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## List of Abbreviations

ASEAN	Association of Southeast Asian Nations
bps	Basis points
BRI	Belt and Road Initiative
B2G	Business-to-Government
CAC	Cyberspace Administration of China
CDC	Center for Disease Control and Prevention
COVID-19	Coronavirus Disease 2019
CO <sub>2</sub>	Carbon Dioxide
COP	Conference of Parties
CPI	Consumer Price Index
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DSR	Digital Silk Road
EAP	East Asia and Pacific
EIA	U.S. Energy Information Administration
EMDE	Emerging Market and Developing Economy
EM7	Seven largest emerging market economies
ETS	Emissions Trading System
EU	European Union
FDI	Foreign Direct Investment
FX	Foreign Exchange
FYP	Five-Year Plan
GDP	Gross Domestic Product
GEP	Global Economic Prospects
G20	Group of 20
H1	First Half Year
H2	Second Half Year
ICT	Information And Communication Technology
ILO	International Labour Organization
LGFV	Local Government Financing Vehicle
LPR	Loan Prime Rate
MLF	Medium-term Lending Facility
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce
MOU	Memorandum of Understanding
NBS	China National Bureau of Statistics
NDC	Nationally Determined Contribution
NDRC	National Development and Reform Commission
NPL	Non-performing Loan
OECD	Organisation for Economic Co-operation and Development
OFDI	Outward Foreign Direct Investment

OPEC	Organization of Petroleum Exporting Countries
PBOC	People's Bank of China
PIPL	Personal Information Protection Law
POE	Private-Owned Enterprise
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
RMB	Renminbi
RRR	Reserve Requirement Ratio
sa	Seasonally Adjusted
SAFE	State Administration of Foreign Exchange
SHIBOR	Shanghai Interbank Offered Rate
SLF	Standing Lending Facility
SME	Small and Medium-sized Enterprise
STRI	Services Trade Restrictiveness Index
SOE	State-Owned Enterprise
SPRF	Special-Purpose Refinancing
TiVA	Trade in Value Added
TMLF	Targeted Medium-Term Lending Facility
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNFCCC	United Nations Framework Convention on Climate Change
U.S.	The United States
USD	U.S. Dollar
VAT	Value-added Tax
WBG	World Bank Group
WDI	World Development Indicators
WIPO	World Intellectual Property Organization
WTO	World Trade Organization
y/y	Year-on-Year
ytd	Year-to-Date
2Y CAGR	Two-year Compound Annual Growth Rate
3mma	Three-month Moving Average

## Executive Summary

Following a strong rebound in the first half of 2021, economic activity cooled rapidly in the latter half of the year. The slowdown was partly policy induced, reflecting significant fiscal tightening and regulatory curbs on the financial and real estate sectors, while recurring COVID-19 outbreaks complicated the normalization of contact service activities. This led to a sharp slowdown in investment and sluggish recovery of private consumption, which was only partially offset by stronger-than-expected exports on the back of robust external demand. In addition, power shortages and production cuts aimed at reducing CO<sub>2</sub> emissions, which surged in the first half of 2021, also weighed on economic activity.

Real GDP growth is expected to reach 8.0 percent this year—0.5 percentage points lower than previously projected. Growth is projected to moderate to 5.1 percent in 2022, closer to its potential, reflecting less favorable base effects, diminished support from exports, and the government's continued deleveraging efforts. Although full-year growth is projected to slow in 2022, momentum is expected to pick up, aided by a more supportive fiscal stance following the rapid withdrawal of fiscal policy support in 2021. The recent cut in the reserve requirement ratio (RRR) and lending rate also signal a more accommodative monetary policy stance, although financial sector de-risking efforts are expected to continue.

The growth outlook assumes that China's COVID-19 strategy will remain broadly unchanged for much of 2022 and will relax gradually thereafter. In the face of recent virus mutations, China's COVID strategy will require continued targeted containment measures, although these are generally expected to be short-lived. As a result, we expect domestic demand to continue to normalize slowly, with real consumption growth projected to only gradually return to its pre-COVID-19 trend, supported by stable labor market conditions and improved consumer confidence. With the authorities focusing on reining in financial risks in the property sector, real estate investment is expected to remain subdued. Meanwhile, infrastructure investment is projected to recover amid more supportive fiscal policies. As external demand weakens, the current account surplus is projected to narrow to 1.4 percent of GDP in 2022. Headline inflation is expected to rise on firming consumer demand and some pass-through from higher producer prices but remain below the People's Bank of China's (PBOC) 3 percent target.

Risks to China's growth outlook are tilted to the downside. Key downside risks relate to the pandemic and the highly leveraged real estate sector. Renewed domestic COVID-19 outbreaks, including the new *Omicron* variant and other highly transmittable variants, could require more broad-based and longer-lasting restrictions, leading to larger disruptions in economic activity. A severe and prolonged downturn in the real estate sector could have significant economy-wide reverberations. China's economy is also vulnerable to global supply disruptions, which may prove more persistent than expected, contributing to burgeoning inflationary pressures as evidenced by sharp increases in global input costs. Other downside risks include heightened tensions with major trading partners and a sharp tightening in global financial conditions, which could lead to a rise in borrowing costs in offshore markets of highly leveraged firms and exacerbate the problems in the real estate sector.



In the short term, the authorities should maintain the ongoing efforts to address excessive leverage in the corporate sector, especially among real estate firms, but provide liquidity support to prevent financial contagion from distressed developers to financial markets more broadly. The authorities should also stand ready to provide policy easing should domestic demand remain sluggish amid the lingering pandemic and the ongoing adjustment in the real estate sector, without abandoning their efforts to contain a further build-up of financial sector risks.

Over the medium term, policymakers will face a difficult rebalancing act as they aim to transition to high-quality growth. Following the strong COVID recovery, the economy has returned to a path of structural moderation, reflecting deteriorating demographics and rising constraints to an investment-driven growth model. Three challenges stand out. First, China's uneven recovery has worsened domestic and external economic imbalances, undoing part of the progress made in reducing China's extraordinarily high savings rate. Second, government responses to the pandemic and recent regulatory reforms have strengthened the role of the state, while market-oriented reforms have seen limited progress. China's private sector, particularly its small and medium enterprises, was hard hit by the pandemic. New rules covering digital platform companies, private tutoring, online gaming and a series of other sectors—while targeted at improving competition and consumer protection—have nonetheless created some uncertainty among private investors and led to a sharp correction in asset valuations. Meanwhile, investment by state firms held up, thanks to government support and better access to credit. Third, China's industry- and investment-led recovery has interrupted the downward trend in China's energy and emission intensity, accentuating the challenge of climate change mitigation. To achieve high-quality growth, China will need to rebalance: from external to domestic demand, from traditional investment and industry to consumption and services, from the state to markets and the private sector, and from a high to a low-carbon economy.

Structural reforms could help with this rebalancing act. First, a more robust corporate and bank resolution framework would contribute to mitigating moral hazard, thereby reducing the trade-offs between monetary policy easing and financial risk management. Addressing distortions in the access to credit—reflected in persistent spreads between private and state sector borrowers—could support the shift to more innovation driven, private sector-led growth. Second, following a wave of new regulations, the authorities could consider shifting their attention to remaining barriers to market competition to spur innovation and productivity growth. A further opening up of the protected services sector, for example, could improve access to high-quality services and support the rebalancing toward high-value service jobs (see also the focus chapter of this report). Eliminating remaining restrictions on labor mobility by abolishing the *hukou*, China's system of household registration, for all urban areas would equally support the growth of vibrant service economies in China's largest cities. Third, fiscal reforms could aim to create a more progressive tax system while boosting social safety nets and spending on health and education. This would help lower precautionary household savings and thereby support the rebalancing toward domestic consumption. Finally, the wider use of carbon pricing, for example, through an expansion of the scope and tightening of the emissions trading system (ETS) rules, as well power sector reforms to encourage the penetration and nationwide trade and dispatch of renewables would not only generate environmental benefits but also contribute to China's economic transformation to a more sustainable and innovation-based growth model.



<b>China Economic Outlook</b>	<b>2019</b>	<b>2020</b>	<b>2021f</b>	<b>2022f</b>	<b>2023f</b>
Real GDP growth (%)	6.0	2.3	8.0	5.1	5.3
Consumer Price Index (CPI) (% change, average)	2.9	2.5	0.9	1.9	2.1
Current account balance (% of GDP)	0.7	1.9	1.6	1.4	1.2
Augmented fiscal balance (% of GDP) <sup>a</sup>	-4.6	-8.9	-5.4	-5.6	-5.2

Sources: 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: China's Services Trade Performance: Strong Growth but Unrealized Potential**

China has made major strides in boosting the size and performance of its domestic service sector. Sustained gains in per capita income levels, demographic changes, and rising urbanization lie behind the rising importance of the domestic services market. China's trade in services reflects its growing economic importance. However, China's services trade performance, while strong overall, nonetheless retains some peculiar characteristics. Thus, China's services trade performance is intrinsically linked with its role as a manufacturing powerhouse and the growing share of services embedded in manufacturing. China's services export basket has diversified toward "modern" services like telecoms, IT, and financial services, but services imports continue to be more "traditional," including transportation and travel. China's import profile partly reflects the maintenance of high market access barriers in key service sectors. The country's services trade has also benefitted from growing levels of outward foreign direct investment (OFDI) and the pull that major government-sponsored infrastructure projects have exerted on exports of information and communication technology (ICT), construction, and financial services. More recently, digital services have experienced strong OFDI-fueled growth, but chiefly through private channels.

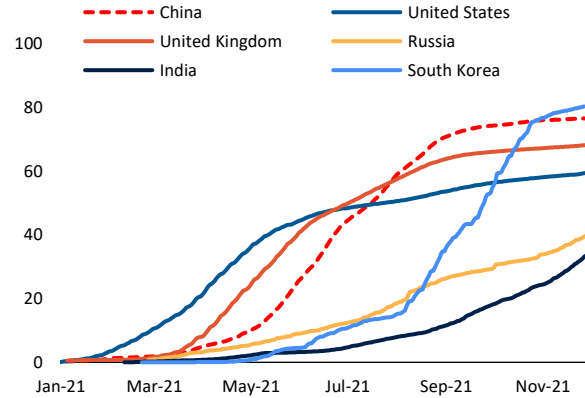
China's transition toward a service-driven economy still has some way to go. In particular, China still lags significantly behind high-income countries in high-value services not directly associated with exports of manufactured goods, such as professional and financial services. In many traditional services sectors, productivity levels also remain low and there is significant remaining scope for convergence. Services trade could help. Lifting barriers on investment and imports of services, where China's market remains significantly more protected than the average in the Organisation for Economic Co-operation and Development (OECD), could bring innovation in technologies, products, and processes. Addressing restrictions in the country's data governance framework for qualified services to engage in cross-border data transfers would open up opportunities for services exports and imports. Reducing restrictive barriers in services will require parallel reforms in regulatory governance, not least to reduce levels of regulatory uncertainty often identified by both foreign and domestic investors as critical for sustainable business operations in China.

**Figure 1. The China Economic Update at a glance**

*China's vaccination rate has slowed after reaching around 80 percent amid recurrent COVID-19 outbreaks*

**A. Share of population fully vaccinated**

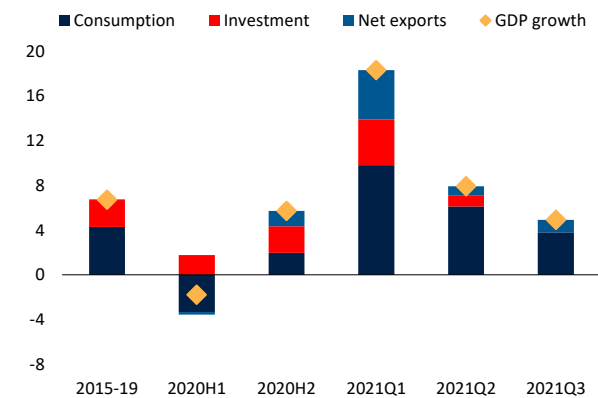
(Percent of population)



*Weak domestic demand, led by a decline in investment, was partially compensated by resilient exports*

**C. GDP demand components**

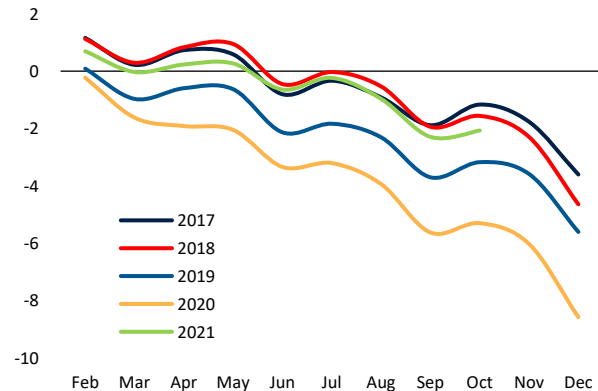
(Contribution to growth, percentage points)



*Following significant fiscal tightening, policies have been incrementally eased to support domestic demand*

**E. Consolidated fiscal deficit**

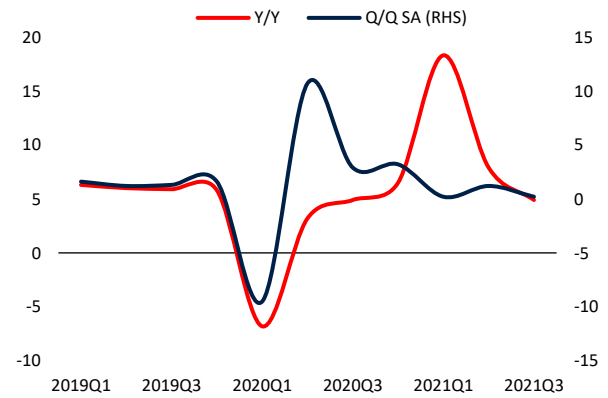
(Percent of GDP)



*Following a strong initial rebound, GDP growth slowed in the second half of 2021, reflecting weak domestic demand*

**B. GDP growth**

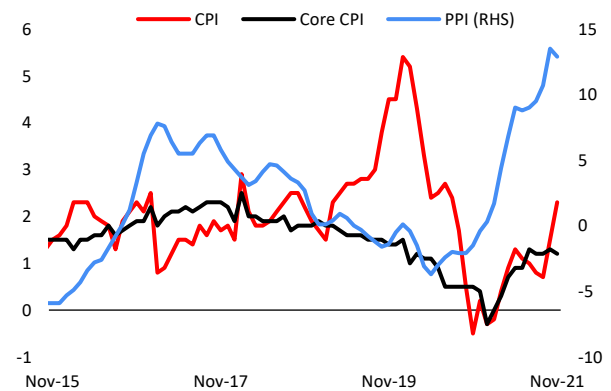
(y/y percent; q/q sa percent)



*China's unbalanced rebound led to a large gap between PPI and CPI inflation*

**D. Producer and Consumer inflation**

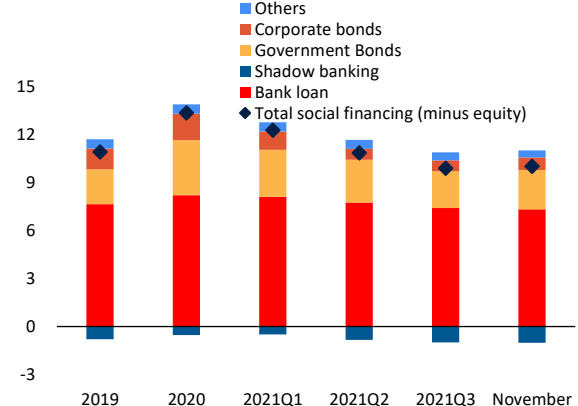
(y/y percent)



*Credit growth stabilized after several quarters of deceleration, reflecting resumed deleveraging efforts*

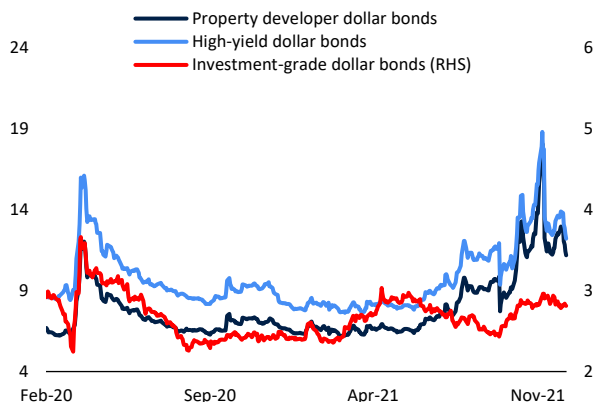
**F. Total social financing growth**

(y/y percent)



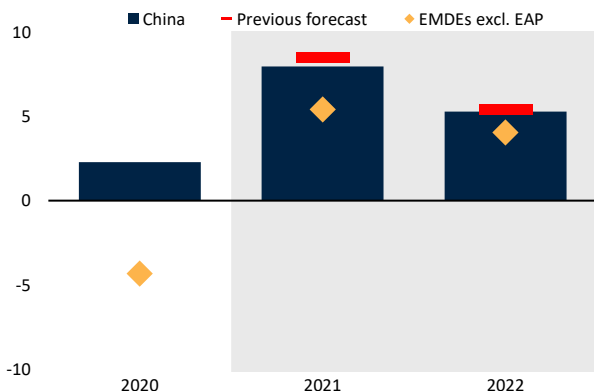
*Offshore bond yields of highly leveraged borrowers increased sharply, triggered by regulatory tightening in the property sector*

**G. Offshore corporate bond yields**  
(Percent)



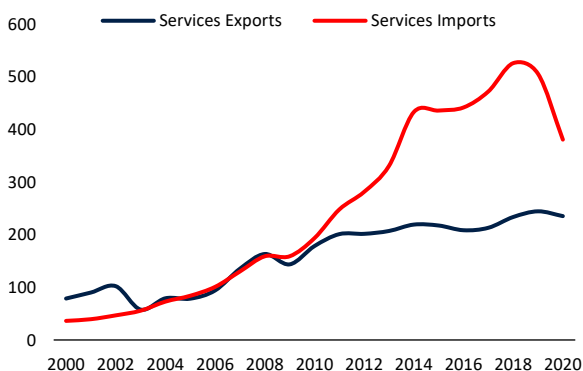
*Growth is projected to slow to 5.1 percent in 2022*

**I. GDP growth**  
(y/y percent)



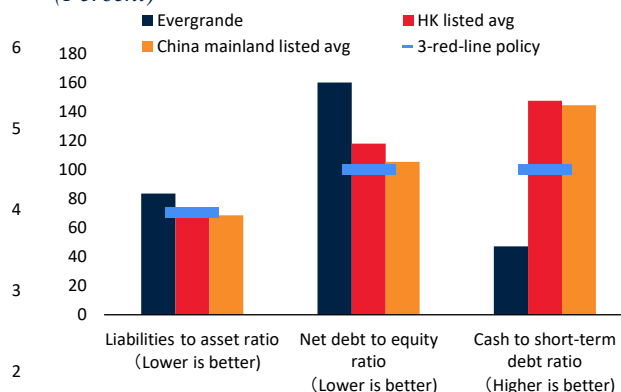
*China's services trade performance has been robust despite a restrictive regulatory framework*

**K. Services trade**  
(Billion USD)



*Severe and prolonged financial stress in the highly leveraged real estate sector could trigger a disorderly deleveraging*

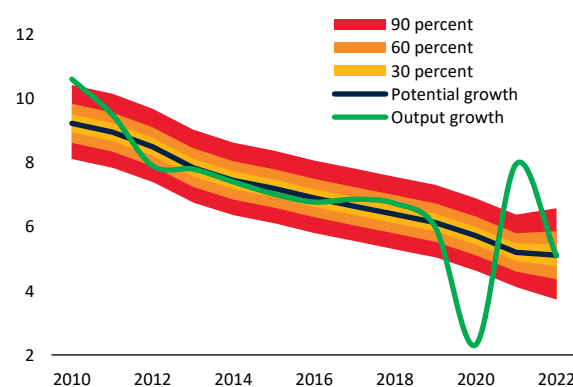
**H. Real estate firm compliance with the "three red line" policies**  
(Percent)



*China's potential growth is trending down, reflecting demographic and investment trends*

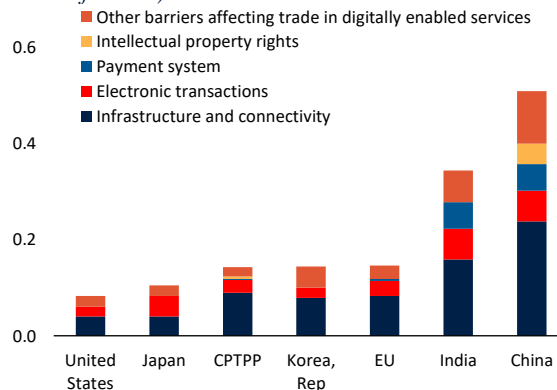
**J. Potential growth**

(y/y percent; percentage point of potential growth)



**L. China and its peers: levels of digital trade restrictiveness**

(Scale of 0 to 1)



Source: National Bureau of Statistics (NBS); People's Bank of China (PBOC); Ministry of Finance (MOF); CEIC Data; Wind Information Database; Haver Analytics; World Development Indicators (WDI); Our World in Data; OECD; World Bank.

Note: A. Percent of population that have received two doses. B. Figure shows year-on-year and seasonally adjusted quarter-on-quarter real GDP growth. C. Figure shows year-on-year real GDP growth and expenditure contributions. Data is based on official estimates published by NBS. D. CPI = Consumer Price Index; PPI = Producer Price Index. E. The consolidated fiscal balance adds up general public budget balance and government fund budget balance. I. Data in shaded areas are forecasts. Emerging Market and Developing Economy (EMDE) excluding East Asia and Pacific (EAP) aggregate is based on the data published in the World Bank's June 2021 Global Economic Prospects report.

# I. Recent Economic Developments

## Global growth has peaked

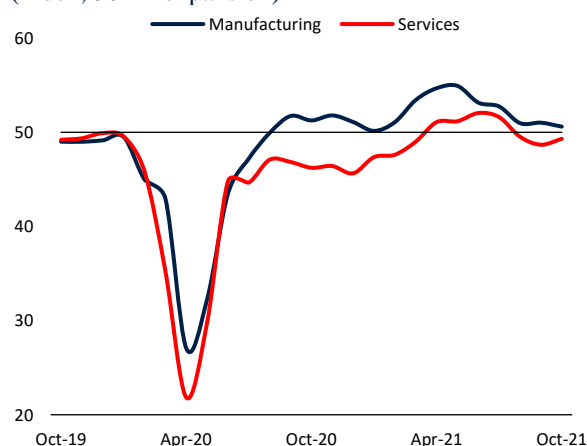
**Global growth has moderated but remains solid** (Figure 2.A). The pandemic continues to linger, with new cases rising again globally, driven by a rapid upsurge across Europe and prompting tighter pandemic restrictions in many economies. Advanced economies still benefit from favorable financing conditions and continued, if diminished, fiscal policy support amid high vaccination rates. Economic activity, however, remains uneven in Emerging Market and Developing Economy (EMDE) countries, in part reflecting different levels of policy support and unequal access to vaccines. Many EMDEs are already experiencing tighter financing conditions amid persistent price pressures and elevated EMDE sovereign credit spreads. Portfolio outflows from EMDEs accelerated in late October and early November in the midst of growing concerns about inflation, growth, and high levels of government debt.

**Higher commodity prices and rising input costs are being passed through to output prices, contributing to elevated inflation.** High frequency indicators point to a moderation in global trade growth amid persistent supply disruptions. These disruptions, along with sharp increases in commodity prices, have contributed to inflationary pressures globally. Throughout 2021, inflation in EMDEs has accelerated rapidly, with median inflation doubling from 2.7 percent year-over-year in January to 5.3 percent in September. In many economies, the sharp increase in headline inflation has partly reflected rising food and energy prices (Figure 2.B). Energy prices have surged, reflecting sharp increases in natural gas and coal, which has affected other commodities, especially food. Some prices have reached levels not seen since the 2011 price spike. Brent crude oil prices reached a seven-year high of \$86/bbl at the end of October.

**Figure 2. Global growth has moderated but remains solid; energy prices have surged**

### A. Global PMIs

(Index, 50+ = expansion)

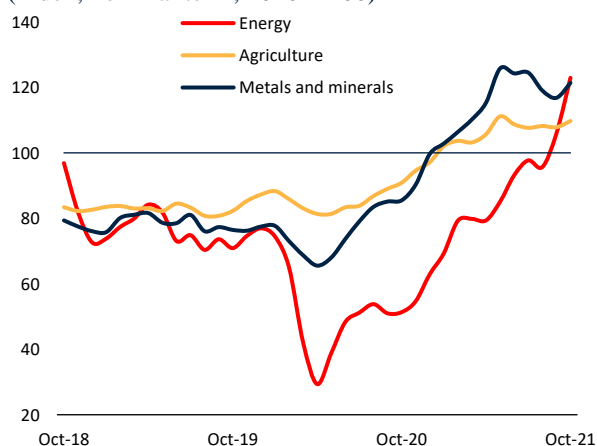


Source: Haver Analytics; World Bank.

Note: Last observation is October 2021.

