Part I

Financial and Macroeconomic Reform in China

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The Chinese Reform Agenda

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After two decades of unprecedented growth since the late 1970s, China's economy has entered a new phase of development. What do we mean when we say 'a new phase of development'? The report of the 16th party congress held in November 2002 defines the 'new phase' as a period of an additional 20 years of high growth to realise a 'well-off' society (*xiaokang*)[1] in an all-round way. Given this challenging objective, we address three questions: (i) what has China achieved so far; (ii) what difficulties and risks are present in the Chinese economy; and (iii) how can the reform agenda be set up to resolve these risks and difficulties and realise the new objective?

1 What Has China Achieved So Far?

China's Role in the World Economy

In 2002, China's gross domestic product (GDP) exceeded RMB10.2 trillion (approximately 1.2 trillion dollars) for the first time, ranking it sixth in the world. From the end of 1978 until 2001, China's average annual GDP growth rate reached 9.3 percent.

[1] The term 'well-off' society – in Chinese *xiaokang* was pioneered by Deng Xiaoping in 1979 to describe the realisation of a Chinese-style modernisation. It is hoped that China will achieve a *xiaokang* society by 2020, one of the goals is to ensure that the nation's per capita GDP will reach 3000 dollars, equivalent to today's standard in Beijing.

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At the end of 2002, China's total trade volume reached 620.8 billion dollars, ranking it the fifth of the world. The trade volume accounted for more than half of GDP, while in 1978 the trade/GDP ratio was less than ten percent. In the past several years, over 55 percent of China's export consisted of trade in processed goods. Any growth in such exports would require a corresponding increase in imports, that is, every $100 of exports requires at least $50-70 worth of imports (Justin Y. Lin, 2002). Thus, China's thriving processing trade translated into an expanding market for many economies.

China became the largest recipient country in terms of the foreign direct investment (FDI) inflow in 2002, which – for the first time – exceeded that of the United States. By 2002, FDI inflow has increased to 448 billion dollars, and foreign joint ventures have contributed to ten percent of the urban employment.

China's foreign exchange (Forex) reserves rose from 167 billion dollars in 1978 to 286.4 billion dollars in 2002 (and 383.9 billion dollars in September 2003), thus becoming the world's second largest nation in terms of foreign reserves after Japan. Although China has often been criticised for maintaining such high foreign exchange reserves given the shortage of capital, the large amount of Forex actually helped China avoid international financial risks and enhanced the capabilities of the Chinese government for macroeconomic control.

In many aspects, we can show the greater role of China in the world economy and its beneficial effects on other economies.

Development of Non-SOEs

China's 'gradual' or 'incremental' reform is mostly taken as a successful model in contrast to the radical reform in Russia and some Eastern European countries. The key feature that characterises China's reform so far has been the development of the market-oriented non-state-owned enterprises (non-SOEs), not the reform of state-owned enterprises (SOEs) (Gang Fan, 1994).

With the progress of non-SOEs, SOEs' dominant role in the economy has been totally altered. As Table 1 shows, non-SOEs now account for 66.0 percent of GDP (1999), 55.2 percent of fixed investment (2002), 58.1 percent of fiscal revenue (1999), and 74.0 percent (2002) of the employment in urban areas.

Table 1 Non-SOEs' Contribution to China's Economy
(in percentages)

	Contribution to GDP	Contribution to Fixed Investment	Contribution to Fiscal Revenue	Contribution to Employment in Urban Areas
1978	42.2		13.8	21.7
1980	44.2	18.1	16.1	23.8
1985	53.0	33.9	28.0	29.8
1987	54.1	35.4	30.1	30.0
1990	53.4	33.9	33.3	37.7
1993	55.0	39.4	35.6	37.9
1996	63.8	47.6	44.3	43.3
1999	66.0	46.6	58.1	59.2
2000		49.9		61.9
2001		52.7		68.1
2002		55.2		74.0

Sources: Gang Fan (2002); *China Statistical Yearbook 2002*.

The Dynamic Evolution of "Objective Model" for the Chinese Reform

The market-oriented reform discussed above, however, kept changing in the official "objective formula", which confused people as to where China's reform is heading. It may be useful to view how the official line was drawn from time to time during the past two decades. Box 1 shows how the official "objective formula" kept changing and evolving (in the same direction) over the past 20 years, from "Planned economy supplemented with some market elements" in 1979 to the "Socialist market economy" with the withdrawing of SOEs from most "competitive industries" and "mixed ownership".

Our analysis reveals that nothing was accidental in the ever changing "objective formula" and that the logic of political economy prevailed. For instance, the major policy shift took place in 1993 when the words "socialist market economy", replaced "planned economy" and was adopted by the "Reform Decisions" of the Central Committee of the Communist Party of China (CCCPC). The previous year, for the first time, the share of the non-state sector in industrial output passed 50 percent, and in 1996, the state industrial sector as a whole suffered its first "net loss". In the following year, the CCCPC adopted policies of "diversifying the

Box 1 The Gradual Evolution of Official "Formula" of Reform Objectives Since 1978

Time	Formulation of reform objectives
1978 - 1984.10	Planned economy supplemented by some market elements
1984.10 - 1987.10	Planned commodity economy
1987.10 - 1989.6	"State regulates the market and market regulates enterprises"
1989.6 - 1991	"Organic integration of planned economy and market regulations"
1992	Share-holding system and security market (started) can be used by Socialism
1992.10	Socialist market economy
1994	"Corporatisation of SOEs and reform of property rights"
1997	Developing the state sector together with all other kinds of ownership; "holding on to large SOEs while letting small ones go to the market".
1998	Constitution Amendment: private ownership should be equally promoted and protected
1999.10	SOEs withdraw from competitive industries; diversification of ownership of corporate and "mixed ownership"; Executive Stock Options for SOEs.
2001.7	"Three Representative Functions of the Party"; allows owners of private and individual enterprises to be Party members; further develop various ownership forms.

Source: Various official documents of Central Committee of the Communist Party of China (CCCPC).

ownership" and "developing the private sector together with the state sector". In 1998, the Constitution was amended by adding "Private ownership should be equally protected and promoted". In short, the contents and definition of "socialist market economy" changed over time in line with the changes of the reality. With the further growth of the private sector and private business community – which serves as the main support of the economic prosperity and social stability – the Communist Party recently started inviting private business "millionaires" to join the Party (see Box 1). There is no doubt that the official "objectives" will continue to change in the same direction in the coming future.

2 Difficulties and Risks in China's Economy

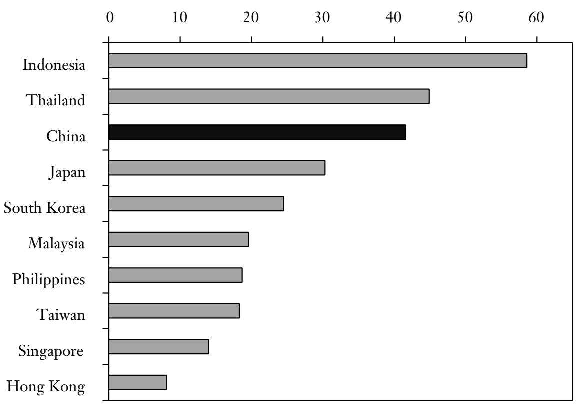
While China has performed quite well during the period of sluggish world economic growth in recent years, fundamental problems still remain in both the financial sector and the real economy.

Financial Risks

Research reports by well-known consulting companies all suggest that great risks are hidden within China's banking industry in terms of the mounting non-performing loans (NPLs). Goldman Sachs estimates that it would take between 44 and 68 percent of China's GDP to clean up the bad loans (see Figure 1).

In recent years, many measures have been taken to tackle the NPLs issue and official figures show a decline in the NPLs ratio. As appraised by the internationally adopted 5-class rating method, the four State banks' bad loans declined by RMB78.2 billion in 2002, and NPLs accounted for 26.1 percent of their total loans, 4.92 percent lower than last year. These optimistic figures, however, need in-depth analysis.

Figure 1 Non-Performing Loans as Percentage of Total Loans*



Note:
* At peak.
Source: Goldman Sachs estimates, In: The Economist (2003).

Table 2 Overall National Contingent Liability of China

	2002 percentage of GDP
(1) NPLs of State Banks	18
(2) NPLs in AMCs	13
(3) Government Domestic Debt	18.6
(4) Total Foreign Debt	14.7*
(5) Current Balance of Social Security	0
Overall National Contingent Liability	64.3

Note:
* Figure for 2001.
Sources: *China's Statistical Yearbook 2002*; Gang Fan (2002).

The NPLs of state banks now amount to more than RMB1800 billion,[2] about 18 percent of GDP. Meanwhile, the NPLs in Asset Management Companies (AMC) account for about 13 percent of GDP.[3] If we add NPLs in state banks and AMCs with government debt, the total contingent liability is much greater. As Table 2 shows, the overall national contingent liability reached 64.3 percent of GDP. This might be one of the highest in the world.

The main task for tackling the NPLs is not just cleaning up the existing NPLs, but preventing the increase of new bad loans. As a result, we should pay substantial attention to the potential financial risk in the new phase of development.

Due to the urbanisation process and the shift of consumption structure, China's state banks have recently concentrated more on consumer finance and lending to urban infrastructure constructions.

[2] In 2001, the NPLs in four major state banks were RMB1800 billion without considering the NPLs in other financial institutions. Therefore, even though the NPLs in four major banks declined by RMB78.2 billion in 2002, the total amount of NPLs must be more than RMB1800 billion.

[3] NPLs stripped to AMCs was RMB1400 billion in 1999, and by 2002, the four AMCs have dealt with about RMB300 billion NPLs, reclaimed RMB100 billion of assets and RMB67 billion of cash. Since some of the reclaimed assets can also be the contingent liability while the reclaimed cash is the real reduction of NPLs, the total NPLs in AMCs might be RMB1333 billion, about 13 percent of GDP.

Table 3 The Change of Credit Term Structure

	2000	2001	2002:1	2002:2	2002:3	2002:4
Short-term loans as percentage of total loans	68.5	67.6	67.1	67.2	66.9	66.1
Medium- and long-term loans as percentage of total loans	24.6	25.8	25.9	25.7	26.1	26.4

Source: Gang Fan (2002).

Given this change, the credit structure of banks has altered with a slight increase in medium- and long-term loans and a decline in short-term loans (see Table 3). This could partly explain the decreased NPLs ratio.

Consumer lending by the big four banks has risen from one percent of their loan books in 1998 to about ten percent now.[4] Consumers seem more reliable than SOEs in terms of paying loans. But some evidences show that with the quick expansion of consumer finance, bad loans have also increased. And the larger amount of loans made to the housing industry, which generated housing bubbles, will inevitably result in potential risks of banks.

Unemployment

To avoid confusion and misjudgement about the unemployment problem, we should note that there are three kinds of unemployment and under-employment in China.

First, the unemployment of urban labour, reflected by the official "urban unemployment rate", mainly refers to the newcomers to the urban labour force, individuals in transition to new jobs, and individuals who have been laid off in the private sectors. The figures show that in recent years, the registered unemployment rate was about 3.5 percent annually, while in 2002, it jumped to 4 percent, and in 2003, the unemployment rate is just under 4.5 percent.

Second, the laid-off state employees are protected under some special arrangement since they keep a special status called "off-post

[4] "China's Financial Market: Bank on Growth", In: *The Economist*, January 18th-24th, 2003.

workers" (Xia-gang Zhi-gong). With this special status, they are entitled to receive a certain minimum payment (higher than the unemployment insurance payment) and access to re-training programmes and several job offers during a 2-3 year period following their lay off. During 1997-2001, more than 23 million state workers were laid off. Under the best scenario, there will be 20 million in the near future.

Third, there are about 500 million rural labourers in total, and 200 million have engaged in non-farming activities (about 100 million have already settled in cities); 60 percent of the remainder are actually underemployed on the small pieces of household land.

For the time being, China's fledgling labour market is under immense pressure from a huge army of job seekers, a combination of nearly 14 million laid-off workers from the SOEs, 150 million rural surplus labourers coveting an urban life, and an annual increase of some 10 million urban youngsters who have reached the working age.

It is predicted that in the next three to five years, Chinese cities and towns will have to provide job opportunities for some 22 to 23 million people when it actually creates about 8 million job opportunities annually. Pessimists say that even if the Chinese economy maintains its current high growth of 7 or 8 percent, the country will still face a shortage of 14 to 15 million jobs a year (Ministry of Labour and Social Security, 2003).

Income Disparities and Migration

The increasing income disparity between groups, regions and rural and urban populations has become a major economic and social problem since the beginning of reform. Now it seems particularly serious in rural-urban disparities and regional disparities.

In 2002, the rural-urban income disparity was less than 1:3, and if we consider that urban dwellers enjoy some social welfare benefits that rural dwellers never have, then the real income gap might amount to 1:6. Meanwhile, the regional disparities are also significant.

Immigration plays an important role in bridging income disparities. During 1982-2000, over 109 million labourers shifted from rural areas to urban areas. On average, the yearly migrants reach about 6.09 million. However, the amount of yearly migrants was about 4 million before 1995, while during 1996-2000, the number of yearly migrants tripled and reached 11.5 million (see Figure 2). Farm workers return their income to rural areas and it becomes one of the main income sources of farmers.

Regarding cross-region migration, about 90 percent of migrating labourers come from central and western China and more than 60 percent of them migrated to coastal regions (see Table 4).

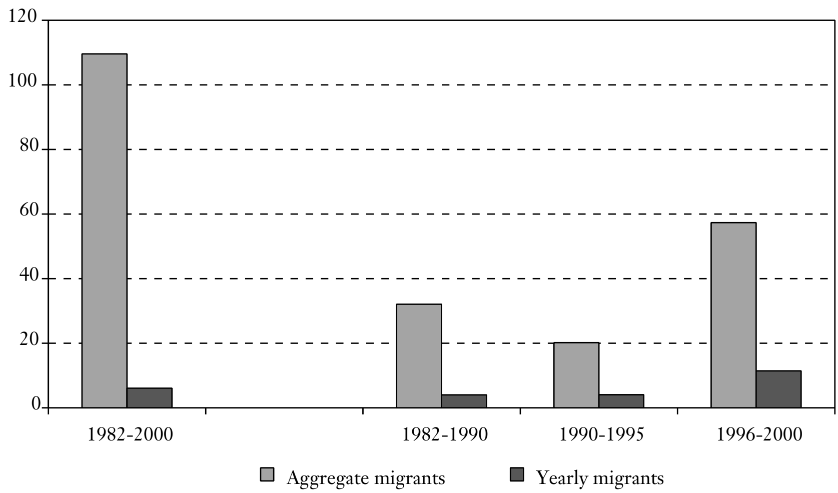
People migrating from rural areas to urban areas foster the process of urbanisation and gradually narrow the rural-urban income disparities and inland-coastal regional disparities.

