The Critical Path for Continuing Chinese Economic Reform

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Outline:

- The Chinese Economy Today
- Review of Chinese Economic Reform (1979-present)
- Problems Old and New
- The Critical Path for Continuing 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 1997-98 notwithstanding
- China is the fastest growing country in East Asia—nearly 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 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 on the margin
- The private (non-state) sector accounts for more than 60% of GDP in 2000
- China is the 7th largest trading country in the world (exports of US$250 billion and imports of US$225 billion in 2000)
- 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)

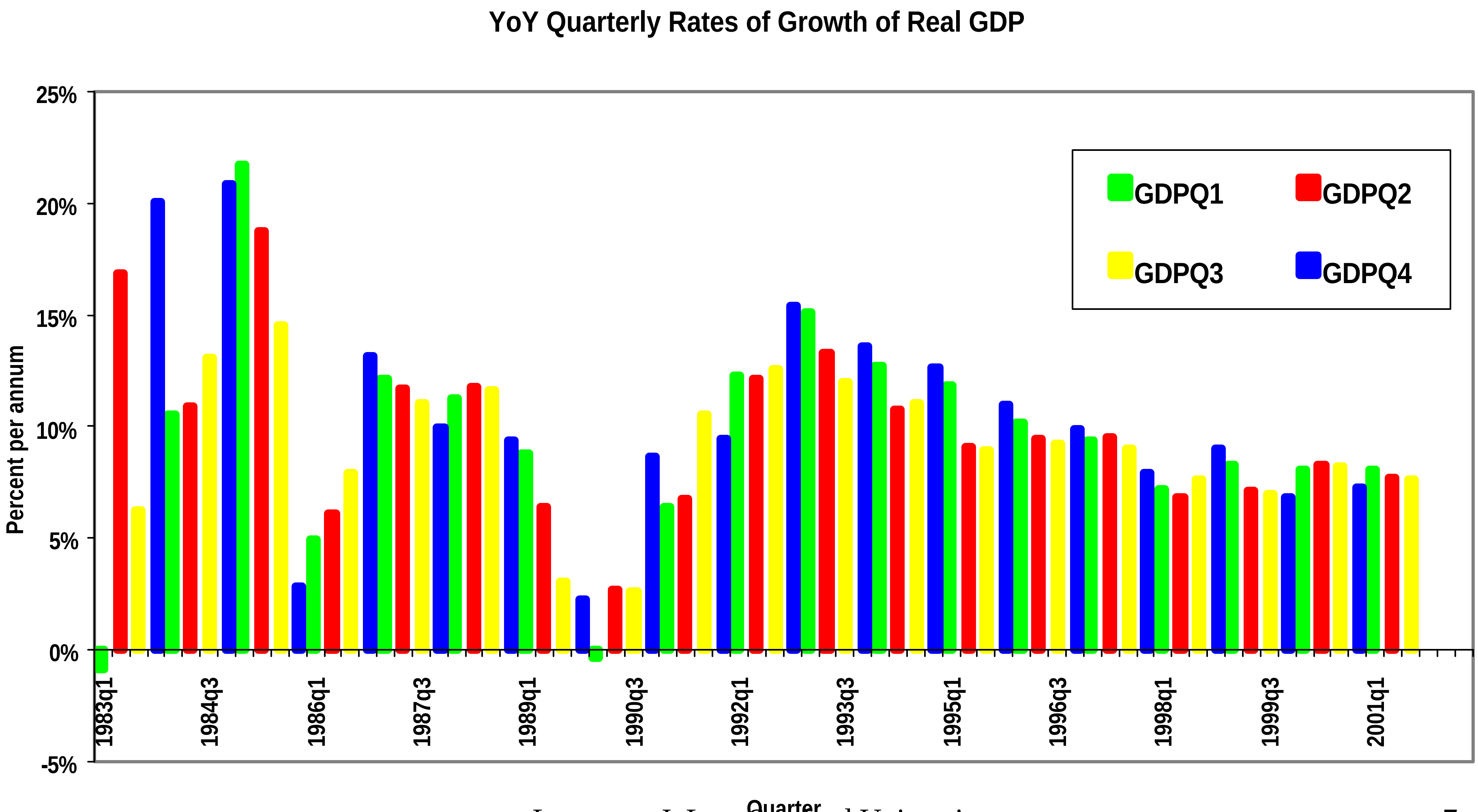
	U.S.	China
	US$ (current prices)	
2000 GDP	9.962 trill.	1.08 trill.
2000 GDP per capita	36,165	860

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

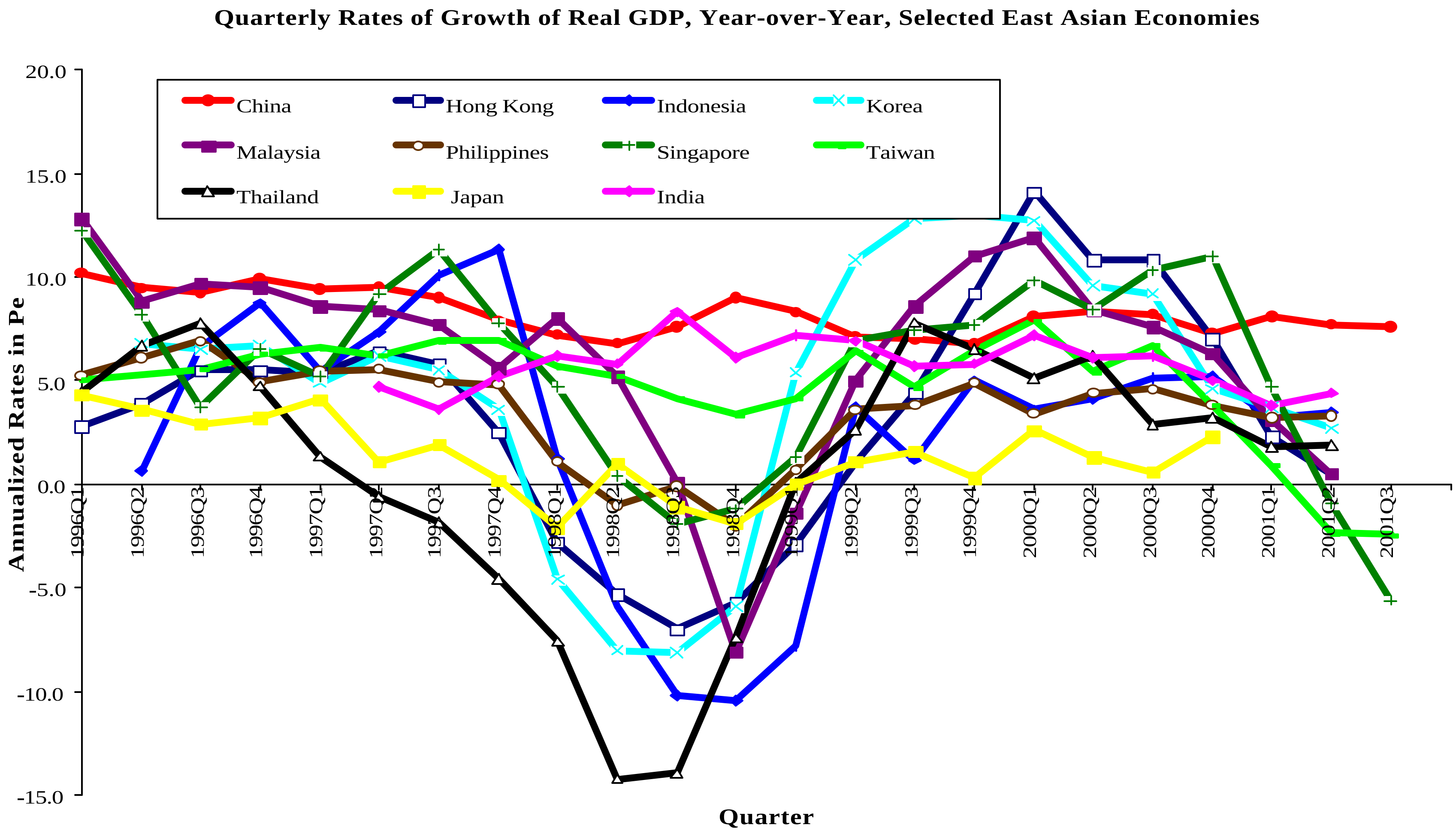
		Real GDP	RPI	CPI	
◆ Actual					
	1997	8.8	0.8	2.8	
	1998	7.8	-2.6	-0.8	
	1999	7.1	-2.9	-1.3	
	2000	8.0	-1.5	0.4	
	2001Q1	8.1	-1.1	0.7	
	2001Q2	7.8	-0.6	1.0	
	2001H1	7.9	-0.5	1.1	
	2001Q3	7.6	-0.5	1.0	
◆ Projections	2001	>7.0			(NBS)
		7.2			(ADB)
		7.5		1.0	(Lau)
		7.6			(PECC)

- The National Bureau of Statistics (NBS) projected that the award of the 2008 Summer Olympic Games to Beijing should add 0.3-0.4% to the average annual growth rate
- 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

Quarterly Rates of Growth of the Real GDP of the Chinese Economy, Y-o-Y

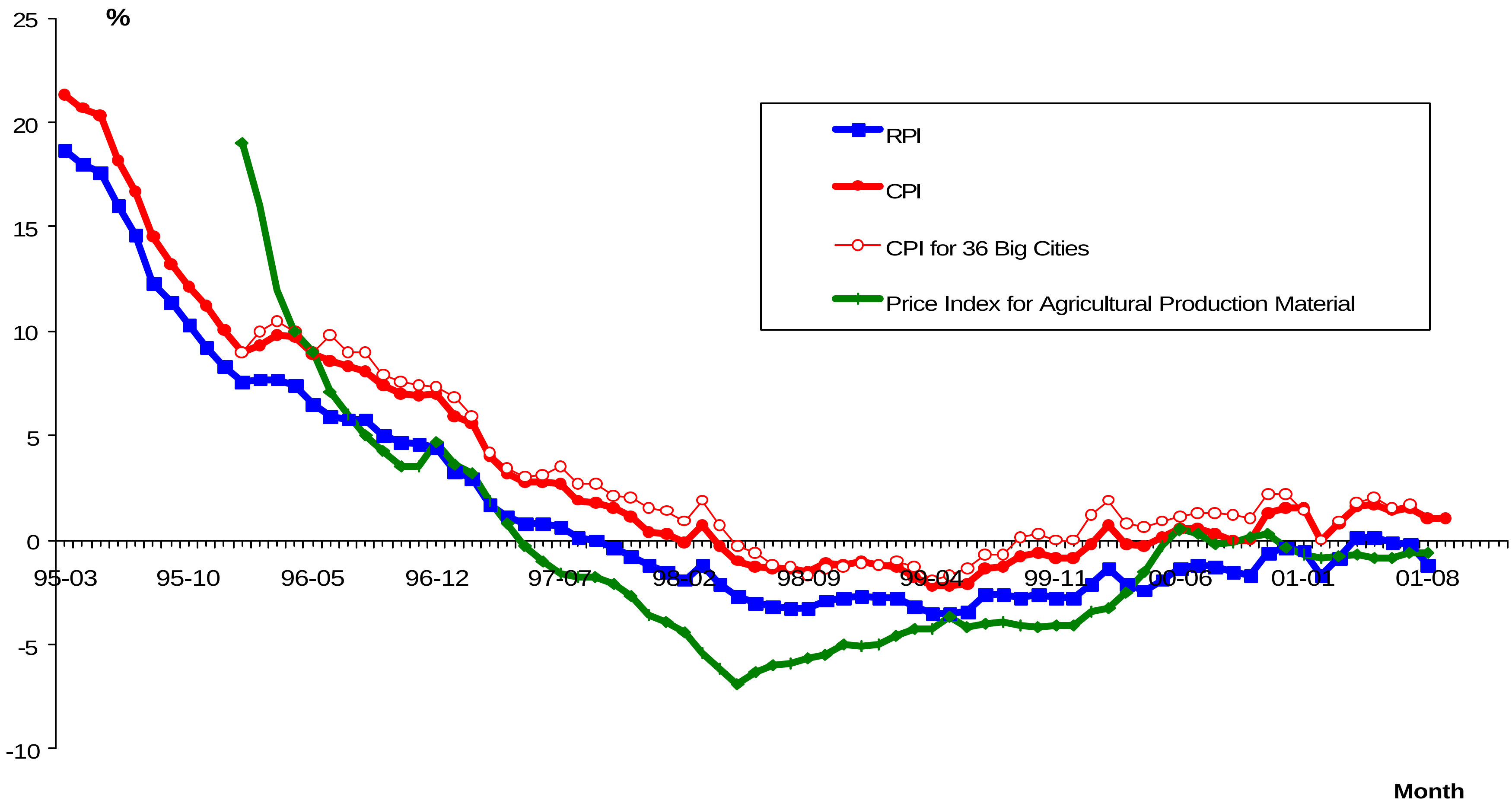


The Rates of Growth of Real GDP: Selected East Asian Economies



The Consumer and Retail Price Indices

Monthly Rates of Change of Price Indices Since 1995 (Y-o-Y)



