October 2006
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People's Republic of China: 2006 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 2006 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 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 26, 2006, 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 11, 2006. 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 31, 2006 updating information on recent developments; and

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 31, 2006 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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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for
the 2006 Consultation with the People's Republic of China

Approved by David Burton and Anthony Boote

July 11, 2006

- The 2006 Article IV discussions with China were held in Beijing, Shanghai, and Chongqing during May 11–26, 2006.

- The staff team comprised Mr. Dunaway (Head), Messrs. Aziz, Aitken, Leigh, and Ms. Cui (all APD), Ms. Fedelino (FAD), Mr. Chamon (RES), Ms. Li (PDR), and Mr. Podpiera (MFD). The team was assisted by Mr. Brooks (Senior Resident Representative) and Mr. Barnett (Resident Representative). Mr. Xiaoyi Wang, Mr. Huayong Ge, and Ms. Fang Yang (OED) participated in the discussions. Mr. Kato joined the mission on May 22–23.

- The last Article IV consultation was concluded on August 3, 2005. (A summary of the Executive Board discussion can be found at www.imf.org/external/pubs/cat/longres.cfm?sk=18709.0). In recent years, the authorities and the Fund have agreed on policy priorities in a number of areas. However, in many of these areas the authorities have favored more measured and gradual steps than the Fund, reflecting their concerns about the risks that stronger and quicker actions might pose. While improvements has been made in monetary policy operations, the authorities have continued to rely on administrative measures to contain investment and credit growth. In part, this reflects the authorities' more gradual approach to introducing greater exchange rate flexibility. The Fund has welcomed the change in the exchange rate arrangement, but it has encouraged the authorities to utilize more fully the flexibility afforded by the new arrangement. At the same time, fiscal consolidation has proceeded broadly in line with the Fund's recommendations. In addition, there is general agreement on a broad range of structural reforms, including in the banking sector, the state-owned enterprises, and dealing with rural-urban income disparities. Differences of view relate principally to the pace of implementing reforms.

- 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 balance of payments. The authorities are making improvements in all of these areas, in particular by recently publishing China's international investment position. China has participated in the GDDS, with its metadata posted on the official website (Dissemination Standards Bulletin Board) since April 2002.

- 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.

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Executive Summary

Economic Setting:

Economic activity remained strong in 2005 and the first five months of 2006. Based on revised official data, GDP growth reached nearly 10 percent in 2005 and increased to 10¼ percent in Q1 2006, led by investment and exports. Inflation remains subdued, running at 1½ percent in May. The external current account surplus rose to more than 7 percent of GDP in 2005, and the trade balance strengthened further in the first five months of 2006. This has led to a further large increase in foreign official reserves, which amounted to $925 billion at end-May. Credit and money growth have increased in recent months, prompting the authorities to take a number of monetary policy actions and administrative measures to try to contain lending and investment growth, but the impact of these measures remains to be seen. Strong revenue overperformance helped to bring down the fiscal deficit by ¼ percentage point to 1¼ percent of GDP.

Policy changes are needed to address both domestic and external challenges. If China is to sustain rapid and stable economic growth the economy needs to be rebalanced away from heavy dependence on export-led growth toward self-sustaining domestic demand, and the opportunity to share in the benefits of growth needs to be spread more equitably across all levels of society.

Policy Discussions:

The staff stressed the urgency of monetary policy actions to prevent a further acceleration of investment. More steps need to be taken to drain excess liquidity from the system and contain credit growth, including further intensification of open market operations together with additional increases in reserve requirements and benchmark interest rates. The authorities agreed on the need for containing investment growth, but maintained that legal and administrative measures were also needed to contain growth in specific sectors where overinvestment was a concern.

The staff urged the authorities to increase exchange rate flexibility. This would allow greater monetary policy control by alleviating the major conflict created by tightly managing the exchange rate in the face of large capital inflows, thereby reducing the need to rely on financial repression. It would also contribute to the sustainability of China's growth over the medium term. The timing is right given the strength of the Chinese economy, with further delay entailing additional costs, which will grow over time. The authorities agreed that greater flexibility was needed over the medium term, but stressed that exchange rate reform would proceed in a gradual and controlled manner.

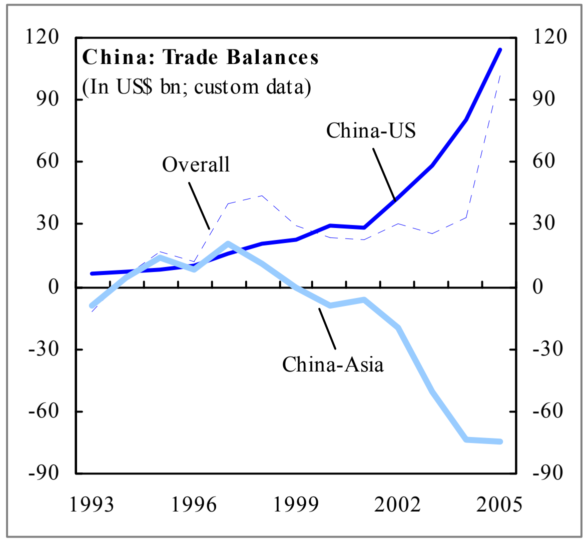
The 2006 budget is generally appropriate from a near-term perspective. Fiscal consolidation has created the space to step up social spending, which is needed to rebalance growth toward consumption. However, the authorities agreed that in the absence of concrete plans and adequate control measures, *ad hoc* or overly ambitious spending now that exceeds implementation capacity would be wasteful. As plans are formulated and implementation capacity improved, social spending can be ramped up over the medium term.

To facilitate rebalancing of the economy, financial sector reforms are needed to improve the intermediation of China's large private savings. The government also needs to raise social spending in the areas of education, health care, and pensions, which will serve to reduce precautionary saving and boost consumption over time.

I. Economic Developments and Outlook

A. Background

1. **This year's discussions took place against the backdrop of continued strong economic performance in China, as well as growing challenges.** High output growth has been maintained, led by investment and exports, and inflation has remained low. In the period ahead, while key risks and challenges facing the economy are in some ways the same as over the past couple of years, the need to address them has increased as imbalances in the economy have widened. Last year's concern that rapid investment growth is leading to overcapacity in some sectors has increased. Abundant liquidity in the banking system is touching off a new surge in lending and investment, with the probable consequence of creating new non-performing loans (NPLs) and undoing some of the progress made in reforming the banking sector. China's increasing integration into the global economy also poses challenges. As China's export market share has continued to rise, frustration in many trading partner countries with China's slow pace of exchange rate appreciation has been mounting. This runs the risk of exposing China to renewed protectionist measures. The gap between incomes of rural and urban areas continues to widen, and concerns are emerging that reform may be proceeding too fast, raising the risk that progress could stall if these concerns are not addressed.



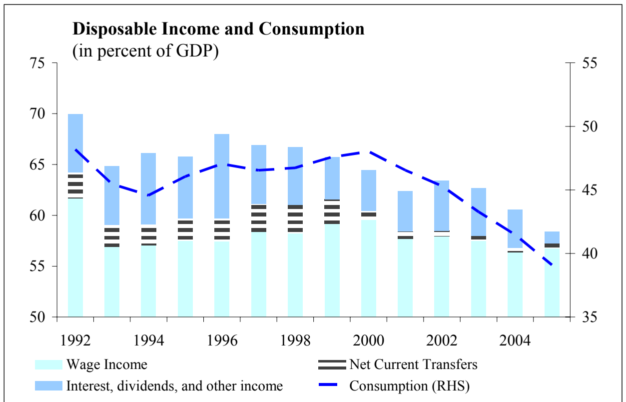
2. **Policy changes are needed to address both domestic and external challenges.** If China is to sustain rapid and stable economic growth the economy needs to be rebalanced away from heavy dependence on export-led growth toward self-sustaining domestic demand, and the opportunity to share in the benefits of growth needs to be spread more equitably across all levels of society.

3. **The authorities are aware of these challenges.** In the annual National People's Congress held in March, the government stressed the need to improve the investment structure, advance reforms in the health care, pension, and education systems, and provide more support to the rural areas and the less-developed regions. These reforms are aimed at boosting consumption by reducing precautionary savings. Along with policies to reduce energy intensity of production, the government aims to support a growth strategy that is more balanced than that in recent years (Box 1).

Box 1. Rebalancing Growth in China

Shifting the composition of growth away from exports and investment towards increased consumption is a key element of the government's overall strategy to rebalance growth.

Chinese households consumed less than 40 percent of GDP in 2005. [1] However, this was not always the case. The consumption-to-GDP ratio stood at 51 percent in 1980 when the liberalization of China's economy had just begun, but has steadily declined since then. The decline is somewhat surprising given that real consumption grew at an annual average rate of 8 percent during this period. However, it was outpaced by real GDP which grew at around 10 percent each year.

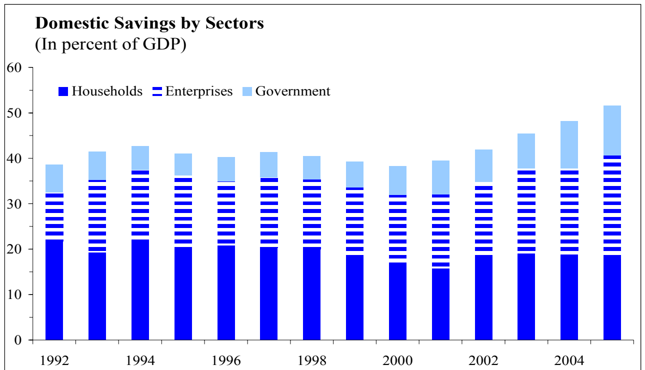


Sources: National Bureau of Statistics of China, and staff estimates.

Much of this decline in the consumption-to-GDP ratio has coincided with the fall in the share of disposable income to GDP. A falling share of wage and investment income relative to GDP, and in recent years that of the government transfers have been the main causes behind the decline in the disposable income ratio. While the average wage rate has risen at a rapid pace, it has lagged productivity growth. Much of the decline in investment income has resulted from continued low saving deposit interest rates, weak equity prices, and a lack of investment alternatives.

At the same time, households save close to 30 percent of their disposable income, a much higher ratio than might be expected given China's income level and its demographic structure. A large part of this reflects strong precautionary savings given the significant uncertainties surrounding public pensions and rising health care and education costs. The underdeveloped financial market has also played a role, as it offers few consumer credit facilities and insurance instruments, and thus limited scope for households to borrow against their future income or pool risks.[2]

National savings have steadily increased, largely driven by rising enterprise and government saving rates. National savings rose to over 50 percent of GDP in 2005. The market-oriented reforms of enterprises and the favorable external environment produced a rapid rise of corporate profits in recent years. Most of these profits have been kept as retained earnings rather than returned to shareholders. In particular, the state-owned enterprises, which account for about half of total corporate profits, do not pay dividends to the government, and instead use these funds to invest. Government savings also rose in the past several years, reflecting buoyant revenue performance. Government consumption has increased less, with the spending on social areas, such as health and education, falling behind that in most other countries as a share of GDP. As a result, the share of publicly provided household consumption has also declined.



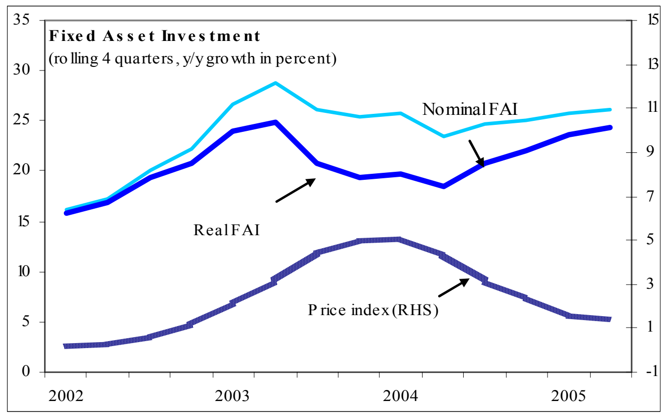
Sources: National Bureau of Statistics of China, and staff estimates.

1/ The data in this box are based on the unrevised expenditure side numbers. The expenditure-based GDP data have been revised only for 2004 and 2005, and thus there are no consistent time series based on the new methodology.
2/ The Selected Issues paper discusses household consumption and savings behavior.

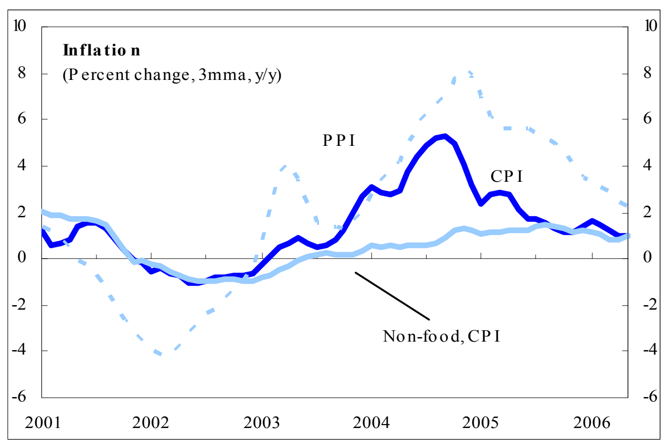
B. Recent Developments

4. **Output growth continues to be strong.** Based on the revised official data, GDP growth in 2005 reached nearly 10 percent, roughly the same as in the previous year (Table 1 and Box 2). Indicators for the major components of demand suggest that output growth in 2005 could have been much higher than officially estimated. Consumption growth has remained high, and investment growth showed signs of increasing beginning in the second half of the year. The contribution of net exports to growth also increased significantly during 2005.

5. **Economic activity maintained its momentum in 2006, with further evidence of acceleration in investment.** GDP grew by 10¼ percent (year-on-year) in the first quarter. Total nominal fixed investment increased from 25.7 percent in 2005 to 29.8 percent in the first half of 2006. Net exports continued to be strong, although the pace of import growth has accelerated. Indicators also suggest that consumption growth remained high.



6. **Inflation remains subdued.** After peaking at 5¼ percent (year-on-year) in mid-2004, headline CPI inflation fell to 1½ percent in May 2006, largely driven by a significant moderation of food price inflation, as agricultural production returned to more normal levels. Non-food inflation also was held down by partly offsetting movements in major components. Price declines have persisted in such items as clothing and household durable goods, reflecting rising capacity and contributing to oversupply in some products, as well as declining unit costs owing to continuing strong increases in productivity. This has been more than offset by price increases in services—including health care, education, and household maintenance—and rising fuel costs. Producer price inflation continues to fall from its peak of 8½ percent in late 2004 to about 2½ percent in May 2006, reflecting some easing in materials prices, especially as new production capacity in steel, chemicals, and coal has come on stream.

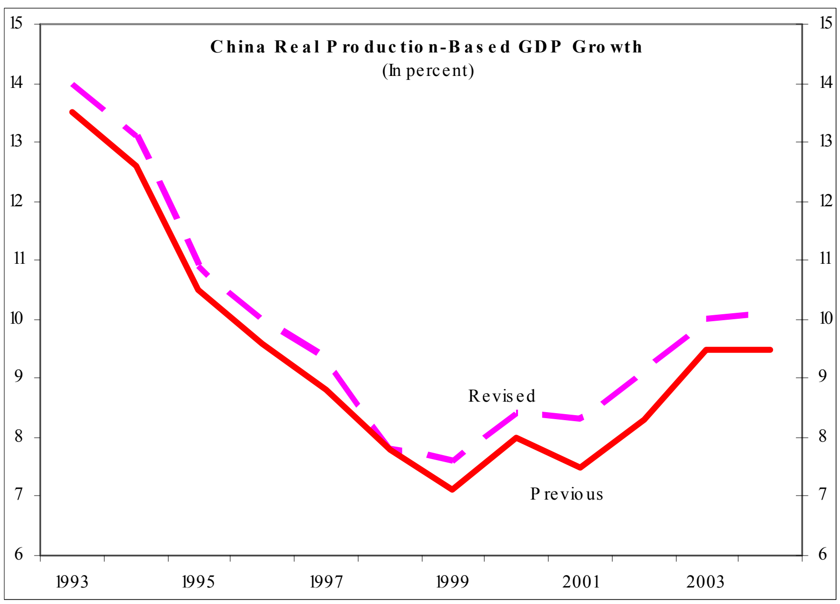


Box 2. Recent Revisions in China's Official GDP Figures

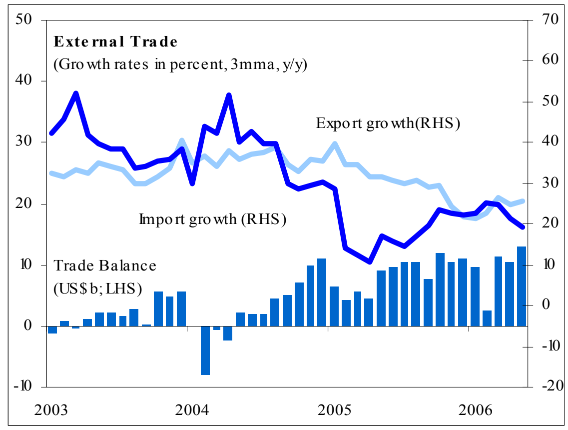
Based on a comprehensive economic census of businesses, China increased the estimate of GDP in 2004 by 17 percent. Based on the 2004 data, a standard statistical technique (the trend-deviation method) was then used to estimate revised data back to 1993. Real GDP growth was raised by an annual average of about ½ percentage point (see figure below) and the 1993–2004 average for GDP growth increased to 9½ percent.

The bulk of the upward revision came in the service sector, which increased by almost 50 percent. As a result, the share of the service sector in 2004 GDP increased by 9 percentage points to 41 percent. Manufacturing's share of output was revised up by only 4 percent as a result of the census.

The revised data show higher GDP implicit price inflation, especially in recent years. In particular, estimated inflation in the service sector increased substantially, with the 2000-04 average annual implicit inflation for this sector nearly doubling from 1¾ to 3½ percent in the revised data.



With regards to expenditure side estimates of GDP, only 2004 data have been revised and published so far, and the 2005 preliminary data using the new methodology have recently been published. The largest revisions were to government consumption and inventories. As a result, the GDP shares of household consumption and gross fixed capital formation both fell slightly, with each accounting for about 40 percent of GDP.



7. **The external position strengthened substantially in 2005.** The trade surplus was the main driver, surging to $134.2 billion compared to $59 billion in 2004 (BoP basis, Table 2-3). Export growth remained strong throughout most of the year, but import growth slowed sharply in the first part of the year before picking up in the second half. The overall slowdown in import growth resulted in a large increase in the current account surplus in 2005 to over 7 percent of GDP, up from 3½ percent in 2004. This slowdown largely reflected a switch away from imports toward domestically produced inputs, a moderation in investment demand for machinery, and some reduction in raw material inventories. Export growth was robust given strong world demand and China's increasing role in the processing trade. The expectation of the renminbi appreciation may have played a role in the rise of the trade surplus, although the impact is unlikely to have been very large.[1]

8. **The trade surplus continued to rise in 2006**, with the $61 billion surplus in the first six months of 2006 up 50 percent from the same period last year. Import growth has picked up somewhat, driven mostly by primary products and machinery, while export growth remains strong. Last year's agreements to limit exports to the United States and the EU of textiles and apparel, which are a small share of China's total exports, appear to have had a very limited impact on China's export growth thus far.[2]

9. **Foreign official reserves accumulation has continued at a rapid pace.** Reserves increased by $208 billion in 2005, broadly in line with reserve accumulation in 2004, and by a further $106 billion in the first five months of 2006, bringing the level at end-May to about $925 billion (Table 4).[3] Reserve accumulation in the second-half of 2005 was increasingly driven by trade flows, in contrast to the situation in 2004 and the first half of 2005 when speculative inflows played a larger role. Net FDI inflows, at $68 billion in 2005, increased compared to 2004 despite a jump to $10 billion in China's foreign investment abroad. Over the period, non-FDI capital flows sharply reversed to an outflow of $22 billion in 2005 (including errors and omissions), compared to an inflow of $85 billion in 2004. The renminbi has fluctuated significantly in both real and nominal effective terms reflecting the volatility of the U.S. dollar against other currencies, and in May 2006, it was about 15 percent below its previous peak in February 2002.

