CONFERENCE PROCEEDINGS

Proceedings of the 6th Annual RAND–China Reform Forum Conference

August 28–29, 2003

Preface by Bijian Zheng and Charles Wolf, Jr.

William Overholt, Angang Hu, Edward Leamer, Renwei Huang, Benjamin Zycher, Yuanlong Wang, K.C. Yeh, Fanzhang Huang, John Despres, Gary Hufbauer, Harold Brown, Jisi Wang

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PREFACE

The relationship between China and the U.S. is one of the most important relationships in the world today. Since its normalization in the 1970s, the relationship has progressed steadily despite frictions and periodic ups and downs. Leaders of the two countries have viewed this relationship from their strategic perspectives and have focused on their common interests above all. As a result, they have strived to build a constructive and cooperative relationship, which has contributed to prosperity and stability in the Asia-Pacific region and the world. In recent years, in dealing with North Korean nuclear weapons, anti-terrorism, proliferation of weapons of mass destruction, cross-border crimes, and contagious diseases, the U.S. and China have expanded their common interests, strengthened the foundation of cooperation, and further developed their relations. Evidenced by history, Sino-U.S. relations ultimately depend on enhancing understanding between their peoples. In this respect, unofficial exchanges and cooperation play an important role and have their own particular advantages.

In light of these considerations, since 1998, the China Reform Forum (CRF) in Beijing and The RAND Corporation in Santa Monica, California, have jointly organized an annual conference of experts from China and the United States. Each of the six annual conferences held thus far has focused on economic and political-security subjects of mutual concern to China and the United States. The venues of the conferences have alternated between Beijing and Santa Monica, and participants have included policy and business practitioners as well as scholars from both countries.

This volume contains the papers and several of the discussant comments presented at the 6th annual conference held in Santa Monica on August 28-29, 2003.

The direct motivation for initiating this collaboration between the two institutions has been and remains to facilitate the exchange of information, analysis and ideas on the topics addressed in each conference. In the process, the six conferences have sought to enhance mutual understanding among the scholars and policymakers from China and the United States and, in some instances, to advance consideration of promising policy options that might be pursued.

With this objective in mind, CRF and RAND have developed a cooperative and interactive process for formulating the agendas of each of the conferences held from 1998 through 2003. Following each annual conference, our two institutions have solicited suggestions from conference participants concerning priority research and policy issues to be addressed at the next year's conference. These suggestions have, in turn, been reviewed, culled, and consolidated to shape the subsequent year's agenda. Thereafter each of our two institutions has selected qualified experts from China and the United States--some who are members of the staffs of the two institutions, and some who are associated with other organizations--and have invited them to write the corresponding papers and to serve as discussants. The process has been designed both to provide some degree of continuity in the successive conferences and to bring new participants into them.

In general, the pattern we have followed in shaping and conducting the conference agendas has been to have separate experts from China and from the United States address each specified topic, with an expert from the United States as discussant of each China paper and an expert from China as discussant of each U.S. paper followed by general discussion among all of the conference participants.

This volume of the 2003 *Proceedings of the CRF-RAND Conference* contains the unedited papers presented by experts from both China and the U.S., as well as some of the discussant remarks about these papers. In some instances, discussant remarks were written and these remarks are included in this volume. However, in other instances, discussant comments were not written, but instead were based on notes or "talking points" that are not included in this volume.

These papers were written to stimulate discussion. The views expressed therein are those of the authors, and not necessarily those of RAND, the China Reform Forum, or other organizations with which these individuals are associated.

The 2003 conference included a dinner on August 28, 2003 for the conferees at which the former U.S. Secretary of Defense, Harold Brown, gave a talk on the North Korean nuclear problem. Dr. Brown's remarks are also included in this volume.

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This document should be of interest to members of the policy, scholarly, and business communities concerned with economic and security relation between China and the United States.