### B. Global commodity prices

(Index, nominal term, 2010 = 100)

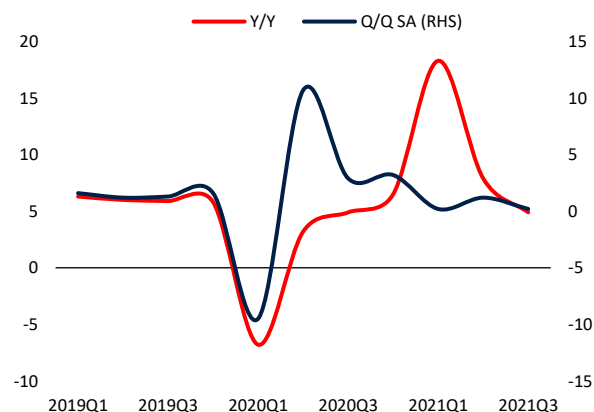


## The pace of China's recovery slowed after the cyclical upturn

Following a strong initial rebound, GDP growth slowed sharply in the second half of 2021. Output expanded 12.7 percent y/y in the first half of 2021, reflecting a low base and strong investment and export growth. Economic momentum slowed visibly in the second half of this year, with real GDP growth decelerating to 4.9 percent y/y in the third quarter on the back of dissipating base effects, a sharp fiscal consolidation, the resumption of de-risking policies in the financial and real estate sectors, and renewed COVID flare-ups (Figure 3). Nevertheless, output still expanded at 9.8 percent y/y in the first three quarters, thanks to strong initial momentum.

**Figure 3. GDP growth slowed following the cyclical upturn**

(y/y percent; q/q sa percent)



Source: NBS; World Bank.

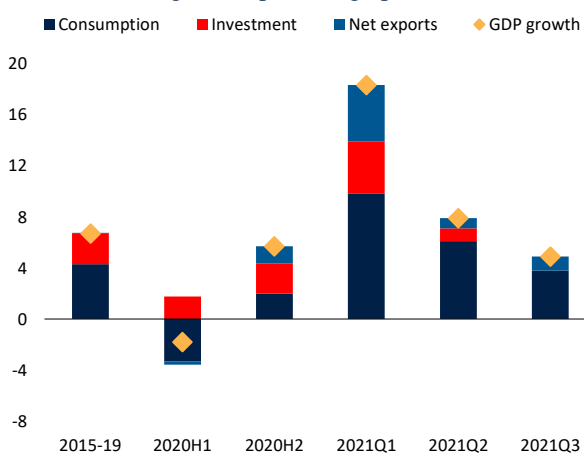
### Demand-side factors predominantly contributed to weaker growth in the second half of 2021.

Significant fiscal policy tightening and regulatory curbs on the financial and real estate sectors reduced investment growth to zero by Q3 (Figure 4.A). In addition, recurring COVID-related mobility restrictions negatively impacted demand by dampening consumer sentiment. The weakness in domestic demand was partially compensated for by stronger-than-expected external demand. On the supply side, power outages and flooding weighed on economic activity in the third quarter of 2021 (Figure 4.B), while global supply disruptions contributed to rising input costs.

**Figure 4. Demand-side factors contributed to weaker growth in the second half of 2021**

#### A. GDP demand components

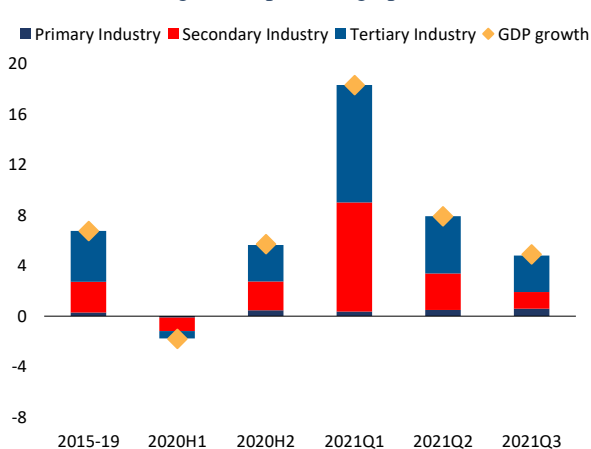
(Contribution to growth, percentage points)



Source: NBS; World Bank.

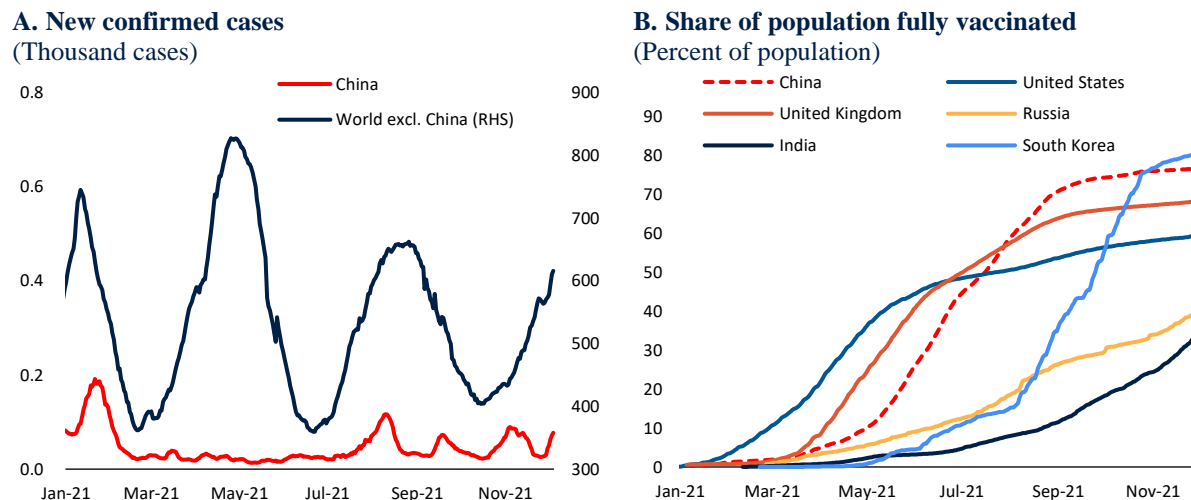
#### B. GDP sectoral composition

(Contribution to growth, percentage points)



**China has continued to maintain its zero-COVID-19 policy, leading to periodic disruptions in economic activity in response to recurrent outbreaks.** Given the higher transmissibility of the Delta variant, COVID incursions are becoming more frequent and widespread (Figure 5.A), despite a sharp uptick in the vaccination rate, which reached 79 percent of China's population in November (Figure 5.B). Since May 2021, China has faced multiple Delta outbreaks. China's policy of testing-tracing-isolation has so far been largely successful at suppressing these outbreaks, albeit at the cost of largely closing off people-to-people contacts with the rest of the world.

**Figure 5. China continues to adhere to its zero-COVID policy amid increased vaccination rates**

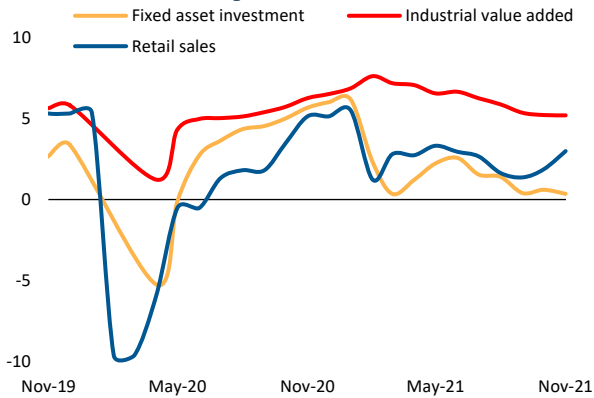
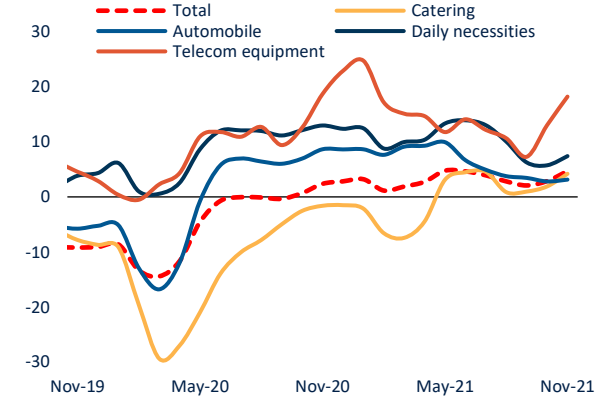


Source: Chinese Center for Disease Control and Prevention (CDC); Our World in Data; Wind Information Database; World Bank.

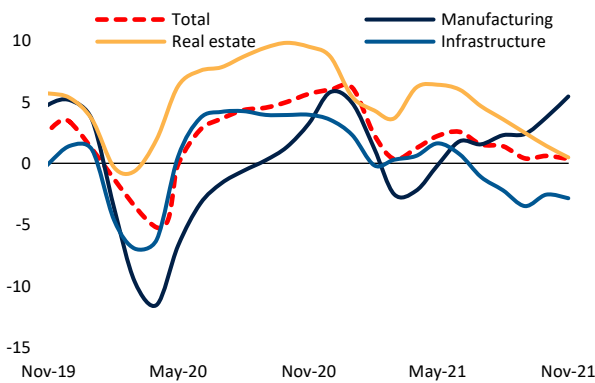
**Consumption recovered more gradually than expected amid recurrent COVID outbreaks.** The contribution of consumption to growth dropped to 3.8 percentage points in the third quarter from 7.8 percentage points in the first half as base effects faded. Improved labor market conditions and a recovery in household disposable incomes have provided some support to consumption. Despite the effective COVID suppression strategy, services and retail sales have seen lasting effects, as consumers have remained cautious given uncertainties (Figure 6.A and B).

**Investment, which led the initial recovery, has decelerated rapidly, reflecting policy tightening and regulatory curbs on the real estate sector.** The contribution of gross capital formation to growth dropped from 2.4 percentage points in the first half of 2021 to zero in the third quarter. The deceleration was driven by infrastructure and real estate investment (see real estate section for more discussion), while manufacturing investment held up relatively well on the back of robust export growth (Figure 6.C). The slowdown in public investment was more pronounced and reflected the sluggish pace of special local government bond issuances. Private investment has also weakened, reflecting policy tightening (Figure 6.D).

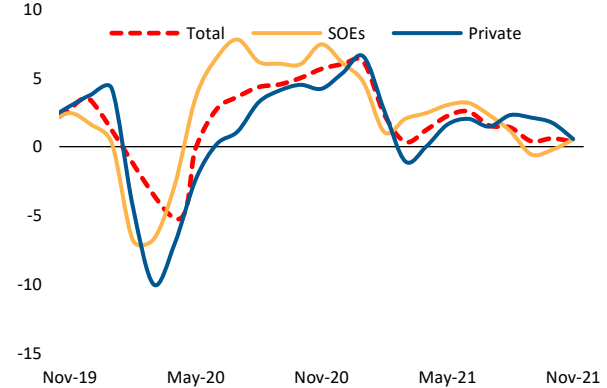


**Figure 6. Sharp slowdown in momentum led by the real estate sector****A. Fixed asset investment, industrial value-added, and retail sales**(2Y CAGR,<sup>1</sup>, 3mma, percent)**B. Retail sales by selected group**  
(2Y CAGR, 3mma, percent)**C. Fixed asset investment by sector**

(2Y CAGR, 3mma, percent)

**D. Fixed asset investment by ownership**

(2Y CAGR, 3mma, percent)



Source: NBS; World Bank.

**On the supply side, growth in industrial production has moderated, while services sector activity has been mixed.** The two-year compound annual growth rate (2Y CAGR) of industrial production slowed to 4.8 percent in the third quarter from 6.1 percent in the first half. Meanwhile, output in the services sector increased by 4.8 percent in 2Y CAGR in the third quarter, similar to its performance in the first half of this year. On the positive side, activity in financial and IT services stayed strong, while recurring travel restrictions weighed on hotel and catering services. Output in the agricultural sector in 2Y CAGR expanded by 5.5 percent in the third quarter from 4.3 percent in the first six months of 2021.

<sup>1</sup> As the COVID-19 shock hit the Chinese economy most severely early last year, the year-on-year growth rate in many macro indicators for the first half of this year can be distorted by large base effects. We therefore also calculate the two-year compound annual growth rate (2Y CAGR) where appropriate to gauge the underlying growth trend compared to the pre-pandemic period.

## Strong exports partly offset weak domestic demand

**Strong growth in exports of goods helped to head off a sharper slowdown in economic momentum in late 2021.** China's goods exports in U.S. dollar value terms expanded by 32.3 percent y/y in the first 10 months of this year, despite supply shortages and production disruptions, which had a limited impact on most export-oriented sectors. The strong growth in exports was driven by robust external demand reflecting the solid economic recovery in advanced economies. In particular, demand for mid- and high-tech products remained firm (Figure 7.A). In recent months, China's exports also benefitted from an upturn in export prices and the diversion of export orders from the Association of Southeast Asian Nations (ASEAN), which experienced disruptions in production amid a resurgence of COVID-19 (Figure 7.B).

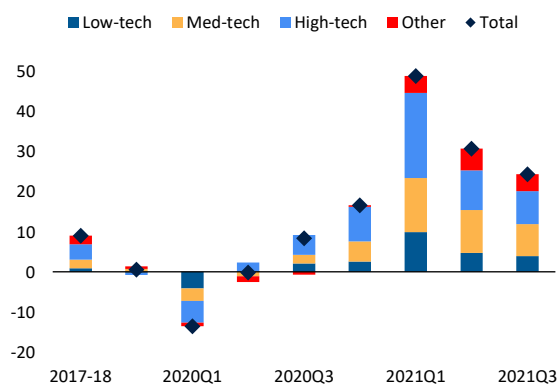
**Import growth lost momentum in recent months after accelerating rapidly at the beginning of the year.** Import activity in the first half of the year was supported by the recovery in domestic demand and restocking of inventories, while surging import prices sustained import values in the second half of the year (Figure 7.C and D). On the back of weakening domestic demand amid new COVID-19 outbreaks and elevated commodity prices, real imports declined by 0.2 percent y/y in 2021Q3, in contrast to an increase of 17 percent y/y in 2021H1. Overall, the merchandise trade surplus in the first 10 months of 2021 amounted to \$510.6 billion, or about 2.9 percent of GDP, compared to \$374 billion or 2.6 percent of GDP in the same period last year.

**The services trade deficit narrowed, further reflecting muted tourism activity due to stringent travel restrictions.** Service exports grew by nearly 40 percent y/y during the first three quarters of 2021. China's strong merchandise exports drove a rapid increase in transport services exports which became the key driver of services exports this year. In contrast, the export of ICT services moderated slightly in the second half of 2021 (Figure 7.E). Meanwhile, services imports started to improve in 2021Q2 on the back of stronger imports of transport services, registering a growth rate of 9 percent y/y in the first nine months of the year (Figure 7.F). Outbound tourism remained muted due to stringent travel restrictions. Overall, China's services trade deficit narrowed to 0.6 percent of GDP in the first three quarters of 2021 from 1.1 percent of GDP in the same period last year.

**Figure 7. Exports outperformed**

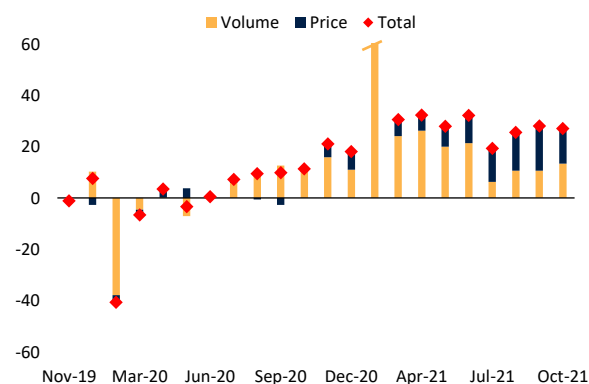
### A. Composition of goods export

(Contribution to growth, percentage points)



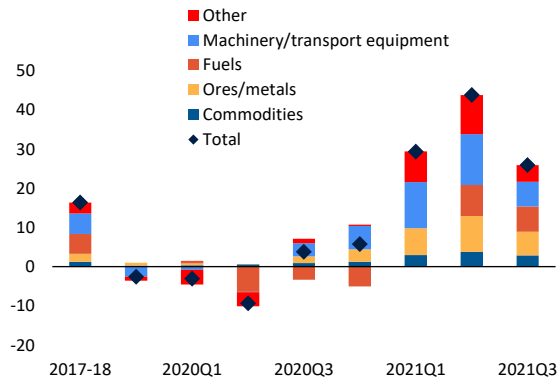
### B. Goods exports growth

(y/y growth, percent)

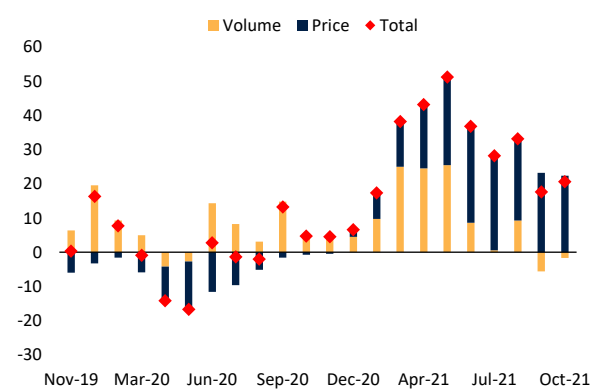


**C. Composition of goods import**

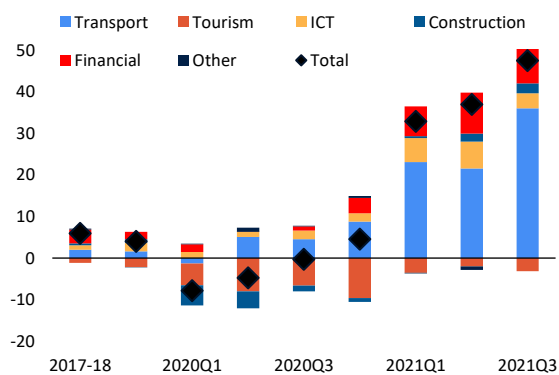
(Contribution to growth, percentage points)

**D. Goods import growth**

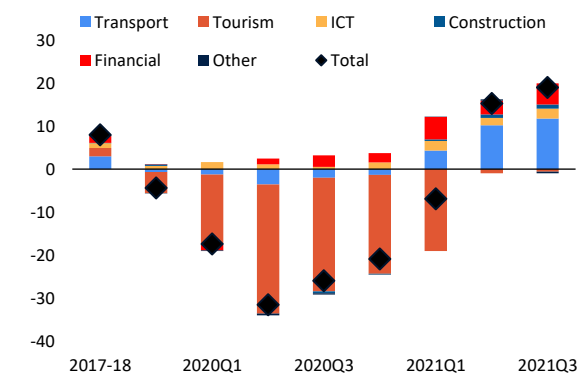
(y/y growth, percent)

**E. Services export growth**

(Contribution to growth, percentage points)

**F. Services import growth**

(Contribution to growth, percentage points)



Source: China Customs; NBS; World Bank.

Note: Other in figure 7.E and F includes personal, cultural and recreational service, and government service not classified elsewhere.

**Sustained current account surplus contributed to RMB strength**

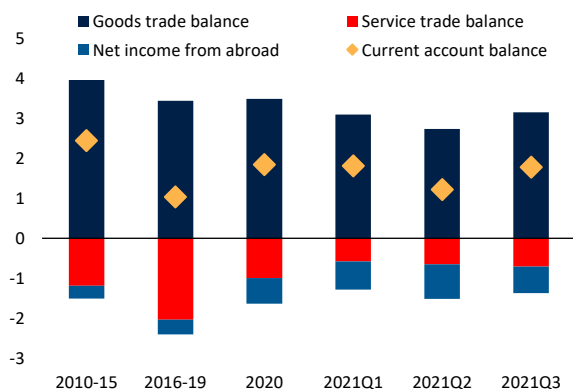
**After rising sharply last year, the current account surplus has remained elevated in 2021 due to a strong trade balance and a tight macroeconomic policy stance.** In the first three quarters of 2021, the current account recorded a surplus of 1.6 percent of GDP, broadly similar to the surplus during the same period of 2020 (Figure 8.A). A large trade surplus supported by buoyant exports more than offset the services and income deficit. On a sequential basis, the current account surplus widened in 2021Q3, reflecting improved terms of trade and a softening in real imports.

**The financial and capital account turned into a surplus in the first half of 2021.** The financial and capital account registered a surplus of 0.3 percent of GDP in 2021H1, following a deficit of 0.5 percent of GDP in 2020H1 (Figure 8.B). Improvement in the financial and capital account was largely driven by stronger Foreign Direct Investment (FDI) inflows and a mild pick-up in portfolio inflows which offset increased non-portfolio outflows. Meanwhile, the negative net errors and omissions position widened further, suggesting increased informal capital outflows. China maintained a strong external position with overall Foreign Exchange (FX) reserves at \$3.2 trillion (the equivalent of around 14 months of imports) by the end of November (Figure 8.C).

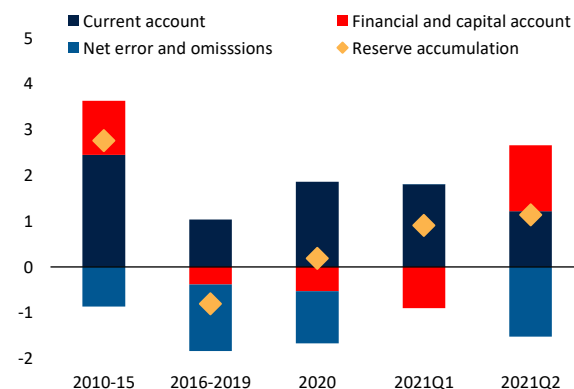
**The RMB has strengthened over the past two years.** Robust capital inflows on the back of China's solid recovery led to a rapid strengthening in the RMB versus the U.S. dollar in the first half of 2021. To alleviate the appreciation of the RMB, the authorities eased controls on capital outflows by increasing the limit for outbound investment by mainland institutions. While these measures temporarily halted the appreciation in 2021Q3, the RMB has continued to strengthen again on the back of a stronger current account surplus in recent weeks (Figure 8.D). To slow the recent rapid appreciation of the RMB, in December, the PBOC hiked the foreign currency reserve requirement ratio (FX RRR) by 200 basis points to 9 percent.

**Figure 8. China continues to maintain a strong external position**

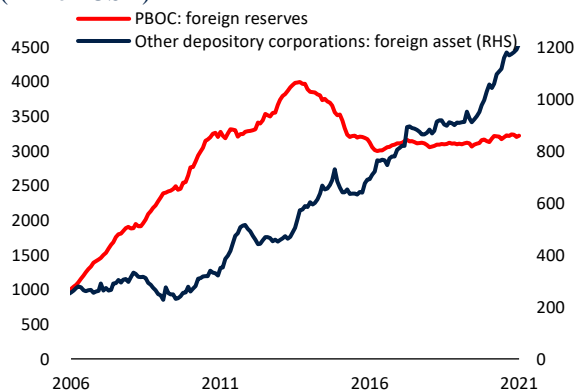
**A. Current account balance**  
(Percent of GDP)



**B. Net capital outflows**  
(Percent of GDP)

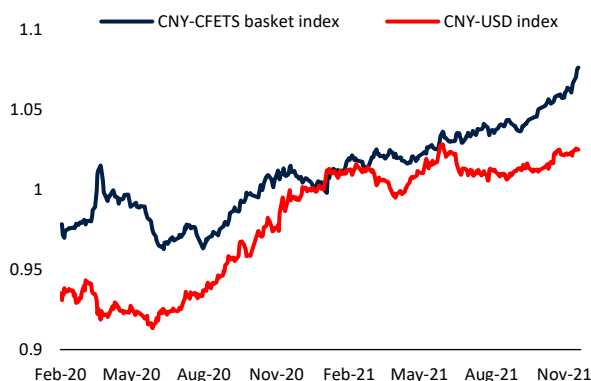


**C. Foreign reserves accumulation**  
(Billion USD)



**D. Exchange rates**

(Index December 31, 2020 = 1)



Source: State Administration of Foreign Exchange (SAFE); PBOC; World Bank.

