The State of the Chinese Economy: A View from Outside

Lawrence J. Lau, Ph. D.

Kwoh-Ting Li Professor of Economic Development

Department of Economics

Senior Fellow

Institute for International Studies

Stanford University

Stanford, CA 94305-6072, U.S.A.

May 2000

Phone: 1-650-723-3708; Fax: 1-650-723-7145

Email: ljlau@stanford.edu; Website: www.stanford.edu/~ljlau

Questions:

- Short-Term Outlook
  - How robust is Chinese economic growth?
  - Will its financial sector collapse?
- Medium-Term Outlook
  - What are the effects of Chinese accession to the World Trade Organization (WTO)?
  - What is the critical path of continued Chinese economic reform?
  - What are the sources of growth of aggregate demand?
- Long-Term Outlook
  - Three paradigms of economic growth

The Chinese Economy Today (1)

- East Asia is the fastest-growing region in the world over the past two decades, the East Asian currency crisis of 1997-1998 notwithstanding
- China is the fastest growing country in East Asia—10% p.a. since beginning of economic reform (1979)
- China is one of the very few socialist countries that have made a successful economic transition from a centrally planned to a market economy

The Chinese Economy Today (2)

	1979	1999
	US$ (1999 prices)	
Real GDP	172 bill.	991 bill.
Real GDP per capita	178	800

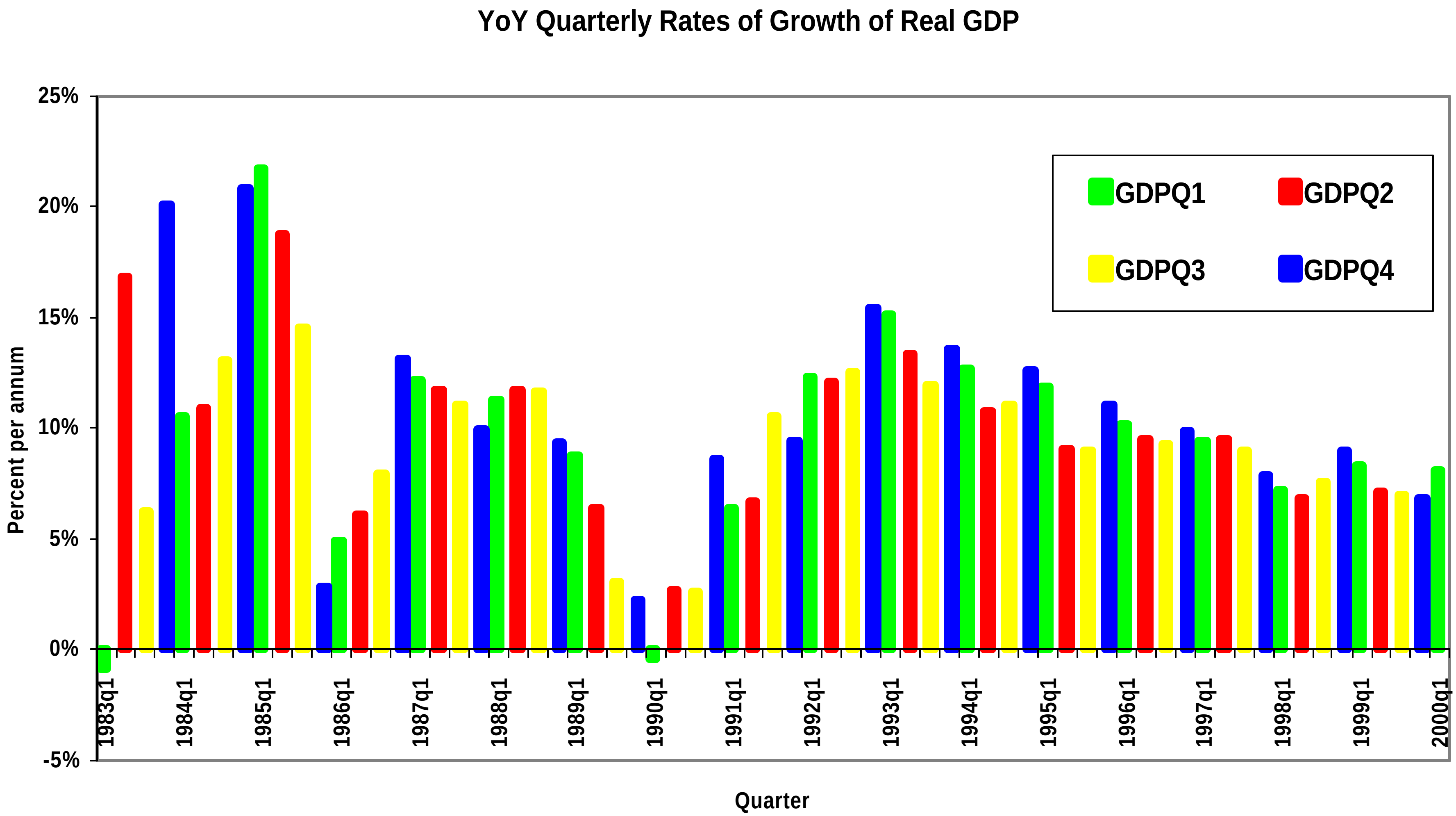
The Chinese Economy Today (3)

