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Quarterly Update

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The World Bank quarterly update provides an update on recent economic and social developments and policies in China, and present findings from ongoing World Bank work on China. The update is produced by a team from the Beijing Office with support from the China country team. Questions and feedback can be addressed to Li Li (lli2@worldbank.org).

OVERVIEW

The impact of the international financial and economic turmoil on China's economy has been manageable so far, but is expected to intensify. China's financial system is relatively insulated from the direct impact of the international financial distress. In the real economy, overall export growth has until recently remained robust due to strong demand from emerging markets and gains in global market share reflecting strong competitiveness, although with pronounced differences in export performance between sectors. However, looking forward, the impact of the crisis is spreading globally, with risk aversion and deleveraging leading to a funding squeeze that affects demand in many countries, including many emerging markets. Thus, as in earlier global downturns, China's export growth is likely to be low in 2009, even with expected continued market share gains.

Domestic factors have already made China's economy slow down in 2008, coming off its high pace in 2007. Due in part to an earlier tightening in macroeconomic policies, investment growth declined in 2008, led by real estate and construction, which then fed through to several "upstream" industries. Most other segments of the domestic economy, notably consumption, seem to have held up reasonably well so far. Looking ahead, private sector investment is likely to be weighed down by the unfavorable external prospects and continued weakness in real estate. Private consumption growth is likely to soften in 2009, but will receive some support from fiscal policy. In the mean time, inflation is coming down steadily. After absorbing higher food prices, headline inflation has receded and, with sharply lower raw commodity prices, inflation is not an issue of concern at this point.

Against this background, the authorities have adopted a more expansionary macro economic stance, and higher government-influenced spending is going to play a key role in 2009. Since the summer of 2008, the authorities have taken several steps to support growth, culminating in November with a ten point plan to stimulate domestic demand and growth. The emphasis will be on accelerating and increasing infrastructure and other investment, although of a different nature than in the wake of the Asian crisis, with many projects focusing on broad long term development and improving living standards. Most of the ten elements mean higher direct government-influenced spending—in the form of investment or consumption— and should thus have a measurable impact on output in the short term. Our forecast for 2009, which sees GDP growth of around 7.5 percent based on current projections of global economic trends, has more than half of that coming from government-influenced spending.

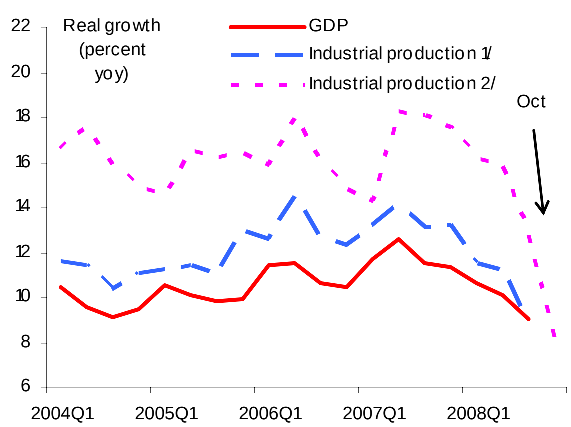
The stimulus policies provide China with a good opportunity to rebalance its economy in line with the objectives of the 11th five-year plan. The stimulus package contains many elements that support China's overall long term development and improve people's living standards. Some of the stimulus measures give some support to the rebalancing of the pattern of growth from investment, exports, and industry to consumption and services. The government can use the opportunity of the fiscal stimulus package to take more rebalancing measures, including on energy and resource pricing; health, education, and the social safety net; financial sector reform; and institutional reforms.

RECENT ECONOMIC DEVELOPMENTS

China's economy has slowed down considerably in the first 10 months of 2008. GDP growth declined from 12.6 percent year on year (yoy) in the second quarter of 2007 to 9 percent (yoy) in the third quarter of 2008, with industrial value added growth sliding even more steeply in October to 8.2 percent (yoy), the first single digit growth since 2001 (Figure 1). Much of the slowdown so far has come from weaker domestic demand.

Over the past year, the impact of the international financial turmoil on China's economy has been manageable. Since mid-September this turmoil intensified and evolved into a global financial crisis. Deleveraging and rising risk aversion is causing capital flows to many emerging markets to slow and in some cases to reverse, which hurts currencies, interest rates, stock markets, trade financing, and the real economy. The direct impact of the financial turmoil on China's financial system has been limited, however, because China's banks have modest exposure to sub-prime assets and the authorities impose capital controls, while the accumulation of large external surpluses mean that the financial system enjoys abundant liquidity and the central bank massive foreign reserves. China's real economy is integrated into the world economy via extensive trade and FDI links, and can thus not escape the global downturn. However, so far exports have held up relatively well, growing at 13 percent (yoy) in real terms since mid-2008, compared to world import growth of almost 6 percent estimated for 2008 (Figure 2). This is because demand from Europe and, particularly, emerging markets held up well until recently, and China continues to gain market share reflecting strong competitiveness.

Figure 1. Economic growth is decelerating rapidly



Source: NBS, staff estimates
1/ Quarterly data from national accounts
2/ Monthly data, covering SOEs and large non-SOEs

Figure 2. Exports have so far been supported by emerging market demand and gains in market share

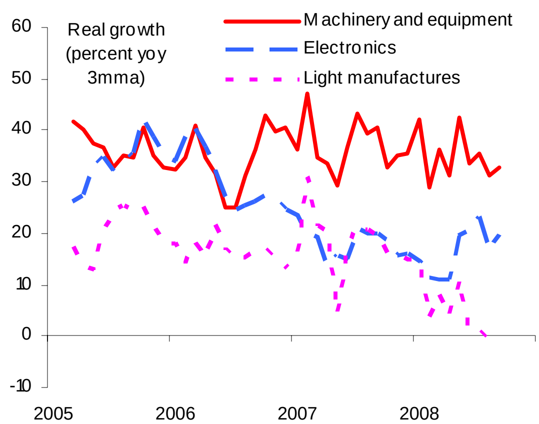
Source: World Bank, China's custom administration

Overall export developments mask significant differences between sectors. While the growth in exports of light manufacturing—including toys and textiles—has declined sharply, exports of (higher value added) machinery and equipment have continued to grow at a high pace, and exports of electronics have also held up well (Figure 3). Clearly, these sectoral trends have regional implications with, for instance, the Pearl River Delta (Guangdong) traditionally concentrating on light manufacturing.

The economic impact in China of the international turmoil is set to intensify. Export growth to the EU started to weaken in August. Exports to emerging markets (including non-Japan Asia)—the destination of over half of China's exports—still grew at 32 percent (yoy) in US$ terms in the third quarter but these are set to weaken too. Looking ahead, prospects are for a sharp reduction in export growth as the impact of the international turmoil deepens in the US and Europe and it starts to hit demand in many emerging markets. Recent indicators on export orders from the purchasing managers' index (PMI) point in this direction.

