Outlook on the Chinese Economy

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A Preview

- The Chinese Economy Today
- Macroeconomic Outlook
- Recent Economic and Financial Developments
  - What are the effects of Chinese accession to the World Trade Organization (WTO)?
  - What are the sources of growth of aggregate demand?
  - The development of the “Great West”
- Progress in Economic Reform
  - What is the critical path for continuing Chinese economic reform?
- Recent Political Developments
- Prospects for Near- and Long-Term Economic Growth
- Implications for Foreign Investors

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 2001
- China is the 5th largest trading country in the world (exports of US$265 billion and imports of US$245 billion in 2001)
- China is no longer a "shortage" economy--insufficient aggregate demand is a real possibility

The Chinese Economy Today (2)

	1979 US$	2001 (2001 prices)
Real GDP	177 bill.	1.17 trill.
Real GDP per capita	183	920

The Chinese Economy Today (3)

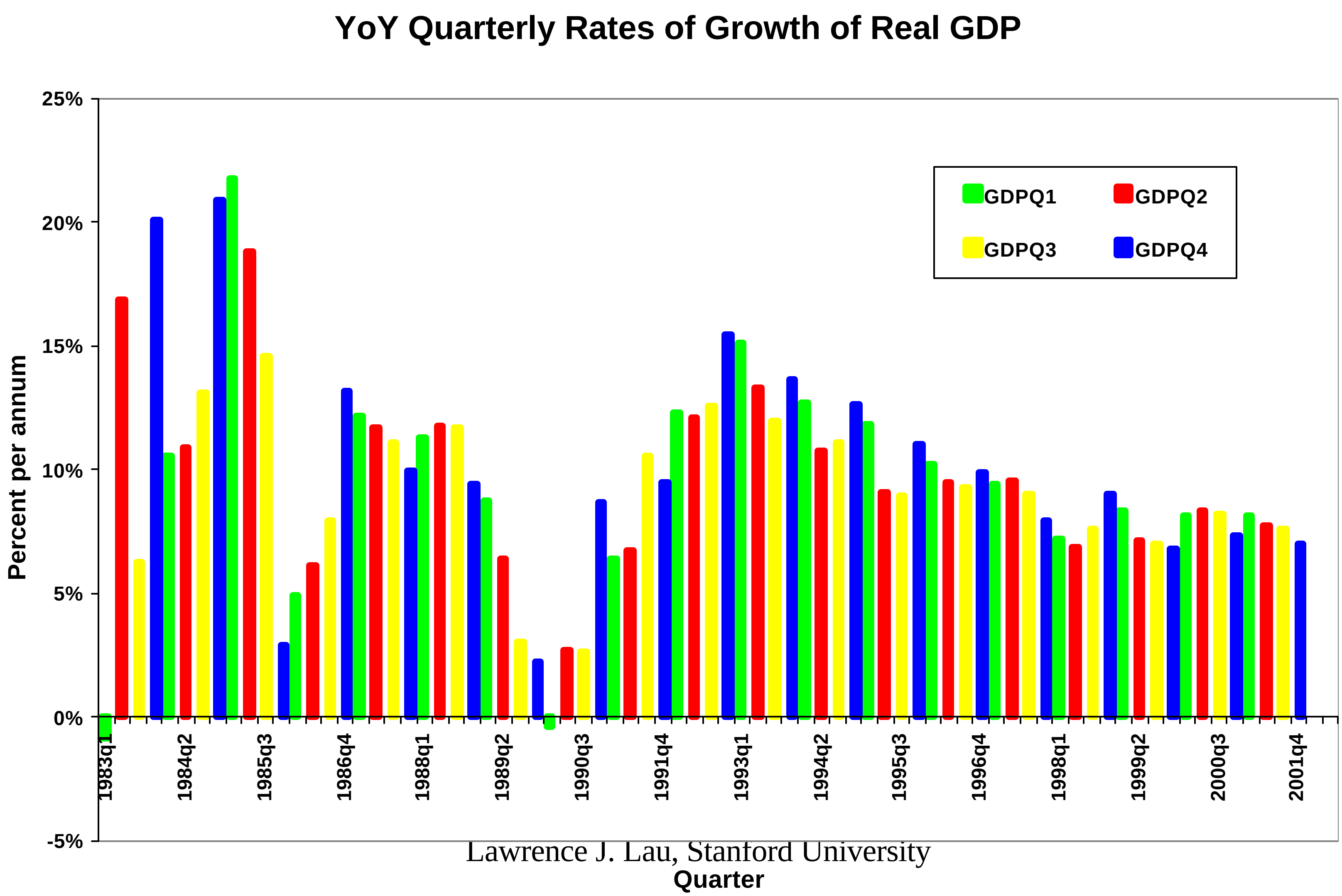
	U.S.	China
	US$ (current prices)	
2001 GDP	10.19 trill.	1.17 trill.
2001 GDP per capita	36,840	920

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

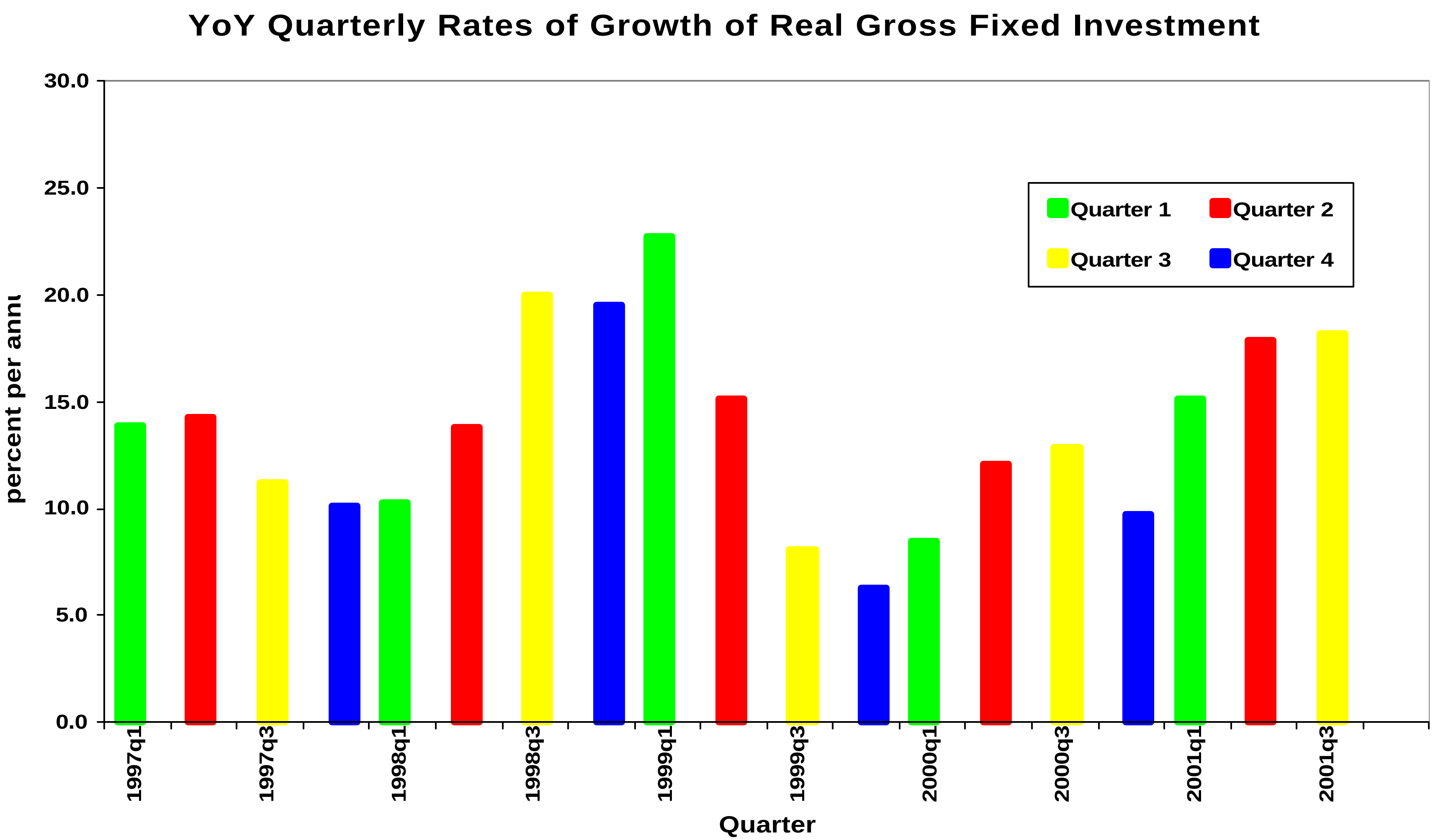
		Real GDP	RPI	CPI	
◆ Actual					
	1997	8.8	0.8	2.8	
	1998	7.8	-2.6	-0.8	
	1999	7.1	-2.9	-1.3	
	2000	8.0	-1.5	0.4	
	2001	7.3	-0.7	0.7	
◆ Projections	2002	>7.0			(NBS)
		7.0			(ADB)
		7.5		1.0	(Lau)
		6.9			(Lehman)

- 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

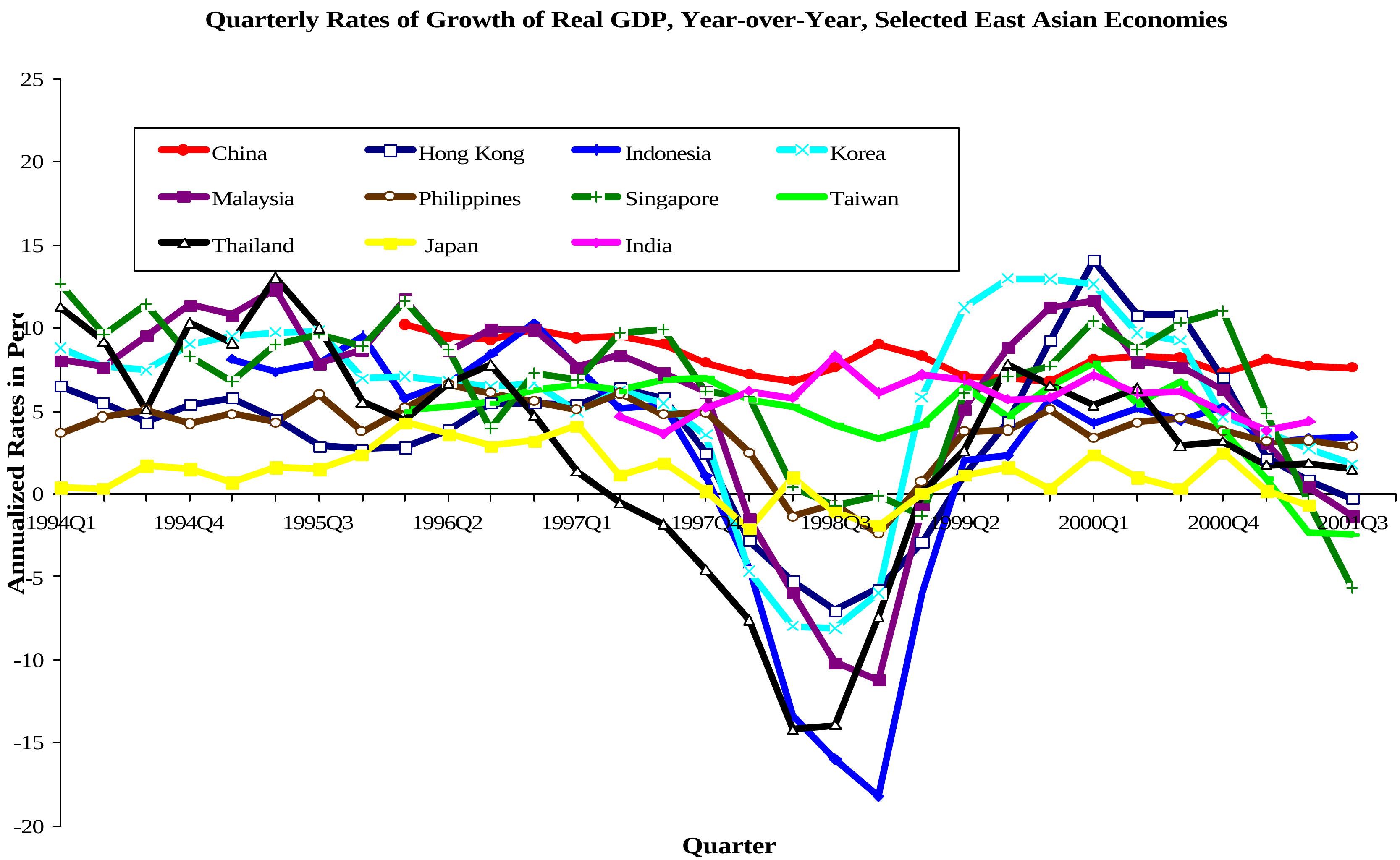
Quarterly Rates of Growth of the Real GDP of the Chinese Economy, Y-o-Y



