

FOIA MARKER

This is not a textual record. This is used as an administrative marker by the Clinton Presidential Library Staff.

Folder Title:

China WTO - Post Agreement Documents [6]

Staff Office-Individual:

National Economic Council-Lee, Malcolm

Original OA/ID Number:

CF 1177

Row:	Section:	Shelf:	Position:	Stack:
23	5	6	1	V

China's Fiscal Time Bomb

With more debt than it lets on, and low tax revenues, China's budget is weaker than the official statistics show

Chi Lo

Beijing's fiscal deficit is a ticking time bomb. The government's total budget deficit could be up to five times greater than official Ministry of Finance figures indicate, because Beijing counts funds raised by bond issuance as budget revenue rather than as borrowing. An inefficient tax system and the government's increasing reliance on debt financing for its spending needs also make the repayment and servicing of the public debt a mounting concern.

The fiscal bomb may not explode just yet, as ample household savings will sustain the fiscal deficit in the short term. But the ongoing decline in fiscal revenue from 28 percent of GDP in 1979 to 12 percent in 1998 is a serious concern, because it limits the authorities' ability to respond to the inevitable need to spend more on social and structural reform. Thorough fiscal reform is needed sooner rather than later to resolve these long-term budgetary woes.

THE TRUE FACE OF THE FISCAL MESS

The culprit for China's worsening fiscal position is the long-term decline in the central government's tax revenues. On the surface, the decline has not led to a widening state budget deficit as a percentage of GDP, because of cuts in government spending. But this official deficit figure is misleading because Beijing inflates its budgetary revenues, mainly by including funds raised by bond issuance as revenue. Such bond issues should be treated as borrowing.

Adjusting for this accounting trick, China's fiscal deficit would have amounted to 5.3 percent of GDP—or ¥423 billion (\$51 billion)—in 1998, instead of the official figure of 1.2 percent, or ¥92 billion (\$11 billion). This adjusted budgetary gap has been widening, with Beijing financing the deficit by issuing still more bonds to

make up for the precipitous fall in tax revenues (see Figure 1).

THE ERODED TAX BASE

According to the International Monetary Fund, the steady decline in China's tax-to-GDP ratio is a result of the combination of a tax policy that gives extensive tax concessions; structural changes that lower the effective tax rate for key economic sectors and erode the tax base; and weak tax administration. Until 1984, Beijing counted all state-owned-enterprise (SOE) profits and depreciation funds as part of central budget revenue, thus imposing an effective 100 percent income-tax rate on SOEs. This public-enterprise revenue was the cornerstone of Beijing's budget in the early 1980s.

But changes to the tax system have cut SOEs' tax obligations substantially over time. Especially damaging to tax collection efforts was the contract responsibility system (CRS), under which taxes were paid according to negotiated tax contracts rather than a standardized tax schedule. The 1994 tax reform replaced the CRS with a much lower, uniform rate of 33 percent for all state and non-state enterprises.

More important, structural changes in the economy have eroded the traditional tax base. The key revenue source—the state sector—has dried up, while the rapidly growing non-state sector has not been sufficiently

Chi Lo is director of research and senior economist (Asia) for HSBC (formerly Hong Kong and Shanghai Banking Corp.) in Hong Kong.

integrated into the tax net. SOEs contributed only 8 percent of total tax revenue and accounted for less than 30 percent of total industrial output in 1998, compared to 29 percent and 65 percent, respectively, in 1985. Meanwhile, the non-state sector, which includes collectives, township and village enterprises, private enterprises, and foreign-funded enterprises, has been taxed relatively lightly—though this may be changing, at least for foreign enterprises (see *The CBR*, July-August 1999, p.8). The poor finances of the SOEs and the declining share of public-enterprise earnings relative to wages have also contributed to this state-sector revenue loss. About half of SOEs are in the red, and SOE wages have been taxed relatively lightly, further dragging down the overall tax intake.

From a macroeconomic perspective, the declining share of consumption in GDP, from 64 percent in 1979 to 59 percent last year, has also reduced the government's goods and services tax intake. This is another indication that tax revenues are not growing in step with the economy. Further, the rise in the export sector's share in GDP—from about 5 percent in 1979 to 20 percent in recent years—does not help raise tax revenue much, as export production is taxed at lower rates to encourage foreign participation in Chinese export industries. After recent VAT rebate increases, many products are taxed at 5 percent or less.

AND THEN THERE ARE COLLECTION PROBLEMS

The 1994 tax reform has failed to arrest the erosion of the central government's fiscal control. Fiscal revenue has declined precipitously, from 28 percent of GDP in 1979 to only 12 percent today, one of the lowest percentages among the major economies in the world. The absence of a nationwide tax system is the main administrative culprit. The State Administration of Taxation and local tax authorities define separate tax laws for their own jurisdictions and grant tax exemptions within their authority.

Local governments collect the bulk of taxes and share the revenues with the central government via complex, contract-based, intra-governmental fiscal arrangements. Local tax authorities work with local financial bureaus to formulate and administer local budgets. But these arrangements, coupled with the fact that many SOEs are locally owned, provide an incentive for some local authorities to maximize local revenues at the expense of tax contributions to the central government. These local authorities grant local SOEs generous exemptions from the taxes that are shared with the central government, but preserve their own portion of tax revenues mostly untouched.

The local authorities also wrung a big compromise out of Beijing in the 1994 reform, in the form of a guarantee that the absolute level of local tax rev-

Fiscal revenue has declined precipitously, from 28 percent of GDP in 1979 to only 12 percent today, one of the lowest percentages among the major economies in the world.

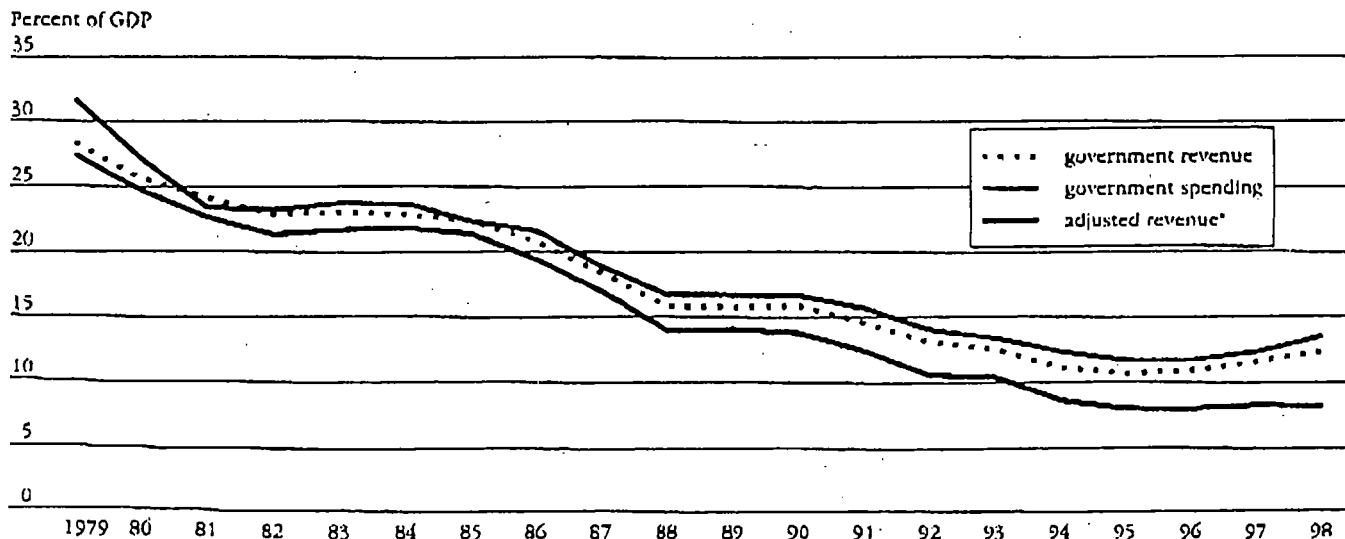
enues would not fall after the reform. Furthermore, Beijing agreed that the post-reform revenue-sharing scheme would only apply to the net future increase in tax revenues. Hence, the reform has failed to improve Beijing's tax-collection ability, as reflected in the figure for tax revenue as a percentage of GDP.

HOW BIG IS THE BUDGET HOLE?

With tax revenues inadequate, Beijing has been relying on debt financing to fund government spending and, more recently, to boost GDP growth. This has led to a sharp rise in the public debt-to-GDP ratio (see Table).

But China also has a hidden debt. Using Bank for International Settlements

FIGURE 1
THE TRUE FACE OF THE FISCAL MESS



SOURCES: HSBC Economics, CEIC

* Total revenues less government bonds issued

*Local authorities
grant local SOEs
generous exemptions
from the taxes that are
shared with the central
government, but preserve
their own portion of tax
revenues mostly
untouched.*

(BIS) statistics. HSBC estimates that China's short-term (less than one year) borrowing from international banks amounted to \$34.5 billion, or 53 percent of total borrowing, at the end of 1998. But official PRC statistics only show \$17.3 billion—or 11.9 percent of the total—in short-term foreign debt. Even if one accounts for the possibility that official statistics may be inaccurate, the magnitude of the discrepancy between BIS and official data suggests that there might have been significant unauthorized foreign borrowing by Chinese enterprises last year—as much as \$17.2 billion. The increasing size of this hidden debt adds to the true debt burden on the economy.

But the official budget deficit does not reflect this rising strain on central-government finances, largely because of Beijing's inclusion of funds raised by bond

issuance in its budgetary revenues, which has effectively deflated the true budget deficit by an average of 2.5 percentage points of GDP in recent years.

Beijing also requires the state banks to increase lending—to a large number of SOEs—by the same amount as the increase in government spending. This has effectively doubled fiscal spending without counting it as expenditure. If bad debts at the state banks, estimated at over \$200 billion in total, were included in the budget, the deficit would be significantly bigger.

DEBT-SERVICING WORRIES

The government's reliance on debt financing suggests that the rising cost of servicing the public debt could become worrisome. Indeed, the resources going toward servicing existing government debt have been rising steadily. Debt servicing and repayment accounted for over 70 percent of new government bond issues, which totaled ¥331.1 billion (\$40 billion) in 1998 (see Figure 2). Thus, the share of fiscal revenue spent on debt servicing and repayment rose to 24 percent of total government fiscal revenue last year, from less than 3 percent in 1989.

If economic growth were strong, Beijing could simply cap spending and enjoy the rise in tax revenues to help ease its fiscal strains. But with the economy struggling through structural reforms, such a cyclical bailout is unlikely.

NO IMMINENT CRISIS

Nevertheless, China's high domestic savings level, estimated at 40 percent

RIISING PUBLIC DEBT

YEAR	PERCENT OF GDP
1994	21.63
1995	20.46
1996	20.55
1997	21.37
1998	26.98
1999 (forecast)	28.13

SOURCES: HSBC Economics, CEIC

of GDP, should provide ample funds for the government in the short term. By selling bonds to the banks, Beijing can tap into the roughly \$630 billion in household savings—61 percent of projected 1999 GDP—in the banking system.

China's rising debt-to-GDP ratio is still low by international standards. Even if the hidden debt is included, China's total debt is still about 30 percent of GDP, far below the internationally acceptable threshold of 60 percent. All this makes China's public-sector dissaving much less problematic. Beijing should have little difficulty financing its fiscal spending needs for at least the next two years.

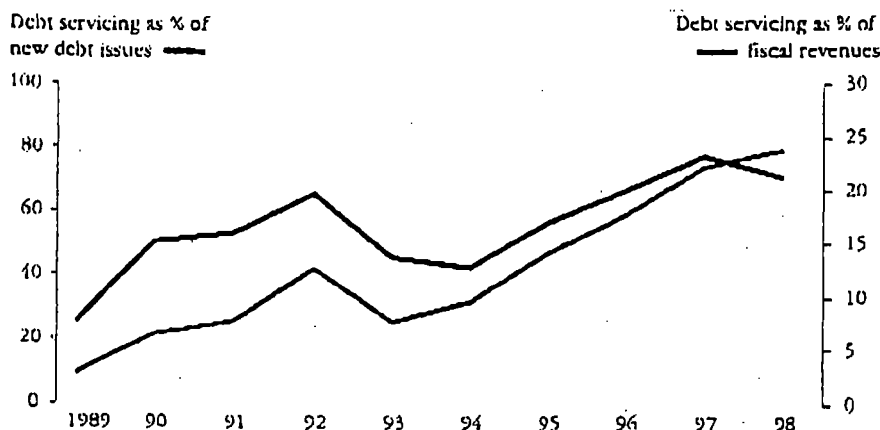
Compared with other countries, China's debt burden does not appear crushing. The public debt of the United States and Britain in 1946, Europe in the early 1990s, and Japan today has exceeded 100 percent of GDP without disaster striking. Indeed, Beijing's effort to generate a cyclical economic rebound, if successful, will help to reduce its financial stress by increasing revenues.

MARKETS REMAIN CALM—FOR NOW

In theory, Beijing can live beyond its means as long as it can borrow from the public at reasonable cost. And such an ability to borrow is, in turn, decided by bond investors. If they are worried, they will demand sharply higher interest rates, causing government debt to spiral. But this does not seem likely in China. The yield of the 11.83 percent June 14, 2006 Treasury bond, traded on the Shenzhen Stock Exchange, has continued to fall despite Beijing's rising demand for funds (see Figure 3).

Several factors suggest that Beijing faces few fundraising difficulties in the near future. The high savings rate and

FIGURE 2
RISING COST OF DEBT SERVICING

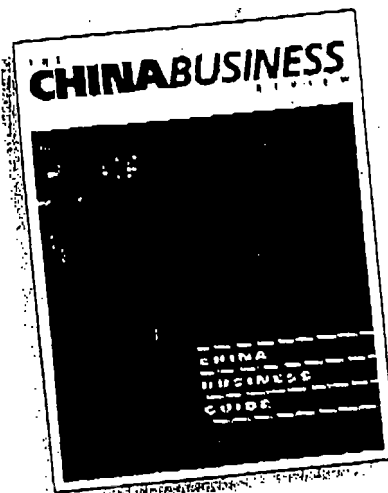


SOURCE: CEIC

the lack of investment alternatives have ensured a strong local demand for bonds. The government is also selling bonds to distressed domestic banks to help improve their balance sheets. At the same time, demand for funds from the non-state sector is weak, due to low investment levels—a result of the economic slowdown—and the absence of a consumer credit market. As long as the flow of funds to non-state borrowers is weak, the government should face little competition for funds. Finally, most of the government debt is domestic. Unlike foreign creditors, who would pull out at any sign of fiscal stress, domestic investors are usually loyal. And at 15 percent of GDP, foreign-currency debts—the proximate cause of the recent Asian financial crisis—are small.

Current levels of fiscal spending, however, are unsustainable. Without thorough fiscal reform, the government could lose control of its finances entirely. This steady decline in fiscal revenue also limits Beijing's ability to respond to economic shocks and economic reform's growing funding needs. Thus, however faithful its bond buyers, Beijing must soon undertake thorough fiscal reform: it must redouble its efforts to mend the tax net; reduce reliance on the state sector for revenues; and collect taxes from the growing non-state sector. Though the recent anti-smuggling campaign has led to an increase in import tax revenue, it will not be enough to improve Beijing's finances—total imports account for only 15 percent of GDP. While a fiscal crisis is not imminent, fiscal reform is. 完

The CBR China Business Guide Now Available



If you're doing business with China, or just thinking about it, here is inside information you should have. Published by *The China Business Review*, the top U.S. authority on trading with China, the guide can be yours for only US\$50 (USCBC members, US\$35)

Secrets of the supply chain. How to avoid ending up with a brand new unprofitable factory.

Where to locate in China. The area you choose will have a big impact on the success of your venture.

How to maximize tax benefits. The bottom line on your tax liability in China.

Acquiring a Chinese company? Facts you should know.

How to export goods to China... without running into costly snafus.

Your best entry strategy. It could be setting up a representative office in China, or partnering with a Chinese firm.

How to cope with foreign exchange regulations. Practical ways to get your goods into China—and get paid for them.

Getting started in China. How to negotiate a joint-venture contract.

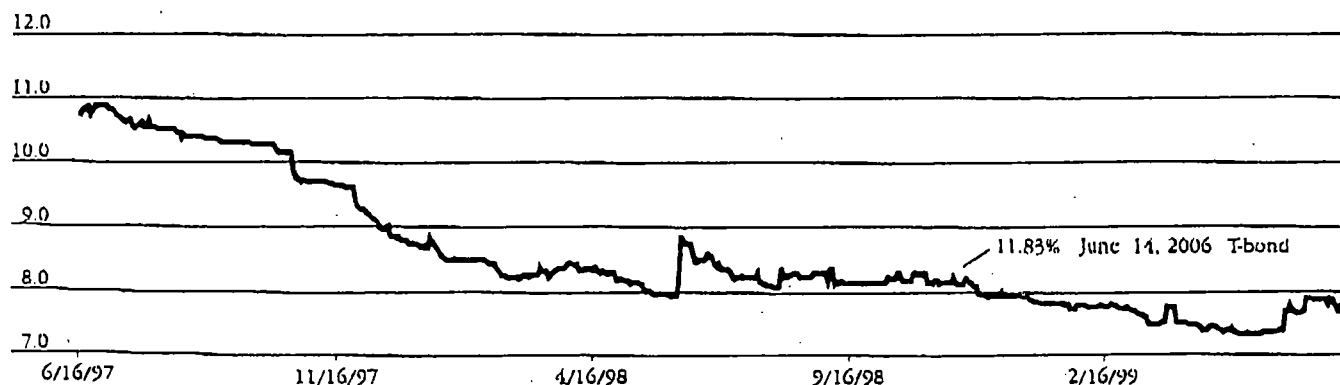
Playing the bureaucratic game. How to get the approvals you need.

Easy import, easy export. A bonded warehouse in the free trade zone outside Shanghai can help.

Contact The CBR at:

Tel: 202-429-0340, Fax: 202-833-9027, or order online at www.uschina.org/cbr

FIGURE 3
FALLING CHINESE TREASURY BOND YIELDS



SOURCE: CEIC

Is China Headed for a Crash?

By HUGO RESTALL

On Monday the Chinese government announced it would tap its bond market for \$7.3 billion, on top of \$43.5 billion in borrowing already planned for this year, in order to stimulate its faltering economy. Unfortunately for the Chinese people, the additional spending is likely to offer only fleeting benefits while exacerbating the country's debt burden. As China squanders its savings, a window of opportunity to reform its financial sector is steadily closing.

The bond issue and a new tax on interest income are just the latest in a string of policies intended to boost domestic demand and get the economy moving again. They show that the leadership in Beijing is becoming increasingly desperate about the slowdown in growth, officially still above 7% but perhaps closer to 5%. Neither President Jiang Zemin nor Premier Zhu Rongji has the political clout or vision to undertake a bold new round of reforms on a par with Deng Xiaoping's "southern tour" in 1992. So instead of focusing on the country's failing banks, they are in the engine room tinkering while the ship takes on water.

Stock-Market Bubble

The immediate economic problem seems simple: Chinese consumers aren't spending. Many worry that their jobs at state-run companies will be eliminated, and they know that their pensions, as well as subsidized health care and housing, are no longer guaranteed. The government is trying to put them in an acquisitive frame of mind by a variety of methods, the most dubious being a stock-market bubble induced in part by a relaxation of controls on banks lending to brokerage firms. If only people felt better and spent more, the thinking goes, everything would turn around.

But it's a mistake for Beijing to focus on consumer psychology, because ordinary Chinese people are right. There is something fundamentally worrying with the Chinese economy that justifies salting away 40% of their income in bank accounts even when interest rates are low. Companies are not producing enough value to sustain growth, employ the growing work force and meet people's expectation for a rising standard of living.

China probably isn't headed for a dramatic collapse in the near future, but as the government spends more propping up growth, the risk of a crash grows. The countries affected by the 1997 Asian crisis at least had flourishing private sectors and were committed to letting the free market operate. China's leaders, on the other hand, have held on too long to the commanding heights of the economy and

have allowed the unchecked power of the Communist Party to spread corruption. For all its apparent resilience, China has as much in common with Russia as with Thailand.

To understand why, look at China's banks. Their problems—as much as 40% of a total loan portfolio of \$1 trillion may be unrecoverable—may look like a case of the Asian flu, but in fact the illness goes deeper. They have been hit with a triple whammy: government-directed loans to a

1997 has only added to the banks' woes. The hoped-for recovery has yet to come. The vacancy rate for office space in Shanghai hovers around 70%. There has been little disclosure of how much of the lending for this boom has now gone bad.

It's widely believed that China's big four state banks are technically insolvent; Moody's Investors Service estimates that it would cost \$120 billion—12% of gross domestic product—to clean up their bad loans. That's a conservative estimate.

The countries affected by the 1997 Asian crisis at least had flourishing private sectors. China has as much in common with Russia as with Thailand.

hopelessly inefficient state sector, real-estate development loans that are now underwater, and massive fraud and corruption. Because the Chinese system is opaque, we don't know how big each of these problems is. But the revelations that occasionally seep out suggest that China has actually been cannibalizing its savings to keep its growth spurt going. If reform isn't undertaken soon, the government won't have the borrowing capacity left to fix the banks. There could be an economic—and political—reckoning.

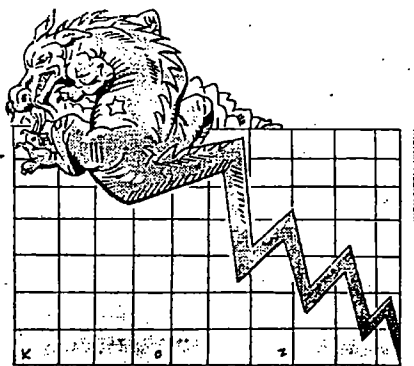
The most critical question is whether the problem of money-losing state-owned enterprises is being solved. The government says it is, pointing out that the number of loss-making SOEs fell by 22% during 1998. But much of the problem remains hidden, since the burden of supporting these enterprises long ago shifted to the banks. Many companies still report profits, but they rely on new loans to pay workers, and they keep rolling over old debts so that, even though they will never pay them back, they can be counted as healthy assets by the state banks. Taxpayers will eventually have to make up this shortfall.

To be sure, there has been an effort to improve management and wean companies off this system. But two problems have taken the impetus out of reform. First, Beijing is afraid that millions of unemployed workers without a social safety net would revolt. Second, the government's demand-side fixation led it to order banks last year to make an additional \$12 billion in loans to "stimulate" the economy. Much of this investment went into propping up state firms or creating unneeded capacity. As competition intensifies in the marketplace, SOEs are getting into deeper trouble.

The bursting of real-estate bubbles in Shanghai, Shenzhen and other cities in

Some experts think the cost could be more than twice as high.

There has also been a spate of failures among other Chinese government-owned investment firms, some of them due in part to the suspicious disappearance of assets. During the boom years of the mid-'90s, many of the investment-trust companies known as ITICs—supposedly China's windows to the outside world—borrowed money from foreign and domestic creditors and lent it out recklessly for trophy projects. When the Guangdong Province ITIC went belly up earlier this year, it had only \$785 million in assets against \$4.7 billion in liabilities. If this surprise was concealed by China's flagship investment



companies, how many shockers lurk in the domestic banks?

The government has announced some reforms that sound promising on paper. The Cinda Asset Management Corp. has been set up to take over the bad loans of the China Construction Bank, one of the big four state banks. Three more asset-management companies will soon follow. There is even a plan to swap some of the debt for equity in the state companies, which could then be sold to investors. This sounds like

the sort of textbook approach the International Monetary Fund might approve. Unfortunately, shunting the problem off into holding companies doesn't change anything if the banks start accumulating bad loans again. So far there is no wide-reaching privatization program for state firms, and no viable plan to reform the management of the banks and put their lending on a commercial rather than political basis.

