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# China Economic Update

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Macroeconomics and Fiscal Management

Global Practice

## Acknowledgements

The World Bank *Economic Update* provides an update on recent economic and social developments and policies in China, and presents findings from ongoing World Bank work on China. The *Update* was led by Karlis Smits (Senior Economist), the main author, with contributions from Chorching Goh (Lead Economist), Luan Zhao (Economist), Ekaterine Vashakmadze (Senior Economist), Justin Hill (Senior Private Sector Development Specialist), Smita Kuriakose (Senior Economist) and Samuel Freije-Rodriguez (Lead Economist). The team gratefully acknowledges the support from the China country team, and guidance of Bert Hofman (Country Director), Sudhir Shetty (Regional Chief Economist), and Mathew Verghis (Practice Manager, Macroeconomics and Fiscal Management Global Practice). The team would like to thank Nannan Liu and Wenrui Li for excellent research assistance. Helpful comments are gratefully acknowledged from Nikola Spatafora, Marius Vismantas and Haocong Ren. The team would also like to thank Tianshu Chen, Li Li, Ying Yu, Xiaoting Li, and Lin Yang for support in the production and dissemination of this report. The findings, interpretations, and conclusions expressed in this report do not necessarily reflect the views of the Executive Directors of the World Bank or governments they represent. This report takes into account information available up to June 20, 2015. Questions and feedback can be addressed to Li Li ([lli2@worldbank.org](mailto:lli2@worldbank.org)).

## Contents\*

<b>Overview .....</b>	<b>2</b>
<b>Section 1: Recent Economic Developments.....</b>	<b>3</b>
The transition to a more moderate—and more balanced—growth trajectory continues .....	3
The aggregate credit impulse moderated despite policy efforts to lower financing costs .....	7
Fiscal policy remains accommodative as quasi-fiscal expenditures tighten .....	9
Decelerating economic activity is affecting wages more than jobs in the urban labor market .....	11
Capital outflows have increased sharply as domestic and external conditions change .....	13
<b>Section 2: Economic Prospects .....</b>	<b>16</b>
China’s growth will keep moderating as the transition to more sustainable growth consolidates.....	16
Balancing reforms and short-term demand management remains a priority in 2015 .....	18
The transition to the “new normal” requires a better allocation of credit and indigenous capacity for innovation.....	21
<b>References .....</b>	<b>28</b>

\* Section 3 on the financial sector that was previously included in this report was removed because it had not gone through the World Bank’s usual internal review and clearance procedures.

## Overview

China's economic growth continues to moderate, in 2014 gross domestic product (GDP) expanded by 7.4 percent, within the government's indicative growth target of about 7.5 percent for the year, but sharply slower than the 10 percent annual growth rate China averaged for three consecutive decades. An orderly correction in real estate—reflecting policy efforts to reduce supply mismatches and tighten nonbank credit—continues to weigh on economic activity. Ongoing adjustments in real estate, a buildup of excess capacity, and decelerating export growth are affecting industrial activity. In contrast growth in services remained robust as composition of growth continues to improve.

China's growth slowdown is not unexpected and is desirable from short- and medium-term perspectives. In the short term, it reflects policies to slow rapid credit growth, contain shadow banking, limit borrowing by local governments, and reduce excess capacity in industry. These policies address the vulnerabilities that built up after the 2008 global financial crisis. Over the medium term, lower growth is consistent with a gradual shift in China's growth model, from manufacturing to services, from investment to consumption, and from exports to domestic spending.

The growth of aggregate financing (stock)—a broad measure of outstanding credit—continues to decelerate. This trend reflected government moves to tighten regulations on trust and interbank assets and to check corporate and government credit demand, as well as investors' greater awareness of risks in nonbank products. Issuance of new debt to finance new projects is falling as the authorities introduced guidelines on management of local government debt. This policy tightening has been partially offset by a series of targeted and limited stimulus measures to prevent growth from slowing too much.

Balancing reforms and short-term demand management remains a priority in 2015 as large-scale, broad-based stimulus measures aimed at supporting short-term growth may conflict with efforts to increase the sustainability of medium-term growth. Efforts to cut excess capacity in heavy industry, dampen unproductive risk taking in shadow banking, and harden budget constraints on local governments will help make investment more efficient and realign growth over the medium term. In the short term, however, such reforms will depress activity. Official targets for 2015 signal a downward trajectory, with GDP targeted at about 7 percent, half a percentage point lower than in 2014.

A narrowly targeted stimulus may mitigate the tradeoff, but will also be harder to implement. The projected gradual deceleration assumes a firm commitment to pushing through structural reforms and to reducing vulnerabilities; at the same time, targeted stimulus is expected to attenuate the impact on short-term growth, should this show signs of slowing to much below the government's indicative target of about 7 percent.

Growth in China is expected to decelerate to 7.1 percent in 2015 and to 6.9 percent by 2017. Progress in rebalancing the sources of growth in domestic demand will remain incremental. An increase in labor share in GDP is critical to rebalance growth on the demand side from investment to consumption. While annual data suggest that household income and wage shares in GDP have started to rise, reversing a two-decade trend, a transition to more equitable growth will be gradual.

Deleveraging the economy while maintaining growth requires a better allocation of credit, which in turn requires financial sector reforms. China has tempered the pace of total credit growth, though leverage is still building up. China's financial system was developed to serve the old investment-driven growth model, effective during earlier phases but less so now. So, reforms should enable the financial system to reallocate credit to those sectors that can maintain reasonable growth over the medium-term.

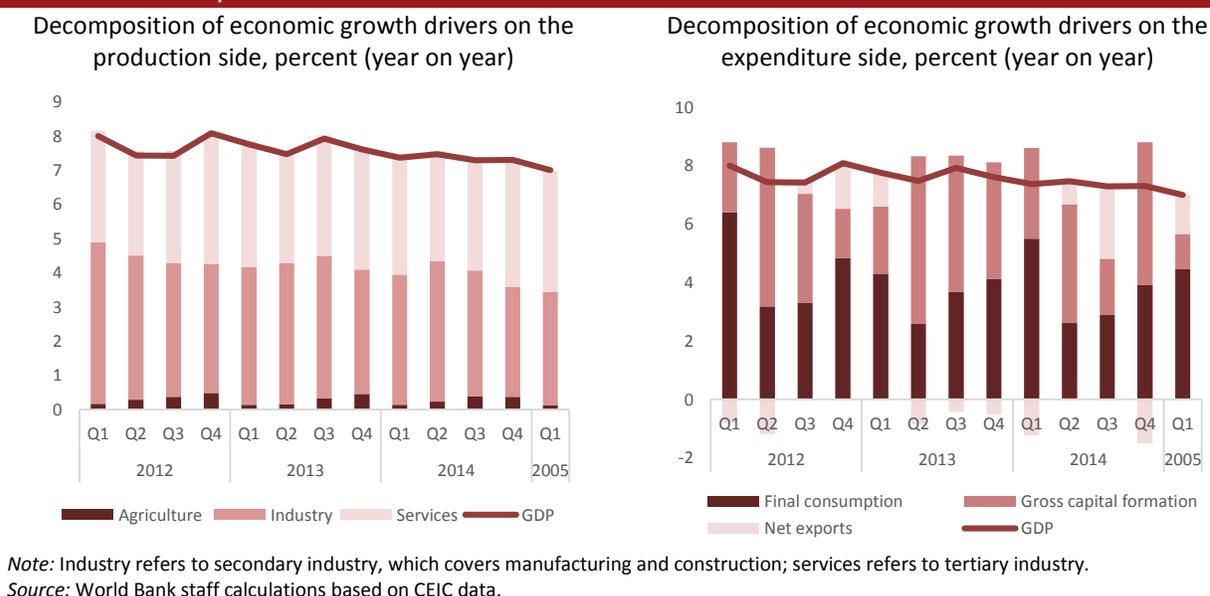
## Section 1

### Recent Economic Developments

#### The transition to a more moderate—and more balanced—growth trajectory continues

China's economic growth continues to moderate, signaling what President Xi has called the “new normal”—a growth trajectory that is slower but more sustainable. In 2014 gross domestic product (GDP) expanded by 7.4 percent, within the government's indicative growth target of *about* 7.5 percent for the year, but sharply slower than the 10 percent annual growth rate China averaged for three consecutive decades. Policies to tighten excessive credit growth and accumulation of local government debt have reduced investment growth, including reducing supply mismatch in real estate. This policy tightening has been partially offset by a series of targeted and limited stimulus measures to prevent growth from slowing too much. Growth continued to taper in the first quarter of 2015—according to preliminary estimates, GDP grew at 7.0 percent (year on year)—and the composition of growth continues to improve—in 2014 almost half of GDP growth came from the services sector, as industry and construction bore the brunt of the adjustment. In the first quarter of 2015 services remained robust (figure 1.1). In most recent years, consumption has grown slightly faster than investment.

**Figure 1.1 Growth continued moderating, with the structure of economic growth marking a gradual shift from industry to services**

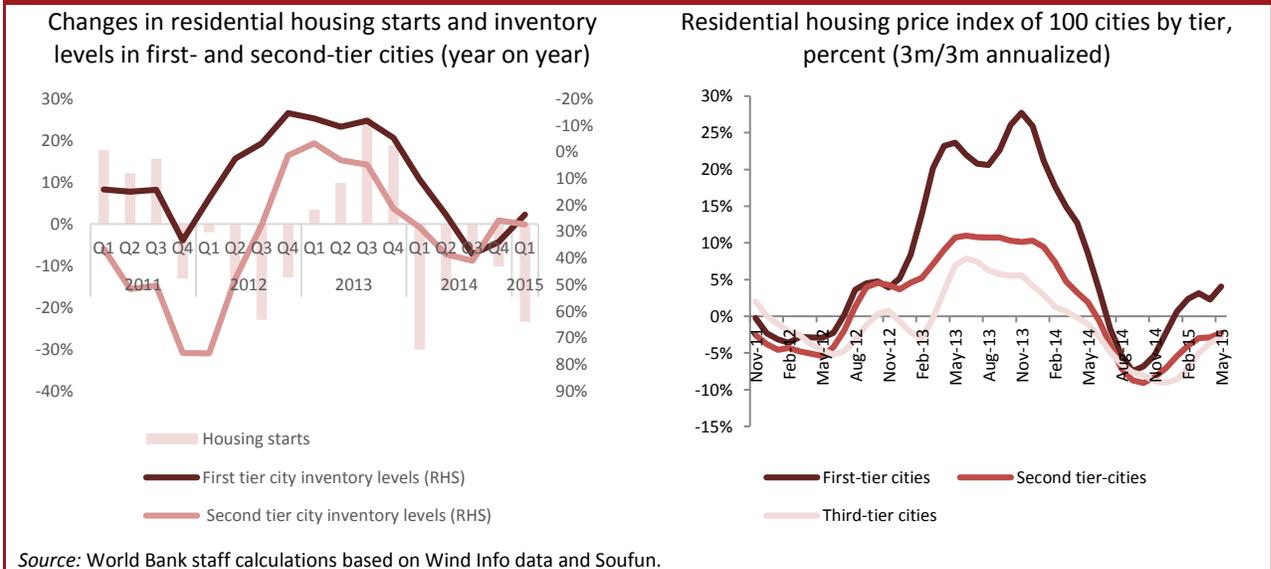


China's growth slowdown is not unexpected and is desirable from short- and medium-term perspectives. In the short term, it reflects policies to slow rapid credit growth, contain shadow banking, limit borrowing by local governments, and reduce excess capacity in industry. These policies address the vulnerabilities that built up after the 2008 global financial crisis. Over the medium term, lower growth is consistent with a gradual shift in China's growth model, from manufacturing to services, from investment to consumption, and from exports to domestic spending.

An orderly correction in real estate—reflecting policy efforts to reduce supply mismatches and tighten nonbank credit—continues to weigh on economic activity. High-frequency data suggest that adjustments

in real estate prices in first-,<sup>1</sup> second-,<sup>2</sup> and third-tier cities are stabilizing (figure 1.2), but excess inventory is constraining housing starts and investment activity in second- and third-tier cities. Month-on-month annualized price changes have returned to positive territory in first-tier cities, while conditions in smaller cities remain weak. Residential housing sales growth rose from 7.7 percent, year on year, in April to 16.4 percent in May signaling stabilization. The varying pace of recovery by city size and geographic location reflects the structural nature of the real estate adjustment (see October 2014's *China Economic Update*).<sup>3</sup>

**Figure 1.2 The real estate market remains weak with high excess inventory and, in most cities, softening property prices**



**Ongoing adjustments in real estate, a buildup of excess capacity, and decelerating export growth are affecting industrial activity.** Growth in industrial output slowed from 7.6 percent (year on year) in the fourth quarter of 2014 to 6.4 percent in the first quarter of 2015. Lower industrial production growth occurred in all three major industrial sectors: in manufacturing from 8.5 percent to 7.2 percent, in utilities from 3.3 percent to 2.3 percent, and in mining from 3.7 percent to 3.3 percent. High frequency data suggest that industrial activity remains weak in May but is stabilizing. Industrial output rose 6.1 percent in May from a year earlier, accelerating from 5.9 percent in April.