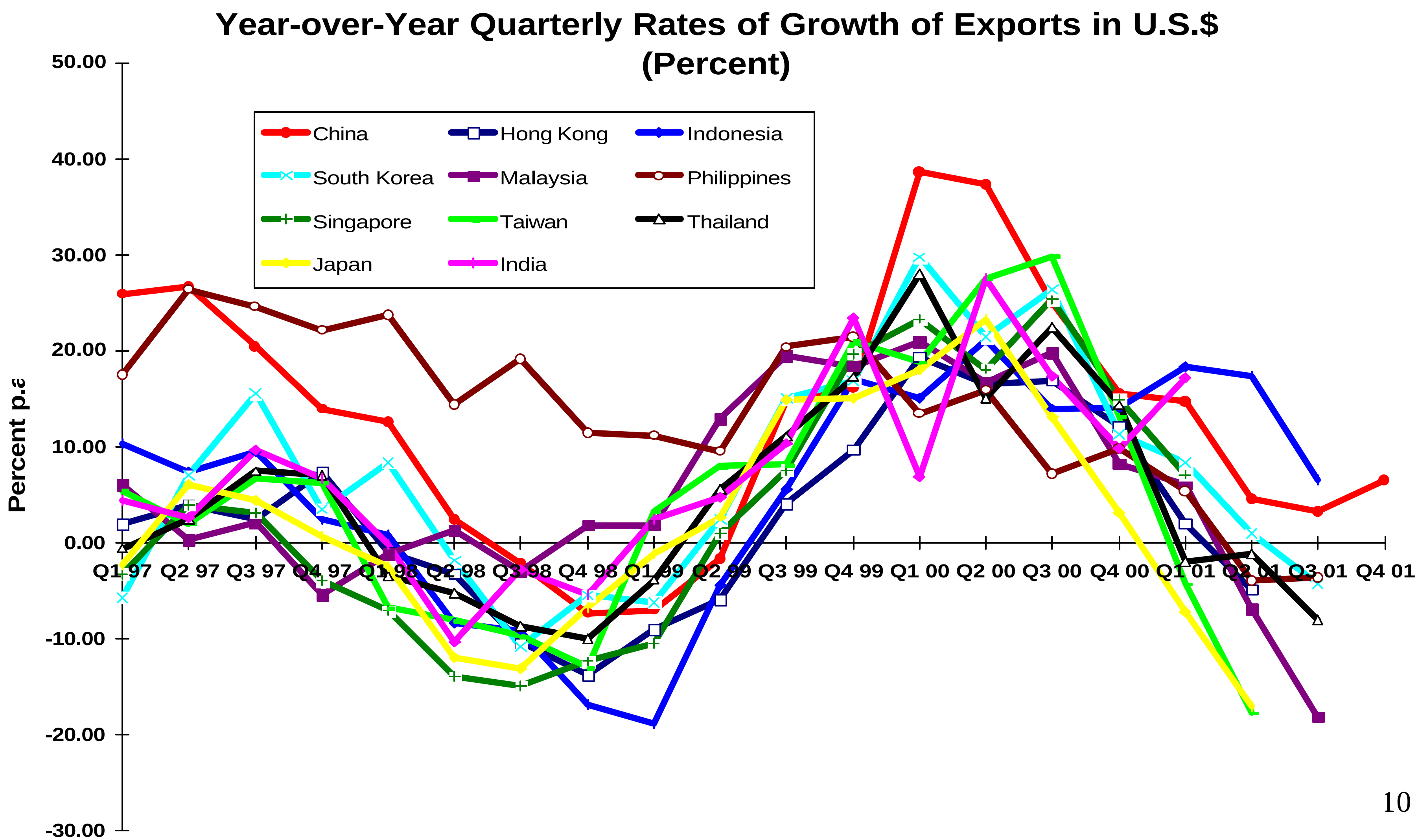
Quarterly Rates of Growth of the Real Gross Fixed Investment of the Chinese Economy, Y-o-Y



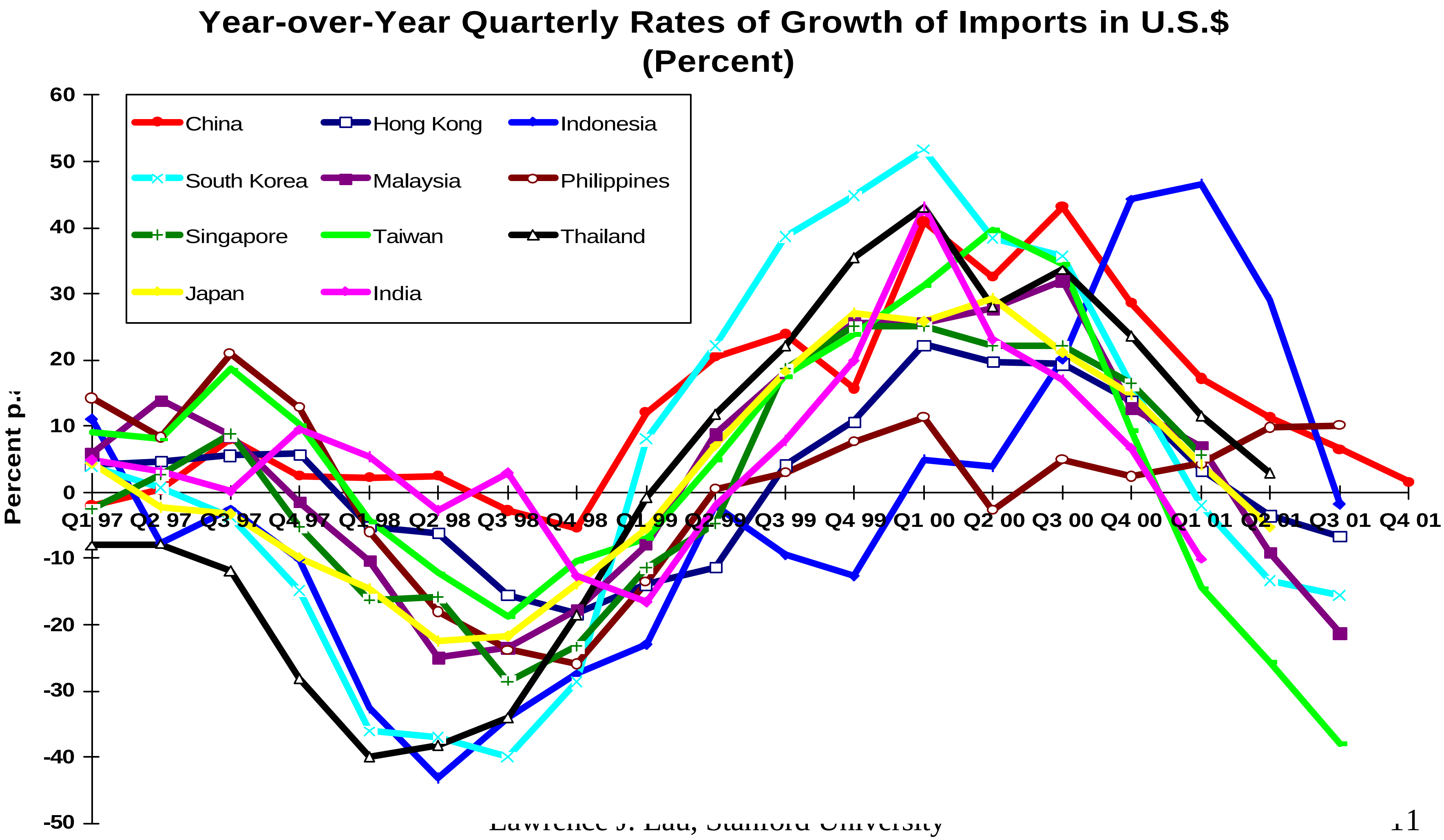
The Rates of Growth of Real GDP: Selected East Asian Economies



Quarterly Rates of Growth of Exports



Quarterly Rates of Growth of Imports



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

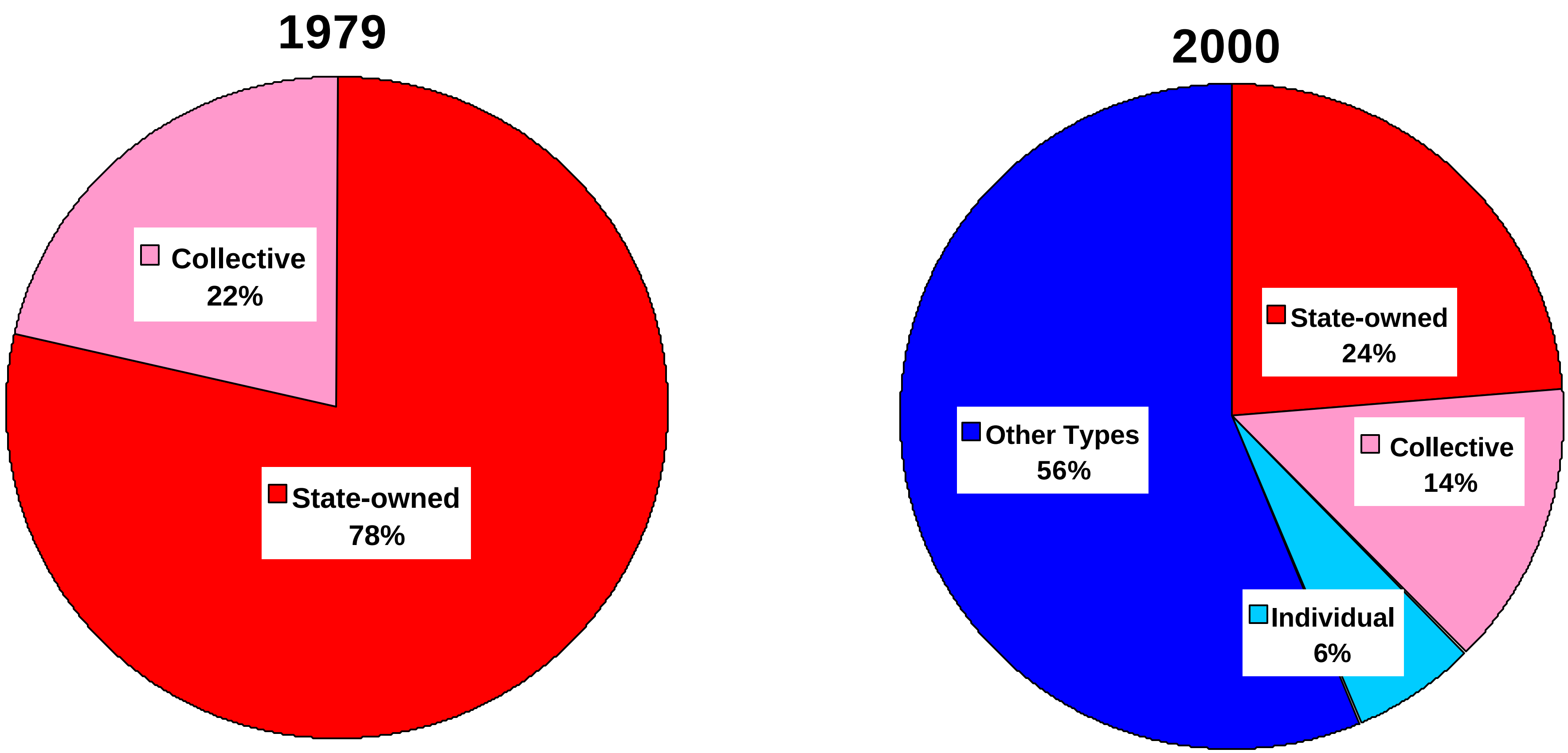
Economic Performance: Pre- and Post-Reform

