable funding ratio. • After issuing Regulation Governing Capital of Commercial Banks in 2012, the CBRC designed a new form of capital adequacy ratio, covering all capital requirements (on- and off-balance sheet). The form was included in the off-site statement index monitoring system, and has reported regularly since 2013. • For securities sector, CSRC has clarified the risk control standard for security firms, published a guideline about information compiling and reporting, and required security firms to make timely reports of related business information. In addition, the new comprehensive Futures Information Supervision System (FISS) was formally launched. • For insurance sector, according to the basic data collected by system and solvency reports reported by insurance companies, the CIRC analyzes the risk situation of companies and rates them.
15. Build a macroprudential framework for measurement and management of systemic risks; this should include increasing the resources and capacity of the PBC and regulatory agencies to monitor financial stability and to carry out regular stress tests. (¶41)	High	NT	• PBC formally introduced the Dynamic Adjustment of Deposit Reserve Ratio in early 2011. • Furthermore, since the end of 2011, PBC has organized financial stress tests for 17 commercial banks. • Regarding the securities industry, relevant authorities have started constructing an indicator system for tracking capital market systemic risk. A preliminary framework is expected to be completed by the end of 2013.
16. Enhance the sterilization of structural liquidity through market-based instruments and manage systemic liquidity spillovers via indirect monetary policy instruments. (¶42, 51)	High	NT	• From 2013, the People's Bank of China continually undertook repo operations to moderately withdraw liquidity. The flexibility and forward-looking nature of liquidity management have been steadily improved.
17. Introduce reserve averaging to facilitate liquidity management and enhance stability and efficiency.(¶43)	High	NT	N/A
18. Start targeting a short-term repo rate on a pilot basis, as a trial of indirect liquidity management, and commence daily open market operations. (¶44, 45)	High	NT	N/A
19. Ensure that PBC's standing facilities operate immediately and automatically, with specified collateral requirement identical across all domestically incorporated institutions. (¶46)	Medium	NT	• At the beginning of 2013, the People's Bank of China established the Standing Lending Facility, to meet the relatively longer maturity and larger amount needs of large financial institutions.

20. Introduce a deposit insurance scheme to assist in the orderly wind-down of financial institutions and to help clarify the contingent liability. (¶7, 48)	Medium	NT	• At present, relevant departments have reached a consensus on the main points of China's deposit insurance system.
Developing securities markets and redirecting savings to contractual and collective investment sectors			
21. Ensure regulations are consistent and clarify regulatory responsibilities to support fixed income market development. (¶69)	Medium	MT	• In 2011, the MOHRSS revised "The Trial Measures for the Management of Enterprise Annuity Funds" to "Measures for the Management of Enterprise Annuity Funds", and issued "Measures for the Management of Collective Enterprise Annuities Plan". In 2013, it issued "Announcement on Enlarging the Scope of Investment of Enterprise Annuity Funds".
22. Continue to improve bond issuance strategies between Ministry of Finance (MOF) and PBC to help improve the existing market-making across all maturities of the yield curve. (¶70)	High	MT	• In June 2011, the MOF and the PBC issued a joint announcement, creating a market-making system for newly issued critical term bonds • In 2012, the MOF established a framework for issuing coupon treasury bonds. • In 2013, the MOF, PBC and CSRC jointly announced a pilot to enhance trading of treasury bonds with a view toward improving the price mechanism of the treasury bond market.
23. Upgrade regulatory and operational repo market framework to increase market liquidity, enhance risk management and reinforce the money and bond market interest rate nexus. (¶68)	Medium	NT	• From 2013, PBC continually undertook repo operations to moderately withdraw liquidity. • In January 2013, NAFMII published "Master Agreement for Bond Repurchase in China's Interbank Market (2013)" introducing adjustment mechanism on marked-to-market repurchase bonds and collateral bond swap mechanism, enhancing market participants' ability to manage risks.
24. Ease the 40 percent of net assets limit applicable to corporation's market based debt issuance to expand their direct funding capacity. (¶72)	Medium	MT	N/A
25. Upgrade links between China Central Depository Trust & Clearing Co., Ltd (CCDC) and Securities Depository and Clearing Corporation Limited (SD&C) to enhance connectivity among Interbank Bond Market (IBBM), Shanghai Stock Exchange (SSE), and Shenzhen Stock Exchange (SZSE), support further development, and contribute to efficiency in all three markets. (¶72)	Medium	MT	N/A
26. Consolidate the multi-pillar pension system, with emphasis on the funded component. (¶75)	Medium	MT	N/A

Improving alternative financing channels and access			
27. Review existing government programs to determine their effectiveness in promoting rural and micro and small enterprise (MSE) finance and formulate an integrated and coherent rural and MSE finance strategy. (¶76)	High	MT	• At the beginning of 2013, the CBRC published "Opinions of the China Banking Regulatory Commission on Deepening the Financial Service for SMEs". • In May 2012, the CSRC launched pilot of SMEs' private placement bonds.
28. Further reform the rural credit cooperatives to enhance their efficiency and sustainability as commercial providers of financial products and services. (¶76)	Medium	MT	• By the end of 2012, 337 rural credit cooperatives and rural cooperative banks were restructured to rural commercial banks, an increase of 252 compared with end-2010.
29. Complete the reform of the Postal Savings Bank (PSB) by optimizing equity ownership, overhauling the bank to become a corporation, and building effective corporate governance. (¶76)	Medium	MT	• In January 2012, the Postal Savings Bank of China was restructured from a limited liability company to a limited stock corporation.

Notes: NT (Near Term) means implementation completed within three years; MT (Medium Term) means implementation completed in three to five years. Paragraph numbers in parentheses attached to recommendations refer to CR 11/321—People's Republic of China: Financial System Stability Analysis.

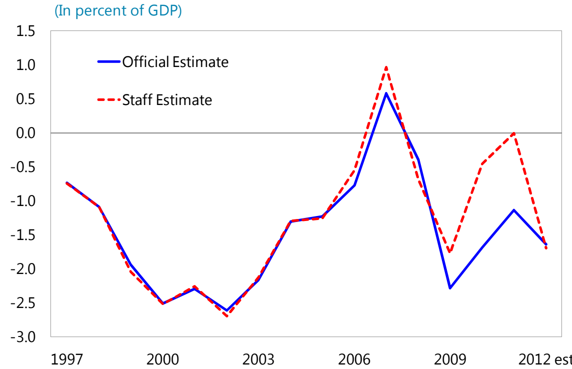
Appendix III. Staff Estimates of Augmented Fiscal Data[5]

This note lays out the data and assumptions used in calculating this staff's estimates of augmented fiscal balances and debt. Section I explains staff's estimate of the general government data. Section II presents the assumptions used to estimate the augmented fiscal deficit and net borrowing; Section III does the same for the augmented debt. Section IV presents additional considerations on the potential perimeter of public sector liabilities.

A. General Government Deficit: IMF and Authorities' Definitions

The accounting treatment of the stabilization fund is the main difference between official and staff estimates of general government data. The authorities do not include the stabilization fund as part of the general government, but instead treat transfers to the fund as expenditure and transfers from the fund as revenue (see table). However, the stabilization fund works analogously to a government bank account, in which the government makes yearly deposits and withdrawals. For this reason, staff, in line with Government Finance Statistics practices, considers the stabilization fund part of the general government, recording cash transactions with the stabilization fund "below the line," as transactions with other government accounts would be treated.

Official vs Staff Estimates of General Government Balance
(In percent of GDP)



Source: CEIC; and IMF staff estimates.

Staff also add external and some local government ("on-budget") debt to the general government balance sheet. The external debt stock is calculated from the flows of external financing, with an adjustment for estimated amortization. The local government is based on the NAO (2011) estimate for the stock at end-2010, and the NAO (2013) report and assumptions about amortization are used to estimate 2011–12 data. Bonds issued by the central government on behalf of local governments are already included in the official general government debt stock. General government expenditure (and thus, the deficit) is adjusted by the amount of this additional financing.

B. Construction of "Augmented Fiscal Deficit" and "Net Borrowing"

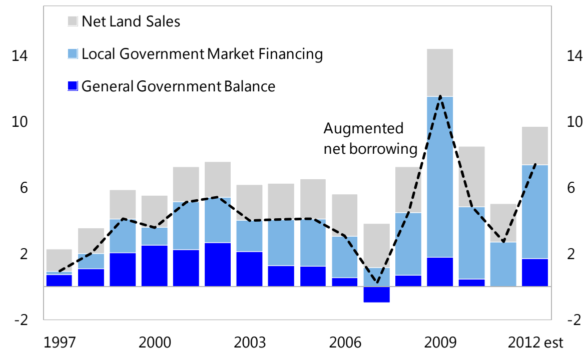
The "augmented fiscal deficit" and "net borrowing" add to the general government data the quasi-fiscal activities which are currently classified as off-budget, chiefly infrastructure spending. Augmented fiscal deficit is equal to augmented net borrowing plus the net proceeds from land sales. The estimates are constructed based on financing (below-the-line) data, and an above-the-line approach is used as a cross-check. The calculation requires numerous assumptions to fill in data gaps, highlighting the uncertainty surrounding the estimates.

