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People's Republic of China: 2004 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with the People's Republic of China, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 25, 2004,** with the officials of the People's Republic of China on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 6, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 28, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 28, 2004 discussion** of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for
The 2004 Article IV Consultation with the People's Republic of China

Approved by David Burton and Anthony R. Boote

July 6, 2004

- The 2004 Article IV consultation discussions were held in Beijing during May 17–25, 2004.
- The staff team comprised Mr. Dunaway (Head), Messrs. Prasad, Rumbaugh, and Feyzioğlu and Ms. Wang (all APD), Ms. Fedelino (FAD), Ms. Baldwin (MFD), and Ms. Baker (PDR). The team was assisted by Mr. Brooks (Senior Resident Representative) and Mr. Barnett (Resident Representative). Messrs. Wang, Ge, and Zheng (OED) participated in the discussions. Mr. Kato and Mr. Nolan joined the mission on May 20-21 and Mr. Burton during May 17–20.
- China has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. Exchange controls continue to apply to most financial account transactions.
- While progress continues to be made in upgrading China's economic statistics, weaknesses remain in key areas. These include the national accounts, fiscal and labor statistics, and the international investment position. The authorities are making improvements in all of these areas. China has subscribed to the GDDS, with its metadata posted on the official website (Dissemination Standards Bulletin Board) since April 2002.
- At the time of circulation, the Chinese authorities have not indicated whether or not they consent to the publication of the paper.
- The last Article IV consultation was concluded on October 31, 2003.

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EXECUTIVE SUMMARY

Economic Setting:

The pace of economic activity increased considerably in 2003, despite the SARS outbreak. GDP grew at an annual rate of 10 percent in the fourth quarter of 2003 and continued roughly at that rate in the first quarter of 2004, led primarily by high levels of investment. CPI inflation picked up to 4.4 percent in May.

In response to overinvestment in several sectors and signs of potential overheating, economic policies were tightened in several stages beginning in mid-2003 through a series of monetary and administrative measures. While money and credit growth rates have slowed, they still remain high at 18–19 percent (y/y) as of May 2004.

Policy Discussions:

Staff believes that a further tightening in monetary conditions is likely to be needed. The authorities recognize that additional steps could be required, but prefer to give the measures taken so far more time to work. Local government-sponsored projects have been a major source of the surge in investment, and the central government has taken administrative measures to exert greater control and help achieve a "soft landing."

Large capital inflows continue to complicate the conduct of monetary policy. Greater exchange rate flexibility would enhance China's ability to pursue an independent monetary policy, as well as to adjust to economic shocks and major structural changes. The authorities agree in principle on the need for greater exchange rate flexibility, but are concerned about the impact of a potential appreciation of the renminbi on the domestic economy, particularly with respect to employment growth.

Fiscal policy has an important role to play in cooling down the economy. The authorities plan to use part of a likely revenue overperformance which is retained by the central government to settle outstanding VAT refunds and are considering reductions in spending, particularly for public investment.

Fundamental fiscal reforms with respect to taxation and expenditure management are moving forward. However, to improve the effectiveness of fiscal management, the introduction of a new budget classification system, together with changes in the chart of accounts, in time for the 2006 budget needs to be expedited.

Progress continues to be made on banking sector reforms. Restructuring plans are being put in place for the two state banks that were recently recapitalized. The staff cautioned that problems in the rest of the banking system should also be addressed expeditiously. The recent rapid credit growth threatens to reverse the progress made in reducing non-performing loans, adding to the urgency of tightening credit policy.

Continued implementation of reforms in other areas will be necessary to address macroeconomic and structural vulnerabilities and support sustainable growth. These include SOE reform, implementation of WTO commitments, development of labor and capital markets, and improvements in economic statistics.

I. Recent Economic Developments and Outlook

A. Introduction

1. **In concluding the 2003 Article IV consultation, Executive Directors cautioned that continued strong investment activity and rapid money and credit growth could lead to a buildup of economic imbalances.** They called for stronger action to rein in excessive credit growth and curb potential overinvestment in some sectors of the economy. They observed that increased flexibility of the exchange rate over time would be in the best interest of China. Directors also urged the authorities to stick to budgeted levels for spending and to use additional revenues to reduce outstanding VAT refunds owed to exporters and to further consolidate the fiscal position. They cautioned that the medium- and longer-term fiscal outlook remains a source of vulnerability and welcomed the authorities' intention to keep the level of the fiscal deficit roughly unchanged in nominal terms over the next few years. They emphasized that medium-term prospects depend critically on the pace of structural reforms. Since the Article IV consultation, China has tried to rein in credit and investment growth, conducting monetary and fiscal policies in a manner broadly consistent with the Executive Board's recommendations.

2. **In March 2004, the 2nd plenary session of the 10th National Peoples' Congress emphasized the importance of a more balanced approach to development and the need to push ahead with structural reforms.** The meeting cautioned against excessive investment in some sectors, and focused more on social and environmental development, as well as measures to address the widening regional and rural-urban income disparities. Policy initiatives to raise farmers' incomes, develop the inland regions, and enhance the social safety net were unveiled. The government also signaled its determination to increase the pace of structural reforms by rolling out a wide range of measures including in the financial and SOE sectors and the fiscal area.

B. Economic Developments

3. **Real GDP growth was slightly above 9 percent in 2003, led by strong investment and export growth, leading to concerns that overinvestment in some sectors might lead to a more generalized overheating** (Figure 1 and Table 1).[1] Fixed capital formation is estimated to have increased by about 20 percent in real terms—the fastest rate since 1993—reaching 44 percent of GDP. Consumption growth is estimated to have declined somewhat from 2002 (annual retail sales growth in real terms dropped 1 percentage point to 9 percent), reflecting the impact of the SARS epidemic in the second quarter. Nevertheless, the overall

[1] There is considerable speculation that the official statistics understate recent GDP growth. The fact that nominal GDP measured on an expenditure basis grew 2 percentage points faster than the official growth rate measured on a production basis lends some support to this view. GDP in real terms is only reported on a production basis.

impact of SARS was short-lived, as economic activity rebounded quickly in the second half of the year, with GDP growth reaching 10 percent (year-on-year) in the fourth quarter. Export growth reached 35 percent in 2003, up from 22 percent in 2002, as China continued to make significant gains in market share in major industrialized countries. Imports were even more buoyant, as strong demand for raw materials (e.g., steel, aluminum, copper, and fuel), inputs for exports, and agricultural products helped to push import growth to 40 percent in 2003.[2]

4. **Growth momentum remained strong in the first quarter of 2004.** Real GDP grew by 9¾ percent (year-on-year). Industrial production growth was particularly strong at 18 percent, and fixed asset investment grew by an estimated 36 percent in real terms. Reflecting continued strong domestic demand, imports increased by 41 percent (year-on-year; customs basis) in the first five months, while exports rose by 33 percent.

5. **CPI inflation rose to 4.4 percent (year-on-year) in May 2004, led by food price increases.** Excluding food, inflation turned slightly positive, following price declines in the previous two years.[3] The increase in food prices partly reflects supply-side factors, including reductions in the area under cultivation and the effects of drought and floods in parts of China last year. Strong investment demand in China and increasing world commodity prices have led to a surge in raw material prices, and in the producer price index, but these factors have not yet been reflected in manufactured consumer goods' prices. These prices have continued to decline, but at a slower pace than previously.

6. **China's role in international trade and, in particular, in the region's production chain continued to grow.** Total exports and imports reached 60 percent of GDP in 2003, and China became the fourth largest exporter in the world. China's growing role in the global production of manufactured goods and rising domestic demand are contributing to the pick-up in growth in several regional economies, as well as pushing up international prices for many key commodities. Imports from Asia grew rapidly, and China's trade deficit with the region increased further, largely offsetting the country's trade surplus with the United States and the euro area. The overall trade surplus was $45 billion (3 percent of GDP; balance of payments basis), about the same level as in 2002.

7. **China's overall external position has continued to strengthen** (Tables 2–4 and Figure 2)**.** The current account surplus increased by ½ percentage point in 2003 to 3¼ percent of GDP, as the balance on invisibles shifted into a small surplus. Official reserves increased by $162 billion in 2003. With the use of $45 billion to recapitalize two state-owned commercial banks, the level of reserves stood at $412 billion at year end (equivalent to about 9 months of imports). Almost half of the increase in reserves was accounted for by net non-FDI capital inflows, which have been attracted by a combination of interest rate differentials

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[2] Based on existing estimates of changes in trade prices, export volume increased by 29 percent in 2003 and import volume by 27 percent.

[3] Recent price developments and the inflation outlook are discussed in the Selected Issues paper.

favoring renminbi-denominated assets and speculation about an appreciation of the currency. External debt increased to nearly $200 billion in 2003, but remains modest relative to exports and GDP. In the first five months of 2004, China registered a trade deficit of $9 billion (custom basis), compared with an overall trade surplus of $2 billion in the same period last year. Sizable capital inflows have continued as foreign exchange reserves increased by another $55 billion despite the trade deficit.

8. **During the course of 2003, China's real effective exchange rate, as estimated by the staff, depreciated by 6½ percent, while the nominal effective exchange rate depreciated by 8 percent, reflecting the depreciation of the U.S. dollar against other major currencies.** In the first five months of 2004, it is estimated to have appreciated by 1.4 percent in nominal effective terms and 2.7 percent in real effective terms. The one-year non-deliverable forward rate appreciated by about 5 percent during 2003, but it depreciated by 4 percent in the first five months of 2004, suggesting that speculative pressures may have diminished somewhat.

China: Sources of Reserve Accumulation, 1998–2003
(In billions of U.S. dollars)

	1998	1999	2000	2001	2002	2003
Increase in gross official reserves	6.4	8.5	10.5	47.3	75.5	162.0 1/
Current account balance	31.5	21.1	20.5	17.4	35.4	45.9
Capital and financial account balance	-25.0	-12.6	-9.9	30.0	40.1	116.2
FDI, net	41.1	37.0	37.5	37.4	46.8	47.2
Non-FDI, net	-66.1	-49.6	-47.4	-7.4	-6.7	69.0
Of which: Error and Omissions	-18.7	-17.8	-11.9	-4.9	7.8	18.4

Sources: Staff estimates for analytical purposes based on data provided by CEIC, PBC, SAFE.
1/ For 2003, staff estimates of the reserve change include the $45 billion used for bank recapitalization. The official figure for foreign reserves increased by $116.8 billion in 2003.

9. **Reflecting growing concerns about overheating, the authorities took a series of monetary and administrative measures to curtail investment.** The push for investment by new local government leadership beginning in the second half of 2002 was fueled by substantial excess liquidity in the banking system. While the People's Bank of China was concerned about rapid credit growth already evident in early 2003, its policy response was delayed by the SARS epidemic in the second quarter of that year. Sustained capital inflows, which grew substantially in magnitude in the latter part of 2003, further complicated the conduct of monetary policy. With the end of the SARS outbreak in July, the PBC announced an increase in the reserve requirement by 1 percentage point effective in September 2003, and by a further ½ percentage point in April 2004, and it engaged in moral suasion to reduce credit growth to banks. The authorities also tightened lending standards in sectors experiencing overinvestment (in particular, metals production, cement, automobiles, and real

estate). In addition, the PBC raised short-term relending and rediscount rates by 0.6 and 0.3 percentage points, respectively, in March 2004. The PBC also intensified its sterilization operations in 2004. While only about one-third of inflows were sterilized in 2003, the PBC sterilized about two-thirds of its foreign exchange purchases from January to May 2004.

10. **While money and credit growth slowed, they remain above the authorities' targets** (Table 5, Figure 3). As of May 2004, M2 growth declined to 17.5 percent and credit growth to 18.6 percent, but they still exceed the authorities' respective targets for the full year of 17 percent for M2 and an increase of RMB 2.6 trillion (16 percent) for lending. However, the extent to which credit growth has actually slowed is unclear. While the month-on-month seasonally adjusted rates of growth in credit have declined, part of the slower rise in the stock of outstanding loans may simply reflect an acceleration in the write-off of existing nonperforming loans (NPLs). Moreover, measures taken thus far have had little impact on interbank interest rates and the average excess reserve ratio for the banking system remains relatively large at around 3 percent as of May 2004. Thus, to the extent that credit growth has slowed, it appears to be more due to the effects of administrative measures, rather than to the impact of indirect monetary instruments.

11. **The fiscal deficit declined in 2003 by about ½ percentage point to 2.5 percent of GDP.**[4] The deficit was ¼ percent of GDP lower than the budget on account of revenue overperformance, part of which was saved, while the remainder was used to reduce outstanding tax refunds owed to exporters. Total revenue was 15 percent higher than in 2002 and 1 percentage point of GDP higher than the budget projections, reflecting stronger-than-expected output and import growth. Revenues from VAT and import duties were particularly strong. Total expenditure rose by 12 percent from 2002 and exceeded the budget by RMB 95 billion (¾ percent of GDP) reflecting, among other things, higher capital and social expenditures, SARS-related expenditures, and natural disaster relief.

12. **In line with the authorities' stated fiscal policy objective, the 2004 budget holds the nominal deficit at its 2003 budgeted level.** This implies, on the basis of the staff's GDP forecast, that the deficit relative to GDP would be roughly the same in 2004 as its outturn in 2003. Revenue is budgeted to increase by 9 percent, but this is likely to be a conservative estimate in part because it is based on an assumption of 7 percent real GDP growth. While total expenditure is projected to decline by almost 0.3 percent of GDP, expenditure in the rural sector is budgeted to increase by about RMB 30 billion to finance policy initiatives such as compensation of local governments for a reduction in the agricultural tax, the so-called

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[4] This is the general government budget deficit according to the official budget classification; the central government deficit was 2.7 percent of GDP. According to the budget law, local government savings can not be used to finance the central government deficit. The consolidated deficit according to the IMF definition was 2.8 percent of GDP. As Tables 6 and 7 indicate, the differences between the official and IMF definitions of the fiscal balance primarily reflect the treatment of privatization receipts and on-lending to local governments of funds borrowed by the central government.

"fee-to-tax" reforms,[5] and the provision of increased direct subsidies to grain farmers. Capital expenditure is to be curtailed significantly, reflecting a lower issuance of construction bonds (by RMB 30 billion) than in the 2003 budget. During the first five months of 2004, revenue increased by 32 percent compared with the same period of 2003, while expenditure increased by 14 percent.

C. Macroeconomic Outlook and Risks

13. **The staff projects that real GDP growth will average around 9 percent in 2004, with growth slowing to an annual rate of 7½ percent (y/y) in the fourth quarter of the year.** This forecast is based on the assumption that macroeconomic policy tightening will be effective in bringing about a substantial reduction in investment growth, engineering a "soft landing" of the economy. Export growth is also expected to ease from the exceptionally high levels reached last year. In contrast, consumption would pick up moderately, aided by the continuing development of the consumer credit market and efforts to boost rural incomes. Import growth would decline, reflecting the slowdown in export and investment growth, although import growth would remain higher than export growth. Consequently, the current account surplus would decline from 3¼ percent of GDP in 2003 to 2½ percent of GDP in 2004. CPI inflation is expected to be 3½ percent in 2004, with inflationary pressures dissipating during the year as food price increases ease and demand pressures diminish.

14. **The Chinese economy is not yet assured of a soft landing despite the measures taken to reduce credit and investment growth, and overheating and inflation remain serious possibilities.** This has prompted concerns that a boom/bust cycle similar to those experienced by China in the past could develop (Box 1). Despite the administrative actions taken, strong incentives remain at local levels to maintain high rates of investment. There is also a risk of a premature easing of policies once there are indications that the economy is slowing, which was a problem during the cycle in the mid-1990s. Furthermore, signs of overheating could be temporarily masked by the buildup of excess capacity in some sectors. This, in turn, could delay the implementation of additional measures necessitating a much sharper tightening of policies later, particularly if inflation begins to rise sharply. Nonperforming loans could rise significantly as credit growth is reined in and the economy slows, prompting a further cutback in bank lending and contributing to a sharper reduction in economic growth. Spillover effects on other countries in Asia of a sharp drop in Chinese growth would be significant but manageable (Box 2).

15. **China's medium-term prospects are favorable, provided that near-term risks are handled effectively and structural reforms implemented expeditiously** (Table 8). Structural reforms, particularly in the enterprise and financial sectors and labor markets, are needed to address macroeconomic vulnerabilities, maintain strong productivity growth and

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[5] The fee-to-tax reform aims to simplify the rural tax system and reduce the tax burden on farmers.

Box 1. Lessons from Earlier Economic Cycles

Since the initiation of economic reforms, China's economic growth has been marked by periods of cyclical surges in economic activity and inflation, followed by periods of retrenchment. In the 1980s, two cycles ended with hard landings. Particularly notable is the 1986-90 cycle. This cycle began with an early relaxation of monetary and fiscal policies due to concerns that stringent policies, adopted during the previous cycle, were causing problems for SOEs. Inflation rose to 19 percent in 1988, and the authorities responded with a heavy reliance on administrative measures. Inflation was quickly brought under control, but growth slowed sharply, and the administrative measures adopted had adverse implications for resource allocation.

The 1991-97 cycle was initiated by a rise in central and local government spending and an easing in bank credit policies. By 1992, an investment boom was underway (similar to the present boom, see table), with real GDP growth exceeding 14 percent. Demand pressures led to a pick up of inflation, boosted by liberalization of food prices and public sector wage hikes. The authorities responded in mid-1993 with a "16-point" plan to cool the economy. The measures included raising interest rates, tightening central bank credit to banks, and limiting investment approvals. But the credit squeeze hit SOEs hard, prompting calls for a relaxation of policies. The authorities then temporarily reversed the tightening in late 1993. This easing and the exchange rate devaluation of 1994 resulted in inflation rising to a peak of over 24 percent in 1994.

The authorities eventually achieved a soft landing of the economy, with inflation in single digits by 1996 and only a modest slowdown in growth. Factors contributing to the soft landing included: structural reforms to increase the market orientation of the economy; a record grain harvest in 1996 that reduced food prices; the buildup of excess capacity that put downward pressure on prices; and greater use of indirect monetary policy instruments. While a soft landing was achieved, the rapid pace of credit growth in 1992–96 contributed to the weakness of the financial sector today. Most of the non-performing loans in the banking system date from this period, as banks funded SOEs with little regard for credit risk.

Several policy lessons can be drawn from the earlier cycles. First, earlier action to rein in credit and investment growth would have restrained the upswings, contained inflation, and mitigated the eventual NPL problems. Second, consistent implementation of monetary tightening actions, rather than premature easing of policies, would have been more effective in restraining domestic demand and bringing inflation down. Third, greater commercialization of banks and SOEs would have supported the effectiveness of monetary policy. Fourth, increased use of indirect monetary policy instruments rather than administrative measures would improve resource allocation and could also help control the cycles.

China: Comparison of the 1991-97 cycle with the current cycle
(In percent change)

	1991	1992	1993	1994	1995	1996	1997	2002	2003	2004 Q1
GDP (real)	9.2	14.2	13.5	12.6	10.5	9.6	8.8	8.3	9.1	9.8
Fixed Investment (real)	13.1	26.2	36.7	14.4	11.5	11.8	9.3	13.3	19.7	30.7
M2 growth	26.5	30.8	24.0	34.9	29.5	25.3	17.3	16.8	19.6	19.1
Domestic credit	20.2	22.8	38.9	26.1	22.5	21.5	16.3	15.8	19.6	18.0
Change in credit/GDP	15.7	17.3	32.6	17.7	17.5	19.3	16.5	22.5	28.8	...
NEER	-9.1	-11.6	-19.2	-9.2	-0.5	4.8	8.4	-1.1	-7.1	-6.0
Fiscal balance (Percent GDP)	-2.2	-2.3	-2.0	-2.7	-2.1	-1.6	-1.8	-3.3	-2.8	...
Consumer prices	3.4	6.4	14.7	24.1	17.1	8.3	2.8	-0.8	1.2	2.8
Food prices	3.3	7.7	14.3	31.8	22.9	7.6	-0.1	-0.6	3.4	7.1

Sources: Data provided by the Chinese authorities, and staff estimates.

Box 2. Regional Impact of a Slowdown in China

Simulations were conducted to assess the impact on other countries in the region (relative to the WEO baseline for 2004) of a one-time 10 percentage point decline in China's import growth for domestic use arising from a slowdown in domestic investment.[1] For simplicity, imports of textiles and electronics products (which serve as a proxy for China's import of parts which are assembled into goods for export) were assumed to remain unaffected. Such a decline in China's imports is estimated to be consistent with an initial drop of 5.5 percentage points in real investment growth. This would correspond to an initial drop of 2.9 percentage points in GDP growth and eventually a 4.3 percentage point decline in GDP growth in the longer term after all multiplier effects are taken into account.

