China's Economy and Implications for U.S. Policy

Lawrence J. Lau, Ph. D., D. Soc. Sc. (hon.)
Kwoh-Ting Li Professor of Economic Development
Department of Economics
Stanford University
Stanford, CA 94305-6072, U.S.A.

Committee of 100
11th Annual Conference, San Jose, California
May 3, 2002

Phone: 1-650-723-3708; Fax: 1-650-723-7145
Email: ljlau@stanford.edu; WebPages: http://www.stanford.edu/~ljlau

A Preview

- The Chinese Economy Today
- Prospects for Long-Term Economic Growth
  - Chinese Accession to the World Trade Organization (WTO)
  - Long-Term Economic Growth
    - The three paradigms of economic growth
    - The development of the "Great West"
- Progress in Economic Reform
- Implications for U.S. Policy

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)
- Chinese real GDP grew from \$177 billion to \$1.17 trillion (2001 prices) and real GDP per capita grew from \$183 to \$920. The U.S. GDP and GDP per capita are respectively 9 and 40 times the comparable Chinese figures.
- 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 10th Five-Year Plan is only indicative and not mandatory and 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 65% of GDP and an even greater percentage of employment in 2001—non-state-owned firms face hard budget constraints and ordinary citizens can make a good living without being beholden to the state.
- China is the 5th largest trading country in the world (exports of US\$266.2 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	2001
	US$ (2001 prices)	
Real GDP	177 bill.	1.16 trill.
Real GDP per capita	183	920

The Chinese Economy Today (3)

	U.S.	China
	US$ (current prices)	
2001 GDP	10.19 trill.	1.16 trill.
2001 GDP per capita	36,840	920

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
  - Autonomy and Incentive at the Enterprise Level
  - Professionalization of Management of Enterprises
- 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***

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

- Actual

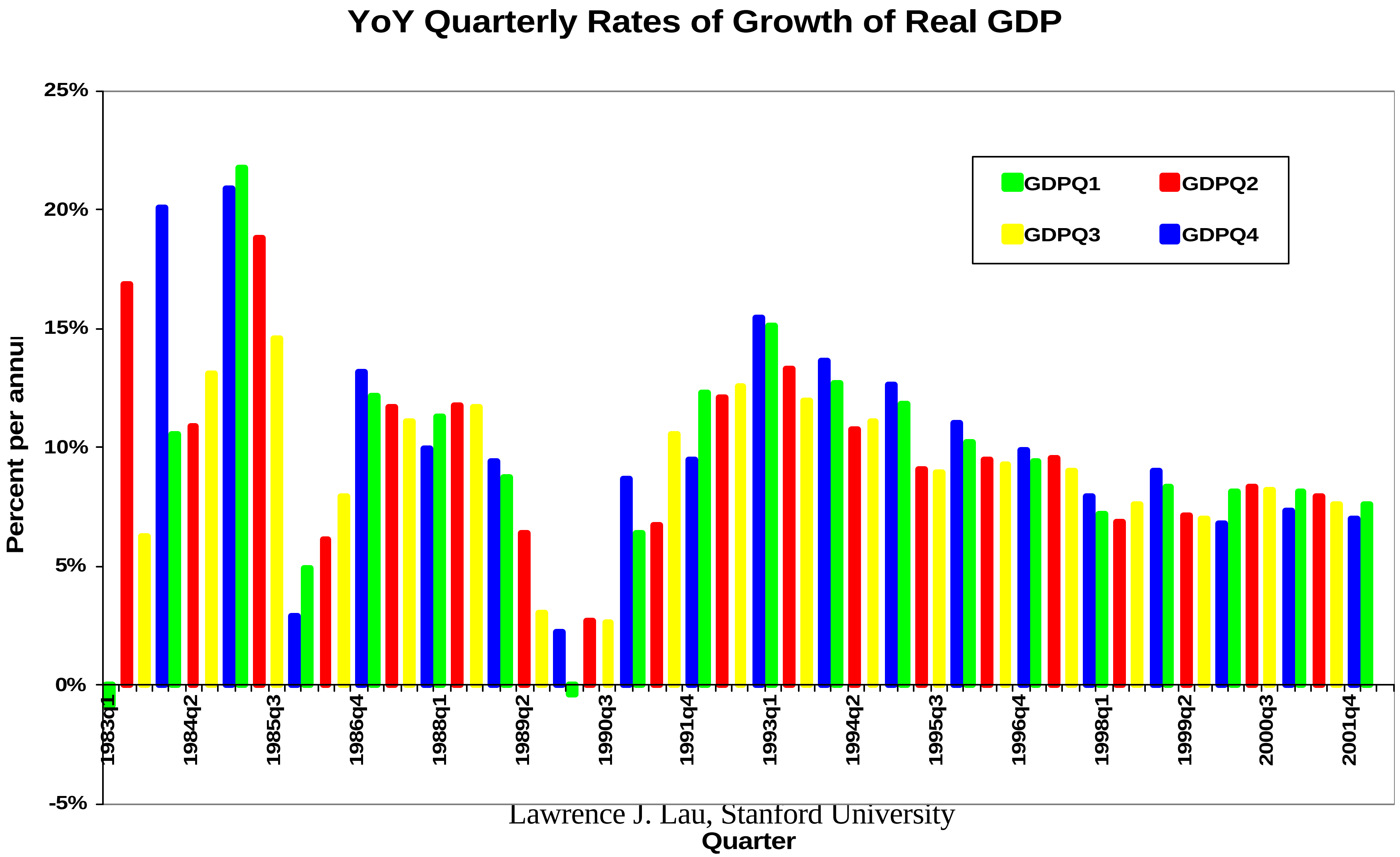
	Real GDP	RPI	CPI	
1997	8.8	0.8	2.8	
1998	7.8	-2.6	-0.8	
1999	7.1	-2.9	-1.3	
2000	8.0	-1.5	0.4	
2001	7.3	-0.7	0.7	
2002Q1	7.6		-0.6	

- Projections

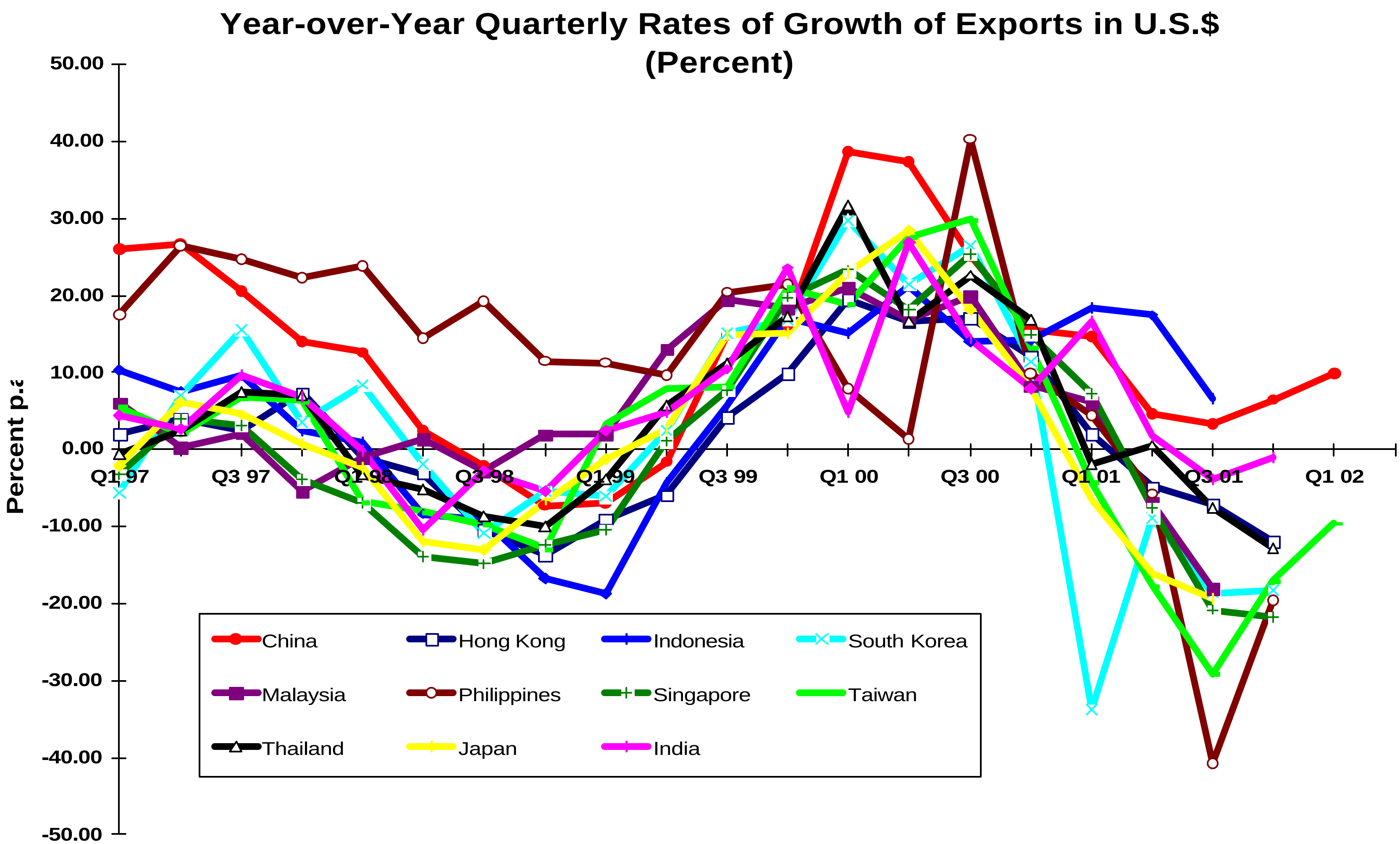
2002	>7.0			(NBS)
	7.0			(ADB)
	7.5		1.0	(Lau)
	6.9			(Lehman)

- Despite fluctuations in exports and imports, the rate of growth of real GDP has remained stable at 7-8%. Exports are approximately 20% of GDP, but the value-added component is approximately only 30%, resulting in an export-generated value-added to GDP ratio of 6%. Chinese exports to the U.S. is approximately 7.3% of Chinese GDP (according to adjusted U.S. data), with a value-added content of 20%, resulting in a value-added to GDP ratio of 1.5%.
- The Development Research Center of the State Council has estimated that accession to WTO will increase the rate of growth of the Chinese economy by 0.5% per annum; the U.S. International Trade Commission has estimated that real GDP would be 4% higher in 2010 than otherwise..
- 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

