People’s Republic of China

Last year saw high and stable economic growth, subdued inflation, and a smaller current account surplus. Slightly lower growth, higher inflation, and a still smaller current account surplus are forecast for 2014 and 2015. Containing credit growth while maintaining growth momentum is one policy challenge, and another to improve income distribution.

Economic performance

After decelerating to 7.6% year on year in the first half of 2013 as domestic demand weakened, GDP growth in the People’s Republic of China (PRC) rose to 7.8% in the third quarter following a limited fiscal and monetary stimulus, then moderated slightly to 7.7% in the fourth quarter (Figure 3.9.1). Over the full year, GDP grew by 7.7%, the same rate as in 2012 and above the government target of 7.5%.

On the supply side, the service sector expanded by 8.3%, contributing 3.6 percentage points to GDP growth. Providing the impetus to growth in the sector were urbanization, rising household incomes, and the rollout since August 2013 of reforms to taxes on services, which effectively lowered them. Industry (including manufacturing, mining, and construction) grew by 7.8%, driven mainly by infrastructure projects and real estate development. The share of services in GDP rose to 46.1% in 2013 current prices, while that of industry fell to 43.9% (Figure 3.9.2). Domestic rebalancing from industry to services has thus continued to gain traction, as planned by the government. As in previous years, the private sector registered higher growth than the public sector. Similarly, growth in the western and central regions, the main beneficiaries of development programs, was higher than in eastern provinces. Monthly data indicate that the growth momentum has weakened in both industry and services since December 2013, most likely owing to monetary tightening and stronger controls on local governments’ off-budget spending.

A good harvest brought agricultural growth up to 4.0% in 2013, after a weaker performance in the first 9 months. The grain harvest reached a new peak above 600 million tons, or 442 kilograms of raw grain per capita. This is well above the 400-kilogram benchmark considered sufficient to meet the aspirations of an increasingly affluent population for a more protein-rich diet. However, agricultural growth remained below its 5-year average of 4.5%, and the share of agriculture in GDP slipped to 10.0%.
### 3.9.1 Income inequality now and in the future

One outcome of rapid economic growth in the PRC over the past 30 years is high income growth. In 2013, urban households’ average disposable income per capita grew by 9.7% to CNY26,955. Rural households’ average net income per capita grew by 12.4% to CNY8,896. The main long-term driver of income growth is exceptionally robust growth in real wages for urban and rural households alike. As rural households work more off the farm, their wage income growth has outstripped that of their urban counterparts every year since 2005. In 2013, rural households’ wage income grew at 16.8%, almost double the 9.6% recorded by urban households. However, because rural incomes started much lower, the gap between urban and rural incomes is still wide, with urban households’ earning and consuming 3 times as much. The gap between coastal and western regions also persists. High income growth, particularly for migrants, suggests that labor demand is still generally healthy, especially for blue collar jobs, and that income distribution is improving as growth in the rural migrant worker population slows. According to the National Bureau of Statistics, 6.3 million new migrants entered the workforce in 2013, fewer than the average of 8.2 million per year from 2000 to 2010. In contrast, university graduates face an increasingly crowded labor market because their numbers rise considerably each year. More than 6 million undergraduate degrees were awarded in 2011 and again in 2012, compared with fewer than 1 million in 2000. The tightening supply of new blue-collar workers, mostly rural migrants, is combining with the rapidly expanding supply of new white-collar workers to narrow the rural–urban income gap. Current trends in urban and rural income and wage growth present a hopeful contrast to the rapidly rising income inequality that the PRC experienced until recently. In 1990, income inequality as measured by the Gini coefficient was 0.320, comparable to Western Europe but low for Asia. The coefficient has risen by more than 50% since then, tracking one of the most rapid increases in inequality in history. Despite moderating to 0.473 in 2013 from 0.491 in 2008 (box figure), the coefficient still exceeds figures for the developed world and the average for Asia. Three important developments mark recent trends in income inequality. First, the ratio of urban incomes over rural has stopped rising as rural households record strong wage income growth. Second, education-related income inequality has increased along with returns on education. Third, the privatization of housing and the emergence of an entrepreneurial private sector have sharply spurred wealth inequality. Thus, despite recently higher rural income growth, the rise in wealth and education inequality could undermine the moderation of the urban–rural income gap.