The impact on the rest of Asia is estimated to be a 0.4 percentage point drop in GDP growth. The impact varies considerably across the economies of the region, with declines in growth rates ranging from near zero to as high as 0.6 percentage points, depending on the importance of China as an export destination and the share of non-textile, non-electronic exports to China. Asian NIEs are most affected, with their GDP growth slowing by 0.6 percentage points (Table 1). These estimates are subject to a number of caveats: (i) import and export prices are assumed to remain unchanged, thus excluding possible adverse terms of trade effects; (ii) the secondary impact of slower growth in each economy on the other economies in the region is not taken into account; and (iii) offsetting policy adjustments by affected economies are not considered. These should offset each other to a certain extent so that the resulting estimates still provide a useful reference point.

Table 1. Estimated Impact of a 10 Percentage Point Decline in China's Non-Processing Import Growth

	Real GDP growth (percentage points reduction)	Current Account Balance (reduction in billions)
Asia excluding China	-0.4	-6.5
Industrial countries	-0.5	-3.8
Japan	-0.5	-3.5
Asian NIEs	-0.6	-2.0
Other Asia	-0.3	-0.7
ASEAN-4	-0.3	-0.5

While this result is significant for several economies, such a shock should be manageable given the fairly robust outlook for the region. Even though China is becoming increasingly important in supporting growth in the region, other Asian economies are still largely dependent on the U.S. and E.U. markets for their exports, and the share of the region's exports that go to China is still only about 15 percent (including exports for processing). As a result, a substantial drop in the growth of exports to China would still leave countries in the region with relatively robust export growth rates provided that growth momentum in industrial markets is sustained. A slowing in China's growth would also have an impact on economies outside the region. However, because their trade shares with China are even lower, the impact would be small. For example, preliminary estimates for the United States and the Euro area reveal an impact of less than 0.1 percentage points.[2]

[1] The estimates derived are based on a framework that captures the main trade flows within Asia. Because economic relationships in the framework are linear, the results can be adjusted for impacts of different magnitude.
[2] The latter results are based on preliminary estimates made in consultation with RES.

increase the market orientation of the economy. These would help China maintain an average annual rate of GDP growth of 7–8 percent, create greater employment opportunities, reduce fiscal risks, and better integrate the country into the global economy. The external position should remain relatively strong, with the current account surplus largely unchanged relative to GDP and continued sizable FDI inflows.

II. Policy Discussions

16. **The authorities agreed with the general economic outlook presented by the staff.** They saw the economic measures already taken producing a slowing in growth momentum in the second half of the year with inflation remaining moderate. Main differences with the staff centered around the need for and timing of additional policy measures. Against this background, the discussions focused on the further steps that may need to be taken to ensure that economic growth moderates and on the difficult balancing act the authorities face in trying to avoid a repetition of the boom/bust cycles of the past. Discussions also focused on how speculative inflows have complicated monetary policy and on the need for greater flexibility in the exchange rate; the role fiscal policy should play in the near term in reducing demand and over the medium term in supporting a high sustainable rate of economic growth; and the structural reform agenda.

A. Monetary and Exchange Rate Policy

17. **The staff argued that a further tightening of monetary policy appears to be needed to ensure that monetary conditions are consistent with a slowing of growth to a more sustainable pace.** Since excess liquidity remains in the system, a further tightening of monetary conditions is likely to be required to make sure that growth in monetary and credit aggregates slows at least in line with the PBC's targets. Moreover, a premature relaxation in policies—a problem experienced in earlier cycles—should be avoided. Reserve requirements could be increased further, and the scale of open market operations should be intensified. With lending rates very low in real terms, the PBC also has scope to increase the base lending rate to provide a clear signal of its intention to tighten monetary conditions. It would also be appropriate to consider further use of prudential and supervisory guidance to tighten bank lending standards, especially for sectors continuing to experience rapid investment growth. Foreign currency lending by banks is still relatively small, but it is also growing rapidly and will need to be monitored carefully.

18. **The authorities concurred with staff's assessment that money and credit growth needed to be reduced**. However, they did not want to overdo the tightening in policies and run the risk of precipitating a hard landing. They felt that it would be prudent to first give the measures taken so far a chance to work, and see what impact they would have. While excess reserves in the banking system appear high, they noted that part of these excess reserves are held by banks for settlement purposes given the undeveloped state of the interbank market.

The staff acknowledged that measures already taken could continue to lower credit growth, but noted administrative measures, which appeared to have had the largest impact so far, could become less effective over time. Monetary policy needed to be forward-looking and market-based, and risks in the present situation were such that it would be better to err on the side of caution since excess liquidity remained in the banking system. Accordingly, the staff suggested that additional action to tighten monetary policy be taken without undue delay. If economic activity were to slow down sharply it would likely be due to the administrative measures. In that case, these measures could be relaxed, but that would make it all the more important to use market-based instruments to bring underlying monetary conditions at least in line with the authorities' monetary targets.

19. **Controlling money and credit growth has become increasingly difficult in the presence of large capital inflows.** The staff continued to stress that greater exchange rate flexibility would enhance China's ability to pursue an independent monetary policy and adjust to shocks. Increased flexibility might best be accomplished by a widening of the exchange rate band, possibly accompanied by a move to a currency basket. The staff also maintained its view that it is difficult to find persuasive evidence that the renminbi is substantially undervalued.[6] While acknowledging the need eventually for increased exchange rate flexibility, the authorities have strong reservations about making an initial move in present circumstances. In particular, they were concerned that a small initial move could exacerbate capital inflows. The staff suggested that, if sizable speculative capital inflows were to continue, a larger initial move would be necessary.

20. **The staff noted that there may be some reasons to expect that the pace of capital inflows could ease in the near term.** The prospect of higher interest rates in the United States and investor concerns about a sharp slowdown in China's economic growth, could change the relative attractiveness of putting and retaining funds in China. This would create a more favorable environment for introducing exchange rate flexibility.

21. **The authorities expressed concerns about the impact that a large change in the value of the renminbi might have on employment.** They noted, in particular, that the economy needed to generate 20–25 million new jobs a year to provide sufficient employment opportunities for new entrants, the unemployed, and migrants from rural to urban areas. The staff agreed that job creation remained a major policy challenge, but suggested that balanced and sustainable growth would provide the best conditions to stimulate employment growth. To this end, increased flexibility of the exchange rate would improve the effectiveness of

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[6] Staff analysis is summarized in SM/03/317 and Chapter IV of Occasional Paper 232, "China's Growth and Integration into the World Economy." As noted in those papers, existing methodologies yield a wide range of estimates of the equilibrium level of the renminbi, with a great deal of uncertainty associated with each of these estimates. Views among academics and market analysts, summarized in the Selected Issues paper, vary widely, with estimates of the degree of undervaluation ranging from 0 to 35 percent.

monetary policy in reducing overheating risks. Staff noted that increased exchange rate flexibility would not pose substantial risks for the banking system as the banks have a limited scale of foreign currency assets and liabilities. Introducing flexibility would also provide the incentive for banks to improve risk management skills. Moreover, rapid productivity growth, the recent real effective depreciation of the renminbi, and the economy's current strong position would work to moderate any adverse effects on growth and employment from an exchange rate change. Greater flexibility would also contribute to the orderly resolution of global imbalances.

22. **Maintaining China's steady and gradual approach to capital account liberalization is appropriate.** The staff and authorities agreed that a premature relaxation of capital controls would expose the financial system to substantial stress and risks. At the same time, staff noted that the existence of capital controls should not be a reason to delay the movement toward greater exchange rate flexibility. In fact, many countries had found it advantageous to increase exchange rate flexibility prior to capital account liberalization. This approach would also help in achieving the authorities' objective of allowing the exchange market and hedging instruments to develop more fully before opening the capital account (Box 3).

23. **The authorities and staff agreed on the need for further developing the foreign exchange market.** The staff, in particular, suggested that foreign exchange surrender requirements could be further reduced and applied uniformly across enterprises. Allowing enterprises access to the China Foreign Exchange Trade System through a licensed broker system would also increase participation and liquidity in the interbank foreign exchange market. Even within a narrow band, bid-offer spreads could be allowed to fluctuate so as to encourage participants to take positions on both sides. In addition, forward markets and instruments should also be allowed to develop.[7]

B. Fiscal Policy

24. **Fiscal policy has an important role to play in cooling down the economy.** Based on collections in the first five months of this year, it is likely that gross revenue collections in 2004 could exceed budget estimates by as much as 1 percent of GDP. In the current circumstances, staff urged the government to save the tax revenue overperformance retained by the central government (likely to be ½ percent of GDP). The authorities stated their intention to hold all central government expenditure items to budgeted levels, and they indicated that consideration might be given to keeping the amount of bonds issued for public construction projects below its budgeted level. Steps were also being taken to rein in local government sponsored investment, especially through the use of environmental and land

[7] These and other issues related to the development of the foreign exchange market are discussed in the Selected Issues paper.

Box 3. Exchange Rate Flexibility and Capital Account Liberalization in China

Full renminbi convertibility has been the stated goal of the authorities since 1993, but they have always emphasized that it would take a long time to achieve that objective. While significant progress on trade liberalization has been achieved (supported by WTO accession), and current account convertibility has been in place since 1996, the authorities have taken a gradual and deliberate approach to capital account liberalization in view of the substantial weaknesses in the domestic financial sector. Controls on international capital and financial flows and other features of China's exchange system are described in Annex I.

While exchange rate flexibility and capital account liberalization are related, they are distinct issues and do not necessarily have to be implemented simultaneously. Some countries have liberalized capital flows without exchange rate flexibility—an approach that entails considerable risks if financial markets are not sufficiently developed, as was experienced during the Asian crisis—while others have introduced exchange rate flexibility well in advance of capital account liberalization. International experience suggests that, in general, countries tend to have better medium-term outcomes if they introduce exchange rate flexibility before fully liberalizing their capital account, especially if there are weaknesses in the financial sector. Many countries including the United Kingdom, Japan, several European countries, and more recently, India have introduced some exchange rate flexibility well in advance of the removal of capital controls.

China's gradual approach to capital account liberalization is appropriate, given the weaknesses in the financial system. While there is wide recognition that capital account liberalization is an important counterpart to trade liberalization and part of a natural progression towards a full market economy, there are substantial risks associated with exposure to capital flows if there is not sufficient institutional development, especially in the financial sector, to mitigate such risks. The liberalization of capital flows should be sequenced in a manner that reinforces domestic financial liberalization and allows for institutional capacity building to manage the additional risks. It also needs to be supported by a sound and credible macroeconomic policy environment.

Exchange rate flexibility should be pursued in a phased manner and this would not, in itself, pose risks to the financial sector. Domestic banks do not have a large net exposure to currency risk, and the introduction of greater flexibility would create stronger incentives for developing the foreign exchange market and for currency risk management, including developing hedging instruments and forward markets that are currently absent. In this way, the introduction of exchange rate flexibility can facilitate further capital account liberalization by better preparing the economy to deal with the impact of increased capital flows. In fact, greater flexibility in the exchange rate should be seen as a prerequisite before fully opening the capital account. A movement toward more flexibility also does not necessarily mean immediate adoption of a free float. In fact, a period of "learning to float" can be advisable to overcome "fear of floating", and the maintenance of capital controls can, to some degree, support this process by providing protection from potential instability arising from capital flows while institutional arrangements needed to support capital account convertibility are allowed to develop.

In view of these considerations, a preferred approach would be to initiate a phased movement toward greater exchange rate flexibility, develop the foreign exchange market, continue implementation of financial sector reform, and carefully sequence opening of the capital account. Gradual capital account liberalization at the margin (e.g., allowing more scope for capital outflows during a period of strength) can be beneficial, provided that the direction is consistent with the longer-term objectives. Accordingly, steps toward relaxation of capital controls should be undertaken carefully so they can be sustained. Uncertainties and policy inconsistencies that would result from the relaxation and reintroduction of controls over time should be avoided.

regulations. The authorities agreed that revenue was on pace to exceed budget estimates, but were less optimistic than the staff regarding the scale of excess revenue. They also noted that at least part of any revenue overperformance would be used to pay down arrears on VAT refunds owed to exporters, and that it was their intention to avoid any further increase in refund arrears.[8] Staff agreed with this approach, especially with respect to cutting back on public investment, and urged that consideration be given to smoothing the timing of any clearing of VAT refund arrears to limit the effect on liquidity and aggregate demand.

25. **The authorities' medium-term fiscal objective is to keep the nominal deficit constant (at RMB 320 billion).** This would imply a gradual decline in the deficit relative to GDP, consistent with the medium-term fiscal adjustment path of ¼ to ½ percent of GDP per year endorsed by the Executive Board during the 2003 Article IV consultation.[9] However, the government faces substantial future demands on the budget to deal with existing quasi-fiscal liabilities in the financial sector (including the possibility of additional NPLs in the future), the pension system, and local government obligations, and to meet demands for health, education, and social spending. In view of this situation, the staff suggested that the authorities should take advantage of the prospect of achieving a lower deficit in 2004 to reduce the medium-term deficit target. The authorities indicated that such a scenario was a possibility, and a change in the medium-term deficit target might be considered.

26. **Achieving medium-term objectives will require expenditure reprioritization and improved revenue collections,** as well as implementation of a number of reforms designed to improve the efficiency of fiscal management. While welcoming the significant progress that has been made, the staff urged the authorities to push ahead more rapidly with these essential reforms.[10]

27. **Expenditure management reforms will be a key to enhancing the efficiency of fiscal policy.** The ongoing introduction of the treasury single account system has already made a fundamental difference in improving cash collections and recording in the budget.

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[8] These refunds are related to VAT and business taxes paid during production and distribution cycles. In 2003, the authorities used part of the revenue overperformance in that year to pay refunds in excess of the amount budgeted. In earlier years, especially 2000-02, high export growth rates meant that insufficient funds were budgeted to pay approved refunds. Arrears on VAT refunds were estimated at RMB 300 billion at end-2003 (2.6 percent of 2003 GDP).

[9] Explicit government debt is low (26 percent of GDP), but there are substantial contingent liabilities. See the 2003 Selected Issues paper (SM/03/317) for an analysis of longer-term fiscal sustainability.

[10] A description of Fund technical assistance, including in support of fiscal reforms, is contained in Annex III.

Further improvements in cash management will be necessary to extract the full benefits for fiscal management. More fundamentally, however, the introduction of a new budget classification system and associated changes in the chart of accounts will be necessary for more transparency, accountability, and better overall control of government spending, as well as for making fiscal policy more effective as a tool of macroeconomic management. Work needs to continue for implementation of the new system in time for the 2006 budget at the latest, as currently envisaged by the authorities. The staff also strongly encouraged the authorities to make additional efforts to move extra-budgetary funds, especially at the local level, on to the budget. Local government-sponsored projects—often financed outside of the budget—have been a major source of the recent surge in investment. The authorities indicated that efforts are ongoing in all of these areas, and underscored once again their commitment to these reforms.

28. **On the revenue side**, **staff urged the authorities to push ahead with pending tax reforms**. Improvements in tax administration have already contributed significantly to higher collections, and these efforts will need to continue to offset the revenue impact of some tax policy changes, such as reductions in agricultural taxes and the business tax on financial institutions. Improved administration and extension of the VAT to services would provide the basis for improved revenue collections over the medium term. The authorities are also making preparations to shift the VAT from a production to a consumption basis. A pilot project in three Northeast provinces was to be implemented this year with a view to extending it to the whole country in the near future. However, this pilot has been postponed owing to concerns that the change in the VAT to a consumption basis would provide incentives to boost investment at a time when government efforts are being directed at slowing it. Staff encouraged the authorities to continue preparations so that when the macroeconomic situation stabilizes, the change could be made quickly. It would also be important to minimize the time between the beginning of a pilot and its eventual extension to country-wide coverage to limit distortions that would arise from partial implementation of a major tax reform.

29. **Center-local fiscal relations remain a critical issue for limiting potential fiscal liabilities, as well as for ensuring that all local governments have sufficient resources to provide basic public services.** Local governments are prohibited by law from direct borrowing to finance their operations. However, they are able to circumvent these formal rules by borrowing through public enterprises set up especially for this purpose. Accordingly, a special task force was recently established to study potential liabilities being generated by local governments. The staff welcomed this initiative and recommended that this work be supported by establishing a fiscal risk register in the Treasury to keep track of any potential liabilities. The staff also emphasized that any future relaxation of legal constraints on direct borrowing by local governments should not take place until a number of structural reforms have been implemented, including strengthening the recording and reporting of local government operations and enhancing the accountability and transparency of local

government financial management.[11] The authorities have also moved to increase transfers to local governments in the 2004 budget to further improve local fiscal systems, and they are considering a rationalization of the functions of lower-level governments within the current five-tier system as a cost saving measure. Notwithstanding these efforts, staff emphasized that the current transfer system may not provide sufficient resources to enable all local governments (particularly those in poorer provinces) to provide a basic level of public services. Key things that need to be done include reforming tax assignments across levels of government, clarifying expenditure mandates, and establishing a rules-based transfer system.

C. Structural Reforms

Financial Sector

30. The authorities recognize the importance of banking reforms for ensuring future financial stability and creating sound domestic banks that will be able to adequately compete after 2006 when the banking sector will be fully open to foreign participation. Progress has been made in strengthening supervision and dealing with problems in the sector, but the financial condition of the banks generally remains fragile. As a result, efforts to reform the banks have been stepped up. The $45 billion recapitalization of two large state banks (Bank of China and China Construction Bank) at end-December was a major new initiative (Box 4). Efforts are being directed at improving internal management and corporate governance in these banks, with time-bound action plans being put in place. The staff emphasized the importance of holding bank management strictly accountable for the timely implementation of these plans. A similar approach to recapitalization is being formulated for a third state bank (Industrial and Commercial Bank of China).[12] However, there is a general need to strengthen bank balance sheets, improve corporate governance, and enhance the ability of banks to manage risk throughout the banking system. It will be important to not allow the focus on the large state banks to divert attention from problems in the rest of the banking system. In particular, rapid loan growth by joint stock banks merits careful monitoring. Moreover, meeting capital adequacy requirements with full provisioning by 2007 should be achieved by all banking institutions, as required by existing guidelines. Further liberalization of lending rates would also help increase the commercial orientation of the banks. The staff added that the government should strengthen its ownership and oversight role in guiding the bank restructuring process. The recently created Central Huijin Investment Company—the holding company for the government's share in BOC and CCB—could fill this role if it were

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[11] Local government's financial management and debt are discussed in the Selected Issues paper.

[12] The last of the four large state banks (the Agricultural Bank of China) is substantially different in character as it was directly involved in policy support to the agricultural sector in the past. Its restructuring will be addressed in the context of overall reform of rural financial institutions.

Box 4. Reform of the Banking System

On December 30, 2003, following a decision by the State Council, the authorities announced a $45 billion (about 4 percent of GDP) capital injection for two of the four state-owned commercial banks, Bank of China and China Construction Bank. The recapitalization was executed by the People's Bank of China by transferring the funds from its international reserves (which at that time amounted to around $450 billion) into a new entity called the Central Huijin Investment Company. The banks will retain these foreign currency assets in their original form as there are some restrictions on the use of the funds and their conversion into domestic assets. The transaction has also increased the risks to the PBC's balance sheet, as reserves have been exchanged for an equity investment of uncertain value.

The Chinese government announced that the capital injection is to be part of a broader reform process for the two banks. These measures include (i) strengthening the corporate governance of the banks; (ii) resolution of NPLs; (iii) reform of the shareholding system; (iv) the use of external auditors to assess the true underlying financial position of the banks; and (v) enhanced external oversight of the banks' operations, including taking prompt action in the event that the capital base is threatened. The authorities have also indicated interest in inviting strategic investors, both foreign and domestic. To measure progress under the reform program, the China Banking Regulatory Commission has established a number of performance assessment indicators against which the banks' performance will be monitored. The guidelines also stipulate that the banks must publicly disclose their compliance with these requirements. Since receiving the capital injection, BOC and CCB have fully provisioned against NPLs, allowing for a more accurate representation of their capital adequacy ratios. As of end-2003, their CARs stood at 6.98 percent and 6.51 percent, respectively.

Additional steps could further strengthen the reform process, including development of a comprehensive plan for government involvement in financial sector restructuring. A clear framework should be established through which the government will exercise its ownership interest in the banking sector. Close monitoring of the newly injected funds, as well as the government's existing equity stake, will ensure that the program stays on track and that public funds are not misused. A review of international experience in bank restructuring reveals other common themes for consideration in designing a comprehensive banking sector restructuring program. Those most applicable to China's current situation include: (i) development and monitoring of time-bound restructuring plans; (ii) adoption of a commercial focus; and (iii) enhancements to the market infrastructure.