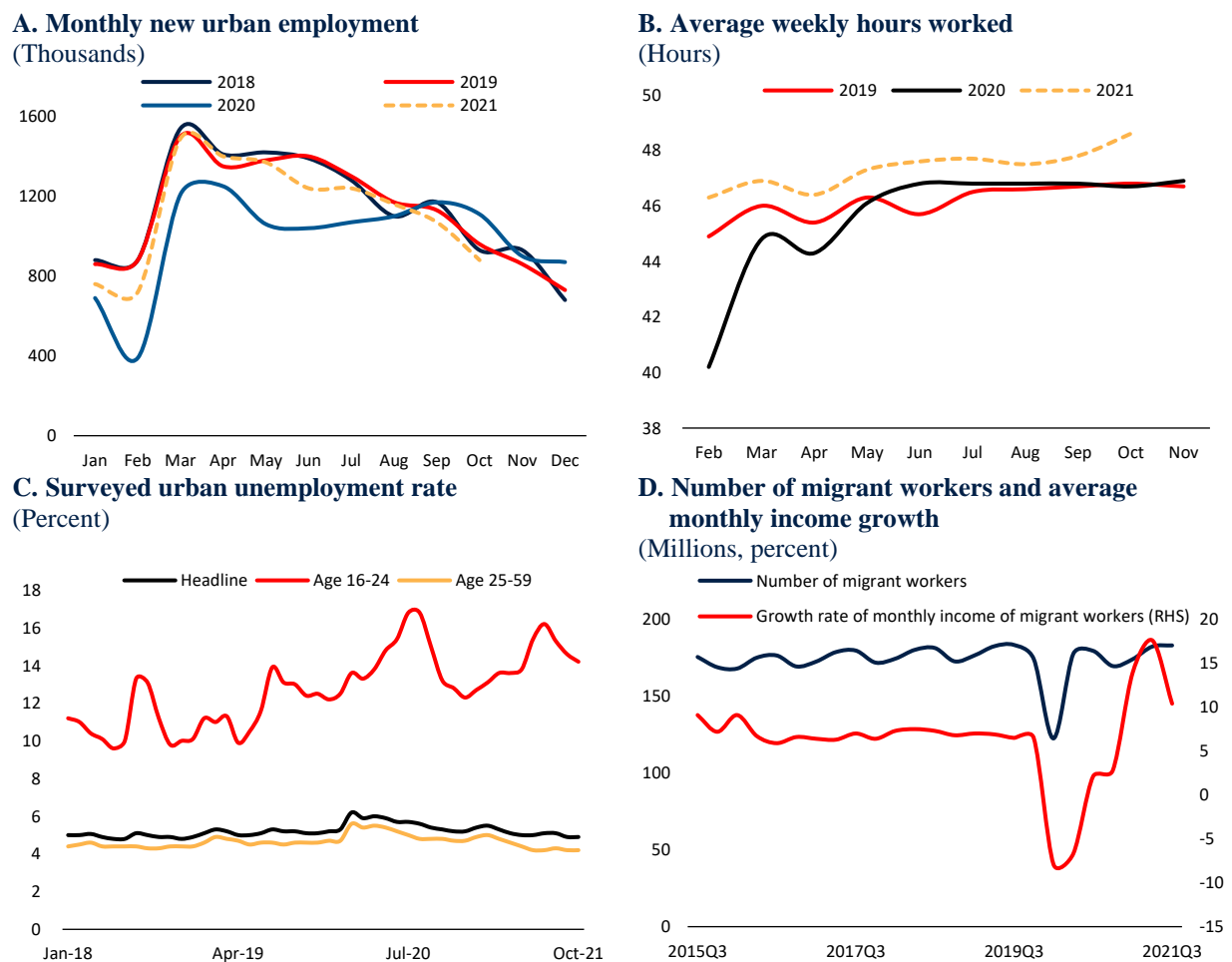
Note: CNY refers to Chinese currency Yuan; CFETS refers to China Foreign Exchange Trade System.

## Stable labor market and recovering incomes

**While the headline unemployment rate has continued to fall, labor market conditions have not fully normalized.** Almost 11.3 million new urban jobs were created in the first 10 months of 2021, exceeding China's annual target of 11 million new urban jobs for this year. This represents a further improvement compared to the 10.1 million new urban jobs created during the same period in 2020 but is still slightly lower than before the pandemic (Figure 9.A). Nationwide average weekly hours worked rose further above the pre-pandemic average (Figure 9.B). The surveyed

urban unemployment rate averaged at 5.0 percent since July, its lowest reading since 2019 and below the government's target of around 5.5 percent for 2021. While the overall unemployment rate is stable, tighter regulation in real estate, private education, ride hailing, and some other digital services is likely to have unintended negative implications for the labor market, especially for the younger labor force. Youth unemployment has increased from 12.7 percent at the start of 2021 to about 14.2 percent in October and remains higher than before the pandemic (Figure 9.C). On the positive side, the number of migrant workers, who account for around 30 percent of the labor force in urban areas, returned to its pre-pandemic level (Figure 9.D).

**Figure 9. Improvement in labor market conditions**



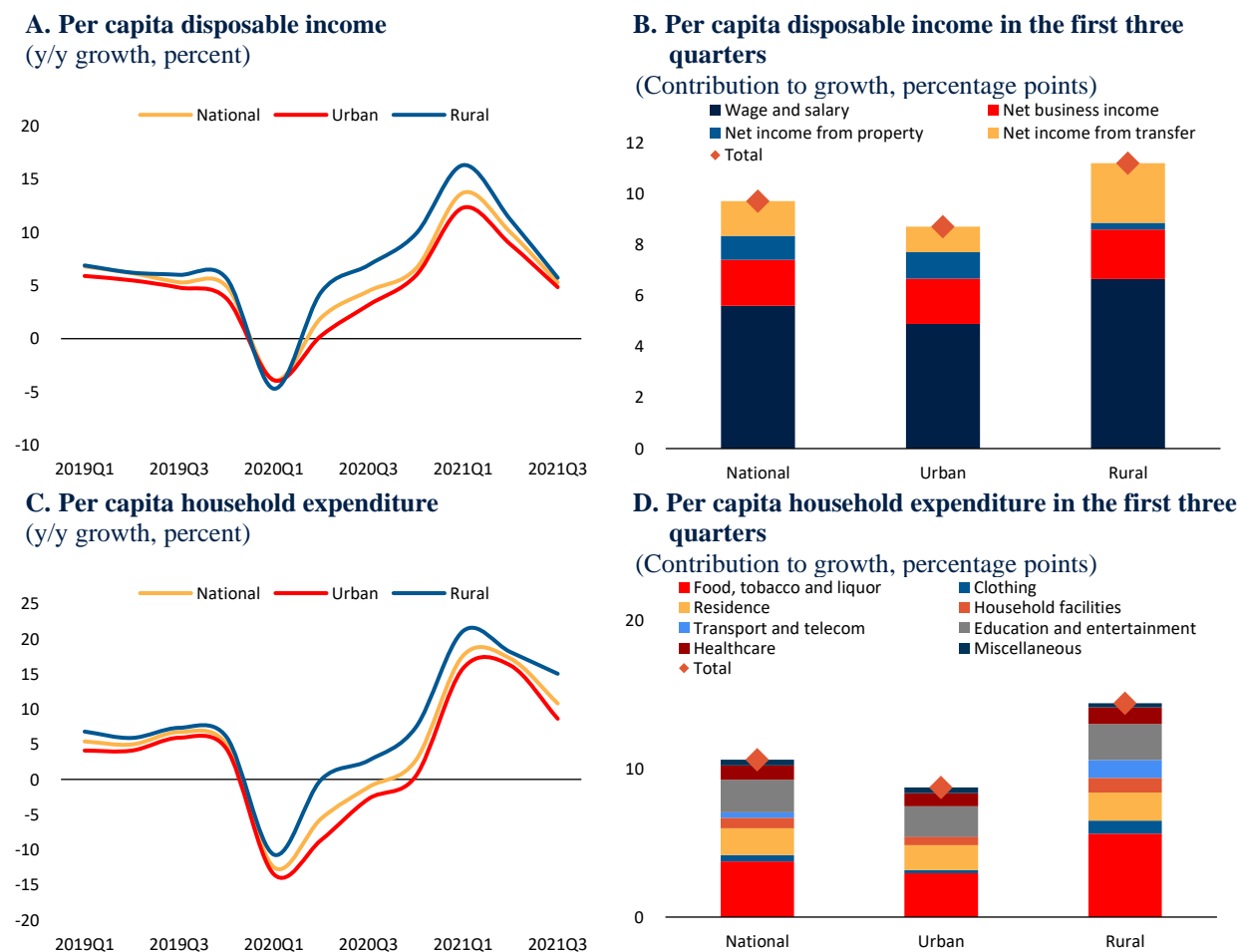
Source: NBS; World Bank.

**Household incomes have recovered, reflecting improving employment conditions.** Income losses endured by households as a result of the COVID-19 shock have been mostly reversed. Real disposable income per capita grew by 9.7 percent y/y in the first three quarters of 2021, with faster growth among rural households (Figure 10.A). Real disposable income per capita of urban households expanded at a slower pace, held back by weaker business income growth which suffered from pandemic-related restrictions on travel and retail. Meanwhile, wage growth remained strong for rural households, contributing to more than 50 percent of the rural income

growth. Increased transfers also played a significant role among rural households, adding to more than 20 percent of rural income growth (Figure 10.B).

**Consumer spending improved further with rising disposable income, especially among rural households.** Following a sharp contraction in household spending in 2020, household per capita expenditure grew by 10.6 percent y/y in the three quarters in 2021, driven by continued strong growth in spending among rural households (Figure 10.C). The increase in spending among rural households was broad-based, with spending on most categories increasing further (Figure 10.D). Meanwhile, urban households remained more cautious in their spending behavior.

**Figure 10. Consumer spending has improved with rising disposable income**



Source: NBS; World Bank.

**As expenditure growth exceeded income growth, the 12-month-average saving rates fell moderately this year.** The savings rate fell to 32 percent in 2021Q3 from about 34 percent at the end of 2020. The decline in savings was more pronounced among rural households whose savings rate has now dropped slightly below pre-pandemic levels. In contrast, the savings rate of urban households, and as a result, the aggregate household savings rate, have remained above pre-pandemic levels.

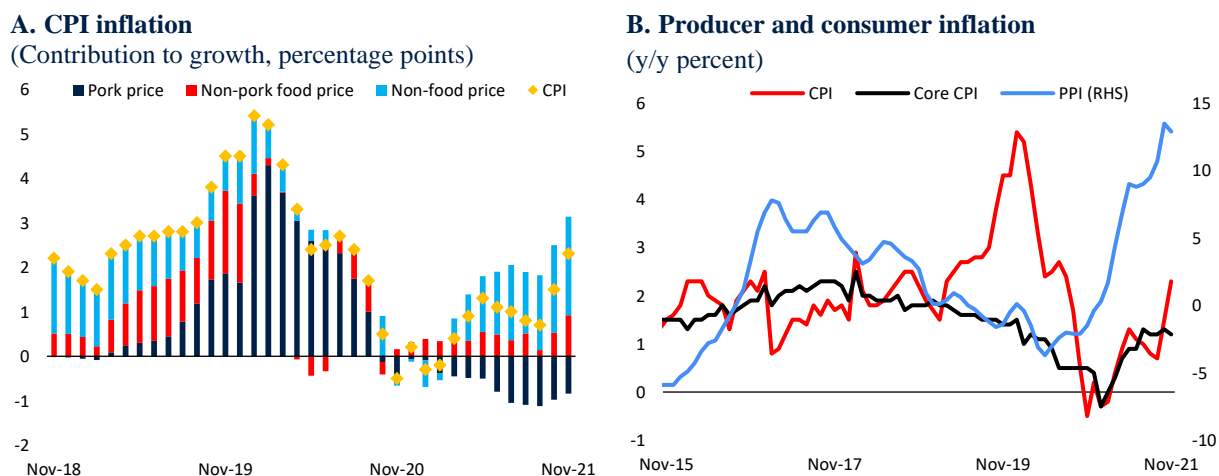
## CPI inflation remained moderate amid surging PPI prices

**Consumer price inflation, which remained muted for most of the year, accelerated in the final months of 2021.** Headline inflation reached a 15-month high of 2.3 percent y/y in November from 0.7 percent y/y in September. The increase primarily reflected higher food and energy costs (Figure 11.A). Core inflation, excluding volatile food and energy prices, also rebounded but remained low at 1.2 percent y/y in November (Figure 11.B). Despite the recent pick-up, headline CPI inflation remains below the official target of 3.0 percent y/y, reflecting weak consumer demand. Declining pork prices, driven by the strong recovery in supply this year, continued to weigh on consumer price inflation.

**PPI inflation has been rising on higher global commodity prices, reflecting buoyant global demand.** After surging from 0.3 percent y/y in January to 8.8 percent y/y in June, PPI inflation has remained consistently above 9 percent y/y in the second half of 2021. Soaring energy, mining, and raw material prices coupled with output curbs of high-emission materials pushed PPI inflation up further to 13.5 percent y/y in October, its highest reading since 1995 (Figure 11.C), before moderating to 12.9 percent y/y in November. In particular, coal prices have risen steeply, although measures by the government to increase production have led to declining prices in recent weeks.

**The large divergence between producer and consumer prices has increasingly affected the profit margins of firms operating in midstream and downstream sectors.** The gap between PPI and CPI inflation has risen to a historic high of 12 percentage points in October from 0.6 percentage points in January, demonstrating China's uneven recovery led primarily by investment. Firms in upstream sectors have benefited from the elevated raw material prices, with their profit share reaching nearly 60 percent of total industrial profit. Meanwhile, midstream and downstream firms have struggled with a declining profit share and narrowing profit margins, as their ability to shift the higher costs to the end consumers remained constrained due to sluggish domestic demand and market competition (Figure 11.D). Export-oriented firms, on the other hand, seem to have been able to partially pass along the higher costs to foreign importers, as reflected by the sharp increase in export price growth in recent months (Figure 7.B).

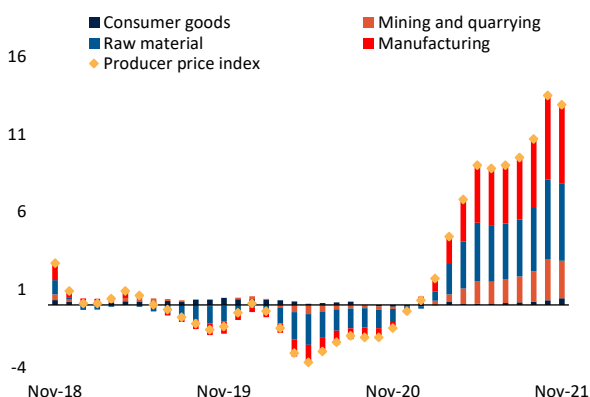
**Figure 11. Rebound in CPI inflation, surge in PPI inflation**





**C. PPI inflation**

(Contribution to growth, percentage points)

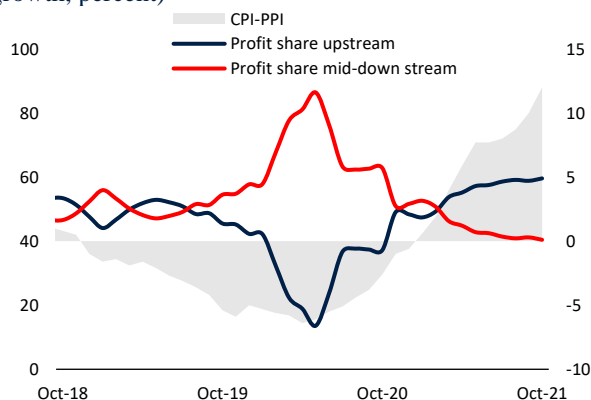


Source: NBS; World Bank.

Note: CPI = Consumer Price Index; PPI = Producer Price Index.

**D. Profit share and PPI-CPI divergence**

(Profit share, 3mma, percent; PPI y/y growth–CPI y/y growth, percent)

**Sharp fiscal consolidation as the government held back fiscal spending**

**China's fiscal policy has been notably tighter than planned under the 2021 budget, even as the economy slows.** The consolidated general public and government fund budget registered a deficit of 2.1 percent of GDP in the first 10 months of 2021, compared to a deficit of 5.3 percent of GDP during the same period last year (Figure 12.A). In comparison, the budget called for a much more modest fiscal tightening as the government set a consolidated deficit target of 8.0 percent of GDP for 2021. The sizable fiscal tightening was largely driven by a sharper than expected contraction in spending, although revenues also outperformed.

**Fiscal revenue was particularly strong in the first half of 2021, reflecting robust tax revenue intakes on the back of the economic recovery.** Consolidated fiscal revenues increased by 12.6 percent y/y in the first 10 months of 2021 compared to -3.0 percent y/y in the same period last year. Notably, tax revenues increased by 15.9 percent in the first 10 months of 2021 as household incomes and industrial revenues recovered. Meanwhile, growth in non-tax revenue slowed to 6.1 percent y/y in the first 10 months of 2021, down from 10.1 percent y/y in the same period of 2020, reflecting weaker revenue growth from the sale of land-use rights.

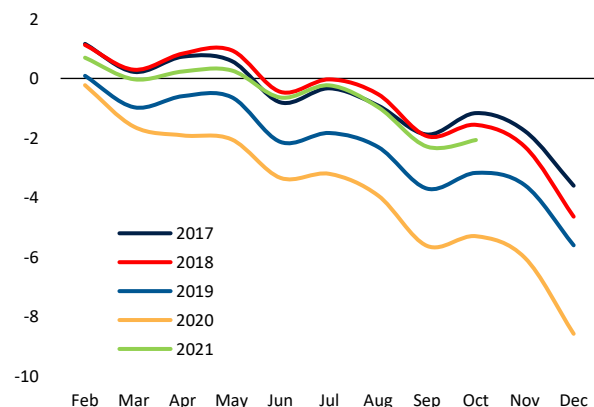
**While revenues outperformed, spending underperformed.** Consolidated fiscal expenditures contracted by 1.1 percent y/y in the first 10 months of 2021, weighed by sluggish spending on infrastructure and the high base in the early months of last year when spending was ramped up (Figure 12.B). Spending from the general public budget in health, education, and social security in the first 10 months of 2021 accounted for only 6.5 percent of GDP, lower than 6.9 percent of GDP during the same period in 2020.

**After a slow start, local government bond issuance accelerated in recent months.** As a result of the slow pace of government bond issuance, especially in the first half of the year, the net financing of government bonds decelerated to 3.1 percent of GDP in the first 10 months of 2021, compared to 6.7 percent of GDP during the same period last year (Figure 12.C). By the end of

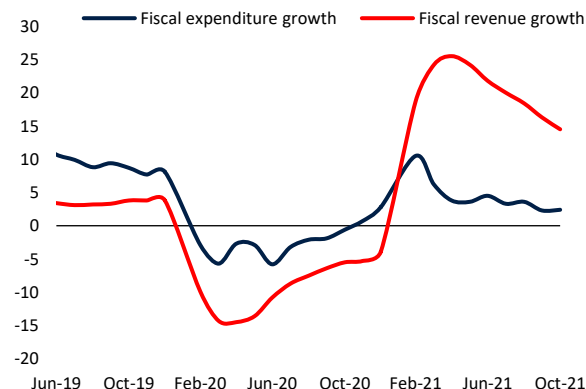
November, around 90 percent of the annual local government special bond issuance quota was met, leaving RMB 400 billion for the remaining month of 2021 (Figure 12.D).

**Figure 12. Consolidated fiscal deficit narrowed**

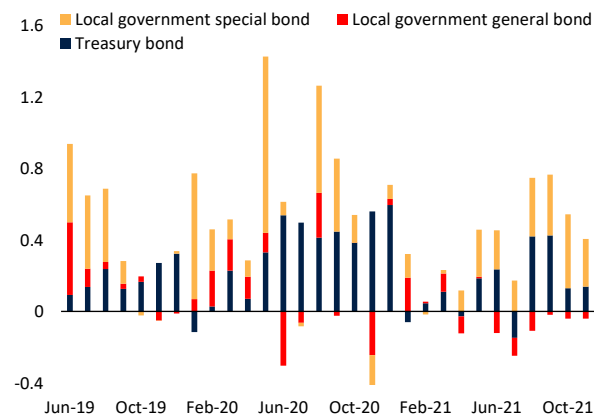
**A. Consolidated fiscal deficit**  
(Percent of GDP)



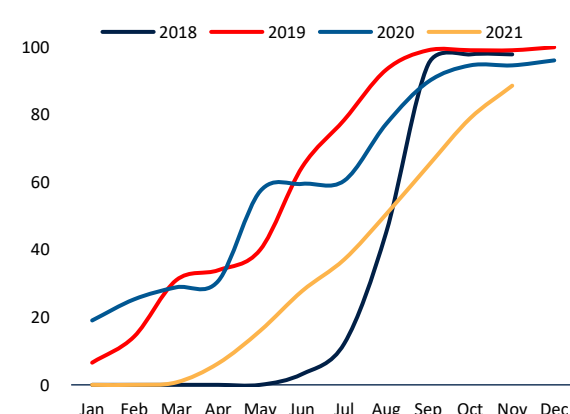
**B. Growth in consolidated fiscal revenues and expenditures**  
(y/y percent, ytd)



**C. Net financing of government bonds**  
(Percent of GDP)



**D. Local government special bond issuance**  
(Percent of annual target)



Sources: NBS; MOF; Wind Information Database; World Bank.

Note: The consolidated fiscal balance adds up the general public budget balance and the government fund budget balance.

## Tighter regulations triggered a sharp adjustment in the real estate sector

The strong economic rebound and widening domestic imbalances prompted Chinese policy makers to resume their de-risking, deleveraging, and decarbonization agenda, centered on the real estate sector. The authorities tightened real estate regulations in 2020Q3 to rein in property sector leverage and stabilize the housing market, but initially, enforcement was not very strict. The main thrust, known as the “three red lines,” was introduced in August of 2020 and sought to curb lending to developers in potential breach of three targets: debt-to-equity ratio of 100 percent, cash to short-term debt ratio of one, and liability-to-asset ratio of 70 percent. Developers exceeding one or more of these targets face a cap on further increases in total interest-bearing debt of 15 percent or lower. The PBOC also implemented caps on commercial bank

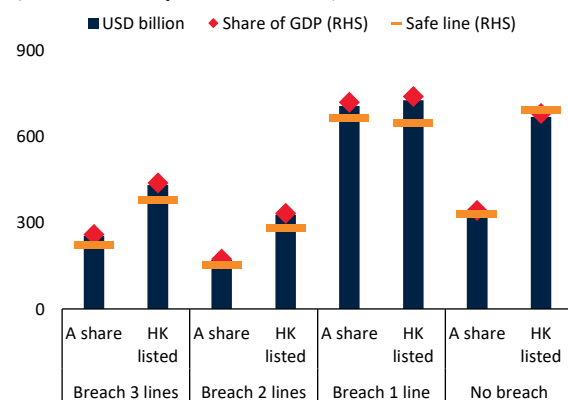
lending to reduce the banking sector's exposure to property loans. Efforts to reduce developer leverage and bank exposure have been complemented by several localized policies, including increases in mortgage interest rates by some local state banks, increasing down payment requirements, and restrictions on sales by owners. In addition, the government's efforts to reduce CO<sub>2</sub> emissions, which surged in late 2020 and early 2021, also weighed on the activity in the real estate sector (see next section).

**The property market curbs have impacted real estate developers through rising financing costs and increased policy uncertainty.** Stricter implementation of the three red lines policies caused several real estate developers to experience liquidity shortages by the second half of 2021, after policy makers increased scrutiny on the financial operations of developers. Liquidity pressures also raised concerns among investors, causing equity prices and the value of bonds issued by major developers to plummet. None were hit harder than the China Evergrande Group, a developer that breached all three lines after accumulating large liabilities in recent years (Figure 13.A and B).

**Figure 13. Leverage and compliance of real estate companies with the “three red line” regulations**

**A. Cumulative liabilities of real estate sector companies according to their compliance with the three red lines policies**

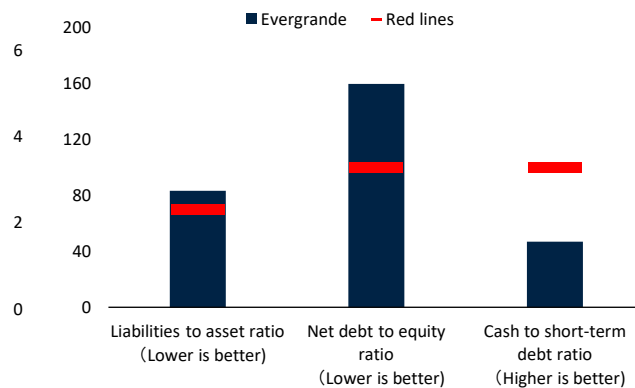
(USD billion; percent of GDP)



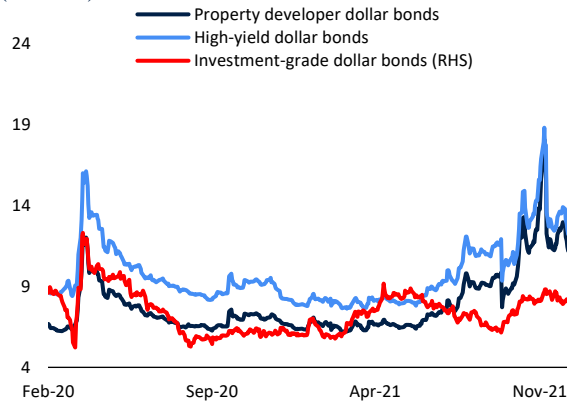
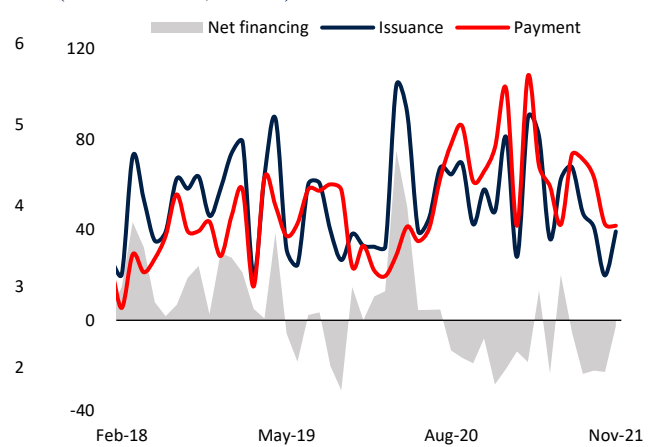
Source: Haver Analytics; World Bank.

