CHINA'S MACRO ECONOMIC POLICIES IN 2010: SUSTAINING RECOVERY WITHOUT OVERHEATING

Sarah Y. TONG & YAO Jielu

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Executive Summary

1. The Chinese government has started to adjust its macro-economic policies since the beginning of this year as circumstances change. However, official rhetoric, such as "to continue to implement a proactive fiscal policy and a moderately loose monetary policy", remains largely unchanged.

2. In the first quarter of 2010, the economy grew strongly at a robust year-on-year 11.9 percent, the fastest quarterly growth since 2007, with a lower than expected inflation rate of 2.2 percent. Given the strong momentum in export recovery and consumption growth, it is widely expected that the economy will grow by over 9.5 percent for 2010.

3. The Chinese government, however, has set the growth target at a conservative 8 percent for 2010, together with an urban registered unemployment rate of below 4.6 percent and inflation rate of around 3 percent. This is in part an attempt to cool down local governments' enthusiasm for high growth, and partly a tradition to deliberately set a low bar for the economy.

4. In the immediate and medium term future, several issues deserve close attention, including a possible overheating of the economy, substantial and sometimes reckless government spending, a potential bubbling and bubble-burst in the property market, and currency tiff between China and the United States.

5. Partly to counter potential economic overheating and reckless lending, growth in China's money supply has eased since the beginning of 2010, where M2 growth moderated to 22.5 percent in March. For 2010, regulators set an annual target of RMB 7.5 trillion for new loans.

6. This year, People's Bank of China raised Reserve Requirement Ratio three times, in January, February and May, each by 50 basis points. The likelihood

of an interest rate hike is contingent upon China's currency policy, as pushing up interest rates might spur speculative capital inflows.

7. A *renminbi* appreciation and a more flexible exchange rate may give the central bank more room to raise interest rate, and currently international political environment seems conducive for China to adjust its policy.

8. For 2010, China has set a budget deficit of RMB 1050 billion, considerably larger than the RMB 740 billion in 2009. The deficit includes RMB 850 billion for the central government and the issuance of RMB 200 billion bonds for local governments.

9. The concern for governments' spending has been prompted by large local governments borrowing via Urban Development Investment Vehicles (UDIVs). These loans may pose credit risks for the nation's banks, as well as fiscal risks for local governments.

10. Chinese banks are required to overhaul the existing exposure to the risks related to UDIVs. China Banking Regulatory Commission also raised lending standards for UDIVs in the beginning of 2010.

11. To shift the economy from heavily investment-driven and export-oriented growth to one driven by technological advances and domestic consumption, much effort has been made to encourage innovation and private sector development, and to strengthen social infrastructure.

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Sarah Y. TONG & YAO Jielu*

Policy adjustment needed

1.1 With the government's firm conviction and strong policy measures, China rebounded more swiftly from the financial crisis than any other big economies. In 2009, gross domestic product (GDP) grew by 8.7 percent, with investment rising by about 18 percent and total retail sales of consumer goods by 17 percent in real terms. Despite a sharp fall in early 2009, export growth also recovered strongly and returned to the pre-crisis level with a year-on-year 17.6 percent gain in December. By the end of 2009, China had surpassed Germany as the world's top exporter.

1.2 As economic recession gives way to a bursting recovery for China, questions are emerging as to when and how the country should adjust its strong and perhaps excessive policies, such as the large stimulus package of *RMB* 4 trillion and a loose monetary stance that pumped nearly *RMB* 10 trillion new loans into the economy in 2009. As official rhetoric, the Chinese leadership has made it clear that the government will "continue to implement a proactive fiscal policy and a moderately loose monetary policy" in 2010.[1] However, policy adjustment has already been under way since the beginning of the year.

1.3 On one hand, the stimulus package will continue to be implemented and the credit conditions remain supportive of the real sector. In other words,

* Sarah Y. Tong is assistant professor of the Department of Economics and research fellow of the East Asian Institute, National University of Singapore. Yao Jielu is research assistant at the same institute. They would like to thank Professor Zheng Yongnian, Professor John Wong, Dr. Yang Mu, and Dr. Zhao Litao for going through earlier drafts and giving useful comments.

[1] "2010 Report on the Work of the Government", Wen Jiabao, March 5, 2010. http://www.china.com.cn/policy/txt/2010-03/15/content_19612372.htm

economic growth still tops the priority list for China. Not only does the government pledge to consolidate the foundations of the recovery and to avoid potential risks of a prematurely early exit, it also strives to sustain the growth momentum to maintain social-political stability.

1.4 On the other hand, Beijing emphasizes the importance of policy flexibility due to potential risks, such as excessive lending, and changing external environments. Domestically, a flood of easy lending, combined with a red-hot property market, may easily lead an overheated economy and a surge in bad loans. Internationally, China's rising prominence in world trade may give rise to growing tension between China and its major trading partners. Therefore, the process of policy normalization will largely depends on the development and the interplay of these internal and external dynamics.

1.5 In the government's work report, policymakers set several main economic targets for 2010. More specifically, the economy is expected to achieve a growth rate of approximately 8 percent while creating over 9 million urban jobs to keep the urban registered unemployment rate at below 4.6 percent.[2] The government also aims to maintain a full-year inflation rate of around 3 percent and to improve the balance of payments. The fairly evenhanded targets reflect the government's attempt to strike a delicate balance between inflation and economic growth. More importantly, the rather conservative growth target reflects the government's attempt to cool down local governments' strong urge for high growth. Moreover, setting a deliberately low bar for economic growth seems to have become a culture in China. For example, the growth target was set at 7 percent for the years 2000 to 2005 while the economy grew by 10 percent a year in real terms.

