

People's Republic of China

A V-shaped economic recovery in 2009 was underpinned by very expansionary fiscal and monetary policies. Strong investment and, to a lesser extent, growth in consumption largely offset the impact of shrinking external demand. Allowing for some adjustments, expansionary policies will continue this year. Coupled with a stronger global economy, GDP growth is forecast to accelerate. Inflation will rise from low rates. A new five-year plan provides an opportunity to revamp the structure of growth, in particular to encourage increases in private consumption.

Economic performance

Aggressive fiscal and monetary stimulus in the People's Republic of China (PRC) in 2009 offset much of the impact of the global recession. After a weak first quarter, the economy picked up pace over the rest of the year (Figure 3.9.1), spurred by the stimulus measures and a recovery in exports, to record growth of 8.7%. That outturn compares with double-digit expansion in the 2003–2007 period and with 9.6% in 2008.

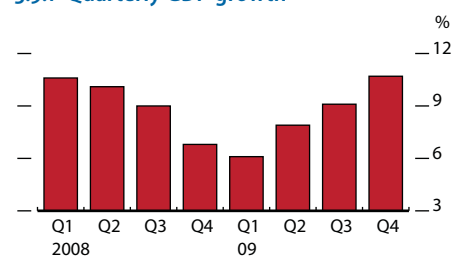
A slowdown in industry, which produces nearly three-fifths of GDP, was the main cause of last year's slower GDP growth on the output side. Growth in industry decelerated to 9.5% in 2009, although it still contributed most to the total expansion of GDP (5.5 percentage points—Figure 3.9.2). Industry picked up as the year progressed (Figure 3.9.3) as a result of a stimulus-led investment boom and some improvement in exports. Growth eased in services to a still robust 8.9%, and in agriculture to 4.2%, owing to a drought in the south.

The V-shaped recovery was driven mainly by domestic demand, especially public investment that benefited from the stimulus policies. Total investment contributed 8 percentage points, or a record 92%, of total GDP growth on the demand side. The investment-to-GDP ratio rose to nearly 46% (Figure 3.9.4), the highest level in at least three decades. Consumption contributed 4.6 percentage points of total growth. In contrast, a fall in net exports subtracted 3.9 percentage points from GDP growth.

Fixed asset investment accelerated by just over 30% in nominal terms in 2009, from 26% in 2008. Reflecting the priorities of the government's stimulus plan, investment in agriculture soared by nearly half and investment in services (mainly transport such as railways and urban public systems) jumped by 33.0%. Investment in industry also surged (by about 27%), while a 17.2% rise in property investment was a little slower than in 2008.

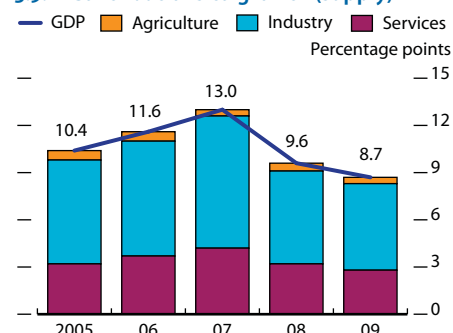
Consumption, both private and government, played a role in 2009's recovery, although not the leading role taken by investment. The volume

3.9.1 Quarterly GDP growth



Source: CEIC Data Company (accessed 15 March 2010).

3.9.2 Contributions to growth (supply)



Sources: National Bureau of Statistics of China. <http://www.stats.gov.cn> (accessed 15 March 2010); ADB estimates.

of retail sales, a proxy for consumption, took a hit early in the year amid widespread layoffs of migrant workers and a fall in consumer confidence, but it then strengthened (Figure 3.9.5) to be up by 16.2% in real terms for the year. Government incentives to buy cars propelled automobile sales to 13.6 million (when the PRC became the world's biggest car producer). Consumption was also supported by rising real incomes—by 9.8% in urban areas and by 8.5% in rural areas.