Then too, available capital is shrinking as foreign bank lending and foreign direct investment both contract and local money slips out of the country. Exports have been declining, although they may recover a bit as the Asian economy begins to revive. There has been deflation for 22 straight months. About the only strengths Beijing can point to are its enormous foreign-exchange reserves and spending-generated positive growth.

Figures in a Ledger

But as we learned from the Asian economic crisis, these advantages can quickly disappear. We also learned that weakness in the financial sector cannot be glossed over. Bad loans may be just figures in a ledger, but they come back to bite the real economy. Even if there is no crash in China, the banks' losses will eventually constrain new lending to productive enterprises. Already the state sector consumes about 70% of lending but contributes less than half of the GDP. If the private sector continues to be squeezed by reckless government spending, can it go on being an engine of real growth?

In the mid-'90s, China ran only a small budget deficit and had a tiny national debt. There was a window of opportunity to recapitalize banks. Today the growing burden of fiscal stimulus is pushing up the interest burden of the national debt, a trend that is particularly worrying for a central government that lacks an efficient tax system. If it waits much longer, Beijing may find that the cost of funding a bank bailout has overtaken its fiscal capacity. The window will have closed.

China's economy has proved remarkably resilient so far. But World Bank representative Pieter Bottelier was right a couple of years ago to call China's banking system a "time bomb." The bomb is still ticking, and time is running out. China faces a painful transition period, having to let go of inefficient companies and repair the damage they have caused. Undermining this process with giant spending packages will only lead to greater disruption. The sooner Beijing figures out it needs healthy banks lending to private companies, the sooner the country will return to double-digit growth rates.

Mr. Restall is deputy editorial page editor of The Asian Wall Street Journal.

Does China Matter?

Gerald Segal

MIDDLE KINGDOM, MIDDLE POWER

DOES CHINA matter? No, it is not a silly question—merely one that is not asked often enough. Odd as it may seem, the country that is home to a fifth of humankind is overrated as a market, a power, and a source of ideas. At best, China is a second-rank middle power that has mastered the art of diplomatic theater: it has us willingly suspending our disbelief in its strength. In fact, China is better understood as a theoretical power—a country that has promised to deliver for much of the last 150 years but has consistently disappointed. After 50 years of Mao's revolution and 20 years of reform, it is time to leave the theater and see China for what it is. Only when we finally understand how little China matters will we be able to craft a sensible policy toward it.

DOES CHINA MATTER ECONOMICALLY?

CHINA, UNLIKE Russia or the Soviet Union before it, is supposed to matter because it is already an economic powerhouse. Or is it that China is on the verge of becoming an economic powerhouse, and you must be in the engine room helping the Chinese to enjoy the benefits to come? Whatever the spin, you know the argument: China is a huge market, and you cannot afford to miss it (although few say the same about India). The recently voiced "Kodak version" of this argument is that if only each Chinese will buy one full roll of film instead of the average half-roll that each currently buys, the West will be rich. Of

GERALD SEGAL is Director of Studies at the International Institute for Strategic Studies in London and co-author, with Barry Buzan, of *Anticipating the Future*.

Does China Matter?

course, nineteenth-century Manchester mill owners said much the same about their cotton, and in the early 1980s Japanese multinationals said much the same about their television sets. The Kodak version is just as hollow. In truth, China is a small market that matters relatively little to the world, especially outside Asia.

If this judgment seems harsh, let us begin with some harsh realities about the size and growth of the Chinese economy. In 1800 China accounted for 33 percent of world manufacturing output; by way of comparison, Europe as a whole was 28 percent, and the United States was 0.8 percent. By 1900 China was down to 6.2 percent (Europe was 62 percent, and the United States was 23.6 percent). In 1997 China accounted for 3.5 percent of world GNP (in 1997 constant dollars, the United States was 25.6 percent). China ranked seventh in the world, ahead of Brazil and behind Italy. Its per capita GDP ranking was 81st, just ahead of Georgia and behind Papua New Guinea. Taking the most favorable of the now-dubious purchasing-power-parity calculations, in 1997 China accounted for 11.8 percent of world GNP, and its per capita ranking was 65th, ahead of Jamaica and behind Latvia. Using the U.N. Human Development Index, China is 107th, bracketed by Albania and Namibia—not an impressive story.

Yes, you may say, but China has had a hard 200 years and is now rising swiftly. China has undoubtedly done better in the past generation than it did in the previous ten, but let's still keep matters in perspective—especially about Chinese growth rates. China claimed that its average annual industrial growth between 1951 and 1980 was 12.5 percent. Japan's comparable figure was 11.5 percent. One can reach one's own judgment about whose figures turned out to be more accurate.

Few economists trust modern Chinese economic data; even Chinese Prime Minister Zhu Rongji distrusts it. The Asian Development Bank routinely deducts some two percent from China's official GDP figures, including notional current GDP growth rates of eight percent. Some two or three percent of what might be a more accurate GDP growth rate of six percent is useless goods produced to rust in warehouses. About one percent of China's growth in 1998 was due to massive government spending on infrastructure. Some three percent of GDP is accounted for by the one-time gain that occurs when one takes peasants off the land and brings them to cities, where productivity is

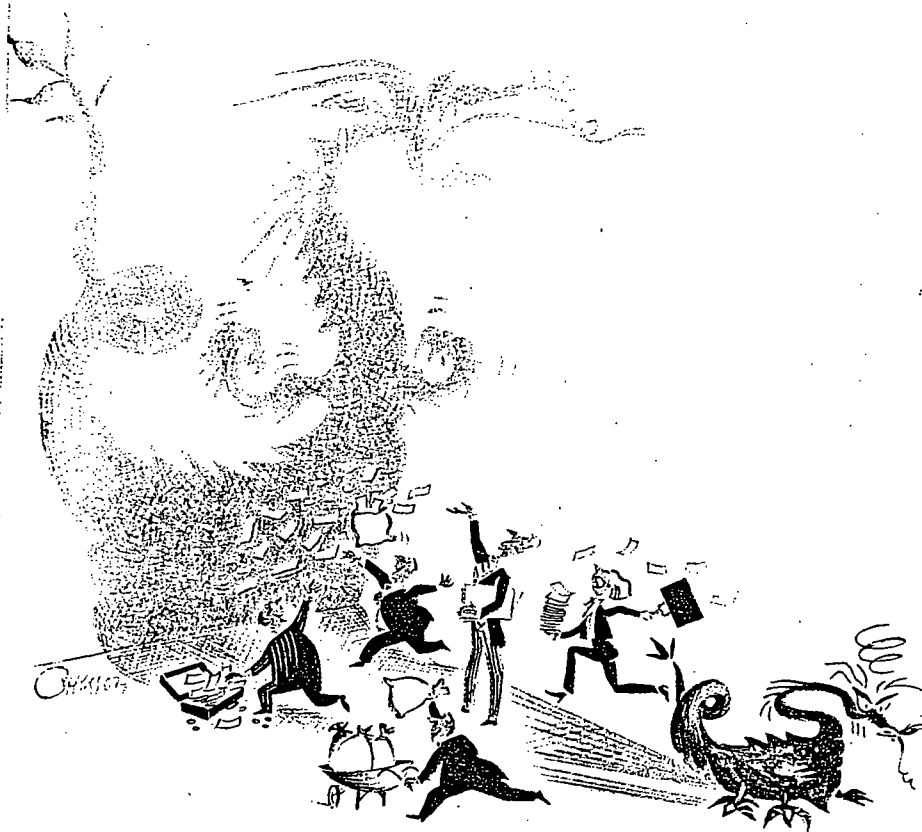
higher. Taking all these qualifications into account, China's economy is effectively in recession. Even Zhu calls the situation grim.

China's ability to recover is hampered by problems that the current leadership understands well but finds just too scary to tackle seriously—at least so long as East Asia's economy is weak. By conservative estimates, at least a quarter of Chinese loans are nonperforming—a rate that Southeast Asians would have found frightening before the crash. Some 45 percent of state industries are losing money, but bank lending was up 25 percent in 1998—in part, to bail out the living dead. China has a high savings rate (40 percent of GDP), but ordinary Chinese would be alarmed to learn that their money is clearly being wasted.

Some put their hope in economic decentralization, but this has already gone so far that the center cannot reform increasingly wasteful and corrupt practices in the regions and in specific institutions. Central investment—20 percent of total investment in China—is falling. Inter-provincial trade as a percentage of total provincial trade is also down, having dropped a staggering 18 percent between 1985 and 1992. Despite some positive changes during the past 20 years of reform, China's economy has clearly run into huge structural impediments. Even if double-digit growth rates ever really existed, they are hard to imagine in the near future.

In terms of international trade and investment, the story is much the same: Beijing is a seriously overrated power. China made up a mere 3 percent of total world trade in 1997, about the same as South Korea and less than the Netherlands. China now accounts for only 11 percent of total Asian trade. Despite the hype about the importance of the China market, exports to China are tiny. Only 1.8 percent of U.S. exports go to China (this could, generously, be perhaps 2.4 percent if re-exports through Hong Kong were counted)—about the same level as U.S. exports to Australia or Belgium and about a third less than U.S. exports to Taiwan. The same is true of major European traders. China accounts for 0.5 percent of U.K. exports, about the same level as exports to Sri Lanka and less than those to Malaysia. China takes 1.1 percent of French and German exports, which is the highest in Asia apart from Japan but about par with exports to Portugal.

China matters a bit more to other Asian countries. Some 3.2 percent of Singapore's exports go to China, less than to Taiwan but on par



with South Korea. China accounts for 4.6 percent of Australian exports, about the same as to Singapore. Japan sends only 5.1 percent of its exports to China, about a quarter less than to Taiwan. Only South Korea sends China an impressive share of its exports—some 9.9 percent, nudging ahead of exports to Japan.

Foreign direct investment (FDI) is even harder to measure than trade but sheds more light on long-term trends. China's massive FDI boom, especially in the past decade, is often trumpeted as evidence of how much China does and will matter for the global economy. But the reality is far less clear. Even in 1997, China's peak year for FDI, some 80 percent of the \$45 billion inflow came from ethnic Chinese, mostly in East Asia. This was also a year of record capital flight

from China—by some reckonings, an outflow of \$35 billion. Much so-called investment from East Asia makes a round-trip from China via some place like Hong Kong and then comes back in as FDI to attract tax concessions.

Even a more trusting view of official FDI figures suggests that China does not much matter. FDI into China is about 10 percent of global FDI, with 60 percent of all FDI transfers taking place among developed countries. Given that less than 20 percent of FDI into

In truth, China is a small market that matters relatively little to the world.

China comes from non-ethnic Chinese, it is no surprise that U.S. or European Union investment in China averages out to something less than their investment in a major Latin American country such as Brazil. China has never accounted for more than 10 percent of U.S. FDI outflows—usually much less. In recent years China has taken around 5 percent

of major EU countries' FDI outflow—and these are the glory years for FDI in China. The Chinese economy is clearly contracting, and FDI into China is dropping with it. In 1998 the United Nations reported that FDI into China may be cut in half, and figures for 1998–99 suggest that this was not too gloomy a guess. Japanese FDI into China has been halved from its peak in 1995. Ericsson, a multinational telecommunications firm, says that China accounts for 13 percent of its global sales but will not claim that it is making any profits there. Similar experiences by Japanese technology firms a decade ago led to today's rapid disinvestment from China. Some insist that FDI flows demonstrate just how much China matters and will matter for the global economy, but the true picture is far more modest. China remains a classic case of hope over experience, reminiscent of de Gaulle's famous comment about Brazil: It has great potential, and always will.

It does not take a statistical genius to see the sharp reality: China is at best a minor (as opposed to inconsequential) part of the global economy. It has merely managed to project and sustain an image of far greater importance. This theatrical power was displayed with great brio during Asia's recent economic crisis. China received lavish praise from the West, especially the United States, for not devaluing its currency as it did in 1995. Japan, by contrast, was held responsible

for the crisis. Of course, Tokyo's failure to reform since 1990 helped cause the meltdown, but this is testimony to how much Tokyo matters and how little Beijing does. China's total financial aid to the crisis-stricken economies was less than 10 percent of Japan's contribution.

The Asian crisis and the exaggerated fears that it would bring the economies of the Atlantic world to their knees help explain the overblown view of China's importance. In fact, the debacle demonstrated just how little impact Asia, except for Japan, has on the global economy. China—a small part of a much less important part of the global system than is widely believed—was never going to matter terribly much to the developed world. Exaggerating China is part of exaggerating Asia. As a result of the crisis, the West has learned the lesson for the region as a whole, but it has not yet learned it about China.

DOES CHINA MATTER MILITARILY?

CHINA is a second-rate military power—not first-rate, because it is far from capable of taking on America, but not as third-rate as most of its Asian neighbors. China accounts for only 4.5 percent of global defense spending (the United States makes up 33.9 percent) and 25.8 percent of defense spending in East Asia and Australasia. China poses a formidable threat to the likes of the Philippines and can take islands such as Mischief Reef in the South China Sea at will. But sell the Philippines a couple of cruise missiles and the much-discussed Chinese threat will be easily erased. China is in no military shape to take the disputed Senkaku Islands from Japan, which is decently armed. Beijing clearly is a serious menace to Taiwan, but even Taiwanese defense planners do not believe China can successfully invade. The Chinese missile threat to Taiwan is much exaggerated, especially considering the very limited success of the far more massive and modern NATO missile strikes on Serbia. If the Taiwanese have as much will to resist as did the Serbs, China will not be able to easily cow Taiwan.

Thus China matters militarily to a certain extent simply because it is not a status quo power, but it does not matter so much that it cannot be constrained. Much the same pattern is evident in the challenge China poses to U.S. security. It certainly matters that China is the only country whose nuclear weapons target the United States. It matters,

as the recent Cox report on Chinese espionage plainly shows, that China steals U.S. secrets about missile guidance and modern nuclear warheads. It also matters that Chinese military exercises simulate attacks on U.S. troops in South Korea and Japan. But the fact that a country can directly threaten the United States is not normally taken as a reason

China is less a global rival like the Soviet Union than a regional threat like Iraq.

to be anything except robust in defending U.S. interests. It is certainly not a reason to pretend that China is a strategic partner of the United States.

The extent to which China matters militarily is evident in the discussions about deploying U.S. theater missile defenses (TMD) in the western Pacific and creating a U.S. national missile defense shield (NMD). Theoretically, the adversary is North Korea. In practice, the Pentagon fears that the U.S. ability to defend South Korea, Japan, and even Taiwan depends in the long term on the ability to defend the United States' home territory and U.S. troops abroad from Chinese missiles. Given the \$10 billion price tag for NMD and the so-far unknowable costs of TMD, defense planners clearly think that China matters.

But before strategic paranoia sets in, the West should note that the Chinese challenge is nothing like the Soviet one. China is less like the Soviet Union in the 1950s than like Iraq in the 1990s: a regional threat to Western interests, not a global ideological rival. Such regional threats can be constrained. China, like Iraq, does not matter so much that the United States needs to suspend its normal strategies for dealing with unfriendly powers. Threats can be deterred, and unwanted action can be constrained by a country that claims to be the sole superpower and to dominate the revolution in military affairs.

A similarly moderated sense of how much China matters can be applied to the question of Chinese arms transfers. China accounted for 2.2 percent of arms deliveries in 1997, ahead of Germany but behind Israel (the United States had 45 percent of the market, and the United Kingdom had 18 percent). The \$1 billion or so worth of arms that Beijing exports annually is not buying vast influence, though in certain markets Beijing does have real heft. Pakistan is easily the most important recipient of Chinese arms, helping precipitate a nuclear arms race

with India. Major deals with Sudan, Sri Lanka, and Burma have had far less strategic impact. On the other hand, arms transfers to Iran have been worrying; as with Pakistan, U.S. threats of sanctions give China rather good leverage. China's ability to make mischief therefore matters somewhat—primarily because it reveals that Chinese influence is fundamentally based on its ability to oppose or thwart Western interests. France and Britain each sell far more arms than China, but they are by and large not creating strategic problems for the West.

Hence, it is ludicrous to claim, as Western and especially American officials constantly do, that China matters because the West needs it as a strategic partner. The discourse of "strategic partnership" really means that China is an adversary that could become a serious nuisance. Still, many in the Clinton administration and elsewhere do not want to call a spade a spade and admit that China is a strategic foe. Perhaps they think that stressing the potential for partnership may eventually, in best Disney style, help make dreams come true.

On no single significant strategic issue are China and the West on the same side. In most cases, including Kosovo, China's opposition does not matter. True, the U.N. Security Council could not be used to build a powerful coalition against Serbia, but as in most cases, the real obstacle was Russia, not China. Beijing almost always plays second fiddle to Moscow or even Paris in obstructing Western interests in the Security Council. (The exceptions to this rule always concern cases where countries such as Haiti or Macedonia have developed relations with Taiwan.) After all, the Russian prime minister turned his plane to the United States around when he heard of the imminent NATO attack on Serbia, but the Chinese premier turned up in Washington as scheduled two weeks later.

NATO's accidental May bombing of the Chinese embassy elicited a clear demonstration of China's theatrical power. Beijing threatened to block any peace efforts in the United Nations (not that any were pending), but all it wanted was to shame the West into concessions on World Trade Organization membership, human rights, or arms control. China grandiosely threatened to rewrite the Security Council resolution that eventually gave NATO an indefinite mandate to keep the peace in Kosovo, but in the end it meekly abstained. So much for China taking a global perspective as one of the five permanent members

Gerald Segal

of the Security Council. Beijing's temper tantrum merely highlighted the fact that, unlike the other veto-bearing Security Council members, it was not a power in Europe.

In the field of arms control, the pattern is the same. China does not block major arms control accords, but it makes sure to be among the last to sign on and tries to milk every diplomatic advantage from having to be dragged to the finish line. China's reluctance to sign the Nuclear Nonproliferation Treaty (NPT), for instance, was outdone in its theatricality only by the palaver in getting China to join the Comprehensive Test Ban Treaty. China's participation in the Association of Southeast Asian Nations Regional Forum—Asia's premier, albeit limited, security structure—is less a commitment to surrender some sovereignty to an international arrangement than a way to ensure that nothing is done to limit China's ability to pursue its own national security objectives. China matters in arms control mainly because it effectively blocks accords until doing so ends up damaging China's international reputation.

Only on the Korean Peninsula do China's capacities seriously affect U.S. policy. One often hears that China matters because it is so helpful in dealing with North Korea. This is flatly wrong. Only once this decade did Beijing join with Washington and pressure Pyongyang—in bringing the rogue into compliance with its NPT obligations in the early phases of the 1994 North Korean crisis. On every other occasion, China has either done nothing to help America or actively helped North Korea resist U.S. pressure—most notoriously later in the 1994 crisis, when the United States was seeking support for sanctions and other coercive action against North Korea. Thus the pattern is the same. China matters in the same way any middle-power adversary matters: it is a problem to be circumvented or moved. But China does not matter because it is a potential strategic partner for the West. In that sense, China is more like Russia than either cares to admit.

DOES CHINA MATTER POLITICALLY?

THE EASIEST category to assess—although the one with the fewest statistics—is how much China matters in international political terms. To be fair to the Chinese, their recent struggle to define who they are and what they stand for is merely the latest stage of at least

THE MOST POWERFUL COMPACT RADIO!



THE GRUNDIG 400PE AM/FM Shortwave Receiver

THE BIG BREAKTHROUGH!
Power, performance, and design have reached new heights! The Grundig 400 Professional Edition with its sleek titanium look is packed with features like no other compact radio in the world.

PINPOINT ACCURACY!
The Grundig 400PE does it all: pulls in AM, FM, FM-Stereo, every shortwave band (even aviation and ship-to-shore)—all with lock-on digital precision.

ULTIMATE FEATURES!
Auto tuning! The Grundig 400PE has auto tuning on shortwave and stops at every signal and lets you listen. With the exceptional sensitivity of the 400PE, you can use the auto tune to catch even the weakest of signals.

Incredible timing features! The Grundig 400PE can send you to sleep listening to your favorite music. You can set the alarm to wake up to music or the morning traffic report; then

switch to BBC shortwave for the world news. The choice is yours!

POWERFUL MEMORY!
Described as a smart radio with 40 memory positions, the Grundig 400PE remembers your favorites—even if you don't!

NEVER BEFORE VALUE!
The Grundig 400PE is only \$199.95 (plus \$10 shipping and handling). Includes deluxe travel pouch, stereo earphones, owner's manual, external antenna and a Grundig AC adaptor. One Year Warranty.



Not satisfied, you may return it within 30 days for a refund of your purchase price of \$199.95

THE GRUNDIG 400PE AM/FM Shortwave Receiver

To order, call us Toll-Free:
1-800-793-6542 Ext. 900FA

Please send _____ Grundig 400PE radio(s).

☐ Visa ☐ MasterCard
☐ Discover ☐ American Express

☐ I prefer to pay by check. Enclosed is my check for \$199.95 plus \$10 shipping/handling, a total of \$209.95 for each radio.

Credit Card No. (Please print clearly) _____ Exp. _____

Name: _____

Address: _____

City: _____

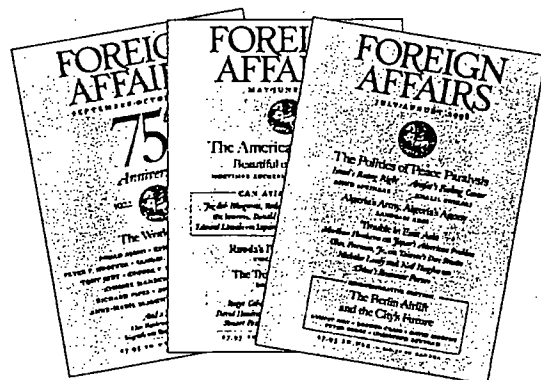
State: _____ Zip: _____

Signature: _____ (Orders subject to acceptance.)

We do not ship to a P.O. Box.
Add 8.25% sales tax for California residents.
Add 7% GST for Canadian orders.
Allow 2-4 weeks after initial payment for shipment. International orders fax (650) 361-1724 for shipping/handling charges.
Grundig Radio • PO Box 2185 • Menlo Park, CA 94026
3520 Haven Ave • Unit L • Redwood City, CA 94063

Intelligent analysis. Broad vision. Deep insight.

Is there a more perfect holiday gift than
FOREIGN AFFAIRS?



Gift subscriptions will start with the January/February issue when possible. Orders not received in time will begin with the next issue. For orders received after December 15th, gift cards will be sent directly to recipients in your name. For Canadian orders, please add \$10 for delivery. Foreign orders, please add \$35 for air-delivery.

When you give
FOREIGN AFFAIRS to someone with an interest in world events, you're giving the most thoughtful gift imaginable.

And with this special holiday gift offer, each gift is just \$32 — a savings of nearly one-third off our newsstand price!

Simply contact us (and mention "79XGA1" to receive the discounted gift price) with your gift recipients' names and addresses — and we'll rush you specially designed holiday cards so that you can announce your gift personally.

FOREIGN AFFAIRS. A gift that's welcomed six times a year!

Does China Matter?

150 years of soul-searching. Ever since the coming of Western power demonstrated that China's ancient civilization was not up to the challenges of modernity, China has struggled to understand its place in the wider world. The past century in particular has been riddled with deep Chinese resistance to the essential logic of international interdependence. It has also been marked by failed attempts to produce a China strong enough to resist the Western-dominated international system—consider the Boxer movement, the Kuomintang, or the Chinese Communist Party (CCP). Fifty years after the Chinese communist revolution, the party that gave the Chinese people the Great Leap Forward (and 30 million dead of famine) and the Cultural Revolution (and perhaps another million dead as well as a generation destroyed) is devoid of ideological power and authority. In the absence of any other political ideals, religions and cults such as the Falun Gong (target of a government crackdown this summer) will continue to flourish.

