INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/270

THE PEOPLE'S REPUBLIC OF CHINA

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE PEOPLE'S REPUBLIC OF CHINA

August 2016

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 2016 Article IV consultation with the People's Republic of China, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 27, 2016 consideration of the staff report that concluded the Article IV consultation with the People's Republic of China.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 27, 2016, following discussions that ended on June 14, 2016, 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 7, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for the People's Republic of China

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
August 12, 2016

IMF Executive Board Concludes 2016 Article IV Consultation with the People's Republic of China

On July 27, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with China.

China continues its transition to sustainable growth, with progress on many fronts yet also many challenges. Growth slowed to 6.9 percent in 2015 and is projected to moderate to 6.6 percent this year owing to slower private investment and weak external demand. The economy is advancing on many dimensions of rebalancing, particularly switching from industry to services and from investment to consumption. But other aspects are lagging, such as strengthening SOE and financial governance and containing rapid credit growth.

Inflation dipped below 1.5 percent in 2015 and is expected to pick up to around 2 percent this year, reflecting the rebound in commodity prices and the exchange rate depreciation since mid-2015.

Infrastructure spending picked up and credit growth accelerated in the second half of 2015. Accommodative macro policies are projected to continue supporting activity over the remainder of 2016.

The current account surplus is projected to decline to 2.5 percent of GDP this year (from 3 percent of GDP in 2015) as imports increase and the services deficit widens with continued outbound tourism. The balance of payments came under pressure in 2015 due to large capital outflows, mainly related to repayment of external debt. The volume of outflows is expected to moderate this year. After appreciating 10 percent in real effective terms through mid-2015, the renminbi has depreciated some 4.5 percent since then and remains broadly in line with fundamentals.

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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.

Executive Board Assessment[2]

Executive Directors commended the Chinese authorities for their strong determination to achieve more balanced, sustainable growth. They noted that economic growth continues to moderate and is driven increasingly by services and consumption. Directors welcomed the impressive progress on structural reforms in many areas, notably interest rate liberalization, internationalization of the renminbi, and urbanization. They also welcomed the 13th Five-Year Plan, with its ambitious goals centered on economic rebalancing.

Directors noted that China's economic transition will continue to be complex, challenging, and potentially bumpy, against the backdrop of heightened downside risks and eroding buffers. They stressed the need for decisive action to tackle rising vulnerabilities; reduce the reliance on credit-financed, state-led investment; and improve governance, risk pricing, and resource allocation in the state-owned enterprise (SOE) and financial sectors. Directors emphasized that consistent, well-coordinated, and clearly-communicated policies are key to a smooth, successful transition, which will eventually benefit the global economy.

Directors highlighted the urgency of addressing the corporate debt problem through a comprehensive approach. They encouraged the authorities to harden budget constraints on SOEs; triage and restructure or liquidate over-indebted firms; and recognize losses and share them among relevant parties, including the government if necessary. Piloting a few SOEs would make a strong start to the process. Directors recommended that the authorities complement these measures with targeted social assistance for displaced workers, and initiatives to facilitate entry of new, dynamic private firms.

Directors concurred that macroeconomic policies should be geared at lowering vulnerabilities, which would likely entail somewhat slower growth in the short term. They welcomed the authorities' intention to rely on fiscal support if growth falls sharply in the near term. To this end, they saw merit in using on-budget, pro-consumption measures, which would help promote internal and external rebalancing. Measures could include raising pensions; increasing social, education and health spending; providing restructuring funds; and cutting minimum social security contributions. Continued efforts are also needed to ensure full implementation of the new budget law, improve fiscal transparency, and modernize the tax system.

Directors underscored the importance of further enhancing financial stability. Priorities include encouraging banks to proactively recognize loan losses and strengthen capital ratios; enhancing supervisory focus on liquidity risk management and funding stability risks; and addressing vulnerabilities in shadow products. Directors also recommended a major upgrade of the supervisory framework to foster cross-agency information sharing and policy coordination,

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[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

reduce the scope for regulatory arbitrage, and enhance crisis management capabilities. They looked forward to the forthcoming Financial Sector Assessment Program Update.

Directors noted the staff's assessment that the renminbi is broadly in line with fundamentals, although the external position in 2015 was moderately stronger than consistent with fundamentals. They welcomed steps toward an effectively floating exchange rate regime and encouraged the authorities to build on this progress while carefully managing the transition, and with the support of a more market-based monetary framework. Directors supported a cautious approach to capital account liberalization that is carefully sequenced with the progress on exchange rate flexibility and financial sector reforms.

Directors encouraged the authorities to continue to improve data quality and policy communications, which would help reduce uncertainty, align expectations, and guard against market turbulence.

China: Selected Economic Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Projections					
NATIONAL ACCOUNTS											
Real GDP	9.5	7.9	7.8	7.3	6.9	6.6	6.2	6.0	6.0	5.9	5.8
Total domestic demand	10.7	7.9	8.1	7.2	7.2	7.2	6.5	6.2	6.1	6.0	5.9
Consumption	12.2	8.7	7.2	7.2	8.3	7.8	7.7	7.1	6.8	6.6	6.4
Investment	9.2	7.1	9.1	7.1	6.1	6.4	5.2	5.2	5.3	5.3	5.3
Fixed	8.8	9.0	9.3	6.8	6.8	6.6	5.3	5.3	5.4	5.4	5.4
Inventories (contribution)	0.4	-0.7	0.1	0.3	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports (contribution)	-0.8	0.2	-0.1	0.3	-0.1	-0.5	-0.2	-0.1	0.0	0.0	0.0
Total capital formation (percent of GDP)	48.0	47.2	47.3	46.7	45.0	43.9	43.3	42.8	42.2	41.6	41.0
Gross national saving (percent of GDP)	49.8	49.7	48.8	49.3	47.9	46.3	44.9	44.1	43.2	42.4	41.6
LABOR MARKET											
Unemployment rate (annual average) 1/	…	…	5.0	5.1	5.1	5.1	5.1	5.0	5.0	5.0	5.0
Wages	16.7	14.0	12.9	10.0	9.9	9.0	8.7	8.5	8.5	8.3	8.1
PRICES											
Consumer prices (average)	5.4	2.6	2.6	2.0	1.4	2.1	2.3	2.4	2.6	3.0	3.0
GDP Deflator	8.1	3.2	2.4	1.2	0.4	0.7	0.9	1.4	1.6	2.0	2.1
FINANCIAL											
7-day repo rate (percent)	6.4	4.6	5.4	5.1	2.5	…	…	…	…	…	…
10-year government bond rate (percent)	3.4	3.6	4.6	3.7	2.9	…	…	…	…	…	…
Real effective exchange rate (average)	2.8	5.6	6.3	3.1	10.1	…	…	…	…	…	…
Nominal effective exchange rate (average)	0.1	5.0	5.3	3.1	9.5	…	…	…	…	…	…
MACRO-FINANCIAL											
Total social financing 2/	18.1	19.1	17.5	14.3	12.4	12.7	11.9	11.4	11.0	10.3	10.1
In percent of GDP	157.9	169.0	180.0	189.5	198.4	208.3	217.4	225.1	232.0	236.9	241.6
Domestic credit to the private sector	16.2	19.8	16.6	13.5	14.7	14.7	13.4	12.1	10.9	9.9	9.7
In percent of GDP	124.8	134.3	141.9	148.2	158.3	169.2	179.0	186.5	192.1	195.5	198.7
House price 3/	5.7	8.7	7.7	1.4	9.1	8.9	7.3	7.0	7.3	6.9	6.8
Household disposable income (percent of GDP)	58.3	59.4	60.0	60.7	62.2	63.2	63.6	63.9	64.2	64.2	64.2
Household savings (percent of disposable income)	41.0	40.8	38.5	37.9	37.4	36.9	35.8	34.7	33.7	32.7	31.7
Household debt (percent of GDP)	27.8	29.6	33.0	35.3	38.4	41.8	45.5	49.1	52.4	55.3	57.5
Nonfinancial corporate domestic debt (percent of GDP)	97.0	104.7	108.9	112.8	120.0	127.4	133.5	137.5	139.7	140.2	141.2
GENERAL GOVERNMENT (Percent of GDP)											
Net lending/borrowing 4/	-0.1	-0.7	-0.8	-0.9	-2.7	-3.0	-3.1	-2.9	-2.9	-2.8	-2.7
Revenue	26.9	27.8	27.7	28.0	28.6	27.8	28.1	28.0	27.8	27.7	27.5
Expenditure	27.0	28.4	28.5	28.9	31.3	30.8	31.2	30.9	30.7	30.4	30.2
Debt 5/	15.2	15.2	15.9	38.5	38.3	38.6	39.1	39.3	39.3	39.2	39.0
Structural balance	-0.1	-0.5	-0.5	-0.5	-2.4	-2.9	-3.1	-2.9	-2.9	-2.8	-2.7
BALANCE OF PAYMENTS (Percent of GDP)											
Current account balance	1.8	2.5	1.5	2.6	3.0	2.4	1.6	1.3	1.0	0.8	0.6
Trade balance	3.0	3.6	3.7	4.1	5.1	5.1	4.5	4.3	4.0	3.8	3.7
Services balance	-0.6	-0.9	-1.3	-1.6	-1.6	-2.0	-2.3	-2.6	-2.7	-2.9	-2.9
Net international investment position	22.4	21.8	20.7	15.2	14.3	16.5	16.9	16.7	16.3	15.5	14.8
Gross official reserves (bn US$)	3,256	3,388	3,880	3,899	3,406	3,181	3,064	2,993	2,890	2,813	2,740
MEMORANDUM											

Nominal GDP (bn RMB) 6/	48,604	54,099	59,696	64,849	69,630	74,715	80,118	86,159	92,834	100,244	108,246
Augmented debt (percent of GDP) 7/	45.8	47.1	51.0	51.8	55.8	60.4	64.5	67.8	70.4	72.2	73.5
Augmented net lending/borrowing (percent of GDP) 7/	-6.0	-5.1	-7.6	-7.2	-7.8	-8.4	-8.2	-7.8	-7.4	-7.0	-6.6
Augmented fiscal balance (percent of GDP) 8/	-8.2	-7.8	-10.3	-9.8	-9.5	-10.1	-9.8	-9.3	-8.8	-8.4	-8.0

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; and IMF staff estimates and projections.

1/ Surveyed unemployment rate.

2/ After adjusting local government debt swap, staff estimate that TSF stood at 203 percent of GDP in 2015.

3/ Average selling prices estimated by IMF staff based on housing price data (Commodity Building Residential Price) of 70 large and mid-sized cities published by National Bureau of Statistics (NBS).

4/ Adjustments are made to the authorities' fiscal budgetary balances to reflect consolidated general government balance, including government-managed funds, state-administered SOE funds, adjustment to the stabilization fund, and social security fund.

5/ Estimates of debt levels before 2015 include central government debt and explicit local government debt (identified by MoF and NPC in Sep 2015). The large increase in general government debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously. The estimation of debt levels after 2015 assumes zero off-budget borrowing from 2015 to 2021.

6/ Expenditure side nominal GDP.

7/ Augmented fiscal data expand the perimeter of government to include local government financing vehicles and other off-budget activity.

8/ "Augmented fiscal balance" = "augmented net lending/borrowing" - "net land sales proceeds" (in percent of GDP) as we treat net land sales proceeds as financing.

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

July 7, 2016

KEY ISSUES

Context. China continues its transition to a sustainable growth path. Rebalancing has progressed on many dimensions, particularly switching from industry to services and from investment to consumption, but less on reining in rapid credit growth. Reforms have advanced impressively across a wide domain, but lagged in some critical areas, and the transition to sustainable growth is proving difficult, with sizable economic and financial volatility. Vulnerabilities are still rising on a dangerous trajectory and fiscal and foreign exchange buffers, while still adequate, are eroding.

Outlook. The near-term growth outlook has improved due to recent policy support. But the medium-term outlook is clouded by continued resource misallocation, high and rising corporate debt, structural excess capacity, and the increasingly large, opaque, and interconnected financial sector. The apparent challenges in implementing a clear and decisive reform path add to concerns that China may exhaust its still-sizable buffers before the economy changes course sufficiently.

Strategy. While the challenges are still manageable, urgent action is needed to ensure they remain so by reducing vulnerabilities while supporting new, market-based growth. This means slowing credit growth by tackling its root causes—the pursuit of unsustainably-high growth targets, soft budget constraints on SOEs and local governments, the web of implicit and explicit guarantees, and excessive risk taking in parts of the financial sector—while maintaining macro stability. Key elements:

- ***Tackling the corporate debt problem,*** with a comprehensive plan and concrete action to harden budget constraints (especially on SOEs), restructure/liquidate weak firms, recognize and allocate losses, improve governance, and facilitate market entry.
- ***Adjusting macro policies for a moderate slowdown,*** by allowing growth to settle at a level consistent with sustainable macro policies, substantially slowing credit expansion and switching from off-budget investment to on-budget, pro-reform and pro-consumption fiscal measures.
- ***Guarding against financial risks,*** by boosting bank buffers, recognizing losses, improving funding resilience, reining in risks in shadow banks/products, and improving the supervisory framework and crisis preparedness.
- ***Continuing progress toward an effectively floating exchange rate regime,*** combining an overarching drive toward progressively greater market-determination and skillful short-term management to avoid excessive volatility.
- ***Strengthening transparency,*** especially in communications and data quality.

Approved By
Markus Rodlauer and Alfred Kammer

Discussions took place in Hohhot, Shanghai, and Beijing during June 1-14. The team comprised J. Daniel (head), S. Guo, J. Kang, M. Nabar, L. Zhang (all APD), P. Wingender (FAD), J. Caparusso, T. Harjes (both MCM), G. Gottlieb (SPR), A. Schipke, W. Lam, and S. Chen (Resident Representatives). Z. Jin and J. Chen (both OED) joined the official meetings. M. Rodlauer (APD) joined for the second week of the mission, and FDMD D. Lipton for June 12–14 high-level policy meetings. D. Ma (COM) coordinated media activities. I. Parry (FAD) joined for outreach related to the background paper on environment. T. Law, J. Meng, Q. Shan, J. Li, R. Li, Y. Liu, L. Yee, and J. Yu supported the mission.

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TABLES

APPENDICES

CONTEXT

"The new normal means… a farewell to the unbalanced, uncoordinated and unsustainable growth model" (Premier Li, 2016). But the transition is proving difficult and bumpy.

Rebalancing Scorecard

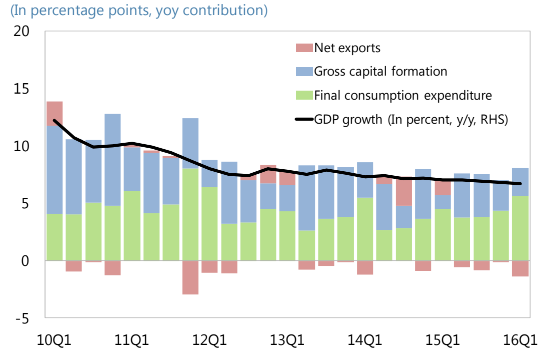
Macro and policy developments

1. Activity slowed modestly through early 2016, shored up by accommodative policies, and rebalancing progressed (see Selected Issues; Figures 1 and 2).

- *Supply-side indicators*. Industrial production has moderated steadily, with a needed rotation from excess-capacity upstream sectors (cement, steel, glass) to more consumer-oriented manufacturing (autos, computers, home appliances). Service sector activity has remained strong, even after stripping out the outsized contribution from financial services. Supply rebalancing—the switch from industry to services—continued its trend traced over the period of the previous five-year plan (2011–2015).

Rising Consumption Contribution to Growth

(In percentage points, yoy contribution)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

- *Demand-side indicators*. Retail sales have remained strong on the back of steady growth in household income. Investment has stabilized following the recovery in real estate in recent months. Demand rebalancing progressed, with consumption accounting for two-thirds of growth in 2015 and 2016:Q1.

- *Inflation remained well anchored.* Core inflation has been stable around 1½ percent. Headline CPI inflation accelerated recently due to food prices. Producer price deflation is still sizable (though moderated recently), reflecting excess capacity in real estate and heavy industry, and weak commodity prices.

- *Policy support.* Benchmark lending rates were cut five times in 2015, and in the second half of the year, fiscal policy turned expansionary, infrastructure spending picked up (supported by policy bank lending and the local government debt/loan swap), and credit growth accelerated.

- *External sector*. Exports have been subdued, reflecting weak external demand and real exchange rate appreciation through mid-2015. But import volumes have been weak as well, in line with slower domestic demand growth (Box 1). Positive terms of trade effects lifted the current account surplus in 2015 to 3 percent of GDP, but the external accounts came under substantial pressure due to large capital outflows.

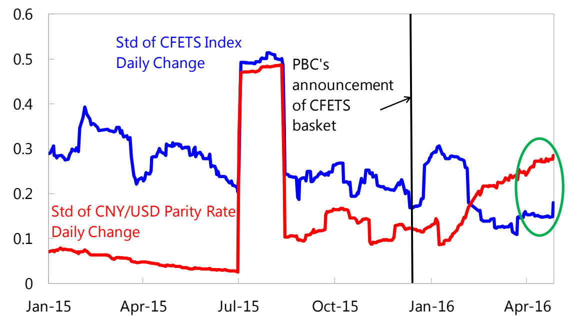
- *Exchange rate*. The real effective rate appreciated by close to 10 percent from mid-2014 through mid-2015 due to the (then) tight link to the U.S. dollar, and has declined 4½ percent since then. The renminbi remains broadly in line with fundamentals (Appendix I).

Reform progress

2. Reform progress continued on many fronts, especially in improving the monetary and fiscal frameworks, and supporting urbanization (Box 2).

- *Monetary framework*. Interest rate liberalization was formally completed and the PBC advanced toward an interest rate corridor centered on the seven-day repo rate (see Selected Issues). The more market-based fixing mechanism for the RMB in August 2015 and the greater reference to a currency basket from December 2015 have allowed more flexibility against the U.S. dollar. Together, these reforms help move China towards an independent, market-based, monetary policy.

RMB Increasingly Referencing a Basket 1/



Sources: Bloomberg LP; and IMF staff estimates.
1/ Standard deviation caculated on a 30-business-day forward rolling window.

- *Fiscal framework*. A wide range of reforms are underway: the new budget law is being implemented (aimed at improving transparency and accountability of local government finances); the VAT extension to services was completed; a carbon emission trading scheme (the largest in the world) will be rolled out nationwide in 2017; social security reforms to unify pension schemes for urban/rural residents and public/private employees were announced, as was a review of revenue and spending responsibilities across levels of government (which should help address the large vertical imbalances that currently limit local governments' ability to implement social spending reform).

- *Urbanization*. The government has continued to encourage rural residents to settle in urban areas—key for boosting productivity through specialization and knowledge spillovers—including by advancing rural land reforms, allocating basic public education spending to the central budget and improving the portability of pensions. Several provinces are rolling out a new household registration system whereby migrants can gradually qualify for basic social welfare and residency benefits.

- *Corporate restructuring*. The restructuring of unviable "zombie" state-owned enterprises (SOEs) has begun on a small scale at the local level, led by provinces with relative strength in public finances and more diverse economic structures.

3. The government adopted a new five-year plan (2016-20), centered on rebalancing the economy. It aims to boost consumption, expand the service sector, protect the environment, further open up the economy, expand public services, and reduce poverty. The government has also announced elements of a reform plan for SOEs and capacity reduction targets in the coal and steel sectors (10–15 percent of existing capacity over the next 3–5 years), together with a RMB 100 billion restructuring fund to re-employ and resettle an expected 1.8 million affected workers. However, in many areas, especially SOE reform, more details and guidelines are awaited.

Box 1. What's Behind the Import Slowdown? 1/

Chinese imports have slowed significantly over the past two years in real terms. Weaker investment, partly due to progress in rebalancing from investment to consumption, accounts for about 40–50 percent of this slowdown. Weaker exports also account for about 40 percent of slowdown, of which about a quarter is due to stronger RMB.

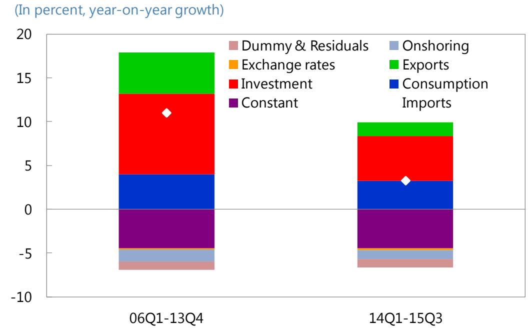
The sharp decline in nominal imports has been largely due to prices. In 2015, goods imports were down 9½ percent in RMB nominal terms, mostly driven by lower import prices, of which two thirds is due to the sharp fall in commodity prices (which alone improves the trade balance by about 1½ percent of GDP). Real imports were up by only 1 percent (compared to about 9 percent on average over the previous three years), accounting for about half of the deceleration in real imports globally.

The weakness in goods imports is broad based. Machinery and transport imports (accounting for about 40 percent of total imports) are decelerating as re-export demand is falling and rebalancing away from investment-based growth continues. Electronics is relatively more resilient. Commodities (accounting for about 30 percent of total imports) have also decelerated as a result of the slowdown in industry and weak real estate and infrastructure investment.

Several factors have contributed to the slowdown in real imports. Overall domestic demand has moderated after the strong surge following the fiscal stimulus in response to the global financial crisis. The economy is undergoing structural change to a model driven increasingly by consumption, with lower import intensity than investment and exports. China has also been substituting imports of higher value-added products with its own production. In addition, sizable currency appreciation has eroded price competitiveness of exports, and thus lowered demand for processing imports.

Staff analysis finds that weaker investment and exports have been the key drivers. Estimation for the post-WTO accession period (2002:Q1–2015:Q3) suggests that weaker investment has been the main factor, accounting for about 40–50 percent of the slowdown over the last two years. Weaker exports also account for about 40 percent of the slowdown, of which about a quarter is due to stronger RMB. Substitution of imported intermediate inputs with domestic production ("onshoring" measured as the ratio of processing imports to total exports) has not been an additional drag over this period but it continues to slow import growth at a constant pace.

Contribution to Import Growth
(In percent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

1/ See J. Kang and W. Liao, IMF Working Paper 16/106.

Box 2. Recent Reforms

Key reforms have been to improve the monetary and fiscal frameworks and to promote urbanization.

Financial sector reforms

- Deposit insurance introduced (May 2015)
- Interest rates formally fully liberalized (October 2015)
- PBC launched the Macro Prudential Assessment (MPA) mechanism (January 2016)
- Pilot programs on securitization initiated (February 2016,)
- Equalized capital requirements and risk weights for certain off- and on-balance sheet activity (CBRC Notice 82, May 2016)
- Applied the "period-average" in monitoring financial institutions' reserve requirements (September 2015)

Structural reforms

- Capacity reduction targets (about 10–15 percent over the next 3–5 years) announced for coal and steel sectors (February 2016)
- A restructuring fund of RMB 100 billion was established for re-employment and resettlement of affected workers in overcapacity sectors (February 2016)
- Published guidelines on SOE reforms; ten pilot programs were implemented (September 2015, February 2016)
- Reduced the number of prices set by central government (December 2015)
- Relaxed the one-child policy (December 2015)
- Property rights for rural land clarified, including use as collateral for securing agricultural loans (March 2016)
- About 30 provinces announced guidelines on "hukou" (household registration) reforms (April 2016); a new household registration system is being rolled out by end-2016
- Social housing program extended (May 2016)
- Certain provinces have commenced restructuring unviable provincial SOEs (June 2016)
- SOE social functions (provision of certain utilities and property services) to be reduced (June 2016)

Fiscal reforms

- Implementation of the new budget law (January 2015)
- Business tax fully converted to VAT for remaining services (May 2016)
- Employer contributions toward social security payments reduced (April 2016)
- Improved regulation and reduced number of fees paid to various government funds by firms (February 2016)
- New fiscal accounting framework introduced from January 2016
- Revised price adjustment mechanism for oil products (January 2016)
- Expanded zero rating for exports (October 2015)
- Tax cuts implemented for small and high tech firms (September and November 2015)
- Reform of the Personal Income Tax to further promote equity and redistribution
- New environmental protection and resource tax laws; carbon emission trading scheme (will be introduced in 2017)

External sector reforms

- Mutual Recognition of Funds program introduced (July 2015) to allow mutual funds domiciled in Mainland China and Hong Kong SAR to mobilize funds from the other jurisdiction
- Access to onshore fixed income and FX markets eased for official sector and qualified institutional investors (July 2015; October 2015; February 2016)
- RMB increasingly referencing a basket of currencies rather than the U.S. dollar; additional basket of currencies ("CFETS") announced with weights (December 2015)
- RMB to be included in the SDR basket effective October 2016 (November 2015)
- RQFII quota announced for United States (June 2016)

Policy obstacles

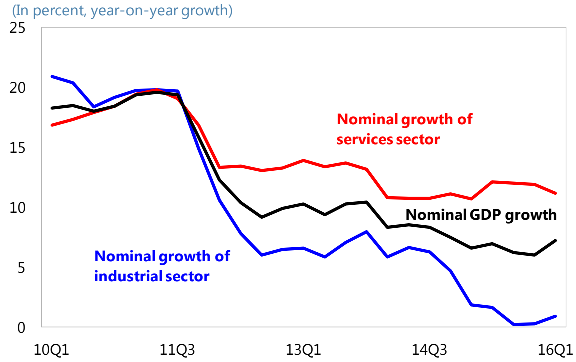
4. While strategic announcements have been in the right direction, obstacles impede implementation and vulnerabilities are rising.

- *Traditional stimulus.* In response to slowing growth in mid-2015, the government boosted infrastructure spending, real estate activity and credit, supporting near-term growth but raising vulnerabilities. It also set a growth target for 2016 of 6½–7 percent, above staff's recommended sustainable range of 6–6½ percent.
- *Uneven reform progress.* A corollary of the focus on near-term growth is less focus on reforms critical for medium-term growth, but growth detracting in the short term. Progress has been relatively slow on some key structural reforms, especially strengthening governance and imposing hard budget constraints for SOEs, tackling excessive corporate debt, and opening up state-dominated service sectors. As a result, resource misallocation continues.
- *Lack of policy clarity.* Government policy and pronouncements seem to alternate between prioritizing reform and growth. Some of these difficulties are to be expected, as the transition from the 'old growth model' is complex and politically challenging. In particular, the task of further liberalizing the economy while disentangling the still-pervasive web of distortions requires a broad set of well-timed and carefully designed policies and will involve learning-by-doing along the way. Nevertheless, the seeming lack of consistency at times feeds market concerns about the commitment to reform (e.g., the heavy-handed response to the equity market correction in June 2015) and prospects for engineering a smooth transition to sustainable growth. In part, this reflects inherent tension in an economic strategy that simultaneously aims to allow the market a "decisive" role in the allocation of resources, yet also affirms the "dominant" role of the state.

Rising vulnerabilities

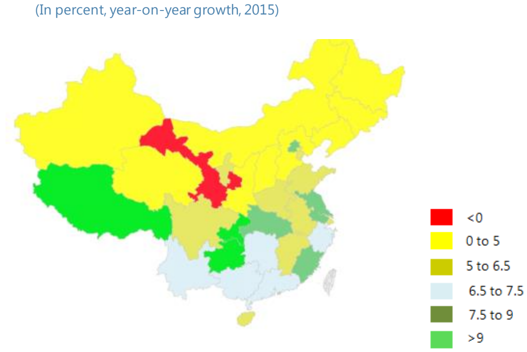
- *'Hard landing' in overcapacity sectors/regions.* Overcapacity sectors were simultaneously hit by falling demand from real estate, lower global commodity prices, exchange rate appreciation, and higher labor costs. The stress is most pronounced in SOEs, where profits have fallen sharply, and in the north.

Two-speed Economy
(In percent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

Wide Regional Growth Disparity
(In percent, year-on-year growth, 2015)

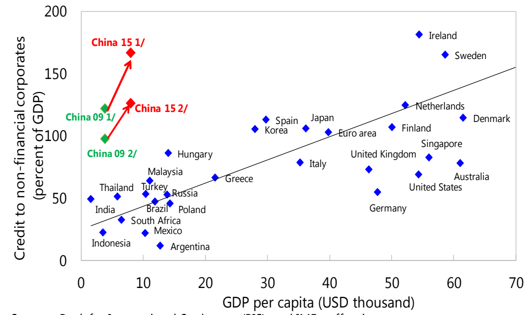


Sources: CEIC Data Company Ltd.; and IMF staff estimates.

- *Weakening corporate fundamentals* (Figure 3). Industrial profits fell in 2015 for the first year since the late 1990s against a backdrop of excess capacity, moderating domestic demand, weak external demand, and declining producer prices. Intercorporate payment arrears are growing—the median number of days for outstanding receivables among listed firms has gone up to 45 from less than 30 in 2010. Defaults and downgrades are increasing. A rising fraction of debt is held by firms with weak interest coverage—about 14 percent by firms with profits less than interest payments. Impaired loans, largely to corporates, are rising fast, especially in smaller banks.

Corporate Credit: High vs. Peers

(Selected economies, 2014)



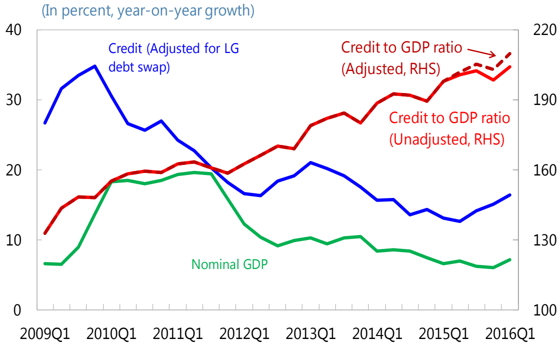
Sources: Bank for International Settlments (BIS); and IMF staff estimates.
1/ Calculated as total social financing minus equity and household loans.
2/ Calculated as total social financing minus equity, LGFV borrowing and household loans.

- *High and rising credit growth*

  - Credit growth has accelerated and is growing twice as fast as nominal GDP. As a result, the already high nonfinancial private credit/GDP ratio has risen rapidly, mainly reflecting corporate debt. The deviation of credit growth from its trend, a key cross-country indicator of potential crisis, has reached 20–25 percent of GDP—very high by international comparison.

Credit: High and Rising 1/

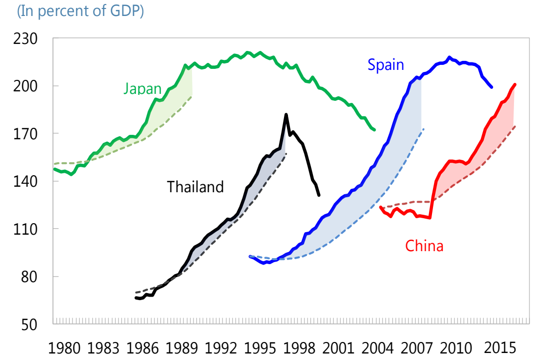
(In percent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.
1/ Total social financing stock.

Fast Credit Growth and Wide Credit Gap 1/

(In percent of GDP)

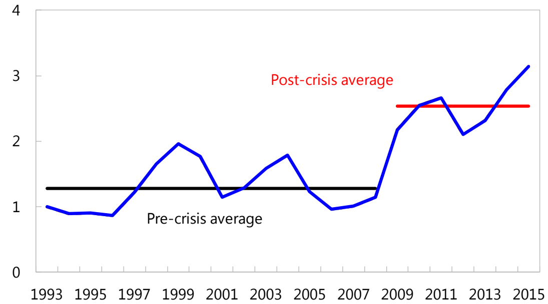


Sources: Bank for International Settlements (BIS); and IMF staff estimates.
1/ Total credit to the private nonfinancial sector. Dotted lines represent the credit trend.

  - The increasing credit intensity of growth, which is rising faster in regions where the traditional industry is concentrated, points to worsening efficiency of credit allocation, weak governance, forbearance, and soft budget constraints.

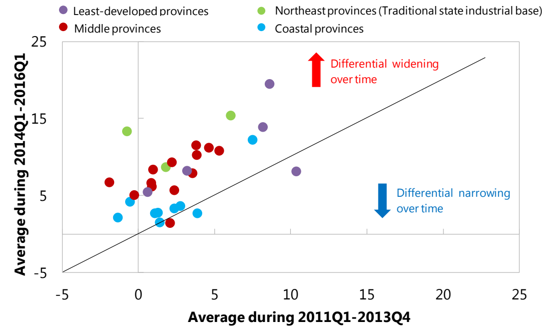
  - Potential losses from such a rapid and inefficient credit expansion could be large. The *Global Financial Stability Report* of April 2016, for example, estimated potential losses of 7 percent of GDP on corporate loans. Additional losses can be expected in other parts of the financial system, especially in shadow credit products.

Credit Intensity Rising Further 1/
(New credit per unit of additional GDP)



Sources: CEIC Data Company Ltd.; and *World Economic Outlook (WEO)* and IMF staff estimates.
1/ Plotted as 3-year rolling average.

Credit Increasingly Outpacing GDP Growth In Most Provinces
(Differential between year-on-year growth rates of credit and GDP, by province)

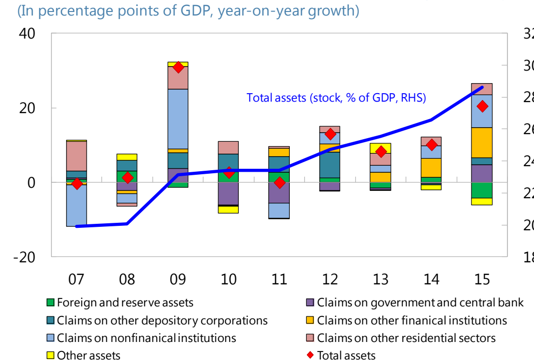


Sources: CEIC Data Company Ltd.; and IMF staff estimates.

