Chinese Accession to the World Trade Organization (WTO) and the Chinese Economy

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Chinese Commitments under the WTO

- 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.

Can Capital Control Remain Effective after Accession to WTO?

- There is a whole spectrum of what is meant by capital control—the capital control that is practiced in China today has three principal features:
  - Short-term inflows and outflows of foreign capital (whether belonging to individuals or institutions) is regulated and is currently largely limited to commercial bank loans
  - Individual Chinese citizens are not permitted to export capital (either short-term or long term) by exchanging Renminbi into US$. They are however permitted to hold foreign exchange that they are able to obtain independently.
  - Long-term inflows of foreign capital, principally in the form of foreign direct investment, and the subsequent repatriation of the principal and profits, if any, are permitted but must go through an approval process.
- Post-WTO accession there must be clearly defined and completely transparent and enforceable regulations apply to all commercial banks, domestic and foreign
- A clear distinction must be made between capital account and current account transactions—current account transactions are always allowed provided no contraband is involved; only selected capital account transactions, as indicated above, are permitted
- A system should be put in place so that foreign exchange transactions can be reported in real time
- A nation-wide system of identification numbers for financial and tax purposes, such as the social security and taxpayer's identification numbers of the United States, should be introduced so that deposits, withdrawals, cash transactions, wire transfers, can all be linked together. Chinese citizens, enterprises and other institutions should be required to disclose any accounts maintained outside of China. The financial institutions will be required to maintain information, such as a date of birth and an address, on and verify the real identities of their customers. Nominees should be outlawed.

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

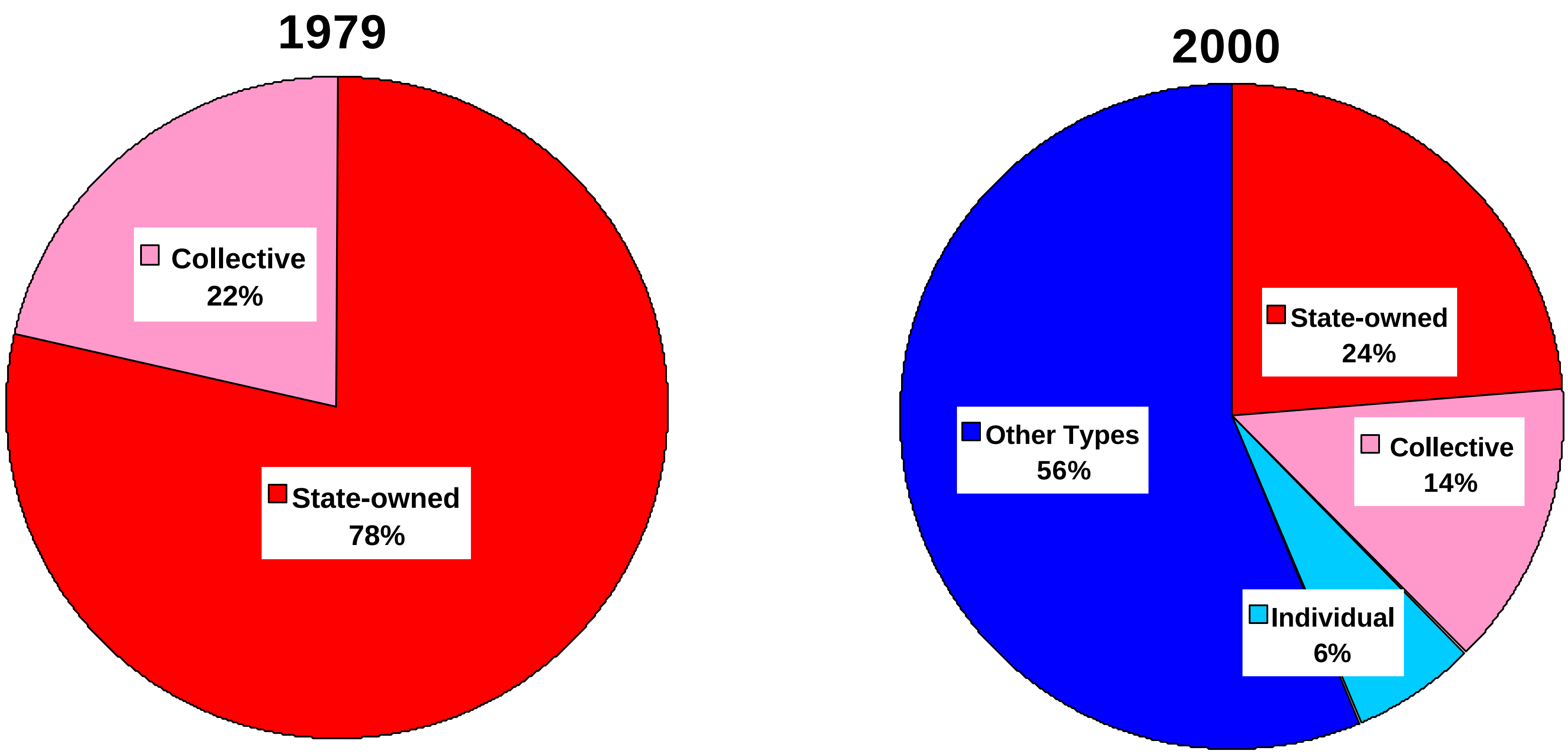
- Reaffirmation of the continuation and deepening of economic reform (the "open door", marketization, devolution of economic power and creation of non-state modes of organization for production)
  - Chinese accession to the WTO is testimony of the enormous success of Chinese economic reform which has 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 Major Components of Chinese Economic Reform (1979-the present)

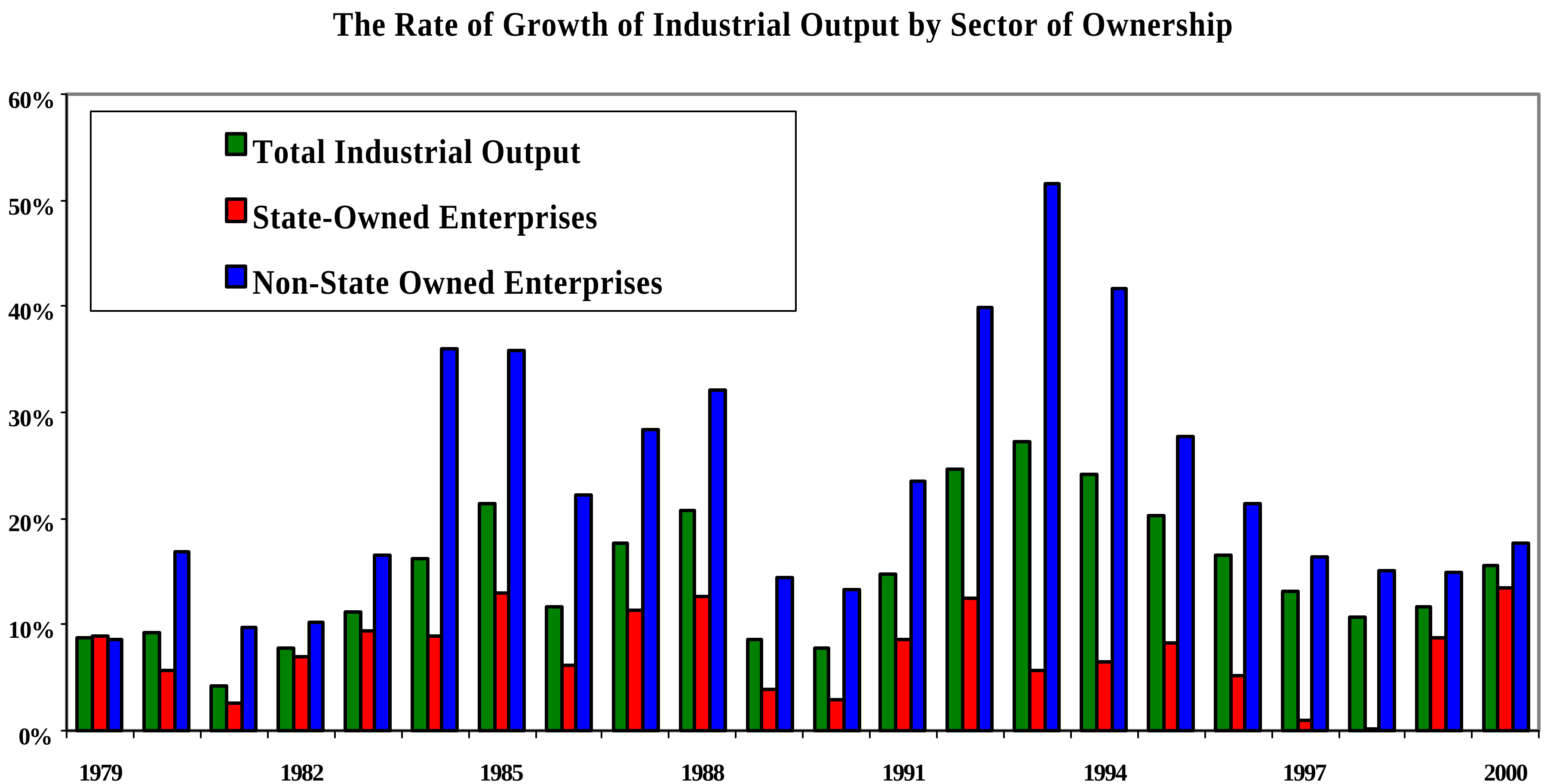
- The "Open Door"
  - International Trade
  - Foreign Direct Investment
- Marketization
  - Goods Market
  - Labor Market
  - Foreign Exchange Market
  - Housing Market
  - Capital Market
- Devolution of economic decision-making power (The "Contract Responsibility System")
  - Empowering Provincial and 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