The slump in exports caused by the global recession bottomed during the first half of 2009 (Figure 3.9.6), and export growth was back in positive territory by December. For the year though, merchandise exports in US dollar terms fell by 16.1%. Merchandise imports, too, shot up late in 2009, reflecting robust domestic demand and recovering exports—but again, for the year they fell by 11.2%. As this was a smaller contraction than exports', the trade surplus narrowed by \$111 billion. With a widening deficit in services trade, the current account surplus was trimmed by about 33%, to \$284.1 billion (5.8% of GDP).

Reflecting the global financial crisis, foreign direct investment (FDI) fell for the first 7 months of 2009, then started to rebound. FDI for the year was down by about 17%, at a still substantial \$90 billion.

The trade surplus, FDI, and other capital inflows boosted foreign exchange reserves to \$2.4 trillion. However, the stepup in capital inflows also raised some concerns about speculation in booming property and stock markets.

A key element of the stimulus program was to flood the economy with credit from state-owned banks, mainly for fixed asset investment. Bank lending surged by CNY9.6 trillion, more than double the amount in 2008 and equivalent to about 29% of GDP. About a quarter of the credit went on infrastructure, such as airports, railways, and city transportation networks, and 15% on housing. State-owned enterprises received the majority.

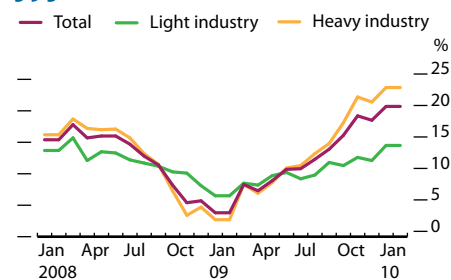
After the first half's huge surge in credit, the authorities started to check it in the second (Figure 3.9.7), concerned that it could fuel asset bubbles and inflation, and erode the quality of bank loan portfolios. Broad money supply (M2) climbed by 27.7% over the year, exceeding the target of 17%.

The yuan was kept steady against the US dollar in 2009, part of the stimulus program to support exports. Against a basket of currencies, though, it depreciated by 5.0% in real effective terms, according to the Bank for International Settlements.

Inflation dissipated in 2009, owing to lower global oil prices, another bumper harvest at home, and overcapacity in several manufacturing subsectors. The consumer price index fell for most of the year, recording year-on-year increases only in November and December (Figure 3.9.8), when food and housing costs rose. The flood of bank lending fed into rising asset prices—the Shanghai A-share stock market index gained 80% last year and property prices rose after midyear (Figure 3.9.9) to be up nearly 6% year on year in the fourth quarter. Local governments rely on land sales for much of their revenue, so have an incentive to promote real estate development. Their income from land sales, according to the central government, climbed by 60% to \$233 billion in 2009.

Fiscal stimulus measures designed to counteract the impact of the global recession focused on infrastructure and, to a smaller extent,

3.9.3 Growth in industrial value added



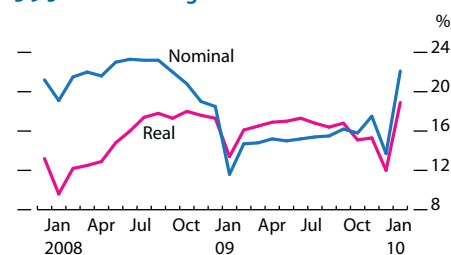
Source: CEIC Data Company (accessed 15 March 2010).

3.9.4 Total investment



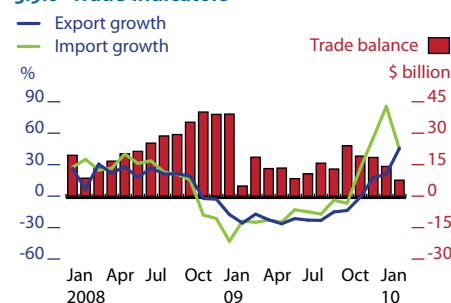
Sources: National Bureau of Statistics of China. <http://www.stats.gov.cn> (accessed 15 March 2010); ADB estimates.

