



CHINA IN THE BALANCE

CHINA STRATEGY

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China's reform lives. State-owned enterprises (SOEs) have laid off 17m workers in two years. SOE reform will likely take five years rather than three, but progress is substantial. The government has been cut in half. The military has withdrawn from commercial business and is laying off 500,000 soldiers.

So far, mass layoffs are not causing unacceptable suffering or a mass political reaction. Major social unrest is unlikely in the coming year.

The economy's heart has stopped and the body is on life support while Premier Zhu Rongji operates. Exports are falling, foreign direct investment (FDI) is down, and town-and-village enterprises (TVEs) are weak. Virtually all GDP growth is government stimulus (8% of GDP deficit) in the form of SOE infrastructure projects.

For now, China will likely not run out of money, either forex or renminbi, for two years. Central government domestic currency debt is only 10% of GDP. But the impending financial squeeze is significant. Foreign commercial banks are refusing to make non-sovereign loans. Government deficits at all levels combine to an estimated 8% of GDP. Eventually, successful continuation of reform will require either consumer spending or trade to recover.

Following the bankruptcy of Guangdong International Trust and Investment Company (GITIC), foreign bank lending to non-sovereign enterprises has essentially ceased. The central government will no longer prevent local governments from bailing out their ITICs, but neither will the central government itself bail them out.

China has undertaken important financial reforms. But the new asset management companies (AMCs) being set up to help banks shed bad loans intend to manage the assets through corporate reorganisation and mergers, not auction them off quickly in the manner of the US and Thailand. We believe this augurs poorly for early restoration of financial health.

We expect the renminbi to remain fixed to the US dollar for 1999, but there appears to be a widening recognition that it would be irrational and unsustainable to peg the currency to the US dollar indefinitely.

China's World Trade Organization (WTO) accession is in trouble. President Clinton's delay has given Chinese opposition time to mobilise. The bombing of the Chinese Embassy in Yugoslavia makes big concessions to the US politically difficult.

We do not see the Falun Gong cult, newly prominent, as a threat to stability, but such movements could become a threat if the economic reform programme were to fail. A similar cult in Korea, that of Sun Myung Moon, faded harmlessly as development proceeded.

China's economy will likely be a drag on the region, and particularly on Hong Kong, in 1999. Not only is the growth rate planned to be less, 7% as compared with 1998's 7.8%, but the character of growth has changed from growth of trade, direct investment, and smaller enterprises, to growth derived from big SOEs building infrastructure projects.

Chinese shares are expected to continue to see liquidity-driven rallies, but the fundamentals are unlikely to revive as quickly as those of other Asian economies.

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In a squeeze

Government use of the credit system to give special privileges to certain sectors has created a financial bubble

China is in a squeeze. The domestic causes are the same as elsewhere in the Asian crisis: government use of the credit system to give special privileges to certain sectors, in this case the state enterprises, has created a bloated sector, a financial bubble. As in South Korea, the favoured enterprises have used their access to excessive funding and low-cost funding to create vast empires of overcapacity and inefficiency. As in South Korea, the availability of funds regardless of profit has underwritten a labour system that protects workers in the favoured firms from market pressures, assuring lifetime employment and a wide range of social benefits even if their companies are providing no useful output and even if they themselves are doing no productive work. As in South Korea, use of the banks to underwrite this system has created a daunting accumulation of bad loans that threatens the viability of the entire financial system and jeopardises decades of improvements in national and individual prosperity.

There are parallels with South Korea...

China's financial bubble crisis is very similar in origin to South Korea's, but there are also important differences. Whereas South Korea's bubble was punctured by a foreign debt crisis in December 1997, China has proportionately far less foreign debt and proportionately far greater foreign exchange reserves, so its bubble will likely be deflated by internal rather than external causes. That is China's advantage. The corresponding disadvantages are more important. China's state enterprises are far less efficient and competitive than Korea's chaebol. China's squeeze comes at a much lower level of administrative and technological development than Korea's. The sheer scale of management problems conducting reform in China's vast expanse, huge population, and diverse society is orders of magnitude greater than in South Korea. And, given China's lower level of per capita income and political development, the consequences of a major economic setback could include extensive starvation and political upheaval, neither of which is at risk in South Korea.

...but China acknowledged and attacked its problems before the onset of a crisis

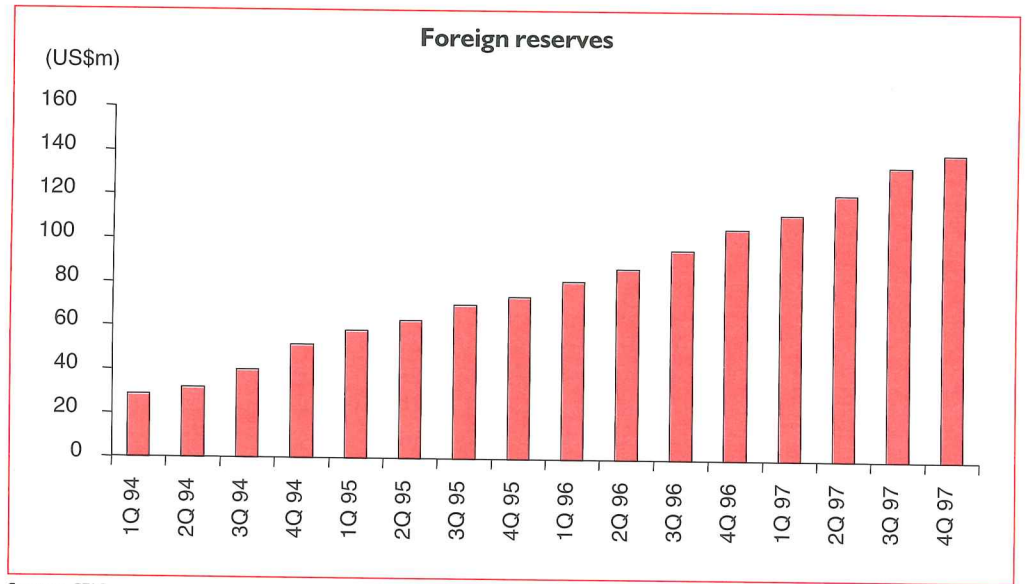
The squeeze results from good policy — the most proactive economic reform programme in Asia and for that matter in the world. Because the stakes are greater in China than elsewhere in Asia (except Indonesia), and because China currently has a forward-looking leadership, China has acknowledged and attacked its problems before the onset of a crisis, rather than waiting to be overwhelmed by events as Indonesia, Thailand and South Korea did. Notably, although China is learning from the smaller countries' experience, it adopted its proactive posture well before the onset of the Asian crisis.

The reform process produced some impressive successes...

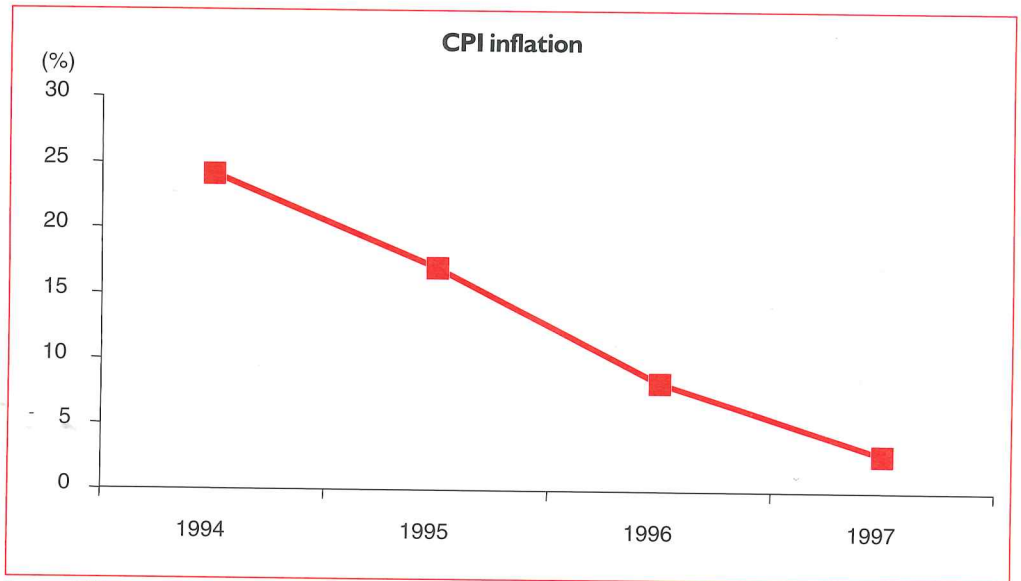
In fact, China's reform successes in the four years prior to the onset of the Asian crisis rank among the most inspiring achievements in the history of economic management. From 1994 to 1997, China pressed inflation down from 22% to negligible while keeping growth up in the 9% range, stimulated a series of record grain harvests, raised foreign exchange reserves from US\$21bn to US\$140bn, attracted foreign direct investment that reached more than US\$40bn per year, and initiated wide-ranging tax reforms, legal reforms, and banking reforms. Such a record of achievement would have been unique in the history of almost any country; it is particularly noteworthy that it could be achieved in a country with a population roughly equivalent to the sum of the former Soviet Union, Eastern Europe, Western Europe, the Middle East, Africa, and South America.

...but these have given way to real problems

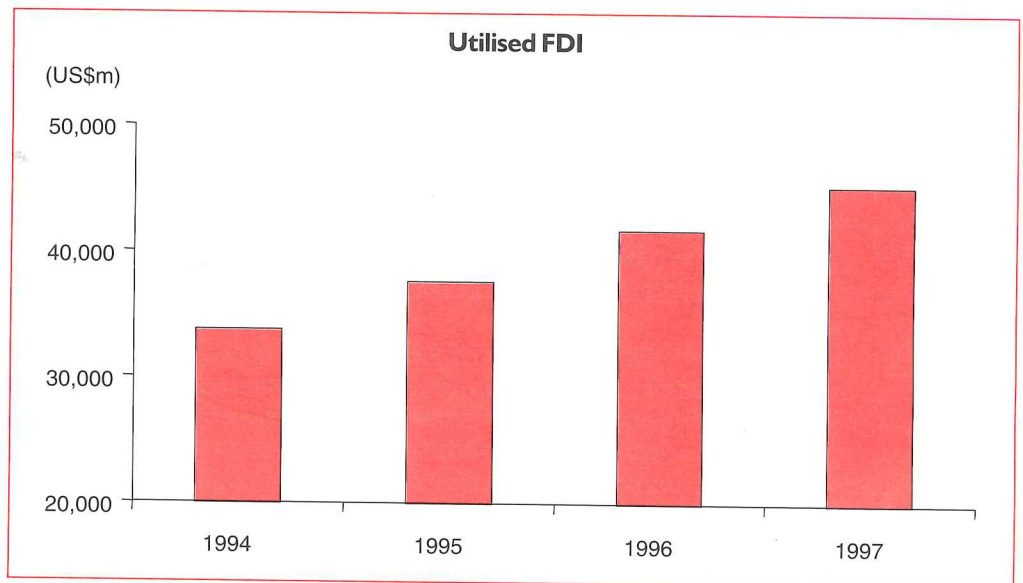
Having achieved all this, China nonetheless found itself in an economic quagmire. This, too, paralleled South Korea and the other great economic success stories of Asia. The same methods of guiding the economy which created the great Asian economic takeoffs have led to overcapacity, deflationary pressures, banking breakdowns, rising unemployment, and severe social strains.



Source: CEIC



Source: CEIC



Source: China Statistical Yearbook 1998

The momentum of reform

Reports that the reform process has stalled are wrong

It seems to have been taken as read in much of the press that Chinese reform has stalled. Certainly, the state enterprise reforms are behind schedule. The great Asian financial crisis of 1998, plus the costs of some of modern history's greatest floods in the summer of 1998, have exacted a heavy price because the pace of reform is ultimately constrained by the economy's ability to employ people who are laid off. But reform has continued at an extraordinary rate.

Government reform

Downsizing led to 4m government lay-offs last year

During 1998, government ministries were downsized by half. The plan was to do this within three years. It was largely accomplished within a single year. Some 4m government employees were laid off in 1998. Virtually all the former officials still live in government housing. Many are being supported by retraining programmes. Many are going back to school at government expense. Most get two to three years of income and benefits broadly in line with what their jobs provided. But there have been vast savings and vast efficiencies. Some 30-40% do not get full retirement benefits. And the officials have not been hired back, as would have happened in Washington D.C., under the guise of consultants or contractors. Hard budget constraints have been imposed.

The military and the Communist Party are not included in this particular downsizing, but all levels of government are part of it. Moreover, this huge reduction of employees and budgets has been accomplished without creating a collapse of morale or a burgeoning of political opposition. In interviews, government officials did not appear gravely disheartened by the changes. Asked how their former colleagues were faring, they said that virtually all central government officials have quickly been employed by the private sector, usually at higher incomes; their skills and connections are badly needed by the private sector. In China's 2,400 county-level governments, there is more of a backup, because county officials do not always have exceptionally valuable skills and contacts, and because there is a tendency to push problems down to the county level.

On balance, the government reform has proceeded with amazing speed and minimal disruption. We believe there is virtually no other government in the world that could accomplish this. No G-7 government could do in ten years what the Chinese have done in one. No African or Latin American government could accomplish it within 20 years.

Military reform

The Chinese military used to have myriad business ties...

Like most Asian militaries, the Chinese military has been heavily self-supporting. As in Thailand and especially Indonesia, the Chinese military developed a vast array of businesses. It didn't just make armaments. It grew cotton. It bottled soft drinks. It was co-owner of Beijing's plush hotel. It sold Baskin Robbins ice cream. In all of China's major cities, the army ran karaoke bars, usually with very warm and welcoming hostesses. It set up car-wash facilities on highways leading into certain major cities and forced every passing driver to have a car wash. It smuggled on a vast scale. (At one point, Hong Kong's port noticed that many of the giant cranes used to move containers had disappeared; they turned up at a Chinese army construction project in nearby Guangdong province and were returned only after Guangdong police outmanoeuvred the army unit and seized the cranes. At another time, extraordinarily fast army-built boats, with cockpits exactly the size of a luxury car, were rapidly depleting Hong Kong's normally over-generous supply of Mercedes-Benz cars — until the Hong Kong police strung wires that did nasty things to boats travelling 80 kilometres per hour.) The People's Liberation Army (PLA) was the best partner a foreign investor could have; army generals could make things happen, they had a national transportation and distribution system, they provided excellent security, and they could ignore the law. So vast was the Chinese military's network of businesses that the US military had a major cottage industry just trying to track the variegated enterprises of its Chinese counterparts.

...but that all changed last year

In 1998, the Chinese government decided to get the military out of business. The task was so vast and so delicate that it was clear from the beginning that it was impossible. But the impossible seems to have happened. China has many patriotic officers who recognised that soldiers who were selling ice cream probably were forgetting how to shoot straight.¹ The army was glad to get out of some businesses, because many were losing money. The politics were complex, and the financial cost to the government was huge, because the administration paid army headquarters trust funds for the businesses it expropriated. But in the end the job was done — in a single year.

Business links have been cut...

China has initiated a total reorganisation of the PLA. Some 500,000 soldiers will be laid off — a huge cut and one that is particularly painful when the economy is doing poorly and many soldiers' wives are simultaneously losing their jobs. Conscripted service of three to four years is being reduced to two years. Professional NCOs are becoming more important, political commissars less important. Civilian education and ROTC programmes are getting new prominence in an effort to produce higher-quality senior officers. Division-level management is frequently being eliminated. The strategic doctrine is being changed. The research and development and acquisition processes are being revamped. Civilian outsourcing is being introduced for equipment, hospitals, restaurants, and many other things.

In addition, the military is being subjected to firmer civilian control. For the first time, there is no military officer on the Standing Committee of the Politburo.

...and a major reorganisation is under way

The military is being rapidly midwived out of the old economy and into the new one. The changes are breathtaking and appear to bode well for the economy. In the long run, they should strengthen the Chinese military. For the next seven or eight years, the Chinese military will be preoccupied with reorganisation and will need to avoid trouble with foreigners.

