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CHINA QUARTERLY UPDATE

SUSTAINING GROWTH

April 2012

The *China Quarterly Update* reviews recent economic developments in China, updates the economic outlook and lays out key policy challenges. This issue was produced by Philip Schellekens (task team leader) and Xiaoli Wan, in collaboration with Xiaofan Liu, Philip O'Keefe, Dewen Wang and Min Zhao, and under the overall guidance of Klaus Rohland, Sudhir Shetty, Bert Hofman and Ardo Hansson. Comments are gratefully acknowledged from country economists in the East Asia and Pacific Poverty Reduction and Economic Management Unit. The team would also like to thank Jianqing Chen, Tianshu Chen, Li Li, Li Ouyang and Yan Wang for support in the production and dissemination of this report. The findings, interpretations, and conclusions expressed in this report do not necessarily reflect the views of the Executive Directors of the World Bank or governments they represent. This report takes into account information available up to end of March 2012.

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EXECUTIVE SUMMARY

RECENT ECONOMIC DEVELOPMENTS

The Chinese economy is in the midst of a gradual slowdown. A weaker global economic environment and tighter domestic policies combined to slow GDP growth from 10.4 percent in 2010 to 9.2 percent in 2011. Slow growth in the Euro area and sluggish recovery in the US limited the contribution of net exports, as exports decelerated more rapidly than imports. Tighter domestic policy conditions dampened investment – particularly in infrastructure and real estate. In contrast, consumption growth remained robust as consumer confidence was sustained and household income continued to grow rapidly.

Inflation, which was a policy concern over 2011, has been on a declining trend. Food inflation receded as one-off factors faded, and non-food inflation eased in line with the global and domestic slowdowns. Wage growth remained robust, but the continued rapid rise in labor productivity acted to dampen unit labor costs. Efforts to curb inflation led to somewhat tighter monetary and financial conditions.

The balance of payments has softened under these conditions. The trade balance fell into deficit early 2012 as manufacturing exports slowed while commodity prices remained high. Foreign direct investment weakened as uncertainty built up. These developments in turn dampened foreign exchange accumulation as well as the pace of nominal and real exchange rate appreciation.

ECONOMIC OUTLOOK

Cyclical weakness is expected to dominate the near-term outlook, with growth projected at 8.2 percent in 2012 and 8.6 percent in 2013. Domestic demand will contribute 8.4 percentage points to growth in 2012 as consumption growth slows slightly partly due to base effects and investment growth decelerates rather sharply. As world trade is anticipated to remain weak, external demand will subtract some 0.3 percentage points from growth. The projected rebound remains modest as these trends are likely to weigh on 2013 as well.

Significant price adjustment – both absolute and relative – is in the pipeline. Inflation will trend to 3.2 percent in 2012, as growth slows, commodity-price impulses fade and property markets cool further. China's external terms of trade will likely improve as import prices dependent on commodities decelerate by more than export prices dominated by manufactures. Exchange rate appreciation is expected to slow as long as the weak external environment continues to weigh on export volumes and prices.

The current account surplus is projected to increase slightly to 3 percent of GDP in 2012 and 3.3 percent in 2013. Terms of trade improvements offset an initially lower trade balance driven by export weakness and import robustness. With trade volumes recovering in 2013 and the terms of trade improving further, the surplus would also expand in 2013. Despite continued net capital inflows, foreign exchange reserves would accumulate more slowly.

While our central projection remains for a gradual slowdown, two downside risks remain significant. While financial market concerns have recently eased, a key external risk remains the ability of high income countries to avert a deeper economic downturn. A further slowing of OECD demand would echo quickly through East Asia's production and trade networks, wherein China occupies an increasingly central position. Domestically, the main downside risk arises from the ongoing correction in property markets, even though property market adjustment has so far remained gradual and orderly.

The longer-term outlook will depend on how China manages key structural challenges. As the traditional engines of growth weaken, GDP growth should gradually slow. The growth benefits of urbanization and industrialization are expected to hit diminishing returns. China will also see major demographic change over time, with old-age dependency rising and the labor force shrinking soon. Total factor productivity growth would likely soften as efficiency gains from first-generation reforms lessen and technology gaps with high-income economies narrow. In addition, the welcome efforts to rebalance the economy are expected to not only alter the pattern of growth, but also bring slower, though higher-quality, headline growth.

These structural trends would play out gradually over time. Illustrative scenarios suggest growth could slow from recent rates of 10 percent to 5 percent in around 20 years' time. This would be accompanied by major structural transformations. Industry and investment would see their importance in GDP diminish, while the share of services and consumption would rise. Supported by continued urbanization, reduced inequality and lower energy intensity, the quality of development would improve.

POLICY PRIORITIES

The policy challenge for the near term is to sustain growth through a soft landing. The ongoing slowdown is partly welcome to the extent that it reflects a deceleration in growth from above-potential in a context where potential growth itself is gradually slowing. While the prospects for a soft landing remain high, there are concerns that growth slows too quickly. However, sufficient policy space exists to respond to downside risks. The burden of any countercyclical response should primarily fall on fiscal policy. Adjustments on the margin would be welcome to the stance of monetary policy given the ongoing shifts in the balance of risks from inflation to growth.

The policy response would need to be carefully crafted, keeping in mind longer-term effects and objectives. Relative to previous episodes, fiscal stimulus would ideally be less credit-fueled, less local government-funded and less infrastructure-oriented. Fiscal measures to support consumption would attract first priority (such as targeted tax cuts, social welfare spending and other social expenditures). Reserve requirements could be tweaked further to ease the availability of credit, with policy rate action best reserved for downside scenarios given already accommodative real rates. Ongoing administrative efforts have been helpful in cooling the property market, but would preferably be substituted eventually by market-based measures that raise the cost of capital and expand the range of investment opportunities.

China's longer term challenge is to continue steering its economy towards a more sustainable path. Given the anticipated structural slowdown, this would involve reinvigorating the underlying drivers of growth to secure healthy per capita income growth. In view of the economic, social, environmental and external imbalances that have accompanied rapid growth and structural change, this would also involve sustaining the ongoing shift in focus from the rate of growth towards the quality of development.

Meeting these longer-term challenges will by no means be easy. Indeed, few countries have managed during the post-war period to break through the glass ceiling that appears to lie between middle and high-income status. New efforts can help China sustain its competitive advantage by progressively shifting from low cost to higher value supported by innovation. New approaches can also help sustain poverty alleviation as the rate of poverty reduction becomes steadily less sensitive to economic growth. Similarly, new strategies can help make growth green and protect the environment.

The 12th Five-Year Plan supports these directions and lays out an ambitious agenda of structural reform. The recent China 2030 study by the Development Research Center and the World Bank builds on these strategic directions and provides ideas on how they could be operationalized.

RECENT ECONOMIC DEVELOPMENTS

The Chinese economy is in the midst of a gradual slowdown driven by a weaker global environment and tighter domestic conditions. GDP growth eased modestly from 10.4 percent in 2010 to 9.2 percent in 2011. Growth of investment demand was slowed by the winding down of earlier stimulus policies and by efforts to cool the property market, while external developments limited the contribution of net exports. However, robust consumption growth, supported by solid labor market fundamentals, sustained consumer confidence and rapid growth of real incomes, helped cushion the impact on overall activity. The macro policy stance was initially tightened to fight general and asset price inflation, but was relaxed somewhat again towards the end of the year as the focus shifted to protecting growth.

GLOBAL ECONOMY PERFORMED UNEVENLY

Weak economic performance in high-income economies continued to weigh on the global economy (Figure 1). Growth in high-income economies decelerated to 1.6 percent in 2011, about half of what it was the year before. Europe continued to post lackluster growth at 1.6 percent, roughly the same as in 2010. The US registered a more pronounced slowdown from 3.0 to 1.7 percent, whereas Japan was in recession at -0.9 percent as a result of the disruptions caused by the earthquake and tsunami.

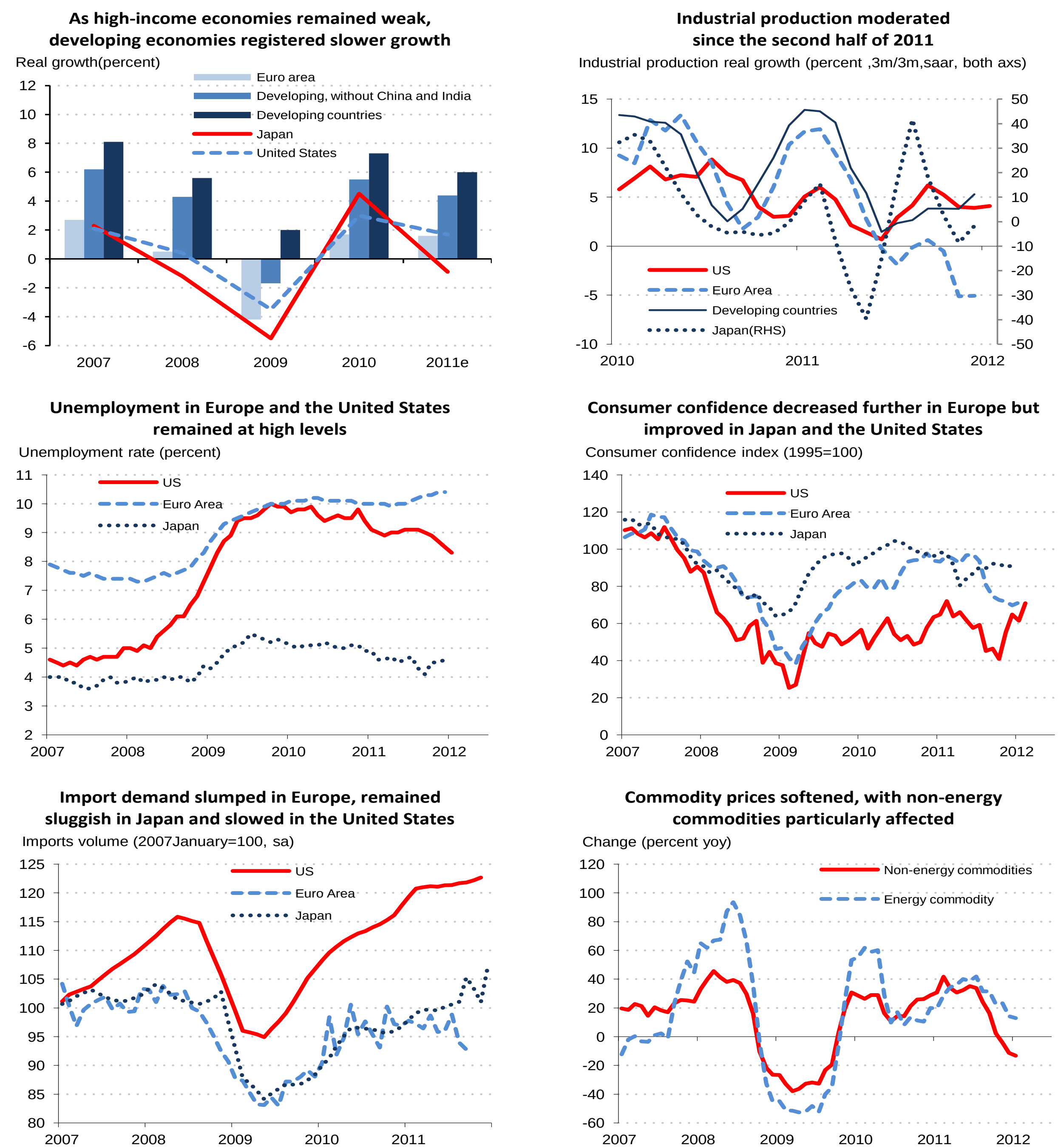
Meanwhile, developing economies registered stronger, albeit slowing, growth. Growth in several major developing countries started to slow partly in response to policy tightening designed to dampen inflationary pressure. For the developing world as a whole, growth slowed from 7.3 to 6.0 percent in 2011 or from 5.5 to 4.4 percent if one excludes China and India. Developing economies in the East Asia and Pacific region continued to grow rapidly at 8.2 percent, though excluding China would reduce this to 5.2 percent (which is closer in line with other regions).

The uneven growth performance became more pronounced towards the end of 2011. Conditions in high-income economies significantly weakened during the last two quarters of last year, with consumption and industrial production softening across the board. With unemployment rates rising – particularly in Europe – consumer confidence also took a hit. High-frequency indicators suggested the euro zone had entered a recession, with continuing uncertainty over the resolution of the fiscal crisis in some countries. While the US economy expanded in 2011 on increased private sector activity, growth remained weak as well. The bounce-back of Japanese activity following the earthquake provided a transitory lift in momentum.

Global weakness also translated into trade volumes and prices. While for the year as a whole world trade volumes expanded by 7.8 percent, the last four months of 2011 saw a decline at an annualized average rate of 16 percent. More than than half of this reflected a decline in European imports from already relatively weak levels – indeed, like Japanese imports, European imports never managed to recover beyond their 2007 levels, in stark contrast to the US. World trade prices also adjusted to changing economic conditions, particularly towards the end of the year.