3.9.5 Retail sales growth



Source: CEIC Data Company (accessed 15 March 2010).

3.9.6 Trade indicators



Source: CEIC Data Company (accessed 15 March 2010).

affordable housing, rural development, and social spending. The fiscal package involves expenditure of CNY4 trillion over 2 years from November 2008 (equivalent to 12.7% of 2008 GDP). The allocation for infrastructure was reduced in March 2009 from 45% to 38% of the total, and funds for social projects (such as health care and education) were raised from 1% to about 4%.

Given relatively low levels of central government debt (about 30% of GDP including domestic and foreign debt) and small budget deficits, the debt-funded package is manageable. The government will issue bonds to cover 25% of the fiscal stimulus, with the rest provided by local governments and low-interest loans from state banks. About half the fiscal stimulus was disbursed in late 2008 and during 2009, leaving the rest for this year.

Total fiscal expenditure, including that for the fiscal stimulus, rose by just over 21% in 2009. Revenue increased by nearly 12%. The fiscal deficit came in at just 2.8% of GDP (Figure 3.9.10).

An estimated 20 million migrant workers had lost their jobs by early 2009 as demand for manufactured exports dived. The labor market started to improve in the second quarter, on the back of improving industrial production and construction. By year-end, some employers in eastern provinces reported labor shortages, a result of strengthening export orders and moves by unemployed migrant workers to other regions that were benefiting from stimulus-funded infrastructure projects. The government said that 11 million new jobs were generated last year, above its target, but fewer than the average 24 million new job seekers who enter the labor market every year.

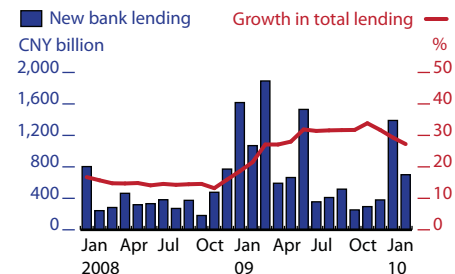
Economic prospects

Fiscal policy is expected to remain expansionary in 2010. There will likely be adjustments as the government acts to avoid potential problems caused by the flood of investment. For example, the authorities have indicated that they will make efforts to contain investment that results in excess industrial capacity, and will curb rising indebtedness of local governments brought about by their extensive investment projects. The fiscal deficit is projected to remain around 2.8% of GDP in 2010 but slightly fall to 2.6% of GDP in 2011.

Some moderation is expected in the highly stimulatory monetary policy, in light of the strengthening of economic activity and rising inflation and asset prices. Policy fine tuning was seen from July last year. A more potent adjustment was made in January and February 2010 when the People's Bank of China (the central bank) raised the reserve-requirement ratio for banks twice, to 16.5%. This ratio may well be raised further this year, and banks may be required to put aside larger provisions for bad debts. Interest rates will probably be raised as the year progresses.

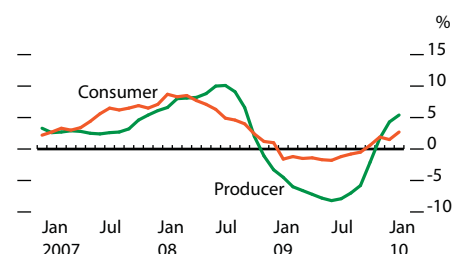
The government's target for M2 money supply growth in 2010 is 17% (as in 2009). The exceptional rate of increase in new bank lending seen in 2009 is to be pared back, but the 2010 target of CNY7.5 trillion is still more than 70% higher than the 2007–2008 average. The monetary authorities will probably shift from a relatively easy monetary policy in 2010 to a tighter stance in 2011.

