

The Macroeconomy of China in the Late Nineties

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Executive Summary

The Macroeconomy of China in the Late Nineties ¹

Joseph Y. Lim ²

1. Introduction

China's socialist experiment effected important structural and distributional reforms that laid the conditions for an environment conducive to growth. The market and incentive reforms undertaken in the late seventies to the present were able to build on these conditions and release productive forces that have brought about much higher and sustained growth.

The Chinese economy easily bounced back after the 1989-1990 political and economic difficulties to achieve in the nineties the highest growth rates for any major country in the world. Growth rates were 10.5%, 9.5% and 8.8% respectively in the 1995 to 1997 period.

Export growth was between 15% to 20% in the early nineties (1991-1993). But with the devaluation of the renminbi in 1994, export growth shot up to 35.6% in 1994 and remained at 25%, 18% and 21% respectively for 1995, 1996 and 1997 (see Table 1).

Because of high export growth during the nineties, trade and current account balances were mostly positive in the nineties and international reserves increased to more than 12 months equivalent of imports in 1997. Foreign inflows consisted mainly of direct investment rather than portfolio investments and short-term debt thanks to capital investments and direct capital biased towards foreign joint venture capital and long-term loans. The strong external position of China insulated it from the principal harmful effects of the East Asian meltdown that occurred in 1997 to the present.

2. The Effects of the East Asian Crisis on China's Economy

However, the East Asian crisis came at a crucial time when some important changes in the Chinese economy were taking place:

- a. domestic demand was starting to weaken as characterized by the slow growth of retail sales, build-up of inventories and deflationary pressures on prices in 1998. Oversupply of light manufactures and consumer products has caused a shift from what China experts call a sellers' market (during the period of high demand growth) to a buyers' market. This means that there will be more intense (and destructive) competition among sellers and a bigger need for

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sellers to undertake product upgrading, technological and productivity improvements and innovative product expansion. Large regional disparities and the inability of other areas in the hinterlands to develop in pace with the coastal areas has shut off a possible venue of domestic demand expansion from the more backward areas.

- b. Continuing and important reforms of the state-owned enterprises – including a hardening of the budget constraints of state-owned enterprises (SOEs) – and strong competitions from the non-state sector had brought deficits and losses to many state-owned enterprises. This has serious implications on the fiscal position of the government and the financial status of state-owned commercial banks. Another important implication is that for state-owned enterprises to be competitive, they will have to layoff some workers and reduce their obligations to provide housing, education and other social services to their workers. Simultaneous therefore should be market-oriented changes in the areas of pensions, health care, housing and education. The uncertainties that these changes bring to urban workers and employees will further dampen domestic demand as they become more cautious and increase their savings to cope with possible losses in wage income and higher expenditures on social services.

Thus, China is, more than ever before, dependent on its export sector and high GDP growth to stave off a slackening of domestic demand and at the same time allow laid-off workers to be absorbed in either non-state sector or the more productive SOEs. This is exactly where the East Asian crisis has affected China negatively. Exports stagnated in 1998 and fell in 1999, reducing the trade and current account surpluses of the country. Because of the weak domestic and external demand for Chinese goods, growth rates decelerated from almost 9% in 1997 and 7.6% in the first half of 1999. The figures are still impressive and were achieved through strong pump-priming and authorities would most likely try to delay this as much as possible since they would not want to ruin an Asian recovery vital to their own export growth. They can also win vital political points in the region if they can delay a significant devaluation of China's currency. Due to high labor productivity, negative inflation, and strong external balances, postponing a devaluation is still very feasible.

3. The Need for Painful Structural and State Reforms

3.1 On the State Owned Enterprises

The relative economic slowdown in China has emphasized the structural problems of China, particularly in the state-owned enterprises (SOEs), financial and fiscal sectors. In recent years, the state has slowly moved to the positions that failing SOEs will be allowed (or forced) to close shop and/or lay off workers as provision of social services are transferred to the private sector and national and local governments. The transfer of social service obligations away from SOEs will economically and financially benefit the SOE as it reduces a big portion of its expenditures. This will allow a better assessment of the viability and profitability of the SOEs. Politically, however, it means that SOEs will be less protected against bankruptcies and closures. At the same time, the state has initiated the hardening of SOEs budget constraints – which means less direct and credit subsidies as well as

directed policy (usually soft) loans and a stricter punishments of SOEs going into arrears.

It is estimated that fifty to sixty percent of SOEs are operating with losses. Profits have been steadily falling and have become negative in the first half of 1998 (Stiglitz (1998)). It is also a fact that capability utilization (the Chinese call this utilization rates) is very low for many firms and industries. Rolled steel industry has a utilization rate of 62% in 1995. The machine tool industry had a utilization rate of 46.2% for the same year (Wu (1998)). In June 1998, color televisions and refrigerators had utilization rates of 46.1% and 50.1%, respectively, while industries for air conditioning, washing machines and vacuum cleaners had rates of 30 to 40 percent. The telephone industry had a utilization rate of 28% (Song (1998)). The very low utilization rates and continuing losses are a reflection of the barriers to exit, bankruptcy and takeover of SOEs due to their overprotection and provision of social services to employees, and continuing competition from the non-state sector.

China's transition economy, as Stiglitz (1998) points out, should put competitions and correct market and performance-based incentives – not exclusive privatization – in the forefront of its reforms. Together with this is proper governance of the economy, where corporate and financial governance and supervision are critical.

3.2 On the Fiscal Sector

With increasing losses and deficits in the state-owned enterprises and reforms that allow profitable SOEs to retain part of their profits, the tax effort (tax revenue to GDP ratio) has fallen from 28.4% in 1980 to 10.5% in 1997. The above is a result of a big mismatch wherein the non-state sector accounts for around 60% of GDP (if one includes urban collectives in the SOE category) while it contributes around 5% of total tax revenues. On the other hand, the troubled SOEs are providing the bulk of state tax revenues. The Chinese government will have to increase its tax efforts, particularly on enterprises in the non-state sector (comprised of private, collective and foreign firms), in order to finance its larger expenditures. Expenditures will be large due to the need for the state to take over the provision of basic social services from the SOEs and in the provision of social safety nets and social insurance. The commitment to harden the budget constraints of SOEs – which will reduce subsidies, both fiscal and quasi-fiscal, to SOEs – will reduce some of its expenditures. But at least in the short run this will be decrease the expected expenditures especially since the government is expected to borrow large sums of money to capitalize a very troubled financial sector.

3.3 On the Financial Sector

Past policy loans and implicit quasi-fiscal subsidies to the SOEs has led to extremely high debt-to-equity ratios for China's SOEs and have led China's four state-owned commercial banks being saddled with non-performing loans estimated to be 24% of total loans in 1997.

