# Assessment and recommendations

*China has weathered the global crisis remarkably well and its importance in the world economy is set to grow further*

Since the OECD's first *Economic Survey of China* in 2005, China's economy has continued to expand rapidly, driven to a large extent by the development of the private sector. Exports were hit hard by the global crisis and activity slowed down sharply over the course of 2008. However, prompt and vigorous policy actions, as well as swift adjustment in the labour market, helped growth pick up by the second quarter of 2009, putting China in the lead of the global recovery. Going forward, China's importance in the world economy is set to increase further, as are living standards within the country. In fact, China already has the world's second-largest economy in purchasing power parity terms, and is expected to shortly achieve the same rank at market exchange rates. It already has the world's second-largest manufacturing sector and is the world's largest exporter of goods. Growth will likely continue to be driven largely by investment and a trend shift out of low-productivity agriculture, as the urbanisation rate, which is approaching 50%, continues to rise. While the size of the labour force is not projected to increase much, education levels have soared since the early 1980s, which will support future productivity growth.

*Macroeconomic policy has helped limit the extent of the slowdown*

In the face of the dramatic slump in exports in late 2008, both monetary and fiscal policy levers were used in China, even more forcefully than in many OECD countries. On the monetary side, policy interest rates were cut in steps, as were required reserve ratios. Meanwhile, the gradual appreciation of the renminbi *vis-à-vis* the dollar in motion since mid-2005 was put on hold, making for a sizeable effective exchange rate depreciation. Furthermore, a number of restraints on lending, put in place when the economy was overheating, were relaxed. On the fiscal side, low public debt and a high budget surplus facilitated the introduction of a massive stimulus package. Precisely quantifying the total additional fiscal impulse is difficult as some outlays and tax reductions were already programmed, but its scale clearly dwarfed fiscal responses in many OECD countries, both in absolute and relative terms. A major portion of the stimulus is in the form of extra outlays on transport, energy and other network infrastructure, where needs remain conspicuous. Some new spending is also directed at social programmes, notably in health care, and, to some extent, at environmental protection, areas that are key to ensure sustainable growth. The central government is slated to fund only part of the stimulus

measures, with local governments, banks and state-owned enterprises financing the rest. Against this backdrop, credit soared during the first half of 2009. An important concern is that the resources thus invested generate sufficient returns down the road.

### *Imbalances remain but are being addressed*

Saving and investment have long been very high in China. In recent years, both household and government net saving have increased further, leading to a widening current account surplus, which reached double digits as a share of GDP in 2007. During the global slowdown, imports held up better than exports, not least thanks to the injection of macroeconomic stimulus. As a result, the current account surplus is projected to shrink to around 5½ of GDP by 2010 and economic growth is set to rebound back to double digits. At the same time, government saving is projected to fall, which is a welcome change. In fact, in recent years, the scale of general government budget surpluses has not been fully appreciated by most observers, not least because the social security system is not integrated into the national budget. More generally, the quality and relevance of public finance data would be improved by publishing aggregate financial data for all urban development infrastructure companies and by greater transparency in the use of funds from land use-right sales (which amounted to over 5% of GDP in 2007). Households' saving might also ease back gradually as the coverage and replacement rates of the broadly defined social safety net increase and weaken the precautionary motive. The deepening of household credit markets and population ageing might possibly work in the same direction. Other imbalances and tensions remain, such as the continued existence of inefficient capacity in some sectors of heavy industry, and severe environmental strains. On both scores, the government has recently made policy announcements, in particular regarding its intention to encourage more efficient energy use. Moving closer to market-based pricing could help create the right incentives in this area.

### *Higher levels of social spending need to be sustained*

Looking ahead at the exit from the ongoing fiscal stimulus programmes, it will be important not revert to budget surpluses. China had an enviably strong fiscal position on the eve of the global economic crisis, and this will still be the case by 2010-11, even with higher levels of public spending. To support the social reforms launched or needed in areas such as education, welfare assistance, pensions and health, the composition of government outlays will need to continue to shift towards greater investment in human capital and social transfers, with more redistribution across the country. Greater public spending on education in particular can help both to boost productivity and to reduce inequality.