In the long run, given the resources and the geographical conditions, migration may be the only way for some regions to increase their per capita income. It can be expected that China will experience even bigger mass domestic immigration, and the map of population will be significantly changed along with the economic transformation.

Rural Development and Urbanisation

China has suffered an over-supply of grains in recent years, so the voices questioning "who will feed China" have been fading.

Figure 2 Rural-Urban Migration (1982-2000)
(in millions)



Source: Department of Industries and Regulations, Ministry of Agriculture.

Table 4 Cross-Region Labourers' Migration
(in percentages)

Outflow Regions	
East	10.3
Central	55.7
West	34
Total	100
Inflow Regions	
Guangdong	37.9
Fujian	4.3
Shanghai	8
Zhejian	7.5
Jiangsu	5.6
Beijing	6.8
Others	29.9
Total	100

Source: Department of Industries and Regulations, Ministry of Agriculture.

However, the low productivity of agriculture and the low income of rural people remain a challenging problem at present and for the near future.

The key issue here is that there are too many people working on the small cultivable land and therefore the ultimate solution to the problem can be nothing other than industrialisation and urbanisation that move people out of the land. Studies show that the marginal product of labour in agriculture is almost negligible and that it will only be possible to use modern technology in China's agriculture if the number of people who rely on the land as their source of income is reduced. Also, only an increase of land per capita can result in a meaningful increase of per capita income in the agricultural sector.

In the past 20 years, the rural industries played a great role in improving the income level of rural people and in supporting overall economic growth. The industrialisation of the Chinese economy progressed significantly up to 56 percent (2001) in terms of non-farming employment[5] as a percentage of the total labour force.

[5] This includes the workers in rural industrial enterprises and rural self-employed non-farming individuals.

More than 100 million rural labourers have found new jobs in non-farming sectors. This process has been slowing down in recent years, demonstrating its own limitation, since it has not been accompanied by urbanisation. At the end of 2002, only 37 percent of the total population lives in cities and towns, which can be taken as the urbanisation rate. This disproportion in the industrialisation and urbanisation process is one of the major bottlenecks for further growth.

The government is adopting policies toward speeding up the urbanisation process. There are going to be more large cities or groups of cities emerging in the coastal areas. Currently, China has more than 660 cities and 19,000 towns and the urbanisation rate is about 37 percent. It is predicted that 1.12 billion people or 70 percent of the total population will live in cities by 2050. More than 600 million Chinese people will shift from rural to urban areas in the next 50 years. By then, China will have 50 major cities, each with a population of more than 2 million, 150 large cities, 500 medium-sized cities and 1,500 small ones. It is estimated that small cities and towns will absorb 7 to 8 million rural surplus labourers annually in the future.

3 The Reform Agenda

In order to realise the target of a well-off society in an all-around way, China has to continue its market-oriented reform in the new phase of development. The reform agenda addressed below mainly includes state sector reform, social security reform, financial reform, rural reform, further opening up and government reform, leaving aside some other reforms that are also crucial but deal with less sensitive issues.

State Sector Reform

Many have observed that the most serious economic problem in China has been the troubles of the SOEs. The inefficient SOEs have increasingly become the burden of economic growth. The unemployment of state employees is the major cause for some local incidents of social unrest. The mounting non-performing loans owed by the SOEs to the state banks have been the main source of

China's financial fragility. The stock market, dominated by listed SOEs and state-owned security companies with soft-budget constraints, fails to reflect the real economy.

The SOEs issue remains the key to understanding the Chinese reform agenda since the question of managing the SOEs and making them viable has constituted the main challenge of the reform agenda since the 1980s.

The management mode of SOEs has changed numerous times. Now the prevailing mode for managing state properties is the so-called 'Five Dragons Control the Water' (Wu-long Zhi-shui), which means that development planning departments are in charge of the investments in SOEs while economic and trade commissions decide on their production and operation, Party committees appoint their senior managerial personnel, finance departments control their revenue and assets registration, and an authorised investment institution exercises the investor's right of listed companies.

With this management style, no one really cares about state property and its operational efficiency. A growing consensus calls for replacing the conventional pattern with a new comprehensive institution that can help realise the separation of ownership and control of state property and the separation of government functions from those of enterprises. Thus China is planning to establish a ministry-level State commission to manage and supervise state assets – to be called the State Asset Management Commission (SAMC).

According to the logic of SAMC, the state will give full play to the initiative of both the central and local authorities on the precondition of upholding state ownership. The state will make laws and regulations and establish a state property management system under which the central government and local government perform the responsibilities of investor on behalf of the state respectively, enjoying owner's equity, combining rights with obligations and duties and administering assets, personnel and other affairs. For the first time, there is a clear indication that the local governments have the right to deal with state properties belonging to them while in the past all state properties were controlled by the central government.

As Table 5 shows, among total non-financial state properties, the central government covers about 60 percent and local government accounts for about 40 percent. The central government now performs the functions of investor in more than 180,000 SOEs, while under the future new management mode, the number of

Table 5 Operational State Properties: Aggregate and Structure
(in billions of RMB and percentages)

	Total	Central Government		Local Government	
	RMB	RMB	%	RMB	%
Industrial and commercial companies	5,755.44	3,069.04	53.3	2,686.4	46.7
Financial and insurance companies	830.39	746.76	89.9	83.63	10.1
Overseas companies	119.57	105.19	88.0	14.38	12.0
Varies of construction fund	155.86	155.86	100.0	–	–
Total	6,861.26	4,076.85	59.4	2,784.41	40.6

Source: Zhang Zhuoyuan (2002).

enterprises directly under the control of the State Council will be less than 200, and the management of the rest will be delegated to the local administrations.

One of the problems of the previous pattern of managing state properties was that SOEs have at least two contradicting targets: one was to serve as a stabiliser of society, and the other was to serve as a profit-maker. The key to reform of the state property management system would be to set a single goal for SOEs: give them the priority of keeping and increasing the value of state properties, and remove the goal of acting as a social stabiliser from their primary task. The SOEs' primary task as well as self-incentives is just to make profit. That does not mean, however, that the SOEs have no social functions. The SOEs will achieve some social goals for the sake of their own interests (i.e. profit-making). Government regulations rather than government administrative instructions can also make the SOEs accomplish some social goals.

Other reforms in state sectors should involve the ongoing dissolution of state-monopolised industries (public utilities in particular), as has recently occurred in the power industry, telecom industry and aviation industry, and the continuous retreat of SOEs from competitive industries.

Social Security Reform

A basic social security system is gradually taking shape in China. By 2003, the number of people covered by the pension system is set to reach 150 million. And those benefiting from unemployment insurance will amount to 110 million. Meanwhile, the number of individuals with medical insurance will reach 100 million. These three programmes of pension system, unemployment insurance and medical insurance constitute the backbone of China's social security system. Besides, some 20 million urban residents have been helped by the monthly allowance so far, 95.8 percent of whom are individuals – and their families – who were laid off from state-run factories.

However, there are still more needy urban residents who should be covered by the welfare programme, let alone that rural people have not yet been involved. The shortage of funds is another problem in the social security system. Given such problems, more reforms will have to be carried out:

- Consider farmers' social security. The current social security programme has not yet covered rural residents possibly due to the farmers taking land as their 'last resort'. But in the urbanisation drive, some land will be requisitioned which means some farmers will lose their 'last resort'. In this case, the social security fund should cover farmers whose land is requisitioned. Moreover, when conditions permit, the rural population should be involved in welfare programmes similar to those that have been developed in some coastal cities.
- Ensure the minimum living standard of urban dwellers and that the welfare programme covers more people. The government recently decided to spread the social security network in Northeast China's Liaoning Province – the province with the highest jobless rate – to some other regions.
- Develop diversified financing channels to reinforce social insurance funds. One channel should allow State pension funds into domestic stock markets in order to close a gaping pension deficit by investing in shares, bonds and investment funds. Another channel should ask for more fiscal support. The fiscal expenditures on social security are set to rise from 10 to 15-20 percent of GDP. The third channel should collect social security funds through improving the method to reduce untradable state shares and issuing lotteries.
- Create more jobs, particularly through the development of non-SOEs that can provide more job opportunities for laid-off workers and newcomers (see Figure 3).

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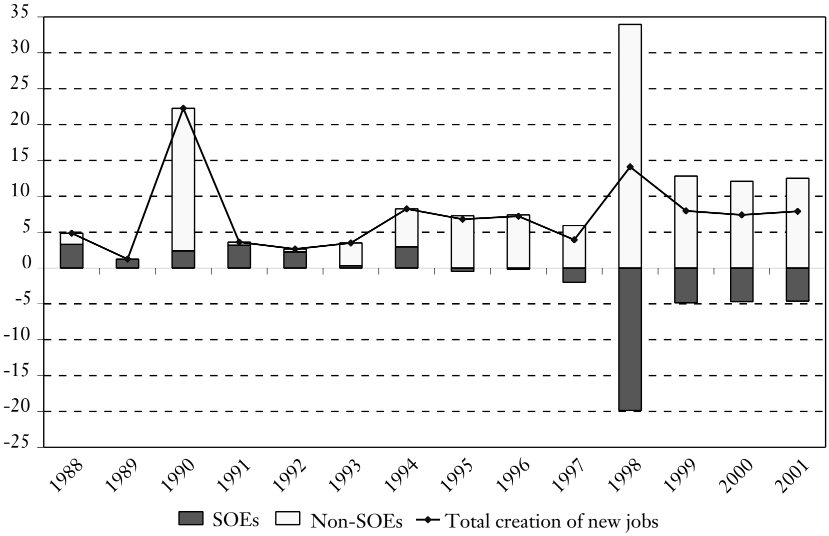
Figure 3 The Creation of New Jobs: SOEs Versus Non-SOEs
(in millions)



Sources: China Reform Foundation (2001); *China Statistical Yearbook 2002*.

- The government will also experiment with old-age insurance and medical insurance programmes in affluent coastal areas in a step-by-step manner, though doing so nationwide is not yet realistic.
- Create a social security law to ensure the implementation of welfare programmes. Previously, the operation of the social security system just relied on administrative regulations or guides.

Financial Reform

The reform of China's financial system has been one of the most urgent reforms in the economy. Four key points form the backbone of the government's financial reform plan.

First of all, financial regulation has to be strengthened to prevent financial risks. As unveiled by a government report, an individual bank supervisory committee is to be established to supervise the banking industry. Meanwhile, the People's Bank of China, the central bank, may take some steps toward relinquishing its supervisory role.

Reviewing the reform of China's banking system, the split of People's Bank of China (PBOC) forms most of the story. Several functions almost irrelevant to a central bank will be separated from the PBOC step by step: commercial banks will be separated first, followed by the CSRC (China Securities Regulatory Commission) and CIRC (China Insurance Regulatory Commission), and the CBRC (China Banking Regulatory Commission) will likely be set up last.

With this reform, the PBOC will become a central bank in the real sense that it is just responsible for the money control and the price level. The major responsibilities of the newly built CBRC are to formulate supervisory rules and regulations for banking institutions, and authorise the establishment, changes, termination, branching out and business scope of banking institutions.

Second, the state-owned commercial banks must be reformed to reduce bad loan ratios and improve management.

The reform will focus on erasing the characteristics of state banks as state administrations. Their administrative rankings will be nullified and senior bank-management staff will no longer be treated as state officials. By doing this, a new system for senior bank officials' appointments and dismissals will be established.

Property rights reform in the financial sector will be the main concern. Though the SAMC is set up to reform state sectors, it just deals with non-financial assets; the question of who should be responsible for state financial assets still remains. Therefore, a new state financial assets management institution should be created soon. The new institution must not only act as the owner, but also as the manager of the State banks, and be responsible for the management of bank personnel, assets and business operations. Currently, management rights are divided among several institutions.

Third, non-state financial institutions will be favoured to support economic development and the reform of rural credit bureaus will be sped up to better serve agricultural growth.

As state banks gradually liquidate or merge their county-level branches, the vacuum left will be filled by new financial institutions and organisations such as local commercial financial institutions, rural credit cooperatives and jointly funded financial entities which will witness considerable development in the coming years.

The Second Board (the board mainly for SMEs) will be set up for the development of non-SOEs (actually, most of non-SOEs are small and medium enterprises or SMEs). Moreover, the further opening of the banking industry will be accelerated and foreign institutions will provide more financial service for China's domestic market.

And last but not the least, the financial reform focuses on the need to establish a national credit record and rating system as soon as possible.

Rural Reform

China is a typical rural country with more than 60 percent of the population still living in rural areas. Improving farmers' income and fostering rural development remains a great challenge if China is to realise its target of a well-off society. Therefore, rural reform should be further deepened as follows:

- Carrying out fee-to-tax reforms to alleviate farmers' financial burden. Fee-to-tax reforms implemented on a trial basis in 20 provinces and cities have been successful, with farmers' economic burden reduced by over 30 percent. In 2002, the national average per capita amount of fees or taxes was 78.7 yuan, down 29.3 yuan from 1997, or an annual average drop of 6.1 percent.
- Continuing to encourage the drive toward urbanisation in order to create conditions for urban areas to absorb surplus rural labour force and increase farmers' income. The non-farming income from farm workers is one of the main sources of farmers' income. Statistics indicate that China's farm workers return about 100 billion yuan ($12.1 billion) in income to their hometowns each year.
- As urbanisation advances and the number of people bundled to land decreases, the scale operation with the transfer of the contractual right of land, carried out according to law and on a voluntary and compensatory basis, will be facilitated.
- Investing more in rural infrastructure construction with favourable fiscal policies to improve farmers' production and living conditions. As official data show, the state fiscal income jumped 121 percent in the 1996-2000 period while China's financial spending in agriculture was only up 75 percent. More favourable fiscal policy should be implemented for rural development.

Further Opening Up

As the Chinese Government lives up to its promises upon accession to the WTO, China will further open up and more foreign investment will flow into China.

Foreign investment is now allowed in many fields which had been forbidden prior to China's WTO accession. In the first year of WTO accession, China mostly opened the sectors with comparative advantages, like manufacturing industries, to foreign competitors. That is why these industries have not experienced a major negative impact. In line with the timetable of WTO requirements, however, more foreign investment will be allowed to penetrate service sectors, like banking, insurance, wholesale and retail business, foreign trade, telecom, transportation and technology service, etc. Therefore, the tougher challenges are yet to come since service sectors – particularly financial sectors – seem rather vulnerable in China.

Recently, China's capital market sped up their opening to foreign investors according to the schedule of WTO accession. China has now granted three foreign banks (i.e. Shanghai branches of Citibank, HSBC and Standard Chartered) approval to act as custodian banks for overseas funds permitted to invest in China's domestic stock markets. They will be allowed to help Qualified Foreign Institutional Investors (QFII) trade yuan-denominated A shares. A new rule on foreign-funded mergers and acquisitions (M&A) in China which aims to promote and regulate foreign investments in China came into effect on April 12, 2003.

China is opening its trade sector wider to foreign firms, and has begun to examine and approve Sino-foreign joint-venture trading firms. Furthermore, other service sectors like the banking industry and the insurance industry have also had joint ventures and will see more foreign investment introduced in the coming years.