Note: A. Safe line is estimated for the liability-to-asset ratio (one of the three red lines). B. Debt of Evergrande includes short-term debt, amortization, and long-term debt.

**B. Evergrande's compliance with the three red lines (Percent)**

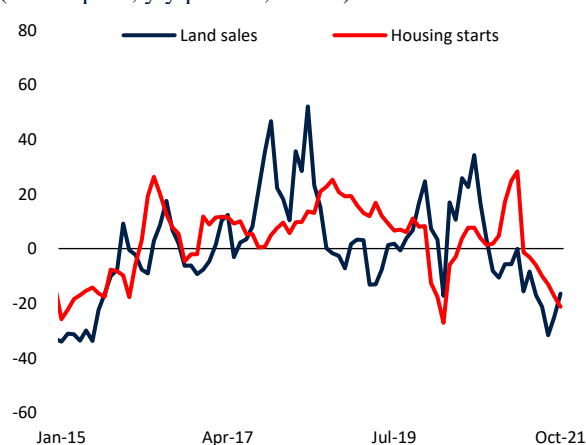
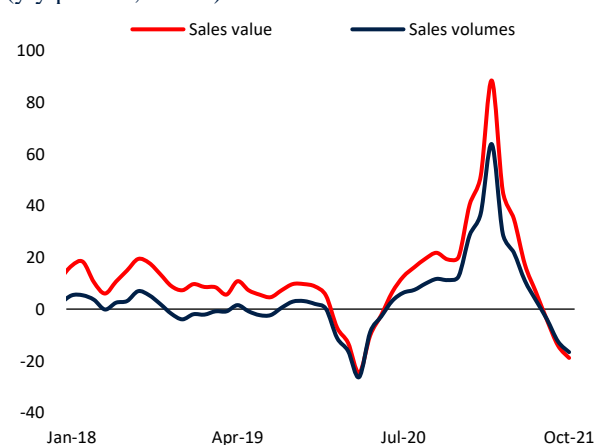


**Borrowing costs in U.S. dollar bond markets have increased significantly for real estate developers and other riskier borrowers.** Following recent incidents of missed coupon payments by large real estate developers, yields on developers' offshore U.S. dollar bonds spiked to almost 20 percent and remained elevated despite some moderation in recent weeks (Figure 14.A). The financial stress experienced by many real estate developers eroded investor confidence for China's riskiest borrowers in international bond markets, as evidenced by sharply rising interest rates on Chinese high-yield bonds issues offshore. The recent woes only had a limited spillover on the yields of offshore U.S. bonds issued by investment-grade rated Chinese companies.

**Figure 14. Debt woes have led to a sharp increase in borrowing costs****A. Offshore corporate bond yields**  
(Percent)**B. Property developer onshore bond financing**  
(Billion RMB, 3mma)

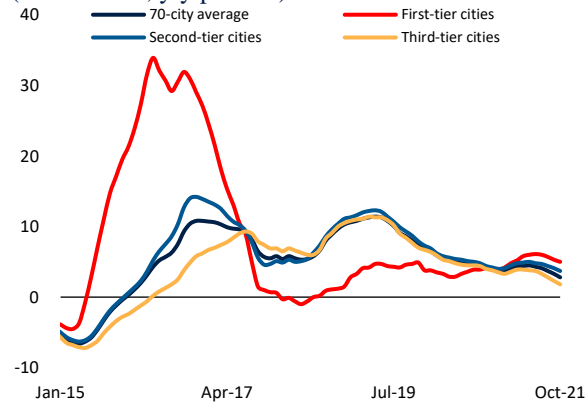
Source: Wind Information Database; World Bank.

**Following a temporary rebound from late-2020 to mid-2021, housing activity has experienced a sharp slowdown.** A short-lived boom in housing demand from late-2020 to mid-2021 was fueled by a surge in household savings that improved the affordability of houses and accommodative credit policies. However, starting in 2021Q2, housing sector activity started to weaken quickly. Fixed asset investment in real estate decelerated sharply, while land sales plummeted owing to regulatory tightening on land purchases and policy uncertainty (Figure 15.A). Construction starts also plunged as major developers experienced bouts of financial stress. Meanwhile, growth in new home sales contracted after surging in the first half of 2021 as developers liquidated holdings to improve liquidity (Figure 15.B). Housing price inflation has been falling for both new and second-hand housing (Figure 15.C and D). On a monthly basis, new home prices fell 0.2 percent in October, the most since February 2015, after a flat reading in September.

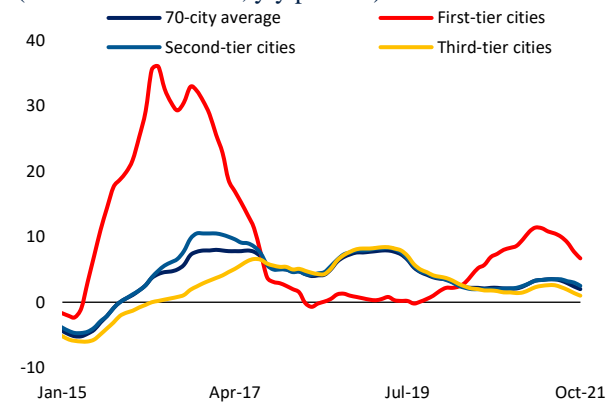
**Figure 15. Housing market activity in China has slowed sharply****A. Land sales and new home starts**  
(Floor space, y/y percent, 3mma)**B. New home sales**  
(y/y percent, 3mma)

**C. Housing price inflation**

(New homes, y/y percent)

**D. Housing price inflation**

(Second-hand homes, y/y percent)



Source: NBS; Wind Information Database; World Bank.

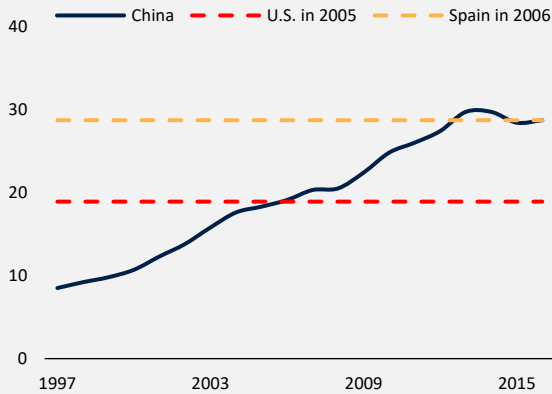
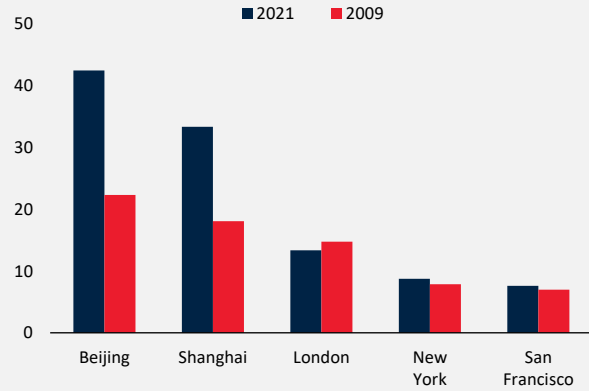
**Box 1. China's real estate sector**

**The real estate sector has experienced a sustained boom since 1990, a result of rapid urbanization and expansion of the country's housing stock, ultimately becoming a significant part of the economy.** The share of housing-related activities increased sharply to about 25 percent of fixed asset investment and GDP in gross value-added terms (including both construction and real estate services), far exceeding the level reached by the United States at the peak of its housing boom in 2006 (Figure 16.A; Rogoff and Yang 2020). Housing prices have roughly tripled over the past 20 years, and the pace of appreciation has accelerated notably since 2015. Home price-to-income ratios in 2018 in Beijing, Shanghai, and Shenzhen exceeded a multiple of 40 compared to 22 in London and 12 in New York<sup>2</sup> (Figure 16.B). Housing became the principal component of households' investment portfolios in the absence of alternative savings options, and sales of land use rights represent an important source of financing for local governments.

**The sustained expansion of the real estate market has been fueled by debt, resulting in high levels of leverage among real estate developers and heightened risks in the sector.** The liabilities of real estate developers total nearly 30 percent of GDP. Alongside bond issuance, developers exploited the presale of housing units as a source of low-cost financing to fund expansive development projects. A similarly rapid accumulation in leverage was witnessed prior to other housing boom-bust episodes, such as Japan in the 1990s and the United States in the 2000s.

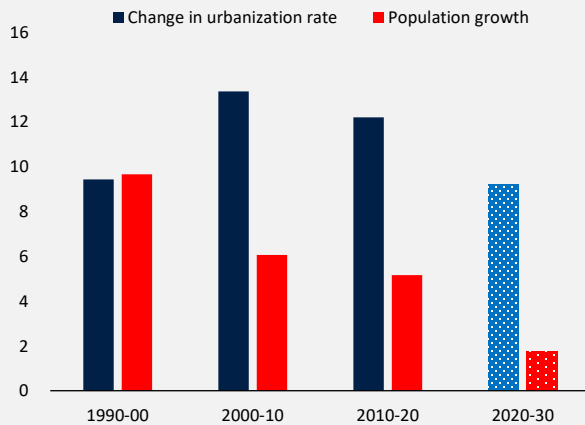
**The fundamentals underpinning China's property boom are weakening while affordability has deteriorated.** The leveraged expansion of real estate developers has allowed China to expand its housing supply rapidly. By 2019, average residential space per person in urban areas was around 40 square meters, and by 2021, an over-supply of housing units materialized at the aggregate level. This supply overhang might not be easily absorbed, given China's unfavorable demographics and slower urbanization over the coming decade (Figure 17.A). At the same time, the pace of disposable income growth is projected to cool alongside slowing long-term growth, further limiting the housing market's ability to sustain high valuations in metropolitan areas (Figure 17.B).

<sup>2</sup> See Rogoff, K. and Yang, Y. "Peak Housing" NBER Working Paper No. 27697, August 2020. The home price to income ratio is calculated as the ratio of median housing price to median household disposable income, expressed as years of income.

**Figure 16. China housing market and international comparison****A. Share of housing in GDP**  
(Percent)**B. House price to income ratio**  
(Ratio)

Source: Numbeo; World Bank.

Note: The house price to income ratio is the ratio of the cost of a typical upscale housing unit of 100 square meters, compared to the country's GDP per capita.

**Figure 17. China housing market****A. Population growth and urbanization rate**  
(Percent)**B. Personal disposable income growth projections**  
(Percent)

Source: NBS; United Nations; World Bank.

**China's CO<sub>2</sub> emissions growth slowed after surging in early 2021**

**After surging in early 2021, China's CO<sub>2</sub> emissions growth has slowed sharply.** China's carbon dioxide (CO<sub>2</sub>) emissions grew by around 1.6 percent y/y in the third quarter of 2021 compared to a year earlier. This marks a significant slowdown from the 13.3 percent y/y increase in emissions in the first half of the year—a rate higher than the corresponding rate of GDP growth (Figure 18.A). The sharp increase in emissions during the first half of 2021 arose primarily from the growth in coal use in the power and industry sectors, reflecting China's carbon intensive industry- and investment-led recovery (Figure 18.B). Power-related emissions stemming from the

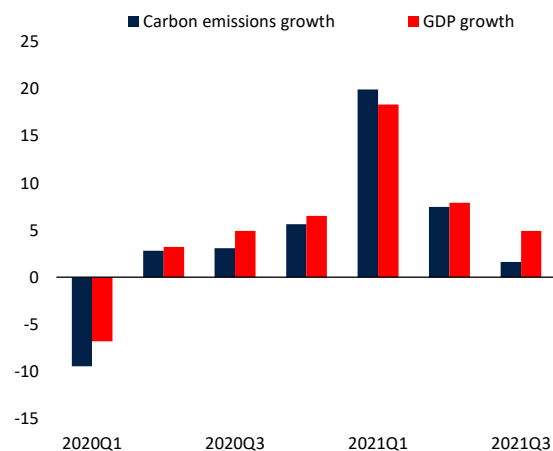
household sector remained limited, given a relatively small share of household consumption in total electricity usage, around 15 percent (Figure 18.C). Reflecting the unbalanced nature of China's recovery and stripping out base effects, the 2Y CAGR of carbon emissions registered a high of 4.7 percent in the first three quarters of 2021, well above its pre-pandemic level. An index by Vivid Economics that tracks the “greenness” of stimulus measures in 2020 and 2021 ranked China lower than major advanced economies, reflecting its relatively small share of policy support aimed at green and sustainable development (Figure 18.D).

**The recent reduction in emissions was driven by a sharp drop in demand for construction materials.** This was precipitated by the slump in infrastructure and real estate investment, the targeted production cuts in highly polluting and energy-intensive sectors, including steel and coal industries, as well as electricity rationing. The building and construction sectors account for around 40 percent and 75 percent of steel and cement consumption,<sup>3</sup> respectively, and over 30 percent of final energy use and process-related CO<sub>2</sub> emission. After the majority of provinces missed at least one of their Dual Control targets for reducing total energy consumption and energy intensity in the first half of 2021,<sup>4</sup> the National Development and Reform Commission (NDRC) in September issued a plan to tighten energy efficiency control measures. In the face of acute power shortages, NDRC also encouraged greater domestic coal production and decreed reforms to the power markets that allow thermal power producers to increase the pass-through of higher input prices to final industrial consumers. By late November, power outages had largely disappeared, and coal inventories had increased. The episode nonetheless reveals the difficulty of coordinating multiple policy objectives in the absence of stronger market-based pricing signals.

**Figure 18. China's CO<sub>2</sub> emissions growth moderated following the post-COVID surge**

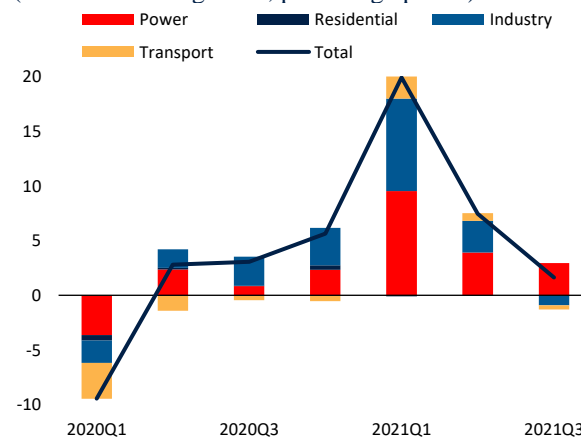
**A. Carbon emissions and GDP growth**

(y/y percent)



**B. Carbon emissions by sector**

(Contribution to growth, percentage points)

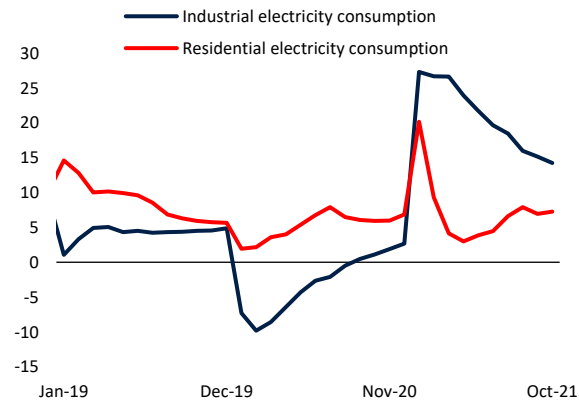


<sup>3</sup> Estimates based on 2018 input-output table of China.

<sup>4</sup> The Dual Control policy was introduced under China's 13<sup>th</sup> Five-year Plan (2016-2020), which required provinces to meet annual quantitative targets for reducing total energy consumption and energy intensity.

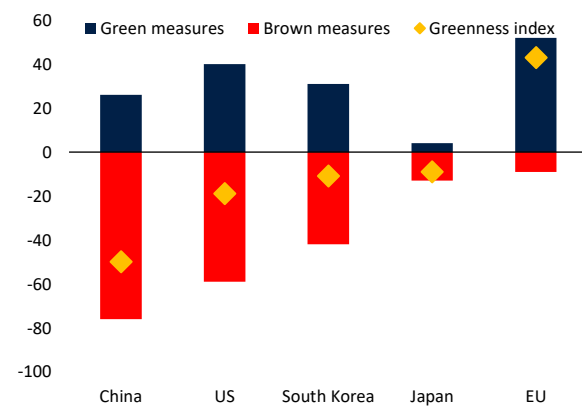


### C. Industrial and household electricity usage (y/y ytd percent)



Source: NBS; Carbon Monitor; Vivid Economics; World Bank.

### D. Greenness of stimulus measures (Index)

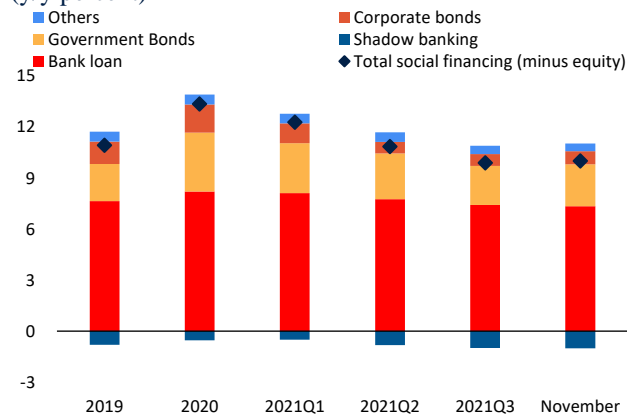


## Deleveraging efforts weighed on credit growth

**Credit growth slowed to 10.0 percent in late 2021 from 13.3 percent at the end of last year (Figure 19.A).** The deceleration in total social financing growth, a wide measure of credit growth, was broad-based, affecting all segments of the economy. Significant fiscal policy tightening resulted in a slower pace of government bond issuance which, together with the continued curtailment of shadow banking activities, weighed on credit growth. Regulatory tightening aimed at reducing financial risks in the real estate sector led to stricter borrowing limits and tighter lending standards for both developers and home buyers. As a result, household loan growth decelerated and corporate loan growth also moderated, reflecting weaker property sector-related loans (Figure 19.B). Meanwhile, the decline in longer-term corporate bond issuance in the third quarter of 2021 was partially offset by increased short-term corporate bill financing, which bottomed out after 12 months of consecutive slowdown.

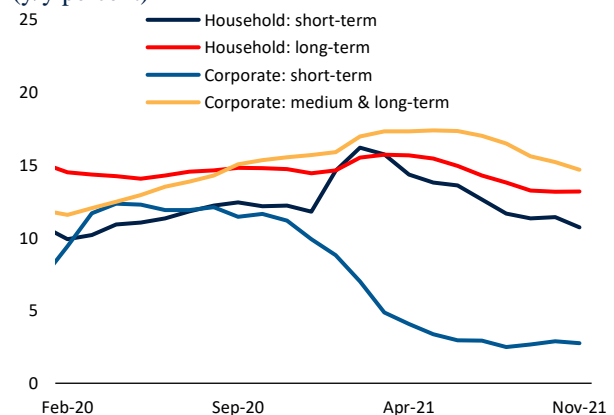
Figure 19. Credit growth weakened broadly

#### A. Total social financing growth (y/y percent)



Source: PBOC; World Bank.

#### B. Corporate and household loan growth (y/y percent)

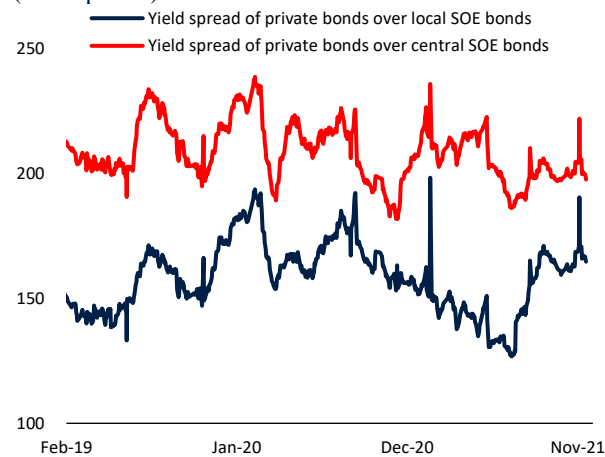


**While borrowing costs in U.S. dollar bond markets increased significantly for real estate developers, borrowing costs remained contained in onshore bond markets.** In domestic debt markets, private-owned enterprise (POE) bonds continue to trade with a higher risk premium as compared to state-owned enterprise (SOE) bonds, and yield spreads have trended up since late 2020 (Figure 20.A). Among POE bonds, yield spreads of real estate developers have increased, reflecting a number of credit rating downgrades and higher risk perceptions, resulting in lower onshore bond issuance (Figure 14.B). The number of onshore bond defaults increased to 137 in the first 10 months of 2021 compared to 123 in the same period last year, with 34.3 percent of defaults by highly leveraged developers (Figure 20.B).

**Figure 20. Spillovers to onshore bond market remained contained**

**A. Yield spreads of onshore private bonds over onshore SOE bonds**

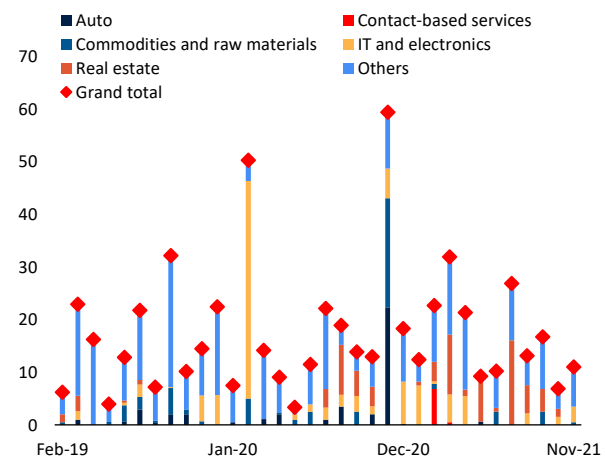
(Basis points)



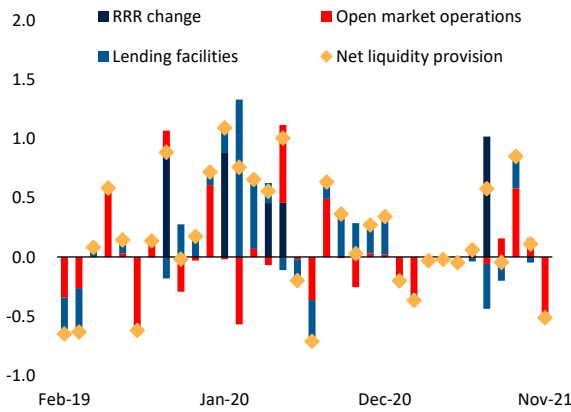
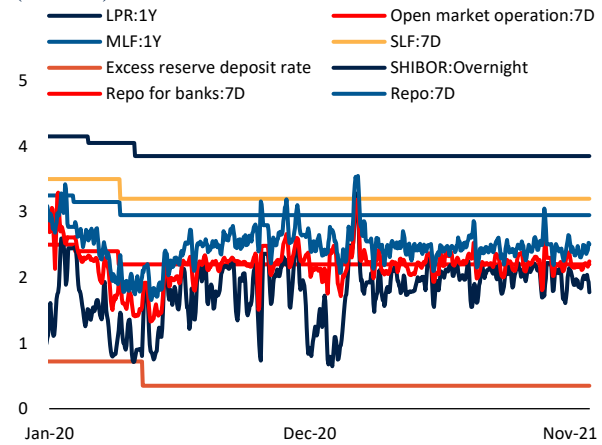
Source: Wind Information Database; World Bank.

**B. Bond default value by sectors**

(Billion RMB)



**The People's Bank of China (PBOC) has maintained a neutral monetary policy stance throughout much of the year but recently signaled some moderate easing.** The PBOC has kept policy rates unchanged since May 2020 and cut the reserve requirement ratio by 50 basis points in July. It also stepped up liquidity support in the second half of 2021 to stem contagion risks in the real estate sector (Figure 21.A and B). The liquidity support has kept market interest rates stable. The PBOC further introduced targeted relending facilities, including facilities to support small and medium-sized enterprises (SMEs) and decarbonization. In December, the PBOC cut the reserve requirement ratio by 50 basis points and reduced the relending rate for rural and small enterprises by 25 basis points. The move reflects growing concerns over the weakness of domestic demand toward the end of 2021 but does not signal a move away from the emphasis on containing financial sector risks.

**Figure 21. Liquidity condition and market rates have remained broadly stable****A. Net liquidity injection**  
(Percent of GDP)**B. Market rates**  
(Percent)

Source: PBOC; World Bank.

