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CHINA

MACROECONOMIC UPDATE

Current Developments

Background

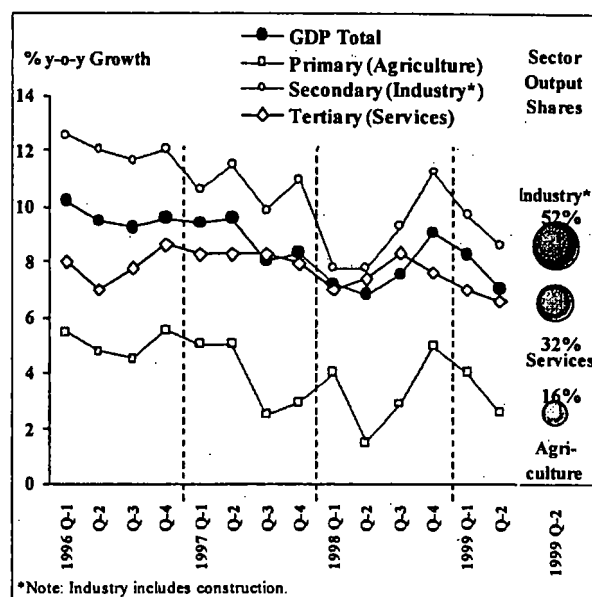
At 7-8% per year, China's GDP growth rate is still high, but the long-term slowdown in economic activity is continuing. The restructuring of employment away from the primary towards the secondary and tertiary sectors seems to have paused during 1998. Last year's fiscal stimulus package appears to have been less expansionary than expected. China's overall price declines are, if anything, strengthening.

Faltering external demand has contributed to the current slowdown, but domestic demand weakness and structural factors are dominant. Weak household demand, especially in China's large rural economy, has been serious for several years. Underlying these trends, urban layoffs and policy-induced uncertainties over future housing, education, healthcare, insurance and retirement costs are discouraging consumption. However, a new structural element is rising to prominence—service-sector output is lagging behind demand. Household spending on services is increasing much faster than for goods. During 1996-98, services spending shares rose from 28% to 36% for urban households, and from 29% to 35% for rural consumers. In contrast to falling industrial prices, services prices have been firm or rising. China may be facing a new element in its twin transitions (planning to markets, agriculture to industry/services)—surpluses and excess capacity in primary and secondary production sectors, and shortages in the tertiary sector.

Trends

As far as the health of the economy is concerned, economic indicators appear to have worsened in July, the most recent period for which data are available. After an apparent recovery at the end of 1998 to 9.1 percent, GDP growth slowed in the second quarter to 7.1 percent (see Figure 1). Most strikingly, the year-on-year growth rate of investment dropped from 23 percent in the first quarter to 3 percent in July. Industrial growth remained essentially unchanged in July at 9.3 percent, compared to 9.4 percent in the first half of the year, supported chiefly by a surge in exports and textile production.

Figure 1. China Quarterly GDP Growth Rates, 1996-99



Source: National Bureau of Statistics Data and World Bank staff calculations.

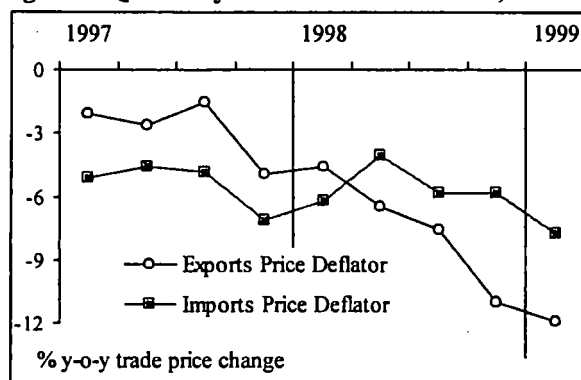
Prices have continued to fall, whether measured year-on-year or month-on-month with seasonal adjustments. The most robust price measures are GDP deflators, which show that falling prices reached their lowest levels in second-quarter 1999. Industrial prices are falling the fastest, and of these, prices for SOE output (down 15%) have dropped significantly faster than non-SOE prices (down 2 percent). Many domestic prices are affected by falling trade prices. Export prices were down nearly 12 percent on average by early 1999, while the prices of imported goods were down more than 7 percent (see Figure 2)¹. SOEs (who are the most heavily engaged in international trade) and in the globally competitive sectors such as textiles, clothing,

¹ Many specialists question the accuracy of official growth data, suggesting that this figure is over-stated by several percentage points. Despite this, and although there are some contradictory signs from economic indicators (e.g., power consumption is up), most signs point to a brief recovery late in 1998 and renewed economic slowdown this year.

consumer electronics, and electronic machinery have seen the largest domestic price drops outside of agriculture.

Financial sector weaknesses continue to be of concern. New bank lending has grown much more slowly in 1999. During January-July it was only 5.3 percent higher than during the same period last year. This reflects the weak growth of investment as well as increased prudence on the part of the four state banks that dominate the banking system. Reserve money growth has also slowed since last year, reflecting both the slower overall lending in the economy and a small decline in net foreign assets. Despite direct government borrowing in 1998 and 1999 intended to mop-up liquidity while supporting the continuing fiscal stimulus program, the banking system's reserves continue to climb, as term deposits rose sharply. In July, M2 was up 15.7 percent year-on-year; however, the January-July increase was 30.5 percent larger than the corresponding period last year.

Figure 2. Quarterly Trade Price Deflators, 1997-99



Source: China Customs Administration.

The trade surplus declined by 65 percent to US\$7.95 billion for the first half of 1999. The strength of net external demand is one of the greatest uncertainties China currently faces. Although July exports (up 7.5 percent year-on-year) responded to increased rebates in value-added taxes, nominal exports for the first seven months of the year are down by 2.8 percent. The decline was due primarily to decreases in external demand rather than a loss of competitiveness. In fact, Chinese export growth has matched the overall import growth trends in five key markets (US, EU, Japan, ASEAN and Korea). China has retained market share in most major export products, although there are some signs of deteriorating competitiveness in textiles and in metals such as steel, aluminum and copper. Nominal imports for the first seven months are up 16 percent. In the absence of reliable estimates of formerly-smuggled goods, it is difficult to match the import trends to other developments in the economy.¹

¹ Despite falling import prices and a 16.6 percent increase in total imports, customs revenues soared by 117 percent in the

The decline in China's trade surplus has accompanied other adverse trends. Inflows of FDI are still large, but have slumped significantly in the first seven months of 1999. FDI through July was down about 10 percent. New commitments for the future were down even more through July, dropping 20.5 percent year-on-year. Likely causes are the weakening trends in domestic demand, concern over China's WTO entry, and market uncertainty about China's plans for the Renminbi exchange rate. With regard to the last of these, China's real effective exchange rate (IMF-method) has returned to levels from before the onset of the July 1997 Asian crisis. Indeed, despite the real appreciation of the Renminbi against the currencies of a few of the crisis-hit competitors who have suffered massive devaluation and real wage cuts (e.g., Korea), China continues to maintain or expand its share in the relevant markets. Two weeks ago, the Government reiterated its commitment to a stable exchange rate.

Policy Implementation and Assessment

Background

China's policy response to these developments has targeted both causes and symptoms. The main policy is a program of deficit-financed fiscal expenditures social safety nets, infrastructure and civil-servant wage increases. Such a program appears fiscally sustainable for at least several years. Begun in 1998, the program slowed in the first half of 1999 but is set to expand significantly in the remaining months of the year. Other policies attempt to curb falling prices, stimulate household consumption, and promote exports. Overall, the policy mix is well balanced and supports market reforms, although a few steps introduce quick fixes which, if institutionalized, risk slowing reforms in the medium term.

Renewed Fiscal Stimulus

China is clearly on the path of a strong deficit-financed stimulus program, and even if contingent liabilities for public pensions and non-performing state bank loans are included, in the short term the budget can sustain such a deficit-based spending program. The central government budget deficit is currently expected to be just above 3 percent of GDP (IMF definition), with interest payments accounting for 38% of the deficit. Clearly, despite the room for maneuver that exists today, the interest burden will have to be monitored closely. At end-August, China's Congress formally passed a resolution to borrow an additional RMB 60 billion tranche of this program (0.7 percent of GDP) in treasury bonds, with the proceeds to be split between the central government and local governments. Depending on economic results in the third quarter, the deficit could be even larger than currently anticipated.

first half, to reach US\$9.44 billion. The surge in customs revenues suggests that the crackdown on smuggling has been successful and may account for a large part of the increases in imports.

In light of weakening domestic demand and uncertainty regarding net exports and domestic consumption, the government's increased deficit-funded stimulus program is appropriate. Maintaining relatively rapid GDP growth also contributes to a range of structural reforms. Slower growth in the near term would jeopardize SOE labor reallocation, further compromise the quality of bank assets facing restructuring, and weaken household purchasing power, just as reforms are attempting to shift housing, medical care, education and pensions in more market-oriented directions.

Diversifying the structure of outlays beyond infrastructure to include increases in civil service pay and social safety net outlays is a welcome trend, in particular because it also targets the lowest-income urban households and hence has poverty-reduction significance. The stimulus program needs to be careful not to undermine on-going structural reforms, especially reforms in state-owned enterprises and banks. In particular, fiscal outlays to subsidize interest payments on loans for enterprise technical upgrading (currently targeted at roughly 0.2 percent of GDP) need careful scrutiny to make sure they go to qualified enterprises. Because most of the stimulus spending should go to support final demand rather than subsidizing imports, the likelihood is good that reform compromises will be minimal.

Falling Prices Prompt Administrative Measures

China's various efforts to use administrative means to counter falling prices for SOE products cannot work for long. The best such policies can hope to accomplish is temporarily to weaken the pressure on SOE profits until prices begin to rise once more. Two of China's best known anti-deflation steps have been prosecuting enterprises selling at below cost and restricting approvals for new capacity in glutted product lines. Both policies have been strengthened in recent months. Government indirectly began setting floor prices in 1998 by authorizing local government and industrial organizations to monitor prices and report those which might be below cost. China's Price Law forbids such sales, and China's planning commission issued detailed regulations this summer strengthening inspections and related record-keeping.

The second policy has been to refuse authorization for investment in new capacity for a range of manufacturing sectors. This policy was stepped up effective September 1, as government announced a list of specific products for which new-capacity investments would not be approved. Such measures benefit existing producers, the majority of which are SOEs, because they can still get authorization--and perhaps subsidies--to modernize existing capacity.

Overall, these policies are difficult to defend from a market reform perspective, because they protect weak competitors at the expense of potentially more efficient producers. However, government argues that since many SOEs have lax governance, they will cut prices quickly to maintain market share, unconcerned about loss of profitability. Also,

from a welfare economics perspective, to the degree that these price support measures absorb the impact of bankruptcies, restructuring, and layoffs, without unduly postponing reforms, they may usefully govern the risk of social disruption from too-rapid reforms. This latter perspective also explains official justification. But to the degree that protection of SOEs is intended to perpetuate them as protected revenue sources for government owners, these policies risk undermining reforms. At present, competitive pressures on many SOEs are intense, and these policies appear not to threaten on-going reforms and related hardening budget constraints.

Weak Rural Consumption

China's policies to promote consumption are mostly targeted at the urban population. They include programs to promote consumer credit, relaxed regulations on housing purchases, lower interest rates to discourage postponement of purchases, and planned budget outlays to increase civil servant wages, urban unemployment and welfare benefits, and benefits for those in urban reemployment centers. By and large, these are laudable policy programs. For rural households, however, there is very little in the way of direct policy programs, aside from the overall fiscal stimulus program, which has a large component for rural infrastructure.

For consumption in rural China, overall agricultural policies are dominant. China's agriculture is characterized by national grain policies that monopolize procurement and wholesale operations. Basic policies also indirectly encourage grain planting at the expense of more remunerative crops.

In August, government published a set of agricultural strategy "Suggestions," based on more general decisions nearly a year ago. The thrust of the strategy is to restructure farm output to improve regional specialization and strengthen incentives for high-quality products. However, the "Suggestions," largely promote mechanisms allowing rural transactions to mimic trends a market might generate, without however leaving results up to the market itself. For example, the "Suggestions" recommend using preferential tax policies and administrative price adjustments to discourage low quality grain output. The "Suggestions" also promote investment in 'production base' installations like those which subsidize production of non-staple foods for most major metropolitan areas, and they call for strengthened 'management' of competitive imports, including a further crackdown on smuggling.

In sum, government is taking an extremely careful approach to the strengthening of market forces in agriculture, and these should eventually improve farm income and consumption growth. The overall policy direction is toward market-like solutions. In the past, cycles of more rapid liberalization have generally resulted in output and price instability, as well as acceleration of rural-to-urban migration. However, rigid administrative controls have

clearly over-corrected for these risks. Hopefully the government's "Suggestions" will promote a more rapid restructuring of rural output and prices in market-friendly directions.

Developments to Watch

The current macroeconomic strategy and policy program is a complex approach supporting growth, poverty reduction, domestic structural reforms and global commercial integration. In general, the main approach is a good one. However, the institutional complexity of China's inherited quasi-market system also requires an emphasis on social and economic stability, resulting in a range of supplementary quick-fix measures. Several new measures are under consideration or have been announced but not yet implemented, for example, a withholding tax on interest earned on bank deposits. They will be assessed in forthcoming quarterly briefs. Meanwhile, the following developments deserve close monitoring:

- *Agreement on China's WTO accession.* Accession would strongly assist reforms and external balances.
- *Export growth and foreign exchange balances.* Deterioration in either case would make policy choices more difficult.
- *Growth of non-state investment.* In past growth recoveries, an initial surge of state-sector investment was followed by a demand-driven non-state investment surge. Such a trend would signal sustained growth recovery.
- *Social safety net spending.* The impact of these on disadvantaged groups as well as on consumer psychology and spending will be an important indicator for the design of future stimulus packages.

Bank Instruments

The strong efforts made by both China and Bank staff on project implementation is showing up in the improved quality of the project portfolio, and in other quality related areas such as processing times, timely audits and improved monitoring. The issue of social sector lending with higher-cost Bank funds (that is, post-IDA) is still unresolved, although some progress has been made in developing options. The total project delivery program is on target, but represents a decline in both number of projects and total funding commitments from last year's exceptionally high level. Moreover, there has been a withdrawal of several projects from the pipeline for self-funding under the Government's stimulus program.

The Bank's analytical activity has been well-received, and generally supports the measured but strong reform program of the Government. It includes \$6 million in ASEM- and PHRD-funded TA activities for financial system, corporate sector and social protection reforms. The Bank is engaged,

in policy studies and five TA projects in these areas. (See Financial Sector, Corporate Sector and Social Updates for details.) Under the direction of the Chinese government, which continues to show strong commitment to a broad range of capacity building and institutional reform activities in the field of economic management, improved arrangements are being worked out to draw upon the strengths of the various partners. This is seen most clearly in the area of public sector management, where OECD, ADB and IMF activities will be better coordinated with those of the Bank.

Please see Economic Indicators at the end of this brief.

FINANCIAL UPDATE

Current Developments

Banking

Taxation of Bank Deposit Interest Income

In an effort to boost consumption and divert some of the vast pool of bank deposits into China's stock and bond markets, on September 1, the 1993 Law on Personal Income Tax was amended to permit taxation of interest income from bank deposits, which is exempt so far. The bill provides for progressive taxation after the requirement for real names is introduced. A sizeable portion of bank deposits is currently held under fictitious names. A maximum tax rate of 20% tax is expected.

Resolution of Non-Performing Loans

In July, the State Council approved three new asset management corporations (the Huarong AMC for the Industrial and Commercial Bank of China, the Dongfang AMC for Bank of China, and the Changcheng AMC for the Agricultural Bank of China).

Cinda AMC was formed in April, and capitalized at RMB10 billion, with the task of disposal of some of the NPLs of China Construction Bank. Initially, certain NPLs from the 1994-96 period, corresponding to the period between the formation of policy banks and the intended commercialization of state banks, are to be transferred at face value. Moody's estimated that the losses from NPLs of the four state banks could "easily reach" RMB 1 trillion (US\$120 billion), or 12% of China's 1998 GDP. Cinda has taken a controlling 44% share in Xinjiang Hongyuan Trust and Investment Company, which may improve its capacity to access capital markets and execute debt-equity swaps.

Relaxation of Controls on Foreign Banks

Several initiatives were taken to relax the controls over foreign bank operations. PBC introduced new regulations on RMB lending against foreign currency deposits by foreign banks w.e.f. July 15. The new regulations simplify foreign debt registration procedures; drop the specific credit rating requirements for offshore foreign bank guarantors; expand foreign currency collateral sources; allow this type of RMB loans to be made for working capital and fixed investment; and extend the maximum loan maturity to five years. Foreign banks licensed to do RMB business in Shanghai are now allowed to conduct RMB business in Jiangsu and Zhejiang provinces and the 6 licensed for RMB business in Shenzhen had been allowed into Guangdong, Guangxi and Hunan. However, these banks are still required to confine their business to foreign funded companies. The cap on RMB-denominated liabilities of foreign banks to their foreign exchange liabilities is raised to 50% from 35%. The cap on foreign banks' interbank borrowing with maturity of more than seven days was abolished on July 17, 1999.

Non-Bank Financial Institutions

Dalian International Trust and Investment Corporation (DITIC) announced plans to merge with other trust firms in the city. The merger is consistent with official desire to consolidate the troubled ITIC sector following the collapse of the giant Guangdong International Trust and Investment Corp (GITIC) last year. The number of ITICs is expected to fall to 70 or 80 from more than 200 through mergers and closures.

Capital Markets and Non-Bank Financial Institutions

Stock Markets Bull Run Ended

Starting mid-May, China has boosted stock markets through media encouragement, permitting brokerages to raise capital and invest in the market, and hinting at taxation of bank deposit interest income. Other longer term measures that may help improve market fundamentals include more market-based determination of issuance prices (CSRC permission will still be needed for prices outside a "band"), reduced trading fees, easier overseas listing and relaxation of trading rules for the large stock holdings by SOEs. In August, the rally seems to have paused, with signs of a decline in consumer confidence. Still the Composite indices at Shanghai and Shenzhen Stock have gained a solid 36.3% and 24.4% respectively for the year through August, with P/E ratios approaching 40. An estimated RMB100 billion were pumped into stocks during the bull run, from individual investors (new investment accounts were opened at a rate of 100,000 per day) and securities firms, through borrowing from banks.

The government encouraged the rally to facilitate heavy issuance by SOEs and to improve the climate for debt-equity swaps by the SOEs. Chinese SOEs are being prepared for sizeable new issuance. (See Corporate Sector Update for details.)

Sovereign Debt Ratings

In July, citing lower growth and higher fiscal costs, Standard & Poor's lowered China's long term sovereign debt rating from BBB+ to BBB, and its short term debt rating from A2 to A3. The outlook was rated stable. S&P also lowered the credit and debt ratings of eight financial institutions. The three largest banks, ICBC, BOC and CCB, were downgraded from BBB- to BB+, while the fifth largest BOCOM's rating was lowered from BB+ to BB. In August, Moody's maintained its long term sovereign debt rating at A3 and short term rating at P3. Moody's cited strong external position and prudent debt repayment policy to support the decision. Rating agencies have also clearly signaled that bank ratings are likely to display greater diversity as the government distances itself from some of the banks.

The government is expected to run a deficit of RMB150 billion in 1999, up from RMB96 billion last year (Chinese government definition). China has issued RMB79.4 billion worth of T-Bonds in five batches so far this year. The latest issue was for eight-years with an annual interest coupon of 3.28%. In July, MOF issued three and five year certificate-based treasury bonds to individual investors, paying 3.02% and 3.25% % respectively. These rates exceeded corresponding deposit rates of 2.7% and 2.88%. Since July, the retail-oriented certificate-based T-bonds are also eligible for bank loans. There has been a sharp rise in interbank trading, following wider access to interbank markets by RCCs, now foreign banks, the introduction of book entry institutionally targeted T-bonds.

Housing Finance

China announced several measures to privatize housing and encourage housing finance. SOE-owned housing units so far provided to employees at little or no rent can be purchased by residents at cost or at incentive prices. Such sales as well as sales of any housing units occupied for a minimum of one year are now exempt from a 5% turnover tax. The authorities are also considering setting up special housing banks in several cities. Local governments are also considering curbs on further development in oversupply segments (China has an estimated 69 million sq. meter overhang in the property market) such as luxury hotels, high-end apartment buildings and office buildings in major cities.

Insurance

The State Council approved the breaking of the China People's Insurance Group Company into three separate companies: China People's Insurance Co., China Life Insurance Co., and China Reinsurance Co.. China Life reported a rise in premium revenues of 20% to RMB 30.33 billion in the first six months of 1999 despite lukewarm

macroeconomic situation and strong competition. The company has developed new policies consistent with a low interest rate environment and is seeking to expand investment alternatives. China Insurance Regulatory Commission plans to open representative offices in all provinces within the next 18 to 24 months.

Selected Financial Indicators

Year	Quarter	GDP	Deposits	Bank Loans	Growth of Bank Loans	Deposit/Loans	Aggregate Bank Credit/GDP
		RMB billion	RMB100 Million	RMB100 million	%	%	%
1993		3463.4	29627.0	32943.1		89.9	95.1
1994		4675.9	40472.5	40810.1	23.9	99.2	87.3
1995		5847.8	53862.2	50538.0	23.8	106.6	86.4
1996		6788.5	68571.2	61152.8	21.0	112.1	90.1
1997		7477.2	82390.3	74914.1	22.5	110.0	100.2
1998		7955.3	95697.9	86524.1	15.5	110.6	108.8
Cumulative							
1997	Qtr 1	1468.6	72172.3	65796.1		109.7	
	Qtr 2	3318.0	75446.2	68169.7		110.7	
	Qtr 3	5115.2	78313.0	70564.5		111.0	
	Qtr 4	7477.2	82390.3	74914.1		110.0	100.2
1998	Qtr 1	1589.9	84175.4	75928.9	15.4	110.9	
	Qtr 2	3473.1	86895.1	78805.9	15.6	110.3	
	Qtr 3	5443.5	91881.4	82644.9	17.1	111.2	
	Qtr 4	7955.3	95697.9	86524.1	15.5	110.6	108.8
1999	Qtr 1	1678.4	99438.0	87826.0	15.7	113.2	
	Qtr 2	3618.9	102761.6	90620.3	15.0	113.4	
	July		102898.4	91157.6	14.6	112.9	

Policy Implementation and Assessment

Banking

State ownership of the banks, the dominance of state enterprise assets in the non-performing loans portfolio, high financial savings, and implicit and explicit guarantees on deposits render assessments of the health of China's banking sector using conventional indicators largely irrelevant. China is still widely expected to be spared a systemic banking crisis. Moreover, the authorities are resolutely engaged in financial sector reforms. However, the longer term problems are serious, and the overall costs of the banking system clean-up are not fully identified but expected to be large. The reported return on assets in the banking system is extremely low, yet considerably overstated, at around 0.2%, and suggests that the incidence of NPLs will likely grow.

While the formation of AMC's underscores the government's attention to NPLs, important questions/flaws remain in AMC's financing plans, adequacy of identification and transfer of NPLs, the incentive effects of transferring NPLs at book value, AMC's ability to add value in packaging and recovery of NPLs, data availability and staffing. While longer term problems of creating a commercial lending culture, market discipline, encouraging competition, privatization, improving accounting and disclosure standards, better enforcement of collateral and effective bankruptcy processes are all well understood, as yet there is limited action on these fronts. China is fixing the large gaps in its prudential regulation relative to international norms, but rather slowly. Important measures are being taken to strengthen capacity and independence of PBC. While the government is urging the state-owned banks to become more commercial, policies concerning fiscal and monetary stimulus, taxation of unearned income, enterprise restructuring, emphasis on debt-equity swaps as a

"resolution" mechanism, quotas for such swaps, and political considerations at enterprise and local levels all continue to interfere with that goal. Hurdles to foreign competition in banking are being removed gradually and divestment of banks has not yet been addressed. There are also concerns about the adequacy of preparation for Y2K problems. With the government focusing its support on the major state-owned banks, failures at smaller financial institutions are more likely. China also has a sizeable problem of anonymous deposits and administrative measures to levy a progressive tax or identify taxpayer could affect the deposit base. All in all, China is making considerable progress in resolving banking sector problems and has succeeded in preventing a crisis. But the sheer magnitude and complexity of the task, continuance of a hybrid economy, and politics will make the task of repairing the health of the Chinese banking system a very long term process whose aggregate cost to the society could be large and still growing.

Capital Markets

Chinese authorities appear to recognize the important role of stock and bond markets in SOE financing, allocation of capital, privatization, and financing of fiscal deficit. A recent official report placed the value of the Chinese state-owned assets at RMB8.22 trillion (about US\$1 trillion) at the end of 1998, up 13.8% from the previous year. The report counted 16,874 state-owned or state-controlled medium and large enterprises with 9,357 large state-owned enterprises, including 113 companies with annual sales of more than RMB5 billion. Even allowing for large over-valuation, divestment clearly represents a potentially large source of capital revenue.

Recent measures to limit the State's control of IPO prices, and permit greater trading of stocks held by legal persons are likely to create a better climate for potential divestment. By contrast, other measures such as the official encouragement of a market rally, setting quotas for debt-equity, or creation of special markets for SOEs can interfere with orderly development of the market. Accounting standards, information disclosure, and corporate governance in China are severely deficient. There are great logistical difficulties of adding thousands of SOEs to the current 950 listed companies, and the young CSRC's market oversight capacity may be quickly tested to its limits. A majority of listed SOEs have continued to operate bureaucratically after listing, and there is a likelihood that their experience will affect negatively future privatization efforts. Thus, China needs to develop and implement a longer term policy for growth and management of stock markets consistent with both SOE privatization and revenue needs, as well as sound stock market development. It needs to encourage pension and mutual funds in intermediation of household savings to limit speculative tendencies.

The recent efforts to transfer state-owned housing to workers and develop a commercial housing market to

replace decades-old welfare housing system are major reforms in the right direction. A well developed system of housing finance may also contribute to diversify bank portfolio and create a high grade collateralized asset. On the other hand, the recent proposal to set up special housing banks need to be carefully considered in the light of mixed international experience of such institutions.

Bank Instruments

Economic and Sector Work

A seminar on institutional and macro policy issues of bad debt restructuring was held in Beijing on July 23, 1999. Chief Economist Stiglitz presented a paper on China's third generation economy wide reforms and attended the session along with several experienced practitioners from within and outside of the Bank. A policy note on improving the performance of AMCs was prepared for MOF and PBC following the seminar. The Bank is also assisting the authorities in estimating the fiscal cost of resolving some of the NPLs in the banking system and alternative financing mechanisms.

Lending and TA

Financial Sector Technical Assistance project (FSTA).

Work is continuing on the 1992 Financial Sector Technical Assistance credit. Of the US\$60 million equivalent, around US\$39 MM is disbursed, the rest is fully committed.

Accounting Reform and Development Project. A Bank loan of US\$27.3 million and an IDA Credit of SDR 4.1 million (US\$33 million equivalent) were signed on March 11.

Technical Assistance / Trust Funds. PHRD/ASEM grant-financed activities for bad debt resolution are under discussion with PBC and CCB. A PHRD grant of JY99 million has been approved for a study of credit information systems in five Asian countries, including China. Two small ASEM grants were signed by the government on May 28 and the process for hiring consultants is under way. The grants will support strengthening of smaller banks and development of deposit insurance.

CORPORATE UPDATE

Current Developments, Policy Implementation and Assessment

Enterprise performance. The government has reported continuous improvements in the financial performance of the state-owned enterprise (SOE) sector. The net profit of state-owned and state-controlled industrial enterprises has reached RMB 24.31 billion by the end of June, which is a significant improvement over the comparable period a year earlier, when this sector had barely broken even with a net profit of less than RMB 10 billion. The large and medium SOEs recorded an even stronger improvement.

Corporate Financial Restructuring

A key development continues to be the establishment of asset management companies (AMCs) related to the Big-Four state commercial banks (see Financial Sector Update for details).

With the AMCs permitted to hold equity, much focus is currently on debt/equity swaps. Besides reducing excessive leverage, such conversions would reduce interest costs, thus contribute to the three-year objective of slashing the share of loss-makers among large SOEs. A set of eligibility criteria for such debt/equity swaps has been spelled out, aimed essentially at viable firms with good markets, strong management, and adequate reporting but burdened with excessive debt. SETC has provided a list of about 100 SOEs to the first AMC (Cinda), and a longer list of up to 500 SOEs is under consideration.

Cinda has now signed its first debt-equity conversion agreement. It concerns the Beijing Cement Factory, with is owned by the Beijing Construction Material Group. As reported by media, the Factory will be transformed into a limited liability company with equity held by the Group as well as, after the swap, Cinda. The Factory has nearly RMB 1 billion bank debts, and the swap would cut debt-asset ratio from 80% to 32%, leading to a small profit after year 2000. Underpinned by these positive prospects, the Group would then be listed in the stock market to raise funds. This would help the Group to buy back Cinda's shares within three years. After the three year period, Cinda could dispose of its remaining shares freely.

Another element in the drive towards the end-2000 target of reducing large loss-making SOEs is the bankruptcy of non-viable firms. This implies a shift of SOE bankruptcies towards large-scale cases. One such case is the recent bankruptcy declaration of a very large state mine in Benxi, Liaoning Province, following a State Council approval of its liquidation. The 90-year-old company was unable to pay its RMB 1.02 billion debts, largely bank loans. Directly affected are 36,000 workers including 15,000 retirees.

The largest joint venture bankruptcy case is the Rose Garden Villa development in Beijing. Bankruptcy had been declared in 9/97. The property complex has now been auctioned off, and was bought by the biggest creditor, a group from Shandong, for RMB400 million. An earlier official assessment had been RMB600 million, and registered debt exceeds RMB 1 billion. Complaints were voiced by home buyers; those who have made a whole or partial payment were offered the option to get a refund, but this would be as a common creditor to be repaid on a proportional basis.

The media have been reporting sundry success stories of turnarounds. For instance, a large Anhui-based chemical company called Fengyuan was on the brink of bankruptcy in the mid-90s after losing money for six years in a row, and

was now reportedly turned around by a 32-year-old manager, leading to a listing in the Shenzhen stock exchange. A Wenzhou-based private firm entered Shanghai market recently by taking over or acquiring controlling stakes of 34 loss-making local state or collectively owned enterprises.

The most prominent workout case at present is Guangdong Enterprises (GDE). Creditors rejected on June 30 the debtor's first restructuring proposal, which would give them up to 40 cents on the dollar. They asked instead for doubling the injection of good assets, and sent a counterproposal to GDE. The provincial government indicated subsequently that it was suspending its financial support that had helped the interest payments of GDE and some subsidiaries. S&P has downgraded GDE from "selective default" to "default".

Various other developments may have a significant impact on corporate financial restructuring. For instance, the central bank's Guangzhou branch posted in July a blacklist of 105 bad borrowers, accounting for RMB 6 billion in outstanding loans, within the three provinces of its jurisdiction. The named firms were given one month to contact creditor banks and negotiate measures of repayment. For those unable or unwilling to pay, a freeze has been ordered on future credit and banking services. Commercial banks have reported positive actions by many of the blacklisted firms. The central bank's Shanghai branch, meanwhile, is overseeing a scheme to have credit rating agencies rate any Shanghai-based domestic enterprise with outstanding bank loans of more than RMB 100 million at end-1998. It is foreseen that firms must in future produce these certificates when they borrow from major state banks. A first batch of 800 firms is being rated.

Ownership Transformation

The government has adopted a plan to sell some of the state equity holdings to finance social security expenditures. One of the state's two giant oil enterprises has reportedly obtained the go-ahead to use part of its state-owned equity to pay pension obligations to its own employees, in the context of its recent large scale re-organization for a stock market listing.

A SETC deputy chairman in charge of enterprise reform told a press conference that the state-held shares of listed companies would become tradable in the near future. He said there was no more objection on theoretical and policy grounds. A question is timing, though, because of concerns about the potential impact on the stock market. By end-98, reportedly 495 or 57% of the companies listed in the A-share markets in Shanghai and Shenzhen were directly controlled by the state (with shares of more than 50% in 265 companies, less than 50% but more than 30% in 163 companies, and less than 30% in 67 companies).

Other Policy Developments in the Enterprise

Sector

- *Industry Rationalization:* The campaign led by SETC to rationalize certain industries affected by over-capacity and small production scale through closing down small firms, banning new investment, incentivizing the scrapping of equipment, or encouraging price cartels and voluntary output restraints, has continued. Textile, coal, metallurgy, power generation, oil refinery, cement, glass are among those concerned. The machinery industry has now complained about demand reductions resulting from this campaign.
- *Competition:* Eight TV tube producers accounting for 90% of national output had stopped production in early July in order to curtail excess inventory and a steep drop in prices. They restarted production after two weeks instead of the planned four, reportedly due to rapidly rising prices.
- Each of five monopolistic defense-related corporations, known as "general corporations", in the nuclear, aerospace, aviation, vessel and weaponry industries, have been broken into two, respectively, in an attempt to promote competition.
- *Capital markets:* CSRC has announced that it will allow non-state firms to list overseas, and that it will switch from approval of batches to continuous case-by-case approval. This follows a similar announcement for the domestic B-markets last May. The move has been applauded especially in Hongkong, where the second board (Growth Enterprise Market) reportedly wishes to target private mainland firms.
- *SME Development.* Parliament has passed the law for sole proprietorships, and kicked off the drafting of a law on SME promotion.
- A guideline has been issued on the establishment of a national SME credit guarantee scheme. Reportedly already by May, 34 cities had set up special units for SME credit guarantees and raised some RMB 3 billion in funds.
- The funding of very small businesses might be impacted by a recent amendment of the tax law to allow the taxation of interest income.
- *Foreign Investment:* State media published rules to allow retail joint ventures in a large number of cities and special zones, and wholesale joint ventures in initially four key cities. Minimum requirements as to registered capital, domestic share, and the partner's prior sales volume will apply.
- *Trade:* Japan has reportedly reached an understanding with China about WTO accession. Talks between the US and China on WTO accession are expected to resume after the recent meeting between Presidents

Jiang and Clinton in New Zealand.

- *Infrastructure:* State media reported Beijing's approval to merge the China Railway Telecommunications Group with its 120,000 km of telecom lines with the telecom company Unicom, thus strengthening the competition to the dominant China Telecom.
- The State Power Corp. announced cross-grid transmission as its future core business; this would reduce the protective barriers between grids, often with lack of connection between them.

Issues and Areas to Watch

The 4th plenary session of the Party in late September will focus on enterprise reform. After the recent annual leadership retreat to Beidaihe, the following expectations for the plenum session have been raised in public speeches and state media:

- All large and medium SOEs with very few exceptions should be corporatized with the participation of multiple shareholders, according to a recent speech by President Jiang Zemin. This would presumably involve the participation of non-state shareholders, except in some wholly state-owned companies where only multiple state entities would be involved. Corporatization is seen as a key link to combine state ownership with a market economy, and multiple shareholders are recognized as key for improving corporate governance of SOEs, which in turn is at the core of the so-called "modern enterprise system".
- An increasing number of firms would be listed in domestic or international markets. This would include also giant enterprises such as Sinopec and CNPC in the oil/petrochemical sector and Baoshan Steel in metals. Sinopec, China's second-largest oil concern, announced an IPO of between \$5-8 billion, to be underwritten by Morgan Stanley and China International Capital Corporation, with possible listings in New York and Hong Kong, the largest in Asia outside of Japan and exceeding the China Telecom (Hong Kong) Ltd.'s \$4.5 billion issuance in 1997. The huge agri-industrial conglomerate Xinjiang Production and Construction has recently applied to the Securities Regulatory Commission (CSRC) for a listing in Hongkong. Some Hongkong media have speculated about up to 350 IPOs of SOEs in the coming 2-3 years.
- State ownership would gradually be withdrawn from certain industries and enterprises. The scope of this withdrawal is not yet clear, but could be substantial. One research team has reportedly proposed withdrawal from all but four areas - large infrastructure construction, large-scale activities in non-renewable natural resources, strategic development of high technology, and industries related to national security and reserves. On the other hand, a formal program of privatizing SOEs through sale has been ruled out.

- SOE managers are likely to be compensated with more competitive and performance related packages, including some share options. At the same time, the Party would retain its leading role in SOEs, including the control of cadres, as President Jiang has repeatedly emphasized.

At the same time, enterprise reform continues being driven by a target of drastically reducing the share of loss-makers among large SOEs within a three-year timeframe ending at about end-2000. Recent developments have been declared critical for this objective by the State Economic and Trade Commission include: The preparation of debt/equity swaps to lighten the interest cost burden of selected large SOEs; the above-mentioned introduction of interest subsidies for "technological upgrading" loans; and the go-ahead to sell state equity to help finance social security and thus ease constraints to labor retrenchment.

Bank Instruments

The Bank's Enterprise Reform Assistance Program of initially about US\$ 13m comprises several elements and is focused mostly on four large pilot cities (Changsha, Shenyang, Wuhan, Wuhu). It supports the adaptation, testing, and dissemination of innovative measures of enterprise reform/restructuring, including also the related areas of management development, labor re-training, and private SME development. A range of WBI activities are fully integrated. The IFC is also part of the Program and its team. Parallel TA programs by the UK, Germany, and potentially soon New Zealand cover some of the four cities in coordination with the Bank/IFC. Additional Bank lending operations under the Program are being identified for micro credit to help absorb laid-off workers and potentially for more intensive TA to corporate/asset restructuring.

Lending: SOE Reform Assistance Credit/Loan (US\$5m IDA LIL, approved 6/99), and parts of the Technical Cooperation Credit III and the Shenyang Enterprise Reform Loan (under supervision). Micro credit operation (US\$25-30m) under identification potentially for FY00, mainly for a micro/mini credit facility and business support services to address lay-offs. The possibility of a TA Loan for intensive corporate work-out is under discussion.

These activities are closely coordinated with: (i) the supervision of industrial investment projects in Shenyang and Chongqing, with increasing emphasis on the restructuring of the beneficiary firms; (ii) a TA Loan/Credit for implementation of accounting reform (recently approved; and (iii) a TA Credit for the reform of economic legislation (under supervision).

Grant-funded TA: PHRD grants for enterprise reform in Wuhan (US\$0.43m), corporate restructuring pilots (US\$0.55m), and preparation of a potential micro credit operation (US\$0.6m). ASEM grants for corporate financial

work-out (US\$0.6m) and social issues of enterprise reform (US\$0.45m). Bilateral funding for WBI training of trainers, managers and reformers (part approved). Sundry consultant trust funds (mobilized case by case).

Studies: Study on bankruptcy (report being produced); informal note on credit securities (being edited); study on SME development in conjunction with IFC Private Sector Assessment (FY00); potentially policy note on enterprise governance.

Coordination with other Sectors: Several activities in the financial and social sectors are closely related and coordinated. They include, for example: Grant-funded TA on bank debt resolution and the establishment of asset management companies; a LIL credit for pension reform; an older credit for enterprise housing reform; an assessment of re-employment programs; and grant-funded TA for health services rationalization.

IFC: Collaboration under the Enterprise Reform Assistance Program, including joint missions, with IFC focusing especially on the mobilization of investors; TA to enterprise reform in Leshan, including two large cases of foreign investment in local firms; private sector assessment study; wide range of IFC equity and loan investments; etc.

Other Donors: Other donors also provide a wide range of support for enterprise reform in China. Only a few examples of these activities can be mentioned here: *UNDP* - Credit guarantee pilot and a service bureau for SMEs; *ADB* - TA for economic legislation; *UK* - Enterprise and banking reform in Liaoning and Sichuan; *Germany* - SME development program in Hubei and Anhui, and various activities for vocational training and industry associations.

SOCIAL UPDATE

Current Developments, Policy Implementation and Assessment

The success of China's economic transition rests crucially on the ability of the government to maintain social stability. The current economic slowdown complicates the structural reforms and exacerbates social costs of transition. Three areas warrant attention. First, the urban labor surplus, resulting largely from enterprise restructuring, has reached a record level of 9.1% by mid-1998 according to World Bank estimates. Second, in the absence of a fully functional social security system, the urban poor and unemployed are vulnerable to significant welfare losses. Third, rising social unrest due to high unemployment and widening income disparities poses risks to social stability.

Rising Urban Unemployment. Urban open unemployment has reached its highest levels since the beginning of reforms, although the officially registered unemployment

rate, which excludes laid-off workers, remained at 3.1% at end 1998. By the end of June 1999, the stock of laid-off workers was estimated at 5.4 million, with an annual flow of laid-off workers of about 3.5 million expected in the coming few years. In addition, reforms of government administration have resulted in a 45% cut in staff at the central level. Local government streamlining is expected to further cut in half the existing workforce of about 5.5 million. Rising urban unemployment poses a serious threat to China's social stability and requires swift action to address the associated social issues. Crime and labor disputes are on the rise in China's cities – both criminal cases and collective labor disputes doubled in number in the first half of 1999 compared to a year ago.

Key Social Indicators

	Latest Data (date)	Previous Period (date)
Human Development (%)	1996	1985
Primary enrollment (gross)		
Female	120	114
Male	121	132
Secondary enrollment (gross)		
Female	66	33
Male	73	46
Tertiary enrollment (gross)		
Female	3.9	1.7
Male	7.3	3.9
Poverty and Income Distribution²	1997	1996
Rural Headcount Index (%)		
Government poverty line, \$0.71/day	10.95	
World Bank poverty line, \$1/day	24.23	24.31
Government Expenditures³	1997	1996
Education (at 1990 prices billion RMB)	101.6	91.9
as % GDP	2.49	2.47
Labor Market	1997	1996
Registered Unemployment Rate ¹ (%)	3.1	3.0
Unemployed + Laid-off Workers ⁴ (%)	6.5	5.6

1. Primary education covers grades 1 through 9. Source: *Education Indicators for East Asia and the Pacific*, World Bank, 1999.

2. World Bank estimates.

3. China Ministry of Education.

4. China Ministry of Labor.

In dealing with unemployment, government attention has focused on supporting laid-off workers from state-owned enterprises (SOEs). The State Council stipulated in June 1998 that all SOEs with laid-off workers must establish re-employment service centers which provide, on average, living stipends of RMB170 (US\$20); life, medical and unemployment insurance of RMB83 (US\$10); and training

and re-employment services. By June 1999, 95% of laid-off workers had registered at re-employment service centers, of whom 94% received income support.