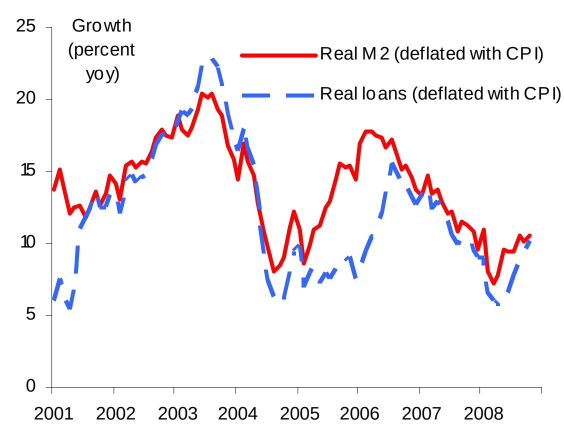
China's overall growth in 2008 has been affected by slower domestic investment growth, partly in response to tighter policies. Monetary and other policies were tightened since the fall of 2007 to contain inflation and "cool off" the economy, notably the real estate sector, with a key role for enforced credit quotas. In real terms (deflated by CPI inflation), M2 and credit lagged economic activity for most of 2008 (Figure 4). Overall real investment growth in 2008 has so far been substantially lower than in 2007 (Figure 5). Surprisingly, investment in manufacturing, which would be expected to be impacted by reduced export prospects, has so far held up well.

Figure 3. Export performance varies sharply



Source: Custom administration, staff estimates

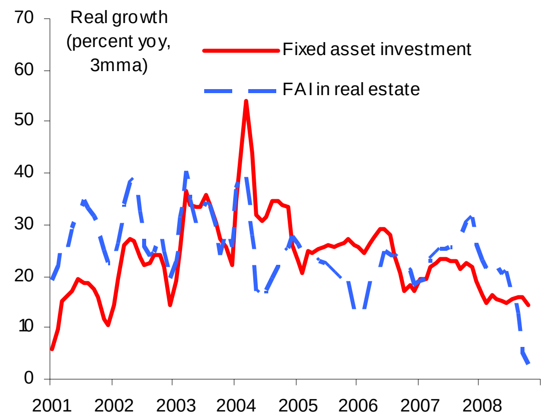
Figure 4. Monetary growth has been low, especially in real terms



Source: PBC, NBS, staff estimates

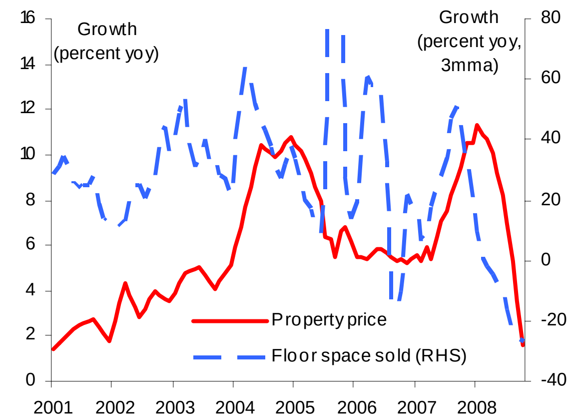
The real estate sector—a key target of the policy tightening—has seen a particularly pronounced slowdown. The initiative to "cool off" the housing market included measures that reduced demand—especially "speculative demand"—such as tighter lending conditions for second houses with others that reduced supply such as stricter land supply and credit policies towards project developers. It appears that the demand side measures had a more rapid impact. Housing sales growth started to decline substantially and housing price increases moderated. The price weakness is affecting most parts of the country, but it seems to be more pronounced in large cities, especially those that saw rapid increases in recent years. Since early 2008 housing sales are falling (yoy) at an increasing rate, probably fueled further by expectations of housing price declines, concerns about overall economic prospects and China's stock market decline (Figure 6). As a result, new real estate construction has started to weaken, with real estate investment growth now close to zero (Figure 7).

Figure 5. Investment growth is down on 2007



Source: NBS, staff estimates

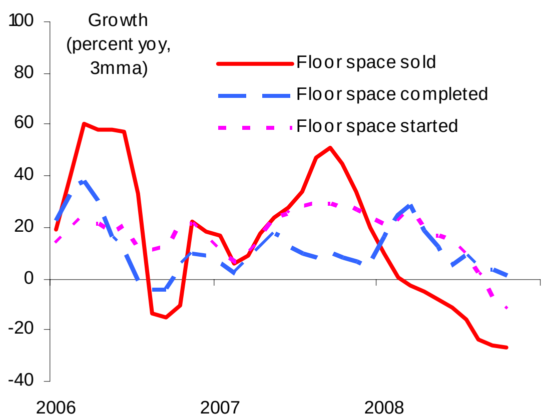
Figure 6. Housing sales weakness translates into housing price weakness



Source: NBS, staff estimates

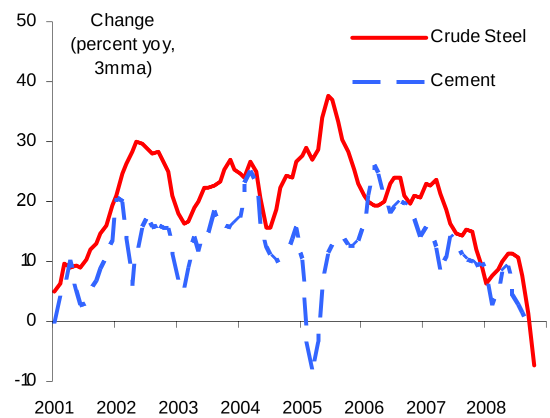
Weakness in real estate construction has contributed to a sharp slowdown in several "upstream" industries. The slowdown in steel and cement gathered pace in October in part in response to large inventory build ups (Figure 8). With these heavy industries decelerating faster than other sectors, "physical indicators" such as of freight volumes and electricity production have slowed significantly more than overall economic activity.

Figure 7. Housing sales weakness has started to affect new construction



Source: NBS, staff estimates

Figure 8. Real estate weakness has contributed to the downturn in production of construction materials



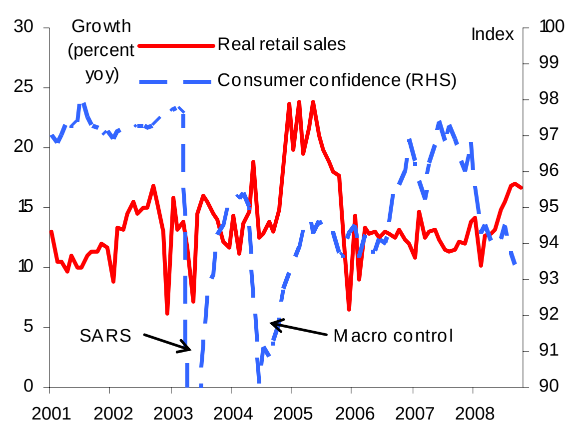
Source: NBS, staff estimates

The impact of continued real estate weakness on the financial sector and households' balance sheets is likely to be modest. For the large banks, real estate lending makes up about 20 percent of total lending—significantly less than in most OECD countries—with about two-thirds in the form of mortgages to households and one-third as project finance to property developers; minimum down payments of at least 20 percent limit the possibility for widespread negative equity; and household gross and net debt is low. More generally, under reasonable scenarios for the future, banks' balance sheets appear strong enough to reject the possibility of financial sector instability in the near future.