China's latest attempt to strengthen itself has been the past 20 years of economic reforms, stimulated by other East Asians' success in transforming their place in the world. But the discourse on prosperity that elicited praise for the order-sustaining "Asian values" or Confucian fundamentals was burned in the bonfire of certainties that was the Asian economic crisis. China was left in another phase of shock and self-doubt; hence, economic reforms stalled.

Under these circumstances, China is in no position to matter much as a source of international political power. Bizarre as old-style Maoism was, at least it was a beacon for many in the developing world. China now is a beacon to no one—and, indeed, an ally to no one. No other supposedly great power is as bereft of friends. This is not just because China, once prominent on the map of aid suppliers, has become the largest recipient of international aid. Rather, China is alone because it abhors the very notion of genuine international interdependence. No country relishes having to surrender sovereignty and power to the Western-dominated global system, but China is particularly wedded to the belief that it is big enough to merely learn what it must from the outside world and still retain control of its destiny.

Bereft of friends,
 China is a beacon to no
 one and an ally to
 no one.

So China's neighbors understand the need to get on with China but have no illusions that China feels the same way.

China does not even matter in terms of global culture. Compare the cultural (not economic) role that India plays for ethnic Indians around the world to the pull exerted by China on ethnic Chinese, and one sees just how closed China remains. Of course, India's cultural ties with the Atlantic world have always been greater than China's, and India's wildly heterogeneous society has always been more accessible to the West. But measured in terms of films, literature, or the arts in general, Taiwan, Hong Kong, and even Singapore are more important global influences than a China still under the authoritarian grip of a ruling Leninist party. Chinese cities fighting over who should get the next Asian Disneyland, Chinese cultural commissars squabbling over how many American films can be shown in Chinese cinemas, and CCP bosses setting wildly fluctuating Internet-access policies are all evidence of just how mightily China is struggling to manage the power of Western culture.

In fact, the human-rights question best illustrates the extent to which China is a political pariah. Chinese authorities correctly note that life for the average citizen has become much more free in the past generation. But as Zhu admitted on his recent trip to the United States, China's treatment of dissenters remains inhuman and indecent.

Still, China deserves credit for having stepped back on some issues. That China did not demand the right to intervene to help Indonesia's ethnic Chinese during the 1998-99 unrest was correctly applauded as a sign of maturity. But it was also a sign of how little international leadership China could claim. With a human-rights record that made Indonesia seem a paragon of virtue, China was in no position to seize the moral high ground.

Measuring global political power is difficult, but China's influence and authority are clearly puny—not merely compared to the dominant West, but also compared to Japan before the economic crisis. Among the reasons for China's weakness is its continuing ambiguity about how to manage the consequences of modernity and interdependence. China's great past and the resultant hubris make up much of the problem. A China that believes the world naturally owes it recognition as a great power—even when it so patently is not—is not really ready to achieve greatness.

DOES IT MATTER IF CHINA DOESN'T MATTER?

THE MIDDLE KINGDOM, then, is merely a middle power. It is not that China does not matter at all, but that it matters far less than it and most of the West think. China matters about as much as Brazil for the global economy. It is a medium-rank military power, and it exerts no political pull at all. China matters most for the West because it can make mischief, either by threatening its neighbors or assisting anti-Western forces further afield. Although these are problems, they will be more manageable if the West retains some sense of proportion about China's importance. If you believe that China is a major player in the global economy and a near-peer competitor of America's, you might be reluctant to constrain its undesired activities. You might also indulge in the "pander complex"—the tendency to bend over backward to accommodate every Chinese definition of what insults the Chinese people's feelings. But if you believe that China is not much different from any middle power, you will be more willing to treat it normally.

This notion of approaching China as a normal, medium power is one way to avoid the sterile debates about the virtues of engaging or containing China. Of course, one must engage a middle power, but one should also not be shy about constraining its unwanted actions. Such a strategy of "constraintment" would lead to a new and very different Western approach to China. One would expect robust deterrence of threats to Taiwan, but not pusillanimous efforts to ease Chinese concerns about TMD. One would expect a tough negotiating stand on the terms of China's WTO entry, but not Western concessions merely because China made limited progress toward international transparency standards or made us feel guilty about bombing its embassy in Belgrade. One would expect Western leaders to tell Chinese leaders that their authoritarianism puts them on the wrong side of history, but one would not expect Western countries to stop trying to censure human rights abuses in the United Nations or to fall over themselves to compete for the right to lose money in the China market.

To some extent, we are stuck with a degree of exaggeration of China's influence. It has a permanent U.N. Security Council seat even though it matters about as much as the United Kingdom and France, who hold their seats only because of their pre-World War II

Gerald Segal

power. Unlike London and Paris, however, Beijing contributes little to international society via peacekeeping or funding for international bodies. China still has a hold on the imagination of CEOs, as it has for 150 years—all the more remarkable after the past 20 years, in which Western companies were bamboozled into believing that staying for the long haul meant eventually making money in China. Pentagon planners, a pessimistic breed if ever there was one, might be forgiven for believing that China could eventually become a peer competitor of the United States, even though the military gap, especially in high-technology arms, is, if anything, actually growing wider.

Nevertheless, until China is cut down to size in Western imaginations and treated more like a Brazil or an India, the West stands little chance of sustaining a coherent and long-term policy toward it. Until we stop suspending our disbelief and recognize the theatrical power of China, we will continue to constrain ourselves from pursuing our own interests and fail to constrain China's excesses. And perhaps most important, until we treat China as a normal middle power, we will make it harder for the Chinese people to understand their own failings and limitations and get on with the serious reforms that need to come. ☸

What to Do With American Primacy

Richard N. Haass

WE'RE NUMBER ONE. NOW WHAT?

WE LIVE in an era of contradictions: globalization and fragmentation, peace and conflict, prosperity and poverty. Only when one or more of these tendencies wins out will our era gain a name of its own, displacing the awkward "post-Cold War" tag line. But amid this uncertainty is the stark reality that the United States is the most powerful country in the world—first among unequals. Still, this is a description, not a purpose or a policy. The fundamental question that confronts America today is how to exploit its enormous surplus of power in the world: What to do with American primacy?

It must be said at the outset that America's economic and military advantages, while great, are neither unqualified nor permanent. The country's strength is limited by the amount of resources (money, time, political capital) it can spend, which in turn reflects a lack of domestic support for some kind of American global empire. De Tocqueville's observation that democracy is ill suited for conducting foreign policy is even more true in a world without a mortal enemy like the Soviet Union against which to rally the public.

Moreover, U.S. superiority will not last. As power diffuses around the world, America's position relative to others will inevitably erode. It may not seem this way at a moment when the American economy is in full bloom and many countries around the world are sclerotic, but the

RICHARD N. HAASS is Vice President, Director of Foreign Policy Studies, and Sydney Stein, Jr., Chair in International Security at the Brookings Institution.



Foreign Policy
Research Institute

WIRE

Volume 7, Number 8

A Catalyst for Ideas

July 1999

IS CHINA UNSTABLE?

by Minxin Pei

Western attitudes toward China tend to oscillate between two extremes, often with confusing rapidity. Not too long ago China was widely portrayed as an emerging military and economic threat to the West. Its total economic output was projected to surpass that of the United States in two decades. Its military modernization was expected to provide China the capability to project its power far beyond its borders (and the recent Cox report on nuclear espionage has revived those concerns). And its authoritarian regime was supposed to be able to retain its grip on power for a long time.

Nowadays, however, the speculation about China's future has generally inclined toward pessimism. The influential British magazine *The Economist* openly speculated about the break-up of China in its last issue of 1998. Not long before that, the same publication ran a cover editorial opining about the imminent collapse of the Chinese economy. And in a speech delivered in April of this year, President Bill Clinton warned of the dangers of an unstable China which failed to reform.

Even within China, signs of danger and nervousness abound. Arguably, the Chinese government now faces the most severe challenge since the Tiananmen Square demonstrations a decade ago. Unemployment is rising at a frightening rate. Several key anniversary dates fraught with symbolic and real political dangers (such as the 50th anniversary of the People's Republic, the 10th anniversary of the Tiananmen Square crackdown, and the 40th anniversary of the uprising in Tibet) have prompted the government to maintain a tight watch over the country's tiny dissident community lest something akin to the 1989 movement break out again.

In my judgment, the current pessimism about China's short-term prospects is as exaggerated as the previous optimism about its long-term economic outlook. In fact, China is likely to retain its short-term political stability despite many signs of potential turmoil, but will face rising instability if the regime fails to undertake significant political reform in the next decade.

CHINA'S CURRENT DIFFICULTIES

While parallels between the problems China faces today and those it confronted during the Tiananmen crisis a decade ago may be alluring, they are misleading. In 1989, the Chinese Communist Party (CCP) faced a genuine crisis of political legitimacy, which had its origins in 1978-79, when the leaders

promised, but repeatedly failed to deliver, political reform. By contrast, the challenges confronting the Chinese government today are primarily economic, although weaknesses in the political system make potential solutions more elusive.

Specifically, China's economic difficulties today originate, externally, from the aftermath of the East Asian financial crisis (falling exports and foreign direct investment) and, internally, from weak consumer demand and severe structural problems. The internal problems are far more daunting than the external.

It is well known that China's two most perilous economic challenges are an insolvent banking system (which has total bad loans of between 25 and 30 percent of gross domestic product) and rising unemployment due to the restructuring and privatization of the loss-making state-owned enterprises (SOEs). Many analysts believe that the latter poses the clearest threat to the Chinese government, because any unrest by the unemployed, who are concentrated in urban areas, would lead to a political crisis akin to the Solidarity movement in Poland in 1981-82. Given the sheer numbers of unemployed and underemployed people in China, this analysis is not without merit. The official China Daily reports that, among urban dwellers, unemployment is about 11 percent (or 16 million people). In addition, as many as 120 million rural laborers are considered underemployed.

However, unemployment alone is unlikely to generate a high level of political instability and is even less likely to bring down the regime. (Can you recall the last time a regime was toppled by unemployment?) In analyzing the political consequences and implications of economic crises, we must understand that not all economic crises are created equal. Although all of them are nasty and harmful to the societies they hit, they produce different political outcomes because their effects are filtered through the political system differently.

In the case of high unemployment, its impact on political instability tends to be limited for two reasons. First, unemployment principally affects only one segment of society, namely, manufacturing workers. It would be difficult for these workers to find political allies in other sectors. In China, workers being laid off from SOEs are viewed as industrial

aristocrats who have had it pretty good for the last fifty years at the expense of the other segments of society. Second, the ranks of the unemployed are relatively fluid. Many unemployed, especially the most able, can find alternative employment. This leaves the ranks of the unemployed without permanent leaders and unorganized.

By contrast, a full-blown banking crisis is far more lethal, because it triggers hyperinflation and a massive run on banks. Unlike unemployment, which tends to hit one segment of society especially hard, a banking crisis would hurt virtually everyone (except the very wealthy). Such a crisis sends out a political signal to the majority of the population that something is terribly wrong, thus facilitating unity and coordination among all the disaffected elements, from the peasantry to the unemployed to the middle-class. A broad anti-regime coalition is therefore more likely to emerge following a banking crisis than high unemployment.

This reasoning leads us to question the conventional wisdom about the connection between the recent crackdown on dissidents and the country's economic problems. Most analysts believe that the government's crackdown was motivated by the fear that dissidents would form a Solidarity-type coalition with the unemployed to challenge the Communist Party's rule. This analysis, while appealing, overlooks another probable explanation. The government's crackdown could well have been motivated, not by the fear of unemployment, but by the fear that any signs of political instability would shake the population's confidence in the government, and hence in the security of their assets. Fearing the loss of their life savings, ordinary Chinese (who have over 80 percent of their total assets deposited in the banks) would unleash a run on banks, which would force the government to print more money to cover the withdrawals, in turn sparking hyperinflation and massive popular discontent.

THE VULNERABILITIES OF THE COMMUNIST PARTY

To be sure, the current economic difficulties have caught the Communist Party in a particularly vulnerable state. Specifically, the ruling party faces the following structural and institutional weaknesses:

1. *Narrower base of support.* Despite the Western media's caricature of the ruling regime as a communist dictatorship, the nature of the Chinese regime has changed profoundly in the last two decades. If we may call the pre-reform Chinese regime a socialist one with a broad base of support among workers and peasants, pro-market reforms have seriously eroded the broad social base of the CCP. This change has come about, ironically, precisely because of the relative success of the economic reform under Deng Xiaoping. For the peasantry, market-oriented reforms have resulted not only in direct economic benefits and independence from the state; they have fundamentally eroded the Communist Party's political control in rural areas and left the regime without means of mobilizing political support there. As for urban SOE workers, market-oriented reforms have begun to hurt their interests by making their jobs insecure and benefits less generous. They blame their plight on the government and have begun to display their discontent openly and violently.

The regime's political support today comes primarily from only four groups: the bureaucracy, the military, the security forces, and the rapidly increasing urban middle-class that will have much to lose (such as the value of their stocks and real estate) in the event of political instability.

2. *Organizational deficit.* The CCP previously controlled a vast network of social organizations, including the official labor unions, women's associations, the youth league, and many professional associations, which in turn controlled most segments of the population. But that is no longer the case. Official organizations closely tied to the party have lost credibility, enjoy little grassroots support, and cannot be expected to serve as instruments of control or political support. Other organizations, notably, religious groups and professional associations, have become more independent and will likely resist manipulation by the party.

3. *Weak institutional channels of resolving state-society conflict.* A related weakness of the present political system is the absence of credible institutions that would allow individuals and groups to articulate and pursue their own interests. In democratic systems, electoral and legislative processes do this, but in China, no institutions perform such functions reliably. In their absence, collective grievances will accumulate, leading in the long term to political instability. In the short term, collective grievances are increasingly expressed in violent protests. In fact, the government admitted there were 5,000 collective protests in 1998.

4. *Absence of effective institutions to resolve conflicts within the state.* China also has no functioning institutions that might resolve conflicts among the various components of the state. The absence of such institutions, which would typically be provided for by federalism, causes cyclical opportunism characterized by frequent policy changes by the central government and resistance to those policies from local governments. Consequently, the policy environment is uncertain and law enforcement weak. In fact, the most serious problem facing China is not that it does not have democracy, but that it does not have federalism. That is, it lacks a clear division of responsibilities between the central and regional governments.

HIDDEN STRENGTHS OF THE REGIME

I have listed a series of structural weaknesses of the party-state in China. However, it would be wrong to conclude from the above observations that the system is about to collapse, for there are several strengths that help offset these weaknesses.

Weak opposition. Domestically, the CCP faces no real threat. Because opposition to the regime is unorganized and dispersed, for most people there is simply no credible alternative. This is perhaps the most important factor working in the CCP's favor. A party song states, "Only the CCP can save China," but it should be, "Only the CCP can govern China" -- at least for now.

Relative elite cohesion. Political turmoil in China in the last 50 years has always come from disunity and power struggles at the highest level of the regime. Today's top elite is much more unified than during any previous period. The political

differences between top elites today are mainly over policy and personality, rather than over ideology.

The CCP remains a formidable force of control. Because the party maintains a relatively effective system of control in dealing with top-priority issues, in the short term it should be able to confront any challenges to its hold on power. The CCP has also learned a key lesson from the 1989 movement: never to allow a minor incident to develop into a full-blown political crisis. That explains why the government reacted swiftly and harshly against the leading dissidents in the last few months.

The Chinese are beginning to tackle their long-term problems. It is encouraging to see that some of the top leaders seem to have realized the long-term threats to the current system and have begun to take some tentative steps to address them. It seems that ideas of federalism are beginning to influence institutional designs in China. Among the most promising steps taken so far is the reform of the central bank along the lines of a Federal Reserve-style system. Moreover, the 1994 tax reform, although far from perfect, was the first step toward fiscal federalism.

CONCLUSION

Although localized incidents of social unrest, sparked mostly by economic difficulties, are likely to increase, the Communist Party should be able to avert significant political turmoil in the near future. However, even if the Chinese government gets through 1999 without a repeat of 1989, it must soon confront the issue of political reform more seriously, because the challenges it poses will only increase as

time passes. If no significant institutional change is undertaken, China will experience rising tensions that its current political system will be incapable of handling. Failure to implement political institutional reforms may lead to rising instability through three mechanisms, either simultaneously or sequentially. First, failure to reform will reduce economic efficiency as the costs of insecure property rights, poor contract enforcement, and exorbitant rents become more baneful. This will inevitably reduce the rate of growth, which will further exacerbate social tensions and damage the legitimacy of the Communist Party. Second, failure to reform will allow corruption to worsen, inequality to rise, and poor governance to persist, eventually causing a massive social explosion such as occurred in Indonesia in May 1998. Third, failure to reform will cause rising division within the current moderate-conservative ruling coalition as the more liberal elements become disenchanted and frustrated with the slow pace of reform. A split within the elite has led to political instability before, and could easily do so again.

Indeed, although China is unlikely to become another Indonesia today, it is very likely to become one in ten years' time if its leaders are lulled into complacency.

Minxin Pei, a senior associate with the Carnegie Endowment for International Peace, is the author of From Reform to Revolution: The Demise of Communism in China and the Soviet Union (Harvard University Press, 1994), and numerous articles on Chinese politics. He is a member of FPRI's Study Group on U.S.-China Relations.

Foreign Policy Research Institute, 1528 Walnut Street, Suite 610, Philadelphia, Pennsylvania 19102-3684
For membership information, contact Alan Luxenberg: (215) 732-3774, ext. 105.

FPRI's Asia Program

Headed by Avery Goldstein, FPRI's Asia Program analyzes important developments in East Asia and assesses their implications for U.S. policy. Among the activities of the Asia Program are an annual conference, regular meetings of FPRI's Inter-University Study Group on U.S.-China Relations, and a series of essays in FPRI bulletins and in Orbis, FPRI's quarterly journal of world affairs, plus articles in other scholarly journals. Below is a partial list of recent publications emerging from this program.

"Montevideo Games and a Chinese Puzzle: The PRC, International Law, and the Taiwan Question," by Jacques deLisle, *Orbis*, Fall 1999 (forthcoming)

"The Taiwan Relations Act: Durable Agreement or Fraying Framework?," by Harvey Sicherman and Avery Goldstein, *FPRI Wire*, September 1999 (forthcoming)

"China and the History of Sea Power in the Pacific," by Walter A. McDougall, *Night Thoughts*, July 1999

"China's Quest for Great Power Identity," by Gilbert Rozman, *Orbis*, Summer 1999

"The Inscrutable Americans, Zhu Rongji, and the Deal that Wasn't," by Harvey Sicherman, *FPRI E-Notes*, 4/23/99

"The Unraveling of Russia's Far Eastern Power," Felix K. Chang, *Orbis*, Spring 1999

"How to Deal With Beijing," by Avery Goldstein, *FPRI E-Notes*, March 1, 1999

"The Chinese Economy: A New Scenario," edited by Murray Weidenbaum and Harvey Sicherman, *FPRI Report*, 2/99

"Religious Revivals in Communist China," by Arthur Waldron, *FPRI Wire*, February 1999

"The Russian Far East's Endless Winter," Felix K. Chang, *Orbis*, Winter 1999

"The Asian Miracle, the Asian Contagion, & the U.S.A.," by Theodore Friend, *FPRI Wire*, December 1998

"Taiwan's December Elections: Implications for Beijing," by Deborah A. Brown et al., *FPRI E-Notes*, 12/11/98

"Which Way for Sino-Russian Relations?," by Stephen Blank, *Orbis*, Fall 1998

"Indonesia in Flames," by Theodore Friend, *Orbis*, Summer 1998

"How to Respond to Asia's Nuclear Arms Buildup," by John H. Maurer, *FPRI E-Notes*, June 23, 1998

"The Year of Living Denglessly: China Under Jiang," by Avery Goldstein, *FPRI E-Notes*, June 11, 1998

"The Asian Panic, Round Two," by Harvey Sicherman, *FPRI E-Notes*, May 22, 1998

"Second Thoughts About China's Military Power," by Avery Goldstein, *FPRI Wire*, April 1998

"Untying the Taiwan Knot," Ben Stavis, *FPRI Wire*, February 1998

Will China Become Another Indonesia?
by Minxin Pei

This abstract is adapted from an article appearing in the Fall 1999 issue of FOREIGN POLICY magazine.

The fall of the Suharto regime in Indonesia in May 1998 was one of the swiftest reversals of national fortune in the developing world in this century. Although the immediate cause of its demise was the East Asian financial crisis, the deeper and more fundamental causes of the country's economic collapse and subsequent political turmoil were the accumulated institutional decay and stresses within the Indonesian political system.

The collapse of Suharto's regime had a profound impact on policy makers in China, who faced similar problems. To their credit, Chinese leaders quickly learned the main economic lessons of the crisis and adopted several reform measures that have temporarily shored up China's shaky financial system. Unfortunately, the preoccupation of China's leaders with the economic causes of the crisis has also made them oblivious to its deeper political and institutional roots.

Although a swift and spectacular regime collapse may be less likely in China than in Indonesia, the Chinese political system must contend with nearly identical weaknesses: systemic corruption and feeble state institutions that are incapable of protecting property rights or resolving conflicts between the state and society.

Together with Indonesia, China shares the distinction of being one of the most corrupt countries in East Asia. Data released in the Chinese official media show that corruption may cost China about 4 percent of gross domestic product each year. Measured in broader terms, however, corruption may take a much greater toll on the Chinese economy: stifled markets and looted public assets, weakened state capacity and increased financial risks, and undersupplied public goods.

China's dysfunctional fiscal system and weak institutions of political accountability (a concept without a full Chinese equivalent) are the two most important causes of systemic corruption. The political origin of such endemic corruption is the Chinese Communist Party (CCP)'s chronic inability to cleanse itself. The dilemma faced by the CCP was best summarized by the late Chen Yun, a senior leader known for his conservative ideology and economic policy: "Not fighting corruption would destroy the country; fighting it would destroy the party."

China's weak legal institutions incur real economic costs. Investors cannot be certain that their contracts and property rights will be secure. Although it is difficult to measure the economic costs of a weak legal system, reports in the official press indicate that they may be substantial, leading to fragmented markets, curtailment of private investment, and greater personal risks to business executives and entrepreneurs.

The weakness of the legal system reflects a larger problem that is the principal source of tensions within the Chinese state: the lack of federalist institutions and constitutional guarantees protecting the power of local governments from the infringement of central authorities. There are no effective constraints on the abuses of power by the central government. Local authorities thus protect themselves against such unpredictable shifts through well-known subterfuges. This cycle of opportunism is at the heart of the paradox of centralization and ineffectiveness—a seemingly all-powerful central government constantly stymied in its effort to implement its policies and enforce its laws.

Such puzzles are not unique to China. The Chinese state in the post-Deng Xiaoping era is among a handful of countries that have retained a peculiar 20th-century invention—the party-state. There are, however, long-term degenerative flaws in a party-state, which are all too visible in present-day China. The organizational decay and ideological decline of the CCP have greatly impaired state effectiveness. And despite an expansion in personal freedom and progress in creating mechanisms to mediate conflicts between the state and society, China still lacks effective and inclusive institutions and processes to resolve such conflicts and express the interests of its people.

Scholars of Indonesian politics believe that President Suharto had the opportunity to implement political reforms in the early 1980s after achieving a period of impressive economic growth and restoring political order to his country. However, instead of strengthening key political institutions and opening up the political process, the Suharto regime retrenched. For those who hold that autocrats never give up power voluntarily and must be ousted by their people, Suharto's fall was perhaps predetermined.

Will the same turbulent course of events repeat itself in China? Present-day signs are not encouraging. Beijing's procrastination on reform will only undermine China's political stability, instead of strengthening it. It is difficult to imagine that China can maintain high rates of growth (upon which the party's legitimacy precariously rests) if the costs of corruption are not cut through reform. The level of political instability may also rise, and internal tensions could build.