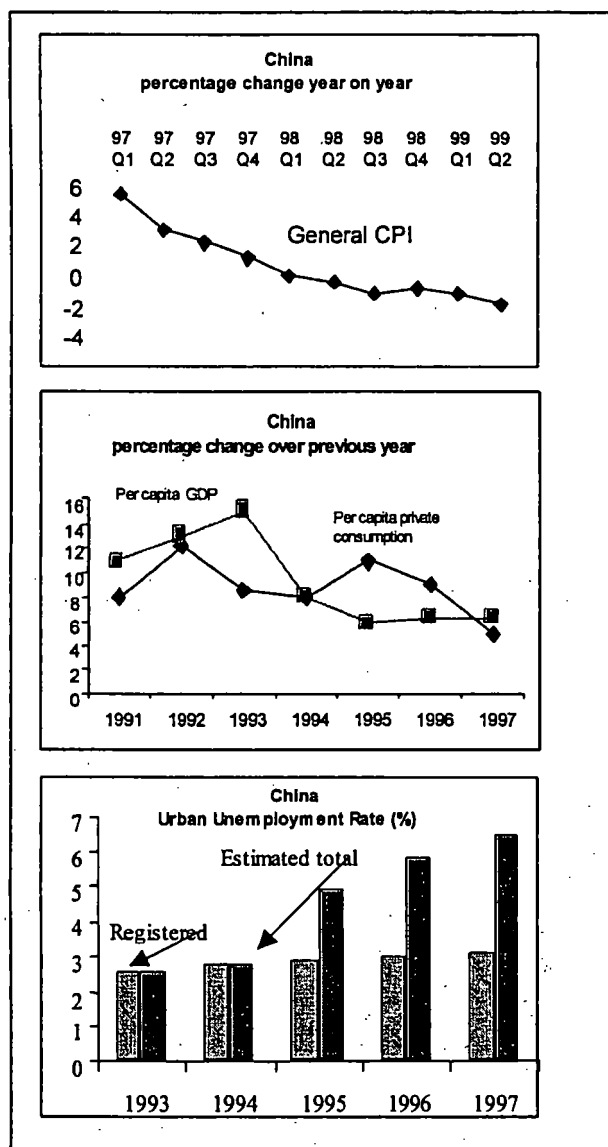
In an effort to stimulate household consumption and remedy the weak impact of the 1998 fiscal stimulus package, the government announced increases in social protection benefits in July. Living stipends for laid-off workers, unemployment benefits and minimum living allowance were increased by 30%, and pension payments by 15%. The payments for laid-off workers' stipends alone will total RMB24.5 billion (US\$2.95 billion) this year. In addition, the government announced a 30% increase in civil service wages.

Social Protection for the Vulnerable In the absence of consolidated safety nets in urban areas, economically and socially disadvantaged groups are more prone to poverty in the wake of economic restructuring and economic shocks.

A 1996 China State Statistical Bureau survey revealed that the older, less educated and female workers were disproportionately represented among laid-off workers, and that women suffer from widespread discrimination in labor markets. The urban informal sector, accounting for about 12% of the urban employed in 1998, has become an increasingly important source of jobs for laid-off workers and rural migrants. But this segment of the labor force is largely unprotected as the existing social protection schemes have limited coverage. Only laid-off workers from SOEs are entitled to income support with new entrants and the unregistered unemployed relying mainly on private transfers within families. There is also a gap between entitlement and actual delivery of living stipends for the laid-off workers - it was reported that about 30,000 laid-off workers this year never received their stipends as many local governments were unable to collect sufficient revenues to cover the payments. Arrears had also accumulated in pension payments affecting at least 3.6 million pensioners in 1998.

The government has made significant strides in reforming social security systems. In May 1998, the government set the target that within five years a fully functional social security system would be established in urban areas to cover both state and non-state sectors. Early this year, the government launched a nationwide campaign to extend the coverage of social insurance schemes – from 84 million to 110 million workers for pensions and from 80 million to 137 million for unemployment insurance. The results are expected to be disappointing because of weak administrative and oversight systems as well as lack of incentives for participation from the private sector. At the same time, unemployment insurance contributions were raised from 1% to 3%. A high proportion of unemployment funds is currently used to support laid-off workers and finance re-employment services. Consequently, uncertainties remain regarding how to raise sufficient funds to meet the future needs when laid-off workers become openly unemployed in the coming two to three years.

Rural Poverty Alleviation China's achievements in poverty reduction are widely recognized. Within a span of two decades, more than 200 million people have been lifted out of poverty (from 260 million in 1978 to 42 million in 1997 based on a government poverty line of US\$0.66 per day). However, poverty reduction has slowed since 1996 and remains a formidable task. Using the internationally comparable poverty line of US\$1/day, the number of poor in 1997 is estimated at 124 million.



Government poverty alleviation programs target designated poor areas and aim to improve infrastructure and provide basic support and assistance to enhance capacity to generate incomes. In 1998, government policies focused primarily on stimulating the economy but the focus on labor intensive public investment in rural areas (34% of total spending in fiscal stimulus package) also helped with the objective of rural poverty reduction. Fiscal funding for poverty

alleviation was further increased in 1999 by RMB6.5 billion to RMB24.6 billion (2.8% of 1997 government revenue). Beyond ensuring adequate funding, there is considerable scope for improving program effectiveness through better targeting, greater transparency, increased beneficiary participation and closer monitoring of the use of funds.

Enhancing Human Capital Investment. In June 1999, the State Council issued a decision at the National Education Conference aiming to increase both the quality and capacity of the current education system. To this end, several targets were set including (i) to increase central government expenditure on education by 1 percentage point annually from 1999 to 2002; (ii) to emphasize quality-oriented education at all stages of the education system and reform teaching methodology; (iii) to grant more autonomy to provincial governments in education delivery, expand enrollments at the senior secondary and tertiary levels, and promote the development of private schools; and (iv) to sustain the National Compulsory Education Program in poor areas, designed to universalize 9 years compulsory education, after the year 2000. The State Council's initiatives on education reforms were partially driven by the potential expansionary impact of increased education expenditures on GDP, estimated at 0.3-1.3%.

The government has also introduced the 'labor preparation system', which aims to place those who fail to enter senior-middle schools or universities into 1-3 year compulsory vocational training programs. This is designed to delay the entry of 300-400 thousand school graduates into the job market, thereby easing pressures on the urban labor market.

Improving Governance. In order to pave the way for deepening economic transition, the government has focused on fostering the legal and institutional environment to promote competition and curb rent-seeking activities. Measures include banning government organizations, the army, armed police and judiciary bodies from engaging in commercial activities; reforming accounting systems and enhancing disclosure requirements; cracking down on smuggling and bribes in customs offices and on ad hoc levies on farmers and enterprises; and bringing increased scrutiny to bear on the lifestyles and conduct of senior government officials.

The National People's Congress Standing Committee has recently approved the Bidding Law which mandates, effective January 1, 2000 that public bidding must be used for construction of all large-scale state supported infrastructure and projects funded by international organizations and foreign government loans.

China has recently taken steps to accelerate the formation and contribution of NGOs. While existing laws (enacted in 1998) provide legal recognition for NGOs and are intended to accelerate the provision of welfare and social services by non-State actors, they fall short of protecting the freedoms of association required by international covenants to which

China is now a signatory. Further laws are being drafted on NGOs and philanthropy and —though NGOs cannot be as independent as in most of other countries —there is a very rapid increase in NGO formation.

Bank Instruments

Bank analytical support for the preparations of the 10th Five Year Plan (2001-2005) will cover issues of inequality and regional development and poverty and social protection.

The Enterprise Reform Project (\$5 m IDA-supported Learning and Innovation Loan) will provide assistance to four pilot municipalities to provide re-training and re-employment of laid-off workers, as well as to restructure large and medium state enterprises, and develop management capacities.

An ASEM-funded technical assistance activity aims at addressing critical social aspects of corporate restructuring, including the transfer of social assets from SOEs to local government, labor retraining and leveraging excess enterprise assets to fund enterprises' social security liabilities. A recently approved PHRD grant will help build capacity in urban health insurance while an ASEM-financed activity aims to minimize the adverse consequences on the poor of education sector adjustment driven by financial constraints.

The Pension Reform Project (US\$5 m IDA-supported Learning and Innovation Loan) aims to formulate a sustainable pension funding strategy and improve pension systems in a pilot municipality and a province, with the ultimate objective of helping the government establish a national unified pension system.

In May 1999, the World Bank sponsored a Conference on Labor Market Policies in Beijing which brought together officials from central ministries and municipalities, and international experts to discuss the nature of China's high urban unemployment, and policy options and lessons emerging from international experience.

The recently approved Western Poverty Project (US\$60 m loan/US\$100 m equivalent credit) is designed to benefit almost 1.7 million of the poorest people in China. But no funds will be disbursed for the US\$40 million Qinghai component of the project until the Bank reaches a decision based on a review by the independent Inspection Panel. The Inspection Panel's response on the Project was provided for the Board's review on August 20. The Board has since approved the Panel's recommendation for inspection, and the Panel plans to visit China by early October."

A poverty assessment, which is a follow-on to the seminal 1992 poverty report, is close to completion. The report's executive summary was shared with the government.

The Health Nine Project (US\$10 m loan and US\$50 m credit) has two main components. The first, and larger (US\$42 m base cost) component for improving Maternal Health and Child Development, would reduce maternal and child mortality and morbidity, and improve child survival and development in the poorest areas of China. The second component (US\$27 m base cost) is for improved prevention and control of HIV/AIDS/sexually transmitted diseases and other blood-borne infections.

The Higher Education Reform Project (US\$20 m loan and US\$50 m credit) aims at improving the quality and relevance of undergraduate basic science and engineering programs through integrated reform activities in curriculum and teaching methodology.

The Bank assisted the establishment of the Bidding Law and associated procurement regulations through providing advice to the government. The Accounting Reform and Development Project aims to help strengthen financial management for state enterprises and government bodies.

To facilitate newly established NGOs to develop management and organization skills, the Bank has recently agreed an IDF grant for NGO Capacity Building.

- Macroeconomic Update was prepared by Albert Keidel and Limei Sun (EACCF).
- Financial Update was prepared by Hemant Shah (EASFS).
- Corporate Update was prepared by Chunlin Zhang (EACCF) and Klaus Lorch (EASPS).
- Social Update was prepared by Limin Wang (EASPR).

Economic Indicators

CHINA	1997	1998	1998		1999						
	Year	Year	Q3	Q4	Q1	Q2	Apr	May	Jun	Jul	Aug
Output, Employment and Prices											
GDP (% change previous year)	8.8	7.8	7.6	9.1	8.3	7.1					
Industrial production index(Value-added)											
(% change, previous year)/1	11.2	8.9	10.5	13.7	10.1	9.0	9.1	8.9	9.1		
Unemployment Rate (%) /2	3.0	3.1									
Real Wage Growth	0.5	-0.6									
Consumer price index (% change, previous yr)	2.8	-0.8	-1.4	-1.1	-1.4	-2.2	-2.2	-2.2	-2.1	-1.4	
Public Sector											
Government balance (% GDP)/3	-1.8	-3.0									
Domestic public sector debt (% GDP)	12.9	16.4									
Foreign Trade, BOP and External Debt											
Trade balance (\$US Million)	40,420	43,590	35,453	7,954	4,264	3,657	967	1,875	873	3,420	
Exports of goods, (\$US Million)	182,790	183,760	69,839	49,631	37,268	45,676	14,804	15,532	15,398	17,340	
(% change, previous year)	21.0	0.5	-2.0	-7.3	-7.3	-1.5	-7.2	4.1	-1.0	7.6	
Key Export (% change, previous year)/4	86.9	88.8	-1.6	-6.3	-7.7	-1.5	-7.0	4.7	-1.6	10.0	
Imports of goods (\$US Million)	142,370	140,170	34,386	41,677	33,004	42,019	13,837	13,657	14,525	13,920	
(% change, previous year)	2.5	-1.5	-2.7	-5.3	11.9	20.6	18.4	21.0	22.5	16.8	
Current account balance (\$US Million)	34,544	32,539									
(percent GDP)	3.8	3.4									
Foreign Direct Investment (US\$ Billion)/5	45.3	45.5	10.9	14.1	7.3	11.2	4.1	2.5	4.7		
Total external debt (\$US Billion)	132.1	145.6									
(% GDP)	14.6	15.2									
Short-term debt (\$US Billion)	18.1	17.3									
Debt service ratio (% exports of g&s)	10.2	10.2									
Reserves, including gold (\$US Billion)	143,363	149,812	145,626	149,812	151,099		151,327	150,977			
(months of imports of goods and services)	10.3	10.5									
Total reserve without Gold (\$US Million)	142,762	149,188	145,016	149,188	150,497		150,727	150,381			
Financial Markets											
Domestic credit (% change, previous year)	19.7	20.0	21.1	20.0	21.0						
Short-term interest rate (less than 20 days)/6	8.9	6.3	5.2	5.0	4.6	4.3	3.2	3.2	3.2	3.2	3.2
Exchange rate (end-period)	8.2798	8.2787	8.2782	8.2783	8.2800	8.279	8.2794	8.2786	8.2780	8.2770	8.2770
Real effective exchange rate (+ = appn) 1995=100	112.40	112.58	113.60	108.01	107.50		108.24	108.13			
(% change, previous year)	4.5	0.2	0.9	-4.6	-6.4		-5.0	-4.6			
Stock market index (Dec. 19, 1990=100)	1,301.6	1,388.3	1,451.2	1,382.3	1,256.1	1,860.9	1,287.9	1,383.9	1,860.9	1,615.7	1,655.1
Memo: GDP in Billion US\$	903.1	960.9									

1. Quarters 3 and 4 are for gross value output; value added series is not available.

2. Official Unemployment only, not including laid-off workers

3. Please specify level of government.

4. Manufactured Exports

5. Gross FDI

6. Central Bank loans to financial institutions.

Renminbi devaluation fears diminish

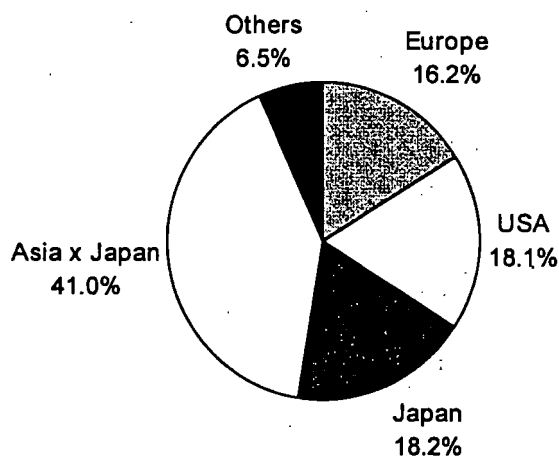
The renminbi is regaining competitiveness as its real effective exchange rate has fallen back to pre-Asian crisis levels. Also, a brighter export outlook will calm fears of devaluation.

Those who are concerned about renminbi devaluation may need to rethink the issue. An improving export outlook for China, plus initial signs that the domestic economy might be recovering, sharply reduces the devaluation risk. The renminbi is regaining competitiveness, with its real effective exchange rate falling back to pre-Asian crisis levels. The institutional set-up of China's foreign trade system is also being improved to aid export growth. Speculation about renminbi devaluation will always exist, but the basis for such speculation is becoming increasingly weak.

Exports recovering

The underlying trend of Chinese exports has been improving since May due to recovering Asian demand, which accounts for more than 40% of total exports, and a strong US market, which accounts for 18% of total exports (Chart 1). Even the Japanese economy, which accounts for more than 18% of China's exports, is stabilising.

Chart 1: Chinese export markets (1994-98 average)



Source: CEIC

Export growth to Asia is likely to improve further. This will help offset an expected slowdown in the US market in the medium-term. Chinese exports to key Asian countries, such as Korea and Japan, have been recovering strongly (Chart 2). The positive impact of higher export-tax rebates (raised from an average 12% to 15% in July) on export growth will continue to come through. A low-base effect (exports fell sharply in 2H98) will amplify these benefits in the coming months.

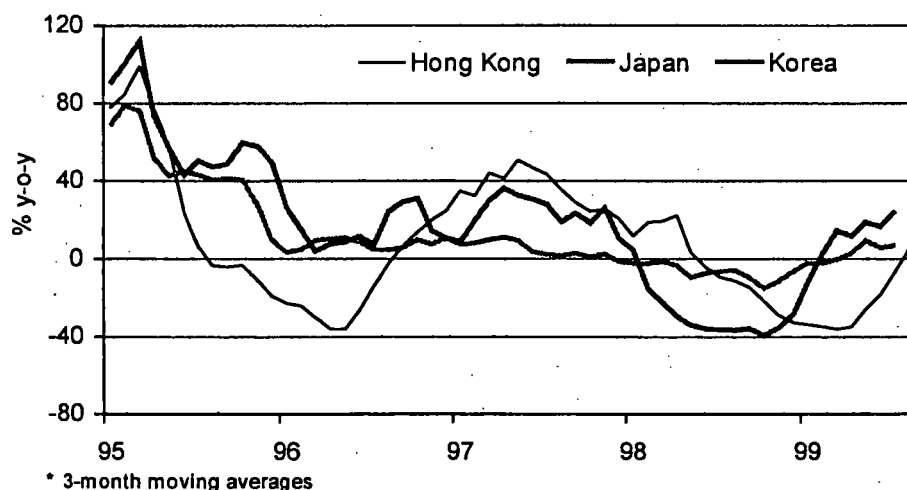
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Renminbi devaluation fears diminish

Chart 2: China exports* to Hong Kong, Japan and Korea

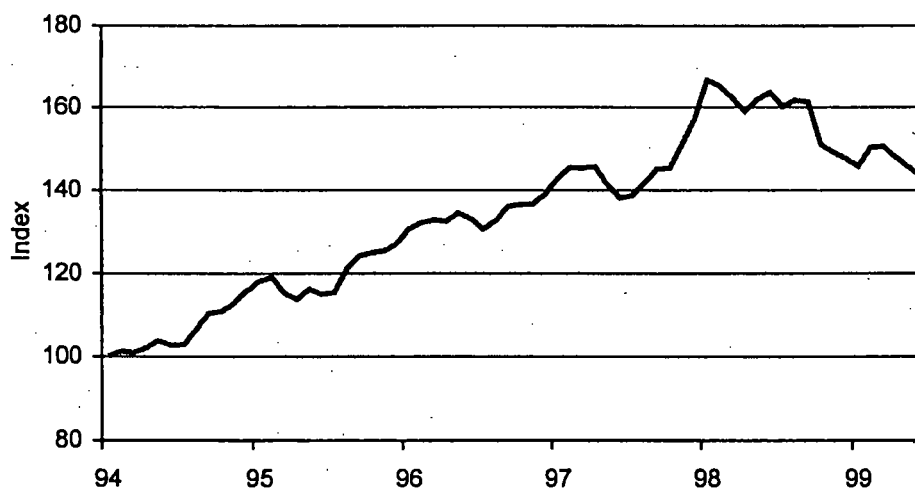


Source: CEIC

Currency competitiveness

Deep deflation in China, with retail prices falling for 23 straight months, is equivalent to a real depreciation of the renminbi. This is seen in the renminbi's real effective exchange rate (REER), which has fallen back to levels before the Asian crisis (Chart 3). (The REER is a trade-weighted exchange rate adjusted for the relative inflation rates of China's trading partners.) It has fallen because China's trading partners are experiencing inflation and exchange rate appreciation while the mainland is experiencing deflation with a fixed nominal exchange rate.

Chart 3: REER back to pre-Asian crisis levels

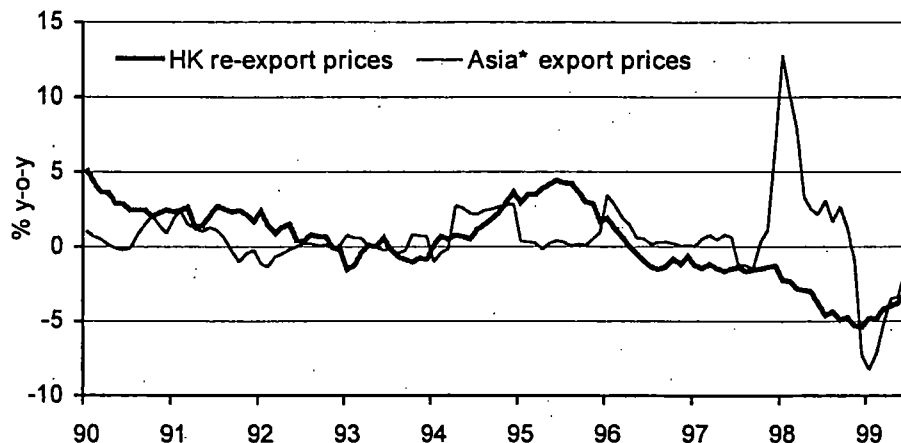


Source: HSBC EIS

Renminbi devaluation fears diminish

Further, China's export prices relatives to those of her Asian competitors remain competitive. As China does not publish export price data, we have approximated them by using Hong Kong's re-export prices since Hong Kong's re-exports are mainly Chinese exports to the rest of the world.

Chart 4: China's relative price competitiveness



* Average export price inflation of Korea, the Philippines, Taiwan, Singapore, Thailand

Source: HSBC EIS

China suffered a large negative relative price shock in 1998 due to her refusal to follow the sharp devaluation of most Asian currencies (Chart 4). But her export price inflation, as approximated by Hong Kong's re-export prices, has remained negative throughout and after the Asian crisis, while that of her Asian neighbours' have rebounded. This helps to explain why Chinese exports have not lost any market share in the US and Europe after the Asian crisis.

Improving foreign trade system

An improving structure for China's foreign trade system will help raise export competitiveness and growth. Numerous import and export trading companies, which are basically middlemen, licensed by the government have monopolised China's foreign trade system for years. This licensing system has raised the cost of China's foreign trade.

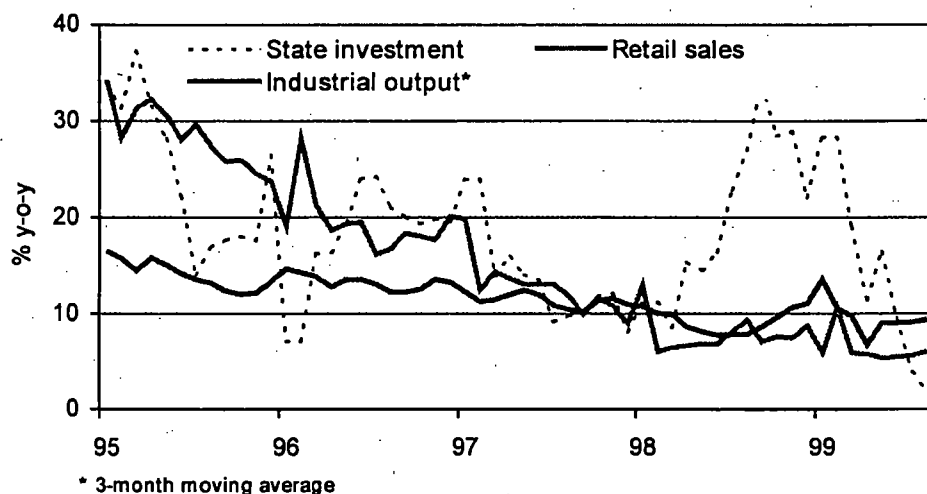
The elimination of these middlemen, which have inflicted a dead-weight loss in the economy, will lead to large efficiency gains in the foreign trade sector. As part of the nation's structural reform, Beijing is phasing out the foreign trade licensing system. Many non-state manufacturers are now allowed to participate in the export-import business and in the distribution of foreign goods within the country.

Domestic worries seen as fading

Finally, the domestic sector may be stabilising. Any signs of a recovery will sharply reduce the fears of devaluation. Bank deposit growth has declined and the sales-to-production ratio has risen in recent months, suggesting that consumer demand might be reviving after two years of government reflationary measures.

More importantly, retail sales and industrial output growth rates have been quiet well sustained, although state support of the economy has been declining since the start of this year (Chart 5). Growth of fixed-asset investment by state companies has declined from almost 30% this January to less than 2% recently. But retail sales growth has remained stable at around 6% and industrial output growth at around 9% during the same period. This suggests that non-state sector demand might be stabilising.

Chart 5: Non-state demand stabilising

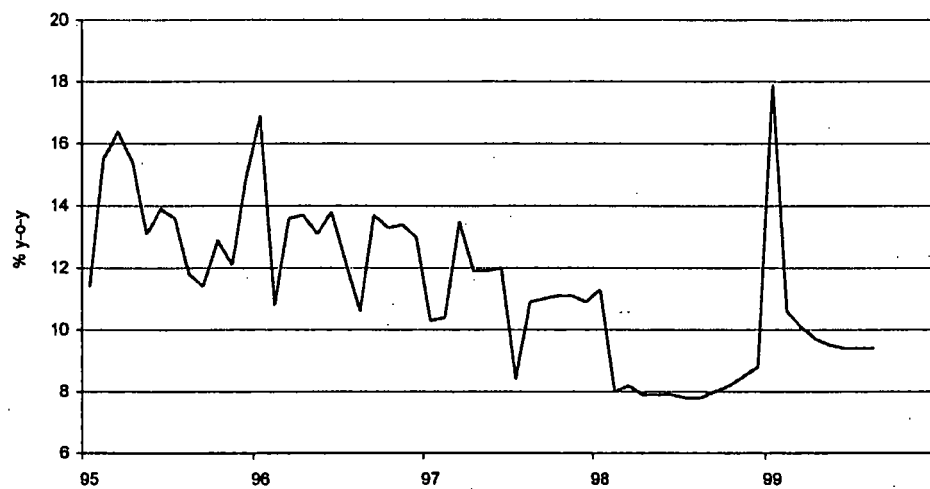


Source: HSBC EIS, CEIC

Since the fundamental risk that will spur a renminbi devaluation is a faltering domestic economy, but not export competitiveness, if these initial signs of stabilisation develops into an economic recovery in the coming months, the risk of devaluation will be greatly reduced.

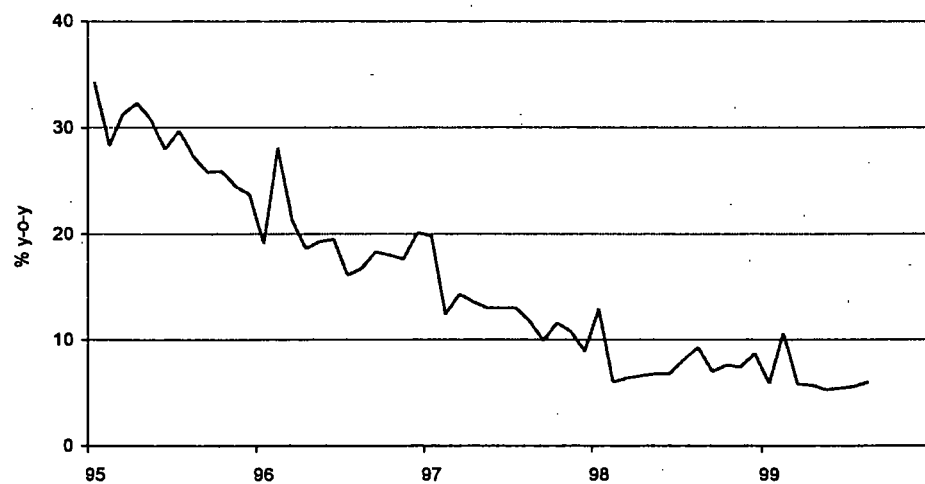
China

Industrial value-added growth



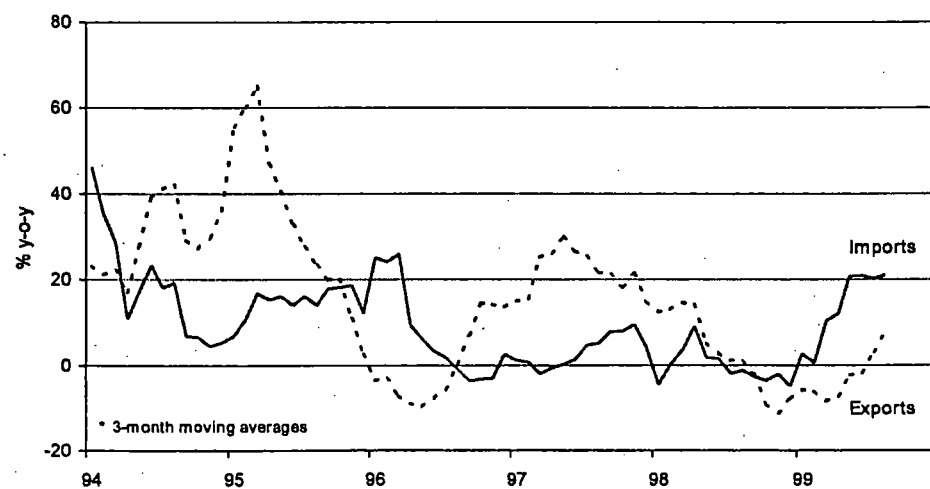
Source: CEIC

Sales of consumer goods



Source: CEIC

Foreign trade*

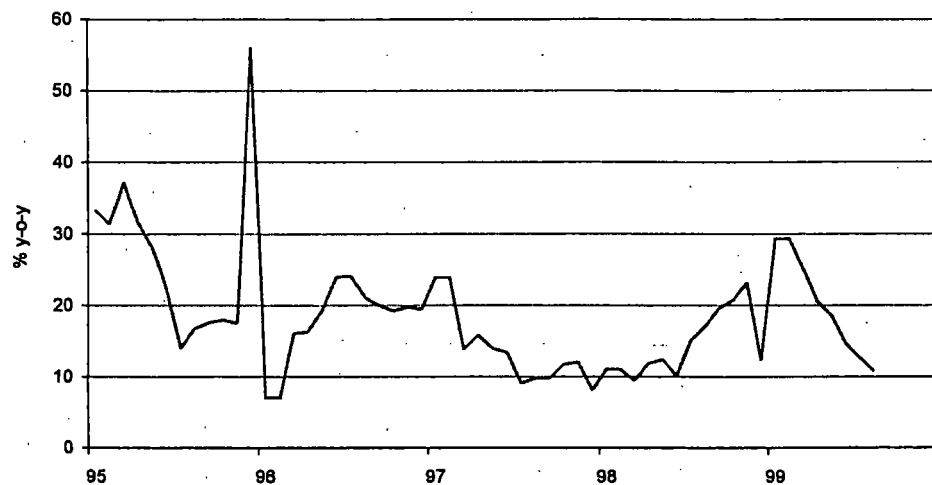


* 3-month moving averages

Source: CEIC

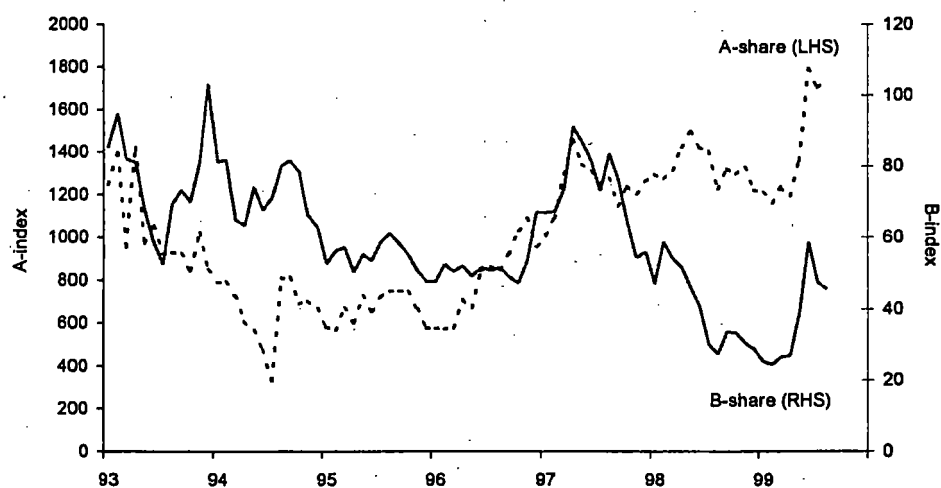
China

Fixed-asset investment



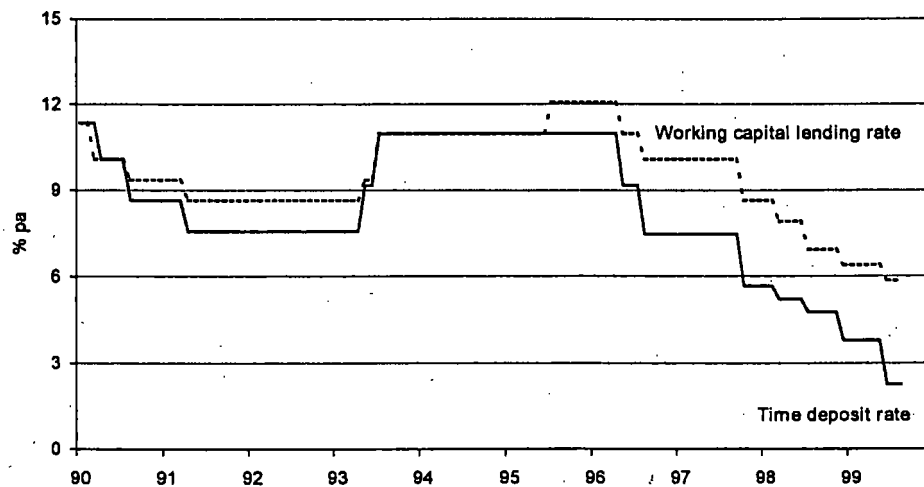
Source: CEIC

Shanghai stock indices



Source: CEIC

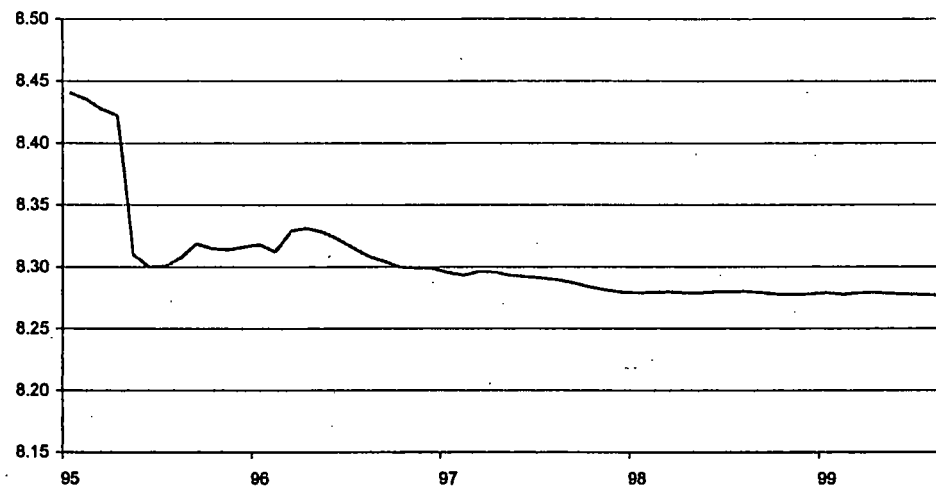
One-year interest rates



Source: CEIC

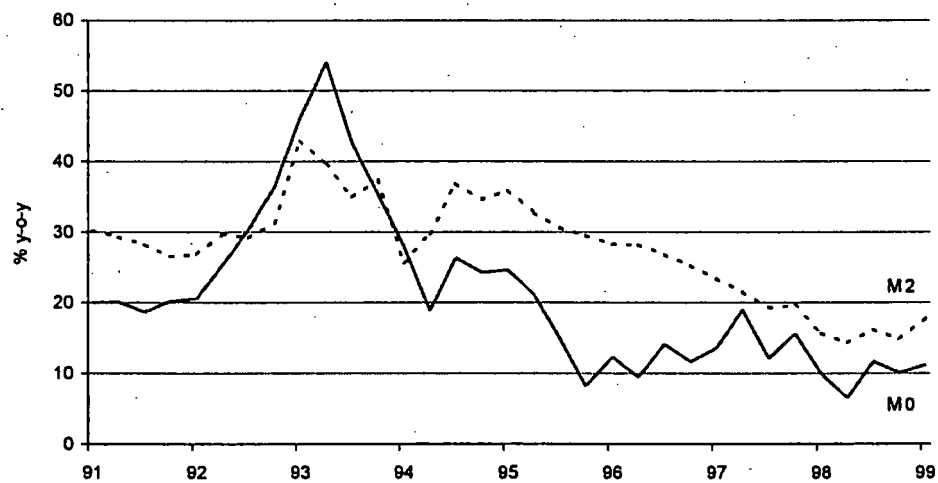
China

Exchange rate: Rmb: US\$



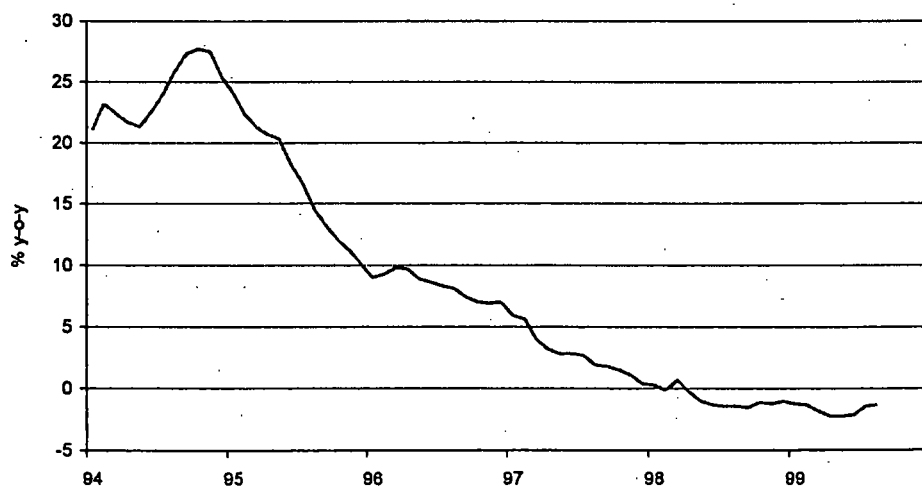
Source: CEIC

Growth in money supply



Source: CEIC

Consumer price inflation



Source: CEIC

Economic forecasts

China economic forecasts

	1994	1995	1996	1997	1998e	1999f	2000f	2001f
Real % year								
GDP	12.6	10.5	9.6	8.8	7.8	7.7	7.9	7.4
Private consumption	12.2	10.8	10.6	8.3	8.4	5.0	6.2	5.7
Public consumption	12.2	10.7	10.6	9.0	8.0	7.5	7.5	6.5
Investment	10.8	8.6	8.7	9.1	15.2	14.0	14.5	12.4
Change in stock (% GDP)	5.1	6.0	5.1	3.8	2.1	0.9	1.2	0.9
Net exports	100.8	18.5	21.1	47.7	8.2	-34.0	-66.2	-95.3
% Contribution to growth								
GDP	12.6	10.5	9.6	8.8	7.8	7.7	7.9	7.4
Private consumption	5.5	5.0	5.1	4.0	3.7	3.6	3.6	3.3
Public consumption	1.5	1.2	1.2	0.9	0.9	0.9	0.9	0.8
Investment	3.9	2.9	2.9	3.1	2.8	3.0	3.2	3.1
Change in stock	0.4	1.0	0.0	-0.9	0.2	0.1	0.1	0.1
Net exports	1.3	0.3	0.4	1.7	0.2	0.2	0.1	0.0
% Weighting in real terms								
GDP	100	100	100	100	100	100	100	100
Private consumption	45.1	46.8	47.9	47.5	47.7	46.7	46.0	45.2
Public consumption	12.7	11.3	11.3	11.3	11.4	11.4	11.4	11.3
Investment	35.8	34.2	33.7	33.8	36.1	38.3	40.7	42.6
Change in stock	5.1	6.0	5.1	3.8	2.1	0.9	1.2	0.9
Net exports	1.3	1.7	2.0	3.6	2.7	2.7	0.8	0.0
CPI inflation (%)	24.1	17.1	8.3	2.8	-0.8	-1.1	1.0	2.9
Rmb/US\$ (year-end)	8.6	8.4	8.3	8.3	8.3	8.3	8.4	8.8
1-y lending rate (% year-end)	11.0	11.0	10.1	8.6	6.4	4.9	3.4	4.5
External sector (US\$bn)								
Export growth (%)	32.0	22.9	1.5	20.9	0.6	7.6	10.0	11.5
Import growth (%)	11.2	14.3	5.1	2.5	-1.5	20.5	23.0	16.5
Trade balance	5.4	16.7	12.2	40.3	46.6	28.8	9.7	0.5
Current account balance	7.7	1.6	7.2	29.7	29.3	11.8	-5.5	-20.8
- % GDP	1.4	0.2	0.9	3.3	3.1	1.1	-0.5	-1.7
FDI inflow	33.7	37.5	41.7	44.0	45.6	33.0	40.0	44.0
Capital account	32.6	38.7	40.0	23.0	-6.3	13.0	19.5	33.0
Balance of payments	30.5	22.0	31.4	34.9	5.1	8.8	3.0	-4.5
Foreign reserves	51.6	73.6	105.0	139.9	145.0	156.7	159.3	154.8
Import cover (months)	5.4	6.7	9.1	11.8	12.4	12.2	10.7	7.7

Executive Summary

This report builds on the framework and vision laid out in the 1997 Country Economic Memorandum, *China 2020: Development Challenges in the New Century*, and its companion reports. Although the vulnerabilities and near-term challenges facing China were less apparent at that time than they are today, the longer-term framework and vision presented in that report remain largely valid. Building on that framework, this year's report focuses on the near term.

The difficulty of dealing with China's main macroeconomic challenge—weakened domestic demand—has been compounded by the Asian crisis and the global economic slowdown. These challenges come at a critical juncture in China's structural reform program. Unemployment and demand for social protection has increased, and corporate debt pressures are building in China, as the transition to a more market-based economy proceeds. However, the country's large and partly insulated domestic economy has inoculated it to some degree against contagion from its less fortunate neighbors. Having weathered the storm so far, China can learn lessons from other countries that have experienced difficulties and, hence, mitigate against the risk of a crisis in China.

The major policy issue facing China is how to respond to the near-term growth pressures in ways that reinforce structural reform and economic development. As implementation of reform proceeds and new storm clouds emerge, policymakers will have to focus on pro-growth reforms that support the development of the labor-absorbing service sector. At the same time, restructuring of enterprises and strengthening of corporate governance must remain high priorities, in order to both

tackle the corporate debt problem and release assets to productive activities. China's strategy also needs to support structural measures that increase household demand by raising rural incomes and providing adequate fiscal support to safety net programs. Increasing household demand is essential to growth recovery and to successfully transforming China into a demand-driven economy that serves Chinese households.

Weathering the Storm: The Effect of the East Asian Crisis

Unlike other countries in the region, China was not severely affected by the East Asian financial crisis that began in 1997. Several factors explain its ability to weather the storm.

China's economy is driven largely by domestic developments. Recent economic performance in China has been dominated by trends in the domestic economy, many of which preceded the onset of the Asian financial crisis. By 1996 China had achieved a soft landing by reducing inflation dramatically without sacrificing high rates of officially reported GDP growth. With the outbreak of Asian financial crisis in the second half of 1997 and the continued weakening of domestic demand, soft landing policies were replaced with a macroeconomic policy mix aimed at stimulating domestic demand.

China's economy had a good starting position, which allowed it to respond to the macroeconomic challenges that emerged in 1998. As a result of the pragmatic stabilization policies adopted since 1993, China enjoyed steady growth, low inflation, and an exceptionally strong external position. Foreign savings played only a negligible role in China's financial system,

and most of those savings were in the form of foreign direct investment and long-term loans. Currency inconvertibility on the capital account provided an additional buffer against destabilizing external financial flows.

