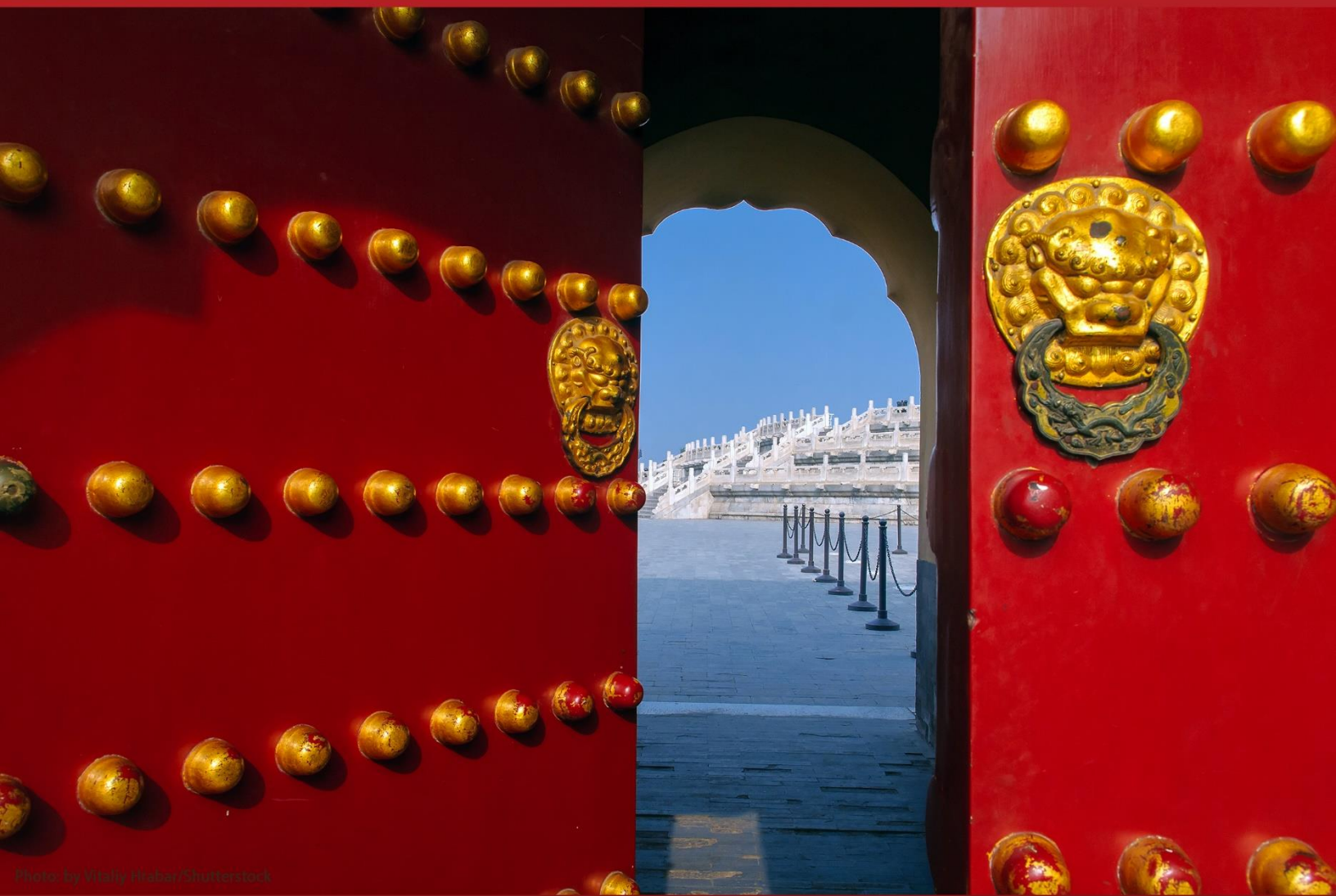


Beyond the Recovery

Charting a Green and Inclusive Growth Path



Special Topic: Extreme poverty has been eliminated.
What comes next?



WORLD BANK GROUP

China Economic Update - June 2021

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List of Abbreviations

CCB	City Commercial Bank
CDC	Center for Disease Control and Prevention
CEADS	Carbon Emission Accounts and Datasets
CEPS	China Education Panel Survey
COVID-19	Coronavirus Disease 2019
CO ₂	Carbon Dioxide
CPI	Consumer Price Index
EMDE	Emerging Market and Developing Economy
ETS	Emissions Trading Scheme
EU	European Union
FDI	Foreign Direct Investment
FX	Foreign Exchange
FYP	Five-Year Plan
GDP	Gross Domestic Product
GEP	Global Economic Prospects
GHG	Greenhouse Gas
H1	First Half Year
H2	Second Half Year
HIC	High Income Country
ICT	Information and Communications Technology
IPCC	The International Panel on Climate Change
IPE	International Petroleum Exchange
LGFV	Local Government Financing Vehicle
LMDI	Log-Mean Divisia Index
LPG	Liquefied Petroleum Gas
LPR	Loan Prime Rate
LULUCF	Land Use, Land-use Change and Forestry
MLF	Medium-term Lending Facility
MOF	Ministry of Finance
MSE	Micro and Small Enterprise
MSME	Micro, Small & Medium Enterprise
NBS	China National Bureau of Statistics
NDC	Nationally Determined Contribution
NPL	Non-performing Loan
OECD	Organization for Economic Co-operation and Development
PBOC	People's Bank of China
PIT	Personal Income Tax
POE	Private-Owned Enterprises
pp	Percent Point
PPI	Producer Price Index
PPP	Purchasing Power Parity
PSL	Pledged Supplementary Lending
q/q	Quarter-on-Quarter
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
RCB	Rural Commercial Bank

RMB	Renminbi
RRR	Reserve Requirement Ratio
sa	Seasonally Adjusted
SAFE	State Administration of Foreign Exchange
SDG	Sustainable Development Goal
SHIBOR	Shanghai Interbank Offered Rate
SLF	Standing Lending Facility
SME	Small and Medium-sized Enterprise
SML	Special Mention Loans
STRI	Services Trade Restrictiveness Index
SOE	State-Owned Enterprise
SPRF	Special-Purpose Refinancing
TMLF	Targeted Medium-Term Lending Facility
UMC	Upper-Middle Income Country
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNICEF	United Nations International Children's Emergency Fund
U.S.	The United States
USD	U.S. Dollar
VAT	Value-added Tax
WDI	World Development Indicators
WRI	World Resources Institutes
WTO	World Trade Organization
y/y	Year-on-Year
2y/2y	Two Year-on-Two Year
ytd	Year-to-Date

Executive Summary

China's economy will post strong growth in 2021. Assuming the continued suppression of COVID-19, growth is projected to reach 8.5 percent this year before slowing to 5.4 percent in 2022, as low base effects dissipate, and the economy returns to its pre-COVID trend growth. The structure of aggregate demand is expected to continue to rotate toward private domestic demand. Real consumption growth is projected to gradually return to its pre-COVID-19 trend, supported by the ongoing labor market recovery and improved consumer confidence. Investment will also remain an engine of growth, but its structure is expected to shift toward private investment as manufacturing capex improves in response to the robust external demand and stronger revenues, offsetting cooling infrastructure and property investment. Amid a stronger global recovery, robust export demand will keep industrial capacity utilization high in the short term, but the contribution of net exports to growth will moderate in the medium term as import growth picks up and international travel slowly resumes in 2022. Despite the recent surge in imported raw material prices and firming domestic demand, consumer price inflation is expected to remain below target, reflecting the limited pass-through of rising producer prices to consumer prices and the effect of pork price deflation after last year's swine fever.

Given persistent uncertainty, the authorities will need to stay agile and proactively adjust the level and composition of macroeconomic policy support. As China's recovery firms up, macroeconomic policies are expected to shift from accommodative to more neutral settings. The pace of policy normalization, however, should continue to be data-dependent and calibrated to the strength of the recovery in China and the rest of the world. Rising financial vulnerabilities, together with subdued productivity growth and persistent imbalances in the structure of aggregate demand, pose medium-term challenges that require attention. Macroeconomic policies and structural reforms should aim at reinvigorating the shift to more balanced high-quality growth. While China is on track to reach the target inoculation rate of 40 percent of the population by early summer, a full recovery will also require continued progress toward achieving wide-spread immunization. This would mitigate the risk of large-scale outbreaks while reducing case mortality rates, allowing for a gradual risk-based relaxation of remaining restrictions, including of those related to cross-border travel.

Unless inflation moves well above target and inflation expectations become unanchored, monetary policy normalization should proceed cautiously. This includes responsive liquidity support to limit increases in interbank rates if liquidity conditions change suddenly. Over the medium term, further modernization of the monetary policy framework would strengthen the effectiveness and transmission of interest-rate policies. Deposit and lending-rate guidance, as well as aggregate and specific credit targets should be relaxed further to strengthen market-based deposit and loan pricing, which will not only enhance the transmission of interest rate policy but also help improve credit allocation.

Financial stability risks associated with high corporate leverage and inflated property markets will need to be closely monitored. As corporate revenues and household incomes recover, regulators should normalize loan classification and provisioning rules, as planned, to ensure banks properly recognize non-performing loans (NPLs) and hold adequate capital and liquidity buffers. Rising corporate defaults may cause short-term financial market volatility but improve risk pricing over the long run. A strengthened corporate insolvency framework would facilitate the orderly exit of

weak or failing corporates, freeing up resources to flow to more productive uses. A comprehensive framework to deal with weak banks that are unable to meet capital requirements is also critical to allow non-viable banks to exit without triggering contagion to the wider banking system. In addition, macro-prudential measures, including stricter enforcement of existing redlines for large property developers and tighter mortgage lending standards can be deployed to curb excessive leverage and help contain macro-financial risks stemming from the real estate market.

Turning to fiscal policy, China has policy space at the central level, and policy makers should be ready to maintain fiscal support should private investment and consumption demand remain sluggish and external imbalances further increase. Focusing additional fiscal efforts on social spending and green investment rather than traditional infrastructure investment would not only help secure the recovery and bolster short-term demand but also contribute to the intended medium-term rebalancing of China's economy.

Looking beyond this year's rebound, policymakers should redouble their efforts toward promoting growth-enhancing structural reforms and steering the economy onto a greener, more resilient, and inclusive development path. Achieving higher-quality growth requires mutually reinforcing reforms: 1) more progressive taxation together with stronger social safety nets to curb high income inequality and boost consumer spending; 2) wider use of carbon pricing together with scaled-up green investment and measures to ensure a just transition to low carbon growth; and 3) an opening-up of domestic markets by further reducing the negative list for private and foreign investment together with policies to mitigate distortions in factor markets, including in the financial system to ensure all firms, regardless of ownership, compete on an equal footing. A strong effort in this direction during China's 14th Five-Year Plan (FYP) will raise productivity and incomes and lead to more balanced, consumption-driven, and environmentally sustainable growth.

China Economic Outlook	2018	2019	2020	2021f	2022f	2023f
Real GDP growth (%)	6.7	6.0	2.3	8.5	5.4	5.3
Consumer Price Index (CPI) (% change, average)	2.1	2.9	2.5	1.5	2.2	2.2
Current account balance (% of GDP)	0.2	0.7	1.9	1.4	1.1	0.9
Augmented fiscal balance (% of GDP) ^a	-3.3	-4.6	-9.0	-7.6	-7.0	-6.6

Source: World Bank.

Notes: f = forecast.

(a) World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the public finance budget, the government fund budget, the state capital management fund budget, and the social security fund budget.

Focus Chapter: Extreme Poverty Has Been Eliminated. What Comes Next?

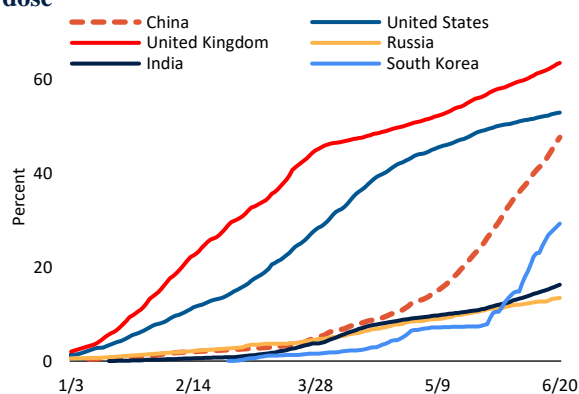
The eradication of extreme poverty in rural areas in 2020 was an important milestone, but China's poverty reduction and social agenda going forward still remains challenging. The second part of this report examines the post-2020 social challenges, proposing a set of policy priorities to tackle new forms of social deprivation and address high levels of inequality—not just in incomes but in access to public services and economic opportunities. China has adjusted its national poverty line three times over the past forty years as average incomes have grown. It may need to develop a new poverty metric once again, consistent with its current income level. Indeed, using the US\$5.50 per day poverty line calibrated by the World Bank for Upper Middle-Income countries, around 18 percent of the people in China would have been considered as poor in 2018, with around a third

residing in urban areas. This group will continue to require support, through a range of social policies, including measures to address inequalities in access to quality public services and economic opportunities. China's inequality levels in income and education remain high, and measures of socioeconomic mobility have declined since the start of reform and opening up. Closing gaps in access to high-quality public services and easing constraints on labor mobility will be key to reverse these trends. In addition, progressive tax systems can play a more active role in addressing inequality and relative poverty, as they do in Organisation for Economic Co-operation and Development (OECD) countries. Finally, better coordination of pro-poor development programs with the social protection system could help protect households from shocks, irrespective of their location.

Figure 1. The China Economic Update at a glance

Effective control of COVID-19 and the vaccine rollout have kept new cases low

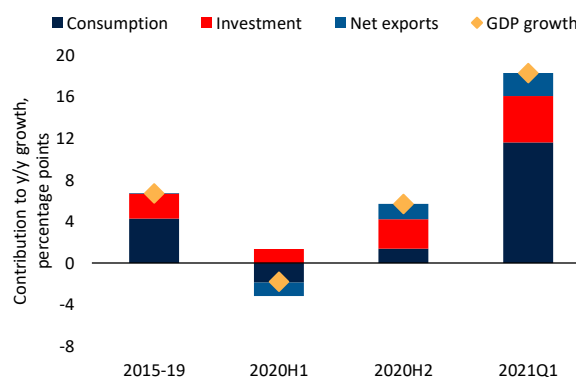
A. Share of population with at least one vaccine dose



Stronger domestic demand and higher energy prices contributed to a narrowing external surplus recently

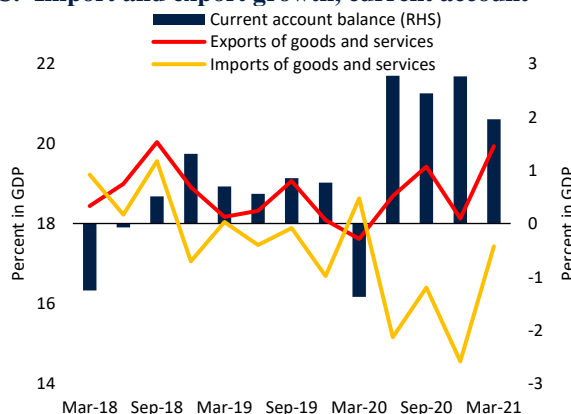
Economic activity has strengthened but masks an uneven recovery

B. GDP demand components



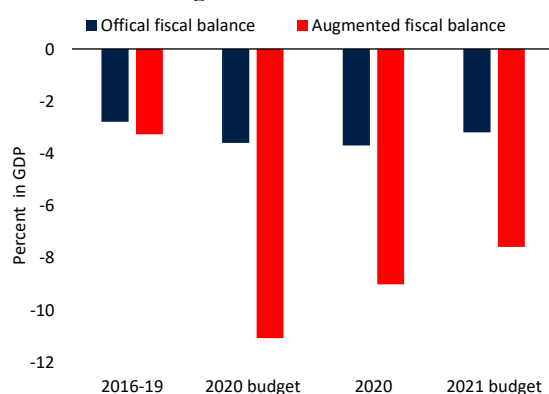
Inflation dynamics differ across PPI and CPI reflecting the uneven recovery

C. Import and export growth, current account

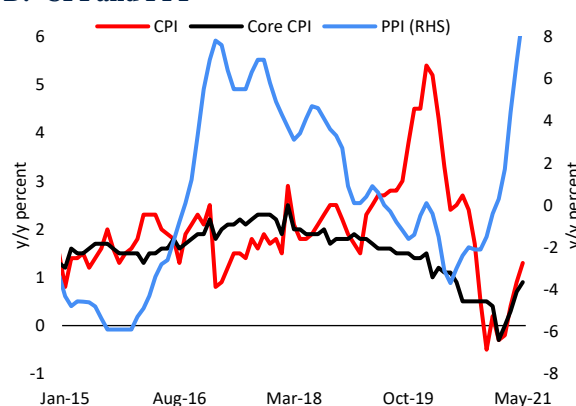


The authorities are envisaging a gradual fiscal consolidation this year

E. Official and augmented fiscal balance

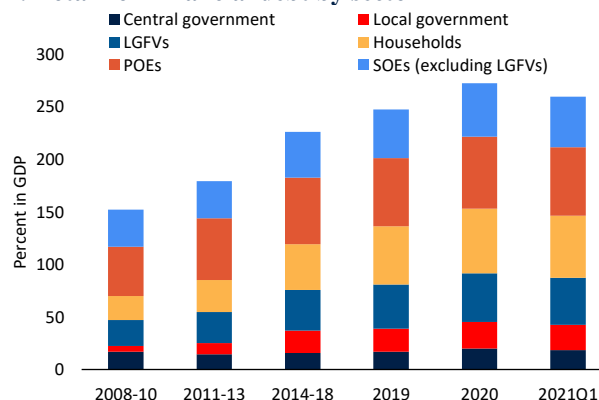


D. CPI and PPI



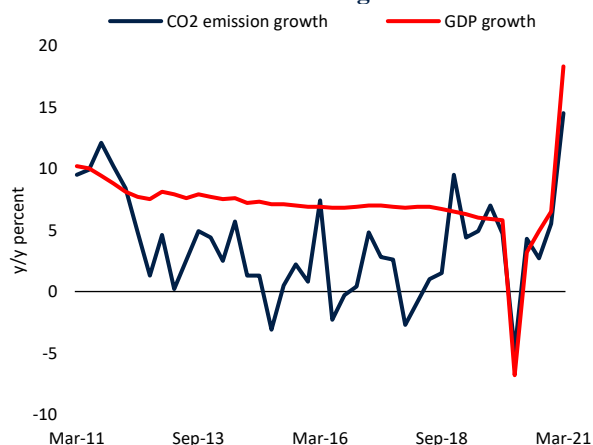
Slower credit growth and the recovery in GDP growth led to modest deleveraging

F. Total non-financial debt by sector

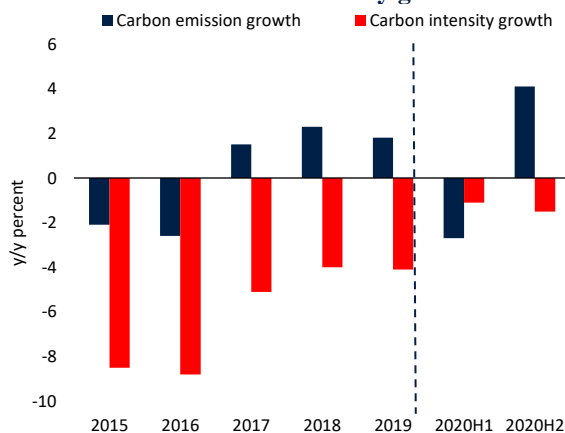


China's post-pandemic recovery has been relatively carbon-intensive

G. Carbon emissions and GDP growth

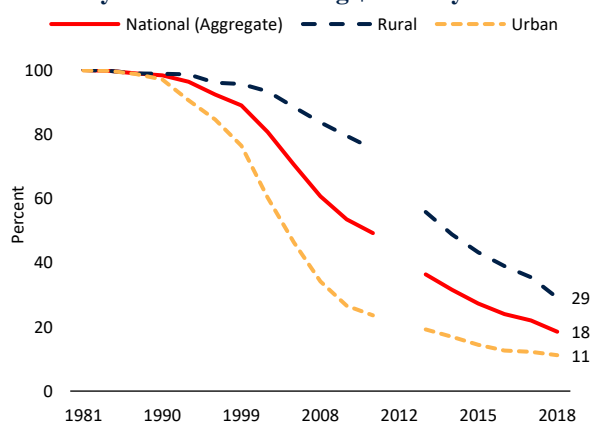


H. Carbon emissions and intensity growth

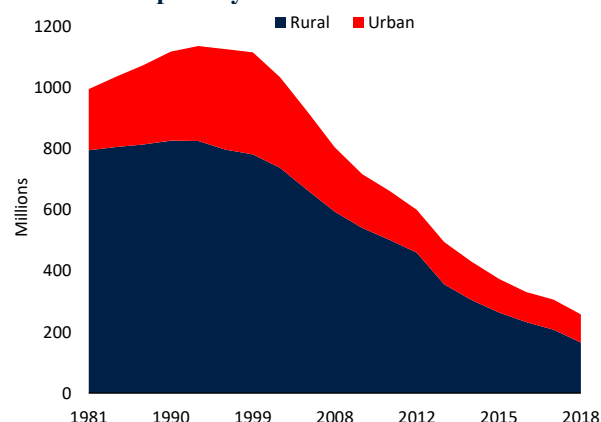


Higher poverty standards more consistent with China's current level of development suggest poverty reduction will still be important going forward, including in urban areas

I. Poverty rates in China using \$5.50/day

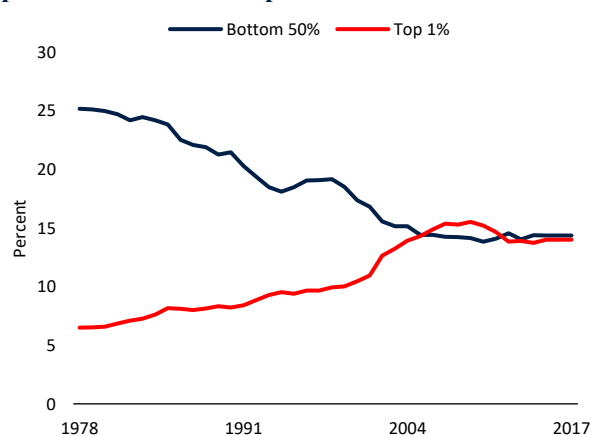


J. Number of poor by location

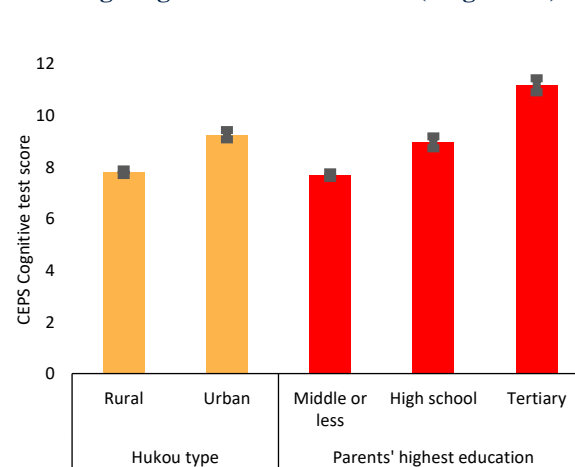


Addressing high inequality in income and education will be crucial for reducing poverty

K. Share of total pre-tax income among top 1 percent and bottom 50 percent



L. Average cognitive skills test score (9th graders)



Source: National Bureau of Statistics (NBS); People's Bank of China (PBOC); Ministry of Finance (MOF); CEIC Database; Wind Info Database; Our World in Data; PovcalNet; World Inequality Database; (Liu et al. 2020); (Wang et al. 2018); China Education Panel Survey (CEPS) 2013-14.