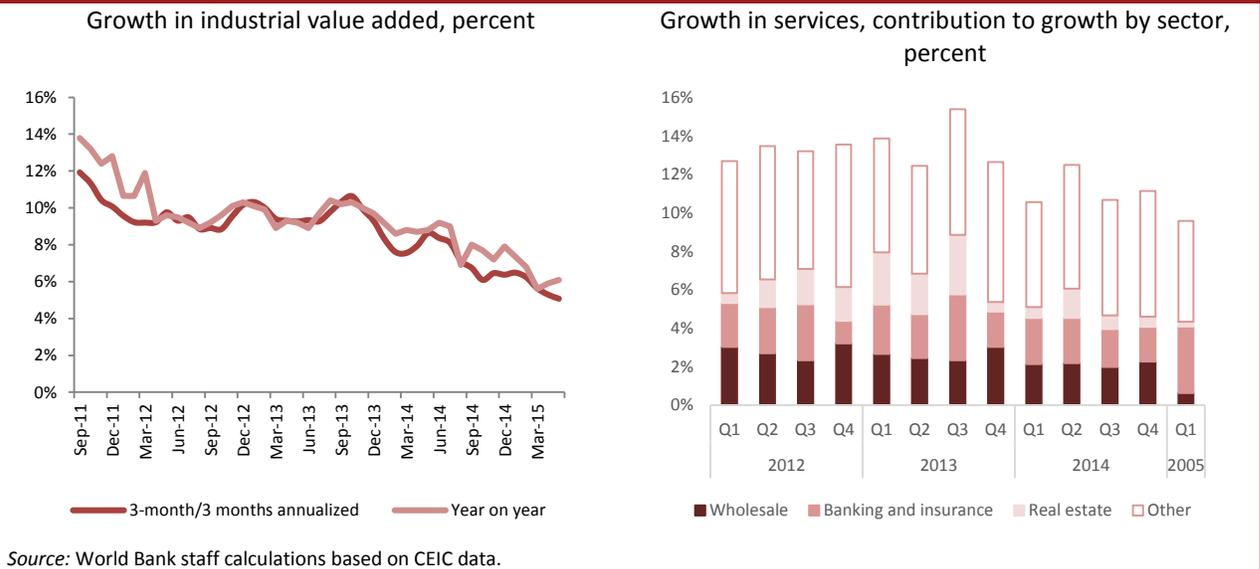
**In contrast to industrial production growth in services stayed robust.** In the first quarter of 2015 services value added increased by 7.9 percent—slightly slower than the 8.4 percent of the previous quarter—as the structure of economic growth continued to evolve from an industrial to a services base. Growth was faster in some advanced services such as banking and insurance (figure 1.3). Recent statistical revisions of national accounts also reveal a more balanced economic structure (box 1.1)

<sup>1</sup> Average comprises Beijing, Shanghai, Guangzhou, and Shenzhen.

<sup>2</sup> Average comprises Tianjin, Chongqing, Hangzhou, Nanjing, Wuhan, Shenyang, Chengdu, Xi'an, Dalian, Qingdao, Ningbo, Suzhou, Changsha, Jinan, Xiamen, Changchun, Harbin, Taiyuan, Zhengzhou, Hefei, Nanchang, and Fuzhou.

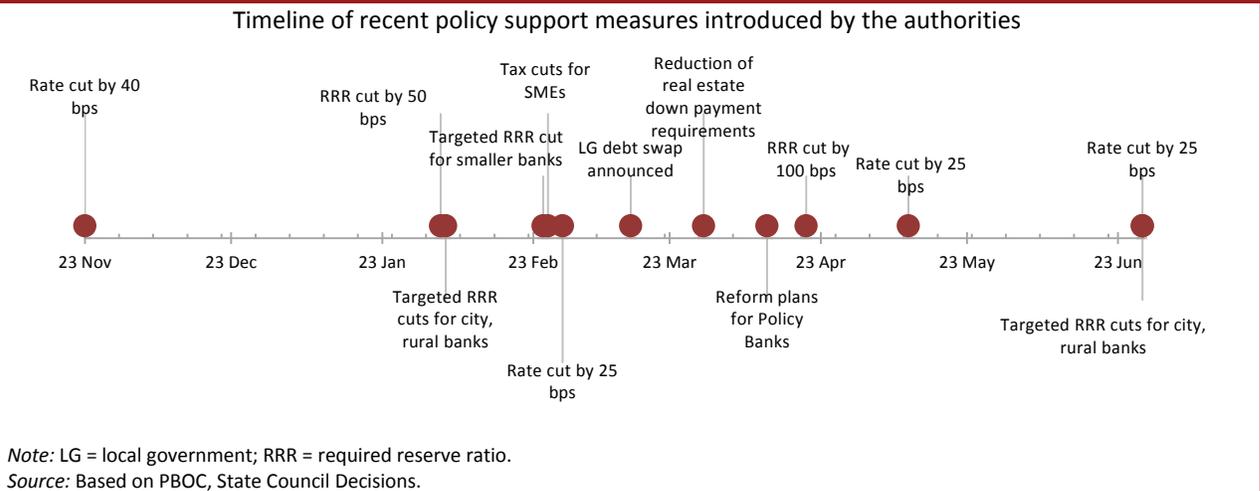
<sup>3</sup> [http://www.worldbank.org/content/dam/Worldbank/document/EAP/China/CEU\\_Oct29\\_en.pdf](http://www.worldbank.org/content/dam/Worldbank/document/EAP/China/CEU_Oct29_en.pdf)

Figure 1.3 A buildup of excess capacity and decelerating export growth are weighing on industrial activity; services growth stayed robust



Targeted stimulus measures remain focused on short-term demand management while permitting structural adjustments toward a more sustainable economic structure. Policy support has become more intensive and increasingly implemented by conventional tools, including monetary policy easing and fiscal support for infrastructure projects. For example, to support activity amid tightening regulations on trust and interbank lending, the People’s Bank of China (PBOC, the central bank) continued to ease monetary policy, lowering benchmark deposit and lending rates, and making targeted cuts in the required reserve ratio (figure 1.4). Efforts to reduce administrative burden also continued.

Figure 1.4 Growth-supporting measures have accelerated in recent months

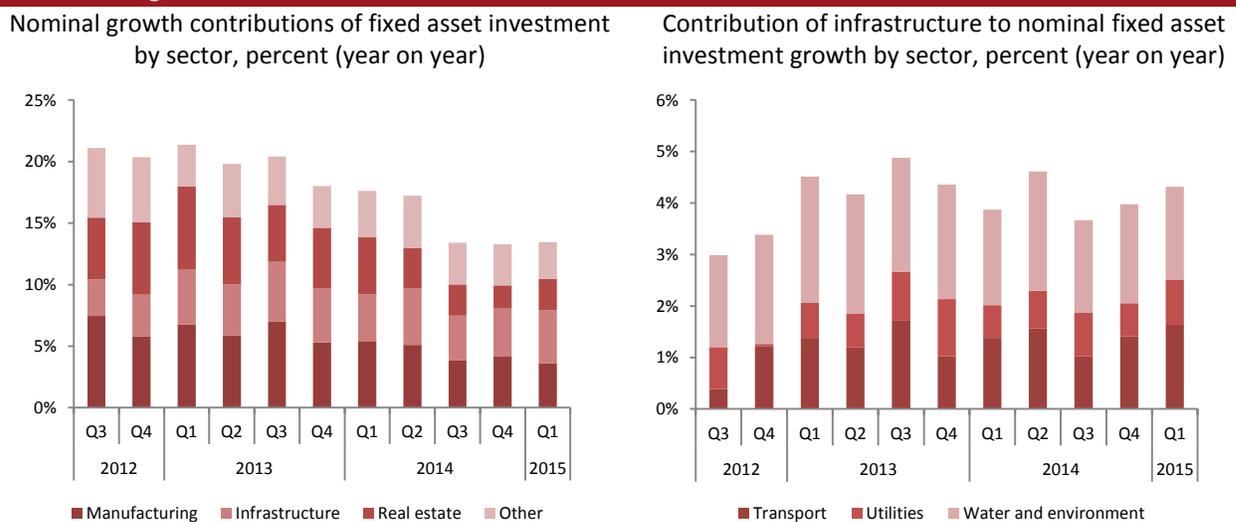


As public investment is one of the levers for stabilizing growth, domestic rebalancing from excessive reliance on investment is moving at a measured pace. Fixed asset investment growth—a broad measure that also includes land sales and purchase of used capital—slowed to 15.2 percent in 2014, down from 19.4 percent in 2013 (figure 1.5). In the first quarter of 2015, investment growth decelerated further to 13.5 percent. Some of the above factors—overcapacity in key heavy industries, policy tightening in energy-intensive sectors, a slump in real estate sales and construction, and regulatory curbs on shadow

banking—have held back private investment. At the same time, public investment has been robust. In the first quarter of 2015, infrastructure investment accounted for the largest share of growth in fixed asset investment, overtaking manufacturing’s contribution. In May infrastructure investment growth slowed to 15 percent year on year, in part due to constrained funding sources.

**Policy interventions are increasingly focused on unlocking new funding sources.** Besides promoting public–private partnerships (PPPs) as a new funding model for infrastructure funding, there have been efforts to intensify use of policy banks. Further, in April the State Council expanded the use of the Social Security Fund to buy local government bonds and other financial instruments. The new rules allow it to invest up to 20 percent of its portfolio in local government debt and corporate bonds. (Previously, the Fund was allowed to invest up to 10 percent of its portfolio in corporate debt, but nothing in local government debt.) It will also be able to invest up to 10 percent of its portfolio in trust loans, up from 5 percent. In May, the State Council issued a plan to continue providing financial support for local-government financing vehicles for the construction of ongoing local projects.

**Figure 1.5 A decline in real estate investment growth is partly offset by an increase in infrastructure investment growth**



Source: World Bank staff calculations based on CEIC data.

**Consumption growth, though still growing faster than the GDP, has decelerated modestly in recent quarters.** Year-on-year real retail sales growth decelerated slightly from 11.7 percent in the fourth quarter of 2014 to 10.5 percent the following quarter. Weakness affected a broad range of consumer goods, including food, garments, footwear, and household electric appliances. Sales of durable goods stayed solid, however. High frequency data suggest that consumption growth continues to stay robust—real retail sales growth rose to 10.2 percent in May.

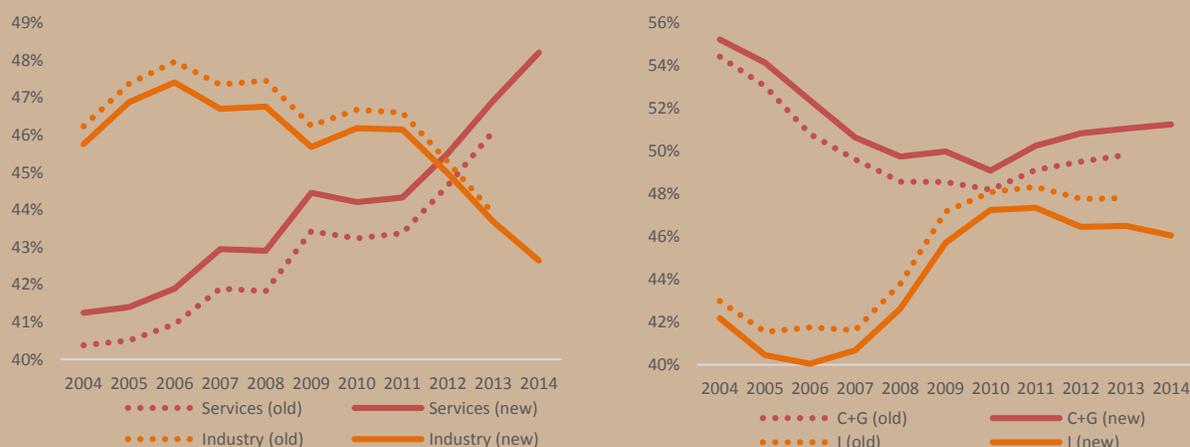
#### Box 1.1 Revisions of national accounts data based on the third economic census

The main objectives of the third national economic census undertaken by NBS were to take a complete survey of China’s secondary and tertiary industries. The economic census covered all legal entities, establishments and self-employed units in the secondary and tertiary industries within the territory of China. The reference time for the census was December 31, 2013, and data collected cover the whole year of 2013.

The revisions of GDP included three adjustments. First, as a result of the Census the China’s GDP was revised up by 3.4 percent in 2013. Second, the structure of three industries was adjusted to reflect a higher proportion of services sector output. Third, the expenditure side of GDP was adjusted to reflect higher GDP, Census results on changes in inventories, as well as adjusting methodologies for investment and consumption in accordance with UN’s System of

National Accounts (SNA). Based on the revised data for 2013 historical data is also updated accordingly using a *trend deviation* method.

**Box figure 1 GDP structure by industry and expenditure (2004-2014)**



Source: World Bank staff calculations based on CEIC data.

