China: Economic Outlook and Prospects for Structural Reforms

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Topics:

- The Chinese Economy Today
- Macroeconomic Outlook
- Recent Developments
  - What are the effects of Chinese accession to the World Trade Organization (WTO)?
  - The development of the "Great West"
- Economic Reform: Progress and Prospects
  - What is the critical path of continued Chinese economic reform?

The Chinese Economy Today (1)

- East Asia is the fastest-growing region in the world over the past two decades, the East Asian currency crisis of 1997-1998 notwithstanding
- China is the fastest growing country in East Asia—10% p.a. since beginning of economic reform (1979)
- China survived the East Asian currency crisis relatively unscathed
- China is one of the very few socialist countries that have made a successful economic transition from a centrally planned to a market economy--the rate of interest (the price of money) and the exchange rate are the only prices that are still administratively determined
- The private (non-state) sector accounts for 60% of GDP in 1999
- China is no longer a "shortage" economy--insufficient aggregate demand is a real possibility

The Chinese Economy Today (2)

	1979	2000
	US$ (2000 prices)	
Real GDP	176 bill.	1.08 trill.
Real GDP per capita	182	860

The Chinese Economy Today (3)

	U.S.	China
	US$ (current prices)	
2000 GDP	9.962 trill.	1.08 trill.
2000 GDP per capita	36,165	860

Rates of Growth of Real GDP and Inflation (% p.a.)

- Actual

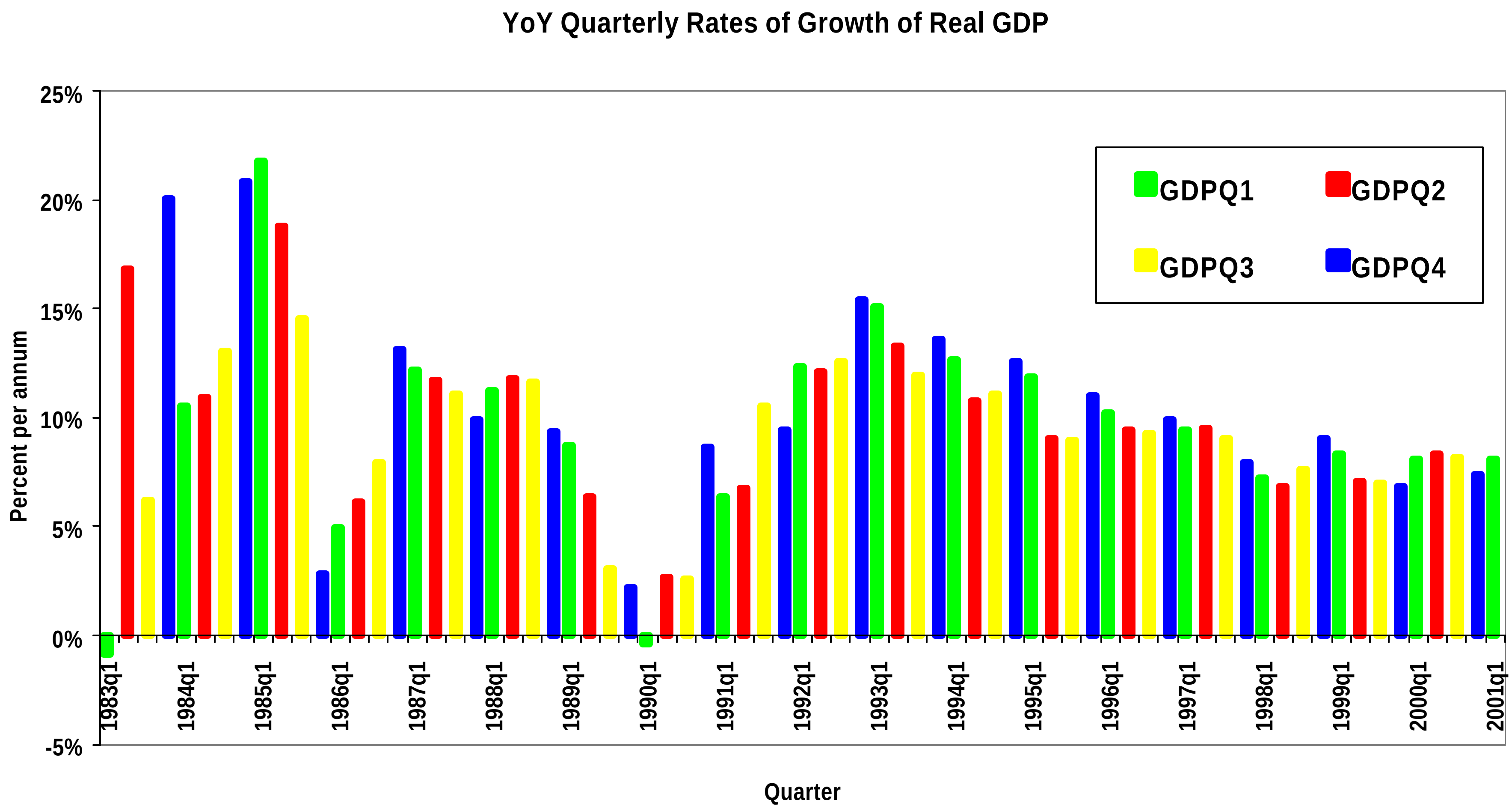
	Year	Real GDP	RPI	CPI	
Actual	1997	8.8	0.8	2.8	
	1998	7.8	-2.6	-0.8	
	1999	7.1	-2.9	-1.3	
	2000	8.0	-1.5	0.4	
Projections	2000	7.5			(ADB)
		7.5		0.5	(Lau)
		7.3			(PECC)
	2001	7.2			(ADB)
		7.5		1.0	(Lau)
		7.6			(PECC)

- The core rate of inflation is approximately 1% p.a.