Note: A. Percent of population that has received at least one vaccine dose. Data for China is an estimate.

Last observation is June 2, 2021. B. Figure shows year-on-year real GDP growth and expenditure contributions. Data is based on official estimates published by the NBS. C. Trade value in U.S. dollars at current prices from the Balance of Payments (BOP) data. D. CPI=Consumer Price Index; PPI=Producer Price Index. E. The augmented fiscal balance = Public Finance Budget balance + Government Fund Budget balance + Social Security Fund and State Capital Operation Budget balance. F. Total debt is defined as a sum of domestic and external debt, including household, non-financial corporate, and public sector debt expressed as a share of GDP. Last observation is 2021Q1. LGFV= Local Government Financing Vehicle; SOE= State-Owned Enterprise; POE= Private-Owned Enterprises; G. Emissions are estimated from National Bureau of Statistics data on production of different fuels and cement, China customs data on imports and exports and Wind Information data on changes in inventories, applying the default emissions factors and annual emissions factors per tonne of cement production until 2018. H. Carbon intensity refers to carbon emissions per unit of GDP. I. Series break in 2012-13 due to changes in sampling and methodology. J. Number of poor calculated based on poverty rates in China using \$5.50/day. L. Urban-rural according to household Hukou registration, not residence.

I. Recent Economic Developments

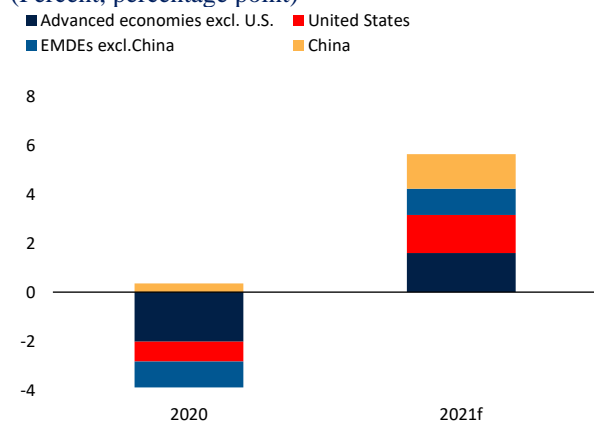
Global recovery is strong but uneven

Following a 3.5 percent contraction caused by the COVID-19 pandemic in 2020, the global recovery has gained strong momentum. Initially led by China, the global recovery has broadened to the United States, where growth received a significant boost from the substantial fiscal stimulus amid an effective vaccination program (Figure 2.A). Activity is also firming across a number of other major economies. Still, many emerging market and developing economies (EMDEs) are experiencing a more protracted recovery because of repeated COVID-19 outbreaks and slow progress with vaccination. The global rebound is supported by still accommodative global financing conditions with spreads on high-yield and investment grade corporate bonds remaining at record low levels and most sovereign borrowing costs holding steady, despite rising inflation expectations.

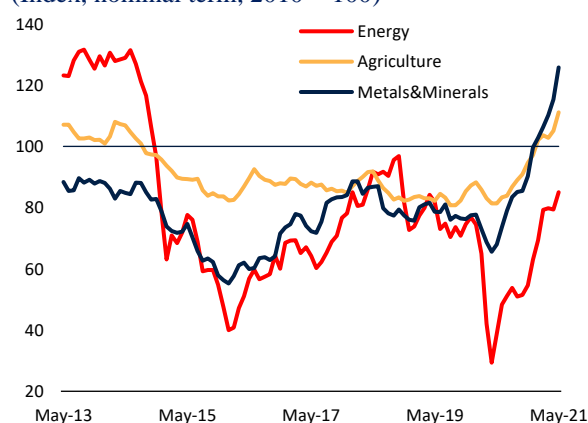
By November 2020, the global goods trade had recovered to pre-pandemic levels, while the services trade, which had been hit harder in 2020, also picked up but remains suppressed by continued travel restrictions. Global goods trade has continued to grow strongly since November of last year, notwithstanding apparent supply bottlenecks, a sharp rise in freight rates, and localized shortages of shipping containers. Commodity prices have seen a sharp increase in 2021, with many now well above their pre-pandemic levels, lifted by a gradual firming in global demand amid various supply constraints and production disruptions (Figure 2.B). Services activity—especially travel and tourism—remains soft, however, reflecting a reluctance to travel amid the lingering pandemic and uneven global vaccination progress.

Figure 2. Global economy gained significant momentum

A. Contributions to global growth
(Percent, percentage point)



B. Global commodity prices
(Index, nominal term, 2010 = 100)



Source: Haver Analytics; World Bank.

Note: In figure A, 2021f is based on the World Bank June 2021 Global Economic Prospects (GEP) forecasts.

COVID-19 continues to spread globally amid an unequal vaccine deployment. The most recent wave of COVID-19, now centered in Asia, is characterized by more transmissible and virulent strains. Vaccinations are accelerating in many advanced economies and several EMDEs,

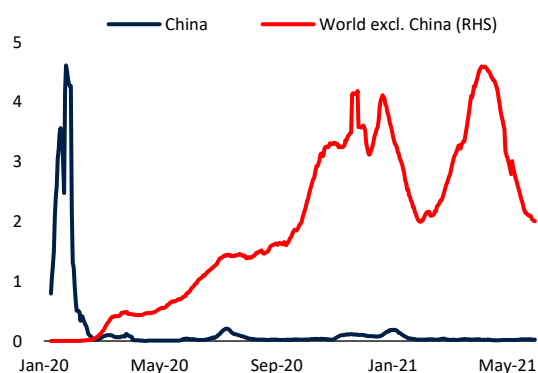
but the majority of EMDEs are lagging behind in their vaccination efforts, in part due to the limited availability of vaccines. It is estimated that about 9 percent of the global population have received at least one vaccine dose and that 85 percent of those doses have been administered in high- and upper-middle-income countries, with only 0.3 percent of doses applied in low-income economies.

China's recovery has broadened, but some imbalances remain

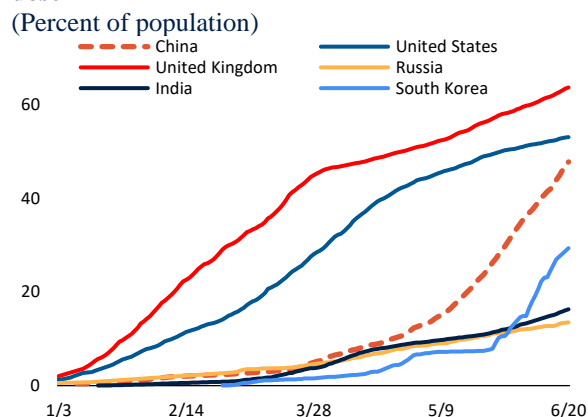
Economic activity in China has continued to normalize, supported by effective suppression of the pandemic. Notwithstanding a localized flare-up of COVID-19 cases at the start of the year, new COVID-19 infections have been quickly contained, thanks to the effective implementation of a targeted virus-control strategy involving wide-scale testing, contact-tracing, and locally targeted restrictions (Figure 3.A). As new domestic cases have fallen, the authorities have almost entirely lifted domestic mobility restrictions in most regions. China's vaccine rollout, which had a slow start earlier this year, has gathered speed in recent weeks following small local outbreaks of COVID-19 (Figure 3.B). By June 20, the share of the population that received at least one dose of the vaccine has surpassed 47 percent of the population.

Figure 3. China successfully suppressed COVID-19 but is lagging behind in vaccinations

A. New confirmed cases
(Thousand cases)

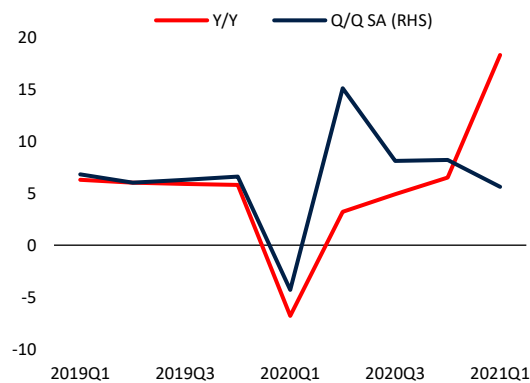
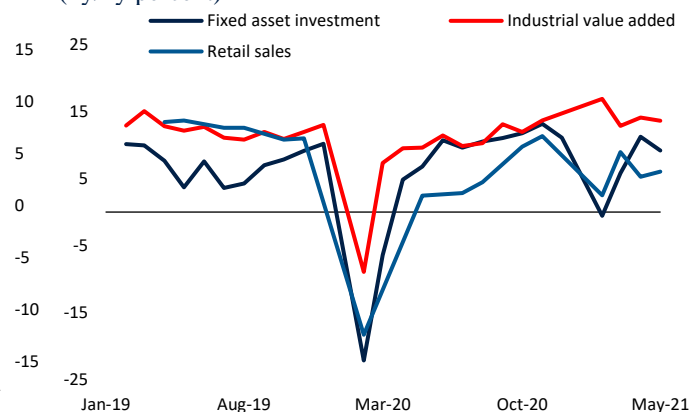


B. Share of population with at least one vaccine dose
(Percent of population)



Source: Chinese Center for Disease Control and Prevention (CDC); Wind Info Database; World Bank.

Output has surpassed its pre-pandemic level by around 7.7 percent by 2021Q1. GDP growth leapt to 18.3 percent y/y in the first quarter of 2021, following growth of 6.5 percent in the final quarter of 2020 (Figure 4.A). The large jump in growth was mainly due to a low base following the historic downturn during the first quarter last year. On a sequential basis, real GDP growth moderated to 0.6 percent in 2021Q1 from 3.2 percent in 2020Q4. The slowdown largely reflected a temporary disruption in economic activity amid renewed COVID-related mobility restrictions during the first two months of the year. Starting March, activity data have pointed to a continued but mildly slower recovery momentum (Figure 4.B).

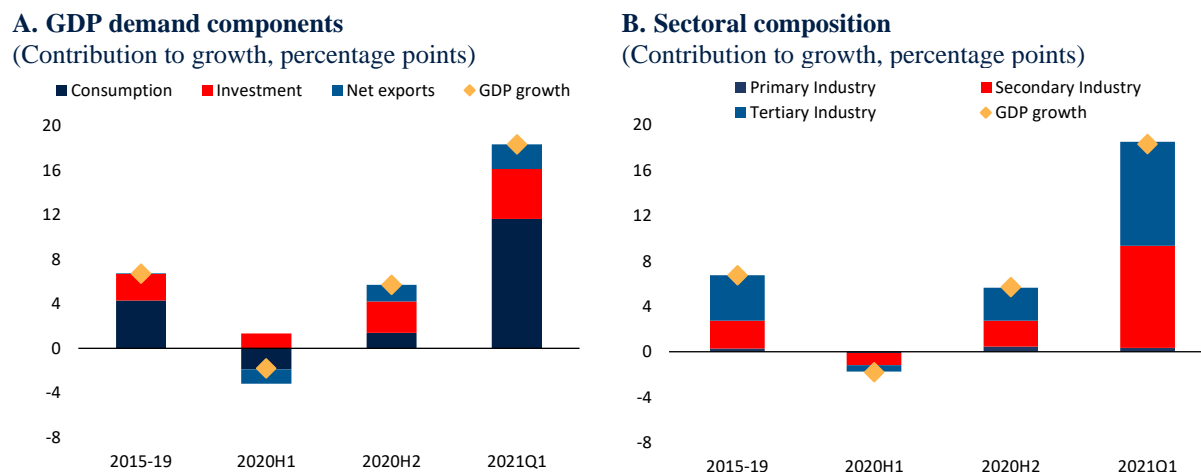
Figure 4. Economic activity continued to recover**A. Quarterly GDP growth rate**
(y/y percent; q/q sa percent)**B. Fixed asset investment, industrial value-added, and retail sales**
(2y/2y percent)

Source: NBS; World Bank.

On the demand side, there are increasing signs of a gradual rotation from investment to consumption-driven growth. Growth in gross capital formation moderated to 6.9 percent 2y/2y in the first quarter of 2021, from 12.0 percent 2y/2y the previous quarter.¹ Policy normalization, especially a slow start in special local government bond issuances, contributed to the softened investment activity in the first quarter. Infrastructure spending in particular, moderated in the first quarter after fueling much of the acceleration in investment last year, while growth in real estate investment remained robust despite regulatory tightening measures. Meanwhile, consumption has contributed about two-thirds of the rise in GDP growth, a much higher contribution than during the second half of 2020 (Figure 5.A). Improved labor market conditions, a recovery in household incomes, and improving consumer confidence have supported private consumption, which, however, remains below its pre-pandemic trend. Net exports contributed positively to growth in the first quarter amid the rebound in global demand.

On the supply side, growth in industrial production has stayed above trend, while services sector growth continued to improve but remained below its pre-pandemic trend (Figure 5.B). Growth in industry inched up to 12.5 percent 2y/2y in the first quarter from 12.1 percent 2y/2y in the previous quarter, supported primarily by robust manufacturing activity. Growth in services moderated to 9.6 percent 2y/2y in the first quarter from 14.1 percent 2y/2y in 2020Q4, mainly due to temporary cross-regional travel restrictions before the Chinese New Year. However, services growth, excluding transportation and hotel and catering, continued to improve. Outputs in the agricultural sector grew modestly by 4.6 percent 2y/2y in the first quarter.

¹ To adjust for the distortions caused by the low base in 2020, it is useful to measure growth dynamics between 2019 and 2021 (2y/2y).

Figure 5. Signs of rotation in growth drivers with previously lagging sectors catching up

Source: NBS; World Bank.

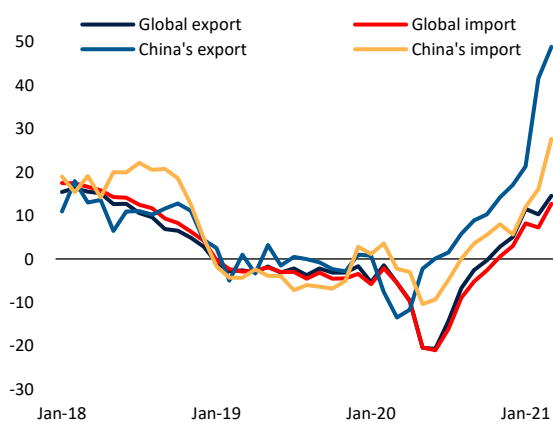
China's recovery has also been supported by robust global demand

Exports and imports of merchandise goods have maintained strong growth momentum in 2021. The U.S. dollar value of China's goods imports and exports surged by 40.0 percent and 35.2 percent y/y in the first five months of 2021 (Figure 6.A). On the back of resilient global demand, export sector activity has picked up and broadened steadily from medical supplies and electronic goods to other product groups, following the sharp contraction in the first quarter of 2020 (Figure 6.B). The rebound in exports was broad based across destination. Specifically, growth of exports to the US rose by 50 percent y/y in the first five months of 2021. Similarly, import growth, which only started to improve in the third quarter of last year, further accelerated on the back of the recovery in domestic demand and restocking of inventories, leading to increased imports of intermediate goods (Figure 6.C). The import of consumer goods also increased moderately, reflecting the gradual recovery in consumer spending. Moreover, the surge in global commodity prices, particularly crude oil and metals, raised commodity imports in value terms. China's goods trade balance continued to record a surplus of 2.9 percent of GDP in the first five months of 2021, compared to 2.0 percent of GDP during the same period last year.

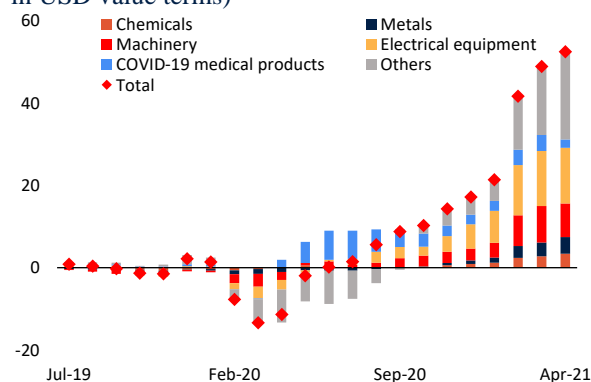
China's services trade deficit has continued to narrow, reflecting the uneven performance of services exports and imports. While China's services exports have outperformed global services exports for most of last year, services imports have been trailing global services imports (Figure 6.D). Services import growth in China, already in negative territory prior to the pandemic, decelerated further in the first half of 2020 driven by the sharp collapse in outbound travel (Figure 6.E). Conversely, China's services export growth has remained resilient, led by strong exports of transport and also ICT services, which have more than offset the drop in inbound travel (Figure 6.F). On the back of these developments, the services trade deficit has steadily narrowed to about 0.4 percent of GDP in the first four months of 2021 from 0.9 percent of GDP in the same period last year. Looking beyond these short-term trends, longer term dynamics underline the growing importance of the service trade for China's economy (Box 1).

Figure 6. Robust trade activity**A. Goods export and import growth**

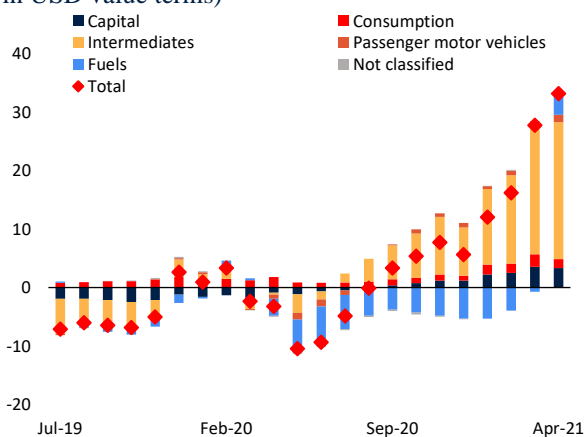
(y/y percent, 3mma; in USD value terms)

**B. Goods export growth**

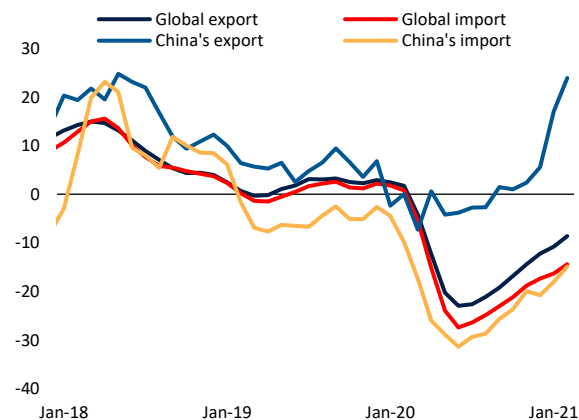
(Contribution to y/y growth, 3mma, percentage points; in USD value terms)

**C. Goods import growth**

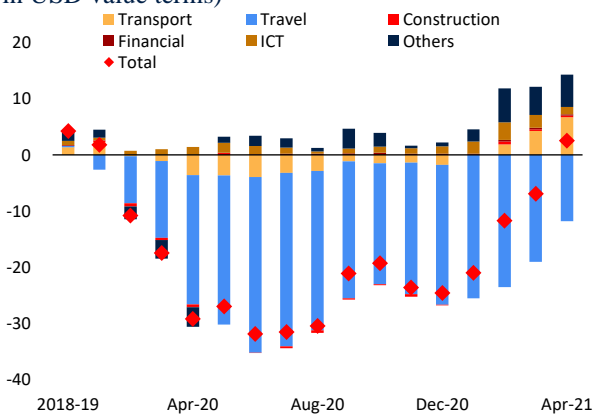
(Contribution to y/y growth, 3mma, percentage points; in USD value terms)

**D. Services exports and imports**

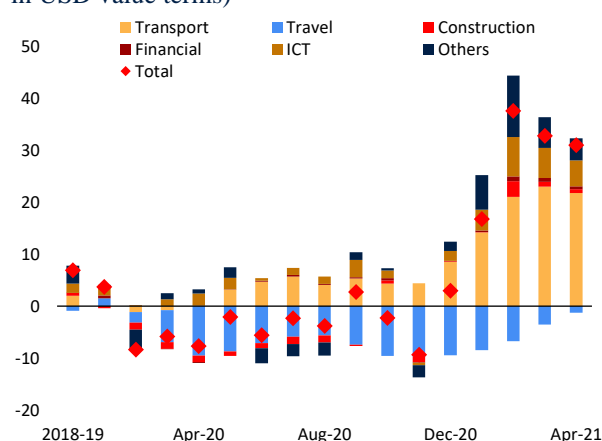
(y/y percent, 3mma; in USD value terms)

**E. Services import growth**

(Contribution to y/y growth, 3mma, percentage points; in USD value terms)

**F. Services export growth**

(Contribution to y/y growth, 3mma, percentage points; in USD value terms)



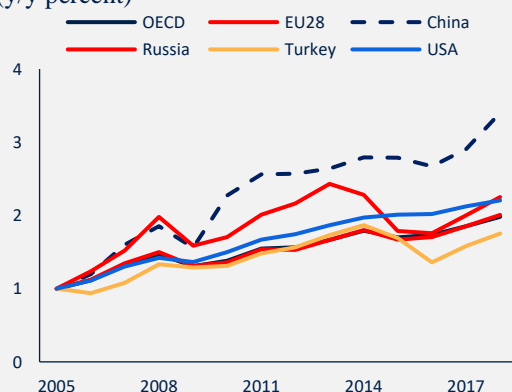
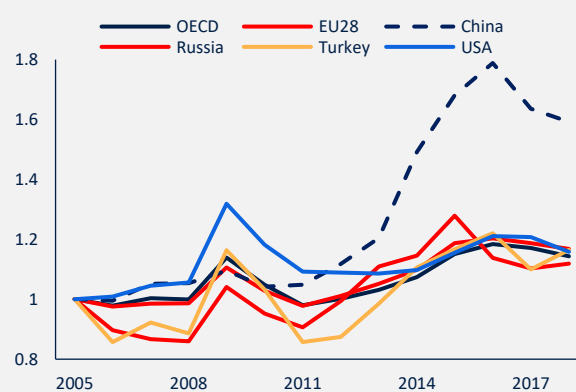
Source: World Trade Organization (WTO); State Administration of Foreign Exchange (SAFE); World Bank.

