REFORMING CHINA'S ECONOMY

A ROUGH GUIDE

A Report from The China Project

Stephen Green

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A rough guide

THE CHINA PROJECT

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This report provides a background guide to China’s economy and an up-to-date and basic assessment of reforms so far. It is designed as an introduction to reforms and is based largely on secondary sources – many of which are listed at the end – and is divided into seven parts: an overview, macroeconomics, the agricultural sector, industrial reform, the social impact of reform, foreign investment and trade, and the financial sector. Each part is comprised of questions and answers which focus on the major issues faced by China’s economy.

An exchange rate of $1:Rmb8.3 has been used throughout.

About the author

Stephen Green is the Head of the Asia Programme at the Royal Institute of International Affairs. He holds a Ph.D. from the London School of Economics and Political Science and a First Class Honours degree from Cambridge University. His first book, *China’s Stockmarket: A Guide to its Progress, Players and Prospects* (Profile Books/The Economist), will be published in April 2003.

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1 China's economic reforms: an introduction

China's economic reforms began in 1978 with the ascension to power of Deng Xiaoping, a long-time Communist Party leader who had been twice dismissed from his posts by Mao Zedong. Agricultural reforms provided the foundation for economic growth. The quiet elimination of the communes, which allowed farmers to lease their land and to sell their produce in rural markets, enabled agricultural output to rise rapidly in the early 1980s. Rural households accumulated funds to invest in small-scale industry, and to buy the consumer goods that they produced. Local governments, suddenly able to keep a portion of the taxes that they levied on business (instead of giving it all up to the central government) became interested in investing in, and generally supporting, these new firms. With the political winds changing, people throughout the country started turning their minds away from politics and towards becoming rich – or, at least, getting by.

During the 1990s, Deng introduced the concept of the 'socialist market economy' to provide an ideological spin to the changes he was overseeing. This concept stressed the importance of markets, public ownership and, of course, the unquestioned role of the Communist Party in running the country. Some analysts argue that political reform is inevitable if economic reforms are to be fully implemented. Others point to the example of Singapore and argue that control by one party is compatible with a capitalist system.

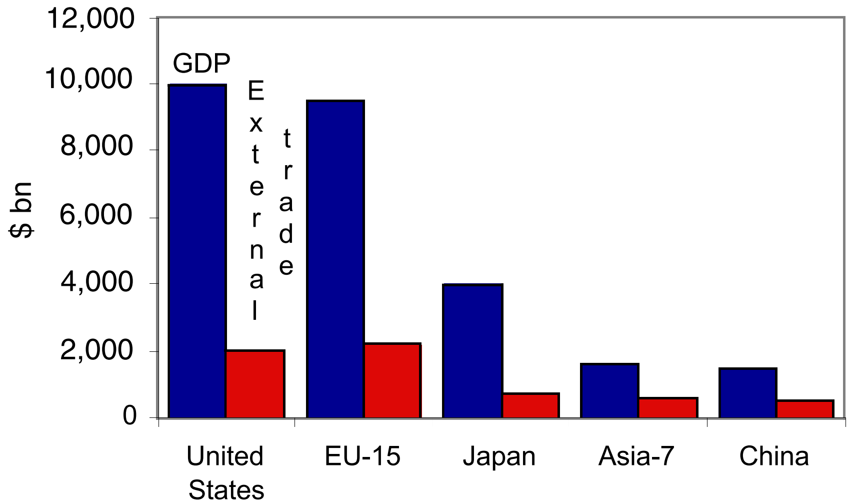
Since the late 1970s, China has experienced continuous and rapid economic growth. In real terms, gross domestic product (GDP), the total amount of goods and services produced in the country, has increased on average by 9.5% each year. In recent years, the growth rate has fallen a little, but not by much. Growth in 2002 was 8%, with some Rmb10.2 trillion worth of goods and services being produced during the year. The government's official estimate is that growth of 7-8% a year can continue for the next decade at least. However, it is likely that the secular decline in the rate of growth will mean economic growth of some 5-6% a year by 2010.The government plans to quadruple the size of its economy between 2000 and 2020, an ambitious target.

Growth has resulted in higher living standards throughout the country. Average per capita income is now approaching US$1,000, is above $3,000 in many of the richer coastal urban centres (including Shanghai), and is above $5,000 in the southern cities of Shenzhen and Guangzhou. By the end of 2001, China had an economy of $1.5 trillion, about 15% the size of that of the United States and the European Union, and about the same as the rest of Asia, as figure one shows. It was doing $550bn worth of trade a year, about a quarter of the value done by the United States and the EU. If present trends continue, China will become the largest manufacturing country in terms of gross output by 2012.

Growth has, of course, created a number of problems. The gradualist approach to restructuring has successfully limited social and political disruption, but many issues have been allowed to fester. These include loss-making state-owned enterprises (SOEs), a sector that remains partially reformed, and an increasingly fragile banking system. China has experienced growing inequality of incomes in the 1990s between the coastal provinces such as Jiangsu and Guangdong where market reforms have been most radical and where foreign investment is concentrated, and the poorer western and central provinces. There is also a growing divide between urban centres and the countryside, as well as intra-urban inequalities as rural-urban migration continues. This is a major concern for town and city governments. The government has struggled to find alternative delivery methods for healthcare, pensions, schooling and housing, all services previously provided by the state via the SOEs. Another problem is the environment: terrible damage has been done to water supplies, to air quality, and to forested areas, and there appears to be little hope that things will improve in the short term. Such issues will increasingly constrain growth in the near future.

China is now a member of the World Trade Organization (WTO), having joined in December 2001. This is the first time the government has been constrained in its economic policies by an external agreement since the treaties that ended the opium wars of the nineteenth century. Gaining WTO membership involved China

Figure 1: China and the rest of the world compared in 2001



Note: Asia-7 is comprised of Indonesia, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.
Source: Goldman Sachs, *The Five Great Myths About China and the World (Part I),* May 2002, p. 7.

in making further deep concessions in its trade regime and foreign investment rules. As the concessions start to bite, there will be additional stress for loss-making SOEs and in the countryside, as both industrial subsidies and grain prices fall.

China's leaders, however, had a number of very good reasons for joining the WTO. They wanted to guarantee access for their exports to foreign markets, to render their trade relations with the United States less sensitive to political manipulation and to gain a voice at the negotiating table when global trade rules are formulated. Most of all the supporters of WTO entry, including most prominently Zhu Rongji, premier between 1998 and 2003, wanted to guarantee further reform and opening up.

Most economists believe that WTO will, over the long term, have a positive impact on China's economy. It will introduce greater competition, force more inefficient firms to the wall, encourage foreign firms to upgrade their China operations, introduce more technology, and open up export markets. According to Elena Ianchovichina and Will Martin, economists with the World Bank, WTO membership will increase China's national income by some $28.6bn by 2005. They also predict that China's entry will have a positive effect on most of the economies of the developed world (although South Asia will suffer). Their projections are shown in table one. However, the benefits will be distributed unevenly. Many people in China will experience considerable hardship, most notably the farmers, many of whom will migrate to the cities.

Table 1: Welfare changes due to China's WTO accession to the WTO

	Income in 1995, $ bn	Income change due to WTO membership, 1995-2005, $ bn	Income change due to WTO as a share of base 2005 income, %
China	714	28.6	2.2
North America	7976	19.7	0.1
Western Europe	8650	9.5	0.1
Japan	5095	7.1	0.1
East Asia	1448	12.5	0.6
South Asia	441	-4.0	-0.6

Source: E. Ianchovichina and W. Martin, *Trade Liberalisation in China's Accession to the World Trade Organization*, World Bank, 2001, p. 27.

China's rise is also a cause for concern in other parts of Asia. Some claim that China is absorbing so much foreign investment and dominating key export markets so successfully that it is stealing away growth from the rest of Asia. Like the tigers economies before it, China is rapidly moving up the technology ladder into electrical goods such as LCD monitors and laptop computers. Unlike the Asian tiger economies, however, China is not simultaneously vacating the labour intensive markets for goods such as textiles and toys. The country's labour supply is huge, a factor that keeps wages low, and which allows China to retain competitive advantage in these sectors as it develops its capabilities in higher-end sectors.

However, China's rise is not everything it appears to be. Much of its high-tech production is foreign owned – or consists simply of assembling high-tech goods from Japan or Taiwan. For relatively well-developed Asian economies, China is a useful outsourcing site. Moreover, rather than beggaring the ASEAN region, China's growth is creating demand for ASEAN exports. It is likely that if they engagedin restructuring on a scale comparable with China's, they could grow in a positive, mutually beneficial relationship with China, and boost their FDI inflows.

2 China's macroeconomic performance

What is driving growth in China?

Being a continental economy, China weathered the 2001 – 02 global slowdown better than all of its Asian neighbours. Demand for China's goods and services comes mainly from the domestic economy, and much of it is funded by government investment. Rmb2.6 trillion was spent on fixed asset investment (FAI) – things like roads, bridges and natural resource development – by the state and state-owned entities in 2002, an increase of 23% year-on-year. Total fixed investment was over Rmb4 trillion. Fixed investment made up 38% of GDP in 2001, as table two shows, and most likely a similar amount in 202. In 2002, another Rmb150 billion ($18 billion) of special Treasury bonds were issued in an effort to raise public funds to continue the spending. The government needs to stimulate domestic demand further, so similarly high levels of FAI – and T-bond issuance – will continue into 2003 – 04.

Table 2: The constituent parts of GDP in 2001

Constituent of GDP	% of GDP at market prices
Private consumption	45.5
Government consumption	12.4
Gross fixed investment	38.1
Stock-building	1.8

Note: GDP measured at current market prices.
Source: Economist Intelligence Unit, *China Economic Forecast*.

Part of the problem is that consumer demand is fragile. One of the consequences of economic restructuring is that considerable uncertainty about the future is created. With the government withdrawing from services such as healthcare and pension provision there is an increased onus on individual saving, to the detriment of spending. During 1999-2000, there was mild deflation – falling prices – and after a brief respite deflation returned in 2002. Consumer prices fell 0.8% over the first nine months of 2002 compared to the same period of 2001. (This was despite some signs that private investment was picking up. Official data shows that private investment rose at about 18% in 2002, twice as fast as during 2001.) Deflation is dangerous since it discourages spending as consumers put off spending decisions to a time in the future when they expect cheaper prices. With demand curbed, firms' sales weaken and employees are laid off. With fewer people employed, fewer goods are purchased, and so a vicious circle of deflation and low growth is created. As well as boosting public investment, in 2002 the government has lowered interest rates and increased public employees' salaries (the fourth increase since 1999) in order to stimulate domestic demand.

During 2002, increasing levels of exports and FDI came to the fore in promoting growth. Exports increased by nearly 20% in 2002, and FDI also grew to some $55 billion. As China has opened up its economy to international trade and investment, it has profited from increased demand for its goods as well as access to the capital that foreign investors bring. Sustaining the growth effects of these two factors was the key aim behind securing WTO entry. In the absence of an effectively functioning banking system, foreign direct investment (FDI), investment in fixed assets which entails taking an ownership stake in a firm, has provided some $400bn in capital to new firms since 1978, a crucial resource to the private economy. Manufacturing has grown at a 10-15% rate for the past decade, and about one fifth of total manufactured output is produced by foreign-invested enterprises (FIEs) which export their products. China's exports increased by nearly 20% in 2002 (while global trade slowed to a low single-digit figure). During 2002, increasing levels of exports and FDI came to the fore in promoting growth—and alongside public investment, they will remain the main drivers of growth as long as consumer spending and private investment remain fragile.

Is growth sustainable?

China's fast growth is only sustainable if it is based on improvements in productivity. Economic growth – an increase in the amount of goods and services produced – occurs for a number of reasons. (The economics profession continues to debate their relative importance). Some growth is the result of the accumulation of key factors – capital and labour. An increase in the size of the labour force will result in more goods being produced. Alternatively, an increase in the amount of capital will, other things being equal, result in more machines being bought and more goods being produced and so is another possible source of growth.

However, growth still occurs without more capital or labour being added to the economy. Economists explain some of this by increases in 'human capital'—a better-educated labour force will produce more things. But there is often some growth that cannot be explained by this factor either. Economists then turn to productivity. Productivity is a measure of the efficiency of the use of inputs. Better technology and more efficient working practices mean that the same amount of inputs can be used to produce more outputs without more capital or more labour being used. Over the long term an economy will only grow if there are sustained improvements in productivity.

The key issue, then, in predicting whether China can sustain growth is to look at productivity improvements. Is growth in China purely 'expansive' – in other words, does it result only from more capital and more labour being employed in the economy? Or is it intensive, relying on productivity improvements. Answering this question is tricky since accurately measuring productivity growth in China continues to be frustrated by data constraints. However, some efforts have been made.

Table 3: Sources of growth in China and its neighbours, 1960 – 2000 (Proportion of growth explained by each factor, %)

	Capital	Labour	TFP
China	47	13	40
South Korea	45	43	12
Taiwan	40	40	20
United States	45	42	13

Note: Figures for China are for 1978-95.
Source: K. C. Yeh, '*China's economic growth: recent trends and prospects*', in *China, the United States and the Global Economy*, Rand Corporation, 2001, p. 74.

Table three suggests that productivity has indeed increased during the reform period – something most studies agree on. This is due to a number of factors. First, during the 1980s there was a huge shift of workers from agriculture into industry, which resulted in people engaging in much more productive activities. Second, China's economy benefited tremendously from opening up. FDI brought in new technologies and managerial techniques that increased efficiency. Third, because of the shift in incentives that the market economy brought about, income has been far more strongly tied to output. This has created incentives for people to work more efficiently. Most of these factors are, however, 'one offs' – they have come about as a result of the shift away from socialism to the market. This explains why productivity growth between 1960 and 2000 has been so much greater in China than in more developed countries.