Even so, because weakness in the real estate sector affects local government revenues and economic growth, the government has taken some supportive measures. As sizable local government revenues are generated from the property market, a long housing slump can affect local government revenues and thus their ability to sustain or increase spending. In addition to lowering interest rates, the central authorities have reduced the deed tax for small houses and the minimum down payment for mortgages, suspended the stamp duty and VAT on land for individual home sales, and lowered the floor on mortgage rates for first homes. Many city governments have taken additional measures including a (modest) tax refund to house buyers, price subsidies, and issuing *hukou* (resident certificate) to house buyers from other areas. These measures have rightly focused on the demand side instead of directly supporting property developers. However, the overall size of the financial incentives is modest. More support for the real estate market will come from the housing element of the November 9 stimulus package (see below).

Most other segments of the domestic economy, notably consumption, seem to have held up reasonably well so far. The extraordinarily strong retail sales data in 2008 may not be completely representative of overall consumption trends, but other indicators support the conclusion that consumer spending and confidence have held up reasonably well. Nominal retail sales growth was 22 percent (yoy) in October, suggesting real growth of around 17 percent (Figure 9). Household survey indicators suggest per capita household incomes have continued to grow at around 10 percent (yoy) in urban areas and 12-13 percent (yoy) in rural areas through the third quarter (in nominal terms). Urban consumption spending growth in the surveys seems to have been affected by the Olympics in the third quarter, even as rural spending growth held up at around 10 percent in real terms through the third quarter. Consumer confidence came down at the end of 2007, but has not budged much yet since. Although overall consumption spending has so far held up well, car sales growth has weakened significantly, possibly in part reflecting similar factors as those affecting housing sales.

Figure 9. Consumer spending is relatively robust



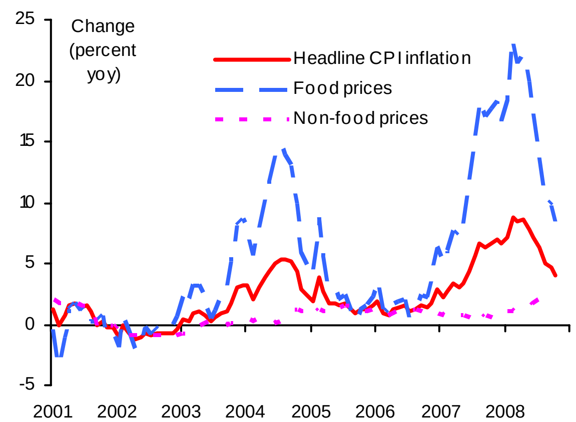
Source: NBS, staff estimates

With the trade surplus soaring again, foreign exchange accumulation continues. While overall export growth has held up quite well, import volume growth declined in the third quarter due to weak processing trade and the impact of inventory build up in upstream industries. As a result, exports have again outpaced imports (yoy) in US$ terms, even though the terms of trade declined substantially from a year ago because of high raw material prices. The trade surplus has started to grow again, breaking new records since mid-2008 to hit US$ 35 billion in October. In all, domestic demand has slowed down more than the contribution of net external trade to GDP growth so far in 2008. Even as net non-FDI capital inflows appear to have slowed somewhat in the third quarter, foreign exchange accumulation continues uninterrupted, adding US$ 97 billion to reach US$ 1.9 trillion by end-September.

Inflationary pressure has receded. As the large food price increases are fading out and core inflation remains very modest, headline CPI inflation fell to 4.0 percent (yoy) in October (Figure 10). In the meantime, the pressure from higher raw material prices is easing as prices of oil and other raw commodities continued to decline in international and domestic markets. The outlook for raw commodity prices means that, looking ahead, inflation is no longer a concern in the near future. During the recent episode of food and raw commodity price related inflation, China's flexible economy and labor market have allowed the economy to absorb the exogenous price shocks well without leading to a wage price spiral. This is encouraging, given the outstanding need to reform several administered prices.

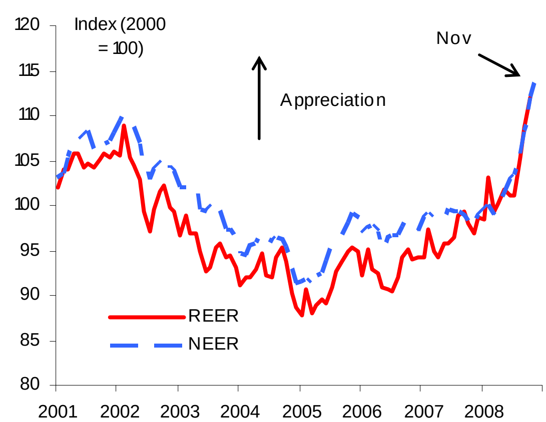
The effective exchange rate has strengthened considerably. In recent months, the authorities' policy has kept the RMB stable against the US$ when the US$ gained strength as demand for dollar liquidity swept world markets (Figure 11). China's exchange rate policy has thus been a source of stability in regional and global financial markets.

Figure 10. Inflation is not a concern at this point



Source: NBS, staff estimates

Figure 11. China's exchange rate has strengthened significantly in 2008



Source: BIS, staff estimates

Despite capital controls, China's equity markets have been affected substantially by the global slowdown. China's stock market has fallen by almost two-thirds since October 2007, from levels considered inflated—one of the sharpest decreases in stock prices in the world. In addition to general contagion and confidence effects, this is because the global slowdown has weakened the outlook for corporate earnings and domestic factors including the circulation of non tradable shares have also been at play. The ups and downs of China's stock market do not seem to have had significant impact on the real economy.

ECONOMIC PROSPECTS AND POLICIES

Prospects

Global growth prospects are distinctly unfavorable. In recent years, even as the US slowed down, overall world growth held up well, in large part because of strength in emerging markets. World GDP growth, weighted for China (using countries' and regions' weights in China's exports), is expected to ease from 4.1 percent in 2007 to 3.0 percent in 2008 (Table in Box 1). However, with the impact of the financial crisis spreading, a significantly faster deceleration is in sight for 2009. The crisis has already affected European demand. The impact is now also spreading to some emerging markets with risk aversion and deleveraging in financial markets leading to a funding squeeze set to affect domestic demand there. In all, a synchronized global slowdown appears to be in sight, and the World Bank (WB) expects China-weighted global GDP growth to slow much more in 2009 than in 2008, to about 1 percent (in market exchange rates), with a recovery in 2010. Moreover, after an expected moderation in real world import growth from 7.4 percent in 2007 to 5.8 percent in 2008, the WB expects world imports to shrink in 2009, for the first time since 1982.[1]

The experience in earlier global downturns suggests very weak export growth in 2009, even though China's exports are likely to outgrow world imports significantly. Box 1 describes how continued gains in global market share have allowed China's exports to keep growing during previous global downturns. In line with this experience, we expect that China's exports will continue to gain overall market share in 2009, allowing for positive export growth in a depressed world market. However, the gain is unlikely to be as large as in 2001, because China's existing market share is now much higher and the effective exchange rate has appreciated significantly in the last half year.

China's overall economic growth is sensitive to export developments. Gross exports are almost 40 percent of GDP. About one-half of exports is from processing trade, and the share of exports in value added terms is probably less than 20 percent.[2] Nonetheless, exports are more important in China than in other large emerging market economies, even as China is more robust than most to external shocks, because of its strong macroeconomic fundamentals and large balance of payment surpluses.

[1] The World Bank fears that, in addition to the normal effects of an economic slowdown, international trade is being affected by the impact of the credit squeeze on trade finance.
[2] He and Zhang (2008) (HKMA Working Paper 14/2008) use input output tables and estimate that the share in value added is currently 17.5 percent.