The government issued guidelines in 2013 to narrow the range of primary income distribution, mainly by mandating wage caps and thresholds. Measures include promoting equal employment opportunity, increasing investments in vocational training, improving the management of revenue from public natural resources, and establishing regulations to narrow the distribution of labor incomes. Minimum wage targets aim to ensure low-income workers about 40% of average urban wages by 2015. Executive compensation will be capped, especially at state-owned enterprises. Financial reform is expected to increase unearned income by liberalizing deposit rates. The guidelines call for improving secondary redistribution through taxes, social insurance, and transfers. Taxation will be made more progressive by reforming individual income and property taxes and cutting taxes on small enterprise. Social safety nets, including health care and pensions, will be extended to rural residents. Education will be improved, especially

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### 3.9.3 Demand-side contributions to growth

On the demand side, investment contributed 4.2 percentage points to GDP growth in 2013, up from 3.8 in 2012, and consumption contributed 3.8 percentage points, down from 4.1 (Figure 3.9.3). Thus no further progress was made toward replacing investment-driven growth with growth driven by consumption. Investment growth was strongest in agriculture, underlining the government’s perception of agriculture as the “foundation” of the economy, followed by services and industry. Within industry, investment growth was strongest in infrastructure, followed by manufacturing, utilities, and mining. Real estate investment continued to grow at a very high rate on the back of strong demand. The floor space sold in residential buildings increased by 17.5% year on year, and in commercial buildings by 17.3%. Weaker net exports dragged GDP growth down by 0.3 percentage points.
in rural and poverty-stricken areas, and more affordable housing and need-based subsidies provided. These reforms will be financed by an increase from 35% to 37% in the social security and employment share of fiscal expenditure by 2015. The PRC will still lag the 52% average in other middle-income countries, limiting how much social safety net improvement can reduce precautionary savings and unleash rural consumption.

The PRC also needs to improve education and strengthen skills and labor productivity. As unskilled wages rise in urban areas, so does the incentive to drop out of high school. Yet rising returns on education worsen wage inequality. Means-tested schooling subsidies, higher than those set in 2006, and conditional cash transfers for upper secondary education may be necessary to increase enrollment and graduation rates.

Improved health care boosts labor productivity and thus narrows wage inequality. In developing economies, health-related financial shocks are the major cause of households sliding into poverty. Despite recent reform to extend health care into rural areas, the urban–rural health care gap remains worse even than labor income inequality. Fiscal spending on health should be raised gradually from the current 1.4% of GDP closer to the 6.5% average in the advanced economies.

Also important is to improve mobility, lending urgency to the announced reform of the household registration system, as graduates need to be able to move to where the jobs are. In 2011, the PRC’s urban population finally surpassed the country’s rural population. The Twelfth Five-Year Plan calls for accelerating urbanization, and the urban share of the population is expected to reach 60% by 2020 and 70% by 2030.

Can inequality be reversed? International experience suggests that large fiscal transfers for health, education, and pensions effectively reduce inequality. So do reforms that broaden the tax base and make taxes more progressive. In the advanced countries, progressive fiscal policies helped lower the average Gini coefficient by about a third from 1985 to 2005. Brazil and Argentina are among the emerging economies that have narrowed inequality by improving social protection, health care, and education.

The PRC currently spends less than 9% of GDP on these services, significantly less than the 20% average in advanced countries or the 15% spent by Brazil and the Russian Federation. It can afford to spend more.

**Recent inequality trends**

| Year | Gini Coefficient | Household Income Per Capita |
|------|-----------------|---------------------------|
| 2003 | 0.475           | 3.35                      |
| 2005 | 0.490           | 3.30                      |
| 2007 | 0.485           | 3.25                      |
| 2009 | 0.480           | 3.20                      |
| 2011 | 0.475           | 3.15                      |
| 2013 | 0.470           | 3.10                      |

Sources: CEIC Data Company (assessed 10 February 2014); National Bureau of Statistics; ADB estimates.

**Click here for figure data**

**3.9.4 Growth of per capita urban and rural incomes**

| Year | Rural | Urban |
|------|-------|-------|
| Q1   | 15%   | 9%    |
| Q2   | 13%   | 9%    |
| Q3   | 11%   | 7%    |
| Q4   | 7%    | 7%    |
| Q1   | 5%    | 5%    |
| Q2   | 7%    | 7%    |
| Q3   | 9%    | 9%    |
| Q4   | 11%   | 11%   |

Q = quarter.