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%
  - In 2001/09, the CPI rose 1% and the RPI declined 0.2%
  - In 2001/01-08, the PPI decline 1.3% Y-o-Y
  - In 2001Q1-Q3, the CPI rose 1.1%
- 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 Major Components of Chinese Economic Reform (1979-the present)

- The “Open Door”
  - International Trade
  - Foreign Direct Investment
- Marketization
  - Goods Market
  - Labor Market
  - Foreign Exchange Market
  - Housing Market
  - Capital Market
- Devolution of economic decision-making power (The “Contract Responsibility System”)
  - Empowering Provincial and Local Governments
  - Professional Management of Enterprises
  - Autonomy and Incentive
- Creation of new, non-state-owned modes of organization for production
  - Agriculture--Abolition of communes; return to a system of individual cultivators with fixed rents and taxes
  - Non-Agriculture (Industry and Services)--emergence of “Township and Village” (T&V) enterprises; (foreign) joint-venture, foreign and private enterprises

Economic Performance: Pre- and Post-Reform

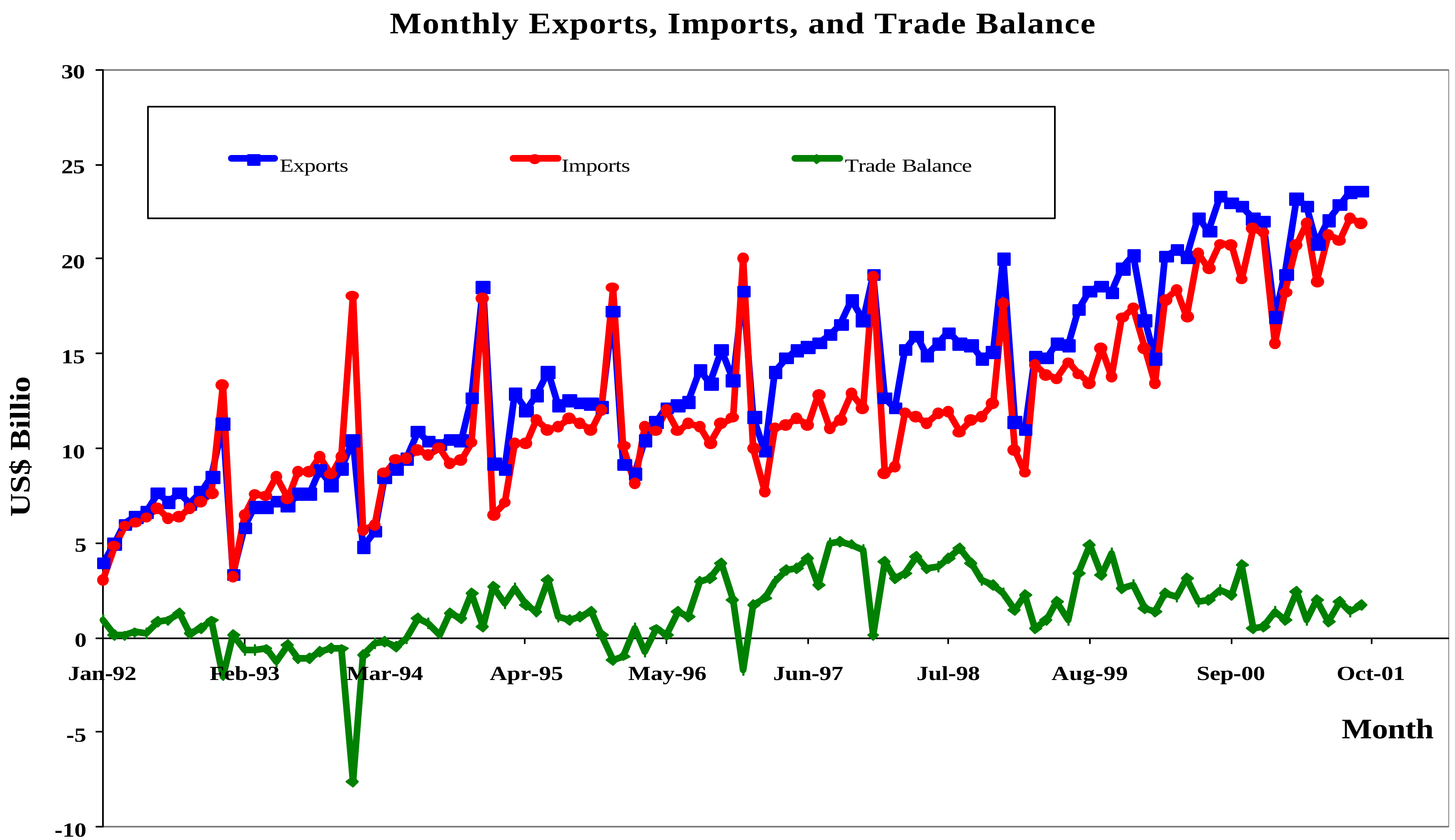
Average Annual Rates of Growth of Selected Economic Indicators (%)

	1952-1979 Pre-Reform	1979-1998 Reform
Real GDP	6.20	9.82
Real GDP/Capita	4.14	8.39
Real Gross Value of:		
Agricultural Production	4.33	8.05
Light Industry	7.83	11.30
Heavy Industry	11.37	11.34
Real Personal Consumption	4.99	8.91
Real Consumption/Capita	2.96	7.51
Real Gross Fixed Capital Formation	11.43	11.10
Capital Stock	5.93	9.77
Employment	2.52	2.91
GDP Deflator	0.59	6.51
Retail Price Index	0.80	7.03
Exports (in current US Dollars)	10.98	14.66
Imports (in current US Dollars)	10.27	12.22

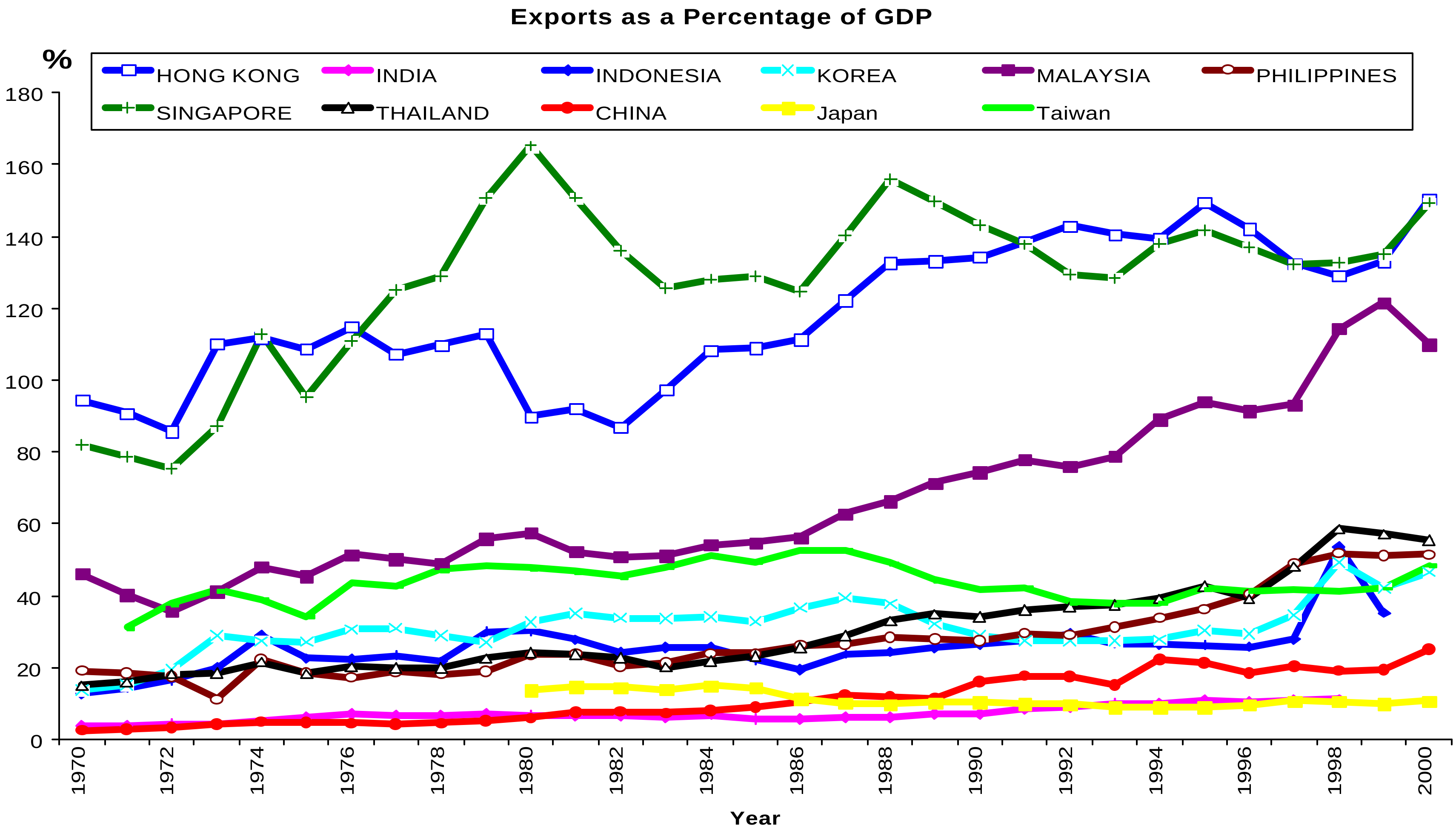
Exports, Imports and Foreign Exchange Reserves