Box 1. The 2009 global downturn and previous ones—what can we say about China's exports?

During recent global downturns, China's export growth declined substantially, but gains in market share contained the slowdown. China-weighted global GDP growth (growth around the world weighted by the importance of countries/regions as markets for China's exports) expected by the WB for 2009 is even somewhat weaker than that in 1998, during the Asian crisis, and in 2001, when the "dot.com bubble" burst. Moreover, the WB expects overall world imports to expand less than in 2001 and, in particular, in 1998 (Box Table). In 1998, when China-weighted real world GDP grew 1.7 percent and real world imports rose 4.8 percent, China's exports grew 7.1 percent in constant prices. In 2001, China-weighted world GDP expanded 1.4 percent and world imports grew only 0.3 percent. However, with a stronger, more competitive manufacturing sector and a more open economy, China's real exports grew an impressive 9.6 percent.

Table. The global outlook for China, comparison with earlier downturns
(in constant prices, average annual change)

	1997	1998	2000	2001	2007	2008 (f)	2009(f)
World GDP (market exchange rates)							
World Bank Nov 08 1/	3.8	2.5	4.2	1.7	3.7	2.6	1.0
IMF WEO Nov 08	3.8	2.5	4.2	1.7	3.7	2.6	1.1
China weighted world GDP 2/							
World Bank Nov 08	3.7	1.7	4.3	1.4	4.1	3.0	1.2
IMF WEO Nov 08	3.7	1.7	4.3	1.4	4.1	2.9	1.4
World imports							
World Bank Nov 08	9.7	4.8	12.2	0.3	7.4	5.8	-2.5
IMF WEO Nov 08	9.7	4.8	12.2	0.3	7.2	4.6	2.1
China:							
Exports	22.6	7.1	30.6	9.6	15.3	11.0	3.5
GDP	9.3	7.8	8.4	8.3	11.9	9.4	7.5

Source: World Bank, IMF, and staff estimates.
1/ World Bank paper for the G20 conference.
2/ Regional growth rates aggregated using market exchange rates.
Weighted using China's export weights, corrected for re-export via Hong Kong.

Private sector investment is likely to be subdued. The weak export outlook for 2009 is set to depress investment in export-oriented industries, which we estimate are responsible for about 15 percent of overall investment.[3] A roughly equal share is real estate investment that in the short term is set to grow slowly because of the current housing weakness, even though the medium term fundamental drivers of demand for urban housing remain good. Another one-third of investment is oriented on the domestic market while geared by market considerations. This investment should be less sensitive to the external weakness, although it will also be affected by the overall slowdown in China, if only because of the weak profit growth expected for next year. The VAT reform announced as part of the November package, under which firms can deduct capital spending for the VAT, may provide some support for investment (with both an income effect and a relative price effect), particularly so for capital-intensive parts of the economy. However, the weak

[3] These shares are in terms of national accounts type gross capital formation, and thus adjusted for land sales.

short-term growth prospects and overcapacity in several upstream industries are likely to limit the short-term impact.

Government-influenced investment and government consumption will be boosted by the fiscal stimulus announced on November 9 (see below). Financed in part by the government budget, in part by related lending by commercial and policy banks, government-influenced investment makes up almost one-third of total investment (including most of transport; some of electricity, water and gas; all of administration; and most of education, healthcare, and social and cultural services). The stimulus package ensures that government-influenced investment, notably in infrastructure, will be very strong in 2009, offsetting some of the weakness in other areas. Government consumption is also set to expand rapidly, supporting overall consumption. In all, government-influenced direct spending would contribute over 4 percentage points (pp) to GDP growth, or more than one-half of the total and about 1.5 pp more than in 2007.

Private consumption growth is likely to soften in 2009, but will receive some support from lower inflation and policy. Slower (nominal) wage and employment growth and weaker confidence will likely depress private consumption growth. However, this will be partly offset by the impact on purchasing power of significantly lower inflation and some fiscal support (mainly higher transfers). Rural consumption is helped by fiscal support to incomes and, in the longer run, other policy support for agriculture, including rural land policy discussed in Box 4.

In a scenario based on these considerations, which include significant policy stimulus, GDP growth would be around 7.5 percent in 2009 (Table 1)**.** In this scenario, import growth is significant, even with processing imports assumed to be stagnant, in line with processing exports. With overall imports substantially outpacing exports, net external trade is likely to have a negative contribution to growth of almost 1 pp, for the first time in many years.

The risks to this scenario are broadly evenly balanced. There are still downside risks in the international picture. Domestically, downside risks come from further weakening of private sector confidence and a more drawn-out inventory adjustment. On the upside, increasing support from policy may have a larger impact, including on confidence.

One bright spot for China is the impact of lower raw material prices on inflation and margins. Against a backdrop of significantly weakened global growth prospects, prices of primary commodities including energy and metals have fallen sharply. The World Bank expects China-specific industrial commodity prices to decline substantially (yoy) on the international markets in 2009. Our empirical estimates suggests that this should result in a further deceleration of (yoy) increases in China's domestic raw material prices into negative territory in the second quarter of 2009, from a peak of over 15 percent in the summer of 2008 (Figure 12). This will help reduce cost pressures in China's industrial sector and support margins in manufacturing industry.

Table 1. China: Main Economic Indicators

	2005	2006	2007	2008 1/	2009 1/
Real GDP growth (production side) (%)	10.4	11.6	11.9	9.4	7.5
Real GDP (expenditure side) 2/	13.4	13.3	12.2	…	…
Consumption 2/	9.7	10.1	10.2	9.8	8.6
Gross capital formation 2/	12.0	13.4	12.6	8.3	8.6
Fixed capital formation	14.0	13.0	11.4	7.8	8.2
Exports (goods and services) 3/	23.6	23.6	18.7	11.0	3.5
Imports (goods and services) 3/	13.4	18.6	14.2	6.9	6.5
Consumer price increases (period average)	1.8	1.5	4.8	6.5	2.0
GDP deflator	3.8	3.6	5.2	5.6	3.0
Fiscal accounts (percent of GDP) 4/					
Fiscal balance	-1.2	-0.8	0.7	-0.4	-2.6
Total revenue	17.3	18.3	20.6	21.2	20.5
Total expenditure	18.5	19.1	19.9	21.6	23.1
External account (US$ billions)					
Current account balance (US$ bln)	161	250	372	386	427
As share of GDP (%)	7.1	9.5	11.3	9.3	8.9
Capital account balance	47	-3	90	130	70
(including errors & ommissions)					
of which: FDI (net)	68	60.3	122	81	65
Change in reserves (increase =+)	207	247	462	517	502
Foreign exchange reserves (US$ bln)	819	1066	1528	2045	2547
Other					
Broad money growth (M2), e-o-p (%)	17.6	16.9	16.7	16.0	15.0

Sources: NBS, PBC, Ministry of Finance, and staff estimates.

1/ World Bank projection.

2/ Estimations are based on the national account data (Table 2-20 in China Statistical Yearbook 2008).

3/ Estimates based on trade deflators for goods published by the Custom Administration.