	U.S.	China
	US$ (current prices)	
1999 GDP	9,248 bill.	991 bill.
1999 GDP per capita	33,857	800

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

Year	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(proj.)	6.0			(ADB)
	7.5		0.5	(Lau)

YoY Quarterly Rates of Growth of Real GDP



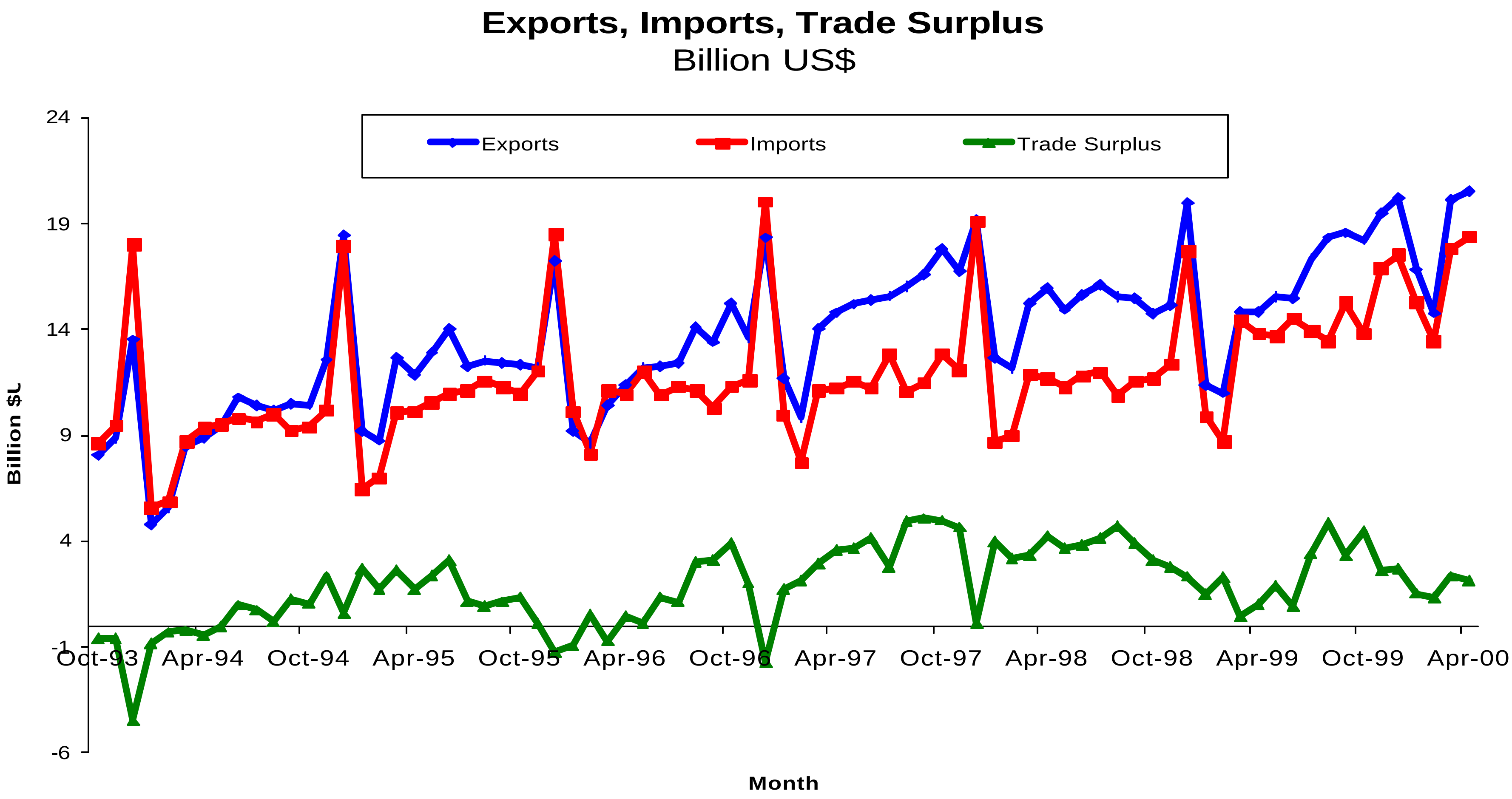
Has Deflation Stopped?

- In Jan-Jun/1999, the consumer price index (CPI) declined 1.8% YoY; In Jan-Dec/1999 the CPI declined 1.4%, while in Jan-Mar/2000 it increased 0.1%.
- The long-term core inflation rate--inflation rate net of changes in the prices of energy and food--may be estimated at 0.5-1.0%--there is no deflation

Is There Sufficient Aggregate Demand?

