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Quarterly Update

March 2010



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 (lil2@worldbank.org).

OVERVIEW

In spite of the global recession, China's economy grew 8.7 percent in 2009. Massive investment-led stimulus was key, but real estate investment gained prominence more recently and household consumption growth has held up very well. The domestic growth momentum continued in the first months of 2010. Exports declined in 2009 as a whole, even as China gained global market share. With imports strong, external trade was a major drag on growth in 2009 and the external current account surplus declined sharply. Exports rebounded strongly through 2009, though, and exceeded the pre-crisis level in early 2010. In a heated real estate market, surging property prices triggered policy measures to expand supply and curb speculation.

We project 9.5 percent GDP growth for this year, with a shift in the composition. Government-led investment is bound to decelerate. But, exports are likely to continue to recover amidst a pick up in the global economy and real estate activity is likely to grow strongly this year. Consumption growth should remain solid. Inflation is on course to be significant in 2010, after being negative in 2009. But, with global price pressures likely to be subdued amidst large spare capacity internationally, China's inflation is unlikely to reach high rates in 2010. We expect the external surplus to remain broadly unchanged this year.

The macroeconomic policy stance needs to be tighter than in 2009. Unlike in most other countries, overall output in China is close to potential. Thus, China needs a different macro stance than most other countries. Macroeconomic risks include a property bubble and strained local government finances. The 2010 budget rightly implies a broadly neutral fiscal stance. Given the remaining uncertainty about the world economy, flexibility in its implementation is important. Inflation expectations can be contained by a tighter monetary stance and a stronger exchange rate, while monetary policy also has a key role to play in containing risks of asset price bubbles. The case for a larger role for interest rates in monetary policy is strong. If policymakers remain concerned about interest rate sensitive capital flows, more exchange rate flexibility would help.

Ensuring economic and financial stability includes mitigating risks of a property bubble and strains on local government finances. With regard to the property market, stability calls for an appropriate macro stance and improving the functioning of markets. Concerns about the affordability of housing for lower income people would be best addressed by a long term government support framework. The central authorities have rightly increased vigilance over lending by local government investment platforms. Given China's solid macroeconomic position, the local finance problems are unlikely to cause systemic stress. But the flow of new lending to the platforms needs to be contained and local government revenues need to become less dependent on land transaction revenues.

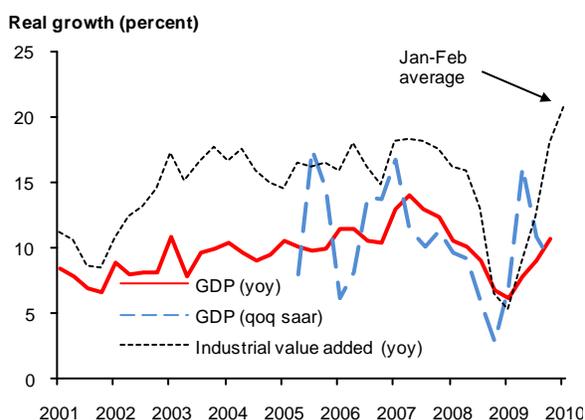
In the presentations to the NPC, the government emphasized the need for structural reforms. As China is preparing for the 12th Five Year Plan, the key overall objectives are making further progress in "rebalancing" the economy, enhancing efficiency gains, moving to a more sustainable spatial transformation of economic activity and employment, further changing the role of the state in the economy, and taking account of China's interaction with the rest of the world.

RECENT ECONOMIC DEVELOPMENTS

In spite of the global recession, China’s economy grew 8.7 percent in 2009. Growth decelerated significantly in end 2008 and early 2009 as exports collapsed amidst the global recession (Figure 1). But, China’s massive stimulus package kicked in in the second quarter of 2009. We estimate that quarter on quarter GDP growth peaked in the second quarter and moderated to an average 10 percent in the second half (seasonally adjusted annualized (SAAR)), bringing year on year (yoy) GDP growth to 10.7 percent in the fourth quarter.

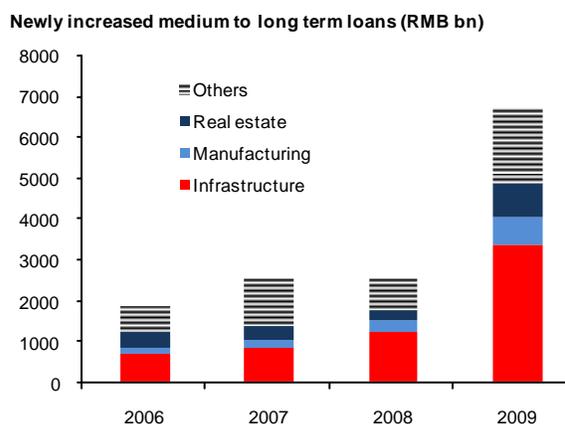
China’s robust growth in 2009 was the result of massive investment-led stimulus. The stimulus has been centered on infrastructure spending, combined with increases in transfers, consumer subsidies and tax cuts. The surge in government-led spending was equal to 5.9 percent of GDP in 2009. However, only a small part of the stimulus was reflected in the budget, with the deficit rising from 0.4 percent of GDP in 2008 to 2.8 percent in 2009. Additional financing—largely bank lending—contributed almost two-thirds of the stimulus. The bank lending towards infrastructure projects run by local government investment platforms has been a key part of the massive monetary expansion that brought total net new bank lending to RMB 9.6 trillion in 2009, or almost 30 percent of GDP. Nonetheless, the lending surge was actually fairly broad based (Figure 2). Infrastructure made up one-half of total medium and long term lending in 2009, compared to one-third in 2007. Medium and long term lending to manufacturing, real estate (including mortgages) and other sectors also soared by more than 100 percent. The share of total new lending going to households, notably mortgages, increased from 14 percent in 2008 to 26 percent in 2009.

Figure 1. China’s growth has remained robust into 2010



Source: CEIC, World Bank staff estimates.

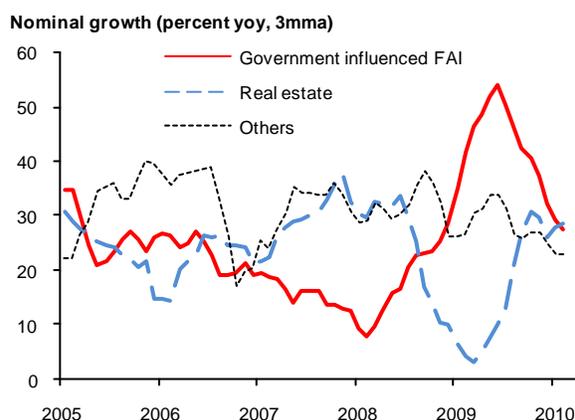
Figure 2. The monetary stimulus has been massive and broad-based



Source: PBOC, World Bank staff estimates.

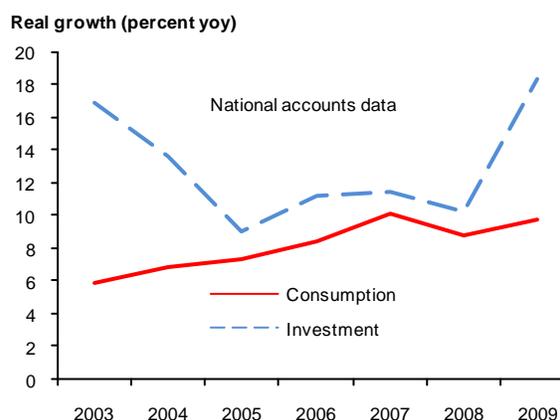
Government-led investment was the key driver of growth for much of 2009, but real estate investment gained prominence more recently. Estimated government-led investment surged 42 percent in 2009, in nominal fixed asset investment (FAI) terms, compared to 18 percent growth of market based FAI.¹ However, by the end of 2009 and in early 2010, government-led investment growth was coming down considerably (yoy) (Figure 3). Real estate investment was very weak in early 2009. But, fueled in part by ample liquidity, housing sales recovered in early 2009 and the real estate sector heated up, with prices rising rapidly in many cities.² As a result, real estate investment rose rapidly in the second half of 2009. Growth in other market based investment has trended down since mid-2008. In all, investment rose around 18 percent in 2009 in real terms, on a national accounts basis, the fastest growth since 1993 (Figure 4).³

Figure 3. Investment growth has varied



Source: CEIC, World Bank staff estimates.