What matters now, however, is whether productivity continues to grow, and there is some disagreement on this question among academics. Some studies have shown productivity growth still at high levels, accounting for over half of GDP growth in the 1990s. Other studies show that productivity is still on the rise, albeit at a much lower rate. The World Bank, for instance, decomposed the annual 10.2% growth rate during 1985 – 94 into three parts: 6.6% was explained by factor accumulation, 1.1% from labour reallocation from rural to urban areas, and 2.5% from total factor productivity (TFP) growth. Others claim that overall productivity actually fell during the 1990s.

Looking to the future, however, there are reasons to be positive about productivity growth. As state firms are privatized and closed down, it is likely that overall productivity gains will be reaped. WTO will promote technology transfer and continuing rural – urban migration will mean a more efficient allocation of labour. Better allocation of financial resources through banks and the stock market would also improve the efficiency of allocation of China's huge capital resources.

Are China's statistics reliable?

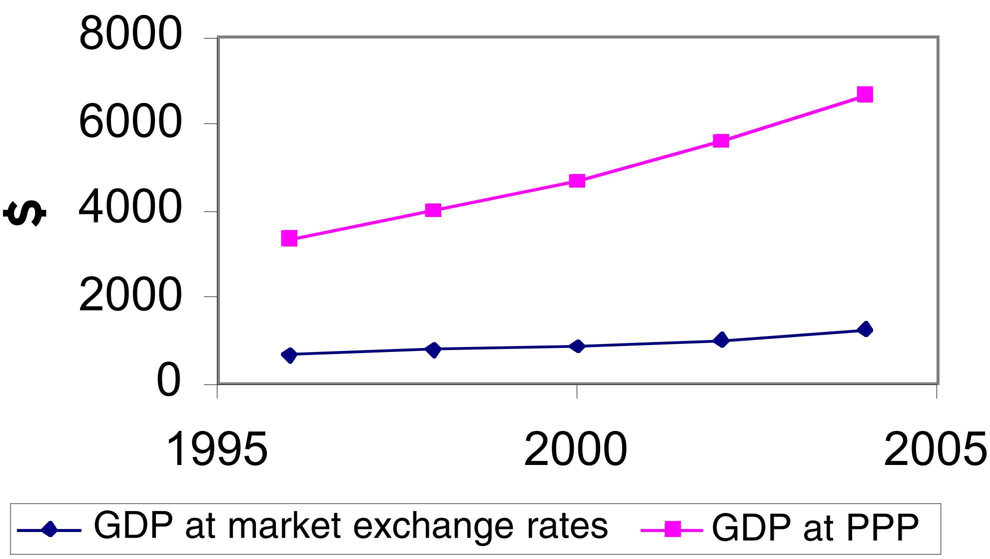
Several commentators have cast doubt on the accuracy of some of China's official statistics. Most of the criticism focuses on the GDP and unemployment figures. There is near universal agreement that the latter (official rate: 4%) are completely bogus, but there is much debate over the veracity of the former. A feeling for the problems can easily be gained by looking at the provincial growth rates for 2000: only two provinces reported growth below the national rate of 7.8%. How can this be?

Economists at the major multilateral institutions are thought to informally discount about 1.5 and 2.0 percentage points from the annual GDP growth figure to take account of over-reporting by local officials. Other economists make more radical adjustments. Thomas Rawski has argued that during 1998 – 1999 China's annual GDP growth was actually between -2.5% and 2.5% (although he admits that these numbers are only guesses). He bases his estimate on output reductions in many industrial sectors; tens of thousands of lay-offs; falls in the increase in air travel (despite huge price-cutting by the airlines); and low levels of energy use during this period. It should also be noted that the country was experiencing mild deflation during some of this period, something that does not usually occur when there is economic growth, especially at the officially claimed rate of 7–8%.

Others, however, disagree and believe that most of China's data, including the GDP growth number, is basically correct. Other alternative proxies for growth can be used to substantiate the offcial growth figure. Compound GDP growth of 34% for 1998 – 2001 (the official figure) sounds reasonable if one looks at tax revenues (which increased 90% over the same period) and imports (up 70%). The debate remains unresolved – and the truth lies probably somewhere between the official figures and those of Rawski.

Another statistical issue is the use of purchasing power parity (PPP) estimates for sizing up China's economy. To claim that China is the world's second largest economy on the basis of PPP measure is a bogus claim. PPP estimates are useful for understanding per capita income in context. By stripping out the value of the local currency/$ exchange rate an estimate of the relative wealth of an individual can be gained. The PPP figure allows a comparison of the standards of living of an average Chinese with a Nigerian, a Malay

Figure 2: Comparing per capita GDP figures



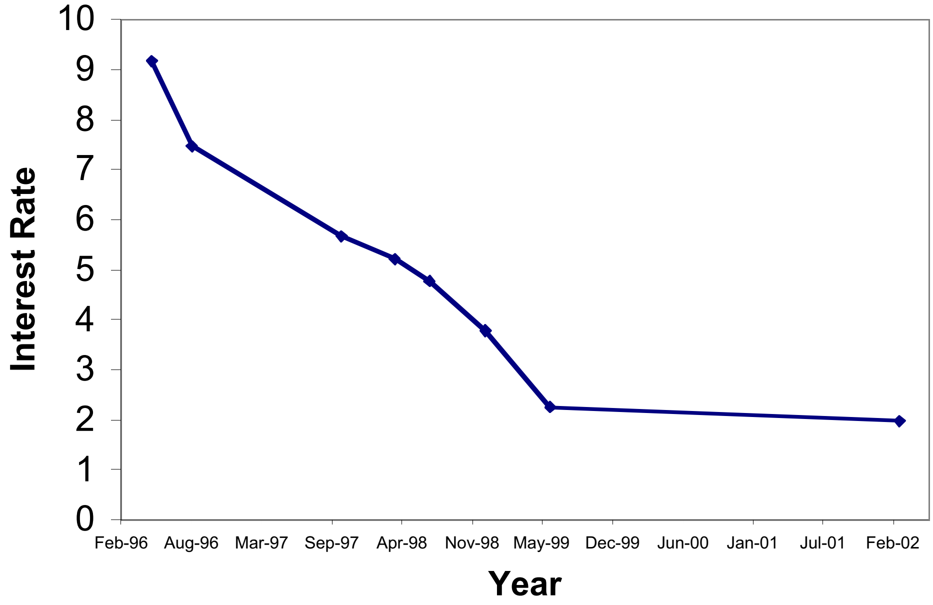
Source: Economist Intelligence Unit, *China Economic Forecast*.

or an American.While China's GDP per capita based on current exchange rates is some $1,000, on a PPP basis it is $7,000, as figure 2 shows. PPP should not be used for comparing countries. Nor is the PPP methodology useful when talking about investment in the China market – PPP estimates exaggerate the purchasing power of consumers. It matters a lot to Nestlé and Proctor and Gamble whether the average Chinese has an income of $1,020 or $5,600, the market exchange rate and PPP per capita numbers for 2001, and for their purposes it is the former figure that counts.

How are interest rates set and why are they so crucial?

China's interest rates are set administratively by the PBoC. The one-year deposit rate is currently 1.98%, as figure 3 shows. Banks charge rates within narrow bands based on a base rate set by the PBoC. They can, for instance, set rates 30% higher than the PBoC fixed rate when lending to small and medium-sized enterprises (SMEs), but only 10% higher when lending to SOEs. Foreign banks are also constrained by these rules.

Figure 3: Variations in the one-year household deposit savings rate, 1996 – 2002



Source: PBoC.

Interest rates are set lower than the market would dictate, a common feature in countries with large amounts of industry is in public hands. This is because a 'repressed' interest rate allows SOEs to receive subsidized loans. The effect is that private savings (which stand at over Rmb6 trillion ($700 billion)) are 'taxed'. While in the short term this system allows SOEs cheap financing, it does long-term harm to the economy. Value-destroying SOEs receive cheap loans (whereas in a market economy they would not make sufficient returns to make the repayments) and productive non-state firms are closed out of the market for credit. In addition, price signals throughout the economy are skewed.

The PBoC recognizes the costs of this financial repression and is planning a gradual move to market-based interest rates. Allowing rates to rise would improve the efficiency with which capital is allocated and help weed out bad borrowers. The central bank cannot move quickly however. Many state-owned enterprises depend on bank loans for their working capital – if lending rates were to rise it would place them under even greater financial strain.

Some foreign currency rates have already been liberalized. During 2003, the PBoC will probably begin relaxing other rates, starting with widening the band in which rural co-operative banks can lend (probably to some 70% of the PBoC's base rate). In late 2002, the PBoC applied to the State Council for approval for a system that would allow the banks more latitude in setting interest rates for SME borrowers (many of which are privately owned). Bank managers are often reluctant to lend to such non-state firms. One reason is that they cannot price loans in such a way as to take into account the risks involved. If the banks can gain greater flexibility in the rates they offer, more loans to non-state firms should result. After lending rates are relaxed, deposit saving rates will gradually follow.

Is the renminbi over- or under-valued?

While the Chinese currency, the renminbi, is convertible on the current account (for trade transactions), it remains controlled on the capital account (for investment in financial assets). This means that it is impossible for Chinese individuals and businesses to buy hard currency freely with their renminbi, or to transmit money abroad. It also prevents speculation on the renminbi.

The closed capital account helped during the 1997 – 1998 Asian financial crisis (AFC) when direct attacks on China's currency were impossible and ordinary Chinese could not escape into dollars, as ordinary Thais, South Koreans and Indonesians did when their currencies came under pressure. The AFC, as well as recent events in Argentina, suggest that there are very real dangers in liberalizing the capital account while the domestic financial sector of a country remains under-developed. There is no reason to expect any change in China's stance on this issue for at least five years, and probably longer: the capital account will remain closed. This means continued frustrations for foreign investors who often have problems remitting capital out of the country.

Official policy states that the renminbi moves in a band with a basket of other currencies. In practice, the renminbi is fixed to the US dollar at a rate of Rmb8.27:$1. There were fears during 1998 – 1999 that the government would devalue the currency, in order to allow Chinese exporters to compete more effectively with the exports of countries whose currencies had devalued during the AFC. However, the Chinese leadership chose to retain the rate, winning international plaudits for not plunging the region into even greater financial turmoil. Little damage appears to have been done by that decision. The World Bank believes that during 2000 – 2001 the renminbi had around the same level of competitiveness with the currencies of its neighbours as it did in 1996.

Indeed, there is a feeling in many parts of Asia that China's currency is undervalued – look at the trade surplus, they say: some 2% of GDP at year-end 2001. Macro-economic theory suggests that since there is more demand for Chinese exports (than China's demand for imports), the renminbi should naturally rise in value, by some 10% according to Goldman Sachs. There were calls by Japanese officials during 2001 – 2002 for the renminbi to appreciate, because cheap Chinese exports were apparently undercutting those of Japan.

In recent months the Japanese government has urged Beijing to take measures to curb deflation by loosening currency controls and allowing the renminbi to appreciate.Chinese officials have responded by defending the renminbi rate and warning that yen devaluation would have a destabilizing effect on Asia, with other governments being forced to devalue their currencies in response.Some widening of 'the band' in which the renminbi is allowed to move is expected (and would be advisable), but it seems unlikely that the government would allow a significant appreciation, as this might well damage exports, one of the main engines of growth at present.

There is some debate over whether the renminbi would fall or rise if the rate were floated and the capital account were opened. Most commentators predict appreciation. While the current account (trade) surplus suggests that it would indeed appreciate, there is a strong suspicion that, given the chance, most middle-class Chinese would trade some of their savings into dollars at the earliest opportunity. If this happened on a significant scale, the renminbi would quickly devalue.

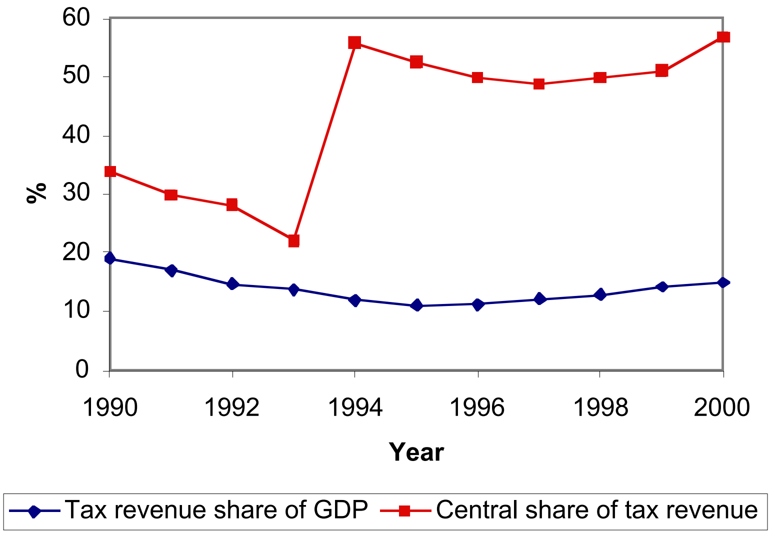
Is the government collecting enough tax?

China's central government has had huge problems in collecting the revenues it needs to sustain its expenditure and to control its deficit. One of the reasons for this is that in the 1980s the government rejigged the tax system in order to promote growth. Another reason is that central and provincial governments have engaged in a long-standing tug-of-war over who gets to keep which revenues. Good progress is being made, however, in moving towards a more rational and effective tax regime.

In the early 1980s a tax-contracting system was rolled out under which each provincial government negotiated a tax quota with the Ministry of Finance (MoF). Provinces remitted a set amount of tax to the centre; and any surplus was retained. Such a system of fixed contributions meant that provincial governments benefited from economic growth in their areas and had an interest in supporting local enterprise.