An end to military smuggling bodes well for government revenues and forex reserves

An important consequence of military reform is that smuggling has declined and import figures have become more accurate. The army was the country's biggest smuggler, and reduction of smuggling was a major incentive for military reform. This explains the amazing jump in imports that began as soon as the military was expelled from business. In March 1999, imports of beverages and tobacco rose 39.2%, food oils rose 58.5%, and machinery and transportation imports rose 52.3% despite a weaker economy, a result that would appear impossible if one did not know that the real reason was not additional imports but rather a move of existing imports from smuggling, which is not counted in the statistics, to legitimate importation. Among the consequences: government revenues will rise substantially because more tariffs will be collected; foreign exchange reserves will rise because less foreign exchange will be hidden offshore; and politically sensitive trade deficits with the US and other countries will be revealed to be substantially smaller than previously believed because huge imports were not being reported.

Financial reform

Financial reform must be the ultimate core of any reform

The ultimate cause of Asia's, and China's, financial bubbles is the misallocation of capital. The most disastrous consequence of a bubble popping is collapse of the banking system. Hence financial reform, defined broadly as movement towards more efficient use of capital, must be the ultimate core of any reform.

China's banks are very sick; the question is whether they can be cured before a South Korean-style collapse occurs. China has chosen to emphasise that the banks cannot be cured until their customers, namely the state enterprises, are cured, because the state enterprises are the source of the accumulating non-performing loans (NPLs). This is a fundamental strategic choice, and it is by no means inevitable. South Korea has focused

¹ In the US, it was common for right-wing commentators to insist that, in judging the threat China posed, one should add the military businesses to the defence budget. As anyone who has dealt with third-world militaries would know, it would have been much more appropriate to subtract.

on fixing the banks, letting the companies fall as they may according to the market — except that the biggest companies have a death-grip on the banks and the government has therefore tried to impose reorganisations. Poland, meanwhile, suddenly decreed "Big Bang" and let the major banks and industries collapse, setting the country back over a decade. Growth later resumed, but after a decade of reform the economy still has not reached its previous income levels. Theoretically, one could put the banks on a market basis and pay subsidies directly from the finance ministry to selected state enterprises.

But financial reform has many dimensions and it will be helpful to paint the broader picture before focusing in on SOE reform.

Suppression of inflation ensured that a Thai- or Japan-style real estate bubble was avoided

Macro-stability helps. At the highest level, proper capital allocation is a function of macro-economic policy. Economic czar Zhu Rongji's greatest contribution to financial reform in the 1994-97 era was to subdue inflation. High inflation was encouraging huge wasteful investments in real estate and other non-productive assets, and threatening to create a real estate bubble. Zhu banned the banks from funding most such investments and brought inflation down to levels that did not encourage a real estate bubble, thereby avoiding the kinds of crisis that humbled Thailand and Japan. To be sure, some smaller real estate bubbles have occurred, most notably in the office buildings of Pudong, across the river from old Shanghai. There, a wondrous collection of some of the world's most interesting architecture impresses the eye, but the office buildings remain 70% unoccupied. Fortunately, this bubble is limited and relatively isolated; although the office buildings remain vacant, the housing is almost fully occupied and Shanghai rents that have come down 60% testify to an old bubble popped, not a new one forming.

US dollar link leads to high real interest rates and inhibits fund flows

Currency stability hurts. On the other side of the ledger, the effort to keep the currency tied to the US dollar requires that Chinese interest rates be tied to US rates. As noted in the section on currency below, this leads to extraordinarily high real interest rates in China's deflating economy and greatly inhibits the flow of funds at reasonable rates to Chinese companies.

Limiting the tendency to attract poorly conceived loans is key

Moral hazard declining. Asian economic models, particularly the more socialist ones like China and South Korea, encourage private banks to fund favoured companies on the assumption that the government will take care of its favourites. Limiting this tendency to attract badly conceived loans is life or death for these economies. The central government tries to police the limits. Local companies, desperate for money, exaggerate the extent of government support, and bankers anxious for customers tend to imagine government guarantees where there are none. This happens everywhere, not just in China, but China has experienced a series of particularly newsworthy incidents as it tries to limit the mutual attractions of inefficient companies and lazy bankers.

In the early 1990s, Western investment banks provided funds for speculation to a wide number of small, undercapitalised state enterprises which lacked the skills to engage in such business. For instance, huge lines were given to CITIC Shanghai, a subsidiary of China's largest company, for speculation on the London Metals Exchange. The individual to whom lines in excess of US\$100m were given made a salary of only US\$1,100 per year and his telephones and Reuters machine had to be provided by his bankers. Naturally, this led to disaster, as both this writer and the *Asian Wall Street Journal* predicted in print long before the crisis occurred, and when it did the Western bank claimed that the Chinese government had an obligation to bail out CITIC Shanghai because the latter was a state enterprise. There was a huge outcry that China did not honour its debts. In fact, Chinese law was the same as US law; a parent is not liable for the debts of its subsidiaries. And this was widely known, having, for example, been prominently published in a credit handbook by Standard & Poor. The Chinese government took a strong stand on principle, fought the issue successfully in a New York court, and then later quietly settled.

Later, numerous Japanese leasing companies operating in northern China found themselves unable to collect a scattering of small debts owed by tiny SOEs, for instance a few million dollars lent to one for a back hoe. These small debts cumulated into a US\$600m problem. Once again the foreign financial institutions railed against the central government but were firmly told they were responsible for the loans they had made and should deal with the individual companies. Later, however, the central government informally moved to get the problem settled.

In 1998, GITIC, the second-largest of China's trade and investment companies and the core investment arm of China's fastest-growing province, found itself insolvent. It became clear that GITIC management had made investments that were wildly speculative. The provincial government had provided comfort letters and verbal assurances to GITIC's bankers, but no formal guarantees. The provincial leadership was inclined to bail out the troubled company, but it was unclear whether they had the money, and apparently did not have the money to bail out both GITIC and other leading provincial and city investment arms. The leadership of the central bank was inclined to bail out GITIC, but Premier Zhu Rongji overruled it. The central government stepped in and forbade even the provincial rescue of GITIC, because the waste of billions of dollars was unspeakable and would simply encourage the continuation of such practices all over China. The losses to foreign financial institutions, and especially Hong Kong banks, were quite large.

The problem was severely compounded by major Chinese policy errors, many of which occurred because of policy differences among government organs. First, assurances of support were offered and then withdrawn. Then, assets were apparently leaked to local creditors with the foreigners left holding the bag. Third, the central government did not seem to have thought through the potential legal consequences: its interference to prevent a provincial bailout might give rise to claims by foreign creditors against the central government and even to seizures of Chinese assets abroad. Foreign bank credit to non-sovereign Chinese entities dried up almost completely. Taken aback, the central government promised not to force any more companies to the wall, and adopted a more supportive attitude than previously towards the remaining ITICs; talk of quickly closing most of them down ceased.

GITIC closure was necessary...

Although important details differ, these incidents exhibit a common pattern. Local Chinese companies present themselves as having more government support than they do. Local representatives of big foreign banks portray Chinese government support as being much firmer than it is. A big insolvency occurs. The foreign banks demand a bailout. The Chinese government takes a very strong stand on principle but later quietly works out some ameliorative understanding. The GITIC case is (hopefully) the ultimate test of the government's ability to control the moral hazard problem. *Had it not closed down GITIC, the spread of financial mismanagement over the next two or three years would almost certainly have brought China to its knees. Hence the closure of GITIC can be seen as an absolute necessity.*

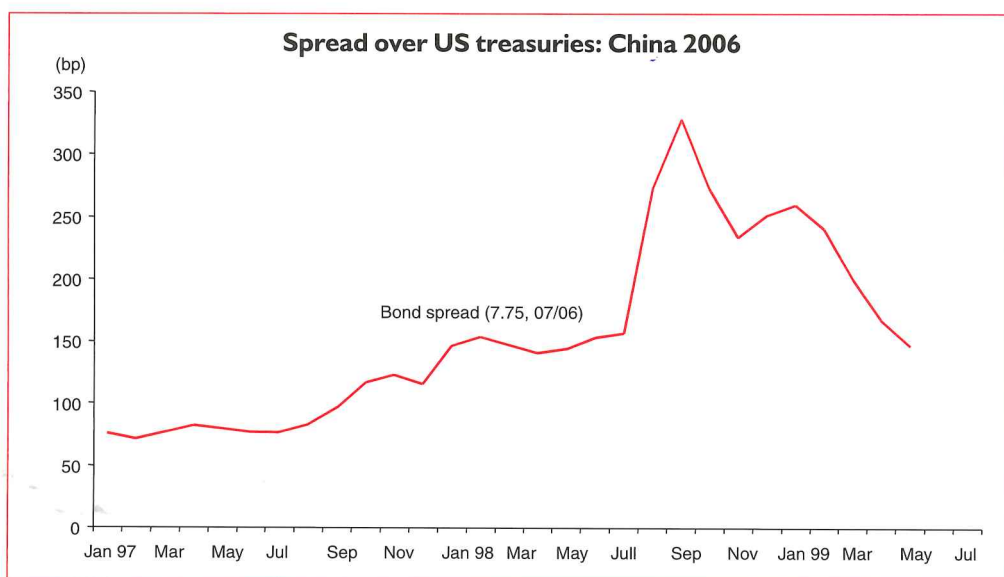
...but mismanaged

On the other hand, the mismanagement of the closure, and the consequent shutoff of bank lines to virtually all Chinese entities without sovereign guarantees carries great risks. Even a smoothly managed closure would have created a confrontation with the foreign banks; on the other hand, head office managers tend to appreciate the necessity of Beijing's acting to curtail mismanagement even while smarting from the losses. If it works out well, foreign banks will become more discriminating and loans will gradually return to China's best companies. If either side mishandles the situation, China's financial squeeze will intensify at the most critical moment for the reform programme. On balance, the likelihood is that banks' competition for business will lead to their gradual return to the Chinese market. The gradual opening of Chinese financial markets should bring foreign banks closer to their potential customers, and the banks should rely more on normal credit standards and less on official whispers of assurance.

Tightened controls on sovereign guarantees help credit rating

Contracting sovereign guarantees. Meanwhile, China has in recent years narrowed the range of sovereign guarantees. The commercial banks and leading companies like CITIC used to have formal, written sovereign guarantees. China's record in honouring sovereign guarantees is as good as any that of country in the world, and being stingy in handing out such guarantees is a vital policy in maintaining a strong sovereign credit rating. The bond markets have rewarded China for this by giving China large amounts of money at reasonable spreads (145 over US treasuries at the time of writing) with correspondingly good ratings (Moody's A3, S&P BBB+).

Similarly, China will no longer permit formal guarantees by local authorities of minimum returns on foreign investments. This should strengthen China's creditworthiness. On the other hand, it is also reviewing past guarantees of this kind and in at least one case denying a foreign investor the foreign exchange to pay its bondholders unless it revokes the minimum guaranteed profit agreement. Such revision of valid, approved contracts causes great antagonism.



Source: Nomura International HK

Bond issues could displace some bank loans

One longer-run scenario for Chinese foreign exchange needs is that bond issues will gradually displace much of the current dependence on relatively short-term bank loans. This would require far higher levels of disclosure and financial discipline than are currently available, but China has in the past proved more willing to move quickly (albeit from a lower base) towards higher standards than some of its otherwise more developed Asian counterparts.

The NPLs of banks, ITICs and state enterprises could amount to one-third of GDP

Covering bad loans. China's banks, ITICs, and state enterprises combined carry non-performing loans (NPLs) amounting to perhaps one-third of GDP. (The state enterprise bad debts mentioned here are what the Chinese call "triangular debt", money owed to one SOE by another, which is not paying because a third SOE hasn't paid up.) The banks' bad loans are believed to amount to 20% of total bank assets. Official numbers are lower and some private estimates are higher. There is a great deal of uncertainty in the Chinese statistics. But these are substantial numbers. Hong Kong banks, arguably the region's best, run 3% of assets in bad loans, Singapore's 6%, Taiwan's 5% officially and 8% according to private estimates, and Thailand's recently hit 49%. The latter result occurs when, unlike China, a government fails to address the problem until after a crisis hits. In addition, there are other kinds of bad loans, albeit in smaller volumes, including the rural cooperative banks, where bad loans reportedly run 50-80% of total loans.

Chinese banks are thought to be well short of international capital-to-assets standard

In 1998, the government partially recapitalised the big banks with RMB270bn raised through bonds. This was supposed to get them to an 8% ratio of capital to assets, the international minimum standard, but international institutions regard all the Chinese banks as having negative equity. In 1999, the government realised that the problem of high NPLs and inadequate capital remained critical, so it decided to adopt a good bank/bad bank approach — relieving a bank of its bad loans, telling it to manage itself better in the future, and turning the bad assets over to another institution, an asset management company (AMC), to manage.

AMCs will take bad loans

Chinese officials speak of following the model of the US Resolution Trust Corporation. Thailand used such a model recently to auction off billions of dollars of bad assets. This puts resources back to work quickly and does so at market prices. But China is actually planning something quite different. The prototype "bad bank," China Cinda Asset Management, will take RMB200bn of bad loans from China Construction Bank. It will be run by seconded employees of Construction Bank who will not hold huge auctions but rather will try to reorganise or merge or reshuffle the companies and assets concerned so as to make them productive again without costing jobs. The assets will be priced not by selling them at auction but by a third institution staffed by people who are supposed to be selected so as to ensure independent evaluations. (The government's assumption is a 33% average rate of recovery.)

Progress is likely to be slow

Such a process will be unlikely to yield market prices; it would take a brave official to mark assets down to a few cents on the dollar as US and Thai auctions frequently do. And it will not redeploy the assets swiftly. The priority for avoiding job losses virtually assures that progress will be slow. There is a serious risk of AMCs selling to related parties at cheap prices or holding onto certain companies indefinitely to get the financial and patronage benefits of controlling them. We believe this system will at best be slow, and at worst it could become a politicised bureaucratic nightmare.

The government has also broadened the ranges of interest rates banks may charge, particularly for small and medium enterprises; reduced reserve requirements; and broadened the spreads between deposit and lending rates. It has changed the tax system so that, rather than being taxed on the interest payments they should receive, banks are taxed on what they actually do receive. All this helps somewhat to recapitalise the banks.

Avoiding uncontrolled increases in unemployment is a valid objective, as will become apparent below, and China can afford to go more slowly than many other countries in cleaning up bad debts. The current scale of its bad debt problem is manageable, for at least a couple years. But the AMC system as planned is not reassuring to anyone who would like to see China's financial assets being deployed with market efficiency by some early deadline.

Having enunciated the huge scale of China's banking problems, and the potential weaknesses of some of the solutions, it is crucial to add that China's banks have very important things going for them. The government has acted long before a collapse. High savings rates keep the banks liquid. High lending rates and low deposit rates create a wonderful opportunity to recapitalise. So there is hope.

The 'extreme moderation' approach

Avoiding new bad loans. The government has taken a number of administrative steps to discourage the further accumulation of bad loans. In doing so, it has followed a path that might be called extreme moderation.

The first steps have been administrative reorganisation. The central bank, the People's Bank of China (PBoC), was forced to divest its commercial banking and trading businesses and become a pure regulator. This removed many layers of conflict of interest and caused much anguish. (At the time, the head of an important branch said to me: "When officials from Beijing visit, they expect to be treated like royalty. Otherwise they will fire me. But I can pay for this only with my gold trading. Now they say they will also fire me if I continue my gold trading." He soon resigned.)

Provincial city government and party pressures have been mitigated

The PBoC was also reorganised into a federal system, with each of nine newly created regional divisions region covering more than one province, in an effort to remove the level of bank management that was particularly vulnerable to provincial and city government and party pressures.

Heightened individual accountability led to cessation of lending

The commercial banks were in principle separated into real commercial banks, which are supposed to follow market imperatives, and policy banks, which are supposed to provide subsidised or high-risk loans for approved policy purposes. At the beginning of 1998, the commercial banks were freed to make their own lending decisions. They basically stopped lending to anyone. After two months, the central bank ordered them to start lending again. And half of the government's stimulus programme is funded by banks. On balance, lending has become somewhat more autonomous and substantially less focused on the SOEs, but progress has been quite gradual.

At the level of individuals, vast anti-corruption campaigns were organised. Top bank managers were given management contracts, subjected to periodic reviews of their bad loans, and put on notice that they would be fired or worse if their banks' performances were poor. They responded like their counterparts elsewhere in the Asian crisis — as much as possible refusing to make loans and instead investing safely in (increasingly available) government bonds. This produced a crunch, just at the time when the government desperately needed to stimulate the economy. The government responded with moral suasion, arm twisting, and a tremendous push to support the building of infrastructure projects by SOEs. The result was a substantial dilution of the drive against bad loans.