[5] See Zhang (forthcoming), IMF Working Paper: "Fiscal Vulnerabilities and Risks from Local Government Finance in China."

Augmented Fiscal Deficit

The "augmented fiscal deficit" adds net proceeds from land sales and local government market financing to the staff definition of the general government. The augmented fiscal deficit calculation only includes the net proceeds from land sales—that is, the portion that is actually used to finance current and infrastructure spending.[6] The net proceeds from these asset sales are treated as financing, not revenue, since they are analogous to privatization proceeds. Market financing is the borrowing by local government entities from the commercial banks, trust companies, and corporate bond market. The "augmented net borrowing" excludes net land sales, but is otherwise the same as the augmented fiscal deficit.

Augmented Net Borrowing and Fiscal Deficit
(In percent of GDP)

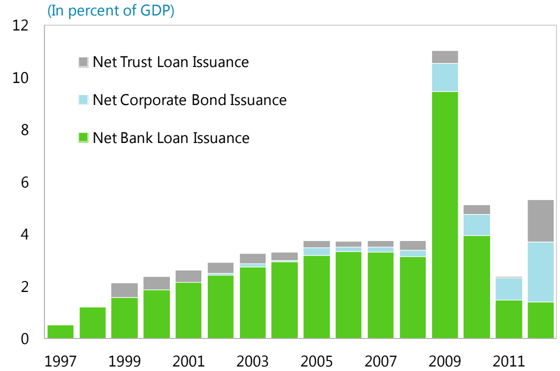


Source: IMF staff estimates.

Market financing

Beginning in 2009–10, local governments expanded market borrowing through the use of Local Government Financing Vehicles (LGFVs). Local governments are in general forbidden to borrow directly unless approved by the State Council. This was relaxed somewhat in response to the global financial crisis, as the central government was allowed to issue bonds on behalf of local governments. However, the amounts were fairly limited and too small to allow local governments to make the expected contribution to the 2009–10 stimulus package. Hence local governments largely channeled their borrowings through LGFVs and other government-related entities that typically borrow from policy banks, commercial banks, and more recently from trust companies and the corporate bond market.

Local Government Market Financing
(In percent of GDP)



Source: IMF staff estimates.

LGFVs are legally distinct entities, often receiving public credit enhancement, that engage in long-term infrastructure projects. Despite legal prohibitions, some LGFV debts were informally guaranteed by local governments, and there is a general perception that the local governments would stand behind their LGFVs if needed. LGFVs borrowing could also be collateralized by land or other assets, either owned by the LGFV itself, pledged by the local government, or provided by another entity. Such guarantees or collateral are important for infrastructure LGFVs, which, especially

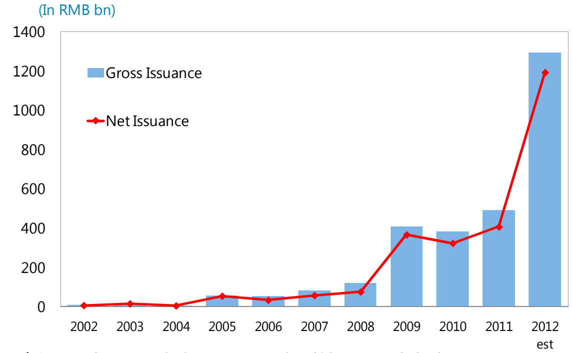
[6] Net proceeds from land sales are calculated by subtracting the cost of acquisition, compensation to farmers, and land development from the gross land sales proceeds.

in the short term, may not generate sufficient cash flow to service their debt. Some LGFVs may operate on a primarily commercial basis, while some local-government owned SOEs may carry out quasi-fiscal activities. However, since the former are exceptions, rather than the rule, the assumption here is that all LGFV debt warrants inclusion in the augmented deficit, while local-government owned SOE debt does not.

If approved by the State Council, local governments and government related entities can issue debt on a discretionary basis. This amounted to around 7 percent of end-2010 local government debt according to the NAO (2011). Staff estimates annual issuance by equally distributing accumulated debt among earlier years. This assumes that central government bonds issued on behalf of local governments were already included in the total stock.

Gross Issuance and Amortization of Corporate Bond by LGFVs[1]

(In RMB bn)



[1]LGFVs are urban construction investment companies, which were set up by local governments to finance their infrastructure and public entities projects. Source: IMF staff estimates.

The other major components of market financing are bank loans, corporate bonds, and trust loans:

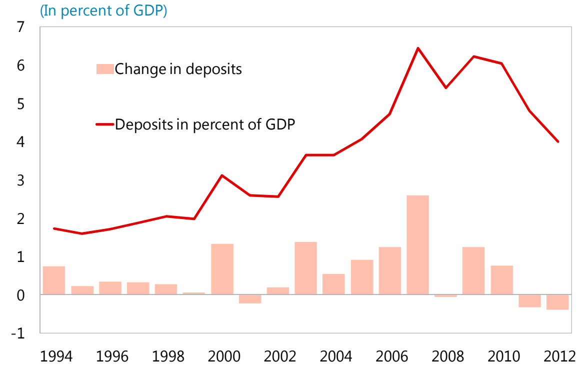
- **Bank loans** accounted for 79 percent of total local government debt by 2010, equivalent to CNY 12.7 trillion, of which CNY 10.7 trillion was borrowed by provincial, city, and county governments (NAO, 2011), CNY 0.8 trillion by township governments (DRC), and CNY 1.2 trillion for roads and highways that are not captured by the NAO (2011). Using the growth rate of local government debt provided by the NAO (2011), staff estimate the net local government debt issuance and the proportion financed through bank loans for earlier years. Information gaps prevent decomposition of net bank loan issuance by the gross amount, repayment through land sales proceeds, and debt rollover. The NAO (2013) report is used to estimate the debt stock at the end of 2012 based on the survey result that debt has risen by 13 percent since 2010.

- **Corporate bonds** are derived from the WIND database, which provides data on gross amount and maturity dates of corporate bond issuance by LGFVs.

- **Trust loans** to infrastructure projects amounted to CNY 1.39 trillion by Sept 2012, based on data from the China Trustee Association. This fell to just below CNY 0.9 trillion by the first quarter of 2010. There is no data before 2010, so the growth rate of bank loans is used to estimate flows for earlier years.

Central Government in the Monetary Authorities

(In percent of GDP)



Sources: CEIC; and IMF staff estimates.

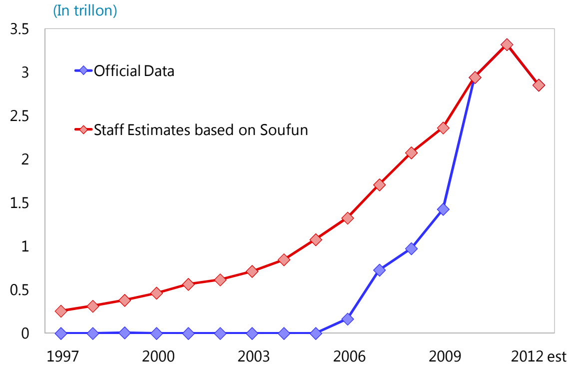
Changes in cash deposits of the government are included as financing. Deposits totaled around 4 percent of GDP at end-2012; these had been growing steadily, but started falling as a share of GDP after the peak of the crisis. Deposits of LGFVs, however, are not included due to lack of data.

Land sales

Data on net land sales are not published for every year and are estimated using some simplifying assumptions. Gross land sales data in recent years are from CEIC. Most land sales are channeled through Government Managed Funds (GMFs), with the gross proceeds recorded as revenue in off-budget accounts. For example, in 2011 gross land sales explained CNY 3.3 trillion (7 percent of GDP) of the CNY 3.8 trillion in GMFs' revenue. Net land sales for 2010 and 2011 are derived from Ministry of Finance data that show how the gross proceeds were used. Net proceeds subtract the cost of acquisition, compensation to farmers, and land development. In 2010, the net proceeds were 50 percent of the gross, whereas they were only 33 percent in 2011. Except for 2010–11, data are not available to calculate net proceeds, so staff assume the net proceeds each year are 42 percent (the average of 2010 and 2011). Land sales data for 2005-9 appear incomplete and for 2005 and earlier are discontinuous, so a series is extrapolated using data on land sales growth from Soufun (a Chinese real estate services firm) and official data for 2010–12.

Official and Staff Estimates of Land Sales Revenue

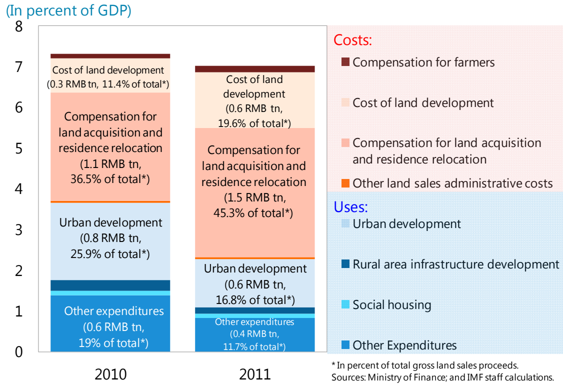
(In trillon)



Sources: CEIC; the Ministry of Finance; Soufun; and IMF staff estimates.