The Tenth Five-Year Plan (2001-2005)

- An indicative (or predictive) plan rather than a mandatory plan
- Doubling of real GDP between 2001 and 2010, with an implied rate of growth of 7.2% p.a.
- An inflation target of less than 3% p.a.
- An increase in the share of central government revenue in GDP (the introduction of a comprehensive individual income tax)—tax revenue rose 22.8% to 1.266 trillion Yuan, or 14.2% of GDP, in 2000
- The National People's Congress has stressed the importance of fighting corruption, organized crime and cults such as the Falun Gong

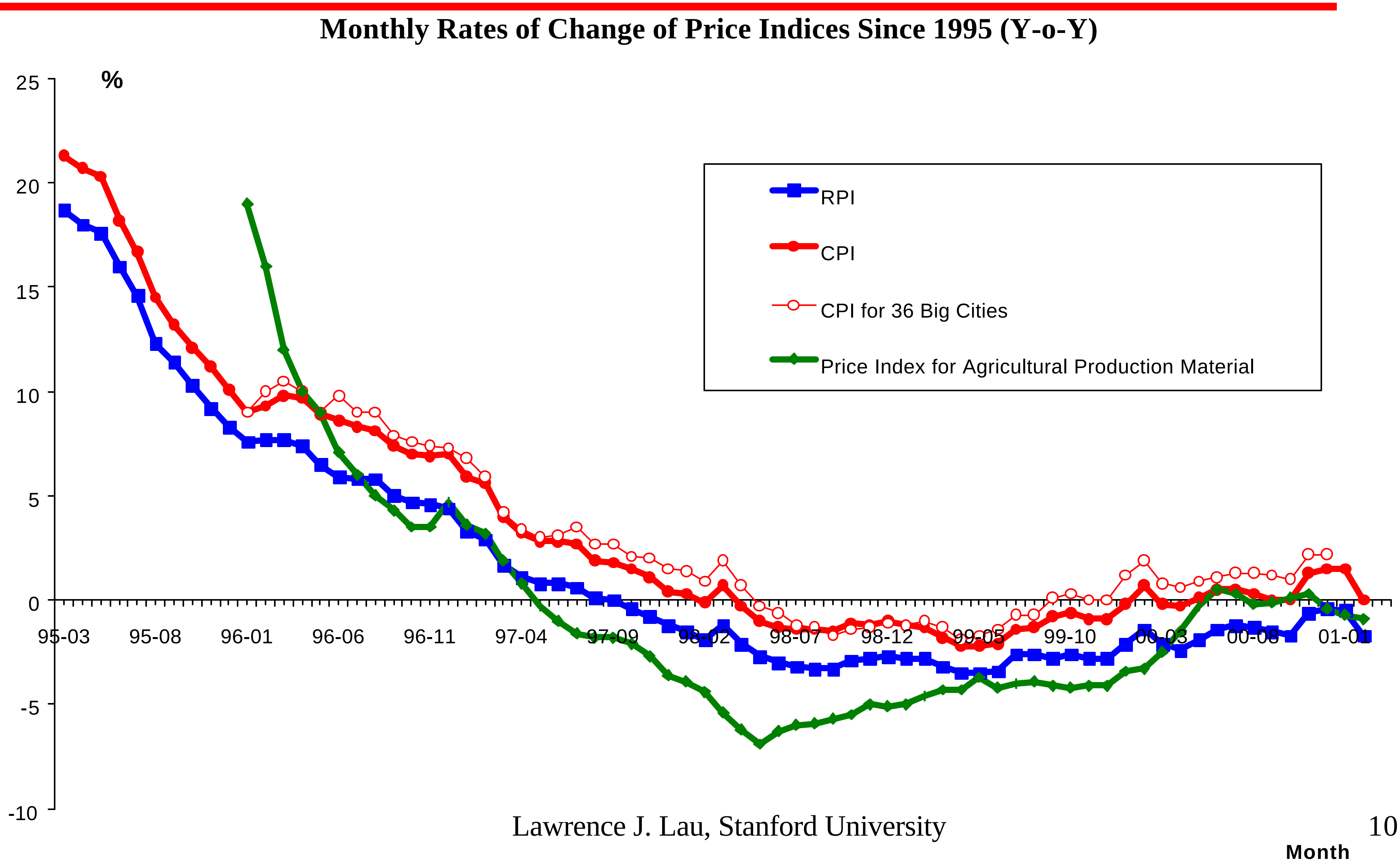
The Pace of Economic Growth Has Picked Up: YoY Quarterly Rates of Growth of Real GDP