More fundamentally, the banks have 2m employees, virtually none of whom have any credit training. Only the top few have any incentives to avoid giving bad loans.

Concerns over unemployment keep bankruptcy numbers low

The government has also employed outright bankruptcy, which terminates a flow of bad loans and forces the banks to recognise their losses — always a salutary experience for bankers. To its credit, both in the bankruptcies and in the anti-corruption campaign, the government has gone after some very big fish and set strong examples, rather than just chasing the minnows. Hainan Development Bank, CACTIC and GITIC all delivered an unmistakable lesson. But the government has also been extremely wary of increasing unemployment, so the total number of bankruptcies has remained extremely small. In all of China, there were only 540 bankruptcies in 1996 and fewer in 1997; the 1998 figure, not yet available, is expected to be just a bit higher. For comparison, Japan, with 10% of China's population, had 18,998 bankruptcies in 1998.

Elsewhere in Asia, inadequacies of bankruptcy law have created serious problems in selling off NPLs and in persuading foreigners to bring in new capital. China's bankruptcy law is hard to implement, and the GITIC bankruptcy, where assets are believed to have been passed to domestic creditors while foreigners were left to take the bulk of the losses, is an inauspicious precedent.

Standards are slowly getting tougher

The banks continue to roll their loans to most of the big SOEs, usually on an annual basis. The government forces some of this lending, but a declining proportion of it. As in South Korea, many of the loans are kept evergreen because the banks regard their customers as too big to fail. So the standards are getting tougher, but not suddenly.

These policies have avoided the extremes of forcing sudden mass corporate bankruptcies, allowing the banking system to collapse as in Poland, or delivering all key SOE subsidies direct from the government budget rather than delivering them in the form of bank loans. Purists would insist on one of these approaches, but the dangers of mass unemployment or financial collapse mitigate against purist approaches. The risk in the vast administrative expanse of China is that the reforms will be nibbled to death by hundreds of thousands of bureaucrats. That is a very real danger, particularly in the AMCs.

Financial institutions' focus on SOEs overlooks the drivers of China's economic dynamism

Delivering capital efficiently. The converse of the imperative to limit bad loans is the necessity to deliver good loans. Here China faces a fundamental structural problem. All the key financial institutions were established to support the big SOEs. The banks until recently lent exclusively to SOEs, though in only a few years the percentage of their loans going to SOEs has declined from 99% to 55%. The equity and bond markets have been equally focused on the biggest SOEs. Stock market listings are difficult and highly political. Foreign banks, which have more skill at lending to smaller borrowers, can take local deposits only to the extent of 35% of their foreign exchange deposits and are permitted to operate only in limited experimental zones.

But China's economic dynamism has come primarily from private enterprises, TVEs, and more generally the small and medium-sized enterprises that the banks mostly ignore. The success or failure of China's economic reform programme depends on one thing — jobs — and the ability to create net new jobs lies entirely outside the SOEs. So China's dilemma is that its financial institutions have virtually no capability to support the companies that will determine the fate of the economic reform and ultimately the fate of the entire political regime.

Private enterprises are now being afforded a higher priority...

The government has recognised this problem. One major step was to revise the constitution so as to legitimate the role of private enterprise. A second step was to formally declare that the banks should make loans to non-SOEs, to instruct the banks to form departments for lending to small and medium enterprises, and to create new ways of accounting collateral and new forms of guarantees that will facilitate loans to smaller companies. Some of the crippled rural credit cooperatives are being reformed and upgraded to what are called Rural and Urban Collaborative Banks, but there are still too few. Officials speak approvingly of Minsheng Bank, owned by the All China Federation of Trade and Industry, which lends exclusively to non-SOEs, but it is still very small. The government has decided to allow private enterprises to list stocks both domestically and overseas. Thus far, China does not have a domestic venture capital market, though a number of foreign direct investment funds are always looking for companies to buy.

So the principles are now established, but the banks still lack the skills and the incentives to focus on the life-and-death sectors. Hence, though progress is beginning to occur it is very, very slow.

...but more needs to be done

To fund smaller and non-SOE companies, the government needs much more open stock markets and much more open bond markets. It needs to make far more use of the Hong Kong markets and far more use of Taiwan and Hong Kong venture-capital funds. It needs to allow foreign banks, which have far greater skill in providing credit to individuals and smaller enterprises, far greater scope to operate in China. Ironically, it needs a lot more big company bankruptcies in order to free resources so that job-creating small companies can flourish.

China has had difficulty expanding its securities markets quickly while avoiding abuses that would discredit the markets. The government has frequently replaced the top regulators and has managed to eliminate some of the worst abuses by the regulators themselves. Early in the development of China's stock markets, foreign investment banks seeking mandates for public offerings were referred to a top regulator's wife, who ran a company consulting on how to get her husband's approval. That no longer occurs. A new Securities Law promulgated in December 1998 and effective in July 1999, together with new government practices and a regulatory crackdown, seems to be improving market functions.

In the primary market, the government no longer decrees the price-earnings ratios for listings, and it has said that it will cease the practice of injecting whatever amount of high-quality assets is required to make a favoured enterprise marketable. In the secondary market there has been a notable crackdown on market manipulation,

rumours and insider dealing, as well as a ban on securities companies lending to customers and on banks engaging in or lending for securities speculation. To decrease volatility in a market that has consisted almost exclusively of 39m (!) individual investors, the China Securities Regulatory Commission has promulgated regulations for securities funds and approved 10 fund management companies. The securities markets still have a long way to go, but the improvements are real.

*Vast ownership reform
is necessary*

Delivering credit to the smaller enterprises also requires a vast ownership reform. For many years, the most dynamic part of the economy was the TVE sector. But ownership ambiguity has reduced incentives, diffused responsibility, and made for confused relations with financial institutions. The governments do not want responsibility for the failed TVEs, but they do not want to lose the profits and patronage of the big successful ones. The result is a financial morass. Mass privatisation, which has occurred in some areas, has been helpful but needs to go much further.

The problem of getting money to smaller companies has been exacerbated by the plight of the lowest-level Chinese financial institutions, the 44,000 rural credit cooperatives. These have about US\$100bn of loans on a deposit base of about US\$150bn.² By all accounts, these are in much worse shape than the big banks, with NPLs thought to run as high as an average 80% and definitely at least 50%. Runs have begun to occur on some of these. Like the big banks, the rural credit cooperatives have been subject to political pressures and mismanagement; the temptation to invest speculatively has been high, and credit skills have been non-existent. Many of the TVEs to which the credit cooperatives lent were dependent on Asian markets, so the Asian crisis put them under and, with them, the local credit coops. A precisely analogous problem exists with local credit cooperatives in Taiwan.

In South Korea, which has a similar banking system to China's, bank credit went primarily to large government-favoured conglomerates, while smaller, less favoured companies were serviced by informal, substantially illegal finance companies which were collectively called the curb market. Abuses induced periodic crackdowns, and curb market interest rates were high, but the smaller companies got their money and real credit skills emerged among the finance companies. In China, similar institutions have long existed but the government has treated them harshly in recent years. They are inclined to create pyramid schemes, which can rapidly become very big and very destabilising — as the governments of Kuwait and Albania among others have discovered at great pain. So Beijing has cracked down hard on the curb market just when it is most desperately needed.

*Getting financing in
place to create jobs*

The government is still at the stage of debating the alternatives and trying experiments, so the process of getting the financing in place is seriously out of sync with the necessity of creating the jobs as soon as possible. But the government does seem to understand the issue and is working hard on solutions.

The future of the Chinese economy depends on Premier Zhu Rongji's efforts to untangle two great, interrelated paradoxes of financial reform. China must save the banks from collapse. It is attempting to do so by fixing the banks' customers, the state enterprises. But SOE reform requires laying off vast numbers of people, hence the economy must be stimulated to create vast numbers of new jobs. This imperative in turn leads the government to press the banks into making huge volumes of new loans that the banks by themselves would reject as too risky. This is not where one would have wanted the syllogism to end.

Second, the entire financial system is geared up to support companies that cannot create new jobs and lacks the skills to make good loans to the companies that can create the jobs needed to save the reform.

² "Rural credit co-ops in fund crisis," *South China Morning Post*, May 5, 1999, plus interviews in Beijing.

The ITICs and their fate

There are two kinds of ITICs...

China has 240 ITICs. There are two kinds of ITICs: those owned by central government ministries and those owned by local governments. The premier company among the former, and in many ways China's premier company, is China International Trust and Investment Corp, or CITIC. The premier locally owned ITIC was GITIC, the main investment arm of Guangdong province.

...and both types have the same problems

The ITICs were formed as windows on the global economy when China had no other substantial windows, and they played an important role in China's early reform successes, trading, investing and raising money overseas. Later, many companies and banks performed this function and the ITICs often turned to quite different roles. They invested heavily in local projects, particularly real estate projects that were often highly speculative, and it was common for them to borrow foreign exchange relatively short-term to invest in long-term projects including real estate development. Eventually, the mis-matches caught up with them.

ITICs restricted themselves to high-return investments...

In order to attract local money, ITICs were allowed to offer higher deposit interest than banks. To cover the higher interest, and to cover the risk of investing short-term deposits in long-term projects, many ITICs, in the manner of US savings and loan institutions in the early 1980s, confined themselves to very high-return investments in real estate, stocks and IPOs. This was profitable until the onset of the Asian crisis. Because they were so profitable, banks and manufacturing companies became deeply entangled financially with the ITICs.

...and were used by local governments for vast off-budget expenses

In addition, local ITICs became budgetary loopholes for local governments. China's central government imposes tough budget constraints on the local governments, but the ITICs are outside those budgets. Hence provincial governors and city mayors were happy to use them for vast off-budget expenses, while telling foreign investors that of course their local governments stood behind their ITICs, though not in writing of course.

In the wake of GITIC's failure, foreign banks will not lend to the ITICs, so all of the latter are in a liquidity squeeze, commercially viable and insolvent ones alike.

The Chinese government wants to treat the ITICs as limited companies in order to ensure that it is not liable for bailouts. The 1994 Ministry of Finance bond prospectus served notice that the government no longer intended to guarantee debts for specialised banks, commercial banks, and ITICs. Moreover, many officials think that the era when the ITICs were needed is over, so many of them should be abolished. Following the GITIC bankruptcy, there was public discussion of cutting them back from 240 companies to 40. However, taken aback by foreign bankers' angry reaction to the GITIC closure, Beijing has stepped back from such a plan. The central government has promised not to repeat the GITIC incident, where it banned the provincial government from bailing out its ITIC. But that does not mean the central government will itself prop up failing ITICs, and it leaves Beijing with considerable leverage because most ITICs and local governments have only local currency and must use central government agencies to trade their local currency for foreign exchange in order to repay foreign debts.

CITIC remains the pinnacle of the government-owned companies. It is in a class by itself, in size, in prestige, in support from the central government, and in having a very successful listed arm in Hong Kong. Originally, CITIC had an explicit central government guarantee and in the early 1990s raised funds in the US under an "extension of sovereignty" clause. The PBoC is no longer allowed to provide guarantees to non-bank institutions, so CITIC is in a grey area where the government declares its full faith and confidence but does not provide a legally binding guarantee.

Even CITIC is finding it hard to meet growth and investment targets

These days, foreign banks only count a full guarantee and Moody's rates CITIC as BBB-stable. CITIC started sorting out its foreign debt situation as long ago as 1994. CITIC officials state that the company's debt to equity ratio is only about 50% and that the banking arm has close to an 8% capital adequacy ratio. But in the aftermath of the post-GITIC cutoff of foreign loans, even CITIC is struggling to meet its growth and investment targets.

The GITIC experience does not signal that the ITICs have become a black hole of foreign debt

China's top bankers say that only a few of the ITICs have large foreign exchange obligations, so the GITIC experience, where the company's foreign debts were far larger than reported, does not mean that the ITICs have become a black hole of foreign debt.

State enterprise reform and unemployment

Crises aplenty...

China's state enterprises face multiple crises. They face a crisis of marketisation because they were not originally structured to cope with market prices or market pressures. They face a crisis of management because their managers are appointed by government bureaucrats and their incentives are not aligned with market performance. They face a crisis of competition because other SOEs and new private and foreign and collective enterprises are competing with them. They face a crisis of overcapacity because a half-century of generous financing divorced from market performance has encouraged them to expand capacity with profligacy — just as in South Korea. And they face a crisis of finance because their lenders are being put on a market basis and no longer want to lend to most SOEs if they can find a way to avoid it.

...but real progress has been made in just 20 years

Some of these are crises of success. For China to have moved from centuries of extreme scarcity to an economy of generalised overcapacity in less than 20 years is a historic triumph. But it nonetheless creates a serious management problem.

Competition among SOEs has gradually increased

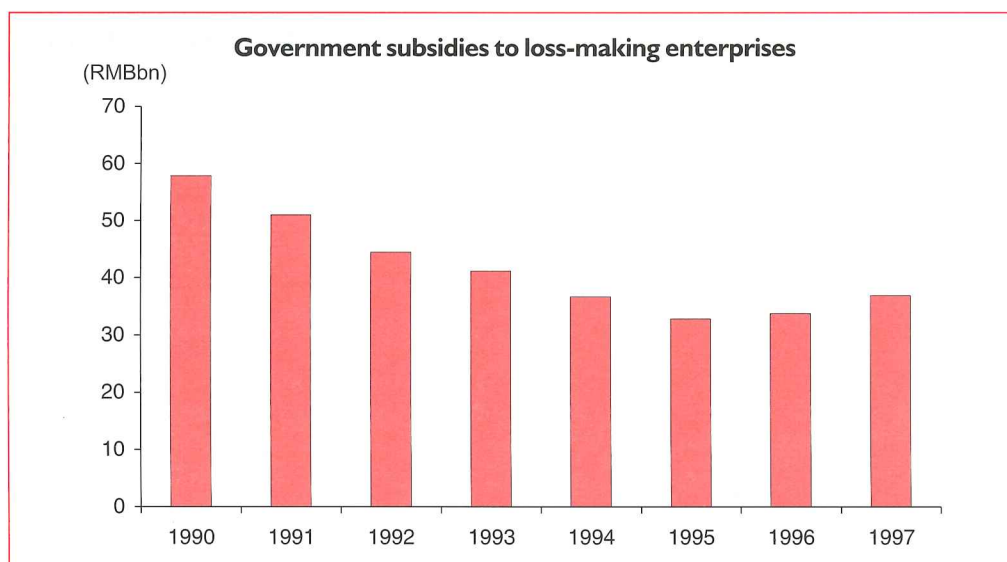
State enterprise reform has been under way for a very long time. The disciplines of market prices were gradually imposed. Competition among the SOEs was gradually increased; for instance, China originally had only one exceptionally bad airline, whereas now it has 30 mostly international standard ones. Thousands of SOEs were sold to foreigners. Many were merged into stronger SOEs. Many jumped into the arms of foreign joint-venture partners, ceding management control and market access for financial or other salvation by the foreigners.

Official figures suggest losses are declining and profits increasing

The condition of the state enterprises varies. Power and telecommunications are in good shape. Oil and petrochemicals went through a successful reform in 1998. Manufacturing in most categories suffers from overcapacity and obsolete technology, and weapons, timber and coal are in particularly bad shape. Airlines, railroads and refineries go up and down with the economic cycle. As a group, though, the state enterprises are in very bad shape. According to the State Statistical Bureau, 42% made losses in 1997 and 45% in 1998, but the lossmakers are making smaller losses and in the first quarter of 1999 the profits of the profitable SOEs have rebounded back to the level of 1997. (Caution: China has many accurate statistics and some very unreliable ones. Because of poor enterprise accounting practices, SOE losses might just be the most unreliable.)

Spontaneous privatisation

In the recent wave of reform, the slogan has been, "Seize the large, release the small." The ideology of public control is maintained by retaining state ownership of the bigger companies, with emphasis on about 1500 of them. Several hundred thousand have been delegated to provincial or local governments, which have engaged in mass selling of them — along with stripping their assets and just letting them die. The central government became concerned about the mass privatisation and attempted to intervene in 1998. The statistics changed, but observers believe that the process of spontaneous privatisation is continuing apace. This is what happened in the early 1980s, when the farmers started spontaneously privatising their farms, and that reversion of agriculture to family control (though technically in the form of long-term leases rather than ownership) proved hugely beneficial. The process of spontaneous privatisation is frequently not equitable or legal, but in the long run it is probably a very good thing for the economy.