### *Further modernisation of the monetary policy framework is warranted*

China's monetary policy framework has gradually moved away from a planned administrative system to a more market-based regime, with money growth as the main intermediate target. As part of this transition, some interest rates have been liberalised,

making them more responsive to market signals, and the tools of monetary policy have been modernised. The central bank now has considerable control over short-term interest rates in the interbank market and more influence over longer-term rates through the term structure. Going forward, the central bank's operational framework needs to place less emphasis on quantity-based liquidity controls and more on interest rate changes. Its benchmark commercial bank lending and deposit rates are losing relevance in the conduct of monetary policy and ought to be progressively phased out. The banking sector has also undergone significant reform and the economy has become far more responsive to market-based policy measures: investment at the firm level is more sensitive to interest rate movements and changes in aggregate demand pressures exert a stronger influence on inflation. Hence, the transmission mechanism has become more effective in China and monetary policy can play a greater role in fostering stability. However, the current exchange rate regime limits the effectiveness of this channel by preventing the value of the currency from adjusting to offset macro shocks. Allowing greater exchange rate flexibility and putting more weight on an inflation objective – while keeping a vigilant eye on asset prices – would offer the central bank more scope to tailor monetary policy to domestic macroeconomic conditions and reduce the costs and risks of sterilising foreign reserve inflows. Besides, real exchange rate appreciation is to be expected in any event over the medium run in an economy that is catching up rapidly.

### *Banking and financial market reforms need to continue*

Considerable headway has been made in implementing key financial reforms, including those reviewed in the previous *Economic Survey*. This has been facilitated by the vigorous economic expansion and, together with a limited exposure to toxic overseas assets, has enabled Chinese banks to weather the global slowdown well so far. The recent surge in lending, however, carries the risk of imprudent borrowing by local authority infrastructure companies and of a resurgence in non-performing loans. Financial institutions have broadened the scope of their activities, housing and consumer credit have expanded rapidly and new financial instruments and facilities have been introduced. The corporate governance structures and risk management systems of the commercial banks have improved. Restrictions on the trading on the exchanges of state-owned and legal-person shares have been eased and securities market institutions have been modernised. In conjunction with banks' new ability to lend for mergers and acquisitions, this could create a market for corporate control. As yet though, there have been few examples of newly tradable shares actually being traded. Efforts have also been made to improve credit access for underserved segments, notably small and medium-sized enterprises and rural China. Steps have been taken to relax controls on international capital flows, and Chinese financial institutions are becoming a growing presence in OECD and other foreign countries, although liberalisation has been slow and the foreign share of their assets remains very small.

Over the longer term, financial system development is likely to be conditioned by decisions about broader economic reforms, for instance, with respect to pensions. While State ownership is likely to continue to prevail in the financial system for the foreseeable future, the pace at which such arrangements should evolve as the private sector expands is a major issue. Raising the ceilings on foreign investment in banks and other financial

institutions would put pressure on these institutions to upgrade their governance, management and technical capabilities, and would facilitate their international expansion. It would also help in light of the general need, in the wake of the global financial crisis, to bolster bank capital and improve risk management. Although the bond market has expanded, corporate bond issuance remains relatively small. Establishing a formal deposit insurance system would help equalise competitive opportunities between larger and smaller commercial banks. Strengthening the Banking Regulatory Commission's capacity to conduct regular on-site examinations of more commercial banks would help accelerate the implementation of banking reforms.

### *Product market competition has intensified but further regulatory reform is called for*

Over three decades of liberalisation, including accession to the World Trade Organisation in 2001, China's product markets have become increasingly competitive and market forces are now generally the main determinant of price formation and economic behaviour. A competition policy framework has been established and regulation of firm entry and exit has improved. Administrative reforms have enhanced the capacity of the central government to oversee a market economy and regulation has become less reliant on microeconomic interventions and more focused on framework conditions, even though industrial policy is being stepped up in the context of the global economic crisis, in the form of ten sectoral plans. Moreover, the first vintage of the OECD's indicators of the extent of government intervention in products markets in China indicate that government intervention remains pervasive, both in absolute and relative terms, and is on a par with that in Russia. This may constrain growth more and more as the economy continues to develop. Loosening the traditional links between state-owned enterprises and the government is an ongoing challenge and one that can be best achieved by further reducing the size of the state sector, especially amongst the smaller public-sector companies. Reducing administrative burdens, making room for more private sector involvement in network sectors and lowering barriers to foreign direct investment in services would also spur competition and productivity growth going forward.

### *Major social reforms have been undertaken but safety nets remain overly fragmented*

Ensuring a sufficient degree of social cohesion and stability throughout the country has been and will remain one of the overarching and increasingly prominent objectives of public policy in China. This will improve efficiency and the prospects for robust economic growth and, in any case, is a desirable outcome of rapid economic expansion. Many ambitious reforms have therefore been launched in the social sphere in recent years and tangible progress has already been achieved. In particular, the coverage of the social safety net has broadened, although much less so for unofficial migrants, who probably represent over 40% of total employment in urban areas. However, decisive further progress will require overcoming the enduring fragmentation of the labour market and of the education, welfare, pension and health systems, which some of the recent reforms have actually accentuated. Major improvements are also needed in the administration of benefits, notably the minimum living allowance, which fails to reduce poverty as much as it could.