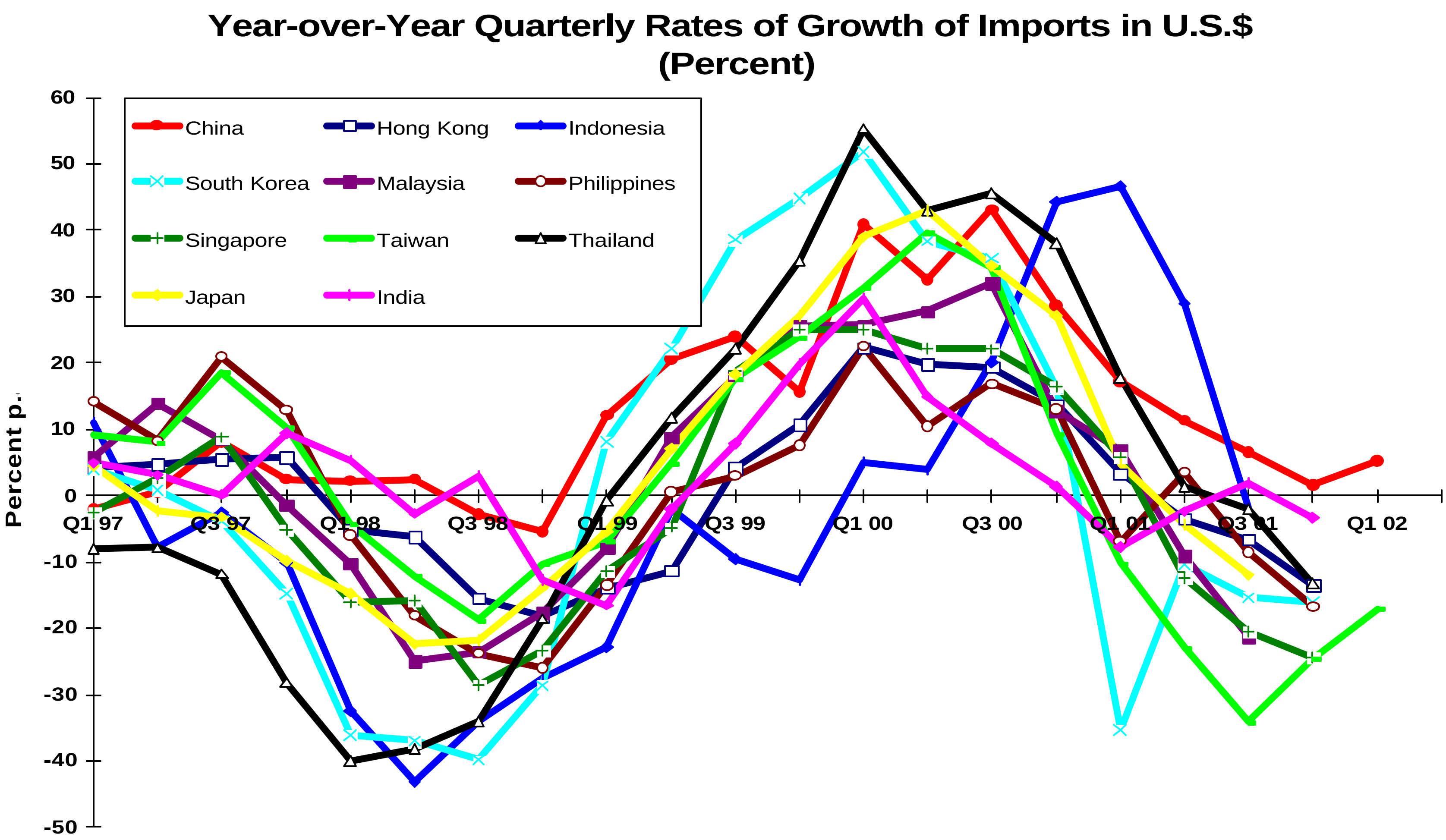
Quarterly Rates of Growth of the Real GDP of the Chinese Economy, Y-o-Y