1.6 Moreover, efforts were also made to achieve medium and long term objectives of transforming the patterns of economic growth, toward more emphasis on the quality of growth and economic restructuring. These include the promotion

[2] While Chinese government has set the growth target at 8 percent, which is deemed necessary to generate employment and to maintain social stability, it is widely believed that growth is likely to outperform in 2010. The economy is expected to grow by 9.5 to 10 percent according to the latest forecast by the World Bank and the International Monetary Fund.

of new strategic industries and the development of small and medium-sized enterprises (SMEs).

1.7 At the same time, further efforts were made to ramp up domestic consumption. Indeed, they were seen as an immediate solution to cushion the sharp slowdown in exports and to reduce the country's exposure to future external shocks. In 2010, the central government budget allocates *RMB* 318.5 billion to improve social security to stimulate consumption by lessening the perceived need for precautionary savings. The government is also taking steps to improve income distribution and to support rural development; both are likely to boost domestic demand.

1.8 Recent data show that China has made an auspicious start in 2010. In the first quarter, the economy grew by a robust year-on-year 11.9 percent, the fastest quarterly increase since 2007, with an inflation rate of 2.2 percent. However, these figures may have mixed policy implications. On one hand, the strong growth performance seems to justify a tighter policy stance to avert the risk of overheating. On the other hand, the relatively modest increase in consumer prices has eased pressures on Beijing to take drastic measures.

1.9 In the immediate and medium term, three problems deserve close examination. One is related to the large and sometimes reckless government investment. Following the announcement of the large fiscal stimulus package in late 2008, the Chinese governments at various levels have launched numerous investment projects. Those by local governments are especially problematic. By law, local governments are not allowed to borrow directly from banks. To circumvent, various kinds of Urban Development Investment Vehicles (地方政府融资平台, UDIV) were set up to finance local projects. If a large number of loans by UDIVs turn sour in the end, as some fear, the banking industry will suffer a massive surge in non-performing loans and local governments might be liable for the loans.

1.10 The second is a potential bubbling and bubble-burst in the property market. It is reported that the housing prices in 70 major cities leapt 11.7 percent in March 2010 from a year earlier, causing the Chinese authority to expand supply and curb speculation. Indeed, a bubble-prone property market increases both credit risk and fiscal risk. If the property market tumbles, bank loans supported by the property will go bad and the proceeds from land sales to repay government borrowing will fall short. Recent policies centered on this issue include a rise in down payment as well as mortgage rate for the second home purchase, and stricter controls over land supply.

1.11 The last issue is the currency tiff between China and the United States. The United States believed that China deliberately undervalued *renminbi* to bolster its export and employment, while China took a strong stance in defending its currency and trade policies. Although the bilateral tension on *renminbi* has eased somewhat in recent weeks, the market expects the Chinese government to relax its *renminbi* exchange policy in the coming months. Such policy adjustment will have a significant impact on China's macro-economy.

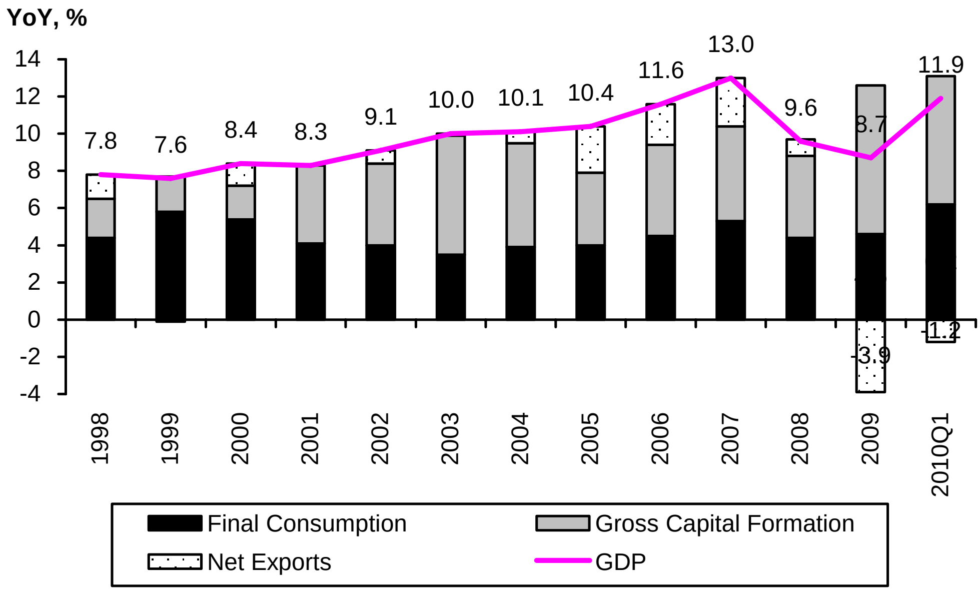
A Modest Tightening of Monetary Policy

2.1 Monetary policy is an important mechanism for economic intervention during the business cycle. Since the late 2008, the Chinese government has adopted a moderately loose stance to stave off the worst of the economic crisis. Although there has been wide speculation that the monetary policy would be noticeably tighter in 2010, the government's work report underlines the need to maintain an accommodative stance. In the longer term, however, policy makers are expected to gradually normalize monetary conditions.

2.2 Two key variables are watched closely by monetary authorities: growth and inflation. As shown in Figure 1, real GDP grew by 11.9 percent in the first quarter of 2010. Consumption was particularly strong, contributing 6.2 percentage points of total GDP growth, compared to a 4.6 percentage points in

2009.[3] While capital formation remains the most important driving force, contributing 6.9 percentage points, it was a considerable drop from the 8.0 percentage points of 2009, reflecting the weakening of government-driven investment. Exports, on the other hand, were on the course to recover as global demand rebounded.