The Consensus results reveal a more balanced economic structure (box figure 1). Services sector size in GDP is estimated to be slightly higher—at 48.3 percent in 2014. And final consumption of private and public sectors at 51.2 percent of GDP, while that of investment at 46 percent of GDP.

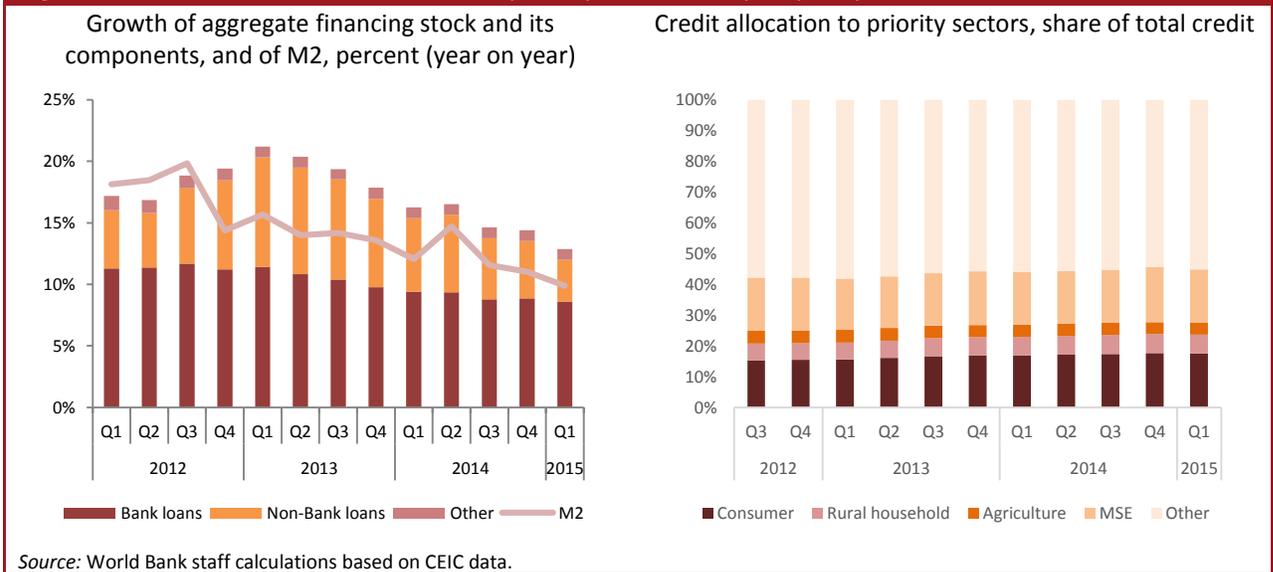
### The aggregate credit impulse moderated despite policy efforts to lower financing costs

**Broad money (M2) growth decelerated due to policy efforts to limit nonbank credit.** The growth of aggregate financing (stock)—a broad measure of credit—decelerated from 19.4 percent (year on year) in the third quarter of 2014 to 14.3 percent in the fourth and 16.8 percent in the first quarter of 2015, driven by moderating growth of credit products linked to China’s shadow-banking sector. This trend reflected government moves to tighten trust and interbank asset regulations and to check corporate and government credit demand, and investors’ greater awareness of risks in nonbank products. In the first quarter of 2015, growth in nonbank credit (stock) decelerated to 15.3 percent (year on year) from 21.3 percent in the same quarter of 2014.

**Notwithstanding slowing credit growth, China’s leverage is rising.** The credit stock as a share of GDP is still increasing, but a weakening of the credit impulse has reduced excessive reliance on investment growth (figure 1.6). Rising debt is forcing China to use substantial resources to repay and roll over debt, although the contained pace of credit expansion has curtailed some inefficient investment in large, capital-intensive industries.

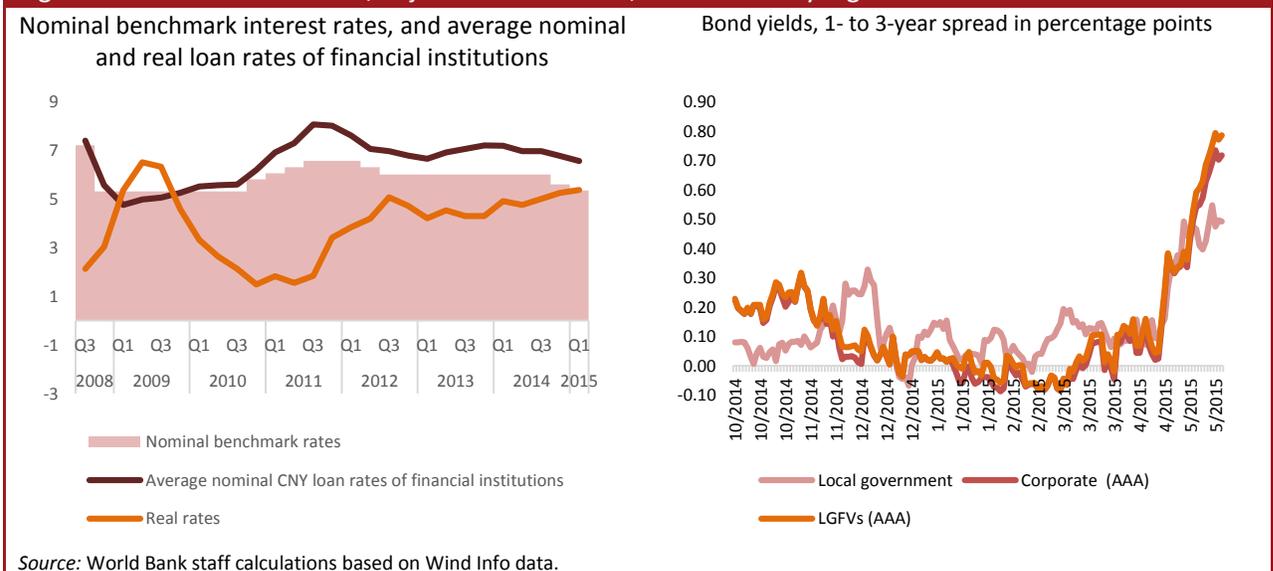
**Even with policy efforts to redirect credit, banks are reluctant to lend to priority sectors.** Although the government is urging banks to adjust their lending practices and to give more support to households, small and medium-sized enterprises (SMEs), labor-intensive industries, and first-time mortgage applicants, progress is gradual. Credit allocation to priority sectors, including micro and small enterprises and households, has not seen huge change over recent years. According to the most recent World Bank Global Findex survey, among the 36.1 percent of households that borrowed any money in 2014, only 9.6 percent had access to formal loans from a financial institution, while 26.2 percent relied on family, friends, or informal lenders.

Figure 1.6 Banks are reluctant to lend to priority sectors, despite policy efforts to redirect credit



**Real interest rates remain high, even with policy efforts to lower financing costs.** The average nominal loan rate for borrowers stood at 6.78 percent in the first quarter of 2015, just 0.15 percentage points lower than in the previous quarter, according to a quarterly survey from the central bank. Real interest rates, adjusted for price changes, remain historically high. Interbank rates are stable with the central bank providing sufficient liquidity, but the 1- to 3-year spread in bond yields has become steeper in recent months (figure 1.7), indicating declining short-term but high medium- and long-term market rates.

Figure 1.7 Real interest rates, adjusted for inflation, are historically high



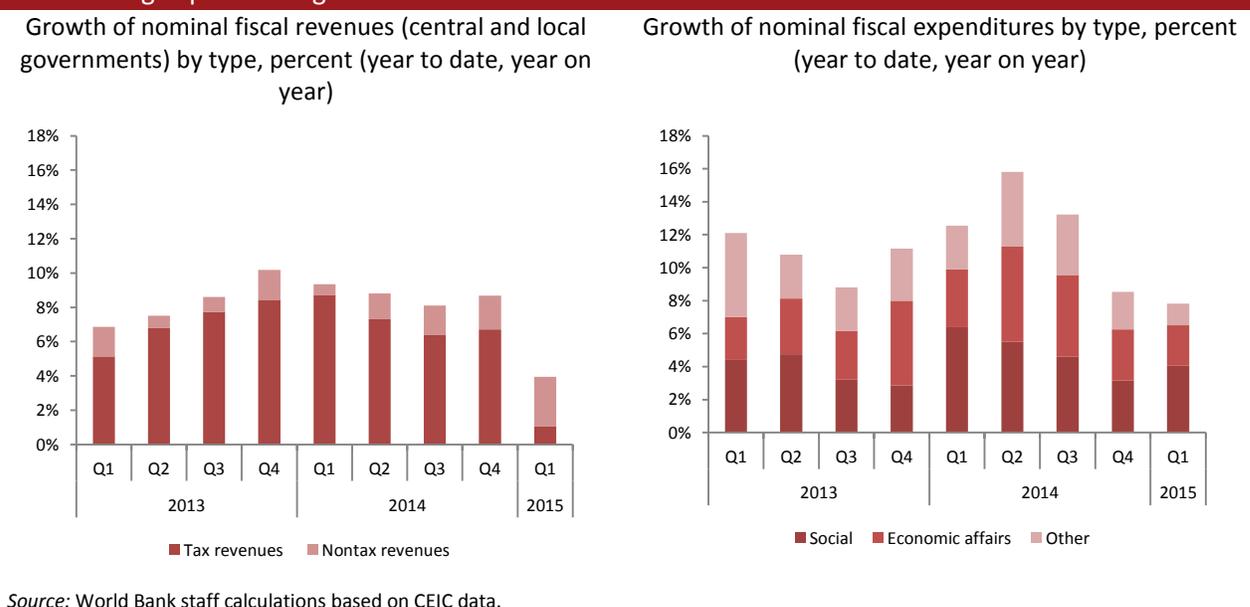
**Lower oil prices have reduced headline inflation but core inflation was largely unchanged in the first quarter of 2015 due to robust private consumption and policy easing.** In the first quarter, inflation as measured by the consumer price index (CPI) decelerated to 1.2 percent from 1.5 percent in the previous quarter. Food price inflation declined to 1.93 percent from 2.57 percent during the same period. Inflation continued to ease to 1.2 percent in May largely due to a drop in food prices inflation. Producer price index deflation widened further to 4.6 percent in the first quarter of 2015, for its 39th consecutive month

in negative territory, suggesting that industry faces deflationary pressures from weak demand and excess supply. These deflationary pressures might in fact be much broader: out of 53 industrial subsectors, 43 had producer price deflation in the first quarter. The GDP deflator was, for the first time since 2009, in negative territory that quarter, at 1.2 percent. High frequency data suggest that deflationary pressures remain strong – the producer price index deflation stayed unchanged at a negative 4.6 percent in May.

### Fiscal policy remains accommodative as quasi-fiscal expenditures tighten

Despite a slowdown in economic activity, China’s overall fiscal position remains strong and its aggregate fiscal deficit of public finance budget was slightly lower than the original budget estimate. The annual fiscal deficit came to 1.8 percent of GDP in 2014, slightly lower than in 2013. A decline in revenues was offset by moderation of expenditure growth in the fourth quarter of 2014 (figure 1.8).

**Figure 1.8 The public finance budget deficit is stable, with slowing revenue growth offset by decelerating expenditure growth**



Source: World Bank staff calculations based on CEIC data.

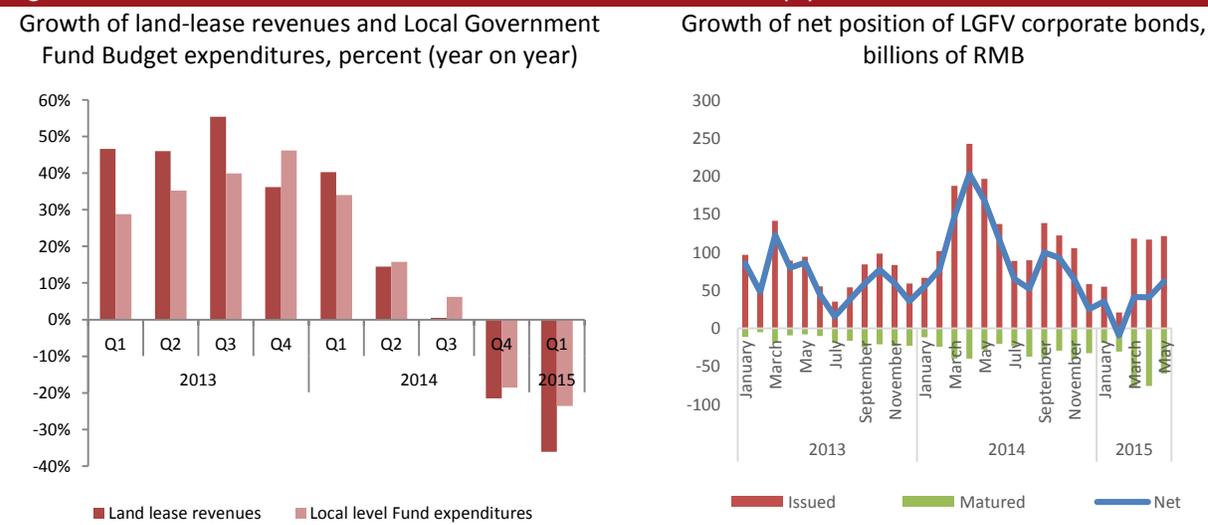
**Moderating economic activity has cut into growth of tax revenues.** In 2014, total public finance budget revenues increased by 8.6 percent (year on year) against an annual increase of 7.9 percent in the Budget Law, but slower economic growth has translated into slower growth in revenue from value-added tax (VAT) and corporate income tax. VAT revenues were 3 percent lower than budgeted for 2014. Moreover, a declining producer price index due to lower commodity prices and a decelerating CPI has put additional pressure on nominal revenue growth. And real estate transactions have fallen, leading to a sharp slowdown in growth of real estate business tax, deed transfer tax, and corporate income tax from real estate enterprises. Policy reforms to expand a pilot program to replace business tax with VAT have also slowed tax revenues. In the first quarter of 2015, total public finance budget tax revenues moderated to an annual increase of only 1.2 percent, improving only marginally in April and May. Weak industrial activity, decelerating inflation and falling import value and recent steps to reduce some taxes and fees to support small business remain a drag on fiscal revenues in 2015.