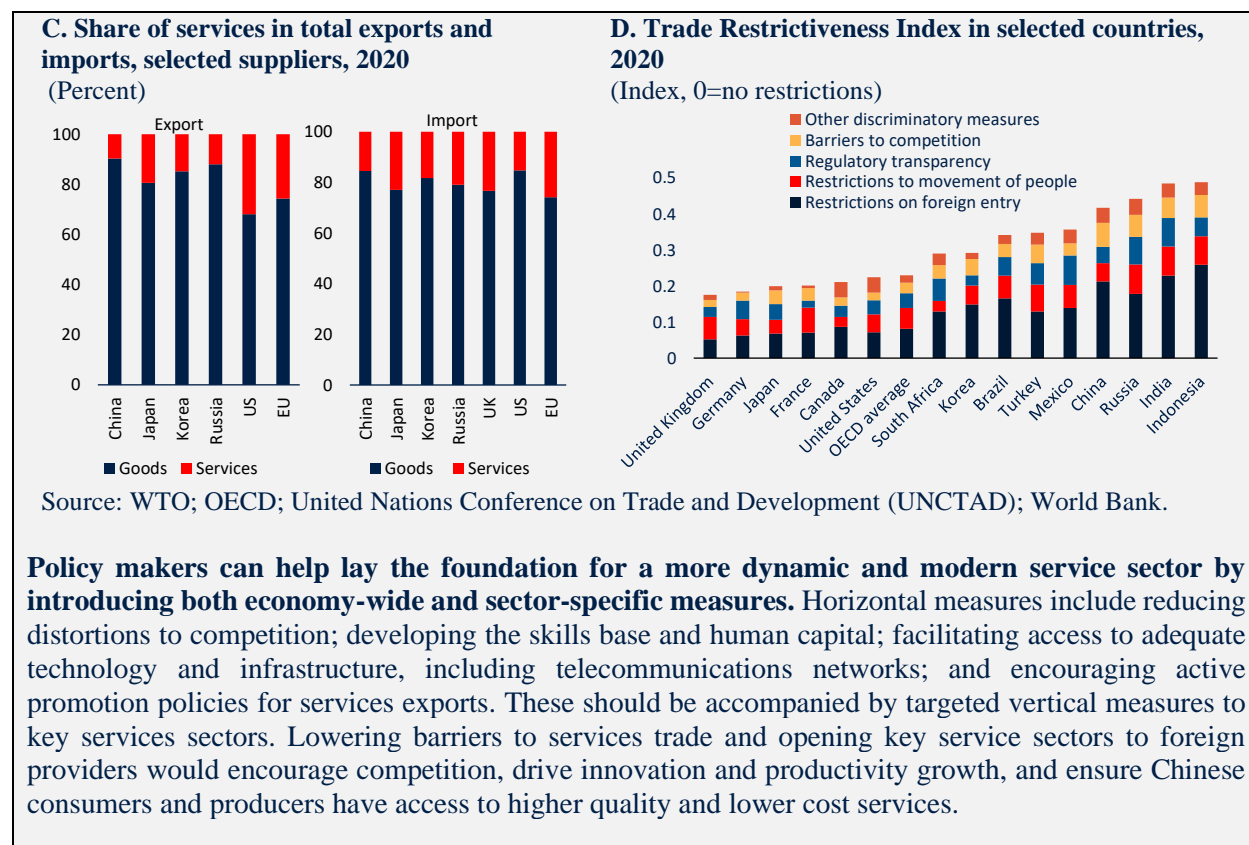
Box 1. Boosting services trade for economic growth

China's services trade integration has deepened steadily over the past two decades. China's exports of commercial services stood at \$281 billion in 2020, ranking fourth in the world (excluding intra-EU trade) and accounting for 4.6 percent of global exports. China also is the world's third-largest importer of commercial services, which reached \$497 billion in 2020, representing 8.7 percent of aggregate imports. China's ascendant services trade growth and the greater sectoral diversity of its services reflect its status as the world's leading supplier of manufactured goods and the goods-services linkages that flow from China's manufacturing prowess. Over the past decade China's commercial services exports grew more rapidly than those of comparator countries (Figure 7.A and B).

Transport and tourism services play a key role for China's services trade. As exports of merchandise goods steadily increased during the past two decades, exports of transport services have also grown rapidly to become an important driver of China's services exports. Meanwhile, exports of ICT services have gradually increased over the past decade, and picked up significantly in 2020 reflecting the larger pandemic-driven demand for information and communications technology services. Meanwhile, China's services imports are largely driven by tourism, accounting for more than 50 percent in total services imports in the years prior to the pandemic. Import of ICT services has increased in recent years, but its share in overall services imports is still less than 10 percent. Similarly, import of financial services plays only a marginal role, largely due to restrictions limiting foreign competition in services.

While the services trade has expanded, its full potential has not yet been realized due to domestic constraints. The share of services exports and imports in overall exports and imports is still relatively small compared to some advanced economies (Figure 7.C). China maintains a relatively restrictive regulatory regime for services, contributing to the sub-optimal performance of its services trade. The OECD's Services Trade Restrictiveness Index (STRI) indicates that market restrictions on China's services sector are in line with those in some other major upper-middle-income countries—such as Brazil, India, and Indonesia—but are more restrictive than those in OECD countries (Figure 7.D). This reflects high restrictions to foreign entry, barriers to competition, and restrictions on the movement of people, as well as issues of regulatory transparency and other discriminatory measures.

Figure 7. Services trade**A. Commercial services exports of leading suppliers**
(y/y percent)**B. Commercial services imports of leading suppliers**
(y/y percent)



Persistent current account surplus and larger two-way cross-border capital flows

Driven largely by a significant increase in goods imports, the current account surplus moderated in early 2021 after rising sharply in late 2020 (Figure 8.A). The surplus in the current account widened to a decade high of 1.9 percent of GDP last year from 1.1 percent of GDP in 2019. The increase reflected a surge in the goods trade surplus driven by resilient exports and a narrowing services trade deficit owing to the sharp drop in outbound tourism and travel (Figure 8.B). In the first three months of 2021, the goods trade surplus narrowed, reflecting less favorable terms of trade, driven by the sharp rise in commodity prices. Meanwhile, the services trade deficit narrowed further in the first quarter as cross-border travel restrictions remained in place. Overall, the current account surplus moderated to 2.0 percent of GDP in the first quarter from 2.7 percent of GDP the previous quarter.

Two-way cross-border capital flows increased notably in 2020, buoyed by the sustained recovery of China's economy, further opening of the domestic financial market, and relaxation of capital outflow controls. Total capital inflows, including foreign direct investment (FDI), increased to \$525 billion in 2020 compared to \$291 billion the year before. Similarly, total capital outflows amounted to \$591 billion in 2020 versus \$281 billion in 2019. Inflows, supported by the economic recovery and financial market opening, were driven equally by FDI and foreign portfolio inflows, specifically into the onshore bond market, with both categories recording net inflows. While China also witnessed some portfolio outflows, more than half of the total capital

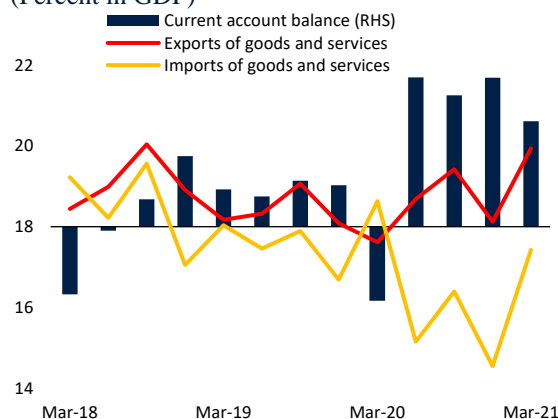
outflows reflected sharp increases in overseas deposits from Chinese banks and corporates, more lending to overseas entities, and trade-related credit (Figure 8.C). The relaxation of some capital outflow restrictions contributed to the notable increase in outflows. The overall capital and financial accounts (including net errors and omissions) recorded a deficit of 2.0 percent of GDP in 2020, widening from 1.1 percent of GDP the year before. China's external position remains strong, with Foreign Exchange (FX) reserves at \$3.2 trillion (the equivalent of around 15 months of imports) by the end of May.

Following the sharp RMB appreciation in 2020H2, the exchange rate has displayed greater fluctuations this year (Figure 8.D). After strengthening rapidly in the second half of last year, the RMB retreated temporarily in the first quarter of 2021, reflecting a moderating current account surplus as well as moderating capital inflows. In recent weeks, however, the RMB has continued to strengthen again on the back of a weaker US dollar and strong portfolio inflows. To rein in the rapid appreciation of the RMB, the authorities introduced a number of administrative measures, including an increase in the FX reserve requirement ratio for financial institutions. They have also taken multiple measures to relax restrictions on capital outflows to stem the RMB appreciation.

Figure 8. China continues to maintain a strong external position

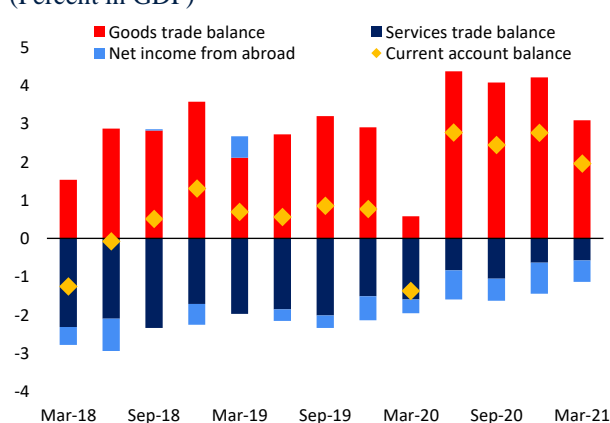
A. Current account surplus

(Percent in GDP)



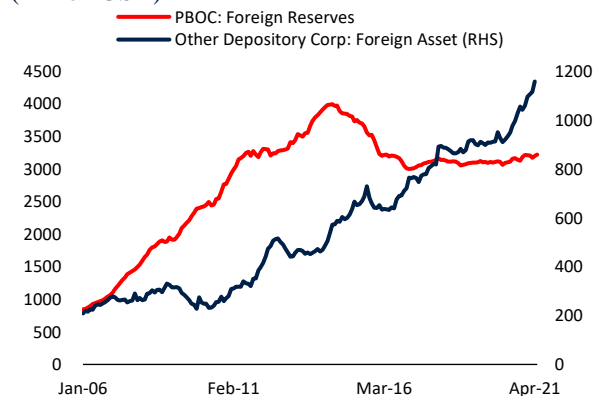
B. Current account by components

(Percent in GDP)



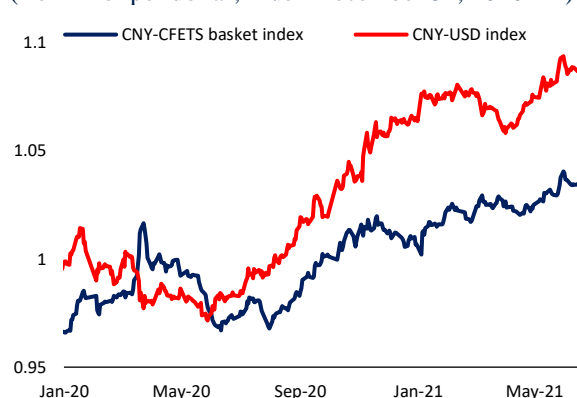
C. Foreign reserves and banks' foreign assets

(Billion USD)



D. Exchange rates

(Renminbi per dollar; Index December 31, 2016 = 1)



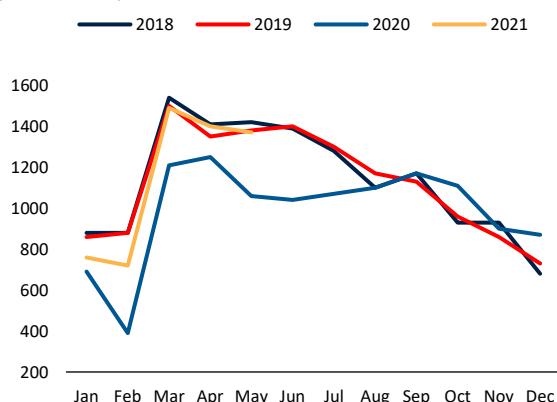
Source: SAFE; PBOC; World Bank.

Rising incomes amid improved labor market conditions

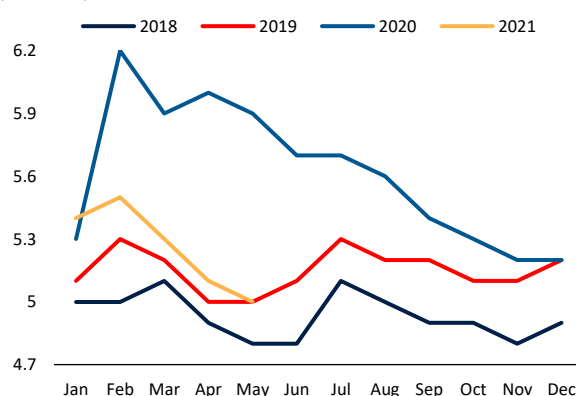
Employment conditions have improved amid the ongoing recovery, especially of labor-intensive service activities. Despite soft first-quarter output growth, almost 3 million new urban jobs were created in the first three months of 2021. This represents a significant improvement compared to 2.3 million in 2020Q1 but is still lower than the 3-3.5 million recorded during the same quarter in 2017-19 (Figure 9.A). The surveyed unemployment rate averaged at 5.4 percent in 2021Q1, lower than the 5.8 percent in 2020Q1 but higher than the first quarter of 2017-2019 (Figure 9.B). More recent data point to a steady recovery of the labor market, with new hiring already approaching the pre-pandemic level in April and the surveyed urban unemployment rate approaching the pre-pandemic level in May.

Figure 9. Improving employment conditions supported by the recovery in services activity

A. Monthly new increased urban employment (Thousands)



B. Surveyed urban unemployment rate (Percent)

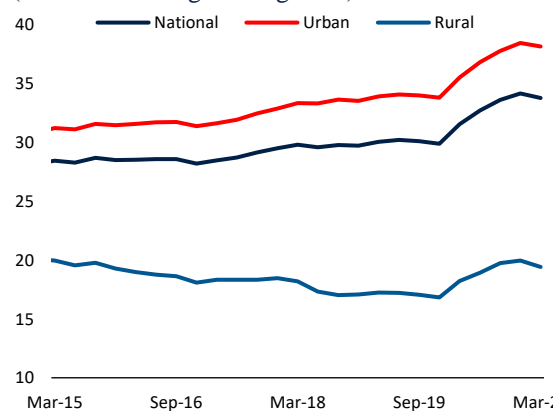


Source: NBS; World Bank.

Reflecting improved labor market conditions, household incomes continued to recover.

Income losses endured by households as a result of the COVID-19 shock have been gradually reversed. Real disposable income per capita grew by 13.7 pp y/y in 2021Q1, with faster growth among rural households. This reflects in part the low base, as incomes had fallen around 4 pp percent in 2020Q1. Still, the recovery more than compensated for the loss, resulting in a 2y/2y growth rate of 9.2 percent, which is slightly lower than GDP growth of 10.3 percent 2y/2y during this period. Wages recovered strongly as employment picked up, especially for migrant workers. Increased transfers also played a significant role among rural households, contributing to 30 percent of the rural income growth between 2019Q1 and 2021Q1 (Figure 11.A).

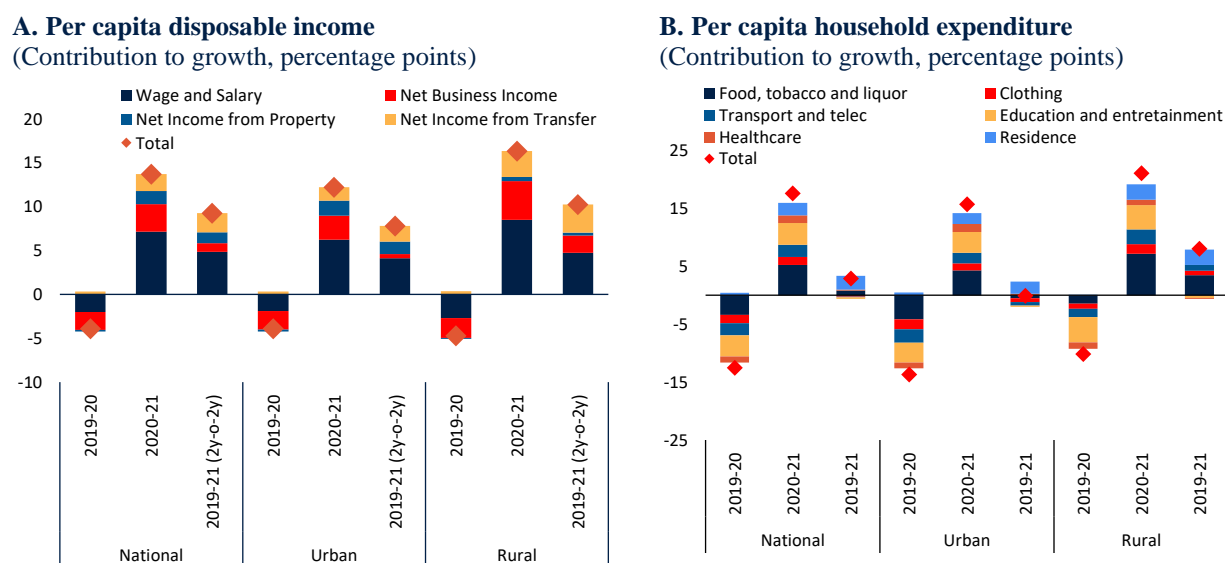
Figure 10. Savings rate has increased (12-month average saving rates)



Source: NBS; World Bank.

Household expenditures also recovered but have yet to catch up with rising disposable income. In 2020, household spending contracted even more sharply and took longer to recover than household incomes, reflecting cautionary behavior as well as restrictions on face-to-face services. In 2021Q1, household expenditure grew by 17.6 percent y/y, reversing the 12.5 fall a year earlier. Compared to 2019 levels, per capita household expenditure in 2021Q1 was 2.9 percent higher, driven by strong growth in spending among rural households. The continuous increase in food and clothing spending among rural households suggests they are no longer cutting back on essential expenditure items (Figure 11.B). Meanwhile, urban households spent less than they did two years ago in all categories, except housing. As urban incomes grew more than expenditures, the 12-month-average saving rates for urban households rose from around 34 percent in 2019 to 38 percent by March 2021, although the 2021Q1 data suggests that the trend is reversing (Figure 10).

Figure 11. Consumer spending has yet to catch up with rising disposable income



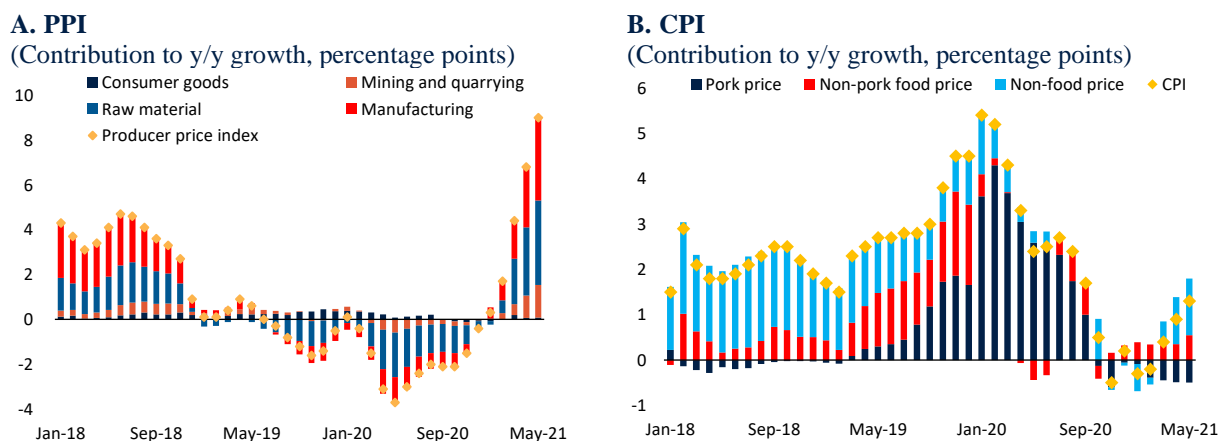
Source: NBS; World Bank.

The uneven domestic recovery has contributed to divergent consumer and producer price trends

After months of deflation, producer prices have picked up sharply this year. In a period of three months, Producer Price Index (PPI) inflation accelerated rapidly to 9.0 percent y/y in May from 0.3 percent y/y in January (Figure 12.A). The recovery in domestic demand, global price trends, supply shortages and bottlenecks in some countries and of certain goods, and sizable production cuts domestically have fueled upstream prices. These, in combination with a low base, pushed up PPI inflation sharply in recent months. In particular, raw material and mining prices have increased sharply, which could start to weigh on small- and medium-sized enterprises. The authorities have expressed concern about the rapid increase in upstream prices and are considering measures that include fine-tuning the pace of carbon-related production cuts and trying to curb speculative commodity trading.