FIGURE 1 COMPOSITION OF GDP GROWTH



Source: National Bureau of Statistics,CICC

2.3 The other key indicator is inflation. The relatively loose monetary stance of 2009 has fueled fears that the seeds of inflation have been planted. But recent data suggest that the government has managed to prevent inflation from rising too sharply while keeping the growth momentum.

2.4 According to the National Bureau of Statistics, China's headline consumer price index (CPI) rose by 2.4 percent in the year to March and 2.2 percent in the first quarter of 2010, considerably below the government's ceiling of 3 percent for the year. On the other hand, however, the producer price index (PPI) jumped by a high 5.2 percent in the first quarter, due to both a domestic price reform of major resource products and rising international commodity

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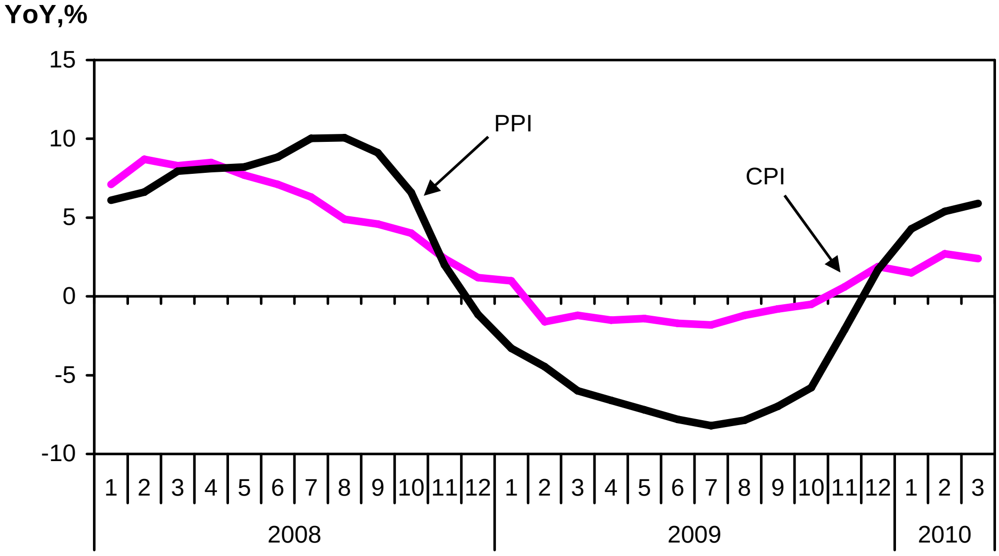
3 "Strong economic growth and modest inflation (经济增长强劲通胀暂时温和)", China International Capital Corporation Limited (CICC), 15 April 2010.

prices. Although both CPI and PPI turned positive, they remain below pre-crisis levels (Figure 2). This suggests that inflation risks remain modest at present but needs to be watched carefully.

FIGURE 2 CHINA'S HEADLINE CPI AND PPI



Source: National Bureau of Statistics

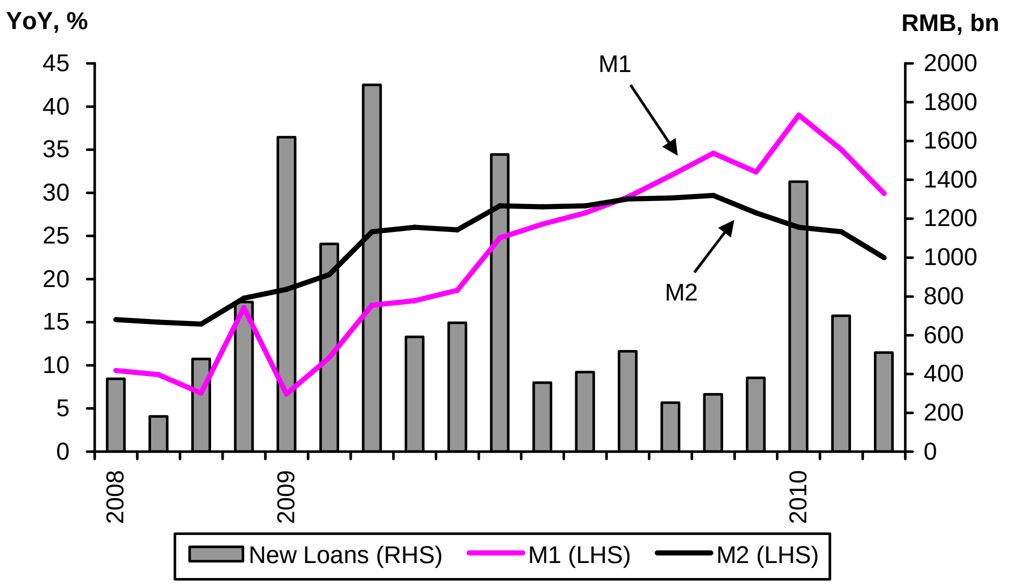
2.5 It is worth noting that volatile food prices have dominated headline inflation in recent years, and the government's intervention in food prices has been effective to stabilize the CPI. One factor that might push up this year's inflation is a possible rise in wages, due in part to the labor shortages in parts of China. As export demand recovers, manufacturers in coastal areas are having problems recruiting workers and local governments of several cities are considering raising minimum wages.