Source: China Statistical Yearbook 1998

Overcapacity is being reduced

Among the large enterprises, it is difficult to quantify the results adequately, but there has been rapid movement. There are formal goals for reducing excess personnel and capacity in textiles, coal, and petroleum, and observers believe the programmes are largely on target. Successful reorganisations of oil and petrochemical groups, and of key steel mills, occurred in 1998. Telecommunications is being restructured. In 1999, the government plans to remove 4,500,000 spindles from textile production and to close 28,000 coal mines with 250m tons of capacity.

Mergers, reorganisations and management changes are the primary tools of reform — rather than breakup or bankruptcy. Initially, the government was fascinated with the idea of creating giant, world-scale conglomerates roughly like Korean chaebol, but that obsession seems to have dimmed, perhaps because some analysts looked at the condition of the chaebol.

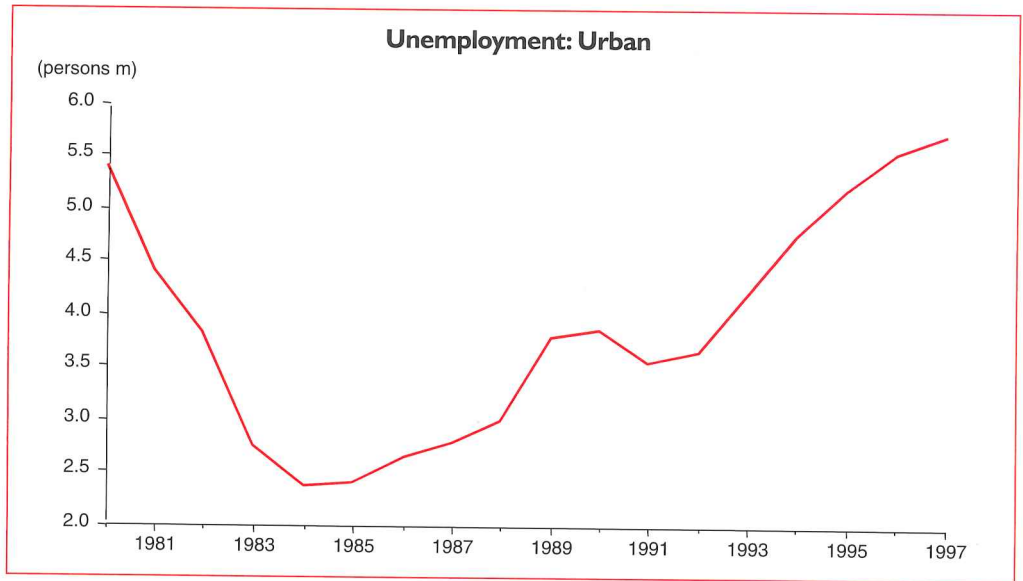
Bank lending to SOEs has fallen sharply

One indicator of ongoing reform is that bank lending to SOEs has declined to about 55% of total bank lending, versus 99% a few years ago. Equally, however, most observers agree that the government is so sensitive about adding to unemployment that obsolete firms are mostly not being closed down.

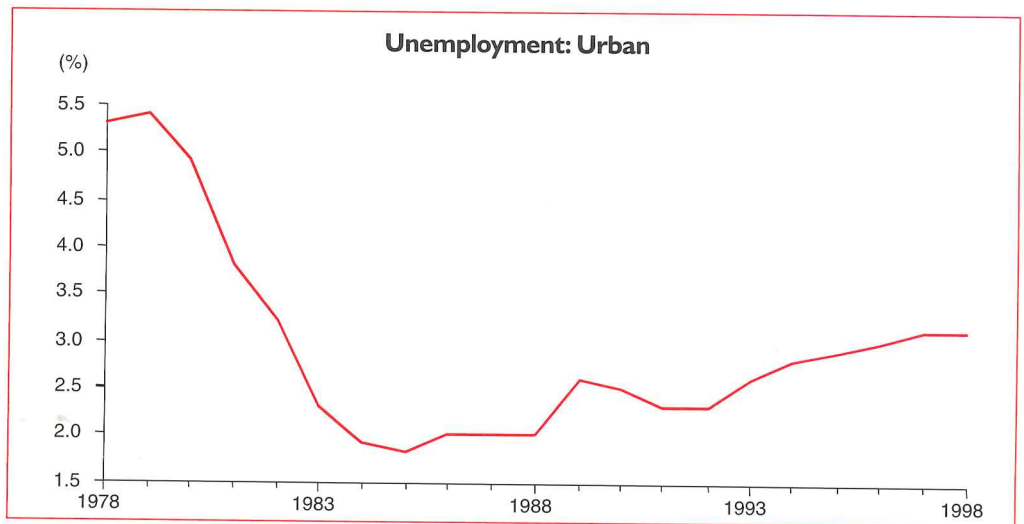
Despite the constraints, layoffs continue

The best indicator of the pace of reform is layoffs. The original estimate was that about 30m SOE jobs would have to be cut over a three-year period. Through 1998, about 17m workers have lost their jobs — 11.5m to the end of 1997, 4.5m in 1H98 and 1m in 2H98. In 2H98, the government decided to slow the layoffs, and the reported numbers did decline as indicated, but international observers believe that the layoffs may actually have continued apace. These layoffs are the best indication that SOE reform is serious and that there is a harder budget constraint (albeit not an absolutely hard budget constraint). The process is hampered by limits on bankruptcy, by inadequate bankruptcy laws and procedures, by restructuring weaknesses, and by limits on private ownership.

Of the 17m who have been laid off, according to official statements, 6m still have not found new jobs. In addition, there are another 6m officially registered unemployed. The picture one gets from these numbers is of an unemployment problem that involves a lot of people but not a high proportion of people. Even when one doubles the numbers in the graphs to include those who have been laid off but are not yet counted as unemployed, the percentage of the workforce is still lower than in the US of the late Jimmy Carter and early Ronald Reagan years.



Source: CEIC



Source: CEIC

A good proportion of former SOE employees have found work

However, the situation is far better and far worse than such numbers suggest. It is far better because many of the unemployed and laid-off do in fact have gainful employment. Some 10m workers are receiving six- to 12-month retraining courses. There has been a long process of state enterprise hollowing-out, during which many workers who were legally employed but who had limited useful work at their SOEs have moonlighted in private-sector jobs. Many make more from their "night" jobs than they did from their "day" jobs at the SOEs. It is impossible to pin down what proportion of the SOE workforce has benefited from this hollowing, both because the workers fear losing benefits if they report their real status and also because the situation undoubtedly varies tremendously from one part of China to another. But the proportions of those counted as unemployed who actually have jobs are not small; one professor who specialises in labour issues resorted to asking taxi drivers whether most people find work eventually and reports that so far the answers have been reassuring.

In some parts of the country, there are large concentrations of truly unemployed people. Recent visitors to Shenyang say that each day more than 10,000 people gather daily in the public park looking for work. The fear that has led much of the population to reduce expenditures indicates how real the unemployment problem is. And yet, after surveying people who have travelled all over China, the amazing thing is that people are not hungry and desperate — at least for now. The government has patched together a system of providing what is called the "minimum living wage" (varying by city), training programmes, job transfer assistance, and encouragement to look in the tertiary sector, and so far the patchwork is holding. Whenever the risk appears that the patchwork will not feed people, the government slows down reform; it has been very conservative.

The service sector has expanded greatly

China's service sector was suppressed during the era of the planned economy, and there has been a huge expansion of service jobs. China has more waitresses, child care workers, milk deliverers, and much else than it did a few years ago, and this expansion of services is absorbing large numbers of laid-off workers. Moreover, these jobs are not necessarily worse or lower-paying, particularly for workers who can often keep their housing and some other benefits.

A social security system is being developed

The government is speeding up the establishment of a social security system, attempting to unify the patchwork of measures currently in place. It will allow women to retire from SOEs at 40, with full pensions, and they will not lose their pensions when the majority of them find jobs in service industries. It is greatly simplifying the requirements for setting up private enterprises, reducing both bureaucratic and capital requirements. Registration in Beijing used to take months, now only a week. An extensive network of retraining centres will seek to facilitate movement of workers from manufacturing industries into services. And infrastructure investment, especially rural electrification, is being expanded to create jobs.

Labour discontent appears manageable

China's workers have not organised a vast subversive labour underground, and protests have been relatively few (relative to China's population) and sporadic. In fact, the meaning of the protests that have occurred may be quite different from the automatic Western assumption that these protests represent situations where workers have tried all available means and in desperation resort to protest. More commonly, they react to layoffs by initially having a demonstration in front of the government offices but then figure out that the government and the enterprise simply don't have any money, so they begin to look for jobs on the open market. In those more limited instances where workers are really desperate or really angry about abuses, the government buys them off. Premier Zhu has made very strong, very high-profile warnings that local governments must not use brutal means to suppress worker demonstrations. So things appear much better than they might be.

But some estimates suggest a further 25m SOE workers must be laid off

But in some respects they are also much worse. Many women over 40 who lack special skills and have lost jobs are in desperate circumstances; nobody wants to hire them. Government officials believe that the real number of workers who should be counted as unemployed — including all those currently labelled as "waiting for work" but not in the unemployment statistics — would be about 100m. There are another 250m farmers who would like to move to the cities — roughly the population of the US and more than double the entire workforce of the US. There are 13-15m new workers each year just through population growth. And, according to some estimates, the SOEs still need to shed 25m workers even though they have already laid off 17m. These numbers inspire fear and awe. What is going on here is so far removed from most of the previous experience of the human race that it is difficult to put it in perspective. How can any reform programme succeed in the face of such numbers?

Official numbers suggest unemployment is low but rising

An analytical perspective on unemployment. The Chinese unemployment numbers show that unemployment used to be virtually non-existent, has risen throughout the reform period, and is now low but rising. The reality is that in Western terms Chinese unemployment used to be incredibly high and that throughout the reform period it has probably been falling drastically but is still high. To understand this, one must go back to the fundamentals and reinterpret the whole communist period.

Labour mobility never used to be an issue

Mao Zedong's social programme is normally characterised as radical Marxist, but in fact it was an effort to return China to a form of peasant feudalism. Farmers were pinned to their villages and as much as possible were not allowed to move to other villages or to the cities. They were forced as much as possible to stick to the same traditional crops. The status of a family was to be determined not by ability or by the market but by what the status of the parents or grandparents had been. There was radicalism within the feudal structure, since Mao wanted the rich peasants to become poor peasants and the poor peasants to become rich peasants, but the structure of the system was reactionary.

Urban industry was structured along the lines of peasant feudalism

The structure of urban industry was an effort to reconstruct peasant feudalism inside steel mills and aircraft factories. The state enterprise, like the peasant village, was to provide all services from work to housing, education, medicine, political organisation and marriage counselling; there was no modern differentiation of function. Workers were supposed to work in the same industry for their whole lifetime, and for the most part the sons would follow in the footsteps of their fathers in the same steel mill. The realities of economic development of course forced many modifications of this basic mould, but this feudal mould was the basic structure.

So inconsistent was this model with the reality of rapid economic and demographic change that after 30 years a large proportion of the peasants and workers alike were no longer adding real economic value. Farmers were growing crops that were now totally inappropriate. Workers were producing goods that nobody needed — steel that was unusable, refrigerators that would not cool, unwanted obsolete models of every imaginable product. Many of the workers actually had almost nothing to do. But the farmer whose inputs cost more than his output was worth officially had a job. And the worker who was producing refrigerators that nobody wanted had a job. In the West, somebody who had nothing useful to do and was being given a subsistence wage by the state was categorised as "unemployed and on welfare". In China, the peasant or worker in that same situation was categorised as employed. The difference is not dishonesty or poor statistical methods; it is an entirely different way of thinking.

Unemployment — a question of definition

If we are to use the Western categories, "employed" and "unemployed", to understand China's plight and the prospects for reforming the system and improving it, then we must use those words in the same way they are used in Western discourse. In those terms, 90-150m peasants who were adding almost no marginal value to the economy, who were drawing only subsistence wages, and have moved to the cities should have been counted as "unemployed". Likewise, 250m who now are at subsistence levels and who could move to the cities without greatly affecting agricultural production should be counted as "unemployed". Perhaps 40% of the rural workforce was "unemployed". There is no way to come up with a precise number. The correct figure may be 50% or 35%. But it is definitely not 10% or 25%.

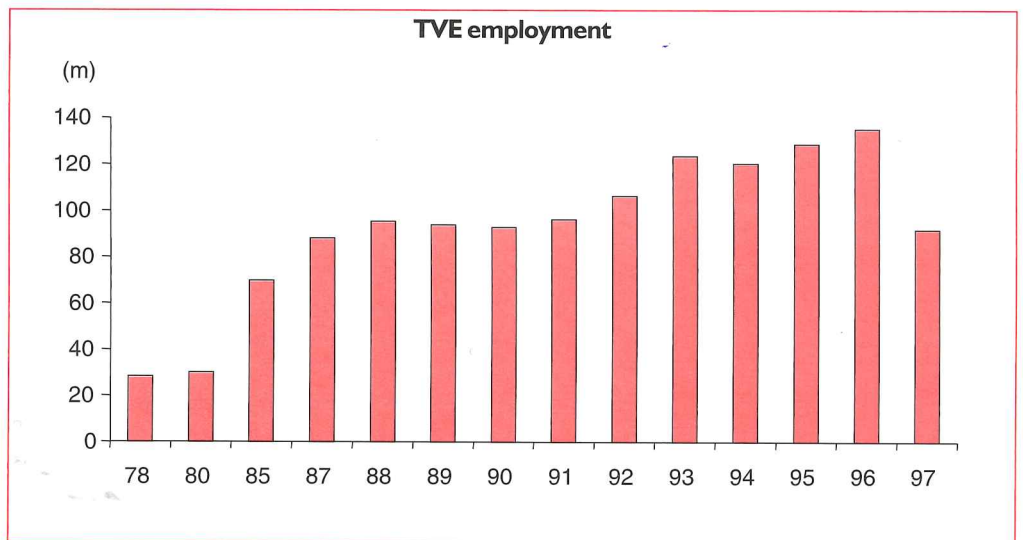
Actual unemployment was high and falling

Similarly, in industry the proportion who were doing no useful work and being given a subsistence wage by order of the state was very high. The government speaks of the need to lay off 30m out of a workforce of 180-210m, suggesting a rate of "functionally unemployed and on welfare" of 15-16%. But that is likely a vast underestimate. When Hong Kong companies buy Chinese companies, it is not unusual to find that half, or even a good deal more than half, of the workforce is adding no net value. It is not rare for a company to quickly multiply production by five or six times with less than half the original workforce. There is little disagreement that cutting the Chinese government in half, as has just been done, is more likely to raise the effectiveness of the ministries

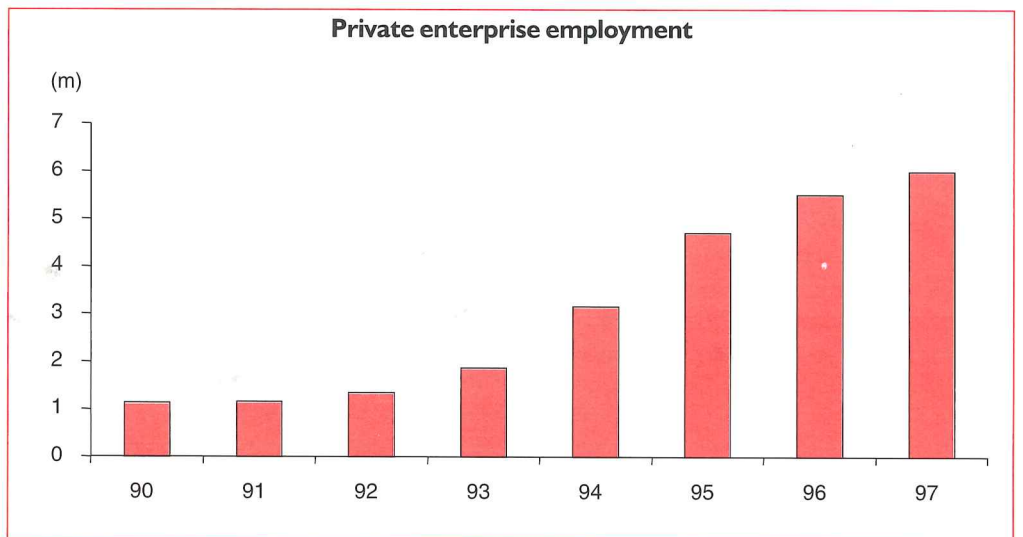
The reform era has brought with it a real decline in functional unemployment

than to reduce it. In other words, the rate of urban functional unemployment probably has also been 40% or so. This number is a "guesstimate" but is more likely to be too low than too high.