Decomposition of Gross Land Sales Proceeds: Costs and Uses

(In percent of GDP)



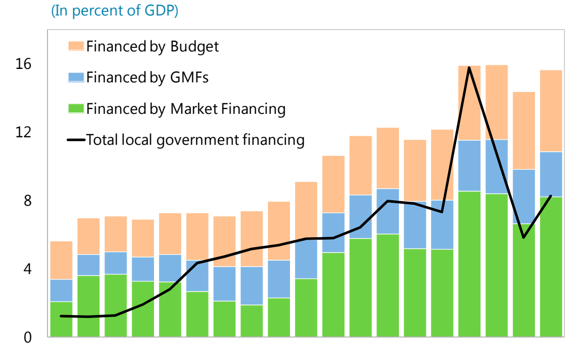
* In percent of total gross land sales proceeds.
Sources: Ministry of Finance; and IMF staff calculations.

Cross-check with Above-the-Line Data

Budgeted revenue is adjusted for GMF income net of land sales. Once land proceeds are excluded, this item is small. In 2011, officially reported GMF revenue was CNY 4.1 trillion, but, after subtracting land sales (which only accrue to local governments), this falls to CNY 0.8 trillion. Of this, CNY 0.3 trillion is from the central government and CNY 0.5 million from local governments (CNY 3.8 trillion less CNY 3.3 million in land sales). Data on central government GMFs come from the Ministry of Finance and CEIC. For local governments, staff assumes that GMF revenue is a constant share of land sales.

Infrastructure Investment and Financing Sources

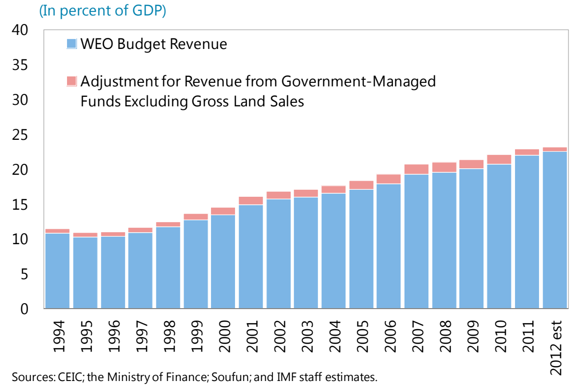
(In percent of GDP)



Source: IMF staff estimates.

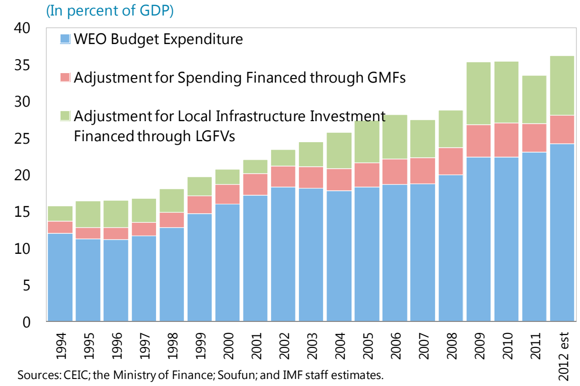
Expenditure is adjusted for spending by GMFs and LGFVs. Data on LGFV spending are not available, so staff includes all infrastructure investment, calculated from data on fixed asset investment, in augmented spending.[7] This is added to total spending by the budget and GMFs, which is then adjusted to avoid double-counting of on-budget and GMF-financed infrastructure spending. Specifically, based on 2011 data, staff assumes that infrastructure spending accounts for 21 percent of local government budget spending, 14 percent of central government budget spending, 36 percent of local GMF spending, and 47 percent of central GMF spending. The residual is the estimate of LGFV infrastructure spending, and broadly corresponds to the financing data.

Augmented Revenue
(In percent of GDP)



Sources: CEIC; the Ministry of Finance; Soufun; and IMF staff estimates.

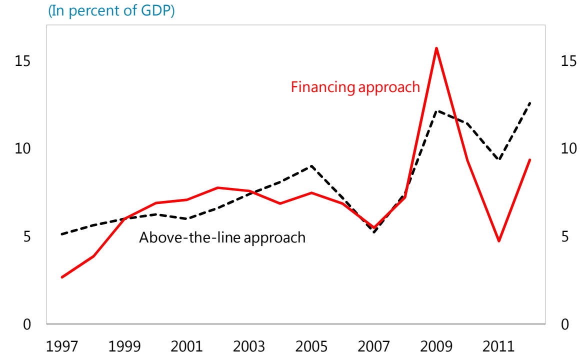
Augmented Expenditure
(In percent of GDP)



Sources: CEIC; the Ministry of Finance; Soufun; and IMF staff estimates.

The above-the-line approach yields an augmented fiscal deficit that is somewhat larger than the financing approach in recent years. This is not surprising, as the above-the-line data include all infrastructure spending even though some is executed by entities outside the augmented government—such as SOEs. Moreover, it could also be inflated to the extent that some LGFV infrastructure spending is financed by own-revenue instead of market borrowing.

Augmented Fiscal Deficit
(In percent of GDP)



Sources: CEIC; Chinabond; EUROSTAT; China Citic Press; China Trustee Association; NAO; and the Ministry of Finance; and IMF staff estimates.

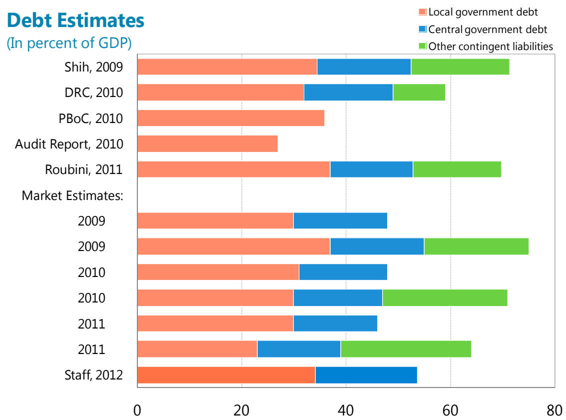
Construction of Augmented Debt Ratio

Debt data are based on public sources or cumulated financing flows. Central government debt data are readily available from public sources. For augmented local government, NAO (2011) provides the starting point, an estimate of CNY 12.7 trillion for 2010. Data for previous and subsequent years are then calculated based on the financing assumptions described above.

[7] Infrastructure investment is calculated as the sum of fixed asset investment in primary industry; electricity and heating; gas; water; highway transport; waterway transport; air transport; water conservancy and environment management. Since the breakdown is only available since 2004, staff assume that infrastructure investment and total fixed asset investment grew at the same rate in previous years.

Differences with other public estimates are minor, and often stem from different methodologies or base years. For example, the DRC and NAO (2011) estimates refer to the end of 2010. While the National Audit Office conducted a nation-wide survey, most investment banks and research institutions, which lack the authority and resources to access microlevel data, took approximations based on publically available information on bank credit.

Debt Estimates
(In percent of GDP)



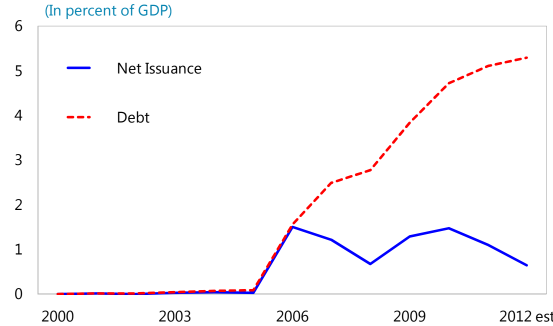
In most cases, higher estimates are due to different coverage. DRC's local government debt estimate, which captures townships in addition to provinces, cities, and counties, is CNY 2 trillion higher than the NAO estimate, which only captures three levels of government. In addition to local government explicit liabilities, many estimates also include central government debt and contingent liabilities at the general government level, such as NPLs held by asset management companies, borrowing by policy banks, and pension fund liabilities.

C. Other Considerations

The augmented fiscal data are intended to provide a better picture of the fiscal policy stance and gross government liabilities. They do not provide a comprehensive picture of government net worth in a balance sheet framework.

Railways Ministry debt is excluded from the augmented data. The Ministry was corporatized this year and debt moved to a new SOE, which should be classified going forward as part of the public sector but not the augmented government. It is consistent, therefore, to exclude it from the estimates of augmented fiscal debt and deficit as defined in this exercise (including it would increase somewhat the estimated augmented deficit and debt).

Ministry of Railway Debt and Deficit
(In percent of GDP)

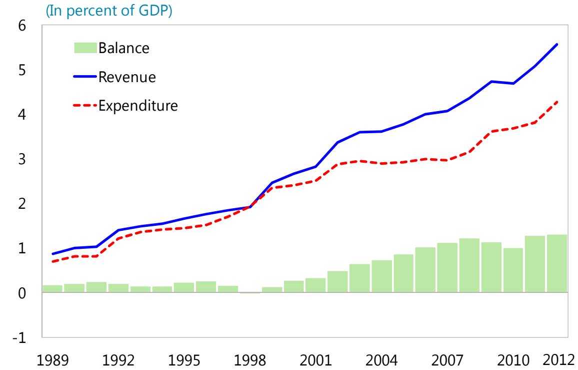


Note: Net issuance were calculated as the difference of debt stock provided by ChinaBond Audit Reports. Debt stock by the end of 2012 were extrapolated from Sept 2012 debt stock and the net issuance in 2012 is the difference between the estimated 2012 debt stock and 2012 debt stock.