This approach had some problems, however. While it apparently did encourage growth, negotiating the quota each year was a time-consuming and difficult business. Special deals proliferated and provincial and central leaders argued about which types of taxes they each had jurisdiction over. As a result, the government's gross revenues fell as a proportion of GDP – down to 11% of GDP in 1995. Governments in other developing countries tend to collect 25 – 30% of GDP in taxes. Another bit of bad news was that the central government's share of the total tax take plummeted from 38.5% in 1985 to 22% in 1993. Figure 4 shows the dramatic fall in both ratios.

Figure 4: The two tax ratios, 1990 – 2000 (%)



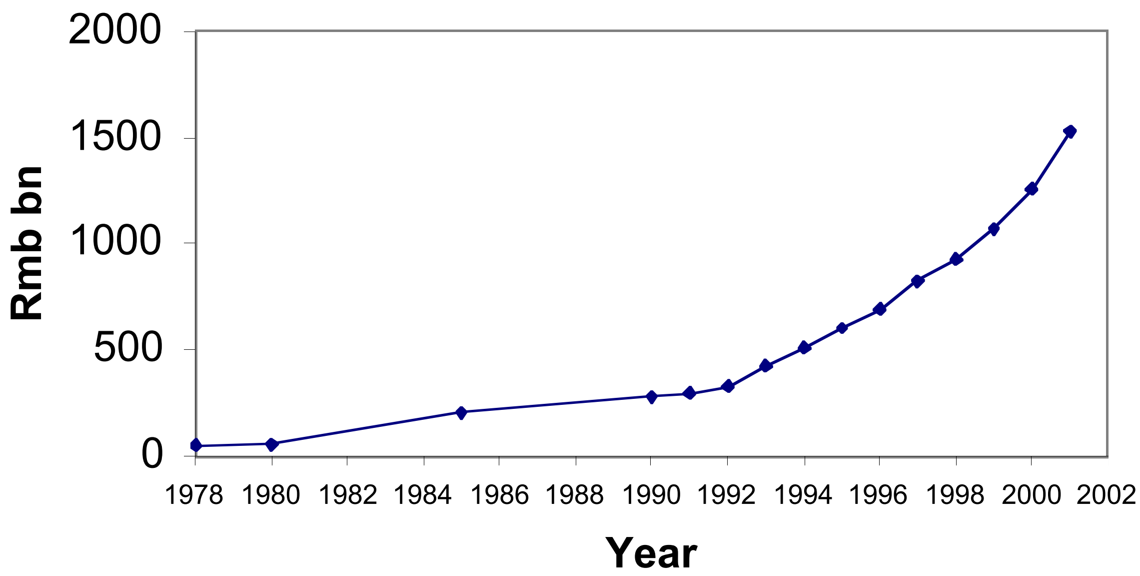
Source: World Bank.

In 1994, the central government decided that enough was enough and reorganized the tax system. Taxes to go to central and local governments were clearly delineated. For instance, import duties went to the centre, personal and business income tax to local government, stamp taxes on share trading were to be shared. All taxes now go to the central government first, and are then distributed. The reforms increased both the state's total revenues and the centre's share (as figures 4 & 5 show). Tax revenues in 2002 totalled some Rmb1.7 trillion, an increase of 12% on 2001. The centre received Rmb1.0 trillion, and local governments received Rmb 661 billion. Total tax revenues are now equivalent to 17% of GDP, and the centre's take is over 50% of the total. Both ratios continue to move in the right direction.

However, the 1994 tax reform also had a number of negative side effects. To persuade the richer provinces to implement it, large rebates had to be promised. Of the Rmb558bn collected by the central government in 1998, Rmb343bn was transferred back to the provinces, most of it to Shanghai, Guangdong and other prosperous places, rather than to the poorer provinces that needed it most.

Another problem is the imbalance between rights to revenues and responsibilities for spending. While the central government's revenues have increased since 1994, its spending commitments have barely budged. It accounted for 33% of total public spending in 1990 and 35% in 2000, leaving local governments of one sort or another – provinces, prefectures, counties and townships – with responsibility for spending on most areas of social welfare but with reduced resources. China's 2,109 counties and 44,741 townships currently pay 70% of all budgetary expenditure on education and 55 – 60% of total expenditure on health. The World Bank recommends that local and central governments share health and education spending, and that the spending responsibilities of the different levels of local government are clarified and matched with revenues.

Figure 5: Total tax income (Rmb bn)



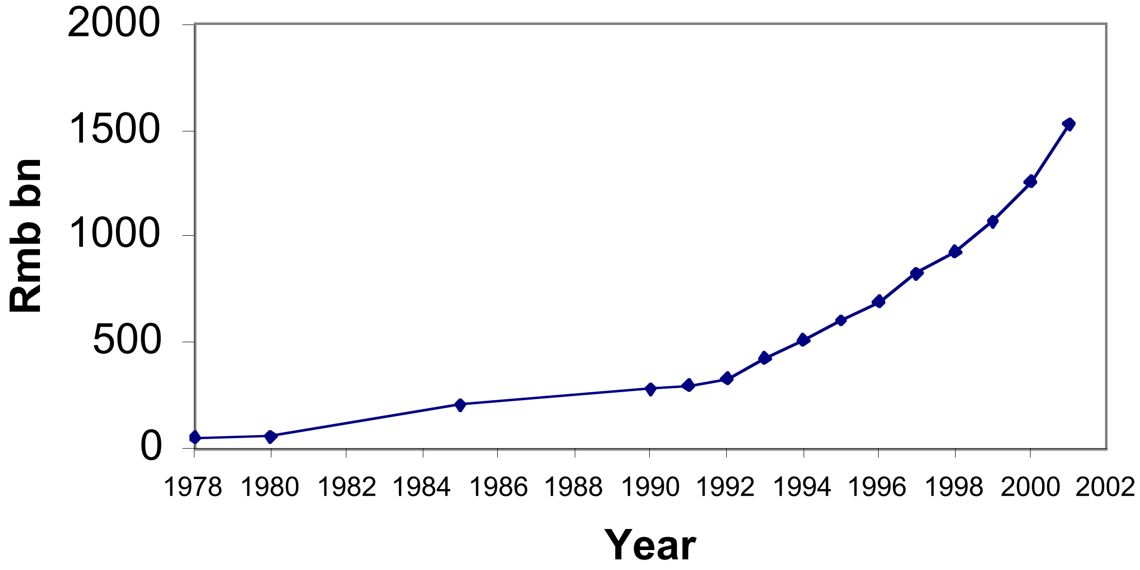
Source: China Statistical Yearbook 2002.

Another idea that has been floated for the tax system is a measure of decentralization. Local governments now have very restricted tax-raising powers, and are often forced to send more money to the centre than the official rules require. As a consequence they continue to levy taxes and fees on an ad hoc basis and channel the revenues into what are known as extra-budgetary fund accounts. These semi-official budgets are thought to be worth around 40% of official local revenues and are therefore an important source of finance. If local governments at levels below the province were given some control over local rates, however, then revenue collection would be made more transparent, and local administrations could link their taxes to their welfare spending more easily.

3 The agricultural economy

Economic reforms began in the countryside with the creation of leased smallholdings and produce markets in the late 1970s. However, after the growth spurt in rural incomes in the 1980s, the sector has experienced slower growth. Figure 6 shows the rapid increase in agricultural output during the 1980s, and a levelling off in the 1990s. While farmers account for 50% of the total workforce, agriculture only accounts for some 25% of GDP. Agriculture is a major headache for the leadership.

Figure 6: Gross output of the agricultural sector, 1978 – 2001 (Rmb bn)



Source: China Statistical Yearbook 2002.

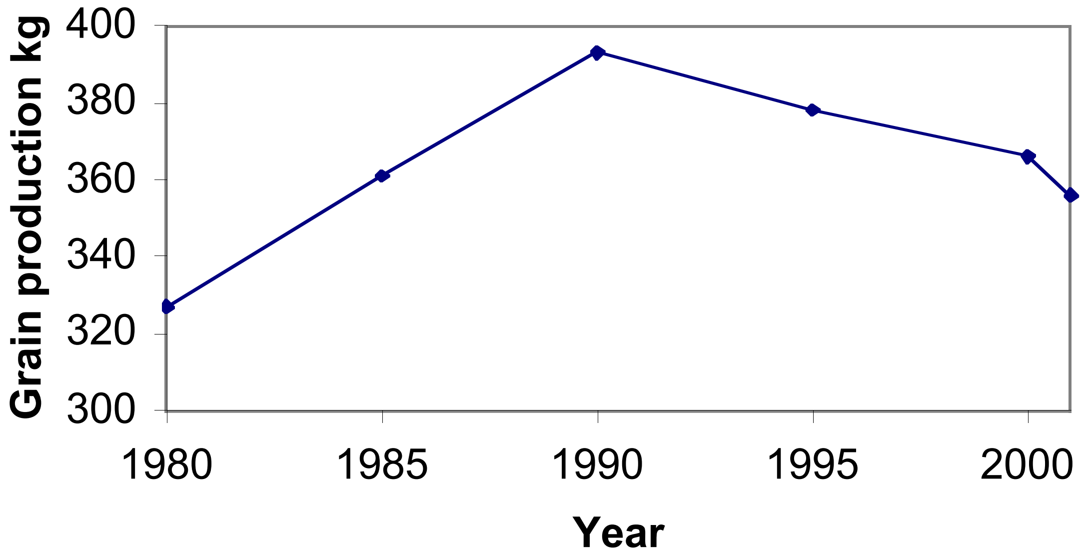
What ails the countryside?

After an increase in grain production in the 1980s, from 327kg per capita in 1980 to 393kg in 1990, production has since declined. Only 356kg of grains per capita were harvested in 2001, as figure 7 shows. A number of factors have contributed to the slowdown in the agricultural economy. A lack of investment (especially in micro-finance for farmers), a downturn in manufacturing activity (thanks to the boom and bust in the early 1990s of the township and village enterprise (TVE) sector), and poor education and health services all undermine rural growth. Many peasants exist on average annual incomes of less than Rmb500. Another problem for farmers is the ad hoc fees levied by local officials. The central government has attempted to put a stop to this by proposing larger fiscal allocations to the localities in return for the abolition of these fees, but so far the policy has been resisted by local leaders.

One of the key structural problems in agriculture has been the lack of a land market. Farmers still lease their land from the state for 30-year periods – private ownership is not allowed and thus the consolidation of small inefficient plots is impossible. The government remains opposed to land privatisation for at least two reasons. First, there are basic ideological objections to the privatization of land. Second, many officials worry that if land is sold and plots are consolidated there will be no safety net for the millions of farmers who move to cities in search of work and then return.

In response the government has recently amended legislation to allow the subletting of land. from March 2003, farmers will be free to sell their land use rights for any or all of their 30-year lease. This could have a tremendously positive impact if local cadres allow the markets to develop (previously they have abused their rights to re-allocate land to sell land on to developers or consolidate holdings in their own hands. Being able to sell their leaseholds will allow farmers to realise some value from their land, and even to use it as collateral on bank loans for investment in other activities. The hope of the government is that this leasehold market will mean that privatisation of land is not needed.

Figure 7: Production of grain, per capita, 1980 – 2001 (kg)



Source: China Statistical Yearbook 2002.

What impact will WTO have on rural areas?

One fear associated with China's WTO entry is that imports of grain will increase and lead to lower prices being paid to China's farmers. That will place further pressure on rural incomes that are already growing at a slower rate than urban ones. Another problem for farmers is that productivity gains on the farm have been passed down to consumers in the form of lower prices rather than being translated into real wage growth in the countryside. Some surveys suggest that rural incomes have stagnated during the 1990s. Others show small increases in rural incomes, mildly accelerating in recent years. Urban wage earners saw a year-on-year wage boost of 17.5% to the end of June 2002, in comparison to 5.9% for workers in the countryside.

In an effort to boost production in the early 1980s, grain prices were increased by the government in order to stimulate production. However, in preparation for WTO entry (and the expected tough American negotiating stance on agricultural trade), the government brought domestic grain prices down by some 20 – 30% in the late 1990s. They still have further to fall.

One way to survive is for farmers to move to higher value-added produce. China is already the largest producer of many labour-intensive vegetables, including garlic, onions, potatoes, spinach, tomatoes, apples and grapes. Total exports of fruit and vegetables in 2001 were worth $3.7 billion. However, it will take several years for the majority of farmers who can convert their land to do so, and many cannot. Improvements to rural infrastructure, storage facilities and quality standards are also required if China is to significantly increase such production.

The government appears ready to defend farmers from any sudden rush of imports. In 2001 it trial tested WTO rules, and the United States' ability to defend them, when the Ministry of Agriculture introduced dubious safety approval procedures to cover genetically-modified (GM) soya imports from America. Soya grown in China is around 40% more expensive to produce than in North America, and yields in China are much lower. The rules required exporters to China to acquire a licence, but did not detail what they needed to do to obtain that licence. The dispute was resolved in early 2002 in the United States' favour, with the safety regime being watered down sufficiently so as to not interfere with imports.

Some improvements in rural areas appear to have occurred in 2001-02. The World Bank reports an increase in rural income of 4.2% and an increase in spending of 6.9% (compared to 8.5% and 6.1% for urban areas) in 2001. A smaller tax burden, lower telecoms and electricity prices and greater investment in infrastructure appear to have had some effect.

4 The industrial economy

Under the plan economy, all significant industrial assets were owned and managed – or rather mis-managed – by the state. Funds were distributed to industrial units from the budget and the outputs of SOEs were distributed via the plan to other SOEs. There was no sense of profit or loss, or of the real cost of inputs (including capital). No one was accountable for the success or failure of the firms. Unlike in the Soviet Union, provincial authorities administered most SOEs rather than central ministries, an arrangement that had profound consequences for how industrial reform in China was organized.

How have SOEs been reformed?