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

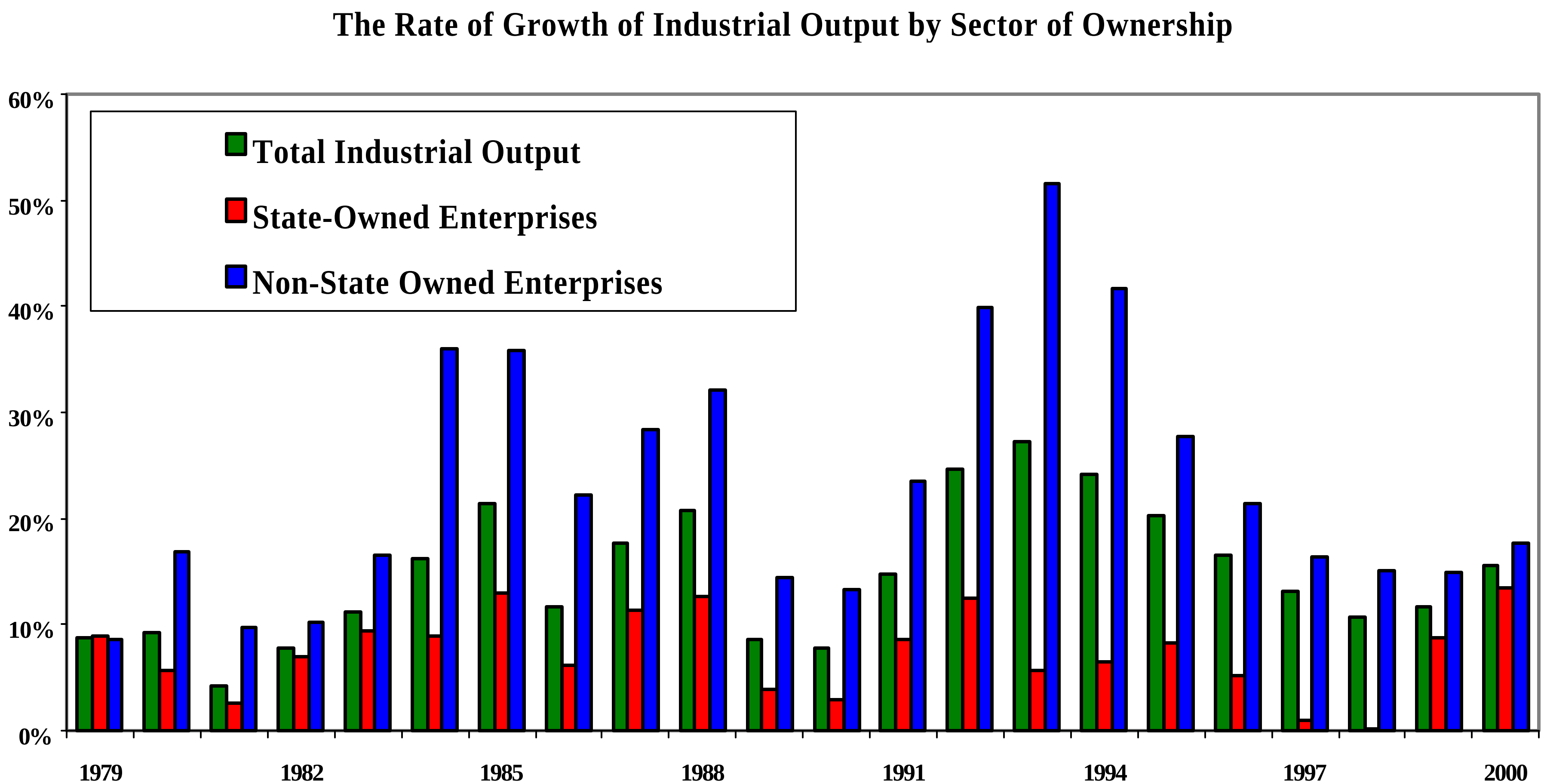
	1952-1979 Pre-Reform	1979-2000 Reform
Real GDP	**6.20**	***9.62***
Real GDP/Capita	**4.14**	***8.24***
Real Gross Value of:		
Agricultural Production	**4.33**	***7.41***
Light Industry	**7.83**	***11.23***
Heavy Industry	**11.37**	***11.10***
Real Personal Consumption	**4.99**	***9.04***
Real Consumption/Capita	**2.96**	***7.70***
Real Gross Fixed Capital Formation	**11.43**	***10.90***
Capital Stock	**5.93**	***9.82***
Employment	**2.52**	***2.71***
GDP Deflator	**0.59**	***5.72***
Retail Price Index	**0.80**	***6.11***
Exports (in current US Dollars)	**10.98**	***14.83***
Imports (in current US Dollars)	**10.27**	***13.53***

The Growth of the Non-State Sector-Industry

Distribution of Gross Value of Industrial Production by Ownership



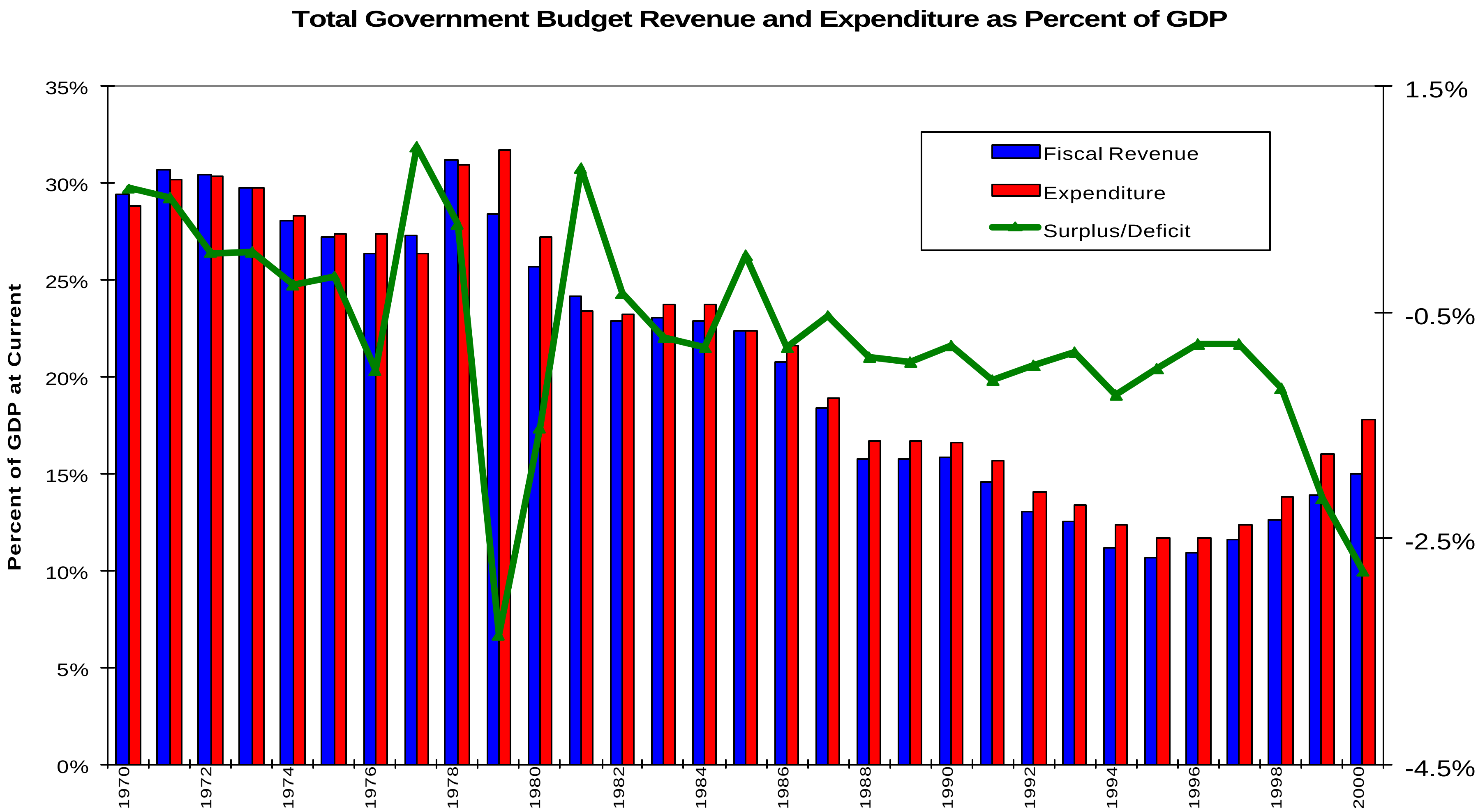
The Growth of Industrial Output by Sector of Ownership