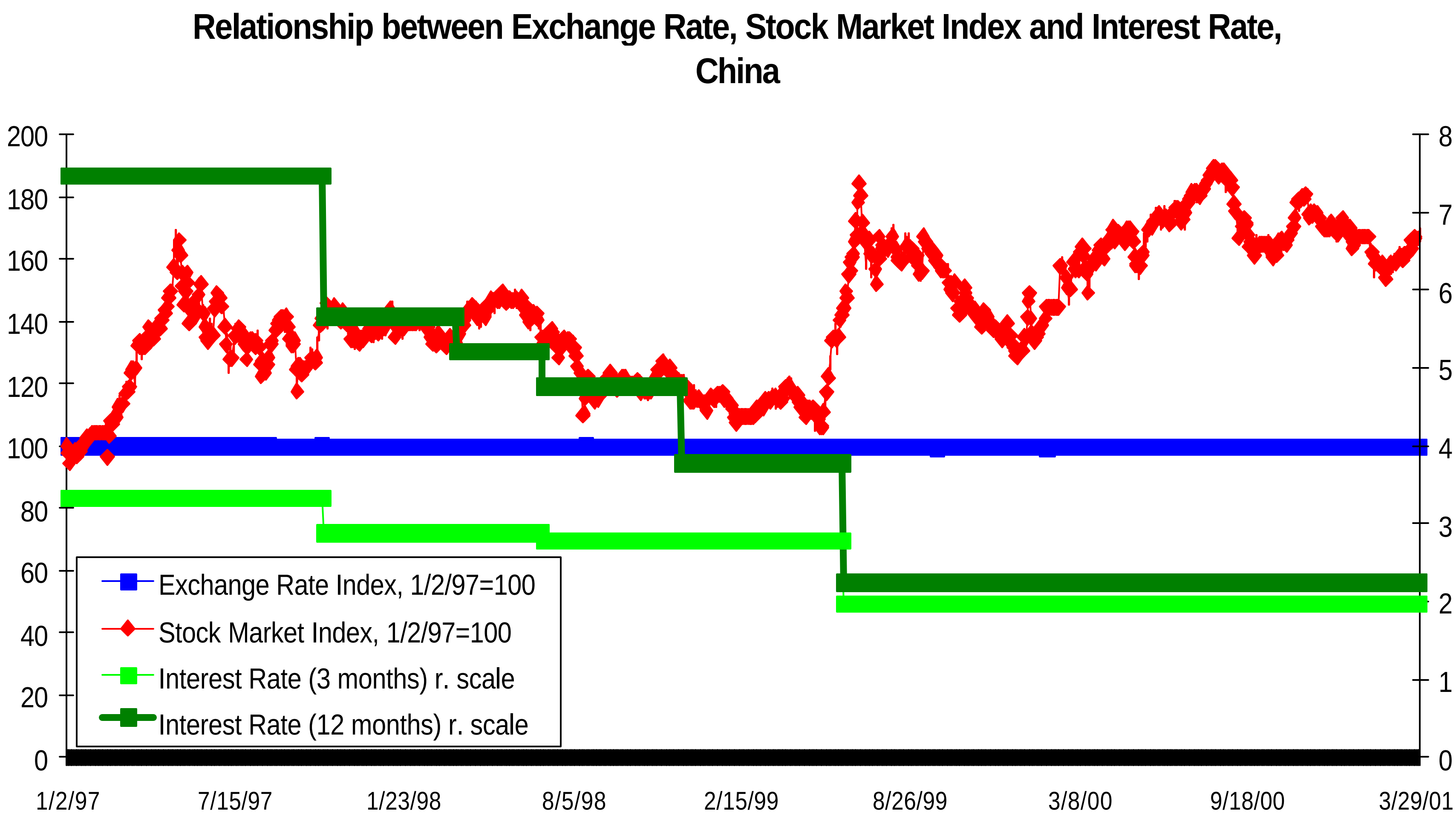
Has "Deflation" Stopped?

- Deflation has slowed/stopped:
  - In 1999 the RPI declined 2.9%; In 2000 the RPI declined only 1.5%;
  - In 1999 the CPI declined 1.3%; In 2000 the CPI rose 0.4%
- The "core" rate of inflation is positive
  - The decline in prices over the past two years was due in part to the fall in the prices of energy and in particular oil and food because of the good harvest
  - The long-term core inflation rate--inflation rate net of changes in the prices of energy and food--may be estimated at 1 percent--there is no deflation

