dzfjkl

November 2005
IMF Country Report No. 05/411

People's Republic of China: 2005 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the People's Republic of China, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 25, 2005, with the officials of the People's Republic of China on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 8, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of August 1, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 3, 2005 discussion of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for
the 2005 Consultation with the People's Republic of China

Approved by David Burton and Carlos Muñiz

July 8, 2005

- The 2005 Article IV discussions with China were held in Beijing, Shanghai, and Shenyang during May 11–25, 2005.

- The staff team comprised Mr. Dunaway (Head), Messrs. Aziz, Aitken, Feyzioğlu, and Wang (all APD), Ms. Fedelino (FAD), Mr. Bannister (ICM), Ms. Li (PDR), and Mr. Podpiera (MFD). The team was assisted by Mr. Brooks (Senior Resident Representative) and Mr. Barnett (Resident Representative). Mr. Xiaoyi Wang, Mr. Huarong Ge, and Mr.Wufu Zheng (OED) participated in the discussions. Mr. Kato joined the mission on May 23-24.

- China has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. Exchange controls continue to apply to most financial account transactions.

- While progress continues to be made in upgrading China's economic statistics, weaknesses remain in key areas. These include the national accounts, fiscal and labor statistics, the balance of payments, and the international investment position. The authorities are making improvements in all of these areas. China has participated in the GDDS, with its metadata posted on the official website (Dissemination Standards Bulletin Board) since April 2002.

- At the time of circulation, the Chinese authorities have not indicated whether they consent to the publication of the paper.

- The last Article IV consultation was concluded on July 28, 2004. At that time, Executive Directors noted that despite moderation in investment, a soft landing of the economy was not yet assured. They cautioned against a premature relaxation of monetary policy and stressed the need for fiscal policy to play a supportive role in achieving a soft landing. Directors reiterated that greater exchange rate flexibility was in China's best interest and noted that the initial move toward this objective was best made from a position of strength. They emphasized that continued structural reforms would be crucial for China to sustain strong growth over the medium term. Since the Article IV consultation, China has concentrated its efforts on reining in credit and investment growth, conducting monetary and fiscal policies broadly in line with the Board's recommendations.

Table of Contents

Table of Contents

EXECUTIVE SUMMARY

Economic Setting:

Economic activity remained strong in 2004 and the first four months of 2005. GDP growth stood at 9.5 percent in 2004 and 9.4 percent in Q1 2005, but its composition shifted as investment growth moderated somewhat and the contribution from net exports increased. Inflation declined, running at 1.8 percent in May, largely due to a reversal of food price increases. The external current account surplus rose to 4¼ percent of GDP in 2004, and the trade balance strengthened further in the first five months of 2005. This, together with strong capital inflows, has led to a further large increase in foreign official reserves, which amounted to nearly $700 billion at end-May.

During the course of 2004, the authorities tightened macroeconomic policies. The People's Bank of China (PBC) took several steps to tighten monetary conditions and slow lending growth. These measures have helped to slow the growth of broad monetary aggregates, but considerable liquidity remains in the banking system. The government also tightened administrative controls directed toward curbing investment growth in certain sectors. Strong revenue overperformance helped to bring down the fiscal deficit by 1 percentage point to 1½ percent of GDP.

Policy Discussions:

With the substantial liquidity in the banking system, the staff advised that open market operations should be intensified. The authorities also need to be prepared to tighten monetary conditions further using market-based instruments if investment and lending growth appears to be rebounding. The authorities agree about the need for containing investment growth, but consider administrative measures to be still needed for this purpose.

Greater exchange rate flexibility continues to be in China's best interest, and an early move would be desirable. It would give China more control over its monetary policy, and increase the economy's resilience to external and domestic shocks. Conditions at present are favorable for making an initial move, with further delay entailing additional costs to China's economy, which will grow over time. While agreeing with the need for more flexibility, the authorities are still considering the appropriate timing for making a first step in this direction.

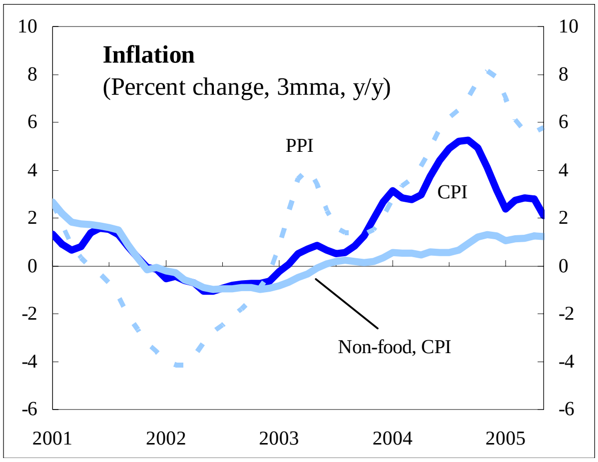
The likely outturn for the 2005 budget is generally appropriate and in line with the objective of steadily bringing down the fiscal deficit over the medium term. Revenues should overperform once again this year, and any overperformance that accrues to the central government should be saved. The authorities regard the staff's revenue estimate to be optimistic, but are confident that at least the budgeted deficit target will be met.