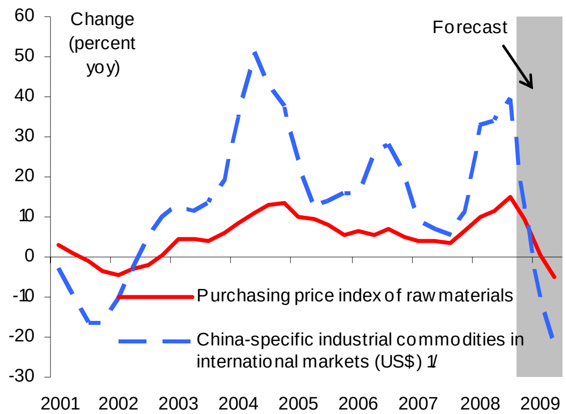
4/ GFS basis; central and local governments, including all official external borrowing.

We think consumer price inflation will recede further. Core inflation has remained low throughout the food price pressure episode that has come to an end. With output expected to be below potential output in 2009 (Figure 13) and raw commodity prices expected to fall, inflation is no longer an issue of concern for the immediate future.

Despite export volume weakness, China's current account surplus is likely to increase further in 2009 due to the lower raw commodity prices. Even as import volumes are likely to outpace export volumes significantly, the large improvement in the terms of trade due to lower primary commodity prices is set to boost the current account surplus to almost US$ 430 billion, or 9 percent of GDP, in 2009.[4]

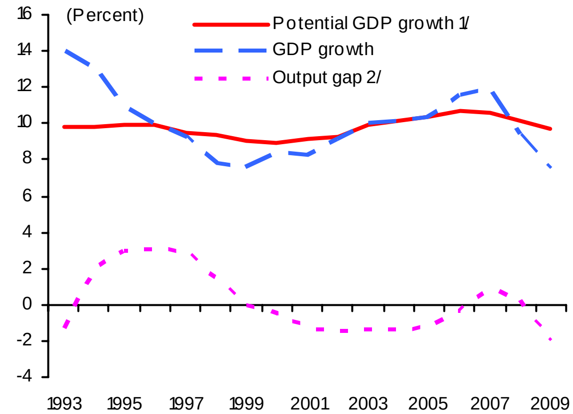
[4] The World Bank expects China's terms of trade to improve 5.5 percent in 2009, after worsening by 8.8 percent in 2008 (DECPG, November 2008).

Figure 12. Sharply lower commodity prices drive down raw material price inflation



Source: World Bank, NBS, staff estimates
1/ Weighted using China's import data.

Figure 13. Output is expected to fall below potential in 2009



Source: NBS, staff estimates
1/ Estimated with a Cobb-Douglas production function.
2/ The difference between actual output and potential output.

Macroeconomic Policies—fiscal policy has moved center stage

The macro policy stance has shifted rapidly recently, and has rightly become expansionary. Until recently, the stance of overall economic policies had been relatively contractionary, with fiscal policy withdrawing some stimulus (being "prudent") for several years and monetary policy tight since the fall of 2007 (Box 2). Since the summer of 2008, however, as international and domestic growth prospects weakened and inflation came down steadily from its peak in early 2008, the need and room for macro economic policy to support domestic demand has increased substantially. As a result, the overall macro stance has shifted, with an acceleration recently. Indeed, in the face of weakening world demand and with competitiveness still overall strong, the case for stimulating domestic demand is stronger than the case for trying to stimulate exports by depreciating the exchange rate or giving tax incentives to exporters.

There are several reasons why economic policy should not to try to offset completely the impact of the external shock and housing weakness on growth. Although it is not helpful to have large swings in economic growth, economic cycles are a key part of economic development, fostering discipline, upgrading capital, and advancing technological progress. Moreover, there may be a limit to how much government-influenced investment and consumption can be increased quickly and efficiently. The consequences of temporary economic dislocation and layoffs can also be alleviated by expanding and using the social safety net. The fact that the private sector now plays a larger role than in 1998 (when China used fiscal stimulus to counter the impact of the Asian crisis) may imply a different trade off between boosting growth by overall government spending and by improving and using the social security system.

Box 2. China's counter-cyclical fiscal policy.

In the wake of the Asian financial crisis, China adopted policies to stimulate the economy. Fiscal policy was key, with many infrastructure projects initiated. The funding came in part from the government budget, including via issuance of additional "construction bonds". However, a large amount of additional financing took place, notably via bank lending to the SOE- type vehicles that execute several types of infrastructure projects. With fiscal policy expansionary, the budget deficit increased from 0.7 percent of GDP in 1998 to 2.6 percent GDP in 2000 (**Box Table**).[5] It is difficult to present exact numbers on investment triggered or influenced by the government. However, estimates put infrastructure investment at around 10 percent of GDP in 2000.

During 2001-07, when growth was high and rising, fiscal policy was appropriately contractionary. In 2005, the fiscal policy stance was officially adjusted to "prudent". In 2006 and 2007, fiscal contraction was particularly sizable. Taking into account the improving balance of the social security funds, calculations of the fiscal impulse imply that 1.5 percent of GDP was withdrawn by the government in 2007.

Table. Fiscal Developments (percent of GDP) 1/

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Budgetary revenue	11.7	12.8	13.5	14.9	15.7	16.0	16.5	17.3	18.3	20.6
Budgetary expenditure	12.8	14.7	16.0	17.2	18.3	18.1	17.8	18.5	19.1	20.0
Budgetary balance	-1.1	-1.9	-2.5	-2.3	-2.6	-2.2	-1.3	-1.2	-0.8	0.6
General government balance 2/	-0.9	-1.6	-2.0	-1.6	-1.6	-1.2	-0.4	-0.2	0.5	2.0
Fiscal impulse, based on										
Budgetary balance	1.1	0.9	0.6	-0.2	0.3	-0.5	-0.9	-0.1	-0.5	-1.4
General government balance	0.9	0.6	0.4	-0.4	0.0	-0.4	-0.9	-0.1	-0.7	-1.6

Sources: CEIC, World Bank staff estimation.
1/ The data are not adjusted for accumulation of arrears in tax rebates to exporters during 2000-02, and their repayment in 2004-05. Such an adjustment would increase the deficit in 2000-02 and lower it in 2004-05.
2/ Including extra-budgetary and social security funds.

Flexibility and transparency in the implementation of expansionary policies is very important. At times of major uncertainty such as now, economic projections can change quickly. This means that the desired size of the stimulus may need to be adjusted as developments unfold. Meanwhile, for the benefit of macro economic policy making and coordination, it is important that information on all spending and funding is available widely. From the public finance perspective, it is better to channel as much as possible of the stimulus via the normal process of fiscal policy. Transparency is also important in order to assess the effectiveness of policies, something Prime Minister Wen Jiabao saw as an important task.[6]

[5] The deficit including extra-budgetary and social security funds was lower.
[6] Remark made during his press conference discussing the November 9 package.

The authorities will need to strike a balance between two considerations that will guide economic policy making for 2009.

First, there is the imperative for maximum impact on domestic demand, growth and employment. Direct government spending, in the form of government direct consumption or investment, typically creates more economic activity than an increase in transfers or tax cuts.[7] This is because higher transfers or tax cuts that increase income may not necessarily induce spending, especially by higher income people or when times are especially uncertain. Stimulus targeted at increasing demand for products of sectors with excess capacity will have a larger activity and employment effect. In the short term, however, there is no difference in the growth impact between government investment and government consumption.

