



BOFIT China Desk

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Yearbook 2005



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Economic Developments

No signs of a slowdown in 2004

The expected slowing of growth towards the end of the year never materialised. Instead, the annual growth rate accelerated slightly from 9.1 % in the third quarter to 9.5 % in the final quarter. For all of 2004, real GDP also increased 9.5 %.

A surprise motor of growth at the end of last year was agriculture. An increase in land area under cultivation and record crop yields raised the total output of grain to 470 million tonnes, 9 % more than in 2003. The harvest exceeded the original forecasts and its main effect was on fourth quarter GDP growth. Production of many other agricultural products also increased. The growth rate of the primary sector in 2004 rose to 6 % from less than 3 % in previous years. Growth in the service sector also accelerated towards the end of the last year, with the value-added of the sector up 8 % for the year. Although the production of industrial sector increased 11 % in 2004, it in fact constituted a slight slowing of growth. Growth slowed down in the construction sector and in many manufacturing sectors towards the end of 2004. The energy sector experienced stable growth throughout the year.

China's aggregate statistics on the demand side of the national accounts tend to lag. Nevertheless, it can be seen from the preliminary figures that investment growth slowed towards the end of 2004. On the other hand, brisk export growth continued and the role of domestic consumption as a demand factor increased in the second half of the year.

China publishes only cumulative statistics on total fixed investment. For all of 2004, investment increased 26 % y-o-y, while in the first quarter of 2004, the growth rate rose to 43 % and in January–September, it was still 28 %. In many manufacturing sectors, e.g. metal and chemical industries, investment growth slowed down significantly. Strong domestic consumption could be seen in the accelerated growth of retail trade to 10 % y-o-y in real terms. Higher urban and rural incomes were the major factor behind the rise in private consumption. Preliminary figures also suggest that government expenditure increased in 2004. The public deficit appears to have declined only slightly from its 2003 level (2.5 % of GDP), while tax revenues increased 26 % y-o-y.

Growth expected to decelerate slightly in 2005

The National Development and Reform Commission (NDRC) forecasts economic growth will moderate somewhat this year. Most forecasts expect real GDP to grow around 8 % in 2005. Investment growth will decelerate, while the domestic consumption will play a larger role in economic growth. Export growth should remain high, due in part to the lifting of quotas on textile imports. Many analysts, however, are warning of a potential downside to the current outlook.

As China's investment rate is exceptionally high (42 % in 2003), even a small drop in the investment growth rate could have a major impact on the GDP growth rate.

Import growth slowed down

China's foreign trade growth continued in 2004, although import growth slowed considerably in the second half of the year. Exports were up nearly 36 % y-o-y in both 4Q04 and 2004 as a whole. Annual import growth, however, cooled to 30 % in the last quarter, lowering the annual growth rate for 2004 to 36 %. As a result, China's trade balance returned to surplus during the second half of 2004. For all of 2004, the surplus amounted to 1.9 % of GDP (1.8 % in 2003).

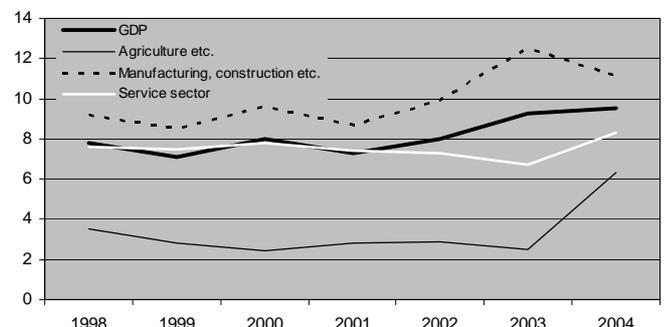
In practice, all export categories experienced stable increases in 2004. On the import side, however, certain sectors experienced a considerable drop in growth. Steel imports, for example, decreased 21 % in 2004 due to increased domestic production. In the second half of 2004, lower investment growth hurt growth in imports of e.g. machinery and electrical appliances, high-tech products and copper products.

Inflation declines

Consumer price inflation fell considerably in the last quarter of 2004. In December, consumer prices were only 2.4 % higher than a year ago. In September, the annual inflation rate was still 5.2 %. The dampening of inflation is mainly explained by food prices. Due to the good harvest in 2004, the rise in food prices has slowed down. Producer prices also seem to have reached a plateau. December producer prices were up 7.1 % y-o-y. The annual rise peaked in October at 8.4 %.

The National Bureau of Statistics expects consumer prices to rise around 4 % in 2005. The inflation forecast of the central bank is somewhat lower, 3.3 %.

Real GDP growth by sectors, %



Source: NBS

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	as of
GDP, y-o-y %-change	8.8	7.8	7.1	8.0	7.5	8.0	9.3	9.5	
Industrial production, y-o-y %-change	11.3	8.9	8.5	9.8	8.7	12.6	17.0	16.7	
Fixed investments, y-o-y %-change	8.8	13.9	5.1	10.3	13.0	16.9	27.7	25.8	
Exports, \$ bn	183	184	195	249	266	326	438	593	
Imports, \$ bn	142	140	166	225	244	295	413	561	
Current account, % of GDP	4.1	3.3	2.1	1.9	1.5	2.8	3.2	1.0	H1/04

Source: People's Bank of China, National Bureau of Statistics of China, Ministry of Commerce.

Capital inflows swell foreign exchange reserves

At the end of 2004, China's foreign exchange reserves reached \$610bn or 38 % of GDP. This is high by international standards as the reserves are sufficient to cover China's imports for about a year. The growth of reserves was particularly brisk in the last quarter of 2004, up by nearly \$100bn. For 2004 overall, reserves rose by over \$200bn.

China has yet to release its balance-of-payments data for 2004. Preliminary figures, however, suggest that the bulk of the rise in reserves was caused by non-FDI capital inflows. The current account surplus probably rose slightly from the 2003 level (\$46bn or 3.2 % of GDP), while the trade surplus reported by the Ministry for Commerce increased to \$32bn in 2004. FDI inflows also increased and amounted to \$60bn. Non-FDI capital flows and the net error and omission term is estimated to have explained nearly \$100bn increase in foreign exchange reserves. The capital inflows were mainly driven by expectations of a yuan revaluation.

Monetary growth slows in line with PBoC targets

To keep the exchange rate of yuan unchanged against the US dollar, the People's Bank of China (PBoC) has to buy all extra foreign currency from the market. In the current situation where foreign exchange inflows are considerable, this leads to a rapid increase in the liquidity in the financial market. As a sign of increased liquidity, average interbank market interest rates fell slightly in 2004. The PBoC, however, has sought to restrain the money supply and credit growth to curtail investment growth and inflation. The bank has sold a considerable amount of central bank bills to commercial banks since spring 2004. So far, the yields on central bank bills have been rather low, which in turn has kept the costs of sterilisation operations moderate.

Partly due to these successful operations, the PBoC managed to slow growth of the money supply and credit last year. However, an increase in capital inflows has caused a slight rise in the growth rates for both the money supply and credit in the last two months of 2004. Broad money (M2) was up 15 % at the end of December, slightly below the year's target of 17 %. Also credit growth slowed significantly from the beginning of 2004. The annual growth rate of loan stock dropped from 21 % in February to around 14 % in December. It is notable that the loan stock in China is exceptionally large compared to the size of the economy and despite the slowdown, loan growth is still considerable in absolute terms. The amount of outstanding loans remained at around 140 % of GDP in 2004. After a rise in the beginning of 2004, consumer price inflation was brought successfully down to 2.4 % in December.

The PBoC aims to restrict monetary growth further in 2005. It has set the target growth rate of broad money supply at 15 % and loan growth at 14 %.

The share of household loans still small

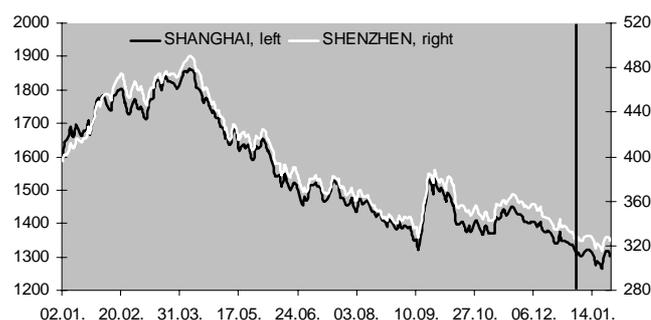
In 2004, loans to non-financial enterprises continued to dominate the loan stock. At the end of 2004, these loans accounted for 85 % of all loans. Despite rapid growth in household loans, their share of all loans was only 15 %. Reflecting the increased revaluation expectations on yuan, the annual growth rate of foreign currency loans dropped to 13 % and their share of all loans was less than 6 % at the end of 2004.

Stock markets decline despite companies' surging profits

The figures presented in the semiannual financial statements of listed companies, combined profits jumped 52 % y-o-y in the first half of 2004. The growth in profits was the strongest for five years. Growth for the year, although still unavailable, probably stayed on track due to continuing brisk economic growth. Yet Chinese stock markets were unimpressed. Both the Shanghai and Shenzhen indices continued to decline. In January, they hit a five-year low. Although the government has increased the stock investment possibilities for insurance companies and social security funds, it has failed to spur stock market growth.

New listing regulations have also been introduced to improve the market atmosphere. Last autumn, listing was interrupted while the authorities prepared new listing price mechanisms to prevent abuses. Under the new regulations, the listing prices of initial public offerings are determined through appraisals by institutional investors. The new rules are intended to assure that newly listed share prices reflect the market. Unfortunately, the new rules also give institutional investors the possibility to manipulate listing prices. When the new regulations entered into force on January 1, 2005, the hold on initial public offerings was also lifted. Ironically, that move increased anxiety on the market over a possible increase in supply. In response, the government indefinitely postponed its plans to sell state-owned shares.