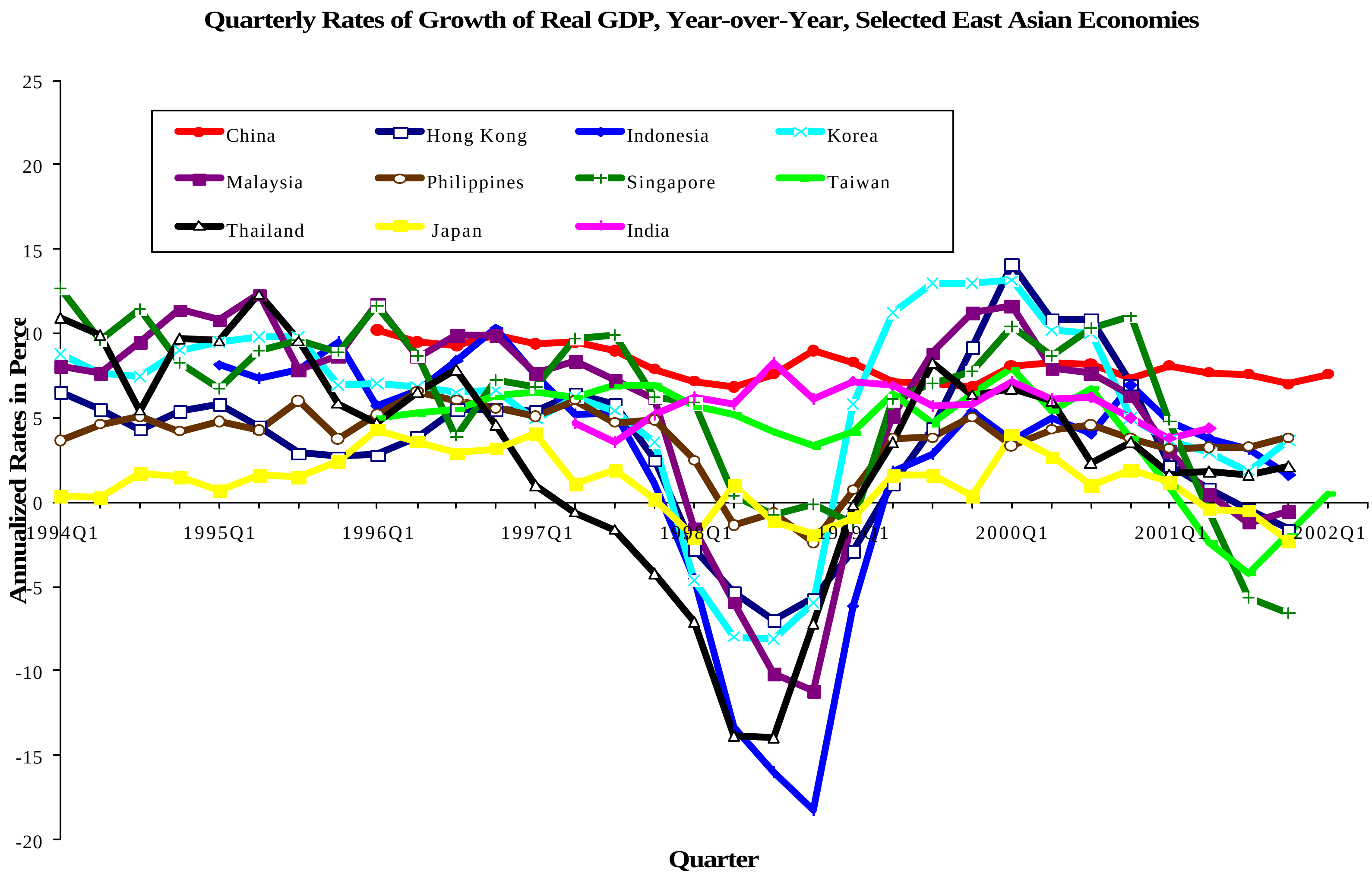
Quarterly Rates of Growth of Exports



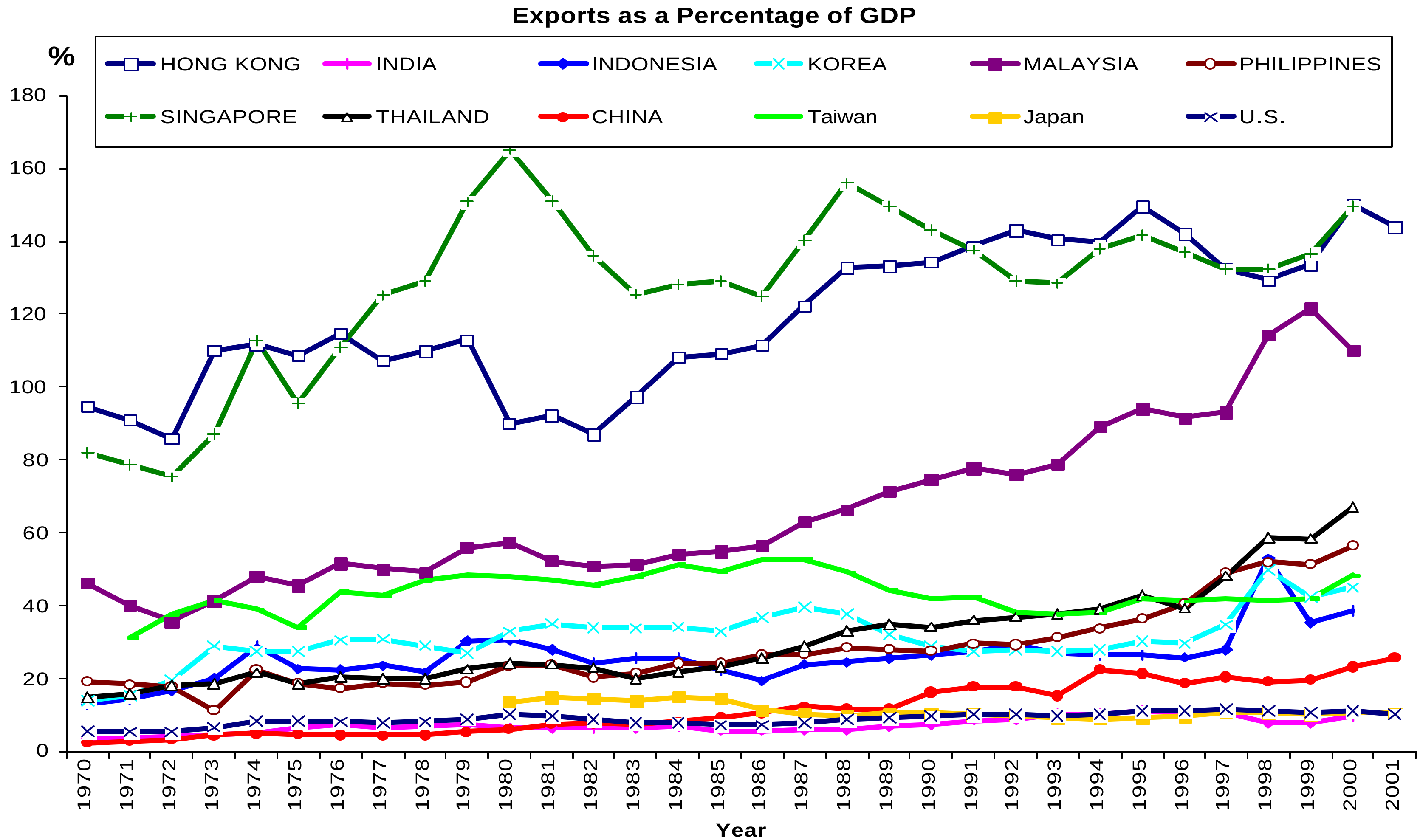
Quarterly Rates of Growth of Imports



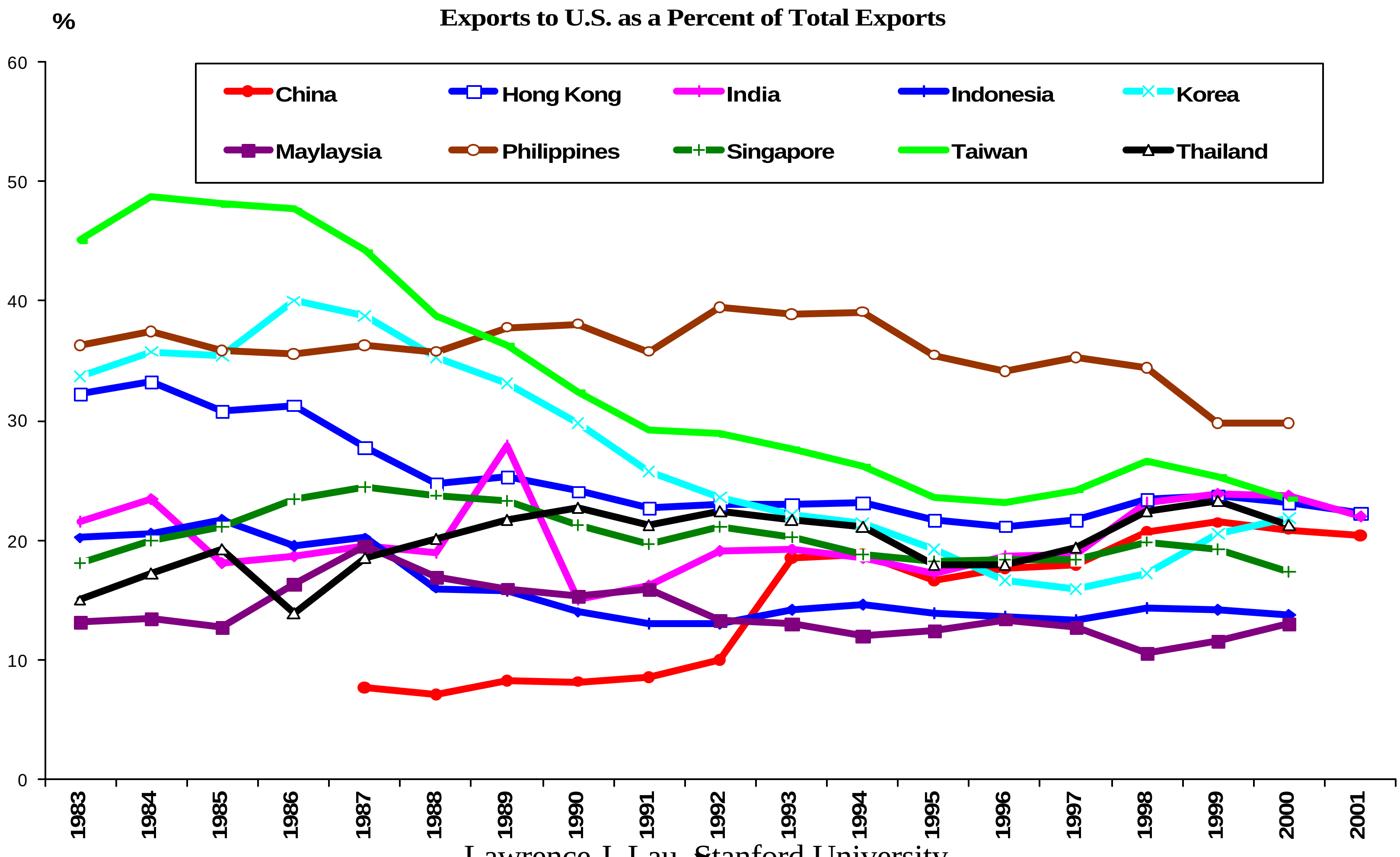
The Rates of Growth of Real GDP: Selected East Asian Economies



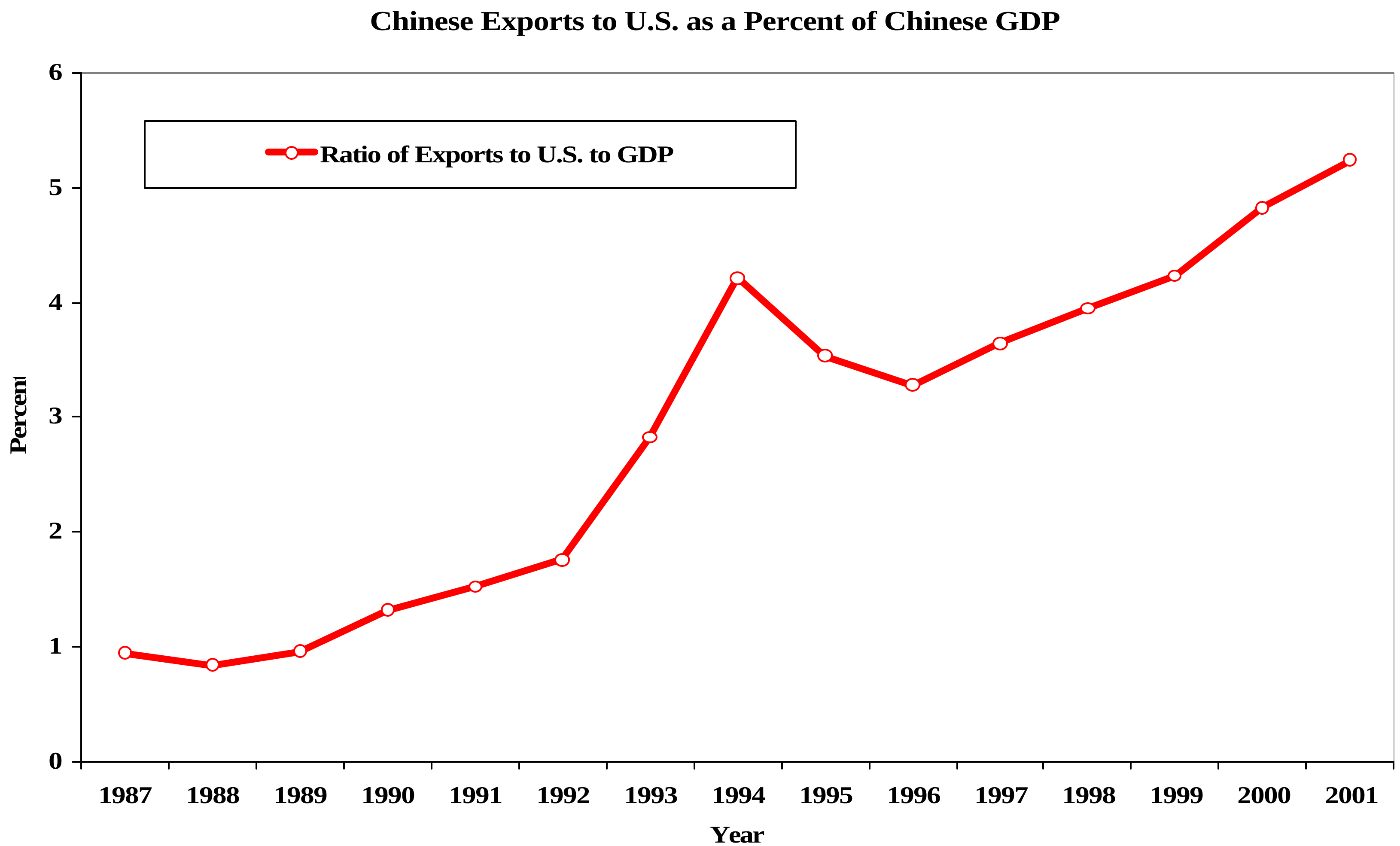
Exports as a Percent of GDP: Selected East Asian Economies and U.S.