Reforms to SOEs have taken a series of different forms since the 1980s. Early efforts focused on devolving more powers down to enterprise managers and giving them profit incentives while the state retained ownership. In the late 1980s and 1990s, however, attention turned to reforming ownership arrangements. With the *zhuada fangxiao* ('grasp the big, let go of the small') policy introduced in 1994, the State Council determined to sell off, bankrupt or contract out small and medium-sized SOEs, those mostly owned by sub-provincial-level governments. Over 38,000 small industrial SOEs have disappeared since 1995: many of them were bought by their employees and became "joint-ownership" enterprises.

The preferred route for reforming large SOEs has been *gufenzhi* (shareholding) reform. The SOE restructures, issues shares and creates two boards, one of directors and the other of supervisors. However, crucially, the state has maintained majority stakes in these firms, and their performance has not been impressive. By the end of 2001 there were 5,692 shareholding enterprises in China, the majority of them large and medium-sized SOEs that had restructured. They now account for nearly one-fifth of industrial output, as table 4 shows. By year-end 2002, some 1,200 large shareholding enterprises had been listed on Mainland China's two stock exchanges. A number of large former SOEs, such as China Unicom, the second largest telecoms firm, and PetroChina, one of China's largest petrochemical firms, are listed in New York and Hong Kong.

Table 4: A breakdown of China's industrial firms in 2001

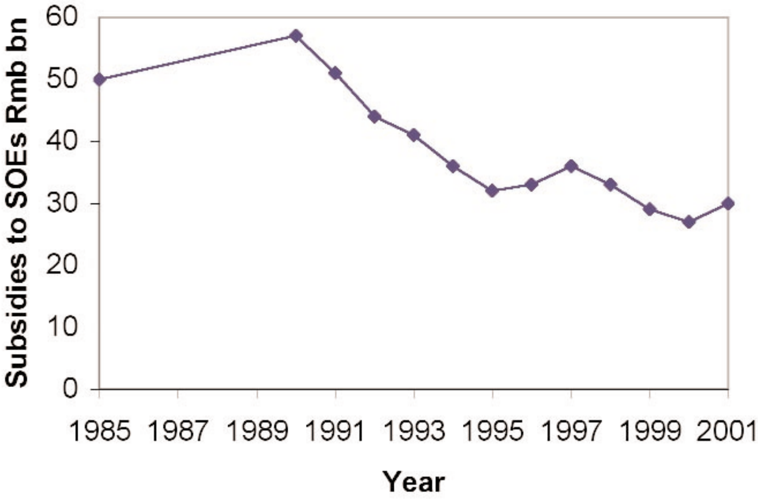
	No. of firms	Gross industrial output, Rmb bn	Share of industrial output, %
State-owned enterprises	34530	1723	23
Collectives	31018	1005	13
Co-operatives	13864	299	4
Joint-ownership enterprises	2234	85	1
Limited liability enterprises	18956	1554	21
Shareholding enterprises	5692	1270	17
Private enterprises	36218	11	0.1
Foreign-funded enterprises	13166	1537	21

Source: China Statistical Yearbook 2002.

Unrestructured SOEs retain a significant place in the economy. There were some 34,530 of them still operating, accounting for over one-fifth of industrial output in 2001. Since 1994 they have been increasingly forced to borrow from the banks at commercial rates as their budgetary funding has dwindled. Budgetary subsidies to the SOEs have fallen from Rmb50bn in 1985, but appear to have stabilized at around Rmb30bn, as figure 8 shows.

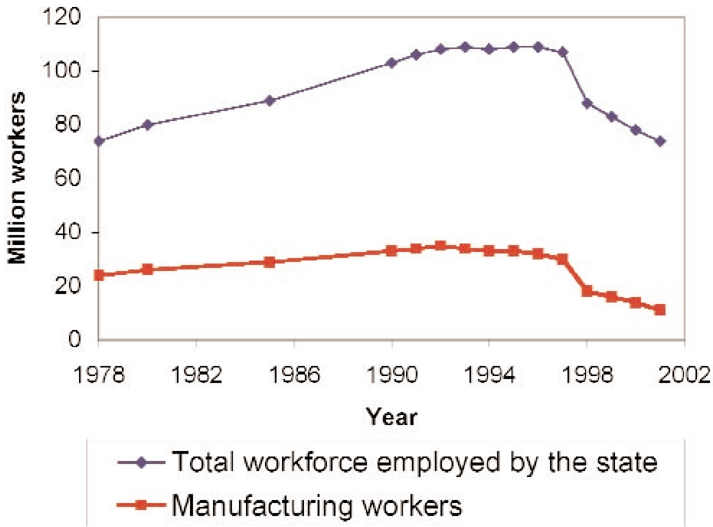
Employment in the SOE sector has also fallen dramatically, from a peak of 35m in 1992 to 11m in 2001, as figure 9 shows. (Total employment by the state has reflected this decline – from 109m in 1992 to 73m in 2001). SOEs' share of urban employment fell from 41% in 1998 to 32% in 2001. These figures indicate that serious and painful reforms have taken place. However, but it should be noted that state-owned shareholding companies accounted for an additional 4.6m workers by year-end 2001.

Figure 8: Official government budgetary subsidies to SOEs (Rmb bn)



Source: China Statistical Yearbook 2002.

Figure 9: Workforce employed by the state* (million)



* Excludes workers at state-owned shareholding companies.
Source: China Statistical Yearbook 2002

Are the SOEs improving?

Officially at least, the performance of China's SOEs has improved in recent years. Profits have increased each year since 1998, to total Rmb238.9 billion in 2001. Some analysts argue that this reflects real improvements in performance. Inventory accumulation – the amount of goods produced that are not sold, a key indicator of inefficient production—has fallen since 1996 to less than 1% at year-end 2001. This is a similar level to that of the United States, and suggests that firms have shed workers who produced the excess goods and are using their capital more efficiently. There are also huge competitive pressures at work. By the time China entered the WTO in late 2001, foreign affiliates were producing some 28.5% of all manufactured goods. Most of these are sold on the domestic market, where they compete with the goods of SOEs. A number of non-viable SOEs have been closed.

However, others suspect that most state-owned firms have not made significant improvements and that high oil prices (which favour firms such as Sinopec and PetroChina, large contributors to the overall profit figure), distorted accounts, fiscal subsidies and cheap bank loans account for much of the improvement in their financial results. In addition, the transfer of Rmb1.4 trillion ($169 billion) worth of bad loans to the asset management companies (see below) in 1999 considerably reduced the SOEs' interest burden. Key SOEs (the largest 511 firms) did particularly badly in 2001 and in the first two months of 2002 overall profits in the sector fell by 37% year-on-year.

There are many difficulties involved in measuring productivity growth across different ownership types. The data is frequently unavailable and/or unreliable. However, a 2000 study by Gary Jefferson and colleagues is interesting. Unrestructured SOEs performed badly – their productivity declined 2.9% a year between 1993 and 1996. In other words, they were destroying value rather than creating it. More worryingly, shareholding firms – many of which were restructured large SOEs – did even more badly: productivity declined nearly 8% a year, as table 5 shows. Non-state firms, however, sustained positive productivity growth over the 1988 – 1996 period.

Table 5. Average annual growth of total factor productivity

	State-owned	Collectives	FIEs	Shareholding	Other
1988-92	2.11	3.13	1.11	-	2.11
1993-96	-2.91	0.43	-3.14	-7.96	0.64

Source: Jefferson, G. et al., "Ownership, productivity change and financial performance in Chinese industry" Journal of Comparative Economics 28, pp. 786-813, 2000.
Notes: Using 1995 weights; state-owned: unrestructured SOEs; 'shareholding': excludes shareholding co-operatives and limited liability companies; FIEs: foreign-invested enterprises; Others: non-shareholding domestic firms, including private firms with more than eight workers, and shareholding co-operatives not part of the collective sector.

Can the government really create a class of internationally competitive firms?

The State Council intends to develop a number of internationally competitive SOEs and state-controlled shareholding companies, headed up by 120 enterprise groups that make up the so-called 'national team'. The model is, of course, the Asian tiger economies such as Japan and South Korea which not only industrialized during the 1950 – 1970s, but which also created dozens of world leading companies like Toyota, Sony, LG, Hyundai and Daewoo.

The world today, however, is a very different place. The Asian tigers made extensive use of tariff and non-tariff barriers to protect their favoured industries. Preferential tax policies, cheap bank loans and special export licences were extended to companies with close links to government. The Asian tigers also benefited from a huge increase in global demand after the Second World War, and from American aid and military spending in Asia.

China will have extreme difficulty in duplicating their policies and good fortune. WTO membership will prevent it from practising protectionist trade policies and from offering subsidy supports to its public firms. Tariff barriers are falling, forcing domestic companies to face the winds of global competition. Indeed, those involved in negotiating China's entry into the WTO must have been aware that they were pulling the rug from beneath the feet of those in the government who wanted to pursue an active industrial policy.

There are other important differences from the situation of the tigers. Although Japanese and South Korean firms were often closely linked with their governments, they were privately owned and run mainly for profit. Too often in China firms lack autonomy from the state and their search for profits are undermined as a result. Local governments frequently interfere with their operations for political reasons. SOEs, for example, are still not allowed to hire and fire at will, and so cannot follow their multinational competitors in aggressively downsizing and outsourcing to cut costs. Instead, national champions have had to absorb smaller, loss-making SOEs, some 2,000 between 1994 and 1997, to help limit unemployment. Mainland businesses have often been prevented from pursuing expansion either through mergers and acquisitions or by organic growth because of local protectionism and ministers' fears that they may lose their influence over management. There is also intense domestic competition for their markets. Thousands of small and medium-sized firms, often supported by their local governments, undercut large state firms on price and hire, and fire labour more flexibly.

A handful of PRC companies, including Huawei (a network equipment maker), Legend (a computer manufacturer) and Hai'er (a white goods manufacturer), are breaking into global markets, but they will be the exceptions – and none of them are owned by the government.

How important is the private sector?

After the revolution in 1949 private enterprise was gradually eliminated. Most firms were closed or taken over by the state. Now, after more than two decades of growth, their contribution to the country is recognized as 'important' by the constitution. They have been granted export licences (whereas previously they had to go through state-owned export companies), and entrepreneurs were formally allowed to join the Communist Party at the 16th Congress in November 2002—although they had been influential members of the party for years before that.

The private sector is now the most dynamic part of China's economy. Its development has been remarkable. Because of extensive mixed ownership in China's industry, and problems in the statistical categories that are available from official sources, there is much debate over how much of China's economy is produced by private enterprise. According to an IFC report authored by Gregory et al. in 2000, the most reliable survey on the sector so far produced, the true private sector's share of GDP was 33% in 1998, smaller than the state sector's 37% share. If one includes agriculture (which is now made up of private farming households which farm publicly owned land), then the private sector's share rises to 51%. Add in the collectives (about half of which are privately owned), and the proportion is 62%. These different breakdowns are shown in table 6.

Table 6: Contribution to China's GDP of private enterprise, 1998

Official private sector	True domestic private sector	True private sector	True non-state sector	True non-state sector
State sector 37	State sector 37	State sector 37	State sector 37	State sector 38
Agriculture 18	Agriculture 18	Agriculture 18	Agriculture 18	Non-state sector 62
Official collective 23	True collective 12	True collective 12	Non-state sector45	
Shareholding 3	Shareholding 3	Private 33		
Foreign enterprises 6	Foreign enterprises 6			
Domestic private sector 13	Domestic private sector 27			

Notes: Official private sector: official collective includes 'red hats' as well as private firms. Domestic private sector consists of formally registered private firms and getihu (private firms with less than eight employees).
True domestic private sector: Domestic private sector consists of shareholding firms and those private firms that masquerade as collectives (assuming they accounted for one half of all collectives).
True private sector: Private sector consists of foreign and domestic private firms.
True non-state sector: Non-state sector excludes agriculture and consists of true collectives and private sector as defined in true private sector.
True non-state sector: Non-state sector includes agriculture.
Source: Gregory, N., Tenev, S. & Wagel, D., *China's Emerging Private Enterprises: Prospects for the New Centur*y, Washington, International Finance Corporation, 2000.

Despite the government's rapprochement with the private sector, its policies still discriminate against the sector in a number of ways. Non-state enterprise cannot yet engage in a number of industries, including defence, telecommunications and finance (although at least the latter category is set to open up in 2003). Accessing funding is still difficult for many private firms. In June 1999, the Industrial and Commercial Bank (ICBC), China's largest lender, reported that 21% of its loans were held by non-state enterprises. However, the majority of this money had been lent to collective and FIEs. Individual entrepreneurs and private enterprises had only received 0.5% of the loans. In addition, China's stock market remains largely closed to private firms (only 57 of the 1,160 firms listed at year end 2001 were not former SOEs) and in many areas bureaucrats prey on non-state firms by levying huge numbers of fees and taxes on them.

5 The social side of reform

Besides engineering an economic revolution, the government is overseeing a social revolution too. It needs to create jobs – as well as facilitate the movement of people to areas where jobs are being created – and to construct new delivery systems for pensions, healthcare and education.

How serious is the unemployment problem?

Every 1% of economic growth is thought to create about 1m new jobs. The government believes that economic growth of 7% a year is the minimum it needs to sustain social stability. The World Bank calculates that from January 1998 to September 2000 21m SOE workers were laid off (including those *xiagang* workers who remain on the books of the firms and receive, in theory at least, a small monthly stipend, but who are in effect laid-off). Of these about 13m found re-employment. Around 5m workers a year are currently being laid off or 'temporarily laid-off' (known as *xiagang*) from the downsizing and bankrupting of SOEs. The rate of lay-offs is slowly falling.

The official unemployment rate of 4%, representing some 6m people, massively understates the extent of the problem. For one, it does not include *xiagang* workers. For another, the rural unemployed are not included. The real national unemployment rate probably lies between 10% and 20%, and much more in the urban areas of the rustbelt northeast of the country. In addition there are huge numbers of under-employed people in agriculture.