The needed unification of social protection arrangements should transfer responsibilities for health care and pensions from cities to provinces and then to the national level. A nationwide system should involve greater fiscal solidarity across the country, but not uniform entitlements, which should depend on local conditions and/or personal histories. This would greatly facilitate labour mobility, both from rural areas to towns and from one city to another. Substantial further migration is needed to sustain growth and urbanisation.

### *Income inequality may no longer be on the rise though geographical disparities remain acute*

Partly as a result of the various social reforms launched over the past decade, there are encouraging signs that the trend increase in nationwide income inequality may have paused in recent years. A set of new indicators suggests that it may even have receded somewhat in some respects. In particular, income disparities across provinces have tended to decline slightly in recent years, partly as a result of migration, which boosts incomes in the poorer areas via remittances and tends to raise the wages of the remaining workers. That said, geographical inequality remains very high by international standards, despite the Western Development Plan, which aims to boost the development of the sparsely populated and under-developed West. One reason for its limited success in that regard is that the bulk of the expenditure under this policy has long been focussed on large capital-intensive projects designed to bring natural resources to the coastal areas. More emphasis needs to be placed on education, especially in senior secondary schools, which would boost human capital and help reduce income differentials over time, and on the development of private entrepreneurship.

### *The labour market has been resilient over the past two years*

The labour market has proved to be remarkably resilient in the face of the economic slowdown, notwithstanding the scale of layoffs a year ago and the attendant fears of mass unemployment. Employment contracted during a few months in late 2008 and early 2009, but has since started to expand anew, albeit at a less buoyant pace. The migrants who lost their urban jobs in large numbers in late 2008 had almost all found new urban employment by mid-2009, although not necessarily in the same workplace. This turnaround, which is far swifter than in many OECD countries, reflects the bounceback in activity as well as wage moderation, in particular migrants' readiness to accept sizeable wage cuts.

### *New labour laws were introduced in 2008*

A set of new labour laws was introduced in 2008, replacing legislation from 1995 that needed to be adapted to current market realities. The objective was to better protect employees in a market that is now dominated by private-sector employers. This has involved more systematic use of labour contracts to ensure that all employers adhere to basic employee rights such as being paid on time. However, the government has underlined that the law is not meant to create life-time employment. The new law may also increase firms' costs insofar as it leads to greater compliance with minimum wage,

hours worked and social security legislation. In principle, individual employees will find it easier to have their rights recognised, even if enforcing any resulting judgement may be difficult. As in other areas, the extent to which the new legislation and implementing regulations will be enforced is of key importance. Currently, the power of labour inspectors to penalise companies is very limited. For the time being, *de facto* employment protection remains far less than *de jure*, with still a preponderance of fixed-term contracts involving few restrictions. In implementing the new laws, it will be important to avoid making open-ended contracts too rigid, which would only entrench labour market dualism.

### *Labour market segmentation hinders labour mobility and needs to be reduced*

While the restrictions associated with the registration (*hukou*) system have been eased over time, especially in the inland and western regions, they still segment the labour market, impeding geographical mobility and splitting families. In larger towns, migrants can now register as temporary residents but without the same rights as permanent ones. The government emphasises that migrant children need to receive education in towns but, in reality, a large share of migrants' children are left behind with grandparents and regulations still stipulate that university admission examinations be taken in the locality of the student's *hukou*, based on the local syllabus. The local registration system needs to be phased out to end not just the distinction between the rural and urban populations in one locality, but also the distinctions between localities and provinces. More pilot programmes ought to be initiated in major Eastern cities easing local registration and hence access to social benefits such as education, subsidised rental housing and local medical insurance on the same basis as local residents. Extra grants from central or provincial governments may be needed to that effect. Other concurrent policy changes may also be called for. In particular, realistic compensation needs to be paid to the owners of land use-rights when the latter are purchased by the government.

### *Pension reforms have addressed only part of the challenges faced by an ageing population*

China's population is ageing fast, owing to low fertility rates and rising life expectancy. With ongoing migration of the younger cohorts to urban areas, the old-age dependency ratio will rise even more in rural than in urban areas. A patchwork of pension arrangements exists across the country, with diverse and segmented systems in urban areas, belated retirement and low replacement ratios in rural areas, and special rules governing public sector pensions. This raises issues of efficiency, in that labour mobility is impeded, and fairness, to the extent that work experience in one sector is not recognised for pension purposes once the individual moves to another. Urban pensions underwent parametric reform around the turn of the millennium and again in 2005. On both occasions, benefits were reduced. Moreover, some geographical pooling has also been introduced. Nonetheless, contribution rates are low in areas that have experienced rapid population growth through migration but much higher in cities with a declining industrial base or a high share of elderly. Measures were also taken in 2005 to raise the coverage of the self-employed and those with flexible forms of employment. A new rural pension scheme was announced in mid-2009 and provisions to cover migrants have been proposed. Some

of the recent reforms have increased fragmentation, while others, notably those providing for greater geographical pooling, have not been fully implemented. Also, under current rules, effective replacement rates are fairly low and projected to decline further, both for rural and urban residents. This may be difficult to sustain, as the elderly are increasingly unlikely to live with their descendants. Furthermore, as most of the ageing population is likely to be concentrated in the countryside, much of the additional burden will be shouldered by local governments, many of which in poorer areas have insufficient resources.

