

## Economic Insight

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# China's recovery

China has undergone a squeeze similar to that of other Asian economies. Now it seems to be recovering. As elsewhere:

- Exports are up.
- Consumer purchases are up.
- Growth is rising.
- The dependence of the economy on government stimulation and state enterprise infrastructure spending is down.
- The currency is stable. The People's Bank of China now has the confidence to foreshadow a forthcoming more flexible currency system.
- Deflation is diminishing and real interest rates are coming down fast.
- State enterprise finances have improved.
- China and Hong Kong have caught hi-tech fever and their efforts seem destined for success.
- In China's case, the majority of layoffs are past, even though millions are yet to come, and popular confidence seems to be reviving.
- There has been no overwhelming political reaction against reform or the reformers.
- Reform is accelerating.
- The reforms include massive efforts to upgrade the role of private enterprise and to greatly expand and reform the role of capital markets.

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## China's emerging economic recovery

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

As we noted in a report published last year, China is in a squeeze similar to those of smaller Asian countries.<sup>1</sup> To provide a context for the signs of recovery that are now emerging, we begin with a reiteration of the nature of China's squeeze and the measures Chinese leaders adopted to deal with it.

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 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.

Elsewhere in Asia, governments pretended there was no problem until a crisis collapsed their financial bubbles and crippled their banking systems. The shock of the crisis, including widespread bankruptcy, high interest rates, and prospective unemployment, scared consumers, who stopped spending. This threw the economies into recession.

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

In China, the sequence has been different. Instead of waiting for a crisis, China adopted the most proactive economic reform programme in Asia and for that matter in the world. As a result, there has been no sectoral bubble collapse, national debt crisis, or collapse of the banking system. But many of the immediate consequences of the Chinese cure proved similar to those of crises elsewhere.

*Proactive policy helped China's timing*

China's proactive strategy enabled it to tailor its reforms to market conditions. In particular, following the catastrophic floods of 1998 it was able to moderate the pace of layoffs, but during the Asian recovery of 1999 it accelerated reforms. Its smaller Asian counterparts waited until events overtook them and had to do the most difficult reforms amid the most painful conditions. More generally, China has paced its reform with great care; notably, it has not abandoned all capital controls before the supervisory structure was prepared for such liberalisation. China has managed the squeeze, while others were managed by the squeeze, and the result is superior Chinese performance even though it is a more difficult squeeze to manage.

<sup>1</sup> See William H. Overholt, *China in the balance*, Nomura International, 12 May, 1999



## The shock of reform

*Reforms 1994-97:  
disinflation, reserves,  
FDI...*

From 1994 to 1997, China pressed inflation down from 22% to negligible while keeping growth 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.

*Reforms 1998-2000:  
government, military,  
financial, SOE, welfare*

In the subsequent years, 1998 to 2000, China has set the goals of cutting the government in half, getting the military out of business, completely restructuring the military, laying off 500,000 soldiers, restructuring most state enterprises, eliminating the net deficits of the state enterprise system, laying off 30m workers to facilitate SOE restructuring, forcing the SOEs to reduce overcapacity, reforming the banks' organisation and incentive structures, partially recapitalising the banking system, reducing non-performing loans through the use of asset management corporations, attacking corruption and smuggling, and using membership in the WTO to increase competition, force the emergence of a truly national market, and acquire foreign banking skills.

It was this massive reform programme, and most notably the prospect of over 10m layoffs per year, that created a consumption and investment collapse and raised issues as to whether China's drive to modernity was sustainable. Consumer spending growth declined. Growth of investment by firms other than state enterprises building infrastructure stagnated. Foreign direct investment declined. The town and village enterprises, which had provided vital employment growth, stagnated and suffered massive net job losses. Net exports ceased to grow. As last May's report observed, the Chinese economy died and was put on a heart-lung machine — namely, government deficits which fund state enterprises to build infrastructure.