Unemployment will probably rise a little over the next couple of years. The hardest hit sectors will be manufacturing, mining and construction, and the impact will be greatest in the northeast. The protests in early 2002 in cities such as Daqing City in Heilongjiang province revealed the considerable disenchantment of people in the rustbelt have with the government. However, the state has successfully kept a lid on the protests by judicious use of the army and arresting the main agitators. Independent labour unions remain banned.

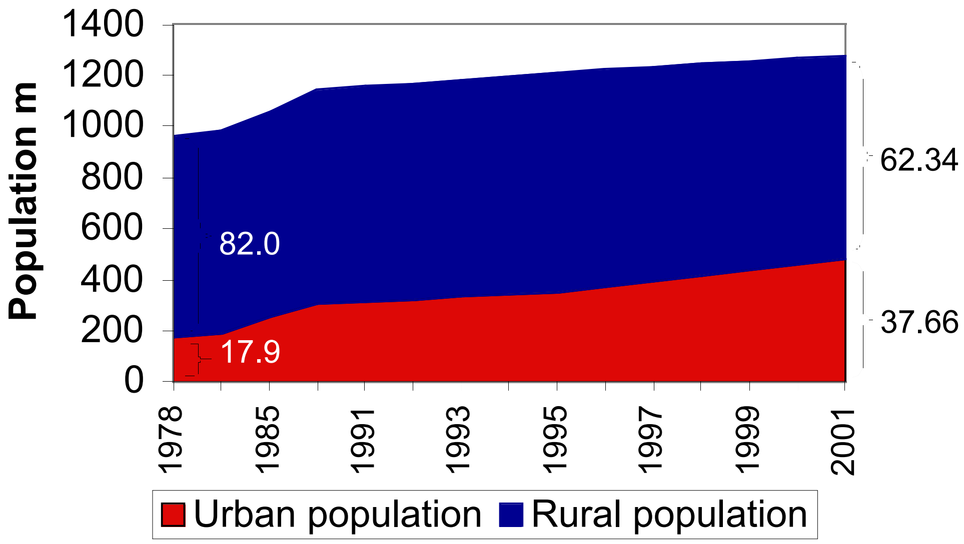
What is happening to facilitate the movement of workers?

One of the most visible signs of social change in China is the development of a huge tide of floating workers (*liudong renkou*). Since foreign capital is concentrated in – and tax and investment policies have favoured – the coastal areas of the country, this is where job creation has been most intensive. While under Mao the movement of people was tightly controlled, under Deng the restrictions have been considerably relaxed. The migrant population is now estimated to total some 150m people.

The common image of migration in China is of a gargantuan flood of workers moving east across the country. However, the country's labour markets remain fragmented largely along provincial lines – migrants are far more likely to travel to their local city rather than to Guangdong or Shanghai. A study in 1997 found that less than 4% of China's total rural population worked outside their province of origin. Other research suggests that of the estimated population of 46m labour migrants in 1995, only a third had moved across provincial borders.

For all its attendant problems, migration does help reduce urban–rural inequality. Large pools of labour keep wages down in the cities and a lot of money is sent home: about Rmb100 billion each year, according to one official estimate. Yet migration has only a limited effect on the larger trend – a growing town-country divide. And that will, of course, propel more farmers townward. The government expects a yearly increase of 8.5m on its official figure of migrants during the course of the 10th five–year plan (2000–05). At present, some 38% of China's population live in urban centres, up from 18% in 1978, as figure 10 shows. China's urban ratio is on track to hit 50% by 2020, which will mean huge pressures on city governments to provide the requisite infrastructure and services.

Figure 10: China's increasingly urban population, 1978–2001



Source: China Statistical Yearbook 2002.

China established its household registration system (HRS, known in Chinese as the *hukou* system) in the 1950s. Each person was issued with a certificate registered to his or her permanent place of residence (the same place usually as the mother) and they were usually thus tied to this place for their entire life. They received either an agricultural or non-agricultural *hukou*, a classification that determined the benefits to which they were entitled.

Some have suggested that the HRS provided the state with a means of securing social and political order. Others argue that the government used the system to control migration because China's grain production could not sustain a large urban population. Whatever its original intent, the system successfully controlled migration and also served to entrench social distinctions between urban and rural residents. Urban residents received many benefits not available to those in rural areas such as subsidized food and housing, permanent jobs, as well as retirement and medical insurance.

Since 1978, the incentives for moving to the urban areas have increased. Jobs and food in cities are now obtained via the market, rather than being provided by administrative bureau. But to move off the farm one must change the registered place of one's *hukou*, as well as convert it into a non-agricultural *hukou*. Both require government approval, something that is often not forthcoming. Graduates of higher education, as well as members of the CCP and/or army, are more favourably looked upon.

Many people fail in their applications, or do not bother to apply, and then move into the cities anyway. Floating workers without proper HRS status cannot, however, gain access to the social services such as education and welfare that the local government provides. If they gain access, they usually have to pay more. China is thought to detain hundreds of thousands of people living in urban centres who do not have the requisite identity card, residence and work permit. The extra financial burden and the hassle from the authorities are sources of tension.

To facilitate the flow of workers to productive areas, and to reduce such tensions, the government is working to reform the HRS. First, a renewable 'Certificate of Temporary Residence' is now available. One has to be over 16 and intending to stay in an urban area to work for more than 3 months to apply. The Ministry of Public Security handles applications. It is renewable. Second, in 1992, the 'Blue-Stamp' hukou was introduced, entitling the holder to urban residence rights and employment. This programme is run by local governments, which allows decisions to be made according to local needs. Applicants are assessed for their potential contribution to the local economy.

There have been suggestions that the hukou system could be eliminated in the next five years. This is unlikely since it is thought to be essential in maintaining public order and curbing unmanageable labour migration. China is after all one of the world's few developing countries without large shanty town dwellings on the edges of its major cities – and the government wants to keep it that way. Gradual changes will be made, however, so that rural hukou holders can move to a town if they are able to present proof of a legal and stable income and a place of abode.

How serious are growing income inequalities?

Incomes nationwide have risen substantially since 1978. However, disparities have emerged between urban and rural, and between coastal and inland, incomes. China's official Gini coefficient, a number which measures inequalities in incomes (1 for the most unequal society) was only 0.46 in 2000, well below most other developing countries, as tabe 7 shows. However, there is much scepticism over the accuracy of this figure. Some independent economists estimate that it is more likely to be around 0.6, making China one of the world's most unequal societies.

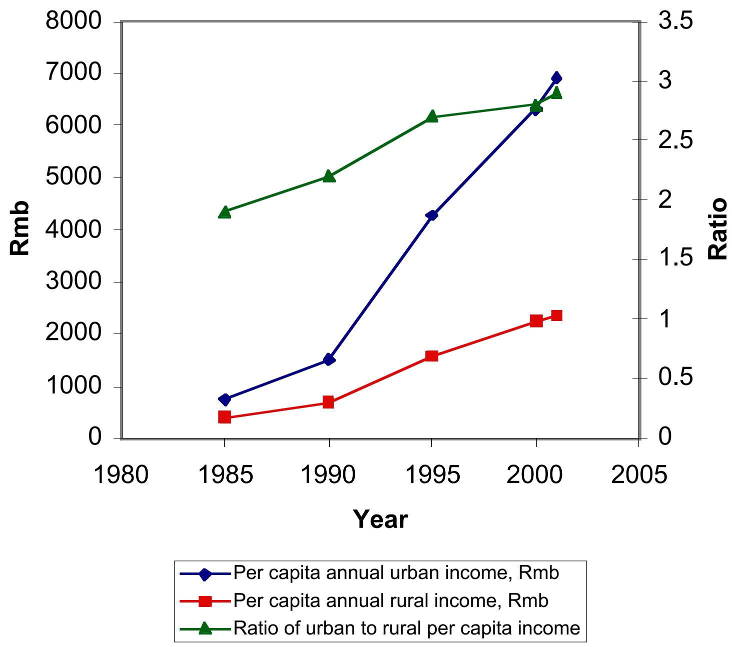
Table 7. Inequality around the world

Country	Year	Gini coefficient
Brazil	1997	0.59
Malaysia	1997	0.49
Philippines	1997	0.46
China (Official)	1980	0.33
China (Official)	2000	0.46
China (World Bank)	1998	0.40
Japan	1993	0.25
United States	1997	0.41

Source: World Bank, National Bureau of Statistics (PRC).

China's entry into the WTO will exacerbate these inqualities. It will mean more investment going into the coastal regions and lower grain prices, threatening many farmers with lower real incomes. As figure 12 shows, the ratio of urban to rural incomes has increased from 1.9 in 1985 to 2.9 in 2001. The situation in areas where SOEs still dominate the economy will get worse before it gets better.

Figure 12: Urban and rural per capita incomes, 1985–2001



Source: China Statistical Yearbook 2002.

Average urban incomes surged in the 1990s, rising from Rmb1,523 in 1990 to Rmb6,907 in 2001, while incomes in rural areas grew much more slowly, a phenomenon examined above. The other axis of inequality in China runs between the coastal and the inland regions. Under Mao, it was the northeastern and central provinces that benefited from state-led industrial development, but Deng Xiaoping's policies primarily benefited the coastal areas. During the 1980s incomes in the coastal and the inland areas converged, but by the early 1990s the coast had begun to pull away. New policies exacerbated the trend. Shanghai, for instance, was festooned with preferential policies to encourage private and foreign investment from 1990. The amount of the revenues it had to remit to the central government was also reduced. The effect on the relative wealth of provinces has been dramatic. Per capita income is now more than ten times as high in Shanghai as it is in inland Gansu province and Xijiang (Tibet).

The government is attempting to narrow the east–west gap by investing massively in roads, railways and industrial development in the inland areas via the 'Develop the West' project which beganin 1999. However, these policies are likely to do little to alter the trend of increasing inequality between the two areas; the amount of public money involved is small compared to the size of the economies in these areas, and few private businesses want to relocate from the coastal areas. Moreover, the Develop the West plan is not actually new: it comprises a souped–up policy that has been in place for the past decade. State-led investment in the interior regions increased in the mid-1990s and was targeted at education, infrastructure, energy and raw materials. But all this had little effect on inequality. Central and inland China will continue to grow apart from the eastern areas, possibly leading to increased political tensions.

Is corruption a more serious problem in China than in other developing countries?

Corruption is endemic in China's economy. One study by Hu Angang, an economist at the Chinese Academy of Sciences, estimated that it cost the country some 15-17% of GDP each year. Another study claimed that 20% of public funds are lost to fraud and other corrupt practices. Stealing of state assets is estimated to cost the state around Rmb 50bn in losses each year.

In Transparency International's Corruption Perceptions Index of 102 nations, China tied in 59th place with Ethiopia. It scored 3.5. Ten is given for no corruption (Finland, the cleanest country, scored 9.7) and zero the highest level of corruption (Bangladesh, with a score of 1.2). China and a number of its competitors are shown in table below. The index, of course, only indicates the level of perception of corruption – not actual corruption. But China did relatively well: forty-two developing countries came out worse than it did.

Table 8: China and Transparency International's Corruption Perceptions Index (CPI)

Country Rank	Country	CPI 2002
1	Finland	9.7
5	Singapore	9.3
10	United Kingdom	8.7
11	Australia	8.6
14	Hong Kong	8.2
16	USA	7.7
20	Japan	7.1
29	Taiwan	5.6
31	Italy	5.2
40	South Korea	4.5
45	Brazil	4.0
52	Czech Republic	3.7
57	Colombia	3.6
57	Mexico	3.6
59	China	3.5
64	Thailand	3.2
71	India	2.7
71	Russia	2.7
85	Vietnam	2.4
96	Indonesia	1.9
102	Bangladesh	1.2

Source: Transparency International.

One important indicator of corruption is the huge amount of capital that leaves China each year. Many rich families have at least one family member living abroad to facilitate these outflows. The 'errors and omissions' column in China's balance-of-payment accounts gives some indication of the extent of this problem. Capital going out of a country (such as foreign currency payments for imports) should equal capital coming into the country (receipts for exports and investment by multinationals, for example). However, in China's accounts there is a regular error that indicates that more money is leaving the country than is officially documented. In 1997, the error was $17.0bn, in 1998 $16.5bn. (And a study carried out by Beijing University estimated that capital leakage actually ranged from $36.4bn in 1997 and $38.6bn in 1998 to $23.8bn in 1999.)

There have been some improvements to the corruption situation in China, notably in the introduction of better auditing systems and more severe punishments for those caught. A number of senior officials and rich businessmen have been executed or imprisoned. However, the suspicion of most is that only a fraction of the criminals are being caught, and most people are cynical about the party's ability to cleanse itself.

How serious are China's environmental problems – and how serious is the government about solving them?

China's economic revolution has come with dire environmental costs. A 1998 report by the World Health Organisation (WHO) noted that seven of the world's ten most polluted cities were in China. Airborne concentrations of suspended particulates and sulphur dioxide in China's major cities are two to five times that recommended by the WHO. More than 90% of municipal wastewater discharge is untreated and two fifths of monitored rivers flowing past cities do not meet the lowest of China's quality standards. Dust storms, acid rain and incidences of industrial waste poisoning are also on the rise.

The total economic cost of air and water pollution in China is estimated to be between 3.5% and 7.7% of GD a year. This includes costs such as premature deaths, increased health care costs, and crop damage. Such costs could double by 2020 if current policies are maintained. Using the lower figure, the World Bank surmises that because of these costs the real rate of economic growth is only three-fifths the official rate.