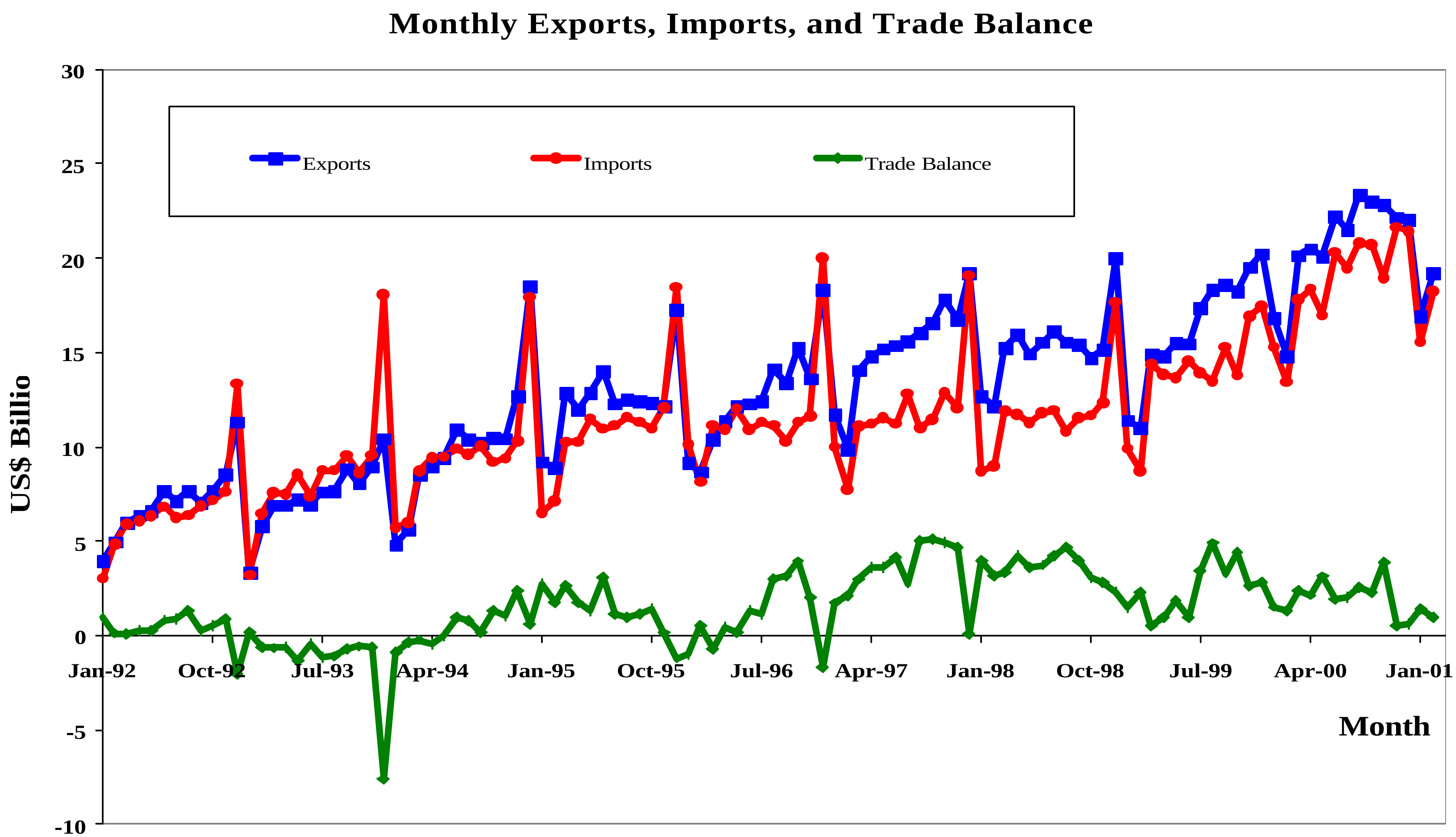
The Consumer and Retail Price Indices



The Exchange Rate, the Interest Rate and the Stock Market Index



Monthly Exports, Imports and Trade Balance Official Chinese Data



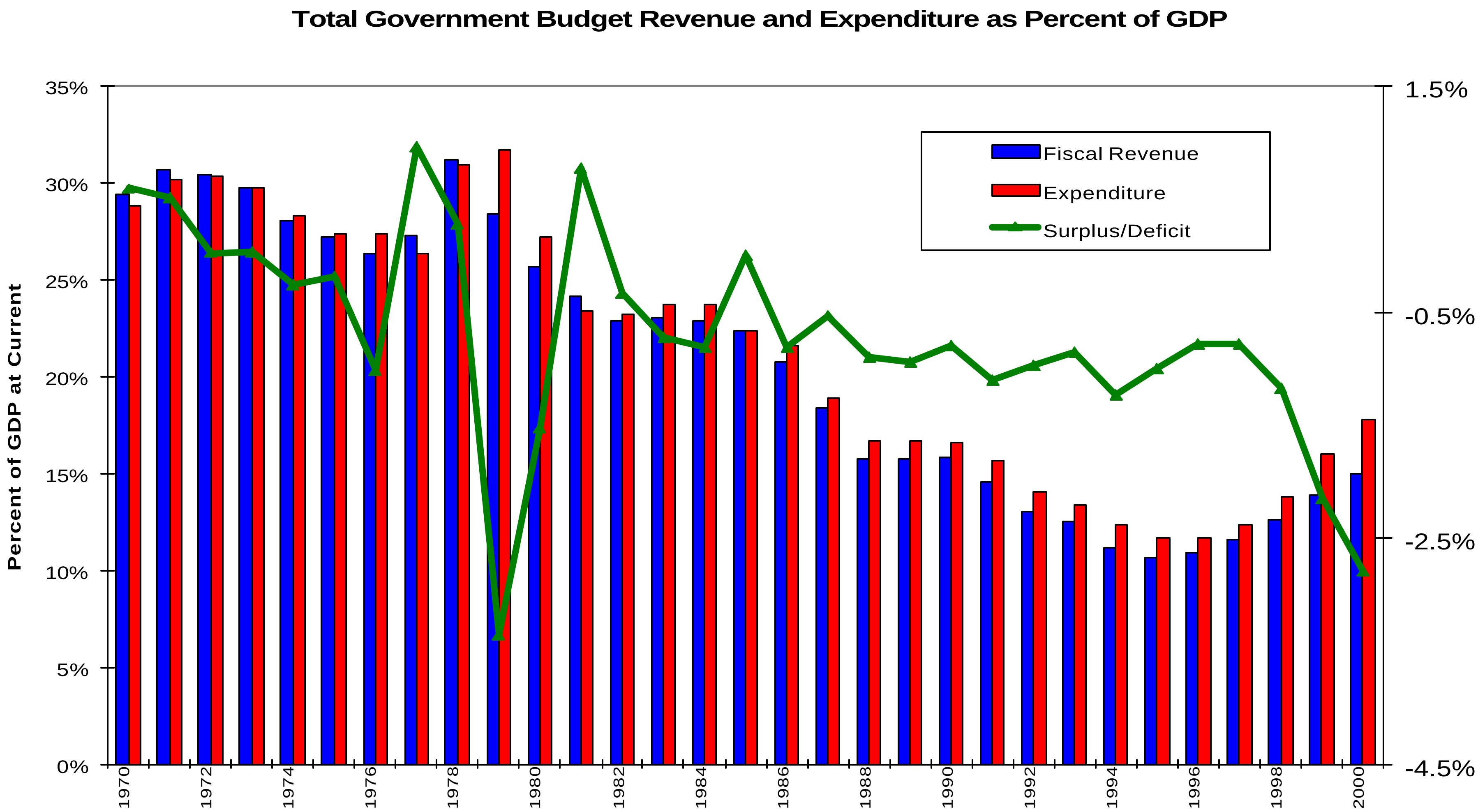
Exports, Imports and Foreign Exchange Reserves

- In 2000, exports rose 27.8% to US$249.2 billion; imports rose 35.8% to US$225.1 billion; with a trade surplus of US$24.1 billion
- For 1-2/01, exports rose 14.5% Y-o-Y to US$36.14 billion and imports rose 17.7% to US$33.77 billion
- Official foreign reserves continued to rise, reaching US$165.6 billion at year-end 2000

Foreign Direct Investment (FDI)