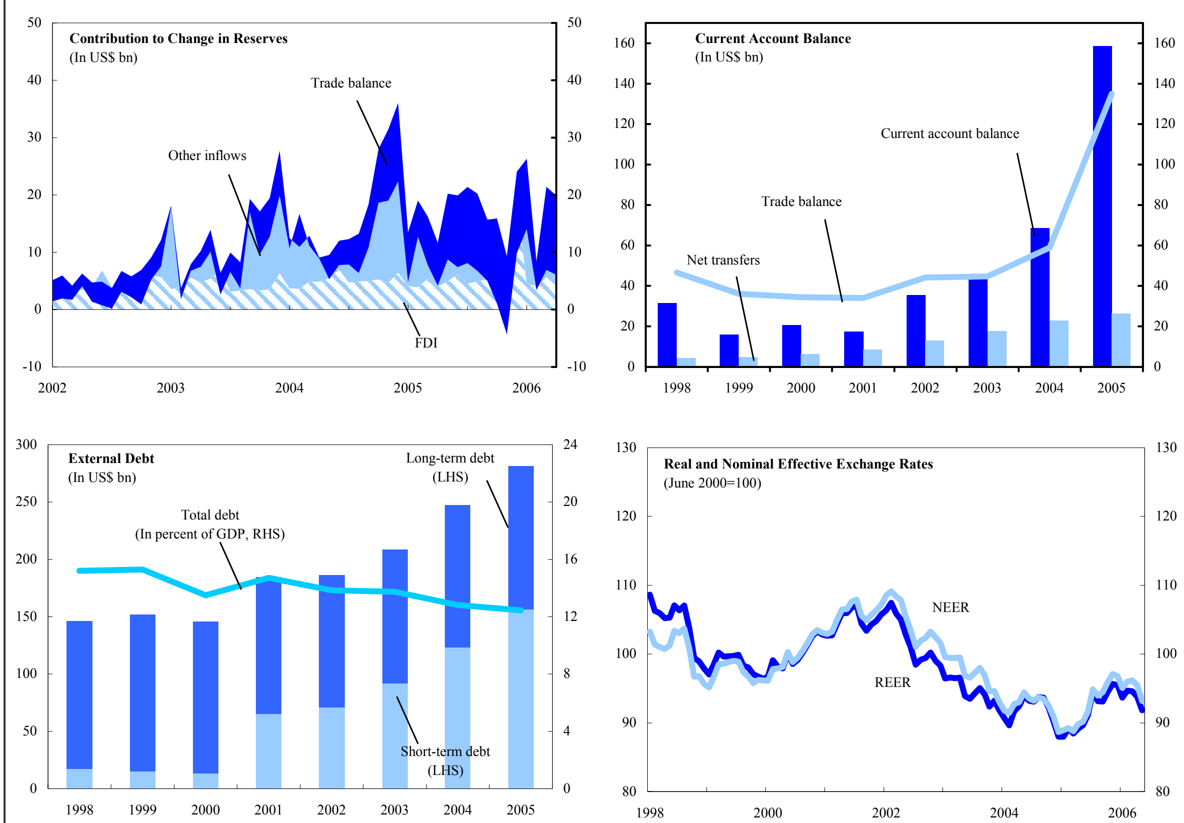
[1] The Selected Issues paper discusses the factors underlying the increase in the current account surplus in 2005.

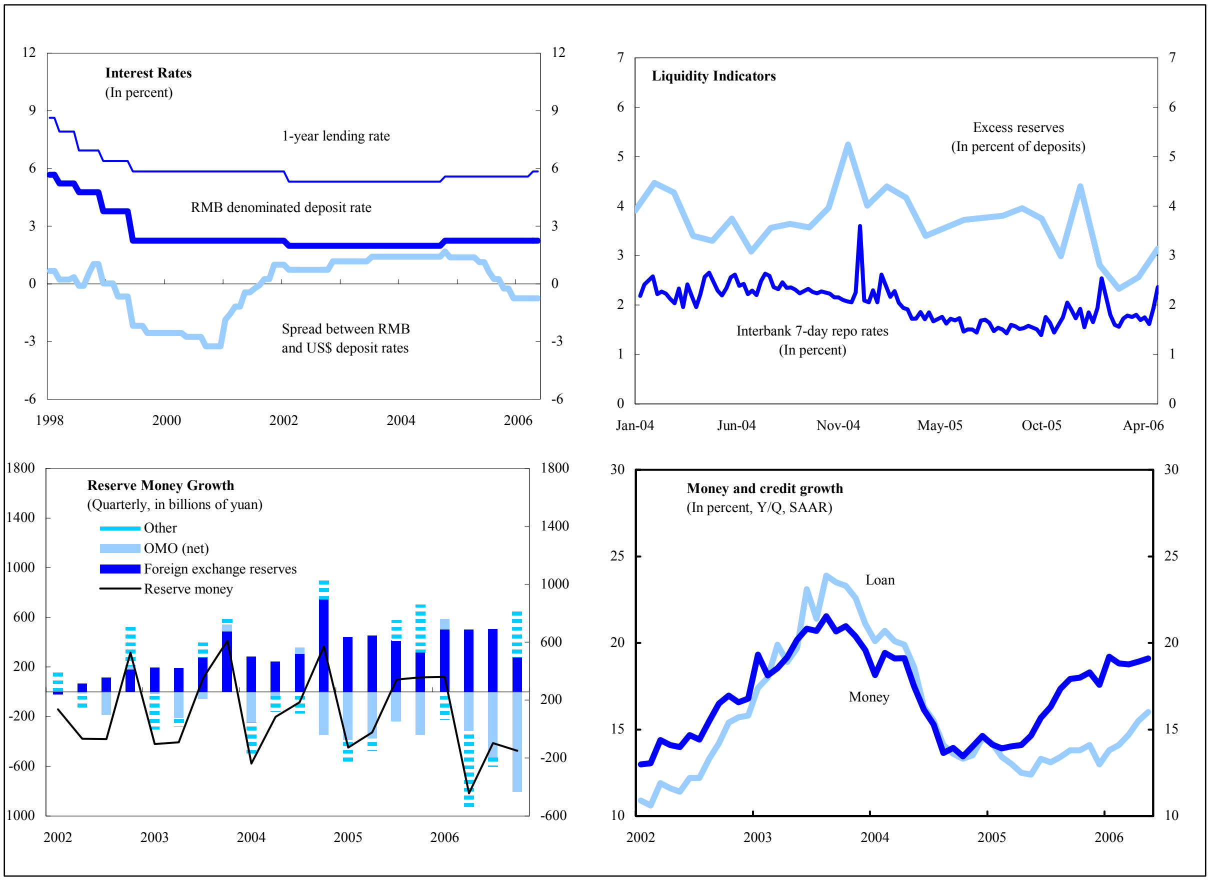
[2] Textiles account for about 14 percent of Chinese exports. In addition to an earlier agreement with the EU, China and the United States reached an agreement limiting exports of certain textiles and apparel items beginning in 2006, setting volume growth limits in a range of 10-17 percent annually through 2008.

[3] Adjusting for capital injections to banks from official reserves and foreign exchange swaps of the central bank, reserves rose by $236 billion in 2005, compared to a $206 billion rise in 2004.

China: A Decomposition of the Reserve Buildup (In billions of U.S. dollars)	2004			2005			2006 1/
	H1	H2	Year	H1	H2	year	Jan.-Apr.
Foreign reserve increase	**67**	**139**	**206**	**100**	**107**	**207**	**76**
Current account balance	**7**	**61**	**69**	**67**	**94**	**161**	**59**
of which: Balance of goods and services	0	49	49	50	74	125	44
Capital and Financial account balance 2/	**59**	**78**	**138**	**33**	**13**	**46**	**17**
FDI, net	30	23	53	22	45	68	16
Non-FDI, net	29	56	85	11	-32	-22	2

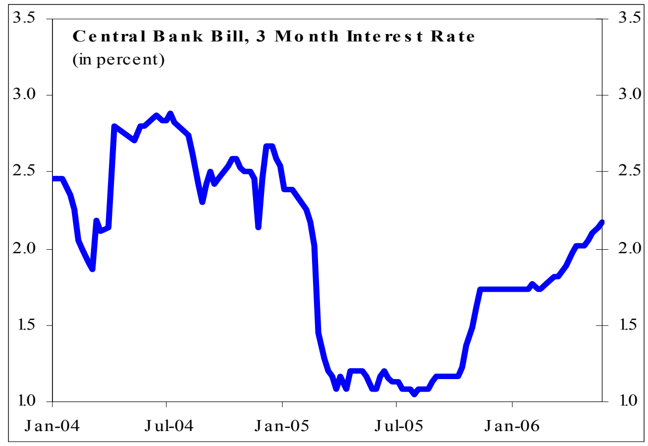
1/ Staff estimates.
2/ Includes errors and omissions.



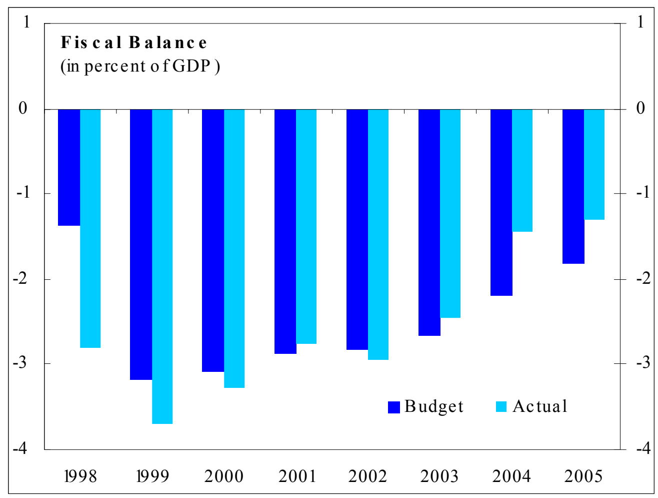


10. **The equity market has been buoyant in 2006, while the rapid growth in property prices has eased.** Progress in equity market reforms, especially in reducing the overhang of non-tradable shares, has helped boost the market—as of mid-June the index for the Shanghai Stock Exchange had increased 35 percent over its end-2005 level. Nevertheless, the market is still 25 percent below its end-2000 level. Property price growth peaked at over 10 percent in the fourth quarter of 2004, and by end-2005 growth had slowed to 6½ percent, partly reflecting the government's control measures. Prices in Shanghai, particularly in certain sections of the city, declined sharply. However, concerns of a rebound in property prices in other urban areas have recently surfaced, with the authorities launching new policies to regulate the property sector, including measures to limit luxury housing developments.

11. **Less than full sterilization of foreign exchange reserve accumulation has left substantial liquidity in the banking system, and credit growth appears to be accelerating.** While broad money (M2) growth has increased since mid-2005, reaching a 17½ percent annual rate by the end of the year, credit growth, averaging around 13½ percent in 2005, remained relatively subdued, reflecting more cautious lending by the large state-owned commercial banks undergoing restructuring and moral suasion on the part of the PBC (Table 5). Broad money growth continued to rise in the first part of 2006, and lending growth picked up as well. By May, M2 and lending were growing at rates of 19 and 15 percent respectively. In response, the PBC increased the benchmark lending rate in April by a modest 27 basis points, and administrative controls and lending guidance were increased.



Reserve requirements were raised by ½ percentage point in June and further administrative measures and lending guidance were initiated. The PBC also introduced a new series of central bank bills that are being sold on a mandatory purchase basis at below market interest rates to banks with fast lending growth. Short-term interest rates have risen somewhat since early November as the PBC stepped up open-market operations, but they still remain below the 2½-3 percent levels of 2004.



12. **Strong revenue overperformance allowed for a further decline in the fiscal deficit in 2005.** At 1.3 percent of GDP, the deficit was lower than the 1½ percent of GDP recorded in 2004 and was ½ percent of GDP better than budgeted (Table 6–7). Revenue, growing at a rate of 20 percent, exceeded budget projections by ¾ percent of GDP, reflecting particularly strong income tax and VAT receipts. In a repeat of developments in 2004, part of the revenue overperformance was used to increase spending on social programs and clear pending liabilities, including repaying all remaining arrears on VAT refunds. As in 2004, local governments recorded a large surplus (about ½ percent of GDP), in part reflecting late transfers from the central government. The 2005 outturn continues the trend of fiscal consolidation over the last few years. If the timing of the build-up and repayment of VAT refund-related arrears is accounted for, the pace of consolidation would be much faster than what the cash-based data show, with the 2005 outturn being near balance.[4] The budget outturn through April 2006 shows that revenue performance continues to be very strong, exceeding the growth rate projected in the 2006 budget.

[4] Clearing of arrears—typically a below-the-line item—is treated as above-the-line expenditure in China's official fiscal accounts.

C. Macroeconomic Outlook and Risks

13. **Staff projects GDP growth to remain around 10 percent in 2006.** This forecast assumes that appropriate macroeconomic policies will be in place to constrain investment growth. However, recent data for investment and exports point to the increasing possibility that GDP growth could exceed 10 percent. Even if policy actions are taken now to constrain investment, the main impact of tightening measures on growth are likely to be experienced in 2007. The outturn in the first five months of 2006 also suggests that export growth may not slow as much as generally expected, which not only would boost GDP growth, but would result in a further widening of the external current account surplus.

14. **Inflation is expected to remain below 2 percent in 2006**. Although consumption growth has remained strong, much of the economy's rapid growth rate has been driven by investment. This has continually added to the economy's productive capacity and in some sectors, such as automobiles and steel, it has led to overcapacity. At the same time, the substantial liquidity in the banking system and the associated acceleration in credit growth have been largely confined to financing investment and not consumption. Moreover, although wage rates have risen in recent years, with substantial underutilized labor resources in the economy, the wage increases have been relatively modest. Indeed, wage and disposable income as a share of GDP remain significantly below even their early 2000 levels (Box 1). As a result, despite the rapid overall growth, inflation has been subdued and is likely to remain so in the near term. Falling prices in sectors with overcapacity offset the likely rise in services inflation and upward adjustments in certain administered prices.[5] As nontradables make up much of the households consumption basket, an appreciation of the currency is unlikely to have a significant direct downward impact and with overcapacity confined to certain sectors at present, the risk of generalized deflation appears small. The risk of a sharp rise in inflationary pressures is also limited, given that consumer credit facilities remain limited.

15. **A significant risk remains that macroeconomic policies will not be sufficiently tight to contain investment growth.** In particular, there appears to be a need for monetary policy to be tightened further to prevent a surge in credit growth from tipping off a boom-bust cycle and an associated rise in banks' nonperforming loans. There is also a risk that, as in the past, it may be difficult to slow investment growth in the run-up to the scheduled change in government in early 2008 (when positions in all levels of government are shuffled). Among other major risks to the outlook, a further sharp increase in oil prices would adversely affect growth both directly and indirectly if this leads to a more pronounced slowdown in global demand.[6] Growing protectionist sentiments in China's major markets

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[5] Prices of utilities and other public services are slated to rise this year, and some modest increases in petroleum product prices are expected to bring them closer in line with world oil prices.

[6] The direct impact of high world oil prices has been limited so far, as the government has not implemented a full pass-through to domestic prices, although in recent months the authorities have taken steps to increase the retail prices of oil products. As a result, gasoline and diesel prices in May 2006 remained about 15 percent and 40 percent below comparable U.S. prices. Despite the restricted pass-through at the retail level, China's oil companies with integrated downstream and upstream operations have generally continued to post significant profits.

also present a major risk. Moreover, a disorderly unwinding of global imbalances would threaten China's growth, as economic activity in partner countries would likely suffer lingering adverse effects. Although less immediate, avian flu remains a threat.

16. **China's medium-term prospects are favorable, but the savings-investment gap would remain large unless further structural reforms and policy changes are implemented to rebalance growth.** The illustrative scenario presented in Table 8 suggests that GDP growth could average around 9¼ percent annually, but the saving-investment gap would remain high at around 6 percent of GDP. To reduce this gap, reforms and policies are needed to rebalance growth away from heavy reliance on investment and exports toward domestic consumption by improving intermediation of savings through further banking sector reform and capital market development, and continuing reforms in the state-owned enterprises and the labor market to maintain strong productivity growth. In addition, reforms to China's pension, education, and health care systems, along with a shift in public expenditures toward these areas, are important in helping to increase private consumption by reducing the need for large precautionary savings. These reforms and policy changes would reduce the saving-investment gap over time, but it would also critically depend on how the real exchange rate might change in the coming years. [7]

17. **In the absence of such a rebalancing, medium-term prospects are subject to significant risks.** Growth could be threatened if China were to continue to rely heavily on inefficient investment as a primary source, especially if such investment leads to overcapacity and falling prices and profitability, burdening banks with additional NPLs in the coming years. If reform of the domestic financial sector is not advanced substantially, vulnerabilities will continue to increase as China further integrates into the global economy, and capital account liberalization would expose the economy to potentially large swings in the direction of capital flows, as household and corporations diversify their portfolios. If changes in the real exchange rate occur through nominal exchange rate adjustment, inflation would remain modest. If the nominal exchange rate remains largely unchanged, then at some point in time, real exchange rate adjustment will have to take place through higher inflation. The adverse effects of this outcome would disproportionately be experienced by the poor, especially in rural areas. A rise in social stresses within China (if, for example, income gaps between the rural and urban areas increase substantially) could also present a significant risk over the medium term.

[7] Following convention, the exchange rate on a real effective basis is assumed to remain unchanged in the illustrative scenario presented here. The impact of a real exchange change was discussed in Chapter II of last year's Selected Issues paper.

II. POLICY DISCUSSIONS

18. **The authorities broadly agreed with the general economic outlook presented by the staff.** They argued that GDP growth is unlikely to slow in 2006, and that inflation should remain subdued but the risk of deflation should be low. There was general agreement among the authorities that excess liquidity in the banking system and strong local government incentives to invest could add to the rebound in investment and bank lending growth already underway. On the external front, the authorities argued that structural factors would likely keep the current account from narrowing rapidly, emphasizing the need for policies to rebalance the economy away from export-led growth toward consumption. Against this background, the discussions focused on near-term macroeconomic challenges and the exchange rate, as well as policy actions needed over the medium term to make growth more sustainable by rebalancing its composition.

A. Monetary Policy

19. **The staff stressed the urgency of monetary policy actions to prevent a further acceleration in investment growth.** The staff argued that a serious situation is looming, with substantial and growing liquidity in the banking system, continuing local government pressure on banks to expand their lending, and restraint on credit growth by the large banks diminishing as they complete their recapitalizations. In addition, financial innovations, such as the introduction of short-term corporate bills and discount bills, have lowered borrowing costs. Without a significant further tightening of monetary policy, a continued rise in credit growth would fuel a further increase in investment growth that would likely be followed by price declines in overcapacity sectors and an associated rise in banks' nonperforming loans.

20. **The authorities recognized the need to contain investment and credit growth, but there were some differences regarding the urgency of action and what measures should be used.** The authorities noted that they had intensified open market operations (OMOs) during 2006. While they agreed that market-based monetary policy instruments needed to be used, the authorities maintained that administrative measures would still be needed, as these were better suited to restrain growth in specific sectors where overinvestment was a particular concern. Steps taken by the authorities subsequent to the discussions reflect this view, with a combination of administered measures and monetary policy actions having been put in place. The staff continues to believe that more steps will need to be taken and that greater reliance should be placed on OMOs, perhaps supplemented by further increases in benchmark interest rates and/or reserve requirements.

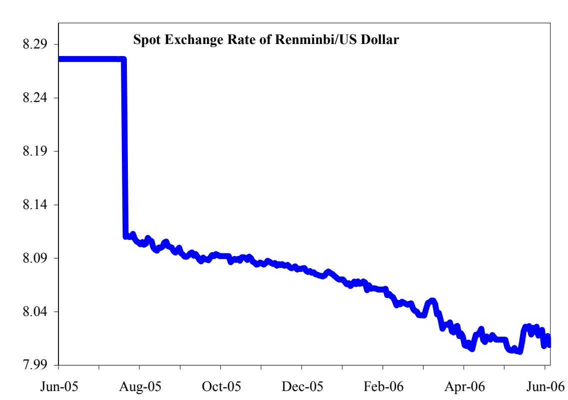
21. **More broadly, the staff urged the authorities to take steps to improve the effectiveness of indirect monetary policy instruments to manage the economy better.** In recent years, China's monetary policy has sought to balance low inflation with continued strong growth, using monetary aggregates as intermediate targets. These aims and the PBC's basic policy framework remain appropriate at this stage of China's economic and financial market development. However, the burden of having to tightly manage the exchange rate in the face of foreign exchange inflows has created a major conflict in monetary policy implementation. To circumvent this conflict, the authorities have relied on moral suasion and administrative controls to restrain credit and investment growth and keep inflation low.

