

# WIIW CHINA REPORT

## ACTIVE FISCAL POLICY AND RISING EXTERNAL DEMAND MAY HALT DECLINE IN GROWTH

# 1

2000

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*In 1999, the Chinese economy grew by 7.1%. Although high by international standards, this was the lowest growth rate since 1990 and the decline since the decade's peak of 14.2% in 1992 has continued. Behind this was sluggish domestic demand, in particular investment, while exports began to recover in the second half of the year and supported growth. For the year 2000, a slightly higher growth rate of 7.3% is expected, reversing the declining trend.*

### Key developments in 1999

In 1999, in all three main sectors of the economy, the growth rate of value added was less than the year before. It reached 8.5% in industry, 2.8% in agriculture and 6.9% in the service sector.

On the demand side, *investment* was much weaker than consumption. Total investment in fixed assets rose 5.2% only, after 13.9% in 1998 (both in nominal terms). This was mainly due to a smaller increase in public investment (including state-owned enterprises and urban collectives). The latter make up 70% of the total and increased by 7.8% compared to 19.5% in 1999. Private investment stagnated, similar to the year before. *Consumer* demand, in nominal terms, rose faster than investment, by about 7%, but similar to consumption in 1998. However, taking the decline of prices into account, *real* consumption rose 10.1%, somewhat faster than in 1998. 1999 retail prices declined by 2.9%, while consumer prices slid by 1.4%, more than the year before.

The foreign sector developed better than expected: Both exports and foreign direct investment began to surge in the second half of the year, when the Asian financial and economic crisis, which had held the region in its grip for two years, started to bottom out. In 1999, Chinese *exports* increased by 6.1%, (compared to only 0.5% in 1998). Although *imports* rose even faster (18.2%), due to their much lower level a massive trade surplus of USD 29.1 bn was reached. We therefore expect the current account to be highly positive as well, probably USD 20 bn. Yet no official figures are given so far. *Foreign direct investment* amounted to USD 40.4 bn in 1999. This was somewhat less than the year before, when USD 45.5 bn were reached, but it is higher than expected given the bleak outlook at the beginning of the year, based on the more pessimistic forecasts for the Asian region as a whole and the massive decline of contracted investment.

Despite repeated speculations about a devaluation of the yuan, the Chinese currency has remained stable at an average exchange rate of 8.28 for one US dollar.

### Outlook for 2000

There are several reasons why the decelerating growth should come to an end in China this year: High and increasing public investment, in particular in the underdeveloped but resource-rich western regions; the reduction of certain obstacles to private investment and various measures to

redistribute incomes and thus promote private consumption. If taken seriously these measures, together with an improvement in the world economy, in particular in Asia, should be sufficient for the Chinese economy to reach a somewhat faster growth in 2000 than the year before – notwithstanding the continuing *problems of transition*, such as the pending reform of state-owned enterprises, rising unemployment and social insecurity, growing income disparities etc.

Preliminary data for January 2000 point in the direction of moderately higher growth this year. Industrial value added increased 8.9% in January, significantly more than in the last months of 1999; industrial exports were up 19.9% over a year ago; deflation shows signs of bottoming out as retail prices declined by 2.1% and consumer prices fell 0.2% only. This decline was smaller than in any month of the last year.

### **Expansive fiscal policy**

For the year 2000, the Chinese government is going to intensify its expansive fiscal and monetary policy. It plans to issue another 'special government bond' of yuan 100 bn to stimulate the economy. A large part of this money shall be invested into the infrastructure in the less developed western regions. This comes on top of a special government bond from September last year (yuan 60 bn), part of which will become effective this year only. To support domestic *private investment*, it has been announced that concrete steps will be taken to eliminate the existing discrimination of private enterprises<sup>1</sup>, especially with regard to financing, e.g. the availability of bank loans. Also, private companies will be allowed to get listed at the stock exchanges in Shenzhen or Shanghai.<sup>2</sup>