The solution to China's financial sector woes are:

-- transfer of non-performing loans out of the books of the state-owned commercial banks. Moves towards this has been started in April 1999 with the creation of Cinda Asset Management tasked to buy the non-performing loans from China Construction Bank, of the four state-owned banks. Cinda was able to get an initial 10 billion renminbi (\$1.2 billion) from the Ministry of Finance to purchase the bad loans. Cinda can force state-owned enterprises with these bad loans to restructure, layoff workers and become more efficient in order to repay the bad loans. It also has the power to convert unpaid debt into equity which means it can become partial owner of badly run SOEs. The creation of Cinda many believe will force an improvement in the accounting, management and risk-assessment practices of both state-owned commercial banks and state-own enterprises. This could be the start of the adoption of basic commercial and market-based banking practices for loan transactions to the corporate sector. These include:

- Part of the recapitalization of the commercial state-owned bank will also start once Cinda purchases the bad loans from the China Construction Bank. The experiment with one state-owned commercial bank is illustrative of the gradualist and experimental style to market reforms the Chinese authorities are undertaking. There is also a practical reason. Capitalization of all of the state-owned commercial banks may require substantial amount of financial capital and may require substantial domestic or foreign borrowing. It is best that government debt be increased slowly while banking and enterprise reforms are undertaken so as not to put undue simultaneous pressures and stresses on the state sector.
- Work towards using commercial and traditional banking principles and practices to loan transactions in the banking sector. This requires the setting up of a credit culture which may actually flourish with the need now of massive funds for mortgages and loanable funds for investments and consumer durable from the non-state sector. This also requires the building up of a more sophisticated accounting, auditing and risk assessment system, reasonably honest self-reporting of enterprises and banks, more transparency and the setting up of a whole financial infrastructure of prudential regulation, enactment and enforcement of banking, credit, bankruptcy laws and regulations. This also entails a sure turning back on massive and widespread subsidies and policy loans to SOEs, a hardening of their budget constraints and less state dictates on the production and distribution of firms.

4. Summary and Conclusion

The release of initial pent-up productive forces in the first two decades of China's market reforms have made it the fastest growing major country in the world. It seems, however, that the easy phase of growth might be ending. Structural changes in demand patterns, painful reforms in the state sector and a less friendly world environment may reduce China's growth to within 6 to 8 percent in 1999 to 2000.

We have seen how important and inter-related changes and reforms will have to be undertaken to effect: a) a more efficient and profitable state enterprise sector; b) increased labor mobility and establishment of a dynamic housing sector; c) a strong government and private system of social services, social insurance and provision of safety nets; d) a more efficient and progressive taxation system; and d) corporate and financial reforms to institutionalize market-based and performance-based incentives and competition in the corporate and financial sector.

All these changes will be easier if the macro environment allows for sufficient growth and external and domestic demand expansion. This is vital for political and economic stability, to allow re-absorption of displaced labor, and to prevent a possible domino-like collapse of state enterprises and financial institutions. A recession will make the reforms extremely difficult to implement and will exacerbate the vulnerabilities of the financial, enterprise and fiscal systems.

But if China is successful in its reforms and world trade picks up again, there may be another big spurt of growth as whole new industries related to housing and consumer durables may combine with exports to give a big boost to the economy. Enterprises and financial reforms will increase efficiency and profitability in the medium and long term, and China will be heading towards genuine economic development and dragon-hood.

The Macroeconomy of China in the Late Nineties *

Joseph Y. Lim

China has been touted as the great dragon and potentially the most powerful addition to the East Asian high-growth economies. It has been in the forefront of economic growth in the eighties and especially in the nineties, its GDP per capita quadrupling during the period from 1980 to 1997³ (see Table 1).

China enters a critical crossroad in the late nineties as the rest of East Asia finds itself mired in the most serious crisis and recession it has ever faced. China must deal with painful structural reforms in its transition to a market-based economy and structural demand changes in its climb towards a higher phase of development.

1. UNDERLYING REASONS FOR CHINA'S SUCCESS STORY

1.1 Good Initial Conditions for Economic Take-Off

China's socialist experiment, despite periods of significant turbulence and excessive restrictions, effected important structural and distributional reforms that laid the conditions for an environment conducive to growth. The market reforms undertaken in the late seventies to the present were able to build on these conditions and release productive forces that have brought about much higher and sustained growth.

The changes instituted by the socialist government include (see Harrold (1992) for a lengthier discussion on these matters):

- Successful land reform and a diversified and self-sufficient peasant agriculture; crucial investments in rural infrastructure, in particular, irrigation facilities, the use of improved seeds and fertilizers, and support services for marketing and credit.
- Sufficient social infrastructure in both rural and urban areas for the provision of health services, and universal education through locally generated funds.
- Significant development of basic industries (mainly through state-owned enterprises in steel, textiles, etc) which are important for such a large country as China.
- A high degree of provincial and local autonomy not only politically but also in economic planning and implementation. (It is said that China consciously encouraged regional sufficiency and relative autonomy due to the fear of being invaded by the erstwhile Soviet Union.)

* This study is part of the research project "China and Its Implication to the Asia Pacific" funded in whole by the Philippine APEC Study Center Network (PASCN).

³ While that of the Philippines had sunk below its 1980 per capita GNP level in 1998.

- Successful redistributive policies that have reduced income disparities, which might be causes for political instability and dissent.
- Strong historical ties with Hong Kong and the overseas Chinese of Southeast Asia, especially after the normalization of China's foreign relations with most countries after the meeting in 1972 of US president Richard Nixon and Mao Zedong.
- A strong state and government which provides political stability as well as a coherent, credible economic program⁴.

Before 1978, China's economic growth was respectable by low-income Third World standards, averaging 3.93 percent for the period 1971 to 1977. This however came in spurts and fluctuated wildly.

The main reasons for this uneven and lower-than-present growth pattern is that the command economy and production targets set by the socialist state did not provide enough incentives to encourage production units to innovate and to improve production processes and product quality. Furthermore, most state-owned enterprises and communes were not free to channel their surplus towards the improvement and growth of their own production units. There was also a lack of healthy competition among production and distribution units that would have encouraged increases in productivity, efficiency and product quality. The relatively closed economy prevented further innovations and technological improvements that would have arisen from a healthy participation in foreign trade and directed exposure to foreign investments. It also limited the exposure of China's products to the world market and prevented it from developing a dynamic export sector, which eventually became China's engine of growth in the eighties and nineties.

2. THE MARKET REFORMS

The market reforms instituted in the late seventies and eighties changed the incentive structure, and revolutionized financial and fiscal processes. The reforms involved a mix of policies designed to integrate China further into the global economy while at the same time strengthening its domestic base and market. Some of the more important reforms are summarized as follows.