Second, policies need to support the medium-term rebalancing and long term development and growth agenda. The key medium-term objective of China's 11th Five Year Plan—the implementation of which has now reached the half way point—is to rebalance the pattern of growth, making growth more domestic-demand led, but also cleaner, less resource intensive, and shared more equally. In terms of the overall economic strategy, rebalancing requires a shift away from a predominance of industry, investment, and exports, towards services and consumption (Figure 14). Such a shift would mean more labor intensive growth, with more urban employment creation. By boosting the share of wages and household income in GDP, this would increase the role of consumption, a key goal of the government, in an economically sustainable way (Figure 15).[8] As such, it would also ameliorate the pressures for current account surpluses. Moreover, more labor intensive urban growth would help reducing excess labor in agriculture and the related poverty and urban-rural inequality. In addition, it would make growth less intensive in energy, raw materials, and resources, and less detrimental to the environment. In addition to the rebalancing agenda, there are other important measures and structural reforms that would support China's long term development agenda, including removing remaining distortions and investing in people-oriented infrastructure.

It would be ideal if the policy stimulus in 2009 can be shaped by the rebalancing and long term development agenda. This is only possible in some policy areas, such as with government spending on health, education, and social security. Many other rebalancing measures are by themselves not expansionary in the short run and would thus not be obvious elements of a stimulus package. However, there is room to supplement stimulus measures with these types of rebalancing measures.

Since the summer of 2008, the authorities have taken several steps to support growth. These include lifting credit quotas, which were the binding constraint on monetary conditions; three (modest) interest rate cuts and one in reserve requirement ratios; several increases in various VAT rebates to exporters; and measures to boost the property market (see above) and the stock market.

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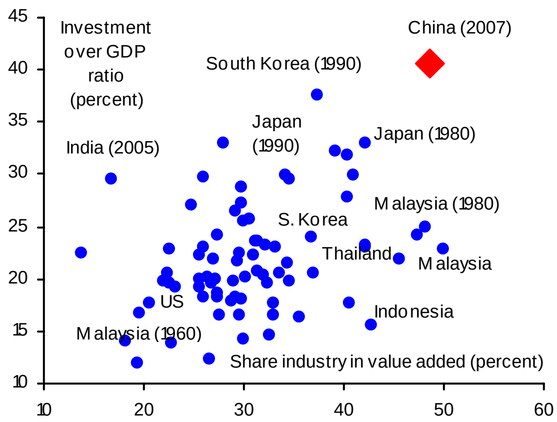
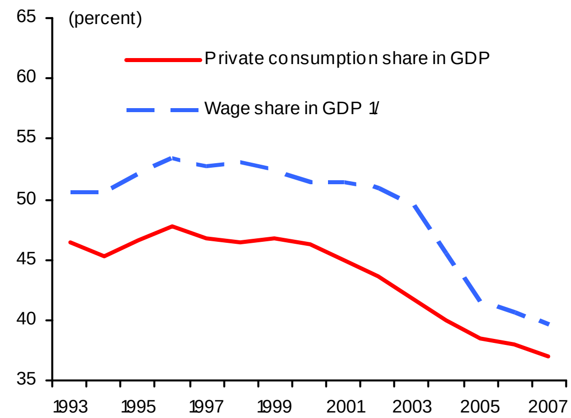
[7] In Keynesian terms, direct spending has a higher multiplier.
[8] See He and Kuijs (2007),"Rebalancing China's Economy—Modeling a Policy Package", World Bank China Research Paper No. 7; www.worldbank.org.cn/english/content/working_paper7.pdf.

Figure 14. China's investment heavy, industry-led economy



Source: World Bank, NBS, staff estimates

Figure 15. Structure of the economy is key to increasing the role of consumption



Source: NBS, staff estimates
1/ from *China Statistical Yearbook*, table 2-20.

On November 9, the government announced the outlines of a large package to stimulate growth and employment. At the same time, the government formally changed the fiscal stance from "prudent" to "active" and the monetary policy stance from "moderately tight" to "moderately easy".

As underscored by the November 9 package, fiscal policy is set to play an important role in supporting growth. And it can, since, unlike in many other countries, with a strong fiscal position and sustainability, there is less need to worry about the negative impact of a fiscal expansion on markets' willingness to hold government debt.[9]

With the November 9 plan, the government identified measures in 10 areas to boost domestic demand and growth in 2009 and 2010. The emphasis is on infrastructure and other investment, although of a different nature than 10 years ago, with many projects geared to broad long term development needs and improving living standards instead of mainly to the needs of industry.

- Public housing projects—notably on low-rent residential units, re-development of slumps and renovating deteriorated rural housing.
- Rural infrastructure investment—including water supply and conservation, including expediting the North South water diversion project; irrigation; rural roads; and the power grid.
- Transport infrastructure—with a focus on railways, both passenger and coal transport lines, but also highways, airports, and the urban power grid.

[9] Including extra-budgetary and social security funds, in 2007 general government revenues increased to almost 28 percent of GDP, the fiscal surplus was 2 percent of GDP, and the government debt estimated at under 20 percent of GDP.

- Health and education—including improving the local clinic service systems; renovating schools in inland provinces.
- The environment—including enhancing urban water and sewage treatment projects, pollution treatment of key water ways, reforestation, and energy efficiency projects.
- Innovation and restructuring—facilitating structural change and R&D, and supporting the development of high tech and service industries.
- Post-earthquake reconstruction.
- Household income—including increasing grain procurement prices and farm subsidies and increasing payments under the minimum living allowance system.
- Rolling out the VAT reform nationwide in 2009, allowing capital spending to be deducted from the VAT in line with international practice, reducing the corporate tax burden by about RMB 120 billion (0.4 percent of GDP) in the government's estimate.[10]
- Increasing bank lending to support growth, with priority being given to key projects, rural investment, SMEs, R&D, M&A, and consumer loans.

The package has secured and in many cases speeded up the execution of investment projects. Many had been in China's medium and long term development plans, but without concrete timing and financial envelopes. The significance of the November 9 announcement is that, with the central government's approval and financial backing, the projects can now be concreticized and prepared, including in terms of arranging supplementary financing. The government estimates that RMB 4 trillion (12 percent of estimated 2009 GDP) is required to carry out the investment projects from the fourth quarter of 2008 until 2010. This spending is planned to be frontloaded, with planned (additional) spending for 2009 higher than for 2010. The central government itself has committed a total of RMB 1.18 trillion, of which RMB 120 billion is to be spent in the fourth quarter of 2008.

With reference to the criteria noted above (impact on growth in the short term and support for rebalancing and long term development), a few observations are:

- **Most of the elements imply higher direct government spending, and should thus have significant effect on output in the short term.** Indeed, the stimulus from the infrastructure projects would target sectors with probably the largest excess capacity—construction and upstream industries—maximizing its impact.
- **The package contains many elements that support China's overall long term development and improving people's living standards.** They include public

[10] The VAT rate for small firms will be reduced to a universal 3 percent from 6 percent for industrial firms and 4 percent for commercial firms.

housing; rural infrastructure; public transport; schools; and waste, water and sewage treatment projects.

- **Policy makers will need to deal with several challenges related to the large infrastructure projects.** The key challenge is to ensure that the selection, preparation, and execution of the projects is as rules-based and efficient as possible, with an eye to long-term development needs (instead of short term visibility). This task is made more difficult by the large size of the overall package and the speed with which it is meant to be executed.