### **More investment for central and western regions**

Because of the special features of the Chinese economic reform after 1979, the transition to a market economy and expanding foreign trade and investment were initially restricted to so-called 'Special Economic Zones' (SEZs). The first SEZs were deliberately established on the south-east

coast, to do business with and attract investors from neighbouring Hong Kong and Taiwan. The system was later extended to several other coastal areas ('Open Coastal Cities', 'Open Coastal Economic Areas') and in 1990 Pudong was set up in Shanghai to become a 'super' SEZ. Only after Deng Xiaoping's famous 'Journey to the South', in 1992, the decisive step was taken to introduce a '*Socialist Market Economy*' all over the country. This stepwise procedure, together with certain advantages from geographical and historical points of view, gave the eastern coastal provinces an early competitive edge, compared to the central and in particular to the western regions. Between 1979 and 1990, average annual growth of industrial production reached 12.7% in the *eastern coastal provinces* but only 9.1% in the *western provinces*. For the period 1991-95, the respective growth rates were 22.2% and 16.7%. (The *central and northern provinces*, including a few northern coastal provinces as well, showed medium growth rates; see Table 1.) This development led to a dramatic widening of regional disparities. In 1996, GDP per capita in the coastal provinces was 40% higher than the national average and per capita income in the poorest provinces reached only one tenth of the richest. Thus, regional problems became of major political concern and in the Ninth Five-Year Plan (1996-2000) an acceleration of economic development in the central and western provinces was given high priority.<sup>3</sup> As indicated by Table 1, this had some immediate positive effects on the growth of the central and northern provinces, but the western regions lagged further behind. Only in 1998, growth in the western regions was faster than in the rest of China, but at a generally much lower level, because of the overall slowdown of the economy. At the same time, an ambitious programme to turn around loss-making SOEs within the next three years, was launched by Premier Zhu Rongji, which will affect different provinces (regions) to a different degree: In China, there has so far been no 'privatization' of SOEs as in the Central and East European countries, and the relative share of the state-owned sector in the individual provinces depended largely on the

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<sup>1</sup> *China Economic Review*, February 2000, Vol. 10, No. 1, p. 3.

<sup>2</sup> At the moment, there are about 1000 Chinese companies listed at the stock exchanges in Shenzhen and Shanghai; however, none of them are private domestic enterprises.

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<sup>3</sup> W. Urban, 'Regional disparities and industrial structure in China', *WIIW China Report*, No. 3, 1998. There is also a more detailed study on this subject available at WIIW (W. Urban, 'Regional disparities and industrial structure in China', project supported by the Jubiläumsfonds of the OeNB, No. 6627, mimeo).

Table 1

**Growth of industrial production<sup>1)</sup> in different provinces of China, 1953-98**

	Average annual growth rates, in %				
	1953-78	1979-90	1991-95	1996-97	1998
<b>National total</b>	<b>11.4</b>	<b>12.0</b>	<b>22.2</b>	<b>11.3</b>	<b>4.7</b>
Coastal regions	11.2	12.7	22.9	11.4	3.8
Central and northern regions.	11.7	11.0	19.3	14.6	2.3
Western regions	12.0	9.1	16.7	6.9	5.3
<i>Standard deviation</i> <sup>2)</sup>	8.8	12.2	36.0	39.3	54.6

Notes: 1) At current prices. – 2) Average squared deviation from national total.