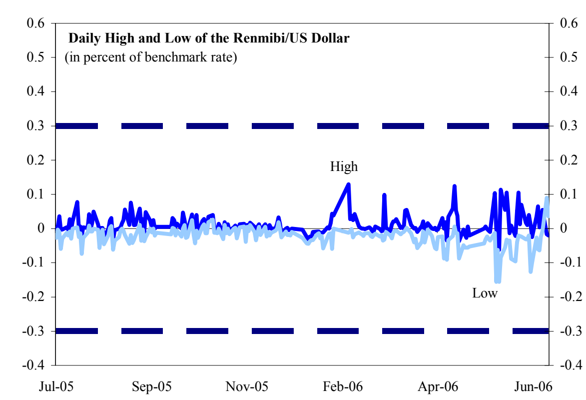
While some use of administrative measures may be warranted at this juncture, the staff argued that over time the effectiveness of administrative controls will diminish as the sophistication of the economy increases. At the same time, the potential costs of the distortions that these controls create could grow larger. Trying to influence bank lending decisions also directly contradicts the government's goal of creating a banking sector operating on a sound commercial basis. Thus, the staff emphasized that allowing the exchange rate to move more flexibly and be increasingly determined by market conditions would help to improve the authorities' control over monetary policy, and the current exchange rate arrangement provides sufficient room to do this without exacerbating capital inflows. The lack of discretion given to the PBC to set interest rates is also an impediment to timely policy action.

22. **The staff noted that over time, it will be important for the PBC to formalize its policy framework**, establishing an appropriate nominal anchor for monetary policy, and more clearly articulating its policy objectives. This would help to underpin market expectations about inflation, interest rates, and the exchange rate. In this regard, the now regular publication of the Monetary Policy Report by the PBC provides a convenient vehicle to increase the transparency of monetary policy formulation.

B. Exchange Rate Regime

23. **Since July 2005, the authorities have undertaken several reforms to improve the functioning of the exchange market, but the rate remains tightly managed.** These reforms represent significant steps and can potentially allow market forces to play a substantial role in determining the exchange rate (Box 3), while allowing banks and enterprises to hedge against greater variability in the rate. These steps have significantly improved the functioning of the spot and forward exchange markets, although these markets remain shallow given the limited variability in the rate. The PBC continues to dominate the foreign exchange spot market—the lack of any discernible appreciation in the renminbi-U.S. dollar rate in recent months, particularly when the dollar had been depreciating against other currencies, and the continued heavy accumulation of reserves serve to confirm this view. The average intra-day fluctuation in the renminbi-dollar rate has remained below the 0.3 percent limit, although it has increased in recent months. Moreover, after the initial 2.1 percent revaluation in July, the renminbi-dollar rate has appreciated by only about 1½ percent.





Box 3. Recent Measures to Liberalize the Foreign Exchange Market

Previously, spot trading of foreign currency occurred through the official foreign exchange market, the China Foreign Exchange Trading System (CFETS). In practice, banks settled currency trades internally throughout the day, limiting their sale of excess foreign exchange in the CFETS to once or twice a day to minimize transactions costs given the limited volatility in the exchange rate. Thus, the volume of transactions in the foreign exchange market was relatively small.

Following the July 2005 reform to the exchange rate regime, a number of steps have been taken to deepen the foreign exchange market and allow market forces to potentially have a greater influence on the exchange rate.

- The number of participants in the interbank market (both domestic and foreign) has been increased.
- Since January 2006, a market maker system in the spot trading of foreign exchange has been in operation. Fifteen banks have been appointed as market makers in the spot market, and they are allowed to trade among themselves in over-the-counter (OTC) trading off the floor of the centralized interbank market (CFETS). The new system allows the market makers to trade with each other directly without paying the high transactions fees charged in the CFETS, which in turn generates more frequent intraday trading.
- The rule for setting the CFETS central parity for the exchange rate has also been changed. Under the new rule, the central parity rate of the renminbi against the dollar (the benchmark rate) is set each morning (at 9:15 a.m., before CFETS trading begins at 9:30 a.m.) based on a weighted average of the prices the market makers intend to offer. This is in contrast to the previous arrangement where the central parity rate was the closing price of the previous trading day on the CFETS floor. Thus, depending on the prices quoted by the market makers, the central parity rate can change by any amount at the start of a trading day, but intraday movements remain constrained by the ±0.3 percent band.
- The market infrastructure has been improved, including by allowing the trading of forward contracts and swaps.
- In April-May 2006, the government also eased restrictions on payments for foreign services by individuals, outward investment by institutional investors and direct investment abroad by Chinese firms.

While these recent reforms are important for the development of the exchange market, they have not had a significant impact on exchange rate movements.

- The volume of transactions since February 2006 in OTC trading has increased significantly to over 90 percent of total trading volumes, an inter-day volatility in the RMB/US$ rate has risen since March.
- The reforms have reduced PBC's status of being an active participant in the market to that of an active client of the market makers. However, given that the PBC is still the largest client by far, it continues to retain considerable influence over the exchange rate.
- The benefit of these reforms so far has been increased involvement by banks in trading and monitoring of exchange rate movements. Over time, this will prepare banks to manage their foreign exchange flows and risks, helping them to adapt to an environment where the PBC allows more exchange rate volatility.

24. **On a real effective exchange rate basis, the renminbi by May 2006 has returned to roughly its June 2005 level despite the revaluation and change in the exchange rate arrangement.** In fact, movement in the renminbi's real value over a considerable period of time has not been in line with most fundamental factors that are generally considered to be important in determining the exchange rate's real value. In particular, since the previous peak in the renminbi's real effective value in early 2002, the currency has depreciated, while such factors as a substantial net foreign asset accumulation and a sharp rise in China's productivity relative to partner countries over the period since 2001 would be expected to have contributed to a real appreciation of the currency.[8] The current account surplus also has risen from 1.3 percent of GDP in 2001 to 7.2 percent in 2005, with the surplus doubling as a ratio to GDP in 2005 alone. With investment as a ratio to GDP continuing to rise during this period, the surge in the current account surplus represents a widening of China's savings-investment balance that is explained by an increase in government savings associated with fiscal consolidation and a substantial rise in corporate savings that is increasingly difficult to explain in terms of fundamental determinants of savings behavior. It is especially difficult to pinpoint a change in such fundamental determinants that would explain the doubling of the surplus in relation to GDP in 2005 and that would suggest that the surplus at its present level could be considered to be a new "normal" level of the savings-investment balance for China. In addition, gross official reserves have risen from $219 billion in 2001 to $930 billion at end-May 2006, with more than $200 billion of reserves accumulated in each of the past two years and another $100 billion in the first five months of 2006. Some of the reserve build-up in 2004 was related to non-FDI capital inflows that may have reflected speculation of renminbi revaluation, but since the first half of 2005, these inflows have diminished substantially. All of these developments point to the currency as being undervalued and that this undervaluation has increased further since last year's Article IV consultation.

25. **The authorities stressed their commitment to the managed floating regime and argued that exchange rate movements since July 2005 were consistent with the new exchange rate arrangement.** They noted that under this arrangement the exchange rate was determined by the supply and demand conditions in the foreign exchange with reference to a basket of currencies (with undisclosed weights). The rate was not intended to be directly pegged to the basket, and short-term deviations from the reference basket were to be expected. The appreciation of the dollar against other major currencies in the period after the July change had led to a deviation from strict adherence to the basket and accounted for the stability in the bilateral exchange rate through March. The authorities suggested that more recently, supply and demand conditions in the foreign exchange market were one factor accounting for the stability of the rate despite the sharp depreciation in the U.S. dollar, with the easing of capital controls in April possibly increasing the demand for dollars.[9]

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[8] From February 2002 to May 2006, the real effective value of the currency has declined by 15 percent.

[9] In mid-April, the government announced limited measures that would ease restrictions on holding foreign exchange bank accounts, simplify approval of service payments in foreign currencies, and allow institutional investors to invest overseas. Regulations formulated to implement these changes suggest that the increase in capital outflows will continue to be tightly controlled, and their effect on capital outflows is likely to be limited.

26. **The authorities noted the substantial problems in making an assessment of the level of the exchange rate, particularly in China's case** where there were large uncertainties over the underlying savings-investment balance, the implicit debt the economy faced in reforming the banking sector and social services, and possible speculative current and capital account inflows because of expectations of a renminbi revaluation. In addition, they argued that China's large current account surplus was less a result of an undervalued currency, but more a result of China's increased openness and the increasing shift of processing trade operations to China by multinational companies taking advantage of favorable labor market conditions. Restrictions on imports of high-technology products were another factor contributing to this surplus. The staff agreed that increased global integration has contributed to a growing current account surplus, but argued that this was not inconsistent with an assessment pointing to further undervaluation of the exchange rate.

27. **The authorities agreed that greater flexibility was needed over the medium term, but stressed that exchange rate reform would have to proceed in a gradual and controllable manner.** They argued that even a significant appreciation of the exchange rate was unlikely to have a large impact on the trade balance, especially since the effects of such a change would be largely felt by exporters of low value-added goods. Their concerns continue to center around potential adverse impact of an exchange rate appreciation on macroeconomic and financial sector stability. In particular, such an appreciation could have a significant adverse impact on employment because low-value added goods tended to be labor-intensive. Given that almost half of rural income was derived from migrant wages, including in such industries, an appreciation could have a substantial negative impact on rural income. The authorities also had doubts as to whether the banking system was sufficiently sound at present to be able to manage a significant exchange rate appreciation. The staff argued that the overall impact on the economy of a moderate, but significant, appreciation would be manageable, and any adverse effects on rural incomes could be mitigated through budgetary measures, such as transitional income support for affected households and advancing the implementation of plans to increase support for health care and education in rural areas. In the financial sector, the impact of such an exchange rate change would be small, given the limited foreign exchange exposure of the banking system and its clients and the availability of instruments to hedge foreign exchange risk. However, the authorities were not persuaded that the disruptive effects of a significant appreciation would be manageable, and thus they saw a need to proceed with caution.

28. **The staff stressed the need to utilize more fully the flexibility provided by the current exchange rate system to allow greater movement in the renminbi-dollar rate and a further significant appreciation of the currency in nominal effective terms.** The staff argued that China's current exchange rate arrangement provides sufficient flexibility to allow for such an appreciation, which is in China's best interest. The timing is right given the strength of the Chinese economy. Increased flexibility would provide much needed space to exercise greater monetary policy control. With limited nominal exchange rate flexibility, the expansionary impulse of reserve accumulation on domestic monetary conditions is being contained to a substantial extent by financial repression. This works at cross purposes with the banking sector reforms since it directly conflicts with the government's aim to create a banking sector operating on a sound commercial basis. From a near-term perspective, greater flexibility would create more room to enable the central bank to use open market operations

to help tighten liquidity conditions without triggering a renewal of speculative inflows. That said, the staff emphasized that exchange rate flexibility, not just appreciation, is what is needed for China's economy going forward. The authorities acknowledged that limited flexibility of the exchange rate creates a conflict in monetary policy, but they were confident that they could manage the situation. The staff said that it could not be done without creating distortions through further repression of the banking system, and noted that it would be better to eliminate the source of the conflict by allowing more flexibility in the exchange rate.

29. **Greater flexibility of the exchange rate of the currency will also contribute to the sustainability of China's growth by helping to the rebalance the economy over the medium term.** It will aid in improving the allocation of investment and its efficiency by giving the right price signals to investors. By increasing households' purchasing power, it will boost consumption. In addition, it may help avert the build-up of short-term foreign currency liabilities that would occur if the exchange rate remains undervalued and financial repression continues, thereby reducing the risk of what could be a significant source of vulnerability.

30. **Some have raised concerns that a renminbi appreciation could push the economy into deflation and the kind of prolonged recession experienced by Japan in the 1990s.** These concerns have been echoed by some Chinese officials. The staff believes that this view is based on a misreading of Japan's experience. Japan's "lost decade" can be mostly traced to an asset price bubble that was the result of an overly loose monetary stance and lax financial supervision and regulation, along with resistance to a real appreciation of the country's currency. The collapse of this bubble caused severe financial and corporate sector strains. The key lesson for China from this experience is that an early move to greater exchange rate flexibility would be desirable. While an appreciation could potentially exert deflationary pressures in the near term, this is less of a concern in the current environment where low inflation is the result of declining prices in certain sectors where previous high levels of investment have led to excess capacity. In addition, the authorities could use the low inflation environment to raise certain administered prices such as those of utilities, where increases are overdue and much needed to improve resource allocation and efficiency in the economy.

31. **From a global perspective, exchange rate flexibility would not only serve China's best interest, but would also help contribute to an orderly process for resolving global current account imbalances.** The authorities argued that dealing with global imbalances requires a concerted effort on the part of all countries to take policy actions, including meaningful fiscal consolidation in the United States, structural reforms in Japan and Europe, and greater investment in the oil-exporting countries. The staff noted that China can play an important role in reducing imbalances through policy actions that are in its own interest, including greater flexibility of the exchange rate, which would permit a significant appreciation, coupled with China's structural reforms aimed at rebalancing economic growth. The authorities responded that the imbalance of China's current account could not be solved solely and fully by changes in the exchange rate, and that the most effective way to deal with the external surplus was through policies and structural reforms that would rebalance China's economy toward self-sustaining domestic demand, while cautioning that this would take time. They stated that the problem of global imbalances was caused in large part by the United States and should be dealt with primarily by the United States taking appropriate

policy actions. The staff acknowledged that on its own the direct contribution of an appreciation in China's exchange rate to reducing global imbalances might not be large, but such a change in combination with other measures to rebalance China's growth and necessary policy actions in other major economies would make a major difference. This is why the Fund was calling for decisive policy actions by all major countries to help deal with the problem.

C. Fiscal Policy

32. **The 2006 budget is appropriate from a near-term perspective.** The budgeted deficit is largely unchanged from its targeted level in the 2005 budget**,** implying a deficit of roughly 1½ of GDP (official definition) in 2006. Revenue is conservatively projected to increase by 12 percent, and expenditure is budgeted to rise by 14 percent. Revenues are once again likely to exceed budget estimates, and the authorities indicated that revenue overperformance would be used for additional transfers to poorer regions, social sector spending, and support for farmers. In the absence of concrete plans and adequate controls to monitor higher spending, the staff encouraged the authorities not to embark on *ad hoc* spending measures to increase consumption in the near term. Rather, the staff emphasized building on some of the pilot projects currently being implemented by selected local governments to broaden and reform the provision of social services, such as health care, education, and pensions.[10] The authorities agreed that overly ambitious spending now that exceeds implementation capacity would be wasteful, and that efforts should be focused on developing and implementing comprehensive plans to improve the provision of social services. As formulation of spending plans and implementation capacity improve, the staff believes that expenditure in these areas can be ramped up over the medium term. As a consequence, the budget deficit could rise over time, but fiscal consolidation over the past few years would allow this without jeopardizing longer-term fiscal sustainability.

33. **Improving the quality and scope of the provision of health care and education is critical to reducing households' precautionary savings.** China's government sector spends much less on health and education than comparator countries, and further increases in spending in these areas are needed. Public spending on education, although growing, remains relatively low, and is a major obstacle to improving compulsory education. Public spending on health care as a share of total health care spending has declined over the last decade, with the result that the share of out-of-pocket spending by households in total health care spending reached almost 60 percent by end-2003, from 20 percent in 1978. The government has recently launched new programs to strengthen education services and health insurance in rural areas. These programs are being implemented by a number of local governments, and are slated to be scaled up nationwide over the next few years. In the area of education, tuition and fees are being eliminated for compulsory education in rural areas. As part of efforts to raise spending, it will also be important to address capacity constraints, especially the availability of trained personnel.

[10] Developments in social spending are discussed in the Selected Issues paper.

34. **Pension reform also can contribute to boosting consumption by reducing savings.** Currently, China's pension system covers only about a quarter of the workforce. The provision of the bulk of these pensions is assigned to lower levels of government. The resulting decentralized and fragmented nature of the pension system does not ensure adequate coverage, is inefficient, does not appropriately pool risks, impedes labor mobility, and has strained local government finances. Moreover, parameter changes are required to ensure the sustainability of the current pension system, including raising the retirement age and changing benefit payments. Some pilot pension reform programs are underway, but they do not fully address all of the shortcomings in the current system.

35. **The authorities and the staff agreed that ensuring the effectiveness of increased spending on social services required further essential measures to strengthen fiscal management, including through better formulation and execution of the budget.** The authorities reiterated their commitment to continuing the reform of the budget process, including by putting in place as scheduled the revised budget classification and chart of accounts, and fully implementing the treasury single account. The new budget classification and chart of accounts are to be in place by next year, and the 2007 budget will be prepared in line with them.

36. **The authorities and the staff also agreed that center-local fiscal relations were in need of significant reform and would play an important role in rebalancing the economy and spreading the benefits of growth.** Income disparities across regions continue to widen, with some localities facing difficulties in funding expenditure mandates especially in health and education. The staff encouraged the authorities in their efforts to address structural imbalances in subnational finances, including by developing a comprehensive strategy that reassesses tax assignments across levels of government, rebalances expenditure responsibilities in line with resources, and reforms the transfer system toward a more rule-based system that ensures all local governments have resources adequate to meet their spending responsibilities.

III. Structural Reforms to Rebalance Growth

A. Banking and Capital Market Reforms

37. **Improving the intermediation of China's large domestic savings through financial sector reforms will make an important contribution to rebalancing the economy.** As banks increasingly operate on a commercial basis and the capital market develops further, the allocative efficiency of investment is likely to improve, while a wider range of household credit instruments would enable households to borrow against future income and raise returns on financial assets, which should boost consumption and bring down the saving rate.

38. **The authorities have placed banking reform at the center of the effort to improve intermediation of China's large private savings**. By mid-2005, the authorities completed financial restructuring of three of the four major commercial banks, including China Construction Bank (CCB), Bank of China (BOC), and the Industrial and Commercial Bank of China (ICBC), through capital injections and sales of non-performing loans. By end-2005, all three banks announced the selection of major foreign financial institutions as

strategic investors with minority ownership stakes, and CCB and BOC have completed IPOs (Table 9). The system-wide ratio of NPLs to total loans declined to 8½ percent at end-2005 (from 13 percent at end-2004), with the three restructured banks having an average NPL ratio of 4½ percent. Banks accounting for 75 percent of total banking assets were compliant with the 8 percent capital adequacy requirement with full provisioning at end-2005.

39. **Nevertheless, the authorities and the staff agreed that further fundamental improvements are required in the banks' commercial orientation, risk management, internal controls, and governance.** Strict adherence to the timetables for implementing the business restructuring plans of the three major banks that have been recapitalized is essential. Banks will have to learn to price risk appropriately to make full use of the latitude provided by the 2004 liberalization of lending rates. Continued strengthening of banking supervision, in particular focusing on the enforcement of existing regulations, will aid the bank reform process. Diversified bank ownership may also speed up the process, particularly if foreign financial institutions, which have taken minority ownership stakes in the banks, transfer much needed technical expertise and demand better governance. The staff emphasized the importance of banks' meeting the capital adequacy rules that come into effect in 2007. In addition, the staff suggested that government involvement in the management and business operations of the banks should continue to be cut and eliminated over time. The authorities' decision after the discussions to force banks with high levels of lending growth to purchase special issues of central bank bills at below market interest rates illustrates one aspect of government interference in the banks' decisions that works counter to the basic intention of bank reform. Such financial repression is a direct consequence of the authorities trying to simultaneously achieve the conflicting goals of tightly managing the exchange rate and controlling monetary conditions.