Government Reform

China has proposed a new government reform package aimed at shifting the government's role in line with the market system and China's WTO accession.

As China's market economy develops, the government will be required to focus more on management at the macro-level and less on concrete cases and details. The government will lose the grip on the economy in many ways in order to conform to international standards. The State Council has scrapped the approval formalities on more than 1000 items since China's entry into WTO.

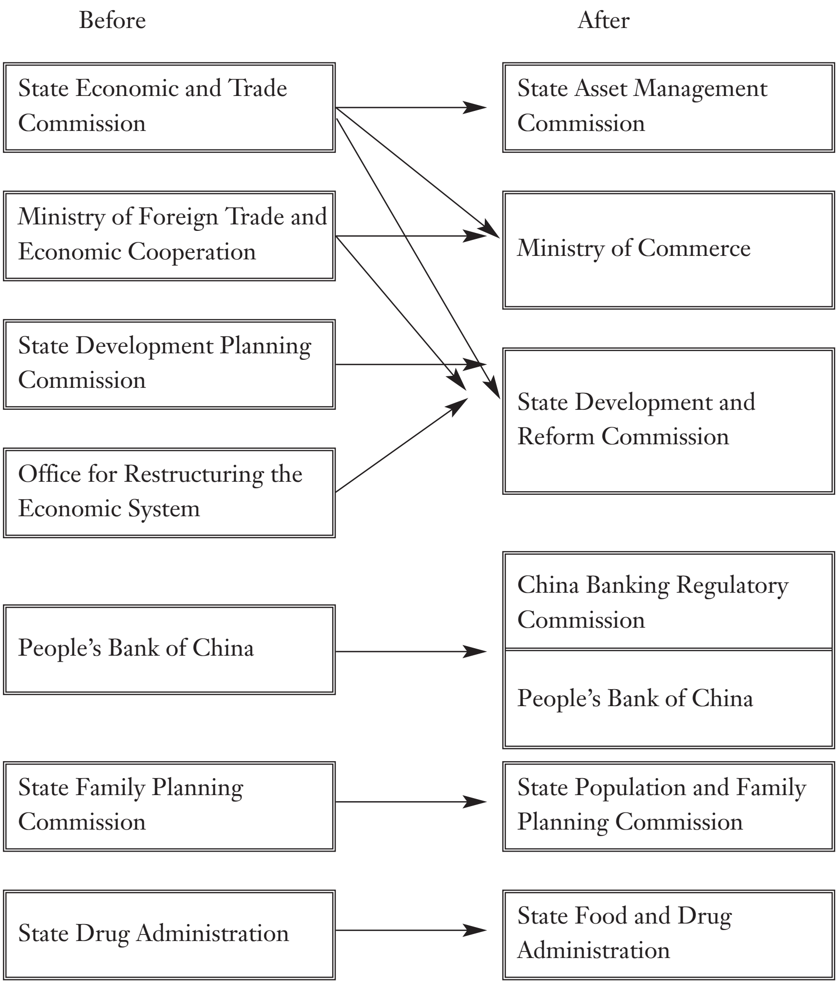
Unlike previous government reforms, which were mainly focused on downsizing, the new restructuring attempts to reduce the overlapping of the government departments' responsibilities, beef up coordination between them, and clarify their duties. It will definitely improve efficiency.

The reform package could be the largest structural reform the government has taken since the late 1970s (see Figure 4):

- The combining of the State Economic and Trade Commission (SETC) and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) into a new agency, the Ministry of Commerce. After China's entry into WTO, some of the functions of MOFTEC have become less important or even futile. The establishment of the new ministry will reduce the power overlap between the departments that used to oversee foreign and domestic trade regulations. This can increase administrative efficiency. For example, SETC originally determined whether foreign imports had harmed domestic firms, and MOFTEC determined whether anti-dumping or safeguarding measures would be implemented. These two functions relevant to China's WTO accession should no doubt be combined into one ministry.
- The establishment of the State Asset Management Commission (SAMC) to manage and supervise State assets, which further deepens the reform of SOEs and attempts to fundamentally resolve the SOEs issue.
- The establishment of a banking regulatory commission (to be called CBRC) to take over supervision of the banking industry from the People's Bank of China (PBOC), the country's central bank.
- The State Development Planning Commission (SDPC) is expected to shed the word 'planning' from its name and gain additional duties from the Office for Restructuring the Economic System and SETC, to become the State Development and Reform Commission to improve its macroeconomic control system. The new commission will merge the functions of development and reform together and make them compatible for economic growth.

- A state food and drug administration will also be established on the basis of the State Drug Administration to supervise the safety of food, health products and cosmetics, while the State Administration of Work Safety will be upgraded to beef up supervision over production and coal mining safety.
- In addition, the State Family Planning Commission will be changed to the State Population and Family Planning Commission.

Figure 4 The Restructuring of Government



4 Conclusion

In the above discussions, we talked about the characteristics of China's reform, the difficulties and risks in the economy and the reform agenda for the new phase of development. China faces more difficulties that need to be resolved and more urgent areas that need to be reformed than those discussed. However, as long as China's economy continues to grow even at a level lower than before, say, 7-8 percent, and the reform maintains, it is sound to project a 'well-off' society (*Xiaokang*) in an all-round way in about 20 years.

Some may wonder whether the progress made at this stage would be sufficient for establishing the foundation for further development or whether it is too small to prevent a crisis in the next stage. Or they may wonder what would be best, gradualism or shock therapy? These questions remain open.

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2

Comment on Gang Fan and Xiaojing Zhang

Keun Lee

The paper by Gang Fan and Xiaojing Zhang has a very straightforward structure. It first lists the achievements to date of the reforms in China and the current problems, and then discusses what is being done to tackle the problems. While this structure makes the paper easy to read, it also renders it less challenging. For example, when one thinks of the achievements of the reform in China (Section 2 of the paper), one would be interested to know how these achievements have been possible. Similarly, when one reads about the current difficulties facing China, one would like to know more about the causes of the problems and their mutual relationships or trade-offs. The solution to the problems would then evolve naturally from the discussion of the origins and interrelationships.

The four problems facing China discussed in the paper (NPLs, unemployment, income disparity and rural poverty) are related. In my view, these problems can be better understood by looking at the reform strategy of the Party leadership and the constraints it is facing. The leadership wants to bring about rapid growth while maintaining political hegemony, social stability and a socialist identity. Therefore, they actively pursue export- and FDI-led growth while preventing the farmers from immigrating to the urban areas in order to maintain social stability. The consequences of this reform strategy have been rapid growth in aggregate terms and rising inequality between urban and rural areas, and between coastal

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and hinterlands. The SOE problem is related to this dual track approach and remains "untouched" since SOEs are the source of the political and economic power of the Communist Party of China. As a result, the SOE losses are translated into the NPLs of the state-owned banks and into rising unemployment since the SOEs have had to cut their jobs.

Thus, there is the dilemma between drastic reform of the SOEs to reduce the debts and the NPLs, on the one hand, and continuing a political strategy that aims at maintaining social stability and equality that would require fewer lay-offs, on the other hand. While more rural-urban migration is needed to increase the income levels of the rural population, there are not enough jobs created in the urban areas. In other words, while growth is needed to absorb the laid-off workers from the SOEs, even more jobs are needed to absorb labourers moving into urban areas. The challenge is daunting, because the Chinese government has been accumulating fiscal deficits over the years while the policies for equalising growth call for more government money, especially in the Western Development Project.

The discussion of current and future reform measures should be seen in terms of how successful these measures are in tackling fundamental problems. The nature of the reform measures can be better understood when set against the strategic trade-offs facing the Party leadership. The Chinese Communist Party does not only aim at increased economic growth, but also at continuing political hegemony and social stability. Economic growth is pursued in so far it serves these other two goals. Being aware of this logic, one can better understand the policy choices of the leadership; it is characterised by constrained optimisation.

3

Challenges in Macroeconomic Management for China's New Leaders

Wing Thye Woo[1]

China stands at a new economic juncture because it became a member of the World Trade Organisation (WTO) in 2002, a development that will require it to allow its basic economic

[1] This paper has improved tremendously by comments from participants at the following meetings: seminar at the China Research Center of Yeungnam University, April 1, 2003; Conference on China's Role in Fostering Financial Stability and Growth in the Asian Region and the World Economy organised by the Forum on Debt and Development (FONDAD) and the Korea Institute for International Economic Policy (KIEP) at Seoul National University, March 27-28, 2003; seminar at the Institute for International Relations of National Chengchih University, March 24, 2003; seminar at Shih Hsin University, 21 March 2003; seminar at the Centre D'Etudes Prospectives et d'Informations Internationales, February 26, 2003; workshop at the Organisation of Economic Cooperation and Development, February 25, 2003; the Hong Kong Economic Association meeting, 16-17 December 2002; and workshop on the "Economic Challenges to the New Generation of Chinese Leaders" convened by the East Asia Institute at Trinity College, University of Cambridge, 12-13 December 2002. I am grateful to Huang Yiping, and Jeffey D. Sachs for letting me draw upon results from joint research. I thank Charles Adams, Cheong Young-Rok, Michel Fouquin, Hua Erh-Cheng, Jean-Francoise Huchet, Kim Si Joong, Lee Chang Kyu, Lee Keun, Francoise Lemoine, Charles Piggott, Xavier Richet, Xiao Geng, Wang Jian, Zhang Zhizhao, Zhang Xiaojing, Zhang Wei, Zhu Lijing, and Zhu Shanli for helpful discussions on China's macroeconomic situation. I am deeply indebted to the Citigroup office in Hong Kong for assistance in data compilation.

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institutions to converge to those of an advanced developed capitalist country. The management of the convergence process is expected to be particularly difficult because China has been experiencing low or negative employment growth in the industrial sector in the years leading up to WTO accession. Because of the substantial amount of economic restructuring that has to occur in a period when the economy has been showing a lower capacity to create jobs in the industrial sector, it has hence become quite usual to encounter gloom-and-doom predictions about China.

In the following pages we will:

- investigate the probability of WTO-induced macroeconomic shocks,
- assess the resilience of China's economy to such shocks,
- explore policies that the Chinese Government can implement to counter negative developments from WTO membership,
- identify the sources of China's underlying deflationary tendency (the paradox of thrift and liquidity trap) to have common roots in the failure of China's financial system to channel the secular rise in private savings into private investments,
- discuss the sustainability of China's expansionary fiscal policy to keep aggregate demand high,
- identify the benefits of WTO membership for macroeconomic management,
- outline the continued challenge to macroeconomic management from China's still-too-large state enterprise sector,
- conclude that the most serious threat to macroeconomic stability comes from the traditional sources of instability in successive rounds of bank recapitalisation, and
- warn of new non-traditional sources of macroeconomic stability – specifically fiscal shocks originating from areas like public health (e.g. an AIDS pandemic, a SARS epidemic) and environmental construction (e.g. water diversion projects, alternative energy systems) – and that management of these non-traditional problems is difficult because China does not have a wealth of successful domestic experiences to draw upon.

The economic costs of SARS have been greatly magnified not only by an inadequate public health system but also by structural weaknesses in information dissemination within China. Given the many structural weaknesses in China's economic system because of its incomplete transition to a modern private market economy, the

2-percentage points safety margin in fiscal management that we identified in Section 4 should at best be regarded as minimally adequate when we consider the sustainability of China's fiscal policy, and its ability to keep the annual growth rate above 7 percent.

1 China at the Beginning of 2003

China is now truly standing at a new juncture in its history. It stands at a new political juncture because an orderly political succession has occurred for the first time since the founding of the People's Republic. China also stands at a new economic juncture because of its recent membership in the World Trade Organisation (WTO), a development that will require it to allow its basic economic institutions to converge to those of an advanced developed capitalist country. One of the biggest economic challenges facing China's new leaders is the proper management of this internationally supervised process of economic convergence.

The management of the convergence process is expected to be particularly difficult because China has been experiencing low or negative employment growth in the industrial sector in the years leading up to WTO accession. Table 1 shows that the average annual employment growth in the industrial sector was 2.8 percent during the 1992-1997 period, with a minimum of 2.1 percent in 1997. The employment growth rate fell significantly after 1997: 0.3 percent in 1998, -1.1 percent in 1999, -1.2 percent in 2000, and 0.4 percent in 2001. The employment situation in the manufacturing component of the industrial sector had actually turned bad earlier in 1996. Manufacturing employment growth was negative throughout the 1996-2000 period with a particularly large decline of 13.5 percent in 1998. The slow rate of employment creation in the industrial sector from 1998 onward coincides with a significant slowdown in the growth of real GDP. Real GDP grew an annual average of 11.5 percent during 1992-1997 but has not exceeded 8 percent in any year since. As we shall see, because China was already in a situation of lower output and employment growth when it joined WTO, a number of doomsayers have appeared.

Table 2 summarises the main institutional changes that WTO membership would require, e.g. tariffs on automobiles will fall from 90 percent to 25 percent, and state trading will be confined to

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Table 1 Employment in China's Industries, 1978-2001

	Employment Level (in millions)		Employment Share (percentage of total)		Growth in Employment (percentage per year)		Memo
	Secondary Industry	Manufacturing Sector	Secondary Industry	Manufacturing Sector	Secondary Industry	Manufacturing Sector	Real GDP Growth (percentage)
1978	69.5	53.3	17.3	13.3			
1988	121.5	86.5	22.4	15.9	5.8*	5.0*	10.3*
1989	119.8	85.5	21.6	15.4	-1.4	-1.2	4.1
1990	138.6	86.2	21.4	13.3	15.7	0.9	3.8
1991	140.2	88.4	21.4	13.5	1.1	2.5	9.2
1992	143.5	91.1	21.7	13.8	2.4	3.0	14.2
1993	149.6	93.0	22.4	13.9	4.2	2.1	13.5
1994	153.1	96.1	22.7	14.3	2.3	3.4	12.6
1995	156.5	98.0	23.0	14.4	2.2	2.0	10.5
1996	162.0	97.6	23.5	14.2	3.5	-0.4	9.6
1997	165.5	96.1	23.7	13.8	2.1	-1.5	8.8
1998	166.0	83.2	23.5	11.8	0.3	-13.5	7.8
1999	164.2	81.1	23.0	11.4	-1.1	-2.5	7.1
2000	162.2	80.4	22.5	11.2	-1.2	-0.8	8.0
2001	162.8	80.8	22.3	11.1	0.4	0.5	7.3
2002							8.0
2003							7.0**

Notes:
* Annual compound growth rate between 1978 and 1988.
** Expected value in 2003.
Sources: *China Statistical Yearbook*, 1990 to 2001 data from 2002 edition, and earlier data from 2001 edition. Citigroup (2003) for GDP growth rates 2002 and 2003.

cereals, tobacco, fuels and minerals. It is clear that the substantial liberalisation of trade in many services and the lowering of the average industrial tariff from 24.6 percent to 9.4 percent by 2004 and the average agricultural tariff from 31.5 percent to 14.5 percent by 2004 will create considerable adjustment costs for China. For example, China is a natural food-importer and a natural factory-oriented society given its low land-man ratio, but its agricultural sector still employs over 332 million people, which is over two-third of the rural labour force. The bulk of China's state-owned sector relies on WTO-contravening policy instruments like subsidies and import barriers[2] for survival, and this sector employs over 40 percent of the urban labour force. Together, the agricultural sector and the state sector employ about 60 percent of the total labour force. Conservatively, almost a fifth of China's workers might have to change jobs, and this could be a politically destabilising process if not handled adeptly, and if external shocks were to slow down economic growth.