Figure 4. Overall, investment soared in 2009



Source: CEIC, World Bank staff estimates.

Household consumption growth has remained steady. After weakening in early 2009, labor market conditions improved and employment and wage growth have held up well through early 2010. Incomes and consumption were further supported by falling consumer prices for much of 2009 (which boosted

¹ The FAI data typically suggests much higher growth than the annual national accounts data on gross fixed capital formation. This is in part because of a conceptual difference. The FAI data includes spending on land transactions, which does not lead to capital formation. But the differences between the two are too large to be fully explained by this factor. Our government-influenced investment covers utilities, transport, scientific research, water and environmental conservation, education, health care, social security, culture, sport, and public administration.

² The total stock of real estate related loans—including those for land development, real estate development and mortgages—rose 38 percent in 2009 to RMB 7.3 trillion at end-2009 (18 percent of the total; 22 percent of GDP).

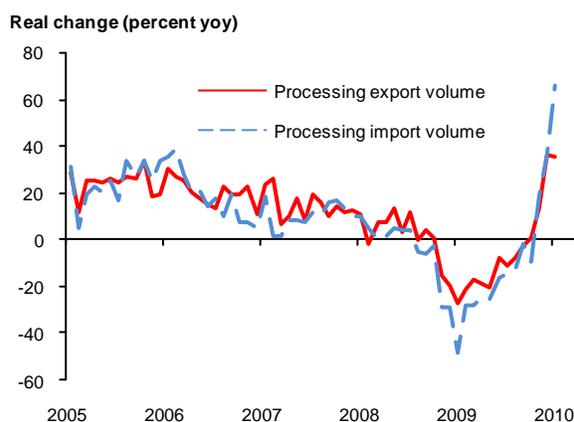
³ The preliminary national accounts data includes changes in inventories.

purchasing power); higher government transfers; and other measures such as lower consumption taxes for small cars and subsidies for rural consumption of electronic appliances. With government consumption also up substantially, total consumption rose by an estimated 9.7 percent in real terms in 2009.

The domestic growth momentum broadly continued in the first months of 2010. Growth of monetary aggregates and investment growth started to ease somewhat in late 2009. After a rush of lending in the first weeks of 2010, the government took measures to contain the pace of lending and loan growth slowed to 27.2 percent (yoy) in February. However, consumption did not slow in early 2010. Retail sales grew 15 percent in the first 2 months of 2010, in real terms, compared to a year ago.

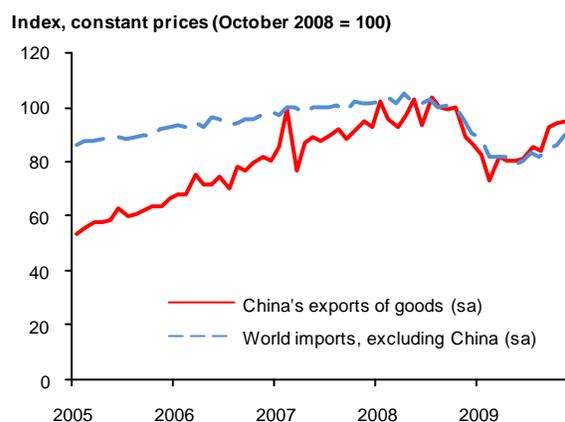
After a sharp fall early in 2009, exports recovered briskly, sequentially, as China gained global market share. With processing exports particularly hard hit by the global crisis, China's exports initially fell even faster than the imports of its trading partners (Figures 5 and 6). However, as the global economy improved, exports staged an impressive recovery, with processing exports rebounding particularly rapidly. For 2009 as a whole, we estimate that China's exports of goods and services fell 10.6 percent, in real terms. This compared to a fall in world imports (excluding China) of 16 percent, in real terms. Thus, overall, China's exporters have continued to gain market share in 2009. The export rebound continued into 2010 and in the first 2 months of this year exports (in US dollar terms) exceeded the 2008 level.

Figure 5. The swing in processing trade has been particularly pronounced



Source: CEIC, World Bank staff estimates.

Figure 6. China's overall exports have recovered impressively



Source: CEIC, Centraal Plan Bureau, staff estimates.

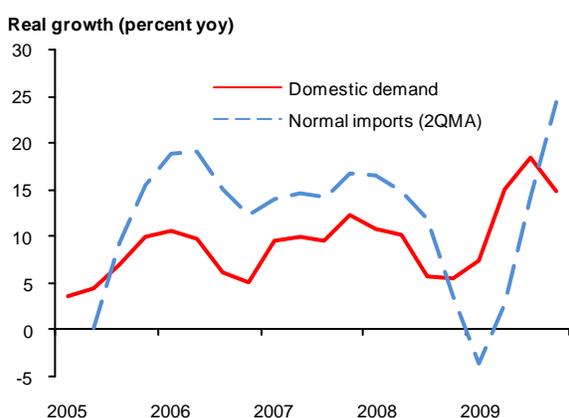
With imports strong, external trade subtracted heavily from growth in 2009. Processing import volumes tracked processing export volumes (Figure 5) while normal, non processing imports were boosted by the strong domestic demand (Figure 7). Combined, economy-wide imports rose an

estimated 3.9 percent in 2009. For the year as a whole, net external trade subtracted 3.9 percentage point from GDP growth, although this contribution improved later in 2009 and early 2010 (Figure 8).

The current account declined sharply in 2009 but reserve accumulation continued apace. The trade surplus declined from US\$ 361 billion in 2008 (8 percent of GDP) to US\$ 243 billion in 2009 (5.1 percent of GDP) as import volumes held up while export volumes fell. It would have fallen more if the terms of trade had not improved substantially, with raw commodity prices falling much more than prices of manufactured goods. In addition, the services balance, the net income balance, and net transfers all fell in 2009. As a result, the current account surplus declined from US\$ 426 billion (9.4 percent of GDP) in 2008 to US\$ 284 billion (5.8 percent of GDP) in 2009. Inward FDI was weak in early 2009. It picked up as the international economy stabilized, but, with outward FDI substantial, net FDI declined significantly, to US\$ 37 billion. On a net basis, financial capital inflows (called “hot money” in China) were US\$ 73 billion in 2009. Including also some positive valuation effects, foreign reserves increased by US\$ 453 billion to US\$ 2399 billion last year.

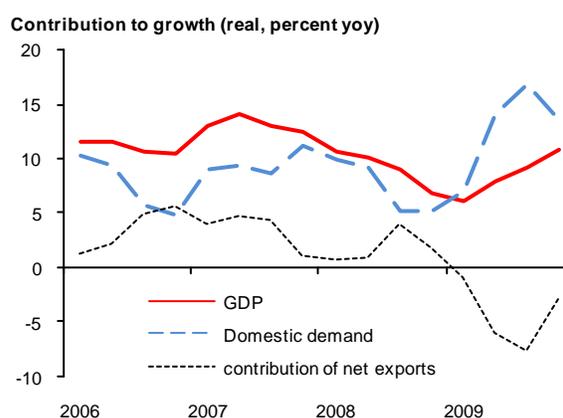
The overall importance and structure of China’s external trade has changed in recent years. Gross exports were 27 percent of GDP in 2009, compared to a peak of almost 40 percent of GDP in 2007. We expect this ratio to recover somewhat in 2010. However, with domestic growth likely to outpace exports in the medium term, we expect the importance of exports in the economy to gradually decline again thereafter. The share of China’s exports to emerging markets around the world rose further in 2009 as the share of exports to US, EU and Japan declined to 46 percent, with the share of the US at 18.4 percent.

Figure 7. Strong domestic demand has boosted normal imports



Source: CEIC, World Bank staff estimates.

Figure 8. Net external trade subtracted heavily from growth in 2009

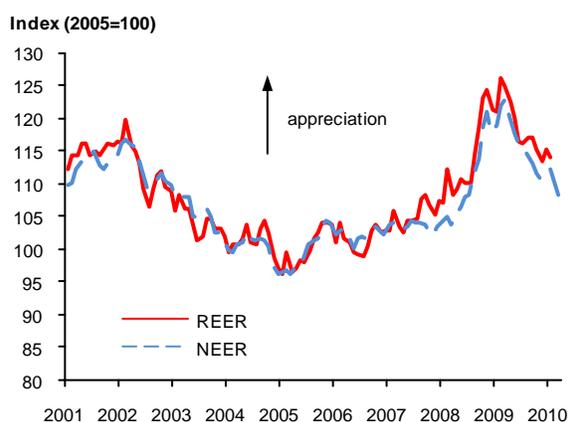


Source: CEIC, World Bank staff estimates.