Despite soaring producer prices, the pass-through to consumer prices has been contained (Box 2). CPI inflation has slowly crept up from deflationary territory at the end of last year to 1.3 percent y/y in May, its highest level in seven months (Figure 12.B). The increase was largely driven by higher non-food prices, especially recovering services prices, which more than offset the drop in food prices. Food price inflation fell in recent months, weighed down by lower pork prices. The drop reflected base effects from last year's price increases triggered by the African Swine Fever and the supply recovery this year. After declining last year, core inflation excluding food and energy prices edged up to 0.9 percent y/y in May, likely reflecting the impact of firming domestic demand.

Figure 12. Inflation dynamics differ across PPI and CPI



Source: NBS; World Bank.

Box 2. Inflation risks in China

China's inflation pressure is rising, with both CPI and PPI inflation picking up this year. This box takes a closer look at inflation dynamics in China, specifically at the interaction between PPI and CPI inflation.

Traditionally, fluctuations in CPI inflation have been largely driven by food price dynamics, especially pork prices (Figure 13.A). Food prices account for about 30 percent of China's CPI basket. As the largest contributor to food price fluctuations, pork prices are highly volatile and have their own idiosyncratic inflation dynamics, mainly caused by the mismatch between demand and supply. Pork prices surged last year after the outbreak of the swine fever. Since then, however, record imports and the recovery in domestic production have driven down pork prices, which in turn lowered headline CPI inflation. Meanwhile, fluctuations in commodity prices, which only account for a small share in the CPI basket, have less of an impact on headline inflation. For example, a 10 percent upside shock to global oil prices translates to only 0.2 percentage points in extra CPI inflation.

Meanwhile, PPI inflation is mostly driven by commodity and industrial prices (Figure 13.B). PPI dynamics are typically dominated by developments in upstream industries (Chen L, et al. 2018). The recent rise in oil and non-oil commodity prices can explain about 75 percent of the increase in PPI inflation. China's PPI is most sensitive to commodity prices, especially oil prices (Figure 13.C). A simple correlation analysis suggests that a 10 percent upside shock to global oil prices would increase PPI inflation by 0.9 percentage points.

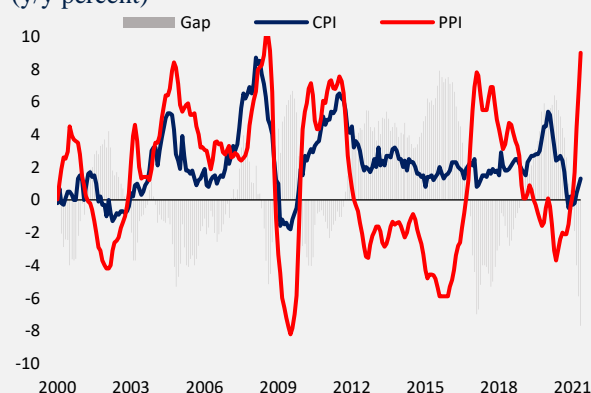
Historically, the transmission from PPI to CPI has been limited. The pass-through ratio from PPI to CPI is estimated at around 25 percent, suggesting that the spillover from upstream to downstream sectors appears relatively small (Figure 13.D). During the past reflation cycle in 2016-17, the inflationary pass-through was relatively sluggish. High upstream inflation partially translated into faster inflation in intermediate goods but was barely visible in downstream consumer goods other than food. Based on a simple correlation, we find that competitive downstream sectors (e.g., textile) and highly regulated sectors (e.g., utilities) tend to accept a squeeze in profit margins when upstream inflation is on the rise. One explanation could be that the downstream industries are more fragmented and face more intense price competition.

To sum up, upside risks to China's consumer inflation seem limited at this point, due to the sluggish inflation pass-through from upstream to downstream sectors. Continued reforms that address supply constraints, improve resource allocation, and strengthen domestic competition will help to contain inflationary pressures.

Figure 13. Consumer and producer price inflation

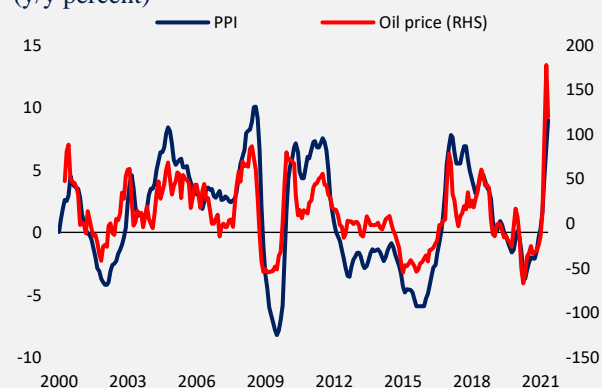
A. Gap between CPI and PPI

(y/y percent)



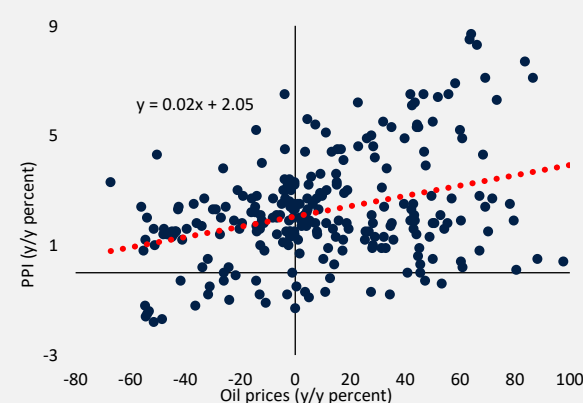
B. PPI and oil prices

(y/y percent)



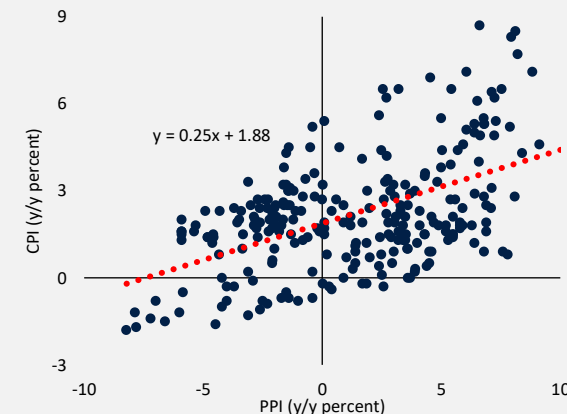
C. Correlation between year-on-year oil price and CPI changes

(y/y percent)



D. Correlation between year-on-year PPI and CPI changes

(y/y percent)

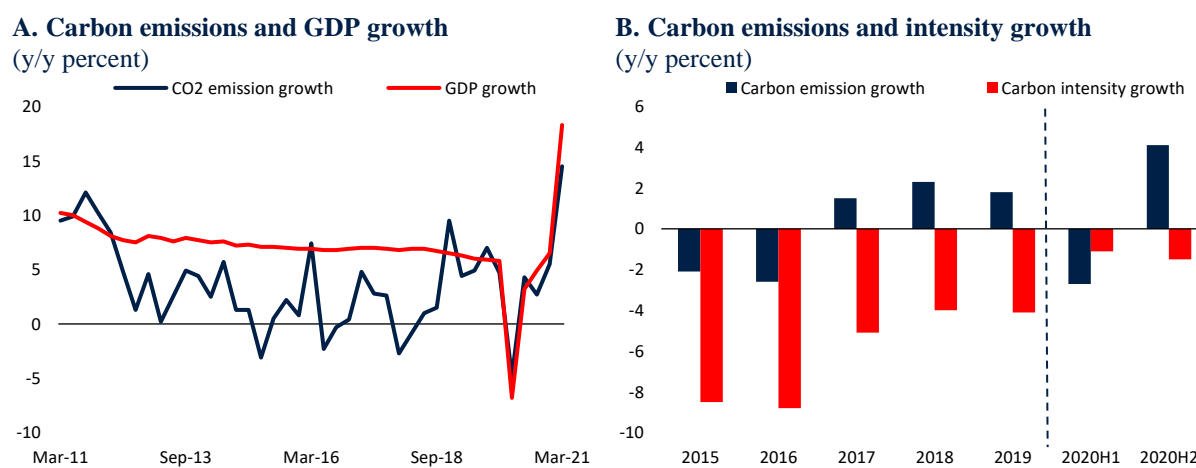


Source: NBS; International Petroleum Exchange (IPE); World Bank.

China's industry and investment-led recovery has been relatively carbon-intensive

China's post-pandemic recovery has been relatively carbon-intensive. While the COVID-19 pandemic caused a 2.7 percent y/y dip in China's carbon emissions in the first half of 2020, the latter half of the year witnessed a 4.1 percent y/y surge in emissions, pushing annual growth of carbon emissions last year to 1.5 percent y/y above the 2019 level (Figure 14.A). Much of this increase was caused by the strong industry and investment-driven growth rebound, as the economy relied heavily on the energy and carbon-intensive sectors to offset weakness elsewhere (Figure 14.B). This pattern is particularly distinct in steel production, which increased by nearly 10 percent y/y in 2020, four times the rate of GDP growth. As a result of this recovery pattern the decline in carbon intensity slowed in 2020, compared to China's long-term trend in reducing carbon intensity (Figure 14.B; Box 3). With a broader and more balanced recovery, especially the catch-up from the services sector, reductions in carbon intensity are likely to have regained momentum in the first half of 2021.

Figure 14. China's post-pandemic recovery has been relatively carbon-intensive



Source: NBS; World Bank.

Note: In figure A, emissions are estimated from National Bureau of Statistics data on production of different fuels and cement, China Customs data on imports and exports and Wind Information data on changes in inventories, applying default emissions factors of the International Panel on Climate Change (IPCC) and annual emissions factors per tonne of cement production until 2018. In figure B, carbon intensity refers to carbon emissions per unit of GDP.

Box 3. The slowdown in China's long-term carbon emission growth

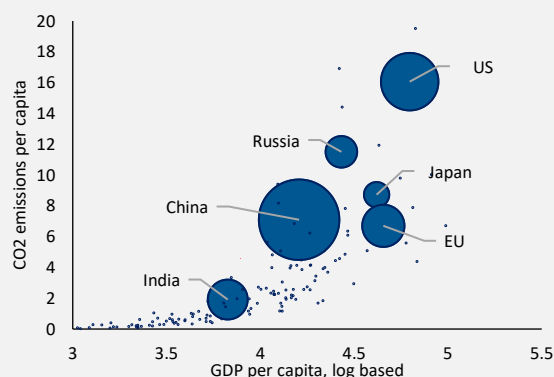
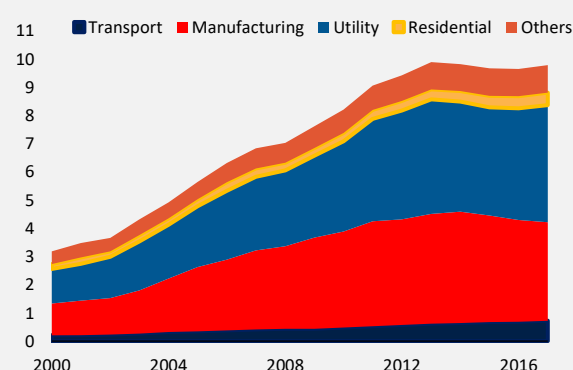
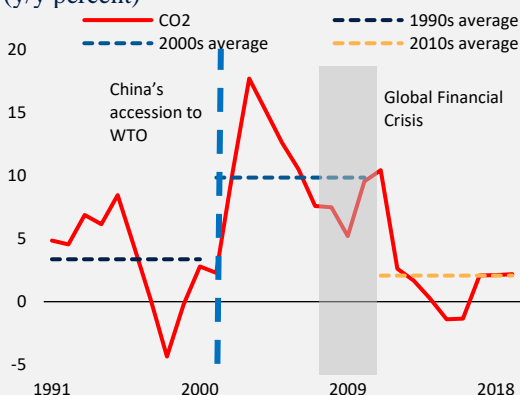
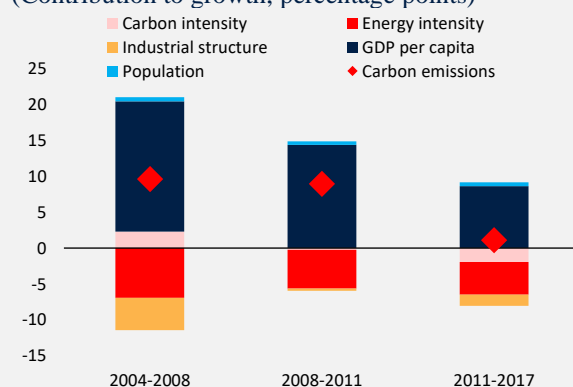
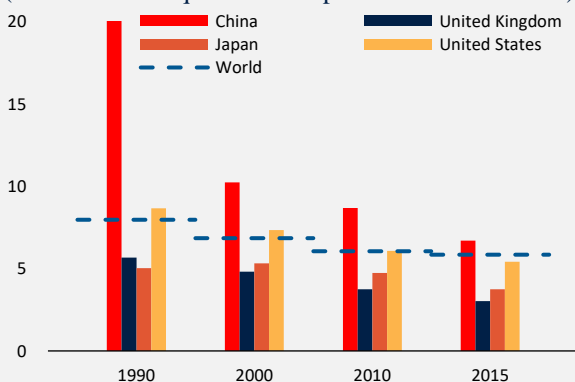
China is by far the largest emitter of carbon dioxide (CO₂), with its per capita emissions of CO₂s now surpassing those of the European Union (EU) (Figure 15.A). After accessing the WTO, China's growth model relied predominantly on fossil-fuel infrastructure, manufacturing, and construction activities, all of which require large energy inputs and produce high carbon emissions. More recently, the utilities sector has become the largest contributor to carbon emissions (Figure 15.B).

China's carbon emission has generally slowed in the recent decade. The growth of China's carbon emissions dropped from an average of 9.4 percent y/y in the 2000s to an average of 1.1 percent y/y in the 2010s (Figure 15.C). Several factors have driven the moderation in China's carbon emission growth in the recent decade (Figure 15.D)²:

- **The deceleration is closely linked to the slowdown in economic growth and changes in the industrial structure.** After rapid industrialization in the past three decades, China has moved toward a more service- and consumption-based economy. The share of industrial value added fell from a peak of 42 percent in 2006 to 32 percent in 2019.
- **The continuous improvement in energy intensity steadily brought about reductions in carbon emissions.** The economy's energy intensity decreased by 45 percent in 2017 compared to the 2005 level (Figure 15.E), three years ahead of the government's target,³ due to a sharp decline in the energy intensity of the manufacturing sector (Figure 15.F).
- **Carbon intensity, which used to drive increases in carbon emissions, has gradually become an important factor in reducing emissions.** China has a much more coal-dominated energy structure compared with advanced economies. As the main source of carbon emissions, coal consumption still accounted for 56.8 percent of total energy consumption in 2020, albeit dropping significantly from 76 percent in 1990. Accordingly, coal's share in total carbon emissions also declined from 82 percent in 1990 to 71 percent in 2019. In addition, 990 gigawatts of non-fossil energy electric power generation capacity had been installed in China as of 2020, accounting for 45 percent of total power generation capacity.
- **The increase in population has had a limited effect on carbon emission growth.** Estimates suggest that changes in carbon emissions are much less sensitive to population than other driving factors (Figure 15.D). Moreover, the population growth rate has already been declining in China due to low fertility rates under the "one-child policy".

² We improved the well-known equation—Kaya Identity (Kaya, 1997)—to analyze the driving factors of carbon emissions. First, total carbon emissions are determined by population and per capita emissions. Second, per capita emissions are determined by per capita GDP (or per capita income), as richer people tend to emit more due to high standards of living, and the amount of CO₂ emissions produced per unit of GDP. Third, the energy intensity (the amount of energy consumed per unit of GDP) and carbon intensity (the amount of CO₂ emitted per unit of energy consumption) jointly determine CO₂ emissions per unit of GDP. Last, the energy intensity of different sectors of the economy varies greatly. Thus, improving energy efficiency through technology or management innovation and industrial structure transformation—away from energy-intensive sectors—can both help reduce energy intensity.

³ In 2009, the Chinese government pledged to reduce the carbon emissions per unit of GDP by 40 to 45 percent in 2020 compared to the 2005 level.

Figure 15. China's carbon emissions**A. Per capita GDP and CO2 emissions**
(2017 international dollar; thousand ton)**B. CO2 emissions by sector**
(Billion ton)**C. China's CO2 emission growth**
(y/y percent)**D. Contribution to carbon emission growth**
(Contribution to growth, percentage points)**E. Energy intensity by country**
(Standard coal equivalent ton per million RMB GDP)**F. Energy intensity by sector**
(Standard coal equivalent ton per million RMB GDP)

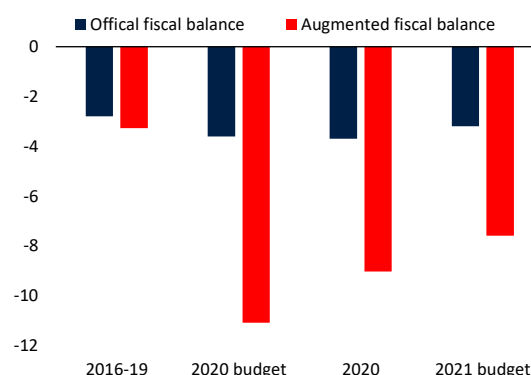
Source: World Development Indicators (WDI); Global Carbon Project; World Resources Institutes (WRI); Carbon Emission Accounts and Datasets (CEADS); NBS; China Statistical Yearbook on Environment 2019; World Bank.

Note: In figure A, the bubble size represents the amount of carbon emissions for the largest six emitters. In figure B, others include agriculture, mining, construction, retail and wholesale trade, hotel and catering services, and other services sectors. In figure D, we use the time series decomposition method Log-Mean Divisia Index (LMDI) (Ang et al., 2001; Ang, 2015) to analyze the change of carbon emissions from nine sectors of the Chinese economy over the period 2004-2017, following (Lu et al. 2013). In figure F, others include agriculture, construction, retail and wholesale trade, hotel and catering services, and other services sectors.

Gradual normalization of fiscal policy

In the context of the robust economic recovery, the authorities are envisaging a gradual fiscal consolidation this year (Figure 16). The government announced it would lower its headline deficit target to 3.2 percent of GDP in 2021, compared with 3.6 percent set for 2020. The augmented fiscal deficit, which, in addition to the headline budget, also includes several extra-budgetary accounts, has been set to 7.6 percent of GDP this year compared to an actual outturn of 9.0 percent (versus a target of 11.1 percent) last year (Table 1). In terms of specific measures, the government phased out the waiver and deferral of corporate social insurance contributions introduced in 2020 to support the economy. In addition, the government halted the issuance of special national bonds aimed at mitigating the COVID-19 shock. It also reduced the local government special bond quota issued to finance infrastructure and shantytown investment to RMB 3.65 trillion compared to RMB 3.75 trillion last year (a decline of 0.1 percent of GDP). The relatively modest adjustment in fiscal targets highlights the government's focus on using fiscal policy as a hedge against remaining downside risks to growth.

Figure 16. Fiscal tightening
(Percent in GDP)



Source: MOF; World Bank

Table 1. Government finances

(RMB billion unless otherwise noted)	2018	2019	2020 Budget	2020	2021 Budget
Public Finance Budget					
Revenues	19,813	21,259	21,025	20,903	21,442
Central government	8,546	8,931	8,277	8,277	8,945
Local government (excludes transfers from central budget)	9,790	10,108	9,750	10,012	10,820
Withdrawal from Stabilization Fund	1,477	2,220	2,998	2,613	1,677
Expenditures	22,193	24,019	24,785	24,663	25,012
Central government (excludes transfers to local governments)	3,271	3,512	3,504	3,510	3,502
Local government	18,820	20,374	21,232	21,049	21,461
Contribution to Stabilization Fund	102	133	50	104	50
Public Finance Budget balance	-2,180	-2,760	-3,760	-3,760	-3,570
Public Finance Budget balance (% of GDP)	-2.6	-2.8	-3.6	-3.7	-3.2
Government Fund Budget balance	-516	-714	-4,468	-2,451	-3,674
Social Security Fund Budget balance	1,162	841	-500	-672	277
State Capital Operation Budget balance	75	168	102	223	123
Augmented fiscal balance*	-3,033	-4,552	-11,573	-9,169	-8,471
Augmented fiscal balance (% of GDP)	-3.3	-4.6	-11.1	-9.0	-7.6
Memo: Nominal GDP**	91,982	98,652	104,444	101,599	111,563

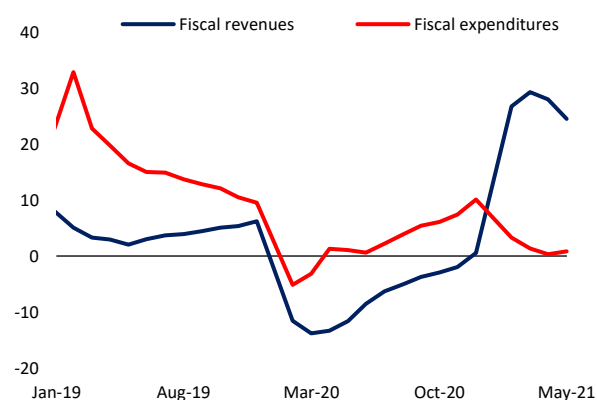
Source: MOF; NBS; World Bank.

Note: * The augmented fiscal balance = Public Finance Budget balance + Government Fund Budget balance + Social Security Fund and State Capital Operation Budget balance; ** Implied nominal GDP forecast from the Public Finance Budget target for 2020-2021.

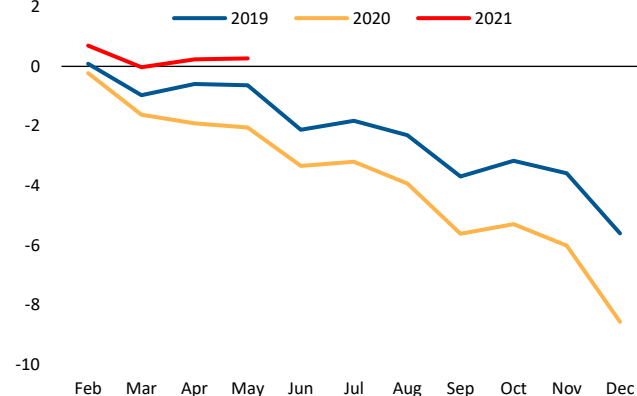
In the first five months of 2021, the fiscal deficit narrowed on the back of buoyant revenue growth. Fiscal revenues increased by 24.5 percent y/y in the first five months of 2021 due to a low base, ongoing economic recovery, and the rollback of most tax exemptions introduced last year in response to the initial outbreak of COVID-19. Fiscal expenditures increased by a much more modest 0.8 percent y/y during the same period, reflecting the high base in the early months of last year when China had ramped up spending to combat the pandemic (Figure 17.A). As revenue growth outpaced expenditure growth, the budget registered a surplus of 0.3 percent of GDP in the first five months of 2021, compared to a deficit of 2.0 percent of GDP during the same period last year (Figure 17.B). As the pace of government bond issuance slowed, net financing decelerated to 1.0 percent of GDP compared to 3.3 percent of GDP during the same period last year.