On the structural reform agenda, bank reform should focus on strengthening the balance sheets of the state banks and improving their internal control systems, governance, and credit risk management. Reform of the state-owned enterprises, further development of financial markets, and improvements in economic statistics need to be carried forward.

I. Economic Developments and Outlook

A. Background

1. **This year's discussions took place at a time when China's policymakers face significant challenges on the domestic front and growing international pressures.** Serious concerns emerged in the last two years that China's rapid rate of investment growth since early 2002 may be creating overinvestment in certain sectors. Coupled with a rise in inflation in 2004, this was seen as potentially fueling a more generalized overheating of the economy like the one in the early 1990s. The associated rapid growth in bank credit also raised the specter of substantial new nonperforming loans (NPLs) being created, adding to the large stock of existing NPLs, much of which was created in the early 1990s. While a series of tightening measures have helped to slow the pace of investment growth, it remains high, and substantial liquidity remains in the banking system

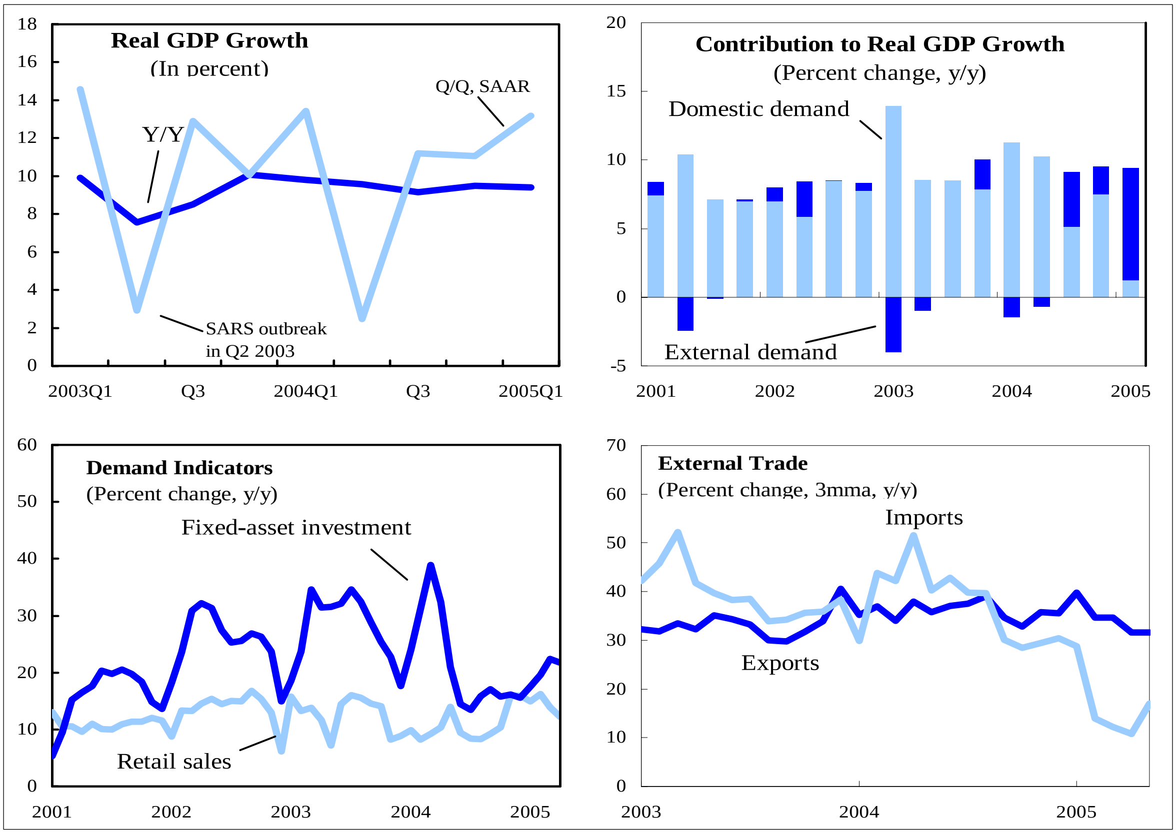


2. **Since mid-2004, China's external position has strengthened further with continued strong reserve accumulation.** This has been perceived as pointing to increasing currency undervaluation and has focused international attention on China's contribution to global imbalances. Against this background, a sharp increase in textile exports to industrial countries after the expiration of MFA quotas at end-December 2004 has sparked increased protectionist pressures in some trading partner countries.

