



PEOPLE'S REPUBLIC OF CHINA

August 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE PEOPLE'S REPUBLIC OF CHINA

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 2015 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 22, 2015 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 22, 2015, following discussions that ended on May 27, 2015, 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, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for the People's Republic of China.

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IMF Executive Board Concludes 2015 Article IV Consultation with the People's Republic of China

On July 22, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the People's Republic of China.

China is transitioning to a new normal, with slower yet safer and more sustainable growth. Growth last year fell to 7.4 percent and, this year, is forecast to slow further to 6.8 percent on the back of slower investment, especially in real estate. The labor market has remained resilient despite slower growth, as the economy pivots toward the more labor-intensive service sector. This, in turn, has supported household consumption. Inflation is forecast to remain at 1.5 percent, pulled down by the appreciation of the real effective exchange rate and falling global commodity prices.

Fiscal policy has been accommodative and continues to be impacted by off-budget activity. As of end-2014, augmented debt (general government plus off-budget activity) rose to around 57 percent of GDP. Monetary policy has remained broadly neutral, as interest rate cuts have matched the decline in inflation. Credit growth has decelerated significantly and shifted more toward conventional banking loans, as a result of stricter regulation on shadow banking. Growth in total social financing—a broad measure of funding—decelerated from the peak of 22 percent in May 2013 to 12½ percent in May 2015.

Considerable progress has been made in external rebalancing. The current account surplus fell to 2.1 percent in 2014 from the peak of around 10 percent in 2007, and the renminbi has appreciated by about 10 percent since last year in real effective terms. Further progress has also been made on domestic rebalancing, with consumption contributing 0.1 percentage points more to GDP growth than investment in 2014, and labor income gaining a larger share in GDP.

Executive Board Assessment²

Executive Directors commended the authorities' success in implementing critical economic policies and reforms, evidenced by China's remarkable development over the last 35 years. They observed that the reliance on credit-financed investment since the global financial crisis has created large vulnerabilities. In this regard, they welcomed the authorities' commitment to move to a more

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.

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>.

sustainable growth model. They considered that a key challenge is to ensure sufficient progress in reducing vulnerabilities while preventing growth from slowing too much and advancing structural reforms.

Directors considered that reining in vulnerabilities is a priority. They welcomed the progress made in this regard, including by slowing down credit growth, especially in shadow banking; moderating investment, led by a slowdown in residential real estate; and passing a new budget law aimed at safeguarding fiscal sustainability. However, they agreed that more needs to be done to put vulnerabilities on a downward path, including a further decline in real estate investment, multi-year deleveraging, and medium-term fiscal consolidation.

Directors highlighted the challenge of managing the slowdown, and recommended that macroeconomic policies should be calibrated to achieve an orderly adjustment by aiming for GDP growth of 6½ to 7 percent this year and 6 to 6½ percent next year. They agreed that monetary policy should take a wait-and-see approach, especially as significant easing would risk exacerbating the credit and investment vulnerabilities. Meanwhile, a sharp contraction in local government spending that would reduce the augmented fiscal deficit should be avoided this year, in view of headwinds to growth from slowing credit and real estate investment. Directors considered it appropriate to start a gradual consolidation next year that lowers the augmented deficit to 8 percent of GDP by 2020 and puts public finances on a sustainable path.

Directors underscored that further structural reforms are needed to make the Chinese economy more open and market-based and promote further internal rebalancing. These include moving to a more market-based financial system and monetary policy framework, including completing interest rate liberalization and eliminating implicit guarantees; reforming state-owned enterprises; moving to an effectively floating exchange rate; and strengthening the fiscal framework, including local-central government relations, the social security system, and tax policy. They noted that these reforms are in the authorities' agenda and welcomed the steps that have been taken. Looking ahead, they urged steadfast and timely implementation of the envisaged reforms.

Directors took note of the staff assessment that the external position in 2014 was moderately stronger than is consistent with fundamentals. They agreed that this highlights the need for continued reforms to further reduce excess savings and achieve a sustainable external balance. They also noted the staff assessment that the substantial appreciation of the renminbi in real effective terms this year has brought the exchange rate to a level that is no longer undervalued. A few Directors pointed out that further exchange rate adjustment could further facilitate external adjustment. Directors welcomed the steps taken to liberalize the capital account and recommended carefully sequencing these efforts.

Directors noted the authorities' wide-ranging policy response to the recent equity market correction. They agreed that exiting these interventions in a timely manner would be consistent with the move toward a more market-oriented financial system. The focus should be on maintaining the liquidity of systemically important institutions and groups of institutions and strengthening the framework for market regulation, supervision, and crisis management.

Directors encouraged the authorities to continue to improve data quality, especially fiscal data, and welcomed their commitment to subscribe to the Special Data Dissemination Standard.

China: Selected Economic Indicators

	2010	2011	2012	2013	2014	2015	2016
						Projection	
National accounts and employment			<i>(In percent, annual growth)</i>				
Real GDP	10.6	9.5	7.7	7.7	7.4	6.8	6.3
Total domestic demand	12.1	10.3	7.5	7.8	7.2	6.5	6.3
Consumption	9.4	11.4	8.2	6.9	6.9	7.1	7.7
Investment	15.3	9.0	6.7	8.9	7.6	5.8	4.7
Fixed	12.6	8.6	8.7	9.2	7.6	6.1	4.9
Inventories 1/	1.4	0.4	-0.7	0.1	0.1	0.0	0.0
Net exports 1/	-1.4	-0.8	0.1	-0.2	0.1	0.2	0.0
Consumer prices							
End of period	4.6	4.1	2.5	2.5	1.5	1.5	1.8
Average	3.3	5.4	2.6	2.6	2.0	1.5	1.8
Unemployment rate (annual average)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
External debt and balance of payments			<i>(In percent of GDP)</i>				
Current account	4.0	1.8	2.5	1.6	2.1	3.0	2.7
Trade balance	4.2	3.3	3.8	3.8	4.6	6.0	5.6
Exports of goods	26.3	25.6	24.3	23.3	22.6	21.0	20.5
Imports of goods	22.1	22.3	20.5	19.5	18.0	15.1	14.9
Gross external debt	9.1	9.3	8.7	9.1	8.6	8.9	9.5
Saving and investment							
Gross domestic investment	47.2	47.3	46.5	46.5	46.0	44.4	43.4
National saving	51.2	49.2	49.0	48.0	48.1	47.4	46.0
Public sector finance							
General government debt 2/	36.2	35.8	37.0	39.3	40.7	42.8	45.6
General government net lending/borrowing 3/	-1.2	0.6	0.0	-1.1	-1.1	-1.9	-2.4
Real effective exchange rate			<i>(In percent, annual growth)</i>				
Annual average	-0.5	2.8	5.6	6.3	3.1	...	...
End of period	4.5	6.1	1.2	8.1	7.9	...	...

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

1/ Contribution to annual growth in percent.

2/ The 2013 NAO audit indicated the debt to GDP ratio as of end-2012 is 39.4 percent of GDP. Staff estimates are based on the explicit debt and fractions (ranging from 14–19 percent according to the NAO estimate) of the government guaranteed debt and liabilities that the government may incur. Staff estimates exclude the central government debt issued for China Railway Corporation.

3/ 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.



PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

July 7, 2015

KEY ISSUES

Context. China is moving to a 'new normal,' characterized by slower yet safer and more sustainable growth. The transition is challenging, but the authorities are committed to it. They have made progress in reining in vulnerabilities built-up since the global financial crisis and embarked on a comprehensive reform program. With China now the globe's largest economy, success is critical for both China and the world.

Focus. The discussions focused on policies to manage this transition. In particular, how to meet the challenge of simultaneously: (i) unwinding accumulated imbalances while preventing growth from slowing too sharply; and (ii) advancing structural reforms toward a new growth model. The baseline assumes that the authorities succeed and move the economy to a more balanced and sustainable growth path, with higher consumption and an external position in equilibrium by 2020.

Outlook and macro policies. Growth is projected at 6.8 percent this year, down from 7.4 percent last year. This slowdown, which is in line with the authorities' target of around 7 percent and staff's recommended range of 6½ to 7 percent, reflects progress in addressing vulnerabilities, including slower total social financing (TSF) growth, tighter oversight of shadow banking, a correction in real estate, and a new budget law. To ensure further progress in addressing vulnerabilities, GDP growth should be permitted to slow to 6–6½ percent next year.

External assessment. Substantial real effective appreciation has brought the renminbi to a level that is no longer undervalued, but the external position is still moderately stronger than fundamentals—highlighting the need for reforms to reduce excess savings and achieve sustained external balance.

Structural reform. Progress has been made, but considerable work remains in implementing the authorities' reform agenda in the financial, fiscal, state-owned enterprises (SOE), and external sectors. Priorities are moving to a more market-based financial system; improving the management of government finances; leveling the playing field between SOE and the private sector; and having an effectively floating exchange rate regime within 2–3 years. The faster the progress, the sooner the growth-enhancing benefits will materialize.

Risks. Insufficient progress in containing vulnerabilities and advancing structural reforms continues to pose the biggest risk to the outlook. If realized, it could result over the medium term in a disorderly correction and/or a protracted period of slower growth. Near-term domestic and external risks are considered low, given existing buffers and policy tools.

Approved By
**Markus Rodlauer and
 Alfred Kammer**

Discussions took place in Beijing, Shanghai, and Taiyuan from May 14–27, 2015. The staff team comprised Markus Rodlauer (head), Steven Barnett, Wojciech Maliszewski, Wei Liao, Longmei Zhang, Si Guo (all APD), Dezhi Ma (COM), Mauricio Soto (FAD), Geoff Gottlieb (SPR), and Alfred Schipke, Waikai Lam, and Shaun Roache (MCM) (Resident Representatives). Mr. Lipton (First Deputy Managing Director) joined the concluding meetings.

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CONTEXT

1. **China's success, China's challenge.** China is now the world's largest economy (PPP basis), which is testament to its record of successful reforms and development policies. But the country is far from rich: per capita income (PPP basis) was 24 percent of the U.S. level in 2014, and 14 percent in U.S. dollar terms. Thus, China still has considerable room to grow and catch-up to advanced economy status. However, as evidenced by international experience and the literature on the middle income trap, convergence is by no means guaranteed. China's future success, like its past accomplishments, will depend on continued implementation of necessary yet often difficult macro policies and reforms.
2. **New leadership, new direction for the economy.** The current leaders have now been in power for two years. Historically, this is a time when policy implementation has often accelerated. It is also the time to formulate the thirteenth five-year plan (2016–20). The leadership has emphasized an economic agenda focused on enduring improvements in people's livelihood. This includes promoting inclusive growth, improving the environment, and fighting corruption. The Third Plenum reform blueprint, announced in late-2013, set out a comprehensive agenda to be completed by 2020. On the economic side, the aim is to move to a more sustainable growth model, including by giving the market a decisive role in the economy. It also covers issues such as urbanization, rural land reform, one-child policy, environment, and institutional frameworks.
3. **Adjustment underway.** The authorities' plans are in line with previous staff advice and progress has been made. Credit growth, in particular the 'shadow bank' component, has slowed; the real estate sector is undergoing a needed adjustment; and a new budget law is tackling the challenges of local government finances. Reforms aimed at liberalizing the financial system have also advanced (Appendix I). Key achievements include the introduction of deposit insurance and progress in liberalizing interest rates.
4. **Significant challenges still ahead.** Faster progress on growth-enhancing reforms is critical. Since the global financial crisis, the pattern of growth has relied on an unsustainable mix of credit and investment. This has led to rising government and corporate debt, increasing pressure on the financial system, and declining investment efficiency. Moving to a safer and more sustainable growth path requires reversing these trends. Doing so will reduce demand, and thus unavoidably slow near-term growth. Managing this slowdown is a key challenge: Going too slow will lead to a continued rise in vulnerabilities, while going too fast risks a disorderly adjustment. The key to managing this trade off is structural reforms to boost potential growth.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

5. **Moving to slower yet safer growth.** Growth in China is moderating, a slowdown that is largely a by-product of moving the economy away from the unsustainable growth path since the global financial crisis. Staff projects China to grow at 6.8 percent this year, consistent with the authorities' target of around 7 percent and within the 6½–7 percent range staff considers appropriate for this year.

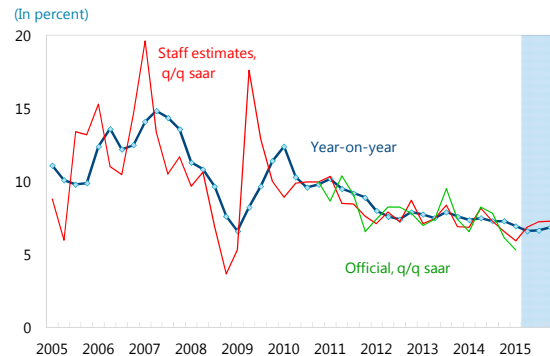
A. Recent Developments: Adjustment Underway

6. Continued moderate slowdown of growth.

In 2014, the economy grew by 7.4 percent, in line with the official target of “around” 7½ percent (Figure 1). It marked the first time in recent history that growth came in below the headline target. Developments so far this year are consistent with staff projections and recommendations. Growth was 7.0 percent in the first quarter (year-on-year) and recent supply side indicators—such as industrial value added and electricity production—show continued moderation.

While demand indicators also point to moderation, led by a correction in real estate construction, household consumption and retail sales have held up well, largely on the back of a robust labor market that reflects the ongoing transition to more labor-intensive growth. In terms of regions, the slowdown is concentrated: six provinces (Tianjin, Liaoning, Jilin, Hebei, Shanxi, and Yunnan) that together account for only 15 percent of GDP explain over 80 percent of the decline in real growth from the 2012–13 average of 7.8 percent to 7.4 percent last year.

Real GDP Growth

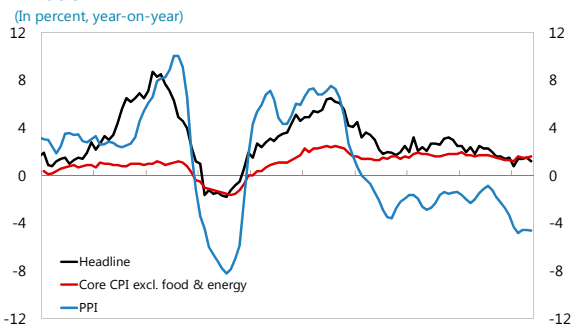


Sources: CEIC; and IMF staff estimates and projections.

7. Inflation has decelerated, but mainly due to supply shocks.

Core inflation has been fairly flat and hovered in the 1–2 percent range for nearly five years. While headline inflation has been more volatile, this largely reflects supply-related shocks to food prices and the effect of real effective exchange rate (REER) appreciation rather than changes in the output gap. Thus, the current slowdown in economic activity does not appear to be a significant driver of slowing inflation (Box 1). Meanwhile, producer prices have been declining for several years. The most recent drop is due to falling global commodity prices effective renminbi appreciation. More broadly, external factors appear to be playing an important role in explaining PPI movements in China and much of the rest of Asia.

Inflation

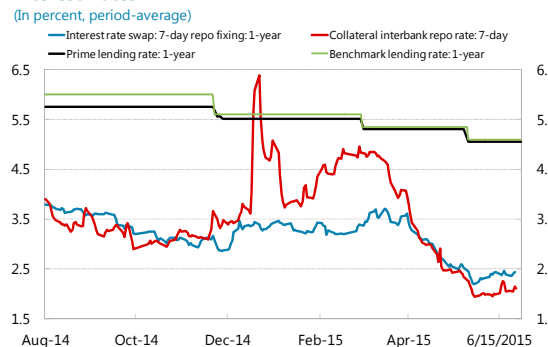


Sources: CEIC; and IMF staff calculations.

8. Credit growth, especially in shadow banking, has declined considerably.

In the aftermath of the global financial crisis, total social financing (TSF), a broad measure of credit, increased dramatically. However, since 2014, the pace of TSF growth has decelerated considerably, from the peak of 34.4 percent (TSF stock, year-on-year) at end-2009 to 12.4 percent in May 2015 (estimated by IMF staff, Figure 2). The change in dynamics was even more dramatic for the flow

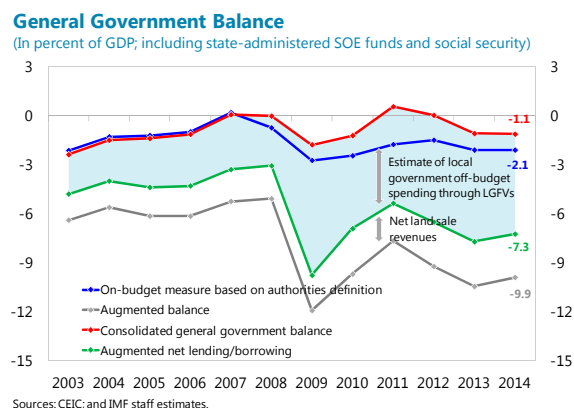
Interest Rates



Source: CEIC.

of credit, which contracted 19 percent in 2015 (January-May, year-on-year). The reversal was a result of stricter regulation of shadow banking activities, which also helped improve the composition of TSF growth toward conventional bank loans. TSF growth has also been affected by tighter financial conditions as reflected in REER appreciation and, earlier this year, rising real interest rates (from falling inflation). The central bank has, since last November, lowered the benchmark lending rate by 90 basis points in three steps and twice cut reserve requirements.¹ While these steps initially coincided with a rise in interbank interest rates, the seven-day interbank repo and one-year interest rate swap have both declined since March.

9. **Fiscal developments continue to be dominated by off-budget activity.** Fiscal policy has supported growth significantly since 2008, mainly through off-budget spending. As a result, the official budget deficit is not a good indicator of the fiscal stance, as evidenced by the sizable gap between the budget deficit and an augmented deficit measure (staff estimate of the deficit including off-budget activity). Preliminary staff estimates point to a modest reduction last year in the augmented deficit to around 10 percent of GDP. This estimate is subject to considerable uncertainty due to data gaps (Table 5). The official fiscal stance in 2015 continues to be 'proactive.' The 2015 budget implies a positive fiscal impulse of about 0.4 percentage points of GDP, with the on-budget deficit expected to widen to around 2½ percent of GDP. The new budget law and declining land sales may constrain local government (LG) spending this year (see below), but so far infrastructure investment has remained buoyant.



10. **Authorities' view.** The authorities recognized the economy is transitioning from a high to a medium-to-high growth rate, which is one of the characteristics as China enters a new normal. They remained confident of achieving their target of around 7 percent growth for this year. Growth moderated, but was still within a reasonable range. While downward pressures remained significant, they expected activity to firm in the coming months as the effect of recent policy measures filtered through the economy. On inflation, they agreed that supply shocks, not slower growth, were the main factor driving down headline CPI. They considered that inflation was likely to stay positive. A recent PBC publication² had projections for this year close to staff's, including growth of 7 percent, inflation of 1.4 percent, and a current account surplus of 2.9 percent of GDP.

B. Rebalancing

11. **Progress in domestic rebalancing.** Shifting to a more consumption-oriented economy will

¹ After the report was written, the authorities announced a further reduction in benchmark interest rates (25 basis points) and targeted reduction in RRRs. This will be covered in a staff supplement that will be issued after the release of second quarter data on July 15.

² Jun Ma and others, "2015 Mid-Year China Macro Forecast," PBC Working Paper No. 9 (2015).

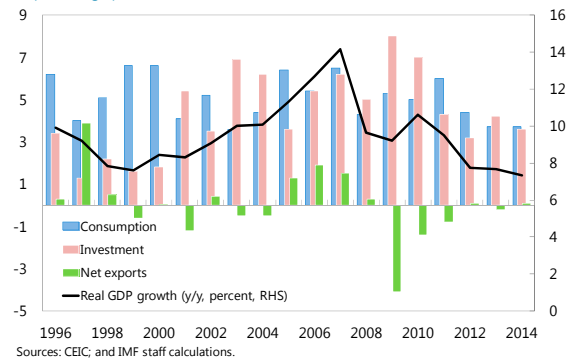
involve both lowering the household saving rate and increasing household's share of income.

Consumption has been playing a more important role in driving growth in recent years. In 2014, staff estimates suggest that consumption contributed 0.1 percentage points more to growth than gross fixed capital formation, and consumption's share of GDP increased (Figure 3). Other indicators also point to some progress in rebalancing, with wage growth that seems to be outpacing GDP (pushing up the share of labor income). These developments are attributable, in part, to the rising share of the tertiary (service) sector in employment and output. GDP is thus becoming more labor intensive, which helps explain the resilience in the labor market and consumption (Box 2).

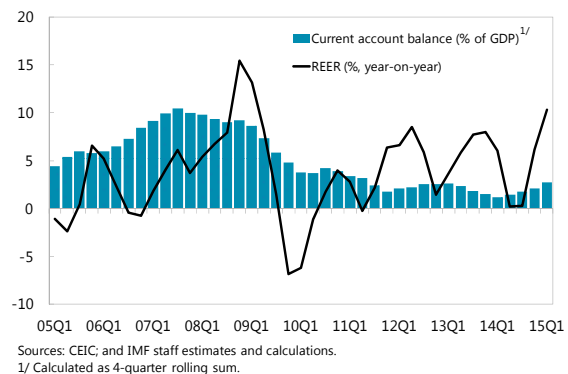
12. Considerable progress in external rebalancing, but the job is unfinished. The current account surplus last year was 2.1 percent of GDP, a big reduction from the 2007 peak of around 10 percent of GDP. Likewise, the renminbi has appreciated considerably in REER terms, up 55 percent since the exchange rate reform in 2005 (Figure 4). Over the past year, the REER has appreciated by over 13 percent (April, year-on-year), in tandem with the rise in the U.S. dollar. Despite this appreciation, Q1 registered a strong trade surplus, driven largely by lower commodity prices and the domestic slowdown. However, capital outflows have also been strong, and monthly proxies for intervention suggest that the PBC has not intervened to buy foreign currency since July 2014. Indeed, the PBC appears to have been selling reserves since late last year, with proxies suggesting cumulative sales of 137 billion U.S. dollars from October 2014 to May 2015.

13. External assessment. The external position in 2014 was moderately stronger compared with the level consistent with medium-term fundamentals and desirable policy settings, and the renminbi was moderately undervalued (Appendix II). Since then, as noted, there has been substantial appreciation in real effective terms. Nonetheless, staff projections for 2015 suggest that the external position probably remains moderately stronger than fundamentals. There are several factors influencing a country's external position, with the exchange rate being one of them. While undervaluation of the renminbi was a major factor causing the large imbalances in the past, staff's current assessment is that the real effective appreciation over the past year has brought the exchange rate to a level that is no longer undervalued. However, staff's assessment that the external position is probably still too strong highlights the need for other policy reforms—which are indeed part of the authorities' agenda—to reduce excess savings and achieve sustained external balance (paragraph 23). Reserves were at 149 percent of the IMF's composite

Contribution to Growth
(In percentage points)



Current Account Balance and REER



metric at end-2014 (down from 160 percent in 2013); relative to the metric adjusted for capital controls, reserves were at 238 percent, down from 254 percent in 2013. Given China's progress and plans with capital account liberalization, the appropriate metric is shifting toward the unadjusted one; under either metric, further accumulation is unnecessary from a reserve adequacy perspective.

14. **Authorities' views.** The authorities concurred with the staff assessment of the progress in domestic rebalancing, citing the stable labor market and job creation, rising household incomes, relatively strong retail sales, and continued expansion of the service sector. They reiterated their commitment to transforming the economy toward the new growth model, and considered the speed of ongoing rebalancing as appropriate. Investment, they noted, would still play a critical role, but the challenge was to make it more efficient while also relying more on consumption as a driver of growth. On external rebalancing, the authorities welcomed the assessment that the renminbi was no longer undervalued. However, they thought the current account surplus last year was in a reasonable range and that the external position was close to equilibrium.

THE CHALLENGE: MANAGING THE SLOWDOWN, ADJUSTMENT, AND REFORM

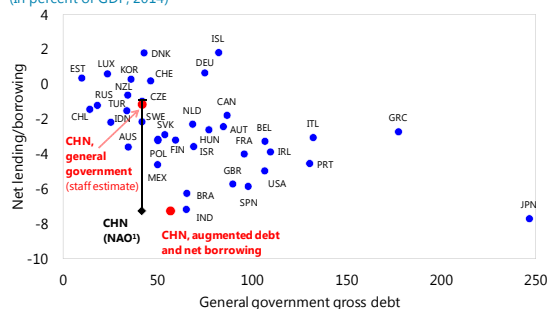
15. **Discussions focused on the challenges of addressing vulnerabilities, managing growth, and implementing reforms.** Vulnerabilities have reached the point that addressing them is an urgent priority. Adjustment cannot be too sharp, as this would be destabilizing, but at the same time it cannot be delayed, as that would only make the problem bigger. Reducing vulnerabilities will inevitably lead to slower growth in the near term. Over the medium term, potential growth will be determined by the progress with structural reforms. The staff baseline assumes that the authorities succeed in reining in vulnerabilities and implementing their reform agenda. Growth is therefore projected to moderate further in the coming years as vulnerabilities are reduced, then stabilize over the medium term as the benefits of structural reform take hold.

A. Vulnerabilities

16. **Despite progress in addressing vulnerabilities, much work remains.** Progress is evident in slower real estate investment and credit growth, especially shadow banking. However, so far this slowdown has largely just reduced the rate at which vulnerabilities are rising (Figure 5). Further progress, therefore, is needed to put vulnerabilities on a firmly declining path.

17. **Rising fiscal debt.** Continued fiscal policy support since the global financial crisis, manifested in the high augmented deficit, has brought the augmented government debt-to-GDP ratio to about 57 percent of GDP. While this is still manageable, with the rise in debt contained by the favorable interest-growth rate

Public Debt and Fiscal Deficit
(In percent of GDP, 2014)



Sources: CBC; NAO; IMF World Economic Outlook; and IMF staff estimates and calculations.
¹ NAO audit indicates general government debt of 39.4 percent of GDP as of end-2012. The NAO audit does not provide a government deficit figure. Staff estimate that the corresponding deficit would be within the range shown.

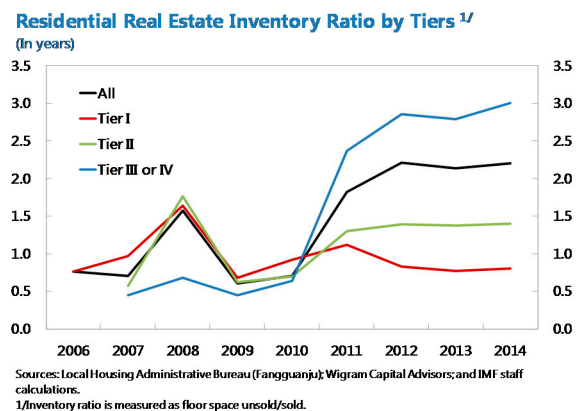
deferential, the dynamic is changing as growth slows. Although there is still fiscal space to support activity in the transition to the new growth model, the augmented deficit has to come down over the medium term.

18. **Rising credit and risks to financial stability.** A variety of indicators suggests that *credit* has risen to an excessive level. These include the Bank for International Settlements (BIS) credit gap measure and the high credit-to-GDP ratio in China relative to other economies at a similar income level (Box 3). The credit-to-GDP ratio is still growing, albeit at a slower rate given the recent slowdown in credit flow. Official banking indicators appear healthy, but there are reasons to believe they could weaken going forward. The *nonperforming loans* (NPLs) ratio—albeit still low at 1.4 percent—has been rising and the sum of NPLs and special-mention loans now constitute about 5.4 percent of GDP. There has also been a significant increase in disposals (26 percent of the gross stock of NPLs in 2014 compared to 18 percent in 2013). Loss-absorbing buffers in the banking sector, thus, could be eroded. Deleveraging and a further slowdown in the economy could reveal more problems with credit quality, especially in the SOE sector—SOEs account for the bulk of corporate liabilities and their performance indicators have weakened since 2008 (Figure 7). The *equity market rally* is another source of financial sector risk, especially given the increasing role of margin financing (Box 4).³ Global debt issuance by Chinese firms and their offshore subsidiaries has also increased considerably, but remains small relative to the stock of TSF and thus does not pose significant risks for financial stability (Figure 8).

19. **Buildup of housing inventory.** Years of very high real estate investment have resulted in considerable oversupply. Residential real estate investment—which accounts for more than two-thirds of total real estate investment—has been an important source of growth and employment, including by boosting activity in related industries. However, housing inventories have risen a lot, especially in smaller (Tier 3 and 4) cities, which on average have unsold supply of around three years of sales. These smaller cities are macro relevant as

All commercial banks	2008	2009	2010	2011	2012	2013	2014	15Q1
Capital adequacy ratio ^{1/}	12.0	11.4	12.2	12.7	13.3	12.2	13.2	13.1
Tier I capital	...	...	...	...	...	10.0	10.8	11.0
NPL ratio	2.4	1.6	1.1	1.0	1.0	1.0	1.3	1.4
Substandard	1.1	0.7	0.4	0.4	0.4	0.4	0.6	0.7
Doubtful	1.0	0.7	0.5	0.4	0.4	0.4	0.5	0.6
Loss	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.2
Provision coverage ratio	117	153	218	278	296	283	232	212
Return on assets	1.1	1.0	1.1	1.3	1.3	1.3	1.2	1.3
Return on equity	19.5	18.0	19.2	20.4	19.9	19.2	17.6	17.8
Construction & real estate loans ^{2/}	...	...	10.2	9.9	10.0	10.1	...	...

Source: CEIC.
1/ Data after 2013 are under Basel III definition.
2/ Percent of total loans.



³ The latest developments in the equity market, including the authorities' policy response, will be covered in a staff supplement (see footnote 1).

they account for over half of real estate investment. While a correction in real estate has started and growth in real estate investment has slowed, working off the excess inventories will require a multiyear adjustment (paragraph 37 and Box 5).

20. **Authorities' views.** The authorities agreed on the importance of shifting the pattern of growth and reducing vulnerabilities. On the augmented fiscal deficit and debt, they continued to consider the staff's estimates as too high, especially as some of the LG debt was commercial. However, they did not provide alternative estimates, and noted that the local government submissions of outstanding debt earlier in the year were still being reviewed and verified. On credit, they acknowledged the rapid rise, but noted that part of the increase represented financial market deepening and a welcome shift toward more market-based financial intermediation.

B. Impact of Reforms

21. **Staying with the current growth model is not an option.** In the near term, it may result in higher growth, but at the expense of a continued rise in vulnerabilities.

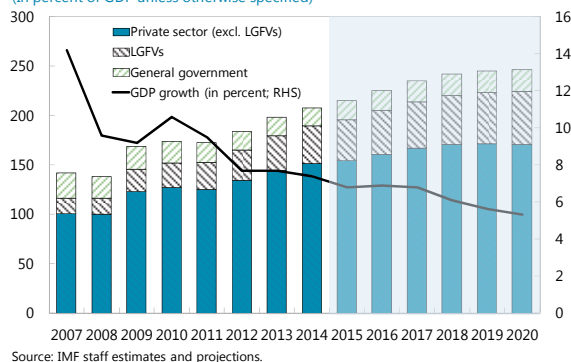
China still has the buffers and tools to prop up growth through continued reliance on credit and investment-fueled growth. However, over time, declining efficiency of investment would weigh on growth and further strain the repayment capacity of the corporate sector. A no-reform scenario illustrates these dynamics: at current levels of productivity, keeping growth at about 7 percent for the next two

years would require another substantial increase in investment (Box 6). Given falling corporate profitability, such investment would require a commensurate increase in credit flow, boosting further the credit-to-GDP ratio and credit gap. Investment efficiency would continue to drop and eventually financial conditions for the private sector would tighten, leading to a sharp reduction in investment, much slower growth, and increasing risk of disorderly adjustment.

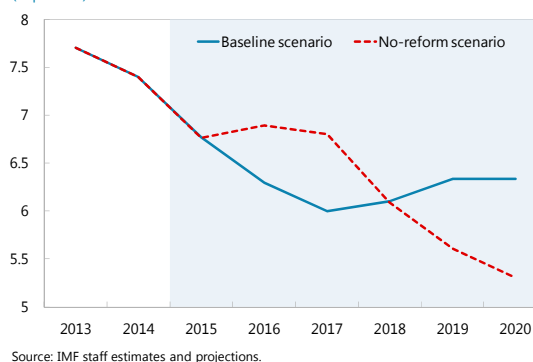
22. **In contrast, staff baseline projections assume steady progress in addressing vulnerabilities and implementing reform.** Growth slows in the near term as a reduction in unsustainable demand weighs on activity. This includes slower credit growth to eliminate the debt overhang and a multiyear correction in real estate investment to bring down excess housing inventories.

Growth thus falls to 6¼ percent in 2016 and 6.0 percent in 2017, cushioned by productivity gains from structural reforms. Starting in 2018, overall growth picks up modestly as those productivity gains begin to dominate. Staff analysis—based on the experience of other fast-growing Asian economies, modeling exercises, and growth convergence regressions—suggests that growth of around 6½ percent in 2020 is

No-reform Scenario: Debt Ratios and GDP Growth
(In percent of GDP unless otherwise specified)



Baseline vs. No-reform Scenario
(In percent)



ambitious yet achievable with successful reforms (Box 6 and Figure 6).

23. **Toward internal and external balance by 2020.** The staff baseline assumes that the Third Plenum blueprint is implemented by 2020 as announced by the authorities.⁴ Implementing these reforms—including social security, financial sector, fiscal, exchange rate, capital account, and SOE reforms—will reduce excess savings, lower investment, raise productivity, and boost consumption. The investment-to-GDP ratio declines as growth becomes less capital intensive and shifts to more labor-intensive services. At the same time, reforms increase income and lower savings by households (with better social security and financial systems) as well as corporates (financial, SOE, and resource pricing reforms). As a result, national savings fall by more than investment, and the external position moves gradually to a level consistent with fundamentals and desirable policies (a current account surplus of less than 1 percent of GDP). This also assumes that the REER adjusts with changes in fundamentals and, for example, appreciates in line with faster productivity growth in China (relative to its trading partners). Although the shift from investment to consumption (domestic rebalancing) continues beyond 2020, the current account surplus remains unchanged as savings falls in line with investment.

24. **Authorities' views.** While the authorities clearly recognized that the current growth model needs to change, they considered that growth may stay close to the current level without jeopardizing long-term sustainability. They viewed China's existing buffers as sufficiently large, and had a more benign view on the efficiency of investment and therefore the outlook for potential growth. They also considered that the excess inventories in housing were less than staff estimated, thus the correction in the market could be shorter and smaller.

POLICIES

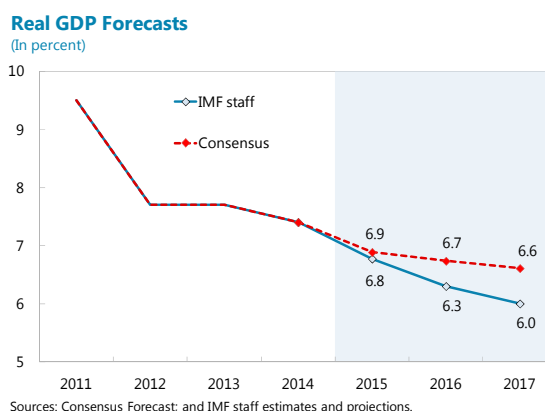
A. Reducing Vulnerabilities while Managing Demand

25. **Demand management—finding the right balance.** For this year, staff continues to see GDP growth of 6½–7 percent as striking the right balance between addressing vulnerabilities and minimizing the risk of too sharp a slowdown/disorderly adjustment. Compared to 2014, this would allow for a further moderation in the growth rates of investment, especially residential real estate, and TSF. If incoming data suggest that growth is likely to exceed 7 percent, then measures should be taken to reduce vulnerabilities faster. If instead growth looks set to dip below 6½ percent, then fiscal policy should be eased. Fiscal stimulus, if needed, should be on-budget and rely on measures that protect the vulnerable, support rebalancing, and are consistent with the reform agenda. All goals that can be best achieved through fiscal policy. For 2016, to allow further progress in addressing vulnerabilities, GDP growth should be permitted to slow to 6–6½ percent.

26. **Current macro policy stance is adequate.** While it is difficult to assess the monetary and fiscal policy stance in China using conventional definitions, staff considers that the current policy setting is broadly consistent with the macro outcomes in the staff baseline (Box 7). However, the

⁴ See Appendix I in the *People's Republic of China—Staff Report*, IMF Country Report No. 14/235 (2014).

impact of recent developments—such as appreciation of the real exchange rate, slowing exports, adjustments in RRR and interest rates, and measures to support local government financing—is still reverberating through the economy. Thus, further policy adjustments may be needed. The staff baseline assumes that the authorities make such adjustments as needed to generate GDP growth of 6.8 percent, with an augmented fiscal deficit of around 10 percent of GDP, TSF growth of 12 percent, and a decline in residential real estate investment. For next year, staff assumes that policies are calibrated to achieve 6.3 percent growth, which is below consensus, consistent with further moderate slowing of TSF growth and the ongoing correction in real estate.



Fiscal Policy: Reform While Avoiding a 'Fiscal Cliff'

27. **Off-budget fiscal activity remains substantial and bringing it on-budget has proven challenging.** Adoption of the new budget law in late 2014 was as an important milestone in fiscal management. It will create a much-needed framework for local government borrowing, improve transparency, and strengthen medium-term fiscal planning. A key goal of the new framework is to bring all spending that is fiscal in nature into the budget and finance it transparently, while clarifying that other, commercial investment projects of local governments do not have an explicit or implicit government guarantee. The transition to this new framework is complex and will take some time, especially for ongoing projects started under the previous regime where the perimeter between government and commercial activity was not clear and financing arrangements often were not consistent with the projects' future cash flow.

28. **Avoiding the fiscal cliff.** Staff advice is to keep the augmented deficit in 2015 broadly unchanged at 10 percent of GDP. Strict implementation of the new budget law could generate a sharp contraction in LG spending ('fiscal cliff') that would reduce the augmented deficit to well below 10 percent of GDP. This would have a large adverse impact on near-term growth, which should be avoided. Accordingly, the authorities have taken a series of measures to ensure that local governments can meet their ongoing financing needs, facilitating both the refinancing of maturing obligations and the funding of ongoing and new projects (by issuing LG bonds, extending bank loans falling due, and public-private partnerships—PPPs—for which new guidelines were issued in May). The staff recommends that a clear and comprehensive transition plan for LG financing under the new budget law be announced as soon as possible. The solution will need to find a balance between (i) preventing an abrupt contraction in fiscal spending; (ii) not undermining the budget law through excessive forbearance; (iii) minimizing moral hazard from rewarding imprudent borrowing by local governments; and (iv) limiting damage to the financial system from uncertainty and shifting the costs to banks.

29. **Medium-term fiscal adjustment.** Gradual fiscal adjustment should start next year, with a modest reduction in the augmented fiscal balance of around ½ percent of GDP each year. Over the coming years, the pace of adjustment could accelerate as the headwinds from reining in vulnerabilities dissipate and the benefits of structural reform take hold. The staff baseline assumes a gradual consolidation in the augmented deficit to around 8 percent of GDP by 2020. While augmented debt would continue to rise, it would peak at around 70 percent of GDP in 2020 (Appendix III). The structure of fiscal spending is also assumed to adjust in line with structural reforms to promote rebalancing, with lower investment creating room for higher on-budget current expenditures reflecting additional spending on health, strengthening of the social safety net, and bringing some of the legacy social security obligations on budget as discussed below.⁵

30. **Authorities' views.** The authorities were confident that the fiscal risk was being resolved gradually without undermining the goal of the new budget law to discipline the spending and financing behavior of local governments. They had developed a transitional plan that ensured that ongoing projects, with contracts signed up to last year, continued to receive financing. They did not regard this as overburdening banks, as many local government projects were commercially viable and did not pose significant credit risk. They highlighted that a key goal of the new budget law was to move all government activity to the budget, thereby clearly distinguishing that all other borrowing must be on commercial terms (such as PPPs) and without a government guarantee. Thus, they continued to question the usefulness of the augmented debt and deficit data. They also reiterated that fiscal policy this year would remain 'proactive,' supporting growth as necessary.

Monetary Policy: 'Wait and See'

31. **The current stance of monetary policy is consistent with achieving appropriate inflation and growth outcomes.** The ongoing slowdown is part of a needed adjustment to more sustainable growth and not a cyclical weakening that warrants a monetary response; and the outlook for inflation is benign, with recent disinflation related mainly to transitory supply shocks. Following the recent steps by the central bank (RRR and benchmark interest rate cuts) and the relaxation of LG borrowing constraints, the staff expects that TSF growth and private credit will be in line with the 2015 projections (12 percent for TSF and 11 percent for private credit—TSF excluding LGFVs). There is room, however, for further RRR reductions (offset by OMOs as needed) as part of the PBC's liquidity management.