**Slowing tax revenues were offset by a robust increase in nontax revenues.** Nontax revenues were 19.3 percent higher than budgeted, largely due to an increase in profit transfers from selected financial institutions to the central government. And in the first quarter of 2015, nontax revenues grew by 20.8 percent, year on year.

**Expenditure growth has tapered sharply in the last two quarters.** This deceleration stemmed largely from slower growth of economic affairs expenditures (see figure 1.8). Social expenditures rose, consistent with efforts to adjust the composition of budget expenditures. Expenditure growth is decelerating because local government fiscal space is constrained, as revenues from land-lease transactions slow and reforms in the budget management system reduce quasi-fiscal activities (figure 1.9).

**Issuance of new debt to finance new projects is moderating as the authorities introduce guidelines on strengthening management of local government debt.** Corporate bonds issued by local government financing vehicles (LGFVs) to fund municipal investments slowed sharply in the first quarter. LGFVs issued only 194 billion RMB, a 45 percent year on year decline (figure 1.9). In recent months activity has accelerated as some of constraints to issue corporate bonds by LGFVs were relaxed—in May alone 121 billion RMB worth of such bonds were issued. At the same time, the authorities continue to make progress in decoupling the use of local government debt and provision of public infrastructure, such that growth of fixed asset investment in infrastructure is no longer strongly correlated with an increase in the net debt position of LGFVs.

**Figure 1.9 Fiscal revenues from land-lease transactions slow sharply**



Source: World Bank staff calculations based on data from CEIC and Wind Info.

However, managing local government debt remains a challenge and policy steps were introduced to address the most immediate funding pressures. The Ministry of Finance (MOF) put into practice controls on the scale of local government debt and budgetary management. The authorities have indicated that a reasonable grace period will be set for current projects to prevent fiscal and financial risks. The MOF's report to the National People's Congress (NPC) indicates that it will allow projects under construction to be refinanced through bank loans. Such refinancing was in doubt immediately after the State Council issued debt management guidelines in October 2014. The RMB 1+1 trillion debt-for-bond swap program (box 2.1) addresses one of the key short-term vulnerabilities—namely, that without an orderly debt rollover, local governments' own resources are insufficient to fully service maturing debt liabilities. The debt-for-bonds swap covers just a portion of all outstanding debt and contingent liabilities of local governments, which were estimated at around RMB 18 trillion at end-2013. However, the program addresses the most immediate concerns with respect to maturing debt in 2015 and clarifies recent regulations. The program could also cut local governments' annual interest expenditures by about RMB 100 billion, implying a reduction in the average interest rate of about 500 basis points. Similarly, using local government bonds instead of corporate bonds to fund new spending would result in lower

interest expenditures. For example, the average interest rate spread between seven-year bonds issued by LGFVs (AA-) and local governments averaged about 320 basis points in the first five months of 2015.

**Efforts to refinance existing debt at lower maturities is underway.** The original plan announced in early March stipulated that provinces and municipalities would be primarily responsible for issuing and repaying the new debt using market mechanisms, such as bond auctions. In May authorities clarified details of the swap indicating that local governments can instead also negotiate directly with creditors of those swappable debts. Interest rates for these new bonds will also be negotiated by debtors and creditors, but should not be lower than the prevailing treasury yields of the same tenor or exceed 30 percent of the treasury yields of the same tenor. Local governments have refinanced debt in amount exceeding RMB 700 billion in a short period between mid-May and June 23, 2015. Most of these bonds were issued using bond auctions with average coupon rates ranging from 2.89 percent for a three year bond to 3.56 percent for a seven year bond. Only a few provinces have exercised the direct-swap option to place bonds. It is planned that these new bonds will be allowed to be used as collateral with the central bank for repo and other liquidity operations.

### **Box 2.1 Local government debt swap**

On March 14, the NPC approved the 2015 budget, which covers important measures for local government debt. First, the budget set a RMB 600 billion bond issuance limit for 2015, an increase of 50 percent from 2014. This limit is split between RMB 500 billion for general obligation bonds and RMB 100 billion for special-purpose bonds tied to specific projects. Second, the MOF will permit regional and local governments to swap RMB 1 trillion of high-interest and short-maturity debt raised through third parties into low-interest and longer-dated bonds. According to the MOF, the debt swap represents “a change of form” and “not a rise of outstanding debt”.

The initial RMB 1 trillion debt-for-bond swap program is designed from a 2013 local government debt audit by the National Audit Office. The program does not take into account debt accumulated after June 30, 2013. All 31 provinces and five centrally planned cities will be allowed to issue new bonds worth up to 53.8 percent of their debt falling due in 2015 as of June 30, 2013. Use of this latter date implies that the MOF has not finalized reclassifying local debt with the latest information that local governments submitted by January 5, 2015, possibly on concerns that these January figures overstate the true outstanding debt. The initial debt-for-bonds swap covers just a portion of all outstanding debt and contingent liabilities of local governments estimated to be around 18 trillion RMB at the end of 2013. It also covers a small share of potential payment responsibilities in 2015 if some of guarantees or contingent liabilities are called upon.

To address these concerns, in early June authorities announced the launch of another RMB 1 trillion debt-for-bond swap for local governments. This will provide an additional buffer to local governments in executing an orderly rollover of maturing debt.

## **Decelerating economic activity is affecting wages more than jobs in the urban labor market**

**Household income growth is showing signs of slowing.** Recent rates of income growth have declined relative to the start of the decade. The average disposable income in urban households grew at real annual rates above 8 percent between 2010 and 2012, but at only 6.9 percent in 2014. Similarly, real growth in the average net income in rural households went down from 12.1 percent in 2011 to 9.4 percent in 2014 (figure 1.10). Real growth of the average income of migrant workers fell sharply from 16 percent to 7.7 percent between 2010/11 and 2014. Still, the rate of income growth in rural areas remains higher than in urban areas, which partly explains the decline in inequality. Growth in rural wages has not slowed, and they are becoming a larger share of average rural incomes, explaining the ongoing

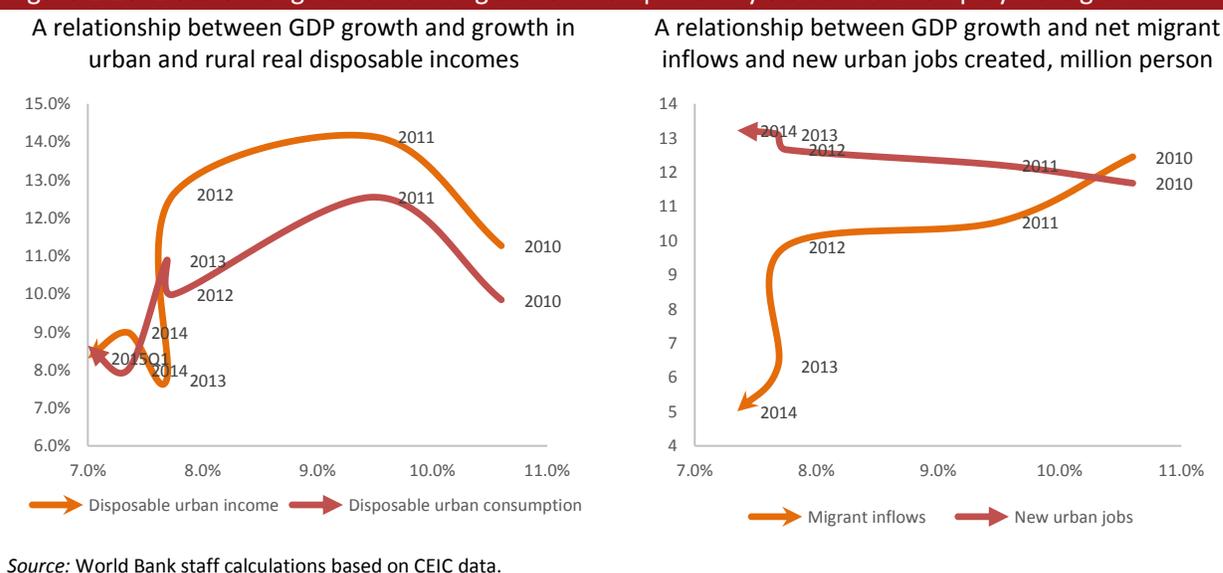
decline in rural poverty. Urban wages, though, have decelerated, which may explain the slower pace of growth in urban household incomes.

**The deceleration of real urban wages is accompanied by a stable growth in urban employment, but declining migration flows.** In 2014, more than 13 million new urban jobs were created, exceeding the indicative annual target of 10 million jobs. A survey of 31 cities suggests that unemployment rate has remained stable at 5.1 percent. However, annual net migrant inflow into urban areas declined to about 5 million in 2014 from nearly 10 million in 2012.

**This combination (slowing real urban wage growth and flat unemployment rate, and declining migration) indicates that the economy's deceleration has translated into a price (wage) adjustment rather than a quantity (job) adjustment in the urban labor market.** These trends are markers of a very dynamic labor market that is becoming more urban, mature, and services oriented. This transformation poses a crucial, long-term challenge to the Chinese urban labor market: how to create high-productivity urban jobs, mostly in services, and how to integrate a growing migrant population. Labor productivity growth in services has already slipped from above 6 percent between 2010 and 2012 to less than 2 percent since 2013.

**A series of measures were issued by the State Council to stimulate employment, including widening tax cuts and exemptions for sole traders.** The government launched active-employment policies to give support to mass entrepreneurship and innovation, but also recognized that employment tends to lag behind economic growth. Companies hiring people who have been jobless for more than six months will receive tax breaks. Tax cuts and exemptions will also be expanded from small businesses launched by graduates or the registered jobless to cover sole-proprietor enterprises. Restrictions on the location of newly established companies have been eased and workers from rural areas are being encouraged to return home and start their own business, including online activities.

Figure 1.10 Decelerating real urban wages are accompanied by stable urban employment growth



### Capital outflows have increased sharply as domestic and external conditions change

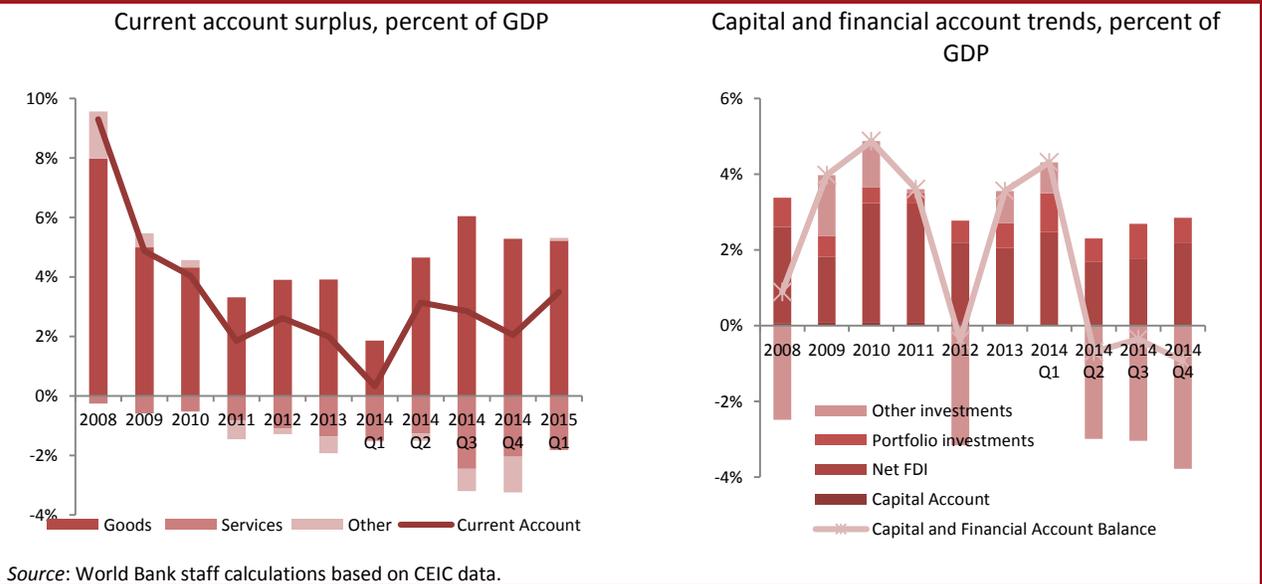
Capital outflows have been encouraged by changing domestic and external conditions. These include: a move toward two-way exchange-rate fluctuations and receding expectations of persistent renminbi appreciation;<sup>4</sup> a narrowing interest rate differential against U.S. policy rates due to domestic policy easing and expectations of policy tightening by the Federal Reserve; greater volatility in cross-border flows; and improved global growth prospects that contrast with weakening growth and a housing price correction in China.