The Growth of the Non-State Sector-Industry

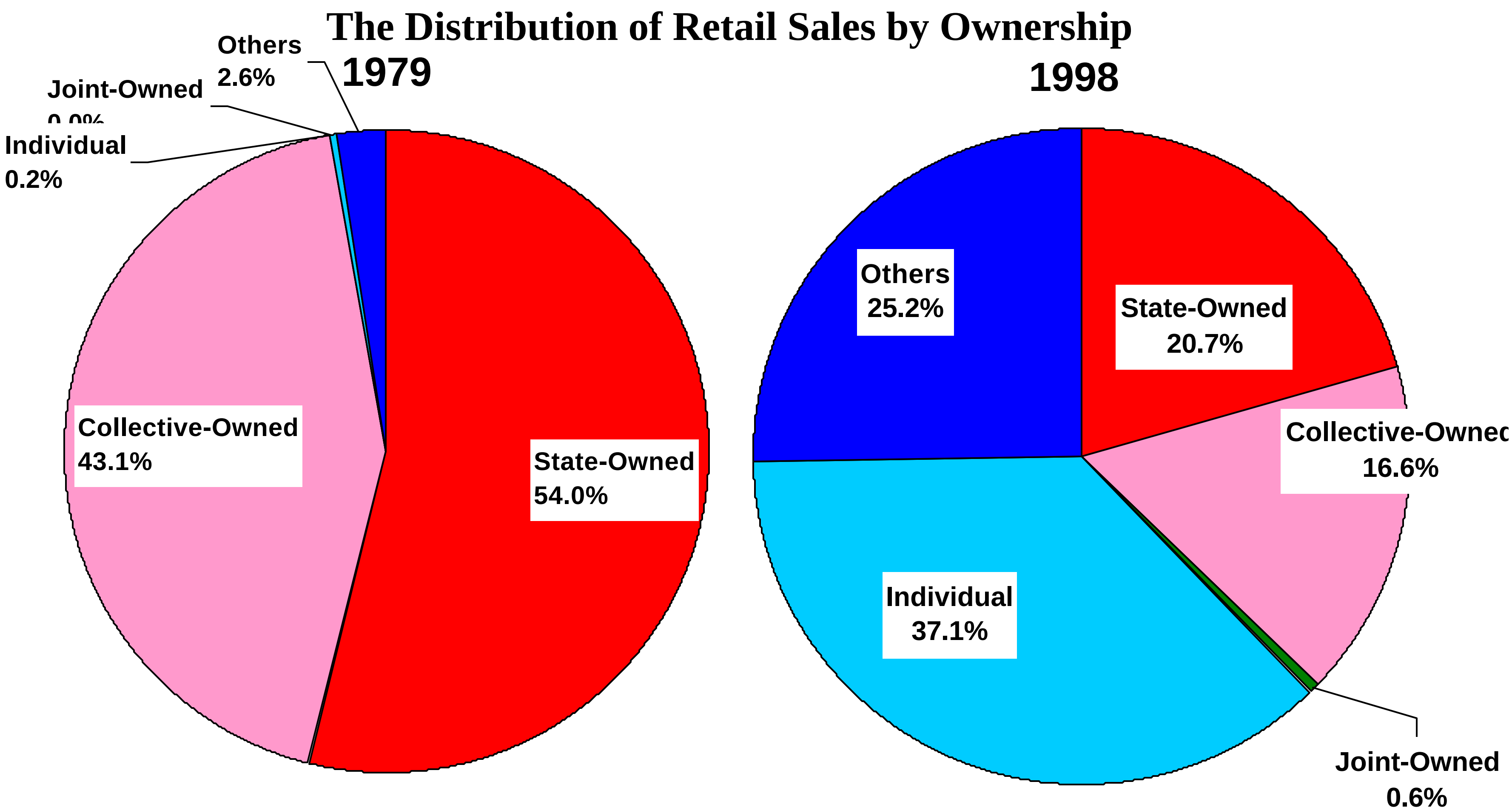
Distribution of Gross Value of Industrial Production by Ownership



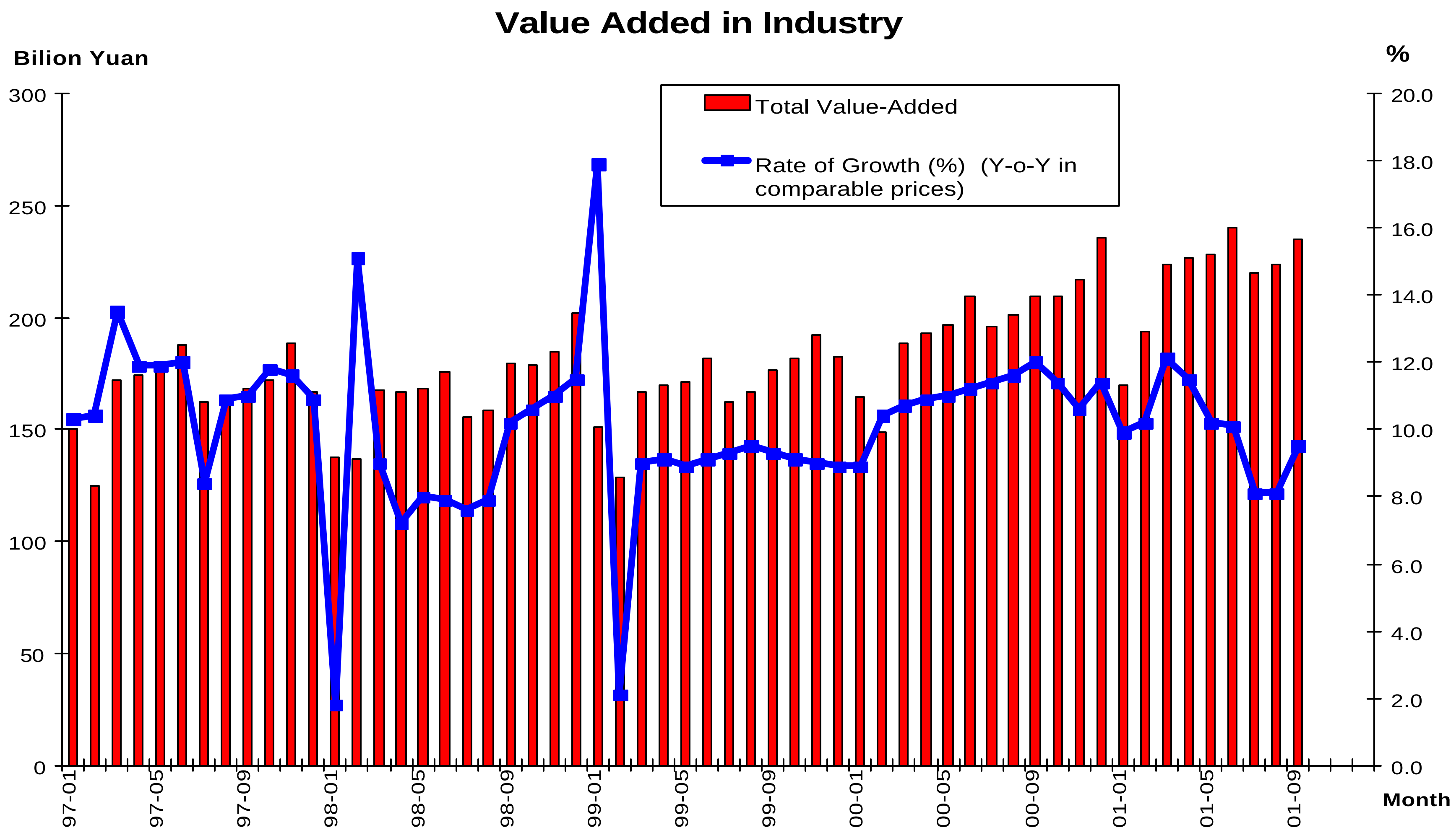
The Growth of Industrial Output by Sector of Ownership



The Growth of the Non-State Sector-Retail



Value-Added in Industry



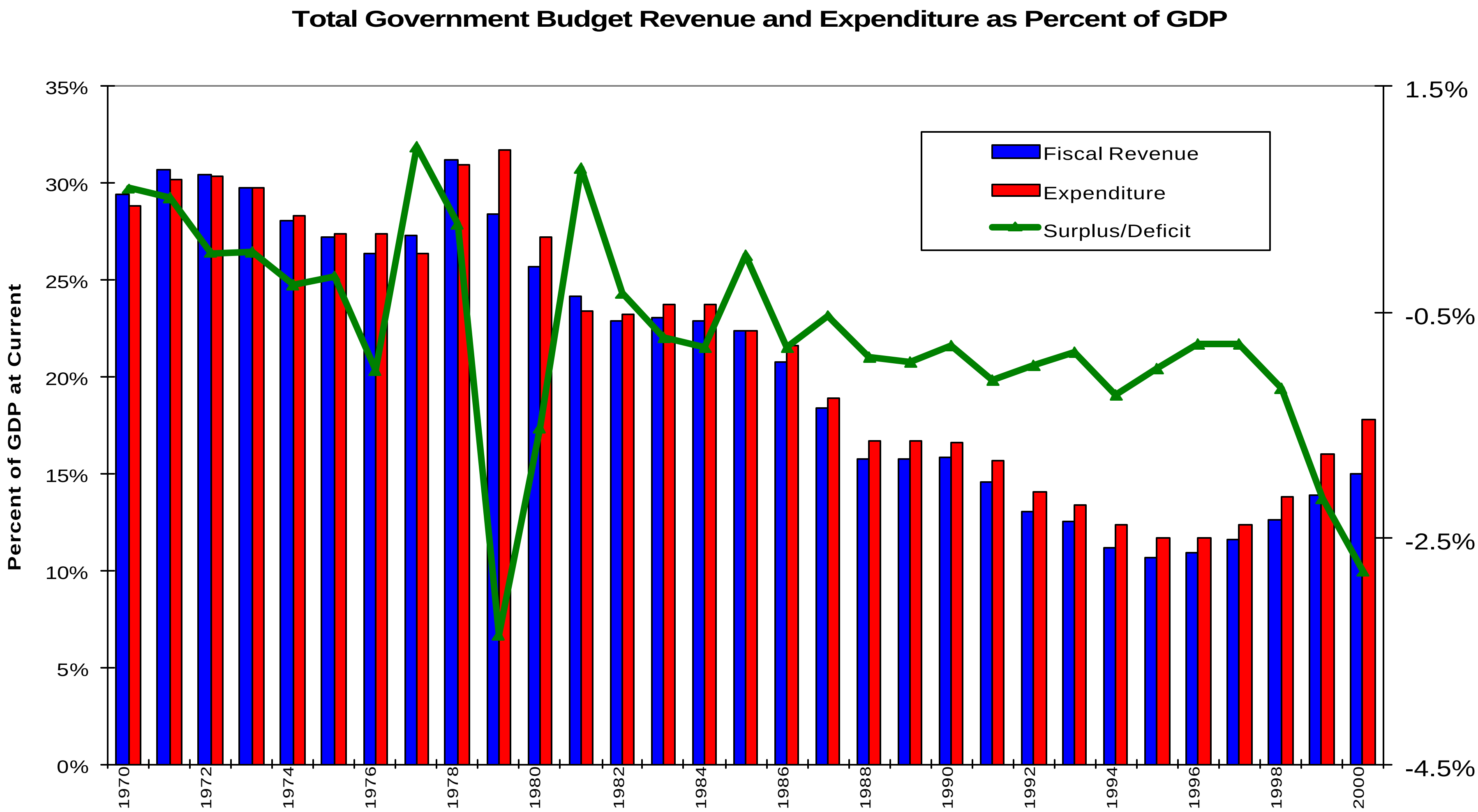
Marketization: Final Abolition of Planned Prices