3.9.7 Bank lending



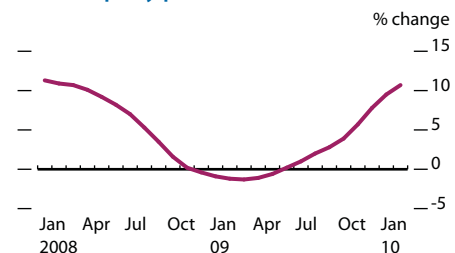
Sources: CEIC Data Company (accessed 15 March 2010); ADB estimates.

3.9.8 Inflation



Source: CEIC Data Company (accessed 15 March 2010).

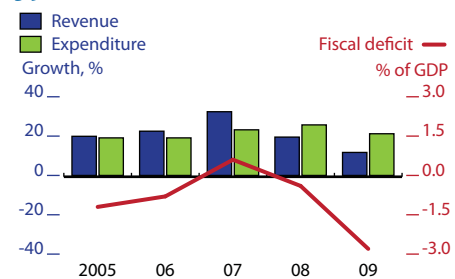
3.9.9 Property prices



Note: Data cover both residential and nonresidential buildings.

Source: CEIC Data Company (accessed 15 March 2010).

3.9.10 Fiscal indicators



Source: CEIC Data Company (accessed 15 March 2010).

Forecasts assume the authorities may well tolerate some slight appreciation of the yuan this year, and more in 2011, in the context of sustained economic growth, a revival of inflation, and a rising current account surplus. They also assume there will be no significant natural disasters or serious epidemic diseases in the forecast period.

Investment in fixed assets is projected to grow by 25% in nominal terms, underpinned by the huge stimulus funding yet to be disbursed and by an expected increase in private investment now that global financial flows are accelerating. Still, investment will slow from 2009's hectic pace because of the firmer stance on bank lending. As the fiscal stimulus phases out, growth in fixed asset investment in 2011 is projected to moderate to 18%.

Private consumption growth in nominal terms is forecast to speed up to 12% in 2010, from 9.0% in 2009, responding to rising incomes and improving consumer confidence (Figure 3.9.11). Planned increases in government spending on health care, education, and pensions will support consumption. Furthermore, the government is considering changes to the *hukou* (household registration) system, which divides the population into rural and urban residents and limits migrant workers' access to subsidized education, health care, housing, and pensions when they move to work in cities. The system hampers the mobility of labor, reduces disposable incomes of migrant workers, and widens the income gap between rural and urban areas. The authorities late last year marginally eased the *hukou* system but only for some small and medium-sized cities.

The modest recovery in world trade envisaged in *ADO 2010* will prompt a rebound in PRC merchandise exports in 2010, forecast at nearly 13.0% in 2010 and 13.5% in 2011. A free-trade agreement between the PRC and members of the Association of Southeast Asian Nations, effective 1 January this year, will contribute to growth in trade. Imports are forecast to increase by 13.5% in 2010 and 15.0% in 2011, owing to robust domestic demand and higher global prices for oil and other commodities. The increase in the trade surplus and the income account will be more moderate than in domestic demand, and the current account surplus is forecast to narrow a little as a share of GDP.

In contrast to 2009, net exports in real terms will probably rise this year and contribute slightly to GDP growth. Net exports will rise further next year, but not to levels seen prior to the global recession, given the modest recovery expected for industrial countries.

Based on the above considerations, GDP is forecast to grow by 9.6% in 2010 (Figure 3.9.12). Growth will be stronger in the first half of 2010 owing to the relatively lower base in the prior-year period than the second half. Taking into account the phasing out of the stimulus policies, growth is forecast at 9.1% in 2011. The declining contribution to GDP growth from investment will be partly offset by a larger contribution from consumption and net exports.