2.1 Rural Reforms

The earliest reforms shifted the production unit from the commune to individual households. Under the new "household responsibility contract system" land was leased to households for 15 to 25 years. While the state stipulated the crop to be produced farmers could retain a sizeable portion of their harvest for sale in the market. Relative agricultural prices (vis-à-vis industrial goods) were raised as an added incentive. Table 2 shows that prices of farm products compared to rural industrial products remained high during most of the reform years. The result here

⁴ The author does not include here repressive policies and undemocratic practices.

was a surge in rural output, profits and savings, giving rise to rural non-agricultural collective enterprises -- the township and village enterprises (TVEs) -- which were allowed to use the surplus generated by the rural sector for light industries. TVEs have been one of the most dynamic sectors in China.

2. 2 Directed Foreign Direct Investments

Another early reform was the opening up of the country to foreign direct investments via joint ventures with the state (1979) and the establishment of special economic zones (SEZs, in 1980). In 1986 foreign exchange swap centers were set up, which basically removed the government requirement that joint ventures be self-sufficient in generating foreign exchange. Thereafter administrative bottlenecks and interference were also reduced. Since then foreign investors have poured into the country, increasing rapidly throughout the eighties but most impressively throughout the nineties. In 1992 alone the volume of net foreign direct investments -- \$7.2 billion -- was greater than total inflows in the first 10 years of China's reform program. By 1997, net foreign direct investments brought in \$41.7 billion (see Table 3). China's abundantly cheap and docile as well as productive labor and its potentially gargantuan domestic market naturally attract foreign investors. The marked increases in the late eighties and nineties are due also to the increasing interest of overseas Chinese in investing in China. Capital from Taiwan, Hong Kong and Southeast Asia have been flowing into South China in massive quantities.

2. 3 Foreign Trade

In 1977, the combined export and import sector already comprised a significant portion of the economy (close to 20 percent of GDP). The various reforms encouraged the trade sector to grow even faster as decentralization of decision-making and the expansion of markets ensued. Official policies to encourage exports can be seen through such incentives as tax rebates, foreign exchange retention, and most especially, a strong depreciation of the Chinese yuan (or renminbi -- RMB) in 1981 to 1987 and again in 1990 and most recently in 1994 (see Table 1). In addition, real output per employee (labor productivity) is also growing fast especially in the nineties (Table 1). This enhances further the competitiveness of China's products. Between 1977 and 1992, the volume of China's merchandise exports ballooned from \$8.77 billion to \$84.9 billion. By 1997, the figure has reached \$182.7 billion (see Table 3).

2. 4 Reforms in State Owned Enterprises (SOEs)

Reforms in state-owned enterprises (SOEs). Starting in 1983, SOEs were no longer required to remit all of their profits to the national government. Instead they had to pay some form of income taxes. Other reforms included the sharing of profits with the SOE management, and a shift of supervisory power from the central ministries to the local industrial bureaus. In 1984, plan targets were lowered and the SOEs were allowed to produce above the targets and sell their products in the market. In 1985 further decentralization of enterprise management was implemented alongside a two-tiered price system wherein target output levels for the state sector are paid lower-than-market (official) prices while above target production levels are sold in the market at market prices. A "contract responsibility" system in agriculture was also adopted in the SOE sector as the SOEs entered three-year contracts with the

state specifying investment targets, profit remittance levels, retention rates, etc. Around 1987 and 1988, the contracts increasingly emphasized and gave positive incentives to meeting financial targets (profits, equity ratios, etc.) as opposed to physical (output) targets. Again the strong incentives given to the SOEs brought about increases in investments and productivity growth many SOEs. Productivity growth was achieved as the SOEs were exposed to competition from the nonstate sector and SOEs of other provinces and areas.

It must also be pointed out that although most SOEs in the manufacturing and industrial sector were retained by the state, most of the commercial and services companies were sold or leased to private owners. New private entrants to the commercial and services sectors were encouraged. In reality it is not the reduction in state factories but rather the growth of the nonstate sector, specifically township and village enterprises (TVEs), that accounts for the structural shift in ownership of enterprises. Table 4 shows the shares in industrial output by ownership type of enterprise. Note that there is a shift of industrial production from the state sector to the nonstate sector. The impressive increases lie with the TVEs and individual and other enterprises (including joint ventures). But even as its share in output and employment declined drastically through the years (from producing 64.9% of industrial output in 1985 to 28.5% in 1996), the state-owned enterprise still produces more than a quarter of industrial output. Its importance is also highlighted if we consider the state-owned enterprises as one of the biggest employer of labor. Table 5 shows that state-owned enterprises and collectively owned enterprises in urban areas hire 20.7% of total employment in 1996. Township and village enterprises employ 19.6% of total employment in 1996. Thus state-owned enterprises and collectively owned enterprises still employ a very big portion of labor in the country.

The state has also maintained strong control over the wholesaling of basic and agricultural products, retailing of essential goods, which are rationed and controlled by price controls, and the operation of large department stores and commercial outlets.

Simultaneous with reforms of SOEs is allowing private firms and enterprises, producers, wholesalers and retailers to operate and set up their own businesses. Together with the TVEs and firms (many of which are SOEs) with foreign joint ventures, this provided healthier competition in the dynamically growing market economy. It can be seen from Table 4 that individual enterprises and other enterprises (including joint ventures) made up only 3.1% of output in 1985. In 1996 they provided 31.1% of industrial output. TVEs almost doubled its share of industrial output from 16.2% in 1985 to 31.2% in 1996.

2.5 Financial Reforms

The Chinese government still controls the entire banking sector. But to be consistent with the market and incentive reforms, it had to separate the functions of central banking and commercial banking. In 1984, the separation began with the People's Bank of China undertaking only central banking functions while newly created state-owned commercial banks took over commercial banking functions. More financial innovations were implemented with the setting up of two universal banks and the creation of nonbank financial institutions in the local areas. The

enterprise reforms saw a great surge of demand for the services of financial institutions, especially at the local level. Enterprises that now retained part of their surplus and invested more, workers whose pay and benefits increased as enterprises' capacity to raise their wage fund became larger, private households and enterprises whose profits and savings were surging fast -- all needed financial institutions in which to lodge their funds. It is indeed this large explosion of financial savings that gave rise to the rapid increase in bank deposits and the phenomenon of financial deepening as money supply to GNP ratios rose rapidly due to growing bank deposits (see Tables 6 and 7). This financial deepening also tempered monetary pressures towards high inflation (one of the periodic macro problems of China) as significant increases in money supply were channeled more to financial savings rather than to high consumption⁵.