2.6 With such mixed economic fundamentals, the Chinese monetary authorities have employed quantitative tools more cautiously and flexibly, while sometimes turning to on-going window guidance, in order to curb excessive credit expansion without jeopardizing the real economy. For 2010, regulators set an annual target of *RMB* 7.5 trillion for new loans. In spite of a 22 percent decline from 2009, the quota was still much higher than the total new loan of *RMB* 4.9 trillion in 2008 and *RMB* 3.6 trillion in 2007.

2.7 While the banks may agree that the quota is sufficient, individually, each wants a bigger share and fears that the central bank may decide to tighten money supply later in the year. As a result, bank lending skyrocketed in the first two weeks of 2010 with a total amount of *RMB* 1.1 trillion. On January 18, the People's Bank of China (PBoC) summoned the banks for a meeting to impose tougher rules, such as allocating the loan quota quarterly or monthly. Aggressive banks could be punished by turning in extra reserves, and some banks were even told to stop all lending for the rest of the month.[4]

2.8 These measures turned out to be quite effective. New loans in February and March dropped dramatically to *RMB* 700 billion and *RMB* 500 billion, respectively (Figure 3). Total new lending in the first quarter of 2010 amounted to 34 percent of the government's target for the year, consistent with the original target of 35 percent.

FIGURE 3 CHINA'S MONEY SUPPLY AND NEW LOANS



Source: People's Bank of China

2.9 Growth of China's money supply has also eased since the beginning of 2010. Growth of M2 moderated gradually from 29.7 percent in November 2010 to

[4] "More on Bank Lending in China", Economic Analysis of Bank of America and Merrill Lynch, January 28, 2010.

22.5 percent in March 2010. Since the trend in money supply is a good indicator of monetary conditions, it is sensible to predict that China's monetary stance would be noticeably tighter in 2010 than 2009.

2.10 Moreover, PBoC has hiked Reserve Requirement Ratio (RRR) three times this year, each by 50 basis points. As a result, the five big commercial banks and the Postal Bank are subject to a 17 percent RRR, while the other smaller banks are subject to a RRR of 15 percent.[5] Assuming that the total loan target for 2010 is sufficiently large, these RRR moves are widely viewed more as liquidity management than outright tightening, and thus the credit costs are unlikely to increase substantially.

2.11 It is interesting to note that the first hike in January was initially interpreted by some as a sign of tightening, which led to a negative reaction in asset markets, while the second hike in February was of no surprise as the market had already priced in multiple RRR hikes.[6] The third rise was announced on 2 May and will take effect on 10 May. Although Chinese monetary authorities continue to opt for raising RRR instead of hiking interest rate or adjusting currency policy, it indicates that Beijing is becoming increasingly concerned with the inflationary pressures.

2.12 Interest rate management is another instrument for central banks to battle inflation. However, since China has basically pegged its currency to the dollar since July 2008, PBoC has very little room to push up interest rates independently of the United States, as it might spur speculative inflows. Meanwhile, China does need more leeway to cope with a looming inflation, given its buoyant economic growth. Therefore, the likelihood of an interest rate hike is contingent upon China's currency policy.

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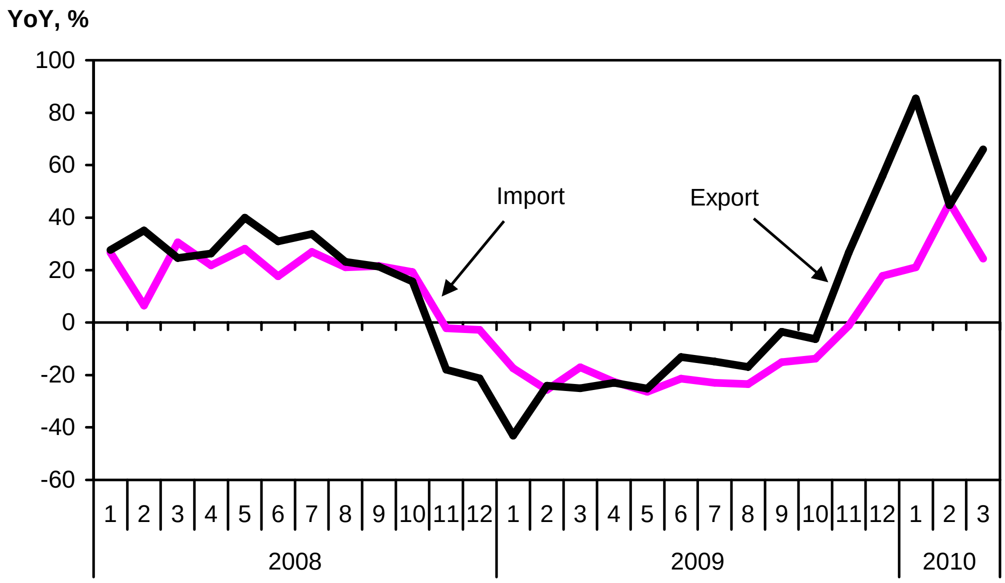
5 The big five state commercial banks include Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Bank of Communication, and Agricultural Bank of China.

6 "China Economics: RRR Hike Cycle Kicks off Earlier than Expected", Morgan Stanley Research, January 12, 2010.

2.13 Indeed, Chinese currency regime remains one of the most hotly debated issues. There is a widely held perception that China has kept the value of *renminbi* deliberately low to maintain export competitiveness, citing as evidence China's huge and growing current account surplus.

2.14 However, there is tentative evidence of a significant change in China's trade pattern in that import growth has rebounded more strongly than export and trade surplus is declining. As is shown in Figure 4, imports held up much better than exports in 2009, and the ratio of current account surplus to GDP decreased from 9.4 percent in 2008 to 5.8 percent of 2009. The figure of the first quarter of 2010 also confirmed this trend.