Since the second quarter of 2014, portfolio and other capital outflows have picked up and were only partially offset by record high foreign direct investment (FDI) inflows into services. Despite a current account surplus of USD 214 billion and USD 199 billion in net FDI inflows in 2014 (figure 1.11), China's foreign exchange reserves rose by a mere USD 22 billion, or USD 118 billion excluding the valuation effect on foreign exchange reserves. Net non-FDI capital outflows reached an estimated USD 295 billion in 2014. The trend continued into 2015, with an estimated capital outflow of USD 209 billion in the first quarter of 2015, after an outflow of USD 168 billion in the previous quarter. Foreign currency reserves declined by an estimated USD 263 billion (7 percent of total) between June 2014 and March 2015, around two-thirds of the drop due to valuation effects.<sup>5</sup> China's foreign exchange reserves are still rock solid, however (about 38 percent of GDP and 24 times monthly imports).

<sup>4</sup> Corporations are increasingly holding on to their foreign currency proceeds (onshore and offshore) and hedging their foreign currency exposure.

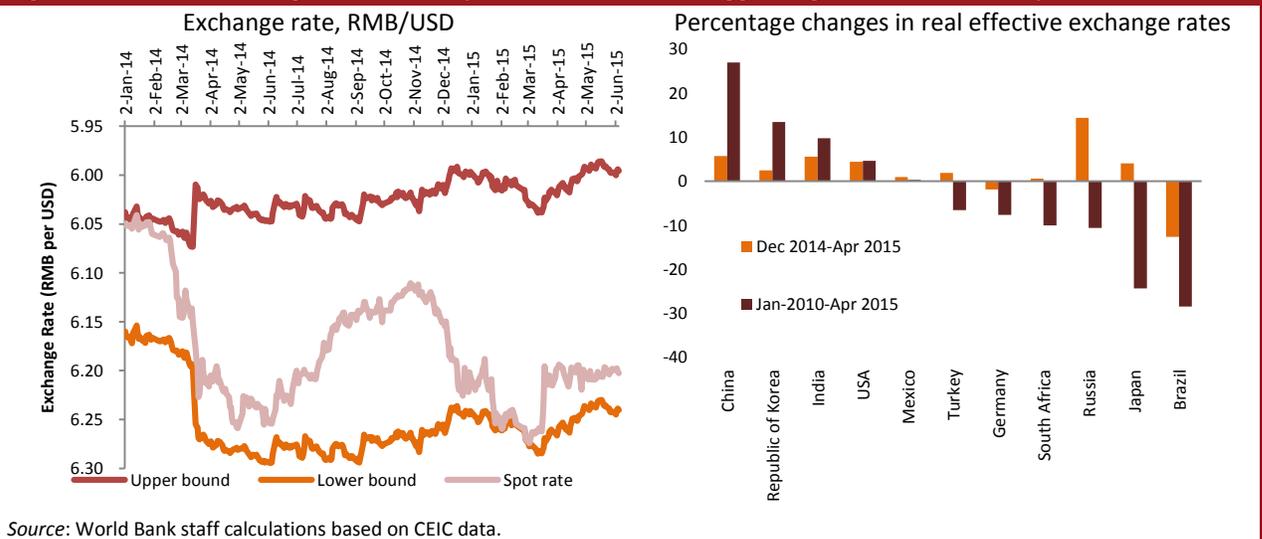
<sup>5</sup> Related to the weakening of non-USD currencies (including the euro and yen, which account for about 40 percent of China's foreign exchange reserves) (Miner 2015).

Figure 1.11 The current account surplus improved



Over the last year the exchange rate volatility against the U.S. dollar has increased. This signaled the central bank’s intention to deter speculators who had been betting on one-way appreciation of the renminbi. Nevertheless, in real effective terms, the Chinese currency has appreciated by around 6 percent since end-2014 and by 27.4 percent since 2010 (figure 1.12). The announcement of quantitative easing by the European Central Bank in January, continued easing in Japan, and the prospect of an interest rate increase in the United States have been associated with a strong, broad-based appreciation of the U.S. dollar and depreciation of currencies of other China’s trading partners.

Figure 1.12 The exchange rate recently reversed its slide, suggesting a return to net capital inflows



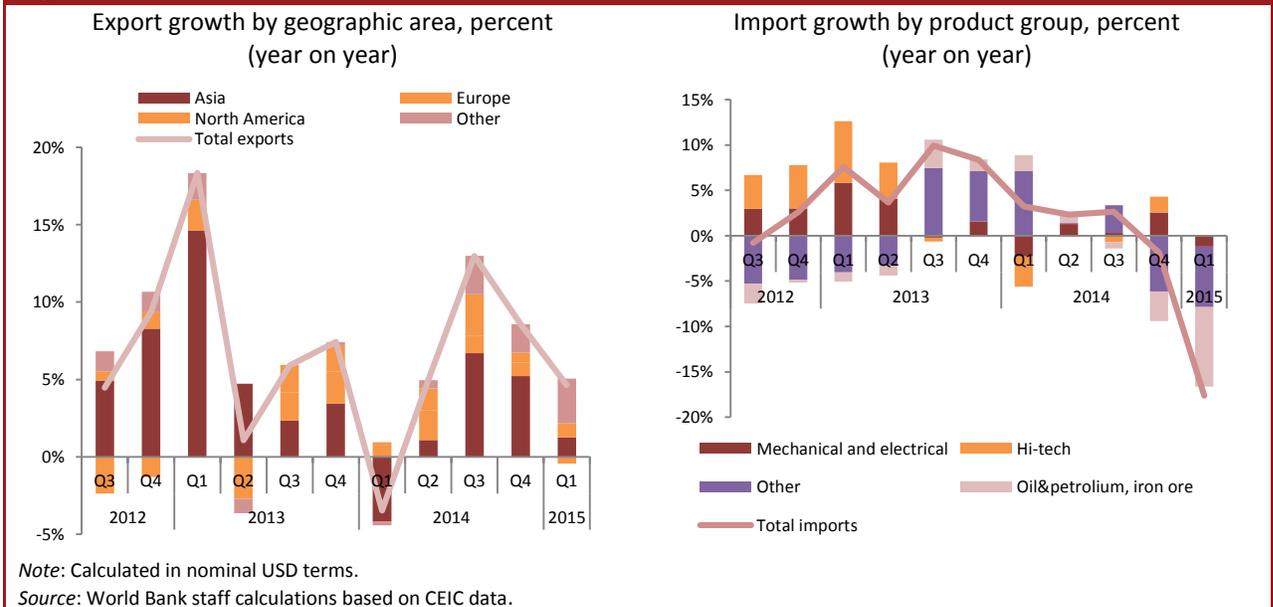
The contribution of net exports in the first quarter was positive, largely due to slowing imports, but high-frequency data point to decelerating export growth momentum. Export growth for the first quarter moderated to 4.6 percent from 8.6 percent in the previous quarter. With recent USD appreciation, China’s merchandise export growth has slowed slightly in real terms, from 8.0 percent in the fourth quarter of 2014 to 5.5 percent in the first quarter of 2015. China’s monthly nominal merchandise trade data (based on customs data) are often very volatile, in part driven by seasonal factors. But the sharp

decline in exports by 15 percent (in nominal USD terms) in March was broad-based: deceleration is recorded in all key export destinations and commodity groups. China’s exports to the European Union (EU) contracted by 19 percent, Japan 24 percent, Russia 50 percent, and the United States 8 percent. High frequency data suggest that demand from the United States is recovering, China’s exports to the United States increased by 7.8 percent in May, while exports to the EU and Japan continued to contract in nominal USD terms.

**Although evidence points to China moving up the merchandise value chain, exports remain dominated by labor-intensive goods or those with low domestic value added.** China has by far outpaced the region of developing East Asia and the Pacific in the manufacture and export of high-technology products. This is particularly evident in computers, telecommunications equipment, and electrical machinery, including their parts and components. In electrical machinery, the greater competition has recently come from the region’s newly industrialized economies (principally the Republic of Korea; Singapore; and Taiwan, China). Relatedly, a recent analysis of China’s global manufacturing value chain concludes that it has increased in length, but in particular that imports have moved upstream, while exports on average have not moved downstream (World Bank 2015a). This suggests that China may be performing some new high value-added downstream activities, but is not necessarily shedding lower value-added (upstream or downstream) activities.

**Imports have slowed.** Import growth contracted by 17.6 percent in the first quarter of 2015, down from a decline of 1.8 percent in the previous quarter (figure 1.13). Lower oil prices are pushing down nominal import growth: a decline in crude petroleum imports alone accounted for 3.1 percentage points of the import decline in March. Weak domestic demand is also making imports more sluggish.

Figure 1.13 The trade balance has improved in recent quarters



## Section 2

### Economic Prospects

#### China's growth will keep moderating as the transition to more sustainable growth consolidates

As structural adjustments and policy efforts to address financial vulnerabilities continue, growth in China is expected to decelerate to 7.1 percent in 2015 and to 6.9 percent by 2017 (table 2.1). Progress in rebalancing the sources of growth in domestic demand will remain incremental. Investment growth will continue to decelerate due to credit tightening and ongoing property adjustments. In 2017 gross capital formation is expected to contribute 44.4 percentage points of GDP, and aggregate consumption 52.7 percentage points. Economic growth will continue moving from an industrial to a services base. A transition from capital and resource-intensive industries to services will remain rapid facilitated by policies to ease business regulations in services sector and tighten excess capacity in industrial sectors. Growth in services is expected to outpace that in manufacturing, contributing more than half of GDP growth by 2017.

Table 2.1 Main economic indicators for China

	2013	2014	2015e	2016f	2017f
<b>Output, employment, and prices</b>					
Real GDP (% change yoy)	7.7	7.4	7.1	7.0	6.9
Domestic demand (% change yoy)	8.3	7.8	7.5	7.3	7.2
Unemployment (%) <sup>b</sup>	4.1	4.1	4.2	4.2	4.2
CPI (% change yoy)	2.6	2.0	1.5	1.8	2.0
<b>Public sector</b>					
Public finance budget revenues (% of GDP)	22.9	21.8	21.7	21.9	22.2
Public finance budget expenditures (% of GDP)	25.0	24.0	24.1	24.0	24.2
Public finance budget balance (% of GDP)	-2.1	-1.8	-2.4	-2.1	-2.0
Domestic public sector debt (% of GDP) <sup>c</sup>	15.3	15.8	16.4	16.8	17.1
<b>Foreign trade, balance of payments, and external debt</b>					
Trade balance (USD billion)	259.0	382.9	468.9	491.5	518.9
Exports of goods (USD billion)	2,209.0	2342.3	2379.1	2472.7	2578.8
Imports of goods (USD billion)	1,950.0	1959.4	1910.2	1981.2	2059.9
Current account balance (USD billion)	188.6	218.2	278.3	253.9	262.1
(% of GDP)	2.0	2.1	2.5	2.1	2.0
Foreign exchange reserves, gross (USD billion)	3,866.6	3813.4	3841.5	3891.6	3937.8
e is estimate; f is forecast.					
b. Official urban unemployment only, excluding laid-off workers.					
c. Includes treasury bonds, policy financial bonds, and other financial bonds (end-period outstanding).					
Source: World Bank staff estimates and projections.					

The external environment will be supportive, but real effective appreciation of the RMB is likely to put pressure on export growth. Global growth remains broadly on track to reach about 2.8 percent in 2015 with a modest pickup to 3.2 percent in 2016-17 (see Global Economic Prospects (World Bank, 2015)). The recovery in some high-income countries has been gathering momentum more rapidly than previously anticipated, while a broad-based slowdown appears to be underway in developing countries. Over the next three years, global activity should be supported by continued low commodity prices and generally benign financial conditions, notwithstanding the expected modest tightening in U.S. monetary policy.

Among major economies, the Euro Area and Japan have picked up, and the United States continues to expand at above potential. High-income countries are expected to grow by 2.0 percent in 2015 and 2.3 percent in 2016-17. Although a gradual tightening in U.S. monetary policy is likely from this year, overall financial conditions have been benign thus far, and while China's reliance on external financing is low, rising interest rates could increase debt-service costs for some corporations. China's external debt represents less than 6 percent of total debt but in absolute dollar terms it is steep, at about USD 1 trillion in mid-2014.

**A tapering pace of economic growth in China will bring slower household income growth and a decline in the rate of fall in rural poverty.** Rural poverty rates, at the World Bank poverty line of USD 1.25 per day, are projected to be cut by more than half, from 6.4 percent in 2014 to 2.8 percent in 2017. Narrowing the gap between rural and urban average incomes will help reduce overall inequality.