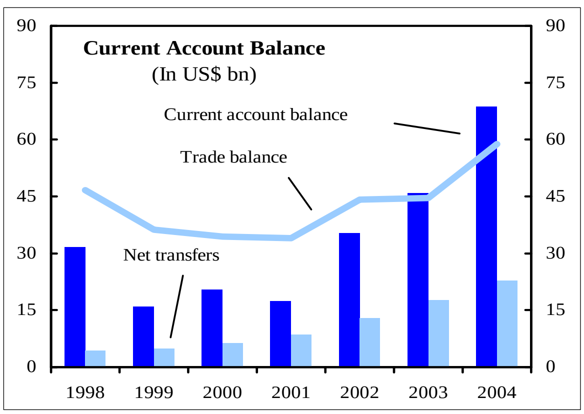
B. Recent Developments

3. **At 9½ percent, GDP growth in 2004 was broadly the same as in 2003, but its composition shifted modestly away from investment in the course of the year** (Table 1)**.** Investment growth moderated somewhat in response to stricter enforcement of administrative controls and tightening of monetary conditions directed at restraining its pace. Net exports increased its contribution to output growth, while consumption remained strong. Private consumption grew by nearly 8 percent, a faster pace than in 2003, supported to a large extent by rising rural income. Despite lay-offs of nearly 1½ million, due to the continued restructuring of state-owned enterprises, the urban unemployment rate edged down by 0.1 percentage point to 4.2 percent in 2004, as job creation remained strong.

4. **Economic activity has maintained its momentum in the first five months of 2005.** GDP in the first quarter grew at 9.4 percent rate (year-on-year), with the contribution from net exports increasing, as export growth remained strong and import growth moderated. Real fixed asset investment grew by around 23 percent, similar to the average level in 2004. Retail sales growth remained robust, suggesting continued strong consumer demand.



5. **Despite continued strong output growth, inflation has come down.** After peaking at 5¼ percent (year-on-year) in Q3 2004, headline CPI inflation fell sharply in late 2004, largely due to a reversal of food price increases as agricultural production rose. Supply-side factors—such as increased capacity from strong investment, persistent productivity gains, and reduction in tariffs—also served to kept non-food prices rises in check. Headline inflation remained



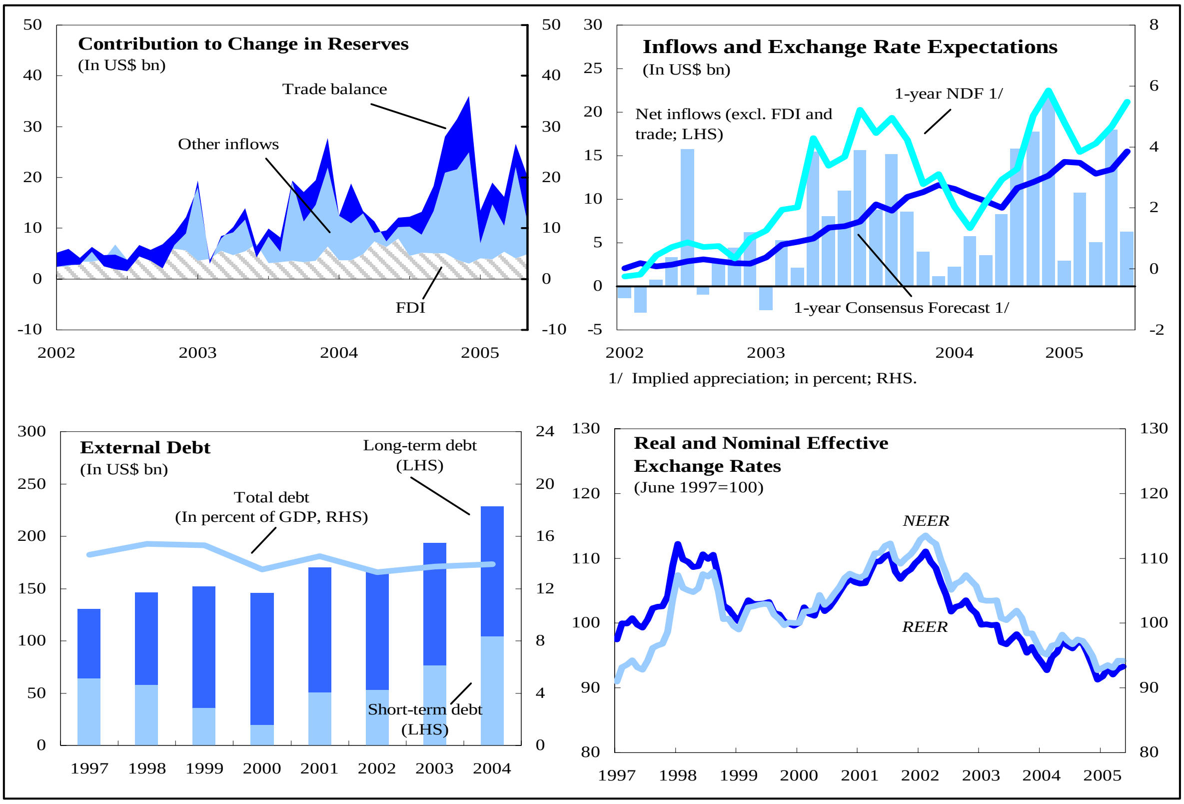
relatively subdued during the first five months of 2005, running at 1¾ percent (y/y) in May. After rising rapidly in the first part of 2004, PPI inflation has declined in recent months, reflecting some easing in world commodity prices and raw materials demand in China.

6. **The external current account surplus rose by 1 percentage point to 4¼ percent of GDP in 2004.** On the trade front, export growth remained strong throughout the year, but import growth slowed, particularly imports of raw materials and machinery and equipment, due to the moderation in investment growth and an increase in the supply of some domestic import substitutes. As a result, the trade surplus rose by 0.4 percentage point of GDP (Table 2). Private transfers also rose, probably reflecting speculative inflows in anticipation of a renminbi appreciation.