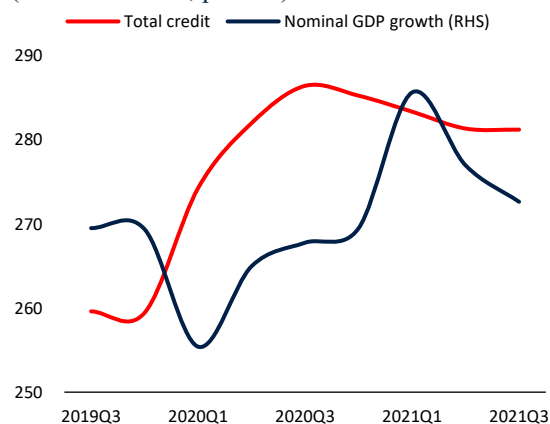
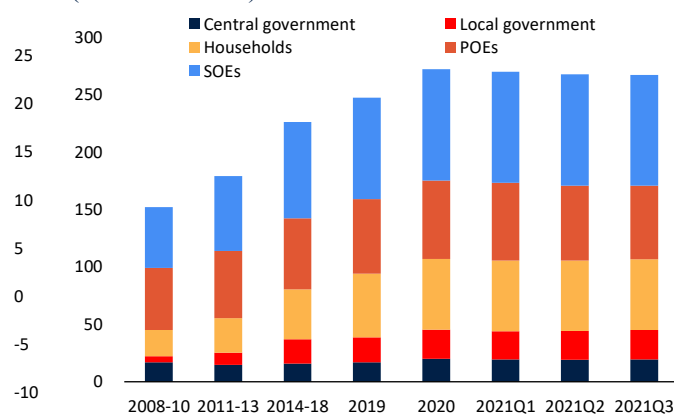
Note: A. net liquidity injection provided by the PBOC through standing lending facility (SLF), the medium-term lending facility (MLF), the targeted medium-term lending facility (TMLF), the pledged supplementary lending (PSL), the special-purpose refinancing (SPRF), and the special relending or rediscounting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

**Regulatory curbs contributed to a modest reduction in debt**

**China's debt-to-GDP ratio has retreated from its peak in 2020 but remains above its pre-pandemic level.** After peaking at 285.2 percent of GDP last year, China's debt-to-GDP ratio, including external debt, declined by 4 percentage points to 281.2 percent of GDP by the third quarter of 2021, largely because of the strong growth rebound (Figure 22.A). Tightening credit conditions in the real estate sector and the resumption of de-risking efforts more generally also contributed to the modest reduction in debt levels. Total external debt has remained broadly stable and low overall at an estimated 14.1 percent of GDP by the third quarter of 2021. The aggregate debt-to-GDP ratio remains about 20 percentage points higher than its pre-pandemic level.

**The corporate debt buildup moderated in 2021, while household debt remained broadly flat.** Deleveraging efforts have been squarely on POEs, especially in some highly levered sectors such as real estate. The debt of POEs fell significantly to 64.2 percent of GDP in 2021Q3 from 68.5 percent of GDP in 2020Q4, accounting for almost all of the reduction in total debt. Household debt remained broadly unchanged in the first three quarters of 2021, while SOEs debt, including local government financing vehicle (LGFV) debt, eased moderately, reflecting a slower pace in LGFV bond issuance (Figure 22.B, Table 1).

**The central government stepped up monitoring of LGFV liabilities.** The authorities issued tighter rules on the use of LGFVs, while banks have been instructed to curb lending to these entities. As a result, growth in LGFV liabilities has slowed modestly to 14.7 percent y/y in 2021Q3 from 15.5 percent y/y at the end of 2020.

**Figure 22. The debt-to-GDP ratio declined but remained elevated****A. GDP growth and total credit stock to GDP**  
(Percent of GDP; percent)**B. Domestic non-financial debt by sector**  
(Percent of GDP)

Source: PBOC; Wind Information Database; CEIC Data; World Bank.

Note: The total debt is defined as the sum of domestic and external debt, including household, non-financial corporate, and public sector debt, expressed as a share of GDP.

**Table 1. China's debt-to-GDP ratio by sector**

	2019	2020	2021Q1	2021Q2	2021Q3
Domestic	247.4	272.2	270.0	267.8	267.1
Households	55.4	61.5	61.3	61.3	61.4
POEs	64.8	68.5	67.9	65.1	64.2
SOEs (including LGFVs)	88.5	97.0	96.7	97.1	96.3
Central government	17.0	20.0	19.3	19.1	19.5
Local government	21.7	25.3	24.8	25.3	25.6
External	12.1	13.0	13.4	13.6	14.1
Total	259.5	285.2	283.4	281.4	281.2

Note: The external debt, excluding the debt of Chinese subsidiaries operating abroad and trade credit, was estimated by World Bank staffs for the third quarter of 2021.

**Banking asset quality improved marginally during 2021Q3 amid continued regulatory forbearance.** While the regulatory forbearance stays in force, the reported nonperforming loan ratio for the banking system remained low at 1.75 percent 2021Q3. The special mention loan ratio has been declining since 2020Q1 (3 percent) and fell to 2.3 percent in September. Even so, city commercial banks and rural commercial banks continued to bear higher credit risks due to more concentrated exposures to micro and small enterprises, individual business owners, and rural consumers, despite some improvements during 2021 (Figure 23.A and B). As of 2021Q3, rural commercial banks and city commercial banks had the highest nonperforming loan ratios, at 3.6 percent and 1.8 percent, respectively (Figure 23.A).

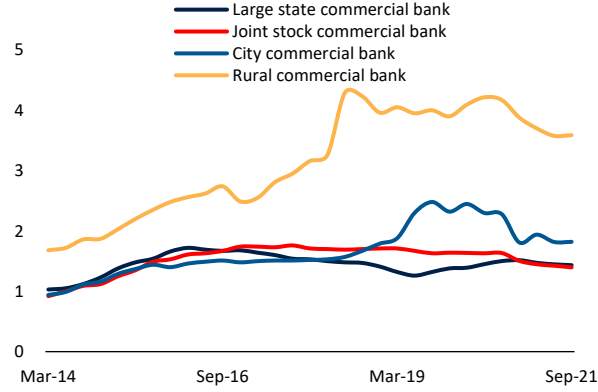
**Commercial banks' buffers generally appear adequate to absorb shocks but localized vulnerabilities persist.** The banking sector overall is reasonably capitalized, with the system capital adequacy ratio and core tier 1 capital adequacy ratio at 14.8 percent and 10.7 percent, respectively, above the respective regulatory minimums of 10.5 percent and 7.5 percent. The provisioning coverage ratio remained high at 197 percent as of the end of September 2021 (Figure 23.D). Rural commercial banks, however, which account for 16 percent of total commercial

banking assets, are most at risk, with lower loan loss provision coverage, thinner capital buffers, and the highest nonperforming loan ratio (Figure 23. A, C, D).

**Figure 23. Regional banks are more vulnerable**

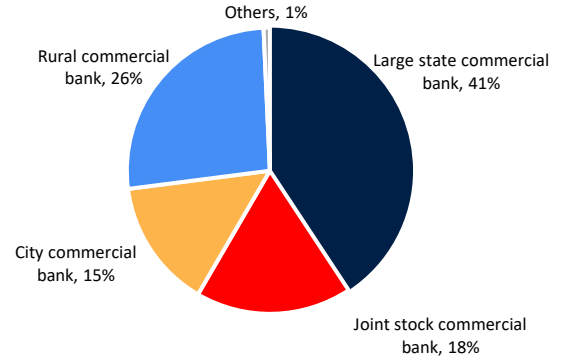
**A. NPL ratios by banking categories**

(Percent of gross loans)



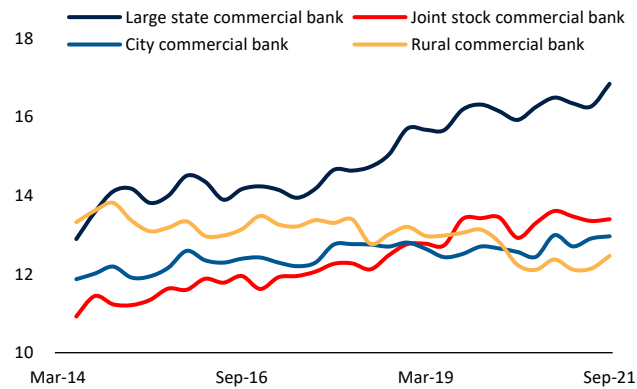
**B. Distribution of NPLs across banking categories**

(Share, percent)



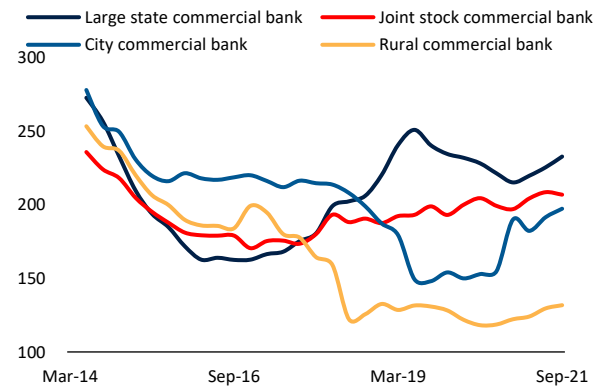
**C. Capital adequacy ratios by banking categories**

(Percent)



**D. Provision coverage ratio by banking categories**

(Percent)



Source: Wind Information Database; World Bank.

## II. Outlook, Risks, and Policy Considerations

### Global outlook

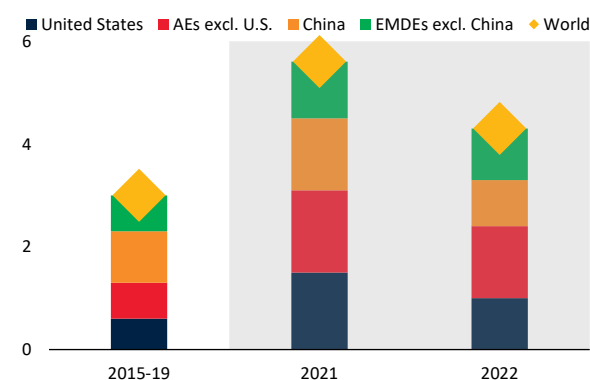
**China will face a weaker global growth environment in 2022.** After bouncing back strongly from the pandemic recession in 2020, global growth is projected to moderate in 2022 (**Error! Reference source not found..A**; World Bank 2021). According to June World Bank projections, global growth is expected to slow to 4.3 percent in 2022 from an estimated 5.5 percent in 2021 as the cyclical boost from reopening fades and macroeconomic support is withdrawn. As demand softens, supply bottlenecks are also likely to abate. For now, inflation expectations generally remain well anchored, but mounting inflationary pressures bear close monitoring. The global spread of a new COVID variety of concern, *Omicron*, increases downside risks on the June global forecast, with several countries reintroducing lockdowns or mobility restrictions and question marks over the effectiveness of vaccine protection.

**Rising inflation is triggering an earlier-than-expected tightening of global financing conditions and is likely to significantly increase borrowing costs for highly leveraged real estate firms and risky borrowers in the offshore markets.** As a result of rising inflation, advanced economies are bringing forward plans to tighten monetary policy, while many EMDEs have already increased policy rates. Earlier in the year, the Federal Reserve signaled that its first rate hike would likely take place in the second half of 2023. In its latest projections, the possibility of liftoff has been brought forward by a full year, to the second half of 2022. Rising inflation expectations could trigger more aggressive monetary policy tightening in EMDEs despite subdued recoveries, with significant implications for financial markets given elevated debt levels, including higher borrowing costs and depreciation pressures. Refinancing record high EMDE debt, the highest since 1987, will become more expensive before the recovery is fully entrenched in EMDEs.

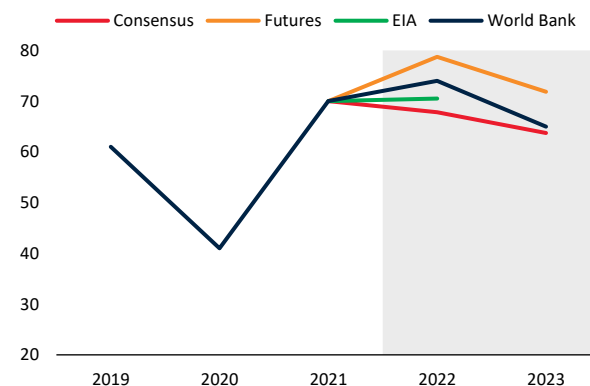
**As a result, the pull from external demand on China's economy is expected to moderate.** Global trade growth and commodity prices are forecast to peak this year, powered by the recovery in global output and investment. Global trade growth is projected to moderate to 6.3 percent in 2022 and slow further to 4.4 percent in 2023, reflecting a gradually diminishing trade intensity of the global recovery. The World Bank, in its latest *Commodity Markets Outlook* (World Bank 2021b), expects average energy prices in 2021 to be 80 percent above their level last year, to remain elevated in the first half of 2022, and to start declining in the second half of the year as supply constraints ease (**Error! Reference source not found..B**). Non-energy prices, including food or agriculture and metals, are projected to decrease in 2022, following strong gains this year.

**Figure 24. Global economy is projected to moderate in 2022****A. Global growth to slow in 2022**

(Percentage points)

**B. Oil price forecasts**

(Percent)



Source: Bloomberg; Haver Analytics; Organization of Petroleum Exporting Countries (OPEC); U.S. Energy Information Administration; World Bank.

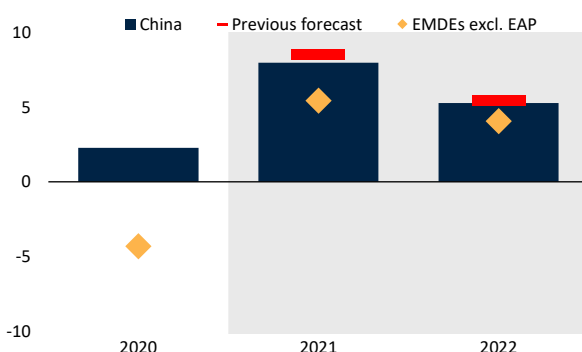
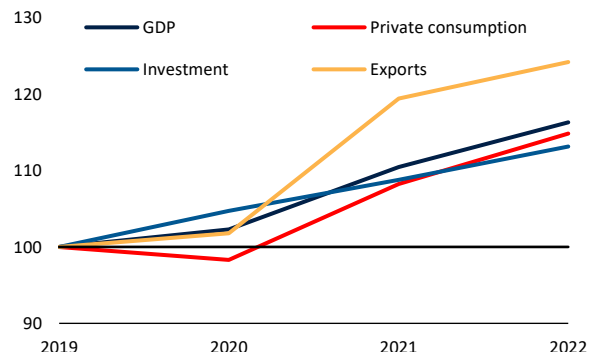
Note: AE=advanced economies. Figure shows contributions to global growth forecast for 2021 and 2022 compared to average contributions to growth in 2015-2019 period. Shaded area indicates forecasts. In figure A, 2021 and 2022 are based on the World Bank June 2021 Global Economic Prospects (GEP) forecasts. In figure B, shaded area indicates oil price forecasts (the equivalent of the World Bank average). Consensus and U.S. Energy Information Administration (EIA) price forecasts were published in October.

**China outlook**

**After reaching 8 percent in 2021, China's growth is projected to slow to 5.1 percent in 2022, close to its potential (Figure 25, Table 2).** Although full year growth is projected to slow in 2022, momentum will pick up, helped by a moderate easing of policy, and contribute to closing the output gap (see Box 2). The baseline projection assumes moderate fiscal easing in 2022, following the sharp consolidation in 2021. The forecast also assumes that monetary policy will continue to focus on maintaining financial market stability, providing liquidity support when necessary. Under these assumptions, growth will gradually converge but remain below its pre-pandemic trend by the end of the forecasting period, as de-risking will weigh on growth.

**The baseline further assumes that China's COVID-19 strategy will remain broadly unchanged for much of 2022.** China will continue to suppress COVID-19 outbreaks and keep cases at a manageable level to avoid stressing its health care system. The restrictions could be gradually relaxed, after more than half of the population receives booster shots to improve protection. However, the advent of *Omicron* may further complicate the exit from the zero-COVID strategy and could weigh on the normalization of domestic consumption.



**Figure 25. Growth projections****A. Full year GDP growth forecasts**  
(y/y percent)**B. GDP expenditure components**  
(Index, 2019 = 100)

Source: Haver Analytics; World Bank.

Note: A. Data in shaded areas are forecasts. EMDEs excluding East Asia and Pacific (EAP) aggregate is based on the data published in the June 2021 Global Economic Prospects report.

**Box 2. Deficient demand and potential growth in China**

In the 10 years prior to the COVID-19 pandemic, China had managed its structural transition relatively well, with potential growth slowing along a smooth path and the output gap effectively closed since 2012. The pandemic, however, upended this environment by generating large deficient demand and magnifying risks of an orderly transition to a consumption-led growth path. This box provides a perspective on the stance of the output gap (the cyclical part of the economy) and potential growth (its structural part).

**Fast recovery from COVID-19 pandemic.** The pandemic generated a collapse in economic activity in China, creating in 2020 a large negative output gap (the difference between what an economy is producing and what can efficiently be produced at full capacity) that in prior years was effectively closed. China's strong policy response and investment-heavy recovery from the initial COVID-19 shock helped effectively close the output gap by the end of 2020. This contrasted with other large emerging market economies that continued to face a weak and deficient demand environment (Figure 26.A). Following the global financial crisis of 2008-09, China was also able to close its output gap about one year earlier than other large emerging market economies, but the credit-fueled investment-led recovery has left the economy saddled with sizable and persistent imbalances.

**Weakening demand environment.** In the aftermath of the global financial crisis, China's output gap remained positive for several years and the economy experienced a period of overheating. In contrast, multiple headwinds in 2021, including stricter regulations on various sectors of the economy and COVID-related production cuts in highly polluting sectors, resulted in a faster-than-expected slowdown of activity. Growth fell below the estimated potential during the first three quarters of the year, leading to the reopening of a negative output gap. The output gap is estimated to average -1.2 percent of potential GDP in 2021, reflecting the growing deficient demand environment throughout the year and inability to maintain stronger growth momentum (Figure 26.B). The output gap is expected to remain slightly negative reflecting growth projections in 2022 and 2023, which are around estimates of potential.

**Drivers of the output gap.** The output gap is estimated with the multivariate filter model using several variables, including capacity utilization, inflation, and the unemployment rate (World Bank 2018). Other measures that directly affect the output gap, including credit extension, house prices, the real exchange

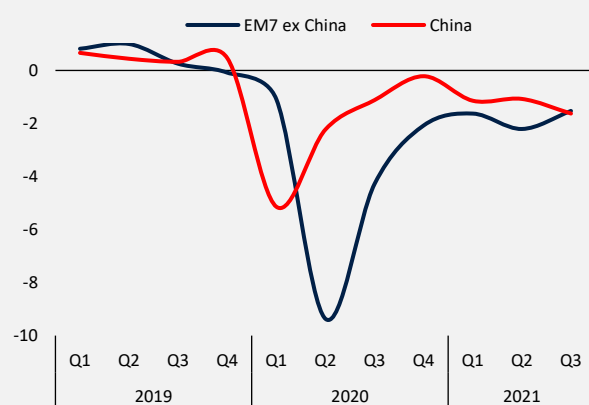
rate, monetary policy stance, and commodity prices, are also used to assess the output gap. These underlying drivers can materially impact the output gap with deteriorating conditions in property and credit markets on average, helping to dampen it (Figure 26.C).<sup>5</sup> Credit growth experienced a brief episode of acceleration in the period immediately following the COVID-19 shock on policy easing measures, but it dropped precipitously to the slowest pace of expansion in almost three decades in 2021Q3, as policies have tightened. House price growth has also slowed, turning negative during the initial phase of the pandemic and again in more recent months.

**Potential growth trending down.** Potential growth in China has slowed significantly from double-digits in the mid-2000s to around 6 percent before the pandemic and is expected to slow further over the forecast period (Figure 26.D). This slowdown reflects China's aging population, slowing productivity growth, a shift in growth away from investment to consumption, and the potential scars from the pandemic (Brandt et al. 2020; World Bank 2020). The slowdown in longer-term growth will likely be limited over the medium term, given that China's per capita income is about one-fifth of those in advanced economies, providing significant room for growth to continue to converge to the productivity frontier. Estimates by the World Bank (2018) suggest that potential growth will be just above 5 percent in 2022, although there is significant uncertainty, given the possible scarring from the pandemic and downside risks to growth. Confidence intervals, within one standard deviation, suggest that this estimate could likely be anywhere between 4.4-5.8 percent.

**Figure 26: China output gap and potential growth**

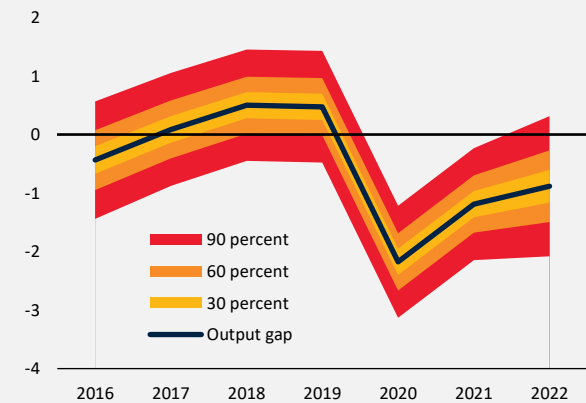
**A. Output gap**

(Percent of potential GDP)

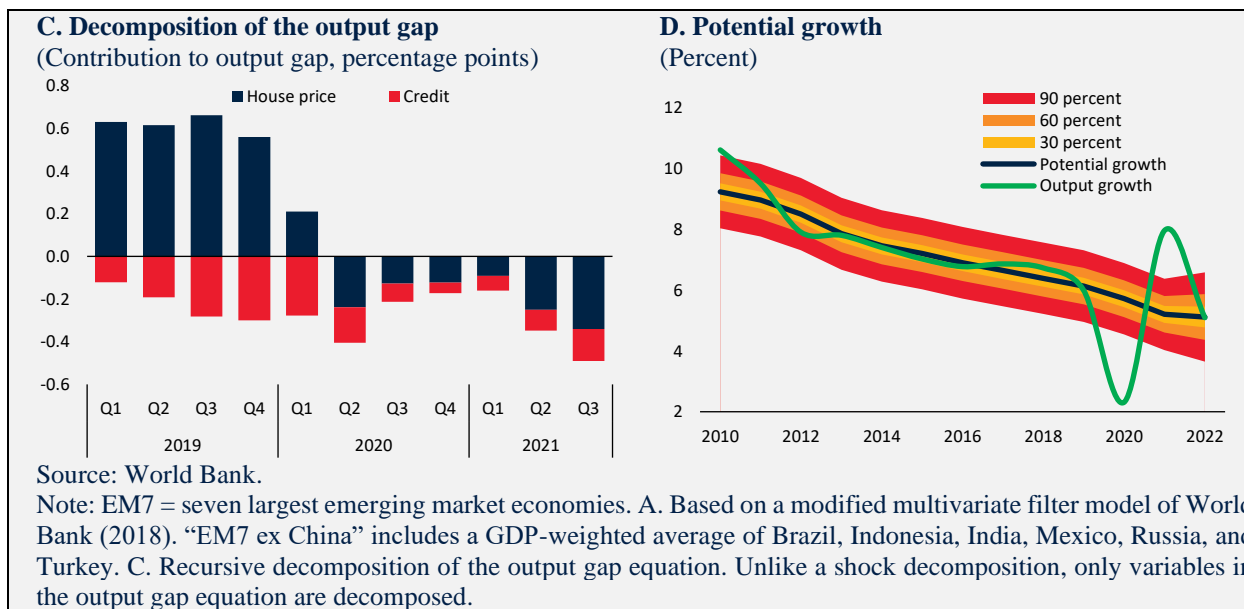


**B. Output gap**

(Percent of potential GDP)



<sup>5</sup> The impact of credit and house prices is based on a recursive decomposition which is an equation-specific decomposition and only looks at the direct drivers of the output gap. Since the model is a system of equations, the output gap is identified and affected by more than just these variables. Decompositions are typically done to the shocks that can provide an alternative narrative to the drivers of the output gap. The recursive decomposition complements other possible explanations of output gap outcomes.



**The government is expected to continue its focus on reducing financial stability risks, but less aggressively than in 2021.** Tighter regulations on various segments of the economy and targeted production cuts will remain in place. Government policies will continue to aim at resolving large imbalances in the real estate sector, including reducing overcapacity and excessive leverage while avoiding a disorderly downturn and financial market stress. The real estate sector will remain under pressure due to ongoing government regulations, lingering investor concerns stemming from the Evergrande crisis, and China’s commitment to reduce greenhouse gas emissions. China has recently revised its Nationally Determined Contribution (NDC) under the Paris Agreement, which offers a modest improvement to its prior goals for reducing CO<sub>2</sub> emissions (see Box 3).

### Box 3. Climate policy updates

**China submitted its updated Nationally Determined Contribution (NDC) to the United Nations Framework Convention on Climate Change (UNFCCC) October 28, just before the Glasgow Conference of Parties (COP) in November.** This was the first update on its NDC since its first submission in 2016. The revised NDC reiterated China’s pledge to achieve peak carbon emissions by 2030 and to hit net zero emissions by 2060. It was also accompanied by a new Long Term Strategy document. The headline targets in the revised NDC in comparison with the 2015 NDC include:

- A reduction in CO<sub>2</sub> intensity of over 65 percent relative to 2005, compared with the 2015 NDC aim of 60-65 percent.
- An increase in the share of non-fossil fuels in primary energy consumption in 2030 of around 25 percent, compared with the 2015 NDC aim of around 20 percent.
- An increase in the volume of forestry stock by 2030 of 6 billion cubic meters, compared with the 2015 NDC aim of 4.5 billion cubic meters.
- A target of 1,200GW solar and wind power capacity by 2030 as a new target.