Shanghai and Shenzhen A-share indices



Source: CSRC

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004
Inflation (CPI), 12-month, %	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9
M2, y-o-y %-change (end of period)	19.6	14.8	14.7	12.3	17.6	16.9	19.6	14.6
Average monthly disposable income in urban areas, CNY	430	452	488	523	572	642	706	785
Average monthly net income in rural areas, CNY	174	180	188	197	206	219	245	245
Forex reserves, \$ bn (end of period)	139.9	145.0	154.7	165.6	212.2	286.4	403.0	609.9
CNY/EUR (end of period)	9.205	9.714	8.318	7.702	7.294	8.68	10.453	11.276

Source: People's Bank of China, National Bureau of Statistics of China.

Rapid increase in electricity sector capacity

Energy consumption went through the roof last year, driven by high growth in energy-intensive sectors, more cars on the road and large increases in commercial and residential floor-space. Although electricity production was ramped up 15 % y-o-y, power outages were common in most regions, particularly in summer. Factories had to adjust their production to available power supply and many even bought their own generators.

China has increased significantly its power generating capacity in response to the growth of electricity demand. In 2005, China plans to increase the capacity by 20 %. Moreover, the growth in demand is expected to moderate in coming years and some optimistic scenarios predict no power outages in 2005. China also wants to decrease the share of coal (around 80 % in 2003) in electricity production. The share of hydropower should increase significantly from the current 14 % and the share of natural gas should rise from 3 % at present to 10 % by 2020. Current plans also include raising the number of nuclear power plants from nine to 40 by 2020. Even with this increase, however, nuclear would only supply 4 % of China's electrical needs because of the ongoing increase in overall production.

Many analysts see low efficiency and excessive regulation as the biggest problems in China's energy sector. Investment decisions are made by officials, while regulated prices disturb the functioning of the market. Last year, for example, the price of electricity was increased just slightly and was thus insufficient to compensate for higher coal prices caused by a sharp spike in demand. This then hurt the profitability of power companies. Additionally, coal producers were reluctant to sell to power generators, who are entitled to purchase coal below market price. Some power generators simply found themselves without coal supplies. To improve the market mechanism, the government has decided to strengthen the link between coal and electricity prices. A new pricing formula is expected to be in place in the first half of 2005.

Soaring dependency on imported oil

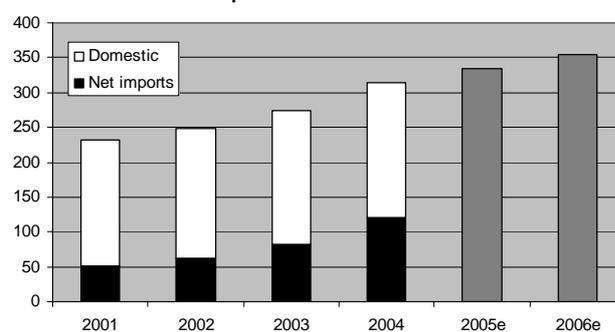
China's demand for crude oil and oil products boomed in 2004. Crude oil consumption increased 15 % y-o-y. Factors in the increase included economic expansion, traffic growth and power outages, which increased private electricity generation and diesel demand. Higher world market prices in the autumn did not decrease demand in China, because the benchmark prices for oil products were raised only slightly. Low retail prices, on the other hand, diminished the incentive for oil refiners to process expensive imported crude and hurt domestic supply of refined petroleum products.

With domestic crude oil production unable to keep up with the rise in consumption, China had to import 120 million tonnes of crude oil last year, or 35 % more than in 2003. Imports covered nearly 40 % of consumption. Imports of refined petroleum products increased 34 % in 2004.

Growth in oil demand is expected to slow this year to around 6 % as increased electricity generating capacity de-

creases demand for diesel oil. In a longer term, however, strong import growth should continue as domestic oil production can grow only moderately. Obviously, China's presence in the world market will increase as its share of world oil consumption rises from the current 8 %. Three quarters of China's crude will be imported in 2025. Rising dependency on other countries' resources has led to an increase of foreign direct investment by Chinese oil companies. For example, China's largest oil producer, China National Petroleum Corporation (CNPC), has nearly 30 oil and gas projects under way in the Middle East, North Africa, central Asia, Russia and South America. Currently, most of the imported crude oil to China comes from the Gulf states, although China aims to diversify its purchases. Imports from Russia are expected to increase this year to around 10 million tonnes. In December, the Russian government preliminarily passed the proposed Daqing oil pipeline in favour of a pipeline from eastern Siberia to the Pacific coast.

China's crude oil consumption in 2001-2006, million tonnes



Source: NBS, IEA, EIU

Major changes in steel and aluminium markets

China's steel consumption increased 13 % y-o-y to 276 million tonnes in 2004 according to preliminary figures. Steel imports, however, diminished 21 % to 29 million tonnes. In the second half of 2004, domestic production rose notably faster than consumption. China plans to add steel production capacity in coming years to cover its consumption. This move is expected to have a major impact on the world steel market as China has been one of the top importers of steel in recent years.

Preliminary data also show China's aluminium consumption rising 15 % y-o-y in 2004. That growth is expected to slow only slightly in coming years and China could even overtake the US as the world's largest aluminium consumer this year. To limit exports of energy-intensive products, China abolished its export rebate for aluminium and several other metals at the beginning of the year. China also imposed a 5 % export tax on aluminium. These measures are hoped to limit China's aluminium exports in 2005, while increasing supply and lowering prices in domestic market. Aluminium imports, in turn, are expected to decline.

Fiscal indicators (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	as of
Revenues	11.6	12.6	13.9	15.0	16.8	18.0	18.5	20.0	1-11/04
Expenditures	12.4	13.8	16.1	17.8	19.4	21.0	21.0	17.7	1-11/04
Balance	-0.8	-1.2	-2.1	-2.8	-2.6	-3.0	-2.5		

Source: National Bureau of Statistics of China.

Regional inequalities widening further in China

by Barbara Bils and Tuuli Koivu*

Widening income disparities in China have raised worries. Although China's level of inequality is not exceptionally high compared to many other low- and middle-income countries, the widening of income disparities has happened unusually fast in China.

One of the best-known indicators of inequality is the Gini coefficient, which measures the extent to which income distribution deviates from a perfectly equal distribution. A coefficient of 0 would be perfectly equal distribution and 100 would be perfect inequality. Using World Bank data, the Gini coefficient for China was only 33.0 in 1980. By 1992, the coefficient had risen to 37.6. Inequality increased rapidly in 1990s, and in 2001, the Gini index was already 44.7. Out of the 130 countries ranked by the World Bank, only 36 countries had more unequal income distribution than China. However, as already mentioned, compared to other low- and middle-income countries, China's level of inequality is unexceptional.

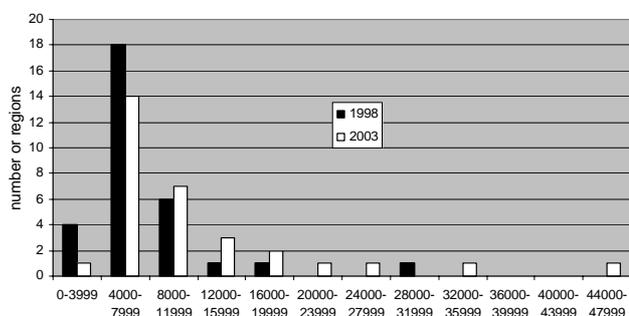
Regional income differences still widening

Income disparities can be attributed to regional disparity, rural-urban differences and income distribution within rural and urban areas. Chinese income disparities have widened in all these respects over the past decade, and the gap is currently largest between rural and urban income levels.

Disparities in income distribution among regions were significant even before reforms were launched in 1978. At the start of reforms, China succeeded in decreasing disparities as liberalisation of the agricultural sector increased rural incomes. Since 1990, however, regional income disparities have widened again.

Over the last five years, all 31 regions have experienced strong economic growth. Even some of the poorest regions have attained growth rates well above 10 % annually. However, the income gap between poorest and wealthiest regions has not declined; growth in the rich coastal regions has remained high. In fact, the income disparities between regions are still widening.

Income distribution of regions by average GDP per capita, 1998 and 2003 (in yuan)



Source: China Statistical Yearbook

For example, the average GDP per capita in 1998 in China's three richest regions (Shanghai, Beijing and Tianjin) amounted to CNY 20,500 (€2,100), six times the average in the three poorest regions (Guizhou, Gansu and Tibet). By 2003, the average GDP per capita in the three richest regions had risen to CNY 35,100, or seven times that of the poorest regions. The general trend in regional income disparities can be seen in the figure. Average per capita GDP rises significantly from 1998 to 2003, while the gap between rich and poor regions continued to grow and the distribution of regions becomes more scattered.

Will differences start diminishing?

There is wide interest in studying the reasons behind regional disparities in China. Various studies note that fiscal and credit policies, regional development strategies (e.g. the establishment of special economic zones) and factor market distortions have favoured coastal region and caused rising regional inequality. Geographic factors and initial conditions have also worked to the benefit of Eastern China. As a result, important growth factors such as foreign direct investment and export industries are concentrated in coastal regions.

Obviously, there is no immediate cure for the current situation. Researchers are split on the issue of whether public spending could be increased to reduce income disparity. Pessimists doubt that China's relatively small modern urban sector has the resources to significantly increase peasant incomes. As the gap between rural and urban areas is the main factor behind inequality in China, some economists argue that China should accelerate urbanisation. Overall, there are still many restrictions to factor mobility in China. For example, regulations on labour mobility, poor housing markets, preferential employment and education opportunities for local residents tend to increase regional disparities.