- Foreign Direct Investment
  - FDI arrivals totaled US$40.39 billion in 1999, an 11% decline from 1998--however, the sources of the FDI were different--real FDI probably rose if "round-tripped" capital were excluded
  - FDI commitments amounted to US$41.24 billion in 1999, a decline of 20.9%
  - FDI arrivals totaled US$40.7 billion in 2000, a 1% increase over 1999
  - FDI commitments amounted to US$62.4 billion in 2000, an 51.3% increase over 1999, partly in response to expected Chinese accession to WTO; for 1-2/01, FDI commitments rose 47% Y-o-Y
  - The nature of FDI has also changed--from export-oriented to domestically oriented; from light industry to heavy and high-technology industries, and from small projects to large projects
- Collateralized loan program as a natural hedge for foreign direct investors
- Initial public offerings (IPOs) and listings on Chinese stock exchanges as a potential exit strategy for foreign direct investors

Total Government Budget Revenue, Expenditure, and Deficit as a Percent of GDP



The Stock Market

- 1110 enterprises (more than 90 percent state-owned) listed on Shanghai and Shenzhen Stock Exchanges combined
- Market capitalization (US$580 billion); market turnover (US$3 billion a day)
- Third largest market in Asia after Japan and Hong Kong
- A-shares for domestic and B-shares for foreign investors; however, beginning in 02/2001, Chinese domestic citizens with foreign exchange can purchase B-shares as well
- 7/8/99--introduction of indexed funds in China 8/99--16 billion Yuan bonds issued and traded on the domestic stock exchanges
- 9/99--state-owned enterprises permitted to trade stocks
- The main boards of the Shanghai and Shenzhen exchanges will be unified in Shanghai
- A new board for high-tech and non-state-owned enterprises will be set up in Shenzhen with relaxed requirements for annual profits and capitalization (Chinese version of NASDAQ)

China and the World Trade Organization (WTO) (1)

- "Permanent Normal Trade Relations" has passed the U.S. Congress
- The government is committed to an "open-door" policy and national treatment for foreign direct investors--a "level playing field" for all, including domestic non-state-owned enterprises
- Remaining obstacle in the trade of agricultural commodities and allowable domestic subsidies
- Possible solution in the form of fixed physical quotas of agricultural commodities eligible for subsidies

The Impact of the Accession to the World Trade Organization (WTO) on China (1)

- Immediate impact small but change in long-term expectations
  - FDI should rise, especially in the services sector--distribution, finance, and telecommunication
  - Exports and imports should rise moderately in the short and intermediate term
  - Massive imports of agricultural commodities unlikely because of limitations of world market supply
  - Closure and consolidation of inefficient enterprises likely even without WTO accession
  - More trade in intermediate goods
  - Tariff reductions from 22% to 17% on average
  - A deadline for reform of the state-owned enterprises and the banking sector
  - WTO accession provides additional incentive and pressure for development of an integrated national market not only for goods but also for factors

The Impact of the Accession to the World Trade Organization (WTO) on China (2)

- Signaling effect
  - Reform and open-door policies are on track and will be continued
- Long-term benefits include:
  - A permanent commitment to an openness and a lock-in to the global economy
  - Insurance for domestic economic efficiency through open global competition--inefficient domestic monopolies will no longer be protected

Is There Sufficient Aggregate Demand? Consumption and Investment

- Real personal consumption has revived as shown by the retail sales data
- Public infrastructural investment has continued
- Enterprise investment has yet to resume the rate of rapid expansion achieved in the mid-1990s

The Development of the Great West: Three Paradigms of Economic Growth

- Growth through domestic demand--the domestic market paradigm a la the United States in the 19th century
- Industrial migration over time--the "wild-geese-flying pattern" metaphor applied to Chinese provinces and regions
- Privatization is not always necessary--shrinking the state sector without privatization--the experience of Taiwan
- What does it take?
  - Availability of infrastructure (transportation and communication, including the internet)
  - Continued marketization of the economy
  - Maintenance of a domestically open economy (the equivalent of the “interstate commerce” clause of the U.S. constitution)
  - Affirmation of property rights and the rule of law
  - The role of the "open door”--WTO

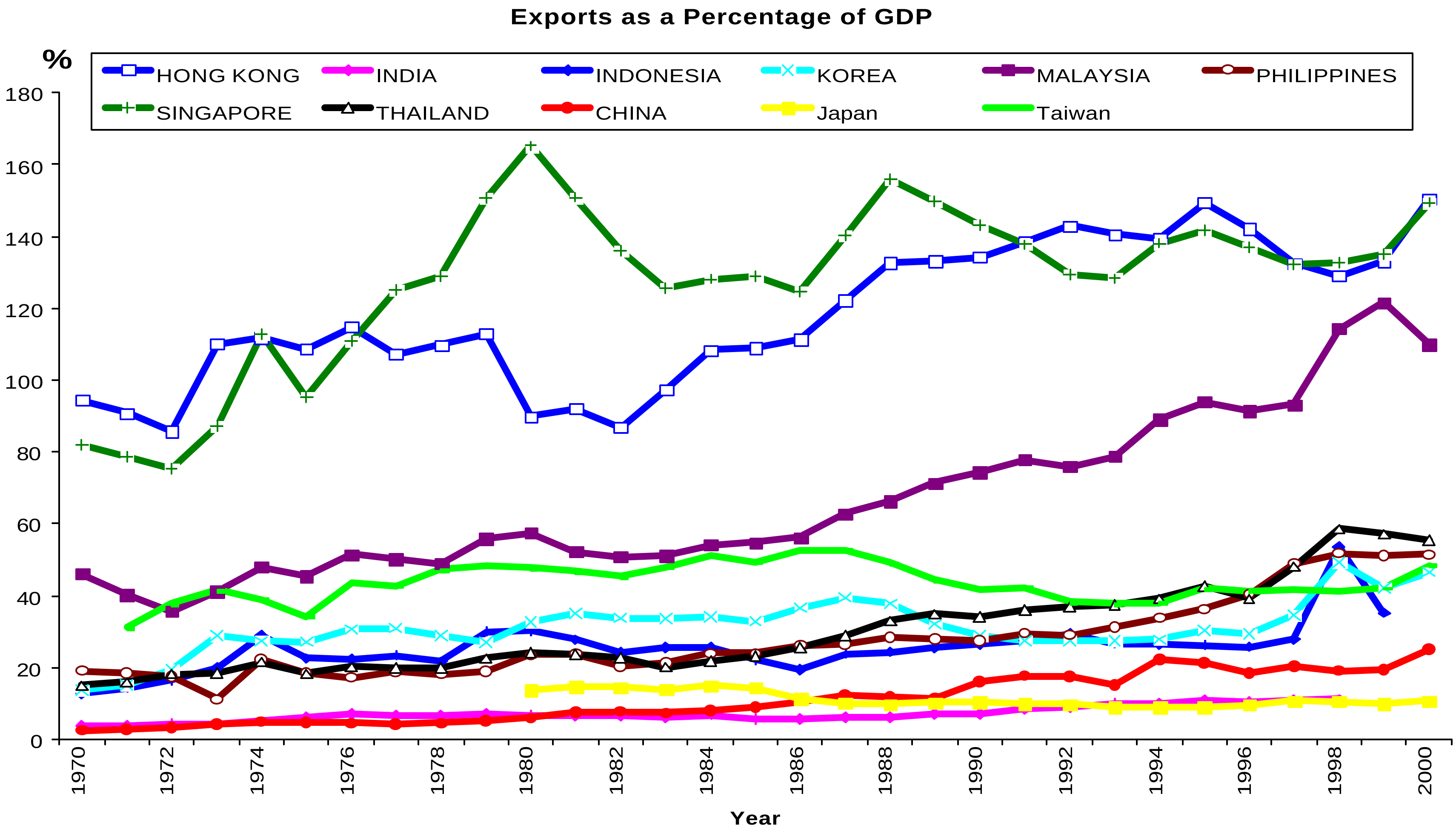
The Development of the Great West: Reducing Regional Inequalities