40. **The staff stressed that particular attention should be given to activities of the Agricultural Bank of China (ABC)**. The ABC has been slow in restructuring its operations and lacks a concrete reform plan. In addition to the efficiency losses in the bank itself, further delay in reforming ABC risks creating serious moral hazard that could undermine the reforms of other banks. The staff urged the authorities to move quickly to adopt an ambitious reform plan, including a time-bound restructuring and recapitalization plan with appropriate performance parameters. The authorities agreed with the staff on the need to restructure the ABC, but noted that it presented a significant challenge given the scale of the bank's operations and the important role the bank plays in the agricultural sector. A restructuring of the bank is currently under consideration in the context of an economy-wide reform of rural financing, but this could take time to resolve. The staff advised that if that were the case, then interim restraints should be placed on the ABC's lending activities.

41. **Progress in reforming the rural credit cooperatives by improving their operations and strengthening balance sheets through capital injections continues**, and the authorities are on track to complete this reform by end-2007. The staff welcomed this initiative as potentially playing a significant role in helping to develop the rural sector. As in the case of the major state-owned commercial banks, establishing and supervising carefully the implementation of time-bound plans for improving the commercial orientation, risk management, internal controls, and governance arrangements for these institutions is essential for this reform to be successful.

42. **The staff welcomed the progress being made in improving bank supervision, although some key shortcomings remain.** The China Bank Regulatory Commission (CBRC) continues to strengthen on-site examinations and monitoring of large exposures and connected lending. The staff reiterated the importance that the CBRC ensure all banks are taking the necessary steps to comply with capital adequacy requirements with and full loan-loss provisioning by 2007, as required by existing guidelines, and enforce appropriate penalties for those banks which fall short. The staff also encouraged the CBRC to strengthen bank supervision further, in particular with regard to assessing banks' foreign exchange and credit risks, and emphasized that closer monitoring of the flow of new non-performing loans is critical to early detection of potential problems.

43. **The staff discussed steps needed to accelerate the development of China's capital markets which would also help to make investment more efficient and raise consumption over time (Box 4).** The limited role of capital markets in China at present reflects the dominance of the state banks in intermediation, but these markets are also plagued with regulatory and governance problems. Developing bond and equity markets is important for improving intermediation and increasing incentives for banks to seek out small- and medium-size enterprises. These reforms will help in increasing consumption by encouraging greater direct and indirect household participation in the equity and bond markets, which would allow households to diversify their portfolios and raise returns on them. As a result, consumption decisions would not be narrowly based on wage developments, but on more diversified sources of income. Expanding the bond market also would help in lowering corporate savings by reducing the need for enterprises to rely on internal savings to fund investment.

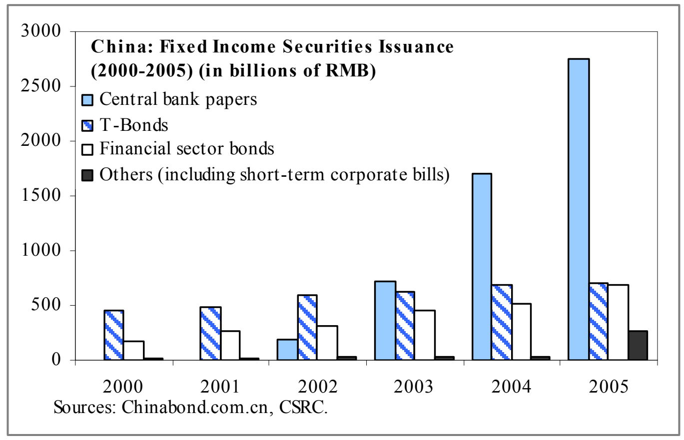
44. **The authorities have made progress in reviving the equity markets.** A critical step in this direction has been the reforms to convert the nontraded shares of state-owned companies listed on the stock market to tradable shares, which is expected to be largely completed by end-year. As a result, stock prices have significantly rebounded and interest in new IPOs and secondary placement offers has soared. Nevertheless, more needs to be done to ease access to the market and allow stocks to be publicly issued based on firms' disclosure of financial data and prospects.

45. **Progress also has been made in developing money and corporate bond markets, although much more needs to done in the latter area.** To boost development of the money market, a corporate bill market was established in 2005 which has grown rapidly. An interbank market for asset-backed securities was also established in November 2005. In the corporate bond market, the new Securities Act has removed some of the legal impediments that has kept the market from expanding. However, the current "merit" based bond issuance system, requiring government selection of each bond issue, has not been replaced by a disclosure-based system and the cap on corporate bond interest rates has not been eliminated.[11] In the staff's view, these are likely to continue to hold back the corporate

[11] Several government agencies currently play regulatory roles in the bond market, often with some overlap of responsibilities. As a result, the bond market is over-regulated, with state control inhibiting development. These and other impediments are discussed in Chapter VI of the 2005 Selected Issues paper.

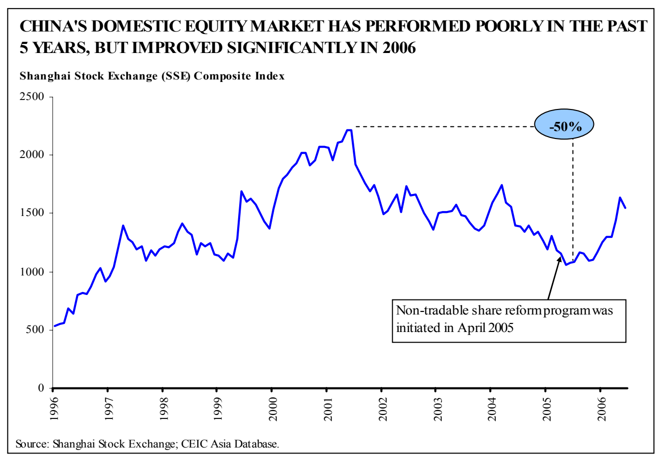
Box 4. China: Developing Capital Markets

Bond market



The PBC has made significant progress to boost the development of the short-term end of the bond market. In May 2005, the PBC opened the short-term corporate bills market (maturities less than one year). To issue, companies are required to register with the PBC and disclose their financial condition and ability to pay interest and principal on the bills to be issued. The market has become very active due to a lower cost for funds raised in this market and PBC's efficient approval process, and it is attracting issuance by a number of China's largest corporations. In addition, gross issuance volumes for T-bonds, central bank papers, policy banks bonds, and enterprise bonds increased significantly in 2005. The PBC also announced the establishment of an interbank market for asset backed securities with maturities of 1 to 10 years. This market is yet to take off, with only three such bonds sold so far.

Equity market



The non-tradable share reform program was a key initiative taken by the authorities to boost the development of China's equity market. China's equity market languished over the last several years reflecting uncertainty over how the government might choose to sell off its large holdings of non-tradable shares, representing some two-thirds of total stock market capitalization. To deal with this situation, the government initiated in April 2005 a reform program to convert state-owned shares to tradable shares in listed companies. This reform program has moved rapidly—out of some 1,350 listed companies, nearly 900 companies, which account for 70 percent of the stock market capitalization, had completed the reform program by April 2006. As part of this reform, existing shareholders agreed to these conversions in exchange for receiving additional shares in these companies, with this compensation being negotiated on a company-by-company basis. Reflecting these efforts, the Shanghai and Shenzhen composite indices rose by 44 percent and 25 percent respectively between January-June 2006. In May 2006, the one-year moratorium on initial public offerings was lifted, which could also further boost China's equity markets. The newly revised Securities Law has also streamlined and reduced the financial requirements for listing on the stock exchange (making it easier for firms with less capital to list) while strengthening the disclosure requirements for firms. In September 2005, the China Securities Investor Protection Fund Company was also set up to monitor the risks and liquidation of securities firms that go bankrupt.

bond market from fully reaching its potential. In this context, streamlining the regulatory responsibilities is also important. The authorities agreed that developing a more market-based long-term corporate bond market is important, but argued that time was needed to strengthen corporate governance, improve bankruptcy laws and regulations, and regulate market intermediaries so as to strike a balance between market development and risk control.

46. **The staff emphasized the benefits of early participation in an FSAP,** which would help take stock of the recent significant progress in financial sector reforms and identify priorities for further reforms. While the decision to participate was formally reached last year, the authorities are still deciding on the appropriate time to launch the process.

B. Reform of State-Owned Enterprise

47. **Further progress in reform of the state-owned enterprises (SOEs) can play an important role in improving investment decisions and rebalancing growth.** As a group, SOEs are now profitable on a flow basis, as legacy debts and social responsibilities have been taken off their balance sheets. These profits have been largely reinvested, and this has been a major contributor to the rise in investment in recent years. The staff encouraged the authorities to exercise stronger governance over SOEs, including by seeking dividends from profitable enterprises. Requiring dividend payments would be an important step in helping to curb investment growth. Such payments should be channeled back to the government through the budget and their use determined in the same manner as other government revenue. The increased flow of income to the budget would provide an opportunity to improve the public provision of social services. The authorities acknowledged that there was a growing consensus among the various government agencies involved that it would be appropriate for the SOEs to pay dividends on the government's ownership stake in them. A high-level task force had been set up to examine the issue and work out modalities for dividend payments, although it was unclear how quickly this task force would reach a consensus and make policy recommendations.

C. Rural-Urban Income Disparity

48. **One of the authorities' major concerns is that the opportunity to share in the benefits of growth is not accessible more equitably across all levels of society.** In particular, urban-rural income disparity has been growing, and the new five-year economic blueprint puts top priority on measures to address this problem. Urban household incomes have more than doubled in real terms in the past 10 years, and by 2005, urban incomes were more than three times rural cash incomes. Rural residents also have less access to public services than urban residents—state spending per capita on education, health, and social welfare is lower in the more rural western provinces. In addition, residency requirements limit rural residents' access to social services in urban areas. Key steps envisaged are to reduce barriers to rural-urban migration which will increase employment opportunities for the rural workforce, of which an estimated 150 million are underemployed, and reduce the pressure on arable land. In addition, migrants will be given greater access to vocational training and social services in the cities. The authorities also plan to develop the countryside by increasing agricultural support services, building rural infrastructure, and improving rural

education and health services. However, the budgetary resources to be devoted to these measures are still unclear given the lack of a medium-term budget framework and weaknesses in expenditure classification—problems that were being addressed.

D. Other Issues

49. **The authorities maintained that implementation of China's WTO commitments remains on track.** Except for a few products, tariff reductions required under WTO commitments have all taken effect by the beginning of 2005—the simple average tariff was reduced to less than 10 percent in 2005 from 15¼ percent in 2001, just prior to WTO entry. All commitments on removing non-tariff measures including import quotas, import licenses, and import tendering have been implemented. Progress on the liberalization of services, including banking, distribution, and telecommunication, is on track. Concrete regulations are being drafted that would fully meet the WTO commitment to provide equal treatment to foreign banks by end-2006. The authorities are fully committed to multilateral trade liberalization and see regional and bilateral free trade agreements as supplementary to multilateral agreements. They noted that the quick resolution of the trade friction with the United States and the EU on some textile products has helped to maintain a stable trade environment, but highlighted the existence of restrictions on China's imports of high-technology products.

50. **China provides significant financial support to low-income countries (LICs).** While China does not participate in the enhanced HIPC Initiative, it provides debt relief on a bilateral basis to many countries although information by beneficiary is not available. The provision of nonconcessional government loans to LICs by China raises some concerns, particularly in the cases of those countries that have only recently received debt relief under the HIPC initiative and the Multilateral Debt Relief Initiative. New nonconcessional lending to still heavily indebted countries also may complicate the implementation of debt relief initiatives, particularly as traditional bilateral creditors expect equal treatment for all foreign government sponsored loans. In this regard, the staff urged the authorities to consider debt and debt sustainability issues in making decisions on official loans to LICs and to exchange with other bilateral lenders information on China's lending activities and provision of debt relief. The authorities stressed their commitment to carefully assessing loans to these countries, and that the question of exchanging information on nonconcessional lending with other donor countries was being considered by the appropriate agencies.

51. **The staff welcomed improvements in the quality of economic statistics.** In particular, the revision to the national income accounts to better reflect previously under-recorded sectors of the economy and reporting of data on the international investment position are welcome achievements. While Chinese data are adequate for surveillance purposes, inadequacies in several areas still constrain the monitoring of macroeconomic developments. The staff suggested that priority should be given to further improving the national income accounts, including publication of annual and quarterly real GDP on an expenditure basis and providing better data on investment, especially on the change in business inventories. Other important areas for improvement are labor statistics, financial sector data (including developing comprehensive data on financial soundness indicators), and some aspects of the balance of payments accounts.

IV. Staff Appraisal

52. **If China is to sustain rapid and stable economic growth over the medium term, the economy needs to be rebalanced away from heavy dependence on investment and exports as primary sources of growth and towards consumption.** The government will need to play an important role in achieving such a boost to consumption through efforts to further reform and develop the financial sector and by increasing spending on health care, education, and pensions. This will serve to reduce households' precautionary savings. Moreover, the opportunity to share in the benefits of growth need to be spread more equitably across all levels of society.

53. **Prospects for the future remain favorable, provided that policy actions are taken to address the risks and challenges China faces.** The key immediate concern remains that rapid investment growth is leading to substantial overcapacity in some sectors. Abundant liquidity in the banking system could touch off further increases in lending growth and investment, with the probable consequence of creating new non-performing loans and undoing some of the progress made in reforming the banking sector. On the external front, growing protectionist sentiment in China's major markets could curb growth. In addition, a disorderly unwinding of global imbalances would have serious adverse effects on China's economy, as activity in the rest of the world would be adversely affected. There are also mounting challenges to economic policy on the domestic front, as the gap between incomes of rural and urban areas continues to widen.

54. **The authorities recognize the need in the near term to contain investment and credit growth,** and they have tightened monetary policy in response and have taken a number of administrative steps. However, with substantial liquidity remaining in the banking system, continuing large capital inflows, local government pressure on banks to expand their lending, and restraint on credit growth by the large banks diminishing as they complete their recapitalizations, additional steps are required. If there is a concern that further tightening of monetary policy would attract additional capital inflows, this only underscores the importance of draining liquidity from the banking system in conjunction with allowing greater exchange rate appreciation. More rapid appreciation of the renminbi along with an intensification of open market operations is needed. These steps may have to be supplemented by other measures to tighten monetary conditions, including further hikes in benchmark interest rates and/or the reserve requirement ratio.

55. **More broadly, the effectiveness of monetary instruments needs to be improved.** The burden of having to tightly manage the exchange rate has created a major conflict in monetary policy implementation. To circumvent this conflict, the authorities have relied on moral suasion and administrative controls to restrain credit and investment growth and keep inflation low. While such controls may be necessary in the short term, over time the effectiveness of administrative controls will diminish as the sophistication of the economy increases, while the potential costs of the distortions that these controls create grow larger. At the same time, trying to influence bank lending decisions directly contradicts the government's goal of creating a banking sector operating on a sound commercial basis.

56. **Thus, exchange rate flexibility, not just appreciation, is what is needed for China's economy going forward.** Allowing the exchange rate to move more flexibly and be increasingly determined by market conditions would enhance monetary policy independence, helping the central bank to meet its policy objectives and reducing interference in the operations of the commercial banks. The lack of sufficient discretion given to the PBC to set interest rates is also an impediment to timely policy action.

57. **Over time, it will be important for the PBC to formalize its policy framework,** establishing an appropriate nominal anchor for monetary policy, and more clearly articulate its policy objectives. This would help to underpin market expectations about inflation, interest rates, and the exchange rate. In this regard, the now regular publication of the Monetary Policy Report by the PBC provides a convenient vehicle to increase the transparency of monetary policy formulation.

58. **Now is the time to more fully utilize the flexibility afforded by the current exchange rate system and allow greater movement in the renminbi-U.S. dollar exchange rate and a further significant appreciation of the currency in nominal effective terms.** This is in China's best interest and the timing is right, as such an appreciation is unlikely to create significant economic disruptions given the strength of the Chinese economy. An appreciation of the currency will also contribute to the sustainability of China's growth. It would help avert the build-up of short-term foreign currency liabilities that will occur if the exchange rate remains undervalued and financial repression continues, reducing the risk of what could be a significant source of vulnerability. In addition, it will also help to improve the allocation of investment and its efficiency by giving the right price signals to potential investors. By increasing households' purchasing power, and thereby boosting consumption, it would aid in rebalancing the economy over the medium term. In any event, if adjustment to the undervaluation of the exchange rate does not come through a nominal appreciation, at some point in time a real appreciation of the currency will occur through higher inflation, and this would have a disproportionately adverse impact on the poor and rural households. Concerns about adverse short-term effects of an appreciation can be addressed through other, more appropriate policy actions than by continuing to tightly manage the exchange rate.

59. **In addition to serving China's own interest, greater exchange rate flexibility would play a role in contributing to an orderly process for resolving global current account imbalances.** A disorderly correction of these imbalances would have lingering adverse effects on all countries. Dealing with global imbalances requires a concerted effort on the part of all countries. In this respect China can play an important role in reducing imbalances through policy actions that are in its own interest, including greater flexibility in the exchange rate, which would permit a significant appreciation, coupled with China's structural reforms aimed at rebalancing economic growth.

60. **The last few years of fiscal consolidation have created the space to step up social spending, which is needed to help rebalance growth towards consumption.** In this regard, the 2006 budget is appropriate from a near-term perspective. *Ad hoc* or overly ambitious spending increases now that exceeds implementation capacity would be wasteful. Instead, building on some of the current pilot projects, comprehensive plans to reform the provision of social services (such as health care, education, and pensions) can be developed. In the

absence of such concrete plans and adequate controls to finance and monitor a substantial increase in social spending, the authorities should continue to shift the composition of expenditures towards social areas in line with their capacity to effectively implement higher spending in these areas. A key part of effective efforts to raise social spending is continuing reform of the budget process, including by putting in place as scheduled the revised budget classification and chart of accounts, and fully implementing the treasury single account. This would help increase fiscal transparency and ensure that funds are actually spent for their intended purpose.

61. **Center-local fiscal relations are in need of significant reform, and such reform is an important part of efforts to rebalance the economy and spread the benefits of growth.** Income disparities across regions continue to widen, with some localities facing difficulties in funding expenditure mandates especially in health and education. These structural imbalances in subnational finances need to be addressed, including by assessing the possibility of reforming tax assignments across levels of government, rebalancing expenditure responsibilities in line with resources, and reforming the transfer system to move toward a more rule-based system that ensures all local governments have resources adequate to meet their spending responsibilities.

62. **Improving intermediation of China's large private savings remains critical to medium-term economic prospects and for rebalancing economic growth.** As banks increasingly operate on a commercial basis, the allocation efficiency is likely to improve, while a wider range of household credit instruments would enable households to borrow against future income, which should bring down their saving rate. Implementation of improved risk management systems should also make banks more willing to meet the borrowing needs of small- and medium-size enterprises. While the authorities have shown substantial progress in bank reform, further fundamental improvements are also required in the banks' commercial orientation, internal controls, and governance. Government involvement in the management and business operations of the banks should continue to be cut and eliminated over time. Banking supervision should be strengthened further, in particular with regard to assessing banks' foreign exchange and credit risks. Closer monitoring of the flow of new non-performing loans also is essential so that potential problems can be detected early.

63. **Particular attention needs to be given to moving quickly to adopt a reform plan for the Agricultural Bank of China.** Further delay in reforming ABC risks creating serious moral hazard that could undermine the reforms of other banks. The authorities should move quickly to adopt an ambitious reform plan, including time-bound restructuring and recapitalization measures with appropriate performance parameters. If the intention is to reform ABC in the context of a comprehensive rural financing reform plan (for which more time may be needed), then interim restraints should be placed on the ABC's lending activities.

