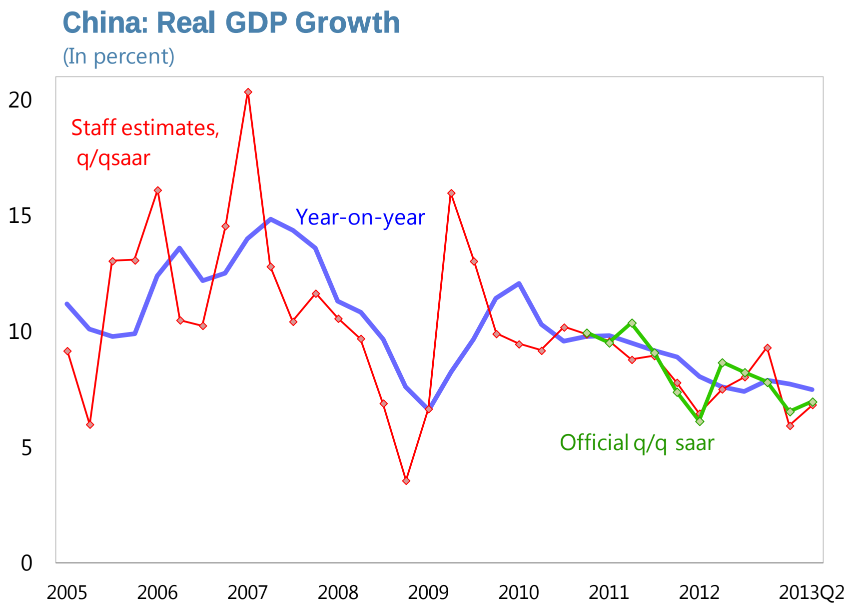
China: Article IV Consultation 2013

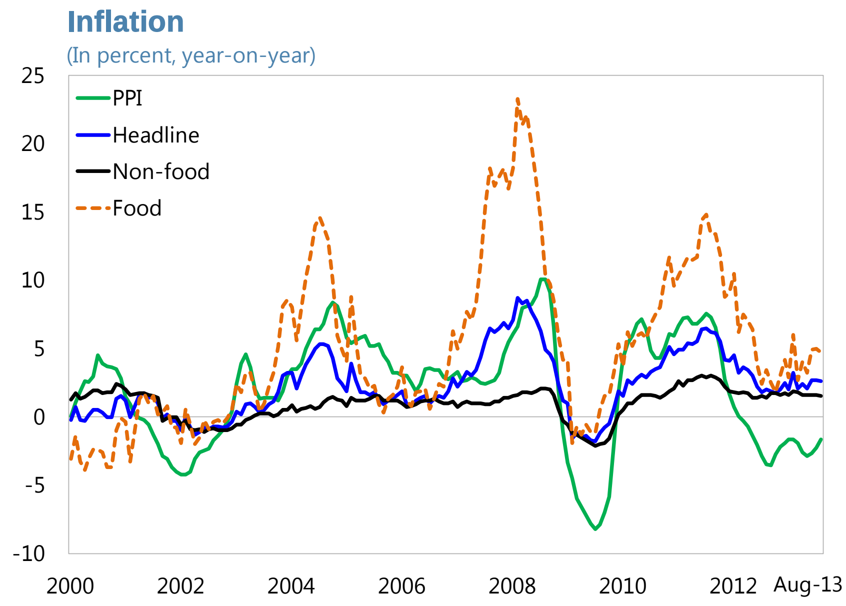
Main Messages

- Near-term growth: moderating, but no imminent ‘hard landing’
- Vulnerabilities are growing along the current growth path…
- …financial and structural reform must be accelerated to contain risks and transition to sustainable growth path

Developments and Outlook

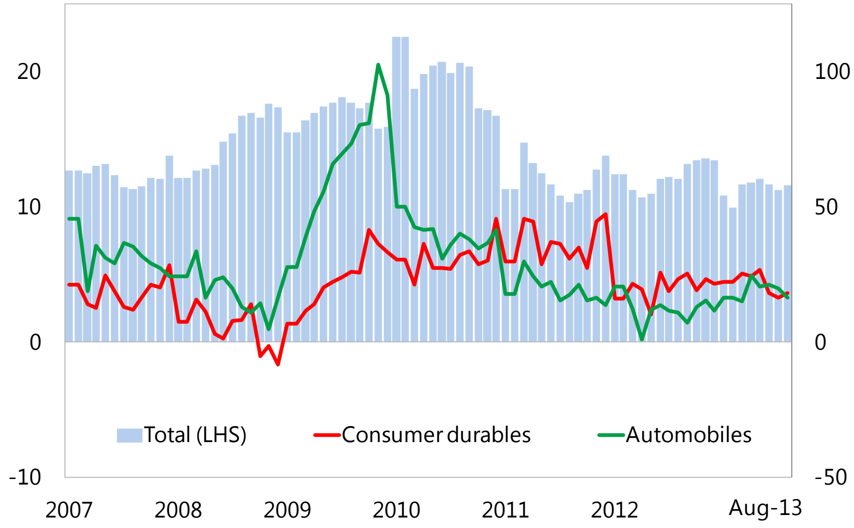
Near-term Outlook: Growth has Moderated, But no Hard Landing