- 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

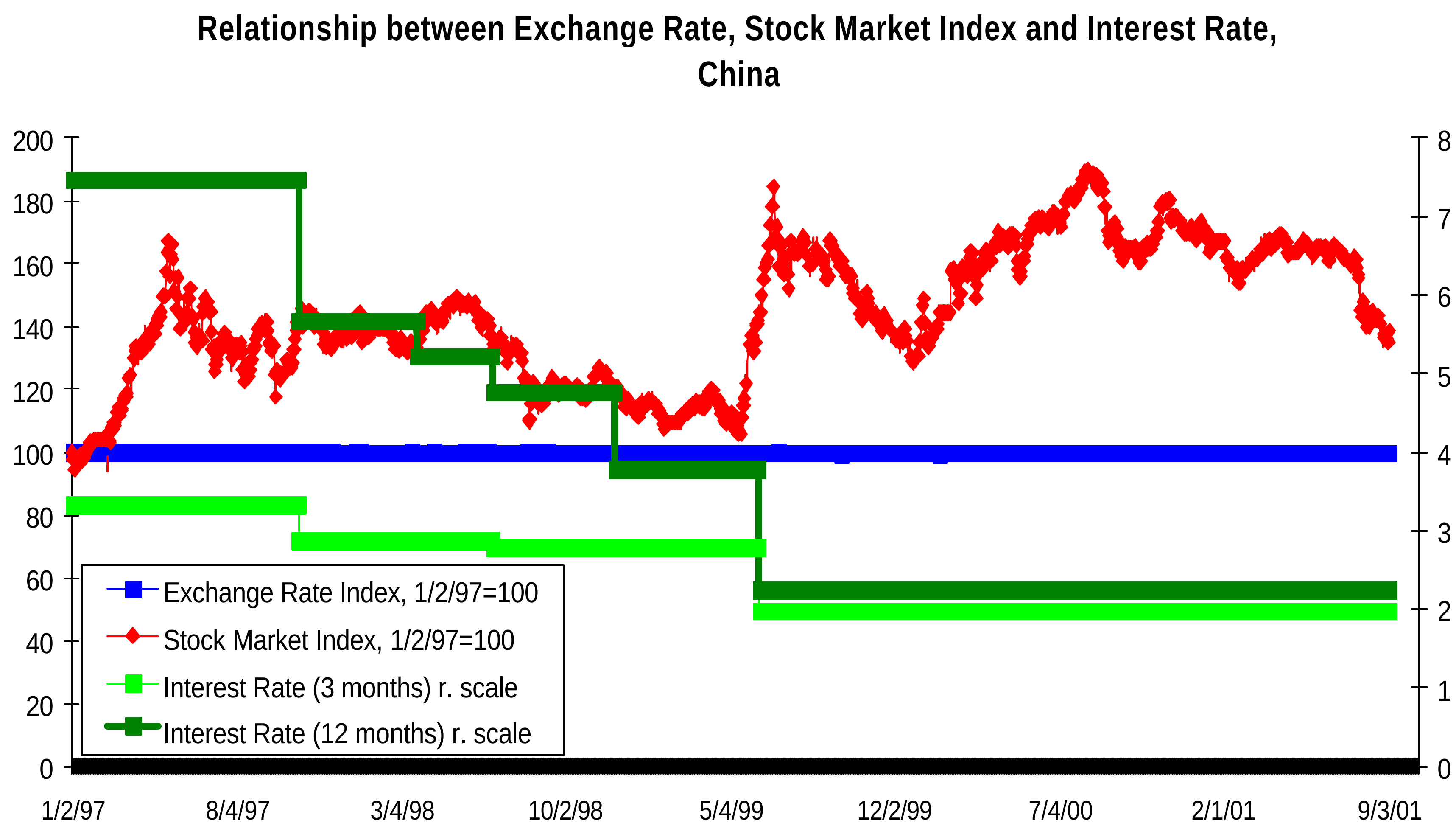
The Tenth Five-Year Plan (2001-2005)

- 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

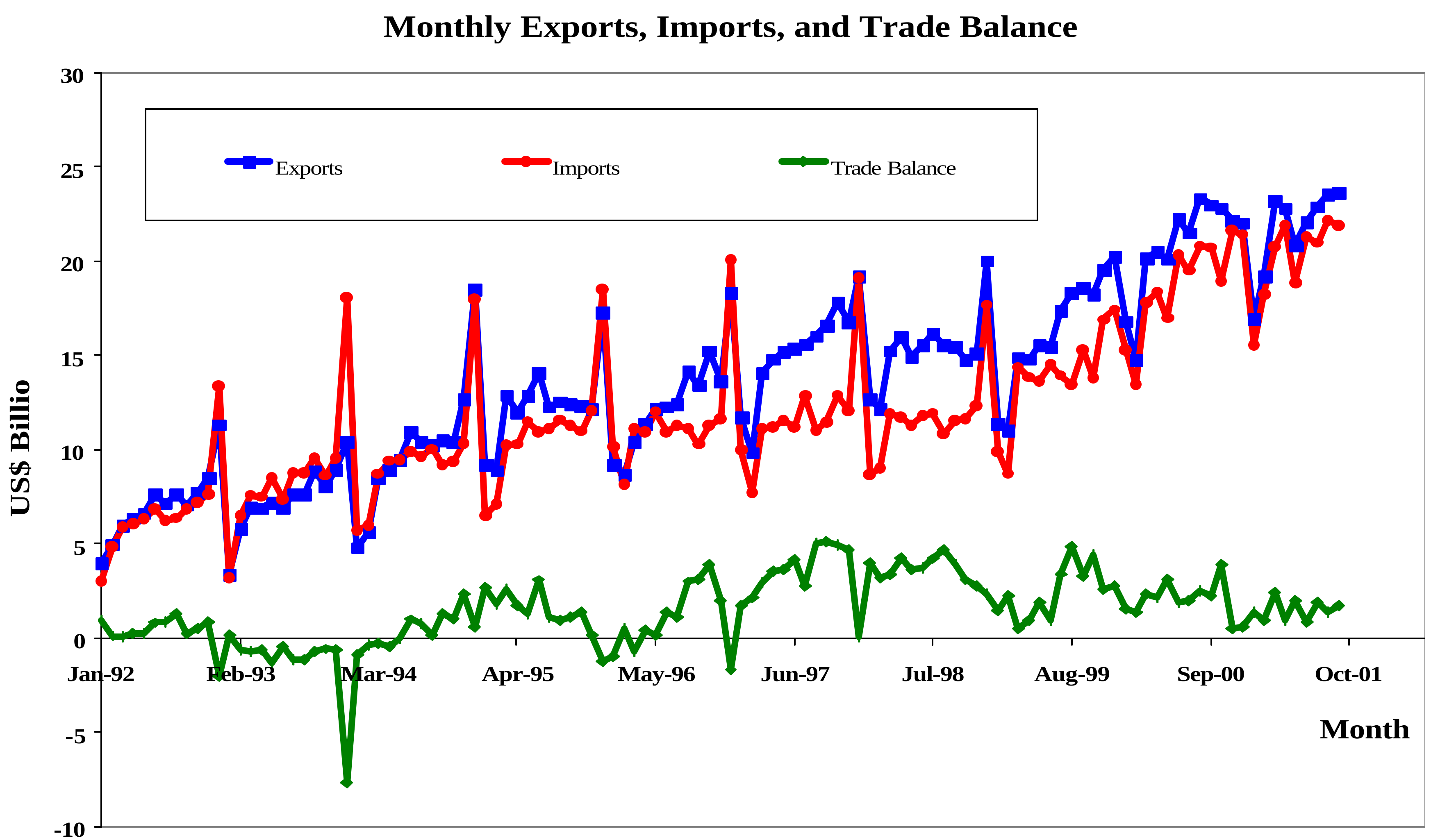
Total Government Budget Revenue, Expenditure, and Deficit as a Percent of GDP