32. **Financial stability.** Going forward, the credit-to-GDP ratio needs to be brought to more comfortable levels. The baseline scenario assumes that this occurs through a gradual reduction in investment and credit flows, with private credit growth dropping to around 8 percent by 2020 (Box 3). Such a path is consistent with the gradual reduction investment while avoiding a credit crunch that would result in too sharp a correction. As financial sector reforms advance, including continued development of capital markets to increase the share of equity and bond financing, the efficiency of financial intermediation will improve. As private sector firms gain better access to financing, productivity gains will allow a given growth rate to be achieved with less investment and

⁵ See also Box 6 in the *People's Republic of China—Staff Report*, IMF Country Report No. 14/235 (2014).

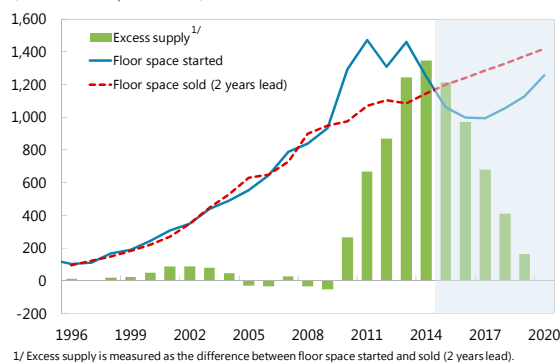
credit. Staff also discussed the benefits of a more proactive policy of encouraging write-offs and corporate restructuring, which would help more quickly to release both credit and physical resources to more efficient uses (see Box 3).

33. **Authorities' views.** The authorities explained that the monetary policy stance remained neutral, and that the recent benchmark rate and require reserve ratio (RRR) cuts were done to offset the reduction of liquidity arising from the decline of foreign exchange deposits, and the tightening in monetary conditions from falling inflation. Going forward, the policy stance would remain the same. Although they saw space for additional cuts in benchmark rates and RRRs if needed to keep the stance neutral, they remained mindful of the need to contain leverage. Policies would continue to work on strengthening the monetary transmission mechanism, and facilitate the broader reform agenda for a more market-based financial system. Regarding deleveraging, the authorities were working to simplify the process of write-offs for nonperforming loans, including through changes in relevant tax policy and legal procedures.

Real Estate: A Multi-Year Adjustment

34. **Real Estate Adjustment.** A multiyear correction in real estate investment—with some variation by city—is necessary to reduce the new supply coming on the market and allow time to work through the existing inventories. The staff baseline scenario assumes that real estate fixed asset investment decelerates further (from 10 percent growth in 2014), turning to negative growth in 2015–2017. The challenge is to ensure that the correction continues, but at an orderly pace. In particular, this means a continued decline in housing construction, but healthy growth in housing demand, to allow time for demand to catch up to supply. To achieve this, policy options—to be calibrated depending on local real estate market conditions—include adjusting mortgage terms, varying restrictions put in place during years of rapid growth, and provision of affordable housing. In March 2015, the authorities introduced a package of measures, including reducing land supply in cities with excess housing inventory; increasing the loan-to-value ratio for second mortgages from 40 percent to 60 percent; and shortening the minimum period for housing sales tax exemption from five to two years of residency. Social housing investment and shanty town renovation projects have also been increased. These policies have helped cushion the adjustment as evidenced by the recent stabilization of prices and floor space sold; going forward policies must be careful to avoid rekindling investment in the real estate market, particularly where housing inventory is elevated.

Residential Market Overbuilding and Adjustment Scenario
(In millions of square meters)



35. **Authorities' views on real estate.** While acknowledging some structural imbalances at the regional level, the authorities regarded the ongoing correction in real estate as largely a cyclical phenomenon, while underlying housing demand remained strong. They were confident that the set of measures introduced to stabilize the market had a desired impact, and that further measures

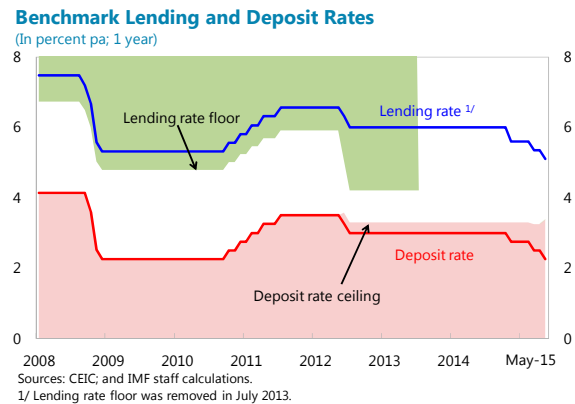
could be deployed in case of a deeper slowdown. They also considered that the imbalances were smaller than estimated by staff, and that measures to boost demand could play a stronger role in restoring balance in the market.

B. Reforms for Growth

36. **Structural reforms to unleash new sources of growth.** While a period of slower growth is necessary to reduce vulnerabilities, slower growth is not a goal unto itself. Instead, the goal is to move the economy to a safer and higher-quality growth path. The Third Plenum reforms will achieve this, but faster implementation is needed—the faster the progress, the sooner the benefits will materialize.

Monetary and Financial

37. **Good progress has been made in liberalizing the financial system, especially interest rates.** The floor on lending rates was eliminated in 2013 and the deposit rate ceiling has been progressively raised to 1.5 times the benchmark rate. In June, 9 core banks were authorized to offer negotiable certificates of deposit (NCDs) for large deposits at maturities ranging from one month to five years. The NCDs have no interest rate ceiling, and can be fixed or floating (benchmarked to SHIBOR). A deposit insurance system was introduced in May. It insures deposits up to RMB 0.5 million (about US\$80,000), which covers slightly under half of deposits but over 99 percent of accounts. The authorities have granted licenses to five new private banks, including some affiliated with large internet companies.



38. **Moving to a market-based financial system.** This means completing interest rate liberalization, ending the over reliance on window guidance and moral suasion, and removing implicit guarantees. A defining characteristic of a market-based financial system is that banks set their deposit rates, lending rates, and loan policies based on market conditions and commercial considerations. Without this, it will not be possible to get the better allocation of resources—through improved access to credit and lower borrowing costs for the private sector—that is critical for transforming the growth model.

39. **Liberalization with strengthened supervision.** The deposit rate ceiling is the last remaining formal interest rate control, but it has a significant impact on the costs of funds and thus interest rates throughout the system. The time has come to complete the liberalization of deposit rates. Deposit insurance is in place, flexibility has been progressively increased, and the ceiling does not appear to be binding for most of the banking system. Concerns about destabilizing competition, especially among smaller banks, should be addressed through supervision and regulation. More

broadly, the progress made in strengthening supervision and regulation should continue. Looking ahead, priorities include (i) continuing with efforts to manage risks from shadow banking (and shift intermediation back to bank balance sheets) and (ii) guarding against new pockets of risk, such as rising leverage in the equity market. The upcoming FSAP will offer an opportunity to discuss a wider range of financial sector reforms.

40. **Breaking the web of implicit guarantees.** Implicit guarantees are prevalent throughout the financial system, leading to mispricing of risk and misallocation of resources. Breaking this web will introduce greater uncertainty into the financial system and cannot be done overnight. At the same time, the process must start and will involve greater acceptance of defaults, credit events, and bankruptcies. This applies, in particular, to state-owned enterprises (SOEs), which benefit from preferential access to financing supported by a perceived state backing of their liabilities. Such perceptions create an uneven playing field that distorts the allocation of financing toward SOEs, crowds out the private sector, and lowers productivity growth.

41. **Upgrading the monetary policy framework.** A key element of a market-based financial system is a monetary policy that uses market-based interest rates as the primary instrument. Building on the progress already achieved, establishing a policy interest rate and using it as the main tool to adjust monetary conditions and signal changes in policy is a priority. Preparatory steps should include reducing the volatility in interbank interest rates through an effective interest rate corridor, improving the functioning of standing facilities, and introducing reserve averaging. Required reserve ratios (RRRs) remain high (18.5 percent for large banks), which imposes an implicit tax on banks that hurts depositors and borrowers and encourages shadow banking. RRRs should be lowered gradually and, if needed, the liquidity impact offset by increased OMOs. In addition, the central bank's efforts to improve communications are welcome, although there is currently no clear interest rate signal for the authorities' policy objectives. A further strengthening of communications—including by explaining monetary policy in the broader context of macroeconomic risks and developments—will be an important part of upgrading the monetary policy framework.

42. **Authorities' views.** The transition to a market-based financial system and monetary policy was progressing, the authorities explained. The monetary transmission mechanism, however, was posing challenges, and, thus, the focus should be on facilitating the transmission mechanism of benchmark lending rate and strengthening the yield curve, especially SHIBOR; introduce reserve averaging; improve the PBC's standing facilities; and enhance the flexibility of open-market operations (OMOs). They noted the progress on interest rate liberalization, and for next steps, the PBC would continue to expand the scope of pricing discretion by financial institutions, and will select the right opportunities to complete interest rate liberalization. Regulation and supervision had been strengthened, especially to limit risks from off-balance sheet activity. Regarding implicit guarantees, they agreed that resolving these would improve credit allocation, but flagged the need to advance gradually to avoid widespread defaults that may pose systemic and macroeconomic risks.

SOE and Fiscal

43. **Deepening SOE reform to level the playing field.** Leveling the playing field between private and public enterprises is critical to unleashing new sources of growth. Progress with SOE reform, however, has been too slow. Important reforms include accelerating the increase in dividend payments, ensuring dividends flow to the budget instead of being recycled to other SOEs, eliminating direct or indirect subsidies of factor costs (land, energy, capital), strengthening governance, and improving the commercial orientation. Ultimately, successful SOE reform will also have to include greater tolerance of SOE bankruptcy and exit while exposing them fully to private competition, especially in the tertiary sector (including financial services, logistics, health, and education). Similar to the SOE reforms in the late 1990s and WTO-related opening of manufacturing, these reforms have the potential significantly to boost productivity growth and create millions of jobs.

44. **Authorities' views.** The authorities' stressed that deepening SOE reform remained one of the priorities, and disagreed with the assessment that it was going too slow. They noted that there had been steady progress, including increasing dividend payouts, tighter rules on compensation, and advances in mixed-ownership and governance. Moreover, they had implemented measures to encourage private entrepreneurship, such as streamlining business registration, and the number of newly registered private firms has surged since last year. They noted that SOE reform featured prominently in the Third Plenum and that they would continue to press ahead with reforms, including leveling the playing field. This would also need to include the costs associated with addressing legacy problems and spinning off social functions of SOEs. Regarding exit of unviable SOEs, they agreed that this was also important, but considered the problem to be substantially smaller than in the late-1990s due to better social safety nets and stronger SOE finances. On dividends, they were committed to reaching the target of 30 percent payout to the budget by 2020.

45. **Continued fiscal reforms.** Fiscal reforms are advancing on many fronts, and Fund management recently signed a multiyear technical cooperation agreement with the MOF. Continued progress is being made in extending the VAT to services, and the authorities plan to finish this by the end of the year. Minimizing the number of VAT rates to, ideally, a single rate would have significant administrative benefits, and the policy objectives of multiple rates could be achieved with other fiscal instruments. Recent increases in petrol taxes and ongoing reforms to natural resource taxation are positive steps that will promote more environment-friendly growth. Following the landmark new budget law, finding a long-term solution to the imbalance between local government spending responsibilities and revenue assignments remains a priority. The national rollout of a property tax will help in this regard by providing an important source of local government revenue.

46. **Further social security reform.** Pension reforms are crucial for achieving the desired rebalancing of the economy toward consumption. The authorities continue making strides toward a more equitable, sustainable, and integrated social insurance system (Box 8). After rapid expansion, pension and health insurance will soon reach universal coverage. Efforts to reduce pension fragmentation include the unification of the pension schemes for rural and urban residents, and recently unveiled plans to integrate the systems for civil service and enterprise workers. The scheme for enterprise workers remains unsustainable in the long term—already today, contributions (excluding subsidies) are only 87 percent of benefits, according to 2015 social security fund budget. Parametric reforms are

needed to help address looming deficits related to population aging. A key step is to increase retirement ages, which would improve pension system finances and help boost labor supply. Another priority is to lower the current high and regressive contribution rates—mandatory contributions to pension, medical, unemployment, occupational injury, and maternity benefits add to over 40 percent of wages. The lost revenue will need to be offset by a combination of parametric reforms and a broader reform of the tax system and the financing of social insurance programs.

47. **Authorities' views.** The authorities noted that tax reform remained an ongoing priority. They explained that the VAT reform was proceeding well and that, while they understood the rationale behind a single rate, multiple rates were helping to smooth the transition to the wider VAT. They highlighted that ongoing work on tax reforms was focused on improving the personal income tax system, including a lower burden on low and middle-income households; strengthening resource taxation to help protect the environment; and introducing a nationwide property tax. The authorities were committed to achieving universal social insurance coverage by 2020. They were equally committed to maintaining the long-term sustainability of the pension system, while ensuring proper incentives to participate in a multi-pillar structure. In addition, they were aiming to improve information systems to facilitate the exchange of records across social security and health insurance systems and provinces, which should help increase portability among social security systems and facilitate policy coordination.

External

48. **Greater exchange rate flexibility.** A more flexible, market-determined exchange rate is needed for allowing the market to play a more decisive role in the economy, rebalancing toward consumption, and maintaining an independent monetary policy as the capital account opens. With capital flows sizable and growing, the “impossible trinity” (inability to have an open capital account, independent monetary policy, and tightly managed exchange rate) will become increasingly binding. Thus, without more exchange rate flexibility, China will have less and less room for its own monetary policy, appropriate for its specific cyclical and structural conditions. Reform should aim to achieve an effectively floating exchange rate—with intervention limited to avoiding disorderly market conditions or excessive volatility—within 2–3 years. International experience suggests there are many options for advancing reform (Box 9). Steps over the next few months could include a further widening of the band and changes to how the central parity is set.

49. **Capital account liberalization.** The past year has seen continued, gradual progress in opening the capital account, including the establishment of the Hong Kong-Shanghai Stock Connect scheme, increased quotas under various cross-border investment programs, introduction of mutual recognition of eligible mutual funds between Hong Kong SAR and the Mainland, and opening the onshore repo market to offshore renminbi clearing and participating banks (up to the limit of their onshore renminbi bonds). This is a key component of the broader financial reform agenda, aimed at enhancing the efficiency of corporate funding and widening the range of investment options available to residents. To achieve this, capital account opening has to be sequenced carefully with reforms to strengthen the financial system, safeguard macrofinancial stability, and make the exchange rate more flexible.

50. **SDR.** The authorities expressed interest in having the renminbi included in the SDR basket and are undertaking reforms to support the international use of renminbi. This issue will be covered in the forthcoming review of the method of valuation of the SDR.

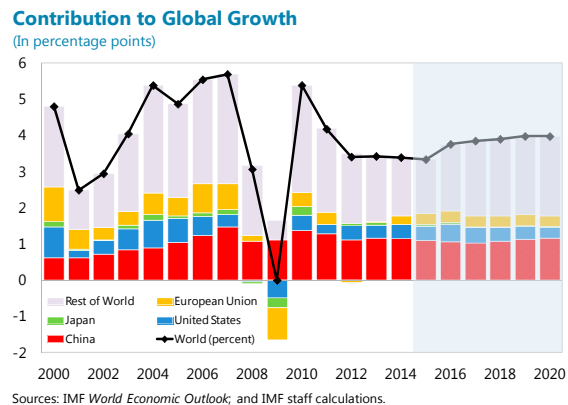
51. **Data.** The authorities are working closely with staff to complete the technical work for China to subscribe to SDDS. Staff encourages the authorities to participate in the Coordinate Portfolio Investment Survey (CPIS).

52. **Authorities' views.** The authorities shared the goal of moving to a more flexible, market-determined exchange rate, and noted the progress they had made. In particular, after years of accumulating foreign reserves, the central bank had retired from day-to-day intervention since the second quarter of 2014. Still, they would step into the market occasionally to reduce unwarranted fluctuations and contain excessive speculative pressures. Regarding the capital account, the authorities planned to continue gradually liberalizing toward "managed convertibility"—supplemented with close monitoring, microprudential limits, and macroprudential and capital flows measures as necessary. Upcoming reforms could include a new qualified domestic individual investors scheme (so-called QDII2) and Hong Kong-Shenzhen Connect for equities. On data, they were committed to continue improving them and were on-track to complete the subscription to SDDS this year.

SPILOVERS, DOWNSIDE RISKS, AND ALTERNATIVE SCENARIOS

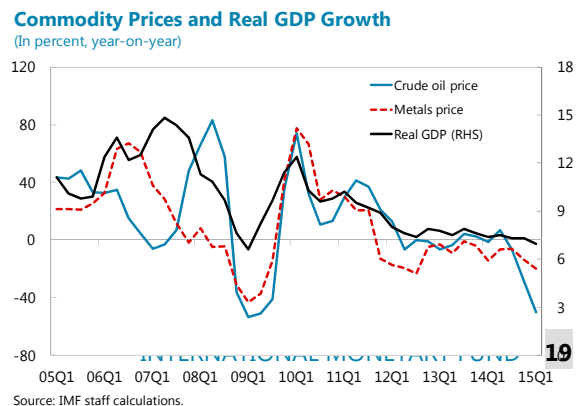
A. Spillovers

53. **Reforms are good for China and the world.** The near-term slowdown in economic activity in China is a price worth paying for safer and more sustainable growth. Staff simulations based on the FSGM model suggest that the impact of such a slowdown on other major economies is relatively minor, while slow progress in reforms or containing vulnerabilities—resulting in much lower income in China over time—would have significant negative spillovers in the medium to long term.



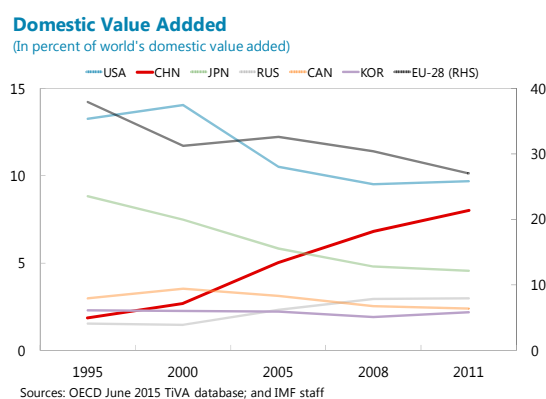
54. **Global benefits are not distributed uniformly.** While China's transition is beneficial for the global economy, benefits accruing to individual countries vary at different stages of this process:

- **Growth transition and commodity prices.** The post-global financial crisis investment drive was associated with a significant increase in the demand for commodities, particularly steel and



other metals. The demand from China has therefore been seen as supporting world commodity prices in the aftermath of the global financial crisis, and this view has been strengthened by the association between the slowdown in China's investment growth and the recent decline in commodity prices. Staff empirical estimates based on a structural VAR indicate that the impact of China on global commodity prices has indeed been increasing and is now sizable. Simulations based on the GIMF model suggest that the impact depends on how the slowdown is perceived: it would be largest if fully anticipated, which could be interpreted as a substantial revision of expectations regarding growth prospects (or, equivalently, a misperception about growth prospects before the slowdown, which could have led to excessive investment in future supply). While this would have an adverse impact on commodity producers, simulations suggest that it would not have a major deflationary impact on the world economy given the cushioning effect of lower commodity prices on global demand and solid medium-term growth prospects in China.

- China moving up the global value chain.** While the post-global financial crisis investment boom had a major impact on China's trade pattern, deep structural changes played an equally important role in shaping China's role in the global economy. In the last two decades China graduated from a low-skill, labor-intensive exporter towards more sophisticated products, increasing domestic value added and reducing import content of exports (Box 10). Such changes have posed challenges and opportunities for its trading partners, particularly in the region. For example, the move up the value chain has contributed to a sharp improvement in China's trade deficit with the main Asian electronics supplier countries even as its surplus with the United States and the European Union has continued to rise. Meanwhile, the exit from labor intensive goods—albeit gradual given remaining pockets of relatively cheap labor in inland China—has allowed low-income Asia (such as Bangladesh, Cambodia, and Vietnam) to fill the space vacated by China.⁶



55. **Authorities views.** The authorities broadly agreed with staff's assessment, emphasizing positive spillovers from the steady rise of the Chinese economy. They also noted potential spillovers from the 'One Belt One Road' initiative, which would bring substantial benefits to both China and the region through greater integration, improvement in infrastructure, and increased trade. While they also concurred with staff assessment that opportunities for growth in low-value added industries are limited, given the ongoing transition to higher-value added products with associated increases in wages, they maintained that reservoirs of relatively cheaper labor in inland China could still allow for some growth in labor-intensive industries, particularly given improvements in infrastructure in less developed regions.

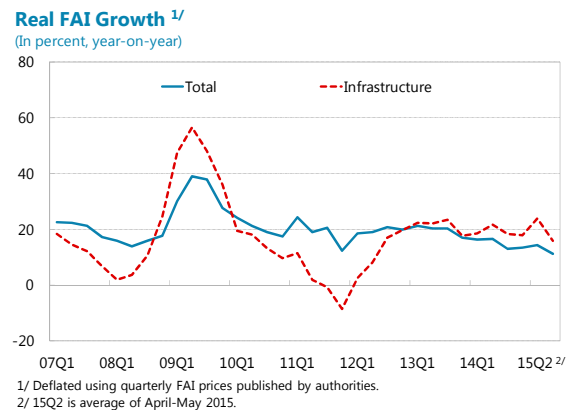
⁶ See G. Gottlieb, G. Hong, S. Jung, K. Mathai, J. Schmittmann, J. Yu, "China and the CLMV: Integration, Evolution, and Implications," IMF Occasional Paper (forthcoming).

B. Downside Risks

56. **The biggest risk is inadequate progress in advancing reforms and containing vulnerabilities.** As illustrated in the no-reform scenario discussed above, vulnerabilities would continue to rise if the unsustainable pattern of growth persisted and reform progress was too slow. Over the medium term, the likelihood of China falling into a period of protracted weak growth would rise considerably, and the risk of a sharp and disorderly correction would increase as the existing buffers—a still relatively healthy public sector balance sheet and large domestic savings—would diminish. This risk would also increase with the opening up of the capital account—potentially leading to large outflows should market sentiment change—pointing to the importance of careful coordination of liberalization steps with other structural reforms. As noted, achieving a ‘soft landing’ of this economy while addressing vulnerabilities and advancing structural reforms, as envisaged in the baseline, will be challenging. Thus, staff considers this risk to be of medium likelihood. The illustrative no-reform scenario and related spillovers analysis suggest that the realization of this risk would have a high impact on China and the global economy.

57. **Near-term risks are manageable.** The hard-landing risk described above is considered to be of low probability in the near term. Fiscal and financial buffers, combined with the still-important role of the state, leave the authorities with sufficient tools to respond effectively to support growth if needed. While these buffers are diminishing over time, they should still allow the authorities to prevent a shock—such as widespread credit events, disorderly correction in real estate, or policy mistake—from triggering a negative feedback loop that spirals out of control. Other risks include:

- *External risks.* China’s large size, limited financial integration, capital controls, and sizable reserves provide cushions against global shocks (see Appendix IV for the Risk Assessment Matrix).
- *Fiscal cliff.* Tighter fiscal control over local government finances combined with falling land sales revenue could lead to a sharp reduction in local government spending. However, as discussed above, so far infrastructure spending has held up in 2015 (a good proxy for local government off-budget spending) and measures have been introduced to ensure financing.
- *Equity market.* The stock market shows signs of froth. Wealth effects from an asset price correction are likely to be small. Thus, while a correction could take place, it is unlikely to have a significant macro impact, although risks are rising given the fast increase in leverage (Box 4). The authorities have taken steps to contain risks, especially from margin lending; staff recommends continued vigilance to prevent macro risks, including potential linkages to the banking system.
- *Deflation.* While a deeper-than-expected slowdown could contribute to deflationary pressures, particularly in upstream industries benefitting from the past investment boom, staff assess the risk of



deflation as low at the current juncture. As noted above, disinflation so far appears largely explained by supply shocks, and price declines in overcapacity sectors do not translate to wider deflationary pressures given robust labor market and consumption. However, the risk of deflation bears close watching.

58. **Authorities' views.** The authorities broadly agree with the staff assessment that risks are low in the near term. In their view, they also had substantial buffers that would be sufficient to fend off any pressures in the medium term, and therefore the trade-off between addressing vulnerabilities and supporting economic activity was not as sharp as illustrated in staff scenarios. They were monitoring closely the developments in equity markets and were confident that their approach was appropriate, aiming to prevent macro risks without being overly interventionist.

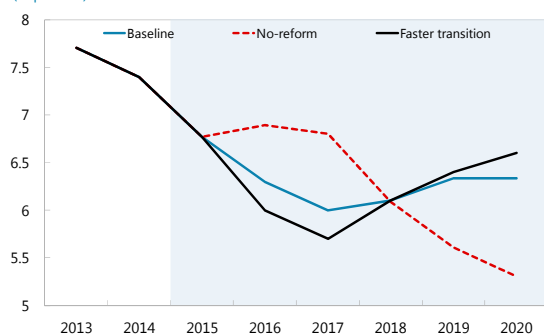
C. Alternative Scenarios

59. **Faster transition.** While the baseline scenario assumes the authorities succeed in addressing vulnerabilities and implementing reforms, there is scope for even faster progress. Staff discussed the following options:

- **Deleveraging.** Keeping credit and labor resources in inefficient activities diminishes growth prospects and leads to a further deterioration in balance sheets. A more proactive restructuring—which could include increased write-offs of NPLs, bankruptcies, and exits (including of unviable SOEs)—would more quickly break this trend. It would help unclog credit intermediation, allowing the dynamic firms that will drive future growth to get better access to credit, and free up labor that could flow to more productive activities. While it would initially hurt bank balance sheets and increase unemployment, these problems could be addressed by a comprehensive plan that would include a strong social safety net for laid-off workers, and a financial sector restructuring program to deal with bad assets and recapitalize banks as needed. Moving faster may ultimately prove less costly than trying to “grow out of the problem” though a protracted period of fairly tight credit conditions.
- **Fiscal spending.** The fiscal adjustment in the baseline assumes a gradual reduction in public sector investment (particularly by LGs), partly offset by increased social spending. Given high multipliers from investment spending, this path supports growth, but at the cost of prolonging potentially inefficient spending. A more aggressive restructuring could more quickly replace it by on-budget spending (while keeping the adjustment path broadly unchanged), which would help accelerate the transition towards consumption-led growth.

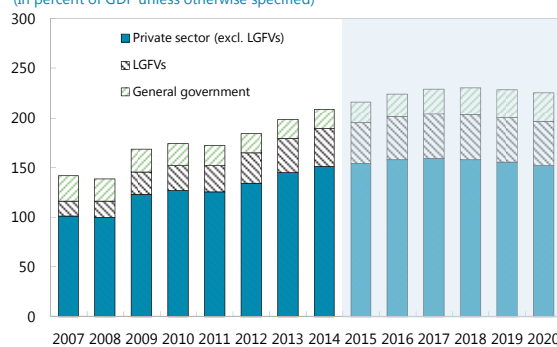
60. **Simulation results show higher medium-term growth and less risks.** While the immediate growth impact would be negative in the faster transition scenario (given potential costs of restructuring under faster restructuring and lower multipliers from higher social spending), these policies would also contribute to faster deleveraging and restructuring of the economy, higher medium-term growth (largely through efficiency gains) and a more sustainable growth pattern.

Different Scenarios
(In percent)



Source: IMF staff estimates and projections.

Faster Transition Scenario: Debt Ratios and GDP Growth
(In percent of GDP unless otherwise specified)



Source: IMF staff estimates and projections.

61. **Authorities' views.** The authorities considered that the current speed of transition struck the right balance between addressing vulnerabilities and supporting growth. While optimization of resources allocation was a key reform goal, it was promoted through several other policy initiatives in the Third Plenum blueprint (such as market-oriented reforms of SOEs), and moving too fast would be both potentially unnecessary and costly. Similarly, the authorities considered the process of implementing the new budget law as orderly and fiscal policy as sufficiently 'proactive,' and they did not see a need for higher budget expenditures to offset the impact of the new budget law on local government spending.

STAFF APPRAISAL

62. **China's development over the last 35 years has been remarkable.** Since 1980, the economy averaged growth of around 10 percent a year, real per capita income quadrupled, and some 600 million people were lifted out of poverty. These achievements are testament to China's success in implementing critical, yet often difficult, economic policies and reforms. As a result, China is now the largest economy in the world (PPP basis). At the same time, income per capita is still a large distance from advanced-economy levels. China thus can, and needs to, continue along its remarkable development path for decades to come. But to do so, it must also continue to implement critical, yet often difficult, economic policies and reforms.

63. **The road ahead is challenging.** Since the global financial crisis, the reliance on credit-financed investment as the prime engine of growth has created large vulnerabilities in the fiscal, real estate, financial, and corporate sectors. Addressing these will inevitably slow growth. Thus, a key challenge is to ensure sufficient progress in reducing vulnerabilities while preventing growth from slowing too much. Slower growth, of course, is not a goal unto itself but an unavoidable by-product of reining in vulnerabilities. Over the medium term, this unpleasant tradeoff can only be improved by structural reforms that create new sources of growth. The faster the progress, the sooner the growth will bottom out in a sustainable way.

64. **The staff's baseline scenario assumes China succeeds in this transition to a 'new normal,' characterized by slower yet safer and higher-quality growth.** This assumption is

justified by the authorities' progress in addressing vulnerabilities, willingness to let growth slow, and announced reform agenda. In the baseline, growth is forecast gradually to slow to 6 percent in 2017 before stabilizing in the 6 to 6½ percent range through 2020.

65. **Vulnerabilities have risen to the point that reining them in is a priority; while notable progress has been made, more needs to be done.** Credit growth has slowed significantly over the past few years, and shadow banking has been reined in; investment is cooling, led by a reduction in residential real estate growth; and a new budget law was passed to address off-budget borrowing. However, in most areas the progress has just succeeded in slowing the pace at which vulnerabilities rise. For example, TSF growth slowed, but is still increasing faster than GDP; and residential real estate investment is still increasing and, thus, adding to the excess supply of housing. Further progress, therefore, is needed to put vulnerabilities on a downward path, including a decline in the level of residential real estate investment, multiyear deleveraging to help close the credit gap, and medium-term fiscal consolidation.

66. **The challenge for macro policy is to manage the slowdown.** Growth will slow as vulnerabilities are reined in. However, adjusting too fast could prove destabilizing. Macro policies, therefore, should be calibrated to achieve an orderly adjustment by aiming for growth of 6½ to 7 percent this year and 6 to 6½ percent next year. With growth this year on track in this range and the inflation outlook benign, monetary policy should take a wait-and-see approach, especially as significant easing would risk exacerbating the credit and investment vulnerabilities. Further cuts in RRR, however, are warranted not as an easing measure but as part of effective liquidity management. The augmented fiscal deficit should remain broadly unchanged this year, given the headwinds to growth from slowing credit and real estate investment. Next year, it would be appropriate to start a gradual consolidation that lowers the augmented deficit to 8 percent of GDP by 2020 and puts public finances on a sustainable path.

67. **Despite progress, the unfinished reform agenda is long and complex.** In the decade before the global financial crisis, a series of bold reforms made the economy more open and market-based. The result was rapid growth, fueled by productivity gains as workers moved from farm to factory. The challenge now is to take the next steps in the transformation to a more open and market-based economy, which will again require bold reforms. These include moving to a more market-based financial system and monetary policy framework; SOE reforms, including increased dividend payments, leveling the playing field (especially in services), and exit of unviable SOEs; having an effectively floating exchange rate within 2–3 years; and strengthening the fiscal framework, including local-central relations, the social security system, and tax policy. All of these elements are in the authorities' reform agenda. With steadfast and timely implementation, China can avoid falling into a low-growth pattern and continue its remarkable convergence to advanced-economy income levels.

68. **China's success is critical for China and the world.** Continuing along the old growth path is not an option. The biggest risk is that progress in reining vulnerabilities and advancing structural reforms is too slow and that China, therefore, stays on the old growth path for too long. This would eventually result in a major slowdown in China that would have significant negative spillovers to the

global economy. Thus, staff commends the authorities for undertaking the transformation to a 'new normal.' While this means somewhat slower growth in the near term, it is a tradeoff worth making for much higher income in China over the medium term. An outcome that brings higher living standards to China and stronger growth worldwide.

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

Box 1. Risk of Deflation¹

Inflation in China has declined, largely reflecting lower global energy prices and currency appreciation. With inflation expectations appearing well anchored and still-healthy wage growth, the risk of deflation in the near-term appears moderate.

CPI inflation has decelerated. As of end-May, headline inflation had fallen to 1.2 percent (year-on-year), after averaging 2 percent in 2014. The decline is largely related to food and energy prices (Figure 1). Core inflation, meanwhile, has been stable and remained between 1–2 percent for some time.

Slower growth is also weighing down inflation, but the impact is relatively small. Previous research has found a fairly weak relationship between the output gap and inflation. For example, Maliszewski and Zhang (forthcoming) estimate a Philips Curve using a system of equations based on a production function, and find that 1 percentage point widening of the output gap pulls down inflation by only 0.1 percentage points.² Simple regressions find a larger impact of changes in the business cycle (based on HP filter) on inflation, operating mainly through food prices. These results suggest that a 1 percent widening of the business cycle would increase inflation one year ahead by 0.5 percentage points. However, the current growth slowdown is more structural than cyclical—HP filter also shows this—and thus turns out not to be a quantitatively important driver of current inflation developments.

More anecdotal evidence also suggests that deflation is not a significant near-term risk.

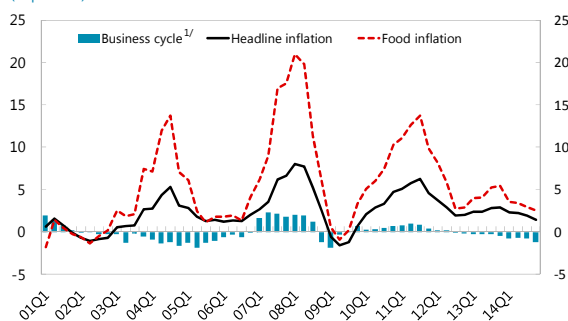
Wages, as discussed in the Labor Market box, have continued to grow at a healthy pace. Thus, there is little evidence of a wage-price downward spiral.

Market inflation projections are low and stable: the latest consensus forecast is for 2 percent average inflation in 2016, similar to staff's forecast of 1.8 percent. Staff's forecast assumes that inflation picks up gradually in the second half of 2015 as the base effect of the oil price shock wanes.

The pass-through from falling producer prices (PPI) to CPI will be limited. Since 2012, CPI inflation has been consistently higher than PPI inflation. The declining PPI could reflect a variety of factors, including excess capacity in some sectors, global developments (PPIs have followed a similar pattern in several Asian economies), and, more recently, falling commodity prices. While the lack of pass through in recent years is not fully understood, it could be related to a Balassa-Samuelson effect (faster productivity growth in tradable sectors drives up wages in all sectors, resulting in rising nontradable prices). Consistent with this, nontradable good prices are rising faster than tradable, as evidenced by prices in tertiary (service) sector growing faster than secondary (manufacturing) sector prices.

Inflation vs. Business Cycle

(In percent)



Sources: CEIC; and IMF staff estimates.

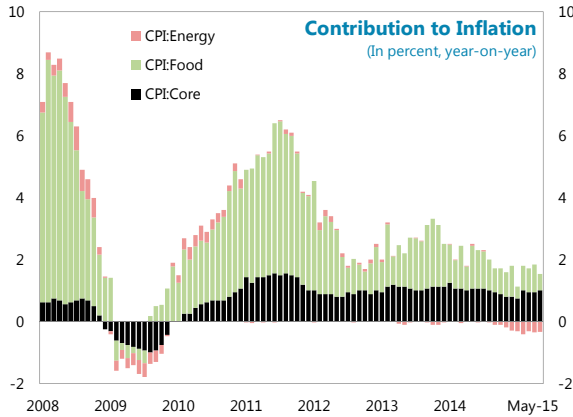
1/ Difference between GDP and HP filter trend (in percent of trend).

¹ S. Jung and L. Zhang, "Deflation in China: Myths and Facts," IMF Working Paper (Washington: forthcoming).

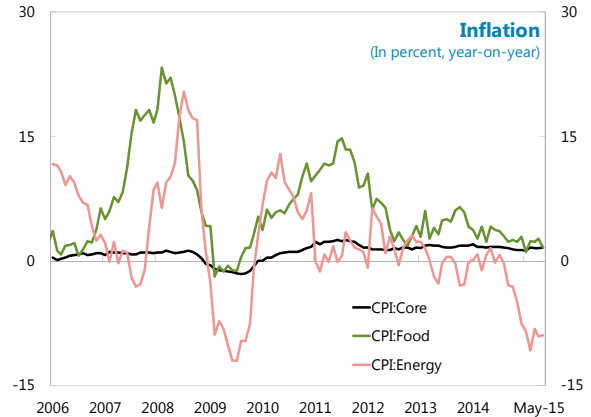
² W. Maliszewski and L. Zhang, "China's Growth: Can Goldilocks Outgrow Bears?" IMF Working Paper No. 15/113 (Washington: International Monetary Fund, 2015).

Box 1. Risk of Deflation (concluded)

CPI inflation is driven largely by food prices...

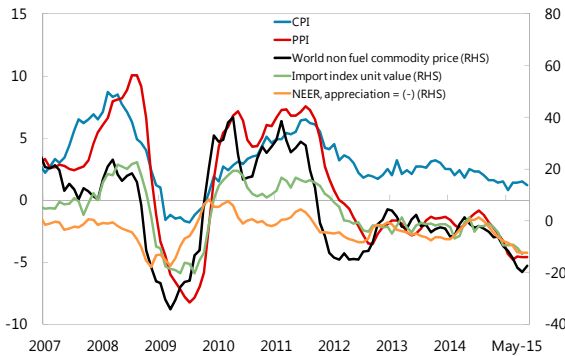


...and core inflation has been stable...



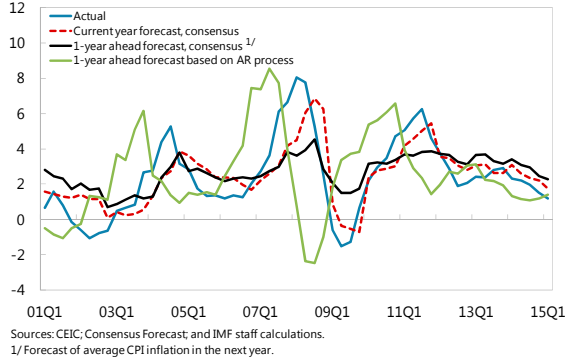
External factors—NEER appreciation and global commodity prices—help explain downward pressure on inflation.

Trade Index, Inflation and Effective Exchange Rate
(In percent, year-on-year)



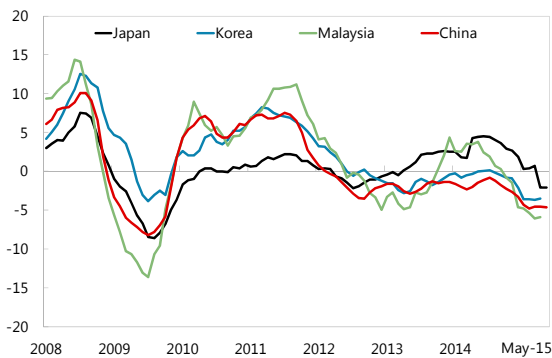
Inflation expectations, based on a simple model and survey data, suggest that inflation will remain positive.

CPI Inflation Forecasts
(In percent)



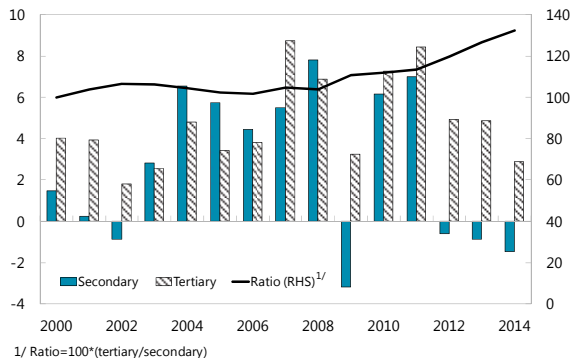
PPI trends in many Asian economies are similar, suggesting a role for common external factors in PPI...

Selected Asia: PPI Inflation
(In percent, year-on-year)



...while robust wage growth in China could explain rising nontradable (service) prices and the recent PPI-CPI gap.

GDP Deflator Inflation, Secondary and Tertiary Sector
(In percent)



Sources: CEIC Data Company Ltd.; Haver Analytics; Consensus Forecast; and IMF staff calculations.

Box 2. Labor Market Developments¹

The labor market has so far been resilient to slowing growth, but reforms are key to the performance going forward.