What most economists do agree on is that no substantial decrease in the regional inequalities is likely in the near future. Indeed, WTO membership is expected to worsen the situation in agricultural areas. In addition, the reform of state-owned enterprises will disproportionately affect employees in northern China rather than the wealthy eastern provinces. On the other hand, reported shortage of suitable labour force in Pearl River Delta may push factories further inland. This might at least end the widening of the regional disparities.

* Barbara Bils is a student of East European Studies and Economics at the Free University of Berlin. Tuuli Koivu is an economist at BOFIT. The article relates to Bils's BOFIT Online article on China's regional development that will be published shortly at www.bofi.fi/bofit

Economic Developments

Economic growth faster than expected

In the first quarter of 2005, China's GDP increased 9.5 % in real terms from the corresponding period last year. Contrary to most forecasts, growth did not slow but continued at last year's level. The pace of growth was well above the government's 8 % target for all of 2005.

In terms of sectoral output, industry and construction led with on-year growth of 11 %. The service sector increased 8 % and agriculture and other primary industries 5 % y-o-y. Despite a lack of precise statistics on GDP demand side, it appears the role of exports in economic growth increased slightly. In addition, investment growth remained strong and prospects for domestic consumption growth are positive. For example, retail trade growth accelerated slightly and trade increased 12 % y-o-y in constant prices. Average income rose 9 % y-o-y in real terms in urban areas and 12 % in rural areas.

Structure of investment changing

Manufacturing growth accelerated slightly from the last quarter of 2004 to above 16 % y-o-y in January-March. Sectors that have received the most fixed investment in recent years experienced the fastest growth in production. For example, production of rolled steel increased 22 % y-o-y, while power generation was up 13 %. Production of aluminium, iron ore and power generating equipment also increased considerably. On the other hand, gains in household consumption and exports have pushed up output of electronic devices and appliances as well as the textile and clothing industry.

Investment growth continued strong. In the first quarter, fixed investment increased 23 % y-o-y in nominal terms (26 % in 2004). By using preliminary data on fixed investment prices, real investment growth rate seems to have risen to around 20 % (18 % in 2004). The structure of investment, however, has been changing. For example, growth has ceased in many branches of metal industry, while investment growth has accelerated significantly in government-supported sectors. Investment growth was up sharply in agriculture and coal mining as well as in railway transportation. Investments in electricity, gas and water production and supply also increased 44 % y-o-y. In the real estate sector, investment growth continued strong (up 27 % y-o-y) despite government measures to restrain growth.

Swelling trade surplus

In the first quarter of 2005, export growth held strong but import growth decelerated. The result was a trade surplus of nearly \$17 billion (3.5 % of GDP) and a large reversal from

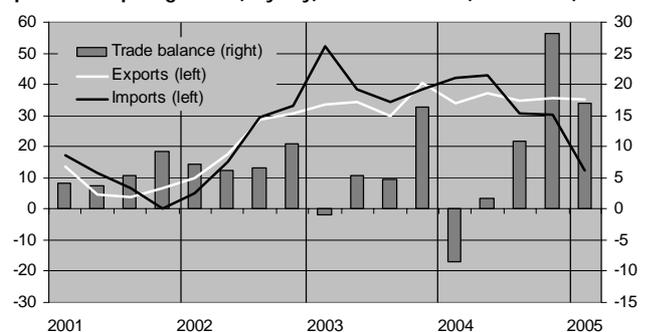
the over \$8 billion deficit of 1Q04. Expectations for this year's trade surplus are significantly above the \$32 billion (2 % of GDP) posted in 2004.

In January-March, exports were up 35 % y-o-y, matching the growth level of 2004. Exports increased rapidly in all main sectors. The most important export products still are mechanical and electronic products which accounted more than half of all exports in January-March and increased 30 % y-o-y. With the worldwide lifting of import quotas, China's garment and textile exports surged at almost the same rate.

Imports were up 12 % y-o-y in the first quarter of 2005, a significant slowing from 2004. The drop partly reflects lower nominal investment growth. For example, machinery imports were up by only 5 % y-o-y in the first quarter. In addition, increased domestic production caused steel product imports to decrease 41 % y-o-y and copper imports 15 % in the first quarter. Crude oil imports declined 2 %. On the other hand, imports of home appliances and electronic products were up 19 %, coal imports 59 % and iron ore imports 25 % y-o-y.

Country-specific trade statistics are only available for the first two months of 2005. In January-February, export growth continued strong for all major markets, while a slowing trend in import growth was apparent with nearly all of China's trading partners. The EU remained China's most important trade partner. China's exports to the EU rose 29 %, while imports from the EU increased only 2 % y-o-y. As a result, the bilateral trade surplus ballooned from \$4 billion in January-February 2004 to \$10 billion. Exports to US rose 37 %, while imports decreased 10 % widening trade surplus from \$9 billion to \$13 billion. Despite lower import growth, China continued to run trade deficits with most Asian countries, e.g. Taiwan, Korea, Japan and ASEAN countries.

Import and export growth (% y-o-y), trade balance (US\$ billion)



Source: Customs General Administration

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP, y-o-y %-change	7.8	7.1	8.0	7.5	8.0	9.3	9.5	9.5	Q1/05
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.2	1-3/05
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	25.8	22.8	Q1/05
Exports, \$ bn	184	195	249	266	326	438	593	156	1-3/05
Imports, \$ bn	140	166	225	244	295	413	561	139	1-3/05
Current account, % of GDP	3.3	2.1	1.9	1.5	2.8	3.2	4.2		

Source: People's Bank of China, National Bureau of Statistics of China, Ministry of Commerce.

Foreign exchange reserves continue to balloon

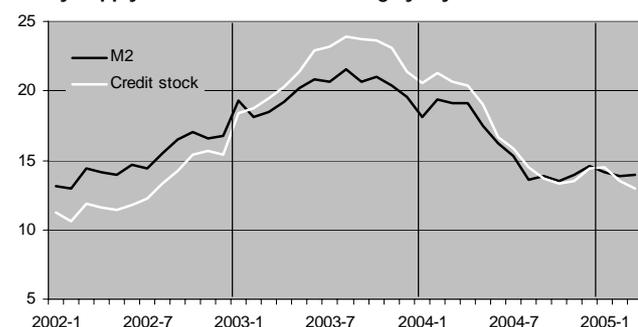
China's foreign currency reserves reached \$659 billion at the end of March. The increase of nearly \$50 billion in the first quarter outpaced the rise a year earlier by about \$12 billion thanks mainly to a large trade surplus. Customs office figures showed a \$17 billion trade surplus in the first quarter of 2005, compared to an \$8 billion deficit in 1Q04. More than a quarter of the rise in reserves was explained by FDI inflows that increased 9 % y-o-y to \$13 billion. Although China only publishes balance-of-payments data on a semi-annual basis, we can infer from preliminary information about the trade surplus and FDI inflows that non-FDI capital inflows, while significant, did not increase substantially from the first quarter of last year.

China does not disclose the composition of its foreign reserves, presently the world's second largest after Japan. Officials have to admit, however, that reserves have traditionally been invested in dollar-denominated assets. Analysts estimate that 70-80 % of reserves remain invested in dollar assets, although the share has probably been decreasing since last year.

Housing loan market tightens

The People's Bank of China succeeded in limiting monetary growth in the first quarter, even though sustaining the renminbi's peg to dollar meant buying up excess foreign currency from the market and issuing more domestic currency. As of end-March, both monetary and credit growth were slightly below targeted levels. Broad money (M2) was up 14 % y-o-y, while the credit stock grew 13 % y-o-y. Nevertheless, foreign exchange inflows continue to swell the liquidity of commercial banks, pressuring the PBoC to take further measures to keep monetary growth under control. Besides keeping last year's restrictions on bank lending in place, central bank governor Zhou Xiaochuan announced medium- and long-term loans will be strictly controlled. At its quarterly meeting in March, the PBoC monetary policy committee noted the possibility of a rebound in fixed-asset investment and increased inflationary pressure.

Money supply and credit stock, % change y-o-y



Source: People's Bank of China

The central bank dropped the preferential interest rate of 5.31 % on housing loans in March. Commercial banks now set their lending rates just as for other loans, i.e. at least 0.9 times the central bank's benchmark rate. The change, which boosted the minimum housing credit rate, should cool the real estate sector somewhat. In addition, new rules allow commercial banks to raise their downpayment demand for housing loans from 20 % to 30 % in areas where real estate prices have risen rapidly. Credit terms as well as purchasing and selling rules were already tightened in e.g. the Shanghai and Shenzhen markets. In 4Q04, real estate prices were up 11 % y-o-y on average. Shanghai led with a 16 % increase.

High oil prices yet to be reflected in retail prices

Consumer prices rose 2.8 % y-o-y in the first quarter. Inflation has slowed from its mid-2004 peak, helped in particular by a more modest rise in food prices. In January-March, food prices were 6.1 % higher than a year ago; housing costs were up 5.6 %.

The rise in producer prices has decelerated gradually since autumn 2004. For 1Q05, prices were up 5.6 % y-o-y. The largest increases were seen in prices for raw materials, fuel and power. The central bank warned rising producer prices may eventually push up consumer prices. Meanwhile, authorities have held down regulated retail fuel prices to moderate the impact of rising oil prices and allowed only small hikes in administratively set electricity rates. The National Development and Reform Commission has barred local authorities from further hikes in utility rates if consumer prices start to pick up in the coming months.

Slow progress in reforming state-owned banks

Reform of the two large state-owned banks (Bank of China BOC and China Construction Bank CCB) has encountered new obstacles in recent months. As anticipated, it has been difficult to find foreign banks willing to invest large amounts of money in state-owned banks without getting a majority share or controlling interest. Although both banks are reportedly in negotiations with international banks, their talks have likely been complicated by the recent spate of bribery and fraud cases at several Chinese banks. In addition, BOC and CCB have failed to reduce their portfolios of non-performing loans since last summer. It is now likely the stock market listings of these banks will be postponed at least until 2006.