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

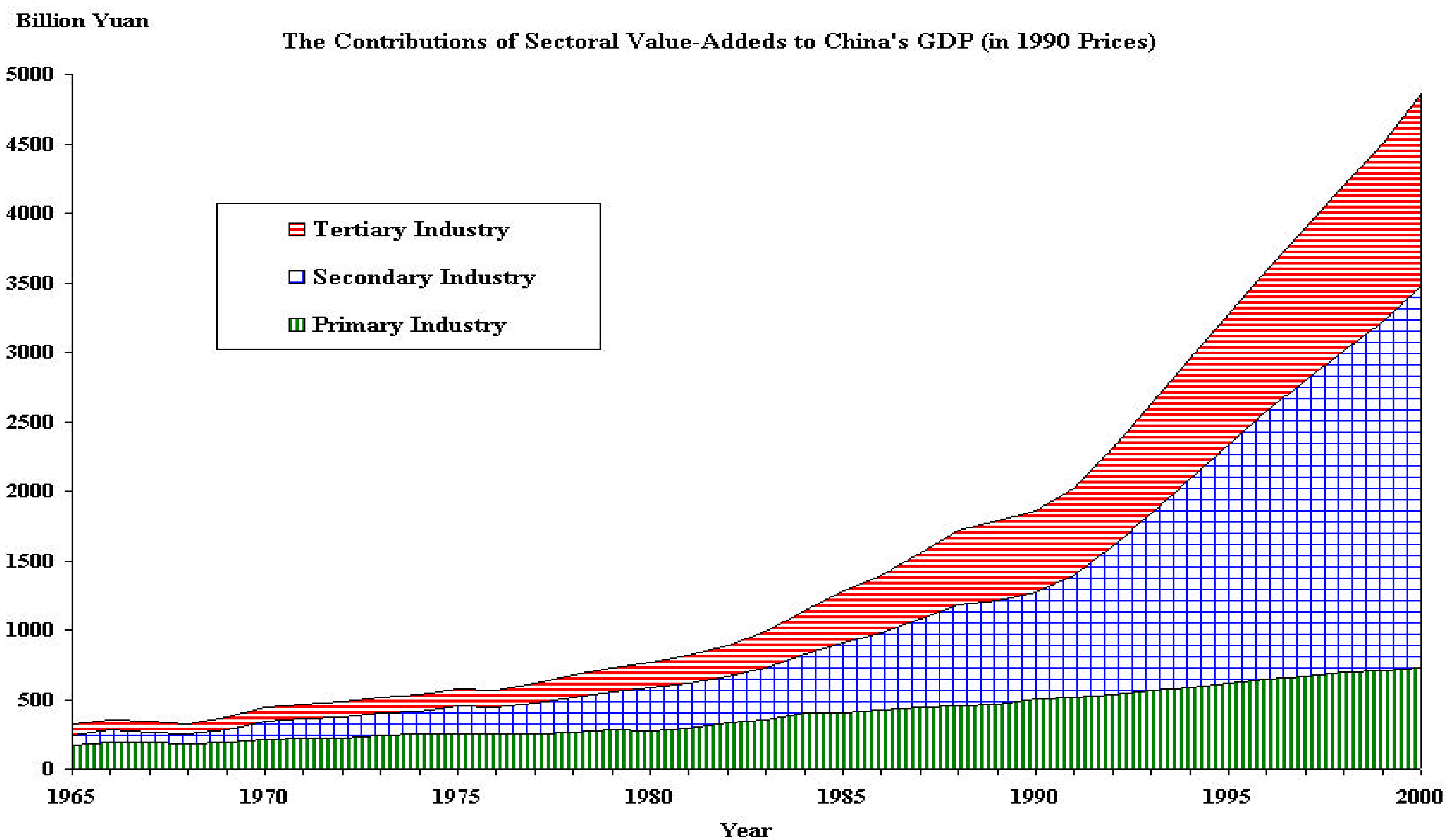
Total Government Budget Revenue, Expenditure, and Deficit as a Percent of GDP



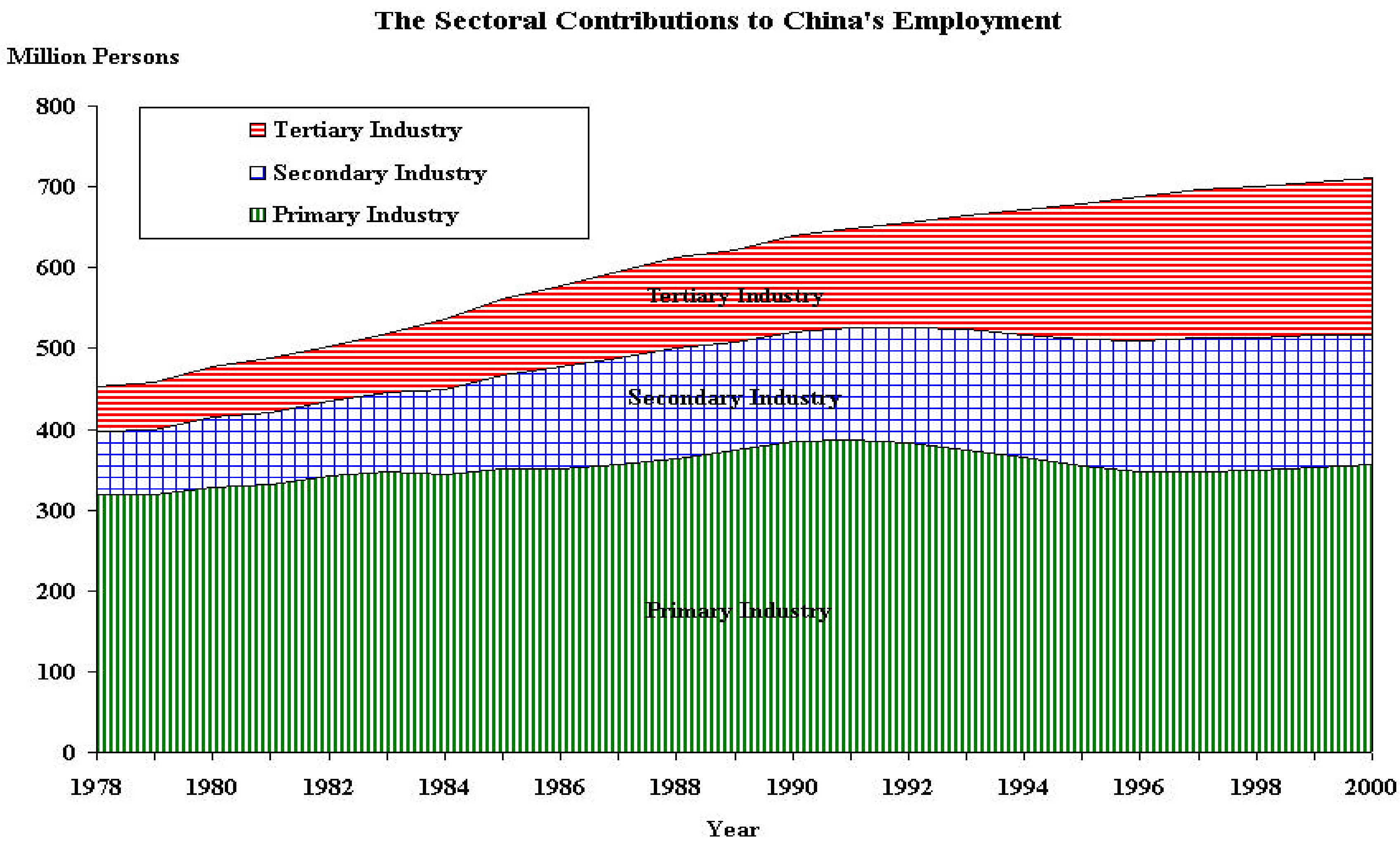
The Tenth Five-Year Plan (2001-2005)

- 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 as a proportion of GDP rose from 14.2% of GDP, in 2000 to 18.3% of GDP in 2001
- 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

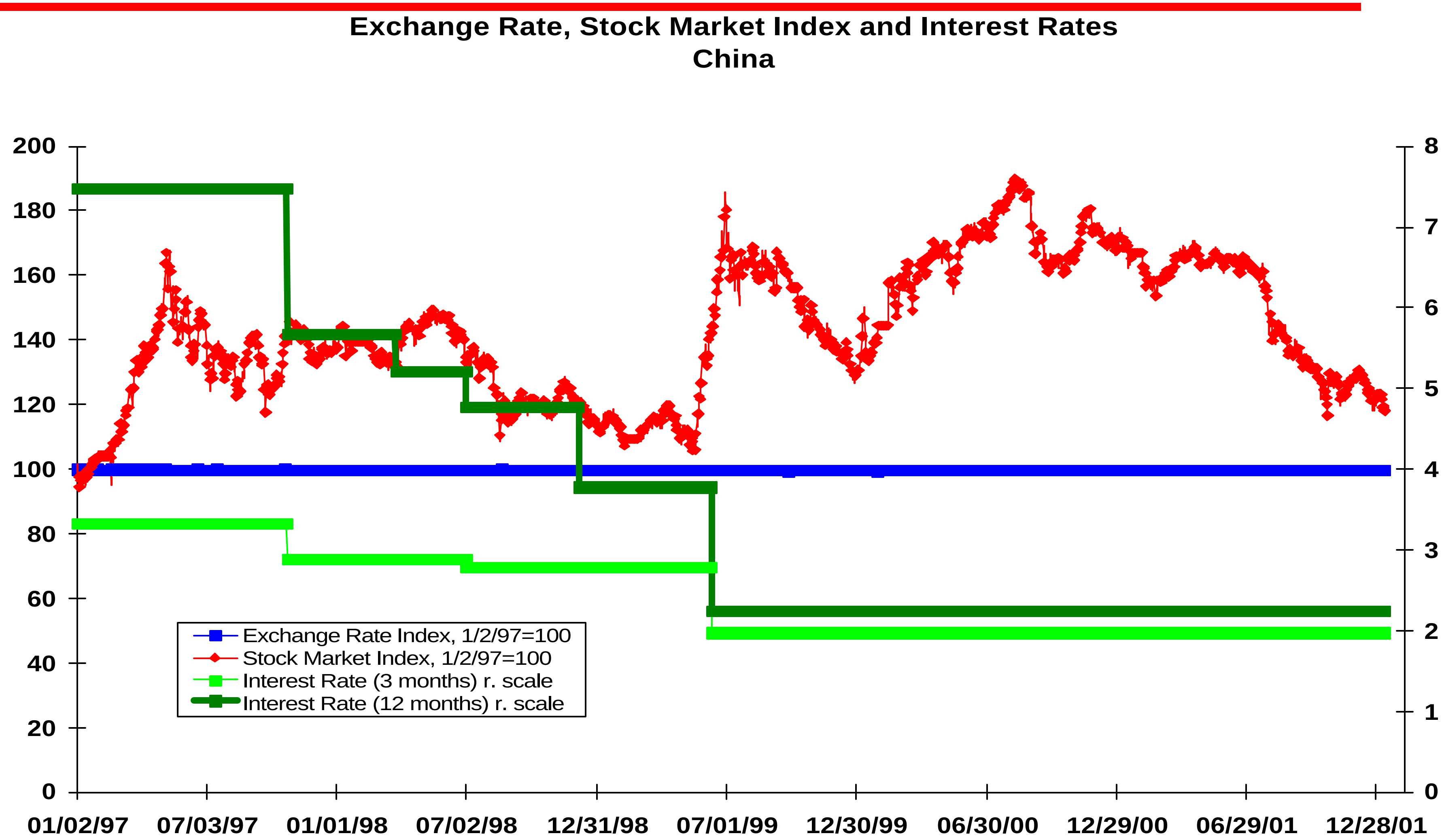
The Contributions of Sectoral Value-Addeds to China's GDP