**There are some downsides to the growth outlook.** Although unlikely, China's gradual rebalancing of growth drivers could still turn into an investment rout. The reforms being cautiously implemented could, unintendedly, disrupt growth, in one of at least two main ways. First, a correction in asset prices, a contraction in public investment and construction, and a rapid unwinding of financial vulnerabilities could arise. Second, as sectors operating at low capacity utilization wind down their activities—as part of the authorities' reform plans—they could slip into financial distress, causing nonperforming loans (NPLs) for financial intermediaries and other investors. A weakening of lending institutions' capital bases could lead to a more general tightening of credit. There is also a risk that if confidence in China's growth prospects wanes as high-income country growth strengthens, private capital outflows might accelerate, despite capital controls, prompting the authorities to tighten domestic financing conditions.

**Global risks to growth remain tilted to the downside.** Deflation risks still lurk for the Euro Area but have largely receded as inflation expectations have recently picked up, and the beneficial effects of lower commodity prices on economic activity may yet turn out stronger than expected. However, new risks have arisen. The likelihood of disruptive exchange rate adjustments in developing countries may have increased, as the first post-crisis policy rate increase nears in the United States. In addition, growth in the United States may be more fragile than anticipated and may be slowed more than foreseen by the broad-based dollar appreciation.

**While China has enough of a buffer to address these risks and avoid recognizing losses and recapitalizing, financial intermediaries may be inclined to roll over NPLs to ailing firms.** The upshot could be constrained lending to productive firms—capital misallocation—and a prolonged period of stagnation. In such a scenario economic resource misallocations, particularly in the financial sector, would continue to reduce the productivity of firms, the strength of financial institutions, and the confidence of consumers. In these circumstances monetary policy loses its effectiveness as even lower interest rates would not be able to trigger highly indebted companies to invest more. At some point high level of corporate debt could trigger a *balance sheet slowdown*—a slowdown of economic growth caused by corporate sector's collective focus on paying down debt rather than on investing and spending as in Japan in the mid-1990s.<sup>6</sup> Mitigation of these risks will require—in the short run—a careful balancing act between reform and demand management measures, and—in the long-run—adopting a systematic approach to strengthening financial sector discipline.

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<sup>6</sup> The drop in asset prices in Japan in 1989-91 severely weakened the balance sheets of heavily indebted households, lending institutions, and nonfinancial corporates (Koo 2011). As banks faced mounting impaired loans, lending to sound companies contracted—partly the result of rolling over loans to weak companies (Caballero, Hoshi, and Kashyap 2006). Investment and consumption growth declined sharply and persistently.

## Balancing reforms and short-term demand management remains a priority in 2015

Engineering a gradual shift to a more sustainable growth path poses challenges for policy makers, given real-sector weaknesses and financial-system vulnerabilities. Efforts to cut excess capacity in heavy industry, reduce supply mismatches in residential property, dampen unproductive risk taking in shadow banking, and harden budget constraints on local governments will help make investment more efficient and realign growth over the medium term. In the short term, however, such reforms will depress activity. Official targets for 2015 signal a downward trajectory, with GDP targeted at about 7 percent, half a percentage point lower than in 2014 (table 2.2).

	2014 target	2014 actual	2015 target	Change in target
GDP growth (%)	about 7.5	7.4	about 7.0	↓
Change in CPI (%)	3.5	2.0	3.0	↓
M2 growth (%)	13.0	12.2	12.0	↓
Fiscal deficit (% of GDP)	2.1	1.8	2.3	↑
Fixed asset investment growth (%)	17.5	15.3	15.0	↓
Foreign Trade volume growth (%)	7.5	3.4	6.0	↓
Retail sales growth (%)	14.5	12.0	13.0	↓
New urban employment (million)	10.0	13.2	10.0	=

Source: World Bank staff calculations based on official government documents.

Conversely, stimulus measures aimed at supporting short-term growth may conflict with efforts to increase the sustainability of medium-term growth. A narrowly targeted stimulus may mitigate the tradeoff, but will also be harder to implement as using just administrative measures to reallocate credit to priority sectors are not as effective as market based mechanisms. The projected gradual growth deceleration assumes a firm commitment to pushing through structural reforms and to reducing vulnerabilities; at the same time, targeted stimulus is expected to attenuate the impact on short-term growth, should this show signs of slowing to much below the government's indicative target of about 7 percent. Weak growth in the first quarter indicates that reaching this target for 2015 would require an accommodative policy stance. It is expected that the authorities will intensify use of demand management to shore up growth (beyond recent measures). Further, the late-April Politburo meeting suggests that growth stabilization is increasingly becoming a priority, and recent policy measures imply that the central government will take a softer line on implementing its reforms for the new local government debt framework: it will likely provide sufficient transitional arrangements to finance ongoing infrastructure projects and refinance maturing debts. Recent policy statements, too, indicate that policy banks will become more active as financing tools for local governments, while a recent reduction of resource tax on iron ore suggests a more gradual approach to reducing excess capacity.

The new budget for 2015 approved in March has fiscal policy becoming more accommodative, with the fiscal deficit widening to 2.3 percent of GDP (table 2.3). The widening of deficit by 0.2 percentage points arises from new tax rates, including replacing business tax by VAT for all industries and reducing fees to strengthen support for the real economy. Efforts will be made to decrease administrative charges for small and micro businesses to limit the administrative and regulatory burden.

Policy support will be needed to address the local government financing gap. While the debt swap discussed in section 1 addresses key immediate challenges, the proportion of debt and contingent liabilities not covered by it will be heavy for many provinces. It is expected that the PBOC will take a more indirect role in purchasing these bonds via its Pledged Supplementary Loan operations window using a proxy, such as the China Development Bank. This window was used in the past to design a financing vehicle for the social housing initiative.

**Public investment will be used as a growth stabilizer.** Recent policy documents suggest that public investment will be increasingly targeted to major national and transregional investment projects that have strong positive externalities. Similarly, efforts to rebuild rundown urban areas will carry on.

**Table 2.3: Main fiscal aggregates of public finance budget 2011–15**

	<i>RMB billions</i>				<i>As % of GDP</i>			
	2012	2013	2014	2015 (budgeted)	2012	2013	2014	2015 (budgeted)
<b>Revenues</b>	<b>11,995</b>	<b>13,029</b>	<b>14,134</b>	<b>15,530</b>	<b>23.1</b>	<b>22.9</b>	<b>22.2</b>	<b>22.8</b>
Central government	5,617	6,017	6,439	6,923	10.8	10.6	10.1	10.2
Contribution to Stabilization Fund	270	100	100	100	0.5	0.2	0.16	0.15
Local government (excludes transfers from central budget)	6,107	6,911	7,585	8,507	11.8	12.2	11.9	12.5
<b>Expenditures</b>	<b>12,620</b>	<b>14,229</b>	<b>15,248</b>	<b>17,150</b>	<b>24.3</b>	<b>25.0</b>	<b>24</b>	<b>25.1</b>
Central government expenditures (excludes transfers to local governments)	1,876	2,047	2,257	2,501	3.6	3.6	3.5	3.7
Payments to replenish Stabilization Fund	24	116	81	50	0.0	0.2	0.1	0.1
Local government expenditures (includes transfers from central budget)	10,718	12,065	12,909	14,598	20.6	21.2	20.7	21.4
<b>Fiscal balance</b>	<b>-624</b>	<b>-1,200</b>	<b>-1,113</b>	<b>-1,620</b>	<b>-1.2</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-2.4</b>
Transfers from central to local government	4,536	4,804	5,160	5,592	8.7	8.4	8.1	8.2
Land-lease revenues (gross)	2,852	4,125	4,261	--	5.5	7.3	6.7	--

.. is not available.  
Source: World Bank staff estimates based on CEIC data and report of the Ministry of Finance to the National People's congress March 2015.

**Monetary policy is set to remain accommodative, in tandem with efforts to contain shadow-banking credit growth.** Aggregate credit growth is poised to remain above nominal GDP growth. However, despite recent efforts to lower the required reserve ratio and benchmark interest rates, liquidity conditions are still tight due to capital outflows, moderating deposit growth, and sharply decelerating nonbank credit. The authorities have also signaled that measures will be taken to increase the trading band of the RMB, but when is unknown.

**The reversal of capital flows (section 1) has tightened domestic liquidity and required active, ad hoc liquidity management by the central bank to avoid a liquidity crunch.** However, the PBOC is also concerned that monetary easing using rate cuts or a reduction in the required reserve ratio would exacerbate the leverage issue and contribute to existing credit imbalances in the financial sector.

**China is progressing with structural reforms.** At the Third Plenum of the Central Committee of the 18th Party Congress of the Communist Party of China (CPC) in November 2013, the government set out an ambitious program of 15 key reform areas covering 60 economic and social reforms, with the overarching objective of giving “the market a decisive role in resource allocation” and of improving government efficiency. The authorities are pressing ahead with implementing these reforms, but with reforms to improve allocation of capital going faster than those to address frictions in labor and land markets (table 2.4).

Table 2.4 Key reforms to give “the market a decisive role in resource allocation”

Reform area	Period	Description
Improve allocation of capital	2014 Q1	<ul style="list-style-type: none"> <li>▪ PBOC widens the daily trading band of USD/RMB to +/-2% around the fixing rate</li> </ul>
	Q2	<ul style="list-style-type: none"> <li>▪ Full liberalization of lending rates</li> <li>▪ State Council issues the “Guiding Principles for the Healthy Development of Capital Markets,” which outline road maps for capital market development in nine major areas.</li> <li>▪ PBOC, SAFE, CBRC, CIRC, and CSRC jointly announce Circular 127 to govern the interbank business and proprietary investments by financial institutions. The aim is to slow the flow of funds from commercial banks to the shadow-banking system</li> <li>▪ Political Bureau of CPC passes the “Overall Plan to Deepen Fiscal and Tax Reform”</li> </ul>
	Q3	<ul style="list-style-type: none"> <li>▪ PBOC and CBRC jointly issue a “Notice on Improving Home Financing Services,” encouraging bank loans to support slum renovation and public housing projects, extending the duration of lending up to 25 years</li> <li>▪ CBRC approves two more private banks in Shanghai and Zhejiang, and requires them to be established within six months</li> <li>▪ State Council announces an action plan for better budget management, the first step of broader fiscal and taxation reforms by 2020</li> <li>▪ National SASAC kicks off central state-owned enterprise (SOE) reform, by naming six SOEs to conduct pilot programs in four areas; mixed-ownership pilot reforms will be carried out at Sinopharm and CNBM</li> <li>▪ New revised Budget Law passed, in its first revision since it came into effect in 1995</li> </ul>
	Q4	<ul style="list-style-type: none"> <li>▪ The State Council strengthens the supervision and management of debts incurred by local governments, including a ‘no bailout’ clause indicating that local governments to meet repayment obligations themselves</li> <li>▪ Shanghai–Hong Kong Stock Connect Program adopted</li> <li>▪ Market access for foreign banks eased</li> </ul>
	2015 Q1	<ul style="list-style-type: none"> <li>▪ Deposit-rate ceiling raised to 1.3 times the benchmark rate</li> </ul>
	Q2	<ul style="list-style-type: none"> <li>▪ Deposit insurance system introduced</li> <li>▪ State Council releases regulations to widen the bank-card clearing market, further opening the financial sector</li> <li>▪ Proposed amendments to China’s Securities Law (under review) would see changes from an approval- to a registration-based IPO system</li> <li>▪ Lenders are allowed to issue certificates of deposits (CDs) with interest rates fixed or floating thus further freeing up interest rates to make them more reflecting of market forces</li> <li>▪ Foreigners’ access to domestic bond market widened</li> <li>▪ The State Council passes a draft amendment to China’s Banking Law that gives banks more freedom to lend by removing the cap on loan-to-deposit ratio of 75 percent</li> </ul>
Land reforms	2014 Q3	<ul style="list-style-type: none"> <li>▪ China approves the “Guideline to Promote Rural Land Transfer.” The reform will promote the concentrated use of farm lands, nurture diversified agricultural businesses, and enhance agricultural productivity</li> <li>▪ China announces 62 cities/counties to be pilot locations for “New Type Urbanization Reforms,” chosen from among 169 that applied</li> </ul>
	Q4	<ul style="list-style-type: none"> <li>▪ Pilot program of identifying land management rights extended to more provinces</li> </ul>
	2015 Q1	<ul style="list-style-type: none"> <li>▪ Plans announced to establish a new-style agricultural management system, accelerate reforms of rural collective property rights system, steadily push forward pilot reforms of rural land system and carry out rural financial system reforms</li> </ul>
Labor market reforms	2014 Q1	<ul style="list-style-type: none"> <li>▪ State Council announces plans for unification of urban and rural pension systems</li> </ul>
	Q2	<ul style="list-style-type: none"> <li>▪ State Council officially issues the “Opinions on Further Promotion of the Reform of the Household Registration System”—the <i>hukou</i></li> </ul>
	2015 Q1	<ul style="list-style-type: none"> <li>▪ The central government unveiled pension reform plans for government and public institution staff members</li> </ul>