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



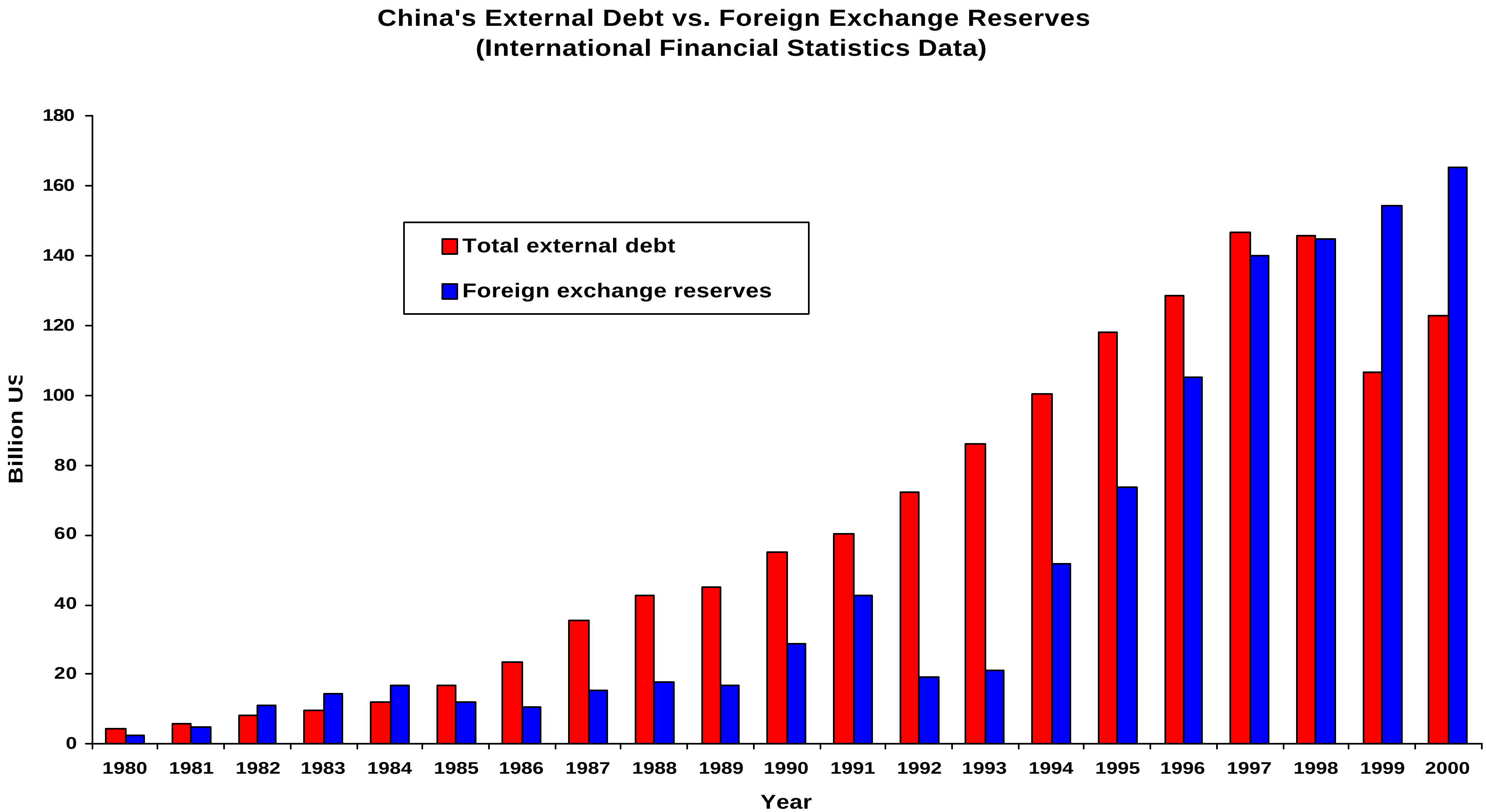
Chinese Exports to the United States as a Percent of Chinese GDP (Chinese Data)



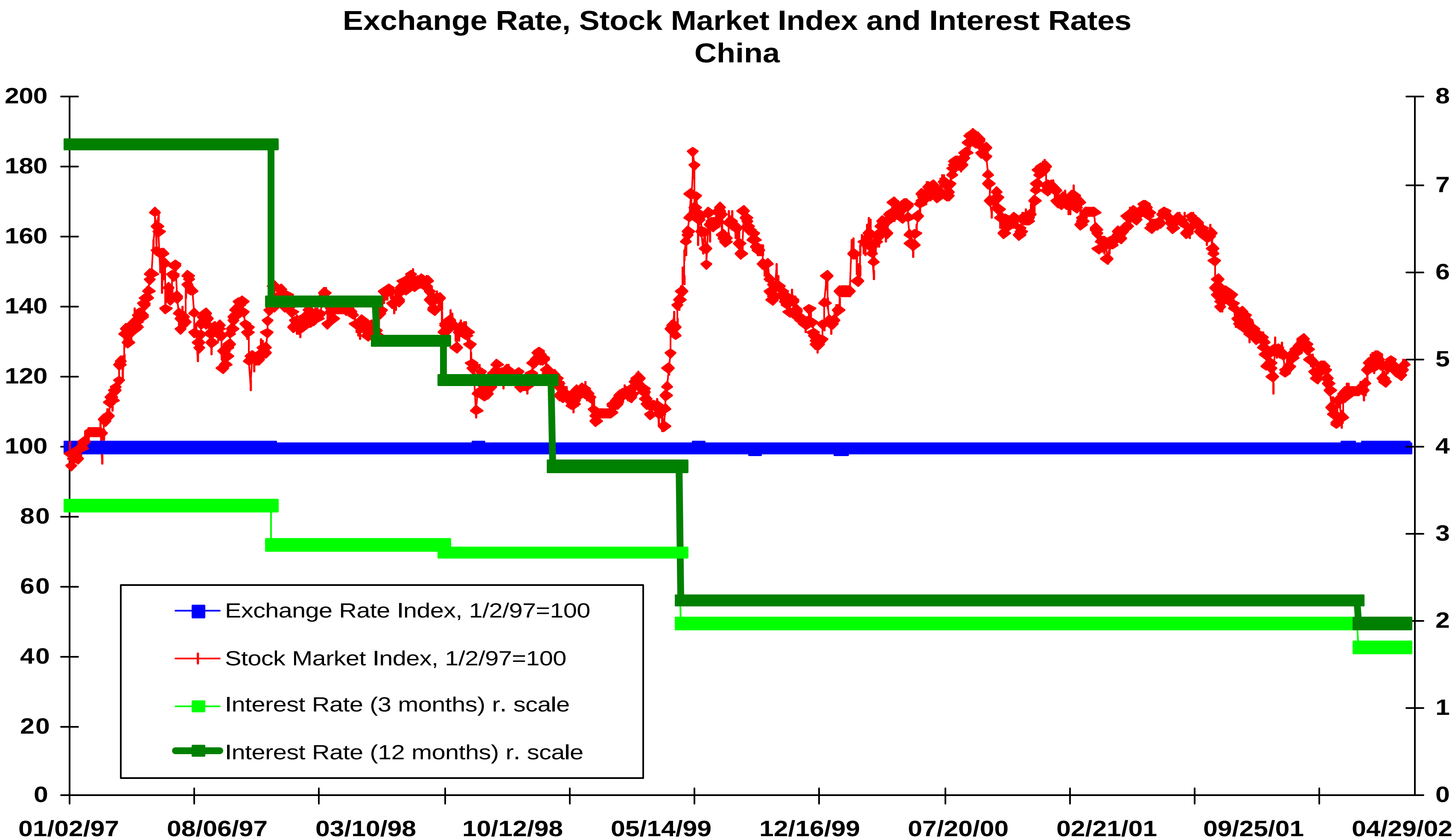
Exports, Imports and Foreign Exchange Reserves

- In 2000, exports rose 27.8% to US$249.2 billion; imports rose 35.8% to US$225.1 billion; with a trade surplus of US$24.1 billion
- In 2001, exports rose 6.8% Y-o-Y to US$266.2 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 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$212.2 billion at year end 2001, an increase of US$46.6 billion over year end 2000 (larger than the trade surplus of US$22.5 billion), and surpassing total outstanding external loans by a wide margin
- The exchange rate of the Renminbi vis-à-vis the U.S. Dollar has remained stable since 1994 (in fact, there has been a slight appreciation from 8.7 Yuan/US$ to 8.3 Yuan/US$)

External Debt and Official Foreign Exchange Reserves: China



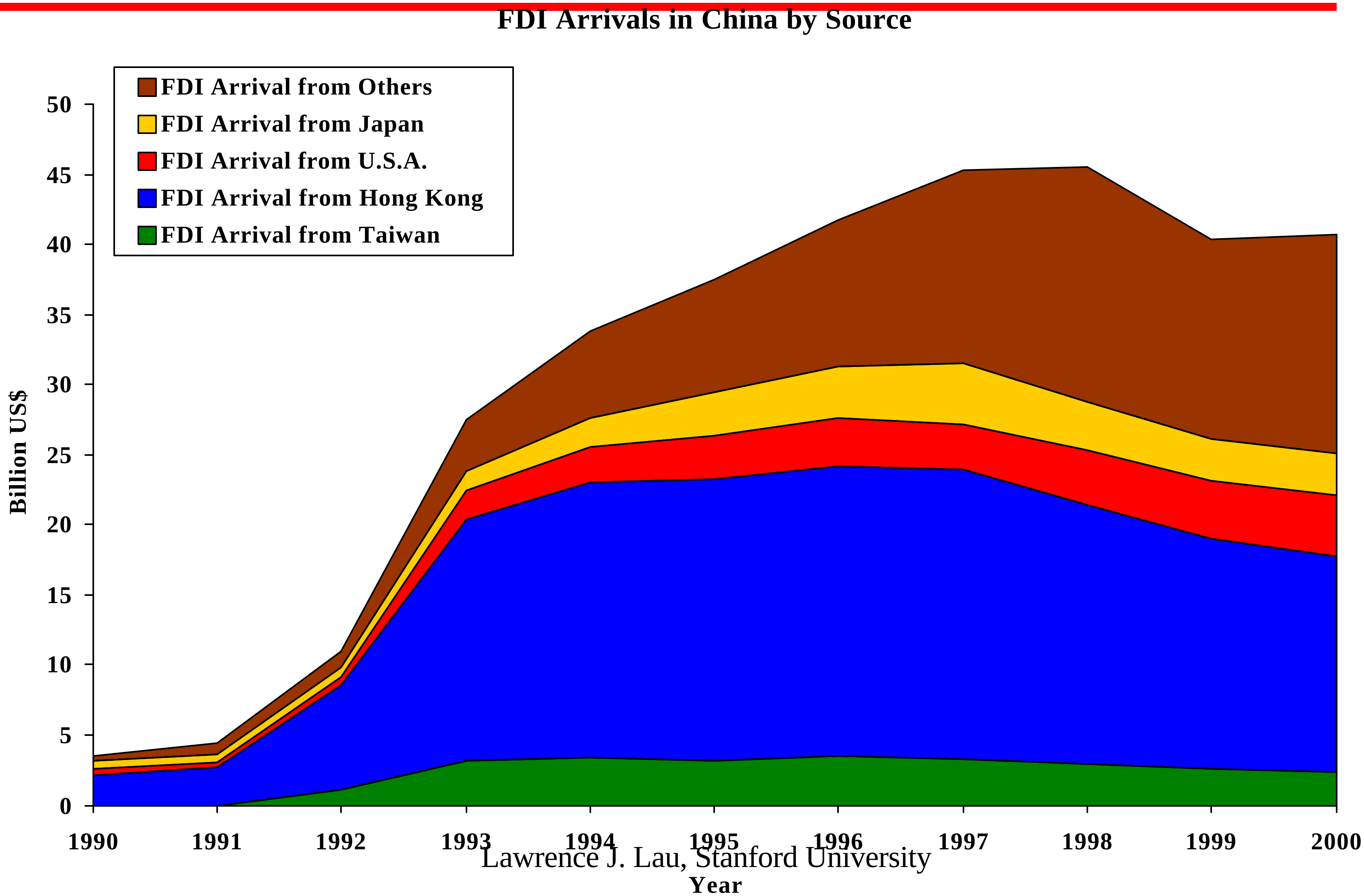
The Exchange Rate, the Interest Rates and the Stock Market Index