- *An increasingly large, leveraged, interconnected, and opaque financial system* (see Selected Issues; Figure 4). Behind the rapid credit growth of recent years lies a complex network of links between banks and nonbanks and a proliferation of investment products. Such innovation can enhance financial inclusion. But it also reflects regulatory arbitrage, makes it more difficult for supervisors to identify emerging vulnerabilities, increases the potential for contagion across market segments, and could amplify financial stress in a downturn. The growing interconnectedness across asset classes and intermediaries is seen through a variety of channels:

  - The sharp increase in bank balance sheets (by 22 percentage points of GDP in 2015), particularly the claims on other financial institutions (up from 5 percent of GDP in 2010 to 26 percent of GDP in 2015), and off- and on-balance sheet bank exposure to 'shadow' credit products.

Commercial Bank Balance Sheets Expanding Rapidly
(In percentage points of GDP, year-on-year growth)

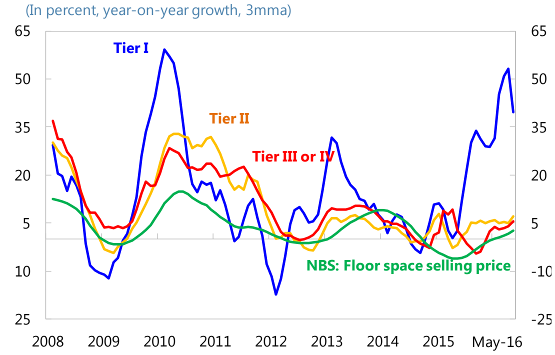


Sources: Haver Analytics; and IMF staff estimates.

  - The rapid expansion of pledged repo borrowing in the interbank market, with trading volume more than doubling in 2015 (mostly overnight lending), as large banks lent to smaller banks and nonbanks (including securities firms, trust companies, and asset management companies).

  - The increasing role of smaller and provincial banks, especially city commercial banks, which have greater exposure to shadow credit products and have grown rapidly.

Booming Tier 1 House Prices
(In percent, year-on-year growth, 3mma)



Sources: Fangguanju; and IMF staff estimates.

- *A propensity for asset price booms.* China has recently experienced a sequence of booms in various asset prices—property, equity and bonds. This propensity is a symptom of a large stock of savings searching for yield, rising leverage, and a belief that the web of implicit guarantees will limit losses. This distorts the pricing of risk and facilitates bouts of speculative excess. Most recently, Tier-1 cities such as Shenzhen, Shanghai, and Beijing, are seeing large housing price increases as bank lending for home purchases increased strongly.

- *Capital outflows*. Despite an external position moderately stronger than fundamentals (Figures 5 and 6), capital outflows in 2015 and early 2016 were in excess of the current account surplus, prompting a substantial fall in FX reserves. The degree of outflows suggests a *de facto* more porous capital account than *de jure* restrictions would suggest. Several factors appear behind these outflows (see Selected Issues), including:

  - *A shift in expectations* about relative near-term returns on RMB assets, as domestic rate cuts, higher FX volatility, and the approaching Fed liftoff reduced the attractiveness of the carry trade. Many investors and market analysts expected the growth slowdown last year to trigger progressive policy easing and, eventually, RMB depreciation—an expectation seemingly reinforced by the August 2015 change in the exchange rate system.

  - *Rising investor concerns about the growth outlook, near and longer term*. Some also questioned China's longer-term growth prospects amidst doubts about the government's ability to carry out the reform agenda. Such concerns may explain, in part, the surge in outward investment during the last year.

OUTLOOK AND RISKS

In staff's baseline growth falls to about 6 percent by 2018 and continues declining thereafter. The lack of decisive progress on addressing corporate debt and governance in SOEs in the baseline implies that the credit-to-GDP ratio continues to rise, with increasing risk of a disruptive adjustment. The baseline does, however, assume continued pro-consumption and pro-service reforms, including strengthening the social safety net and deregulating the service sector; as a result, the structure of demand and production would shift further toward consumption and services.

5. Near-term growth. The economy is expected to grow by 6.6 percent in 2016, slowing to 6.2 percent in 2017. This assumes:

- *Domestic demand* holds up on generally robust labor market conditions, with consumption contributing more than half of overall growth. Investment growth is expected to pick up slightly in 2016—as strong infrastructure spending and a rebound in real estate and SOE investment offset weakness in manufacturing and non-SOE investment—but to moderate in 2017 as stimulus measures wane.

- *External demand* is expected to remain subdued, with net exports dragging growth in 2016–17. Export growth will stay tepid, while imports are likely to pick up in line with investment.

- *Policy support* provides a positive fiscal impulse in 2016, returning to gradual consolidation in 2017. The projection assumes a slightly higher 'augmented' deficit relative to last year, resulting from a larger on-budget deficit as well as slightly stronger off-budget local government spending supported through policy bank lending and the new special construction fund (Appendix II).[1]

- *Credit growth* is assumed at 15 percent year-on-year in 2016, based on the authorities' total social financing (TSF) projection and staff adjustments for local government debt/loan swaps.[2] In 2017, credit growth is assumed to slow to 13 percent as investment growth moderates and corporate profitability improves with the pick-up in producer price inflation and progress in reducing overcapacity.

6. Inflation is expected to gradually pick up reflecting the rebound in commodity prices, the exchange rate depreciation since mid-2015, and progress in cutting overcapacity, but to remain contained at 2–2½ this year and next. Over the medium term, inflation is expected to rise gradually to around 3 percent as commodity prices recover and wage pressures build with the slower growth of the labor force.

7. Current Account. The current account surplus is expected to narrow to just under 2½ percent of GDP in 2016, driven by an increase in the services and income deficit.

- The *trade surplus* is projected to remain stable in 2016 at slightly over 5 percent of GDP, with terms of trade effects broadly offsetting the pick-up in imports. Over the medium term, as the economy rotates further toward private consumption and away from external demand, the trade surplus is expected to decline to below 4 percent of GDP. The *services deficit* is expected to continually rise with healthy outward tourism, while the income deficit is expected to remain broadly stable.

- Over the medium term, the current account surplus is expected to fall to around ½ percent of GDP by 2021. Savings are projected to decline from 48 percent of GDP in 2015 to around 42 percent by 2021. This reflects an expected fall in household savings, owing to demographic effects and a stronger social safety net, lower corporate savings as factor costs rise and efficiency diminishes, and a decline in public savings as social spending increases. Investment is expected to decline from 45 percent of GDP in 2015 to around 41 percent of GDP by 2021, reflecting both moderating private investment, as returns diminish in a slowing economy, and less excess in public investment.

8. Capital flows. The volume of capital outflows is expected to be broadly similar to last year as a percent of GDP. The large outflow seen in 2015:Q3–2016:Q1 will gradually moderate as the pressure from external debt repayment peters out. The secular trend of residents' acquisition

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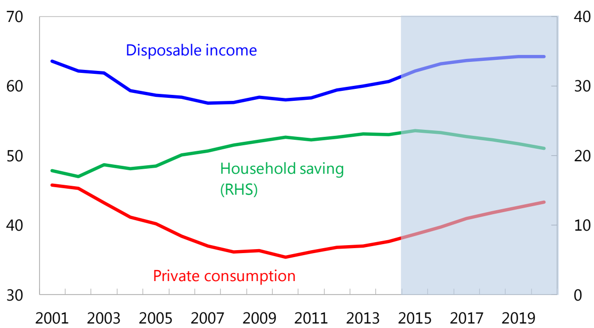
[1] See IMF Working Paper 14/4 for an explanation of augmented deficit and debt: http://www.imf.org/external/pubs/cat/longres.aspx?sk=41204.0.

[2] Under the new budget law, around RMB 14 trillion of existing local government financing vehicle (LGFV) borrowing has been recognized as explicit local government debt, of which nearly a quarter has already been swapped into LG bonds. Since the swapped portion is no longer counted in TSF, the reported TSF growth underestimates credit growth. Staff adjust the official TSF statistics for this swapped amount to correct the underestimate. Unadjusted for this swap, TSF is projected to grow by 12.7 percent in 2016.

of foreign assets to balance their investment portfolio is expected to continue, but not materially accelerate from current levels.

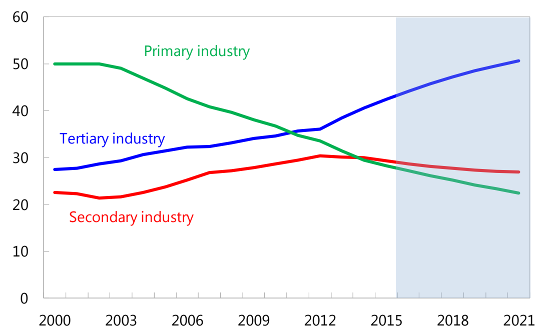
9. Rebalancing. The high national savings rate, the crux of China's internal and external imbalance, is expected to fall gradually due to aging and a stronger social safety net. Household consumption is expected to continue to pick up on the back of falling household savings and rising disposable income, which, in turn, derives from labor-intensive services increasingly replacing industry as the main fulcrum of activity on the supply side (which should also reduce the carbon intensity of output and income inequality). But the baseline assumes only modest progress on corporate restructuring and SOE reform; hence credit rebalancing is projected to progress only slowly.

Consumption Share to Rise...
(In percent of GDP)



Source: IMF staff estimates and projections.

... and Services
(In percent of total employment)



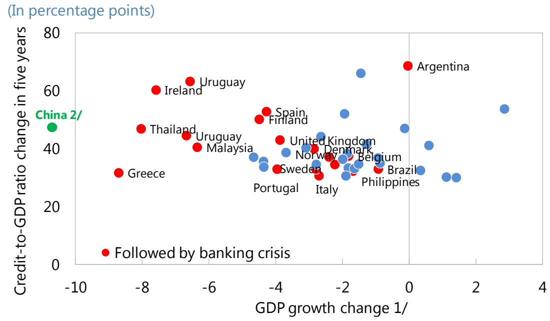
Sources: CEIC Data Company Ltd.; and IMF staff estimates and projections.

10. Medium-term growth prospects. The near-term reliance on policy easing and credit-financed investment, and the lack of decisive progress on addressing corporate debt restructuring, SOE reform, and entry of dynamic private firms is expected to add to the existing stock of vulnerabilities and worsen resource allocation. The price of achieving stronger near-term growth in this way is that the economy will likely encounter further diminishing returns, slowing to 6 percent by 2018 and declining further into the medium term. In particular, the credit intensity of growth is projected to decrease only modestly, resulting in a continuously rising nonfinancial private sector credit/GDP ratio. This gives rise to an increasing risk of disruptive adjustment (banking crisis and/or sharply slower growth), as credit booms often have in other countries.

11. Despite the relatively benign near-term outlook, downside risks dominate (Appendix III).

- ***Downside:***
  - *Near term:* the key risks are a loss of investor confidence, disorderly corporate defaults, a sharp fall in asset prices, and a quicker fading of the stimulus impact. With high leverage, corporates are especially sensitive to declines in profitability and higher borrowing costs (but less so to FX risk given low aggregate

Credit Booms Tend to End Badly
(In percentage points)



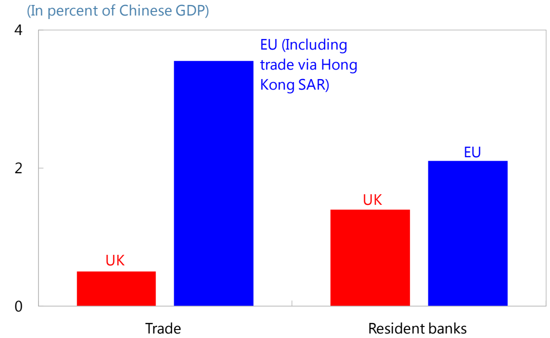
Source: IMF staff estimates.
1/ Average growth differential between 5-year post-boom and 5-year pre-boom periods.
2/ No growth change as China's boom has not ended.

FX exposure). These could be amplified by the financial system, with renewed capital outflows and exchange rate pressure.

- *Medium term:* the key risk is slow progress on reform and continued reliance on policy stimulus and unsustainable credit growth, which would add to vulnerabilities, worsen resource misallocation, and lead to permanently lower growth. While near-term growth will be temporarily boosted, medium-term growth would continuously fall under an illustrative "no-reform" scenario, reflecting a sustained TFP growth slowdown. The nonfinancial private credit/GDP ratio would rise significantly higher than under the baseline, as would the risk of a disruptive adjustment.

- *UK / European Union*. The direct impact of UK voters' June 23 decision to exit the European Union (EU) is likely to be limited (for example, the UK accounts for 2½ percent of China's exports). However, should growth in the EU be affected significantly, the adverse effect on China could be material (exports to the EU, including those routed via Hong Kong SAR, are equivalent to almost 4 percent of China's GDP). Staff estimates suggest that a 1 percentage point growth slowdown in the EU is associated with a reduction in Chinese growth by about 0.3 percentage points. Financial spillovers are also expected to be contained, given the modest direct financial exposures to the EU and the authorities' readiness to respond.

Brexit: Limited Direct Exposure
(In percent of Chinese GDP)



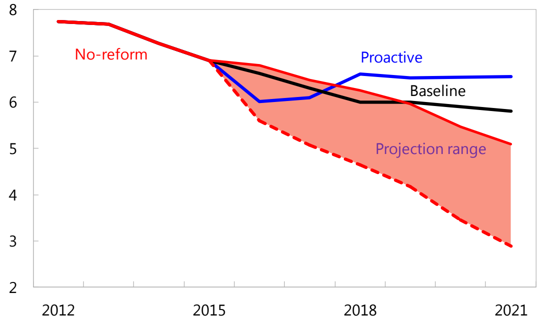
Sources: CEIC Data Company Ltd.; and IMF staff estimates.

- ***Upside:***

  - *Near term:* the stimulus may have a bigger and more sustained impact, with a larger pick-up in real estate and a slower reduction in overcapacity investment (though this would increase medium-term risks).

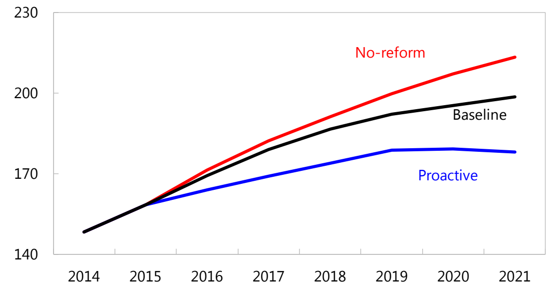
  - *Medium term:* Faster progress on enacting structural reform (especially SOE reform), curbing credit growth, and improving overall resource efficiency would lift medium-term growth prospects. Under an illustrative "proactive" scenario, near-term growth could dip to 6 percent reflecting the faster adjustment partially offset by high-quality fiscal support (without such support, growth would fall to about 5½ percent), while medium-term growth would rise to 6½ percent driven by higher TFP growth. The improved efficiency would reduce credit intensity further, and stabilize the nonfinancial private debt/GDP ratio by 2021 significantly lower compared to the baseline. The pace of rebalancing from investment to consumption would also be faster.

GDP Growth: Illustrative Scenarios
(In percent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

Credit Ratio: Illustrative Scenarios 1/
(In percent of GDP)



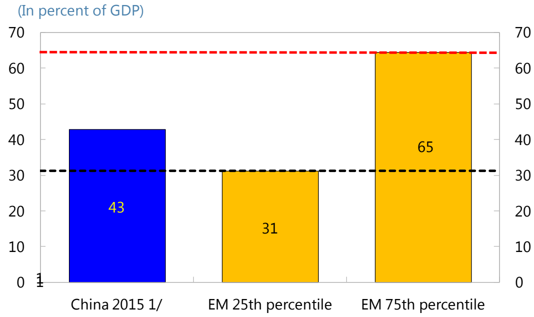
Sources: CEIC Data Company Ltd.; *World Economic Outlook (WEO)* and IMF staff estimates.
1/ Nonfinancial private debt, calculated as total social financing stock adjusted for local governemnt debt swap minus equity financing and LGFV borrowings.

Explaining the "Fan" in the Illustrative Growth Scenarios Graphic

- In the no-reform growth scenario (left chart), the upper bound of the "fan" is the growth rate absent a disruptive adjustment. The lower bound is growth in an illustrative disruptive adjustment simulated by staff, adjusted by the probability of such an event.
- The probability of the disruptive adjustment is derived from cross-country evidence linking disruptive adjustments to the size and duration of credit booms (Dell'Ariccia and others, 2016).
- The baseline, and especially the "proactive" reform scenario, would have lower risk, but still significant given the growing credit/GDP ratio even under these scenarios.

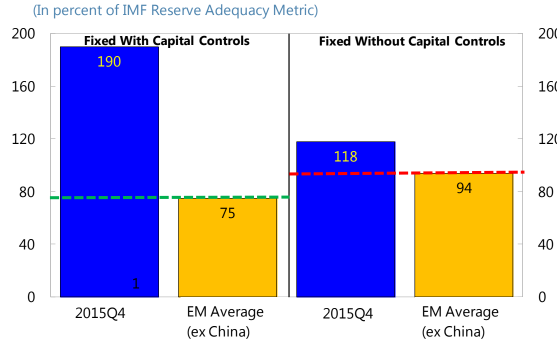
12. **Buffers, while still adequate, are shrinking fast, calling for urgent action to address these rising risks.** China used around 20 percent of its FX reserves (relative to the mid-2014 peak) in supporting the currency, but the buffer remains above reserve adequacy metrics. Similarly, despite high public spending on infrastructure in recent years, augmented general government debt (i.e., including contingent liabilities from estimated off-budget local government borrowing) remains relatively low at around 60 percent of GDP and explicitly recognized general government debt at only about 40 percent of GDP, with a highly favorable growth-interest rate differential. These buffers have been deployed to combat outflow pressure and support growth over the past several months. But as vulnerabilities grow, contingent liabilities expand, and the buffers erode, the window for reforms and preventing downside risks from materializing will close.

Gross Government Debt ...Not High
(In percent of GDP)



Sources: *World Economic Outlook (WEO);* and IMF staff estimates.
1/ Including all explicit government (central and local) liabilities and part of the contingent liabilities that the government might be responsible for.

Reserves Still Adequate
(In percent of IMF Reserve Adequacy Metric)



Sources: *Assessing Reserve Adequacy*; IMF Policy Papers; February 14, 2011.

Authorities' views

13. Outlook. The authorities viewed the economy as well on track to achieve the target growth range of 6½ to 7 percent this year. They disagreed with staff's view that policy support was adding to vulnerabilities, emphasizing, in particular, that higher infrastructure spending in less developed parts of the country would help boost long-term growth prospects. They also noted that policy support had stabilized momentum and a handoff to private activity was underway with real estate and related sectors taking the lead. In general, corporate investment remained soft, but recent high-frequency indicators pointed to an uptick ahead. The authorities highlighted that the quality of growth was improving, evidenced by stable employment, robust wages, rising contributions of private consumption on the demand side and labor-intensive services on the supply side, and reductions in the energy intensity of GDP. Over the medium term, the authorities expected growth to remain in the range of 6–7 percent, which, they emphasized, was sustainable considering the potential for restructuring, upgrading, and convergence in less developed regions. They further noted that the range is consistent with the 2020 goal of doubling the level of income per capita relative to 2010.

14. External position. The authorities observed that despite a recent recovery in exports, the trade surplus was expected to be broadly unchanged from last year as imports were likely to firm with the recovery in commodity prices and improvements in domestic demand over the rest of the year. The services deficit was expected to widen on stronger tourism outflows, while the income balance was likely to be uncertain, depending on whether lower returns on reserves could be compensated by higher returns on outward investment and lower interest payments on external debt. . Over the medium term, the authorities expected the current account surplus to remain at 2–3 percent of GDP, with investment and savings staying broadly at current levels. The authorities concurred that the large net outflows in 2015 were mainly due to repayment of liabilities, and expected outflows to moderate this year since external debt is now lower and market understanding of the more market-based and flexible exchange rate regime had improved. They viewed the economy as well prepared to weather a Fed rate hike in the months ahead.

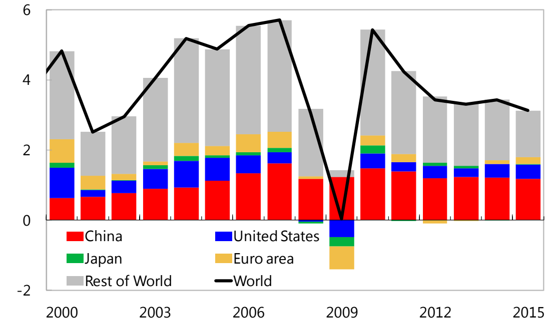
15. Risks. The authorities observed that there were downside risks to the outlook, especially from a weakening external environment. Their key concerns were depressed investment and uncertain prospects in several emerging markets (EMs); sluggish and tentative recoveries in AEs; rising geopolitical tensions; and an intensification of the refugee crisis in Europe. They viewed the likely fallout from the UK's June 23 decision to exit the EU as manageable, but nevertheless stood ready to take appropriate measures to support aggregate demand, and ensure interbank liquidity remained adequate and market conditions orderly. On domestic risks, the authorities agreed with staff that corporate debt had risen excessively, but took the view that China's large pool of domestic savings, the largely state-owned entities involved both on borrower and creditor sides, ample banking system buffers, and ongoing equity market development would facilitate a smooth adjustment. They concurred, however, that further substantive progress was needed on deleveraging and capacity reduction, without which there was a tangible risk of permanently lower medium-term growth. The authorities observed that property prices were beginning to show signs of moderation in Tier 1 cities, while equity prices were more in line with fundamentals after the substantial correction over the last 12 months. They recognized that there were some financial sector risks, but that these were limited and the supervisors were responding proactively.

SPILLOVERS

16. China's transition will be positive overall for the global economy, but continue to produce large spillovers that vary by country/region.

- China will continue to drive global growth during its transition. Despite its growth slowing, China doubled its real GDP since 2009, thus continuing to account for about a third of global growth in 2015 (more than it did in 2010 when China was growing in double digits).

Contribution to Global Growth: Still Large
(In percentage points)



Sources: *World Economic Outlook (WEO)*; and IMF staff estimates.

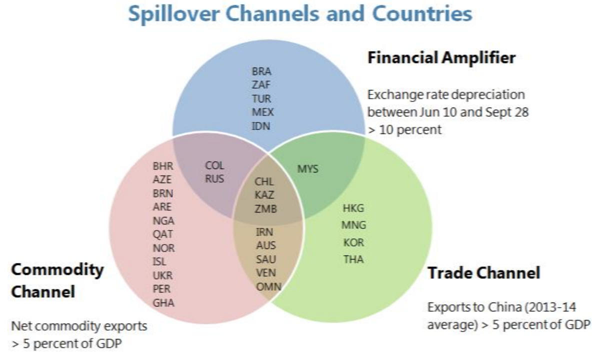
- Sustained progress on reforms and reining-in of vulnerabilities will reduce downside risks, thereby boosting sentiment and lifting investment in trading partners. The announced capacity reductions in coal and steel, if implemented, could also have a sizable effect on global capacity (e.g., the envisaged cuts in steel capacity over the next 3–5 years are broadly equivalent to recent annual steel output of the world's second-largest producer, Japan).
- The counterfactual to China's transition is not everlasting, investment/import-intensive, double-digit growth, but much slower growth, and possibly a sharp slowdown, which would have much more significant negative spillovers.

17. The evolution of China's production mix is already creating opportunities for frontier and developing economies. Staff analysis shows that China's movement up the value chain with its wages rising has led China to exit some lower-end, more labor-intensive sectors. This trend is creating opportunities for frontier and developing economies, particularly in Asia (e.g., Cambodia, Lao P.D.R, Myanmar, and Vietnam) to enter those sectors and to satisfy rising Chinese consumption demand.

18. That said, developments in China's will continue to produce large global spillovers, some of which will be negative for some countries/regions.

- ***Spillovers through trade.*** Economies most adversely affected by trade spillovers are those that have been closely integrated with China through the global value chain, such as Korea, Malaysia, and Taiwan Province of China, as these economies are heavily exposed to China's investment activity. In contrast, New Zealand will be least negatively affected, as its exports to China will benefit from the increase in China's consumption demand. Staff analysis (April 2016 *World Economic Outlook*) suggests that a 1 percentage point investment-driven drop in China's output

Spillover Channels and Countries



Source: IMF staff estimats.

growth would reduce G20 growth by ¼ percentage point.

- ***Spillovers through commodity prices***. China is a major importer across a range of commodities, especially metals, where it accounted for about 40 percent of global demand in 2014. China's investment slowdown has had a significant impact on the demand for, and prices of, commodities closely related to investment activities. Staff analysis suggests that China's rebalancing might account for between a fifth and a half of the declines in broad commodity price indices, with marked difference across commodities.

- ***Spillovers through financial markets***. Financial spillovers from China have increased, in particular since the global financial crisis, magnified by direct trade exposures. Staff analysis suggests that purely financial contagion effects remain less significant, but the impact of shocks to economic fundamentals, such as news about China's growth, on equity returns in both emerging market and advanced economies has been rising. Over the past year, for example, China has likely transmitted more shocks to other countries than it has received (see Selected Issues).

- ***Overall***, countries most heavily exposed to China's growth slowdown are those within the Asian regional supply chain and heavy commodity and machinery exporters.

Authorities' views

19. The authorities acknowledged that the needed slowdown in heavy industrial sectors in China could have transitional negative effects on commodity prices and trading partners' growth, but that this adjustment, by placing China on a sustainable growth path, would benefit the global economy in the long run. The authorities agreed that financial spillovers from China appeared to be rising, but cautioned that establishing a causal relationship was difficult. Several other factors have contributed to global risk-off episodes in recent years, including general weakness in EMs and uncertainty about the direction of unconventional monetary policy stances in AEs. The authorities also observed that negative interest rate policies in some advanced economies appeared to have hurt prospects for bank profitability, at times adding to pressure on equity prices and fueling contagion effects in international markets.

POLICIES TO SECURE THE TRANSITION

Preventing downside risks and ensuring the transition to more robust, sustainable medium-term growth requires decisively implementing a proactive and comprehensive policy package. The challenge for policymakers will be to focus less on traditional investment stimulus to support short-term growth, and more on fostering a well-regulated, consumer-oriented private sector to generate stronger, and more sustainable, growth in the medium term.

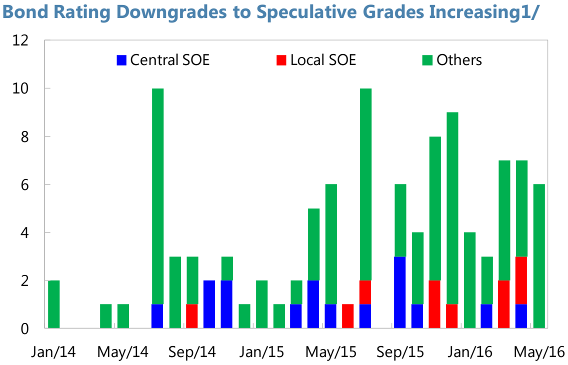
A. Tackling the Corporate Debt Problem

20. International experience, including China's own in the 1990s, suggests that tackling a systemic corporate debt problem requires a comprehensive approach. Without this, individual initiatives, like debt-equity conversions, will likely fail. The strategy outlined below cuts across topics and government agencies, affects swathes of people, firms, cities, banks, investors, and regions, and requires politically challenging decisions. There may thus be merit in establishing a well-staffed, high-level group with a clear mandate for policy formulation and communication. Progress should be kick-started in the next few months with a few high-profile pilot restructurings/liquidations of weak SOEs in more dynamic regions where it is relatively easier for displaced workers to find new employment, building on the plans for "zombie" company exits already underway in a few provinces (see Selected Issues). Key elements include:

21. High-level decision. Upfront and most importantly, a high-level decision is needed to stop financing weak firms, strengthen corporate governance, mitigate social costs, and accept the likely lower growth. This decision should be reflected in the coordinated action of all involved public bodies, especially SOEs, local governments, and financial supervisors.

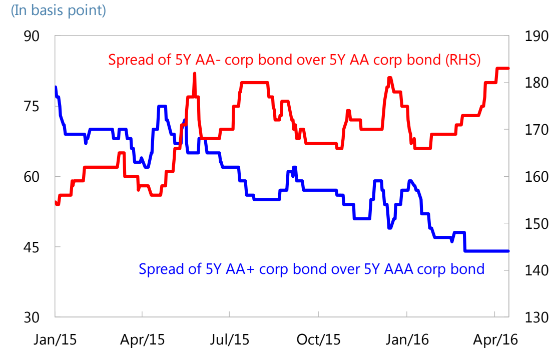
22. Hardening budget constraints. Reducing the access to credit of weak firms is critical not only to help address the existing debt overhang, but also to improve the efficiency of new credit allocation. This requires hardening budget constraints by removing implicit guarantees and subsidies and allocating losses to firms and investors carefully in a system relatively unaccustomed to defaults. Indeed, the number of firms defaulting on bond coupon payments has increased in recent months, as have ratings downgrades and issuance cancellations. These developments will help investors to price risk more accurately (as seen in the recent widening of credit spreads) and improve the allocation of credit over time.

Bond Rating Downgrades to Speculative Grades Increasing1/



Sources: WIND; and IMF staff estimates.
1/ Rated at or below BB+.

Spreads Between Ratings Widening
(In basis point)



Sources: WIND; and IMF staff estimates.

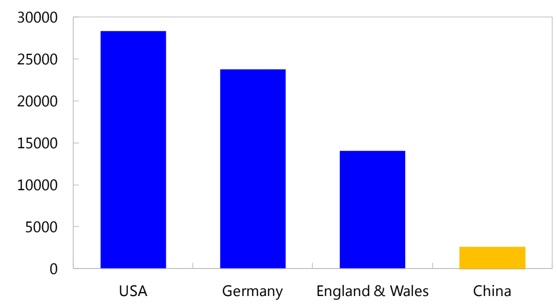
23. Triage. Continued support of fundamentally unviable firms will only result in greater losses in the future and further resource misallocation. Thus, firms facing difficulties servicing their debts should be triaged into the viable, which should be restructured, and nonviable, which should be liquidated. From the government's perspective, this means triaging the universe of SOEs and beginning to liquidate nonviable firms, with fiscal support to help meet the welfare costs of laid-off workers, along the lines of the recently announced restructuring fund for coal and steel sectors. Viable but insolvent SOEs will need a restructuring plan and a management that can execute it (which will likely require a greater role for the private sector). Their nonmarket objectives and responsibilities should be removed. This plan should also involve scaling back subsidies (e.g., for land use and preferential access to credit) to these firms and raising their dividend payouts to the budget to the targeted 30 percent.

24. Loss recognition. Regulatory and supervisory oversight should require banks proactively to recognize and manage impaired assets. Critical policies include loan classification and provisioning; bank capital; collateral valuation; prudential reporting; and a supervisory review approach fostering proactive NPL resolution (restructuring, write off, or sale). Asset quality recognition standards should be applied equally to loans and to securities whose underlying assets embody credit or market risk, and encompass both banks and nonbank financial institutions. Once losses are recognized, techniques such as debt-equity conversions, NPL securitization, and sales to AMCs, can be useful to workout impaired assets, if nested in a comprehensive strategy and with the right design.[3]

25. Burden sharing. Recognizing the full extent of impaired assets will likely result in significant losses. A plan to allocate these losses, taking into account appropriate hierarchy of claims among banks, corporates, and investors, and if necessary backstop them with government funds, will be critical. This in turn calls for an active role for the state, which China is well placed to undertake.

26. Restructuring mechanism. While the legal framework for enterprise insolvency does not seem significantly to deviate from best international practice, its application has been extremely limited. Large-scale and expedited restructuring requires creative approaches to complement the existing framework, such as an out-of-court debt restructuring mechanism for priority-distressed companies that would use independent restructuring experts to provide valuations and restructuring/liquidation proposals. This process should be market based, rather than relying on forced mergers between weak and strong firms, and transparent, to prevent corruption and the state losing value.

Insolvency Little Used
(Number of cases, 2014)



Sources: China Court; Sinotrust; Euler Hermes; US Trust Offices; Credireform; and UK Insolvency Service.

27. Distressed debt market. A more market-based system for resolving distressed debt would facilitate the disposal of nonperforming loans. This may require greater involvement of specialist financial institutions and legal workout agencies, and would also benefit from better functioning collateral auctions to help increase recovery values. Existing AMCs can also play a role in jump-starting the market for distressed assets, provided they have the right incentives and independence.

28. Social costs. A comprehensive restructuring will involve substantial social welfare costs, such as layoffs. Staff estimate potential employment losses in the excess capacity sectors (aluminum, cement, coal, construction, plate glass, and steel) at close to 8 million—some 1 percent of total employment. Given the likely regional concentration of this economic hardship, the central government should bear a portion of the welfare costs related to displaced workers.

[3] See IMF Technical Notes and Manuals, 2016/05: http://www.imf.org/external/pubs/cat/longres.aspx?sk=43876.

The costs of structural unemployment and worker resettlement are best borne by targeted assistance through earmarked funds to complement existing local social security programs, such as with the RMB 100 billion Restructuring Fund for the coal and steel sectors.

29. Facilitating market entry. Improving resource allocation is not just about the exit of nonviable firms, but equally the entry of dynamic private firms. Where possible, markets should be made more contestable by lowering barriers to entry for potential competitors and dismantling monopolies, for instance in services (especially telecommunications and healthcare) and utilities (electricity, gas, and water). The recently announced SOE reform strategy has underscored some of these elements—the key is to follow through with decisive implementation (see Selected Issues).