- China is the 7th largest trading country in the world (exports of US$250 billion and imports of US$225 billion in 2000)
- 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 2001/01-09, exports rose 7% Y-o-Y to US$195 billion and imports rose 11.2% to US$181.4 billion with a surplus of US$13.6 billion
- For 2001/06, exports declined (the first time in 2 years) 0.6% Y-o-Y and imports rose 4.7%; for 2001/09, exports rose 2.7% Y-o-Y and imports rose 5.5% Y-o-Y with the trade surplus continuing to narrow
- All these data confirm a slowdown in the growth of exports and a narrowing of the trade surplus—export growth is likely to be zero or even negative in the near term
- Chinese tourists traveling abroad exceeded 10 million in 2000; the tourism component of the balance of payments turned negative in 2000
- Official foreign reserves continued to rise, reaching US$195.7 billion at the end of 2001Q3, and surpassing total outstanding external loans by a wide margin
- The exchange rate of the Renminbi vis-à-vis the U.S. Dollar has remained stable since 1994 (in fact, there has been a slight appreciation from 8.7 Yuan/US$ to 8.3 Yuan/US$)

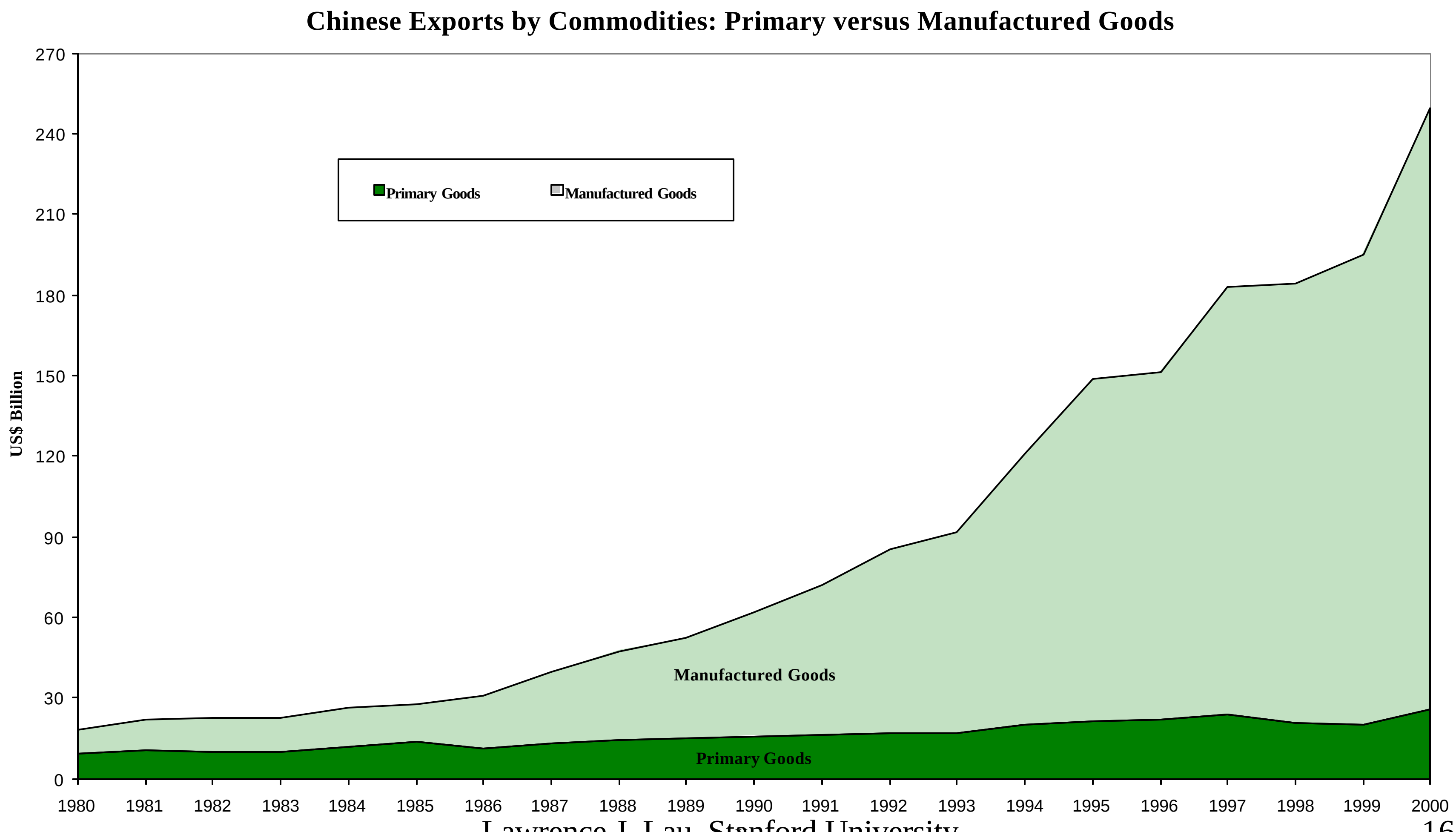
Monthly Exports, Imports and Trade Balance Official Chinese Data



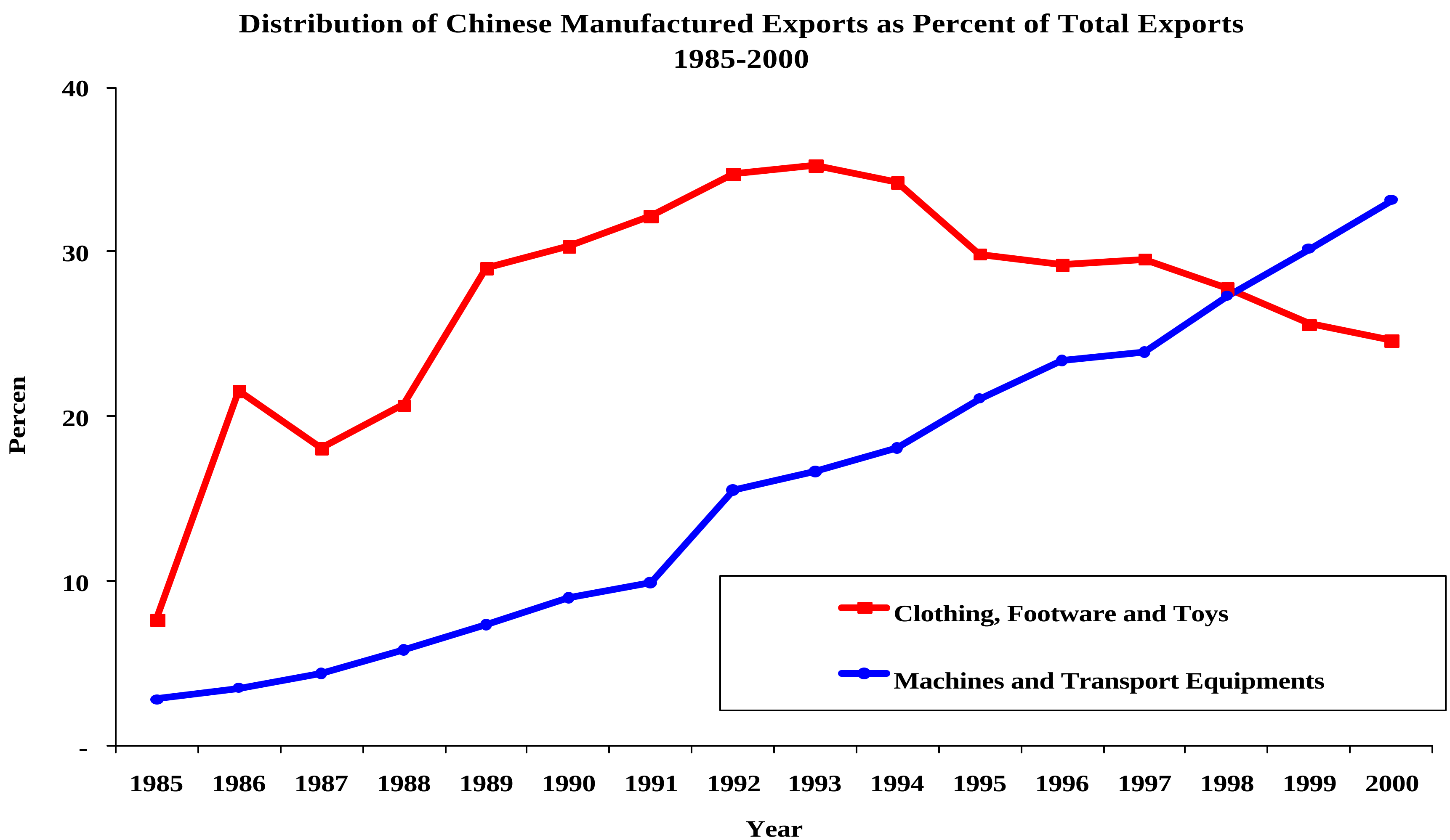
Exports as a Percent of GDP: Selected East Asian Economies



Composition of Chinese Exports by Primary Commodities versus Manufactured Goods



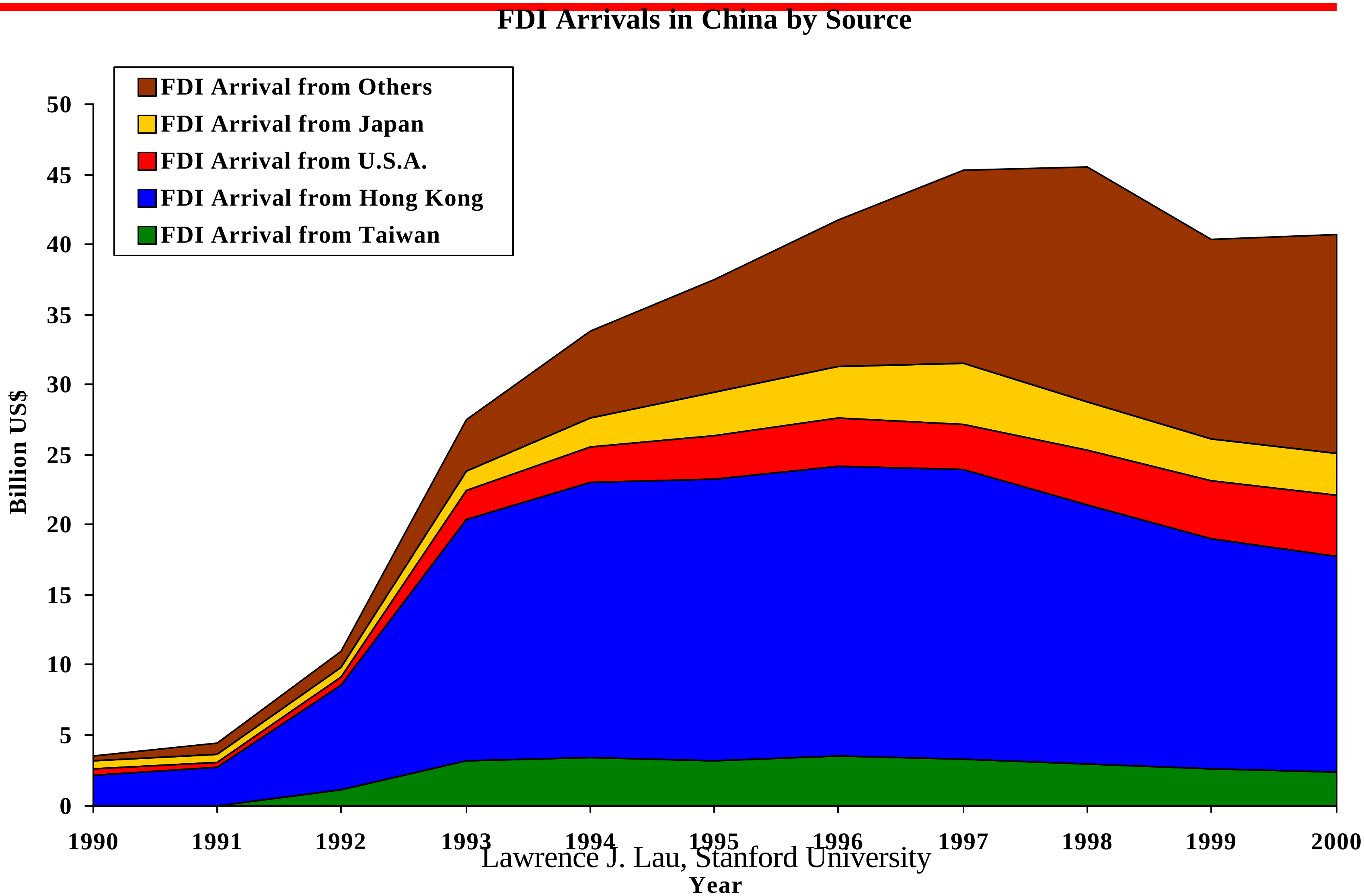
Manufactured Exports as a Percent of Total Chinese Exports