**China signed the G20 Leaders Declaration on October 31 during the Glasgow COP.** This included the pledges to reach net-zero “by or around mid-century;” to take further action this century, including

enhancing 2030 NDCs, where necessary; and to accelerate action in the energy sector to meet the timeframes required by the Paris Agreement. On November 10, the U.S. and China also announced a Joint Glasgow Declaration in Enhancing Climate Action. This declaration included plans to establish a “Working Group on Enhancing Climate Action in the 2020s,” the intention to cooperate to enhance the measurement of methane emissions, exchange information, and conduct joint research, among others.

**These international commitments have been reflected in the development of a series of domestic plans, detailing policy measures and targets to implement China’s NDCs in various sectors.** These include the Action Plan for Peaking CO<sub>2</sub> Emission before 2030, the newly released Five-year Plan for the Green Development of Industry, proposed green building standards for new urban buildings, new energy efficiency standards for vehicles, and developing pilot demonstration cities and industrial parks for carbon neutrality. These efforts signal the important weight that climate targets are being given, although scope remains for increasing the level of detail and ambition of China’s emissions targets, particularly the timing of the emissions peak and targets beyond 2030. If China succeeds at rebalancing the economy toward services and consumption, China may outperform its own target and reach carbon neutrality as early as the middle of the century.

**The structure of aggregate demand is expected to shift gradually in favor of domestic demand.** Real consumption growth is projected to gradually return to its pre-COVID-19 trend, supported by stable labor market conditions and improved consumer confidence. The structure of investment is expected to rotate from real estate toward infrastructure investment. Larger infrastructure investment will partly offset lower real estate investment, while manufacturing investment growth will weaken somewhat as external demand slows. China is expected to gradually expand green investment supported by a technological shift away from high polluting and energy-intensive industries.

**On the supply side, drivers of economic growth will continue to shift from industrial production toward services.** The recovery in the lagging services sectors is expected to continue, although contact-based services may not see a complete return to pre-pandemic levels while China’s zero-COVID policy remains in place. Real estate services are projected to remain weak on the back of slower housing market activity. Industrial production growth will stabilize at around 5 percent y/y, and its composition will shift toward higher value-added, less polluting, and less energy-intensive sectors.

**The current account surplus is projected to narrow to 1.4 percent of GDP in 2022, reflecting a gradual decline in the trade surplus.** China is expected to face a steady decline in global demand as growth in major economies moderates. Export growth will likely experience a steady decline over the course of 2022 and 2023, as the base effect becomes less favorable and global demand peaks. In addition, 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, especially in 2022. Import growth is expected to firm due to stronger domestic demand.

**After slowing to 0.9 percent in 2021, headline inflation is projected to pick up to 1.9 percent in 2022.** Inflation dynamics will reflect some pass-through from producer to consumer prices and higher food prices as the deflation in pork prices, a major driver of CPI inflation in China this year,

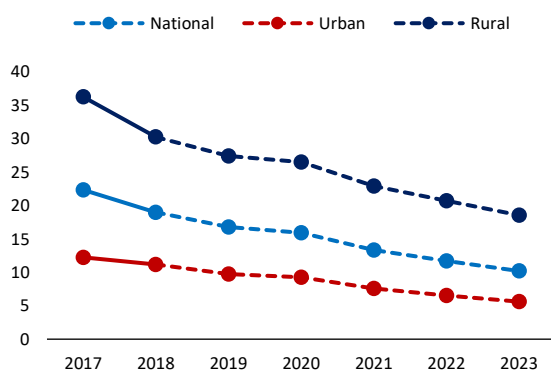
eases on dissipating base effects. Core inflation is projected to rise steadily, reflecting firming consumer spending. PPI inflation is expected to peak this year and decline to around 3 percent next year, amid a high base effect and easing supply constraints.

**Poverty is expected to return to its pre-pandemic trend, reflecting improvements during 2021 in labor market conditions and output.** While rural extreme poverty by national definitions (\$2.30/day per person in 2011 purchasing power parity (PPP)) has effectively been eliminated, about 13 percent of the Chinese population is expected to have consumption levels below the typical upper-middle-income poverty line of \$5.50/day per person (2011 PPP) in 2021 (Figure 27.A). Using this threshold, the decrease in poverty between 2020 and 2021 is projected to be significant, with a 36 million reduction in the number of poor (Figure 27.B). Among the remaining poor, over a third reside in urban areas, suggesting that policies to improve the welfare of the most vulnerable would need to be directed to both rural and urban areas.

**Figure 27. Poverty reduction is expected to return to a pace as observed in pre-COVID years**

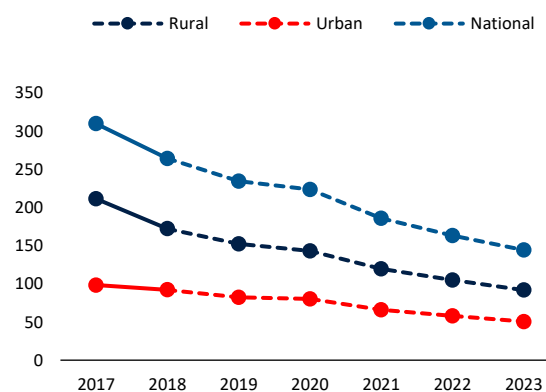
**A. Poverty rate**

(\$5.50 per person per day, percent)



**B. Number of poor**

(\$5.50 per person per day, millions of persons)



Source: World Bank staff estimates using tabulated data from China NBS and World Bank 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>	<i>2018</i>	<i>2019</i>	<i>2020</i>	<i>2021f</i>	<i>2022f</i>	<i>2023f</i>
Real GDP growth, at constant market prices	6.7	6.0	2.3	8.0	5.1	5.3
Private consumption	7.5	6.5	-1.7	10.2	6.1	6.9
Government consumption	9.0	6.0	0.9	6.8	5.8	5.3
Gross fixed capital formation	7.4	5.3	4.7	3.8	4.4	4.5
Exports, goods and services	4.0	2.2	1.8	17.3	4.0	3.6
Imports, goods and services	7.4	-1.7	-2.0	13.0	4.8	4.8
Real GDP growth, at constant factor prices	6.7	6.0	2.3	8.0	5.1	5.3
Agriculture	3.5	3.1	3.0	5.7	3.2	3.1
Industry	5.8	4.9	2.6	8.6	5.2	5.0
Services	8.0	7.2	2.1	7.8	5.3	5.8
Inflation (Consumer price index)	2.1	2.9	2.5	0.9	1.9	2.1
Current account balance (% of GDP)	0.2	0.7	1.9	1.6	1.4	1.2
Financial account balance, excl. reserves (% of GDP)	1.2	0.1	-0.5	-0.2	0.1	0.3
Net foreign direct investment (% of GDP)	0.7	0.4	0.7	1.1	0.9	0.9
General public budget balance (% of GDP)	-2.6	-2.8	-3.7	-3.2	-3.1	-2.9
Augmented fiscal balance (% of GDP) <sup>a</sup>	-3.3	-4.6	-8.9	-5.4	-5.6	-5.2
Government debt (% of GDP)	36.5	38.5	45.4	46.6	49.7	52.0
Primary balance (% of GDP) <sup>a</sup>	-2.4	-3.6	-7.8	-4.2	-4.4	-4.0

Source: World Bank.

Note: f = forecast (baseline).

(a) World Bank staff calculations. The augmented fiscal balance (narrow definition) adds up the general public 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

**Risks to China's growth are tilted to the downside.** The most prominent downside risks remain those related to the pandemic. Despite high vaccination rates, China remains at risk of renewed localized outbreaks. While China's zero-COVID approach has required only temporary restrictions so far, the potential greater transmissibility of new variants such as *Omicron* could lead to more prolonged disruptions to economic activity. This could weigh heavily on private consumption of contact-based services while disrupting production and transportation logistics.

**Risks in China could also emanate from a severe and prolonged downturn in the real estate sector.** Real estate and land sales have been declining for five months in a row now, and house price inflation dipped into negative territory for the first time since 2015 in October 2021. If these trends persist, they will have direct effects on households as well as local government budgets. Households in China are disproportionately dependent on the real estate sector, with a majority of household wealth tied to housing, whether through home ownership or holdings of wealth management products issued by real estate developers (PBOC 2019).<sup>6</sup> Moreover, the fortunes of local governments are also intertwined with those of the property market as they rely on the sale of land-use rights to generate on average more than one-third of their revenues.

<sup>6</sup> Housing is the most important asset in household wealth, accounting for nearly 60 percent of household assets based on the 2019 PBOC survey. The home ownership ratio is also very high in China at around 90 percent.



**The troubles of real estate developers could spill over into banks, particularly at the local level, and affect borrowing costs for riskier companies more generally.** Although distress among real estate developers is unlikely to cause a systemic financial crisis, around 40-50 percent of total bank loans are property-related if loans to real estate developers, mortgage loans, construction loans, and other loans collateralized by land or property are summed up. A significant decline in collateral values may, therefore, sharply reduce the willingness of banks to lend, worsening the credit crunch.

**A slowdown in growth, whether triggered by recurring COVID-19 outbreaks or a prolonged downturn in the real estate sector, would complicate the calibration of the government's policy efforts to rebalance the economy and meet its growth targets.** An aggressive countercyclical policy response to slowing growth could escalate medium-term macro-financial risks. In this environment, traditional policy support, including accelerating infrastructure spending, channeling credit to SOEs, and rekindling the real estate sector, could undo rebalancing efforts, impair hard-won deleveraging efforts, and worsen the housing market's supply overhang. Some recommendations on how to address these difficult policy trade-offs are offered in the next section.

**Lastly, China's economy is also vulnerable to global supply disruptions, a sharp tightening in global financial conditions, and heightened tensions with major trading partners.** Ongoing global supply disruptions may prove more persistent than expected, contributing to burgeoning inflation pressures as evidenced by sharp increases in global input costs. Domestically, a shortage of intermediate inputs and continued tight energy markets could weigh heavily on production and corporate profits, encouraging firms to curtail private investment. Outside of China, major central banks may be compelled to tighten monetary policy at a faster than anticipated pace, triggering a sharp tightening of global financial conditions with adverse spillovers to China's economy. The possibility of tensions between China and its key trading partners represents another risk to growth, particularly if these weigh on the import of critical technology, slow the transfer of productivity-enhancing innovations, and foster a decoupling of high-tech supply chains.

## **Policy implications: From recovery to high-quality growth, a difficult rebalancing act**

**China faces a challenging rebalancing act as it transitions to high-quality growth.** While this year's growth will be exceptionally high, the economy is expected to return to a path of structural moderation thereafter, reflecting demographics and the rising constraints of an investment-driven growth model. The pandemic and subsequent recovery have worsened domestic and external economic imbalances and make the need for structural reforms to address constraints to sustainable, high-quality growth more urgent. Three challenges stand out: first, rebalancing from external to domestic demand and from investment and industry-led growth to a greater reliance on consumption and services; second, shifting from the significant weight placed on state leadership and regulation to a greater role for markets and the private sector; and third, transitioning from a high to a low-carbon economy.



- **Rebalancing from external to domestic demand:** While China's growth this year benefited from strong export performance, the strength of external demand going forward is unlikely to be sustained, lending additional urgency to rebalancing the economy from external to domestic demand.
- **Rebalancing from traditional investment and industry to consumption and services:** China's return to its deleveraging and de-risking policies during 2021 signals that the authorities understand the limits to further investment-driven growth. Shovel-ready infrastructure projects are increasingly hard to find, while the energy and emission intensity of China's construction and real estate sector is one reason the country found itself confronted with unexpectedly severe energy shortages during August and September 2021. A rebalancing toward consumption and services, while challenging as the pandemic lingers, is nonetheless necessary to make growth more sustainable.
- **Rebalancing from the state to markets and the private sector:** To stem the decline in productivity growth, there is a need to reduce the footprint of the state and enhance the role of the private sector. It is well known that productivity growth in China has been private-sector led in the past. The scope for future gains through the diffusion of modern technologies and practices among smaller private companies remains large, while the profitability and productivity of state-owned enterprises continues to lag their private sector peers. While SOEs played a useful role during the pandemic to stabilize employment, deliver key services, and in some cases, close local government budget gaps, their ability to drive the next phase of growth is more questionable.
- **Balancing from a high to a low-carbon economy:** China's approach to reaching peak and net-zero emissions will have macroeconomic consequences. A carefully designed transition strategy could become a driver of productivity-enhancing structural transformation, as well as potentially spurring faster global climate action and averting future climate damage. Inconsistent policies, on the other hand, risk disrupting energy markets, creating uncertainty, deterring private investment, and leaving stranded assets and displaced workers in their wake.

**These are difficult policy challenges but the authorities should avoid the temptation to fall back to traditional growth patterns.** The following policy options, which are mutually reinforcing, could help China mitigate the trade-offs and accelerate the transition to high-quality growth.

#### *Balancing from external to domestic demand*

- **Easing the fiscal stance to support domestic demand and help narrow external imbalances.** Following considerable fiscal tightening in 2021, China has fiscal space, especially at the central level, to provide fiscal support to strengthen short-term demand should economic activity weaken. A looser fiscal stance would also help rein in external imbalances. Furthermore, reorienting fiscal efforts toward social spending and green investment rather than traditional infrastructure investment would facilitate the rebalancing to a more sustainable structure of China's economy.

- **Mitigating financial stability risks related to high corporate leverage and inflated real estate markets to safeguard domestic demand.** In the short term, the authorities should maintain the ongoing efforts to address excessive leverage in the corporate sector, especially among real estate developers, but be ready to provide liquidity support when necessary to contain the risks of financial contagion. Financial regulators should also assess the exposure of banks, identify associated vulnerabilities, and take steps to strengthen capital and provisioning buffers as appropriate. In the medium term, strengthening insolvency and bank resolution frameworks would facilitate an orderly exit of weak or failing corporates and reduce the trade-off between monetary accommodation and financial de-risking.
- **Phase out non-conventional monetary policy tools to improve policy transmission throughout the cycle.** With the adoption of a more robust corporate and bank resolution framework, moral hazard risks in the financial sector would be more easily controlled. This would allow the authorities to phase out non-conventional tools, such as specific rediscount facilities or window guidance, and facilitate the transition to a market interest-based framework, strengthening monetary policy effectiveness. As China continues to gradually liberalize its capital account, the exchange rate should be allowed to flexibly adjust to market forces.

### *Balancing from traditional investment and industry to consumption and services*

- **Reforming social security and liberalizing household registration in all cities to reduce precautionary household savings and lift domestic consumption.** Further extending the liberalization of the household registration system (Hukou) to China's large cities could yield substantial benefits to migrant workers and their families in terms of access to public welfare, education, and health services. Tax reforms and improvements in social security coverage and benefits would further reduce the precautionary savings motive. The introduction of a progressive income tax and a property tax could mobilize resources to help local governments finance additional outlays for public services and strengthen social safety nets while reducing inequality in final household incomes. The pooling of pension and unemployment insurance funds at the national level would facilitate labor mobility, reducing the costs of the required economic transformation.
- **Liberalizing market access in the services sector to foster competition and promote innovation.** 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. Taking further advantage of some of the more modern services—such as professional, financial, and IT-enabled services—will create new opportunities for growth in response to rising incomes, a more urbanized population, and growing consumption levels. Given the low carbon intensity of most services, this would also contribute to decarbonizing growth. The liberalization of services also plays an important role for the services trade, which continues to gain in importance (see also the special focus chapter of this report).

### *Balancing from the state to markets and the private sector*

- **Promoting a stable and predictable regulatory environment and strengthening the innovation system.** Policy makers have accelerated regulatory interventions across multiple sectors in recent months. These interventions comprise regulatory changes on monopolistic practices, data security, worker protection, the fintech industry, and private sector education, among others. When well designed, communicated transparently, and introduced in an orderly fashion, regulations can play an important standard-setting role, facilitate market creation, and protect consumers. All of this underscores the importance of how policy makers regulate. While the authorities are adapting the regulatory system to economic, social, and technological realities that are changing rapidly, it is critical to ensure a stable and predictable regulatory environment to foster private investment and innovation and release productivity growth. Although China has an extensive national innovation system, this could be further solidified through increasing funding for basic research, promoting the adoption of existing innovations, and strengthening intellectual property rights to promote innovation.
- **Ensuring a level-playing field between SOEs and private firms.** While SOEs will maintain a central role in China's economy, SOE reforms would complement the promotion of market competition by helping to ensure fair competition, which ensures that markets will select the most productive enterprises irrespective of their ownership structure. An important step would be the introduction of a formal state ownership policy for SOEs that would articulate the purpose of state ownership and focus SOEs in strategic sectors.

### *Balancing from a high- to a low-carbon economy*

- **Economy-wide policies including expanded carbon pricing, power sector reform, leveraging green finance, and reducing the energy intensity of growth.** Broad-based carbon pricing is widely seen as an indispensable instrument to achieve economy wide and cost-effective abatement. China could build on the existing Emissions Trading System (ETS) by converging and unifying carbon intensity benchmarks, moving toward a mass-based ETS design, or introducing auctioning as the default allocation mechanism of initial allowances. An alternative option could be carbon taxation, which would expand the tax base while aligning incentives in favor of emissions reductions. The recycling of carbon tax revenues could avoid regressive impacts. Deepening power market reform—including developing an ancillary market, fully implementing the recent abolition of dispatch quotas for industrial consumers, and increasing interprovincial power trade would enhance the transmission of price signals and enable carbon pricing to drive abatement. Finally, expanding green finance and mobilizing private sector capital while managing climate-related financial risks will also be imperative to harnessing the power of private capital markets to drive low-carbon investment.
- **Targeted sector-specific policies, public investments in clean technology infrastructure, and research to advance critical low-carbon technologies.** Economy-wide pricing has typically been shown to be the most efficient way to drive abatement, due to constraints on the acceptability of higher energy prices. However, the use of reinforcing instruments at the sectoral level, such as feebates and regulations, for example, and emissions rate regulations for vehicles or buildings, can also play an important role in driving abatement. In addition, public

investments in clean technology infrastructure networks (for example, electric vehicle charging infrastructure or grid updates to accommodate renewables) that would not be provided privately will play a key role in the medium term. Finally, it will be important to fund basic research needed to advance critical technologies that are far from being market-ready and to correct for market failures in early technology development.

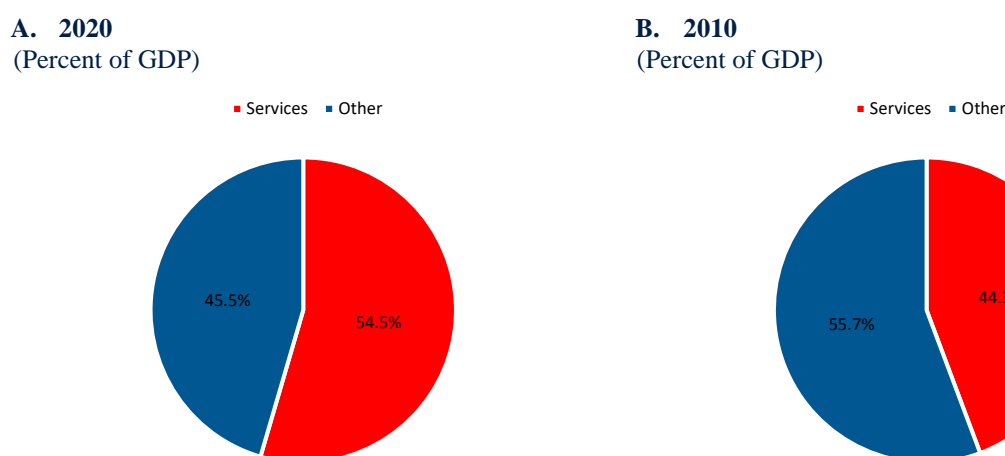
- **Enabling the adjustment of the economy by enhancing the flexibility of factor markets, assisting displaced workers, and providing social safety nets.** When financial institutions misallocate capital and do not price risks well, and when workers find it difficult to switch employment because of barriers to labor mobility, high hiring and firing costs, or skills mismatches, the costs of adjustment can be high. Along with the gradual introduction of carbon pricing and tighter regulations, parallel reforms to factor markets—labor and capital—are needed to avoid persistent losses. Government policy can also directly aid the adjustment process. For instance, the government can invest in supporting workers in industries negatively affected by climate action through active labor market policies. The government can also invest in regions and communities negatively affected by the loss of activity and tax income to ensure the continued provision of critical government services. Such policies are essential to ensuring broad-based public support and overcoming resistance from vested interests.

### III. China's Services Trade Performance: Strong Growth but Unrealized Potential

#### Services are driving China's structural change

**Structural changes are bringing services to the forefront of China's future growth and development trajectory.** Services accounted for just under 55 percent of Chinese aggregate output in 2020, up from 44.3 percent a decade earlier (Figure 28.A and B). While the pace of change has been rapid, relative to other countries, China's services sector still has significant room to grow.

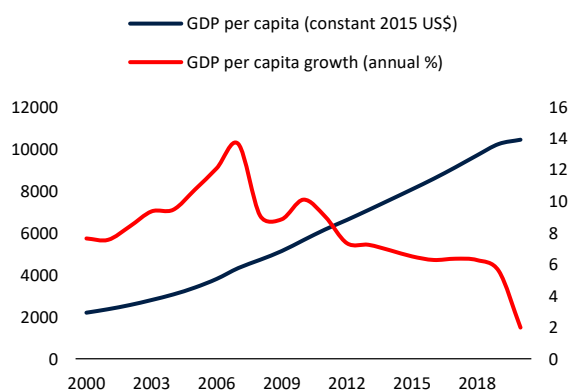
**Figure 28. Share of services in GDP**



Source: Ministry of Commerce (MOFCOM), WDI, World Bank.

**Several factors lie behind the ongoing process of structural transformation and the rising importance of the domestic services market.** These include sustained gains in per capita income levels, increasingly large shares of which are spent on a host of quality of life enhancing services. As Figure 29 shows, the past two decades have witnessed a fivefold increase in China's per capita GDP level. Other factors underpinning the growth of China's domestic service sector include far-reaching demographic changes, for example, the growing demands on healthcare and wellness resulted from an aging population, the quest for environmental sustainability and associated decarbonization efforts, as well as growing urbanization, to which a wide range of services spanning construction and engineering,

**Figure 29. Trends in GDP per capita and per capita GDP growth**  
(Constant 2015 US\$)



Source: WDI, World Bank.

infrastructure, energy, urban transport, education, retail trade, cultural and entertainment services as well as a host of professional and business services are connected.

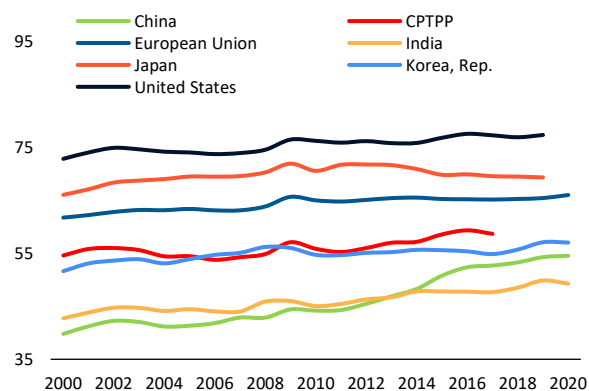
**These changes hold important implications for the country's labor market performance, patterns of consumption and trade, and productivity growth, as well as the country's environmental footprint.** As the World Bank's *Innovative China* report put it, a new Chinese economy is rapidly emerging (World Bank 2019). However, the COVID pandemic has put a temporary halt to this transformation, as contact-based services, in particular, have been negatively affected by mobility restrictions and consumption growth has moderated as precautionary savings have gone up.

**China's structural transformation toward a consumption-based, services driven economy still has some way to go.** While the share of services in China's GDP has increased by a fourth over the 2010-21 period, it remains below the world average of 65 percent and lower than that of all of China's major peers other than India (Figure 30.A). A similar trend holds for the share of final consumption expenditure in aggregate output, where China lags all major comparator economies by a significant margin (Figure 30.B). This chapter looks at the longer-term trends in China's services development in general and China's trade in services in particular, with the aim of identifying future areas for potential growth and the reforms that would facilitate such growth.

**Figure 30. Services sector has room to grow**

**A. Share of services**

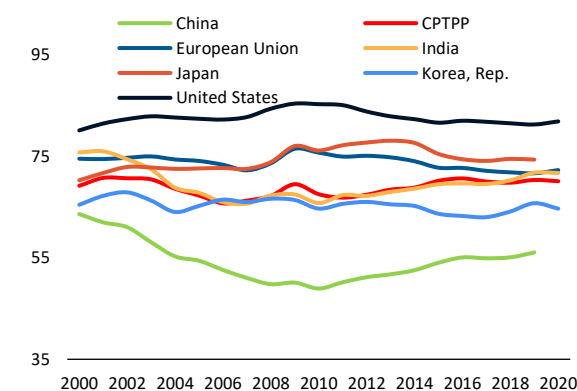
(Percent of GDP)



Source: WDI, World Bank.