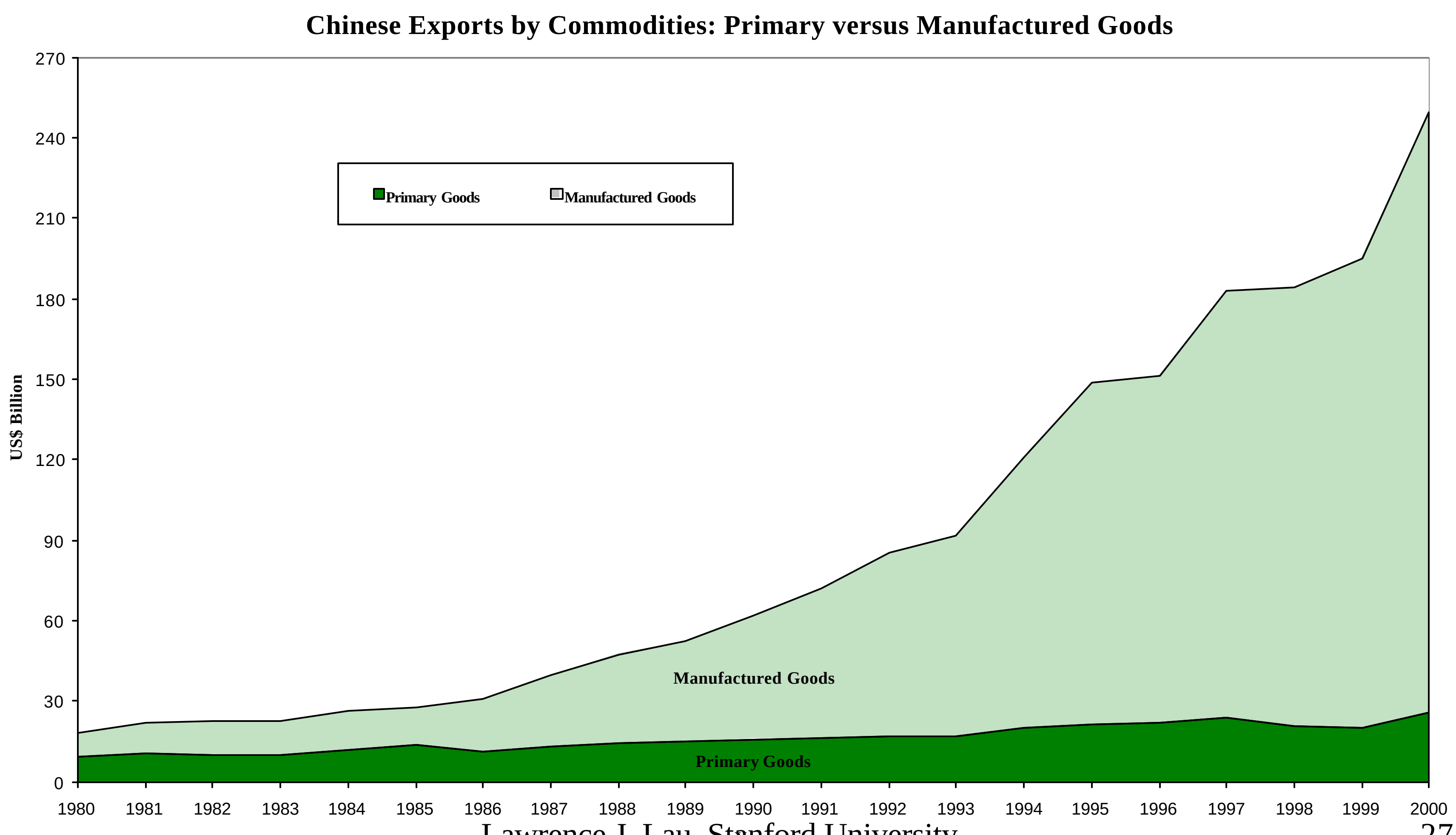
The Exchange Rate, the Interest Rate and the Stock Market Index



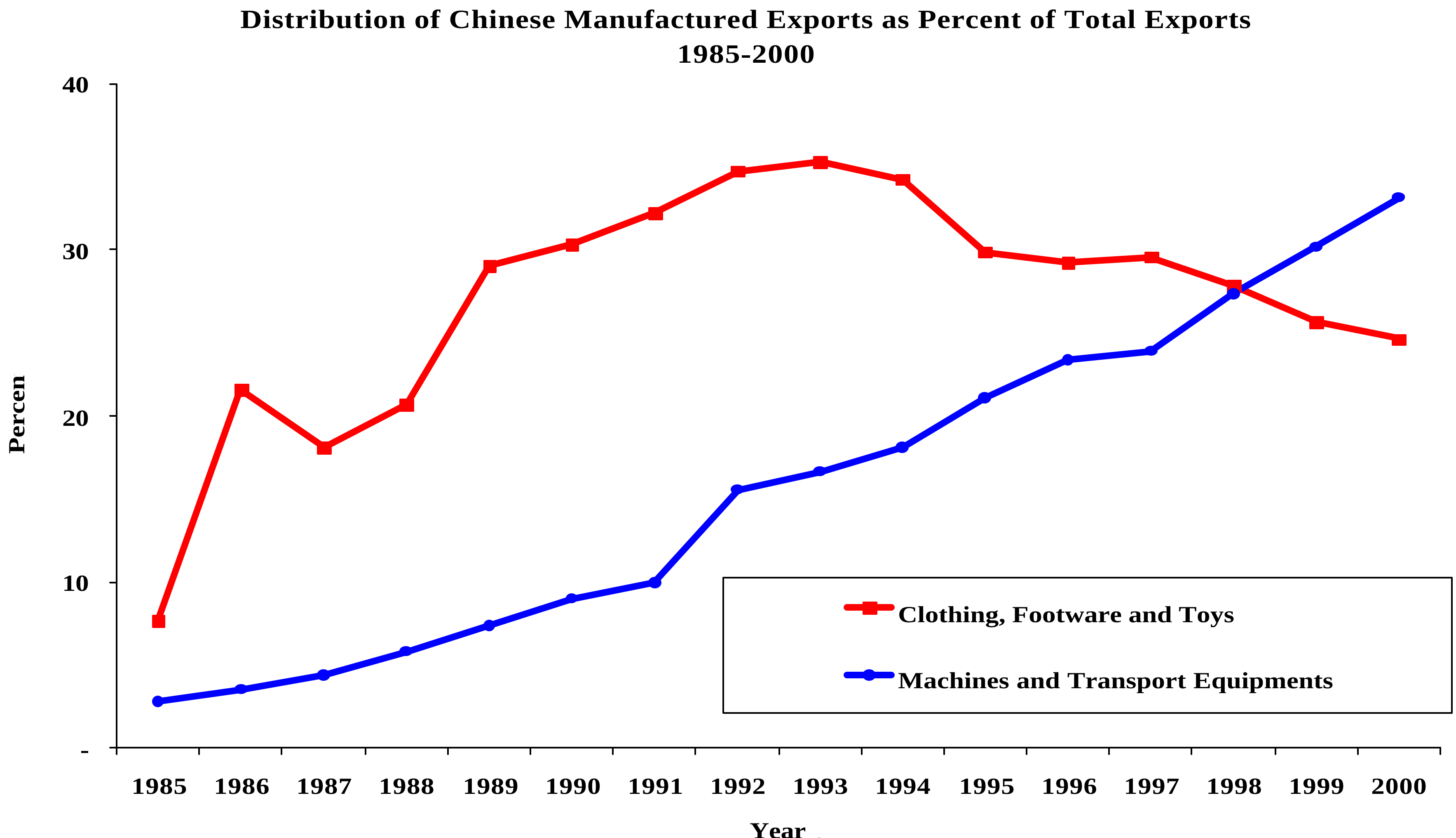
Monthly Exports, Imports and Trade Balance Official Chinese Data



Composition of Chinese Exports by Primary Commodities versus Manufactured Goods



Manufactured Exports as a Percent of Total Chinese Exports



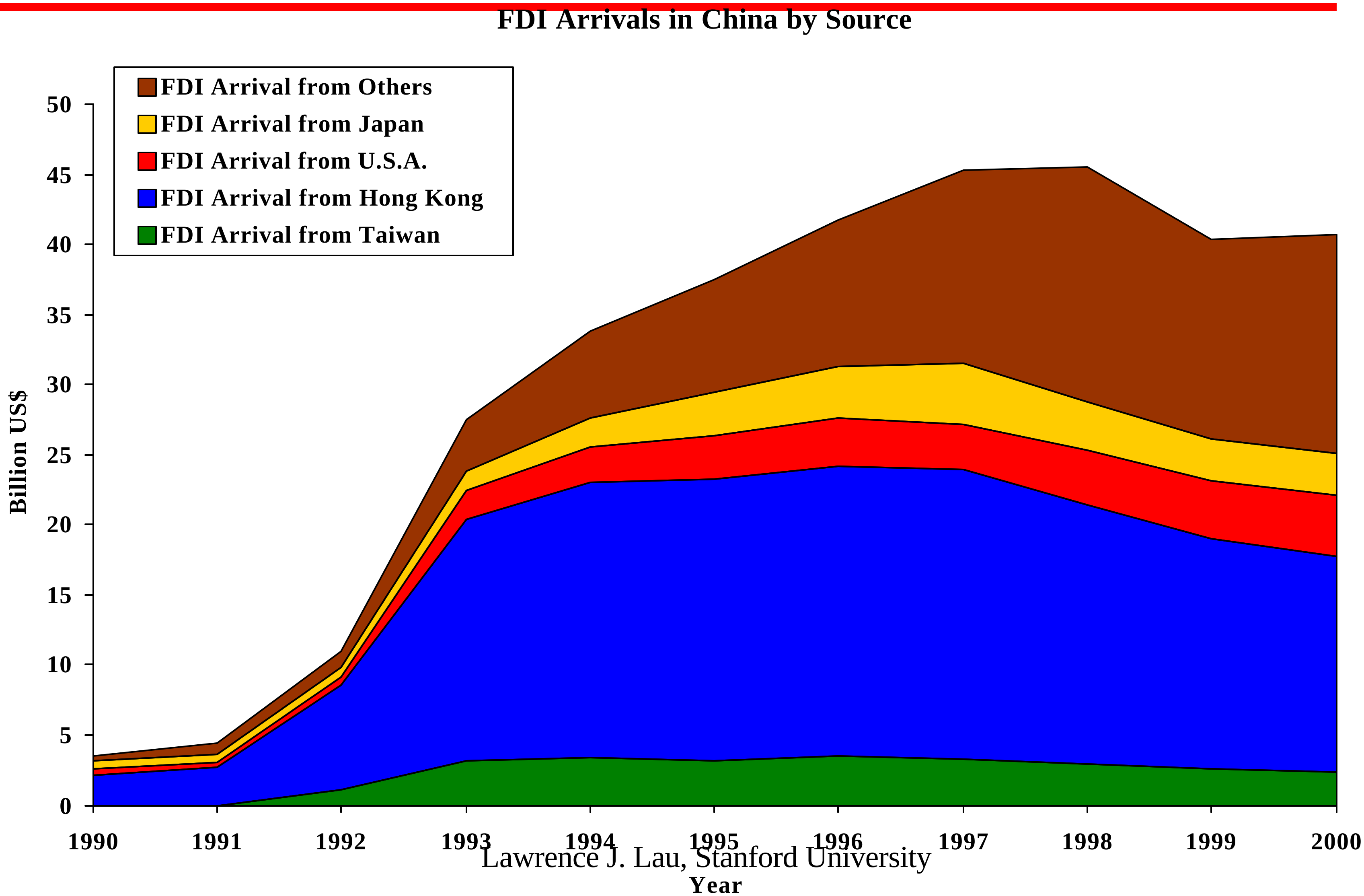
Foreign Direct Investment (FDI)