Sources: W. Urban, *WIIW China Report*, No. 3/1998, Table 1; China Statistical Yearbook 1998 and 1999, Table 13-5.

degree by which this sector was 'grown out' by collective and private enterprises. Thus, at the beginning of the SOE reform, the less dynamic inland provinces showed much higher SOE shares. Given these circumstances, the Chinese government has decided to speed up *infrastructure investment*, such as transport, energy supply and education, in the western provinces this year. This will immediately raise incomes and alleviate unemployment. In the longer run, these measures should improve the basis for private (and collective) economic activity there. As illustrated by the example of the coastal provinces, foreign direct investment plays a crucial role in private sector development. Therefore, the government has also increased efforts to attract foreign direct investment to these regions, by preferential policies (e.g. special tax rebates).<sup>4</sup> Also, foreign companies will be allowed to prospect for minerals. The new regulations should in particular favour investment in the resource-rich western regions. Only recently a new natural gas deposit has been discovered in the Tarim basin in the province of Xinjiang, supporting plans to build a new gas pipeline to connect the major gas producers in the west with the major gas consumers in the east.

than the coastal regions and will therefore have to pay a higher price in the form of labour shedding and probably de-industrialization during the reform.

#### **Redistribution of incomes to stimulate consumption**

Private consumption as measured by retail trade turnover accelerated significantly in the last quarter of 1999. Most probably, this was due to the generous increase in lower and middle-range salaries of government employees, of pensions and of unemployment benefits on the occasion of the 50th anniversary of the People's Republic of China in October 1999. Most probably, the introduction of a 20% tax on interest earnings from bank deposits in November has raised private expenditures, too: Household savings rose by 11.6% in 1999 only, after 17% in the year before. As low-income earners usually have a higher propensity to consume, from a more general point of view, redistribution of incomes would be an effective means to prop consumption in China: The transition to a market economy has led to a great widening of income disparities, not only between the inland and the coastal regions, but also between the rural and the urban population<sup>5</sup>, and between employees of the public and the private sector. The biggest losers of transition are those who have lost their jobs. Often, high incomes on the one hand and the loss of jobs on the other, are the consequence of various forms of corruption. Thus, government measures to fight corruption, to

<sup>4</sup> Currently, the Ministry of Foreign Trade and Economic Co-operation is drafting a directory for foreign investment in the central and western areas and the State Taxation Administration is working out new tax incentives for overseas funded firms (*China Daily, Business Weekly*, 5-11 December 1999). In 1998, 87% of FDI went to the coastal areas and only 3% to the western provinces.

<sup>5</sup> In 1999, per capita income was yuan 5870.5 (USD 709) in the urban areas and yuan 2202.5 (USD 266) in the countryside.

enforce tax laws<sup>6</sup>, and the establishment of a comprehensive social security system will also help to alleviate the current problem of under-consumption and thus deflation. For the near future, further significant increases of civil servants' salaries and probably the introduction of an inheritance tax are planned. For the year 2000, an amount of yuan 70 bn (USD 8.5 bn) has been earmarked for the increase of civil servants' salaries and the establishment of a social security system.<sup>7</sup> Another re-distributive measure to be mentioned are subsidies to low income earners for buying or renting of houses/flats under the new housing system, where accommodation will no longer be provided by the employer.

### Deflation bottoming out

Prices have been declining for about two years in China now, but there are signs of deflation bottoming out in the year 2000. Apart from increasing domestic and external demand, rising prices for rents and petrol and probably other raw materials as well will support this development.

### Housing reform stimulates real estate business

Although the real estate sector is still down, the above-mentioned housing reform shows already some effects: Sales of private housing rose by 16%, although from a very low level. With regard to office buildings and luxury apartments there is still a large oversupply. However, it is expected that China's accession to the World Trade Organization (WTO) will significantly push up demand in this market segment.

### China's WTO accession not yet settled

After the breakthrough agreement between the Chinese and the US government about the terms for China's WTO accession in November 1999, two major issues remained open: the US Congress' consent to grant China 'permanent normal trading relations' (PNTR) and the agreement between the European Union and China on the terms of its WTO accession.