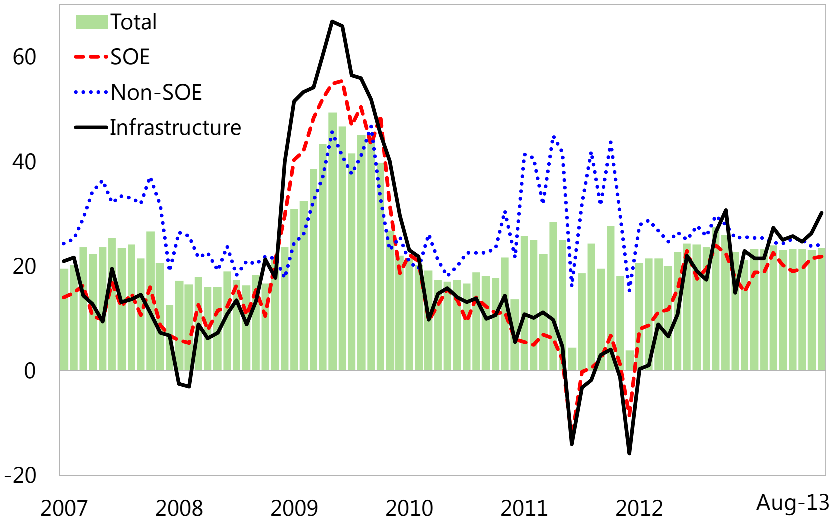


Activity: High-Frequency Indicators

Retail Sales
(In percent, year-on-year growth)



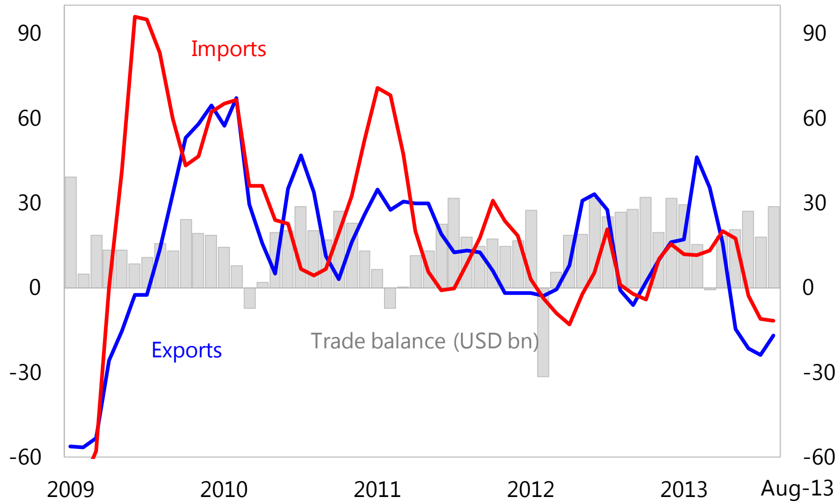
Real Fixed Asset Investment
(In percent, year-on-year)



Balance of Payments

Trade Balance

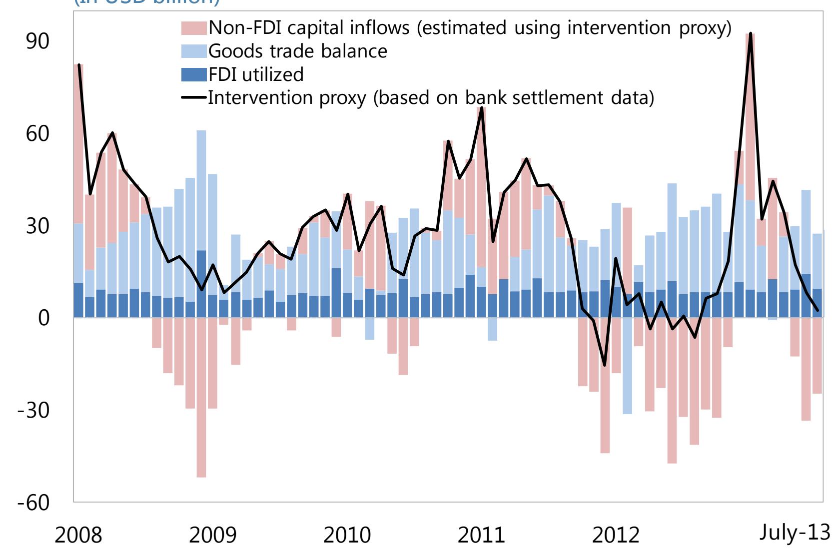
(In percent, 3mma, 3m-on-3m, saar*)



* Seasonally adjusted using X12 after averaging January and February data.

Trade, FDI, and Foreign Exchange Intervention

(In USD billion)