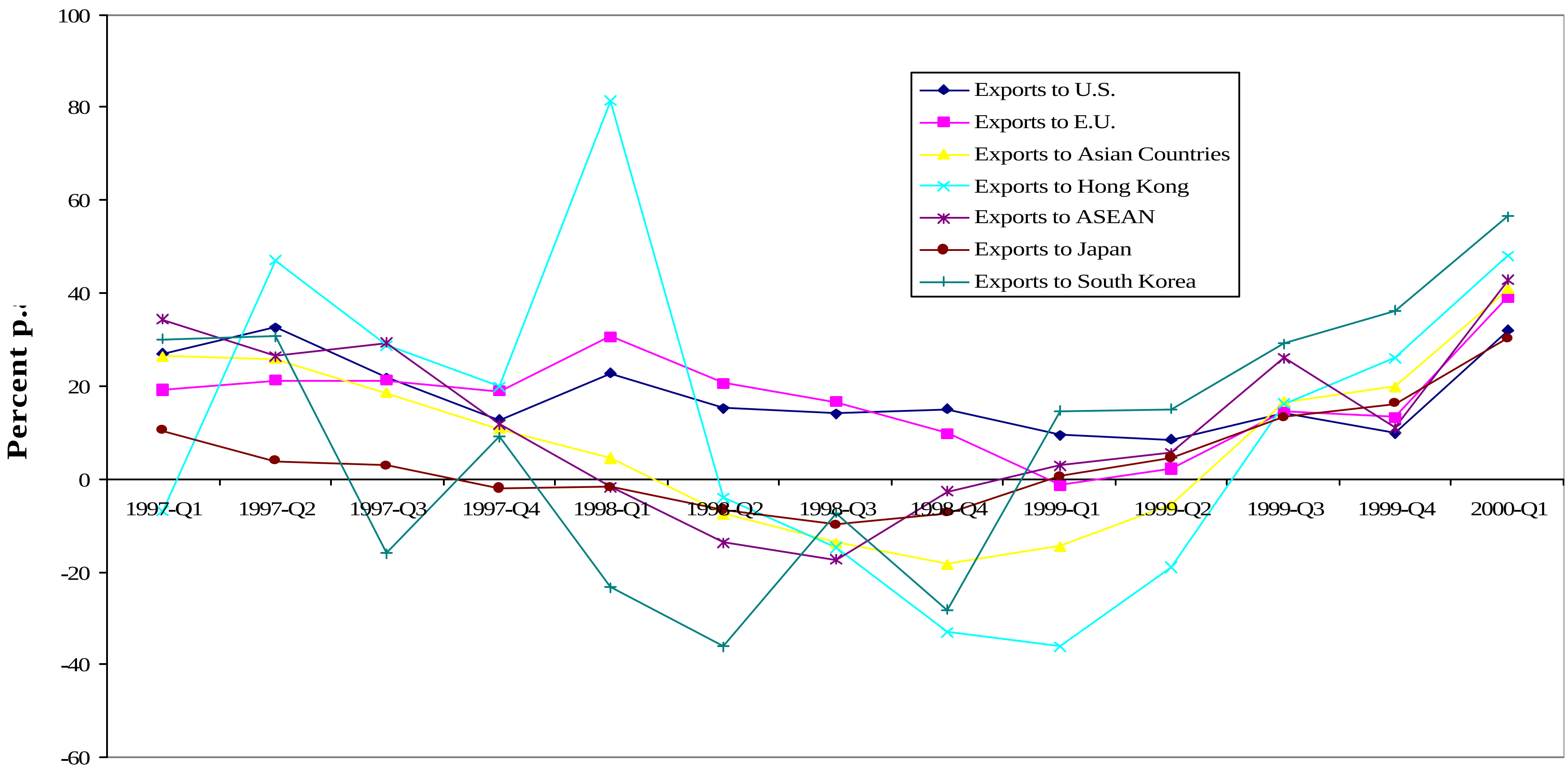
- International Trade
  - Aggregate exports rose 6.1% in 1999 and 39.1% in 1Q/2000; the increase is mostly attributable to the revival in exports to some of the affected East Asian economies (such as South Korea and Thailand) and Japan and continued strong growth in exports to U.S. and Europe
  - Aggregate imports rose 18.2% in 1999 and 41% in 1Q/2000, due to the replacement of smuggled imports as well as more robust domestic growth