64. **Additional steps are needed to accelerate the development of China's capital markets.** These markets have been mired in complex regulations and plagued by governance problems. Developing bond and equity markets is important for improving intermediation and increasing incentives for banks to seek out small- and medium-size enterprises. It will

serve to boost consumption by proving greater opportunities for direct and indirect household participation in the financial markets. Expanding the bond market also would help lower corporate savings, reducing enterprises' substantial reliance on internal savings by providing a broader set of financial instruments to raise funds. The authorities have made progress in reviving equity markets, but more needs to be done to ease access to the market and allow stocks to be publicly issued based on firms' disclosure of financial data and prospects. Progress on developing the corporate bond market has been less encouraging. The development of the short-term corporate bills market, along with launching the interbank market for asset-backed securities, are steps in the right direction. However, advances in developing the longer-term corporate bond market has been disappointing, and the implementation of the new Securities Law to date appears to have done little to remove key impediments and streamline regulatory responsibilities. In particular, reforms are needed to replace the current "merit" based bond issuance system, requiring government selection of each bond issue, with a disclosure-based system and to eliminate the cap on corporate bond interest rates.

65. **Early participation in an FSAP would be beneficial,** as it would help take stock of the recent significant progress in financial sector reforms and identify priorities for further reforms.

66. **Exercising stronger governance over enterprises where the government owns shares would be an important step contributing to rebalancing growth.** Central to strengthening governance over the SOEs would be requiring them to make dividend payments to the budget. Reinvested enterprise profits have contributed to the sharp rise in investment in some sectors of the economy and have aggravated demand management by generating procyclical investment. Requiring that dividend payments be made to the budget would improve the efficiency of investment and increase public sector resources to fund reforms in social services.

67. **The IMF staff welcomes improvements in the quality of economic statistics, although incomplete data in several areas still affects the monitoring of macroeconomic developments.** The revision to the national income accounts to better reflect previously under-recorded sectors of the economy and the reporting of data on the international investment position are welcome achievements. However, inadequate data in several areas still constrain the monitoring of macroeconomic developments. Priority should be given to publication of annual and quarterly real GDP on an expenditure basis; improving labor statistics; providing data that would facilitate on-going monitoring of the financial sector; measuring investment better; addressing the lack of reliable data on the change in business inventories; and improving some aspects of balance of payments statistics.

68. **The authorities' provision of financial support and debt relief to many low-income countries is welcome.** We encourage the authorities to share information on these activities with staff, participate fully in the HIPC initiatives, and make their lending activities consistent with the low-income country debt sustainability framework.

69. **It is proposed that the next Article IV consultation with China take place on the standard 12-month cycle.**

Table 1. China: Summary Indicators

Nominal GDP (2005): US$2,225 billion
Population (2005): 1.308 billion
GDP per capita (2005): US$1,702
Quota: SDR 6,370 million

	2001	2002	2003	2004	2005	2006 Proj.
			(Change in percent)			
Real GDP (production)	8.3	9.1	10.0	10.1	9.9	10.0
Consumer prices (period average)	0.7	-0.8	1.2	3.9	1.8	1.5
Registered unemployment rate in urban areas (in percent)	3.6	4.0	4.3	4.2	4.2	…
			(In percent of GDP)			
Total capital formation	34	35	38	39	40	44
Of which : Fixed capital formation	34	35	38	39	41	44
Gross national saving	35	38	41	43	47	51
External current account	1.3	2.4	2.8	3.6	7.2	7.0
Overall budget balance, IMF basis 1/	-2.7	-3.0	-2.4	-1.5	-1.3	-1.2
Revenue	15.1	15.9	16.2	16.6	17.5	18.3
Expenditure (including net lending)	17.9	18.9	18.6	18.1	18.8	19.5
Overall budget balance, authorities definition, in bn RMB	-247	-315	-293	-209	-208	-220
Overall budget balance, authorities definition	-2.3	-2.6	-2.2	-1.3	-1.1	-1.1
Government gross debt (in percent of GDP)	17.7	18.9	19.2	18.5	17.9	17.3
			(Change in percent; end of period)			
Banking system's net domestic assets 2/	15.2	16.2	19.7	7.7	12.6	…
Of which : Domestic credit 2/ 3/	6.4	30.7	19.6	10.9	13.6	…
Broad money 2/	14.4	16.8	19.6	14.6	17.6	…
Reserve money	9.2	13.3	17.1	11.4	9.3	…
Interest rate (one-year time deposits, year-end)	2.3	2.0	2.0	2.1	2.3	…
			(In billions of U.S. dollars)			
Current account balance	17	35	46	69	161	179
Of which : Exports	266	326	438	593	762	937
Imports	232	281	394	534	628	779
Capital and financial account balance	35	32	53	111	63	41
Of which : Direct investment inflows (net)	37	47	47	53	68	54
Errors and omissions	-5	8	18	27	-17	…
Change in net international reserves (increase -)	-47	-76	-117	-206	-207	-220
Gross international reserves 4/	219	295	412	619	826	1046
In months of imports of goods and nonfactor services	8.0	7.9	8.2	10.4	11.3	11.8
As a percent of short-term external debt 5/	432	558	535	502	500	…
External debt 5/	185	186	209	248	281	323
Of which: Short-term debt 5/	65	71	92	123	156	…
Debt-service ratio (in percent of exports) 5/	7.5	25.3	21.3	17.0	17.8	17.7
Exchange rate at end-period (renminbi per US$)	8.28	8.28	8.28	8.28	8.07	…
Nominal effective exchange rate 6/	105.8	104.6	97.2	92.4	92.6	…
Real effective exchange rate 6/	104.8	101.9	94.5	91.9	91.9	…
Memorandum items:						
Nominal GDP (in billions of RMB)	10,966	12,033	13,582	15,988	18,232	20,348
Exports growth (value terms, in percent)	6.8	22.4	34.6	35.4	28.5	23.0
Imports growth (value terms, in percent)	8.1	21.3	39.8	35.8	17.6	24.0
Net imports of oil (in billions of USD)	12	13	21	39	50	59
(In percent of GDP)	0.9	0.9	1.3	2.0	2.2	2.3
Real GDP growth of trading partners (in percent)	0.9	1.8	2.3	4.6	3.9	3.7

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

1/ Central and local governments, including all official external borrowing.
2/ Banking survey.
3/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.
4/ Includes gold, SDR holdings, and reserve position in the Fund.
5/ 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. Trade credit data since 2001 was revised in 2005.
6/ Annual averages (2000 = 100).

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

	2003	2004	2005				
			Q1	Q2	Q3	Q4	Year
Current Account Balance	45.9	68.6	29.5	37.8	41.0	52.6	160.8
Trade balance	44.7	59.0	23.5	30.8	37.3	42.7	134.2
Exports	438.3	593.4	156.0	186.5	204.2	215.8	762.5
Imports (BOP basis)	393.6	534.4	132.5	155.7	166.9	173.1	628.3
Services	-8.6	-9.7	-2.3	-1.6	-4.2	-1.3	-9.4
Income	-7.8	-3.5	3.2	1.7	1.3	4.5	10.6
Current transfers	17.6	22.9	5.2	6.9	6.6	6.7	25.4
Capital and Financial Account Balance	52.7	110.7	17.6	20.7	-6.6	31.3	63.0
Capital Account	0.0	-0.1	0.0	2.2	1.0	1.0	4.1
Financial Account	52.8	110.7	17.6	18.6	-7.6	30.3	58.9
Net foreign direct investment	47.2	53.1	10.1	12.4	13.1	32.3	67.8
inward investment (net)	47.1	54.9	12.2	14.2	13.3	39.4	79.1
abroad	0.2	-1.8	-2.1	-1.8	-0.2	-7.2	-11.3
Portfolio investment	11.4	19.7	-2.3	1.4	12.1	-16.1	-4.9
assets	3.0	6.5	-3.0	-5.4	3.8	-21.5	-26.2
liabilities	8.4	13.2	0.7	6.8	8.3	5.4	21.2
Other investment	-5.9	37.9	9.9	4.8	-32.8	14.1	-4.0
assets 1/	-17.9	2.0	-0.9	-17.2	-33.8	2.9	-48.9
liabilities	12.0	32.3	10.7	22.0	1.0	11.2	44.9
Errors and Omissions 2/	18.4	27.1	1.6	-6.8	23.0	-34.6	-16.7
Overall Balance	117.0	206.4	48.7	51.8	57.3	49.2	207.0
Reserve assets	-117.0	-206.1	-48.7	-51.8	-57.3	-49.2	-207.0
Memo items:							
Current account as percent of GDP	2.8	3.6	…	…	…	…	7.2
Export growth (value terms)	34.6	35.4	35.1	30.9	29.1	21.7	28.5
Import growth (value terms)	39.8	35.8	12.3	16.2	18.9	21.9	17.6
FDI (inward) as a percent of GDP	2.9	2.8	…	…	…	…	3.6
External debt	208.8	247.5	…	…	…	…	281.0
as a percent of GDP	12.7	12.8	…	…	…	…	12.6
Short term external debt (original maturity)	92.2	123.2	…	…	…	…	156.1
Gross reserves	412.2	618.6	667.3	719.1	776.4	825.6	825.6
as a percent of ST debt by remaining maturity	418.0	583.2	…	…	…	…	574.9
Net international investment position	…	120.3	…	…	…	…	287.5
(In percent of GDP)	…	6.2	…	…	…	…	12.9
Nominal GDP	1,641	1,932	…	…	…	…	2,225

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. 2005 include bank capitalization and foreign exchange swap, estimated at $28.8 billion.
2/ Includes counterpart transaction to valuation changes.

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

	2000	2001	2002	2003	2004	2005
By Debtor	145.7	184.8	186.4	208.8	247.5	281.0
Government and government agencies	49.0	49.8	50.5	34.1	33.6	33.0
Domestic entities	49.1	46.5	46.4	64.3	72.3	65.9
Chinese enterprises	13.5	11.2	10.0	7.6	6.0	4.6
Chinese banks	29.8	34.4	36.3	56.3	66.0	61.1
Chinese non-bank financial institutions	5.7	0.9	0.1	0.3	0.3	0.3
Foreign funded entities	46.5	52.2	48.2	58.7	76.2	91.3
Foreign-funded enterprises	...	35.2	33.2	37.8	44.6	50.5
Foreign funded banks	...	17.0	15.0	20.9	31.6	40.8
Trade credit	...	36.3	41.3	51.7	65.4	90.8
Other	1.2	0	0	0	0	0
By Creditor	145.7	184.8	186.3	208.8	247.5	281.0
Official creditors	51.0	51.3	52.1	51.9	57.3	54.0
Multilateral	26.3	27.6	27.7	26.5	25.1	26.8
Bilateral	24.6	23.7	24.4	25.4	32.2	27.2
Commercial banks	46.2	46.5	44.1	53.7	55.6	58.5
foreign banks and financial institutions	32.9	33.5	31.7	42.4	43.8	49.2
suppliers (buyer's credit)	13.2	13.1	12.4	11.3	11.9	9.3
Bonds	12.3	12.7	10.8	11.2	13.3	13.0
Other	36.3	74.3	79.3	92.1	121.2	155.6
Loans from non-bank financial sources	22.9	23.6	24.2	28.9	34.7	39.6
International financial leasing	11.9	10.1	9.2	7.7	7.3	6.7
Trade credits	...	36.3	41.3	51.7	65.4	90.8
Deferred payments	1.6	2.7	3.2	1.2	9.6	13.3
Deposits from overseas	0.0	1.5	1.4	2.5	4.2	5.2
By Maturity						
Medium and long-term debt	132.7	119.5	115.6	116.6	124.3	124.9
Short-term debt (remaining maturity basis)	25.7	26.3	88.3	98.6	106.1	143.6
Short-term debt (original maturity basis)	13.1	65.3	70.8	92.2	123.2	156.1
Memorandum item:						
Gross international reserves	168.9	218.7	295.2	412.2	618.6	825.6

Sources: Chinese authorities and staff calculations.

1/ The breakdown of debt by debtor and coverage of entities were changed in 2001. In addition, loans from foreign governments to policy banks are moved from debt of government category to debt of Chinese-funded financial institutions from end-2003 onward. The adjustment was $15.2 billion at end-2003. In 2001, trade credits and loans borrowed by foreign funded financial institutions are included. Their stock at end-2001 was 38.7 billion. In 2005, switching to sample based estimation increased trade credit for 2001 onwards and by $14.7 billion for 2001 compared with methods used previously.

Table 4. China: Indicators of External Vulnerability

	2000	2001	2002	2003	2004	2005	2006 Proj.
Monetary and Financial Indicators							
General government domestic debt (official data; in percent of GDP)	15.9	17.2	18.5	18.9	18.0	17.5	…
Broad money (M2: annual percentage change)	14.0	14.4	16.8	19.6	14.6	17.6	…
Foreign currency deposits to broad money (percent)	7.7	7.1	6.7	5.6	5.0	4.4	…
Credit to nonstate sectors (annual percentage change)	11.7	2.1	26.5	20.6	11.2	7.3	…
Foreign currency loans to credit to the economy (in percent)	4.2	5.2	5.0	5.4	5.1	4.9	…
Stock exchange Index (end of period, Dec. 19, 1990 = 100) 1/	2192	1713	1419	1569	1330	1221	…
Stock exchange capitalization (percent of GDP)	49	39	32	31	23	25	…
Number of listed companies (A-share)	1049	1141	1207	1269	1341	1361	…
Balance of Payments Indicators							
Exports (annual percentage change, U.S. dollars)	27.9	6.8	22.4	34.6	35.4	28.5	23.0
Imports (annual percentage change, U.S. dollars)	35.4	8.1	21.3	39.8	35.8	17.6	24.0
Current account balance (percent of GDP)	1.7	1.3	2.4	2.8	3.6	7.2	7.0
Capital and financial account balance (percent of GDP)	0.2	3.0	2.2	3.7	5.7	2.8	1.6
Of which: Gross foreign direct investment inflows	3.2	3.3	3.4	2.9	2.8	3.6	2.7
Reserve Indicators							
Gross reserves (billions of U.S. dollars)	169	219	295	412	619	826	1046
Gross reserves to imports of GNFS (months)	7.5	8.0	7.9	8.2	10.4	11.3	11.6
Gross reserves to broad money (M2) (percent)	10.1	11.4	13.2	15.4	20.1	22.3	…
Gross reserves to short-term external debt by remaining maturity (percent) 2/	656.6	831.4	334.4	418.0	583.2	574.9	580.8
External Debt and Balance Sheet Indicators 3/							
Total external debt (percent of GDP)	12.2	13.9	12.8	12.7	12.8	12.6	12.7
Total external debt (billions of U.S. dollars)	145.7	184.8	186.4	208.8	247.5	281.0	322.6
Of which: Public and publicly guaranteed debt 4/	49.0	49.8	50.5	34.1	33.6	33.0	…
Banking sector debt	29.8	51.4	51.3	77.3	97.6	101.9	…
Short-term external debt by original maturity (billions of U.S. dollars)	13.1	65.3	70.8	92.2	123.2	156.1	…
Short-term external debt by remaining maturity (billions of U.S. dollars)	25.7	26.3	88.3	98.6	106.1	143.6	176.9
Net foreign assets of banking sector (billions of U.S. dollars)	64.4	88.6	109.8	88.6	113.9	163.8	…
Total debt to exports of GNFS (percent)	52.1	61.7	51.0	43.0	37.7	33.6	31.4
Total debt service to exports of GNFS (percent) 5/	9.7	7.5	25.3	21.3	17.0	17.8	17.7
Of which: Interest payments to exports of GNFS (percent) 5/	1.3	1.0	1.2	1.0	0.8	0.6	0.5
Bond spread (benchmark bond, end of period, basis points)	162.0	107.0	97.0	86.0	64.0	41.4	…
Foreign-Currency Sovereign Bond Ratings							…
Moody's	A3	A3	A3	A2	A2	A2	…
Standard and Poor's	BBB	BBB	BBB	BBB	BBB+	A-	…
Memorandum Items:							
International investment position	…	…	…	…	120.3	287.5	…
Nominal GDP (US$ billions)	1,198	1,325	1,454	1,641	1,932	2,225	2,544
Exports of GNFS (US$ billions)	280	299	365	485	656	837	1027
Real effective exchange rate (end of period, annual percentage change)	6.7	2.8	-7.1	-6.6	-4.3	8.7	…

Sources: Chinese authorities and Fund staff estimates and projections.

1/ Shanghai Stock Exchange, A share.
2/ Based on official data on short-term debt at original maturity and medium and long-term debt repayment in the BOP.
3/ Based on official debt data unless otherwise indicated.
4/ Debt of banking sector not included.
5/ Staff estimates.

Table 5. China: Monetary Developments

	2000	2001	2002	2003	2004	2005				2006
						March	June	Sep.	Dec.	Prel. March
					(In billions of yuan)					
Net foreign assets	2,012	2,642	3,175	3,773	5,535	5,961	6,530	6,917	7,570	7,870
Net domestic assets	11,449	13,188	15,326	18,349	19,770	20,483	21,036	21,811	22,268	23535
Domestic credit 1/	11,725	12,556	17,262	20,628	22,428	23,110	23,576	24,222	24,837	25,377
Net credit to government	588	1,102	1,333	1,318	1,550	1,219	1,050	1,155	1,520	1,450
Credit to non-government	11,137	11,454	15,929	19,311	20,878	21,891	22,525	23,067	23,317	23,927
Other items, net 1/	-276	632	-1,936	-2,279	-2,658	-2,628	-2,540	-2,411	-2,568	-1,841
Broad money	13,461	15,830	18,501	22,122	25,305	26,444	27,567	28,728	29,838	31,405
Reserve money	3,649	3,985	4,514	5,284	5,886	5,759	5,736	6,077	6,434	6,255
Of which:										
Required reserves	720	850	1,006	1,410	1,738	1,825	1,912	1,989	2,060	2153
Excess reserves	879	857	907	845	987	741	680	809	953	526
Net foreign assets of PBC	1,519	1,935	2,282	3,066	4,640	5,081	5,534	5,948	6,280	6,775
Net domestic assets of PBC	2,130	2,050	2,232	2,218	1,246	677	202	129	154	-520
					(Twelve-month percentage change)					
Net foreign assets 2/	2.6	4.7	3.4	3.2	8.0	7.9	8.6	8.5	8.0	6.1
Net domestic assets	11.3	15.2	16.2	19.7	7.7	7.7	8.8	11.7	12.6	14.9
Domestic credit 3/ 4/	9.7	6.4	30.7	19.6	10.9	10.7	13.2	14.3	13.6	9.8
Of which: Loans	13.4	11.6	15.4	21.1	14.5	13.0	13.3	13.8	13.0	11.1
Other items, net 2/ 3/ 4/	0.2	6.8	-10.9	-3.1	-4.4	-4.2	-5.7	-4.5	-3.2	-4.9
Broad money 5/	17.0	14.4	16.8	19.6	14.6	14.0	15.7	17.9	17.6	18.8
Including foreign currency deposits	13.1	16.7	16.3	18.2	13.8	14.0	15.4	17.0	17.2	18.1
M1 5/	16.0	12.7	16.8	18.7	13.6	9.9	11.3	11.6	11.8	9.0
M0 5/	8.9	7.1	10.1	14.3	8.7	10.1	9.6	8.5	11.9	8.9
Quasi money	10.0	15.5	16.8	20.1	14.7	16.5	17.7	21.6	21.8	22.5
Reserve money	8.5	9.2	13.3	17.1	11.4	14.1	11.8	14.3	9.3	8.6
Net foreign assets of PBC 6/	2.2	11.4	8.7	17.4	29.8	34.4	37.9	38.7	27.9	33.3
Net domestic assets of PBC 6/	6.4	-2.2	4.6	-0.3	-18.4	-20.3	-26.1	-24.3	-18.5	-177
Reserve ratios: 7/										
Required reserves	6.0	6.0	6.0	7.0	7.5	7.5	7.5	7.5	7.5	7.5
Excess reserves	7.3	6.1	5.4	5.4	5.3	4.2	3.7	3.8	3.8	1.8
Memorandum items:										
Money multiplier	3.7	4.0	4.1	4.2	4.3	4.6	4.8	4.7	4.6	4.9
Forex deposits of residents (US$ billior	128.3	134.9	150.7	148.7	153.0	162.8	165.3	157.5	161.6	164.3
In percent of total deposits	8.1	7.3	6.9	5.8	5.2	5.3	5.1	4.6	4.5	4.6
Forex loans of residents (US$ billion)	61.2	80.7	102.8	131.3	135.3	146.9	149.7	149.6	150.5	151.6