Because of the large amount of economic restructuring that has to occur in a time when the economy has been showing a lower capacity to create jobs in the industrial sector, it has hence become quite common to encounter gloom-and-doom predictions about China. The WTO process would allegedly generate such large political turmoil that there would be economic stagnation for an extended period. The most-discussed mechanism through which WTO would create a political meltdown is a macroeconomic shock. The macroeconomic shock from WTO membership could take two forms. First, WTO membership might promote a flood of imports that would cause widespread unemployment in the urban and rural areas, and hence provoke the social unrest that would bring about the macroeconomic collapse. Second, the entry of foreign banks could divert deposits from the already bankrupt domestic banks, and the resulting shutdown of the credit system would disrupt production economy-wide.

In the ominous words of Gordon Chang (author of *The Coming Collapse of China*), WTO accession "will shake China to its foundations".[3]

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[2] This is why China has over 30 car-making firms when Japan, possibly the most efficient car manufacturer in the world, has only 5.

[3] Chang (2001), p. xviii.

Table 2 Summary of Key Commitments by the Chinese Government on WTO Membership

Sectors	Key Commitments
Agriculture	Farm subsidy capped at 8.5% of value of domestic production (current level = 2%). Elimination of export subsidies. Average bound tariff down to 15% (1-3% in-quota rate and up to 65% above-quota rate on cereals), further reductions mostly by 2004.
Automobiles	Import tariffs on automobiles to 25% by mid-2006 from current 80-100% Restrictions on category, type and model of vehicles produced to be lifted in two years.
Banking	Foreign bank business conducted in foreign currency permitted immediately, business conducted in local currency with local corporations permitted within two years after accession, business in local currency with local residents permitted within five years. Geographic restrictions on foreign banking business to be lifted over five years.
Insurance	Foreign ownership: 50% of life insurance and 100% of non-life insurance (property/casualty) geographic/business restrictions will be gradually phased out.
Securities	Minority foreign-owned joint ventures in fund management industry. Foreign ownership up to 49% in five years.
Distribution	Foreign companies are allowed to set up joint ventures within two years after accession with majority ownership and without geographic restrictions, with exceptions for a few products.
Telecommunications	Foreign company stakes: 25% in mobile phone, up to 35% in one year and 49% after three years; area restriction will be lifted after 5 years.
State trading and trading rights	State trading will continue in cereals, tobacco, fuels and minerals. All enterprises will be free to import or export after 3 years.

Source: Compiled by the Citigroup (2002) from WTO documents.

"In 1998, there were 60,000 protests ... [and in 1999], there were 100,000. Anecdotally, we know at least that demonstrations last year grew bigger ... But the most significant aspect of the recent demonstrations is not their increasing size. It is that these days, barehanded peasants and workers are desperate enough to do battle with armed state security forces. That tells us volumes about the state of China today.

"... China's imminent accession to the World Trade Organisation can only aggravate the problem of instability because membership will limit Beijing's ability to postpone solutions ... [Imports] will flood the country. And that means uncompetitive state-owned enterprises will fail in even greater numbers than they do today... And in the countryside, expect China's peasants to be hit even harder than the urban proletariat, as efficient foreign agribusiness penetrates Chinese markets.

"... Accession will knock one or two percentage points off increases in GDP ... [and] China is at the point where the loss of even a percentage point of growth would have a disproportionate impact on urban workers and the peasantry ... [The fact is that] many Chinese today are still hungry, angry and, worst of all, desperate. That desperation will escalate as the country settles into the WTO."[4]

"The People's Bank of China, the country's central bank, says that about 30 percent of the loans of the four biggest banks are nonperforming, but that assessment is based on accounting with Chinese characteristics. Foreign observers put the figure closer to 50 percent, and some even say higher.

"... But in less than five years, foreign banks, in accordance with China's World Trade Organisation commitments, will be able to accept local-currency deposits from Chinese citizens. If foreign institutions are able to divert just a little liquidity away from the Big Four banks, there will be a banking crisis of historic proportions. Beijing's leaders will try to avoid tragedy, but they might not succeed. For one thing, they don't have enough money."[5]

Given the above possible negative scenarios, it is somewhat puzzling why China has been so keen to join WTO. Since the removal of barriers to the entry of foreign goods and foreign banks could have been implemented unilaterally by China at a pace of its

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[4] Gordon G. Chang, "The Shahs of Beijing", In: *Far Eastern Economic Review*, September 13, 2001.

[5] Gordon G. Chang, "Don't Bank on China", In: *Far Eastern Economic Review*, July 18, 2002.

own choosing, it is paradoxical why China had pursued arduous trade negotiations with the United States for over a decade in order to undertake a trade deregulation that is set and monitored by other WTO members.

The answer to this paradox has two parts. The first part of the answer is that during the period of China's self-imposed isolation, 1949-1978, the rest of the world (with some notable exceptions, especially Africa) created new wealth on an unprecedented scale. Conventional wisdom attributes this generalised increase in prosperity to the open international trading system that was institutionalised at the end of World War II.[6] Clearly, China agrees with this conventional wisdom because it has stated numerous times that its full participation in the international trading system is fundamental to keeping its economic growth sustainable. After twenty years of evolution in economic institutions, of rotation in political leadership, and of tectonic change in the political fortune of the communist parties in Eastern Europe and the former Soviet Union, the only organised opposition today to the continued convergence of China's economic institutions to international forms comes from a small group of sentimental Stalinists like Deng Liqun.[7] The social and political landscape in China has changed so much that the political leadership now incurs only minimal ideological liability when they introduce more capitalist incentives (e.g. differentiated pay, leveraged buy-out, stock options for managers) and capitalist tools (e.g. joint-stock company, bankruptcy law, unemployment insurance). The leadership is confident that its explicit embrace of capitalist institutions under WTO auspices would be seen by the general Chinese public (and the Chinese elite) as a step forward in the reform process rather than as surrender of China's sovereignty in economic experimentation.

The second, and more important, part of the answer to the paradox of why China is so enthusiastic in joining WTO is that WTO membership will greatly enhance China's economic security.

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6 Sachs and Warner (1995) present convincing evidence in support of this professional consensus.

7 "Elder warns on economic change", In: *South China Morning Post*, January 13, 2000, and "Leftists make late bid to slow reforms", In: *South China Morning Post*, February 10, 2000. There is a big debate in the academic literature about whether China's post-1978 growth has been due to institutional innovations or to institutional convergence, see Woo (1999, 2001) for a critical review of this debate.

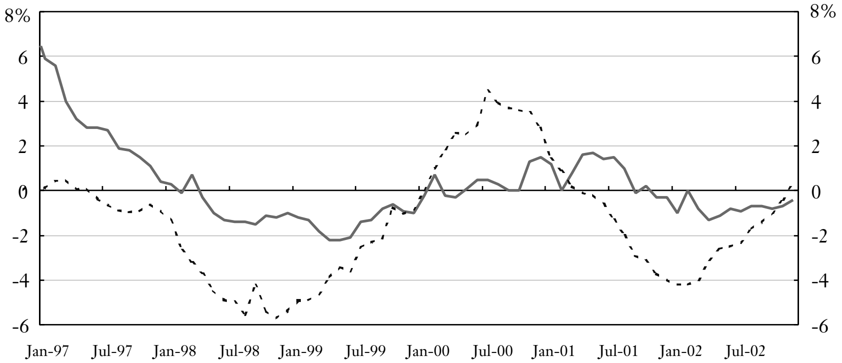
Before China became a WTO member, it required annual approval from the US Congress for most-favoured-nation (MFN) status in order for its exports to compete in the US markets on equal terms against the exports from WTO countries. This annual congressional approval process inevitably rendered China's exports vulnerable to passing passions in the US political arena over accidents like military airplane collisions in the South China Sea, and the Chinese burning of the US consulate in Chengdu following the unintended US bombing of the Chinese embassy in Belgrade. The importance to China of maintaining high export growth and of maintaining the access of its exports to the US market is hard to overstate. Deficit spending and exports are the two growth engines that have kept recent GDP growth rates above 7 percent. Through WTO membership, this second engine of growth could no longer be unilaterally shut off by the United States without the action being a major violation of international commitments of the United States.

The organisation of this paper is as follows. Sections 2 and 3 investigate the probability of WTO-induced macroeconomic shocks, the resilience of China's economy to such shocks, and explores the policies that the Chinese Government can implement to counter negative developments from WTO membership. Section 4 discusses the sustainability of China's expansionary fiscal policy to keep aggregate demand high, and Section 5 identifies the benefits of WTO membership for macroeconomic management. Section 6 outlines the continued challenge to macroeconomic management from China's still-too-large state enterprise sector. Section 7 concludes the paper with some final observations.

2 Import-Induced Unemployment

Gordon Chang's claim that WTO membership would involve considerable costs to China is undeniable. What is deniable is his second claim that WTO membership would definitely lead to the collapse of China's economy. In our view, it would require China's government to mishandle technically the macroeconomic difficulties in order to produce the collapse that Chang has envisaged. The fact is that the recent record of macroeconomic management in China has been satisfactory to good. China has been facing deflation since 1997. Figure 1 shows negative growth of the producer price index

Figure 1 Price Deflation in China
(percentages year-over-year)



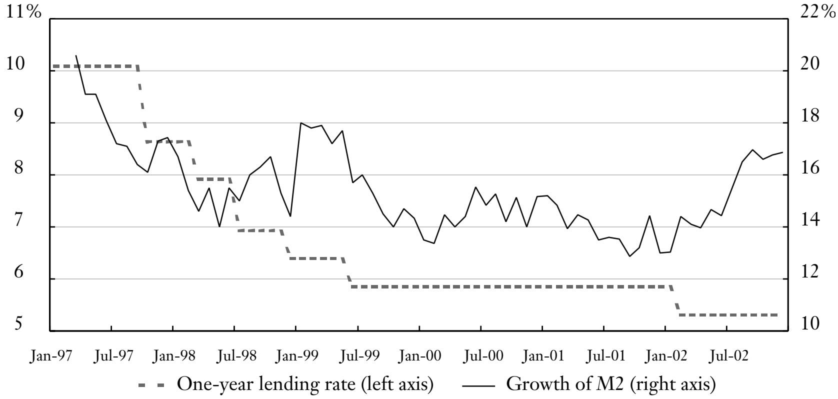
Source: Citigroup (2002) updated in February 2003.

from 1997:2Q to 2000:4Q, and then again since 2001:2Q.[8] The expansionary fiscal and monetary policies that the authorities have undertaken have succeeded in keeping annual GDP growth at 7 to 8 percent.

The government's vigorous efforts at economic stimulation are summarised in Figures 2 and 3, and Table 3. The interest rate has been cut eight times in less than six years, with the latest rate cut on 21 February 2001 which brought the 1-year deposit rate to 1.98 percent and the 1-year lending rate to 5.31 percent. The annualised (year-on-year) growth rate of fixed asset investment of the state sector was kept above 15 percent from July 1998 to July 1999 period, and then lowered as exports to the other East Asian economies recovered. Fiscal stimulus was renewed in 2001. State spending on capital construction jumped from RMB209.5 billion in 2000 to RMB251.8 billion in 2001, which kept the annualised growth rate of state sector fixed asset investment above 15 percent for 11 of the 12 months in 2001.[9] When the CPI slipped again into

8 A less severe picture of the deflationary pressures is given by the consumer price index (CPI) because it includes the prices of services. The retail price index (CPI minus services) – not shown in Figure 1 – shows negative growth since 1998.
9 Apart from investment in capital construction, the government also implemented three pay rises since 1999. In 2001, for example, the public servants, including those employees of the state-run education and research institutions and military personnel, received a 30 percent increase in their base salaries plus the

Figure 2 Growth of Money Supply and Interest Rates



Source: Citigroup (2002) updated in February 2003.

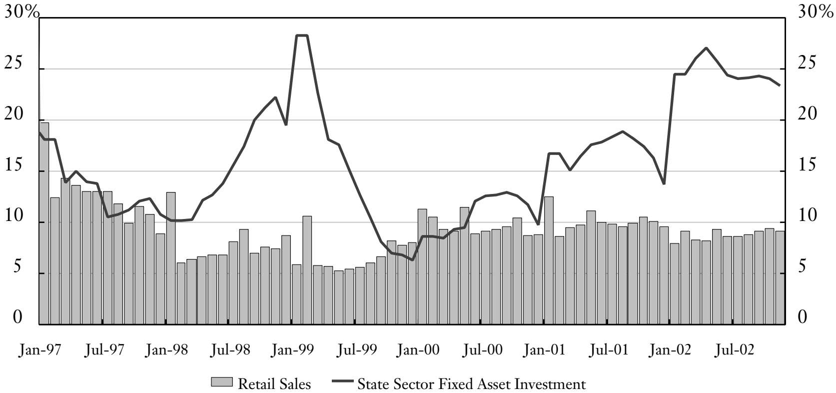
negative growth rates in November 2001 (reaching -1.3 percent in April 2002), the Chinese government increased the intensity of the fiscal stimulus; e.g. the growth rate of state sector fixed asset investment has stayed above 23 percent since February 2002.[10] Most government economists tend to believe that the investment using funds raised through treasury bond issuance contributed about 2 percentage points to GDP growth each year during the past four years (Jia, 2002).

The result of this jump in government spending is that the fiscal deficit has increased substantially from 1.1 percent of GDP in 1998 to 1.9 percent in 1999, 2.5 percent in 2000, 2.7 percent in 2001, and 2.9 percent in 2002 (see Table 3). Citigroup (2003) has projected the budget deficit to be 2.8 percent in 2003. So the important question about import-induced unemployment is whether there are technical

year-end bonus equivalent to one-month's base salary. Between 1998 and 2001, the Ministry of Finance issued a total of RMB510 billion of Treasury bonds for spending on infrastructure projects, especially in the western provinces. The government issued RMB100 billion in 1998, RMB110 billion in 1999, and RMB150 billion each in 2000 and 2001. The planned issuance for 2002 is also RMB150 billion.

[10] The government has also announced a fourth round of pay increase to civil servants that would begin from July 1, 2002 (an increase that some economists have argued as excessive) "Fourth raise for China civil servants attacked", In: *The Straits Times* (Singapore), June 11, 2002.