Monthly Exports, Imports and Trade Balance Official Chinese Data

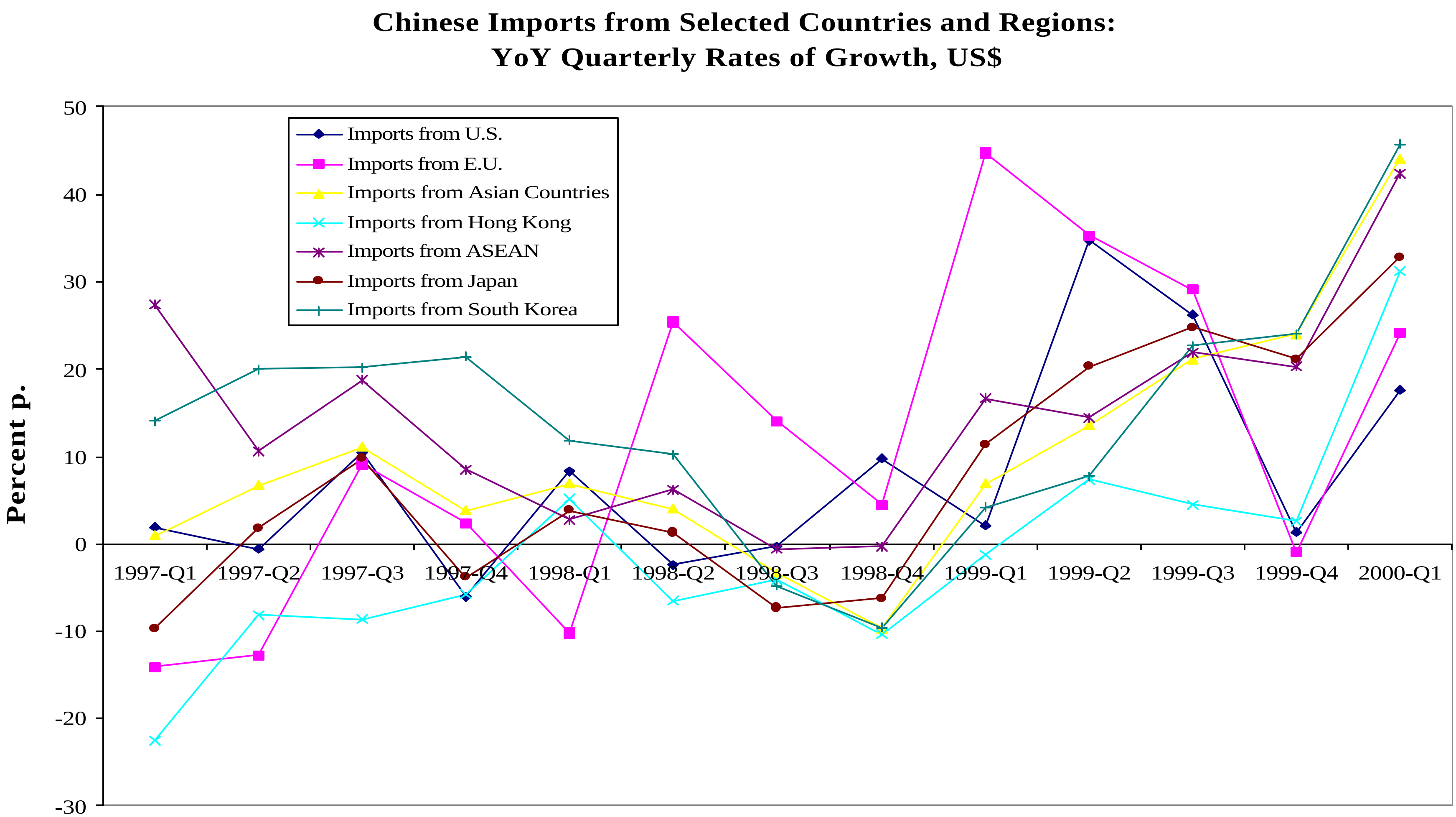


Growth Rates of Exports to Selected Trading Partners: Official Chinese Data

Chinese Exports to Selected Countries and Regions: YoY Quarterly Rates of Growth, US$



Growth Rates of Imports from Selected Trading Partners: Official Chinese Data



Is There Sufficient Aggregate Demand?

- Foreign Direct Investment
  - FDI arrivals totaled US$40.39 billion in 1999, an 11% decline from 1998--however, the sources of the FDI were different--real FDI probably rose if "round-tripped" capital were excluded
  - FDI commitments amounted to US$41.24 billion in 1999, a decline of 20.9%
  - FDI arrivals declined 12.4% whereas FDI commitments rose 13.5% in Jan-Feb/2000
  - The nature of FDI has also changed--from export-oriented to domestically oriented; from light industry to heavy and high-technology industries, and from small projects to large projects
- Collateralized loan program as a natural hedge for foreign direct investors
- Initial public offerings (IPOs) and listings on Chinese stock exchanges as an exit strategy for foreign direct investors