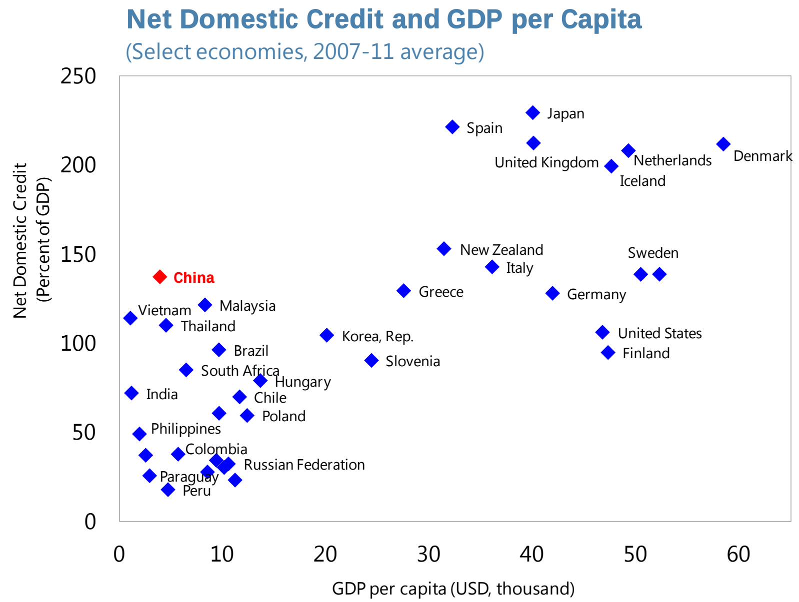


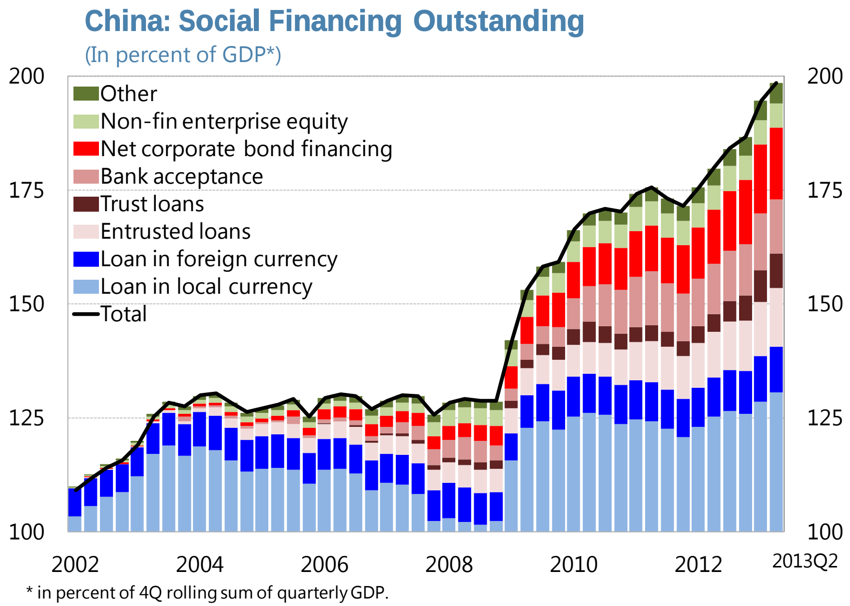
Risks and Vulnerabilities:
Still Manageable, But Growing

Risks

- Financial Sector
- Local Government Finances
- Real Estate
- Insufficient Domestic Rebalancing

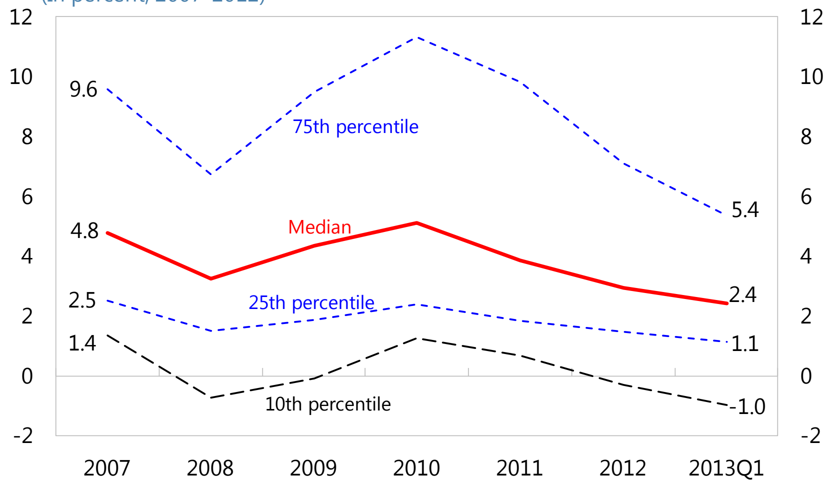
Financial Sector Risks





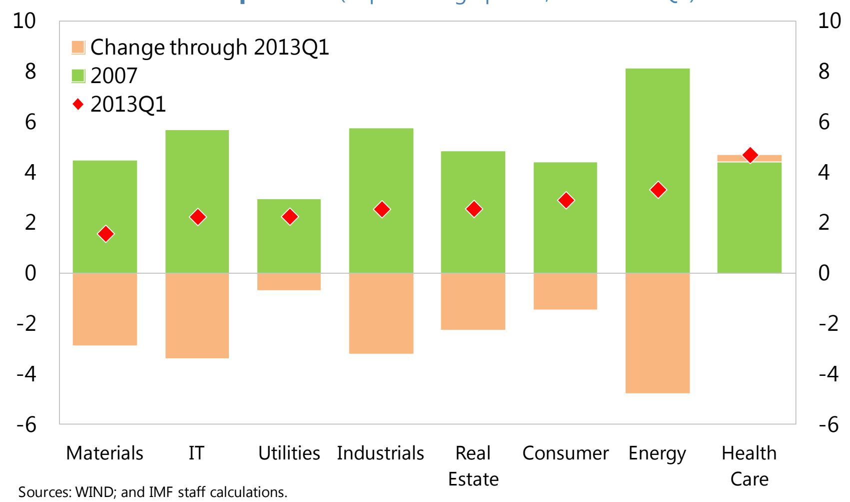
Corporate Leverage

Ratio of EBIT to Interest Expense in Listed Chinese Companies [1]
(In percent, 2007-2012)



Sources: WIND; and IMF staff calculations.
1/ Computed for a balanced panel of 1,210 (equally weighted) nonfinancial companies with data availability for the entire sample period. EBIT = earnings before interest and taxes.

Change in the Median Ratio of EBIT to Interest Expense by Sector in Listed Chinese Companies [1] (In percentage points, 2007-2013Q1)

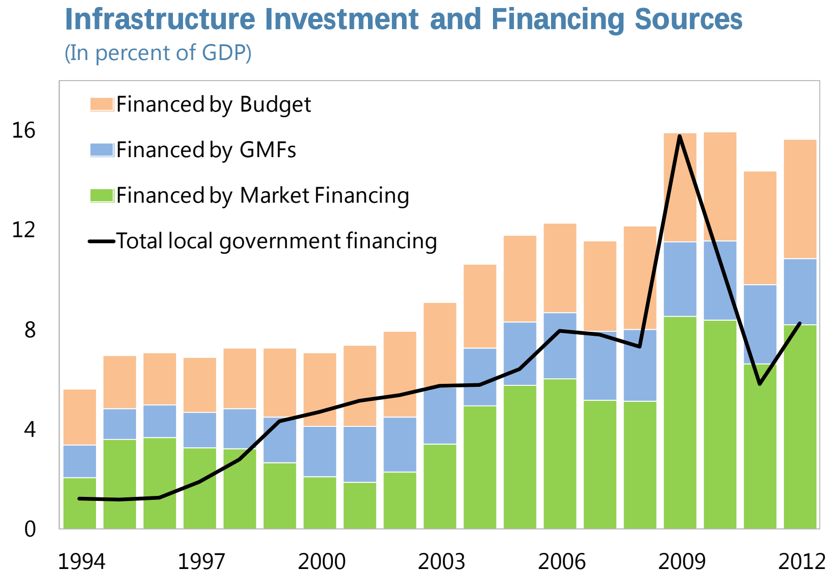


Sources: WIND; and IMF staff calculations.
1/ Computed for a balanced panel of 1,210 nonfinancial companies with data availability for the entire sample period. Median computed based on equal-weighting of companies.