In April, the government approved a \$15 billion capital injection to the state-owned Industrial and Commercial Bank of China (ICBC). Just like the injections at the end of 2003 to the BOC and CCB, the bail-out will be financed from foreign exchange reserves. International analysts doubt this injection will be sufficient, given ICBC's high NPL ratio and low capital adequacy ratio. Out of the four large state-owned banks, Agricultural Bank of China will thus be the last one to receive capital injection from the government. It is believed to be in the worst shape of the large state-owned banks.

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Inflation (CPI), 12-month, %	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	2.7	3/05
M2, y-o-y % change (end of period)	14.8	14.7	12.3	17.6	16.9	19.6	14.6	14.0	3/05
Average disposable income in urban areas, y-o-y % change	5.1	8.0	7.2	9.4	12.2	10.0	11.2	11.3	Q1/05
Average net income in rural areas, y-o-y % change	1.1	2.2	3.3	4.8	4.6	6.3	11.9	15.9	Q1/05
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	659.1	3/05
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	10.73	3/05

Source: People's Bank of China, National Bureau of Statistics of China.

Attacking unemployment

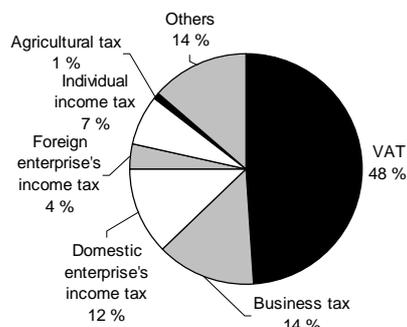
The government gave a positive overview of economic development in 2004 at the annual National People's Congress (NPC) meeting in March. This year, stable development is expected to continue. Premier Wen Jiabao set the GDP growth target for 2005 at 8 % and the ceiling on growth in consumer prices at 4 %. The role of prudent fiscal and monetary policies was emphasised to ensure steady economic development this year. The government promised to continue structural reforms in many sectors, and expressed concern about uneven regional development.

Job creation is seen as a key to social stability. According to government reports, 9.8 million new jobs were created in 2004. This year's goal is 9 million new jobs, which should be sufficient to keep the official rate of registered urban unemployment rate below 4.6 %, or slightly up from last year's level. The official rate, of course, excludes many groups normally classified as unemployed elsewhere. Many observers put China's actual urban unemployment rate above 10 %. In rural areas, actual underemployment and unemployment is even higher.

Public sector deficit smaller than budgeted in 2004

The performance of public finance was better than expected last year. Both revenues and expenditures surpassed the budgeted amounts. Revenues to central and local budgets amounted to CNY 2,600 billion (€250bn) or 19.3 % of GDP. That was 21 % more than in 2003 and 12 % more than budgeted. Tax income formed over 90 % of total revenues and revenues from all major taxes grew more than predicted. Revenues from value-added tax and corporate income tax increased most. Expenditures rose 15 % y-o-y to CNY 2,800 billion, or 20.8 % of GDP.

Central and local government tax revenues by category, 2004



Sources: NBS, Ministry of Finance

According to preliminary figures, the fiscal deficit was a smaller-than-expected 1.5 % of GDP. The deficit at the central level was almost on budget (2.3 % of GDP), while local level budgets ran surpluses. The deficit would have been even smaller if China had used international budgetary accounting methods that take into account extra-budgetary is-

ssues and the fact that the central government used part of its extra revenues to pay off export tax rebates from earlier years.

NPC approves 2005 budget

The government's fiscal policy guidelines call for tightening measures this year and abandonment of its active intervention policies launched in 1998. The new policy aims at limiting investment growth and dampening overall economic growth. The 2005 budget for central and local governments was approved at the NPC annual meeting in March. The budget foresees the central government deficit decreasing slightly to around 2 % of GDP and no major shifts in central government spending are expected. The main public finance challenges relate to inequitable distribution of funds among local governments, implicit liabilities caused by non-performing loans and local level debt, as well as the low efficiency of public funds. In 2005, transfers will be increased from the central government to local governments facing serious financial difficulties in order to safeguard their ability to govern and maintain social stability. Development in rural areas will also be promoted with further cuts in the agricultural tax and greater rural investments. Although they represent only a small share of national spending, subsidies to grain farmers will continue.

Tax reforms delayed

The next major tax reforms are expected in value-added tax and corporate income tax. The VAT system in China is production based, i.e. a tax paid on purchased fixed assets is not deductible against the output tax. The general VAT rate is 17 %, but there are many exceptions to this rate. The government's goal is to move to a consumption-based VAT that encourages investment. The proposed reform would decrease tax revenues by around 4 %. Three northeastern provinces have been experimenting with a consumption-based VAT in eight industrial sectors since July 2004 in the hope of attracting investment to their relatively poorly performing provinces. Although the experiences have been positive, no timetable has been specified for the new nationwide system. VAT revenues are shared between central and local governments.

Corporate income tax also is set for reform. Currently, the income tax rate for foreign-owned companies is 15 %. Domestic companies, however, are taxed at a rate of 33 %. If preferential tax policies are taken into account, the actual tax on foreign companies is about 11 % and on domestic enterprises 22 %. Under WTO principles, China should treat foreign and domestic companies equally. Unification of the tax rates has been on agenda for many years but according to latest information, it could be delayed until 2007. The new rate is predicted to be around 24 %.

Fiscal indicators (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004*
Revenues	11.6	12.6	13.9	15.0	16.8	18.0	18.5	19.3
Expenditures	12.4	13.8	16.1	17.8	19.4	21.0	21.0	20.8
Balance	-0.8	-1.2	-2.1	-2.8	-2.6	-3.0	-2.5	-1.5
Government debt				22.8	23.6	25.1		

* Preliminary figures.

Source: Budget: National Bureau of Statistics of China. Government debt: IMF.

The challenges facing public spending policy

by Margit Molnar*

At nearly 21 % of GDP, China's official on-budget expenditure figures for 2004 reflect at most three-quarters of all government spending. Extra-budget spending (financed by legally sanctioned fees, surtaxes, user charges and other levies) represented another 3.5 % of GDP, while disbursements from social security funds were over 3 %. Adding in central government bond issues on behalf of local governments to the above items already puts general government spending relative to GDP at 28 %. And that figure still does not include unrecorded disbursements financed by illicit levies at the local level. Neither are the government's accumulated contingent liabilities, most notably non-performing loans incurred by financial institutions nor unrecorded debts incurred at the local level (technically illegal as local governments are required to balance their budgets) recorded anywhere.

Imbalances...

Imbalances, which are present in various aspects of public expenditure, not only violate the principle of equity but also reduce efficiency and thereby deter growth.

...across categories

Although the functional classification of China's public expenditure does not fully conform to international standards, available data suggest the country spends relatively little on education, science and health. Instead, a large share of public funds is channelled to capital formation and capital transfers. At just 3.2 % of GDP, spending on education in 2002 was lower than in any OECD country and well below the government's own long-standing goal of 4 %. Spending on science and technology was a mere 0.8 % of GDP, and public health received a similar share. On the other hand, expenditure on fixed capital formation and capital transfers equalled nearly 10 % of GDP in 2002, a level well above that of any OECD country.

Audit reports also indicate large-scale ineffectiveness and inefficiencies in infrastructure spending.

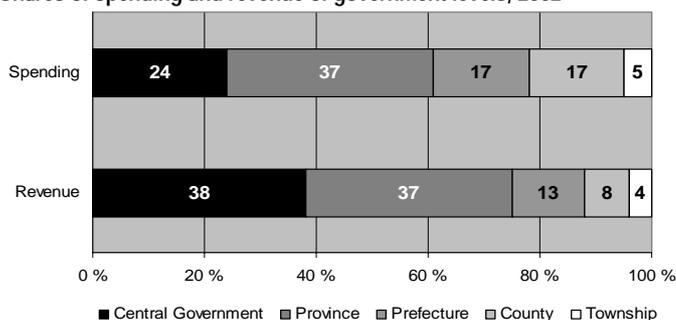
...between spending mandates and financing sources

Because spending is far more decentralised than revenue collection, public expenditure across sub-national government levels does not match up with revenues at various government levels. Sub-national government is responsible for 76 % of total spending, yet only collects 62 % of total revenues. Townships and counties, the two lowest government layers, respectively raise just 4 % and 8 % of general revenues, even though they are responsible for such key spending areas as education and health. To finance these mandates, townships and counties rely on transfers from above. When transfers are inadequate, lower government levels are forced to incur debt. Prefecture-level government, which mainly performs administrative functions, is responsible for providing a share of outlays for infrastructure and

education. Provinces, however, shoulder the main burden of infrastructure investment. Provincial administrations also collect and distribute the bulk of social security and extra-budgetary funds.

Overlapping spending obligations for different government levels in categories such as health, infrastructure and education reduce the efficiency of spending.

Shares of spending and revenue of government levels, 2002



Source: Author's calculations. To approximate SNA definitions, we use data from the Public Finance Yearbook 2003 and Public Finance Data of Prefecture and County Level Governments for 2003.

...and across regions

Spending disparities within provinces tend to be greater than between provinces. This is because central government transfers substantially reduce spending inequalities between provinces, while sub-provincial transfers are less effective due to the structure of fiscal relations in individual provinces. Decomposition of disparities in expenditure at the county level indicates that about two-thirds of such disparities are intra-provincial in nature, while the remainder is due to inter-provincial disparities.

Possible ways to reduce imbalances

To ensure effective government spending, the imbalances noted here should be corrected. For a start, better allocation of expenditure would help secure long-term growth. More funds could be channelled to human capital formation and social development, where returns are high (and simultaneously reduce inefficient public investment). A better match between expenditure assignments and financing sources (including own revenue and transfers) at all government levels would help ensure delivery of public services and avoid the need for off-budget fund-raising and illicit debt. Disparities among localities, particularly within provinces, could be reduced by implementing a more equitable (possibly central) design for sub-national transfer and tax-sharing schemes.