Figure 17. Fiscal deficit narrowed

A. Growth in fiscal revenues and expenditures
(y/y percent, ytd)



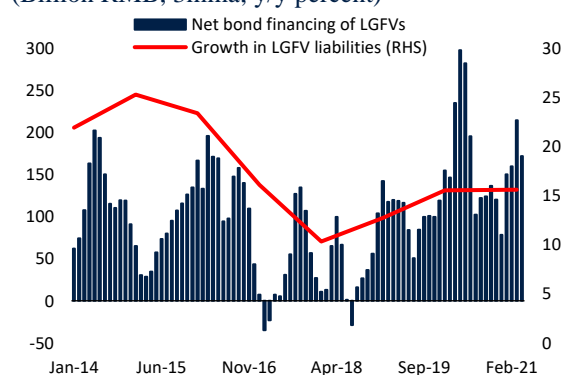
B. Augmented Fiscal deficit
(Percent in GDP)



Sources: NBS; MOF; World Bank.

Central government authorities have also reiterated their calls to curtail fiscal risks associated with off-budget borrowing at the local government level. Off-budget borrowing, in the form of a new LGFV bond issuance, rose from 1.3 percent of GDP in 2019 to 1.9 percent of GDP in 2020 and climbed further in 2021Q1. Accordingly, the liabilities of LGFVs that have issued bonds accelerated to 15.6 percent y/y in 2021Q1 from 12.7 percent y/y in 2019 (Figure 18). Concerned with the increase in leverage, the authorities signaled a more conservative approach to off-budget local government financing and issued new guidance in March 2021, which strictly prohibits local governments from accumulating “hidden” local government debt. Meanwhile, financial institutions are urged to exercise prudence in lending to government-related entities. If these measures are successfully implemented, overall fiscal policy, both on- and off-budget, could be less expansionary than in 2020.

Figure 18. LGFV financing has accelerated
(Billion RMB, 3mma; y/y percent)

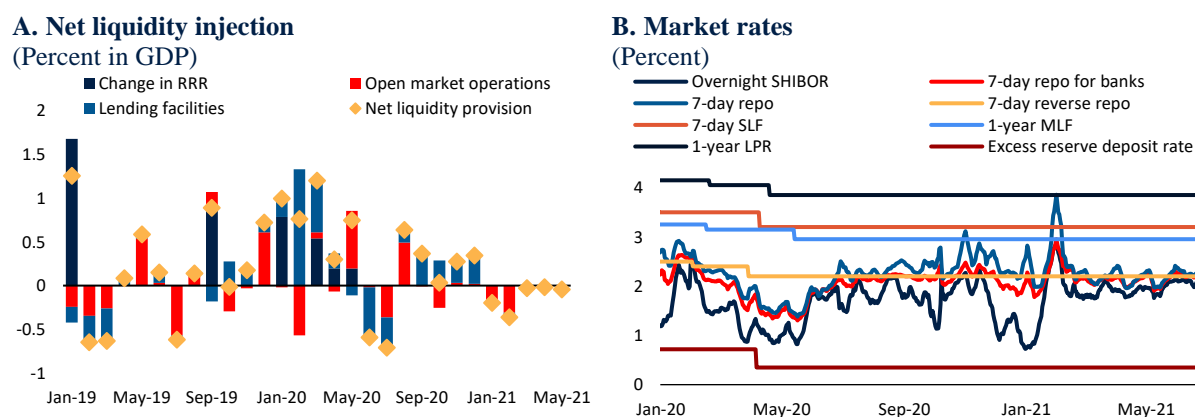


Source: MOF; Wind Info Database; World Bank.

Credit growth has moderated

The People's Bank of China (PBOC) has maintained a neutral monetary policy stance by keeping liquidity conditions broadly steady. The authorities have rolled back a significant part of the lending facilities adopted to provide targeted support in the context of the COVID shock (Figure 19.A). In addition, the PBOC has used open market operations this year for liquidity management while keeping its key benchmark lending rates on hold for 12 consecutive months (Figure 19.B). Market interest rates have consequently remained largely flat this year, signaling stable domestic financing conditions.

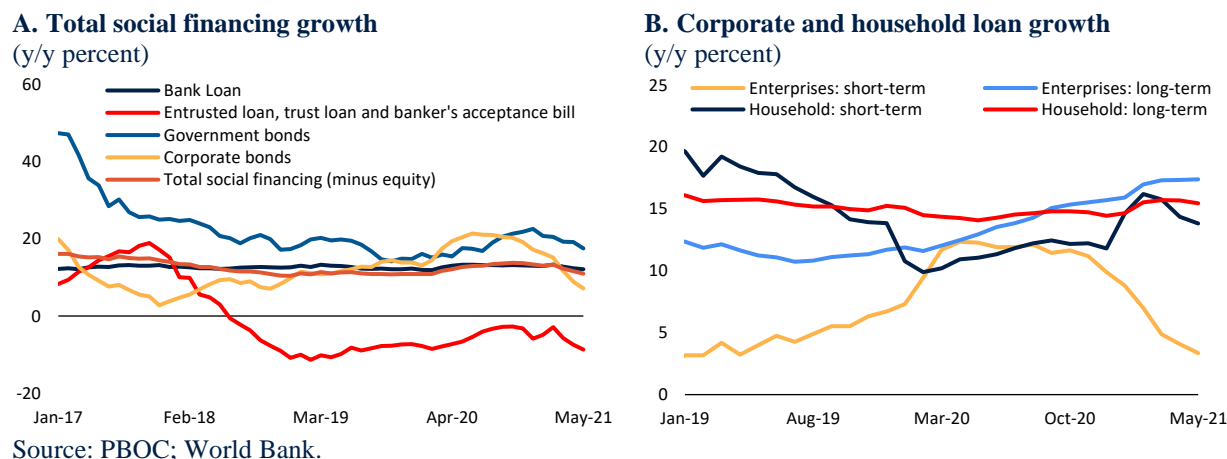
Figure 19. Despite some liquidity withdrawal, market rates have remained broadly stable



Source: PBOC; World Bank.

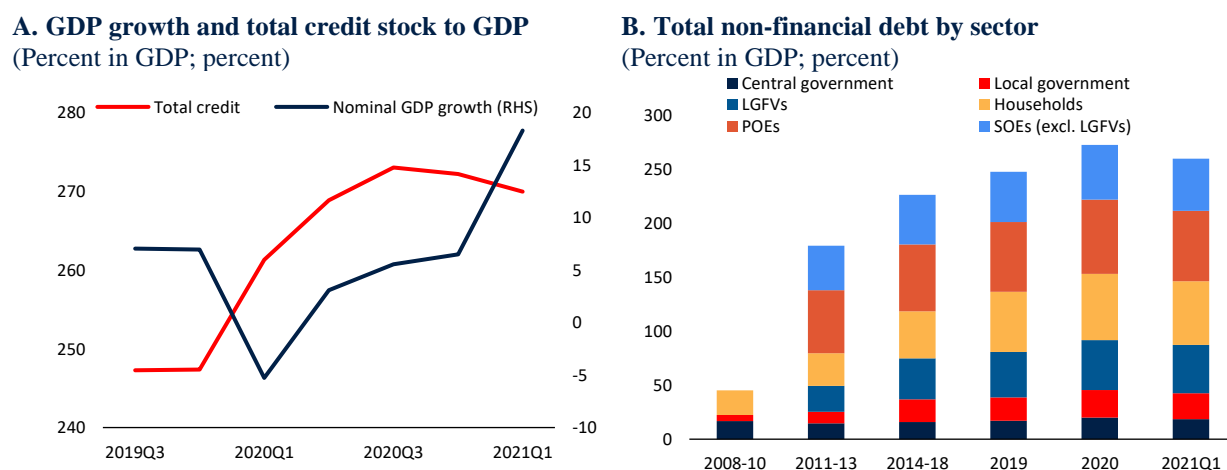
Note: In figure A, net liquidity injection provided by the PBOC through standing lending facility (SLF), the medium-term lending facility (MLF), the targeted medium-term lending facility (TMLF), the pledged supplementary lending (PSL), the special-purpose refinancing (SPRF), and the special relending or rediscounting facilities. RRR= Reserve Requirement Ratio. In figure B, LPR= Loan Prime Rate; SHIBOR=Shanghai Interbank Offered Rate.

Credit growth has weakened amid weaker bond issuance and continued curtailment of shadow banking activities (Figure 20.A). Credit growth to the non-financial sector decelerated to 10.9 percent y/y in the first five months of 2021 from 13.5 percent y/y in the second half of 2020. The drop was driven by a moderation in the issuance of government bonds amid reduced fiscal support, a continued contraction in shadow banking segments, weaker corporate bond issuance on rising bond defaults in recent months, softened bank lending on lower short-term corporate borrowing, as well as a high base owing to monetary easing last year to mitigate the COVID-19 impact (Figure 20.B).

Figure 20. Credit growth weakened on policy tightening

Elevated debt levels remain a key concern

After last year's sharp increase, China's debt-to-GDP ratio has declined due to a larger nominal GDP. After several years of deleveraging, leverage increased sharply last year, with the debt-to-GDP ratio reaching 285 percent of GDP from 258 percent in 2019. While declining slightly to 280 percent of GDP in the first quarter of 2021, reflecting largely higher nominal GDP growth, the debt-to-GDP ratio remained about 20 percentage points higher than before the pandemic (Figure 21.A). At current market interest rates, China's large debt stock implies a significant aggregate interest burden, exceeding 10 percent of GDP. It is estimated that more than one-third of new credit to the non-financial sector is used to service the existing debt.

Figure 21. The debt-to-GDP ratio moderated on higher GDP growth in the first quarter of 2021

Source: PBOC; Wind Info Database; CEIC Database; World Bank.

The pace of deleveraging was uneven across sectors (Figure 21.B). Lower issuance of local government bonds has led to a decline of the explicit government debt to 43 percent of GDP in 2021Q1. However, implicit liabilities of local governments have continued to grow in line with

GDP following the rapid pickup in the issuance of LGFV bonds. Household debt moderated on declining mortgage loans, driven by reduced housing sales as well as tighter lending standards, including higher down-payment requirements. In contrast, non-housing consumer debt has increased on the back of the recovery in private consumption and consumer confidence. The pace of corporate debt buildup has moderated overall. Nevertheless, local state firms and real estate and transportation firms have continued to gain leverage in recent quarters (Box 4).

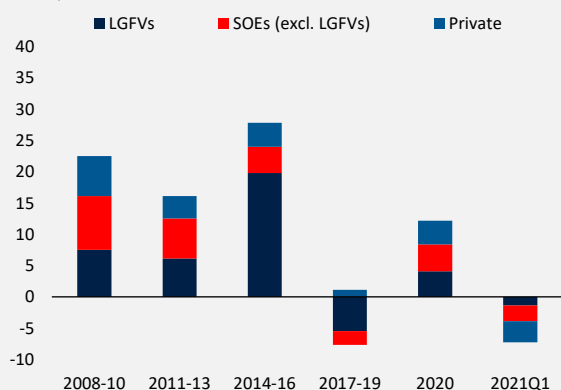
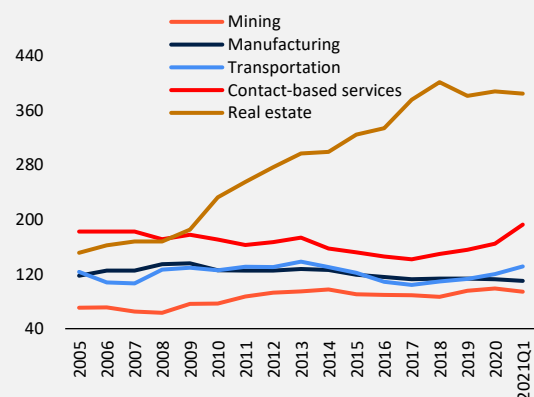
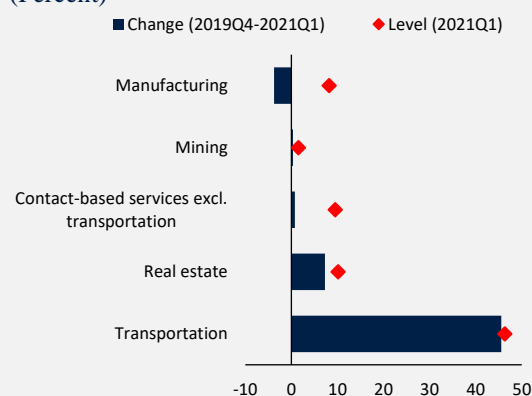
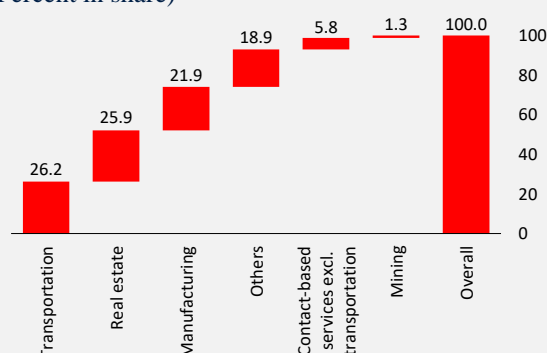
Box 4. Recent trends in corporate leverage

After several years of deleveraging, China's corporate leverage has rebounded since 2020, driven primarily by the rapid debt accumulation of local state firms (Figure 22.A). De-risking measures implemented since 2016 have led to a modest decline in China's corporate debt (including LGFVs) to 153 percent of GDP in 2019 from 155 percent in 2016. The moderation was driven mostly by the reduced leverage of state firms, reflecting tighter off-budget financing to address the surging debt among high-leveraged state-owned enterprises (SOEs). Affected by the COVID-19 pandemic, corporate leverage rebounded in 2020, with corporate debt rising to 160 percent of GDP. Firm-level analysis suggests local government entities are the major beneficiaries of the increased borrowing.

By industry, most of the buildup in leverage concentrated in the real estate sector, and to a lesser extent, in the transportation, retail and wholesale sectors (Figure 22.B). Property developers entered the COVID-19 crisis with significant leverage (Chivakul and Lam 2015). The leverage of real estate firms has risen since 2020, accounting for about one-third of new corporate debt by the end of 2021Q1. Contact-based industries have been severely hit by the COVID-19 pandemic, leading to significantly increased corporate leverage in these sectors. The transportation, retail, and wholesale sectors are estimated to account for about one-fourth of new debt accumulation from 2019Q4 to 2021Q1. The manufacturing sector, which is dominated by private firms, has seen a mild decline in leverage, due to weak investment and lower working capital needs amid a fast recovery of profits. Despite the sharp swing in commodity prices, the liability ratio of the mining firms has been relatively stable since 2020.

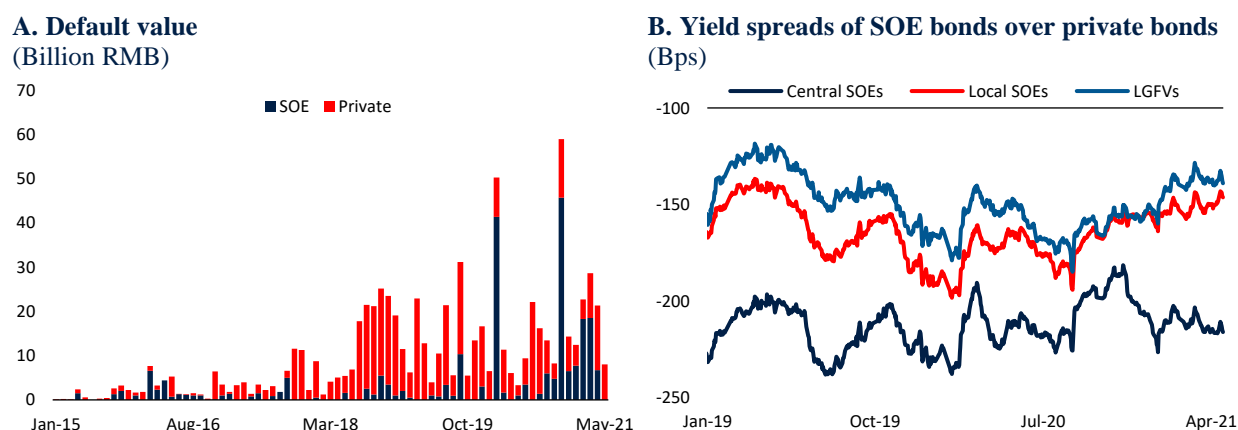
A significant share of local SOEs and real estate firms have insufficient earnings to cover their interest payments, putting their debt at risk. The interest coverage ratios, which measure a company's ability to meet its interest payments, have broadly deteriorated since 2020, particularly among local SOEs. It is estimated that around 10 percent of local SOEs have an interest coverage ratio of less than one in 2021Q1, 2 percentage points higher than 2019. By industry, the share of debt-at-risk (defined as the debt of borrowers with insufficient earnings to cover interest expenses) of corporates in the real estate and transportation sectors has dramatically increased, to 10.1 and 46.3 percent in 2021Q1 from 2.8 and 0.8 percent in 2019, respectively (Figure 22.C). Real estate and transport firms, many of which overlap with local SOEs, account for over 50 percent of the total "at risk" debt of listed firms, a rise from about 12 percent in 2019 (Figure 22.D).

Given highly leveraged balance sheets, some corporates are vulnerable to a rise in interest rates. An interest rate rise by 100 bps would raise the debt at risk by about 4.3 percentage points, to 14.7 percent in 2021Q1. Real estate firms in particular are sensitive to an interest rate hike. An increase of the interest rate by 100 bps would lead to a surge in the share of "at risk" debt among real estate firms by 10 percentage points, to 21.4 percent.

Figure 22. Corporate leverage and debt risks**A. Change in corporate debt by types of enterprises**
(Cumulative change in share of GDP, percentage points)**B. Leverage ratios by sector**
(Median liabilities to equity ratio)**C. Debt at risk ratio by sector**
(Percent)**D. Share of debt at risk by sector**
(Percent in share)

Source: PBOC; Wind Info Database, CEIC Database; World Bank.

There have been signs of distress in some highly leveraged corporates, with defaults shaking the corporate bond market in recent months (Figure 23.A). This has led to rising bond yields for local SOEs, especially LGFVs, which are highly leveraged and less profitable than private firms (Figure 23.B). It has also raised investor concerns that local government's implicit guarantees may be weakening. On the positive side, allowing SOEs to default would reduce public perception of an implicit guarantee, thereby enhancing market-based credit allocation. However, elevated debt levels make corporates vulnerable to rising financing costs accompanied by the repricing of risks. China's corporate debt is large, amounting to about 160 percent of GDP, and estimates suggest that SOEs account for as much as two-thirds of this debt. In addition, some of the SOE debt, especially at the local level, is related to infrastructure investment and may create contingent liabilities for the budget.

Figure 23. SOE bond defaults have increased, but public sector discounts persist

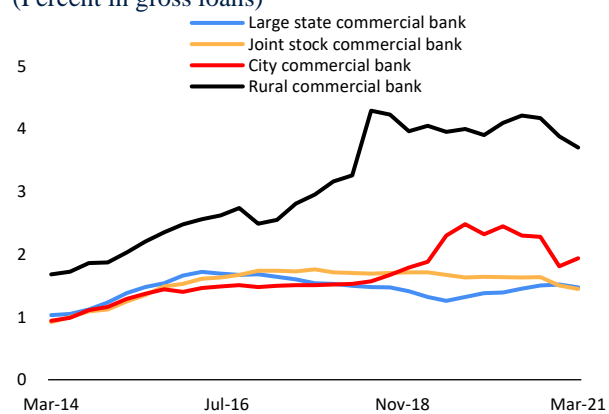
Source: Wind Info Database; World Bank.

Liquidity injections and regulatory forbearance have prevented a major rise in bad debts in 2020. Although the NPL ratio remains low, at about 1.8 percent in 2021Q1, NPLs are likely to go up once forbearance and financial lifelines are rolled back. In addition, actual NPLs might be even higher due to regulatory loopholes. In the past, for example, loans over 90 days past due could be classified as “special mention loans” (SMLs) instead of non-performing, contrary to international best practice. The stock of loans classified as SMLs is higher than NPLs, at 2.4 percent of total loans. Moreover, some regional banks appear more vulnerable, due to their high exposure to the commercial service sector, unsecured consumers, and micro and small enterprises (MSEs), as well as their weaker financial performance even before the pandemic. As of 2020Q1, Rural Commercial Banks (RCBs) and City Commercial Banks (CCBs) have had the highest NPL ratios, at 4.2 and 2.3, respectively (Figure 24. A and B).

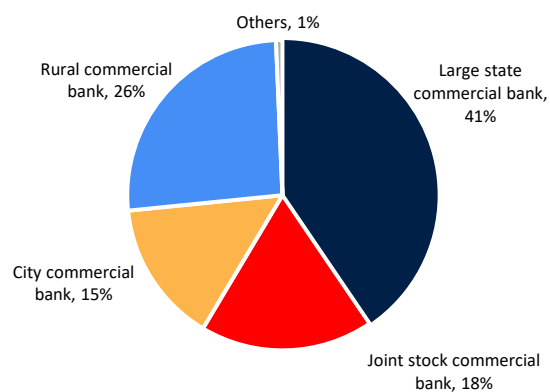
System-wide buffers in the financial sector appear adequate to absorb shocks, but localized vulnerabilities—especially in regional banks—may intensify. The system-wide capital adequacy ratio of commercial banks stood at 14.7 percent in 2020, well above the regulatory requirement. In addition, anticipating deteriorating asset quality, banks have increased provisioning to cover potential bad loans. Risks are particularly high in several smaller regional banks with thinner capital buffers and greater and often concentrated exposure to high-risk clients. Several local governments have taken actions to bolster bank balance sheets, including using bonds to recapitalize banks.

Figure 24. Regional banks are more vulnerable

A. NPL ratios by banking categories
(Percent in gross loans)



B. Distribution of NPLs across banking categories
(Percent share)



Source: Wind Info Database; World Bank.