Foreign Direct Investment (FDI)

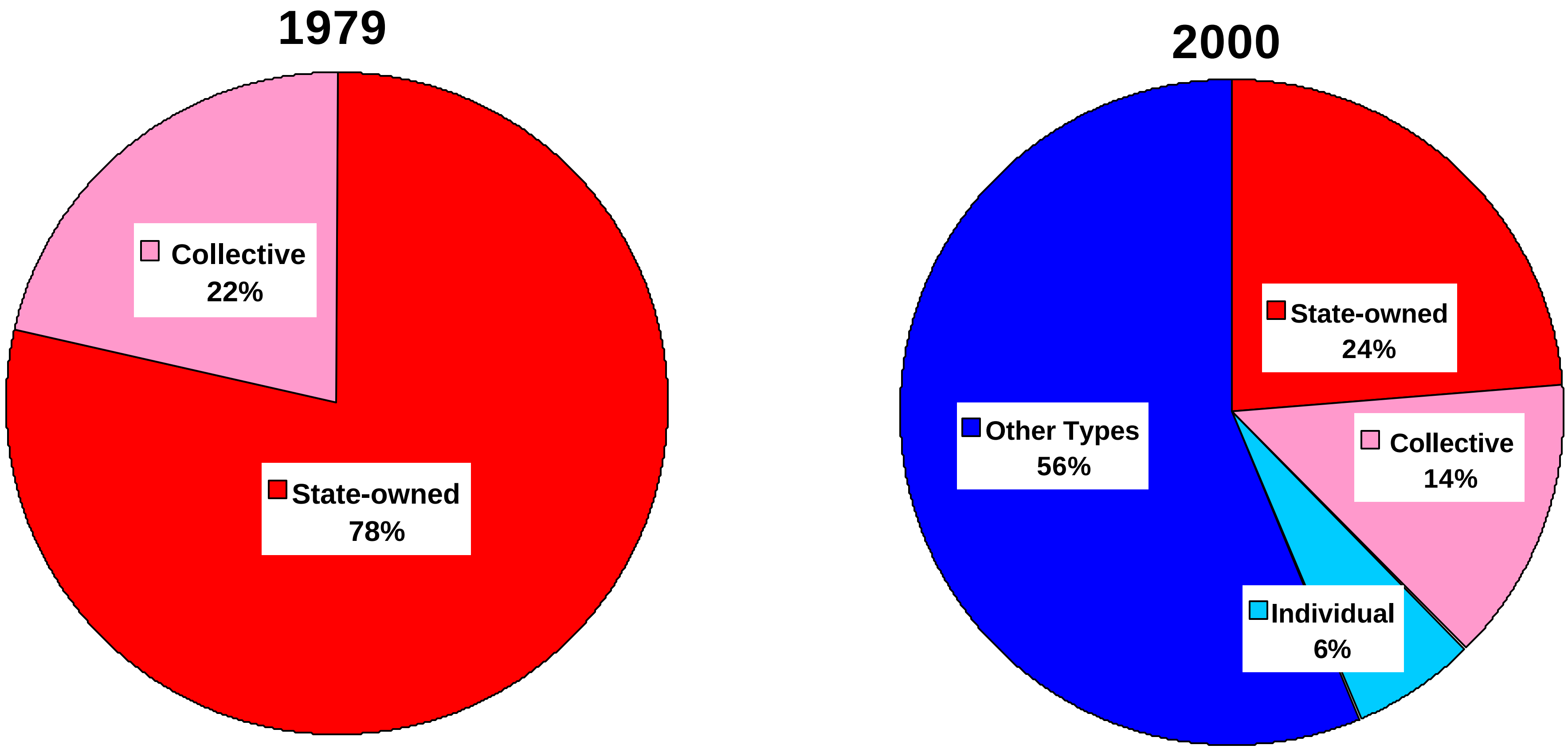
- FDI, at US$45 billion a year, amounts to approximately 10% of the annual Chinese aggregate gross domestic investment of approximately US$450 billion. Moreover, a significant proportion of it is what is known as “recycled” or -tripped” investment ultimately originated by Chinese entities and individuals. Quantitatively, FDI is not critical to the Chinese economy.
- Qualitatively, FDI is probably more important because it brings in technology, know-how, business methods, management techniques and markets that will otherwise be unavailable in China.
- 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

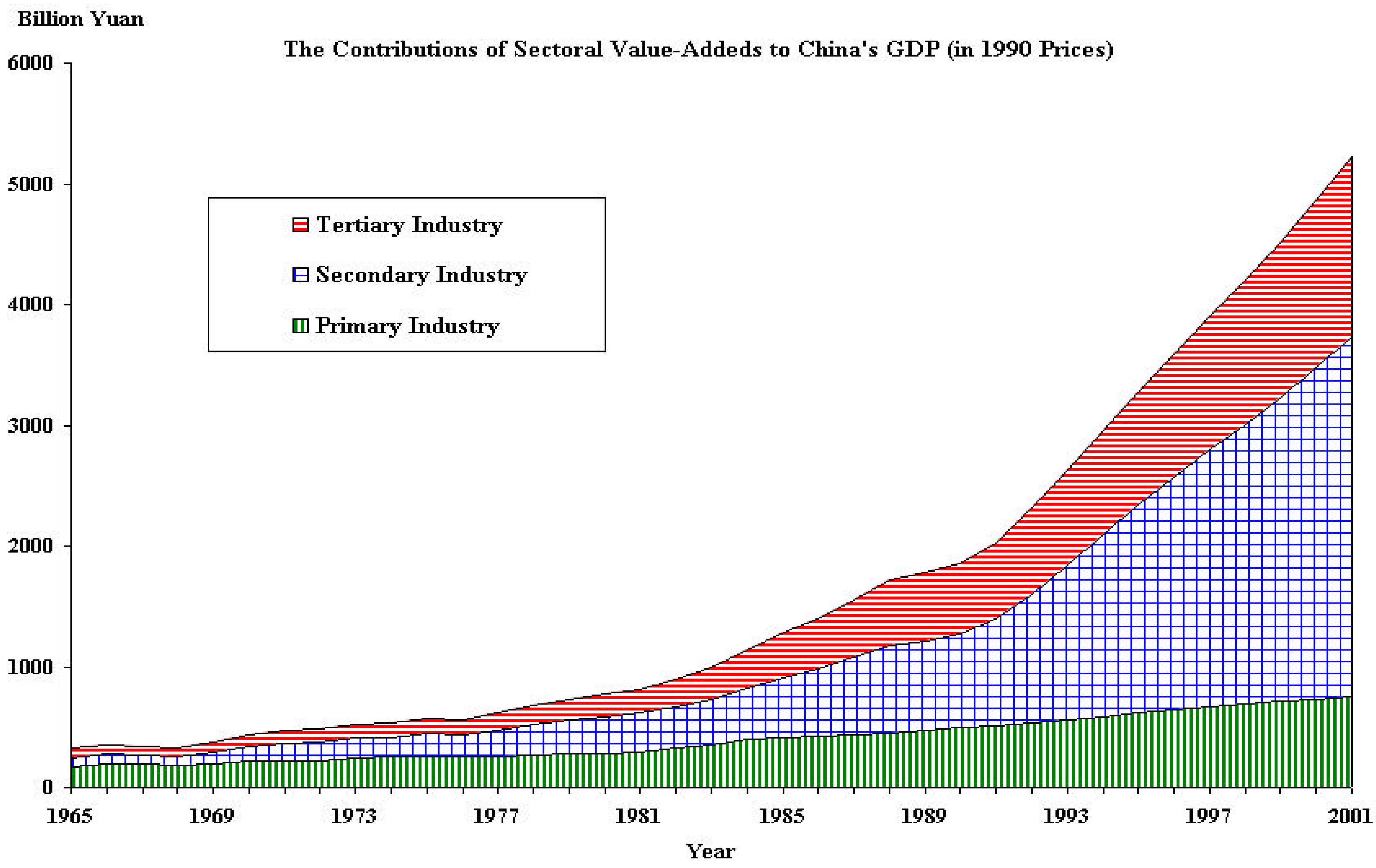


The Growth of the Non-State Sector-Industry

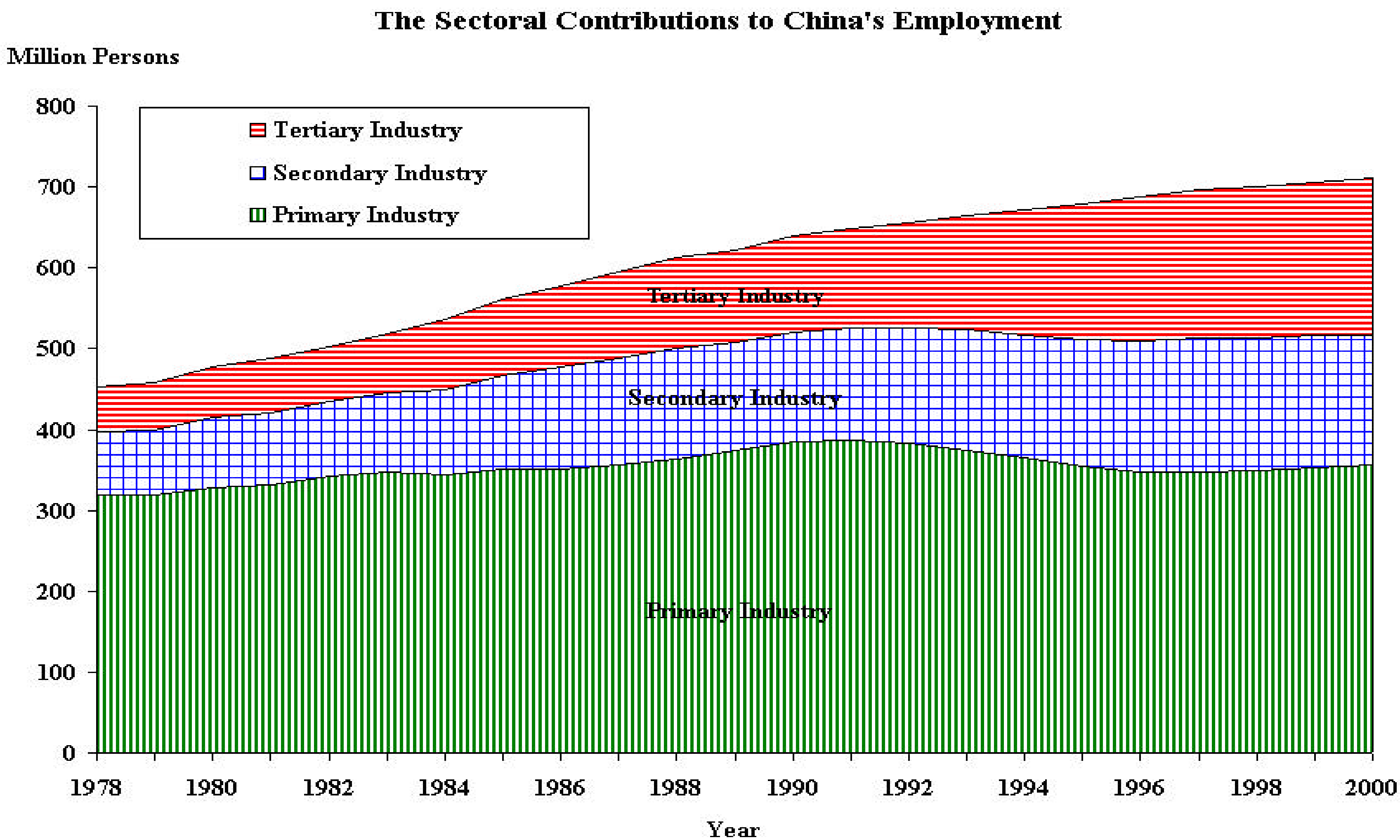
Distribution of Gross Value of Industrial Production by Ownership