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Economic Developments

No signs of a slowdown

Available indicators suggest the anticipated economic slowdown in the first half of 2005 never materialised. Official figures show GDP increased 9.5 % y-o-y in the second quarter of 2005 with continued strong growth in investment, retail trade, manufacturing and exports. The high figures have encouraged many to raise their projections for GDP growth this year to 9 %. Growth in 2006 is now expected to slow slightly to around 8 % as investment and export growth cool.

Investment growth was earlier anticipated to slow significantly in the first half of 2005, but in fact investment growth remained steady in most sectors. While China only publishes monthly investment figures for urban investment, this is still sufficient to cover most investment. In January-July, fixed investment in urban areas increased in nominal terms 27 % y-o-y; due to low inflation, the real growth rate was likely quite similar. In the first half of 2005, investment growth accelerated notably in the mining and real estate sectors. Investment in the industrial sector overall increased 35% y-o-y. Within the sector, the lion's share of investment went to ferrous metal smelting and extending, chemical sector and transportation equipment manufacturing. While nearly 60 % of investment went to eastern provinces, investment grew fastest in the central and western provinces. Investment by the government and state-owned enterprises increased at a pace below the average, but still accounted for over half of all investment.

The poor quality of domestic demand statistics makes it difficult to draw conclusions about consumption trends. The traditional indicator, retail trade, showed annual growth of 12 % in constant prices for the first half of 2005 – a growth rate very close to last year's level. Preliminary figures indicate government expenditure rose 15 % y-o-y in the first half of 2005, which is slightly faster than in 1H04.

Export growth boosts industrial production

Industry is the main component in China's GDP. Value-added from industrial sector (construction excluded) forms 45 % of total production. This year, industrial growth has sustained nearly the same pace as in 2004. In January-July, production increased 16 % compared to the corresponding period a year earlier. Main demand factors behind growth were exports and investment in fixed assets.

Strong production growth continued in most sectors. Steel and other metal industries continued to increase their production rapidly. Energy-related sectors also boomed as consumption of electricity increased 13 % y-o-y in January-June. Electronic and textile industries were boosted by an

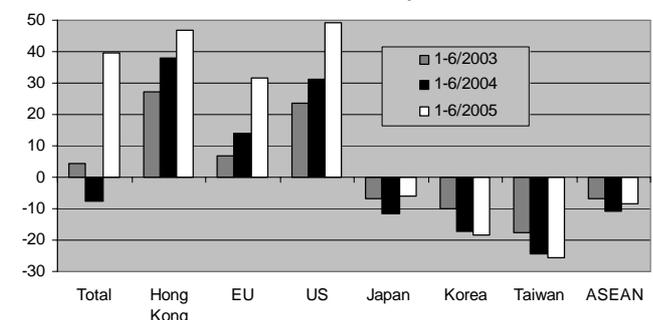
increase in exports. Carmakers seem to have turned the corner: after registering miniscule and even negative growth rates, on-year car output rose significantly in June-July. Car sales also recovered this summer partly due to lower prices.

Slower import growth boosts trade surplus

Chinese exports increased 32 % y-o-y in January-July as import growth simultaneously slowed to 14 %. As a result, the trade surplus hit record-high levels. While export growth was broad across sectors, many minor factors hampered import growth. First, a slight slowdown and redirection of investment growth reduced demand for imported machinery and equipment. In January-July, machinery and electronic product imports increased only 9 % y-o-y. Second, some sectors (e.g. steel and aluminium) have seen domestic production increase rapidly. Third, good harvests in 2004 and spring 2005 decreased the need to import agricultural products. Finally, growth in oil imports has slowed. The amount of crude oil imported to China rose only 6 % y-o-y and even the record high oil price has not increased the value of imported crude oil as much as in 2004 when the value of imported crude oil was up 71 % y-o-y. Imports of petroleum products decreased from last year in January-July. The drop is partly due to the strict controls on prices of petroleum products. Oil companies feel little incentive to import pricey oil and oil products to sell at lower prices in Chinese markets. As a result, fuel shortages have been reported in some parts of China, most recently in the Guangdong province.

The slowdown in imports has increased China's trade surplus, particularly with the US and the EU. When taking into account the role of Hong Kong as a transit port, the trade imbalances are even more severe. On the other hand, China continues to run trade deficits with most Asian countries.

China's trade balance with selected trade partners, US\$ billion



Source: General Administration of Customs

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP, y-o-y %-change	7.8	7.1	8.0	7.5	8.3	9.5	9.5	9.5	H1/05
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.3	1-7/05
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	25.8	25.4	H1/05
Exports, \$ bn	184	195	249	266	326	438	593	408	1-7/05
Imports, \$ bn	140	166	225	244	295	413	561	358	1-7/05
Current account, % of GDP	3.3	2.1	1.9	1.5	2.8	3.2	4.2		

Source: People's Bank of China, National Bureau of Statistics of China, Ministry of Commerce.

Trade surplus raises tensions

China's widening bilateral trade imbalances have become sources of irritation for its key trade partners. In April, the US Senate supported an amendment that would punish China for its undervalued currency by imposing a 27.5 % tariff on all Chinese imports. Further approval of the bill, however, was delayed as China modified its exchange rate regime in July. The US House of Representatives is expected to take up the amendment in October. The US has also been vocal critic of China's feeble efforts at protecting intellectual property rights – a situation inflamed by China's suggestion it could favour domestic software in government purchases.

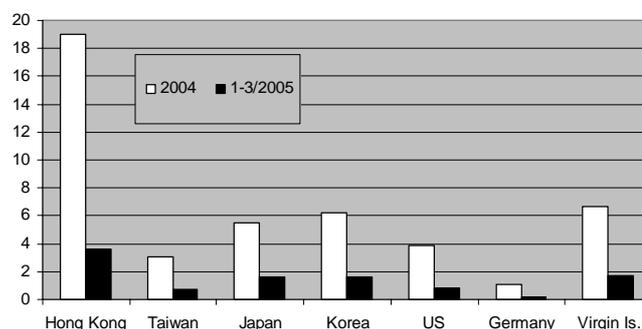
The liberalisation of textile trade at the beginning of this year has also sparked considerable controversy. Many countries, mainly for domestic reasons, have sought to postpone total liberalisation of trade. Although China imposed export tariffs for certain textiles at the beginning this year (and even increased some in May), the impact has been miniscule. China's trading partners thus continue to worry about the impending flood of imported Chinese textiles, with some countries limiting import growth under China's WTO accession terms. In June, the EU and China agreed on limiting growth of China's major textile products to the EU to between 8-12.5 % annually until end-2007. Under the agreement, all restrictions on textile trade would be lifted after 2008. Some Chinese exports already exceed the quota set for 2005 and the EU and China must now negotiate what to do with quota-exceeding order made by companies before the agreement came into effect. Reflecting the sensitivity of the textile issue, the EU itself is divided on the question. The US has set an annual 7.5 % growth ceiling on certain textile imports from China in May and is presently negotiating with China on a bilateral textile agreement. Chinese statistics show China's garment and clothing exports increased 17 % y-o-y in the first half of 2005; most trading partners' figures suggest a more dramatic rise.

China is a prime target for both anti-dumping probes and measures. WTO figures show China was subject to 42 anti-dumping measures (28 % of all cases) from its trade partners in 2004. The number of cases has remained approximately at the same level in recent years and the number of cases is not likely to decline this year. This summer the EU imposed anti-dumping tariffs on Chinese bicycles and certain iron castings and launched investigations into Chinese shoes and recordable CD and DVD discs. Many developing countries have also started to use anti-dumping measures against Chinese products. China, in turn, using WTO rules, has retaliated with its own anti-dumping measures. However, the 14 new measures China imposed on its trading partners last year are relatively insignificant.

No more growth in FDI inflows?

Huge inflows of foreign direct investment (FDI) into China are one of the factors driving bilateral trade imbalances. As international companies move part of their production to China, trade flows naturally increase. This year, however, it appears that FDI inflows into China have plateaued. In January-July, China received \$33 billion in FDI, or slightly less than in the same period last year. While almost half of China's FDI nominally originated from Hong Kong or the Virgin Islands, the actual sources in many cases are likely the US, the EU, or (particularly in the case of the Virgin Islands) Mainland China itself as money is circulated via a third country to take advantage of tax breaks and other benefits available to foreign companies.

FDI inflows to China by originating countries, US\$ billion



Source: Ministry of Commerce

Chinese enterprises invest abroad

The Chinese government launched its "Go Out" policy of encouraging Chinese enterprises to make investments abroad in 2003. This year the authorities are further motivated in supporting such investment partly as it is seen as a way to counteract capital inflows to China. To date, the amount of Chinese investment abroad has been tiny compared to FDI inflows. Chinese enterprises' FDI amounted to less than \$4 billion last year.

In principle, Chinese investment abroad can be divided into two categories. First, there are state-owned companies eager to buy energy and raw material reserves outside China (e.g. oil concessions). Second, there are companies, such as electronics manufacturers, interested in widening their operations outside China. These corporations are keen on acquiring foreign partners with know-how and market shares in Europe and the US. This strategy was well embodied in Lenovo's purchase last December of IBM's PC unit.

While the number of such deals is still small, the amount of money involved has increased dramatically. The now-withdrawn offer of Chinese CNOOC for the US oil company Unocal was an all cash offer of nearly \$20 billion.

Fiscal indicators (% of GDP)

	1998	1999	2000	2001	2002	2003	2004*	2005*	as of
Revenues	12.6	13.9	15.0	16.8	18.0	18.5	19.3	24.3	1-6/05
Expenditures	13.8	16.1	17.8	19.4	21.0	21.0	20.8	18.4	1-6/05
Balance	-1.2	-2.1	-2.8	-2.6	-3.0	-2.5	-1.5		
Government debt			22.8	23.6	25.1				

* Preliminary figures.