- 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% YoY 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

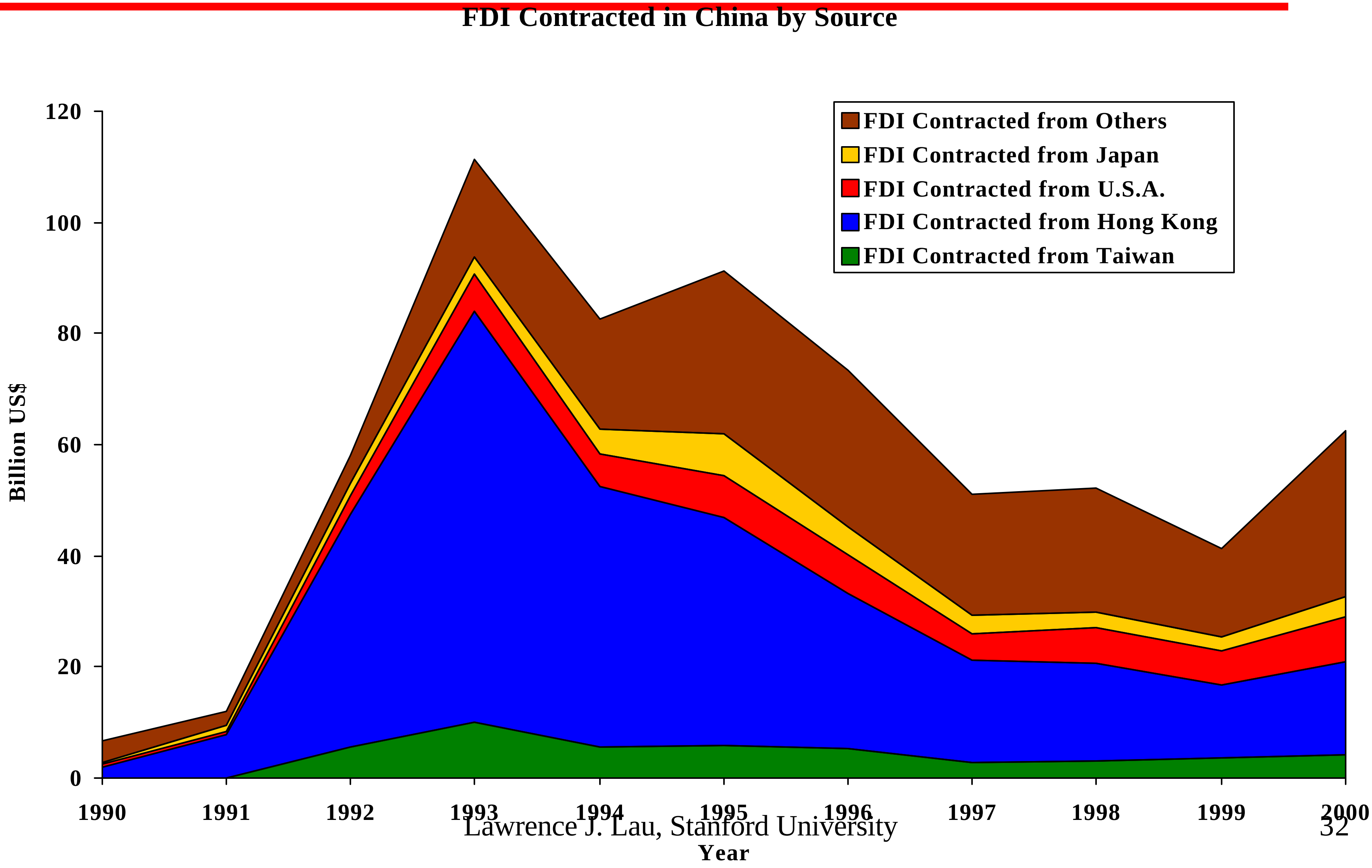
Foreign Direct Investment

- FDI, at US$40 billion a year, amounts to approximately 10% of annual Chinese aggregate gross domestic investment
- Collateralized loan program as a natural hedge for foreign direct investors
- Initial public offerings (IPOs) and listings on Chinese stock exchanges (the second board) as a potential exit strategy for foreign direct investors

FDI Arrivals in China by Origin

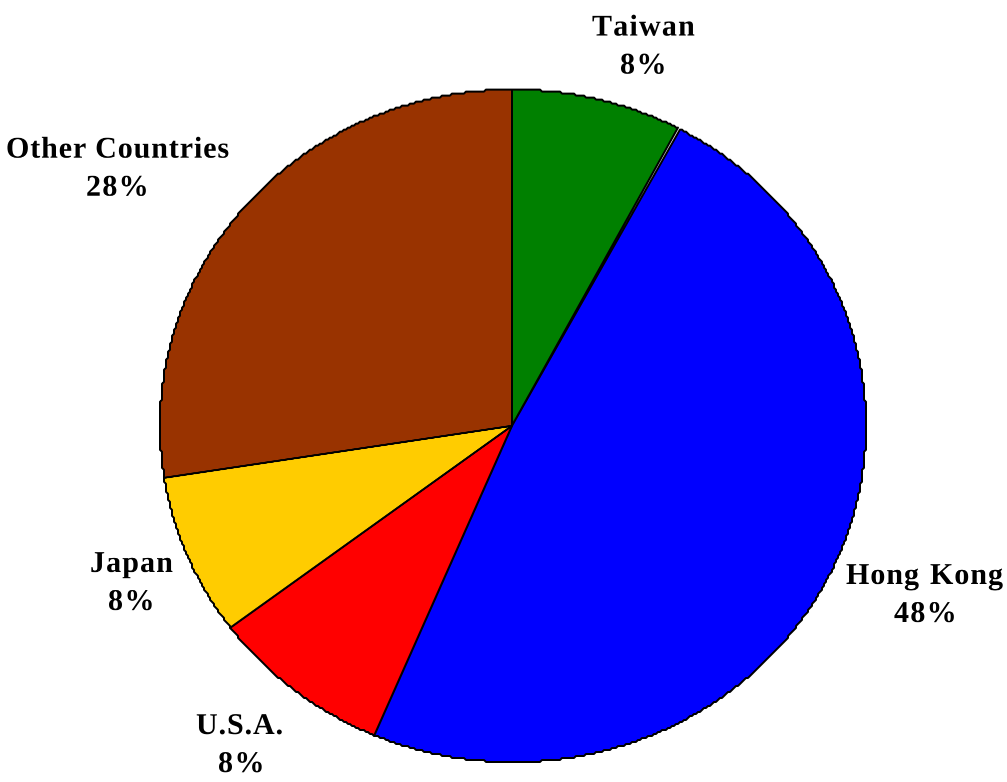


FDI Contracted by Origin



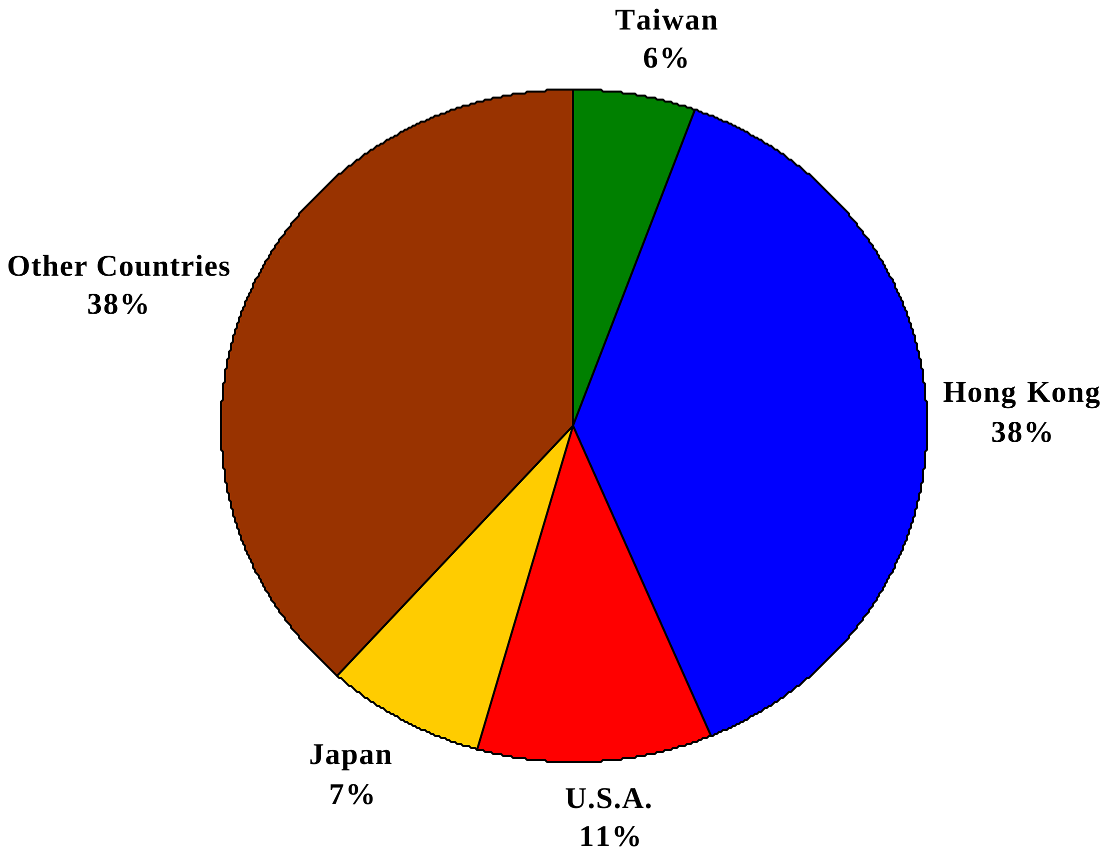
Distribution of Cumulative FDI Arrivals

Distribution of Cumulative FDI Arrivals in China, 1990-2000



Distribution of FDI Arrivals in 2000

Shares of FDI Arrivals in China, 2000



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.