While the two recapitalized banks are developing action plans, monitoring and enforcement will be key to keeping the program on track. Other banks should be encouraged to develop similar plans, even in the absence of additional government capital being invested. In order to operate on a truly commercial basis, all the banks will need to adopt modern corporate governance structures and be relieved of public policy responsibilities and government influence in lending decisions. Further enhancements to the market infrastructure would facilitate commercial operations. The legal framework could better support the enforcement of financial contracts and the balance between creditor and debtor rights. Legislation addressing both financial transactions—such as securitization—and financial institution bankruptcy would be useful, and enhancements to accounting, auditing, and disclosure requirements would promote market discipline.

properly staffed, granted the necessary enforcement authority, subject to appropriate accountability requirements, and operated independently of agencies responsible for regulation, supervision, or the implementation of monetary policy.[13]

31. **While considerable emphasis has been placed on reform of the large state banks, the authorities said that they are also paying close attention to other parts of the banking system.** They have been actively engaged on a country-wide basis in steps to address the problems of Rural Credit Cooperatives (RCCs) and in promoting consolidation of the smaller city commercial banks. For the RCCs, a pilot program has been launched in eight provinces involving ownership diversification and the injection of significant amounts of private capital. It was also the authorities' intention to strengthen the Central Huijin Investment Company to exercise an ownership function on behalf of the government, with it operating under international corporate governance standards. Other new initiatives include the central bank beginning work on establishing a credit information system, and relevant government agencies setting up an early warning system to identify emerging financial sector problems.

32. **The authorities agreed with the staff on the need to continue with efforts to reduce nonperforming loans (NPLs).[14]** The authorities acknowledged the importance of limiting the occurrence of new NPLs, and that this would require slowing the current rate of credit expansion. The staff argued that, in addition to improving overall supervision, tightening of lending standards and advancing SOE reforms would be necessary. Orderly resolution of existing NPLs also needs to remain a priority, including by enhancing the ability of banks and asset management companies (AMCs) to resolve distressed debts by improving the legal framework for creditor rights, foreclosure, and bankruptcy, and by allowing full tax deductibility for specific loan loss provisions.

33. **Significant progress has been made in the on-going self assessment of the financial system.** The authorities expect that the assessment will be finalized soon and a report will then be submitted to the State Council. After the State Council reviews the report, a decision on participating in an FSAP will be made. The staff continued to strongly urge the authorities to take part in an FSAP, as this would help in formulating next steps in financial sector reform.

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[13] International experiences with banking sector restructuring are discussed in the Selected Issues paper.

[14] The evolution of NPLs in China's banking system is discussed in Chapter VII of IMF Occasional Paper 232 "China's Integration with the Global Economy: Prospects and Challenges."

SOE Reform

34. **Restructuring the SOE sector remains a key policy priority.** SOE profitability improved considerably in 2003 with total profits increasing by 31 percent (to RMB 495 billion; 4 percent of GDP), reflecting strong economic growth, the positive effects of high international commodity prices on resource-producing companies, and progress in implementing reforms. The State Asset Supervision and Administration Commission (SASAC) has taken a number of steps to improve management of the SOEs and speed up the reform process since its creation last year. These include the initiation of performance reviews for senior SOE managers and new laws and regulations related to supervision, restructuring, and the sale of state assets.

35. **The staff pointed to the importance of moving forward more rapidly with SOE reform, especially since it is essential for supporting other reforms.** While the steps taken by SASAC over the last year are welcome, greater efforts are needed to put these policies into effect and in evaluating SOEs based on commercial criteria. Furthermore, to encourage commercial orientation, SOEs need to be subject to hard budget constraints and operate independently. Staff recommended that all profitable SOEs should pay dividends to the government, especially if dividends are being paid to private shareholders. SOEs that are not viable should be closed or, if deemed socially important, receive support directly from the budget. The authorities explained that the focus of their attention so far has been on improving the regulatory framework, closing loss-making SOEs, and boosting performance of large SOEs. For example, shareholding systems are being introduced in large SOEs and more than 28 million workers have been laid off since 1998.

Labor and Capital Markets

36. **The authorities noted that, even with a high rate of GDP growth, labor market pressures will continue**. Registered unemployment in urban and township areas increased to 4.3 percent in 2003 from 4.0 percent in 2002, in part due to the closure of SOE reemployment centers and the movement of laid-off SOE workers (*xiagang*) to the registered unemployment rolls.[15] In addition, there are an estimated 150 million excess rural workers and more than 10 million new workers are projected to enter the labor force each year for the next 5–6 years, before labor force growth begins to slow around 2010. The staff stressed that improvements in the functioning of labor markets will be needed to absorb these inflows into the labor pool. This should include better information on job opportunities, improved education and training, and steps to enhance labor mobility. Further reforms of the household registration (*hukou*) system to allow freer movement of labor will also be important for mitigating underemployment in rural areas and reducing income disparities. The authorities noted that

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[15] The actual level of unemployment remains uncertain given the poor quality of the data. Labor market performance and challenges are described in Chapter VIII of Occasional Paper 232.

they plan to improve the environment for rural workers by further removing restrictions and charges on rural migrant workers and offering job training to 60 million people within the next seven years.

37. **Further improvements in the social safety net for both rural and urban workers are necessary.** The current pension system is severely underfunded, and there are rising cash deficits in many regions—as growth in the numbers of those receiving benefits is exceeding that of new participants—which have been met by transfers from the budget.[16] To address the system's problems, the authorities are expanding the administrative level of pooling for some regions to the city or provincial level, and are considering expanding the coverage of the system, including to the self-employed. Also, in the Liaoning pilot program, budgetary resources were used to fully fund the individual accounts that are used to cover current pension payments. This pilot program is being extended to two more provinces with revisions to some parameters. The staff underlined that additional reforms are needed to deal with remaining unfunded liabilities. These reforms should include further increases in the level of pooling and adjustments to key parameters such as benefit payments and retirement age. More generally, improvements in safety nets in both urban and rural areas are needed to protect vulnerable groups and reduce poverty levels. In this regard, the central government is studying the feasibility of implementing a nationwide minimum living allowance scheme for the rural population.

38. **Capital markets need to be further developed to reduce the current heavy reliance on the banking system.** The relative size of bond issuances and IPOs is small and the majority of shares (accounting for about two-thirds of total stock market capitalization) are not traded. Moreover, the futures markets are limited and the bond and inter-bank markets are not unified. To promote the development of capital markets, the State Council issued guidelines in January 2004 to allow qualified non-bank financial institutions to issue securities and to give more latitude to insurance and pension funds to participate in the capital markets.[17] Substantial improvements in the availability and reliability of information on companies' activities and performance are essential for further capital market development. Specifically, for bond market development, there is a need for a unified regulatory framework and removal of restrictions on coupon rates to improve the liquidity and efficiency of the market.

39. **The authorities continue to move gradually toward greater capital account liberalization.** Sixteen international financial institutions have been approved under the Qualified Foreign Institutional Investors scheme to invest in domestic equity and bond

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[16] A detailed description of China's pension system and the need for reform is contained in the Selected Issues paper for the 2002 Article IV consultation (SM/02/231).

[17] A "second board" equity market for small and medium enterprises started trading in May 2004.

markets with a total approved investment quota of $1.9 billion and a number of applications are pending. Plans for a Qualified Domestic Institutional Investors scheme are under careful review. The social security fund and insurance companies have been allowed to invest in overseas securities markets.

Trade, Statistics, and Other Issues

40. **The authorities noted that the implementation of WTO commitments is broadly on track and, in some cases, ahead of schedule.** The unweighted average tariff rate was reduced to 10.4 percent in 2004 from 11.3 percent in 2003 and key commitments with respect to banking services and trade and distribution rights have also moved forward. The authorities are committed to implement agreed reforms and plan to further liberalize trading rights with effect from July 1, six months ahead of schedule.[18] The authorities see multilateral agreements as their biggest trade priority and indicated full support for the completion of the Doha Development Round. A number of regional and bilateral free trade agreements under discussion are seen as supplementary to this broader effort. Staff encouraged the authorities to improve the administration of tariff-rate quotas for agriculture, and to address other issues related to WTO compliance. The authorities indicated their willingness to do so, and to discuss any issues raised by partner countries through the WTO's dispute resolution procedures, if necessary. The authorities expressed alarm at the number of anti-dumping claims being made against them and indicated that they are engaged in discussions with a number of countries to recognize China as a market economy.[19]

41. **External debt remains low relative to GDP and the level of international reserves.** However, both short-term debt and foreign-currency denominated domestic debt have risen sharply. While still not a serious concern (see Table 4), staff advised the authorities to watch these categories closely as their growth may represent potential vulnerabilities. The authorities noted that the recent growth is from a very low base, and both are still quite low relative to international reserves and foreign exchange deposits. They have conducted an investigation and found that recent increases in debt largely correspond to legitimate underlying transactions. China continues to forgive external debt owed by HIPC-eligible and other low income countries. Partial debt relief agreements have been concluded with a number of African and Asian countries, and China has pledged to cancel all its debt owed by 31 African countries totaling $1.27 billion.

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[18] China’s WTO commitments are described in IMF Occasional Paper 232.

[19] Some countries, including Malaysia, New Zealand, Singapore, and Thailand, have recognized China as a market economy. The European Commission recently ruled that China could not yet be designated a market economy.

42. **Progress continues to be made in upgrading China's economic statistics.** However, inadequate data in several areas still adversely affect the monitoring of macroeconomic developments. The greatest needs are in national accounts, labor statistics, and government finance. The authorities indicated that they will continue to make improvements in statistics in the context of their participation in GDDS, and expressed interest in subscribing to SDDS in the future. They are currently improving the quality of real GDP by expenditure category and expect to begin quarterly estimates in the near future. The staff strongly encouraged the provision of data on the international investment position (IIP). The authorities said that they are still resolving some data issues.

43. **China does not have a separate anti-money laundering (AML) framework, but continues to enforce existing provisions contained in various other laws.** At end-2003, an amendment to the central bank law assigned the responsibility for guiding the development of China's AML system to PBC. A working group to draft comprehensive AML/CFT legislation has been established and the PBC and SAFE issued regulations in 2003 for: (i) customer identification; (ii) the monitoring and reporting of financial transactions; and (iii) procedures for seizure and confiscation of illegal proceeds. In May 2004, the authorities participated in an MFD/LEG workshop on AML/CFT issues and at that time indicated a three-year time frame to come into compliance with FATF requirements.

III. Staff Appraisal

44. **China has favorable medium-term prospects for maintaining strong growth and continuing its integration into the global economy.** The biggest near-term risk to the economic outlook is that policy measures taken may not be sufficient to ensure a soft landing of the economy. Strong investment momentum remains, and continued rapid credit growth will risk a further significant rise in nonperforming loans. To ensure that economic growth slows to a more sustainable pace, a further tightening of monetary policy would appear to be needed. The measures taken so far will contribute to reducing money and credit growth. However, continued vigilance will be needed to ensure that further policy tightening is undertaken in a timely manner. Excess liquidity remains in the system, and a further monetary tightening would ensure that growth in monetary and credit aggregates comes down, at least in line with the central bank's targets. It would also be appropriate for efforts to reduce the pace of credit growth to continue to be complemented by prudential and supervisory guidance to tighten bank lending standards, especially for sectors experiencing rapid investment growth.

45. **Greater exchange rate flexibility continues to be in China's best interest.** Controlling money and credit growth has become increasingly difficult in the presence of large capital inflows. A more flexible exchange rate would enhance China's ability to pursue an independent monetary policy and adjust to shocks. Increased flexibility of the exchange rate would also improve the effectiveness of monetary policy in containing domestic demand and price pressures. While recent strong capital inflows potentially complicate the

introduction of flexibility, it is best for China to move from a position of strength, which should serve to limit adverse effects, and a move to greater exchange rate flexibility should not be unduly delayed.

46. **The staff continues to support a gradual approach to capital account liberalization.** However, the maintenance of capital controls should not deter a movement toward exchange rate flexibility. Greater exchange rate flexibility has preceded capital account convertibility in many advanced and developing countries. In fact, experience suggests that it is advantageous to have exchange rate flexibility for a period of time prior to the liberalization of capital flows to allow the exchange market and hedging instruments to more fully develop. While the cautious removal of some restrictions on overseas investment could be implemented, this should not be seen as a substitute for the benefits of greater exchange rate flexibility.

47. **Fiscal policy should play a more supportive role in achieving a soft landing of the economy.** The authorities are urged to save the expected revenue overperformance that is retained by the central government, reduce public investment by limiting the amount of construction bonds, and lower the deficit below the level targeted in the 2004 budget. Further administrative steps might also be taken to hold down local government sponsored investment. At the same time, new claims for VAT refunds should be settled in a timely fashion, and efforts made to clear the remaining stock of arrears. However, consideration should be given to the timing of clearing these arrears to limit the impact on overall liquidity.

48. **Medium-term fiscal consolidation will be required to meet prospective demands on state resources without putting public debt on an unsustainable path.** The staff continues to recommend that the authorities aim to steadily reduce the fiscal deficit by ¼ to ½ percent of GDP per year over the medium term. A further reduction of the 2004 budget deficit below its target would provide an opportunity to pursue a more rapid fiscal consolidation. This would also provide more resources over time to address large contingent liabilities arising from nonperforming loans in the banking system, unfunded pension obligations, and liabilities at the local government level. It would also facilitate the government's ability to cope with spending pressures related to SOE restructuring, improving the social safety net, and rising health care needs, especially with an aging population.

49. **A combination of expenditure reprioritization and revenue measures would facilitate fiscal consolidation and promote economic efficiency.** Expenditure management reforms will be the key to improving the effectiveness of spending. These include the adoption of a revised budget classification system and chart of accounts, the full introduction of the treasury single account, and improved cash management. Extra-budgetary funds, especially at the local government level, should continue to be brought onto the budget. These measures need to move forward as quickly as possible to enhance the effectiveness of fiscal policy as a macroeconomic tool. On the revenue side, priority reforms include extending the VAT to services, shifting the VAT from a production to a consumption-based tax, unifying income tax rates for domestic and foreign companies, reducing the tax burden on the financial sector, and continuing to strengthen tax administration.

50. **A number of measures are needed to address growing concerns over fiscal risks at the local government level.** The recent establishment of a special government task force to study local governments' potential liabilities is a welcome development, but this should also be supported by a fiscal risk register in the Treasury (Ministry of Finance). Strengthening the recording and reporting of local government operations and enhancing the accountability and transparency of local government financial management should precede any future relaxation of legal constraints on direct borrowing by local governments. Fundamental changes in center-local fiscal relations are also needed to ensure that all local governments have sufficient resources to provide a basic level of public services, particularly education and health care, which should help reduce income disparities. Key measures include reforming tax assignments across levels of government, clarifying expenditure mandates, and reforming the transfer system to move toward a more rules-based equalization system.

51. **Achieving continued strong growth over the medium term will depend on speedy implementation of structural reforms in a number of key areas.** These include restructuring of the banking system, SOEs, and the pension system, further development of labor and capital markets, and meeting scheduled WTO commitments.

52. **The financial condition of the banking sector remains weak, although considerable efforts have been made in recent years to improve its performance and to strengthen supervision.** The recapitalization of two state commercial banks at end-2003 was an important new initiative aimed at stepping up the pace of reform. It will be crucial to monitor progress in implementing the time-bound action plans for these banks, evaluate the banks' performance relative to these plans, and ensure that capital adequacy requirements with full provisioning can be achieved by 2007, as required by existing guidelines. In this regard, recent efforts to address the problems of rural financial institutions are welcome. More generally, bank balance sheets need to be considerably strengthened throughout the system, governance improved, and the banks need to be better able to manage risk. Diversifying ownership in the banks—including by allowing qualified foreign financial institutions to take strategic ownership stakes—would aid the restructuring process. The further liberalization of lending rates would allow banks to increase the commercial orientation of their lending over time and should contribute to improved financial performance.

53. **More effective execution of the government's ownership role going forward would also aid the restructuring of the banks.** The Central Huijin Investment Company could fill this ownership and oversight role if it was properly staffed, granted the necessary enforcement authority, and subject to appropriate accountability requirements. It should also operate independently of agencies responsible for regulation, supervision, or the implementation of monetary policy in order to avoid conflicts of interest.

54. **Progress has been made in reducing nonperforming loans, and these efforts need to continue.** Strong efforts will be needed to limit the occurrence of new nonperforming loans, and this argues for slowing the current rate of credit expansion. In addition to improving overall supervision, tightening of lending standards will be necessary. A more

favorable environment for the orderly resolution of existing NPLs also needs to be made a priority. The ability of banks and AMCs to resolve distressed debts needs to be enhanced by improving the legal framework for creditor rights, foreclosure, and bankruptcy, and allowing full tax deductibility for specific loan loss provisions. Consideration should also be given to granting AMCs legal powers to more easily seize and dispose of collateral. The staff welcomes the progress the government has made in conducting its self assessment of the financial sector, and continues to recommend that China participate in the Financial Sector Assessment Program at the earliest opportunity. The authorities should also move forward with plans to develop AML/CFT legislation.

55. **Restructuring the SOE sector remains a key policy priority.** The current strong pace of economic activity and job creation provides a conducive environment for moving forward rapidly with SOE reforms. A number of initiatives to improve management of the SOEs and speed up the reform process have been taken. Greater efforts are needed to put these policies into effect and to evaluate SOEs based on commercial criteria. Furthermore, to encourage commercial orientation, SOEs need to be subject to hard budget constraints, operate independently, and pay dividends to the government. SOEs that are not viable should be closed or, if deemed socially important, receive support directly from the budget.

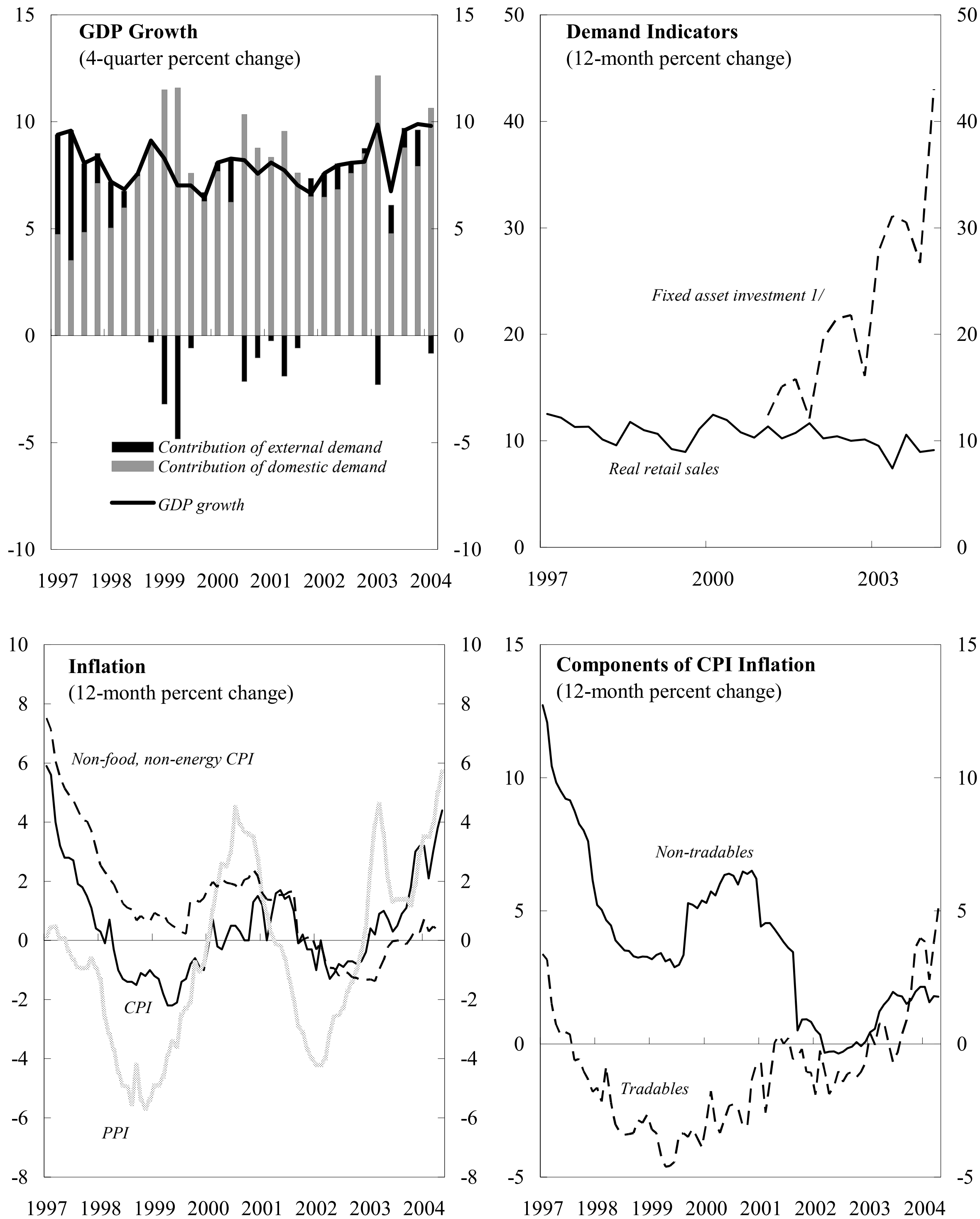
56. **Continued successful implementation of WTO commitments is the key to maintaining market access in industrial countries and sustaining integration with the global economy.** The staff welcomes the authorities' intention to implement remaining commitments as scheduled and China's ongoing support for the completion of the Doha Development Round.