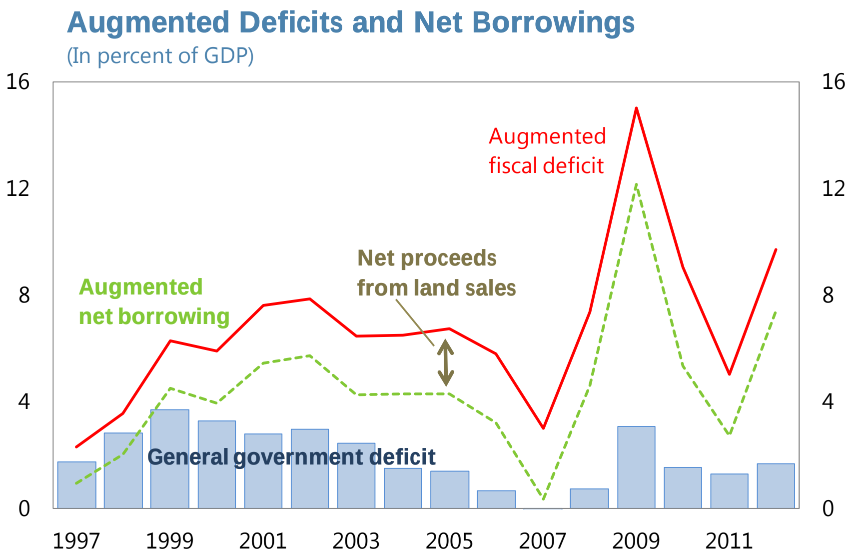
Financial Risks: Assessment

- New channels are progress toward more market-based finance, but pose risks to financial stability
- Rapid credit growth points to potential asset quality problems
- Maturity transformation implies liquidity risks
- Problems still manageable (fiscal space, capital and provisioning), but reforms more urgent

Local Government Finances

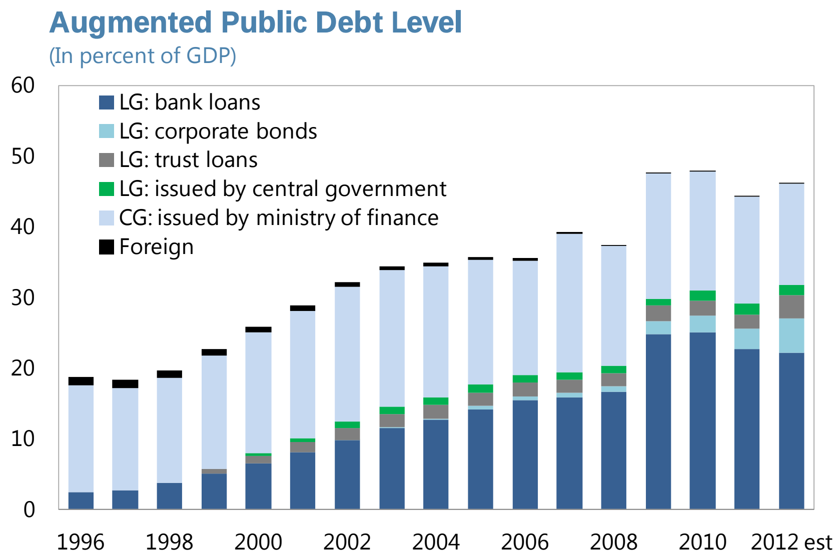


Source: IMF staff estimates.

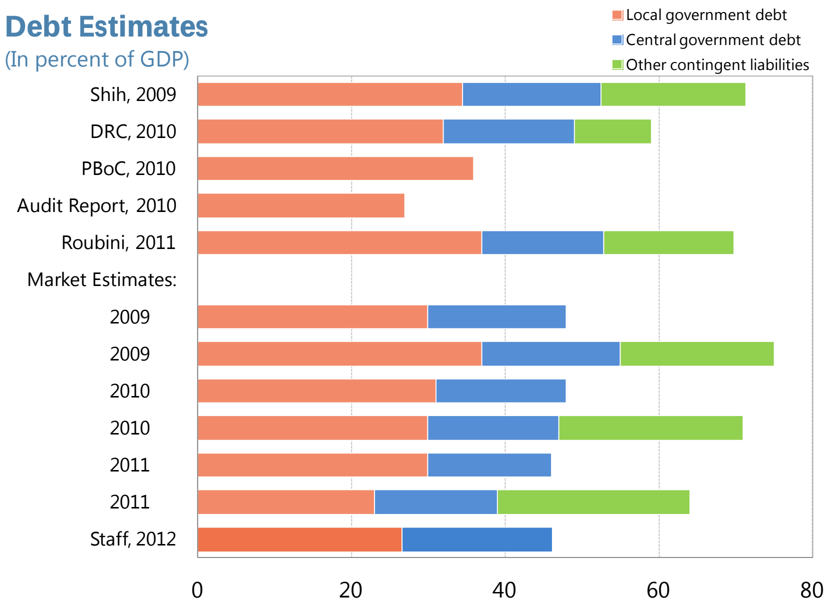


Sources: CEIC, Chinabond, EUROSTAT, China Citic Press, China Trustee Association, NAO, and the Ministry of Finance, Zhang and Barnett (2013).