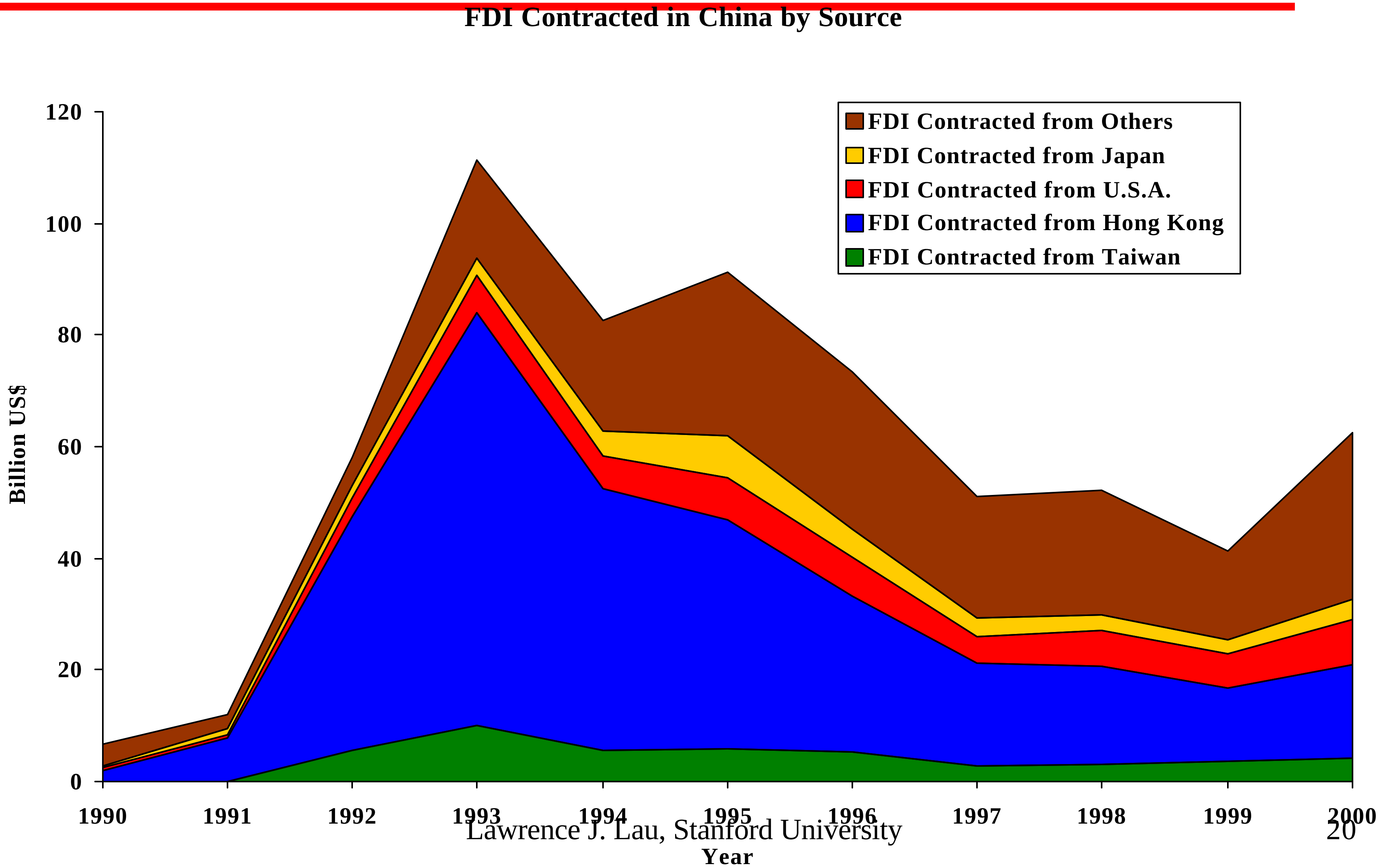
Foreign Direct Investment (FDI)

- 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; for 2001Q1-Q3, FDI arrivals rose 20.7% Y-o-Y to US$32.2 billion
- 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 2001Q1-Q3, FDI commitments rose 45.8% Y-o-Y
- Cumulative FDI as of 2001/09 amounted to US$380.82 billion
- 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

FDI Arrivals in China by Origin



FDI Contracted by Origin



Marketization: Final Abolition of Planned Prices

- The market prices of more than 99% of commodities have been determined by supply and demand for at least a decade
- In 2001/07, the remaining planned prices are abolished with the exception of the following: the prices of natural gas, oil, edible oils, grains, tobacco, water, salt, and products related to national security
- The exchange rate and the rate of interest are still determined administratively by the People's Bank of China, the central bank
- The dual-track system of prices introduced in the mid-1980s to facilitate the transition of China from a centrally planned to a socialist market economy has finally been phased out, reducing to a single-track market-based system, with the exceptions noted above

The Tenth Five-Year Plan (2001-2005)

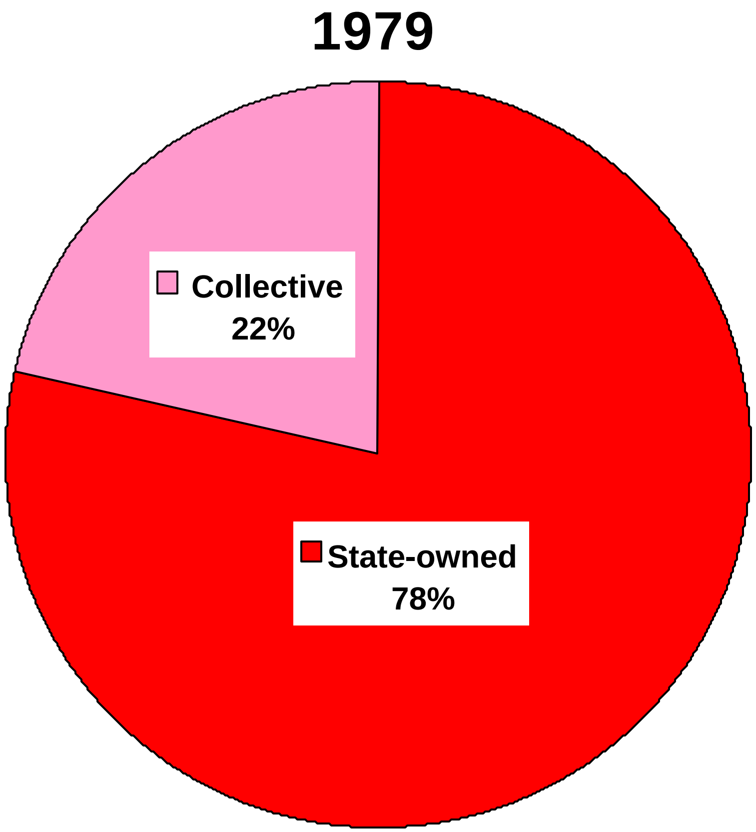
- An indicative (or predictive) plan rather than a mandatory plan
- Doubling of real GDP between 2001 and 2010, with an implied rate of growth of 7.2% p.a.
- An inflation target of less than 3% p.a.
- An increase in the share of central government revenue in GDP (the introduction of a comprehensive individual income tax)—tax revenue rose 22.8% to 1.266 trillion Yuan, or 14.2% of GDP, in 2000
- Indirect (macroeconomic) control of the economy using instruments such as money supply, interest rate and exchange rates rather than direct (microeconomic) control through administrative directives, commands and central planning with mandatory targets

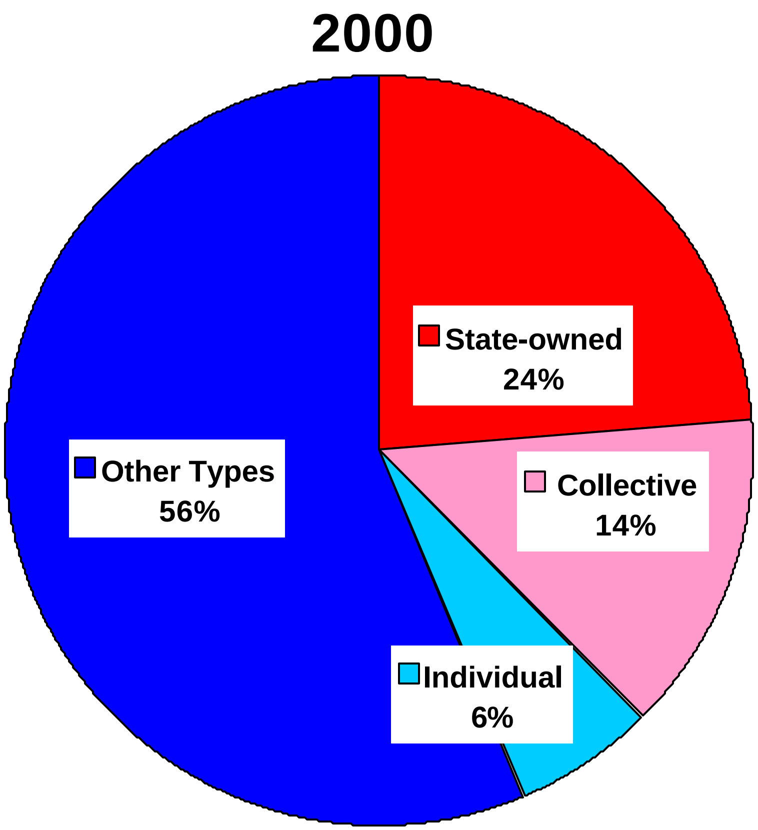
The Stock Market

- 1151 enterprises (more than 90 percent state-owned) listed on Shanghai and Shenzhen Stock Exchanges combined
- Market capitalization (US$510 billion); market turnover (US$2.5 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 reduced requirements for annual profits and capitalization (Chinese version of the American Stock Exchange)