Surprisingly, SOEs are not the primary culprits for these problems. Between 1990 and 1995 their combined pollutant emissions declined by 9%. Regulation developed in the early 1990s has apparently been most effectively enforced at medium and large-sized SOEs where the central government has the most clout. Non-state enterprises pose the greatest environmental threat. The sector has grown rapidly in the last 20 years. It now accounts for 72% of gross industrial output, compared to 45% in 1990 and 14% in 1980. In 2000, there were 6.7m industrial township-village enterprises (TVEs) in operation, compared with 42,000 industrial SOEs. Their small size and huge numbers means that TVEs are largely ignored by the central government. Local governments responsible for enforcing regulations are more often interested in the firms' profits (and tax contributions) than their long term environmental impact.

There are fears that China's opening up might lead to 'pollution havens', places where FIEs are attracted by favourable regulatory policies and lower environmental standards. However the available evidence suggests that FIEs are the most likely types of firm to obtain environmental certifications and adhere to environmental regulation. They make up about two-thirds of the 90-plus companies which have gained ISO14000 environmental management certification.

China's efforts to enter the international community have lent clean-up efforts credibility and some of the necessary political clout. Beijing's Olympic bid will cost the government $12.2bn in projects aimed at improving the city's environment. One ambitious target is to replace coal with natural gas as the main energy source. Since work began in 1999 air quality has improved significantly. Officials report that it took Beijing only two years to meet standards that Tokyo, Paris and New York only achieved in seven. Another development has been China's surprise announcement in 2002 that it would ratify the 1997 Kyoto Protocol for controlling global warming.

How successful have efforts been to create a new pension system?

Pensions for urban workers have traditionally been covered by their employers. No pensions are provided in rural areas. Workers at SOEs currently retire at the age of 60 (men) or 55 (women) and have been entitled to a pension of up to 90% of their final income. This was one of the reasons why these firms were so inefficient: many paid more in retirement benefits than in wages to their actual workforce. The way pensions are delivered has to change now since the SOEs are being converted into commercial companies that do not have responsibility to supply cradle-to-grave support to their workers and their workers' families.

The government also has to cope with a rapidly changing demographic profile. China's is a rapidly ageing population, thanks in part to the one-child policy rolled out in the 1970s. The old-age dependency ratio, the number of people aged over 65 to the number of 15–64 year-olds, will rise from 11% in 1999 to an estimated 36% in 2050. This means that the current pensions system in which today's employees pay the pensions of today's retirees will quickly become unsustainable. A rapid fall in the birth rate has provided some relief since the number of children (also dependants on working parents) is falling as the number of pensioners rises.

The government's long-term aim is to replace the workplace-based welfare system with an independent social security system. Funds will be managed by provincial authorities, rather than firms, and funds will accumulate into individual accounts rather than being pooled. There are plans for pension coverage for 100m urban workers (and unemployment insurance to cover 137m). New schemes – which are still being rolled out on a very small scale – rely on three types of contribution: from the local government, the enterprise and the individual. A pilot scheme in Liaoning province has received much attention (partly because it has dragged on for so long) and looks likely to be rolled out nationwide over the next two years. This scheme takes an 8% contribution from employees (plus more from the employer) and puts it into a savings pot. Unlike the old scheme, in which pensions were paid out from current contributions, in future individuals will have their own pot into which they save, and out of which they are paid. It is unclear, however, how the Liaoning scheme will be fine-tuned as it is implemented.

There have been problems in forcing enterprises to pay contributions; many simply refuse. Individuals too have been suspicious of the new scheme (since it means giving away a part of one's salary without a credible guarantee that one will ever see the money again). As a result many of the small local funds that have been built up have been plundered to pay today's liabilities. The central government is having to subsidize them. A National Social Security Fund was launched in early 2001, and has so far raised some Rmb 60 billion. It is designed as a national 'top-up' scheme for local government funds. Eventually, the NSSF will channel funds earmarked for welfare payments into the local (and later, international) securities markets. The endowment needs of the local and central funds are huge. In 2001, the government paid around Rmb205bn in pensions.

6 Foreign investment and trade

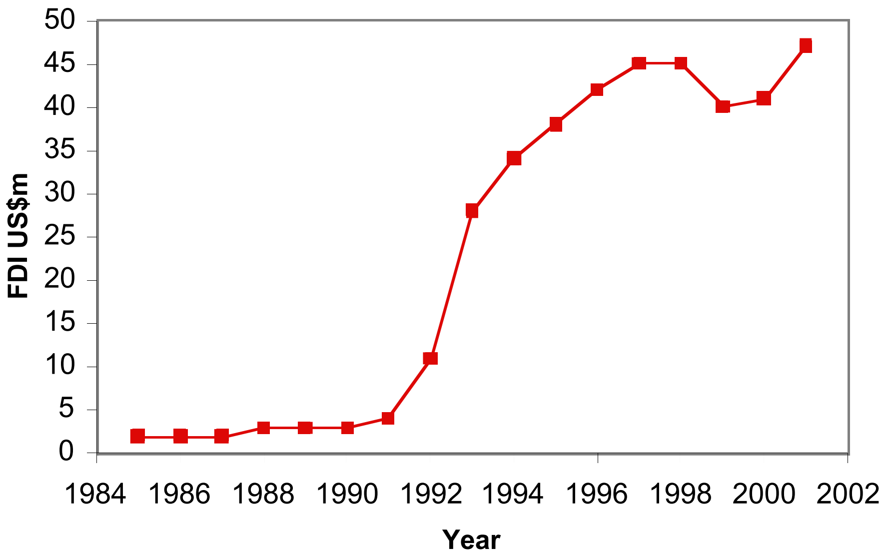
Entry into the WTO binds China into a series of wide-ranging and deep concessions in its investment and trade rules. While WTO entry was welcomed by the most members of the government and the foreign business community it was, of course, not expected to be a panacea. One major concern is the extent to which the Chinese government is willing – or even able – to ensure that all the concessions they granted will be implemented in practice. Local governments, as well as certain ministries, have demonstrated their ability in the past to disregard and frustrate State Council policy when their interests were threatened.

After one year of WTO membership, in December 2002, the general verdict on China's implemenation of WTO rules was 'OK'. There was a palpable sense of frustration with China over a range of issues – and the extra monitoring mechanisms established especially for China have not achieved much – but there have been no flagrant breaches.

How much foreign direct investment is China actually receiving?

During the 1990s, the amount of FDI coming to China increased dramatically. Utilized FDI (in contrast to contracted, or promised, FDI) rose from $11m in 1992 to $47m in 2001, as figure 13 shows. About two-thirds of all the FDI that flowed into Asia in the early 1990s went into ASEAN countries such as Malaysia, Indonesia and Thailand. Two-thirds now goes to China. Its total stock of FDI is now some $400bn and in 2002, contracted FDI totalled $82.8.4bn, up 19.6%, while actual FDI increased 12.5% percent to $52.7bn.

Figure 13: Utilized FDI into China, 1978–2001 (US$m)



Source: *MOFTEC*

Such was the extent of the global downturn in FDI flows that China – for the first time – could have attracted more FDI than any other country in 2002. Its apparently endless supply of cheap well-educated labour and stable political situation make the country an attractive place to invest.

It is well, however, not to take these figures at face value. First, they include a large amount of domestic capital that 'round-trips' out of China, travels overseas (perhaps to the British Virgin Islands, Bermuda or Hong Kong) and then re-enters China as "foreign" capital. It is thus able to profit from special treatment, primarily in the form of tax breaks and looser remittance rules. Although it is notoriously difficult to estimate the proportion of FDI that is actually domestic capital, one estimate in the mid-1990s was that the proportion was about 30% of the utilized FDI total. As WTO membership leads China to treat foreign firms on an equal basis with domestic firms, it is likely that the proportion of capital round-tripping will decrease.

Excluded from the FDI figure is the amount of retained earnings of foreign-invested enterprises (FIEs) that is used by foreign partners to buy additional stakes in their firms, often giving them control of the venture. This capital does not enter the country (since it is earned by FIEs already in-country), and is not included in the FDI data, but it does indicate an investment decision by a foreign company. It is extremely hard to estimate the amount of foreign investment that comes from 'inside' the country.

Does FDI actually benefit China's economy?

Some critics have claimed that although China hosts a huge amount of FDI, it does little to help the economy. One criticism is that much of the money, especially in the Pearl River Delta area near Hong Kong, is involved only in labour-intensive manufacturing operations – which involve low wages and zero technology transfers (one of the sources of long-term economic growth). Certainly some of the conditions in which workers in these areas live and work are terrible, but most still prefer working there to staying at home in the less prosperous interior provinces. FDI is, at least, providing jobs.

A related criticism is that FIEs are not actually linked up with the rest of the economy. About half of all China's manufactured exports are sold by FIEs. One theory is that FIEs simply assemble imported parts and then export them. If this were true, there would be some benefit to China in terms of job creation, but little benefit in terms of helping the economy upgrade technologically. Fortunately there is evidence to suggest that the domestic 'value-added' component of FIEs is rising. The proportion of the value that is added to FIE exports is on the rise, from 16% in 1994 to over 35% in 2001. This indicates that exporters are increasingly using suppliers from the domestic economy, and that technology is increasingly being transferred.

Another, more credible, strand of thinking is that large amounts of FDI are a sign of China's economic weakness rather than strength. Large capital inflows – into a country with a high savings rate and a huge comparative advantage in labour – is somewhat puzzling, especially if the FDI goes into low-tech industries. Why would local entrepreneurs not set up their own businesses? Why would they sell stakes to foreigners? The answer is that China's inefficient financial system has systematically discriminated against private firms, leaving them with no choice but to go to foreign investors for financing. Thus FDI does benefit the economy, but also indicates a structural flaw in it.

Will China's growing attractiveness to foreign investors have a negative impact on the rest of Asia?

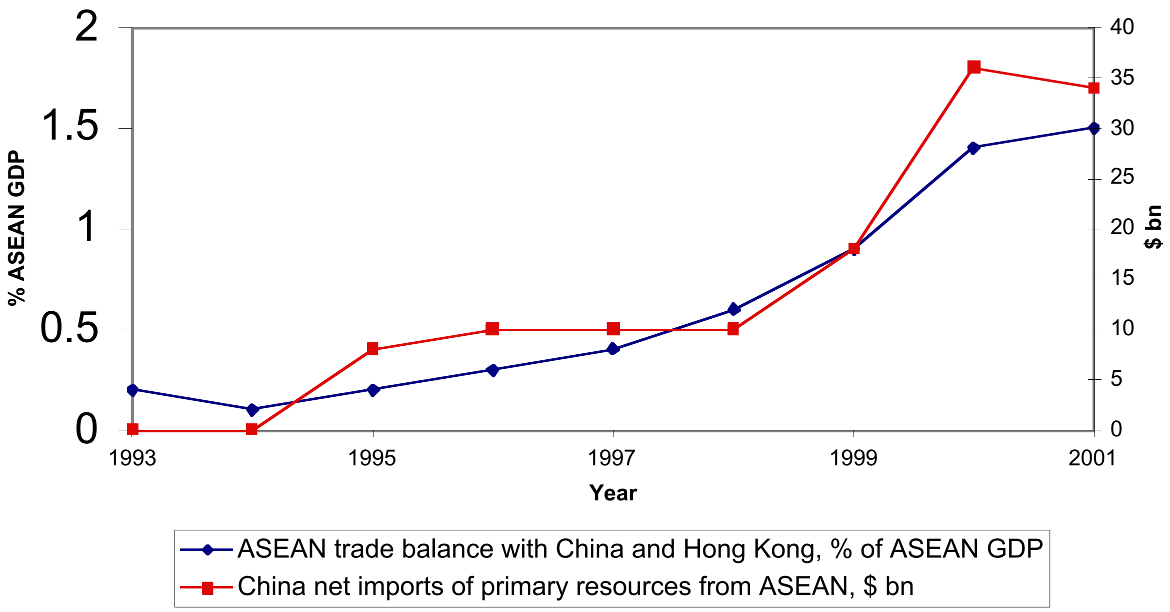
China's economic rise is having an enormous impact on the Asian region. With their relatively advanced economies, Japan and South Korea should largely benefit. Their manufacturing operations can relocate into the Mainland, taking advantage of cheaper labour costs, leaving their domestic economies to move into higher value-added services that support these factories, such as finance and R&D work.

Other countries, however, have a different relationship with China. Many of Indonesia's footwear factories, Thailand's textile industry, Malaysia's IT companies – even Mexico's maquiladora firms – are relocating to China. Some argue that there has been a diversion of FDI flows out of Southeast Asia into China and that China will undermine development in the rest of the region.

However, other analysts point to the fact that much of the ASEAN region is still recovering from the Asian financial crisis, and that this is the cause of comparatively weak FDI flows into these countries. Before 1997 the ASEAN economies' ability to attract FDI and gain market share in markets where they competed with China was robust. Once the right structural reforms have been implemented, there should be no reason for the ASEAN region not to attract more FDI and continue to grow.

Indeed, China's development will also support this development in a number of ways. For instance, China is increasingly reliant on sourcing raw materials from the ASEAN region, as figure 14 shows. Imports of primary resources from ASEAN into China increased from $10bn in 1998 to $34bn in 2001.

Figure 14: ASEAN trade balance with China and Hong Kong



Source: Goldman Sachs, The Five Great Myths About China and the World (Part 4), May 2002.

One of China's most remarked upon advantages for foreign investors is the low wages of its workers. Table 9 shows the average per capita incomes of parts of China and its Asian neighbours. Average incomes in eastern China are higher than those in Indonesia, India and Vietnam. Indeed, Vietnam has a per capita income of $350, lower than that in southwest China. Phillips Electronics has 17 factories and a third of its Asia-based staff working in China. It has reported an 8–9% increase in its wage costs in the last three years. Of course, there are a number of important points to note about these figures. First, they are incomes, not wage rates. Second, they are averages, and therefore do not give much of a clue to the incomes of manufacturing workers. The average monthly factory wage in China is around $100, and given its good infrastruture and high levels of education, China is, despite slowly raising wage rates among the more educated segments of the workforce, in many ways a more attractive place in which to invest than many parts of Asia.