57. **Improvements in the functioning of labor markets will be needed to deal with a rapidly growing labor force.** Even with a high rate of GDP growth, labor market pressures will continue, given projected increases in the working age population and further substantial migration from rural to urban areas. Labor market reforms should include better information on job opportunities, improved education and training, and a strengthened social safety net (including pensions) for both rural and urban workers. Further reforms of the household registration (*hukou*) system to allow freer movement of labor are important for mitigating underemployment in rural areas and reducing income disparities.

58. **The staff welcomes the continued improvement in the quality of economic statistics.** However, inadequate data in several areas still adversely affect the monitoring of macroeconomic developments. The greatest need is the provision of annual and quarterly estimates of real GDP on an expenditure basis. Compilation of fiscal and labor statistics also needs to be brought in line with international standards. As required by the IMF's Articles of Agreement, reporting of data on the international investment position should be done as soon as feasible.

59. It is proposed that the next Article IV consultation with the People's Republic of China take place on the standard 12-month consultation cycle.

Figure 1. China: Growth and Demand Indicators



1/ Prior to January 2004 fixed-asset investment includes investment by state-owned units and others. After January 2004 it refers to state-owned units and others, urban collectives, and urban private-owned enterprises.

Figure 2. China: External Indicators

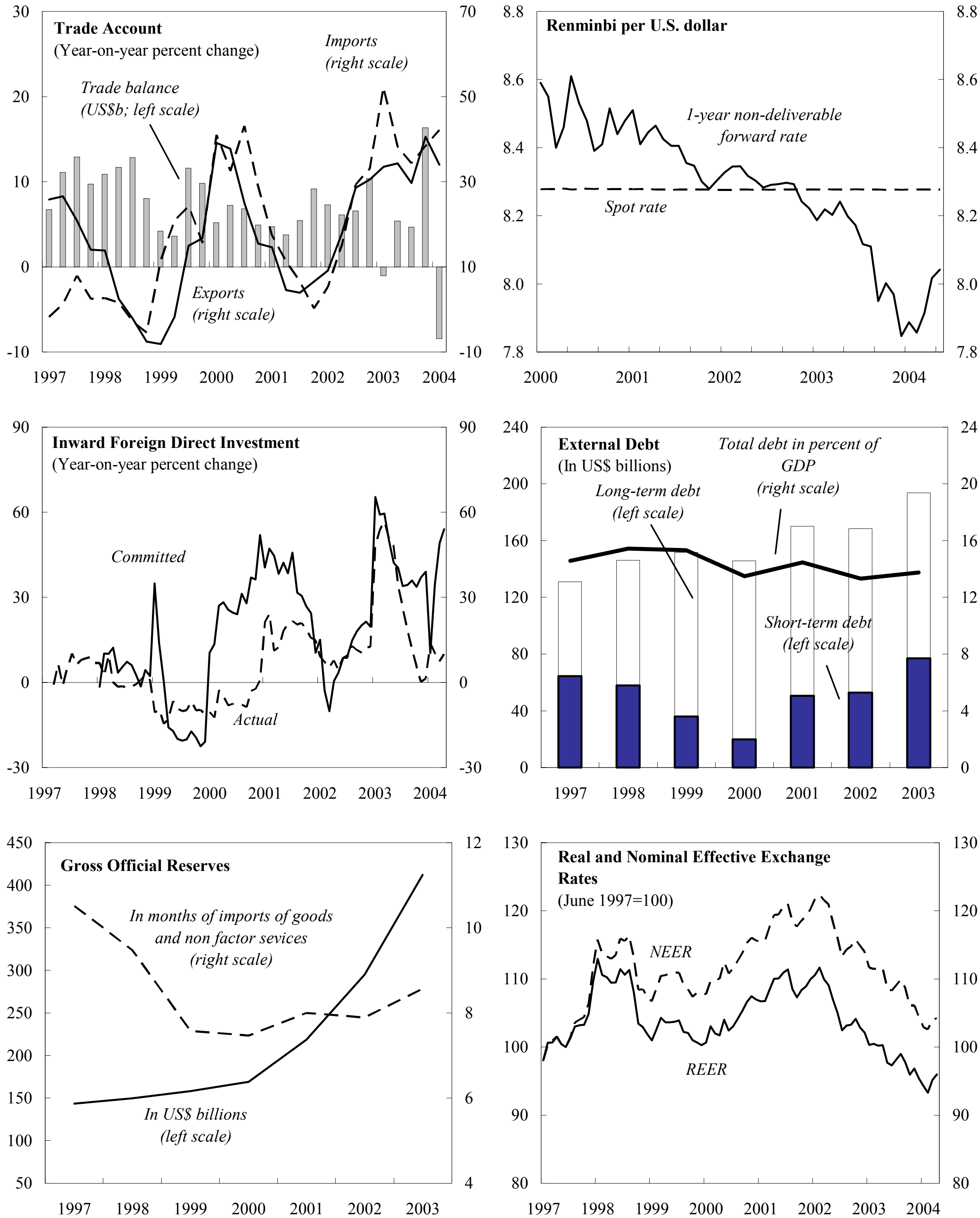
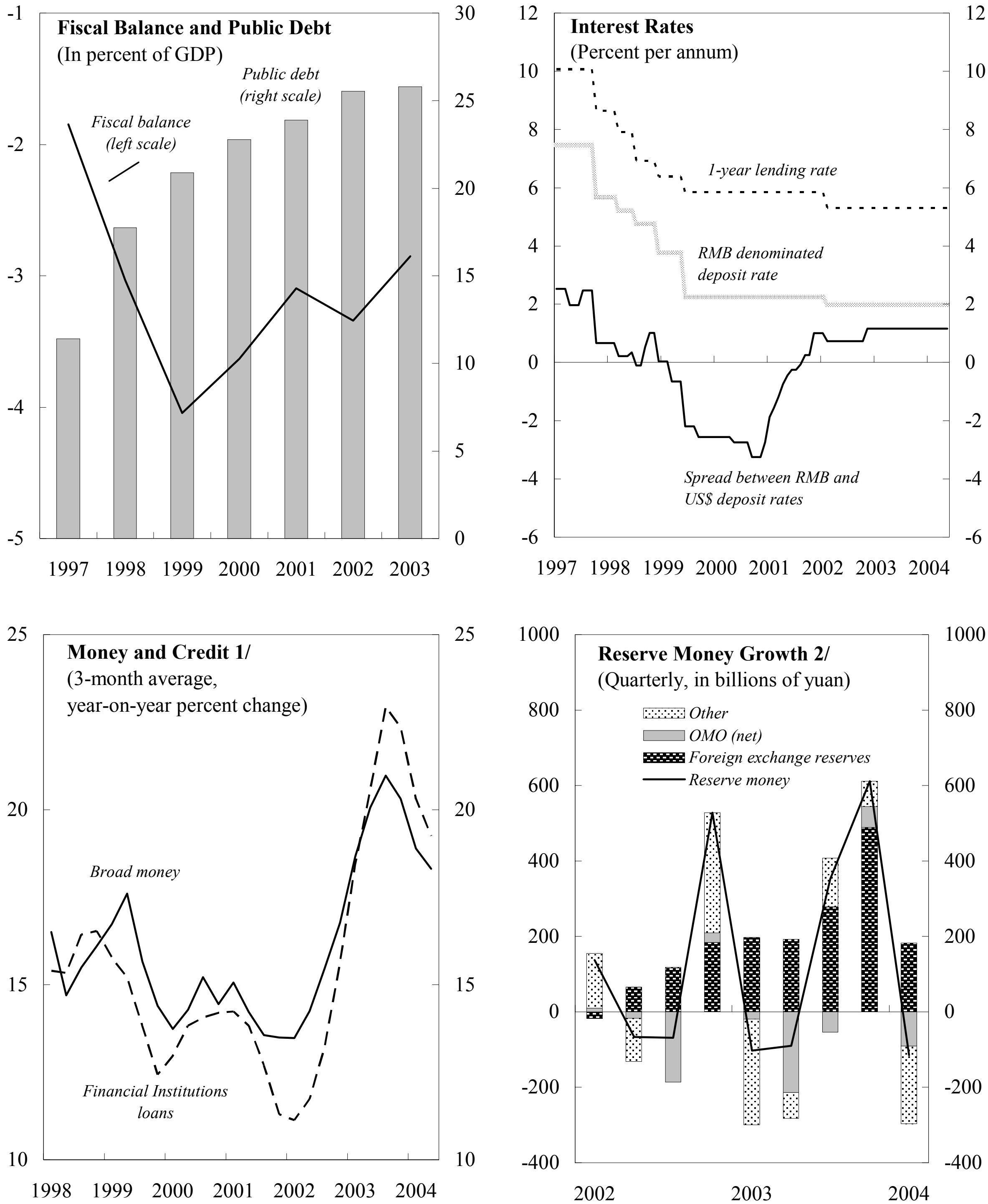


Figure 3. China: Macroeconomic Policies



1/ 2004Q2 covers April and May.
2/ 2004 covers the first two months of the year.

Table 1. China: Summary Indicators

Nominal GDP (2003): US$1,410 billion
Population (2003): 1.292 billion
GDP per capita (2003): US$1,091
Quota: SDR 6,370 million

	1999	2000	2001	2002	2003	2004	2005
					Prel.	Proj.	
			(Change in percent)				
Real GDP (production)	7.1	8.0	7.5	8.3	9.1	9.0	7.5
Real GDP (expenditure) 1/	6.7	7.4	9.1	9.3	11.5	…	…
Real domestic demand	8.1	7.1	7.9	7.9	9.5	8.9	6.7
Consumer prices	-1.4	0.4	0.7	-0.8	1.2	3.5	3.0
			(In percent of GDP)				
Total capital formation	37.4	36.3	38.5	40.3	44.4	45.8	44.7
Of which : Fixed capital formation	35.9	36.5	37.8	40.1	44.4	45.8	44.5
Gross national saving	39.0	38.2	40.0	43.1	47.6	48.3	47.7
External current account	1.6	1.9	1.5	2.8	3.2	2.5	3.0
Overall budget balance, IMF basis 2/	-4.0	-3.6	-3.1	-3.3	-2.8	-2.2	-2.0
Revenue	14.3	15.3	17.0	18.2	18.7	19.0	19.6
Expenditure (including net lending)	18.3	18.9	20.1	21.5	21.6	21.2	21.5
Overall budget balance, authorities definition, in bn RMB	-174	-250	-246	-310	-292	-260	-260
Overall budget balance, authorities definition	-2.1	-2.8	-2.5	-3.0	-2.5	-2.0	-1.8
			(Change in percent; end of period)				
Banking system's net domestic assets 3/	15.0	10.8	16.5	15.3	19.7	…	…
Of which : Domestic credit 3/	15.9	21.2	6.5	17.2	19.6	…	…
Broad money 3/	14.7	17.0	14.4	16.8	19.6	…	…
Reserve money	7.3	8.5	9.2	13.3	17.1	…	…
Interest rate (one-year time deposits, year-end)	2.3	2.3	2.3	2.0	2.0	…	…
			(In billions of U.S. dollars)				
Current account balance	21	21	17	35	46	40	52
Of which : Exports	195	249	266	326	438	543	678
Imports	159	215	232	281	394	512	634
Capital and financial account balance 4/	5	2	35	32	53	110	47
Of which : Direct investment inflows (net)	37	37	37	47	47	48	49
Errors and omissions	-18	-12	-5	8	18	…	…
Change in net international reserves (increase -)	-9	-11	-47	-76	-117	-150	-100
Gross international reserves 5/	158	169	219	295	412	562	662
In months of imports of goods and nonfactor services	7.6	7.5	8.0	7.9	8.6	9.5	9.3
As a percent of short-term external debt 6/	1,043	1,291	432	529	535	611	682
External debt 6/	152	146	170	171	194	216	230
Of which: Short-term debt 6/	15	13	51	56	77	92	97
Debt-service ratio (in percent of exports) 6/	9.1	7.3	7.1	6.5	5.1	4.6	4.1
Exchange rate at end-period (Rmb per US$) 7/	8.3	8.3	8.3	8.3	8.3	…	…
Nominal effective exchange rate 7/	70.8	72.7	76.9	76.1	70.6	…	…
Real effective exchange rate 7/	107.2	108.8	114.1	110.9	102.9	…	…
Memorandum items:							
Nominal GDP (In billions of RMB)	8,207	8,947	9,731	10,517	11,690	13,188	14,602
Exports growth (in percent)	6.1	27.9	6.8	22.4	34.6	24.0	24.8
Imports growth (in percent)	15.8	35.4	8.1	21.3	39.8	30.0	24.0
Real GDP growth of trading partners	3.4	5.5	0.9	2.0	2.8	4.2	3.6

Sources: Data provided by the Chinese authorities; and staff estimates and projections.

1/ IMF staff estimate. For data up to 2002, the implicit deflators from the production GDP was used. For 2003, consumption was deflated with CPI, investment with implicit deflator for fixed investment.

2/ Central and local governments, including all official external borrowing. Figures for 2004 are budget estimates.

3/ Banking survey.

4/ For 2004-05, includes errors and omissions.

5/ Includes gold, SDR holdings, and reserve position in the Fund.

6/ Official data sources. The coverage and classification of official external debt data were modified in 2001. Categories of debt previously not covered are now included.

7/ Annual averages (1990 = 100), using revised weights.

Table 2. China: Balance of Payments
(In billions of U.S. dollars)

	1999	2000	2001	2002	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2003 Prel.
Current Account Balance	21.1	20.5	17.4	35.4	2.6	8.5	8.7	26.0	45.9
Trade balance	36.0	34.5	34.0	44.2	3.1	10.5	9.4	21.7	44.7
Exports	194.7	249.1	266.1	325.7	86.3	104.1	117.2	130.7	438.3
Imports (BOP basis)	158.7	214.7	232.1	281.5	83.2	93.6	107.7	109.0	393.6
Services	-5.3	-5.6	-5.9	-6.8	-3.1	-3.1	-1.8	-0.5	-8.6
Income	-14.5	-14.7	-19.2	-14.9	-1.1	-2.6	-3.6	-0.6	-7.8
Current transfers	4.9	6.3	8.5	13.0	3.8	3.8	4.7	5.4	17.6
Capital and Financial Account Balance	5.2	1.9	34.8	32.3	23.2	21.2	16.1	-7.8	52.7
Capital Account	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	7.7	2.0	34.8	32.3	23.2	21.2	16.1	-7.7	52.8
Net direct investment	37.0	37.5	37.4	46.8	11.2	21.2	9.1	11.2	47.2
Foreign direct investment in China	38.8	38.4	44.2	49.3	12.0	15.8	8.3	11.0	47.1
Direct investment abroad	-1.8	-0.9	-6.9	-2.5	-0.8	0.0	0.7	0.3	0.2
Portfolio investment	-11.2	-4.0	-19.4	-10.3	-4.1	-0.2	1.6	14.1	11.4
Assets	-10.5	-11.3	-20.7	-12.1	-4.4	-5.0	1.4	6.6	3.0
Liabilities	-0.7	7.3	1.2	1.8	0.3	0.3	0.2	7.6	8.4
Other investment	-20.5	-31.5	16.9	-4.1	16.1	5.7	5.5	-33.1	-5.9
Assets 1/	-24.4	-43.9	20.8	-3.1	12.9	5.3	2.3	-38.4	-17.9
Liabilities	3.9	12.3	-3.9	-1.0	3.2	0.4	3.1	5.3	12.0
Trade credit	13.3	18.2	-2.4	2.8	1.8	-0.5	3.9	-0.5	4.7
Loans	-0.5	-2.4	-1.5	-4.1	1.4	0.6	-0.3	4.9	6.6
Long term	0.2	-1.9	-1.2	-4.5	0.8	-1.1	...	...	-5.4
Credit	12.5	8.7	7.1	18.4	5.6	4.9	...	...	17.5
Debit	-12.4	-10.6	-8.3	-22.9	-4.8	-6.0	...	...	-22.9
Short term	-0.7	-0.5	-0.3	0.4	0.6	1.7	...	...	12.0
Credit	2.5	3.5	3.2	33.7	8.8	12.7	...	...	61.4
Debit	-3.2	-4.0	-3.5	-33.3	-8.2	-11.0	...	...	-49.4
currency and deposits	-1.5	-0.1	0.5	0.3	0.3	0.3	-0.1	0.2	0.7
other	-7.3	-3.5	-0.5	0.0	-0.3	0.0	-0.4	0.7	0.0
Errors and Omissions 2/	-17.8	-11.9	-4.9	7.8	4.0	0.7	12.7	1.0	18.4
Overall Balance	8.5	10.5	47.3	75.5	29.8	30.4	37.5	19.3	117.0
Reserve assets	-8.5	-10.5	-47.3	-75.5	-29.8	-30.4	-37.5	-19.3	-117.0
Memo items:									
Current account as percent of GDP	2.1	1.9	1.5	2.8	...	...	...	...	3.2
Export growth (value terms)	6.1	27.9	6.8	22.4	33.6	32.3	31.5	40.1	34.6
Import growth (value terms)	15.8	35.4	8.1	21.3	52.1	38.0	34.8	38.0	39.8
FDI (inward) as a percent of GDP	3.9	3.6	3.8	3.9	...	...	...	...	3.3
Gross reserves (excludes gold valuation)	157.7	168.3	215.6	291.1	321.0	351.4	388.9	408.2	408.2
as a percent of ST debt by remaining maturity	...	...	426	523	...	...	...	...	530
Real effective exchange rate (1990 = 100)	107.2	108.8	114.1	110.9	...	...	...	...	102.9
GDP	991.4	1,080.7	1,175.8	1,270.7	...	...	...	...	1,412.3

Sources: Chinese authorities and IMF staff calculations

1/ 2003 figure includes the counterpart transaction to the US$ 45 billion of foreign exchange reserves used for bank recapitalization.
2/ Includes counterpart transaction to valuation changes.

Table 3. China: External Debt
(In billions of U.S. dollars)

	1998	1999	2000	2001	2002	2003
Debt to Commercial Banks	55.8	53.4	46.2	46.5	44.1	53.7
Foreign banks and financial institutions	26.5	24.4	20.2	33.5	31.7	42.4
Buyer's credit	13.0	13.8	13.2	13.1	12.4	11.3
Debt to Official Creditors	45.4	51.7	51.0	51.3	52.1	51.9
Bilateral official creditors	22.4	26.6	24.6	23.7	24.4	25.4
Multilateral creditors	23.0	25.1	26.3	27.6	27.7	26.5
Bonds Issued Abroad	12.4	12.0	12.3	12.7	10.8	11.2
Debt to other creditors	32.5	34.8	36.3	59.6	64.3	76.9
Of which:						
Loans from other non-bank sources	17.4	20.2	22.8	23.5	23.6	27.5
Trade credit	1.7	2.0	1.6	24.4	26.3	36.6
International financial leasing	13.1	12.3	11.9	10.1	9.2	7.7
Total debt	146.0	151.8	145.7	170.1	171.4	193.6
Of which:						
Short-term debt (original maturity) 1/	17.3	15.2	13.1	43.9	47.9	73.0
Short-term debt (remaining maturity) 1/	…	…	…	50.6	55.7	77.0

Sources: Chinese authorities, Bank for International Settlements, Organisation for Economic Cooperation and Development and Fund Staff estimates.

1/ Significant changes in coverage and classification of official external debt data were made in 2001. Categories of debt previously not covered are now included, especially under short-term debt (e.g., trade credit).