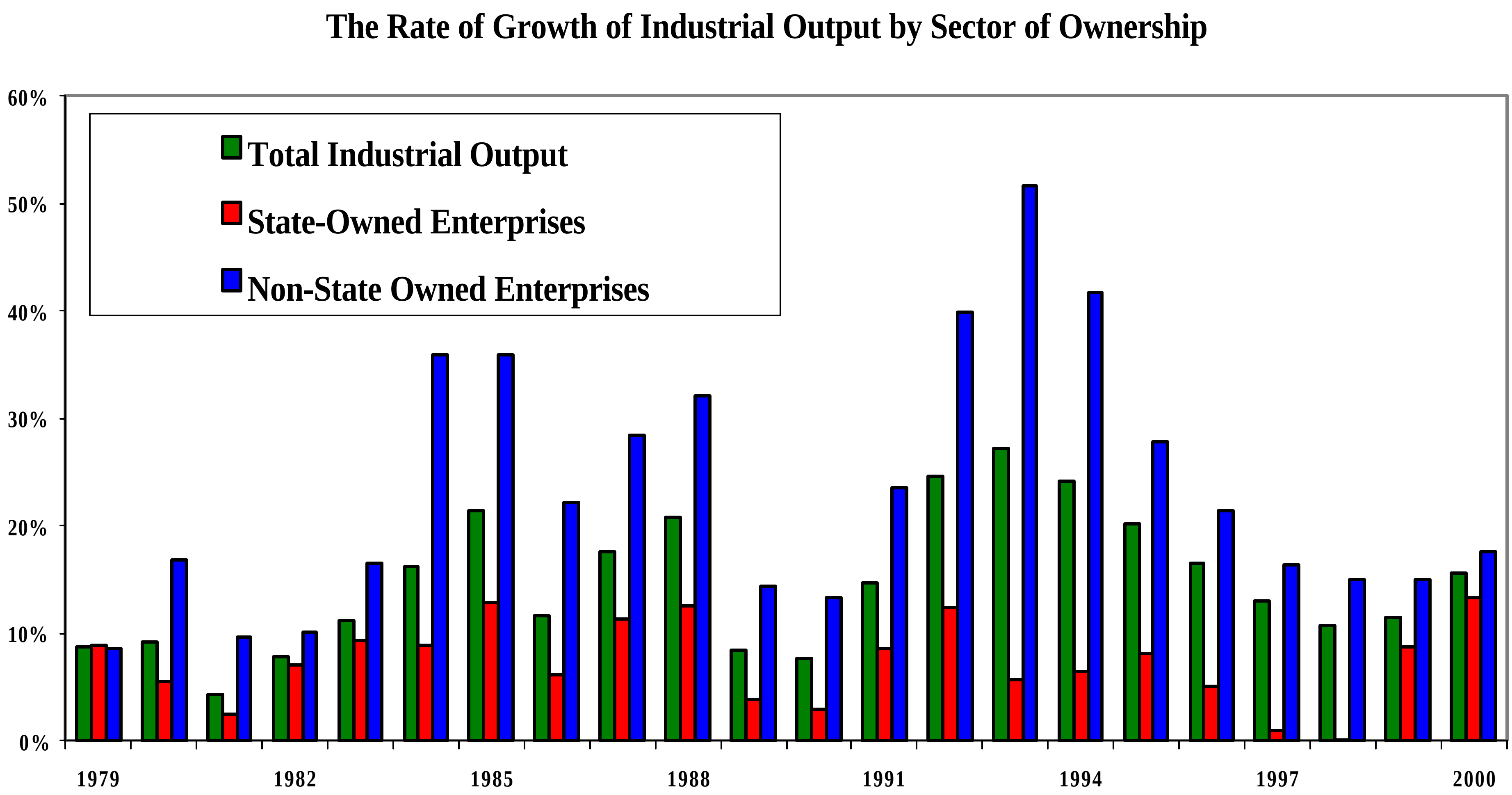
The Growth of the Non-State Sector-Industry

Distribution of Gross Value of Industrial Production by Ownership

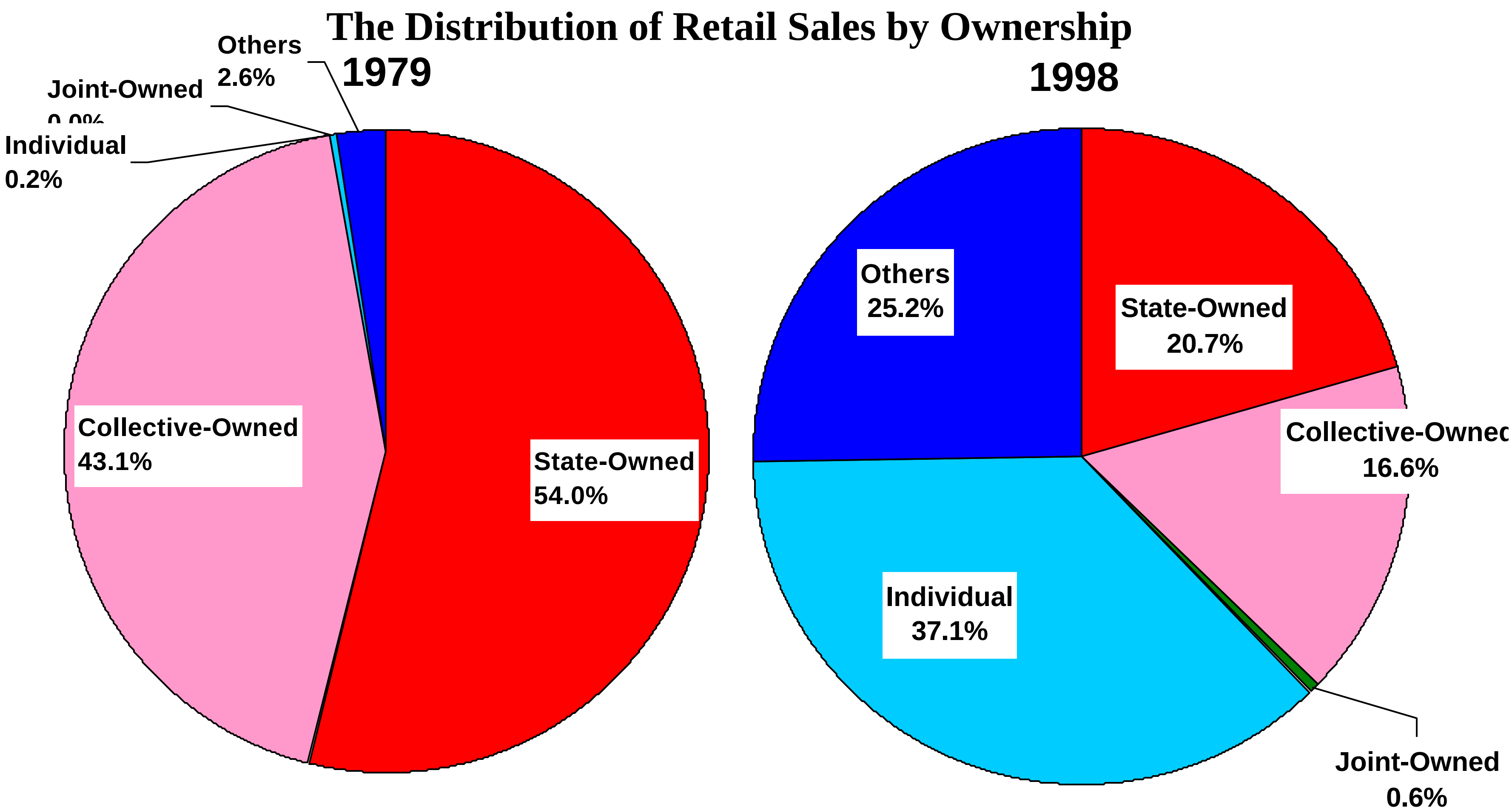




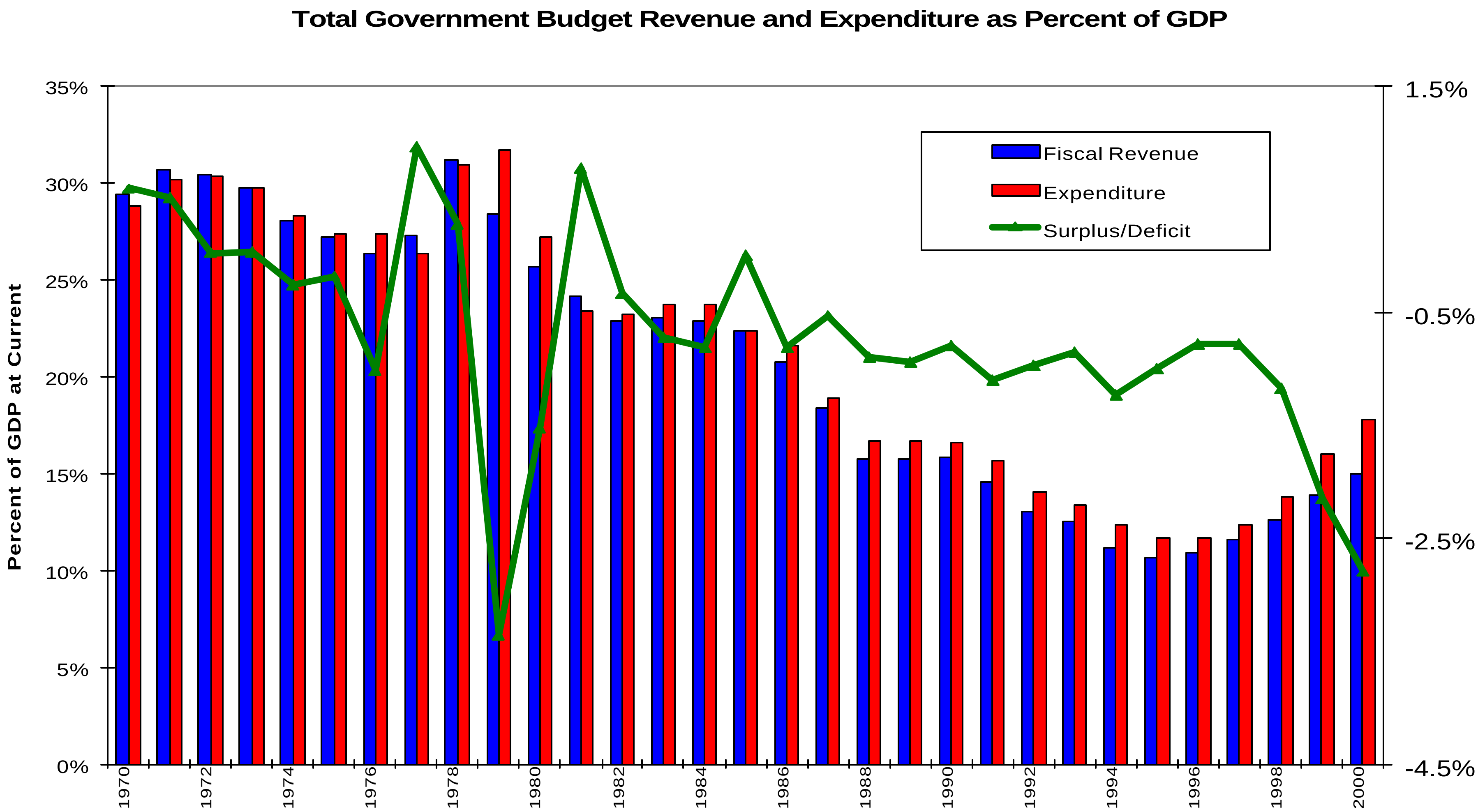
The Growth of Industrial Output by Sector of Ownership



The Growth of the Non-State Sector-Retail



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



Remaining Problems and New Problems Caused by the Success of the Economic Reform

- The state-owned enterprises are unable to compete effectively with the newly formed enterprises
- The state-owned enterprises are unable to fulfill their obligations to existing and retired employees
- Accession to the World Trade Organization (WTO) means much greater competition for state-owned enterprises
- Export markets have become saturated as the Chinese market shares have risen—continued rapid growth is no longer possible
- The rise of inter-regional and intra-regional inequality
- The deterioration of social services such as education and public health
- Rise of a new elite outside of the state sector (including the public government sector and state-own-enterprises (SOE) sector)