While sentiment improved in recent months, markets remained skittish. Positive news came from the United States where first-quarter results suggest an up-tick in activity, early signs emerged of a recovery in the housing market. Nonfarm employment rose in February, even if unemployment remained at 8.3 percent. In Europe progress was made in recent months through reform and adjustment measures in crisis countries, efforts towards a stronger Euro Area fiscal governance framework and the ECB's long-term refinancing operations. This has helped ease global financial market stress and contribute to an improvement in economic sentiment. Yet, markets remain skittish in view of the elevated downside risks and yields on the sovereign debt of large high-income countries like Spain, Italy and France remain elevated.

Figure 1. Global Developments



Sources: CEIC, World Bank staff estimates.

CHINA'S ECONOMY SLOWED GRADUALLY

Growth Softened from Rapid Pace

The Chinese economy has registered slower growth against a backdrop of external weakening and internal tightening (Figure 2). Growth decelerated from 10.4 percent in 2010 to 9.2 percent in 2011, with quarterly patterns suggesting a dip in momentum towards the end of 2011.

External weakening– together with base effects following the rapid expansion in 2010 – led to a deceleration in export demand with export growth estimated at less than half the rate in 2010. As consumption remained resilient, import demand decelerated by much less, despite the slowing of processing trade. Overall, external demand subtracted 0.5 percent from growth in 2011, compared to a positive contribution of 1 percent in 2010.

Internal tightening dampened investment but was compensated by robust consumption. Investment growth – the main engine of GDP growth in the last decade – slowed from an estimated 12.1 percent in 2010 to 10.3 percent in 2011. Credit-dependent private investment was especially affected by policy efforts to raise rates, lift reserve requirements and tighten prudential controls. Public investment slowed as infrastructure-oriented stimulus support was withdrawn. In contrast, consumption remained robust at 10 percent in 2011, roughly in line with historical trends. Robust consumption growth was underpinned by solid labor market fundamentals and by rapid income growth despite inflationary pressure.

Recent indicators have painted a mixed picture. *Retail sales* rose during the first two months at 14.7 percent, well below market expectations and December's growth rate of 18 percent. Nevertheless, comparing similar periods given Spring Festival effects, growth remained relatively robust – in line with rates observed before the subprime crisis and exceeding last year's observation. *Industrial production* slowed to 11.4 percent over the first two months of this year, compared with 12.8 percent in December, but edged up slightly in sequential terms. *Profit growth of industrial sectors* slowed down to 1.1 percent (yoy, 3mma) in February, the lowest growth rate observed since the middle of 2009. Although manufacturing purchasing manager indices (PMI) of NBS improved somewhat in March, they still remained weaker than in February after considering seasonal effects. This pattern of continued weakness is also mirrored in the PMI indices of HSBC. According to latest HSBC data, the PMI contracted to 49.6 in March, and SMEs experienced contracting new orders for the fourth month in a row.

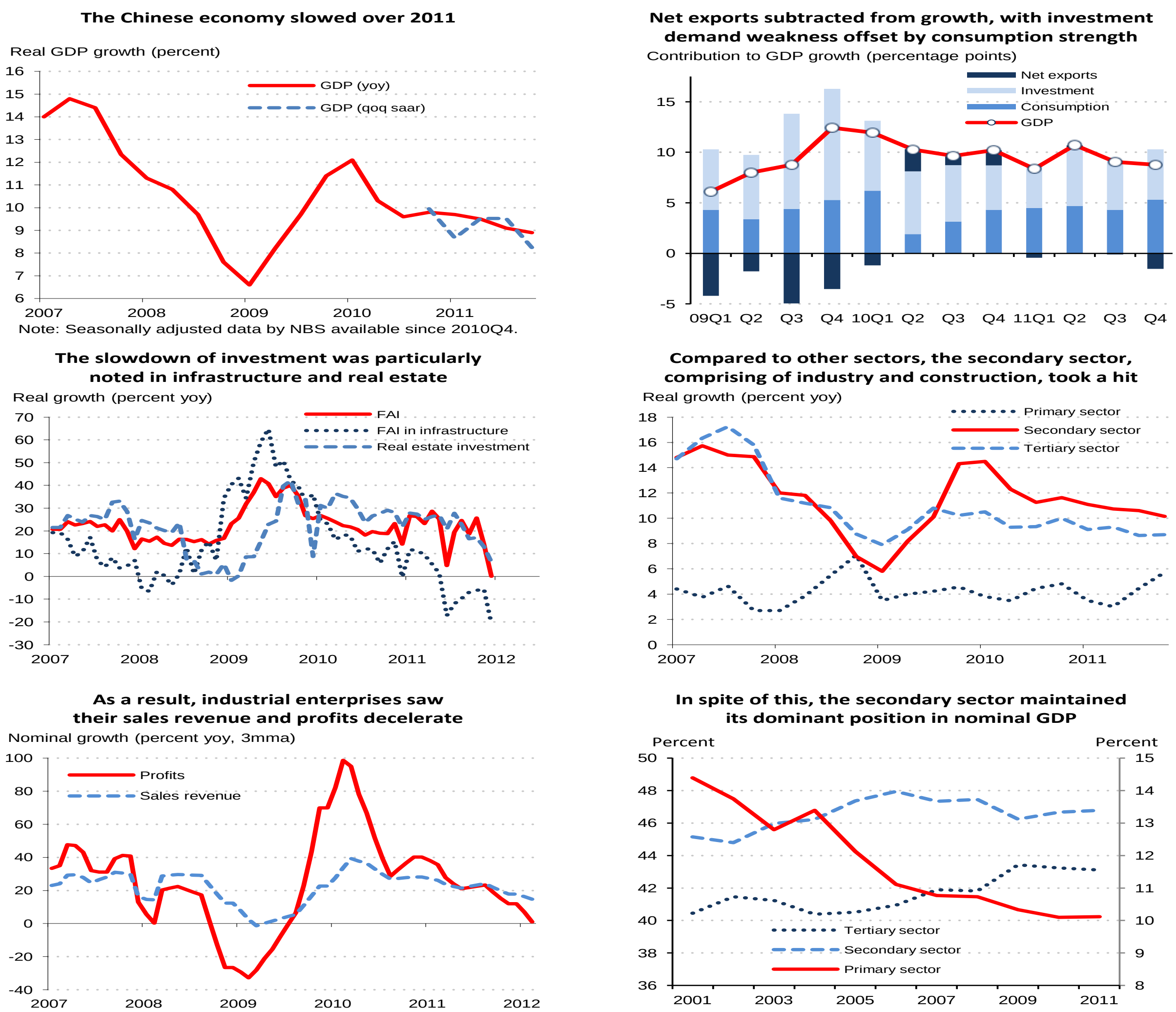
Labor Markets Became Less Tight

The economic slowdown brought a slight softening of labor market conditions (Figure 3). By the third quarter of 2011, manufacturing employment had already been affected, with the brunt of adjustment registered in coastal areas. Industry employment growth slowed since the second quarter of 2011, whereas employment growth in the services sector remained robust through 2011. The relatively good performance of the services subsector was explained by demand from the real estate management and health sectors, where the former would be expected to have moderated in later months given the property downturn. Employment in wholesale and retail trade continued to grow, reflecting the continued strength of domestic consumption.

The softening of labor markets occurred in the context of previously tight conditions with urban demand-supply ratios at historically high levels. Through the third quarter of 2011, urban demand for labor continued to outpace supply. This tightness eased somewhat, especially along coastal areas. This reflected primarily a slowing of private sector employment, with employment in the state-owned sector remaining robust.

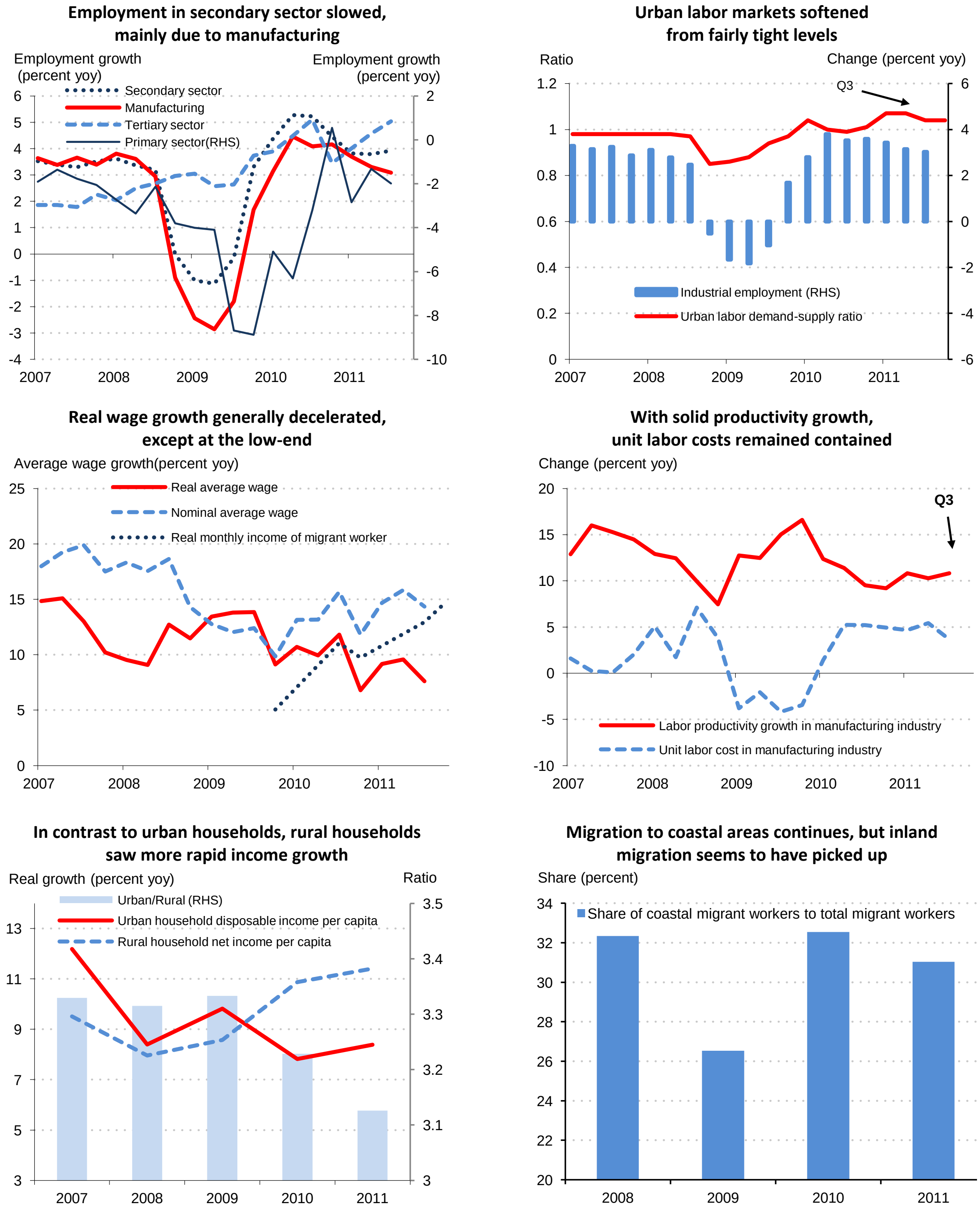
Real wage growth decelerated, except at the lower end of the labor market. Nominal wage growth remained generally robust, even though the slowing of the economy contained upward pressure during the second half of 2011. Real wage growth slowed markedly given higher inflation. Interestingly, as the demand for low-skill workers remained strong, real wages at that end of the market expanded robustly – a trend noted since the end of 2009. Migrant workers experienced real wage increases of more than 11 percent in 2011. Cyclical volatility coupled with inland development has led to inland areas attracting an increased share of total (inland and coastal) migrants. Nevertheless, unit labor costs remained contained as labor productivity continued to grow robustly.

Figure 2. Output Developments



Sources: NBS, CEIC, World Bank staff estimates

Figure 3. Labor Market Developments



Sources: NBS, CEIC, World Bank staff

Rural income growth remained strong. Despite high rates of rural inflation (close to 6 percent), net per capita incomes still grew by more than 11 percent. In contrast, per capita disposable income of urban households grew some 3 percentage points more slowly. This reflected a greater sensitivity of urban incomes to the ongoing slowdown as well as expanded fiscal expenditures in rural areas. In spite of this, the urban-rural divide remains wide, with average incomes in urban areas some 3.1 times higher than in rural areas. While significant progress has been made in poverty eradication, poverty remains an important issue with the official number of rural poor at 128 million (this reflects an increase in 2011 from 27 million following the revision of the official rural poverty line from 1,276 to 2,300 yuan, which was a welcome development).

Property Markets Eased

Following a spate of tightening measures, transaction volumes in residential property markets have cooled (Figure 4). Since April 2010, measures have been undertaken to cool the residential property market. These have ranged from higher transaction fees to progressively stricter qualification requirements for mortgages and administrative restrictions on price, purchases and financing. Complementing these were supply-side measures to boost the availability of subsidized housing. As a result, transaction volumes fell dramatically since the third quarter of 2011 – decreasing by 20 percent on the year before in first-tier cities and by as much as 50 percent in Chongqing, where a property tax was first piloted.