Bijian Zheng,
Chairman, China Reform Forum

Charles Wolf, Jr.,
Senior Economic Adviser and
Corporate Fellow in
International Economics, RAND

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Wang Jisi, CRF

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William Overholt, RAND
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Hu Angang, Tsinghua University
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Wang Yuanlong, Bank of China
Discussant: Gary Hufbauer, IIE

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K. C. Yeh, RAND
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CONFERENCE PARTICIPANTS

Richard Baum, UCLA

Harold Brown, Warburg, Pincus; Center for Strategic and International Studies

Cao Huayin, CRF

Gina Despres, Capital Group Companies

John Despres

James Dobbins, RAND

Roy Doumani, Center for Asia Pacific Policy (CAPP)

Nina Hachigian, RAND

Ted Harshberger, RAND

James Hodgson, CAPP

Galen Hoskin, Capital Group Companies

Hu Angang, Tsinghua University, China Reform Forum

Benny Hu, China Development Industrial Bank, CAPP

Huang Fanzhang, The Academy of Macro-economic Research, Commission of Development and Reform

Huang Renwei, Shanghai Academy of Social Sciences

Gary Hufbauer, Institute for International Economics

David Karl, Pacific Council on International Policy

Tom Mcnaugher, RAND

William Overholt, RAND

Michael Rich, RAND

James Thomson, RAND

Rachel Swanger, RAND

Wang Hui, First China Capital, Inc.

Wang Jisi, CRF, Chinese Academy of Social Sciences

Wang Yuanlong, Institute of International Finance, Bank of China

Charles Wolf, RAND

Andrew Nien-Dzu Yang, Institute of Advanced Policy Studies

K.C. Yeh, RAND

Benjamin Zycher, RAND

"CHINA'S ECONOMY, BEYOND 2003"
BY WILLIAM H. OVERHOLT

China's economy has demonstrated extraordinary resilience in the face of a global economic slowdown combined with the SARS tragedy. This resilience results from the successful shift to domestic-led growth prior to the global slowdown and from rising productivity caused by economic reform, rising competition, and high levels of foreign direct investment. Overall, the success results from a disciplined and politically courageous process of reform and opening.

Each phase of Chinese growth and reform presents new challenges. The challenge of the initial phase was to open the economy to trade, to revive farm productivity through an orderly transition to family farms, and to move toward market prices. In the early 1990s the principal challenge was to overcome inflation. In the later 1990s the principal challenge was to get state enterprise (SOE) inefficiency and losses under control. Failure to cope with any of these challenges would have been fatal to China's economic miracle. So far, each challenge has been successfully surmounted. Along the way, major successes have been registered. Growth has been high. Poverty has fallen sharply. Trade has grown rapidly. Foreign direct investment has exceeded all expectations. A dynamic private sector has emerged as a major contributor to growth.

Two recent successes deserve particular mention. First, the shift to domestic-led growth. All of the Asian economic miracles have been driven by exports, and China initially followed this pattern. Japan continues to depend on growth of net exports as virtually its only source of economic growth, despite warnings by foreign economists from the late 1970s onward, and despite official endorsement of the Maekawa Plan in 1986, that only a shift to domestic-led growth could avoid eventual stagnation. China on the other hand not only accepted the imperative of such a shift but also implemented it decisively, beginning at the end of the last decade. The result has been an economy driven by domestic housing, cars, retail consumption, and infrastructure investment. These founts of domestic growth have permitted economic growth of about 8 percent even when net export growth has been negative.

Indeed, China has grown rapidly in 2003 even though the current account balance for the first half of 2003 appears to have gone negative. Such a rapid shift is a remarkable feat.

The second success has been surmounting the economic challenge of SARS. We do not yet know whether SARS will recur; virtually all U.S. experts believe that all coronaviruses are seasonal and that SARS will therefore recur in the autumn. What we do know is that SARS was vanquished as a short-term threat to the economy and the society in the first half of 2003. That threat was very severe, threatening to curtail tourism, trade, investment, education, and virtually all services that involved face to face contact. We know that small private service businesses suffered severely. Despite this, industrial production rose 16.2 percent in the first half of 2003 and exports 28 percent. Retail sales grew just under 8 percent as compared with a 9 percent growth rate for all of 2002. Utilized foreign direct investment rose 34.2 percent to a record $30.3 billion. While SARS slowed GDP growth to 6.7 percent in the second quarter, from 9.9 percent in the first quarter of 2003, most forecasts are that growth for the year will be well above 7 percent. If SARS recurs, China and the world will be better prepared the next time. Meanwhile the economy's resilience in the face of the SARS challenge is a historic success.