Figure 3 Growth of Domestic Demand



Source: Citigroup (2002) updated in February 2003.

and political obstacles that can prevent China from implementing macroeconomic policies (especially, fiscal policy) that are even more expansionary, and for a longer period.

Before answering this question, however, we first examine the possibility of WTO-induced bank collapse. This is because, as we will see, the prevention of WTO-induced bank collapse is, in part, ultimately a fiscal issue as well.

Table 3 Growing Fiscal Spending
(billions of RMB and percentages)

	Fiscal revenue	Fiscal expenditure	Fiscal balance	*Share of GDP*	Spending on capital construction	*Share of GDP*
1997	865.1	923.4	- 58.2	*-0.7*	102.0	*1.4*
1998	987.6	1079.8	- 92.2	*-1.1*	138.8	*1.8*
1999	1144.4	1318.8	-174.4	*-1.9*	211.7	*2.6*
2000	1339.5	1588.7	-249.1	*-2.5*	209.5	*2.4*
2001	1637.1	1884.4	-247.3	*-2.7*	251.8	*2.6*
2002			-309.8	*-2.9*		
2003			-319.8	*-2.8*		

Sources: Citigroup (2002) for 1997-2001 data, and Citigroup (2003) for 2002-2003 data.

3 WTO Membership and the Problems in the Banking System

China's banks are in undeniably serious financial straits. According to the People's Bank of China (PBOC), the proportion of non-performing loans (NPLs) of the four big state-owned banks (SOBs) is presently about 26 percent, which is 2 percentage points lower than a year ago. However, the recently revealed scandals of the Bank of China suggest that there are probably still undiscovered black holes in the banks' books. Table 4 presents estimates that put NPLs to be 35 percent of outstanding loans at the four big SOBs at the beginning of 2002, and the average capital adequacy ratio (CAR) of these four banks to be 5.0 percent.

The bank reform efforts of the past several years have failed. The proportion of NPLs has come down from its record high of 48 percent in 1998, but this reduction was achieved mainly by the transfer of the NPLs to the state-owned asset management corporations (AMCs). The major portion of the transferred NPLs still needs to be disposed and is thus still the responsibility of the banks or the Ministry of Finance. Worse, most of the problem SOEs remain clients of the parent banks and continue to create new NPLs. What has facilitated the creation of new NPLs is the intermittent pressure on the banks from the government to expand investment credit to combat deflation, and to expand social stability

Table 4 Rising Fragility of China's Banking Sector
(in percentages)

	End-1996	End-1998	Beginning-2002
Proportions of NPLs			
Big four banks	40.0	48.0	35.0
Ten joint-stock banks		13.5	15.5
Average capital adequacy ratio			
Big four banks	4.4	>8.0	5.0

Note:
Proportion of non-performing loans for the four major banks for 1996 and 1998 are re-estimated based on new information made available at the beginning of 2001. The proportion for 2001 excluded the 1.4 trillion of RMB transferred to the Asset Management Companies in the previous year.
Source: Citigroup (2002) estimates.

loans to reduce firm closures.[11] This may be an important reason why the quality of banking assets has deteriorated rapidly during the past years, causing the capital adequacy ratio to fall to 5 percent in early 2002 from the 8-plus percent achieved in late 1998 after the recapitalisation of the banks.

The reason that we ended the last paragraph on a tentative note is because it is possible that a large part of the post-1998 NPLs may actually be pre-1999 NPLs that were not recognised as such in the 1998 recapitalisation because the SOBs did not want to reveal that the actual NPL situation then made a big lie out of previous official NPL estimates. In any case, the state banks are now in need of another round of recapitalisation.

In this situation of a fragile banking system, China has committed itself to opening up the banking system completely within five years of joining WTO (which it joined in December 2001). Foreign banks could conduct transactions in foreign currencies from the beginning of WTO membership, conduct transactions with the local corporate sector in renmimbi after two years, and conduct transactions with local households in local currencies after five years. Although foreign banks are likely to compete only in the coastal cities, at least in the initial period, the pressure on domestic banks can be high as the big four banks extract about 95 percent of their profits from about half a dozen coastal cities (Shanghai, Beijing, Xiamen, Shenzhen, Guangzhou, and Tianjin). Because there is no depositor insurance in China, the obvious question is whether depositors will believe that these foreign banks will drive the SOBs into open bankruptcy, and hence rush to withdraw their savings from the SOBs, setting in motion the vicious downward spiral of credit contraction, leading to business failures, rendering sound financial institutions insolvent and contracting credit further.

Our reading is that even if pressures on the state banks do occur through depositor withdrawals, there is no need for a full-blown crisis since the central bank will be able to issue currency to the state banks to meet the withdrawals. This expansion of high power

[11] Clearly, it is likely that not all of the additional NPLs after 1998 were created after 1998. Some of them were just not recognised in the banks' books in the pre-1999 period, and they came to light after the bulk of the recognised NPLs was transferred to the asset management companies.

money cannot be easily translated into a loss of foreign reserves because capital controls, which we support, remain in place and are likely to do so for the forseeable future. The resulting expansion of high power money will also not have much impact on inflation because this is mainly a shift out of bank deposits into cash, or from some banks to others, and not a shift into goods. In fact, in the present deflationary atmosphere, a run from bank deposits to goods is a macroeconomically stabilising development! Simply put, the government has the technical ability to accommodate shifts in bank deposit preferences, even a modest bank run, without risking exchange rate collapse or a runaway inflation.

However, the fact that the government can prevent a bank run from causing a financial meltdown is not good enough. If the banking system is plagued by frequent bank runs, its role as a financial intermediary will be greatly reduced, and economic growth could suffer significantly. The real issue is not whether depositor shifts, or a bank run, could be accommodated, but how to prevent a banking crisis from occurring in the first place. Because depositors have the incentive to withdraw their funds as long as the banks are seen to be insolvent, the prevention of bank runs requires that the government keeps the banks adequately capitalised at all times.

Another reason why the banks deserve recapitalisation is that this will lower the lending rate, and hence spur capital formation. To see how NPLs raise the lending rate, we note that the cash-flow constraint that a bank (regardless of solvency) must meet in the absence of state subsidies, of operating costs, and of a required reserve requirement is given by:

$r_D D = r_L [D\text{-}NPL]$

r_D = deposit rate

r_L = lending rate

D = amount of deposits

This means that if NPL equals one-third of deposits, then the lending rate has to be at least 50 percent higher than the deposit rate. The important implication, however, is that a new bank (domestic or foreign) can undercut the lending rate of the existing SOBs because it will not have any NPLs on its books. We will use this fact later in our discussion on the policy options available to deal with the present NPL situation.

Since the government had recapitalised the banks in 1998, and needs to do so again now, the important question is whether there are technical and political obstacles that can prevent China from implementing another round of bank recapitalisation. Or, to put it differently, how many more rounds of bank recapitalisation can China afford without generating a fiscal crisis?

4 Difficulties in Fiscal Management

For China, the prolonged use of loose fiscal policy carries two major risks. The first risk is low economic efficiency of the state investments, especially of many of the infrastructure projects implemented in the last four years. Almost all of these projects were implemented by the SOEs in a rush, with some of the projects approved even before the feasibility reports were completed. In 1998 and 1999 there were frequent reports about the collapse of bridges and roads that were built recently. This risk of a rise in fiscal inefficiency has been confirmed by an internal study of the Ministry of Finance which found that the amount of investment required to create one additional unit of GDP has increased significantly in recent years (Gao, 2002).

The second, and possibly more serious, risk to fiscal management is fiscal sustainability. The proactive fiscal policy contributes to fiscal risks in two ways – it directly increases both fiscal deficits and public debts, and indirectly increases the amount of NPLs by influencing banking lending decisions. A higher debt-GDP ratio means more debt servicing in future periods, and this could require expenditure cuts in order to prevent an upward spiral of the debt-GDP ratio, a development that may convince the financial markets that the state is resorting to a Ponzi scheme to finance its deficits, and cause a shutoff of credit to the state.

The simple fact is that fiscal sustainability lies at the heart of whether a banking crisis would actually occur. As long as the state is perceived to be able and willing to bail out the SOBs, depositors would retain their confidence in the SOBs regardless of the actual state of their balance sheets. The stock of publicly acknowledged government debt comes to only 16 percent of GDP, and so it is commonplace to hear official assurances that the current fiscal deficits of less than 3 percent of GDP do not pose a problem for debt servicing by the state. However, the analytically correct measure of public debt should be the consolidated debt of the state

Table 5 Contingent Liabilities in China, End of 2001
(billions of RMB and percentages)

	RMB billion	percentage of GDP
Accumulated public debts	1,550	16.2
Special T-bonds in 1998 for recapitalisation	270	2.8
Estimated costs for bank restructuring	4,500	46.9
Estimated costs for social security funds	2,500	26.1
Municipal government contingent debt	700	7.3
External debts	1,500	15.6
Total	11,020	114.9

Note:
This is an updated estimation based on new information available on both gaps in social security funds and municipal government contingent debts that the central government is the guarantor for. These were estimated based on communication with government economists.
Source: Citigroup (2002) estimates.

sector, which would include at least some part of the contingent liabilities (e.g. foreign debts of SOEs and SOBs, and unfunded pension schemes in the SOE sector) that the state might have to assume responsibility for when the state-owned units default on their financial obligations. We should note that if an analyst counts NPLs as contingent liabilities, then he or she is really computing what the public debt will be after one more round of bank recapitalisation, i.e. the second bank recapitalisation since 1997. According to Fan (forthcoming), the consolidated public debt at the end of 2001 was 72 percent of GDP; and according to Citibank (2002), it could be as high as 115 percent (see Table 5). So is China's present debt-GDP ratio too low or too high?

To answer this question, we note that the central government debt-GDP ratios in Italy, Sweden and the United States were, respectively, 117.6 percent, 70.8 percent, and 50.5 percent in 1995.[12] So if China undertakes its second bank recapitalisation since 1997, its public debt will still be within the range seen in advanced OECD countries that are not experiencing fiscal crises. However, there are two important points to be made to show that this finding is not an optimistic one.

[12] The US ratio is for 1996. Ratios were constructed from the IMF's *International Financial Statistics*.

First, the forthcoming recapitalisation of China's banks appears to be the last *major* one that the government could implement in the short term without risking the stability of the domestic financial markets and its credit standing in the international financial markets. A third recapitalisation (since 1997) will push the debt-GDP ratio to over 150 percent, well above the OECD norm.

Second, if China recapitalises the SOBs a second time, it will have to compromise the expansionary fiscal policy that has been keeping GDP growth above 7 percent since 1997. This is because China raises much less state revenue, as a share of GDP, than the OECD countries, and hence has a much lower capacity to service its public debt. The revenue-GDP ratio was 16.2 percent for China in 2001, 30 percent for Italy in 1995, 38 percent for Sweden in 1995, and 21 percent for the US in 1996.[13] The additional debt service from the second bank recapitalisation will be about 1.5 to 2.5 percent of GDP.[14] If China increases tax collection or reduces infrastructure spending to cover this increased debt service, then this second recapitalisation of the SOBs will reduce the fiscal stimulus that has been keeping the GDP growth rate above 7 percent. Between these two options, expenditure reduction cannot be considered the less likely outcome because China's experience in the reform era is that frequent changes to the tax system have not been able to raise revenue significantly for a sustained period. The reason for the low revenue-GDP ratio could be because increasing tax collection is as much a political challenge as it is an administrative challenge.

If the issue of fiscal sustainability is viewed from the broader picture of debt dynamics, one might be tempted to be more optimistic about the present situation, and dismiss the existence of a trade-off between bank recapitalisation and fiscal stimulus as stated in the preceding paragraph. Such an optimistic assessment would be based on the fact that China's annual trend growth in the next decade and a half is likely to be at least 7 percent, and so the high debt-GDP ratio of 115 percent of today would be reduced over time

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[13] The revenue-GDP ratio for China is from Deutsche Bank (2002) which estimated that it will rise to 16.4 percent in 2002 and 16.6 percent in 2003. Debt-to-GDP and revenue-to-GDP ratios for other countries are from the IMF database.

[14] This assumes a bond rate of 4 to 6 percent – an assumption discussed in the next paragraph.

by the high rate of output growth. There is, thus, no need to cut back on the fiscal stimulus in order to service the additional debt from the new round of bank recapitalisation – just borrow more to cover the additional debt service, and wait for the economy to "grow" out of its debt.

To state the above argument more formally, the optimism is based on the evolution of the debt-GDP ratio as given by:

$d\,(\ln[\text{debt/GDP}]) \,/\, d\,t = r + p = b - y$, where

r = real interest rate on government debt

p = primary fiscal deficit rate (i.e. [state expenditure excluding debt service – state revenue] / GDP)

b = NPL creation rate (i.e. [change in NPL in SOBs] / GDP)

y = trend growth rate of real GDP.

For convenience, we assume:

- y to be 8 percent,
- p to be 2 percent (according to Deutsche Bank, 2003, p was 1.8 percent in 2001 and 2.2 percent in 2002, and is likely to be 2.1 percent in 2003),
- r to be 4 percent (which is obtained by combining the facts that the government bond rate on 25 March 2003 is 2.65 percent, and that the inflation rate is about negative 1 percent); and
- b to be 0 percent after this second recapitalisation.

In this contrived example, we see that y exceeds the sum of r and p by 2 percentage points, which means that the debt-GDP ratio will decline over time. This safety margin of 2 percentage point for China's debt situation allows the optimistic conclusion that China can simply grow out of its debt without having to face the trade-off between bank recapitalisation and fiscal stimulus. It is important to note, however, that this optimistic conclusion is dependent on the two highly unrealistic assumptions: (i) that there will not be another round of bank recapitalisation in the future – an assumption about state banks that has been falsified not only by international experiences but also by China's own experience since 1998 where the NPL creation rate (b) was about 7 percent; and (ii) that China can promote the development of its financial sector without freeing the presently state-set interest rates.

Because the real interest rate of 4 percent used in the above paragraph is the product of interest rate ceilings, we think that the shadow interest rate is likely to be substantially higher. As China is a capital-shortage country, the real rate of return on physical capital in China must be higher than the 10-plus percent (in the United States it is over 10 percent). So if there were an efficient government bond market in China today, the lower bound of the real government bond rate in China might be at least 6 percent. This minimum 2 percentage point rise in the real interest rate is made more plausible by the fact that the state would have to issue new bank recapitalisation bonds that amount to 40 percent of GDP. Realistically, the rate of NPL creation will continue to be positive, say 1 percent, which means that under interest rate liberalisation, the primary fiscal deficit (p) would have to be cut from 2 percent to 1 percent, i.e. the fiscal stimulus would have to be reduced, in order for the debt-GDP ratio not to spiral uncontrollably upward.