China’s effective exchange rate continues to fluctuate even as it stays unchanged against the US dollar. Since end-2008 the RMB has been re-pegged to the dollar.⁴ However, a large and increasing part of China’s trade is with countries other than the US. Thus, as a result of movements of the US dollar versus other currencies, movements in China’s trade-weighted exchange rate have differed significantly from movements against the US dollar. China’s nominal effective exchange rate (NEER) has appreciated 12.3 percent between July 2005 and early March 2010, after depreciating in 2000-05, and is now broadly at the same level as in 2001 (Figure 9). This is also true for the (CPI-based) real effective exchange rate (REER). Also, large movements in the US dollar versus other currencies have meant that since the re-pegging against the US dollar in end-2008 the RMB has moved up and down recently against the currencies of the bulk of its trading partners.

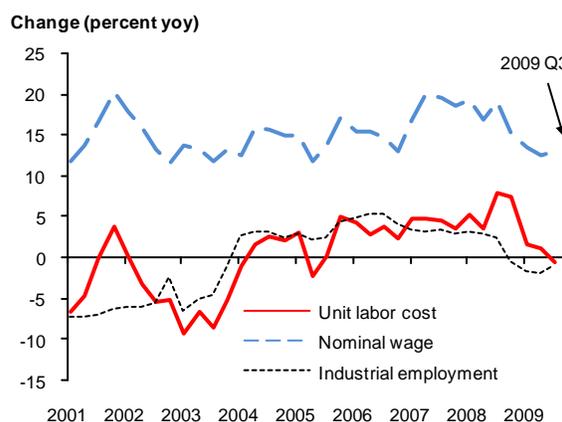
Reflecting the robust economic growth, China’s labor market conditions have improved. Job shedding in export-oriented manufacturing was substantial, in early 2009 (Figure 10). However, new job creation in the domestic economy remained significant, notably in services, construction, and the public sector. Overall, both employment growth and wage growth remained positive and started to pick up again around the summer.⁵ Survey data on the balance between demand and supply on the labor market also suggest improving labor market conditions through early 2010, while recent press reports suggests strong demand for migrant labor in coastal areas, compared to supply.

Figure 9. China’s (effective) exchange rate is back at the level of 2001



Source: CEIC, World Bank staff estimates.

Figure 10. Labor market conditions are strengthening again



Source: CEIC, World Bank staff estimates.

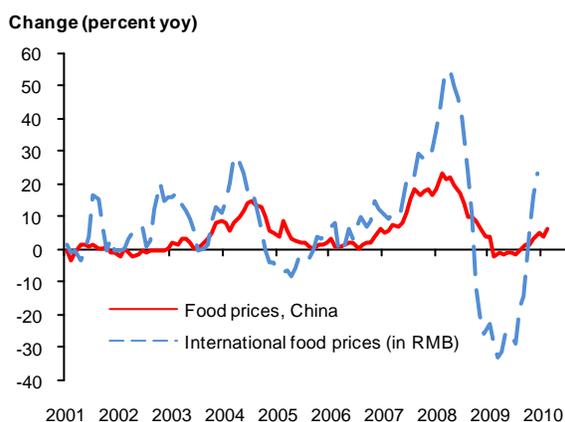
⁴ At a press conference during the NPC meetings in early March, PBC governor Zhou referred to the peg as a “special policy” during a “special period.”

⁵ Per capita rural wage income growth, which includes the impact of both wage and employment developments, dropped sharply to 7-8 percent (yoy) in the last quarter of 2008 and the first quarter of 2009. However, it recovered quickly and reached more than 13.5 percent (yoy) in the second half of 2009.

Consumer price inflation has picked up. After price declines earlier in 2009, consumer prices picked up in the second half (yoy), predominantly because of higher food prices. In February they were 2.7 percent up on a year ago. Food prices increased together with international food prices (Figure 11) and because of unusually cold weather in China in the last months of 2009. The residential component of consumer prices also rose as imputed housing rent increased in line with higher house prices and utility prices were raised (Figure 12). Meanwhile, with industrial raw commodity prices higher, producer prices are now also rising. This implies some further price pressure in the first half of 2010, although industrial raw commodity prices, including food, are not projected to continue to rise strongly in the medium term.

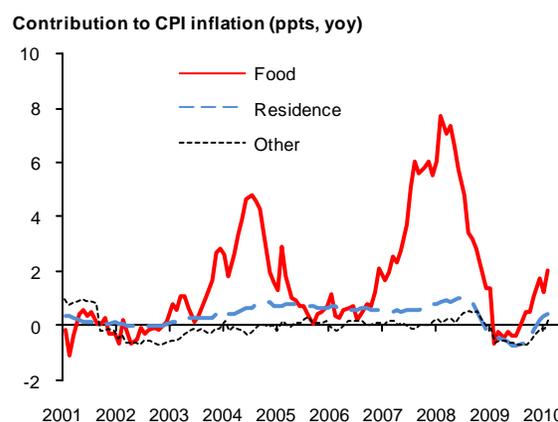
In a heated real estate market, housing prices have risen rapidly recently. Despite the strong economic growth and ample liquidity, stock market prices have not moved much in recent months. However, after having gone through a downturn, the housing market has heated up and property prices have risen rapidly, particularly in large cities. The nation-wide average property price was up 10.7 percent on a year ago in February, while the average price in 36 large cities jumped 32 percent on this basis in January.

Figure 11. China's food prices have risen alongside international ones



Source: CEIC, World Bank staff estimates.

Figure 12. Higher food prices have led to renewed inflation



Source: CEIC, World Bank staff estimates.

Surging property prices triggered policy measures to expand supply and curb speculation. These included clarifying and enforcing the policy on the minimum down payment ratio for second houses (to 40 percent); removing the “discount” on the mortgage interest rate; raising the minimum down payment ratio for buying land from local governments by companies from 20/30 percent to 50 percent; and resuming the previously suspended turnover tax for real estate transactions. Meanwhile, according to surveys, the rapidly rising property prices boost people's inflation expectations.

ECONOMIC PROSPECTS

After the recession of 2009, global growth prospects for 2010-11 appear favorable. Global output bounced back in the second half of 2009, after falling precipitously in late 2008 and early 2009. In addition to help from restocking, the bounce back was supported by extraordinary amounts of fiscal stimulus and highly expansionary monetary policy globally, which brought interest rates in most high income countries down to unprecedented lows. On the back of the recent growth momentum, with the policy stance remaining expansionary, globally, the World Bank projects world GDP (in market exchange rates) to rise 2.7 percent in 2010, after falling 2.2 percent in 2009 (Table 1).⁶

Table 1. The global environment.
(percent change, unless otherwise indicated)

	2007	2008	2009	2010	2011
World GDP (market exchange rate)	3.9	1.7	-2.2	2.7	3.2
High income countries	2.6	0.4	-3.3	1.8	2.3
Developing countries	8.1	5.6	1.2	5.2	5.8
World imports, excluding China (volume)	6.6	2.8	-15.9	3.3	5.9
World prices (US\$)					
Oil (\$/bbl)	71.1	97	61.8	76	76.6
Non oil commodities	17.1	21	-21.6	5.3	0.7
Manufactured export products	5.5	6.0	-4.9	1.5	0.7
\$ Libor interest rate (6 m percent per year)	5.2	3.2	1.2	1.8	...

Source: World Bank (DEC), and staff estimates.

However, the recovery in 2010-11 is likely to be sluggish in high income countries and global import demand subdued. The World Bank anticipates growth in high income countries to be 1.8 percent in 2010, and to edge up to 2.3 percent in 2011. Coming on the back of a large decline in output in 2009, such growth means that most economies will continue to operate substantially below capacity in the coming years, with high unemployment and large output gaps. The Bank expects growth in emerging and developing economies to be more robust, at 5.2 percent in 2010 and 5.8 percent in 2011. But even there output gaps are generally projected to be unusually large in the coming years. In this scenario, world imports (excluding China) rise by 3.3 percent in real terms this year, after a fall of 15.9 percent in 2009 (other forecasters have broadly similar numbers). Thus, compared to the rebound in global growth this year, much less of the decline in world imports is projected to be recouped. This is in part because investment in machinery and equipment, which is import-intensive, is expected to be relatively weak.