Authorities' views

30. The authorities emphasized that the key focus areas in the 13th Five Year Plan—drawn up keeping in mind corporate debt-related vulnerabilities and financial stability considerations—were supply side structural reforms, deleveraging, destocking, reducing energy intensity, facilitating entry, and giving markets a more decisive role in resource allocation. They noted that a list of state-owned "zombie" companies was being prepared, mostly in the coal and steel industries, and that capacity reduction was underway in these sectors. Disbursements from the restructuring fund to facilitate worker resettlement had begun, with close to RMB 30 billion (a third of the total) already transferred to provinces that had provided commitments on capacity reduction. The authorities, however, cautioned that the process would be necessarily slow due to complicated corporate structures involving overlapping balance sheets and control of assets among parent, subsidiary, and affiliated companies that made valuation assessments difficult. Ultimately, they saw a need for more market involvement—rather than government directives—in the process, with creditors discriminating more carefully among borrowers and thereby hardening budget constraints.

31. The authorities further noted that implicit support to SOEs had been largely phased out and they were increasingly competing on an equal footing with private firms. They also expected the envisaged mixed ownership reforms in SOEs would instill professional management, strengthen corporate governance, and attract private participation to improve efficiency. The authorities also observed that entry was being facilitated with approval procedures for capital injection in new growth areas cut by a third.

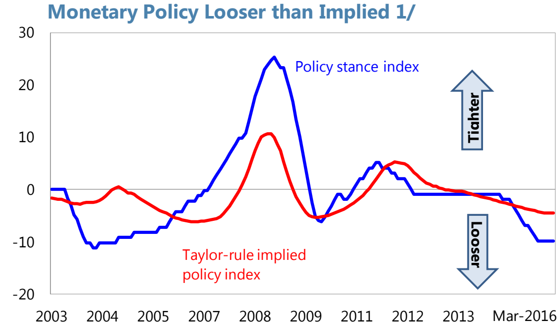
B. Accepting the Slowdown

32. Macro policies should be consistent with lowering vulnerabilities and the resulting moderately slower near-term growth. Restructuring will likely entail slower growth in the near term. This should be accepted in the interest of achieving higher, better-quality, and more robust longer-term growth. Some of the negative impact on near-term growth may be offset if sentiment were lifted by sending a strong signal of policy intent. On-budget, pro-consumption fiscal stimulus can be used if growth threatens to fall excessively.

33. Targets. The practice of setting annual growth targets (rather than projections) has fostered an undesirable focus on short-term, low-quality stimulus measures. If annual targets are to be maintained, they should be downplayed in importance compared to other indicators (such as household income growth), set flexibly (wider ranges) and at sustainable levels—for 2017, around 6 percent.

34. Credit growth, most importantly, needs to fall substantially to stabilize the nonfinancial private credit/GDP ratio. This should be done by decisively tackling the problem at source—soft budget constraints on SOEs and local governments, the web of implicit and explicit guarantees, excessive risk taking by financial institutions and the pursuit of unsustainably-high growth.

Monetary Policy Looser than Implied 1/



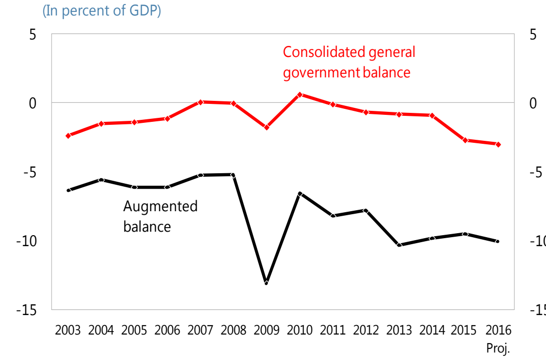
Source: IMF staff estimates.
1/ The monetary policy stance index is constructed on the basis of a short-term interest rate, reserve requirement ratio, open market operations and credit growth. The implied policy index is estimated with a simple Taylor rule that includes inflation and output developments.

35. Interest rates. Staff's monetary policy index suggests rate cuts have gone beyond what the historical relationship with output and inflation would imply as necessary. Short-term rates are barely positive in real terms and likely below the longer-run neutral level. Interest rates should rise towards less accommodative levels as inflation picks up as projected. This should be data dependent, with an earlier upward move if, for example, inflation strengthens faster than envisaged, growth surprises on the upside, or capital outflows intensify substantially. Stronger prudential settings—which, in the past, have contributed to a significant slowing of credit expansion—should be the main financial policy tool to restrain credit growth, but somewhat higher interest rates could play a complementary role, for example, by reaching parts of the financial system that prudential measures may miss (such as shadow banking and the corporate bond market). That said, higher rates should be used with caution as they could intensify corporate distress and worsen credit conditions for SMEs.

36. Fiscal stance:

- Monitoring the fiscal stance in China is especially difficult. Much spending and most of the deficit and financing occurs off budget with little transparency, and the line between public and private is blurred. Staff's estimates of the "augmented" balance and debt (i.e., including estimated off-budget spending/financing) are thus subject to a particularly high degree of uncertainty, but likely reflect more accurately the effective fiscal position than the official budget balance and debt.

Fiscal Deficit Remains Large, But More on Budget
(In percent of GDP)



Sources: CEIC Data Company Ltd.; Chinese Authorities; and IMF staff estimates.

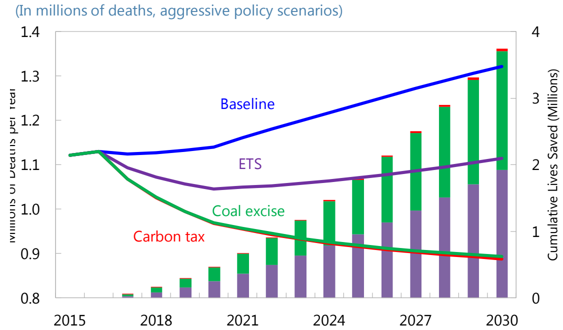
- Over the medium term, the large augmented deficit should gradually decline towards around 7 percent of GDP, to slow and eventually stabilize debt. The projected increase in the augmented deficit in 2016 is thus not warranted from a structural perspective. Neither is it warranted from a cyclical perspective given the growth outlook. For 2017, a moderate reduction of the augmented deficit seems appropriate. Only if growth threatens to fall sharply (well below staff's projection of 6.2 percent) should the deficit widen (and if so, with measures that promote rebalancing, as detailed below).

- The on-budget fiscal deficit is projected to increase from 2.7 percent of GDP in 2015 to 3 percent of GDP in 2016. Going forward, the reallocation of fiscal resources from off-budget investment towards on-budget measures that support rebalancing (boosting household incomes and consumption) and restructuring should continue. Such a reallocation could be helped by setting fiscal policy within a sound multi-year budgeting framework and greater coordination between the various bodies responsible for fiscal policy and planning. Provincial government quotas for new debt issuance should be set consistent with this overall envelope, with the aim of curtailing off-budget local government borrowing and bringing it on budget.

- Increasing on-budget support for consumption should include raising pensions, social assistance, education and health spending, unemployment benefits and providing restructuring funds, while cutting minimum social security contributions and raising SOE dividend payments. Increases in social benefits should be targeted to ensure progressivity.

- Substantially raising taxes on fossil fuel and pollution (e.g., a carbon or coal tax) would help curtail emissions, improve energy efficiency, raise revenue and prevent almost 4 million premature deaths by 2030 (see Selected Issues).

Pollution-Related Premature Deaths: 2015-2030
(In millions of deaths, aggressive policy scenarios)



Source: IMF staff estimates.
Note: Columns indicate cumulative deaths prevented.

- Progress should continue on structural fiscal reforms that will facilitate better use of public resources and reduce the distortions and costs imposed on the private sector (see D. Lipton, *Finance and Development*, March 2016). Key reforms include: (1) implementing the new budget law, improving the transparency of local government financing, and closing new "back-doors" for continued quasi-fiscal borrowing/spending (2) modernizing the tax system and making it more progressive (e.g., relying more on direct taxes and allocating local governments revenues to match their spending responsibilities) and (3) expanding social security and improving the portability of all types of benefits, liberalizing residency restrictions, and improving active labor market policies.

Authorities' views

37. The authorities emphasized that monetary and fiscal policies would provide a supportive environment for supply-side restructuring. They viewed the level of interest rates as appropriate from a cyclical perspective. They expected credit growth to normalize in the remainder of the year, observing that the exceptional pace of expansion in early 2016 was in part driven by the real estate sector—which would likely moderate going forward. The authorities highlighted that the pace of credit growth would fall over the medium term, given the emphasis on deleveraging and structural reforms in the 13th Five Year Plan. They noted, however, that the speed of deleveraging would need to be gradual to prevent adverse feedback loops between the financial sector and the real economy, as seen for example in Europe after the financial crisis. The authorities also emphasized that reducing the pace of credit growth would mean foremost reining in credit to unviable "zombie" firms, while ensuring that dynamic firms continued to have access to finance.

38. The authorities noted that fiscal policy would proactively take the lead in supporting aggregate demand, with a higher on-budget deficit projected this year compared to last. They questioned staff's 'augmented' balance, arguing that the concept was no longer relevant since local government off-budget spending had been prohibited. The authorities observed that the implementation of the new budget law was largely on track, although some local governments continued to guarantee borrowing by LGFVs, requiring the central government to step up its monitoring and enforcement of the rules. They emphasized that losses on any new loans to these entities would be shouldered by the financial institutions advancing the credit. The authorities also highlighted that tax reforms were underway, including to the personal income tax, environmental protection, resource and excise taxes. However, they questioned staff's estimate of the expected health benefits of a carbon or coal tax, arguing that causal links from higher tax rates to lower mortality rates had not been conclusively identified.

C. Guarding Against Financial Stability Risks

39. Securing financial stability requires action on multiple fronts.

- ***Banks***
  - Provisioning and loan classification regulations should be examined to foster more proactive recognition of potential loss. This could involve, for example, classifying all loans with overdue payments beyond 90 days as nonperforming. This process could usefully be complemented by a focused asset quality review (e.g., of a random selection of assets or those from a particular sector).
  - Capital ratios should be increased. Increasing loan-loss provisions will help absorb higher potential NPLs, but banks face a broad variety of risks, which call for a stronger layer of equity capital. This can be achieved, for example, by imposing a high countercyclical capital buffer and encouraging common equity issuance (helped by removing constraints on issuing when valuations are below book).
- ***Funding.*** As banks and other financial institutions have grown total assets far faster than deposits, funding has shifted toward wholesale, short-tenor, and more volatile instruments. Banks' reliance on interbank funding has increased, leverage has risen in the repo bond market, and collateral quality is deteriorating. These developments should be kept under

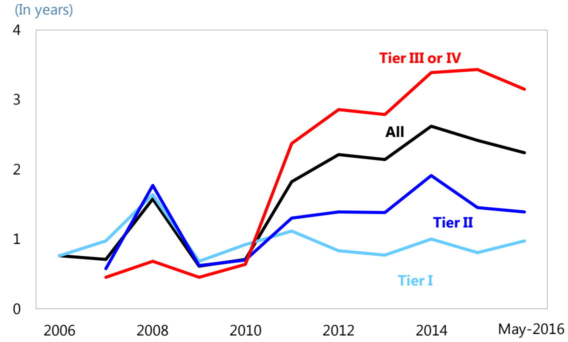
close review and measures considered to strengthen liquidity in stress scenarios. These should include a strong supervisory focus on the adequacy of liquidity risk management as set out in the Liquidity Coverage Ratio standard and associated Basel guidance, and paying close attention to collateral standards.

- ***Shadow products.*** The proliferation of shadow credit products calls for a holistic approach to their supervision. The recently published "CBRC Notice 82" appears to close some regulatory arbitrage opportunities and should be implemented aggressively; additional action should be considered as necessary for a comprehensive approach.

- ***Capital markets.*** The priority should be on orderly functioning of markets (which could include emergency liquidity provision by the central bank), not on intervention to influence valuation. Fundamentally, the solution to recurrent market excesses lies in addressing the underlying search for yield and curtailing excessive liquidity creation. A set of more immediate issues includes refraining from intervention during sell-offs and tightening underwriting and disclosure standards, in particular in the bond market where issuance of publicly traded products has surged over the past year with relatively limited dispersion in credit ratings. The resilience of securities firms and other regulated institutional investors should be strengthened through capping leverage and improving risk management practices.

- ***Property.*** Residential investment is reviving again in several parts of the country, even as excess inventory remains high, and region-specific policies could be appropriate. Specifically, tighter macroprudential measures in Tier 1 cities seem warranted (for example reducing loan-to-value ratios on mortgages for second homes). For lower-tier cities, where multi-year excess inventory levels are particularly acute, restricting new starts seems warranted, for example by tightening prudential measures on credit to property developers.

Tier III or IV City Real Estate Inventory Still High 1/
(In years)

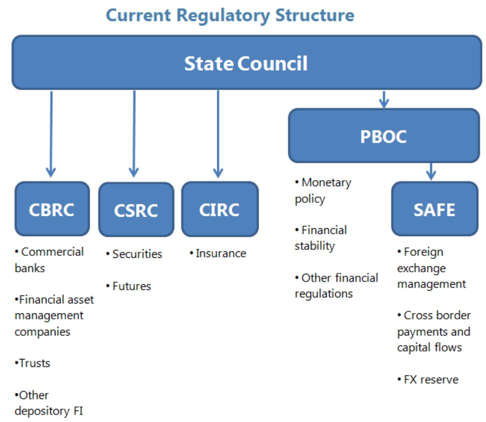


Sources: Local Housing Administrative Bureau (Fangguanju), Wigram Capital Advisors, IMF staff estimates.
1/Inventory is measured as floor space unsold; inventory ratio is measured as floor space unsold/sold.

- ***Crisis preparedness.*** Given the rising vulnerabilities, the authorities should be prepared for potential idiosyncratic and systemic stress. Key actions include: (1) conducting stress tests and readying the emergency liquidity framework; (2) preparing a strategy, including a resolution framework, for distressed financial institutions, especially nonbanks; (3) instituting a clear public funding backstop for the deposit insurance scheme; (4) ensuring adequate data and analysis (e.g., on bank/shadow bank interlinkages and FX exposures); and (5) allocating coordination of crisis preparedness and management to a high-level forum with a clear implementation plan and communications strategy.

- ***Regulatory structure.*** International experience does not speak clearly in favor of a particular structure. Nevertheless, a major upgrade in supervisory cooperation and coordination is necessary.

The goals should be: (1) seamless information sharing, coordination and communication among agencies; (2) more proactive response to markets' proven agility to expand into regulatory gaps and engage in regulatory arbitrage; and (3) stronger crisis management capabilities.



Authorities' views

40. The banking regulator disagreed with staff's assessment of corporate debt-at-risk. Their own internal exercise, taking into account the mitigating impact of loan collateral, had produced significantly lower estimates. They noted that unlisted companies—assumed the same as the listed universe in staff's exercise—were healthier as a group than the listed universe. The regulator also argued that the classification of loans as nonperforming would need to consider other criteria besides payments overdue beyond 90 days, such as judgment about the borrowers' long-term viability and whether they faced cyclical or structural cash flow problems. The regulator noted that bank exposures to nonstandard credit assets was a key concern and they had already instructed banks to conduct stringent asset quality classification, which would require them to set aside more reserves against these exposures than against loans. The banking regulator was also closely monitoring the growing reliance on wholesale funding, but viewed this as a needed adaptation in banks' business models with the growing competition for deposits. The banking regulator argued that bank capital ratios were sufficient and stable, and viewed dynamic provisioning (introduced in 2011) as effectively playing a similar role to a countercyclical buffer.

41. The securities regulator concurred with staff that the regulatory focus should be on ensuring smooth functioning of capital markets. They emphasized they stood ready to provide liquidity to distressed securities firms and would avoid indiscriminate and large purchases of securities. Information requirements for bond issuers had been raised and onsite inspections increased.

42. The authorities questioned staff's view on instituting a public backstop for the deposit insurance scheme. They argued that the deposit insurance system was a market-based framework to prevent moral hazard and should not be directly linked to public funding. The authorities further noted that international experience and standards suggested that premium contributions—not fiscal resources—should be the main source of financing deposit insurance. At the same time, the legal framework does not preclude public emergency liquidity funding for the deposit insurance system, though such public funding shall be repaid by bank premiums. More generally, the authorities agreed that closer cross-agency coordination was needed to bolster supervision, policymaking, and crisis preparedness. Steps were already being taken in this regard, for example through closer collaboration on issuing new liquidity guidelines for securities firms.

D. Progressing Toward an Effectively-Floating Exchange Rate Regime

43. **FX regime.** China has made progress over the past year in moving toward a more flexible, market-determined exchange rate system. The past year has also shown that the transition from many years of stability/gradual appreciation is difficult and potentially bumpy, particularly amid the challenging global and domestic context. Achieving a smooth, successful transition will need to combine a clear overarching drive toward progressively greater market determination and skillful, short-term management to avoid excessive volatility. In particular

- Achieving an effective float within the next couple of years, ideally by 2018, remains a key goal. A more flexible, market-determined exchange rate is needed to allow the market to play a more decisive role in the economy, absorb shocks, and maintain an independent monetary policy as the capital account opens.

- While staff assesses the current level of the RMB as broadly in line with fundamentals, the value of permitting market forces to help guide the exchange rate toward equilibrium levels should be recognized. Therefore, the effective exchange rate (relative to a basket) should over time be allowed to move in response to market conditions.

- At the same time, the authorities should also ensure that such adjustment is not destabilizing by preventing overshooting, one-way expectations, and disorderly market conditions—the large buffer of reserves provides ample ammunition for such intervention, to be deployed, for example, in the event of a significant shock.

- A possible framework for managing this transition could be to progressively widen a tolerance band around an equilibrium effective rate within which the spot rate could fluctuate. The band could be widened gradually or in discrete steps; spot rate fluctuations within the band could be smoothed by intervention; and the center of the band could be adjusted if the equilibrium effective exchange rate is assessed to have changed (influenced heavily by sustained market pressures in either direction).

44. A more market-based monetary framework. The move to a more flexible exchange rate should proceed in tandem with completing the transition toward a more market-based monetary framework. Key elements include:

- **Objectives.** Although the PBC does not operate under an explicit inflation targeting regime, its official mandate includes maintaining "the stability of the currency value and thereby promote economic growth." Formally, the PBC targets multiple objectives (inflation, balance of payments, growth, financial stability). As an important first step, the authorities should introduce an explicit medium-term inflation target or a range (set by the government/State Council) together with operational (instrument) independence for the PBC.

- **Instrument.** The PBC should declare the seven-day repo rate its new intermediate policy target for monetary policy purposes and publish a new market rate (seven-day repo) representative of lending conditions for Tier 1 banks. The clearer the policy framework, the easier it will be for the market to establish a yield curve. Standing facilities should act as a backstop with unlimited access for banks against appropriate collateral.

- **Operational framework.** While the volatility of short-term repo rates has decreased significantly since last summer, the PBC could further improve its operational framework to ensure the stability of the short-term market rates. For instance, reserve averaging (introduced in 2015) could be expanded to a 4–5-week period to allow easier liquidity management by banks.

- **Backstop.** Clear standing facilities should be put in place as a backstop. The overnight standing credit facility may function as an important backstop for the payment system. In addition, eligibility and collateral requirements for the PBC's liquidity facilities should be clear.

- **Transparency.** Most central banks have found that policy operates more efficiently and effectively if it is clearly and simply communicated and implementation clearly supports the stated policy. For example, domestic monetary policy would be clearer if the PBC were explicitly to announce its monetary policy goals and use monetary policy instruments to achieve those goals in the most transparent manner possible.

45. Capital account. Enforcement of capital controls has been tightened since last summer and some additional measures, notably the 20 percent unremunerated reserve requirement on FX forwards, have been introduced to stem significant depreciation pressures. Such tightening has likely contributed to the restoration of stability in the capital account, but has come at some cost to the efficiency of individual corporate treasury management. While new controls should be avoided, further liberalization should be phased very cautiously. Indeed, capital account liberalization (and financial liberalization more broadly) can only succeed if supported by a strengthened financial system, enhanced corporate sector governance and greater exchange rate flexibility, suggesting that much further progress on the former (capital account liberalization) may need to await the latter (a strengthened financial system, enhanced corporate governance and greater exchange rate flexibility). Care should also be taken to ensure that enforcement of existing capital controls does not spillover to affect current account transactions.

Authorities' views

46. The authorities noted that exchange market pressures had eased considerably in recent months and the move to a more market-based exchange rate was progressing. The approach was to continue maintaining broad stability against a currency basket while allowing market forces a greater role in determining the level. FX intervention had decreased in recent months and was used largely to smooth adjustments and curb overshooting. The authorities remain committed to gradually liberalizing the capital account over the medium term. They may complement such reforms (including the reserve requirement on FX forwards that the authorities consider macroprudential measures) to maintain stability and minimize disruptive short-term capital flows. The monetary framework was also being adapted to elevate the role of interest rates as a policy lever. Daily open market operations, open bid auctions for liquidity, and 10-day reserve averaging had contributed to increased stability and predictability in money market rates. The PBC did not see the need to extend the period over which reserve averaging is calculated, citing banks' liquidity management had adapted well to the current system.

E. Enhancing Transparency and Communications

47. Contributing to the market turbulence in recent months is a lack of clarity about what is happening in the economy and the authorities' policy intentions.

- **Data gaps.** Lack of confidence in macroeconomic data prompts many investors to suspect the economy is much weaker than officially reported (Box 3). While progress has been made, for example, in monetary, financial and external statistics and by disseminating data via SDDS and CPIS, important gaps remain. Addressing these data gaps, especially in the national accounts (e.g., providing quarterly GDP by expenditure, high-frequency indicators on services and the "new" economy, and improving the deflation methodology), government finance statistics (e.g., tracking off-budget spending by local governments and providing an expenditure breakdown by economic type) and credit composition (e.g., by sector) would enable better monitoring of macro developments, identification of key risks, and design of the policy stance. Ensuring adequate data are available on bank/shadow bank linkages and FX exposures is also critical for financial stability analysis. While data are broadly adequate for surveillance, they are only barely so, and are not commensurate with China's systemic importance.

- **Communications.** Clear, authoritative, and consistent communications about policy objectives and how they are being achieved would reduce uncertainty and align expectations. This requires developing a communication strategy integrated closely with policy decisions; identifying key audiences (both domestic and foreign); using a range of user-friendly communication tools and channels; and learning from international experience. Recent efforts by key policymakers to convey their insights on the outlook and their policy intentions are encouraging, as is the initiative to increase the frequency of press conferences on data releases from quarterly to monthly.

Authorities' views

48. The authorities noted that data collection and dissemination was being upgraded in three main areas: consistency between provincial and national GDP, national balance sheet, and natural resource balance sheet (accounting for environmental assets such as land, forests and water). They were exploring possibilities for publishing expenditure-based quarterly GDP in real terms and high-frequency indicators for services. From a financial regulatory perspective, the authorities did not see any major data gaps in bank/shadow bank linkages or credit allocation by sector. They intended to publish more detailed breakdowns of bank credit and increase the frequency of dissemination. The authorities acknowledged the importance of communications and pointed to recent press conferences and media interviews by key policymakers.

Box 3. How Reliable is China's Output Data?

There is some evidence pointing to possible overstatement of growth recently, but the overstatement is likely moderate and the official national accounts data—while there is much room for improvement—likely provide a broadly reliable picture.

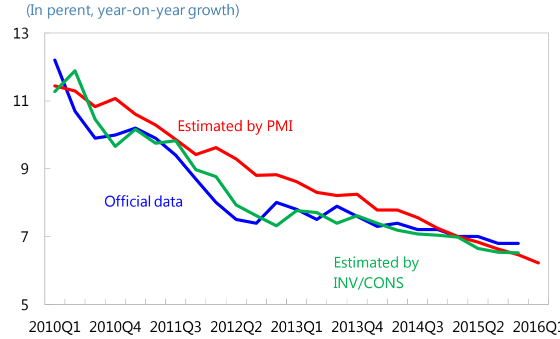
China's nominal GDP is probably larger than the official estimate. This could reflect flaws in measuring service consumption, including the inability to fully capture the switch from state-owned industrial firms to market-based (and often smaller) service firms. A study by the Rhodium Group, which duplicates the authorities' statistical methodology, but addresses some key weaknesses, suggests nominal GDP is underestimated by, for example, 13–16 percent in 2008, and some other studies, while using different approaches, show similar results.

But growth may be smoothed since the smallest and most volatile firms may not be adequately captured in the statistical methodology. Indeed, skepticism that growth is overstated has grown recently, arising largely from the more pronounced weakening in some hard indicators compared to official growth data, including consumption of energy, industrial value added, and commodity imports. A few studies indicate that growth is not overstated over a long time horizon, but that the volatility is understated. Some further argue that the official nominal GDP data are reliable, but the weaknesses in deflators cause real growth to be smoothed. For example, the single deflation approach, which deflates input and output using the same deflator, tends to overstate growth when commodity prices decline sharply. But a counterargument is that the dynamism in the service sector is robust and not well reflected in the hard indicators mentioned above. For example, private consumption is buoyant, with retail sales growing by around 10 percent y/y in real terms.

"Underlying" growth may be weaker than officially reported, but only somewhat.

- *Correlation.* A sudden decline in the correlation between overall growth data and individual hard indicators could signal that the official data might overstate growth. However, looking at 12-month rolling correlations for real GDP growth versus electricity production, cement, crude steel and freight, does not suggest a recent significant decline (though the series are noisy).

GDP Growth: Official and Estimated
(In perent, year-on-year growth)



Sources: CEIC Data Company Ltd.; and IMF staff estimtes.

- *High frequency-based estimates*. Out-of-sample estimates of growth from high-frequency PMIs and consumption/investment indicators are about ¼–½ percent lower than official growth data in 2015.

These results, however, are only indicative of possible slower underlying growth. While providing some cross checks, they are not based on comprehensive datasets and cannot substitute for national account statistics. These approaches focus on underlying growth by analyzing variables traditionally shaping economic fundamentals, while actual growth also includes transitory factors not captured (e.g., the current strength of financial services).

STAFF APPRAISAL

49. Reform and rebalancing amid a bumpy transition. China continues its transition to a sustainable growth path. Rebalancing has progressed on many dimensions, particularly switching from industry to services and from investment to consumption, but less on reining in credit growth. Reforms have advanced impressively across a wide domain, but lagged in some critical areas, and the transition to sustainable growth is proving difficult, with sizable economic and financial volatility. Vulnerabilities are rising on a dangerous trajectory and buffers, while still adequate, are eroding.

50. Policy plans. Recognizing these challenges, the recently launched 13th Five Year Plan appropriately aims to boost consumption, expand the service sector, protect the environment, and reduce poverty. The government has put supply-side reforms at the center of its economic policy agenda, including the restructuring of SOEs, capacity reduction in the coal and steel sectors, and facilitating firm entry and worker resettlement to new growth areas.

51. Benign near-term outlook… Growth is expected at 6.6 percent this year, shored up by policy stimulus, falling to 6.2 percent in 2017. This assumes robust consumption and wage growth, and a slight pick-up in investment this year, but moderating next year. Net exports will likely continue to drag growth in the near term as external demand remains tepid. Inflation should gradually pick up as commodity prices recover.

52. …but increasingly uncertain medium-term prospects. More urgent action is needed to tackle vulnerabilities and improve resource allocation. Under staff's baseline scenario, growth will decline below 6 percent over the medium term, the credit/GDP ratio will continue rising, and the risks of a disruptive adjustment will increase. Under an alternative, proactive scenario with decisive measures to tackle corporate debt and reform SOEs, near-term growth would dip below baseline but, critically, medium-term growth prospects would improve and the nonfinancial private credit/GDP ratio would stabilize at a significantly lower level than in the baseline.

53. Tackling the corporate debt problem. Corporate debt, though still manageable, needs to be decisively tackled to ensure it remains so. International experience, including China's during the 1990s, suggests that addressing a systemic corporate debt problem requires a comprehensive approach and decisive implementation to: harden budget constraints; triage excessively indebted firms, restructure the viable and liquidate the nonviable; recognize and share financial losses among firms, banks, other creditors, and, if necessary, the government; absorb the social costs of layoffs through earmarked funds; and facilitate entry of dynamic private firms. Progress should be kick-started by piloting a few high-profile restructurings/liquidations of weak SOEs in the next few months.

54. Macro policies should be consistent with lowering vulnerabilities and the resulting moderately slower, near-term growth. Most importantly, credit growth and investment need to decline, partially offset by a further increase in on-budget measures that support rebalancing by boosting household consumption. Pro-rebalancing measures should include raising pensions, social assistance, education and health spending, providing restructuring funds, and cutting minimum social security contributions.

55. Further action is needed on multiple fronts to secure financial stability. This includes proactive recognition of losses in banks' loan books; strengthening capital ratios; enhancing supervisory focus on liquidity risk management and funding stability risks; and addressing risks in shadow products. A major upgrade in supervisory coordination and cooperation is necessary to foster more seamless cross-agency information sharing and policy coordination, reduce the scope for regulatory arbitrage, and enhance crisis management capabilities.

56. Steady progress toward an effectively floating exchange rate regime should continue. Staff encourages the authorities to build on the progress made over the past year in moving toward a more flexible, market-determined exchange rate system. Achieving an effectively floating exchange rate regime, ideally by 2018, will need to combine a clear overarching drive toward progressively greater market-determination and skillful short-term management to avoid excessive volatility. The move to greater flexibility should be supported by progress to a more market-based monetary framework. Further capital account liberalization should be phased carefully, supported by a strengthened financial system, enhanced corporate governance and greater exchange rate flexibility.

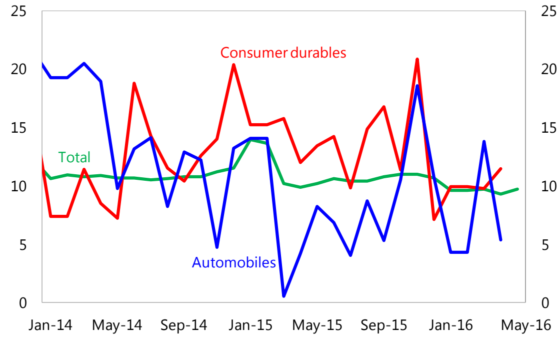
57. Transparency in data and communications. Greater clarity about developments in the economy and the authorities' policy intentions would reduce uncertainty, align expectations, and help contain market turbulence. This requires more comprehensive and timely dissemination of economic and financial data and a communication strategy integrated with policy decisions, conveyed via a range of user-friendly tools.

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

Figure 1. Activity: Slowing Trend, Bumpy

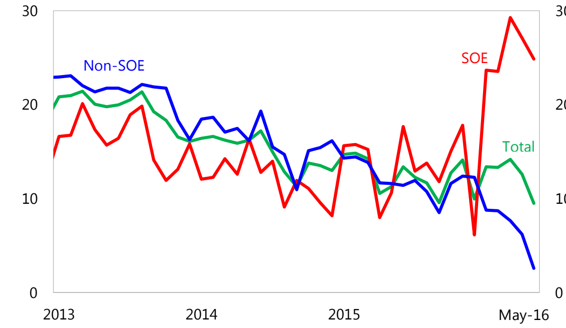
Consumer spending has held up…

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



…while private investment has slowed…

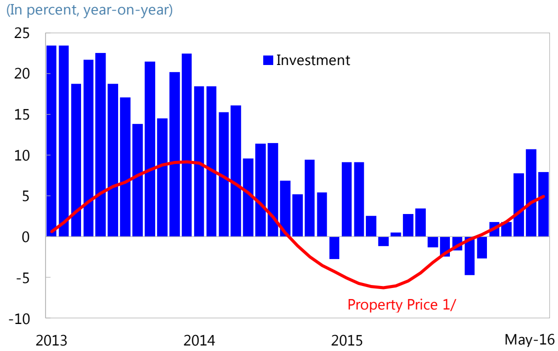
Real Fixed Asset Investment Growth [1/]
(In percent, year-on-year)



1/ Deflated by FAI prices; authorities publish quarterly index and staff estimates monthly index.

…despite the recent recovery in residential real estate.

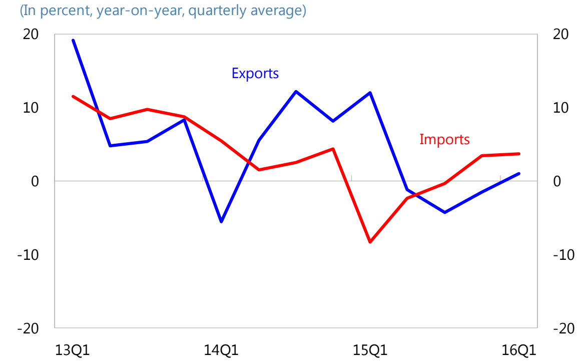
Residential Housing Growth
(In percent, year-on-year)



1/ NBS 70-city new constructed residential property price.

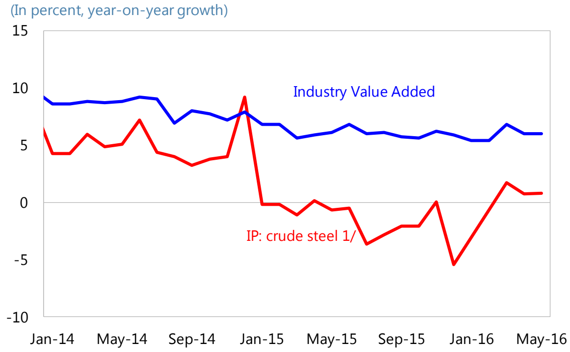
Trade volumes are improving, but remain subdued.