Property prices declined in response – but remained buoyant in commercial markets and residential markets less affected by the controls. Residential markets in first- and second-tier cities experienced property deflation since last October. By February, the deflationary pattern had spread to more than half of the 70 large cities surveyed by the NBS. Residential property markets in third- and fourth-tier cities, where controls were less prevalent, and commercial property markets continued to see rapid, though also decelerating, inflation. The authorities announced last October that more cities would need to adopt controlling measures.

Real estate investment slowed significantly. As residential markets cooled, some developers experienced funding pressures. Given past profitability these pressures remained contained. However, in combination with the expectation that property controls would be in place for a protracted period of time, they did dip into profitability and dampened real estate investment growth to a degree not seen since 2008/09. Compared to the previous quarter and adjusted for seasonal effects, floor space started – a leading indicator of housing investment – more than halved. However, real estate investment rebounded unexpectedly in the first two months of 2012, while transaction volumes in many big cites also recovered in February according to Soufun's statistics.

NOMINAL PRESSURES ARE SUBSIDING

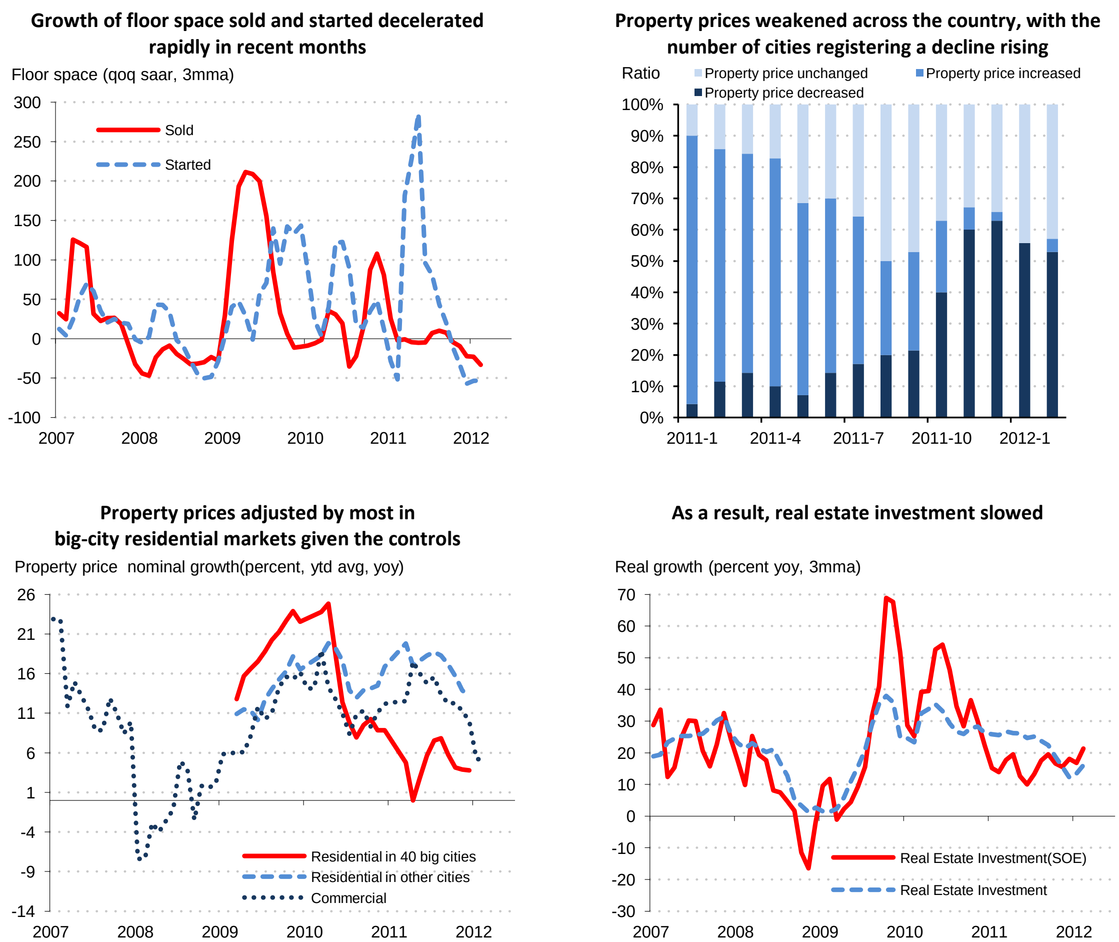
Inflation Rose and Then Receded

Consumer price inflation reached high levels in 2011, but has well passed its peak by now (Figure 5). The CPI rose from 2 percent early 2010 to over 6 percent in the summer of 2011. On a seasonally adjusted basis, inflation started to decelerate in July. Inflation for the year as a whole reached 5.4 percent, 1.4 percent higher than the policy target set in early 2011.

Inflation developments have been largely a function of food price fluctuations. Two-thirds of consumer price inflation associates with food – the result of high food inflation (11.8 percent in 2011) and food's weight in the consumption basket (an estimated 31 percent as of early 2011). After vegetable and fruit prices drove food inflation initially, pork prices became the key driver as a result of cyclical effects (the 'hog cycle') and a local disease outbreak. Food inflation started to slow in September 2011. Non-food inflation has come down as well with the slowing economy and the impact of softening commodity prices during the second half of 2011.

These patterns were broadly mirrored in the evolution of producer prices. As the macro stance was tightened, the slowdown of the domestic economy triggered a decline in producer prices as of the third quarter of 2011. Given the dependence of the Chinese economy on energy and non-energy commodities, producer prices were also closely related to international developments in commodity prices.

Figure 4. Property Market Developments



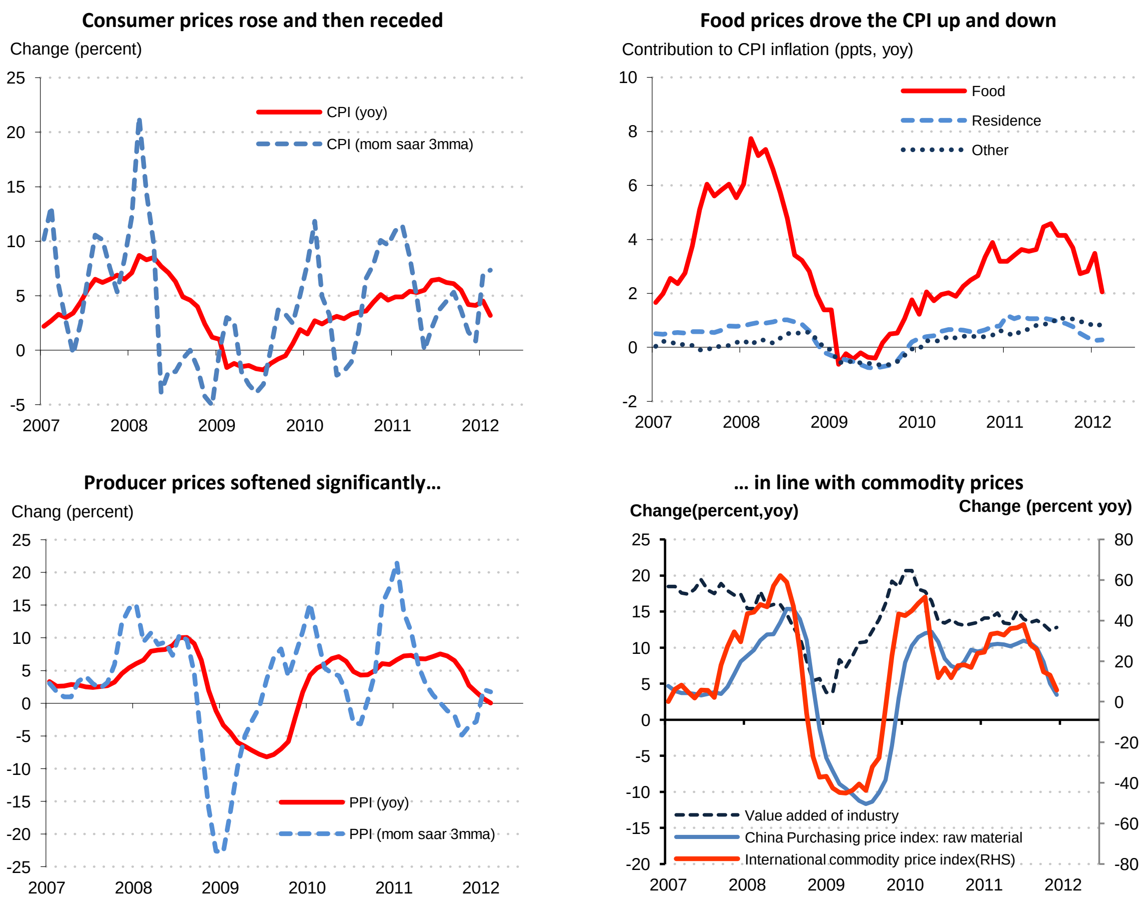
Sources: NBS, CEIC, World Bank staff

The most recent data suggests that inflation is decelerating further. Consumer price inflation stood at 3.2 percent in February, the lowest level in 20 months. Food price inflation remained relatively high at 6.2 percent. Producer price inflation continued to ease as well, reaching 0 percent in February.

Money and Credit Growth Slowed

While during most of 2011 the policy setting was tightened, the end of the year marked a gradual easing (Figure 6). In an effort to curb money growth and contain inflationary pressure, the required reserves ratio was raised six times in 2011. Benchmark interest rates were raised three times. In addition, credit quotas were adjusted and supervision was tightened, particularly of off-balance sheet activities. As the focus incrementally shifted from fighting inflation to protecting growth, the policy stance was somewhat eased towards the end of the year with a lowering of reserve requirements. This was followed by further measures in early 2012.

Figure 5. Price Developments



Sources: NBS, CEIC, World Bank staff estimates.

Monetary and financial conditions responded to the tightening of policy. Money and loan growth initially moderated, with new RMB bank lending undershooting the target ceiling of RMB7.5 trillion for 2011. The flow of net new social financing was reduced by more than 10 percent. Off-balance sheet activity remained buoyant initially as SMEs and some property developers sought financing elsewhere given the tighter conditions for traditional credit products. As a result, entrusted lending more than doubled during the first three quarters of 2011. However, with the introduction of tighter regulations on off-balance sheet activities and given the emergence of problems in informal lending markets, full-year growth was contained to 15 percent. Real estate lending also weakened in line with developments in the property markets.

More recent developments reflected the gradual easing of policy in the face of slower trade and growth. Fourth-quarter data suggests RMB lending picked up as policies were eased and overall credit conditions improved. The last two quarters saw weaker foreign exchange inflows. While the more difficult external environment dampened base money growth, the easing of required reserves provided support. In addition, efforts were made to protect the ability of banks to lend, particularly to small- and medium-sized enterprises.

Official indicators point to limited effects so far of slower credit growth on the profitability and soundness of the banking system. The apparent resilience of the banking system was helped by buoyant revenue growth given earlier balance sheet expansion, solid interest margins and off-balance sheet revenue sources. Given the importance of interest income, the credit slowdown dipped into these buffers, with the reported return on equity of commercial banks falling over 2 percentage points over the last two quarters of 2011. Non-interest income also weakened somewhat. Non-performing loan data point to a declining trend followed by a modest uptick in the fourth quarter of 2011. However, information gaps and weaknesses complicate the assessment of leverage, contingent liabilities, off-balance sheet positions, and cross-border and sectoral exposures of the banking system.[1]

Balance of Payments Softened

The trade surplus shrank to its lowest level since 2006 (Figure 7). Export growth was by machinery and transport equipment and manufactured goods. While export demand weakened across all markets, the slowdown of demand from the EU was most noteworthy. Despite China's growth slowdown, import demand remained relatively robust on the strength of commodity demand. While commodity prices declined during that period, the increased volume of imports of raw materials and mineral fuels helped sustain total import growth. Such imports accounted for 30 percent of total imports in 2011, compared to 20 percent a year earlier.