⁶ For more discussion on global prospects, see the WB's Global Prospects 2010 at www.worldbank.org/gep2010

Globally, price pressures are likely to remain subdued. The substantial spare capacity in the global economy is set to continue to moderate pressures on prices of manufactured goods and raw commodities in the coming years. For 2010 as a whole, the World Bank expects international raw commodity prices, including those of energy and food, to rise modestly, with most of the rise because of whole year effects of increases that already took place in the latter part of 2009 (Table 1).⁷

Significant risks pertain to the global outlook. On the growth front, risks include premature exits from fiscally supportive policies by governments, but also deepening financial market concerns about the fiscal health of some high income countries in Europe and possible resulting economic impact. Another key risk is household spending in high income countries remaining restrained in the face of rising unemployment. On the price front, raw commodity prices may be higher than expected.

In China, building on the momentum shown in the first months of 2010, growth is likely to remain strong this year. Our projection of 9.5 percent GDP growth for the year as a whole calls for average quarter on quarter (qoq) growth of 8.8 percent (SAAR), slower than the almost 10 percent qoq (SAAR) pace in the second half of 2009 (Table 2). Growth should remain robust in 2011.

The composition of growth is set to shift markedly in 2010. We project a recovery in exports and, as a result, a halt in the negative contribution of net trade to growth (see below). Moreover, with housing starts rebounding swiftly, real estate investment is likely to add significantly more to growth than in 2009. On the other hand, government-led investment, the key driver of growth in 2009, is bound to decelerate. Spending under the stimulus package may rise somewhat in 2010. However, this implies a large deceleration after the spectacular growth in 2009.⁸ We project overall investment growth in 2010 to be around half of the rate last year, in real terms (on national accounts definition) (Figure 13). Amidst favorable labor market conditions and expected continued fiscal support for households, income growth should remain solid. Despite some headwind from inflation, consumer sentiment remains strong, as evidenced by the Chinese new year retail sales. Thus, consumption growth should remain robust.

Short term export prospects appear good but the prospects for later in 2010 are not clear. Given the impressive sequential recovery in exports in 2009 and early 2010, export volumes seem on course for rapid growth for 2010 as a whole even if export volumes remain flat for the rest of the year, sequentially. However, the subdued forecasts for world trade for 2010 as a whole call for caution. Based on the Bank's world trade projections, our export forecast for 2010 as a whole of almost 15 percent implies a substantially larger increase in China's global market share than in 2008 and 2009, although in 2002-07 the market share gains were even higher. We expect import growth to be somewhat faster than export growth. However, because the level of exports is much higher than that of imports, we project a mildly positive contribution of net external trade to growth this year, after the strongly negative contribution last year (Figure 14).

⁷ The Bank expects energy and metal prices to be contained by the large inventory overhang and agricultural markets to be "well supplied." See Global Commodity Markets, companion to the GEP 2010.

⁸ The Ministry of Finance in January announced that central government public investment will amount to RMB 993 billion this year, compared to RMB924 billion in 2009 (and RMB 421 billion in 2008).

Table 2. China: Main Economic Indicators
(percent change, unless otherwise indicated)

	2006	2007	2008	2009	2010 f	2011 f
The real economy						
Real GDP	11.6	12.9	9.6	8.7	9.5	8.7
Domestic demand 1/	9.7	10.7	9.4	13.8	9.7	8.6
Consumption 1/	8.4	10.1	8.8	9.7	9.6	9.1
Gross capital formation 1/	11.1	11.4	10.2	18.3	9.7	8.2
Contribution to GDP growth (pp)						
Domestic demand 1/	9.4	10.4	8.8	12.7	9.1	8.3
Net exports 1/	2.2	2.6	0.8	-3.9	0.4	0.5
Contribution net exports (WB, pp) 2/	3.8	3.4	1.8	-4.8	0.4	0.5
Exports (goods and services) 2/	23.8	19.9	8.6	-10.6	14.7	9.4
Imports (goods and services) 2/	15.9	14.1	5.1	3.9	16.4	9.2
Potential GDP growth	10.5	10.4	10.1	10.4	9.3	8.7
Output gap (pp)	0.0	2.5	2.1	0.4	0.6	0.6
CPI increases (period average) (%)	1.5	4.8	5.9	-0.8	3.7	2.8
GDP deflator	3.6	7.5	11.4	-2.1	2.7	2.6
External terms of trade	-0.8	-0.9	-4.3	8.6	-2.9	-0.1
Fiscal accounts (percent of GDP)						
Budget balance 3/	-0.8	0.6	-0.4	-2.8	-2.8	...
Revenues	18.3	19.9	19.5	20.6	19.6	...
Expenditures	19.1	19.3	19.9	23.4	22.4	...
External account (US\$ billions)						
Current account balance (US\$ bln)	250	372	426	284	304	341
As share of GDP (%)	9.4	11.0	9.4	5.8	5.5	5.4
Foreign exchange reserves (US\$ bln)	1066	1528	1950	2400	2818	3289
Other						
Broad money growth (M2), e-o-p (%)	16.9	16.7	17.8	27.0	17.0	...

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

1/ WB estimations using data on contribution to growth (Table 2-20 in China Statistical Yearbook).

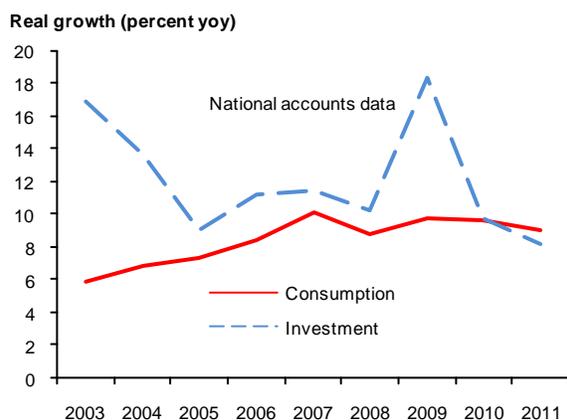
2/ WB staff estimates based on trade data for goods from the Custom Administration, adjusted for estimated difference in price development for services trade.

3/ For 2009 and 2010 this is the commitment data presented to the NPC.

We expect the external surplus to remain broadly unchanged this year and next. With international raw material prices expected to recover more than prices of manufactured goods, we expect China's terms of trade to decline in 2010. As a result, in our scenario, the trade surplus edges down in US dollar terms in spite of the positive contribution of real net trade to growth. We project the current account surplus to increase somewhat in US dollar terms, though, mainly due to higher income on China's foreign reserves. As a ratio of GDP, we expect the current account surplus to edge down further in 2010.

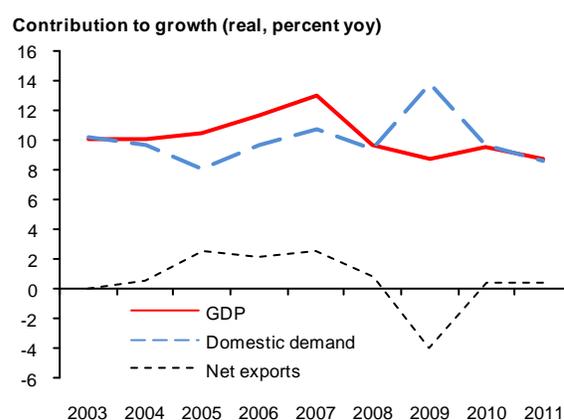
Inflation is on course to be significant in 2010, after being negative in 2009, but it is unlikely to be very high. People’s inflation expectations have increased after the massive monetary expansion. Meanwhile, due to rising food prices and imputed rent recently and some further pressure in the pipeline ahead from the recent increases in raw commodity prices, inflation is likely to increase and reach 3.5-4 percent on average in 2010. However, prices are unlikely to continue to increase sequentially as rapidly as they did at the end of 2009. Unlike in 2007, as noted above, international inflation prospects for this year and next are subdued. The China-specific factors behind food price increases are also not likely to persist. With regard to core inflation, unit labor costs in industry have actually decelerated and high core inflation remains unlikely in China. The net supply of labor on the urban labor market is likely to come down in the coming years. However, given China’s pattern of growth, increases in the supply of goods and services tend to be rapid and large, compared to increases in demand. Indeed, overcapacity in certain sectors is likely to remain a concern. However, depending on the policy stance, property prices may well continue to rise significantly this year, particularly in the first half, before policy tightening begins to have a stronger impact and substantial new supply is expected to be finalized.