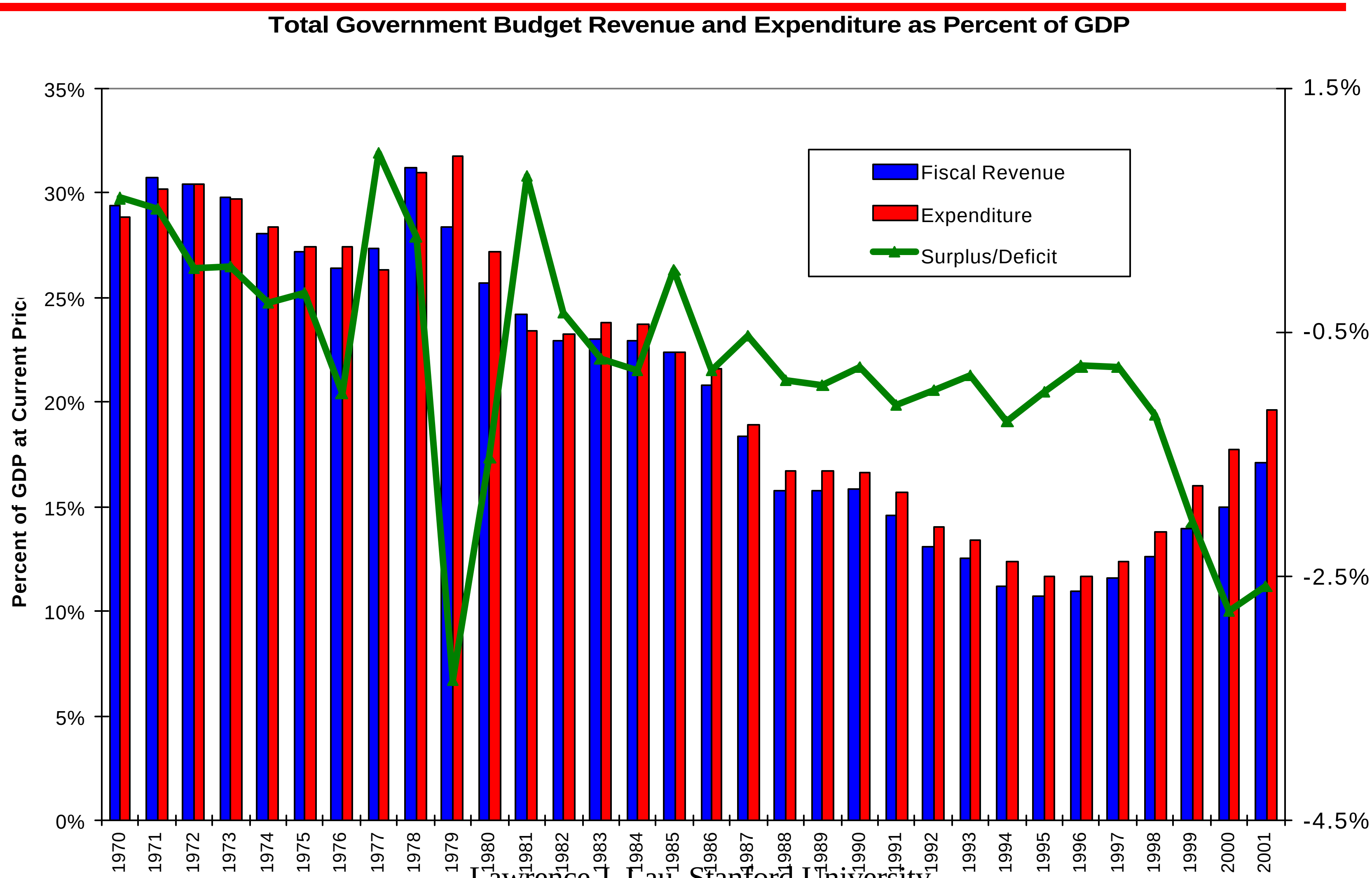
The Contributions of Sectoral Value-Addeds to China's GDP



The Sectoral Contributions to China's Employment



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



Near-Term Economic Prospects: The External Environment

- The U.S. economy, 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 was officially in recession with 2001Q3 GDP contracting by 1.3 percent. The 2001Q4 rate of growth has been revised upwards from 0.2% to 1.7% and the "advan
2002Q1 is 5.8%. However, the unemployment rate has continued to rise and capital spending by businesses has not shown any signs of recovery.
- 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 according to Chinese data and 7.3% according to U.S. data, with a value-added of exports to GDP ratio of 1.0-1.5%--the U.S. slowdown will have only an impact on Chinese economic growth of no more than 0.5% and the global recession approximately 1%.
- 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

The Effects of the Global Slowdown

- 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

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 2001, fixed investment grew 12.1% in real terms.
- 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 2001, state fixed investment rose 12.8% Y-o-Y.
- 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 2001, retail sales grew 11.5% while income rose 8.5% in urban areas; retail sales grew 7.7% 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

Government Revenues and Expenditures

- In 2001, government revenue increased 22.2% YoY, compared to 17.0% in 2000
- In 2001, government revenue as a percent of GDP reached 17.1%.
- In 2001, government expenditure increased 18.6% YoY

Long-Term Economic Growth: Three Paradigms of Chinese Economic Growth

- Domestic demand-driven growth--the domestic market paradigm a la the United States in the 19th century. China is a large 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.
- The "wild-geese-flying pattern" metaphor of East Asian industrial migration over time can apply to Chinese provinces and regions
- Privatizing the economy without privatization--shrinking the state sector through the growth of the non-state sector in the absence of explicit privatization--the experience of Taiwan and South Korea
- 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?)
  - Maintenance of an internationally open economy--the role of the "open door” (WTO)

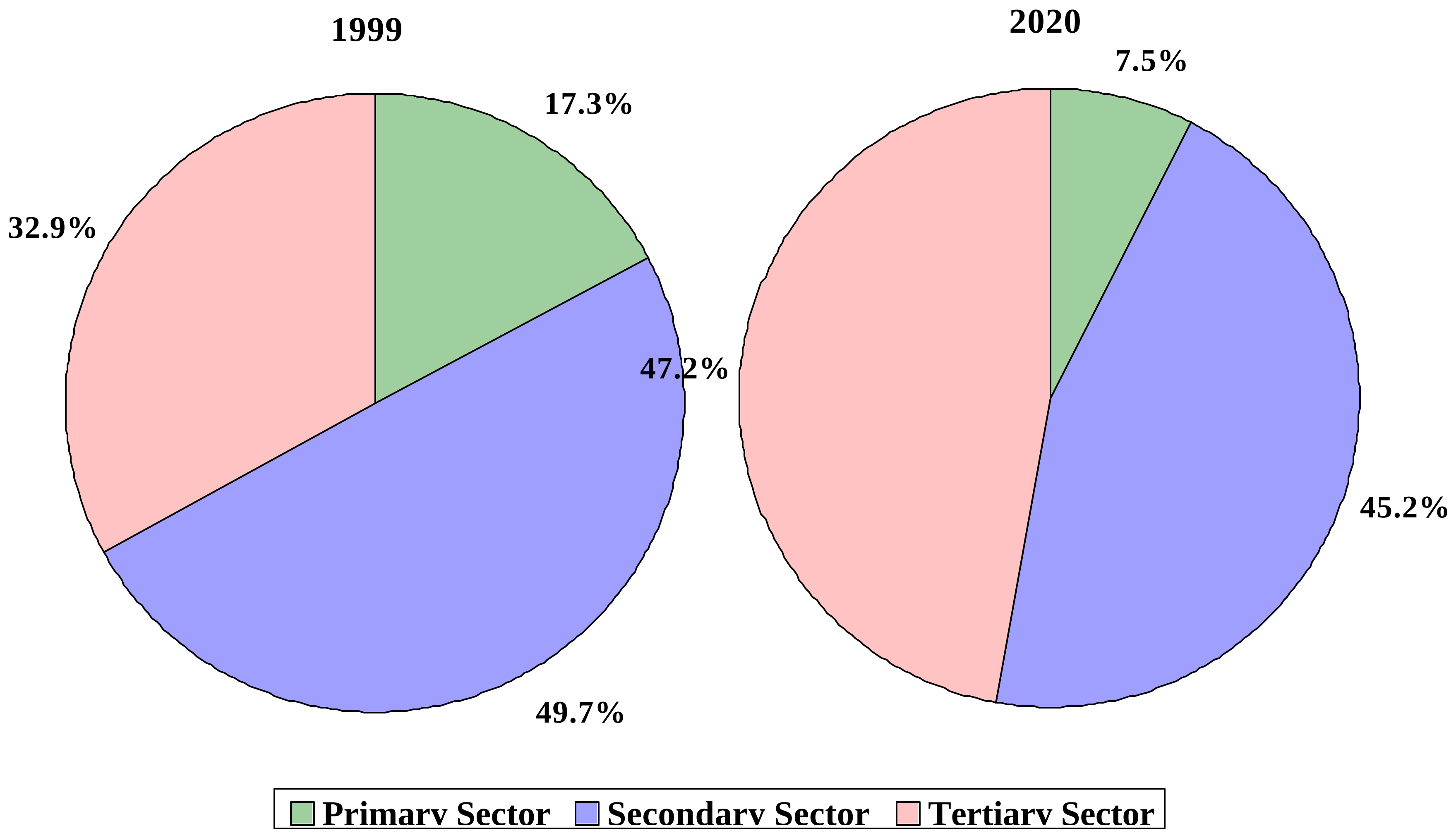
Long-Term Economic Trends

- 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%
  - The source of this growth will come primarily from tangible capital accumulation, supported by a national savings rate of 40%, human capital accumulation, and economies of scale, and to a lesser extent on the growth of intangible capital (for example, R&D capital) and improvements in efficiency
  - 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