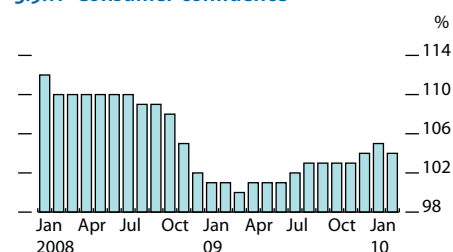
Growth data for the first 2 months showed a solid start to 2010, although some of this was a low-base effect—the prior-year period was the weakest part of 2009. In year-on-year nominal terms, fixed asset investment climbed by nearly 27%, retail sales by about 18%, and exports by 31% in January–February 2010 from a year earlier. Industrial value added grew by about 21% in real terms. M2 money supply growth of

3.9.1 Selected economic indicators (%)

	2010	2011
GDP growth	9.6	9.1
Inflation	3.6	3.2
Current account balance (share of GDP)	5.7	5.3

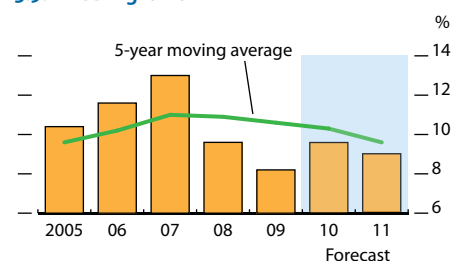
Source: ADB estimates.

3.9.11 Consumer confidence



Source: CEIC Data Company (accessed 15 March 2010).

3.9.12 GDP growth



Sources: National Bureau of Statistics. <http://www.stats.gov.cn> (accessed 15 March 2010); ADB estimates.

25.5% in February was well above the 2010 target, and new bank lending in the first 2 months totaled CNY2.1 trillion, or already 28% of the full-year target.

Higher prices for oil and commodities, coupled with a narrowing of the economy's output gap, will put upward pressure on prices, offset to some extent by the expected firmer stance in monetary policy. Consumer price inflation is forecast at 3.6% in 2010 and 3.2% in 2011 (Figure 3.9.13), still below the 2007–2008 levels of about 5%–6%. For the first 2 months of 2010, it averaged 2.1%. Residential property prices jumped by 13.0% year on year in February, even though the growth rate of housing sales eased.

Downside risks to the growth forecasts are a weaker than expected global recovery and an intensification of trade-related disputes. On the upside, a continuation of highly stimulatory monetary policy (without the expected adjustments) would likely produce higher rates of GDP growth, but could overheat the economy so that a spike in inflation and increased speculation in stocks and property trigger a more severe monetary tightening later. Rapid rates of lending, if maintained for too long, also raise the risk that local governments, in particular, pursue imprudent investment projects that erode bank asset quality, leading to higher levels of nonperforming loans that weaken the banking system.

Development challenges

The global recession and expected modest recovery in industrial countries have reduced the potential for exports to be a major driver of growth. While massive fiscal and monetary stimulus has acted as a substitute in the short term, there is a limit to public investment and monetary expansion. Sustaining economic growth in the medium and long term is likely to require a revamp of the structure of growth.

From the supply side, services have great potential to generate growth and employment. They accounted only for about 42% of GDP and 35% of employment in 2008, much less than in other countries with similar per capita incomes (Figure 3.9.14). However, unlocking the potential of services requires comprehensive reforms (Box 3.9.1).

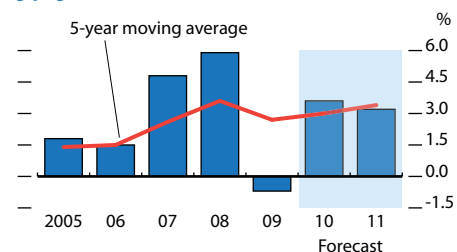
On the demand side, a greater emphasis on private consumption would promote economic growth and raise living standards. Under the current investment-driven economic growth model, the share of private consumption in expenditure-based GDP has fallen by 15.8 percentage points in the past 20 years (Figure 3.9.15).

The stress on investment has also led to overcapacity in some industries and unsustainable use of natural resources. Expanding investment is relatively easy in a system where state-owned enterprises are fed with substantial amounts of public investment that they promptly channel into expansion. Increasing private consumption, in contrast, requires raising purchasing power and changing saving habits across the population.