Exports to Asia have fallen, but the balance of payments remains strong. Regional turbulence has reduced exports to Asian markets and foreign direct investment from traditional Asian sources. The overall impact on export demand and foreign direct investment flows has been muted, however, by continued growth from major North American and European sources, particularly in the first half of the year. Exports rose 0.5 percent (8.2 percent in real terms) in 1998, foreign direct investment inflows remained roughly at 1997 levels, and the observed trade account surplus remained large and positive (\$43.6 billion).

Illegal capital outflows have increased amidst concerns about the stability of the exchange rate, large-scale smuggling activities, and the reversal of capital flows, as gains from interest rate arbitrage in 1997 fell following cuts in yuan interest rates. In response, the government recently strengthened its management of capital account transactions and closed loopholes for illegal capital outflows under the current account. Overall the balance of payments position did not deteriorate.

Other Developments in the Chinese Economy

Rural income and consumption demand have weakened. China's agricultural sector represents about 20 percent of GDP; the nonagricultural rural economy accounts for another 30 percent. A slight decline in real agricultural growth—from 4–5 percent in recent years to 3.5 percent in 1997 and 1998—was compounded by large declines in farm procurement prices in 1996, 1997, and 1998. In the nonagricultural rural sectors, rural enterprise growth has been slowing since the early 1990s but remains relatively strong. Labor absorption has weakened considerably, however, and may have declined. As a result, rural income and rural consumption demand have weakened, with real household income rising by less in the rural sector than in the urban sector in both 1997 and 1998 (a reversal of the trends of the previous few years).

With total rural consumption equal to total urban consumption in China, stimulating both rural and urban economic growth will be critical to recovery.

The Government's Policy Response

In 1998 the authorities responded to the challenges facing the Chinese economy. Their program relied on stimulating domestic demand (largely through infrastructure investment) while maintaining currency stability. China's willingness to forgo external stimulus acted as an anchor for East Asia economic stability in an environment of acute crisis.

Public sector investment—and a monetary policy that accommodates it—stimulate demand. The centerpiece of the 1998–99 stimulus package is a public sector infrastructure investment program, which is being leveraged by additional complementary financing from the banking sector and local budget counterpart funds. The program, which represents about 2.5 percent of 1998 GDP spread over two years, also increases allocations to various social protection programs and seeks to narrow regional differences by offering more attractive on-lending rates to inland provinces.

The heavy focus on infrastructure investment was aimed partly at meeting China's infrastructure needs and partly at avoiding allocating resources to manufacturing, a sector beset with excess capacity. The program's investments span water conservation, grain storage, road and rail transport, power grids, and urban infrastructure, with small allocations to housing and poverty relief. Some allocations are financing public goods, such as flood prevention projects; others are augmenting the equity base of public enterprises, helping those enterprises qualify for complementary bank financing.

In close coordination with fiscal policy, China adopted a more relaxed monetary policy. Interest rates were cut repeatedly in 1998, and the reserve requirement was lowered. Lower interest rates spurred fixed asset investment, alleviated the interest burden on state-owned enterprises, and discouraged banks from keeping excess liquidity with the central bank.

The stimulus package has proved effective, with signs of revival emerging in late 1998. Driven by a surge in state-led investment, China remains an engine of growth, growing 7.8

percent in 1998, according to official figures. China's strong performance is remarkable given the regional crisis affecting its neighbors. To sustain the recovery, it will be critical to build additional pro-growth structural reform measures into the program for 1999 and beyond.

China's countercyclical fiscal stance is appropriate given the limitations on monetary and external stimulus. Because of conservative fiscal policies in the past, China's level of government debt remained relatively low (about 10 percent of GDP). In the medium term, however, the fiscal sustainability of the program will depend on how the government can contain its additional liabilities—notably in the banking and pension systems—and strengthen the central government's revenue base in order to service those liabilities rather than on the magnitude of the stimulus package.

The Government's Commitment to Reform

The new government installed in March 1998 laid out an ambitious agenda that guaranteed growth and committed itself to reforming state-owned enterprises, the financial sector, and the government structure within three years. The agenda also established five reform priorities for 1998: grain marketing, investment procedures, housing, health financing, and fiscal and extra-budgetary financing. Tackling corruption and financial fraud also received renewed attention. Progress on all of these fronts has been made.

The Asian financial crisis has highlighted the importance of addressing systemic weaknesses in China's financial and enterprise sectors. The new government's agenda clearly recognizes that the domestic financial-corporate nexus represents a major source of risk in the near term. Although the external threat of contagion is modest in a country with a large and partly insulated domestic economy, recognition that the triggers for a crisis are hard to predict has lent urgency to China's efforts to tackle systemic weaknesses.

Much progress has been made in China toward reforming the financial and enterprise sectors. Preliminary analysis of medium- and large-scale firm-level industrial data suggest that a group of productive enterprises exists in

China that could help form the basis for a dynamic economy as long as progress continues to be made on restructuring enterprises away from inefficient, low value-added activities. Serious problems remain, however. Many enterprises serving the domestic market are uncompetitive, and some large enterprise groups have focused on investment and size rather than profitability and efficiency. Financial performance has worsened since 1995 across all groups of medium- and large-scale industrial enterprises. Collectively owned and township and village enterprises whose growth had been key in the past decade are having difficulty transforming themselves into efficient enterprises. According to official figures, half of all medium-size and large state-owned enterprises reported losses in 1998. Including underreported losses (often uncovered in audits) would raise this figure even higher. Corporate leverage is high, increasing vulnerability to shocks. The average liabilities to equity ratio is about 2:1 for industrial and state-owned enterprises and about 4:1 for commercial enterprises.

In the financial sector, dependence on the banking system is excessive. China's financial sector is dominated by the banking system, which accounts for three-quarters of households' financial asset holdings and enterprises' external funding sources. The government continues to interfere in investment decisions. Financial management of financial institutions is weak. Financial skills are also lacking; turning bureaucrats and clerks into bankers has proved no easy task. Bank portfolios include a large share of nonperforming loans. The official estimate of the proportion of nonperforming loans in bank portfolios (based on the current classification system) exceeds 20 percent, of which at least 5–6 percent are considered unrecoverable. These figures probably underestimate the true scope of the problem. Finally, regulatory capacity is inadequate. Expansion of the role of the financial system in China has outpaced regulation and supervision of the financial system, often leading to ad hoc government interference in financial decisionmaking and inconsistent policy messages. Lack of adequate regulation has allowed many nonbank financial institutions to take on excessive risks.

Fortunately there are additional factors that give China time to learn lessons and avoid a crisis. Without taking into account China's continuing ability to support domestic banks and

enforce foreign exchange supervision, as well as the reform initiatives already taken, it might appear that China's economy is rather vulnerable in the face of risks of financial crisis. For China, however, the likelihood of a crisis in the near term remains small. The central role of domestic savings, the composition of foreign saving, and the currency inconvertibility on the capital account provide a buffer against destabilizing external financial flows. The major commercial banks are state-owned, and depositor confidence in the banks remains high. The level of narrowly defined government debt is low enough to allow the government to manage the contingent liabilities imbedded in the banking system. Continued attention to resolving the underlying systemic weaknesses in the corporate and financial sectors is required, however, to prevent an increase in the risk of a crisis over the medium term.

The pace of reform has accelerated since the Fifteenth Party Congress . . . Steps toward fostering corporate innovation began in the mid-1990s. Despite progress in many areas, however, these reforms have only gradually altered the basic governance mechanisms that left central government ministries and local government bureaus in control of operations. Reform accelerated after the Fifteenth Party Congress, held in September 1997, when the government restated the important role for "public" ownership (to be interpreted more broadly than state control), and acknowledged the role of other forms of ownership, including limited liability corporations, stock share corporations, and a variety of hybrid ownership and control forms. The Fifteenth Party Congress also called for bolder steps to separate government units from enterprises, significant progress toward which was made in the second half of 1998.

. . . with recent efforts focusing on financial reform. Drawing partly on lessons from the Asian financial crisis about the financial vulnerability of large enterprises and enterprise groups, Chinese policymakers shifted their emphasis in 1998, placing greater attention on the financial aspects of state-owned enterprises. Initial steps focused primarily on banking sector reforms aimed at managing financial risk and reducing the rate of accumulation of nonperforming loans in the system. A risk-based loan classification system was introduced, the central bank's network of branches was consolidated along regional lines to enhance supervision and reduce local government inter-

ference, and problems at some small troubled financial institutions were resolved. These measures have only begun to address the weaknesses in the sector, however. Moreover, the pace of financial sector reform continues to be constrained by lack of progress on the enterprise side.

As incentives in the financial sector improve, credit expansion will be dampened as banks become more discriminating about making loans—a trend that is already evident. Careful management of these reforms will be needed to ensure that they foster rather than hinder corporate restructuring.

The Need to Address the Social Agenda

Maintaining employment and ensuring that social protections are major challenges for China as it moves to a more market-oriented economy. The slowdown in the economy has further highlighted the need to address the social agenda in China.

Urban labor market equilibrium is increasingly fragile. Rationalization of the labor force through enterprise reform has increased unemployment in China. A growing economy was creating jobs in urban areas at a rate of about 7 million a year between 1994 and 1997, many in the tertiary and informal sectors. Despite this job creation, employment growth has not been sufficient to absorb natural urban labor force growth, rural migration, and workers let go by state- and collectively owned enterprises. As a result, about 8.1 percent of the urban labor force was unemployed by mid-1998, according to World Bank estimates, with rates of unemployment of 12–13 percent in some urban areas. The emergence of urban unemployment and reduced migration from rural areas means that the labor market equilibrium has become increasingly fragile. The problem has been particularly serious because of the inadequacy of the safety net. Because of the high unemployment levels, the government may wish to hold in abeyance removal of remaining administrative impediments to rural-urban migration; but over the long term, as the excess labor overhang is absorbed, removing these impediments will be essential to increase labor productivity.

Regional incidence of external shock not limited to coastal area. Based on preliminary analysis through late 1998, the Asian and global crisis has affected not only the

better-off coastal provinces but other provinces as well. The direct impact has been relatively mild in the poorest rural provinces, more severe in the coastal provinces, and most severe among middle-income areas in the interior, which are suffering the most severe urban labor problems and have sizable poor populations. With the risks of exports deteriorating further, policymakers will need to look carefully at regional impacts.

Funding of social protection schemes has increased but remains inadequate. During 1998 both the central government and local governments injected additional funding into the major social protection programs. The central government subsidized local outlays for guaranteeing a basic living standard for workers laid off from state-owned enterprises in central and western areas and old industrial bases. Efforts were also made to reduce pension arrears. The injection has not yet been on the scale required, however. As a result, not all laid-off workers eligible for re-employment services and subsistence allowances and not all lower-income urban households eligible for minimum living stipends are receiving them.

Public investments associated with the fiscal stimulus package are relatively labor intensive, with a direct and indirect employment impact estimated at about 5 million jobs over the two-year life of the program. Much of the investment program is rural based, employs unskilled workers, and will stimulate employment in the building materials sectors, which have excess capacity. Given the location of provinces experiencing the largest temporary demand shock, efforts to direct a larger share of fiscal financing toward the central and western regions represent appropriate regional targeting. Much smaller amounts have been allocated to supplement poverty relief projects, however, suggesting further scope for targeted initiatives.

Policy Options for the Future

Although new storm clouds are gathering, lessons of experience—on macroeconomic management, capital account liberalization, the corporate and financial sectors, and social issues—are emerging. The key challenge for the near term will be to make macroeconomic and structural reform policies even more mutually rein-

forcing than they have been. Policies and programs must emphasize pro-growth structural reform measures that increase both demand and supply. The pace of these reforms will need to be accelerated in order to reduce the need for implementing additional expansionary fiscal and monetary policies.

Avoid extremes in growth

Chinese policymakers must try to maintain growth within a narrow band. Lower growth—the greater risk in China at this time—could cripple job creation and exacerbate financial problems imbedded in the corporate sector. Higher growth could cause inflation and the need for sharp adjustments in the future.

Growth will be affected by two major uncertainties: changes in the global environment and the extent to which the domestic economy—in particular, household consumption and nonstate investment—responds to the macroeconomic stimulus package. In the base case scenario, despite continuing difficult global economic conditions, the domestic economy responds modestly to the macroeconomic stimulus package, growing about 7 percent in 1999. Under the downside scenario the global economy is assumed to deteriorate sharply, reducing GDP growth in China by 3 percentage points. Assuming that China can only partly offset this decline through domestic measures, growth would fall to 5 percent a year. This possibility requires foresight and preparation by the government, including stronger efforts to tackle the social agenda.

In either scenario some deterioration in the external trade accounts would be consistent with the Chinese authorities' policy of maintaining relatively strong domestic economic performance. Given China's strong external reserves position and modest external debt burden, such developments are not likely to lead to unsustainable external imbalances or an externally induced crisis in the base case. Policymakers will, of course, need to communicate their intentions clearly to the market—by providing as much reliable information as possible—so that any deterioration in the external accounts is recognized as a consistent part of the government's overall macroeconomic stance. Without such recognition, market confidence could decline, setting off disorderly capital account behavior.

The downside scenario poses more serious risks, because a sharper decline in the trade accounts could be accompanied by short-term capital outflows. It is too early to assess the extent to which measures to intensify enforcement and scope of capital controls will have a lasting impact. Should such risks materialize, adjustments would need to be made to both domestic and external policies. Additional efforts may be required to remove structural impediments, improve the competitiveness of exports, and reduce the attractiveness of imports. China would still be well advised to cushion the impact on the domestic economy with some decline in international reserve levels. With current reserve levels standing at about 11 months of imports of goods and services, there is scope for such reduction without exposing China to excessive risks. As long as global demand remains weak, it will be difficult to rely on the external sector as a major source of growth.

Stimulate domestic demand if necessary. Adequate domestic activity is key to minimizing risks on both the employment and corporate-financial fronts, which are likely to increase in 1999–2000. Should the growth pattern evolve as expected, the government may not have to resort to major macroeconomic initiatives. It nevertheless needs to be prepared to stimulate demand further if necessary. Maneuvering space has existed for short-term fiscal measures, subject to tackling the fundamental problems affecting fiscal sustainability. Recent World Bank analysis shows that while the government may be able to cover its existing contingent liabilities in the banking and public pension systems, fiscal sustainability requires both successful containment of such contingent liabilities and the strengthening of the finance of its central government. These factors, rather than the magnitude of the short term fiscal stimulus alone, will determine fiscal sustainability. While the reform of extrabudgetary funds is expected to raise the revenue to GDP ratio by up to 5 percent over the next two to three years, the discretionary allocative power of the budget will not increase, as extrabudgetary funds are currently financing many government activities. More fundamental fiscal restructuring will have to be implemented, including broadening the tax base to include rapidly growing sectors and emerging nonstate activities.

Given the large share of GDP accounted for by investment of the nonstate system (16 percent) and rural and urban household consumption (45 percent), sustainable growth will depend on structural measures that can stimulate their growth. Further reliance on centrally driven public investment as the primary fiscal instrument of reform could reduce the quality of investment.

Transform the financial-corporate sectors—in time

Clearly, the way to gradually replace the poorly performing parts of the economy is to develop the dynamic sectors of the economy.

Develop the service and informal sector. Nurturing of vigorous enterprises and industries within the service sector is a critical element of the pro-growth structural reform agenda. The same type of dynamism evidenced in the growth of China's external trade in recent years can be equally well used to tap the potential of the domestic market.

In other low- and middle-income countries, the service sector accounts for more than half of nonagricultural employment and two thirds in large developing countries. In China less than half of nonagricultural employment is generated by the service sector. Slightly faster growth in that sector could add an additional 2 million jobs by 2000, reducing the job shortfall by half. Expansion of service activities could take place in various sectors, such as telecommunications and tourism, which are growing rapidly. An array of business-related services—such as accounting, auditing, legal, secretarial, media, public relations, information technology, and communications—needs to be developed. Facilitating the development of this package of services is essential to the restructuring enterprises and transformation of corporate culture that is the second prong of a pro-growth enterprise strategy.

Create a financial sector that serves dynamic domestic markets. Excessive attention to centralization and consolidation of financial risks can impede precisely the financial sector transformation needed to improve intermediation of domestic savings. Increased financial supervision needs to be underpinned by a desire to develop the kinds of

financial markets and instruments that help develop dynamic domestic markets. More vigorous enterprises need greater access to capital so that they can increase the returns to the large pool of domestic savings. Such access could be increased by approving public issues of debt or equity for private firms; promoting leasing; introducing a venture capital investment mechanism; supporting development of smaller financial institutions, which traditionally serve smaller, more dynamic clients; developing over-the-counter equity markets; and expanding the corporate bond market. Capital markets can play an equally important role in strengthening corporate governance.

Restructure enterprises with excess capacity and strengthen corporate governance. The corporatization and commercialization of state-owned enterprises—and the separation of party politics and government from business—represent steps in the right direction. China's incentive structures, legal framework, and code of conduct remain inadequate to strengthen corporate governance, however. Restructuring of physical capacity must go hand in hand with financial restructuring and deleveraging of enterprises; enterprise reform must be closely coordinated with banking reform and capital market development.

A framework must be established for resolving bad bank debts and attracting investors. The recent increase in emphasis on financial sector reform is a welcome start. Unless the quality and allocation of new financial flows is improved within China, however, problems will recur. Strengthening supervision, enforcement, and transparency will be critical to improving the incentives to financial institutions as well as to maintaining confidence of others in the financial system.

The interrelationships between the enterprise and financial sector are extremely complex and involve several hundred thousand enterprises. Because the bulk of loans are with the four large state-owned banks, the authorities have selected reform of those institutions as the key entry point for tackling the bad debt problem. The initial impact has been to harden the budget constraint on state-owned enterprises, which in turn has created pressures in the system for additional reforms, such as improving the legal and regulatory framework

for enterprise restructuring, bankruptcy, and debt workouts and developing better accounting standards, judicial processes, and other procedures.

The size and complexity of the Chinese economy defies any one comprehensive overarching strategy for tackling these issues, and one would expect to see a large degree of diversity in approaches across localities, sectors, and institutions. The experience of other countries suggests that managing such problems is a complex and lengthy process that requires some fiscal contribution (although an emphasis on recovery can reduce the cost to taxpayers).

A growing economy will facilitate tackling of systemic weaknesses... Addressing systemic weaknesses by developing dynamic industries and increasing growth can—in fact, must—be done simultaneously. Based on analysis of the liquidity position of enterprises in the industrial survey, firms with higher productivity appear to have a cushion to absorb some deterioration in financial performance without jeopardizing their ability to employ workers or service financial obligations. Most firms with low or negative productivity, however, are already unable to meet current obligations to workers and suppliers, let alone financial institutions. More worrisome yet, firms with marginal productivity (which control about a third of total assets) have little margin for further stress. The precarious position of many Chinese firms reinforces the importance of avoiding excessive declines in growth, which threaten survival of firms that could remain viable in a healthier economy. Improving the climate for dynamic firms and sectors is essential to managing the difficult balancing act of accelerating corporate restructuring and maintaining macroeconomic stability.

... and relieve the strain on the labor market. The strains on the labor market in China are likely to be unusually acute in the next two or three years until the compounding urban overhang has been absorbed. Economic growth can facilitate labor absorption and reduce slackness. If, for example, the economy grows by 7 percent a year, the expected annual urban job shortfall of about 4 million jobs could be equilibrated largely through a sizable absorption by the informal sector. The urban unemployment rate could rise by about 1 percentage point, however, and rural labor absorption could fall by about

a third. Growth of just 4–5 percent a year could have a more severe effect on employment.

Even with growth of 9 percent a year, however, China is likely to face an employment shortfall of about 2 million jobs a year. These figures highlight the need to develop labor-intensive enterprises. Reforms that help develop the service sector, private sector employment, urban informal sector, processing industries, and non-grain agricultural production are essential to reduce or absorb the job shortfall.

Given disparities in regional labor markets, the intensity of labor market interventions should vary across regions. Internal migration should be facilitated, but it is likely to have only a marginal equilibrating effect in the short run in the face of large disparities. Retraining will need to be selective to ensure adequate social returns.

China's labor surplus appears to be a transitory problem. If current rates of natural attrition and layoffs were to continue, the surplus would disappear by as early as 2001 and no later than 2004. With the urban labor overhang exhausted, the flow imbalance in the urban labor market would be corrected. The urban labor market would be able to absorb more workers than required; the pace of rural-urban migration could be restored, if not accelerated; and levels of structural unemployment built up during the transition could be reduced. The right combination of macroeconomic and structural policies could allow this transition to be accelerated.

Foreign direct investment can serve these domestic business developments. As the lessons from the recent Asian crisis indicate, China should remain cautious about portfolio and short-term capital flows until it is prepared to assume the associated risks. At the same time, it should continue to encourage longer-term flows. China is fortunate to have sufficient policy levers to continue to attract foreign direct investment with which it can augment and enhance domestic business development. Although overall interest by foreign direct investors has declined since the Asian crisis, there is scope for making up the shortfall by encouraging investment in the more dynamic sectors of the economy (many of which remain on the "restricted" list), promulgating the build-operate-transfer (BOT) law and other steps to liberalize foreign and private investment

in infrastructure, and introducing clear enabling legislation for foreign investment to help restructure state-owned enterprises.

The Asian financial crisis has shown that caution must be used in encouraging international short-term capital flows. It has also shown, however, that excessive restrictions over foreign participation in the provision of domestic financial services can impede healthy development of the domestic financial system.

Increase household consumption

Growth in household consumption is important both to increase demand and to restructure the economy away from heavy and supply-driven investments toward a production structure that responds to market demand. The economy has begun to reflect the needs of Chinese households, but the legacy of past imbalances remains. Policies that encourage greater rural and urban consumption are essential to both near-term growth recovery and the quality of that growth.

Strengthen the safety net. One of the major factors that has constrained consumption for many households is uncertainty with respect to future income security. Creation of adequate safety nets for households experiencing temporary adjustment problems would increase public confidence in future household economic security, which in turn would stimulate urban household consumption.

Building on efforts by both local and central government in 1998, the authorities will need to ensure that social protection programs receive adequate fiscal support. Less than 0.5 percent of GDP would be required to fully fund the social protection programs already established by the government. These programs must reach fiscally distressed localities, especially if a continued slowdown continues to disproportionately affect provinces with the greatest urban labor imbalances.

The 1998 public investment program stimulus package, which relied largely on traditional large-scale investments, missed the opportunity to use the public works programs to target areas in need. Funding of small public workfare programs could enhance regional targeting and have a strong social impact in depressed urban economies and poor rural areas.

Should growth and employment slow significantly, adequate fiscal support for social protection programs will prove even more vital. To prepare for such a possibility, the authorities must develop a contingency plan for reaching the rising number of distressed rural and urban households.

Increase revenue mobilization. China's macroeconomic stance must not threaten key public expenditures over the medium term. To enable the government to finance—and expand—its involvement in the social sectors, especially in rural areas, revenue mobilization must be strengthened. Many of the institutional measures required will take time, but the groundwork must be laid now. Improvements in budgetary management systems will be critical to improving the link between the government's priorities and its budget.

Implement other structural reforms. The shift toward consumption has implications for a range of policy issues, many of which China is already pursuing. Housing reform is essential to stimulating demand for housing in the medium term. The timing is right for monetization of nonwage benefits. In the rural sector, agricultural policies can enhance rural consumption and benefit domestic firms producing lower-end goods. Opportunities for continued rural migration are also essential. These and other pro-household shifts in consumption need to be accelerated.

Organization of the Report

The report is organized as follows. Chapter 1 describes macroeconomic developments in China in the past two years in the context of developments since 1991. It also reviews China's policy stance, examines the response of the Chinese economy to the domestic stimulus program, and identifies factors that will affect the success of the program in the future. Chapter 2 examines the weaknesses in the financial and enterprises sectors and describes the reforms that have been adopted. It also describes China's public investment program. Chapter 3 examines the effects of macroeconomic shocks on employment and income distribution, looking at labor markets, external shocks and the terms of trade, and public spending and fiscal tradeoffs. Chapter 4 examines three alternative scenarios for the future, linked to the global picture, and shows how the government can use fiscal (especially expenditure), monetary, exchange rate, and trade policies to deal with an economic slowdown. Chapter 5 presents specific recommendations for reforming the enterprise and financial sectors. Chapter 6 looks at ways in which policymakers can maintain employment, support consumption, and increase social protection, thereby tackling the social agenda.

Agonising choices accompany change

Measures needed to deliver growth may force the government to let go of the levers through which it exercises authority

The first 30 years of the People's Republic was riddled with disasters, says Cao Siyuan, a private economist. "In the next 20 years we walked out of the shadows of disaster. In the next 50 years we will walk into the embrace of civilisation."

It is a daring comment, but the forward-looking Mr Cao, the first to suggest in the 1980s that China should enact a formal bankruptcy law, is used to thinking the unthinkable. Now his message is that, until China moves to full-scale privatisation, its economic reforms will not be complete.

His view finds echo elsewhere. The transformation of China's economy has been dramatic. Over the past two decades, employment in the private sector has risen from 150,000 to 32.3m or 15.6 per cent of the urban workforce, says Li Donglin, director-general of the ministry of labour and social security. China has launched its own stock markets and opened to foreign investment.

This year, it amended the constitution to endorse formally the concept of private ownership. It has even launched debt-equity swaps in an attempt to clean up its banking sector and alleviate the debt problem of state enterprises. But local officials, as well as western economists, believe there is still a long way to go.

In a report entitled *Weathering the Storm and Learning the Lessons* published earlier this year, the World Bank listed continuing weaknesses in China's enterprise and financial sectors including:

- Corporate governance with poor definition of ownership and accountability;
- Continued government interference in investment decisions; and
- A regulatory capacity unable to deal with the fast development of its financial sector.

Chinese business executives and officials have other concerns. Feng Lun, chairman of the Vantone venture capital group, believes the country lacks management talent and the ability to channel resources to the best managers.

Qin Xiao, president of China International Trust

and Investment Corporation (Citic), the leading state-owned conglomerate, believes the absence of a rule of law increases risk and makes doing business too expensive.

Shao Ning, head of enterprise reform at the State Economic and Trade Commission, recognises that ailing state enterprises are a drag on the economy. The problem with central planning was that it allowed enterprises to be created without any proper justification. The task now is to create a competitive environment where only the strongest survive, and the weakest pull out "peacefully" from the field, he says.

As part of the process, China has been moving to close some enterprises, including a large number of uneconomic small mines in the highly sensitive coal industry. It has also begun to experiment with new incentives for managers. Pilot schemes have been started in coastal cities, such as Shanghai and Xiamen, where commissions have been set up to appoint and assess managers and fix their rewards.

Western economists argue that the country is at a crossroads on reform. "China has brought itself to the stage where it has to - and can - address these difficult problems that have been postponed for a number of years," says Yukon Huang, China Director of the World Bank. Despite the recent cyclical slowdown, the country has created enough intrinsic growth to continue with adjustment. "Reform is potentially manageable," he says.

In the background is a concerted effort to set the stage for serious reform. Not only is China moving to ease the non-performing loan problems facing banks and state enterprises. The four large state banks are setting up special asset management companies to remove doubtful loans from their balance sheets and a first debt-equity swap was agreed recently between China Construction Bank and Beijing Cement Company.

It is also setting in place a centrally-funded social safety net providing retrain-

ing for laid-off workers and welfare benefits that should increase labour mobility and relieve state enterprises from the costly obligation of providing social support.

Nonetheless, it is a daunting task. Mr Li of the Labour Ministry says the total budget cost of social security rose 23 per cent last year to Rmb165bn. In the first half of this year it rose a further 17.2 per cent to Rmb85.6bn. According to his own conservative estimates, about 20m workers in state enterprises are surplus to requirements. "We cannot just put them into the market," he says. "Many of these workers are also still used to the system of 'cradle-to-grave' guarantees. It's difficult for them to find a job for themselves."

Though even conservatives in the Chinese establishment acknowledge the need for reform to achieve sustainable growth, there is an underlying concern that social unrest could develop if growth slips too far, adding to the strain on employment. At times this year, China's enthusiasm for reform has seemed to wane with instructions to banks to top up the working capital of enterprises in difficulty and a slower approach to reforms that involve job cuts.

"The major policy issue facing China is how to respond to near-term growth pressures that reinforce structural reform and economic development," says the World Bank report. But, according to Mr Cao, a more fundamental issue is also at stake. "Bureaucratic power in this country depends on control of the state-owned sector," he says. Full privatisation and the imposition of the rule of law would make the exercise of this control much harder, he says.

This is the government's dilemma. If it fails to move forward on reform, it may not deliver the lasting high growth to which the population now aspires. But if it moves decisively ahead, it may be forced to let go of the levers through which it exercises authority. For China's leaders, this implies agonising choices. Small wonder that, as Mr Cao says, "their legs want to march forward, while their heads tell them to stand still".

A palpable shift in sentiment

The first fall in foreign funds this decade is a sign that foreign companies are taking a more hard-headed approach

For 20 years, ever since Deng Xiaoping's "Open Door" policy heralded market liberalisation, foreign investors have looked at China as a mouth-watering commercial opportunity.

Today, many of those same investors are taking a harder-nosed attitude towards the land of a billion consumers. Not all are in retreat, but there is a palpable mood of retrenchment among those staying.

The shift in sentiment reflects the difficulties of doing business in an economy struggling to escape the shackles of deflation, the impact of the Asian financial crisis, and worries over the stability of the currency. But it also points to a loss of patience with an economy where sustained profits have proved more elusive than imagined.

Foreign direct investment has fallen by 10 per cent in the first seven months of this year. Although officials in Beijing and Shanghai predict there will be a slight pick-up in the second half, the total figure is expected to reveal a decline for the first time in this decade.

In some respects, the new realism among the foreign investment community is a healthy sign. It shows, says one western lawyer in Shanghai, that investors are treating China like any normal country, rather than a developing country making the transition from a command economy to a social market economy.

But he adds: "There is no doubt that a lot of people are frustrated right now."

The slowdown has profound implications for the government, both in its management of the economy and its relations with the west. Foreign direct investment has created much-needed jobs, particularly in eastern

regions, where state-owned companies are laying off workers. If foreign investment dries up, it will be a further drag on the economy and could exacerbate unemployment and labour unrest.

Last year, for example, foreign direct investment (FDI) in China was \$45.6bn. This makes China the largest recipient of foreign investment after the US, and easily the largest among developing countries. Dai Xianglong, governor of the People's Bank of China, the central bank, tentatively predicts a total of \$35bn for the full year.

Foreign investment in China has sharpened competition, improved social welfare and the distribution of resources and spread the use of new technology. Total output of foreign invested enterprises accounted for 17 per cent of the total industrial output in 1997, according to Hu Angang, a leading Chinese economist and author of a recent paper on the foreign direct investment policy orientation in China.

Yet FDI is a double-edged sword. Mr Hu notes that the past few years have witnessed unseemly-bidding wars between regions and provinces for the favours of foreign investors. A succession of tax breaks and other incentives have resulted in significant tax losses for the government.

Despite these costs, officials leave little doubt that they are determined to court more foreign investment, albeit on their terms. Wang Ande, responsible for attracting investment in Shanghai's Pudong district, rolls out the names of foreign companies with relish: GM, NEC, Sharp, Hitachi, Siemens, BASF, and Pilkington, each with hundreds of millions of dollars at stake.

Yet a small but growing

been folding their tents. Royal Bank of Canada has pulled out of China, worried about the health of the financial sector. South Western Bell withdrew from a telecommunications joint venture because of regulatory obstacles and Foster's, the Australian brewer, is selling the bulk of its Chinese operations after failing to make a profit.

In some cases, the Chinese blame events beyond their control such as the wave of international mergers which has forced companies to rationalise their Chinese operations or representative offices; but elsewhere it is plain that head offices of multinationals have ordered new projects to be put on hold until the Chinese operations are either streamlined or the joint ventures are scrapped in favour of management structures which offering greater degree of control.

One example of new corporate thinking about doing business in China is Eastman Kodak's purchase last year of three state-owned photographic film enterprises. The deal suggested that foreign companies were becoming more leery of pouring large sums and lots of corporate energy into making a greenfield operation work, and were prepared to bide their time until they could buy into established Chinese ventures.

The next step, says Mr Hu, is to develop a rules-based system for FDI which seeks to attract regional headquarters of foreign companies, improve the quality of exports, and continue the search for high-value, high-tech projects. In other words, second generation reform.

For the moment, however, the atmosphere is more sober. The gold-rush mentality has gone.

Reform slows as buyers increase

The rise in mortgages underlines the commercial potential in China's newly liberalised property market

Just outside Shanghai International Airport, a huge blue and white sign proudly proclaims: "Individual mortgages from China Construction Bank now exceed Rmb22bn."

A few months ago, the figure was Rmb7bn. The spurt in lending to home-buyers underlines the commercial potential in China's newly liberalised housing market.

In March 1998, Zhu Rongji, China's prime minister, announced that the subsidised housing traditionally made available by state sector employees to Chinese workers would be phased out. Instead, workers would be encouraged to buy their own homes or at least pay a more commercial rent.

This was hardly a new development in China's more advanced cities such as Shanghai and Guangzhou, where the residential market is dominated by the private sector. But for the rest of country it was a radical departure which could have profound social and political ramifications.

The reform promises to relieve state enterprises of the burdens of providing housing for employees, while freeing up state funds for much-needed spending on infrastructure. At the same time, economists predict a boost to domestic demand as house buyers draw on savings to furnish or upgrade their new houses.

But for the authorities in Beijing, changes in the housing market are turning into a test case for the broader reform process in China. Above all, it raises the crucial question: how far is the Communist party willing to cede full property rights to the people, allowing individuals the right to own and sell their houses, make money and move jobs in line with a functioning market?

Finance minister Xiang Huaicheng says it would be wrong to deprive the Chinese people of the chance to own their own property. Indeed, the finance ministry has set up a task force to examine the liberalisation of

the secondary market, which many see as vital to tap the full potential of the sector.

Mr Xiang says he is also open to considering the introduction of stamp duty to tax the sale and purchase of houses, partly to bolster state revenues. "The trading of housing is both good economics and good politics."

Despite these reassuring words, the general view is that housing reform is moving more slowly than many of the more ardent reformers had hoped and that the process is yielding fewer short-term benefits than initially expected.

The reasons are fourfold:

The authorities remain reluctant to cede full property rights to ordinary people

● First, the authorities remain reluctant to cede full property rights to ordinary people. Many Chinese who buy their houses gain the right to own the house, but not the automatic right to sell it. In some cases they can wait years to obtain the relevant certificate from municipal bureaucrats.

● Second, state-owned housing is usually sold at a discount to market prices. How big a discount depends on the building's quality and the length of service of individual employees at the relevant work unit. But as the purchase price is often artificially low compared to a resale value three to four times higher, it leaves party officials open to accusations of having allowed profiteering.

● Third, China's residential property market needs to be more differentiated to reflect levels of purchasing power in the economy, says Yukon Huang, China director of the World Bank. But this has

profound implications in a society which sets such store by equity and fairness.

● Fourth, bank mortgage lending terms tend to be too short-term and strict on collateral. Wang Zhenzhong, professor at the Social Science Academy in Beijing, says there is an absence of trust, which is essential to the functioning of a market economy.

"There is no such thing in China," he says. "If you want to go the commercial route you have to do it 100 per cent."

The optimistic view is that the process of housing liberalisation, however faltering, has passed the point of no return. Fang Xinghai, a senior official at China Construction Bank, a pioneer in mortgage lending, says the total mortgage portfolio is about Rmb60bn. Business is growing at 30 per cent a year.

CCB charges roughly 7 per cent for 15-year mortgages, while the cost of funds is 3 per cent. "It is a very good business," he adds.

Mr Fang says CCB targets young people working for foreign companies in big cities and earning higher salaries. The down payment is about 30 per cent. If the owners default, the bank reckons it can recover the entire value of the property. Moreover, CCB is securitising its mortgage portfolio.

"We are being encouraged by the government to do more consumer lending. We do more around housing loans," he says.

The potential prize is huge: a more deregulated residential property market would give people assets against which they could borrow to finance new business activities, allowing other new service industries such as insurance to spring up.

But all this implies relinquishing a measure of political control over the lives of ordinary people, something the Chinese authorities may find hard to swallow, whatever the potential economic benefits.

Figuring out a long-term trend

The finance minister says he is worried about the size of the deficit, which may be larger than official figures indicate

By normal standards China's government finances are very healthy. This year's deficit of Rmb180bn will be a record, but it is still only 2 per cent of gross domestic product and government debt is only about 10 per cent of GDP.

With such figures, China would have a far easier time than Germany in qualifying for entry into European monetary union, but, with spending being stepped up to combat deflation, China's cautious policy-makers are keeping a sharp eye on a trend they believe will need fixing in the longer term.

Xiang Hual-cheng, finance minister, says he is "very concerned" about the deficit's size. During his predecessor's term, he says, it fell from 1.4 per cent to 1 per cent of GDP. Now, the ratio has doubled. "I hope it won't go on expanding," he says.

He knows that government revenues of only 12 per

cent of GDP do not provide much leeway to service an ever-increasing volume of debt. There is also general recognition that China's own statistics understate the deficit figure. Interest payments have not hitherto been included in the official budget figures, while the government has also accumulated a high volume of off-balance sheet liabilities. The true deficit is certainly considerably larger than official figures suggest.

Mr Xiang says there are two strands to strengthening government finances. One involves tightening up collection procedures and introducing new taxes, the other, introducing more accounting transparency so that the true position of government finances is clearer.

For now, pressure has been eased by an unexpected boost to government revenues from a recovery in profits at state-owned enter-

prises and a sharp increase in import tariff receipts due to last year's clampdown on smuggling. According to Mr Xiang, government revenues rose 23 per cent in the first seven months of the year, with tariffs more than doubling. For the year as a whole, revenues should rise by 18 per cent as seasonal factors cause the increase to taper off, he says.

There has also been a fall in arrears on tax payments, says Chen Faguang, vice-minister at the State Administration of Taxation. Last year, about Rmb27.5bn in arrears were collected, leaving only about Rmb20bn outstanding, although some of these may be irrecoverable.

A big part of the quest for new revenues involves turning unofficial fees levied by government departments for their services into formal taxes. Even though this has some limits - fees which are illegal cannot be turned into

taxes and fees are an appropriate means of charging for some types of government services - it will involve a substantial change. "The erosion of the tax base by fees will be stopped and the base will become relatively larger," says Mr Fang.

New taxes include a 20 per cent withholding tax on interest paid on bank deposits due to be imposed this month. The aim is to raise finance from wealthier savers to help low-income households and to discourage excess flows of savings into banks. But economists believe the revenue will be modest, partly because the tax does not extend to interest on bonds.

More radical may be a planned social security tax to which employers and individuals will contribute, says Mr Xiang. This will cover the expected sharp increase in social security and other welfare payments as govern-

ment struggles to cope with restructuring the economy.

The other part of efforts to improve the budget is more transparent accounting. For example, only half the special infrastructure bonds totalling Rmb160bn in the past two years are included in the deficit figure. A further issue is the non-inclusion of interest payments. This will change next year, says Mr Xiang, adding about 0.7 percentage points of GDP to the deficit total.

The aim of all this, says Mr Xiang, is to ensure government finances can cope with effects of continuing reform. Revenues should rise to 20 per cent of GDP within five years, he adds, so "my successor will have an easier time".

How easy this will prove remains to be seen. The move away from fees means changing a deeply ingrained culture, while there is evidence of resistance to new

taxes. Earlier this year, the National People's Congress rejected plans for a new petroleum tax and pressure remains limited while buyers abound for new government bonds.

The wider deficit means government issues of treasury bonds this year will rise to Rmb401.5bn from an original target of Rmb342bn, but only about Rmb150bn of this represents new offtake from the market, while the rest is refinancing of existing

issues. Bankers say the market can easily absorb this amount, especially while business demand for credit remains weak.

But there is also a general recognition that the government's ability to proceed with reform will depend heavily on its ability to keep the budget under control. In conversation, Mr Xiang is relaxed and jovial, but there is no doubting his determination to succeed.

Farmers miss out 5 on the good times

Production has increased dramatically during the past two decades. But the rural economy remains a drag on resources

Ma Yongquan is the most successful retailer in the most remote corner of China, but even he says he has no luck selling things to Chinese peasants.

"I don't want to disparage people from the countryside, but expensive things they say they cannot afford and cheap things they say are no good... There is no business in the rural market," says Mr Ma, head of the Xinjiang Friendship Group in the north-west city of Urumqi.

Mr Ma's experience of China's reluctant rural consumers is evidence of one of the most stubborn problems in China: the underdevelopment of the countryside.

China's leaders have presided over a significant increase in agricultural output. In the 20 years since the introduction of the household responsibility system has given farmers a sense of ownership and an incentive to move towards market-oriented agriculture, grain production has risen by more than 50 per cent and meat production has multiplied almost five times.

But, these achievements have fallen short of the Communist revolution's pledges 50 years ago. The 900m people living in rural areas in China have been excluded from the benefits of urban China's boom of the 1990s. The agricultural economy remains a large and growing drag on strained budgetary resources. The kind of farming fostered by Beijing has had a high cost in soil erosion and depletion of natural resources.

The relative impoverishment of the Chinese countryside has been a consequence of the two preoccupations of the Chinese leadership:

- How to feed a 1bn-plus population; and
- How to keep hundreds of millions of rural workers from swamping the cities.

By focusing on these questions rather than on farmers' needs and the rural economy, China has fostered an inefficient agricultural sector of tiny plots of land and high levels of labour, wasteful farming and producing goods the market does not need. Yet attitudes to these two issues - food security and rural migration - are shifting. With the change in the thinking, fundamental reforms in the structure of the Chinese rural economy may be afoot. This could affect not only the lives of rural Chinese inhabitants but also farmers further afield interested in selling food to China.

The income gap between China's urban and rural workers has remained stubbornly wide, and is widening further in some areas. While urban annual per capita incomes have risen to Rmb5,160 in 1997 from Rmb478 in 1980, rural incomes have grown to Rmb2,090 from Rmb191 in the same period.

Over the half century of communist rule, China's farmers have sometimes suffered from neglect, sometimes from something worse. The Great Leap Forward, Chairman Mao's misguided attempt to multiply output through collectivisation, caused a famine in which tens of millions of people died, mostly in rural areas.

Beijing's long emphasis on the cheap supply of food to fuel urban industrial growth meant Chinese farmers in the late 1970s had among the world's lowest per capita rural incomes. In recent years, farmers have suffered steep falls in prices for farm produce caused by a series of bumper harvests adding to already overstocked supplies of staple grains and other commodities.

The gradual decline of the economic weight of the agri-

cultural sector has only very slowly been accompanied by a retreat in the social and political importance of the countryside in Chinese life.

China's agriculture accounts for just over 18 per cent of GDP, having fallen from more than 30 per cent in 1980. Meanwhile, agriculture's share of employment has fallen to nearly 50 per cent from 68 per cent over the same period. Perhaps more importantly, 70 per cent of the Chinese population still lives in rural areas, suggesting a surplus of 200m people who could migrate to already swollen cities looking for work.