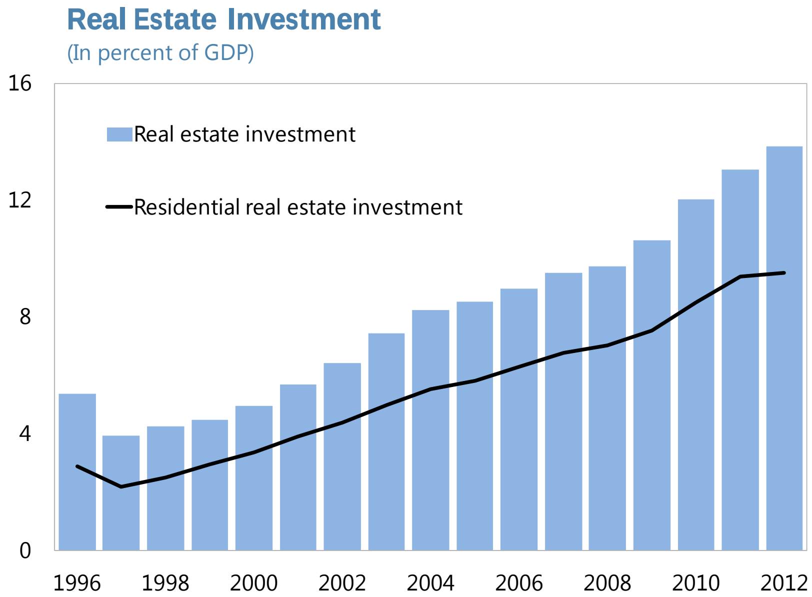
Augmented Public Debt



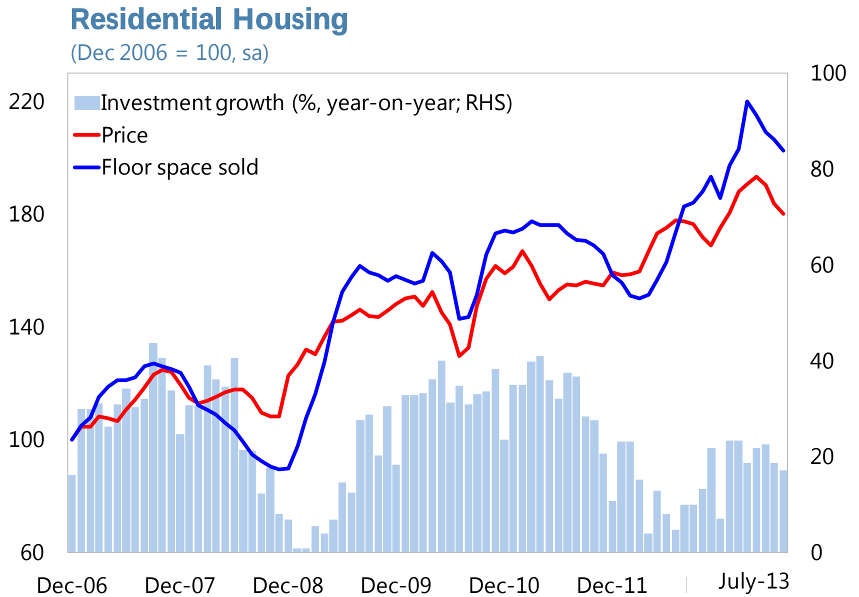
Sources: CEIC, Chinabond, EUROSTAT, China Citic Press, China Trustee Association, NAO, and the Ministry of Finance; and IMF staff estimates.



Real Estate



Real Estate Investment
(In percent of GDP)
16
12
8
4
0
Real estate investment
Residential real estate investment
1996
1998
2000
2002
2004
2006
2008
2010
2012

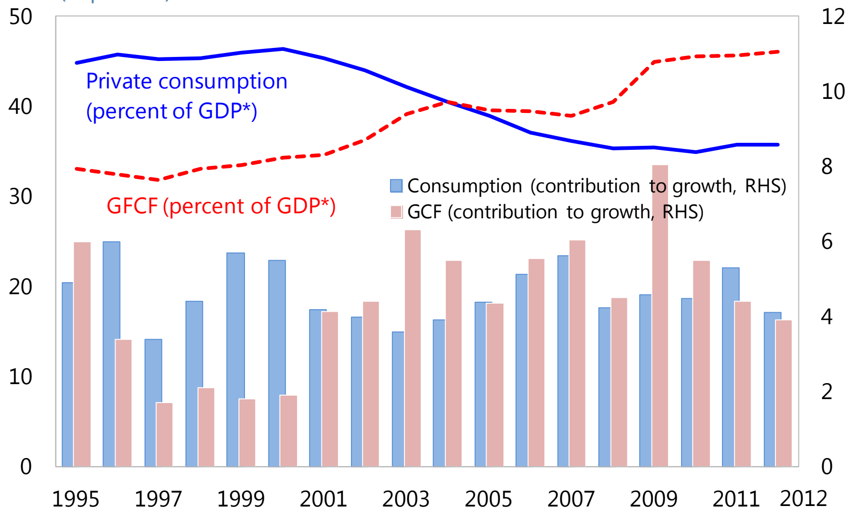


Residential Housing
(Dec 2006 = 100, sa)
220
180
140
100
60
100
80
60
40
20
0
Investment growth (%, year-on-year; RHS)
Price
Floor space sold
Dec-06
Dec-07
Dec-08
Dec-09
Dec-10
Dec-11
July-13