Contingent liabilities are also excluded. Quasi-fiscal debts are explicit liabilities, but the government is also exposed to contingent liabilities, including debt of nonfinancial state-owned enterprises excluding LGFVs, policy banks' outstanding debt, nonperforming loans (NPLs) in the banking sector, old NPLs assumed by asset management companies, and pension fund liabilities. The Chinese Academy of Social Science (CASS) estimated total 2010 contingent liabilities at just above 100 percent of GDP.

Social security funds are excluded from the data. China does not consolidate social security into general government accounts. Inclusion would increase augmented revenue and spending, but somewhat reduce the deficit. The social security funds have also built up financial assets: the National Pension Fund held assets of 4.3 percent of GDP at end-2012. However, the pension system faces significant challenges going forward. *World Bank* (2013) notes that legacy costs in the pension system were 80–132 percent of GDP in 2008 and that the system had a potentially large actuarial deficit (estimates, albeit dated, suggest the actuarial deficit was around 95 percent of 2001 GDP).

Social Security Fund
(In percent of GDP)



Sources: CEIC; and IMF staff calculations.

On the other hand, state assets, including public sector financial assets, are also excluded from the gross augmented debt estimates. The government's significant ownership stake in SOEs is also excluded. China does not publish a public sector balance sheet, and estimation of the government's equity stake is difficult, though the value is probably large. According to CASS, the government owns CNY 60 trillion (147 percent of GDP) worth of equity of state owned for-profit nonfinancial enterprises, CNY 8 trillion (20 percent of GDP) worth of equity in state-owned for-profit financial enterprises, and almost CNY 8 trillion of worth of equity in state-owned nonprofit enterprises.

Appendix Table III.1. China: General Government Fiscal Data, Staff and Authorities' Estimates

	2006	2007	2008	2009	2010	2011	2012
				(RMB bn)			
Authorities							
(1) Revenue	3,876	5,132	6,243	6,902	8,320	10,537	11,991
Headline revenue	3,876	5,132	6,133	6,852	8,310	10,387	11,721
Withdrawal from budget stabilization fund	0	0	110	51	10	150	270
(2) Expenditure	4,092	5,081	6,278	7,852	9,348	11,406	12,791
Headline expenditure	4,042	4,978	6,259	7,630	8,987	10,925	12,571
Contribution to budget stabilization fund	50	103	19	10	225	289	18
Other adjustments	0	0	0	212	136	192	201
(3) Overall balance (1-2)	-216	51	-35	-950	-1,028	-868	-800
(4) General government debt (MOF)	...	...	...	6,224	7,153	7,804	8,407
Central government	...	...	...	6,024	6,753	7,204	7,757
Local government bonds	...	...	...	200	400	600	650
Staff							
(5) Revenue	3,926	5,235	6,152	6,862	8,535	10,677	11,739
(+) Authorities' revenue	3,876	5,132	6,243	6,902	8,320	10,537	11,991
(-) Withdrawal from stabilization fund	0	0	110	50.5	10	150	270
(+) Contribution to stabilization fund	50	103	19	10	225	289	18
(6) Expenditure	4,057	5,003	6,384	7,695	9,148	11,282	12,858
(+) Authorities' expenditure	4,092	5,081	6,278	7,852	9,348	11,406	12,791
(-) Contribution to stabilization fund	50	103	19	10	225	289	18
(+) Withdrawal from stabilization fund	0	0	110	51	10	150	270
(+) Externally financed spending	15	25	15	15	15	15	15
(+) Local government expenditure carried forward	0	0	0	0	136	192	1
(-) Other adjustments	0	0	0	212	136	192	201
(7) Overall balance (5-6)	-131	233	-232	-834	-613	-605	-1,118
(8) General government debt	3,502	5,207	5,327	6,024	13,466	13,588	13,547
(+) Authorities' debt	...	...	...	6,224	7,153	7,804	8,407
External debt	64	61	47	50	56	63	82
(-) Local government bonds (from (4))	...	...	...	200	400	600	650
(+) Local government debt (NAO report, 2013)	...	...	...	...	6,711	6,384	5,791
Memorandum:				(In percent of GDP)			
Overall balance							
Authorities	-1.0	0.2	-0.1	-2.8	-2.6	-1.8	-1.5
Staff	-0.6	0.9	-0.7	-2.4	-1.5	-1.3	-2.2
General government debt							
Authorities	...	...	...	18.3	17.8	16.5	16.2
Staff 1/	16.2	19.6	17.0	17.7	33.5	28.7	26.1

Sources: CEIC Data Company Ltd.; MOF; and IMF staff estimates.

1/ Figures do not include local government financing vehicles and other off-budget activities.

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 27, 2013

Prepared By

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

CONTENTS

FUND RELATIONS

(As of May 31, 2013)

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

General Resources Account:

	SDR Million	% Quota
Quota	9,525.90	100.00
Fund holdings of currency	8,554.65	89.80
Reserve position in Fund	971.29	10.20
Lending to the Fund		
New Arrangements to Borrow	3,810.27	

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	6,989.67	100.00
Holdings	7,378.63	105.56

Outstanding Purchases and Loans: None

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

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.00	0.04	0.04	0.04	0.04
Total	0.00	0.04	0.04	0.04	0.04

Exchange Arrangements:

China's exchange rate regime has been classified as a crawl-like arrangement since June 21, 2010. De jure classification of the exchange rate is managed floating. On July 21, 2005, the People's Bank of China (PBC) announced that the exchange rate of the renminbi against the U.S. dollar would be revalued upward by about 2.1 percent (from RMB 8.28/US$ to RMB 8.11/US$) and the exchange rate regime would move to a managed float in which renminbi's value is set with reference to a basket of currencies. The stated intention of the Chinese authorities was to increase the flexibility of the renminbi's exchange rate. The authorities indicated that they will not publish the currencies in the reference basket and their relative weight. The PBC indicated that it would adjust the exchange rate trading band as necessary to reflect market developments and financial and economic conditions. Under the new regime, the band around the daily trading price of the U.S. dollar against the renminbi was kept at ± 0.3 percent around the central parity published by the PBC while the trade prices of the non-U.S. dollar currencies against the renminbi were allowed to move within a certain band announced by PBC, which was initially set at ±1.5 percent and increased to ±3 percent in September 2005. In August 2005, the governor of PBC revealed that U.S. 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. So far this year, the renminbi-U.S. dollar rate has remained in a 2 percent crawling band and the de facto exchange rate arrangement is a crawl-like arrangement. The trading prices for the renminbi against the euro, yen, Hong Kong dollar, and pound sterling on the one hand and against the ringgit and the ruble on the other hand float within a 3 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 15 banks initially designated as market makers. The number of market makers has since risen to 31 with all the banks approved as spot market makers, and 27 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 using various factors, including the transaction volumes of the respective market makers in the market. The method for determining is as follows: The CFETS determines the middle rate for the renminbi against the ringgit, yen, and the ruble similarly. The middle exchange rates of the renminbi against the euro and 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 current operations may keep foreign exchange receipts according to their operational needs in their current foreign exchange accounts. With SAFE approval or registration, domestic institutions may open foreign exchange capital accounts and retain foreign exchange revenues from capital transactions. Domestic institutions that had no current 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 relevant 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 investment limit for QFIIs was US$80 billion in 2012. As of the end of 2012, a cumulative total of 207 QFIIs had been approved, with a total investment limit of US$37.443 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 freely purchase up to US$20,000 foreign exchange and this limit was raised to US$50,000 in September 2006. Above this amount, 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. Starting from January 6, 2011, resident enterprises in

20 provinces and cities in the Mainland may use renminbi for outward FDI in those countries which accept such settlement. In December 2011, a new pilot scheme was announced to allow up to RMB20 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. Since 2012 all residents and non-residents can use RMB for FDI. Under the expanded RMB qualified foreign institutional investors (RQFII) scheme, Hong Kong subsidiaries of Chinese financial institutions, as well as financial institutions registered and operated in Hong Kong, may invest in domestic securities markets using RMB proceeds raised overseas. Hong Kong-based banks may provide yuan loans to companies based in the Qianhai District of Shenzhen, with limits on the size of the loan.

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.

Article IV Consultation:

China is on the standard 12-month consultation cycle. The 2012 Article IV mission was concluded on June 7, 2012 and the staff report was published on July 6, 2012.

Technical Assistance:

Technical assistance provided from 2000 through April 2013 is summarized in Annex V.

Resident Representative:

The resident representative office in Beijing was opened in October 1991. Mr. Murtaza Syed is the Resident Representative.