Although EU negotiators declared that 80% of their demands were already settled by the China/US agreement, solving the remaining questions turned out more difficult than expected. After two bilateral meetings, no agreement was reached and no further talks have been scheduled so far. The biggest problem left in the negotiations seems to be the degree of opening up the telecommunication sector to investors from the EU. In China, telecommunication has not only an enormous economic potential, but is politically a very sensitive issue as well. Therefore, it will be very difficult for the EU negotiators to reach an agreement which goes beyond the bilateral agreement with the US in this field, except perhaps in certain sub-sectors.<sup>8</sup>

With regard to the other problem, the granting of PNTR by the US Congress, one should assume that there had already been reached a certain accord between the government and the Congress on that matter before concluding the WTO agreement in November 1999. However, the recent developments in the Taiwan question and the dragging negotiations between the EU and China were not anticipated then. Originally it was planned to submit PNTR for approval in Congress only *after* a bilateral agreement EU/China had been reached. But with the presidential elections approaching, the Clinton administration was put under pressure to ask Congress for a decision before an EU agreement with China has been concluded. On 8 March President Clinton has submitted legislation to Congress that would grant China PNTR status. A vote can be expected by the end of May.

### Is there a 'new' Taiwan policy?

The Chinese Taiwan policy still adheres to the 'One-China Principle' and 'peaceful reunification' under the formula of 'one country – two systems'. What is *new* is a more *aggressive wording*, the call for a *timetable* and the *speeding-up* of the process of reunification.

The Taiwan issue has always been at the core of the US-China relations, therefore any change in the China-Taiwan relations will affect the China-US

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<sup>6</sup> In 1999, government revenues rose by 15.2%, much faster than GDP, which can partly be attributed to the successes of the anti-smuggling campaign (*China Daily*, 7 March 2000).

<sup>7</sup> Annual gathering of the National People's Congress (NPC), 5-15 March 2000 (*Neue Zürcher Zeitung*, 7 March 2000).

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<sup>8</sup> Already in April last year, the leaking of information that Premier Zhu Rongji had granted US companies the right to own a share of 51% in Chinese telecom companies had caused him great trouble at home. As a consequence, in the US-China agreement of November 1999, a very differentiated approach regarding the different sub-sectors in this branch was taken.

relations as well; there have always been ups and downs in this respect. The current problems started last year with considerations of the US to include Taiwan in their planned 'Theatre Missile Defence System (TMD). In summer, Taiwanese leader Lee Teng-hui stated 'that talks between the PR China and Taiwan on unification were a *state-to-state* affair', thus questioning the One-China Principle. This caused the opening of a grandiose media campaign against him and his followers by the Chinese government, which has to be seen as an attempt to prevent the Taiwanese from voting for candidates supporting an independent Taiwan in the coming presidential elections.<sup>9</sup> In December, the Portuguese enclave of Macao returned to China, leaving Taiwan as the last candidate for 'reunification'. Finally, in February this year, the so-called 'Taiwan Security Enhancement Act' was passed by the US Congress, which is to let the US sell advanced weapons to Taiwan and expand direct military communication between the two, so far restricted by several Sino-US 'joint communiqués' and other commitments.<sup>10</sup> But there are some indirect causes as well, in particular the ongoing democratization process in Taiwan – a thorn in the side of the communist regime in China – and attempts on the part of the Chinese government to divert from pending economic problems while demonstrating power towards the outside world and calling on the national sentiments of the Chinese people. Also, the Nato strike against Yugoslavia might have played a certain role, as it can be seen as a practical example of armed interference across the borders of a sovereign state, without UN consent. Something similar could be applied to defending Taiwan, although it is an acknowledged part of the Chinese territory.

In February this year, to clarify its tough position in the Taiwan question, the Chinese government published a White Paper entitled 'The One-China Principle and the Taiwan Issue'.<sup>11</sup> There, and in the media campaign accompanying it, the demand for

some *timetable* for the unification with Taiwan and the pressure for *more speed* is clearly stated ('the issue should not be postponed indefinitely'). This urgency is explained on the grounds that now, after Macao has returned, the unification with Taiwan has to be tackled more seriously. However, it might also be related to the ambitions of President Jiang Zemin to fulfil the historical task of the *total reunification* of China under his rule.