Then again, Chinese leaders today are perhaps better positioned than Suharto was at a comparable stage. A combination of pressures from the market and tactical political decisions has created or revitalized institutional arrangements that could constitute the building blocks for reform. But this window of opportunity for political reform will not remain open for long. Experience shows that autocratic regimes that reform from a position of relative strength generally fare better than those forced to reform by crisis.

The cold and cruel logic of political reform—those who can, will not; those who try when forced, cannot—has been tragically validated in all too many countries, Indonesia included. Now it falls to China to prove whether this logic is right or wrong.

September 30, 1999

AWSJ Column: Beijing Needs To Act Decisively

By GORDON G. CHANG

(Editor's Note: This is an opinion piece from Friday's Asian Wall Street Journal. Chang is an attorney in Beijing with an international law firm.)

BEIJING -- As the People's Republic of China celebrates its 50th birthday, the economic forecasts coming out of Beijing are getting rosier. Some are even predicting that China will blossom into the world's biggest economy by 2015. But Beijing's leaders should not get carried away with their rhetoric. Deng Xiaoping was fond of saying, "Seek truth from facts." The facts today say the years of real growth are over and China's economy is in decline.

The signs of economic decay are everywhere. Deflation has gripped the economy for two years. Beijing has tried, without success, almost every macroeconomic tool to restart domestic consumption. The ordinary comrade, seeing what is happening around him, views an uncertain future. China's big four commercial banks are insolvent and have racked up trillions of yuan in bad and nonperforming loans. Lenders, domestic as well as foreign, cannot recover from borrowers protected by a decrepit legal system.

China's state-owned enterprises are at the heart of the problem. Once the backbone of the economy, they are dying, hopelessly uncompetitive, even in China's restrictive economic system. Mountains of obsolete inventory scar balance sheets. Foreign investment sinks by the month. Corruption eats away at the fabric of the economy, and foreign currency flees the country.

Can Beijing prevent the economic tragedy that is unfolding? Yes, but only if the central government recognizes the urgency of the problems and if it acts decisively—two big "ifs" in these days of apparent political stalemate in Beijing.

China's leaders, to their credit, recognize that problems exist. Every day brings a torrent of new edicts from ministries in the capital. Beijing seems, however, to fail to understand the urgency of the tasks that confront China. If left unsolved, the country's economic problems will threaten the stability of Chinese society.

Today, China is half way to somewhere with no clear consensus as to the future. It suffers from the pain of a transition partially completed, yet at the same time does not enjoy many of the benefits of modernization. Liberalization, if pursued, would help China, but a half-liberalized society stagnates. China is drifting, afraid to go forward but unwilling to turn back.

In the meantime, the situation becomes even more serious. Yes, the economy is growing, but growth is largely the product of fiscal stimulus. China, which had little debt at the beginning of this decade, now borrows continually. It builds roads and bridges and dams. It hands out pay increases to civil servants. All in the hope of reigniting domestic spending. None of this, however, impresses China's own citizens, who see hard times ahead and save accordingly.

Today, Beijing supports SOEs by a stream of "loans" from state-owned banks. Turn off the tap and thousands of these relics of China's Stalinist past will collapse. Contrary to popular belief, most of the doubtful assets in the banking system were created this decade, not long ago. In the 1990s, things are getting worse, not better, as far as the fragile banks are concerned.

All the while China moves closer to the day of final reckoning, the day when the cupboard is bare and Beijing can borrow no more. At that time it is hard to see how central planners will keep the economy going. When will this occur? Some predict, at the current rate of spending, two years. That estimate seems overly gloomy, but Beijing cannot borrow at this pace for very long, especially without substantially increasing tax and customs revenues. In any event, China has a decade at most to put things right.

If public spending won't work, how about reform? Unfortunately, Beijing is in denial as to the extent of the problems. For example, China's central bank still insists that bad loans, defined as those that are unrecoverable, constituted only 2.9% of total assets in China's financial system at the end of last year. Most outside observers think that the real figure is many multiples of that. China can't fix insolvent banks, or any other problem for that matter, until it recognizes the dimensions of the problems.

Reform has little chance of succeeding until Beijing is willing to make hard decisions. Gradualism, unfortunately, appears to have become enshrined as official Communist Party doctrine. Cadres in the capital are famous for making small changes on an experimental basis and waiting to see the results. A period of examination then is followed by a period of further tinkering. China's bankruptcy statute has been a "trial" law for almost 14 years. A proposed antitrust law has been debated behind the scenes for about 10. There is reform, but progress is made at the speed of molasses.

Privatization probably won't work either, at least as it is presently conceived. Now, Beijing insists on keeping control of the bigger enterprises. Minority interests held by financial investors seem to have had little effect as far as modernization goes. Except in low-end goods and labor intensive products, these firms, with just a handful of exceptions, are not competitive outside the protected confines of China's economy. Real reform is still a stranger to many of the larger enterprises.

Finally, many of Beijing's policies are simply moving China in the wrong direction. Take competition policy, to pick perhaps the most important. Central planners have decided that, in order to make China's enterprises competitive in an increasingly tough world, they will, by administrative fiat, make them bigger and less subject to competition. Beijing is busy consolidating many industries, such as cement and airlines to name two that have made the headlines recently. Sure, China's companies need to be bigger to win in the world's marketplaces. But they need to become bigger through competition, not government edict. Rules restricting, and even outlawing, price decreases are simply unrealistic in a China plagued by overcapacity in virtually every industry.

Beijing's gradual methods are not suited for the severe problems that plague China. While China is stuck half way between a command economy and a free market system, the nation suffers. The biggest economy in the world in 2015? Unless Beijing acts decisively and acts now, economic failure is a more likely scenario.

Sino-American relations have been marked recently by conflict and controversy over Chinese espionage, WTO membership for China, and the American bombing of the Chinese embassy in Belgrade. "Although the past six months may appear to have caused irreparable damage to Sino-American relations, a longer view would argue that the current deterioration is not exceptional, but to be expected."

Getting China Right

ELIZABETH ECONOMY

Viewed through the lens of nearly a half-century, great strides have been made in relations between the United States and the People's Republic of China. In 1950, trade and diplomatic ties were nonexistent, and the two countries were at war over the Korean Peninsula. Today, bilateral trade totals \$85 billion, China and the United States exercise the full range of diplomatic relations, and the two countries are working together to ensure the stability of North and South Korea. Both the United States and China share clear interests in maintaining peace in the Asia-Pacific, enjoying the fruits of an expanding global economy, and protecting their citizens against global threats such as weapons proliferation, environmental pollution, and narcotics trafficking.

Despite such accomplishments and shared interests, America's relationship with China has been contentious, prone to frequent stops and starts. During the past year, the two countries appeared poised to make substantial progress on a wide range of issues, including human rights, trade, and environmental protection. Bill Clinton's visit to China in June 1998 marked the first trip by an American president to China in almost a decade. During the summit, the Chinese leadership took the unprecedented step of televising a press conference between President Clinton and Chinese President Jiang Zemin in which the two leaders engaged in a frank discussion of human rights. The two men

also signed a number of agreements on weapons proliferation, the environment, the rule of law, and commercial ventures.

The atmosphere of goodwill and increased expectations for future progress in the relationship proved short-lived. In the aftermath of the summit, domestic politics in both countries led to a series of crises that rocked relations. It was the mistaken bombing of the Chinese embassy in Belgrade by American-led NATO forces, however, that precipitated China's decision in May 1999 to suspend all military, trade, and human rights discussions with the United States.

This precipitous decline in relations is neither surprising nor without precedent. China has long inspired vociferous debate within the United States government, stirring equally strong emotions among supporters and detractors. There is a general consensus that American interests would be best served by a China that adheres to the rule of law, acts responsibly with regard to security in the Asia-Pacific and globally, and participates fully in the global system of free trade. However, a deep and persistent political cleavage has emerged within the policymaking community and among important sectors of American society over whether such a vision is realistic and attainable. The division is especially evident between the executive and legislative branches of the United States government.

PARTNER OR THREAT?

The executive branch and its supporters in Congress and among the American public, especially the business community, traditionally have articulated, either implicitly or explicitly, a long-term strategy of "engagement": involving China in a range of multilateral agreements and accords and pursuing extensive bilateral trade and other rela-

ELIZABETH ECONOMY is senior fellow for China and deputy director for Asia Studies at the Council on Foreign Relations. Her most recent publications include "Painting China Green," *Foreign Affairs* (March-April 1999) and, as coeditor with Michel Oksenberg, *China Joins the World: Progress and Prospects* (New York: Council on Foreign Relations Press, 1999).

tions. It is believed that expanding such relations will ensure that as China's economic and military influence increases, it will develop institutions—such as the rule of law, an open market, and a more pluralistic society—that will help it adhere to its international agreements and become a constructive partner for the United States.

The legislative branch and other sectors of the American public offer a sharply different assessment. They argue that engaging China over the past several decades has yielded little real progress. On the issues of greatest importance to the United States, such as improving China's human rights practices, securing a more favorable bilateral trade relationship, and limiting China's role in weapons proliferation, the People's Republic continues to ignore international norms and to act contrary to United States interests. In this view, China is likely to emerge as a threat—perhaps similar to that posed by the Soviet Union. Hence the United States should concentrate on containing China's growth and more willingly employ sanctions or threats to elicit the desired changes in the country's behavior.

In China the domestic political scene is equally polarized. Top Chinese leaders remain committed to pursuing closer bilateral ties with the United States. But there is a growing sense among some in the Chinese leadership, military, and citizenry that American policy toward China on issues such as trade, environmental protection, and weapons proliferation are designed to maintain the status quo and prevent China from achieving its political and economic potential. Moreover, a seeming lack of consistency in American policy, especially over the sensitive issue of Chinese sovereignty over Taiwan, has left a deep imprint of mistrust and confusion in the minds of many Chinese policymakers.

The politics and policy differences that have conspired to derail the Sino-American relationship time and again, and that are at the root of the most recent deterioration in relations, have their origins in the shared history of the two countries. Crafting a sustainable China policy that can withstand the inevitable frictions requires first an understanding of this history and the interests at stake in the relationship.

FROM ESTRANGEMENT TO ENGAGEMENT

In the immediate aftermath of the 1949 victory of the Chinese Communist Party and the defeat of the American-supported Nationalists led by Chiang Kai-shek in the Chinese civil war, the United States and China found little common ground. The two

countries squared off on opposite sides of the conflict in the Korean Peninsula; as a result, the United States embargoed trade and investment, as well as travel to China. China established a formal alliance with the Soviet Union. In 1954 President Harry S. Truman reversed his initial position on the critical question of Chinese sovereignty over Taiwan and signed a mutual defense treaty with the Nationalist leadership, recognizing the Republic of China on Taiwan as the legitimate government of China.

Improved Sino-American relations remained elusive until the late 1960s and early 1970s, when shared concern about the Soviet Union prompted both sides to initiate negotiations. President Richard Nixon's visit to China in 1972 ushered in a new era in the relationship, with the United States and China agreeing to set aside their conflict over Taiwan in pursuit of broader strategic interests. Cultural exchanges flourished, and in 1979, following the establishment of formal diplomatic relations and American recognition of the People's Republic of China as the sole legal government of China, the two sides began to explore the vast potential of the relationship. As China initiated economic reforms, bilateral trade and American investment in China soared; educational and cultural exchanges developed rapidly; and security ties deepened through military exchanges. Indeed, during the mid-1980s, the United States began to see signs of greater political openness and debate in China, the emergence of private entrepreneurs, and new forms of semi-private associations among Chinese citizens.

At the same time, the relationship was punctuated by frequent conflict. Shortly after President Jimmy Carter normalized relations with China in 1978, Congress passed the Taiwan Relations Act, which guaranteed continued trade and cultural relations with the island and provided assurances for Taiwan's security. Beijing condemned both the act and subsequent American arms sales to Taiwan as violating the 1978 communiqué normalizing relations. However, in August 1982, President Ronald Reagan and Prime Minister Zhao Ziyang negotiated a communiqué between the United States and China on American arms sales to Taiwan that staved off a crisis in the relationship. Still, other difficulties emerged between the two countries on trade issues such as textile imports to the United States, Chinese restrictions on foreign investment, and American constraints on the sale of advanced technology to China. American policymakers also voiced serious concern about Chinese nuclear proliferation and arms sales.

TIANANMEN

Despite the frequent frictions, the decade spanning 1979 to 1989 represented a dramatic improvement in relations at all levels of society and government. This period ended abruptly when the Chinese government sanctioned a violent crackdown on Chinese students demonstrating for greater political freedoms in and around Tiananmen Square on June 4, 1989. The government's suppression resulted in the death of hundreds of demonstrators, as well as the ouster of the most reform-oriented leaders within China, including Prime Minister Zhao.

The reaction from the United States was immediate and severe. Congress placed sanctions on all forms of government assistance and exchange, and annual renewal of most favored nation trade status for China was tied to progress in the country's human rights record. Tiananmen became a reference point for an entire generation of thinking about China, especially the potential for future change in China; more than 15 years of the United States policy of engagement was drawn into question.

The events at Tiananmen, and the American response, exposed the fragile foundation upon which the Sino-American relationship rested. From the outset of United States relations with China, a vast chasm had separated the two countries on fundamental issues of governance, such as sovereignty, Taiwan, economic development, and military security. While many in both countries have made efforts to reestablish the linkages and ties that were severed because of Tiananmen, it has been a difficult process. Certainly, a consensus in the United States policymaking community as to the merits of re-engaging China has yet to emerge. Indeed, the positions have only solidified over time.

In early 1994 President Clinton took steps to end the linkage between trade and human rights. In a move that defied his own campaign rhetoric—which had criticized engagement with China as untenable—the president gambled that a return to the earlier policy of engagement would best advance American interests in China. Throughout the mid-1990s, and in the face of significant congressional opposition, the White House repeatedly tried to pave the way for a sustained improvement in relations by working quickly to resolve potential crises such as China's sale of M-11 short-range mis-

sile technology to Pakistan, violations of American companies' intellectual property rights, and the imprisonment of Chinese-American human rights activist Harry Wu.

In 1995 and 1996, conflict over Taiwan produced a serious crisis and near military confrontation between the United States and China. In 1995 Taiwanese President Lee Teng-hui requested a visa to the United States to attend his reunion at Cornell University, thereby testing the limits of a tacit ban on official visits by senior Taiwanese officials to the United States. The State Department assured China that Lee would not receive a visa. However, in the face of overwhelming congressional support for President Lee's visit, President Clinton reversed his decision. China responded by conducting surface-to-surface short-range missile tests off the coast of Taiwan. Less than a year later, in March 1996, China

again held missile tests in an area just off Taiwan in an effort to intimidate Taiwanese voters before Taiwan's first direct presidential election. The United States responded by sending two carrier battle groups near the strait.

Recrimination, retribution, and reconciliation have characterized the relationship since the establishment of diplomatic relations in 1979.

RELATIONS BACK ON TRACK. . .

Despite the missile crises and the other challenges to the relationship, improving bilateral ties remained a central priority for leaders of both countries. In March 1997 they resumed the process of summitry that had been suspended in the wake of Tiananmen with an initial visit to China by Vice President Al Gore. The trip came at a time when the political atmosphere in the United States was not auspicious: the FBI was in the midst of investigating whether China had attempted to influence the 1996 presidential and congressional elections by making illegal campaign contributions to a number of candidates, including the president and vice president.

The subsequent visit by Chinese President Jiang Zemin to the United States the following October signified a step forward in the relationship. Presidents Jiang and Clinton established a new conceptual framework for Sino-American relations: a "constructive strategic partnership." While slight on detail, it was hoped that this framework for cooperation would further progress on a set of common objectives such as peace on the Korean Peninsula and combating the proliferation of weapons of mass destruction.

Jiang and Clinton also attempted to strengthen

the foundation of the relationship by establishing a more formal framework, in the form of "nine baskets," to facilitate bilateral discussion and cooperation on a range of functional issues such as the rule of law, drug trafficking, and environmental protection. The summit concluded with more than 20 agreements in the nine different issue areas, including the resumption of Sino-American military exchanges, and the initiation of cooperative ventures between Chinese and American agencies.

Despite the accomplishments at the summit, the political climate in both countries grew increasingly hostile. A wave of anti-China and anti-United States books was published in each country that caught the attention of the media and the general public. In the United States, members of Congress accused the White House of trading American national security for business deals by allowing American aerospace companies to export sophisticated satellites for launching aboard Chinese rockets; investigations continued into the funneling of money from China to the president's 1996 campaign.

Amid wide-ranging criticism and calls to end the policy of engagement, Clinton traveled to China in June 1998 for a third round of official talks. The success of his visit temporarily silenced even the most outspoken critics of engagement. Presidents Clinton and Jiang announced important progress on virtually every front. In advance of the summit, China had made substantial concessions on human rights, releasing political dissidents Wang Dan and Wei Jingshen and signing the United Nations Covenant on Civil and Political Rights. In exchange, the United States promised not to sponsor a UN Human Rights Commission resolution condemning China's human rights record. During the summit the two sides reached agreements on restricting the spread of chemical and biological weapons and antipersonnel mines, defusing nuclear tensions in South Asia, cooperating on environmental problems, and strengthening China's legal system. In addition, several high-profile business agreements were signed.

Even on the thorny issue of Taiwan, the United States and China achieved compromise. Although the United States had rejected China's proposal for a communiqué reiterating America's commitment to a "one China" policy, Clinton appeared to add credence to China's position toward Taiwan. He enunciated a policy of "three nos": no support for Taiwanese independence, no support for "two Chinas" or "one Taiwan, one China," and no membership for Taiwan in international organizations that

require statehood. Although the statement did not reflect a fundamental change in policy, it did reinforce an American commitment to limit Taiwan's efforts to enhance its visibility internationally.

... ONLY TO BE DERAILED

The positive atmosphere of cooperation and congeniality in both countries that surrounded the June Clinton-Jiang summit quickly dissipated. During the summer and fall of 1998, the Chinese leadership—concerned about the ramifications of its economic reforms for urban unemployment and social unrest and upcoming political anniversaries, including the tenth anniversary of Tiananmen—cracked down on political dissent and issued new restrictions on non-governmental organizations.

As China's domestic situation became more difficult, debate in the United States over policy toward China intensified. From the perspective of an American Congress never fully committed to engagement, the policy had yielded little tangible results, and evidence was growing that China was positioning itself as a significant security threat to the United States.

In the winter of 1998, reports of a Chinese missile buildup across the strait from Taiwan prompted Congress to request a study from the Defense Department evaluating the feasibility of including Taiwan in a missile defense system. The move was both strategic and economic. Congress was expressing its long-held fears of a militarily aggressive China. Moreover, arms sales to Taiwan were highly lucrative for American defense contractors. Between 1990 and 1995, the United States sold more than \$8 billion in weapons to Taiwan. From the Chinese perspective, Congress's move was inflammatory, raising the specter of a far more formal alliance between Taiwan and the United States.

At the same time, the Clinton administration, under substantial congressional pressure, agreed to push for a resolution to censure China at the UN Commission on Human Rights in Geneva. The pressure stemmed from the issuance in February of the State Department annual report on human rights. The report cited China as one of the worst human rights offenders and detailed a deteriorating rather than ameliorating situation for Chinese political activists.

Hovering in the background to all this was the expected publication of a several-hundred-page congressional report of the Select Committee on United States National Security and Military/Commercial Concerns with the People's Republic of

China, chaired by Representatives Christopher Cox (R-CA) and Norman Dicks (R-OK). The Cox report promised to reveal a widespread pattern of Chinese espionage at American nuclear-weapons laboratories. Speculation about the report's contents and leaks to the media concerning some of the committee's findings created an atmosphere of suspicion and fear in the United States concerning a possible China threat to America's national security.

Despite the rapidly deteriorating political atmosphere in the United States, the Chinese and American leaderships forged ahead with the scheduled visit of Prime Minister Zhu Rongji in April 1999. Both countries hoped that Zhu's visit would help keep the relationship on track and even improve the perception of China among the general American public. Hopes were also high that the visit would conclude with the signing of a bilateral agreement for China's accession to the World Trade Organization. From the United States perspective, China's entry into the WTO was a means not only of advancing American business interests but also promoting the rule of law and further integrating China into the international system. For China, participation in the WTO would reinforce domestic economic reforms and ensure China's future economic competitiveness.

When Prime Minister Zhu arrived, the president and his advisers were sharply divided on the merit of attempting to sell the deal to Congress that United States and Chinese negotiators had reached earlier on China's possible entry into the WTO. Although Congress technically had no approval rights on the issue of China's accession, it did control an important vote on granting China permanent normal trade relations (formerly known as most favored nation trade status), an essential element of any bilateral accession agreement. Moreover, taking advantage of a growing negative sentiment in Congress, the chairman of the Senate Foreign Relations Committee, Jesse Helms (R-NC), along with Senator Ernest Hollings (D-SC), proposed a bill during Zhu's visit that would block the admittance of China into the WTO on the basis of its human rights violations and the espionage allegations. President Clinton was persuaded that Congress would not support a bilateral accession deal for China and rejected it.

In the aftermath of Zhu's visit, the relationship suffered its most precipitous decline since Tiananmen. With the actual release of the Cox report, even

traditionally strong supporters of engagement began to revisit their position. In China, the reaction to the failed WTO deal was disappointment and anger. China's reform leaders felt betrayed by Clinton's public rejection of the proposal, which had been negotiated in the face of significant political opposition within China.

Any hopes for a quick resolution to the WTO stalemate were dashed by events just one month later when United States-led NATO forces in Yugoslavia mistakenly bombed the Chinese embassy in Belgrade, killing three Chinese journalists. Following the bombing, Chinese demonstrators, in some cases actively supported by the government, protested throughout China. In Chengdu, Sichuan province, protesters set fire to the United States consulate and in Beijing, angry Chinese citizens threw rocks and bottles at the American embassy, virtually holding the American ambassador, James Sasser, and his staff prisoners for several days.

Why the strong Chinese reaction?

First, the Chinese government opposed NATO's bombing campaign; it believed the intervention—aimed at forcing Yugoslavia to respect the rights of the ethnic Albanians in the province of Kosovo—signaled a dangerous precedent for future international action in territory China considered its

sovereign domain, such as Taiwan, Tibet, and Xinjiang. In addition, many in China did not believe the bombing was accidental. Moreover, the seemingly offhand nature of President Clinton's apology, which acknowledged the bombing as a tragedy but appeared to excuse it on the grounds that it paled in comparison to the Yugoslav government's atrocities in Kosovo, offended the Chinese. Finally, the Chinese leadership also fanned the flames of popular anger by not reporting for several days that Clinton had in fact apologized. The end result was that many Chinese believed the United States did not take their loss seriously.

Despite successive diplomatic forays by senior American officials, Beijing suspended all talks with Washington on human rights, arms control, and trade and canceled planned military-to-military contacts and cultural exchanges, bringing the relationship to its current standstill.

Tensions were further heightened on July 12, when Taiwan President Lee Teng-hui recast the relationship between China and Taiwan as one of "state to state," thereby challenging previous formulations

*Both countries
should move quickly
to reengage on issues
of significant mutual
interest.*

on Taiwan that had been agreed to by China and the United States. However, the Clinton administration immediately reiterated its commitment to the "one China" policy and urged President Lee to soften his statement.

PUTTING ENGAGEMENT TO WORK

Although the past six months may appear to have caused irreparable damage to Sino-American relations, a longer view would argue that the current deterioration is not exceptional, but to be expected. It is part of the pattern of recrimination, retribution, and reconciliation that has characterized the relationship since the establishment of diplomatic relations in 1979. Indeed, despite the tensions, signs already can be seen that senior American and Chinese officials are eager to resume the relationship. Neither country believes it has the luxury of watching relations stagnate, or worse, deteriorate even further.