Figure 13. Investment growth in 2010 may be half of what it was in 2009



Source: CEIC, World Bank staff estimates.

Figure 14. The composition of growth is likely to change substantially this year



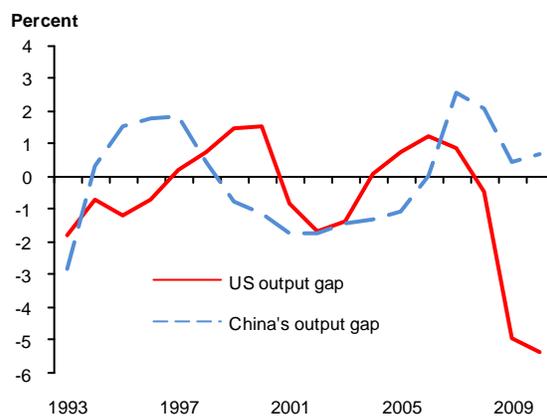
Source: CEIC, World Bank staff estimates.

Key macroeconomic risks include higher asset prices and strained local government finances. Risks to growth are two way. Export prospects are rather uncertain and, domestically, the dynamics between economic developments and macroeconomic policy responses imply large risks and uncertainties this year. There is also some uncertainty about investment developments. But, growth prospects are much less uncertain than a year ago. There are risks with regard to prices, but these are also relatively modest. Probably the largest macroeconomic risks—and thus challenges for policymakers— are implications from the massive monetary stimulus: large asset price increases, a potential housing bubble, and local government finances.

ECONOMIC POLICIES

The macroeconomic policy stance needs to be tighter than in 2009 to contain the emerging risks. The world economy is still subdued, with output far below potential in many parts. However, China's growth has been strong and, based on traditional yardsticks, China's actual output is actually close to potential (Figure 15). Thus, China needs a substantially different macro stance than most other economies. We think that inflation risks remain modest, in large part because of the global context. Nonetheless, the macro stance needs to be noticeably tighter than in 2009 to manage inflation expectations and contain the risk of a property bubble. Financial stability also requires policy attention to keeping local government debts manageable.

Figure 15. China's cyclical conditions differ sharply from those in the US



Source: CEIC, IMF, World Bank staff estimates.

- **The budget presented to the NPC rightly implies a broadly neutral fiscal stance.** The 2010 budget presented to the NPC foresees a broadly unchanged budget deficit, compared to 2009.⁹ As emphasized by the government, it is important to have flexibility in implementation. We think that means contingency plans and, importantly, letting automatic stabilizers work.
- **The monetary policy stance needs to be tighter than last year and the case for exchange rate flexibility and more monetary independence from the US is strengthening.** It would also be helpful to increase the tolerance for modest inflation, to ensure room for desirable relative price changes. Strengthening the exchange rate can help reduce inflationary pressures and rebalance the economy. Over time, more exchange rate flexibility can enable China to have a monetary policy independent from US cyclical conditions, with is increasingly necessary.
- **Ensuring financial stability includes mitigating the risk of a property price bubble and ensuring the sustainability of local government finances.** This calls for both macroeconomic and other measures.

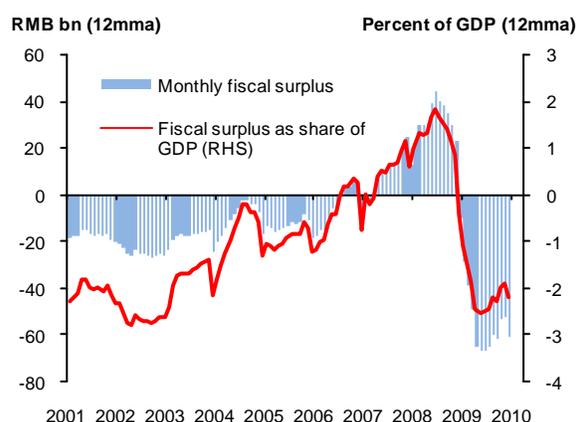
Sustained, sustainable growth requires structural reforms. In the presentations to the NPC, the government emphasized the need to adjust the structure of the economy. With growth prospects good and China preparing for 12th Five Year Plan, this is a good time to both look at the whole structural reform agenda and to select those that can be advanced in the short term.

⁹ As explained below, while some local government expenditures are carried over into 2010, revenues are estimated conservatively in the budget, and on mainstream economic projections and revenue buoyancy assumptions the cash deficit could remain more or less unchanged.

Fiscal policy

The increase in the 2009 budget deficit was remarkably small (Figure 16). Government revenues were down sharply in early 2009 on the back of economic weakness. Revenues from corporate Income taxes and VAT slowed significantly, reflecting low profit growth and the VAT reform. However, revenues picked up as the economy recovered and on intensified collection efforts. Reflecting those efforts, revenues from the windfall tax on oil companies soared in 2009. Consumption-type tax revenues were boosted by strong car sales and higher tobacco taxes. In all, budgetary revenue grew by 11.7 percent, and tax revenue 9.7 percent—much faster than nominal GDP growth of 6.8 percent despite the VAT reform. Budgetary expenditures grew 21.2 percent in 2009. In addition to large increases in infrastructure spending, budgetary spending on health, education and social security rose substantially (by 42, 15, and 11 percent, respectively). The budget deficit was 2.8 percent of GDP in 2009, on a commitment basis, up from 0.4 percent of GDP in 2008.¹⁰ With revenues and expenditures of social security funds up respectively 17 and 25 percent, they ran a surplus of 1.1 percent of GDP, about the same as in 2008.¹¹

Figure 16. The budget deficit remains modest.



Source: Ministry of Finance, WB estimates.

However, fiscal policy was much more expansionary than the on-budget fiscal activity suggests. As discussed above, almost two-thirds of the stimulus from government-led spending was financed in ways other than via the government budget—largely by bank financing.

The fiscal plans for 2010 rightly imply a broadly neutral fiscal stance. The robust growth projected for 2010 calls for a neutral fiscal stance in 2010, with a broadly unchanged fiscal deficit compared to 2009 and much less off-budget stimulus. The budget presented to the NPC showed a deficit of 2.8 percent of GDP on “commitment” basis, the same as in 2009. With 0.7 percent of GDP in local government spending carried over into 2010, the “cash” deficit in the Ministry of Finance’s budget rises in 2010. However, revenue growth in the budget is estimated conservatively.¹² Based on mainstream projections for nominal GDP growth and assumptions on revenue buoyancy the cash budget would be broadly

¹⁰ The fiscal deficit reported by the government includes local government infrastructure spending equal to 0.7 percent of GDP that was carried over into 2010.

¹¹ The financial data of the extra-budgetary funds is not yet known.

¹² The budget estimates revenue growth of 8 percent. On mainstream economic forecasts and taking note that revenues have outgrown nominal GDP growth substantially in recent years would result in higher revenues.

neutral. The conservatism gives the government some useful leeway. If growth turns out weaker than expected, the targeted budget deficit may still be in reach without taking revenue measures.

Given the remaining uncertainty with respect to global growth, additional fiscal flexibility in implementation would be good. This calls for a contingency plan and, importantly, for allowing the automatic stabilizers to work. That is, to accept deviations in tax revenues and the budget balance if economic conditions are different than expected at the time of the budget.