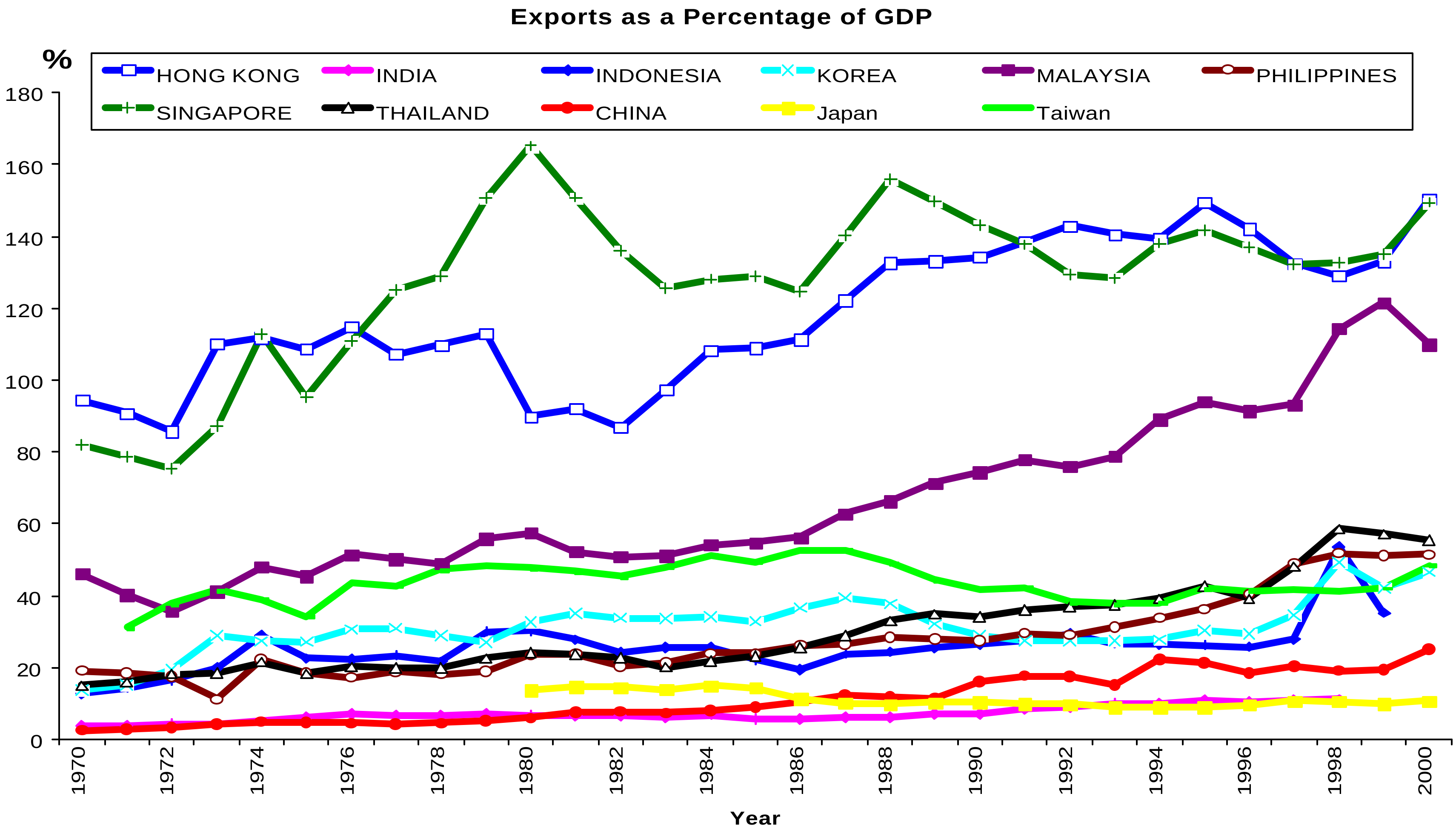
Establishment of a Centralized and Unified National Commercial and Tax Court

- 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 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

Exports as a Percent of GDP: Selected East Asian Economies



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

Are Fears of Globalization/WTO Justified?

- The Chinese economy is a net beneficiary of its WTO accession
- International trade is not a zero-sum game—everyone can be a net beneficiary—one country's net benefit does not have to be another country's net cost
- However, there will be transitional pains as global production is re-allocated in accordance with the principles of comparative advantage (Note that it is not necessarily from the less efficient to the more efficient producers)
- Moreover, looking ahead to the future, globalization of supply chains and the information and communication technology revolution imply that production will be footloose as ever. Jobs that come to China today can just as easily leave China for India or Africa when the circumstances change. One lesson that is being learned very quickly is that no industry, and no enterprise, in any given country can assume that it will last forever.
- Lifetime employment will become a thing of the past. No employer can guarantee or offer it (except possibly the government); and no employee should expect it.
- Thus, both the labor market and the participants in the labor market must maintain flexibility so that adjustment can be made quickly. This implies in turn that human capital, especially the more general and less enterprise-specific kind, will become much more important.

China Can Maintain Its Competitiveness without Devaluation

- China, with its own large domestic market, almost unlimited supply of labor, high savings rate, rising investment in human capital, can maintain its competitiveness over time not through devaluation, but through
  - Maintaining price stability
  - Upgrading continuously the quality of manpower
  - Maintaining flexible labor markets (wage rates)
  - Opening up new regions with lower labor, land and other costs
  - Socializing and establishing a viable and sustainable social security (including unemployment) system
  - Providing infrastructure, tangible and intangible
  - Investing in intangible capital, including R&D and intellectual capital (protection of intellectual property rights is a must)
  - Exploiting the “new economy”

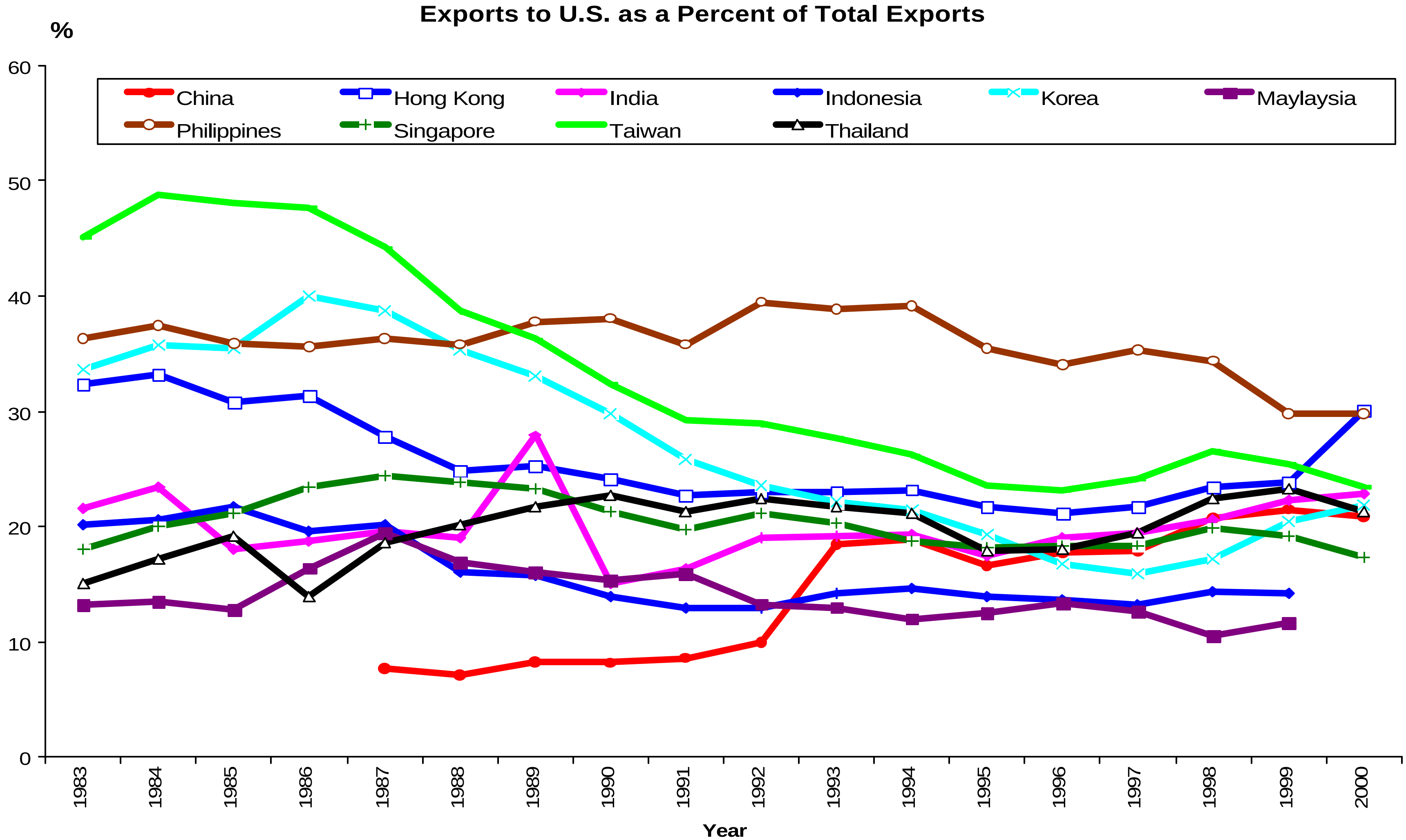
WTO and the Global Digital Divide—The Internet as an Equalizer