2. 6 Fiscal Reforms

The fiscal processes also had to undergo major transformations. The government lost much of its revenue generating capacity when it allowed SOEs to retain a sizeable portion of their surpluses. (This in effect transformed the revenue generation from SOEs into something akin to a corporate income tax.) Though this also reduced the state's investment expenditures for the SOEs, the decline in the profitability of SOEs has caused a revenue and fiscal squeeze on the national government especially as many SOEs started to incur deficits and losses, requiring subsidies and/or restructuring by the government.

The central government has always relied on provincial taxation bureaus to collect revenues and taxes. Again in 1985 and 1986, the responsibility contract system was applied to the local governments as they were required to enter into a contract with the central governments on the sharing of revenues between them. In 1994 the central government introduced a national corporate and personal-income tax and a value-added tax, but it still depends to a large extent on the local governments for collection. Tables 8 and 9 show that with the decline in revenues from SOEs, the dependence of the government on indirect taxes (especially value-added taxes) increased tremendously in the late eighties and nineties making it the biggest and most important source of revenue of the government.

As the government increased its deficits through the years, the need for it to develop financial instruments to borrow domestically will become even more pressing.

3. STRONG MACROFUNDAMENTALS OF CHINA: THE PRE-CRISIS PERIOD

The Chinese macroeconomy has surged in the eighties and throughout the nineties. There were periodic spurts of high inflation in 1988-89 and 1993-95, which required deflationary and demand-reducing policies. There was just one major slowdown in 1989-90 as a result of aggregate demand reduction and political

⁵ One of the features of the impressive growth of China is very high savings rates, as will be discussed later.

upheavals (the Tienanmen demonstrations and crackdown) and their economic repercussions (especially on foreign investments).

The Chinese economy easily bounced back after the 1989-90 political and economic difficulties to achieve in the nineties the highest growth rates for any major country in the world. The growth in the nineties was spurred by industry (double-digit) growth followed by services. Agricultural growth remained respectable at more than 3% growth. GDP growth rate climbed to 12% to 15% in 1992 to 1994 and decelerated in 1995 to 1997 as a result of demand-reducing policies to tame the inflation in the 1993-1996 period. Growth rates were 10.5%, 9.5% and 8.8% respectively in the 1995 to 1997 period.

Gross domestic savings grew to more than 40% of GDP in the mid-nineties while gross investments grew to around 34% of GDP. The high accumulation achieved by the country no doubt contributed to the impressive growth rate of the economy.

Export growth was between 15% to 20% in the early nineties (1991 to 1993). But with the devaluation of the renminbi in 1994, export growth shot up to 35.6% in 1994 and remained high at 25%, 18% and 21% respectively for 1995, 1996 and 1997 (see Table 1).

Because of high export growth during the nineties, trade and current account balances were mostly positive in the nineties (Table 3) and international reserves increased to more than 12 months equivalent of imports in 1997 (see Table 1).

Foreign inflows consisted mainly of direct investments rather than portfolio investments and short-term debt thanks to capital controls and directed capital biased towards foreign joint venture capital and long-term loans. Table 10 shows that based on gross inflows of foreign direct investments, portfolio investments and other financial investments – as percentages of GDP – China had only relied on foreign direct investments for foreign capital inflows. In the nineties, portfolio investment and/or other investment inflows increased for the East Asian countries that liberalized their capital accounts. Other investments took the form of short-term unhedged borrowings, which made them so vulnerable to contagion and illiquidity caused by credit cut-off. The same table shows that China's external debt to GDP ratio (15.6% in 1996) and the size of short-term debt (3.1% of GDP in 1996) are low in China compared to other East Asian countries hard-hit by the crisis. Lack of capital convertibility and liberalization, together with the strong international foreign reserves position of China, shielded the country from contagion and successful speculative attacks as a result of the East-Asian crisis. Table 10 shows that the import cover of China in 1997 (the year the Asian crisis erupted) was equivalent to almost 13 months of imports, much more than any country in East Asia. No amount of speculative attack on China's currency would have succeeded.

Fiscal deficits of China have been reduced from more than 2 % of GDP in the early nineties to around 1.5 % of GDP in 1996 (see Table 8). The seemingly healthy fiscal balance, however, hides structural fiscal problems to be discussed later.

China's inflation was reduced substantially from double-digit in 1993 to 1995, to 8.3% in 1996, to 2.8% in 1997. The inflation rate in 1998 appears to be negative

from the preliminary data (Table 1). Without the East Asian crisis China would have achieved a soft landing in its latest fight against inflation.

4. EFFECTS OF THE EAST ASIAN CRISIS

The East Asian crisis came at a crucial time when some important changes in the Chinese economy were taking place:

- a. domestic demand was starting to weaken as characterized by the slow growth of retail sales, build-up of inventories and deflationary pressures on prices in 1998. The slowing domestic demand may initially be due to the deflationary policies as a result of high inflation in the 1993-95 period. But in 1998, the weak domestic demand may indicate some satiation in the traditional consumer durables (such as color televisions, refrigerators and washing machines) and the inadequacy of income to increase demand of more expensive and more protected durables such as automobiles and housing. The lack of a dynamic market on housing also contributes to inadequate supply in the sector while lack of mortgage and loanable funds reduces its affordability and accessibility. Oversupply of light manufactures and consumer products has caused a shift from what China experts call a sellers' market (during the period of high demand growth) to a buyers' market. This means that there will be more intense (and destructive) competition among sellers and a bigger need for sellers to undertake product upgrading, technological and productivity improvements and innovative product expansion. TVEs have been particularly hard-hit by the shift away from light manufacturing consumer goods and durables.

Large regional disparities and the inability of other areas in the hinterlands to develop in pace with the coastal areas has shut off a possible venue of domestic demand expansion from the more backward areas.

- b. Continuing and important reforms of the state-owned enterprises – including a hardening of SOEs' budget constraints -- and strong competition from the non-state sector had brought deficits and losses to many state-owned enterprises. This has serious implications on the fiscal position of the government and the financial status of state-owned commercial banks. These will be discussed in a later section. Another important implication is that for state-owned enterprises to be competitive, they will have to layoff some workers and reduce their obligations to provide housing, education and other social services to their workers. Simultaneous therefore should be market-oriented changes in the areas of pensions, health care, housing and education. The uncertainties that these changes bring to urban workers and employees will further dampen domestic demand as they become more cautious and increase their savings to cope with possible losses in wage income and higher expenditures on social services.

Thus China is, more than ever before, dependent on its export sector and high GDP growth to stave off a slackening of domestic demand and at the same time allow laid-off workers to be absorbed in either the non-state sector or the more productive SOEs. Without the strong export stimulus and continuing strong GDP growth, domestic demand will weaken further, state-owned enterprises will suffer higher losses and deficits, and more workers will be laid-off and unable to be absorbed by

other sectors due to a weakening economy. SOE losses and deficits will translate into bigger fiscal and financial problems and volatility. Economic, financial and political stability will be jeopardized.