WORLD BANK-IMF COLLABORATION

(As of June 18, 2013)

1. **The IMF China team led by Mr. Rodlauer (mission chief) met with the World Bank team led by Mr. Rohland** on May 24, 2013 to discuss key areas of reform to ensure sustainable medium-term growth in China, minimize risks, and improve the inclusiveness of growth. The teams discussed their agendas for 2013-14. The last such meeting was held May 2012 in Beijing.

2. **The teams agreed the focus of reform in China should be on shifting growth to a more balanced and sustainable path.** Reforms should aim at preventing further buildup of risks stemming from rapid credit growth and quasi-fiscal spending. These measures would reinforce structural steps taken to reform the financial sector and social security system, strengthen the social safety net, raise resource prices, and open up the service sector to competition.

3. **Based on this assessment, teams identified the following reform areas as macrocritical:**

- ***Reform of social safety nets***. Strengthening China's pension systems will reduce incentives for personal savings, helping to rebalance the economy toward consumption. In particular, ensuring sufficient resources for current pensioners while improving the actuarial prospects of the current system will reduce uncertainty for the elderly and current workers. Addressing coverage issues in the Chinese health system would further reduce incentives to save, and help develop China's service sector.

- ***Climate change and renewable energy.*** Air pollution, water quality and supply, and issues such as desertification, dependence on coal, and degradation of grasslands have social, health, and economic effects. Underpricing of energy and inadequate consequences for pollution have worsened these effects while contributing to China's dependence on industry. Raising these factor costs and investing in renewable energy will make growth more sustainable and inclusive.

- ***Infrastructure.*** Investment in infrastructure has been a key driver of the Chinese economy, particularly during the slowdown around the Global Financial Crisis. However, the rapid pace of investment has in some cases left communities behind, and in other cases has led to excessive investment in projects with relatively low social or financial returns. Filling in the gaps of investment in social projects will make growth more inclusive while improving the overall social and financial efficiency of infrastructure investment. Measures to improve the process of approving new infrastructure projects will ensure that investments are focused in areas of the highest social return.

- ***Financial liberalization.*** Rapid credit growth has been at the center of China's impressive growth record for the past few decades, but in recent years has led to a buildup of vulnerabilities. As the labor force peaks and capital intensity declines, ensuring continued strong growth will require a nimble financial system that can support projects raising total factor productivity without further adding to financial sector risks. Key measures in this area include the gradual liberalization of interest rates, stepped-up supervision and regulation of the financial system, overhaul of the system of resolving failed financial institutions, and the introduction of deposit insurance.

- ***Strengthening the execution of fiscal policy.*** Off-budget spending, in infrastructure but also in other areas, undertaken by local-government owned entities have led to a buildup of debt estimated by the Fund at around 50 percent of GDP in 2012. Bringing these projects on-budget and improving the transparency of fiscal policy will reduce fiscal and financial sector risks.

4. **The teams agreed to the following division of labor.**

- ***Social safety nets.*** The Bank will continue to work with the Chinese authorities on both parametric and structural reforms to the Chinese pension system, with a view toward ensuring that the system protects the most vulnerable, ensures a fair return on savings for all participants, and is financially sustainable in the long term. The Fund will look at issues related to the balance between social contributions and other revenue sources, as well as how social safety nets fit into the overall fiscal and macroeconomic policy framework.

- ***Renewable energy.*** The Bank's focus on climate change and renewable energy in China will continue to emphasize cutting-edge renewable energy technologies, scale-up of energy conservation and investments in energy efficiency, and green building policies (for heat and energy efficiency). Engagements with a climate change focus will extend to expansion of distribution of electricity from natural gas generation, analysis of carbon capture and storage potential, and development of carbon markets. The Fund is ready to provide assistance on shifting the pricing and taxation of energy, and discussing the growth and fiscal implications of such a shift.

- ***Fiscal framework.*** The Bank will continue its work with the Shanghai municipal government to transfer technical assistance on Medium Term Expenditure Framework and debt sustainability analyses. The Fund can provide advice on strengthening the fiscal framework (including for central-local relations), streamlining budgetary preparation to bring off-budget spending on-budget, and establishing frameworks for shifting infrastructure projects toward a public-private partnership basis in cases where this is appropriate.

- ***Financial liberalization.*** The Bank is working with the authorities on the development of a financial sector reform strategy. The Fund will continue to follow up on the recommendations of the 2011 FSAP and provide technical assistance to the Chinese authorities as needed.

- ***Fiscal issues.*** The Bank will continue its work on expenditure and revenue policies and on fiscal management in the context of its urbanization study, currently under preparation together with the Development Research Center of the State Council and expected to be completed early 2014. The Fund will continue to discuss the near- and medium-term implications of China's fiscal stance and policy choices on the broader economy as well as implications for global spillovers.

5. **Teams have the following requests for information from their counterparts:**

- The Fund team requests to be kept informed of progress in the above macroeconomic structural reform areas, as milestones are reached and at least on a semiannual basis.
- The Bank team requests to be kept informed of the Fund's assessments of macroeconomic policies and prospects in the context of the Article IV consultation and staff visits, and at least semiannually.

The following table lists the teams' separate and joint work programs for June 2013–June 2014.

Appendix I. China: Bank and Fund Planned Activities in Macrocritical Structural Reform Areas

	Products	Expected Delivery Date
Bank Work Program	• China Economic Reform Implementation Project (umbrella TA project, including various subprojects with MOF, PBoC, and provincial finance bureaus).	• December 2012
	• China Quarterly Update	• Ongoing
	• "Just-in-time" Policy Notes for MOF	• Delivered on demand
	• TA on Mid-term Macrofiscal Framework	• June 2013
	• Subnational Intergovernmental Fiscal Relationship	• June 2013
	• Municipal Financing and Local Debt Management	
	• Inclusive Innovation	• July 2013
	• Inclusive Finance Academy	• Ongoing
	• Financial Consumer Protection and Consumer Literacy	• Ongoing
	• Financial Reform Strategy	• Ongoing
	• Capital Market Development	• Ongoing
	• Effective, Inclusive, and Sustainable Urbanization	• Ongoing
	• The Role of Housing Provident Fund in Affordable Housing	• Ongoing
	• TA report on Statistical Master Plan	• June 2012
Fund Work Program	• December Staff Visit	• Dec 2013
	• 2014 Article IV Consultation	• May/Jun 2014
Joint Work Program	• No joint projects currently envisaged.	

RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

1. The Asian Development Bank's (AsDB) partnership with the People's Republic of China (PRC) has grown in many ways since the PRC became a member of AsDB in March 1986. The PRC is AsDB'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 2012, the PRC's cumulative borrowing from AsDB reached $26.3 billion with 192 loans for public sector projects. Of the total public sector loans, 51 percent was allocated to the transport sector, followed by agriculture and natural resources (12.5 percent) and energy (11.4 percent), water and other municipal infrastructure services (9.9 percent), industry and trade (2.6 percent), finance (2.2 percent), and multisector (10.3 percent). Over the past 25 years, AsDB has helped finance 34 private sector projects in the PRC totaling $3.54 billion.

2. AsDB also funds Technical Assistance for the PRC. By the end of 2012, AsDB had provided a total of $402.8 million in grants for 691 technical assistance projects, consisting of $124.7 million for preparing projects and $278.1 million for policy advice and capacity development.

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

4. The PRC has demonstrated its strong partnership with AsDB 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 AsDB 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 Country Partnership Strategy (CPS) 2011–15 was endorsed by AsDB Board of Directors in May 2012. The CPS 2011–2015 is aligned with the priorities of the PRC's 12th Five-Year Plan 2011–15 that intersect with those of AsDB's long-term *Strategy 2020*, particularly the redoubling of efforts to promote socially inclusive and environmentally sustainable development. The CPS reflects the PRC's changing circumstances as a rapidly growing middle-income country with increasing emphasis on innovation and value addition and South-South cooperation to underpin the evolving AsDB-PRC partnership. The CPS is built on three strategic pillars: (i) inclusive growth, (ii) environmentally sustainable growth, and (iii) regional cooperation and integration. It identifies four priority sectors for country operations during the CPS period: (i) energy, (ii) natural resources

[1] Prepared by Asian Development Bank staff.

and agriculture, (iii) transport, and (iv) urban development. The sector selection reflects AsDB's comparative strengths and expertise through its longstanding operations in these sectors.

6. Projected public sector lending in 2013–2015 will total about $4.21 billion, of which 36 percent will support the transport sector; 15 percent for agriculture, rural development, and natural resource management; 38 percent for urban development, water supply, and sanitation improvement; and 12 percent for the energy sector. Over 90 percent of the projects are located in the western, central and north-eastern regions in line with the CPS's priorities of promoting inclusive growth and environmentally sustainable growth.

AsDB'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 1. China: AsDB'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
2012	19,476	1,343

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

STATISTICAL ISSUES

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 (2010) 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. Data on the levels of expenditure components of real 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 a quarterly basis.

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). 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 at least 600 for small cities and counties and more for large and medium-size cities (e.g., 1800 for Beijing). 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 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.

Monetary and Financial Statistics

7. In recent years, improvements have been made in monetary and financial statistics. 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.