Table 9: Average per capita incomes in China and Asia in 2001

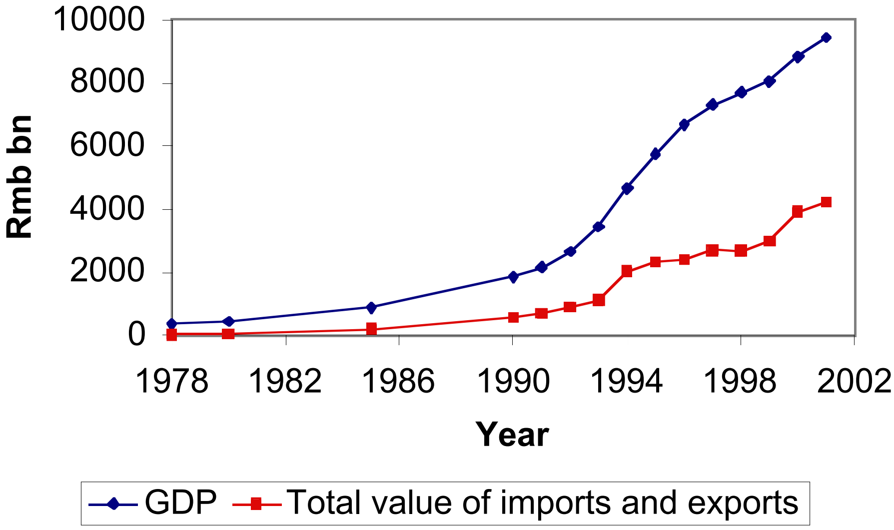
Country/region	Per capita income, $
Malaysia	3670
Shanghai	3360
Thailand	2160
Beijing	2073
East China	1228
Northeast China	1154
South China	1111
The Philippines	1050
North China	913
Central China	705
Indonesia	640
Northwest China	479
India	440
Southwest China	389
Vietnam	350

Source: Citigroup.

What is China's role in world trade?

After opening up to the outside world, China now trades a lot more than before. While GDP growth increased by some 2,000% between 1980 and 2001 (measured in renminbi), the value of China's trade (imports plus exports) increased by some 7,500%, as figure 15 shows.

Figure 15: China's economic and trade growth, 1978–2001 (Rmb bn)



Source: China Statistical Yearbook 2002.

China experienced a fourfold increase in its share of world trade from 1970 to 2000. However, this growth was entirely expected, and was similar to the experience of both Japan and much of the ASEAN region during their fast growth periods. Much of China's trade is associated with export processing – assembling equipment made outside the country for re-export. Much of its higher value-added exports comes from such operations.

During its two and a half decades of reform, China's trade regime has become steadily more liberal. Tariffs – taxes on imports – and non-tariff barriers – things like quotas and quality standards that have a similar import-reducing effect – have been systematically dismantled. WTO membership continues the trend. In agriculture, for example, tariffs on all major products will fall from an average of 31.5% in 2000 to 14.5% by 2004. Industrial tariffs will fall from an average of 24.6% in 1997 to 9.4% by 2005. Major cuts in the tariffs on industrial products (including automobiles) have been promised, as has the eventual elimination of tariffs on high-tech goods. In addition, across all products, current regulations restricting the right of foriegn firms to import, export and distribute are being relaxed.

In all these regards China is considerably more of a 'free trader' than most other developing countries. This is partly due to the immense pressure exerted by the United States during China's WTO entry negotiations. More importantly, however, it is due to the fact that many within the PRC government are well-trained economists who understand that trade liberalisation – even if undertaken unilaterally – will result in gains for the Chinese economy.

In the first three quarters of 2002, China's trade grew 18.3% to $445.1bn, with exports up 19.4% to $232.6bn and imports increasing 17.2% to $212.6bn. The trade surplus reached $20 billion, less than 2% of GDP. In other words, China just about buys as much as it sells. Indeed, after the trade that is associated with export-processing is stripped out China is found to be running a growing trade deficit. It is likely to move to an overall deficit on its trade account over the next couple of years. Its surplus with the United States will grow, but trade deficits with most of its Asian trading partners will also increase as China imports more goods from these areas.

The opening up goes the other way too: China's WTO entry will benefit its textile, shoe and toy exporters. They will profit from the phasing out of the Multilateral Fibre Agreement (MFA) in 2005, a device used by developed countries to restrict textile imports from the developing world. Its elimination will result in the removal of almost all quota and quantitative restrictions on China's textile exports, although the United States will reserve the right to continue its protectionist stance until at least 2008. Many developing countries fear the flight of their textile industries to China.

7 Financial-sector reform

The financial sector lies at the heart of a modern market economy. Although reforms to China's financial system have lagged behind those in other areas of the economy, much has already been done. Commercial banks have been established and are increasingly turning their attention away from SOEs and towards individuals, as table 10 shows. A $200bn stock market – as measured by tradable market capitalization – has been built, and there are over 50 investment funds now available to small investors. Private insurance is growing as the SOE-based model of welfare delivery falls apart.

Table 10: Consumer loans outstanding, 1997–2001 (Rmb bn)

	1997	1998	1999	2000	2001
Total amount	17.2	—	137.6	424.4	699.9

Source: PBoC.

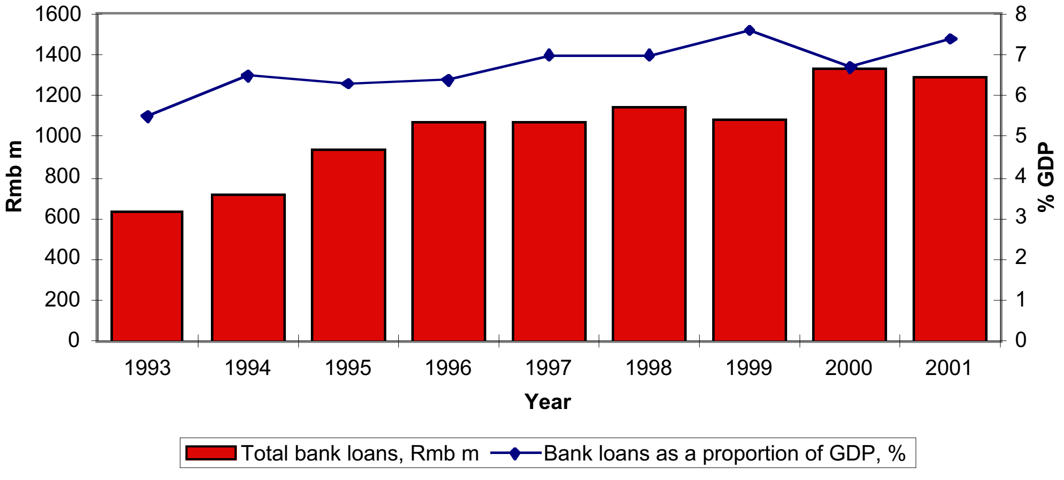
Yet despite the many signs of strength – huge foreign reserves, a current account surplus and a stable currency – China's financial sector is fragile. The four large state banks have been forced to support the SOE sector through extensive lending and as a result have built up large numbers of non-performing loans (NPLs). The pensions and welfare system are underfunded. A roadmap for resolving these problems is still lacking. This is a concern. Many, including Zhu Rongji, believe that a financial crisis is the likeliest trigger of social unrest and political problems for the regime. During his time in Beijing Zhu crafted policies designed to eliminate financial corruption, centralize decision-making and resolve the NPL problem. He made some progress. His successor as premier, Wen Jiabao, still has much to do.

How successful have recent reforms at the state banks been?

Painful reforms have already hit the four state-owned banks, almost all of which have led to more efficient lending activities. Staff numbers fell from over 1.6m in 1997 to just over 1.4m in 2001, while over 40,000 branches were closed over the same period. There has also been a shift in the types of lending being undertaken. Previously the loan portfolios were almost exclusively dominated by loans to SOEs. However, consumer loans have risen from close to zero to an estimated Rmb 200 billion in 2002, some 8.2% of all loans outstanding. Mortgages are the most common type of consumer loan.

Despite these improvements, the state banks still provide credit to unprofitable SOEs. As funding via the budget dried up, these companies have been forced to rely more on bank loans. Largely as a result, total bank loans as a proportion of GDP rose from 5.5% in 1993 to 7.4% of GDP in 2001, as figure 16 shows. Moreover, banks do not tend to attempt to foreclose on bad loans because of the difficulty of filing for bankruptcy and the low recovery rates involved – usually only 10-15% of the loan.

Figure 16: Growth in bank loans as a proportion of GDP, 1993–2001



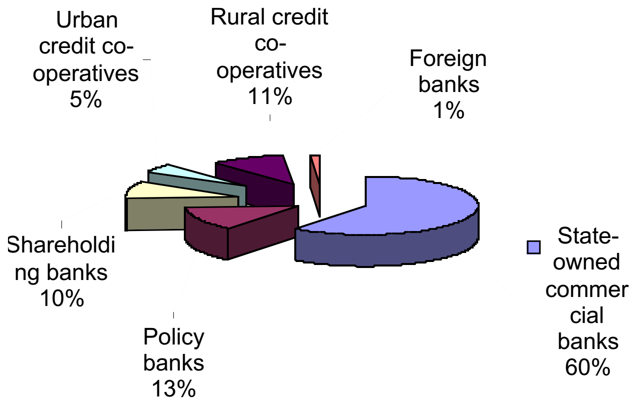
Source: CSRC, *China Securities and Futures Statistical Yearbook 2002, Beijing: Baijia Chubanshe.*

Another problem is that with such bad balance sheets, bank managers are now reluctant to lend more money, especially to non-state firms. In late 2001 to early 2002 there were signs of credit drying up. This was a bizarre occurrence considering that as of year-end 2001 the banks were estimated to have some Rmb3 trillion in 'excess liquidity', deposits which were not being lent out. In late 2002, however, bank lending increased again. Loan growth at the shareholding banks was the fastest.

What about the shareholding banks?

The shareholding banks, including Minsheng, Merchants, Huaxia and others, are healthier than the four state-owned banks. Unlike them, they are owned by local governments or state-owned organs, rather than by the State Council. These dynamic institutions are likely to provide the greatest competition for foreign banks. However, they are still small, accounting for less than 10% of all outstanding loans at year-end 2001, as figure 17 shows.

Figure 17: Loans held by Chinese financial institutions, year-end 2001



Source: PBoC.

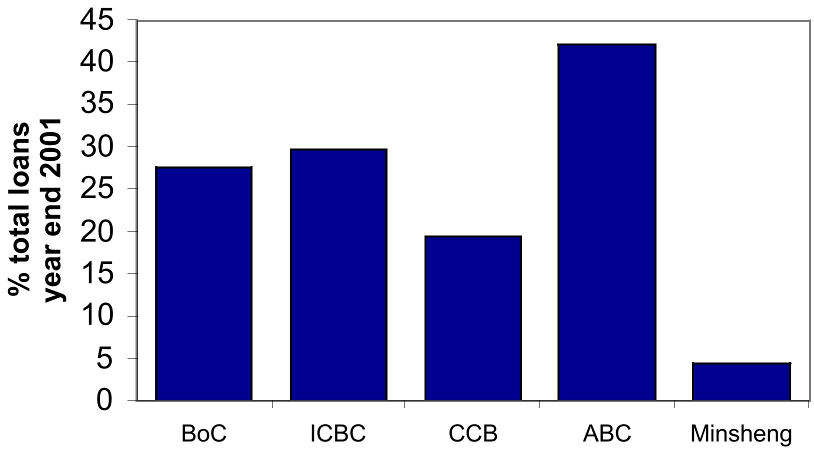
The share of lending of the four state banks is, however, on the decline – another signal of positive change. From accounting for some 72% of new lending in 1997, state banks now account for only 50% of new loans (and 60% of outstanding ones). Shareholding banks tend not to lend to SOEs, which means that their loan portfolios are likely to be considerably better than those of the state banks. However, the rapid growth in lending in which they have been involved since 2000 suggests that the quality of their portfolios is in decline.

It is likely that shareholding banks will merge with, and acquire, urban banks (of which there are about one hundred) to expand their branch networks. Private investors are now allowed to take small stakes in China's regional and city-based banks. This should help improve governance and performance. Foreign banks are looking for small stakes in domestic firms. In late 2001, HSBC bought an 8% stake in the Bank of Shanghai and in early 2003, Citigroup purchased a stake in the Pudong Development Bank. Others will undoubtedly follow. In late 2002, it seemed that an American financial firm would take a controlling stake in the Shenzhen Development Bank.

How serious is the non-performing loan problem?

As a result of the rapid growth in lending to the SOE sector in the 1990s, the four large state-owned banks now have large portfolios of non-performing loans (NPLs). Just how big these are is a matter of some debate. For a long time, the official stance was that NPLs made up less than 10% of the loan portfolios of the four state banks. Then in March 2001 the Bank of China released data that appeared to be much more realistic: NPLs accounted for around 28% of all its loans. The other banks followed suit, also releasing more reasonable figures, as figure 18 shows.

Figure 18: NPLs as a proportion of total loans, year-end 2001



Source: PBoC.

Independent estimates of the NPLs lie between 30% and 60%. With inadequate capital, these bad loans put the four state banks on the edge of insolvency. The only thing preventing the four state banks from collapsing, or experiencing runs that would lead to their closure, is the government's statement that it will guarantee their deposits. This promise only works, however, as long as the government's financial credibility can be sustained.

There have been improvements in the official NPL position. In early 2002, the PBoC announced that the four state banks had successfully reduced their NPLs, both as a share of their total loan portfolios and in absolute terms. NPLs at the four banks officially fell from 25.5% of GDP at year-end 2000 to 24.3% of GDP a year later. This was partly due to the increasingly commercial nature of the banks' operations. However, some analysts are not convinced by these figures, arguing that there has been no obvious increase in lending to the non-state sector, and that since SOEs are not suddenly performing much better, the real level of NPLs is likely to be static – or even be increasing.