Table 1 shows that exports, after growing by around 20% in 1995 to 1997 (see Table 1) grew only by 0.58% in 1998. Table 11 shows that the large slowdown in export growth is mainly due to a decline in the exports to Japan, Hong Kong, Korea and ASEAN -- all in financial and economic distress in 1998 and 1999. China had been vulnerable to the East Asian crisis inasmuch as the majority of its exports go to Asian markets. Table 11 shows that in 1996 (the year before the Asian crisis erupted), more than 60% of China's exports went to Asia, with 21.8% going to Hong Kong⁶, 20.4% to Japan, 5% to Korea, 3.7% going to ASEAN countries and 2.1% to Taiwan. In 1998, exports to Asia had been reduced to 53.4% of total exports, while exports shares to North America (especially the SA) and Europe had increased. The sharp deceleration in export growth in 1998 clearly was due to the sharp contraction of the East Asian export market and China's large exposure to this market.

Table 12 shows that much of the deceleration in export growth in 1998 reflects a fall in primary commodities exports (with animal and vegetable oils, mineral fuels and lubricants and non-edible materials falling sharply) and slower growth in exports of manufactured export goods (including a fall in light and textile industrial goods).

The slowdown in export growth was originally accompanied by significant cutbacks in imports. The deceleration of import growth started as early as 1997 when import growth was a measly 3.7% (while export growth was 21%). In 1998, there was import contraction of 1.54% that accompanied the export growth slowdown. The situation has changed in the first half of 1999 as initial reports show exports falling between four to five percent in the first half of 1999 and imports increasing by fifteen to sixteen percent during the same period. The drastic fall in China's trade surplus in 1999 will no doubt keep talks about a renminbi devaluation very much alive.

Because of weak domestic and external demand, the government decided to embark in a strong pump-priming drive to stir up the Chinese economy in 1998 and 1999, hoping to keep economic growth from declining sharply. The pump-priming measures include:

- Infrastructure building in roads, railways, telecommunications, irrigation, rural electricity networks and environmental protection. It is too early to tell whether these projects are being undertaken in more backward areas in order to reduce regional disparities.
- Undertaking housing investments and projects in 50 sectors of the economy. Housing investments are targeted to comprise 15% of total fixed asset investments in the next three years.
- Provide loans for housing, and purchases of consumer durables, especially motor vehicles.

⁶ Hong Kong is however a transit point only for many of China's exports.

- A series of interest rate cuts, as inflation is at its historic trough. There is however little room for further cuts as interest rates are already very near US interest rates.
- Increases in money supply through loan expansion to the state-owned banks and reduction of the required reserve ratio.
- Financing the investment expansion by issuing treasury bonds. With excess capacity in the industrial sector, it is hoped that this will still result in a multiplier increase in aggregate demand.

The Chinese government targeted an 8% growth for 1998 and announced that they had achieved 7.8%. This will be sixth consecutive year of growth that is lower than the previous year (starting from 14.2% growth in 1992 and down to 7.8% in 1998). In the first half of 1999, growth reportedly slowed down slightly to 7.6%, while the authorities have lower their GDP growth target to 7%. Even with the slowing down of the Chinese economy, the growth achieved is high especially in current East Asian (crisis) standards.

What is more worrisome is the little room for maneuverability currently available for the Chinese authorities to continue sustaining the respectable growth. The problems faced by the Chinese authorities are:

If investment projects are not efficiently and wisely done, this might lead to duplications, unnecessary wastage and inefficiencies, which may lead to further SOE losses and loan defaults in the future. The economy might crash into a recession. With SOE losses threatening to ruin financial markets and the government's fiscal position, this crash may be very disastrous to the Chinese economy.

The government's deteriorating fiscal position as a result of deteriorating SOE deficits and losses will necessarily curtail government's future capacity to further pump-prime the economy without resorting to loans and credit subsidies. The use of quasi-fiscal measures and credit facilities, on the other hand, may aggravate an already weak financial sector burdened with tremendously large bad debts.

'Animal spirit' has already been seriously eroded with the slowdown in growth and exports, with the deteriorating fiscal position and especially with the growing non-performing loans of the state-owned banks.

It is therefore to China's interest that the East Asian and Japanese crises and recession would end as soon as possible so that exports can provide a much needed stimulus to sustain growth while hard reforms are being done.

On the domestic front, proper reforms, if properly done, can provide engines to medium and long-run growth. Apart from increasing productivity and efficiency in the state-owned industries, the transfer of SOEs' social service obligations to the private sector will lead to the privatization and commercialization of the housing sector, which in turn can give rise to a whole array of ancillary services and industries (carpentry, architecture, plumbing, house repairs and maintenance, furniture and appliances) that can absorb labor thrown off from failing SOEs (see Stiglitz (1998)).

The same can perhaps be said of the private and market-oriented health and education sectors. It must be pointed out that state participation and regulation in these sectors are still essential to ensure the meeting of standards of quality, equity and universality (with special emphasis on the availability of these social services in backward areas) in all the three sectors (housing, health and education).

5. ON THE EXCHANGE RATE DILEMMA

The most controversial question with respect to China's role in the East Asian crisis is whether China should or will be forced to devalue its currency to save its exports and remain competitive with the other East Asian countries. Fig. 1 shows the real exchange rate (nominal exchange rate less inflation rate) of various countries with 1990 as the base year⁷. Note that China originally had the most depreciated currency especially with its devaluation in 1994. It still had the most depreciated currency in 1996 on the eve of the crisis. But with the onset of the East Asian crisis, we find that in 1998, on the average, China's currency had appreciated (based on 1990 real exchange rate levels) with respect to the East Asian countries except the Philippines. This appreciation of China's currency to its neighbors, many fear, may force China to devalue its currency.

There are several reasons why this scenario may not happen in the short run.

First, the slowdown in China's export so far is mainly due to the decline in the East Asian economies rather than China losing its exports to other East Asian countries. This can be seen in Table 11 where it is clear that exports to Asia decreased significantly but exports to North America and Europe grew substantially in 1998. This is verified by preliminary data showing exports of crisis-ridden East Asian economies performing poorly in 1998 despite significant depreciation in their currencies.⁸ These all point to the fact that a renminbi devaluation is not yet of vital urgency.

Furthermore, a renminbi depreciation now will cause another round of destructive competitive devaluation in the East Asian economies. This will defeat the original purpose of the renminbi devaluation. Furthermore, it will potentially ruin the recovery of the East Asian economies, which we have seen is vital to the recovery of China's exports. A significant renminbi devaluation may cause significant pressures for currency depreciation and further economic dislocation for Hong Kong, Korea, Taiwan and the ASEAN countries which together comprise more than 30% of China's exports. Furthermore East Asia (especially Japan and Hong Kong) has a big trade deficit with China, and so its recovery would be important to sustain China's strong trade and current account position.