8. The April 2012 monetary and financial statistics mission discussed with the authorities the possibility of expanding the data scope of FSIs 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

9. The data are compiled (in U.S. dollars) largely in accordance with the fifth edition of the *Balance of Payments Manual* (*BPM5*). The authorities continue their efforts to improve the coverage of direct investment transactions in the balance of payments (BOP) and IIP statistics, and progress is being made in developing these statistics. Since the International Transactions Reporting System 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).

10. Despite an ostensibly modest level of external vulnerability, there remains a need to strengthen external debt monitoring and compilation. In 2010, China started submitting total and public external debt data for the Quarterly External Debt Statistics (QEDS) database, a notable step forward.

Data Standards and Quality

11. 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.

Data Reporting to STA for Publications

12. 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 publication in the *International Financial Statistics (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.

13. China has reported general government cash-based budget data for 2003–09 following the *GFSM 2001* methodology for publication in the 2011 *Government Finance Statistics 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.

14. 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.

15. 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) , which has been planned to begin in May 2013.

16. 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 semi-annual reporting prior to compiling the quarterly data.

17. The authorities have resumed reporting data on international reserves for publication in the *IFS*. However, the monthly time series are now submitted every three months, instead of every month. With regards to BOP and IIP data, the authorities started submitting quarterly data to STA for publication in the *IFS* and the *Balance of Payments Statistics Yearbook* (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

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.

China: Table of Common Indicators Required for Surveillance

(As of June 4, 2013)

	Date of Latest Observation	Date Received	Frequency of Data[9]	Frequency of Reporting[9]	Frequency of Publication[9]
Exchange rates	05/13	06/13	D	M[9]	D
International reserve assets and reserve liabilities of the monetary authorities[1]	04/13	05/13	M	M	M
Reserve/base money	04/13	05/13	Q, M	Q, M	Q, M
Broad money	04/13	05/13	M	M	M
Central bank balance sheet	04/13	05/13	M	M	M
Consolidated balance sheet of the banking system	04/13	05/13	M	M	M
Interest rates[2]	05/13	06/13	[10]	[10]	[10]
Consumer price index[3]	04/13	05/13	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	2012	03/13	A	A	A
Revenue, expenditure, balance and composition of financing[4]—central government	04/13	05/13	M	M	M
Stocks of central government and central government-guaranteed debt[6]	Q4/12	03/13	Q	Q	Q
External current account balance	Q1/13	05/13	Q	A, Q	A, Q
Exports and imports of goods and services[7]	04/13	05/13	M	M	M
GDP/GNP[8]	Q1/13	04/13	A, Q (cumulative)	A, Q (cumulative)	A, Q (cumulative)
Gross external debt	Q4/12	03/13	A, Q	A, Q	A, Q
International investment position	Q4/13	03/13	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 (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[6] Including currency and maturity composition.

[7] Goods trade data are provided monthly. Services trade data are 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.

TECHNICAL ASSISTANCE

Table 1. China: Summary of Technical Assistance, 2001–13 1/

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	Tax Administration (Peripatetic Expert Visit 5 of 5)	October 2011
FAD	Large Taxpayer Compliance	October 2011
FAD	Workshop on practical tax analysis for tax officials	December 2012
FAD	Large taxpayer admin mission	January 2013

Public Financial Management		
FAD	Workshop on government fiscal management information system	February 2001
FAD	Mission on treasury/accounting reform; macrofiscal coordination	November 2001
FAD	Mission on budget preparation, classification, and treasury reform	June 2002
FAD	Mission on budget classification	March 2003
FAD	Workshop on Budget and Treasury Modernization in Washington	October 2003
FAD	Mission on treasury and accounting reforms	November 2003
FAD	Mission on Budget Law I	March 2004
FAD	Mission on cash management	April 2006
FAD	Mission on Budget Law II	September 2007
FAD	Discuss FAD's PFM program with authorities	September 2007
FAD/STA	Mission on Accrual Accounting	September 2007
FAD	Seminar on local government cash management	December 2009
FAD	Presentation of the Budget Institutions Paper	May 2010
FAD	Fiscal Medium-Term Budget Management Seminar	November 2011
FAD	Medium-Term Revenue Administration Program and Policies Discussion	June 2012
FAD	High-level Dialogue on PFM Institutions	November 2012
FAD	Treasury Modernization	February 2012
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
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
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
LEG	Bank Resolution	May 2012
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
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
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
A. STA	Course on Government Finance Statistics	June 2011
B. INS	H. Course on Balance of Payments Statistics	October 2011
STA	I. Course on Macroeconomic Diagnostics	November 2011
C. STA	Course on Monetary and Financial Statistics	February 2012
D. INS	Course on National Account Statistics	March 2012
E. ICD2	Course on Macroeconomic Management and Financial Sector Issues	May 2012
F. STA	Course on Macroeconomic Forecasting	September 2012
G. ICD	Course on Financial Soundness Indicators	October 2012
STA	Course on Macroeconomic Diagnostics	April 2013
	Course on Balance of Payments Statistics	

1/ The new Institute for Capacity Development (ICD) was formed from the merger of the former IMF Institute (INS) and Office of Technical Assistance Management (OTM) on May 1, 2012.

PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

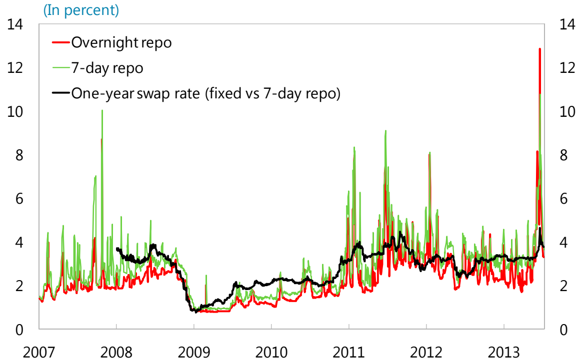
July 9, 2013

Prepared By | Asia and Pacific Department

1. **This supplement reports on developments since the staff report was finalized**. This new information does not alter the thrust of the staff appraisal.

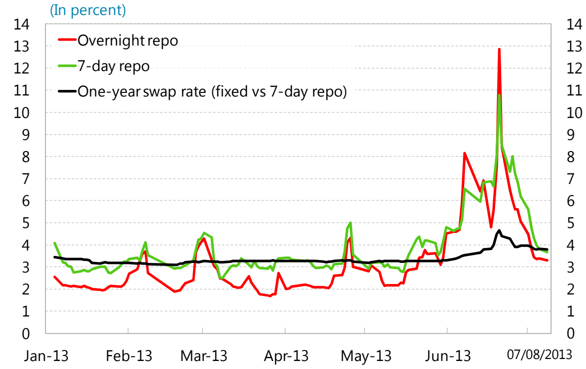
2. **Interbank market**. Interbank interest rates increased markedly in early-June, but have since retreated close to their previous levels. The tight liquidity conditions reflected a combination of domestic seasonal factors (such as a June 10–12 holiday and corporate tax payments), reduced capital inflows, and the fact that the central bank did not accommodate fully the associated demand for liquidity. This was designed to signal the central bank's intention to contain overall credit expansion and, in particular, to rein in rapid growth of nontraditional forms of lending that make use of the interbank market. Interbank interest rates periodically spike, often around holidays when demand for liquidity is high. However, the recent episode was more pronounced and lasted longer than previous ones as the central bank initially refrained from providing liquidity. After several days of progressively tighter market conditions, exacerbated by uncertainty and a stronger reaction by banks than anticipated (as even liquid banks were reluctant to lend), the central bank provided some additional liquidity. It also announced that it would ensure sufficient market liquidity going forward, while emphasizing that banks needed to improve their own liquidity management. As a result, interbank rates have come down significantly. For example, as of July 8, the seven-day repo rate stood at 3.7 percent compared to an average of 3.3 percent during the first five months of the year. The one-year swap rate was 3.8 percent as of July 8, which suggests that the market expects a further easing of liquidity conditions in the months ahead.[1]

Interbank Interest Rates
(In percent)



Sources: CEIC; Bloomberg; and IMF staff calculations.

Interbank Interest Rates
(In percent)

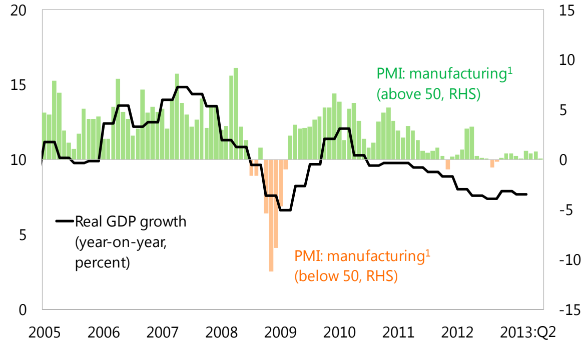


Sources: CEIC; Bloomberg; and IMF staff calculations.

[1] The one-year swap rate captures expectations about the future direction of the seven-day interbank repo rate, as well as a term-premium.