As feudal constraints on physical mobility and job mobility have been removed, there has been an enormous flowering of new jobs, of useful employment. The TVEs created more than 100m jobs in the rural areas. The 90-150m "migratory" workers now have useful jobs in the cities whereas previously they added almost no value in the countryside. At one time, rural people who moved into the environs of Shanghai were experiencing a very fast 700% improvement in their standards of living — the consequence of moving from functional unemployment to productive employment. Tens of millions of people who nominally were employed in state enterprises, but in reality were doing nothing useful, put their energies and resources into sideline occupations that were real jobs, adding economic value and moving the families above subsistence level. Even after subtracting the nine-figure increase in the labour force, the rate of functional unemployment has certainly been in major decline throughout the reform era.



Source: China Statistical Yearbook, 1998



Source: China Statistical Yearbook, 1998

The collapse of feudal enterprises creates a statistical illusion that unemployment is rising

Meanwhile, the remaining feudal enterprises get into trouble. After a while, even within the feudal framework, feudally organised steel mills and clothing factories often cease to function from internal rigidities or are left behind when their customers no longer want what they produce. When subjected to competition from more flexible non-feudal enterprises, they simply collapse. This turns functional unemployment into nominal unemployment and generates the statistical illusion of rising unemployment.

This development creates two kinds of dangers, neither of which necessarily derives from any rise in the overall level of real unemployment. One is that pockets of workers could be left unemployed and desperate in certain areas and that this could generate a critical mass of discontent and spreading revolt. This is a particular risk if such projects comprise workers who are politically sensitive. The second is that, even in the context of a general rise in living standards, the move from feudal security to market insecurity, the vast migration of urban people into unfamiliar cities, and the vast shift out of unproductive jobs into productive ones, could create such a high level of general anxiety that the entire social order can become vulnerable. People can become distraught that life is unpredictable, that none of the old rules apply any more, that people who break all the rules are the winners, and that no new rules have replaced the old rules. Society then becomes extremely vulnerable to shocks and sudden instability.

Discontent has been checked...

So far, China appears to be coping well with the first danger, the risk of pockets of desperate people. So far, the regime has moderated the pace of change so that the pockets are not too large. When people do get desperate and riot, the government buys them off; crucially, so far, the government has the resources to buy them off. The government has explained itself and made visible efforts to ameliorate the situation, so ideologies of revolt and antagonism have been slow to develop. The government has been — so far — repressive enough to prevent discontented groups from linking up around the country into a broad opposition, but not brutally repressive in ways that would trigger widespread outraged resistance movements.³

...and social anxieties have found an outlet in high savings rates

Given the rapid reduction of unemployment and rise of living standards over the past 20 years, and given that the government has seemed competent and has not been replicating 4 June 1989 every time peasants or workers protest, the anxiety has found its outlet economically in very high savings rates and socially in the rapid spread of religions, cults, and self-improvement societies (see the section on Falun Gong on page 35). China is experiencing a vast flourishing of Buddhism, Christianity, Confucianism, *qi gong*, and much else. The energies of these movements are directed towards improvement of oneself or one's locality within the context of the current government and social system, not towards overthrow of the system.

Were the reforms to founder, or were some shock to convince important parts of the population that the government was incompetent or malicious (incompetent governments always come very quickly to be viewed as malicious), then these individualised responses to change could rapidly develop into Solidarity-type unions, violent secret societies, warlord-type rejection of central policies, and revolutionary ideologies. None of this is happening today. None of it appears to be in prospect. But continuation of the current stable situation depends completely on avoiding massive economic setbacks, on a sense that reform is progressing steadily and that there are limits to the insecurity, and on conviction that the government is competent and vigorous. Russia in the decades prior to 1917 was Europe's fastest-growing economy, and France in the decades prior to 1789 was progressing economically and attempting to make major reforms, but both foundered when they experienced major setbacks.

³The Western sensibility finds all political repression brutal, and this can lead to endless debate about what is brutal and what is not. But there are degrees of these things. Few pre-modern societies are democratic and encouraging of political opposition. In Western eyes, all Chinese emperors and leaders in the last 6000 years were brutal and intolerant and abusive of human rights. But Chinese account some of those emperors very good and others very bad. What will influence China's future is what today's Chinese think about today's situation compared with the available alternatives.

Pension reform efforts have borne little fruit

Pension reform. One of the most important aspects of state enterprise reform and management of unemployment has been the effort to create a national pension system that would ease the burden on the SOEs. These efforts have been very high profile, but their fruits have been limited. Pension liabilities are large and ambiguous, and each solution creates further problems. The government is trying to consolidate local pension pools into provincial pools, and provincial pools into one big national pool. As this has happened, the units tend to make big payouts and to greatly expand eligibility. Thus the funding problem is becoming worse even as the government tries to make it better.

Net state enterprise losses were targeted to be zero by 2000 — now probably 2002

The realities of SOE reform. The goal of reform has been that state enterprise losses should net out to zero by the end of the third year of the latest reform wave, namely the year 2000, with a decrease of one-third each year until that goal is achieved. Now senior officials acknowledge that this goal will have to be pushed out another two years. Even so, the goal is quite ambitious. Currently losses are accounted as 1.4% of GDP; international observers believe the figure is more likely 3% or US\$25bn, a substantial amount but very cheap if one regards it as the price of a welfare system that has covered all of China's urban workers for unemployment, medical care, education, pensions, and other services like marital counselling.

The focus is on improving SOE management and technology, and reducing social burdens

There is a fundamental divide in Chinese thinking about the state enterprises. Younger, more market-oriented thinkers believe that state ownership itself is the core of the problem. Older officials tend to believe that the problems have little to do with ownership. The latter, who dominate government policy, point out that, quite aside from ownership, the imposition of huge social burdens (most notably responsibility for education, medical attention, pensions and housing) on the SOEs ensures that they will be unprofitable. They argue that the government creamed off resources and left the enterprises with outdated technology. They say that state enterprises can be very profitable and forward looking, like Singapore Airlines, and that private enterprises can be poorly managed and can pressure the state for support when they get into trouble. They say that privatisation in eastern Europe accomplished little or nothing in improving efficiency. So China's policy towards the big SOEs is to concentrate on improved management, improved technology, and reduction of social burdens.

Critics of this line of thought argue that the market would be much more ruthless in eliminating poor companies, much more generous in rewarding good management, and would align managerial incentives much more with the welfare of the enterprise.

A state enterprise management consultant provided what she said was a reasonably typical example. A consumer products enterprise was very successful through the early 1990s and always had a full orderbook. Then management became more ambitious and invested heavily in a whole new product line, which failed to sell. The company could not repay its loans and offered to give the banks product rather than money. The banks refused, and finance costs became a huge burden, threatening the original successful business. Management began to rely on middlemen to take the new product at huge discounts, in order to generate some cash, and find buyers. Soon the management was in collusion with the middlemen and the top managers were getting rich while the business failed.

Business innovators or bureaucrats?

Facing this situation, the current Chinese leadership argues that what is needed is management overhaul. With less corrupt, more modern management, this company can be turned around. The younger generation argues that privatising the ownership would align the financial interests of the managers with those of the company as a whole. In practice, the central government sends in a team, overhauls the management, and frequently gets good results. The problem is that indefinite continuation of such good results requires constant vigilance from teams handpicked by an exceptionally conscientious prime minister, and it is impossible to be watching all the companies all the time or to ensure that every prime minister will always have good teams. Vigorous reforms will patch up the SOEs that come under scrutiny, not create self-sustaining

forces for efficient management. Moreover, China is continuing the practice of having the ministries appoint the top managers of the state enterprises they own, and this ensures that enterprises will always be vulnerable to political manipulation and the management will face incentives more appropriate to bureaucrats than to business innovators.

Because of this, the case for success of China's reforms must hinge on an argument that the rest of the system is being altered enough to be permanently disciplined by the market and that the number of big state enterprises is being cut down sufficiently so that the government can manage them adequately (adequately, not necessarily efficiently). Fortunately, there is enough reform going on so one can make that case. But the case cannot yet be decisively proved; the situation still hangs in the balance.

China's ideological evolution on SOEs is similar to Britain's

The debate between the older generation and the younger, between the relatively pro-market and the relatively pro-socialist views, is virtually the same as the debate between the old British Conservative Party and the old British Labour Party. But the entire spectrum of the debate has moved in a market direction at perhaps ten times the speed of the British debate. Many of the top 40-year-olds in China's government are well to the right of the British Conservative Party before Thatcher, and most of the key officials under Zhu Rongji are well to the right of the British Labour Party before Neil Kinnock on the subject of state enterprises. The Chinese are going through a wearily familiar debate; they started later but do it more quickly than their predecessors in the West. China's fate hangs not on ideology but rather on whether the reform programme can be sustained and financed through the next three years. At this point, it appears that it can be, but it remains potentially vulnerable to relatively low probability events like 1998's great floods, international confrontations over Taiwan or other issues, or weakening of Premier Zhu's leadership position.

Growth and the sustainability of reform

*Spending is down,
savings are up*

As layoffs have risen, anxiety has risen, with the same consequences as elsewhere in Asia: spending has declined and savings have risen. Planned reforms of education and medical care would force families to pay new bills, so people are saving against that prospect. Savings may have been further enhanced by the looming prospect that families may have to, or be able to, buy their apartments for the first time since 1949. As a result, retail consumption has declined from a previously normal growth rate of well over 20% to under 10% in 1998 and early 1999. Efforts by the government to prop up consumer spending by encouraging the banks to give generous consumer loans have not worked so far. Exports, which historically have grown more than 20% annually, declined 7.9% in 1Q99. Declines in local spending, declines in Asian export markets, the reluctance of banks to lend, and the flood devastation of 1998 have greatly weakened Chinese growth.

*The TVEs have been
undermined*

The TVEs, previously the great engine of employment growth, have greatly weakened as a result of weak consumption, weak exports, and greater competition. Ironically, efforts to upgrade the state enterprises have undermined the TVEs; SOE department-store prices are now similar to those of the TVEs. The rural credit cooperatives that funded the TVEs are in more trouble than the big banks, and the government has cracked down on informal finance companies.

*Foreign investment is
falling*

At the same time, foreign investment has begun to decline, possibly from US\$45bn at the peak to just over US\$30bn in 1999. Surveys by A T Kearney (very limited surveys) indicate that only about 40% of foreign-invested companies are profitable. Japanese trade agencies say that only about half of Japanese companies in China are profitable. There is rising impatience with lack of profits, widespread disregard of contract provisions, foreign exchange restrictions, and over-optimistic market projections. Euphoria over the size of the market and rapid economic growth is giving way to a focus on the bottom line. Foreign investors are raising the hurdles, and the overseas Chinese investors don't have as much cash as they once did. At the same time, China is levelling a playing field that has previously given foreign companies huge advantages over domestic companies. This is fair but will not increase foreign investment.

*Foreign commercial
banks have turned their
backs on China*

At this worst of possible times, the foreign commercial banks have simply walked away from China. In the wake of the GITIC bankruptcy, there are virtually no new loans to non-sovereign entities and project finance is nearly gone. In the absence of state support, Chinese companies' accounting is too poor and they just don't have the track records banks need, so the loans won't flow.

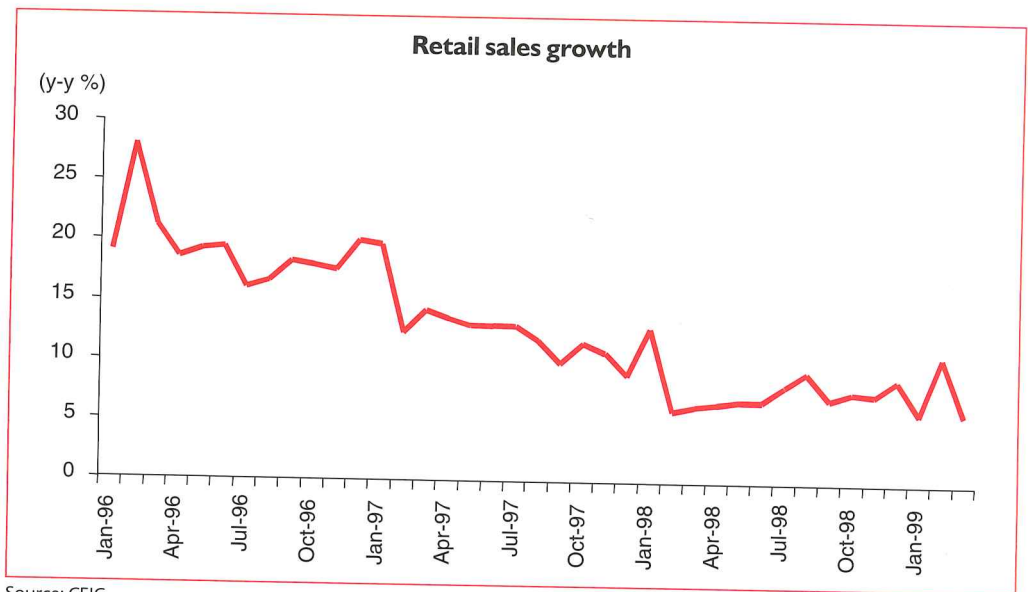
All this has raised the prospect that China might lose its capacity to create new jobs just at the time when reforms are laying off tens of millions of workers.

*8% growth target
reflects the need to
create new jobs and
keep unrest in check*

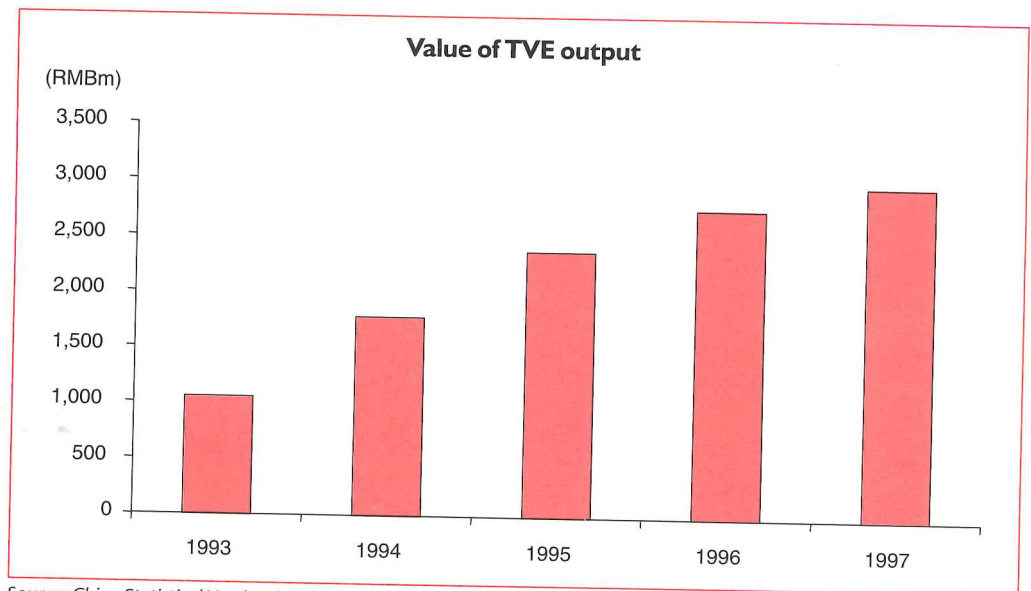
Fear that weak growth means failure to create new jobs and hence political unrest has driven the government to insist on the necessity of an 8% economic growth rate. In the past, each one percentage-point growth in GDP created 850,000 jobs in agriculture and industry plus another 500,000 tertiary jobs. The government is counting on that, but the new kind of growth may not replicate those figures.