7. **China's trade balance strengthened further in the first five months of 2005.** In particular, the trade balance during January-May shifted to a sizeable surplus in contrast to the deficit registered in the same period of 2004. Exports during this period rose by 33 percent (y/y) while imports increased by only 13¾ percent, mainly reflecting continued weak demand for raw materials and machinery and equipment. Chinese customs data suggest that total textiles exports grew at roughly the same rate as in 2004 (at an annual rate of around 20 percent), but importing country data indicate that the United States and the European Union registered a surge in textiles from China. The United States has imposed safeguards against textile imports from China, while the European Union has come to an agreement with the Chinese authorities to limit the growth of textile exports.[1] National income accounts data suggest that the increase in the external current account surplus reflected rising domestic savings that exceeded investment. China's already high overall savings rate rose further to around 49 percent of GDP in 2004 fueled by strong corporate profits, with the contribution of retained earnings rising to close to half of the total. In contrast, household savings, although still high, are estimated to have declined relative to GDP in the last few years.[2]

[1] Textiles account for about 14 percent of Chinese exports. In the first four months of 2005, textile exports from China to the United States (based on importing country data) jumped by 53 percent and to the EU by 71 percent. In response, the U.S. Department of Commerce re-imposed quotas on 7 categories of textile imports from China in May. In reaction, China revoked export taxes on about half of the textile items subject to this tax, which was originally introduced January 1, 2005. On June 10, the EU and China agreed to limit export growth of ten categories of textile exports from China to 8-12½ percent per year up to end-2007. Members of the U.S. Senate have proposed imposing a 27½ percent import tariff on Chinese imports if the renminbi is not revalued by early October 2005.

[2] This decline is unlikely to be caused by the increase in corporate savings, as only a small part of the total enterprise equity is traded publicly in the stock market, and these shares are not widely held by individuals, directly or through institutional investors.



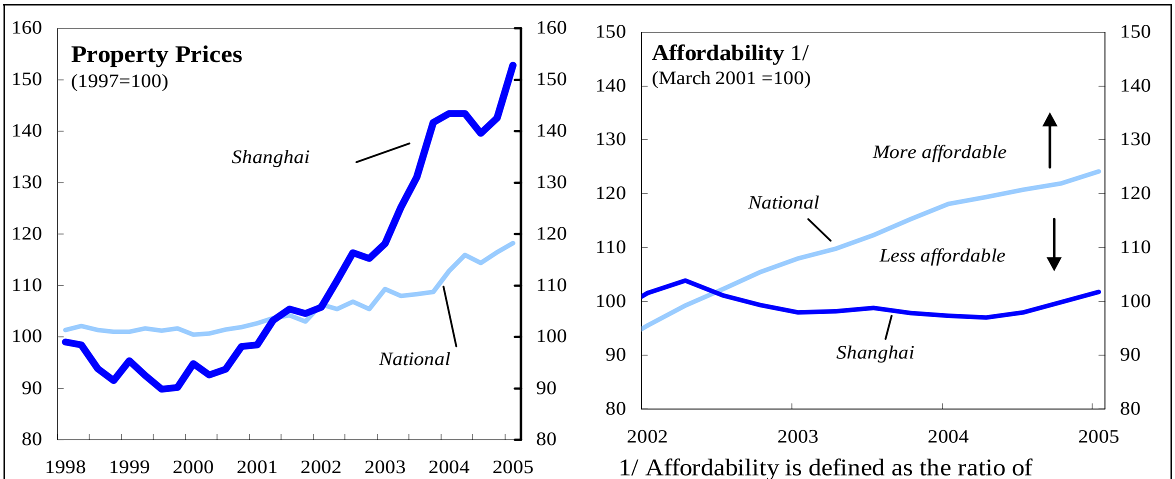
8. **The larger external current account surplus, together with strong capital inflows, led to a further sizable increase in foreign official reserves** (Tables 3 and 4)**.** International reserves increased by $206 billion in 2004 and by a further $81 billion in the first five months of 2005, bringing the level at end-May to nearly $700 billion.[3] While FDI inflows (mainly from Hong Kong SAR, Korea, and Japan) remained strong, a substantial portion of the reserve accumulation was accounted for by net non-FDI capital inflows (including errors and omissions) largely attracted by the prospects of a renminbi appreciation. The renminbi has depreciated in both real and nominal effective terms since mid-2004, and by end-April 2005, it was about 18 percent below its previous peak in February 2002.

9. **Real estate prices have continued to rise, with particularly large increases in certain areas of fast-growing cities such as Shanghai.** Some of the rise in housing prices is due to the cumulative impact of liberalization steps in land markets undertaken since 1998, but anecdotal evidence suggests that speculators are also quite active in the market.

---

[3] In late-April, $15 billion of international reserves were used for the capital injection into the Industrial and Commercial bank of China (ICBC), reducing the end-April reserve level by that amount.