3. Economic outlook. Downside risks to staff's 2013 growth projection have increased. The Purchasing Managers Index, an indicator of industrial activity, weakened slightly in June (to 50.1, from 50.8 in May). Official second-quarter GDP estimates, along with many of the monthly indicators for June, will be published on July 15, 2013 and will provide further insights on the outlook for the remainder of this year.

China: Real GDP Growth and PMI



Sources: CEIC; and IMF staff calculations.
[1] Calculated by subtracting 50.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 13/260
FOR IMMEDIATE RELEASE
July 17, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation Discussions with the People's Republic of China

On July 12, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions with the People's Republic of China.[1]

China's economy is expected to grow at around 7¾ percent this year, notwithstanding a moderate slowdown during the first half, with resilient domestic demand offsetting lingering weakness in the external environment. Inflation has continued its downward path, and with persistently high investment contributing to excess capacity in many sectors, is likely to remain subdued around 3 percent this year and next.

Macroeconomic policies have been supportive toward achieving this year's growth target. The overall fiscal deficit is likely to be around 2 percent of GDP, similar to last year. Strong growth in total social financing is expected to underpin a slight rebound of activity in the second half of this year. Capital inflows have resumed in recent months and the renminbi has appreciated by around 1½ percent against the U.S. dollar in the year through June, and by about 6 percent in real effective terms. International reserves have risen to about US$3.44 trillion at the end of March (up from US$3.31 trillion at the end of 2012).

Last year the current account surplus increased slightly to 2¼ percent of GDP, from just under 2 percent in 2011. Nevertheless, China's progress on external rebalancing has been substantial—the current account as a share of GDP is now less than a quarter of its pre-crisis peak in 2007. By contrast, domestic imbalances remain large. National accounts data show that last year gross fixed capital formation grew further as a percent of GDP, while private consumption was broadly unchanged, indicating that a decisive shift toward a more consumption-based growth path has yet to occur. Accelerating the transformation of the

[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.

growth model remains the main priority, as reaffirmed in recent policy announcements by the new administration.

Executive Board Assessment

Executive Directors welcomed China's continued strong economic growth with subdued inflation. Directors noted nevertheless that the growth outlook is clouded by mounting domestic vulnerabilities in the financial, fiscal, and real estate sectors. At the same time, potential spillovers from developments in the euro area and major advanced economies continue to pose external risks. Directors agreed that China has the capacity to withstand shocks, but considered that a further strengthening of policy buffers over time would be desirable.

Accordingly, Directors underscored the importance of transitioning to a new growth path that is more consumption-based, inclusive, and environmentally friendly. They welcomed the authorities' reform strategy in this direction, which charts a path toward mitigating risks, rebalancing growth, and addressing income disparities, thus safeguarding China's important contribution to global growth.

Executive Directors agreed that the near-term challenge is to contain risks to financial stability, by reining in credit growth and nontraditional forms of lending. Going forward, Directors stressed that a more market-based financial system would help improve the allocation of capital, boost household income, and prevent a further buildup of risks. Emphasizing that financial sector liberalization should progress at the appropriate pace and sequencing, they considered as pressing priorities further deregulation of interest rates, greater use of market-based instruments in monetary management, and enhanced prudential oversight, including over the activities of non-banks.

In this connection, Directors agreed that a more robust and transparent framework for resolution of bad debts and troubled financial institutions would facilitate an orderly exit of weak institutions. They also welcomed the authorities' plan to introduce deposit insurance, and encouraged them to take steps to remove the perception of implicit government guarantees on some financial products, which would ensure a more effective pricing of risk and limit moral hazard.

Directors recognized the contribution of off-budget, quasi-fiscal activity in supporting demand since the global financial crisis. Nonetheless, they encouraged the authorities to unwind it gradually to limit fiscal risks and, if economic growth slows down too sharply, they recommended using on-budget fiscal stimulus, focused on consumption.

Directors also encouraged continued efforts to strengthen the governance and transparency of local government finances while protecting priority spending. In addition, shifting the tax burden from social contributions toward more progressive and efficient forms of taxation, including a value added tax, would boost the role of private consumption as a growth-driver and reduce income inequality. Directors welcomed the authorities' indication to consider this as part of a comprehensive reform of the social security system.

Taking note of the staff's assessment that the renminbi remains moderately undervalued, Directors considered that a more market-based exchange rate system would facilitate further internal and external rebalancing. They supported the authorities' policy of restraining foreign exchange intervention, thereby allowing market forces to play a greater role in exchange rate determination.

Directors stressed the importance of advancing structural reform under the Twelfth Five-Year Plan. They encouraged continued liberalization of the capital account, carefully sequenced with financial and exchange rate reforms. Further progress on demand rebalancing is particularly crucial, including by opening markets to domestic and foreign competition, especially in the services and upstream industries, raising resource prices and taxes, and increasing dividend payments by state-owned enterprises to the budget.

Recognizing China's rapid economic and financial development and its increasing global importance, Directors supported plans to continue to upgrade the statistical base, which they hoped will eventually lead to China's subscription of the Fund's Special Data Dissemination Standard. In particular, they welcomed the authorities' ongoing efforts to improve data on local government finances.

China: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013	2014
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	9.6	9.2	10.4	9.3	7.8	7.8	7.7
Total domestic demand	9.6	13.9	10.6	10.2	8.4	8.3	8.0
Consumption	8.6	9.4	9.2	11.0	8.4	8.5	8.1
Investment	10.8	19.2	12.0	9.5	8.4	8.1	7.9
Fixed	9.5	22.8	11.4	9.1	10.0	8.4	8.2
Inventories 1/	0.8	-0.8	0.5	0.4	-0.5	0.0	0.0
Net exports 1/	0.9	-3.5	0.4	-0.4	-0.2	-0.2	-0.1
Consumer prices							
End of period	1.2	1.9	4.6	4.1	2.5	3.1	3.0
Average	5.9	-0.7	3.3	5.4	2.6	3.0	3.0
Unemployment rate (annual average)	4.2	4.3	4.1	4.1	4.1	4.1	4.1
	(In percent of GDP)						
External debt and balance of payments							
Current account	9.3	4.9	4.0	1.9	2.3	2.5	2.7
Trade balance	8.0	5.0	4.3	3.3	3.9	3.7	3.4
Exports of goods	31.7	24.1	26.7	26.0	25.0	24.6	24.7
Imports of goods	23.8	19.1	22.4	22.7	21.1	20.9	21.3
Gross external debt	8.6	8.6	9.3	9.5	9.0	9.8	10.3
Saving and investment							
Gross domestic investment	44.0	48.2	48.2	48.3	48.8	48.8	49.0
National saving	53.4	53.1	52.2	50.1	51.2	51.4	51.6
Public sector finance							
General government gross debt	17.0	17.7	33.5	28.7	26.1	22.4	19.9
General government balance	-0.7	-3.1	-1.5	-1.3	-2.2	-2.1	-1.8
	(Annual percentage change)						
Real effective exchange rate							
Annual average	9.2	3.4	-0.4	2.7	5.7	...	...
End of period	12.4	-5.0	5.3	5.9	1.1	...	...

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; 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 2013 Article IV Consultation with People's Republic of China
July 12, 2013

On behalf of my authorities, I thank staff for the discussions held during the mission. My authorities value staff's constructive dialogue and advice, and appreciate the importance of this annual consultation with the Fund. I am pleased to confirm my authorities' intention to publish the staff report.

The Chinese economy remains firm despite facing a lackluster external environment. In particular, growth was maintained at a solid pace, and inflationary pressures remained subdued. At the same time, structural adjustments of the economy continue to proceed, with consumption playing a bigger role in driving economic growth, helping to restrain current account surplus alongside. Meanwhile, the banking sector remains sound, and new measures were actively rolled out to regulate local credit conditions and nonbank financing. Issues on local government debt also continue to be monitored closely and were addressed with further rounds of actions. To promote a healthy development in the local property market, measures were implemented and fine-tuned to contain price pressures, while social housing construction continues to receive full policy support to assist the less well-off.

The Chinese Government will build on the progress achieved under the Twelfth Five-Year Plan to continue to balance the economy toward consumption, putting balanced emphasis on the quality and pace of growth. The Government is determined to transform the growth model through accelerating structural reforms, including further interest rate liberalization, exchange rate reform, capital account convertibility, and strengthening the service sector. Meanwhile, urbanization will continue to be promoted to help double the GDP as well as income per capita by 2020, compared with the levels in 2010. While a short-run economic slowdown may result, the Government sees reforms to be necessary in order to settle the economy on a sustainable and inclusive long-run growth path. Having said that, the Chinese economy is still on track to achieve the 7.5 percent growth target this year, with monetary and fiscal policies being well-placed to help smooth the structural adjustment in the economy.