Based on official data, labor market conditions appear to have held up well so far, despite the growth slowdown. Newly-created urban jobs reached 13.2 million in 2014, exceeding the official target of 10 million new jobs; and Q1:2015 saw an additional 3.2 million of new urban jobs created. Available data for wages also suggest that, on average, demand for urban labor has remained quite robust, growing by around 8 percent in line with GDP growth. Since the global financial crisis, demand for urban labor has consistently outstripped supply, wages have grown faster than nominal GDP, and the official registered unemployment rate remained stable at around 4 percent (and the unemployment rate based on surveys around 5 percent). Migrant workers' wages have stayed at about 60 percent of urban workers over the past few years, after growing significantly faster than urban wages during late 1990s and early 2000s.

Several factors may explain the apparent resilience of labor market conditions. The impact of slowing GDP growth is likely mitigated by favorable longer-term trends that support labor market conditions, including continuing urbanization and the expansion of (more labor-intensive) services sectors. Also, anecdotal evidence suggests that state-owned enterprises (SOEs) may be keeping workers formally employed despite overcapacity and weakening profitability, and that the use of migrant labor is declining. And finally, data shortcomings make an accurate, up-to-date assessment of labor market conditions difficult—while key data series on labor markets are available, their coverage, frequency, and timeliness have important limitations. For example, the registered unemployment rate is based on self-registration for unemployment insurance, which misses the migrant workers that return home when losing their job.

Going forward, implementation of the reform agenda will play a key role in labor market conditions. The planned reform of the household registration system (*hukou*) and less labor hoarding in SOEs will likely increase the supply of labor, which in turn should be absorbed by new employment opportunities that will arise from opening up the services sector and other, productivity-enhancing reforms. At the same time, fiscal reforms on taxation, health care, pensions, and education will help narrow the urban-rural income gap (Lam and Wingender, 2015), which will limit rural-urban (migrant) labor flows and unemployment pressures. (Empirical analysis based on provincial data and international comparison suggests that migrant labor flows are driven strongly by growth and the urban-rural income gap, while the services sector share of output and employment is closely related to per-capita GDP.)

Staff analysis suggests that, with reforms, urban employment growth could stay around 10 million per year. A quantitative scenario analysis illustrates the impact of structural trends, demographics, and reform implementation on labor market conditions (taking into account demographic trends). It finds that, with medium-term growth of around 6–6½ percent, net urban employment could stay near 10 million per year—meeting the current policy target.² Stepped-up reform of SOEs and adjustment in overcapacity sectors would, in the near term, release excess labor and push up unemployment rate by ½–¾ percentage points. However, this would facilitate the structural transformation—including services sector expansion and new investment in productive enterprise—to a more sustainable growth path. In contrast, delays in reform implementation would further build up vulnerabilities and weaken medium-term employment prospects.

¹Prepared based on W. Lam, X. Liu, and A. Schipke, "Can China's Labor Market Stay Resilient during Economic Transformation," IMF Working Paper (forthcoming).

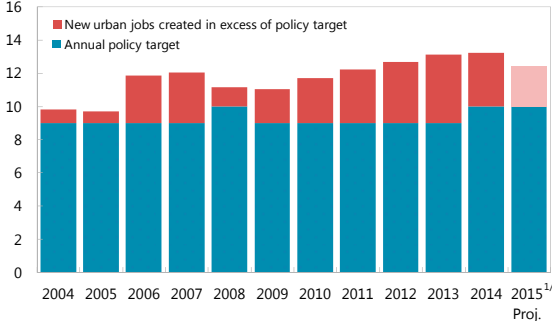
²The policy target refers to the 'newly urban created jobs', which cannot be directly observed but is correlated with the net annual change of urban employment and the change in nonagricultural employment.

Box 2. Labor Market Developments (concluded)

Labor market has stayed resilient despite growth slowdown, with job creation exceeded the policy target...

Meeting the Annual Employment Target

(In millions of persons)

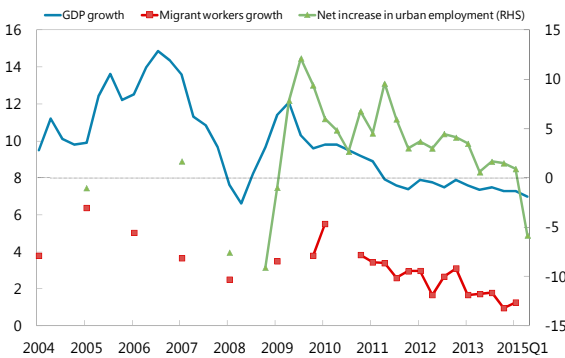


1/ New urban jobs created in 2015 is estimated using the Q1 outturn and the average ratio of Q1 to a whole year during 2012-2014; the ratio has been stable at about 3.83.

Migrant flows track GDP growth more closely, acting as a shock buffer against a rise of unemployment.

GDP Growth, Migrant Workers, and Urban Employment

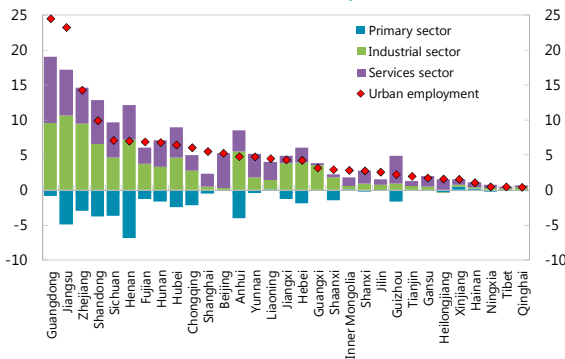
(In percent, year-on-year)



Growing services sector has contributed significantly to total employment across provinces...

Change in Employment by Provinces

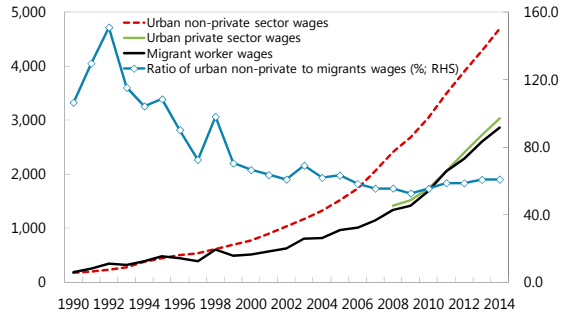
(In millions of workers; between 2002 and the latest year available)



...and average wages for both migrant and urban workers' wages have grown in line with nominal GDP.

Average Urban Workers and Migrants Monthly Wages 1/

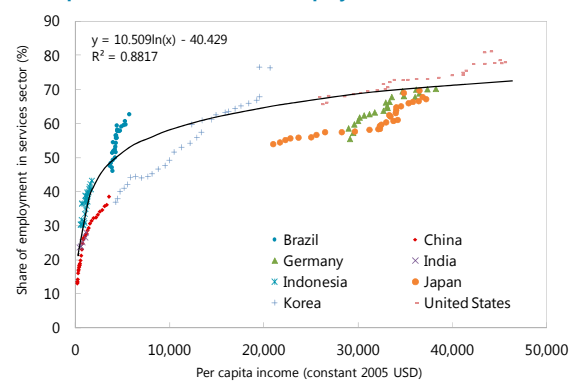
(In RMB unless otherwise specified)



1/ Based on Lu (2012) estimates in "Trend in China Migrant Workers' Wages" in Journal of China Social Science, Vol.7 on migrant worker wages before 2007.

Based on cross-country comparison on per-capita income, the share of employment in the services sector is set to rise further in China.

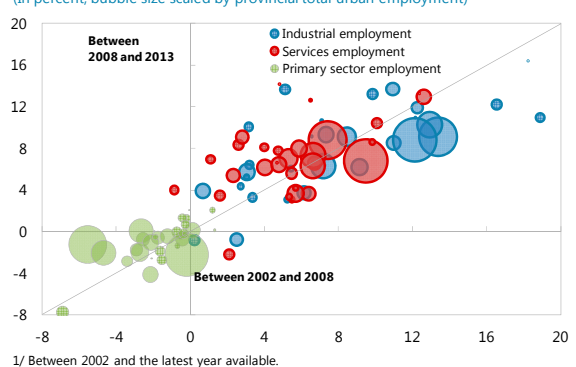
Per-capita Income and Share of Employment in Services Sector 1/



...particularly after the global financial crisis between 2008 and 2013.

Annualized Growth in Employment by Sector 1/

(In percent; bubble size scaled by provincial total urban employment)



Sources: CEIC Data Company Ltd.; National authorities; Xinhua News; World Development Index; Lu (2012); and IMF staff estimates and projections.

Box 3. Deleveraging¹

Credit in China has risen rapidly and is high by many metrics. The corporate sector, in particular, has increased debt-to-GDP ratios since the global financial crisis and a period of deleveraging is warranted.

Credit is high. Total social financing (TSF) and the BIS measure of credit to the private sector are complementary ways to measure credit to the nonfinancial private (that is, nongovernment) sector. Both increased dramatically since the global financial crisis. Subtracting from TSF equity and borrowing by LGFV, still leaves a significant rise in credit in the past few years. Although the pace of growth has moderated, the credit-to-GDP ratio remains high and exceeds the level implied by economic fundamentals as indicated by the BIS 'credit gap' measure² and cross-country comparisons. The rise has been driven by the corporate sector, particularly in real estate firms, SOEs, and over-capacity sectors. Household debt has doubled since 2008, but is still low. It is primarily for mortgages (with relatively low loan-to-value ratios), represents just a fraction of household wealth, and is actually less than household deposits.

Total Social Financing Components
(In percent of GDP)

	2003	2008	2014	2008-2014
TSF	119.2	119.9	193.0	73.1
Equity	1.0	4.0	6.0	1.9
LGFV	11.5	16.1	37.1	21.0
Private Credit	106.7	99.8	150.0	50.2
Corporate	88.9	81.7	113.6	31.9
Household	17.8	18.0	36.4	18.4

Sources: CEIC; and IMF staff estimates.

The high level of credit could weigh on China's growth and financial stability. Cross-country evidence suggests that episodes of similar credit booms often ended abruptly, accompanied by financial crises or prolonged slowdowns in GDP growth³ (see figures). This risk is still low in China, but it is growing. The steep rise in corporate investment after the global financial crisis has been financed by credit. But the efficiency of investment has been falling, with a commensurate fall in corporate sector profitability. This makes debt servicing costs more difficult and therefore debt more risky. In particular, the interest-coverage ratio has been falling in SOEs and in over-capacity sectors (which together account for the bulk of the increase in credit). While the high level of domestic saving has made it easier to finance this growth model, it is not sustainable as falling investment efficiency will eventually drag down GDP, household income, and thus savings. A decline in asset prices would also pose risks. While the average debt-to-asset ratio is relatively benign compared to other countries, the ongoing housing market correction may erode the asset side of corporate balance sheets (especially land and property), particularly in the real estate sector.

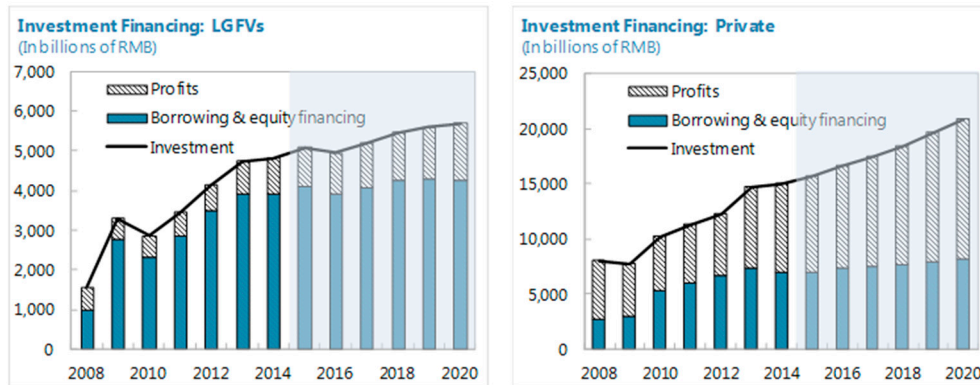
Going forward, investment remains an important driver of growth, thus large credit flows are still needed to finance new projects. Under staff baseline projections for gross fixed capital formation, this implies TSF growth staying relatively high, although falling gradually from around 12 percent in 2015 to 8 percent in 2020. This assumes only a moderate increase in corporate profitability, as productivity-enhancing reforms are largely offset by the rationalization of factor costs (including higher wages). Greater reliance on capital markets to raise financing would reduce the need for credit for the corporate sector, but this is offset by growing lending and borrowing within sectors, particularly the process of financial deepening facilitating access to financing for households.

¹ S. Arslanalp, W. Lam, W. Liao, and W. Maliszewski, "Deleverage China," IMF Working Paper (forthcoming).

² Defined as the gap between the credit-to-GDP ratio and its trend, as recommended by the BIS in the guidance for national authorities operating the countercyclical capital buffer regime.

³ W. Liao and W. Maliszewski, "Credit Boom in China," IMF Working Paper (forthcoming).

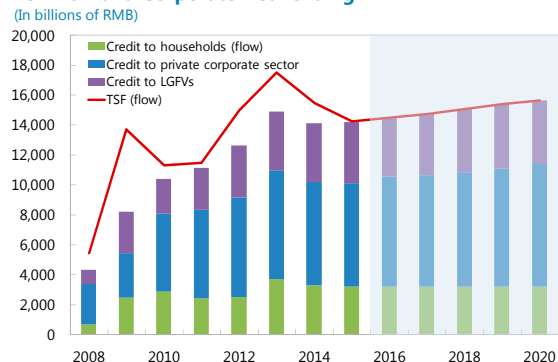
Box 3. Deleveraging (continued)



Sources: CEIC; and IMF estimates and projections.

Faster debt write-offs would help improve credit flow and investment efficiency, and reduce risks. While there is no evidence that the credit channel is impaired in China, financing for the private sector appears to have been crowded out by lending to SOEs. This is especially a problem if banks allocate credit to support unviable or inefficient SOEs. Write-offs—combined with restructuring of viable companies and steps to facilitate exit and bankruptcy of nonviable firms—could reduce the burden on banks and allow them to reallocate credit to more efficient sectors. Companies' restructuring and exits would also release physical resources (a strong social safety net to cushion the impact of layoffs), which would support private sector growth. The result would be that the credit-to-GDP ratio would come down faster. In contrast, in the no-reform scenario (with faster initial growth driven by higher investment; see Box 6), the credit-to-GDP ratio would continue to rise on an unsustainable path. This shows that 'growing out of the debt' is not an option under the old growth model.

TSF Flow and Corporate Net Lending



Sources: CEIC, BIS, and IMF staff projections.

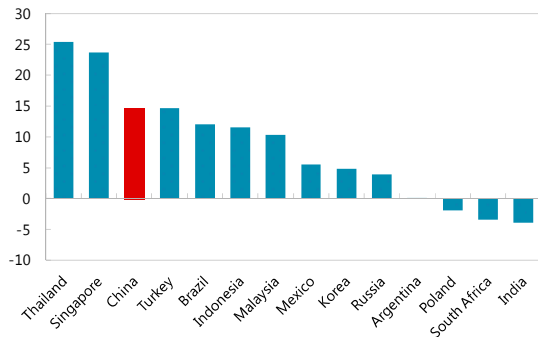
The size of potential write-offs would be manageable. Staff estimates that closing the BIS 'credit gap' by 2020—would require write-offs averaging around 1 percent of current debt (around 1.5 percent of GDP) per year, relying on a combination of transferring bad assets to asset management companies and public sector support. The scenario assumes that capital buffers and provisioning remains unchanged, which would allow banks to lend to new and more productive projects. The gross fiscal costs in this scenario would be under 10 percent of GDP excluding the cost of putting in place an enhanced social safety net. This, however, assumes no recoveries and overstates the net cost to the public sector to the extent that the write-offs facilitate exit of unviable and loss-making SOEs (removing implicit subsidies, and potentially leading to an increase in dividend payments to the budget from remaining SOEs as overcapacity is reduced). Any fiscal support to banks or companies should be done in an incentive-compatible way that minimizes moral hazard going forward. For the banks, an immediate step should be a rigorous quality assessment of loan portfolios, setting the stage for addressing NPLs and the potential need for bank recapitalizations. Recapitalization should be conditional on reforms to prevent a repeat accumulation of bad loans.

Box 3. Deleveraging (concluded)

The post-GFC credit boom in China resulted in large credit gap.

Basel III Credit-to-GDP Gap ^{1/}

(In percent of GDP, 2014)

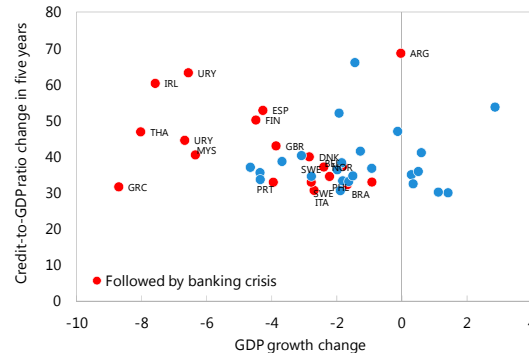


^{1/} For China, data excludes LGFV borrowings.

Similar booms elsewhere were generally followed by either banking crisis or prolonged declines of GDP growth.

Credit Booms and Change in GDP Growth Rates

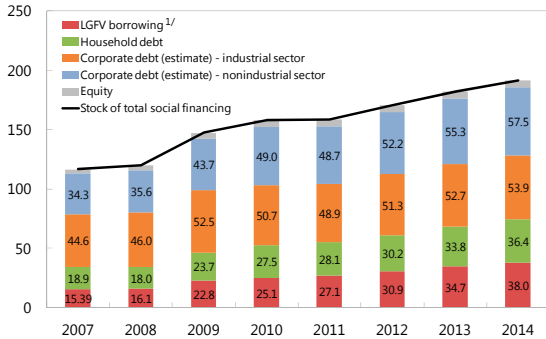
(In percentage points)



Corporate sector debt has risen, especially to the nonindustrial sector...

Total Credit by Sectors

(In percent of GDP)

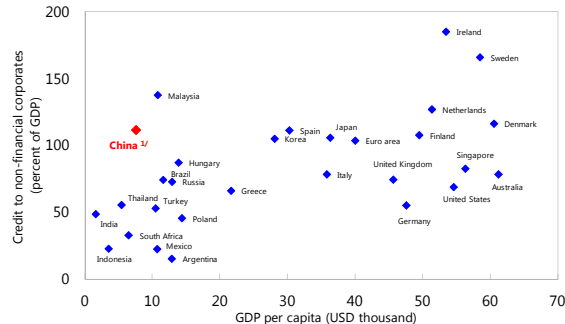


^{1/} Includes all local government debt except local government bonds.

...and corporate sector debt is high by international standards, even after excluding LGFV debt.

Credit to Nonfinancial Corporates and GDP per Capita

(Selected economies, 2014)

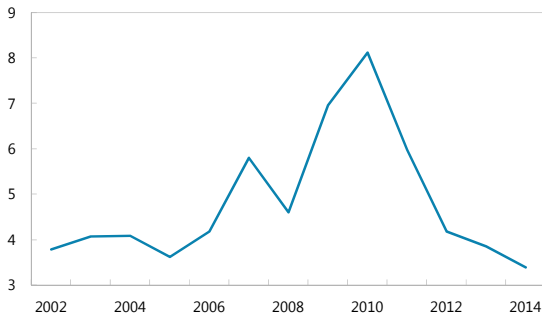


^{1/} Corporate debt for China is calculated as total social financing minus equity, LGFV borrowing and household loans.

Corporate profitability has been declining, which adversely affects debt dynamics.

Corporate Interest Coverage Ratio ^{1/2/}

(In percent)

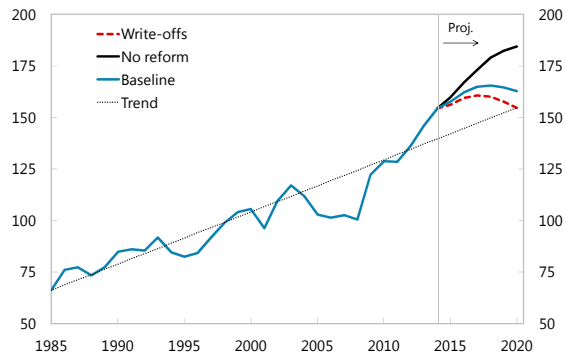


^{1/} Calculated as EBIT/interest expenses.
^{2/} Includes SOEs and private firms.

Write-offs could help arrest the adverse debt dynamics.

Non-financial Private Sector Debt

(In percent of GDP)



Sources: CEIC Data Company Ltd.; BIS; WIND; IMF World Economic Outlook; and IMF staff calculations.

Box 4. China's Equity Market: Recent Developments and Risks

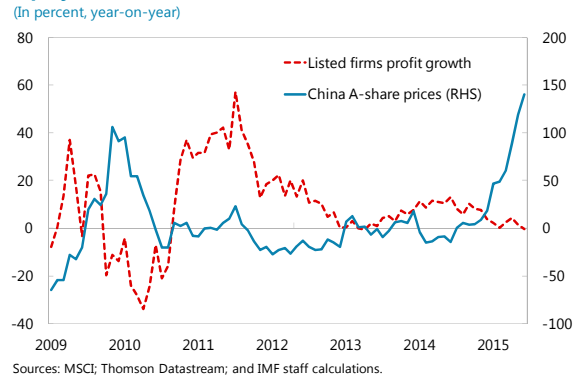
The stock market has more than doubled over the last year, despite a slowing economy and declining profit growth. The influx of new investors, a surge in margin lending, and rising leverage and interconnectedness of securities firms pose potential financial stability risks. The broader risks for growth are rising, but likely still relatively small.

Sharp rise in prices. The market's rapid ascent since the middle of 2014 understandably raises concerns about the prospect for future price volatility and the possible implications for broader financial stability. The market's more than 150 percent gain stands in sharp contrast to modest price changes for international markets and has come even as domestic economic growth has moderated. The upswing has been broad based, encompassing almost every listed stock, with some segments of the market such as the technology sector experiencing particularly dramatic price gains. These developments have pushed equity valuations above emerging market peers for some, but not all, commonly-used yardsticks (see figures).

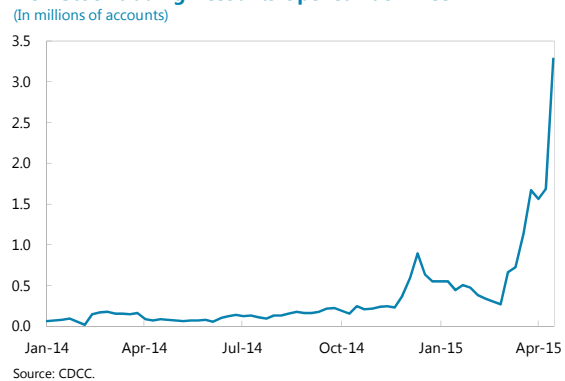
A number of factors may have pushed prices higher. Some market participants point to comments by high-level officials that may have been interpreted as offering "official support" to the market. The authorities and securities exchanges have implemented measures to promote equity investment including easing rules for margin borrowing (April 2013), liberalizing mutual funds (August 2014), and allowing investors to open multiple brokerage accounts (April 2015). Inflows to the equity market may also have been boosted by households reallocating saving away from real estate and optimism about shareholder-friendly SOE reforms.

China's financial development benefits from sustainable growth in the stock market. Boosting equity issuance from relatively low levels can diversify corporate financing, reduce the reliance on debt and shadow banking, facilitate deleveraging for more indebted sectors, and advance SOE reform through mixed ownership. An efficient and representative market can also provide opportunities

Equity Market Prices and Profits



New Stock trading Accounts Opened Each Week



Capital Raised through Public Offerings



Box 4. China's Equity Market: Recent Developments and Risks *(continued)*

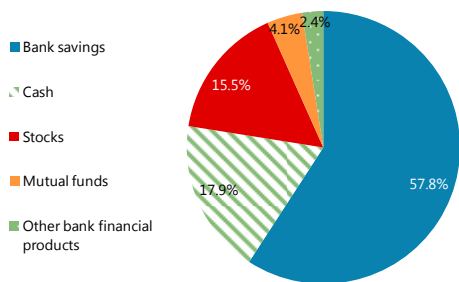
for households and institutional investors to achieve a more desirable risk-return profile for their savings and assets. Through end-May, there had not been a substantial increase in capital raised through domestic (A share) public offerings.

The rally is associated with rising risks, such as a sharp rise in margin financing. An influx of new, potentially less informed, investors and rising leverage increase the risk of a disorderly market correction. New investors are flooding into the market and retail investors account for about 80 percent of traded volume. The amount of money investors have borrowed from securities firms to buy equities has risen more than five-fold since end-Q2:2014, to RMB 2.2 trillion or 8 percent of the free-float market capitalization (3.2 percent of GDP). The regulator's increased scrutiny of securities firms' lending has done little to slow the rise in borrowing. Until recently, wealthy investors were accessing leverage multiples far higher than brokerage accounts through structured products known as "umbrella trusts," with the funding provided by other investors, including wealth management products. Such borrowing is estimated by some analysts to have reached RMB 1 trillion, and regulators have recently taken steps to tighten the regulation on umbrella trust.

Wealth effects from changes in equity prices are rising, but previous studies suggest they are likely to be small. This holds even after accounting for the recent increase in the market's size and number of investors.¹ Based on free-float capitalization, a 25 percent change in prices would change the value of household, corporate, and institutional investor equity holdings by about RMB 7 trillion, equivalent to 10 percent of GDP and 9 percent of household financial assets at the end of 2013. As a comparison, an equivalent price change in the United States would lead to a change in free-float value of over 30 percent of GDP. Moreover, survey data suggest that financial assets account for just 5 percent of total household assets; financial assets are primarily bank savings and cash (text chart); and only 9 percent of households own equities and 4 percent mutual funds. Financial services have also been contributing more to growth, especially since the equity rally started. A correction, especially if it has implications on the financial sector, could directly reduce growth with knock-on effects to the rest of the economy.

Components of Household Financial Assets

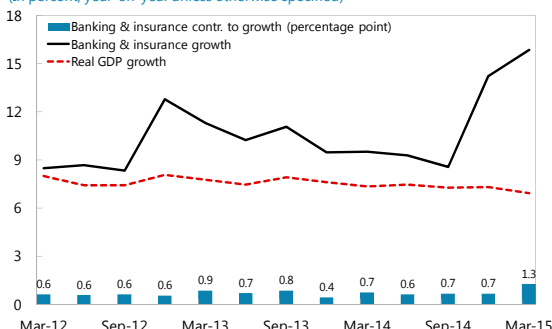
(In percent of total)



Sources: China Household Finance Survey, Texas A&M University and Southwestern University of Finance and Economics; <http://zhfs.swufe.edu.cn/>

Real GDP: Banking and Insurance

(In percent, year-on-year unless otherwise specified)



Sources: CEIC; and IMF staff calculations.

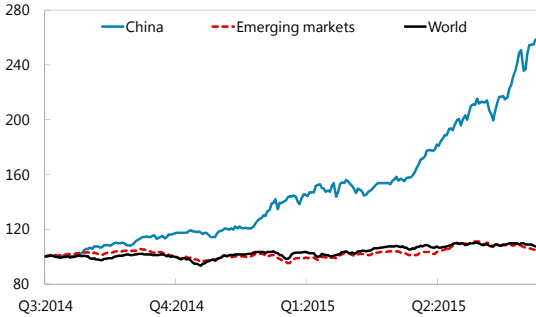
¹Y. Hu and C. Guo, "Stock Wealth, Signaling and Consumption of Urban Residents in China," *Economic Research*, Issue No. 3, pp. 115–26 (2012); and F. Wang, G. Zhou, Z. Chen, "Stock market Wealth Effect and Consumption Expenditure Analysis," *Securities Market Herald*, No. 11, pp. 48–57 (2009).

Box 4. China's Equity Market: Recent Developments and Risks (concluded)

China's equity rally stands in contrast to other markets...

Emerging Market Equity Prices

(Local currency index rebased end-Q2=100)^{1/}

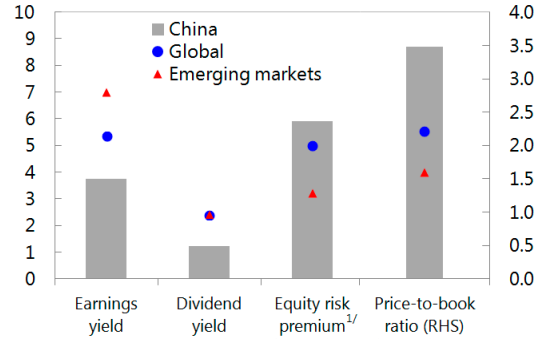


^{1/} China index is the market capitalization-weighted average of the Shanghai Composite and Shenzhen Composite indices.

...and has pushed valuations above emerging market peers for some common metrics.

Equity Market Valuations

(In percent unless otherwise specified)

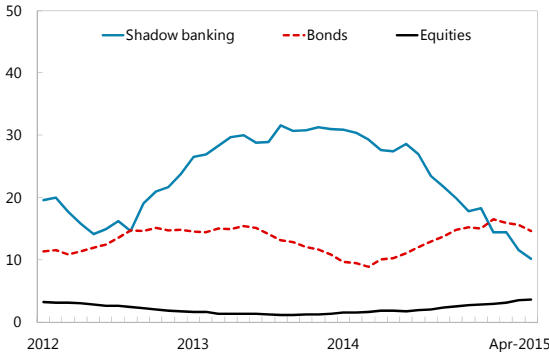


^{1/} Using consensus long-term GDP growth, dividend yields, and the 10-year government bond yield.

Equity finance is a small share of total social financing...

Shares of Total Social Financing

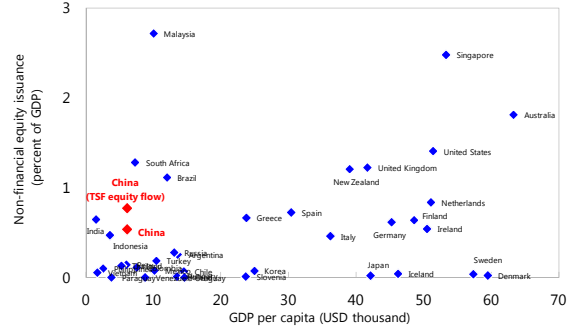
(In percent of total; 12-month cumulative)



...suggesting room for increased reliance in public offerings.

Non-financial Equity Issuance and GDP per capita^{1/}

(Selected economies, average of 2010-2014)

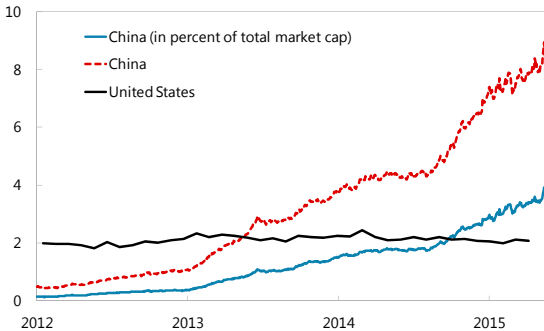


Sources: Dealogic; IMF World Economic Outlook; and IMF staff calculations.
^{1/} Equity issuance by nationality of the borrower.

Margin financing has risen considerably...

Equity Margin Balances

(In percent of free-float market capitalization)^{1/}

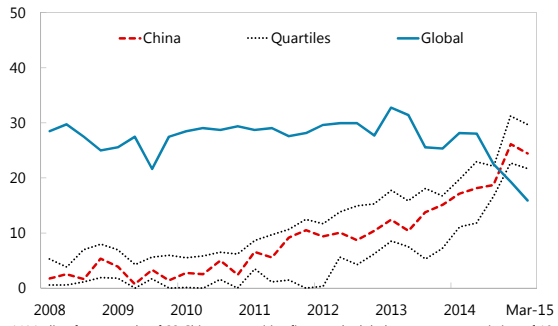


^{1/} Tradable market cap for Shanghai and Shenzhen.

...as has short-term debt of securities companies.

Securities Firms Short-Term Debt^{1/}

(In percent of total assets)



^{1/} Median for a sample of 22 Chinese securities firms and global peer group consisting of 10 securities firms listed in the United States, France, Germany, Switzerland, and Japan.

Sources: CEIC Data Company Ltd.; NYSE; MSCI; Thomson Datastream; Dealogic; IMF World Economic Outlook; WIND; Bloomberg; and IMF staff calculations.

Box 5. How Big Is the Risk of a Real Estate Slowdown and Does It Matter?

China's housing market has softened visibly since 2014, reflecting oversupply in most cities. More adjustment is likely.

All indicators point to weakness in China's housing market. Housing prices have been moderating both at the national level and across all city tiers, with the weakest performance among the smaller cities. Floor space sold, a good indicator of housing, has declined on a year-on-year basis since mid-2013 (sales volume picked up slightly at end-2014, following the relaxation of home purchase restrictions and easing of mortgage financing). On the supply side, floor space starts contracted by 14.4 percent in 2014, compared with 11.6 percent growth in 2013. This is mirrored by slowing real estate fixed asset investment, from about 20 percent growth in 2013 to 9.2 percent in 2014.

Housing inventory ratio—floor space unsold to floor space sold—shows a buildup since 2013, suggesting oversupply. Even though there is uncertainty regarding the level (National Bureau of Statistics (NBS) data show inventory of four months, while data from local housing bureaus suggest higher than two years), the direction of the buildup is clear. Inventory is especially high in Tier 3 and Tier 4 cities.^{1, 2}

Continued adjustment in floor space starts is warranted to let demand catch up with supply. To better understand how the oversupply came about and how the real estate market may return to equilibrium, staff analyzed China's housing demand and supply dynamics. The oversupply is measured by the cumulative gap between floor space starts and floor space sold (1–2 years ahead to account for the average construction time). Floor space sold is projected taking into account fundamental determinants of demand, which indicates that a continuation of the historical demand trend is likely. The baseline scenario assumes that the oversupply is eliminated by 2020, broadly in a linear fashion, through a moderate contraction in floor space starts. A stronger pickup in demand could help marginally to narrow the excess supply gap, but it is unlikely to fully offset a potential contraction in floor space starts.

The adjustment will have significant impact on GDP growth. Given the estimated relationship between growth in floor space starts and in real estate gross fixed capital formation (GFCF), real estate GFCF could slow to -2 to -4 percent in 2015 from about 3 percent in 2014.³ As real estate GFCF accounts for about 9 percent of GDP, this would imply a drop of GDP growth by about ½ percentage point in the baseline scenario. This abstracts from the indirect effect arising from real estate linkages to upstream and downstream sectors. Some of these sectors suffer from oversupply, and a slowdown in construction activity could bring losses, exposing vulnerabilities and posing risks (IMF, 2014).

¹The differences may be attributable to different methodologies in data collection. The NBS data rely on developers' self-reporting registration that is subject to underreporting in unsold units and over-reporting in sales, while data from local housing bureaus record all real estate registration, including buildings that have obtained permits to sell.

²Chinese cities are generally grouped into four categories: Tier 1 cities include Beijing, Shanghai, Guangzhou, and Shenzhen; Tier 2 cities include 35 cities, mostly provincial capitals; other small and medium-sized cities are grouped into Tier 3 or Tier 4 cities.

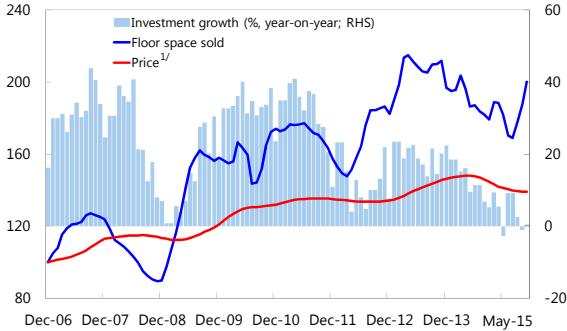
³Staff uses the real estate GFCF series estimated using the NBS data to keep the investment concept compatible with the national account (GDP) data. Staff estimates the real estate GFCF series by taking a share of real estate investment in total fixed asset investment (both series from the NBS) and apply it to the measure of GFCF in the national account.

Box 5. How Big Is the Risk of a Real Estate Slowdown and Does It Matter? (concluded)

Residential real estate sales have picked up...

Residential Housing

(Dec 2006 = 100, sa, 3mma)

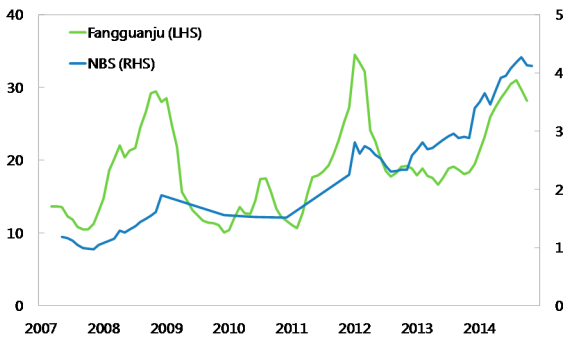


1/ NBS 70-city new constructed residential property price

...reducing inventories, albeit from a very high level.

Residential Real Estate Inventory Ratio ^{1/}

(In months, 3mma)

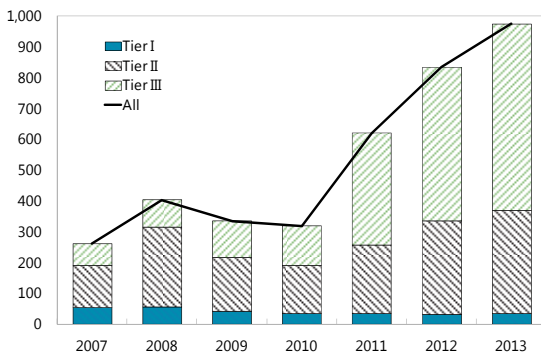


1/ Inventory ratio is measured as floor space unsold/sold.

Inventories are particularly high in smaller cities...

Residential Real Estate Inventory: Lower Bound Estimation

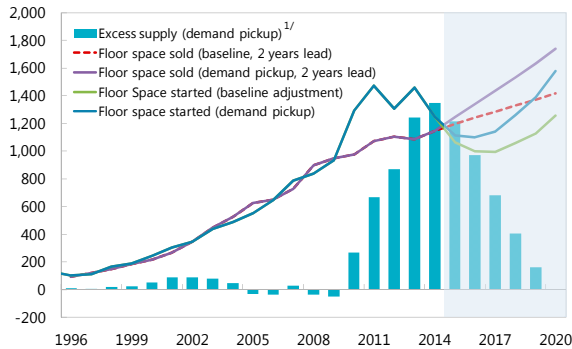
(In millions of square meters)



...which suggests a prolonged adjustment period, even with a pickup in demand.

Residential Market Overbuilding and Adjustment Scenarios

(In millions of square meters)

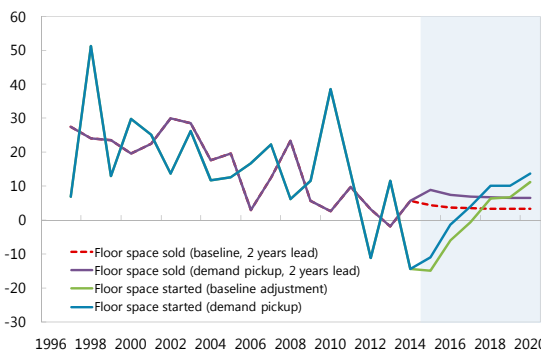


1/ Excess supply is measured as the difference between floor space started and sold (2 years lead).

The adjustment will weigh on construction activity...

Annual Growth of Residential Floor Space Newly Started and Sold

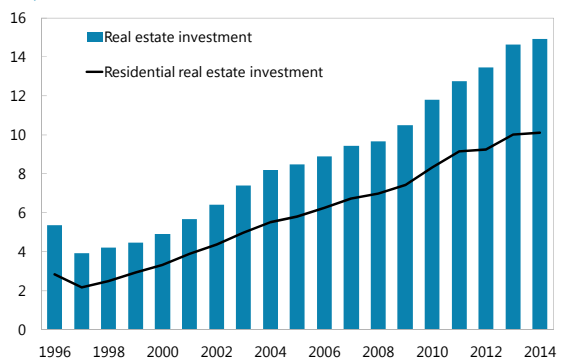
(In percent, year-on-year)



...with a sizable impact on GDP growth given the size of the sector.

Real Estate Investment

(In percent of GDP)



Sources: CEIC Data Company Ltd.; NBS; Local Housing Administrative Bureau (Fangguanju); Wigram Capital Advisors; and IMF staff estimates and projections.

Box 6. Growth Scenarios

Although growth is initially higher under a no-reform scenario, the benefits are ephemeral. Over the medium term, the staff baseline results in both higher and more sustainable growth.

How fast can China's economy grow? Implementation of the authorities' reform agenda is critical for boosting potential growth. Without reforms, vulnerabilities would continue to rise. On the supply side, there would be strong headwinds from falling productivity and negative labor force dynamics. On the demand side, the dynamics of credit and investment would be unsustainable due to a combination of rising interest costs in the highly indebted corporate sector and local governments, and falling returns on investment. This would increase the risk of a sharp or protracted growth slowdown over the medium term, even though policy buffers limit risks in the near term. On the other hand, the implementation of the authorities' reform program would lead to an initially slower, but ultimately more robust and higher growth.