Growth Model Based on Investment and Capital Accumulation

Consumption and Investment

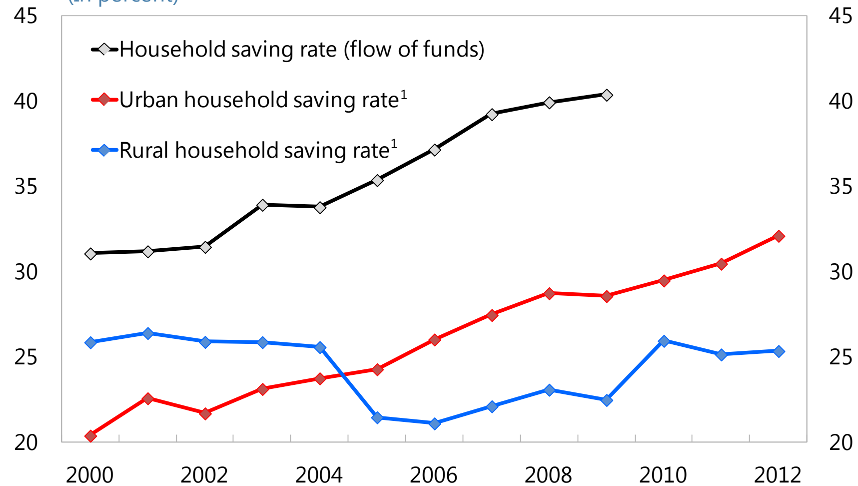
(In percent)



* percent of expenditure-based GDP. Sources: CEIC; and IMF staff estimates.

Household Saving Rate

(In percent)

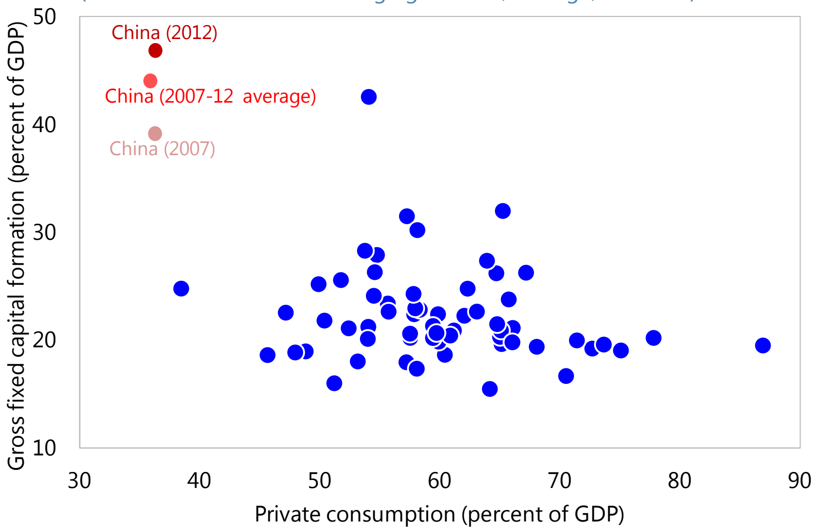


[1] Rural household saving rate =(net income -living expenditure)/net income, percent; urban household saving rate = (disposable income-consumption)/disposable income, percent; household survey.

More Progress Needed on Domestic Rebalancing ...

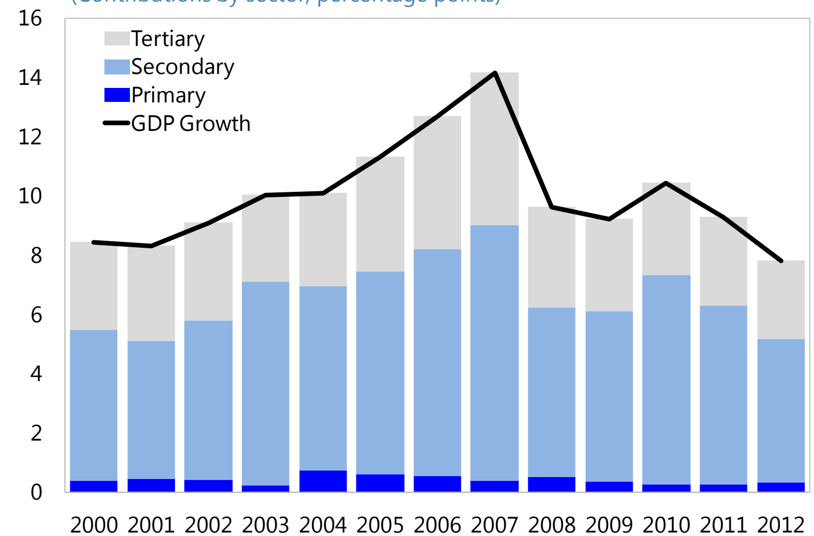
Private Consumption and Investment

(Industrial countries and emerging markets; average, 2006 –12)



China: GDP Growth

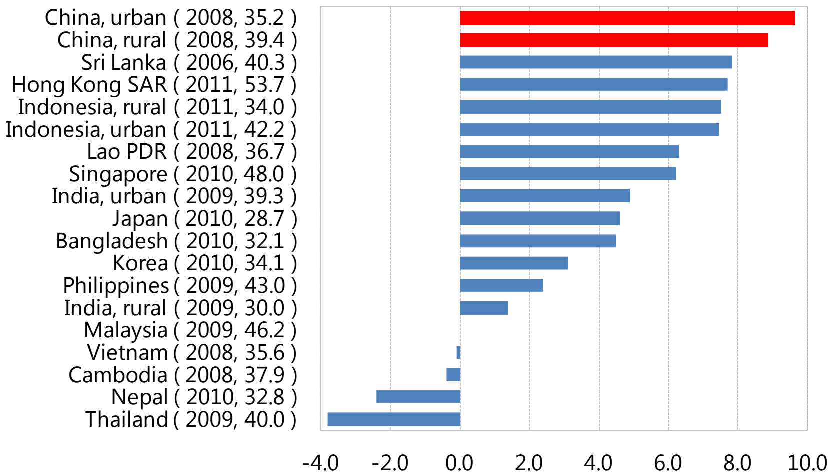
(Contributions by sector, percentage points)