This situation belied the seeming good news of a 7.1% growth rate in 1999. The drastic negative change in the quality of growth was far more important than the relatively small decline of the growth rate from 7.8% to 7.1%. Most ominously, the fiscal deficits that were sustaining growth could not be continued much beyond 2001 without causing serious inflation or credit problems, the lower quality of growth did not create jobs at a rate sufficient to maintain employment rates, and it was taking three dollars of deficit to create one dollar of growth.

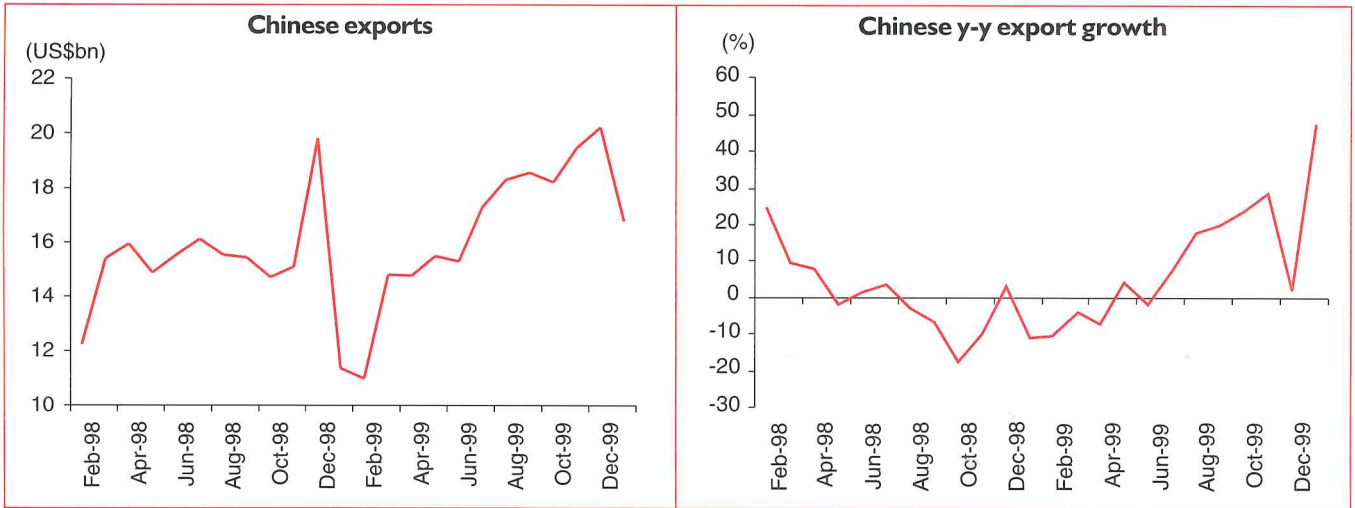
## Signs of recovery

*Exports have recovered*

In other Asian countries, recovery was evinced by revival of consumption, revival of export growth, and stabilisation of currencies. These signs have now appeared in China.

Exports have recovered, along with the Asian recovery, and the current cycle is at a higher level than the previous cycle. This is the pattern observed in other Asian economies.