Table 4. China: Indicators of External Vulnerability

	1999	2000	2001	2002	2003	2004	2005
					Est.	Projections	
Monetary and Financial indicators							
Public sector domestic debt (official data; in percent of GDP)	15.5	17.7	19.4	21.2	22.0	21.6	21.5
Broad money (M2: annual percentage change)	14.7	12.3	14.4	16.8	19.6	…	…
Foreign currency deposits to broad money (percent)	7.1	7.7	7.0	6.7	5.6	…	…
Credit to nonstate sectors (annual percentage change)	15.6	18.1	8.5	15.3	21.2	…	…
Foreign currency loans to credit to the economy (in percent)	6.3	4.2	5.2	5.0	5.4	…	…
Stock Exchange Index (end of period, Dec. 19, 1990 = 100) 1/	1,452	2,192	1,713	1,419	1,569	…	…
Stock Exchange capitalization (percent of GDP)	32.4	53.8	44.4	36.5	36.5	…	…
Number of listed companies	484	572	646	715	780	…	…
Balance of payments indicators							
Exports (annual percentage change, U.S. dollars)	6.1	27.9	6.8	22.4	34.6	24.0	24.8
Imports (annual percentage change, U.S. dollars)	15.8	35.4	8.1	21.3	39.8	30.0	24.0
Current account balance (percent of GDP)	2.1	1.9	1.5	2.8	3.3	2.5	3.0
Capital and financial account balance (percent of GDP)	0.5	0.2	3.0	2.6	3.7	5.9	1.9
Of which: Gross foreign direct investment inflows	3.9	3.6	3.8	3.9	3.3	3.3	3.1
Reserve indicators							
Gross reserves (billions of U.S. dollars)	158	169	219	295	412	562	662
Gross reserves to imports of GNFS (months)	7.6	7.5	8.0	7.9	8.6	9.5	9.3
Gross reserves to broad money (M2) (percent)	10.9	10.4	11.8	13.6	…	…	…
Gross reserves to short-term external debt by remaining maturity (percent) 3/	438	852	432	530	535	579.1	648.7
External debt and balance sheet indicators 4/							
Total external debt (percent of GDP)	15.3	13.5	14.5	13.5	13.7	13.5	13.0
Total external debt (billions of U.S. dollars)	151.8	145.7	170.4	171.4	193.6	215.6	229.6
Of which: Public and publicly guaranteed debt 5/	47.3	49.0	49.8	50.5	52.8	58.8	62.6
Banking sector debt	34.4	29.8	30.1	29.1	58.1	64.7	68.9
Short-term external debt by original maturity (billions of U.S. dollars)	15.2	13.1	43.9	47.9	73.0	80.6	85.6
Short-term external debt by remaining maturity (billions of U.S. dollars)	…	…	50.6	55.7	77.0	92.0	97.0
Net foreign assets of banking sector (billions of U.S. dollars)	36.6	70.0	88.6	109.8	…	…	…
Total debt to exports of GNFS (percent)	69.5	52.1	56.9	46.9	39.9	35.8	30.6
Total debt service to exports of GNFS (percent)	9.1	7.3	7.1	6.5	5.1	4.6	4.1
Of which: Interest payments to exports of GNFS (percent)	3.8	2.9	3.2	2.8	2.3	2.0	1.8
Bond spread (benchmark bond, end of period, basis points)	137	162	116	88	83	…	…
Foreign-Currency Sovereign Bond Ratings							
Moody's	A3	A3	A3	A3	A2	…	…
Standard and Poor's	BBB	BBB	BBB	BBB	BBB	…	…
Memorandum items:							
Nominal GDP (US$ billions)	991	1,081	1,176	1,266	1,412	1,593	1,764
Exports of GNFS (US$ billions)	218	280	299	365	485	602	752
Real effective exchange rate (end of period, annual percentage change)	-1.5	6.7	2.8	-7.1	-6.6	…	…

Sources: Chinese authorities and Fund staff estimates and projections

1/ Shanghai Stock Exchange, A share.
2/ The sum of the current account, FDI inflows, and identified non-FDI flows from BIS data less reserve accumulation.
3/ Based on BIS debt data until 2000, and on official data from 2001 on.
4/ Based on official debt data unless otherwise indicated.
5/ Debt of banking sector not included.

Table 5. China: Monetary Developments

	2000	2001	2002	2003				2004
				March	June	Sep.	Dec.	March
				(In billions of yuan)				
Net foreign assets	2,058	2,642	3,175	3,376	3,501	3,690	3,773	4,139
Net domestic assets	11,403	13,288	15,326	16,072	16,989	17,667	18,349	19,015
Domestic credit 1/	13,066	14,002	17,262	18,026	19,067	19,845	20,628	21,239
Net credit to government	588	1,102	1,333	1,198	1,172	1,169	1,318	1,231
Credit to non-government	12,479	12,900	15,929	16,828	17,895	18,676	19,311	20,008
Other items, net 1/	-1,664	-714	-1,936	-1,954	-2,078	-2,178	-2,279	-2,224
Broad money	13,461	15,930	18,501	19,449	20,491	21,357	22,122	23,154
Reserve money	3,649	3,985	4,514	4,411	4,321	4,673	5,284	5,046
Of which:								
Required reserves	720	856	1,006	1,064	1,128	1,172	1,410	1,487
Excess reserves	879	851	907	678	505	623	845	634
Net foreign assets of PBC	1,519	1,935	2,282	2,479	2,671	2,949	3,066	3,346
Net domestic assets of PBC	2,130	2,050	2,232	1,932	1,649	1,724	2,218	1,700
				(Twelve-month percentage change)				
Net foreign assets 2/	3.0	4.3	3.3	4.4	4.3	4.4	3.2	3.9
Net domestic assets	10.8	16.5	15.3	16.9	19.8	19.5	19.7	18.3
Domestic credit 3/ 4/	21.2	6.5	17.2	16.5	19.7	20.7	19.6	18.0
Of which: Loans	13.4	11.6	15.4	19.5	22.9	23.5	21.1	20.1
Other items, net 2/ 3/ 4/	-11.4	7.2	-2.3	-2.5	-3.2	-4.2	-3.1	-2.7
Broad money 5/	17.0	14.4	16.8	18.5	20.8	20.7	19.6	19.1
Including foreign currency deposits	13.1	17.4	15.7	17.7	19.7	19.5	18.2	17.8
M1 5/	16.0	12.7	16.8	20.1	20.2	18.5	18.7	20.1
M0 5/	8.9	7.1	10.1	10.1	12.3	12.8	14.3	12.8
Quasi money	10.0	15.5	16.8	17.6	21.2	22.0	20.1	18.5
Reserve money	8.5	9.2	13.3	7.0	6.5	17.2	17.1	14.4
Net foreign assets of PBC 6/	2.2	11.4	8.7	13.6	17.0	21.4	17.4	19.7
Net domestic assets of PBC 6/	6.4	-2.2	4.6	-6.6	-10.4	-4.1	-0.3	-5.3
Reserve ratios: 7/								
Required reserves	6.0	6.0	6.0	6.0	6.0	6.0	7.0	7.0
Excess reserves	7.3	6.0	5.4	4.2	3.0	3.1	4.6	4.6
Memorandum items:								
Money multiplier	3.7	4.0	4.1	4.4	4.7	4.6	4.2	4.6
Forex deposits of residents (US$ billion)	128.3	134.9	150.7	148.8	151.1	148.1	148.7	146.8
In percent of total deposits	8.1	7.3	6.9	6.5	6.2	5.9	5.8	5.4
Forex loans of residents (US$ billion)	61.2	80.7	102.8	107.9	117.3	126.4	130.2	140.2

Sources: The People's Bank of China; and staff calculations.

1/ Starting 2002, includes foreign currency operations of domestic financial institutions and domestic operations of foreign banks.
In addition, some items were moved from Other Items Net to Net Credit to Government.
2/ Twelve-month change as a percent of beginning-period stock of monetary liabilities.
3/ 2002 growth rates are based on data that exclude the revisions made in 2002 (see footnote 1).
4/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.
5/ The growth rates are based on official announcements, which correct for the definitional changes in the series.
6/ Twelve-month change as a percent of beginning-period reserve money stock.
7/ In percent of total bank deposits. 2003-04 excess reserve figures are averages provided by the authorities.

Table 6. China: State Budgetary Operations 1/

	2000	2001	2002	2003		2004	
				Budget	Prel.	Budget	Proj.
	(In billions of yuan)						
Total revenue	1,366	1,657	1,916	2,076	2,194	2,380	2,501
Tax revenue 2/	1,257	1,529	1,763	1,908	2,000	2,169	2,290
Taxes on income and profits	262	391	472	479	476	519	544
Taxes on goods and services	847	977	1,112	1,226	1,298	1,401	1,491
Other taxes	149	162	180	204	226	249	255
Nontax revenue	109	127	154	168	194	211	211
Total expenditure	1,691	1,958	2,272	2,435	2,527	2,730	2,792
Current expenditure, *of which:*	1,316	1,564	1,820	1,985	2,035	2,267	2,358
Administration and defense	396	481	576	612	655	714	757
Culture, education, public health, and science	286	350	415	456	471	520	544
Pensions and social welfare relief	153	204	272	245	266	295	306
Subsidies	133	104	90	88	84	96	98
Interest	73	79	68	97	96	76	112
Capital expenditure	300	351	411	411	452	433	403
Unrecorded expenditures 3/	75	43	40	39	39	31	31
Overall balance	-325	-301	-355	-359	-333	-351	-291
Financing	325	301	355	359	333	351	291
Domestic (net, residual)	311	294	349	354	328	346	287
Foreign (net)	14	7	6	5	5	5	4
	(In percent of GDP)						
Total revenue	15.3	17.0	18.2	18.3	18.8	18.4	19.0
Tax revenue 2/	14.1	15.7	16.8	16.8	17.1	16.8	17.4
Taxes on income and profits	2.9	4.0	4.5	4.2	4.1	4.0	4.1
Taxes on goods and services	9.5	10.0	10.6	10.8	11.1	10.8	11.3
Other taxes	1.7	1.7	1.7	1.8	1.9	1.9	1.9
Nontax revenue	1.2	1.3	1.5	1.5	1.7	1.6	1.6
Total expenditure	18.9	20.1	21.6	21.4	21.6	21.1	21.2
Current expenditure, *of which:*	14.7	16.1	17.3	17.5	17.4	17.5	17.9
Administration and defense	4.4	4.9	5.5	5.4	5.6	5.5	5.7
Culture, education, public health, and science	3.2	3.6	3.9	4.0	4.0	4.0	4.1
Pensions and social welfare relief	1.7	2.1	2.6	2.2	2.3	2.3	2.3
Subsidies	1.5	1.1	0.9	0.8	0.7	0.7	0.7
Interest	0.8	0.8	0.6	0.9	0.8	0.6	0.8
Capital expenditure	3.3	3.6	3.9	3.6	3.9	3.3	3.1
Unrecorded expenditures 3/	0.8	0.4	0.4	0.3	0.3	0.2	0.2
Overall balance	-3.6	-3.1	-3.4	-3.2	-2.8	-2.7	-2.2
Financing	3.6	3.1	3.4	3.2	2.8	2.7	2.2
Domestic (net, residual)	3.5	3.0	3.3	3.1	2.8	2.7	2.2
Foreign (net)	0.2	0.1	0.1	0.0	0.0	0.0	0.0
Memorandum items:							
VAT refunds to exporters (in billions of yuan)	-105	-108	-115	-115	-199	-221	-221
Primary balance	-2.8	-2.3	-2.7	-2.3	-2.0	-2.1	-1.4
Government debt	22.2	23.6	25.1	26.4	25.6	25.8	24.9
Domestic	17.7	19.4	21.2	22.6	22.0	22.5	21.6
External	4.5	4.2	4.0	3.7	3.7	3.3	3.2
Budget balance (authorities' definition)	-2.8	-2.5	-3.0	-2.8	-2.5	-2.5	-2.0
Nominal GDP (in billions of yuan)	8,947	9,731	10,517	11,355	11,690	12,946	13,188

Sources: Ministry of Finance; People's Bank of China; National Bureau of Statistics; and staff estimates.

1/ The coverage is central government, provinces, municipalities, and counties.
2/ Tax revenues are net of refunds for VAT and business taxes paid on inputs. As of end-2003, refunds amounting to roughly RMB 250 billion had been claimed but not paid. The IMF definition is not adjusted for tax refund and wage arrears in the absence of adequate data.
3/ Includes external borrowing excluded from the budget and unbudgeted "fiscal stimulus" spending (see Table 7).

Table 7. China: Official and IMF Budget Definitions

	1999	2000	2001	2002	2003 Budget	2003 Prel.	2004 Budget	2004 Proj.
	(In billions of yuan)							
Revenue (official definition) 1/	1,144	1,338	1,639	1,890	2,050	2,172	2,357	2,478
Plus :								
Subsidies to loss-making SOEs 2/	29	28	30	26	26	23	23	23
Minus :								
Privatization proceeds	0	0	12	0	0	0	0	0
Revenue (IMF definition)	1,173	1,366	1,657	1,916	2,076	2,194	2,380	2,501
Expenditure (official definition)	1,319	1,588	1,884	2,205	2,370	2,465	2,677	2,738
Plus:								
Subsidies to loss-making SOEs 2/	29	28	30	26	26	23	23	23
External borrowing excluded from the budget 3/	52	13	3	15	14	14	16	16
Unrecorded fiscal stimulus spending 3/ (onlending to local governments)	46	62	40	25	25	25	15	15
Expenditure (IMF definition)	1,505	1,691	1,958	2,272	2,435	2,527	2,730	2,792
Balance (official definition)	-174	-250	-246	-315	-320	-293	-320	-260
Balance (IMF definition)	-332	-325	-301	-355	-359	-333	-351	-291
	(In percent of GDP)							
Revenue (official definition)	13.9	15.0	16.8	18.0	18.1	18.6	18.2	18.8
Revenue (IMF definition)	14.3	15.3	17.0	18.2	18.3	18.8	18.4	19.0
Expenditure (official definition)	16.1	17.7	19.4	21.0	20.9	21.1	20.7	20.8
Expenditure (IMF definition)	18.3	18.9	20.1	21.6	21.4	21.6	21.1	21.2
Balance (official definition)	-2.1	-2.8	-2.5	-3.0	-2.8	-2.5	-2.5	-2.0
Balance (IMF definition)	-4.0	-3.6	-3.1	-3.4	-3.2	-2.8	-2.7	-2.2
Memorandum item:								
Nominal GDP (in billions of yuan)	8,207	8,947	9,731	10,517	11,355	11,690	12,946	13,188

Sources: Ministry of Finance; and staff calculations.

1/ Tax revenues are net of refunds for VAT and business taxes paid on inputs. As of end-2003, refunds amounting to roughly RMB 300 billion had been claimed but not paid. The IMF definition is not adjusted for tax refund and wage arrears in the absence of adequate data.
2/ Assumption for 2004 budget.
3/ Assumptions for 2003 preliminary and 2004 budget.

Table 8. China: Medium-Term Scenario

	2000	2001	2002	2003 Est.	2004	2005	2006	2007	2008	2009
					Projections					
					(Percent change)					
Real GDP	8.0	7.5	8.3	9.1	9.0	7.5	7.5	7.5	7.5	7.5
Real domestic demand	7.1	7.9	7.9	9.5	8.9	6.7	7.4	7.6	7.2	7.0
Consumer prices (average)	0.4	0.7	-0.8	1.2	3.5	3.0	2.5	2.5	2.5	2.5
					(In percent of GDP)					
Total capital formation	36.3	38.5	40.3	44.4	45.8	44.7	44.5	44.2	43.9	43.4
Of which: fixed capital formation	36.5	37.8	40.1	44.4	45.8	44.5	44.3	44.1	43.9	43.0
Gross national saving	38.2	40.0	43.1	47.6	48.3	47.7	47.1	46.7	46.4	45.9
Fiscal balance	-3.6	-3.1	-3.3	-2.8	-2.2	-2.0	-1.8	-1.6	-1.5	-1.4
Revenue	15.3	17.0	18.2	18.7	19.0	19.6	19.9	20.3	20.6	20.8
Expenditure	18.9	20.1	21.5	21.6	21.2	21.5	21.7	21.9	22.1	22.2
Current account balance	1.9	1.5	2.8	3.2	2.5	3.0	2.6	2.5	2.5	2.5
					(In billions of U.S. dollars)					
Current account balance	21	17	35	46	40	52	51	54	59	66
Trade balance	34	34	44	45	32	44	42	41	42	48
Exports	249	266	326	438	543	678	803	932	1072	1228
(Percent change)	27.9	6.8	22.4	34.6	24.0	24.8	18.5	16.0	15.0	14.6
Imports	215	232	281	394	512	634	761	891	1030	1180
(Percent change)	35.4	8.1	21.3	39.8	30.0	24.0	20.0	17.0	15.5	14.6
Net services and transfers (incl. inv. inc.)	-14	-17	-9	1	8	9	9	13	17	18
Of which: net investment income	-15	-19	-15	-8	-5	-5	-2	1	2	3
Capital and financial account, net 1/	2	35	32	53	110	47	24	21	16	14
Direct investment, net	37	37	47	47	48	49	42	42	42	42
Portfolio investment, net	-4	-19	-10	11	1	-9	-9	-8	-8	-10
Other investment, net	-32	17	-4	-6	61	7	-10	-13	-19	-19
Errors and omissions	-12	-5	8	18	…	…	…	…	…	…
Change in reserves (- indicates increase)	-11	-47	-76	-117	-150	-100	-75	-75	-75	-80
Memorandum items:										
International reserves	169	219	295	412	562	662	737	812	887	967
(Months of imports of goods and nfs)	(7.5)	(8.0)	(7.9)	(8.6)	(9.5)	(9.3)	(8.9)	(8.5)	(8.0)	(8.0)
External debt (official definition) 2/	146	170	171	194	216	230	245	261	279	297
(Percent of GDP)	(13.5)	(14.5)	(13.5)	(13.7)	(13.5)	(13.0)	(12.6)	(12.2)	(11.8)	(11.4)
Debt-service ratio (official definition)	7.3	7.1	6.5	5.1	4.6	4.1	3.7	3.4	3.1	2.9
Nominal GDP (In billions of RMB)	8,947	9,731	10,517	11,690	13,188	14,602	16,090	17,729	19,535	21,525

Sources: Data provided by the Chinese authorities; and staff estimates and projections.

1/ Exludes errors and omissions up until 2003, included erros and omissions from 2004 onwards.
2/ The coverage and classification of official external debt data were modified in 2001. Categories of debt previously not covered have since been included.

China—Fund Relations
As of May 31, 2004

I. Membership Status: Joined 12/27/45; Article VIII (December 1, 1996)

II. General Resources Account:

	SDR Million	% Quota
Quota	6,369.20	100.00
Fund holdings of currency	4013.67	63.02
Reserve position in Fund	2,355.57	36.98

III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	236.80	100.00
Holdings	757.41	319.85

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	11/12/86	11/11/87	597.73	597.73

VI. Projected Obligations to Fund: None

VII. Exchange Arrangements:

1. On January 1, 1994 the Chinese authorities introduced a market-based, unified and managed floating exchange rate system. Under the new system, certain banks are designated to sell and purchase foreign exchange. On December 1, 1996, the renminbi became convertible for current account transactions. In the interbank market, the PBC has limited daily movements against major currencies. For example, the PBC has limited movements of the renminbi against the U.S. dollar to +/-0.3 percent around a reference rate announced daily. On May 31, 2004 the exchange rate was Y 8.28 per U.S. dollar.

2. China accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement on December 1, 1996. There are repatriation and surrender requirements on proceeds from exports and from invisible transactions and current transfers. With effect from May 1, 2004, enterprises authorized to conduct current account transactions may retain foreign exchange equivalent to 30 or 50 percent of their current account foreign exchange earnings in the previous year (depending on the ratio of foreign exchange expenditures to the previous year's foreign exchange earnings), except for special purpose transactions, such as donations and international postal remittances, for which the ceiling is 100 percent. They must sell the rest of their foreign exchange earnings to authorized banks. Importers must provide valid proof and commercial bills to obtain foreign exchange. In 1998, new requirements expanded the scope of documentation required for most forms of current transactions and required prior verification of the underlying transactions in some instances (e.g., the customs service must certify the value of imports before banks can provide foreign exchange for payment). There are no measures currently in force that have been determined to be exchange restrictions subject to Fund jurisdiction.