**B. Final consumption expenditure**

(Percent of GDP)



## Services top Chinese employment but at a much lower level than in advanced economies

**Services account for the largest share of Chinese employment, supplying just under one in every two jobs (47.3 percent) at year-end 2019 according to International Labour Organization (ILO) estimates (Figure 31.A).** China's labor market performance contrasts with that of most advanced economies. While the share of services in total employment grew by over 70 percent since 2000, it remains lower than the world average of 52 percent. China's employment in agriculture was halved over the past two decades. Meanwhile, China employs a fifth more

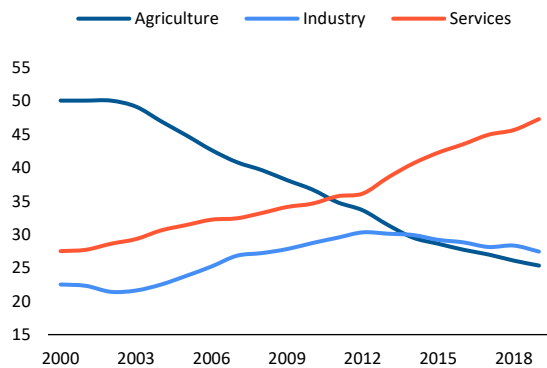


workers in manufacturing today (27.4 percent) than it did 20 years ago (22.5 percent) (Figure 31.A).

**Figure 31. China's employment share by sector**

**A. Employment share**

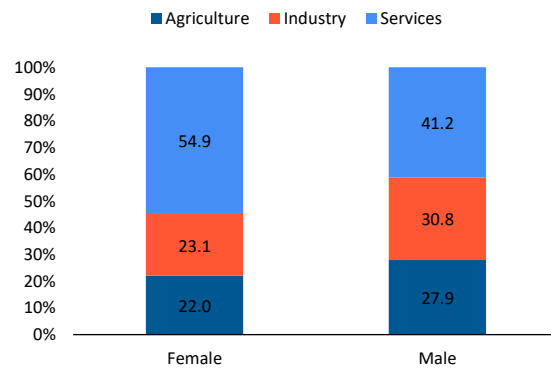
(Percent of total employment)



Source: WDI (modeled ILO estimate); World Bank.

**B. Employment share by gender in 2019**

(Percent of total employment)



**Services are particularly important to women's employment, and China is no exception.**

Figure 31.B documents significant gender differences in Chinese employment patterns, with services accounting for a significantly greater share of female employment and attendant gains in inclusiveness. While the ILO estimates that 48 percent of men worked in services globally in 2019, as compared to 41.2 percent in China, the sector supplied close to three-fifths (58 percent) of global female employment. Such a level slightly exceeds that in China (54.9 percent). Since services are the predominant source of female employment, one implication is that expanded services trade may benefit female Chinese workers and female owned or managed firms more than merchandise exports (World Bank and WTO, 2020).

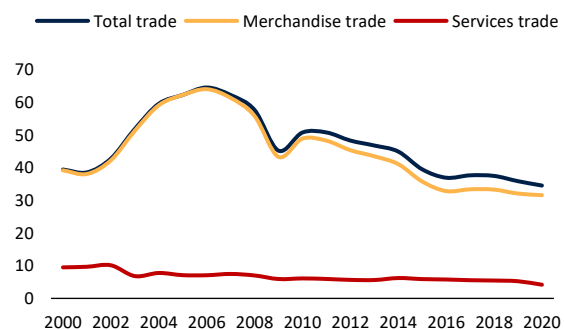
**China's services trade performance: an expanding export basket but untapped potential remains**

**China's overall services trade performance has been robust but exhibits a number of peculiarities.**

First, China's services trade has grown as rapidly as trade in goods, making the country one of the largest traders in services worldwide. On closer inspection, this is not surprising, because the biggest share of China's services trade is directly linked to its trade in goods (see next section). Second, China shows a markedly lower reliance on services exports than comparator economies (Figure 33). The share of services in China's aggregate exports stood lower in 2019 than in 2010 (9.3 percent versus 10.8 percent), setting China apart from comparator peers and suggesting

**Figure 32. China: trends in merchandise and services trade**

(Percent of GDP)



Source: WDI; World Bank.

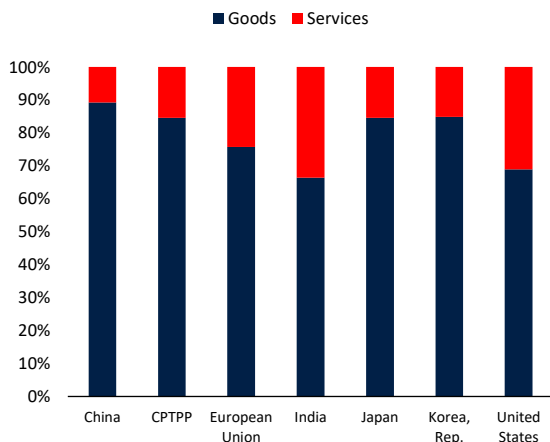


significant untapped potential to grow the sector. Third, the past two decades have witnessed a significant drop in the contribution of external demand to Chinese aggregate output (Figure 32), including from services trade, although the share of manufacturing trade in GDP declined more rapidly.<sup>7</sup>

**Figure 33. Share of services in total export**

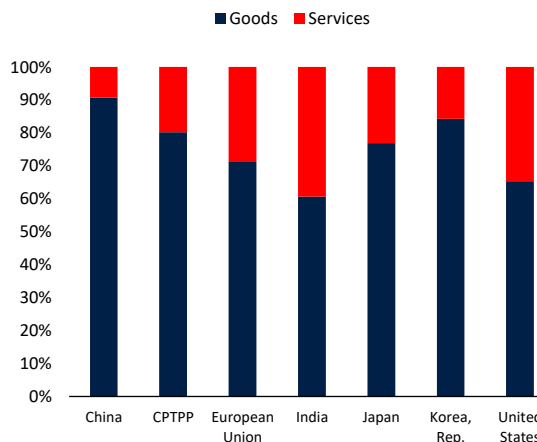
**A. 2010**

(Percent of total exports)



**B. 2019**

(Percent of total exports)

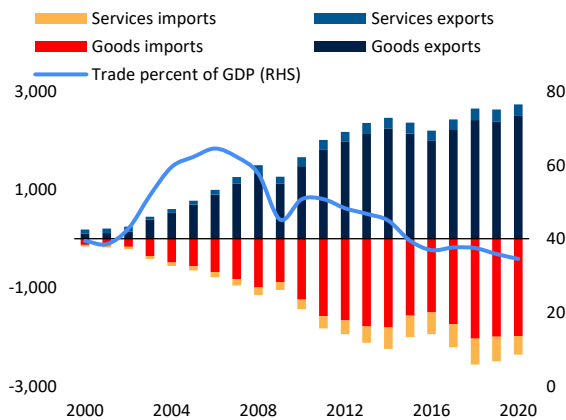
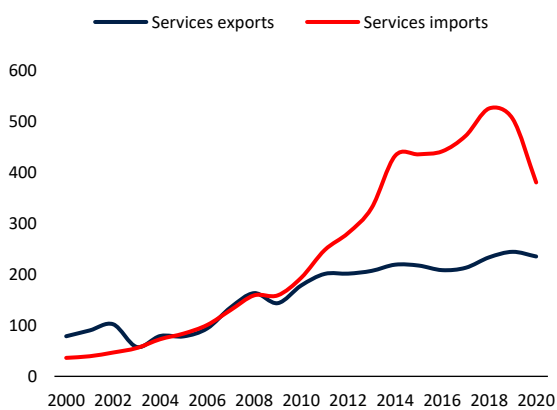
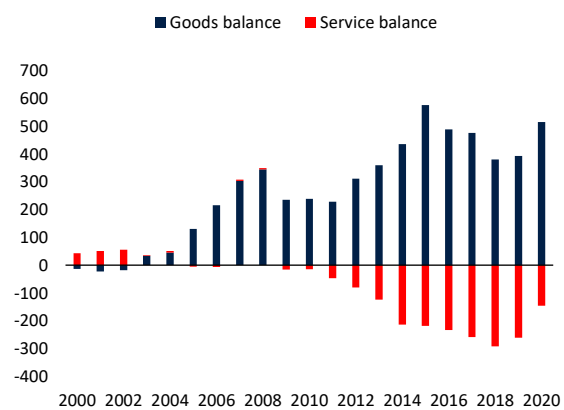


Source: Calculations based on data from WDI; World Bank.

**Contrasting the surplus registered on its merchandise trade account, China has run a persistent deficit on its services trade balance over the past decade (Figure 34).** The country's exports of commercial services stood at US\$278 bn at year-end 2020, ranking it fourth in the world (excluding intra-EU trade) and accounting for 5.8 percent of global exports.<sup>8</sup> China's US\$377 bn worth of 2020 imports of commercial services ranked second globally (third when intra-EU trade is included). World Trade Organization (WTO) data shows that China's services exports held up well during the first year of the COVID-19 pandemic, experiencing a modest 1 percent fall. This contrasts with the steep 24 percent contraction in the country's services imports, driven in large measure by the drying up of Chinese tourism abroad. China's share of world imports of commercial services stood at 8.7 percent in 2020 (WTO, 2021).

<sup>7</sup> The share of goods trade in Chinese GDP dropped from a peak in 2006 at 64 percent to 31.6 percent in 2020. The share of services trade in GDP stood at 4.2 percent in 2020, down from a 2002 peak of 10.1 percent.

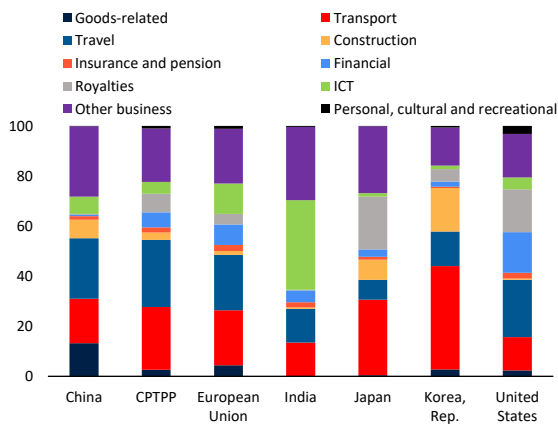
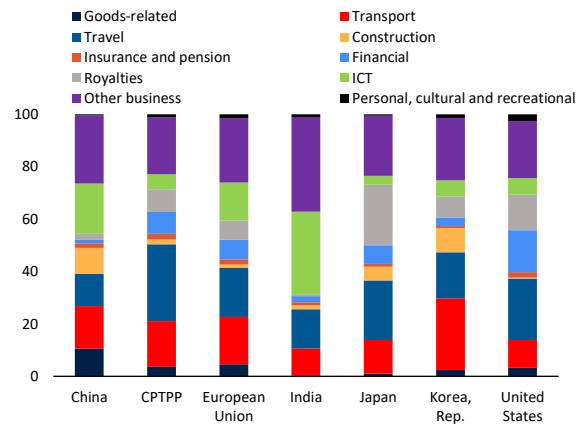
<sup>8</sup> China accounts for 14.7 percent of aggregate goods exports and 11.5 percent of world goods imports.

**Figure 34. China's trade in goods and services****A. Trade in goods and services**  
(Billion USD; percent of GDP)**B. Goods trade**  
(Billion USD)**C. Services trade**  
(Billion USD)**D. Trade Balance**  
(Billion USD)

Source: WDI; World Bank.

## The changing structure of China's services trade: modern exports, traditional imports

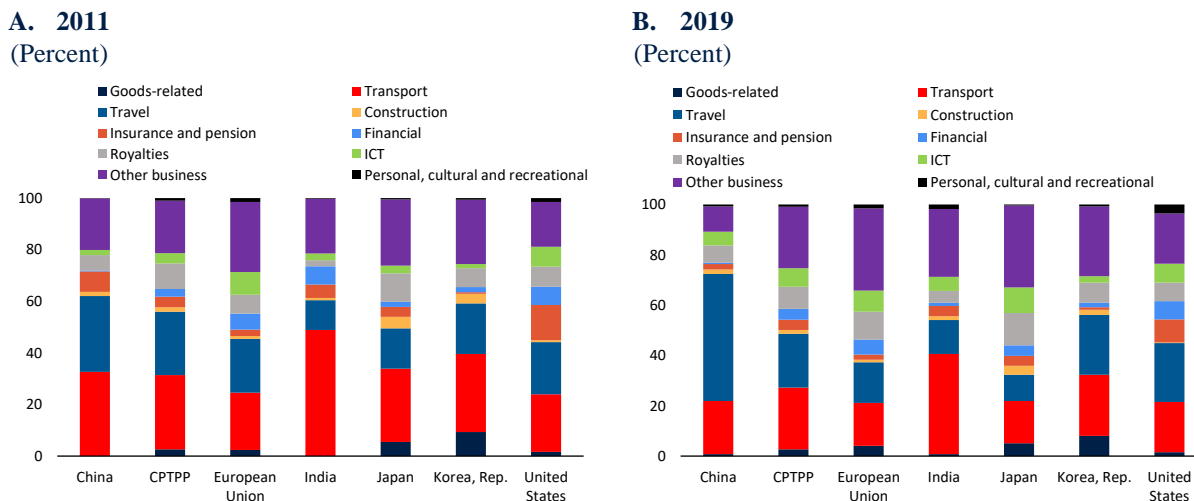
A closer look at the composition of Chinese exports of commercial services reveals the rising importance of “modern” services. “Modern” services that increasingly rely on remote delivery over digital networks have expanded considerably, from about 20 percent of services exports in 2005 to some 50 percent in 2019. The country's top five services export categories—other business services (26 percent), ICT services (19.1 percent), transportation (16.3 percent), travel (12.2 percent), and construction (9.9 percent)—accounted for over four-fifth (83.5 percent) of the total in 2019 (Figure 35).

**Figure 35. Composition of services exports****A. 2011**  
(Percent)**B. 2019**  
(Percent)

Source: Calculations based on data from the United Nations Conference on Trade and Development (UNCTAD); World Bank.

**Further signs of qualitative changes in China's services export basket can be seen from the declining importance of travel receipts and the rising share of ICT services exports.** The share of travel receipts in aggregate exports was cut in half over the past decade, from 24.2 percent to 12.2 percent, while exports of ICT services nearly tripled their share from 6.9 percent in 2011 to 19.1 percent in 2019. The digitalization of China's services sector was given a strong boost by the COVID-19 pandemic, fueling a marked rise in the share of knowledge-intensive services in total exports and most recently prompting novel policy experimentation through the creation of pilot digital free zones in several large urban areas.

**China chiefly imports traditional services,** with travel (50.5 percent) and transportation (21.1 percent) accounting for a dominant share of total services imports in 2019 (Figure 36). Travel expenditures contracted sharply during the pandemic, contributing to a significant narrowing of China's services trade deficit in 2020. China's top five services import categories relate to travel, transportation, other business services, royalty payments, and ICT services. The presence of royalty payments among China's leading services imports suggests that despite the country's much-improved innovation performance—China ranked 12th among a sample of 132 economies under the World Intellectual Property Organization's (WIPO) *Global Innovation Index* in 2021, moving up from the 29th position it held a decade earlier—scope remains to enhance the level of process and product innovation of the country's leading service-providing firms.

**Figure 36. Composition of services imports**

Source: Calculations based on data from UNCTAD; World Bank.

**While the composition of China’s services exports is broadly similar to that of comparator economies, its import profile shows distinct differences.** China’s import profile partially reflects the relatively restrictive nature of its trade and investment policy stance in services, particularly as regards to modern services such as digital services. But it could also point to the steady rise in the competitiveness of domestic service suppliers and the corresponding declining share of foreign value added in the county’s gross exports (OECD 2018; 2021). These two factors are examined more closely below.

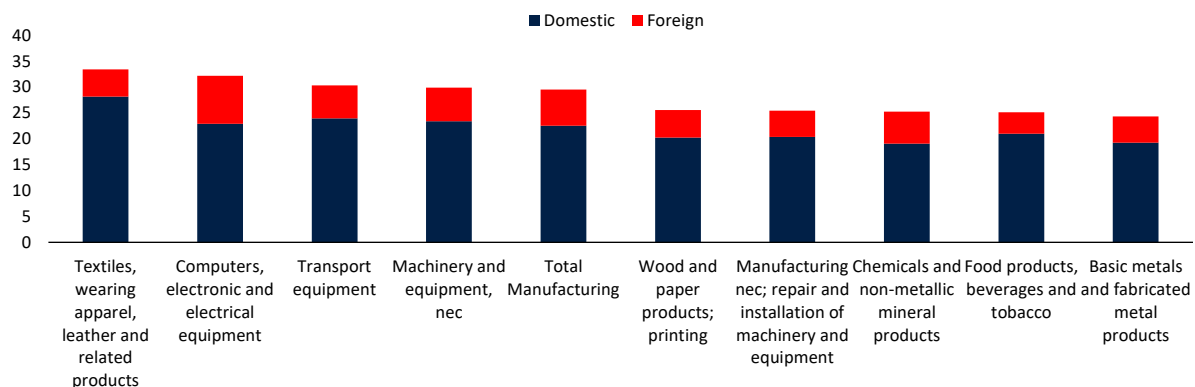
### **Domestically produced services are increasingly important for Chinese manufacturing exports**

**Access to high-quality, efficient, and productive inputs is critical for competitiveness.** Because of the value chain linkages between sectors of an economy, the competitiveness of an upstream sector that is used as input to production is important for that of other downstream sectors. Forward linkages from the services sector could include, for example, a manufacturing firm hiring an engineering firm or designers in building a new factory or the hiring of ICT professionals to create a website for online sales. If these inputs are supplied by domestic providers rather than imported, they show up as domestically produced value-added inputs in manufacturing, agriculture, or services output (referred to as “value-added linkages”).

**Services are increasingly important to China’s manufacturing competitiveness,** contributing roughly 30 percent of the value added of gross manufactured exports in 2018, up from 26 percent in 2010 (Figure 37). Compared to a sample of peer economies, China registered the largest relative increase in the contribution of services value-added of domestic origin over the 2010-18 period. This points to steady gains in the competitiveness of domestic service suppliers and strengthened linkages with industry, a process often referred to as “servicification” (Figure 38).

**China's shift toward consumption-driven growth is also raising the demand for final consumer services**, such as tourism, entertainment, cultural services, retail trade, health, and education services. These services are generally not heavily traded, but China's imports of final consumer services with the exception of tourism expenses are nonetheless quite low. This could reflect trade and investment restrictions. This is examined next.

**Figure 37. China: services value-added in gross exports of selected manufacturing subsectors, 2018**  
(Percent of value-added)

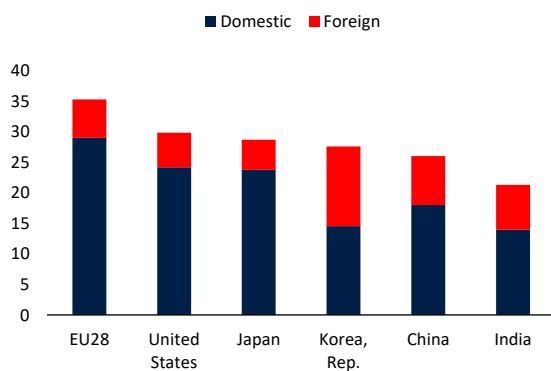


Source: Calculations based on data from OECD Trade in Value Added; World Bank.

**Figure 38. Services value-added in manufacturing gross exports**

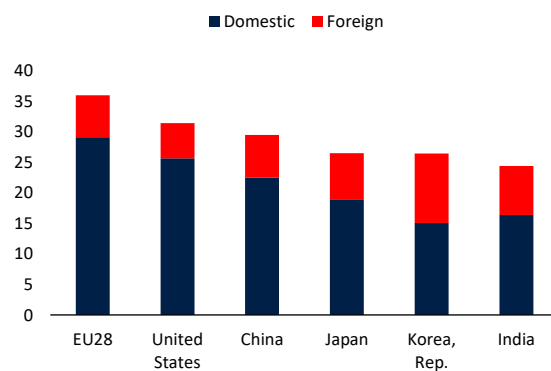
**A. 2010**

(Percent of manufacturing exports)



**B. 2018**

(Percent of manufacturing exports)



Source: Calculations based on data from OECD TiVA; World Bank.

## China's services trade regime: healthy growth despite a restrictive regulatory environment

**China's services trade has registered robust export and import growth despite a restrictive regulatory framework.** Unlike trade in goods, which chiefly entails border measures governing the entry of foreign merchandise, trade in services responds to a complex set of domestic laws and regulations affecting market access conditions and the operations of established firms. The central intermediation function that services perform across all sectors implies that inefficient regulatory regimes in services represent a potentially heavy tax on economy-wide performance.

**World Bank Group and OECD datasets mapping *applied* policy measures in services offer evidence of China's restrictive regulatory regime for services.**

Such a policy stance arguably contributes to the suboptimal performance of the country's trade in services. China's overall Services Trade Restrictiveness Index (STRI) stands a third higher than the OECD average and close to double that of the EU, the US, and Japan (Figure 39).

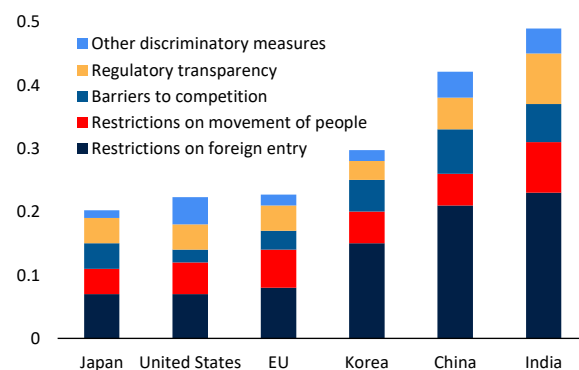
**China's policy stance in services is most restrictive with regard to conditions governing foreign entry, is second only to India among major peers, and is significantly**

more trade and investment deterring than that of major advanced economies.<sup>9</sup> While the levels of China's policy restrictiveness in regard to other STRI metrics—regulatory transparency, restrictions on the movement of people, barriers to competition, and other discriminatory measures—are all significantly lower than for those governing foreign entry, China's policy regime generally remains more restrictive than that of its advanced country peers across all subindices other than the movement of people.

**Constraints on foreign entry, barriers to competition, and the application of discriminatory measures make China a restrictive market for foreign services suppliers.** Foreign firms face a range of challenges when establishing a subsidiary in China, including limitations on foreign equity and mandatory joint venture requirements, foreign investment screening, and residency and nationality requirements for senior personnel. China's restrictive digital policies, combining data localization requirements and limits placed on cross-border data flows, further impede competition in the country's services market and entrench the market dominance of local suppliers.

**A closer look at the restrictive nature of applied regulations across sectors and comparator economies reveals that China is also more restrictive than its peers in almost all services subsectors, and particularly so in sectors closely associated with the operation of digital markets (broadcasting, motion pictures, telecommunications, and sound recordings)<sup>10</sup> as well as in courier and accounting services (Figure 40).**

**Figure 39. STRI restrictions by main categories in 2020**  
(Index)



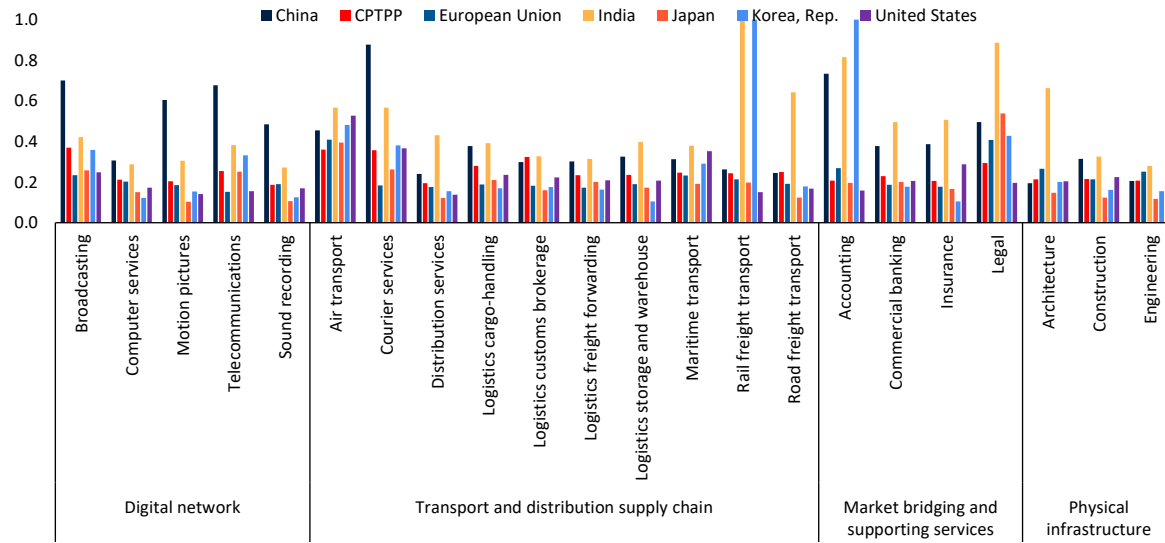
Source: OECD; World Bank.