Reform of the agricultural sector has become a policy priority, therefore, not only for economic reasons. As a recent report by the OECD notes, there are also "socio-political dimensions" behind the need to adjust China's farm and food supply structure, which include "assuring farmer purchasing power for consumer goods, influence on rural-urban migration and social stability."

Food security remains a highly sensitive issue. A line in the Book of Rites from about 500 BC warns "a country without stocks for nine years' requirements has insufficient reserves; with less than six years' reserves, the situation becomes tense; and, with less than three years' stocks, the government will not survive". More recently, Lester Brown's book, *Who Will Feed China? Wake-up Call for a Small Planet*, revived concerns about feeding a country with a 1.3bn population expected to rise to 1.6bn by 2050.

But, there are signs Chinese officials have begun to take a more flexible approach to food security, moving towards market mechanisms for food supply and away from what has Continued on facing page

CAUTIOUSLY OPTIMISTIC

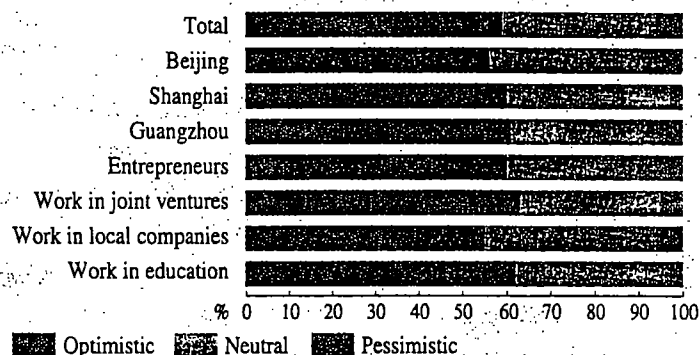
After two years of worrying about the looming threat of the Asian financial crisis, as the region's economies begin to show signs of rebounding, China's rising upper-middle class is becoming increasingly optimistic—but ever cautious—about the future of the country.

This is the second survey of the views and attitudes of the country's growing upper-middle class, a group that only began to emerge over the past decade. As the survey shows, despite the lingering effects of the Asian crisis, the continuing economic downturn at home and the growing threat of social instability, the majority of the country's elite are satisfied with their situation. But while they have high expectations for themselves and the country, they are also spending less, and saving more, and have their feet planted firmly on the ground.

recovery." Another 59% said they were optimistic in their personal view of the economic situation, with less than 6% expressing pessimism.

This is probably partly a response to signs that Asia is pulling out of the financial crisis that has wreaked havoc

Personal View of the Economic Situation in China



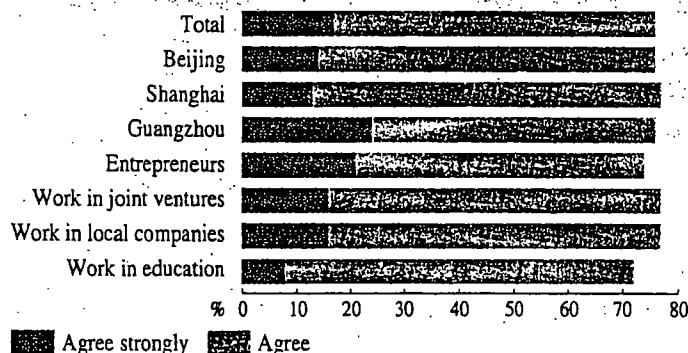
On the road to recovery

The majority of respondents said they felt that the economy was improving, with 17% strongly agreeing, and 59% agreeing, that China is "well on the road to

over the region for the past two years. However, these sentiments fly in the face of reality at home: consumer spending is flat, foreign investment and trade have been declining and economic growth is slowing, with no hint of a boost in sight.

Some 35% said that the general population had a positive view of the economy. While a majority of respondents last year said the general population was pessimistic, this year only 21% expressed this feeling. People in Guangzhou were the most optimistic, with 48% saying the general population was optimistic, compared with just 30% in Beijing and 26% in Shanghai. This may be explained in part by the fact that Beijing and Shanghai have large numbers of state workers who are worried about being laid off, while those working for enterprises in Guangzhou, which are heavily focused on foreign trade and foreign investment, are taking courage

China's Now Well on the Road to Economic Recovery

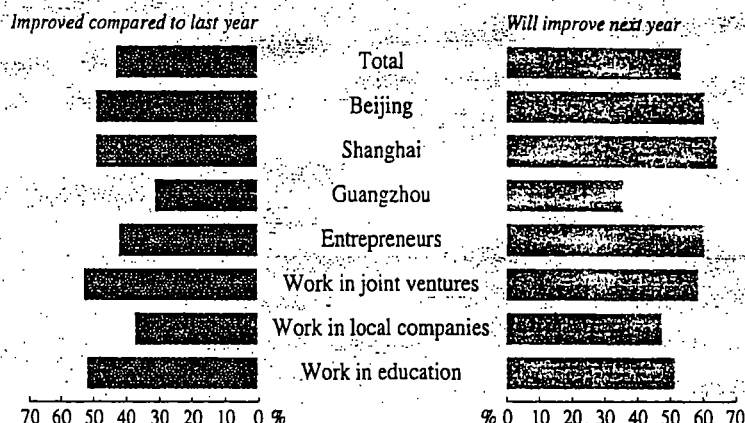


Respondent Profile

This is the second survey of its kind in China. Below is the profile of those surveyed:

- Gender: 72% men, 28% women
- Family status: 73% married with a child
- Age: 33% under 35, 33% 35-44, 27% 45-54, 7% 55 and over
- Education: 61% attended university or higher; 25% completed high school
- Sector: 4% education; 96% business — of which half are local companies, a quarter are joint-venture companies and a quarter are private businesses
- Spending: While respondents indicated that they are spending less money now than they did last year, the majority expresses confidence in the future of China's economy as it moves into the millennium, and a desire to purchase more high-priced consumer goods over the coming year.

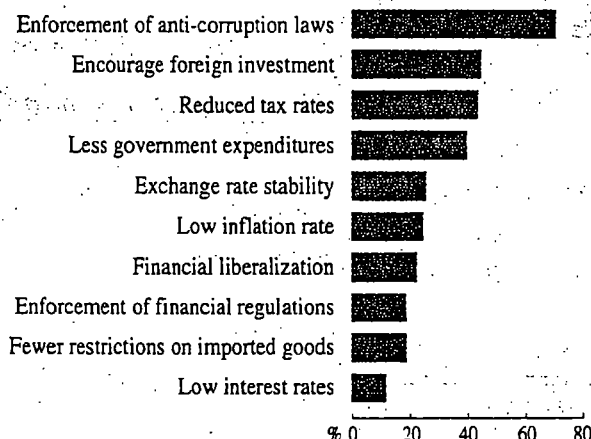
Personal Economic Situation



from the economic rebound in the Asia-Pacific region.

In comparing their own economic situation to last year, 43% said it had improved. Of those surveyed, 38% said they experienced no change at all, while 19% reported that their economic situation had actually worsened during the year. However, 54% predicted that their economic situation would improve over the next 12 months, a further sign of rising confidence in the economy.

Top 10 Factors to Help Economic Development



When asked which factors were most important in improving economic development, 71% said enforcement of anti-corruption laws, an indication of growing dissatisfaction with widening official corruption.

And in a year in which foreign investment has begun to decline, 45% said encouragement of foreign investment would boost the economy. Other measures included reduced tax rates (44%), less government expenditures (40%), exchange-rate stability (26%), low inflation (25%), and financial liberalization (23%). Surprisingly, less than 1% felt that reform of the country's ailing state enterprises, more than half of which are in the red, was an important factor, and less than 1% cited increasing employment opportunities, despite the fact that the ranks of the

unemployed in China have been swelling dramatically in recent years.

According to the survey, 22% of the respondents said they had a personal income of less than 2,000 renminbi (US\$242) a month, 37% reported 2,000-3,999 renminbi, and 16% 4,000-5,999 renminbi. Some 16% claimed earnings of more than 6,000 renminbi monthly. Entrepreneurs reported the highest personal incomes, with 55% reporting monthly incomes of 2,000-5,999 renminbi.

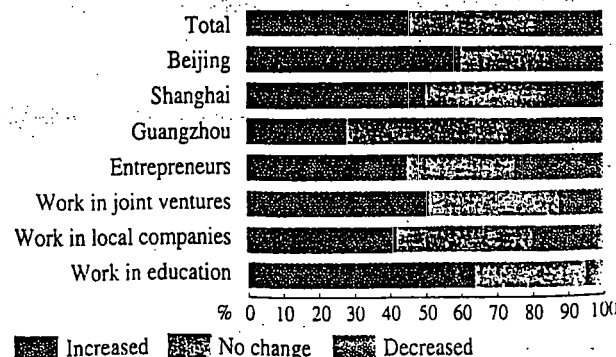
However, joint-venture employees took the lead over entrepreneurs in the salary category above 7,000 renminbi. While women in general tend to earn less than men in China do, the survey showed that elite women matched, or surpassed, men in most salary levels. Joint-venture employees led those whose earnings exceeded 15,000 renminbi (6%), followed by 4% of entrepreneurs. However, only 2% of women reported such high earnings.

Some 46% of respondents said their salaries had increased, 35% said they had remained the same and 19% reported a decrease. Furthermore, while 60% of Beijing respondents and 50% of Shanghai respondents reported increases in salaries, the figure for Guangzhou was a smaller 28%. Educators (64%) and joint-venture employees (51%) reported the highest gains.

Respondents were careful with their extra income, with 47% saying they saved a portion of their increased salaries. Guangzhou respondents, who received the lowest increases, reported saving 67% of their extra money, compared with just 46% for Beijing and 37% for Shanghai. The age group above 55 was the most likely to save, with 62% of this age category saying they had saved their extra income, against just 47% for the 35-44 age group. People earning higher incomes were also less likely to save, with 40% of those earning above 4,000 renminbi saying they saved their extra income, compared with 58% for those earning under 2,000 renminbi and 53% for those earning between 2,000-3,999 renminbi.

Of the total number of respondents, 48% said they spent their extra income on home improvements, 34% on

Change in Income in Past 2 Years



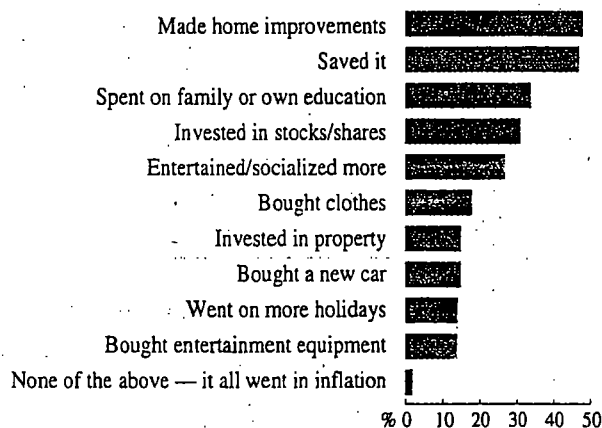
CHINA'S ELITE

education, 31% on stocks and shares, 27% on entertainment and socializing, 18% on new clothes, 15% on property, 15% on new cars and 14% on vacations.

Men and women had basically the same spending habits, with the exception that women were more likely than men to spend on investing in stocks and shares, holidays and clothing.

When asked if they were spending as much money now as they did last year, 33% agreed and 5% strongly agreed, with 22% saying neither was the case. However, 38% disagreed and 2% disagreed strongly.

How Extra Income Was Spent



The good life

The vast majority of respondents reported being happy with their lives, with 74% agreeing that their lives were "full and satisfying," and just 7% disagreeing. Another 76% said they derived "a lot of satisfaction" from their jobs, and 72% said more opportunities exist today than ever before. Still, some 36% said that if they had the opportunity, they would emigrate to another country, as opposed to 37% who had no desire to move and 26% who were neutral.

The late Chinese leader Deng Xiaoping told people, "To get rich is glorious," and the Chinese are often criticized for being obsessed with economic gain. However, this sentiment was not borne out by the survey. When asked what was essential for a good life, the majority of respondents put non-material items ahead of material ones, with 94% citing a happy marriage or relationship, 91% good health, and 74% having children. This compared with 11% who said good quality clothes and

Survey Details

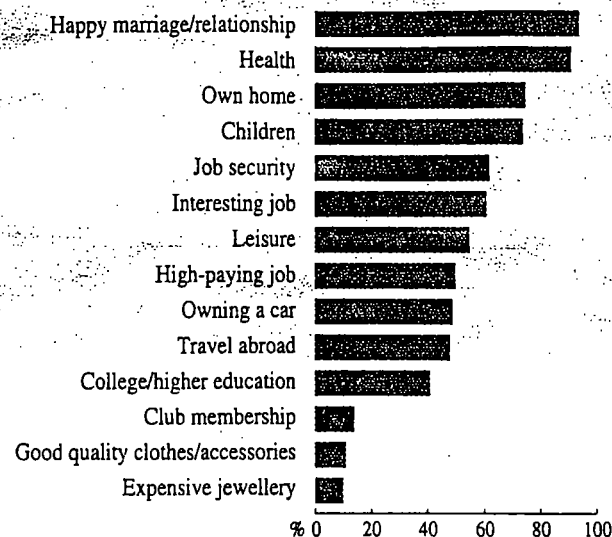
Respondents: 1,512

Cities: Beijing, Guangzhou, Shanghai

Dates: July - August 1999

Conducted by: Asia Market Intelligence (H.K.)

Essentials for the Good Life

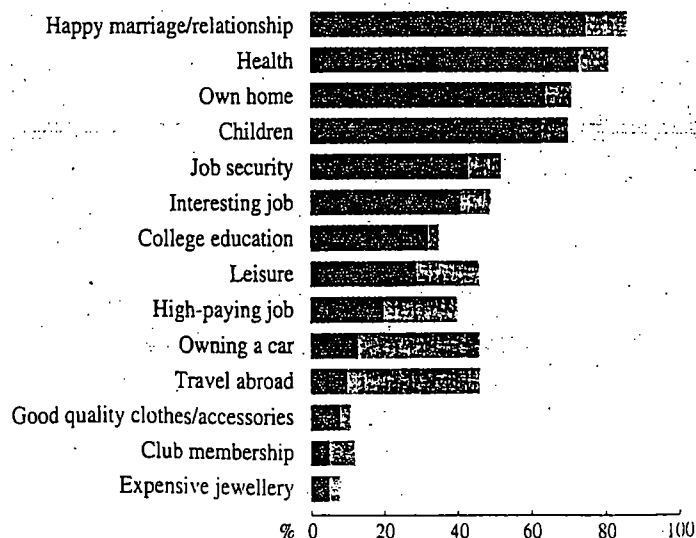


accessories and 10% who cited expensive jewellery. The consumer categories that placed high on people's lists were owning one's home (75%), owning a car (49%) and travelling abroad (48%). Some 41% said increasing one's level of competence or higher education were essential.

There were 33% of respondents who said they expected to own a car, while 36% said they expected to travel abroad, within the next three years. According to the survey, 64% of China's elite already own their own homes, the percentage jumping from 44% for those under 35 to more than 70% for those 35 and older.

A very large proportion of respondents had major

Enjoying the Good Life

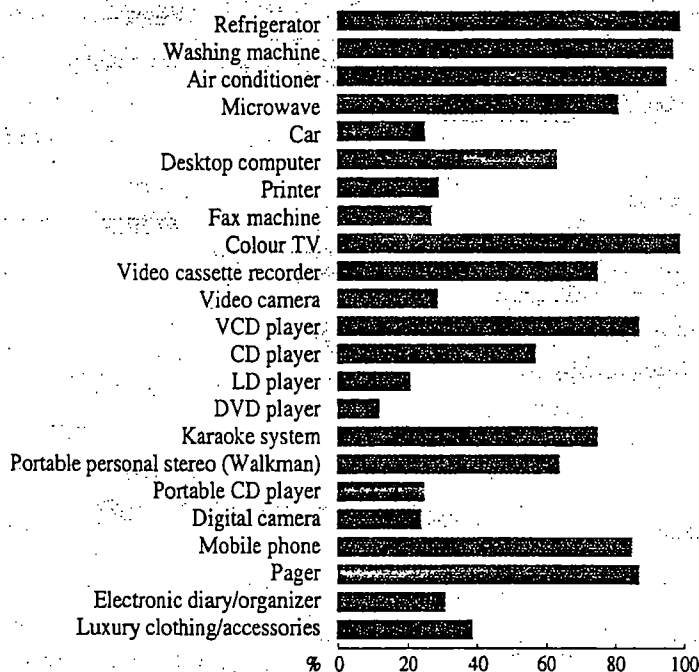


Those who already have

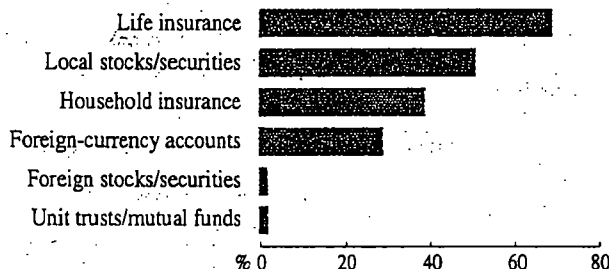
Those who do not have yet but expect to have in next 3 years

CHINA'S ELITE

Product Ownership



Ownership of Financial Products



household electrical appliances: refrigerator (99%), washing machine (97%), air conditioner (95%), and microwave (81%). And 99% said they owned colour TVs, 87% VCD players, 75% video-cassette recorders, 75% karaoke machines, 64% Walkman units, 57% CD players, 24% digital cameras and 12% DVD players. In the telecommunications category, 87% reported having pagers, 85% mobile phones and 31% electronic diaries. And 39% said they owned luxury clothing or accessories, such as diamonds/expensive jewellery (22%), luxury watches costing more than US\$500 (18%), designer-brand handbags (15%) or shoes (15%) and designer-brand clothes (11%).

We asked the respondents what items they expected to own in the next 12 months, and they answered: cars (22%), desktop computers (17%), laptop computers (9%), printers (6%), fax machines (5%), digital cameras (8%),

DVD players (8%), video cameras (7%) and mobile phones (7%).

When asked which foreign/joint-venture products they owned, 84% said they owned foreign/joint-venture-brand household appliances, 28% motor vehicles, 48% PC/peripherals, 92% entertainment equipment and 29% luxury clothing and accessories.

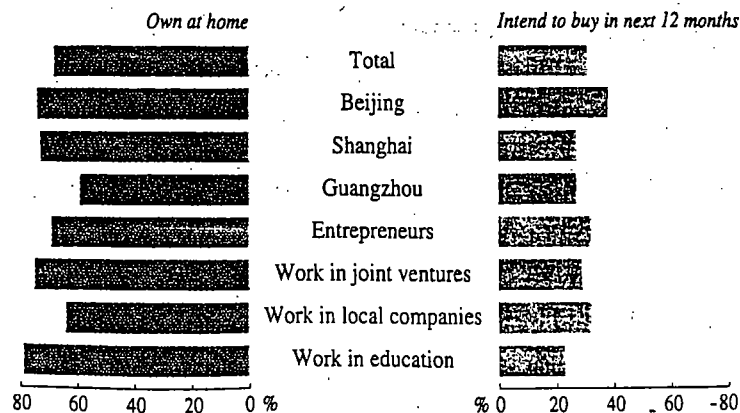
However, foreign producers of these items may have to work harder to hold on to their market share, as a significantly smaller percentage of respondents indicated a desire for foreign products. According to the survey, just 5% of respondents said they planned to buy a foreign/joint-venture-brand household appliance, 19% motor vehicles, 23% PC/peripherals, 19% entertainment equipment, and 7% luxury clothes and accessories. As the previous survey has shown, Chinese consumers—who once clamoured for foreign-name-brand goods—are becoming much less inclined to buy foreign or joint-venture products unless these products are clearly superior to locally produced goods.

Slightly more than half (51%) of the respondents said they owned local stocks and securities, with another 2% owning foreign stocks and securities, 29% foreign-currency accounts, 2% unit trusts and mutual funds, 69% life insurance and 39% household insurance. When asked which financial products they expected to own in the next 12 months, they said local stocks/securities (14%), foreign stocks/securities (4%), foreign-currency accounts (7%), unit trusts/mutual funds (3%), life insurance (16%) and household insurance (19%).

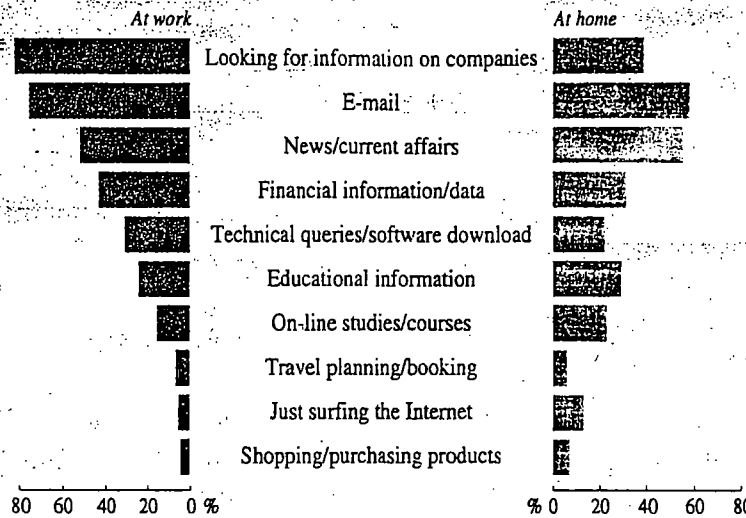
Getting wired

The rise in the use of computers and the Internet will have profound changes on China over the next few years. Computer ownership is increasing rapidly, with 63% of the respondents owning a desktop computer, 10% a laptop computer and 29% a printer. People in Guangzhou were the least likely to own any of the above, reporting that only

Ownership and Demand for Computers & Peripherals



Use of the Internet



59% had such computer equipment, compared with 74% for Beijing and 73% for Shanghai. Again, the higher the income, the higher percentage of those possessing computers and peripheral equipment.

According to the survey, 34% of China's elite have access to the Internet. While some 40% have access in Beijing and Shanghai, however, just 18% of those in Guangzhou use the Internet. Also noteworthy, 53% of those working for joint ventures have access, more than double the other two categories. Understandably, more younger people reported using the Internet, with 47% of those under 35 saying that they have access, compared with an average 28% for those 35 and older. While males and females reported almost equal access, only 22% of those with incomes under 2,000 renminbi said they had access to the Internet, compared with 33% of those earning 2,000-3,999 renminbi and 43% for those earning more than 4,000 renminbi.

The survey showed that 76% of users had access at

work, while 53% used the Internet at home. Some 43% said they used the Internet on a daily basis at the office, with another 23% saying they were on-line just two or three times a week. Just 23% said they used the Internet at home on a daily basis.

The majority of those who used the Internet at the office did so to find information about companies (75%), to send and receive e-mail (69%), obtain news (47%), find financial information (39%) and to access educational information (22%) and on-line studies or courses (14%). Interestingly, 6% said they did travel planning or booking on the Internet and another 4% said they did shopping. While foreign companies have been keen to get involved in e-commerce in China, such business has so far been severely restricted by a lack of payment methods, as few Chinese possess credit cards.

This could change in the near future, as the government and the central bank are working on ways to make it easier for Chinese consumers to shop on-line. The growing popularity of the Internet was made clear by respondents, with 69% predicting that demand for the Internet would increase substantially over the next two years, and another 28% saying they expected a slight increase.

Next week's report will look further at consumer trends in China among the country's increasingly wealthy and sophisticated upper-middle class.

- Written by Paul Mooney in Beijing

Reporting on Income

For the purposes of this survey, we looked at responses and divided them into those reporting earnings of less than 2,000 renminbi a month, those reporting from 2,000 renminbi to 3,999 renminbi a month, and those reporting more than 4,000 renminbi.

These three income categories help to differentiate between the attitudes and aspirations of those three broad income groups. But the reported earnings here almost certainly underestimate disposable income.

Cash bonuses may as much as double income. Free housing and free medical care are thinner on the ground than before, but many top managers, entrepreneurs and educators obviously continue to enjoy these privileges. Executives may have access to special schemes to buy state housing at low cost, may have access to chauffeured cars, or use of the company's mobile phone, or they may simply enjoy entertaining and pleasure trips at the company's expense. So remember, monthly income tells just one part of the story.

How to Purchase the Survey

The research survey on which the "China's Elite" series of special reports is based, is available for purchase for US\$100 (or equivalent in local currency) per copy. A special discount price of US\$50 is available to REVIEW subscribers only (please provide your FR subscription mailing label number with your order). Additional discounts are available for multiple orders. Send a cheque/postal order for the appropriate amount or a valid credit card number, expiration date and your signature to:

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INFORMATION~~

July 2, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Staff Report for the 1999 Article IV
Consultation**

Attached for consideration by the Executive Directors is the staff report for the 1999 Article IV consultation with the People's Republic of China, which is tentatively scheduled for discussion on Friday, July 23, 1999.

Mr. D.J. Robinson (ext. 37489), Mr. Husain (ext. 34941), or Mr. Krelove (ext. 38692) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 13, 1999; and to the Asian Development Bank and the European Investment Bank, following its consideration by the Executive Board.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 1999 Article IV Consultation¹

Prepared by Staff Representatives for the
1999 Consultation with the People's Republic of China

Approved by Yusuke Horiguchi and Ishan Kapur

July 2, 1999

- The 1999 Article IV consultation discussions were held in Beijing and Kunming during May 4–18, 1999. The staff team comprised Messrs/Mmes. Tseng (Head), Robinson, Krelove, Husain, Duenwald (all APD), Richardson (FAD), Dorsey (PDR) and Laurens (MAE), and was assisted by Mr. Heytens (Deputy Resident Representative). Mr. Wei (Executive Director) participated in the last week of discussions, and Mr. Sugisaki joined the team during May 15–18 for its final meetings. Mr. Fischer visited China during June 20–21, 1999.
- The team met with People's Bank of China (PBC) Governor Dai Xianglong; PBC Deputy Governor Liu Mingkang; Vice Minister of Finance Lou Jiwei; Vice Governor of Yunnan Province Cheng Ying Xuan; senior officials from other government ministries and agencies; and members of the academic, banking and business communities.
- At the 1998 Article IV consultation, Executive Directors noted that China had continued to weather the Asian crisis better than most other countries in the region. However, with growth slowing and the balance of economic risks on the downside, Directors agreed that there was scope for a temporary relaxation of fiscal policy. Given China's relatively strong external position, Directors strongly supported the authorities' commitment to maintain the stability of the renminbi, although—given ongoing structural reforms—they believed a more flexible policy would be required over the longer term. The key challenge remained to accelerate implementation of structural reforms, particularly of the banks and public enterprises, accompanied by a strengthening of the revenue-to-GDP ratio to ensure fiscal sustainability can be maintained. They also underscored the need to improve statistics.
- Just following the Article IV mission, a staff team visited Beijing to assess the jurisdictional implications of the intensified enforcement of exchange and capital control regulations under Article VIII of the Fund's Articles of Agreement. The mission's conclusions will be set out in a supplement to be issued before the Executive Board meeting.
- The principal authors of the staff report were Messrs. Robinson and Krelove.

¹The term "country" as used in this paper does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

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I. EXECUTIVE SUMMARY

- China has continued to weather the Asian crisis relatively well, aided by skillful macroeconomic management, a relatively strong external position, and—to some extent—the protection provided by capital controls.
- However, weak private demand, rising unemployment, and high capital outflows remain serious problems. In addition, the weak financial position of banks and state enterprises—and the associated problem of long-run fiscal sustainability—give rise to significant risks.
- The authorities have appropriately eased fiscal policy to boost demand, and have taken a series of measures to encourage the private sector. With downside risks to growth, a further modest fiscal stimulus—presently under preparation—would provide helpful support to demand later in the year.
- The policy of maintaining the stability of the renminbi remains appropriate, given China's relatively strong external position; however, the recent sharp reduction in interest rates has opened up a wide differential with U.S. dollar rates; the impact on the capital account will need to be closely monitored, and contingency plans developed. With China likely to experience continued rapid structural change, greater exchange rate flexibility will be needed in the future.
- As the authorities well recognize, reform of banks and enterprises remains the central economic challenge. Since late 1997, financial sector reform has been significantly accelerated, culminating in the recent decision to set up asset management companies (AMCs) for each state commercial bank. This will need to be accompanied by the development of a strong credit culture, further strengthening of the regulatory and supervisory framework, and measures to address problems in smaller financial institutions.
- The success of financial sector reform continues to depend critically on reform of the state enterprises. Over the coming year, it will be critical that the AMCs play a strong role in enterprise restructuring, supported by greater reliance on bankruptcies (as the authorities intend). Continued efforts to strengthen the social safety net will also be essential.
- Given the substantial costs of structural reforms, urgent attention must be given to strengthening fiscal sustainability, especially through raising the revenue/GDP ratio. This will need to be supported by reform of intergovernmental relations.
- To counter widespread evasion, the authorities significantly intensified enforcement of China's exchange controls. While this appears to have had some success in

curtailing illegal activities, additional efforts are needed to limit the impact on legitimate transactions.

- China's economic statistics continue to suffer from significant deficiencies in many areas, seriously hampering surveillance, and further improvement remains a central priority.

II. BACKGROUND

1. **Over the past two decades, China's economic performance has been impressive.** The policies of "opening up" and market-oriented reform have resulted in rapid GDP growth, a dramatic reduction in poverty, and sizable total factor productivity (TFP) growth (Chart 1). Since 1993, however, TFP growth has slowed, and GDP growth has been increasingly accounted for by high investment. The financial performance of the state owned enterprises (SOEs) has also deteriorated (Box 1), accompanied by excess capacity and high stock building. With SOE losses financed primarily by state commercial banks (SCBs), non-performing loans rose and the SCBs' financial position deteriorated. Consequently, the linked issues of banking and SOE reform have become a top priority.

2. **Following the investment-led boom of the early 1990s, a "soft landing" was successfully achieved by 1996.** Thereafter, macroeconomic developments remained initially favorable, aided by strong external demand (Table 1 and Chart 2). However, with the onset of the Asian crisis, the external environment deteriorated. From early 1998, exports began to decline in U.S. dollar terms (Box 2 and Chart 3), and foreign direct investment flattened off. Despite several cuts in interest rates, domestic demand growth was sluggish, as households postponed consumption in the face of uncertainties arising from SOE reforms (including higher unemployment² and increasing costs of housing, health, and education); slower rural income growth and weak nonstate investment also contributed. As a result, GDP growth slowed to 7 percent by mid-1998. The combination of weakening demand, excess capacity, and falling export and import prices, also led to deflationary pressures.

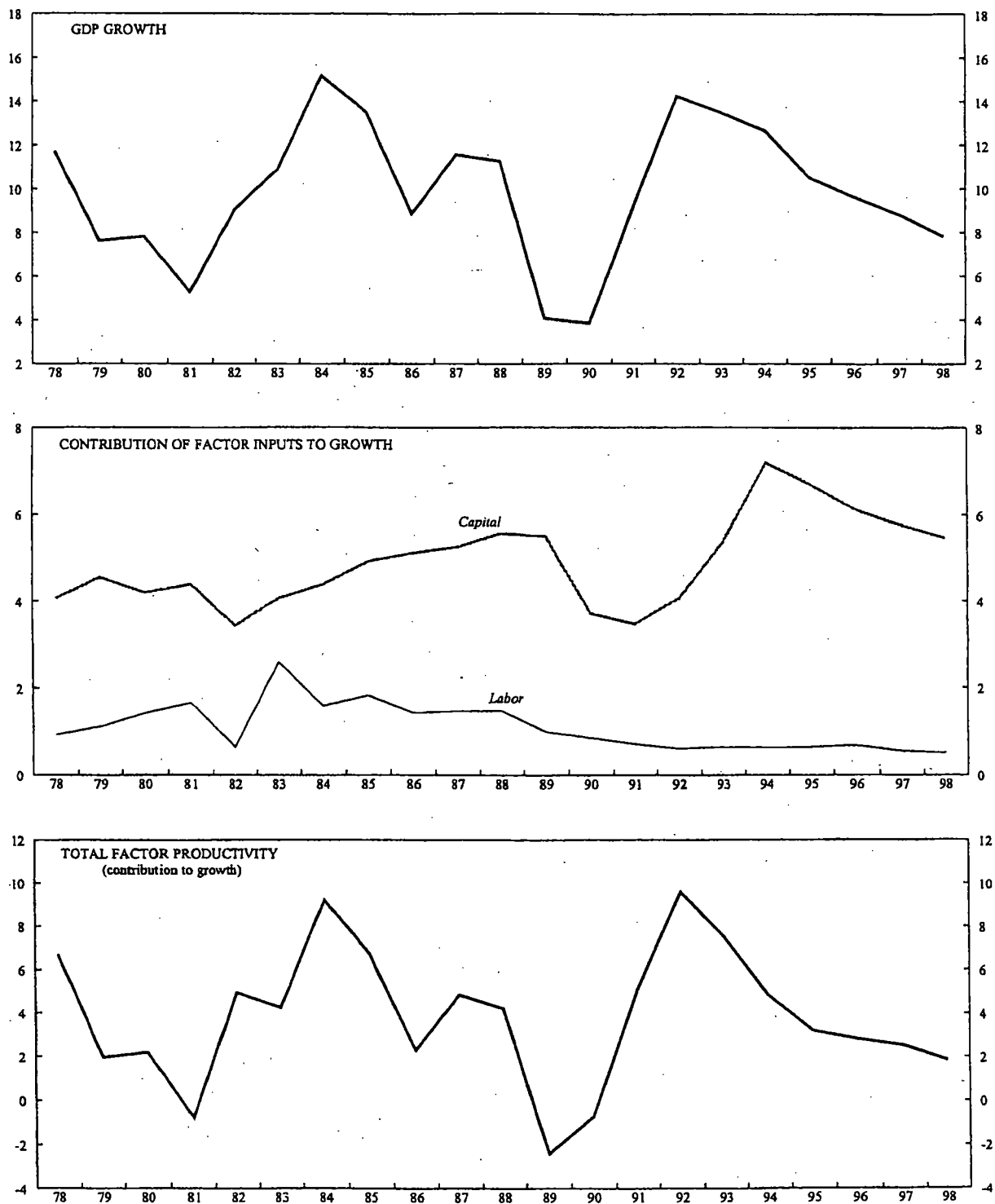
3. **In response to the growing impact of the Asian crisis, the authorities moved quickly to boost domestic demand.** In mid-1998, a fiscal stimulus package amounting to about 2½ percent of GDP was announced, focused on infrastructural (and to a lesser extent) social safety net spending, particularly in the poor central and western regions of China. In addition, the authorities have taken the lessons of the Asian crisis to heart in acting to reduce financial risks and vulnerabilities, notably through the acceleration of financial sector reform

²While data on unemployment are weak, the unemployment rate has risen since the mid-1990s as layoffs from SOEs accelerated (Box 3).

Chart 1

CHINA: GDP GROWTH AND TOTAL FACTOR PRODUCTIVITY, 1978-98

(In percent)



Source: Staff estimates.

Box 1. China: State Enterprise Reform

State enterprise reform has occupied a central place in the authorities' policy agenda since the 15th Party Congress in September 1997, when President Jiang called for an expansion and acceleration of the reform experiments already underway (see below). The subsequent ascension of Zhu Rongji as Premier in March 1998 marked the beginning of a three-year program to restore China's larger SOEs to health. During the National People's Congress this past March, it was announced that the final two years of the program would be focussed on improving the performance of a select group of 7,680 large and medium-sized SOEs, and in particular on reducing the proportion of loss-making enterprises within this group from one-third in 1998 to 15 percent by end-2000.

The financial performance of China's 250,000 SOEs, which employ an estimated 70 million workers (some 35 percent of the urban labor force), nevertheless continued to deteriorate over the past year (Table 5). As in the past, poor performance was caused by a variety of macroeconomic and industry-specific factors, which were exacerbated by slowing growth and disastrous summer floods. Most manufactured and industrial product sectors continued to be plagued by excess capacity, which prompted increasingly intense price competition among enterprises to maintain market share. Other problems included weak management, over staffing, high debt, outdated products and technologies, an excessive social welfare burden, and high relative tax rates.

Against this background, the broad strategy of state enterprise reform has been guided by the principle of "seize the large and release the small," concentrated along two tracks:

- Reform of large enterprises has been undertaken through a variety of pilot programs, centered on industrial consolidation through acquisitions and the creation of large enterprise groups; introducing greater autonomy and improved corporate governance through the separation of enterprises from government ministries and the introduction of modern management structures; and diversifying ownership, primarily through issuance of stock on exchanges.
- Small enterprise reform has been left to the provincial and local governments, who are removing them from state ownership through sales to management, workers or outside investors, among other methods.

Progress continued to be made in SOE reform during 1998, despite concerns about social unrest:

- An estimated six million workers were laid off from state enterprises (nearly 10 percent of SOE employment), a significant increase over previous years, prompting the authorities to accelerate efforts to establish a social safety net.
- Sectoral restructuring programs were launched to reduce excess capacity in industries suffering the largest losses. In the textile sector, 5.12 million spindles (11 percent of the total) were idled while 660,000 workers (17 percent) were laid off, reducing losses by Y 2.6 billion during 1998; in the coal sector, 15,000 small and inefficient mines have been shut since November, with a view to reducing output by 25 percent.
- The volume of debt writeoff rose to Y 40 billion (1/2 percent of GDP), a Y 10 billion increase over 1997. In contrast with previous years, virtually all of the debt write off in 1998 was focussed on large enterprises; in total, nearly 1,900 SOEs were merged, acquired, or put into bankruptcy proceedings under the debt write-off program.
- Steps were initiated to break up monopolies in the petroleum and telecommunications sectors, leading to increased competition and lower domestic prices for crude oil and mobile telephone services.
- Activity to move small enterprises out of the state sector accelerated in the wake of the 15th Party Congress. By end-1998, the more progressive coastal and southern provinces had "released" most of their smaller SOEs, while many northeastern "rust belt" provinces had also made significant progress in disposing of small enterprises.

Table 1. China: Summary Indicators, 1994-99

Nominal GDP (1998)	\$961 billion
Population (1998):	1.25 billion
GDP per capita (1998):	US\$769
Quota:	SDR 4,687.2 million

	1994	1995	1996	1997	1998	Proj. 1999
(Change in percent)						
Real GDP	12.6	10.5	9.6	8.8	7.8	6.6
Real domestic demand	8.9	10.1	9.1	6.9	7.9	8.5
Consumer prices (period average)	24.3	16.7	8.4	2.8	-0.8	-1.5
(In percent of GDP)						
Gross domestic investment	41.2	40.8	39.2	38.1	37.8	39.3
Of which: Fixed investment	36.0	34.7	34.0	33.6	36.1	37.7
Gross national saving	42.5	41.1	40.0	41.9	41.2	40.4
External current account 1/	1.3	0.2	0.9	3.8	3.4	1.0
Overall budgetary balance 2/	-2.7	-2.1	-1.7	-1.8	-3.0	-3.4
Revenue	11.9	11.2	11.3	12.0	12.8	13.4
Expenditure (including net lending)	14.6	13.3	12.9	13.9	15.8	16.8
(Change in percent end of period)						
Banking system's net domestic assets 3/	28.2	29.9	23.0	13.0	15.7	16.9
Of which: Domestic credit 3/	23.8	22.8	25.5	12.8	20.0	17.0
Broad money 3/	34.5	29.5	25.3	17.3	15.3	15.0
Reserve money 4/	31.0	20.6	29.5	13.9	2.3	8.3
Interest rate (one-year time deposits, year-end)	11.0	11.0	7.5	5.7	3.8	2.3 5/
(In billions of U.S. dollars)						
Current account balance 1/	6.9	1.6	7.3	34.7	32.6	10.2
Of which: Exports	102.6	128.1	151.1	182.7	183.5	180.8
Imports	-95.3	-110.1	-131.5	-136.5	-136.9	-154.7
Capital account balance	32.6	38.7	40.0	23.0	-6.3	-6.0
Of which: Direct investment inflows (net)	31.8	33.8	38.1	41.7	41.1	25.0
Errors and omissions	-9.1	-17.8	-15.5	-22.0	-19.9	-11.0
Change in net international reserves (increase -)	-30.4	-22.5	-31.7	-35.7	-6.4	6.8
State gross international reserves 6/	53.5	76.0	107.7	143.4	149.8	143.0
In months of imports of goods and nonfactor services	5.8	6.7	8.4	10.3	10.8	9.2
As a percent of short-term external debt 7/	492	638	764	792	864	780
External debt 7/	95.4	106.6	116.3	132.1	146.0	154.0
Of which: Short-term debt 7/	10.9	11.9	14.1	18.1	17.3	18.3
Debt-service ratio (in percent of exports) 7/	11.1	10.6	10.5	6.1	7.5	8.2
Exchange rate at end-period (Y per US\$)	8.5	8.3	8.3	8.3	8.3	8.3
Nominal effective exchange rate 8/	59.0	58.7	61.5	66.7	73.2	71.4 8/
Real effective exchange rate 8/	75.6	83.5	90.1	95.9	100.0	93.8 8/

Sources: Data provided by the Chinese authorities; and Fund staff estimates and projections.

1/ Series has breaks in 1995 and 1996 due to changes in the coverage of services items.

2/ Central and local governments, including all official external borrowing.

3/ Banking survey.

4/ In November 1996, an increase in demand for reserve assets resulting from a tightening of the enforcement of reserve requirements for rural financial institutions was accommodated by an expansion in reserve money.

The reported growth rate of reserve money includes this operation.