- The new economy levels the playing field between large and small firms
  - Small firms can have access to services and supplies heretofore only available to large firms
    - E.g., Charles Schwab and E-trade benefit small investors by bringing down the cost of securities trading proportionally much more than large investors
    - Rapid delivery services and warehousing facilities, e.g., FedEx, are available to both large and small firms
  - Small firms can also become more accessible to their customers and potential customers through the Internet with only marginal expenditures on advertising and public relations
  - Small firms have access to large firms as potential suppliers and customers in a global supply chain
- The Chinese economy with its high and potentially even higher concentration of smaller firms and more primitive information infrastructure (and thus the potential for leap-frogging) may benefit much more from the new economy than other economies
  - E.g., B2B dot.coms seem to have relatively greater success in East Asia than in the United States

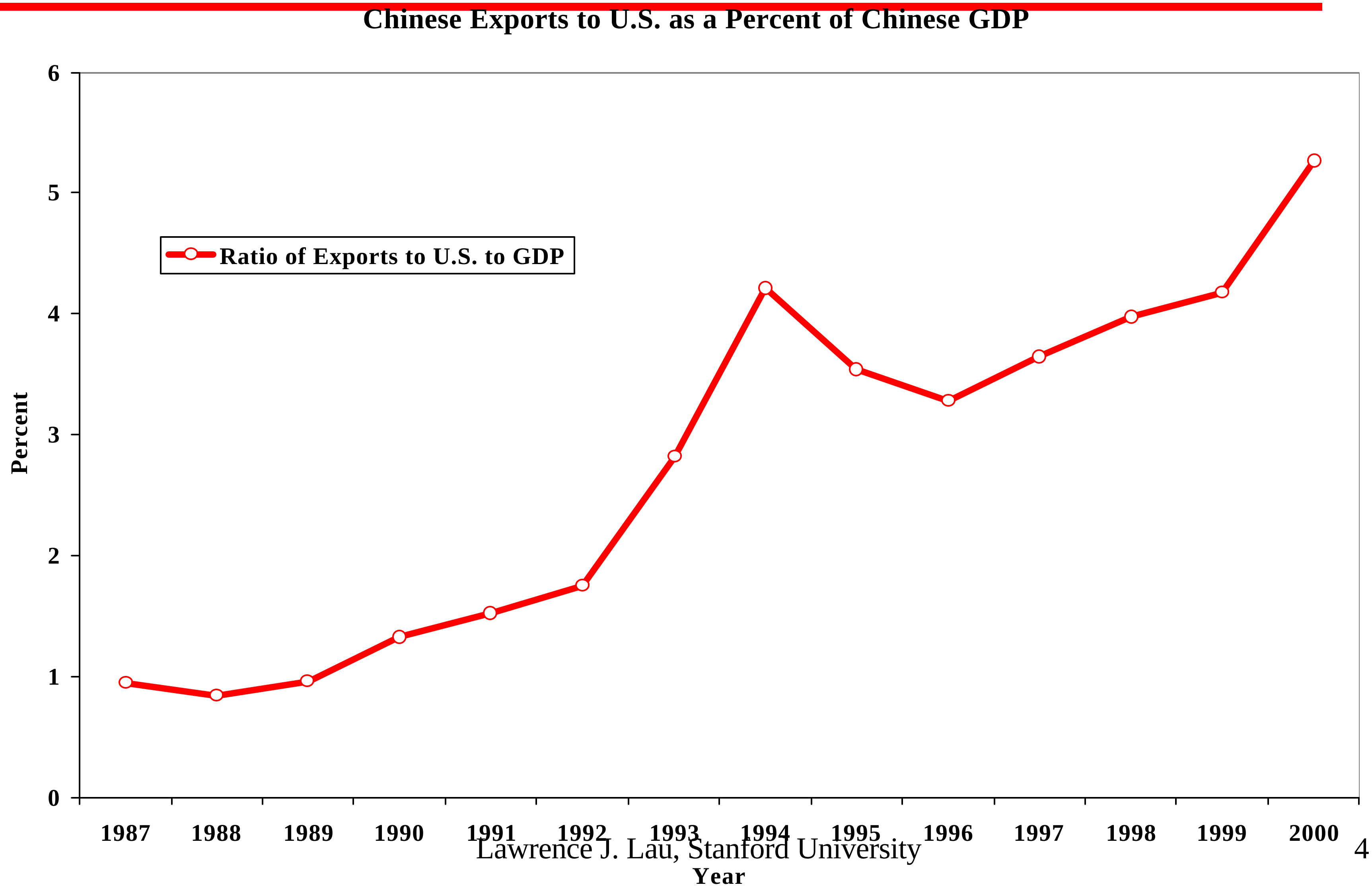
Looking Ahead: The External Environment Has Deteriorated

- The U.S. economy, already hard hit by the bursting of the stock market bubble and the recession in its high-technology sector, suffered an additional blow to business and consumer confidence from the terrorist attack in New York on September 11, 2001. The U.S. economy is now heading towards certain recession with Q3 GDP contracting by 0.4 percent and at an even higher rate for Q4. The rate of growth of real GDP is expected to be either zero or negative 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, Singapore and Taiwan
- The continuing stagnation of the Japanese economy does not help but is not expected to have a negative impact because it has already gone on for an entire decade
- The European economies are expected to grow somewhat faster than the U.S. and thus to provide a partial offset to the U.S. economic slowdown
- Chinese exports to the U.S. constitutes only 5% of Chinese GDP, with a value-added of exports to GDP ratio of less than 1.5%--the U.S. slowdown will have only an impact on Chinese economic growth of no more than 0.5%

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



Chinese Exports to the United States as a Percent of Chinese GDP



Rising Confidence of Enterprises and Households: Investment

- Both the investment and retail sales data indicate that business and consumer confidence has been reviving rapidly since the beginning of 2001 and is at the highest level since 1997; Beijing winning the right to host the 2008 Summer Olympics and the successful conclusion of the negotiations in connection with the accession to WTO boosted public confidence in the future of the economy even further
- In 2001Q1, fixed investment grew 12.4% in real terms
- In 2001H1, fixed investment grew 15.1% in real terms, the highest since 1997 (with public fixed investment growing at 17.9%)
- In 2001/01-05, aggregate investment grew 20.3% YoY, an increase from the 16.5% of the period 2001/01-04, whereas manufacturing investment grew 27.1% YoY
- Investment by enterprises was responsible for a large part of the growth in fixed investment, for the first time since the East Asian currency crisis; however, it has yet to match the rate of rapid expansion achieved in the mid-1990s
- Public infrastructural investment has continued at the same or higher level—in 2001/07, state fixed investment rose 20.14% YoY, an increase from 15.1% in 2001/06
- The positive 2008 Summer Olympic Games decision and the accession to the WTO should lead to a quantum increase in foreign direct investment, further boosting the Chinese economy

Rising Confidence of Enterprises and Households: Consumption

- In 2001Q1 and 2000H1, retail sales grew 10.3% in real terms
- In 2001H1, retail sales grew 11.6% while income rose 5.5% in urban areas; retail sales grew 8.1% while income rose 4.2% in rural areas
- A real owner-occupied residential housing boom almost everywhere except in Beijing
- Derivative demands for not only steel and building materials but also appliances, furniture, carpets, drapes, etc. and architectural, engineering, and interior design services

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

Sources of Growth of Aggregate Demand Promotion of Science and Education in China

- Investments in information technology
  - Leap-frogging traditional development in telecommunication (the experience of the wireless phone)
  - E-commerce among enterprises
  - New models of marketing, distribution and sales
  - A PC in every classroom (in every urban home)
  - Set-top boxes on television sets with point and click device and numeric pad can link 400 million households to the internet
  - New modes of education and information dissemination
  - The Chinese language is uniquely suited to communication based on a graphic interface (the experience of the fax machine)
- Extension of compulsory education to 12 years
- Investments in tertiary education and in R&D