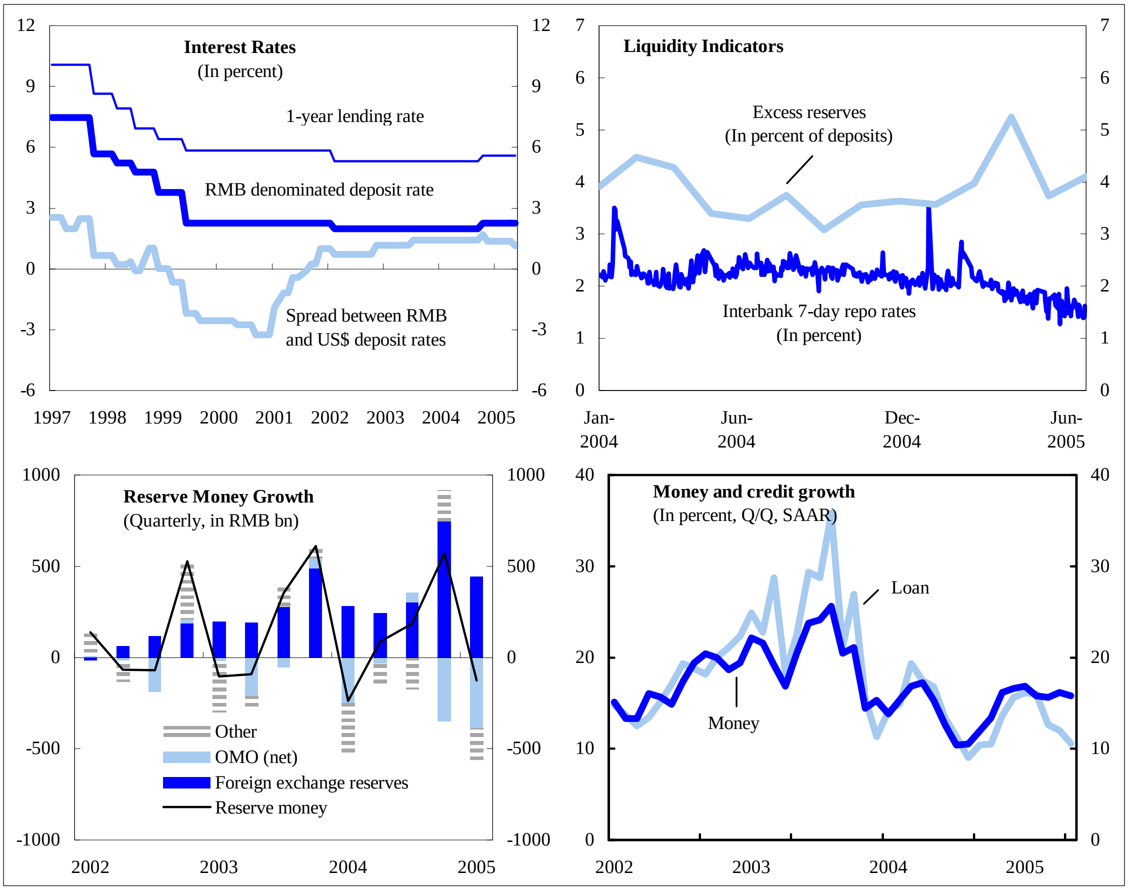
Concerned with speculative pressures, the People's Bank of China (PBC) raised mortgage interest rates in March 2005. In May, the authorities also announced a new set of property-related measures aimed at curbing speculation in residential and commercial markets.[4] Despite the rise in real estate values, affordability indices have generally improved as household incomes have outpaced price increases.



1/ Affordability is defined as the ratio of household income to housing price.

10. **During the course of 2004, the PBC took several steps to reduce liquidity in the banking sector and slow lending growth.** The steps taken included intensifying open market operations, raising the reserve requirement ratio and short-term re-lending and rediscount rates, increasing bank deposit and lending interest rates (for the first time in 9 years), and eliminating the ceiling on lending rates. These were supplemented with credit allocation guidance provided by the PBC and the China Bank Regulatory Commission (CBRC) to influence banks' lending decisions. These measures helped reduce broad money growth to 14 percent and loan growth to 12½ percent by April 2005, down by about 5½ and 8½ percentage points, respectively, from their growth rates in 2003 (Table 5).

[4] Some key elements of these measures are: (i) residential flats sold within two years of the initial purchase will be subject to a sales tax; (ii) developers who do not develop land within a year of purchase will face a tax penalty; (iii) land still idle after two years will be reclaimed by the government; (iv) resale of unfinished flats will be banned; and (v) commercial banks are required to tighten controls on lending to the property sector.



11. **Nevertheless, considerable liquidity remains in the system at present, as evidenced by a still high excess reserve ratio and low interbank interest rates.** In March 2005, the PBC cut the interest rate it pays on excess reserves held at the central bank, adding to downward pressures on interbank rates and reducing interest rates on central bank bills. The build-up in official reserves also continues to add substantially to liquidity. While the PBC stepped up its open market operations to sterilize most of the inflows beginning in late 2004, for the year as a whole only about half of the liquidity arising from the increase in international reserves was sterilized (as the trade surplus and capital inflows remained high). Overall, despite the liquidity in the banking system and some loosening of administrative controls,[5] credit growth remains relatively constrained owing to continued lending guidance to banks provided by the PBC and the CBRC and restrained lending by the large state-owned banks (SCBs) that are undergoing restructuring.