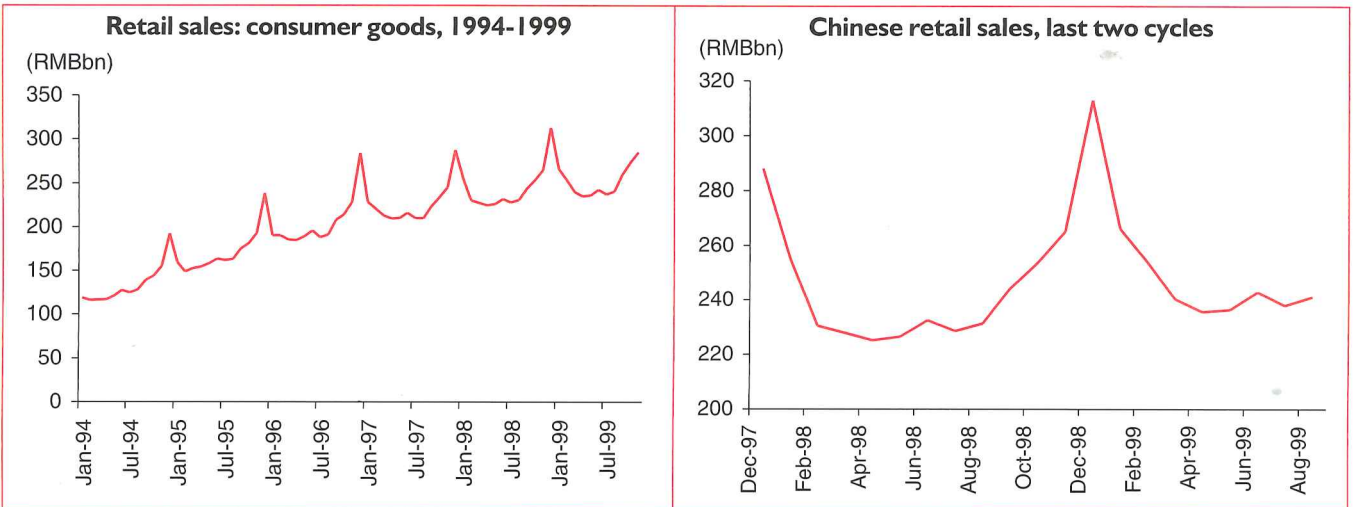
Even more revealing is the acceleration of growth rates in recent months, after a period of negative growth that encompassed much of 1998.



Source: CEIC

**Consumption gradually recovering**

Similarly, retail consumption has cycled higher. Notably, the retail consumption growth rate in 2H99, 7.2%, was higher than in 1H99, 6.4%. Even the 2H performance is far short of the 15% rate typical of China's boom times, but it clearly shows improvement. If Japan, which faces a similar liquidity trap, were to show similar growth of consumption, the whole world would celebrate. China reports that consumer confidence surveys show strong confidence. This seems to demonstrate that, as in other countries, the initial shock of reform has worn off and, though reforms have far to go, just as they do elsewhere, the population has decided that it is not the end of the world.



Source: CEIC

**Coming off the heart-lung machine**

Perhaps most important, the quality of Chinese growth began to improve markedly by the end of 1999. The table on the next page shows GDP growth in 1998 and 1999, followed by the rate of fixed asset investment (FAI) in those two years, and then the rate of growth of GDP if one excluded fixed asset investment. What this demonstrates is that fixed asset investment, mainly comprising infrastructure construction by state enterprises that are funded by government deficits, was the principal driver of growth in 1998; that is what we mean by low-quality growth. In 1999, however, the rest of the economy grew nearly as fast as overall GDP, a sign that the heart-lung machine is being withdrawn and the patient seems to be coming back to life. Again, this is a sharp contrast with Japan, where every partial withdrawal of the heart-lung machine to date has jeopardised the life of the patient.



**Components of Chinese growth**

(%)	GDP	FAI	GDP ex FAI
1998	7.8	14.1	5.7
1999	7.1	7.8	6.9

Source: Official statistics, Nomura International (HK) estimates

**Currency stable**

In other Asian countries, the crisis was manifested by a currency collapse, and recovery included a partial recovery of the currency. Here, China's situation is different, because China's financial bubbles were inflated with local currency rather than foreign currency. But, during the worst of China's squeeze, lack of confidence, along with declines in exports and foreign direct investment, created downward pressures on the Chinese currency. A noteworthy sign of recovery is the dissipation of pressures on the currency. The renminbi has traded stronger against the US dollar recently, for instance a selling price of RMB8.65:US\$1 on 24 February, 2000, versus RMB8.72:US\$1 on 13 January, 2000, and RMB9.00:US\$1 on 29 April, 1999.<sup>2</sup> Recognising this recovery of stability and confidence, in February, the government indicated its intention to adopt a more flexible currency policy in the near future.<sup>3</sup> This was emphatically a sign of confidence in currency stability, not an acquiescence in pressures for devaluation.