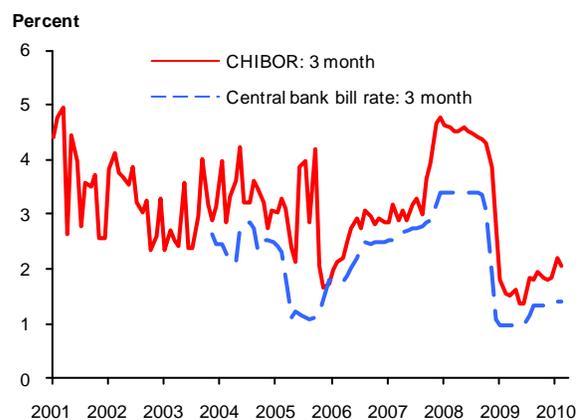
The 2010 budget foresees little change in the composition of spending. The government intends to increase total budgetary spending by 10 percent in 2010. Public investment financed by the budget is set to increase by a modest 7.5 percent (in nominal terms). With respect to the “livelihood” areas that the government has emphasized recently, budgetary spending on subsidized housing is set to increase by 6.7 percent, on social security spending 10 percent, on health 14 percent, and on education 14 percent. The policy schemes to subsidize rural consumption will continue, with some adjustments.

Monetary policy

The key task for monetary policy in 2010 is to help mitigate the major macro and financial risks: high inflation expectations, unwarranted property price increases, and strained local government finances.

The authorities have outlined a less expansionary monetary policy stance and taken some steps. Overall credit growth this year is targeted at about 18 percent, compared to 30 percent in 2009. Monthly credit quota are employed to keep lending growth in check. The authorities have also taken some administrative measures and adjusted prudential regulation to mitigate risks in the property sector and with respect to local government finance (see below). The reserve requirement ratio has been raised twice by 50 basis points to withdraw liquidity.¹³ However, overall liquidity remains abundant, as evidenced by still low interbank interest rates (Figure 17).

Figure 17. Interbank interest rates remain low.



Source: CEIC.

Inflation expectations and pressure can be contained by tightening the monetary stance and allowing the exchange rate to strengthen. To help anchor inflation expectations, it is important to ensure that the target of RMB 7.5 trillion in new lending in 2010 is met. Higher interest rates would make the tightening more convincing. A stronger exchange rate helps reducing inflation pressures by lowering the

¹³ An increase in the reserve requirement ratio (RRR) has a similar one-off impact as an open market operation. Thus, while it is a useful signaling device, RRR adjustments do not tighten monetary conditions in a lasting way.

price of imports and toning down demand. It also helps rebalancing China's pattern of growth towards more services and consumption and less industry and investment.

Further on inflation, it would be useful to increase the tolerance for modest inflation to allow useful relative price adjustment. High inflation is distortive and not helpful. However, in rapidly growing countries like China, relative prices need to change as the economy is reformed and develops. In many emerging markets moderate inflation—of 4-5 percent—is not seen as a major problem. Constraining inflation to be very low may hinder the needed relative price changes. For instance, China needs to increase administrative prices for resources and utilities that are necessary to adjust the structure of the economy. And, higher prices for agricultural products and higher migrant wages can help boost rural incomes and reduce urban-rural inequality, thus helping to improve the primary income distribution. It would be unfortunate if such desirable developments were suppressed because of concerns about moderate inflation.

In addition to containing inflation expectations, monetary policy has a key role to play in containing risks of asset price bubbles. The recent global financial crisis has shown the dangers of neglecting asset price increases in monetary and financial policy making. While inflation may be contained by large output gaps globally, China's monetary policy needs to pay attention to its own output gap and liquidity-driven asset price inflation.

The case for a larger role of interest rates in monetary policy is strong.

- With interest rates substantially lower than expected rates of return on physical investment, property, land, and equity, relatively low interest rates contribute to the overinvestment and speculation that the government is trying to limit.
- The role of interest-sensitive capital inflows in fueling liquidity is small, compared to domestic liquidity creation. The US\$ 73 billion net financial capital inflows in 2009 were equivalent to 5 percent of new bank lending. This is in part because capital controls, though not perfect, are effective in containing capital flows. Moreover, financial capital flows into China are not likely to be very interest sensitive, since much it is attracted by the equity and, especially, the property market.
- Quantitative and administrative measures such as credit quotas are effective in containing credit, but tend to create volatility and uncertainty on financial markets—as was underlined in early 2010. Such instruments are also distortive and sit oddly with efforts to make banks more commercially oriented.

If policymakers remain concerned about interest rate sensitive capital flows, more exchange rate flexibility would help. The perceived constraint on raising interest rates is particularly problematic when cyclical conditions in China differ from those in the US. US monetary conditions (the interest rate) are then not appropriate for China. This has been the case recently and may happen more often in the future than in the past. More exchange rate flexibility would make monetary policy more independent.

By introducing useful two way risk on the foreign exchange market, such flexibility gives monetary policy more room to be in line with domestic needs and to raise interest rates even though interest rates in high income countries remain low.

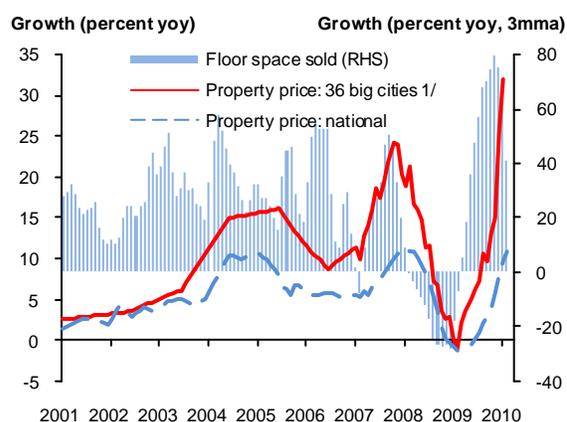
Ensuring financial stability

Ensuring financial stability calls for mitigating the risk of a property bubble and avoiding strains on local government finances. In addition to monetary tightening and other measures, several structural reforms would help.

The property market—defining the role of the government in a market economy

Policymakers are right to closely monitor the property market (Figure 18). This is so even though it is not clear to what extent nationwide property prices are systemically overvalued and how likely a negative price correction on the property market is. The impact of such a correction on households would be relatively limited as their leverage is still relatively low. However, property makes up a sizeable share of the portfolio of many firms and banks. Moreover, local governments' finances would be affected strongly, as these rely significantly on land sale revenues which, in turn, are affected by housing prices. Also, a housing sector slowdown would affect the overall economy in a major way.

Figure 18. Real estate prices have risen rapidly in a recovering housing market



Source: CEIC, World Bank staff estimates.

The authorities have taken several measures recently to contain risks of a price bubble. In 2009, the CBRC urged banks to ensure that loans for “real” investment are not diverted to the property or stock market. The “Recent Economic Developments” section above discusses recent measures to increase supply and curb speculation on the property market. Looking ahead, more adjustment of prudential regulation and other administrative measures can be implemented, including more increases in loan-loss and minimum down payment ratios and higher reserve requirements. Overall monetary tightening is another important instrument.

In addition, several types of structural reforms can help mitigate risks with respect to asset prices. The supply of financial instruments can be increased, by financial sector deepening, including in the bond and equity market. Where interest rates on bank deposits are still capped, easing the caps and stimulating the development of more long term saving instruments would help absorb financial surpluses. Introducing a capital gains tax on real estate would reduce pressures as well.

With regard to property market prices, concerns about market bubbles need to be separated from concerns about the affordability of housing ownership for low and middle income people. When

prices on China's real estate market are rising rapidly, as now, concerns about possible overheating of the market and bubbles are combined with concerns that lower and middle income people cannot afford to buy an apartment in or close to the center of large cities. As a result, the government sometimes takes measures to influence the general market price. Actually these two types of concerns require very different policy responses.

In addition to an appropriate macroeconomic stance, ensuring financial and macroeconomic stability calls for improving the functioning of markets and reducing distortions. First, the functioning of the housing market can be improved, including by improving the quality and consistency of data on prices and vacancies. As a result of poor data on the real estate sector, there is a lack of clarity about affordability—the ratio between housing prices and household income—the often-used indicator of the potential for negative price corrections.¹⁴ The real estate market would benefit from more representative data on property prices and how they compare to incomes of different groups. Second, the land transfer and sale process can be improved. A key objective should be to reduce the incentives of local governments for high prices of real estate and land, including by reducing their reliance on land sales for their revenue, by introducing a stable form of local revenue such as a property tax or adjusting the tax sharing arrangements between the central and local governments. Third, it is important to monitor and regulate the financial market aspect of housing finance—including the development of instruments such as mortgage-backed loans and the refinancing market.