FIGURE 4 GROWTH OF CHINA'S EXPORTS AND IMPORTS



Source: Ministry of Commerce

2.15 Moreover, it is quite likely that *renminbi* will be modestly appreciated and allowed more flexibility in the near future. Indeed, exchange rate could play a crucial role in financial management and be an important instrument for a deliberate tightening of financial conditions. Thus, a *renminbi* appreciation and a more flexible exchange rate may give the central bank more room to raise interest rate, and thus be more effective in easing inflationary pressure. Furthermore, considering China's substantial foreign exchange reserves, now standing at US$ 2.4 trillion and amounting to more than 50 percent of GDP, it becomes increasingly costly for China to intervene in currency market and more difficult for it to manage appreciation expectations.

2.16 From a political perspective, the international political environment is currently conducive for China to adjust its currency policy. On April 3, U.S. Treasury Secretary Geithner announced that it would delay a decision on whether to declare China as a currency manipulator. On April 12, the Chinese President Hu Jintao also met his U.S. counterpart Barack Obama in Washington to exchange views on economic and trade relations. As it is highly unlikely for China's leadership to make policy changes in the face of overt pressure, the recent lessening of tension could make it a good opportunity for China to appreciate *renminbi* and to reform its currency regime.

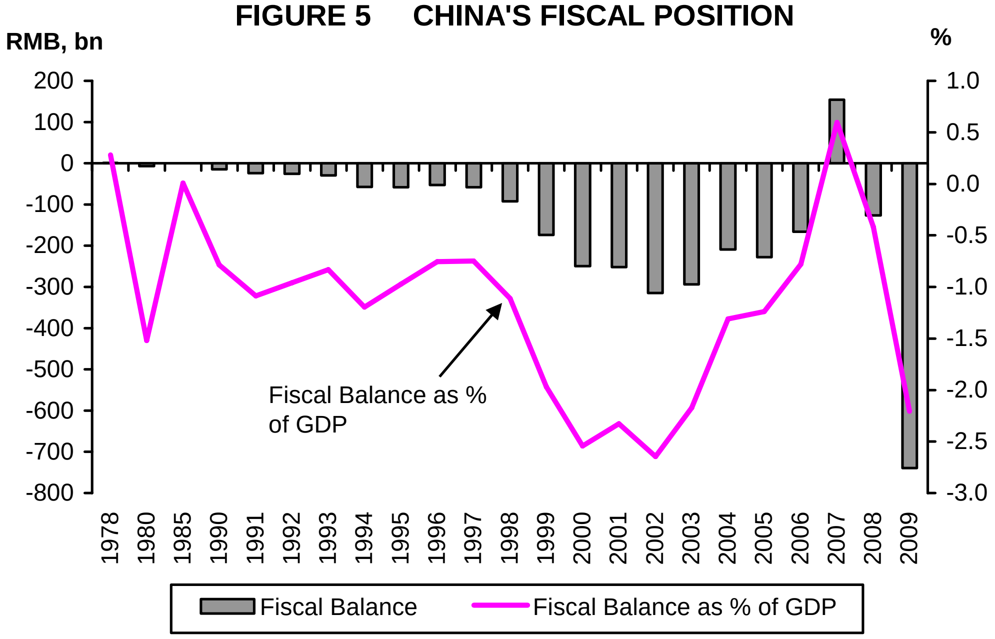
2.17 In short, China’s monetary policy is on the path of steady normalization. To contain the emerging risk of inflation, China has and will remain vigilant to prevent the monetary policy from becoming excessively loose.

Adjusting Fiscal Policy

3.1 Thanks in large part to the government’s aggressive fiscal stimulus of *RMB* 4 trillion announced in late 2008, China’s economy managed to recover quickly and strongly from a sharp slowing down. For 2010, China has set a budget deficit of *RMB* 1050 billion, considerably larger than the *RMB* 740 billion in 2009. The deficit includes *RMB* 850 billion for the central government and the issuance of *RMB* 200 billion bonds for local governments.

3.2 Despite substantial spending by governments at all levels, China’s full-year fiscal deficit in 2009 amounted to a modest 2.2 percent of GDP (Figure 5), considerably better than many other countries, such as the United States where budget deficit amounted to 9.9 percent of GDP. This largely reflected the strong rebound in fiscal revenue in the second half of 2009, due to a solid economic recovery and a sharp rise in asset markets.

FIGURE 5 CHINA'S FISCAL POSITION



Source: Ministry of Finance and National Bureau of Statistics

3.3 For 2010, the fiscal stance remains growth-supportive as highlighted in the government's work report. Not only does China need to complete ongoing investment projects, it has to build up social infrastructure to help maintain social harmony and spur domestic consumption.

3.4 Nonetheless, China has already started adjusting its fiscal policy, while official statement suggests that the government is only "considering gradually withdrawing its proactive fiscal policy though so far no timetable has been established."[7] Indeed, the sharp rise in government spending has fueled fears of fiscal risk and credit risk both domestically and international.[8] On the other hand, private sector activities are expected to expand solidly this year. Thus there is little doubt that the government does not need to continue to stimulate the economy.

7 "Speech at the 2010 China Development Forum in Beijing," Wan Jun, March 21, 2010. http://www.chinadaily.com.cn/china/2010-03/21/content_9619027.htm

8 "Government Borrowing Is Rising Risk to World Financial System", International Monetary Fund, April 20, 2010.