But these frequent periods of crisis do have long-term deleterious effects. Significant effort is required to recover the momentum of the relationship, and while both sides focus on the crisis at hand, progress and resolution of other important issues is delayed; perhaps most important, a degree of trust is sacrificed that is extremely difficult to recapture.

To move beyond the current crisis and achieve sustained progress in Sino-American relations, advocates of engagement in the United States and China must regain control of their respective domestic debates. The overarching framework of engagement is an appropriate one; it also retains substantial public support in both countries. Even in the wake of the publication of the Cox report, a recent public opinion poll indicated that 64 percent of Americans do not consider China an enemy.

Both countries should move quickly to reengage on issues of significant mutual interest, such as China's accession to the WTO. For the United States, including China in the WTO will enhance the transparency of the Chinese economy, lower tariff barriers for American exports, and open the Chinese market in key sectors such as finance, telecommunications, and agriculture. For China, WTO membership is an integral part of its ability to create a modern and competitive economy.

President Clinton and other supporters of engagement must also make a greater effort to explain to their critics that engagement is a long-term strategy. Other much smaller nations, such as South Korea and Taiwan, took decades to develop

the institutions and norms that have allowed them to participate as responsible members of the international system. Similarly, their evolution from authoritarian states to democracies was a long-term process, enabled in large part by substantial American institutional and financial assistance.

If engagement is to deliver the political and economic benefits that its proponents have articulated, the United States must also fulfill its commitments to China to assist in the development of Chinese political and economic institutions. For example, the United States and China have recently signed a number of agreements that would enable China to more rapidly develop its capacity to enforce intellectual property rights, to ensure fair arbitration for foreign investors involved in disputes with their Chinese counterparts, and to help protect the natural environment. Congress, however, has restricted funding for all these programs. Many members of Congress mistakenly believe that by withholding assistance the United States will bring about more rapid political change in China. Instead, they undermine their central objective of protecting American interests in China and enabling the Chinese government to fulfill its bilateral and international obligations.

The United States cannot and should not ignore China's violations of its bilateral or international agreements. When appropriate, the United States must enforce the sanctions embodied in various agreements. But arbitrary linkage between different issue areas such as trade and human rights has not proved effective. Rather, the greatest progress has been realized when the bilateral relationship is strongest, and when the United States demonstrates its willingness to employ incentives rather than sanctions. Recall the American decision in 1998 not to support censuring China for its human rights violations in Geneva, which saw China release two prominent dissidents and sign the International Covenant on Civil and Political Rights.

Progress in the Sino-American relationship requires the high-level, continuous dialogue between the leaders of both countries that has taken place since 1997. Such personal contact is essential not only for the leaders to understand each other's priorities, but also for their ability to communicate that understanding to their domestic constituents. The interests of the United States in China, and those of China in the United States, are significant and growing. Neither can afford to permit the past to continue to serve as prologue. ■



Pension Reform in China



Pension Reform in China

Overview

China's pension system has two problems: the long-term problem of a rapidly aging population and the short-term problem of funding pensions for employees of state-owned enterprises.

The long-run problem. China's population is aging rapidly, a process accelerated by the one-child policy of the late 1970s and 1980s, and increased life expectancy. By 2030 the absolute size of the labor force in China will begin to decline, and by 2050 the ratio of workers to pensioners (those 65+), which was 10:1 in 1995, is projected to decline to about 3:1. While it took most OECD countries as much as a century to double the proportion of their old people (60+) to 18 percent (their current average share), China will do it in just 34 years (1990 to 2024). In short, in 2030 China will be facing the problems of a mature economy like Japan while its per-capita income will most likely be about one-fifth that of the industrial countries today. Although China's current rapid growth rates make it relatively easier to implement pension reform now, it is likely that growth rates will be slowing just as China's old age burden increases, which suggests that even "long-term" reform should not be delayed.

The short-run problem. A more urgent and immediate problem, however, is the pension crisis in the state-owned enterprise (SOE) sector. State enterprises inherited heavy pension obligations from the central planning era. With the transition to a market economy, employment in the state enterprise sector is declining, while the number of pensioners is rising rapidly. In some cases the ratio of pensioners to workers is over 100%. An associated problem is the slowing of restructuring. The bankruptcy or sale of a SOE raises the difficult issue of how the commitment to pensioners (along with other social welfare obligations of the enterprise) will be honored. When alternative arrangements for pensions and other social services are not available, enterprise reform is delayed since liquidations, joint ventures, or mergers cannot proceed smoothly until the social obligations of SOEs are assigned elsewhere.

Under the old central planning system, when the profits of SOEs were pooled and resources were allocated according to plan, pensions were not a consideration for managers. Today, individual enterprises are responsible for their profits and losses, and many are unable to manage the burden of their pensions. Even when the core business is profitable, an enterprise may show a loss because it has a large pool of pensioners, and this may affect its capacity to operate, borrow, and expand. Alternatively, some pensioners may not receive adequate payments because they are tied to enterprises that are now doing poorly financially. Thus, the current system has several problems entailing both inequity and inefficiency.

The Current System: Key Features and Problems

The formal pension system in China is a largely urban-based, pay as you go, defined benefit system that covers mainly the state sector in urban areas. Though localities are trying to bring the non-state sector (which often accounts for more than half of employment) under the formal

pension system, most nonstate firms are resisting because contribution rates are high and benefits uncertain. In rural areas, extended families are the chief means of support for the elderly, which often comes into conflict with the government's "one-child" policy. Moreover, contribution rates are high and variable: in 1994 the contribution rate among the provinces ranged between 19% and 28%, with a simple average was 23.5%, well above the international norm of 20% (see attached table). With contribution rates high and rising, compliance rates are falling.

The current system also suffers from a high degree of fragmentation due to the wide dispersion of authority over pension policy and administration. Several national-level ministries oversee different aspects of the pension system, or have contributed to policy design and implementation. There is also a great deal of authority at lower levels of government, where provincial and local governments can modify plans and policy parameters. This is often done intentionally to differentiate their schemes and introduce nontransparency to retain authority over their own program and the surplus funds that are emerging in the short-run. As a result there are now hundreds of separate pension schemes in China. One result is that most pension pooling is conducted at the county or municipal level. Many localities also have separate pools for state enterprises and other population groups. Some provinces have experimented with some form of pooling, but the scope for pooling to ensure uniformity and reduce risk over regions with different demographics remains low. Fragmentation has also made the portability of benefits across groups difficult, requiring separate negotiations between the old and new employers or pools.

The Chinese official team analyzing the pension burden over the long term (1995-2050) came to the following conclusions:

- By 2033, if the pay as you go system is not reformed, it will require a contribution rate of 39.27 percent.
- a fully funded system with an additional contribution rate to meet the needs of transition cohorts will require a 34 percent contribution rate from 2004 to 2031.
- a combination of social pool and individual accounts can smooth the rise in contribution rates, but it will still require a 28 percent contribution rate for 2001-2050 if borrowing (from future generations or other sources) is not used.

Principles of Pension Reform

The problems of the current system of pensions in China are deep-seated and widely recognized. The broad directions of reform are becoming clear, including the four changes outlined below. But implementation has proven difficult, hampered by misperceptions about the costs of transition and by the political implications of change.

- *Unifying the system.* Enterprises and workers covered under separate plans or not covered at all would be brought into a single system with common standards. Management of the program would be transferred from enterprises to government agencies, and administrative management and fund management would be separated.

- *Reducing the pension burden*, which can be achieved through three policies. The retirement age (60 for men, 55 for women) can be raised in accord with longer life expectancy to allow lower contribution rates. The wage replacement rate (which at 80-90 percent of total compensation is high by international standards) can be lowered (e.g., to about 60 percent of net wages). Finally, pensions, which are currently indexed to nominal wages, should be indexed to prices to ensure a more certain real level of transfers.
- *Introducing funded individual accounts* is more appropriate than the pay as you go system in dealing with China's rapidly aging population, and would take advantage of the country's current rapid economic growth in achieving a maximal rate of return.
- *Ensuring an adequate real rate of return on pension funds*. Individual accounts cannot provide a reasonable level of security unless interest rates are close to the growth in real wages. The rate of return on pensions can be high only if the general interest rate structure is rationalized, a reform that will increase the financial costs of state enterprises and the government. One short-run solution is raising interest rates on longer-maturity loans, which borrowers for long-term investments can afford to pay, given the high productivity of capital in infrastructure and other long term assets in China.

The best solution for China seems to be a system that combines social pooling and fully funded individual accounts. The approach preferred by the World Bank is a *three pillar system* based on the directions of reform identified above (see attached figure). It provides a basic pension component to keep retirees above the poverty line (pillar 1) and for large mandatory individual accounts (pillar 2) to obtain the advantages of funding. These would be supplemented by voluntary accounts (pillar 3) as desired.

There is no consensus on how to finance the transition to a multipillar system. With funding, much of the current contributions would go to individual accounts. Other financial resources will be needed to pay the current pensioners and the accrued pension rights of workers who contributed under the old system. The problem is how to make these "double" payments. Rough calculations by Chinese analysts suggest that the implicit pension debt could be 3 to 4 times GDP, which has discouraged authorities from reforming the system. However, World Bank estimates suggest that the debt is actually less than half of current GDP (and foreseeably less, given China's anticipated growth rate), but pension debt can be expected to rise with time and as coverage expands, if the country maintains a pay as you go system.

TABLE 1.3

Features of pension schemes of selected provinces, municipalities, and sectors, 1994
(percent)

Locality	Covered pensioners/ Covered contributors	Average pension contribution rate			Wage replacement rate	Gross pension/ gross wage
		Employer	Worker	Combined		
Provinces						
Liaoning	27.2	21.9	3.0	24.9	—	21.9
Jilin	23.2	23.0	2.0	25.0	—	15.4
Heilongjiang	22.6	23.0	2.0	25.0	90	—
Jiangsu	21.7	20.0	3.0	23.0	65	14.0
Zhejiang	20.4	22.5	3.0	25.5	80	—
Fujian	22.7	20.0	4.0	24.0	81	13.5
Henan	16.3	25.0	3.0	28.0	75	17.5
Hubei	18.4	20.0	2.0	22.0	85	17.9
Guangdong	23.2	17.0	2.0	19.0	70	—
Hainan	26.9	18.0	3.0	21.0	65	9.9
Sichuan	25.4	19.5	3.0	22.5	95	22.3
Yunnan	26.9	21.0	3.0	24.0	71	22.3
Shanxi	—	20.0	2.0	22.0	95	—
Simple average	22.9	20.8	2.7	23.5	79	17.2
Municipalities						
Beijing	36.0	22.0	5.0	27.0	75	18.0
Tianjin	32.5	25.0	4.0	29.0	—	—
Shanghai	40.5	21.0	4.0	25.0	—	—
Harbin	26.2	22.0	2.0	24.0	102	21.3
Changchun	27.7	22.0	2.0	24.0	75	—
Shenyang	38.5	22.0	3.0	25.0	83	—
Taiyuan	24.5	20.0	3.0	23.0	100	—
Wuhan	36.9	26.0	3.0	29.0	90	—
Chengdu	14.0	22.0	5.5	27.5	83	—
Chongqing	33.1	27.0	3.0	30.0	60	—
Guangzhou	—	24.0	2.0	26.0	—	—
Shenzhen	3.3	13.5	7.5	21.0	61	—
Simple average	28.5	22.2	3.7	25.9	81	—
Sectors						
Civil aviation	5.9	8.0	2.0	10.0	—	—
Coal mining	28.7	21.5	3.0	24.5	88	25.0
Communication	—	—	—	—	—	—
Construction	19.7	10.0	3.0	13.0	83	—
Banking	10.7	12.0	2.0	14.0	—	—
Electrical Power	—	13.0	2.0	15.0	80	—
Hydropower	—	18.0	1.0	19.0	—	—
Nonferrous metal	29.3	—	—	—	—	26.8
Petroleum & natural gas	13.9	12.0	3.0	15.0	85	—
Railway	29.4	—	—	17.0	—	—
Transportation	—	—	2.0	—	80	—
Simple average	19.7	13.5	2.3	15.9	83	—

— Not available.

Source: Background materials provided by the provinces, municipalities, and relevant ministries.

FIGURE 2

Objectives, management, and funding of the proposed three pillars

	Mandatory basic benefit, pillar 1	Mandatory fully funded individual account, pillar 2	Supplementary individual account, pillar 3	Transition mechanism
Objectives	• Redistribution plus social insurance	• Savings plus social insurance	• Savings plus private coinsurance	• Pay off the implicit pension debt to existing pensioners and current workers
Role of government	• Implicit guarantor of last resort • Administration • Tax benefit	• Guarantor of a minimum rate of return on pension funds • Supervision • Tax benefit	• Supervision (by the central bank) • Tax benefit (subject to a maximum)	• Implicit guarantor of last resort • Administration
Management agency	• Social insurance companies (affiliated with social insurance agency or ministry)	• Pension fund management companies (autonomous public companies or private companies)	• Private and public insurance companies • Employer-sponsored pension funds	• Social Insurance Bureau at municipal level
Payments	• 24% of average provincial wages paid to new retirees • Surplus invested in government bonds (for both transition and investment purposes) and other approved instruments • Disability and survivor benefits	• Annuities • Surplus invested in government bonds and other approved instruments • Disability and survivor benefits	• Annuities • Investment in financial instruments	• Payment to existing pensioners • Accrued rights of existing workers when they retire
Source of funds	• Contribution: 9% of wage bill contributed by employers • Pooling at provincial level and fund adjustment at national level • Income from investment of surpluses	• Contributions: 8% of workers' wages contributed by employers and workers on a 50:50 basis • Investment income	• Contributions from enterprises • Investment income • Contributions from informal sector workers to their individual accounts opened at a licensed pension fund management company • Premium paid to life insurance companies by informal sector workers (including farmers)	• Receipts from additional contribution rates (1.1%) from workers • Borrowings from pillars 1 and 2 • Issuance of bonds collateralized by housing assets and land use rights



Did China Cause the Asian Crisis?



DID CHINA CAUSE THE ASIAN CRISIS?

Some observers claim that Asian crisis has its origins in China's 1994 devaluation. In our view, this charge is ludicrous. Another possibility -- that Chinese export growth caused the crisis, either through competition with the affected countries' exports in third-country markets or through increases of imports into the crisis countries -- is also unsustainable by the data.

The 1994 Devaluation

Attributing the crisis to the 1994 devaluation makes little sense because the devaluation was really quite small. While the official exchange rate was devalued by 50% on January 1, 1994 -- the figure cited in most reports -- this figure is misleading. The 1994 action was actually a unification of different exchange rates, with the new value pegged at the then-existing swap rate. Since most transactions were already taking place at the swap rate, *the meaningful devaluation was less than 7%*. Furthermore, the real effective exchange rate (adjusted for inflation and China's trade mix) was devalued by less than 5% and recovered all of this by July 1994. It has since continued to rise, meaning that China's exchange rate has appreciated by more than 1/3 since the unification (figure 1).

Did China's Exports Crowd Out East Asia's?

China's exports have grown rapidly over the past decade -- an average of almost 25% p.a. from 1990-1996. It could be argued that this rapid growth came at the expense of other East Asian countries, and therefore was a proximate cause of the crisis -- devaluation aside. Certainly, Chinese exports must, in some cases, have crowded out exports from the crisis countries. These effects were not, however, sufficient to spark the crisis.

The greatest Chinese export growth has come in the U.S. market, whose imports from China more than tripled between 1990 and 1996, during which period China's market share rose from 3.1% to 6.5%. This growth did not come at the expense of the other East Asian developing nations, however: the market share of these seven (Korea, Thailand, Indonesia, the Philippines, Taiwan, Malaysia and Singapore) changed little over the period, falling from 5.46% to 5.31%.

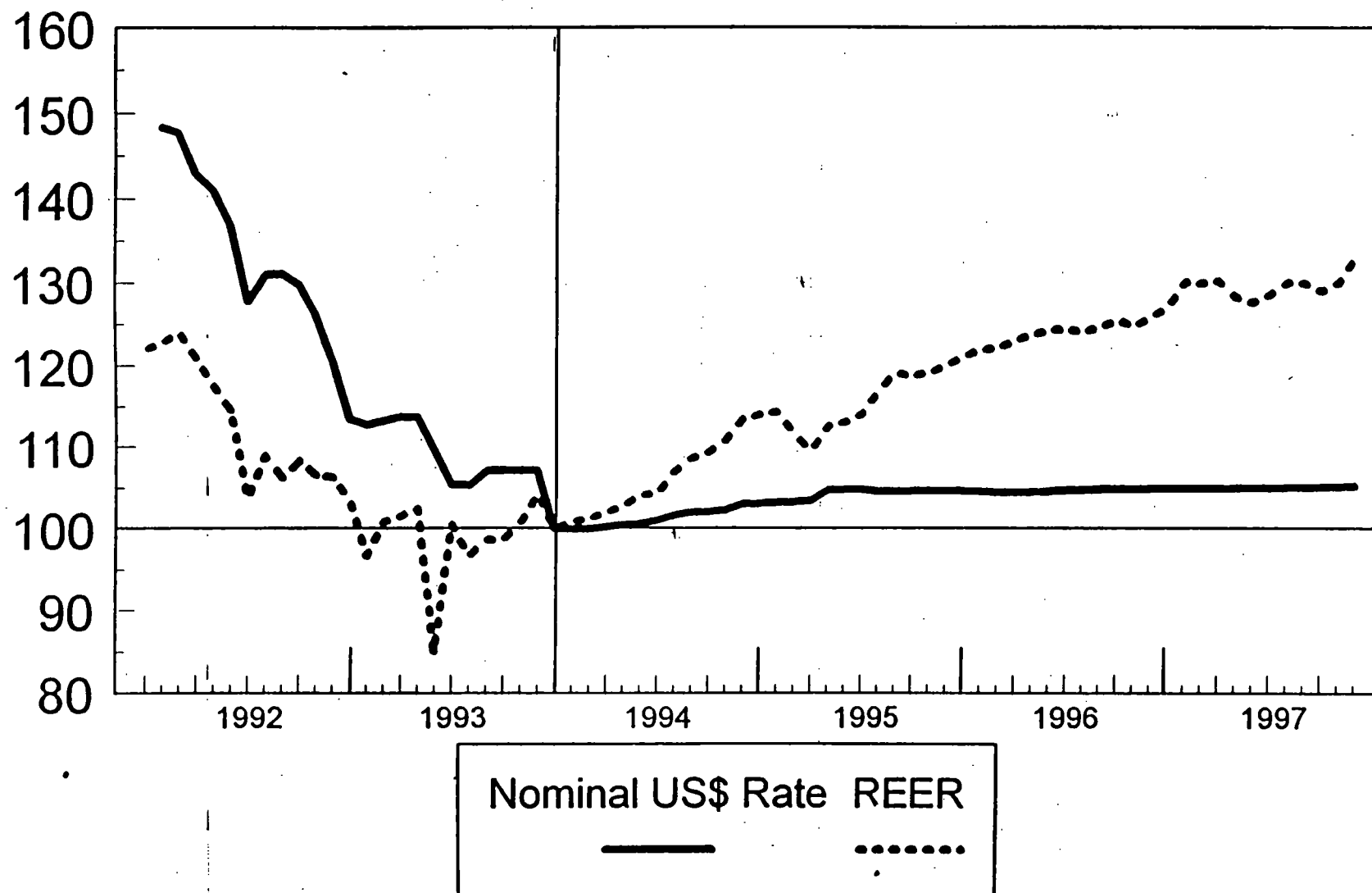
Attributing the crisis to competition from the Chinese export boom would require that Chinese exports to the world grew at the expense of those from the crisis countries. Figure 2 shows that this was not the case, however. Rather, growth rates of exports from China and from the seven East Asian countries tended to rise and fall together, suggesting that developments in the global economy were the primary determinants of export growth rates. Indeed, in 1996, the year before the crisis, Chinese exports grew *less* than those of its neighbors, other than Thailand. Chinese exports grew rapidly again in the first six months of 1997, immediately before the crisis struck, as did those of the Philippines and (less so) Indonesia. Export growth in the other five countries remained sluggish.

Did Imports from China Cause the Crisis?

Chinese exports could conceivably have caused the crisis not by competing with the affected countries' exports, but by providing a surge of imports which threw the balance of payments into catastrophic deficit. All of the crisis countries did, indeed, experience upsurges in their current account deficits in the years before the crisis. Again, however, it is difficult to attribute this to China. While imports grew significantly in all three countries over the 1991-6 period, China's market share remained modest, rising from 5.2% to 6.4% in Korea and from 4.1% to 6.2% in Indonesia, and falling from 5.1% to 3.8% in Thailand. Over this period, China accounted for only 7.4% of Korea's import growth, for 4.3% of Indonesia's and for only 2.3% of Thailand's. In the non-crisis countries (other than Taiwan, for which data are not available), the picture is similar: the Chinese market share grew slightly, but remained in the low single digits in all cases, while imports from China explained only a small portion (2.2-3.4%) of overall import growth.