⁷ The graph will be very sensitive to the base year. If the base year was just slightly before 1990, China would have depreciated more since its currency devalued sharply in 1990. If the base year was 1986, Korea would have appreciated heavily since its currency became increasingly strong in 1987 to 1989. If the base year was 1994, China would have appreciated most since the graph would not have captured the significant devaluation during that year.

⁸ This is due to credit constraints that have affected export production in these countries and the continuing slowdown of the world semiconductor market.

It is also true that even if China's currency has appreciated in real terms from its 1990 level more than other East Asian countries, it has remained very competitive with its strong growth in labor productivity. Table 13 gives us the growth rate of labor productivity of China compared with other East Asian countries. It is clear that throughout the nineties China's growth in labor productivity had outpaced all the other countries. The gap in the growth in labor productivity would have even widened in 1997 and 1998 when China's growth and efficiency gains were far greater than the East Asian countries in crisis. Also in 1997 and 1998, China's inflation rates fell to near zero and even into negative territory while East Asian inflation rates soared to double-digit or high single digit rates. All these again point to the fact that despite some real appreciation of the renminbi vis-à-vis other East Asian currencies, China's continuing high productivity growth and low inflation during the East Asian crisis period would make its export products competitive with East Asian products. China should be more concerned with regaining the export markets of the fallen East Asian countries rather than on competing with them.

Since China is not yet a member of the World Trade Organization (WTO), it has the advantage of giving tax credits and credit subsidies to the export sector, which can be as effective (if not more so) as a currency devaluation.

Macroeconomic and trade theory also dictates that economic fundamentals of China should allow for some appreciation of its currency. Table 13 shows the current account balance of China (as percentage of GDP) vis-à-vis other East Asian countries. Together with Taiwan, China had in the nineties achieved current account balance or surpluses in the nineties. 1997 and 1998 would also be periods of even higher current account surpluses for China due to the bigger slowdown in imports compared to exports⁹. The good current account position is matched with strong international reserves which have grown to more than ten months worth of imports. The increase in foreign exchange reserves, unlike the East Asian economies hit by the crisis, is matched with increased capacity for earning foreign exchange. Capital inflows are made up mainly by foreign direct investments, which directly contribute either to export production or to import substitution, thus building up foreign exchange capabilities in the medium and long run. This contrasts sharply with the massive short-run portfolio and short-term debt inflows to the East Asian countries (before the crisis) which led to an artificial appreciation of their currencies as their foreign exchange earning capabilities deteriorated.

Finally, it is China's goal to become an economic and political leader in Asia and in the world. It will win China quite a few political points and goodwill if it postpones any depreciation of its currency until such time as when the East Asian economies have gotten over this crisis and are strongly participating in the world economy again. China had made it clear that it is only a massive depreciation of the yen that can force it to devalue its own currency. The yen has now stabilized below the 130 yen to a dollar level. China can concentrate on improving its productivity and continue its low inflation trend to keep competitiveness strong while restructuring and reforming its fiscal, financial and state sectors so as to further enhance long run productivity, efficiency and technological growth. In the meantime, it is to

⁹ Even if 1999 threatens to reduce substantially the trade surplus with negative growth in exports and growing imports, current account balances are still expected to be positive, though much reduced.

everybody's interest, especially China, to see the East Asian economies (particularly Japan and Hong Kong) back at their feet and again trading strongly with China.

6. ON PROBLEMS OF A TRANSITION ECONOMY

6.1 The Theoretical Debate

Before tackling problems of a transition economy, it is best to first discuss briefly the issues concerning the Chinese path to development. There is now a minor debate between two camps of China analysts. The first camp, called the 'big bang' theory or the Convergence school, is composed of economists such as Jeffrey Sachs, Michael Bruno, Gang Fan, Geng Xiao and Wing Thye Woo (1999). They espouse faster privatization and market liberalization and view government interventions and socialist principles as impeding long run growth and development of China. This school also defends the one-shot and blanket liberalization and privatization of the economy and the state sector as the best path for transition economies. It views the Chinese economic success as the typical East Asian success story of countries opening up their markets and trade sectors and employing cheap, surplus labor from agriculture to light manufacturing. The continuation of high growth in China however critically depends on the privatization of the state and collective sectors and in the liberalization of the product and factor markets in the economy. The failure of some East European transition economies to progress into successful capitalist countries had more to do with the lack of rural and agricultural labor surplus and the complete dominance of the state sector in labor employment on the eve of the transition.

The other school, called the gradualist or 'experimental' school, is comprised of economists such as Peter Nolan, Barry Naughton, Thomas Rawski and Gary Jefferson. Recently this group had been strengthened by the entry of Joseph Stiglitz, chief economist of the World Bank, to their ranks. This school contends that it was the gradual opening up of the economy by giving market and performance-based incentives (such as a percentage or share of profits in the 'contract responsibility systems') to market players and exposing them to domestic and foreign competition that released the tremendous productive forces in China. This is more effective than 'privatization in a non-competitive environment'¹⁰. 'Rather than focusing on the privatization of existing enterprises, [China] focused on the creation of new enterprises.'¹¹ The gradualist nature of China's opening up had to do with 'maintaining and strengthening social organization during the transition and to create the institutional infrastructure that a market economy requires.'¹² In particular, necessary legal and institutional mechanisms to implement and enforce bankruptcy, competition and contract laws are required. Transparency and standard accounting practices will have to be learned and made prevalent.

It is within the framework of this second school where our earlier analysis of China's initial socialist reforms combining successfully with strong market reforms will be appreciated.

¹⁰ Stiglitz (1998) p. 2.

¹¹ Ibid p. 3.

¹² Ibid p. 2.

6. 2 Increasingly Painful Reforms of State-Owned Enterprises

The relative economic slowdown in China has emphasized the structural problems of China, particularly in the SOE, financial and fiscal sectors. In recent years, the state has slowly moved to the position that failing SOEs will be allowed (or forced) to close shop and/or lay off workers as provision of social services are transferred to the private sector and national and local governments. The transfer of social service obligations away from SOEs will economically and financially benefit the SOE as it reduces a big portion of its expenditures. This will allow a better assessment of the viability and profitability of the SOEs. Politically, however, it means that SOEs will be less protected against bankruptcies and closures. At the same time, the state has initiated the hardening of SOEs' budget constraints – which means less direct and credit subsidies as well as less directed policy (usually soft) loans and a stricter punishment of SOEs going into arrears.