- **Some of the stimulus measures announced directly support the medium term effort to rebalance the pattern of growth.** In particular, the 10 point plan includes several measures increasing government consumption and transfers, including on health and rural subsidies and transfer payments. These are good examples of measures that can boost disposable incomes, especially of lower income people, and the propensity to consume. Moreover, additional initiatives along these lines are expected. For instance, the government now expects the subsidized voluntary basic pension plan for rural people to cover 60 percent of rural people by 2010 and 80 percent by 2015, an advancement compared to the earlier schedule.[11] Also, while not in the package, the large appreciation of the effective exchange rate in the last several months helps rebalancing.

- **The package would by itself not lead to decisive rebalancing of the pattern of growth.** That is in the nature of the trade off between policies to rebalance and those to stimulate growth.

- **Policy making for 2009 is not finished, and further initiatives towards rebalancing are needed and likely.** During a press conference discussing the package, Prime Minister Wen Jiabao noted that the policy stimulus provides a good opportunity to implement the reform of energy pricing. Indeed, the recent sharp decline in oil price and subsiding of inflation pressures provides a very good window of opportunity to reform energy pricing, combining a re-link to international prices with a fuel tax for oil products. Additional measures are necessary to make headway with rebalancing the pattern of growth, including on resource and utility pricing; government spending on health, education and social security; and financial reform. Box 3 gives a general overview of possible rebalancing measures.

Fiscal policy in 2009 is likely to lead to a sizable but manageable increase in the government deficit. In 2008, revenue growth was strong for much of the year but weakness set in in the fall because of weaker profits and a large swing in tax revenues from the stamp tax on stock market transactions. With the large increase in spending planned for the fourth quarter, the government is likely to run a modest deficit in 2008 (Table 2). As discussed above (prospects), in our scenario for 2009 government-influenced direct expenditure could contribute more than 4 pp to GDP growth. Broadly, current indications are that more than one-halve of this will come from government-influenced investment,

[11] Confirmed by the Ministry of Human Resources and Social Security on November 17, 2008.

and the rest from government consumption and transfers. Only a minority share of government-influenced investment is financed by the central and local governments. Government revenues are likely to lag GDP considerably, largely because of the impact of the two VAT reforms. In all, these rough estimates suggest an increase in the government deficit of 2-2.5 percent of GDP in 2009, most of that because of discretionary policy. The Ministry of Finance has noted that the overall budget deficit in 2009 and 2010 will not be higher than 3 percent of GDP.

Table 2. A tentative fiscal scenario (percent of GDP)

	2007	2008	2009
Budgetary revenue	20.6	21.2	20.5
Budgetary expenditure	20.0	21.6	23.1
Budgetary balance	0.6	-0.4	-2.6
General government balance 1/	2.0	0.9	-1.7
Fiscal impulse, based on			
Budgetary balance	-1.4	1.0	2.2
General government balance	-1.6	1.1	2.6

Sources: CEIC, World Bank staff estimation.

1/ Including extra-budgetary and social security funds.

Monetary and exchange rate policy

The authorities have started to ease monetary policy. They have already reduced interest rates and reserve requirements. More importantly, in end-October, the PBC announced it would no longer apply the credit quota that had been the binding constraint on credit extension since the more strict enforcement of window guidance beginning in the fall of 2007. The quotas had been partially eased at the beginning of August.

It is difficult to say at the moment how credit growth will develop. Since the re-imposition of the credit quota in late 2007, actual loan growth has been lower than loan demand as expressed by the business sector in the PBC's survey (Figure 16). While loan demand appears to have decelerated recently, the gap remains significant. In October, after the initial partial easing of the quotas but before the complete lifting, credit growth picked up. In addition, because of the way that infrastructure is financed in China, the stimulus package calls for bank lending (and/or other finance). However, private sector demand for loans is likely to soften as growth prospects weaken. Moreover, banks are likely to become more cautious in lending in such an environment.

The calls for more bank financing in specific areas, such as rural investment and to SMEs may create challenges. These calls possibly create tensions with the strive for a stronger commercial and market based orientation of banks.

Lingering concerns about inflation among some of China's authorities strengthen the case for more exchange rate flexibility and monetary independence. Despite the prospects for very low inflation in 2009, some of China's policy makers remain concerned

Box 3. Overview of rebalancing policies

First, several macroeconomic and structural measures will help to stimulate domestic consumption and stimulate the services sector:

- Increase government spending on health, education, and social security, to raise disposable incomes, especially of low income people, and reduce the reluctance to consume. Good examples in health include increasing the government contribution to the New Rural Cooperative Medical System and Medical Assistance, the basic health care system, and the community health service system. In education, funding for education in poor and rural areas can be increased.
- Strengthen further the exchange rate to shift production from tradables to non-tradables and increase exchange rate flexibility to give more independence to monetary policy.
- Further strengthen financial market opening and reform, to improve the efficiency of the allocation of capital—thus sustaining growth with less investment—and increase the role of consumption. Such reform and more efficient allocation of capital should benefit the service sector and small and medium-sized enterprises. Higher demand deposit rates would support the role of household income in overall income.
- Expand the dividend policy for State Owned Enterprises (SOEs) introduced in 2008 and improve corporate governance, to remove the over-investment bias, especially in large, industrial SOEs. This could possibly be combined with an overall cut in the corporate tax rate. Such a combination would improve the level playing field between SOEs and non SOEs.

Second, fiscal and tax policy can help to adjust the structure of production:

- Eliminate the underpricing of industrial inputs—land, energy, water, utilities, natural resources, and the environment through price increases, tax measures, and/or pollution charges. Accelerated energy price reform would allow prices to reflect the full costs of supply, including environmental and depletion costs.
- Further remove distortions in the tax system that subsidize and stimulate manufacturing, including from the VAT system and remaining preferential tax treatment of FDI.
- Remove remaining restrictions on the development of the services industry, including addressing monopolies and oligopolies in several service sectors and removing other barriers. China's WTO commitments support this agenda and the government may want to consider even further liberalization of international trade and investment in service industries.

Third, further relaxing restrictions on the movement of labor and land transaction would facilitate rural-urban migration and mitigate rural poverty. Relatedly, the fiscal system could be improved to provide host cities with more incentives to deliver social services to incoming migrants.

Fourth, institutional reforms can be introduced to give local decision makers stronger incentives and better tools to pursue rebalancing. A key is to strengthen accountability, especially via the performance evaluation of local officials and enforcement of laws and regulations.

Fifth, reform of the intergovernmental fiscal relations would allow poor regions to have the resources to carry out improvements in the social sectors. Inadequate local funding (and capacity) in poor regions is a serious constraint on further progress in many areas, including the delivery of rural services, social protection, education, health, and resource efficiency.

Box 4. Rural land policy reform

China's reform efforts were launched 30 years ago in rural areas. Rapid rural development has been reflected in substantial decreases in absolute poverty and continued rural income growth. However, as reforms deepened, urban incomes grew even faster, leading to an ever widening gap between urban and rural incomes.