There are thus various aspects of the 'new' Taiwan policy in China: to influence Taiwanese voters, to divert from internal problems, to speed up the unification process, perhaps for personal reasons, and to show muscles to the US.

### Overall prospects

Supported by an active fiscal policy, investment will grow faster, probably by around 10%, in the year 2000. Exports, too, will rise faster because of an improving world economy. Imports might develop at similar speed as the year before as the effects of the anti-smuggling campaign are levelling out and WTO membership is not effective yet. Thus an even higher trade- and current account surplus than in 1999, at about USD 35 bn and 25 bn respectively, could be reached. Foreign direct investment might rise again, due to the better economic situation in Asia, preferential treatment for FDI in western regions and rising investment in the services sector anticipating China's WTO accession. The exchange rate will remain stable. As a consequence of higher demand, industrial production will expand faster. However, with the three-year period targeted for the turnaround of loss-making state-owned enterprises running out at the end this year, unemployment will remain high<sup>12</sup> and will increase further in certain regions and/or branches, and private consumption will stay more or less at the same level as the year before. We therefore expect the growth rate of GDP to be only slightly higher than last year, probably reaching 7.3%.

<sup>9</sup> With the same purpose, military manoeuvres were held in the Taiwan street when the first free presidential elections took place in Taiwan in 1996.

<sup>10</sup> However, as the Clinton administration will veto the bill, the US Senate's approval is still needed for the act to be put in force.

<sup>11</sup> Full text printed in *China Daily*, 22 February 2000, pp. 4 and 5.

<sup>12</sup> Officially, registered unemployment in the cities is given at 3.1%. But independent estimates, e.g. by the UN, reach between 7.9% and 8.3% (*Neue Zürcher Zeitung*, 12 January 2000). However, if rural migrant workers and underemployment in rural areas is included, the rate is certainly much higher (see *China Report*, No. 3, 1999).

In the medium run, the reform of the state-owned enterprises and the restructuring of industry will still be going on and dampen overall growth to a certain extent. On the other hand, WTO accession, if finally taking place, will accelerate growth, although at a slow pace. We therefore believe the downward trend in growth rates since 1992 to be over, but do not expect a significant upturn to occur in the foreseeable future. In the political field, the Taiwan question will stay prominent and thus relations with the US might be more tense than in the past.