Trade Volumes
(In percent, year-on-year, quarterly average)



Industrial production appears to be stabilizing, although adjustment in heavy industrial sectors continues…

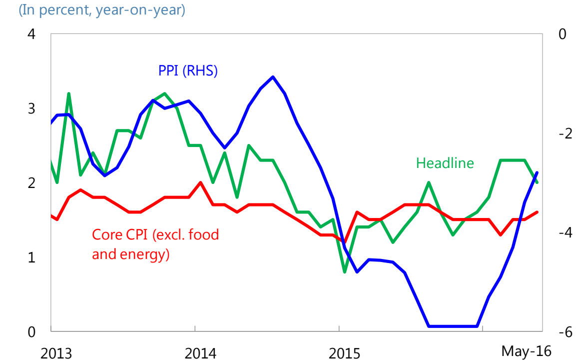
Industry Value Added
(In percent, year-on-year growth)



1/ No reported data for January and February 2016.

…where excess capacity has weighed on producer prices.

Inflation
(In percent, year-on-year)

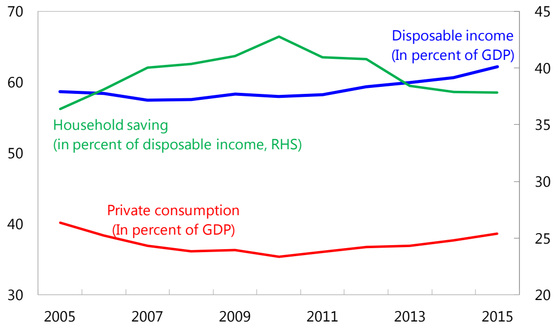


Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff estimates.

Figure 2. Rebalancing: Some Progress

Since 2010, private consumption has grown owing to a rising income share and a decrease in the saving rate.

Private Consumption

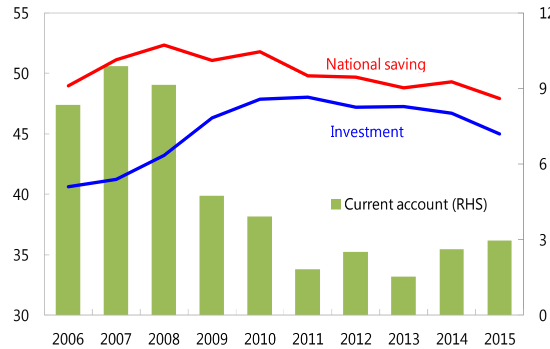


Note: Saving rate is defined as household saving in percent of disposable income.

Investment has moderated along with national saving, especially in 2015.

Investment and Saving

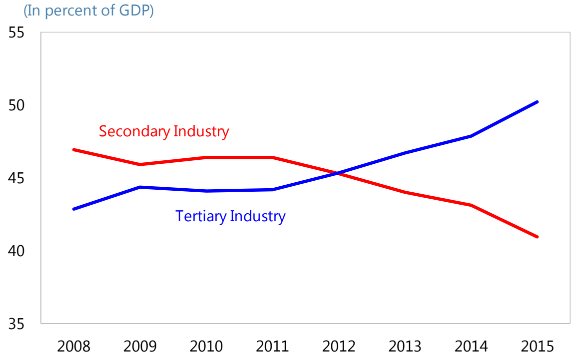
(In percent of GDP)



On the supply side, services have accounted for a rising share of nominal GDP since 2012...

GDP by Production

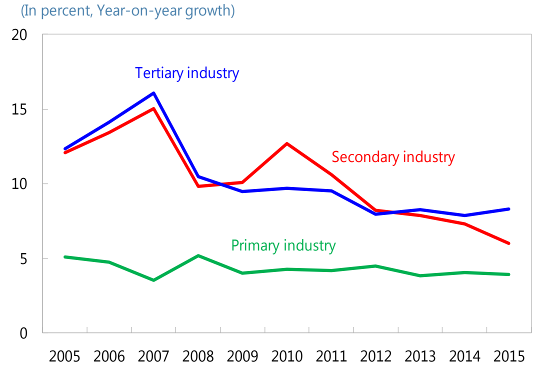
(In percent of GDP)



...with the tertiary sector growing faster than the secondary in real terms over this time.

Real GDP Growth by Activity

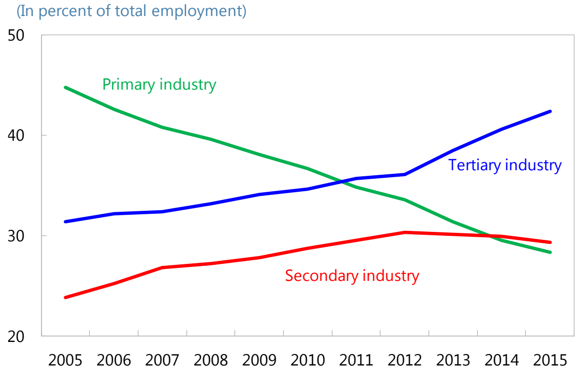
(In percent, Year-on-year growth)



Similar patterns are visible in the labor market, where the tertiary sector share of employment has risen rapidly...

Employment by Sectors

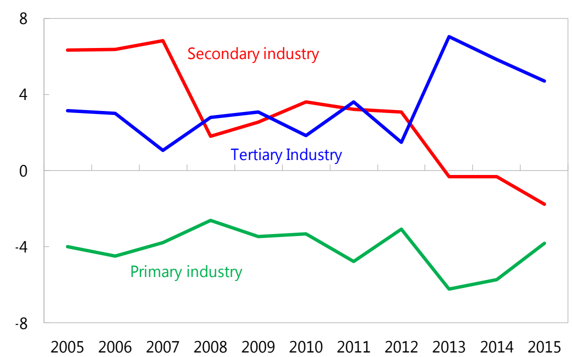
(In percent of total employment)



...after three successive years in which it was the only segment of the economy with net job creation.

Employment Growth

(In percent, year-on-year growth)

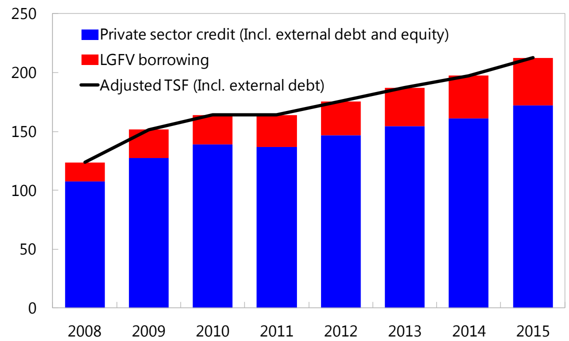


Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff estimates.

Figure 3. Corporate Sector: Rising Stress

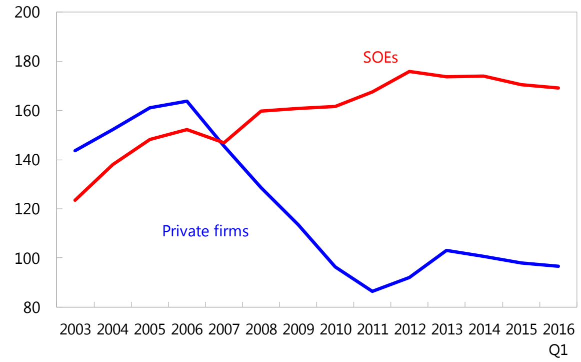
The stock of credit outstanding relative to GDP has grown by a third over the last five years.

Adjusted Credit
(In percent of GDP)



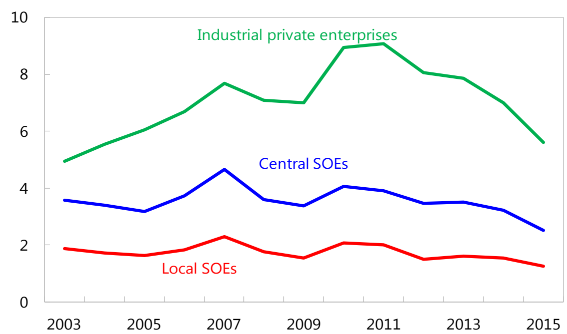
Leverage in private firms picked up after 2010, while SOEs continued to operate with high leverage…

Leverage Ratios (Average Mean)
(In percent)



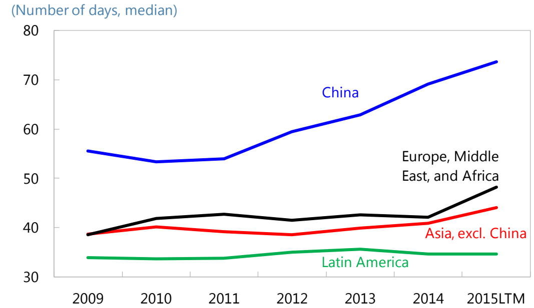
…even as profitability has deteriorated.

Weak and Deteriorating SOE Profitability
(In percent, returns on total assets)



Arrears in intercorporate payments have risen…

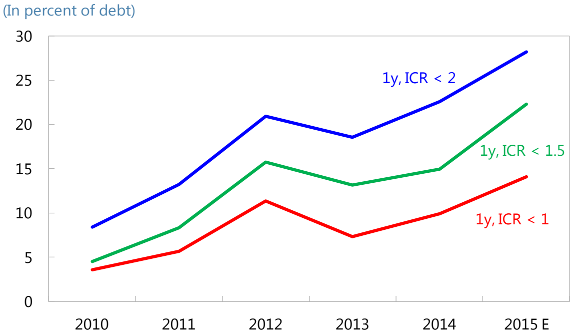
Payables Days
(Number of days, median)



Note: Payables days = payables / annual sales x 365. The China sample contains 3139 firms (2015E). LTM = last twelve months.

…contributing to an increase in the share of corporate loans held by firms with low debt service capacity…

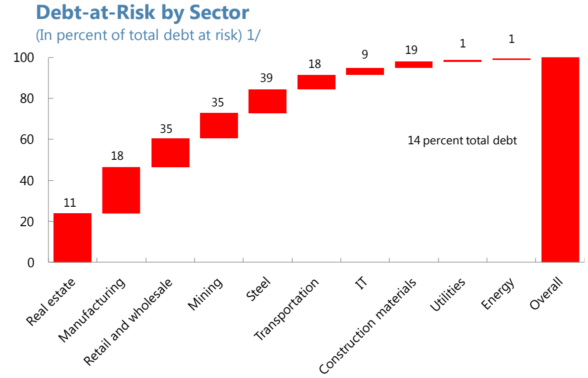
China Listed Companies' Potentially Impaired Loans 1/
(In percent of debt)



1/ Estimated impaired loans on each ICR standard as a share of total loans in the sample. The sample is from the S&P Capital IQ database.

…with firms in construction-related and upstream sectors accounting for large portions of the debt-at-risk.

Debt-at-Risk by Sector
(In percent of total debt at risk) 1/



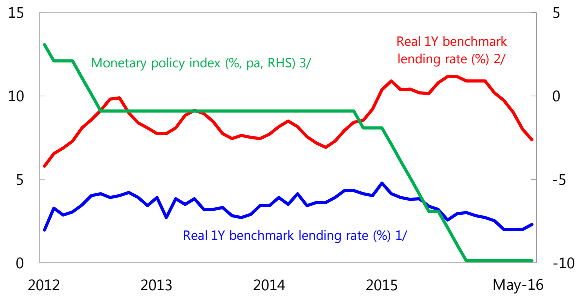
1/ ICR<1.

Sources: Bloomberg; CEIC Data Company Ltd.; Haver Analytics; Standard & Poor's Capital IQ; and IMF staff estimates.

Figure 4. Credit: Seeking Yield

Lower nominal rates have contributed to an easing in overall monetary policy.

Real Interest Rates and Monetary Policy Index

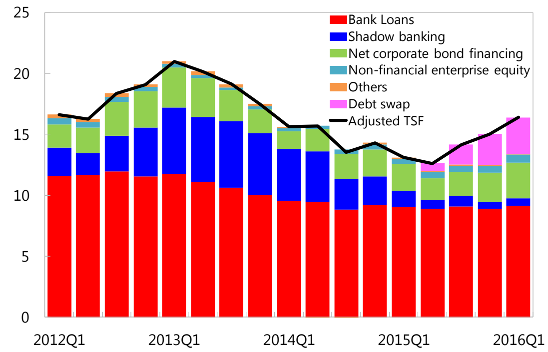


1/ Deflated by actual CPI inflation (year-on-year).
2/ Deflated by actual PPI inflation (year-on-year).
3/ The monetary policy stance index is constructed on the basis of interest rate, reserve requirement ratio, open market operations and excessive credit growth. Since October 2015, it has solely reflected short-term rates given the progress of interest rate liberalization and development of interest rate corridor.

Credit growth to the real economy has re-accelerated since 2015:H2…

Contribution to TSF Stock Growth

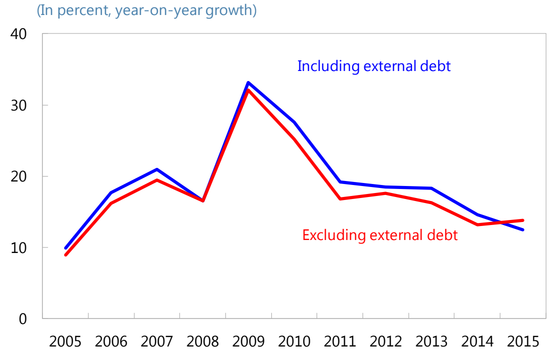
(In percent, year-on-year growth, adjusted for LG debt swap)



…in part reflecting an increase in domestic borrowing to repay external debt.

Adjusted TSF Stock Growth

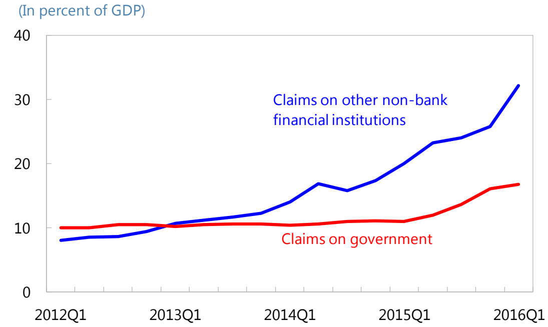
(In percent, year-on-year growth)



Bank claims on other financial institutions and the government have surged.

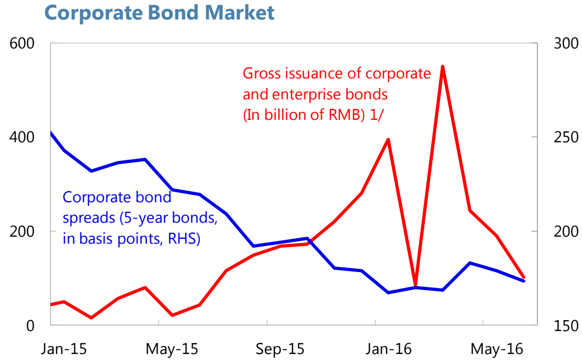
Claims on Government and Other Non-banks Financial Institutions

(In percent of GDP)



Bond issuances picked up significantly…

Corporate Bond Market

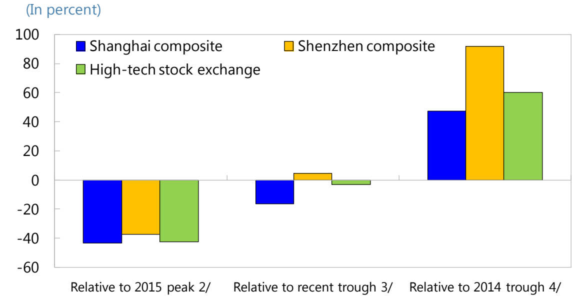


1/ Data are up to June 15, 2016.

…after the equity market began correcting last June.

Equity Market 1/

(In percent)



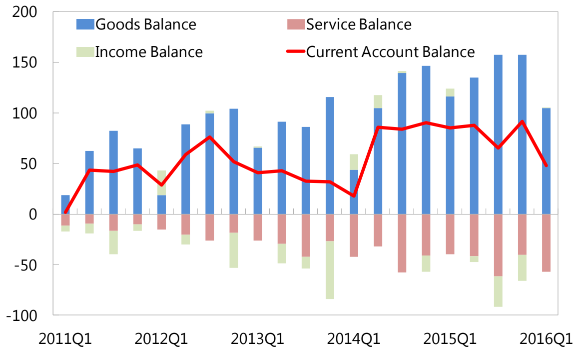
1/ As of July 1, 2016
2/ June 12, 2015
3/ July 8, 2015
4/ January 20. 2014

Sources: CEIC Data Company Ltd.; WIND database; Chinese authorities' websites; and IMF staff estimates.

Figure 5. External Sector: A Reversal of Trends?

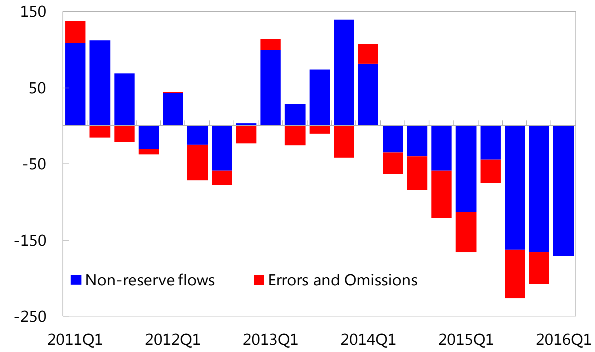
The current account surplus has grown as the terms of trade have improved and real imports have softened…

Current Account
(In billion of US dollars)



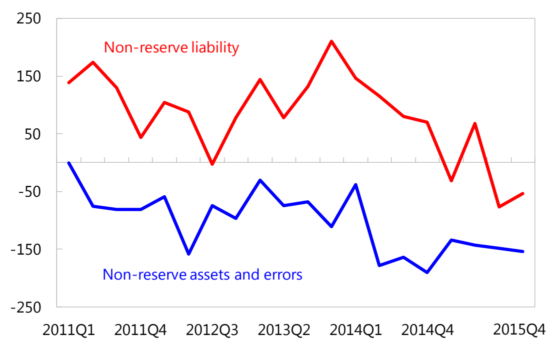
…but the broad balance of payments has deteriorated with the large net capital outflows in 2015…

Financial Acount and Errors and Omissions
(In billion of US dollars)



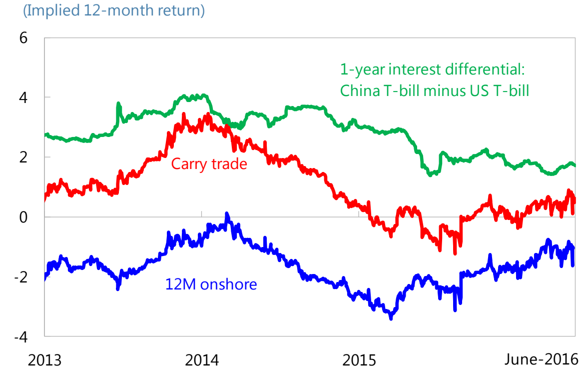
…reflecting a combination of weaker inflows by nonresidents and larger gross outflows by residents…

Capital Outflows
(In billion of US dollars)



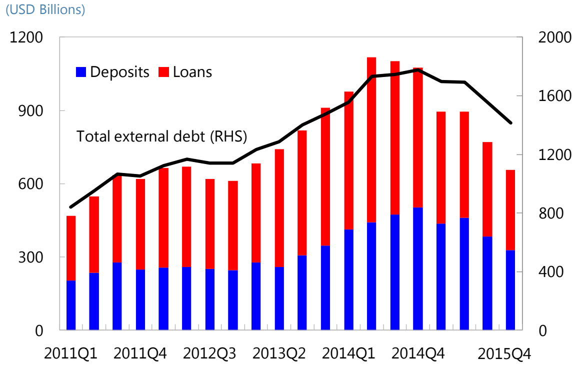
…in part traceable to a change in exchange rate expectations and compression in the China-US yield differential.

Exchange Rate
(Implied 12-month return)



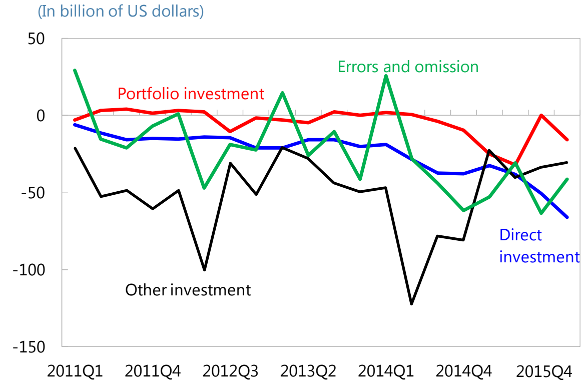
Repayment of external debt has been a large contributor to the swing in net capital flows…

External Debt
(USD Billions)



…but outflow pressure has been broadening across various channels through which residents transfer capital overseas.

Assets Outflows
(In billion of US dollars)

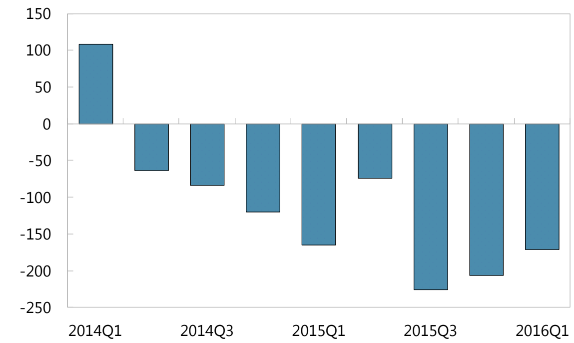


Sources: Bloomberg; CEIC Data Company Ltd.; HKMA; and IMF staff estimates.

Figure 6. FX and Stock Markets: Pressures Easing?

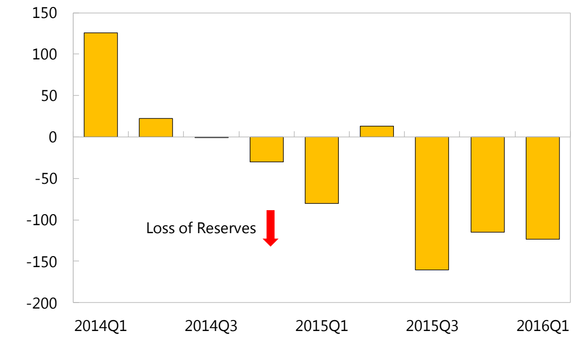
Capital outflows, on the rise since 2014:Q2, accelerated in 2015:H2…

Net Capital Flows
(In billion of US dollars)



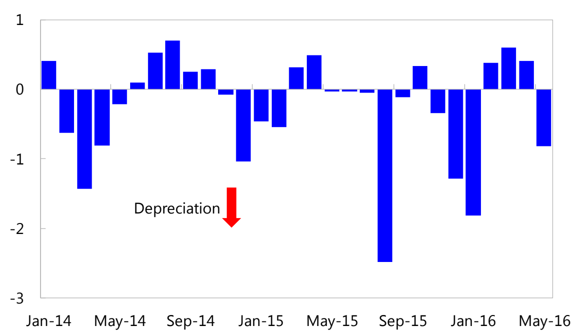
…prompting large and unprecedented intervention….

China: FX Intervention
(In billion of US dollars)



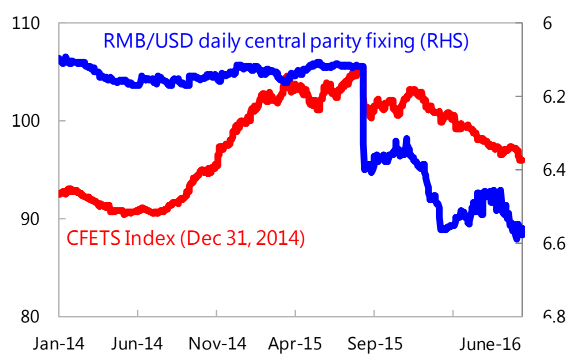
…to arrest depreciation pressures prompted by the August 2015 switch in exchange rate policy…

RMB - USD, Monthly Average Spot Rate
(In percent, month on month percent change)



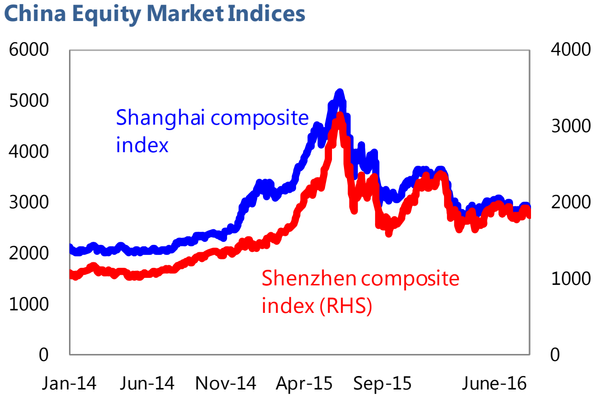
…from a de facto tight dollar link to referencing a basket of currencies.

RMB Exchange Rates vs. the US Dollar and CFETS Index



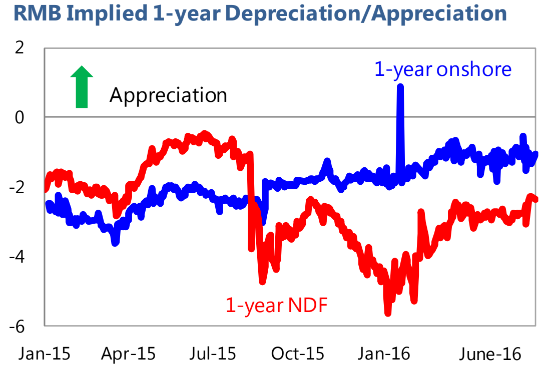
The stock market correction has also weighed on sentiment.

China Equity Market Indices



Markets continue to price in further depreciation, although expectations have recently eased somewhat.

RMB Implied 1-year Depreciation/Appreciation



Sources: CEIC Data Company Ltd.; HKMA; Haver Analytics; and IMF staff estimates.

Table 1. China: Selected Economic Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Projections					
	(Annual percentage change, unless otherwise indicated)										
NATIONAL ACCOUNTS											
Real GDP	9.5	7.9	7.8	7.3	6.9	6.6	6.2	6.0	6.0	5.9	5.8
Total domestic demand	10.7	7.9	8.1	7.2	7.2	7.2	6.5	6.2	6.1	6.0	5.9
Consumption	12.2	8.7	7.2	7.2	8.3	7.8	7.7	7.1	6.8	6.6	6.4
Investment	9.2	7.1	9.1	7.1	6.1	6.4	5.2	5.2	5.3	5.3	5.3
Fixed	8.8	9.0	9.3	6.8	6.8	6.6	5.3	5.3	5.4	5.4	5.4
Inventories (contribution)	0.4	-0.7	0.1	0.3	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports (contribution)	-0.8	0.2	-0.1	0.3	-0.1	-0.5	-0.2	-0.1	0.0	0.0	0.0
Total capital formation (percent of GDP)	48.0	47.2	47.3	46.7	45.0	43.9	43.3	42.8	42.2	41.6	41.0
Gross national saving (percent of GDP)	49.8	49.7	48.8	49.3	47.9	46.3	44.9	44.1	43.2	42.4	41.6
LABOR MARKET											
Unemployment rate (annual average) 1/	…	…	5.0	5.1	5.1	5.1	5.1	5.0	5.0	5.0	5.0
Wages	16.7	14.0	12.9	10.0	9.9	9.0	8.7	8.5	8.5	8.3	8.1
PRICES											
Consumer prices (average)	5.4	2.6	2.6	2.0	1.4	2.1	2.3	2.4	2.6	3.0	3.0
GDP Deflator	8.1	3.2	2.4	1.2	0.4	0.7	0.9	1.4	1.6	2.0	2.1
FINANCIAL											
7-day repo rate (percent)	6.4	4.6	5.4	5.1	2.5	…	…	…	…	…	…
10 year government bond rate (percent)	3.4	3.6	4.6	3.7	2.9	…	…	…	…	…	…
Real effective exchange rate (average)	2.8	5.6	6.3	3.1	10.1	…	…	…	…	…	…
Nominal effective exchange rate (average)	0.1	5.0	5.3	3.1	9.5	…	…	…	…	…	…
MACRO-FINANCIAL											
Total social financing 2/	18.1	19.1	17.5	14.3	12.4	12.7	11.9	11.4	11.0	10.3	10.1
In percent of GDP	157.9	169.0	180.0	189.5	198.4	208.3	217.4	225.1	232.0	236.9	241.6
Domestic credit to the private sector	16.2	19.8	16.6	13.5	14.7	14.7	13.4	12.1	10.9	9.9	9.7
In percent of GDP	124.8	134.3	141.9	148.2	158.3	169.2	179.0	186.5	192.1	195.5	198.7
House price 3/	5.7	8.7	7.7	1.4	9.1	8.9	7.3	7.0	7.3	6.9	6.8
Household disposable income (percent of GDP)	58.3	59.4	60.0	60.7	62.2	63.2	63.6	63.9	64.2	64.2	64.2
Household savings (percent of disposable income)	41.0	40.8	38.5	37.9	37.4	36.9	35.8	34.7	33.7	32.7	31.7
Household debt (percent of GDP)	27.8	29.6	33.0	35.3	38.4	41.8	45.5	49.1	52.4	55.3	57.5
Non-financial corporate domestic debt (percent of GDP)	97.0	104.7	108.9	112.8	120.0	127.4	133.5	137.5	139.7	140.2	141.2
GENERAL GOVERNMENT (Percent of GDP)											
Net lending/borrowing 4/	-0.1	-0.7	-0.8	-0.9	-2.7	-3.0	-3.1	-2.9	-2.9	-2.8	-2.7
Revenue	26.9	27.8	27.7	28.0	28.6	27.8	28.1	28.0	27.8	27.7	27.5
Expenditure	27.0	28.4	28.5	28.9	31.3	30.8	31.2	30.9	30.7	30.4	30.2
Debt 5/	15.2	15.2	15.9	38.5	38.3	38.6	39.1	39.3	39.3	39.2	39.0
Structural balance	-0.1	-0.5	-0.5	-0.5	-2.4	-2.9	-3.1	-2.9	-2.9	-2.8	-2.7
BALANCE OF PAYMENTS (Percent of GDP)											
Current account balance	1.8	2.5	1.5	2.6	3.0	2.4	1.6	1.3	1.0	0.8	0.6
Trade balance	3.0	3.6	3.7	4.1	5.1	5.1	4.5	4.3	4.0	3.8	3.7
Services balance	-0.6	-0.9	-1.3	-1.6	-1.6	-2.0	-2.3	-2.6	-2.7	-2.9	-2.9
Net international investment position	22.4	21.8	20.7	15.2	14.3	16.5	16.9	16.7	16.3	15.5	14.8
Gross official reserves (bn US$)	3,256	3,388	3,880	3,899	3,406	3,181	3,064	2,993	2,890	2,813	2,740
MEMORANDUM ITEMS											
Nominal GDP (bn RMB) 6/	48,604	54,099	59,696	64,849	69,630	74,715	80,118	86,159	92,834	100,244	108,246
Augmented debt (percent of GDP) 7/	45.8	47.1	51.0	51.8	55.8	60.4	64.5	67.8	70.4	72.2	73.5
Augmented net lending/borrowing (percent of GDP) 7/	-6.0	-5.1	-7.6	-7.2	-7.8	-8.4	-8.2	-7.8	-7.4	-7.0	-6.6
Augmented fiscal balance (percent of GDP) 8/	-8.2	-7.8	-10.3	-9.8	-9.5	-10.1	-9.8	-9.3	-8.8	-8.4	-8.0

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; and IMF staff estimates and projections.

1/ Surveyed unemployment rate.

2/ After adjusting local government debt swap, staff estimate that TSF stood at 203 percent of GDP in 2015.

3/ Average selling prices estimated by IMF staff based on housing price data (Commodity Building Residential Price) of 70 large and mid-sized cities published by National Bureau of Statistics (NBS).

4/ Adjustments are made to the authorities' fiscal budgetary balances to reflect consolidated general government balance, including government-managed funds, state-administered SOE funds, adjustment to the stabilization fund, and social security fund.

5/ Estimates of debt levels before 2015 include central government debt and explicit local government debt (identified by MoF and NPC in Sep 2015). The large increase in general government debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously. The estimation of debt levels after 2015 assumes zero off-budget borrowing from 2015 to 2021.

6/ Expenditure side nominal GDP.

7/ Augmented fiscal data expand the perimeter of government to include local government financing vehicles and other off-budget activity.

8/ "Augmented fiscal balance" = "augmented net lending/borrowing" - "net land sales proceeds" (in percent of GDP) as we treat net land sales proceeds as financing.