China and the World Trade Organization (WTO): Chinese Commitments

- Reduction of tariffs on all imported goods, including high-technology and agricultural products
- Removal or reduction of non-tariff barriers
- Elimination of export subsidies, if any
- Transparency of economic procedures, laws, rules and regulations
- Opening of the government procurement process
- Opening of service sectors to foreign investment and participation—international trade, distribution sectors, financial sectors (banking, insurance and securities), telecommunication and transportation sectors
- Enforcement of intellectual property rights, including patents, copyrights, brand names and trade secrets
- National treatment for all foreign direct investors

Chinese Benefits under the WTO

- Permanent "Normal Trade Relations" (most-favored-nation treatment) with all member countries and territories of WTO—no discriminatory tariffs and non-tariff barriers
- Reciprocal rights for trade and investment in services
- The right to use the WTO dispute settlement mechanism
- Chinese textile industry will benefit from the phasing-out of the quota restrictions of the Multi-Fibre Agreement (MFA) in 2006
- Joining the World—assuming its rightful place in the community of nations

The Direct Economic Impacts of Chinese Accession to the World Trade Organization (WTO) on China (1)

- Immediate impacts are relatively small; but it will lead to a change in long-term expectations about the Chinese economy
- Impacts on international trade
  - Exports and imports should rise moderately in the short and intermediate term, with the major positive impact on Chinese exports coming in 2006 when the quota restrictions on Chinese textile exports imposed by the Multi-Fibre Agreement expire
  - There should be increased trade in intermediate goods in both directions
  - Reduction of tariffs on technology imports would put some pressure on Chinese domestic producers but should also increase Chinese competitiveness in the global high-technology supply chain

The Direct Economic Impacts (2): International Trade in Agriculture

- Massive increases of imports of agricultural commodities are unlikely because of the limitations of the sizes of the total international markets in these commodities.
  - For example, annual Chinese production of grains is approximately 500 million metric tons, compared to an annual global total international trade of approximately 100 million metric tons so that any significant increase in Chinese annual imports to, say, 25 million metric tons (5 percent of Chinese domestic output), will cause significant increase in the world market price of grains and make imports uncompetitive with domestic Chinese production. In any case, for security reasons, in the absence of long-term supply contracts that can be credibly enforced against possible political interruptions, it is unlikely that Chinese imports of grains will increase much beyond 5 percent of annual production/consumption.
  - Moreover, there is currently excess production of grains in China, due in part to the procurement policies of the Chinese Government. If the procurement policy is changed from unlimited purchases to fixed quota purchases, the aggregate annual supply will decline, with the marginal, high-cost grain producers shifting into the production of other crops. Those producers who remain in grain production will have a lower cost structure on the margin that can be competitive with imports.
- However, there is also room for China to specialize in accordance with its comparative advantage, e.g., to grow fruits and vegetables and to diversify away from producing beef, which can be more inexpensively imported from Argentina, Australia and the United States
- Government-sanctioned national standardization and grading can greatly increase the market for Chinese agricultural products, especially higher-value-added ones, both domestically and overseas

The Direct Economic Impacts (3): State-Owned Enterprises in Non-Agriculture

- The accession to WTO sets an implicit deadline for the reform and restructuring of the state-owned enterprises and the commercial banks
- Inefficient state-owned enterprises can no longer be protected either directly, through tariff and non-tariff barriers, or indirectly, through subsidies and preferential government procurement, and de facto local monopoly privileges
- The state-owned enterprises must therefore be restructured so that they can survive on their own in the post-WTO competitive market. This implies labor force reduction, assumption of historically inherited liabilities such as the unfunded pension for past and current employees by the central government either directly or through the Social Security Fund, reduction of debt (e.g., debt-to-equity swap), transfer of responsibility for social services such as education, health care and housing to either the government or to the individual workers themselves. In other words, social security (including pension benefits) and social services must be "socialized," that is, become the responsibility of society or government rather than the enterprises themselves.

The Direct Economic Impacts (3): State-Owned Enterprises in Non-Agriculture

- Moreover, going forward, a new, viable and sustainable social security and pension scheme must be put in place. Otherwise the same problem will occur again, and given the demographic situation in China, much sooner than expected.
- Those state-owned enterprises that cannot be made viable through restructuring will have to be closed down, with the government or the Social Security Fund providing "subsistence" (welfare) benefits and if necessary, retraining and placement, to the displaced workers (the pension liabilities will be assumed by either the government or the Social Security Fund).
- It should be noted that restructuring, closure and consolidation of the inefficient sate-owned enterprises are likely to occur even without WTO accession; e.g., there are more than 100 automobile manufacturers in China; even in the absence of WTO, the overwhelming majority of these firms, more than 90 percent, will have to be closed down because of competition from the more efficient firms in China that have managed to achieved the minimum economic scale. WTO accession merely makes them more urgent as they cannot be delayed any more with imports threatening to take over whatever markets that are left to the state-owned enterprises
- Restructuring of the state-owned enterprises is the essential pre-condition for the restructuring of the banking system and the commercial banks with high "non-performing loans" ratio

The Direct Economic Impacts (4): Domestic and Foreign Investment

- An increase in domestic fixed investment in anticipation of the increased trade and investment, as well as the increased in competition, resulting from WTO accession
- A quantum increase in foreign direct investment (FDI), currently running at approximately US$40 billion annually, is expected upon WTO accession, further boosting Chinese economic growth. The post-WTO FDI should be on the order of US$60 billion a year
  - Foreign manufacturers are no longer subject to export requirements
  - Investment opportunities open up in the services sector—e.g., distribution, finance, and telecommunication
- Increases in investment lead to increases in real GDP and in employment—it is critical for more new jobs to be created with Chinese accession to WTO so that new entrants as well as the re-entrants caused by the inevitable restructuring of the state-owned enterprises into the labor force can be absorbed

The Direct Economic Impacts (5): The Financial Sector

- The arrival of foreign commercial banks in China should not have an overwhelming impact on the domestic banking industry if appropriate adjustments are made. The adjustments should mostly consist of leveling the playing field between the domestic and foreign banks. In any case, the domestic commercial banks have the home court advantage.
- The predominant client base of the foreign commercial banks will be foreign and joint-venture enterprises in China. It will be very difficult for the Chinese commercial banks to hang on to this business. Most enterprises like to be able to deal with a single principal bank that can serve their global needs. Most likely this will be a commercial bank headquartered in their home country.
- The foreign commercial banks are also likely to compete with the domestic Chinese commercial banks for business related to international trade for both foreign and joint-venture enterprises and for domestic Chinese enterprises by offering superior service.

The Direct Economic Impacts (5): The Financial Sector

- However, it is also unlikely that the foreign commercial banks will be able to take away significant deposits from the Chinese depositors. This is because deposit-taking is a very local business and the cost structure of the foreign commercial banks is higher than that of the domestic commercial banks. Thus, the foreign commercial banks will not be able to offer higher rates of interest on deposits than the domestic commercial banks. This has been borne out by experience in Hong Kong, Taiwan, and elsewhere in Southeast Asia.
- Moreover, as long as there is either explicit or implicit deposit insurance that is credible, the fact that the Chinese commercial banks have higher ratios of non-performing loans than foreign commercial banks will not disadvantage the domestic banks in terms of deposit-taking.
- Furthermore, the experience of these countries and regions also indicate that even under the freest circumstances, such as in Hong Kong, the proportion of total bank deposits taken by foreign commercial banks is on the order of 20 percent.

The Direct Economic Impacts (5): The Financial Sector

- The foreign commercial banks will also have a disadvantage in terms of microeconomic credit information. It is therefore likely to charge a higher rate of interest for loans, holding credit quality constant.
- Foreign commercial banks are also unlikely to make unsecured loans to small and medium enterprises in China, or to make loans to state-owned enterprises without very strong balance sheets.
- They are also unlikely to lend to Chinese consumers in the first instance because of the difficulty of obtaining useful credit information. On mortgage loans, the constraint is the ability to find sources of long-term funds.
- The net result is that the domestic commercial banks will be able to maintain a significant proportion of their current domestic business.
- Moreover, the competition may actually lead to new banking services and an overall expansion of the entire market

The Direct Economic Impacts (5): The Financial Sector

- The biggest threat of foreign commercial banks on Chinese commercial banks is the poaching of their existing staff. For foreign commercial banks, the easiest thing to do is to offer double, triple or even ten times the salaries of current employees of the Chinese commercial banks to induce them to work for the foreign commercial banks instead. This would decimate the manpower of Chinese commercial banks.
- In order to counter this threat, the Chinese commercial banks must begin to pay market wage rates, monetize the total compensation, and de-link their wage and salary scales and practices from the civil servants salary scale and practices. They must begin to use incentives such as portable and fully vested pension plans, profit-sharing as well as low-cost mortgages and other fringe benefits that are conditional on the continuing employment of the employees.

The Direct Economic Impacts (5): The Financial Sector

- Should China permit one-bank holding companies and/or universal banking, i.e., allow the same financial institution to engage in commercial banking, investment banking, insurance and securities? Should China continue to maintain a form of Glass-Stegall Act?
- I believe that the information disclosure and transparency in China and the degree of compliance with and enforcement of laws, rules and regulations are not sufficiently high for the time being to warrant removing the separation between these various financial activities. The probability of moral hazard is simply too high.
- If the policy of separation is to be continued post-WTO accession, new legislation and regulations must be formulated so as to assure compliance by foreign banks, most of which are permitted to engage in all of these business lines, so that they do not put Chinese commercial banks at a competitive disadvantage.

The Direct Economic Impacts (6): The Role of the Central Bank

- With the entry of foreign commercial banks into the Chinese market, the role of the People's Bank of China will be slowly transformed. It will have to regulate all the banks, domestic and foreign, in a fair and uniform manner.
- The People's Bank of China should assume the responsibility of clearing and settlement.
- The People's Bank of China should be responsible for the monitoring and enforcement of capital and reserve requirements.
- The People's Bank of China, or the Deposit Insurance Corporation, should begin to charge all banks, domestic and foreign, deposit insurance premia and specify the limits of such deposit insurance.
- The People's Bank of China has to monitor and enforce compliance with rules and regulations on foreign exchange transactions, so that capital control remains effective.
- Up to the present, the People's Bank of China has underwritten and assumed most, if not all, of the risks of long-term fixed rate loans on mortgages and other projects by re-discounting these loans. This is potentially very risky and cannot be expected to continue, especially with the foreign commercial banks entering the Chinese market in a substantial way after accession to WTO. A market must be developed so that these long-term fixed rate loans can be securitized, transferring the risks from the banks and the banking system to institutional (e.g., the newly established Social Security Fund) and individual investors other than the banks themselves. Securitization is the only way to spread the risks away from the financial institutions. No one wants a repeat of the U.S. Savings and Loan Associations debacle in the early 1980s.
- Financial regulation must be clear, transparent, uniform and enforceable.