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/

	2002	2003	2004	2005		2006	
				Budget	Prel.	Budget	Proj.
	(In billions of yuan)						
Total revenue	1,916	2,194	2,661	2,949	3,182	3,562	3,724
Tax revenue 2/	1,763	2,002	2,414	2,675	2,878	3,220	3,374
Taxes on income and profits	472	476	593	658	749	859	915
Taxes on goods and services	1,111	1,299	1,535	1,692	1,807	1,985	2,087
Other taxes	180	227	287	325	321	377	372
Nontax revenue	154	192	247	274	305	342	350
Total expenditure	2,272	2,527	2,899	3,278	3,421	3,887	3,974
Current expenditure, *of which:*	1,747	1,950	2,300	2,639	2,706	3,074	3,180
Administration and defense	576	655	766	853	888	992	1,012
Culture, education, public health, and science	415	471	537	625	637	739	784
Pensions and social welfare relief	264	266	309	341	365	398	413
Subsidies	90	84	101	101	119	117	137
Interest	68	93	74	82	81	98	98
Capital expenditure	484	537	570	609	687	757	794
Unrecorded expenditures 3/	40	39	29	29	29	30	30
Overall balance	-355	-332	-238	-329	-239	-325	-250
Financing	355	332	238	329	239	325	250
Domestic (net, residual)	365	328	236	327	244	325	250
Foreign (net)	-10	5	2	2	-5	…	…
	(In percent of GDP)						
Total revenue	15.9	16.2	16.6	16.2	17.5	17.5	18.3
Tax revenue 2/	14.6	14.7	15.1	14.7	15.8	15.8	16.6
Taxes on income and profits	3.9	3.5	3.7	3.6	4.1	4.2	4.5
Taxes on goods and services	9.2	9.6	9.6	9.3	9.9	9.8	10.3
Other taxes	1.5	1.7	1.8	1.8	1.8	1.9	1.8
Nontax revenue	1.3	1.4	1.5	1.5	1.7	1.7	1.7
Total expenditure	18.9	18.6	18.1	18.0	18.8	19.1	19.5
Current expenditure, *of which:*	14.5	14.4	14.4	14.5	14.8	15.1	15.6
Administration and defense	4.8	4.8	4.8	4.7	4.9	4.9	5.0
Culture, education, public health, and science	3.5	3.5	3.4	3.4	3.5	3.6	3.9
Pensions and social welfare relief	2.2	2.0	1.9	1.9	2.0	2.0	2.0
Subsidies	0.8	0.6	0.6	0.6	0.7	0.6	0.7
Interest	0.6	0.7	0.5	0.4	0.4	0.5	0.5
Capital expenditure	4.0	4.0	3.6	3.3	3.8	3.7	3.9
Unrecorded expenditures 3/	0.3	0.3	0.2	0.2	0.2	0.1	0.1
Overall balance	-3.0	-2.4	-1.5	-1.8	-1.3	-1.6	-1.2
Financing	3.0	2.4	1.5	1.8	1.3	1.6	1.2
Domestic (net, residual)	3.0	2.4	1.5	1.8	1.3	1.6	1.2
Foreign (net)	-0.1	0.0	0.0	0.0	0.0	…	…
Memorandum items:							
VAT refunds to exporters (in billions of yuan)	-115	-199	-348	-380	-404	-426	-426.4
Primary balance	-2.4	-1.8	-1.0	-1.4	-0.9	-1.1	-0.7
Government debt	18.9	19.2	18.5	…	17.9	17.3	17.3
Domestic	18.3	18.6	18.0	…	17.5	16.9	16.9
External	0.6	0.6	0.5	…	0.4	0.4	0.4
Budget balance (authorities' definition)	-2.6	-2.2	-1.3	-1.6	-1.1	-1.4	-1.1
Nominal GDP (in billions of yuan)	12,033	13,582	15,988	18,232	18,232	20,348	20,348

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 paid on inputs. The IMF definition is not adjusted for tax refund 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

	2002	2003	2004	2005		2006	
				Budget	Prel.	Budget	Proj.
			(In billions of yuan)				
Revenue (official definition) 1/	1,890	2,172	2,640	2,926	3,163	3,542	3,704
Plus :							
Subsidies to loss-making SOEs	26	23	22	23	19	20	20
Minus :							
Privatization proceeds	0	0	0	0	0	0	0
Revenue (IMF definition)	1,916	2,194	2,661	2,949	3,182	3,562	3,724
Expenditure (official definition)	2,205	2,465	2,849	3,226	3,371	3,837	3,924
Plus:							
Subsidies to loss-making SOEs	26	23	22	23	19	20	20
External borrowing excluded from the budget	15	14	14	14	16	15	15
Unrecorded fiscal stimulus spending (onlending to local governments)	25	25	15	15	15	15	15
Expenditure (IMF definition)	2,272	2,527	2,899	3,278	3,421	3,887	3,974
Balance (official definition)	-315	-293	-209	-300	-208	-295	-220
Balance (IMF definition)	-355	-332	-238	-329	-239	-325	-250
			(In percent of GDP)				
Revenue (official definition)	15.7	16.0	16.5	16.0	17.3	17.4	18.2
Revenue (IMF definition)	15.9	16.2	16.6	16.2	17.5	17.5	18.3
Expenditure (official definition)	18.3	18.1	17.8	17.7	18.5	18.9	19.3
Expenditure (IMF definition)	18.9	18.6	18.1	18.0	18.8	19.1	19.5
Balance (official definition)	-2.6	-2.2	-1.3	-1.6	-1.1	-1.4	-1.1
Balance (IMF definition)	-3.0	-2.4	-1.5	-1.8	-1.3	-1.6	-1.2
Memorandum item:							
Nominal GDP (in billions of yuan)	12,033	13,582	15,988	18,232	18,232	20,348	20,348

Sources: Ministry of Finance; and staff calculations.

1/ Tax revenues are net of refunds for VAT paid on inputs. As of end-2003, refunds amounting to roughly RMB 250 billion claimed but not paid. The IMF definition is not adjusted for tax refund arrears in the absence of had been adequate data.

Table 8. China: Illustrative Medium-Term Scenario 1/

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
	(Percent change)									
Real GDP	9.1	10.0	10.1	9.9	10.0	10.0	9.5	9.0	9.0	8.5
Consumer prices (average)	-0.8	1.2	3.9	1.8	1.5	2.2	2.3	2.4	2.5	2.5
	(In percent of GDP)									
Total capital formation	35	38	39	40	44	46	48	48	48	48
Gross national saving	38	41	43	47	51	53	54	54	54	54
Fiscal balance	-3.0	-2.4	-1.5	-1.3	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0
Revenue	15.9	16.2	16.6	17.5	18.3	17.9	18.2	18.5	18.8	19.0
Expenditure	18.9	18.6	18.1	18.8	19.5	19.0	19.2	19.5	19.8	20.0
Current account balance	2.4	2.8	3.6	7.2	7.0	7.0	6.9	6.7	6.5	6.2
	(In billions of U.S. dollars)									
Current account balance	35	46	69	161	179	200	222	240	260	274
Trade balance	44	45	59	134	158	188	212	230	249	264
Exports	326	438	593	762	937	1,129	1,323	1,524	1,728	1,920
(Percent change)	22	35	35	28	23	20	17	15	13	11
Imports	281	394	534	628	779	941	1,111	1,294	1,479	1,656
(Percent change)	21	40	36	18	24	21	18	17	14	12
Capital and financial account, net 2/	32	53	111	63	41	30	18	10	0	-14
Capital Account	0	0	0	4	0	0	0	0	0	0
Direct investment, net	47	47	53	68	54	52	48	42	41	35
Portfolio investment, net	-10	11	20	-5	5	3	1	0	-1	-2
Other investment, net	-4	-6	38	-4	-18	-25	-31	-32	-40	-47
Errors and omissions	8	18	27	-17	…	…	…	…	…	…
Change in reserves (- indicates increase)	-76	-117	-206	-207	-220	-230	-240	-250	-260	-260
Memorandum items:										
External debt (official definition) 2/	186	209	248	281	323	358	390	422	434	451
(Percent of GDP)	13	13	13	13	13	13	12	12	11	10
Nominal GDP (In billions of RMB)	12,033	13,582	15,988	18,232	20,348	22,871	25,616	28,586	31,932	35,506

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

1/ Following convention, the scenario assumes a constant real exchange rate and a continuation of the current policy framework including fiscal policy.

2/ The coverage and classification of official external debt data were modified in 2001. Categories of debt previously not covered have since been included.

Table 9. China: Foreign Investors in the Five Largest Banks

Bank (estimated assets, end-2005)	Foreign Investor	Board Representation and Management Responsibility	Technical Assistance	Investment Safeguards, Specific Cooperation	Listing Status
Industrial and Commercial Bank of China ($827 billion).	**Goldman Sachs**, **Allianz**, and **American Express**, 8.5 percent (combined) for $3.8 billion (of which Goldman Sachs $2.58 billion).	Goldman Sachs to nominate one Board member, no management responsibility.	Risk management, corporate and investment banking, credit cards (Amex), and insurance (Allianz).	Compensation only if book value declines below end-2005 level prior to the IPO.	Listing in Hong Kong SAR expected in the second half of 2006; to raise about $10 billion.
Agricultural Bank of China ($608 billion).	None	--	--	--	--
Bank of China ($587 billion).	Consortium led by the **Royal Bank of Scotland**, 9.6 percent for $3.0 billion (all data pre-IPO). **UBS**, 1.6 percent for $492 million. **Temasek**, 4.8 percent for $1.5 billion	RBS to nominate one Board member, no management responsibility None None	Corporate governance, risk management, and IT. Cooperation with RBS in wealth management, credit cards, and corporate banking; partnership with UBS in investment banking and securities.	Compensation if book value through end-2007 declines below book value at end-2004. Credit cards: 50:50 management of a business unit with RBS, when a separate joint venture is established, RBS will have 49 percent ownership.	Raised $11.2 billion in Hong Kong SAR and started trading on June 1, 2006.
China Construction Bank ($568 billion).	**Bank of America**, 8.5 percent for $3 billion. **Temasek** 6.0 percent for $2.5 billion.	One Board member and no management responsibility. Could nominate one Board member, but no plans to do so now; no management responsibility.	Approximately 50 personnel to assist in risk management, governance, consumer banking, and other areas. 1000 person/day training in treasury, SME credit, corporate business and other areas.	An adjustment of the purchase price if December 2004 financial statements are restated; credit card venture under negotiation. No known adjustment.	IPO in Hong Kong SAR, started trading on October 27, 2005. Total funds raised $9.2 billion.
Bank of Communications ($176 billion).	**ISBC**, 19.9 percent for 1.75 billion.	Two Board members, one on audit committee, the other on personnel and compensation committee. One senior manager (vice president) and management of the credit card business.	At least 150 hours of technical assistance each year, eight HSBC experts are working in BoComm now, three more to arrive in 2006.	Credit card business unit set up, with 50:50 representation of BoComm and HSBC managers, to be converted to a Sino-foreign joint venture with 50:50 shares.	IPO in Hong Kong SAR in June 2005, raising $2.16 billion.

Sources: Prospectus, banks' annual reports and discussion with banks.

ANNEX I: CHINA—DEBT SUSTAINABILITY ANALYSIS

1. **An analysis of the sustainability of China's government debt (based on the standard Fund framework) does not point to major difficulties over the next few years, although, over the longer term, large quasi-fiscal liabilities and rising expenditure pressures might translate into 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; there are also considerable uncertainties in trying to gauge the magnitude of potential expenditure pressures over the longer term.[12]

2. **China's official government debt is low, estimated at below 18 percent of GDP at end-2005.**[13] However, on a gross basis it could be significantly larger if quasi-fiscal liabilities were included; while on a net basis could be smaller if China used its substantial stock of state assets to net out government debt obligations. Contingent liabilities include nonperforming loans (NPLs) in the banking system, unfunded pension obligations, and external borrowings by state-owned enterprises (SOEs). 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.[14] 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.[15] Moreover, potential pressures on spending are expected to intensify over time, especially due to an ageing population; however, their fiscal impact would mainly fall outside of the medium-term horizon covered here.

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

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[12] For an assessment of longer-term fiscal sustainability issues, see "Medium-Term Fiscal Challenges" in *China's Growth and Integration into the World Economy: Prospects and Challenges* IMF Occasional Paper 232, edited by E. Prasad (Chapter VI).

[13] This estimated stock 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.

[14] Based on authorities' data, the stock of NPLs is estimated to amount to about 25 percent of GDP at end-2005 (also including the stock of NPLs originally transferred to AMCs, amounting to about 8 percent of 2005 GDP). In the DSA exercise shown in Table I.1, it is assumed that NPLs have a recovery rate of about 20 percent; for the projections of future NPLs, it is assumed that 16 percent of new loans will eventually become nonperforming. Unfunded pension liabilities equivalent to 7 percent of GDP are assumed to be covered by the budget in 2007; interest will also be paid on these and the bonds issued to cover NPLs as of 2008.

[15] While not allowed to borrow directly by law, local governments have indirect access to borrowing through onlending from the central government, and through public enterprises, especially to fund infrastructure projects. This indirect financing (for which estimates are not available) carries fiscal risks for the local governments and, ultimately, the central government

- GDP growth is projected to gradually decelerate to 8.5 percent a year in 2011.

- The deficit will be held constant at its projected 2008 level (1 percent of GDP).

- The average domestic real interest rate increases gradually to 2.5 percent within five years, reflecting gradual liberalization of the financial sector.

4. **Under these assumptions, the debt-to-GDP ratio would have a step increase in 2007 (to about 45 percent of GDP), but then would resume a gradually declining path over the projection period** (Table I.1 and Figure I.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 maintaining an unchanged primary position and all the key variables at their historical levels were simulated. In both cases, the debt-to-GDP ratio would increase, reflecting, in particular, the historically higher real interest rate and larger primary deficit than recorded in more recent years and projected for the future.

5. **Isolated or combined temporary adverse shocks on these key variables would only increase the debt-to-GDP ratio in the short run** (Figure I.1).

- *Individual temporary shocks*. A temporarily lower GDP growth rate would increase the debt-to-GDP ratio to about 45 percent in 2007, similar to the effect produced by a higher real interest rate. Under both cases, the debt ratio would then resume a declining path as in the baseline scenario.

- *Combined temporary shocks*. Should GDP growth be slower, the real interest rate higher, and public spending more expansionary all at the same time (by one standard deviation), the debt-to-GDP ratio would increase and remain at about 46 percent of GDP over the projection period.

- *Higher initial public debt stock*. If debt-creating flows were to be 10 percentage points of GDP higher in 2007, the debt-to-GDP ratio would reach about 55 percent in 2007, but gradually fall over the medium term.

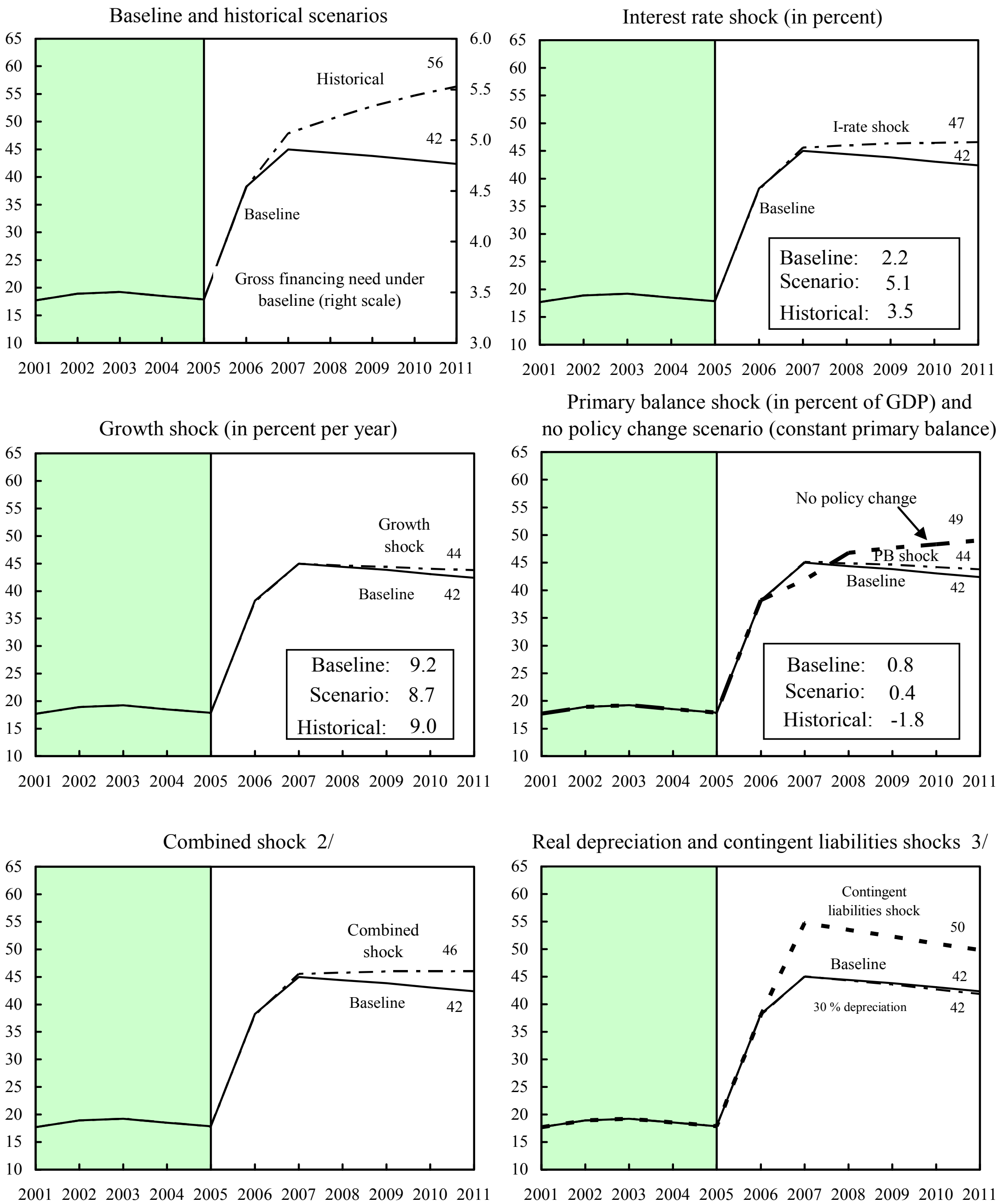
Table I.1. Public Sector Debt Sustainability Framework, 2001-2011