China: Exchange Rates

January 1992 - December 1997

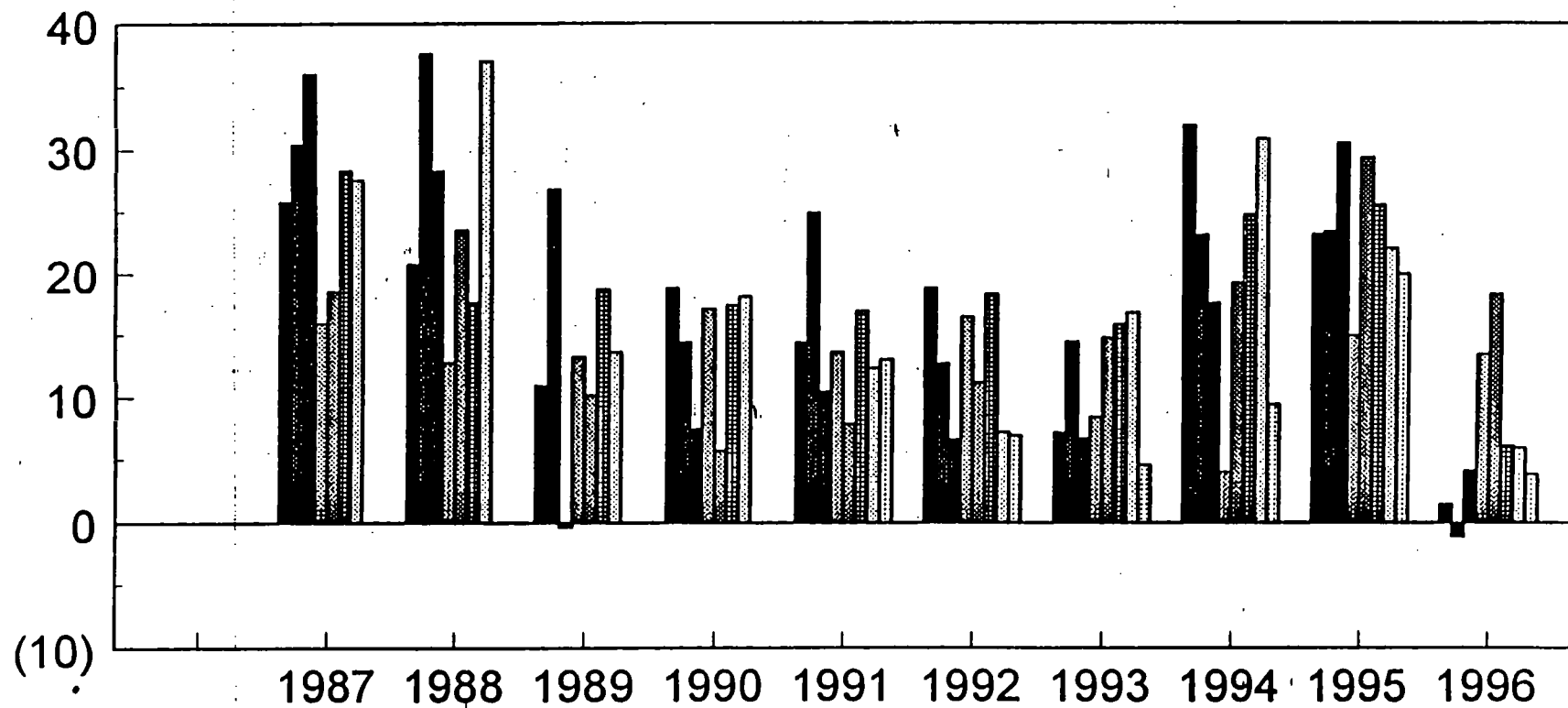


January 1994 = 100; increase indicates appreciation

Rates are weighted averages before 1994

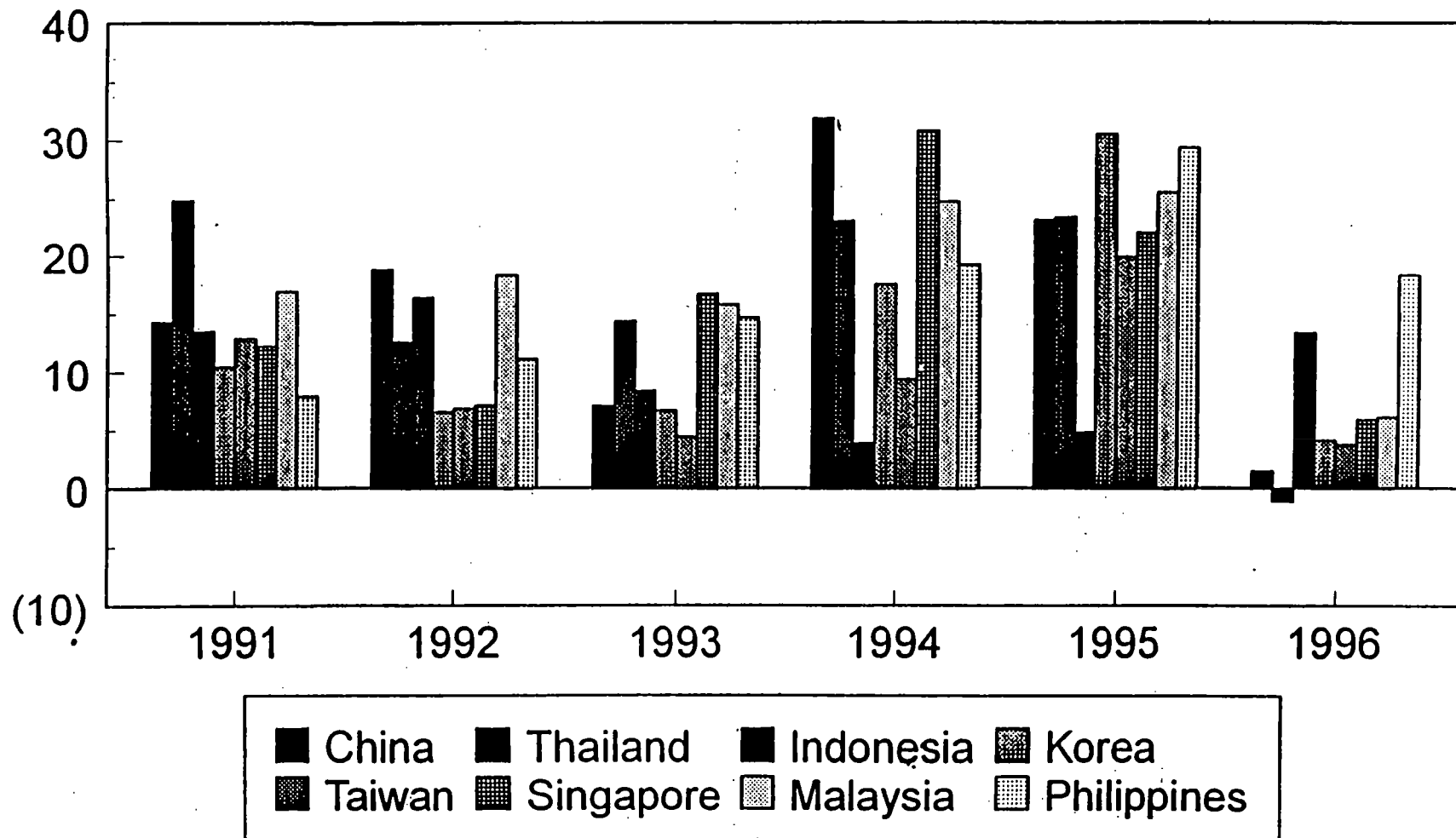
Sources: IMF, Bloomberg

Export Growth, 1987-1996



■ China	■ Thailand	■ Korea	■ Indonesia
■ Philippines	■ Malaysia	■ Singapore	■ Taiwan

Export Growth, 1991-1996





China: Market Access and Investment Climate



CHINA: MARKET ACCESS AND INVESTMENT CLIMATE

The objective of the U.S.-China agreement on trade relations, signed in 1979, is to promote international trade based upon the principles of mutual benefit, equality and non-discriminatory treatment. Nearly 20 years after the United States normalized relations with China, we still do not have a reciprocal trade relationship. China enjoys the benefit of multinational principles of fair trade but its trade regime operates upon unfair merchantilist trade practices.

The JCCT meeting in Beijing will touch upon some of the market access and investment issues explained below, but will not address them all. As a result of economic liberalization and government restructuring, these issues are increasingly vexatious because the power of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), the Commerce Department's interlocutor, has diminished over time. So while MOFTEC promotes foreign trade and investment on the right hand, other more powerful central government ministries and commissions implement protectionist industrial policies on the left. The right hand and the left hand are working against each other. U.S. investors, exporters, and service providers are caught in the middle of inter-ministerial rivalries which create a very unpredictable regulatory environment. This paper describes the major business climate issues.

China maintains non-tariff measures which restrict imports on more than three hundred tariff lines including licensing requirements; import quotas, restrictions and controls; tendering requirements; and safety certification requirements. China's restrictive system of trading rights severely limits domestic and foreign-invested enterprises' ability to directly import and export, distribute, and sell their products. Such excessive governmental intervention in the market undermines open and fair competition. Protection of intellectual property is also a market access issue, but it is not discussed here because it is addressed in another section of the briefing book.

Statistical Trends

Trade statistics show the effect of China's complex maze of tariff and non-tariff barriers to trade. U.S. merchandise exports to China in 1997 were \$12.8 billion, an increase of 6.9 percent from 1996. China is the United States' fourteenth largest export market, accounting for 1.86 percent of total U.S. trade in 1997. Following Hong Kong, the U.S. is China's second largest export market, accounting for 18 percent of its total exports. U.S. imports from China in 1997 were \$62.6 billion, an increase of \$11.1 billion (21.4 percent) from 1996. The U.S. merchandise trade deficit with China was \$49.7 billion, an increase of \$10.2 billion from 1996. The U.S. and Chinese governments do not agree upon the actual size of the trade deficit, but they do agree upon the trend. In 1997, Chinese exports to the U.S. increased three times more than U.S. exports to China.

Estimated U.S. direct investment in China fell in 1997 by all indicators: the number of contracts was down 22 percent to 1,070; contracted investment was at its lowest level in 5 years, down 42 percent to \$4 billion; and utilized investment decreased 12 percent to \$3 billion. The U.S. ranks second as an investor in China's market, after Hong Kong with 34 percent market share and investment value exceeding \$12 billion, followed by the U.S. with 9 percent, and Japan with 7 percent market share and investment value of approximately \$2.5 billion.

A. Import Policies

China has generally complied with the requirements of the 1992 Market Access Memorandum of Understanding (MOU) to reduce tariffs and remove certain non-tariff barriers such as quotas and licensing requirements, but still maintains numerous non-tariff administrative controls to implement its trade and industrial policies.

1. Tariffs and Taxes

In 1996, China lowered its average import tariff from 42.1 percent to 23 percent, and on October 1, 1997, further lowered the average import tariff to 17 percent. Many other tariff reductions are still under negotiation in the context of WTO accession discussions. U.S. industry continues to express concern that tariff rates for sectors in which China is seeking to build its international competitiveness remain extremely high, particularly on chemicals and motor vehicles. China's customs valuation practices also lack uniformity because local authorities at different ports of entry have authority to charge less than the official rate. Negotiation between the importer and the customs officials result in charging different duty rates for the same product. In addition to tariffs, imports are subject to a 13 or 17 percent value-added tax (VAT) and a consumption tax. U.S. exporters complain that imposition of the tariff, VAT, and consumption tax reduce consumer demand for their products, and the taxes are not consistently applied to all products.

2. Transparency and Rule of Law

China does not have a system of administrative law which requires public participation in rulemaking, consistent interpretation of the regulations, and administrative adjudication of claims raised by citizens adversely affected by the regulations. Because it is not possible to obtain a binding administrative opinion on any trade and investment regulation, U.S. companies operate in an opaque and unpredictable regulatory environment. The transparency of China's trade regime has improved as a result of implementing one of the 1992 Market Access MOU's requirements. MOFTEC now publishes all trade-related regulations issued by the central government in a gazette and any rules remaining unpublished are to have no legal effect. A barrier to information access still exists because U.S. companies must subscribe to the gazette to keep abreast of regulatory changes. The Market Access MOU requires China to establish an official central repository of all laws and regulations which govern international trade, but this obligation has not yet been met.

A great deal of work must be done in this area to improve the reliability of the regulatory system. U.S. companies suggest that China should establish a process which enables them to seek official, binding administrative interpretations of trade-related regulations so that they can make informed business decisions before undertaking commercial transactions.

3. Non-Tariff Measures

China's non-tariff measures (NTMs) are a complex maze of import licensing requirements, quotas, and other administrative controls. The NTMs enable China to manage its foreign exchange reserves, ensures imported products do not compete with similar domestic products, and prevents foreign companies from acquiring control over important industries.

Import Substitution Policies. In the 1992 Market Access MOU, China agreed to eliminate the use of import substitution policies and measures which bar market access because an equivalent product is produced in China. It also agreed to refrain from subjecting any foreign product to import substitution policies in the future. Despite this commitment, in 1994 China announced an automotive industrial policy that explicitly called for production of domestic autos and auto parts as substitutes for imports, and established local content requirements. In 1996, the State Council issued regulations that discriminate against imported pharmaceutical products and impose a certain pricing formula based on whether domestic substitutes exist. In 1997 the former Ministry of Post and Telecommunications issued a directive that prohibits importation of telecommunications equipment which can be produced by domestic enterprises at less cost and same quality.

Standards, Testing, and Import Certification With few exceptions, China does not accept U.S. certification of product quality or safety. China's Import and Export Commodity Inspection Law explicitly requires that certain imported products, which have met international standards, be inspected by Chinese authorities prior to use or sale in China. Safety and quality licensing requirements vary according to the product, and affect U.S. exports in the areas of chemical products, electronic products, medical devices, industrial machinery, automotive parts, and telecommunications.

According to affected U.S. companies, the licensing and inspection process is not transparent, predictable, or based upon the principle of national treatment. There is some evidence that the safety and inspection procedures applied to foreign suppliers are more rigorous than those applied to domestic producers. U.S. exporters claim that the licensing process is burdensome, due to inconsistent inspection procedures and the maze of registration requirements. U.S. manufacturers must pay substantial fees for testing product samples and onsite inspections at the U.S. production facility. Certain products are subject to more than one safety license requirement, including boiler and pressure vessel products, pharmaceuticals, medical devices and instruments. U.S. companies have suggested that Chinese authorities should publish standard fee schedules and justify the need for duplicative safety license inspections.

According to U.S. exporters and investors, new alternative import requirements may be undercutting market access gains pursuant to the 1992 Market Access MOU. The MOU required removal of controls, quotas, and licenses on 176 categories of goods in 1995, and removal of other import restrictions on 13 other categories in 1997. About 400 products covered by the MOU's annex are now subject to "automatic registration" requirements. The imposition of this requirement appears to be a new defacto licensing requirement. The Chinese government has also imposed new quality and safety licensing requirements on electronic and medical equipment which were previously controlled by quotas.

Since 1992, China has made some progress on agricultural sanitary and phytosanitary issues having signed bilateral protocols for several agricultural items. However, unscientific agricultural import standards are a barrier to export of products such as citrus, meat and Pacific Northwest wheat.

Trading Rights. Authority to engage in international commercial transactions is restricted to state-owned trading enterprises which are owned by the central, provincial or municipal government. Manufacturing enterprises, wholesale distributors, and retail enterprises in the state-owned or non-state sector cannot directly import products or commodities. They are required to engage the services of an authorized trading enterprise to act as an agent to procure foreign products and commodities. The trading enterprise negotiates the international purchase contract, arranges the method of payment, and takes title to the goods after clearing customs. Every international trade

transaction involves two contracts, one between the foreign supplier and the Chinese trader, and a second domestic purchase contract exists between the trading enterprise and the actual buyer.

The Chinese trading system creates numerous problems for U.S. companies. It is difficult to locate an appropriate sales agent or distributor, and it is impossible to set up a nationwide marketing and distribution system for a particular product. Commercial disputes arise in instances where the buyer is involved in breach of the domestic purchase contract which causes the trading enterprise to breach its obligations under the international sales contract.

A separate distribution system exists for goods produced by domestic manufacturers. Foreign involvement in retail distribution is severely restricted and involvement in wholesale distribution is prohibited. The discussion below concerning services thoroughly explains this issue. Even if market access improves as a result of reducing tariffs or removal of other non-tariff measures, the distribution restrictions imposed through business licenses remain a significant trade barrier.

In the context of China's WTO accession negotiations, China pledged to liberalize current restraints on the right to import, export, and distribute products. At the end of the three year transition period, all foreign and domestic enterprises will have trading rights.

B. Services Barriers

The U.S. has a positive services trade balance with China. The value of U.S. services exported to China reached \$3.1 billion 1996, while the value of U.S. service imports was \$2.0 billion. Despite this services trade surplus, China's restrictive laws limit U.S. service exports and investments in all service sectors. Since China's services sector is underdeveloped, and foreign participation is minimal, it is difficult to gauge how significantly market access barriers have limited U.S. export potential. Nevertheless, Chinese regulation of the services sector is clearly inconsistent with WTO principles of transparency and national treatment.

Chinese law governing the services sector is at the "experimental regulation" stage and imposes limits on the form of establishment, scope of activity, and geographic location through restrictive business licenses. In accounting, insurance, and inspection services, a foreign company cannot establish a wholly-foreign owned profit-making entity. Instead foreign firms are required to establish joint ventures, which ensures transfer of business skills and limits market penetration. In addition to the service sectors discussed below, law, accountancy, engineering and tourism are also subject to various restraints which protect domestic service providers.

In the banking sector, Shanghai is the center of regulatory experimentation. Foreign branch banks and banking joint ventures were first established there in the mid-1990s. To date, only nine foreign branch banks have obtained permission to conduct local currency transactions in Shanghai, including Citibank. All other banking entities are restricted to foreign currency transactions and primarily engage in foreign currency exchange, negotiation of letters of credit, and loans to foreign invested enterprises. By 1997, China approved 142 branch banks, seven joint venture banks, and five wholly-owned banking firms, located in nineteen different cities.

In the insurance sector, China severely restricts foreign activity by limiting the form of business establishment to representative office or joint venture. While China has approved 181 representative offices, it has granted only three business licenses to foreign insurance companies, including one U.S. firm, American International Group. Since a representative office is not technically allowed to earn a profit and is authorized to only engage in "liaison" activities, most insurance companies have

established a presence in China in anticipation of market liberalization. Firms which have secured licenses are subject to limitations on geographic scope of operation. They are allowed to only operate in the city where they are licensed to do business and cannot offer services nationwide. In addition, scope of activity is restricted because a foreign insurance firm is allowed to sell only one form of insurance. The insurance law requires them to select either property or personal life insurance.

In distribution services, U.S. companies are significantly restricted in their scope of activity to a singular aspect of distribution service. Foreign firms are not allowed to provide a full range of services including marketing, equipment maintenance and after-sale service, and customer support. Chinese regulations prohibit foreign companies from directly servicing equipment exported to China. To offer equipment maintenance service within China, the equipment manufacturer must establish a joint venture with a Chinese entity.

Retail and direct sale activity by foreign firms is restricted in geographic scope and nature of activity. A foreign firm cannot set up one office to engage in nationwide sales activity. Instead, a business license must be obtained in each city. A foreign firm is allowed to only sell the products of the parent company and cannot sell or distribute domestic products.

In telecommunications services, foreign firms are not allowed to operate telecommunications networks. Their activity is limited to indirect market participation by providing equipment and services to state-owned Chinese entities. This issue is discussed in detail in a separate briefing paper.

C. Investment Issues

China's investment policy and regulations contain many restrictions such as debt-equity ratios, foreign equity limitations, export requirements, foreign exchange balancing requirements and local content requirements. Other significant disincentives to investment include labor laws which require the employer to heavily subsidize employee housing and health care and limit termination of excessive employees; excessive government interference in FIE operations; inconsistent interpretation of the law; and complex contract approval procedures.

Since initiation of its open door policies in 1978, China has offered a variety of incentives to attract foreign investment. Recently the investment climate has become more restrictive in some respects because key investment incentives have been modified. On January 1, 1998, a new investment guidance policy became effective which continues the preexisting categories (encouraged, restricted, and prohibited) but shifts certain projects between the categories to a less preferential status. The new policy also added projects to the "encouraged" category which entail more sophisticated technology. China encourages projects which support economic development objectives such as environmental protection, disaster mitigation, utilize advanced technology, and upgrade the infrastructure. Projects in the restricted category reflect protection of infant industries and strategic basic industries.

Value Added Tax. The imposition of a value added tax on exports in 1996 reversed a longstanding investment incentive which encouraged foreign invested enterprises (FIEs) to use domestic parts and components in their products. High rates of localization were previously tied to relaxation of foreign exchange balancing requirements. In 1996, the VAT refund for use of domestically sourced parts and components was reduced from 17 percent to 9 percent. Parts and components imported for FIE production are exempt from the VAT. The policy change increases production cost and reduces price competitiveness on the international market. It also penalizes FIEs which comply with China's local sourcing and export requirements.

May 23, 1998

**MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS**

FROM: MEG LUNDSÄGER
SUBJECT: China JEC: Financial Services

Summary:

In my meetings this week in Beijing, the Chinese gave no clear indication that they are willing to significantly improve their financial services offer for their WTO accession. Their current offer provides only a very limited expansion of the local currency experiment for banks, nothing for securities firms, and little in terms of additional market presence for insurance companies. The common refrain was they 'need time.'

I had very good meetings at the PBOC, including with Deputy Governor Liu, who reiterated his and the leadership's strong commitment to financial sector reform. His staff hinted that they had proposed additional measures with regard to the local currency experiment for **banking**, including a reference to 'national treatment,' but would not provide any further specifics, saying only that the senior leadership would decide. I had a somewhat cool reception from the Vice Chairman of the Chinese Securities Regulatory Commission (CSRC), who stated bluntly that he would not make any commitments for entry by foreign financial firms into the **securities** arena beyond the very narrow role they now can play. Officials at the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) reaffirmed that position, saying that we would get nothing on securities in the WTO offer. With regard to **insurance**, PBOC officials said they were committed to revising their offer, but provided no details as to what extent. They also hinted they may include more areas of financial services activities in their offer.

Next steps: I left a paper with the Chinese, outlining the revisions we would like to see in their offer. They promised to get back to us in the next few weeks, saying many times that it was up to senior leadership to decide these market opening issues. While I pressed for a down payment at Tuesday's JEC meeting, it was clear that they did not believe their bosses could make any decisions that quickly.

On a separate note, USTR officials with us (Bob Cassidy, who is leading the overall negotiations) felt that we all needed to make as much progress as possible before the Presidential summit in June, since this period may be our only opportunity to secure concessions from the Chinese. With that said, he made little to no progress on agriculture and other services issues and was not even able to meet with all the relevant Chinese officials.

RECOMMENDATION:

That you make a strong case at the JEC for significant commitments to future access to the local currency Chinese market. Express a willingness to negotiate phased-in liberalization.

Annual Financial Inspection. Another onerous sign of increasing restriction of foreign investors is the imposition of annual financial inspections. The FIEs are now required to submit various financial statements which allow Chinese regulators to evaluate production volume, debt management, and adherence to contract terms. The inspection results in an "A" or "B" rating which will be used in the future to evaluate requests to expand operations or increase registered capital. American investors are concerned that the exercise is simply another way for the Chinese government to exact fees and subject them to arbitrary regulation.

Tariff Exemption on Capital Equipment On the positive side, Chinese authorities reversed their plans to phase-out the tariff exemption on capital equipment imported by foreign investors. The exemption was reinstated because foreign investment dropped dramatically during the time it was being phased out in 1996 and 1997. Under the revised policy, certain foreign-invested enterprises may receive a duty and tax exemption on mechanical appliances, electronic equipment, and measuring devices. Investment projects which utilize advanced technology and contribute to particular economic development goals in agriculture, environmental protection, telecommunication, disaster mitigation, and public health qualify for the exemption as projects in the "encouraged" or "restricted" investment categories. U.S. investors have encountered difficulty in determining the applicability and conditions for the capital equipment exemption. The issue is important because it contributes to the instability of the investment climate and significantly increases operation costs of affected investment projects.

Domestic Chinese enterprises also enjoy a tariff exemption on certain kinds of capital equipment, however the list applies only to domestic enterprises. Whether this exemption will cause enterprises to import more foreign equipment is unclear. Other factors affecting equipment imports include availability of funds, the equipment's degree of technological sophistication, and whether the equipment is destined for an inland province.

D. Government Procurement

The World Bank estimates that China will need to spend \$500 billion to upgrade its infrastructure during the 9th Five Year Plan (1996-2000). Tendering procedures for projects funded by international organizations such as the World Bank must comply with standards set by the donor organization, and the Chinese adhere to them. Many of these tender opportunities are available online through the internet.

Transparent and competitive procurement procedures for projects funded by the Chinese central government do not exist, although regulations purportedly exist on the provincial level. This is a significant issue because China's vast infrastructure needs present significant trade and investment opportunities. In 1997, Chinese officials revealed that the State Planning Commission has been working on a government procurement law and suggested the law would be promulgated during the National People's Congress (NPC) in 1998. Since the NPC's legislative agenda is not a public document, whether the procurement law is on this year's agenda is unknown. The NPC is scheduled to resume its work at the end of April.

U.S. companies have informed the Department that Chinese government procurement procedures are not transparent and that it rewards contracts based on the type of concessions it can obtain from foreign bidders. Chinese officials characterize this practice as "allowing foreign participation on the basis of mutual benefit." These concessions include soft loans, technology transfers, refuted investment contracts, and counter-trade. Foreign bidders are not accorded national treatment in that these concessions not required of domestic Chinese firms. Since China is not a signatory to the

Background

US Financial Community: I also met with the US financial community in Beijing. With regard to banking, we have no US banks in the queue for new licenses, therefore all their focus is on expanding their ability to do local currency business, including with Chinese customers. Even when the Chinese give them a little bit more, such as the recent right to enter the inter-bank market, the Chinese do it in such a manner that it is unprofitable for the foreign banks to engage in that activity. They all complained about the large continuing role for the State Authority for Foreign Exchange (SAFE) and the lack of transparency in approving activities.