- Even though all regions benefited from the economic reform since 1979, the coastal regions benefited much more than the inland regions
- Interregional income inequality has risen, resulting in:
  - Dissatisfaction and restiveness
  - Deterioration of social services, especially education and health care
  - Massive illegal migration from the inland regions to the coastal regions, creating huge pressure on social and physical infrastructure
- Moving jobs to where people are, not people to where jobs are
- Urbanization through the creation of new towns and cities, not the growth of existing towns and cities
- Developing a truly integrated national market
- Maintaining long-term competitiveness without devaluation

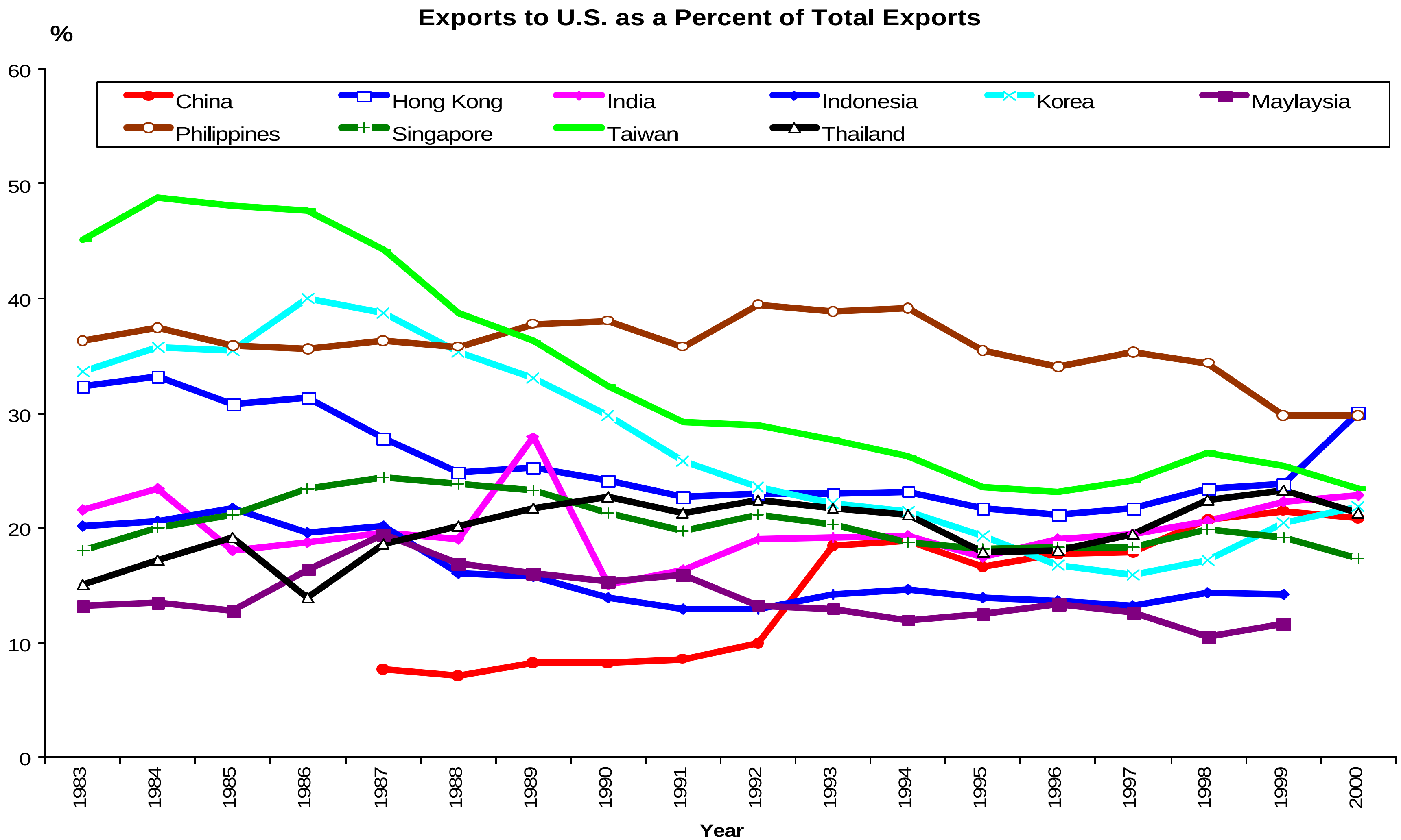
Looking Ahead: The External Environment Has Deteriorated