II. Outlook, Risks, and Policy Considerations

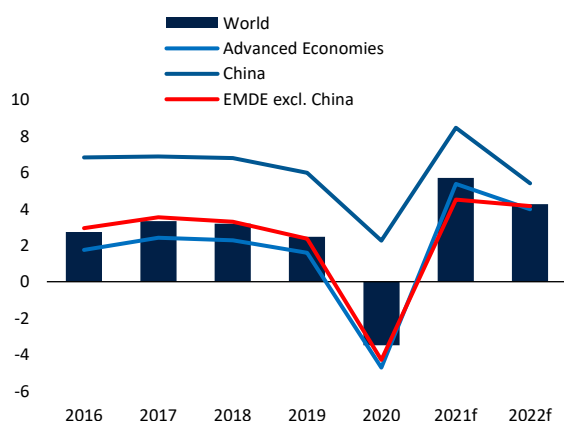
Global outlook

The external environment is expected to be generally supportive, but inflation expectations appear to be on the rise. The global economy is projected to expand 5.6 percent in 2021—its strongest post-recession pace in 80 years (World Bank 2021a) (Figure 25.A). The recovery will be uneven, however, with growth concentrated in a few major economies where vaccination campaigns are proceeding rapidly. Conversely, COVID-19 will continue to disrupt activity in many EMDEs, including in low-income countries, amid slow vaccination progress and weak confidence. Global inflation will likely continue to rise in 2021H2, but is expected to remain within target bands in most inflation-targeting countries. This, combined with large output gaps in many countries, will limit the extent of EMDE policy tightening in the short-term.

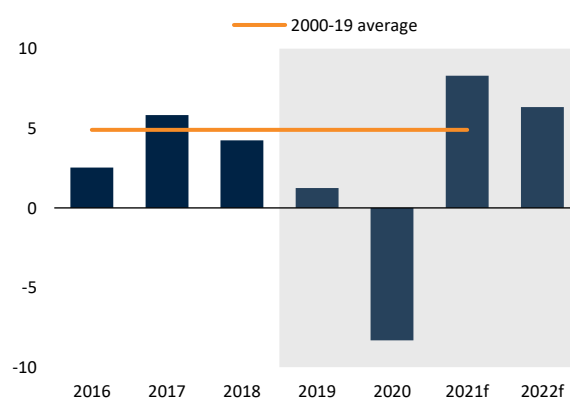
Global trade growth and commodity prices are expected to peak this year, powered by the recovery in global output and investment. Global trade is forecast to grow 8.3 percent this year after an equally sharp contraction in 2020 and moderate to 6.3 percent in 2022, reflecting a gradually diminishing trade intensity of global recovery (Figure 25.B). Oil demand will continue to firm but will not regain its pre-pandemic level until next year. Oil prices are expected to remain at around \$62/bbl on average in 2021 and 2022 amid lingering travel restrictions. Metals prices are projected to be 36 percent higher on average in 2021 compared to last year—based on strong demand from China and the rest of the world—before moderating in 2022 on easing supply constraints. Agricultural prices are expected to rise by 16 percent in 2021 before plateauing in 2022.

Figure 25. Global economy is projected to expand

A. GDP growth
(Percent)



B. Global trade volumes
(Percent)



Source: Haver Analytics; World Bank.

Note: In figure A, 2021f and 2022f are based on the World Bank June 2021 Global Economic Prospects (GEP) forecasts. In figure B, shaded areas indicate forecasts. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Trade is measured as the average of export and import volumes.

China outlook

Economic growth is projected to accelerate to 8.5 percent in 2021, reflecting a low base effect, the release of pent-up demand, and strong exports (Table 2). This marks an upward revision by 0.6 percentage points from the December projections (World Bank 2020b), largely due to stronger-than-expected foreign demand. This will allow for a steady normalization of activity and gradual convergence of growth toward around 1 to 2 percent below pre-pandemic projections by the end of the forecasting period, as a lack of aggregate demand will constrain expansion. Policies are expected to continue to shift away from supporting activity toward reducing financial stability risks.

The structure of aggregate demand is expected to continue to gradually rotate toward private domestic demand. Real consumption growth is projected to gradually return to its pre-COVID-19 trend, supported by the ongoing labor market recovery and improved consumer confidence. The structure of investment is expected to shift in favor of private investment as the manufacturing capex improves in response to the robust external demand and stronger revenues, offsetting lower infrastructure and property investment.

On the supply side, drivers of economic growth are expected to shift from industrial production toward services. The recovery in the lagging services sectors is expected to accelerate following further relaxation of travel and mobility restrictions and improved consumer confidence in the wake of accelerated vaccination progress. Meanwhile, the above-trend industrial production growth is expected to moderate on diminished policy support, decarbonization-related production cuts, and tighter property regulations.

The current account surplus is projected to narrow to 1.4 percent of GDP this year and about 1 percent of GDP in 2022, reflecting a gradual decline in the trade surplus. Notwithstanding the global economic recovery, export growth will likely slow later this year as the base effect becomes less favorable, the global capex cycle peaks, and demand for pandemic-related goods eases. Despite the upbeat demand outlook, supply-side constraints—including the global semiconductor shortage, shipping disruptions, and record-high freight rates—are expected to persist for some time and weigh on exports. Meanwhile, import growth is expected to firm due to stronger domestic demand. Import growth will get additional boost in 2022 with a gradual resumption of international travel. The recovery in manufacturing capex and robust consumer demand will support the stronger imports of capital and consumer goods. Higher commodity import prices will also contribute to higher imports. Imports of services are also expected to recover as travel restrictions are gradually relaxed and outward travel picks up.

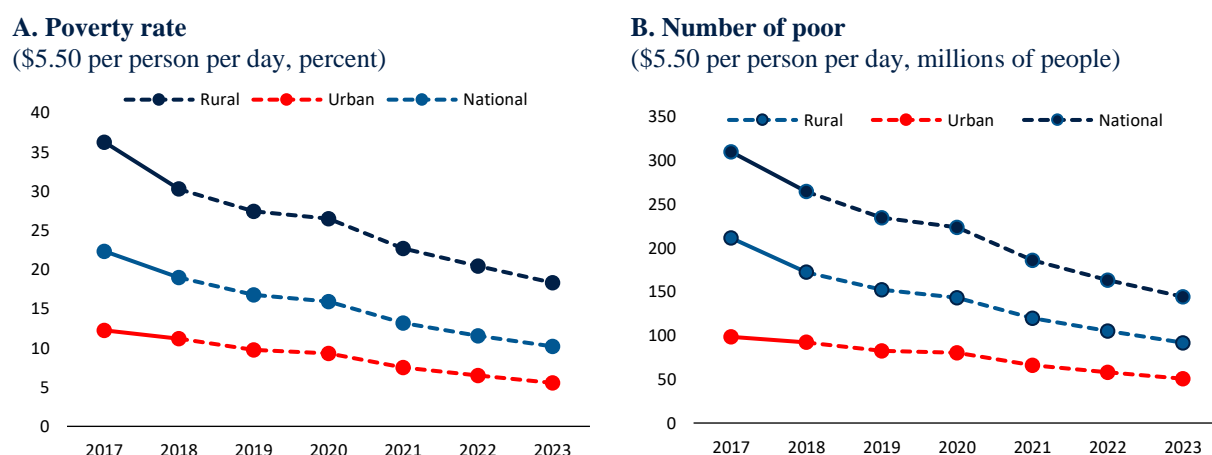
Headline inflation is expected to rise steadily but remain below the government's 3 percent annual target for this year. This reflects a combination of low base effect, stronger demand dynamics, and higher commodity prices. Pork prices, a major driver of CPI inflation in China, are expected to ease further on continued supply recovery. Core CPI inflation, which excludes food and energy price inflation, is projected to inch up steadily, reflecting firming consumer spending and some pass-through of higher industrial costs. PPI inflation is expected to peak this year on higher material prices and decline thereafter in line with the projected moderation of commodity

prices. Policy makers will continue their counter-cyclical credit tightening and may slow the pace of decarbonization-related production cuts if inflation pressures persist.

Growth is expected to moderate to 5.4 percent in 2022 amid diminishing fiscal and monetary support and tighter property and macroprudential regulations. This reflects the progressive de-risking and deleveraging efforts, policy normalization, and diminished support from net exports. Domestic demand will continue to trend toward its pre-pandemic level, and its structure will gradually shift in favor of private domestic spending. GDP growth will stabilize slightly below its earlier trend rate by late 2022, as fiscal consolidation and de-risking and deleveraging will weigh on growth.

The pace of poverty reduction is expected to return to its pre-COVID-19 trend. Tracking the expected economic recovery, poverty is expected to decline rapidly in 2021 and will continue to drop—though more slowly—in subsequent years. The share of people falling below the \$5.50 per day poverty line (2011 Purchasing Power Parity (PPP)) is projected to fall from 15.9 percent in 2020 to 10 percent by 2023, representing 80 million fewer poor people than in 2020 (Figure 26. A and B). Notwithstanding China’s continued progress in reducing poverty, there is an important post 2020 social agenda, which is discussed in Chapter III of this report.

Figure 26. Poverty reduction is expected to return to a pace as observed in pre-COVID years



Source: World Bank staff estimates using tabulated data from China NBS and World Bank’s GDP growth projections. Note: Last grouped data available to calculate poverty is for 2018. Projections based on per capita GDP growth estimates, using a neutral distribution assumption with pass through 0.85 to per capita household consumption.

Table 2. China selected economic indicators

<i>China selected indicators</i>	2018	2019	2020	2021f	2022f	2023f
Real GDP growth, at constant market prices	6.7	6.0	2.3	8.5	5.4	5.3
Private consumption	7.4	6.5	-1.0	11.5	6.0	5.8
Government consumption	8.9	6.0	9.7	7.2	8.1	8.0
Gross fixed capital formation	6.7	4.0	1.4	5.8	4.1	4.0
Exports, goods and services	4.0	2.5	1.6	9.0	3.3	3.3
Imports, goods and services	7.9	1.0	-1.7	10.0	3.5	3.5
Real GDP growth, at constant factor prices	6.7	6.0	2.3	8.5	5.4	5.3
Agriculture	3.5	3.1	3.0	3.4	3.3	3.3
Industry	5.8	4.9	2.6	6.5	4.7	4.7

Services	8.0	7.2	2.1	10.8	6.2	6.0
Inflation (Private Consumption deflator)	2.1	2.9	2.5	1.5	2.2	2.2
Current account balance (% of GDP)	0.2	0.7	1.9	1.4	1.1	0.9
Financial Account Balance, excl. reserves (% of GDP)	1.2	0.1	-0.5	0.1	0.4	0.6
Net foreign direct investment (% of GDP)	0.7	0.4	0.7	0.8	0.9	1.0
Public finance budget balance (% of GDP)	-2.6	-2.8	-3.7	-3.2	-3.0	-2.8
Augmented fiscal balance (% of GDP) ^a	-3.3	-4.6	-9.0	-7.6	-7.0	-6.6
Primary balance (% of GDP) ^a	-2.4	-3.5	-8.0	-6.5	-5.8	-5.2
Government debt (% of GDP)	36.4	38.6	45.8	49.1	52.8	55.8

Source: World Bank.

Note: f = forecast (baseline).

(a) World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the public finance budget, the government fund budget, the state capital management fund budget, and the social security fund budget. The primary balance is the difference between revenue and non-interest expenditures.

Risks

Positive surprises to growth since December 2020 suggest that risks to China's growth outlook remain balanced. The downside risks to the outlook are principally related to the path of the pandemic globally and regionally and the possibility of renewed domestic outbreaks. Delays in vaccination globally could lead to a more severe and durable pandemic, increase the possibility of repeated outbreaks even in China, slow the reopening of borders and the resumption of international travel, affect domestic production through limited imports of critical intermediate goods (such as chips) and lead to delays in the recovery of lagging services sectors. China's strong recovery has been partly attributed to its strict virus containment policies in the last year. As immunization in China and the rest of the world progresses, maintaining too strict movement control policies and zero-tolerance COVID-19 suppression strategy could risk slowing down the recovery especially in the service sector.

Risks in China could also emanate from a wave of corporate bankruptcies and defaults, which could trigger financial market stress and derail the recovery. COVID-19 has brought to the fore balance sheet vulnerabilities of corporates, banks, and government entities. Corporate and household debt levels, already high before the pandemic, have risen further, eroding previous deleveraging gains and increasing financial stability risks. A sudden rise in interest rates or abrupt policy or regulatory tightening for de-risking and deleveraging purposes could force struggling corporations and small and medium-sized enterprises (SMEs) into bankruptcy, trigger a cascade of defaults, and aggravate debt overhangs. While system-wide buffers appear to be adequate to absorb shocks, and banks in the aggregate have robust buffers, vulnerabilities in smaller regional and local banks and fintech companies could intensify.

In addition, persistent policy uncertainty due to renewed economic tensions between major economies could dampen investor and consumer confidence. Specifically, continued bilateral tensions between China and its key trading partners could weaken private investment demand and harm potential growth by restricting China's access to imports of critical goods. This, in turn, could further exacerbate the ongoing structural slowdown of potential growth (World Bank 2020a; World Bank 2021a).

The risk of high and persistent inflation is low in China. Nevertheless, there are upside risks to inflation should domestic consumption strengthen at a faster-than-expected pace and the pass-through from PPI to CPI is higher than expected.

On the upside, global growth could be more robust if the virus is contained more quickly or if spillovers from rapid growth in major economies support a sustained, broad-based global rebound. Vaccine rollouts at the global level have proceeded unevenly but somewhat faster than anticipated earlier (World Bank 2021b). There is a possibility that by December 2021, the world will have more than 13 billion vaccine doses available, more than enough to fully inoculate about 80 percent of the world's population (Duke Global Health Innovation Center 2021; World Bank 2021b). A large vaccine surplus could promote a more equitable global vaccine distribution and accelerate vaccination progress in lagging countries, resulting in the faster-than-expected removal of stringent control measures and contributing to a faster and more sustained global recovery.

The spillovers from strong economic activity in the major economies could help release pent-up demand, bolster global confidence, and lead to a stronger-than-expected global recovery. A synchronized, stronger, more durable, and broad-based global upturn would reduce the scarring caused by the pandemic through higher labor participation and stronger-than-expected investment and productivity growth. Stronger potential output growth would provide additional boost to global trade and also help keep inflation pressures in check and help reduce debt ratios.

Policy implications: charting a more inclusive and resilient post-pandemic development path

Solidifying the recovery

Given considerable uncertainty and remaining downside risks, the authorities will need to stay agile and proactively adjust the level and composition of macroeconomic policy support. As China's recovery becomes more entrenched, macroeconomic policies are expected to shift from accommodative to more neutral settings. The pace of this policy exit, however, should continue to be data-dependent and calibrated to the strength of the recovery in China and the rest of the world. Rising financial vulnerabilities, together with subdued productivity growth and persistent imbalances in the structure of aggregate demand, pose medium-term challenges that require attention. Macroeconomic policies and structural reforms should aim to reinvigorate the shift to more balanced high-quality growth. While China is on track to reach the target inoculation rate of 40 percent of the population by early summer, a full recovery will also require continued progress toward achieving wide-spread immunization. This would mitigate the risk of large-scale outbreaks while reducing case mortality rates, allowing for a gradual risk-based relaxation of remaining restrictions, including of those related to cross-border travel.

- **Maintaining responsive monetary policies:** Unless inflation moves well above target and inflation expectations become unanchored, monetary policy normalization should proceed cautiously, and the authorities should continue to signal a commitment to maintaining broadly accommodative conditions. This includes responsive liquidity support to limit increases in interbank rates if liquidity conditions change suddenly. Over the medium term, further

modernization of the monetary policy framework would strengthen the effectiveness and transmission of interest-rate policies. Deposit and lending-rate guidance, as well as aggregate and specific credit targets, should be relaxed further to strengthen market-based deposit and loan pricing, which will not only enhance the transmission of interest rate policy but also help improve credit allocation.

- **Managing vulnerabilities to safeguard macro-financial stability:** Financial stability risks associated with high corporate leverage and inflated property markets should be closely monitored. As corporate revenues and household incomes recover, regulators should normalize loan classification and provisioning rules, as planned, to ensure banks properly recognize NPLs and hold adequate capital and liquidity buffers. Alongside strengthened corporate insolvency procedures, a comprehensive framework to deal with weak banks that are unable to meet capital requirements is also critical to allow non-viable banks to exit in an orderly fashion (see also below). In addition, macro-prudential measures, including stricter enforcement of existing redlines for large property developers and tighter mortgage lending standards, can be deployed to curb excessive leverage and help contain macro-financial risks stemming from the real estate market.⁴
- **Flexibly deploying fiscal policy to secure short-term recovery while boosting medium-term rebalancing:** China has policy space at the central level, and policy makers should be ready to maintain fiscal support should private investment and consumption demand remain sluggish and external imbalances further increase. Focusing additional fiscal efforts on social spending and green investment rather than traditional infrastructure investment would not only help secure the recovery and bolster short term demand but also contribute to the intended medium-term rebalancing of China's economy.

Rebalancing to more productivity-driven and consumption-led growth

Looking beyond this year's rebound, policy makers should redouble their efforts toward promoting growth-enhancing structural reforms and steering the economy onto a greener, more resilient, and inclusive development path. The Government Workplan for 2021 and the 14th FYP, adopted earlier this year outline important policy priorities for the near term and the coming five years. Dominant themes include stimulation of more innovation driven growth and a shift toward low carbon development, in line with China's long-term goals of achieving carbon peaking before 2030 and carbon neutrality by 2060. The policy documents also emphasize demand-side management to achieve the desired shift toward a more consumption-based growth model. The following policy options could help achieve these stated policy objectives:

- **Effective and efficient market exit:** Strengthened insolvency and bank resolution frameworks would facilitate an orderly exit of weak or failing corporates and banks and free up resources

⁴ Against a backdrop of growing debt levels, rising land prices and booming property sales, China imposed the three red lines on selected developers in August 2020. Under this policy, 12 pilot developers are required to submit regular detailed financial reports to regulators that will assess their financial health against three criteria: i) Liability-to-asset ratio (excluding advance receipts) of less than 70 percent; ii) Net gearing ratio of less than 100 percent, and iii) Cash-to-short-term debt ratio of more than 1x.

to flow to more productive uses. This is particularly important in the context of COVID-19, which has put additional strain on corporate and banking sector balance sheets. Resolving insolvency cases in China is more costly, takes more time, and achieves a relatively low recovery rate. China's estimated recovery rate for secured creditors is 36.9 cents on the dollar, below the OECD high-income average of 70.2 cents. It costs an estimated 22 percent of the value of the insolvency estate to resolve an insolvency case, just over six times more than in the Republic of Korea. Lastly, it takes an average of 1.7 years for creditors to recover in an insolvency case. A more effective insolvency regime could also facilitate a more market driven reduction of excess capacity in some industries and help liquidate so-called zombie SOEs – non-performing insolvent SOEs. The effectiveness of the Bankruptcy Courts and Administrators are likely to improve as they gain more experience and training in insolvency matters. Further enhancements to the law could also enhance creditors' rights and participation in insolvency proceedings.

- **Addressing financial sector distortions that impede the efficient allocation of resources:** Productivity growth would require efficient use of capital to flow to the most productive companies and investment opportunities. Moreover, since productivity levels vary widely across firms in China, there is significant untapped potential for productivity growth through the diffusion of improved technologies and management practices. This would require all enterprises, regardless of ownership, to be treated equally. In practice, though, SOEs continue to benefit from implicit government guarantees that distort the allocation of financing and may contribute to slowing the diffusion of technologies, particularly among micro, small and medium enterprises (MSMEs). Recent cases of corporate distress and insolvencies have triggered some repricing of risk, but further steps are needed to ensure price signals in financial markets respond more directly to underlying credit risks.
- **Quality opening up, especially in service sectors:** Increasing competition through the opening of more sectors to private and foreign investment would be particularly beneficial for the services sector, where China's market restrictions are greater than those of OECD countries. The government's commitment to further reduce the negative list for private and foreign investment is a welcome move in this direction. SOE reforms would complement the promotion of market competition by helping to ensure fair competition—long advocated in China. China could introduce a formal state ownership policy for SOEs that would articulate the purpose of state ownership and focus SOEs in strategic sectors. Taking further advantage of some of the more modern services—such as professional, financial, and information technology-enabled services—could not only help upgrade China's manufacturing but will also create new opportunities for growth. Given the low carbon intensity of services this would also contribute to decarbonizing growth.
- **Expanding domestic consumption will require steps to reduce precautionary household savings:** While prioritizing consumption rebalancing, government policies continue to almost exclusively focus on the supply side, e.g., enhancing the operation of the retail sector by easing restrictions and fostering expansion of e-commerce, especially in rural areas. Arguably, consumption growth is constrained less by the lack of buying opportunities than by the reluctance of consumers to spend. More attention should therefore be given to demand-side policies that address reasons for high savings. For example, rebalancing fiscal spending from

investment to social safety nets would encourage households to reduce precautionary savings, lifting domestic consumption. Further extending the liberalization of China's household registration system (hukou) to large cities would equalize access to services and amount to a significant transfer of wealth to migrant families. The next section elaborates on some of these points in the context of China's post-2020 social policy agenda to reduce remaining relative poverty.

Making growth more inclusive

Achieving inclusive growth and broad-based welfare gains is a key priority under the government's 14th FYP. Recognizing the critical importance of quality job creation, the government targeted the creation of 11 million additional urban jobs per year, aiming to stabilize the urban surveyed unemployment rate at 5.5 percent. Government policy statements also emphasize improving access to quality services and strengthening social protection and social insurance mechanisms. Building on these commitments, several policy options could be considered to lay the foundation for more inclusive growth and equitable social development:

- **Tax reforms aimed at a more progressive tax structure could help stem rising income inequality while mobilizing resources for higher social spending:** Reforms to make the tax system more progressive could play an important role in stemming the rise in income inequality. China relies heavily on regressive value-added tax (VAT) and other consumption taxes, which account for half of general government tax revenue in China compared to one-third on average in OECD countries. Progressive personal income tax (PIT) accounts for only 5 percent of revenue in China while yielding close to 15 percent on average in the OECD. Enhancing the role of a progressive PIT would improve the social burden sharing and contribute to lowering inequality and relative poverty. In addition, wealth and property taxes, which are generally considered progressive, remain underutilized in China and could play an important role in reducing imbalances, especially in local government budgets. Introducing broader environmental taxes, including carbon charges, could help achieve China's carbon emission targets and contribute to enhanced equality if combined with progressive revenue recycling.
- **Deepening hukou reform is critical for greater equality and quality urbanization:** A large gap (around 16 percentage points) persists in China between the share of the total and the share of the registered urban population. The new government target of 65 percent for the total urbanization rate for the 14th FYP implies that more than 60 million people will become urban residents in the next five years. To achieve this target while closing the gap between the total and registered urban populations will require a deepening of hukou reform, including in the larger cities. This would create significant benefits to migrant worker households in terms of access to public education and health services, thus reducing their need to hold precautionary savings. It also would support employment creation in the most productive areas of China, thereby facilitating the targeted rapid labor productivity growth.
- **Reinforcing social safety nets and labor market policies to enable rapid economic transformation:** While government social policy priorities rightly emphasize job creation, the labor market challenges associated with China's structural transformation could receive more

attention. Indeed, the accelerated green transition of the economy and digital transformation after COVID-19 will generate significant shifts in the labor markets. Therefore, labor market policies should stand ready to help provide more demand-driven training programs, strengthen public employment services, and support labor market flexibility both through portable social insurance and through improved labor market regulations. In addition, an integrated employment statistical system covering urban and rural labor markets will be essential to timely monitor the dynamics of employment and labor markets and inform evidence-based decision-making.