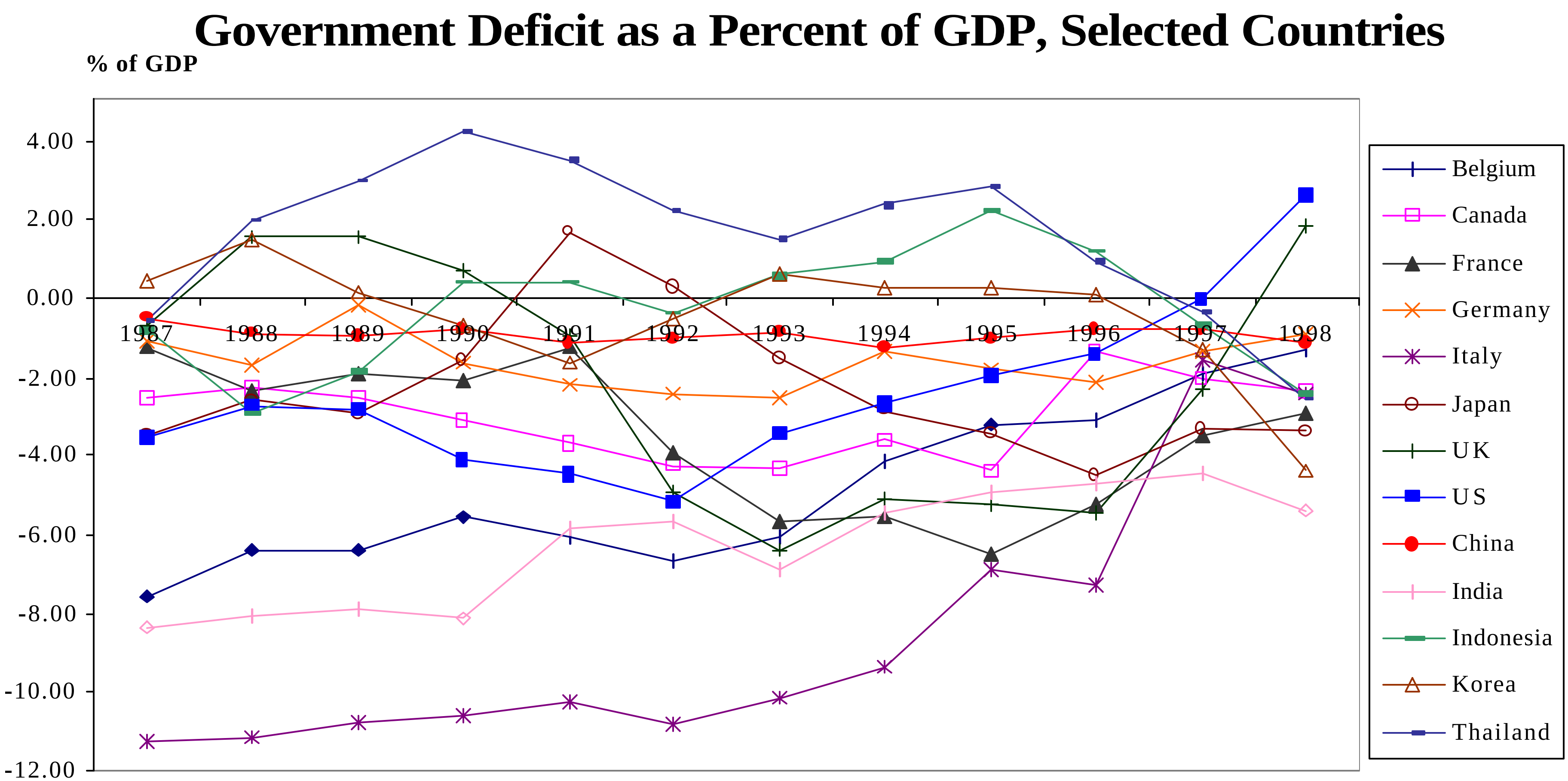
Non-Performing "Loans" of the State-Owned Banks (1)

- Borrowers are all state-owned enterprises (SOEs)
- Non-performance is not a surprise
- In terms of flows, they amount to 2-3% of GNP, comparable to budget deficits in many countries
- In terms of stocks, they amount to approximately US$200 billion or 20-30% of GNP--according to People's Bank of China (PBOC), 20%; according to rating agencies, at least 25%
- Ultimately non-recoverable non-performing loans has been estimated to be on the order of 6-7% of all outstanding loans by PBOC, or up to 15% by non-government analysts, e.g., Moody's Investors Service estimated the total cost of cleaning up bad loans to be US$120.8 billion in 8/1999, or 12.5% of Chinese GDP
- The loans should be regarded as indirect loans to the central government which also owns all of the major banks, I.e. public debt