International experiences show interest rate liberalisation to be indispensable for the deepening and the sophistication of financial markets, so we really see no reason to be assured about the sustainability of China's fiscal situation. The lesson that we learn from this debt dynamics exercise is that we have to be very cautious about the validity of the benign scenario for China's fiscal situation. In a case where the safety margin of 2 percentage points is the result of interest rate ceilings and the unrealistic assumption that SOBs would cease generating NPLs, it might be wiser to err on the side of caution rather than on the side of complacency. If so, the sustainable fiscal options in dealing with the second bank recapitalisation is to either decrease state spending or increase state taxes.

In summary, China's consolidated debt-GDP ratio will be relatively high by international standards after a second bank recapitalisation, while its revenue-GDP ratio will remain relatively low. The greatest threat to the stability of China's financial market is fiscal sustainability, and the biggest threat to fiscal sustainability is successive rounds of bank recapitalisation. This outcome is a systemic feature of the current banking system, and cannot be attributed to WTO membership. In fact, we argue below that WTO membership is likely to rehabilitate China's financial system, and, may, as a by-product, reduce the deflationary tendencies evident since 1997.

5 The Benefits of WTO to Macroeconomic Management

At a superficial level, the systemic deflationary pressures that have plagued China since 1997 have their sources in two Keynesian maladies, the liquidity trap and the paradox of thrift. The liquidity trap refers to the phenomenon of the last few years where monetary policy does not seem to work. China has tried to boost the domestic economy with successive cuts in interest rates, but the rise in credit creation has been disappointing. Credit growth has been much lower than expected, except for brief intervals when the central bank leaned heavily upon the banks. The paradox of thrift refers to the low level of private aggregate demand because the private saving rate has been increasing. The Chinese government has concluded that, because private aggregate demand is falling and monetary policy seems incapable of stimulating it, the key to maintaining macroeconomic stability is government spending.

At a deeper level, however, we suggest that both of these phenomena spring from the same cause, which is the absence of adequate financial intermediation in China. Why, for example, is China suffering from an apparent liquidity trap? The main reason seems to be that state bank managers have been told that if the ratio of non-performing loans were to increase for two consecutive years, they would lose their jobs. The traditional client-base of the state banks is state enterprises, of which, half to two-third, are reporting zero or negative profits. By extending more loans to state enterprises, the non-performing loan ratio would inevitably rise. At the same time, state banks are also unwilling to lend to non-state enterprises and for very good reasons. First, the accounting practices of the non-state enterprises are neither uniform nor transparent. Second, it is politically more risky to do so. A loan to a state-owned enterprise might be a bad economic decision, but a loan to non-state enterprise that goes bad could potentially be a bad political decision as well. The bank manager could be accused of consorting with the private sector to embezzle the state.[15] The liquidity trap then arises

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[15] The Chinese government has sought to increase bank lending to private individuals by encouraging banks to establish mortgage loans, which are perceived as less risky because of their seemingly fully collateralised nature. Mortgage lending, however, is a totally new product to be provided to a totally new set of customers, and so the state banks have understandably been slow in setting up this market.

because the banks are unwilling to lend money to either the state-owned enterprises or the private enterprises. The only activity that the banks are happy to allocate their funds to is the purchase of state bonds, i.e. the financing of the government's deficit. The fundamental step to eliminating the liquidity trap is to end the bias against lending to the private sector.

For the paradox of thrift, the right solution to the insufficient domestic demand in the Chinese economy is not mainly for the government to use up the private savings in public investments, but to set up mechanisms to channel private savings into increased private investments. This is where the entry of foreign banks will be exceedingly important. Foreign banks will be concentrating their activities in the large coastal cities, where the state-owned banks are now making the bulk of their profits. This increased competition in the profit centres of the state-owned banks could push the state-owned banks to focus on areas of banking where they have a comparative advantage over the foreign banks.

China's state-owned banks have a comparative advantage in operating in the inner provinces and the rural areas because of their existing extensive branch systems. The state banks have traditionally neglected the inland provinces and the rural areas. The number of rural banks has actually decreased in the 1985-1995 period. One reason is that the regulated interest rate for loans in China made it unprofitable to extend small loans. Large loans and small loans require the same amount of paper work and time to process. It is only natural that rural banks should charge a higher interest rate since the cost of monitoring and processing the loan is higher. But because the government-set margin that rural branches can charge above the (also government-set) lending rate in urban areas is too low to cover the additional costs and higher default risk, banks have retreated from lending in the rural areas (Woo, 2001). The liberalisation of interest rates combined with increased competition in the coastal urban markets will motivate the state banks to expand their activities in the long-neglected inland provinces and rural areas.

What has been happening in the face of strong rural industrial growth is that a lot of informal rural financial institutions have sprouted to meet the financing needs of the rural industries. Given the illegal nature of these rural financial institutions, they live under the constant threat of closure, and so they tend to focus only on the short run and take more risks. It is not surprising that these risky rural financial institutions often failed. Whenever they failed, the government had to bail them out in order to maintain political stability. The government has therefore been clamping down even harder on these illegal financial intermediaries, because it does not want to choose between the risk of bailing them out and the risk of having social instability. However, increasing strict enforcement of the ban on private financial intermediation is exactly opposite to what ought to be done. The efficient solution is to allow private financial intermediaries in the rural area, and bring them under proper prudential supervision.

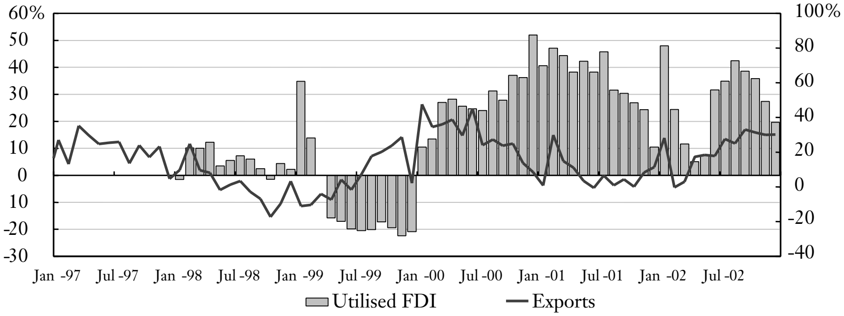
The general principle, and a trend that the Chinese government will find increasingly costly to prevent, is reducing interest rate controls and allowing private banks to come into existence. The improvement in financial intermediation induced by WTO membership can help to eliminate the liquidity trap and reduce the paradox of thrift through improved financial intermediation, and hence ease the task of macroeconomic management.[16]

The entry of foreign banks will also improve financial intermediation by enabling the transfer of modern banking technology through a seldom-mentioned channel. In the future, when a successful Chinese enterprise group establishes a bank, it will do by hiring away the local managers employed by the foreign-owned banks. This is exactly the South-East Asian experience – the top managers of the big domestic banks were all ex-employees of foreign banks. This is perhaps what the Chinese leadership sees and why it is willing to allow the entry of foreign banks, giving them national treatment within five years of WTO membership. The Chinese leadership is betting that in the short run, there could be significant displacement of Chinese state banks by foreign banks, but in the long run, Chinese banks (most likely private ones) will rise in importance. Twenty years from now, the international financial world will have more to fear from Chinese banks than vice versa.

We should mention that entry of Western banks into China's financial markets is not the same thing as capital market liberalisation. We do not believe that China would be well served by

[16] For a formal model and empirical investigation of the macroeconomic consequences of inadequate financial intermediation (in other countries, especially in Taiwan), see, Liu and Woo (1994).

Figure 4 Growth Rates of Exports, and Foreign Direct Investment (year-over-year)



Source: Citigroup (2002) updated in February 2003.

a rapid opening of the capital account since that could subject China to rapid swings of short-term capital in the same manner that has whipsawed the economies of South-East Asia and Latin America. Capital market liberalisation should proceed gradually and in stages, because it must be accompanied by sophisticated financial market regulation, something that is clearly not in place at this time. We do not relish the phenomenon of foreign banks suddenly becoming a conduit for large-scale capital flight, or for rapid swings in short-term lending and repayments, or as facilitators of bank runs (in which depositors do not merely switch banks, or switch from domestic banks to domestic currency, but actually switch from domestic deposits to foreign assets).

Finally, we must mention that there has been too little attention given to the fact that WTO membership also creates new employment, especially by ensuring the access of Chinese exporters to markets in the United States, Europe, and other regions. China's entry into the WTO will allow several big Chinese exports greater access to the markets in the United States and Western Europe, e.g. the multi-fibre agreement would be ended. Instead of China losing its shirt because of entry to WTO, Chinese textile industry would expand. Labour-intensive exports will expand more generally to offset some of the increase in imports. For the same reason, WTO membership could increase the flow of foreign direct investments into China in export-oriented sectors, and this will certainly create new (and, most likely, also higher paying) jobs. Figure 4 shows that the level of utilised foreign direct investment into China has been increasing every month since December 2000, when there was no longer any doubt that China would soon become a WTO member.[17]

6 Macroeconomic and Social Instability from the State Enterprise Sector

We have so far concentrated on the WTO-created difficulties for macroeconomic management. This is not to say, however, that the inflationary problem generated by the traditionally biggest macroeconomic destabiliser – the SOE sector – no longer exists. If anything, the SOE sector in 2003 has not only become a source of potentially greater macroeconomic instability, it has also emerged as a source of socio-political instability. To understand the origin of these negative developments, we review the Fan and Woo (1996) argument that the reform strategy for the SOE sector during the 1978-1993 period was inherently inflationary.[18]

The crux of the 1978-93 SOE reform strategy was to transfer decisionmaking power from the industrial bureaux to the state enterprises (as advocated by Oskar Lange[19]). The increased operational autonomy of the SOEs reduced the ability of the industrial bureaux to monitor the financial situation within the SOEs, and hence created the incentive for SOEs to greatly increase their demand for investment funds. The reduction in bureaucratic oversight of SOEs in a soft-budget environment allowed the SOEs to use creative accounting to privatise profits from good investment projects, and to receive state subsidies to cover losses from bad investment projects. Until about 1996, the SOEs were generally able to satisfy their large appetite for investment because the local governments, in the interest of local development, inevitably lobbied the local branches of the state banks to grant the SOEs' applications for investment loans. The evidence overwhelmingly

[17] The jump in the amount of contracted FDI had occurred earlier when China completed its WTO bilateral negotiation with the United States.

[18] See Huang, Woo, and Duncan (1999) for an account of the failure of SOE reform.

[19] See Lange and Taylor (1938).

shows that the local bank branches, at least until 1995, were unable to resist the demand for easy money.[20]

The losses at SOEs exploded after 1992 when mother Russia officially went capitalist because many Chinese SOE managers saw the same fate for China in the future, and concluded that this was their last chance to steal. This is why SOE losses skyrocketed even though GDP grew in the range of 10 to 14 percent annually in the 1992-95 period. By 1995, it was common even for government officials to say that "one-third of the country's state enterprises were in the red, and another one-third were in a latent loss-making state".[21] The academic literature, however, failed to catch up with reality by attributing the mounting SOE losses either to increased competition from the non-state enterprises (Naughton, 1995) or to slower improvements in SOE efficiency (Lin *et al.*, 1996). Although the first explanation – the competition explanation – appears to be the favourite one among traditional China-scholars, it lacks empirical validity. Fan and Woo (1996) show that the profit rates of SOEs in the sectors of industry that experienced little entry by non-SOEs displayed the same dramatic drop as the profit rates of SOEs in sectors with heavy penetration by non-SOEs. Profits in SOEs fell regardless of whether they faced competition from non-SOEs.

From the vantage point of 2003, it seems that continued inefficiency, and *de facto* asset-stripping and embezzlement of firm profits by managers and workers are the primary causes for the general decline in SOE profits, with the latter being the more important. The devolution of financial decisionmaking power to the SOEs, and the steady reduction in discrimination against the private sector have made it increasingly easy for the managers to transfer state assets to themselves. In December 1995, the State Bureau for the Administration of State Property reported that asset-stripping in the SOE sector "has been about 50 billion yuan [annually] since the early 1980s".[22] This would mean that the cumulative loss of SOE

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[20] The institutional reforms of the central bank and the state banks implemented in July 1993 as part of an austerity campaign have not been successful in changing things. Chen Yuan (1996), deputy governor of the central bank, reported that "the enthusiasm for economic growth in some localities is so strong that it is very difficult to stop completely excessive investment financed through *forced* bank credit" (emphasis added).

[21] Lin *et al.*, (1996, p. 215).

[22] "State asset drain must end", In: *China Daily*, December 13, 1995.

assets in the 1983-1992 period was equivalent to some 34 percent of the net value of fixed assets in the SOE sector as of 1992. It is hence, perhaps, only natural that of the 327 cases of embezzlement, bribery and misuse of public funds that were tried in Beijing in 1999, "76 percent took place in SOEs".[23] The increasing public outrage over the inequity of the informal privatisation of the SOE sector is well captured in the book by He Qinglian who wrote that the SOE reform has amounted to:

> "a process in which power-holders and their hangers-on plundered public wealth. The primary target of their plunder was state property that had been accumulated from forty years of the people's sweat, and their primary means of plunder was political power."[24]

By 1994, the Chinese leadership had recognised the increasingly serious economic and political problems created by the principal-agent problem innate in the decentralisation reforms of Lange-inspired market socialism, and it announced that the clarification of property rights of SOEs would be added into its SOE reform programme. The Communist Party of China (CPC) publicly committed itself in July 1997 to convert most of the SOEs to publicly traded shareholding corporations – a form of industrial organisation that originated in capitalist economies. The 1994-1997 decisions to address the loss-making SOE problem more decisively are the reasons why the employment growth rate in the industrial sector (in Table 1) fell from 2.1 percent in 1997 to 0.3 percent in 1998, and then went negative in the following years. (The restructuring of the state manufacturing industries had occurred even earlier, in 1996.)

The state's decision in 1997 to accelerate diversification of the ownership structure of the SOEs has to be recognised as a bold move because the experiences with mass privatisation in Eastern Europe and the former Soviet Union (EEFSU) show that the task is an extremely difficult one and that the outcomes have consistently

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[23] "Judicial Attention to SOEs Pledged", In: *China Daily*, February 19, 2000.

[24] He Qinglian, *Zhongguo de Xianjing*, (China's Pitfall), Mingjing Chubanshe, Hong Kong. The translated quote is from Liu Binyan and Perry Link, "China: The Great Backward?", In: *The New York Review of Books*, October 8, 1998, p. 19.

fallen below initial expectations. For example, in Russia, the "loans-for-shares" privatisation transferred the country's enormous mineral wealth to a group of oligarchs, and the weak administrative and legal structures allowed many managers to take effective control of the privatised firms and loot them instead of improving their operations. Furthermore, the EEFSU experiences warn that *mass* privatisation is an exceedingly dangerous business politically, no matter how it is done, be it outsider privatisation or insider privatisation. This is because the mass privatisation of SOEs generates so much rent that massive corruption has not been avoided, and the resulting corruption inevitably delegitimises the government, e.g. Vaclav Klaus in the Czech Republic and Boris Yeltsin in Russia.