Source: National Bureau of Statistics.

**Click here for figure data**
Annual consumer price inflation averaged 2.6% in 2013, the same as in 2012, with fluctuations over the year caused mainly by food price volatility. Nonfood inflation and core inflation (which omits energy as well as food) remained relatively low and stable within a range of 1.6%–1.7%. Average producer price deflation accelerated to 1.9% in 2013 from 1.7% in 2012, reflecting lower commodity prices and overcapacity in domestic industries. This suggests that inflationary pressures within the economy remain modest. Although producer price deflation moderated to 1.4% year on year in December 2013, it reverted to 2.0% in February 2014, casting doubt on the possibility that demand is strengthening or capacity utilization improving (Figure 3.9.5).

The official budget deficit for 2013 stood at 1.9% of GDP, slightly higher than in 2012 but within the government target of 2.0%. Revenue growth slowed to 10.1% in 2013, the lowest annual rate since 1991 and only marginally above nominal GDP growth, while expenditure growth moderated to 10.9% in 2013 from 15.3% in 2012 (Figure 3.9.6). The decline in revenue reflected mainly overdependence on indirect taxes. Value-added, business, and consumption taxes currently bring in over 60% of total tax revenues. Reflecting the higher sensitivity of these taxes to economic up- and downswings compared with direct taxes, falling import growth suppressed import-related duties and taxes.

A recent audit suggests that the augmented budget deficit, which includes off-budget spending, was higher than officially reported, and the fiscal stance more expansionary. The audit showed local government debt increasing from 26.7% of GDP in 2010 to about 36.0% at the end of June 2013. Most of this debt was borrowed off budget through special financing vehicles because local governments are prohibited from borrowing on budget, despite their expenditure needs substantially exceeding their revenues. The augmented local government debt was partly invested in nonearning infrastructure assets, making it difficult for these governments to meet their debt service burden, which is high for some, particularly in light of maturity mismatches. Deeply indebted governments are now allowed to borrow only to refinance existing liabilities with longer-term loans. As central government debt is still low at 13.6% of GDP, however, consolidated central and local government debt does not appear excessive from an international perspective.

The M2 money supply was growing at 13.6% year on year at the end of 2013 (Figure 3.9.7). This exceeded the 13.0% target set by the People’s Bank of China (PBOC), the central bank, for 2013, as in the previous years. The ratio of M2 to GDP rose to nearly 200%, which is high for a developing country. Despite efforts to pursue a firmer monetary stance to rein in credit growth and financial risks, which have driven up interbank interest rates since May 2013, credit growth outpaced nominal GDP growth. The root cause of high credit growth in 2013 was an increase in the PBOC’s net foreign assets resulting from strong capital inflows, which put upward pressure on the currency. The PBOC had to purchase foreign currency to stem renminbi appreciation, thereby inflating the monetary base and the money supply. The government and banks increased their deposits at the central bank, but this sterilized only about a third of the expansion.
Another factor behind strong money supply growth in 2013 was the difficulty of controlling lending, particularly lending associated with shadow banking. However, some progress was made in the second half of 2013, when tighter interbank market conditions and stricter regulations forced a sharp decline in the issuance of trust loans and bankers’ acceptances (Figure 3.9.8). This trend continued into 2014, helping to further reduce broad money growth to 13.2% year on year in January 2014.

The trend appreciation of the renminbi vis-à-vis the US dollar continued as capital inflows remained strong except for short interruptions in mid-2013 and early 2014. By December 2013, the renminbi had appreciated by 3.1% year on year against the US dollar (Figure 3.9.9). In nominal effective terms, the appreciation was higher at 7.2% because the Japanese yen depreciated early in 2013. In real effective terms, the renminbi appreciated by 7.9% year on year. Real effective appreciation peaked in September 2013 at 9.3% year on year—a magnitude that, if sustained, might be difficult to compensate for through productivity gains. The downward trend since then, resulting mainly from yen stabilization and higher inflation in Japan, is thus good news for the PRC’s external competitiveness.