Source: Budget: National Bureau of Statistics of China. Government debt: IMF.

A shift in exchange rate policy

The People's Bank of China (PBoC) announced on July 21 that it had abandoned the pegging of China's currency to the US dollar. While the value of renminbi is now referenced to a bunch of currencies, the central bank repeatedly emphasises that the new regime is not a pegging to a basket of currencies. On August 10, central bank governor Zhou Xiaochuan explained that the US dollar, the euro, the Japanese yen and the South Korean won have the largest weights in the new currency basket, but that the Singapore dollar, British pound, Malaysian ringgit, Russian rouble, Australian dollar, Thai baht and Canadian dollar also play roles in setting the value of the Chinese currency.

In conjunction with the regime shift, the renminbi was revalued 2 % against the US dollar, a move that lowered the exchange rate of renminbi against dollar from 8.28 to 8.11. The new system also allows the renminbi to float within a narrow daily fluctuation range of 0.3 % against the dollar. In practice, the renminbi has closely tracked the dollar since July 21. The official rate as of August 24 was 8.10. The former system in principle also included a fluctuation band. However, the use of band was dropped from summer 2003 onwards. It is thus unclear whether the renminbi will actually be allowed to fluctuate much against the dollar in the near future. In its statements, the PBoC has emphasised the importance of exchange rate stability in China's economic development.

Related to the exchange rate reform, China has also been developing its foreign exchange markets to provide Chinese companies with better tools for hedging foreign exchange risks. In May, a new foreign-exchange trading system was launched. Initially, the system allowed trading and clearing of eight spot foreign currency pairs, but no trading against the yuan. In August, the interbank market was deepened further by introducing currency swaps and access to forwards markets was provided to 370 banks and selected non-financial institutions. Previously, only seven domestic banks had access to the forwards markets.

Gradual liberalisation of capital flows

Capital inflows to China remained strong in the first half of 2005. The country's foreign exchange reserves reached \$711 billion at the end of June. The reserves ballooned \$100 billion in the first half of 2005 and \$240 billion from the end of June 2004. According to the figures from the customs office, the trade surplus covered \$40 billion of the rise in January-June and FDI inflows amounted to \$29 billion. Much of the increase in reserves was attributable to non-FDI capital inflows.

The State Administration of Foreign Exchange (SAFE) continues to liberalise the capital account, in part to encourage capital outflows from China. In May, SAFE facilitated foreign direct investment by Chinese companies. In August, it raised the amount of foreign exchange Chinese travellers

abroad could purchase. As a part of the exchange rate reform, authorities increased the independence of large Chinese companies by allowing them to keep in their own accounts 70% of their foreign currency export earnings. The limit was set earlier at 50 %.

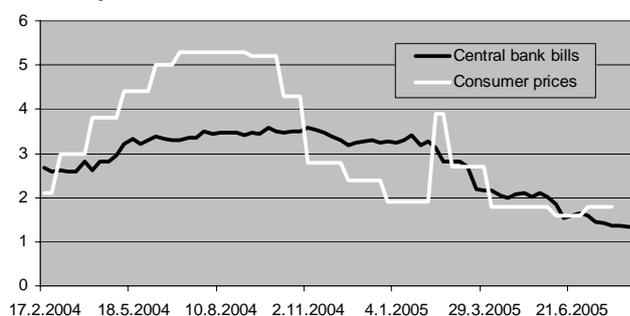
At the same time with gradual liberalisation of capital outflows, China pushed to restrain external borrowing by limiting local banks' borrowing this year to \$35 billion and foreign banks' borrowing to \$24.5 billion. In 2004, China's financial account surplus was mainly augmented by foreign direct investment inflows and a \$35 billion increase in external borrowing. In the first quarter of 2005, China's foreign debt increased by nearly \$5 billion. The Chinese authorities have also attempted to curb other types of capital inflows related to revaluation expectations. In June, SAFE tightened monitoring of foreign trade payments to reduce abuses of trade credits.

Monetary growth and inflation under control

Despite the inflows of foreign exchange into China, the PBoC has successfully kept monetary growth under control. In July, the on-year growth of the money supply (M2) slightly accelerated to 16 % and rose slightly over the target rate of 15 %. The central bank has sterilised a large share of capital inflows by selling an increasing amount of central bank bills to the commercial banks. The tactic has worked so far and the interest rate level for the bills has remained low. In March, the level dropped further as liquidity in the market swelled after the PBoC cut its rate for extra reserve funds deposits.

Inflation remains low. In July, consumer prices were 1.8 % higher than a year ago. Producer prices climbed 5.2 % y-o-y, mainly due to higher oil prices. Any significant acceleration in consumer prices in the second half of 2005 seems unlikely. The PBoC lowered its 2005 inflation forecast from 4 % to 3 % in the summer. Investment growth has boosted production capacity in many sectors and some analysts have even speculated that a reappearance of deflation might be possible. On the other hand, rising oil and energy prices, as well as increased production costs, are likely to restrain any downward pressure on prices.

12-month inflation and interest rates of 12-month central bank bills (reference yield), %



Source: NBS, PBoC

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Inflation (CPI), 12-month, %	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	7/05
M2, y-o-y %-change (end of period)	14.8	14.7	12.3	17.6	16.9	19.6	14.6	16.3	7/05
Average disposable income in urban areas, y-o-y %-change	5.1	8.0	7.2	9.4	12.2	10.0	11.2	9.5	H1/05
Average net income in rural areas, y-o-y %-change	1.1	2.2	3.3	4.8	4.6	6.3	11.9	12.5	H1/05
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	711.0	6/05
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	9.80	7/05

Source: People's Bank of China, National Bureau of Statistics of China.

China's governance in transition: Adjusting relations across levels of government

by Irène Hors*

The Chinese constitution defines China as a unitary state, yet the country's system of governance de facto features legacies of non-federal and federal aspects from the central-planning era and successive decentralisation and recentralisation reforms. Mainland China has four sub-national levels of state administration (province, prefecture, county and township), as well as a fifth, essentially local, level (villages and urban neighbourhood communities).

The 1994 tax reform represents a major milestone in the evolution of relations across levels of government. The reform provided the central government with greater fiscal control over local levels and gave priority to redefining the functional responsibilities of various levels of government and better organising fiscal transfers. Nevertheless, the central government's inability to control local governance persists through problems of enforcement and localism. The Chinese administrative system neither resembles the classic pyramid, where decisions taken at the top are implemented smoothly at lower levels, nor a simple federal model with clear divisions of labour among government levels. A multiplicity of hierarchical lines obscures responsibilities and accountability, making it very difficult for an outsider to know which authority controls in a given situation. The resulting dilution of higher-level authority provides considerable scope for local leaders to make arbitrary decisions.

Dysfunctional intergovernmental fiscal structure

Despite recent reform efforts, there is still a significant mismatch between revenues and expenditure assignments across governmental levels. Local governments at the county and township levels remain saddled with heavy spending mandates that include social security, education and health. In addition, 90 % of distressed state firms are located at sub-national levels, along with three-quarters of employment. Thus, liquidation of the most problematic firms raises significant employment concerns. The heavy responsibilities are supported neither by an appropriate set of revenue assignments nor an effective system of transfers. Fiscal revenue raising, while still quite decentralised, is less so than expenditure, particularly after the 1994 tax reform significantly increased the central government's overall share of total revenue. Transfers from the central to the provincial governments to bridge the resulting gap have risen substantially, but still fall short of covering the gap between expenditure responsibilities and tax revenue resources. Moreover, many earmarked transfers arrive late in the year and in unpredictable amounts.

Another aspect of this problem is the overly centralised character of the policy-making process. Policies made by the central government usually have financing implications for local governments, but local governments are not always consulted before rollout. In one case, local officials learned of a salary increase for civil servants from TV broadcasts, even though the costs were mostly borne at the local level. Nevertheless, improvements in consultation with local governments have been clearly evident in recent years. For example, the recent reforms in rural fees and agricultural taxes were worked out with local governments.

Negative effects

China's dysfunctional intergovernmental fiscal structure contributes to local disparities and problems of enforcement. First, provision of services to the local populace is vulnerable to variations in local fiscal health, and inequality has increased among provinces (and is even worse below the provincial level). Second, the decentralisation process has aggravated inequality in social welfare, in particular between rural and urban areas. According to the Ministry of Health, rural Chinese have access to only 20 % of the country's medical resources, even though the vast rural areas are home to 900 million of China's 1.3 billion inhabitants. Third, the shortage of revenues at the lower tiers, especially in poor regions, constitutes a bottleneck to national policy implementation in the sectors of social security, basic education and health. A major consequence has been the growth of illegal taxes and fees. By some estimates, illegal fees may equal official budgets at lower sub-national levels, in counties and townships. However, the situation varies from county to county.

Finally, the shortage of funds biases the enforcement of policies. In the environment field, for instance, Environmental Protection Bureaus (EPBs) are often heavily dependent on collecting pollution levies to cover their operating costs. This provides EPBs with a perverse incentive to allow enterprises to continue polluting so that they will keep paying their pollution levy. Compliance with emissions standards means an end to payments. The shortage of funds also contributes to corruption and rent-seeking behaviour. When payment arrears are serious or operating funds insufficient, officials face strong temptation to use their office to extort bribes from citizens or companies.

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Economic Developments

Strong growth continued

China's GDP increased 9.4 % in the third quarter of 2005. According to preliminary statistics, GDP growth amounted to 9.4 % also in January-September and has remained constantly above 9 % since summer 2003.