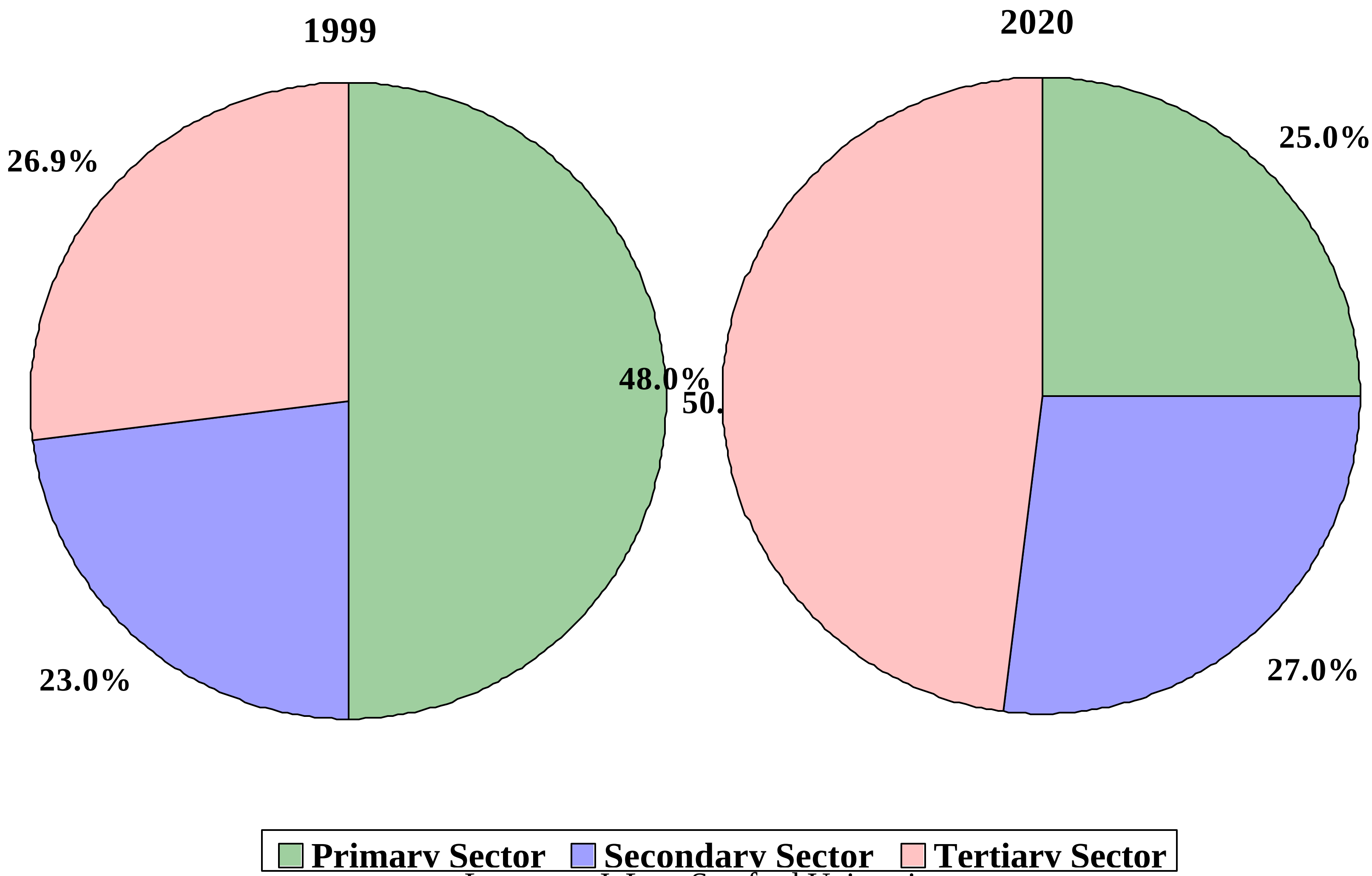
Long-Term Projections

	2001	2010	2020
		US$ (2001 prices)	
Real GDP	1.16 trilll.	2.25 trill.	4.5 trillion
Real GDP/per capita	920	1,750	3,400

The Structure of the Economy: GDP



The Structure of the Economy: Employment



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
- Housing reform has taken root in major urban centers except Beijing

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—there is an estimated 6 to 1 or even 8 to 1 ratio between the per capita GDP of the richest and poorest province/region.
- 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
- Relaxation of rural-urban migration (mostly controlled by the local authorities)
- Transfer payments from the central government
- Raising agricultural incomes
- 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

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
- Anti-dumping provisions to apply to Chinese exports for 15 years
- 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 Commitments under the WTO: Opening of Service Sectors to Foreign Investment

- International trade
- Distribution sectors—retail by foreign firms will be permitted with some exceptions (books, periodicals, pharmaceuticals and pesticides)
- Financial sectors
  - Banking—local currency business open to foreign banks in 2003; retail business open in 2006
  - Insurance—additional licensees and expansion into health and group insurance within 3 years (2004)
  - Securities—33% ownership of asset management companies, increasing to 49% in 3 years; 33% ownership in underwriters
- Telecommunication sectors—49% ownership permitted in 6 years (2007); 100% ownership permitted for internet content providers
- Transportation sectors
- Professional services
  - Foreign accountants can obtain Chinese licenses through examinations
  - Foreign legal firms may operate without restrictions to locations and number of offices within one year of accession (2002)

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 (for the U.S., in 2009; in addition, U.S. can adopt anti-surge measures for another 12 years)
- 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
  - Massive increases of imports of agricultural commodities are unlikely in the absence of long-term supply contracts because of the limited sizes of the international markets in these commodities

The Direct Economic Impacts (2): Domestic and Foreign Investment

- An increase in domestic fixed investment in anticipation of the increased trade and investment, as well as the increased competition, resulting from WTO accession.
- An increase in foreign direct investment (FDI), currently running at approximately US$45 billion annually, is expected upon WTO accession.

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

- The accession to WTO sets an implicit deadline for the reform and restructuring of the SOEs and the commercial banks
- Inefficient SOEs 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 SOEs 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 local government or to the individual workers themselves.
- Those SOEs 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" ratios.

The Direct Economic Impacts (4): 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 retain this business.
- The foreign banks are also likely to compete with the domestic Chinese 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 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 banks is higher than that of the domestic 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 banks should not disadvantage the domestic banks in terms of deposit-taking.
- Furthermore, the experience of East Asian economies also indicates that even under the freest circumstances, such as in Hong Kong, the proportion of total bank deposits taken by foreign banks is on the order of 20 percent.
- The net result is that the domestic banks will be able to maintain a significant proportion of their current domestic business.
- The competition between domestic and foreign banks may actually lead to new banking services and an overall expansion of the entire market.
- The biggest threat of foreign banks is the poaching of the existing staff of domestic banks.

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

- Reaffirmation of the resolve for the continuation and deepening of economic reform
- Permanent commitment to an open economy
- Acceleration of 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 not be able to operate under protection in the future
- The protection of intellectual property rights will spur a major investment in R&D, branding, and other forms of intangible capital
- Trade (accession to WTO) is not a zero-sum game—it is a positive-sum game—expansion of the entire market.

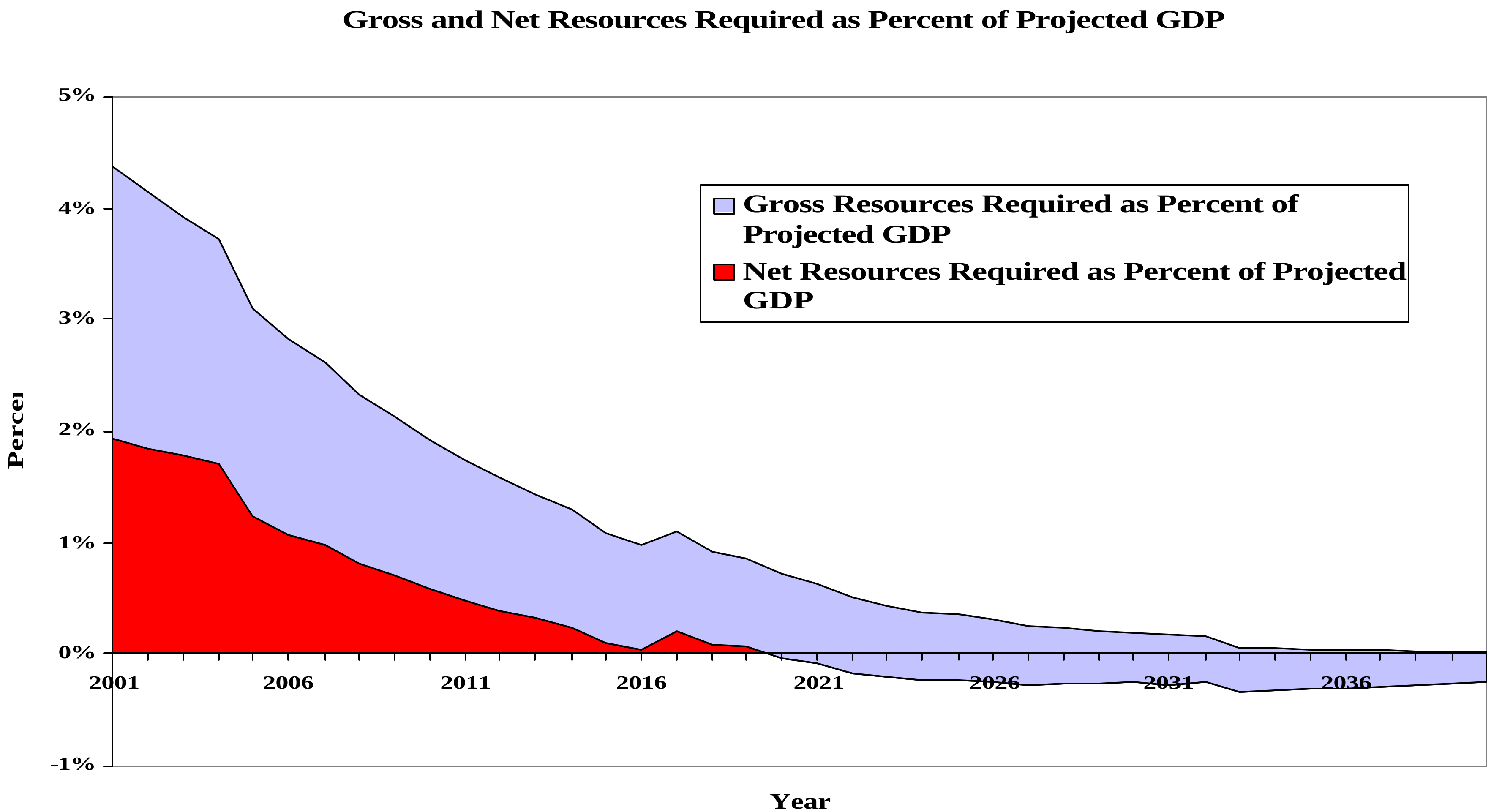
The Critical Path for Continuing Economic Reform