Longer-Term Implications--The Challenges and the Opportunities (1): Commitment

- Reaffirmation of the continuation and deepening of economic reform (the "open door", marketization, devolution of economic power and creation of non-state modes of organization for production)
  - Chinese accession to the WTO is testimony of the enormous success of Chinese economic reform which has transformed China from a stagnant centrally planned economy to an open and dynamic market economy
  - Accession to WTO reinforces urgency of continuing and accelerating the reform process—much-needed but difficult and possibly painful reforms can no longer wait—e.g., labor market reform, social security reform, pension reform, state-owned enterprises reform, banking reform, housing reform, and legal reform; it also signals the commitment of the Chinese Government to continuing the economic reforms that have proved to be both successful and popular among the Chinese people
- Permanent commitment to an open economy
  - Chinese accession to the WTO represents a commitment to lock in permanently the links of the Chinese economy to the global system of market economies, making irreversible the economic reforms already implemented in China over the past two decades—including the "open door" to the world economy for trade and investment, marketization, devolution of economic decision-making, and creation of the non-state-owned sector—and to an economy based on rules
  - Chinese accession also accelerates the process of globalization, and in particular, Chinese participation in the international specialization and division of labor

The Challenges and the Opportunities (2): The Emergence of a Unified National Market in China

- Chinese accession to the WTO, together with the Western Development Plan, provide additional incentive and pressure to accelerate the emergence of a large, truly integrated and unified national market in China, not only for goods, but also for factors, especially capital.
- It is this one single national market that will enable Chinese and foreign firms alike to benefit from the economies of scale.
- However, the rule of law must be strengthened in at least two areas before these benefits can be realized.
  - Elimination of provincial and local barriers to the movement of goods and factors
  - Establishment of a centralized and unified National Commercial and Tax Court to handle all economic and tax disputes, including intellectual property issues
- These two measures, if adopted, will lead to significant economic benefits to China and will also avoid many potential legal disputes between and among foreign and domestic firms and provincial and local governments in China

Elimination of Provincial and Local Barriers to the Movement of Goods and Factors

- First, the Central Government must make the elimination of provincial and local barriers to trade in goods and services, and to investment; a first priority. It must strive to realize and maintain a fully unified national market—with free flows of goods, services, capital and labor. Under existing Chinese laws, the provincial and local authorities are not supposed to be able to restrict the flows of goods, services and capital. But in fact, it is often difficult for factories in one province to sell their products to another province. If steps are not taken to eliminate these barriers, China will not be one large market, but will become more than thirty, perhaps even 2,000, small fragmented markets.
- It is interesting to note that the "Interstate Commerce Clause" of the U.S. Constitution is intended precisely to outlaw such similar activities by state governments in the United States.
- A new "federalism," aimed at the definition and division of obligations and responsibilities for social services and the sources of revenue between the central and provincial/local governments (this removes the incentives to establish and maintain provincial and local barriers). The institution of a system of comprehensive individual and corporate income taxation is probably required to make this work.
- In order to spur this effort, the provincial and local governments will have to realize that their primary economic objectives should be the creation and continuous maintenance of durable employment and the generation and increase of resources under public control through taxation rather than through profit. Then they should not care who makes the money as long as it provides gainful, unsubsidized employment and pays taxes. They should welcome and protect investment from any source, foreign or domestic.

Establishment of a Centralized and Unified National Commercial and Tax Court

- Second, the Central Government should establish as soon as possible a centralized and unified system of National Commercial and Tax Courts, reporting directly to and controlled directly by the central government for the expeditious, fair and non-discriminatory adjudication and settlement of all commercial (including intellectual property rights) and tax disputes (like the U.S. National Tax Court). This has the great advantage of making judgments, decisions, standards and practices uniform and transparent and legal precedents applicable and binding in all regions across the entire country. Firms, both domestic and foreign, will no longer be subject to the vagaries and variability of the local court systems. The judgments of these courts will be enforced by the central government if necessary
- The new system of courts will be responsible for the enforcement of contracts and the prosecution of commercial fraud—implementation of the rule of law in the economic sphere

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. China is a continental economy--International trade will never be as important as other, smaller countries and China must rely on internal demand for further economic growth. Value-added from exports constitutes only 6 percent of Chinese GDP.
- 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 Challenges and the Opportunities (3): Reforms in the Regulatory Infrastructure

- Replacement of the current discretion-based system by a more transparent and rule-based system in economic regulation; implementation of the rule of law in the economic sphere
- Maintenance of a competitive market environment with free entry and exit (use of anti-trust and fair trade laws to prevent unfair competition and monopolistic practices)
- Regulation as well as deregulation of the public utilities sectors—transportation, communication, power, etc.--promotion of lower and more competitive rates for universal access--prevention of monopoly rents (maintenance of standards and mutual communicability and promotion of competition)
- The welfare of the consumer rather than the profit of the state-owned enterprises as the objective of regulation

Longer-Term Implications: The Challenges and the Opportunities (4)

- National treatment for all
  - Foreign direct investors in China will be granted full national treatment--a "level playing field" for all—as well as Chinese domestic non-state-owned enterprises, the "unintended beneficiaries"
- Insurance for domestic economic efficiency through open global competition--inefficient domestic monopolies will no longer be able to continue to operate under protection
- The protection of intellectual property rights will spur a major investment in R&D, branding, and other forms of intangible capital

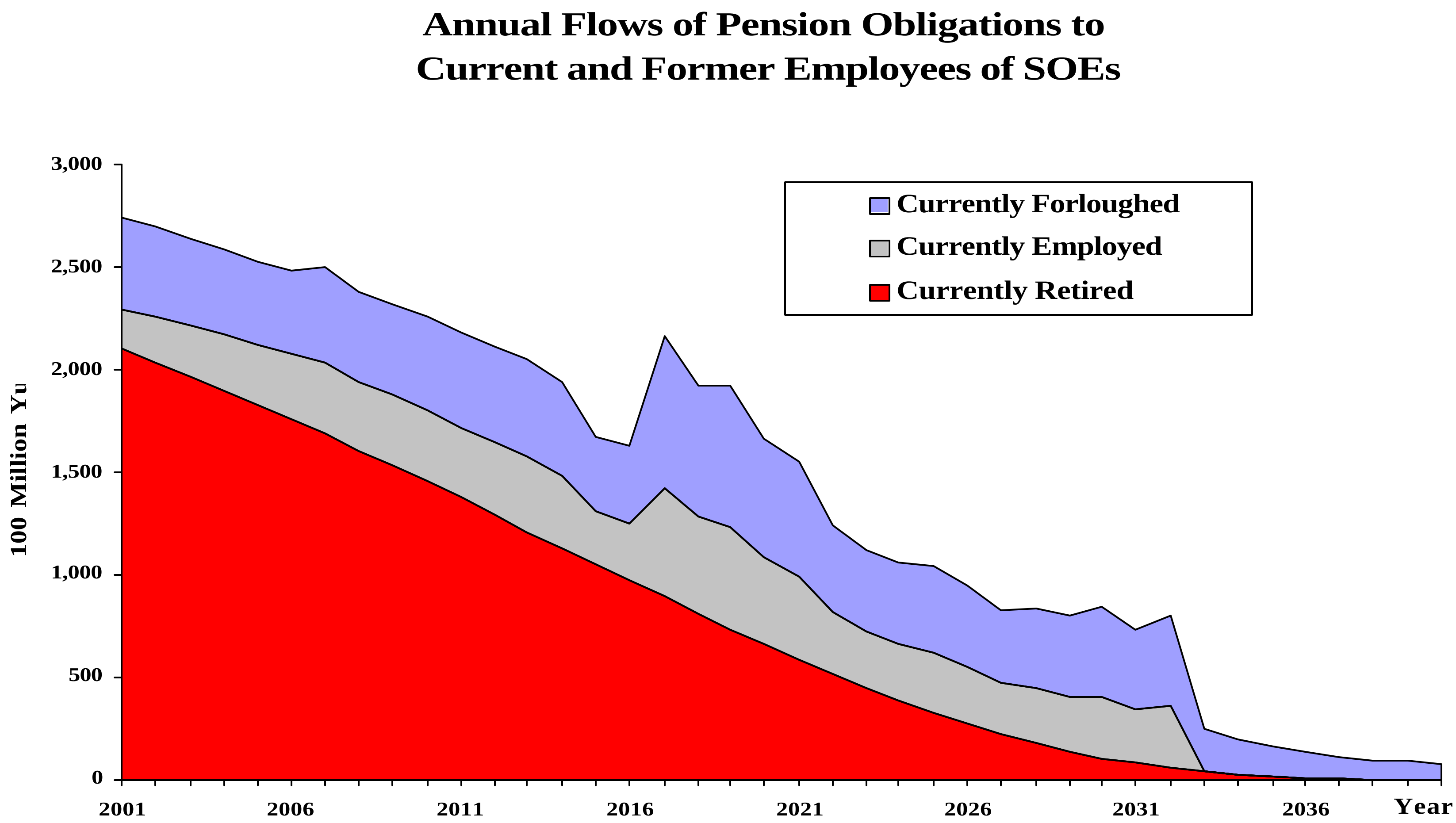
The Critical Path for Continuing Economic Reform

- Establishment of a viable social security and pension system (including unemployment "insurance") to take care of both the inherited historical problems and the future
- Restructuring of the state-owned enterprises
- Reform of the banking system and the capital market
- In parallel, agricultural reform should be undertaken
- In parallel, development and deepening of the factor markets
  - Capital markets
  - Labor markets
    - Towards full monetization
- Reform of the housing market
- Accession to WTO reinforces urgency of reform

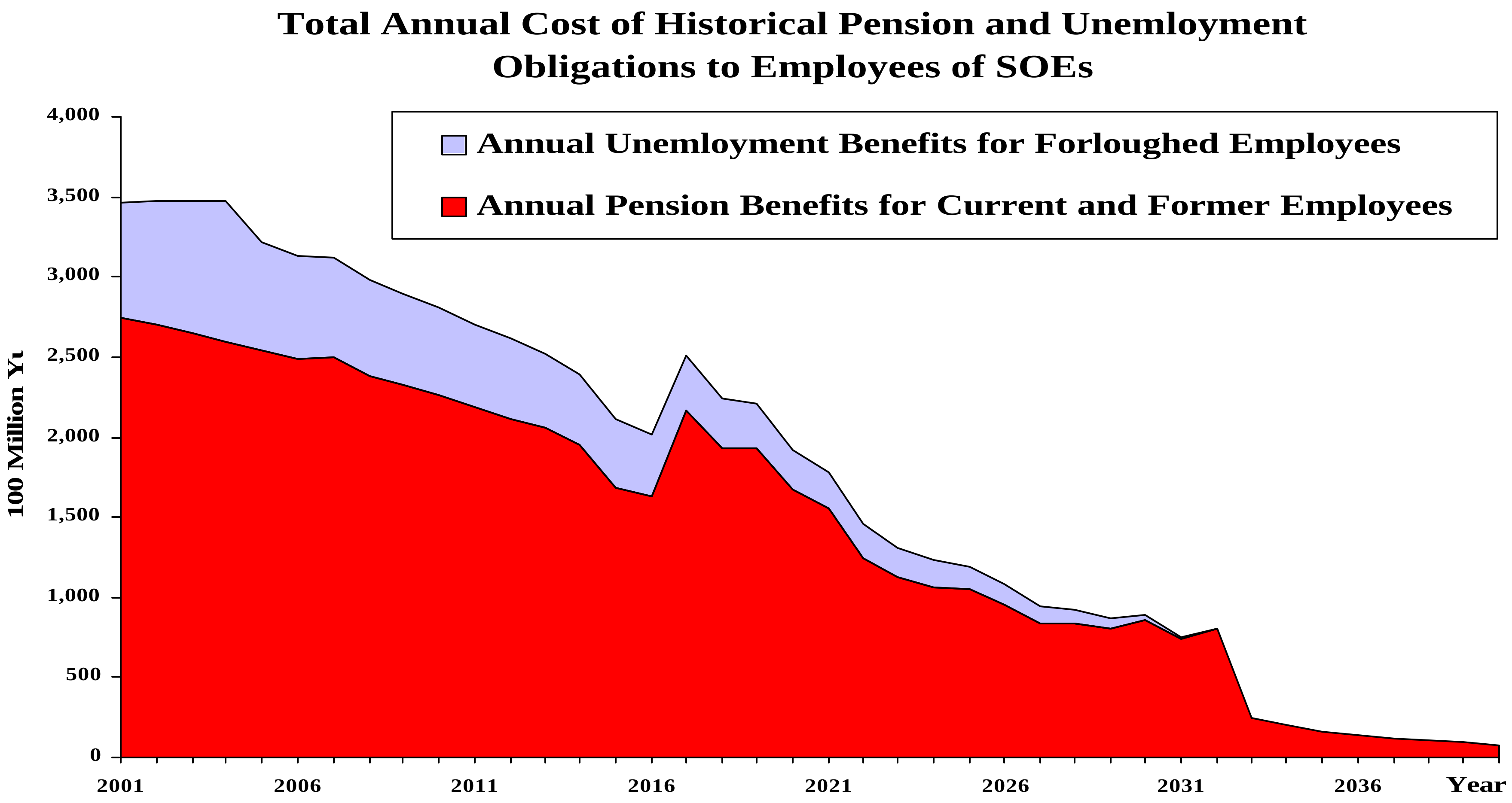
The Establishment of a Social Safety Net