3.5 Much concern over governments' spending has been prompted by the large borrowing of local governments via UDIVs.[9] As warned by Zhou Xiaochuan, the Chinese central bank governor, "local government financing vehicles using land as collateral may pose risks for the nation's banks" and "local governments might be liable for the loans borrowed by UDIVs", which leads to "fiscal risks".[10]

3.6 Prohibited from borrowing directly by the Government's *Budget Act* and *Guarantee Law*,[11] China's local governments often raise funds through UDIVs for their public projects. Such hidden off-balance-sheet liabilities have been soaring since the extraordinary expansion began in 2009. In a recent report, Goldman Sachs estimated that the total balance of loans to UDIVs in 2009 could be between RMB 4 and 4.8 trillion, or 12-14 percent of 2009 GDP.[12]

3.7 The Chinese authorities are trying to manage the risks related to UDIVs through ring-fencing the "stock problems" and limiting the "flow problems".[13] For existing exposure, banks are required to assess borrowings of UDIVs and categorize them into three groups based on their ability to repay the loans: 1) Loans for infrastructure projects with cash flow or collateral sufficient to cover the debts. 2) Loans for social purpose but reliant on fiscal revenue for repayments, and 3) Loans without sufficient cash flow and credible guarantee from the local government.

3.8 Specific measures are taken to monitor existing loans in each category. First, the UDIVs with loans in the first category will continue to receive credit from

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9 For more discussion on the issue of Urban Development Investment Vehicles, see a forthcoming *EAI Background Brief* by Sarah Y. Tong and Yao Jielu on the same topic.

10 "China's Zhou Sees Bank Risks in Local-Government Financing", Bloomberg, March 6, 2010.

11 Article 28 of the Budget Act (*中华人民共和国预算法*) and Article 8 of the Guarantee Law (*中华人民共和国担保法*), http://www.chinaacc.com/new/63/74/1994/3/ad78648011122349914248.htm and http://www.gov.cn/banshi/2005-09/01/content_68752.htm.

12 "China's Credit Watch 1: What New Loans Allocated in 2009; What is the Credit Outlook for 2010", Goldman Sachs Gao Hua, February 8, 2010.

13 "Three Positive Ongoing Developments; Add on Attractive Risk/Reward", Goldman Sachs Gao Hua, March 5, 2010.

banks, although they are required to improve the capital adequacy, introduce private investors, and transform into shareholding companies. Second, for the loans that rely on fiscal revenue or government subsidies, the Chinese banks are required to investigate the liability of local governments, especially that of county-level governments, to avoid fiscal risk. Moreover, the authorities suggest that the UDIVs relying on fiscal revenue to repay the loans be closed after paying off the loans if they were designed merely to raise funds. For the UDIVs that not only raise funds but also construct and operate the projects, they are required to cease financing the activity after completing the construction and paying back the loans. Third, local governments and UDIVs are responsible for their existing loans, and banks should take all measures available to mitigate the losses and to take back loans as soon as possible.

3.9 For the flow problem, China Banking Regulatory Commission (CBRC) raised lending standards for UDIVs in early 2010, while requiring that the balance of loans to UDIVs in 2010 should not exceed the amount of 2009. With rising concerns over overcapacity and inefficient spending, as well as local governments' fiscal conditions, the central government is especially prudent with the approval of new local investment projects.

3.10 Besides, the Ministry of Finance (MoF) is also mulling an indicator system to normalize the borrowing of local governments. The system will not only set explicit targets for indicators such as debt ratio, current ratio, and debt service coverage ratio for UDIVs, but lay down rules to prevent local governments from defaulting on bank loans.[14]

3.11 A potentially important policy is that qualified local governments might be allowed to issue bonds in the near future, either to build new public projects or to repay current loans. It is widely believed that the move would increase the transparency of local infrastructure projects and improve market supervision.

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[14] "The Ministries Collaborate to Investigate and Reduce loans to UDIVs (多部委联手清收压缩政府平台贷款)", Jiang Shan, *The 21st Century Business Herald,* March 08, 2010.

3.12 The Chinese authorities have refocused public spending more toward social infrastructure. The 2010 government work report highlighted four key areas. The first is to narrow rural-urban development gap. The central government allocates *RMB* 818.3 billion for the so-called San'nong Wenti (三农问题, or three agricultural isssues), including those related to agriculture, farmers and rural development. The second is to allocate *RMB* 43.3 billion from the budget to generate employment, to create 9 million urban jobs. Third, governments at all levels are required to spend more on social security, with *RMB* 318. 5 billion set aside. Fourth, the central government prepares *RMB* 63.2 billion for low-income housing, such as the building of 3 million new housing units and upgrading of 2.8 million existing housing units in rundown areas.

3.13 Overall, these measures intend to not only address concerns about income equality and social stability, but also reduce savings rates by households, thus boosting households' consumption. This is also in line with the country's objective to move away from heavily investment-led and export-oriented growth to focus more on consumption.

Policies intended to Ensure Sustainable Development

4.1 Since late 2008, the Chinese government has employed numerous policies to stabilize and to stimulate the economy. More significantly, many policies were also intended to address the country's long term restructuring needs, such as a shift toward an economy driven by technological advances and domestic consumption. As pointed out by Premier Wen at NPC's annual meeting, the intrinsic problems that might impede China's sustainable development include lack of innovation capability, overcapacity of some industries, employment pressure, and a fragile social security system.

4.2 Innovation is identified as a main engine for China's new growth model, and the government has launched a national strategy to build an innovation-driven economy and society by 2020.[15] The policymakers emphasize the importance of new technologies and industrial upgrading, and prioritize the development of new energy, new materials, energy conservation, environmental protection, biomedicine, information technologies, and high-end manufacturing.