Despite the mediocre to poor privatisation outcomes in EEFSU, privatisation has been going forward in China, albeit with occasional stops, for two main reasons. The first reason comes from John Nellis (1999) who points out that "governments that botch privatisation are equally likely to botch the management of state-owned firms". The answer is not to avoid privatisations but to implement more careful privatisations: governments in transition economies should "push ahead, more slowly, with case-by-case and tender privatisations, in cooperation with the international assistance community, in hopes of producing some success stories that will lead by example".

The second reason lies in that the delay of privatisation can be costly to China's government politically. Stealing by managers does occur during privatisation and creates a social backlash against the government, but the maintenance of the status quo has become increasingly difficult because SOE managers in China know from the EEFSU experience that they are in an endgame situation. The widespread spontaneous privatisation by SOE managers could create grave social instability.

Our opinion is that the solution to the SOE problem in China is not privatisation *per se*, but a transparent, legal privatisation process that society at large can accept, at the minimum, as tolerably equitable. Because an adequate privatisation programme must compensate the retired and layed-off workers, permit takeover by core investors, and respect the rights of minority shareholders, it is important that legal reforms be carried out simultaneously. Only with a transparent, equitable privatisation process that is overseen by an adequate legal framework, would China be likely to avoid a state-created Russian-style *kleptoklatura* that would fuel social dissatisfaction.

Recently, there has been some questioning on whether the case for privatisation has been overstated.[25] When Zhu Rongji was designated the new premier in 1997, he announced that he would solve the SOE problem in three years. In 2000, he declared victory on the SOE front when the profits of the industrial SOEs leaped from 53 billion yuan in 1998 to 241 billion in 2000. This is indeed favourable news, but should be put in context. This improvement in SOE profitability was actually part of a general phenomenon; the profits of the industrial non-SOEs increased from 93 billion yuan in 1998 to 199 billion in 2000 for a variety of macroeconomic reasons.[26] Table 6 summarises a study by Zhou and Wang (2002) who quantified the sources of the financial turnaround. They found that:

- the lower interest rate in 2000 increased profits by 52 billion yuan (28 percent of the increase in SOE profits);
- the higher oil prices boosted overall SOE profits by 79 billion yuan because almost all oil companies are state-owned (42 percent of the increase);[27] and
- the conversion of the bank loans of SOEs into equities held by state asset management companies raised profits by 10 billion yuan (5 percent of the increase).

About 75 percent of the increase in the profits of industrial SOEs in the 1998-2000 period was not due to actions taken within these enterprises but to external factors. When Zhou and Wang (2002) calculated the profit rate after deducting the profits from the more favourable external environment, they found that it had increased from 0.7 percent in 1998 to 1.2 percent in 2000 for the SOE sector, and from 2.8 percent to 4.8 percent for the non-SOE sector. Despite the recent good news on SOE profitability, the fact remains that the SOE sector still lags considerably behind the non-SOE sector in efficiency.

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[25] See Nolan and Wang (1999) for a recent assertion of a turnaround in SOE performance,.

[26] The non-SOE data exclude small non-SOEs with sales at or below 5 million yuan. Data in this paragraph are from Zhou and Wang (2002).

[27] This estimate has taken into account the additional production cost of the non-oil SOEs.

Table 6 Analysing Sources of Profit Growth in SOEs and Non-SOEs (1998-2000)

(in 100 millions of yuan and percentages)

	SOE				Non-SOE			
	1998	2000	Change	Exp*	1998	2000	Change	Exp*
Total profit	525	2,408	1,883	(100)	933	1,985	1,052	(100)
From								
Interest rate reduction			523	(27.8)			300	(28.5)
Higher oil price			791	(42.0)			-341	(-32.4)
Loan-equity swap			101	(5.4)				
Residual = Own Effort			468	(24.8)			1,093	(103.9)
Real return rate**	0.7	1.2	0.5		2.8	4.8	2.0	

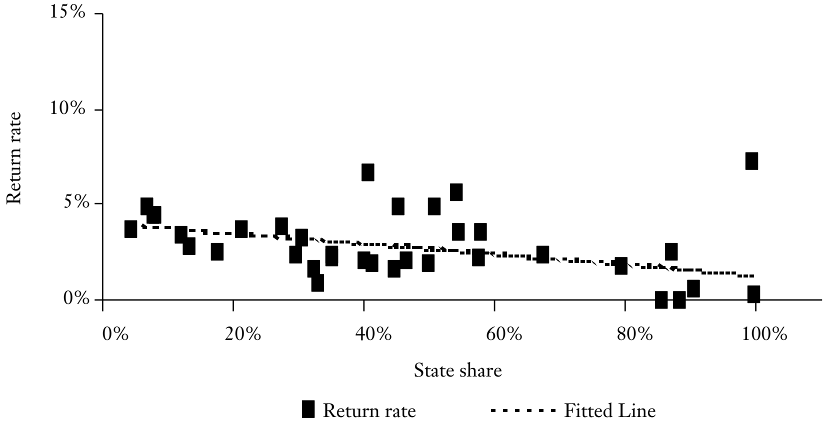
Notes:
* Data in parentheses under "Exp" are share of contribution by different factors to total profit changes.
** "Real return rate" for 2000 is calculated as the ratio of total profit, excluding profits that resulted from the three external factors, to total assets. The estimate on the effect of higher oil prices has taken into account the additional production cost of the non-oil SOEs.
Source: Zhou and Wang (2002). Some terms used here differ from the source.

Zhou and Wang's conclusion is supported by the independent evidence in Figure 5, which plots the profit rate in each of the 37 industrial sectors against the proportion of sectoral output produced by SOEs in 2000. It shows that the profit rate of the sector declined as the SOE presence in the sector increased.

To sum up, while the recent rise in profits surely gives some breathing space, the capacity of SOEs to "dissipate rents" through high payments to managers and workers, if not illegal transfer of assets, should remain clearly in the policymakers' minds. Thus, any gains could well be squandered, if not reversed, in a relatively short period of time. It is hence important for China to replace the present uncontrolled (and uncontrollable) process of asset-stripping in the SOE sector with transparent and equitable privatisation in order to improve macroeconomic stability and to defuse socio-political instability.

Figure 5 Relationship Between Profitability and State Dominance in Different Industrial Sectors in 2000

(in percentages)



Note:
Data are for 37 industrial branches. The return rate is defined as the ratio of total profit to total assets of each industrial branch.
Source: Zhou and Wang (2002).

7 Final Remarks

We have argued that China's dysfunctional financial system has imparted a deflationary bias to the economy by creating the Keynesian maladies of the paradox of thrift and the liquidity trap. The government has actively fought the deflation through an aggressive fiscal policy. Clearly, the more efficient solution is for private investment rather than public investment to recycle the pool of private savings back into the economy. This means that the key to eradicating the deflation bias in China's economy is to establish an efficient financial intermediation mechanism.

One commonly heard diagnosis is that the large amount of NPLs in the state banks have made them susceptible to periodic bank runs, and hence prevented the banks from becoming efficient financial intermediaries. In 1998, the Chinese government tried to revitalise the role of the state banks as financial intermediaries by recapitalising, but the final outcome was the creation of additional bad loans. We differ from conventional wisdom in holding that the primary determinant of bank runs in China is not the amount of NPLs in the banks but the credibility of the belief that the Chinese government can afford to bail out the affected banks. Because it appears to us that the government can afford only one more big recapitalisation of the state banks and still be fiscally sustainable, we think that as long as it continues to discriminate heavily against domestic private banks, then there is really little to be gained by recapitalising the SOBs. This suggests that one possibly effective way to slow down the pace of NPL creation in an SOB-dominated financial system and keep the fiscal situation sustainable is to keep the NPLs on the books of the SOBs, and, as suggested by Fan Gang (forthcoming), "the financial status of these loans should be constantly watched and openly discussed" in the public media.

One must note, however, that in order for Fan Gang's suggestion to work, it is necessary that the foreign banks (which will no longer face more restrictions than Chinese banks by 2008), for some reasons, will not expand aggressively out of the big coastal cities to blanket the rest of the country with branches in a short period of time. If the foreign banks do so, then their lower costs from the absence of non-performing loans will allow them to charge lower lending rates than the SOBs. This will eliminate the SOBs because WTO regulations make it illegal for the government to subsidise the SOBs against foreign competition. Our guess is that Fan Gang's method can work for as long as ten years because we think that only HSBC and Citibank are likely to actively expand their banking network in China in the next decade, and even then mostly in the major coastal provinces.

In concluding, we want to stress that beside successive rounds of bank capitalisation, there are other shocks that would undermine the fiscal sustainability of the state. One such shock would be an AIDS pandemic that would send state spending on public health soaring, and another would be massive construction to offset major ecological disasters and significant climatic changes (e.g. water shortage in northern provinces, alternative energy systems to traditional methods of burning coal). We note that the fiscal burden aside, these two examples are new macroeconomic challenges that the proven policies of China's past economic managers cannot solve. The severe acute respiratory syndrome (SARS) epidemic that is emerging at the time that this paper is being written (first draft completed in December 2002) could become a serious macroeconomic shock to China on both the supply and demand side, just like a massive oil price shock. There is no doubt that the economic costs of SARS have been greatly magnified not only by an inadequate public health system but also by structural weaknesses in information dissemination within China. The SARS epidemic is clearly showing that macroeconomic stability depends on more than just keeping focus on the traditional shocks (e.g. changes in sales taxes) to the aggregate macroeconomic accounts like the state budget deficit.

In short, the existing safety margin of 2-percentage point in China's fiscal management (identified in Section 4) is vulnerable to more than the two factors we had identified – a future round of bank recapitalisation (i.e. the second after 1998) and a rise in interest rates from financial sector deregulation. Given the many structural weaknesses in China's economic system because of its incomplete transition to a modern private market economy, this 2-percentage point safety margin might at best be regarded as minimally adequate when we consider the sustainability of China's fiscal policy, and its ability to keep the annual growth rate above 7 percent.

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4

Comment on Wing Thye Woo

Chang Kyu Lee

Professor Woo's paper is very insightful and informative and it helped me to better understand China's economy. I would like to make two brief comments.

First, Professor Woo evaluates the NPL problem in China's banking sector and analyses the debate about the potential bank-bank loans in China. Professor Woo does not see the possibility of bank loans in the near future in China. I agree with his position completely.

The NPL problem in China should eventually be tackled with NPL funds inserted by the Chinese government. As Professor Woo said, the Chinese government may have enough financial capacity to insert the second re-capitalisation of the Chinese state-owned banks. Basically, I agree with this evaluation, but even after the injection of additional capital into the banking sector, the NPL problem can re-emerge unless the Chinese banks are transformed into commercially viable entities. So in my opinion, re-capitalising alone is insufficient.

The Chinese state-owned banks should function as commercially oriented banks, not as palace banks. The opening of the banking sector after China's accession to the WTO will prompt increasing competition between China's domestic banks and the foreign banks. It will provide great opportunities to convert the Chinese domestic banks into more commercially viable entities.

Second, Professor Woo points out that China's economy has a serious problem of excess of supply. As you know, China's economy was traditionally a shortage of supply economy. That was one of the characteristics of the socialist economy – probably until the mid-

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1990s. But since 1996-1997, the Chinese economy has been transformed from a shortage economy into a surplus economy. Aggregate supply now exceeds aggregate demand. Professor Woo suggests that the insufficiency of aggregate demand was mainly caused by a poor financial intermediation system in China, and he argues that improvements in the financial system in China will help to address the supply problem. But it is well known that over 60 percent of China's population still lives in rural areas and until now, the urban-rural income disparities in China have been substantial. So I am not sure that the improvement of the financial system alone can encourage the rural areas to increase consumptive spending sufficiently to tackle the problem of relatively insufficient consumptive spending in China. The increase of rural income and the consequent increasing of consumptive spending in rural areas should be one of the essential policy priorities.

During the past two decades, China's economy has shown excellent performance. China is a solidly growing region in the sluggish world economy. A lot of factors contributed to China's rapid economic development, but generally speaking, China's liberalisation of the commodity market and, since the late 1990s, its liberalisation of the labour market, contributed substantially to the recent economic success. The next step will surely be the liberalisation of the financial markets. The development of the financial system and the financial market is a very important issue in China right now, and the new leadership in China also recognises this problem very well.

In conclusion, after accession to the WTO, some of China's agricultural sectors may feel increasing pressures. However, China should find its own new way to enhance productivity in the agricultural sector and to raise the income of the rural population.

5

Floor Discussion of "Financial and Macroeconomic Reform in China"

The Fan and Zhang Paper

Wing Thye Woo, of the University of California, dwelled on the views of those who believe that a rapid increase in the rate of urbanisation in China would lead to reproducing the horrors of Mexico City, Lagos and Calcutta. He suggested that the Chinese government could prevent this by speeding up urbanisation and, at the same time, trying to improve conditions in the countryside. "Urbanised immigration is certainly one of the best instruments for improving the distribution of income within China," he said. "What is wrong now is that the poor people are locked in their provinces because of the household registration system. So, first of all, in terms of social stability and increasing income, faster urbanisation is needed to move these people from the poorer to the richer areas. Second, such movement is also desirable for ecological reasons because a lot of places where these folks are living now are running out of water. Northern China is running out of water and instead of moving water to where the people are, you should also encourage the people to move away from these places to the southern and coastal areas. Third, urbanisation is a very effective way of improving the human capital stock because creating a good rural education system is much more expensive in scattered areas than within a concentrated space. Similarly, in order to improve the human capital stock in terms of public health, there will certainly need to be increased legal immigration and urbanisation because the present system of illegal immigration means that only the man

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moves, and this creates greater hazard for sexually transmitted diseases."

Choong Young Ahn, of KIEP, followed up on the urbanisation issue stressing that under the current household registration system, the migrant workers normally do not bring their families and their children to the cities. "Although they work in urban areas, their children are denied access to urban education, so they settle down in the cities without bringing their families and children. This is a very serious problem. If China wants to continue the build up of human capital formation, a substantial amount of fiscal resources should be allocated to the urban centres or the urban local governments to augment the existing education facilities."

Xiaojing Zhang underlined the importance of carrying out the urbanisation in a well-organised way. "Some people in China say that industrialisation is low-cost and urbanisation is high-cost. Urbanisation can indeed create social problems if we carry out this urbanisation process too quickly. For the time being, the government just pushes forward urbanisation, but I think in about 5 to 10 years we will know better how to speed up this urbanisation process and, at the same time, find ways to increase the farmers' income."

Wing Thye Woo gave an interesting explanation for the high increase in foreign direct investment (FDI) in China. "It has to be recognised that FDI is also a sign of weakness. Part of the explanation for why there has been so much FDI into China is that there was, until recently, strong legal discrimination against the private sector. There were opportunities for enterprises to be set up and export to the rest of the world, but these opportunities were not seized by the domestic capitalists and given instead to the foreign capitalists. Of course this is not unique to China, this is exactly what happened in the case of Malaysia and explains why 90 percent of Malaysian exports are carried out by foreign-owned firms. Because if a local Chinese in Malaysia would expand to become an exporting firm, he has to hand 30 percent of his assets to the government for redistribution. So legal discrimination is a particular reason why FDI has come into Malaysia and China to take advantage of opportunities that domestic capitalists could not exploit."