**The majority of layoffs are in the past**

The most likely reason for the recovery of consumer and currency confidence is that the huge programme of layoffs is more in the past than in the future, although there are certainly many still to go. According to official statistics, there were 11.5m layoffs in 1997, 5.5m in 1998, 11.9m in 1999, and an anticipated 10m more planned for 2000, bringing the total closer to 40m than to the originally planned 30m.<sup>4</sup> But nearly 30m are in the past. As elsewhere in Asia, the terror of coming layoffs is worse than the reality, even when the reality is severe, so confidence begins to recover well before the programme of retrenchment is complete. The Chinese consumer is recovering despite a terrible shock, whereas the Japanese consumer remains petrified by the prospect of a limited shock.

**State enterprise deficits have diminished**

One indicator we are very cautious in using is the profitability of state enterprises. A central goal of the Chinese reform is to eliminate net state enterprise deficits, and official data indicate that this was achieved in 1999, with the state enterprise sector showing net profits of over US\$9.6bn. Certainly many state enterprises have eliminated their deficits, and certainly laying off tens of millions of unneeded employees should have had beneficial effects on SOE bottom lines. In addition, considerable overcapacity is being forcibly reduced and inventory levels are falling. However, state enterprise profit/deficit numbers are probably the least reliable of Chinese statistics, not because they are falsified at the top but because accounting is incompetent and politicised at the bottom and because the data are tainted by debt forgiveness. So, while there is undoubted progress here, we rely more on other indicators.

**Government revenue is rising**

One of the vital signs of the government's ability to continue implementing its programme is the revenue base of the Chinese government. For years, the revenue base has been eroding as a share of the economy, from about 13% of GDP early in the 1990s to about 10% today. That has been occurring during a period when the need to build infrastructure and to stimulate the economy has been rising. This has been a dangerous trend, because a government that cannot fund itself cannot survive. In this context, it is crucial that in 1999 government revenues rose at 13.7%, nearly twice the rate of GDP growth. One central contributor to this result was the government's success in getting the military out of business, an achievement that among other things crippled the world's largest smuggler, namely the old PLA business machine.

<sup>2</sup> Black market rates are available on ChinaOnline.com. We cite the 29 April 1999, figure because it was a benchmark used in the May, publication mentioned in the earlier footnote.

<sup>3</sup> This was reported, citing an "authoritative source," on the internet site Sina.com, on 24 February, and widely circulated in the print media afterward. Had the quotation been incorrect, the central bank would certainly have contradicted it.

<sup>4</sup> The 1999 figure is from a 10 January 2000, announcement by the Ministry of Labour and Social Security. The 1997 and 1998 figures were provided by the State Statistics Bureau, as indicated in the May 1999 Nomura report cited above.

### Stable politics

Crucially, throughout this period China's political situation has remained stable. Notwithstanding local demonstrations, the layoffs and broader insecurity have not given rise to any fundamental challenge to the government's authority. There is no Chinese equivalent of Poland's Solidarity labour movement, which used economic sabotage and went far beyond economic demands to mount a challenge, ultimately successful, to the authority of the government. China has no spreading anti-government ideology and no significant rural or urban insurgency. The top leadership is committed to reform, despite inevitable squabbling over the details. China's intellectuals and students largely support the basic thrust of the reform programme and most of its major policy thrusts. The politically aware population seems to perceive the government as doing its best to do what is right for the people in a difficult situation, rather than as imposing iniquitous and unjustifiable burdens from malicious motives. It is this apparently solid political base that allows the reforms to accelerate.