Recent economic developments

The Chinese economy maintained a stable growth pace on the back of solid domestic demand. Real GDP grew at 7.7 percent on a year-on-year basis in the first quarter of this year, after expanding at 7.8 percent in 2012. Growth of fixed asset investment also remained stable, registering at 20.6 percent in 2012 and 20.4 percent in the first five months of this year, with the pickup in infrastructure and real estate development investment largely countering the slowdown in manufacturing and other investment. Retail sales growth, however, slowed to 12.6 percent in the first five months of this year from 14.3 percent in

2012, partly due to my authorities' efforts to rein in administrative spending. Industrial production growth also slowed down somewhat over the same period, from 10.0 percent in 2012 to 9.4 percent in the first five months of this year. Recent releases of the PMI suggested that China's economic growth is likely to remain steady in the near term, with solid income growth of households and the pickup in industrial profits growth expecting to provide support to consumption and investment spending going forward.

Inflation remained largely subdued. After registering at 2.6 percent in 2012, the CPI inflation rate dropped to 2.4 percent on a year-on-year basis in the first half of this year, mainly due to the moderation in food price inflation. Meanwhile, the producer price inflation rate dropped further to -2.2 percent on a year-on-year basis in the first half of this year, from -1.7 percent in 2012, as global commodity prices remained largely contained during the period. Notwithstanding the subdued inflationary pressures, my authorities remain highly vigilant to potential challenges to price stability, in view of the upward pressures on labor cost, resource products price reforms, and abundant global liquidity. My authorities' projection of CPI inflation for 2013 is 3.5 percent.

Fiscal policy

My authorities see a proactive fiscal policy to remain appropriate. On the revenue front, fiscal revenue growth moderated to 6.6 percent on a year-on-year basis in the first five months of 2013, after registering at 12.8 percent in 2012. The deceleration in the revenue growth was largely due to the economic slowdown and structural tax cuts, with the latter being part of my authorities' continuous efforts to promote a stronger private sector. On the expenditure front, fiscal expenditure growth dropped from 15.1 percent in 2012 to 13.2 percent in the first five months of this year, with my authorities continuing to shift expenditure composition away from administrative spending to social spending. For 2013 as a whole, the budget deficit is set at RMB 1.2 trillion (about 2 percent of GDP), and my authorities will provide any needed fiscal cushion mainly through on-budget stimulus.

Fiscal indebtedness remains manageable. The central government debt-to-GDP ratio edged down further to 14.9 percent in 2012, while the pace of expansion in local government debt remained controllable. According to staff's estimates based on official data, taking into account local government debt, the general government debt-to-GDP ratio still remained moderate by international standards, and has dropped to 26.1 percent of GDP in 2012, from 28.7 percent of GDP in 2011 and 33.5 percent of GDP in 2010, respectively. More importantly, China's favorable interest rate-growth differential, as estimated by the latest IMF Fiscal Monitor, will help restrain any upward pressure on the debt-to-GDP ratio going forward. Having said that, my authorities are highly vigilant to potential risks stemming from local government indebtedness, and had taken prompt actions to restrain local government borrowing, such as prohibiting injection of land reserves into LGFVs and halting irregular financing activities of local governments. Meanwhile, pilot programs on municipal bonds and property tax had been implemented, and can be expanded, when appropriate, to provide more transparent and sustainable funding sources to ease local governments' fiscal pressures.

Monetary policy

A prudent monetary policy stance remains appropriate to guard against inflation and financial risks. M2 growth picked up during the year to reach 15.8 percent in May, on the back of the large increase in foreign exchange inflows, robust loan growth, and money creation through channels such as bond purchases by financial institutions and interbank transactions. Were foreign exchange inflows to dampen going forward, my authorities are confident that M2 growth will gradually be brought back into line with the annual target of 13 percent, and will take appropriate policy action, if needed. My authorities also remain vigilant to ensure that credits are expanding at an appropriate pace, and are flowing to support the real economy, particular the SMEs. On the other hand, the PBC introduced new liquidity management tools, namely the short-term liquidity operations and standing lending facility, to smooth interbank liquidity conditions. While volatilities in the interbank market had emerged recently, partly due to seasonal and sentimental factors, it is important to emphasize that overall liquidity in the banking system has been adequate, as evidenced by banks' ample excess reserves. The PBC has also pledged to maintain stable interbank liquidity conditions and to provide liquidity support to financial institutions that meet macroprudential requirements. As such, interbank liquidity conditions have largely normalized.

Financial sector

The banking sector remains in good shape, with the latest stress-testing results conducted by the CBRC suggesting that commercial banks would be resilient to various shocks and exposures. Meanwhile, the Basel III capital requirement has begun to be implemented, conducive to banking stability going forward. To further guard against financial stability risks, my authorities have stepped up supervision on banks' off-balance sheet and nonbank financing activities, such as imposing new requirements on banks' wealth management product (WMP) business, and restricting nonbank financing for LGFVs. The CBRC also issued new guidance requiring banks to enhance their monitoring, underwriting standards, and disclosures of exposures to LGFVs, as well as capping banks' exposures to LGFVs. On the other hand, actions were taken to address other sources of vulnerabilities in the financial system, such as the concerted actions taken to eliminate irregular activities in the interbank bond market, and the imposition of new requirements on limiting excessive positions on foreign exchange flows. A new round of measures, including enforcement of capital gains tax on existing home sales, hiking down-payment ratio and mortgage rate, were also implemented to dampen the property market, further ensuring financial stability.

External sector

China's current account surplus remained subdued at a low level of 2.3 percent of GDP in 2012 due to a confluence of factors, mainly including structural adjustments in the economy. In particular, the RMB has become more flexible over time, which allows the level of the RMB exchange rate to stay close to its equilibrium level. Contained international commodity prices and subdued external demand also contributed to the reduction in the current account surplus. While cyclical factors had been at work, my authorities see staff's baseline view on the medium-term current account path to lie on the high side, particularly in view of the observed upward bias in staff's past projections. In my authorities' view, the current account path under the rebalancing scenario is deemed more accurate, with the ongoing economic adjustments amidst further urbanization, increased flexibility of the RMB, demographic changes, and factor price reforms helping to restrain the medium-term current account.

On the exchange rate assessment, my authorities view that the quality and the reliability of the EBA estimation results are yet to be addressed. The sizable unidentified factors in the estimated model also make it very clear that the EBA methodology is not yet ready for policy analysis. Meanwhile, the broad range of estimates under the CGER methodology means that it is contentious of whether the RMB is indeed undervalued. Overall, my authorities view that both the EBA and the CGER methodologies have not yet been able to capture the rapid structural changes in many economies, including China, and so further work on the subject is needed.

As noted in the staff report, the small net capital outflows in 2012 were associated with changes in exchange rate expectation. This suggested that the RMB exchange rate could exhibit more two-way movements, as flexibility of the exchange rate increases further going forward. My authorities continue to uphold the principle that foreign exchange intervention would be restrained in order to allow market supply and demand to play a greater role in exchange rate formation. This can be observed from the fact that reserve accumulation was largely absent in 2012, with the recent intervention being an anomaly triggered partly due to the unconventional monetary policies in advanced economies.

Reforms

Structural rebalancing of the economy has been proceeding in line with the Twelfth Five-Year Plan. The importance of the service sector in the economy continued to increase, with the size of the tertiary industry largely equalizing that of the secondary industry in 2012. There are also signs that labor share of income has picked up, with both growth in the per capita real disposable income of urban household and the per capita real net income of rural household outpacing the real GDP growth in 2012. This, together with my authorities' efforts on strengthening social spending, supported a continued rebalancing of the economy toward consumption during the year. In particular, consumption remained as the main driver of growth in 2012, with the growth contribution of the final consumption expenditure component being higher than that of the gross capital formation component for the second consecutive year.

While the importance of investment in the economy is set to be reduced, investment growth is expected to remain steady as economic rebalancing proceeds. While my authorities have actively voiced against investment in sectors with excess capacity and high pollution, my authorities continued to support urban and social infrastructure investment in order to promote urbanization and enhance people's living standards. Moreover, my authorities are determined to strengthen social housing investment in order to address social tensions and protect the poor. With all that said, investment is unlikely to experience any sharp contraction going forward, with an orderly rebalancing process in China benefiting the global economy alongside.

My authorities have actively rolled out new reform plans, manifesting the strong determination for reforms. On the financial sector, my authorities see the desirability of facilitating orderly operations of market forces, and will continue to strengthen financial infrastructure and supervisory oversight. A priority for this year is to promote further interest rate liberalization and introduce deposit insurance. Meanwhile, further capital account convertibility has been streamlined. Deepening exchange rate reform remains an important agenda, with my authorities committing to further increase the flexibility of the RMB exchange rate. On the fiscal front, measures have been initiated to improve the expenditure structure and reform the budget system for better transparency and inclusiveness. Government restructuring was also carried out to improve administrative functions and reduce government intervention on the economy. To ensure sustainable growth, my authorities have outlined plans for establishing a strict environmental protection system, by expanding further the resource pricing reform, and imposing higher taxes and levies on products and sectors that cause pollution, particularly coal. On social welfare, my authorities continue to emphasize social protection, particularly the importance of enhancing the pension, education, medical, and healthcare system. In this regard, my authorities see the need for allowing migrant workers to access the same social services as urban residents.

My authorities place high importance on transparency, and are committed to maintain high data quality in order to benefit the international community. My authorities have been supportive of the Fund's data initiatives, such as the GDDS and the SDDS, and have stepped up efforts to engage with the Fund in this regard.