4.3 In addition, the government pays special attention to supporting the development of SMEs and start-up companies by allocating *RMB* 10.6 billion from the budget. Apart from a preferential income tax policy, CBRC encourages commercial banks to lend more to SMEs and requires loan growth to SMEs to be no lower than their overall loan growth. A multilevel system for credit guarantee is also developed to better finance SMEs and start-ups. These measures aim to encourage private entrepreneurship and technological innovations.

4.4 Most significantly, China is undergoing an important transition toward a largely domestic consumption-driven economy. Over the past thirty years, the country has grown at an astonishing rate of 10 percent a year thanks largely to its high rates of saving and investment. In contrast, the ratio of household consumption to GDP has been on a steady decline (Figure 6). Although the earlier drop reflects the large investment need to support growth, the size of the recent fall in private consumption and the deteriorating imbalance between investment and private consumption justify serious attention.

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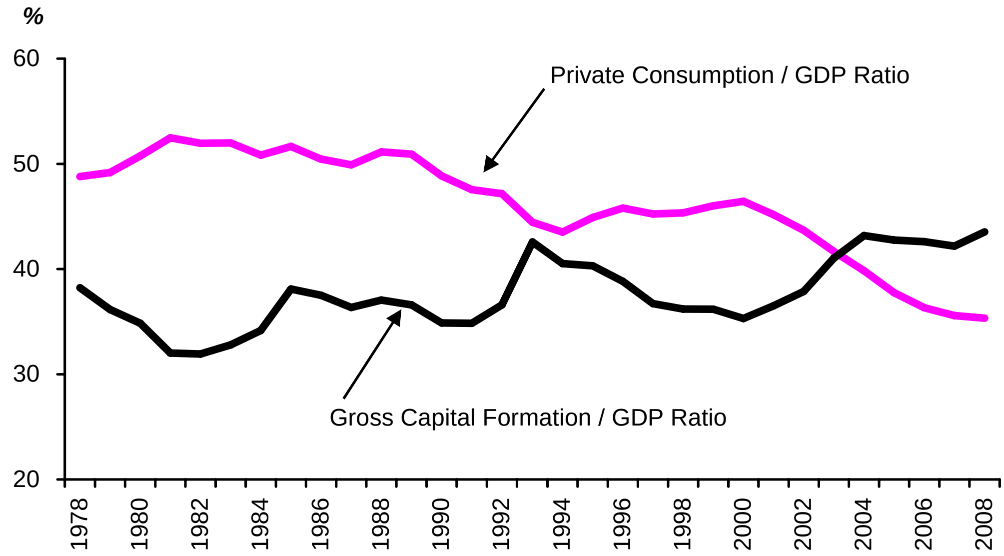
[15] The government has designed a series of guidelines to facilitate this transition. In 2006, China issued its first plan on an innovation-driven economy: "National Guideline on Medium- and Long-Term Program for Science and Technology Development (2006-2020)". [国家中长期科学和技术发展规划纲要 (2006 - 2020 年)]. And the Ministry of Education just completed soliciting opinions from the public for the second plan of "National Guideline on Medium- and Long-Term Program for the Reform and Development of Education 2010-2020" [国家中长期教育改革和发展规划纲要 2010 - 2020 年)] on 28 March 2010. The third plan on the development of human resources is also in the pipeline.

FIGURE 6 PRIVATE CONSUMPTION AND INVESTMENT IN GDP, 1978-2008



Source: National Bureau of Statistics

4.5 The government recognizes the urgency to fix this imbalance, especially at a time when investment can result in over-capacity in many industries and external demand can no longer absorb excessive outputs. According to an International Monetary Fund (IMF)'s report, efforts to raise household income and share of employment in the services sector and to develop capital markets are likely to have the biggest impact on China's consumption.[16]

4.6 Indeed, many policy initiatives are proposed to address these issues. For example, in order to increase household disposable income, several cities, including Beijing, Shanghai, and Guangzhou, indicated that they would raise the minimum wage this year following an initiative taken by Jiangsu province to increase the minimum wage by 12 percent in early February 2010. The government also lifted the threshold of income tax payment in 2008, from *RMB* 800 in 1994 to the current *RMB* 2000, and further move is expected.

[16] "Determinants of China's Private Consumption: An International Perspective", Kai Guo and Papa N' Diaye, IMF Working Paper 10/93.

4.7 Policies were also considered to increase rural income. The government would continue to increase its minimum procurement price of grains and provide *RMB* 133.5 billion financial subsidy in 2010 to help farmers buy seeds, agricultural machinery, and agricultural inputs. The allotment to agriculture, farmers, and rural areas in the government budget totals *RMB* 818.3 billion, up *RMB* 93 billion from that of last year.

4.8 To stimulate domestic household consumption, employment in the services sector will be looked into. Not only does service sector development increase the labor share of income (the services sector is generally more labor intensive than other sectors), it encourages consumption by providing more and better services. An empirical study by IMF shows that for China the consumption share could increase by 3.5 percent points for every 10 percent point increase in the share of employment in the services sector.[17]

4.9 In 2009, China's primary, secondary, and tertiary industries accounted for 10.6 percent, 46.8 percent, and 42.6 percent of GDP respectively. While the secondary sector has played a major role in China's development in recent years, the service sector is expected to grow at an accelerated rate, with government's favorable policy measures. For example, the government has gradually lowered utility fees for key service industries to the same levels charged to manufacturing industries. Besides, sectors related to people's wellbeing, such as utilities, real estate, and community services, would receive preferential support from the authorities.