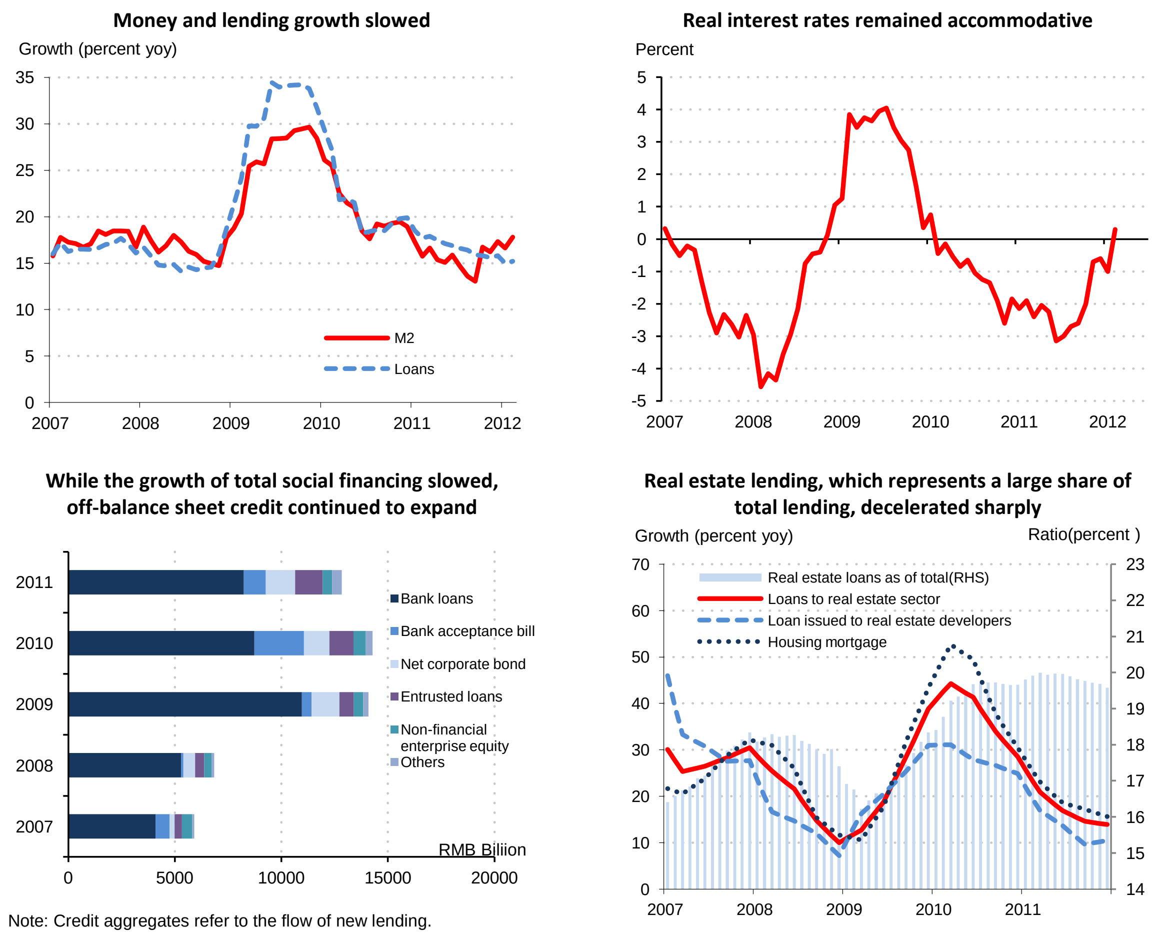
Recent data confirm the weakness of foreign trade. In February, China posted its largest trade deficit in over two decades at USD31 billion, with imports surging by 40 percent and exports growing at only half that rate. These numbers however paint a distorted picture as the Chinese lunar New Year fell in January this year. Still, the combined trade deficit for January and

[1] International Monetary Fund and World Bank (2011).

February stood at USD4.2 billion, far below the 2011 outcome for the same period (USD0.8 billion) and also the lowest trade balance since 2004.

The lower trade surplus occurred as other balance of payments flows also fell, dampening foreign exchange appreciation and accumulation. The RMB appreciated 4.9 percent in 2011 against the US dollar. As the US dollar appreciated substantially against many other currencies in the second half of 2011, the appreciation of the RMB was more in effective terms (against a trade-weighted basket of currencies). Foreign exchange reserve accumulation slowed significantly since the third quarter, with the latest data for the last quarter of 2011 suggesting that reserves declined by USD21 billion (after accounting for about USD32 billion in valuation effects).

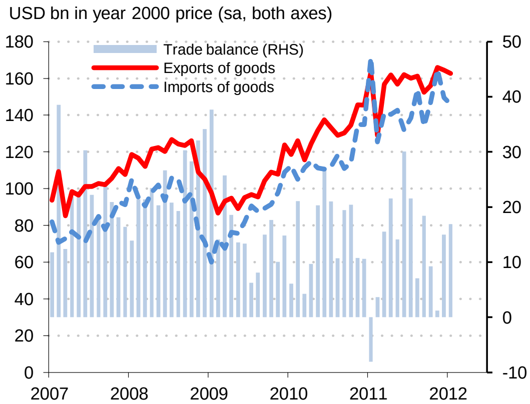
Figure 6. Monetary and Financial Sector Developments



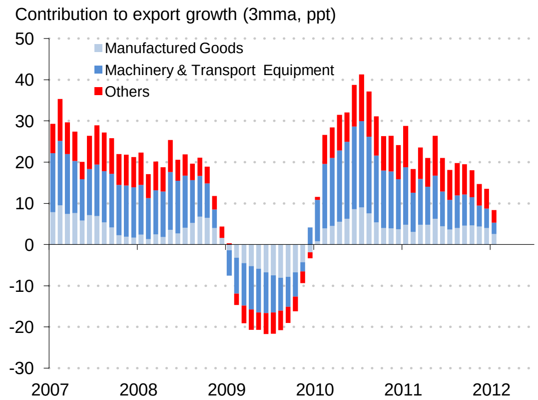
Sources: NBS, CEIC, World Bank staff estimates.

Figure 7. Balance of Payments Developments

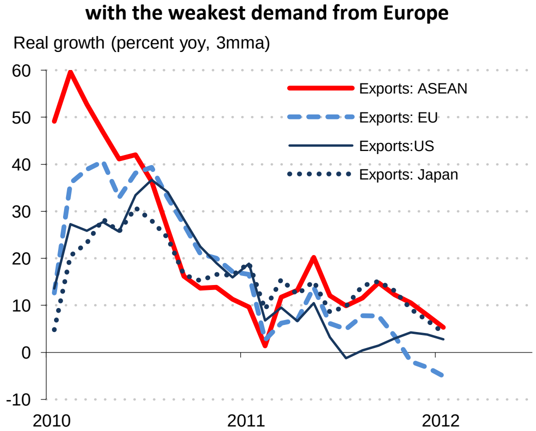
Exports moderated against robust imports



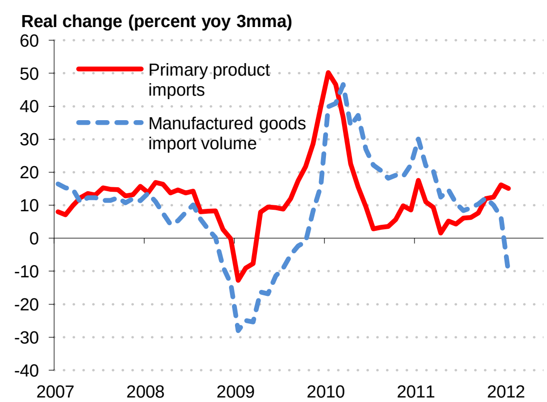
Equipment and manufactures were key contributors to slower export growth



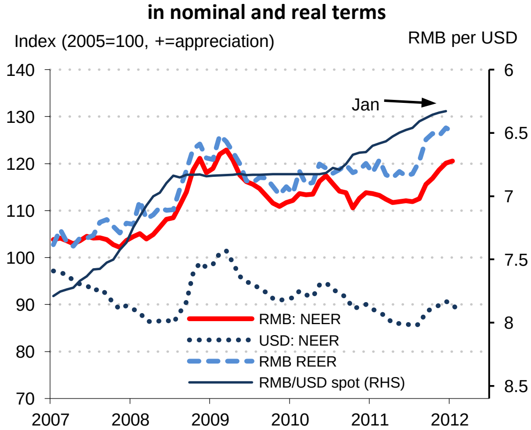
Export demand weakened across markets, with the weakest demand from Europe



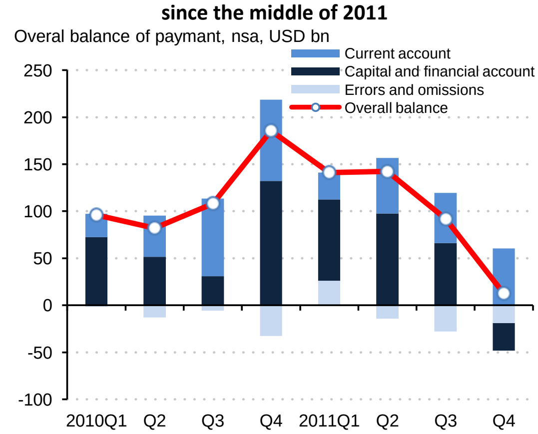
Commodity demand held up import levels, as imports of manufactured goods saw a decline



The currency rate appreciated in nominal and real terms



The overall balance of payments declined since the middle of 2011



Sources: NBS, CEIC, World Bank staff estimates.

ECONOMIC OUTLOOK

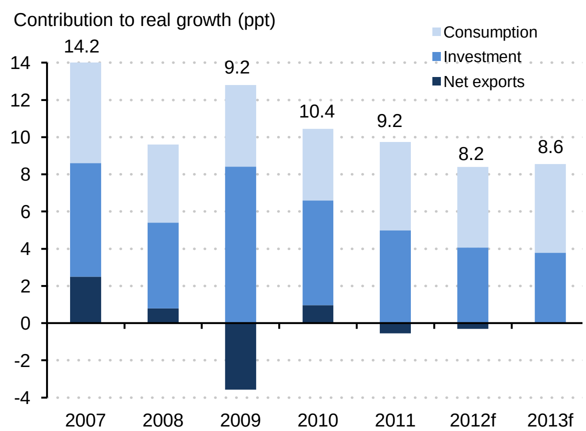
A CHALLENGING ECONOMIC ENVIRONMENT

The Chinese economy faces challenges that are set to constrain growth both in the near and over the longer term. In the near term, growth will continue to respond to the external and domestic factors behind the current cyclical slowdown. Over the longer term, structural changes are expected to gradually alter the rate and pattern of growth as the traditional engines of growth wane and the economy rebalances towards consumption and services. Over time, China is expected to reach a new equilibrium of higher-quality, albeit slower, growth.

External Weakening and Domestic Tightening

Global activity and trade are set to soften further this year and remain relatively subdued thereafter. With Europe already in recession, high-income economies are expected to register more sluggish growth. Growth is also decelerating in most developing economies. As a result, world trade will continue weakening in terms of volumes and pricing, affecting China's export-oriented economy.

Figure 8. External weakening and domestic tightening expected to weigh on near-term outlook



Source: NBS, CEIC and World Bank staff forecasts.
Note: Overall GDP growth numbers listed at top of bars.

The ongoing domestic adjustment in response to a previously overheated economy will likely continue with pronounced effects on investment demand. This adjustment partly reflects the impact of policy initiatives such as the winding down of earlier stimulus measures and efforts to cool the property market.

Structural Slowdown and Rebalancing

As China's traditional engines of growth lose steam, a structural growth slowdown is anticipated into the longer term. Spurred by high savings, cheap finance and other inputs, and export-oriented policies, China's impressive growth has been investment- and industry-led. As the immediate gains from capital accumulation and labor reallocation wear out and the labor force declines due to population ageing, growth will slow.

The longer-term outlook also foresees adjustments as imbalances associated with past economic success are gradually addressed. Swift growth and associated structural change, while resolving many problems, have been accompanied by rising economic, social, environmental, and global imbalances. Resolving these will lead to welcome changes in the pattern of development.

CYCLICAL SOFTNESS TO DOMINATE NEAR TERM

Growth to Dip in 2012, Followed by Mild Recovery

Our baseline scenario foresees a growth slowdown in 2012 to 8.2 percent, followed by a mild rebound to 8.6 percent in 2013 (Figure 8). These forecasts compare to earlier forecasts of 8.4 and 8.3 percent as of November 2011 (World Bank, 2011). Since then, the impact of external weakening and domestic tightening has come into sharper focus. It is their combination that dampens the outlook for 2012.

Box 1. Global Economic Prospects Have Deteriorated

The World Bank's most recent forecast is for global growth to ease to 2.5 and 3.1 percent in 2012 and 2013 (World Bank, 2012). The euro area would be in mild recession through 2012, with growth anemic during 2013. While this affects their growth prospects through trade and financial channels, the United States and Japan would fare better. This reflects stronger demand fundamentals for the United States – expected to carry over to 2013 – and the reconstruction-related rebound from the Tohoku disaster expected to wear off in 2013. High-income economies as a group are likely to see subdued growth of 1.4 and 2.0 percent.

Developing economies grew strongly by 6.0 percent in 2011, but this would slow to 5.4 percent for external and domestic reasons. The difficulties in high-income economies, responsible for two-thirds of global trade flows, will circumscribe prospects. World trade is expected to slow to 4.6 percent and the prices of manufacturing, oil and non-energy commodities are projected to fall by 4.5, 5.5 and 9.3 percent. In addition, growth of domestic demand would weaken in several countries in response to efforts to address earlier overheating.

Figure 9. East Asia without China would see faster growth

Source: World Bank (2012).
Note: e= estimate, f = forecast; developing East Asia Pacific region.