Table 2. China: Balance of Payments

(In percent of GDP, unless otherwise noted)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Projections					
Current account balance	1.8	2.5	1.5	2.6	3.0	2.4	1.6	1.3	1.0	0.8	0.6
Trade balance	3.0	3.6	3.7	4.1	5.1	5.1	4.5	4.3	4.0	3.8	3.7
Exports	24.0	23.0	22.3	21.3	19.2	18.1	17.1	16.1	15.2	14.3	13.5
Imports	21.0	19.4	18.6	17.1	14.1	13.0	12.6	11.8	11.1	10.5	9.8
Services balance	-0.6	-0.9	-1.3	-1.6	-1.6	-2.0	-2.3	-2.6	-2.7	-2.9	-2.9
Income balance	-0.9	-0.2	-0.8	0.1	-0.4	-0.6	-0.6	-0.3	-0.2	-0.2	-0.1
Current transfers	0.3	0.0	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Capital and financial account balance	3.5	-0.4	3.6	-0.5	-4.3	-4.3	-2.6	-1.8	-1.7	-1.2	-1.0
Capital account	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	3.5	-0.4	3.6	-0.5	-4.3	-4.4	-2.6	-1.9	-1.7	-1.3	-1.0
Net foreign direct investment	3.1	2.1	2.3	1.4	0.6	-0.4	-1.2	-1.8	-1.8	-1.5	-1.2
Portfolio investment	0.3	0.6	0.5	0.8	-0.6	-0.7	-0.1	-0.1	-0.1	-0.1	-0.1
Other investment	0.1	-3.0	0.7	-2.6	-4.3	-3.3	-1.4	0.0	0.1	0.3	0.3
Errors and omissions 1/	-0.2	-1.0	-0.7	-1.0	-1.7	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	5.2	1.1	4.5	1.1	-3.1	-2.0	-1.0	-0.5	-0.7	-0.5	-0.4
Reserve assets	-5.2	-1.1	-4.5	-1.1	3.1	2.0	1.0	0.5	0.7	0.5	0.4
International investment position:											
Asset	62.9	60.8	62.1	61.0	55.6	56.9	56.1	55.1	53.5	51.6	49.8
Direct investment	5.6	6.2	6.9	8.4	10.1	12.1	13.8	15.6	16.9	17.7	18.3
Secuirties investment	2.7	2.8	2.7	2.5	2.3	2.9	3.4	3.7	4.0	4.2	4.3
Other investment	11.3	12.3	12.3	13.2	12.7	13.8	14.0	13.5	13.0	12.4	11.9
Reserve assets	43.3	39.5	40.3	36.9	30.5	28.0	24.9	22.2	19.6	17.3	15.3
Liability	40.5	39.0	41.4	45.8	41.3	40.4	39.3	38.3	37.2	36.1	35.0
Direct investment	25.4	24.1	24.2	24.6	25.4	26.8	26.2	25.1	23.9	22.5	21.4
Secuirties investment	3.3	3.9	4.0	7.5	7.2	7.1	7.1	7.1	7.0	6.8	6.6
Other investment	11.8	11.0	13.2	13.6	8.6	6.6	5.9	6.1	6.4	6.7	7.0
Net international investment position	22.4	21.8	20.7	15.2	14.3	16.5	16.9	16.7	16.3	15.5	14.8
Memorandum items:											
Export growth (value terms)	21.6	9.2	8.9	4.4	-4.5	-4.2	2.5	2.9	3.4	4.0	3.8
Import growth (value terms)	27.3	5.2	7.7	1.1	-12.9	-6.2	4.6	3.0	3.2	3.7	3.1
FDI (inward)	3.7	2.8	3.0	2.5	2.2	1.8	1.5	1.2	1.0	0.9	0.8
External debt (Billion of US$)	1,047.1	1,162.8	1,532.8	1,788.1	1,416.2	1,154.2	1,175.3	1,317.4	1,480.0	1,673.5	1,868.1
As a percent of GDP	13.9	13.6	15.9	16.9	12.7	10.2	9.6	9.8	10.0	10.3	10.5
Short-term external debt (Billion of US$, remaining maturity)	754.6	853.5	1,201.5	1,311.3	920.6	720.6	733.2	817.1	913.0	1,021.4	1,130.3
Gross reserves (Billion of US$) 2/	3,255.8	3,387.9	3,880.4	3,899.3	3,406.1	3,181.4	3,063.6	2,993.4	2,889.8	2,813.1	2,739.9
As a percent of ST debt by remaining maturity	431.4	397.0	323.0	297.4	370.0	441.5	417.8	366.3	316.5	275.4	242.4
Real effective exchange rate (2010 = 100)	102.8	108.5	115.3	118.9	131.0	…	…	…	…	…	…
Nominal GDP (Billion of US$)	7,522.2	8,570.3	9,635.2	10,557.6	11,181.6	11,354.8	12,279.6	13461	14777.4	16294.6	17852.9

Sources: CEIC Data Co., Ltd.; IMF, Information Notice System; and IMF staff estimates and projections.

1/ Includes counterpart transaction to valuation changes.

2/ Includes foreign currency reserves and other reserve assets such as SDRs and gold.

Table 3. China: External Vulnerability Indicators

	2011	2012	2013	2014	2015
Monetary and financial indicators					
General government debt (in percent of GDP) 1/	15.2	15.2	15.9	38.5	38.3
Broad money (M2: annual percentage change)	17.3	14.4	13.6	11.0	13.3
Foreign currency deposits to broad money (percent)	2.0	2.6	2.4	2.9	2.9
Local currency loans to the economy (annual percentage change)	15.8	15.0	14.1	13.6	14.3
Foreign currency loans to credit to the economy (in percent)	5.0	5.3	5.1	4.7	4.0
Stock exchange index (end-of-period, December 19, 1990 = 100) 2/	2,304	2,376	2,214	3,389	3,704.3
Stock exchange capitalization (percent of GDP)	54.2	53.5	51.6	70.3	94.8
Number of listed companies (A-share)	2,320	2,472	2,468	2,592	2,808
Balance of payments indicators					
Exports (annual percentage change, U.S. dollars)	21.6	9.2	8.9	4.4	-4.5
Imports (annual percentage change, U.S. dollars)	27.3	5.2	7.7	1.1	-12.9
Current account balance (percent of GDP)	1.8	2.5	1.5	2.6	3.0
Capital and financial account balance (percent of GDP)	3.5	-0.4	3.6	-0.5	-4.3
Of which : gross foreign direct investment inflows	3.7	2.8	3.0	2.5	2.2
Reserve indicators					
Gross reserves (billions of U.S. dollars) 3/	3,256	3,388	3,880	3,899	3,406
Gross reserves to imports of goods & services (months)	28.3	22.3	24.0	22.1	18.1
Gross reserves to broad money (M2) (percent)	24.7	22.0	21.7	19.5	15.2
Gross reserves to short-term external debt by remaining maturity (percent)	431.4	397.0	323.0	297.4	370.0
External debt and balance sheet indicators					
Total external debt (percent of GDP)	13.9	13.6	15.9	16.9	12.7
Total external debt (billions of U.S. dollars)	1,047.1	1,162.8	1,532.8	1,788.1	1,416.2
Short-term external debt by original maturity (billions of U.S. dollars)	754.6	853.5	1,201.5	1,311.3	920.6
Net foreign assets of banking sector (billions of U.S. dollars)	259.9	300.4	177.3	189.4	443.8
Total debt to exports of goods & services (percent)	52.1	53.5	65.1	70.8	58.3
Total debt service to exports of goods & services (percent)	25.2	25.1	28.9	51.6	38.1
Of which : Interest payments to exports of goods & services (percent)	0.3	0.2	0.2	0.2	0.2
Foreign-currency long-term sovereign bond ratings (eop)					
Moody's	Aa3	Aa3	Aa3	Aa3	Aa3
Standard and Poor's	AA-	AA-	AA-	AA-	AA-
Memorandum items:					
International investment position (billions of U.S. dollars)	1,688.4	1,866.5	1,996.0	1,776.4	1,769.5
Nominal GDP (billions of U.S. dollars)	7,522	8,570	9,635	10,558	11,182
Exports of goods & services (billions of U.S. dollars)	2,009	2,175	2,356	2,524	2,429
Real effective exchange rate (annual percentage change)	2.8	5.6	6.3	3.1	10.1

Sources: CEIC Data Co. Ltd; Bloomberg; IMF, Information Notice System; and IMF staff estimates.

1/ Estimates of debt levels before 2015 include central government debt and explicit local government debt (identified by MoF and NPC in Sep 2015). The large increase in general government debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously. The estimation of debt level in 2015 assumes zero off-budget borrowing during 2015.

2/ Shanghai Stock Exchange, A-share.

3/ Includes foreign currency reserves and other reserve assets such as SDRs and gold.

Table 4. China: Monetary and Credit Developments

	2011	2012	2013	2014	2015	2016Q1
MONETARY SURVEY						
			(Annual percentage change)			
Net foreign assets	11.3	2.9	8.6	2.6	-2.7	-7.7
Monetary authority (contribution)	9.1	1.9	11.7	2.4	-8.6	-10.8
Depository institutions (contribution)	2.3	1.0	-3.1	0.3	5.9	3.1
Domestic credit	17.1	17.1	15.1	16.2	23.7	25.4
Claims on government, net (contribution)	1.3	1.2	-0.2	0.6	4.0	4.3
Claims on nonfinanical sectors (contribution)	13.4	13.6	12.7	11.4	13.8	12.8
Claims on other financial sectors (contribution)	2.4	2.3	2.6	4.1	5.9	8.2
Broad money (M2)	17.3	14.4	13.6	11.0	13.3	13.4
M1 (contribution)	3.2	2.2	2.9	1.0	4.3	5.8
Quasi-money (contribution)	14.1	12.2	10.7	10.0	9.0	7.6
Reserve money	21.2	12.3	7.4	8.5	-6.0	-4.2
TOTAL SOCIAL FINANCING						
			(Annual percentage change)			
TSF 1/	18.1	19.1	17.5	14.3	12.4	13.4
Bank loans (contribution)	12.1	11.5	10.0	9.2	8.8	9.1
Shadow banking (contribution)	3.1	4.0	5.1	2.3	0.6	0.6
Net corporate bond financing (contribution)	2.1	3.0	2.0	2.2	2.4	2.9
Non-financial enterprise equity (contribution)	0.7	0.3	0.2	0.4	0.6	0.7
Others (contribution)	0.2	0.2	0.2	0.2	0.0	0.0
			(In percent of GDP)			
TSF 1/	157.9	169.0	180.0	189.5	198.4	204.7
Bank loans	117.3	121.8	125.7	130.9	137.5	141.7
Shadow banking	23.0	26.4	31.7	33.1	31.8	32.2
Net corporate bond financing	10.7	13.8	15.6	18.0	21.0	22.5
Non-financial enterprise equity	6.0	5.8	5.6	5.9	6.5	6.8
Others	0.9	1.1	1.4	1.6	1.5	1.5
MEMORANDUM ITEMS						
			(In percent)			
Nonperforming loans ratio	1.0	1.0	1.0	1.3	1.7	1.8
Provision coverage ratio	278.1	295.5	282.7	232.1	181.2	175.0
Liquidity ratio	43.2	45.8	44.0	46.4	48.0	48.1
Loan to deposit ratio	64.9	65.3	66.1	65.1	67.2	67.0
Return on assets	1.3	1.3	1.3	1.2	1.1	1.2
Return on equity	20.4	19.9	19.2	17.6	15.0	15.9
Capital adequacy ratio	…	…	12.2	13.2	13.5	13.4
Tier 1 capital adequacy ratio	…	…	10.0	10.8	11.3	11.4
Core tier 1 capital adequacy ratio	…	…	10.0	10.6	10.9	11.0

Sources: Haver Analytics; and IMF staff estimates.

1/ After adjusting local government debt swap, staff estimate that TSF grew by 15.9 percent (y/y) and stood at 209.3 percent of GDP as of 2016Q1.

Table 5. China: General Government Fiscal Data

	In RMB billions	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
							Projections					
	Fiscal balance											
	Authorities' definition											
(1)	**Revenue 1/**	10537	12020	13036	14137	16027	15892	17421	18760	20190	21808	23553
(2)	**Expenditure 2/**	11387	12820	14276	15497	17647	18072	19930	21363	23012	24829	26841
(3)	**Fiscal balance (Authorities) (1)-(2)**	-850	-800	-1240	-1360	-1620	-2180	-2509	-2603	-2822	-3020	-3288
	In percent of GDP 3/	*-1.7*	*-1.5*	*-2.1*	*-2.1*	*-2.3*	*-2.9*	*-3.1*	*-3.0*	*-3.0*	*-3.0*	*-3.0*
	Staff estimates											
(4)	**Revenue**	13081	15016	16538	18158	19944	20735	22514	24114	25819	27728	29778
(5)	**Expenditure**	14234	16838	18651	20463	22995	24202	26247	27882	29740	31855	34181
(5a)	Authorities definition of expenditure	11387	12820	14276	15497	17647	18072	19930	21363	23012	24829	26841
	Of which: interest payment	*238*	*264*	*306*	*359*	*404*	*589*	*861*	*1145*	*1391*	*1492*	*1596*
(5b)	(+) Social security expenses	1888	2393	2862	3367	3936	4355	4529	4710	4898	5094	5298
(5c)	(+) Transfers to state-administered SOE fund	116	140	151	200	208	226	235	244	254	264	275
(5d)	(+) Adjustment for local government spending	200	250	0	0	0	0	0	0	0	0	0
(5f)	(+) Local government spending financed by net land sale proceeds 4/	1105	1459	1617	1717	1175	1220	1230	1250	1269	1370	1480
(5i)	(-) contribution to stabilization funds	289	25	116	82	70	70	77	85	93	102	113
(5j)	(-) Other adjustment 2/	173	200	138	237	-100	-400	-400	-400	-400	-400	-400
	General government net borrowing/lending (4)-(5)+(5f)	-47	-363	-497	-587	-1877	-2247	-2503	-2519	-2652	-2757	-2923
	(In percent of GDP)	*-0.1*	*-0.7*	*-0.8*	*-0.9*	*-2.7*	*-3.0*	*-3.1*	*-2.9*	*-2.9*	*-2.8*	*-2.7*
(6)	Fiscal balance (staff estimate) (4)-(5)	-1153	-1822	-2113	-2305	-3051	-3467	-3733	-3769	-3921	-4127	-4403
	(In percent of GDP)	*-2.4*	*-3.4*	*-3.5*	*-3.6*	*-4.4*	*-4.6*	*-4.7*	*-4.4*	*-4.2*	*-4.1*	*-4.1*
	Estimates of augmented balances											
(6)	Overall fiscal balance	-1153	-1822	-2113	-2305	-3051	-3467	-3733	-3769	-3921	-4127	-4403
(6a)	(-) Estimate of additional local government infrastructure spending financed by debt	2847	2395	4061	4072	3571	4050	4100	4205	4250	4308	4208
(7)	**Augmented balance**	-3999	-4217	-6175	-6377	-6623	-7517	-7833	-7974	-8171	-8435	-8611
	(In percent of GDP)	*-8.2*	*-7.8*	*-10.3*	*-9.8*	*-9.5*	*-10.1*	*-9.8*	*-9.3*	*-8.8*	*-8.4*	*-8.0*
	of which: interest payment on LGFV borrowings	*758*	*975*	*1161*	*1423*	*1557*	*1582*	*1518*	*1457*	*1471*	*1759*	*2051*
(5f)	(+) Net land sale proceeds 4/	1105	1459	1617	1717	1175	1220	1230	1250	1269	1370	1480
(8)	**Augmented net lending/borrowing 5/**	-2894	-2757	-4558	-4659	-5448	-6297	-6603	-6724	-6902	-7065	-7132
	(In percent of GDP)	*-6.0*	*-5.1*	*-7.6*	*-7.2*	*-7.8*	*-8.4*	*-8.2*	*-7.8*	*-7.4*	*-7.0*	*-6.6*
	General government debt											
(12)	Central government debt	7204	7757	8675	9566	10660	11657	13760	15879	18131	20488	22891
	In percent of GDP	*18.6*	*17.7*	*17.6*	*14.8*	*15.3*	*15.6*	*17.2*	*18.4*	*19.5*	*20.4*	*21.1*
(13)	Local government debt 6/	13249	15894	19955	24045	28217	33447	37947	42552	47202	51910	56638
(12)+(13)	**Augmented debt**	22273	25470	30450	33611	38877	45103	51707	58430	65332	72398	79529
	In percent of GDP	*45.8*	*47.1*	*51.0*	*51.8*	*55.8*	*60.4*	*64.5*	*67.8*	*70.4*	*72.2*	*73.5*
	General government debt (staff estimate) 7/	16081	18405	22045	25830	29885	34738	39951	45249	50710	56314	62018
	In percent of GDP	*33.1*	*34.0*	*36.9*	*39.8*	*42.9*	*46.5*	*49.9*	*52.5*	*54.6*	*56.2*	*57.3*
	General government debt (including only explicit government debt, assume no off-budget borrowing from 2015) 8/	7404	8207	9475	24966	26660	28837	31340	33859	36511	39268	42191
	In percent of GDP	*15.2*	*15.2*	*15.9*	*38.5*	*38.3*	*38.6*	*39.1*	*39.3*	*39.3*	*39.2*	*39.0*

Sources: CEIC, Data Co. Ltd.; China Ministry of Finance; NAO; and IMF staff estimates and projections.

1/ Includes central and local governments' withdrawal from budget stabilization funds.

2/ Includes adjustments for local government balance carried forward, redemption of local government bonds and government bond issued under government managed funds.

3/ GDP in this table refers to expenditure side nominal GDP.

4/ Net land sale proceeds refer to the portion used to finance current and infrastructure spending, which is estimated by subtracting the acquisition cost, compensation to farmers, and land development from the gross land sale proceeds.

5/ The overall net lending/borrowing includes net land sale proceeds as a decrease in nonfinancial assets recorded above the line.

6/ Includes local government bonds and other market financing through the use of local government financing vehicles (LGFVs).

7/ Staff estimates are based on the explicit debt and fractions (less than 19 percent according to the NAO estimate) of the government guaranteed debt and liabilities that the government may incur.

8/ Estimates of debt levels before 2015 include central government debt and explicit local government debt (identified by MoF and NPC in Sep 2015). The large increase in general government debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously. The estimation of debt levels after 2015 assumes zero off-budget borrowing from 2015 to 2021.

Table 6. China: Nonfinancial Sector Debt

<table>
<tr><th rowspan="2"></th><th colspan="2">(In RMB trillion)</th><th colspan="2">(In percent of GDP)</th><th colspan="4" rowspan="2">Coverage</th></tr>
<tr><th>2014</th><th>2015</th><th>2014</th><th>2015</th></tr>
<tr><td>Total</td><td>134</td><td>153</td><td>206</td><td>220</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Central government</td><td>10</td><td>11</td><td>15</td><td>15</td><td rowspan="4">MOF GG Debt</td><td rowspan="8">Staff GG Debt</td><td rowspan="11">Augmented Debt</td><td rowspan="3"></td></tr>
<tr><td>Local government</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Regular financing</td><td>1</td><td>2</td><td>2</td><td>2</td></tr>
<tr><td>Former LGFV debt 1/</td><td>14</td><td>14</td><td>22</td><td>21</td><td rowspan="11">Adjusted TSF excluding equity financing (= TSF - equity financing + LG bond swap)</td></tr>
<tr><td>Local government financing vehicles (LGFV)</td><td></td><td></td><td></td><td></td><td rowspan="11"></td></tr>
<tr><td>Likely to be recognized</td><td></td><td></td><td></td><td></td></tr>
<tr><td>As per the 2014 audit</td><td>1</td><td>1</td><td>1</td><td>1</td></tr>
<tr><td>New borrowing in 2015 (staff estimate) 2/ 3/</td><td>0</td><td>2</td><td>0</td><td>3</td></tr>
<tr><td>Unlikely to be recognized</td><td></td><td></td><td></td><td></td><td rowspan="7"></td></tr>
<tr><td>As per the 2014 audit</td><td>8</td><td>8</td><td>12</td><td>11</td></tr>
<tr><td>New borrowing in 2015 (staff estimate) 2/ 3/</td><td>0</td><td>1</td><td>0</td><td>2</td></tr>
<tr><td>Households</td><td>23</td><td>27</td><td>35</td><td>38</td><td rowspan="4">Private Sector Debt</td></tr>
<tr><td>Corporates (excluding LGFV)</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Domestic</td><td>73</td><td>84</td><td>113</td><td>120</td></tr>
<tr><td>External</td><td>4</td><td>4</td><td>6</td><td>6</td><td></td></tr>
<tr><td>Memo items:</td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Corporates (including LGFV)</td><td>86</td><td>100</td><td>133</td><td>144</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Households</td><td>23</td><td>27</td><td>35</td><td>38</td><td></td><td></td><td></td><td></td></tr>
<tr><td>General government (MOF definition)</td><td>25</td><td>27</td><td>39</td><td>38</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Nominal GDP</td><td>65</td><td>70</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

Sources: CEIC Data Co., Ltd.; Ministry of Finance and IMF staff estimates.

1/ LGFV debt recognized as LG debt as of 2014 (by the 2014 audit).

2/ New LGFV borrowing estimate for 2015 is based on infrastructure fixed asset investment data.

3/ Relative share of "likely to be recognized" new LGFV borrowing is based on the historical recognition ratio.

Appendix I. China: External Sector Report

		Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Gross foreign assets, at 56 percent of GDP by end-2015, are dominated by foreign reserves, while gross liabilities, at 41 percent of GDP, mainly represent FDI liabilities. Reserve assets fell to US$3.33 trillion by end-2015 and to US$3.19 by May 2016 (about 28.5 percent of 2015 GDP), from US$3.84 trillion at end-2014 (about 36.4 percent of 2014 GDP), due to net sales of reserve assets and valuation losses. Net IIP has declined from 15.2 percent of GDP in 2014 to 14.3 percent of GDP at end-2015; the ratio has been declining since the global financial crisis in light of the much-reduced current account (CA) surpluses, valuation changes, and still fast growth of GDP. **Assessment**. The NIIP to GDP ratio is expected to be close to 15 percent of GDP over the medium term, consistent with the CA surplus. The NIIP is not a major source of risk at this point, given the large foreign reserves and FDI-dominated liabilities. However, there is a possibility that capital outflow pressure could persist and reserves fall further.	**Overall Assessment**: *The external position in 2015 was moderately stronger compared with the level consistent with medium-term fundamentals and desirable policy settings.* The renminbi was broadly in line with fundamentals and desirable policies, although its assessment is subject to a high degree of uncertainty. Developments through June 2016 do not suggest a change in this assessment. The assessment of the external position reflects still-large policy gaps that affect the saving-investment imbalance, such as social spending. The uncertainties about the assessment of renminbi reflect factors outside the models such as shifts in expectations and the nature of recent capital flows. **Potential policy responses**: External imbalances have declined considerably since the global financial crisis. Achieving a lasting balance in the external position—will require continued progress in closing the remaining domestic policy gaps. Success will move the economy to a more sustainable growth path, with higher consumption and lower overall saving. This can be achieved through successful implementation of the authorities' reform agenda as well as consistent macroeconomic policies. Priorities include improving the social safety net; increasing on-budget fiscal support; SOE reform and opening markets to more competition; creating a more market-based financial system; and achieving a flexible, market-based exchange rate with a better communication strategy. Continuing the move toward a more market-based and transparent monetary policy framework is a key element in ensuring an orderly transition to a float, which may also require use of foreign exchange reserves to some degree to smooth excessive volatility not justified by fundamentals.
Current account	**Background**. The CA surplus in 2015 was 3.0 percent of GDP (3.0 percent of GDP cyclically adjusted), which was about 0.3 percent of GDP higher than 2014. The increase of the CA surplus was mainly due to weak real import growth and favorable terms of trade (the gain was about 1 percent of GDP in 2015), and occurred despite sizeable REER appreciation and a rise in outward tourism. In a longer perspective, the CA surplus has fallen substantially relative to its peak of about 10 percent of GDP in 2007, reflecting strong investment growth, REER appreciation, weakness in major advanced economies, and, more recently, a trend widening of the services deficit. **Assessment**. The EBA CA regression approach estimates that the cyclically-adjusted CA is stronger (by about 2.4 percent of GDP) than consistent with medium-term fundamentals and desirable policies. While the estimated total policy gap has declined substantially, mainly driven by the change in FX intervention, fiscal policy, social spending and credit growth gaps remain. The total gap is mostly driven by the residual, reflecting factors not captured by EBA, including distortions that encourage excessive savings. There is also large uncertainty about China's cyclical position. As a result, staff assesses the CA gap is 1-3 percent of GDP stronger than implied by fundamentals and desirable policies. 1/	
Real exchange rate	**Background**. In 2015, the average REER appreciated by about 10 percent relative to the 2014 average, mainly driven by the appreciation in the NEER, and reflecting the link to the US dollar. Through June 2016, again driven by the change of NEER, the REER has depreciated by 6 percent relative to its 2015 average. 2/ **Assessment**. The EBA REER index regression estimates China's REER to be 3.9 percent stronger than levels warranted by fundamentals and desirable policies. This gap (as well as the minus 0.1 percent policy gap) is small relative to the statistical errors of EBA regressions, suggesting that the REER is broadly in line with fundamentals and desirable policy settings. However, this assessment is subject to large uncertainties. This is because the EBA framework, with its focus on factors underlying the savings-investment balance, does not capture other factors potentially affecting demand for a country's assets, such as diverging market views on the outlook and shifts in portfolio allocation preferences. 3/ Overall, staff assesses the REER to be -10 to +10 percent different from the level consistent with fundamentals and desirable policies.	
Capital and financial accounts: flows and policy measures	**Background**. In the past year, China has liberalized its financial account further, including the granting of onshore access to official sector investors. China's financial account has been relatively open in FDI and other investment. Nonetheless, restrictions remain, particularly with respect to portfolio flows. After a long period of net capital inflows (averaging US$80 billion per year over 2000-14), the financial account recorded a net outflow of US$673 billion in 2015. Net direct investment flows remained positive—at US$ 62 billion—but well below the 2000-14 average (US$114 billion). The large deficit in errors and omissions are included as capital outflows as they are likely to be unrecorded capital rather than current account transactions. **Assessment**. Over the medium term, a well-sequenced loosening of capital controls consistent with domestic financial liberalization and exchange rate flexibility would be appropriate. The further opening of the capital account is likely to lead to sizable gross flows in both directions. The adjustment path is hard to predict, and equilibrating such balance sheet adjustments and shifts in market sentiment argues for moving to a flexible exchange rate as soon as practical, while also using foreign reserves to a limited degree in the interim to smooth excessive volatility not justified by fundamentals.	

FX intervention and reserves level	**Background**. After a long period of reserve accumulation, FX reserves declined by US$513 billion (4.6 percent of GDP) in 2015, of which intervention accounted for about US$342 billion (3.1 percent of GDP). FX reserves further declined by US$139 billion to US$3.19 trillion (about 28.5 percent of 2015 GDP) at end-May 2016. **Assessment.** Reserves stood at 118 percent of the IMF's composite metric unadjusted for capital controls at end-2015 (down from 149 percent in 2014); relative to the metric adjusted for capital controls, reserves stood at 190 percent (down from 238 percent in 2014). Given China's progress in capital account liberalization, the appropriate metric is shifting toward the one unadjusted for capital controls. By any metric, the current reserve level thus remains adequate, although the rapid decrease of reserves since August, if continued, could alter this assessment.		
Technical Background Notes	1/ The total CA gap from EBA is 2.4 percent of GDP for 2015, smaller than the gap in 2014 (3.1 percent of GDP). The contribution of identified total policy gaps is minus 0.3 percent of GDP (versus 1.8 percent of GDP in 2014), but individual policy gaps remain in health expenditure, fiscal policy, FX intervention and capital controls. The EBA REER Index model estimates a total REER gap of 3.9 percent, with identified policy gaps of minus 0.1 percent. The EBA REER Level model estimates a total REER gap of 16.3 percent, with identified policy gaps of 2.9 percent. However, that estimate is discarded from consideration, as the model fit of the EBA Level model is very poor for China. 2/ In August 2015, the PBC required market makers to submit quotes that take account of the closing (onshore) spot rate of the previous day as well as supply and demand in the market, for determining the central parity of the +/-2 percent trading band that it announces before the market opens. Previously, market makers were supposed to quote to the PBOC exchange rates based on their sense of the market in the morning, an opaque system that allowed substantial discretion and, in practice, resulted in the central parity barely moving from day to day, even though the market rate had often closed at some distance from it the previous day. 3/ For example, changing expectations about monetary and exchange rate policy, re-evaluation of a government's reform agenda, or a desire by residents to diversity into foreign assets can trigger large changes in capital flows and exchange rate pressures, even in the absence of significant changes in fundamentals as captured by EBA (GDP growth, employment, etc). China currently appears to have recently experienced such capital account pressures on the exchange rate that are not well explained by the EBA framework.		

Appendix II. Debt Sustainability Analysis

Because of uncertainty about the size of contingent liabilities, the debt sustainability analysis assesses government debt under narrow and broad definitions. While government debt under the narrow definition remains low and sustainable, "augmented" debt (broad definition) is on a slight upward trajectory in the baseline. The risk of debt stress depends on the implementation of the new budget law, which aims to curb off-budget spending of local governments.

China's public debt sustainability analysis (DSA) is based on the following assumptions:

- **Public debt coverage**. Two definitions of government debt are used. The main difference is the coverage of local government debt.

    - The narrow coverage scenario includes central government debt and "on-budget" local government debt identified by the authorities. For 2004–13, general government debt includes central government debt and local government bonds (issued by the central government). From 2014, general government debt includes central government debt and explicit local government debt (which consists of local government bonds and other off-budget liabilities incurred by end-2014). The change of definitions in 2014 is mainly a result of the change of official data coverage.

    - "Augmented" debt is used in the broad coverage scenario. It adds other types of local government borrowing, including off-budget liabilities (explicit or contingent) borrowed by Local Government Financing Vehicles (LGFVs) via bank loans, bonds, trust loans and other funding sources, estimated by staff. The augmented deficit is the flow counterpart of augmented debt. Augmented fiscal data are a complement to general government data. Since some nongovernment activity is likely included, the augmented debt and deficit estimates should be viewed as an upper bound.

- **Macroeconomic assumptions:**

The projection reflects a gradual slowdown of real GDP growth to a more sustainable level (about 6 percent y/y by 2021) and GDP deflator of about 2 percent. The fiscal assumptions differ in the scenarios with general government debt or augmented debt.

- *Fiscal balance in the narrow coverage scenario*. Because only on-budget liabilities are included in this scenario, the projected fiscal deficits are the same as the projected on-budget deficits. This will only be the case if the new budget law is strictly implemented and all spending is on budget. In particular, the fiscal deficits are assumed to decline from around 3 percent of GDP in 2016 and 2017 (reflecting the fiscal support for restructuring the overcapacity industries) to around 2¾ percent of GDP in 2021.

- *Fiscal balance in the broad coverage scenario*. The decline of off-budget local government spending is assumed to be gradual (instead of being immediate, as in the narrow coverage scenario). The augmented fiscal deficit, which includes the on-budget fiscal deficit and off-budget spending financed by land sales revenue and debt, is projected to decline from around 10 percent of GDP in 2016 to around 8 percent of GDP by 2021. The local government expenditure to GDP ratio is projected to decline owing to: (i) lower expenditure financed by net land sales; and (ii) the authorities' reforms to limit local government borrowing.

- *Local government financing.* While many local governments relied on net revenue from land sales and LGFV borrowing to finance their investment in the past, the DSA assumes that future financing needs will be increasingly met by bond issuance, in line with the authorities' plan to replace all local government debt with bonds within three years.

- *Interest rates and amortization.* The interest rates for central government and local government bonds are assumed to be about 3–4 percent (in line with historical average). The interest rates of off-budget borrowing (only in the augmented scenario) are assumed to be about 6–7 percent (based on the yield differential between sovereign bond and LGFV bond). The amortization profile is not central to the analysis because we assume all maturing debt will be rolled over.

In the narrow coverage scenario, general government debt is on a declining path.

- General government debt under narrow coverage is broadly stable at around 39-40 percent of GDP over the projection period. Off-budget local government spending is assumed to stop immediately after the implementation of the new budget law in 2015. The growth-interest rate differential contributes to the decline of debt-to-GDP ratio.

- It should be noted that the general government debt-to-GDP ratios (under the narrow coverage) are higher than that in the 2015 DSA. This is because the authorities included the off-budget local government debt borrowed before end-2014 into the official statistics since September 2015.

But in the broad coverage scenario, debt continues to rise.

- Augmented debt, however, rises to about 74 percent of GDP in 2021 from around 55 percent of GDP in 2015. This is because the broad coverage scenario assumes that local government off-budget spending continues after 2015 (although expected to gradually decline in the medium term). It should be noted, however, the augmented debt measures an "upper bound" of the government liabilities, because some of the LGFV borrowing is potentially on a commercial basis (thus should not be treated as government liabilities).

China faces relatively low risks to debt sustainability, but is vulnerable to contingent liability shocks.

- In the narrow coverage scenario, general government debt remains relatively low and on a stable path in all standard stress tests except for the scenario with contingent liability shocks. A contingent liability shock in 2017 will result in a sharp increase from about 40 percent of GDP in 2015 to about 64 percent of GDP in 2018.[1] While the debt level is still manageable, the authorities would potentially have to deal

[1] Mechanically, the standard contingent liability shock in IMF DSA toolkit assumes that 10 percent of banking system assets stock would turn into government liabilities. The banking system assets stock was about 210 percent of GDP in 2015. It also assumes that the real GDP growth in 2017 and 2018 would be 2–2.5 percent lower.

with an increase in gross financing needs that could be sensitive to market financing conditions. Without any extra fiscal consolidation, the debt-to-GDP ratio will stay around 66 percent of GDP over the medium term under a contingent liability shock. In the broad coverage scenario, the augmented debt level is also sensitive to a contingent liability shock (beyond those already captured in the broader coverage), which would push debt to around 100 percent of GDP in 2021.

China's debt profile will largely depend on the implementation of the new budget law.

- Based on the projected debt dynamics under the narrow coverage, China's debt profile is still manageable, especially given most of the public debt stock is financed domestically.

- However, the debt profile crucially depends on the implementation of the new budget law, as it determines whether the debt dynamics will be closer to the narrow coverage scenario or broad coverage scenario. If the new budget law is strictly implemented and future LGFV borrowing will be completely on a commercial basis, the debt-to-GDP will be stable around 40 percent of GPD. However, if local governments still incur off-budget liabilities,[2] the debt profile will move closer to that in the broad coverage scenario and the debt-to-GDP ratio will continue to rise in the medium term.

[2] This can happen in many forms. For example, the National Development and Reform Commission recently launched a special fund for financing local investment and local entities can use it to leverage more borrowing from commercial banks. If local governments are eventually held responsible for the repayment, it could potentially be a substitute of the LGFV borrowing observed in the past.