Growth in consumption is limited by household income's declining share of total income. The share of household income in total national disposable income shrank from about 66% in 1997 to 58% in 2007, while the share of government income increased from about 17% to 20% and that of enterprises from 17% to 22% (Figure 3.9.16).

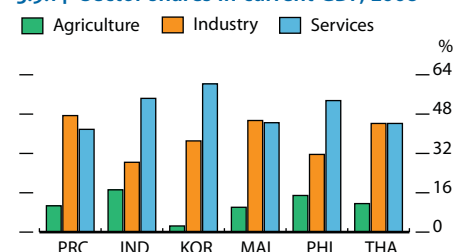
Furthermore, households are concerned about saving for education,

3.9.13 Inflation



Sources: National Bureau of Statistics. <http://www.stats.gov.cn> (accessed 15 March 2010); ADB estimates.

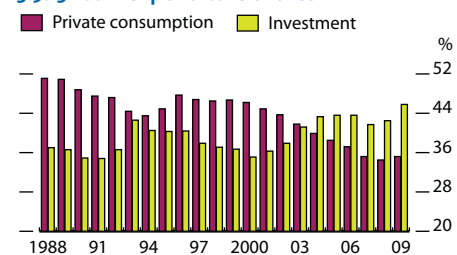
3.9.14 Sector shares in current GDP, 2008



PRC = People's Rep. of China; IND = India; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; THA = Thailand.

Source: Asian Development Outlook database.

3.9.15 GDP expenditure shares



Source: CEIC Data Company (accessed 15 March 2010).

health care, and old age, in the context of inadequate social services. Urban and rural incomes in nominal terms rose by an annual average of 12.4% and 9.7%, respectively, in 2000–2008. Savings of all households rose faster than incomes, by 16.5%. Against this backdrop, a significant increase in consumption is likely to require a strengthening of the social safety net, and provision of well-targeted public goods, such as education, health care, and affordable housing, as well as higher incomes.

High GDP growth rates in the past three decades have not been accompanied by the expected increases in employment generation. On the contrary, the relationship between GDP growth and employment has weakened, given the capital-intensive nature of growth in the past few years. This has led to large labor surpluses, mainly in rural areas, compounded by rigidities in the labor market, including the non-portability of benefits and restricted labor mobility owing to the cumbersome *hukou* system.

To address these issues, a profound reform in the labor market is warranted. The main targets should include labor mobility through the relaxation of the *hukou* system, improved social security provision for all workers (including migrants), and greater portability of acquired benefits of potentially mobile workers. Enhanced mobility will help both lift rural incomes and narrow urban-rural and regional income disparities. This process would greatly benefit from development of labor-intensive services and from further urbanization, the latter entailing great potential for future growth.

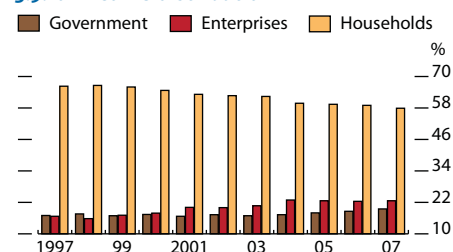
Increased labor mobility and a better educated and trained workforce would also help mitigate the impact on the economy of the aging of the population. Aging is particularly challenging in the PRC, because it is happening at a relatively low level of per capita income.

The sustainability of the current high energy-consuming and environment-unfriendly growth model is doubtful. A more sustainable model would be more reliant on technology, innovation, and skills. That could be achieved by increasing spending on research and development, which at present is below the government's target. Large investments in education and vocational training are also needed.

The government is aware of these challenges—indeed it started planning some restructuring of the economy in the mid-1990s, as reflected in the Ninth five-year plan (1995–2000). By the 11th plan (2006–2010), it had set certain targets, such as raising the shares of services in nominal GDP (from 40.3% to 43.3%), that of services in total employment (from 31.3% to 35.3%), that of research and development expense in GDP (from 1.3% to 2%), and that of urban residents in the total population (from 43% to 47%). However, trends in the past 4 years suggest that it will be difficult to realize these targets by the end of this year.