Getting on the path to carbon neutrality

The 14th FYP is a critical opportunity to translate China's long-term commitment to achieve carbon neutrality by 2060, outlined by President Xi Jinping at the UN General Assembly last year, into commensurate short-term targets and specific policy actions to achieve them. The following policy options could be considered to underpin faster progress and achieve more rapid decarbonization in a growth-friendly and distributionally fair manner:

- **Raising short-term climate ambition through the revised Nationally Determined Contribution (NDC):** By setting an ambitious NDC, China could play a leading role in global climate change efforts. For example, a commitment to achieve peak carbon emissions well ahead of 2030 and establishing an ambitious absolute mass-based emission cap in the context of the 14th FYP would anchor deeper decarbonization efforts domestically and reinforce the credibility of China's long-term carbon neutrality pledge internationally. If China raises its short-term commitments, this will contribute greatly to the success of both the 26th session of the Conference of Parties to the United Nations Framework Convention on Climate Change and the 15th session of the Conference of the Parties to the Convention on Biological Diversity, both of which are due to take place in 2021.
- **Accelerating the energy transition away from coal:** While the share of coal in China's energy mix has declined in recent years, coal capacity in absolute terms has been rising to meet growing energy demand. In light of China's long-term ambition, cutting coal consumption and replacing it with cleaner energy sources is an important priority. Recent advances and falling prices in renewable energy have made replacing coal an easier abatement option than cutting oil use in transportation and emissions from farm fields and livestock. On the other hand, new coal-fired power plants that are currently planned or under construction could lock in pollution and high greenhouse gas emissions for several decades, implying financial losses if those plants were to close early as China accelerates the low carbon transition. Against this backdrop, the economic viability and technical feasibility of introducing a moratorium on investments in new coal-fired power plants could be examined in tandem with a push to scale up renewable capacity.
- **Wider application of carbon pricing could be considered to drive efficient and economy-wide abatement.** The national Emissions Trading Scheme (ETS) plan, which is currently being rolled out, will initially cover the power sector. The sector accounts for about 30 percent of China's total emissions and so is an appropriate place to start. Indeed, China's ETS once in operation will be the largest national emissions trading system in the world. However, price

signals in the power sector are distorted by various barriers to efficient power trade, including a dispatch system that continues to favor coal. Quotas were also set generously, and the initial carbon price in the ETS may thus be relatively modest. This may limit the impact of the ETS without complementary power sector reform. Additionally, China's ETS could also be expanded beyond the energy sector to include steel, cement, and other heavy industries, turning it into a true cap-and-trade regime. This would create incentives for end users of energy to increase efficiency. In other carbon intensive sectors, such as transport, agriculture and construction, emissions trading will be technically challenging because monitoring and verification of emissions is difficult. In these sector complementary carbon taxes could be considered. Such carbon excise taxes are a relatively simple and efficient instrument, charged in proportion to the carbon content of fuel and a set carbon price. Without considering the climate and other co-benefits, carbon taxes are likely associated some welfare losses. In addition, distributional impacts may be regressive. These adverse effects can be mitigated if the revenue generated by carbon pricing is recycled back into the economy to subsidize abatements costs, offset negative social impacts and rebalance the tax mix by cutting other distortionary taxes on labor, general consumption or profits. Simulations show that a wider application of carbon pricing could significantly contribute to achieving China's carbon neutrality target (see Box 5 below for illustrative simulation results).

- **Ensuring a just transition:** A faster transition also means a faster exit from polluting industries. Some provinces will face significant transition costs. To make this feasible, some losses from stranded assets may need to be absorbed by power producers or compensated from other sources. In addition, mitigating social risks calls for a mix of increased labor mobility, skills upgrading and retraining efforts to diversify local economies away from coal and polluting industries, and strengthened social safety nets to protect households from adverse shocks associated with economic restructuring. Provincial-level decarbonization strategies would help tailor policies to specific local conditions, industrial structure and hence differences in abatement options and transition challenges and risks. However, national financial support will be required in provinces that rely heavily on coal-based economies.

Box 5. Fiscal foundations of carbon neutrality—simulating impacts of carbon charges in China

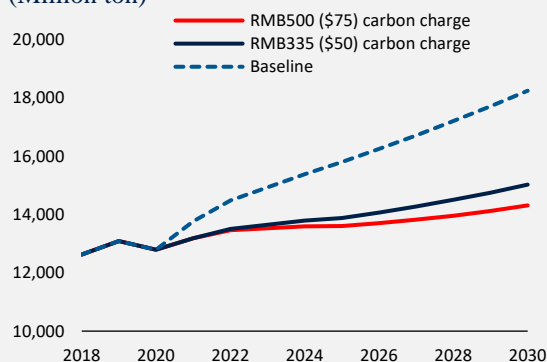
China’s commitment to carbon neutrality by 2060 is a major policy shift with near-term ramifications. Carbon charges could make a major contribution to emission reductions in the near term, while achieving multiple other social, environmental, and economic objectives. To illustrate the potential impact of carbon charging in China, two potential designs were considered. First, a “moderate carbon charge” (RMB170/\$25 per tCO₂ in 2021, rising to RMB340/\$50 by 2030, based on current exchange rates) and second, a “strong carbon charge” (RMB340/\$50 per tCO₂ in 2021, rising to RMB500/\$75 by 2030). Revenues were split equally between increases in public investment and lump-sum transfers.

Key findings:

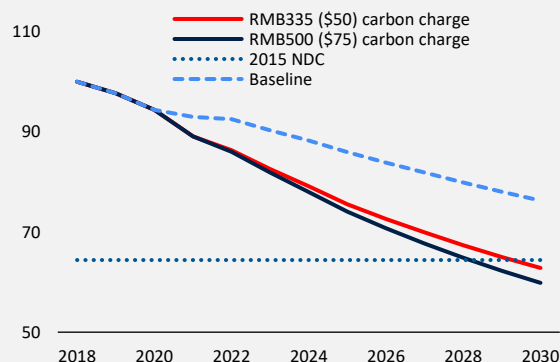
- **Carbon charges could be a central lever to help China jump-start its decarbonization efforts.** Both a moderate and a strong carbon charge would help China achieve its 2015 climate commitment (NDC) on carbon intensity. The 2015 NDC target seeks to reduce CO₂ intensity of GDP by 62.5 percent in 2030 compared with 2005 (Figure 27.B). However, additional efforts may be needed to ensure that emissions peak in the coming ten years. The ‘moderate’ and ‘strong’ carbon charges could keep emissions to about 15 gt.CO₂ and 14.1 gt.CO₂ by 2030, respectively, thereby abating 2 to 2.9 gt.CO₂ per year (Figure 27.A). Under both scenarios, China would achieve its 2015 NDC target
- **Both reforms could raise substantial revenues.** Potential additional revenues from fossil fuels could be about \$456 billion (2.0 percent GDP) or \$621 billion (2.7 percent GDP) by 2030 against a baseline of maintaining the existing excise regime (Figure 27.C and D). These revenues can make a substantive contribution to China’s post-COVID efforts and its 14th Five Year Plan (2021-5).
- **The reform can be both poverty-reducing and equity-enhancing.** Illustrative examples suggest that rebating revenues to citizens directly via targeted or untargeted transfers can reduce poverty and increase equity. The bottom two deciles and rural Chinese disproportionately benefit if half of revenues were used to fund lump-sum transfers (Figure 27.E and F). Alternatively, these revenues could fund a 25-44 percent increase in health expenditures or a 67-120 percent increase in education expenditures, both of which would benefit poorer Chinese.
- **The remaining half of the revenues could be used to fund various other objectives, such as dealing with transition risks.** Using revenues to fund green public investments could boost medium-term GDP growth by the end of the decade by about 0.6 percentage points, though greening existing public investment flows may be preferable. Alternatively, enhanced fiscal space could help deal with transition risks, such as, compensating coal producing regions or absorbing losses from stranded assets.
- **Lastly, carbon charges could help improve health outcomes of Chinese citizens: air pollution concentrations (PM_{2.5}) would decline, helping avert about 1.7 million deaths by 2030.** Air pollution is a major cause of premature deaths in China, accounting for about 1.5 million deaths annually. Cutting fossil fuel combustion would reduce concentrations of PM_{2.5} and around 1.7 million deaths cumulatively from 2021-30. In addition, costly road accidents could be reduced, saving about 16,000 lives by 2030, and congestion—a rising problem for urban Chinese—could be reduced, especially where substitute forms of mobility (e.g., public transport) are available.
- **In total, the welfare benefits from reduced air pollution, road deaths, and avoided climate damages alone could be worth about 3.5 percent of GDP by 2030.**

Figure 27. Carbon charges could induce significant emission reductions and generate fiscal revenue; recycling parts of the revenue could mitigate regressive distributional impacts.

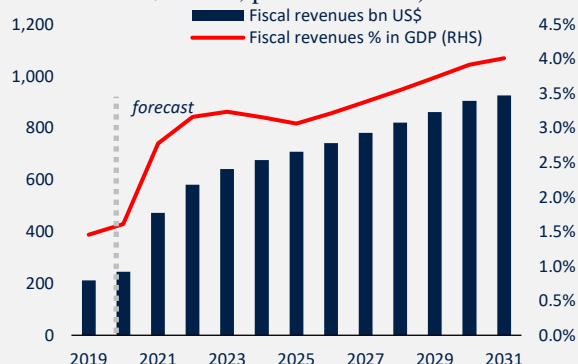
A. China's total Greenhouse Gas (GHGs) emissions excl. land use, land-use change and forestry (LULUCF)
(Million ton)



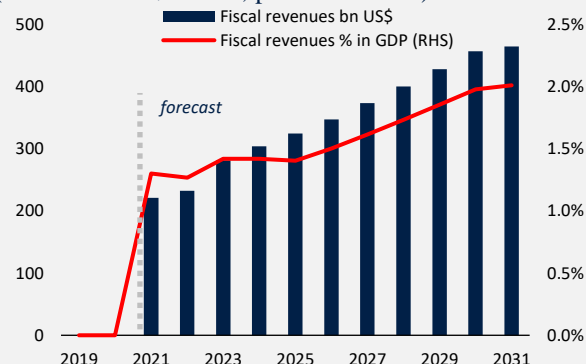
B. Indexed emissions vs. 2015 NDC
(Index, 2018=100)



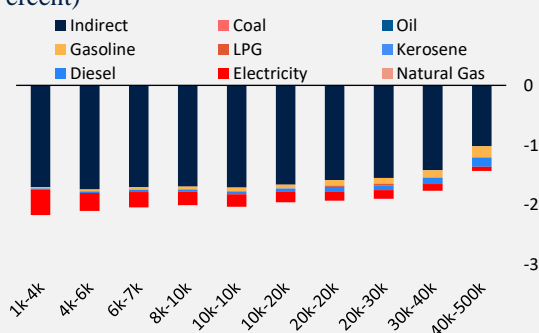
C. Total fiscal revenues from fossil fuels for moderate carbon charge regime
(Real 2018 US\$ billion, percent in GDP)



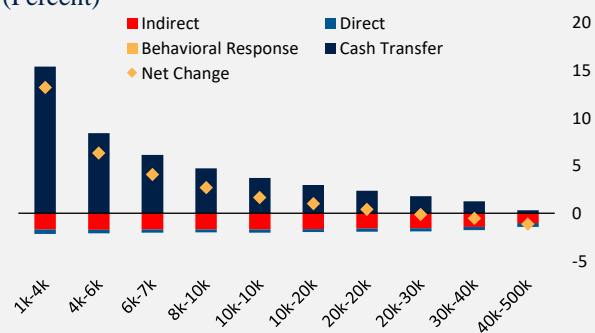
D. Additional fiscal revenues from fossil fuels for strong carbon charge regime
(Real 2018 US\$ billion, percent in GDP)



E. Direct impact on household consumption without mitigation
(Percent)



F. Direct impact on household consumption after transfers
(Percent)



Source: Simon Black 2020; Fiscal Foundations of Carbon Neutrality; Policy Note prepared with Carbon Pricing Assessment Tool.

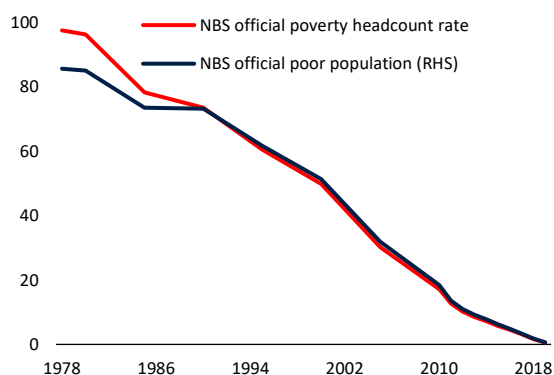
III. Extreme Poverty Has Been Eliminated. What Comes Next?

Introduction

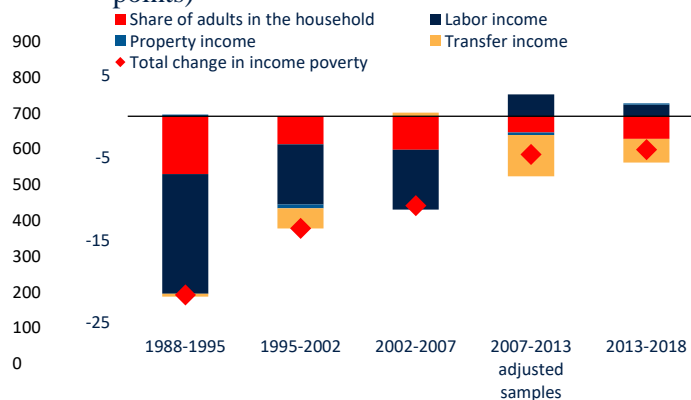
China's goal of eliminating rural extreme poverty has been reached, the government announced on February 25.⁵ The proportion of people living in poverty according to the official 2010 standard—equivalent to \$2.30 per day in 2011 Purchasing Power Parity (PPP),—fell in China from 96.2 of the rural population in 1978 to 0.6 percent in 2019 (Figure 28.A), representing 765 million fewer poor people after four decades. The major drivers of China's poverty reduction are rapid and widespread economic growth, complemented, particularly in recent years, by targeted poverty reduction policies and programs. On average, increased labor income accounted for around two-thirds of the poverty reduction between 1988 and 2007 (Figure 28.B). Increased productivity in agriculture was key in the first period (1988-95), while more labor opportunities in industry and services drove poverty reduction in the second period (1995-2007). Since then, transfer incomes, which include (domestic) remittances and public transfers, played a major role in lowering poverty. From 2013 to 2018, public transfers among rural households in the bottom quintile almost doubled, driven by the increased coverage of rural pensions, the expansion of social assistance, social insurance and social assistance benefits, and the introduction of universal health care with a basic reimbursement package extended to rural areas.

Figure 28. Poverty reduction in China over the past 40 years based on the 2010 poverty standard was driven by economic transformation and social programs

A. Poverty headcount and headcount rate in rural areas, 2010 Standard
(Percent, millions)



B. Contribution of all sources of income to rural poverty reduction
(Contribution to poverty reduction, percentage points)



Source: 2019 NBS China Statistical Yearbooks using the 2010 standard, equivalent to \$2.30 per person per day, 2011 Purchasing Power Parity; (Lugo, Niu, and Yemtsov forthcoming 2021), based on China Household Income Project surveys 1988, 1995, 2002, 2007, 2013, and 2018.

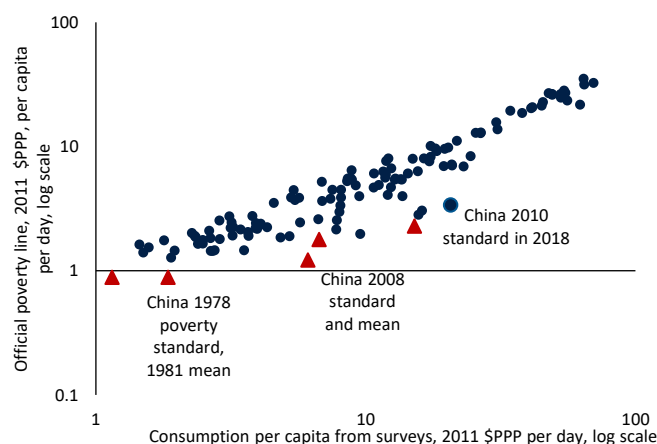
⁵ <https://apnews.com/article/china-celebrates-end-extreme-poverty-1449b5dc8a48483af847f4c38f64c326>

With the goal of eradicating extreme poverty in rural areas met, China is redefining the social agenda for the years to come. The 14th FYP (2021-25), formally adopted on March 11, reaffirmed the goal of achieving “common prosperity” through new rural revitalization and urbanization strategies. The social agenda will shift from the national poverty alleviation strategy to rural revitalization, with the aim of preventing a slide back into poverty and narrowing the wealth divide between cities and the countryside. Urbanization is expected to continue, fueling the household incomes that would help boost consumption, which is key to the “dual circulation model” that the country is adopting. This chapter section reflects on two key areas that will underlie the agenda going forward.

A new poverty standard for a new era

Going forward, standards to measure poverty and broad-based social welfare will have to be adapted to the realities of a “moderately prosperous society.” As countries grow wealthier and extreme poverty becomes rare, assessing what defines a minimum bundle of goods and services changes. Accordingly, national poverty lines tend to increase with growing per capita income (Figure 29). China has updated its standards twice (in real terms) since the first poverty line was set in 1985. In each revision, the minimum consumption bundle was upgraded to reflect the country’s economic and social development. The 2008 revision maintained the calorie threshold at 2,100 kcal per person per day, but the quality of the food bundle was improved to consider its nutritional value. In addition, the non-food component was increased from 15 percent to 40 percent of the line. The 2010 standard is meant not only to cover food and clothing needs but also basic education, health, and housing. Non-food goods represent 54 percent of the total minimum basket (National Bureau of Statistics, NBS 2016). Consequently, the value of the Chinese poverty lines, expressed in US\$ 2011 purchasing power parity, grew over time, from \$0.98 per person per day of the 1978 standard to \$1.30 of the 2008 standard, and finally to \$2.30 of the 2010 standard (Chen and Ravallion 2020). As the country has reached the goal of eliminating extreme poverty, it is natural now to define a new poverty standard that is better suited to a “moderately prosperous society”.

Figure 29. Consumption per capita vs national poverty lines, 120 countries and China
(2011 \$PPP)



Sources: (Jolliffe and Prydz 2016), PovcalNet (<http://research.worldbank.org/PovcalNet/povOnDemand.aspx>).
Note: In 2011 US\$ PPP, latest available data for all countries for China 1980-2018; log scale

While setting new poverty (or low-income) lines is a complex and often lengthy technical process, existing higher absolute thresholds can provide a first approximation. Absolute poverty thresholds based on valuations of the cost of basic needs are widely used across middle-

income countries as well as rich economies.⁶ Most of the lines presented in Figure 29 are derived from using absolute thresholds. The median poverty line used in upper-middle-income countries, such as China, is equivalent to \$5.50 per person per day (in 2011 PPP). The US line is set at \$21.7 a day (in 2011 PPP). In China, the Dibao standards are being used on a de facto basis to target social assistance for those considered “low-income.” Dibao lines are meant to be based on the local minimum cost of basic needs: food, clothing, housing, and education. While thresholds differ among provinces and within provinces for urban and rural areas, the average thresholds have increased over time, on average. In addition, the Dibao lines have converged, with rural thresholds approaching urban thresholds and Western lines closing with Eastern lines. On average, the urban minimum standard in 2020 was 678 yuan per month per beneficiary, while the average rural minimum standard was 479 yuan per month. These are equivalent to 4.2 and 3.6 USD per person per day in 2011 PPP, respectively. The implied poverty rates and headcount, using these alternative thresholds are presented in Table 3.

Table 3. Estimates using absolute poverty lines

Absolute lines	Welfare aggregate	Value of threshold		Poverty rate (percent)	Number of poor (million)	Year of the data
		RMB / year	2011 PPP/ daily			
2010 standard (NBS)	Per capita consumption	3,218	2.2	0.6 (rural)	5.5	2019
Upper-middle income line	Per capita consumption	6,443	5.5	18.9 (national)	264	2018
		5,326		30.2 (rural)	172	
		6,773		11.2 (urban)	92	
Dibao average rural	Per capita consumption	4,836	3.6	9.8	55	2018
Dibao average national	Per capita consumption	6,960	4.2	4.5	37	2018

Source: Staff calculations based on ventile data provided by NBS; urban/rural CPI from NBS and 2011 PPPs for China: urban = 3.91; rural = 3.04; national = 3.70.

An alternative to setting an absolute revised threshold is the adoption of a relative poverty line. EU and OECD countries set their minimum living standard at 50-60 percent of the median equivalent disposable income, respectively. Typically, the same threshold is used for the whole country, despite geographic differences in living standards. The United Nation’s SDG adopted a relative poverty indicator (10.2.1), defined as the proportion of people living below 50 percent of median income.⁷ The justification for the use of relative poverty lines is clear: People are said to be living in poverty if their income and resources preclude them from having a standard of living considered acceptable in the society in which they live.⁸ In other words, individuals’ welfare

⁶ Increasingly, countries are replacing or complementing their monetary poverty measure with multidimensional measures. Some combine monetary and non-monetary dimensions into a single index, such as Mexico or the EU, while others construct a solely non-monetary measure, such as Colombia. See World Bank-UNICEF-UNDP recent document for a description of steps and examples adopted by countries.