[5] A key administrative measure, a six-month moratorium on converting agricultural land for property development, expired in October 2004. The authorities replaced this with other measures regulating land use, including encouraging land use rights auctions and tightening environmental protection standards.

12. **Strong revenue overperformance allowed for a further decline in the fiscal deficit in 2004.** The deficit fell to 1½ percent of GDP (official definition; 1¾ percent according to the IMF definition; Tables 6 and 7), about one percentage point of GDP below its targeted level in the 2004 budget and the 2003 outcome. Once again, revenue was substantially above its budget projection by 1¾ percentage points of GDP, reflecting strong activity and continued improvements in tax administration. About half of this revenue overperformance was used to finance increases in social expenditures and subsidies and to clear up old government liabilities, including arrears on VAT refunds to exporters.[6] The remainder was unspent, partly because some transfers to local governments were made late in the year. During the first four months of 2005, gross revenue (excluding VAT refunds) grew by about 21 percent relative to the same period last year, compared with a budget forecast for 2005 of an 11 percent rise, while expenditure growth was broadly in line with the budget.

C. Macroeconomic Outlook and Risks

13. **Staff projects GDP growth to slow slightly during the year and to average around 9 percent in 2005.** This forecast assumes that appropriate macroeconomic policies will be in place to further slow investment growth. Export growth will remain strong, but slow from its current pace, with the growth in textile exports depending on the extent of safeguard measures imposed by China's trading partners. Import growth should pick up in the remainder of the year—with orders that were temporarily put on hold in anticipation of a currency appreciation brought on stream as inventories are depleted—but will remain below its 2004 level, reflecting slower investment growth. Consumption growth is expected to remain relatively strong as household credit facilities continue to expand and rural incomes rise further, reflecting cuts in rural taxes and government efforts to stabilize domestic grain prices. The external current account surplus would increase by nearly 2 percentage points to 6 percent of GDP, mainly reflecting a higher trade surplus. Inflation should average around 3 percent in 2005. Slower food price increases are likely to be only partially offset by a rise in non-food prices as some of last year's rapid producer price increases is passed through to consumer prices and certain administered prices are raised.[7]

14. **A significant risk remains that macroeconomic policies will not be sufficiently tight to curb investment growth.** In particular, there is a need for monetary policy to prevent a surge in credit growth as large capital inflows add liquidity to the banking system, increasing the odds of tipping off a boom-bust cycle and igniting inflationary pressures. Given the continuing volatility in world oil markets, a further sharp increase in oil prices would adversely affect growth both directly and indirectly if this leads to a more pronounced slowdown in global demand. Growing protectionist sentiments in China's major markets,

---

[6] Clearing of arrears—typically a below-the-line item—is treated as above-the-line expenditure in China's official fiscal accounts.

[7] Prices of utilities and other public services are slated to rise this year, after increases were postponed in 2004; however, there are prescribed limits to such increases.

presents another key risk. Moreover, a disorderly unwinding of global imbalances would threaten China's growth, as economic activity in all countries would likely suffer lingering adverse effects.