Note: EU excludes Bulgaria, Croatia, Cyprus, Malta, and Romania.

<sup>9</sup> Restrictions on foreign entry include information on foreign equity limitations, requirements that senior management or members of boards of directors be nationals or permanent residents, foreign investment screening, restrictions on cross-border mergers and acquisitions, capital controls, and restrictions on cross-border data flows, as well as a number of sector-specific investment measures.

<sup>10</sup> Policy restrictiveness metrics for both services trade and FDI point to services related to media and broadcasting as well as telecommunications as the most restricted in China. Policy concerns over market concentration and foreign ownership in media and mass communication are hardly unique to China and often subject to a wide range of

**Figure 40. STRI by sector, China and its peers, 2020**  
(Index)



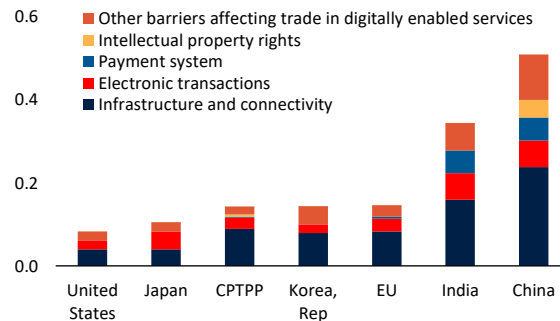
Source: OECD; World Bank.

Note: Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) excludes Brunei Darussalam, Singapore, and Vietnam. EU excludes Bulgaria, Croatia, Cyprus, Malta, and Romania

**The OECD's Digital Restrictiveness Index ranks China as the least open country to digital trade among the 44 economies in its sample (Figure 41).** The country's digital restrictiveness is heavily influenced by its data sharing policies. While content limitations on media and some internet services are hardly unique to China and often desirable on public policy grounds (World Bank, 2021c), China's policies to control and curb potentially harmful online content rely on regulatory tools whose breadth may have repercussions beyond the intended policy areas.

**Figure 41. Country rankings in the OECD Digital Restrictiveness Index, 2020**

(Index)



Source: OECD; World Bank.

**China's restrictions on cross-border data flows create a cumbersome framework that deters international data transfers.** While China does not prohibit the sharing of data across borders, it mandates a series of procedures and authorizations that can entail long delays and substantial compliance costs. Box 4 describes the process for requesting permission for data transfers under

restrictive practices rooted in concerns over cultural diversity, the dissemination of harmful content, or national security. In most countries, such regulations have not, or have to a limited extent, carried over to social media and other digital platforms. By broadening the scope of its media policies to apply to the digital environment, including social media and user-generated content, China's policy stance sets it apart from major comparator peers. China's digital environment subjects its digital operators to tight scrutiny, including those that are not designed as mass communications systems but rather provide interpersonal connections like social media or even peer-to-peer communication platforms.



the recently enacted Personal Information Protection Law (PIPL). Under these rules, the Cyberspace Administration of China (CAC) has up to three months to accept or reject a data transfer request. Similar restrictions have been in place in various forms for over a decade.

#### **Box 4. China’s cross-border data transfer procedures**

On October 29, 2021, the CAC published draft rules to standardize security assessments required by the Cybersecurity Law, the Data Security Law, and the Personal Information Protection Law. With this regulation, the government holds all organizations accountable for security self-assessments before exporting data. The self-assessment must indicate the data export’s scope, purpose, legality, method, sensitivity, risk to national security and individuals, and other listed inquiries. An organization will need to apply for a governmentally run security assessment if it reaches any of the following thresholds: (1) a critical information infrastructure operator collects or generates personal information or important data; (2) the data to be exported is deemed “important;” (3) the data operator processes personal information of 1 million people or more; (4) the exporting data includes personal information of over 100,000 people or sensitive data of over 10,000 people; and (5) any other situations designated by the CAC. Within seven days of receiving an application, the CAC will inform an operator on whether its application is accepted. The CAC then has 45 working days to complete its security assessment, with the ability to extend the time for review by an additional 60 working days. If the data is accepted for export, the organization will be able to conduct exports for two years with the option to renew. If, however, changes occur in data handling procedures or regulations in the recipient country, Chinese data operators must apply for a new assessment.

**Chinese data policies arguably impede the country’s digital services exports.** While the effects of Chinese data policies on trade and FDI have received ample attention in the literature (Casalini and López González, 2019; Cory and Dascoli, 2021; Ferracane and van der Marel, 2018; Ferracane and van der Marel, 2021; UNCTAD 2016), their impact on domestic services firms and their internationalization strategies has not. Onerous restrictions on cross-border data flows are likely to have inhibited the access of larger Chinese digital and IT-enabled service providers to foreign markets.

**In practice, China’s data policies can be likened to “delocalization requirements” for its own service providers, forcing them to establish abroad to serve foreign markets.** Given the costs, uncertainty, and business risks associated with conducting data transfers from China, Chinese service providers face an incentive to “delocalize” by establishing in a foreign country to offer digital services to the rest of the world. To secure full operational independence from the Chinese authorities, service providers may need to set up wholly separate corporate structures, including through joint ventures with foreign partners.

**These policies also impact the operation of foreign firms in the domestic market.** Compliance with China’s Great Firewall not only inflates operational costs, notably by requiring dedicated resources for security assessments needed and for filing authorization requests before the relevant authorities, but also raises uncertainty regarding the regulatory treatment of cross-border data flows. For instance, a Chinese social media application or an e-commerce app linking vendors and consumers from China with the rest of the world would need to request new data transfer permissions as new users are added to their platforms—each time running the risk that such permission might be denied. While such costly procedures may be manageable for larger firms, they are unduly burdensome for start-ups entering the market. Furthermore, concerns over the

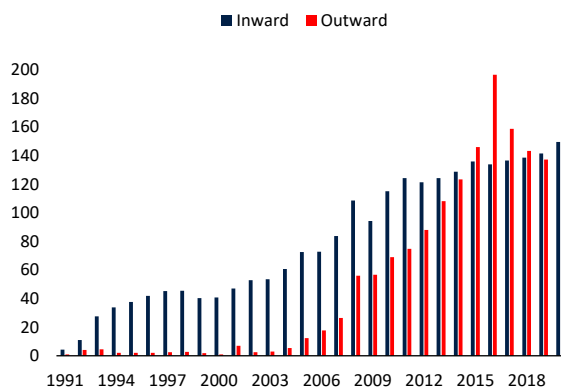
possible sharing of business data with Chinese authorities may strongly deter potential foreign clients, who may hesitate to engage with a firm based in China over privacy concerns. Meanwhile, foreign operations in China are *de facto* on a pathway to becoming more like local Chinese entities rather than integrated into global networks. The latter are not decoupling from China but rather decoupling their Chinese operations from their global ones (MERICS 2021).

## China's investment regime remains restrictive despite recent liberalization steps

**Foreign direct investment remains the most important mode of supplying services internationally**, accounting for an estimated two-thirds of aggregate services trade (WTO, 2020). Therefore, the restrictiveness of the foreign investment regime is a key determinant of the market access for potential foreign suppliers and the contestability of the domestic services sector.

**Outward foreign direct investment has been a key component of the expansion of China's services exports.** Since the launch of its "Going Out" initiative in 1999, China has gone from being a net importer of capital with negligible presence in foreign markets to balancing massive inward FDI flows with equally large flows of outward FDI (OFDI) (Figure 42). China's outward investment boom has positioned it as a top global investor, making it the third leading source of global FDI during the 2010s (UNCTADStat). State-owned enterprises, including smaller firms owned by provincial governments, are typically the first to invest abroad as they are better able to absorb risks. Investments from large and medium-sized private firms follow the lead of state-owned investors, usually without explicit government support (Mlachila 2011).

**Figure 42. China: inward and outward foreign direct investment flows**  
(Billion USD)

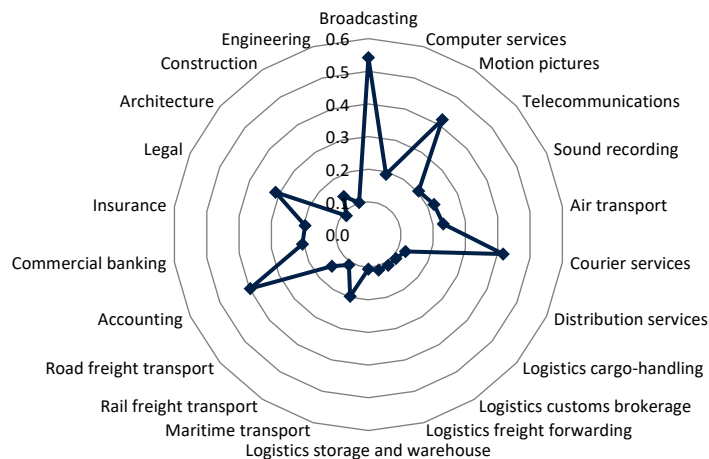


Source: UNCTADStat; World Bank.

**However, China maintains levels of restriction against inward FDI and thus limits services imports as well.** Among OECD countries and middle-income peers, China trails only Russia and Indonesia for the restrictiveness of its FDI regime. Regulatory challenges are not limited to the establishment phase of the investment cycle. Once established, foreign invested firms face discriminatory measures linked to government procurement contracts and subsidies as well as difficulties in complying with standards unique to China, even where international standards are the norm. Moreover, foreign firms, like domestic privately-owned firms, also face competitive distortions from SOEs, which may enjoy preferential access to financing conditions at below-market rate and closer ties with regulators and policy makers. China's highest investment barriers are found in digital services like broadcasting, motion pictures, media sound recording, and telecommunication services, as well as in courier services, accounting, and legal services (Figure 43). The generally lower restrictions maintained in distribution, logistics, and transport services

(other than air transport) reflect the high dependence of China's manufacturing sector on foreign markets and the corresponding need to reduce trade costs.

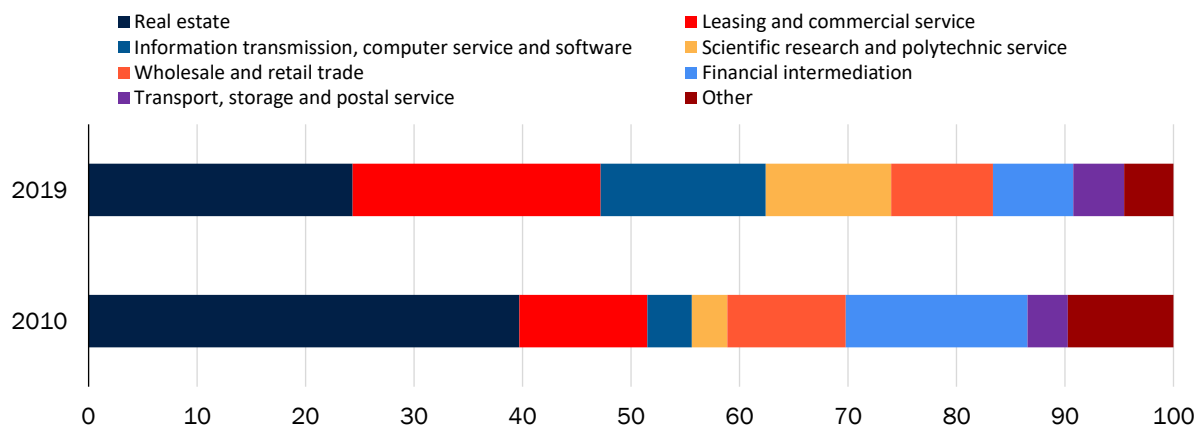
**Figure 43. Sectoral breakdown of China's STRI restrictions on foreign entry, 2020**  
(Index)



Source: OECD; World Bank.

**Nevertheless, inward FDI in services increased 60 percent in value from 2010 to 2019, attracted by China's growing domestic market.** Inflows in scientific research (from a negligible base) and ICT services registered the strongest growth during the period. Parallel with the rapid development of China's digital economy, its share in FDI inflows rose from 4.1 percent in 2010 to 15.2 percent in 2019, while the share of FDI in real estate dropped from 39.7 to 24.3 percent of total service sector inflows (Figure 44). China's quest for sustained productivity growth in services will require a continued drop in levels of FDI in real estate and a shift toward higher value-added sectors.

**Figure 44. China: sectoral breakdown of FDI inflows in services, 2010 and 2019**  
(Percent)



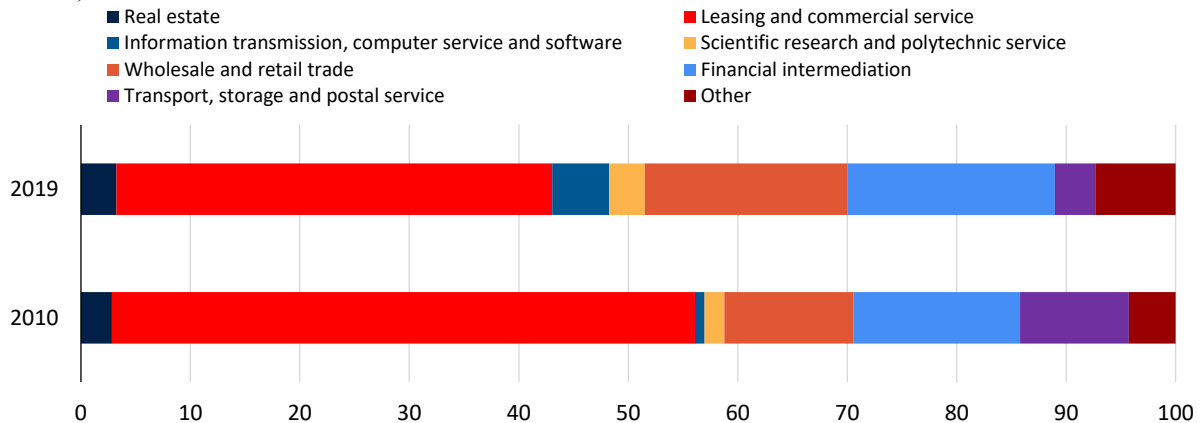
Source: MOFCOM; World Bank.

Note: Other includes construction, accommodation & catering trade, culture, sport & recreation, residential and other service, water conservancy, environment & public utility mgt, health care, social security & welfare, education, public management and social organization

**Outward FDI in services has been a key channel for Chinese services exports.** Services sold by Chinese firms with an established commercial presence abroad (so-called Mode 3 trade in services) are almost on par with those sold by foreign established entities in China. The sharp recent upward trend in China's OFDI in services was led by financial services, especially insurance; digital trade (e-commerce), for which the Digital Silk Road (DSR) has been a key driver; as well as construction services, notably boosted by the Belt and Road Initiative (Figure 45).

**Figure 45. China: sectoral breakdown of FDI outflows in services, 2010 and 2019**

(Percent)

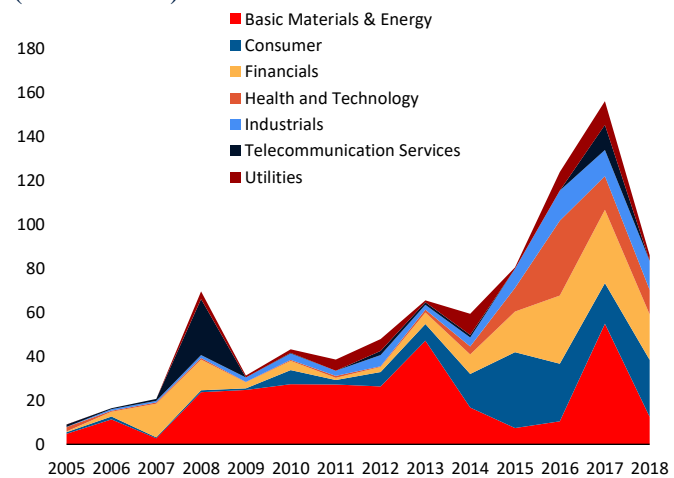


Source: MOFCOM; World Bank.

Note: Other includes construction, accommodation & catering trade, culture, sport & recreation, residential and other service, water conservancy, environment & public utility mgt, health care, social security & welfare, education, public management and social organization

**The past decade has witnessed a marked shift in China's OFDI pattern, with investments increasingly pursuing market-seeking aims, particularly in services.** Since 2013, Chinese M&A activity has progressively shifted away from natural resources and pivoted toward investments in retail trade, financial services, and health and technology (Figure 46). While the sectoral nature of Chinese OFDI shifted, its modalities remained broadly similar, with investments in services typically led by large SOEs, notably in the financial sector, or connected to major infrastructure projects often negotiated between the Chinese government and recipient countries (Quer Rienda and Andreu, 2019; Sauvants and Nolan, 2015).

**Figure 46. Sectoral breakdown of merger and acquisition activity of Chinese firms**  
(Billion USD)



Source: Ding, 2021, and Thomson Reuters.

**Reflecting the industry’s nascent emergence, OFDI in digital and IT services did not feature prominently in the early stages of China’s “Going Out” strategy** (see Box 5). The digital sector was a late participant in China’s OFDI boom. In 2010, investments directed toward the ICT sector amounted to only US\$500 million, ranking eighth in China’s sectoral priorities, preceded by sectors such as real estate and scientific research. The ten-fold growth registered in the sector’s size propelled it to fourth place in China’s OFDI in 2019. Still, flows directed to wholesale and retail trade, ranked third, were almost four times larger, while those of leasing and other commercial services, the top-ranked sector, were almost nine times larger.

#### **Box 5. A closer look at China’s digital OFDI**

**Chinese OFDI in the ICT sector follows two distinct tracks.** As with most Chinese OFDI, a first track is for outward investment to be linked to large, government-sponsored infrastructure deals. The Digital Silk Road (DSR) initiative epitomizes this first track. A second track is led by large private firms pursuing their own internationalization strategies independently of Chinese governmental policies.

**The DSR has been China’s tool for global investments in digital connectivity and data analytics which can be viewed as the “digital” complement of the “analog” Belt and Road Initiative (BRI).** Launched in 2015, some 30 countries have signed DSR memorandum of understanding with China. The government’s role under the DSR is less pronounced than under its BRI engagements, encouraging lead private players to seek business deals and domestic financing under the DSR (Wedell 2020).

**The DSR aims to boost China’s services digital exports, particularly business-to-government (B2G) trade.** The DSR encompasses a vast array of technology projects, including building the physical infrastructure for 5G networks, laying fiber optic cable, as well as constructing and equipping data centers. By design, it also aims to promote China’s standards for telecommunications, satellite navigation, artificial intelligence, quantum computing, and electronic payment systems in DSR partner countries (Wedell 2020). The BRI’s broader umbrella and its focus on infrastructure have been particularly helpful for companies building digital connectivity that can then offer related services, such as “smart cities” involving e-governance, data centers, big data analytics, and remote surveillance services (Eurasia Group 2020). By combining investment in hard and soft infrastructure, the main target for BRI and DSR projects remains in the public sector. The DSR operates as a powerful market opening tool for Chinese providers of digital services to gain a privileged foothold in large B2G service contracts.

**China’s tech giants can also internationalize without government support.** Many firms have ventured into foreign markets independent of official support. This channel is particularly valuable for business- or consumer-oriented tech firms with a lesser dependence on government contracts. Chinese firms operated in business-to-business (B2B) and business-to-consumer (B2C) services engage in strategic asset-seeking FDI by acquiring brands or products liable to boost their international reputation and visibility. They also enter foreign markets through equity participation in both start-ups and established companies. Large Chinese firms can leverage their revenue streams and access to finance in the domestic market to pursue this type of internationalization.

**Large digital service providers focused on B2B and B2C activities are most likely to pursue this latter route to internationalization.** Market opening support from China’s participation in multilateral and preferential trade negotiations is of greater relevance for firms whose main need is to secure enhanced access to foreign markets with a view to deploy their vast know-how and financial resources abroad.



**The internationalization efforts of Chinese digital services firms are, however, hampered by growing security concerns.** The close ties between Chinese firms and the government that benefit them in cases like the BRI and the DSR can also impede their internationalization aims. In the context of 5G connectivity developments, Chinese firms have come under increasing scrutiny from governments in Europe and North America on national security grounds, prompting a major recent tightening in investment screening measures (UNCTAD, 2020).

**Consumer distrust in Chinese digital practices, in data privacy and protection in particular, is another obstacle to the expansion of digital services exports.** Lack of trust in Chinese digital services is not limited to governments. Firms and consumers remain wary that business or personal information may be shared with Chinese authorities or others in China. To overcome this challenge, Beijing-based ByteDance, the developer of TikTok, a world leading app for short videos, opted to sever its international-focused app (TikTok) from its Chinese equivalent, Douyin. To be able to serve the Chinese and foreign markets, ByteDance had to fully duplicate its product and corporate structure, resulting in an inefficient allocation of capital. This mirrors the constraints faced by foreign suppliers of data-based services in China, which are required by Chinese data security legislation to localize their activities.

## Final thoughts

**China has in recent years made major strides in boosting the size and performance of its domestic service sector.** Several key factors, among them rising incomes, population aging, decarbonization efforts, and urbanization account for the growing role of services. Still, the country's transition toward a consumption-based economy has some way to go as China lags most of its peers across a broad spectrum of services-related metrics.

**Manufactured exports, and the rising share of services embedded in them, remain the key drivers of China's services trade performance.** Government-led initiatives involving rising levels of outward foreign direct investment in services have also featured prominently as vectors of Chinese service sector internationalization in areas such as construction, logistics, and ICT-related services. However, apart from a handful of firms linked to e-commerce and digital trade whose expansion, both domestically and internationally, appears to have recently come under greater regulatory scrutiny, China has produced few globally recognizable brand names in services whose expansion on the world stage was wholly divorced from manufacturing activities or government hand-holding.

**As the domestic service economy grows, the competitiveness of Chinese service providers can be expected to increase and contribute to expanding the country's services export basket in its wake.** Indeed, the size of China's domestic market may provide scale economies and diversity in consumer preferences sufficient to spawn domestic innovation in services, without the need for import competition. However, there is a risk in extending such arguments to make the case for maintaining restrictive services imports and investment practices for two reasons. First, without access to foreign ideas and practices, domestic services may develop in idiosyncratic ways and hamper future export competitiveness. Second, China's trade partners may be less tolerant going forward with a strategy of import protection to nurture domestic competitiveness, precisely given China's past successes in manufacturing. China may thus have strategic interests in opening up to prevent others from closing down.

**Further liberalization of services imports and investment would help strengthen the competitiveness of China's own services and accelerate the transformation toward a services and consumption based growth model.** Services liberalization could enlarge the basket of competitive exports and imports in services able to underpin China's quest for continued industrial upgrading, decarbonization, and quality of life improvements. Moving in this direction will boost competition and innovation as well as fuel the growth of tradable services while also supplying the country's manufacturing sector with the more sophisticated range of knowledge intensive services and talent required for sustained progress in advanced manufacturing.

**Reducing restrictive barriers in services needs to rest on parallel reforms in regulatory governance with a view to reduce levels of regulatory uncertainty often identified by both foreign and domestic investors as problematic in sustaining business operations in China.** Data from the World Intellectual Property Organization's (WIPO) latest Global Innovation Index Report shows only a modest improvement in China's regulatory environment over the last decade (from 108th to 106th globally) and slippage in its regulatory quality index, for which it ranked 91st in 2021, eight steps lower than the ranking achieved a decade earlier (WIPO, 2011 and 2021).

**Significant scope remains for expanding the supply of services by private entities, both domestic and foreign.** A strong case for lifting investment restrictions that weigh more heavily on China's service sector can be made in light of the greater role of the state and of state-owned enterprises in services relative to manufacturing. Recent World Bank research has shown that while investment in Chinese manufacturing was dominated by private firms, accounting for close to four-fifths (78 percent) of total investment, the state remains the leading source of service sector investment, accounting for close to half (45 percent) of the total as opposed to 37 percent for private firms (World Bank 2019).

**Reform efforts in services can be pursued through autonomous means or through greater engagement in trade and investment agreements at both the multilateral and preferential levels.** China's 14th Five-year Plan, which devotes considerable attention to the service sector and to services trade as well as China's recent trade policy initiatives, such as joining the Regional Comprehensive Economic Partnership (RCEP), the creation of the Hainan free trade port, and the application to join the CPTPP are important signals that services liberalization is high on the authorities' agenda.<sup>11</sup> The analysis in this section suggests such attention is well warranted.

<sup>11</sup> China has shortened the country's negative list for foreign investment for four consecutive years and recently issued a negative list for cross-border trade in services at the Hainan free trade port. China is conducting a number of municipal-level policy experiments in service sector liberalization with a view to their possible scaling on a nationwide basis. China has also been addressing its services interests through engagement in preferential trade agreements and multilateral negotiations. It undertook WTO+ market opening commitments in 22 new service subsectors by signing onto the RCEP agreement. China's recently announced quest to join the CPTPP would further align its services governance and market opening regimes to frontier status. At the WTO level, China has been an active participant in so-called structured discussions on a host of latest generation trade issues (e.g., trade and environmental sustainability, e-commerce, investment facilitation for development). China was a signatory of the recently concluded plurilateral negotiations on services domestic regulation, leading to new disciplines on measures that are closely linked to the process of authorization to supply a service. Such disciplines aim at facilitating trade and investment conditions and improving domestic regulatory frameworks in services by ensuring that existing market access and national treatment commitments are not nullified by opaque and complex authorization procedures (WTO 2021).



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