Developing East Asia would slow only little and maintain rapid growth relative to other regions. China distorts this picture given its 80 percent share in regional GDP. Excluding China would reduce growth rates in 2012 from 7.8 to 5.5 percent – in line with other developing regions. Without China, the region would not see a growth slowdown in 2012 – unlike most other regions – thanks to what may be sufficient vigor in ASEAN-4 domestic demand (Figure 9).

Table 1. Global Outlook

Percent change from previous year, unless otherwise mentioned

	Latest (Jan 2012)				
	2009	2010	2011e	2012f	2013f
Real GDP growth					
World	-2.3	4.1	2.7	2.5	3.1
High-income countries	-3.7	3.0	1.6	1.4	2.0
Euro area	-4.2	1.7	1.6	-0.3	1.1
Japan	-5.5	4.5	-0.9	1.9	1.6
United States	-3.5	3.0	1.7	2.2	2.4
Developing countries	2.0	7.3	6.0	5.4	6.0
Developing, without China and India	-1.7	5.5	4.4	3.8	4.5
East Asia and Pacific	7.5	9.7	8.2	7.8	7.8
East Asia and Pacific, without China	1.5	6.9	5.2	5.5	5.6
Trade volume and prices					
World trade volume	-10.6	12.4	6.6	4.7	6.8
Manufactures unit export values	-6.6	3.3	8.9	-4.5	0.8
Non-oil commodity prices	-22.0	22.4	20.7	-9.3	-3.3
Oil price	-36.3	28.0	31.6	-5.5	-1.2

Source: World Bank (2012).

China's growth slowdown in 2012 is driven by a smaller contribution of domestic demand and a continued negative contribution of external demand. Domestic demand growth decelerates in 2012, contributing only 8.4 percentage points to overall growth – a significant decline from the 10.7 percent average for the period 2006 through 2010. External demand continues to contribute negatively in 2012, subtracting 0.3 percentage points as in the year before – again significantly below the positive contribution of 0.5 percentage points over 2006 to 2010.

As the external environment likely improves in 2013, growth is forecast to rebound somewhat. The contribution of domestic demand to GDP growth would improve slightly to 8.5 percent. External demand would register a modest come-back, contributing 0 percent to growth (relative to earlier contributions that were negative).

Consumer Demand Provides Support

Consumption is expected to slow but should remain supportive. Consumption expenditure surprised on the upside in 2011. Relative to a higher base, private consumption growth would decelerate to 8.7 percent, roughly in line with estimated historical averages. In spite of the negative influence of wealth effects arising from equity and property price adjustment, consumption should remain broadly supportive given still-solid labor market fundamentals, healthy income growth and lower projected inflation. Government consumption is expected to fill some of the slack during 2012 with social spending picking up.

Investment Demand Is Likely to Disappoint

Investment demand is expected to slow during 2012. As noted above, real estate markets have started to weaken. Tighter liquidity conditions for developers and falling housing prices could combine to depress residential real estate investment. As the business outlook for export-oriented manufacturing remains bleak and credit controls continue to bite, capital investment would remain soft. Government investment would mitigate this partially. Growth of overall investment is expected to slow to 8.5 percent, compared to 14.7 percent during 2006-2010. Inventory investment would contribute only slightly to overall growth given the lack of an inventory overhang and the expectation of an only modest recovery.

Trade Would Again Subtract from Growth

External trade will likely be a drag on growth in 2012 as exports slow more than imports. The projected slowing of world trade growth from 6.6 percent in 2011 to 4.7 percent in 2012 would weigh on China's export growth, which is expected to slow to 9.7 percent. China would still expand its world market share, but the rate of increase would likely not exceed 0.4 percentage points in the years to come (compared to 0.6 percentage points over 2006 through 2010).

Import growth is projected to decelerate to 12 percent. The slowdown is primarily driven by the processing trade, with processing imports following the fate of processing exports. Non-processing imports however provide (relative) support: they slow too, but by less given that domestic demand is projected to remain more resilient than export demand.

Prices – Absolute and Relative – Adjust

Inflationary pressures are expected to subside temporarily. Inflation is likely to stay on its declining trend falling to 3.2 percent for 2012. This will be the result of the weakening of growth, the fading of earlier commodity price impulses (even though recent food inflation was still strong) and the policy-induced cooling of the property market.

Demand-pull factors are expected to recede in the near term, but would feed inflationary pressure again later as growth differentials with the rest of the world attract capital inflows and as consumption growth remains relatively strong in a setting where potential growth decelerates. Cost-push factors played a leading role recently and could also fuel future inflationary pressure. Sustained wage increases may hit profitability and, depending on productivity developments, lead producers to raise prices.

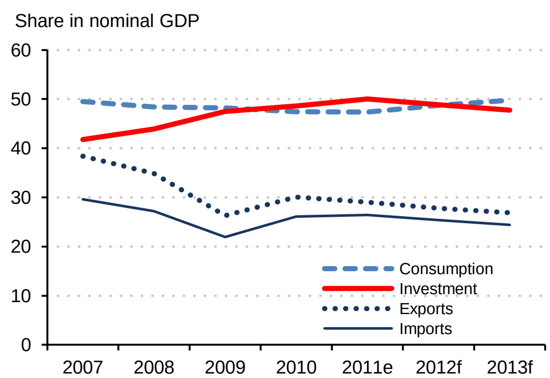
China's external terms of trade will likely improve in the coming years. Both export and import prices are expected to come down in 2012 and beyond. However, import prices – which also saw a more pronounced upswing in recent years – could decline by more given the importance of commodities in China's import demand and the projected deceleration of commodity prices. As a result, the terms of trade would improve by 1.5 percent in 2012 and 1.3 percent in 2013. As commodity price adjustment plays out in later years, the effect would likely diminish and eventually reverse itself in view of China's longer-term needs for commodities.

The outlook for trade is likely to constrain the pace of currency appreciation over the next few years as China's export prices come under greater pressure. The more difficult trading environment would also constrain China's ability to expand market share. These conditions would likely apply as well to 2013.

Cyclical Weakening Aids Rebalancing

The near-term outlook foresees a rebalancing in the structure of nominal demand – particularly domestic demand (Figure 10). The share of domestic demand in nominal GDP remains roughly constant at around 97.5 percent. The aggregate however masks a change in the composition of domestic demand, with the share of consumption rising back to its 2007 levels (close to 50 percent of GDP) and the share of investment seeing a corresponding decline. The nominal contribution of external demand remains at historically low levels. Given the forecasts for trade volumes and prices, net exports shrink to a low of 2.4 percent in 2012 and are projected to remain at similar levels thereafter.

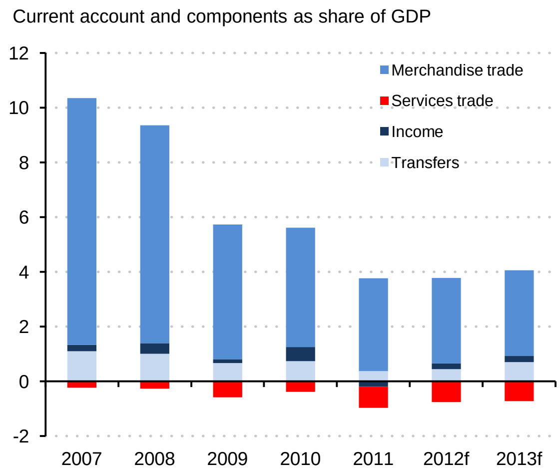
Figure 10. Given cyclical softness in exports and investment, the consumption share in GDP rises



The current account surplus would rise modestly from 2.8 percent in 2010 to 3 percent and 3.3 percent in 2012 and 2013 (Figure 11). These gradual increases largely reflect an improvement in the terms of trade, where trade volumes initially offset some of that improvement in 2012 but later contribute to it in 2013. The income and transfer balances are expected to provide support in both 2012 and 2013, as these gradually recover from their poor outturns in 2011.

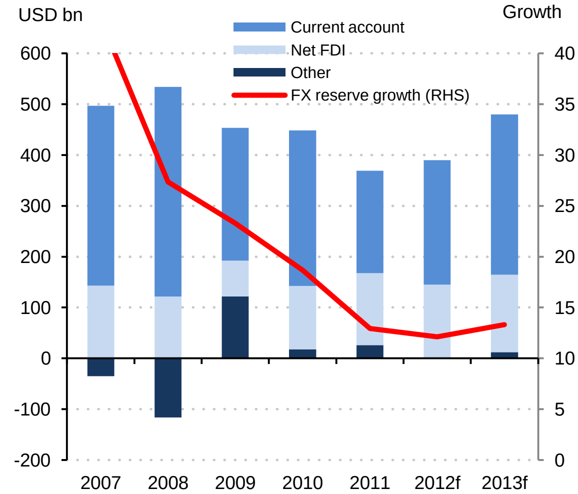
Foreign reserves are expected to keep on accumulating, reaching USD3.2 and 3.6 trillion in 2012 and 2013 on the back of a still positive trade balance and continued net capital inflows (Figure 12). The rate of accumulation would slow somewhat further to 12.1 percent in 2012 and 13.3 percent in 2013. This deceleration is mainly explained by the evolution of the current account combined with the a projected decline in net FDI flows, as outward investment sees faster growth given policy support and longer-term needs for raw materials.

Figure 11. The current account remains weaker compared to a few years back



Source: NBS, CEIC and World Bank staff forecasts.

Figure 12. The pace of foreign exchange accumulation is expected to slow



Source: NBS, CEIC and World Bank staff forecasts.

Table 2. China Near-Term Outlook
Annual percent change, unless otherwise indicated

	2007	2008	2009	2010	2011	2012f	2013f
Real Sector Developments							
Real growth: 1/							
Real GDP	14.2	9.6	9.2	10.4	9.2	8.2	8.6
Domestic demand	12.5	9.6	13.9	9.9	10.1	8.7	8.8
Consumption	10.9	8.4	8.9	7.8	10.0	9.1	9.9
Investment	14.6	10.9	19.8	12.1	10.3	8.3	7.6
Contribution to real GDP growth (ppts): 1/							
Domestic demand	11.7	8.8	12.8	9.5	9.7	8.4	8.5
Consumption	5.6	4.2	4.4	3.8	4.8	4.3	4.8
Investment	6.1	4.6	8.4	5.6	5.0	4.1	3.8
External demand	2.5	0.8	-3.6	1.0	-0.5	-0.3	0.0
World Bank estimates: 2/							
External demand (contribution, ppts)	3.2	2.0	-5.4	3.8	-0.5	-0.3	0.0
Exports (gnfs, real growth)	19.4	7.6	-10.2	28.2	12.1	9.7	11.6
Imports (gnfs, real growth)	14.1	3.6	4.4	19.9	15.7	12	12.5
Processing imports (real growth)	11.0	-4.1	-12.3	20.1	9.1	5.7	7.6
Nonprocessing imports (real growth)	16.3	9.0	14.6	19.8	18.5	14.4	14.5
Price Developments							
Deflator growth: 1/							
GDP 1/	4.7	8.1	0.7	3.1	7.9	2.8	4.2
Consumption	5.3	6.9	0.6	3.9	6.9	4.9	5.2
Investment	4.2	12.4	-0.7	4.0	10.0	0.3	2.7
Consumer price index (yearly average)	4.8	5.9	-0.7	3.3	5.4	3.2	3.6
External terms of trade 2/	-0.8	-4.7	7.1	-8.9	-1.6	1.5	1.3
Exchange rate (RMB/USD, average)	-4.6	-8.7	-1.6	-0.9	-4.6	..	..

	2007	2008	2009	2010	2011	2012f	2013f
Nominal Developments							
Share in GDP (percent):							
Domestic demand	91.2	92.3	95.7	96.0	97.4	97.6	97.5
Consumption	49.5	48.4	48.2	47.4	47.3	48.7	49.8
Investment	41.7	43.9	47.5	48.6	50.0	48.9	47.7
Net exports	8.8	7.7	4.3	4.0	2.6	2.4	2.5
Exports (gnfs)	38.4	34.9	26.3	30.1	29.0	27.8	26.9
Imports (gnfs)	29.6	27.2	22.0	26.1	26.4	25.4	24.4
GDP per capita (USD)	2,646	3,414	3,799	4,344	5,335	5,957	6,885

Source: NBS, CEIC and World Bank staff estimates and forecasts.

Notes:

1/ GDP by expenditure approach based on contributions data provided by NBS. in 2005 constant prices for 2006-2010 and in 2010 constant prices for 2011 onwards.

2/ World Bank estimates of goods and nonfactor services trade based on trade data for goods from the Customs Administration and adjusted for estimated differences in price developments for services trade. Trade deflators are expressed in renminbi terms.