*Growth is being driven
by massive fiscal
stimulus*

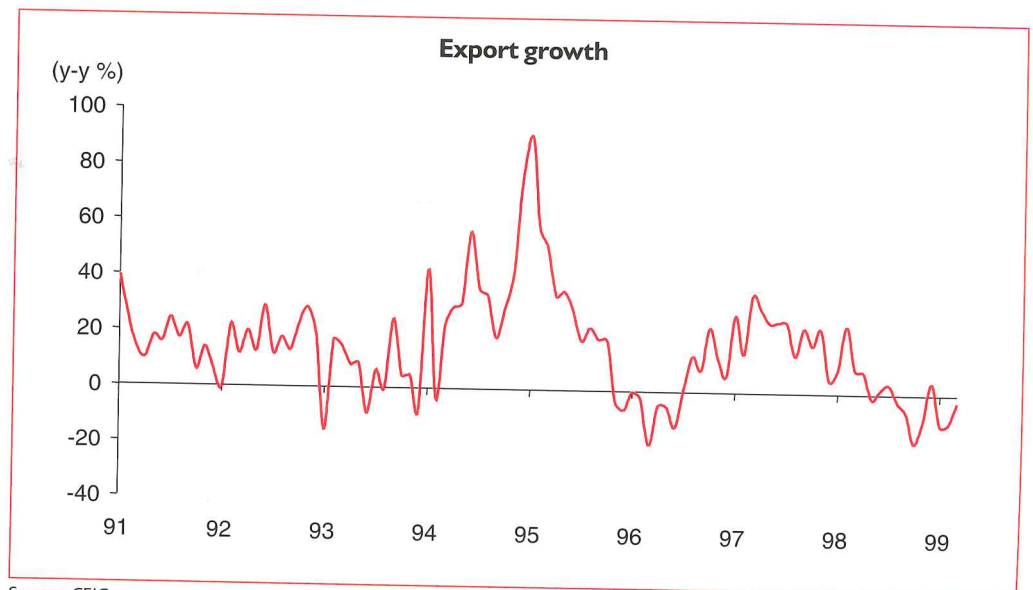
Growth in 1998 came in at 7.8% and 1999 is officially projected at 7% — although off to a faster start than that. Such growth is being achieved only through massive fiscal stimulus. Fixed asset investment and infrastructure spending are driving growth. Worryingly, inventories rose a good deal in 1998. Although the official deficit is only 1.7% of GDP, the real deficit is a multiple of that. Chinese statistics exclude interest payments from the calculation of the budget deficit, and they exclude all the deficits of China's multiple layers of provincial and local government. No precise data are available, but the most knowledgeable observers estimate the total fiscal stimulus at 8% of GDP or more.



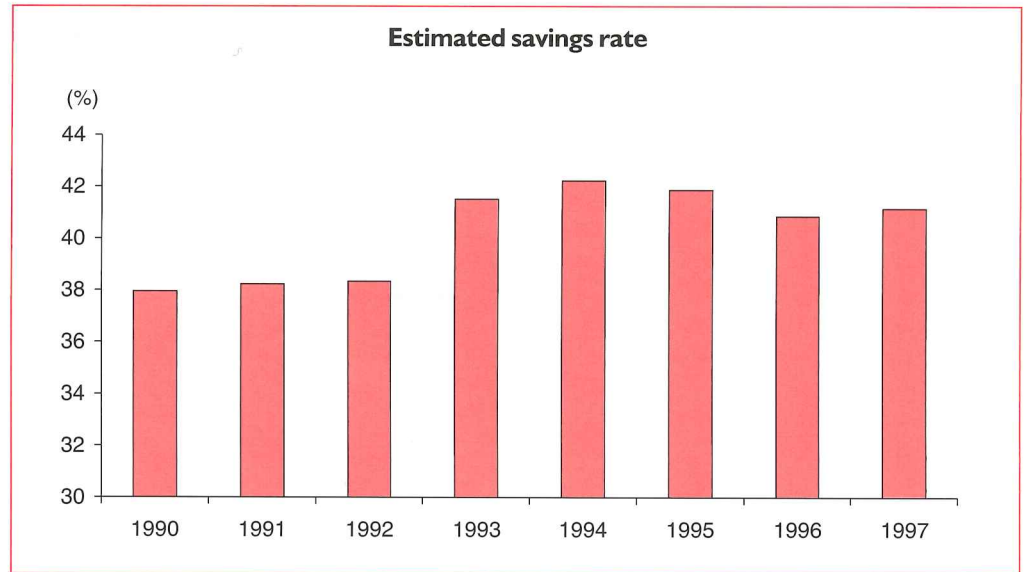
Source: CEIC



Source: China Statistical Yearbook 1998



Source: CEIC



Source: China Statistical Yearbook 1998

Broader-based dynamism is needed to ease the fiscal burden and generate jobs that sustain reform

Such strong fiscal stimulus has kept growth up even in the face of horrendously high real interest rates (10%-plus). But the character of growth has changed. No longer is growth coming from export growth, TVE dynamism, vigorous private enterprise, and more generally from the small and medium enterprises. Now it is virtually all coming from government stimulus, mostly in the form of big SOEs building infrastructure projects: irrigation, electricity, telecommunications, ports, and rural roads. If the projects are well chosen and well constructed (an assumption that cannot yet be validated), this growth could be helpful to China's future. But it does not have the same beneficial effects on China's neighbours and it does not generate jobs on the scale of the earlier kind of growth. Thus it is vital to get back to broader-based dynamism, both to ease the fiscal burden and to generate the jobs that can sustain reform.

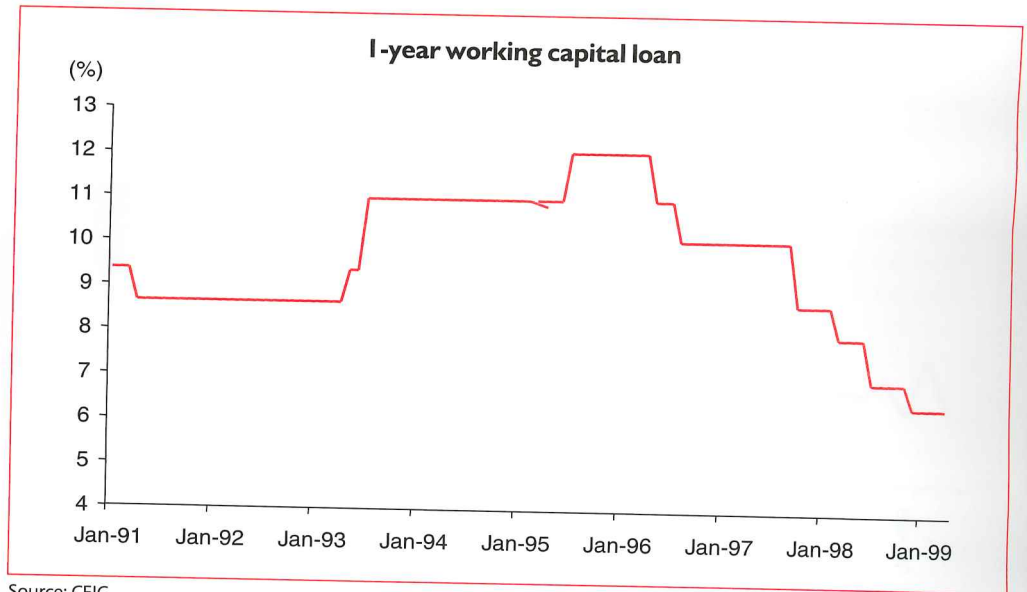
The huge deficit is bearable — for now

For now, the huge deficit is bearable. Given the reality of deflation, an expansive surplus will not cause inflation. Nor will it create a debt crisis. Government debt is only about 10% of GDP. Add the NPLs and this becomes perhaps 45%. Compared with, for instance, around 100% for Japan, this seems quite modest. But there are limits to how long such deficits can be sustained. Whereas G-7 countries can raise tax revenues to 40% or 50% of GDP when necessary, China has difficulty getting much more than 10%. Moreover, China must fund a pension system and will have other expenses. For a couple of years, the country's stellar savings rate should make it possible to float bonds and cover the deficit (as is required by a 1994 law), but such stimulus cannot continue for many years. Bond issuance has already gone from 4% of government revenues to 20% between 1993 and 1998.

The PBoC has repeatedly reduced interest rates. This helps, but nominal interest rates remain high and real interest rates remain ridiculously high. (To the nominal rates in the accompanying chart one must add the 3.5% deflation rate.)

Infrastructure programmes are necessary anyway...

China certainly needs the infrastructure programmes behind the fiscal stimulus. Away from the coast, the network of highways and railroads is hardly connected. China has only 73km of subways for its 1.2bn people. Water management, on which China spent RMB35bn in 1998, is increasingly a life or death issue, with both droughts and floods seriously damaging people's livelihoods. Rural electrification is just beginning to bring much of China into the modern world; 1500 of 2400 counties are not fully electrified. China faces vast environmental problems — use of coal for heating in the absence of central energy distribution systems, deforestation, desertification, uncollected and untreated sewage for one-sixth of the human race. China is probably the only country in the world with a 50-year environmental improvement plan.



Source: CEIC

So China does not have Japan's problem of trying to stimulate the economy by paving over good roads for the fourth time. But China's crucial questions about whether the right projects have been chosen and whether they have been built efficiently enough to justify the cost will not be answerable for quite some time. On one hand, China's roads have clearly been built more solidly and honestly than Mexico's or the Philippines'. On the other, scandals are multiplying, and foreign observers say that for the first time signs of widespread shoddy construction are quite obvious in places like Chungking. Only time will reveal the balance.

...but housing reform has been disappointing

Aside from infrastructure development, China's economic managers have bet heavily on creation of a mass housing market. Currently, almost all housing is controlled by the government and the SOEs. The hope is that a shift to a private housing market will create a great wave of building and purchases. The State Statistical Bureau says that housing construction has accelerated sufficiently to be the fastest-growing form of infrastructure investment and to lift growth of the glass and steel industries. But the overall rate of housing reform has been disappointing.

Wages just don't pay the cost of new housing for most people. Credit is given to the developers and construction companies — for one year and for very high interest rates plus all sorts of fees for consultation and transportation among others. These companies are effectively excluded from issuing either stocks or bonds. Most are small in size, high in debt, low in creditworthiness. They have to build very fast, and usually provide cheap, low-quality flats that don't excite demand. Loans to consumers, who would insist on better quality, are now officially encouraged but still rare. Because interest rates are fixed, it is impossible to securitise mortgage loans.

The housing market is highly illiquid. The government and the SOEs still own nearly all of the housing. Where the government has directed that housing be privatised, it has frequently placed restrictions on selling, so the secondary market is quite small. In many cases, ownership is unclear. In many cases, senior executives and officials are building housing for their companies or ministries and then selling it to themselves, or their families and friends, for a song. There is now so much resentment of housing arrangements that the government must be very careful. On balance, the housing reform is a good idea and may well be the driver of the next great wave of Chinese development if the current reform programme succeeds. But it is unlikely to take off sufficiently fast to be the driver that makes the reform succeed.

Government stimulus is likely to mean growth targets are met for 1999 and 2000

The ultimate hope is that households will begin spending and exports will begin recovering. The gradual recovery of China's Asian neighbours gives some hope for the latter, modified by concern that the neighbours' ability to produce competing exports will also revive. The experience of the neighbours that vigorous reform can revive confidence and lead to recovery also provides grounds for hope. Certainly, China should benefit from not sitting on its hands like Japan. But China is also different from South Korea, so one cannot confidently project when domestic demand will recover. The government hopes to electrify 500 counties by October 1, 1999,⁴ and hopes that will mean lots of colour TV sales, but nobody can be sure. Some observers do believe that the credit crunch is easing and note that Procter & Gamble seems to be selling a lot more shampoo, but so far these are just straws in the wind. In 1999, the government can stimulate the economy sufficiently to achieve its targets. Probably, it can do the same thing in 2000. But shortly after that, the economy must develop an engine of its own.

Future reliance on domestic demand

The shift to domestic-led growth. In the midst of all these difficulties, China is executing a vast strategic shift from an economy that has been driven heavily by foreign trade, foreign investment and foreign financing to one driven primarily by domestic engines. US threats to cut off normal trade relations, US anger over its trade deficit with China, the cessation of most foreign bank lending, the collapse of Asian demand for Chinese exports in 1998, and European protectionism have all underlined the risks associated with dependence on foreign sources of growth and finance. The vast fiscal stimulus necessary to keep the economy going during the current reform, and the concomitant expansion of China's infrastructure, will hopefully lay solid foundations for future reliance on domestic demand. This by no means implies a return to autarky or a rejection of the opening to the world that has occupied the past two decades. Rather, it is a rebalancing of the kind that the US and Europe have urged up on Japan, quite unsuccessfully, for the same two decades. If this rebalancing succeeds, then China will have reached more solid ground both in its sources of growth and in its relations with its trading partners.

⁴ 900 of China's 2400 counties are already electrified. The plan is to electrify the remaining 1500 by the year 2001. Of these, 900 will be started in 1999 and 500 are supposed to be finished by the 50th anniversary of the revolution.

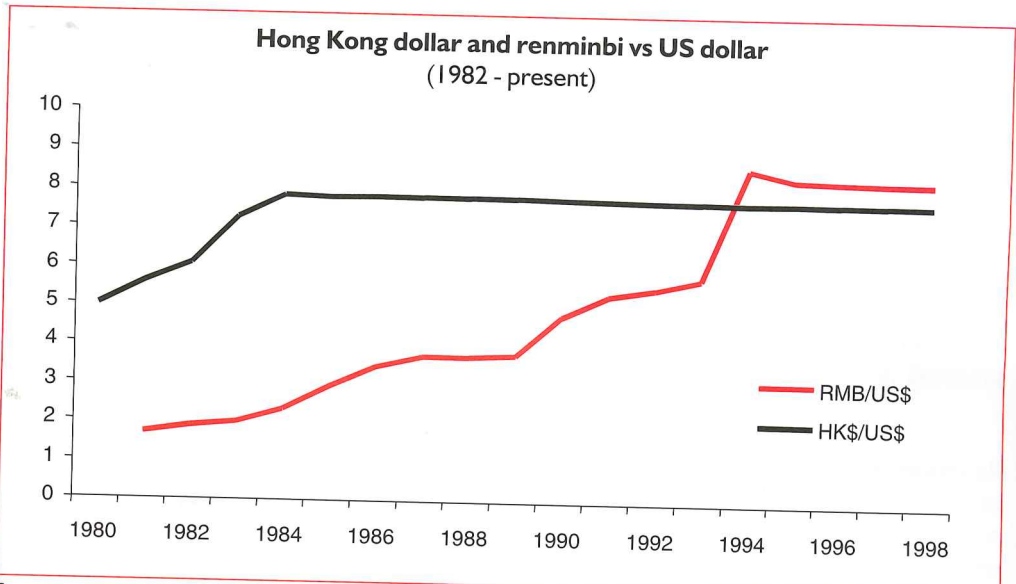
The currency

The great myth — the renminbi must be held at its current value to avoid a crisis that affects the whole region

The big Asian devaluations were not caused by competitive devaluation; they occurred as a result of short-term debt crises

The mythology of the Asian crisis has held that it is essential for the renminbi to be held at its current value in order to avoid plunging China into a crisis similar to other Asian countries and in order to avoid a domino effect in which Chinese devaluation would cause crashes of the Hong Kong dollar and other Asian currencies. The Chinese authorities have argued there would be no economic benefits from a devaluation. US, European, Japanese and other Asian leaders have urged China to avoid devaluation at all costs, in order to avoid a regional and possibly global domino effect, and some have held out such incentives as an improved atmosphere for WTO entry if China behaves well on this subject.

This writer believes that the international pressures on China have been entirely inappropriate. Asian currencies have not been vulnerable to a regional domino effect since mid-1998, when the short-term debt crises of South Korea and Thailand were clearly history. Contrary to the model implicit in most arguments for a domino effect, the big Asian devaluations were not caused by competitive devaluation. South Korea did not devalue because Thailand devalued, and the amount of the South Korean devaluation had nothing to do with the amount of the Thai devaluation; in other words, trade competition was never the driver. Rather, Thailand, South Korea, and Indonesia had crises of short-term debt. As those crises set in, everybody in the country suddenly needed dollars to repay loans, so the price of dollars temporarily skyrocketed. As soon as the debt crises were over (January 1998 for Korea, mid-1998 for Thailand), the Asian currency crisis was over, though futile efforts by speculators to re-ignite it persisted until the failure of the attack on the Hong Kong dollar in October 1998. This is why we argued in January⁵ that neither a Brazilian devaluation nor a Chinese devaluation would have much effect on the region. There was some controversy in response to that argument, but then the Brazilian devaluation happened with no significant Asian consequences. (Of course, some countries outside Asia are still vulnerable to foreign debt crises and currency problems.)



Source: Nomura International HK

We do not believe that a renminbi devaluation would affect the value of Hong Kong dollar...