3. Exchange controls continue to apply to most capital transactions. In general, capital account transactions require the approval of the SAFE, however there has been some relaxation of controls in recent years. Effective December 1, 2002, qualified foreign institutional investors (QFIIs) are allowed to invest domestically in A shares, subject to the following restrictions: (i) QFIIs must have minimum experience in the industry (5 years for fund managers; 30 years for insurance companies) and at least $10 billion in assets under management in the latest financial year, and be cleared of any major irregularities in their home market over the past three years; (ii) a QFII that is a bank must be among the top 100 international banks by assets in the latest financial year; (iii) a QFII that is an insurance or a securities company must have a minimum paid-up capital of $1 billion; and (iv) for each QFII, ownership of any Chinese company listed on the Shanghai or Shenzhen stock exchange is limited to 10 percent, and the total shares owned by QFIIs in a single Chinese company cannot exceed 20 percent. QFIIs must set up a special renminbi account with domestic banks and use the services of domestic securities companies. Close-ended QFIIs can only remit capital after three years, in installments of no more than 20 percent of the total each time, and at intervals of one month or more. Other QFIIs can only remit capital after one year, in installments of no more than 20 percent of the total, and at intervals of three months or more. Regarding investment abroad, the National Council of the Social Security Fund has been approved to invest in overseas markets; no transactions have yet taken place. In addition, as of November 22 and December 5, 1991, respectively, nonresidents are allowed to purchase B shares denominated in U.S. dollars and B shares denominated in Hong Kong dollars. Effective from February 19, 2001, residents are allowed to purchase B shares denominated in both currencies, using their foreign currencies deposited with the commercial banks before that date. And effective from June 1, 2001, residents are allowed to buy B shares using the foreign currencies deposited after the date (i.e. February 19, 2001). Nonresidents are not permitted to issue capital or money market securities in the domestic market. Purchases of

capital and money market instruments abroad by residents are restricted to a few financial institutions and listed enterprises, as are foreign stock and bond issues which also require prior approval. In 2001, measures were introduced to ease restrictions on the purchase of foreign exchange with RMB for the advance repayment of foreign debts, foreign exchange on-lending and domestic foreign exchange loans. Prior approval from the SAFE is needed for licensed commercial banks to convert foreign exchange into yuan for capital investment purposes, except in some provinces where it was eliminated under a 2001 pilot program. Also, since December 2001, FFEs no longer need SAFE approval to convert foreign currency into yuan and commercial banks are now responsible for verifying the related documents.

4. An annual foreign borrowing plan sets mandatory ceilings for all medium- and long-term borrowing by government departments and enterprises (except FFEs which are subject to individual limits negotiated in the investment approval process). The State Development and Reform Commission determines the ceilings, while the SAFE is responsible for the approval of each issue and management of external borrowing (pre-approval investigation covers the financial situation of the enterprise, the need for the loan, and whether the terms of the loan are consistent with the use of the proceeds). For short-term borrowing by financial institutions (less than a year), the amount of borrowing is subject to an overall limit determined by the SAFE on an annual basis (there are also enterprise-specific limits); financial institutions can conduct business within this limit without explicit approval, but must register the borrowing with the SAFE.

5. Regulations on guarantees by residents to nonresidents have the following key features. First, guarantees consist of collateral and pledges in addition to what are commonly known as guarantees. Second, prior SAFE approval is required for financing guarantees provided by banks and all guarantees provided by other institutions (with the exception of FFEs). Prior approval is not required for nonfinancing guarantees. Third, both domestic and foreign-currency-denominated guarantees are covered by the regulations. Fourth, the approval process for guarantees is based on prospective guarantors' profits, assets to liabilities, and asset-quality-ratio requirements.

6. China maintains controls on FDI, although it has generally pursued an "open door" policy toward inward FDI. In the case of outward FDI, foreign exchange can be remitted abroad after a SAFE review of sources of foreign exchange funds, the approval by the agencies in charge of investment abroad, and registration with SAFE. From October 2001, on a pilot basis, some provinces and municipalities were authorized quotas of \$5 million to \$200 million for overseas investment. In July 2004, the pilot was expanded to 21 provinces and municipalities, with overseas investment quotas totaling to \$2.33 billion. In the case of inward direct investment, nonresidents can invest in China subject to meeting certain regulations and MOC approval. On April 1, 2002, a new four-tier classification system for foreign investment was introduced, defining activities where foreign investment is encouraged, permitted, restricted or banned. In effect, this resulted in the opening up of many industries previously closed to foreign investment, particularly in the services sectors, consistent with China's WTO-related commitments.

7. Domestic financial institutions and firms cannot engage in such derivative transactions for purposes of speculation. However, transactions designed to hedge interest rate or exchange rate risk are possible. All transactions involving derivative instruments under foreign debt items must be registered with SAFE, except those undertaken by FFEs. With respect to the development of a forward foreign exchange market for the renminbi, a few banks have been permitted to offer forward transactions involving the renminbi, but the market remains small and proof of an underlying current transaction is required for access to forward cover. In 2001, some domestic enterprises were approved to hedge their risks in the international futures market. From 2003, eligible forward transactions have been expanded from current account transactions to also include foreign debt with maturity up to one year (compared with four months previously).

VIII. Article IV Consultation:

8. The 2003 Article IV consultation was concluded on October 31, 2003 (SUR/03/116 rev. 1, staff report SM/03/316). China is on the standard 12–month consultation cycle.

IX. Technical Assistance:

9. Technical assistance provided in 2000 through March 2004 is summarized in Annex III.

X. Other Visits:

10. The Managing Director, Mr. de Rato, visited China in June 2004, and the Deputy Managing Director, Mr. Kato, in May 2004. A mid-term staff visit was held in December 2003. Former Managing Director, Mr. Köhler, visited China in September 2003.

XI. Resident Representative:

12. The resident representative office in Beijing was opened in October 1991.
Mr. Ray Brooks is the Senior Resident Representative and Mr. Steve Barnett is the Resident Representative.

CHINA—DEBT SUSTAINABILITY ANALYSIS

1. An analysis of the sustainability of China's government debt based on the standard Fund framework does not suggest major difficulties over the next few years; however, over the longer term, large quasi-fiscal liabilities and rising expenditure pressures are key sources of potential fiscal vulnerability. The standard Fund framework cannot be easily extended to longer horizons because data limitations preclude precise estimates of quasi-fiscal liabilities, and there are considerable uncertainties in trying to gauge the magnitude of potential expenditure pressures over the longer term.[1]

2. **China's official government debt is low, but would be significantly larger if quasi-fiscal liabilities were included**. Official data show that the stock of explicit government debt stood at 26 percent of GDP at end-2003.[2] Contingent liabilities include nonperforming loans (NPLs) in the banking system, unfunded pension obligations, and external borrowings by state-owned enterprises (SOEs) and semi-governmental finance companies. Owing to lack of data, this debt sustainability analysis only includes estimated losses from reported NPLs and the minimum transition costs of shifting to a viable pension system.[3] However, potential data weaknesses and inevitable problems in implementing new prudential regimes suggest that the scale of problem loans may be higher. Transition costs of the pension reform could also be substantially higher, depending on the magnitude of changes to the pension parameters. Liabilities, direct and contingent, of local governments are not included, as no information is available. On the other hand, China could potentially use its substantial stock of state assets to finance government debt obligations. Moreover, potential pressures on spending are expected to intensify over time, and the bulk of their impact on the fiscal position would fall outside of the medium-term horizon that this debt sustainability analysis is based on.

3. **The debt sustainability analysis is based on the staff's macroeconomic projections and on the authorities' medium-term fiscal framework**. Key assumptions include:

- GDP growth is projected to average 7½ percent a year.

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[1] For an assessment of longer-term fiscal sustainability issues, see *China: Selected Issues* (SM/03/317).

[2] This includes regular issues of bonds to finance the central government's budget deficits, as well as the bonds issued to recapitalize the four state-owned commercial banks in 1998 and bonds used for on-lending to local governments.

[3] According to the authorities' data, NPLs amounted to 38 percent of GDP at end-2003, with a recovery rate of about 21 percent. Unfunded pension liabilities are assumed to be 7 percent of GDP.

- The nominal value of the deficit will be held constant at its projected 2004 level, implying a decline in the primary deficit of about ¼ percent of GDP a year.

- The average domestic real interest rate increases gradually to 3 percent within five years, reflecting gradual liberalization of the financial sector.[4]

4. **Under these assumptions, the debt-to-GDP ratio would decline from 61 percent of GDP in 2004 to 58 percent in 2009** (Table II.1). The sensitivity analysis suggests that fiscal sustainability may not be a major concern over the next few years, provided that structural reforms continue to be implemented. To take into account the uncertainties about the future macroeconomic conditions, spending needs, and the actual level of contingent liabilities, the effects of a higher real interest rate, lower growth, wider primary deficit, and a higher stock of contingent liabilities were simulated. Isolated or combined temporary adverse shocks on these key variables would only increase the debt-to-GDP ratio in the short run.

- *Individual temporary shocks*. A temporarily lower GDP growth rate would increase the debt-to-GDP ratio to about 63 percent in 2006, and a higher real interest rate would increase the ratio to 67 percent, but these ratios would then decline as in the baseline scenario.[5]

- *Combined temporary shocks*. Should GDP growth be slower, the real interest rate higher, and public spending more expansionary all at the same time (but by only one standard deviation), the debt-to-GDP ratio would increase to about 67 percent in 2006 and then decline.

- *Higher initial public debt stock*. If debt-creating flows were to be 10 percentage points of GDP higher in 2005, the debt-to-GDP ratio would reach 70 percent in 2005, but would fall to about 66 percent of GDP by 2009.

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[4] Given the existing interest rates and maturity structure of public debt, the projected return of modest inflation produces a decline in the aggregate effective real interest rate during the projection period.

[5] The standard deviations and means for all variables have been calculated on the basis of the last 10 years.

Table II.1. China: Public Sector Debt Sustainability Framework
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	Actual					Projections					
						I. Baseline Projections					
Public sector debt and contingent debt 1/	...	...	...	...	**62.2**	**60.8**	**59.9**	**59.9**	**59.4**	**58.6**	**57.7**
Contingent debt	...	...	...	...	**36.6**	**35.9**	**35.4**	**35.9**	**35.9**	**35.9**	**35.7**
1 **Public sector debt**	20.3	22.2	23.6	25.1	25.6	**24.9**	**24.5**	**24.0**	**23.4**	**22.8**	**22.0**
o/w foreign-currency denominated	4.8	4.5	4.2	4.0	3.6	3.2	3.0	2.7	2.5	2.3	2.1
2 Change in public sector debt	3.2	1.9	1.4	1.5	0.4	-0.7	-0.4	-0.5	-0.6	-0.7	-0.8
3 Identified debt-creating flows (4+7+12)	3.3	2.0	1.4	1.6	0.3	-0.7	-0.4	-0.5	-0.6	-0.7	-0.8
4 Primary deficit	3.3	2.8	2.3	2.7	2.0	1.6	1.1	0.9	0.8	0.6	0.5
5 Revenue and grants	14.3	15.3	17.0	18.2	18.7	19.0	19.6	19.9	20.3	20.6	20.8
6 Primary (noninterest) expenditure	17.6	18.1	19.4	20.9	20.8	20.6	20.7	20.9	21.0	21.2	21.3
7 Automatic debt dynamics 2/	0.0	-0.9	-1.0	-1.0	-1.7	-2.3	-1.5	-1.4	-1.3	-1.3	-1.2
8 Contribution from interest rate/growth differential 3/	0.0	-0.9	-1.0	-1.0	-1.7	-2.3	-1.5	-1.4	-1.3	-1.3	-1.2
9 Of which contribution from real interest rate	1.1	0.6	0.6	0.7	0.3	-0.3	0.1	0.3	0.3	0.3	0.3
10 Of which contribution from real GDP growth	-1.2	-1.5	-1.5	-1.8	-2.1	-2.0	-1.7	-1.7	-1.6	-1.6	-1.5
11 Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3) 5/	-0.1	0.0	0.1	-0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	141.8	145.5	139.0	137.9	136.4	131.2	124.9	120.4	115.5	110.3	105.6
Gross financing need 6/	5.6	5.4	5.2	5.9	5.5	4.8	4.6	4.4	4.2	3.9	3.7
In billions of U.S. dollars	55.1	58.4	61.4	74.4	77.1	76.9	81.0	85.0	89.1	93.2	97.2
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	7.1	8.0	7.5	8.0	9.1	9.0	7.5	7.5	7.5	7.5	7.5
Average nominal interest rate on public debt (in percent) 7/	4.4	4.4	4.0	3.0	3.6	2.5	3.8	3.9	4.0	4.2	4.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	6.7	3.4	2.8	3.3	1.6	-1.0	0.8	1.4	1.5	1.7	1.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-2.2	0.9	1.2	-0.3	2.1	3.5	3.0	2.5	2.5	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	24.7	10.9	15.1	17.0	8.2	8.1	8.1	8.3	8.4	8.5	7.8
Primary deficit	3.3	2.8	2.3	2.7	2.0	1.6	1.1	0.9	0.8	0.6	0.5
						II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 8/						**60.8**	**60.2**	**60.5**	**60.3**	**60.1**	**59.8**
A2. No policy change (constant primary balance) in 2005-09						**60.8**	**60.4**	**61.1**	**61.3**	**61.5**	**61.6**
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 9/						**60.8**	**60.8**	**60.9**	**60.3**	**59.5**	**58.6**
B. Bound Tests											
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006						**60.8**	**63.4**	**67.0**	**66.0**	**64.9**	**63.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						**60.8**	**61.3**	**63.2**	**63.3**	**63.2**	**62.9**
B3. Primary balance is at historical average minus two standard deviations (1.6 percent of GDP) in 2005 and 2006						**60.8**	**62.4**	**64.9**	**64.1**	**63.1**	**62.0**
B4. Combination of 2-4 using one standard deviation shocks						**60.8**	**63.5**	**67.3**	**66.3**	**65.2**	**64.0**
B5. One time 30 percent real depreciation in 2005 10/						**60.8**	**61.4**	**61.3**	**60.7**	**59.9**	**58.9**
B6. 10 percent of GDP increase in other debt-creating flows in 2005						**60.8**	**69.9**	**69.4**	**68.3**	**67.0**	**65.7**

1/ It is assumed that the government will make a decision in 2005 to bring contingent liabilities related to nonperforming loans onto explicit public debt in 2006, from which point these debt will accrue interest The coverage is central government; unfunded pension liabilities are also included. Contingent liabilities of local governments, which are not known, are excluded.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ The implied change in other key variables under this scenario is discussed in the text.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

CHINA'S FISCAL REFORMS AND TECHNICAL ASSISTANCE

1. In recent years technical assistance has focused on statistical development, banking supervision, economic training, and a comprehensive fiscal program. The attached table lists recent technical assistance missions to China. This annex highlights the main staff recommendations in the fiscal area, and summarizes recent fiscal reforms.

Fiscal Technical Assistance Program

2. FAD provides advice in the areas of budget management, tax policy, tax administration, and intergovernmental fiscal relations in the context of a US$2.6 million project in coordination with UNDP and UK DFID. The current project covers 2000-2004, and discussions are underway on a successor project that would continue to support priority fiscal reforms.

Tax policy

3. The scope of the Fund TA work in this area has been quite comprehensive, covering every major tax: the value-added tax (VAT), the business tax, the enterprise income tax (EIT), and the personal income tax (PIT). Some of the TA has also targeted the tax treatment of specific sectors, including the financial sector and small businesses.

4. The VAT is currently the most important tax in China from a revenue standpoint. However, it has two unique features: (1) it is a production-type VAT, i.e., credits are not given for the VAT on capital goods; and (2) it excludes most services, which are taxed under a separate business tax. The focus of the Fund's TA advice on the VAT has been on transforming it into a consumption-type VAT, and bringing the service sector into the VAT net. As there are important revenue and central-province intergovernmental implications of the VAT reform, the Fund has paid particular attention to alternative transition strategies.

5. With respect to income tax, the Fund's TA advice has focused on improving the structure of the enterprise income tax (EIT), including the unification of the regimes applying separately to domestic and foreign enterprises, and rationalizing and reducing the scope of EIT incentives. Steps are underway for EIT unification, to be implemented in 2005. For the personal income tax (PIT), while the present revenue yield is still relatively insignificant, it is important for its distributive implications and revenue consequences over time. Its structure should be streamlined and its rates simplified. The PIT should also be made more progressive at the low ranges of the income scale.

6. The liberalization of the financial sector under the WTO commitments will have important tax implications, in particular as the financial sector opens up to foreign competition. The Fund's TA advice in this area has covered topics of taxing banks, insurance companies, investment and pension funds, derivatives, and security transactions, allowing tax deductibility of specific loan provisions, and shifting business tax from a gross interest base to a net interest base.

7. The authorities also intend to streamline and reduce the tax burden on farmers. In this regard, the 2004 budget announced the reduction of the agricultural tax by 1 percentage point each year starting this year, the elimination of special excise taxes except for tobacco, and the continuation of the nationwide extension of the pilot on the fee-to-tax reform.

Tax administration

8. The authorities have been putting in place the basic building blocks of a modern national tax administration. In this regard, the Fund TA program has aimed at assisting the State Administration of Taxation (SAT) to develop the strategic capacity required for it to manage a national tax system, with assistance provided to both the central and provincial governments. Information technology (IT) development has been satisfactorily completed and risk management techniques have been introduced to SAT and to its provincial level managers.

9. The operational effectiveness of the national tax administration still needs to be improved, for instance, by developing a nationally consistent organizational structure, improving compliance management, and developing self-assessment practices.

Public expenditure management

10. In order to improve the efficiency of public spending, a number of budget and treasury reforms are being implemented. In the budget area, the budget coverage is being expanded to include extra-budgetary revenue and spending, the budget preparation cycle has been brought forward and extended, and departmental budgets are being implemented. On the treasury reform side, a treasury single account (TSA) has been established at the central level and is being rolled out to the provincial level.[1]

11. The authorities have recently announced their intention to reform the Budget Law, in line with recent Fund TA. Areas to be improved include the clarification of the roles and rights of the legislative and executive in the budget process; restriction on the use of extrabudgetary funds; improvements in the sequencing and timetable for budget preparation; stronger medium-term focus of the budget; and the joint consideration of current and capital budgets.

12. Work is, however, still needed in the treasury and accounting area, where there are three main concerns. First, while there are valid arguments for using the pilot testing approach favored by the authorities, these pilots should best be developed after the decision is taken on the underlying process reforms and the appropriate IT strategy. Otherwise, there is a

[1] A standard Treasury Single Account (TSA) is a bank account or a set of linked bank accounts through which the government, including its entities and spending units, transacts all receipts and payments, and consolidates its cash balances. Cash balances held by a government are efficiently centralized through a TSA.

risk that communication (and particularly data transfer) between different parts of the system will be compromised. Second, insufficient progress has been made on the chart of accounts, which represents a key requirement for the computerized General Financial Management Information System (GFMIS) conceptual design. Finally, and more generally, treasury reforms have advanced faster than those in the budget area. For this reason, it is crucial that the adoption of budget classification system in line with international standards—currently on hold—be resumed expeditiously, as this is a key prerequisite for developing an appropriate reporting system.

Intergovernmental fiscal relations

13. In recent years, the authorities have become increasingly aware of the need to reform the intergovernmental fiscal relations, as imbalances between the center and subnational levels are growing and regional disparities are widening. There is a need to clarify expenditure mandates, including by centralizing some spending responsibilities such as pensions. Revenue assignments and the design of the transfer system also need to be looked at. Key considerations should include giving more control over tax rates to local governments, while transfers need to be sufficient to allow each province to deliver minimum standards of public services.

14. There is also growing concern about the fiscal risks building up at the local government level. Local governments, faced with a legal prohibition to borrow, resort to creative financing to fund their expenditures. As no comprehensive records are available on the resulting liabilities, the authorities have recently announced the establishment of a special task force to study fiscal risks of local governments. In line with recent Fund TA recommendations, at a minimum a fiscal risk register should be established in the treasury to keep track of these liabilities. The possible relaxation of the legal constraints on local government borrowing will need to be preceded by a number of structural reforms, including strengthening the recording and reporting of local government operations and enhancing the accountability and transparency of local government financial management.