- The U.S. economy, and its high-technology sector in particular, has slowed down rather precipitously--the rate of growth of real GDP is expected to be no higher than 1% in 2001
- The slowdown in the U.S. will have an impact on East Asia, both directly and indirectly, and in particularly in economies where the high-technology sector is important, such as South Korea, Malaysia and Taiwan
- The continuing stagnation of the Japanese economy does not help but is not expected to have a negative impact because has gone on for an entire decade
- The European economies are expected to grow somewhat faster and thus to provide a partial offset to the U.S. economic slowdown

Exports as a Percent of GDP: Selected East Asian Economies



Exports to U.S. as a Percent of Total Exports



The Effects of the Slowdown in the United States Economy on China

- While exports is a very high percentage of GDP in Hong Kong, Malaysia, Singapore and Taiwan, it is a relatively low percentage of the Chinese economy, amounting to approximately 20 percent
- The proportion of total exports destined for the U.S. has generally declined in the East Asian economies over the years, to less than 30 percent
- The one exception is the Chinese economy, where the proportion of Chinese exports destined for the U.S. has been rising to its current level of approximately 20 percent
- The slowdown in the U.S. economy will have a significant, but not overwhelming, negative impact on the rate of growth of real GDP in the East Asian economies--on the order of 1 percentage point decline in Hong Kong, Malaysia, Singapore and Taiwan and a less than 0.5 percentage point decline in the other East Asian economies, including China

Non-Performing "Loans" of the State-Owned Banks (1)

- Borrowers are all state-owned enterprises (SOEs)
- Non-performance is no surprise to either the lenders or the borrowers
- In terms of flows, they amount to 2-3% of GNP, comparable to budget deficits in many countries
- In terms of stocks, they amount to approximately US$200 billion or 20-30% of GNP--according to People's Bank of China (PBOC), 20%; according to rating agencies, at least 25%
- Ultimately non-recoverable non-performing loans has been estimated to be on the order of 6-7% of all outstanding loans by PBOC, or up to 15% by non-government analysts, e.g., Moody's Investors Service estimated the total cost of cleaning up bad loans to be US$120.8 billion in 8/1999, or 12.5% of Chinese GDP
- The loans should be regarded as indirect loans to the central government which also owns all of the major banks, I.e. public debt

Non-Performing "Loans" of the State-Owned Banks (2)

- Outstanding Chinese national debt is approximately 10% of GNP (compared to 70% for the United States, 100% for Japan, 75% for Zone Euro and 120% for Belgium)
- Non-performing loans can be approximately divided into three parts
  - Loans to traditional old-line industrial enterprises
  - Loans to enterprises established during the mid-1980s in lieu of a founding equity
  - Loans contracted during the over-heated period in the early 1990s
- Rollovers (appropriately camouflaged) of these non-performing loans since 1994
- Permanent resolution depends on reform of the SOEs
- The banks will never be allowed to fail in a way that hurts the depositors--implicit deposit insurance

Restructuring of the Non-Performing Loans/Policy Loans (1)

- Permanent solution of the problem of non-performing loans of the state-owned enterprises (SOEs) requires that the SOEs be viable afterwards--I.e. a successful reduction of the currently redundant labor force, assumption of the social welfare costs, and debt-equity swaps if appropriate, so that the continued flow can be stopped
- Assumption of non-performing loans by another government-sponsored entity (like the Resolution Trust Corporation of the United States)
  - China Construction Bank is the first of the four major commercial banks to set up an asset management company, CINDA, to restructure its non-performing loans
  - Other management companies formed are Great Wall (Agricultural Bank of China), Dongfang (Bank of China) and Huarong (Industrial and Commercial Bank of China)