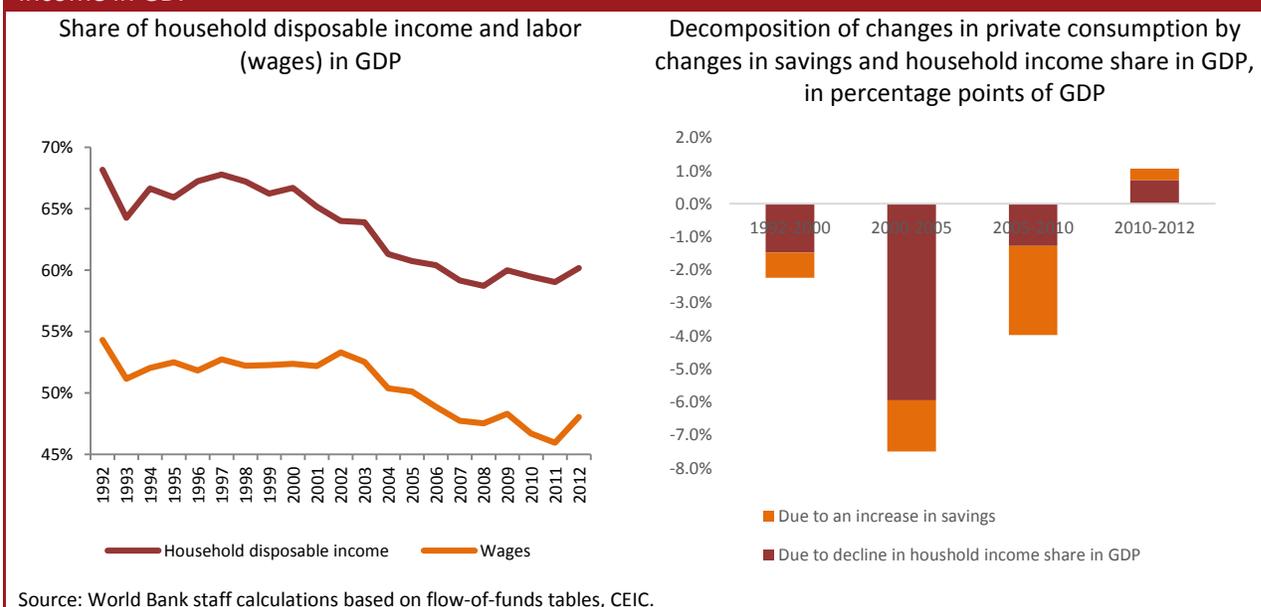
Source: World Bank staff, based on official government documents.

A decline in the CPI provides an opportunity to address price distortions in product and factor markets. As part of its price reforms, the government is expected to continue adjusting prices for transport, energy, and utilities, and taxes on resources, energy, and the environment. Not only should these moves reduce or even eliminate government price controls, they should also help lessen price distortions and improve resource allocation in the economy, offsetting (to an extent) mounting deflationary pressures.

### The transition to the “new normal” requires a better allocation of credit and indigenous capacity for innovation

China’s key medium-term policy challenge is to engineer an orderly transition toward higher-productivity, equitable, and sustainable growth—as seen. An increase in productivity is critical to rebalance growth on the supply side from capital- and resource-intensive industries to services, while an increase in the labor share of GDP is critical to rebalance growth on the demand side from investment to consumption. While annual data suggest that household income and wage shares in GDP have started to rise (in part due to a demographic transition), reversing a two-decade trend (figure 2.1), a transition to more equitable growth will be gradual. Hence, aggregate consumption to GDP will continue to increase supported by a declining savings rates and higher household income share in GDP. Continued efforts to undertake structural reforms will facilitate these transitions, but a gradual moderation of medium-term potential growth trajectory will continue (box 2.1).

Figure 2.1 More equitable growth means continuing to increase the share of household disposable income in GDP



In May 2014 President Xi Jinping used the term “new normal” to describe an evolving economy of slower growth and new risks that will require a more efficient and effective bureaucracy, the rule of law, and other reforms. His premise is that upgraded economic structures and innovation will be the core of a strategy for sustainable, albeit moderated, growth over the next two decades. China’s top leadership has articulated the needs for markets to play an expanded role in this growth. The leadership’s policies to adjust to the new normal include structural fiscal and financial reforms, governance modernization, a streamlined bureaucracy, the rule of law, upgraded economic structures, and greater innovation. He acknowledged the risks and challenges flowing from the new paradigm, and reiterated the collective will to “comprehensively deepen reform” to benefit from this new normal.

**Box 2.1 China's medium-term potential growth trajectory**

Will China be able to sustain medium to high growth over the next two decades? Much depends on how the global environment evolves and on the structural forces that are already at work within China. But this much is likely to happen: within the next decade, China's economy will shift from rapid to moderate growth, with average annual growth of around 5 percent. First, because of a weaker external demand, China's export growth will slow. Second, continuing capital accumulation will contribute less to growth as the capital-labor ratio rises. And changes in the demographic profile will lead to a decline in the labor market participation rate. China's working-age population is expected to decline, and labor's contribution to growth will turn negative. In addition, the spatial transformation in labor markets will contribute less to growth. And finally, total factor productivity (TFP) growth—a measure of improvements in economic efficiency and technological progress—has also declined, in part because the economy has exhausted gains from first-generation policy reforms and the absorption of imported technologies.

While there is broad consensus that China's growth is likely to slow, there are different views how fast this adjustment will happen. The baseline scenario assumes that this moderation of growth will be orderly and gradual. China has avoided economic setbacks: not only did economic growth average nearly 10 percent over more than three decades, it fell measurably below 7 percent only once. At the same time, global and domestic trends are also likely to give rise to many risks that could slow economic growth and disrupt China's progress to become a high-income, harmonious, and creative society. Managing the transition from a middle-income to a high-income society will itself prove challenging, and a global environment that will likely remain uncertain and volatile for the foreseeable future makes the task doubly daunting.

Any sudden slowdown could unmask inefficiencies and contingent liabilities in banks, enterprises, and different levels of government—heretofore hidden under the veil of rapid growth—and could precipitate a fiscal and financial crisis. The risk of sharply lower growth rates is exacerbated by China's relatively high income and asset inequality, low consumption, and unequal access to quality public services.

**Box figure 2 Medium-term sources of growth, five year averages: Baseline and reform scenarios**

Baseline scenario	2015-20	2020-25	2025-30	Reform scenario	2015-20	2020-25	2025-30
<b>Annual GDP growth</b>	<b>7.0</b>	<b>6.0</b>	<b>4.9</b>	<b>Annual GDP growth</b>	<b>7.2</b>	<b>6.1</b>	<b>5.2</b>
<u>Sources of growth:</u>				<u>Sources of growth:</u>			
Labor	-0.2	-0.2	-0.4	Labor	-0.2	-0.2	-0.4
Capital	8.3	6.6	5.1	Capital	8.1	6.3	4.7
Total Factor Productivity (TFP)	2.1	2.1	2.1	Total factor productivity (TFP)	2.4	2.5	2.5

Source: Estimates of the Development Research Center's Computable General Equilibrium Model for Urban China.

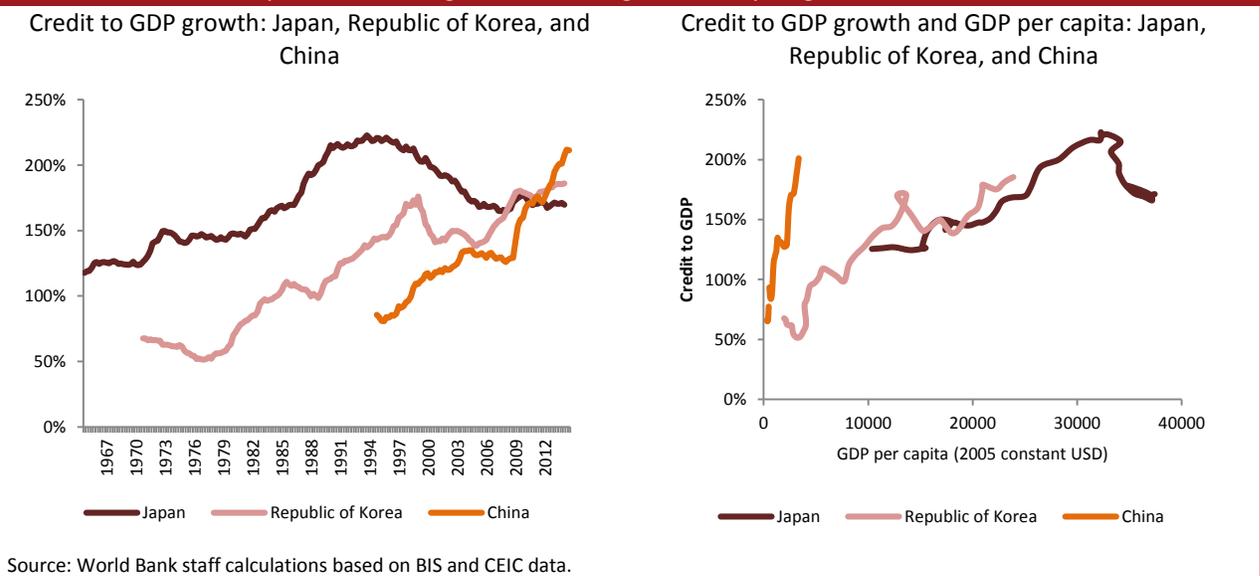
Implementation of much needed structural reforms will not reverse a moderation of economic growth over the next decades. It is also clear that many second-generation reforms are likely to have a significantly smaller impact on growth than the first-generation reforms that led to rapid technological absorption in the manufacturing sectors. However, without reforms the growth slowdown would be more severe. Analyzing the effect of such a reform package will require quantifying both the supply- and demand-side factors of economic growth and their links. To project the effect of reforms on growth, Urban China study adopted the computable general equilibrium model of China's Development Research Center. Different from the simple macro model of aggregate production function, it can better simulate the effect of structural changes. China still has potential to use reforms to unlock growth dividends from increased labor force participation, reallocation of excess labor from agriculture and total factor productivity growth. The following three sets of policies will contribute to higher growth rates under a reform scenario:

- Land and labor market reforms that stimulate the reallocation of excess labor from agriculture to other sectors can increase annual growth by about 0.2 percentage points.
- Public finance reforms that strengthening the accumulation of human capital by ensuring equal access to public services.
- Reforms that enhance the efficiency of urbanization by strengthening agglomeration, connectivity, and specialization will promote agglomeration economies.

Sources: Urban China (World Bank and DRC, 2014), China 2030

First, the transition to the “new normal” will require a better allocation of credit to deleverage the economy while maintaining growth. An increase in corporate and local government leverage after the global financial crisis has been very rapid and has resulted in declining debt-service capacity (see box 2.2). Globally, rapid rises in the credit-to-GDP ratio, as in China, are usually followed by slower economic growth. This is true for economies as varied as Chile, Ireland, Malaysia, and the United States. Cross-country evidence shows that credit booms can stimulate economic activity (figure 2.2), but a rapid buildup of leverage has a long-lasting impact on corporate and household behavior, leading to subsequent below-trend economic growth, which on average slows by 2.2 percentage points after a credit boom. Only a minority of booms have ended in financial sector crashes, but some of these crashes have been spectacular. Countries with high savings rates appear to decelerate less sharply.