On a third major challenge, WTO, the results are preliminary but highly auspicious. While there are innumerable foreign complaints, and many domestic stresses, following from the first year of WTO implementation (2002), the overall balance appears highly favorable. China has proceeded with WTO implementation, and the domestic consensus has held. In a few key sectors where WTO rules were believed to risk devastating problems, the result has been the opposite. Agricultural incomes, instead of declining, seem to have managed a slight bit of growth. The auto industry was supposed to be devastated by WTO; instead, it created a mass market and a big win for all major participants, including consumers, domestic manufacturers, foreign joint ventures, and importers. Vehicle sales expanded by half in 2002. Transportation sector profits rose 71 percent. Imports increased 77 percent. General Motors' revenues in China rose 325 percent. It is not clear yet, at least to this writer, whether these are typical of the overall response of the economy to WTO, but these do show that seemingly insuperable problems can be overcome. The auto sector successes clearly do provide a template that other pressured industrial sectors can emulate. Demonstrably, globalization can be good even for those sectors where everyone expected it to be troublesome.

On the foreign side, there will be a deluge of detailed complaints about China's WTO implementation and those are about to become much more vocal. That was inevitable because of the vast educational and organizational tasks required for full implementation. There are many disputes ahead, and much diplomacy as well as concrete action will be required. However, there has not been a single major foreign actor asserting that China has strategically ignored its WTO obligations; this in itself is a preliminary success. The ascent of the WTO hill has just begun, but the early signs are auspicious.

As in the past, China's successes are being achieved by reforms that overcome severe challenges. The challenges for China's new leaders are as daunting as those faced by their predecessors.

One immediate challenge is a combination of foreign pressures and domestic problems created by the currency. The G-7 is bringing pressure on China to revalue its currency. In America's Midwest and South, Japan's Kansai, and Europe's Po Valley, the politics of this issue has become feverish. These foreign pressures are largely based on bad economics. While Japan's deflation is caused overwhelmingly by domestic banking problems and industrial overcapacity, it is more convenient for Japanese political leaders to blame China for their deflation than to undertake the politically painful banking reforms and corporate closures that would allow banks to lend freely and companies to price their goods profitably. While an RMB revaluation would do little to increase U.S. jobs, it is easier with an election looming in 2004 to blame China than to request union and corporate patience in the face of the inevitably slow recovery from bubble overcapacity and from the inexorable consequences of productivity that grows much faster than GDP. While the Euro has simply rebounded to the level that European leaders declared desirable several years ago, it is much easier to blame China than to increase resource mobility and to admit errors in the charter of a central bank that, through excessively high interest rates, is depressing growth and creating inappropriately strong incentives for investment in euros.

Having said that, China has a problem. As a result of massive purchases of dollars to stabilize the currency, the money supply is expanding excessively and the economy is blinking warning lights. First quarter 2003 GDP growth of 9.9 percent constituted overheating, and that overheating would have become serious had not SARS intervened. By June, foreign exchange reserves had reached $346.5 billion and M2 money supply was growing at a 20.8 percent annual rate (monthly figure, year on year), which is only consistent with economic stability if the real economy is growing around 15 percent. New loans in the first half of 2003 (1.78 trillion RMB) were nearly as large as new loans for all of 2002 (1.85 trillion RMB). Normally, such growth of money supply would create a threat of inflation, but in an economy where overcapacity is prevalent, the prices of goods are unlikely to inflate.