⁷ <https://sdg-tracker.org/inequality>

⁸ European Commission, Joint Report on Social Inclusion 2004. (Fuchs 1967) was one of the first proponents of relative lines, as 50 percent of the current median income. See (Chen and Ravallion 2020) for a brief description.

depends on their incomes relative to others. The argument is closely aligned with China's idea of shared prosperity, which emphasizes equitable development. In addition, the notion of a minimum threshold increasing with median income is supported by people's perception of a "just sufficient" amount to cover their household expenditures, according to a survey conducted in urban China (Gustafsson and Sai 2020).

To contribute to the discussion, several researchers in the past few years have produced poverty estimates using relative thresholds. A selection of these studies is summarized in Table 3 below. The value of the thresholds was derived using strongly relative lines (as in Gustafsson and Sai 2020 or Shen and Li 2020) in several multiples of the existing 2010 standard. Using an approach similar to the EU's (60 percent of the national median), the poverty line would be almost four times higher than the current standard. If the SDG Indicator is used instead, China's threshold in 2018 would have been around three times the current standard. (Chen and Ravallion 2020) analyze the use of a "weakly relative line" that is anchored around an absolute threshold. This means that the poverty threshold depends on the mean or median income, with a minimum floor of what is considered needed for survival. In addition, these proposals assume that the new standard would expand the measurement of poverty in China to be truly national for the first time in its history, covering both rural and urban areas. This is consistent with the vision in the 2016-30 National Development Plan, which underscores the need for a shift "from primarily addressing rural poverty to comprehensively addressing urban and rural poverty" (Shen and Li 2020). Furthermore, in all the cases, income instead of consumption is used as a welfare measure. This is similar to the practice in most high-income economies.⁹

Table 4. Estimates using relative poverty lines (selected studies)

Authors	Definition of threshold	Welfare aggregate	Value of threshold		Poverty rate (percent)	Number of poor (million)	Year of the data
			RMB / year	2011 PPP/ daily			
(2010 standard NBS)	Absolute threshold	Per capita consumption	3,218	2.3	0.6 (rural)	5.5	2019
(Gustafsson and Sai 2020)	40% urban median	Equivalent disposable income	8,910	5.9	8 (urban)		2013
	50% urban median		11,136	7.4	14 (urban)		
	60% urban median		13,364	8.9	20 (urban)		
(Shen and Li 2020)	40% national median	Per capita disposable income	8,000	5.1	14		2018
	50% national median		10,000	6.4	20	280	
	60% national median		12,000	7.7	27	370	

	50% rural median		6,000	4.7	17 (rural)	100	
	50% urban median		15,000	9.1	14 (urban)	120	

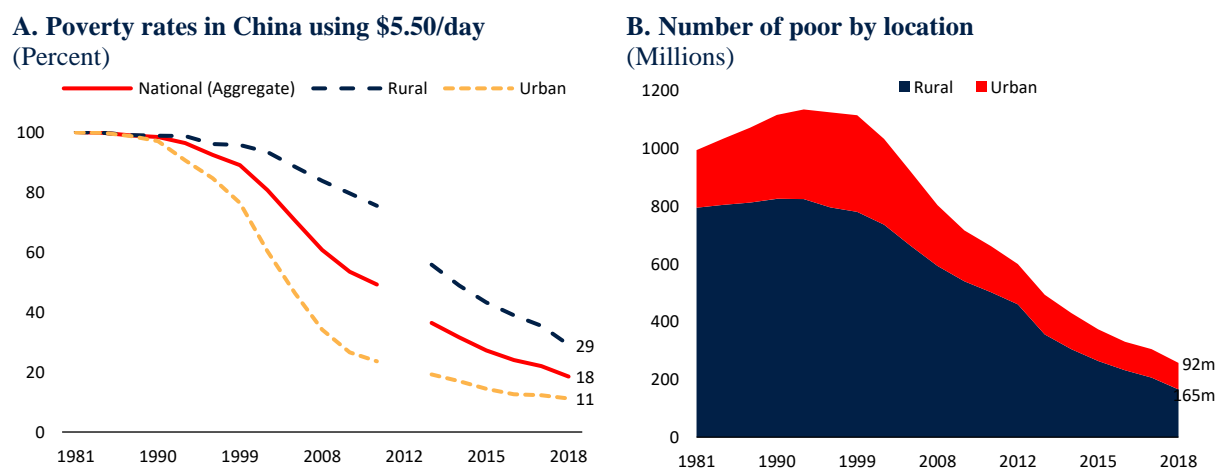
⁹ Consumption is typically the preferred welfare aggregate for developing countries where subsistence agriculture and informal employment are prevalent (Deaton, A. 1997). In richer economies, these types of employment are marginal, and thus income becomes an attractive alternative to measuring welfare, representing potential command over resources (see 2011 Canberra Group recommendations on household income statistics).

(Chen and Ravallion 2020)	Weakly-relative line, anchored at \$1.90. $Z = \text{Max}(\$1.9, 0.9 + 0.7M^*)$ $M^* = (1 - \text{Gini}) * \text{Mean}$	Per capita disposable income	9,376	7.46	23		2014
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Whether relative or higher absolute lines are used, some 15-25 percent of China's population would be considered poor (in 2018), and around a third would be located in urban areas. Poverty in China has traditionally been considered a rural phenomenon. Therefore, all government efforts to address poverty and monitor its evolution focused on rural areas. But if a higher standard is used, such as the upper-middle-income countries' line, the composition of the poor changes. With growing urbanization, the share of people who fall below the \$5.50 a day line (2011 PPP) and live in urban areas has increased, from 20 percent in the early 1980s to 35 percent in 2018. According to these latest estimates, 92 million urban residents would be considered poor in 2018 (Figure 30.A and B).

The urban poor differ from the rural poor. According to (Shen and Li 2020), the urban poor—as defined using a relative urban line—are more likely to be in China's Eastern and Central regions, unlike the rural poor. The urban poor tend to be working but receive low wages. They have limited social security coverage and relatively high expenditures, as they remit part of their income to their family in rural areas.

Figure 30. At higher poverty standard, a third of the poor in China live in urban areas



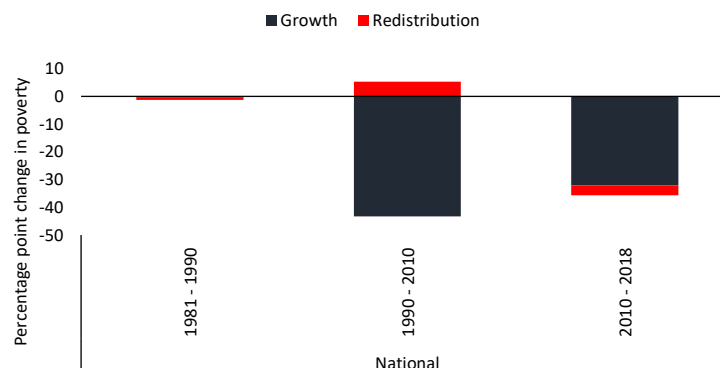
Source: Povcalnet 1981-2016 and preliminary estimates for 2017-18 from NBS grouped data. Series break in 2012-13 due to changes in sampling and methodology.

Addressing inequality will be key

At this higher standard, addressing high levels of inequality will be crucial for reducing poverty going forward. The ability to translate growth into reduced poverty depends on the initial level of inequality and changes in inequality over time. For example, rising inequality in China between 1990 and 2010 took a toll on poverty reduction. Had consumption growth been equally distributed from 1990 to 2010, an additional 5.3 percent of the population would have moved out of poverty during this period, based on a poverty line of \$5.50 a day in 2011 PPP (Figure 33). In

contrast, declining inequality from 2010 to 2018 bolstered overall poverty reduction by 3.6 percentage points.

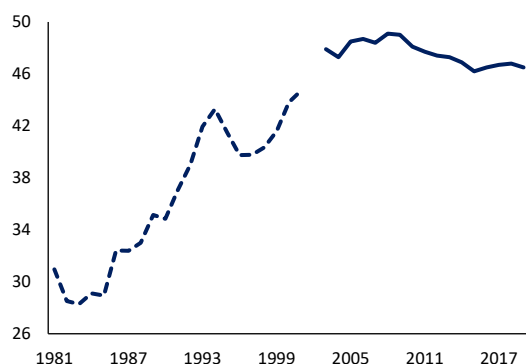
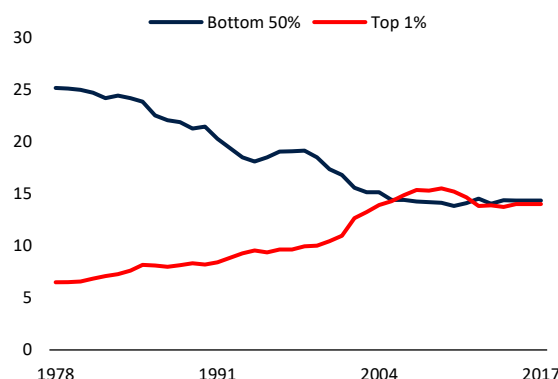
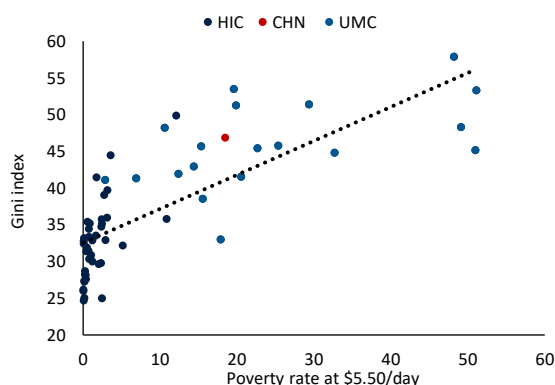
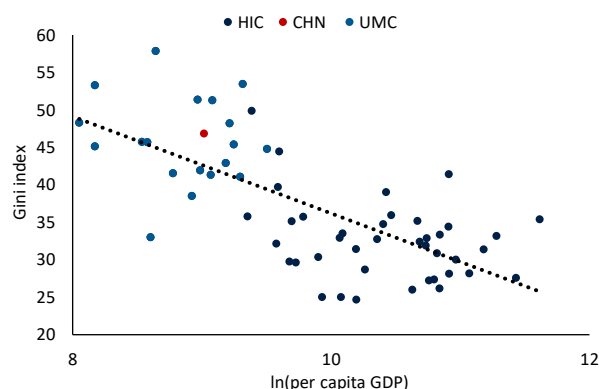
Figure 31. Decomposition of national poverty into a growth and change in inequality components
(Contribution to poverty reduction, percentage points)



Source: (Lugo et al. 2021), based on Povcalnet, using the international poverty line (\$5.50/day per person, 2011 PPP).

Note: Poverty decomposition following (Datt and Ravallion 1991). Data available for 1981-87 is based on per capita disposable income, while 1990-2018 is based on per capita household expenditure.

China's inequality remains relatively high, particularly for an aspiring high-income economy. Income inequality rose rapidly in the first three decades of reform and opening up of the economy, with the Gini index increasing from 30 in the mid-1980s to 49 in 2008. This is a level typically found in highly unequal Latin American economies or Sub-Saharan Africa. As the country moved to a market economy, it was expected that interpersonal disparities would increase. The fast development in coastal urban areas triggered spatial disparities in the lagging regions and rural areas. The end of the 2000s was a turning point, as the Gini index began to fall, declining to 46.2 by 2015 (Figure 32.A). This change in the trend is referred to as the “Chinese inequality turnaround,” and is attributed to factors that include the shift in public policies toward the Western and Northern regions, the end of agricultural taxation, the rise of social protection spending, and the increase in the minimum wage and its enforcement (Kanbur et al. 2021). In the last five years, despite further progress in extreme poverty reduction, improvements in income inequality stalled: the Gini coefficient was still 46.5 in 2019, a level that is high for a country aspiring to join the ranks of high-income economies (Figure 32.C and D) (Dixon and Gill 2021). Using a different metric confirms this: the share of national income flowing to the top 1 percent is virtually equal to that going to the bottom half of the distribution (Piketty et al. 2016) (Figure 32.B).

Figure 32. Inequality in China remains relatively high compared to its current and aspirational peers**A. Gini index**
(Index)**B. Share of top 1% = Bottom 50%**
(Percent share)**C. Income inequality and poverty rates**
(Percent, index)**D. Income inequality and per capita GDP**
(USD, index)

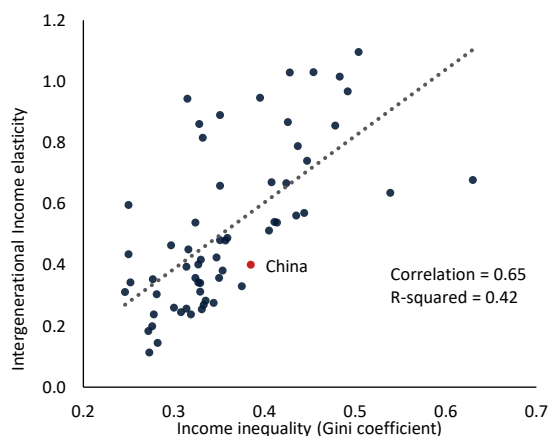
Source: Poverty and inequality estimates for China based on NBS ventiles (for poverty) and as reported for Gini index; for the rest of the world, from PovcalNet; World Inequality Database, based on (Piketty et al. 2019); (Wang et al. 2018), based on 2015 micro-census.

Note: Only countries that report income inequality (not expenditure) are included. HIC=High-income countries. UMC=Upper-middle income countries.

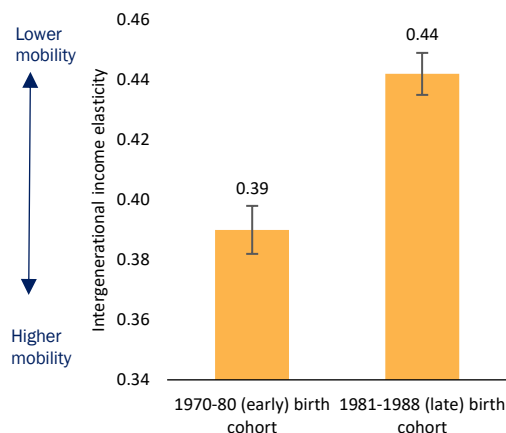
Even if inequality does not increase further (as suggested by more recent data), the existing high levels of inequality in China today may constrain the socioeconomic mobility of future generations. An analysis by (Narayan et al. 2018) across developing and developed countries shows a strong negative correlation between income inequality and intergenerational mobility (Figure 33.A), a stylized fact dubbed “the Great Gatsby Curve” (Corak 2013; Krueger 2012). While China appears to have higher than average intergenerational mobility (i.e., lower than average intergenerational income elasticity) for its level of income inequality in Figure 32, more recent evidence suggests that intergenerational mobility in China has declined for younger generations (Fan, Yi, and Zhang 2021). According to these estimates, the intergenerational income elasticity increased from 0.390 for those born between 1970 and 1980 to 0.442 for those born between 1981 and 1988 (Figure 33.B), indicating worsening prospects for intergenerational mobility. Intergenerational income persistence is more prevalent among urban and coastal residents than rural and inland ones. If such a trajectory continues in China, reducing poverty could become more and more difficult.

Figure 33. High levels of inequality may restrict economic mobility Addressing inequality will help improve the well-being of those who are worse-off

A. Inequality and intergenerational income mobility (Coefficients)



B. Intergenerational income elasticity for China (Coefficients)



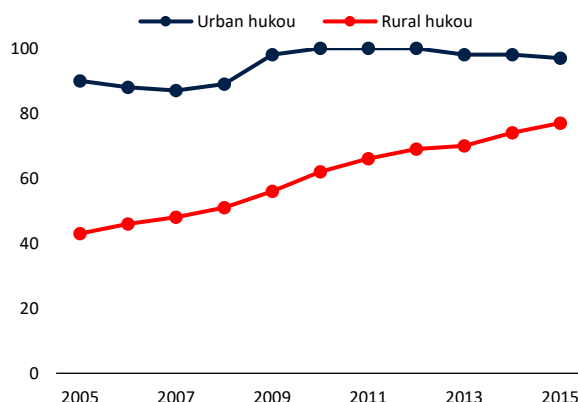
Source: Global Database on Intergenerational Mobility for Intergenerational income elasticity; World Development Indicators for Gini coefficient; (Fan, Yi and Zhang 2021).

Note: Higher values of intergenerational income elasticity indicate lower relative intergenerational mobility. In figure A, the intergenerational income elasticity is calculated for cohorts born in the 1960s or 1970s. China's elasticity is based on the 1960 birth cohort. A total of 61 countries are included. In figure B, estimates based on China Family Panel Survey for 2010.

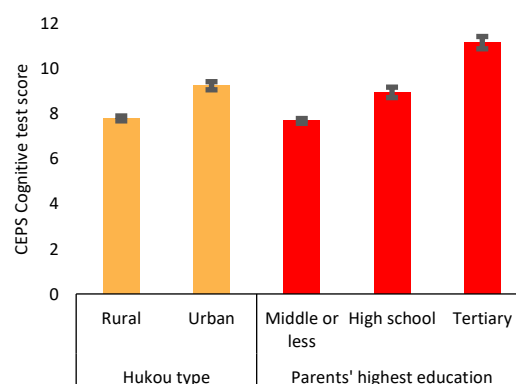
In addition, inequalities in other areas, such as education, remain prominent in China. Since 1977, China has implemented a number of educational reforms, including making nine years of basic education compulsory and expanding higher education institutions. An impressive increase in educational outcomes has followed these reforms. Between 1977 and 2019, the average years of schooling among those ages 15 and over in China increased from 5.8 to 10.3. But despite the increases in attainment, particularly among the rural population, a significant urban-rural divide still exists. Based on the 2015 micro-census, while children with rural hukou became more likely to attain an upper secondary-level of education than in the past, a 20-percentage point gap with children with urban hukou persists (Figure 34.A). Increasingly, low educational attainment has become a rural phenomenon, with poor rural areas the most likely to fall behind (Hell and Rozelle 2020). Urban-rural disparities also exist in quality of education: Test performance data indicate that students with rural hukou perform on average 1.5 points lower than their counterparts with urban hukou. The distance is significantly larger among those that have tertiary educated parents and those with less than high school degrees (Figure 34.B). Similarly, despite the expansion of higher education, some evidence suggests that it is becoming increasingly challenging for socioeconomically disadvantaged students to gain access to college relative to non-disadvantage students, who come from richer and better-educated families (Gruijters et al. 2019; Wu et al. 2020).

Figure 34. There are large remaining gaps in access and quality of education across rural and urban hukou status

A. Share of 15-17-year-old with some upper secondary attainment
(Percent)



B. Average cognitive skills test score (9th graders), by category
(Points)



Source: (Wang et al. 2018), based on 2015 micro-census; China Education Panel Survey (CEPS) 2013-14

Note: In figure B, urban-rural according to household Hukou registration, not residence. Weighted means. Capped lines represent 95 percent confidence intervals.

Given that higher educational attainment is a significant determinant of obtaining more secure, higher-paying, formal jobs, persistent educational gaps may inhibit balanced growth and better employment opportunities for rural workers. Returns to higher education have increased since the 1990s, contributing to growing income inequality (Wang et al. 2013). Factors such as greater educational funding in urban areas, more highly educated teachers, and more (and better quality) schools have all contributed to the urban-rural divide in education. The hukou system has additionally restricted educational opportunities for the children of migrants with a rural hukou by preventing them from benefiting from better quality services in urban areas (Ma et al. 2018; Wang et al. 2014; Wu et al. 2020; Yang et al. 2014). Fast migration to urban areas opened economic opportunities for rural workers. Yet, the majority of children have been left behind in predominantly rural areas (NWCCW, NBS, UNICEF 2018). Even children who migrate with their parents to urban areas have faced greater challenges in obtaining education. They are less likely to complete compulsory education and their academic performance is significantly lower than that of urban students (Ma et al. 2018; Yiu and Yun 2014; Zhang et al. 2015).

Looking ahead

As the country adopts higher poverty standards, poverty reduction will again become an inclusive growth agenda. Job creation has been quintessential to the success of China's poverty reduction over the past four decades, with two-thirds of rural poverty reduction between 1988 and 2007 coming from increased labor incomes. During the last decade, using the \$5.50-a-day poverty line, non-agricultural earnings becomes again a major source of poverty reduction. The 14th FYP stresses the country's objective to rebalance the economy toward a service-based, domestic consumption growth model while emphasizing technology, innovation, and a move toward the decarbonization of the economy. The new jobs will increasingly be in services and in urban areas.

In addition, they will demand a different (and higher) set of skills than those in the past, which may take time to develop, particularly among the disadvantage groups for which access to quality education have lagged behind. Social safety nets and equitable skills development may be key to supporting the needed labor relocation while protecting the worse-offs, in line with the ambitions of “common prosperity.”

Addressing inequality may not only support poverty reduction but also spur economic growth. Closing gaps in access to high quality public services and easing constraints on labor mobility will remain vital. In addition, progressive tax systems can play a more active role in addressing inequality and relative poverty, as they do in OECD countries. A recent study by Lustig and Wang (2020), using 2014 data, showed that the personal income tax in China is, indeed, equalizing. But its effect on inequality is minor, compared to that of social contributions and direct transfers, and is almost reversed by the unequalizing effect of indirect taxes (value-added and consumption taxes). Compared to other countries, progressive personal income tax accounts for only 5 percent of revenue in China; it yields close to 15 percent on average in the OECD. Furthermore, and crucially, the fiscal system increased the urban-rural gap. The main driver of this result is contributory pensions, which are significantly more generous in urban than rural areas.

Finally, coordinating pro-poor development programs with the social protection system could help protect households from shocks, irrespective of their location. The emphasis on rural revitalization could be complemented with efforts to support job creation and strengthen social protection mechanisms for urban and rural populations, including many informal and migrant workers. At present, the coverage of major social assistance programs, such as Dibao, is relatively low for specific groups. Less than 5 percent of migrants in the bottom quintile are estimated to be Dibao beneficiaries (Song et al., forthcoming). In addition, social assistance programs (including cash transfers, health and education assistance, employment, and housing) have separate service delivery systems, impeding coordination and systematic data exchanges. Full integration of the registries and databases could improve the targeting and identification of needs. Together with enhanced social insurance, social protection systems can support and facilitate the rapid structural changes that lie ahead.

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