Table 1

## China: Selected Economic Indicators

	1990	1995	1996	1997	1998	1999 forecast	1999 <sup>1)</sup> actual	2000 forecast
Population, mn pers., end of period	1143.3	1211.2	1223.9	1236.3	1248.1	.	1260.6	.
Gross domestic product, CNY bn, nom.	1854.8	5847.8	6788.5	7446.2	7939.6	.	8205.4	.
annual change in % (real)	3.8	10.5	9.6	8.8	7.8	7.0	7.1	7.3
GDP/capita (USD at exchange rate)	339.1	578.2	667.5	729.6	769.8	.	797.0	.
GDP/capita (USD at PPP - WIIW)	1307.8	2638.2	2904.1	3183.4	3445.4	.	3686.7	.
Industrial value added								
annual change in % (real)	3.2	13.9	12.1	10.5	9.2	9.0	8.5	10.0
Agricultural value added								
annual change in % (real)	7.3	5.0	5.1	3.5	3.5	.	2.8	.
Services value added								
annual change in % (real)	2.3	8.4	7.9	9.1	7.6	.	6.9	.
Goods transport, bn t-km	2620.7	3573.0	3645.4	3821.2	3770.6	.	.	.
Total investment in fixed assets, CNY bn <sup>2)</sup>	451.7	2001.9	2291.4	2494.1	2840.6	.	2988.0	.
annual change in % (nominal)	2.4	17.5	14.8	8.9	13.9	7.8	5.2	10.0
Construction output, CNY bn	194.8	950.5	1157.9	1246.3	1374.1	.	.	.
annual change in % (nominal)	-10.2	23.6	21.8	7.6	10.3	.	.	.
Employment total, mn pers., end of period	567.4	679.5	688.5	696.0	699.6	.	.	.
annual change in %	2.6	1.1	1.3	1.1	0.5	.	.	.
Unemployed (urban) reg., th, end of period	3832	5196	5530	5700	5710.0	.	.	.
Unemployment rate (urban) in %, end of per. <sup>3)</sup>	2.5	2.9	3.0	3.1	3.1	.	3.1	.
Average gross annual wages, CNY <sup>4)</sup>	2140	5500	6210	6470	7479	.	.	.
annual change in % (real) <sup>5)</sup>	9.2	3.8	3.8	1.1	7.2	.	.	.
Retail trade turnover, CNY bn	725.0	2062.0	2477.4	2729.9	2915.3	3113.7	3114.0	.
annual change in % (real)	0.4	12.0	13.0	9.4	9.4	9.1	10.1	10.0
Retail prices, % p.a.	2.1	14.8	6.1	0.8	-2.6	-2.3	-2.9	-0.5
Consumer prices, % p.a.	3.1	17.1	8.3	2.8	-0.8	-0.5	-1.3	-0.3
General government budget, CNY bn								
Revenues	293.7	624.2	740.8	865.1	987.6	.	1137.7	.
Expenditures	308.4	682.4	793.8	923.3	1079.8	.	1317.4	.
Deficit (-) / surplus (+)	-14.6	-58.2	-53.0	-58.2	-92.2	.	-179.7	-229.9
Money supply, CNY bn, end of period								
M0, Currency outside banks	264.1	788.5	880.2	1017.8	1120.4	.	1345.6	.
M2, Money + quasi money	1468.2	5823.0	7609.5	9099.5	10499.9	.	11900.0	.
Refinancing rate of NB % p.a., end of period	7.9	10.4	9.0	8.6	4.6	.	3.2	.
Current account, USD bn	12.0	1.6	7.2	29.7	29.3	20.0	.	25.0
Official forex reserves excl. gold, USD bn	11.1	73.6	105.0	139.9	145.0	155.0	154.7	.
Gross debt, USD bn	52.5	106.6	116.3	140.0	146.0	.	.	.
Foreign direct investment, USD bn	3.5	37.5	41.7	45.3	45.5	37.0	40.4	42.0
Exports total, USD bn	62.1	148.8	151.1	182.8	183.8	192.0	194.9	.
annual change in %	18.2	22.9	1.5	20.9	0.5	4.1	6.1	.
Imports total, USD bn	53.4	132.1	138.8	142.4	140.2	162.0	165.8	.
annual change in %	-9.8	14.2	5.1	2.5	-1.5	15.0	18.2	.
Trade Balance, USD bn	8.7	16.7	12.2	40.4	43.6	30.0	29.1	35.0
Average exchange rate CNY/USD	4.78	8.35	8.31	8.29	8.28	8.28	8.28	8.25
PPP (CNY/USD), WIIW	1.24	1.83	1.91	1.90	1.85	.	1.79	.

Note: CNY: ISO-Code for the Chinese yuan.

1) Preliminary. - 2) 1990 excl. projects with a value of 20,000-50,000 yuan which are not listed in the state plan. Quarterly data excl. investments by rural collectives and urban and rural individuals. - 3) Ratio of registered urban unemployed in per cent of urban employed and unemployed. - 4) Average gross annual wages of staff and workers, defined as: total wages of staff and workers per average number of staff and workers; 1998: including only fully employed staff and workers. - 5) Staff and workers cost of living index is used as deflator for calculating real wage.

Sources: China Statistical Yearbook; International Financial Statistics; Economic Statistics Communiqué for 1995 of the State Statistical Bureau of the PR China; China Financial Outlook of the People's Bank of China; China Monthly Statistics; China Daily.