Growth also remained surprisingly stable within production sectors in the first three quarters of 2005. In *primary industry* (agriculture and forestry), production increased 5 % y-o-y or the same rate as in the first half of the year. Perspectives for grain supply for 2005 are good as early rice crops exceeded last year's figures. Growth continued fastest (11 %) in *secondary industry* which includes manufacturing, construction, mining and electricity supply. Mining and the energy sector have benefited from strong growth of energy demand as output of electricity increased 13 % in January-September, nearly the same pace as in 2004. High growth rates in both exports and investment buoyed manufacturing; industrial production overall was up 16 %. *Service sector* output increased 8 % in January-September. More exact information on the role of the service sector in the Chinese economy should be available at the end of the year when preliminary results from the economic census will be released. The results of the census, which was conducted at the beginning of this year, are expected to show the service sector making a larger contribution to economic output than revealed by the current estimate (about 33 % of GDP).

Exports and investment still drive growth

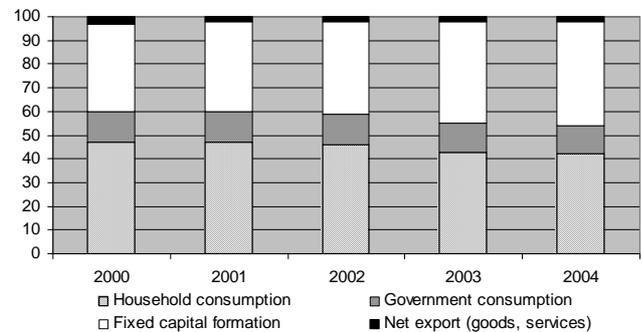
The figures for GDP demand components are published only once a year and suffer from statistical weaknesses such as inadequate and distorted price indices. The just-released 2004 figures suggest that China's already exceptionally high share of investment in GDP continued to increase last year as the investment rate climbed to 44 % of GDP. Strong investment growth has continued this year; in January-September, fixed investments were up 26 % in nominal terms. Although real growth is estimated to be a couple of percentage points lower, investments continue to increase their importance in the economy.

At the same time, domestic consumption has remained somewhat sluggish. Household consumption amounted to the equivalent of only 42 % of GDP last year, while government consumption was a mere 12 % of GDP. Against many expectations, neither of these components has increased its share of GDP in recent years. Indeed, the share of household consumption has dropped since 2000 despite strong income growth. Household incomes in urban and rural areas have continued to increase this year at around

10 % y-o-y. Households apparently still save a large share of their income. Retail sales, the only available indicator of household consumption, continued to grow 12 % in January-September.

While export growth currently plays a crucial role in China's economic development, China's net exports of goods and services remained modest at around 2 % of GDP in 2001–2004. The goods trade surplus will be significantly higher this year. In the first nine months, trade surplus amounted to 5 % GDP.

Components of expenditure-based GDP, %



Source: People's Bank of China

Forecasts for next year

Many institutions and banks have lately raised their projections for Chinese GDP growth in 2006. Most forecasts now put growth at between 8 % and 9 %. Next year, investment growth is expected to slow and be partly absorbed by accelerated domestic consumption growth. While analysts generally expect export growth to slow next year with calmer trends in international trade, China's current account surplus will remain significant. The largest risks facing the economy are a possible quick drop in investment due to overcapacity and lower profitability in certain sectors. Progress in banking sector reform also deserves careful attention. Strong GDP growth is expected to continue also in a longer term. The government's recently released 5-year plan for 2006–2010 targets average GDP growth of 7.5 % a year.

Forecasts for GDP and consumer price inflation, annual %-change

	GDP		CPI	
	2005	2006	2005	2006
ADB	9.2	8.8	2.5	2.6
IMF	9.0	8.2	3.0	3.8
OECD*	9.0	9.2	4.0	4.0

*) The OECD forecast was carried out already in June.

Macroeconomic indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
GDP, y-o-y %-change	7.8	7.1	8.0	7.5	8.3	9.5	9.5	9.4	Q1-3/05
Industrial production, y-o-y %-change	8.9	8.5	9.8	8.7	12.6	17.0	16.7	16.3	1-9/05
Fixed investments, y-o-y %-change	13.9	5.1	10.3	13.0	16.9	27.7	25.8	26.1	Q1-3/05
Exports, \$ bn	184	195	249	266	326	438	593	547	1-9/05
Imports, \$ bn	140	166	225	244	295	413	561	478	1-9/05
Current account, % of GDP	3.3	2.1	1.9	1.5	2.8	3.2	4.2		

Source: People's Bank of China, National Bureau of Statistics of China, Ministry of Commerce.

International oil prices and the Chinese economy

International oil prices increased 30 % in 2004; this year they are expected to rise almost 50 % compared to 2004. Given the fact that China's oil imports rose by 35 % in volume terms in 2004, it is somewhat surprising how little higher oil prices have affected the Chinese economic growth. There are several factors explaining why higher energy prices have yet to be reflected in lower GDP growth.

First, China's oil demand growth has been much weaker this year than in 2004. Even with much higher oil prices, the share of crude oil and oil products remains below 10 % of total merchandise imports. Assuming that China's current oil imports are about 140 million tonnes annually, the expected \$20 increase in international oil prices to around \$60 per barrel this year translates to an additional \$20 billion transfer to oil exporting countries. That amount represents around 1 % of China's forecast GDP this year.

Second, in spite of high oil prices, robust growth of the global economy has sustained strong export demand for Chinese goods. Indeed, Chinese exports to oil-exporting countries (e.g. Russia) have ballooned. This together with slower import growth in China effectively compensates for the increased oil import expenses such that the contribution of net exports to GDP growth is even more positive than in previous years.

Third, the Chinese government has not allowed international oil price increases to pass through fully to domestic prices. The IMF recommends that the government increase domestic prices of oil products another 30 % in order to let domestic prices fully reflect changes in international prices during the last two years. While keeping energy prices below market prices has supported domestic demand and dampened inflation pressures, there are significant implicit fiscal costs related to current price regulations. Moreover, current policy has led to serious mismatch between energy demand and supply. Finally, environmental reasons justify a change in current energy pricing policies.

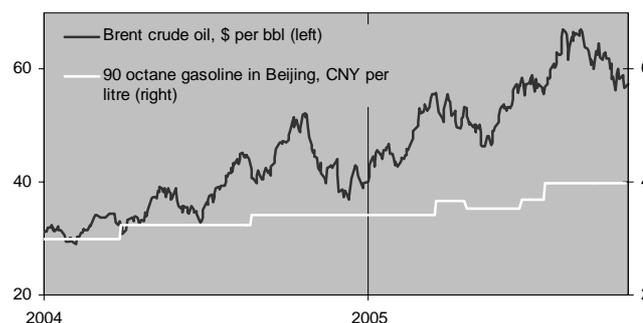
Pricing mechanism – consumers dream, refiner's nightmare?

Unlike Chinese crude oil prices, which closely track international prices, fuel prices are regulated by National Development and Reform Commission (NDRC). End-user fuel prices are set based on a benchmark retail price, which is linked in principle to the previous month's crude oil market price in international markets. For gas stations, it is then possible to set a pump price within 8 % fluctuation band of the benchmark price. NDRC has lifted the benchmark price three times this year, but these hikes have been moderate compared to the increase in international crude oil prices. While the international oil price is projected to soar almost 50 % this year, Chinese retail fuel price have only increased 17 % so far. Currently, the price for regular (90 octane) gasoline is 4 yuan per litre (€0.40), about a third of prevailing European prices. In addition, city governments are un-

willing to raise fares for public transport and taxis. By some estimates, the total government subsidy through regulated fuel prices may be as high as 2 % of GDP. Although problems with the pricing system are widely known to the government, there is countervailing fear that sharp price increases would hurt key sectors such as agriculture, defence and transportation. The government is also committed to assuring social stability; most consumers oppose even moderate fuel price increases.

This situation has had a negative impact on China's fuel supply, because petroleum refiners have little incentive to sell fuel at a loss. The price gap between world prices and domestic regulated prices has already forced China's refiners to incur heavy losses in the first half of the year. State-owned refiner Sinopec has managed to compensate with profits on its crude oil production and chemical operations, but small private refiners with no side businesses have been hard hit. Price regulation could also have some positive effects in the long term, since narrow or negative price margins make refineries focus on efficiency. Private oil companies are already merging to larger companies. China's low fuel price and export controls may also lead to unwanted developments such as fuel smuggling. For example, in Hong Kong the smuggling incentive is high as price of fuel can be threefold of that on the Mainland.

Price development of crude oil and domestic gasoline



Sources: Sinopec and Energy Information Administration

Oil companies investing in domestic production

Chinese oil companies have sought to improve their production capacity by acquiring large foreign oil companies from abroad. They are also investing heavily to the domestic oil production and exploration. In January-September, fixed asset investment to the sector rose over 30 % y-o-y. International Energy Agency (IEA) expects China's production growth to accelerate to 4 % y-o-y in current year, outpacing demand growth by a percentage point. China's domestic oil reserves could also be considerable: many potential oil deposits are still under- or unexplored. In the first half of this year alone, China's biggest oil company CNPC increased its known oil reserves by 300 million tonnes, an amount approximately equal to China's annual crude oil consumption.

Fiscal indicators (% of GDP)

	1998	1999	2000	2001	2002	2003	2004*	2005*	as of
Revenues	12.6	13.9	15.0	16.8	18.0	18.5	19.3	24.3	1-6/05
Expenditures	13.8	16.1	17.8	19.4	21.0	21.0	20.8	18.4	1-6/05
Balance	-1.2	-2.1	-2.8	-2.6	-3.0	-2.5	-1.5		
Government debt			22.8	23.6	25.1				

* Preliminary figures.

Source: Budget: National Bureau of Statistics of China. Government debt: IMF.