China: Public Sector Debt Sustainability Analysis (General Government Debt Under Narrow Coverage)

(In percent of GDP, unless otherwise indicated)

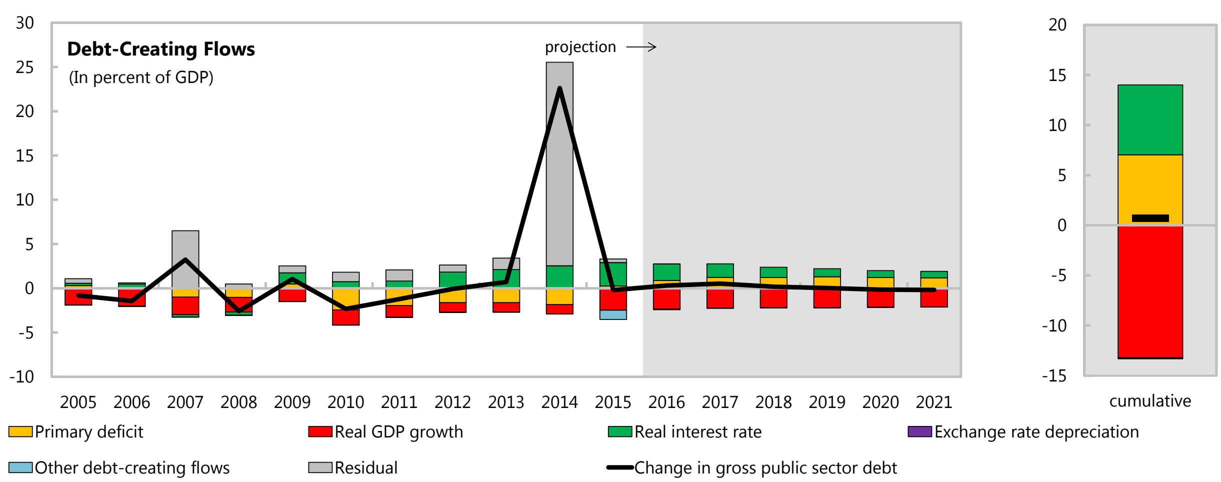
Debt, Economic, and Market Indicators 1/

	Actual			Projections					
	2005-2013 2/	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	17.2	38.5	38.3	38.6	39.1	39.3	39.3	39.2	39.0
Public gross financing needs	9.5	10.6	10.2	12.9	11.2	10.9	10.2	3.8	3.7
Real GDP growth (in percent)	10.3	7.3	6.9	6.6	6.2	6.0	6.0	5.9	5.8
Inflation (GDP deflator, in percent)	4.8	1.2	0.4	0.7	0.9	1.4	1.6	2.0	2.1
Nominal GDP growth (in percent)	15.6	8.6	7.4	7.3	7.2	7.5	7.7	8.0	8.0
Effective interest rate (in percent) 4/	10.6	18.8	6.8	6.0	5.3	4.7	4.3	4.2	4.2

As of June 12, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		138
5Y CDS (bp)		126
Ratings	Foreign	Local
Moody's	Aa3	Aa3
S&Ps	AA-	AA-
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	Cumulative	Debt-stabilizing primary balance 9/
Change in gross public sector debt	-0.4	22.6	-0.2	0.3	0.5	0.2	0.0	-0.2	-0.2	0.7	
Identified debt-creating flows	-1.8	-0.4	-0.6	0.3	0.5	0.2	0.0	-0.2	-0.2	0.7	
Primary deficit	-1.0	-1.8	0.2	0.9	1.2	1.2	1.3	1.2	1.2	7.0	-1.4
Primary (noninterest) revenue and grants	22.8	28.0	28.6	27.8	28.1	28.0	27.8	27.7	27.5	166.8	
Primary (noninterest) expenditure	21.8	26.2	28.9	28.6	29.3	29.2	29.1	28.9	28.7	173.9	
Automatic debt dynamics 5/	-0.8	1.5	0.2	-0.5	-0.7	-1.0	-1.3	-1.4	-1.4	-6.2	
Interest rate/growth differential 6/	-0.8	1.5	0.2	-0.5	-0.7	-1.0	-1.3	-1.4	-1.4	-6.2	
Of which: real interest rate	0.8	2.6	2.6	1.9	1.5	1.2	0.9	0.8	0.7	7.0	
Of which: real GDP growth	-1.6	-1.1	-2.5	-2.3	-2.2	-2.2	-2.2	-2.1	-2.1	-13.2	
Exchange rate depreciation 7/	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	-1.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
Net privatization proceeds (negative)	0.0	0.0	-1.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	1.4	23.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data. The large increase in public debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period. The large residual in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed by end-2014.

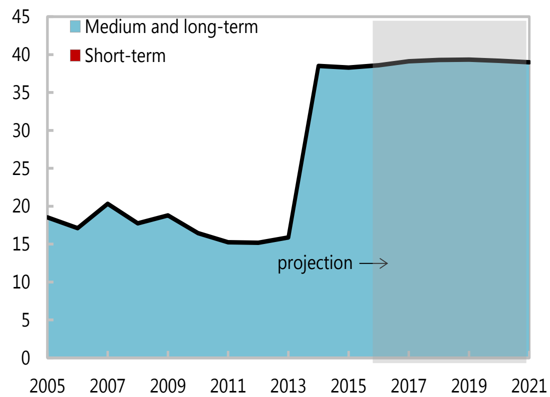
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

China: Public DSA—Composition of General Government Debt (Narrow Coverage) and Alternative Scenarios

Composition of Public Debt 1/

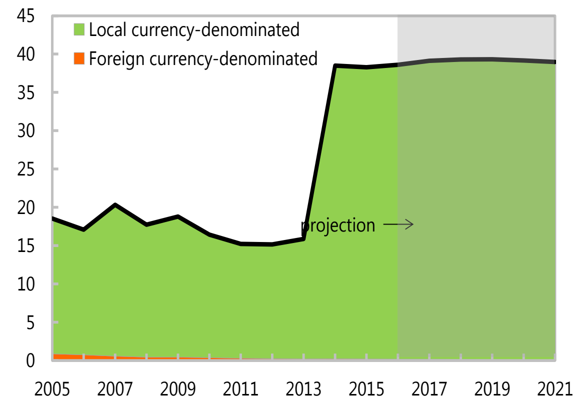
By Maturity

(In percent of GDP)



By Currency

(In percent of GDP)

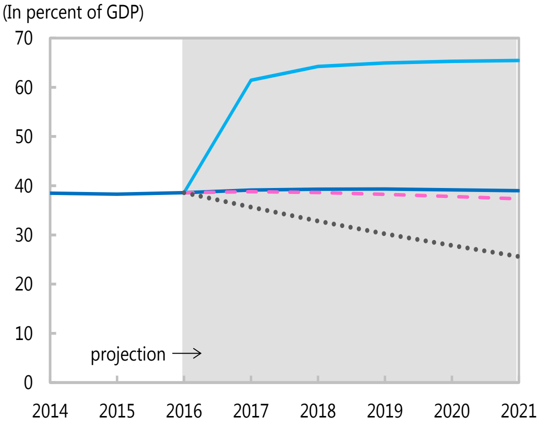


Alternative Scenarios

Baseline
Historical
Constant primary balance
Contingent liability shock

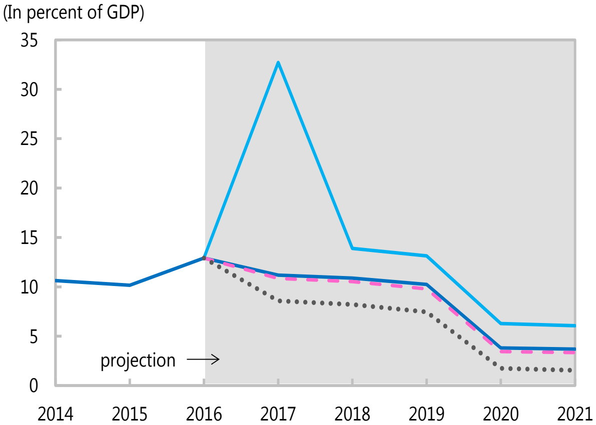
Gross Nominal Public Debt

(In percent of GDP)



Public Gross Financing Needs

(In percent of GDP)



Underlying Assumptions

(In percent)

Baseline scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	6.6	6.2	6.0	6.0	5.9	5.8
Inflation	0.7	0.9	1.4	1.6	2.0	2.1
Primary balance	-0.9	-1.2	-1.2	-1.3	-1.2	-1.2
Effective interest rate	6.0	5.3	4.7	4.3	4.2	4.2
Constant primary balance scenario						
Real GDP growth	6.6	6.2	6.0	6.0	5.9	5.8
Inflation	0.7	0.9	1.4	1.6	2.0	2.1
Primary balance	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Effective interest rate	6.0	5.3	4.7	4.3	4.2	4.2

Historical scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	6.6	9.6	9.6	9.6	9.6	9.6
Inflation	0.7	0.9	1.4	1.6	2.0	2.1
Primary balance	-0.9	1.1	1.1	1.1	1.1	1.1
Effective interest rate	6.0	5.3	5.7	6.2	7.0	7.2
Contingent liability shock 2/						
Real GDP growth	6.6	3.9	3.7	6.0	5.9	5.8
Inflation	0.7	0.3	0.8	1.6	2.0	2.1
Primary balance	-0.9	-22.2	-1.2	-1.3	-1.2	-1.2
Effective interest rate	6.0	6.0	7.2	6.7	6.5	6.3

1/ The large increase in public debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously.

2/ The contingent liability shock scenario also assumes that 10 percent of banking assets would turn into government liabilities.

China: Public Sector Debt Sustainability Analysis (Broad Coverage Scenario)

(In percent of GDP unless otherwise indicated)

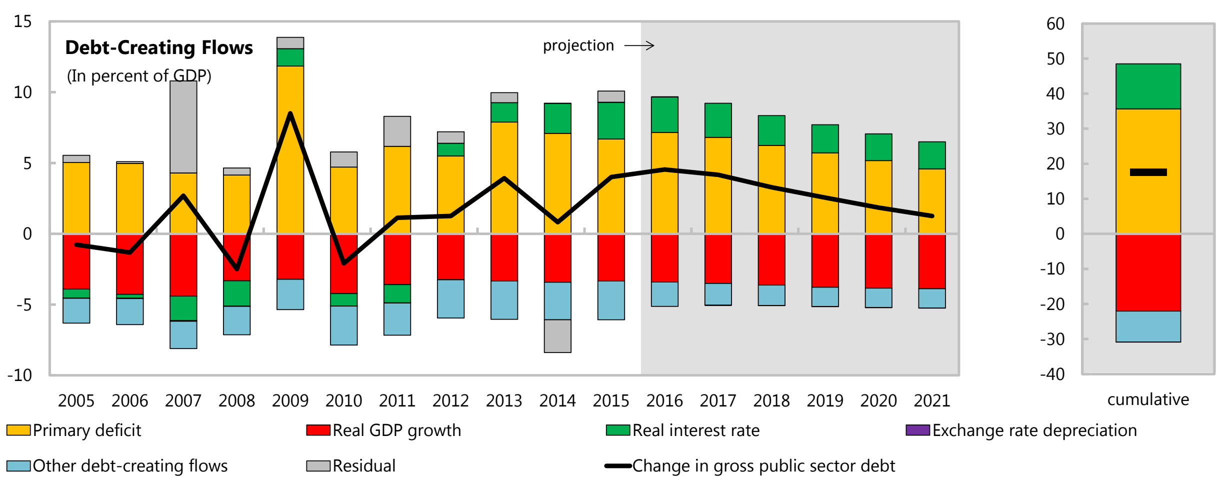
Debt, Economic, and Market Indicators 1/

	Actual			Projections					
	2005-2013 2/	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	43.5	51.8	55.8	60.4	64.5	67.8	70.4	72.2	73.5
Public gross financing needs	19.0	19.6	17.0	20.0	17.8	17.2	16.2	9.5	8.9
Real GDP growth (in percent)	10.3	7.3	6.9	6.6	6.2	6.0	6.0	5.9	5.8
Inflation (GDP deflator, in percent)	4.8	1.2	0.4	0.7	0.9	1.4	1.6	2.0	2.1
Nominal GDP growth (in percent)	15.6	8.6	7.4	7.3	7.2	7.5	7.7	8.0	8.0
Effective interest rate (in percent) 4/	4.2	5.9	5.8	5.6	5.3	5.0	4.9	5.0	5.0

As of June 12, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		138
5Y CDS (bp)		126
Ratings	Foreign	Local
Moody's	Aa3	Aa3
S&Ps	AA-	AA-
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	Cumulative	Debt-stabilizing primary balance 9/
Change in gross public sector debt	1.2	0.8	4.0	4.5	4.2	3.3	2.6	1.8	1.3	17.6	-3.3
Identified debt-creating flows	-0.3	3.1	3.2	4.5	4.2	3.3	2.6	1.8	1.3	17.6	
Primary deficit	6.1	7.1	6.7	7.2	6.8	6.2	5.7	5.2	4.6	35.7	
Primary (noninterest) revenue and grants	22.8	28.0	28.6	27.8	28.1	28.0	27.8	27.7	27.5	166.8	
Primary (noninterest) expenditure	28.8	35.1	35.3	34.9	34.9	34.2	33.5	32.8	32.1	202.5	
Automatic debt dynamics 5/	-4.1	-1.3	-0.7	-0.9	-1.1	-1.5	-1.8	-2.0	-2.0	-9.2	
Interest rate/growth differential 6/	-4.1	-1.3	-0.7	-0.9	-1.1	-1.5	-1.8	-2.0	-2.0	-9.2	
Of which: real interest rate	-0.3	2.1	2.6	2.5	2.4	2.1	2.0	1.9	1.9	12.8	
Of which: real GDP growth	-3.7	-3.4	-3.3	-3.4	-3.5	-3.6	-3.8	-3.8	-3.9	-22.0	
Exchange rate depreciation 7/	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-2.2	-2.6	-2.7	-1.7	-1.5	-1.5	-1.4	-1.4	-1.4	-8.8	
Net privatization proceeds (negative)	-2.2	-2.6	-2.7	-1.7	-1.5	-1.5	-1.4	-1.4	-1.4	-8.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	1.5	-2.3	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

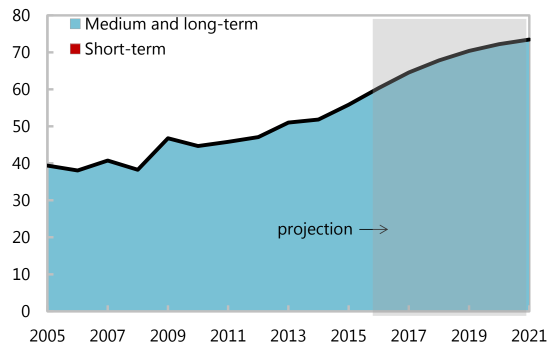
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

China: Public DSA—Composition of Augmented Debt and Alternative Scenarios

Composition of Public Debt

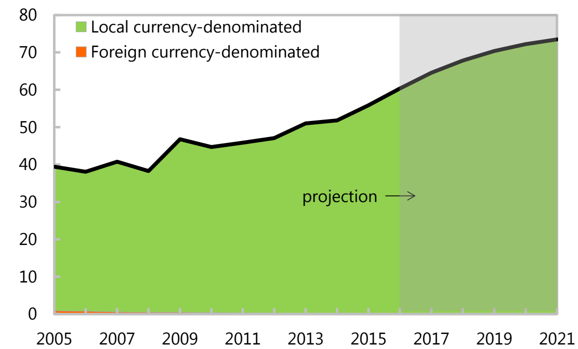
By Maturity

(In percent of GDP)



By Currency

(In percent of GDP)

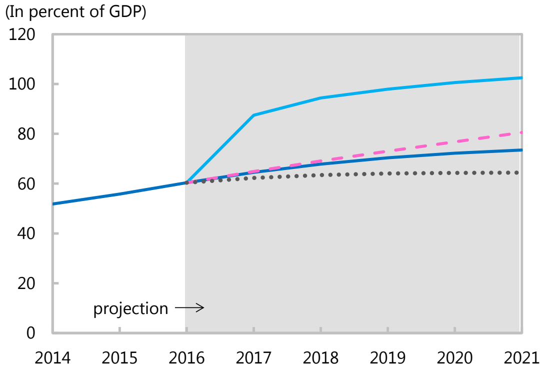


Alternative Scenarios

Baseline
Historical
Constant primary balance
Contingent liability shock

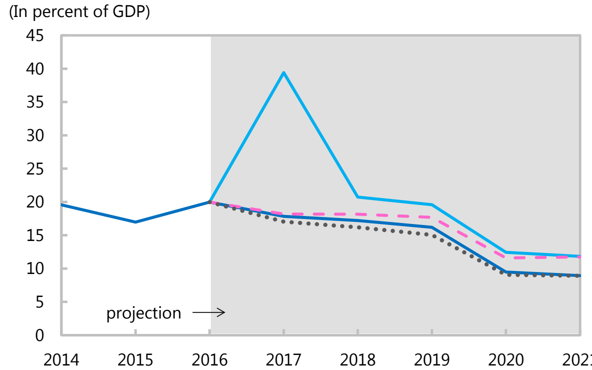
Gross Nominal Public Debt

(In percent of GDP)



Public Gross Financing Needs

(In percent of GDP)



Underlying Assumptions

(In percent)

Baseline scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	6.6	6.2	6.0	6.0	5.9	5.8
Inflation	0.7	0.9	1.4	1.6	2.0	2.1
Primary balance	-7.2	-6.8	-6.2	-5.7	-5.2	-4.6
Effective interest rate	5.6	5.3	5.0	4.9	5.0	5.0
Constant primary balance scenario						
Real GDP growth	6.6	6.2	6.0	6.0	5.9	5.8
Inflation	0.7	0.9	1.4	1.6	2.0	2.1
Primary balance	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2
Effective interest rate	5.6	5.3	5.0	4.9	5.0	5.1

Historical scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	6.6	9.6	9.6	9.6	9.6	9.6
Inflation	0.7	0.9	1.4	1.6	2.0	2.1
Primary balance	-7.2	-6.3	-6.3	-6.3	-6.3	-6.3
Effective interest rate	5.6	5.3	4.3	3.6	3.1	3.0
Contingent Liability Shock 1/						
Real GDP growth	6.6	3.9	3.7	6.0	5.9	5.8
Inflation	0.7	0.3	0.8	1.6	2.0	2.1
Primary balance	-7.2	-27.8	-6.2	-5.7	-5.2	-4.6
Effective interest rate	5.6	5.7	7.3	6.9	6.8	6.7

1/ The contingent liability shock scenario also assumes that 10 percent of banking assets would turn into government liabilities.

Appendix III. China: Risk Assessment Matrix 1/

Likelihood	Impact	Policy Response
	Upside	
	High	
Low	**1. Faster-than-anticipated implementation of reforms.** Faster implementation of reforms, especially on corporate debt restructuring, SOE governance and eliminating implicit guarantees, can help address vulnerabilities and rebalance the economy toward more sustainable growth.	
	Low	
Medium	**2. Stronger-than-anticipated stimulus.** The recent stimulus measures may either have a larger impact on the economy, for example, if real estate investment picks up significantly, or additional stimulus measures could be undertaken. Both would increase near-term growth prospects (though likely reduce medium-term growth prospects and increase vulnerabilities).	
	Downside	• Tackle the corporate debt problem • More sustainable macro policies (especially credit). Use on-budget, pro-consumption fiscal stimulus if growth threatens to fall excessively. • Guard against financial risks, enhance crisis preparedness. • Move, flexibly, to effectively floating exchange rate regime, but intervene to avoid excessive volatility. • Improve communications.
	Medium	
High/ Medium	**1. Structurally weak growth in key advanced and emerging economies.** Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persistent financial imbalances in the euro area and Japan. The end of easy global financial conditions and insufficient reform progress undermine medium-term growth in emerging markets and suppress commodity prices. The weak growth in key advanced and emerging economies is likely to be a drag on China's export growth. **2. UK / EU:** in the event of significant impact on EU activity, the adverse effect on China's exports and growth could be material.	
	High	
Low	**3. Short-term risks:** a loss of investor confidence, a wave of disorderly corporate defaults, a sharp fall in asset prices, and a quicker fading of the stimulus impact. These could be amplified by the financial system, with renewed capital outflows and exchange rate pressure.	
	High	
Medium	**4. Medium-term risks:** slow progress on reform and continued reliance on policy stimulus and unsustainable credit growth, would add to vulnerabilities, worsen resource misallocation, and lead to permanently lower growth.	

1/The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Nonmutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Appendix IV. Implementation of Main Recommendations from the 2010–11 FSAP for China

The authorities have made steady progress since the 2015 Article IV Consultation in advancing implementation of the high priority recommendations from the 2010–11 Financial Sector Assessment Program (FSAP). A number of market-oriented reforms have been introduced focusing on interest rate and foreign exchange market liberalization. Interest rate reform has focused on relaxing the constraints of interest rate ceilings. Most importantly, the ceiling of renminbi deposit interest rates has been abolished. The efficiency of institutions and the regulatory framework has been enhanced by greater interdepartmental collaboration and a comprehensive restructuring of the banking regulator aimed at boosting regulatory capacity. The authorities strengthened the financial stability and liquidity framework by introducing the Macroprudential Assessment (MPA) and expanding stress test coverage. Efforts to build a representative yield curve continued with more regular issuance of bonds across maturities.

Main FSAP Recommendations	**Priority**	**Timeframe**	**Measures Adopted** 1/
Accelerating Market-oriented Reforms			
1. China should continue to carry out reforms on interest and exchange rates, while ensuring that financial institutions are able to provide appropriate credit risk management.	High	MT	**Market-oriented Interest Rate Reform** • **Basic lifting of interest rate controls.** On August 26, 2015, caps for floating rate term deposits with terms of a year or more were lifted. On October 24, 2015, ceilings for term deposits were cancelled, indicating that interest rate controls had officially been liberalized. • **Systematic acceleration of financial product innovation.** In June 2015, certificates of deposit were issued for enterprises and individuals. The range of market-oriented fixed prices for commercial bank debt products continued to expand. **Exchange Rate Formation Mechanism Reform** • On August 11, 2015, PBC completed the RMB's central parity exchange rate quotation mechanism. This strengthened the degree of marketization and the benchmark for RMB's central parity exchange rate against the U.S. dollar. • On December 11, 2015, the China Foreign Exchange Trading Center (CFETS) officially issued the CFETS RMB Exchange Rate Index, which emphasizes the need to increase efforts to reference a basket of currencies. • Since February 2016, initial steps were taken to develop the formation mechanism for the RMB's central parity exchange rate against the US dollar based on "closing exchange rates + exchange rate changes for a basket of currencies." **Credit Risk Management** • In June 2015, the China Banking Regulatory Commission (CBRC) issued the *Notice Concerning Strengthening Customer Risk Information Sharing* (CBRC No. 95 [2015]), which increased customer risk information sharing efforts, expanded the scope of information sharing, enhanced information applicability, and guided credit risk prevention. • In May 2016, the CBRC issued *Notice Concerning Further Strengthening the Integrity of the Banking Industry* (CBRC No. 89 [2016]), which improved public announcements for credit information, sharing, and application. It also strengthened the integrity for the banking industry by completing the joint work on the design of penalty for financial dishonesty activities.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
2. Clear distinction should be made between the role and function of policy financial institutions and commercial financial institutions.	Medium	MT	• Reform plans were approved for China Development Bank, China Export and Import Bank, and the Agricultural Development Bank of China. The reform programs for these three banks underscored the orientation and function of each respective bank. China Development Bank is to exercise development functions, while reforms for China Export and Import Bank and China Agricultural Development Bank are to strengthen policy functions.
3. The four asset management companies should be transformed into commercial entities. As a first step, they will be required to regularly publish financial statements and management reports.	Medium	MT	• China Huarong Asset Management Company was listed on the Hong Kong Stock Exchange in October 2015. • China Great Wall Asset Management Corporation and China Orient Asset Management Corporation are proactively advancing commercial reform and transformation.
Improving the Efficiency of Institutions and the Regulatory Framework			
4. The PBC and the three regulatory commissions should be given specialized mandates, operational autonomy and flexibility. They must also have adequate capital and skilled personnel, with increased interdepartmental collaboration, in order to address the challenges to the financial sector brought on by rapid development.	High	MT	• Concerning cross-sector cooperation, the Joint Ministerial Conference on Financial Regulation has convened twelve times on over 50 research and discussion topics. While furthering financial reform, improving the coordination and cooperation of macro and financial regulation, and increasing financial risk prevention in key areas, the conference defined regulations for aspects such as cross-market, cross-sector financial innovation. It introduced or established a series of policies and institutional arrangements that enhanced the effectiveness of financial service entities, facilitated the standardized development of emerging financial industry trends, and held firmly to its bottom line—preventing systemic or regional financial risks.
5. A regulatory framework should be set up for financial holding companies, financial group companies and informal financial enterprises. During the transition period, any M & A activity by the regulated institutions must be approved by their respective regulatory commission.	Medium	NT	• No updates.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
6. A more forward-looking assessment of credit risk should be practiced within the CBRC's risk rating system, in order to eliminate any gaps with regular credit risk ratings and the market risk capital framework.	Medium	NT	● On December 29, 2015, the CBRC issued a revised *Interim Measures for Offsite Regulations*. This document clarifies that regulatory ratings should be judicious while striving to make sound judgments and prudent forecasts. It also requires the consideration of "loan amounts and their growth rates, overdue amounts, nonperforming amounts, classifications, and losses as well as development trends" when issuing credit risk ratings in order to fully integrate the forward-looking requirements of regulatory ratings. ● The authorities focused on the systemic importance of large banks. In addition to the *Internal Guidelines on Regulatory Ratings of Commercial Banks*, the CBRC also has a specialized indicator system for large banks (CARPALS indicator system for large banks) that boosted the focus and efficiency of risk monitoring for large banks. Currently, the CBRC is researching how to further enhance the forward-looking nature of credit risk indicators in order to better project loan risks for large banks, to more effectively portray loan quality issues, and to continue becoming increasingly future-oriented in reflecting trends in risk for large banks and to transition away from static monitoring indicators toward dynamic monitoring indicators.
7. A formal mechanism should be put in place for the Chinese Securities Regulatory Commission (CSRC) to conduct regular on-site inspections of securities exchanges for enhanced oversight.	Medium	NT	● In 2015, the China Securities Regulatory Commission (CSRC) took steps to formulate a program for inspecting futures exchanges. The program intends to inspect items such as daily operations and maintenance, frontline regulation, and the processing of violations.
8. A risk capital solvency regime should be instituted for insurers, with an appropriate transitional period, that will prohibit insurance companies from developing new business if their solvency level is lower than 100%.	Medium	MT	● On January 1, 2016, the China Insurance Regulatory Commission (CIRC) formally implemented 17 rules for the Chinese Risk-oriented Solvency System (hereafter abbreviated as the "Solvency II") while also introducing a new data system. Insurance companies submitted solvency reports in accordance with the Solvency II regulatory rules.
9. Clear and transparent regulations should be developed to facilitate the exit from market by insurance companies through termination at expiration or through transfer of assets.	Medium	NT	● No updates.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
10. A law governing payment systems should be developed to provide comprehensive protection of the finality of payments and the settlement of derivatives and securities contracts.	Medium	MT	• PBC is currently developing the *Payment and Settlement Regulations*. Preliminary studies were completed, and legislative proposals from market institutions have been collected. *Payment and Settlement Regulations* are listed as a research item for the 2016 State Council Legislative Work Plan. • Currently, revisions to *Securities Law* and *Futures Law* are underway. These laws contain content from regulations for the settlement of securities and derivatives pertaining to transaction finality and net settlements. In addition, PBC continues to promote the development of administrative regulations for financial infrastructure that also covers the finality of settlements and other issues.
11. It is imperative that information on beneficial ownership and control is sufficient and accurate and that such information is available to the competent authorities.	High	MT	• No updates.
12. Information sharing and collaborative arrangements must be improved between the PBC and other relevant agencies on anti-money laundering (AML) and other regulatory issues.	High	MT	• China established the Ministerial Joint Conference on Anti-Money Laundering (AML). Comprised of twenty-three ministries and commissions, the joint conference directs all of China's AML efforts and develops China's major AML objectives and policies. It formulates national AML policy measures for international cooperation and coordinates the commencement of AML by all twenty-three members and commissions. On July 24, 2015, the eighth inter-ministerial meeting was held to discuss how to improve cooperation between the joint conference members among other issues.
Framework for Enhancing Financial Stability, Systemic Risk Monitoring, System Liquidity, and Crisis Management			
13. The establishment of the Financial Stability Board, with the PBC as its secretariat.	High	MT	• No updates.
14. Improved data collection on financial institutions, including their leverage, liabilities, off-balance sheet positions, unregulated products and cross-border and sectoral exposures.	Medium	NT	• PBC has advanced the construction of a robust statistical infrastructure. It further improved its macroprudential policy framework. In 2015, the PBC altered the verification algorithm for its financial statistics monitoring and management information system to improve system validation mechanisms. It also increased the robustness of the system's ability to use CONGNOS for multidimensional analysis. • **Improving related statistical systems.** In order to accurately assess the impact of financial institution off-balance sheet products on monetary policy, the authorities provided effective tools. (1) In 2016, PBC amended and made improvements to the off-balance sheet business statistical system, which includes indicators for both off-balance sheet business volume and earnings related to four types of off-balance sheet business: secured, pledged, financial asset services, and financial derivatives. (2) PBC developed the "bond statistical system." This system absorbed the accounts statistics concept of "from-whom-to-whom" that was

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			developed following the financial crisis. At this concept's core is the performance of statistical analysis for each individual bond. The statistical system is designed to link securities products, participants, and prices, to create multidimensional information data sets. It uses flexible processing and provides comprehensive, accurate, uniform, and timely statistical data. Currently, all financial statistical data reporting services are pushing for implementation of the bond statistical system, and preliminary steps have been taken to integrate the system. During 2016, we will gradually develop data submission tests and also obtain the ability to trace historical data. 3) In mid-October of 2015, CSRC developed a statistical system for market funds and established data transfer mechanisms together with the CBRC. This made for a more robust statistical monitoring of financing activities, structured information management products, and other leverage ratios. ● **Promoting comprehensive financial sector statistical analysis.** (1) The government accomplished the initial setup of mechanisms for sharing financial monitoring information and for comprehensive financial sector statistical coordination. In September 2015, Inter-Ministerial Joint Conference on Financial Supervision and Coordination convened its tenth meeting to further clarify that PBC is responsible for the coordination of efforts of all ministry-level organizations involved in financial monitoring by means of information sharing to launch comprehensive financial sector statistical analysis efforts. In March 2016, the *Notice on the Pilot Program of Comprehensive Financial Statistics* under the "three boards and one management" (meaning a shareholder meeting, a board of directors, a board of supervision and a management team) corporate governance structure was issued. It officially launched data collection efforts to develop core comprehensive statistical indicators for the financial sector in Tianjin, Guangdong, Zhejiang, and Anhui provinces. (2) Established a statistical monitoring system for statistics concerning the scale of social financing regulations from the national to local levels. Beginning in 2016, data was officially released monthly on the scale of social financing level data. (3) Completed the initial steps for developing comprehensive statistical core indicators and a reporting system for the financial sector. The system for financial sector core collection indicators is applied to banks, security companies, insurance companies, that are the foundation and core of the financial sector's comprehensive statistics. PBC has already finished the initial steps for constructing a set of core collection indicators through performing complex categorization according to tool, product, and transaction counterparties. After processing the data, the government could obtain a series of important, comprehensive data that reflected financial sector operations and the summary or consolidated financial statements to fully reflect the financial operations and business situation conditions provide reference for monetary policy and financial stability. ● **Strengthening the monitoring on financial institutions.** (1) CBRC increased monitoring of bank off-balance sheet and investment business by expanding periodic monitoring of banks' consign business, escrow assets, and entrusted loans, while simultaneously enhancing monitoring of the investment, business especially non-bond investment according to asset quality and investment types. (2) In accordance with BCBS' final Net Stable Funding Ratio, the CBRC edited and improved relevant reports and increased the monitoring frequency of the group's report, increased from six months to one quarter. (3) CSRC built new regulatory mechanisms for the interim and post-event supervision of the securities and futures institutions, upgrading the related systems of the regulatory agencies,