Table 3. China Near-Term Outlook (continued)

	2007	2008	2009	2010	2011	2012f	2013f
External developments							
Level (RMB billion):							
Merchandise trade balance	315	361	250	254	244	253	295
Current account balance	354	412	261	305	201	245	315
Foreign exchange reserves	1,528	1,946	2,399	2,847	3,216	3,606	4,086
Share of GDP (percent):							
Merchandise trade balance	9.0	8.0	4.9	4.4	3.4	3.1	3.1
Current account balance	10.1	9.1	5.2	5.2	2.8	3.0	3.3
Share of world exports (gnfs, percent)	7.7	7.9	8.4	9.3	9.7	10.2	10.7
Fiscal developments							
Budget balance (percent of GDP) 1/	0.2	-0.8	-2.8	-1.7	-1.1	-1.9	-1.5
Revenue share	19.3	19.5	20.1	20.7	22.0	22.1	22.2
Expenditure share	18.7	19.9	22.4	22.4	23.1	23.9	23.7
Monetary developments							
Broad money growth (M2, percent)	16.7	17.8	28.4	18.9	17.3	..	..
RMB lending growth (percent)	16.1	15.9	31.7	19.9	14.3	..	..

Source: NBS, CEIC and World Bank staff estimates and forecasts.

Note: 1/ In some years, the balance differs from the net of revenues and expenditures due to Adjustment Fund transactions.

Downside Risks Remain Elevated

While financial market pressures have eased somewhat recently, the ability of high income countries to avert a deeper downturn remains a key downside risk. Slower OECD demand can echo quickly through East Asia's production and trade networks, wherein China occupies an increasingly central position. The export growth slump of the last few months could become further accentuated if the fundamentals of high-income economies deteriorate further. This risk is mitigated somewhat, at least for China, by the impact on the terms of trade as in such scenario demand for commodities would decline more rapidly and depress prices. Relatedly, commodity demand would ease if emerging economies (including China) which generate most of the growth in overall commodity demand were to slow more than expected. Given their sensitivity to industrial production, metal and energy prices would be the most vulnerable to such a scenario.

Domestically, the downside risks are centered on the ongoing adjustment in property markets. Since April 2010, the authorities have applied a range of measures to cool down this sector. These measures reflect a trading off between the cost of provoking short-term volatility in property markets and the benefit of containing the built-up of vulnerabilities which could produce a more costly adjustment down the road. While data remain scant, most available indicators clearly suggest that a correction is finally under way.

The adjustment in property markets is welcome, but given the significance of the sector in the overall economy, continued vigilance will be required to contain negative spillover effects. The sector has important linkages to upstream activity such as cement and steel. It can influence the finances of industrial enterprises which engage in property development as a side business. Local governments have derived major revenues from the sale of land use rights to property developers. Thus, a more amplified downturn could have negative economy-wide impacts. Given the length and variability of policy lags and uncertainties about possible counter-interventions, the future trajectory of property prices remains unclear.

LONGER-TERM HORIZON CHARACTERIZED BY STRUCTURAL ADJUSTMENT

Structural Developments to Dampen Outlook

China's growth performance over the last three decades was nothing short of impressive. With growth rates at around 10 percent per year, China emerged as the world's second-largest economy and the largest exporter and manufacturer. Per capita income also rose rapidly, allowing for the transition from low-income to upper-middle income status. The poverty rate fell dramatically, lifting over half a billion people out of poverty.

Urbanization and market reform lied at the heart of China's economic expansion. Rapid urbanization transformed China from a primarily rural, agricultural economy into an increasingly urban one with a more diversified economic structure. The last three decades also saw the transformation from a command-based economy to a more decentralized and market-based system. These two factors coalesced to produce large efficiency gains and have facilitated China's emergence as a world-class competitive powerhouse.

Traditional Growth Drivers Weaken

While the traditional driving forces of growth are far from exhausted, many signs suggest that they are likely to gradually weaken over time. Much of the growth contribution from shifting resources from agriculture to industry has already occurred. Going forward, the continued accumulation of capital, although sizable, will inevitably contribute less to growth as the capital-labor ratio rises (even though further capital accumulation will be needed given that China's current capital stock per worker is estimated at only about a tenth of the US level).

Moreover, China is poised to go through major demographic change: the old age dependency ratio will double in the next two decades, reaching the current level in Norway and the Netherlands by 2030 (between 22 and 23 percent); and the size of China's labor force is projected to start shrinking as soon as 2015, dampening savings. Yet workers will become more productive as the physical and human capital stock per worker continues to rise.

Finally, total factor productivity (TFP) growth—a measure of improvements in economic efficiency and technological progress—would also decline, in part because the economy has exhausted gains from first-generation reforms and the absorption of imported technologies that were relatively easy to access, adopt and adapt. As a result, the distance to the technological frontier has shrunk, and second-generation policy reforms are likely to have a smaller impact on growth.

China Rebalances

While serving China well in many respects, rapid growth and accompanying structural change have also introduced economic imbalances. Spurred by high savings, cheap finance and other inputs, and export-oriented policies, growth has been industry- and investment-led. The priority accorded to industry stunted services development, while the emphasis on physical investment constrained investment in human capital. With wages lagging productivity growth, the share of wage income in GDP declined to 48 percent by 2008, with the consumption share at low levels for a major economy.

These trends also contributed to imbalances in other spheres. Income disparity widened to high levels and social imbalances were exacerbated by unevenness in access to basic public services and by tensions surrounding land acquisition. On the back of industry-driven growth and urbanization, China became the world's largest energy user. Fast growth also led to serious environmental pollution. Finally, many of the policies that generated China's internal imbalances also contributed to its twin current and capital account surpluses. Together with China's expanding global market share, these fueled protectionist pressures in key foreign markets.

Addressing these imbalances – as the 12th Five-Year Plan seeks to do – will fundamentally alter the pattern of development. The Five-Year Plan foresees a more balanced growth structure. Emphasizing the quality over the rate of economic expansion, the Plan also foresees efforts of industrial upgrading to move the country's production mix up the value chain. Efforts to address social disparities and protect the environment would also have an important economic impact. For example, government consumption may rise to finance public goods such as education and health while other reforms work to reduce household saving. On the environment side, measures to reflect the negative environmental externalities in the pricing of inputs would alter the pattern and energy-intensity of investment.

Illustrative Scenarios Point to Profound Impact

Illustrative scenarios suggest that these structural trends – a weakening of traditional growth drivers and a rebalancing toward improved quality of growth – would have both a profound and a welcome impact on the Chinese economy.[2] Overall GDP growth is expected to decline gradually from an average near 8.5 percent in 2011–15 to around 5 percent by 2030 (Figure 13).

The composition of production and expenditure would also see gradual but significant changes. As domestic sources of growth are emphasized, the Chinese economy would see a higher share of services and consumption and a lower share of exports, savings, and investment (Figure 14). Reforms which encourage urban job creation and greater upward pressure on wages boost the share of wages and household income in GDP, increasing the role of household consumption. Government consumption would rise to meet increasing expenditure demands in the social sector and on operations and maintenance.

Savings and investment as a share of GDP decline over time. Corporate savings decrease as real wages rise and as the economy becomes less capital intensive and less industry-based. Government savings fall because of more current and less capital spending. Reforms in health, education and social security work to reduce household saving. Despite lower investment, the current account surplus gradually declines relative to GDP, easing external imbalances.

Urbanization—a driver of China's increased global competitiveness—is poised to continue. Over the coming two decades, the urban population would grow at the equivalent of more than one Tokyo each year, with the share of urban residents climbing to about two-thirds. Growth and job creation in urban centers would attract more rural-urban migration and result in higher rural productivity and income and less urban-rural inequality. More urbanization stimulates the service industry, including via the spending patterns of urban residents. As China continues to urbanize, the share of employment in agriculture would fall to around 12.5 percent in 2030.

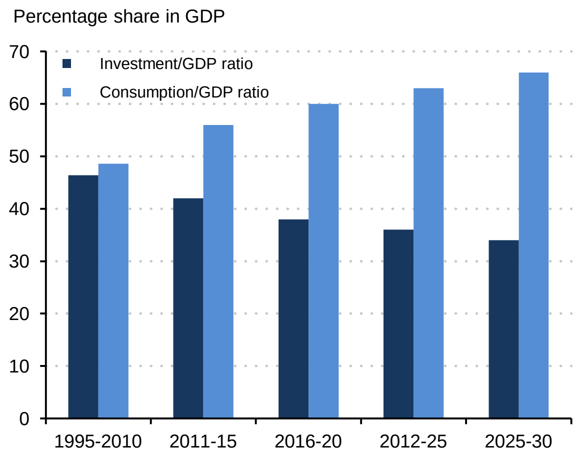
Income inequality is showing tentative signs of beginning to flatten and possibly even decline on the back of three factors. First, faster growth in the middle and western regions would continue, reducing the gap with coastal areas. Second, migrant wages would continue to rise rapidly, reducing the income gap with urban residents. Third, even if urbanization continues, rural-urban migration will gradually slow as the structural shift from agriculture to manufacturing eases and the rural-urban wage gap narrows.

[2] Development Research Center and World Bank (2012).

Figure 13. Slower growth is predicted in the long term as the labor force shrinks and labor productivity slows

Source: Development Research Center and World Bank (2012).

Figure 14. Investment as a share of GDP falls, with the consumption share filling the slack



Source: Development Research Center and World Bank (2012).

Finally, China would be expected to use fewer primary commodities, consume less energy and produce less pollution. This is because it would have less industry and, within industry, less heavy and dirty industry, in large part because of better pricing of energy, commodities, and environmental degradation.

POLICY PRIORITIES

SUSTAINING NEAR-TERM GROWTH

With the economy slowing in the near term, the policy challenge is to ensure that this continues in a gradual fashion. The slowdown is to be partly welcomed since it reflects a deceleration from above-trend growth in a context where trend growth is also gradually weakening. In spite of this, there is a concern that the economy – in view of external and domestic risks – could slow too quickly. However, sufficient policy space exists to facilitate an orderly adjustment and respond to downside risks if they were to materialize. Any such policy support should be crafted carefully keeping in mind longer-term effects and objectives.

The need to walk a fine line in light of current uncertainties is well reflected in recent policy statements (such as the recent Government Work Report at the National People's Congress). China would maintain a policy mix of proactive fiscal policy and prudent monetary policy in 2012, but the policy stance would be kept flexible in accordance with changes in the economy. Macroeconomic regulations would be strengthened to maintain a balance between keeping economic growth, restructuring the economic pattern and managing inflation.

Soft Landing Calls for Additional Policy Support

With activity weakening, the burden of the countercyclical response should in the first instance fall on fiscal policy. China has room to support the decelerating economy by fine tuning the stance of fiscal policy. China has more fiscal space than most other countries, although less than it had in late-2008. While concerns about local government debt have risen, the general government balance sheet remains healthy and the ability to fund is not a problem. This fiscal space could be used to facilitate a soft landing and probably should be used if downside risks to growth were to heighten (see below).

Fiscal stimulus measures that support consumption would attract first priority. Relative to the previous episode of fiscal easing, the stimulus would ideally be less credit-fueled, less local government-funded, and less infrastructure-oriented. Policy options to lift consumption would include targeted tax cuts (particularly consumption taxes and social contributions), social welfare spending (to provide support to those suffering as a result of the downturn) and other social expenditures (such as on education, healthcare and pensions). Such measures would also assist in promoting longer-term rebalancing in the drivers of growth.

The stance of monetary policy could be fine-tuned further in light of the shifting balance of risks from inflation to growth. Monetary policy began to ease back in November with a reduction in the reserve requirement ratio. The beginning of the easing cycle – the first since 2009 – reflects the shift of emphasis to protecting growth, with the central bank targeting a slightly higher rate of M2 growth than last year. Policy action on the interest rate side is subject to the constraint that administered real interest rates are already highly accommodative – even if they have recently become slightly less supportive as inflationary expectations moderated.

Reserve requirements could be lowered further given tighter financing conditions, with policy rate action best reserved for downside scenarios. This would support the flow of credit to firms afflicted by slowing export demand or the adjusting real estate market. Lowering policy rates further could sow the seeds for inflationary pressure and speculative activity later on. It would also conflict with the need for higher real interest rates to facilitate the economy's rebalancing through a sustained rise in the cost of capital.

Prudential and administrative efforts have helped in deflating property values, scaling back speculative activity and improving affordability. In the absence of more fundamental measures, the continuation of these efforts will help complete the adjustment in property prices, while also avoiding a resurgence of speculative activity once the economy picks up again. This is also the approach advocated by the authorities, where the policy objective remains to bring housing prices back to 'reasonable levels' to ensure fairness and stability.

Meanwhile, as their revenue base is tied to the volatility of property markets, fiscal reform measures will be welcome to strengthen local government finances.[3] Looking ahead, rather than rolling back property controls to support revenue in the short term, the optimal measure to buffer local government finances would be to make headway on fiscal reform. This would

[3] In Beijing, for example, land transfer revenues stood at RMB123 billion in 2011, a fall of 35 percent compared with 2010. Much of this was accounted for by the residential market, which led to a drop in land revenue of 55 percent.

require reducing the large disparities in resource availability between sub-national governments.[4] To this end, the authorities have announced measures to improve the fiscal payments transfer system.