China—Summary of Technical Assistance, 2001–2004		
Department	Purpose	Date
Tax system reform		
FAD	Mission on VAT and inheritance tax	April 2001
FAD	Mission on tax preference	September 2001
FAD	Mission on financial sector taxation	Aug/Sep 2002
FAD	Mission on personal income tax reform	November 2003
Tax administration reform		
FAD	Missions on computerizations (5)	June 2000–Oct. 2002
FAD	Missions on strategic planning (2)	Nov. 2001–Aug. 2002
FAD	Seminar on strategic planning in Washington	October 2002
FAD	Mission on revenue administration	November 2003
Budget reform		
FAD	Workshop on treasury, government fiscal management information system	February 2001
FAD	Mission on budget classification, treasury single account, macro-fiscal coordination, budget preparation	November 2001
FAD	Mission on budget preparation, budget classification, and treasury reform	June 2002
FAD	Mission on budget classification	March 2003
FAD	Workshop on budget and treasury modernization in Washington	October 2003
FAD	Mission on treasury and accounting reforms	November 2003
FAD	Mission on budget law reforms	March 2004
Intergovernmental fiscal relations		
FAD	Mission intergovernmental relations	November 2002
	Mission on subnational fiscal risks	November 2003
Statistics		
STA	Seminar on General Data Dissemination System	April 2001
STA	Seminar on money and banking statistics	April 2001
STA	Missions on trade statistics	June 2001–Jan. 2002
STA	Mission on GDDS	Feb./March 2002
STA	Seminar on Balance of Payments	August 2002
STA	Mission on government financial statistics	September 2002
STA	Seminar on GDDS/SDDS in Washington	September 2002
STA	GDDS Review	December 2003

China—Summary of Technical Assistance, 2001–2004		
Department	Purpose	Date
Monetary Policy and Bank Supervision		
MFD	Missions on banking supervision	October 2003
MFD	Bank Restructuring	April 2004
MFD	AML/CFT Issues	September 2003
MFD	AML/CFT Seminar	April 2004
Review of TA		
FAD	Visit to review and reschedule UNDP/IMF/China fiscal reform TA activities	February 2001
FAD/TAS	Missions for tripartite review of the UNDP/IMF/China fiscal reform TA activities (2)	Jan. 2002, Feb. 2003
MFD	Mission on TA needs in banking sector reform	July 2002
MFD	Mission on TA needs in financial sector	October 2003
FAD	Participation in UNDP/DFID fiscal reform workshop	February 2004
Training		
INS	Courses on financial programming and policies (3)	July 2000–June 2002
INS	High-level seminar on banking reform	March 2001
MFD	Capital Account Convertibility	April 2001
MFD	Course on monetary policy and operations	May 2001–June 2002
MFD	Banking Risk Management	July 2001
FAD	Course on public sector expenditure management	June/July 2002
MFD	Central Bank Accounting	November 2002
INS/MFD	High-level seminar on monetary policy transmission	April 2004

CHINA—STATISTICAL ISSUES

1. China has made significant strides in bringing its economic and financial statistics into line with international good practice. In April 2002, China began participation in the Fund's GDDS, and posted its metadata on the Fund's DSBB (the most comprehensive documentation of Chinese economic and financial statistics available in English). In December 2003 the GDDS metadata were updated. However, weaknesses remain in the quality of the data, including coverage, frequency and timeliness. The main statistical issues are noted below.

Real sector

2. Data on the expenditure components of GDP are not published on a quarterly basis; nor are the estimates of expenditure components at constant prices on an annual basis. The data are produced in cumulative form, with minimal revisions of previous data, making it difficult to assess quarterly developments accurately or to make seasonal adjustments. Constant price measures of GDP are also suspect because of deficiencies with the price indices and techniques used to derive the estimates. Nevertheless, the National Bureau of Statistics has made a number of improvements to the range and quality of national accounts data, including quarterly estimates of GDP by industry and estimates of GDP by type of expenditure. Further improvements are intended, including the adoption of the *1993 System of National Accounts*, further development of income and expenditure data, and improvements to quarterly GDP estimates. However, no target dates have been set. As in other countries, rapid economic change, including the expansion of the nonstate sector, presents new problems for data compilation. The ability to change the collection of data is restricted by the decentralized nature of the statistical system. Extensive technical assistance has been provided from multilateral and bilateral institutions.

3. Monthly industrial production, retail sales, and fixed investment data also have a shifting base that does not permit the production of a consistent time series. Data revisions tend to be made without publishing the entire revised series. Retail sales and fixed investment data are published only in nominal, not real, terms.

4. Labor market statistics—including employment and wage data—are not comprehensive, and are only available on an annual basis, with considerable lag.

5. Prior to December 2000, the consumer price index was not produced in a time series format, as there were only comparisons between the current month and the previous month, and the current month with the same month of the previous year. For most items, the weights were for the previous year's expenditures with the other weights being updated each month. Technical assistance missions in September 1991, April 1995, and June 1997 dealt with the concepts and methodology of internationally used index formulae. The authorities have received technical assistance and training on price index methodology under a cooperative

program with Statistics Canada. A technical assistance mission in August 1999 reviewed the methodology to compile fixed-base price indices in test projects in four provinces and found that only in one province the index was adequate. In January 2001, the NBS began to publish a new fixed base CPI, which more accurately reflects consumer spending patterns (e.g., the weight of services increased, while the weight of food declined). The number of survey items has been expanded to more than 700 from the previous 325. The weights of the major CPI components were provided to the staff during the 2001 Article IV mission.

Government finance

6. Serious data shortcomings continue to hamper fiscal analysis. Budgetary data exclude spending associated with domestic bond proceeds on-lent to local governments and official external borrowing. Also, data on the social and extra budgetary funds are only provided annually and with a long lag. Expenditure classification remains very poor, mainly because data are not classified by economic type. This should start to improve when the new budget classification system is introduced.

7. China irregularly reports central government and local government budget data for publication in the *GFS Yearbook.* The latest published data are for 2001. No data are provided on government debt or the operations of extrabudgetary funds. The revenue classification does not fully distinguish between revenue and grants, tax and nontax revenue, and current and capital revenue. The presentation of expenditure is by function only. The functional classification does not comply with international standards.

Monetary accounts

8. In recent years, improvements have been made in the classification of accounts of the monetary authorities and banking institutions. From 2002, compilation and reporting of monetary data include foreign-currency-denominated accounts of residents and accounts of the branches of foreign banks.

9. The monetary and banking surveys lack sufficient detail with regard to detailed breakdowns of bank credit extended by industry and by borrower (including by the various elements of the state and nonstate sectors). The staff continues to encourage the authorities to report information of this nature for analytical purposes.

10. Due to the restructuring of the banking sector, new statistical issues have arisen, such as how to record the transfer of non-performing loans to asset management companies, and how to classify these companies in the banking survey. As a result, there is a need for some revisions to the current *Monetary and Financial Statistics Manual.*

11. The reported net foreign assets position of PBC does not include exchange rate valuation effects nor interest earnings on foreign reserves.

Balance of payments

12. The State Administration of Foreign Exchange (SAFE) obtains data relating to service, income, current transfers, and capital and financial account transactions through an "international transactions reporting system" (ITRS). Data on travel receipts are obtained from sample surveys conducted by the National Bureau of Statistics and China National Tourism Administration, while those on travel payments are derived from ITRS and estimated by SAFE. Data on stock issuance are provided by the China Securities Regulatory Commission, and bond issuance data are from SAFE debt statistics. Sources for data on overseas securities investment and direct investment inflow are provided by PBC and the Ministry of Commerce and data on direct investment outflow are obtained from ITRS.

13. The data are compiled (in U.S. dollars) largely in accordance with the fifth edition of the *Balance of Payments Manual* (*BPM5*). Semi-annual (January-June) data are compiled and disseminated within four to five months after the end of the reference period while data on an annual basis are disseminated within six months of the close of the reference period. It appears that the authorities may be close to being able to publish quarterly estimates of the balance of payments. Within the current account, component detail is available on goods, services, income, and transfers. Data on the financial account are also available with significant component detail for functional categories, but with limited sectoral breakdown.

14. The Fund has provided extensive technical assistance for China to improve balance of payments and IIP statistics. In August 2002 a seminar was held on Balance of Payments and IIP statistics in Chengdu, China. The coverage of direct investment transactions remains a problematic issue in the Chinese balance of payments and IIP statistics. Data on these transactions, received mainly from the Ministry of Commerce (formerly Ministry of Foreign Trade and Cooperation), apparently do not cover all required elements such as disinvestments. On the other hand, the direct investment survey developed by SAFE has not provided reliable data. Another issue that has to be addressed by the authorities is to extend verification and auditing programs to reduce measurement errors and ensure the long-term performance of the ITRS. For this purpose regular training programs for staff in the provincial offices of SAFE were recommended. In addition, in January 2003 a legislative guarantee for the improvement of the quality of ITRS reporting entitled "The Checking System on Balance of Payments Reporting Data (experimental)" was promulgated by the SAFE.

15. The authorities reported that they have been compiling international investment position (IIP) statements for four years (1999-2002). However, because some data categories still need to be improved, no IIP data have been published thus far.

16. The Fund has also provided technical assistance on the coverage, timeliness, and periodicity of China's data on official reserves, reserves-related liabilities, as well as on other external assets and liabilities, financial derivative activities, and other contingent and potential liabilities. In the December 2003 GDDS progress review, the authorities indicated

that they had completed the preparatory work for completing the template on international reserves and foreign currency liquidity in accordance with the SDDS and that there were no technical problems remaining. The authorities also noted that the definition and coverage of China's external debt data follow closely the recently-published *External Debt Statistics: Guide for Compilers and Users*. Such data are apparently compiled monthly and have been published quarterly since the third quarter of 2003 (monthly data have not been provided to Fund staff on a regular basis). Despite an ostensibly modest level of external vulnerability, there remains a need to strengthen external debt monitoring and compilation, while introducing additional transparency in data dissemination.

17. In April 2004, STA conducted a seminar in Xi An China on the Coordinated Portfolio Investment Survey (CPIS) to explain the concepts and practical issues involved in undertaking the survey. There was active participation in the seminar although no commitment was made at that time to participate in the CPIS.

Data reporting to STA for publications

18. In June 1999, the PBC resumed reporting monthly monetary data and has agreed to their publication in *IFS*. These improvements in reporting notwithstanding, a number of breaks remain in the series, and comparable historical data are not available.

19. Since 1994, China's Ministry of Finance (MOF) has regularly reported annual GFS data for publication in the *GFS Yearbook*. The GFS database currently includes data on the central government budget for 1990–97, and on provincial and local governments for 1995–1999. The MOF also reports annual GFS data for publication in *IFS* although with substantial delays. Data through 1998, relate to revenue, expenditure, and the deficit/surplus of the central, provincial, county-level, and municipal governments' budgets.

20. Reporting of data to STA for *IFS* has, in the past, tended to be sporadic and with a considerable time lag. Following the introduction of new reporting arrangements, the timeliness of consumer price, industrial production, trade value, and total GDP data in *IFS* has improved substantially. However, the range of information is relatively limited, with no data published on producer prices, wages, trade volumes or prices/unit values.

Data dissemination to the public

21. The publication of a quarterly statistical bulletin by the PBC has significantly improved the timing and coverage of publicly available data on the monetary accounts and the main real sector indicators. However, the monthly statistical publications do not contain many time series (e.g. unemployment) or the disaggregation necessary for analysis. Moreover, several important time series, particularly on the main fiscal variables, are not released in a systematic and timely manner. Extensive annual economic data are available in various statistical yearbooks, but these are published nine months or more after the end of the year.

China: Core Statistical Indicators
(As of June 18, 2004)

	Exchange rates	International reserves	Reserve/base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index 1/	Exports/ Imports	Current account balance	Overall government balance	GDP/ GNP 2/	External debt
Date of latest observation	May 31, 2004	March 2004	April 2004	April 2004	April 2004	April 2004	March 2004	March 2004	Dec. 2003	Feb. 2004	March 2004	Dec. 2003
Date received	June 4, 2004	April 20, 2004	May 27, 2004	May 27, 2004	May 27, 2004	May 27, 2004	April 16, 2004	April 15, 2004	April 28, 2004	April, 2004	April 16, 2004	April 2004
Frequency of data	D	M	Q, M	M	M	... 3/	M	M	A,Q 7/	A,M	A, Q (cumulative)	Q
Frequency of reporting	M 4/	M	Q, M	M	M	... 3/	M	M	A,Q 7/	A,M	A, Q (cumulative)	Q
Frequency of publication	D	M	Q, M	M	M	... 3/	M	M	A,Q	A,M 5/	A, Q (cumulative)	A
Source of data	C	C,A,N	C,A,N	C,A,N	C,A,N	C,N	C,N	C,N	C,A	C,A,N	C,N	A
Mode of reporting	E	E,M	E,M	E,M	E,M	E,M	E,M	E	E,M	E,M	E,M	M
Confidentiality	C	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/

1/ Only 12-month growth rates are reported (price indices are not available).
2/ For real GDP, level data are available only on an annual basis (growth rates are available on a quarterly, cumulative basis).
3/ Interest rates change only infrequently; these changes are publicly announced.
4/ While officially transmitted on a monthly basis, these data are available from news sources on a daily basis.
5/ Data on interest expense not published.
6/ Restricted until publication.

Explanation of codes is as follows:
Frequency of data: D - daily, M - monthly, Q - quarterly, A - annually.
Frequency of reporting: D - daily, M - monthly, Q - quarterly, A - annually.
Source of data: A - direct reporting by the authorities, C - commercial electronic data provider, N - official publication.
Mode of reporting: E - electronic data transfer, M – mail
Confidentiality: C - unrestricted use, D - embargoed for a specific period, and for unrestricted use thereafter.

China—Relations With The World Bank[1]

1. The World Bank has been active in China since 1980. World Bank commitments to China as of June 30, 2004 are expected to total about $38.4 billion for 254 projects. About 90 of these projects are still under implementation, making China's portfolio by far the largest in the Bank. World Bank-supported projects are found in almost all parts of China and in many sectors of the economy, with infrastructure (transport, energy, industry, urban development) accounting for more than half of the total portfolio, and agriculture, social sectors (health, education, social protection), environment, and water supply and sanitation comprising the remainder.

2. In FY2004, lending is projected to total $1,218 million in IBRD loans for nine projects. Given the increased availability of domestic financing—as a result of China's fiscal stimulus policy—and a shift of the government's development program to the central and western areas, the focus of the World Bank's assistance program is now on the poorer and institutionally weaker inland provinces. As a consequence, the amount of lending per project has been scaled back to suit the absorptive capacity of those provinces, leading to a lower lending level compared with the mid-1990s. By sector, the projects to be approved in FY2004 include two for agricultural development in poor rural areas, one for basic education in western areas, two for urban environmental improvements in Zhejiang and the Pearl River Delta, an urban transport in Wuhan, and three transport projects (for the national railway, inland waterways development and highway development). A summary of Bank commitments and disbursement to China is given in Table V.1. Details of the sectoral breakdown of past lending can be found in Table V.2.

3. Over the next two years, lending is expected to total around $2.5 billion, with support provided to economic reform nationwide, development of health, agriculture and infrastructure in the interior provinces, and for urban management and the environment in both coastal and inland areas. Since China is no longer borrowing IDA funds, the Bank, in collaboration with the government and the United Kingdom's Department for International Development (DFID), has developed a mechanism to blend grant resources with IBRD loans, resulting in more concessional loans (at an interest rate of about 2 percent) for the social sectors and poverty reduction. The FY2004 Basic Education Project was supported by a blend. Use of this blending mechanism with other development partners is envisioned.

4. The current World Bank Group assistance strategy, covering both lending and non-lending activities, is designed to help China: (i) improve the business environment and accelerate the transition to a market economy, mostly through an array of knowledge transfer

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[1] Prepared by World Bank staff.

activities; (ii) address the needs of the poorer and disadvantaged people and lagging regions, through investment lending in rural development, infrastructure, and the social sectors, as well as analytical and advisory services and training; and (iii) facilitate an environmentally sustainable development process, through investment lending in natural resource management, watershed rehabilitation and wastewater treatment, energy, global environment projects supported by the Global Environment Facility and Montreal Protocol, and policy work.

5. In addition to financial assistance, the provision of non-financial services in the form of technical assistance, policy advice, seminars and training is an essential part of the cooperation program. The government has strongly endorsed Bank efforts to make its non-lending activities more responsive to the country's evolving needs, by having a better balance between detailed studies of issues requiring lengthy technical analysis and quick delivery of briefer policy notes, supplemented by other forms of collaboration such as senior-level workshops. Some recent or upcoming outputs include: support to formulation of the 11th Five-Year Plan; an economic memorandum on promoting growth with equity; issues in the management of economic crises (building on previous work on public expenditures, including at the sub-national level, and on the management of fiscal and financial risks); studies of public service unit reforms, national market integration, maximizing rural health contributions to growth and employment, education strategies for lagging regions, and labor reform; program of long-term energy security studies; and a financial sector program focused on capital market development, banking reform, infrastructure finance and rural finance. In FY2005, besides continuing support on the 11th Plan, the World Bank expects to assist on, among other things, macromodeling for Plan formulation, intergovernmental fiscal and regional development issues (including in the Northeast), a study of public finance reform for rural development, a poverty assessment as well as major programs of work on the financial sector and rural health.

Representation:	The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.
Capital Subscription:	China holds 4,480 million shares or 2.85 percent of the total authorized capital of the IBRD. Currently, China is fully subscribed.
Technical Assistance:	A technical assistance loan to the People's Bank of China to enhance the central bank's supervision, research, and clearing capabilities was approved in FY1993. A second technical assistance project, approved in the same year, is financing reform-supportive studies and economic research, the strengthening of core agencies responsible for macroeconomic management and local training institutions, and preinvestment support. Technical assistance for economic law reform was approved in FY1995. Fiscal technical assistance, also approved in FY1995, supported the implementation of a broad range of public sector reforms. Assistance in bond market development

has also been provided. In FY1999, technical assistance projects were approved for reform of accounting, pension and enterprise systems. Further technical assistance support for economic research and preinvestment was also provided in FY1999. A supplemental loan for financial sector technical assistance was approved in FY2001. A large program of technical assistance is currently financed by trust funds from within and outside the Bank, covering economic and financial sector reform, statistical reform, poverty issues, social sectors, debt management, and social security.

Resident Mission: A resident IBRD office in Beijing has been in operation since October 1985. In October 1997, responsibility for managing the Bank's total program for China was decentralized to the Beijing office.

International Finance Corporation (IFC): As of March 31, 2004, IFC has committed financing for 49 projects in China. For these projects IFC has provided US$673 million: US$589 million for IFC's own account, and US$84 million for the account of participating banks. A resident IFC office in Beijing has been in operation since 1992. In July 2000, a joint IFC/World Bank regional office for private sector development was established in Hong Kong SAR, with management of this program decentralized to that office.

IFC's priorities in China include: supporting private sector development in interior provinces; expanding the presence of private enterprises in infrastructure, social services, and environmental technology sectors; and improving the business environment, particularly as it relates to financial markets, private participation in infrastructure, and small and medium enterprises.

Table V.1. China: IBRD-IDA Lending Activities, FY1981–04 1/
(In millions of U.S. dollars)

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
1981	100	100	0	0
1982	60	0	0	0
1983	150	463	33	0
1984	424	616	134	20
1985	442	660	146	236
1986	450	687	252	352
1987	556	867	361	318
1988	640	1,054	399	302
1989	515	833	549	685
1990	590	0	557	569
1991	978	602	494	620
1992	949	1,578	753	618
1993	1,017	2,155	763	813
1994	925	2,145	869	1,057
1995	630	2,370	659	1,555
1996	480	2,490	891	1,328
1997	325	2,490	722	1,405
1998	293	2,323	596	1,497
1999	423	1,674	614	1,412
2000	0 2/	1,673	420	1,408
2001	0	788	345	1,476
2002	0	563	260	1,755
2003	0	1,145	153	1,628
2004 3/	0	1,218	101	1,100
Total	9,947	28,494	10,071 4/	20,154

1/ The financial year (FY) runs from July through June.
2/ As of July 1, 1999, China no longer borrows from IDA.
3/ Lending for 2004 is for entire year; disbursement numbers are actuals as of May 31, 2004.
4/ IDA disbursements exceed commitments due to changes in the US$-SDR exchange rate.

Table V.2. Distribution of Lending, FY 1980–04

Sector	US$ mn.	Percent	No. of Projects
Rural devt./poverty alleviation	9,833	25.6	64
Industry and energy	10,127	26.3	54
Industry/corporate reform	3,013		20
Energy/renewable energy	7,114		34
Transport	10,121	26.3	54
Human resources	2,650	6.9	30
Education	1,727		19
Health	***923***		***11***
Environment and urban	5,252	13.7	38
Environment	2,965		21
Urban development	1,466		10
Water supply	821		7
Technical assistance/public sector	455	1.2	14
Total	38,441	100	254

CHINA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK[27]

1. The Asian Development Bank's (AsDB) new Country Strategy and Program (CSP) for China was completed in late 2003. The CSP focuses on a set of four interrelated challenges: (i) promoting pro-poor inclusive economic growth; (ii) building an enabling environment for the private sector and strengthening public sector governance; (iii) fostering regional cooperation to help integrate the PRC into the global economy; and (iv) promoting environmental sustainability.

2. Since China became a member of ADB in 1986, 101 public sector loans totaling $13.5 billion and 418 technical assistance projects amounting to $223.1 million have been approved as of end-December 2003. In addition, ADB has approved nine private sector projects without government guarantee including investments in two commercial banks, three investment funds for small and medium enterprises, two power projects loans, and two water sector project loans. The projects involve aggregate investments of $2.1 billion, for which ADB's funding commitment consisted of $152 million of direct loans, $79 million of equity investments, and $172 million in complementary financing.

3. ADB's proposed lending program for the next three years will focus mainly on three areas: (i) agriculture and rural development, (ii) transport and energy primarily in the central and western regions, and (iii) the environment. Agricultural projects will be more focused on environment projects (e.g., land degradation, and soil and water management), productivity enhancement, and poverty-oriented projects. Road projects will include highways complemented by feeder roads to rural communities, and improving urban transport systems. In the energy sector, the emphasis will be on renewable energy and clean energy to reduce air pollution. Improving the urban environment, including water supply/wastewater treatment, air pollution abatement, and solid waste management projects will constitute the core of social infrastructure projects.