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			further improving the statistical data analysis, risk monitoring, and control functions.
15. The establishment of a macroprudential framework to measure and manage systemic risk, which should include increased resources at the PBC and the regulatory agencies and their improved ability to monitor financial stability and regularly carry out stress tests.	High	NT	● PBC has made progress in the macroprudential policy framework. – In 2016, PBC started to use the dynamic adjustment mechanism "upgrades" on differential reserves for the "macroprudential assessment system" (MPA) for counter-cyclical adjustment in order to adapt to trends in asset diversification. – PBC has constructed and improved the macroprudential policy framework for cross-border capital flow. First, suppress market short-term speculation by means of reserve tools and levy risk reserve on banks' foreign exchange loans. Second, expand the entire aperture of cross-border financing and macroprudential management pilots, and stabilize foreign currency external debt deleveraging activity. Third, enforce normal deposit-reserve ratios for overseas financial institutions with deposits in domestic financial institutions. Establish a permanent mechanism for counter-cyclical adjustment of cross-border RMB capital flow. – PBC continues to improve China's medium and large bank stress testing framework and methods. Increase standards for test subjects to include commercial banks with at least RMB 500 billion in assets. At the same time, dynamically adjust exposure and stress scenarios according to the state of China's macroeconomic development and potential banking industry risks. ● CBRC is actively constructing a banking monitoring system that combines micro- and macroprudential approaches. – Develop a more robust early warning system for risk. – Utilize stress tests to evaluate banking system risks. CBRC issued the *Guidelines on Stress Testing China's Banking Industry*, which provides guidance for commercial banks to carry out stress testing according to the actual circumstances and risk factors of the respective bank. These guidelines are especially for carrying out corresponding stress tests to overheated industries like real estate and high-risk sectors. – Target the characteristic cyclical changes of the real estate industry. CBRC dynamically adjusts the down payment of personal real estate loans (loan-to-value) and other credit policies with PBC to effectively control real estate loan risks. ● CSRC conducts research on how to improve the overall framework for industry risk stress tests with the intention of conducting comprehensive, normalized stress tests on operators in the securities and futures sectors, on securities and futures market infrastructure, and on all key financial products. ● In 2015, CIRC issued the *Interim Guidelines on Domestic Systemically Important Insurance Companies* for public consultation. This is expected to be implemented in 2016. In early 2016, CIRC developed an insurance sector stress test based on "C-ROSS." CIRC recently completed the data collection work.
16. Enhanced hedging of structural liquidity through market-based tools and managing spillovers from systemic liquidity	High	NT	● No updates.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
through indirect monetary policy tools.			
17. The implementation of an average reserve system to facilitate liquidity management and to improve stability and efficiency.	High	NT	• In September 2015, PBC reserve appraisal system underwent reform and implemented the average reserve system method for reserve appraisal. During the maintenance period, the value of the average daily arithmetic mean of the financial institution's deposit reserve must meet statutory requirements. After the maintenance period, the financial institution deposit reserve will not be required to meet statutory requirements on a daily basis.
18. Launching a trial run of the targeted short-term repo rate, as an experiment of indirect liquidity management, and starting daily open market operations.	High	NT	• Since mid-2015, PBC continued to carry out open-market reverse repurchase transactions for a 7-day period that effectively regulated banking system liquidity, strengthened the guidance and regulation of short-term money market interest rates, and assessed the effectiveness and fairness of using the 7-day repurchase rate as the central bank policy rate. • On February 18, 2016, the PBC adopted the open market operations at a daily frequency.
19. Ensuring the deposit and lending operations at the PBC is on a real time and automatic basis, with uniform collateral requirements for all domestically registered entities.	Medium	NT	• No updates.
20. The implementation of a deposit insurance system to provide support for the orderly shutdown of financial institutions; and assistance for sorting out contingent liabilities.	Medium	NT	• No updates.
Developing Securities Markets by Channeling Deposits to Contract and Pooling Types of Investment Institutions			
21. Ensuring consistency of regulatory rules and assigning regulatory responsibilities in support of developing the fixed-income market.	Medium	MT	• In order to improve the efficiency of bond issuance and to strengthen the dissemination of bond information disclosure, the National Development Reform Commission issued *Opinions on Simplifying the Approval and Reporting Procedures for Corporate Bonds to Strengthen Risk Prevention and Reform the Regulation Mode*. • The third meeting for the *Joint Ministerial Conference on Credit Debt Market* was convened on December 29, 2015. The meeting held discussions on risks facing the bond market, the regulation coordination and uniformity for corporate credit bond issuance, market infrastructure and administration, uniformity of bond market law enforcement, and other issues. A consensus was reached for several issues.
22. Continued improvement of bond	High	MT	• The authorities publicly announced key terms and the short end of the Treasury yield curve. On this basis, the authorities further improved the

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
issuing strategies by the Ministry of Finance and the PBC, to help improve the existing market-making activities in products of various maturities on the yield curve.			long end of the Treasury yield curve. The Treasury bond renewal mechanism was established and enhanced. Key terms Treasury bonds and 30-year Treasury bonds were renewed after initial issuance. The government also increased the frequency of short-term Treasury bond issuance. In 2016, the 30-year bond issuance program was developed and issued as planned and Treasury yield curve was improved by adding 30-year Treasury bond yields. ● Under existing institutional arrangements, the Treasury bond market monitoring and system construction were improved. Design a Treasury market monitoring template and complete system development. Gradually construct a more complete and systematic monitoring system to ensure the healthy operation of the government bond market.
23. Enhancing the management and operational framework of the repo market, in order to improve market liquidity and risk management, in addition to strengthening the linkage between money market rates and bond market rates.	Medium	NT	● In order to increase the efficiency of interbank market pledge repurchase transactions and improve the repurchase price formation mechanism, the Foreign Exchange Trading Center launched the *Interbank Bond Market Anonymous Click Repurchase Transactions Secured by Bond Pledge service* (X-Repo System). After the launch of this service, results from its operation were favorable and trading volume remained active. By late 2015, X-Repo had a total of 14,000 turnovers worth RMB 16 trillion.
24. Relaxing the restriction that accumulated balance of market-issued bond of a company may not exceed 40% of net assets, in order to expand its capacity for direct financing.	Medium	MT	● No updates.
25. Improving the interoperability among the inter-bank bond market and the Shanghai and Shenzhen Stock Exchanges, by upgrading the linkage between the China Central Depository & Clearing Co., Ltd. (CCDC) and the China Securities Depository and Clearing Corporation Limited (SD&C), thus providing support for the further development of these	Medium	MT	● No updates.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
three markets, and help improve their efficiency.			
26. Building a multi-pillared pension system, focusing on a basic pension system that is fully funded.	Medium	MT	● On August 17, 2015, the State Council issued *Measures for the Administration of Investment in Basic Pension Insurance Funds* (State Council 2015 No. 48) which explains that basic pension insurance funds for enterprise and government personnel and both urban and rural residents can be delegated to State Council-authorized institutions for investment. Investment must adhere to market-oriented, diversified, and professional principles to ensure the security of the funds and to increase their value.
Improving Alternative Financing Channels and Accessibility			
27. Reviewing existing governmental programs to determine their effectiveness in terms of promoting financing for rural, small, and microenterprises, and developing a comprehensive and coherent strategy on such financing.	High	MT	**Rural Financial Services** ● The authorities optimized the combination of monetary, credit, and other policy tools. – *Different reserve policies were used as incentives*. The authorities reduced deposit reserve ratios for financial institutions by 2.5 percentage points, targeted reduction of reserve ratios was implemented five times in 2015. The additional cumulative reductions of reserve ratio reached 0.5 to 1 percentage point with banks that satisfied prudential management requirements as well as those of the "Three Rurals," or small and micro-enterprise loans reaching certain requirements. There was an additional cumulative reduction of the deposit reserve ratio for rural financial institutions (rural cooperative banks, rural credit cooperatives and village banks) of 2 to 2.5 percentage points. As of late April 2016, the required deposit reserve ratio for county firms, rural cooperative banks, rural credit cooperatives, and rural banks is lower than state-owned commercial banks by 5, 8, 8, and 8 percentage points, respectively. – *Guidance on credit policy was strengthened* to encourage financial institutions to improve and perfect financing support for areas such as new types of agricultural business entities, agricultural infrastructure, and the modern seed industry. The authorities increased investment in agriculture-related credit, implemented agricultural credit policy impact assessments, and bolstered assessments and evaluations of credit investment in agriculture-related financial institutions. As of late April 2016, the comprehensive balance of agricultural loans is RMB 26.9 trillion, an increase of 8.8 percent over the previous year. The proportion of these loans accounted for 27.1 percent of all loan types. ● The authorities improved the rural financial system and actively fostered the development of new rural banks and other financial institutions. By the end of March 2016, a total number of new rural financial institutions to open nationwide was 1,395, which includes 1,333 rural banks, 14 loan businesses, and 48 rural mutual cooperatives. Rural bank loans amounted to RMB 617.1 billion, which included rural households and small and microenterprise loans that amounted to RMB 278 billion and RMB 294.5 billion, respectively. Together, they accounted for 93 percent of rural loans and a total of 72.2 percent of private capital holdings. ● Rural financial reform and innovation were accelerated. The authorities also further developed mortgage pilots for improving the right to operate

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			contracted land and the right of rural residents to housing assets, thereby providing the "two rights" of mortgage financing. ● Rural basic financial services were promoted. Since 2009, a total of 1,532 rural institutional gaps were resolved and 708 rural service gaps in basic financial services were covered. **Financial Services for Small and Micro-Enterprises** ● **Improving the effectiveness of implementation**. As of the end of April 2016, small and microenterprise loan amounts totaled RMB 18.7 trillion for an increase of 14 percent over the previous year. ● **Strengthening credit policy guidance** and encouraging financial institutions to increase lending to small and micro-enterprises. The authorities actively improved small and micro-enterprise credit policy impact assessments and guided and supervised financial institutions to optimize business processes and innovative financial products. ● **Consistent monitoring the policy implementation.** Financial support was promoted for small and micro enterprises in conjunction with the relevant ministry-level institutions. ● **Developing innovative financial products and services.** 1. Gradually broadened intellectual property, equity, forest rights, for banking institutions of intellectual property, ownership, forest property rights, right to future earnings, and other pledged loan business types; actively developed supply chain financing and strive to resolve SME financing issues. 2. Emphasized the important role of entrepreneurial secured loan. We provided credit support to labor-intensive small enterprises to assist them in complying with requirements. CIRC and other departments jointly issued guidance on credit guarantee insurance to support small and micro-enterprise development. Fully utilized insurance to increase faith in financing. As of the end of March 2016, nationwide banking institutions issued entrepreneurial secured loans totaling RMB 75.3 billion. 3. Actively developed small financial institutions and increased small and microenterprise supplies. Banks were required to prioritize management of unreasonable or high fees. The authorities reduced effectively the cost of financing for SMEs. By the end of 2015, the number of small and micro-enterprise loans was 13.226 million. The ratio of successful loan applications to total application was 92.8 percent. In more than half of the provinces (autonomous regions and municipalities), the coverage of small and microenterprise loans surpassed 20 percent. ● **Strengthening SME credit system**. The government continuously improved SME credit information collection, evaluation, and application mechanisms and persisted in promoting the construction of a foundational financial credit information database to provide optimal credit information services. As of the end of March 2016, the authorities made improvements in national accumulation and supplementing of information for SMEs that did not have a credit relationship with any bank, which numbered 2.595 million. There are nearly 454,000 SMEs that have received bank loans for a balance of RMB 10.3 trillion. ● **Deepening capital market services.** CSRC issued *Several Opinions on Further Promoting the Development of the National Small and Medium Enterprise Share Transfer System* (CSRC Public Notice [2015] No. 26). Its

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			content covers multiple areas such as financing, transactions, market stratification, and management of sponsored securities brokers. As of May 6, 2016, nationwide share transfer systems listed 7,056 companies. Total share capital amounted to 411.7 billion shares with a total market value of RMB 2.98 trillion. About 2,800 listed companies carried out direct issuance of shares 4,113 times. The total issuance of shares amounted to 35.48 billion shares with a total financing amount of RMB 185.8 billion.
28. Further reforms of rural credit cooperatives, to enhance their efficiency and sustainability as commercial providers of financial products and services.	Medium	MT	● Actively and prudently promoted the restructuring of rural credit cooperatives and establish rural commercial banks. By the end of March 2016, there was a total combined number of 1052 rural commercial banks and rural cooperative banks. Assets, liabilities, and owners' equity accounted for 66.0 percent, 65.5 percent, and 72.7 percent of rural cooperative financial institutions, respectively. By April 2016, Beijing, Tianjin, Shanghai, Chongqing, Jiangsu, Anhui, and Hubei had completed the task of establishing rural commercial banks. ● The asset quality of rural credit cooperatives improved significantly, and agriculture-related financial service functions were considerably upgraded. According to the statistical methods and scope of the five-category loan classification system, the percentage of nonperforming loans for all of China's rural credit cooperatives was 4.3 percent and capital adequacy was at 11.1 percent as of late March 2016.
29. Completing the reform of the Postal Savings Bank by optimization of the ownership structure, marketization and the establishment of effective corporate governance.	Medium	MT	● Postal Savings Bank established the "three boards and one management" corporate governance structure and introduced ten domestic and foreign strategic investors in December 2015 to achieve equity diversification.
1/ Information as reported by the authorities, with IMF staff providing translation and minor edits.			

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 7, 2016

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2016)

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

General Resources Account:

	SDR Million	% Quota
Quota	30, 482.90	100.00
Fund holdings of currency	25,416.74	83.38
Reserve position in Fund	5,066.21	16.62
Lending to the Fund		
New Arrangements to Borrow	2,362.66	

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	6,989.67	100.00
Holdings	7,442.78	106.48

Outstanding Purchases and Loans: None

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
Stand-by	03/02/81	12/31/81	450.00	450.00

Projected Payments to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2016	2017	2018	2019	2020
Principal		0.00	0.00	0.00	0.00
Charges/interest		0.24	0.24	0.24	0.24
Total		0.24	0.24	0.24	0.24

Exchange Arrangements:

China's exchange rate regime has been classified as a crawl-like arrangement since June 21, 2010. De jure classification of the exchange rate is managed floating. 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 (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 weight. 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 U.S. dollar against the renminbi was kept at ± 0.3 percent around the central parity published by the PBC while the trade prices of the non-U.S. dollar currencies against the renminbi 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. dollar, euro, Japanese yen, and Korean won were the main currencies included in the basket; and U.K. pound, the Thai baht, and the Russian ruble were among other currencies included in the basket. In May 2007, the band around the daily trading price of the U.S. dollar against the renminbi was widened to ± 0.5 percent. After maintaining the renminbi closely linked to the U.S. dollar between July 2008 and June 2010, the PBC announced on June 19, 2010 a return to the managed floating exchange rate regime prevailing prior the global financial crisis with the exchange rate allowed to move up to ±0.5 percent from a central parity rate to enhance the effectiveness of monetary policy. As of today, the band has been widened to 2 percent, allowing daily fluctuations relative to the central parity rate. The trading prices for the RMB against the euro, Japanese yen, pound sterling, Australian dollar, Canadian dollar, and New Zealand dollar float within a 3 percent range of the current day's middle exchange rates for the RMB against these currencies. The trading prices against the Malaysian ringgit and the Russian ruble float within a 5 percent range of the current day's middle exchange rates of the RMB against these currencies. The trading price of the RMB against the Thai baht in regional interbank markets floats within a 10% range of the reference price.

On January 4, 2006, over-the-counter (OTC) trading of spot foreign exchange was introduced with 15 banks initially designated as market makers. The number of market makers has since risen to 31 with all the banks approved as spot market makers, and 27 approved as forward and swap trading market makers by the end of 2014. 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 on each business day, exclude the highest and lowest offers, and then calculates the weighted average of the remaining prices in the sample as the central parity for the renminbi against the U.S. dollar for the day. The weights for the market makers, which remain undisclosed, are determined by the CFETS using various factors, including the transaction volumes of the respective market makers in the market. The CFETS determines the middle rate for the renminbi against ringgit, yen, Hong Kong dollar, pound sterling, and ruble similarly.

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 requirements on proceeds from exports and from invisible transactions and current transfers. Starting on August 13, 2007, all enterprises (domestic institutions) having foreign exchange revenue from current operations may keep foreign exchange receipts according to their operational needs in their current foreign exchange accounts.

With SAFE approval or registration, domestic institutions may open foreign exchange capital accounts and retain foreign exchange revenues from capital transactions. Domestic institutions that had no current foreign exchange revenue may purchase foreign exchange for imports in advance based on documentary proof of the payment and deposit the funds into their foreign exchange accounts. Individuals may, also open foreign exchange savings accounts and deposit foreign exchange purchased in accordance with the relevant regulations. China maintains an exchange system free of restrictions on payments and transfers for current international transactions. However, China has notified measures to the Fund, pursuant to procedures under the Executive Board Decision 144-(52/51), which apply to measures imposed solely for national or international security reasons.

Exchange controls continue to apply to most capital transactions. Effective on July 1, 2006, quotas on foreign exchange purchases for foreign direct investment (FDI) were 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 overall investment limit for QFIIs was US$150 billion in 2016. As of the end of May 2016, a cumulative total of 273 QFIIs had been approved, with a total investment limit of US$81.098 billion. The Qualified Domestic Institutional Investor (QDII) scheme was introduced in 2004, and measures have since been taken to promote its development. Since May 1, 2006, residents can freely purchase up to US$20,000 foreign exchange and this limit was raised to US$50,000 in September 2006. Above this amount, purchases require relevant documents. In May 2007, the QDII scheme was expanded to allow qualified banks to invest retail funds in foreign equities. Effective July 5, 2007 the China Securities and Regulatory Commission extended QDII to securities and fund-management companies. The firms have to meet certain capital and other requirements. From April 2006, qualified insurance companies were also allowed to invest their own foreign exchange externally under the QDII scheme up to 15 percent of their total assets. QDIIs may also invest in foreign derivative instruments.

The use of renminbi in international transactions has been expanded. In 2010, international financial institutions were approved to raise funds domestically in renminbi for use offshore. Since August 2011, trade transactions between all provinces and cities in the Mainland with other countries may be settled in renminbi. Since August 17, 2010, eligible foreign institutions may invest in the interbank bond market in renminbi (CIBM). The eligible institutions include foreign banks engaged in cross-border trade settlements in renminbi, the Hong Kong SAR and Macao SAR region renminbi clearing banks, and foreign central banks and monetary authorities. These investments are subject to limits, but there is no minimum holding period. Starting from January 6, 2011, resident enterprises in 20 provinces and cities in the Mainland may use renminbi for outward FDI in those countries which accept such settlement. In December 2011, a new pilot scheme was announced to allow up to RMB20 billion in portfolio flows into the securities markets (through a renminbi Qualified Foreign Institutional Investor scheme), and in October, rules were published to allow overseas firms to invest renminbi raised offshore in the Mainland as foreign direct investment. Since

2012 all residents and nonresidents can use RMB for FDI. RMB qualified foreign institutional investors (RQFIIs) may invest in domestic securities markets. Under the expanded RMB qualified foreign institutional investors (RQFII) scheme, Hong Kong subsidiaries of Chinese financial institutions, as well as financial institutions registered and operated in Hong Kong SAR, may invest in domestic securities markets using RMB proceeds raised overseas. RMB clearing banks were or will be established in these countries/regions.

As of 2016, resident-associated companies of multinational corporations may directly lend to overseas-associated enterprises within a certain limit; they may also provide loans to overseas-associated enterprises through domestic banks. Foreign loans to domestic institutions, with a maturity of more than one year, are subject to NDRC approval. Short-term external borrowings are subject to the limits of SAFE approval.

Article IV Consultation:
China is on the standard 12-month consultation cycle. The 2015 Article IV mission was concluded on May 27, 2015 and the staff report was published on August 14, 2015.

Technical Assistance:
Technical assistance provided from 2001 through September 2016 is summarized in Annex V.

Resident Representative:
The resident representative office in Beijing was opened in October 1991. Mr. Alfred Schipke is the Senior Resident Representative and Mr. Waikei Raphael Lam is the Deputy Resident Representative,

WORLD BANK-IMF COLLABORATION

(As of June 22, 2016)

1. **The IMF China Resident Representatives held discussions with the World Bank team in** June 2016 to exchange views on key areas of reform to ensure sustainable medium-term growth in China, minimize risks, and improve the inclusiveness of growth. The teams discussed their agendas for 2016-2017. The last such meeting was held during January 2016 in Beijing.

2. **The teams agreed the focus of reform in China should be on shifting growth to a more balanced and sustainable path, along the line of the Third Plenum reform blueprint.** Reforms should aim at preventing further buildup of risks stemming from rapid credit growth and quasi-fiscal spending, and move the economy to a more inclusive, environment-friendly, and sustainable growth path. Giving the market a more decisive role, eliminating distortions, and strengthening institutions will result in a more efficient use of resources, faster productivity growth, and rising living standards across the income spectrum.

3. **Based on this assessment, teams identified the following reform areas as macrocritical:**

- ***Financial sector reforms.*** Further progress in financial sector reform is central to containing risks and boosting growth by facilitating better allocation of resources. Widespread implicit guarantees—of savers, intermediaries, and borrowers distort the pricing of risk and borrowing costs, resulting in misallocation of credit and inefficient investment. Key measures in this area include hardening budget constraint, enhanced debt restructuring mechanism to facility NPL resolution, as well as stepped-up supervision and regulation of the financial system. In particular, stronger measures to monitor and regulate the large shadow banking sector should be taken and regulatory arbitrage opportunities should be closed. Given the rising vulnerabilities, more effective mechanisms are needed to ensure a functional policy coordination framework is in place. There is also a need to upgrade the regulatory structure to ensure adequate supervisory cooperation and coordination.

- ***Fiscal reforms.*** *Off-budge*t spending, in infrastructure but also in other areas, undertaken by local government-owned entities have led to a significant buildup of debt. The new budget law aims to bring these projects on-budget and strengthen control over public financial management, but implementation would be key. Improving the fiscal framework is a priority for the medium term, including strengthening budget processes, data transparency, local government finances, and medium-term budget planning. Tax reforms should continue to modernize the current tax system and make it more progressive (e.g., relying more on direct taxes and allocating local governments revenues to match their spending responsibilities.

- ***Reform of the social security system***. Further strengthening the pension and health insurance systems—including by improving adequacy and expanding coverage—would have macro-benefits such as reducing precautionary household savings, but would need to be done with a careful eye to fiscal sustainability. It is crucial to improve benefit portabilit*y within and across provin*ces and economic sectors. Reforms should be done in a way that ensures the sustainability of the social security system, including through parametric changes (such as increasing retirement age, indexation, and so on) and structural reforms to the pension system (such as introducing the NDC approach, deepening the alignment of civil service and PSU pension schemes with the urban worker scheme, upgrading the pooling level, developing the medium and long term financing strategy, including for financing legacy costs outside the pension system), and strengthening the budget processes and administration for social security funds. .

- ***SOE reform.*** Reforms include opening up to full and fair competition activities currently reserved to SOEs, properly pricing finance and other factor inputs, requiring adequate dividend payments to the budget, and imposing hard budget constraints. Opening up the service sector to more competition will also be critical for generating the productivity gains necessary to fuel growth and for boosting household income, as services tend to be more labor intensive than industry.

- ***Green growth.*** Air pollution, water quality and supply, soil contamination, and issues such as desertification, and degradation of grasslands, and dependence on coal and energy intensive economic options have social, health, and economic effects. Underpricing of energy and inadequate consequences for pollution has worsened these effects while contributing to China's dependence on industry. Raising these factor costs to capture the cost of externalities, such as introducing a carbon tax and investing in green development including in renewable energy will make growth more sustainable and inclusive. This will also require mobilization of private capital and utilize the capital markets to support green investments.

- ***Infrastructure.*** Investment in infrastructure has been a key driver of the Chinese economy, particularly during the slowdown around the Global Financial Crisis. However, the rapid pace of investment has in some cases left communities behind, and in other cases has led to excessive investment in projects with relatively low social or financial returns. Filling in the gaps of investment in social projects will make growth more inclusive while improving the overall social and financial efficiency of infrastructure investment. Measures to improve the process of approving new infrastructure projects will ensure that investments are focused in areas of the highest social return.

4. **The teams agreed to the following division of labor.**

- ***Financial sector reforms.*** The Bank and the Fund will jointly conduct the 2017 FSAP; assess financial sector risks and needed reforms. The Fund will also continue to provide technical assistance to the Chinese authorities as needed.

- ***Fiscal reforms.*** The Bank will continue to work with the Ministry of Finance (MOF) to help in implementing key reforms in public finance in the context of an ongoing fiscal technical assistance investment project. The Fund will continue its technical cooperation on the fiscal framework and budgetary preparation, including strengthening the medium-term macro and fiscal framework, enhancing local government borrowing monitoring, and modernizing accounting and treasury management. The Fund will also continue to discuss the near- and medium-term implications of

China's fiscal stance and policy choices on the broader economy as well as implications for global spillovers.

- ***Social Security System.*** The Bank will continue to work with the Chinese authorities on reforms to improve the equity, sustainability, and portability of the social security system. This includes helping provincial governments in developing more integrated social security information systems. The Bank will also work with MOF to provide technical support on the overall reform and the pooling and financing strategies, and optimize fiscal risk management associated with social security liabilities through policy dialogue and engagement. The Fund will look at issues related to the how different social insurance schemes (including pensions and health care) fit into the medium-term fiscal and macroeconomic policy framework. The Fund will also review the balance between benefits and financing from different revenue sources, including social contributions and other revenue. Both the Bank and the Fund will continue to encourage the authorities to undertake regular and robust actuarial modeling of social insurance liabilities.

- ***Green growth.*** The Bank's focus on climate change and renewable energy as well as pollution reduction and prevention in China will continue to emphasize cutting-edge green technologies, scale-up of energy conservation and investments in energy efficiency, green transport and green building policies (for heat and energy efficiency). Engagements with a climate change focus will extend to expansion of distribution of electricity from natural gas generation, analysis of carbon capture and storage potential, and development of green finance, including carbon markets. The Fund will continue to discuss options to capture the cost of externalities through the use of fiscal policy such as better calibration of excise and introducing a carbon tax. It is ready to provide assistance on shifting the pricing and taxation of energy, and discussing the growth and fiscal implications of such a shift.

5. **Teams have the following requests for information from their counterparts:**

- The Fund team requests to be kept informed of progress in the above macroeconomic structural reform areas, as milestones are reached and at least on a semiannual basis.

- The Bank team requests to be kept informed of the Fund's assessments of macroeconomic policies and prospects in the context of the Article IV consultation and staff visits, and at least semiannually.

The following table lists the teams' separate and joint work programs for June 2016 to June 2017.

China: Bank and Fund Planned Activities in Macrocritical Structural Reform Areas

	Products	Expected Delivery Date
Bank Work Program	• Building a Modern Fiscal System Technical Assistance Project to support implementation of central government's public finance reforms.	• Ongoing
	• China Economic Reform Implementation Project (umbrella TA project, including various subprojects with MOF, PBC, and provincial finance bureaus).	• Ongoing
	• China Economic Update	• Ongoing
	• "Just-in-time" Policy Notes for MOF	• Delivered on demand
	• TA on Mid-term Macrofiscal Framework	• Ongoing
	• Subnational Intergovernmental Fiscal Relationship	• Ongoing
	• Municipal Financing and Local Debt Management	
	• Inclusive Finance Academy	• Ongoing
	• Financial Consumer Protection and Consumer Literacy	• Ongoing
	• Financial Reform Strategy	• Ongoing
	• Capital Market Development	• Ongoing
	• Deepening health reform in China-building high quality and value-based service delivery	• Ongoing
	• Strengthening China's social protection and labor systems	Ongoing
Fund Work Program	• December Staff Visit	• Dec 2016
	• 2017 Article IV Consultation	• May/June 2017
	• Cooperation Program for Fiscal Reforms (FAD)	• Ongoing
Joint Work Program	• Financial Sector Assessment Program	• 2017

RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

1. The Asian Development Bank's (AsDB) partnership with the People's Republic of China (PRC) has grown in many ways since the PRC became a member of AsDB in March 1986. The PRC is AsDB's second largest shareholder among regional members and the third largest overall, as well as an important middle-income country client. By the end of 2015, the PRC's cumulative borrowing from AsDB reached $29.2 billion with 226 loans for public sector projects. Of the total public sector loans, 55.7 percent was allocated to the transport sector, followed by agriculture and natural resources (12.6 percent) and water and other municipal infrastructure services (12.6 percent), energy (11.9 percent), industry and trade (2.3 percent), finance (2.3 percent), education (1.0 percent) and multisector (1.6 percent). Over the past 27 years, AsDB has helped finance 27 private sector projects in the PRC totaling $4.96 billion. AsDB also funds technical assistance for the PRC. By the end of 2015, AsDB had provided a total of $464.4 million for 802 technical assistance projects, consisting of $147.4 million for preparing projects and $317.0 million for policy advice and capacity development.

2. Overall, the PRC has demonstrated strong capabilities in implementing projects. The good performance shows 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 financing. Loan disbursement and contract award performance is good.

3. The PRC has demonstrated its strong partnership with AsDB by contributing to the Asian Development Fund, establishing the $20 million PRC Poverty Reduction and Regional Cooperation Fund (the PRC Fund), and replenishing another $20 million to the PRC Fund. The PRC Fund—the first fund established in AsDB by a developing member country—providing technical assistance projects to support subregional cooperation initiatives, particularly Central Asia Regional Economic Cooperation (CAREC) and Greater Mekong Subregion (GMS) programs.

4. The Asian Development Bank's Country Partnership Strategy (CPS) 2016–2020 was endorsed by AsDB Board of Directors in February 2016. The CPS 2016–2020 is aligned with the priorities of the PRC's 13th Five-Year Plan 2016–2020, the Midterm Review of AsDB's long-term Strategy 2020, and AsDB's approach to supporting upper middle-income countries. The CPS will support the government's reform agenda by focusing on the following strategic priorities: managing climate change and the environment, promoting regional cooperation and integration, supporting inclusive economic growth focusing on the remaining poor, fostering knowledge cooperation, and supporting institutional and governance reform. AsDB's sovereign and nonsovereign operations will support activities within these strategic priorities.

5. Projected public sector lending in 2016–2018 will total about $4.56 billion, of which 30 percent will support agriculture, natural resources, and rural development; 6 percent will support education; 8 percent will support energy; 5 percent will support health; 29 percent will support

[1] Prepared by Asian Development Bank staff.

transport and 22 percent will support water and other urban infrastructure and services sectors. Over 90 percent of the projects are located in the western, central and north-eastern regions in line with the CPS's priorities of promoting inclusive growth and environmentally sustainable growth.

6. AsDB's technical assistance will complement the lending program to improve the sector policy environment, support governance and capacity development, and strengthen the knowledge base and innovative features of lending operations.

China: AsDB's Commitments and Disbursements (Public Sector Loans), 1993–2015

(In millions of U.S. dollars)

Year	Commitments 1/	Disbursements 2/
1993	1,031	371
1994	1,618	492
1995	2,304	558
1996	3,282	707
1997	4,033	715
1998	4,518	818
1999	5,337	792
2000	6,159	832
2001	6,748	1,313
2002	7,563	782
2003	8,075	705
2004	8,733	636
2005	11,060	892
2006	11,794	988
2007	13,214	1,190
2008	14,519	1,234
2009	15,623	1,342
2010	16,964	1,342
2011	18,244	1,580
2012	19,476	1,343
2013	20,416	1,063
2014	21,748	1,303
2015	23,096	1,152

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

STATISTICAL ISSUES

(As of June 16, 2016)

I. Assessment of Data Adequacy for Surveillance
General: While data are broadly adequate for surveillance, they are only barely so. Efforts at strengthening the statistical system and enhancing data transparency led to China's subscription to the SDDS in October 2015. Nevertheless, China's statistics continue to have gaps that hamper surveillance. The areas of concern relate mainly to national accounts data and government finance statistics.
National Accounts: The National Bureau of Statistics (NBS) compiles and disseminates annual GDP by activity in current and constant prices (2010) and quarterly estimates of GDP. The NBS is in a transition period from 1993 SNA to 2008 SNA. The 2008 SNA is applied for some industries, such as for the calculation of financial intermediation services indirectly measured (FISIM). Since 2015, quarterly national accounts are compiled on a discrete basis –that is, January to March, April to June, July to September, and October to December, which is in line with international standards. The techniques for deriving volume measures of GDP are not sound and need to be improved. GDP by expenditure is compiled at current and constant prices, but the constant price estimates are not published. Data on the expenditure components of GDP are not available on a quarterly basis. Nevertheless, the NBS has made a number of improvements to the range and quality of national accounts data, the most important being improving the exhaustiveness of the GDP estimates by activity. Further improvements are intended for both the annual and quarterly accounts; however, no target dates have been set. As in other countries, rapid economic change, including the expansion of the private sector, presents new problems for data collection and compilation. The ability to change the data collection systems is restricted by the decentralized nature of the statistical system. Monthly industrial production, retail sales, and fixed investment indices are compiled with the corresponding month of the previous year as a base period, but no chain-linked indices are produced. Data revisions tend to be made without publishing the entire revised series.
Price Statistics: The CPI covers approximately 500 areas throughout the country, including around 200 counties and around 300 cities. The current CPI is a chained Laspeyres price index, which is compiled and disseminated since 2001**.** Weights are derived from urban and rural households' surveys every five years. Current weights are for 2008-2010. The weights from the base period are price-updated every month**.** PPI survey covers 40 percent of the total industry turnover including 60,000 enterprises in 31 provinces and over 430 cities. Prices cover 1702 product groups (basic sub-categories). The current base year is 2010. The PPI definitions are consistent with international standards defined in the PPI manual (2010). The PPI is not seasonally adjusted.
Government Finance Statistics: Serious data shortcomings continue to hamper fiscal analysis. Data on the social security and extra budgetary funds are only provided annually and with a long lag. Expenditure classification remains in need of improvement, mainly because data by economic type are not published. The authorities have indicated an intention to begin collecting these data and to develop accrual based measures of fiscal performance over the medium term while also strengthening the compilation of cash based GFS.
Monetary and Financial Statistics: In recent years, improvements have been made in monetary and financial statistics. However, 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 reported net foreign assets position of PBC does not include exchange rate valuation effects and interest earnings on foreign reserves. 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 has led to breaks in data series of monetary base and monetary aggregates. The monetary and financial statistics missions in March 2015 made several recommendations for improvements in monetary data compilation with a view to accelerating PBC's implementation of the standardized report forms (SRFs). The authorities plan to finalize the SRF data for depository corporations by the end of 2015 and begin regular reporting of SRF data after PBC's review and approval process of these data is complete.
Financial sector surveillance: China reports financial soundness indicators (FSIs) to the Fund for dissemination on the IMF's website. The authorities expanded the data scope in early 2015 by including two encouraged FSIs for deposit takers in their regular reporting to the Fund. The periodicity of data was also improved in May 2015 from annual to semi-annual frequency.