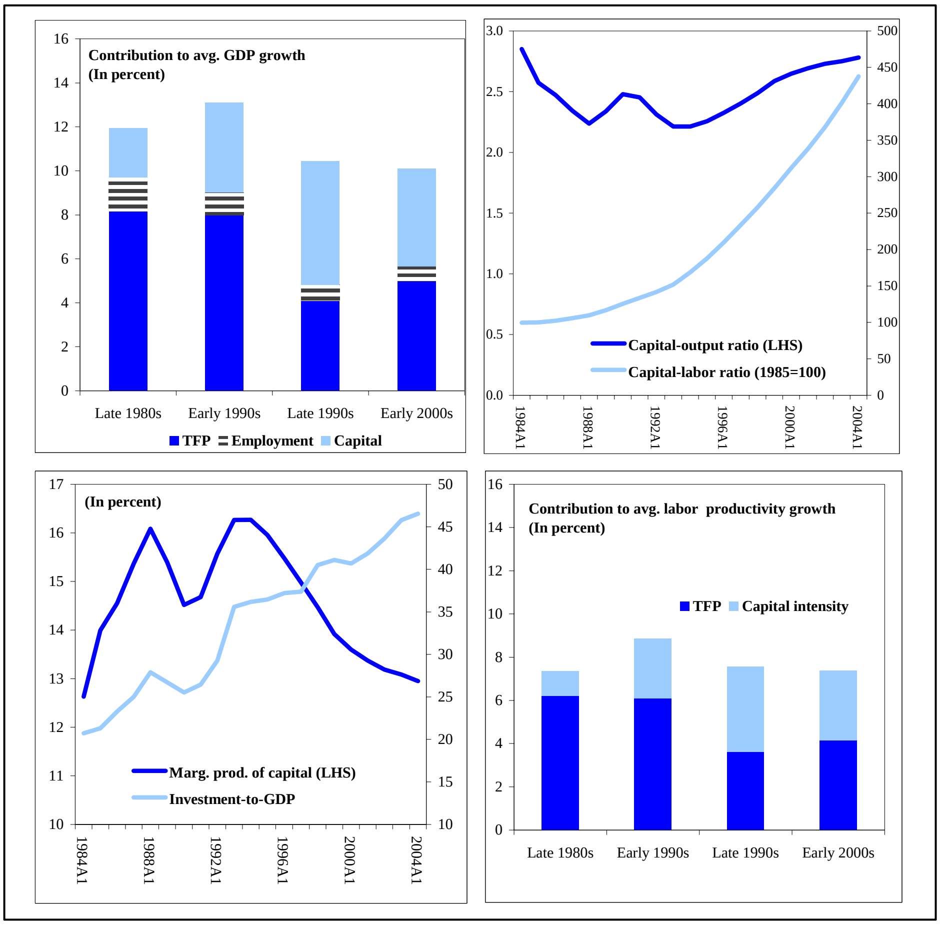
15. **China's medium-term prospects are generally favorable provided near-term risks are well managed and further structural reforms are implemented.** The illustrative medium-term scenario presented in Table 8 suggests that GDP growth could average 7-8 percent annually, if structural reforms are advanced in the financial sector to improve intermediation of savings and in the state-owned enterprises and the labor market to maintain strong productivity growth. Fiscal reforms could also contribute to promote a more effective use of China's high domestic savings. Better financial intermediation and reforms to China's pension and health care systems would help to raise private consumption by further improving credit facilities and reducing the need for large precautionary savings. However, unless enterprise profits fall sharply or SOEs pay substantially more dividends to their shareholders (particularly the government), corporate retained earnings would remain high. Modest fiscal consolidation over the medium term, which is needed to ensure sustainability of public finances, will add to overall savings. With investment growth projected to decline, which is desirable and intended by current government policies, China's current account surplus would not be expected to narrow substantially in the medium term in the absence of a change in the real exchange rate. In particular, real appreciation would help raise consumption as households' purchasing power strengthened and renminbi prices of foreign goods declined. However, following convention, the real exchange rate is assumed to remain unchanged in the illustrative scenario presented here. In general, the extent of any change in the real exchange rate, the form that it might take (the relative contribution of changes in China's inflation rate versus changes in its nominal exchange rate), and the consequent impact on China's external balance are uncertain, depending to a large degree on the structural reforms that would be adopted in the medium term.

16. **Medium-term prospects are subject to significant risks.** Growth could be threatened in the years to come if China were to continue to rely heavily on investment as a primary source, especially if inefficient investment in some sectors leads to overcapacity and falling prices and profitability—as is already evident in the automobile industry, for example—burdening banks with additional NPLs in the coming years (Box 1). If reform of the domestic financial sector is not advanced substantially, vulnerabilities will continue to increase as China further integrates into the global economy, and capital account liberalization would expose the economy to potentially large swings in the direction of capital flows as household and corporations diversify their portfolios. If the expected change in the real exchange rate occurs through nominal exchange rate adjustment, inflation would remain modest. In the absence of adjustment in the nominal exchange rate, not only would the real exchange rate adjustment eventually take place through possibly much higher inflation, the economy would also need to unwind the likely large build-up of imbalances in resource allocation. Together these could have serious adverse effect on output. A rise in social stresses within China (if, for example, income gaps between the rural and urban areas increase substantially further) could also present a significant risk over the medium term.

Box 1. Changing Sources of Growth

Investment in China has soared since the mid-1990s, while GDP growth—although still relatively high—has moderated from its pace in the late 1980s and early 1990s. At that time, investment was a lower share of GDP, so that productivity and employment growth contributed more to economic activity.

A simple growth accounting exercise reveals a significant shift over time in the factors driving China's GDP growth away from total factor productivity (TFP) and employment growth to capital accumulation. As the charts illustrate, investment took over in the late 1990s and early 2000s as a dominant driver of growth. Over this period the capital/output ratio and the capital/labor ratio have increased markedly, and while the investment to GDP ratio has risen sharply, the estimated marginal productivity of capital has fallen. TFP has continued to be a significant contributor to GDP growth, but its growth rate has declined. In contrast, employment growth has clearly become a less significant factor in explaining GDP growth. Although the growth in labor productivity has remained high, this is largely accounted for by rising capital intensity (a higher capital-labor ratio). Overall, the rise in capital-intensive production and the low contribution of employment to growth in recent years is striking, given China's large number of underemployed workers. At the same time, the sustained fall in the marginal productivity of capital suggests that the efficiency of investment is increasingly declining.



A standard growth accounting framework is used for this analysis. Aggregate output is assumed to be produced using a Cobb-Douglas production function: $Y = AK^{\alpha}N^{1-\alpha}$, where Y is aggregate output, A is total factor productivity, K is the capital stock, and N is total hours worked. Aggregate output is measured by GDP. The capital stock is constructed using a perpetual inventory method, assuming an initial (1965) stock and a physical depreciation rate of 0.06 that is based on the structure of fixed asset investment and industry surveys of depreciation costs. N is approximated by the total number of employed workers. The elasticity of capital, α, is set at 0.36, as is standard in the literature. A is derived as a residual. While the relative contributions to GDP growth of the three principal factors affecting production may change somewhat with small changes in feasible ranges in assumptions for key parameters, the basic trends in the data over time remain the same.