4. During 2004–2006, ADB's lending to the PRC will be around $1.5 billion annually, an increase from about $1 billion per year in the past five years. The proposed level is considered appropriate for a large country with sound macroeconomic fundamentals, strong absorptive capacity, and good project implementation. During 2004-2006, more than 80 percent of the proposed lending will finance projects in the central and western regions. The transport sector will continue to dominate ADB operations, with environment and social infrastructure increasing its share.

5. The ADB's lending program will continue to be supported by technical assistance focusing on governance, private sector development, the environment, poverty and regional cooperation. Efforts to promote social development will be facilitated through new TA proposals for the education sector. In line with China's increased decentralization, TA proposals for forging strategic partnerships with provincial governments in addressing specific thematic priorities have also been included.

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[27] Prepared by AsDB staff.

6. Overall, China has demonstrated strong project implementation capability. The good performance reflects the strong sense of project ownership among agencies involved in the design, implementation, and management of projects, as well as the rigorous screening process for development projects, particularly those proposed for external assistance. Loan disbursement and contract award performance is good.

7. The establishment of AsDB's China Resident Mission in Beijing in June 2000 has contributed to improving portfolio management and project administration and enhanced the development impact of its lending and knowledge-based operations.

Table VI.1: ADB Distribution of Lending (Public Sector)
(In millions of U.S. dollars; as of 31 December 2003)

Sector	Amount	Percentage	No. of Loans	Percentage
Agriculture and Natural Resources	877	7	12	12
Energy	2,055	15	18	18
Industry and Finance	1,217	9	11	11
Transport and Communications	7,262	54	44	43
Social Infrastructure	1,085	8	9	9
Others	1,003	7	7	7
Total	13,499	100	100	100

Table VI.2. China: AsDB's Commitments and Disbursements, 1993–2003
(In millions of U.S. dollars)

Year	Commitments 1/	Disbursements 2/
1993	1,031	421
1994	1,618	492
1995	2,304	558
1996	3,282	707
1997	4,033	715
1998	4,518	831
1999	5,337	819
2000	6,159	848
2001	6,748	1,042
2002	7,563	782
2003	8,075	705

1/ Refers to cumulative contract awards.
2/ Refers to disbursements for the year.

China: Millennium Development Goals
(In percent, unless otherwise specified)

	1990	1995	2001	2002
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates			
Population below US$1 a day	...	...	16.1	...
Poverty gap at US$1 a day	...	...	3.7	...
Share of income or consumption held by poorest 20 percent	...	...	...	...
Prevalence of child malnutrition (percent of children under 5)	17.4	12.9	10.0	...
Share of population below minimum level of dietary energy consumption	16.0	...	9.0	...
2 Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	97.4	97.9	93.2	...
Percentage of cohort reaching grade 5	86.0	93.8	...	...
Youth literacy rate (ages 15-24)	95.3	96.5	97.9	98.1
3 Promote gender equality	2005 target = education ratio to 100			
Ratio of girls to boys in primary and secondary education	81.1	87.3	97.6	...
Ratio of young literate females to males (ages 15-24)	95.5	97.0	98.1	98.2
Share of women employed in the nonagricultural sector	...	...	...	...
Proportion of seats held by women in national parliament	21.0	21.0	22.0	22.0
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds			
Under 5 mortality rate (per 1,000)	49.0	46.0	39.0	36.4
Infant mortality rate (per 1,000 live births)	38.0	37.0	31.0	30.0
Immunization, measles (percent of children under 12 months)	98.0	93.0	79.0	...
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	60.0	...	...
Births attended by skilled health staff (percent of total)	50.3	...	70.0	...
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.			
Prevalence of HIV, female (ages 15-24)	...	...	0.1	...
Contraceptive prevalence rate (of women ages 15-49)	84.6	90.4	83.0	...
Number of children orphaned by HIV/AIDS	...	...	76,000	...
Incidence of tuberculosis (per 100,000 people)	...	...	107.0	...
Tuberculosis cases detected under DOTS	...	16.0	33.0	...
7 Ensure environmental sustainability	2015 target = various 1/			
Forest area (% of total land area)	15.6	...	17.0	...
Nationally protected areas (percent of total land area)	...	6.4	6.4	7.8
GDP per unit of energy use (PPP $ per kg oil equivalent)	1.7	2.9	4.2	...
CO2 emissions (metric tons per capita)	2.1	2.6	2.3	...
Access to an improved water source (percent of population)	71.0	...	75.0	...
Access to improved sanitation (percent of population)	29.0	...	38.0	...
8 Develop a Global Partnership for Development	2015 target = various 2/			
Youth unemployment rate (percent of total labor force ages 15-24)	...	2.9	3.1	...
Fixed line and mobile telephones (per 1,000 people)	5.9	35.9	247.7	...
Personal computers (per 1,000 people)	0.4	2.3	19.0	...
General indicators				
Population (in billions)	1.1	1.2	1.3	1.3
Gross national income (US$ trillion)	0.4	0.6	1.1	1.2
GNI per capita (US$)	320	520	890	940
Adult literacy rate (percent of people ages 15 and over)	78.3	81.9	85.8	86.4
Total fertility rate (births per woman)	2.1	1.9	1.9	1.9
Life expectancy at birth (years)	68.9	69.4	70.5	70.7

Sources: World Development Indicators database, April 2002. In some cases the data are for earlier or later years than those stated.
1/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.
2/Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Statement by the IMF Staff Representative
July 28, 2004

1. This statement contains information that has become available since the Staff report was circulated to the Executive Board on July 7, 2004. This information does not materially alter the thrust of the staff appraisal.

2. New data for the second quarter of 2004 point to some success in slowing down the economy, but data revisions and incomplete reporting make it difficult to draw firm conclusions. Real GDP grew by 9.6 percent (y/y), down from 9.8 percent in the first quarter. The slowdown in the reported growth rate appears to have been influenced to some extent by an upward revision to GDP growth in the second quarter of 2003.[1] Without this revision, second quarter 2004 growth would have been about 11 percent. However, staff estimates of GDP seasonally adjusted on a quarterly basis suggest a significant slowdown in second quarter 2004 GDP growth. Indicators for expenditure show a marked decline in fixed asset investment growth from 36 percent (y/y) in real terms in the first quarter to 22 percent in the second. Consumption growth, on the other hand, appears to have picked up, as real retail sales rose by 11½ percent (y/y) in the second quarter, following a 9¼ percent increase in the first quarter.

3. External trade continued to be buoyant, with exports and imports increasing by 46 percent and 51 percent (y/y), respectively, in June. China had a small trade surplus of $1.7 billion (customs basis) in the second quarter, compared with a deficit of $8.5 billion in the first quarter. Foreign exchange reserves increased by $30 billion during the second quarter, in part reflecting strong net FDI inflows of $20 billion. On a monthly basis, official reserves increased on average by $10 billion in the second quarter, compared with $12 billion in the first, suggesting that non-FDI capital inflows (including errors and omissions) may have declined in the second quarter.

4. Food price increases continued to drive CPI inflation. The CPI in June increased by 5.0 percent (y/y), compared with 4.4 percent in May. Food prices were up by 14.0 percent (11.8 percent in May), and non-food prices by 0.4 percent (0.7 percent in May). Staff estimates of the CPI on a seasonally adjusted basis suggest that inflation stood at 5.8 percent (month on month at an annual rate) in June, roughly the same as in May, but less than the 7.8 percent rate in April.

5. Broad money and loan growth declined to 16¼ percent in June (y/y), compared with average growth of 19¾ percent and 20 percent, respectively, in the first five months of 2004. Estimates of loan growth, however, may understate the growth in new lending to some extent because of the substantial writeoffs of nonperforming loans by banks at the end of last year and during the first half of 2004. Although broad money and loan growth rates have come down, the staff believes that continued monetary policy vigilance is needed to ensure a soft landing of the economy.

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[1] In the release of GDP data for the first half of 2004, revised data for the same period in 2003 were published, but revised GDP data for the whole of 2003 were not.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
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IMF Concludes 2004 Article IV Consultation with the People's Republic of China

On July 28, 2004, the International Monetary Fund's (IMF) Executive Board concluded the Article IV consultation with China.[1]

Background

China has continued its rapid economic growth and integration into the global economy. Real GDP grew by 9.1 percent in 2003, underpinned by strong fixed investment and exports, which registered growth rates of 20 percent and 29 percent in real terms, respectively. Consumption growth declined somewhat from 2002, reflecting the impact of the SARS epidemic in the second quarter. In the first half of 2004, GDP grew by 9.7 percent (year-on-year), with indications that economic activity was beginning to slow down in response to measures taken to reduce investment growth. External trade continued to expand rapidly, and consumption growth has also picked up momentum. Inflationary pressures have emerged. After rising by 1.2 percent in 2003, consumer prices increased by 4.4 percent in the first half of 2004, largely due to food price increases. Despite the strong GDP growth, unemployment continues to rise; registered unemployment in the urban areas increased to 4.3 percent in 2003, up 0.3 percentage points from 2002. The level of surplus labor in the agricultural sector is estimated to be large, and rural-urban income disparities have continued to widen.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

China's overall external position has strengthened further. The current account surplus rose from 2¾ percent in 2002 to 3¼ percent in 2003, mainly as a result of an increase in private transfers and a decline in the deficit on investment income. The capital and financial account posted another large surplus in 2003, as net foreign direct investment (FDI) inflows amounted to $47 billion and net porfolio investment turned positive. Official reserves increased by $117 billion in 2003 (excluding the $45 billion used for bank recapitalization). In the first half of 2004, the trade account registered a deficit of $7 billion, as imports surged by 43 percent, while exports grew by 36 percent. Nevertheless, foreign exchange reserves rose by $67 billion, reaching 471 billion by end-June (equivalent to around 9½ months of imports), as current transfers and capital inflows continued at a rapid pace.

Real GDP growth is projected to average around 9 percent in 2004. As the effects of recent macroeconomic tightening continue into 2005, economic activity should maintain a more sustainable pace, with real GDP growing at about 7½ percent. The CPI is expected to rise by about 3-4 percent over the next year and a half, with inflationary pressures dissipating towards the end of 2004 as food price increases ease and demand pressures diminish. The external current account surplus would decline by about ¾ percent of GDP in 2004, as import growth continues to outpace export growth, with the latter slowing down from the very high rates recorded over the last year. Sizable net capital inflows, including FDI, are likely to continue in 2005, and the external position is expected to remain strong.

Significant progress has been made in structural reforms. In the banking sector, restructuring plans are being put in place for the two state banks that were recently recapitalized, stricter prudential regulations have been adopted, improved lending practices have contributed to a decline in the reported ratio of nonperforming loans to total loans, and asset management companies have made progress in recovering distressed assets. In the state-owned enterprise (SOE) sector, the government has taken a number of new initiatives to improve management of the SOEs, including new laws and regulations related to the supervision, restructuring, and sale of state assets. Shareholding systems are being introduced into large SOEs, while more than 28 million workers have been laid off since 1998 as a result of closures of loss-making SOEs and reduction of redundant employees. To mitigate the social impact of reforms, the authorities have taken steps to strengthen the social safety net, including by increasing pension coverage and payments, widening the coverage of unemployment insurance and urban minimum living allowance assurance schemes, and providing assistance to laid-off workers for finding new employment.

Executive Board Assessment

Executive Directors commended the Chinese authorities for their skillful economic management, which has reduced the risk of overheating and further strengthened the Chinese economy. Efforts to rein in credit and slow investment appear to have started to bear fruit, as evidenced by the recent signs of moderating economic expansion. The key challenge going forward will be how to harness the strong potential for sustained economic expansion in China, while maintaining macroeconomic balance and ensuring sound, broadly-based economic development.

A crucial short-term concern is that despite the recent indications of moderation in the fast pace of investment and economic growth, a soft landing of the economy is not yet assured. Addressing this challenge, while at the same time maintaining the stability of the financial system and further integrating China into the global economy, will require the authorities to pursue prudent macroeconomic policies and accelerated structural reforms in key areas, including the banking sector, state enterprises, and labor markets. The scope and timing of actions by the Chinese authorities on all these fronts will have a decisive influence on China's medium-term prospects.

Directors noted that in view of the state of development of China's economy and the observed overinvestment in certain sectors, the authorities have relied on macroeconomic policies, legal measures, and some administrative means to deal with the current macroeconomic and sectoral pressures. Most Directors considered that, as the effects of the various measures already taken may not yet have been fully realized, additional time may be warranted before deciding whether further monetary tightening is needed. A number of Directors, however, felt that the administrative measures taken so far may not be sufficiently effective in reducing the risk of overheating and credit growth, and were of the view that a further tightening of the monetary policy stance would facilitate a soft landing. Going forward, Directors agreed on the need for continued vigilance, and cautioned against a premature relaxation of policy, noting in particular that significant excess liquidity remains in the banking system. They encouraged the authorities to further develop indirect monetary policy tools and improve the effectiveness of market-based instruments, which will allow a gradual phasing out of administrative measures that are not prudential in nature.

Directors carefully considered China's exchange rate regime in the context of the Fund's obligation to exercise firm surveillance over members' exchange rate policies. They reiterated that greater exchange rate flexibility remains in China's best interest, as it will improve the effectiveness of monetary policy in containing domestic demand and price pressures, and enhance the economy's ability to adjust to shocks. Several Directors stressed that greater exchange rate flexibility should also be helpful in contributing to an orderly resolution of global imbalances. Directors accordingly welcomed the Chinese authorities' aim to introduce, in a phased manner, greater exchange rate flexibility, with several Directors recognizing that the exact timing of such a change should be left to the authorities to decide. Directors suggested that greater exchange rate flexibility is best introduced from a position of strength, as this would help limit any adverse effects on growth and employment. Many Directors therefore considered that, in view of the present favorable circumstances, it would be advantageous for China to make an initial move toward greater exchange rate flexibility without undue delay, with some Directors preferring that this move be made soon. At the same time, many Directors also emphasized the importance of carefully sequencing such a move in relation to measures being taken to develop the capital and foreign exchange markets, liberalize the capital account, and reform the financial sector to ensure a successful exit from the current exchange rate regime.

Directors supported the authorities' gradual approach in moving to capital account liberalization, observing that a key pre-requisite for liberalization is a well-capitalized and sound banking system. Several Directors observed that many countries had found it advantageous to increase exchange rate flexibility prior to liberalization of their capital accounts in order to allow exchange market and hedging instruments to develop more fully. They accordingly agreed with the view that maintenance of capital controls should not deter a movement toward greater exchange rate flexibility.

Directors stressed that fiscal policy should play a supportive role in achieving a soft landing of the economy, and urged the authorities to save part of this year's expected revenue overperformance, to reduce public investment, and to lower the deficit below the level targeted in the 2004 budget. Directors noted that fiscal consolidation will also have medium-term benefits, in view of the likely sharp increase in fiscal pressures associated with the large contingent liabilities in the financial sector, the pension system, and local government obligations, as well as rising demand for social expenditures, including on health and education. They therefore welcomed the authorities' intention to keep the level of the fiscal deficit roughly unchanged in nominal terms over the next few years, which should imply a reduction in the deficit by ¼ to ½ percent of GDP per year over the medium term.

Directors stressed that both expenditure reprioritization and revenue measures will facilitate fiscal consolidation and promote economic efficiency. They emphasized the importance of timely adoption of a revised budget classification system and chart of accounts, full introduction of the treasury single account, and improved cash management to enhance the effectiveness of spending. Directors encouraged the authorities to continue to bring extra-budgetary funds, especially at the local government level, onto the budget. They stressed also that priority should be given to considering an extension of the VAT to services, shifting the VAT from a production to a consumption-based tax, unifying income tax rates for domestic and foreign companies, reducing the tax burden on the financial sector, and continuing to strengthen tax administration. Noting the growing fiscal risks at the local government level, Directors emphasized that local governments' accountability and transparency need to be significantly enhanced, and center-local fiscal relations revamped, including by reforming tax assignments, expenditure mandates, and transfers of revenue between levels of government.

Directors emphasized that structural reforms in a number of key areas will be crucial for China to achieve continued strong growth over the medium term. Of particular importance is banking sector reform to ensure future financial stability and sound, competitive domestic banks. Directors considered the recent recapitalization of two state-owned commercial banks at end-2003 as an important initiative aimed at stepping up the pace of reform. In this regard, they stressed the need to carefully monitor the implementation of the time-bound action plans for these banks and to ensure that all banks fully meet capital adequacy requirements with full provisioning by 2007, as required by existing guidelines.

Directors underscored the need for rigorous efforts to strengthen balance sheets throughout the banking system, improve corporate governance, and enhance the ability of banks to manage risks. They noted that diversification of bank ownership and further liberalization of lending rates will facilitate the restructuring process and increase the commercial orientation of the banks. Directors welcomed the progress made so far in reducing nonperforming loans, and encouraged the authorities to tighten lending standards and further improve overall, consolidated supervision, including through greater coordination among financial sector supervisors. To create a more favorable environment for the orderly resolution of existing nonperforming loans, Directors called for additional actions to strengthen the legal framework for creditor rights, foreclosure, and bankruptcy, and to allow full tax deductibility for specific loan loss provisions. The development of domestic equity and debt markets to reduce domestic dependence on bank financing and mitigate risks also remains a priority.

Directors commended the authorities for undertaking a self-assessment of the financial sector, and encouraged China to participate in the Financial Sector Assessment Program in the near future. They welcomed the steps recently taken by the authorities to improve the framework for anti-money laundering and combating terrorism financing (AML/CFT), and looked forward to the finalization of work on comprehensive AML/CFT legislation that matches international standards.

Directors welcomed the initiatives taken to improve the management of state-owned enterprises (SOEs). Continued reforms are needed to ensure that SOEs are subject to hard budget constraints, operate independently, and pay dividends to the government. Directors urged the authorities to close nonviable firms or, if deemed socially important, support them directly from the budget.

Directors cautioned that, even with a high rate of GDP growth, labor market pressures will continue with projected increases in the working-age population and the restructuring of the SOE and agricultural sectors. To cope with these pressures, Directors emphasized that the functioning of labor markets should be further enhanced, including by facilitating better information flow on job opportunities, improving education and training, and strengthening the social safety net for both rural and urban workers. Further reforms of the household registration (hukou) system to allow freer movement of labor will help mitigate underemployment in rural areas and reduce income disparities.

Directors encouraged the authorities to continue to implement WTO commitments as scheduled, and welcomed China's ongoing support for the completion of the Doha Development Round. Directors expressed appreciation for China's provision of debt relief in line with the HIPC Initiative.

Directors welcomed the continued improvement in the quality of economic statistics and the authorities' commitment to make further improvements in line with the General Data Dissemination System. They noted that further efforts are particularly needed to improve the provision of annual and quarterly estimates of real GDP on an expenditure basis, to bring the compilation of fiscal and labor statistics in line with international standards, and to report data on the international investment position as soon as feasible. Directors welcomed China's intention to join the Special Data Dissemination Standard in the future.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

People's Republic of China: Selected Economic and Financial Indicators 1/

	2000	2001	2002	2003	2004 IMF Staff Projections
			(Change in percent)		
Domestic economy					
Real GDP	8.0	7.5	8.3	9.1	9.0
Consumer prices (period Average)	0.4	0.7	-0.8	1.2	3.5
			(In billions of U.S. dollars)		
External economy					
Exports	249	266	326	438	543
Imports	-215	-232	-281	-394	-512
Current account balance	21	17	35	46	40
Capital and financial account balance 2/	2	35	32	53	110
Of which: Direct investment, net	37	37	47	47	48
Gross official reserves 3/	169	219	295	412	562
Current account balance (in percent of GDP)	1.9	1.5	2.8	3.2	2.5
			(In percent of GDP)		
***Public finance** 4/*					
Overall budgetary balance	-3.6	-3.1	-3.3	-2.8	-2.2
Revenue	15.3	17.0	18.2	18.7	19.0
Expenditures	18.9	20.1	21.5	21.6	21.2
			(Change in percent)		
Money and interest rates					
Broad money (M2) 5/	12.3	14.4	16.8	19.6	…
Interest rate 6/	2.3	2.3	2.0	2.0	…

Sources: Chinese authorities; and IMF staff estimates.

1/ As of August 25, 2004.

2/ Excluding errors and omissions.

3/ Includes gold, SDR holdings, and reserve position in the Fund.

4/ Central and local governments. Data include all expenditure financed by official external borrowing, interest payments on government debt, and unbudgeted expenditures in 2000 related to the fiscal stimulus program.

5/ Banking survey.

6/ One-year time deposits, year-end.