On the other hand, concerns about the affordability of houses for lower and middle income people should be dealt with by a predictable, rule-based government support framework. In a market economy, objectives such as improving the access of people to housing or making housing more affordable are a responsibility of the government and need to be furthered through specific government support, not via measures or intervention with respect to the overall market. The government support could be based on subsidies or public housing, but should be in the form of a long term framework. It would need to be led and probably also backed by the central government.¹⁵

Local government finances and debt—assessing the risks

The stimulus spending has raised concerns about local government finances. Local governments have ramped up infrastructure spending since late 2008, while they are also under pressure to spend more on health, education, and social security, for which they are in large part responsible. With monetary

¹⁴ Movements over time in this indicator using official data do not look particularly worrying. However, there are concerns that the official data underestimates average house price increases and overestimate average wage growth. Moreover, it is difficult to benchmark the level of the ratio, due to the unequal income distribution.

¹⁵ Premier Wen Jiabao noted during the NPC meetings that the central government aims to speed up the construction of common commercial housing and affordable housing, and speed up the construction of public rental housing for low-income families.

conditions likely to become tighter and land revenues possibly slowing down or even declining, local government finances may become strained.

At the heart of the concerns are local government investment platforms. These are SOE-type entities set up to finance infrastructure construction and urban development.¹⁶ Set up in part to circumvent rules prohibiting local governments from borrowing, their investment activities are mainly financed by land sale revenue and bank financing, often using as collateral land requisitioned from local residents.

The amount of new lending to such platforms in 2009 has been very large, but this is not a new phenomenon. The CBRC recently estimated that their bank debt increased by RMB 1.3 trillion in 2009 to RMB 5-6 trillion at end 2009, with estimated additional committed lines of RMB 3 trillion. The possible total of RMB 9 trillion is equal to 27 percent of GDP, while some other estimates of the total liability are even higher. However, a large portion of this debt was accumulated before 2009 and so far no systemic problems have occurred as a result of it.

Problems would emerge if the infrastructure projects do not generate enough growth and revenues to pay the operating and interest costs and repay the loans. While the obligations are technically a liability of the platforms, they can become a liability of the local government in the case of an explicit or implicit guarantee from the local government or via subsidies to cover operating costs of projects that are otherwise not financially sustainable. To date, some local governments have at times gotten into financial problems. However, infrastructure construction in China has by and large created additional economic growth and the loans were repaid using higher future tax and land transaction revenues. Looking ahead, if things go well, this could continue to be the case. However, after the large increase in investment and debt in 2009, it is important to reduce the flow of new activity. In the medium term, the major risks lie in low(er) growth and volatile land sale revenues. New challenges are higher relocation fees for resettled people and the possibility that some of the second generation of infrastructure now being emphasized—sewage systems, environmental projects, public housing—may not boost economic growth and revenues as much as roads and ports have done in the past.

Such financial problems would affect future local government investment spending and could lead to a rise in NPLs.¹⁷ Lower extra-budgetary revenues—because of policy tightening or a correction in the property sector—would mostly affect infrastructure construction and urban development. Localities that have relied heavily on land revenues and that have accumulated a lot of debt may face liquidity problems and may could default on their debts, leading to non performing loans (NPLs) for the banks. While this is a problem for all banks, it is probably particularly a problem for smaller, local level banks and credit cooperatives. These are likely to have weaker risk management, may be more susceptible to

¹⁶ Sometimes called Urban Development and Construction Companies, in the economic statistics their activities show up in the enterprise sector.

¹⁷ Local government fiscal activity is broadly divided in two parts. General budget spending is largely current spending, financed by local current revenues and central government transfers and refunds. The spending on infrastructure and urban development is extra-budgetary, financed by land sale revenue and other non-current revenue, notably bank loans. Since 2007, land sales and related expenditures are reported in local governments' funds budgets, but they are not consolidated with the general budget of local governments.

political pressure, and tend to have fewer low risk loans in their portfolios. For the large, nation-wide banks, NPLs are likely to be less of a problem, as their portfolios tend to be better balanced and their lending to infrastructure has tended to go to larger projects with support from the central authorities.

The authorities are aware of the problems and have taken/announced measures to contain new local government lending and mitigate the risks. The PBC and the CBRC have both warned of potential problems and called on banks to strengthen risk assessment of lending to local government projects. Some individual banks subsequently announced increased vigilance towards this type of lending. The central government is apparently considering issuing new rules on local government guarantees, with suggestions that letters of guarantee or comfort will not be valid anymore.

Given China's healthy growth prospects, with an appropriate policy response these problems are unlikely to be large enough to cause systemic fiscal or banking sector stress. The scale of the debt of the local government investment platforms and the possible problems created by it in the coming years will depend on economic growth and on the effectiveness of the government's measures to contain new local borrowing. If large portions of the debt end up being taken over by the government, that will add significantly to the official government debt. However, China's fiscal position appears to be sound enough to take that on, especially when compared to the fiscal position of most other major economies. Moreover, as a surplus country China has more room in deciding how to deal with such problems, since the government debt is largely held domestically.

However, reforms may be indispensable to mitigate such risks in the future. Overall, China's model for infrastructure financing has served the country well. However, reform of the intergovernmental fiscal system is needed to increase and diversify the revenue base of local governments, making it rely less on volatile land sale revenues. Moreover, local fiscal activity needs to become more transparent. It would be good to include land sale revenues and the infrastructure and urban development activity in local government budgets.

Key Medium-Term Challenges and Reform Priorities

As the most acute phase of the global financial crisis recedes, and as China begins to prepare its new 12th Five-Year Plan (5YP), the focus of policy debates is also shifting from short-term stimulus back towards the medium-term structural reform agenda.

In the coming years, two key challenges stand out. The first is laying the basis for continued rapid development. In countries near China's level of per capita GDP, this is often termed the challenge of "avoiding the middle income trap". China's recent record of rapid GDP growth, and thus its ability to so far avoid this "trap", can be linked to successive bold efforts to reform and open up the economy, and to

undertake needed public investments.¹⁸ Continued success will require further impulses to create major new sustainable sources of demand and supply.

The second key challenge is sustaining recent progress in moving towards a “harmonious society”. Much has already been done under the current 11th 5YP, which is heavily focused on meeting this challenge, but the agenda is far from complete. Specific challenges include creating conditions for more employment generation and for improvements in the “primary income distribution”, in the quality of and access to public services, in expanded social security and other means to reduce vulnerability, and in efforts to create a less resource-intensive and more environmentally friendly form of growth.

Meeting these challenges will require a range of reforms and policy adjustments, most of which already featured prominently in the important speeches and policy documents presented to the recent session of the National People’s Congress. In many of these areas, some progress has already been made and policy plans and/or proposals are in the pipeline. Implementing them effectively will be the key to success. These reforms aim to achieve the following five inter-related objectives:

First, making further progress in “rebalancing” the economy. While China’s past growth model registered many successes, senior leaders and economic analysts have long recognized its unbalanced and ultimately unsustainable nature. Speeding the shift from a model led by exports, investment and industry to one led more by domestic demand, consumption and services sectors, has become more critical than ever. This is for three main reasons. First, while China has made strong progress in achieving many objectives of its 11th 5YP, more limited progress has been made in rebalancing growth. This has in turn limited progress on other key objectives of the 5YP. Second, with subdued near- and medium-term prospects for the post-crisis global economy - and thus for export demand – China will need to generate more domestic demand if it is to sustain relatively fast GDP growth. Third, issues of social and environmental sustainability are now prominent in the reform agenda, with rebalancing also being key to progress in these areas. Rebalancing would support growth by creating new, permanent sources of domestic demand, including more consumption, more health and education spending, and new investment opportunities in growing sectors (notably services) and booming localities (e.g. inland provinces, cities). A rebalanced economy would be more labor-intensive and thus support the “harmonious society” agenda by creating more jobs for a given level of growth. This could in turn create the basis for improvements in the primary income distribution. Such changes require a range of policy adjustments to address distortions which have worked to overstimulate exporting, investment and industrial output and to overly discourage domestic demand, consumption or the services sectors.