In China's case, the outcome would be similar. It would not affect the value of the Hong Kong dollar, although market misunderstanding of the economics of the Hong Kong dollar would lead to a certain amount of shorting and thus to a few weeks of high interest rates. When the Hong Kong dollar peg was introduced, the exchange rate was RMB2.1:US\$1. It subsequently devalued to RMB8.7:US\$1 and then revalued

⁵ William H. Overholt, *Asia's bubble crisis: No instant cure*, Nomura, 19 January 1999

to RMB8.28:US\$1 without any effect on the Hong Kong dollar. Through one of those great confusions that would be quite unlikely regarding the yen or the Deutschmark, because the quality of information and analysis of the G-7 currencies is higher, much of the market came to believe that somehow the political transition of Hong Kong in 1997 had tied the Hong Kong dollar more tightly to the Chinese renminbi. That was not the case. Moreover, the arguments that Hong Kong now has more trade with China and in other ways has become more tied to China also fail. A Chinese devaluation would probably increase China's trade at the margin, and Hong Kong takes a haircut off China's trade, so there would be a marginal strengthening of the Hong Kong currency's position.

...or indeed that of other Asian currencies

Similar results apply for other Asian currencies. Interviews with top South Korean economists revealed no belief that a 15% renminbi devaluation would harm the Korean won. In the case of Taiwan, there would be two countervailing effects on the NT dollar: Taiwan companies' exports from the mainland would become more competitive and their profits would rise, strengthening the Taiwan currency. On the other hand, the value of their fixed investments on the mainland would decline. The net outcome, in the view of leading government and private economists in Taiwan, would be neutral. Other Asian currencies would be less affected than Taiwan and Korea. The campaign to pressure China to fix the renminbi has been based entirely on a wrong model.

Should China devalue for its own reasons?

On the other hand, it is much more difficult to decide whether China should devalue for its own reasons. Certainly, China has considerable ability to resist devaluation. It has about US\$146bn of foreign exchange reserves against foreign debt that international agencies estimate at around US\$210bn.⁶ Much of the debt has relatively long maturities. China continues to run a trade and current account surplus. The capital account is closed and there is almost no hot money, so markets cannot suddenly force China to devalue.

The benefits to exports of a devaluation appear limited

On aggregate data, about 60-70% of the value in China's exports comes from imported inputs, so arguably the benefits to exports of a devaluation are limited. While China's exports have been declining, that has been caused mainly by the weakness of its Asian trade partners and China has actually increased its market share in the US and Europe, so it seems to be as competitive as ever. To the argument, which everyone agrees is true, that many foreign investors have been deferring investments while they wait for a devaluation, Chinese officials reply that speculators anticipated a devaluation after the currency unification in 1994 but gave up in 1995; the government expects the same thing to happen this time.

Many advantages gained from other Asian devaluations have been offset by subsequent revaluation and inflation...

Chinese government economists argue that other Asian economies have lost much of the advantage gained from their original devaluations because their currencies have since revalued part of the way and their inflation has been significant. In Indonesia's case, currency gains and inflation have completely wiped out any cost advantage. They argue that the average Asian currency gain was 8% and that China's weighted average appreciation was 3%, but Chinese productivity has improved 8% and the quality of products has improved. On that calculation, China hasn't lost anything and its wage costs are still well below Southeast Asian levels. Moreover, the government can help exporters by increasing export tax rebates and simplify the approval procedures. This is already being done for coal, textiles, cement, steel, electronics, and others. China has also made it much easier for a wide range of Chinese companies to obtain export licences. Finally, officials believe that a recent crackdown on smuggling will lead to resumption of the rise in foreign exchange reserves.

⁶ China's official statistics show foreign debt of US\$135bn at the end of 1997, but the BIS shows about US\$40bn more. Chinese statistics don't count obligations of under three months and don't include the debts of offshore subsidiaries. There is also believed to be around US\$20bn of debt not captured by the BIS statistics. So the debt was probably US\$200bn at the end of 1997 and is believed to have risen by about US\$10bn during 1998.

...but China has been competitive because other Asian countries' banks have been unable to finance exports

On the other hand, China has been competitive with other Asian countries partly because those countries' banks were in such trouble that they could not finance their exports. Price competitiveness was irrelevant in 1998 for Korean, Thai and Indonesian companies that could not get working capital to produce for export. In the latter half of 1999, their banks should be in better shape, their companies will be leaner, and the test of competitiveness will be more severe.

Moreover, the overall average numbers may hide important differences. The big SOEs, which do not create jobs, may have enough foreign debt and chunky foreign imports so that they would not be helped by a devaluation, but the smaller non-SOEs, which do create jobs, might experience greater gains; that could be crucial to the fate of the reform. The data are inadequate to decide the issue, but the Thai devaluation of 1984, where the same arguments against devaluation proved wholly incorrect, suggests that this is a critical issue. Second, about 25% of China's exports are higher-end items like hair dryers, consumer durables, and machinery, and these compete directly against economies like Taiwan and South Korea which have devalued, so a fixed Chinese currency may slow China's move up the value-added chain.

A fixed currency requires real interest rate above 10%

Above all, a currency fixed to the US dollar has to maintain interest rates roughly similar to US interest rates in order to avoid devaluation pressures. Since China has negative inflation, this means it suffers from real interest rates in excess of 10% (6.6% nominal interest plus 3.5% deflation) at a time when the economy is on the edge of a liquidity trap and there is almost no growth from any cause other than government stimulation. This is a dangerous situation.

Against this, many officials argue that a stable currency is essential to the stability of China's banks. If the roughly 40% savings rate were to decline sharply, the economy would be in very serious trouble. It is difficult to measure the risk of a run, but there are few other outlets for Chinese people's savings and the government is clearly able to bail out the banks, so the argument of instability seems weak.

The consensus in China seems to be that devaluation would be undesirable now...

That is the theory. What will actually happen? There is now a consensus in Beijing that devaluation would be undesirable. Freeing the currency would lead to a modest devaluation. On 29 April, the black market buying rate was RMB9.00:US\$1, a 9% discount to the bank rate of RMB8.28:US\$1.⁷ After the bombing of the Chinese Embassy in Belgrade, demand for dollars weakened to a rate of RMB8.97:US\$1. Since US dollar deposit rates in Chinese banks are higher than renminbi rates, and since the volume of the black market is very low, the currency is not under severe pressure. The strong reserves, low debt and trade surplus ensure that any devaluation could be held to a modest one.

...but that over the longer term it would not make sense to hold the currency at a fixed rate

There is an emerging consensus in Beijing and in international financial institutions that over the longer run it would be irrational to try to hold the currency at a fixed rate. The economy is undergoing rapid changes so complex that nobody other than the market could calculate what the proper rate should be. The Asian crisis has shown that, while floating rates can work and currency boards can work, relatively fixed exchange rates in the absence of a currency board allow pressures to build up to disastrous levels and can then wreck the economy.

Officials have begun to differentiate between a stable rate, which they say is policy, and a fixed rate, which they say is not their longer-term intention. The problem is how Beijing gets off its current policy onto a more sustainable one. The current view will likely be held through 1999. During that period, specific export sectors can be helped by tax rebates if necessary. It is notable that most exporters are not screaming for devaluation. But continuing to have a fixed currency much beyond the end of 1999, or even making pledges now to hold it fixed for a prolonged period, would be mismanagement, not sound policy. Almost certainly the currency will be allowed to move within a considerably wider band in 2000.

⁷ Black market rates are available at www.chinaonline.com

Can the reform be sustained politically?

Reshaping society

The Chinese reform is one of human history's most ambitious attempts to reshape a society. So much change is inherently risky. Risks arise at three levels: the top leadership, the implementing bureaucracies, and affected social groups.

There is a broad consensus for continuation of the directions of reform

The prevailing view of Chinese reform from 1979 onward has been that it depended overwhelmingly on one man, initially Deng Xiaoping, now Zhu Rongji. This view is partly right, mostly wrong, as this writer has argued consistently over the years.⁸ The broad directions of reform have long since become matters of consensus. Every elite family and every social group was harmed in some way, usually some very serious way, by the insanity of the Cultural Revolution (1966-75), and tens of millions of people died in the earlier Great Leap Forward (1958-61). Conversely, with no exceptions, every social group has benefited from reforms, so there is a very broad consensus at both the elite and popular levels for continuation of the broad directions of reform. China has a few Soviet-style leftists today, but no substantial Maoists.

Moreover, the entire top leadership has acknowledged for about the past five years that failure to address the state enterprise and bank problems would eventually lead China toward a fate similar to what happened to the Soviet Union in 1989. There was a debate about SOE strategy lasting some four years, and China's present course is the outcome of that lengthy leadership discussion. The result was a consensus on the basic policies of reform, including giving the premier's job to Zhu Rongji, with a mandate for radical change. That does not mean the decision cannot be changed, nor does it mean there are no disagreements about vital details. Of course there are. The important point is that the leadership has both a shared sense of urgency about the problem and a collective decision about the broad directions of solution. This was not one faction imposing its will on another faction. So there is considerable momentum behind the reform decisions.

Momentum could be lost if Zhu were to be sidelined

Having said that, the reason the collective leadership chose Zhu to spearhead the strategy is that he is uniquely forceful and coherent in implementing the strategy. If he were weakened or sidelined, China would not reverse course, but it could lose momentum. And momentum is crucial for getting the big employment and institutional upheavals behind China before the money runs out. At this moment, the strategy is still in place and Zhu is still very much in charge. But he and President Jiang may have been significantly wounded by Clinton's turnabout on WTO and by the accidental Nato bombing of the Chinese Embassy in Belgrade. Some Chinese observers believe there is a slightly perceptible coalescence around former Premier Li Peng, now head of the National People's Congress, of ministries upset about WTO concessions, disappointed former military businessmen, and others. Li Peng has been giving a lot of speeches denouncing hegemonism, presumably positioning himself as the beneficiary of any backlash against foreigners. But even if such a grouping does emerge, so far it is still relatively weak. On balance, what is noteworthy is that, for instance, the leadership still reaffirmed its determination to get into WTO three days after the peak demonstrations over the Embassy bombing. At the leadership level, reform is still on track.

A more substantial risk is that officials in the ministries and the provinces could nibble the reform to death. The premier's orders have to pass through hundreds and thousands of hands in order to get implemented. China is the country that, during the Cultural Revolution, invented the concept of "waving the red flag to defeat the red flag" — shouting Mao's slogans while trying to move in the opposite direction. What makes predicting the future difficult in China is the layers of protective coloration that opposition animals are capable of adopting. All one can say is that, across the board, from the government to the military to the banks, implementation of reform seems to be in the hands of exceptionally capable people who appear to be enthusiastic about their reforms. Certainly, there have been tactical retreats, for instance the order in the second half of 1998 to slow down SOE layoffs, and certainly market reforms are often implemented with a peculiarly socialist twist, as in the case of the AMCs. But the direction is firm and movement so far is rapid.

At the popular level, China's situation is complex. Every major group has benefited from reform, but change is so rapid and so potentially disorienting that the Chinese body politic could become vulnerable to anxiety attacks. For the first time, there are large groups which, although they are being provided with subsistence incomes, may seem themselves as big-time losers — particularly state enterprise employees in certain parts of the northeast and Sichuan. Moreover, modern communications and a relaxation of restrictions on freedom of speech have given dissidents the ability to communicate with large numbers of people over large distances regardless of what the leadership desires. So far, no large groups are hungry. So far, though there are many scattered outbreaks of protest, there is no widely accepted dissident ideology and no widely popular dissident labour union or political movement. This is because most of the society believes the government is trying its best to help the people and believes it is in fact making valuable progress. In the event of major economic setbacks, that could change very quickly, but it hasn't yet.

Intellectuals back reform

Crucially, the intelligentsia almost uniformly back the reform programme and the premier who is implementing it. When I was invited to give a centennial lecture at Beijing University in 1998, I was amazed to find a campus full of supporters of Premier Zhu. Normally, all third-world universities are in opposition. In Korea, for instance, students have continuously been in opposition, usually violent opposition, to the government throughout the entire twentieth century. My predominant thought was that, if this had been Harvard or Yale or Berkeley (or, for that matter, Hong Kong University), the students would have been out demonstrating in favour of dispossessed workers. For one of the first times in modern history, the universities are solidly behind a reform and a leader.

How much more stress can the system take before reform gets hobbled? This is a much harder question to answer than the earlier question of financial sustainability. Resistance to change is everywhere, as it is in any society. The arguments that things are going too fast, that the collateral damage is too great, that the principles of the revolution are being betrayed, that Chinese interests are being sold out to foreigners, and that particular groups are being asked to pay too much of a price, come from many directions. From abroad, China and its leaders are besieged by pressures, particularly from the US, for economic and political concessions that are beyond what any Chinese leader could accept and survive. Zhu's proffered concessions on WTO in the spring of 1999 drew particularly vociferous reactions from affected ministries; the humiliation inflicted by Clinton's backing away from the deal did far greater political damage to Zhu than has been publicly acknowledged. The subsequent student response to the accidental bombing of the Chinese Embassy in Belgrade showed how widespread students' and others' nationalist fear of the US has become. (Arguments that the students were just mobilised and manipulated by the government are totally wrong; feeling was strong even in Hong Kong and even among liberal Chinese students at US universities.)

The defenders of reform are deeply entrenched, but unnecessary shocks could pose a threat

On balance, the reform still seems to be basically on track, its defenders deeply entrenched. But the huge damage done to the strongest advocates of rapid domestic reform and rapid international opening by completely unanticipated problems with the US shows that there is real risk that further unnecessary shocks, either domestic or international, could put the success of reforms at risk. Zhu Rongji and Jiang Zemin have been weakened relative to others, so the risk of the reforms being nibbled away has risen. A bet on the success of reform is likely to win, but the risks cannot be ignored.

⁸ See William H. Overholt, "China After Deng Xiaoping," *Foreign Affairs*, May-June 1996

At this point in the reform, China cannot afford a pause. A pause would slow the loss of some jobs but would undermine confidence that the leaders know what they are doing and that policy is leading to a predetermined end. Once one has mounted the tiger of reform, it is dangerous to try to get off prematurely. If the reform is put on a stop-go basis, there is little chance that confidence will revive, hence little chance that the economy would revive. Investors in the region need to monitor this carefully.

Falun Gong

As an example of the impact of rapid change on Chinese society, it is worth looking in detail at the recently publicised Falun Gong movement.

The cult highlights the impact of change on Chinese society

A dramatic and mysterious demonstration in April 1999 called attention to the spread of Chinese *qi gong* cults. On April 25, more than 10,000 people quietly assembled on the street outside Zhongnanhai, the area beside the Forbidden City where China's top leaders live, to protest the banning of their cult, Falun Gong. They assembled quickly and without warning, stood still and remained absolutely silent for a brief period, and then vanished as quickly as they had come. In the aftermath, the whole world became aware that this cult now encompassed millions of people, followers of New York-based Li Hongzhi, who claims to be an ancient religious figure superior to the Buddha.

Qi gong is a millennium-old Chinese set of mental and physical disciplines, centred on focused breathing and meditation, which purport to mobilise sources of energy (*qi*) that are believed to flow through the human body. Individuals frequently seek to use *qi gong* to improve their own health, energy and mental balance. *Qi gong* healers seek to cure other people by mobilising the energy and then laying hands on the ill person, often purporting to extract cancers or to resolve serious back problems in a moment; this aspect of *qi gong* is analogous to the quasi-Christian faith healing common in the Philippines and elsewhere. The practice of *qi gong* can only be learned by apprenticing oneself to a *qi gong* master, and this necessity creates the potential for a charismatic *qi gong* master to acquire great influence over his disciples. Because of this, *qi gong* may, as in the case of Falun Gong, become the basis of a social movement.

Belief in *qi gong* is by no means confined to the dispossessed and the uneducated. Nor is it confined to communist China. The practice of *qi gong* is very widespread in Hong Kong and Taiwan, and among the practitioners one finds many graduates of elite US universities. (In May 1999, Falun Gong scheduled a series of five nine-day seminars in California, starting at Stanford University). Moreover, there is just enough evidence from modern biology of nerve and electrical flows somewhat analogous to traditional concepts of *qi* (energy) pathways through the body to leave the modern scientific mind intrigued with a few of the ancient Chinese concepts.

Modern China is in a spiritual and ethical vacuum...