The Sectoral Contributions to China's Employment



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



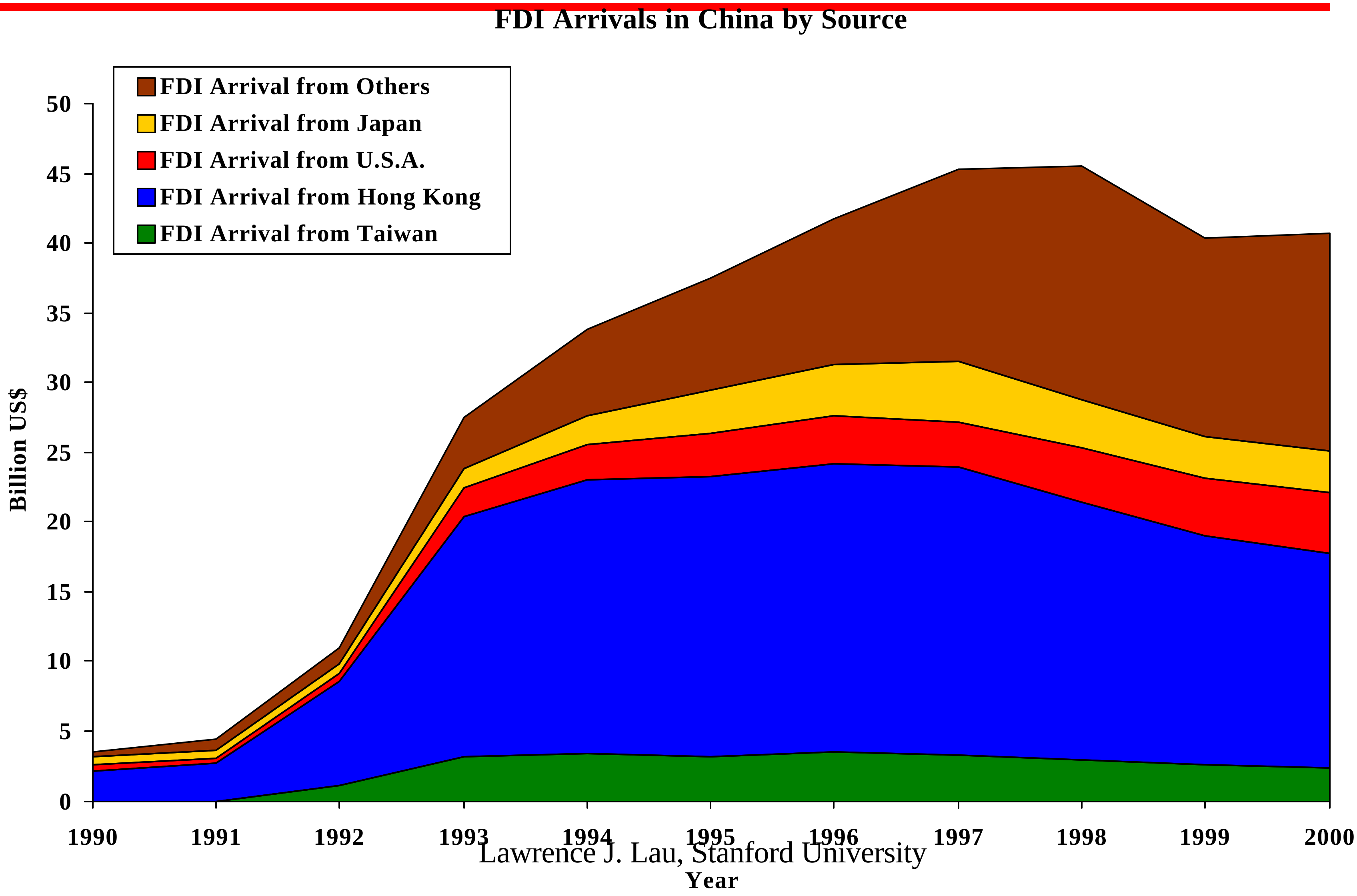
Exports, Imports and Foreign Exchange Reserves

- In 2000, exports rose 27.8% to US$249.2 billion; imports rose 35.8% to US$225.1 billion; with a trade surplus of US$24.1 billion
- In 2001, exports rose 6.8% Y-o-Y to US$266.1 billion and imports rose 8.2% to US$243.6 billion with a trade surplus of US$22.5 billion
- 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$212 billion at the end of 2001, an increase of more than US$46 billion over year end 2000, and surpassing total outstanding external loans by a wide margin

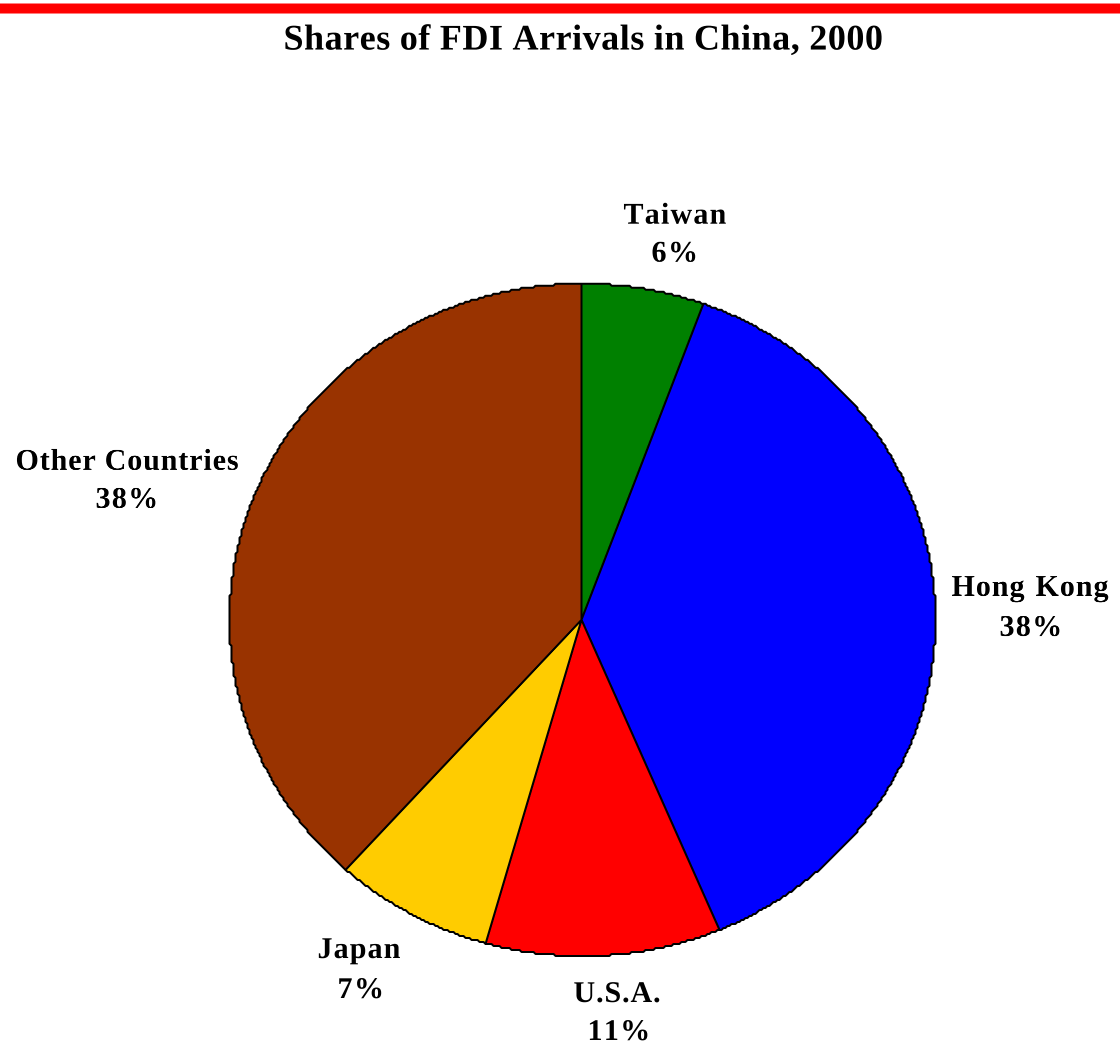
Foreign Direct Investment (FDI)

- FDI, at US$45 billion a year, amounts to approximately 10-15% of annual Chinese aggregate gross domestic investment
- FDI arrivals totaled US$40.39 billion in 1999, an 11% decline from 1998--however, the sources of the FDI were different--real FDI probably rose if "round-tripped" capital were excluded
- FDI commitments amounted to US$41.24 billion in 1999, a decline of 20.9%
- FDI arrivals totaled US$40.7 billion in 2000, a 1% increase over 1999; in 2001, FDI arrivals reached an all-time high of US$46.85 billion, a 14.9% rise from 2000
- FDI commitments amounted to US$62.4 billion in 2000, a 51.3% increase over 1999, partly in response to expected Chinese accession to WTO; in 2001, FDI commitments amounted to US$69.19 billion, a 10.43 rise from 2000
- Cumulative FDI at year end 2001 amounted to US$395.47 billion
- The nature of FDI has also changed--from export-oriented to domestic-market oriented; from light industry to heavy and high-technology industries; and from small projects to large projects