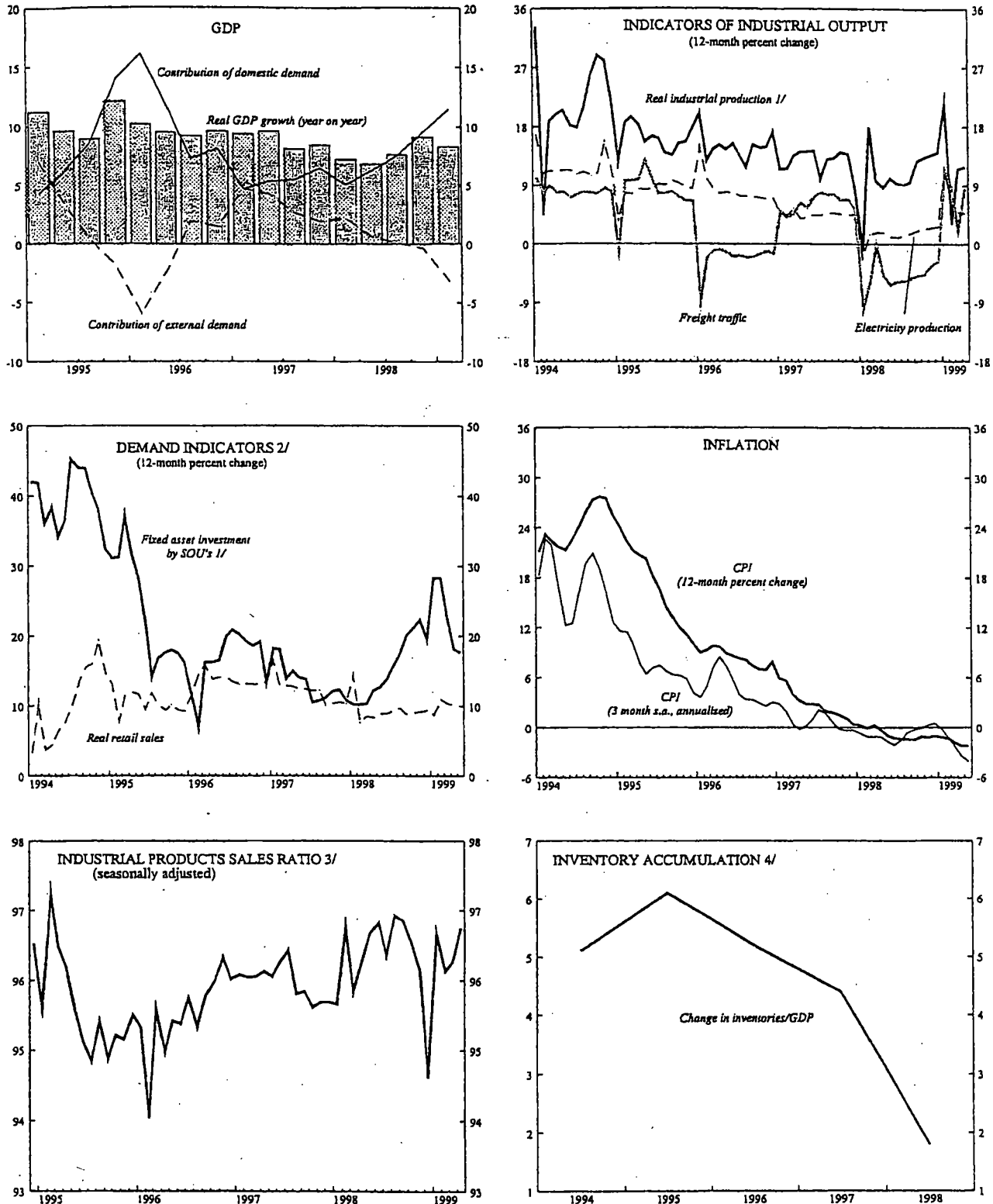
5/ Data for 1999: since June 10, 1999.

6/ Includes gold, SDR holdings, and reserve position in the Fund.

7/ From official sources.

8/ Annual averages (1990 = 100), using revised weights. Data for 1999 are estimates for April.

CHINA: GROWTH AND DEMAND INDICATORS



1/ Data for 1996 are not directly comparable to previous year due to changes in methodology and coverage.

2/ Cumulative from beginning of year.

3/ China Latest Economic Indicators (National Bureau of Statistics, various issues).

4/ Data provided by the Chinese authorities.

Box 2. China: The Export Slowdown

Following the onset of the Asian financial crisis, China's export growth fell sharply to ½ percent in 1998, from 21 percent in 1997. Seasonal adjustments to the monthly data indicate that there was a steady decline in the dollar value of exports during the course of the year, followed by a pickup in early 1999 (Chart 3). The export decline is characterized by the following:

- **The decline in export growth was due mainly to weaker external demand.**

According to the latest WEO, imports of goods by China's trading partners fell by 2 percent in real terms in 1998, compared with an increase of 6-8 percent in 1996-97.

- **Exports to the Asian region fell sharply in 1998;** exports to the United States and the E.U. continued to rise at a healthy pace, albeit somewhat more slowly than in 1997.

- **China's export shares in all major markets held steady or rose in 1998.**

- **Monthly exports of industrial and manufactured products were flat in 1998,** while exports of primary and semi-primary products edged downward and exports of textiles and garments declined more steeply.

- **Monthly exports by foreign-funded and joint-venture enterprises remained steady during 1998,** but those of domestic enterprises fell steeply during the year.

- **Overall export prices fell by 7½ percent—and by 12 percent for ordinary**

(nonprocessing) trade—in 1998. However, the effect on profit margins was partly offset by lower import prices, which fell by 2 percent overall and by 9 percent for ordinary imports. It may be noted that misinvoicing of trade transactions for capital flight would tend to overstate the decline in export prices and understate the decline in import unit values.

- **While some foreign trading companies (FTCs) are encountering financial difficulties—mainly those that have invested heavily in real estate—others appear to be performing well.** The FTCs have tended to increasingly focus on shipping in recent years, and their marketing role has diminished. Moreover, the number of companies with trading rights has risen considerably, even before the granting of direct trading rights to a large number of manufacturers in early 1999.

While exports have contracted on a year-on-year basis in the first five months of 1999, the seasonally adjusted pattern suggests a modest recovery relative to the last quarter of 1998 (Chart 3). Nevertheless, notwithstanding the projected recovery in external demand, the staff expects the dollar value of exports to decline by 1½ percent for the year as a whole. The decline in export and import prices has intensified, particularly for ordinary trade.

Market Share in Major Export Markets

(Imports from China in percent of total imports)¹

	1995	1996	1997	1998	1998Q1	1999Q1
U.S.	6.3	6.7	7.3	8.0	3.2	3.3
EU	1.7	1.8	2.0	2.1	...	...
Japan	10.7	11.6	12.4	13.0	8.7	9.2
Asia-5 ²	3.8	3.9	4.7	4.8	3.8	4.5

Sources: IMF, Direction of Trade Statistics; China Customs Statistics; WEFA Intline; and Nikkei Telecom.

¹ Quarterly figures, which are based on China's export data, are not comparable to annual figures, which are based on partners' imports.

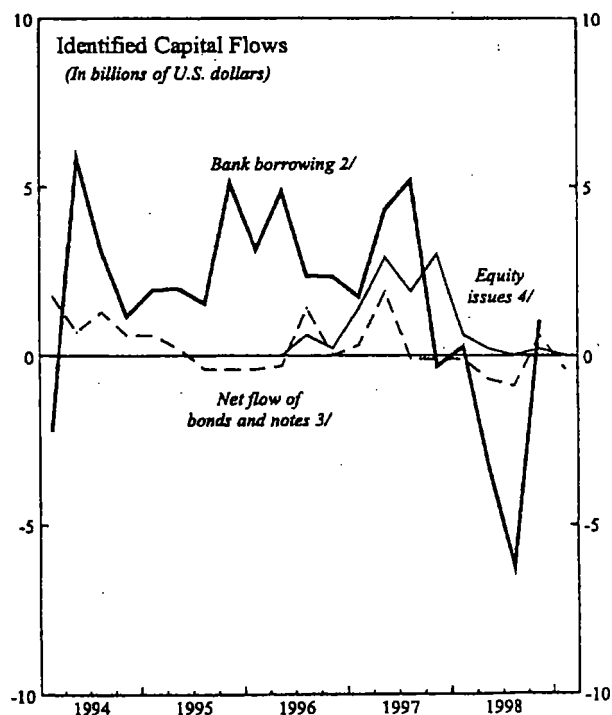
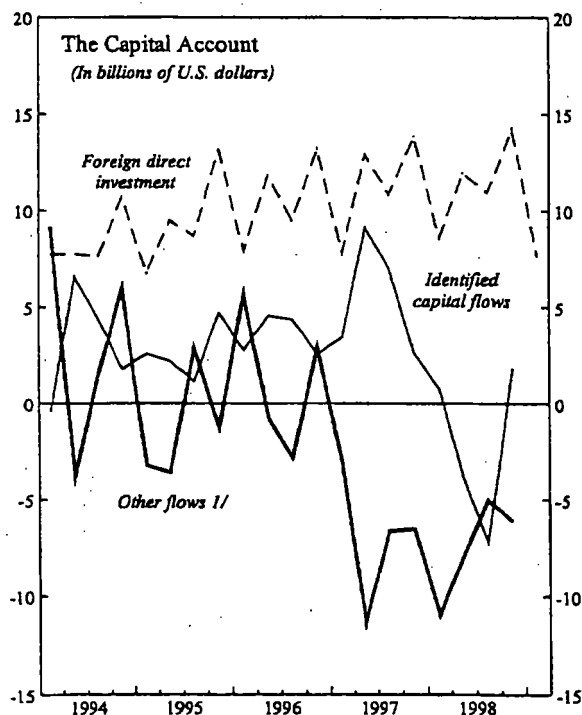
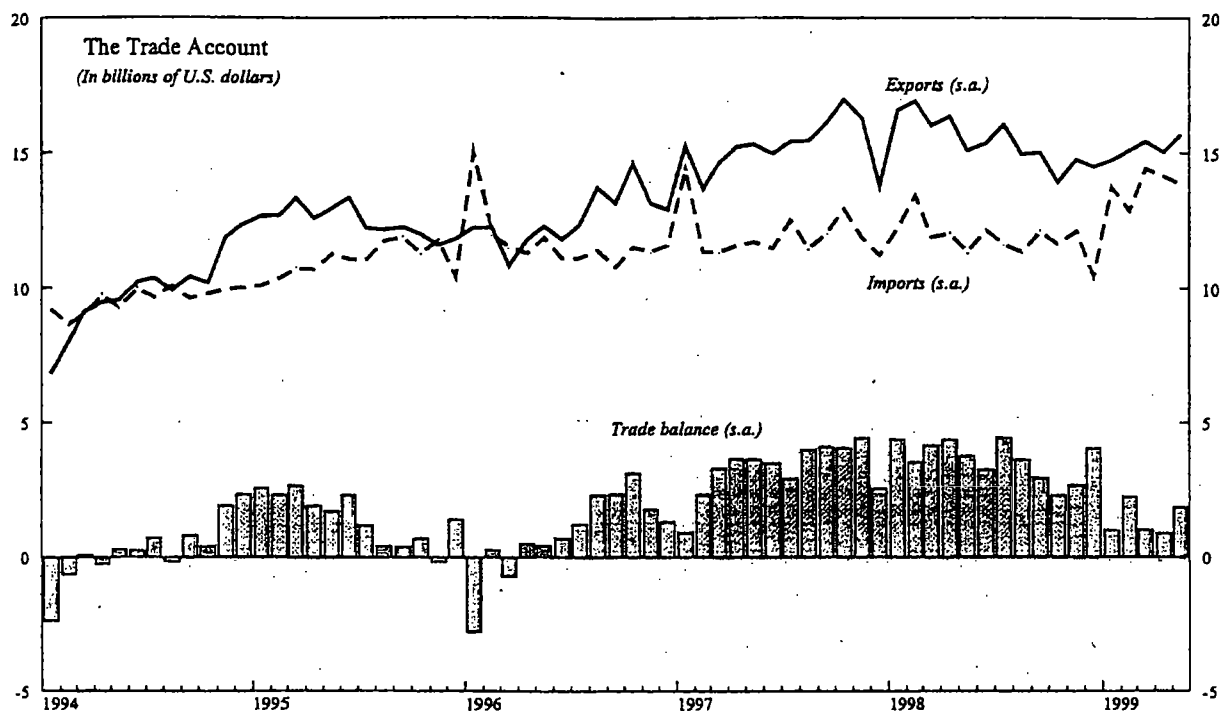
Export Growth

(In percent; U.S. dollar terms)

	1996	1997	1998	1999Q1
Total Exports	1.5	20.9	0.6	-7.4
By destination:				
U.S.	8.0	22.5	16.2	9.5
E.U.	3.1	20.3	18.2	-1.4
Japan	8.5	3.1	-6.7	0.4
Asia-5	3.2	24.9	-25.6	14.7
By type of enterprise:				
Foreign/joint venture	31.2	21.8	8.1	3.3
Domestic	-12.1	20.4	-4.6	-15.2
SOE	-13.3	19.3	-5.7	-16.0
Collective	32.7	45.9	17.6	-2.1

Chart 3

CHINA: SELECTED EXTERNAL INDICATORS, 1994-99



- 1/ Defined as the change in reserves less the trade surplus, foreign direct investment inflows, and capital account inflows derived from creditor data; includes the deficit on services and factor income.
- 2/ BIS exchange rate adjusted changes from 1997 Q3, changes in stocks for previous observations.
- 3/ Data compiled by the BIS from Bank of England and Euromoney sources.
- 4/ BIS data on new international equity issues on a nationality basis. These data would include securities offered offshore by Chinese-controlled entities, but not the secondary market transactions or buybacks.

Box 3. China: Urban Unemployment and the Social Safety Net

A consequence of slowing growth and structural reforms has been slowing urban employment growth and an increase in unemployment. While total employment grew by 6 million jobs per year on average between 1992 and 1997, it grew by only 4.7 million in 1998, to 206.8 million. It is likely that the number of employees of SOEs and collectives continued to fall in 1998 and that private sector and joint venture employment continued to grow. The number of registered unemployed did not change in 1998, to keep the registered unemployment rate constant at 3.1 percent of the urban labor force.¹ However, registered unemployment does not include those who have been laid off but retain links to their employers (the *xiagang*) and who have not found new jobs. Unemployed *xiagang* were estimated to total 6.9 million workers at the end of 1997,² leading to a broad unemployment rate of around 6 percent. It is estimated that an additional 6 million workers were laid off from the SOEs in 1998, but centers were established to speed up reemployment (see below). The authorities estimate that about 8.9 million *xiagang* remained unemployed in 1998, leading to an overall unemployment rate of 6.7 percent. However, other observers, including the World Bank, estimate that the unemployment rate could be 1½-2 percentage points higher.

China: Urban Labor Market Developments, 1992-98

(In millions of persons)				
	1992	1995	1997	1998
Urban labor force	182.5	200.2	211.9	218.7
Urban employment	172.4	190.9	202.1	206.8
Of which: SOUs and COEs	145.1	144.1	139.2	...
Joint units	2.8	8.9	11.1	...
Private businesses	8.4	20.5	26.7	...
Registered unemployed	3.6	5.2	5.7	5.7
<i>Xiagang</i> unemployed 2/	...	...	6.9	8.9
Unemployment rate	...	...	5.9	6.7

Since layoffs are a relatively recent phenomenon in the Chinese economy, the social security system has been partial and incomplete. To improve the social safety net for the *xiagang*, a three-phase system is being implemented:

- *Income support and reemployment of xiagang:* reemployment centers are being set up to aid the transition to new jobs. Laid off workers are eligible for income support based on prevailing wages in the region. The program is financed by local governments, local unemployment insurance funds, and the SOEs. In addition, the central government has increased transfers to localities that have been hit hardest by unemployment to help them meet their contributions to the reemployment centers.
- *Unemployment insurance:* *Xiagang* who have not found employment after three years must now sever their relation with their reemployment center implying the loss inter alia of nonwage benefits provided by the employer, and can join the registered unemployed pool and become eligible for unemployment insurance payments (which are lower than payments in the reemployment centers) for a period of two years. In addition, the unemployment insurance system is being expanded to cover almost all urban workers (up from about 60 percent coverage), and contribution rates have been increased. Since the funds are pooled only locally, in some high unemployment areas beneficiaries receive partial or no payments because of a lack of funds.
- *Minimum income program:* After unemployment insurance eligibility expires the worker can collect a minimum living stipend, under programs that were introduced beginning 1994 to deal with poverty. Currently most cities have introduced such programs, and they will be introduced in all county-level cities by the end of 1999. The programs are locally financed, and in some cities stipends are low or not paid altogether because of fiscal constraints.

While these changes will go some way in easing the transition to employment for the laid off, payments remain low in many cases, coverage is incomplete, there remain some disincentives to take new jobs quickly, and insufficient risk pooling means that regional disparities in ability to finance the programs remain.

Because unemployment is largely a structural problem, further efforts are needed to improve the structure of the social safety net for the unemployed and its financing. High unemployment will persist into the medium term for a number of reasons: (i) there is a large surplus labor pool in the SOEs, banks, and government, and the process of reallocating this labor will take a number of years; (ii) there is a large surplus rural labor pool (more than 130 million, according to estimates) that will need to be absorbed into nonagriculture (both rural and urban) employment; and (iii) labor market rigidities (e.g., legal restraints on mobility, imperfect housing markets, and education and health insurance provided by employers) restrict the ability of wages to perform their allocative role and slow the rate at which released labor can be reabsorbed.

¹In the statistics reported by the Chinese authorities, the levels of registered unemployment and labor force are not consistent with the reported registered unemployment rate.

²Since the mission, the authorities have reportedly revised their estimate of *xiagang* unemployed at end-1997 to 11.5 million which would raise the unemployment rate to 8 percent in 1997, implying a decline in the unemployment rate in 1998. The staff is presently seeking further information on the reasons for the revisions.

since late 1997. Notably, the closure and eventual bankruptcy of the Guangdong International Trust and Investment Company (GITIC) served to reduce moral hazard (Box 4).

4. **As a result of the fiscal stimulus—about two-thirds of which was disbursed in 1998—GDP growth accelerated sharply in the second half of the year.** Thus, even though private sector demand remained subdued, stockbuilding fell (partly reflecting restructuring of sectors with excess capacity and hardening budget constraints), and China experienced the worst flooding in many years, GDP growth reached 7¾ percent for the year, very close to the authorities' 8 percent target.³ However, with deflationary pressures emerging—due to the combination of excess capacity, weakening demand, and falling grain prices—inflation was negative for the year (-0.8 percent).⁴ Based on official data, unemployment is estimated at nearly 7 percent, although other observers—including the World Bank—estimate that the rate could be 1½–2 percentage points higher (Box 3).

5. **The current account surplus declined marginally to 3½ percent of GDP in 1998, still very high by historical standards (Table 2).** A slight improvement in the trade account in U.S. dollar terms—due mainly to a decline in imports of investment goods by foreign funded enterprises, and of primary products, including oil—was offset by higher outward tourism and interest payments. However, while foreign direct investment inflows remained strong (partly due to the approval of a number of major projects early in the year), the capital account deteriorated sharply, and negative errors and omissions remained high. Thus, the overall balance of payments surplus fell sharply from \$36 billion in 1997 to \$6 billion in 1998; reserves increased to \$150 billion (11 months of imports of goods and nonfactor services and 256 percent of short-term external liabilities).

6. **The deterioration in the capital account between 1996 and 1998 remains difficult to explain fully,** given the lack of consistent balance of payments and debt data. The key factors in 1998 included (i) a sharp increase in net outflows of trade credit, reflecting

³GDP data in China have a number of deficiencies (Annex I), and many analysts, including the World Bank, have suggested that they systematically overestimate growth by 1–2 percent annually. Some analysts—citing the weakness in electricity production and freight traffic—have suggested that this discrepancy increased in 1998. The weakness in electricity production and freight traffic partly reflects specific factors—such as higher electricity prices, and falling coal production (which accounts for a substantial part of freight traffic). Nevertheless, while the data provide an important indicator of broad trends, they have to be interpreted cautiously.

⁴Econometric work by the staff suggests that external factors—including falling tradeable prices, and the diversion of export goods to domestic markets—have also played an important role (see “Price Formation in China: Examining the Causes of Deflation,” in the Selected Issues paper, forthcoming).

Box 4. China: GITIC Bankruptcy and its Effects

Following its closure by the PBC in October 1998 for failing to meet its debt obligations, the Guangdong International Trust and Investment Corporation (GITIC) was declared bankrupt in January. GITIC's liabilities, around one half of which had not been registered, amounted to \$4.4 billion—mostly in foreign exchange to external creditors—while its assets were valued at \$2.6 billion. It was announced that individual depositors, whose principal claims amounted to \$0.1 billion, would be repaid immediately by the provincial government.¹ In April 1999, decisions of Chinese courts and new financial information released through creditors meetings resulted in a downward revision of GITIC's assets and implied that creditors can expect the recovery of at most 17 percent of their claims. On April 23, 1999 the liquidation committee announced that there was no possibility that GITIC will be restructured.

The closure of GITIC without a bailout of most creditors sends a strong signal to markets that the Chinese authorities do not implicitly guarantee all external obligations of Chinese entities, and that markets should base lending decisions on credit risk analysis rather than personal connections or an assumed sovereign guarantee. As a result, problems of unproductive investment financed in an environment of moral hazard should be reduced in the medium and longer term.

The GITIC case has led to increased uncertainty among investors as they perceive it to involve a *de facto* change in the authorities' implicit guarantee of external obligations.² Creditors have complained of a lack of transparency in the liquidation proceedings thus far; in response, the authorities have hired foreign legal and accounting advisors to assist in the liquidation process. While repayment priorities for GITIC's obligations have not yet been announced, Chinese law accords the highest priority to employees, followed by government taxes, and then creditors. This is China's largest bankruptcy since 1949 and there is no legal precedent for such proceedings involving foreign creditors.

Several other ITICs and Hong Kong SAR window companies of mainland enterprises have also encountered financial difficulties in recent months. The PBC has announced that the trust and investment (TIC) sector will be restructured through mergers, consolidation, and closures. It may be noted, however, that the TICs together account for only around 5 percent of the total assets of the financial system, and only around 20 ITICs (out of a total of 239) have borrowed from abroad. Total registered ITIC external debt is about \$8 billion; including unregistered external claims, the staff estimates that the ITICs' external obligations could be about \$18 billion, with an additional \$6 billion in external contingent liabilities.

ITICs' External Liabilities

(In billions of dollars)

	GITIC	Other ITICs	Total
Total	3.7	19.6	23.3
Debt	1.9	15.8	17.7
Registered	...	5.8	...
Unregistered ¹	...	10.0	...
Contingent liabilities	1.8	3.8	5.6
Registered	...	1.4	...
Unregistered ¹	...	2.4	...

¹Estimated based on Hong Kong SAR banks' ratio of unregistered to registered claims.

The GITIC bankruptcy and the difficulties in the ITIC sector have prompted markets to increasingly differentiate between sovereign and nonsovereign entities in China. This has been reflected in wider differentiation in ratings assigned by international credit rating agencies in recent months to obligations of the government, state commercial banks, and the ITICs (Chart 4).

There have also been reports of a credit squeeze for mainland enterprises, including those registered in Hong Kong SAR. While the financially strongest enterprises have continued to have access to credit, an orderly withdrawal of credit from mainland and mainland-related firms as a whole has been reported, with the Hong Kong SAR banking system's total exposure to such firms declining by 8½ percent in the last quarter of 1998. Several mainland firms have postponed initial public offerings in Hong Kong SAR, and at least one enterprise has abandoned plans of an overseas bond issue in favor of domestic bonds. Moreover, several local government-owned enterprises in Guangdong province have reportedly missed domestic debt payments, raising questions about the extent to which local and provincial governments stand behind their obligations.

¹Although the ITICs are prohibited from accepting deposits, GITIC had around 25,000 individual depositors at the time of its bankruptcy.

²For their part, the authorities have issued several statements in recent years warning investors that unauthorized external borrowings would not be guaranteed by the central government.

Table 2. China: Balance of Payments

(In billions of dollars; authorities' presentation)

	1994	1995	1996	1997	1998	1999
Trade balance	7.3	18.1	19.5	46.2	46.6	26.1
Exports	102.6	128.1	151.1	182.7	183.5	180.8
Imports	95.3	110.1	131.5	136.5	136.9	154.7
Services balance	0.3	(6.1)	(2.0)	(5.7)	(4.9)	(6.0)
Transportation	(5.0)	(8.7)	(7.4)	(7.3)	(7.0)	(7.0)
Travel	4.3	5.0	5.7	1.9	3.4	3.2
Other, net	1.0	(2.4)	(0.4)	(0.3)	(1.7)	(2.2)
Income balance	(1.1)	(11.8)	(12.4)	(10.9)	(13.3)	(14.9)
Compensation of employees	...	...	-	0.2	(0.1)	(0.1)
Investment income	(1.1)	(11.8)	(12.4)	(11.1)	(13.2)	(14.8) 1/
Credits 1/	5.7	5.2	7.3	8.0	8.5	8.7
Debits	6.8	17.0	19.8	19.1	22.0	23.4
Current transfers, net	0.3	1.4	2.1	5.1	4.3	5.0
Current account	6.9	1.6	7.3	34.7	32.7	10.2
(In percent of GDP)	(1.3)	(0.2)	(0.9)	(3.8)	(3.4)	(1.0)
Foreign Direct Investment, net	31.8	33.8	38.1	41.7	41.1	25.0
Direct investment in China	33.8	35.8	40.2	44.2	43.8	...
Direct Investment abroad	(2.0)	(2.0)	(2.1)	(2.5)	(2.6)	...
Portfolio investment	3.5	0.8	1.7	6.8	(3.7)	(4.0)
Other Investment	(2.7)	4.1	0.2	(25.5)	(43.7)	(27.0)
Trade credit 2/	...	...	...	(6.3)	(22.1) 2/	...
Loans	...	...	...	(0.7)	(4.7)	...
Currency and deposits	...	...	...	(12.5)	(4.6)	...
Other	...	...	...	(6.0)	(12.2) 2/	...
Capital and Financial Account	32.6	38.7	40.0	23.0	(6.3)	(6.0)
Net errors and omissions	-9.1	(17.8)	(15.5)	(22.0)	(19.9)	(11.0)
Overall balance	30.4	22.5	31.7	35.7	6.4	(6.8)
Change in reserves	(30.4)	(22.5)	(31.7)	(35.7)	(6.4)	6.8
Memorandum items:						
Adjustment to income credits 1/	...	...	-	5.0	3.3	... 1/
Change in net foreign assets of banks	(1.2)	(11.9)	(12.5)	(3.1)	9.6	...

Sources: Chinese authorities and staff estimates.

1/ Official data for investment income credits are revised upward to offset the omission of interest on reserves in 1997 and 1998.

2/ The 1998 figures for trade credit reflect a reclassification of approximately US\$10 billion in reported trade credit net outflows into other items within other investment.

deteriorating payments terms for Chinese exporters and importers, hedging by importers and exporters to reduce risks in the event of a devaluation; and misinvoicing to finance capital outflows; and (ii) falling portfolio inflows, as new issues by Chinese firms abroad dried up and foreign investment in Chinese “B” share markets dropped. The remainder includes approximately \$10 billion in reclassified outflows originally recorded as trade credits, the nature of which is not fully clear. Illegal or misrecorded outflows—likely to be captured primarily under trade credit and errors and omissions—became an increasing problem from late 1997, driven by concerns of a devaluation of the renminbi, the falling differential between domestic and foreign interest rates, and rising smuggling.

7. **In response to these developments, the authorities significantly intensified enforcement of exchange and capital controls,⁵ and moved forcefully to reduce smuggling.** These measures have reduced illegal activities, although there are widespread reports that legal transactions have also been adversely affected (Section IV.E). Thus, since late 1998, reserves have risen, despite a weakening trade balance, falling foreign direct investment, and the impact of the closure of the GITIC (which, while desirable from the perspective of reducing moral hazard, had the short-term effect of causing investors to reassess China risk).

8. **The state budget deficit increased by 1¼ percent of GDP to 3 percent of GDP in 1998 (Table 3 and Chart 4).** The revenue ratio rose by ¾ percent of GDP, the third successive annual increase; about one-third of this growth was due to enhanced collection of arrears. This was offset by additional expenditures relating to the fiscal stimulus program, as well as for defense and public administration. It should be noted that the state budget excludes the social and extra budgetary funds, as well as quasi-fiscal lending through the banking system. While limited data are available, the staff’s calculations suggest that the broad-based deficit—the state budget deficit plus estimated quasi-fiscal lending⁶—could be over 7 percent of GDP.

9. **Broad money (M2) growth slowed to 15¼ percent in 1998, slightly below the authorities’ 16–18 percent target (Table 4).** While bank lending behavior has become generally more cautious to contain credit risk, credit growth picked up in the second half as

⁵The main measures included intensified enforcement of documentation requirements for all authorized transactions; and new and reinforced measures to control capital account transactions.

⁶The quasi-fiscal deficit in the banking system is defined conceptually as the sum of the nonrecoverable portion of new nonperforming loans (NRNPLs), plus interest on the outstanding stock of NRNPLs. Since data on these are not available, it is assumed for illustrative purposes that the stock of NRNPLs is 20 percent of credit outstanding, and the flow is 20 percent of new credits extended (see Box 8).

Box 5. External Vulnerability

An assessment of China's external debt vulnerability, adjusting for discrepancies with BIS data, suggests that the situation remains manageable, given China's high external reserves and continued current account surplus.

The staff has divided China's external liabilities into three categories

- The lowest risk category (30 percent of the stock at end-1998) is government and government-guaranteed debt, primarily lending from official creditors to the government. Being of relatively long maturity, and having a clear claim on official reserves (and accounting for only 1/3 of those reserves) it appears relatively safe from both creditor and borrower perspectives.
- The moderate risk category (41 percent at end-1998) comprises registered debt of foreign funded enterprises, joint venture enterprises, and state commercial banks (SCBs). There is an implicit potential external guarantor (the foreign parent or partner for the enterprises and the Chinese government for the SCBs), but clearly potential risk (for example, SCB ratings have been below the sovereign ratings for a while—Chart 6).
- The higher risk category (28 percent at end-1998) covers debt without any implicit guarantee and debt not registered with the Chinese authorities. Unregistered debt, which appears overwhelmingly short term, includes liabilities not requiring registration, (e.g., trade credits), as well as liabilities that should be registered but aren't.

Liabilities of state commercial banks and nonbank financial institutions have been nearly flat in recent years. Most of the growth in recorded external liabilities has come in the debt of foreign-funded and foreign joint venture enterprises and, until 1998, unregistered debt.

The share of moderate risk debt increased steadily between 1994 and 1998, offset through 1996 by a decline in the share of low risk borrowing, and in 1997-98, by a reversal of higher risk flows from BIS commercial bank creditors. While the risk structure of this debt continues to embody substantial vulnerability, this should be set against the large increase in the current account surplus and in international reserves over that period (Table 7).

Chinese External Liabilities by Level of Vulnerability

(In billions of U.S. dollars, percentages of total debt in parentheses)

	1994	1996	1997	1998
Total debt	115.8 (100)	152.3 (100)	166.5 (100)	169.1 (100)
Low Risk	34.7 (30)	41.8 (27)	44.5 (27)	51.2 (30)
Official lending to the government	26.0 (22)	30.6 (20)	31.5 (19)	35.8 (21)
Government borrowing from private creditors	2.2 (2)	2.9 (2)	4.5 (3)	5.8 (3)
Non-government borrowing from official creditors	6.5 (6)	8.3 (5)	8.5 (5)	9.5 (6)
Moderate Risk (excluding from official creditors)	36.8 (32)	51.0 (33)	62.0 (37)	69.7 (41)
Foreign-funded enterprises	1.2 (1)	3.8 (2)	6.8 (4)	9.1 (5)
Foreign joint ventures	9.6 (8)	21.0 (14)	30.2 (18)	35.6 (21)
State commercial banks	26.0 (22)	26.3 (17)	25.0 (15)	25.0 (15)
Of which: registered short-term debt	7.7 (7)	...	13.7 (8)	...
Higher risk	44.3 (38)	59.6 (39)	58.9 (35)	48.2 (28)
Registered	21.9 (18)	23.6 (15)	24.5 (15)	25.1 (15)
Domestic enterprises	9.5 (8)	12.3 (8)	13.3 (8)	15.5 (9)
Non-bank financial institutions (e.g., ITICs)	10.1 (9)	9.6 (6)	9.4 (6)	8.0 (5)
Leasing companies	1.7 (1)	1.6 (1)	1.8 (1)	1.7 (1)
Unregistered debt	23.0 (20)	36.0 (24)	34.4 (21)	23.0 (14)
Memorandum items:				
Unregistered short-term debt or short-term debt recorded as medium- and long-term	21.3 (18)	33.7 (22)	46.8 (28)	39.4 (23)
Short-term as a share of total debt	39.5 (27)	47.8 (31)	64.9 (39)	58.6 (35)

Table 3. China: State Budgetary Operations (IMF Definitions), 1994-99 1/

	1994	1995	1996	1997	1998	1999
	Actual	Actual	Actual	Actual	Prel.	Budget
(In billions of yuan)						
Total revenue	558.4	657.0	774.5	900.8	1,018.7	1,116.0
Tax	524.0	609.0	692.5	820.6	952.2	1,019.5
Nontax	34.4	48.0	82.0	80.2	93.5	96.5
Total expenditure and net lending	684.6	778.1	888.2	1,036.0	1,258.1	1,402.4
Current of which:	538.5	622.5	733.7	853.9	986.0	1,109.9
Subsidies 2/	68.0	69.3	79.1	90.7	...	...
Interest 3/	16.7	35.6	49.2	59.6	75.1	79.8
Capital	94.1	128.3	143.0	162.0	199.5	236.2
Unrecorded expenditures	52.0	27.3	11.6	20.1	72.6	56.3
Overall balance	-126.2	-121.1	-113.7	-135.2	-239.4	286.4
Financing	126.2	121.1	113.7	135.2	239.4	286.4
Domestic (net)	119.1	124.4	105.7	134.5	235.3	280.2
Banking system 1/	16.0	-0.7	85.4	-56.9	53.4	60.0
Of which: People's Bank of China 4/	-22.5	-24.5	-25.2	-26.1	-24.0	0.0
Other 5/	103.0	125.2	20.3	191.4	181.9	220.2
Foreign (net) 6/	7.1	-3.3	8.0	0.7	4.1	6.2
Gross foreign borrowing	14.7	1.1	11.6	4.2	8.3	8.3
Amortization	-7.6	-4.4	-3.6	-3.5	-4.1	-2.1
(In percent of GDP)						
Total revenue	11.9	11.2	11.3	12.0	12.8	13.4
Tax	11.2	10.4	10.1	11.0	11.6	12.2
Nontax	0.7	0.8	1.2	1.1	1.2	1.2
Total expenditure and net lending	14.6	13.3	12.9	13.9	15.8	16.8
Current of which:	11.5	10.6	10.7	11.4	12.4	13.3
Subsidies 2/	1.5	1.2	1.2	1.2	...	...
Interest 3/	0.4	0.6	0.7	0.8	0.9	1.0
Capital	2.0	2.2	2.1	2.2	2.5	2.8
Unrecorded expenditures	1.1	0.5	0.2	0.3	0.9	0.7
Overall balance	-2.7	-2.1	-1.7	-1.8	-3.0	-3.4
(In billions of yuan)						
Memorandum items:						
Unrecorded expenditures, of which:	52.0	27.3	11.6	20.1	72.6	56.3
Official external borrowing not recorded in national data 7/	52.0	27.3	11.6	20.1	42.8	28.1
Unrecorded 1998 fiscal stimulus					29.8	28.2
Primary balance (percent of GDP)	-2.3	-1.5	-0.9	-1.0	-2.1	-2.5
Bank recapitalization bonds (unrecorded in fiscal accounts)					270.0	

Sources: Ministry of Finance; People's Bank of China; State Statistical Bureau; and staff estimates.

1/ These budgetary statistics represent a consolidation of the budget of the central government, provinces, municipalities, and counties. Intergovernmental transfers are netted out. Extrabudgetary financial operations of the various levels of government are not included. Nor are Y 270 billion in recapitalization bonds.

2/ Comprises price subsidies on daily living necessities and agricultural inputs, plus operating losses of SOEs.

3/ Estimated for 1998-99. Excludes interest on unrecorded external debt for lack of data.

4/ Change in gross credit to government less change in Treasury deposits at the People's Bank of China.

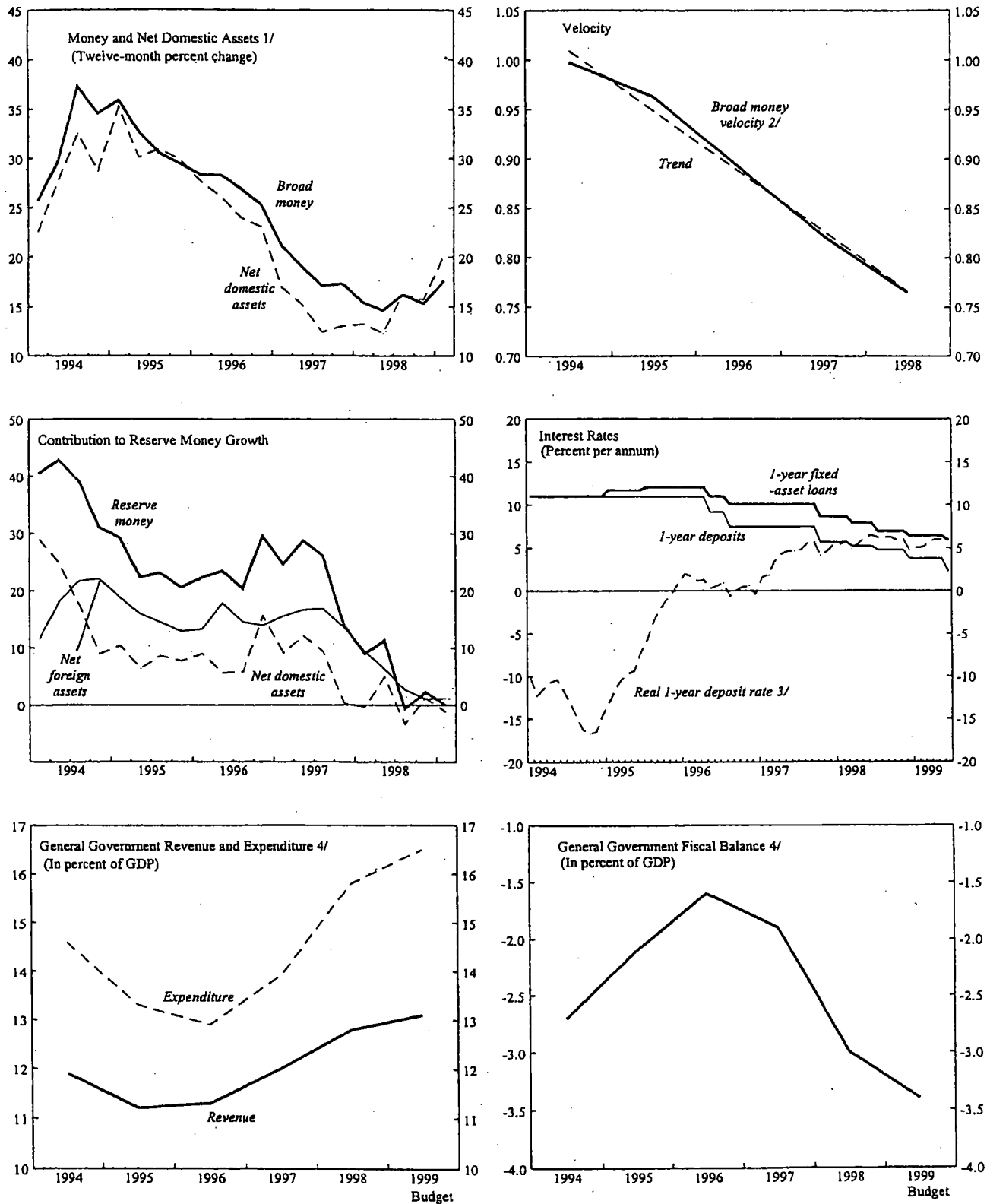
5/ Mainly government bonds issued to households and enterprises.

6/ Foreign bond placement by the MoF, excluding all official credits (bilateral and multilateral).

7/ Official credits (IBRD, ADB, bilateral) guaranteed by the government and on-lent to the private sector (estimate in 1999).

Chart 4

CHINA: MONETARY AND FISCAL DEVELOPMENTS



Sources: Chinese authorities; and staff estimates.

1/ Data relate to the banking survey.

2/ Defined as nominal GDP divided by the end-of-period stock of broad money.

3/ Nominal interest rate less 12-month change in CPI.

4/ Adjusted to include unrecorded expenditures (see footnote to Table 3).

Table 4. China: Summary of Monetary Developments, 1995-99 1/

	1995	1996	1997				1998				1999
			Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
(In billions of yuan)											
Net foreign assets	637	921	1,068	1,128	1,277	1,366	1,406	1,430	1,484	1,504	1,473
Net domestic assets	5,438	6,688	6,891	7,153	7,312	7,734	7,798	8,036	8,496	8,946	9,370
Domestic credit	5,293	6,641	6,979	7,156	7,387	7,868	7,919	8,277	8,979	9,446	9,573
Net credit to government	132	218	174	141	128	162	117	189	430	484	487
Other domestic credit 2/	5,161	6,423	6,805	7,015	7,259	7,706	7,802	8,089	8,549	8,962	9,086
Other items, net	145	47	-88	-3	-75	-135	-121	-241	-483	-501	-202
Broad money	6,075	7,609	7,958	8,281	8,589	9,100	9,221	9,466	9,980	10,450	10,844
(Twelve-month percentage change)											
Net foreign assets 3/	2.8	4.7	6.0	5.5	6.1	5.8	4.2	3.7	2.4	1.5	0.7
Net domestic assets	29.9	23.0	16.9	15.2	12.4	13.0	13.2	12.3	16.2	15.7	20.2
Domestic credit	22.8	25.5	16.9	12.6	13.3	12.8	13.5	15.7	21.6	20.0	20.9
Of which: Other domestic credit 2/	23.6	24.5	18.1	14.2	14.9	14.0	14.7	15.3	17.8	16.3	16.5
Other items, net 3/	5.7	-1.6	0.4	2.3	-0.5	0.3	-0.4	-2.9	-4.8	-4.0	-0.9
Broad money 4/	29.5	25.3	21.1	19.0	17.1	17.3	15.4	14.6	16.2	15.3	17.6
Memorandum items:											
Reserve money (billions of yuan)	2,076	2,689	2,681	2,749	2,838	3,063	2,921	3,059	2,818	3,134	2,919
(percentage change) 5/	20.6	29.5	24.6	28.7	26.1	13.9	9.0	11.3	-0.1	2.3	-0.1
Money multiplier	2.9	2.8	3.0	3.0	3.0	3.0	3.2	3.1	3.5	3.3	3.7
Foreign-currency deposits of residents (US\$ billion)	...	...	...	...	...	76.9	78.0	80.5	86.8	88.5	89.6 6/
Foreign-currency loans of residents (US\$ billion)	...	...	...	...	...	84.3	87.6	87.85	87.5	88.6	86.0 6/

Source: Data provided by the Chinese authorities.

1/ There are breaks in the series beginning in 1997. The growth rates reported are based on official announcements.

2/ Comprises loans to enterprises, individuals, and nonbank financial institutions.

3/ Twelve-month change as a percent of initial level of monetary liabilities.

4/ There is a break in the series in 1998. The growth rates reported are based on official announcements. (Ignoring the break, the December 1998 growth rate was 14.8 percent.)

5/ In November 1996, an increase in demand for reserve assets resulting from stricter enforcement of reserve requirements for rural credit cooperatives was accommodated by an expansion in reserve money. The growth of reserve money for 1996 excluding this operation was 20.3 percent.

6/ Data for end-February.

lending for infrastructural projects accelerated due to the fiscal stimulus. As inflation turned negative, and U.S. interest rates eased, deposit interest rates were lowered by an average 1.2 percentage points during 1998. A further reduction, averaging 1 percentage point, took place in June 1999; the benchmark one-year deposit rate was reduced to 2¼ percent, approximately 3½ percentage points below corresponding rates on U.S. dollar deposits abroad. In March 1998, reserve requirements were reduced by 5 percentage points to 8 percent, and excess reserve requirements were abolished, with the liquidity impact offset by a reduction in PBC credit to SCBs; greater flexibility in interest rates for lending to small enterprises was also introduced.