Without reforms, growth would gradually fall to around 5 percent in 2020, with steeply increasing debt ratios. A no-reform scenario is constructed that assumes the authorities attempt to stabilize growth at around 7 percent. This strategy would eventually fail, as growth would slow as the marginal product of capital falls and productivity growth stagnates. The slowdown would be due largely to the falling contribution from capital accumulation and productivity growth:

- *Productivity growth stays low.* Investment efficiency has been adversely affected by the rapid scale-up, and the contribution of total factor productivity (TFP) to GDP growth has fallen to about 1½ percent per year. The no-reform scenario assumes the decline is permanent, with TFP growth gradually stabilizing at around 1 percent per year by 2030.
- *Labor force dynamics start subtracting from growth.* The contribution of employment to growth has remained positive, but has been falling fast (from ½ percent per year in early 2000s to ¼ percent now). Population aging combined with a falling participation rate will further reduce labor force growth, which is projected to drop to zero by 2020 and then turn negative, stabilizing at about -¼ percent per year.
- *Capital contribution starts falling.* The investment ratio would stay high initially, as the authorities attempt to stabilize growth at around 7 percent by relying on old growth engines (credit and investment). But this investment would contribute proportionally less to the capital stock than in the past, and the investment ratio would subsequently fall given the unsustainable credit-investment dynamics. The decline would be gradual, though, and the ratio would stay well above 40 percent of GDP by 2020.
- *Credit intensity of growth continues to be high* given the reliance on investment, which translates to increasing debt ratios both for the private and public sector.

The policies assumed in the staff baseline would translate to higher and more efficient growth. Specifically, reining vulnerabilities and implementation of Third Plenum reforms would improve resource allocation and facilitate the transition to more sustainable growth. These objectives translate to lower, but more efficient investment. Staff estimates based on a broad range of previous studies (Barnes and others, 2011)¹ suggest that gains in TFP growth would be in the 1–1½ percent range per year (Lam and Maliszewski, forthcoming).² Although activity would temporarily weaken with slower investment, the reforms would ultimately lead to higher growth with less investment and credit, which the overall debt ratio (private and public sector) of about 15 percent of GDP lower than in the no-reform scenario.

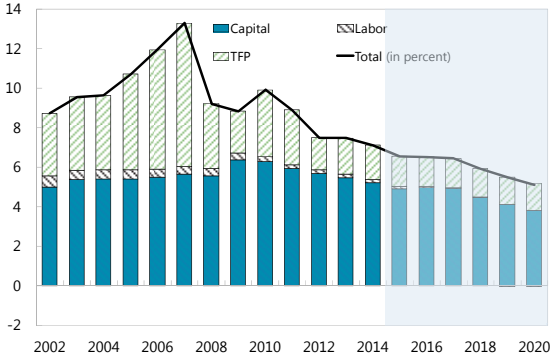
¹S. Barnes, R. Bouis, P. Briard, S. Dougherty, and M. Eris, "The GDP Impact of Reform: A Simple Simulation Framework," OECD Economics Department Working Papers 834 (2011).

²W. Lam and W. Maliszewski, "Giving Credit to China's Slowdown," IMF Working Paper (forthcoming).

Box 6. Growth Scenarios (concluded)

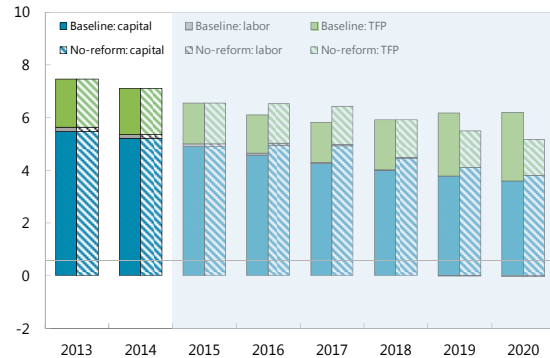
Growth is set to decline without reforms...

No-reform Scenario: Contribution to GDP Growth
(In percentage points)



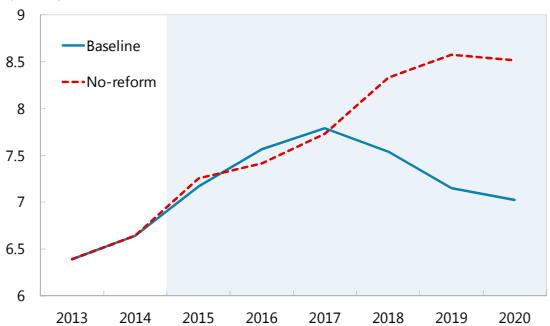
Growth with reforms would be less capital intensive and more reliant on TFP growth...

Contribution to GDP Growth
(In percentage points)



...as lower but more efficient investment...

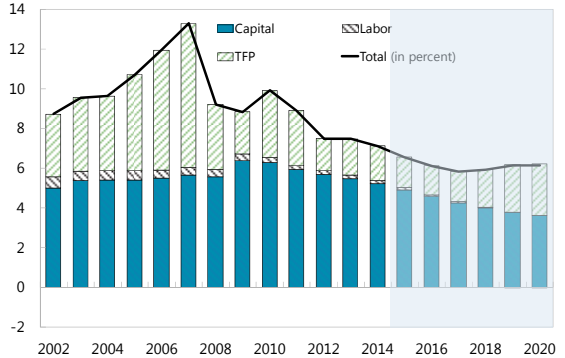
Incremental Capital Output Ratio (ICOR) ^{1/}
(In ratio)



^{1/}ICOR ratio is a proxy of the inverse marginal product of capital. The higher the index, the less productive the capital.

...but convergence process will continue under the reform scenario.

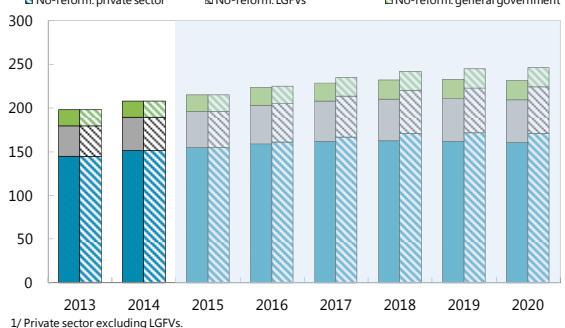
Baseline Scenario: Contribution to GDP Growth
(In percentage points)



...and would require less credit...

Debt Ratios

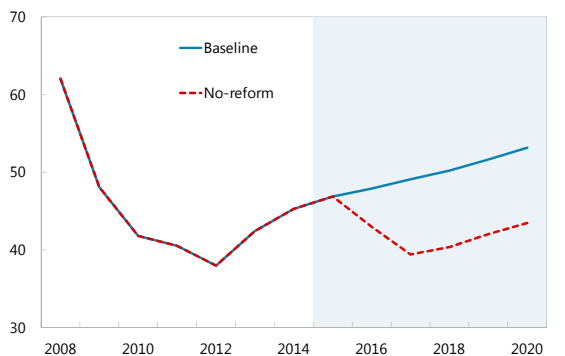
(In percent of GDP)



^{1/} Private sector excluding LGFVs.

...is increasingly financed by stronger profits.

Share of Investment Financed by Profits
(In percent)



Sources: CEIC Data Company Ltd.; Penn World Table, version 8.0; IMF *World Economic Outlook*; and IMF staff estimates and projections.

Box 7. Monetary and Fiscal Policy Stance: Assessing and Projecting

Assessing the monetary and fiscal policy stance in China is difficult. Monetary policy lacks a policy interest rate to signal changes in the stance, and the bulk of fiscal borrowing occurs off budget and is recorded as private credit, which blurs the line between monetary and fiscal policy. To deal with these issues, staff constructs complementary monetary and fiscal indicators to help assess developments and make projections.

What is the current fiscal and monetary policy stance? It is difficult to categorize the policy stance in China using conventional definitions. The official budget excludes a substantial amount of off-budget fiscal activity. Thus, staff considers the augmented deficit a better indicator of the fiscal stance, but it is hard to estimate and there is no budget for such activity. On the monetary side, there is no policy interest rate to signal changes in the monetary stance. Policy is conducted using a variety of tools including benchmark interest rates, liquidity management (OMOs and RRRs), and window guidance. Several indicators provide a sense of the stance—including benchmark interest rates, interbank interest rates, M2, and TSF—but may send conflicting signals and reflect developments as much as policies. For example, slow credit growth could reflect tight monetary policy, weak credit demand, or both. Moreover, the line between monetary and fiscal developments is also blurred by the fact that LGFV borrowing—a fiscal activity—shows up in TSF, the most commonly used measure of private credit.

Augmented fiscal deficit indicates the fiscal stance. LGFV borrowing accelerated in the aftermath of the global financial crisis as a way for local governments to support demand while circumventing the rules against local government borrowing (see figures). While some LGFV activity is commercial, staff considers that the bulk of it is fiscal in nature. This is supported by the 2013 NAO report, which found that the government was ultimately responsible for two-thirds of the stock of debt from LGFVs (and other local entities). Moreover, it is not feasible to separately identify the commercial portion of LGFV borrowing based on available data. Thus, staff constructs augmented fiscal data by expanding the perimeter of government to include all LGFVs.¹ However, data on LGFV borrowing from banks—which is the main source of LGFV financing—are generally not available. Staff estimates of the augmented deficit are thus subject to considerable uncertainty.

LGFV borrowing has been sizable, thus adjusting the monetary and fiscal data for LGFV borrowing is important. Since LGFVs are included in the augmented fiscal data, their borrowing should be removed from TSF. This avoids double-counting and makes the TSF data a better indicator of lending to the private sector, defined to include SOEs but exclude government and the financial sector. Private credit is thus defined as TSF less equity financing (which is in TSF) and less LGFVs. For end-2014, this adjustment reduces TSF and raises government debt by 37 percent of GDP. Moreover, this adjustment is becoming increasingly important with the rollout of the new budget law. The law could result in a reclassification of local government liabilities from TSF to government debt as both local borrowing shifts to more on-budget financing and part of the existing stock of local liabilities is swapped into government bonds. While TSF and government debt are impacted by these changes, staff estimates of the augmented deficit and private credit are not. The staff-constructed measures, thus, provide a more consistent series for assessing and distinguishing between monetary and fiscal developments.

Staff's macro projections are based on explicit assumptions for the augmented fiscal deficit and private credit. For 2015, staff forecasts the augmented deficit to be 10 percent of GDP, including 6 percent of GDP (RMB 4.1 trillion) in LGFV financing recorded in TSF. Private credit is forecast to grow by around 11 percent, which is consistent with financing the private investment assumed in the staff baseline. TSF growth will depend on whether local infrastructure spending is financed through government bonds or LGFVs; staff assumes that,

¹See Appendix III and Box 3 in *People's Republic of China—Staff Report*, IMF Country Report No. 14/235 (2014).

²This assumes that the 2 trillion local government bonds from the debt swap program will still be included in TSF. If instead these bonds are recorded as government debt, then this year's TSF growth would fall to 10.4 percent.

Box 7. Monetary and Fiscal Policy Stance: Assessing and Projecting *(continued)*

in line with past practice, it is financed through LGFVs.² Regardless of how it is financed, the staff projections are predicated on an augmented deficit of 10 percent of GDP and private credit growth of around 11 percent. Projections for later years are done the same way, with explicit forecasts of the augmented deficit and private credit, and private credit linked to forecasts of private investment (see Box 3).

Staff's baseline assumes that monetary policy is adjusted as necessary to achieve the forecasted growth in private credit. For this year, private credit growth of 11 percent translates into a 7.6 percent decline in the flow of private credit. This likely requires a pick-up in the flow of private credit in the remainder of the year. The flow of TSF was minus 18 percent (May, year-to-date), and while some of this is likely due to sluggish LGFV borrowing in the early part of the year—the extent is hard to estimate with available data—private credit growth was also likely weak. However, the benchmark interest rate cuts and, more recently, declines in interbank interest rates are still working through the economy and will provide some support to credit in the remainder of the year. The staff baseline assumes that further steps are taken, if needed, to adjust the pace of private credit growth to reach staff's year-end forecast.

Likewise, the staff baseline assumes that local government financing is consistent with a 10 percent of GDP augmented deficit. The augmented deficit treats land sales as a financing item, whereas the augmented net borrowing is the more relevant measure for financing needs. With land sales proceeds expected to decline this year, augmented net borrowing is forecast to rise somewhat to around 8 percent of GDP. The local government financing need is estimated to be RMB 6 trillion. Local governments have been authorized to issue bonds to swap for maturing debt and to finance the current year deficit (text table). Through mid-June, around RMB 500 billion of such bonds had been issued or placed with banks. After Jiangsu province initially had to postpone its issuance—reportedly due to the high yields demanded by buyers—steps were taken to make the bonds more attractive to banks. These included putting a ceiling on the interest rate (1.3 times of sovereign yields) and allowing the bonds to be used as collateral for repos with the central bank. These steps were widely seen as providing an implicit central government guarantee to the bonds, which have since been issued at yields quite close to the sovereign. In addition, LGFVs have continued to issue bonds on the interbank market.

Additional measures may be needed to meet local government financing needs. In May 2015, the state council issued a directive (GuoFa Document 40) that asked banks to continue to finance ongoing projects based on existing contracts signed before this year. For those LGFVs that cannot meet their debt service obligations, banks and local governments can negotiate to refinance LGFV debt by extending the maturity of the debt and/or requiring additional collateral. The remaining financing need is expected to be met through policy banks, PPPs and, if needed, additional measures. This could include a drawdown of fiscal deposits, asset sales, or authorization for additional borrowing.

Financing Needs for LGFVs and Other Local Government Entities in 2015 (In trillions of RMB)

Financing need	6.0
Local government financing projects	4.1
Maturing debt in 2015 1/	1.9
Identified financing	3.1
Debt swap for maturing local and LGFV debt	2.0
Provincial bonds to cover deficit	0.6
LGFV gross interbank bond issuance (as of mid-June)	0.5
Other financing	2.9
Public-private partnership (announced projects) 2/	0.2
Policy bank lending (such as social housing) 3/	1.0
To be specified	1.7

1/ Excludes 0.9 billion local government contingent liabilities.

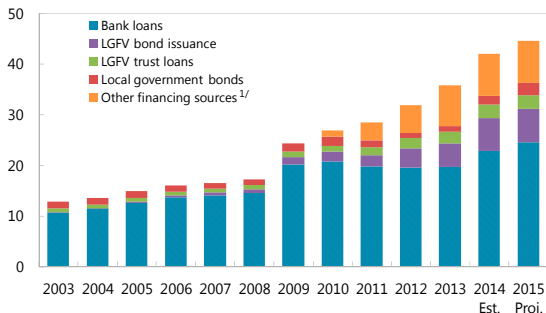
2/ Total announced PPP investment is about RMB 2 trillion, assuming the executed contribution for 2015 financing stands at 10 percent based on various analyst estimates.

3/ From Mizuho and UBS estimates.

Box 7. Monetary and Fiscal Policy Stance: Assessing and Projecting 1/ (concluded)

LGFV borrowing has been sizable, with more than half financed through bank loans.

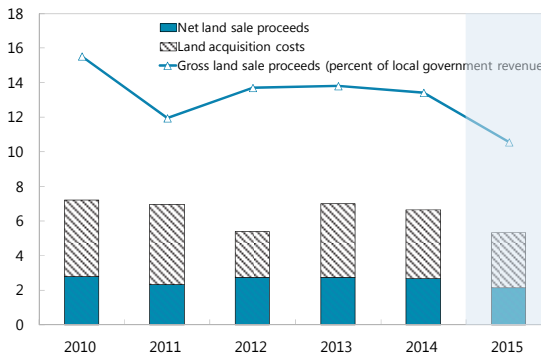
Financing Sources of Local Government and LGFV Debt
(In percent of GDP)



1/ Other financing sources include Build to Transfer, account receivables, accruals as outlined in NAO report (2013).

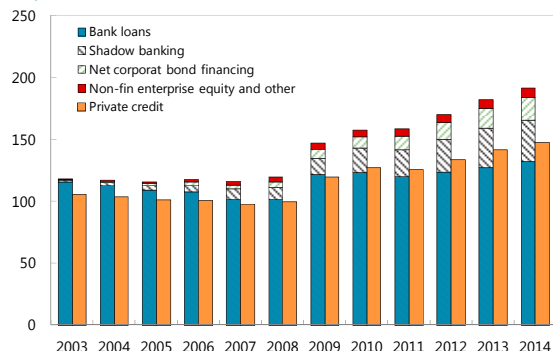
Proceeds from land sales, an important source of financing local spending, is forecast to decline.

Land Sale Proceeds
(In percent of GDP unless otherwise specified)



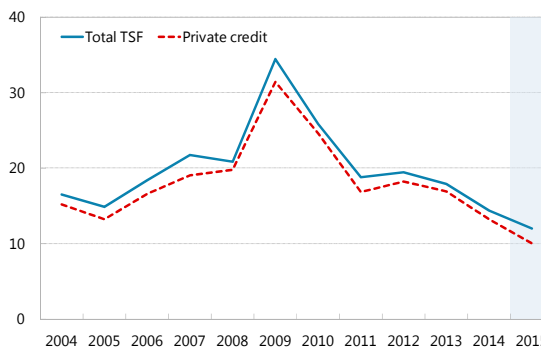
Private credit is constructed by removing LGFV borrowing and equity issuance from the TSF data.

Total Social Financing Components
(In percent of GDP)



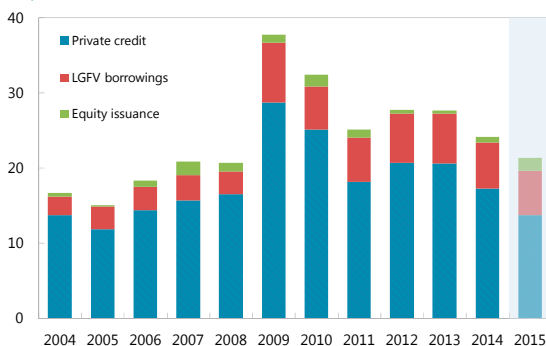
Private credit has been growing somewhat slower than headline TSF...

Total TSF and Private Credit
(In percent, year-on-year)



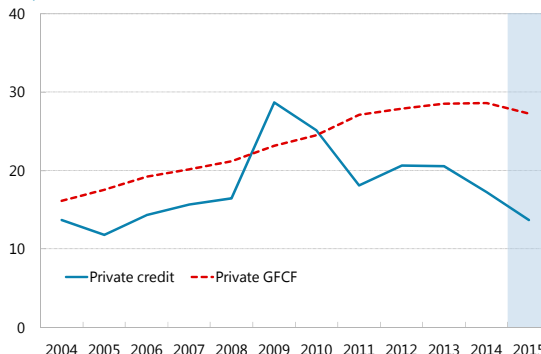
...and the flow is expected to continue to decline, especially as a share of GDP...

Private Credit, LGFV and Equity
(In percent of GDP)



...as credit to the private sector slows broadly in line with the decline in private investment (GFCF).

Private Credit and Private GFCF
(In percent of GDP)



Sources: CEIC Data Company Ltd.; NAO report (2013); and IMF staff estimates and projections.
1/ Private credit is calculated as total TSF minus LGFV borrowings and equity issuance.

Box 8. Toward an Equitable, Sustainable, and Integrated Social Insurance System

Coverage has been expanded. Remaining challenges include addressing disparities, ensuring adequate benefits, and increasing incentives to participate in formal employment, while maintaining long-term fiscal sustainability.

China has a dual social insurance system with nearly universal coverage. Separate schemes provide insurance for old age and health care for workers in the formal enterprise sector (Urban Workers and Staff, UWS), and nonsalaried workers (Urban and Rural Residents, URR). After a rapid expansion of schemes for URR over the past five years, coverage is nearly universal (health care insurance coverage is about 95 percent and pensions cover nearly 100 percent of those more than 60 years old). However, large disparities remain in terms of the adequacy of benefits across schemes. For example, average URR pensions are under 5 percent of those for enterprise retirees. Reducing this gap remains an important challenge.

The pension system needs reforms to ensure its long-term sustainability, and reduce inequities. The pension scheme for UWS has a sizable long-term imbalance reflecting the prospects of population aging—the present discounted value of expenditure minus contributions over 2015 to 2050 is 67 percent of 2014 GDP. Parametric reforms could help address these looming deficits. One priority includes increasing retirement ages, which would improve the

system finances and help boost labor supply. In contrast, in the pension scheme for URR, it seems crucial to boost the adequacy of benefits. In particular, policies should aim to reduce

	2014		2015-2050		Contributors to labor force	Pensioners to population 60 and older
	Expenditure	Contributions	Pension spending increase (percentage points of GDP)	Actuarial imbalance (percent of 2014 GDP)		
PUWS	3.0	2.9	4.0	64	29	41
PURR	0.2	0.1	0.3	12	42	72
Total	3.2	3.0	4.3	76	71	113

gaps in contributions to the individual-account component of this scheme, and raise contribution levels (today, most participants contribute only the minimum allowable). This would allow for a larger role of contributory pensions in the future. In addition, the modest noncontributory basic pension for the current elderly (about 2½ percent of the average private urban wage) could be raised and moved to the budget, given that these benefits constitute an element of the social safety net.

Pensions and health care insurance remain fragmented. This is true both geographically (the central government provides guidelines and financing, but social insurance is administered at the provincial level), and across schemes (UWS and URR are not integrated). It impedes the development of an integrated national labor market, and contributes to rural-urban income disparities. Further integration could improve the pooling of demographic and economic risks, simplify administration, and increase the portability of benefits.

The relatively high level of social security contributions is a concern. For the UWS—mandatory contributions to pension, medical, unemployment, occupational injury, and maternity benefits add to over 40 percent of wages. Reviewing the financing sources so as to reducing this burden would be crucial in the medium term as part of a broader tax reform.

Box 9. Moving To a More Flexible Exchange Rate Regime

Since 2005, the exchange rate regime has been made gradually more flexible. However, accelerated progress is becoming increasingly important for managing the economy and transforming the growth model. While there are many options for moving forward, conditions are ripe for taking the next steps.

The exchange rate regime has improved a lot over the past 10 years. Since the reform in July 2005, the intraday band has been gradually widened and the regime has facilitated considerable adjustment (the renminbi appreciated about 30 percent against the U.S. dollar since 2005). Currently, flexibility is limited by a daily 2 percent trading band around a central parity. Officially, the parity is determined by the weighted average of preopening market quotes, without any limit on day-to-day movements. Thus, in theory the parity could move significantly from day-to-day, while in reality it moves very little and much less than suggested by market conditions.

More flexibility is becoming increasingly critical to move to an effectively floating exchange rate. It is necessary for allowing the market to play a more decisive role in the economy, rebalancing toward consumption, and maintaining an independent monetary policy as the capital account opens. With capital flows sizable and growing, the “impossible trinity” (inability to have an open capital account, independent monetary policy, and tightly managed exchange rate) will become increasingly relevant. Thus, without more exchange rate flexibility, China will have less and less room for its own monetary policy, appropriate for its specific cyclical and structural conditions.

There are many options for transitioning to a floating exchange rate. International experience provides some lessons, but China’s strategy will have to be tailored to China’s specific characteristics. Unlike many historical cases, China is proceeding from a position of strength with considerable international reserves, a current account surplus, relatively strong growth, and low inflation. Key elements of the reform strategy include:

- **Band widening.** Several countries (Chile, Israel, and Poland) have advanced by gradually widening the band around a central parity. China has already been doing this and conditions are good for taking the next step. The exchange rate often closes at or near an edge of the band, highlighting that the band is generally a binding constraint. Widening it, therefore, will promote more flexibility.
- **Central parity.** This is the most challenging element. The principle should be to allow the central parity to move over time in line with market forces. In theory, this would be easy if the rate was at the market equilibrium. However, in practice the market equilibrium is both unknown and changing. The challenge is that moving too slowly to the market equilibrium will invite speculative flows, while going too fast will undermine the parity’s role as an anchor in the system. One option is to set the parity based on a basket. This will introduce more flexibility against the U.S. dollar and allow the parity to move automatically in line with global currency movements. Countries have tried various strategies for adjusting the parity, ranging from rules-based systems (Russia) to a preannounced crawl (Israel and Poland). Another option would be to adopt a system where the central bank explicitly sets the central parity and adjusts it on a discretionary basis. The principle is to have a system that sets ‘speed limits’ on exchange rate movements, dampening fluctuations due to temporary shocks, but adjusts in the event of sizable and persistent pressures.
- **Intervention.** To allow market forces to play a stronger role, intervention should be limited to the edges of the intra-day band or follow a rules-based system. Sustained one-way intervention should be avoided and, if it occurs under a given band, be a cause for adjusting the central parity and/or widening the band. Russia, for example, had a rules-based system that entailed no intervention if the rate was near the parity, and increasing intervention (by predetermined and preannounced amounts) as the rate moved toward an edge. Moreover, the central parity was adjusted using a formula based on the cumulative amount of intervention,

Box 9. Moving To a More Flexible Exchange Rate Regime *(continued)*

thus allowing the parity automatically to adjust in line with evolving market conditions. Staff simulations illustrate the relative advantages of different systems. For example, a Russian-style system can better accommodate persistent fundamental shocks, as the central parity would adjust—based on the preannounced rule—to a period of one-sided intervention (the bottom left panel). Pre-committed bands, as used in Poland and Israel, could accommodate persistent shocks if they are wide enough, but the process of widening typically takes time, and intervention in the meantime could be sizable. A credible band can have a self-stabilizing effect because of the *expected* intervention near the edges, but this effect might be dampened if band widening is a possibility (the bottom right panel).

- **Rules versus discretion.** A rules-based system has advantages of making adjustments automatic and shielding the system from political pressure to move rate one way or another. However, discretion would allow for easier adjustment to unusual or unforeseen developments, especially as it is difficult to design a rule that could work in all situations.
- **Transparency.** Countries vary in how much information is shared about the system design and operation, including data on intervention (e.g., India, Russia, and several countries in Latin America publish intervention data, while most other emerging countries do not). Openness has the benefit of promoting accountability, but could also facilitate destabilizing speculative flows by making the system too predictable.

Complementary reforms would facilitate the move to greater exchange rate flexibility. India quickly liberalized the exchange rate by ending intervention and switching to relying on interest rates as the primary monetary instrument—in tandem with steps to strengthen interest rate management. This highlights the complementary role of reforms to strengthen the monetary policy framework, especially the use of interest rates to influence liquidity conditions and help achieve both internal and external balance. Another consideration is hedging. Onshore and offshore hedging instruments exist, though are not widely used. There is an aspect of a “chicken and egg” problem, as firms may not want to hedge given the lack of volatility in the exchange rate. However, the infrastructure for hedging is largely in place and could readily be upgraded as needed to accommodate an increase in demand.

Exchange rate reform will result in more volatility of the renminbi against the U.S. dollar. The stability against the U.S. dollar, however, is creating instability elsewhere in the economy. In particular, it can lead to sizable, unintended changes in the effective (trade-weighted) exchange rate, even over relatively short periods of time; contribute to significant volatility in capital flows, and fuel excessive risk taking in both real and financial investments as firms make decisions predicated on continued stability against the U.S. dollar.

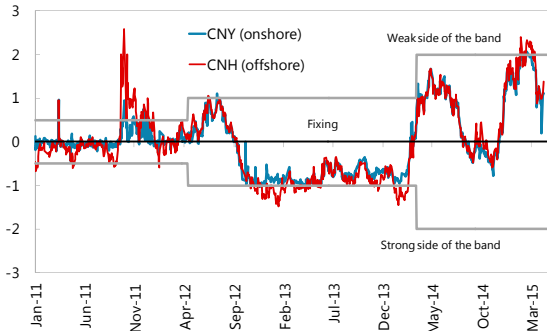
The next step is to develop a reform strategy. An effectively floating exchange rate should be in place within 2–3 years, before the full liberalization of the capital account. Any number of combinations of the elements described above could work, so the key is to forge a domestic consensus so that implementation can proceed, with the understanding that there will be some learning-by-doing and fine tuning along the way.

Box 9. Moving To a More Flexible Exchange Rate Regime (concluded)

Exchange rate band in China has been widened to ±2 percent...

RMB Daily Closing

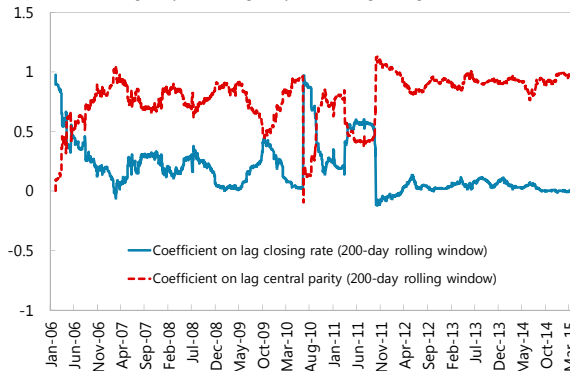
(In percent change from the fixing)



Sources: Bloomberg; Haver Analytics; and IMF staff calculations.

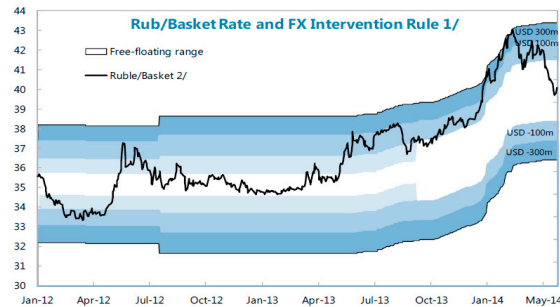
...but the central parity does not fully reflect market conditions.

$$\log \text{Parity} (t) = a * \log \text{Parity} (t-1) + b * \log \text{Closing Rate} (t-1) + c$$



Source: IMF staff calculations.

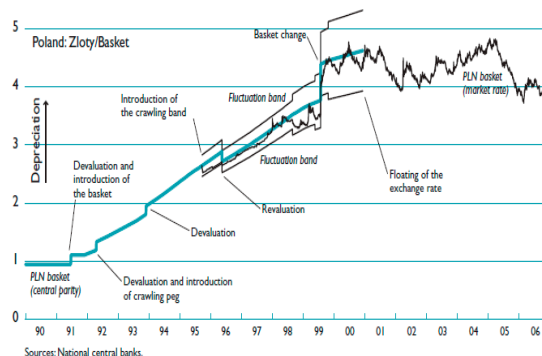
A transition to a more flexible regime could be through a more flexible central parity (as in Russia)...*



Sources: Central Bank of Russia; Bloomberg; and IMF staff calculations.

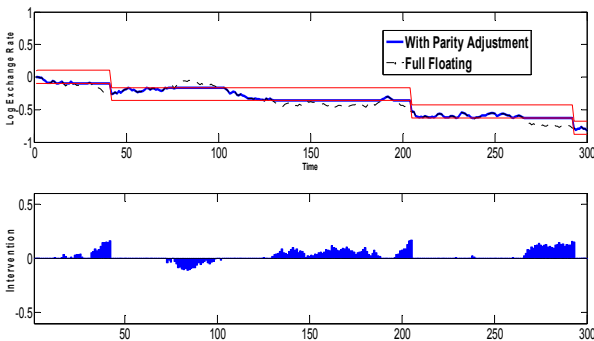
1/ Until end-February, the position of the band was shifted after USD 300m of cumulative untargeted interventions. In March, the CBR announced that the threshold was revised up to USD 5bn. Bands show the size of untargeted daily interventions according to the rule.
2/ Russian ruble per basket (55% USD and 45% EUR).

...or by making the band wider and limiting interventions to the edge of the band (as in Poland)**

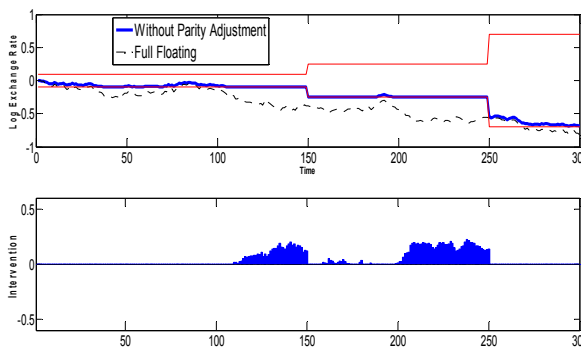


Sources: National central banks.

Numerical example: rule-based changes in central parity can better accommodate persistent shocks.



Precommitted band has a stabilizing effect through expectations. But discrepant changes of band widths would be needed to accommodate persistent shocks.



* The figure is from Russian Federation: 2014 Article IV Consultation—Staff Report, IMF Country Report No. 14/175.

** The figure is from IMF, "Moving to Greater Exchange Rate Flexibility—Operational Aspects Based on Lessons from Detailed Country Experiences," Occasional Paper 256 (2007).

Box 10. Spillovers from Changing Patterns in Chinese Trade

China's share of global exports grew rapidly. It has also been evolving, with domestic value added rising and signs that China is losing competitiveness in some labor-intensive sectors. These changes create both challenges and opportunities for other economies.

China has experienced a rapid export growth in the past two decades, especially before 2009. China's export market share rose from 2 percent in 1990 to 7 percent in 2001 (when it joined the WTO) and 13 percent in 2013. This rise has largely come at the expense of advanced economies. Their market share is characterized by depth, such as 56 percent of global computer equipment exports or 65 percent of global plastic toy exports; as well as breadth, as China has at least a 10 percent global market share in one-third of all categories measured by Comtrade.

China has also moved up the value chain throughout this period. China's value added as a share of global totals has risen from 2 percent in 2000 to 8 percent in 2011, leaving it only below the United States at 10 percent. China's value added as a share of its own gross exports is still below levels of the mid-90s, but this simply reflects the initial stages of China joining the global supply chain in which gross trade rises rapidly.

The rise in the value chain resulted in less dependence on imports for a given level of exports. China is increasingly producing sophisticated inputs at home rather than importing them. Processing exports, a customs classification which indicates high import content, has fallen from 56 percent of total trade in 2005 to 35 percent in recent data. This is also evident in the import intensity of specific export goods. For example, the amount of intermediate parts imported for a final computer or telephone has plummeted.

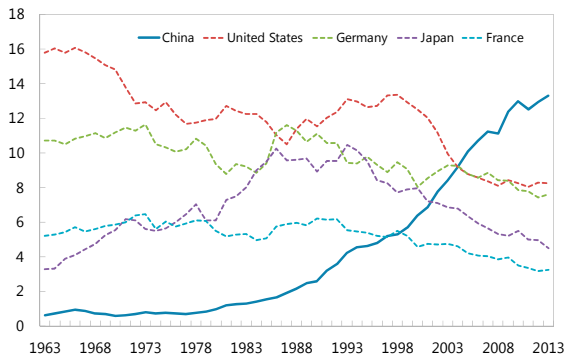
China has lost some competitiveness in low-end categories, but less so than other economies at the same stage of development. The higher productivity which has allowed production of more sophisticated inputs has been accompanied by some loss of competitiveness in certain low-end categories. In furniture, footwear, apparel and plastic toys—the categories where China first made its export mark—global market share has reached an inflection point in recent years with mild signs of decline. However, this inflection point has only come after reaching a market share in apparel of 50 percent, as compared to 13 percent for Hong Kong SAR and Korea. Moreover, such an inflection point is still not evident in other labor intensive sectors like electronics assembly. This is a testament to China's deep supply of low-wage labor and scope for moving production inland

Changes in China's trade patterns have posed challenges and opportunities for its trading partners, particularly in the region. For example, the move up the value chain has contributed to a sharp improvement in China's trade deficit with the main Asian electronics supplier countries even as its surplus with the United States and European Union has continued to rise. Meanwhile, the exit from labor intensive goods such as apparel has already created opportunities for other Asian economies, including Bangladesh, Cambodia, Indonesia, and Vietnam.

Box 10. Spillovers from Changing Patterns in Chinese Trade (concluded)

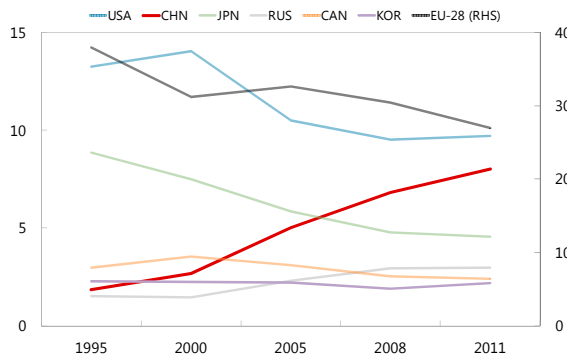
Historically, China has mainly dominated global "gross" export market share...

Global Export Market Share
(In percent; Top Five Exporters)



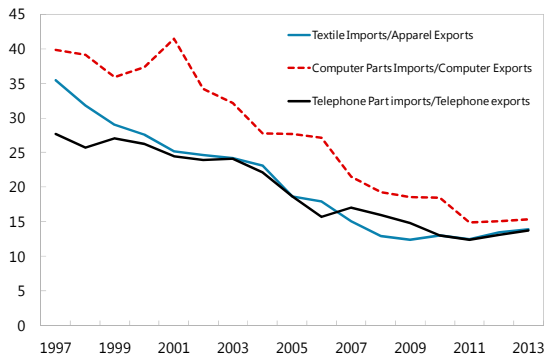
...but in recent years it has taken a rising share of global value added as well.

Domestic Value Added
(In percent of world's domestic value added)



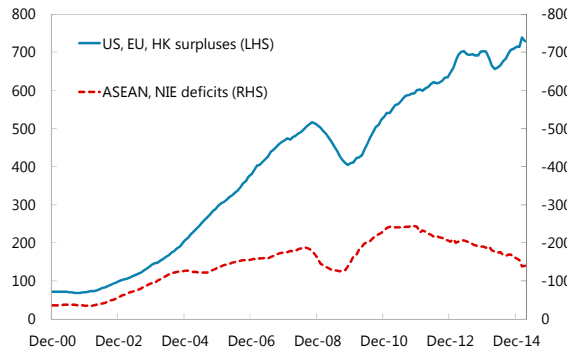
This can be seen in falling dependence on imported inputs...

Import Intensity of Exports
(In percent)



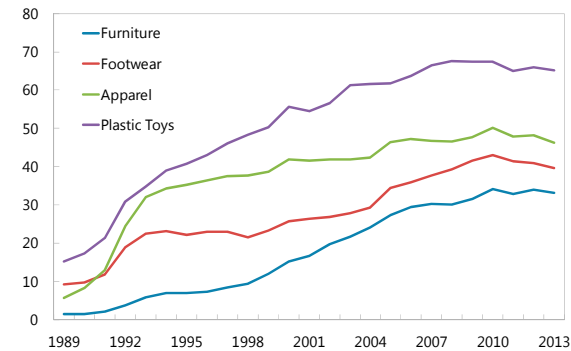
...which has resulted in less reliance on the Asian supply chain.

Trade Balances by Region
(In billions of USD; 12M rolling sum)



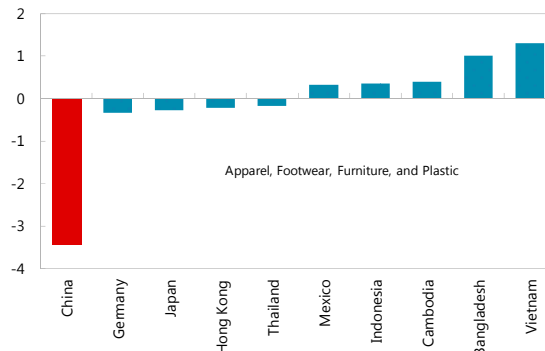
At the same time, China's market share in low end-labor intensive goods may have reached an inflection point...

Chinese Market Share in Labor Intensive Final Goods
(In percent)



...and this has resulted in new opportunities for other Asian economies in particular.

Change in Market Share in Major Low End Goods
(In percentage points; 5 largest and smallest changes since 2010)

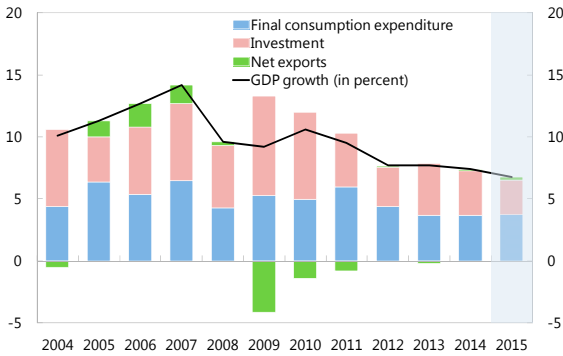


Sources: UN COMTRADE database; Haver Analytics; OECD June 2015 TiVA database; and IMF staff calculations.

Figure 1. Real Sector Developments

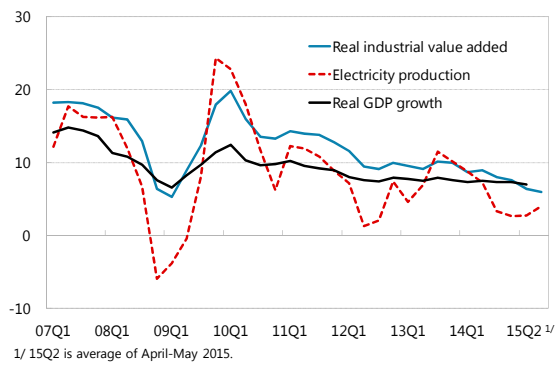
The economy has been slowing...