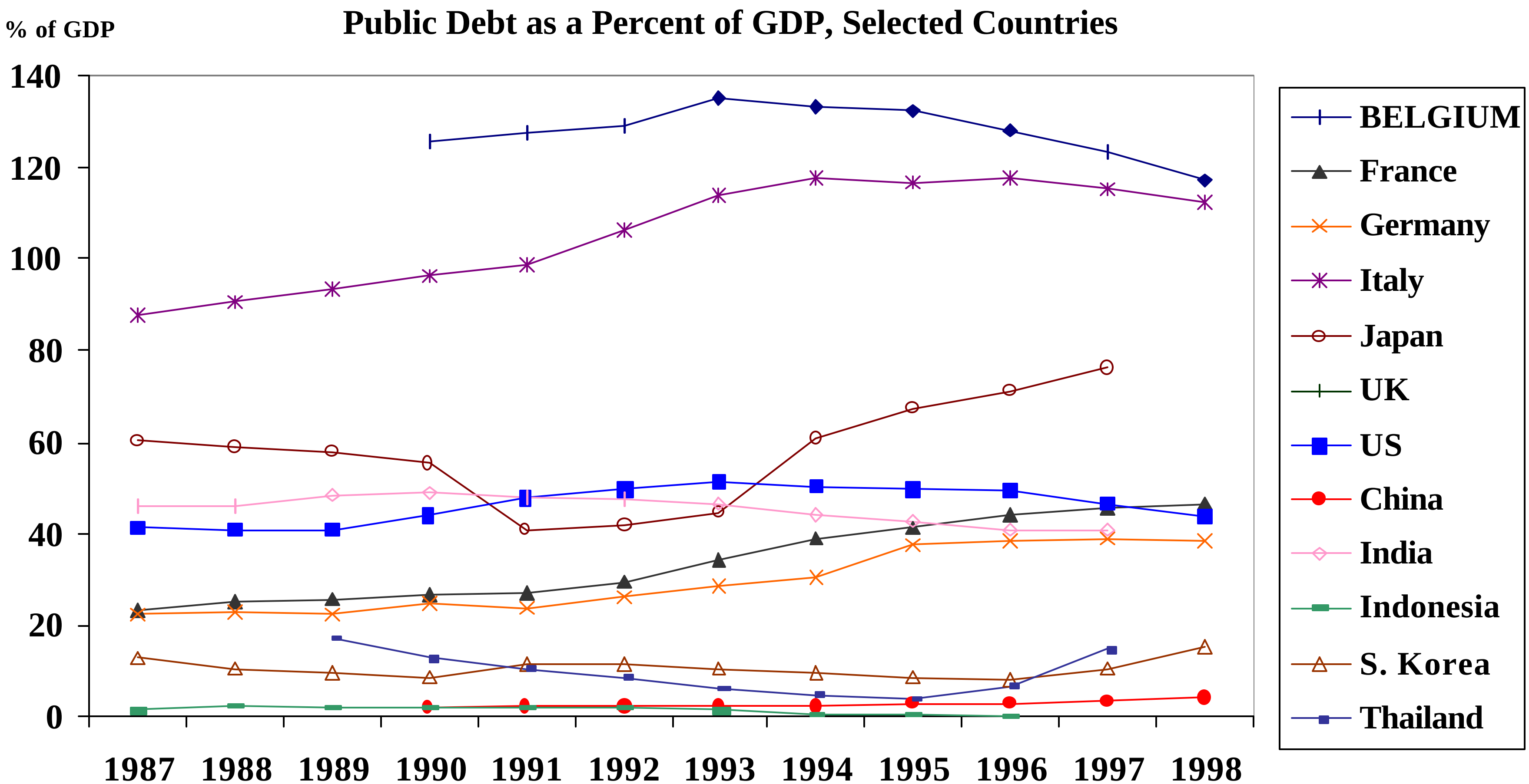
Non-Performing “Loans” of the State-Owned Banks (2)

- Outstanding Chinese national debt is approximately 15% of GNP (compared to 70% for the United States, 100% for Japan, 75% for Zone Euro and 120% for Belgium)
- Non-performing loans can be approximately divided into three parts
  - Loans to traditional old-line industrial enterprises
  - Loans to enterprises established during the mid-1980s in lieu of a founding equity
  - Loans contracted during the over-heated period in the early 1990s
- Rollovers (appropriately camouflaged) of these non-performing loans since 1994
- Permanent resolution depends on reform of the SOEs
- The banks will never be allowed to fail in a way that hurts the depositors--implicit deposit insurance

Government Deficit as a Percent of GDP--Selected Countries



The Stock of Public Debt as a Percent of GDP--Selected Countries



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

- The government is committed to an “open-door” policy and national treatment for foreign direct investors--a “level playing field” for all, including domestic non-state-owned enterprises
- Immediate impact small but change in long-term expectations
  - FDI should rise, especially in the services sector--distribution, finance, and telecommunication
  - Exports and imports should rise moderately in the short and intermediate term
  - More trade in intermediate goods
  - Tariff reductions from 22% to 17% on average
  - A deadline for reform of the state-owned enterprises and the banking sector
- Signaling effect
  - Reform and open-door policies are on track
  - U.S.-China relations are on the mend

China and the World Trade Organization (WTO) (2)

- Long-term benefits include:
  - A permanent commitment to an openness and a lock-in to the global economy
  - Insurance for domestic economic efficiency through open global competition--inefficient domestic monopolies will no longer be protected
- Current Chinese exports are mostly carried out by non-state-owned enterprises--a rupture of U.S.-China trade will not hurt the state-owned enterprises but instead those who have benefited the most from liberalization
- "Permanent Normal Trade Relations" is a must--neither China nor the U.S. can afford a failure--an indicator of intent

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

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

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

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

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
- Assumption of non-performing loans by another government-sponsored entity (like the Resolution Trust Corporation of the United States)
  - China Construction Bank is the first of the four major commercial banks to set up an asset management company, CINDA, to restructure its non-performing loans
  - Other management companies formed are Great Wall (Agricultural Bank of China), Dongfang (Bank of China) and Huarong (Industrial and Commercial Bank of China)