Renminbi still following dollar

On September 23, the People's Bank of China announced it had widened the daily fluctuation band of the renminbi against non-dollar currencies from $\pm 1.5\%$ to $\pm 3.0\%$. The dollar band ($\pm 0.3\%$) was left unchanged. The move was expected as strict multi-currency pegs would have hamstrung the PBoC's exchange-rate policy, e.g. whenever dollar and euro moved against each other more than 1.8% in one day. The announcement may even be interpreted as a re-strengthening of the dollar-renminbi linkage, and not surprisingly, the renminbi's exchange rate has continued to closely follow the dollar since the regime shift in July. On October 28, the CNY-USD rate was at 8.08 – only 0.3% higher than after July's micro-revaluation.

Competition holding down prices and cutting into profits

Consumer prices were only 0.9% higher than a year ago in September. Inflation has slowed significantly over recent months as good harvest prospects have decreased the rise in food prices to 0.3% while prices of clothes and durable goods have continued to decline. The effects of high international oil prices have remained limited due to regulated retail prices and the fact that the share of oil products in the consumer price index is only 1.2%. Producer prices continued to increase faster than consumer prices. In September, producer prices were up 4.5% y-o-y, mainly due to higher energy prices and prices for certain raw materials. Producer price inflation has also slowed significantly in construction materials and steel, sectors that have attracted substantial investment in recent years.

While strong growth in demand has kept growth of sales revenues at the last year's high level, tougher competition has prevented many companies from raising their selling prices – even as higher energy and material prices have increased production costs. The thinner profit margins have halved the growth rate of industrial companies' total profits from 40% in January-September 2004 to 20% in the same period this year. In addition to slower profit growth, industrial companies' losses have increased significantly this year. It appears that while strong economic growth increases profits in e.g. energy and certain raw material sectors, rapid investment growth has led to a glut of capacity and stiffened competition in industries ranging from manufacturing of construction materials to cars and electronic appliances. The steel industry has reacted quickly to decreasing prices and growing inventories. At the end of October, major steel producers announced they were planning to cut output 5% in the last quarter of 2005 to avoid further price declines. Competition is expected to tighten further in many industries in coming months, with manufacturers losing what little pricing power they have.

Foreign investment to banking sector ballooning

The most visible measures in the banking sector reform have been a number of sales of minority stakes in Chinese banks to foreign investors. While the law limits a single foreign owner's stake in a Chinese bank to less than 20% and a group of foreign investors to less than 25% of a Chinese bank, foreign banks have been keen to penetrate Chinese banking markets by purchasing shares in local banks. Three out of four of China's large state-owned banks have recently sold minority stakes to foreign strategic investors in deals totalling nearly \$13 billion. China Construction Bank (CCB) also staged its IPO on the Hong Kong stock exchange at the end of October. The demand for shares well exceeded supply and the price for the 12% stake was \$8 billion. CCB's market value was assessed at \$67 billion – the highest among the banks in non-Japan Asia. Another fast-track reformer, Bank of China, has announced plans to list in the first half of 2006. A number of smaller banks have also been active in seeking foreign strategic investors, with several announcing IPO intentions. This is fully consistent with the China Banking Regulatory Commission's current policy of encouraging foreign investment in the banking sector. The CBRC sees the role of foreign banks as crucial to banking-sector reform.

Obviously, foreign banks are taking huge risks when they invest billions of dollars in Chinese banks. Although the latest figures suggest that many banks are continuing to strengthen their balance sheets and improve efficiency, the amount of non-performing loans (NPLs) in the major commercial banks was still CNY 1,280 billion (€130bn) or 9% of all loans at the end of September. The drop from the beginning of the year was due to the single transfer of NPLs worth CNY 460 billion from Industrial and Commercial Bank of China to a state-owned asset management company. The central bank assisted in the transfer, a major step in reforming the bank. At the other end of the spectrum, reforms have hardly started at Agricultural Bank, reputed to be in sorry condition. There are also many smaller banks and credit cooperatives in need of serious reforms. When estimating the need for recapitalisation in the banking sector, plenty of NPL concerns await down the road. Some analysts already note the increasing trend in the core stock of NPLs this year. Inevitably, part of the loans channelled to the investment boom in recent years end up non-performing as increasing competition pushes inefficient companies out from the market. During 2003–2004, the loan stocks in renminbi and foreign currencies increased by more than a third (nearly CNY5,000 billion) to 140% of annual GDP – an astronomical figure by international comparison. The ongoing reforms in the exchange rate regime and foreign exchange markets imply that Chinese banks have to increase competence also in the exchange rate risk management. Otherwise, the new instruments can cause additional risks to the vulnerable banking sector.

Monetary indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Inflation (CPI), 12-month, %	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	0.9	9/05
M2, y-o-y %-change (end of period)	14.8	14.7	12.3	17.6	16.9	19.6	14.6	17.9	9/05
Average disposable income in urban areas, y-o-y %-change	5.1	8.0	7.2	9.4	12.2	10.0	11.2	9.8	Q1-3/05
Average net income in rural areas, y-o-y %-change	1.1	2.2	3.3	4.8	4.6	6.3	11.9	11.5	Q1-3/05
Forex reserves, \$ bn (end of period)	145.0	154.7	165.6	212.2	286.4	403.0	609.9	769.0	9/05
CNY/EUR (end of period)	9.71	8.32	7.70	7.29	8.68	10.45	11.28	9.744	9/05

Source: People's Bank of China, National Bureau of Statistics of China.

Mainland China's experience with deflation – A comparison with Japan and Hong Kong

by Aaron Mehrotra *

The period of high inflation that accompanied the overheating of the Chinese economy in the early 1990s gave way to a period of rapid disinflation. While annual inflation exceeded 24% in 1994, consumer prices were falling in 1998 as the economy slowed down because of the Asian financial crisis (see figure). Unlike Japan's stubbornly persistent deflation, Chinese deflation was relatively short-lived. Moreover, while deflation reached a yearly rate of 6% in the Hong Kong Special Administrative Region in mid-1999, deflation in China never went much below 2%.

Previous studies about the causes of deflation in China predominantly point to supply-side effects on price development. These effects arose out of changes in commodity prices, as well as longer-term productivity improvements and the increasingly competitive domestic business environment. While media discussion of Chinese deflation tended to emphasise the international transmission of deflationary shocks from this economy to the rest of the world, it would perhaps be prudent not to exaggerate the magnitude of such influences. Interestingly, while Japan's well-publicised deflation occurred in an environment of weak demand and after the bursting of an asset price bubble, China's deflation occurred in an environment of rapid economic growth.

Different determinants of consumer price development

In a new study, we evaluate the importance of interest-rate and exchange-rate channels during recent deflationary episodes in Japan, Hong Kong and China. A comparative approach is appealing, as all three economies have experienced deflation despite their different monetary regimes, economic structures and degrees of openness. During our observation period (1996–2004) the nominal effective exchange rate of the Chinese renminbi went through phases of both appreciation and depreciation – even with the US dollar peg. Interestingly, the deflationary episode of the late 1990s coincided with renminbi appreciation, while the re-emergence of positive inflation rates tracked a depreciating Chinese currency (see figure). Although Chinese monetary policy is implemented partly through administrative measures, the People's Bank of China has increasingly relied on interest-rate adjustments to achieve macroeconomic stabilization. Administratively set interest rates were lowered seven times during the slowdown of 1996–1998. However, the deflationary climate of recent years has implied rather high real rates. In stark contrast with the Japanese experience, the one-year lending rate (a commonly used reference rate for the Chinese economy) never came near the zero-interest rate floor.

We found that neither interest-rate nor exchange-rate shocks appear to be important determinants for Chinese consumer prices during the recent disinflationary episode. This

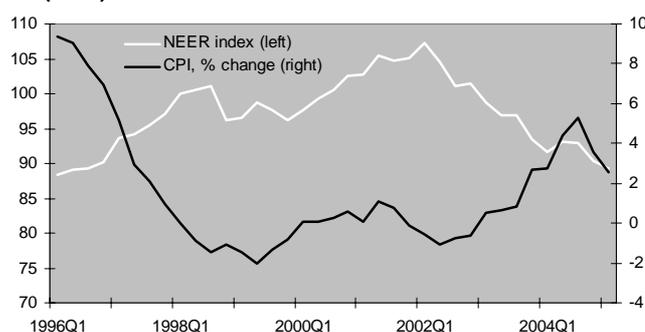
finding differs from our results for Hong Kong and Japan, where both interest-rate and exchange-rate shocks are found to be of relevance. In retrospect, the Bank of Japan probably could have lowered rates even more aggressively before the zero floor on interest rates was hit. The importance of the exchange-rate channel is not surprising in the case of Hong Kong's extremely open economy. The high nominal interest rate implied by the currency board arrangement during the deflationary episode in Hong Kong may have presented a disadvantage of the dollar peg.

The limited importance of interest-rate and exchange-rate shocks in the development of Chinese prices may be a consequence of administratively set prices (especially in the case of gasoline). It is also conceivable that capital controls somewhat insulated the domestic economy from changes in the nominal (trade-weighted) exchange rate. Finally, interest rates in China have not assumed a role comparable to that of economies with more advanced financial systems.

Persistent low inflation cannot be ruled out

Recent fluctuations in Chinese consumer prices mainly reflect changes in food prices rather than aggregate price pressures. Indeed, one can argue that little domestic inflationary pressure should exist in the Chinese economy, particularly due to the high supply of labour and the scope for ongoing productivity improvements. If this is so, the likelihood of future deflationary episodes – even if ones of short duration – cannot be ruled out.

Chinese 12-month inflation rate (%) and nominal effective exchange rate (index)



Source: IFS database

* The author is an economist at BOFIT.

Mehrotra, Aaron (2005), "Exchange and Interest Rate Channels during a Deflationary Era – Evidence from Japan, Hong Kong and China", BOFIT Discussion Paper, forthcoming.