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011
								I. Baseline Projections					
Public sector debt 1/	17.7	18.9	19.2	18.5	17.9			**38.2**	**45.0**	**44.4**	**43.8**	**43.1**	**42.4**
o/w foreign-currency denominated	0.8	0.6	0.6	0.5	0.4			0.4	0.3	0.3	0.3	0.2	0.2
Change in public sector debt	1.3	1.2	0.3	-0.7	-0.6			20.3	6.8	-0.6	-0.6	-0.8	-0.7
Identified debt-creating flows (4+7+12)	1.2	1.4	0.3	-1.4	-1.0			20.3	6.8	-0.6	-0.5	-0.6	-0.5
Primary deficit	2.0	2.4	1.7	1.0	0.9			0.7	-0.3	-0.9	-0.9	-0.9	-1.0
Revenue and grants	15.1	15.9	16.2	16.6	17.5			18.3	17.9	18.2	18.5	18.8	19.0
Primary (noninterest) expenditure	17.1	18.3	17.9	17.7	18.3			19.0	17.6	17.3	17.6	17.9	18.0
Automatic debt dynamics 2/	-0.8	-1.0	-1.4	-2.4	-1.8			-1.5	-2.9	-3.0	-2.8	-2.7	-2.4
Contribution from interest rate/growth differential 3/	-0.8	-1.0	-1.4	-2.4	-1.8			-1.5	-2.9	-3.0	-2.8	-2.7	-2.4
Of which contribution from real interest rate	0.4	0.5	0.2	-0.8	-0.2			0.1	0.5	0.8	0.8	0.8	0.9
Of which contribution from real GDP growth	-1.2	-1.5	-1.7	-1.7	-1.6			-1.6	-3.4	-3.8	-3.6	-3.5	-3.3
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			21.0	9.9	3.2	3.2	3.1	2.9
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
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			21.0	9.9	3.2	3.2	3.1	2.9
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
Residual, including asset changes (2-3)	0.1	-0.2	0.0	0.7	0.3			0.1	0.0	0.0	-0.1	-0.2	-0.2
Public sector debt-to-revenue ratio 1/	117.1	118.8	119.1	111.3	102.5			208.9	251.4	244.0	236.9	229.1	223.0
Gross financing need 5/	2.7	3.0	2.4	1.5	1.3			1.2	1.1	1.0	1.0	1.0	1.0
in billions of U.S. dollars	36.4	42.9	40.2	28.8	29.2			31.3	31.3	31.3	35.0	38.8	42.5
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	8.3	9.1	10.0	10.1	9.9	9.0	1.0	10.0	10.0	9.5	9.0	9.0	8.5
Average nominal interest rate on public debt (in percent) 6/	4.9	3.5	4.2	2.8	2.8	5.6	3.7	3.0	4.1	4.6	4.7	4.9	5.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.8	2.9	1.6	-4.1	-1.0	3.5	5.7	1.0	1.8	2.2	2.3	2.3	2.5
Exchange rate (LC per US dollar)	8.3	8.3	8.3	8.3	8.1	8.3	0.1	8.0	8.0	8.0	8.0	8.0	8.0
Nominal depreciation of local currency (LC per dollar)	0.0	0.0	0.0	0.0	-2.5	-0.3	0.8	-0.9	0.0	0.0	0.0	0.0	0.0
Exchange rate (US dollar per LC)	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	2.6	0.3	0.8	0.9	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.1	0.6	2.6	6.9	3.8	2.4	2.7	2.0	2.2	2.3	2.4	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	13.7	16.6	7.5	8.7	13.9	13.6	5.8	13.8	1.7	7.8	10.6	10.5	9.4
Primary deficit	2.0	2.4	1.7	1.0	0.9	1.8	0.8	0.7	-0.3	-0.9	-0.9	-0.9	-1.0
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 7/								**38.1**	**47.9**	**50.5**	**52.8**	**54.7**	**56.4**
A2. No policy change (constant primary balance) in 2006-10								**38.2**	**41.9**	**46.8**	**47.7**	**48.3**	**49.0**
B. Bound Tests													
B1. Real interest rate is at baseline plus one standard deviations								**38.0**	**45.6**	**46.0**	**46.4**	**46.5**	**46.6**
B2. Real GDP growth is at baseline minus one-half standard deviation								**38.0**	**44.9**	**44.6**	**44.4**	**44.0**	**43.8**
B3. Primary balance is at baseline minus one-half standard deviation								**38.0**	**45.1**	**44.9**	**44.7**	**44.2**	**43.8**
B4. Combination of B1-B3 using one-quarter standard deviation shocks								**38.0**	**45.5**	**45.8**	**46.0**	**46.0**	**46.0**
B5. One time 30 percent real depreciation in 2006 9/								**38.0**	**45.1**	**44.3**	**43.6**	**42.7**	**41.9**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**38.0**	**54.7**	**53.5**	**52.3**	**51.0**	**49.8**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure I.1. China: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: Data provided by the Chinese authorities; and staff estimates and projections.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline scenario. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

ANNEX II: CHINA'S FISCAL REFORMS AND TECHNICAL ASSISTANCE

1. In recent years, the Fund has provided technical assistance in a number of areas (Table II.1). This annex focuses on the main issues and recommendations in the fiscal area.

Fiscal Technical Assistance Program

2. FAD has largely provided advice on tax policy, tax administration, and budget and treasury 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), or the tax treatment of specific sectors (i.e., financial sector).

4. On the VAT, the focus of the Fund's TA advice on the VAT has been on transforming it into a consumption-type VAT (now being piloted). As there are important revenue and central-province intergovernmental implications of the VAT reform, the Fund has paid particular attention to alternative transition strategies. The Fund's TA advice has also focused on improving the structure of the 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. For the PIT, whose yield is still relatively insignificant, its structure should be streamlined and its rates simplified; the authorities have recently increased the PIT income exemption threshold, along the lines of previous Fund's advice. In addition, the liberalization of the financial sector under the WTO commitments has important tax implications, some of which already covered by Fund TA; a mission is currently advising the authorities on the VAT treatment of financial services. Finally, the authorities have also expressed interest in receiving TA on streamlining real estate taxes, which are an important revenue handle for local governments.

Tax administration

5. 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 development has been satisfactorily completed and risk management techniques have been introduced to SAT and to its provincial managers.

Despite progress, the SAT is yet to adopt a nationally consistent organizational structure. As an initial step, Fund TA would advise on an appropriate structure, its implications and needed changes. There is also a need to strengthen other aspects of SAT operational effectiveness, for example by improving compliance management and developing self-assessment practices. Planned TA activities for 2006 will cover business process reengineering, information technology, risk assessment, and taxpayer services.

Public financial management

6. In order to improve the efficiency of public spending, a number of budget and treasury reforms are being implemented, including broader budget coverage and establishment of a treasury single account (TSA) at the central level, now being rolled out to the provincial level.[16] These efforts have been supported by Fund's extensive technical assistance. In line with the authorities' request, in 2006 the Fund will provide TA on reforming the Budget Law and strengthening the cash management system.

Intergovernmental fiscal relations

7. In recent years, the authorities have become increasingly aware of the need to reform the system of 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 sharing and the design of the transfer system also need to be reformed.

8. Building on past activities in these areas, the Fund stands ready to provide TA on the reform of the system of intergovernmental fiscal relations.

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[16] A standard Treasury Single Account (TSA) is a centralized 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.

Table II.1. China—Summary of Technical Assistance, 2001–2006		
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
FAD	Mission on VAT treatment of financial services	April 2006
Tax Administration Reform		
FAD	Five missions on computerizations	June 2000–Oct. 2002
FAD	Two missions on strategic planning	Nov. 2001–Aug. 2002
FAD	Seminar on strategic planning in Washington	October 2002
FAD	Mission on revenue administration	November 2003
FAD	Review of computerization project	September 2004
FAD	Mission on business process reengineering pilot	November 2005
FAD	Mission on IT modernization	June 2006
Public Financial Management		
FAD	Workshop on government fiscal management information system	February 2001
FAD	Mission on treasury/accounting reform; macrofiscal coordination	November 2001
FAD	Mission on budget preparation, 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
FAD	Mission on cash management	April 2006
Intergovernmental Fiscal Relations		
FAD	Mission intergovernmental relations	November 2002
FAD	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
STA	Mission on government financial statistics	January 2005
STA	High level seminar on macroeconomic statistics	January 2005
STA	Mission on monetary and finance statistic	Feb./March 2005
STA	Seminar on International Investment Position	April 2005

Table II.1. China—Summary of Technical Assistance, 2001–2005 (Cont.)		
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
MFD	Mission on AML/CFT	January 2005
Review of Technical Assistance		
FAD	Visit to review UNDP/IMF/China fiscal reform TA program	February 2001
FAD/TAS	Two missions for tripartite review of the UNDP/IMF/China fiscal reform TA program	January 2002/February 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
FAD	Visit to discuss TA needs under UNDP/DFID fiscal reform project	December 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
INS/MFD	High-level seminar on exchange rate issues	May 2004
STA	Seminar on coordinated portfolio investment survey	April 2004
STA	Seminar on quarterly national accounts	September 2004
MFD	Workshop on Monetary Strategy and Operation	May 2005

ANNEX III: CHINA—FUND RELATIONS
As of April 30, 2006

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	5,629.97	88.39
Reserve position in Fund	739.27	11.61

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	236.80	100.00
Holdings	927.32	391.82

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**:
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming			
	2007	2008	2009	2010
Principal	0	0	0	0
Charges/Interest	0.01	0.01	0.01	0.01
Total	0.01	0.01	0.01	0.01

VII. **Exchange Arrangements**:

1. China's exchange rate regime is currently classified as a conventional peg to a single currency[17]. On July 21, 2005, the People's Bank of China (PBC) announced that the exchange rate of the renminbi against the U.S. dollar would be revalued upward by about 2.1 percent

[17] On July 21, 2005, China announced a 2.1 percent revaluation of the renminbi-U.S. dollar exchange rate and a change in its exchange rate arrangement to allow the value of the renminbi to fluctuate based on market supply and demand with reference to an undisclosed basket of currencies. To permit a greater role for market forces in determining the renminbi exchange rate, steps have been taken since July 2005 to liberalize and develop China's foreign exchange markets, including the establishment of an over-the-counter spot foreign exchange market and markets for currency swaps and futures. From end-July 2005 to end-April 2006, the renminbi's exchange rate was more flexible, but, the fluctuation in the renminbi-U.S. dollar exchange rate was less than the 2 percent range (for a three-month period) used in the IMF's de facto exchange rate classification scheme as an indicator for a conventional fixed peg exchange rate arrangement.

(from RMB 8.28/US$ to RMB 8.11/US$) and the exchange rate regime would move to a managed float in which renminbi's value is set with reference to a basket of currencies. The stated intention of the Chinese authorities was to increase the flexibility of the renminbi's exchange rate. The authorities indicated that they will not publish the currencies in the reference basket and their relative weights, and many of the operational details regarding the new arrangement remained unclear at that time. The PBC indicated that it would adjust the exchange rate trading band as necessary to reflect market developments and financial and economic conditions. Under the new regime, the band around the daily trading price of the US dollar against the RMB was kept at ± 0.3 percent around the central parity published by the PBC while the trade prices of the non-US dollar currencies against the RMB were allowed to move within a certain band announced by PBC, which was initially set at ±1.5 percent and increased to ±3 percent in September 2005. In August 2005, the governor of PBC revealed that U.S. dollars, Euro, Japanese Yen, won of the Republic of Korea were the main currencies included in the basket, and UK pound, the Thai baht, and the Russian ruble were among other currencies included in the basket. The weights were not disclosed.

2. On January 4, 2006 over-the-counter (OTC) trading of spot foreign exchange was introduced with 13 banks initially designated as market makers. The centralized spot foreign exchange trading system (CFETS) remains operative, but its central parity rate (renminbi against the U.S. dollar) is now based on a weighted average of CFETS and OTC transactions. Under the new system, CFETS first inquires prices from all market makers before the opening of the market in each business day, exclude the highest and lowest offers, and then calculate the weighted average of the remaining prices in the sample as the central rate of the RMB against the US dollar for the day. This is in contrast to the previous arrangement where the central parity rate was the closing price of the previous day in the CFETS. The weights for the market makers, which remain undisclosed, are determined by the CFETS in line with the transaction volumes of the respective market makers in the market. On June 20, 2006 the RMB/dollar rate stood at 8.0036.

3. 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. Starting on May 1, 2006, all enterprises (domestic institutions) having foreign exchange revenue from foreign operation or from current accounts may keep foreign exchange equivalent to the sum of 80 percent of their previous year's foreign exchange revenue and 50 percent of current account foreign exchange expenditure. Domestic institutions that had no current account foreign exchange revenue in the previous year are allowed to retain an initial limit of foreign exchange revenue equivalent to US$500,000. There are no measures currently in force that have been determined to be exchange restrictions subject to Fund jurisdiction.

4. Exchange controls continue to apply to most capital transactions, but are being relaxed. Effective on July 1, 2006, quotas on foreign exchange purchases for foreign direct investment (FDI) was abolished, and domestic investors were allowed to purchase foreign exchange to finance pre-FDI activities. Since December 1, 2002, qualified foreign institutional investors (QFIIs) have been allowed to invest domestically in A shares, subject to certain restrictions, and

all nonresidents have been allowed to purchase B shares, which are denominated in U.S. dollars or Hong Kong dollars. The Qualified Domestic Institutional Investor (QDII) scheme was introduced in 2004, and new regulations are under preparation to allow qualified banks, asset management companies and insurance companies to invest abroad. To promote the development of QDII, starting on May 1, 2006, residents can purchase up to $20,000 foreign exchange for depositing in banks or for current account transactions. Beyond the quota, purchases require relevant documents. In 2004, international financial institutions were approved to raise funds domestically in renminbi for use offshore, while other nonresidents are still not permitted to issue capital or money market securities in the domestic market. 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).

VIII. Article IV Consultation:

5. The Board discussion for the 2005 Article IV consultation was concluded on August 3, 2005 and the staff report was published on November 17, 2005. China is on the standard 12-month consultation cycle. The 2006 Article IV mission was concluded on May 26, 2006.

IX. Technical Assistance:

6. Technical assistance provided in 2000 through May 2006 is summarized in Annex II.

X. Other Visits:

7. A mid-term staff visit was held in December 2005. The Managing Director met with Governor Zhou in Shanghai on March 18, 2005 and in Washington D.C on August 22, 2005. On September 3, 2005 Mr. Carstens had a dinner meeting with Deputy Governor Hu in Beijing.

XI. Resident Representative:

8. 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.

ANNEX IV: CHINA—STATISTICAL ISSUES

1. While China's economic statistics are adequate for surveillance purposes, weakness remain in the quality of the data, including coverage, frequency and timeliness. Nevertheless, 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 its metadata were posted on the Fund's DSBB (the most comprehensive documentation of Chinese economic and financial statistics available in English). The most recent metadata updates were received in April 2005 and 2006 updates are expected imminently. STA held a workshop and a high-level seminar on the use of macroeconomic statistics for policy analysis and decision making in China in January 2005. A STA mission in May 2006 discussed the key issues of macroeconomic statistics and the likely follow-up activities. The main statistical issues are noted below.

Real sector statistics

2. Data on the expenditure components of GDP are not available on a quarterly basis. Annual GDP by expenditure is compiled at current and constant 2000 prices, but the constant price estimates are not published. Quarterly 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 needs to be improved 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. At the end of 2005, the NBS released revised estimates of GDP for 2004. The revisions were based on the results of an economic census conducted at the beginning of 2005, which improved the coverage of services and the second industry activities. Based on the 2004 data, a standard statistical technique (the trend-deviation method) was then used to revise the data back to 1993. The revisions resulted in a significant upward shift in the estimated levels of GDP.

4. 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.

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

6. 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 an annually-chained Laspeyres price index, 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 around 700. The most recent weights of the major CPI components were provided to the staff in 2006.

Government finance statistics

7. 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. However, the situation should improve with the introduction of a revised budget classification system, starting with the 2007 budget.

8. China has reported relatively detailed central government and local government budget data for 2003 for publication in the 2005 *GFS Yearbook*. No data are provided on government debt and only limited data were submitted for STA's review on 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 primarily by function and does not fully comply with international best practice. The authorities have agreed to resubmit a more comprehensive set of data on general government for review by STA's Government Finance Division.

Monetary and financial statistics

9. 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.

10. The monetary and banking surveys lack sufficient detail with regard to bank claims on the government, hampering the estimation of the fiscal deficit from the financing side. The PBC has also ceased to report separate data on central government deposits in its balance sheet since April 2005 because the MOF no longer distinguishes between central and other government deposit accounts. This change will lead to breaks in data series of monetary base and monetary aggregates. In addition, detailed breakdowns of bank credit extended by industry, and by borrower (including by the various elements of the state and nonstate sectors), are not publicly available. The staff continues to encourage the authorities to report information of this nature for analytical purposes.

11. 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. The monetary and financial statistics mission that visited Beijing in early 2005 made recommendations for addressing these issues.

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

13. The most notable progress made by the PBC on monetary statistics is as follows: (1) expanding the coverage of financial institutions; (2) adjusting the classification of financial corporations; (3) improving the "all accounts" reporting system and (4) improving its data dissemination following the GDDS recommendations, such as disseminating advance release calendars on the PBC's websites, and reporting to the IMF using the integrated correspondence system. On financial soundness indicators, China is in the process of establishing its own system of financial soundness indicators and at this stage is soliciting comments on the new system from all relevant agencies.

External sector statistics

14. The State Administration of Foreign Exchange (SAFE) relies on an International Transactions Reporting System (ITRS) which produces data derived from information on foreign exchange transactions conducted by banks. To supplement the ITRS, data on travel credits and trade credits are collected through periodic sample surveys, while additional data are collected from other government agencies and reports on balance sheet information from financial institutions and data on portfolio investment and direct investment.

15. 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 three to five months after the end of the reference period while annual data are disseminated four to five months following the end 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. The international investment position for 2004 and 2005 were published in May 2006.

16. 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, and a seminar on IIP statistics was delivered in Shanghai in April 2005. 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, while the direct investment survey has not provided reliable data. Since ITRS is the major data source for BOP in China, in order to ensure its smooth operation, 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.

17. SAFE officials reported during a visit to STA in December 2005 that there have been some improvements in external sector statistics, including the dissemination of higher frequency balance of payments statistics, and the new Management Information System (MIS) for compiling balance of payments and IIP statistics that would become operational in 2006.

18. 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 *External Debt Statistics: Guide for Compilers and Users*. Such data are compiled monthly but published on a quarterly basis (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. STA conducted a seminar on external debt statistics in August 2005 as part of the China Training Program.

19. In April 2004, STA conducted a seminar in Xianyang, 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

20. 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. Balance of payments data are reported on an annual basis for publication in the *Balance of Payments Statistics Yearbook* and the *IFS.*

21. 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

22. 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: Table of Common Indicators Required for Surveillance
(As of June 23, 2006)

	Date of latest observation	Date received	Frequency of Data[8]	Frequency of Reporting[8]	Frequency of publication[8]
Exchange Rates	6/19/06	6/19/06	D	M[9]	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2006	May 2006	M	M	M
Reserve/Base Money	May 2006	6/14/06	Q, M	Q, M	Q, M
Broad Money	May 2006	6/14/06	M	M	M
Central Bank Balance Sheet	Apr 2006	Jun 2006	M	M	M
Consolidated Balance Sheet of the Banking System	Apr 2006	Jun 2006	M	M	M
Interest Rates[2]	6/19/06	6/19/06	[10]	[10]	[10]
Consumer Price Index[3]	May 2006	6/12/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[5]	April 2006	May 2006	M	M	A
Revenue, Expenditure, Balance and Composition of Financing[4]– Central Government	Dec 2005	Mar 2006	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[6]	Dec 2004	Dec 2005	A	A	A
External Current Account Balance	Dec 2005	May 2006	A, Q[11]	A, Q[11]	A, Q[11]
Exports and Imports of Goods and Services	May 2006	6/12/06	M	M	M
GDP/GNP[7]	Dec 2005	Jan 2006	A, Q(cumulative)	A, Q(cumulative)	A, Q(cumulative)
Gross External Debt	Dec 2005	Mar 2006	A, Q	A, Q	A, Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Only 12-month growth rates are reported (price indices are not available).
[4] Data on financing (foreign, domestic bank, and domestic nonbank financing) is not available.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] For real GDP, level data are available only on an annual basis (growth rates are available on a quarterly, cumulative basis).
[8] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[9] While officially transmitted on a monthly basis, these data are available from news sources on a daily basis.
[10] Interest rates change only infrequently; these changes are publicly announced.
[11] Data provided semi-annually.

ANNEX V: CHINA—RELATIONS WITH THE WORLD BANK[18]

1. The World Bank has been active in China since 1980. World Bank commitments to China as of June 7, 2006 totaled about $40.4 billion for 270 projects. About 80 of these projects are still under implementation, making China's portfolio 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 rural development, social sectors (health, education, social protection), and direct poverty reduction comprising the remainder. A strong environment focus runs across sectors, and environment-related projects in energy, urban wastewater, water supply and sanitation, and rural development together account for around 60 percent of the IBRD portfolio.

2. In FY2006, lending is projected to total about $1.45 billion in IBRD loans for eleven 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 FY2006 include two supporting agricultural development in poor rural areas, four for urban environmental and transportation improvements in Shanghai, Fuzhou, Henan, and Liaoning, projects supporting highways and inland waterways to improve access to interior provinces, one for renewable energy, one for integrated land and watershed management in the Changjiang/Pearl River Watershed, and one technical assistance project. 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 range from $2.0-3.0 billion, with support provided to the development of infrastructure, agriculture and health in the interior provinces and in the provinces of NE China, and urban management and the environment principally in these 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), is currently blending grant resources with IBRD loans, resulting in more concessional loans (at an interest rate of about 2 percent) for selected projects in the social and rural sectors. The FY2004 Basic Education Project and FY2005 Poor Rural Communities Development Project were supported by this mechanism. In FY2007 a rural water supply and sanitation project is also expected to benefit from this mechanism.