As its foreign trade continued to grow, the PRC replaced the US in 2013 as the largest goods-trading nation. Merchandise export growth was volatile throughout the year but reached 7.8% year on year based on customs statistics, only marginally below the export growth rate in 2012 (Figure 3.9.10). Export figures since late 2013 do not yet clearly support the view that stronger growth in developed economies translates into higher export demand for the PRC, as export growth was strong in November 2013 and January 2014 but weak in October and December 2013, and even negative in February 2014. Import growth was lower than export growth but more stable. It reached 7.3% for the year as a whole. Therefore, the trade surplus rose to $261 billion, 12.3% higher than in 2012, but remained unchanged as a percentage of GDP at 2.8%.

The improved trade balance and lower deficit in the income account were offset by an expanding deficit in the service account and a small deficit in net transfers. The current account surplus thus narrowed to $188.7 billion or 2.1% of GDP from $193.1 billion or 2.3% of GDP in 2012. In contrast, the financial and capital accounts closed with a large surplus of $262.7 billion in 2013, following a deficit of $16.8 billion in 2012. This impressive turnaround came mainly from strong net inflows of portfolio investment in 2013, particularly in the first and fourth quarters, following strong net outflows in 2012. Gross inflows of foreign direct investment also increased in 2013, by 5.3% to $117.6 billion according to the Ministry of Commerce, but the PRC’s direct investment abroad rose more quickly, recording 17.3% expansion to reach $87.8 billion. This means that net foreign direct investment inflows may well have declined, but the balance of payment figures to confirm this have yet to be disclosed. The overall balance of payments surplus increased fourfold over 2012, boosting official reserves by $510 billion to nearly $4 trillion.
Economic prospects

GDP growth is projected to decelerate somewhat to 7.5% in 2014, which is the official target, and 7.4% in 2015 (Figure 3.9.11). Slightly weaker growth momentum from the fourth quarter of 2013 is carrying over into 2014. Support for growth over the forecast period should come from more equitable income growth and higher social spending in line with government objectives, which will sustain growth in consumption. GDP growth should also benefit from the upturn in developed countries, which should sooner or later generate stronger demand for PRC exports despite continuing real renminbi appreciation and higher unit labor costs.

Investment growth, on the other hand, will likely decelerate as the government tries to rein in high credit growth, reduce industrial overcapacity, and bring local government debt under control. These efforts are already forcing many local governments to adjust their investment targets for 2014. Other structural reforms outlined at the Third Plenary Session of the 18th Central Committee of the Communist Party of the PRC in November 2013 may also weigh on headline growth: state-owned enterprise reform, higher prices and/or taxes for primary resources, and a change in how senior local government officials are evaluated that depends less on economic growth. However, such reforms have the potential to improve the quality of growth and ensure its long-term sustainability. The government has announced that it will try to prevent a sharp downturn to avoid social problems, implying that reforms will be rolled out over longer periods. Therefore, GDP growth is forecast to decelerate slowly over several years before it stabilizes or rises again.

Inflation is forecast to remain subdued at 2.6% on average in 2014, below the government target of 3.5%, as moderating GDP and credit growth keeps price pressure in check (Figure 3.9.12). Low capacity utilization in manufacturing should help contain domestic price pressures for some time to come. However, increases in administered prices, in line with the government’s plans to reform the pricing of energy, water, and other commodities, may push annual average inflation to around 3.0% in 2015. Volatile food prices harbor risks to this inflation forecast.

As the government has announced that fiscal policies will stay broadly unchanged, the consolidated budget deficit is forecast to remain at about 2.1% of GDP in 2014 and 2015. The government will likely try to broaden its fiscal space and options by gradually increasing budget revenues through tax system reforms. Efforts to reduce local governments’ off-budget spending may, however, have the effect of fiscal tightening. Government current expenditure should rise more than in 2013 as fiscal spending related to social security, public housing, education, and health care will continue to increase in line with announced government policies. In contrast, administrative spending will be cut further.

Monetary policy needs to strike a balance between mitigating risks in the financial and property sectors that stem from high past credit growth and supporting sustainable economic growth. As current growth momentum seems sufficiently high to provide enough jobs, monetary policy is expected to lean further toward tightening over the forecast period. This should bring the growth rate of money supply closer to that of nominal GDP and possibly even below the official target of 13% (Figure 3.9.13).
As global commodity prices are forecast to fall, the PRC’s foreign trade will likely benefit from improved terms of trade. The merchandise trade surplus should thus widen further in 2014 and 2015. As the deficit in the service account will also likely widen, the current account surplus is forecast to narrow marginally to 2.0% of GDP in 2014 and 1.9% in 2015 (Figure 3.9.14).