How can the NPL problem be solved?

The PBoC is hoping that the asset-management corporations (AMCs) will help resolve some of the bad debts. In 1998, the MoF and PBoC established four AMCs, one for each of the main state banks. These then bought Rmb 1.4 trillion ($170bn) worth of NPLs, about 18% of all bank loans (at face value), from the four state banks.

Huarong AMC, responsible for the debt from the Industrial and Commercial Bank (ICBC), took the largest share. It is now attempting to sell off this portfolio of NPLs to foreign and domestic investors. Most analysts initially believed that the AMCs would recover only some 10% of the face value of the NPLs, leaving the PBoC and MoF to cover the rest of the Rmb 1.4 trillion. However, results so far have been surprisingly positive. By year-end 2001, the four AMCs reported that NPLs with a face value of Rmb 125bn had been sold, resulting in cash of Rmb 26.2bn, a cash recovery rate of 26%, as table 11 shows.

Table 11: NPL disposal and asset recovery, year-end 2001 (Rmb bn)

AMC	Face value of NPLs	Face value of disposed assets	Cash recovery	Cash recovery rate, %
Orient	267.4	18.3	4.4	24.2
Great Wall	345.8	53.1	3.7	6.9
Cinda	373.0	29.9	10.5	35.1
Huarong	407.7	23.2	7.6	32.5
Total	1,393.9	124.5	26.2	21.0

Note: Figures for Huarong do not include the two international deals signed, but not executed, in 2001.
Source: Ma Guonan and Ben Fung, *China's asset management corporations,* BIS Working Paper, Bank for International Settlements, 2002.

However, it is likely that this cash recovery rate will decline as the more difficult loans are worked through. The government needs to work further on its bankruptcy framework, and foreign investment rules, in order to attract non-state and foreign-investor interest in these loans. In late 2002, the State Council gave the go-ahead for two joint ventures, between Huarong and two consortia of international banks led by Goldman Sachs and Morgan Stanley, which will work out out a small number of loans. It will be tough going. Foreign investors will want to bankrupt most of the SOEs whose debt they buy, and bankruptcy is likely to be resisted by local governments. If they receive backing from senior officials, though, in facilitating restructuring, China's bad debt market could easily become the world's largest.

Will foreign banks be allowed to compete – and will they trigger a banking crisis?

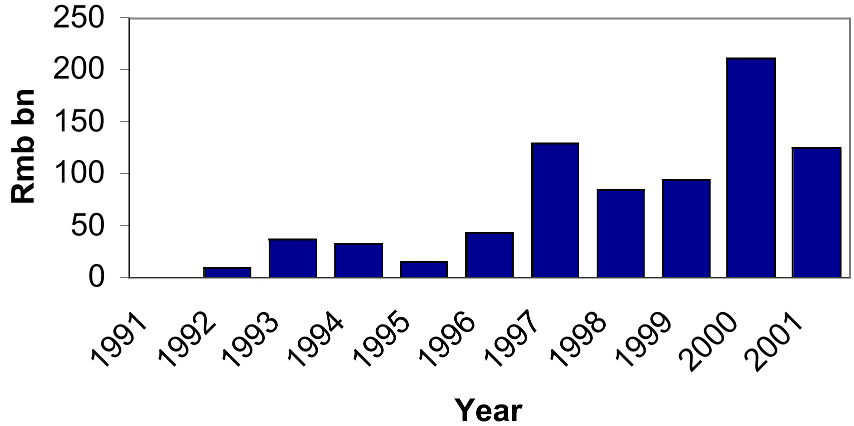
At present, the 160-odd branches of foreign banks in China account for only 0.5% of all banking deposits, and less than 1% of all lending. As the bans on foreign banks' ability to take deposits from Chinese companies and Chinese individuals expire in 2004 and 2006 respectively, they hope to quickly develop their own savings pools. This presents an enormous challenge to the domestic banks: if savers switch to foreign branches in large quantities their own deposit base will be destabilized, creating serious liquidity problems. It could trigger a wider financial crisis. Local banks are therefore racing against the clock to improve their businesses and the PBoC will be careful to slant the rules to ensure that foreign banks do not destabilize the sector.

The PBoC currently limits the number of branches a foreign bank can open in any one city (usually just one at present) and has imposed limits on their access to renminbi funding. Onerous registered capital requirements will create disincentives for foreign banks to open new branches. And even after 2007 all banks in China will be subject to interest rates set by the PBoC, a fact that will limit the ability of foreign banks to compete. The PBoC is likely to experiment with allowing a couple of foreign banks to lend to and take deposits from Chinese individuals and firms before the WTO deadline to measure the possible impact of the move.

Has stock market development helped China's financial reforms?

At year-end 2002, there were 1,224 enterprises listed at the stock exchanges in Shanghai and Shenzhen. They have been largely used to raise finance for former SOEs. A-shares (traded by domestic individuals and institutions) raised around Rmb 494bn during 1992-2002. The B-share market, originally designed for foreign investors, has died. Chinese SOEs have also been listing, with varying success, overseas. The scale of issuance and trading decreased in 2001, although the Rmb 10bn ($1.bn) issue of Sinopec, the petrochemical firm, in the summer of that year was the largest the market had seen. Because of capital controls, foreign investment in China's stock market is prohibited. However, with the Qualified Foreign Institutional Investor (QFII) scheme due to start in 2003, this will change as qualified investors will be allowed to remit in capital for A-share investment.

Figure 19. Total raised capital from domestic and overseas share issuance, 1991-2001 (Rmb bn)



Source: CSRC, *China Securities and Futures Statistical Yearbook 2002, Beijing: Baijia Chubanshe.*

Perhaps the most serious problem with the stock market is the awful state of China's listed firms. Although the listing requirement is a 10% return on assets for three continuous years, many listed firms faked their accounts and relied on political support to gain their listings. Some 12% of listed enterprises are officially loss-making; the real figure is certainly higher. In addition, prices in the secondary market continue to be manipulated. Only about 10m people, less than 1% of the population, trade shares actively despite claims by the government that there are now over 70m investors. The government is working hard to improve reporting standards and company behaviour, but it faces an uphill task and much political opposition.

Since its peak in March 2001, China's share market has lost 40% of its value – some Rmb 800bn. The fall was triggered by two events. First, investigations into corruption by the CSRC caused a lot of money, much of it involved in illegal schemes, to exit the market. Second, the government started asking former SOEs to sell off their state shares, shares that were previously non-tradable. Many investors feared that the sell-off would flood the market with shares. The sell-off policy was suspended in November 2001, but investors have remained anxious. The State Council still intends to implement this policy, although the timing and pricing of the sales have yet to be decided.

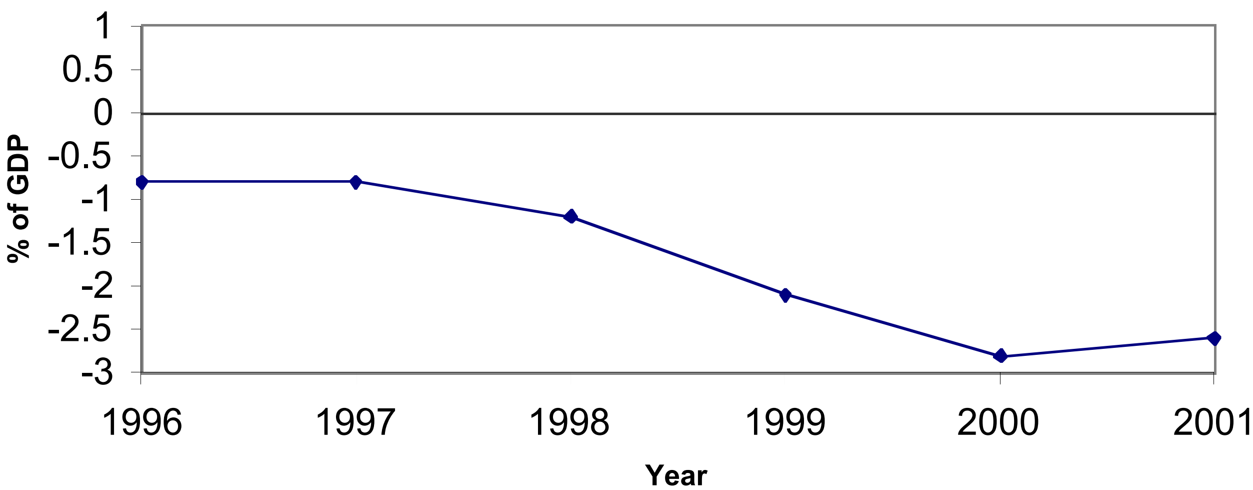
Formal institutional investment is still small; there are only around 55 investment funds, including at least ten open-end funds. However, there is a huge sector of firms which manage funds for SOEs and high net worth individuals on an informal basis; no government regulations have yet been issued to regulate this business. These firms manage around Rmb 800bn, ten times the amount of the formal fund sector. Insurance funds are now being allowed greater access to the share market, as will pension funds in the future. Plans for a NASDAQ-style stock market to be set up in the southern city of Shenzhen have been postponed. The main boards in Shanghai and Shenzhen will eventually be merged in Shanghai.

The bond market is underdeveloped. Treasury bonds (T-bonds) all have long-term maturities. Since there are no regular auctions of short-term T-bonds, there is no way for a 'yield-curve' to be created by which the PBoC could estimate and set the interest rates on a market basis. The MoF is considering improvements to the market, and moved in early 2002 to merge the certificate bond market (where individuals can buy and hold T-bonds until maturity) with the inter-bank market (where banks and other financial institutions trade T-bonds). This will allow individuals to trade their bonds and should increase overall demand for government paper.

How indebted is the government?

The official debt of the PRC government is valued at some 24% of GDP. It is low by international standards: Japan's official debt is now above 160%. China's international debt is also low, standing at $169.1 billion in June 2002 – some 14% of GDP – 70% of which was medium- and long-term.

Figure 20. The government's budget deficit (% of GDP)



Source: Economist Intelligence Unit, China Economic Forecast.

The government is, however, having to rely on deficit financing to stimulate growth. As figure 20 shows, the budget deficit (a measure of how much more the government is spending than it receives in taxes and other income) had grown to nearly 3% of GDP by 2001. To fund this the government has issued a large number of Treasury and other official bonds.

However, the government has a number of other, non-official, liabilities. These include loans extended by China's three policy banks (which do not have savings deposits to support them), the debts, including pensions, owed by SOEs to their employees and the funds that will be needed to recapitalize the four state banks (which the government is on record as guaranteeing). Added together, the government's liabilities equal some 90%, perhaps more, of GDP. This figure is subject to much debate, however – the exact worth of NPLs is unknown, as are the government's total liabilities for pensions, since the final arrangements for the national pensions scheme have not yet been decided.

Two things, however, are certain. First, Beijing needs to be extremely cautious about taking on more debt. If macro-economic demand weakens, the government will face increasing budgetary pressures. Second, the present stock of debt must be unwound in an orderly, transparent and market-friendly way. This is likely to involve a combination of strategies.

What can be done to forestall a financial crisis?

In recent months, some analysts have spoken of the likelihood of some form of banking system collapse – based on fears that the NPL problem will trigger a general loss of confidence in the banks and that the government will be unable to provide enough funds to fill the hole. Although the government has guaranteed deposits at the four state banks, its promise would lose credibility if its debt situation were more widely known, if welfare spending were obviously cut back, or if a major financial institution ran into difficulty. Other analysts have noted continued public confidence in the domestic banks, the banks' high liquidity ratios and their lack of external vulnerabilities (a freely traded currency, for instance) to argue that China is not facing imminent financial crisis. China had foreign reserves of some $276 billion at the end of November 2002, up $62 billion on the year.

The government can employ a number of strategies to resolve its debts and forestall a financial crisis.

1. Economic growth. If the debt can be capped, then as the economy grows it will become less of a problem. However, the sheer size of the problem does not allow for this to be the only solution, as some government officials appear to believe.

2. Increase fiscal revenues. The more the government can raise in taxes, the better financed it will be. Revenues are on the way up but, again, this is not enough.

3. Write-offs. Some of the debt will simply have to be covered by outlays from the budget and from the issuance of additional bonds. There is room for more international bond issues because the government's external debt is still small. However, using the budget to write off bad loans at the banks is not ideal since it would reduce the incentives to maximize the recovery of assets from the delinquent borrowers.

4. State asset sales. Some analysts believe that the value of the state's assets outweigh the value of its liabilities, and argue that properly organized sales of state assets could do much to raise funds. Other analysts are more pessimistic about the ease with which such assets (especially shareholdings) could be sold and how much they would raise. They look to Eastern Europe and the former Soviet Union, where initial expectations about state asset values were vastly overstated. The rationale for more wide-reaching privatization in China must therefore be to improve the efficiency of industry rather than to raise investment funds.

5. Inflation. Mild inflation will eat away at the value of the government's debt: the actual value of a bad loan will be less tomorrow than today if there is inflation over this period. The leadership could, if the debt problem becomes very serious, print money and inflate its way out of the debt. This, however, would trig-

ger rapid urban inflation, and would lead to social unrest. Urban inflation of 20–25% a year was one of the factors behind the protests in Tiananmen Square and throughout China in 1989. The party will remember this, and is thus likely to use inflation only in an emergency.

6. Cut back on social spending. This would, of course, also be deeply unpopular.

There are clear dangers if the government does not intensify efforts to resolve its debt problem. If bad debts continue to accumulate at the banks, if growth slows (leading to fewer jobs being created and lower tax revenues, both of which would increase pressure on the budget), or if deflation exacerbates the debt (since deflation increases the value of the debt, just as inflation deflates it), then the government will be left in severe financial difficulties.

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The following are some of the best books on China's economic reforms and the politics that drive them.

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