...and on Making Growth More Inclusive and Environmentally Sustainable

Asia: Change in Gini Index, Last Two Decades[1]

(in Gini points, since 1990)

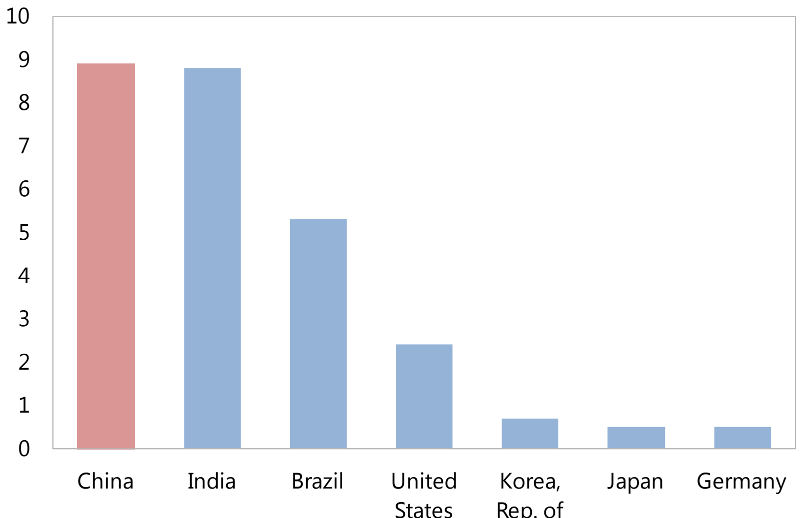


Sources: World Bank; national authorities and IMF staff calculations.

[1] In parentheses, the latest available year and corresponding Gini coefficients.

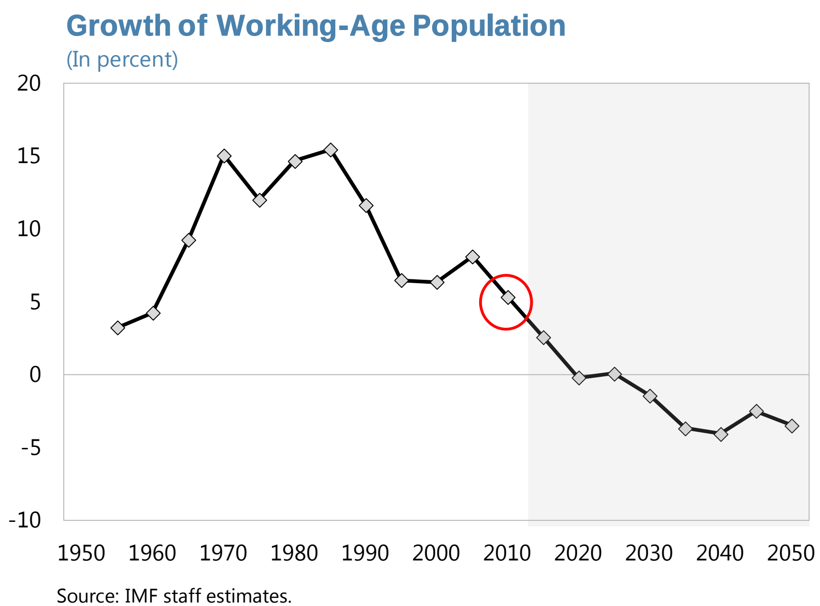
Environmental and Natural Resource Degradation and Depletion

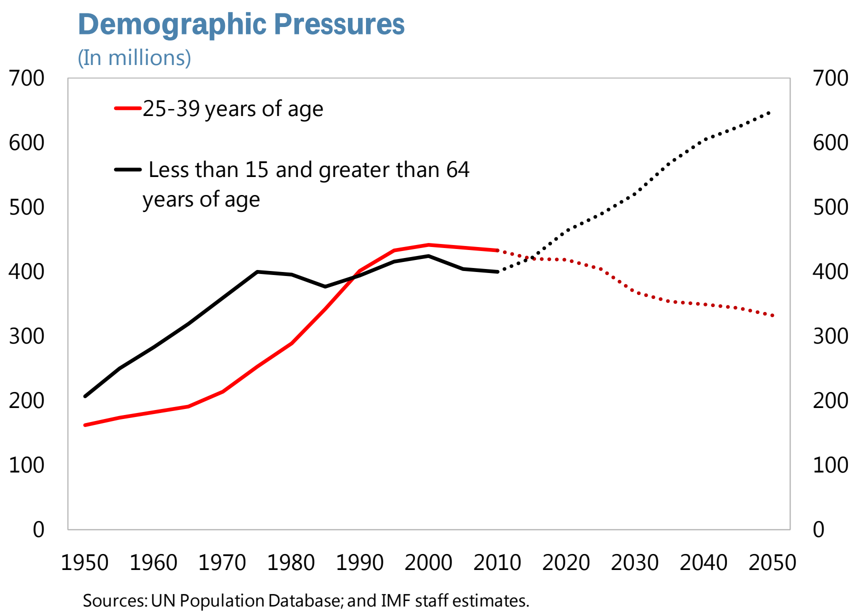
(In percent of GNI)



Source: World Bank and DRC *China 2030* report.