Reformist China is highly vulnerable to social movements. Modern Chinese society finds itself in a spiritual and ethical vacuum. The old Confucian culture provided broad and detailed guidelines for social order and ethical behaviour — not quite a religion but serving the principal social functions that are elsewhere served by religion. While Confucianism was intended to undergird a social order that has long since vanished, it had, like Christianity and Buddhism, adapted and left a pattern of thinking that transcended its historical origins. The central institution of the Confucian social order, the patriarchal Chinese family, survived intact until relatively modern times. Maoism systematically attacked Confucian ideas and institutions, and in particular it disrupted the educational and examination systems that for centuries had instilled Confucian thinking in the elite and, through the elite, in broader Chinese society. Maoism disrupted the Confucian governing bureaucracies, the educational system, and even to some extent the family. But then Maoism itself was discredited by its horrendous excesses, particularly as manifested in the Great Leap Forward's millions of deaths (1958-61) and the Great Proletarian Cultural Revolution's anarchy and strife (1966-75). This left China without any widely accepted religion or ideology.

Reformist Marxism and the principles of the market could hardly fill this vacuum. All the core principles of Maoist Marxism have been discredited. Incessant class struggle as a principle of political and social management has, in the aftermath of the Cultural Revolution, become totally repugnant. Universal state ownership of industry has been exposed as economically harmful and politically corrupt. And so forth. Market principles, even when supplemented by declared devotion to the rule of law, cannot replace what has been lost. The core principle of the market, namely that competitive greed can be harnessed to maximise prosperity, is highly efficient but morally unattractive. It can be made consistent with broad moral principles and religious beliefs, as has happened with Calvinist and other Protestant Christian beliefs (the Roman Catholic tradition, including the present Pope, still have problems reconciling with key aspects of the market economy) but cannot substitute for them. The metaphysics of greed and fear may or may not satisfy Wall Street investment bankers, but they certainly don't comfort Chinese peasants and state enterprise labourers.

...which has wide-ranging consequences

The resulting vacuum has had wide-ranging consequences for reformist China. A revolution in sexual behaviour, though positive in some respects, has created widespread anger and uncertainty in the absence of any broadly accepted principles of behaviour. In business and government, the old vulgar Marxist equation of capitalism with theft has substantially become reality in the absence of any consensus on what constitutes acceptable behaviour. The universality of corruption in today's China has many causes, but certainly the absence of generally accepted standards both contributes to the corruption and makes it difficult to eradicate. For instance, in Mao's China, all industry was the property of the state and in principle the property of society generally, so there was no system of ethics or law to prohibit a minister from regulating the steel industry, administering steel mills owned by his ministry, making life or death decisions that affected other steel mills competing with those owned by the ministry, and having a variety of family members in the steel business themselves. Such conflicts of interest occur throughout the third world, but in China there has been the additional problem that no overriding principles enunciated what was acceptable and what was not. A system without organising principles is inherently corrupt. The government's effort to create a body of law that will enunciate coherent rules is necessary to fill the vacuum but not sufficient.

For individuals, the absence of broad religious or ethical or ideological principles is severely disorienting. What is proper behaviour in business? In government? In sex? What are Mr Wang's family obligations when he has travelled halfway across China in search of a job and hasn't seen his family for three years? What is happening to China, to his or her village, to the factory? Where will all this end? The result of this disorientation is the spread of all sorts of religions and cults. The practice of Buddhism is spreading everywhere. Ironically for Western Christian fundamentalist opponents of China on grounds of religious oppression, there are probably more new adherents of Christianity in each year in China than at any previous time and place in world history — and the residual (limited but very real) repression just adds to their fervour. Confucian temples have reappeared all over China, especially along the coast where they are frequently subsidised by overseas Chinese from Taiwan and elsewhere. Village China has seen the periodic sprouting of Mao Zedong wannabes with local followings that usually create some disruption for a few weeks or months and then disappear. Various secret societies and criminal gangs have also found the social space in which to expand.

The cult does not necessarily pose a real challenge to the administration...

Like these other manifestations of spiritual vacuum, Falun Gong does not necessarily pose a fundamental challenge to the regime. Most of the emergent movements, other than the would-be Maoist peasant groupings, are potentially stabilising as well as potentially disruptive forces. It all depends on the context, in particular on whether the reform succeeds and how the regime deals with the movements. Falun Gong has not overtly challenged the regime, except to demand legalisation and recognition. It does not explicitly challenge the government's policies. It does not seem to have a detailed policy agenda. To the extent that it has a view on major economic and social issues, its perspective seems similar to traditional Chinese communism. There is of course much we do not know. But it seems fair to predict that, to the extent the economic

reform succeeds in stabilising the economy, providing most people with basic necessities, and creating a general sense of hopefulness, all these movements are likely to prove manageable and even stabilising.

It is worth remembering that the mid-19th century Taiping Rebellion, led by a Christian who believed he was the brother of Jesus Christ, was able to spread so far and so fast only because the Qing dynasty had already reached a very advanced degree of internal disintegration. Similarly, the Communist party was able to fight back from the distant rural areas after the Long March only because internal strife, economic collapse, and the Japanese invasion had already devastated the Kuomintang regime of Chiang Kai-shek. Today's regime in Beijing is not suffering any of these fatal maladies. If the reforms were to fail, if large groups were left hungry and hopeless, or if much of China became engulfed by a sense of chaos and confusion, then groups like Falun Gong would quickly spread, become radical, and link into overtly opposition movements, but that is not in prospect today.

...but repression would strengthen such groups

Brutal repression would also strengthen such groups. That is not happening at the moment. Although the Chinese government's refusal to recognise Falun Gong as a religion was the justification for the protest, police action against the group has been minimal and the government has agreed that senior officials will hold some meetings with Falun Gong representatives. All this means that for the time being neither this group nor others constitutes an early threat to the regime.

The closest analogy in contemporary Asia to the Falun Gong cult is the South Korean cult of the Reverend Sun Myung Moon, which arose in a phase of Korean development very similar to where China is now. Sun Myung Moon developed a large following in South Korea and throughout the world. He put on seminars that attracted numerous Nobel Prize winners in a variety of disciplines. In some places his cult inspired such fanatical behaviour, particularly among youth, that a cottage industry grew up in the United States of groups that specialised in seizing youths at the behest of their parents and breaking the hold of the cult on them. Sun also managed to build a business empire. As South Korean economic and political development matured, and created a solid middle-class society, both the cult and the business empire faded. If China's development is successful, a similar pattern is likely.

Foreign affairs

China faces no vital security threats

China's foreign policy and security situation is in uniquely good shape. For the first time in centuries, there is no foreign power that directly threatens China's security. Russia is weak, Japan is largely disarmed. India is more a threat to itself than to China. The Mongols, Manchus and Tibetans, once looming invaders, have descended to the status of human-rights problems. The US is, in Chinese perspective, a pain but a distant one.

The military is preoccupied with reform

But China needs a nurturing environment if its economic reform is to succeed. It needs to sustain about US\$300bn of trade, US\$40bn or so of foreign direct investment, and extensive international bank and bond financing. It must avoid having to divert resources into foreign defence or foreign adventures; China's leaders know that such diversion would be economically fatal, and ultimately politically fatal, at this juncture in their history. As noted earlier, the Chinese military is preoccupied with reorganisation and is not postured for trouble.

Sino-US stresses happen periodically

In the reform era, China has sought to forge a productive relationship with the US. This has been a top priority. And the US, after several years of angry posturing about cutting off normal trade relations (1992-1995) and two years of confrontation over Taiwan (1995-1996), seemed to have chosen a more cooperative relationship with China. But the relationship periodically becomes very stressed, and now is one of those times.

China is not planning to attack Taiwan

It is particularly important to note that, despite a recent outcry in the US about Chinese missiles, the Chinese military does not have the logistics or weaponry necessary to its ability to attack Taiwan. Nor has it indicated plans for any such investments. The PLA has the ability to defend China and to do very little else. What it has done vis-à-vis Taiwan is to accumulate gradually a significant stock of missiles which augment the capability China has always had: the ability to create a psychological shock and the ability to disrupt the island's trade. There is nothing fundamentally new here. Assertions that China is engaging in a great military buildup generally, or one aimed specifically at Taiwan, simply have no basis in fact. And there is no evidence whatsoever of any timetable for retrieval of Taiwan; there are groups that would like to impose a deadline, but those groups do not determine government policy.

Superficially, the principal causes of the relationship's deterioration on the US side are a Beijing crackdown on dissidents, a spy scandal in which Beijing is alleged to have acquired designs for building compact nuclear weapons, and a missile buildup opposite Taiwan. The real causes are much more fundamental. China's nuclear breakthroughs graphically illustrate the fundamental strategic fact of the modern world: China is the one country that can potentially (albeit many years in the future) challenge the American role as the world's sole superpower. Many groups in the US are upset by that, and some of them exaggerate distant future potential into present intention.

Nato's involvement in Yugoslavia has struck a raw nerve in China

On the Chinese side, the Nato decision to ignore Yugoslav sovereignty and attack Serbia because of human rights abuses is very disturbing. China, like other third-world countries, is fanatical about sovereignty. Two centuries of national humiliation and division are just now being overcome, and that achievement is the centre of national consciousness. Chinese leaders feel, correctly, that the US has never acknowledged their legitimacy. China resents the West's attacks on human-rights abuses in places like Tibet and sees in these attacks an effort to return China to the bad old era of national division and humiliation. On the other hand, Europe is moving into a post-nationalist era when it takes increasing pride in deemphasising national boundaries and focusing attention on shared concerns for human rights and democracy. The attack on Yugoslavia and the rationale presented for it are profoundly threatening to China.

Anti-US sentiment has had only a moderate impact on policy

These differences are very fundamental in theory but need not have large or immediate consequences. According to leading Western diplomats, the upsurge in American anti-Chinese sentiment has so far had regrettable but moderate impacts on Chinese policy. Jiang Zemin has been forced by the other leaders to back off on his pro-American stance, and he has been forced to defer initiatives on Tibet that would potentially have mollified the US. He has been forced to give more rein than he would prefer to expansionist moves in the Spratleys and to anti-Western rhetoric on Kosovo. Both Jiang Zemin and particularly Zhu Rongji have been badly humiliated, and Zhu may be in a very weak position for at least six months. It seems to be almost a law of nature that the consequences of major upsurges in anti-Chinese sentiment among American journalists and Congressmen have consequences that defeat the ostensible goals of these groups: pro-Taiwan initiatives in 1981 and 1995 ended up damaging Taiwan; the anti-MFN movement strengthened Chinese conservatives; and current moves have cost Tibet a major opportunity and weakened China's leading reformers.

US-Chinese frictions potentially impinge on China's economy in two ways. First, anti-Chinese sentiment in the US successfully pressured President Clinton to back away from an early WTO deal. In China, that has caused embarrassment to the reformers and given opponents of China's vast concessions time to mobilise. Much has been written about WTO recently, and there is little use in recounting it here, but WTO success is not a foregone conclusion and failure could be a major setback for China's reforms. Zhu Rongji appears to have been counting on WTO membership to put further pressure on key Chinese industries and to force the dismantling of China's internal barriers to national distribution. Public anger over the bombing of the Chinese Embassy in Belgrade will make it very difficult for Chinese leaders to make further major concessions to the US.

All sites seek calm over Taiwan...

Second, there is always the risk of a clash over Taiwan. In the realm of grand strategy, this should be a time of calm around Taiwan. Neither China nor Washington wants a confrontation. China's top negotiator will soon visit Taiwan. Next year, Taiwan President Lee Teng-hui will be replaced by one of five candidates, all of whom are inclined to be less provocative towards Beijing than he has been. But a US proposal to build a regional theatre missile defence, designed primarily to defend Japan against new North Korean missiles, could be broadened to include Taiwan. This would physically incorporate Taiwan into a de facto alliance of Japan, South Korea, and the US and in Beijing's eyes would thereby reverse all the vital gains China made in the 1970s when it got the US to sever its military alliance with Taiwan and withdraw its troops.

...but missile defence proposals could create a confrontation

The great Chinese achievement of the 1970s was to get Taiwan out of an alliance with the US, and the great US achievement was to do so in a way that did not endanger Taiwan's political freedom, human rights, or prosperity. If Beijing's gain is unilaterally taken away, America's and Taiwan's gains will likely disappear with it. This issue has the potential to create a major Washington-Beijing clash and, if it got out of control, to disrupt the Chinese reform. This will not necessarily happen, but it is a real danger. This is where the philosophical difference between the US and China could become a very palpable confrontation.

Both sides have seasoned leaders

On the positive side, the leaders of China and America have a great deal of important business with each other that does not meet the public eye. As the world enters the next century, the greatest dangers to the peace probably come from unstable regimes and rogue regimes that have acquired nuclear weapons. China has the misfortune to be surrounded by such unstable regimes: Russia, India, Pakistan and North Korea. Ever since the 1970s China has quietly and truculently helped keep North Korea from destabilising northeast Asia. Whether blocking a potential North Korean invasion of South Korea in 1976 or helping slow a North Korean weapons programme two decades later, China, acting in its own interest and maintaining the façade of an ally of North Korea, has acted in parallel with the US. The chief executives on both sides of the Pacific understand this. Their journalists and legislators rarely do, and the public never comprehends. Hence Chinese-American relations tend to be smoothest when both countries are firmly guided by seasoned leaders and roughest when national policies are strongly influenced by waves of public passion or guided by inexperienced leaders. At the moment, both sides have seasoned leaders, but public passions and powerful sub-national interests await any moment of weakness on their part.

Market implications

The liquidity bull market

Asian markets continue to be driven primarily by liquidity. Among Asian shares, the mainland China companies available to foreigners have been relatively late in responding to the tidal waves of liquidity, so the group as a whole will still likely benefit from the liquidity bull market.

Transportation and key industrial raw materials should benefit from infrastructure push

Chinese economic growth will likely remain relatively strong by regional standards, at about the level of the government forecast of 7%. However, we expect this growth will be a drag on the Hong Kong and Taipei markets, for two reasons. First, it is lower than last year, and everything in economics is change at the margin. Second, and more important, the kind of growth that stimulates Hong Kong and Taipei has died. Private investment, small and medium enterprises, and trade growth are all weak, and those are the kinds of growth that benefit the mainland's neighbours. State enterprises building roads and telecommunications inside China will undoubtedly help China in the future, but not the neighbours this year.

However, even this kind of growth means that certain sectors, such as transportation and key industrial raw materials, should continue to experience earnings benefits. The expressways will likely continue to have consistent and rising earnings; their share prices should benefit and their credit ratings improve. Usage of raw materials that are key to the infrastructure programme will probably also improve.

Outside these sectors, 2H99 results could weaken

Outside such privileged sectors, the latter half of the year may well see weaker results. Conglomerates may suffer even more from poor economic conditions. WTO accession, if it occurs, could hurt agriculture, steel, chemicals, oil and refining, and machinery, while helping transportation, textiles, and banking and insurance. Our analysts are positive on China Telecom Hong Kong (0941.HK, HK\$17.35, BUY) despite the prospect of liberalisation.

Glass, cement and steel producers should benefit from housing programme

Although consumption remains weak, there are sectors that will likely prove strong. While the housing programme is not yet experiencing the kind of takeoff that would drive the Chinese economy as a whole, it has enough growth to greatly benefit the producers of glass, cement and steel. That has already shown up in the numbers.

Later in the year, the Chinese authorities hope that the huge rural electrification programme will lead to strong growth in the consumer sectors that serve poor but newly electrified communities. The villagers have high savings rates, and some believe they will buy small televisions, radios, and home appliances. On the other hand, our analysts think that the impact will be weaker because villagers already have low-quality sources of electricity and have bought many of the appliances.

Expect China's sovereign creditworthiness to improve over time

We expect China's sovereign creditworthiness will improve over time as a consequence of the reduction of moral hazard and the contraction of sovereign guarantees. For now, bank loans to non-sovereign entities are expected to continue contracting following the GITIC bankruptcy, and it will take considerable time before foreign banks will be able to differentiate good corporate credits from poor ones.

Death of reform has been greatly exaggerated

If China follows the model of what has happened in South Korea and elsewhere in Asia, local consumers will begin to regain confidence and start buying again well before reforms are complete. If so, this would stimulate a boom in China stocks similar to what we have seen in South Korea and Thailand. But China is sufficiently different that the timing of this auspicious event will remain a mystery until it occurs. In the meantime, the death of China's reform has been greatly exaggerated. For further information on our stock selections, see Jason Cheung's accompanying 12 May piece on China market strategy.

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