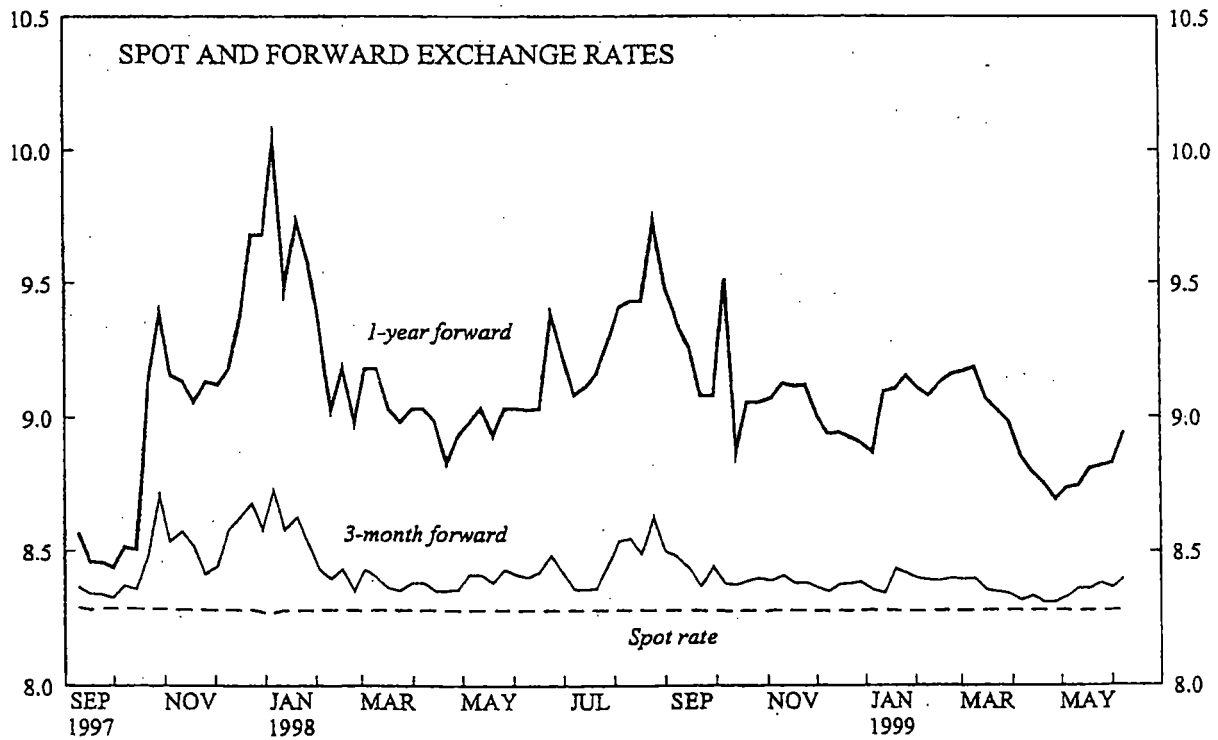
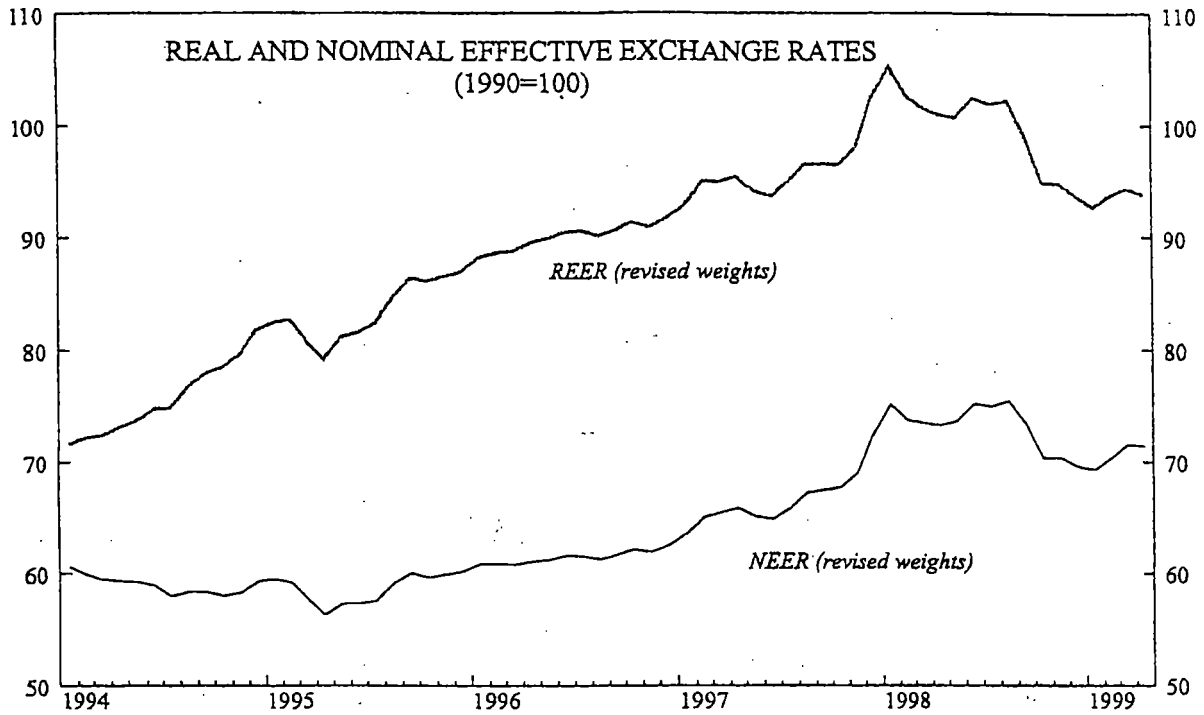
10. **Despite episodes of pressure—particularly in July and August, 1998—the renminbi was kept stable against the U.S. dollar.** Following the Asian crisis, the real effective exchange rate initially appreciated (Chart 5), prompting several measures to boost exports, including increasing VAT rebates (to a range of 9–17 percent for nonagricultural products, compared with a VAT rate of 17 percent), allowing more enterprises direct trading rights, and providing subsidized credits to exporters. The real appreciation has since been reversed as the currencies of the crisis countries and the yen strengthened, and domestic prices fell; by end-April 1999, the real effective exchange rate had returned to its June 1997 level.

11. **On the structural side, solid progress was made in reforms of the financial and SOE sectors.** In the financial sector, the PBC branch network was restructured along the lines of the U.S. Federal Reserve to increase its operational independence from provincial governments; the SCBs were partially recapitalized and given greater independence; the credit plan was abolished; work to improve the regulatory and supervisory framework was begun, including a pilot project to introduce improved classification standards (although these remain below international standards—Annex III); and a number of insolvent financial institutions were closed (with domestic depositors compensated). While SOE profitability declined (Table 5), ties with government agencies and the military were largely severed; restructuring of sectors with excess capacity accelerated; and the social safety net was strengthened.

12. **In 1999, negotiations on China's accession to the World Trade Organization (WTO) intensified.** While discussions still continue, China has offered major market-opening measures, including substantial cuts in tariffs on agricultural and industrial products; reductions in quantitative restrictions; allowing foreign companies greater freedom to import, export and distribute their products in China; and liberalizing foreign investment in the services sector, including telecommunications and financial services.

13. **Developments in the asset markets were mixed** (Chart 6). The “A” share markets—limited to domestic residents—remained relatively unaffected by the Asian crisis, despite the worsening performance of listed companies. However, the “B” share markets—limited to foreigners—dropped by some 80 percent through early 1999, due to the deterioration in external sentiment, as well as growing illiquidity. Both the “A” and

CHINA: EXCHANGE RATE DEVELOPMENT, 1994-99



Sources: data provided by the Chinese authorities; IMF: Information Notice System; and Reuters.

Table 5. Industrial SOE Indicators, 1993-98

(In percent)

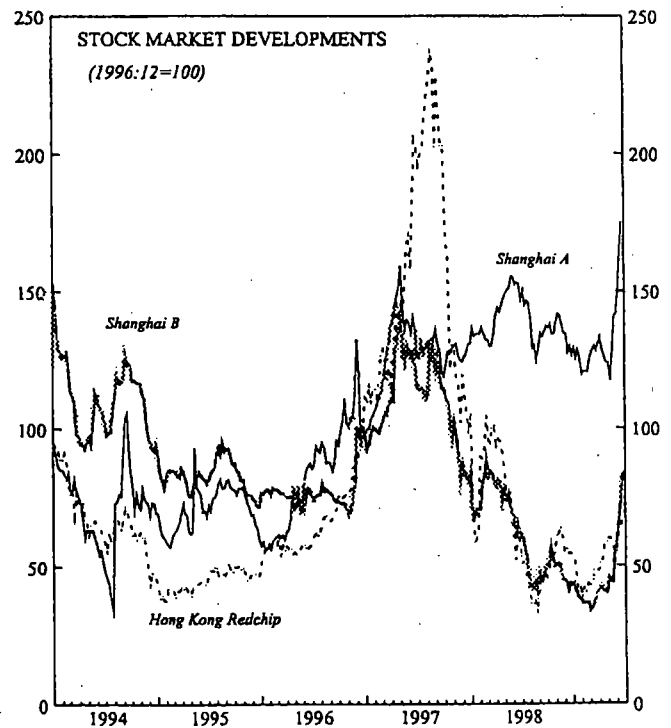
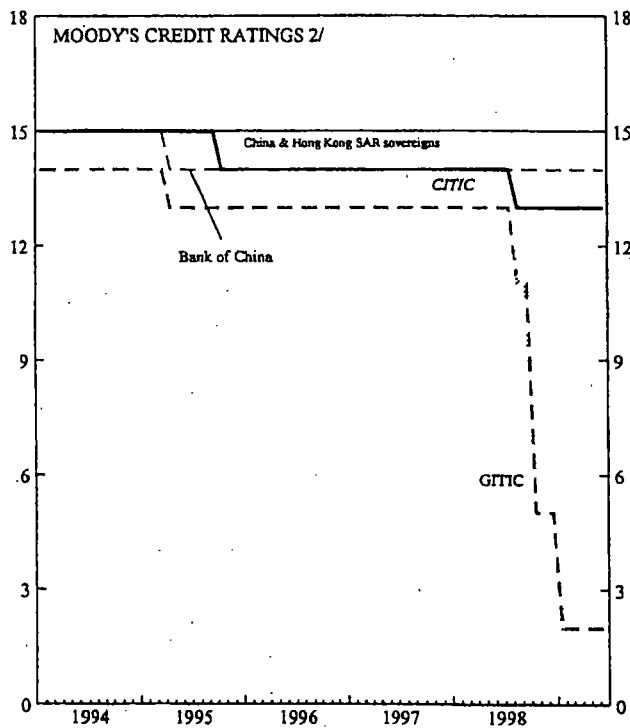
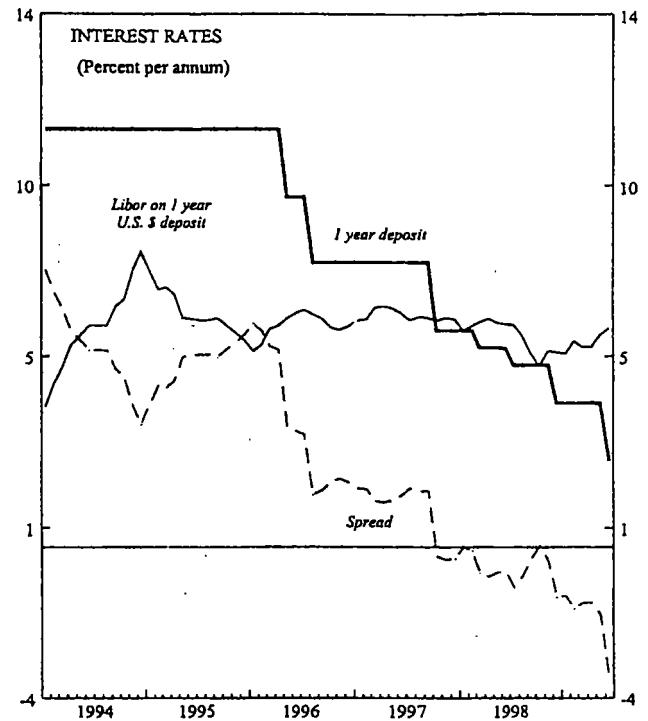
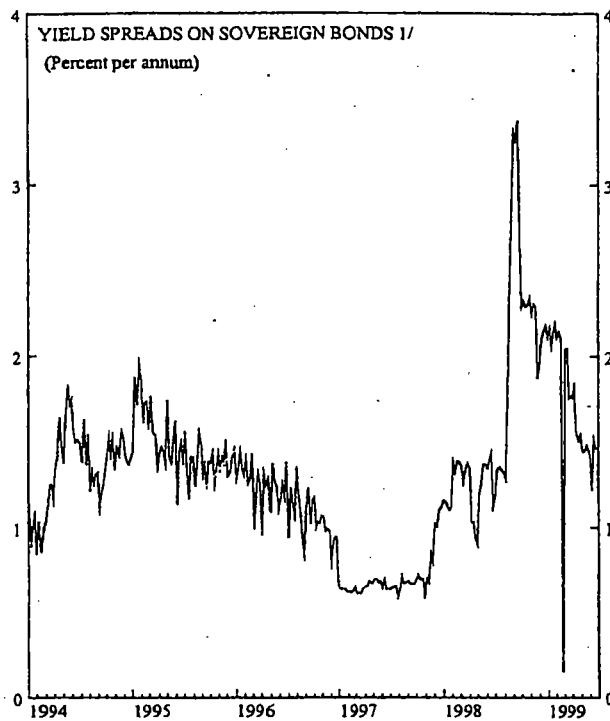
	1993	1994	1995	1996	1997	1998
Growth of industrial value-added						
All industrial enterprises	20.1	18.9	14.0	12.5	11.1	8.9
Industrial SOEs	...	5.5	7.2	6.4	5.4	4.9
Share of SOEs in gross industrial output	47.0	37.3	34.0	28.5	25.5	22.9
Liability-asset ratio 1/	67.5	67.9	65.6	65.1	64.8	64.6
Profit ratio 1/ 2/	4.3	3.8	2.6	1.5	1.5	0.9
Proportion of loss-making firms 1/	...	30.9	33.8	35.9	42.2	50.1
Share of SOEs in industrial employment	38.1	36.2	35.7	33.5	31.0	28.6

Source: National Bureau of Statistics and preliminary staff estimates (in italics).

1/ Enterprises at the township level and above, with independent accounting systems.

2/ Ratio of after-tax profits to gross output.

CHINA: SELECTED FINANCIAL INDICATORS, 1994-99



1/ Spreads against U.S. Treasury bills.

2/ Moody's ratings: Aaa=21, Aa1=20, Aa2=19, Aa3=18, A1=17, A2=16, A3=15, Baa1=14, Baa2=13, Baa3=12, Ba1=11, Ba2=10, Ba3=9, B1=8, B2=7, B3=6, Caa1=5, Caa2=4, Caa3=3, Ca=2, C=1.

“B” markets have recently rebounded strongly—prompted in part by government measures to boost the market (Section IV.C)—although the “B” markets remain well below pre-crisis levels. In the property market, real estate investment accelerated during 1998 and early 1999, again partly reflecting the fiscal stimulus package; however, substantial excess supply of retail and office space persists in a number of major cities.

III. OUTLOOK AND RISKS

14. **For 1999, GDP growth will initially continue to be boosted by the fiscal stimulus, but the effects will steadily decline during the year.** Thus, while GDP growth in the first quarter of 1999 has remained high (8.3 percent), it is estimated to have slowed to about 7 percent in the second quarter, and is expected to average 6½ percent for the year as a whole (Table 6), with the growth rate slowing significantly in the latter half. Allowing for a further 7 million new layoffs from SOEs, as the authorities plan, urban unemployment would likely rise further (depending on the success of retraining and reemployment measures). The CPI is expected to decline by 1½ percent, with a pickup in import prices more than offset by the continued impact of excess capacity, weak domestic demand, and structural reforms.

15. **On the external side, the current account surplus is projected to decline by 2½ percent of GDP to 1 percent of GDP,** largely accounted by a fall in the trade surplus. Although exports are expected to pick up modestly during the year as external demand improves, they are projected to decline by 1½ percent for the year as a whole (reflecting the carryover effect from the previous year). At the same time, import growth is expected to rise significantly, mainly due to the anti-smuggling campaign (through a substitution of recorded for unrecorded imports, which has already been evident from late 1998).

16. **Projections of the external capital account remain subject to great uncertainty.** Inflows of foreign direct investment are projected to decline sharply in 1999, as the full effects of the Asian crisis are felt; and net portfolio flows are projected to remain weak. Lending to nonsovereign borrowers, which had already turned substantially negative in 1998, is expected to show continued—albeit reduced—outflows.⁷ Finally, the recent reduction in interest rates is expected to result in some increase in outflows in the second half of the year. Overall, the capital account deficit is expected to remain broadly unchanged; however, even allowing for some reduction in errors and omissions (the counterpart of the reduction in unrecorded imports), the overall external position would show a small deficit, implying a deterioration in the second half of the year. This projection is, however, subject to wide margins of error, and close monitoring of capital account developments will be needed.

⁷This mainly reflects a less marked decline in net trade credits, as the shortening of trade credit maturities available to Chinese importers (and lengthening of trade credits offered by Chinese exporters) slows and illegal outflows are constrained by intensified enforcement of controls.

Table 6. China: Medium-Term Scenario, 1997-2004

	1997	1998	1999	2000	2001	2002	2003	2004
	Projections							
	(Percent change)							
Real GDP	8.8	7.8	6.6	6.0	5.5	6.0	6.6	7.3
Real domestic demand	6.9	7.9	8.5	6.7	5.7	6.4	6.6	7.2
Consumer prices (average)	2.8	-0.8	-1.5	1.5	2.0	2.0	2.0	2.0
	(In percent of GDP)							
Gross domestic investment	38.1	37.8	39.3	36.9	36.2	35.5	34.8	34.0
Of which: Fixed investment	33.6	36.1	37.7	35.5	35.0	34.5	34.0	33.5
Gross national saving	41.9	41.2	40.4	37.2	36.3	35.2	34.4	33.6
Current account balance	3.8	3.4	1.0	0.3	0.1	-0.3	-0.4	-0.4
	(In billion of U.S. dollars)							
Current account balance	34.7	32.6	10.2	3.6	1.4	-3.8	-4.9	-6.2
Trade balance	46.2	46.6	26.1	21.8	21.9	20.4	23.1	26.1
Exports	182.7	183.5	180.8	188.9	204.0	224.4	253.6	286.6
(Percent change)	20.9	0.5	-1.5	4.5	8.0	10.0	13.0	13.0
Imports	136.5	136.9	154.7	167.1	182.1	204.0	230.5	260.5
(Percent change)	3.7	0.3	13.0	8.0	9.0	12.0	13.0	13.0
Net services and transfers (incl. inv. inc.)	-11.5	-14.0	-15.8	-18.2	-20.5	-24.2	-28.0	-32.3
Capital account, net 1/	23.0	-6.3	-6.0	10.0	20.0	21.0	23.0	23.0
Of which: Direct investment, net	41.7	41.1	25.0	30.0	30.0	30.0	30.0	30.0
Portfolio investment, net	6.8	-3.7	-4.0	1.0	4.0	5.0	7.0	7.6
Other investment, net	-25.5	-43.7	-27.0	-21.0	-14.0	-14.0	-14.0	-14.0
Errors and omissions	-22.0	-19.9	-11.0	-11.0	-11.0	-10.0	-9.0	-8.0
International reserves	143.4	149.8	143.0	145.7	156.1	163.3	172.4	181.1
(Months of imports of goods and nonfactor services)	(10.3)	(10.8)	(9.2)	(8.7)	(8.5)	(8.0)	(7.5)	(6.9)
External debt (official definition)	132.1	146.0	154.0	168.5	184.5	204.0	225.0	246.5
(Percent of GDP)	(14.6)	(15.2)	(15.3)	(15.5)	(15.8)	(16.2)	(16.4)	(16.4)
Debt-service ratio (official definition)	6.1	7.5	8.2	8.3	8.4	8.5	8.3	8.2
Memorandum items:								
Change in reserves (- indicates increase)	-35.7	-6.4	6.8	-2.6	-10.4	-7.2	-9.1	-8.8
of which: trade surplus	46.2	46.6	26.1	21.8	21.9	20.4	23.1	26.1
Services and transfers, net	-11.5	-14.0	-15.8	-18.2	-20.5	-24.2	-28.0	-32.3
FDI, net	41.7	41.1	25.0	30.0	30.0	30.0	30.0	30.0
Other capital account and E&O	-40.7	-67.3	-42.0	-31.0	-21.0	-19.0	-16.0	-15.0

Sources: Staff estimates and projections.

1/ Excludes errors and omissions.

17. **The medium-term outlook** is centered on two key assumptions: an improving external environment in line with World Economic Outlook projections, and an acceleration of the pace of structural reform. The latter will adversely affect output in the short run as inefficient industries are closed down (although the quality of GDP growth is likely to improve). Thus, GDP growth would slow below 6 percent through 2001, rising to above 7 percent by 2004 as the productivity gains from reform begin to be felt. This would be unlikely, however, to be sufficient to absorb the combination of new entrants to the labor force, additional laid off workers, and new rural migrants, implying that urban unemployment will remain a serious problem. The current account position is expected to shift gradually into modest deficit, with a pickup in exports as external demand strengthens offset by buoyant import growth driven by rising domestic demand and continued trade liberalization. With some further strengthening of the capital account as external confidence improves, the balance of payments would revert to modest surplus.

18. **There are, however, a number of risks to the outlook.** In the short run, if private and external demand are weaker than projected, GDP growth could slow more than the staff projects toward the end of the year. The balance of payments could also come under pressure if exports slow further or the capital account weakens. On the structural side, the problems in banks and SOEs are—as the authorities recognize—very serious. Without steady progress with reforms, nonperforming loans would continue to rise, and the financial position of the banking system would deteriorate further, resulting in rising quasi-fiscal liabilities, steadily weakening growth and rising macroeconomic risks. Rising unemployment could also lead to strains on social stability.

19. **Analysis of macroeconomic risks and vulnerabilities in China is significantly hampered by the weak statistical base.** Poor transparency, weak accounting practices, an underdeveloped legal system, and corruption also increase the possibility of adverse surprises and of contagion effects. The authorities are well aware of these issues, and are working vigorously to address them. In the interim, however, given the large margin of error in assessing risk and vulnerabilities, the design and implementation of policies affecting areas of particular uncertainty needs to be especially prudent.

IV. POLICY DISCUSSIONS

20. **The authorities stated that, as the Asian financial crisis had deepened, the impact on China had been greater than initially expected.** With exports slowing, and domestic demand also remaining sluggish, a proactive fiscal policy had therefore been adopted from mid-1998, with the aims of supporting growth, ensuring social stability, and helping address regional inequalities. During 1999, the external environment was expected to remain difficult, and therefore macroeconomic policies would need to continue to be supportive of domestic demand, underpinned by measures to boost exports, encourage the private sector, and strengthen rural consumption. At the same time, the stability of the renminbi would be maintained. On the structural side, the authorities believed that the

coming two years would be crucial for China's financial system and for SOE reforms. With the key vulnerabilities well understood, reforms in both areas would be further accelerated over the coming year, supported by a strengthened social safety net. Reforms were made even more necessary by China's prospective entry into the WTO.

21. **The staff broadly supported the authorities' position, in particular welcoming their commitment to accelerate structural reforms, which was essential to support growth and maintain macroeconomic stability.** It noted, however, that balancing the various objectives would involve difficult policy choices during the year. In particular, as noted above, the acceleration of structural reform would adversely affect growth and employment in the short run. At the same time, macroeconomic policy options to support growth were constrained by the commitment to exchange rate stability and by longer-run fiscal sustainability concerns. Thus, the discussions focused on how best to manage these potential conflicts and risks.

A. Exchange Rate Policy and External Vulnerability

22. **The authorities reconfirmed their commitment to maintaining the stability of the renminbi during the remainder of 1999.** For 1999, they believed that China's strong economic fundamentals provided a solid foundation for maintaining the exchange rate. They anticipated only modest pressure on capital flows as a result of the large differential between domestic and U.S. interest rates and the GITIC collapse, which would anyway be manageable given the high level of reserves. Even so, capital flows would be carefully monitored and policies—including if necessary capital controls—adjusted appropriately.

23. **The staff agreed that stability of the renminbi remained in the best interest of both China and the region at the present time.** While slowing export growth was a concern—and some exporters had been hit hard by declining export prices—China's export shares had continued to hold up in major export markets. Thus, it appeared that weak external demand, rather than inadequate competitiveness, had been the main reason for the export slowdown. However, with China likely to experience continued rapid structural change, greater exchange rate flexibility would be required in the future, once the regional situation stabilized (Box 6). The authorities broadly agreed, noting that over the medium-term market forces would have to be the major determinant of the exchange rate.

24. **China's external vulnerability remains manageable** (Chart 7). As of end-1998, external debt (official definition), stood at \$146 billion, of which \$17 billion was short term.

Box 6. China: Is the Asian Contagion Over?

Regional market conditions appear to be stabilizing, reflected in a marked decline in contagion effects. This follows a sharp increase in correlations between Asian currencies and stock market indices in late 1997 as market sentiment weakened, suggesting that regional shocks—contagion—rather than country-specific shocks had been driving movements in currencies and stock markets from late 1997 to late 1998.

Analysis of the trend over time of cross-market correlations of China's stock market index and nondeliverable forward (NDF) exchange rate with those in the region suggests that contagion effects have dissipated. The trend component of correlations of the one-year renminbi NDF rate with most regional currencies has declined substantially since late-1997 and early-1998 (see charts). Similarly, correlations of the Shanghai B-share index, shares in which are held by foreigners, with most regional stock market indices are presently lower than in mid-1998, although in many cases the correlations are somewhat higher than a few months ago (see table).

China: Correlations with Asian Stock Markets and Currencies¹
(Trend component² of 4-month moving correlation of daily data)

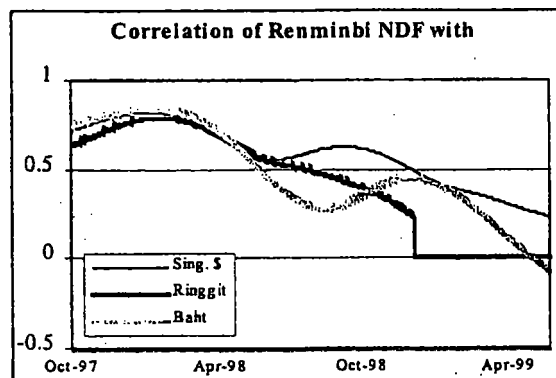
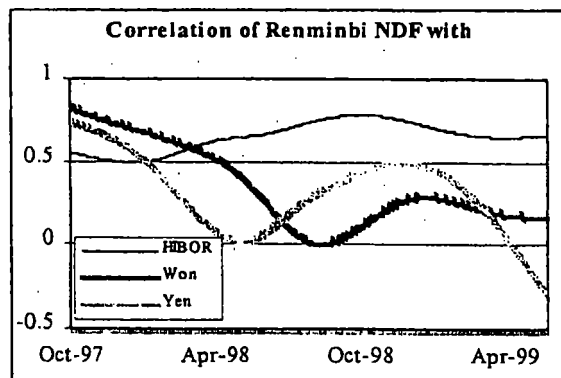
	Shanghai B-shares			Renminbi 1-yr. NDF rate		
	1997-98 High Month	Current Level	Current Level	1997-98 High Month	Current Level	Current Level
Hong Kong SAR	Jun-98	0.89	0.62	Oct-98	0.78	0.66
Indonesia	May-98	0.48	0.93	Oct-97	0.56	0.77
Japan	Jan-98	0.49	0.56	Oct-97	0.73	-0.30
Korea	Jul-98	0.60	0.83	Oct-97	0.82	0.17
Malaysia	Jul-98	0.93	0.74	Feb-98	0.79	0.00
Philippines	Jul-98	0.87	0.71	Mar-98	0.73	0.87
Singapore	Jun-98	0.95	0.79	Jan-98	0.82	0.23
Taiwan Province of China	Jun-98	0.77	0.70	Oct-97	0.90	0.05
Thailand	Jul-98	0.84	0.80	Feb-98	0.83	-0.08

¹Correlations of Shanghai B-shares are with stock markets; correlations of renminbi nondeliverable forwards (NDF) are with currencies except with Hong Kong SAR, where the correlation is with 3-month HIBOR.

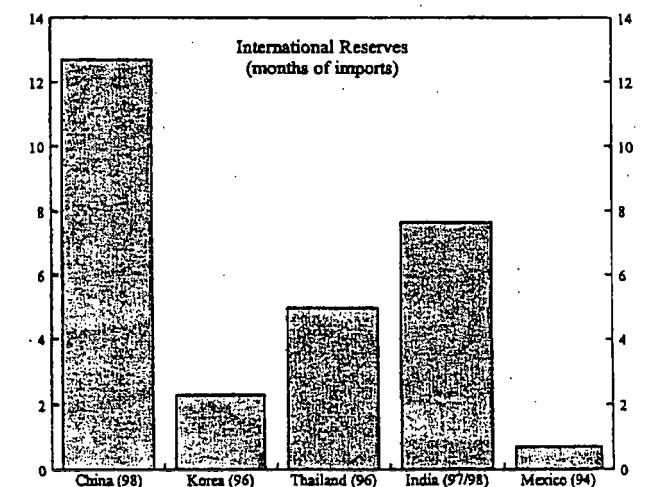
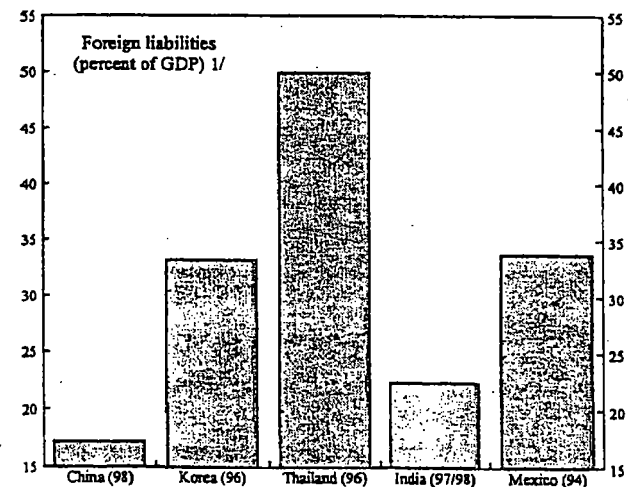
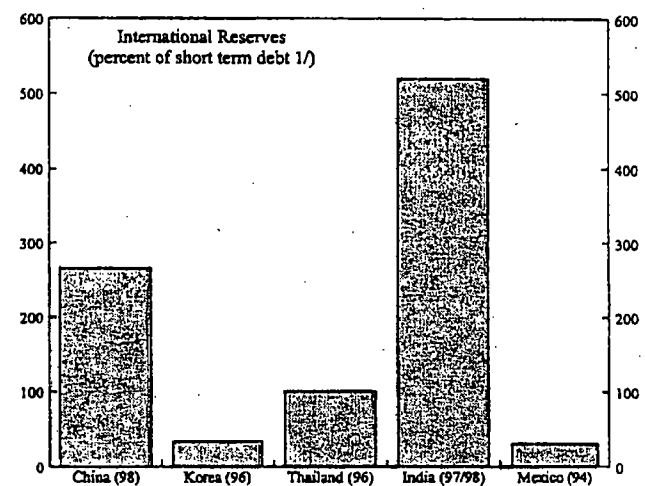
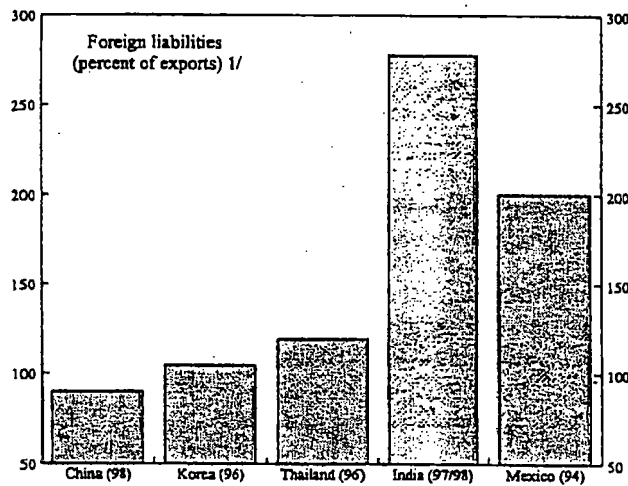
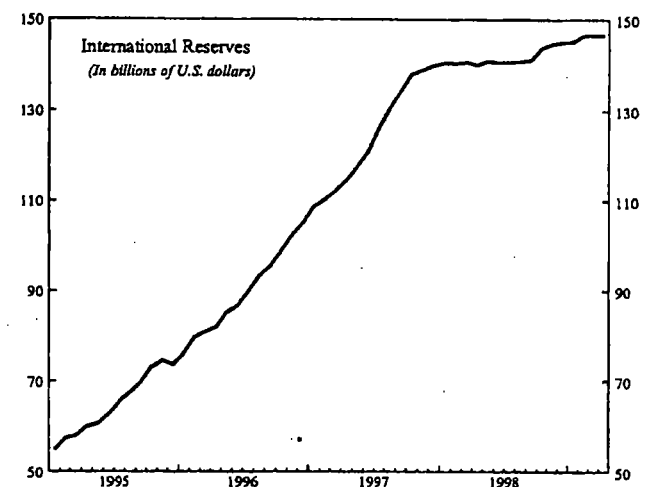
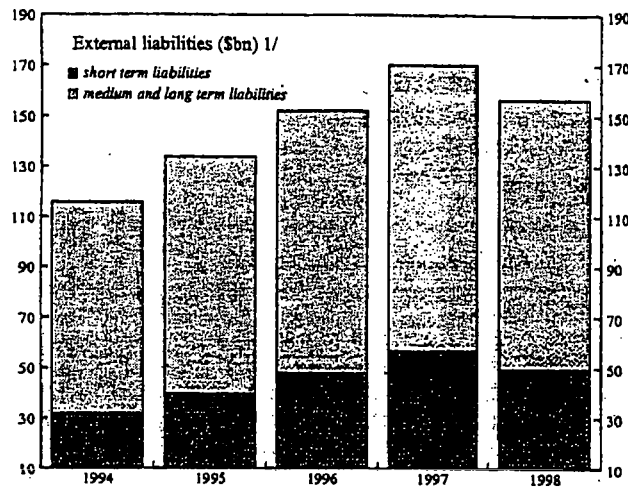
²Estimated by applying Hodrick-Prescott filter to moving correlation series.

While the pattern of declining correlations is evident in most bilateral correlations of regional currencies and stock markets amongst one another, several cross-market correlations have increased in the last three months, suggesting that regional factors—including improved market sentiment toward the region—have played an important role in the recent rise in Asian stock markets. In some cases, the present level of the cross-correlation is higher than at any time during 1997-98 (e.g. the correlations between China's currency and stock market values with those of the Philippines and Indonesia). Moreover, the correlation between renminbi NDFs and Hong Kong SAR (measured against Hong Kong interbank interest rates since the Hong Kong dollar is fixed under the linked exchange rate system), though declining somewhat, remains relatively high.

The decline in most regional cross-market correlations, together with the improvement in regional market sentiment, appears to suggest that the prospect of contagion effects from China have weakened in recent months. While it is possible that a large shock could lead to renewed contagion, it is noteworthy that neither the financial situation in Brazil nor the GITIC bankruptcy led to a significant rise in cross-market correlations in the region in early 1999.



CHINA: EXTERNAL LIABILITIES AND RESERVES INDICATORS, 1994-99



1/ China's official debt data are adjusted using data from BIS. Data for 1995 are estimates.

2/ Excludes dollar indexed Tesobonos, which were considered domestic debt.

Taking account of discrepancies with creditor data,⁸ external liabilities are estimated at \$169 billion, of which \$59 billion is short term (on a remaining maturity basis and including bonds with put options coming due); even so, debt and debt-service indicators are manageable in both absolute and relative terms (Box 5 and Table 7).⁹ Gross official reserves, now \$151 billion, are high in terms of both current and capital account indicators. The authorities stated that reserves were invested in high quality and liquid assets, with no transactions involving commercial loans; and that reserve management was fully in line with international practices. However, they declined to provide any specific information on reserve composition or management.

B. Short-Run Macroeconomic Management

25. **The authorities noted that China's economy had remained resilient and relatively stable despite the deteriorating external situation, aided by a timely fiscal stimulus in mid-1998.** However, despite the impact of the stimulus—and of earlier interest rate cuts—private demand remained sluggish and deflationary pressures persisted, reflecting a combination of excess supply, weak demand, and continued good harvests. The difficulty in stimulating private demand in part reflected the fact that private consumption was presently depressed by precautionary savings, and nonstate investment was constrained more by the availability of credit, rather than its price. Thus, the authorities had taken a series of additional measures to boost consumption (including raising rural incomes through higher procurement prices for grain, developing rural infrastructure, and strengthening the social safety net), and to strengthen the private sector (Section IV.C and Box 7). Over the medium term, housing reform was also expected to have an important impact.

26. **With activity remaining strong in the first quarter, the authorities believed that GDP growth of 7 percent for the year as a whole was within reach.** They stressed that robust GDP growth was very important for China, especially given the pressures in the labor market; nevertheless, it was not a mandatory target, and a modest shortfall would not be a cause for concern. The most important factor was the quality of growth, and not its quantity. The staff agreed, noting that it was important to avoid unduly ambitious growth targets that could only be achieved at the expense of economic efficiency or the needed economic reforms.

⁸China's external debt data suffer from a number of deficiencies, including incomplete coverage of borrowing from commercial banks, the absence of data on a remaining maturity basis; and gaps and long lags in the publication and provision of data.

⁹However, there may be other potential obligations, including liabilities of subsidiaries of Chinese firms outside Mainland China (significant in the case of the GITIC), and direct investments with guaranteed minimum rates of return.

Table 7. China: External Liabilities and Reserves

(In billions of U.S. dollars, remaining maturity basis)

	1993	1994	1995	1996	1997	1998
External Assets	...	105.8	123.0	158.2	206.8	222.4
Official reserves at end-December	23.0	53.6	76.1	107.7	143.4	149.8
State Administration of Foreign Exchange forward obligations	0.0	0.0	0.0	0.0	0.0	...
Official reserves net of forward obligations	23.0	53.6	76.1	107.7	143.4	...
Foreign assets of resident banks	...	52.2	46.9	50.5	63.4	72.6
Total identified external liabilities	101.7	115.8	118.2	152.3	166.5	169.1
Medium and long-term debt	70.0	84.0	78.7	104.5	101.5	110.5
Debt to official creditors	24.8	32.5	36.9	38.9	40.0	45.4
Debt to commercial banks	33.2	35.6	33.6	39.0	27.0	...
Debt to non-bank private creditors	12.0	15.9	8.2	26.6	34.5	...
Short-term liabilities (remaining maturity basis, calculated from BIS data)	31.7	31.8	39.5	47.8	64.9	58.6 1/
Debt to commercial banks	22.2	24.8	32.0	38.9	56.4	48.3 1/
Debt to private non-bank creditors	9.5	6.9	7.6	8.9	8.6	10.3 1/
Memorandum items:						
External liabilities/GDP ratio (in percent)	16.9	21.4	16.9	18.6	18.1	17.6
External liabilities/exports ratio (in percent)	134.4	117.1	115.3	100.8	91.1	92.1
External liabilities/exports of G&NFS ratio (in percent)	111.4	95.5	93.2	85.1	79.1	81.4
Official reserves						
in months of merchandise imports	3.2	12.8	14.2	9.8	12.6	12.8
in months of imports of goods and non-factor services	2.8	6.7	8.3	8.4	10.3	10.8
in percent of short-term liabilities (remaining maturity, from BIS data)	72.7	168.6	192.3	225.3	220.8	255.8
in percent of total external liabilities	22.6	46.3	64.3	70.7	86.1	88.6
as a percentage of reserve money (M0)	10.1	26.8	30.6	33.2	37.8	38.4
as a percentage of money (M1)	7.9	21.4	24.8	29.1	31.0	28.7
as a percentage of broad money (M2)	3.8	9.8	10.5	11.7	12.9	11.7
Official external debt data						
Total debt	83.6	92.8	106.6	116.3	132.1	146.0
Short-term debt (original maturity basis)	13.5	10.4	11.9	14.1	18.1	17.3

Sources: Chinese authorities, Bank for International Settlements, and Fund Staff estimates.

1/ Staff estimates based on BIS quarterly and semi-annual data, includes puttable bonds with options falling due within one year.

Box 7. Supporting the Development of China's Private Sector

The nonstate sector, which has grown rapidly, played a key role in China's rapid productivity growth during the reform period.¹

- Between 1980 and 1997, the share of the state sector in industrial output fell from 76 percent to 25 percent, while, correspondingly, that of the nonstate sector rose to 75 percent. In addition, within the nonstate sector, the share of "other" (i.e., private) enterprises in industrial output rose dramatically to almost match that of the collectives. Most of the growth in collectives took place in the 1980s, whereas the private sector expanded most rapidly in the 1990s.
- Similarly, the state sector's share in industrial employment has fallen to under 30 percent, while the nonstate sector's share has risen correspondingly. It is noteworthy that the private sector's share in employment has more than doubled since 1985, accounting for 31 percent of industrial employment in 1997. This has been accompanied by a corresponding fall in the share of the collectives sector. The partial figures available for 1998 suggest that this trend may have continued, with employment in private firms and self-employment rising 21 percent over 1997.

The Changing Ownership Structure of China's Economy in percent				
	1980	1985	1990	1997
Share in Industrial Output				
State	76.0	65.0	54.6	25.5
Nonstate	24.0	35.0	45.4	74.5
Collectives	23.5	32.0	35.6	38.1
Other	0.5	2.0	9.8	36.4
Share in Industrial Employment				
State	49.7	39.4	35.8	29.3
Nonstate	50.3	60.6	64.2	70.7
Collectives	50.3	46.3	44.5	40.1
Other	0.0	14.4	19.7	30.6

In the past, the Chinese leadership viewed private enterprises as peripheral, resulting in significant constraints on private sector expansion. Thus, relative to collectively owned and state-owned enterprises, private enterprises' property rights were less secure; access to credit from the state banks was very limited, forcing private firms to use retained earnings, informal financial markets, and family and friends as sources of capital; and they were often subject to arbitrary fees and charges.