Instead the surplus money is feeding into such things as bank loans for fixed asset investment, which could lead to an explosion of non-performing loans, and into property, which could lead to a classic Asian property bubble. In fact, signs of such a bubble are already apparent in Shanghai, where property prices rose 15 percent in 2002 and 18 percent in the first seven months of 2003. Medium quality housing there now costs 5,000 to 7,000 yuan per square meter (US$600 to $850).[1] Old single-family houses sell for 20,000-50,000 RMB per square meter.[2] These prices are not yet outlandish, but if they keep rising at current rates they will create serious bubbles. Such bubbles eventually pop, and when they do economic miracles can suddenly end; that is what happened in Bangkok, Tokyo, Taipei, and Hong Kong. It would be catastrophic if China followed a similar path. In the past, Beijing has suffered sale price declines of 75 percent and Shanghai has suffered rental price declines of 84 percent, but as the percentage of the

[1] "New Home prices still on the rise," *Shanghai Daily News*, August 14, 2003, available on the web from English.eastday.com at http://english.eastday.com/epublish/gb/paper1/995/class000100022/hwz154434.htm

[2] "Old houses now a hot commodity,: *Shanghai Daily News*, reprinted in English. Eastday.com. 19 August 2003, http://english.eastday.com/epublish/gb/paper1/998/class000100022/hwz154947.htm

population who own houses becomes high the social and economic costs of such busts become severe.

To avoid such bubbles, China must either revalue its currency, allow large capital outflows, encourage a large flow of imports in order to run a large current account deficit, or use some combination of reserve requirements and higher interest rates to tighten monetary policy. China must choose some combination of these that fits its own national interests, but it must choose. Otherwise the Tokyo-Taipei crisis of 1990 and the Bangkok-Seoul-Jakarta crisis of 1997-'98 will be followed several years from now by the Beijing-Shanghai crisis of 2005, 2006 or 2007. For the other Asian miracle economies, such a bust has caused the end of the miracle and engendered a period of political weakness.

The G-7 demarche about the currency reflects the frustrations of societies where slow growth has led to falling profits and massive layoffs and rapid productivity growth in relatively flat economies (most true in the U.S.) leads to even more layoffs. Economic recovery should naturally lead to reduction of such political pressures, but such reduction may not come quickly. Jobs recover more slowly than other economic factors, the recovery is largely confined to the U.S. and spotty even there, and the U.S. is headed into an election year. This is not likely to lead to specific action directed at the currency, both because the currency arguments are intellectually weak and because it is difficult to draft specific measures. It could easily evolve into specific measures directed against China's trade, investment and intellectual property practices; in these areas, the intellectual case is stronger and specific measures are easier to draft. The U.S. policy figures with the most global views are trying to keep the international dialogue focused on the currency issue, because currency dialogues do not endanger the trade liberalization process. For this reason it is actually in China's interest for the currency discussions to drag on for some time, and if China takes dramatic measures to open or encourage imports that will further defer the potential threat of protectionist measures from Japan (the leader on this matter), the U.S., and Europe.

The bubble risk is tightly connected to another of China's increasingly urgent challenges, namely the banking system. While official statistics calculate non-performing loans (excluding those transferred to asset management companies or AMCs) at about one-quarter of GDP, the IMF estimates them (including those transferred to AMCs but not yet resolved) at between one quarter and three quarters of GDP; the lower end of the IMF estimate is included only to be diplomatic. If bubbles are forming, and if a whole range of new steel mills, car factories, and property developments go sour several years, hence, the banking squeeze could become unmanageable.

Just as serious, China's economic growth now depends on successful financing of small, medium and private enterprises that the big state banks don't know how to fund. Moreover, banks' inability to enforce legal judgments on debtors who do not pay means that even highly skilled new banks cannot prudently lend to companies that do not have government backing. So the system is unable to perform the basic function of any market-oriented financial system, namely to allocate resources to their most productive uses. In this respect it is discouraging that the corporate bond market is shrinking; it cannot compete with banks that have vast resources to lend despite their problems.