- In order to reform the Chinese banking sector, the NPL problem must be resolved.
- In order to resolve the NPL problem of the Chinese banks permanently, it is necessary not only to take care of the outstanding stock, but also to stop the continuing flow.
- In order to stop the flow, it is necessary to restructure the borrowers, so that they are independently viable without relying on new loans afterwards.
- In order to insure the viability of the restructured SOEs, most of the existing obligations of the SOEs must be assumed by the central and local governments, i.e., "socialized".
- Socialization of these obligations requires, in turn, the creation of a credible social safety net--a viable social security and pension system (including unemployment "insurance") to take care of both the inherited historical problems and the future--and the provision of social services by the local governments instead of the SOEs.
- Provision of social services by the provincial and local governments instead of the enterprises requires an independent source of revenue, through either the sharing of revenue with the central government, the division/sharing of tax bases, and subsidies.
- Thus, continued economic reform must start with the creation of a social safety net and the division of social responsibilities and revenue/tax base sharing/division.
- In parallel, agricultural reform should be undertaken to provide an income floor in the rural areas
- Accession to WTO reinforces the urgency of continuing 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 220 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 90 billion Yuan in 2004, compared to an estimated flow of 20 billion Yuan under the current system for the year 2000
- Taking into account the contributions of the central government should make on behalf of its current employees for the future pensions, the peak annual net additional cost of the social safety net may be estimated at approximately 200 billion Yuan in 2004 or less than 2% 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

Provision of Social Services

- Basic education (primary and secondary), public health, individual health care, and housing, for their employees and retirees and their families, are traditionally provided by the SOEs.
- In order that the SOEs can compete effectively on the market, this responsibility must be assumed by either local governments and/or the individuals themselves.
- What this implies is a reform of provincial and local public finance (a new federalism)
  - Division of the revenue bases and responsibilities between the central and local governments
  - Subsidies for provinces and local areas with low real GDP per capita
  - Expanding options for the financing of education, especially tertiary education (private universities, tuition, loan programs) and health care (private group health insurance)

Non-Performing "Loans" of the State-Owned Banks

- 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 GDP, comparable to government budget deficits in many countries
- In terms of stocks, they range from US$300 billion (People's Bank of China (PBOC)) up to US$500 billion (25-40% of GDP)
- Assuming that only 25% of the NPLs are ultimately recoverable, the bad debt provision required ranges between 20 and 30% of GDP. (Auctions for the NPL portfolios have been held successfully recently with a recovery ratio of approximately 25%.)
- The loans should be regarded as indirect loans to the central government which also owns all of the major banks, i.e. public debt
- Outstanding Chinese national debt is approximately 18% of GDP (compared to 60-70% for the United States, 120% for Japan, 75% for Zone Euro and 160% for Belgium)
- Total public debt, assuming the conversion of all non-recoverable non-performing loans into public debt, would amount to 40-50% of Chinese GDP
- Vice Minister LOU Jiwei estimated that the NPLs would raised the public debt/GDP ratio by approximately 20 percentage points.

Political Uncertainties

- 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—is unlikely to improve significantly as long as the Taiwan side does not wish to return to the "one-China" consensus of 1992
- 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

Implications for U. S. Policy: Economic Considerations

- Chinese economic growth during the next several decades will depend mostly on internal factors and be largely unaffected by the actions of either the U.S. or other countries.
- There are numerous serious problems confronting the Chinese economy—however, these problems are not intractable.
- On the margin, U.S. involvement in the Chinese economy will make some, but not a critical, difference; but it can be mutually beneficial for both the U.S. and China.
- Chinese GDP and GDP per capita will remain low relative to the United States for at least three or more decades.
- The share of Chinese GDP produced by the non-state-owned sector will rise from 65% to 80% in another decade.
- There is significant complementarity between the 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. It is this complementarity that maximizes the potential gains from free trade between the two countries.

Current Situation

- The U.S. is now the second largest trading partner of China and the second largest foreign direct investor (accounting for 11% of all FDI in 2000), after Hong Kong.
- Both trade and investment are likely to increase further, in both directions, as a result of Chinese accession to WTO.
- China is the world's fastest growing market for high-technology products such as aircraft, computers, and semi-conductors in which the U.S. has a strong competitive advantage.
- Anti-terrorism provides further common ground for U.S.-China cooperation in the near term.
- 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

Political Factors

- A steadily growing Chinese economy with reasonably widely distributed gains is a pre-condition for the internal political stability of China, which is in turn a pre-condition for durable peace and security in East Asia.
- The major sources of uncertainty in the future of China are not economic, but political. Two nightmare scenarios:
  - (1) a war (most likely in the Taiwan Strait) and
  - (2) internal fragmentation.
    - A poor and fragmented China will be a source of constant instability in East Asia and the world (e.g., it may engage in military adventurism; parts of it may become a refuge for terrorists). Domestic stability and cohesion 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 leadership succession is expected to be smooth and predictable (no surprises). A new generation of young and well-educated technocrats will be moving up to ministerial ranks.
- Rising income and wealth per capita, the continued (both relative and absolute) expansion of the non-state-owned sector, and the emergence of a middle class will help to promote expansion of civil society and pluralism, enhance political stability and predictability, and encourage moderation.
- Since 1979, there has been enormous progress in democratization and human rights in China and there will continue to be in the future, albeit probably gradually.
- By comparing China with other countries, Prof. Henry Rowen of Stanford University predicted that China would be democratized by 2015 (but this is likely to be a democracy with Chinese characteristics).

Implications for U. S. Policy: U.S. Interests

- Some have argued that it is in the interests of the United States to maintain its status as the sole super-power in the world and to prevent, if possible, the emergence of a potential challenger or rival. However, short of a war, it is unlikely that China's steady rise, backed by its growing economic strength, can be permanently blocked. (In any case, in the aftermath of such a war, great instability may ensue in China, which is probably not in the interests of the U.S. either.)
- The range of realistically feasible options is quite narrow for both sides, if war is ruled out. A mixture of constructive engagement, cooperation and containment may be a preferable strategy.
- A peaceful, secure, law-abiding and prosperous China will have little incentive to engage in weapons proliferation. A rich but open China is unlikely to be a threat to the interests of the U.S. or the world, whereas an isolated China, especially one in economic shambles (as North Korea is today) may be even more of a menace.
- It is therefore in the interests of the U.S. for China to become
  - A peaceful, secure, (international-) law-abiding, and contributing member of the international community;
  - A partner in maintaining peace and security in the world;
  - An open market for U.S. goods and services;
  - A safe and profitable destination for U.S. investments; and in time
  - A source of potential investment funds for the U.S.

Implications for U. S. Policy

- Increased exchange and economic interdependence should improve U.S.-China relations in both the short run and the long run.
- U.S. policy should be aimed at keeping China open and engaged with the rest of the world, economically, culturally, legally, and in matters of global and regional security.
- Enhanced mutual understanding and economic inter-dependence increase transparency and predictability, facilitate the peaceful settlement of disputes, and reduce the potential for confrontation and conflict.
- Engagement maximizes leverage and the potential for influencing the future course of China. In contrast, containment and isolation increase the probability of misunderstanding and misjudgment and the potential for armed conflicts.
- Conflict between the U.S. and China is not inevitable. In fact, the expectation of whether China is friend or foe of the U.S. in the long run is largely self-fulfilling. Thus U.S.-China relations must be carefully managed by both countries to prevent it from spiraling out of control.
- A peaceful, prosperous, open, and stable China is win-win for both the U.S. and China, and for the rest of the world as well.

Implications for U. S. Policy: Concrete Steps

- Enhancing economic exchange and hence economic interdependence
  - Facilitating international trade and investment, in both directions, including maintaining a level playing field and reciprocal, symmetric national treatment (e.g., open skies?); mutual protection of investment; mutual protection of intellectual property rights (e.g., reciprocal registration of patents, copyrights, and brand names)
  - Conclusion of tax treaties that provide for the elimination of double taxation, mutual exchange of financial, tax; and customs information
  - Conclusion of extradition treaties that cover economic crimes
  - Formation of bi-national commission(s) for the maintaining a dialogue and possibly working towards a resolution of difficult and sensitive issues
- Cooperation in law enforcement and anti-terrorism
- Depoliticization of commercial and trade disputes through reliance on multilateral or bilateral legal dispute settlement mechanisms such as the WTO
- Increasing mutual understanding and goodwill at all levels of society
  - Facilitation of exchanges and visits in both directions
  - Training of students, business executives and government officials—the future leaders of China
  - Providing technical assistance on systems of taxation, prudential regulation and supervision, customs administration, court administration, etc.
- Setting an example by actually doing what the U.S. preaches (e.g., free trade, adherence to treaties, compliance with international law, protection of civil liberties). In the long run, it is not military might, but winning the hearts and minds that count.