[18] Prepared by World Bank staff.

4. The new World Bank Group Country Partnership Strategy (CPS), endorsed by the WB Board in May 2006, covers both lending and non-lending activities and is designed to support the five strategic focal areas consistent with China's 11th Five Year Program: integrating China into the world economy, reducing poverty and inequality, addressing resource scarcities and environmental challenges, strengthening the financial sector, and improving market and public institutions.

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 partnership 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; quarterly economic updates and a series of policy notes covering topics ranging from intergovernmental fiscal policies to health care to state enterprise dividends; a study of public service unit reform; an economic memorandum on managing scarce resources; and studies of foreign capital utilization. In FY2006, the World Bank has been assisting on, *inter alia,* on the following areas: (i) *poverty and vulnerability*, including a poverty assessment, a major study of rural health care reform, and analysis of social protection pilots, and rural connectivity; (ii) *managing resource scarcity and environment*, including studies on land policy, water scarcity, and metropolitan area management; (iii) *financing rapid growth,* including a financial sector program focused on access to finance, financial stability, and capital markets; (iv) *improving public and market institutions*, including the Northeast Revitalization strategy, and studies on sub-national fiscal reforms, rural finance, local investment climates, and public service delivery.

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. The Economic Reform Implementation project, a technical cooperation credit, was approved in FY2006. 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 May 31, 2006, IFC had outstanding commitments for financing 76 projects in China. For these projects IFC has provided US$1,457 million: US$1,283 million for IFC's own account and US$174 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. IFC's interventions in China focus on completing standard-setting model transactions for private sector investments, with a view of promoting innovation, creating demonstration effects and improving corporate practices. IFC's priorities in China include: improving the business environment and strengthening regulatory capacity mainly through the IFC's technical assistance facility PEP-China; expanding access to markets by supporting the entry of private enterprises in new sectors and through projects in agribusiness and forestry; upgrading corporate practices in the area of corporate governance, environmental and social impacts; expanding access to finance and financial sector development by supporting SME lending and the growth of private financial institutions; enhancing environmental sustainability and energy efficiency; promoting private participation in infrastructure; and helping to address regional imbalances.

Table V.1. China: IBRD-IDA Lending Activities, FY1981–06 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	2,202	869	1,057
1995	630	2,434	659	1,555
1996	480	2,540	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	0	1,218	105	1,205
2005	0	1,030	55	1,075
2006 3/	0	1,455	53	970
Total	9,947	31,149	10,151 4/	22,302

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 2006 is an estimate for the entire year; disbursement numbers are actuals as of June 7, 2006.
4/ IDA disbursements exceed commitments due to changes in the US$-SDR exchange rate.

Table V.2. Distribution of Lending, FY 1980–05

Sector	US$ mn.	Percent	No. of Projects
Rural devt./poverty alleviation	10,033	25.3	66
Industry and energy	10,214	25.8	55
Industry/corporate reform	3,013		20
Energy/renewable energy	7,201		35
Transport	10,221	25.8	55
Human resources	2,650	6.7	30
Education	1,727		19
Health	923		11
Environment and urban	5,895	14.8	43
Environment	3,256		24
Urban development	1,818		12
Water supply	821		7
Technical assistance/public sector	628	1.6	14
Total	39,641	100	263

ANNEX VI: CHINA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

1. The Asian Development Bank's operation in the PRC 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 the PRC became a member of ADB in 1986, 114 public sector loans totaling $16.2 billion and 498 technical assistance projects amounting to $256.8 million have been approved as of end-December 2005. In addition, ADB has 17private sector loans totaling $137.2 million in loan and $274.3 million in equity as of 31 December 2005.

3. Infrastructure, urban development, environmental improvement and rural and agriculture development will remain Government's priority sectors identified for ADB assistance. ADB lending will continue to focus on the central, western and northeastern provinces.

4. The Country Strategy and Program Update (2006–2008) has programmed a total loan assistance of $4.5 billion for the period 2006–2008, amounting to an annual average lending of about $1.5 billion. Of this, 47.6% is for the transport sector, 20.0% for the agriculture and natural resources sector, 14.8% for the social infrastructure sector, 12.0% in the energy sector and 5.6% for multi-sectors. About 85% of the loan projects are located in the central and western provinces.

5. The ADB's lending program will continue to be supported by technical assistance. The annual nonlending program amounts to around $11 million for the period 2006–2008. TAs for operational support cover: (a) transport, (b) energy, (c) land management, (d) water supply and wastewater treatment, (e) urban development, (f) education and health, and (g) environment. TAs for policy impacts and knowledge-based products fall into the following areas: (a) support for policy reform and deepening the impact of ADB lending projects, (b) financial sector reform, (c) law and development, (d) fiscal reform, and (e)support to education and health.

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.

Table VI.1. China: AsDB's Commitments and Disbursements, 1993–2005
(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
2004	8,733	636
2005	11,060	875

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

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

	1990	1995	2001	2002	2003
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates				
Population below US$1 a day	33.0	...	16.1	...	...
Poverty gap at US$1 a day	8.9	...	3.9	...	...
Share of income or consumption held by poorest 20 percent	...	...	4.7	...	...
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	11.0	...
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	...
	2005 target = education ratio to 100				
3 Promote gender equality					
Ratio of girls to boys in primary and secondary education	87.0	87.3	97.6	98.4	...
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	37.7	38.7	39.2	39.4	39.5
Proportion of seats held by women in national parliament	21.0	21.0	22.0	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	37.0
Infant mortality rate (per 1,000 live births)	38.0	37.0	31.0	30.0	30.0
Immunization, measles (percent of children under 12 months)	98.0	83.0	84.0	84.0	84.0
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	97.0	...
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	87.0	...	...
Number of children orphaned by HIV/AIDS	...	...	76000.0	...	...
Incidence of tuberculosis (per 100,000 people)	116.5	110.8	104.4	103.3	102.3
Tuberculosis cases detected under DOTS	...	14.9	30.7	30.0	42.9
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	7.8
GDP per unit of energy use (PPP $ per kg oil equivalent)	1.7	2.8	4.7	4.7	...
CO2 emissions (metric tons per capita)	2.1	2.7	2.3	...	...
Access to an improved water source (percent of population)	70.0	...	75.0	77.0	...
Access to improved sanitation (percent of population)	23.0	...	38.0	44.0	...
8 Develop a Global Partnership for Development	2015 target = various 2/				
Youth unemployment rate (percent of total labor force ages 15-24)	2.5	2.9	3.1	...	...
Fixed line and mobile telephones (per 1,000 people)	5.9	36.0	247.7	327.8	423.8
Personal computers (per 1,000 people)	0.4	2.3	19.0	27.6	...
General indicators					
Population (in billions)	1.1	1.2	1.3	1.3	1.3
Gross national income (US$ trillion)	0.4	0.6	1.1	1.2	1.4
GNI per capita (US$)	320.0	520.0	900.0	970.0	1100.0
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	1.9
Life expectancy at birth (years)	68.9	69.4	70.5	70.7	70.8

Sources: World Development Indicators database, April 2006. 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 31, 2006

1. **This statement contains information that has become available since the staff report was circulated to the Executive Board on July 11, 2006.** The thrust of the staff appraisal remains valid.

2. **Economic growth accelerated in the second quarter of 2006**. GDP grew by 11¼ percent (year-on-year), up from 10¼ percent in the first quarter, reflecting continued high investment and rising net exports. Despite some tightening measures, investment growth topped 30 percent (year-on-year) in the second quarter, while the trade surplus increased, as growth in exports outpaced that of imports. Inflation in June was slightly higher at 1½ percent (year-on-year). With GDP growth in the first half of 2006 at about 11 percent, there are upside risks to the current staff projection of a 10 percent GDP growth rate for the year as a whole, as noted in the staff report (paragraph 13).

3. **Money and credit growth slowed modestly in June, but liquidity in the banking system remains high.** Broad money (M2) grew by about 18½ percent (year-on-year) in June, down from 19 percent in May. Total loan growth also moderated to 14¼ percent (year-on-year) in June, from 15 percent in May. In an effort to further mop up the liquidity and curb credit growth, the People's Bank of China on July 21 raised the required reserve ratio on bank deposits by another 50 basis points (effective August 15), adding to the 50 basis point increase in early July. Despite these recent steps, as noted in the staff report, a significant risk remains that macroeconomic policies are not sufficiently tight to rein in lending and investment growth.

4. **The renminbi/US$ rate remains tightly managed although its variability has increased.** In the past two weeks, the daily rate has generally traded below RMB 8 per U.S. dollar with inter-day changes ranging from an appreciation of 0.14 percent to a depreciation of 0.08 percent. Foreign exchange accumulation remains rapid with total reserves reaching $941 billion in June reflecting a $122 billion accumulation in the first half of 2006.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 06/103
FOR IMMEDIATE RELEASE
September 11, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with the People's Republic of China

On July 31, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the People's Republic of China.[1]

Background

China's output growth continues to be strong. Based on the revised official data, GDP growth in 2005 reached 10 percent, roughly the same as in the previous year. Indicators for the major components of demand suggest that output growth could have been much higher than officially estimated in 2005. Economic activity maintained its momentum in the first quarter of 2006, with further evidence of acceleration in investment. GDP grew by 10¼ percent (year-on-year) in the first quarter. Total nominal fixed investment increased from 25.7 percent in 2005 to 29.8 percent in the fist half of 2006. Net exports continued to be strong, although the pace of import growth has accelerated. Indicators also suggest that consumption remained robust. Despite strong growth, inflation remains subdued. After peaking at 5¼ percent (year-on-year) in mid-2004, headline CPI inflation fell to 1¾ percent in 2005 and 1½ percent by May 2006, largely driven by a significant moderation of food price inflation.

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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. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

The external position strengthened substantially in 2005**.** The trade surplus was the main driver, surging to $135 billion in 2005 compared to $59 billion in 2004. Export growth was robust given the strong world demand and China's increasing role in processing trade. The overall slowdown in import growth resulted in a large increase in the current account surplus in 2005 to over 7 percent of GDP, up from 3½ percent in 2004. This slowdown largely reflected a switch away from imports toward domestically produced inputs, a moderation in the investment demand for machineries, and some reduction in raw material inventories. The trade surplus continues to strengthen in 2006, with a surplus through May 2006 of $47 billion, significantly higher than the $30 billion recorded for same period last year. Despite a pickup in import growth driven mostly by primary products and machinery, export growth remains strong. Reserves increased by $208 billion in 2005, broadly in line with reserves accumulation in 2004, and by a further $76 billion in 2006, bringing the level at end-April to about $895 billion. Net FDI inflows reached $68 billion in 2005 compared to $53 billion in 2004. Over the period, non-FDI capital flows sharply reversed to an outflow of $22 billion in 2005 (including errors and omissions), compared to an inflow of $85 billion in 2004.

Less than full sterilization of foreign exchange reserve accumulation has left substantial liquidity in the banking system, and credit growth appears to be accelerating. While broad money (M2) has accelerated since mid-2005, reaching 19 percent annual growth through May 2006 (compared to PBC's annual target of 16 percent growth), credit growth averaging around 13½ percent in 2005, remained relatively subdued, reflecting more cautious lending by the large state-owned banks undergoing restructuring and "moral suasion" on the part of the PBC. However, credit growth has since risen to 16 percent in May 2006 (compared to the PBC's annual target of 12 percent). In response, the PBC increased the benchmark lending rate modestly in May (by 27 basis points), the second such increase in 10 years and announced that the reserve requirement ratio of all banks except the rural credit co-operatives will be raised by 0.5 percentage point to 8 percent on July 5 2006. Short-term interest rates have risen somewhat since early November, as the People's Bank of China (PBC) stepped up open-market operations, but they remain well below the 2½–3 percent levels of 2004.

Staff projects GDP growth to remain around 10 percent in 2006. This forecast assumes that appropriate macroeconomic policies will be in place to constrain investment growth—unless these policy actions are taken, GDP growth could easily exceed the 10 percent forecast. Export growth is expected to remain strong, but to moderate from its 2005 pace. Import growth, although higher than in 2005, would remain subdued as investment and export growth slows. Consumption growth is expected to remain relatively strong, as rural incomes continue to rise and consumer credit facilities expand. The export slowdown and higher import growth should keep the external current account from growing further relative to GDP in 2006. However the outturn in the first few months of 2006 points to the possibility that export growth may not slow as much as generally expected, which could result in a further widening of the annual current account surplus. Inflation is expected to remain below 2 percent in 2006, as falling prices in sectors with overcapacity will likely be offset by a modest rise in services inflation, as well as some upward adjustments in certain administered prices. With price declines confined to certain sectors, the risk of generalized deflation in the economy at present appears small. In the near term, a significant risk remains that macroeconomic policies will not be sufficiently tight to contain investment growth. In particular, there is a need for monetary policy to prevent a surge in credit growth from tipping off a boom-bust cycle and an associated rise in banks' nonperforming loans. Growing protectionist sentiments in China's major markets, especially the United States and the EU, also present a major risk. Moreover, a disorderly unwinding of global imbalances would threaten China's growth, as economic activity in partner countries would likely suffer lingering adverse effects. Although less immediate, avian flu remains a threat.

China has continued to implement a broad range of structural reforms. In the banking sector, progress has been made in strengthening supervision and improving bank operations, especially in the three large state-owned commercial banks, which have been recapitalized. State-owned enterprises have become more market oriented and corporate and management restructuring has continued. A number of steps also have been taken in line with China's WTO commitments, including further tariff reductions that lowered the unweighted average tariff rate by half a percentage point to 10 percent in 2005.

Executive Board Assessment

Executive Directors commended the authorities for sustaining high economic growth and noted that China's prospects for the future remain favorable, provided that the risks and challenges faced by the country are addressed. They broadly endorsed the government's medium-term economic reform strategy, particularly the need to rebalance the economy away from heavy dependence on investment and exports for growth towards consumption.

Directors agreed that liquidity in the banking system is abundant and noted that, in light of this, a further pick-up in the already high rate of credit and investment growth remains a near-term risk. While the monetary policy actions taken so far were welcomed, it was emphasized that additional steps will likely be needed. Directors viewed that the authorities should further step up reliance on open market operations to drain liquidity from the banking system, and observed that this may need to be supplemented by other monetary policy measures, such as additional hikes in benchmark interest rates and/or the reserve requirement ratio.

Directors emphasized the importance of improving the effectiveness of monetary policy. Directors noted that the authorities also use moral suasion and administrative steps to restrain credit and investment growth. While recognizing that there might be need for such measures, a number of Directors noted that they made it difficult for banks to operate fully on a commercial basis. Directors stressed that greater exchange rate flexibility is needed to enable the PBC to use its monetary policy instruments more effectively. Some Directors also viewed the PBC's lack of sufficient discretion in setting interest rates as an impediment to timely and effective policy action.

Many Directors found it appropriate for China to continue to allow greater flexibility in its exchange rate in a gradual and controlled manner. They shared the authorities' concern that accelerating exchange rate flexibility could have an adverse impact on macroeconomic stability. Some of these Directors also viewed that exchange rate adjustment alone would have a limited impact on external balances. A number of other Directors, however, stressed that the flexibility afforded by the current exchange rate system should be used more extensively. These Directors noted that the current strength of the Chinese economy provides a favorable context for adjustment and should serve to alleviate the authorities' concerns about the potential adverse economic effects. Directors noted that greater exchange rate flexibility, along with other policy changes and reforms in China, will aid in rebalancing the economy over the medium term, and will contribute to the orderly resolution of the global current account imbalance, in conjunction with concerted policy efforts by other key economies.

Directors noted that the last few years of fiscal consolidation have created the space for a needed step-up in social spending, which would serve to help rebalance growth towards consumption, as well. In this regard, they considered the initiatives in the 2006 budget to raise social spending to be appropriate from a near-term perspective. Directors supported the priority given by the authorities to developing comprehensive plans to reform the provision of key social services, such as health care, education, and pensions, and to improving implementation capacity, including the reforms entrained in the budget process (the revised budget classification, chart of accounts, and extension of the treasury single account). They noted that such steps will be needed before embarking on large scale increases in spending in these areas. Directors also emphasized the importance of reforms in center-local fiscal relations, and urged the authorities to ensure all local governments have adequate resources to meet their spending responsibilities.

Directors commended the progress achieved in bank reform. They noted that improving intermediation of China's large private savings will be critical to rebalancing economic growth over the medium term. In this regard, they welcomed the authorities' efforts to further improve the banks' commercial orientation, internal controls, and governance, and stressed the need for the early adoption of a formal reform plan for the Agricultural Bank of China (ABC). More generally, Directors recommended the continued scaling-back, and eventual elimination, of government involvement in the management and business operations of the banks. They urged a further strengthening of banking supervision, in particular with regard to assessing banks' foreign exchange and credit risks, and noted that closer monitoring of the flow of new non-performing loans is also essential to the early detection of potential problems.

Directors also welcomed the steps taken to accelerate the development of China's capital markets. They recognized the progress realized in reviving the equity markets, the strong growth in the short-term corporate bills market, and the launching of the interbank market for asset-backed securities, as important steps. While noting that some impediments in the corporate bond market had been addressed by the new Securities Act, Directors observed that allowing bonds to be issued based on a disclosure-based system, while removing the cap on corporate bond interest rates and streamlining regulatory responsibilities, will be key steps to accelerating the development of this market. In this context, they welcomed the authorities' agreement in principle to conduct an Financial Sector Assessment Program and encouraged them to set an early date for participation. Such an exercise would contribute to a stocktaking of recent progress in financial sector reforms and to identifying priorities for further reforms.

Directors commended the authorities for setting up a task force to look into the modalities for greater dividend payments to the government by the state-owned enterprises, and emphasized that such dividend payments should be made to the budget. Directors considered that this policy, by curbing the sharp rise in investment in some sectors and by providing additional resources to fund reforms in social services, will be an important element of the strategy to rebalance growth.

Directors welcomed improvements in economic statistics, including in the national income accounts and the international investment position. Looking ahead, they viewed the publication of annual and quarterly real GDP on an expenditure basis and further improvements in some aspects of balance of payments statistics as key priorities, and urged the authorities to continue to make use of the IMF's technical assistance in these areas.

Directors welcomed China's provision of financial support and debt relief to many low-income countries. Directors encouraged the authorities to share information on these activities with the IMF, to participate fully in the Heavily Indebted Poor Countries initiatives, and to make their lending activities consistent with the low-income country debt sustainability framework.

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People's Republic of China: Selected Economic and Financial Indicators 1/
(In percent of GDP, unless otherwise stated)

	2001	2002	2003	2004	2005	2006 IMF Staff Projections
Domestic economy						
Real GDP growth (in percent)	8.3	9.1	10.0	10.1	10.2	10.0
Consumer prices (in percent, period average)	0.7	-0.8	1.2	3.9	1.8	1.5
External economy						
Exports (in billions of US$)	266	326	438	593	762	937
Imports (in billions of US$)	-232	-281	-394	-534	-628	-779
Current account balance (in billions of US$)	17	35	46	69	161	179
Capital and financial account balance 2/ (in billions of US$)	35	32	53	111	63	41
Of which: Direct investment, net (in billions of US$)	37	47	47	53	68	54
Gross official reserves 3/ (in billions of US$)	219	295	412	619	826	1046
Current account balance	1.3	2.4	2.8	3.6	7.2	7.0
***Public finance** 4/*						
Overall budgetary balance	-2.7	-3.3	-2.4	-1.5	-1.3	-1.6
Revenue	15.1	15.9	16.2	16.6	17.5	17.5
Expenditure	17.9	18.9	18.6	18.1	18.8	19.1
Money and interest rates						
Broad money growth (M2) (in percent) 5/	14.4	16.8	19.6	14.6	17.6	…
Interest rate (in percent) 6/	2.3	2.0	2.0	2.1	2.3	…

Sources: Chinese authorities; and IMF staff estimates.

1/ As of June 26, 2006.

2/ Excluding errors and omissions.

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

4/ Central and local governments. The 2006 figures reflect official budget data.

5/ Banking survey.

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