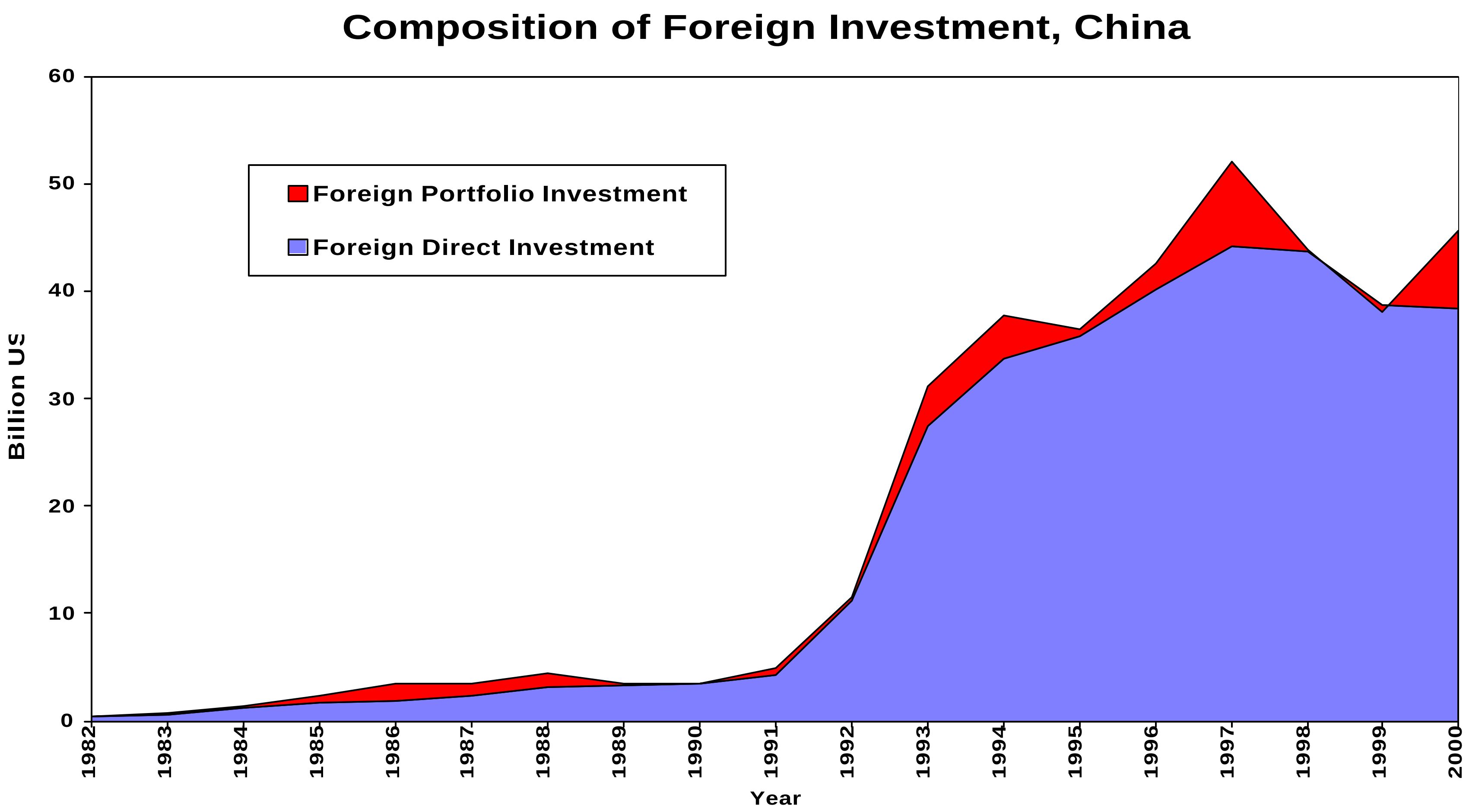
FDI Arrivals in China by Origin



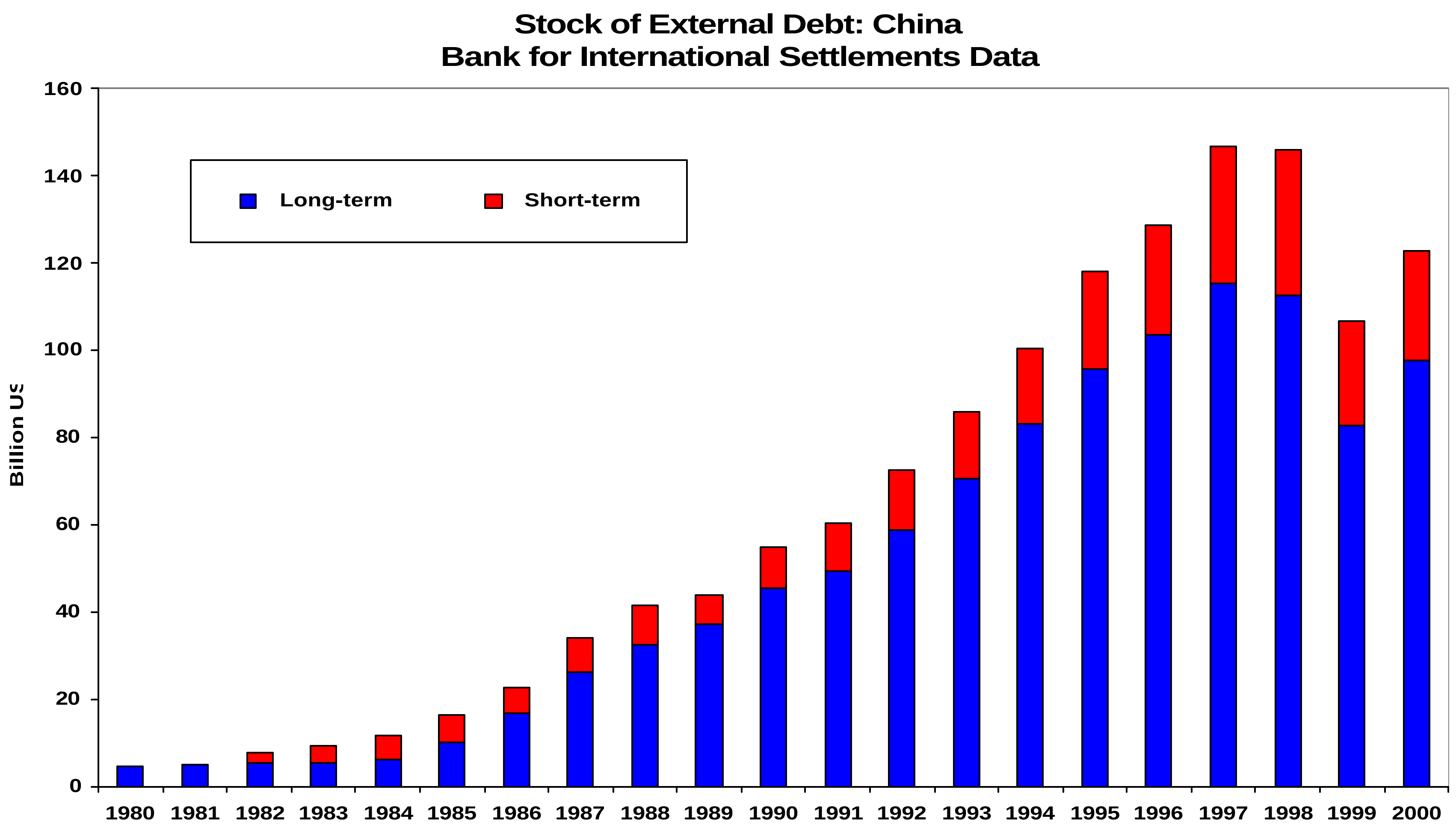
Distribution of FDI Arrivals in 2000



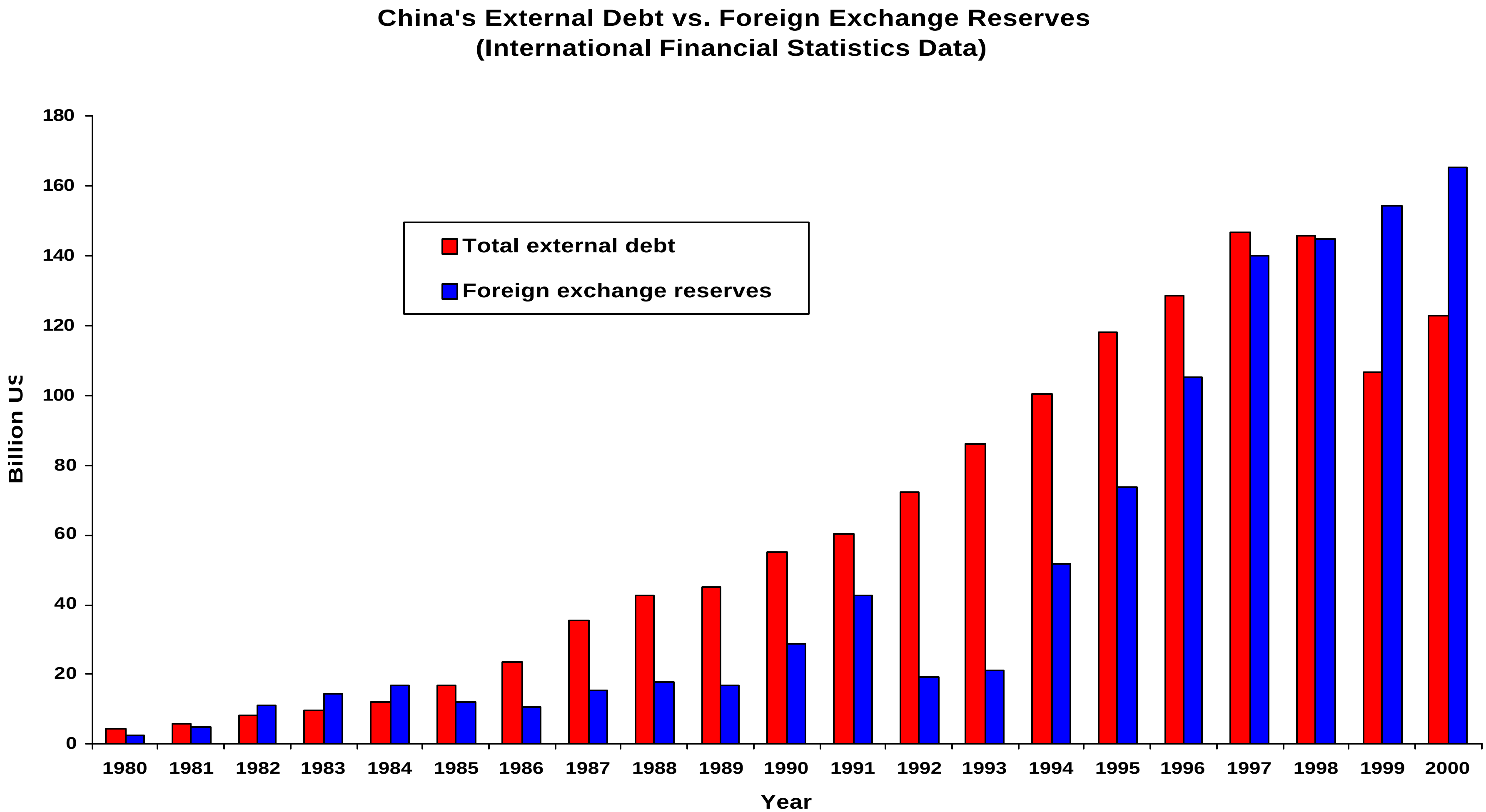
Composition of Foreign Investment—Portfolio vs. Direct: China (Annual Data)



Composition of External Debt—Short-Term (Less Than a Year) vs. Long-Term: China



External Debt and Official Foreign Exchange Reserves: China



China Can Maintain Its Competitiveness without a 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"

Chinese Commitments under the WTO

- Reduction of tariffs on all imported goods, including high-technology and agricultural products
- General tariff rates to fall to 10% by 2005; Automobile tariffs to fall to 25% from the current 80-100% by 2006
- 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
- 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 2005 (but U.S. can adopt anti-surge measures)
- 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.
- However, there is also room for China to specialize in accordance with its comparative advantage, e.g., to grow fruits and vegetables and other higher value-added cash crops such as asparagus and mushrooms, 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, such as cotton and rice and other 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.
- Those state-owned enterprises that cannot be made viable through restructuring will have to be closed down.
- 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 increase in competition, resulting from WTO accession
- A quantum increase in foreign direct investment (FDI), currently running at approximately US$45 billion annually, is expected upon WTO accession.

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. 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.
- 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.
- 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
- Moreover, as long as there is either explicit or implicit deposit insurance that is credible, the higher ratios of non-performing loans of the domestic relative to foreign commercial banks should 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 net result is that the domestic commercial banks will be able to maintain a significant proportion of their current domestic business.
- The competition between domestic and foreign commercial banks may actually lead to new banking services and an overall expansion of the entire market.
- The biggest threat of foreign commercial banks is the poaching of the existing staff of domestic banks.

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

- 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)
- Permanent commitment to an open economy
- The emergence of a unified national market in China
  - 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
- 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
  - Regulation as well as deregulation of the public utilities sectors
  - 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 (2)

- 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

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

WTO Accession and U.S.-China Relations

- A win-win situation--both U.S. and China stand to gain from Chinese accession to WTO
- Complementarity between U.S. and Chinese economies—The U.S. does not export anything that China exports and China does not export anything that the U.S. exports; moreover, the U.S. has not been making the products it imports from China for decades (e.g., garments, shoes) and China does not make the products it imports from the U.S. (aircraft, microprocessors, semi-conductor manufacturing equipment)
- U.S. is now the second largest trading partner of China and the second largest foreign direct investor (11%), after Hong Kong—trade and investment are likely to increase in both directions post WTO accession
- Increased exchange and economic interdependence should improve U.S.-China relations in both the long-run and the short-run
- Short-term friction between U.S. and China is reduced because
  - The annual renewal of "normal trade relations (NTR)" is no longer necessary
  - Trade disputes can now be settled through WTO dispute settlement mechanisms, which tend to be much less politicized
  - Chinese commitments in the areas of national treatment, transparency, and intellectual property right protection

The ASEAN Free Trade Area (AFTA)

- Intra-ASEAN tariff rates have been lowered to 5% on Jan. 1, 2002 with the inauguration of the ASEAN Free Trade Area (AFTA) among Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. The goal is to reach zero tariff rate within AFTA by 2010. The reduction in tariffs applies to 90% of products provided the ASEAN content of the product exceeds 40%.
- Khmer Republic, Laos, Myanmar and Vietnam are expected to join AFTA in 2006 and reach zero tariff rate within AFTA by 2015.
- Specific protection on manufactured and agricultural products still remains.