State enterprise reform has hitherto taken priority over financial reform, on the reasonable argument that the banks cannot be fully reformed until their principal customers, the state enterprises (SOEs), have been reformed. While that decision on priorities has been defensible, a great deal of progress has now been made on SOE reform and the banking problem is becoming both a formidable threat to government finances and a formidable barrier to the financing of the companies that provide China's growth. Future historians writing about the accomplishments of China's new leaders are likely to focus heavily on one of two stories: (a) The new leaders of 2003 implemented revolutionary reforms of the banking system and far-reaching supportive improvements of the legal process, while taking decisive measures to avoid the emergence of financial bubbles. Their decisiveness avoided a banking meltdown and enabled the nation's resources to be allocated much more efficiently. That carried the Chinese economy to a whole new level of growth and development, and it created the vast number of jobs needed for social stability; or (b) The new leaders of 2003 continued very gradual banking reforms and mistook the emergence of bubbles as evidence of rapid economic progress; in this way they followed the errors of Japanese, Thai and Korean leaders and endangered China's future economic progress and political stability.

The South Korean banking transformation since 1998 may be a useful model for China. The South Korean and Chinese banking and corporate systems shared many characteristics. China chose to give priority to enterprise reform over banking reform, South Korea to banking reform over enterprise reform. The two countries have many lessons to share.

Two generations of Chinese leaders have acted decisively to preempt major economic problems, and that record supports optimism that future historians will be telling story (a). But it is always the job of economists to point out the risks.

If that were not enough, problems, the coming years are likely to see more of a budget squeeze than China has experienced for some years. China went through a terrible budget squeeze in the early and mid-1990s as it lost large revenues from the SOEs and shifted to a more modern system of tax collection. That shift was marvelously successful, and revenues have risen sharply in both absolute terms and as a share of GDP. However, that great wave of success may now give way to another squeeze--at a much higher level of income and competence.

In recent years the government has benefited from a virtuous circle of rapid economic growth, rapidly improved rates of revenue collection, ability to shift costs off budget to the banking system, and ability to neglect basic social services. In addition, suppressed interest rates and accounting contrivances allowed a budget with an opportunity cost deficit of 8 percent of GDP (according to IMF calculations) to look like a deficit of only 3 percent of GDP. This virtuous circle has made budget "miracles" possible, for instance allowing the military budget to grow 17 percent per year for four years without greatly increasing the military's share of the total budget.

Of the five components of the virtuous circle, three are dramatically reversing and becoming vicious circles. Shifting the burdens has reached a limit that risks financial and economic instability; state enterprise losses have been shifted from the SOEs to the banks, then from the banks to AMCs and from AMCs to the central bank. After this, there only one place to shift the deficits: back onto the central government budget. Similarly, neglect of the basic social services once provided by the communes and state enterprises now risks a whole series of national crises. The government faces massive pension, social security, agriculture, environment and medical problems, along with potentially destabilizing social inequality; these will squeeze the budget for decades.

The most dramatic indication of the emergent realities is how SARS revealed that China's rural medical system, serving 800 million people, had largely evaporated and that this could put the national economy and social stability at risk. Quite aside from SARS, the national death rate from infectious diseases has risen from a little over 1 percent to 2 percent in the past three years--primarily due to tuberculosis, Legionnaire's disease, hepatitis, and other traditional diseases. Although 2 percent sounds like a small number, this increase is frightening. One further component, the ability to suppress interest rates and understate the cost of transferring budget problems to the banks, cannot be sustained indefinitely in an increasingly marketized economy.

I have not attempted to enumerate all of China's successes; such an enumeration would have to mention the increase of its trade, the benefits of increasing competition in sectors like telecommunications, the increasing technological sophistication, and many others. Nor have I sought to analyze all of China's major problems; such an analysis would have to look at demographic issues, environmental issues, agricultural consolidation, and many others. What I have sought to do is to portray the most decisive issues, both the great successes and the great challenges. China is like a man being chased by a tiger. It is very impressive that he runs faster than virtually anyone else in world history; it is also impressive how big the tiger is.

Most other countries facing such a big tiger would get eaten. Indonesia, the Philippines, Argentina, and many others have been eaten by far smaller tigers. What distinguishes China is both economic and political. It has chosen a process of gradual reform and opening that has proved economically correct in several Asian countries. And for 24 years it has demonstrated an ability to form a workable leadership consensus regarding the most important problems, to implement solutions in the face of enormous political and social stress, and to overcome the stress by delivering large benefits to most of the Chinese people. Effective politics has been the key to good economics.