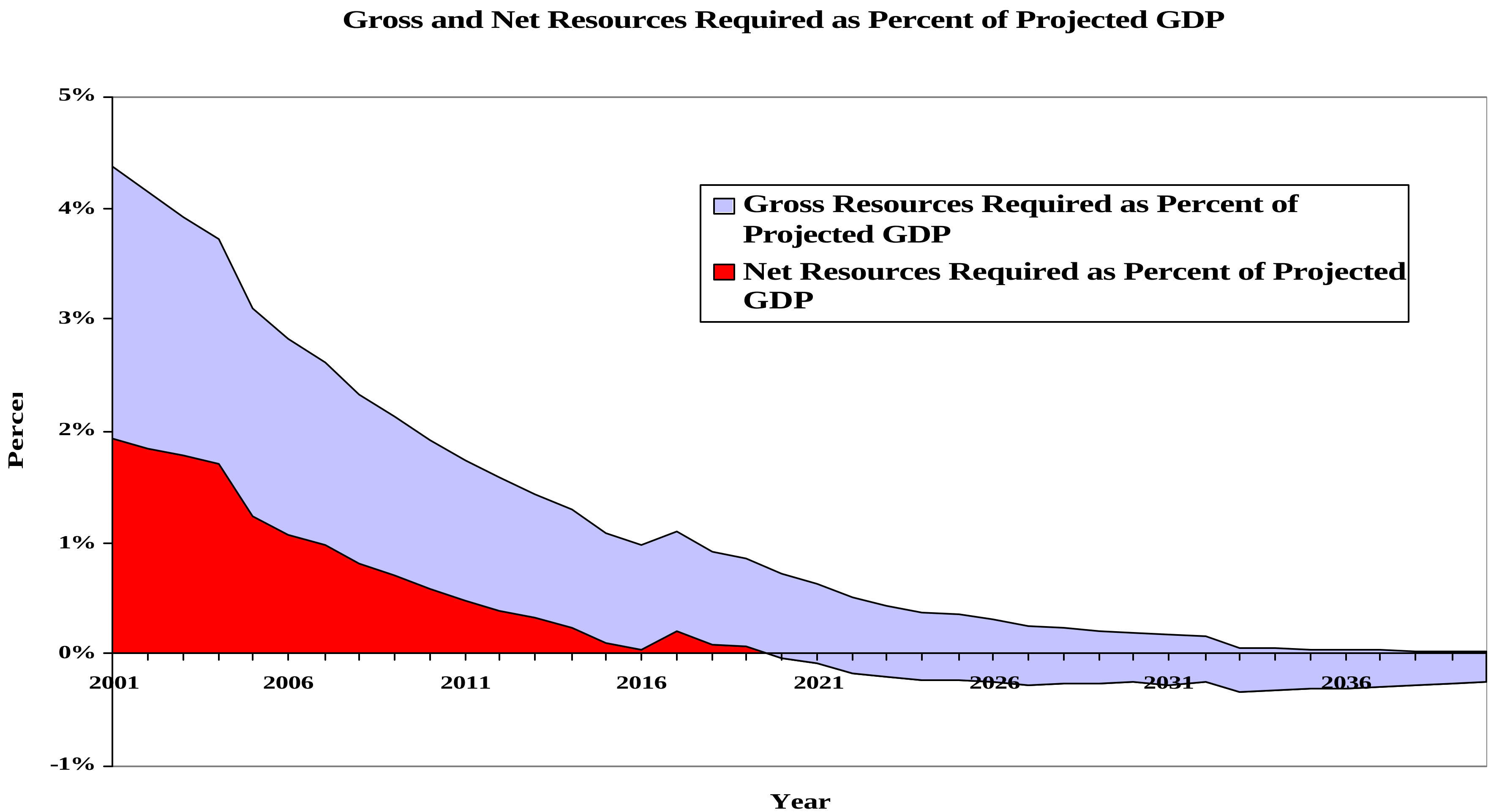
Restructuring of the Non-Performing Loans/Policy Loans (2)

- Restructuring to be followed by recapitalization
  - government bonds can be exchanged for non-performing loans
  - government/central bank purchases of subordinated debt of the banks
  - change in the bank reserve ratio
  - issuance of new stock by the banks in the public market
- Reform of the SOEs is absolutely essential for the long-term success of banking reform

The Establishment of a Social Safety Net

- Assumption of current and future unfunded pension liabilities of the SOEs
- Provision of unemployment “insurance” benefits for the redundant employees of the SOEs
- Assumption of the responsibility for the provision of social services such as education and health care by the local governments, relieving the enterprises
- Establishment of a Social Security Fund with state-owned shares of SOEs as an endowment to cover unfunded pension liabilities of SOEs as well as unemployment benefits for employees of the SOEs

The Annual Flows of Resources Required as a Percent of Projected GDP



The Estimated Cost of the Social Safety Net

- The peak annual flow of unfunded pension obligations may be estimated at 275 billion Yuan, compared to an estimated flow of 216 billion Yuan under the current system for the year 2000
- The peak annual flow of unemployment benefits for furloughed employees of SOEs may be estimated at 88 billion Yuan in 2004, compared to an estimated flow of 22.5 billion Yuan under the current system for the year 2000
- The peak annual net additional annual flow of the cost of the social safety net may be estimated at slightly above 200 billion Yuan in 2004 or approximately 1.7% of projected GDP
- The stock of unfunded pension obligations may be estimated at 4 trillion Yuan compared to a current GDP of 8 trillion Yuan and an estimated value of total state-owned assets of 9 trillion Yuan

The Need for a Sustainable Social Security System

- The Social Security Fund can solve the one-time problem of transition--it is not a permanent solution
- A credible and sustainable pension system must be set up, taking into account China’s demographic conditions
- A “Pay-as-you-go” system is doomed to eventual failure
- A system based on individual retirement accounts in a central provident fund provides a credible and sustainable system in the long run

Agricultural Reform

- Excessive production leads to low prices. Low prices lead to low income for individual farmers. Government procurement through above-market subsidized prices supports the prices of agricultural commodities and the incomes of individual farmers but results in excessive supply and inventory, low market prices and huge budget deficits.
- The Question: How to provide an income floor to individual farmers without stimulating excessive production?
- Government purchases from individual farmers should be limited by quantity on a per farm household basis

Capital Market Reform

- Greater emphasis on performance of enterprises--delisting of loss-making enterprises
- Tighter supervision and enforcement against market manipulation and insider trading
- More demanding requirements on financial disclosure
- Stress on transparency and corporate governance
- The use of IPO proceeds for partial funding of unfunded pension liabilities
- Merging of A & B shares?
- Chinese Depository Receipts (CDRs)?

The Critical Path of Economic Reform

- Establishment of a viable social security and pension system
- Restructuring of the state-owned enterprises
- Reform of the banking system and the capital market
- In parallel, agricultural reform should be undertaken
- Accession to WTO reinforces urgency of reform

Investment in China by Foreign Investors: Considerations

- Covariance between East Asian and U.S. markets
  - The high-technology sector versus the traditional and the non-tradable sectors
- Public versus private markets
  - Credibility of public markets (insider trading, manipulation, protection of minority shareholders, disclosure and transparency)
  - Ease and necessity of direct financial monitoring
  - Casino mentality of public markets
- Portfolio versus direct investment
  - Possibility of capital control and other forms of restrictions on short-term capital flows
  - Necessity of continuous active direct monitoring
  - Choice of joint-venture partner(s), if any, critical
- Competitive advantage
  - Money alone is not sufficient because of relative abundance of domestic savings—foreign direct investors must have superior technology, know-how, knowledge of markets