The Chinese authorities have recently sought to expand the role of the private sector in the economy, realizing the sector's potential to absorb the rapidly rising unemployed. The most recent measures include:

- amending the constitution to elevate the status of the private sector to an "important component" instead of only a "complement" to the socialist economy, and to promote the rule of law in China;
- increasing the private sector's access to bank lending, including by issuing guidelines to the state commercial banks to extend a certain portion of their lending to small and medium-size enterprises (SMEs—many of which are private), by expanding credit guarantees for SMEs, and by the PBC making additional credit available to farmers;
- reducing the arbitrary fees and charges on private business, including via the anti-corruption campaign; and
- increasing the number of private companies allowed to conduct foreign trade.

Nevertheless, much remains to be done to support the further expansion of the private sector. Critical measures include:

- increasing private firms' (both urban and rural) access to capital (via bank lending, domestic and overseas stock market listing, and leasing); and
- removing sectoral entry barriers (especially in telecommunications and financial services).

¹ In China, the nonstate sector consists of the collective enterprises (including the township and village enterprises) and "other" enterprises. The latter category, which the staff treat as a rough approximation of the private sector, is composed of individual-owned enterprises and other enterprises (including mainly foreign-funded enterprises, domestic joint ventures, and privately-owned enterprises). There are some problems associated with measuring the size of the private sector in China, including the fact that some collectives are actually private firms, and that some joint ventures are state-owned.

27. **For 1999, the state budget deficit is estimated to increase by ½ percent of GDP to 3½ percent of GDP**, due to additional expenditures to complete infrastructure projects begun in 1998; social safety net-related subsidies to local governments; higher defense expenditures (to offset the loss of off-budget revenues from enterprises formerly owned by the military); and—to a lesser extent—higher export tax rebates. The revenue ratio is projected to increase by ½ percent of GDP (excluding exceptional collection of arrears in 1998). The authorities report that revenues have increased by 25 percent in the first five months of 1999, while expenditures increased 17 percent. While the staff has no breakdown of the data, it understands the revenue increase is due to the anti-smuggling drive, improved enforcement, and higher stamp tax receipts from the recent pickup in the stock market. While an assessment of these developments will need to await further data, were they to continue, the budget deficit would be lower than projected. The authorities expected the increase in the deficit to be temporary, and that the overall deficit would decline in 2000 (although the earlier target of primary balance would be hard to achieve).

28. **Given the continued weakness of demand, the staff supported the budgeted increase in the fiscal deficit.** However, it expressed concern at reports of implementation problems relating to the infrastructural program, including corruption and shoddy construction. The authorities said that rapid start up of some projects had resulted in some problems, but that quality was in general acceptable. A supervisory task force had been established to audit project quality, and if problems emerged, government loan disbursements could be suspended for all projects in that province. In addition, a responsibility system with administrative and legal penalties was introduced to ensure project quality.

29. **The authorities stated that monetary policy would be supportive of economic growth.** To this end, M2 growth is targeted at 14–15 percent, implying a somewhat more rapid decline in velocity than trend; in the first part of the year, monetary growth has been somewhat higher, reflecting the continued rapid growth in household savings. Domestic credit is projected to increase by 17 percent, with banks encouraged to lend to small and medium-sized enterprises; agriculture and the rural economy; exports; infrastructure; and consumer credit, including mortgages. The authorities stated that these guidelines were indicative, and that banks were not subject to pressure to lend to noncommercial projects.

30. **The staff observed that, as noted above, there were potential downside risks to GDP growth in the second half of the year.** If growth were to slow substantially below the level projected by the staff, additional macroeconomic stimulus would need to be considered. A further reduction in interest rates might have only a limited impact on demand, and would add to risks on the capital account. Therefore, the staff suggested that any further stimulus should focus primarily on the fiscal side (despite the need to strengthen the medium-term fiscal position). With the World Bank now assessing that the pipeline of efficient infrastructural projects is limited, this should be focused on additional social safety net expenditures (which would facilitate structural reform), and possibly further increases in VAT rebate rates (up to a maximum of zero rating). The authorities were broadly in agreement, but believed

that they had more scope on the monetary side than the staff suggested; while external considerations were a constraint, the recent intensified enforcement of capital controls had given them room for maneuver.

31. **Following the mission, the latest data suggest that activity has weakened further, and deflationary pressures intensified.** Against that background, in early June, the authorities cut interest rates sharply (paragraph 9). They have also indicated that they are preparing a further fiscal stimulus package (possibly of the order of 1 percent of GDP), comprising additional infrastructural and social safety net expenditures. Given the weakening outlook for demand, and stronger-than-expected revenue developments, the staff is supportive of further fiscal stimulus, which could provide helpful support to demand in late 1999 and early 2000. Given the concerns about additional infrastructural expenditures already noted, the staff would encourage the authorities to focus the package on strengthening the social safety net. It remains concerned, however, that the interest rate cut will add to pressures on the capital account and further test capital controls; the authorities will need to develop contingency plans for such an event.

C. Accelerating Structural Reform

Financial Sector Reform

32. **Over the past five years, financial sector reform has followed a phased approach,** beginning with the establishment of policy banks to relieve SCBs from policy lending in 1994, and followed by efforts to commercialize SCBs and make them responsible for the quality of their lending. From late 1997, in light of the lessons from the Asian crisis, reforms were significantly accelerated in several areas (paragraph 11). While significant progress has been made, the financial sector continues to face serious structural problems, and—although the staff does not have sufficient data to make a full assessment—its financial position is generally believed to be very weak.¹⁰

33. **During 1999, the focus of financial reforms will shift to setting up asset AMC**s for each SCB, thereby relieving them of the bulk of their remaining NPLs (the AMC for the China Construction Bank has already been established). The AMCs will buy NPLs with some prospect of recovery at book value in exchange for bonds, and then seek to maximize recovery through a variety of means, including direct sale, a debt-equity swap, negotiation of an orderly restructuring with debtors, and bankruptcy. To prevent new bad loans emerging,

¹⁰The authorities have in the past stated that NPLs (using the old classification system) are in the range of 20–25 percent; market analysts' estimates are in the range of 20–40 percent. A recent pilot project in Guangdong, using the new classification system which is closer to international standards, found NPLs of 40 percent (the equivalent level under the old system is not available).

SCBs will sign "governance contracts" setting out key performance goals; new risk management and monitoring procedures are also being established, along with supervisory boards to oversee the performance of top managers. The authorities are also considering further improvements to the classification and provisioning system, including reducing the classification period for overdue loans from one year to six months (and ultimately three months); raising the general provision from 1 percent to 1½ percent; and introducing specific provisioning.¹¹ The staff urged that these proposals be promptly implemented.

34. **While the staff welcomed these measures, it stressed that additional actions would be needed to ensure that they were fully effective. It highlighted four key areas:**

- **Rapidly clarify the remaining operational modalities of the AMCs**, including how they would be financed (the staff urged that this be done transparently through the budget). It would thus be crucial to ensure that AMCs are used to the full to promote enterprise restructuring, and clarifying how best to provide credit to enterprises undergoing restructuring.
- **Move forward rapidly in developing a credit culture**, including further strengthening bank independence; further commercialization of bank operations (including ensuring that subsidies to loss-making enterprises were provided transparently through the budget or policy banks); retraining of commercial bank staff; and improving legal and accounting standards, including the bankruptcy law (which remains unduly biased against creditors).¹²
- **Strengthen banking supervision**, including through continued efforts to train supervisors, improving the reporting system for off site monitoring, and prioritizing on site supervision.
- **Make a full assessment of the financial condition of banks** using international provisioning and classification standards, to determine the size of the problem faced. The financial position of the nationwide and regional banks, and the extent to which they also require restructuring, should be given particular attention.

The authorities broadly agreed, although they placed less emphasis on further assessment of the financial position of banks than on improving bank management and governance, which they saw as the most serious problem.

¹¹Under the present system, general provisioning is restricted to 1 percent of outstanding loans; there are no specific provisions.

¹²See "The Bankruptcy Law in China," in the Selected Issues paper, forthcoming.

35. **The staff noted that enhancing competition in the banking system could make an important contribution to improving the credit culture.** While the SCBs would inevitably retain a dominant role in the short run, there was room to expand the role of foreign banks and allow entry of new private banks (consistent with the development of banking supervision capacity). Once the SCBs had been rehabilitated, consideration could be given to breaking them up into smaller banks, in which foreign or domestic investors could purchase shares. The authorities said that an extension of the role of foreign banks was under consideration in the WTO negotiations; diversification of ownership of SCBs would be considered once the AMCs had been set up, and NPLs transferred, but majority state ownership would be maintained.

36. **Over the past year, a number of rural credit cooperatives (RCCs) have experienced difficulties, including in some cases runs on deposits.** The authorities noted that these problems stemmed from high NPLs and administrative costs; there had also been contagion effects from the closure of illegal financial institutions. To address these problems, the authorities are considering introducing a limited deposit insurance scheme for RCCs.¹³ The staff expressed concern that, given the weak financial position of RCCs, a deposit insurance scheme might not be financially viable; moreover, since it would offer only limited coverage, it might encourage depositors to shift funds to institutions where there is believed to be a full implicit guarantee (such as SCBs). It therefore recommended that the scheme be postponed until the financial position of the RCCs had been strengthened through an appropriate restructuring program, and supervisory capacity enhanced (the Asian Development Bank has provided assistance in these areas). The authorities noted these concerns, and indicated that they would proceed cautiously.

37. **Financial difficulties have also emerged in a number of International Trust and Investment Companies (ITICs), exemplified by the closure and eventual bankruptcy of the Guangdong ITIC.** The authorities expect shortly to announce a consolidation and restructuring plan for all trust and investment companies—primarily through mergers and acquisitions—including limiting their activities strictly to asset management, and preventing them from borrowing abroad. The staff welcomed these plans which will need to be supported by strengthened supervision, and it also supported the decision to put the GITIC into bankruptcy in order to limit future moral hazard. However, despite the recent appointment of foreign legal and accounting firms to advise in the GITIC liquidation process, it noted that creditors were still expressing concern about a lack of transparency and creditor consultation during the liquidation proceedings, and urged that efforts in these areas be strengthened. It also advised the authorities to further enhance collection of data on ITIC external debt to include the liabilities of offshore subsidiaries.

¹³While individual RCCs are generally very small, they account in total for about 20 percent of household deposits.

Public enterprise reform and the social safety net

38. Since 1994, the reform of the SOEs has been conducted under the guiding principle of “seize the large, release the small.” During 1998, reform of medium and large enterprises focused on improving corporate governance, including through breaking links between the government, the military, and the enterprise management; restructuring sectors with excess capacity, especially the textiles and coal sectors; and breaking up monopolies, including in the petroleum and telecommunications sector, to foster competition. However, partly due to the Asian crisis, the profitability of SOEs deteriorated further in 1998 (although—partly due to the anti-smuggling campaign—profitability improved from the latter part of the year).

39. **Ownership diversification of small enterprises, which is the responsibility of local government, has accelerated significantly in recent years.** The authorities noted, however, that in early 1998 this had resulted in growing abuses (including direct sales to enterprise managers at very low prices, illegal loan write-offs, and forced sales to workers). Thus, they had issued regulations seeking to curb such abuses, and encourage other methods of ownership transfer, such as conversion to joint stock companies and leasing. While no data were available, the authorities believed that the pace of disposal of small enterprises nevertheless remained rapid.

40. **For 1999, the authorities stated that enterprise reform would be accelerated, despite concerns over unemployment.** In particular, there would be greater emphasis on bankruptcy—with no annual limit on debt write-offs¹⁴—and sectoral restructuring would be accelerated. The staff welcomed this, but underscored that it would be essential that sufficient fiscal resources were made available to finance it; it also suggested accelerating ownership transfer of large enterprises through direct sales of shares to private investors, including foreigners. The authorities said that this was being considered as part of a further major package of SOE reform measures expected to be announced in the fall.

41. **With unemployment likely to remain a pressing issue, strengthening the social safety net remains a key objective.** To this end, the authorities noted that a three-tier social security system had been set up (Box 3), financed by local governments, social insurance funds, and the SOEs; central government had also increased transfers to local governments who were unable to pay their share of the costs. In addition, during 1998 some 3 million workers had been retrained and about 50 percent of laid off SOE workers had been reemployed. The staff welcomed this progress, but noted that further fiscal resources might be needed to finance the social safety net in particularly hard hit regions. There was also scope to increase interregional pooling of unemployment and pension funds.

¹⁴Previously, bankruptcies have been constrained by an annual limit on debt write-offs (Y 40 billion in 1998).

Strengthening the private sector and developing domestic capital markets

42. **The authorities are seeking to expand the role of the nonstate sector, given its dynamic performance in recent years and its potential to create employment.** In March 1999, the National People's Congress passed constitutional amendments to elevate the role of the private sector in the economy, and to promote the rule of law; measures have also been taken to improve access to bank credit (including through guarantee schemes); reduce arbitrary fees and charges; and permit more private companies to conduct foreign trade. The staff noted that it would be important to ensure that guarantee schemes were designed to minimize the risk of contingent fiscal liabilities. Consideration could also be given to allowing more private firms to list on the stock exchange; further strengthening private property rights; and reducing restrictions on private sector activities (e.g., in the construction sector).

43. **Strengthening China's capital markets, which are relatively small and underdeveloped, remains a key policy aim.** In late 1998, the NPC approved the long awaited Securities Law, which includes unified supervision of securities markets; a two-tier ranking system for securities companies; greater transparency in listing and issuance procedures, and in data provision by listed companies; and tougher penalties on illegal trading.¹⁵ In June 1999, the authorities moved to strengthen the "B" share markets by reducing stamp tax from 0.4 percent to 0.3 percent, and allowing collectives and other firms to issue "B" market shares, opening the door for the private sector to tap the markets on a wider scale.

D. Ensuring Fiscal Sustainability

44. **While China's state budget deficit and debt are relatively modest by international standards, the fiscal position is much weaker when account is taken of quasi-fiscal activities in the banking system.** In addition, in coming years there will be a need for additional expenditures for social sector reforms, infrastructure, and the environment (assessed at up to 5 percent of GDP annually by the World Bank); there are also substantial accrued pension liabilities—of some 50 percent of GDP—which may fall partly or fully on the government. An illustrative medium-term scenario suggests that, without underlying fiscal or quasi-fiscal adjustment, government debt (including quasi-fiscal liabilities) could rise to 95 percent of GDP within a decade, and interest expenses could increase to over 80 percent of central government revenue (Box 8 and Table 8). This would be clearly unsustainable.

45. **The staff therefore underscored the urgency of measures to strengthen the fiscal position over the medium term.** A key element, of course, would be successful financial

¹⁵See "The Development of China's Stock Market," Selected Issues paper, forthcoming.

Box 8. Medium-Term Fiscal Sustainability in China¹

Both the authorities and the staff believe that ensuring fiscal sustainability is critical to underpin macroeconomic stability and growth over the medium term. Although the underlying data are subject to very significant uncertainties, two key concerns appear to merit special consideration:

1. **The accumulated stock, and the new flow, of nonperforming and nonrecoverable (quasi-fiscal) lending by the banking system, particularly to the SOE sector.** While little data is available, in these calculations we assume that about 30 percent of bank lending is nonperforming, and, in line with rates elsewhere in the region, that only about 1/3 of that is recoverable.
2. **The likely magnitude of extra fiscal spending priorities for which China will need to make budgetary provisions over the medium term.** The budget will need to accommodate a number of additional spending pressures over the coming decade, including for physical infrastructure (roads, housing, environment, water conservancy) and social infrastructure (extending coverage and funding of the education, health, pension and unemployment systems).^{2,3} Although IBRD estimates suggest that the amount needed could eventually rise to as much as 5 percent of GDP, we have conservatively assumed an increase of 3 percent of GDP, phased in smoothly over the period.

The fiscal sustainability scenarios in Table 8 share a common set of macroeconomic assumptions: the real growth rate falls to 5.5 percent in 2001, and gradually rises by 2006 to 7½ percent, where it stays constant, while the real interest rate goes to 6 percent in 2000, where it stays constant as well. The real growth rate of credit falls smoothly from around 8 percent in 2000-01 to 2 percent in 2004, and stays at that level thereafter. To illustrate the possible impact of each of the two key factors above, a pair of scenarios are presented in Table 8.

The baseline scenario illustrates the outlook with no policy adjustment (either of the state budget or of quasi fiscal activities). In that case, with new quasi-fiscal lending continuing at assumed current levels, and new spending needs coming on line as well, China's debt stock almost doubles over ten years. The share of central government revenue which needs to be devoted to the interest on this debt rises fourfold.

The alternative scenario illustrates the broad scale of fiscal adjustment needed to contain the debt to GDP ratio at around 65 percent. This involves a smooth reduction in the flow of new nonrecoverable loans (from 20 percent of all banking system lending to the economy to 2½ percent by 2008), as well as a fiscal adjustment of about 4 percent of GDP.

These scenarios are obviously illustrative in nature, and are subject to considerable uncertainties arising in the underlying data and the policy response to the problem. For instance, if the initial size of the bad loan problem was 40 percent rather than 20 percent of bank lending, then the fiscal adjustment above causes the debt stock to stabilize at around 83 percent of GDP, with debt service occupying 60-65 percent of central government revenue.

¹The work on fiscal sustainability in this report builds on previous joint work with the World Bank.

²*China 2020: Development Challenges in the New Century*, World Bank (1997), p.26.

³The projections include an element to cover the carrying cost of the implicit pension debt, but not a formal conversion to government debt.

Table 8. China: Medium-Term Fiscal Framework—Illustrative Scenarios

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(In percent of GDP)										
1. Baseline scenario—No improvement in revenue or quasi-fiscal spending 1/										
State budget revenue	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4
State budget expenditure	16.8	17.0	17.6	18.1	18.6	19.1	19.6	20.2	20.7	21.3
Noninterest	15.8	14.8	14.8	14.8	14.8	14.8	14.8	14.8	14.8	14.8
Interest 2/	1.0	1.9	2.1	2.3	2.5	2.6	2.8	3.0	3.3	3.5
Additional expenditure needs 3/	0.0	0.3	0.6	1.0	1.3	1.6	2.0	2.3	2.6	3.0
State budget balance	-3.4	-3.7	-4.2	-4.7	-5.2	-5.7	-6.3	-6.8	-7.4	-7.9
State budget primary balance	-2.5	-1.8	-2.1	-2.4	-2.8	-3.1	-3.4	-3.8	-4.1	-4.4
Quasi-fiscal net expenditure	3.2	3.2	3.1	2.9	2.7	2.4	2.5	2.5	2.5	2.5
Interest on quasi-fiscal debt	0.8	1.5	1.8	2.0	2.1	2.2	2.3	2.4	2.5	2.6
Broader balance	-7.4	-8.3	-9.1	-9.6	-10.0	-10.4	-11.1	-11.7	-12.4	-13.1
Of which: Total interest burden	1.7	3.4	3.9	4.2	4.6	4.9	5.2	5.5	5.8	6.1
Broader primary balance	-5.7	-5.0	-5.2	-5.4	-5.5	-5.5	-5.9	-6.3	-6.6	-6.9
Overall debt stock 4/	52.8	57.4	62.4	67.4	72.0	76.2	80.6	85.2	90.1	95.2
Of which: Quasi-fiscal debt	24.2	27.2	30.1	32.7	34.9	36.6	38.2	39.7	41.3	42.7
Interest as percent of central government revenue 5/	23.3	45.1	52.4	56.9	61.2	65.2	69.0	73.2	77.6	82.3
2. Alternative scenario—Bad loan problem gradually reformed and gradual fiscal adjustment										
State budget revenue	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4	13.4
State budget expenditure	16.8	17.0	17.6	18.0	18.4	18.8	19.1	19.5	19.8	20.2
Required fiscal adjustment	0.0	0.4	0.9	1.3	1.8	2.2	2.6	3.1	3.5	4.0
State budget balance	-3.4	-3.2	-3.3	-3.3	-3.3	-3.2	-3.1	-3.1	-3.0	-2.9
Quasi-fiscal net expenditure 6/	3.2	3.0	2.6	2.1	1.7	1.3	1.1	0.8	0.6	0.3
Interest on quasi-fiscal debt	0.8	1.5	1.8	1.9	2.0	2.1	2.1	2.1	2.1	2.1
Broader balance	-7.4	-7.7	-7.6	-7.3	-7.0	-6.6	-6.3	-6.0	-5.6	-5.3
Of which: Total interest burden	1.7	3.3	3.8	4.1	4.2	4.3	4.4	4.4	4.4	4.4
Broader primary balance	-5.7	-4.3	-3.8	-3.3	-2.7	-2.2	-1.9	-1.5	-1.2	-0.8
Overall debt stock 4/	52.8	56.7	60.3	63.1	65.1	66.0	65.5	66.6	66.4	65.9
Interest as percent of central government revenue 5/	23.3	43.7	48.5	50.0	50.6	50.4	49.7	48.8	47.7	46.4

Sources: MoF, PBC; and staff calculations.

1/ Share of outstanding banking system credit to the economy that is nonrecoverable at end-1998 is assumed to be 20 percent and the flow of new nonrecoverable loans is assumed to continue at that rate in baseline, but fall in alternative scenario. (See footnote 6.)

2/ Interest forecast in the 1999 Budget is somewhat low, reportedly due to bonds falling due from 2000 on which pay interest at maturity.

3/ Somewhat below World Bank estimates of the fiscal costs of reforms in the areas of housing, health, education, social safety net, infrastructure and the environment (which rise to about 5 percent of GDP).

4/ Includes Y 270 billion in 1998 bank recapitalization bonds.

5/ Central government revenue is assumed to stay constant at 56 percent of total revenue.

6/ Flow of new nonrecoverable lending falls smoothly from 20 percent in 1999 to 2.5 percent in 2008.

sector and public enterprise reforms that reduce the flow of new NPLs. However, even if new quasi-fiscal spending by banks was largely eliminated within a decade, significant additional fiscal adjustment would be needed to stabilize the debt/GDP ratio at around 65 percent of GDP (alternative scenario, Table 8). While this adjustment could partly be achieved through expenditure reductions, a substantial strengthening of the revenue ratio would be necessary. The staff recommended a further strengthening of tax administration (especially monitoring, enforcement and auditing, which may also require increased manpower); a reduction or elimination of income tax preferences; broadening the VAT base (and ultimately extending it to services); increasing the business and excise taxes (including on fuel and tobacco); and introducing a property tax.

46. **While the authorities believed that the pressures on the fiscal position were likely to be lower than projected by the staff, they agreed that the revenue ratio should be strengthened.** In this context, the progress over the past three years had been encouraging, and would be continued, driven by improved collection and enforcement procedures and new policy measures (including some mentioned by the staff). In addition, they planned to convert about 8 percent of GDP of fees charged by extrabudgetary funds into taxes and bring them onto the budget. The staff agreed that this had merit from the perspectives of equity and efficiency; however, it would not substantially improve the underlying fiscal situation unless the expenditures that the fees presently finance could also be reduced.¹⁶

47. **The staff observed that fiscal strains were exacerbated by the system of intergovernmental fiscal relations.** As the medium-term scenario shows, the costs of bank and enterprise reforms will fall disproportionately on the central government whose revenue share is very low. In addition, the limited fiscal transfers between provinces (and lack of pooling of unemployment and pension funds) have led to serious difficulties in poorer provinces with high concentrations of loss-making SOEs. Finally, revenue reforms themselves will affect revenue distribution—and therefore transfers—between central and provincial governments. Thus, a fundamental reassessment of intergovernment fiscal relations was needed to assure fiscal sustainability over the medium term. The authorities recognized the problems in the present system, and noted that recent efforts to convert many local road fees into a centralized fuel tax had been designed to improve flexibility and reduce vulnerability at the central level.

E. Trade and Capital Account Issues

48. **While China has made progress in liberalizing its trade regime in recent years, tariffs remain high and substantial nontariff barriers persist, including import quotas**

¹⁶However, if the revenue accrued to the central government, and was not earmarked to specific expenditures, this would help to reduce the central government interest service ratio and thereby fiscal sustainability (see paragraph 47).

and licenses, and restrictions on entry in the services sector. The staff welcomed the recent progress in WTO negotiations, noting China's accession would result in significant liberalization which would be supportive of reforms, bolster domestic competition, and ultimately yield substantial productivity gains. The authorities agreed, although they noted that in the short term a number of sectors would face significant pressures, underscoring the importance of moving forward rapidly with structural reforms. While the trade surplus would likely fall in the short run, they expected this to be offset by rising foreign investment inflows.

49. **China's capital account remains relatively closed, with most transactions subject to government approval (Annex II).** While capital controls have not been a panacea—and have clearly been leaky—in China's particular circumstances they have helped reduce external vulnerability. In particular, limitations on foreign borrowing have helped ensure that external debt remains manageable in an environment where most banks and corporates are state owned (so that moral hazard is a major potential problem) and prudential regulations and supervision are in need of strengthening. Also, because it is difficult for nonresidents to take positions against the renminbi, China has been to some degree insulated from contagion effects. The authorities indicated that while capital account liberalization was still their long-term objective, it would need to be carefully sequenced with reforms in other areas (particularly the financial sector).

50. **The authorities stated that the recent intensification of enforcement of exchange controls had been necessary in view of widespread evidence of smuggling and illegal capital outflows.** While they acknowledged that there had been some negative effect on legitimate transactions, they believed this was transitory; indeed, following the introduction of a computer link between the customs administration and the exchange control authorities, the time needed to complete many import payments had been greatly reduced. (Many firms had also benefited from reduced competition from smuggled goods as a result of the anti-smuggling campaign.) To improve transparency and efficiency, new regulations were being posted on the Internet, and in future the business community would be consulted on them in advance. The staff welcomed this, but noted that recent surveys of foreign investors had found that serious payments delays persisted (including for services transactions). It therefore encouraged the authorities to seek to reduce delays further, including by focusing enforcement more narrowly on problem entities, and establishing mechanisms to promote voluntary compliance.

51. **Just following the Article IV mission, a staff team visited Beijing to assess the jurisdictional implications of the intensified enforcement of exchange and capital control regulations under Article VIII of the Fund's Articles of Agreement.** The mission's conclusions will be set out in a supplement to be issued before the Executive Board meeting.

F. Statistics and Y2K Issues

52. **While much progress has been made in recent years, China's economic statistics continue to suffer from serious weaknesses (Annex I), hampering macroeconomic analysis by both policy makers and outside analysts.** The key problem areas include:

(i) the GDP data, which are produced in a cumulative form during the year, without revisions of previous data, making it difficult to assess quarterly developments accurately or to make seasonal adjustments; (ii) the fiscal data, which exclude expenditures financed by external aid, some interest payments, and a large portion of the recent stimulus package, and where information on fiscal activities outside general government is very limited; (iii) monetary data provide only a limited breakdown of credit by borrower or economic sector, and foreign exchange transactions by residents are not yet consolidated (although progress is being made in this area); (iv) the financial sector where very limited data are available; and (v) the balance of payments and external debt data, where large errors and omissions, and discrepancies with creditor debt data persist. Breaks in series—in part due to ongoing efforts to improve statistical methodologies—also limit the scope for time series analysis.

53. **The staff therefore again underscored the importance of strengthening the statistical base.** While technical assistance should continue to play an important role, the staffing levels in the National Bureau of Statistics (NBS)—which were nearly halved during the recent civil service restructuring—might also need to be reconsidered. The staff also stressed the importance of improving data provision to the Fund during the year, particularly fiscal and external debt data. The authorities acknowledged that much remained to be done to strengthen the statistical base, which required continued technical cooperation and assistance from international organizations, including the Fund. They will consider more frequent provision of fiscal and external debt data to the Fund, but noted that fiscal data were available only with a long lag and even then were incomplete.

54. **While China's level of computerization is still relatively modest, many outside observers believe that the Y2K problem could lead to significant disruption (Box 9).** The authorities agreed that China had got off to a late start in tackling the problem, but stated that preparations were much more advanced than outside experts had realized. Their latest survey—conducted in April 1999—concluded that almost all sectors had made reasonable progress, with the financial sector most advanced. A number of international organizations had been invited to make assessments of progress and provide assistance; in addition, contingency plans had been developed to limit any potential impact in critical sectors.

Box 9: Y2K Issues in China

With the use of computers still relatively new in China, most analysts agree that the potential for Y2K problems in China is less than in most developed countries. However, significant disruptions could occur because many vital sectors such as finance, telecommunications, power, water supply, civil aviation and railways are highly computerized. The potential problems are further complicated by the diversity of hardware and software in use; widespread use of pirated software; and a general tendency not to back up data, which makes it harder to shut down and repair systems.

The Chinese authorities got off to a late start in tackling the issue. Outside the financial sector, serious efforts only began following a State Council notice issued in August 1998, which required government computer systems to be revised by March 1999 and Y2K tests and modifications to be completed by September 1999. There has also been increasingly widespread publicity of Y2K issues, and training centers have been set up to help state run institutions address the problem. In addition, to help ease the funding shortage, enterprises have been granted selective tax breaks and a special loan program is being created.

Based on the information available to the staff, progress varies significantly across sectors:

- The financial sector has made most progress. The state media report that all financial institutions will have completed internal testing by May 1999, and external testing will be conducted through September. The stock exchanges, securities and futures industries, and civil aviation and telecommunications sectors are also reportedly making progress.
- Efforts have started in power, railways, and taxes and customs. Less progress has been made in rural areas, and in many sectors including: food, retail and medical services, police and the military, and in the chemical and oil refining industry.
- Awareness/progress is limited outside central and provincial governments. Large SOEs plan to complete testing in June, and fix the problems by September. However, an official survey of 512 large enterprises in February 1999 found that over half did not know how to identify the Y2K problem; only 30 percent of listed companies discussed the issue in their annual reports.

Outside observers generally believe that China is likely to experience significant problems. In October 1998, the Gartner Group gave China the lowest rating for Y2K awareness/preparedness, and said that 66 percent of the companies in China would experience at least one critical system failure. Moody's rates China's banks as among the least prepared in Asia. The U.S. Central Intelligence Agency (CIA) assesses a significant risk of widespread interruption of government services, and power and phone loss; it expects that food, water and oil shortages will be isolated but severe. It judges the chance of unrest or bank panics to be moderate.

The authorities acknowledged that progress in tackling the Y2K issue had been slow, and varied considerably across sectors due to a lack of awareness and a shortage of funds. However, surveys had led them to conclude that almost all sectors had made reasonable progress, and they expressed the view that the assessments by outside observers of China's Y2K efforts were overly negative. These assessments have nevertheless prompted the authorities to strengthen their public relations efforts, including by directly addressing the issue at the APEC meetings in mid-April. In addition, the Global 2000 Coordinating Group will be visiting China in June to make an assessment and provide assistance, while the PBC has invited the BIS, the U.S. Fed, and the Reserve Bank of Australia to assess efforts in the financial sector. The authorities have also requested assistance from the World Bank. They stressed that contingency plans were in place for the areas considered most vulnerable, and noted that any disruptions would be localized.

V. STAFF APPRAISAL

55. **Over the past year, China has continued to weather the Asian financial crisis considerably better than most countries in the region,** aided by skillful macroeconomic management, its relatively strong external position, and—to some degree—the protection provided by capital controls. Nevertheless, the strains in the economy are clearly showing, reflected in weakening private demand, large capital outflows, and high unemployment. In addition, the financial position of the banks and state enterprises—and associated with this, the issue of long-run fiscal sustainability—continue to give rise to significant risks.

56. **Over the coming year, the authorities face three key challenges:** ensuring the macroeconomic policies provide adequate support to demand to create productive employment and maintain social stability; ensuring that policies are supportive of the present exchange rate policy; and pressing ahead with critical structural reforms necessary to ensure high quality growth over the longer term.

57. **The policy of maintaining the stability of the renminbi has served both China and the region well during the recent Asian crisis.** The recent sharp cut in interest rates have opened up a substantial differential with foreign rates; this carries the risk of increasing pressures on the capital account, and the authorities will need to monitor market developments closely and develop contingency plans. Moreover, with China likely to experience continued rapid structural change, greater exchange rate flexibility will be required. The authorities should be giving thought as to how and when such a transition might best be achieved.

58. **The timely easing of fiscal policy in mid-1998 provided desirable support to demand, although the quality of the expenditures undertaken needs to be very closely monitored.** With increasing downside risks to growth toward the end of 1999, a further modest fiscal stimulus—as the authorities are now planning—would be appropriate. With the pipeline of efficient infrastructure projects now much more limited following last year's stimulus package, the staff would encourage the authorities to focus the additional spending on social safety net expenditures, which would be supportive of consumption and reforms.

59. **While fiscal policy can play an important short-term role in supporting growth, it is clearly not a long-term solution. Thus, as in previous years, the central economic challenge remains the reform of the financial and enterprise sectors,** which continue to face very serious structural problems. The staff is encouraged by the authorities' clear recognition of the problems in these sectors, and their determination to accelerate reforms before a crisis develops; this will be essential to maintain macroeconomic—including fiscal—stability and high quality growth over the medium term.

60. **While data weaknesses preclude a full assessment, over the past year, important steps have been taken in financial sector reform.** The staff encourages the authorities to

move quickly to address outstanding operational issues relating to AMCs, and to ensure that they are transparently financed through the budget. The development of a strong credit culture—through improving bank commercialization and independence, reforms to legal and accounting standards, improvements to classification and provisioning regulations, and strengthening bank supervision—will also be critical. This should be supported by measures to enhance competition, including new entry of foreign and domestic banks (subject to appropriate safeguards), and allowing outside investors to purchase shares in SCBs.

61. **The financial difficulties of small financial institutions are also a source of risk.** The staff supports the authorities' decision to put the GITIC into bankruptcy in order to limit future moral hazard, and the decision to restructure the trust and investment companies; it urges that the authorities ensure the maximum possible transparency as the GITIC liquidation continues. The proposed introduction of limited deposit insurance for RCCs should be delayed until the financial position of the RCCs has been strengthened through an appropriate restructuring program, and supervisory capacity enhanced.

62. **The success of financial sector reform continues to depend critically on reform of the SOEs.** The staff supports the authorities' emphasis on reducing capacity in key sectors, greater reliance on bankruptcies, and enhancing competition. Over the coming year, it will be especially important that the AMCs play a full role in accelerating enterprise restructuring, supported by the necessary legal changes; there is also scope for direct sale of shares in SOEs to private investors, including foreigners. Continued efforts to strengthen the social safety net are also essential; building on the considerable progress made last year, including further interregional pooling and additional central government transfers to particularly hard hit regions.

63. **The authorities' recent initiatives to strengthen the private sector and the capital market will play an important role in supporting activity and reducing labor market pressures.** In this connection, the staff attaches particular importance to improving firms' access to capital; strengthening private property rights further; and reducing barriers to entry for private firms. It will be important that the operations of loan guarantee agencies are structured to avoid creating large contingent fiscal liabilities.

64. **To support the reforms of the financial sector and the SOEs, urgent attention must be given to strengthening the government finances.** While there is scope to reduce expenditures in certain areas—including by reducing the flow of new bad loans—further revenue mobilization—through strengthened administration and changes in tax policies—will be essential. The replacement of extra budgetary fees and charges by taxes is welcome from the perspectives of equity and efficiency, but will only improve the underlying fiscal situation if the expenditures that they presently finance can also be reduced. Attention also needs to be given to reforming the present system of inter-governmental fiscal relations, supported by technical assistance from the Bank or the Fund.

65. **The staff welcomes the progress that has been made in WTO negotiations, and looks forward to China's early accession.** Internationally, this will bring a major trading country into the framework of the world trading system. For China, while there will be adverse effects on certain sectors in the short run, it will strengthen competition, and provide support for the reforms that are necessary to secure China's continued growth and long-term prosperity.

66. **The intensification of enforcement of capital and exchange regulations and customs enforcement has been an appropriate response to evidence of widespread evasion.** However, despite the authorities' efforts, there are still reports of disruption to legitimate transactions, adversely affecting foreign direct investor sentiment. The staff encourages the authorities to strengthen their efforts to improve the efficiency of the controls in this area, including through focussing enforcement more narrowly on problem entities, and encouraging voluntary compliance. While capital account liberalization remains an important medium term goal, it should be carefully sequenced with financial and other reforms.

67. **While much progress has been made in recent years, China's economic statistics continue to suffer from serious weaknesses in many areas, hampering macroeconomic analysis, and increasing the margin of error in the assessment of economic risks and vulnerabilities.** While technical assistance must continue to play an important role in data improvement, the authorities may also need to reconsider the staffing levels in the NBS. Limited provision of available data to the Fund in core areas, especially fiscal and external debt, has also hampered Fund surveillance, and the staff urges the authorities to strengthen their efforts in these areas.

68. **While China's dependence on computers is still relatively modest, the Y2K problem could lead to disruption, with potentially important macroeconomic implications.** Given the limited time now available, efforts should continue to focus on developing contingency plans in critical sectors.

69. **The staff recommends that the next Article IV consultation with China take place on the standard 12-month cycle.**

China—Statistical Issues

Data weaknesses

1. The authorities have sought to improve economic statistics with extensive technical assistance from the Fund and other international and bilateral institutions. Nevertheless, weaknesses as regards coverage, quality, frequency and timeliness of the data remain very serious and continue to affect the staff's ability to formulate a consistent view of macro-economic developments.
2. A multisector statistical mission visited China in September 1998 to conduct an assessment of China's macroeconomic statistics and to further develop the strategy for technical cooperation between the Chinese authorities and the Fund to strengthen China's statistical system. The mission also presented a seminar for agency officials on the GDDS. The authorities expressed interest in the GDDS as a framework in which to move toward international methodological standards, and a GDDS coordinator for China has been named.

The main statistical issues and weaknesses are:

Real sector

3. Data on the expenditure components of GDP are not available on a quarterly basis; nor are deflators for the expenditure components—either on a quarterly or annual basis. The data are produced in cumulative form, without revisions of previous data, making it difficult to assess quarterly developments accurately or to make seasonal adjustments. Constant price measures of GDP are also suspect because of deficiencies with the price indices used for deflating and their application. Nevertheless, the National Bureau of Statistics has made a number of improvements to the range and quality of national accounts data, including quarterly estimates of GDP by industry and estimates of GDP by type of expenditure. Further improvements are intended, including the adoption of the 1993 *System of National Accounts*, further development of income and expenditure data, and improvements to quarterly GDP estimates. However, no dates have been set. As in other countries, rapid economic change, including the expansion of the nonstate sector, present new problems for data compilation. The ability to change data collections is restricted by the decentralized nature of the statistical system. Extensive technical assistance has been provided from multilateral and bilateral sources.
4. Many observers have expressed concerns about the reliability of China's economic statistics and their usefulness to policy makers and the public. Many analysts, including the World Bank, believe that GDP growth rates in China are overstated by 1–2 percentage points. However, the discrepancy last year between strong GDP growth and very weak growth in other indicators of activity—including electricity production and freight traffic—caused some observers to suggest that the “usual” overstatement of growth had widened. Indeed, the December 1998 World Economic Outlook devoted a box to this issue, concluding that, while the data had to be interpreted with care, GDP growth rates in China provided an

important indicator of broad economic trends (see Box 4.1, December 1998 *World Economic Outlook*).

5. Monthly industrial production, retail sales, and fixed investment data also have a shifting base that does not allow a consistent time series. Data revisions tend to be made without publishing the entire revised series. Retail sales and fixed investment data are published only in nominal, not real, terms.

6. The consumer price index is not produced in a time series format, as there are only comparisons with one month and one year earlier on shifting bases. Technical assistance missions in September 1991, April 1995, and June 1997 dealt with the concepts and methodology of internationally used index formulae. The authorities have received technical assistance and training on price index methodology under a cooperative program with Statistics Canada. The Fund has proposed that a follow-up mission on production of price data in time series format be held in August.

Government finance

7. Since 1994, China's Ministry of Finance (MOF) has regularly reported annual GFS data for publication in the GFS Yearbook. The GFS database currently includes data on the central government budget for 1990-96, and on provincial and local governments for 1995-96. However, the data still exclude social security and most extrabudgetary operations. In GFS terms, the revenue classification does not fully distinguish between revenue and grants, tax and nontax revenue, and current and capital revenue. The presentation of expenditure is by function only and lacks an economic classification.

8. The MOF also reports annual GFS data for publication in *IFS*. Data, through 1998, relate to revenue, expenditure, and the deficit/surplus of the central provinces, counties, and municipal governments' budgets. These data are provided with substantial delays.

9. The data reported to the area department for surveillance are more detailed than those in *IFS* and have improved somewhat in 1998-99, with an agreement between the resident representative's office of the Fund and the Ministry of Finance on a quarterly schedule for data provision and discussion. However, selected key items have been provided only with substantial delays (including a breakdown of debt service), and definitional and coverage problems make it difficult to assess the fiscal situation. For example, some of the recent fiscal stimulus program was not recorded by the budget; the interest on the bonds issued to finance the stimulus program, and on the banking sector recapitalization bonds, was excluded from the budget as well. Moreover, expenditures (including onlending) associated with external aid are not recorded in the budget. The data also exclude any reporting on quasi-fiscal operations undertaken by the banking system through policy lending by state commercial banks and policy banks to SOEs. Finally, information on the extent of enterprise debt that is guaranteed by the government is also not available at this time.

Monetary accounts

10. The People's Bank of China (PBC) commenced in June 1997 the reporting of revised monetary data to the Fund on the basis of the All-Accounts Reporting System. Some improvements have been made for the revised monetary data in classification of accounts of the monetary authorities and the banking institutions. However, although efforts are underway, advances are still needed in the compilation and reporting of monetary data inclusive of foreign-currency-denominated accounts of residents and accounts of the branches of foreign banks in line with STA recommendations, most recently in the multisector statistics mission of September 1998 and a monetary statistics mission in April 1999. Although monthly monetary data are compiled by the PBC, their reporting to STA has ceased since January 1998. Currently, only quarterly monetary data are published in *IFS*. In addition, there are a number of breaks in the series, and comparable historical data are not provided.

11. Detailed breakdowns of bank credit extended by industry (e.g., manufacturing, property, etc.), and by borrower (e.g., the various elements of the state and nonstate sectors) are very important for economic policymakers, and are available in many countries. The staff continues to encourage the authorities to prepare information of this nature for analytical purposes.

12. Following the September 1998 multisector mission, the authorities have planned to expedite the work on implementing STA's recommendations for improving institutional coverage and bank account classification for monetary statistics. The PBC has recently committed to resume reporting of monthly data beginning with data of the second quarter of 1999 and has agreed to the publication of monthly monetary data in *IFS*. The PBC has also started sending monetary data to STA via e-mail.

Balance of payments

13. Until 1996, the State Administration of Foreign Exchange (SAFE) compiled China's balance of payments statistics based largely on information collected from various government agencies. To compile timely, accurate, and comprehensive balance of payments data, SAFE in January 1996 launched an "international transactions reporting system (ITRS)." This system utilizes bank transaction records to derive data on China's various types of international transactions on goods, services, and capital flows. To supplement the ITRS, SAFE since early 1997 has developed four periodic surveys to collect data on financial flows in and out of the country.