### Falun Gong mis-step

The government's over-reaction to the Falun Gong movement is a costly mis-step but not a fatal one. Falun Gong focuses on individual and group improvement through enhanced breathing, not on overthrow of the government. If the economic reform succeeds, as it has begun to do, Falun Gong will fade as South Korea's similar Sun Myung Moon movement did. The government's over-reaction means the this fading will take much longer.

### Growth is rising

As a result of the continuing recovery, growth is expected to be higher in 2000 than in 1999, perhaps 7.8% as compared with 1999's 7.1%. In parallel with this, deflation is decelerating and the government expects it to be largely eliminated by the end of the year. Increasing firmness in steel prices and others supports this view.

### Real interest rates are declining

Another benefit of emerging recovery is declining real interest rates. A year ago, real interest rates were around 12%. The government has been able to cut nominal interest rates seven times. Declining deflation will mean that real interest rates fall far more than that. Increased currency stability is enabling this to happen. Now that the government has the confidence to de-peg the renminbi from the US dollar, Chinese interest rates will no longer have to be closely tied to US interest rates. So Chinese monetary policy has entered a virtuous circle that facilitates growth.

## Reforms are accelerating

### No reform fatigue yet

China's existing reform programme, which anticipates 30m SOE layoffs, a halving of government employment, comprehensive bank reform, and the exit of the military from business, is already one of the most ambitious reform programmes in world history when one takes into account the size of the population involved. Less ambitious programmes in South Korea and Thailand are showing signs of reform fatigue, with Kim Dae Jung's popularity having fallen by roughly half and Chuan's government showing some vulnerability. But in China reforms continue to accelerate.<sup>5</sup>

In addition to laying off considerably more SOE employees than originally envisaged, China is transferring state enterprise social responsibilities to local governments. Schools, hospitals and welfare will be increasingly managed by local governments, removing from SOEs these financial burdens and enabling them to lay off employees without causing the laid-off to lose these vital social supports. Similarly, China has indicated that it wants to move toward a commercially managed social security programme.

<sup>5</sup> Contrast what follows with Gerald Segal's unsubstantiated assertion that reform has died in China in "Does China Matter?" *Foreign Affairs*, September-October 1999. Similar assertions are common in the US press. The Segal article is fascinating, since nearly every major assertion, such as that China is in recession or that reform has died or that China is a very minor trade power, is either factually incorrect or based on careful selection of statistics that distort reality beyond recognition. An article with such evident flaws could not achieve publication in the world's most prestigious magazine of foreign policy on any subject other than China. That it was published and became quite influential shows the degree to which ideological cant has distorted perceptions in the US-China relationship.



### *Housing liberalisation*

China plans to accelerate the liberalisation of the housing industry. It has studied Singapore's experience, where housing reform was crucial to sustaining a high growth rate for decades; in addition to the direct effect of a buoyant housing industry, there are collateral benefits for industries such as furniture and furnishings.

### *Interest-rate liberalisation*

A forthcoming gradual liberalisation of interest rates will facilitate housing reform, because it should make possible securitisation of mortgages. In addition, interest-rate liberalisation would make it possible for Chinese banks to expand their lending outside the big state enterprises; currently, with fixed interest rates, banks cannot exact a risk premium for lending to companies not covered by some implicit government guarantee and therefore are unwilling to lend to the most dynamic firms.

In a related development, Beijing is pushing the expansion of consumer loans. For instance, Bank of China doubled its consumer loans in 1999.

### *Financial services liberalisation*

Beijing is accelerating the opening of financial services ahead of the World Trade Organization (WTO) deadlines because it needs the skills of foreign financial institutions. The key example of this is that Chinese banks lack the credit skills to judge the risks in lending to smaller companies and private companies, which as a result are deprived of funds. But these deprived companies are precisely the ones that can create jobs rapidly and offset the SOE layoffs. So China is allowing foreign banks to do more renminbi business, accelerating the access of foreign insurance companies to the Chinese market, and allowing foreign direct investors to borrow renminbi in China against collateral held offshore.