From a longer-term perspective, administrative efforts to contain property markets are likely to see diminishing effectiveness and could be replaced by more fundamental policy changes. This would include structural reforms to expand the range of investment opportunities, make the price of capital more responsive to market forces and dissuade speculative activity through indirect means such as taxation. China is already piloting property taxes in Chongqing and Shanghai, the lessons of which could serve as a basis for further measures.

Flexibility Needed Should Risks Heighten

While the prospects for a soft landing remain high, there are concerns that growth could slow too quickly. Should the downside risks heighten, more forceful policy action may be justified. Contingency planning for such a scenario would be welcome so as to line up initiatives that optimize the countercyclical impact with due consideration to longer-term effects and objectives.

While similar principles would apply to the design of the fiscal stimulus (i.e. channeling through the budget, emphasis on social spending), consideration could be given to targeted infrastructure support and selective relaxation of administrative restrictions in case the property market were to adjust more sharply. Under such a scenario, administrative purchase restrictions could be selectively relaxed to support property demand, even though prudential requirements such as loan-to-value ratios are best left untouched so as to support financial stability.

Further monetary support would be appropriate if the economy slows down further. To support access to credit and facilitate refinancing, further reserve requirement and policy rate action would be called for. Even under such circumstances, caution should be exercised with regard to long-term effects and also in view of the objective of rebalancing, which hinges on higher real interest rates that better reflect the market price of capital.

[4] Strengthening the resource base of cities will require improved arrangements for tax sharing and transfer payments with the central government as well as new tax instruments, such as land and property taxes that permit an elastic tax base.

Securing Long-Term Prosperity

For the longer term, the challenges is for China to continue steering its economy towards a more sustainable path. Since a structural slowdown is anticipated, this would involve reinvigorating the underlying fundamentals for growth so as so as to maintain slower yet still-healthy per capita income growth. In view of the imbalances that have accompanied rapid growth and structural change, this would also involve the ongoing shift in focus from the rate of growth towards the quality of development.

Sustaining Growth and Improving Its Quality

Sustaining relatively rapid growth and improving its quality will require new strategies. Only few countries have over the post-war period managed to become high-income economies. The source of China's competitive advantage will need to gradually shift from low cost to unique value based on innovation (Figure 15). Similarly, the promotion of inclusive growth will require changing tack, since the rate of poverty reduction becomes steadily less sensitive to economic growth as a country develops and inequality also remains a concern (Figure 16). New strategies will also be required to 'green' growth and protect the environment (Figure 17).

The 12th Five-Year Plan provides an overarching framework to support these directions. Building on this agenda, the recent China 2030 study by the Development Research Center and the World Bank provides ideas organized around six themes:[5]

- *Implementing structural reforms to strengthen the foundations of a market economy*, by redefining the role of government, reforming

Figure 15. To sustain relatively rapid growth, continued productivity growth supported by innovation will be key

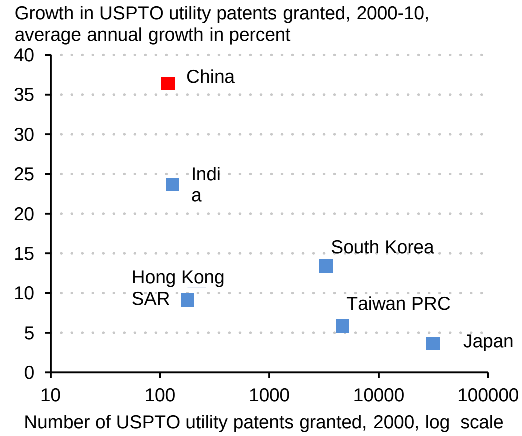
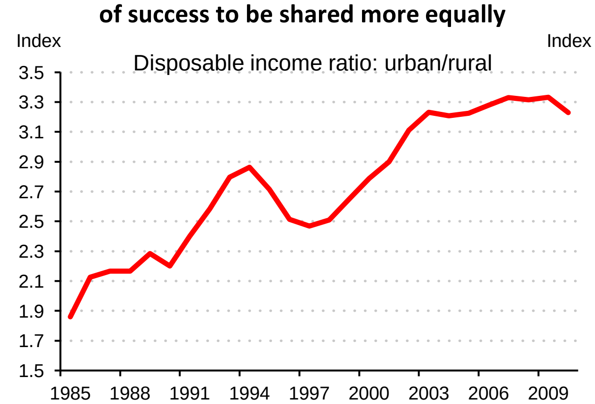
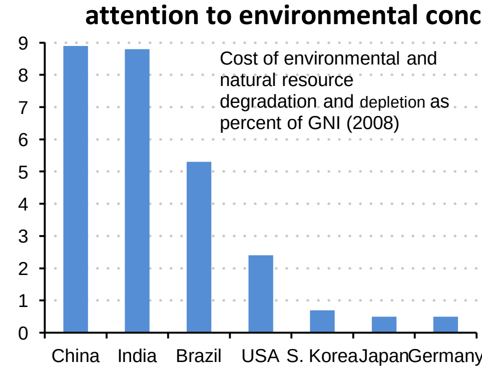


Figure 16. Inclusive growth will allow the benefits of success to be shared more equally



Source: NBS and World Bank Estimates.

Figure 17. Sustainable growth will require attention to environmental concerns



Source: Development Resource Center and World Bank (2012).
Note: Environmental degradation includes damages from CO_2, small particulate matter (PM10) and water pollution. Natural resource depletion is the sum of net forest depletion, energy depletion, mineral depletion, and soil nutrient.

[5] DRC and World Bank (2012): www.worldbank.org/cn

state enterprises and banks, developing the private sector, promoting competition, and deepening reforms in the land, labor, and financial markets.

- *Accelerating the pace of innovation and creating an open innovation system* in which competitive pressure encourages firms to engage in product and process innovation through their own research and development but also by participating in global knowledge networks.

- *Seizing the opportunity to go 'green'* through a mix of market incentives, regulations, public investments, industrial policy, and institutional development.

- *Expanding opportunities and promoting social security f r all* by facilitating equal access to jobs, finance, quality social services, and portable social security.

- *Strengthening the fiscal system* by restructuring public spending while maintaining fiscal sustainability, easing the fiscal pressures on sub-national governments, and strengthening fiscal institutions.

- *Seeking mutually beneficial relations with the world* by becoming a pro-active stakeholder in the global economy, actively using multilateral institutions and frameworks, and shaping the global governance agenda.

As the economy transitions to somewhat slower but higher-quality growth, attention will also need to be paid to ensuring that short-term volatility does not derail long-term plans. This would include managing the near-term risks discussed above.

Selected Pathways to Long-Term Prosperity

In what follows illustrations are offered of how the ongoing slowdown places longer-term challenges into sharper perspective and how these perspectives may serve as pathways to longer-term prosperity. [6] The unifying theme among these illustrations is their connection to the current cyclical conditions. However, each offers a different angle on what the pursuit of long-term prosperity might entail:

- The first example sheds light on the need to sustain economy-wide growth through productivity enhancement supported by innovation.

- The second example illustrates how China can enhance the quality of economic expansion by balancing the continued need for flexibility I n labor regulation with adequate protection of workers.

[6] Since the discussion serves to illustrate the interaction between the current cyclical challenges and the longer-term reform agenda, the coverage of these topics is necessarily succinct. For more in-depth treatment, see Development Research Center and World Bank (2012).

- The third example highlights the scope for making growth more sustainable through institutional reforms to contain future fiscal risks.

Example 1:
Sustaining Growth by Promoting Innovation

China's growth success has been largely the result of rapid productivity growth (Figure 18). The growth of labor productivity – a key indicator of economic efficiency and a fundamental determinant of real wages – was sustained at high levels, particularly in industry.

Looking ahead, the challenge will be for China to sustain productivity growth as a driver of growth. Key in this respect will be the innovation agenda, whereby through technological catch-up and original innovation China could further improve efficiency. The source of the country's competitive strength will need to progressively shift from low cost to high value supported by innovation.

China has already made significant progress in strengthening its technological capabilities. While increasing sophistication of exports is linked to investments by multinational corporations, recent trends in patenting point to the upgrading of indigenous technology assets (Figure 15 and 19).[7] This has also been underpinned by growing R&D expenditures, the sheer volume of science and technology employees (5 million as of 2008) and China's increasing share in the global output of scientific publications (8.5 percent as of 2008).

Large investments in physical infrastructure have supported technological upgrading. By strengthening multimodal transport, China is raising the efficiency of logistics. Investments in renewable energy, a smart grid and rail transport work to reduce energy consumption. Mobile networks were serving 860 million users by 2010, an increase of 460 million over 2006. In 2010, 450 million users had access to broadband services.[8]

These achievements notwithstanding, a large share of China's export-oriented manufacturing industry is still engaged in processing and assembly operations. Its export competitiveness remains primarily based on low factor costs, and over one half of exports are produced by foreign-owned firms or joint ventures. In addition, productivity in the services sector has lagged and the focus remains on lower-value services. Also, while China has seen a rapid increase in patenting, the stock level of patents remains relatively small (Figure 16).

Unleashing the forces of innovation will require policy intervention as market failures and imperfections of the enabling environment constrain China's innovation potential. These interventions could focus on the following key areas.

[7] In 2009, China reached fifth place in WIPO patent rankings. Koopman and others (2008, 2009).
[8] Ministry of Industry and Information Technology (2010).

Strengthening Human Competencies

Innovation rests in the first place on the talent of people: their capacity to absorb knowledge, their creativity to develop new ideas, and their skill and entrepreneurship to turn ideas into results.

China's expanding education system and large supply of science and engineering skills bode well for the future. But there remain a range of challenges as it seeks to deepen its human capital base and impart the flexible core competencies that workers of the future will need to remain productive across their working lives in the face of rapid technological change and structural shifts in China's labor market.

The first is ensuring 'equality of quality' across the education cycle. With the consolidation of educational coverage, attention will turn to efforts to avoid overly high divergence in quality across space and across social groups within the same localities. Perhaps the most challenging group in this respect are the children of migrants, whether already in urban areas and unable to access affordable quality schooling, or 'left behind' and in need of special support.

Figure 18. Manufacturing growth has been driven by TFP and capital accumulation, with labor playing a larger role in services

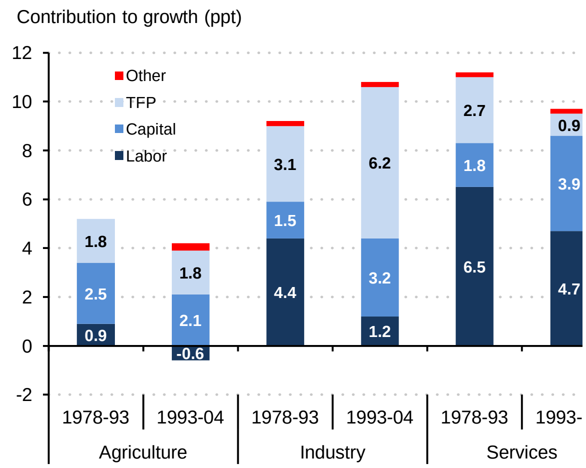
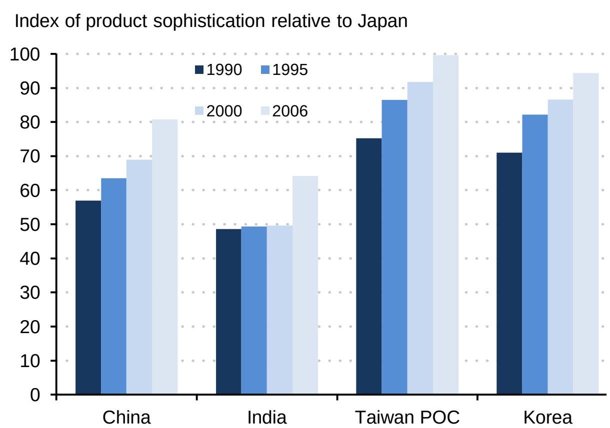


Figure 19. The sophistication of China's exports has grown rapidly



A second direction already outlined in China's medium to long term educational strategy is starting early and equal: basically closing the large gaps in pre-primary coverage and school readiness between urban and rural/migrant children. Increased public investment in early child development - not only early education but linked nutritional interventions and parental education - has been shown globally to yield the highest returns of all social spending.

A third element of deepening the human capital base will be movement towards fee-free senior secondary education, as exists in nearly all OECD countries. Given China's target of nearly universal senior secondary coverage, expanding the fee-free educational cycle will allow more rapid and equitable achievement of its policy goals.

A fourth direction worth considering is reducing the divide between technical-vocational training and academic streams from senior secondary school onwards. Both streams have important roles to play in enhancing China's productivity. But China can also benefit by creating stronger pathways for students wishing to shift between streams, promoting more common curriculum on core competencies, and in time developing an integrated qualifications framework which allows for mutual recognition of credits and provides more modular approaches to acquiring qualifications.

Finally, looking beyond regular education, China will benefit from developing channels for life-long learning which allow workers continuously to upgrade skills in flexible ways throughout their working lives.

These broad strategies would enable China to further expand and deepen its human capital, so that the contribution to productivity growth takes place in a diverse set of locations and across a wide range of education levels and skill sets.