14. The new system has significantly improved the coverage and timeliness of China's balance of payments accounts. Currently, the data are compiled in accordance with the fifth edition of the Balance of Payments Manual (BPM5). In addition, such data are compiled on a quarterly basis, as opposed to semiannually in 1997 and annually in earlier years. Such data were recently provided, for the first time, to APD. Within the current account, component detail is available on goods, services, income, and transfers. Data on financial account, however, are available only for key functional categories with few component breakdowns.

The major steps that SAFE needs to take to refine the system to produce timely, accurate, and comprehensive data include (i) intensifying efforts to implement the periodic surveys to derive estimates of direct, portfolio and other investment flows; and (ii) strengthening the coverage of the ITRS. These are crucial to enhance the accuracy of data on China's financial flows and reduce the magnitude of the persistently large net errors and omissions of the country's balance of payments accounts.

15. The SAFE, in collaboration with the multitopic mission, developed a two-year work plan to strengthen the ITRS, and in particular, to improve the estimates of financial flows and reduce the net errors and omissions of the BOP accounts. The work plan includes developing data sources and estimation methods to derive more reliable estimates of trade credits and more reliable estimates of external bank assets and liabilities.

16. In relation to the work of the Fund Task Force on External Debt and Reserves, a Fund mission visited China during April 27–May 4, 1998 to discuss with the authorities the coverage, timeliness, and periodicity of China's data on official reserves, reserves-related liabilities, as well as those on other external assets and liabilities, financial derivative activities, and other contingent and potential liabilities. Qualitative information on reserves was provided in the context of this mission although it was not possible to update that information for the 1999 mission. Data on external debt are apparently compiled semi-annually but published only on an annual basis; these semiannual data have not been provided to Fund staff thus far. The mission found that, despite an ostensibly modest level of external vulnerability, there is an urgent need to strengthen external debt monitoring and compilation, while introducing additional transparency in data dissemination. On the compilation of external debt data, the mission recommended that better use be made of existing domestic data sources, that domestic data sources (from the banking and corporate sectors) be strengthened, and that full use be made of available external sources (especially BIS and OECD):

17. The multitopic mission also followed up on issues relating to external debt data. In an effort to strengthen external debt statistics, the SAFE continues to review the concepts, definitions, classifications, and coverage of the BIS, OECD, and World Bank databases and make the necessary adjustments to enhance the usefulness of the existing official data. The SAFE also plans to redesign the debt registration form, upgrade computer software and training, and implement an improved external debt compilation system.

18. The balance of payments data for 1997 and 1998 do not appear to fully reflect interest income on official foreign exchange reserves under the investment income credits item. The authorities have indicated that the 1997 data will be revised accordingly, but have not indicated the magnitude of the likely revision nor whether the 1998 data will be similarly revised. There are also very substantial inconsistencies between flows and changes in debt stocks well beyond what could be explained by exchange rate fluctuations or similar factors.

Data reporting to STA for *IFS*

19. Reporting of data to STA for *IFS* has, in the past, tended to be sporadic and with a considerable time lag. Following the introduction of new reporting arrangements, the timeliness of consumer price, industrial production, trade value, and total GDP data in *IFS* has improved substantially. However, the range of information is relatively limited, with no data published on producer prices, wages, and trade volumes and prices/unit values.

Data dissemination to the public

20. The publication of a quarterly statistical bulletin by the PBC has significantly improved the timing and coverage of publicly available data on the monetary accounts and the main real sector indicators. However, public access to data remains considerably below international standards. The monthly statistical publications do not contain many time series nor the disaggregation necessary for analysis. Moreover, several important time series, particularly on the main fiscal variables, are not released in a systematic and timely manner. Extensive annual economic data are available in various statistical yearbooks, but these are published nine months or more after the end of the year.

Survey of Reporting of Main Statistical Indicators

(as of end-May 1999)

Country: China

	Exchange rates	International reserves	Reserve/base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index 1/	Exports/Imports	Current account balance	Overall government balance	GDP/ GNP 2/	External debt
Date of latest observation	May 31, 1999	Apr. 30, 1999	March 31, 1999	March 31, 1999	April 30, 1999	May 31, 1999	April 30, 1999	Apr. 30, 1999	Dec. 31, 1998	Dec. 31, 1998	Mar. 31, 1999	Dec. 31, 1997
Date received	May 31, 1999	May 24, 1999	April 28, 1999	April 28, 1999	May 15, 1999	May 31, 1999	May 12, 1999	May 13, 1999	May 6, 1999	April 27, 1999	April 20, 1999	April 27, 1998
Frequency of data	D	M	M	M	M	... 3/	M	M	A,Q	A	A,Q	A
Frequency of reporting	M 4/	M	M	M	M	... 3/	M	M	A,Q	A	A,Q	A
Frequency of publication	D	M	M	M	M	... 3/	M	M	A,Q	A 5/	A,Q	A
Source of data	C	N	C,A,N	C,A,N	C,A,N	C,N	C,N	C,N	A	C,A,N	C,N	A
Mode of reporting	E	M	M	M	M	M	M	E	M	M	M	M
Confidentiality	C	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/	D 6/

1/ Only 12-month growth rates are reported (price indices are not available).

2/ For real GDP, level data are available only on an annual basis (growth rates are available on a quarterly, cumulative basis).

3/ Interest rates change only infrequently; these changes are publicly announced.

4/ While officially transmitted on a monthly basis, these data are available from news sources on a daily basis.

5/ Data on interest expense not published.

6/ Restricted until publication.

Explanation of codes is as follows:

Frequency of data: D - daily, M - monthly, Q - quarterly, A - annually.

Frequency of reporting: D - daily, M - monthly, Q - quarterly, A - annually.

Source of data: A - direct reporting by the authorities, C - commercial electronic data provider, N - official publication.

Mode of reporting: E - electronic data transfer, M - mail.

Confidentiality: C - unrestricted use, D - embargoed for a specific period, and for unrestricted use thereafter.

China: Fund Relations

As of May 31, 1999

I. Membership Status: Joined 12/27/45; Article VIII (December 1, 1996)

II. General Resources Account:

	SDR Million	% Quota
Quota	4,687.20	100.0
Fund holdings of currency	2,508.79	53.5
Reserve position in Fund	2,178.42	46.5
Operational budget transfers (net)	-110.00	

III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	236.80	100.0
Holdings	524.92	221.7

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	11/12/86	11/11/87	597.73	597.73
Stand-by	3/02/81	12/31/81	450.00	450.00

VI. Projected Obligations to Fund: None

VII. Exchange Arrangements:

On January 1, 1994 the Chinese authorities introduced a unified exchange rate system. Under the new exchange system, domestic enterprises are required to sell their foreign exchange to designated banks and can freely purchase foreign exchange from banks for trade and trade-related transactions with the necessary import documentation. A managed float system was adopted on January 1, 1994 under which the PBC intervenes through the purchases and sales of foreign exchange in the interbank market to limit intraday volatility of the exchange rate. On May 30, 1998 the exchange rate was Y 8.3 per U.S. dollar.

With regard to current account transactions, China accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement on December 1, 1996. There are repatriation and surrender requirements on proceeds from exports and from invisible transactions and current transfers. Domestic establishments must sell their export earnings to designated banks; foreign-funded enterprises (FFE) may retain their export earnings. Importers must provide valid proof and commercial bills to obtain foreign exchange. As of October 15, 1997, certain domestic firms, on the basis of their capital and foreign trade positions, have been permitted to retain up to 15 percent of the value of their imports and exports in foreign exchange.

From the second half of 1998, a broad range of new requirements have been implemented to expand the scope of documentation required for most forms of current transactions and require prior verification of the underlying transactions in some instances (e.g., the customs service must certify the value of imports before banks can provide foreign exchange for payment). Other measures have been introduced to further limit the channels through which foreign exchange may be obtained by closing foreign exchange swap centers and introducing regulations to discourage domestically-funded entities from conducting business with foreign banks operating in China.

Exchange controls continue to apply to most capital transactions. In general, a capital account transaction requires the approval of the State Administration of Foreign Exchange (SAFE). Equity purchases in China by nonresidents are limited to special shares ("B"shares). Nonresidents are not permitted to issue capital or money market securities in the domestic market, although sales of collective investment securities are possible, subject to approval. Purchases abroad of capital and money market instruments by residents are restricted to a few financial institutions and enterprises, as are foreign stock and bond issues, which also require prior approval. From the second half of 1998, additional measures have been introduced to prohibit prepayment of foreign debt and expand the range of transactions subject to registration as foreign debt to include, inter alia, payment terms for imports beyond 90 days.

An annual foreign borrowing plan sets mandatory ceilings for all medium- and long-term borrowing by government departments and enterprises (except FFEs which are subject to individual limits negotiated in the investment approval process). External borrowing regulations were revised effective January 1, 1998. While SAFE will continue to be responsible for the approval and management of external borrowing, approval will now cover the financial situation of the enterprise, the need for the loan, and whether the terms of the loan are consistent with the use of the proceeds. For short-term loans (less than a year), the amount of borrowing will be subject to an overall limit determined by SAFE on an annual basis (there are also enterprise-specific limits); enterprises can conduct business within this limit without explicit approval, but subject to reporting of activity to SAFE within one month. For medium- and long-term loans, approval will be subject to a limit determined by the State Development and Planning Commission, while the terms of the issue will be examined by SAFE.

New regulations on guarantees by residents to nonresidents went into effect in January 1998, with the following key features: First, the concept of guarantees provided by authorized domestic institutions has been redefined and clarified. Under the new definition, guarantees consist of collateral, liens, and pledges in addition to what were commonly known as guarantees. Second, the approval process has changed. Banks do not need approval to issue guarantees, but must register them with SAFE. All other guarantees have to be approved by and registered with SAFE. Third, both domestic and foreign-currency-denominated guarantees are now covered by the regulations. Fourth, the approval process for guarantees has been clarified, and is now based on prospective guarantors' profits, assets to liabilities, and asset-quality-ratio requirements.

China also maintains controls on FDI, although it has generally pursued an "open door" policy toward FDI. In the case of outward direct investment, foreign exchange is provided after a SAFE review of sources of foreign exchange assets and an assessment of the investment risk involved, approval by the Ministry of Foreign Trade and Cooperation (MOFTEC), and registration with SAFE. In the case of inward direct investment, nonresidents can invest in China subject to meeting certain regulations and MOFTEC approval. For environmental and security reasons, inward direct investment in some industries is prohibited.

With regard to derivative transactions, domestic financial institutions and domestic firms cannot enter such transactions for speculation. However, transactions designed to hedge interest rate or exchange rate risk are possible. Positions entered into by nonfinancial institutions must be approved by SAFE, while positions entered into by financial institutions must be registered at SAFE. Transactions undertaken by FFEs do not need to be registered. With respect to the development of a forward foreign exchange market for the renminbi, the Bank of China has been permitted, as part of a pilot project, to offer forward transactions involving the renminbi, but the market remains small and proof of an underlying current transaction is required for access to forward cover.

VIII. Article IV Consultation:

Discussions for the 1998 Article IV consultation took place during April 27–May 11, 1998. The staff report (SM/98/170) was discussed by the Executive Board on July 29, 1998 (EBM/98/83). China is on the standard 12-month consultation cycle.

IX. Technical Assistance:

Technical assistance provided in 1997 through May 1999 is summarized in Annex IV.

X. Other Visits:

The Managing Director visited China in January 1998. The Deputy Managing Director, Mr. Sugisaki, visited China in November 1998, and again in May 1999. The First Deputy

Managing Director, Mr. Fischer, visited China in June 1999. A midterm staff visit was held in November 1998.

XI. Resident Representative:

The resident representative office in Beijing was opened in October 1991. Mr. Ichiro Otani has been appointed as the Resident Representative and Mr. Paul Heytens is the Deputy Resident Representative. Mr. Otani is expected to assume his post in August.

China: Recent Financial Reforms

1. At the end of 1998, the financial system in China comprised four state commercial banks (SCBs), three policy banks, 98 other domestically owned commercial banks (including 10 joint-equity commercial banks, 88 city commercial banks), 173 operational entities representing foreign banks, about 45,000 credit cooperatives (including 3,240 urban credit cooperatives and 41,508 rural credit cooperatives), and various nonbank financial institutions (including 239 trust and investment corporations—TICs, 71 finance companies affiliated to industrial groups, and 15 leasing companies). All these institutions are under the supervision of the Peoples' Bank of China. In addition, the financial system includes some 90 securities firms under the authority of the China Securities Regulatory Commission (CSRC).
2. The banking system is dominated by the SCBs, which accounts for about 2/3 of the total assets (Table 1). The other domestically owned commercial banks have increased their market share to 11.2 percent, in part due to the transformation of urban credit cooperatives into city commercial banks; subsequently the share of the credit cooperatives has decreased to about 10 percent. The policy banks and the non-bank financial institutions (NBFIs) have increased their market share to 8.7 percent and 6.9 percent, respectively, while the market share of the foreign banks has decreased to about 1 percent.

Table 1. Market Share of Financial Institutions, 1993-98

	Number of Institutions	Assets in Percent of Total		
		1993	1995	1998
Policy banks	3	-	6.3	8.7
State commercial banks (SCBs)	4	84.2	68.3	62.1
Other commercial banks	98	6.9	6.4	11.2
Foreign banks	173	-	1.6	1.1
NBFIs 1/	325	-	4.5	6.9
Credit cooperatives	44,748	8.9	12.9	10.0
Of which: Urban credit cooperatives	3,240	3.0	3.8	1.7
Of which: Rural credit cooperatives	41,508	5.9	9.1	8.3

Sources: Data provided by the Chinese authorities; and staff estimates.

1/ Data for foreign banks and nonbank financial institutions (NBFIs) are not available for years prior to 1995.

Number of institutions is at end-1998.

3. While only limited information is available to the staff on the banks and other financial institutions in China—and is difficult to interpret given the serious weaknesses in accounting regulations—it is generally accepted that they have very serious financial problems. The Chinese authorities report that NPLs—on their definition—stand at about

20-25 percent, of which some 6 percent is unrecoverable. Estimates by private analysts, however, are significantly higher.¹

4. Following a seminal conference on financial risks in November 1997—attended by almost the entire senior leadership—financial sector reforms have been significantly accelerated over the past 18 months. The following note provides a brief summary of the key measures taken since the last Article IV consultation,² and of the staff's recommendations.

Restructuring financial institutions

5. The authorities are presently engaged in major efforts to restructure four groups of financial institutions: the SCBs, the rural credit cooperatives, the Trust and Investment Corporations (TICs), and the securities firms.

State commercial banks

6. The restructuring strategy of the SCBs involved the establishment of policy banks in 1994 to relieve the banks from policy lending. Subsequently, in 1996, the SCBs were made responsible for the quality of new loans. In mid-1998, the authorities implemented a Y 270 billion recapitalization of the four SCBs. The recapitalization was designed to compensate them for their non performing loans with no residual value, and to bring their risk weighted capital adequacy ratios above 8 percent (measured on the basis of Chinese classification and provisioning standards). In early 1999, the authorities announced that asset management companies (AMCs) will be set up for each of the four SCBs. The first, for the China Construction Bank, was set up in April 1999, and the remainder are expected to be in place by the end of the year. The SCBs will then be expected to improve their capital base through internal profits or by issuing shares in the market (i.e., there is no plan for further recapitalization by the government).

7. AMCs will purchase non performing loans with some residual value from the SCBs at book value, in exchange for bonds. This will be a once off-operation with no opportunity to make further sales. They would seek to maximize recovery of the loan through a variety of vehicles, including direct sale, debt-equity swaps, debt restructuring, or liquidation (Box 2). However, a number of key issues concerning the AMCs' operations remain to be resolved. In particular, while it is understood that the Ministry of Finance will be ultimately responsible for losses, it is unclear how the AMCs' initial capital, or the interest payments on bonds

¹ For example, recent estimates by Goldman Sachs suggest that the four SCBs taken together are technically insolvent, and that some \$164 billion (16.5 percent of GDP) would be required to bring the capital adequacy ratio to 8 percent.

² See "China—Recent Banking Reforms," (SM/98/170, 7/6/98), for a discussion of earlier reforms.

provided to the SCBs, will be financed. It is also unclear how credit will be provided to enterprises undergoing restructuring.

8. The success of the AMCs will depend crucially on operational restructuring of the SCBs. In order to restrain the emergence of new bad loans, banks will sign "governance contracts" with the Ministry of Finance and the PBC under which they would have to meet certain performance targets, benchmarked on international best practices. Finally legislation will need to be drafted to give the AMCs the necessary powers to restructure enterprises.

Rural credit cooperatives

9. The rural credit cooperatives, while individually very small, account for about 20 percent of household deposits; they lend primarily to farmers (32 percent), township and village enterprises (43 percent), and the private sector (25 percent). Since the 1990s, the performance of RCCs has been mixed. This can be attributed to poor management; the declining profitability of township and village enterprises; interest rate exposure in a context in which most of their deposits are at fixed interest rates and loan rates are declining; and high operating costs due to their small size. In addition, some RCCs may have suffered from contagion effects due to closure of Rural Cooperative Funds (RCFs).³

10. With the assistance of the Asian Development Bank, the authorities have taken steps to restructure the RCCs, including establishing (i) a National Association which would be a self regulatory body and provide technical assistance to individual RCCs; (ii) a regional structure to supplement the 2500 RCCs at the county level; and (iii) a unified payments system. The authorities envisage merging (rather than liquidating), weak institutions with stronger ones at the county level; in the event that this is insufficient, the authorities may allow required reserves held at the PBC to be used to pay depositors in insolvent RCCs. The authorities are also considering establishing a deposit insurance scheme (DIS) for the RCCs, and a proposal is presently being considered by the State Council (Box 3).

Trust and investment corporations (TICs)

11. The authorities noted that the recent difficulties in a number of TICs had evidenced the need to reassess their business scope. Over the years the financial conditions of the TICs deteriorated due to a combination of factors, including poor management and deficient internal controls; a policy of diversification into a range of business (i.e., property development, securities trading) that are much riskier than the financing of investments in

³ RCFs were established by the Ministry of Agriculture to provide financial services to small farmers. PBC regulations (i.e., on deposit and lending rates and reserve requirements) did not apply to them. In 1997, the PBC decided to close the RCFs by merging solvent ones with RCCs or liquidating insolvent ones. The decision was motivated by the fact that RCFs had exceeded their original business scope.

manufacturing and other traditional activities; and weak supervision. In the specific case of the GITIC, it appeared that total liabilities amounted to \$4.4 billion, while its assets were valued at \$2.6 billion.

12. Against this background, the authorities intend to restructure and consolidate the TIC sector. In the future, TICs will only be allowed to undertake genuine trust business; they will be banned from doing banking and securities business; and they will no longer be allowed to borrow abroad. Consequently, the number of TICs will be substantially reduced, mainly through mergers and acquisitions. Local governments will be given one year to submit plans for the restructuring of their TICs.

Securities firms

13. The new securities law enacted at the end of 1998 provided the legal basis for the development of China's capital market. In particular, it enshrined the segregation of banking and securities business and of the regulatory and supervisory authority for banks and securities firms.⁴ Furthermore, the CSRC issued regulations for the implementation of provisions of the new securities law with regard to minimum capital requirements for securities firms. The authorities plan to enforce the new rules gradually in order to give sufficient time for firms which do not comply to take appropriate measures. While some securities firms may face losses due to investments in the securities market with funds of their customers, the authorities believe that the problem is not large. A comprehensive assessment is expected to be completed by year end.

Strengthening the institutional framework

14. The authorities have taken a number of steps to strengthen the institutional framework in order to develop the credit culture. These include plans to further enhance loan classification and provisioning rules; steps to achieve the operational restructuring of the SCBs; measures to strengthen supervisory responsibilities; and new legislation to support a sound business environment.

Classification, provisioning and accounting regulations

15. Classification, provisioning and accounting regulations are all significantly below international standards. In mid-1998, the authorities announced a new five category loan classification system which was tested on an experimental basis in Guangdong Province, and is to be introduced nationwide by end-1999. Based on the initial results of the pilot, the authorities are considering a number of changes to the classification rules (Box 3), including

⁴ Supervisory responsibilities for securities firms were transferred to the CSRC during the course of 1998. Similar developments occurred in the insurance sector with respect to the Insurance Supervision Commission of China established in 1998.

a reduction in the trigger point for loans to be classified as substandard from 1 year to 6 months (and eventually 3 months). These changes would bring the new system close to international standards.

16. Banks are subject to a maximum limit on provisioning of 1 percent, while interest can be accrued on overdue loans for 1 year. This results in a substantial overstatement of banks' capital and profits. The authorities are considering replacing the existing 1 percent limit by a general provision of 1½ percent and specific provisioning for each category in the new classification system (Box 3); and reducing the interest accrual period to 3 months within two years.

Operational restructuring

17. The following measures were implemented by the SCBs to strengthen risk management: (i) establishment of internal control systems whereby borrowers are monitored after lending is extended; (ii) establishment of a "uniform credit approval" system whereby all the loans to single borrowers are consolidated and monitored; (iii) establishment of an independent supervisory board with representatives of the PBC, the Ministry of Finance and SETC, to oversee their operations and senior management; and (iv) a clarification of the responsibilities of the branches with regard to their ability to decide on loans approval with a view to curtail the ability of small branches to authorize loans. In addition, the SCBs have launched a downsizing campaign with a view to reducing their staff by 10 to 30 percent, and rationalize their branch structure.

18. Following the enactment of measures to make loan officers responsible for non-performing loans, credit risk assessment is increasingly becoming a binding constraint on the behavior of the banks. The nation-wide implementation of the new loan classification rules is also expected to raise the consciousness of bank managers to credit risks. It is also expected to provide a useful benchmark for bank supervisors when assessing the financial conditions of the banks. Finally, the new classification rules will pave the way for the introduction of minimum specific provisioning rules as discussed above.

Supervisory responsibilities

19. The authorities took a number of initiatives during the course of 1998 to strengthen the prudential framework for the financial sector. Following the administrative reorganization of the PBC branch network the head office (with the assistance of the branches) is responsible for the supervision of the four SCBs on a consolidated basis rather than on a branch by branch basis, while the regional branches are responsible for the supervision of local financial institutions in their constituency.⁵ About half of PBC staff are involved in

⁵ The PBC's 30 provincial branches were replaced by 9 regional branches along the lines of the U.S. Federal Reserve to increase its operational independence from provincial

(continued...)

supervision, including 1/3 of the staff at PBC head office, half of staff at the regional level, and most of the staff at the city and county levels. A training institute for bank supervisors was established by the PBC in 1998; it plans to train 30,000 bank supervisors during the course of 1999.

20. Concerning the securities market, the China Securities Regulation Commission (CSRC) took a number of steps to strengthen the supervision of securities firms. In particular, regional branches along the lines of the PBC regional structure were established to focus on supervisory functions; regulatory powers were centralized at the head office; and regulations were issued requiring professionals in the securities business to take qualifying exams.

Business environment

21. In an effort to reduce financial risks and to support the development of a sound business environment, several pieces of legislation were introduced to crack down on illegal financial activities. In particular, legislation was introduced to define illegal financial activities in banking, securities and foreign exchange transactions, and to establish penalties for non compliance. Sanctions were taken by the PBC against bank officials found guilty of misconduct that had resulted in bad loans. In the foreign exchange sector, the uncovering of sizable fraudulent transactions triggered a strengthening of screening arrangements for international transactions, sanctions on bank officers responsible for fraudulent transactions, and a prohibition on banks' branches undertaking foreign exchange business.⁶

Conclusions and recommendations

22. The staff welcomed the acceleration of financial sector reforms since late 1997. It made the following specific points.

- A meaningful operational restructuring of the SCBs is of crucial importance for the success of the AMCs. In this regard, full introduction of loan classification in line with best international practice, and the prompt introduction of the proposed rules for bad loans provisioning would support the development of the credit culture and the commercialization of the banking system.
- While there is an understanding that the Ministry of Finance will ultimately be responsible for any final losses of the AMCs, the sources of working capital required

governments. Financial supervisory offices were established in provincial capitals that do not have a regional branch.

⁶ The authorities reviewed the documentation associated with 51,900 international payments made during the first half of 1998 and determined that 13,900 could not be demonstrated to be legitimate; these accounted for \$11.9 billion of foreign exchange.

for the purchase of NPLs have not yet been decided. Critical for their success of the AMCs will be early recognition by the government of its responsibility for losses due to past policy lending. This should be done transparently through the budget.

- The enactment of the legal framework giving the AMCs the necessary powers to restructure SOEs will be critical for their success. This involves a strengthening of the bankruptcy law which remains unduly biased against creditors.
- Appropriate mechanisms will need to be set up for the provision of working capital to the enterprises undergoing a restructuring process.
- A full assessment of the financial conditions of the nationwide and regional banks should be undertaken using international classification and provisioning standards in order to determine the size of the problem and design an appropriate strategy of restructuring and recapitalization.
- The project to set up a DIS for the RCCs is broadly in line with international best practice. However, the introduction of deposit insurance in circumstances where the underlying position of the RCCs is weak runs a number of risks. In particular, the DIS may not be financially viable, and—because the guarantee will be limited in nature—there is a risk of encouraging depositors to shift deposits to other institutions that are perceived to have a full implicit guarantee (such as SCBs). Implementation of the DIS for the RCCs should be delayed until weaknesses in the prudential framework have been addressed, and the banking system is set on a sounder footing.
- Establishing a strong bank supervision capacity is key for the prevention of financial risks. Efforts should be directed at implementing bank accounting principles fully consistent with International Accounting Standards; improving the implementation of supervisory standards in line with international best practices; and training of bank supervisors.

Box 1. Asset Management Companies (AMCs)

On AMCs, a proposal was sent by the PBC to the State Council on April 2, 1999, with the following main elements:

- One AMC will be set up for each of the four SCBs. Following transmittal of the proposal, the State Council agreed in late April 1999 on the establishment of the first such company, Xinda AMC, the pilot project of the China Construction Bank. AMCs for the other SCBs are expected to be established by the end of 1999;
- The AMCs would be owned and supervised by the Ministry of Finance. The life of AMCs is expected to be 8–10 years. Once established, primarily with staff drawn from the SCBs, they would operate entirely independent of the banks;
- In a single transaction, the AMCs would buy at book value the bulk of NPLs, considered to have any residual value, and incurred from pre-1996 loans. Those assets considered to have no value would be written off. There would be no future opportunity to make further sales. In exchange the SCBs will receive long-term bonds, which they would expect to hold until maturity. The bonds would be implicitly obligations of the government, which would, therefore, accept any ultimate losses, through its ownership of the AMC, rather than through its ownership of the banks. The AMCs would also have access to PBC lending;
- AMCs will be able to sell the claims, either to foreign investors, domestic private firms, existing foreign-owned companies in China, or sound state-owned enterprises (SOEs). Alternatively, the AMC could liquidate or negotiate a restructuring of the borrowers' debts. The AMCs would be able to accept equity in exchange for debt. They could place the equity and arrange for others to provide loans to restructured companies. They could also access the corporate bond market;
- The establishment of AMCs will remove the burden of NPLs from the SCBs. Subsequently, they are expected to focus on commercial lending activities; and
- To achieve operational sustainability the SCBs will be required to improve credit risk assessment and management capabilities; they will sign "bank governance" contracts to this effect. The AMCs would sign memoranda of understanding with the Ministry of Finance and with the CSRC under which they will have to meet certain performance standards.

Box 2. Deposit Insurance Scheme (DIS)

PBC officials view a DIS as a structure to help deal with the problems faced in resolving small- and medium-sized urban and rural credit cooperatives and some regional banks. In particular, in the course of the past two years the PBC closed 42 deposit-taking institutions including one commercial bank, 23 urban credit cooperatives, and 18 rural credit cooperatives. In addition, the PBC closed 3 TICs. Although no accurate data are available at this juncture, many more face solvency problems that have arisen from weak management compounded by lax supervision.

While no formal DIS is yet in place in China, the PBC has given priority to repaying small- and medium-sized household deposits whenever a liquidation process has taken place, and accepted an obligation to ensure all such deposits are repaid even if the liquidation proceeds are insufficient, so as to maintain depositor confidence.

While many aspects of the DIS proposal remain to be resolved the following are the main features of the proposed DIS:

- The DIS would be organized as an independent institution, funded by premia paid by member institutions (differentiated by institution). After an initial period, premia could be risk-adjusted;
- Coverage would be limited, possibly applying only to small and medium income households;

The ultimate objective would be to establish a centralized fund. However, given technical and legal problems, during an initial period, separate funds could be established for each categories of deposit-taking institutions, beginning with rural credit cooperatives (a proposal was sent to the State Council in early 1999), and then moving to urban credit cooperatives, city commercial banks and other commercial banks including the SCBs.

Box 3. Proposed Rules for Loan Classification and Provisioning

1. Classification rules

The PBC is contemplating introducing modifications to the 5 category loan classification scheme used in the pilot project in Guangdong province. The following changes are under consideration:

- Definition of Normal Loans: "No identified doubt that the loan cannot be repaid", instead of "loan contract fully complied with;"
- Definition of Substandard Loans: "Main business operations (i.e., expected cash flows) and other means (in particular collateral) are insufficient to cover interest and principal servicing" instead of "cash flows from business operations;"
- A reduction from one year to 6 months for overdue loans to be classified as non-performing. The objective of the PBC is to further reduce the period to 3 months (i.e., closer to best international practice).

2. Provisioning rules (including accrual of interests)

Strengthened provisioning rules, as proposed by the PBC are the following:

- The general provision would be raised from 1 percent to 1.5 percent. The general provision should be taken after income taxes are paid;
- Minimum specific provisions on the basis of the 5 category loan classification as follows: special mention: 5 to 7 percent; substandard: 20 to 30 percent; idle: 50 percent; loss: 100 percent. Specific provisions should be taken before income taxes;
- Special provisions to cover country risk (based on country risk rating) and specific industrial risks;
- A further reduction in the period for accrual of interest from one year to 6 months and to 3 months within two years.

China: Summary of Technical Assistance, 1998-99

Department	Purpose	Date
Tax system reform		
FAD	Mission and seminar on tax policy	May 1998
FAD	Mission on tax policy and administration	November 1998
FAD	Seminar on tax administration	Feb.-March 1999
Tax administration reform		
LEG	Workshop on security transaction taxation	May 1998
LEG	Seminar on tax law	July 1998
LEG	Workshop on tax law	December 1998
Monetary and banking reform		
MAE	Workshop on monetary research and analysis	June 1998
MAE	Workshop on base money programming	October 1998
MAE	Seminar on capital account liberalization	December 1998
MAE	Mission on bank soundness issues	March 1999
MAE	Seminar on capital account liberalization	March 1999
MAE	Seminar on central bank accounting	May 1999
Statistics		
STA	Mission on balance of payments statistics	January 1998
STA	Mission on balance of payments statistics	April-May 1998
STA	Mission on multisector statistics	September 1998
STA	Mission on money and banking statistics	April-May 1999
Review of TA		
MAE	Review of TA projects for the PBC and the SAFE (together with TAS)	April 1998
OLA	Review of TA	October 1998
FAD	Visit to assess TA needs in the fiscal area	April 1999
Training in economic analysis and policy		
INS	Course on financial programming	November 1998

China—Relations with the World Bank Group¹

The World Bank has been active in China since 1980. Combined IBRD/IDA lending in FY 1998 was \$2.6 billion, slightly below the approximately \$3.0 billion lent yearly to China in the mid-1990's. Lending in FY 1999 is expected to total about \$2.1 billion for 17 projects, and to remain at about that level over the next few years. The lower lending program reflects the government's request for continued Bank support but at lower levels than in the recent past, given China's high savings rate and increasing reliance on domestic resources. Increasingly, the government is calling on the Bank to provide non-lending services, particularly involving collaborative studies with the government on policy issues and participation in technical assistance activities. A summary of Bank commitments and disbursement to China is given in Table 1.

The Bank's overall assistance objectives in China are in the process of being redefined to respond to current realities. In the past, the overarching aim was to promote broad-based economic development and reduce poverty in an environmentally sustainable way. The assistance strategy had five focal areas: (i) implementation of macroeconomic and structural reforms; (ii) easing of infrastructure constraints; (iii) human development and reduction of poverty; (iv) agriculture and rural development; and (v) safeguarding the environment. However, China's accelerated reform agenda in response to the regional crisis, its heightened concern with urban and environmental issues, particularly as they affect water resources, and the need to stimulate the economy through various means including investment in infrastructure have spurred the Bank to begin discussions with the Government of a revamped Bank assistance strategy suited to China's current, pressing needs. Agreement on this strategy should be reached later in CY 1999. Details of the sectoral breakdown of past lending can be found in Table 2.

Since 1990, the Bank has carried out studies in collaboration with Chinese counterparts in the fields of financial policies and institutional development, capital markets development, public investment and finance, budgetary and fiscal issues, national accounts assessments, trade policies, internal markets, reform and management arrangements for state enterprises, the social security system, health financing, price reform, housing reform, policies for higher education and for overall education policy in the 21st century, regional income disparities, urban employment, grain policy and food security, rural development, and provincial development strategies. Six country economic memoranda (CEMs) have been completed. The last full CEM, in 1997, assessed the state of China's economy at that time and analyzed the range of development challenges facing China in the next century. The 1999 CEM focuses on the current challenges of maintaining near-term growth while reinforcing medium-term reforms and economic development.

¹Prepared by World Bank staff.

Representation:	The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.
Capital Subscription:	China holds 4,479 million shares or 2.87 percent of the total authorized capital of the IBRD. As of February 28, 1999 China was fully subscribed with its paid up shares accounting for 2.9 percent of the total subscription.
Technical Assistance:	A technical assistance loan (\$60.0 million) to the People's Bank of China to enhance the central bank's supervision, research, and clearing capabilities was approved in FY 1993. A second technical assistance project (\$50.0 million), approved in the same year, is financing reform- supportive studies and economic research, the strengthening of core agencies responsible for macroeconomic management and local training institutions, and preinvestment support. Technical assistance for economic law reform was approved in FY 1995. <u>Fiscal technical assistance, also approved in FY 1995</u> , supports the implementation of recent fiscal reforms by developing and establishing a new National Tax Administration, and by developing an intergovernmental grants scheme and improved budgetary practices. In FY 1999, a technical assistance project for <u>accounting reform</u> (\$33.0 million) has been approved and additional technical assistance projects are expected to be approved for <u>pension and enterprise reform</u> (\$5.0 million each) as well as for support to economic research and preinvestment (\$45.0 million).
Resident Mission:	A resident IBRD office in Beijing has been in operation since October 1985. In October 1997, responsibility for managing the Bank's total program for China was decentralized to the Beijing office.
International Finance Corporation (IFC):	IFC commitments held as of March 31, 1999 total about \$235.7 million in loans and \$55.6 million in equity, of which \$206.7 million of the loans and \$45.8 million of the equity are disbursed. This does not include \$403.6 million in loan commitments held for participants, of which \$347.4 million is disbursed. A resident IFC office in Beijing has been in operation since 1992. The focus of IFC's activities in China is on pioneering transactions and demonstration projects focused on five core objectives: (i) developing limited recourse financing; (ii) supporting the restructuring of SOEs; (iii) promoting the liberalization and modernization of the financial sector; (iv) assisting the development of indigenous (nonstate)

enterprises and SMEs (such as township and village enterprises);
and (v) increasing the focus on interior provinces.

Table 1. China: IBRD-IDA Lending Activities, FY 1981-99 1/

(In millions of U.S. dollars)

FY	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
1981	100.0	100.0	0.0	0.0
1982	60.0	0.0	0.1	0.0
1983	150.4	463.1	32.6	0.6
1984	423.5	616.0	133.6	20.2
1985	442.3	659.6	146.2	235.7
1986	450.0	687.0	251.9	352.7
1987	556.2	867.4	361.3	317.8
1988	639.9	1,053.7	399.2	302.2
1989	515.0	833.4	549.4	684.5
1990	590.0	0.0	556.5	568.6
1991	977.8	601.5	493.6	620.3
1992	948.6	1,577.7	752.9	617.8
1993	1,017.0	2,155.0	762.9	812.5
1994	925.0	2,145.0	868.5	1,057.0
1995	630.0	2,369.5	659.3	1,554.9
1996	480.0	2,490.0	890.9	1,328.2
1997	325.0	2,490.0	722.9	1,405.3
1998	293.4	2,323.0	596.4	1,497.2
1999	280.0 2/	798.0 2/	571.0 2/	1,266.4 2/
Total	9,804.1	22,230.9	8,749.2	12,641.5

1/ The financial year (FY) runs from July through June.

2/ As of May 30, 1999.

Table 2. Distribution of Lending, FY 1980-99 1/

Sector	US\$ mn.	Percent	Number of Projects
Rural Development	<u>9,099.6</u>	28	<u>57</u>
Industry and energy	<u>9,497.6</u>	30	<u>49</u>
Industry	3,003.6		19
Energy	6,494.0		30
Transport	<u>7,379.1</u>	23	<u>40</u>
Human resources	<u>2,456.0</u>	7	<u>28</u>
Education	1,637.4		18
Health	818.6		10
Environment and urban	<u>3,190.0</u>	11	<u>25</u>
Environment	1,297.0		12
Urban development	1,118.0		7
Water supply	775.0		6
Technical assistance/other	412.7	1	<u>12</u>
Total	<u>32,035.0</u>	100	<u>211</u>

1/ As of May 30, 1999.

China—Relations with the Asian Development Bank¹

Asian Development Bank (AsDB) operations in China have focused on three strategic objectives: (i) economic efficiency enhancement; (ii) promotion of growth to reduce poverty in poor inland provinces; and (iii) environmental protection and natural resource management. These three broad objectives will help maximize employment generation, further eliminate factor market distortions, and address market failures of rapid growth by spreading the benefits of growth more evenly, and minimizing environmental degradation. Accordingly, the AsDB has given significant attention to reinforcing market-oriented reforms, developing efficient financial markets, restructuring the industrial sector, and improving agricultural productivity. By increasingly focusing the operational program on inland provinces and rural areas where the poor are concentrated, the AsDB is also addressing the government's objective to eradicate poverty by the year 2000 and bring about a more balanced pattern of development. Environmental projects aim at pollution control, human resource development in management, and institutional strengthening of environmental agencies, while natural resource conservation projects aim at soil and industrial energy conservation.

Since China became a member of the AsDB in 1986, 69 project loans totaling \$8,076.7 million (see Table 1) have been approved as of December 31, 1998. In addition, the AsDB has approved one line of equity for \$3 million, four equity investments totaling \$44.3 million, two loans of \$90 million to the private sector without government guarantee, and 303 technical assistance projects amounting to \$146.7 million.

The 1999 lending program is estimated at \$1,315.6 million for 8 projects. The loan projects include: Northeast Flood Damage Rehabilitation (\$330 million); Shanxi Environment Improvement (\$102 million); Southern Yunnan Road Development (\$250 million); Shanxi Road Development (\$250 million); Zhejiang-Shanxi Water Supply II (\$82 million); Shanghai Suzhou Creek Rehabilitation (\$300 million); and a TA loan on National Automated Payments System (\$1.6 million). In addition, the proposed technical assistance program for 1999 includes 25 projects totaling \$18.5 million. The program is aimed at assisting the government prepare projects for possible AsDB financing; undertaking policy studies in support of the reform program; and strengthening the capacities of selected government institutions involved in policy analysis and implementation as well as the executing agencies of AsDB-financed projects.

Overall, China has demonstrated a strong project implementation capability. Generally, loans are declared effective on time and most projects are completed within the planned period. Loan disbursement and contract award performance is good (see Table 2). Of the 69 loan projects approved as of December 31, 1998, 23 are fully disbursed and closed, 46 are under implementation, while 9 loans had yet to be made effective.

¹Prepared by the staff of the Asian Development Bank.

In the initial years of AsDB lending to China (1987–90), two-thirds of total lending was accounted for by the industrial and development finance sectors. Since 1991, transport and communications has emerged as the leading sector followed by energy, industry, development finance, social infrastructure, and agriculture and agro industry. The AsDB's proposed operational program in the next few years will follow the same pattern in order to address the critical issues associated with rapid economic growth, such as transport bottlenecks and energy shortages. The sectoral distribution of loans over the medium term will continue to be dominated by physical infrastructure.

The AsDB's proposed program in the next few years will also address two other major issues: growing income disparities and environmental degradation. Particular emphasis is placed on ensuring that environmental issues are addressed and that the project beneficiaries include the poor. Increased attention will be given to the less developed inland provinces; about 70 percent of the proposed projects in AsDB's operational program for 1997–2001 are located in inland provinces compared with 40 percent during the 1987–96 period. The strategic thrust of projects in AsDB's major project areas is now shifting to inland provinces.

The AsDB's lending program will continue to be supported by a technical assistance program aimed at assisting the government in carrying out policy reforms as well as in formulating quality projects. Support will also be provided to the government in seeking alternative financing such as private sector participation through build-operate-own projects. The ongoing restructuring of the industrial sector is expected to provide opportunities for foreign equity investment in selected enterprises in China, which will be facilitated through continued AsDB support for the development of the country's capital markets, the use of equity investments to mobilize international funds for investment in China, and arranging for cofinancing with commercial banks.

China views regional cooperation as an essential part of its strategy for integration with the world economy. The AsDB is facilitating China's participation by providing technical assistance; China is an active participant in the AsDB-approved Regional Technical Assistance (RETA) project for Promoting Cooperation in the Greater Mekong Subregion. China is also pursuing cooperation with the Central Asian Republics through three AsDB-financed technical assistance projects (the Kyrgyz Republic and Xinjiang Uygur Autonomous Region Power Development Study; a Conference on Regional Economic Development Along the New Asian-European Continental Land Bridge; and Regional Economic Cooperation in Central Asia).

The AsDB will continue to exchange views with the government concerning the country's ongoing reforms. Such policy discussions, to be facilitated through the provisions of advisory technical assistance and the AsDB's economic and sector work, will focus on financial, fiscal, legal, and enterprise reforms, and sector level reforms which implement the AsDB's lending program. Institutional development will also continue to be a key feature of the AsDB's operations in China.

Table 1. China: AsDB Distribution of Lending, 1986-98 1/

(In millions of U.S. dollars)

Sector	Approved Loan Amount	Percent of Total	No. of Projects
Agriculture and agro-industry	449.6	5.6	7
Energy	1,616.3	20.0	13
Industry (nonagriculture)	686.8	8.5	5
Transport and communications	3,848.0	47.6	30
Social Infrastructure	390.0	4.8	4
Finance	530.0	6.6	6
Multisector	400.0	5.0	3
Others	156.0	1.9	1
Total	8,076.7	100.0	69

1/ Excludes two private sector loans of \$90 million in the energy sector.

Table 2. China: AsDB's Commitments and Disbursements, 1986-98

(In millions of U.S. dollars)

Year	Commitments 1/	Disbursements 2/
1986	0.0	0.0
1987	0.0	0.0
1988	254.00	2.70
1989	107.97	52.00
1990	180.75	55.40
1991	111.04	172.70
1992	588.64	178.50
1993	1,030.99	421.30
1994	1,617.68	492.09
1995	2,304.42	558.27
1996	3,282.32	707.19
1997	4,032.85	714.68
1998	4,517.55	831.33

1/ Refers to cumulative contract awards.

2/ Refers to disbursements for the year.