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

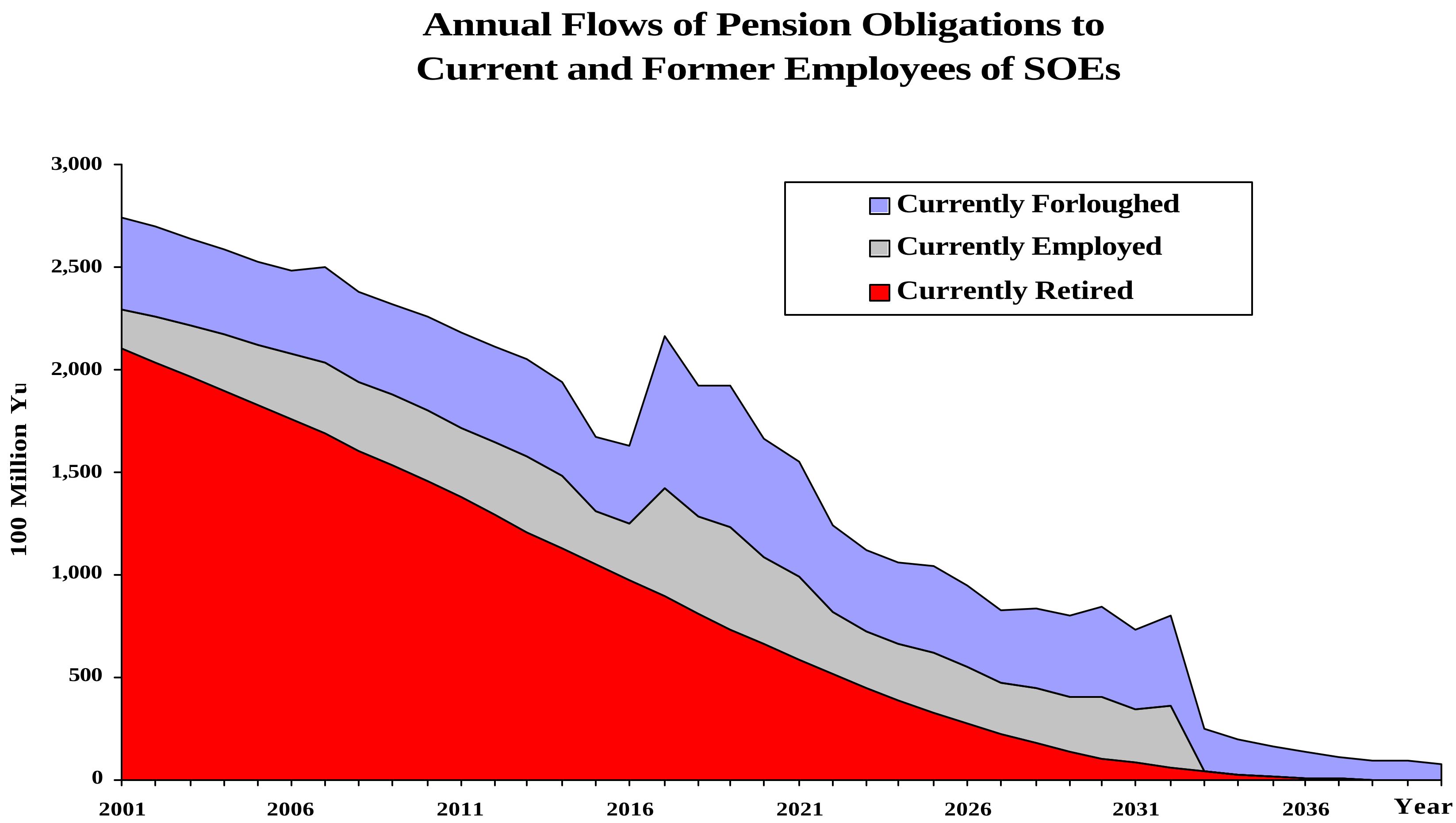
The Critical Path for Continuing Economic Reform

- 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

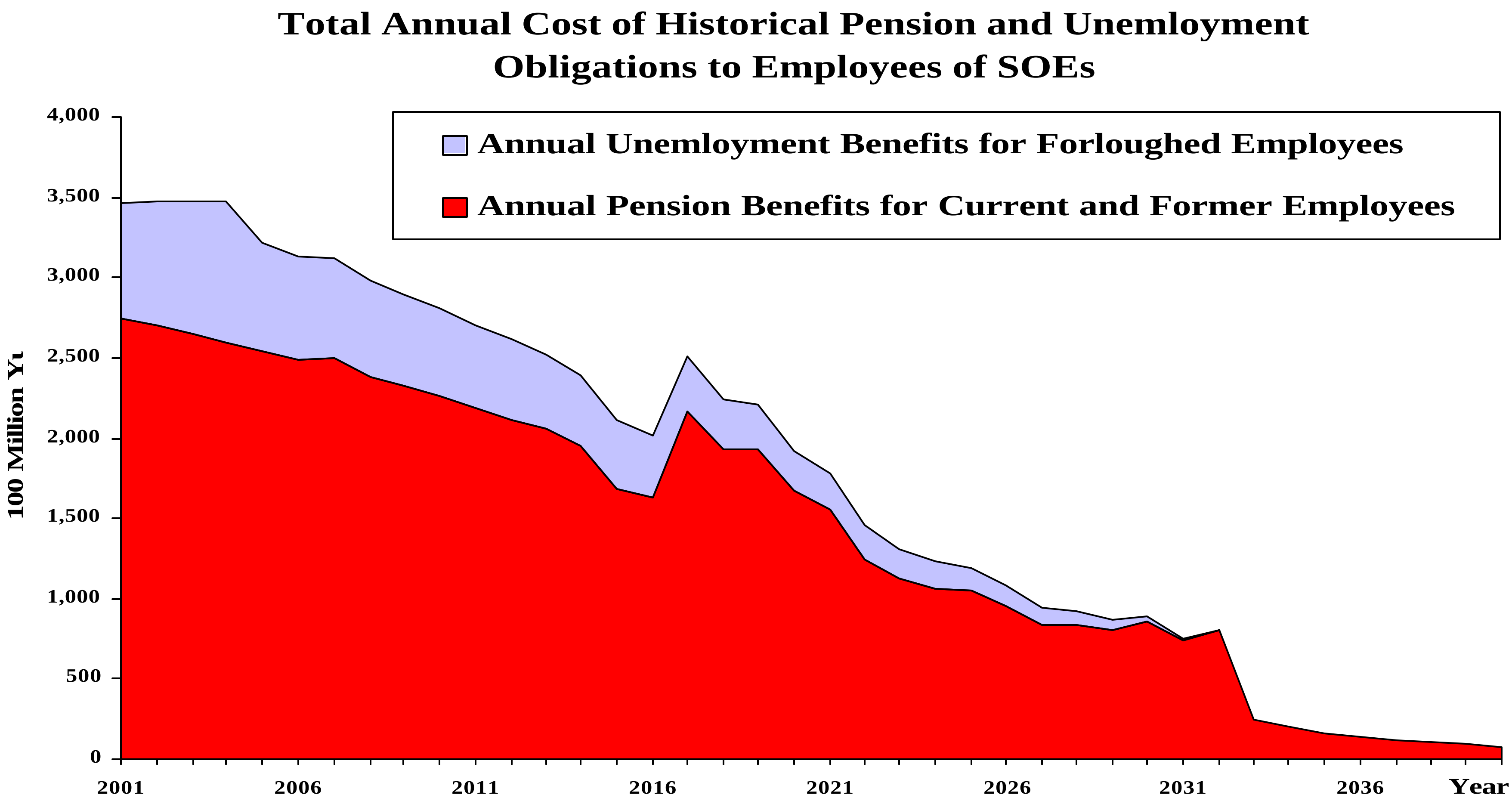
The Establishment of a Social Safety Net

- 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

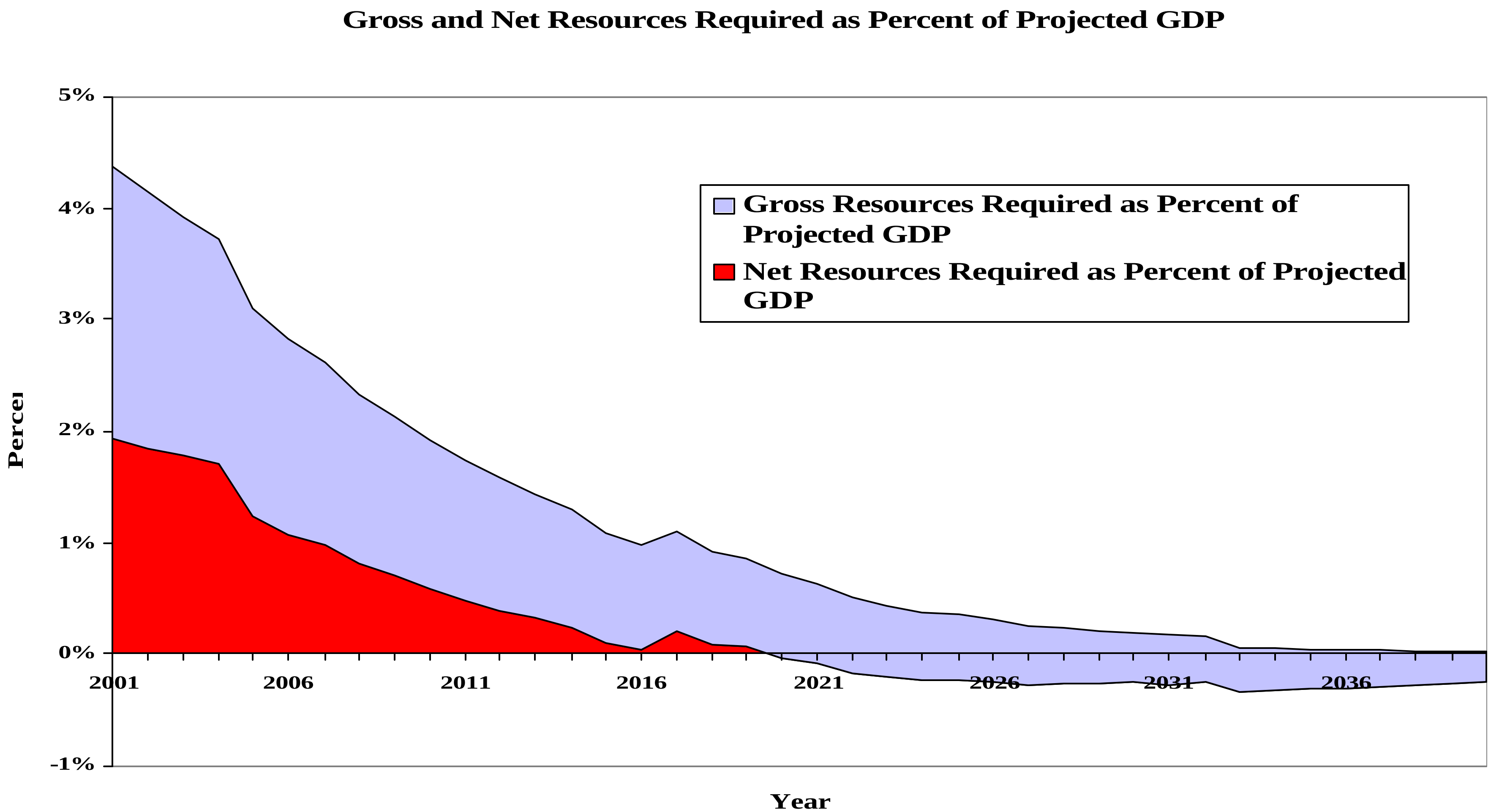
The Annual Flows of Resources Required for Historical Pension Obligations



The Total Annual Cost of Historical Pension and Unemployment Obligations



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