It is estimated that fifty to sixty percent of SOEs are operating with losses. Profits have been steadily falling and have become negative in the first half of 1998 (Stiglitz (1998)). It is also a fact that capacity utilization (the Chinese call this utilization rates) is very low for many firms and industries. Rolled steel industry has a utilization rate of 62% in 1995. The machine tool industry had a utilization rate of 46.2% for the same year (Wu (1998)). In June 1998, color televisions and refrigerators had utilization rates of 46.1% and 50. 1%, respectively while industries for air conditioning, washing machines and vacuum cleaners had rates of 30 to 40 percent. The telephone industry had a utilization rate of 28% (Song (1998)). The very low utilization rates and continuing losses are a reflection of the barriers to exit, bankruptcy and takeover of SOEs due to their overprotection and provision of social services to employees, and continuing competition from the non-state sector. Gore (1999) claims that this is also a result of incentives for local bureaucrats to achieve high local growth via over-investments, duplication not only of firms and industries but also of entire provincial economies in a system marked by a striking lack of regional specialization based on comparative advantages. No doubt these explanations are also tied in with the lack of labor and capital mobility, the inadequate supply and mortgage funds for housing (to support labor mobility), and the inadequate government investments in backward areas to achieve better regional equity.

Nolan (1998) points out that this doesn't mean that SOEs should all be dismantled. In fact, when redundant labor are allowed to be shed, wages are allowed to move with market forces, and social service obligations are removed, many of them may become reasonably viable and profitable. He points to many SOEs in the upstream industries that are doing well and turning in reasonable profits. Critics may point out that these profits are due to the SOEs' monopoly status and overprotection. But Nolan has a point when he claims that upstream industries, key public utilities and other vital sectors that involve some economies of scale, externalities and learning by doing -- where correct government interventions can correct some market failures -- may be economic areas where viable SOEs may be allowed to remain. *Chaebols* of Korea and *zaibatsus* of Japan are examples of large firms that have become economically and technologically strong through competition in the domestic and world market and through government help and guidance. In fact Nolan (1998) points out that the government has indeed been privatizing or closing small and

medium SOEs involved in trade and downstream production. It has hang on to the firms in the upstream industries, public utilities and higher technology SOEs.

China's transition economy, as Stiglitz (1998) points out, should put competition and correct market and performance-based incentives -- not exclusive privatization -- in the forefront of its reforms. Together with this is proper governance of the economy, where corporate and financial governance and supervision are critical.

6.3 The Shedding of Labor, Its Re-absorption, and Social Insurance

Because of barriers to entry and exit of labor, SOEs are plagued with redundant labor and wages that are way above rates commensurate with productivity and market rates. With the ongoing reforms however 12 million SOE workers had been laid off in 1997, comprising 10% of SOE employees and 7% of total urban employment (Meng (1998)). Half of these workers were able to be reabsorbed in the economy in 1997. In the first half of 1998, another 3 million workers were laid off. China's Ministry of Labor estimates that there are 22 million redundant workers in state and collective enterprises in the cities (Wu (1998)). The ongoing reforms will no doubt displace more workers. The good news is that decades of slow reforms have reduced the state sector in terms of its share of output and its share of employment (see Tables 4 and 5). This should make additional reforms easier as the shedding of labor continues at a lesser pace. The bad news is that the size of labor in the state and collective sectors is still enormous. In 1996, the state-owned enterprises and urban collectives still employ slightly more than 20% of total employed persons, while township and village enterprises (TVEs) employ another 20% (see Table 5). Another bad news is that in the past much of the displaced labor was reabsorbed because of the high growth in the economy. Between 1995 and 1997, SOE employees dropped by 3.6 million, while private sector employment increased by 12 million (Stiglitz (1998)). But starting 1998, the slowdown in domestic demand and domestic growth, as discussed previously, have affected adversely not only SOEs' performance, but also TVEs' performance and profitability, and the non-state sector's ability to absorb further displaced labor. Thus the issue of China's external and domestic demand and growth potential becomes critical to the ongoing reforms.

Of course, the picture is not that bleak. State reforms itself should create new sectors and new industries that will be able to generate dynamic labor employment. Housing is a very important sector that has two vital functions. One is its large contribution to labor mobility and well functioning labor market that is so important to efficiency and productivity of the country. The other is the multiplier effect on domestic demand and labor employment that we have discussed earlier as it itself is a big stimulus for domestic demand and creates also a series of ancillary service sectors.

Equally important in the set of state reforms are the state provision of social services and the creation of a social insurance scheme as these obligations are being taken off the backs of the SOEs. Inasmuch as SOEs are still in a state of flux, widespread implementation of employment insurance schemes for private employees may be limited, though urgently needed. Schemes for unemployment and health insurance and pensions are critical but beyond the scope of this paper. The government will have to assume much of the duties of providing basic education and health services for the general public, while allowing the private sector to serve the

higher income groups. This will require important revenue sources, and will be discussed immediately.

6.4 Problems in the Fiscal Sector

With increasing losses and deficits in the state-owned enterprises and reforms that allow profitable SOEs to retain part of their profits, the tax effort (tax revenue to GDP ratio) has fallen from 28.4% in 1980 to 10.5% in 1997 (see Table 8). This is one of the lowest in the world. Table 8 and 9 also shows that taxes on income and profits are dominated by state owned enterprises, thus accounting for the small share of direct taxes in total tax revenue and the large decline in tax revenues. Table 9 shows that in 1996 18.7% of total tax revenue is made up of taxes on income and profits, of which 13.4% of total tax revenue are from SOEs. Thus the major contribution to tax revenue are taxes on goods and services, accounting for two-thirds of tax collection (value added taxes account for around 43% of total tax revenue in 1996).

The above shows a big mismatch wherein the non-state sector accounts for around 60% of GDP (if one includes urban collectives in the SOE category --see Table 4) while it contributes around 5% of total tax revenues. This makes the tax system very regressive. Thus improvements in tax schemes and collection efforts on the non-state sector will have to be undertaken immediately. The Chinese non-state firms are charged 33% corporate income tax rate while foreign enterprises are charged 15% corporate income tax rate. There is a prevalence of illegal tax avoidance from private and collective sectors as well as the foreign sector, which is hard to detect due to inadequate and underdeveloped accounting and audit systems. But with the state having to shoulder much of basic social services, there will be an urgent need to undertake important tax reforms especially on direct taxes. This will entail the adoption of proper accounting procedures and a universal self-reporting from all the enterprises of the state and non-state sectors.

Table 8 also shows that the government deficits in the mid-nineties hover around the 1.5 to 1.7 percent of GDP. This amount is grossly underestimated since it doesn't include debt payments, which in 1995 would have increase government deficit to around 2.9% of GDP.