II. POLICY DISCUSSIONS

17. **The authorities agreed with the general economic outlook presented by the staff.** They noted that inflation remained moderate and economic measures already taken had slowed investment growth significantly from its peak in the first half of 2004, and they pointed to the risk that excess liquidity in the banking system and strong local government incentives to invest could lead to a rebound in investment and bank lending growth. On the external front, the authorities recognized the risks of a more pronounced slowdown in global demand, and they were especially concerned by a rise in protectionist pressures in some major trading partners. Against this background, the discussions focused on: further steps that may need to be taken to constrain investment growth and keep inflationary pressures in check; the likelihood that speculative inflows will continue to complicate monetary policy; the need for an early move toward greater exchange rate flexibility; the scope for further budget consolidation given an expectation of continued strong revenue overperformance; and the structural reform agenda, including in particular financial market reform to substantially improve the intermediation of China's large domestic savings.

A. Monetary Policy

18. **The authorities recognize the need to contain investment and credit growth.** Monetary and credit aggregates have grown roughly in line with their annual targets, but the restrained growth of the monetary aggregates—despite the abundant liquidity held by banks—appears largely due to administrative measures and more cautious lending by the state-owned banks undergoing restructuring. The staff cautioned that the substantial liquidity in the banking system carried with it a risk of triggering a rebound in lending growth, and thus, it suggested that the PBC should intensify open market operations to drain more of this liquidity.

19. **Beyond more intense open market operations, the authorities need to be prepared to tighten monetary policy further.** If investment and lending growth appeared to be rebounding, the staff recommended that stepped-up open market operations be supplemented with increases in interest rates and reserve requirements. Staff also argued that monetary tightening measures could be complemented, if needed, by further strengthening of prudential rules relating to bank asset quality, such as guidance on bank lending standards, provisioning requirements, and concentration limits. In addition to enhancing overall financial stability, these steps would help curb near-term credit growth. The authorities acknowledged that further policy tightening might be needed if investment and credit growth were to rebound. While they favored making use of market-based monetary policy instruments, the authorities pointed out that administrative measures would still be needed, as these were better suited to restrain growth in the specific sectors where overinvestment was a particular concern. Staff agreed that some administrative measures might be needed, but favored measures that would enhance supervision of bank lending to vulnerable sectors.

20. **The staff discussed ways to improve the effectiveness of indirect monetary policy instruments to manage the economy better.** The effectiveness of monetary instruments depends on the timeliness of policy actions. Accordingly, the staff urged the authorities to consider granting the PBC more discretion to independently set interest rates. While recognizing that interest rate changes are a national concern and that consultations within the government could be beneficial in building support for a change, staff cautioned that policy action could be unduly delayed. Moreover, reliance on administrative means of control, while necessary at present, will have to diminish as the increasing sophistication of the economy reduces their effectiveness and raises the cost of the distortions that they create. As a transitional arrangement, staff suggested that consideration be given to granting the PBC the authority to set benchmark interest rates at least within a specified range.

B. Exchange Rate Regime

21. **The staff reiterated the arguments for greater exchange rate flexibility in China, emphasizing that an early move is warranted.** Staff noted that greater flexibility is in China's best interest, as it would help in strengthening macroeconomic control by increasing the scope for pursuing an independent monetary policy and the ability of the economy to adjust to shocks. A phased approach in moving to full flexibility was recommended to limit disruption to the domestic economy, especially since currency risk management instruments are underdeveloped. While recognizing that the authorities are best positioned to decide on the precise timing of a change, the staff stressed that conditions at present were favorable for making an initial move, given that the economy is currently quite strong and that there are no major impediments in foreign exchange and financial markets to doing so. The economic costs of maintaining the current regime have been evident over the past year, and continue to mount, suggesting an early move is warranted. Although it is difficult to reach firm conclusions about its extent, the continued strengthening of the external balance points to increased undervaluation of the renminbi, adding to the urgency of making a move.

22. **Further delay in moving toward greater exchange rate flexibility would entail additional costs to China's economy.** The staff pointed out that under the current fixed exchange rate, adjustment in China's economy to growing external surpluses was taking place, but in ways that may be creating serious distortions and potential vulnerabilities for the economy. In particular, delay in making a change in the exchange rate regime would likely continue to create visible problems in the form of a further large build-up in reserves and growing difficulties in sterilizing capital inflows. This situation also runs the risk that the PBC's ability to conduct monetary policy could be compromised, particularly if concerns about the impact on the central bank's income position constrained decisions on interest rate increases. Less visible would be a likely build-up of short-term foreign currency liabilities, as Chinese firms find it increasingly attractive over time to borrow funds offshore, substantially raising the economy's external vulnerability. Investment decisions across the economy would also continue to be distorted, with resources allocated to projects in the traded goods sector than may not be viable over the medium term. Consequentially, the economic costs of delaying a move might be growing faster than is currently evident. The staff also raised concerns about rising protectionist pressures and the growing possibility of a disorderly