*The various pension regimes need to be gradually consolidated, and the average retirement age needs to be increased*

These challenges can be addressed by gradually consolidating the various regimes, shifting more of the cost of rural pensions to the central government, pooling pension contributions nationally and increasing retirement ages. Even if different schemes for different categories of workers (employees *versus* self-employed in particular) are to persist, each should be unified geographically over time, first provincially and then nationally. In the process, the distinction between rural and urban residents ought to be phased out, in line with the recommended ending of the local population registration system. Retirement ages are currently very low and to ensure long-run pension system sustainability they should in due course be raised incrementally, at least in line with rising life expectancy, as is the case in some OECD countries. For the time being, pre-funding future government pension liabilities is not necessary, as national saving is already very high.

*Progress with health care has been genuine but incomplete*

In many respects, health outcomes in China have improved tremendously over past decades, in no small part thanks to the near eradication of some traditional infectious diseases. Overall, health outcomes are not so different from those in lower-income OECD countries such as Mexico and Turkey, despite lower incomes in China. However, health status varies widely across the country and in general death rates from chronic diseases have been on the rise, not least owing to changes in life styles, including greater tobacco consumption. Improving health outcomes will require addressing a number of imbalances and incentive problems plaguing the health care system, in a context of rapidly rising demand for care. Health care is overwhelmingly publicly provided and hospitals have been absorbing a growing share of public funding, at the expense of primary care. The number of doctors has increased rapidly but their qualification levels are often modest and their geographical distribution does not match local needs. Hospital budgets and their doctors' pay are partly based on the pharmaceuticals they prescribe and sell, the prices of which are regulated and involve considerable cross-subsidisation. Against this backdrop, household out-of-pocket medical expenses have soared. Many of these problems have long been recognised and since 2003 the government has launched several reforms to address them, notably the introduction of new urban and rural insurance schemes. As a result, coverage and use of medical facilities has increased considerably, except for migrants. Even so, both

catastrophic and chronic illnesses continue to push people into poverty, especially in the poorer regions. Given that risk pooling at the national level remains limited, it is often impossible to provide patients with the reimbursement rates they are legally entitled to.

*A set of ambitious health care reforms are being rolled out but more may still be needed*

A new set of reforms was announced in April 2009, aiming at universal, safe, affordable and effective basic health care by 2020. They involve additional spending of CNY 850 billion over 2009-11 (equivalent to 0.8% of GDP over that period). While sizeable, this represents just a down-payment on the extra spending that will be needed in the health sector over the longer haul. These reforms include investment in medical infrastructure, generalising insurance coverage, more focus on prevention, retraining less-qualified doctors, a new essential drugs system and far-reaching reorganisation, including of hospital budgets. It will be important to ensure that primary care plays a greater role in health care delivery to reduce the inappropriately high demands on hospitals for minor health problems. It will also be important that hospitals are managed more efficiently, with less hierarchical structures, and that the link between pay and prescriptions is abolished. Prices paid by the insurance system also need to reflect actual costs. Indeed, failing to address these supply-side issues would reduce the effectiveness of increasing insurance coverage, as many countries have found. Progress will also require changes in relative prices, in the form of more attractive wages for doctors, less distorted prices for pharmaceuticals and higher taxes on and prices for tobacco. Once near universal coverage is achieved, including of migrants in their place of residence rather than their place of origin, the different insurance systems should be merged and a greater portion of their funding should be shouldered by the central government.

*Continued structural reforms will help boost living standards and alleviate macroeconomic imbalances*

In sum, China has launched many reforms which are starting to bear fruit, by supporting domestic demand in the face of the global slowdown, helping to reduce internal and external macroeconomic imbalances and by restructuring China's economy. In many countries, undertaking structural reforms involves painful trade-offs between short run costs and longer-run benefits, not least because public finances do not allow such reforms to be undertaken without offsetting restrictive fiscal measures. In contrast, China is in the fortunate position to have room for continued, ambitious social reforms whose financing can help bring down an uncomfortably high national saving rate. By stepping up social expenditure even as public infrastructure investment reverts to more normal levels, China will enjoy higher living standards and greater internal social cohesion, and contribute to a more harmonious global economy.