External sector statistics: The historic data series are compiled (in U.S. dollars) largely in accordance with the fifth edition of the *Balance of Payments Manual* (*BPM5*), however STA has converted BOP and IIP series into the *sixth edition of the Balance of Payments and International Investment Position Manual (BPM6)* for dissemination in the *IFS. From 2015, the data are compiled and disseminated largely in accordance with BPM6*. The authorities continue their efforts to improve the coverage of direct investment transactions in the balance of payments (BOP) and IIP statistics, and progress is being made in developing these statistics. Since the International Transactions Reporting System is the major data source for balance of payments (BOP) statistics, in order to ensure its smooth operation, regular training programs for staff in the provincial offices of SAFE have been recommended. In 2011, China commenced participation in the Coordinated Direct Investment Survey (CDIS), although only inward direct investment positions are currently recorded. At the end of 2015, China initiated reporting data for the Coordinated Portfolio Investment Survey (CPIS). Despite an ostensibly modest level of external vulnerability, there remains a need to strengthen external debt monitoring and compilation. In 2010, China started submitting total and public external debt data for the Quarterly External Debt Statistics (QEDS) database, a notable step forward.

II. Data Standards and Quality	
China began subscription to the Special Data Dissemination Standard in October 2015.	

China: Table of Common Indicators Required for Surveillance
(As of June 15, 2016)

	Date of Latest Observation	Date Received	Frequency of Data[9]	Frequency of Reporting[9]	Frequency of Publication[9]
Exchange rates	05/16	06/16	D	M[9]	D
International reserve assets and reserve liabilities of the monetary authorities[1]	04/16	05/16	M	M	M
Reserve/base money	04/16	05/16	Q, M	Q, M	Q, M
Broad money	04/16	05/16	M	M	M
Central bank balance sheet	04/16	05/16	M	M	M
Consolidated balance sheet of the banking system	04/16	05/16	M	M	M
Interest rates[2]	04/16	05/16	[10]	[10]	[10]
Consumer price index[3]	04/16	05/16	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	2013	03/14	A	A	A
Revenue, expenditure, balance and composition of financing[4]—central government	04/14	05/14	M	M	M
Stocks of central government and central government-guaranteed debt[6]	Q4/13	03/14	Q	Q	Q
External current account balance	Q4/15	06/16	Q	A, Q	A, Q
Exports and imports of goods and services[7]	Q4/15	06/16	M	M	M
GDP/GNP[8]	Q1/14	04/14	A, Q (cumulative)	A, Q (cumulative)	A, Q (cumulative)
Gross external debt	Q4/13	03/14	A, Q	A, Q	A, Q
International investment position	Q4/15	06/16	A, Q	A, Q	A, Q

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[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 (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] Goods trade data are provided monthly. Services trade data are released with the current account statistics.
[8] For real GDP, level data are available only on an annual basis (growth rates are available on a quarterly, cumulative basis).
[9] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[10] Interest rates change only infrequently; these changes are publicly announced.

TECHNICAL ASSISTANCE

China: Summary of Technical Assistance, 2001–16 1/		
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
LEG	Seminar on Basic Tax Law	December 2005
FAD	Mission on VAT Treatment Of Financial Services	April 2006
FAD	Mission on Estimation Of VAT Gap And Capacity	June 2009
FAD	Mission on VAT Treatment Of Financial Services	June 2010
FAD	Mission on Tax Gap Analysis	September 2011
FAD	Micro-Simulation Models	December 2013
FAD	Analysis of the Macroeconomic Impact of Tax Policy	March 2015
FAD	Reforming the Personal Income Tax	October 2015
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 on Computerization Project	September 2004
FAD	Mission on Business Process Reengineering Pilot	November 2005
FAD	Mission on IT Modernization	June 2006
FAD	Mission on Strategic Planning, Risk Management, And Taxpayer Services	September 2006
FAD	Mission on VAT Invoice Cross-Checking And Other Administration Issues	March 2007
FAD	Mission on Business Process Re-Engineering And Golden Tax Project 3	August 2007
FAD	Seminar on Strategic Planning And Management	January 2008
FAD	Mission on VAT on Services, Resource Tax Policy	October 2009
FAD	Mission on Project Management Golden Tax Project 3	June 2010
FAD	Expert Visit on Strategic Planning	October 2010
FAD	Mission on Tax Administration: Large Taxpayers	October 2010
FAD	Peripatetic Expert Visit On Tax Administration	October 2010
FAD	Tax Policy And Administration	September 2011
FAD	Tax Administration (Peripatetic Expert Visit 4 Of 5)	October 2011
FAD	Tax Administration (Peripatetic Expert Visit 5 Of 5)	October 2011
FAD	Large Taxpayer Compliance	October 2011
FAD	Workshop on Practical Tax Analysis For Tax Officials	December 2012
FAD	Large Taxpayer Administration	January 2013
FAD	Tax Administration Follow-Up	April 2014
FAD	Tax Collection Law Revision	May 2014
FAD	Tax Collection Law Revision	July 2015
LEG	Mission on Reforming Tax Collection Law	July 2015
FAD	Reforming the Personal Income Tax	October 2015
Public Financial Management		
FAD	Workshop on Government Fiscal Management Information System	February 2001
FAD	Mission on Treasury/Accounting Reform; Macro-Fiscal Coordination	November 2001
FAD	Mission on Budget Preparation, Classification, And Treasury Reform	June 2002

Public Financial Management		
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 I	March 2004
FAD	Mission On Treasury Single Account and Cash Management Reform	April 2006
FAD	Mission On Budget Law II	September 2007
FAD	Discuss FAD's PFM Program With Authorities	September 2007
FAD/STA	Mission On Accrual Accounting	September 2007
FAD	Seminar On Local Government Cash Management	December 2009
FAD	Presentation of The Budget Institutions Paper	May 2010
FAD	High-level Dialogue on PFM Institutions	June 2011
FAD	Medium-Term Expenditure Framework Seminar	November 2011
FAD	Medium-Term Revenue Administration Program And Policies Discussion	June 2012
FAD	High-Level Dialogue on PFM Institutions	November 2012
FAD	Mission on Introducing Advanced Treasury Reforms	February 2013
FAD	High-level Seminar on Fiscal Reforms	January 2014
FAD	Mission on Modernization Of Government Accounting	April 2014
FAD	Mission on Medium Term Expenditure Frameworks	July 2014
FAD	Expert visit on Treasury management (accounting)	September 2014
FAD	Expert visit on Chart of Accounts Improvements	March 2015
FAD	Expert visit on Treasury Management (cash management)	March 2015
FAD	Mission on Strengthening Local Government Borrowing Reform	April 2015
FAD	Mission on Accounting Modernization	November 2015
FAD	Workshop on Medium-Term Expenditure Frameworks	April 2016
FAD	Seminar and Case Study on Local Government Borrowing and Bond Market Development	April 2016
FAD	Local government Borrowing Framework	April 2015
FAD	Accounting and Financial Reporting Reforms	November 2015
FAD/MCM	Regulatory Framework of Local Government Finance	April 2016
FAD	Medium-Term Expenditure Framework Workshop	April 2016
FAD	Expert visit on Treasury – Central Bank Coordination	June 2016
Intergovernmental Fiscal Relations		
FAD	Mission Intergovernmental Relations	November 2002
FAD	Mission On Subnational Fiscal Risks	November 2003
FAD	Conference On Reforming Assignments And Next Steps In Intergovernmental Reforms	November 2007
Statistics		
STA	Seminar On General Data Dissemination System	April 2001
STA	Missions On Trade Price Statistics	Jun. 2001–Jan. 2002
STA	Mission On GDDS	Feb./Mar. 2002
STA	Seminar On GDDS/SDDS In Washington	September 2002
STA	GDDS Review	December 2003
STA	Mission On Government Financial Statistics	January 2005
STA	Mission On Monetary And Financial Statistic	Feb./Mar. 2005
STA	Seminar On International Investment Position	April 2005
STA	Seminar On IIP Statistics	April 2005
STA	Seminar On External Debt Statistics	August 2005
STA	Macroeconomic Statistics	May 2006

Statistics		
STA	Balance Of Payments And IIP Course	June 2007
STA	Mission On Monetary And Financial Statistics	August 2007
STA	Seminar On Balance Of Payments And International Investment Position Manual, Sixth Edition (*BPM6*)	April 2008
STA	*BPM6* Course	June2009
STA	Seminar On Services Statistics	November 2009
STA	Seminar On Financial Derivates, Direct Investment And External Debt	September 2010
STA	Balance Of Payments And IIP Course	June 2011
STA	Government Finance Statistics	September 2008
STA	Financial Soundness Indicators	June 2009
STA	Monetary And Financial Statistics	October 2010
STA	Workshop On Special Data Dissemination Standard	April 2011
STA	Government Finance Statistics	May 2011
STA	Data Work: SRFS Data Development for OFCs/ FSI Data Reporting	April 2012
STA	Quarterly National Accounts	November 2013
STA	Total Social Financing(TSF) Indicators/Monetary and Financial Statistics	March 2014
STA	SDDS Assessment	August 2014
STA	Data Work: Monetary Data Reported in SRF	September 2014
STA	SDDS Assessment	December 2014
STA	TSF/Monetary Data Reported in SRFs	March 2015
STA	Multi-sector Mission: SDDS Metadata Development and Topical TA	June 2015
STA	Real Sector Statistics (*scheduled*)	August 2016
Monetary Policy, Bank Supervision, and AML/CFT		
MFD	Missions On Banking Supervision	October 2003
MFD	AML/CFT Issues	September 2003
MFD	AML/CFT Supervision	March 2004
MFD	Bank Restructuring	April 2004
MFD/LEG	AML/CFT Advisory Mission	January 2005
MFD/LEG	AML/CFT Issues	April 2005
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	Jan. 2002/Feb. 2003
MFD	Mission On TA Needs In Banking Sector Reform	July 2002
MFD	Mission On TA Needs In Financial Sector	October 2003
FAD	Participation In UNDP/DFID Fiscal Reform Workshop	February 2004
FAD	Visit To Discuss TA Needs Under UNDP/DFID Fiscal Reform Project	December 2004
LEG/MFD	AML/CFT Issues	April 2006
LEG	AML/CFT Mission To Discuss TA To The Monetary Authority Of Macao SAR	July 2006
LEG	AML/CFT Legislative Drafting	July 2006
LEG	AML/CFT Legislative Drafting	August 2006
LEG	AML/CFT Legislative Drafting	September 2006
LEG	AML/CFT Legislative Drafting TA To The Monetary Authority Of Macao SAR	September 2006
LEG	AML/CFT Financial Institutions Inspection STX Advice Mission, Macao SAR	December 2008
LEG	AML/CFT Financial Intelligence Unit Procedural Improvements, Macao SAR	March 2010
LEG	AML/CFT Legislative Drafting	July 2010
LEG	AML/CFT Legislative Drafting	March 2011
LEG	Bank Resolution	May 2012
LEG	AML/CFT Mission To Discuss Future Cooperation And TA	November 2009

Monetary Policy, Bank Supervision, and AML/CFT		
INS	Courses On Financial Programming And Policies (3)	Jul. 2000–Jun. 2002
INS	Course On Banking Supervision	June 2001
INS	High-Level Seminar On Banking Reform	March 2001
STA	Seminar On Money And Banking Statistics	April 2001
MFD	Course On Banking Supervision (On-Site And Off-Site)	July 2001
MFD	Banking Risk Management	July 2001
INS	Course On Financial Programming And Policies	August 2001
MFD	Seminar On Capital Account Convertibility	October 2001
FAD	Course On Public Sector Expenditure Management	June/July 2002
STA	Seminar On Balance Of Payments And IIP Statistics	August 2002
STA	Course On Government Financial Statistics	September 2002
INS	Course On Banking Supervision	September 2002
MFD	Central Bank Accounting	November 2002
STA	Course On Government Financial Statistics	September 2003
INS	Course On Financial Programming And Policies	October 2003
MFD	Course On Assessing Financial Systems	November 2003
INS	Course On Advanced Financial Programming (Washington)	November 2003
STA	Course On Monetary And Financial Statistics	Nov./Dec. 2003
Training		
STA	Money and Banking Statistics: Training Course	December 2003
STA	Money and Banking Statistics: Meeting and Lecturing	December 2003
FAD	International Experience with Budget Law and Budget Law Reform	March 2004
INS	High-Level seminar on Monetary Policy Transmission	April 2004
LEG/MFD	AML/CFT Workshop	April 2004
INS	High-Level seminar on China's Foreign Exchange System	May 2004
STA	Seminar on Coordinated Portfolio Investment Survey	April 2004
INS	Course on Financial Market Analysis	June 2004
MFD	Workshop on Ex and Balance of Payments Issues	June 2004
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2004
STA	Seminar on Quarterly National Accounts	September 2004
INS	Course on Financial Programming and Policies	October 2004
STA	High Level Seminar on Macroeconomic Statistics	January 2005
MFD	AML/CFT Training for PBC Officials	February 2005
LEG	AML/CFT Symposium	May 2005
MFD	Workshop on Monetary Strategy and Operation	May 2005
INS	Course on Financial Programming and Policies	June 2005
INS	Course on Macroeconomic Management and Fiscal Issues	June 2005
LEG	National IT Symposium	July 2005
LEG	AML/CFT Workshop	July 2005
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2005
STA	Course on External Debt Statistics	August 2005
STA	Course on Monetary and Financial Statistics	September 2005
MFD	AML/CFT Symposium	September 2005
MFD	AML/CFT and Internal Control Workshop	November 2005
LEG/MFD	Advanced Training on ML and TF Typologies and STRs	December 2005
LEG	AML/CFT Workshop	January 2006
MFD	Course on Foreign Exchange Operations	March 2006
INS	Course on Macroeconomic Management and Financial Sector Issues	May 2006

Training		
LEG	AML/CFT Workshop on Information Management Technology	June 2006
MFD	Course on Determining the Intermediate Target for Monetary Policy	June 2006
STA	Seminar on Banking Statistics on Cross-Border Flows	June 2006
MFD	Seminar on Capital Account Convertibility	October 2001
FAD	Course on Public Sector Expenditure Management	June/July 2002
STA	Seminar on Balance of Payments and IIP Statistics	August 2002
STA	Course on Government Financial Statistics	September 2002
INS	Course on Banking Supervision	September 2002
MFD	Central Bank Accounting	November 2002
STA	Course on Government Financial Statistics	September 2003
INS	Course on Financial Programming and Policies	October 2003
MFD	Course on Assessing Financial Systems	November 2003
INS	Course on Advanced Financial Programming (Washington)	November 2003
STA	Course on Monetary and Financial Statistics	Nov./Dec. 2003
FAD	International Experience with Budget Law and Budget Law Reform	March 2004
INS	High-Level seminar on Monetary Policy Transmission	April 2004
LEG/MFD	AML/CFT Workshop	April 2004
INS	High-Level seminar on China's Foreign Exchange System	May 2004
STA	Seminar on Coordinated Portfolio Investment Survey	April 2004
INS	Course on Financial Market Analysis	June 2004
MFD	Workshop on Ex and Balance of Payments Issues	June 2004
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2004
STA	Seminar on Quarterly National Accounts	September 2004
INS	Course on Financial Programming and Policies	October 2004
STA	High Level Seminar on Macroeconomic Statistics	January 2005
MFD	AML/CFT Training for PBC Officials	February 2005
LEG	AML/CFT Symposium	May 2005
MFD	Workshop on Monetary Strategy and Operation	May 2005
INS	Course on Financial Programming and Policies	June 2005
INS	Course on Macroeconomic Management and Fiscal Issues	June 2005
LEG	National IT Symposium	July 2005
LEG	AML/CFT Workshop	July 2005
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2005
STA	Course on External Debt Statistics	August 2005
STA	Course on Monetary and Financial Statistics	September 2005
MFD	AML/CFT Symposium	September 2005
STA	Workshop on Coordinated Compilation Exercise (CCE) for Financial Soundness Indicators (FSIs)	November 2005
STA	NBS/OECD Workshop on NA- Bilateral Meetings with Authorities - Int. Workshop on Strategy of Reform and Development of Stat. System	November 2005
STA	NBS: International Workshop on the Strategy of Reform and Development of Stat. System in China	November 2005
STA	Course: Banking Statistics on Cross Border Flows: Compilation and Monitoring	June 2006
INS	Course on Advanced Financial Programming	July 2006
INS	Course on Macroeconomic Management and Financial Issues	July 2006
LEG	National Workshop on IT for FIUs	September 2006
LEG	AML/CFT Workshop on Mutual Evaluation Process	October 2006
LEG	AML/CFT Symposium	November 2006
LEG	Workshop for APC Countries	December 2006

Training		
LEG	AML/CFT Workshop	May 2007
LEG	AML/CFT Training for Supervisors	May 2007
LEG	AML/CFT Training for Macao SAR Supervisors	May 2007
INS	Course on Financial Programming and Policies	May 2007
STA	Course on Balance of Payments Statistics	June/July 2007
INS	Course on Macroeconomic Management and Financial Sector Issues	July 2007
LEG	AML/CFT Training for Insurance and Securities Sectors Supervisors	October 2007
STA	Course on Monetary and Financial Statistics	October 2007
STA	Course at the CTP on Money and Banking Statistics	October 2007
MCM	Workshop on FSAP and Financial Stability	December 2007
MCM	Workshop on Stress Testing	December 2007
LEG	AML/CFT Risks in the Casino Sector	December 2007
STA	Training: CCE/FSIs Seminar to Visiting Chinese Delegation	December 2007
FAD	Seminar on Revenue Forecasting	March 2008
LEG	AML/CFT Legislative Drafting Workshop	January 2008
FAD	Seminar on Revenue Forecasting	March 2008
INS	Course on Financial Programming and Policies	April 2008
STA	Seminar: BPM6 Training with BOP Compilers from Head Office and Local Offices	April 2008
LEG	AML/CFT Supervision Workshop	May 2008
INS	Course on External Vulnerabilities	June 2008
STA	Course on Government Finance Statistics	September 2008
STA	Seminar on Financial Soundness Indicators and Money and Banking Statistics	September 2008
INS	Course on Macroeconomic Management and Financial Sector Issues	October 2008
LEG	AML/CFT Risk-Based Supervision Workshop	November 2008
INS	Course on External Vulnerabilities Analysis	February 2009
INS	Course on Financial Programming and Policies	May 2009
STA	Course on Balance of Payments and International Position Statistics	June 2009
STA	Coordinated Direct Investment Survey/ External Debt	
INS	Course on Macroeconomic Management and Financial Sector Issues	November 2009
LEG	AML/CFT Risk-Based Supervision Workshop	November 2009
STA	National Accounts Statistics	November 2009
STA	Seminar: Services Statistics	November 2009
INS	Course on Financial Programming and Policies	January 2010
MCM	FSAP Workshop	January 2010
STA	Course on Monetary and Financial Statistics	March 2010
LEG	AML/CFT Risk-Based Supervision Workshop	April 2010
INS	Course on Macroeconomic Management and Financial Sector Issues	May 2010
LEG	AML/CFT Legislative Drafting Mission	July 2010
LEG	AML/CFT Risk-based Supervision Workshop	September 2010
STA	Seminar on Financial Soundness Indicators Reporting and Disseminating	September 2010
STA	Seminar on Balance of Payments Statistics: FDI/EXD/CPIS	September 2010
STA	Workshop on Statistics on Derivative Transactions	September 2010
MCM	Financial Regulation Workshop	October 2010
LEG	AML/CFT Legislative Drafting Mission	March 2011
INS	Course on Macroeconomic Management and Financial Sector Issues	March 2011
INS	Course on Macroeconomic Forecasting	April 2011
INS	Government Finance Statistics Course at CTP	May 2011
STA	Course on Government Finance Statistics	May 2011

Training		
STA	Course on Government Finance Statistics	June 2011
INS	BOP and IIP Course at CTP	June 2011
STA	Course on Balance of Payments Statistics	October 2011
INS	Monetary and Financial Statistics Course at CTP	November 2011
STA	Participate in OECD-NBS Workshop on National Accounts	March 2012
INS	FSI Course at CTP	September 2012
MCM	Medium Term Debt Management Workshop	November 2012
INS	BOP/IIP Course at CTP	April 2013
MCM	Workshop on Capital Account Convertibility and Exchange Rate Policy	June 2013
STA	SDDS Seminar	July 2013
INS	Introductory Course on Monetary and Financial Statistics in CTP	September 2013
STA	Quarterly National Accounts Seminar organized by NBS	November 2013
ICD	Macroeconomic Management & Financial Sector Issues	January 2014
MCM	Financial Statistics	March 2014
MCM	Workshop on Financial Regulation and Supervision	March 2014
ICD	Macroeconomic Management & Financial Sector Issues	March 2014
ICD	Macroeconomic Diagnostics	September 2014
INS	Financial Soundness Indications in CTP	September 2014
STA	Seminar at Fund HQ for SAFE Officials on Experiences and Challenges in the Implementation of BPM6	September 2014
ICD	Macroeconomic Forecasting	October 2014
STA	OECD/NBS Workshop on Sectoral Accounts (with STA participation)	December 2014
ICD	Macroeconomic Management and Financial Sector Issues	March 2015
MCM/STA	Total Social Financing Indicator	March 2015
STA	Meeting: ECB Meeting with Delegation from China on Debt Securities & Data Issues	April 2015
STA	Meeting: BIS Meeting with Delegation from China on Debt Securities & Data Issues	April 2015
MCM	SDR Review/Operational Issues	June 2015
ICD	Macroeconomic Forecasting	June/July 2015
INS	Advanced Course on Monetary and Financial Statistics in CTP	August 2015
STA	SAFE-Course on Compilation of Balance of Payments Statistics	September 2015
ICD	Macroeconomic Diagnostics *(scheduled)*	September 2015
STA	Balance of Payments Statistics	September 2015
STA	Debt Securities Statistics	March 2016
STA	OECD/NBS China Workshop on National Accounts (with STA participation)	March 2016
ICD/FAD	Fiscal Analysis and Forecasting	November 2015
FAD/ICD	Course on Fiscal Analysis and Forecasting	December 2015
MCM	Sub-national Debt Market Development	April 2016
MCM	Workshop on Securities Supervision	April 2016
ICD	Macroeconomic Forecasting *(Scheduled)*	June/July 2016
ICD	Macroeconomic Forecasting – Advanced *(Scheduled)*	July 2016
ICD	Financial Sector Surveillance *(Scheduled)*	June/July 2016
ICD	Dynamic Stochastic General Equilibrium Modeling *(Scheduled)*	November 2016

1/ The new Institute for Capacity Development (ICD) was formed from the merger of the former IMF Institute (INS) and Office of Technical Assistance Management (OTM) on May 1, 2012.

Statement by the IMF Staff Representative on the People's Republic of China
Executive Board Meeting
July 27, 2016

1. This statement contains information that has become available since the staff report was circulated. This information does not alter the thrust of the staff appraisal.

2. Recent data releases are in line with staff projections:

- Q2 GDP growth was 6.7 percent (y/y), driven by continued strong consumption growth (contributing two-thirds of GDP growth), while overall investment growth stabilized (contributing one-third of GDP growth).

- High-frequency indicators for June point to continued robust momentum. Retail sales continued to grow strongly at 10.6 percent (y/y) and industrial production edged up to 6.2 percent (y/y), while fixed asset investment moderated to 9.0 percent (y/y). The profits of industrial enterprises rose by 6.4 percent (y/y) in the first five months of this year.

- The trade surplus narrowed marginally in June, with export growth (in USD terms) slowing modestly (-4.8 percent, y/y) and import growth falling (-8.4 percent, y/y). FX reserves increased by US$14 billion, to US$3,205 billion. However, the central bank's FX purchase position fell by the equivalent of US$15 billion.

- Credit growth moderated somewhat, with total social financing growth of 12.3 percent (y/y) in June. Adjusting for the local government bond swap, total social financing moderated to 16.3 percent (y/y) in June.

- Headline CPI inflation eased slightly to 1.9 percent (y/y) in June while PPI inflation picked up to -2.6 percent (y/y).

3. Financial markets remain stable after UK voters' June 23 decision to exit the European Union.

- After a small loss (1.3 percent) on the first trading day after the decision (June 24), the Shanghai composite index rose by 6.5 percent as of July 21.

- As of 21 July, the onshore exchange rate against the USD had weakened by 1.5 percent since June 23, while the CFETS basket RMB index remained relatively stable, depreciating 0.2 percent. The spread between the RMB/USD exchange rates in Mainland China (CNY) and Hong Kong SAR (CNH) markets remained below 0.7 percent during this period.

Statement by Mr. Zhongxia Jin, Executive Director for the People's Republic of China; Mr. Ping Sun, Alternate Executive Director; and Mr. Jing Chen, Senior Advisor
July 27, 2016

China is undertaking a determined transition to a more balanced and sustainable growth trajectory. Its economic growth, albeit moderated from its peak to 6.7 percent in the first half of 2016, is still among the strongest worldwide. CPI growth is well anchored at around 2 percent. The labor market remains robust with 13 million new urban jobs being added in 2015. Seven million more were created during the first half of 2016. These latest developments indicate the strong fundamentals of the real economy. High frequency indicators also saw new signs of revival during the first half of the year. PPI strengthened month-on-month; industrial inventory declined for the first time since 2010; the growth of industrial value-added picked up month-on-month; and sales of housing and automobiles increased markedly.

The rebalancing continued to see concrete progress, with the consumption's contribution to GDP growth reaching 73 percent, up by 13 percentage points over the last year. The current account surplus stayed below 3 percent of GDP, while capital account outflows moderated, resulting in a slight increase of foreign reserves in June.

It is particularly noteworthy that overcapacity has started to phase out in the coal and steel sectors. The service industry contributed 54 percent of GDP in the first half, up by 2 percentage points over the last year. The manufacturing sector is moving up the value chain, as the growth of the high-tech sector outpaced the industrial average by 70 percent. E-commerce has kept growing at double digits, taking up an increasing market share.

Return to growth potential

China has committed to structural changes aimed at long-term potential rather than short-term growth numbers. It has been widely accepted that the slowdown is a needed transition to the new sustainable growth path. China would not rely on excessive stimulus to pursue unrealistic targets at the cost of the long-term outlook, while appropriate macroeconomic policy response is necessary to ensure a smooth transition. In fact, the credit boom earlier this year has already waned; growth of credit and M2 has been smoothed and moderated, and housing price hikes in Tier 1 cities were largely reined in. Long-term goals of transition and reform have been reassured in the 13th five-year plan.

Looking ahead, China has the potential to sustain growth within a desired range of around 6 to7 percent, sometimes slightly higher than the staff's baseline assessment. Specifically, the potential for growth is huge on the demand side:

- The capital/labor ratio, urbanization ratio, and infrastructure (especially in per capita terms) are still far below the AEs' level, implying large gaps to close, and great potential for catching up; hence, there is lasting demand for investment.

- Continued migration of the rural population to the urban areas, moving from agricultural sector to more productive sectors, will support robust employment shifting and income convergence with advanced economies.

  Such demands would also be supported by strong fundamentals on the supply side:

- National savings—even though moderating—would remain high by global standards to fuel the lasting investment demand.

- The manufacturing sector in China—featuring the world's largest capacity and a complete supply chain—would be able to support the rising demand.

- The labor force, albeit with less new flows, will generate more human capital, with an increasing share of educated graduates and skilled workers.

- Both private and public sectors in China are heavily investing in new technologies and "new economies," reflected by China's top ranking in new patent applications and registrations and its moving up along the world's export value chain. Hence, productivity would be boosted.

In view of such strong potential for growth, existing policy space could be tapped to avoid a "hard landing," thus achieving the potential output. Decisive structural reforms on the supply side would further unlock the potential, notably SOE reforms, streamlining administrative approvals, and enhancing the role of market forces based on broad entry, smooth exit, proper pricing, and effective oversight.

Tackling the high leverage

Based on BIS data (Table 1 below), the overall leverage in China is high but is not particularly outstanding compared to peers. Leverage in China, unlike most AEs, is prominent in the corporate sector, reflecting the dominant banking sector and underdeveloped capital market; but leverage is rather low in the government and in households. Unlike most EMs, 97 percent of leverage in China is financed by domestic savings, with much smaller exposure to currency mismatch, and is, therefore, more of a combined issue of maturity mismatch and soft budget constraint in some SOEs. In addition, debt-to-GDP ratios are not to be compared across countries, because of their high savings rate differential. Debt in stock should be measured against assets in stock rather than against GDP—which is a flow—to reflect more precisely the actual solvency. In fact, the debt-to-asset ratio of China's industrial corporate sector averaged at 56 percent in June, indicating the higher debt coverage by assets than by GDP.

Table 1: Total Credit at end-2015, % of GDP, BIS

	Non-financial sector	General government	Households and NPISHs	Non-financial corporations
Total reporting countries	235.3	83.2	59.6	92.5
Emerging economies	**179.3**	**42.3**	**33.1**	**103.6**
China	254.8	44.4	39.5	170.8
Korea	234.8	40.4	88.4	106.0
Singapore	247.4	104.7	60.3	82.4
Advanced economies	**268.2**	**107.0**	**75.2**	**86.0**
US	250.6	100.1	79.2	71.2
Japan	388.2	221.0	65.9	101.3
Euro Area	266.3	104.3	59.3	102.8
France	290.2	108.8	56.5	124.9
UK	265.5	105.2	87.3	73.0
Italy	275.1	153.7	42.5	79.0

That said, the authorities have paid great attention to the rapid expansion of credit and investment in the 2009-2010 period and more recently the credit in 2015-2016, which, as a counter-cyclical measure, may be understandable but apparently unsustainable. In response, a comprehensive package of deleveraging and restructuring has been worked out. The staff's proposed solution to the debt stock (including triage, loss recognition, restructuring, and market-based disposal) is helpful and constructive to the authorities' decisive actions.

Although the staff's bottom-line approach deserves sufficient attention, we would reiterate that the presumed potential loss of 7 percent of GDP from corporate debt at risk may well be overstated, as the staff's calculation is based on narrow samples of listed firms, oversimplified measure of insolvency (only by interest coverage), and excessively high loss ratio assumption (higher than Basel III). Furthermore, even at 7 percent of GDP, the potential losses would be adequately absorbed by the strong capital base, sufficient provisioning, and profit margins of the banking system; and, in the worst scenario, would not challenge fiscal debt sustainability.

The authorities are confident that the corporate debt issue can be properly tackled, and the deflation-debt spiral would be curtailed. The 52-month PPI deflation that worsened corporate profitability, raised real interest rates, and threatened corporate debt sustainability, has begun to moderate due to the recent domestic rally of commodity prices and reduction in inventory. Moreover, driven by both structural and cyclical factors, the growth of overall profit margins of industrial enterprises rebounded from last year's negative figures to 6.4 percent and the debt-to-asset ratio has seen a decline of 0.5 percent in May, which, if persist, would further improve the debt-service capacity of the corporate sector.

Policy outlook

On the monetary front, China will continue its prudent monetary policy, aimed at appropriate liquidity in the market and reasonable growth of credit and total financing. Efforts to achieve the objectives have been largely effective so far. The money market is fairly liquid with interest rates stabilizing at around 2 to 2.5 percent. M2 growth and credit growth have slowed in June to 11.8 percent and 13 percent, respectively—the lowest since last June.

It would be risky to simply deploy a monetary policy index to assess the monetary stance and to draw a conclusion that the current stance is looser than desired. In fact, the prevailing lending rates in the market are still high, particularly in real terms, if adjusted by the PPI deflation. In addition, reasonably low nominal interest rates will also help reduce the debt-service burden and facilitate deleveraging.

On the fiscal front, in view of the apparent fiscal space, the mild expansion of budget deficit is appropriate, given the emphasis on social spending and infrastructure investment that would benefit long-term potential. Furthermore, critical structural reforms on the supply side, including reduction of corporate debt and overcapacity, as well as incentives to encourage innovation and the "new economy," also require fiscal support. In this context, caution is warranted in interpreting and using the "augmented" deficit in comparison to other countries. This is because a large part of the local government's liability corresponds to assets that will generate financial and economic return, rather than general expenditures. Historical sample records show that the payment ratio for the local government's contingent liability has been only 20 percent. We believe the increased transparency, the hardened budget constraint, and the ongoing standardization of local government finance will improve the quality and efficiency of their spending. After all, even the very unlikely "upper bound" of the "augmented" debt—74 percent of GDP—is still low by international standards.

On the revenue side, the full adoption of VAT in the service sector would entail an estimated tax reduction of RMB 600 billion. The intended fiscal reforms—especially a new fiscal federalism system to better match local governments' revenue with their spending commitments and a more direct tax-based system with broader tax base, greater progressiveness, and less procyclicality—are already in the pipeline. These are expected to improve revenue prospects and further enhance fiscal soundness.

On the financial front, the overall banking sector is adequately capitalized, well provisioned, and properly supervised in accordance with the Basel III, demonstrating strong buffer and great resilience to potential risks. The authorities have made substantial efforts to implement FSAP recommendations, especially those of high priorities. In view of concerns on the rising NPLs and booming nonbank financing, the authorities have kept close watch of the evolving risks and the interlinkages across the entire financial system, with committed efforts in the early warning of potential risks, the mitigation of emerging risks, and a thorough stocktaking of the actual risk profile of financial institutions. Toward this end, the authorities have been cooperating with the Fund and the Bank on undertaking a full scope update of FSAP. A macroprudential framework has been put in place and coordination among regulatory authorities, as well as communications, have been enhanced so as to guard against systemic risks and better guide public expectations.