Upgrading Technological Capabilities

The signature characteristic of an innovative economy is a learning and research environment encouraging new ideas and lateral thinking. An innovative economy is also characterized by a reliance on market signals to guide the direction of innovation with the public sector playing a facilitating role, seeding experimental research with a long-term pay-off, providing the legal and regulatory institutional scaffolding and establishing enforceable standards.

Most applied research and innovation are done within firms and the majority of scientists will be employed by businesses However, an adequate volume of basic research will depend on government initiatives and funding. Government agencies, key universities and research institutes and large corporations will need to take the lead especially in the high risk, blue skies research through well targeted incentives, by committing a sufficient funding to high-caliber institutions, and by means of prizes and awards.

However, merely increasing scientific publications or patenting may produce little effect unless the quality of research and its commercial relevance and uptake are also raised. Good research must be aided by a stringent process of evaluation and refereeing of research programs and findings with the feedback incorporated in policies. The government can help building countrywide research networks to mobilize national talent and create consortia comprised of firms from around the country. These networks could be anchored to global research networks to create mutually beneficial exchanges.

Many high-tech multinational corporations have invested in R&D facilities in China. This could be further encouraged because of its potentially significant long-run spillover effects, the reputational gains for Chinese cities a few of which are fast becoming science hubs, and the contribution such research can make to industrial upgrading. Closer collaboration and partnerships with MNCs on the basis of mutual trust and recognition will contribute to the making of a dynamic and open innovation system. In this context, an efficient patenting system and effective protection of intellectual property will expedite the growth of China's innovation capabilities.

Finally, competition is the driving force of innovation. While China has made steady progress in expanding the scope for competition, further potential remains. To increase competition in product markets, China could consider further lowering barriers to firm entry and exit, breaking up state monopolies or oligopolies in key industries and promoting the growth of dynamic SMEs and increasing their access to finance. International competition could be enhanced through further integration with the global economy and a reduction in behind-the-border trade barriers.

Example 2:
Raising the Quality of Growth through Flexicurity

Flexicurity is a term that originated in Denmark which combines flexibility in labor market regulations with decent social security and active labor market policies to ensure adequate worker protection and smooth job transitions. In short, flexicurity 'protects workers, not jobs'. The concept is intended to break down the traditional assumption that labor market flexibility and worker protection are incompatible, and instead to promote an environment of efficiency-enhancing turnover in the labor market without dire welfare consequences for workers. It is usually built over a wage determination system which balances the interests of workers for decent and fair pay with the needs of the economy for sustaining competitiveness.

There have been to date several constraints to realizing such a balance between flexibility and security in China's urban labor market. On one hand, China's urban labor market has been very flexible in the face of a major influx of migrant workers and considerable turnover of workers between jobs. On the other, a range of rigidities undermine equitable worker protection, and create disincentives for formal sector participation. These include:

- the effects of the hukou system in biasing access to 'good' jobs (e.g. in the civil service and SOEs) towards those with local hukou. In turn, only half of the wage premium in monopoly sectors (dominated by SOEs) can be explained by the underlying characteristics of workers.[9]

- coverage of social insurance among local and migrant workers and across ownership categories of employer remains highly variable. For example, based on 2010 survey data, only around a quarter of migrant workers were participating in a pension scheme, compared to over 80 percent of local workers. Even among local residents, private sector coverage was just over

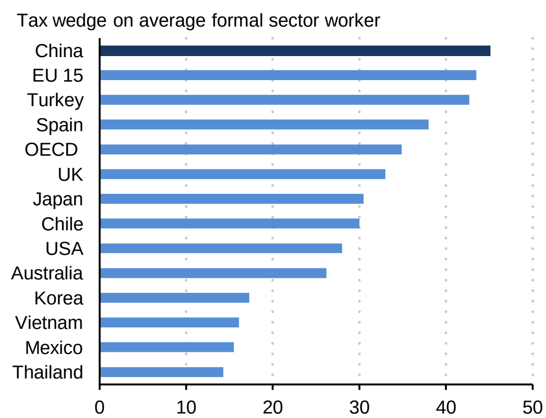
[9] Yue, Li and Sicular (2011).

60 percent against close to full coverage in government and SOE sectors. [10]

- lack of portability of social security entitlements, both across segments of the workforce within cities (civil servants, public sector undertaking, other urban workers and urban residents outside the formal sector all have separate pension and health insurance schemes), and across space between rural and urban areas and between cities. While Government has approved regulations to allow portability between cities within the urban workers' pension scheme, the underlying data and financial exchange systems to facilitate portability remain under-developed. Cross-scheme portability remains challenging.

- taxation of formal sector workers in China remains high, well above the OECD average and slightly higher than even the EU15 average (Figure 20). For low-paid workers, the marginal burden is extreme, due to the floor on contributions (60 percent of average city wage). This creates significant disincentives to participate in formal sector social insurance schemes and results in 'selective formalization' as workers and employers choose strategically what social insurance schemes they will contribute to.

Figure 20. Marginal taxation of formal work is high in China



Source: OECD, except China Bank staff estimate.
Note: The tax wedge is calculated as (total labor cost – net take home pay) / total labor cost.

These factors undermine the security element of flexicurity and create inequities and distortions in China urban labor markets.

The new labor legislation that took effect in 2008 represents an important effort to ensure that workers' rights are better protected. This includes stronger obligations to ensure social insurance coverage, written contracts, and labor dispute resolution mechanisms. At the same time, provisions such as severance pay and short probationary periods are notably above OECD average levels of employment protection: with an emphasis on protecting jobs at the possible expense of promoting employment. Initial evidence among larger firms in selected capital cities suggest that more active enforcement efforts are being made.[11] However, it is too early to assess how well the new laws balance labor market flexibility and incumbent worker protection, or to judge how effectively they will be enforced across different segments of the workforce.

The Chinese government is seeking to strike a balance between flexibility and security for its workers and firms. And there has been progress in a number of areas. For example, pension

[10] Giles, Wang and Park (forthcoming).
[11] Park, Giles and Du (forthcoming).

coverage of migrant workers has more than doubled between 2005 and 2010; the share of urban workers with written contracts is increasing steadily; and the principles of social security portability are being put in place. But there remains a large unfinished agenda to promote a more equitable and socially sustainable pattern of growth. Directions that could be considered for deepening flexicurity in urban labor markets include:

- Accelerating reform of the hukou system to increase the benefits of labor mobility for workers and the economy. Hukou reform needs a phased strategy implemented over an extended period, with the end goal of hukou being a simple population registration system, delinked from social entitlements. The first step of the reform strategy could be to set a national framework for extension of the residence permit system, in order to begin the process of delinking social entitlements of non-local residents from their hukou status. A key challenge in making such a transition would be agreement on the financing responsibilities for social services of those obtaining residence permits. This would be a complex negotiation between national and sub-national authorities but should be guided by a clearer understanding of migrant flows across space and of the positive externalities of labor mobility.

- Expanding portability of social security entitlements and investing in the underlying systems for data and funds exchange across space. Following the lead of the urban scheme, it would be desirable to put in place guidelines during the 12th Plan period for portability of entitlements across all pension schemes to facilitate spatial and sectoral labor mobility. To facilitate portability of both individual accounts and social pooling entitlements, a clearing mechanism would be needed for transfer of individual social insurance records and any necessary cross-jurisdiction and/or cross-scheme financial settlement. The more fundamental long term reform that would facilitate portability of social insurance rights is the achievement of national pooling of social insurance contributions.

- As part of an adjustment of the tax structure, China could lower the tax burden on labor over time. If new revenues such as property taxes can be introduced, the potential to reduce taxes on labor may increase. Any reduction would need to be gradual and carefully sequenced to avoid over-volatility in public revenues. Even within the current system, labor taxation could be reduced in some areas without unduly harming the benefits that workers derive. These include housing, unemployment, and pensions. An additional issue that could be addressed is the high marginal contribution rate for low-paid workers, in order to incentivize formal sector participation.

- Closely evaluating the implementation of the new labor legislation over time to assess the degree of enforcement and its impact on worker protection and rights, employment patterns, wage determination practices and outcomes.

Example 3:
Making Growth More Sustainable Through Fiscal Reform

While China retains significant 'fiscal space', new fiscal pressures will build over time. As noted above, China's fiscal space appears smaller than in 2008, and narrow definitions of public debt understate the true magnitude of such liabilities. Even on the basis of broader definitions, China's budget deficits and public debts remain modest enough to allow further active short-term fiscal stimulus, should the need arise. However, looking forward, the likely slowing of GDP growth, combined with growing demands for additional spending to meet social, environmental and other objectives can create new challenges for maintaining fiscal stability. Those pressures which are not captured in the standard reports used to guide budget planning and execution can also surface unexpectedly.

To ensure more sustainable future growth, China could reform relevant institutions and establish new practices to better reveal or reduce such risks. Three such directions could be considered.

Fiscal Consolidation

China has already made much progress in subjecting entirely off-budget flows to some form of budgetary control. Most extra-budgetary charges have been abolished or brought on budget. As in many countries, while social security contributions and revenues from sale of land use rights and other state assets flow to separate funds, these have been subject to budget type management.

However, public spending is still fragmented into many separate budgets. A consolidated view of public finance, while possible to construct in principle, rarely features in budget documents or policy deliberations. This is a limitation for two reasons. First, the macro impact of fiscal policy is primarily driven by the overall level of revenues, expenditures and deficits. Without a true picture of such aggregates, it is hard to assess the thrust of fiscal policy, thus its appropriateness for managing existing macro risks. Second, the absence of a comprehensive budget makes it difficult to assess or alter the aggregate allocation of government resources across priority sectors and programs.

To address these issues, China could gradually prepare a comprehensive budget that combines the general budget, the government-funded budget, and the state capital operating budget, and includes current and capital expenditures together with transfers. The resulting comprehensive view of public revenues and spending could feature prominently in the budget planning process, while regular publication of actual outcomes would provide a full picture of actual spending. This would not only strengthen fiscal management, but also be a concrete step towards enhanced government transparency. The upcoming revision of the budget law is an opportunity to anchor such reforms in law.

Multi-Year Fiscal Planning

China's current system of annual budgeting heightens fiscal risks by precluding analysis of the impact of today's policy decisions and investments on future fiscal outcomes. Examples include the future recurrent cost implications of today's major infrastructure investment and the future obligations resulting from changes in pension policy. Annual budget planning also limits the authorities' ability to deliberately adjust the level and composition of spending and revenues to meet evolving challenges and achieve strategic objectives.

Greater medium-term fiscal planning would address these issues. As a specific tool, China's national and sub-national governments could construct a macro-fiscal framework (combining medium-term fiscal planning with debt sustainability analysis) grounded in the relevant Five Year Plan. By quantifying the implications of current taxation and spending policies on future budgetary and financing needs, such tools would help evaluate the consistency of public spending with the present and future resource envelope. They can also bring out the fiscal risks from various sources such as contingent liabilities being called, global shocks hitting output growth, etc. Were such analysis to show that debt limits are likely to be breached over the projection horizon, the government's plans could be revised accordingly.

On-Budget Sub-national Borrowing

The management and financing of infrastructure projects through 'Urban Development Investment Corporations' (UDICs) and other special purpose vehicles (SPVs) is the last remaining major form of fully off-budget public spending in China. While China's sub-national governments can formally borrow only with State Council approval, they can skirt this limit by borrowing through such SPVs. According to a 2011 survey by the National Audit Office, total sub-national government debt had reached around 26% of GDP, the vast bulk of which was related to SPVs. Such indirect borrowing has played a positive role in financing important infrastructure investments. However, limited transparency and regulation has created potential risks to fiscal sustainability and the quality of bank assets, especially as some such borrowing may not have been for revenue generating purposes that can pay back the loan. Such quasi-fiscal financing also obscures the true size and composition of public spending and revenues. By preventing a unified planning, execution and monitoring of spending, it can lead to sub-optimal allocation of public funds.

Debt financing will remain important for China's future urbanization drive, but needs to be gradually brought on budget. Direct borrowing would expose these governments to market disciplines and reporting requirements, helping strengthen fiscal transparency and financial management. The government's recent inventory of all borrowings by sub-national governments and their entities was an important step towards greater transparency. The recent pilot program allowing four selected sub-national governments to issue bonds with a guarantee from the Ministry of Finance was another positive reform.

Moving forward, the central government could establish an institutional and regulatory framework to reap the benefits while mitigating the risks of direct sub-national borrowing. Building on the lessons learned from the current pilots, such borrowing could be gradually expanded, beginning with authorities with the greatest revenue capacity and most reformed fiscal system. Financially weaker localities could initially rely more heavily on transfers, with the central government establishing clear rules about when a sub-national government can graduate from one status to another.

Preconditions for UDIC borrowing would include corporate governance reform and clarity in its financial relationship with the sub-national government. Credit ratings and disclosure of audited financial accounts (UDICs) and fiscal accounts (sub-national governments) are prerequisites for borrowing from the financial market. Those sub-national governments and UDICs that are allowed to borrow should be subject to hard budget constraints, without recourse to central government support.

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