Contributions to Growth
(In percentage points, year-on-year)



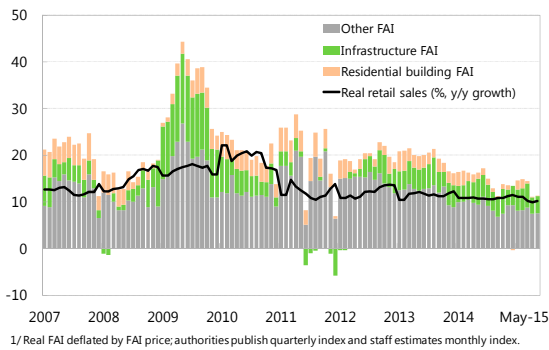
...and supply-side indicators point to further weakness...

Electricity Production, Value Added and Growth
(In percent, year-on-year)



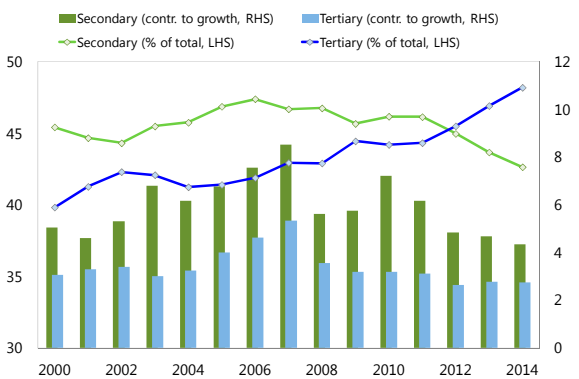
...while demand-side indicators are holding up better...

Real Fixed Asset Investment Contributions and Retail Sales^{1/}
(In percentage points unless otherwise specified)



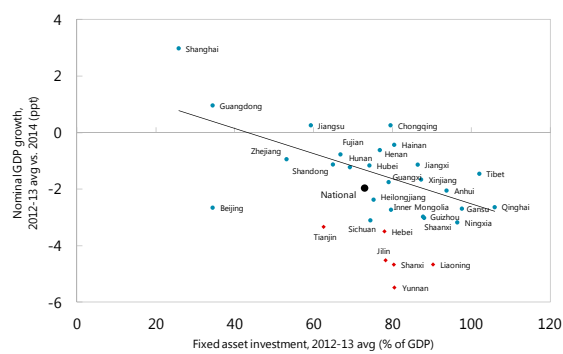
...consistent with a shift of activity from manufacturing (secondary sector) to services (tertiary sector).

GDP Shares and Contributions by Sector



Provinces with mining and heavy industry, industries associated with the old growth model...

Provincial Nominal GDP and Fixed Asset Investment



...have slowed more, especially when measured in nominal terms.

Provincial Nominal GDP Growth
(In percent)



Note: Provinces colored in red are the six lowest growing provinces in terms of nominal GDP growth.

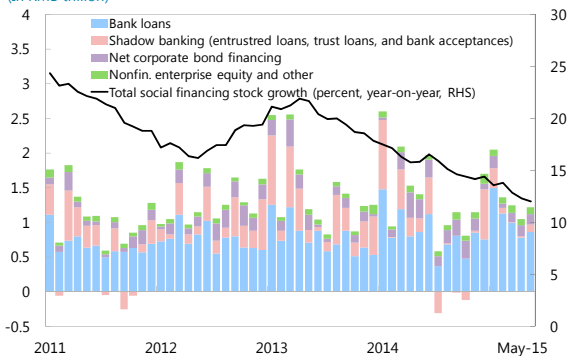
Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff estimates and projections.

Figure 2. Monetary and Financial Developments

TSF growth has slowed considerably...

Social Financing Flow

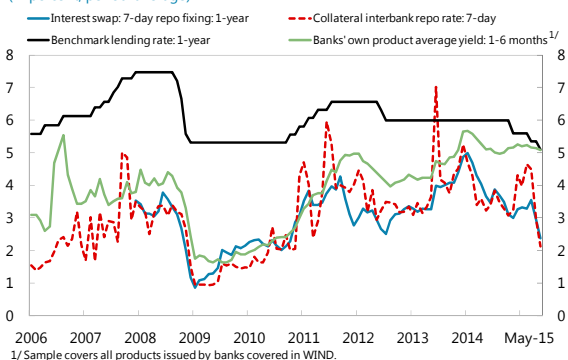
(In RMB trillion)



Nominal interest rates have declined...

Interest Rates

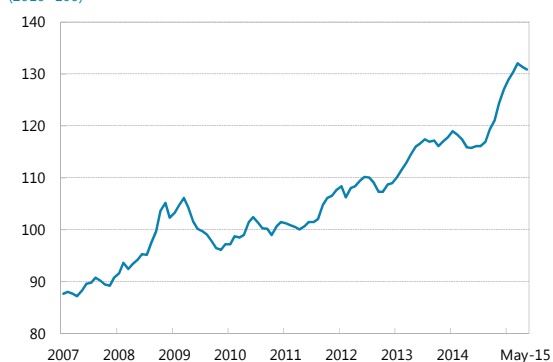
(In percent, period-average)



...and renminbi appreciation in trade weighted terms.

REER

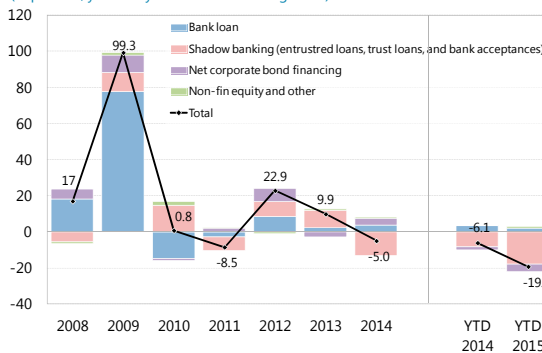
(2010=100)



...with the flow shrinking in nominal terms, led by a reduction in shadow banking.

Social Financing Flow

(In percent, year-on-year contribution to growth) ^{1/}

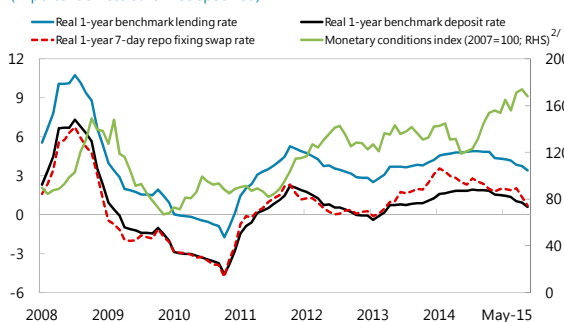


^{1/} For year-to-date series, January-May total over corresponding period previous year.

...but less so in real terms, and monetary conditions have tightened with the decline in inflation...

Real Interest Rates and Monetary Conditions Index ^{1/}

(In percent unless otherwise specified)

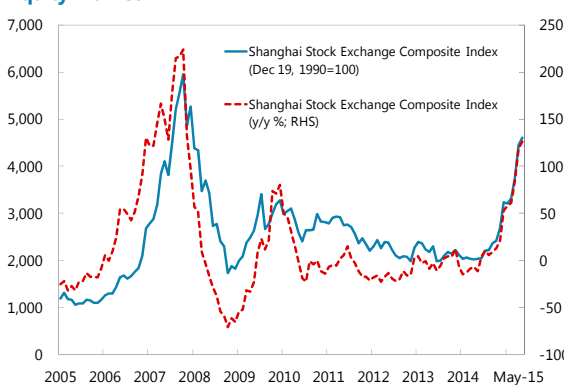


^{1/} Real interest rates deflated by 1-year CPI inflation forecast using AR process.

^{2/} Inverse of Bloomberg's MCI index; higher level indicates tightening of monetary conditions.

The equity market is in the midst of a strong rally.

Equity Market

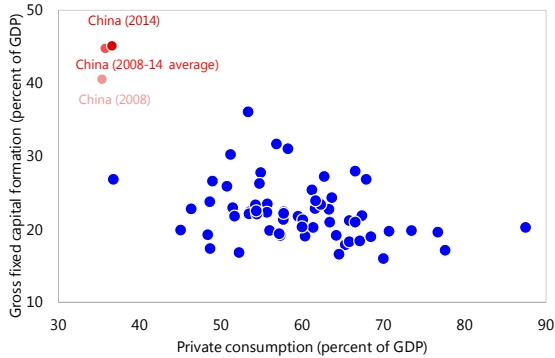


Sources: CEIC Data Company Ltd.; Haver Analytics; WIND; Bloomberg; and IMF staff calculations.

Figure 3. Domestic Rebalancing

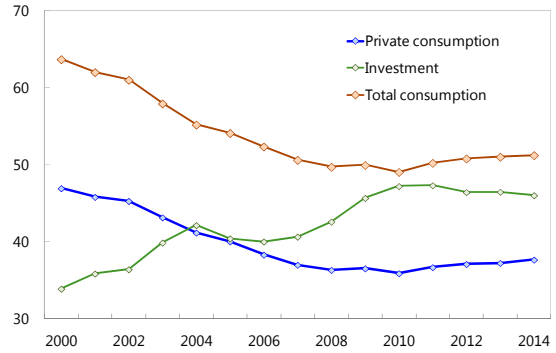
China continues to be a global outlier in terms of investment and consumption shares of GDP...

Private Consumption and Investment
(Industrial Countries and Emerging Markets; average, 2008-14)



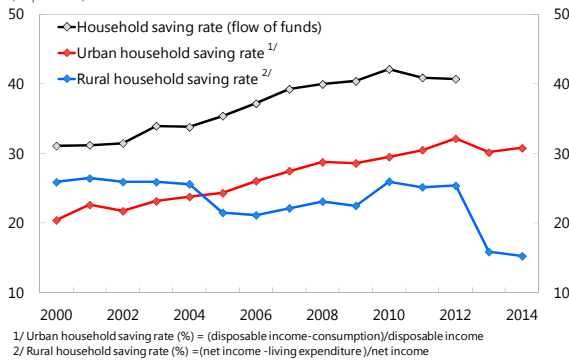
...although the consumption share appears to be rising, with consumption growth faster than GDP...

GDP Expenditure Components
(In percent of GDP)



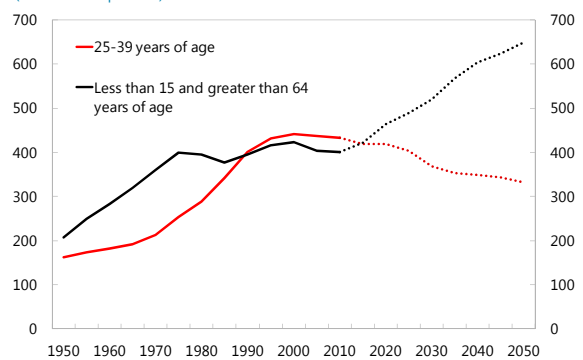
...as household saving rates are declining, which could reflect success in strengthening the social security system...

Household Saving Rate
(In percent)



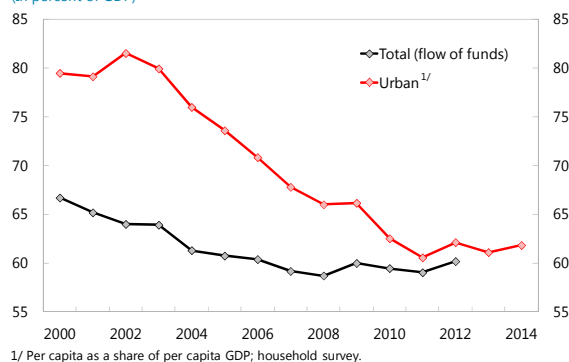
...as well as population aging.

Demographic Pressures
(In millions of persons)



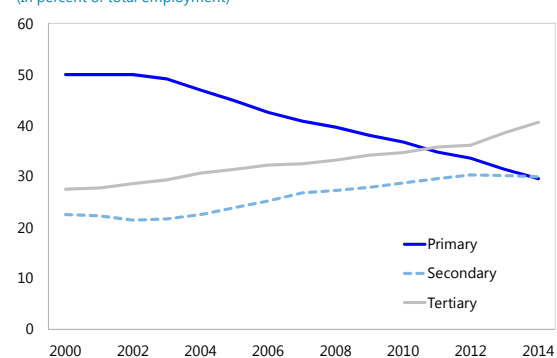
Household's share of GDP appears to be no longer shrinking...

Household Disposable Income
(In percent of GDP)



...which could reflect the shift in employment to the service (tertiary) sector, where labor gets a higher share of income.

Employment Shares by Sector
(In percent of total employment)



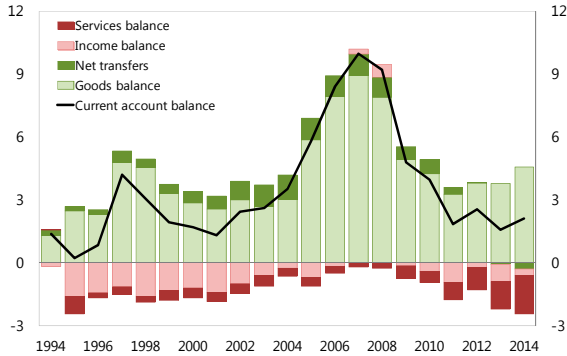
Sources: CEIC Data Company Ltd.; Household Surveys; UN Population Database; IMF *World Economic Outlook*; and IMF staff estimates and projections.

Figure 4. External Developments

Current account surplus has been falling as the services deficit increases...

Current Account and Components

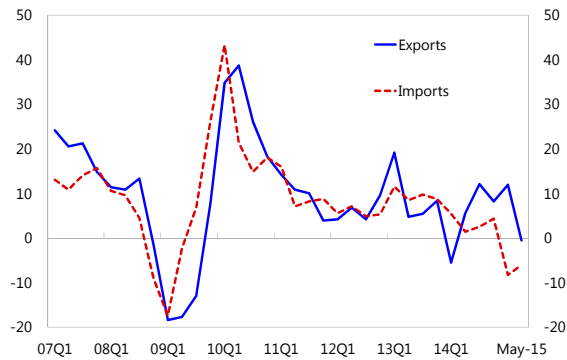
(In percent of GDP)



...reflecting declines in import quantities as well as prices.

Trade Quantum Index

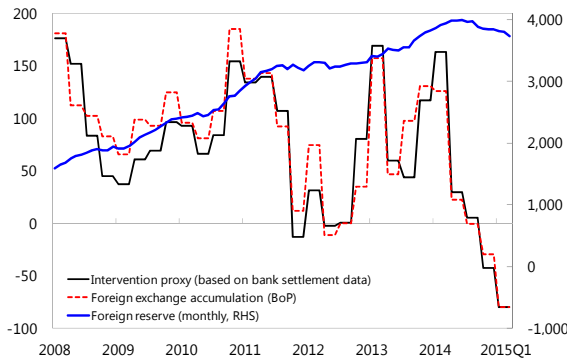
(In percent, year-on-year, quarterly average)



...that has reduced intervention. Data suggest the PBC has been selling foreign exchange in early 2015.

Foreign Exchange Accumulation and Intervention

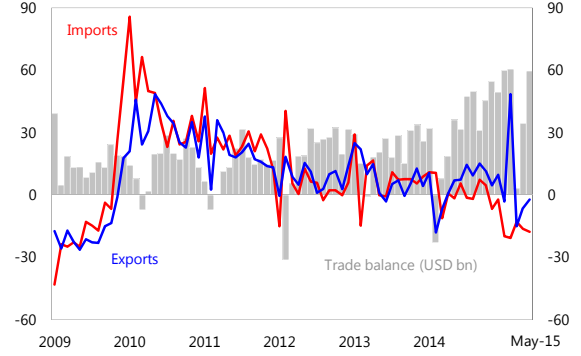
(In USD billion, quarterly)



...while the trade surplus has risen, most recently fueled by lower imports...

Trade balance

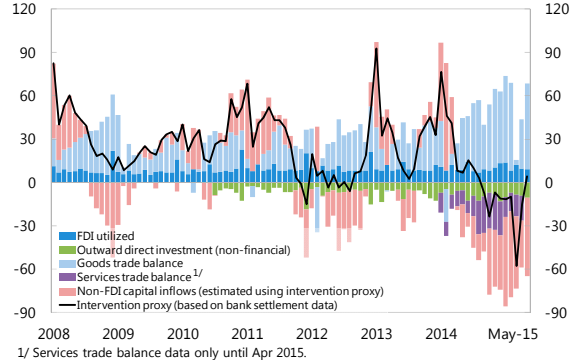
(In percent, year-on-year)



The increase in the trade surplus has been offset by a higher service deficit and a surge in capital outflows...

Trade, FDI, and Foreign Exchange Intervention

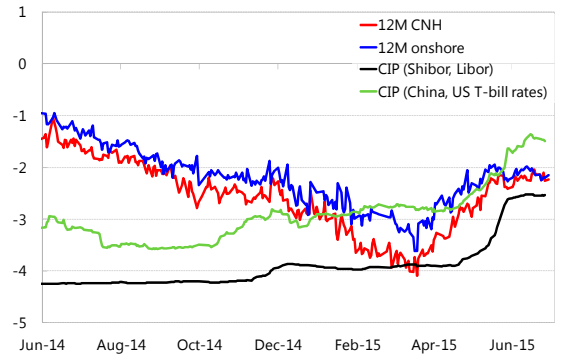
(In USD billion, monthly)



Forward markets have been pricing in less depreciation against the U.S. dollar since March.

Exchange Rate

(Implied 12-month appreciation)

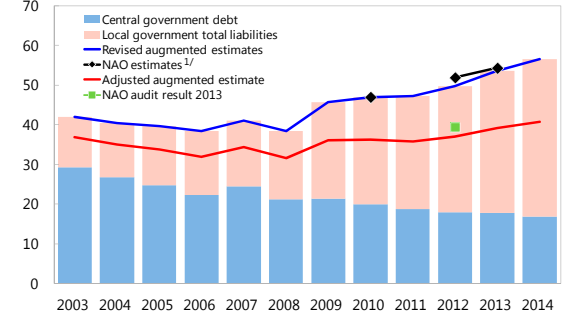


Sources: CEIC Data Company Ltd.; Haver Analytics; Bloomberg; and IMF staff calculations.

Figure 5. Reduction in Vulnerabilities

Augmented government debt rose considerably...

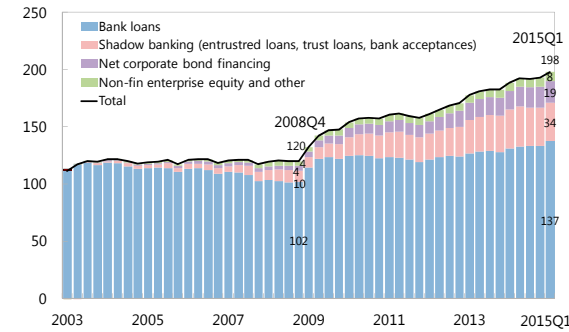
General Government Debt: Augmented Measure and NAO Audit
(In percent of GDP)



1/ Includes explicit government debt, government guaranteed debt, and the liabilities that the government may incur obligations.

...helping push up TSF, illustrating how the growth model relied on credit...

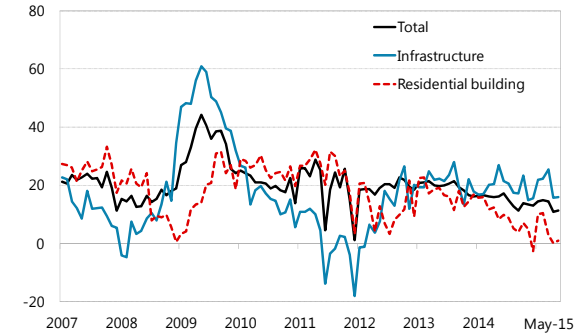
Social Financing Stock
(In percent of GDP) 1/



1/ In percent of 4Q rolling sum of quarterly GDP.

...and investment, which has slowed recently. Infrastructure remained strong while real estate slowed...

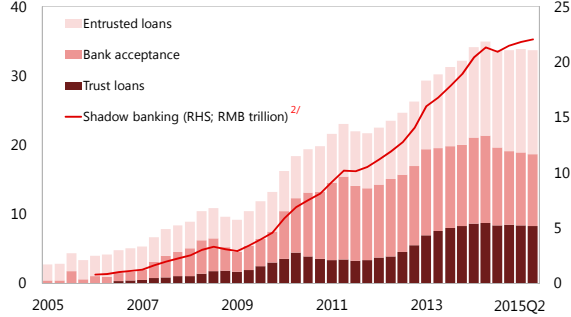
Real Fixed Asset Investment Growth 1/ (In percent, year-on-year)



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

...and, until recently, shadow banking was also growing fast...

Social Financing Outstanding
(In percent of GDP unless otherwise specified) 1/

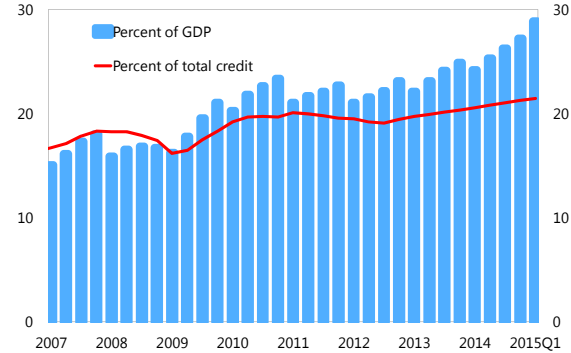


1/ In percent of 4Q rolling sum of quarterly GDP.

2/ Shadow banking includes entrusted loans, bank acceptance and trust loans.

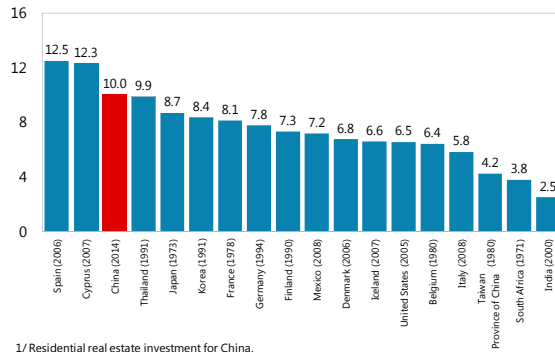
...including bank lending to the real estate sector...

Bank Exposure to Real Estate
(In percent)



...but is high by international standards.

Peak Residential Construction Investment 1/ (In percent of GDP)



1/ Residential real estate investment for China.

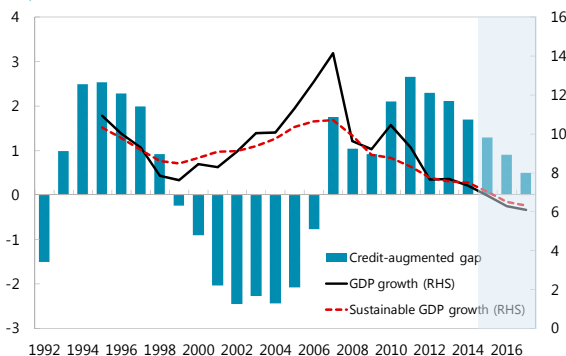
Sources: CEIC Data Company Ltd.; Haver Analytics; NAO; and IMF staff calculations.

Figure 6. Growth Projections

Credit boom led to a large deviation from sustainable demand, which is projected to fall in the medium term.

Sustainable and output dynamics

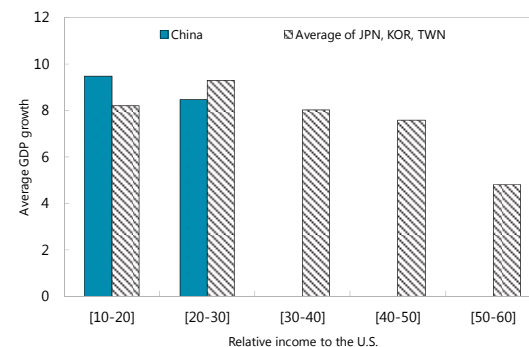
(In percent)



But the growth slowdown is also structural, reflecting the dynamics of the convergence process...

Growth in the Catching Up Process

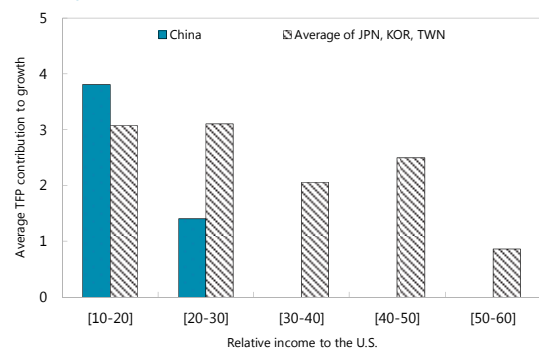
(In percent)



...and also steep declining trend in TFP growth, which has to reverse to keep China at the fast convergence path.

TFP Contribution to Growth in the Catching Up Process

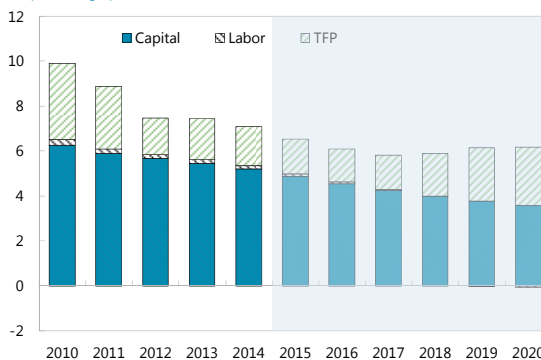
(In percentage points)



Going forward, reforms are projected to boost productivity growth.

Potential Growth Decomposition

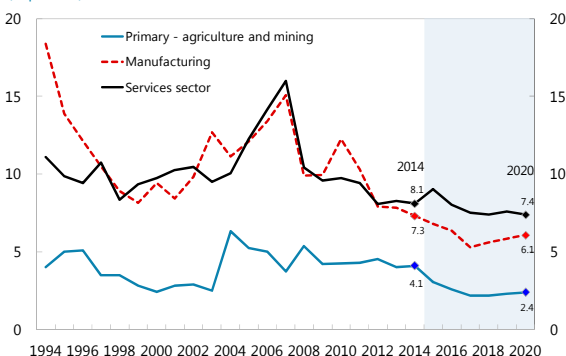
(In percentage points)



Growth is projected to be driven by the services sector...

Real GDP Growth by Sector

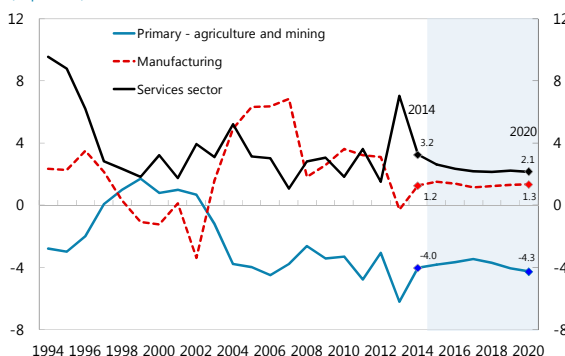
(In percent)



...which will support employment.

Employment Growth by Sector

(In percent)

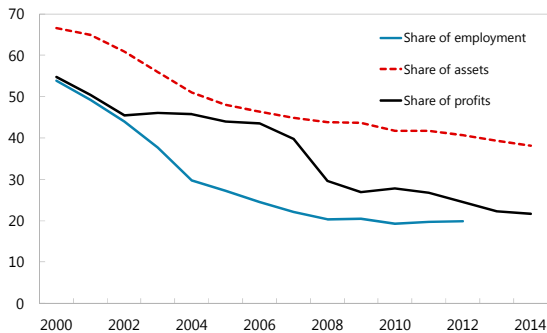


Sources: CEIC Data Company Ltd.; National Bureau of Statistics; IMF *World Economic Outlook*; and IMF staff estimates and projections.

Figure 7. State-Owned Enterprises

China's SOE's share in the economy has been declining...

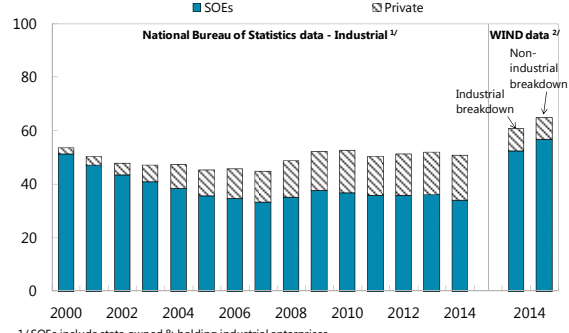
Industrial Enterprises: SOEs ^{1/}
(In percent of total)



^{1/} SOEs include state owned & holding industrial enterprises.

...but SOE borrowing still accounts for a big share of total liabilities.

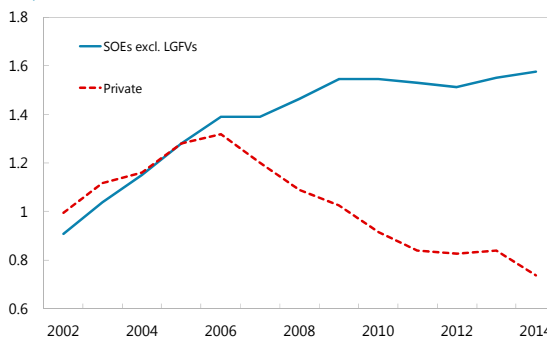
Liabilities
(In percent of GDP)



^{1/} SOEs include state owned & holding industrial enterprises.
^{2/} SOEs include central and local SOEs excluding LGFVs.

Moreover, leverage has gone up since the GFC...

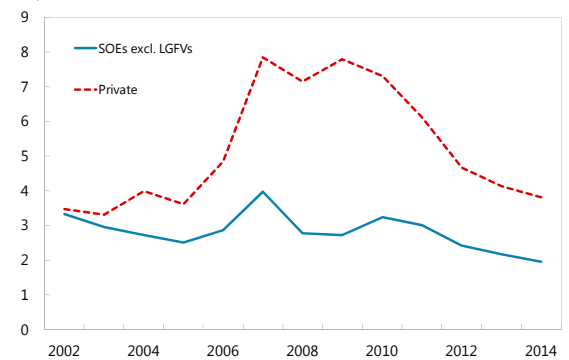
Leverage Ratios ^{1/}
(In percent)



^{1/} Calculated as debt/equity.

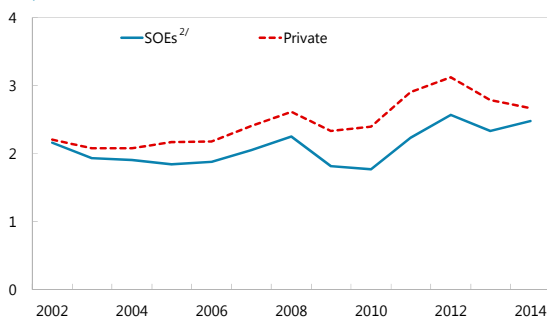
...while return on assets has been much lower than private firms in recent years.

Return on Assets
(In percent)



Although their interest expense as a share of liabilities is lower...

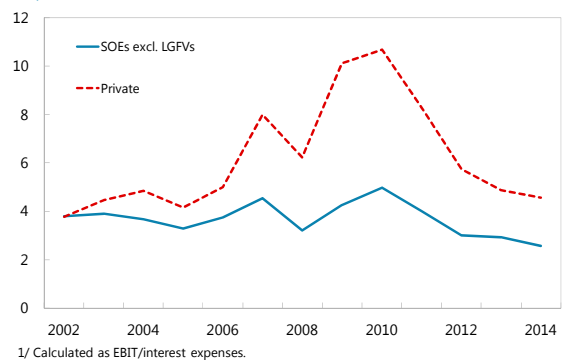
Implied Interest Rate ^{1/}
(In percent)



^{1/} Calculated as interest expenses/liabilities.
^{2/} SOEs include state owned & holding industrial enterprises.

...their debt-servicing capacity, measured by interest coverage ratio, is worsening.

Interest Coverage Ratios ^{1/}
(In percent)



^{1/} Calculated as EBIT/interest expenses.

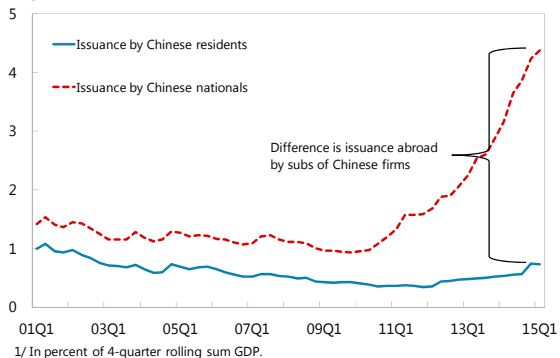
Sources: CEIC Data Company Ltd.; NBS; WIND; and IMF staff calculations.

Figure 8. External Debt

Global bond issuance by Chinese firms and their offshore affiliates has increased...

Chinese International Bonds Outstanding

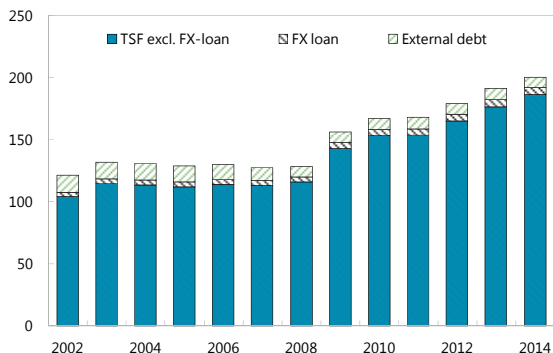
(In percent of GDP)^{1/}



...but is small relative to the stock TSF (external debt is not included in TSF).

Total Social Financing and External Debt

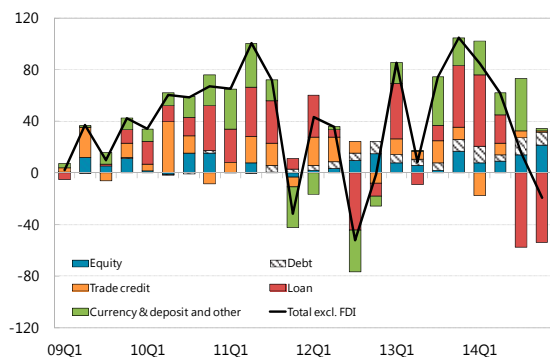
(In percent of GDP)



... but growing fast until recently.

BOP: Liabilities

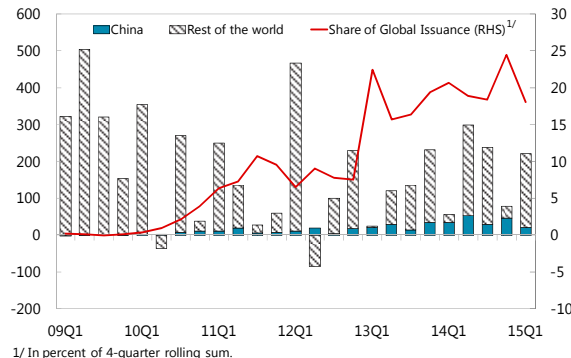
(In billions of USD)



...and now accounts for a sizable share of total global bond issuance...

Global Net International Bonds Issuance

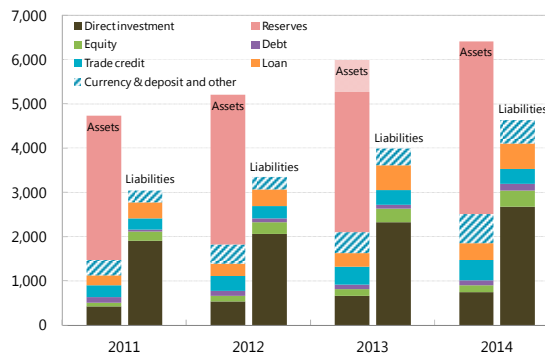
(In billions of USD)



External liabilities in the IIP data are also still small...

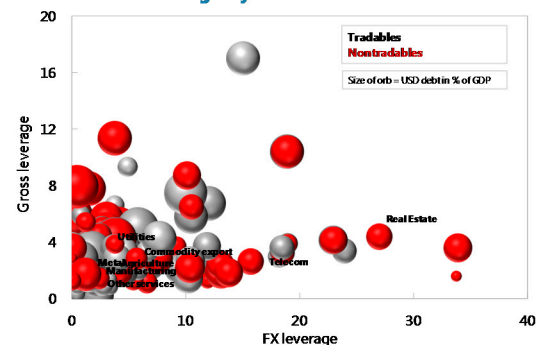
IIP: Assets and Liabilities

(In billions of USD)



Leverage for Chinese industries does not seem high relative to a sample of EMs, with the exception of foreign currency leverage for the real estate sector.

Gross and FX Leverage by Industries^{1/2/}



^{1/} Orbs are based on a sample of emerging market countries; labeled orbs correspond to China.
^{2/} Y. Zhang, "Emerging Market Corporate Sector Vulnerabilities", forthcoming, IMF working paper.

Sources: CEIC Data Company Ltd.; BIS; Haver Analytics; Orbis; VESD; Bloomberg; CVU; and IMF staff estimates.

Table 1. China: Selected Economic Indicators

	2010	2011	2012	2013	2014	2015	2016
						Projection	
National accounts and employment							
	<i>(In percent, annual growth)</i>						
Real GDP	10.6	9.5	7.7	7.7	7.4	6.8	6.3
Total domestic demand	12.1	10.3	7.5	7.8	7.2	6.5	6.3
Consumption	9.4	11.4	8.2	6.9	6.9	7.1	7.7
Investment	15.3	9.0	6.7	8.9	7.6	5.8	4.7
Fixed	12.6	8.6	8.7	9.2	7.6	6.1	4.9
Inventories ^{1/}	1.4	0.4	-0.7	0.1	0.1	0.0	0.0
Net exports ^{1/}	-1.4	-0.8	0.1	-0.2	0.1	0.2	0.0
Consumer prices							
End of period	4.6	4.1	2.5	2.5	1.5	1.5	1.8
Average	3.3	5.4	2.6	2.6	2.0	1.5	1.8
Unemployment rate (annual average)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
External debt and balance of payments							
	<i>(In percent of GDP)</i>						
Current account	4.0	1.8	2.5	1.6	2.1	3.0	2.7
Trade balance	4.2	3.3	3.8	3.8	4.6	6.0	5.6
Exports of goods	26.3	25.6	24.3	23.3	22.6	21.0	20.5
Imports of goods	22.1	22.3	20.5	19.5	18.0	15.1	14.9
Gross external debt	9.1	9.3	8.7	9.1	8.6	8.9	9.5
Saving and investment							
Gross domestic investment	47.2	47.3	46.5	46.5	46.0	44.4	43.4
National saving	51.2	49.2	49.0	48.0	48.1	47.4	46.0
Public sector finance							
General government debt ^{2/}	36.2	35.8	37.0	39.3	40.7	42.8	45.6
General government net lending/borrowing ^{3/}	-1.2	0.6	0.0	-1.1	-1.1	-1.9	-2.4
Real effective exchange rate							
	<i>(In percent, annual growth)</i>						
Annual average	-0.5	2.8	5.6	6.3	3.1	...	...
End of period	4.5	6.1	1.2	8.1	7.9	...	...

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

1/ Contribution to annual growth in percent.

2/ The 2013 NAO audit indicated the debt to GDP ratio as of end-2012 is 39.4 percent of GDP. Staff estimates are based on the explicit debt and fractions (ranging from 14–19 percent according to the NAO estimate) of the government guaranteed debt and liabilities that the government may incur. Staff estimates exclude the central government debt issued for China Railway Corporation.

3/ 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.