Securities firms pointed out that the Chinese Finance Ministry likes the idea of having the foreign firms able to operate as primary dealers, figuring that it will help bring down their cost of borrowing. US firms know it will be difficult to get approval for them to become local firms, despite the expertise they would bring to market development. They mentioned that Premier Zhu is 'angry' at foreign securities companies, since they are making 'too much' profit, even in their limited presence (rep offices and one JV).

Insurance companies are also concerned about getting into the local market, as many as 15 foreign companies are now seeking licenses. American reps speculated that 2-3 licenses for US firms may be granted at the summit.

Chinese Views:

The Chinese explained their concerns. They were worried about the ability of the local PBOC offices to regulate the foreign banks. Loss of staff from Chinese banks to foreign banks paying higher salaries was a major concern, which was also voiced by the Bank of Chinese officials with whom we met separately. While PBOC officials pointed with pride to their rapid liberalization and their willingness to expand the local currency experiment to additional cities and regions, they were disappointed that no foreign banks had applied for licenses in the non-coastal cities that were already open to foreign firms (they conceded my point, however, that those markets were not attractive without the ability to engage in rmb business with Chinese clients). They hinted they may lift geographic restrictions in the future. And of course they raised the matter of the Chinese banks' requests for branches in the United States. I replied that I understood the Federal Reserve was willing to come to China to explain its requirements.

Wang Yi of the CSRC was the most hard line of all officials I met. He had reviewed the guiding principles Deputy Secretary Summers had sent to China, and said flatly that they did not have the legal, regulatory, or enforcement capability yet to allow the foreign securities firms into the A shares market. The Peoples' Congress hadn't even yet approved the Securities Act, which will give the CSRC full authority, removing the PBOC from the securities regulatory arena. He claimed they would need more time to reform the securities market than was necessary for the banking or insurance sector. He also 'noted' US positions on textiles trade and Chinese bank licenses in the US, although his agency had nothing to do with those issues.

cc: Assistant Secretary Geithner, DAS Zelikow, Todd Crawford, Anthony Marcus

***Description of China's Financial Institutions
and Markets***



INTERNAL FR

John Fernald
April 22, 1998

Description of China's Financial Institutions and Markets

Overview

- Under central planning, finance plays a passive role. As China has moved away from the plan towards the market, a more active and diverse financial system has developed. Ultimately, China hopes to develop a system that allocates resources efficiently and sharpens indirect instruments of macroeconomic control such as open market operations.
- The People's Bank of China, the central bank, supervises the financial system.
- The next most important set of financial institutions are four specialized state banks: the Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China, and the China Construction Bank. These banks have been given considerable leeway in recent years to seek business in new areas, but the banking system remains highly segmented and uncompetitive.
- Three new policy lending banks were established in the first half of 1994 to take over some of the quasi-fiscal policy lending of the state banks, such as for fixed investments in priority projects. They are funded primarily by selling domestic bonds to the state banks; hence, the state banks still bear some of the risk of these policy loans. In addition, the state banks continue to provide substantial quasi-fiscal lending, especially for working capital as opposed to lending for fixed investment.
- Foreign bank presence in China remains relatively small and circumscribed. At the end of 1997, there were 142 foreign bank branches in China; Japanese banks have the greatest presence, followed by Hong Kong banks. Four U.S. banks had branches in China in 1996, with total assets of \$1.0 billion. In addition, 26 U.S. banks had representative offices.
- In early 1997, China licensed nine foreign banks, including Citibank, to undertake local-currency business for foreign-invested enterprises and foreign nationals. Chinese authorities have not fully defined the limits on local-currency activity, but it appears these banks must rely on renminbi deposits to make renminbi loans, with the total quantity of these loans limited as well by the quantity of foreign-currency deposits.
- In January 1996, China established a unified national interbank market. Previously, the interbank market in China was fragmented into numerous local markets and much "interbank" activity was, in fact, between branches of the same bank. Since July 1996, interbank interest rates have been market determined.
- In 1990, securities exchanges opened in Shanghai and Shenzhen. Trading involves government and enterprise bonds as well as shares in joint-stock companies. The capitalization of China's stock markets was about \$200 billion at the end of 1997. Share prices have tended to be volatile.

Introduction

Under Chinese central planning, finance played a passive role. The state designed a physical plan and the credit plan accommodated it. As China has moved away from the plan and towards the market, a more active and diverse financial system has developed. However, financial reform remains incomplete. A major problem is that financial reforms are integrally connected with reforms in other areas such as state-owned enterprises and tax collection. Ultimately, China hopes to develop a financial system that allocates resources efficiently and facilitates the use of indirect monetary instruments such as open market operations.

The remainder of this note describes Chinese financial institutions and markets, and foreign involvement in China's financial markets.

Domestic Institutions

The People's Bank of China (PBOC), the nation's central bank, is at the core of the system. The PBOC sets monetary policy subject to the approval of the State Council, China's cabinet. The PBOC regulates banks and many other financial institutions. (See the separate note on the PBOC.)

The next most important set of institutions are the four major state commercial banks, which primarily lend to the state-owned sector. As of September 1997, these four banks held 70 percent of the assets of China's financial system. Traditionally, these banks have specialized in their operations.¹ All four state banks have in recent years been permitted to seek business in areas not originally intended for them. Nevertheless, banking operations remain highly segmented, minimizing the competition among these banks. Typically, half or more of specialized bank lending has been at the direction of some level of government, either to state-owned enterprises (SOEs) or to desired policy projects such as infrastructure investment. A Commercial Bank Law, enacted in 1995, seeks to make the banks act more like traditional Western commercial banks. Both Chinese and Western analysts suggest that the banks are unlikely to act on a fully commercial banking basis for some time. For example, few bankers have the skills to properly assess credit quality. However, the banks have begun making progress by, for example, improving local branch reporting, implementing asset/liability controls, and investing heavily in new technologies.

Enormous quantities of bad loans remain on the books of the banks. Government authorities acknowledge that more than 20 percent of bank loans are nonperforming, although they usually argue that only 5 to 6 percent of loans

¹ The Industrial and Commercial Bank of China provides fixed and working capital to industrial areas; the Agricultural Bank of China does the same in rural areas. The Bank of China traditionally handles all foreign exchange transactions, while the China Construction Bank (until recently called the People's Construction Bank of China) provides financing for construction projects.

are unrecoverable. Western observers usually estimate that the proportion of non-performing and unrecoverable loans is much higher.

Three new policy lending banks were established in the first half of 1994 to take over some of the quasi-fiscal policy lending of the state banks, such as for fixed investments in priority projects. The State Development Bank and the Agricultural Development Bank took over directed domestic-policy lending, while the China Export-Import Bank provides foreign trade financing. Although they receive some state revenue and have issued several international bonds, they are funded primarily by selling domestic bonds to the state banks; hence, the state banks still bear some of the risk of these policy loans. In addition, the state banks continue to provide substantial quasi-fiscal lending, especially for working capital as opposed to lending for fixed investment.

Other banking institutions are smaller than the state banks but of growing importance. These include several smaller commercial banks (such as the Bank of Communications, which has a branch in the United States), created to increase competition in the financial sector. Other institutions include several provincial development banks, and an extensive network of rural and urban credit cooperatives.

The nonbank sector has grown steadily since 1978. In terms of assets, the most important nonbank financial institutions (NBFIs) are trust and investment companies, whose activities include domestic currency loans, direct investment, and trust business (e.g., intermediating lending by one enterprise to another). The People's Insurance Company of China accounts for about three-quarters of China's insurance market. Other institutions, though relatively small, continue to expand rapidly. As new financial institutions have developed, the regulatory framework has often not kept pace, contributing to the difficulties faced by the center in seeking to control the economy.

Foreign Institutions

Foreign bank presence in China remains tightly restricted. Foreign bank branches may operate in only 24 cities and, except for the nine foreign banks in Pudong that are allowed to provide renminbi service, foreign banks are limited to foreign currency business. At the end of 1997, there were 142 foreign bank branches in China, with total assets of \$38 billion (equal to about 3 percent of the assets of the domestic financial system). More than 500 other foreign financial institutions had representative offices in China. Japanese financial institutions had the greatest representation in China, accounting for about one-quarter of branches or representative offices of foreign financial institutions; Hong Kong institutions had the second greatest representation, accounting for about one-eighth of offices. In 1996, four U.S. banks had branches in China, with total assets of \$1.0 billion. In order of assets, the banks were Citibank, Bank of America, Chase Manhattan, and First National Bank of Chicago. In addition, 26 U.S. banks had representative offices.

In early 1997, China licensed nine foreign banks, including Citibank, to undertake local-currency business for foreign-invested enterprises and foreign nationals. Only 35 percent of liabilities can be denominated in local currency, and only about 8 percent of local-currency loans can be funded from the interbank market (described below). Hence, these banks must rely on renminbi deposits to make renminbi loans, with the total quantity of these loans limited as well by the quantity of foreign-currency deposits.

Three foreign insurance companies, including the American International Group (AIG), operate in Shanghai or Guangzhou, the only cities currently open to foreign insurers. A number of foreign brokerages, securities companies, and accounting firms also operate in China, mostly in Shanghai and Shenzhen.

Money and Capital Markets

In January 1996, China established a unified national interbank market. Previously, there were numerous fragmented interbank markets, and much "interbank" activity was, in fact, between branches of the same bank. This short-term money market has never been a strictly *interbank* market, since it still includes numerous non-bank financial institutions (NBFIs). Lending and borrowing can now take place for periods up to 120 days; in the past, much of the borrowing, particularly by NBFIs, was much longer term.

The national interbank market has two levels. The first is the National Interbank Trading Center, which links the headquarters of the commercial banks as well as 35 Regional Finance Centers (RFCs). The second is the RFCs, which link bank branches and NBFIs at a local level. In order to clear the market, the RFC is a party to each transaction, and hence bears some liquidity and interest risks.²

China began issuing treasury bonds in 1981. These bonds were sold involuntarily to enterprises and individuals. Since 1991, China has generally relied instead on voluntary placement, although in 1993 authorities returned temporarily to involuntary placement, since interest rates did not keep pace with inflation. Even when voluntary, the placement of new bonds is not routine: the placement is conducted like a political campaign. In early 1996, China for the first time began issuing a few discount treasury bills with maturities of one year or less, in order to provide instruments for central bank intervention. Nevertheless, short-term issues remain the exception; most debt has a maturity of between two and five years. In addition, the majority of government debt issues have not been legally tradeable. At the end of 1996, the total outstanding stock of government debt was about 8 percent of GDP (equivalent

² In several conversations last fall, PBOC economists indicated that the interbank market works poorly. One major problem is that the RFCs bear the credit risk at a local level--so they are considered very safe, and everyone wants to lend to them. At the same time, borrowers do not always think they need to repay, since the RFC is owned by the PBOC. At the time, these economists suggested that reforms to the system would be implemented shortly.

to \$65 billion). Since the mid-1980s, SOEs and financial institutions have also issued domestic (though not foreign) bonds, subject to an annual quota which is generally very restrictive. (In 1997, enterprises issued about \$1 billion in bonds, but press reports suggest that issues will increase substantially in 1998.)

Secondary bond trading was introduced in 1988, and a nationwide electronic trading network was established in 1991. This secondary market lacks liquidity, however, both because not all bonds can be legally traded, and because the majority of outstanding treasury bonds are in the hands of individual investors, who tend to hold bonds to maturity. In 1995, China opened futures markets in Treasury bonds, but it closed the markets later that same year, following several market-manipulation scandals. A treasury bond repurchase (repo) market was established in 1992, with trading volume becoming sizeable in early 1996. Anecdotal evidence indicates that the repo market is often a place where securities firms and other non-banks borrow short-term from the banks, often to fund speculative activities. The domestic bond market remains closed to foreigners.

In 1990, securities exchanges opened in Shanghai and Shenzhen. Trading involves government and enterprise bonds as well as shares in joint-stock companies. The capitalization of China's stock markets was about \$200 billion (about 20 percent of GDP) at the end of 1997. China has intentionally segmented the stock market, establishing one class of shares that only domestic residents can purchase (known as A shares) and one class that only foreign residents can purchase (B shares). In addition, about 40 companies have foreign-only shares in Hong Kong, and several have shares in New York. The majority of companies with foreign-only shares also have a domestic-only share. These shares are identical except for who is allowed to own them and the currencies in which they trade (foreign-only shares trade in Hong Kong or U.S. dollars), yet they trade at very different prices. When converted to a common currency, foreigners typically pay about *one-quarter* the price paid by a Chinese resident for the same share. This pricing difference appears to reflect primarily the high prices paid by Chinese residents, who have few formal investment alternatives other than bank accounts; domestic price-earnings ratios are currently about 40.

Share prices, particularly for domestic shares, have been volatile. For example, from 1993 through 1997, the daily standard deviation of price changes for domestic shares was about 3.3 percent, compared with about 2 percent for foreign shares; by comparison, the S&P 500 Index had a daily standard deviation of about 0.8 percent over this period. Following a rapid runup in share prices in December 1996, authorities attempted to discourage stock speculation by announcing that they would not support the stock market if it fell, and by announcing an increase in new share issues for 1997. In response, the Shanghai and Shenzhen markets fell more than 30 percent over a two-week period. Early in 1997, the runup in prices resumed. In May and June, 1997, China passed a number of additional regulations, seeking primarily to limit the ability of banks to speculate in the stock market. According to one PBOC

economist, almost every commercial bank branch was involved with the stock market. Since 1995, banks cannot own securities companies. However, they continued to lend heavily to securities companies, and also traded for themselves.

Despite these restrictions, for 1997 as a whole, domestic shares rose about 25 percent, while foreign shares fell about 10 percent. Much of the difference reflects the effects of the Asian financial crisis—domestic shares were largely unaffected, while foreign shares fell sharply following declines in the Hang Seng in late 1997. As of April 15, 1998, domestic shares were up about 9 percent from the beginning of the year, while foreign shares were down about 5 percent.

What is a market interest rate in China?

China sets most interest rates administratively. Although informal credit markets exist, there is little data on those loan terms. It appears there are only two officially sanctioned financial markets with market-determined interest rates: the interbank market and the treasury bond repo market. The attached chart shows 7-day interbank and repo rates (data are Friday closing prices), as well as the one-year lending rate, which is fairly representative of official interest rates. The interbank rate tends to be relatively smooth, and is almost always *higher* than the lending rate. The repo rate is highly volatile, and has fallen substantially since mid-1997, when China restricted activity in the repo market in order to limit speculative activity in financial markets.

Planned Reforms

In early 1998, China announced sweeping financial market reforms, in part in response to Asia's recent financial crises. Within three years, China hopes to have a reasonably viable commercially oriented financial system, with reformed banks at the core.³ Reforms include first, removing credit quotas so that banks lend on the basis of merit and asset-liability ratios. Second, China plans to issue 270 billion renminbi (\$33 billion) in special Treasury bonds to increase the capital of the four major state banks, with a stated goal of helping them reach a minimum capital-adequacy ratio of 8 percent. (It appears that the bonds will be sold primarily to the banks, who will purchase them using funds freed up by a reduction in required reserves. Nevertheless, the move has the advantage of making explicit that the government takes responsibility for at least some of the bad loans on the books of the banks.) Third, the PBOC announced the adoption of a five-category loan classification system based on international standards, in order to help banks spot and monitor bad loans more effectively. In April, authorities plan to begin conducting broad examinations

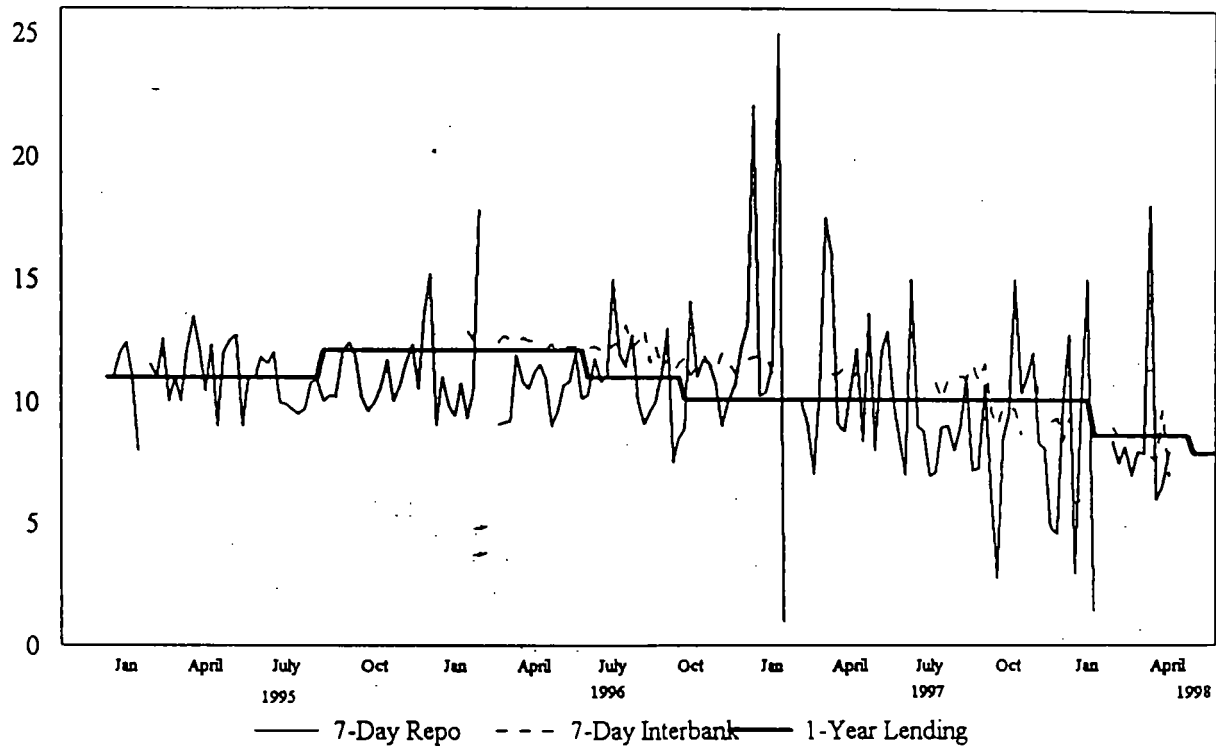
³ In conversation with Vice Chair Rivlin in early April, PBOC Deputy Governor Liu MingKang suggested that the timetable for financial reforms was two years, with enterprise reforms in three years.

7

of financial institutions, in part to identify the true extent of bad loans. Finally, the reforms would include restructuring the PBOC along the lines of the Federal Reserve System.

8

Chinese Interest Rates
Weekly Data (Friday Closing)





***Monetary Policy , the People's Bank of China,
and Prospects for Reform***



INTERNAL FR

John Fernald
April 22, 1998**Monetary Policy, the People's Bank of China, and Prospects for Reform****Overview**

- The People's Bank of China (PBOC) has been China's central bank since 1984. The PBOC is not an independent central bank, but implements monetary policy under the direction of the State Council, China's cabinet.
- The State Council, China's Cabinet, has ultimate responsibility for setting monetary policy. Policy choices are thus influenced by ministries other than the PBOC that are affected by monetary policy and that have a voice in the State Council. China established a "Monetary Policy Commission" in 1997 to advise the PBOC on monetary policy, with representatives of major banks and ministries. The Commission is scheduled to meet at the beginning of every quarter.
- China has a long-term goal of shifting monetary policy towards the use of indirect monetary policy instruments such as interest rates rather than direct credit allocation. In 1996, the PBOC formally began open market operations. However, given the limited quantity of tradeable treasury bills on the market as well as the continuing system of credit quotas and mandated interest rates, these open market operations are likely to remain small and largely experimental for some time to come.
- Monetary policy is set centrally but implemented locally. Local branches of the PBOC have substantial independence from the head office, and are often susceptible to pressure by local interests. As a result, the PBOC has sometimes found it difficult to control local lending decisions. In 1993, the PBOC officially terminated the ability of local branches to allocate credit without central approval; however, anecdotal evidence suggests that some unauthorized lending continues, though it is much more limited and circumspect.
- In January 1998, China announced plans to reorganize the PBOC along the regional lines of the Federal Reserve System, with 12-14 regional branches replacing 44 (roughly) provincial-level branches. Policymakers hope that since these regional branches will cross provincial lines, they will be more responsive to the head office and less responsive to local authorities.

Introduction

Since its founding in 1948, the People's Bank of China (PBOC) has formed the core of China's financial system. The institutional structure of the system changed several times in the 30 years before 1978, but the nature of the all-inclusive monobanking system never changed. Specialized state banks, which served the role of commercial banks in market economies, served in essence as departments of the PBOC or the Ministry of Finance. For a time, the PBOC was itself incorporated into the Ministry of Finance. Whatever the form, the system's function was to accommodate the physical output plan.

Since 1978, the financial system has steadily taken a more active role in allocating resources, and reforms of the PBOC have accompanied this. In 1978, the PBOC was formally separated from the Ministry of Finance and granted ministerial rank. In 1984, the PBOC became the nation's central bank, and most of the commercial banking activities of the PBOC were transferred to the newly established Industrial and Commercial Bank of China.

The PBOC supervises and regulates the banking system and helps oversee most of the rest of the financial system. It handles official foreign exchange reserves, and a PBOC subsidiary (the State Administration of Foreign Exchange, or SAFE) controls and regulates foreign exchange transactions. The PBOC represents China in international financial institutions such as the IMF.

In recent years, China has implemented numerous financial reforms, including reforms of the PBOC. One goal of reforms has been to improve the effectiveness of monetary policy as an instrument for macroeconomic control. The PBOC is currently only one voice in the setting of monetary policy, and its decentralized structure makes it difficult to implement policy effectively. Hence, key aspects of proposals to strengthen the central bank are to increase the autonomy of the PBOC in setting policy, to give the head office of the PBOC greater control over the actions of its branches, and to give the PBOC viable indirect monetary instruments. In addition, the Asian financial crisis in 1997 has focused the attention of Chinese authorities on the potential problems of weak financial systems, spurring announcements of rapid reforms aimed at avoiding a future crisis.

The Structure and Independence of the People's Bank

The State Council, roughly China's equivalent to the Cabinet, has ultimate responsibility for monetary policy decisions. Beneath the State Council are a number of ministries and commissions, including the PBOC. The State Council appoints the governor and deputy governors¹ of the PBOC. There are no fixed terms, and it appears that the governor and the deputy governors can be replaced at any time.

China's 1995 central bank law provides a legal framework for the PBOC, and officially gives the PBOC primary responsibility for setting monetary policy. In practice, however, the PBOC appears to have no ability to pursue monetary policy independently, since it remains subject to the State Council.

For almost all borrowing and lending, the PBOC sets administratively the interest rates that financial institutions can charge. However, the primary instrument of monetary policy remains the direct credit plan, which is effected through ceilings on the credit of the specialized and universal banks. (In early 1998, policymakers announced plans to abolish credit quotas for banks sometime this year.) Setting the annual plan involves negotiation among all interested parties, including SOEs, various ministries, the State Development Planning Commission, the Ministry of Finance, and the PBOC. The State Council serves as final arbiter, since it must approve the plan.

In 1997, China established a new Monetary Policy Commission, which includes the governor and several

¹ There can be as many as six deputy governors, though usually there are fewer

deputy governors of the PBOC, as well as representatives of the State Planning Commission, the Finance Ministry, the commercial banks, and other agencies. The commission plans to meet during the first month of every quarter, with the first meeting held in July 1997. Currently, the commission plays an advisory rather than policymaking role. When the PBOC proposes a change in policy, it appears the commission will review the proposal, and provide the State Council with a summary of the discussion, thus providing a forum for the views of different groups within the government.

The PBOC has a long-term goal of shifting away from direct credit allocation towards the use of indirect monetary policy instruments. In 1996, the PBOC formally began open market operations. However, only a limited quantity of tradeable treasury bills have been issued, and the system of credit quotas and mandated interest rates remain in force; hence, these open market operations remain small and largely experimental.