On October 12, 2008, the CPC Central Committee approved a broad policy document aimed at a more balanced and integrated rural-urban development. It sets a goal of doubling rural per capita incomes by 2020, and includes several major decisions on rural reform and development, with a new land policy at its core. Most importantly, under the new policy, farmers' leases on land will be extended from the current 30-year term to an open-ended one. Moreover, the new land policy will reduce the scope of land to which "eminent domain" can be applied. Land acquisition will only be permitted for public purposes and a market-value based compensation mechanism will be established. Plot level land registration and certification will also be introduced to grant farmers more tenure security and better protected land use rights, including the right of land transfer. Reconfirming national food security as a priority, the document commits to a stringent 'farmland protection system'.

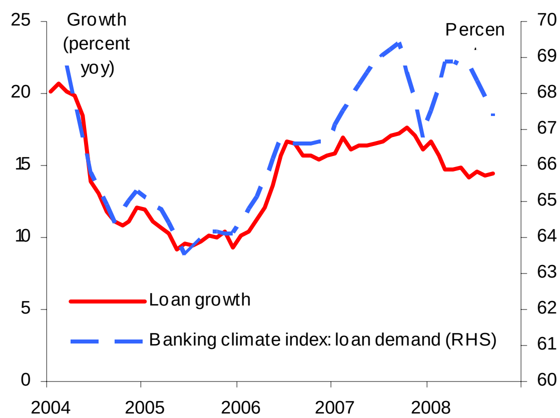
The new land policy, together with the Property Law passed in March 2007, reflects China's determination to address the challenges facing rural development and narrow the gap between rural and urban sectors. The new land policy encourages an orderly evolution of agriculture from household-based towards larger-scale operations, promotes the development of a rural land rental market by improving tenure security, and strengthens farmers' bargaining position in land transactions and acquisitions. The new land policy can over time result in significant improvements in China's rural sector, including higher agricultural productivity, more rural-urban labor migration, an integrated land market, and higher incomes for China's farmers.

Effective implementation of the new land policy can be facilitated by a range of follow-up actions. First, changes in the legal framework may be needed, including amendments to the Land Administration Law, the Rural Land Contracting Law, and even land-related articles of the Constitution. Second, a large-scale pilot of rural land registration could serve as an effective model. As China has 250 million farm households, with each household having on average 5 plots, nation-wide land registration and certification will be a daunting task. Third, since land still functions as a rural safety net, it will be desirable to closely monitor the impact of potential land concentration on farmers' livelihood and social stability. Fourth, effective information campaigns and legal aid activities can strengthen farmers' awareness of the policy changes and their legal rights. Fifth, additional policy changes to enable farmers to enjoy a more complete bundle of land rights could be tested. One example could be a pilot to examine the impact of allowing farmers to use their land as collateral to access credit and granting a higher degree of marketability to farmers' residential plots. Finally, appropriate tenant rights are important for land leasing. Too strong tenant rights can be a deterrent to the development of rental markets; too weak tenant rights can lead to mistreatment of tenants, which also discourages rental markets. Thus, it will be important to find the right balance.

about inflation, including because of the impact of the liquidity injections and other measures in developed countries. This worry should probably not shape monetary and financial policy in China now. However, if policymakers are seriously worried about inflation pressures in the industrial countries, increasing the independence of monetary policy—via more exchange rate flexibility—would insulate China from inflation dangers in the large industrialized countries.

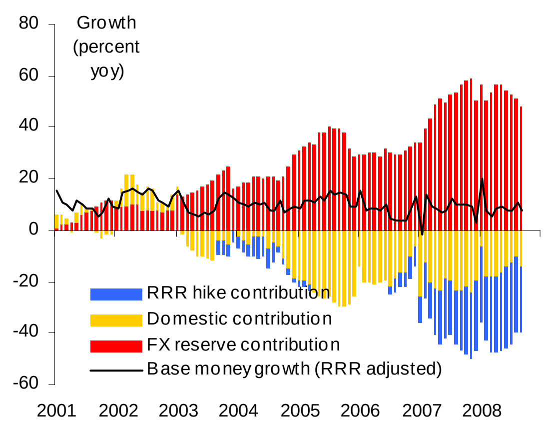
Although speculative capital inflows seem to have diminished in recent months, China's large external surpluses are unlikely to go away soon, and sterilization to contain domestic liquidity will remain needed regularly (Figure 17).

Figure 16. Loan demand had been constrained by quota



Source: PBC, staff estimates.

Figure 17. Sterilization will remain necessary



Source: PBC, World Bank staff estimates.

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World Development Report 2009: Reshaping Economic Geography
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How China's Farmers Adapt to Climate Change
Author: Wang Jinxia, Roobert Mendelsohn, Ariel Dinar, Huang Jikun
Report No.: WPS4758
Abstract: This paper uses a cross sectional method to analyze irrigation choice and crop choice across 8,405 farmers in 28 provinces in China. The findings show that Chinese farmers are more likely to irrigate when facing lower temperatures and less precipitation. The analysis of how Chinese farmers have adapted to current climate, provides insight into how they will likely adapt when climate changes

The Great Proletarian Cultural Revolution, Disruptions to Education, and Returns to Schooling in Urban China
Author: John Giles, Ablert Park, Meiyan Wang
Report No.: WPS4729
Abstract: The paper identifies the returns to schooling in urban China using individual-level variation in educational attainment caused by exogenous city-wide disruptions to education during the Cultural Revolution from 1966 to 1976. The analysis demonstrates that these results are unlikely to be driven by sample selection bias associated with migration, or by alternative pathways through which the Cultural Revolution could have affected adult productivity.

Rising Income Inequality in China: a Race to the Top
Author: Luo Xubei, Zhu Nong
Report No.: WPS4700
Abstract: The authors argue that rising income inequality can be part of a normal process of development at a certain stage, and that the dynamics of spatial income divergence in the form of "a race to the top" can be desirable to some extent as it unleashes competitive pressure and creates incentives for investment in skills. Continuing to improve market efficiency

Financing Rural Development for a Harmonious Society in China: Recent Reforms in Public Finance and Their Prospects
Author: Achim Fock, Christine Wong
Report No.: WPS4693
Abstract: This report analyzes the performance of the intergovernmental fiscal system - the financing of rural development through counties, townships, and villages - and the impact of recent reforms. The authors argue that a comprehensive reform strategy is needed to address fundamental vertical and horizontal imbalances in the intergovernmental fiscal system. The reforms must reach beyond the fiscal system to build improved accountability mechanisms to improve public service

delivery at the grassroots level. And, given China's size and diversity, reform efforts must focus on improving incentive structures at the county, township, and village levels.

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Author: Wang Hua, Xie Jian, Li Honglin
Report No.: WPS4690
Abstract: This paper presents a multiple bounded discrete choice household survey model. It discusses how the model can be utilized to collect and analyze information about the acceptability of different water prices by different types of households, as well as households' willingness to pay for water service improvement. The results obtained from these surveys can be directly utilized in the development of water pricing and subsidy policies.

China and Central and Eastern European Countries: Regional Networks, Global Supply Chain, or International Competitors?
Author: Fung , K.C. ; Korhonen, Iikka ; Li, Ke ; Ng, Francis
Report No.: WPS4689
Abstract: The authors use a panel data set to investigate whether foreign direct investment flows to these two regions are complements, substitutes, or independent of each other. The authors find no evidence that foreign direct investment flows to one region are at the expense of those to the other. Instead, the results suggest that foreign direct investment flows are driven by distinct regional production networks (and thus are largely independent of each other) and the development of global supply chains (indicating that foreign direct investment flows are complementary).