Second, enhancing efficiency gains in all sectors and spheres of activity. While recent growth of total factor productivity (TFP) has by no means been low, the main driver of China’s GDP growth has been physical capital accumulation. However, if rapid growth is to be maintained, TFP will have to play an increased role. China’s investment rate is already very high, making further increases unlikely and/or

¹⁸ Examples include the introduction of the household responsibility system in agriculture, the opening up of the tradables sector beginning with the establishment of special economic zones, extensive price liberalization, restructuring and privatization of SOEs, and reforms associated with accession to the WTO.

undesirable. The shrinking demographic dividend will work to further cut the contribution of labor. Greater efficiency can be supported in many ways. Reforms to the pricing of capital, energy, and other natural resources will lead to more efficient use of resources. Financial sector reform can improve the efficiency of capital, as can SOE dividend policy (Box 1). Further policies to support innovation can help China's export enterprises move up the value chain. Opening several "monopoly" sub-sectors in services and public utilities to competition and private sector participation can produce large efficiency gains not unlike those achieved by similar policies in the manufacturing sector a decade ago. Further rural reforms, especially in implementing recent policy reforms on land use rights, can lead to a more productive agricultural sector. An enhanced focus on human capital creation (health and education) will lead to a more productive workforce.

Third, pursuing a more sustainable spatial transformation of economic activity and employment.

While the core of this agenda is about moving to a more permanent and successful form of urbanization, it also includes the shift of economic activities, e.g. from coastal towards inland areas. Further urbanization is inevitable as China continues to develop. It can also be a positive source of sustained consumption growth, and creating demand for major new investments in productive activities, infrastructure, and housing. The resulting agglomeration effects can further raise productivity, especially if backed by investments to connect urban centers. However, urbanization needs to be pursued with due attention to social and environmental sustainability. Movements of people create challenges for public service providers in both locations losing and gaining population (health, education, social services, local utilities and infrastructure). But the benefits of more urbanization and mobility are so large that it is important to overcome these challenges. The recent measures to improve the portability of pension rights are very welcome in this regard (Box 2). Urbanization can further be spurred and made more effective by complementary reform of land markets, urban planning, and the household registration ("hukou") system. It also needs to be balanced by a substantial transformation of the rural economy. Absolutely central for progress on this agenda is the reform of local government financing and inter-governmental fiscal relations.

Fourth, further changing role of the state in the economy. This role has evolved significantly over the past 30 years, and should continue to do so. In some sectors, this will entail expanding the role of the market, with the state shifting from the use of direct controls or dominant ownership stakes towards a greater focus on incentives, appropriate regulation, and other indirect means of governance. Such areas include the financial sector, the broader services sectors, some of the to date more restricted utilities sectors, and land use rights. Conversely, in some other areas, the direct role of the state could be enhanced. These include the provision of health and education services and various dimensions of reducing vulnerability, including pensions, social assistance and climate change adaptation.

Five, taking account of China's interaction with the rest of the world. This has three dimensions. First, as the global financial crisis will almost certainly have deep sustained effects on the growth rate and structure of world demand, China's external environment will not return to "business as usual". As a large country which has greatly benefited from opening up and globalization, this will require non-trivial adjustments in the sources and patterns of economic growth. Second, as China's role in the global

economy increases, including through increased outward investment, its development and policies will have increasing impacts on global markets and other countries, which needs to be factored into policy making. These growing links will also have implications for planning physical infrastructure and promoting trade facilitation. Finally, working in concert with other countries, China will be involved in tackling a range of issues on global and regional public goods, including on the environment.

Box 1. Possible next steps in reform of SOE dividend policy

China's SOEs have become very profitable. Continuous reform and restructuring in the 1990s, rapid overall growth, and a favorable policy setting have led to steady improvement of SOE profitability in China since 1998. SOE profits fell in the first part of 2009, but recovered and were up 10 percent for the year as a whole. In 2007, aggregate profits of nonfinancial SOEs reached 7 percent of GDP. Had they been completely added to the government's budget, total fiscal revenue would have been around one-third higher.

China is carrying out a pilot scheme on raising SOE dividend. In view of the absence of a SOE dividend policy since 1994, the State Council launched a reform in 2007 that aims to collect dividend from central SOEs and channel it to a State Capital Management Budget (SCMB) on a pilot basis. In 2008, the first SCMB was formulated and implemented. The pilot was scheduled to be completed in three years.

What is the desirable direction for further reform of China's SOE dividend policy after the pilot? A recent World Bank policy note recommends three main policy actions.¹⁹

The first is to increase the flexibility of SOE dividend payments by adding a dividend ratio determination mechanism to the existing system of the state ownership function. A desirable mechanism could be defined as follows: each SOE's dividend ratio has two components, a fixed one and a variable one. The fixed component is uniform across the sector. The variable component is set via a four-step process with the SOE board's proposal of the variable dividend ratio target as part of the Responsibility Statement, SOE and SASAC discussion followed by agreement, and SASAC's evaluation.

The second involves government monitoring and adjustment of the average dividend ratio of all central SOEs. One or more of the following three approaches could be considered. The first is to accept whatever is turned out by the recommended mechanism to determine the dividend ratio. If some degree of planning and targeting with regard to the average dividend ratio of all central SOEs turns out to be justified, two other approaches could then be considered. The authorities could either carry out an in-depth study to gauge the appropriate level of dividend ratios in various sectors and key SOEs by assessing the investment efficiency of SOE profit, or simply set a target in the 20-50 percent range in the 12th Five-Year Program, taking into consideration factors such as overall SOE reform strategy and sectoral development program.

The third is to start integrating the SCMB with the general budget. The government could consider to: (i) transfer the SOE dividend revenue to the general budget, and (ii) incorporate the SCMB into the general budget.

¹⁹ See www.worldbank.org/china (English version) and www.worldbank.org.cn/china (Chinese version).

Box 2. Pension Portability Reform in China

In early 2010, the government took measures to improve the portability of pension rights and benefits. According to the “Interim guideline on the portability of pension benefits” issued by the State Council, urban and migrant workers will become able to carry and retain accumulated pension benefits with them when they move between provinces and change jobs. This is an important step toward unifying the pension system nationwide and pooling of pension funds at higher level to facilitate labor mobility in China.

China’s fragmented urban pension system has hindered the portability of pension rights and benefits and thus labor mobility and labor market efficiency. Pension funds have operated locally at the city/county level. The balances of pension funds differ significantly between provinces. Those in developed provinces usually have a large surplus, while those in lagging provinces tend to face deficits. In the absence of a national framework or policy, there were no incentives encouraging the transfer of accumulated pension funds between provinces under the decentralized fiscal system. Since workers could only transfer the funds from accumulated individual accounts, most rural migrants choose to claim the benefits accumulated in individual accounts and withdraw from the urban pension scheme when they returned to the countryside or moved to another city.

The measures are meant to make portable also a part of the social pooling account benefits. China’s urban pension scheme is partially funded with two pillars: a social pooling account and an individual account. Employers are asked to contribute 20 percent of their total payroll to the social pooling account and workers are asked to contribute 8 percent of their wage to individual accounts. Pension benefits have two sources: the social pooling pension and the annuitized individual account accumulation.²⁰ The new policy measures allow workers to transfer the full amounts from the individual account and three-fifth from the social pooling account. This is the first time that workers become able to transfer a portion of the accumulated social pooling funds between regions.

If implemented successfully, this policy reform could have several positive impacts. First, it would improve protection of pension rights for urban and migrant workers and increase equity. Second, it would encourage urban and migrant workers to participate in the urban pension scheme and expand its coverage. In 2008, 24.2 million rural migrants participated in the urban pension scheme, 17.2 percent of all rural migrants. Third, it could facilitate rural-urban integration and improve the quality of urbanization. Urbanization in China is inevitable and most rural migrants are young and tend to choose to live in cities permanently. In addition to encouraging the participation of workers, the portability of pension rights and benefits would allow the pooling of funds from the provincial to the national level, thus creating favorable conditions for eventual unification of China’s pension system. Fourth, it could improve labor mobility and labor market efficiency as well as people’s quality of life.

These measures are a good step towards further reform facilitating high quality urbanization. Regional coordination of pension funds and service delivery requires a strong capacity of management systems and service networks as well as information exchange, to support the increasing transfer of pension funds and labor mobility. It may be necessary to boost this capacity. Also, these measures may put more pressure on resolving the remaining factors that limit labor mobility, such as the Hukou system and eligibility for public services and, fundamentally, the intergovernmental fiscal system.

²⁰ The social pooling pension depends on the weighted average provincial wage, the indexed individual wage, and the number of years people have contributed.

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