Figure 2.2 Credit allocation is generally recognized as an important determinant of economic growth, but China’s financial system is no longer contributing effectively to growth



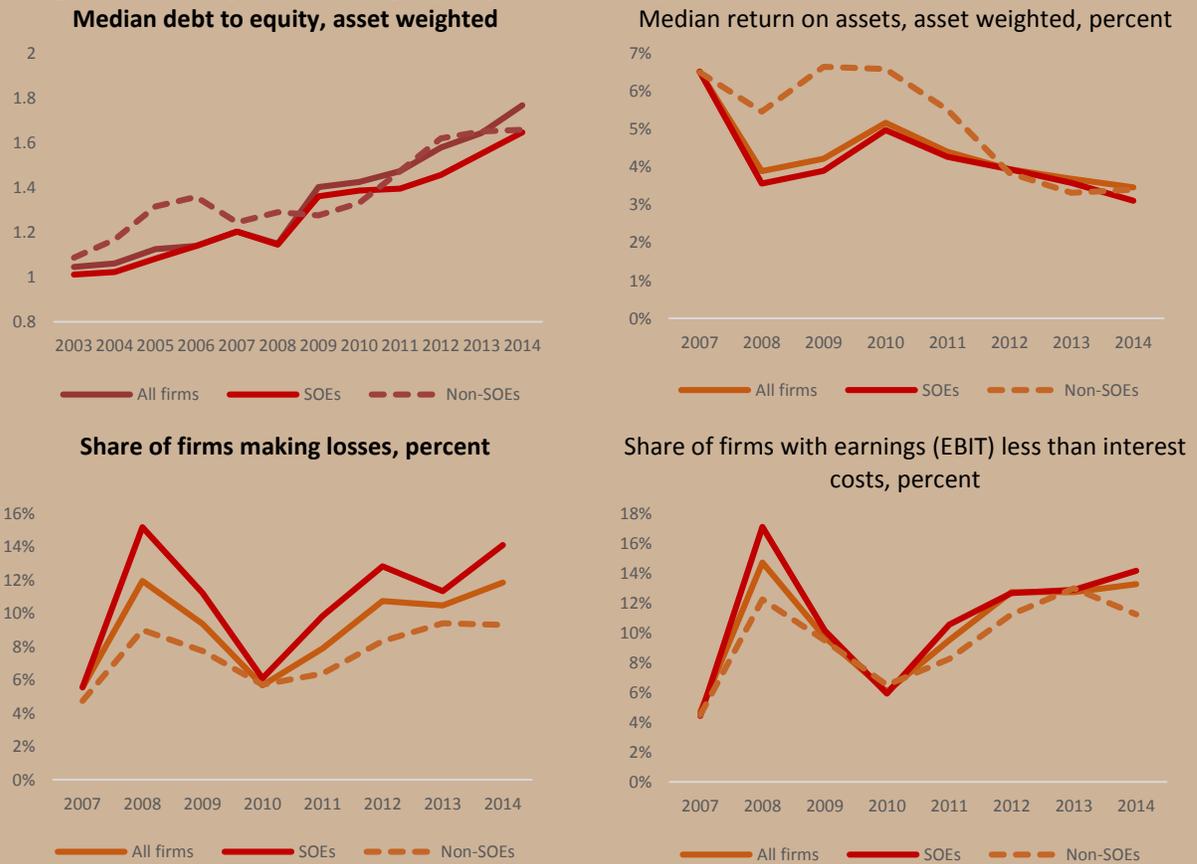
Source: World Bank staff calculations based on BIS and CEIC data.

China has tempered the pace of total credit growth, but unless it adopts a systematic approach to strengthening financial sector discipline the measures are inadequate to ease the misallocation of credit and the buildup of risk. China’s financial system was developed to serve the old investment-driven growth model, effective during earlier phases but less so now. So, absent policy interventions, the financial system will be unable to support any major reallocation of credit to those sectors that can maintain reasonable growth.

### Box 2.2 A gradual decline in debt-service capacity

A surge in corporate and local government leverage in China after the global financial crisis is a concern. Chinese research has concluded that China's economy has been "dynamically inefficient" for most of the past decade: the capital sector (corporates and local governments) systematically overinvest and the economy does not maximize long-run growth of consumption per capita.<sup>7</sup> The declining debt-servicing capacity is even more clearly reflected in performance indicators of listed firms, such as higher debt-to-equity ratios, reduced profitability, increases in the share of loss-making firms, and declining ratios of earnings to interest payments, and firms with earnings (EBIT) less than interest costs since 2009 (box figure 3)

**Box figure 3 Declining debt-servicing capacity is reflected in performance indicators of listed firms**



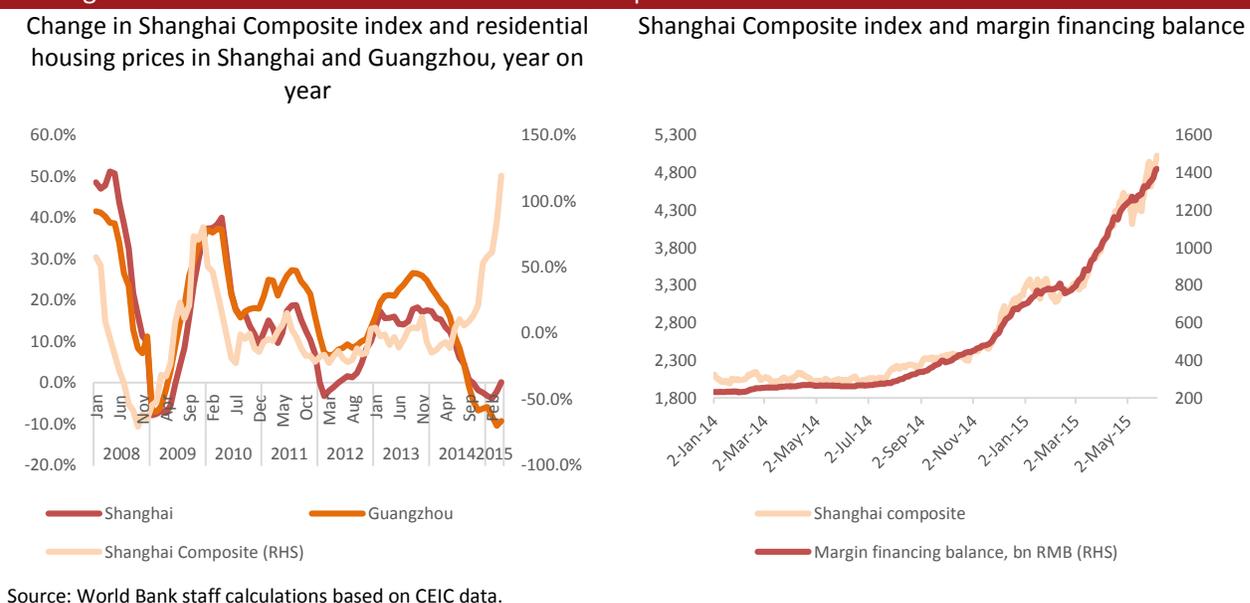
Source: World Bank staff calculations based on Wind data.

**Checks on unsound borrowing through supply-side discipline are important in credit deleveraging.** In fact, international experience shows that "market discipline" alone regularly fails to restrain irresponsible borrowing, and it is increasingly appreciated that reforms to correct structural deficiencies and to build supply-side discipline are important in limiting it, and thus overindebtedness. Policy steps to check wasteful demand for credit include rationalizing credit growth to local governments, hardening budget constraints to SOEs and sectors with excess capacity, and curtailing credit growth to sectors and activities

<sup>7</sup> Abel et al. (1989) assess whether an economy is dynamically inefficient or exceeds the "golden rule" level of capital accumulation by determining if total investment systematically exceeds capital income. Yongdong and Yingfei (2002), Zhigang and Zhangyong (2003), Benwu (2008), Feiming (2010), and Liangxin (2011) use this approach to conclude that China became dynamically inefficient during the 2000s.

liable to asset-price bubbles. For example, the recent stock market rally has been unfolding against a backdrop of a surge in margin financing for buying stocks (figure 2.3).

**Figure 2.3 Checks on unsound borrowing through supply-side controls are important in restraining credit growth to sectors and activities liable to asset-price bubbles**



Source: World Bank staff calculations based on CEIC data.

**Financial sector reforms would need to support a substantial reallocation of credit in order to promote productivity growth.** Reallocating credit resources to sectors with high growth potential could be facilitated with improved market contestability, a stronger investment climate, and less red tape. Such a reallocation would require better aligned incentives on the financial sector which in turn require a rebalancing of the role of the state in the financial system.

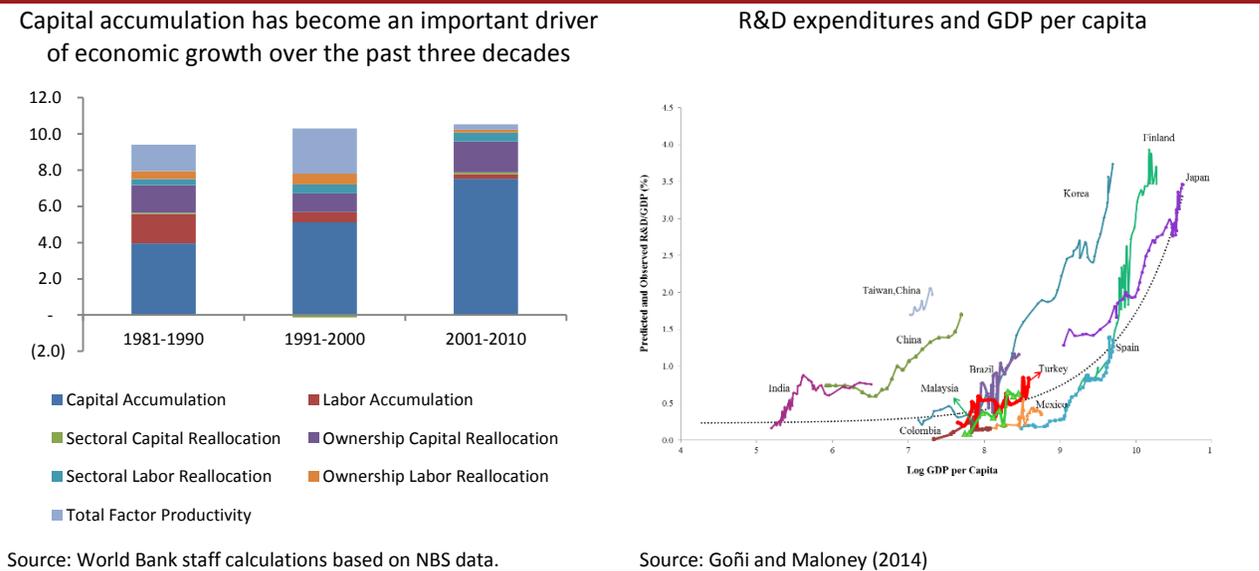
**Second, the transition to the “new normal” will require sustained productivity growth that demands, however, the cultivation of indigenous innovative capacity.** China, like many other countries, has grown for long periods on the rents from pairing cutting-edge production technologies with extremely cheap labor. But in the future continued rapid growth will require that it develop the capacity to grow, based on the quasi-rents of innovation across many sectors.

**This process is not automatic, and will draw on policies to upgrade tasks in a range of sectors rather than relying on these sectors’ intrinsic properties.** China acknowledges this, as seen in an official goal of moving from “Made in China” to “Innovated in China.” While industrial R&D activity in China has surged over the last 15 years and is expected to surpass levels in the United States and Europe over the next decade, the challenge is daunting. Moreover, while China is also one of the favorite destinations for multinational R&D investment, most of this investment is to develop products for multinational enterprises (MNEs) to sell in the Chinese market. China is still integrated to only a shallow extent with the global supply chain of advanced technologies.

**Over the past decade China increased key innovation inputs and outputs, such as R&D spending and patent applications, but these are not yet translating into productivity growth.** Patenting activity has picked up quickly, but China has not yet caught up with leading nations on innovation performance. To harvest the fruits of the extensive expenditure on hard and soft research and R&D, the Chinese innovation ecosystem needs to increase its quality and range of market-driven innovations that drive value creation and productivity gains. Nor are patents converting into economic value, as the vast majority are either co-

invented and assigned to MNEs or are Chinese invented but then assigned to MNEs. There is a growing portion of Chinese invented and owned patents, but it remains relatively small (figure 2.4). If most of the R&D generating these patents is in Taiwan, China or U.S. firms, the knowledge, product, and entrepreneurial spillovers are likely very small.

**Figure 2.4 Sustained productivity growth rather than capital accumulation will become a driver of growth**



**It is now even more important to develop China's innovative capacity as the country's traditional growth model has started showing signs of fatigue.** Economic growth that was driven mainly by exports of low value-added, labor-intensive manufacturing goods will not work in the future as the dividends from labor reallocation from agriculture to industry are about to peter out. Moreover, the existing growth model has been very extensive in natural resource use and damaging to environment. After the great recession that started in 2008, the global economic environment has changed and exports can no longer be a driver of growth. Domestic investment is now the main engine of growth, and must vastly increase its indigenous innovation in products and processes as a new productivity driver. China has identified that key avenues for doing so will increasingly be local high-tech industries commercializing local intellectual property and upgraded low- and medium-tech industries using indigenous innovation more.

**The indigenous innovation agenda will only succeed if implemented in concert with continued broader reforms.** Current innovation policy is heavily supply driven and R&D focused. Merely investing another 1 percent of GDP in R&D will not translate into growth. The elements necessary to stimulate markets that reward innovation include further private sector development and increased competition, reforms in factor markets, the development of a green growth strategy, human capital deepening, and the harnessing of urban agglomeration economies to advance ideas and technologies. For example, the weaknesses in intellectual property protection (which MNEs often complain about), also undermine attempts by Chinese firms to capture the rents from investing in brands and technologies, and provide an active disincentive for them to even try and do so. (As an aside, nor is the quality of innovation in Chinese firms captured by this measure: much patenting activity appears driven by subsidies for patent registration, as most patents are not reregistered after the first year.)

**The innovation system focuses heavily on R&D-intensive high-tech industries, but these still make up only a small proportion of the Chinese economy.** As the domestic market becomes more sophisticated and loses some cost advantage in export markets, China's innovation system needs to support the continuous

upgrading of low- and medium-tech industries by building blocks of organizational and process innovation, of which a core underpinning is management quality, in addition to R&D, information and communications technology, design, brand equity, and education and training.

**Yet China does not have the luxury of waiting decades to fully develop these skills.** To reap the benefits of extensive R&D spending, the entire ecosystem (including institutions) has to be directed to developing innovations and productively applying them. China has a vast number of institutions supporting this ecosystem, but their overall dovetailing is a work in progress.

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