Masaru Yoshitomi, former dean of the Asian Development Bank Institute, wanted to know the scope of privatisation and the sort of corporate governance system the new government in China has in mind under the economic reform process. "I wonder to what extent the ownership structure of state-owned banks and state-owned enterprises will be changed to enhance the incentives for better management. Will the state continue to own the enterprises, and will management continue to be appointed by the Party or the government? So my question is about the ownership and management issue."

Xiaojing Zhang thought that it was still too early to give a clear picture of the changes in ownership and management that will occur. "With regard to the privatisation of state-owned enterprises, I think the central government should just control the very big SOEs and let the others go. Such a reform will give incentives to the local government to sell its properties. Another channel for the privatisation of China's state sector is that the foreign companies have the right to do mergers and acquisitions in China's stock market.

Regarding the changes in management, with the establishment of the new State Asset Management Commission (SAMC) the previous mode of management of SOEs will be changed. There is now only one institution that will control the personnel and the routine operation. In the past several years, there has been some experimenting in Shanghai and other coastal areas to reform the management system of SOEs. They have gained a lot of experiences and I think this will find its way in improving the management of the state-owned enterprises in the non-financial state sector. For the financial state sector, i.e. the banks and other financial institutions, setting up a new institution similar to the SAMC has also been suggested. The current reform of property rights for state-owned banks aims at listing the four big state-owned banks in the stock markets in the next three years. This will also change the corporate governance in the state-owned banks."

Charles Adams, of the IMF, had a question about the Chinese banking system and about the split between the SOE and the non-SOE sector. "What is the composition of the non-SOE sector because I understand that it is not just the private sector but includes quite a diverse range of ownership structures. My second question is about the banking system. In recent years, the non-state banks have become a more important source of credit provision. On the one hand, that might be seen as a plus in terms of credit allocation. On the other hand, I am wondering whether that makes the financial system more vulnerable."

Xiaojing Zhang explained that non-SOE is a broader term, which includes the private sector, the foreign companies and also the collectively owned companies such as the township and village enterprises (TVEs). He observed that in the last 20 years the TVEs have played a major role in China's development, but thought that times were changing for the TVEs. "Some of the TVEs have disappeared and some of them have become very large companies in the financial or manufactures sector. They tend to move from the land to the cities, so the character of the TVE is also changing. I think that the future force of growth is not going to be TVEs but rather the non-SOE sector broadly."

Concerning the banking sector, Choong Young Ahn wondered how the large state-owned banks would change their lending decisions. "On what criteria will they reallocate their limited financial resources to state-owned enterprises? Lending criteria should be evolving to commercial lending criteria, but how will these criteria be developed? Chinese scholars and policymakers are saying that the Chinese banking system is now introducing new governance schemes and international standard practices and so on, but are they really adapting to commercial banking criteria when they continue to give loans to state-owned enterprises?"

Xiaojing Zhang responded: "As long as the property rights in the state-owned banks (SOBs) have not been clearly defined, we will not have a sound credit system, nor will we be able to manage the NPLs in a satisfactory manner. The lending decisions were always controlled by the central government and this should end. If a new institution, similar to the SAMC, is going to be set up for the financial sector, and if the main goal of this new institution is making profit, and if, in addition, the property rights in state-owned banks are clearly defined, then I think the lending decisions will be much better than before."

Barbara Stallings, of Brown University, added: "Xiaojing Zhang talks about the new SAMC for changing the management of state-owned enterprises and suggests that a similar commission might be set up for the financial sector, but to me it is not at all clear what thoughts there are in China about privatisation, which is an issue of key importance. Moreover, another aspect of managing the state-owned enterprises is related to the issue of centralisation and decentralisation. My understanding is that in many areas, China has to re-centralise because the decentralisation, for example in the financial sector, created more problems, more corruption and more bad management. Why is the government advocating decentralisation when it has had such a bad experience in the past?"

Xiaojing Zhang agreed that financial institutions in rural areas had created many problems including non-performing loans (NPLs). "These local financial institutions did not lend carefully and so the NPLs increased rapidly. However, the reform objective of China's government and the way to deal with these NPLs is not to take the right of decentralised financial institutions back, but to introduce more non-SOEs in the financial sector. Not only foreign financial institutions but also domestic financial institutions. With these kinds of reforms, decentralisation will not be a problem. Our paper does not mention corruption, although it is a very serious problem in China. In the past five years, a number of high officials have been exposed. More and more official corruption has been found and this shows that the problem is quite serious. But it also shows that the government is taking the problem seriously and is trying to do its best to deal with corruption. However, if the political system cannot be changed, the corruption problem and the problem of NPLs will continue to exist in China in the near future."

Robert McCauley, of the BIS, wondered whether the decline in NPLs could be explained in part by the change in the maturity structure of the loans. Xiaojing Zhang explained that in absolute terms, the NPLs had declined only by a small amount. "But if you look at the ratio of NPLs to total loans," he said, "you will find that the ratio declined because total loans increased very quickly. The other reason indeed is that the credit-term structure changed, in the sense that short-term loans decreased and medium and long-term loans increased, thus pushing the NPL problem to the farther future."

Xiaojing Zhang concluded with a remark on the timeframe and focus of China's economic reform agenda.

"The Chinese reform agenda is a comprehensive reform agenda and some of the issues are part of a long-term agenda which you cannot finish in 20 years, especially those relating to urbanisation and employment. We should try to focus on the most urgent issues. We should probably focus on the banking system and the capital market because all of the problems we talked about – urbanisation, employment or whatever – will be reflected in the banking system and the capital market; especially the capital market, because the capital market is at the top of the property rights system. Unless we are able to establish a good capital market, the economy will not be robust. Look around the world; the US economy has the best, most robust capital market. So by focusing on the capital market we can sharpen our reform agenda."

The Woo Paper

Yung Chul Park, of Korea University, wanted to get a clearer understanding of what Wing Thye Woo meant by a liquidity trap. "If it means that the saving rate is too high, I would say that this must have something to do with the high rate of growth. Usually a high rate of growth stimulates savings and I am sure that the high rate of growth in China accounts for much of the savings increase. But Wing Thye Woo seems to give a different explanation. He says that because of inefficiency of financial intermediation, much of the domestic savings has not been channelled into domestic investment and has been flowing out of the country. However, my explanation would be that domestic savings have been channelled to finance government investment and, indeed, also to finance foreign investment in the form of current account surpluses. So if you could provide incentives to the private sector to invest more, then you might be able to reduce this investment-savings gap.

In my view, Wing puts too much emphasis on financial intermediation and the importance of the financial sector. If you look at the composition of Chinese savings, the bulk of the increase in savings in the last years has come from the corporate business sector, not the household sector, and these savings have been used to finance business investment. This is the way to look at it rather than saying that people are saving a lot of money which the banks are not able to lend. Instead of looking at the situation from the financial side, I would suggest looking at it from the real sector side and then focus on investment and the increases in savings in relation to development in the real sector."

Masaru Yoshitomi wondered what assumptions Wing Thye Woo had made about the real interest rate and about the level of government debt that would be acceptable. "If the real growth rate is 7 to 8 percent and the real interest rate is only 4 percent, this would be too low an interest rate and create a biased economy. A firm could borrow and invest a lot if it is borrowing at only 4 percent per year. The other fundamental question is what would be the maximum of deficit allowable for China without getting an explosion of debt and too high a deficit. What would be the maximum debt-GDP ratio allowable for China and for what reasons?"

Geng Xiao, of the University of Hong Kong, followed up on the interest rate issue, which he considered one of the most important issues in Asia and China. "The question is whether a low interest rate will stimulate the economy or actually lower the economic activity. When the interest rate is low, it does not differentiate good projects from bad projects, everything just goes on. That is, for instance, the worrying situation in Japan, where you have a zero interest rate and everything just goes on as usual. In the case of China, supposedly the interest rate should be high because there are so many opportunities, which is confirmed by the huge foreign direct investments in China. However, since FDI does not rely on China's domestic financial system but on the global financial market, China's interest rate is irrelevant for FDI. The domestic interest rate in China is low largely because of Wing Thye's version of the liquidity trap. That is, you have a huge amount of deposits – deposits increased from 30 percent of GDP to 160 percent of GDP during the last decade. However, there is no way you can continue a situation in which the deposits are increasing and the proportion of loans within the entire credit assets and liabilities is shrinking. Wing Thye is right that it is very difficult to carry out lending in China's domestic sector other than the FDI sector. In recent years, on average, FDI as a proportion of fixed capital formation has increased – up to 23.7 percent in 2001. This is very high and if you look at the top 9 provinces, that proportion is even higher: 43.3 percent. In the most advanced economies, FDI is almost half of the fixed capital investment. So that shows how convincing Wing Thye's story is that the domestic financial sector is not working. The reason that China continues to grow is largely because of FDI, which gets around this financial bottleneck successfully."

Xiao observed that Woo had not paid any attention to the advantage of China's population structure. "China's population today is almost exactly like Japan's in 1975, with only 7 percent of population above age 65. Today, 20 percent of Japan's population is above 65. So China has a window of opportunity for high growth for the next 20 years partly due to its population structure."

Charles Adams believed that the domestic banks in China were ill prepared for the competition from foreign banks in two or three years time under the WTO agreements. "If foreign banks are going to come in and compete seriously, then the problem will get serious because of cherry-picking and similar behaviour."

Zdeněk Drábek, of the WTO, believed that despite what had been said about the importance of FDI in China, FDI was still playing a relatively small role in the context of aggregate spending and aggregate savings. "When I look at the growth rate of investment finance by the government and the growth rates of investment finance by the state-owned enterprises, they are completely mind-boggling. This is an incredible growth. The state enterprises are over-investing, probably because credit is too cheap and because they are under no serious budgetary constraints. I would not be surprised if it is the investment boom in the public sector that is driving the growth . In that context I find it a little bit difficult to understand Yung Chul's plea for generating more investment opportunities."

Li-Gang Liu, of the ADBI, dwelled on the issue of a credit crunch. "Wing seems to indicate that the credit crunch is quite severe but the money supply growth, M2 growth, is actually quite high, more than 14 or 15 percent during the last several years. On the other hand, some firms, especially small and medium enterprises, are experiencing a credit crunch; they cannot get loans easily. This seems to indicate that there is a dis-intermediation issue in the Chinese banking system. However, Xie Ping told me that the lending rate in the last year has picked up rapidly to around 14 or 15 percent. So the question is: how do you explain this apparent paradox.

The other issue ADBI recently conducted research on is whether non-performing loans is a serious problem for China. We did a simple calculation to show that if you use a crowding-out approach, it will take many years, about 13 to 17 years depending on what level of non-performing loans you put in the banks, before China can grow out of it or not. That's why we think NPLs need to be taken care of seriously.

We also looked at small and medium commercial banks that are emerging quickly in China. These banks have rapidly growing loans catered to small and medium enterprises. So if we allow this segment of the financial sector to grow in addition to the foreign entry of banks, then perhaps this state-owned bank dis-intermediation issue could be alleviated in the near future.

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Another point that Wing hasn't mentioned here, but on which he has worked in the past, is whether China can continue the same development pattern into the next 10 or 20 years without addressing the fundamental issue of property rights."

Finally, Zdeněk Drábek asked what Wing Thye Woo would recommend as "the three most important things" for the Chinese government to do in the next year.

In his reply to the various comments, Wing Thye Woo started with Yung Chul Park's remark on the liquidity trap. "Professor Park suggested that if you look at high growth rates you always see a rising savings rate, and that the corporate sector has a lot of savings. All I am saying is that if the corporate sector could get investment loans easily, it would not need to have so much internal savings, and could have just handed out these savings in dividends. That is normally the choice: you either have the profits as retained earnings to finance future investment, or you distribute them as dividends and get them back in the form of corporate bonds. But because you don't have a functioning bond system in China, the corporate savings have to go up in order to generate the financing for the investment.

What do I mean with the liquidity trap? The credit multiplier is smaller than before. But even that is not necessarily a problem, because if the multiplier is smaller you can just increase your base money even more.

Here I come to the point of the lending rate. Why has the lending rate gone up? Since 1994, when the government leans on the banks, the banks temporarily increase their lending rate. And to whom did they lend the money? I suspect to the social stability loans and to a lot of construction companies for infrastructure in the West.

It would be a misstatement of Professor Park's point to say that China should increase investment even more. I think what Yung Chul and I agree on is that we want to change the composition of investment. It was the government undertaking the investment, but it should be more the private sector. So that would be a big change in the composition of investment. This does not happen because of the non-functioning of the banking system.

As for the problem of non-performing loans, the idea is that you could grow out of it by keeping the rate of the new generation of NPLs lower than the rate of economic growth. How do we get the

NPL problem under control? In the case of China there are basically two schools of thought. One is the ADBI approach that says: recapitalise and privatise, and the private sector will take responsibility for it. The second school is the Fan Gang approach which says: just keep the NPLs on the books of the banks and use that as a disincentive for them to lend more money but, at the same time, promote the growth of alternative financial institutions. This Fan Gang solution works only if the foreign banks do not aggressively expand branches throughout China. Because if they do, they will take away the deposits, take away the lending business. But Fan Gang's assumption is not a bad one, because I don't think foreign banks will come in massively.

Charles Adams said that the Chinese banks are ill prepared for competition with foreign banks. I think he is right, but they have got a breathing space of about 4 to 6 years, possibly even 10 years. The entry of foreign banks should be seen for what it is, a transfer of foreign banking technology to China. In the future, when a Chinese business group wishes to enter in the financial sphere, it will just hire back the local manager to run the Chinese banks.

What are the three big issues I would recommend the Chinese government tackle in the coming year? One of the things I would advocate is what Professor Lee talked about: reforming the agricultural sector. That is something that needs to be done with more imagination and in a more comprehensive manner. It needs to be handled in basically two ways: improving rural income and, at the same time, enabling big migration to the coastal areas. In agriculture, we have to use science in a serious manner and not just build infrastructure. We need to invest in a new Green Revolution, develop new species of seeds that are specific to the ecology of the region. Right now we don't have that, the poorest areas are the areas with very particular crops. We also need to invest in extension services and in irrigation technology, for example.

Second, we need to improve the rural financial sector. The number of legal financial institutions in rural areas has decreased over time, largely because of the interest rate controls. The cost of making a small loan is almost the same as making a big loan and that is why the banks have been retreating from the countryside to the cities. We need more personalised banking; we need more local banks that are under proper supervision of the central bank.

That brings me back to the earlier point about NPLs, where

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one school says recapitalise and privatise. But, actually, if you just privatise, all you do is create private monopolies because we have these agricultural banks dominating the agricultural sector. So my third recommendation would be to open up the legalisation of the banking sector. That is also an exceedingly important issue."