The PBOC has more than 2500 branches. Hierarchically, below the head office there are 44 major branches in provinces and major cities; below this are city and county sub-branches. As discussed in the next section, the branches affect the implementation of monetary policy but appear to have no role in its formulation. The PBOC had about 180,000 employees in early 1998, including about 1,000 at the head office. The large staff is a holdover from the time when the PBOC monitored the accounting and implementation of the national economic plan, and according to Chinese press reports, the PBOC plans to reduce that number by 50,000 (no timetable has yet been announced).

The operational autonomy of the PBOC and the influence of its professional staff depends to some extent on the governor's standing in the State Council. PBOC governor DAI Xianglong is reported to be a close advisor to Premier Zhu Rongji, suggesting relatively high standing. Zhu himself served as PBOC governor from 1993 to 1995.

The Relationship between the Head Office and the Branches

Monetary policy tends to be set centrally, but implemented locally. As a result, in looking at the autonomy of the PBOC one must assess not only the political power of the head office in Beijing, but also how independent the 44 provincial branches and 2,500 sub-branches of the PBOC are from the head office. At present, the branches are often more responsive to local interests than to the PBOC head office. As a result, the PBOC has often found it difficult to control lending decisions at local levels.

The branches of the PBOC have traditionally had two main functions. First, they distributed currency and allocated credit, and second, they guided and supervised the operations of the specialized banks and other financial institutions. The branches have generally had close ties with specialized banks and with provincial governments. Local

staffing of PBOC branches comes largely from the local population. Indeed, only since 1988 has the PBOC head office appointed the provincial heads of its own branches. Even now many reports indicate that local PBOC staff salaries are determined by local authorities and not by the center.

The PBOC branches thus performed a balancing act between orders from the PBOC head office and from local governments. Central monetary plans gave substantial control over the allocation of credit to local branches. If the goal of price stability conflicted with the realization of local projects or with the health of local SOEs, then the local interests carried substantial weight. The influence of local elites on local PBOC operations thus made it difficult for the central bank in Beijing to enforce its credit plans.

In terms of bank supervision, under central planning the primary focus was on ensuring that banks carried out state credit plans. Credit risks were largely ignored so long as the banks allocated loans as dictated by the PBOC. As banks have gained greater autonomy, it becomes necessary to assess their creditworthiness. Thus, PBOC supervisors must learn a new approach and new skills. In addition, the close ties between branches of the PBOC and the state banks make effective monitoring of the banking system difficult.

Reforms

Numerous reforms have been put in place in recent years. In 1993, the PBOC officially terminated the ability of the branches to allocate credit without central approval. The branches remain responsible for supervising banks in their jurisdictions. (It is unclear how much power over credit the branches still retain; anecdotal evidence suggests that some unauthorized lending by branches at the city and county level). Since 1994, the government can no longer order the PBOC to extend its credit, but must finance budget deficits through domestic and external bond issues. PBOC officials have also been required to sever personal connections with investment companies.

In recent years, the PBOC has upgraded and reform its ability to supervise banks. For example, the PBOC has worked with the IMF, the UNDP, and the Federal Reserve to train bank examiners to analyze risk properly. The PBOC has implemented a system of offsite monitoring of banks.

In mid-January 1998, China announced sweeping financial market reforms, which included plans to reorganize the PBOC along the lines of the Federal Reserve System. In order to reduce interference by local authorities, the reforms would replace the 44 provincial-level branches with 12-14 regional branches that cut across provincial lines.

PBOC Governor Dai has stated that this restructuring should take place in 1998. Although the PBOC has little independence and still requires State Council approval to change policy, the recent reforms do give the PBOC greater influence in setting monetary policy. Hence, the reforms may help the government to act more quickly and flexibly

5

in response to changing economic circumstances.



Reforming the Chinese Economy 1978-1998



Part of these gains reflect the economy's low starting level. Economic liberalization improved allocative efficiency, allowing output and hence productivity to rise even with unchanging inputs and technology. Inputs and technology have not, however, remained unchanged. That is, long-run potential growth has risen, both because of rapid capital accumulation and because of incentives for technology transfer and innovation.

Despite widespread gains in economic efficiency, China's reforms remain incomplete. One implication of China's partial financial market reforms, for example, is that macroeconomic management increasingly difficult. The old direct instruments of control have lost much of their power. But new indirect instruments are not yet effective enough to take their place. The resulting loss of macroeconomic control has contributed to cycles of economic activity since 1978. The attempt to develop new tools of macroeconomic control, as well as to keep growth high, has motivated the latest round of reform plans.

Economic Reforms 1978-1997

Unlike countries in Eastern Europe and the former Soviet Union, China did not begin economic reforms with a clear vision of the system it sought to create. Initially, the role of the market was viewed as a useful supplement to—but no substitute for—a predominately planned economy. Political views have evolved over time, though, and a market-based economy is now generally viewed as compatible with either capitalism or socialism. At the 15th Communist Party Congress in September 1997, President Jiang Zemin enshrined as official party doctrine what he euphemistically referred to as "socializing ownership of the means of production"—in other words, privatizing (a word Chinese politicians still usually avoid). For example, the state officially now finds it acceptable to sell off all or parts of most of its enterprises as shareholding enterprises. Broad share ownership, in turn, preserves the "socialist" desire for broad public ownership of the means of production.

China has generally introduced reforms through intermediate mechanisms. For example, China opened to foreign investment by establishing SEZs in the late 1970s and early 1980s, only slowly opening more completely in recent years. China liberalized prices by using a dual-track pricing system: input and output prices remained administratively fixed for the quantities required to fulfill the plan, with free-market pricing at the margin for other sales. In foreign-exchange markets, China established relatively free-market swap centers in 1986, and the official and free-market rates coexisted until they were unified in 1994.

This incremental and experimental approach had three advantages, according to Chinese authorities. First, moving slowly avoided major disruptions, and if policies worked poorly they could be modified. Second, leadership built political support for reform by implementing first those policies that were most likely to succeed, hence minimizing social unrest and political conflict. Third, China had time to develop some of the prerequisites for

successful markets, including training personnel and developing new institutions and a new legal and regulatory framework.

This style of reform is usually described as "gradualist"—"feeling the stones to cross the stream," in Deng Xiaoping's words. Several authors have argued, however, that China's "dual-track" reform strategy was not, in fact, gradual.² In particular, a dual-track strategy can, in principle, achieve full economic efficiency as quickly as the big-bang strategy of abolishing the central plans and immediately opening all markets. With a dual-track approach, at the margin, markets determine prices and the allocation of resources; the central plan provides for intramarginal rent transfers. In addition, the dual-track approach may be easier to implement politically than a big-bang approach, since the dual-track approach can be Pareto-improving: No one is made worse off and at least some one is made strictly better off. Since the pre-existing distribution of rents under the plan remains, the dual-track approach in essence implements lump-sum transfers to compensate any losers under the reforms.

The argument that China has not followed a gradualist strategy almost surely overstates the case. First, not all markets opened immediately and simultaneously, so marginal efficiency conditions have not necessarily been achieved. Second, China's property rights remain poorly defined, and hence contracts cannot always be enforced. This lack of property rights prevents some Pareto-improving transactions from taking place. Third, the need to provide subsidies to loss-making state-owned enterprises (SOEs) have led to continuing distortions in financial markets. Fourth, many intermediate inputs (for example, steel and energy) continue to be produced only by SOE monopolies, who do not necessarily price at marginal cost, and who often ration quantities because they cannot meet demand. These continuing distortions in intermediate input markets lead the economy to produce inside its production possibilities frontier, as shown long ago (in analyzing optimal tax policy) by Diamond and Mirrlees.

Nevertheless, the argument that in principle, a dual-track strategy can quickly achieve efficiency points out that China's approach is not necessarily less radical than the big-bang approach. Nor should we be surprised that China has grown so quickly despite its substantial remaining distortions.

To date, prominent areas of reforms include the following:

- *Agriculture.* In the late 1970s, China broke up large communes and returned agricultural production to individual households. Land transfers remain difficult and sometimes impossible, but households have to a limited extent received property rights through long-term leases. Agricultural surpluses have largely funded the growth of rural industry.

- *Industry.* Most enterprises now sell some or all outputs and buy some or all inputs in free markets. State-owned

² Lawrence Lau, Yingyi Qian and Gérard Roland, "Reform Without Losers: An Interpretation of China's Dual-Track Approach to Transition." Center for Economic Policy Research Working Paper No. 1798, February 1998.

Part of these gains reflect the economy's low starting level. Economic liberalization improved allocative efficiency, allowing output and hence productivity to rise even with unchanging inputs and technology. Inputs and technology have not, however, remained unchanged. That is, long-run potential growth has risen, both because of rapid capital accumulation and because of incentives for technology transfer and innovation.

Despite widespread gains in economic efficiency, China's reforms remain incomplete. One implication of China's partial financial market reforms, for example, is that macroeconomic management increasingly difficult. The old direct instruments of control have lost much of their power. But new indirect instruments are not yet effective enough to take their place. The resulting loss of macroeconomic control has contributed to cycles of economic activity since 1978. The attempt to develop new tools of macroeconomic control, as well as to keep growth high, has motivated the latest round of reform plans.

Economic Reforms 1978-1997

Unlike countries in Eastern Europe and the former Soviet Union, China did not begin economic reforms with a clear vision of the system it sought to create. Initially, the role of the market was viewed as a useful supplement to—but no substitute for—a predominately planned economy. Political views have evolved over time, though, and a market-based economy is now generally viewed as compatible with either capitalism or socialism. At the 15th Communist Party Congress in September 1997, President Jiang Zemin enshrined as official party doctrine what he euphemistically referred to as "socializing ownership of the means of production"—in other words, privatizing (a word Chinese politicians still usually avoid). For example, the state officially now finds it acceptable to sell off all or parts of most of its enterprises as shareholding enterprises. Broad share ownership, in turn, preserves the "socialist" desire for broad public ownership of the means of production.

China has generally introduced reforms through intermediate mechanisms. For example, China opened to foreign investment by establishing SEZs in the late 1970s and early 1980s, only slowly opening more completely in recent years. China liberalized prices by using a dual-track pricing system: input and output prices remained administratively fixed for the quantities required to fulfill the plan, with free-market pricing at the margin for other sales. In foreign-exchange markets, China established relatively free-market swap centers in 1986, and the official and free-market rates coexisted until they were unified in 1994.

This incremental and experimental approach had three advantages, according to Chinese authorities. First, moving slowly avoided major disruptions, and if policies worked poorly they could be modified. Second, leadership built political support for reform by implementing first those policies that were most likely to succeed, hence minimizing social unrest and political conflict. Third, China had time to develop some of the prerequisites for

successful markets, including training personnel and developing new institutions and a new legal and regulatory framework.

This style of reform is usually described as "gradualist"—"feeling the stones to cross the stream," in Deng Xiaoping's words. Several authors have argued, however, that China's "dual-track" reform strategy was not, in fact, gradual.² In particular, a dual-track strategy can, in principle, achieve full economic efficiency as quickly as the big-bang strategy of abolishing the central plans and immediately opening all markets. With a dual-track approach, at the margin, markets determine prices and the allocation of resources; the central plan provides for intramarginal rent transfers. In addition, the dual-track approach may be easier to implement politically than a big-bang approach, since the dual-track approach can be Pareto-improving: No one is made worse off and at least some one is made strictly better off. Since the pre-existing distribution of rents under the plan remains, the dual-track approach in essence implements lump-sum transfers to compensate any losers under the reforms.

The argument that China has not followed a gradualist strategy almost surely overstates the case. First, not all markets opened immediately and simultaneously, so marginal efficiency conditions have not necessarily been achieved. Second, China's property rights remain poorly defined, and hence contracts cannot always be enforced. This lack of property rights prevents some Pareto-improving transactions from taking place. Third, the need to provide subsidies to loss-making state-owned enterprises (SOEs) have led to continuing distortions in financial markets. Fourth, many intermediate inputs (for example, steel and energy) continue to be produced only by SOE monopolies, who do not necessarily price at marginal cost, and who often ration quantities because they cannot meet demand. These continuing distortions in intermediate input markets lead the economy to produce inside its production possibilities frontier, as shown long ago (in analyzing optimal tax policy) by Diamond and Mirrlees.

Nevertheless, the argument that in principle, a dual-track strategy can quickly achieve efficiency points out that China's approach is not necessarily less radical than the big-bang approach. Nor should we be surprised that China has grown so quickly despite its substantial remaining distortions.

To date, prominent areas of reforms include the following:

- *Agriculture.* In the late 1970s, China broke up large communes and returned agricultural production to individual households. Land transfers remain difficult and sometimes impossible, but households have to a limited extent received property rights through long-term leases. Agricultural surpluses have largely funded the growth of rural industry.
- *Industry.* Most enterprises now sell some or all outputs and buy some or all inputs in free markets. State-owned

² Lawrence Lau, Yingyi Qian and Gérard Roland, "Reform Without Losers: An Interpretation of China's Dual-Track Approach to Transition." Center for Economic Policy Research Working Paper No. 1798, February 1998.

enterprises (SOEs) no longer must remit all profits to the state. Managers receive monetary rewards related to firm performance, and have increasing control over what, how, and how much to produce. In addition, numerous collective and private firms now exist to fill market gaps, especially in light industry. This "nonstate" sector includes township and village-owned enterprises (TVEs), and hence is not necessarily private; the key characteristic of these nonstate firms is that unlike SOEs, they are not owned by the central government, they face hard budget constraints, and can legally sell their assets. One advantage of TVEs is that their ownership by local governments helped substitute for the lack of clear property rights, since local bureaucrats could help provide political protection. In 1978, the nonstate sector produced 19 percent of China's industrial output; in 1996, it produced 66 percent. Collectives and TVEs have increased their share from under 5 percent to 26 percent.

• *Prices.* China began price reforms in agriculture, and after 1985 adopted the two-track price system for industry. Prices of consumer goods were liberalized earlier than prices of industrial materials. In recent years China has begun to phase out the two-track system. About 80 percent of production materials, 85 percent of agricultural products, and 95 percent of consumer goods now are reportedly priced by the market.³ (When inflation rises, however, China tends to reimpose price controls. For example, between 1993 and 1994, the share of agricultural prices set by the market fell from 88 percent to 80 percent, before rising again to 85 percent in early 1997.)

• *Foreign Trade and Investment.* Merchandise trade (the sum of exports and imports) rose from \$5 billion (10 percent of GDP at the official exchange rate) in 1975 to \$325 billion (36 percent of GDP) in 1997. Numerous SEZs have been established to free foreign investors and exporters from red tape. Since 1978, cumulative foreign direct investment of more than \$200 billion has brought foreign technology and management techniques. The proximity to Hong Kong clearly helped China, since about two-thirds of FDI came from Hong Kong. Hong Kong producers have steadily shifted production to Southern China, with head offices remaining in Hong Kong. China actively seeks to enter the WTO.

• *Public Finance.* China implemented major tax reforms at the start of 1994, unifying corporate tax rates and introducing a value-added tax and a graduated individual income tax. The purpose of these tax changes was to broaden the tax base and increase central government revenues. Tax revenue as a share of GDP has steadily fallen over time, and the reforms appear to have stabilized revenue as a share of GDP at about 11 percent in 1995 and 1996. The value-added tax accounts for more than 40 percent of revenue; the income tax accounts for less than 2 percent.

• *Financial Markets.* In 1984, China separated the central banking activities of the People's Bank of China (PBOC) from its commercial banking activities. Numerous nonbank financial institutions have been allowed to operate. New

³ These data from a speech by the Minister of the State Planning Commission in Davos, Switzerland, in February 1997, and appear to refer to early 1997 or late 1996. These data are consistent with data reported by the IMF for 1994.

capital markets have formed, including equity markets and secondary markets in government bonds.

Reforms in all areas remain incomplete. The authorities often protect SOE monopolies, for example, and if these firms lose money they face soft budget constraints. While many prices have been freed, key prices (notably for energy and transport as well as most factor prices for land, labor, and capital) are still controlled. Even "market prices" remain subject to official intervention, either through occasional price caps or through the release of buffer stocks of basic commodities such as grain. The government still directs much of bank credit to borrowers who are unlikely ever to repay; and the inefficient interbank market and payments system make bank reserve management difficult. Trade restrictions are often opaque, and enforced capriciously.

Recent and Prospective Reforms

In 1997 and early 1998, the pace of proposed reforms has accelerated markedly, with a particular focus on state-owned enterprises and financial markets (separate notes discusses reforms of the People's Bank and China's financial sector at greater length).

China currently has more than 300,000 SOEs, including more than 100,000 industrial SOEs. From 1991 to 1996, industrial output by SOEs grew at an average rate of 7 percent per year, compared with growth of 28 percent per year in the non-state sector; output of SOEs now accounts for less than a third of industrial output. Nevertheless, SOEs account for about two-thirds of industrial employment, and more than half of total investment—much of which appears to have a low rate of return. SOEs receive strong political support, and hence face soft budget constraints.

At the 15th Party Congress in September, President Jiang Zemin announced that China plans to keep state control over only about 1,000 of the largest core enterprises. (Policymakers have occasionally suggested that Korean chaebol system as a model, although the Asian financial crisis appears to have led to some reconsideration of this point.) Of the rest, some may be merged with more successful partners, some may sell stock to employees or through a stock-market listing, and some may be sold outright to the private sector. Non-viable firms are expected to go bankrupt. (Chinese leaders generally avoid the word "privatization," preferring phrases such as "clarifying property rights," or establishing "common ownership" through stock sales.)

The announcements clear many of the ideological hurdles to selling state assets. Nevertheless, major reforms are unlikely to take place quickly, irrespective of official announcements. First, China lacks effective corporate governance. The stock market lacks large institutional investors who could provide such governance, and in any case, the market probably lacks the capacity to absorb the required quantity of new issues. Second, many Chinese enterprises are probably not commercially viable; outside investors may be unwilling to buy them at any positive price. The state sector currently employs about 100 million workers (two-thirds of the urban labor force), and policymakers appear

concerned that closing non-viable enterprises would substantially raise unemployment, thus threatening social stability.

In order to facilitate enterprise restructuring, China is trying to reduce the importance of enterprises in providing social services such as education, health, pensions, and housing. Numerous cities have begun preliminary efforts to put social programs in place—pooling pensions at a city-wide level, for example, rather than enterprise-by-enterprise. In 1998, Premier Zhu Rongji announced substantial housing reforms. The reforms are slated to include: ending the allocation of state-subsidized housing, starting in the second half of 1998; gradually increasing state-subsidized rents; paying cash subsidies to state workers to compensate for rising rents; widespread selling of government housing to current occupants at low prices; increasing availability of provident and commercial mortgage loans for private home buyers.

China's legal system remains inadequate. Chinese companies—and the Chinese government itself—often do not view contracts as binding, and enforcement through the courts remains unreliable at best. As a result, many foreign investors attempt to find alternative mechanisms to ensure payment, such as developing close ties to their customers or dealing only with firms with identifiable overseas assets.

However, China has made some progress at providing clearly defined property rights and improving its judiciary. The National People's Congress has approved numerous new laws in the past few years, establishing formal legal underpinnings in numerous areas. In financial areas, for example, China has passed laws regulating the central bank, the commercial banks, insurance markets, and trade in negotiable instruments. In some areas, China's courts now appear increasingly willing to enforce the laws on the books. For example, numerous foreign firms have filed court cases regarding violations of intellectual property rights (a source of bilateral conflict between the United States and China), and the Chinese courts have increasingly been willing to rule in their favor. Nevertheless, even in this relatively high-profile area, courts move slowly, it remains difficult to win cases, and even winners rarely get more than token compensation for monetary damages.

Conclusion

China's approach to reform differs substantially from the approach taken by Russia and other countries of the former Soviet Union and Eastern Europe, who generally implemented market reforms much more quickly. Chinese economists sometimes point to post-reform problems in Russia's economy as vindication for the go-slow approach. This conclusion is probably not warranted, since Russia and China had very different initial conditions and structural characteristics at the onset of reform.

As noted by the World Bank's *1996 World Development Report*, China remains much less industrialized than

Russia, even after 19 years of reform. In 1978, industry accounted for 15 percent of China's employment, while agriculture accounted for 71 percent. As of 1994, the share in industry had risen to 18 percent, while the share in agriculture had fallen to 58 percent. By contrast, in 1990 industry accounted for 42 percent of Russia's employment, while agriculture accounted for only 13 percent; the shares have changed little since then. One consequence of this different employment mix is that China's economy was much less centrally planned and administered than the Soviet economy.

The World Bank thus concludes that "the right reform mix must reflect initial conditions, and so cannot simply be transplanted between such starkly different countries as China and Russia." Moreover, when the World Bank surveys the range of transition economies, they find that those countries that liberalized rapidly and extensively also turned around more quickly.

For China, an incremental and experimental approach has served well over the past two decades. However, enormous interrelated problems remain—notably, China must rely on banks to finance enterprises, in part to finance the social services that these enterprises provide, since the government lacks the fiscal and institutional capacity to provide these services directly. Chinese policymakers appear to have concluded that they must move quickly to resolve these issues, and have therefore set a three year time frame for achieving reasonable results.

Numerous obstacles remain. Local politicians and SOE managers, for example, oppose reforms that eliminate their power to direct resources towards themselves and their friends. In addition, China may lack the necessary institutional and human capital for rapid reforms; corporate governance, for example, remains weak, and banks lack experience making loans on commercial grounds. Hence, the road ahead remains difficult and uncertain.



Extra stuff....

Macroeconomic Management

The partial nature of reforms complicates macroeconomic management. As economic and bureaucratic power has been decentralized, policy coordination becomes necessary but difficult, curbing the effectiveness of existing fiscal and monetary tools. Under central planning, the physical plan and the credit plan provided two sources of administrative oversight over aggregate demand. The physical plan is now relevant for only a few decisions, and the credit plan is easily bypassed. At the same time, the mechanisms and institutions needed for successful use of indirect instruments are not fully in place.

The primary monetary instrument for managing the economy remains the credit plan. The credit plan is formulated by the PBOC under the direction of the State Council and the State Planning Commission. Traditionally, the credit plan served a passive role in facilitating the physical plan that specified output targets. Market reforms have minimized the importance of the physical plan, giving monetary policy a more active role in affecting how resources are allocated. At the same time, however, market reform and decentralization make it more difficult to control credit while also loosening the link between credit and activity.

The credit plan is designed centrally, but implemented locally. For several reasons, this leads monetary policy to accommodate demand shocks, especially the "investment hunger" of the SOEs, and the plan has typically been exceeded in recent years. First, in the creation of the plan there appears to be room for bargaining between firms and specialized banks, and between specialized banks and the PBOC. In the past, the ability to bargain was restricted by the need to receive an entitlement from the physical plan as well as the credit plan. Second, local PBOC authorities are heavily influenced by local political and economic interests. Third, financial market developments, such as the growth of nonbank financial institutions and securities markets, have created new non-plan sources of credit. These factors make credit creation and aggregate demand more difficult to administer by fiat.

Although direct monetary tools have been blunted, indirect tools are not yet sharp enough to replace them. Reforming financial markets and the SOEs are key for sharpening them. Open market operations or changes in reserve requirements, for example, generally work by changing market signals such as interest or exchange rates. In China, however, these signals often do not fully reflect underlying supply and demand conditions, and in any case many economic agents are relatively unresponsive to the changes in these signals. Because of interest rate controls, directed credit, and the inefficient interbank market, for example, banks have little incentive to behave competitively or to be sensitive to their costs of funds in deciding lending rates or the volume of loans. Even if lending rates did respond, firms facing soft budget constraints do not determine their borrowing and investment decisions on the basis of price.