Table 2. China: Balance of Payments
(In billions of U.S. dollars, unless otherwise noted)

	2010	2011	2012	2013	2014	2015	2016
						Projection	
Current account balance	237.8	136.1	215.4	148.2	219.7	336.6	324.0
Trade balance	254.2	243.5	321.6	359.9	476.0	676.2	686.3
Exports	1,581.4	1,903.8	2,056.9	2,219.0	2,354.1	2,386.4	2,495.5
Imports	1,327.2	1,660.3	1,735.3	1,859.1	1,878.2	1,710.2	1,809.2
Services balance	-31.2	-61.6	-89.7	-124.5	-192.0	-222.2	-266.4
Income balance	-25.9	-70.3	-19.9	-78.4	-34.1	-87.2	-65.6
Current transfers	40.7	24.5	3.4	-8.7	-30.2	-30.2	-30.2
Capital and financial account balance	286.9	265.5	-31.8	346.1	38.2	-334.0	-250.4
Capital account	4.6	5.4	4.3	3.1	0.0	3.9	3.9
Financial account	282.2	260.0	-36.0	343.0	38.3	-337.9	-254.3
Net foreign direct investment	185.7	231.7	176.3	218.0	208.7	73.5	48.0
Portfolio investment	24.0	19.6	47.8	52.9	82.4	-11.4	-25.1
Other investment	72.4	8.7	-260.1	72.2	-252.8	-400.0	-277.2
Errors and omissions ^{1/}	-52.9	-13.8	-87.1	-62.9	-140.1	0.0	0.0
Overall balance	471.7	387.8	96.6	431.4	117.8	2.6	73.6
Reserve assets	-471.7	-387.8	-96.6	-431.4	-117.8	-2.6	-73.6
Memorandum items:							
Current account, as percent of GDP	4.0	1.8	2.5	1.6	2.1	3.0	2.7
Export growth (value terms)	31.4	20.4	8.0	7.9	6.1	1.4	4.6
Import growth (value terms)	39.1	25.1	4.5	7.1	1.0	-8.9	5.8
FDI (inward), as a percent of GDP	4.1	3.8	2.8	3.1	2.8	2.3	2.0
External debt ^{2/}	548.9	695.0	737.0	863.2	895.5	1,014.2	1,156.9
As a percent of GDP	9.1	9.3	8.7	9.1	8.6	8.9	9.5
Short-term external debt (remaining maturity) ^{2/}	375.7	500.9	540.9	676.6	786.4	882.4	966.5
Gross reserves ^{3/}	2,914.2	3,255.8	3,387.9	3,880.4	3,899.3	3,901.9	3,975.5
As a percent of ST debt by remaining maturity	775.7	650.0	626.3	573.5	495.9	442.2	411.3
Real effective exchange rate (2010 = 100)	100.0	102.8	108.5	115.3	118.9	...	...
Net international investment position	1,688.0	1,688.4	1,866.5	1,996.0	1,776.4	...	...
In percent of GDP	28.1	22.7	22.0	21.0	17.0	...	...
Nominal GDP	6,005.2	7,442.0	8,471.4	9,518.6	10,432.3	11,350.5	12,148.4

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

1/ Includes counterpart transaction to valuation changes.

2/ Data provided by the Chinese authorities, unless otherwise indicated.

3/ Includes gold.

Table 3. China: Indicators of External Vulnerability

	2007	2008	2009	2010	2011	2012	2013	2014
Monetary and financial indicators								
General government debt (in percent of GDP) ^{1/}	34.5	31.5	36.0	36.2	35.8	37.0	39.3	40.7
Broad money (M2: annual percentage change)	16.7	17.8	28.4	18.9	17.3	14.4	13.6	11.0
Foreign currency deposits to broad money (percent)	2.9	2.6	2.3	2.1	2.0	2.6	2.4	2.9
Credit (annual percentage change)	16.1	18.7	31.7	19.9	15.8	15.0	14.1	13.6
Foreign currency loans to credit to the economy (in percent)	4.8	4.4	5.2	5.1	5.0	5.3	5.1	4.7
Stock exchange index (end-of-period, December 19, 1990 = 100) ^{2/}	5,521	1,912	3,437	2,940	2,304	2,376	2,214	3,389.4
Stock exchange capitalization (percent of GDP)	129.2	45.6	80.0	75.3	54.8	54.1	52.3	71.1
Number of listed companies (A-share)	1,507	1,581	1,678	2,041	2,320	2,472	2,468	2,592
Balance of payments indicators								
Exports (annual percentage change, U.S. dollars)	25.8	17.6	-16.1	31.4	20.4	8.0	7.9	6.1
Imports (annual percentage change, U.S. dollars)	20.2	18.8	-11.2	39.1	25.1	4.5	7.1	1.0
Current account balance (percent of GDP)	10.0	9.2	4.8	4.0	1.8	2.5	1.6	2.1
Capital and financial account balance (percent of GDP)	2.7	0.9	3.9	4.8	3.6	-0.4	3.6	0.4
<i>Of which</i> : gross foreign direct investment inflows	4.4	3.8	2.6	4.1	3.8	2.8	3.1	2.8
Reserve indicators								
Gross reserves (billions of U.S. dollars) ^{3/}	1,547	1,966	2,453	2,914	3,256	3,388	3,880	3,899
Gross reserves to imports of goods & services (months)	15.1	21.2	19.4	18.3	19.4	18.6	20.6	21.5
Gross reserves to broad money (M2) (percent)	29.2	28.8	27.5	27.2	24.7	22.0	21.7	19.5
Gross reserves to short-term external debt by remaining maturity (percent)	656.5	868.9	946.2	775.7	650.0	626.3	573.5	495.9
External debt and balance sheet indicators								
Total external debt (percent of GDP)	11.0	8.5	8.5	9.1	9.3	8.7	9.1	8.6
Total external debt (billions of U.S. dollars) ^{4/}	389.2	390.2	428.6	548.9	695.0	737.0	863.2	895.5
<i>Of which</i> : public and publicly guaranteed debt ^{5/}	34.9	33.3	36.9	38.8	37.4	36.6	34.3	...
Banking sector debt	126.6	126.3	132.4	183.5	266.0	256.6	327.6	342.8
Short-term external debt by original maturity (billions of U.S. dollars)	235.7	226.3	259.3	375.7	500.9	540.9	676.6	786.4
Net foreign assets of banking sector (billions of U.S. dollars)	188.3	250.8	204.5	170.6	259.9	300.4	177.3	189.4
Total debt to exports of goods & services (percent)	29.0	24.7	32.2	31.5	33.3	32.8	35.6	35.2
Total debt service to exports of goods & services (percent) ^{6/}	17.9	14.6	19.8	21.8	24.2	24.3	28.1	27.1
<i>Of which</i> : Interest payments to exports of goods & services (percent) ^{6/}	0.4	0.3	0.4	0.3	0.2	0.2	0.2	0.2
Foreign-currency long-term sovereign bond ratings (eop)								
Moody's	A2	A1	A1	A1	Aa3	Aa3	Aa3	Aa3
Standard and Poor's	A	A	A+	A+	AA-	AA-	AA-	AA-
Memorandum items:								
International investment position	1,188.1	1,493.8	1,490.5	1,688.0	1,688.4	1,866.5	1,996.0	1,776.4
Nominal GDP (billions of U.S. dollars)	3,543	4,565	5,071	6,005	7,442	8,471	9,519	10,432
Exports of goods & services (billions of U.S. dollars)	1,342	1,582	1,333	1,744	2,090	2,248	2,425	2,545
Real effective exchange rate (annual percentage change)	3.9	8.9	3.7	-0.5	2.8	5.6	6.3	3.1

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

1/ The 2013 NAO audit indicated the debt to GDP ratio as of end-2012 is 39.4 percent of GDP. Staff estimates are based on the explicit debt and fractions (ranging from 14–19 percent according to the NAO estimate) of the government guaranteed debt and liabilities that the government may incur. Staff estimates exclude the central government debt issued for China Railway Corporation.

2/ Shanghai Stock Exchange, A-share.

3/ Includes gold.

4/ Data provided by the Chinese authorities.

5/ Debt of banking sector not included.

6/ IMF staff estimates.

Table 4. China: Monetary Developments
(In billions of RMB, unless otherwise noted)

	2011	2012	2013	2014	2014												2015				
					Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
Net foreign assets	25,164	25,885	28,099	28,839	28,311	28,359	28,403	28,558	28,749	28,901	28,868	28,867	28,887	28,941	28,950	28,839	29,112	29,358	29,464	29,249	...
Net domestic assets	59,995	71,530	82,554	93,998	84,041	84,817	87,665	88,324	89,481	92,058	90,557	90,883	91,319	90,983	91,911	93,998	95,159	96,380	98,070	98,829	...
Domestic credit ^{1/}	68,797	80,559	92,701	107,696	94,122	94,797	97,233	97,947	99,123	101,686	100,810	101,948	103,289	103,258	104,588	107,696	109,356	111,242	113,655	114,775	...
Net credit to government	4,236	5,068	4,904	5,505	4,924	4,523	4,841	4,331	4,316	4,667	4,291	4,339	4,709	4,037	4,029	5,505	4,822	5,341	5,618	5,574	...
Credit to nongovernment	64,561	75,491	87,796	102,192	89,198	90,274	92,392	93,615	94,807	97,020	96,519	97,609	98,580	99,221	100,560	102,192	104,534	105,901	108,038	109,201	...
Other items, net ^{1/}	-3,306	-5,742	-6,091	-5,391	-6,280	-6,635	-7,433	-7,588	-7,977	-8,355	-7,910	-7,460	-6,590	-6,489	-6,283	-5,391	-5,467	-5,009	-4,847	-4,679	...
Broad money	85,159	97,415	110,652	122,837	112,352	113,176	116,069	116,881	118,229	120,959	119,425	119,750	120,205	119,924	120,861	122,837	124,271	125,738	127,533	128,078	130,736
Reserve money	22,464	25,235	27,102	29,409	28,773	27,400	27,474	27,296	27,393	27,990	27,665	27,796	28,530	27,938	28,005	29,409	28,834	29,867	29,575	29,313	...
Of which:																					
Excess reserves	1,862	3,028	2,401	3,074	1,862	1,898	1,964	1,844	1,867	1,931	2,567	2,570	2,591	3,037	3,055	3,074	2,815	2,813	2,872	...	...
Net foreign assets of PBC	23,520	23,995	27,015	27,679	27,521	27,671	27,818	27,958	27,972	27,869	27,883	27,879	27,816	27,839	27,846	27,679	27,704	27,695	27,467	27,391	...
Net domestic assets of PBC	-1,056	1,239	88	1,730	1,252	-271	-344	-661	-579	121	-218	-83	714	99	159	1,730	1,130	2,173	2,109	1,922	...
Net foreign assets ^{2/}	3.5	0.8	2.3	0.7	1.8	1.7	1.4	1.3	1.5	1.5	1.6	1.6	1.5	1.2	0.9	0.7	0.7	0.9	0.9	0.6	...
Net domestic assets growth (percent)	20.0	19.2	15.4	13.9	15.6	15.9	14.4	16.1	16.2	17.8	16.0	15.2	13.5	14.6	15.0	13.9	13.2	13.6	11.9	11.9	...
Domestic credit ^{3/}	17.1	17.1	15.1	16.2	15.6	15.6	14.9	15.9	16.5	17.2	15.9	16.0	14.9	15.2	15.8	16.2	16.2	17.3	16.9	17.2	...
Of which: loans	15.1	15.6	14.7	13.3	14.6	14.3	13.9	13.3	13.5	13.8	13.1	13.0	12.6	12.5	13.1	13.3	13.4	13.9	13.5	13.6	...
Other items, net ^{2/3/}	-2.9	-2.9	-0.4	0.6	-0.2	-0.5	-0.1	-0.5	-0.5	-1.2	-1.1	-0.5	0.0	-0.6	-0.4	0.6	0.7	1.1	1.6	2.4	...
Broad money ^{4/}	13.6	13.8	13.6	12.2	13.2	13.3	12.1	13.2	13.5	14.7	13.5	12.8	12.9	12.6	12.3	12.2	10.8	12.5	11.6	10.1	10.8
Including foreign currency deposits	17.3	15.0	13.4	11.5	13.3	13.4	12.1	13.3	13.8	15.2	14.2	13.6	12.2	12.6	12.5	11.5	11.3	11.8	10.6	10.1	...
M1 ^{4/}	7.9	6.5	9.3	3.2	1.2	6.9	5.4	5.5	5.7	8.9	6.7	5.7	4.8	3.2	3.2	3.2	10.6	5.6	2.9	3.7	4.7
M0 ^{4/}	13.8	7.7	7.2	2.9	22.5	3.3	5.2	5.4	6.7	5.3	5.4	5.6	4.2	3.8	3.5	2.9	-17.6	17.0	6.2	3.7	1.8
Quasi money ^{4/}	16.8	17.6	15.6	14.4	18.8	16.0	14.9	16.5	16.7	17.2	16.4	15.8	14.4	15.8	15.8	14.4	10.6	13.2	12.6	11.9	...
Reserve money growth (percent)	21.2	12.3	7.4	8.5	13.8	8.7	8.3	8.5	9.8	8.6	8.7	8.0	8.4	8.1	7.7	8.5	0.2	9.0	7.6	7.4	...
Net foreign assets of PBC ^{5/}	11.1	2.1	12.0	2.5	11.0	10.5	10.0	9.5	9.2	8.5	8.7	8.3	7.0	5.3	4.0	2.5	0.6	0.1	-1.3	-2.1	...
Net domestic assets of PBC ^{5/}	10.2	10.2	-4.6	6.1	2.7	-1.8	-1.7	-1.0	0.6	0.1	0.1	-0.3	1.4	2.8	3.7	6.1	-0.4	8.9	8.9	9.5	...
Reserve ratios ^{6/}																					
Required reserves	20.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.0	19.0	18.0	18.0
Excess reserves	2.3	3.3	2.3	2.7	1.8	1.8	1.8	1.7	1.7	1.7	2.3	2.3	2.3	2.7	2.7	2.7	2.3	2.3	2.3	...	...
Memorandum items:																					
Money multiplier	3.8	3.9	4.1	4.2	3.9	4.1	4.2	4.3	4.3	4.3	4.3	4.3	4.2	4.3	4.3	4.2	4.3	4.2	4.3	4.4	...
Forex deposits of residents (US\$ billion)	275.1	406.5	438.6	573.5	483.2	493.0	507.4	529.1	565.8	593.6	608.6	624.1	605.3	596.2	592.1	573.5	655.7	674.4	694.0	676.7	663
In percent of total deposits	2.1	2.7	2.5	3.0	2.8	2.8	2.8	2.9	3.1	3.1	3.3	3.3	3.2	3.2	3.1	3.0	3.2	3.3	3.3	3.2	3.0
Forex loans of residents (US\$ billion)	538.7	683.6	776.9	835.1	802.9	824.2	846.4	849.4	846.8	852.6	849.8	846.6	838.3	826.7	826.2	835.1	911.6	903.8	914.6	919.8	920

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

1/ Includes foreign currency operations of domestic financial institutions and domestic operations of foreign banks. In addition, some items were moved from "other items net" to

2/ Twelve-month change as percent of beginning-period stock of monetary liabilities.

3/ The growth rates are corrected for the transfer of NPLs from banks to the AMCs.

4/ The growth rates are based on official announcements, which correct for the definitional changes in the series.

5/ Annualized contribution to reserve money growth, percent.

6/ In percent of total bank deposits.

Table 5. China: General Government Fiscal Data

	In RMB billions	Projection										
		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Fiscal balance												
Authorities' definition												
(1)	Revenue 1/	8320	10537	12020	13036	14135	15530	16163	17321	18651	20052	21675
(2)	Expenditure 2/	9320	11387	12820	14276	15485	17250	18390	19608	21111	22667	24340
(3)	Fiscal balance (Authorities) (1)-(2)	-1000	-850	-800	-1240	-1350	-1720	-2226	-2288	-2460	-2615	-2665
	<i>In percent of GDP</i>	-2.5	-1.8	-1.5	-2.1	-2.1	-2.5	-3.0	-2.9	-2.9	-2.8	-2.6
Staff estimates												
(4)	Revenue	10103	13081	15016	16538	18156	19970	20831	22230	23813	25480	27385
(4a)	Authorities definition of revenue	8320	10537	12020	13036	14135	15530	16163	17321	18651	20052	21675
(4b)	(+) Social security contributions	1707	2576	3141	3452	3919	4309	4524	4750	4988	5237	5499
(4c)	(+) Transfers from state-administered SOE fund	86	118	150	165	202	241	265	291	320	352	388
(4d)	(-) withdrawal from stabilization funds	10	150	295	115	100	110	121	133	146	161	177
(5)	Expenditure	11733	13922	16465	18801	20587	22774	24158	25642	27433	29304	31313
(5a)	Authorities definition of expenditure	9320	11387	12820	14276	15485	17250	18390	19608	21111	22667	24340
	<i>Of which: interest payment</i>	184	238	264	306	338	360	400	453	506	560	616
(5b)	(+) Social security expenses	1331	1888	2393	2862	3367	3846	4000	4160	4327	4500	4680
(5c)	(+) Transfers to state-administered SOE fund	82	116	140	151	200	241	241	241	241	241	241
(5d)	(+) Adjustment for local government spending 3/	200	-112	-123	150	150	150	150	150	150	150	150
(5f)	(+) Local government spending (est. by net land sale proceeds) 4/	1133	1105	1459	1617	1704	1473	1572	1687	1819	1973	2141
(5g)	Land sale revenue	2940	3348	2889	4125	4261	...	...	...	...	...	...
(5h)	Acquisition and compensation cost	1807	2243	1430	2508	2556	...	...	...	...	...	...
(5i)	(-) contribution to stabilization funds	226	289	25	116	82	86	94	104	114	125	138
(5j)	(-) Other adjustment 2/	107	173	200	138	237	100	100	100	100	100	100
	General government net lending/borrowing (4) - (5) + (5f)	-497	265	10	-646	-727	-1332	-1755	-1726	-1802	-1851	-1787
	<i>(In percent of GDP)</i>	-1.2	0.6	0.0	-1.1	-1.1	-1.9	-2.4	-2.2	-2.1	-2.0	-1.8
(6)	Fiscal balance (staff estimate) (4)-(5)	-1630	-841	-1449	-2263	-2431	-2804	-3327	-3413	-3620	-3824	-3928
	<i>(In percent of GDP)</i>	-4.0	-1.7	-2.7	-3.8	-3.8	-4.1	-4.5	-4.3	-4.2	-4.1	-3.9
Estimates of augmented balances												
(6)	Overall fiscal balance	-1630	-841	-1449	-2263	-2431	-2804	-3327	-3413	-3620	-3824	-3928
(6a)	(-) Estimate of local government infrastructure spending 5/	2318	2847	3495	3911	3922	4097	3911	4069	4249	4285	4264
(7)	Augmented balance	-3948	-3687	-4944	-6174	-6353	-6902	-7238	-7481	-7869	-8108	-8192
	<i>(In percent of GDP)</i>	-9.7	-7.7	-9.2	-10.5	-9.9	-10.0	-9.8	-9.4	-9.2	-8.7	-8.1
	<i>of which: interest payment on LGFV borrowings</i>	517	713	928	1174	1424	1630	1837	2084	2334	2588	2849
(5f)	(+) Net land sale proceeds 4/	1133	1105	1459	1617	1704	1473	1572	1687	1819	1973	2141
(8)	Augmented net lending/borrowing 6/	-2814	-2582	-3484	-4558	-4649	-5429	-5666	-5795	-6051	-6136	-6051
	<i>(In percent of GDP)</i>	-6.9	-5.4	-6.5	-7.7	-7.3	-7.8	-7.7	-7.3	-7.1	-6.6	-6.0
General government debt												
(12)	Central government debt	8155	9025	9577	10495	10786	11517	13272	14998	16799	18651	20438
	<i>In percent of GDP</i>	20.1	18.8	17.9	17.8	16.8	16.6	18.0	18.9	19.7	20.1	20.3
(13)	Local government debt 7/	10951	13686	17057	21119	25477	30174	34085	38154	42403	46688	50952
	<i>In percent of GDP</i>	26.9	28.5	31.9	35.8	39.8	43.6	46.1	48.1	49.6	50.4	50.6
(12)+(13)	Augmented debt	19106	22710	26634	31614	36263	41691	47358	53152	59203	65339	71390
	<i>In percent of GDP</i>	47.0	47.2	49.8	53.6	56.6	60.2	64.1	67.0	69.3	70.5	71.0
	General government debt (staff estimate) 8/	14726	17236	19811	23166	26072	29622	33723	37891	42242	46664	51009
	<i>In percent of GDP</i>	36.2	35.8	37.0	39.3	40.7	42.8	45.6	47.8	49.4	50.3	50.7
	General government debt if incl. only LG bonds (excl. swap)	8904	9662	10091	11159	11886	13217	14972	16698	18499	20351	22138
	<i>In percent of GDP</i>	21.9	20.1	18.9	18.9	18.5	19.1	20.3	21.1	21.6	22.0	22.0
	<i>Memorandum item:</i>											
	<i>General government debt (NAO audit) 8/</i>			21085								
	<i>In percent of GDP</i>			39.4								

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

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

2/ Includes adjustments for local government balance carried forward and redemption of local government bonds.

3/ Estimated from local government bond market financing.

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/ Derived from net changes in estimated market financing of local government financing vehicles (LGFVs).

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

7/ Include major components of market financing of local governments, including bank loans, corporate bonds, trust loans, and LG bonds issued by central government on their behalf. Beginning 2009-10, local governments expanded market borrowing through the use of local government financing vehicles (LGFVs). The NAO 2013 report also lists out other new funding sources of local governments, including build-to-transfers (BT), credit and wages payable, lease financing etc.

8/ The 2013 NAO audit indicated the debt to GDP ratio as of end-2012 is 39.4 percent of GDP. Staff estimates are based on the explicit debt and fractions (ranging from 14-19 percent according to the NAO estimate) of the government guaranteed debt and liabilities that the government may incur. Staff estimates exclude the central government debt issued for China Railway Corporation.

Table 6. China: Illustrative Medium-Term Scenario 1/

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
						(Percent change)					
Real GDP	10.6	9.5	7.7	7.7	7.4	6.8	6.3	6.0	6.1	6.3	6.3
Total domestic demand	12.1	10.3	7.5	7.8	7.2	6.5	6.3	6.0	6.1	6.3	6.3
Consumption	9.4	11.4	8.2	6.9	6.9	7.1	7.7	7.7	7.6	7.9	7.8
Investment	15.3	9.0	6.7	8.9	7.6	5.8	4.7	4.0	4.2	4.3	4.3
Fixed	12.6	8.6	8.7	9.2	7.6	6.1	4.9	4.2	4.4	4.5	4.4
Inventories ^{2/}	1.4	0.4	-0.7	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports ^{2/}	-1.4	-0.8	0.1	-0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.0
Consumer prices (average)	3.3	5.4	2.6	2.6	2.0	1.5	1.8	2.2	2.5	3.0	3.0
						(In percent of GDP)					
Total capital formation	47.2	47.3	46.5	46.5	46.0	44.4	43.4	42.2	41.2	40.1	38.9
Gross national saving	51.2	49.2	49.0	48.0	48.1	47.4	46.0	44.4	42.8	41.3	39.5
Current account balance	4.0	1.8	2.5	1.6	2.1	3.0	2.7	2.2	1.6	1.2	0.6
Trade balance	4.2	3.3	3.8	3.8	4.6	6.0	5.6	5.3	4.8	4.2	3.7
Services balance	-0.5	-0.8	-1.1	-1.3	-1.8	-2.0	-2.2	-2.4	-2.5	-2.5	-2.6
						(In billions of U.S. dollars)					
Current account balance	237.8	136.1	215.4	148.2	219.7	336.6	324.0	287.2	227.6	192.5	103.5
Trade balance	254.2	243.5	321.6	359.9	476.0	676.2	686.3	686.4	675.1	657.7	627.4
Exports	1,581	1,904	2,057	2,219	2,354	2,386	2,495	2,607	2,707	2,791	2,863
Imports	1,327	1,660	1,735	1,859	1,878	1,710	1,809	1,921	2,032	2,134	2,235
Services balance	-31.2	-61.6	-89.7	-124.5	-192.0	-222.2	-266.4	-310.7	-353.3	-380.8	-437.5
Exports	162.2	186.0	191.4	206.0	190.9	245.2	267.7	293.1	325.8	380.2	450.2
Imports	193.3	247.7	281.2	330.5	382.9	467.4	534.1	603.8	679.1	761.0	887.7
Capital and financial account, net	286.9	265.5	-31.8	346.1	38.2	-334.0	-250.4	-221.0	-150.6	-131.1	-105.4
Capital account	4.6	5.4	4.3	3.1	0.0	3.9	3.9	3.9	3.9	3.9	3.9
Direct investment, net	185.7	231.7	176.3	218.0	208.7	73.5	48.0	-4.6	-65.8	-105.2	-114.5
Portfolio investment, net	24.0	19.6	47.8	52.9	82.4	-11.4	-25.1	-42.0	-44.3	-49.5	-49.5
Other investment, net	72.4	8.7	-260.1	72.2	-252.8	-400.0	-277.2	-178.4	-44.4	19.7	54.7
Errors and omissions	-52.9	-13.8	-87.1	-62.9	-140.1	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- indicates increase)	-471.7	-387.8	-96.6	-431.4	-117.8	-2.6	-73.6	-66.2	-77.0	-61.3	2.0
Gross reserves	2,914	3,256	3,388	3,880	3,899	3,902	3,975	4,042	4,119	4,180	4,179
						(In percent of GDP)					
General government net lending/borrowing ^{3/}	-1.2	0.6	0.0	-1.1	-1.1	-1.9	-2.4	-2.2	-2.1	-2.0	-1.8
Revenue	24.8	27.2	28.1	28.0	28.3	28.8	28.2	28.0	27.9	27.5	27.2
Expenditure	26.1	26.7	28.1	29.1	29.5	30.8	30.6	30.2	30.0	29.5	29.0
Finance by net land sales proceeds	2.8	2.3	2.7	2.7	2.7	2.1	2.1	2.1	2.1	2.1	2.1
General government debt ^{4/}	36.2	35.8	37.0	39.3	40.7	42.8	45.6	47.8	49.4	50.3	50.7
General government structural balance	-1.3	0.6	0.2	-0.8	-0.7	-1.6	-2.2	-2.1	-2.1	-2.0	-1.8
Memorandum item:											
Nominal GDP (in billions of yuan)	40,658	48,086	53,474	58,974	64,080	69,225	73,888	79,273	85,478	92,710	100,616
GDP Deflator (2013 = 100)	87.6	94.6	97.7	100.0	101.2	102.4	102.8	104.0	105.7	107.8	110.1
Real effective exchange rate growth rate											
Annual average	-0.5	2.8	5.6	6.3	3.1	12.0	2.0	2.0	2.0	2.0	2.0
End of period	4.5	6.1	1.2	8.1	7.9	12.0	2.0	2.0	2.0	2.0	2.0
Terms of trade ^{5/}	-10.0	-3.5	2.8	1.2	1.2	7.0	-1.4	-0.9	-0.8	-0.5	-0.4
Augmented debt ^{6/}	47.0	47.2	49.8	53.6	56.6	60.2	64.1	67.0	69.3	70.5	71.0
Augmented net lending/borrowing ^{6/}	-6.9	-5.4	-6.5	-7.7	-7.3	-7.8	-7.7	-7.3	-7.1	-6.6	-6.0
Augmented fiscal balance ^{7/}	-9.7	-7.7	-9.2	-10.5	-9.9	-10.0	-9.8	-9.4	-9.2	-8.7	-8.1

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

1/ Following convention, the scenario assumes a constant real exchange rate and a continuation of the current policy framework.

2/ Contribution to annual growth in percent.

3/ 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.

4/ The 2013 NAO audit indicated the debt to GDP ratio as of end-2012 is 39.4 percent of GDP. Staff estimates are based on the explicit debt and fractions (ranging from 14-19 percent according to the NAO estimate) of the government guaranteed debt and liabilities that the government may incur. Staff estimates exclude the central government debt issued for China Railway Corporation.

5/ Percentage change of annual average.

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

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

Appendix I. Implementation of Main Recommendations from the 2014–15 FSAP for China

The authorities have made steady progress since the 2014 Article IV Consultation in advancing implementation of the high priority recommendations from the 2010 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 on the floating range of renminbi deposit interest rates has been increased to 1.5 times the benchmark deposit rate. 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 expanding stress test coverage and introducing new liquidity facilities. 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	<p>Interest rates</p> <ul style="list-style-type: none"> In May 2015, the interest rate ceiling on small foreign currency deposits was removed. The ceiling on renminbi deposit rates was expanded from 1.1 to 1.5 times of the benchmark deposit rate with steps in November 2014, March 2015, and May 2015. Benchmark interest rates across maturities were simplified and consolidated as appropriate, providing financial institutions greater discretion in setting interest rates. <p>Exchange rate</p> <ul style="list-style-type: none"> On July 2, 2014, the People's Bank of China (PBC) deregulated on banks' dollar bid-ask spread for their clients. <p>Credit risk management</p> <ul style="list-style-type: none"> In 2014, the China Banking Regulatory Commission (CBRC) issued the <i>Guidelines on the Prevention and Control of Non-performing Loans in 2014</i>, for the purpose of enhancing the management of nonperforming assets and controlling credit risks.
2. Clear distinction should be made between the role and function of policy financial institutions and commercial financial institutions.	Medium	MT	<ul style="list-style-type: none"> The State Council approved reform programs for the Agricultural Development Bank of China, the Export-Import Bank of China, and China Development Bank. These reforms will clarify their functional orientation, better define their business scope, distinguish clearer their role relative to commercial banks, and further enhance their role in providing financing for policy and development purposes.
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	<ul style="list-style-type: none"> China Huarong Asset Management Corporation has invited strategic investors and completed its shareholding reform. China Orient Asset Management Corporation and China Great Wall Asset Management Corporation are exploring their own transformation into purely commercial entities.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
Improving the Efficiency of Institutions and the Regulatory Framework			
<p>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 inter-departmental collaboration, in order to address the challenges to the financial sector brought on by rapid development.</p>	High	MT	<ul style="list-style-type: none"> ● In early 2015, the CBRC launched a round of restructuring that moved more departments and personnel to the regulatory side without adding resources, with the number of regulatory departments accounting for 77 percent of the total, compared with 57.9 percent previously, thus improving and enhancing the regulatory arm. The number of regulatory offices increased from 85 to 109, accounting for 78 percent of the 140 total offices. The composition and responsibilities of the departments were adjusted, with the creation of the following entities: an on-site inspection bureau and a prudential regulation bureau, for the purpose of improving the capability for discovery and investigation; a trust department, a department for city commercial banks and a department for financial inclusion, for the purpose of enhancing the supervision of the growing city commercial banks and trust companies, and of improving service to small and micro enterprises and the agricultural community. ● In terms of cross-sectoral cooperation, the Inter-Ministerial Joint Conference on Financial Supervision and Coordination, established in August 2013, has held 8 meetings, focusing on further financial reforms, enhanced financial risk prevention in key areas, and timely development of regulations on cross-market and cross-sector financial innovations. It introduced a series of policies and institutional arrangements for better serving the real economy. It also focused on the prevention of systemic and regional financial risks.
<p>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.</p>	Medium	NT	<ul style="list-style-type: none"> ● The PBC is pursuing the clarification of regulatory responsibilities with regard to financial holding companies. It is developing, in conjunction with the financial regulatory authorities, a set of regulatory rules covering: 1) enhanced regulation on capital adequacy, in order to avoid double counting of capital, prevent capital arbitrage, and effectively control leverage; 2) the regulation of related party transactions, by keeping to the principles of fair pricing and market transparency, including enhancing the supervision of risk concentration and by avoiding cross-sectoral risk infection; and 3) improvement of corporate governance, by enforcing eligibility requirements for shareholders and management and by preventing controlling shareholders from abusing their power to the detriment of the legitimate rights and interests of small shareholders and customers. ● On December 30, 2014, the CBRC issued the <i>Guidelines on Managing and Regulating Commercial Banks on Consolidated Basis</i>, which will take effect as of July 1, 2015. The <i>Guidelines</i> contain the following key elements: an emphasis on the primary responsibility of commercial banks in managing themselves on a consolidated basis; further clarification of the scope of such management based on the substantiality principle of risk management; added provisions on operational synergies and total risk management; expanded requirements regarding corporate governance; refinement of risk isolation requirements; and additional provisions on recovery plans. ● The CSRC is exploring a cross-licensing regime and supporting rules for financial institutions such as securities companies, fund management companies, futures companies and securities investment consulting companies. The related research is being actively pursued.

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	<ul style="list-style-type: none"> In June 2014, the CBRC issued the revised <i>Internal Guidelines on Regulatory Ratings of Commercial Banks</i>. This new ratings system features improvements mainly in the areas of forward-looking orientation, comprehensiveness, and accuracy by: 1) adopting the evaluation of risk trends, requiring that banks with gradual deterioration of quarterly indicators be subjected to a comprehensive analysis of risk trends as well as to increased scrutiny of changes in their nonperforming loans and assets; 2) adding a new quantitative indicator, called the "ratio of loans overdue for more than 90 days to nonperforming loans," based on an overall consideration of risk exposure, accuracy of loan classification, loan concentration, and level of risk coverage, which is used to verify the authenticity of, and identify any error in, the classification of bank loans, so as to enhance the examination of the status of risk management vis-à-vis loans and other assets on and off the balance sheet; 3) employing the arithmetic mean of the 4 quarters of a year as a quantitative indicator for ratings purposes, to minimize the impact from any sudden surge in business for cosmetic purposes by banks at key points of time. In order to balance qualitative factors and quantitative indicators, the new ratings system, by adding and modifying some of the quantitative indicators, puts emphasis on the professional judgment of the ratings staff in developing regulatory ratings, so that the ratings system can more fully reflect the relevant risks at commercial banks.
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	<ul style="list-style-type: none"> The CSRC has begun to perform formal site inspection on securities exchanges. It is also developing plans for site inspection on future exchanges. For example, the Commission conducted a comprehensive inspection in 2014 on the security of information systems and use of business passwords at such exchanges. In 2015, the Commission performed an overall examination of the soundness of the share transfer system for small and medium enterprises, including filing and daily self-regulation procedures, and confirmed the effectiveness of the current system as well as the usefulness of self-regulation.
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	<ul style="list-style-type: none"> The development of the China Risk-Oriented Solvency System (referred to below as "C-ROSS) is moving forward steadily. All technical standards of the system and plans for switching from the old to the new system were put in place in 2014. On February 13, 2015, the China Insurance Regulatory Commission (CIRC) released the 17 regulatory rules of the C-ROSS, at which time the system entered into the operational phase of the transition period. During this period, the old and new systems will run in parallel to each other, but the old system will serve as the basis for regulation. The CIRC will decide on the timing for formal implementation and overall handover on the basis of the operational and preparatory status during the transition. The C-ROSS is a risk-based solvency regulatory system. It classifies the inherent risks, one of three types of risks faced by insurance companies, into seven categories, which are further broken down into subcategories. These serve as the basis to formulate regulatory standards, quantitative monitoring indicators (solvency ratios) and qualitative methods for rating overall risk, which are then used to accurately identify and thoroughly analyze various types of risks insurance companies carry, in order to achieve timely and accurate identification and measurement of

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			changes in risks related to underwriting, investing, corporate governance, and liquidity.
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	<ul style="list-style-type: none"> In 2014, the CIRC issued <i>Regulations on Merger and Acquisition Activities of Insurance Companies</i>, laying down the rules that govern M&A matters in the insurance industry.
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	<ul style="list-style-type: none"> The PBC is working on the Law of Systems for Payment Clearing and Settlement in order to provide comprehensive protection of the finality of payments and netting arrangements for clearing and settling financial transactions. It will take time for the Law to be promulgated as its making involves a number of Ministries. There is not yet a timetable. In April 2015, the Securities Act (draft amendment) was submitted for the first time to the National People's Congress (NPC) Standing Committee for consideration. The draft amendment contains provisions regarding securities settlement, clearing of securities transactions, and institutions responsible for securities registration and settlement.
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	<ul style="list-style-type: none"> The PBC is in the process of drafting the Rules on Fighting Money Laundering and Terrorist Financing at Certain Non-Financial Institutions, which will require certain nonfinancial institutions to ascertain the identity of customers, obtain information on the beneficial ownership and control of corporate entities. The Rules are scheduled to be made effective in two years.
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	<ul style="list-style-type: none"> China has established a framework for holding joint inter-ministerial meetings on fighting money laundering involving 23 participating entities. The meetings will guide the national fight against money laundering, develop important national guidelines and policies, formulate policy measures for related international cooperation, and coordinate efforts of the participants. On October 16, 2014, the seventh inter-ministerial meeting was held to discuss the deployment of the next program of work and to launch the national assessment of money laundering risks. The PBC, CBRC, CSRC, and CIRC share and communicate regulatory information on fighting money laundering including through meetings and publishing annual reports.
Framework for Enhancing Financial Stability, Systemic Risk Monitoring, System Liquidity and Crisis Management			
13. The establishment of the Financial Stability Board, with	High	MT	No updates.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
the PBC as its secretariat.			
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	<ul style="list-style-type: none"> ● Counterparties (financial institutions) have been further categorized; classification is established regarding off balance sheet wealth managers, trust plans and small businesses; and nonfinancial enterprises are further subdivided into those with financing and those without. ● Monitoring has been intensified of lending volume at financial institutions; and a new statistical system has been set up to record factors influencing movements in lending. ● The statistical system on entrustment loans has been modified by specifying the accounting treatment of net entrustment funds. ● More entities are now required to submit data under various reporting systems. These include rural banks, finance companies, consumer finance companies, money brokers, and other small financial institutions. This has improved the coverage and consistency of financial statistics. ● In January 2015, the <i>Rules on Managing Leverage at Commercial Banks (revised)</i> were released in order to further establish regulatory standards and policy framework with regard to leverage. ● In August 2014, implementation began on the <i>Regulations on Publicly Offered Securities Investment Funds</i>, with restrictions on fund leverage added to previous versions. In addition, the CSRC expanded mandatory reporting of leverage data and required fund managers to report in a timely manner to the Commission instances of noncompliance with the above-mentioned restrictions in order to prevent funds from enlarging investment risks by increasing leverage.
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	<ul style="list-style-type: none"> ● The PBC continues to use the dynamic adjustment mechanism on differential reserves to strengthen macroprudential management, and places more financial operations under its macroprudential management framework on the basis of changes in the field. ● The CBRC established a bureau of prudential regulation in early 2015 to take charge of early warning and monitoring of systemic risks in banking. ● The PBC continues to improve its stress testing framework. First, coverage was expanded from 17 major commercial banks (large banks and joint-stock banks) to 28 commercial banks that have total assets of more than RMB 400 billion each, making the stress test more representative. Secondly, the credit risk stress test was expanded to include off balance sheet exposures, so that coverage is more inclusive. Thirdly, the percentage decline in housing prices was added as a stress indicator to the macro scenario stress test of credit risk, resulting in an improvement of the testing model. The CBRC started certain stress tests in 2014, covering the State Development Bank, five state-owned commercial banks, 12 joint-stock commercial banks, and the postal savings bank for a total of 19 banks. In addition, the CBRC is working to enhance the foundation on which the stress tests are based, including in the following five aspects: revising the <i>Guidelines on Stress Testing Commercial Banks</i>; preparing the <i>Technical Manual of Stress Testing</i>; conducting training on the <i>Guidelines</i> and the <i>Manual</i>; and data collection and professional development. ● The CSRC is establishing a macroprudential regulatory framework to measure and manage systemic risks. The components include: 1) a system

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			of indicators to monitor and provide early warnings of systemic risks in capital markets has been completed and is in the data collection phase; 2) a study on identifying financial institutions that have market wide importance and related risk monitoring; and 3) an annual comprehensive stress test of securities companies organized by the Securities Industry Association.
16. Enhanced hedging of structural liquidity through market-based tools and managing spillovers from systemic liquidity through indirect monetary policy tools.	High	NT	<ul style="list-style-type: none"> The PBC has created a standing lending facility and a medium-term lending facility, to provide short-term and medium-term liquidity support to financial institutions.
17. The implementation of an average reserve system to facilitate liquidity management and to improve stability and efficiency.	High	NT	No updates.
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	No updates.
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	<ul style="list-style-type: none"> The PBC has set up a preliminary framework for managing collateral, with uniform requirements for all financial institutions; the collateral required for different instruments may vary. The PBC adjusts the scope of collateral depending on financial market developments.
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	<ul style="list-style-type: none"> On May 1, 2015, China established a deposit insurance system by issuing the <i>Rules on Deposit Insurance</i>. The PBC, as the agency managing the deposit insurance fund, is responsible for implementing the system. The Chinese deposit insurance system is designed to cover all deposit-taking institutions in the banking industry, with the maximum reimbursement limit set at RMB 500,000. Premiums are charged at a rate that includes a base component and a risk-based component. The agency managing the deposit insurance fund may issue risk warnings and take necessary corrective measures vis-à-vis insured entities, so as to detect financial risks early and are make them less likely to materialize. When individual financial institutions are in distress, the agency managing the deposit insurance fund will act as the receiver in charge of the resolution process. As needed, it will use market-oriented and professional disposal of assets to reduce costs and safeguard financial stability while protecting the interests of depositors.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
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	<ul style="list-style-type: none"> ● In June 2014, the PBC organized the second inter-ministerial meeting on corporate credit bonds. The meeting reached consensus on the principle of “unified rules of certain type of bond for the same group of investors” and normalizing corporate credit bond issuing behavior. ● In January 2015, the CSRC issued the amended <i>Regulations on Corporate Bond Issuance and Trading</i>, which enhances market regulation and bond holder protection.
22. Continued improvement of bond 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.	High	MT	<ul style="list-style-type: none"> ● In 2014, the trial pre-issuance of Treasury bonds was expanded to include not only seven-year notes but all key term bonds. ● In 2015, China further improved its periodic renewal mechanism for key maturity Treasury bonds by making the three-year and five-year Treasury bonds renewable twice after initial issuance, increased the frequency of issuance of key maturity Treasury bonds, and expanded the issuance size of any single Treasury bond, thus improving liquidity in the secondary market. ● In 2015, 10-year Treasury bond futures were launched and the months for issuing new 10-year bonds designated so as to avoid months when bond futures are delivered. The sources of deliverable bonds were expanded and the interoperability between the spot and futures markets improved. ● One-year Treasury bills were issued. In April 2015, periodic rolling issuance of six-month Treasury bills was started, as a step toward the gradual expansion of similar short term paper in an attempt to improve the short end of the Treasury yield curve.
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	<ul style="list-style-type: none"> ● In February 2015, the PBC approved a request by the Shanghai Clearing House to engage in inter-bank netting and agency settlement operations with regard to bond market repurchase contracts. These operations draw on an array of international experience in mature markets and help improve the efficiency of the repo market, enhance risk management and improve market liquidity.
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	<ul style="list-style-type: none"> ● A draft amendment has been formulated to the existing Securities Act, proposing the elimination of the provision that cumulative balance of publicly offered corporate bonds of a company shall not exceed 40% of its net assets.
25. Improving the interoperability among the inter-bank bond	Medium	MT	<ul style="list-style-type: none"> ● The PBC, together with the CSRC and other relevant agencies, are promoting interoperability among various depository and clearing institutions and support the orderly development of the bond market.