If strong net capital inflows continue, which seems likely, the PBOC will find it difficult to widen the exchange rate band for the renminbi, which was already extended from ±1% to ±2% in mid-March this year as an intermediate step toward the declared policy objective of full exchange rate liberalization. It will also be more difficult to rein in money supply growth. The authorities are therefore likely to facilitate capital outflows to ease upward pressure on the renminbi, followed in later years by steps toward further exchange rate liberalization. A more balanced capital and financial account would help slow the accumulation of reserves, which boosted money supply in 2013, given the limited scope for sterilization owing to the shallow financial market. Unexpectedly high trade surpluses and net capital inflows harbor risks for these exchange rate and monetary forecasts.

Among the international risks to the forecast is unexpectedly severe financial volatility in developing economies as the US Federal Reserve gradually tapers quantitative easing. If some countries suffer excessive capital outflows, the PRC may be affected indirectly through weaker demand for its exports. Another global risk is recovery in developed economies remaining sluggish. While there seems to be evidence of improved performance in these markets, a setback to recovery in the PRC’s main trading partners would translate into lackluster demand for its exports, which would slow growth during the forecast period. On the other hand, an unexpectedly strong external environment would improve the upside potential for the PRC economy and create room for bolder structural reforms.

The principal domestic risks to the forecast stem from uncertainties regarding the effectiveness of monetary management and the concern over credit quality. A number of trust funds are already facing difficulties, and a few have reportedly defaulted on bonds in recent months for lack of repayment from their own borrowers. Many of these borrowers, which include real estate developers and companies in industries with excess capacity, are subprime and struggle in an environment of decelerating economic growth. The factors mitigating these risks are that debts are mainly domestic and, at least in the case of local government debt, largely backed by long-term assets. Further, given relatively low central government debt and a well-capitalized banking system, the PRC is in a strong position to forestall domestic risks.

**Policy challenge—maintaining GDP growth while taming credit expansion**

The key challenge for policy makers during the forecast period is to implement policies that help to decelerate investment growth in a controlled manner, thereby ensuring orderly debt accumulation by local
governments and state-owned enterprises and the safety and soundness of the banking system, without derailing the growth momentum of the economy. After launching the key structural reforms outlined at the November 2013 party plenum, the government will pursue, as in the past, a gradual reform strategy and regularly fine-tune the speed of reform and the selection of specific measures to apply.

While this strategy will help to contain instability, achieving results will take time. In the short term, the PBOC needs to find the right balance between subduing credit growth and supporting economic growth. Attempts to slow credit growth too rapidly may impose additional stress on enterprises and financial institutions, eroding investor confidence. However, if continued, the current pace of credit growth and the associated increase in debt, including the debt of local governments and state-owned enterprises, may aggravate existing asset quality problems, which also risks undermining investor confidence. Responding to this bind requires strengthening monetary, fiscal, and exchange rate policies in a coordinated way. To this end, the PBOC can be expected to target a monetary growth rate in 2014 that exceeds nominal GDP growth but by less than in 2013, invigorate competition in the financial sector to help allocate credit more efficiently, and strengthen sector oversight to prevent excessive risk taking. Other needs are further interest rate liberalization, financial market deepening, and more flexibility in exchange rate policy to reduce the need to sterilize eventual large capital inflows.

In the fiscal area, the government intends to further improve tax collection and cut preferential tax treatments, introduce property taxes, and start adjusting the distribution of fiscal responsibilities and resources between the central and local governments by recentralizing social expenditure responsibilities and enlarging the block transfers that the central government pays to local governments. Both measures will, over time, ease the need for local governments to accumulate more debt.

Reform of personal income tax may also be launched during the forecast period, as a broader income tax base would go a long way toward mobilizing the resources needed to better provision social and infrastructure services without accumulating more debt. Equally important, progressive income taxes would help to shift the tax burden from low-income to high-income households. This would improve income distribution and equity, which are declared policy objectives.