4.10 Many believe that the decline in private consumption can be attributed to a rise in household's saving rate, reflecting precautionary savings due to limited pension, healthcare, and education benefits. In recent years, the government has increasingly focused on improving the social security system. For example, the central government decided in 2009 to expand rural pension, with contributions from both central and local governments, in addition to household contributions. Moreover, China is expected to introduce a nation-

[17] Ibid.

wide scheme of "deferred pension insurance (个人税收递延型养老保险)" this year, where deduction for pension insurance will be made through personal income tax. Such policy measure will likely help increase domestic consumption.

4.11 Moreover, the government would continue to improve healthcare by expanding the coverage of guaranteed basic medical care and further reforming its public healthcare system. In 2009, the government released the "Healthcare Reform Implementation Plan" (2009-2011 年深化医药卫生体制改革实施方案). It stipulates that basic medical care will be extended to all urban and rural residents by 2011. In education, strong emphasis was given to balancing the development of compulsory primary education, reforms in vocational education, and development of quality tertiary education. The central government is expected to spend *RMB* 198.1 billion on education in 2010, up 23.6 percent year-on-year. Local governments will probably spend an additional *RMB* 900 billion.

4.12 In fact, China has made a good start for the transition to a domestic consumption-driven economy. Not only did it register a monthly trade deficit of $7.24 billion this March for the first time since May 2004, it has also overtaken U.S. as the biggest auto market with domestic sales of 13 million cars in 2009. [18] Goldman Sachs reckons that China would become the world's largest importer by 2016 and accounting for 20 percent of global imports by 2025.[19]

4.13 However, as measures to stimulate household consumption take time to generate significant effects, investment remains important as a source of growth. China's fixed asset investment jumped briskly by 26.4 percent in the first quarter of 2010. The growth momentum mainly came from property investment in the private sector, with a rise of about 35 percent. In contrast,

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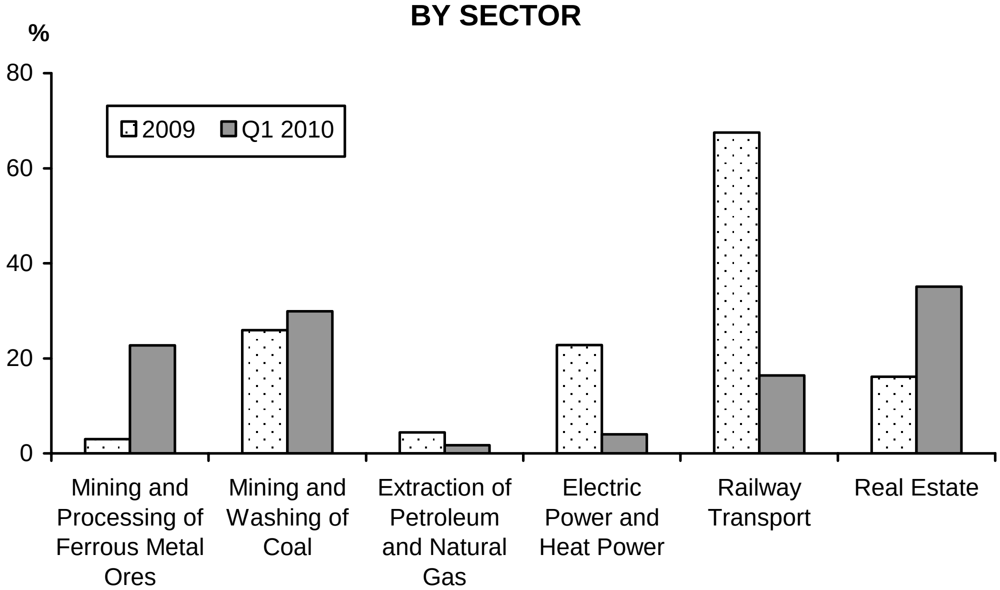
18 "Domestic Consumers Push Economy to New Heights", *The Wall Street Journal*, April 30, 2010.

19 "An Appetite that Changes the World", *International Herald Tribune*, April 27, 2010.

infrastructure investment growth has dramatically slowed down this year. For instance, the growth rate of railway transport investment dropped from 67.6 percent of 2009 to 16.4 percent of the first quarter of 2010, and the same can be said for fixed assets investment in the sector of electric power and heat power (See Figure 7). Therefore many are worried that the real estate sector is at risk of overheating.

4.14 In response, the government has taken various measures to curb speculation in the property market in the short term, and more importantly, promote steady and sound development of the property market and satisfy people's basic need for housing in the long term.

FIGURE 7 GROWTH OF FIXED-ASSET INVESTMENT BY SECTOR



Source: National Bureau of Statistics

4.15 On the demand side, the State Council requires second-home buyers to place a down payment worth half of the property's value and at a mortgage rate of no less than 1.1 times the benchmark rates. Besides, for the first-house purchase, a minimum 30 percent down payment must be paid if the unit is bigger than 90 square meters. Chinese banks have also stopped accepting applications for the third house loan. On the supply side, the Ministry of Land ensures that no less than 70 percent of new land supply would be used for affordable or small apartments, and it strictly forbids land supply for villas.

4.16 Overall, the objectives of current monetary and fiscal policies are two-fold. They are first of all centered on immediate post-crisis challenges while taking the opportunity to restructure the economy for a more balanced growth. In an attempt to prevent the economy from overheating and jeopardizing economic growth, the Chinese leaders remain vigilant to macro-economic conditions and are flexible enough to adjust quantitative tools when executing a gradual modification of strong policy measures. It remains to be seen if a new formula of development for the world's fastest-growth economy could be arrived at.