Furthermore, the estimated subsidies to SOEs (amounting to 1.2% of GDP in 1996 in Table 8) is underestimated since there is quasi-fiscal subsidies to SOEs in the form of policy loans from state-owned banks to failing or losing state-owned enterprises. Because of the large levels of non-performing and bad loans, government may have to shoulder these bad loans in a capitalization of the troubled state-owned banks. If we include this, government deficits will balloon to even higher numbers.

In summary then, the Chinese government will have to increase its tax efforts, particularly on enterprises in the non-state sector (comprised of private, collective and foreign firms), in order to finance its larger expenditures. Expenditures will be large due to the need for the state to take over the provision of basic social services from the SOEs and in the provision of social safety nets and social insurance. The commitment to harden the budget constraints of SOEs -- which will reduce state subsidies, both fiscal and quasi-fiscal, to SOEs -- will reduce some of its expenditures. But at least in the short run this will not decrease the expected expenditures especially

since the government is expected to borrow large amounts of money to capitalize a very troubled financial sector.

6.5 Reforming the Financial System

Past policy loans and implicit quasi-fiscal subsidies to the SOEs has led to extremely high debt-to-equity ratios for China's SOEs and have led to China's four state-owned commercial banks being saddled with non-performing loans estimated to be 24% of total loans in 1997 (see Huang and Yang (1998)). Conservative estimates put bad debts at 6% of total loans and overdue loans at 18%. The 6% bad debts amount to 400 billion yuan, more than the four banks' net assets amounting to 317 billion yuan. Furthermore 30% of the gross assets of the banks are deposits essentially of SOEs. Thus the state-owned commercial banks are technically insolvent. SOEs, producing less than 30% of the country's output in 1996, borrows nearly 80% of bank loans. Over-investments and low utilization rates in SOEs and 'asset bubbles' in the fastest growing provinces can be partially traced to this mismatch.

On paper the trouble of China's banks seem to exceed that experienced by Korea or Thailand on the eve of the Asian crisis. In fact, however, the solutions to China's problems may be easier to handle if the government does not unnecessarily lengthens and aggravates the existing problem and if the correct credit and commercial culture is put in place in the financial institutions.

First of all, China's bad debts do not involve much foreign currency (except in the case of the two big investment firms in Guangdong province). There is no danger of illiquidity and credit stoppage due to foreign creditors' response to the crisis, or to aggravation of bad loans due to currency depreciation.

Second, the problem being faced by China now is a change in regimes. Past command-economy oriented policies have made the state give direct financial money to SOEs for stipulated production and investments. This has resulted in the current state of bad and non-performing loans. The change towards market and decentralized decision making in financial transactions, as long as it is credible, will erase the moral hazard problem to financial bail out of the state-owned banks. In other words, as long as it is clear that there is a change in regimes in the workings of the state-owned commercial banks from a state-dictated policy to commercial policies based on expected rates of returns and viability of projects, it will not cause any moral hazard problems (as in excessive lending and borrowing) to bail-out the troubled banks by taking out the bad loans out of the books of the state-owned commercial banks (Stiglitz (1998)). Another advantage is that both state-owned enterprises and the commercial banks are owned by the state. Thus it is easy to take money out of one pocket and put it in the other pocket as long as the pockets are owned by the same entity, the state (Stiglitz (1998)).

Third, the under-capitalization of the state-owned commercial banks will have to be resolved by the state infusing capital in these banks. It is fortunate that China has a low government debt level (around 15% of GDP) so that it can still afford some room for domestic and foreign borrowing to infuse capital in the state-owned commercial banks.

The solution therefore to China's financial sector woes are:

- transfer of non-performing loans out of the books of the state-owned commercial banks. Moves toward this has been started in April 1999 with the creation of Cinda Asset Management tasked to buy the non-performing loans from China Construction Bank, one of the four state-owned banks. Cinda was able to get an initial 10 billion renminbi (\$1.2 billion) from the Ministry of Finance to purchase the bad loans. Cinda can force state-owned enterprises with these bad loans to restructure, layoff workers and become more efficient in order to repay the bad loans. It also has the power to convert unpaid debt into equity which means it can become partial owner of badly run SOEs. The creation of Cinda many believe will force an improvement in the accounting, management and risk-assessment practices of both state-owned commercial banks and state-owned enterprises. This could be the start of the adoption of basic commercial and market-based banking practices for loan transactions to the corporate sector. These include:
 - Part of the recapitalization of the commercial state-owned bank will also start once Cinda purchases the bad loans from the China Construction Bank. The experiment with one state-owned commercial bank is illustrative of the gradualist and experimental style to market reforms the Chinese authorities are undertaking. There is also a practical reason. Capitalization of all of the state-owned commercial banks may require substantial amount of financial capital and may require substantial domestic or foreign borrowing. It is best that government debt be increased slowly while banking and enterprise reforms are undertaken so as not to put undue simultaneous pressures and stresses on the state sector.
 - Work towards using commercial and traditional banking principles and practices to loan transactions in the banking sector. This requires the setting up of a credit culture which may actually flourish with the need now of massive funds for mortgages and loanable funds for investments and consumer durable from the non-state sector. This also requires the building up of a more sophisticated accounting, auditing and risk assessment system, reasonably honest self-reporting of enterprises and banks, more transparency and the setting up of a whole financial infrastructure of prudential regulation, enactment and enforcement of banking, credit, bankruptcy laws and regulations. This also entails a sure turning back on massive and widespread subsidies and policy loans to SOEs, a hardening of their budget constraints and less state dictates on the production and distribution of firms.

7. SUMMARY AND CONCLUSION

The release of initial pent-up productive forces in the first two decades of China's market reforms have made it the fastest growing major country in the world. It seems, however, that the easy phase of growth might be ending. Structural changes in demand patterns, painful reforms in the state sector and a less friendly world environment may reduce China's growth to within 6 to 8 percent in 1999 to 2000.

We have seen how important and inter-related changes and reforms will have to be undertaken to effect: a) a more efficient and profitable state enterprise sector, b) increased labor mobility and establishment of a dynamic housing sector, c) a strong government and private system of social services, social insurance and provision of safety nets, d) a more efficient and progressive taxation system, and d) corporate and financial reforms to institutionalize market-based and performance-based incentives and competition in the corporate and financial sectors.

All these changes will be easier if the macro environment allows for sufficient growth and external and domestic demand expansion. This is vital for political and economic stability, to allow re-absorption of displaced labor, and to prevent a possible domino-like collapse of state enterprises and financial institutions. A recession will make the reforms extremely difficult to implement and will exacerbate the vulnerabilities of the financial, enterprise and fiscal systems.

But if China is successful in its reforms and world trade picks up again, there may be another big spurt of growth as whole new industries related to housing and consumer durables may combine with exports to give a big boost to the economy. Enterprise and financial reforms will increase efficiency and profitability in the medium and long term, and China will be heading towards genuine economic development and dragon-hood.

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