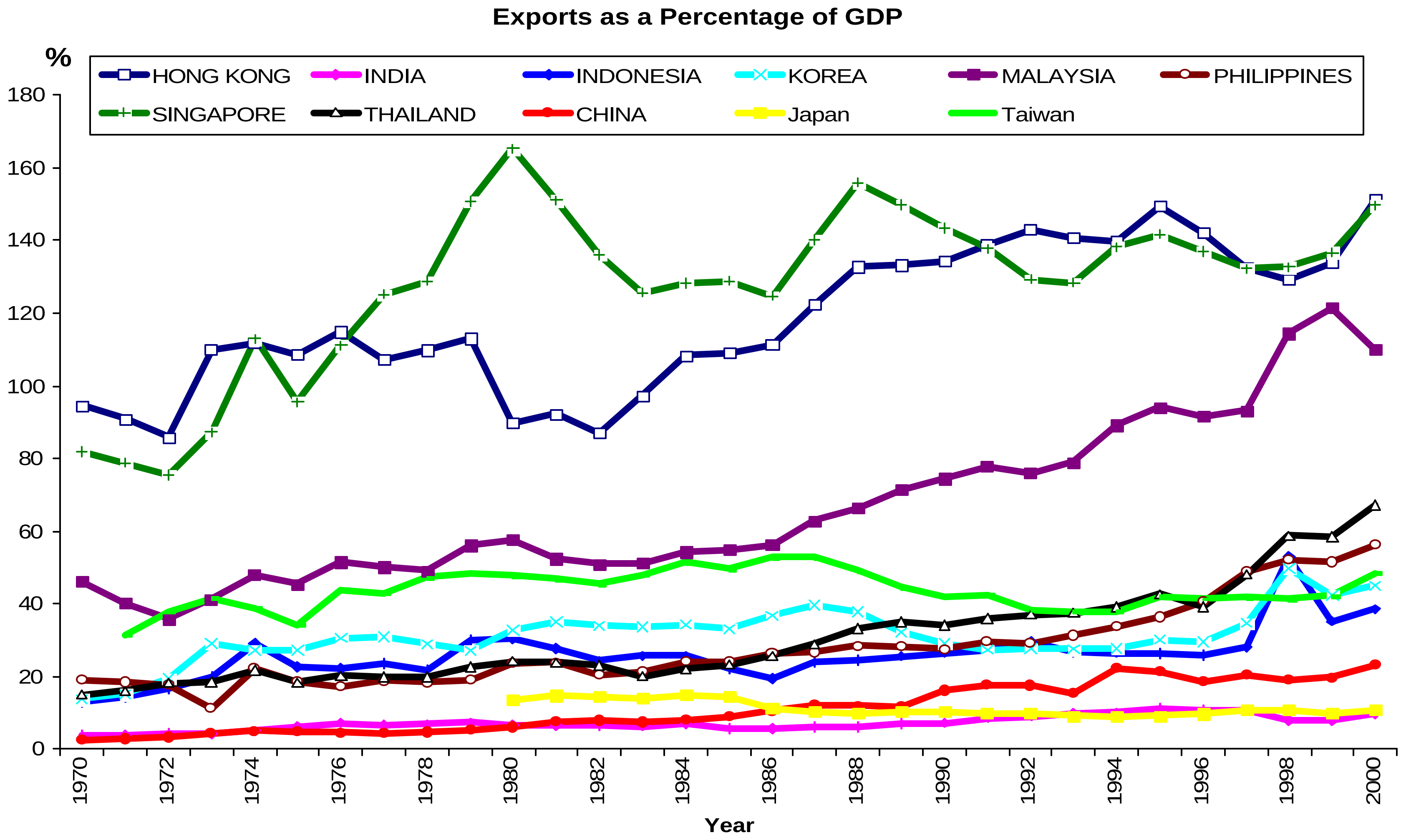
The China-ASEAN Free Trade Area

- Chinese Premier ZHU Rongji proposed in Brunei in November, 2001 a new free trade area, covering China and the ASEAN (Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), to be created within ten years
- A 3 trillion US$ market and almost 2 billion consumers
- Complementarity (primary raw materials) and competition (light manufactures)
- Opening the economies for trade—China will become a major export market for the ASEAN and vice versa
- The free trade area will promote foreign direct investment in the ASEAN region itself through the enlargement of the potential market
- A mutual support program for the currencies of one another, leading possibly to a currency area
- Significant political implications
- Near term—a simultaneous, coordinated expansion among ASEAN + 3 can help accelerate the recovery of the depressed economies of East Asia

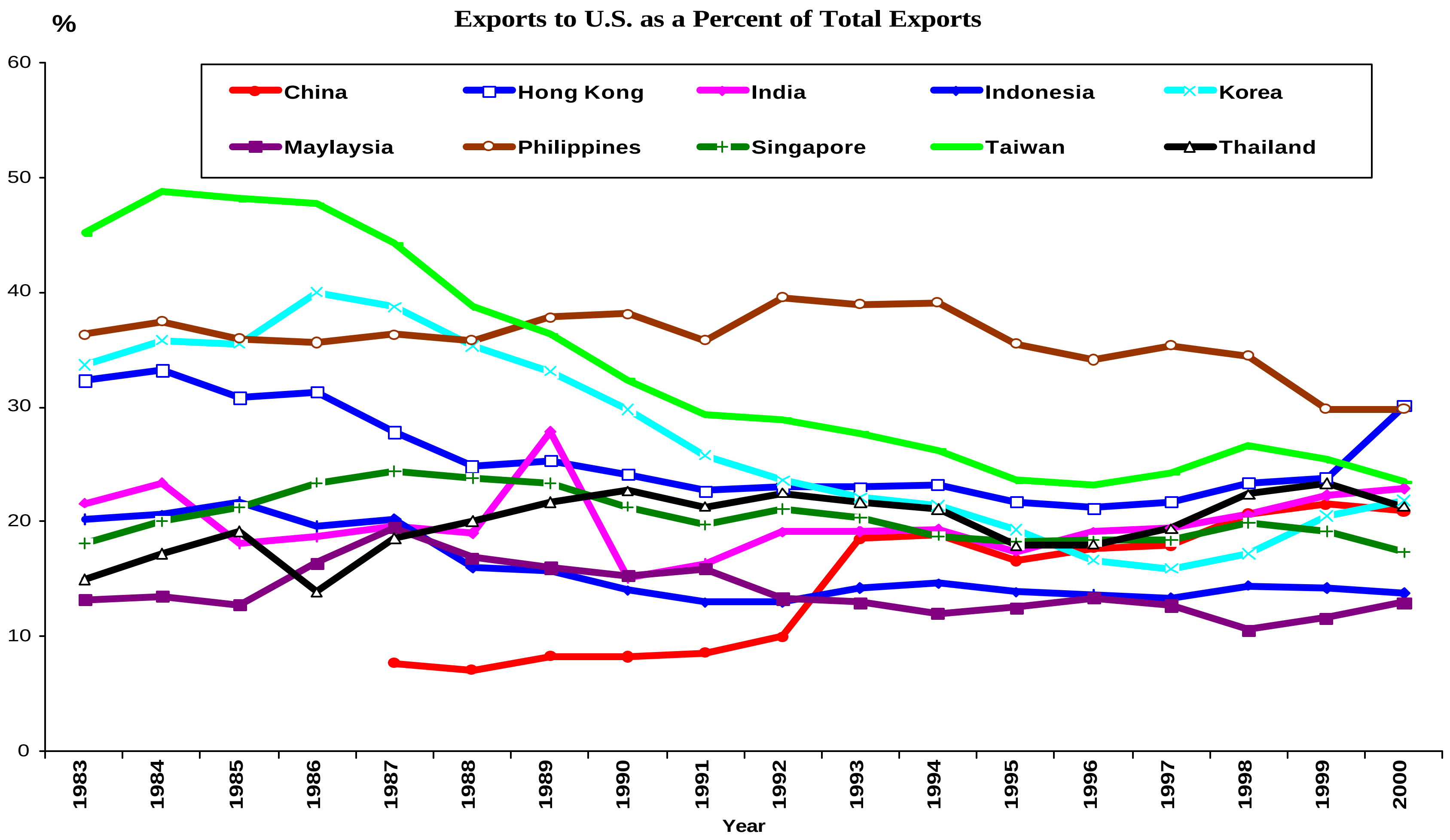
Looking Ahead: The External Environment Has Deteriorated

- 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 officially in recession with 2001Q3 GDP contracting by 1.3 percent. Preliminary results indicate a rate of growth of 0.2% in 2001Q4. It is expected that a downward adjustment will have to be made.
- The slowdown in the U.S. has had an impact on East Asia, both directly and indirectly, and in particular 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; however, a significant devaluation of the Japanese Yen brings renewed pressure on the currencies of East Asia
- 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%
- In 2001, net exports of China did not grow and was not a net contributor to economic growth; this is expected to continue in 2002

Exports as a Percent of GDP: Selected East Asian Economies



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



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

- While exports is a very high percentage of GDP in Hong Kong, Malaysia, Singapore and Taiwan, it is a relatively low percentage of the Chinese economy, amounting to approximately 20 percent
- The proportion of total exports destined for the U.S. has generally declined in the East Asian economies over the years, to less than 30 percent
- The one exception is the Chinese economy, where the proportion of Chinese exports destined for the U.S. has been rising to its current level of approximately 20 percent
- The slowdown in the U.S. economy will have a significant, but not overwhelming, negative impact on the rate of growth of real GDP in the East Asian economies--on the order of 1 percentage point decline in Hong Kong, Malaysia, Singapore and Taiwan and a less than 0.5 percentage point decline in the other East Asian economies, including China
- The proportion of high-technology exports in total Chinese exports is only 10%, thus the global slowdown in high-technology demand is going to affect the Chinese economy much less than others
- The value-added to gross value ratio of Chinese exports is approximately 30%, which implies that the value-added generated by Chinese exports to the world is approximately 30% x 20% or 6% of Chinese GDP

The Argentinean Crisis and the Fixed US$ Peg of the Hong Kong Dollar

- The impact of the Argentinean Peso crisis was quite well contained
  - Contagion through speculative activities has not recurred in East Asia because of an overall decline in the vulnerability of these economies and because of the reduction of hedge fund activities due to supply side constraints (generous bank credit lines are no longer available for hedge funds)
- The viability of the fixed peg between the Hong Kong Dollar and the US$
  - A devaluation is not necessary for Hong Kong to maintain competitiveness
    - Tradable goods are always already at world prices no matter what the exchange rate is—there is no gain in international competitiveness here
    - Non-tradable goods include only labor and land—wage rates, except those for civil servants, are downward flexible and the price of land has been falling
    - One can achieve an equivalent degree of competitiveness by letting the price of land decline in lieu of a devaluation
  - A devaluation will lead to instant inflation in both goods and wage rates, including the replacement cost of structures, erasing whatever advantages that may be obtained
  - A devaluation will lead to an irreversible flight from the Hong Kong Dollar as a store of value—households will wind up holding only the US$ and the Renminbi
  - Over time, creeping, partial dollarization is inevitable