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
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 three markets, and help improve their efficiency.			Efforts are being made in the following areas: 1) expanded cross-market trading in high quality securitized credit products between the auction systems in the interbank and exchange markets by drawing on the established custody arrangements for cross-market trading in Treasury bonds; 2) offering and listing of policy-oriented financial bonds on the exchange market, leading to the offering by China Development Bank of RMB 30 billion of such bonds for the first time on the Shanghai Stock Exchange during the first half of 2014; 3) the PBC has, together with the Ministry of Finance, expanded the scope of trial pre-issuance of Treasury bonds to include all book-entry Treasury bonds of key maturities and trading venues now cover both the exchange and inter-bank markets.
26. Building a multi-pillared pension system, focusing on a basic pension system that is fully funded.	Medium	MT	<ul style="list-style-type: none"> ● On January 14, 2015, the State Council adopted the <i>Decision on Reforming the Pension System for Members of Governmental Organizations and Institutions</i>. ● On March 27, 2015, the State Council announced the <i>Rules on Occupational Pension for Members of Governmental Organizations and Institutions</i>.
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	<p>Rural Financial Services</p> <ul style="list-style-type: none"> ● Actions have been taken to improve the combined use of monetary, credit, and other policy tools. In April and June 2014, the PBC twice lowered the reserve ratios in a targeted manner by cutting the deposit reserve ratios at county-level rural commercial banks and rural credit banks by 2 and 0.5 percentage points, respectively. It also reduced the renminbi deposit reserve ratio by 0.5 percentage points for commercial banks that meet requirements on prudent operation and where loans to rural or small and micro-enterprises reach a certain percentage of total loans. In September 2014, special financial bonds were launched for rural entities. In December 2014, the PBC lowered interest rates on loans in support of agriculture and on relending to small rural entities by 0.25 and 0.4 percentage points, respectively. ● Improved rural financial channels by actively fostering the development of new rural financial institutions. By the end of 2014, there were a total of 1,233 rural banks, 14 loan companies, and 49 funding unions, with loans in support of agriculture and small and micro-enterprises accounting for 93 percent of their total loans. Private capital accounted for 73 percent of the capital at these institutions. ● In an effort to improve rural financial infrastructure, rural noncash payment and settlement services have been expanded through the establishment of standard and simplified outlets, ATM machines, and POS machines. Rural financial institutions have been created in an additional 1,375 rural districts and financial services have been offered for the first time in 708 rural districts since 2009. Full credit scoring

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			<p>coverage of farmers has also been pursued. By the end of 2014, credit files were in place on a total of 160 million farmers, of which 90 million obtained loans. Actions have been taken to spread financial knowledge in rural areas and penalize noncompliant operations in order to effectively safeguard the legitimate rights and interests of rural financial consumers.</p> <p>Financial Services for Small and Micro-Enterprises</p> <ul style="list-style-type: none"> ● Efforts have been made to optimize monetary policy tools in order to improve macro guidance of lending activities. This includes implementing the <i>Instructions by the State Council on Supporting the Healthy Development of Small and Micro-Enterprises</i> (GF [2014] 52) by improving the incentive mechanism for relending to small rural entities so as to further increase such relending, and by pooling financial resources to support the development of small and micro enterprises. By the end of 2014, the national balance of loans to small and microenterprises amounted to RMB 20.7 trillion, accounting for 24 percent of all outstanding loans, reaching the related target for six consecutive years. Loans have been extended to 11.4 million small and microenterprises, with more than 75 percent of applications for such loans having been approved. Coverage of integrated financial services now stands at more than 70 percent. In more than half of the provinces (autonomous regions and municipalities), coverage of small and micro enterprise loans is higher than 20 percent. ● The reform of the Growth Enterprise Market (GEM) was promoted. The CSRC on May 14, 2014 revised the <i>Regulations on Initial Public Offering and Listing on the GEM</i>, which lowered the financial criteria for access, eliminated the requirements on continuous growth and simplified offer terms, thus expanding the coverage of the GEM. The <i>Interim Rules on Share Offering by GEM-Listed Companies</i> were subsequently announced, creating the GEM refinancing system, which constitutes a mechanism that offers small, fast, and flexible financing. ● Significant efforts were made to develop the national small and medium enterprise (SME) share transfer system. In January-April 2014, the CSRC modified the <i>Regulations on Non-Listed Public Companies</i>. It also issued Guidelines No. 1 through 4 on regulating such companies and Guidelines No. 1 to No. 4 on their information disclosure and the related format. During the second half of 2014, the Commission issued the <i>Regulations on Acquisitions of Non-Listed Public Companies</i>, the <i>Regulations on Major Asset Restructuring of Non-Listed Public Companies</i>, <i>Guidelines No. 7: Content and Format of Information Disclosure on Non-Listed Public Companies</i> and <i>Guidelines No. 8: Content And Format of Information Disclosure on Non-Listed Public Companies—Application for Targeted Issuance of Preferred Shares</i>. These would help nonlisted public companies broaden financing channels and carry out mergers and acquisitions. In May 2015, the Commission issued the <i>Guidance on Enhancing Regulation of Non-listed Public Companies</i> in order to tighten the related supervision. Currently, the basic regulatory system on nonlisted public companies has been created, providing a solid foundation for financing by innovative enterprises and SMEs. ● Further steps have been taken to promote the development of the

Main FSAP Recommendations	Priority	Timeframe	Measures Adopted 1/
			<p>bond market On January 15, 2015, the CSRC issued the amended <i>Regulations on the Issuance and Trading of Corporate Bonds</i>, expanding the coverage of corporate bond issuers (previously including only listed companies and certain others) to include all companies, including small and micro-enterprises. In the future, small and micro-enterprises will be able to conduct public or private bond offerings, thus gaining more direct financing channels.</p>
<p>28. Further reforms of rural credit cooperatives, to enhance their efficiency and sustainability as commercial providers of financial products and services.</p>	Medium	MT	<ul style="list-style-type: none"> ● The reform of rural credit cooperatives has been completed. Rural credit institutions (including rural commercial banks and rural cooperative banks) continue to grow in their ability to support agriculture. Agriculture-related loans and loans to farmers accounted for one-third of and around 70 percent of all loans, respectively, playing a dominant role in providing continued support to agriculture and rural development. ● The country has engaged in steady reform of the joint-stock system, which was used to restructure rural credit cooperatives into rural commercial banks. By the end of 2014, rural commercial banks and rural cooperative banks numbered 809 in total, with assets, liabilities and owners' equity accounting for 58.5 percent, 57.9 percent, and 67.1 percent, respectively, of those of all rural financial institutions.
<p>29. Completing the reform of the Postal Savings Bank by optimization of the ownership structure, marketization and the establishment of effective corporate governance.</p>	Medium	MT	<ul style="list-style-type: none"> ● A standard corporate governance structure has been created at the Postal Savings Bank, with a shareholder meeting, a board of directors, a board of supervision, and a management team.
<p>1/ Information as reported by the authorities, with staff providing translation and minor edits.</p>			

Appendix II. External Sector Assessment

	China	Overall Assessment
Foreign asset and liability position and trajectory	<p>Background. Gross foreign assets, at 62 percent of GDP at end-2014 are dominated by foreign reserves, while gross liabilities, at 42 percent of GDP, mainly represent FDI liabilities. Net IIP has further declined to around 20 percent of GDP at end-2014; the ratio has been declining since the global financial crisis in light of the much reduced current account surpluses, valuation changes, and still fast growth of GDP.</p> <p>Assessment. The NIIP to GDP ratio is expected to be slightly above 20 percent of GDP over the medium term, with a modest rise of the current account in 2015. Vulnerabilities are low with large foreign exchange reserves and FDI-dominated liabilities.</p>	<p>Overall Assessment:</p> <p><i>The external position in 2014 was moderately stronger compared with the level consistent with medium-term fundamentals and desirable policy settings, and the renminbi was moderately undervalued. Since then, there has been substantial appreciation which has brought the exchange rate to a level no longer undervalued. Also, foreign exchange intervention has dropped sharply. Nevertheless, the trade surplus has risen and domestic policy gaps remain, which suggests that the external position probably remains moderately stronger than warranted. Sustained external rebalancing will require addressing the remaining domestic policy gaps.</i></p> <p>Potential policy responses:</p> <p>External imbalances have been reduced considerably since the global financial crisis. Finishing the job—meaning 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, that secures both domestic and external balance. This can be achieved through successful implementation of the authorities' reform agenda. Priorities include creating a more market-based financial system; opening markets to more competition and SOE reform; improving the social safety net; and achieving a flexible, market-based exchange rate. The latter is critical for facilitating the likely further REER appreciation over the medium-term as well as allowing for two-way movements in line with evolving conditions.</p>
Current account	<p>Background. The current account (CA) surplus has fallen from its peak of over 10 percent of GDP in 2007 to 2.1 percent of GDP in 2014 (2.5 percent of GDP cyclically adjusted). The decline reflects strong investment growth, REER appreciation, weakness in major advanced economies, and, more recently, a trend widening of the services deficit (mainly due to strong outbound tourism and education spending). Gross national saving has remained around 50 percent of GDP. In 2015, the Terms-of-trade (ToT) gains from lower commodity prices—estimated at about 1 percent of GDP—are expected increase the CA surplus to 3.0 percent of GDP.</p> <p>Assessment. The CA in 2014 is 1-3 percent of GDP stronger than implied by fundamentals and desirable policies. This assessment is unchanged from the last ESR, as the actual CA, cyclically adjusted CA, and identified policy gaps are somewhat smaller than last year 1/. Uncertainty about the cyclical adjustment justifies a range of 2 percent for the gap. The CA gap is mainly attributed to low social spending, reserve accumulation, and capital controls. Reforms, if successfully implemented, will lower private saving, and reduce the CA gap.</p>	
Real exchange rate	<p>Background. The REER has been on an appreciating trend since the 2005 exchange rate reform, gaining an average of 5 percent a year during 2006–14 (3 percent in 2014). By May 2015, the REER appreciated by 11 percent against the 2014 average, against the background of ToT gains and link of the exchange rate band to the appreciating U.S. dollar (the renminbi appreciated against the euro (16 percent) and yen (13 percent); and appreciated 0.5 percent against the U.S. dollar). China continues to manage closely its exchange rate and conducts intervention on an intermittent basis.</p> <p>Assessment. The REER appreciation through 2014 has been broadly consistent with changing fundamentals (especially faster productivity growth than in trading partners). The EBA models and staff judgment, consistent with the CA gap, suggest that the 2014 average REER was 3-12 percent below the level consistent with medium-term fundamentals and desirable policies 2/. The subsequent sizable REER appreciation appears to be more than would be suggested by changes in fundamentals (productivity growth and improved ToT), which suggests the exchange rate is no longer undervalued.</p>	
Capital and financial accounts: flows and policy measures	<p>Background. China continues liberalizing its capital account, but restrictions remain broad-based. For example, external borrowing is regulated and portfolio flows are primarily channeled through programs that are subject to quotas and approvals. Nonetheless, actual gross flows of FDI and other investments have been sizable</p> <p>Assessment. Over the medium term, a well-sequenced loosening of capital controls that supports domestic financial liberalization would be appropriate. The opening of the capital account is likely to lead to sizable gross capital outflows reflecting domestic savers' desire for portfolio diversification over the medium term. The adjustment path, however, is hard to predict and could vary depending on prevailing market and economic conditions.</p>	

China (continued)	
FX intervention and reserves level	<p>Background. Intervention declined in 2014, with BOP data suggesting an accumulation of US\$119 billion, US\$314 billion less than 2013. Moreover, data suggest that there was minimal intervention in 2014: Q3 and, since then, sales of reserves of US\$29 billion in 2014:Q4 and US\$ 80 billion in 2015:Q1. .</p> <p>Assessment. Reserves were at about 149 percent of the IMF's composite metric unadjusted for capital controls at end-2014 (down from 160 percent in 2013).); relative to the metric adjusted for capital controls, reserves were at 238 percent, down from 254 percent in 2013. Given China's progress and plans with capital account liberalization, the appropriate metric is shifting toward the unadjusted one; under either metric, further accumulation is unnecessary from a reserve adequacy perspective.</p>
Technical Background Notes	<p>1/ The total CA gap from EBA is 2.5 percent of GDP for 2014, up from 1.5 percent of GDP in 2013 due to a change in the residual. The change in the residual in large part reflects a revised EBA model to better capture demographics. The staff assessment puts more weight on the identified policy gaps, which capture the link between domestic reforms and securing balance in the external position. The contribution of identified policy gaps is 1.8 percent of GDP (versus 2.2 percent of GDP in 2013), actual CA is 2.1 percent of GDP (versus 1.6 percent of GDP in 2013); and cyclically adjusted CA is 2.5 percent of GDP.</p> <p>2/ A range of 3–12 percent for the REER is consistent with the range of 1–3 percent of GDP for the CA using inverse elasticities of 3-4 (that is, 3-4 percent REER appreciation is equivalent to a 1 percent of GDP decline in the current account surplus). The EBA Index REER model for 2014 data shows a total REER gap of minus 6.5 percent and the contribution of identified policy gaps of minus 7.5 percent, both in the range of 3–12 percent assessed by staff. The EBA Level model estimates a total REER gap 6.8 percent (that is, REER is stronger than the level consistent with medium-term fundamentals and desirable policy settings) identified policy gaps of minus 3.5 percent. However, that estimate is discarded from consideration, as the Level model estimates appear implausible, particularly for earlier years, suggesting little reliability in China's case.</p>

Appendix III. Debt Sustainability Analysis

The debt sustainability analysis assesses both general government debt and augmented debt, which represent the lower and upper bound of fiscal obligations. While China's general government debt remains low and sustainable, augmented debt is on a slight upward trajectory in the baseline. Augmented debt is sensitive to contingent liability shocks, but the risk of debt distress is low given China's favorable debt profile.

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

- **Public debt coverage.** Two definitions of government debt are used. General government debt includes central government debt and local government bonds.¹ Augmented debt adds other types of local government borrowing, including off-budget borrowing by Local Government Financing Vehicles (LGFVs) via bank loans, bonds, trust loans and other funding sources. 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 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 and low inflation. In the baseline, growth converges to 6.3 percent by 2020 though is lower in some of the intervening years. Inflation is projected to drop to 0.4 percent in 2016 and then rise to 2 percent over the medium term.

- **Fiscal assumptions:**

- *Fiscal balance assumptions.* In line with the authorities' gradual withdrawal of fiscal stimulus, the augmented fiscal deficit is projected to decline from around 10 percent of GDP in 2015 to around 8 percent of GDP by 2020. Local government expenditure to GDP ratio is projected to decline. This is due to: (i) lower expenditure financed by net land sales; and (ii) the authorities' reforms to limit local government borrowing. Meanwhile, the general government net borrowing is projected to increase slightly due to the shift from off-budget spending to on-budget spending.
- *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 met by bond issuance, in line with the authorities' reform plan and recent progress on local government bond issuance. Three bond types are assumed: (i) central government bonds; (ii) local government bonds, and (iii) a separate bond to repay existing local government debt according to amortization scheme in the NAO 2013 report.

¹ It corresponds to "General government debt if incl. only LG bonds (excl. swap)" in Table 5.

- *Interest rates and amortization.* The interest rates for central government and local government bonds are assumed to follow the historical pattern. The interest rates of local government bonds are assumed to be higher than central government bonds. The amortization profile is not central to the analysis because we assume all maturing debt is rolled over and that all debt is subject to a variable interest rate.

In the baseline, China's general government debt is on a declining path, but augmented debt continues to rise.

- The general government debt is slightly above 20 percent of GDP over the projection periods. Augmented debt, however, rises to about 71 percent of GDP in 2020 from less than 57 percent of GDP in 2014. Even with the favorable interest rate-growth differential, augmented debt rises over the medium term as the augmented deficit is assumed to decline gradually. The drag on growth from fiscal consolidation will thus spread out to provide time for growth enhancing structural reforms to take hold.
- The projected general government and augmented debt-to-GDP ratios are higher than in the 2014 DSA. This reflects that the baseline now assumes larger fiscal deficits, lower inflation, and slower growth than in the 2014 DSA.

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

- 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 2016 will result in a sharp increase in debt level from about 19 percent of GDP in 2015 to about 41 percent of GDP in 2016.² While the debt level is manageable, the authorities would potentially have to deal with an increase in gross financing needs that could be sensitive to market financing condition. Without any extra fiscal consolidation, the debt-to-GDP ratio will stay around 44 percent of GDP over the medium term under a contingent liability shock. A real GDP growth shock—with growth in 2016 and 2017 each 2 percentage points lower than in the baseline—would have a minimal impact on government debt (2020 debt-to-GDP ratio would be around 25 percent compared to 22 percent in the baseline scenario).
- The augmented debt level is also sensitive to a contingent liability shock, which would push debt to near 100 percent of GDP in 2020. Such a shock, for instance, could be a large-scale bank recapitalization or financial system bailout to deal, for example, with a potential rise in NPLs from deleveraging. A combined macrofiscal shock would increase the debt-to-GDP ratio from about 71 percent to 78 percent in 2020.

² 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 is slightly above 205 percent of GDP in 2014.

- Overall, China's debt profile is favorable as most of the public debt is financed through a domestic investor base, and the small external debt is mostly from official creditors. In addition, the DSA focuses on gross debt. The analysis thus ignores that China has considerable state assets, including around US\$4 trillion in foreign exchange reserves and sizable equity holdings in state owned enterprises (many of which are listed on domestic and international stock exchanges).

China: Public Sector Debt Sustainability Analysis (General Government Debt—Baseline Scenario)

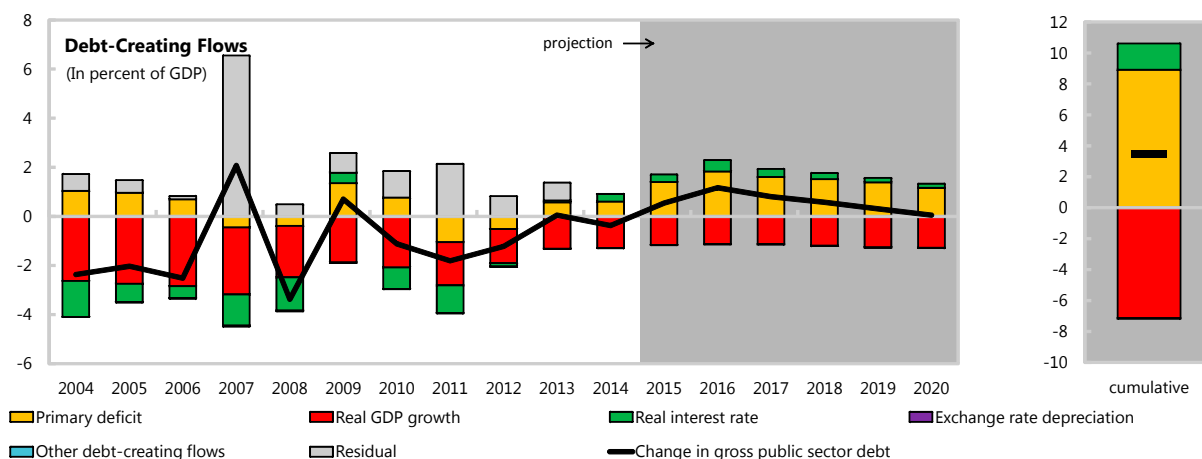
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of June 05, 2015		
	2004-2012 ^{2/}	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	23.3	18.9	18.5	19.1	20.3	21.1	21.6	21.9	22.0	EMBIG (bp) ^{3/}		127
Public gross financing needs	0.2	1.1	1.1	1.9	2.4	2.2	2.1	2.0	1.8	5Y CDS (bp)		88
Real GDP growth (in percent)	10.5	7.7	7.4	6.8	6.3	6.0	6.1	6.3	6.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	5.2	2.4	1.2	1.2	0.4	1.2	1.6	2.0	2.1	Moody's	Aa3	Aa3
Nominal GDP growth (in percent)	16.4	10.3	8.7	8.0	6.7	7.3	7.8	8.5	8.5	S&Ps	AA-	AA-
Effective interest rate (in percent) ^{4/}	2.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							Cumulative	Debt-stabilizing primary balance ^{9/}
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020			
Change in gross public sector debt	-1.3	0.1	-0.4	0.5	1.2	0.8	0.6	0.3	0.1	3.5		
Identified debt-creating flows	-2.8	-0.7	-0.4	0.5	1.2	0.8	0.6	0.3	0.1	3.5		
Primary deficit	0.3	0.6	0.6	1.4	1.8	1.6	1.5	1.4	1.2	8.9	-1.1	
Primary (noninterest) revenue and grants	21.7	28.0	28.3	28.8	28.2	28.0	27.9	27.5	27.2	167.6		
Primary (noninterest) expenditure	22.0	28.6	28.9	30.3	30.0	29.6	29.4	28.9	28.4	176.6		
Automatic debt dynamics ^{5/}	-3.0	-1.2	-1.0	-0.9	-0.7	-0.8	-0.9	-1.1	-1.1	-5.5		
Interest rate/growth differential ^{6/}	-3.0	-1.2	-1.0	-0.9	-0.7	-0.8	-0.9	-1.1	-1.1	-5.5		
Of which: real interest rate	-0.8	0.1	0.3	0.3	0.5	0.3	0.3	0.2	0.2	1.7		
Of which: real GDP growth	-2.2	-1.3	-1.3	-1.2	-1.1	-1.1	-1.2	-1.3	-1.3	-7.2		
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Net privatization proceeds (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
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	0.7	0.0	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 $-g$.

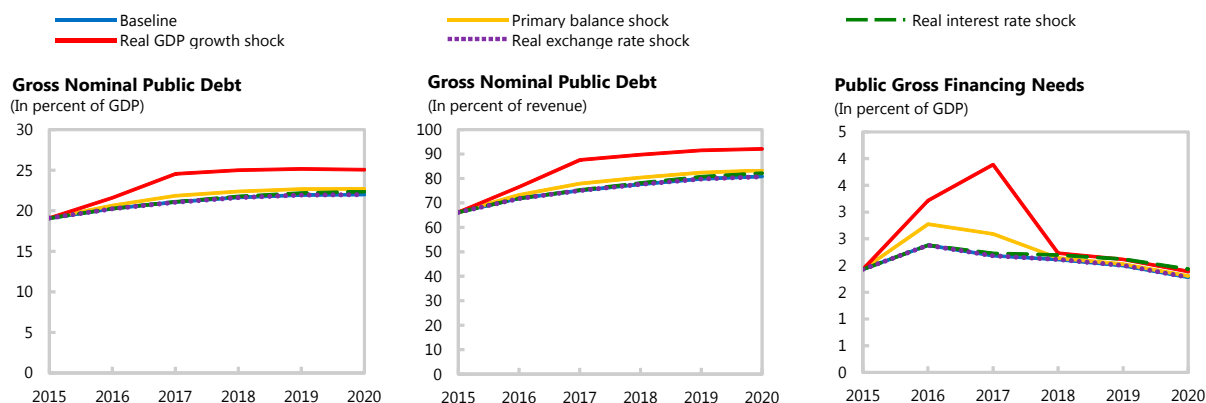
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

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

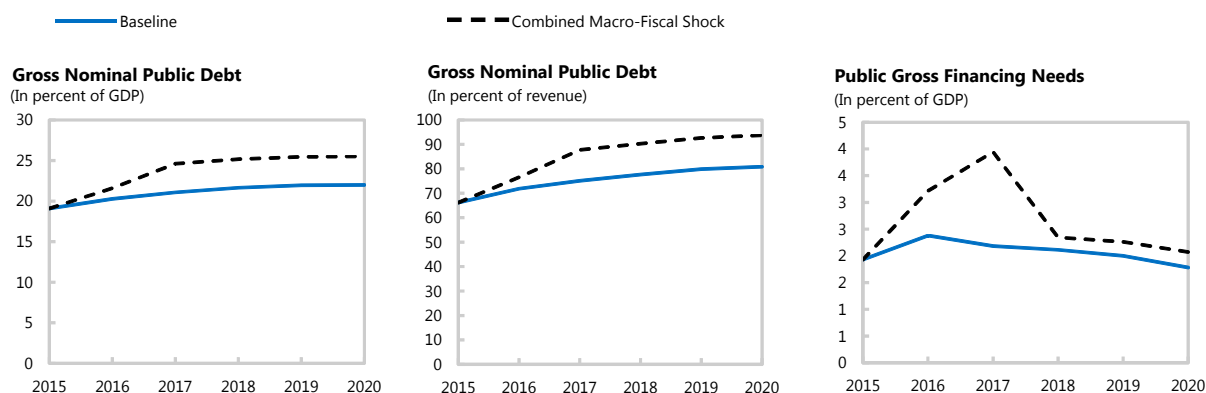
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

China Public Sector Debt Sustainability Analysis (General Government Debt-Stress Tests)

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions (In percent)

	2015	2016	2017	2018	2019	2020
Primary balance shock						
Real GDP growth	6.8	6.3	6.0	6.1	6.3	6.3
Inflation	1.2	0.4	1.2	1.6	2.0	2.1
Primary balance	-1.4	-2.2	-2.0	-1.5	-1.4	-1.2
Effective interest rate	3.0	3.0	3.0	3.1	3.1	3.0
Real interest rate shock						
Real GDP growth	6.8	6.3	6.0	6.1	6.3	6.3
Inflation	1.2	0.4	1.2	1.6	2.0	2.1
Primary balance	-1.4	-1.8	-1.6	-1.5	-1.4	-1.2
Effective interest rate	3.0	3.0	3.3	3.5	3.6	3.7
Combined shock						
Real GDP growth	6.8	4.1	3.8	6.1	6.3	6.3
Inflation	1.2	-0.2	0.7	1.6	2.0	2.1
Primary balance	-1.4	-2.7	-3.2	-1.5	-1.4	-1.2
Effective interest rate	3.0	3.0	3.3	3.6	3.7	3.8
Real GDP growth shock						
Real GDP growth	6.8	4.1	3.8	6.1	6.3	6.3
Inflation	1.2	-0.2	0.7	1.6	2.0	2.1
Primary balance	-1.4	-2.7	-3.2	-1.5	-1.4	-1.2
Effective interest rate	3.0	3.0	3.1	3.1	3.1	3.1
Real exchange rate shock						
Real GDP growth	6.8	6.3	6.0	6.1	6.3	6.3
Inflation	1.2	0.5	1.2	1.6	2.0	2.1
Primary balance	-1.4	-1.8	-1.6	-1.5	-1.4	-1.2
Effective interest rate	3.0	3.0	3.0	3.0	3.0	3.0

Source: IMF staff.

China: Public Sector Debt Sustainability Analysis (Augmented Debt—Baseline Scenario)

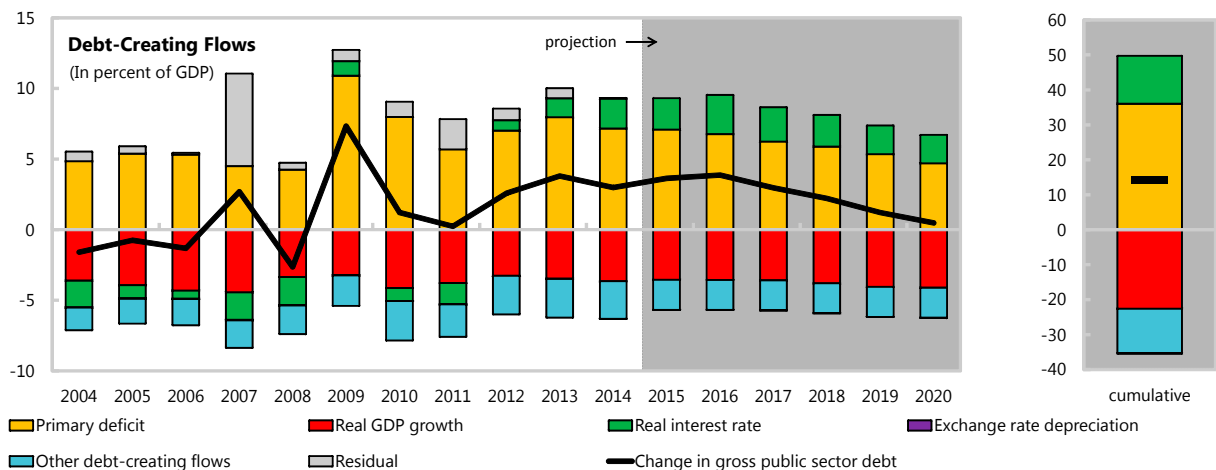
(In percent of GDP unless otherwise indicated)

Debt, Economic, and Market Indicators ^{1/}

	Actual			Projections						As of June 05, 2015		
	2004-2012 ^{2/}	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	43.1	53.6	56.6	60.2	64.1	67.0	69.3	70.5	71.0	EMBIG (bp) ^{3/} 127		
Public gross financing needs	8.5	10.5	9.9	14.0	12.4	11.2	14.9	15.9	14.8	5Y CDS (bp) 88		
Real GDP growth (in percent)	10.5	7.7	7.4	6.8	6.3	6.0	6.1	6.3	6.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	5.2	2.4	1.2	1.2	0.4	1.2	1.6	2.0	2.1	Moody's	Aa3	Aa3
Nominal GDP growth (in percent)	16.4	10.3	8.7	8.0	6.7	7.3	7.8	8.5	8.5	S&P's	AA-	AA-
Effective interest rate (in percent) ^{4/}	3.2	5.6	5.6	5.5	5.4	5.4	5.3	5.3	5.3	Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections						Cumulative	Debt-stabilizing primary balance ^{9/}
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020		
Change in gross public sector debt	0.9	3.8	3.0	3.6	3.9	3.0	2.2	1.2	0.5	14.4	
Identified debt-creating flows	-0.6	3.1	3.0	3.6	3.9	3.0	2.2	1.2	0.5	14.4	
Primary deficit	6.2	8.0	7.2	7.1	6.8	6.2	5.9	5.3	4.7	36.0	-4.2
Primary (noninterest) revenue and grants	21.7	28.0	28.3	28.8	28.2	28.0	27.9	27.5	27.2	167.6	
Primary (noninterest) expenditure	27.9	36.0	35.5	35.9	35.0	34.3	33.7	32.8	31.9	203.7	
Automatic debt dynamics ^{5/}	-4.7	-2.1	-1.5	-1.3	-0.8	-1.2	-1.5	-2.0	-2.1	-8.9	
Interest rate/growth differential ^{6/}	-4.7	-2.1	-1.5	-1.3	-0.8	-1.2	-1.5	-2.0	-2.1	-8.9	
Of which: real interest rate	-0.9	1.3	2.1	2.2	2.8	2.4	2.2	2.0	2.0	13.7	
Of which: real GDP growth	-3.8	-3.5	-3.7	-3.5	-3.6	-3.6	-3.8	-4.0	-4.1	-22.6	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	-2.1	-2.7	-2.7	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-12.8	
Net privatization proceeds (negative)	-2.1	-2.7	-2.7	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-12.8	
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	0.7	0.0	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 $-g$.

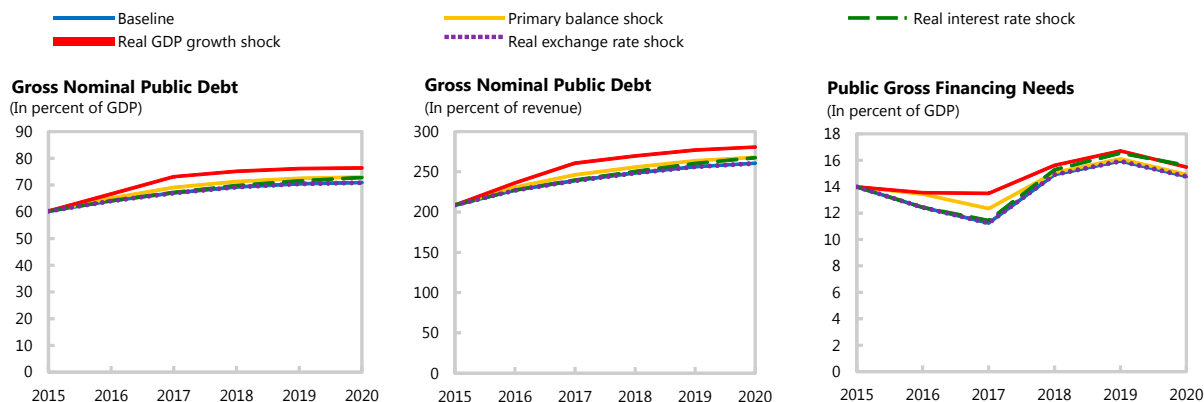
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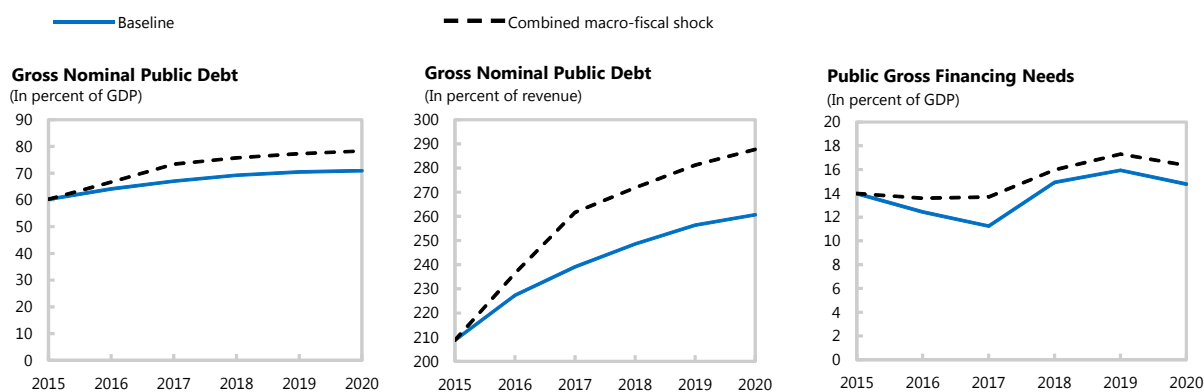
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

China: Public Sector Debt Sustainability Analysis (Augmented Debt-Stress Tests)

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions (In percent)

	2015	2016	2017	2018	2019	2020		2015	2016	2017	2018	2019	2020
Primary balance shock							Real GDP growth shock						
Real GDP growth	6.8	6.3	6.0	6.1	6.3	6.3	Real GDP growth	6.8	4.1	3.8	6.1	6.3	6.3
Inflation	1.2	0.4	1.2	1.6	2.0	2.1	Inflation	1.2	-0.2	0.7	1.6	2.0	2.1
Primary balance	-7.1	-7.8	-7.2	-5.9	-5.3	-4.7	Primary balance	-7.1	-7.7	-8.1	-5.9	-5.3	-4.7
Effective interest rate	5.5	5.4	5.4	5.4	5.4	5.4	Effective interest rate	5.5	5.4	5.4	5.5	5.4	5.4
Real interest rate shock							Real exchange rate shock						
Real GDP growth	6.8	6.3	6.0	6.1	6.3	6.3	Real GDP growth	6.8	6.3	6.0	6.1	6.3	6.3
Inflation	1.2	0.4	1.2	1.6	2.0	2.1	Inflation	1.2	0.5	1.2	1.6	2.0	2.1
Primary balance	-7.1	-6.8	-6.2	-5.9	-5.3	-4.7	Primary balance	-7.1	-6.8	-6.2	-5.9	-5.3	-4.7
Effective interest rate	5.5	5.4	5.7	5.9	6.2	6.5	Effective interest rate	5.5	5.4	5.4	5.3	5.3	5.3
Combined shock													
Real GDP growth	6.8	4.1	3.8	6.1	6.3	6.3							
Inflation	1.2	-0.2	0.7	1.6	2.0	2.1							
Primary balance	-7.1	-7.8	-8.1	-5.9	-5.3	-4.7							
Effective interest rate	5.5	5.4	5.7	6.0	6.2	6.5							

Source: IMF staff.

Appendix IV. Global Risk Assessment Matrix

Main Sources of Risks		Overall Level of Concern	
		Likelihood (over next one to five years)	Impact and Policy Response
Global	<p>Persistent dollar strength</p>	<p>High</p> <p>With U.S. economic prospects continuing to improve while dimming elsewhere, the dollar has appreciated significantly against the euro, yen, and many emerging market currencies. If these divergences in outlook continue to build the dollar could surge rapidly and stay elevated.</p>	<p>Medium</p> <p>The impact would depend on what happens to the renminbi. If it appreciated in REER terms in line with the stronger U.S. dollar, then it would reduce growth mainly through lower exports as a result of a loss of competitiveness. <i>Policy response</i> : Allow for a more flexible, market-determined exchange rate. This would likely result in less REER appreciation. If near-term growth were to slow too sharply, then fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.</p>
		<p>Medium</p> <p>New sources of supply, such as shale gas and a ramping up of production in some emerging economies may generate global excess capacity, while global demand remains weak.</p>	<p>Medium</p> <p>A sustained decline of commodities prices over a period of several years could benefit China, which is a large importer of natural resources. <i>Policy response</i> : Advance structural reforms to accelerate the transition towards a greener, more inclusive, and sustainable growth. This could include opportunistically accelerating the hike in resources taxes, as was done with petroleum taxes during the recent fall in oil prices.</p>
		<p>High</p> <p>Lower-than-anticipated growth and persistently low inflation in advanced economies due to a failure to fully address legacies of the financial crisis would lead to secular stagnation, and potentially complicate efforts on rebalancing and restoring fiscal sustainability.</p>	<p>High</p> <p>External trade would be affected due to the slower recovery of global demand. Capacity utilization rates in export sectors would decline, leading to a fall in profitability, rising unemployment, and diminished ability to service corporate debt. A deterioration in banks' asset quality, together with tighter financing conditions, would further slow investment and growth. <i>Policy response</i> : Advance structural reforms to accelerate the transition towards a greener, more inclusive, and sustainable growth. If near-term growth were to slow too sharply, then fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.</p>
Domestic	<p>Sharp slowdown in 2015-16</p>	<p>Low</p> <p>Growth falls significantly below target, possibly due to a severe housing downturn or a shock in the shadow banking sector, and absent offsetting stimulus.</p>	<p>High</p> <p>Such a shock could trigger a negative feedback loop between real activity, bank asset quality, lending, and local government finances. <i>Policy response</i> : If near-term growth were to slow too sharply, then fiscal stimulus should be used in a manner that supports rebalancing and helps protect vulnerable groups.</p>
		<p>Medium</p> <p>Insufficient progress with reforms leads to a continued buildup of vulnerabilities, which over the medium term results in a significant growth slowdown.</p>	<p>High</p> <p>Main impact would be through continued resource misallocation, leading to significant TFP slowdown and overall potential growth in the medium term. <i>Policy response</i> : Advance structural reforms to accelerate the transition towards a more balanced and sustainable growth path.</p>



PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION— INFORMATIONAL ANNEX

July 7, 2015

Prepared By

The Asia and Pacific Department
(In consultation with other departments)

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FUND RELATIONS

(As of May 31, 2015)

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

General Resources Account:

	SDR Million	% Quota
Quota	9,525.90	100.00
Fund holdings of currency	9,281.62	97.44
Reserve position in Fund	244.32	2.56
Lending to the Fund		
New Arrangements to Borrow	3,156.39	

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	6,989.67	100.00
Holdings	7,495.03	107.23

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
Principal	0.00	0.00	0.00
Charges/interest	0.12	0.12	0.12
Total	0.12	0.12	0.12

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 method for determining is as follows: The CFETS determines the middle rate for the renminbi against the ringgit, yen, and the ruble similarly. The middle exchange rates of the renminbi against the euro and Hong Kong dollar, and pound sterling, respectively, are determined through cross rates by the CFETS based on the day's foreign exchange middle rate for the renminbi against the U.S. dollar and the exchange rates for the U.S. dollar against the euro, yen, Hong Kong dollar, and pound sterling on international foreign exchange markets.