The 12th five-year plan (2011–2015), which will likely be unveiled in March 2011, provides an opportunity to add momentum to the restructuring efforts by establishing new targets, including one for the share of private consumption in GDP, coupled with policy adjustments to achieve such a target.

3.9.16 Income distribution



Source: Shanghai Security News, 2010. The Growth of Household Incomes Should Be Matched with the Growth of the Macroeconomy (translated from Chinese). http://www.cnstock.com/paper_new/html/2010-02/25/content_72101965.htm. 25 February.

3.9.1 Developing services

Expanding the services sector would strengthen the domestic engine of growth, generate new sources of employment, and raise living standards. However, unlocking the sector's potential requires policy action on a long list of constraints. They include:

- **Excessive market concentration and entry barriers.** The authorities committed to liberalizing the services sector when it joined the World Trade Organization in 2001; however, implementation and enforcement of the commitments remain weak. As a result, state-owned enterprises dominate services, a fact that restrains competitiveness and obstructs the entry of new players, thus reducing the benefits that greater competition and liberalization would bring. Entry barriers include administrative hurdles; opaque regulations; cumbersome licensing requirements; and restrictions on the geographic range in which businesses can operate, their legal structure, and their access to banking services.
- **Restrictions on direct foreign participation.** With the exception of a few subsectors, such as hotels and some types of banking, services remain largely closed to foreign firms and hence the capital, technology, skills, and competition that they would inject.
- **Incentive bias toward manufacturing.** Fiscal incentives direct investment to the production of goods, and exemptions and rebates favor export of goods, discouraging investment in services.
- **Inefficient allocation of capital.** Large state-owned enterprises, including those in services, receive about two-thirds of total lending. In contrast, private enterprises get only one quarter of the credit available and face much higher interest rates. Despite their significantly smaller capital allocation, private firms generate about half of GDP and are the main generators of employment. The current embryonic stage of capital market development aggravates the difficulties in accessing credit.
- **Incomplete urbanization and labor market rigidities.** Service providers generally thrive in cities, where demand is strong and customers are concentrated in a relatively small area. While there are many cities, about 65% of the population still lives in far-flung rural areas. Urbanization has been slowed by rigidities in the labor market, in particular by the *hukou* system.

- **Underinvestment in education and training.** Not only is expenditure on education relatively low, but the education system is oriented toward rote learning and exam-based performance. Further, there is a decline in the proportion of students in science and engineering, which will hinder development of technology-oriented services and, more broadly, innovation. Employers report shortages of specialized skills. The policy investment bias favors the acquisition of equipment and materials, to the detriment of investment in training.

Wide-ranging policy changes are needed to facilitate the transition to a more services-oriented growth model. These include improving the regulatory framework, changing production incentives, further liberalizing the finance sector, reforming the labor market, and investing more in education and training.

To ease barriers to entry into services, reform should aim at fostering greater private sector participation in services. This could be achieved through enforcement of antitrust legislation, including against all state-owned enterprises, and opening more services to foreign participation. There is significant scope to improve the policy environment for small and medium-sized enterprises and the self-employed, for example, by improving their access to credit. Liberalizing the finance sector and developing capital markets would help to lower the cost of, and improve access to, finance, including in rural areas that often lack basic financial services.

Given that the private sector generally is more productive and innovative than state-owned enterprises, as shown by its contribution to GDP and employment, more efficient capital allocation could increase the rate of GDP growth by several percentage points.

A larger services sector could absorb much of the surplus labor from agriculture and manufacturing, as well as a significant share of new workers entering the labor force. Reforming the *hukou* system would maximize employment gains, as would other policies that speed up the move of the population to cities. To minimize the impact of job losses caused by reducing policy incentives for low-skilled manufacturing, it would be necessary to implement supportive measures, including large investments in education, vocational training, and social safety nets.