The Devaluation of the Japanese Yen

- An ineffective policy for solving Japanese domestic economic problems
- A potential for causing another round of competitive devaluation in East Asia, and pushing the region into even deeper recession in the short run, which cannot be beneficial to the Japanese economy
- Inconsistency with the spirit of the rules of the World Trade Organization if not the letter
  - A devaluation can be viewed as a unilateral simultaneous increase in the rates of tariffs on all imports and subsidies on all exports, Japan, with a large and rising current account surplus, and the world's largest official foreign exchange reserves, and as the world's largest net foreign creditor, has no strong justification for a devaluation of its currency at this time
- Possible Counter-Strategies of East Asian Economies
  - A countervailing tariff on Japanese imports and perhaps even a countervailing subsidy on exports to Japan, offsetting any advantage gained by Japan.
  - Voluntary boycotts of Japanese goods in the affected East Asian economies

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 2000, fixed investment grew 9.3% 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 2001Q1-Q3, aggregate investment grew 15.8% Y-o-Y, an increase from the 15.1% of 2001H1, whereas manufacturing investment grew 24.1% Y-o-Y
- Investment by manufacturing enterprises was responsible for a large part of the growth in fixed investment, for the first time since the East Asian currency crisis
- Public infrastructural investment has continued at the same or higher level—in 2001Q1-Q3, state fixed investment rose 18.2% Y-o-Y, an increase from the 17.9% of 2001H1
- 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 2000, consumption grew 9.7% in real terms
- 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
- In 2001Q1-Q3, retail sales grew 11.5% while income rose 7.4% in urban areas; retail sales grew 7.8% while income rose 5.2% 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

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

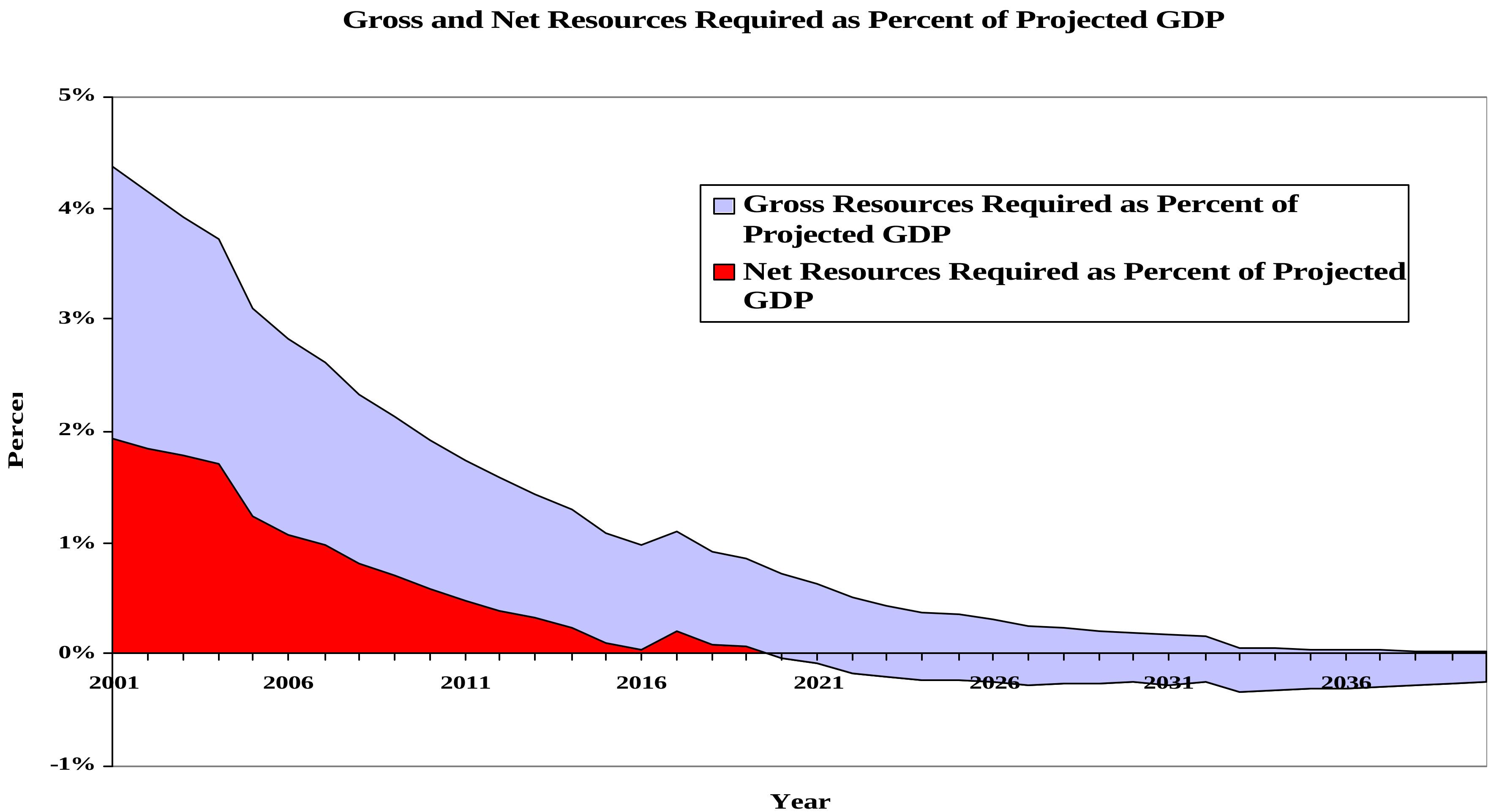
The Critical Path for Continuing Economic Reform

- 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 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 almost 10 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

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$300 billion or 20-30% of GNP--according to People's Bank of China (PBOC), 20%; according to rating agencies, at least 25%, and up to US$500 billion (or 40% of GNP) according to other observers
- Ultimately non-recoverable non-performing loans have been estimated to be on the order of 6-7% of all outstanding loans by PBOC, or up to 15% by non-government analysts
- Assuming a worst-case scenario, that only 25% of the non-performing loans are ultimately recoverable, the bad debt provision required ranges between US$225-375 billion, or 20-33% of GNP
- 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 20% of GNP (compared to 60-70% for the United States, 120% for Japan, 75% for Zone Euro and 160% 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
- Total public debt, assuming the conversion of all non-performing loans into public debt, would amount to 40-53% of Chinese GNP

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)
  - Auctions for the non-performing-loans portfolios have been held successfully with a recovery ratio of approximately 25%

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

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 through the Social Security Fund
- Merging of A & B shares?
- Chinese Depository Receipts (CDRs)?

Political Developments

- Domestic stability—domestic stability can be maintained as long as the economy performs well and the gap between the have's and have-not's does not become too large. The agricultural procurement program, the establishment of the social security fund, the Western Development Initiative, and the renewed focus on education are all intended to address these issues.
- The succession
  - It is expected to be smooth and predictable (no surprises)
  - Young technocrats will be moving up to ministerial ranks
- Cross-Strait relations—unlikely to improve significantly as long as the Taiwan side does not wish to return to the "one-China" consensus of 1992
- The institution of the rule of law is the most critical component of political reform—democratization without the rule of law can lead to worse outcomes than authoritarianism
- Extension of democratic elections from the village to the township levels
- Nightmare scenarios
  - A war in the Taiwan Strait
  - Internal fragmentation

U.S.-China Relations

- U.S.-China relations—is expected to remain steady on average but it will have its ups and downs—neither close ally nor implacable foe—from strategic partner to strategic competitor to strategic cooperation—the range of options is quite narrow for both sides
- Whether U.S. and China will be friend or foe in the longer term is very much determined by the expectations on both sides (which can be self-fulfilling)
- Stability in U.S.-China relations requires predictability and transparency
- Anti-terrorism and increasing economic interdependence can provide the common ground for the near term

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—a national commercial and tax court?
  - The role of the "open door”--WTO

Long-Term Economic Trends

- Aggregate GDP
  - The Chinese economy is likely to continue to grow, more or less independently of what happens in the rest of the world, over the next several decades at an average annual rate of approximately 7%
  - By 2020, aggregate Chinese GDP will exceed the aggregate GDP of Japan (and approximately half of aggregate U.S. GDP
  - By 2035, aggregate Chinese GDP will reach the same level as aggregate U.S. GDP
- Per capita GDP
  - However, Chinese GDP per capita will only reach US$10,000, or approximately 20% of U.S. GDP per capita, in 2035
  - Chinese GDP per capita will approach the level of U.S. GDP per capita only beyond 2050
- Population
  - By 2035, India will have overtaken China as the most populous nation in the world
- The currency
  - The Renminbi will in time become one of the strongest currency in East Asia and a quasi-reserve currency like the Euro

The New Economy and China

- The possibility of leap-frogging--there are no vested interests to protect; no existing businesses to be cannibalized; there can be "creation without destruction"
  - e.g., facsimile machines instead of telexes; video compact discs instead of VCRs; a new keyboard layout; mobile and wireless telephones instead of fixed lines; debit and credit cards instead of checks
- The possibility of influencing/setting standards--the markets are potentially large enough in China for the benefits of economies of scale to be realized and for it to have a significant influence on future standards
  - e.g., Linux; wireless telephone standards (CDMA)
- The possibility of local adaptation--taking advantage of local conditions
  - e.g., the Legend story—language; local supply and demand conditions, e.g., stability of the voltage of the electric power supply
- Transformation of the "Old Economy" through the information and communication technology

Globalization and Investment Diversification

- Geographical diversification has to be re-thought because of globalization
  - Diversification by multinational corporations: e.g., IBM is not a U.S. risk because of its significant business around the globe; similarly, Nestle is not a Swiss risk; these are all globally diversified corporations
  - Covariance due to supply-chain connections, e.g., Dell, and its sub-contractor in Taiwan, Quanta Computer, face the same risks—Quanta is not really a Taiwan risk
  - Covariance of markets—the stock markets have in recent years tended to move together
- There are gains from geographical diversification only if the economic performance of the different regions of investment are uncorrelated or negatively correlated
- China, India, and potentially Latin America are candidates for investment if diversification is the objective because they are large economies the rates of growth of which are not very sensitive to what happens outside

Investment in China by Foreign Investors: Considerations

- Covariance between East Asian and U.S. markets
  - Covariance increased by globalization
  - The high-technology sector versus the traditional and the non-tradable sectors
  - Covariance between U.S. and China is small, hence maximum gain from diversification
- Public versus private markets
  - Credibility of public markets (insider trading, manipulation, protection of minority shareholders, standards of audit, disclosure and transparency)
  - Ease and necessity of direct financial monitoring
  - Casino mentality of public markets
- Portfolio versus direct investment
  - Possibility of capital control and other forms of restrictions on short-term capital flows
  - Necessity of continuous active direct monitoring
  - Choice of joint-venture partner(s), if any, critical
  - Availability of depositary receipts in liquid, transparent and well-regulated markets with no capital control as an alternative instrument of foreign portfolio investment
- Competitive advantage
  - Money alone is not sufficient because of relative abundance of domestic savings—foreign direct investors must have superior technology, know-how, knowledge or control of markets

Investment in China by Foreign Investors: Considerations

- The nature of foreign direct investment (FDI) in China has been undergoing a transformation
  - The nature of FDI has changed gradually from export-oriented to domestic market oriented, taking advantage of the large Chinese domestic market; from light industry to heavy and high-technology industries; and from small projects to large projects
  - Foreign direct investors increasingly view China not so much as an export base but as a market for their finished products--e.g., BASF, General Motors, Motorola all plan to market at least a significant proportion of the products they produce in China in China itself