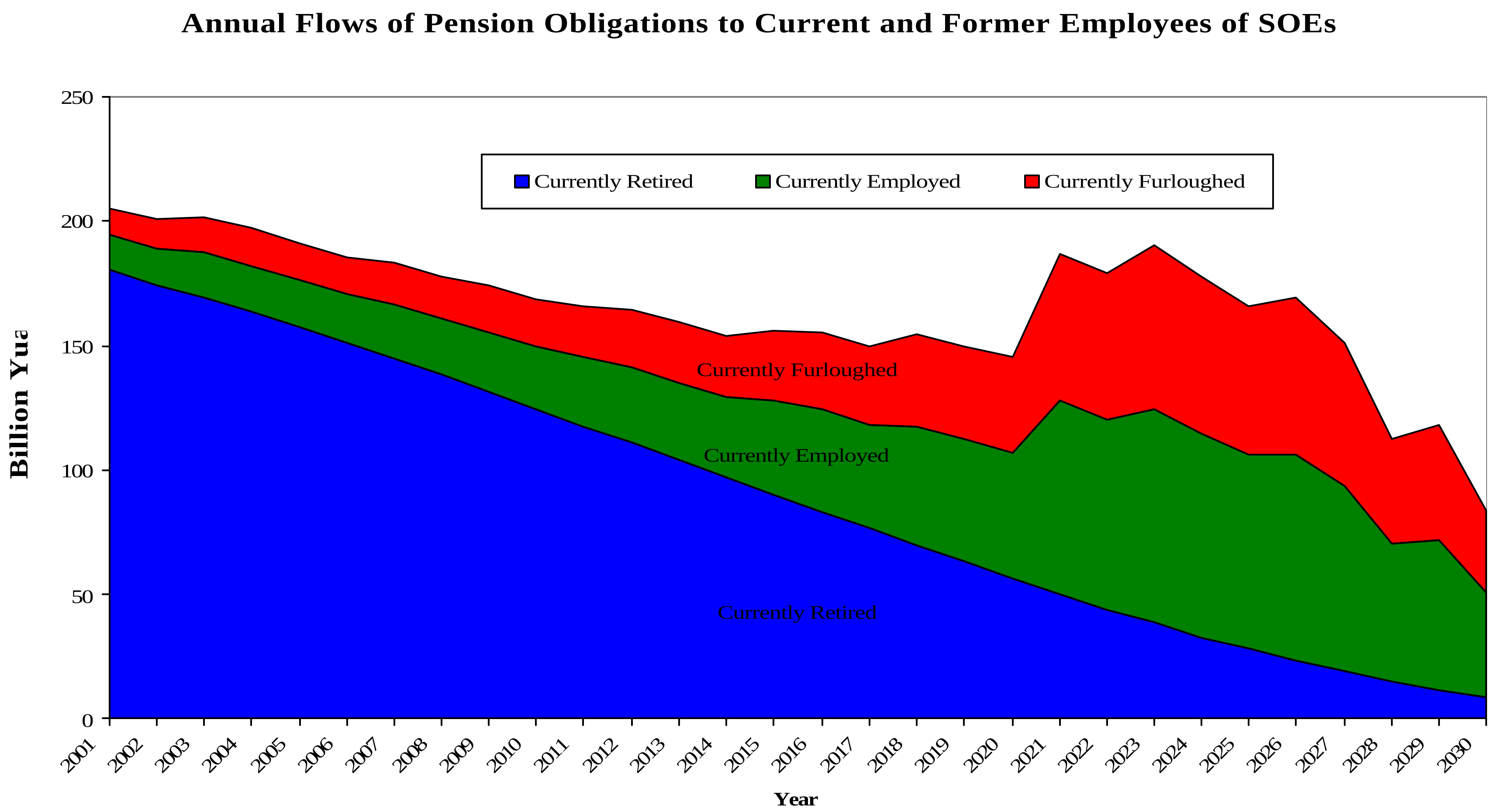
Restructuring of the Non-Performing Loans/Policy Loans (2)

- Restructuring to be followed by recapitalization
- Reform of the SOEs is essential for the long-term success of banking reform