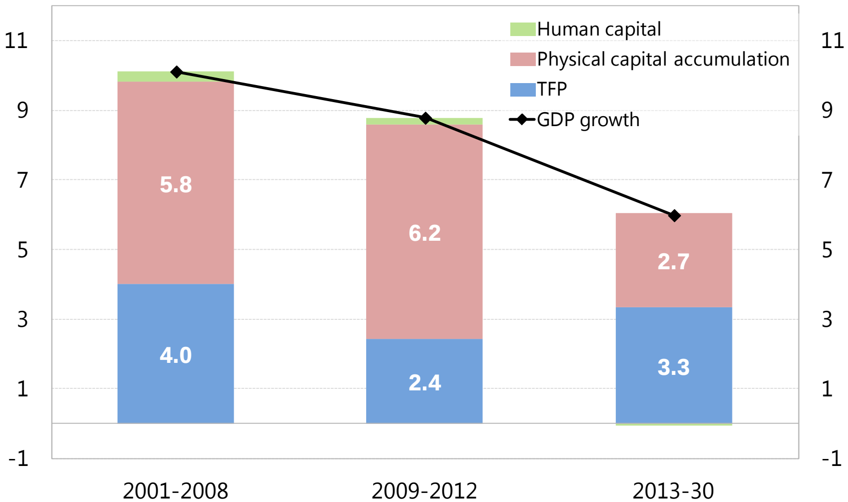
Looming Demographic Changes





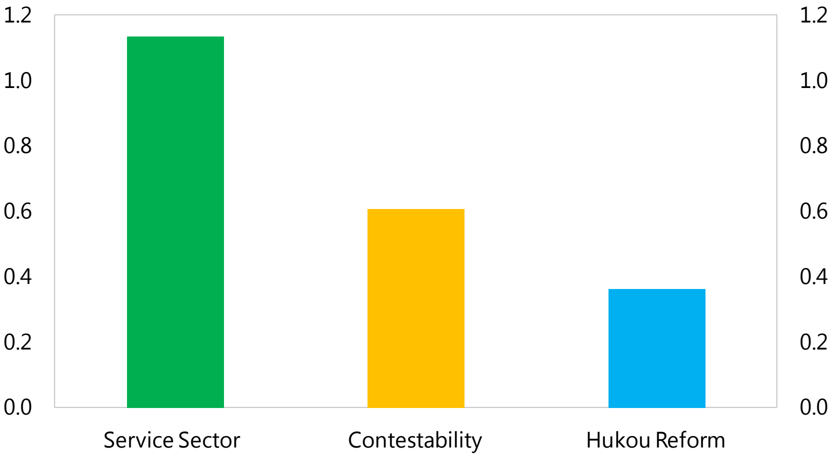
Moving to High-Income Status: Unleash "New" Productivity Growth

China: Contribution to Growth by Input
(In percentage points)



Source: IMF staff estimates.

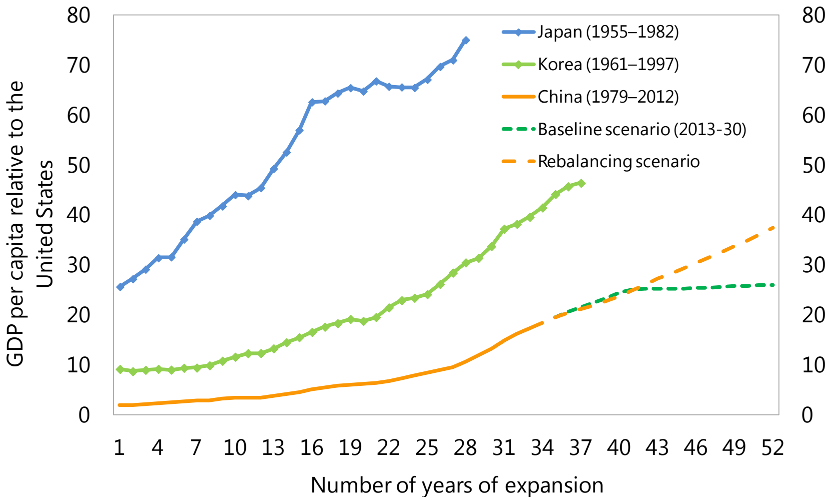
China Reform Payoffs: Potential Increase in Average TFP Growth[1]
(In percentage points)



Source: IMF staff estimates.
[1] Reforms envisage moving the national average of service sector employment share, contestability, and nonagricultural hukou share of population to the level of Shanghai in 2010.

Time is Running out on the Current Growth Model

Convergence Process of Per Capita GDP: China, Japan, Korea
(PPP, relative to United States)



Source: IMF staff estimates.

- *Current model: relies on extensive growth—factor accumulation and relocation of labor.*
- *Reform delays: vulnerabilities will increase as will the probability that China's convergence process stalls.*
- *Moving to high-income status: requires transitioning to a growth model more reliant on total factor productivity ("intensive" growth).*

Policies

The Challenge

- Accelerate transition to a more balanced and sustainable growth path...
- ...while maintaining adequate domestic growth and stability
- ...in a difficult external environment
- Likely entails slower growth as economy adjusts: a tradeoff worth making

Reform Strategy

- Provide greater role to market forces
- Embed strong governance in lower-level state or state-related economic institutions
- Boost household incomes and consumption

Economic Policy Areas

- Financial sector
- Local government finances
- Structural measures

Near-term Priorities

- Contain build up of risks in financial sector, local governments, and real estate

- Strong launch to new round of reforms

- If growth slows too much: use on-budget fiscal stimulus, in a way that promotes domestic rebalancing

Financial Sector Reform

- Liberalize interest rates;
- Strengthen regulation and supervisory oversight;
- Establish a robust and transparent framework for resolving bad debts and troubled financial institutions;
- Move to using interest rates as the primary tool of monetary policy;
- Remove widespread implicit government guarantees

Fiscal Reforms

- Gradually unwind off-budget and quasi-fiscal activity
- Strengthen management, transparency, and overall governance framework of local government finances
- Shift tax burden from regressive social contributions to more progressive and efficient forms of taxation

Other Reforms

- More market-based exchange rate determination
- Open-up markets to more domestic and foreign competition
- Raise resource prices and taxes
- Increase the dividends SOEs pay to the budget
- Gradual opening of the capital account

To Sum Up: Key Takeaways

- Near-term outlook: growth around 7 ½ percent
- Vulnerabilities are growing along the current growth path
- Financial and structural reforms should be accelerated to contain risks and transform the growth model

Thank you