Beijing has announced that it will allow some open bidding for supply of electric power, a step that Hong Kong has yet to take.

### *Expansion of securities markets*

Another major cluster of reforms will expand China's reliance on securities markets. Premier Zhu Rongji has indicated that he believes much of the US success in hi-tech development results from its flexible stock markets, which he intends to duplicate. Hence China is allowing more listing and trading of SOE shares, allowing companies to participate in secondary trading after a period of restrictions to clean up abuses, and allowing the market to set IPO prices rather than have regulators impose them. Securities markets are now permitted to raise money in the interbank market, and key securities firms have been allowed to vastly increase their capital. China will soon introduce forex forward markets and stock futures markets, and it will set up separate hi-tech stock boards on the model of the US Nasdaq. In February 2000, a major shakeup of the leadership of China's financial industry pivoted on Beijing's desire to put its most forward-looking management in charge of regulating the securities industry.

### *Higher status for private enterprise*

Perhaps the most important cluster of liberalising reforms seeks to enhance the role of private enterprise. China has revised its constitution to give private enterprise equal legal standing. It has directed banks to allocate at least a certain quota of loans to private enterprises and SMEs, and it has announced a forthcoming ban on discriminatory tax, land use, or trade treatment that hitherto has hindered private enterprise. The city of Beijing recently announced that it will fund no new state enterprises.

Beijing is successfully fostering Silicon Valley-type hi-tech takeoffs in Beijing and Shenzhen, both of which benefit from enthusiastic collaboration with Hong Kong entrepreneurs. In a suburb of Beijing, Chinese students from abroad are being offered free facilities for hi-tech startups, and the initiative appears headed for major success.

### *Closure of ITICs*

In a further financial reform, China announced in February that about half of its international trust and investment companies (ITICs) would be closed. These institutions are no longer needed to intermediate between foreign and Chinese companies, and have become prone to speculation as well as providing channels for local governments to bypass budget constraints.

Beijing has also announced further civilian controls on the military, proposals to relax the regulation of lawyers, and a 30% expansion of tertiary education combined with a major pay rise for teachers.

### WTO reforms

All these are in addition to the reforms that will flow from China's planned membership in the WTO. The drive to move forward into the WTO is itself a central symbol of China's continued reformist drive. While foreign negotiators have seen China as resisting foreign demands for liberalisation, as indeed it has in many cases, Beijing's reformist leadership sees the WTO as a useful lever for further reform. WTO membership will mean elimination of many restrictions of foreign direct investment, including geographic constraints and requirements that a certain proportion of production be exported. It will mean greater competition in such industries as agriculture, telecoms, chemicals, and pharmaceuticals. It will force consolidation of some industries, most notably automobiles. It will inject foreign banking skills and create massive competition for China's banks. It will create a more integrated domestic market, gradually overcoming the current fragmented market where provinces protect their companies against competition from other provinces in the manner of pre-revolutionary France. The hallmark of this process will be the more rapid emergence of national retail distribution, with all the implied economies of scale and efficiencies of competition.

### Risks are real but seem manageable

Thus China seems to be powering into both economic recovery and accelerated reform. Are there risks to this virtuous circle? Of course there are. We do not fully understand the dynamics of power in Beijing, and we do not know much of what transpires politically in the provinces. China sometimes surprises us. A major economic debacle in the US, perhaps triggered by a stock-market collapse, or a major conflict with the US, perhaps because of clashes over Taiwan, could worsen economic prospects or produce a changed leadership constellation. But the acceleration of reform at a time when other economies are tiring of reform, and the acceleration of reform even when Premier Zhu Rongji was under fire in mid-1999, testify eloquently to the momentum of reform and recovery in China as the year 2000 opens.

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