The Establishment of a Social Safety Net

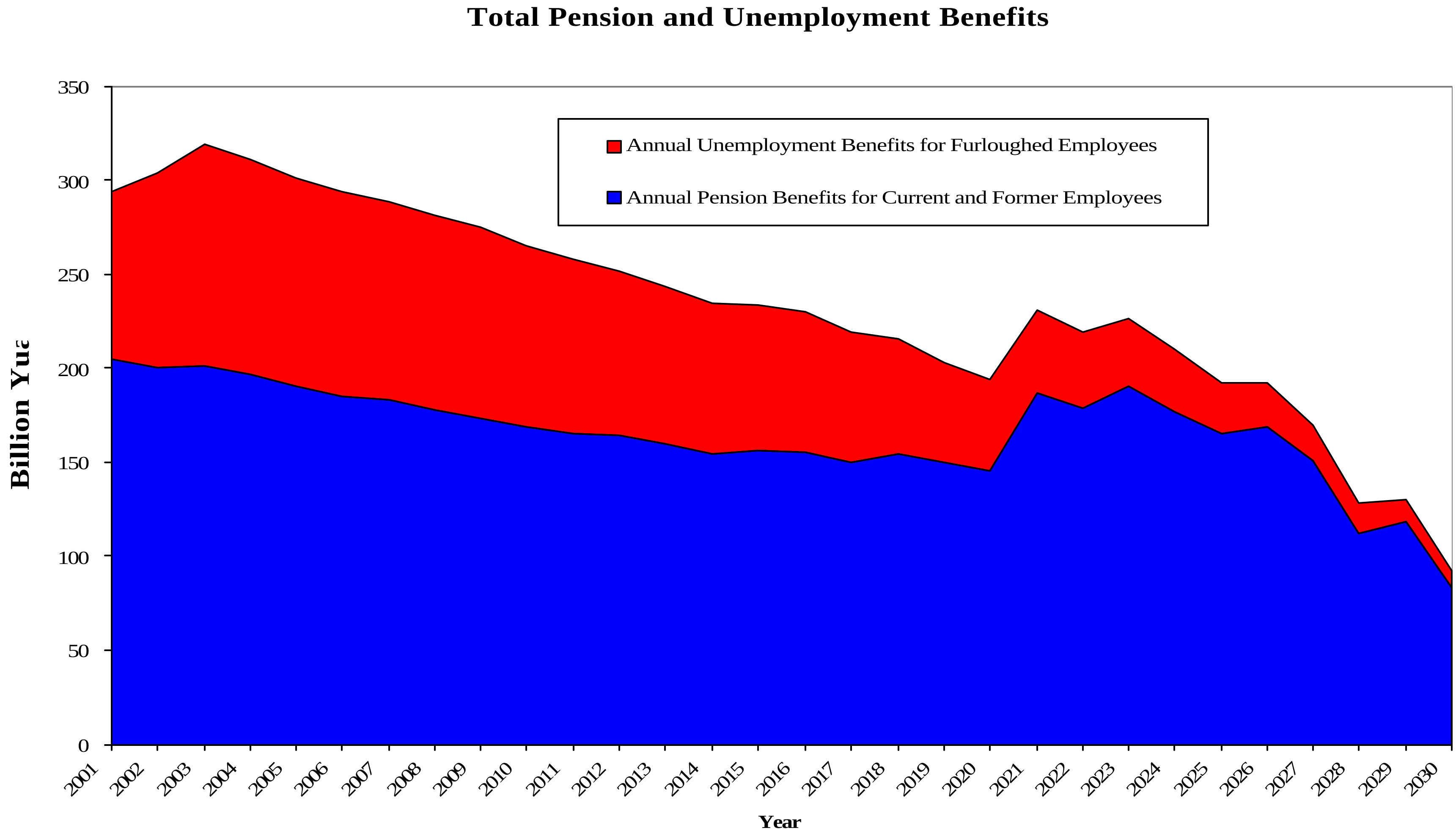
- Assumption of current and future unfunded pension liabilities of the SOEs
- Provision of unemployment "insurance" for the redundant employees of the SOEs
- Provision of social services such as education and health care by the local governments

The Annual Flows of Resources Required for Pension Obligations



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

Total Annual Cost of Pension and Unemployment Obligations



The Estimated Cost of the Social Safety Net

- The peak annual flow of unfunded pension obligations may be estimated at 200 billion Yuan, compared to an estimated flow of 208 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 118 billion Yuan in 2003
- The net additional annual flow of the cost of the social safety net may be estimated at no more than 110 billion Yuan or approximately 1.1% of projected GDP
- The stock of unfunded pension obligations may be estimated at 2.9 trillion Yuan compared to a current GDP of 9 trillion Yuan

Sources of Growth of Aggregate Demand (1)

- The need to turn around expectations--to get enterprises to invest and households to consume again
- The importance of limiting unemployment and creating jobs--10 million new workers enter the labor force each year
- Preserving social stability--a policy of "no losers"--at least "no immediate losers"
- Establishment of a "social safety net"
- Economic growth and economic reform are complementary--one cannot run ahead of the other

Sources of Growth of Aggregate Demand (2) Infrastructural Investment

- Infrastructural investment (US$750 billion-1.2 trillion within the period 1998-2001)
- Infrastructural investment projects include roads and highways, railways, telecommunications networks, irrigation and water conservancy facilities, ecological projects such as reforestation, urban infrastructure such as mass transit systems, environmental protection, urban and rural electricity networks, urban mass transit
- Development of the Central and Western Regions

Sources of Growth of Aggregate Demand (3) Affordable Owner-Occupied Housing

- 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

Sources of Growth of Aggregate Demand (4) 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

Long-Term Economic Outlook

- A relative abundance of natural resources
- A potentially huge domestic market (Economies of Scale and "Coordination Externalities")
- An almost unlimited supply of surplus labor
- A high domestic saving rate of 35-40%
- A cultural preference for education
- The agricultural sector has been performing well
- Existing and expected fiscal reforms should reduce structural government deficit

Three Paradigms of Economic Growth

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

Long-Term Projections

	1999	2010	2020
	US$ (1999 prices)		
Real GDP	991 bill.	2.5 trill.	5 trillion
Real GDP/per capita	800	1,800	3,500