- 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
- 10% of new IPOs will consist of state-owned institutional shares with the proceeds dedicated to the Social Security Fund

The Annual Flows of Resources Required for Historical Pension Obligations



The Total Annual Cost of Historical Pension and Unemployment Obligations



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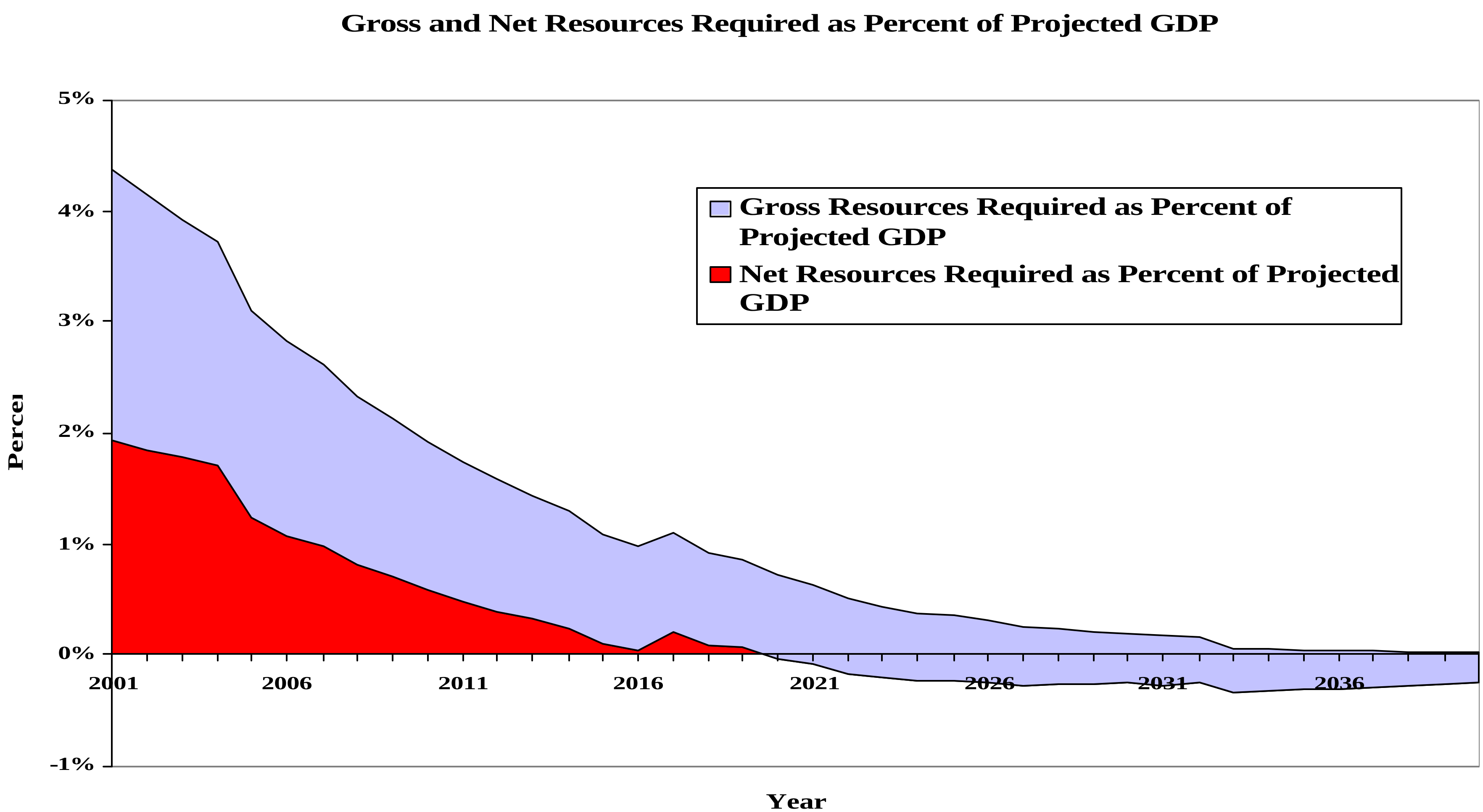
The Annual Flows of Resources Required as a Percent of Projected GDP



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 9 trillion Yuan and an estimated value of total state-owned assets of 9 trillion Yuan
- Total market capitalization of publicly listed Chinese firms may be estimated at US$700 billion, approximately 70% of which is held by the state in the form of institutional shares, amounting to slightly more than 4 trillion Yuan; there are additional Chinese state-owned firms remaining to be publicly listed

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

Why Do State-Owned Enterprises Lose Money? (1)

- Burden of unfunded or under-funded pension and other social welfare liabilities
- Burden of interest costs caused by the lack of a founding equity
- Losses due to improper transfer pricing and other irregular practices--as long as the state, or state-owned banks, are ready to absorb them--some of the losses are accounting losses and only imply that the shareholders (the state), as opposed to the management, are losing money
- Losses due to lack of incentives for efficient management or efficient allocation of new investment
- Losses due to diversion or re-lending of funds with or without the connivance of the loan officers

Why Do State-Owned Enterprises Lose Money? (2)

- The really relevant losses are the genuine operating losses due to antiquated equipment and technology and/or over-employment
- The system of governance of the SOEs has to be reformed to solve the principal-agent problem and to reduce moral hazard through the hardening of the budget constraint
- **LOSSES MAY NOT REFLECT SOCIAL EFFICIENCY OR LACK THEREOF, ESPECIALLY IF THEY ARE CAUSED BY FIXED FACTORS AND ARE INFRA-MARGINAL**

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 15% 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

Liberalization and De-Regulation of the Rate of Interest

- Since 09/2000, the association of bankers can set the deposit and lending rates for foreign currency
- Widening the band of discretion for banks to set deposit and lending rates in the urban areas
- Central Bank will regulate the rate of interest through open market operations and changes in the re-discount rate
- Regulation in the form of minimum lending rates and maximum deposit rates to deter moral hazard

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)?
- Creation of a long-term bond market (securitization of mortgages and other loans)
- A second board as a source of capital for non-state-owned enterprises

Labor Market Reform

- Full monetization of labor compensation
- Flexibility on both the employers' and the employees' sides—mobility in lieu of guaranteed lifetime employment
- Lifetime employment in the same firm or even the same industry may not be possible in this age of globalization and rapid technological progress and diffusion

Sources of Growth of Aggregate Demand: Affordable Owner-Occupied Housing

- Huge pent-up demand for new affordable owner-occupied residential housing and rebuilt and renovated residential housing—a housing boom that can last for decades
- Promotion of affordable owner-occupied residential housing investment for and by the domestic population is one of the few alternative new and durable sources of growth of aggregate demand
  - Simultaneous adjustment of salaries and rents, providing purchasing power for employees not currently provided housing
  - Establishment of properties (transfer) rights to residential housing similar to those already available in the rural areas
  - Provision of long-term, preferably fixed rate, mortgages; development of secondary markets for such mortgages to avoid maturity mis-match; adoption of "safe-harbor" rules to over come "reluctance to lend"
  - Institution of urban zoning and land use laws; absorption of land costs but maintaining fairness through land leases adjustable upon renewal
  - Development of mass urban transit

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 and causing uncontrollable budget deficits?
- Abolition of specific agricultural taxes
- Government purchases from individual farmers should be limited by quantity on a per farm household basis and made at pre-announced fixed prices sufficient to guarantee a subsistence income to the farmers
- The market prices of agricultural commodities will be determined by supply and demand in the market without government intervention
- Improvement of grading and standardization practices and introduction of greater competition in the distribution of agricultural products can result in significant increases in the income of farm households without a corresponding increase in the government's budgetary burden

Public Investments in the Legal Infrastructure: Implementation of the Rule of Law

- Affirmation of private ownership of means of production side-by-side with public ownership and the protection of such property rights
  - Private venture capital can be more efficient than public venture capital because of ability (resulting from necessity) to terminate unsuccessful projects at an earlier stage
  - It is a paradox that an indicator of the degree of success of venture capital is the failure rate of projects—a higher failure rate, within limits, is associated with greater success
- Protection of intellectual property rights, including patents, copyrights, brand names and trade secrets
- Institution of comprehensive individual and corporate income taxation system
- Transparent implementation of the rule of law in the economic sphere

Public Investment in Human Capital

- Investment in Human Capital (formal, technical, on-the-job training, and re-training); re-orientation from firm-specificity to worker-specificity (flexibility, adaptability and re-employability); mobility (institutional and legal); network externalities and benefits from networking; accreditation, standardization, quality assurance and examinations and tests
  - Lengthening of the time for formal and general education--extension of compulsory education to 12 years; expansion of tertiary education
  - Investments in information and communication technology
    - A PC in every classroom (in every urban home)
    - New modes of education and information dissemination

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 unified national market
- Education and investment in human capital is the most effective means for reducing income inequality
- Maintaining long-term competitiveness without devaluation; WTO accession can help by putting pressure on enterprises to move inland to lower their costs and maintain competitiveness
- Relocation of the capital from Beijing to a city in the Western region of China can significantly accelerate the development of the Great West

Reforms of Provincial and Local Government Finance: A New Federalism

- Division of revenue base
- Division of responsibilities
- Subsidies for provinces with low real GDP per capita
- Socialization of local public services such as basic education (primary and secondary education) and public health
- Expanding options for the financing of tertiary education (private universities, tuition, loan programs)

The Speech of President Jiang Zemin at the 80th Anniversary of the Founding of the CCP (7/1)

- Emphasized the “Three Represents”: Advanced productive forces, all classes, and all cultures
- The Chinese economy is still in the “primary stage of socialism” (=capitalism)
- Non-state and private ownership of property is recognized and protected
- Non-state and private entrepreneurs, industrialists, managers, traders, high-technology innovators, writers, actors and people from all walks of life will be eligible to join the Chinese Communist Party
- The party itself will actively recruit new members—a step towards a form of elitist politics (China will be going through a technocratic phase in the next couple of decades)