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. There are no measures currently in force that have been determined to be exchange restrictions subject to Fund jurisdiction. 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 2014. As of the end of 2014, a cumulative total of 251 QFIIs had been approved, with a total investment limit of US\$49.701billion. 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. 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 Singapore, Taiwan Province of China, France, Canada, Luxembourg, Australia, Germany, Korea, and the UK.

As of 2014, 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. All external borrowing must be registered with the SAFE.

Article IV Consultation:

China is on the standard 12-month consultation cycle. The 2014 Article IV mission was concluded on June 5, 2014 and the staff report was published on July 30, 2014.

Technical Assistance:

Technical assistance provided from 2001 through September 2015 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. Waikai Raphael Lam is the Deputy Resident Representative.

WORLD BANK-IMF COLLABORATION

(As of June 26, 2015)

1. **The IMF China Resident Representatives held discussions with the World Bank team in May 2015** 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 2015-16. The last such meeting was held during December 2014 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 macro-critical:**
 - **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—and the cap on deposit rates distort the pricing of risk and borrowing costs, resulting in misallocation of credit and inefficient investment. Key measures in this area include deposit interest rate liberalization, stepped-up supervision and regulation of the financial system and overhaul of the system of resolving failed financial institutions. In addition, stronger measures to monitor and regulate the large shadow banking sector should be taken. Renewed focus on reforming the role of the state in the financial sector should be made, with particular emphasis on the governance of state financial institutions. More effective mechanisms to be put into place to ensure a functional crisis management framework is in place and more coordinated macroprudential monitoring is implemented. And there is a need to continue to push for innovations to facilitate greater financial inclusion for those households and businesses not served by the formal financial markets.
 - **Fiscal reforms.** Off-budget spending, in infrastructure but also in other areas, undertaken by local government-owned entities have led to a significant buildup of debt. Bringing these projects on-budget and strengthening control over public financial management will help control fiscal risks. 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—many of them planned and some already partly in place or in pilot form—will promote more efficient and inclusive growth. These reforms include extending the VAT to services, improving the progressivity of the personal income tax, and implementing a property tax.

- **Reform of social safety nets.** 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. It is also crucial to improve benefit portability across provinces and economic sectors. Reforms should be done in a way that ensures the sustainability of the social security system, including through parametric changes to the pension system and transferring the welfare and legacy components to the budget.
- **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, and issues such as desertification, dependence on coal, and degradation of grasslands have social, health, and economic effects. Underpricing of energy and inadequate consequences for pollution have worsened these effects while contributing to China's dependence on industry. Raising these factor costs to capture the cost of externalities and investing 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 is working with the authorities on the development of a financial sector reform strategy. The Fund will continue to follow up on the recommendations of the 2011 FSAP and 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 a proposed 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 safety nets.** The Bank will continue to work with the Chinese authorities on reforms to improve the equity, sustainability, and portability of the Chinese pension system. This includes helping provincial governments in developing more centralized information systems. The Bank will also work with MOF to optimize fiscal risk management associated with social security liabilities in the context of the fiscal technical assistance investment project. 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.
 - **Green growth.** The Bank's focus on climate change and renewable energy in China will continue to emphasize cutting-edge renewable energy technologies, scale-up of energy conservation and investments in energy efficiency, 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 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 other taxes. 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 2015–June 2016.

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

	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • China Economic Reform Implementation Project (umbrella TA project, including various subprojects with MOF, PBC, and provincial finance bureaus). • China Economic Update • “Just-in-time” Policy Notes for MOF • TA on Mid-term Macroeconomic Framework • Subnational Intergovernmental Fiscal Relationship • Municipal Financing and Local Debt Management • Inclusive Finance Academy • Financial Consumer Protection and Consumer Literacy • Financial Reform Strategy • Capital Market Development • Deepening health reform in China-building high quality and value-based service delivery 	<ul style="list-style-type: none"> • Ongoing • Ongoing • Delivered on demand • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing • Ongoing
Fund Work Program	<ul style="list-style-type: none"> • December Staff Visit • 2016 Article IV Consultation • Cooperation Program for Fiscal Reforms (FAD) 	<ul style="list-style-type: none"> • Dec 2015 • May/June 2016 • Ongoing
Joint Work Program	<ul style="list-style-type: none"> • Financial Sector Assessment Program 	<ul style="list-style-type: none"> • 2016

RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

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 2014, the PRC's cumulative borrowing from AsDB reached \$29.35 billion with 215 loans for public sector projects. Of the total public sector loans, 56.8 percent was allocated to the transport sector, followed by agriculture and natural resources (11 percent) and water and other municipal infrastructure services (12.8 percent), energy (12.5 percent), industry and trade (2.3 percent), finance (2.3 percent), education (0.5 percent) and multisector (1.7 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 2014, AsDB had provided a total of \$446.933 million for 714 technical assistance projects, consisting of \$139.956 million for preparing projects and \$306.977 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) 2011–2015 was endorsed by AsDB Board of Directors in May 2012. The CPS 2011–2015 is aligned with the priorities of the PRC's 12th Five-Year Plan 2011–15 that intersect with those of AsDB's long-term *Strategy 2020*, particularly the redoubling of efforts to promote socially inclusive and environmentally sustainable development. The CPS reflects the PRC's changing circumstances as a rapidly growing middle-income country with increasing emphasis on innovation and value addition and South-South cooperation to underpin the evolving AsDB-PRC partnership. The CPS is built on three strategic pillars: (i) inclusive growth, (ii) environmentally sustainable growth, and (iii) regional cooperation and integration. It identifies four priority sectors for country operations during the CPS period: (i) energy, (ii) natural resources and agriculture, (iii) transport, and (iv) urban development. The sector selection

¹ Prepared by Asian Development Bank staff.

reflects AsDB's comparative strengths and expertise through its longstanding operations in these sectors.

5. Projected public sector lending in 2014–2016 will total about \$4.13 billion, of which 32 percent will support the transport sector; 27 percent for agriculture, rural development, and natural resource management; 30 percent for urban development, water supply, and sanitation improvement; and 11 percent for the energy sector. 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), 1993–2014
(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

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

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

1. Data provision has some shortcomings, but is broadly adequate for surveillance. Priorities for improvement include national accounts and government finance statistics. Progress has been made in meeting the SDDS standard, as most of data requirements are observed although several data categories are compiled but not disseminated in accordance to the SDDS standard (for instance, the quarterly GDP is compiled on a cumulative and not a discrete basis). Some planned improvements include strengthening the data dissemination by the National Bureau of Statistics (NBS), and revising the reporting codes and classification of BOP transactions to *Balance of Payments and International Investment Position Manual*, Sixth edition (*BPM6*) by the State Administration of Foreign Exchange (SAFE). For a fuller discussion planned improvements see <http://dsbb.imf.org/Pages/GDDS/SummaryReport.aspx?ctycode=CHN&catcode=s1>

Real Sector Statistics

2. The National Bureau of Statistics (NBS) compiles and disseminates annual GDP by activity in current and constant prices (2010) and quarterly estimates of GDP. Both the annual accounts and quarterly accounts are based on the *System of National Accounts, 1993 (1993 SNA)*. 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.

3. 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.

4. Labor market statistics—including employment and wage data—are not comprehensive, and are only available on a quarterly basis.

5. In January 2001, the NBS began to publish a Laspeyres price index that provides a time series for each January to December including last month=100, same month of preceding year=100, and same period of preceding year=100. This more accurately reflects consumer spending patterns (e.g., the weight of services increased, while the weight of food declined). The number of survey items has been expanded to at least 600 for small cities and counties and more for large and medium-size cities (e.g., 1800 for Beijing). The most recent weights of the major CPI components were provided to the staff in 2006.

Government Finance Statistics

6. 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

7. 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.

8. 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.

9. With regards to financial soundness indicators (FSIs), the authorities expanded the data scope in early 2015 by including two encouraged FSIs for deposit takers in their regular reporting to the Fund.

External Sector Statistics

10. The data are compiled (in U.S. dollars) largely in accordance with the fifth edition of the *Balance of Payments Manual (BPM5)*. From 2015, the data are compiled largely in accordance with the sixth edition of the *Balance of Payments and International Investment Position Manual (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.

11. 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.

Data Standards and Quality

12. China has participated in the General Data Dissemination System since April 2002, and the metadata posted on the Fund's Dissemination Standards Bulletin Board (DSBB) are regularly updated.

Data Reporting to STA for Publications

13. Despite improvements in reporting a number of breaks remain in the series, and comparable historical data are not available. Reporting of data to STA for publication in the *International Financial Statistics (IFS)* has, in the past, tended to be sporadic and with a considerable time lag. Long time series for the consumer and producer price indices and industrial production levels are not available, although the comparison is made and available for each period with the same period of the previous year. However, the range of information is relatively limited, with no data published on wages, trade volumes, or prices/unit values.

14. China has reported general government cash-based budget data for 2003–09 following the *GFSM 2001* methodology for publication in the 2011 *Government Finance Statistics Yearbook*. However, these data are limited, with no data provided on government transactions in expense, assets, and liabilities. The revenue classification does not fully distinguish between revenue and grants, tax and nontax revenue, and current and capital revenue. The presentation of expenditure by function is largely aligned with international best practice.

15. Owing to source data issues, the authorities have not yet been able to report a *GFSM 2001* Statement of Sources and Uses of Cash for the budgetary central government accounts on a subannual basis. As a result, there are no fiscal data for China on the Principal Global Indicators website.

16. For reporting monetary data to the Fund, the authorities have not begun using SRFs. Monetary data continue to be reported using the old format.

17. The FSI data currently posted on IMF's website are available for all core indicators and two encouraged FSIs on an annual basis with data beginning from 2010. The April 2012 mission encouraged the authorities to compile and report the FSI data with quarterly periodicity. The authorities agreed with the improved periodicity for their FSI data, but indicated that they would prefer to move to semi-annual reporting prior to compiling the quarterly data.

18. The monthly time series on international reserves for publication in the *IFS* are now submitted on a timely basis. With regards to BOP and IIP data, the authorities started submitting

quarterly data to STA for publication in the *IFS* and the *Balance of Payments Statistics Yearbook* (BOP data are available on a quarterly basis starting in 2010 and IIP starting in 2011). Additionally, China participates in the CDIS as mentioned above but not yet in the Coordinated Portfolio Investments Survey (CPIS).

Data Dissemination to the Public

19. The publication of a quarterly statistical bulletin by the PBC has significantly improved the timing and coverage of publicly available data on the monetary accounts and the main real sector indicators. However, the monthly statistical publications do not contain many time series (e.g., unemployment) or the disaggregation necessary for analysis. Moreover, several important time series, particularly on the main fiscal variables, are not released in a systematic and timely manner. Extensive annual economic data are available in various statistical yearbooks, but these are published nine months or more after the end of the year. Nevertheless, in the case of quarterly external debt data disseminated in QEDS, time lag is around four to six months.

China: Table of Common Indicators Required for Surveillance
(As of May 8, 2015)

	Date of Latest Observation	Date Received	Frequency of Data⁹	Frequency of Reporting⁹	Frequency of Publication⁹
Exchange rates	05/14	06/14	D	M ⁹	D
International reserve assets and reserve liabilities of the monetary authorities ¹	04/15	05/15	M	M	M
Reserve/base money	03/15	05/15	Q, M	Q, M	Q, M
Broad money	03/15	05/15	M	M	M
Central bank balance sheet	03/15	05/15	M	M	M
Consolidated balance sheet of the banking system	03/15	05/15	M	M	M
Interest rates ²	03/15	05/15	¹⁰	¹⁰	¹⁰
Consumer price index ³	01/15	n.a.	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	Q3/14	03/15	Q	A, Q	A, Q
Exports and imports of goods and services ⁷	05/14	05/14	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	Q3/14	03/15	A, Q	A, Q	A, Q

¹ Any reserve assets that are pledged or 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, 2001–15 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
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 Of 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
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
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

Public Financial Management		
FAD	Mission On Budget Law I	March 2004
FAD	Mission On Cash Management	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	Fiscal Medium-Term Budget Management Seminar	November 2011
FAD	Medium-Term Revenue Administration Program And Policies Discussion	June 2012
FAD	High-Level Dialogue On PFM Institutions	November 2012
FAD	Treasury Modernization	February 2012
FAD	Treasury Modernization	February 2013
FAD	Modernization Of Government Accounting	April 2014
FAD	Medium Term Expenditure Frameworks	July 2014
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
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 (<i>BPM6</i>)	April 2008
STA	<i>BPM6</i> Course	June 2009
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: Data Collection from Ofcs and SRFS Data Development / FSI Data Reporting	April 2012
STA	Quarterly National Accounts	November 2013

Statistics		
STA	SDDS Assessment	August 2014
STA	Data Work: Monetary Data Reported in SRF	September 2014
STA	SDDS Assessment	December 2014
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
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
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

Training		
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.	November 2005
STA	Workshop on Strategy of Reform and Development of Stat. System	
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
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

Training		
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
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

Training		
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
ICD	Macroeconomic Management and Financial Sector Issues	March 2015
MCM/STA	Total Social Financing Indicator	March 2015
ICD	Macroeconomic Forecasting (<i>scheduled</i>)	June/July 2015
INS	Advanced Course on Monetary and Financial Statistics in CTP	August 2015
STA	Debt Securities	September 2015
STA	SAFE-Course on Compilation of Balance of Payments Statistics	September 2015
ICD	Macroeconomic Diagnostics (<i>scheduled</i>)	September 2015
Statistics		
STA	Money and Banking Statistics	March 2014
STA	Monetary Data Reported in SRF	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
STA	Balance of Payments Statistics	September 2015
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.		



PEOPLE'S REPUBLIC OF CHINA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

July 17, 2015

Prepared by **Asia and Pacific Department**

This supplement provides additional information on developments since the staff report was finalized in mid-June, with focus on the equity market, recent data releases, and monetary policy. This information does not change the thrust of the staff appraisal and paragraph 6 of this supplement adds the staff appraisal of recent developments.

Equity market

- 1. The equity market declined sharply starting in mid-June, giving back part of the preceding rally, with ongoing volatility.** In little more than a year, the market had risen by around 150 percent through mid-June (see Box 4 in the staff report). It then dropped by over 30 percent in less than three weeks, followed by some rebound after a broad set of measures were implemented to stabilize the market. Despite the correction, the market as of July 17 was still up over 80 percent relative to April 2014. During the decline, many stocks had their trading suspended temporarily as they hit the 10-percent daily stop-loss limit or at the request of the company; at market trough on July 8 over half of listed firms were not trading. In subsequent days, many companies resumed trading and the number of listed firms reported as not trading dropped to about one-fourth of listed firms by July 17. As of July 17, sizable volatility in stock indices and prices of individual firms continued. There was some spillover to the foreign exchange market and Hong Kong SAR markets, albeit limited and short lived so far.
- 2. The authorities responded with a range of measures to restore orderly market conditions and stabilize the market.** Initial steps in the first few days of the correction were perceived by many market participants and observers as poorly coordinated and ineffective. They were then escalated to a broad and powerful set of actions which included:
 - *Providing liquidity.* China Securities Finance Corporation (CSFC), which is the clearing house for margin financing and stock lending, received liquidity with the assistance of the PBC, and provided more liquidity to securities firms; margin rules were relaxed, including by expanding the type of collateral to include real estate, and easing requirements for margin calls and liquidation of margin loans.
 - *Reducing selling pressure.* Twenty-one securities firms pledged not to sell proprietary positions; the regulator set a six-month ban on sales by large shareholders; margins for selling certain futures were increased; and an investigation into suspicious short sellers was started.
 - *Supporting new purchases.* CSFC bought a wide range of stocks; big shareholders of listed

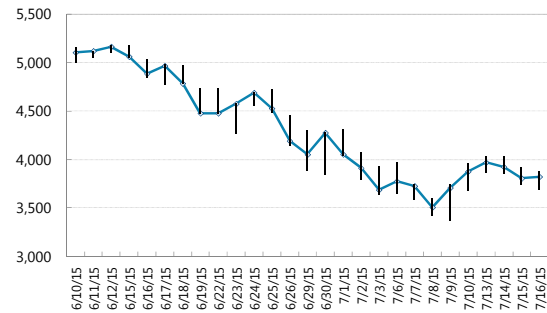
SOEs and mutual funds were encouraged to buy stocks; the CBRC supported banks to increase collateralized lending for equity buybacks; and transaction fees were lowered.

- *Reducing the supply of stocks.* New initial public offerings (IPOs) were temporarily suspended.

Following these actions, stocks stabilized and rebounded starting on July 9, with declining intraday volatility.

Shanghai Composite Index ^{1/}

(Dec 19, 1990=100)



Source: Bloomberg.

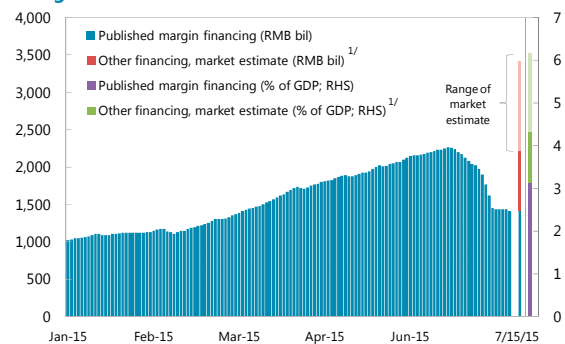
^{1/} Black line shows daily high and low of the index. Blue line refers to daily closing price.

3. Even though the market correction was sizable and fast, the economic and macro-financial consequences are likely to be manageable given the available buffers.

Wealth effects from past equity price changes in China were small, with only a small portion of household wealth in stocks, and the relative brevity of the preceding rally suggests that it had not yet significantly altered spending behavior. Thus, even if there were a further correction, the impact on consumption would likely be limited.

Regarding financial stability risks, while the linkages between securities companies, banks, and the repo market have strengthened, they do not yet appear systemically important. Margin financing had risen fast over the past year, though from a low base; at its peak in mid-June

Margin Balance



Sources: CEIC; and IMF staff estimates.

^{1/} Other margin financing is based on market estimate of 0.8 - 2 trillions of RMB.

market estimates put it at 4–6 percent of GDP. Since then, it has declined significantly, although further unwinding is to be expected. Securities companies, the sector most exposed to losses from an equity market decline and margin financing, on average have balance sheets strong enough to absorb considerable losses. In addition, since they are a relatively small share of the financial system, they are unlikely to pose systemic risks. Nevertheless, there is some uncertainty about the extent of equity-related lending in shadow banking and the nonfinancial sector. Hence, it is important that the authorities closely monitor—as they are now doing—developments and potential spillovers.

4. Going forward, the authorities should curtail market intervention, focus on maintaining the liquidity of systemically important institutions and groups of institutions, and strengthen the framework for market regulation, supervision and crisis management.

The authorities' actions signaled their determination to ensure orderly market conditions and prevent excessive volatility and systemic financial risk. However, the heavy intervention created risks exacerbating 'moral hazard' (fostering a perception of government support for a market floor), and may raise questions about the system's and policies' market orientation. Thus, the authorities' strategy should now focus on maintaining orderly market conditions and confidence

in the stability of the system, without shoring up prices around a particular level. This approach would involve exiting price support mechanisms and restoring price discovery and transparency as soon as possible, irrespective of the impact on price levels. Systemically important institutions (or groups of institutions) may need continued liquidity support in the short term, subject to strict oversight and collateral requirements. Once conditions have calmed, exceptional measures can be removed, combined with further strengthening the resilience of the financial system, would support the goal of maintaining momentum towards a well-regulated, market-based financial system. Improved coordination among relevant agencies, under clear leadership and communication, will be key to effective and swift action in similar circumstances in the future.

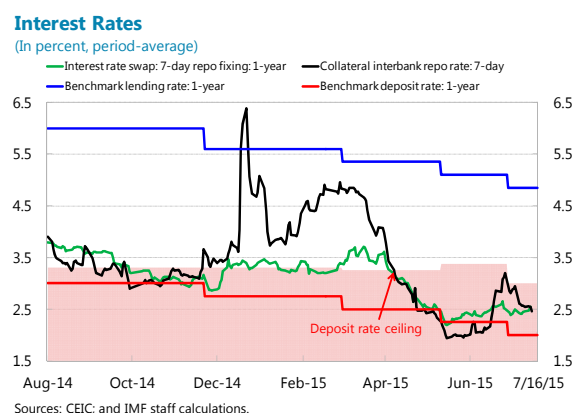
5. **Authorities' views.** The authorities emphasized that their response was focused on preventing disorderly market conditions and excessive volatility, especially as large-scale unwinding of margin positions risked triggering a negative feedback loop between declining prices and margin calls. Looking ahead, they agreed that market regulation and supervision needed to be vigilant against the build-up of risks, including large margin positions, and expected the exceptional measures applied to stabilize the market to be phased out over time as market conditions permitted.

Economic developments

6. **Recent data suggest developments are broadly in line with staff's forecast.** GDP growth in Q2 was 7.0 percent, which is somewhat higher than staff forecast (Figure 1). However, growth in the second half of the year is likely to be somewhat weaker given the headwinds from recent equity market turbulence, which could reduce the contribution to growth from financial services and have some, even if small, impact on demand through wealth and confidence effects. Thus, on balance, developments are consistent with the staff's forecast for growth this year (6.8 percent) and the authorities' target of around 7 percent. Headline and core CPI increased modestly in June, while PPI inflation remained negative.

Monetary policy

7. **Benchmark interest rates were further lowered on June 28.** The one-year benchmark deposit and lending rates were lowered by 25 basis points. As the margin above the benchmark deposit rate remained unchanged (1½ times), the maximum deposit rate fell by 37.5 basis points (to 3 percent). The authorities explained that the nominal rate cut maintained an appropriate level of real interest rates in light of lower inflation. They also noted that credit growth had remained stable, with TSF growth at 12.2 percent (y/y) and M2 growth at 11.8 percent in June. Staff considers, and the authorities agreed, that monetary and credit developments now appear to be on track toward achieving



GDP growth of around 7 percent for the year. Staff therefore considers that monetary policy need not alter its course as a result of recent stock market developments, given their limited systemic or macroeconomic impact. Regarding benchmark deposit rates, staff continues to believe that the time has come to complete the liberalization of interest rates by removing the deposit rate ceiling (staff report paragraph 39).

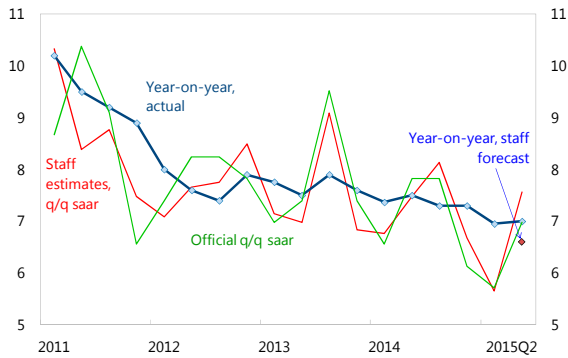
Staff appraisal

8. **Policies following the recent correction in equity markets should aim to restore fully functional market conditions as soon as possible.** After a major rally over the past year, the market corrected sharply in a short period of time. Initially less effective, the policy response soon widened to a broad range of measures to restore orderly market conditions and stop the decline. While the market appears to have stabilized for now, the measures reached far into areas that involved the approval of companies' requests to suspend trading, reducing sales, and boosting purchases of stocks through public entities. This set of interventions needs to be curtailed to permit a return to normal price discovery. Future interventions should focus on restoring orderly market conditions, irrespective of the impact on price levels. The recent episode has also highlighted the need to improve coordination among relevant agencies, under clear leadership, and to communicate policy goals and actions early, clearly, and with a unified voice.

Figure 1. China: Recent Developments

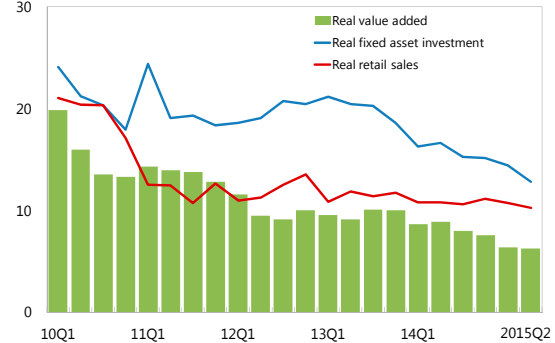
Q2 GDP growth was somewhat above the staff projection, but trends are broadly in line with staff's annual forecast...

Real GDP Growth
(In percent)



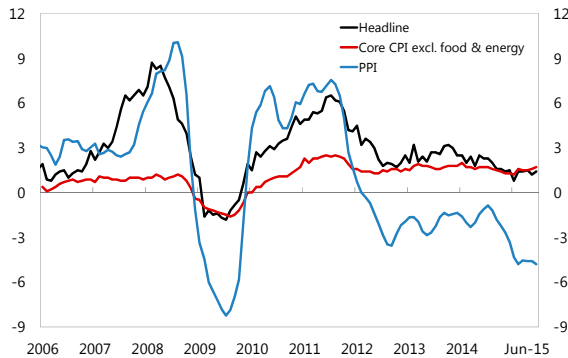
...with investment and industrial activity moderating, while consumption remains more resilient.

Real Fixed Asset Investment, Industrial Value Added and Retail Sales
(In percent, year-on-year growth)



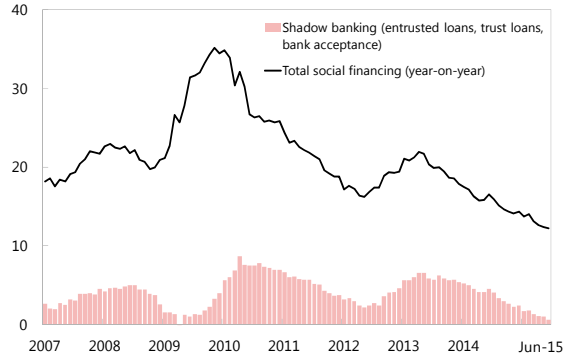
Headline and core CPI inflation picked up modestly in June.

Inflation
(In percent, year-on-year)



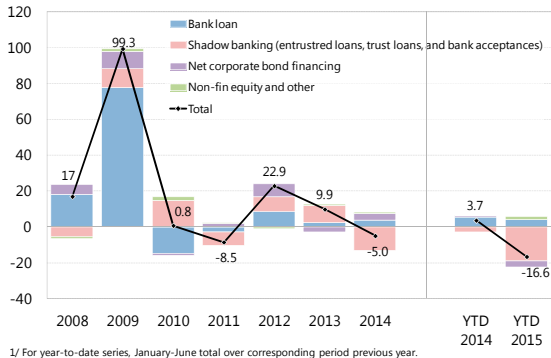
Credit (TSF) growth has continued to moderate, reflecting a decline in shadow banking...

Social Financing Stock
(In percent, contribution to growth)



...with the flow of credit down in nominal terms from last year.

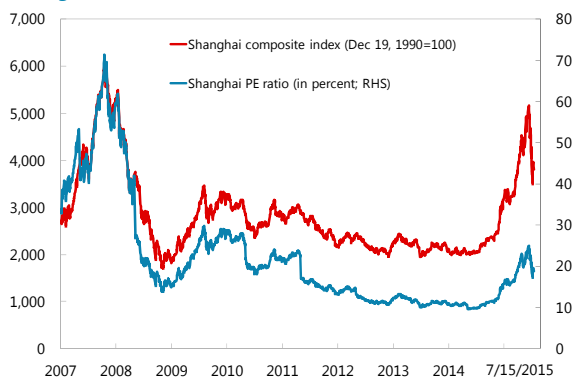
Social Financing Flow
(In percent, year-on-year contribution to growth) ^{1/}



^{1/} For year-to-date series, January-June total over corresponding period previous year.

After a sharp run-up in the stock market, prices corrected starting in mid-June.

Shanghai Market Indicators



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

Statement by Zhongxia Jin
Executive Director for People's Republic of China
July 22, 2015

On behalf of my authorities, I would like to thank staff for their constructive and candid dialogue held during the mission. My authorities welcome staff's thorough assessment of the Chinese economy, and see merit in staff's recommendations in several policy areas. Valuing the Fund's expertise and role in the international monetary system, my authorities will continue to maintain close cooperation with staff going forward.

Recent economic developments

The Chinese economy is transiting to its new normal amidst an uneven and brittle global economic recovery process. China's real GDP growth edged down from 7.4 percent in 2014 to 7.0 percent in the first half of this year, which is still high compared to economies of similar size. Labor market conditions remain firm amidst strengthening tertiary industry and consumption, while new industries, such as e-business, have grown at a vibrant pace.

Meanwhile, price pressure in China remains subdued, mainly due to the moderation in food price inflation, the substantial appreciation in the renminbi effective exchange rate, and the decline in global oil and commodity prices. In particular, the y-o-y CPI inflation rate moderated to 1.3 percent in the first half of this year from 2.0 percent in 2014, while the y-o-y producer price inflation rate dropped to -4.6 percent from -1.9 percent over the same period. With all that said, my authorities agree with staff that the risk of deflation in China has been contained, given the firm core price and labor cost pressures, and the ample policy space to guard against the risk.

My authorities will endeavor to foster new growth engines and upgrade traditional ones, including through building up highly efficient markets for resource allocation, enhancing the provision of public goods and services, and promoting innovation and industrial upgrading by implementing the "Internet Plus" and "Made in China 2025" strategies. My authorities will also continue to integrate China with the global economy through the implementation of the "One Belt, One Road" strategy and new free trade agreements.

Fiscal policy

My authorities have proactively provided fiscal support to counter the downward pressure facing the economy and promote inclusive growth. Spending on infrastructure investment, environmental protection, healthcare, and other social expenditure all picked up, while tax cuts and fee reductions were made to alleviate the burden on small and micro enterprises. The budget deficit in 2015 is set to rise to 2.3 percent of GDP from the actual deficit of 2.1 percent of GDP in 2014.

With the general government debt level registering about 40 percent of GDP in 2014, China's fiscal indebtedness remains manageable, particularly after taking into account the favorable interest rate-growth differential and strong government asset position. My authorities continue to caution against staff's augmented fiscal measures, given that such measures also include the debt of local government financing vehicles operating on pure commercial basis.

To harden budget constraint and safeguard fiscal sustainability and transparency, my authorities amended the Budget Law and issued new guidelines, involving: (1) promulgating the modality of local government debt issuance and repayment; (2) making it mandatory to disclose budget information; (3) fine-tuning the management of local government debt, and; (4) improving the performance assessment criteria of local governments; (5) promoting public-private partnership (PPP) in infrastructure investment¹; (6) developing an early-warning system and contingency management mechanism; and, (7) introducing a multi-year budget framework, which can reduce fiscal procyclicality.

In addition, my authorities have taken steps to improve the alignment of responsibilities between the central and local governments by enhancing the fiscal transfer system and have boosted budget efficiency. My authorities have also required both central and local governments to reduce the amount of accumulated surplus carried over from the previous years. Meanwhile, to address the funding pressures facing the local governments, my authorities launched local government debt swaps amounting to RMB 3.0 trillion—which have replaced the existing short-term and high interest rate commercial bank lending with long-term and low-cost local government bonds.

Monetary policy

China's monetary condition remains stable under a prudent monetary policy stance. Growth in M2, RMB deposits, and nonbank financing have shifted to a low gear amidst the strengthened regulation of interbank and nonbank businesses, reduced foreign exchange inflows, and ongoing structural adjustments in the economy. Against the downward pressure facing the economy, my authorities implemented a combination of both price- and quantity-based measures to ensure adequate liquidity and reasonable growth in credit and social financing, including: (1) conducting open market operations (2) lowering the benchmark lending rate and cutting the required reserve ratio; and, (3) adjusting the differentiated reserve requirement. Thanks to these efforts, funding pressures have eased, while bank lending, particularly to the rural sector and small and micro enterprises, continues to increase at a firm pace.

¹ As of May 25, 2015, 1043 PPP projects amounting to RMB 1.97 trillion had been revealed, covering areas including transportation, water conservancy, and environmental protection.

With the proposed removal of the loan-to-deposit requirement, it is expected that the banking sector can further strengthen its support to the real economy, and the stability of money market will be improved. Recognizing the merit of an interest rate corridor in the interbank market, my authorities will also continue to improve the interest rate transmission mechanism, so as to transit eventually to a policy rate that is based on interbank market operations.

The significant progress made over the years has resulted in near-full interest rate liberalization. Most interest rates had already been liberalized, and the SHIBOR has increasingly become the benchmark for pricing financial products. Membership of the self-regulatory market interest-rate pricing mechanism has expanded, while interbank issuance and trading of negotiable certificate of deposits has picked up. Marking another milestone in the liberalization process, the deposit insurance scheme and negotiable certificates of deposit for individual investors and nonfinancial corporate were launched recently. Thus, after raising consecutively the deposit rate cap to the current level of 1.5 times the benchmark rate—with anecdotal evidences suggesting that in many cases the cap is not binding—, conditions may become ripe for completely removing the cap by the end of this year, which will then finish the whole liberalization process.

Financial sector

The banking sector remains sound, thanks to strengthened capital level, stable return, and reduced cost-to-income ratio. Notwithstanding a moderate pickup in nonperforming loans, the regulator's latest stress-testing results also indicated that the sector can withstand a wide range of macrofinancial shocks—including severe credit shocks from local government financing platforms, correction in the real estate sector, and off-balance sheet exposures.

According to the FSB's latest estimate, the size of China's shadow banking system remains moderate in comparison to that in other major economies, as well as the size of the Chinese economy². The FSB's latest peer review also recognized the notable progress made in implementing the 2011 FSAP recommendations on strengthening the macroprudential framework and regulating nonbank credit intermediaries.

My authorities have endeavored to improve the governance and the operational efficiency of large commercial banks, and open up the sector for private participation with the successful establishment of five private banks. My authorities have also approved reform plans and provided funding support to the three policy banks, to strengthen their roles in providing medium and long-term financing and supporting the agricultural and external sectors.

² According to the FSB's Global Shadow Banking Monitoring Report 2014, the size of China's non-bank financial intermediation amounted to USD 3.0 trillion as at end-2013, while that of the U.S. and the U.K. amounted to USD 25.2 trillion and USD 9.3 trillion respectively. Using the more narrower measure of shadow banking, the size of China's shadow banking amounted to USD 2.7 trillion as at end-2013, while that of the U.S. and the U.K. amounted to USD 14.0 trillion and USD 4.7 trillion respectively.

It is worth noting that, with the banks' lending rate being liberalized already; banks would offer different lending rates in accordance with the credibility and risk profile of borrowers. As SOEs are generally bigger and have higher credit rating than private firms, which are mostly SMEs, the respective interest rate spreads would reflect mainly the risk premium of the borrowers—as in other countries—and would not have much to do with the ownership of the firms. As such, we strongly suggest staff to shift their analytical focus from a simplified ownership concept to shareholding system of both commercial banks and borrowers, their risk pricing and competition environment, in order to have a better description of the interest rate development in China.

Asset market

The real estate market continues to adjust in an orderly manner. Due to a buildup of inventory, the real estate market has moderated since 2014, bringing ramification to the real economy. In view of these, my authorities relaxed the mortgage policy (for second-home buyers), increased financial support to property market development, and expanded capital-gains tax exemption. As a result, signs of stabilization in the real estate market have emerged in recent months. Going forward, my authorities will continue to recalibrate real estate market policy as necessary, which, together with the ongoing urbanization and hukou reforms, will be conducive to a healthy development in the market.

Despite some turbulence recently, the development of China's stock market will continue on the back of sound macroeconomic fundamentals. Amidst the start of interest rate cuts, and rising margin financing, the Shanghai Composite Index recovered from its undervalued level of about 2000 and eventually registered an increase of about 150 percent from its level in July 2014. The subsequent warranted correction, however, is complicated by the acceleration of the unwinding process. As such, my authorities implemented a series of conventional and unconventional measures—which are in line with international practices while taking into account country-specific circumstances—to restore market confidence, prevent a disorderly unwinding of margin financing, and contain spillover. Since then, the market has stabilized, and it is expected that once the market restores fully its norm, the unconventional measures will be phased out.

The turbulence had limited systemic implication for either the real economy or the financial system, as: (1) Chinese households allocated less than 10 percent of their wealth to equities, and estimated stock market wealth effect in China was found to be small; (2) despite its rapid growth, equity financing still accounts for less than 5 percent of total social financing; (3) the total amount of money borrowed from the banking sector accounts for less than 2 percent of total banking assets.

Going forward, my authorities will further identify and reduce market failure, improve crisis response, strengthen the integration and coordination of the financial supervisory framework.

External sector

China's external position remains broadly stable amidst a volatile external environment. The current account surplus edged up to 2.8 percent of GDP in the first quarter of this year from 2.1 percent of GDP in 2014. Two-way movements in the RMB/USD exchange rate have become more frequent, after repeated steps in widening the daily floating band. More importantly, China has basically exited from its intraday interventions on the foreign exchange market. Reflecting the fundamental role of the market force in the RMB exchange rate formation mechanism, foreign reserves have moderated since the second half of 2014, amidst outflows of capitals that offset the current account surplus.

Given the sizable 35% real appreciation of the RMB since 2005, the subdued current account surplus, and emerging capital account deficit, there is little doubt that the RMB is no longer undervalued. Thus, my authorities welcome the shift in the Fund's view on the RMB's valuation. I would also encourage staff to continue to refine the External Balance Assessment methodology and recognize that the size of China's foreign reserves is broadly appropriate against a backdrop of volatile capital flows, avoiding a mechanistic application of the Fund's reserve adequacy metric.

On the capital account, 35 out of the 40 capital account items are now fully or partially convertible—according to the Fund's latest Annual Report on Exchange Arrangements and Exchange Restrictions—and it should be noted that summary indices of capital control (e.g., Chinn-Ito Index) cannot reflect the true picture of China's capital account openness, particularly since such indices do not take into consideration the continued expansion of existing channels (i.e. cross-border investor programs) and the size of actual flows.

My authorities want to point out that the capital account opening process is gaining momentum with the launch of the Shanghai-Hong Kong Stock Connect in 2014 being followed by the launch of the mutual recognition of funds between China and Hong Kong SAR, the launch of the Shanghai-Hong Kong Gold Connect, and the freer access of relevant overseas institutional investors to the onshore interbank market.

At the same time, my authorities continue to broaden channels for RMB flows, including through expanding the RMB Qualified Foreign Institutional Investor (RQFII) Program, and introducing the RMB Qualified Domestic Institutional Investor (RQDII) Program. The RMB is now the fifth most used global payment currency, the second most used currency in trade financing, and the ninth most traded currency in the world.

China has embarked on a new round of trade liberalization, China (Shanghai) Pilot Free Trade Zone (FTZ) was established in 2013, followed by the establishment of new FTZs in Guangdong, Tianjin, and Fujian. After the recent signing of bilateral trade agreements with Australia and Korea, China will continue to advance new free trade agreements and promote the multilateral trade system. On the other hand, China's overseas direct investment surpassed foreign direct investment for the first time in 2014. My authorities will continue to encourage overseas investment through implementing the "One belt, One road"³ and cooperate closely with the existing IFIs and the newly-established Silk Road Fund, Asian Infrastructure Investment Bank as well as the New Development Bank in helping address the infrastructure investment gap facing many countries.

Structural reform

Reflecting the transition to a more balanced and sustainable growth path, the tertiary sector and consumption continue to strengthen its importance in the economy, while the central and western regions continue to catch up with the eastern regions. Meanwhile, thanks to my authorities' steadfast efforts to strengthen the social safety net—including through implementing the hukou reform and the new urbanization plans announced last year—the urban-rural income inequality gap continues to narrow, while urban and rural saving rates had declined over the past two years. At the same time, the private sector continues to thrive, with the sector's shares in fixed asset investment (excluding rural household), goods exports, and bank loans to enterprises all increasing steadily over time to reach 40-50 percent in the last two years.

On the environmental front, China's forest coverage has continued to increase over the past two decades, rising from less than 13 percent of total land area in early 1980s to 22.6 percent in 2012. Carbon emission per unit of GDP has been reduced by 33.8 percent since 2005. To further contribute to the global combat against climate change, my authorities had recently pledged to cap carbon emissions by 2030 or earlier, raise the consumption share of non-fossil fuels from the current 11.2 percent to about 20 percent, and cut carbon emissions per unit of GDP by 60-65 percent from the corresponding level in 2005.

Finally, my authorities have recently started to release data on China's foreign reserves in accordance with the Special Data Dissemination Standard (SDDS). With comprehensive technical preparation, conditions are ripe to subscribe to the SDDS by the end of this year.

³ The "One belt, One road" strategy refers to the New Silk Road Economic Belt, which will link China with Europe through Central and Western Asia, and the 21st Century Maritime Silk Road, which will connect China with Southeast and South Asian countries, Africa, Europe, and even other regions.