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Reforming China's enterprises

The basic objectives of this article are to describe the problems of the enterprise sectors (state-owned enterprises and non-state enterprises); the main reforms being undertaken to solve the problems; the progress being made; and the issues that remain to be addressed. In addition to the individual areas of reform, the study also attempts to evaluate the overall progress being made toward its ultimate goals of securing enterprises' ability to compete over the longer term and to support economic growth in line with China's potential. The analysis takes as given the goals and constraints that together make China's reform process somewhat distinctive. At the same time, it seeks to apply insights derived from the experiences of OECD and other economies about the fundamental economic processes involved in systemic economic changes that are relevant to China as well.

* * *

China's economy back on track

In the first half of this year, the Chinese economy grew by 8.2%, significantly faster than in 1999. The acceleration of growth was based on both, domestic as well as external forces. Exports rose particularly fast, but investment and private consumption, too, were brisker than last year. Although a deceleration of growth is likely during the second half of the year, the growth rate of GDP over the year 2000 as a whole will be higher than originally expected, and should reach about 7.6%.

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REFORMING CHINA'S ENTERPRISES

BY CHARLES PIGOTT[1]

Reforms of China's enterprises are central to the effort to complete the transformation to a market economy that has been underway since 1978. Enterprise reforms are now at a critical juncture. Financial problems of China's businesses have reached the point where they have become a drag on real growth and could pose serious risks to China's longer-term economic performance if they are not alleviated. Enterprise reforms have become all the more urgent given the increased competitive challenges China's businesses will face with entry into the World Trade Organization.

This article summarizes the conclusions of a recent OECD study: '*Reforming China's Enterprises'.* This study is a comprehensive examination of a wide range of policies shaping the development of China's enterprise sectors including state owned enterprises (SOE) and non-state enterprises.[2]

The structure of the enterprise reforms

As in other transition economies, enterprise reforms in China encompass a broad range of individual policies that are aimed at three basic objectives (Figure 1). The first is to improve *enterprise economic performances* so that enterprises are capable of competing profitably in domestic and international markets. These reforms involve economic restructuring to alleviate the current financial problems of enterprise and to improve their efficiency over the longer term. They also involve reorganization of the SOE sector to concentrate state ownership in those sectors where continued government control and intervention are seen as necessary to the longer-term development needs of the economy or other social objectives. Measures to improve economic performances have become a central priority of enterprise reform as the economic performances of China's businesses have deteriorated.

The second objective is to improve *enterprise behaviour* so that enterprises respond appropriately to market forces and are managed in the interests of their owners. Many of the present problems of enterprises stem from weaknesses in internal decision making mechanisms and distortions in the external environment that need to be corrected if the problems are to be avoided in the future. Improvement in enterprise behaviour encompasses corporate governance reforms, particularly for state owned enterprises, and measures to strengthen external market incentives and disciplines. Efforts in the latter area are focused on strengthening financial discipline but also involve measures to reduce the presently large disparities in access to external credit among various types of non-state and state enterprises.

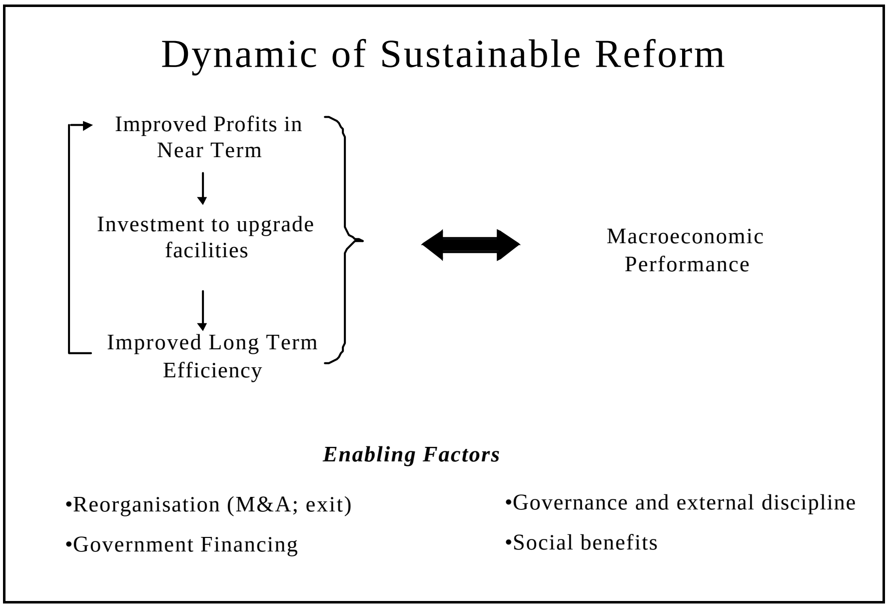
The third objective of enterprises reform is to establish and strengthen *supporting institutions and infrastructure* needed to allow enterprises to focus on their commercial objectives, facilitate adjustments entailed by the reform process itself, and provide for the longer-term social needs of the population. Particularly important in this regard are reforms to social benefit programs, which are needed to deal with the workers displaced by reforms; and in the longer-term, to reduce financial burdens on SOE, to broaden the coverage of the benefits, and to improve the functioning of labour markets. Changes in laws and regulations governing property rights and contracts, as well as tax and budget reforms (although not discussed in detail), are also important components of these reforms.

As with the broader economic reform effort, enterprise reform in China is a complex dynamic process whose individual policies are highly interdependent. A recurring theme of reforms in China, as well as those in transition countries of Eastern Europe (TCEE), is that otherwise sound reforms in particular areas often do not yield the expected economic benefits because other key conditions essential to their functioning were not put in place. The need to avoid undermining the social consensus permitting reform and the low level of government financial resources in China compared to other developing countries further accentuates the interdependence of individual reforms. The key challenge to China's reformers is to sustain a 'virtuous circle' (Figure 2), whereby near-term gains in enterprise financial performances generate the funds necessary to achieve a lasting improvement in efficiency and competitiveness over the long term. Reforms to improve enterprise behaviour are crucial in this regard, since unless enterprises make sound business decisions and use their resources

Figure I: Schematic of the enterprise reform process

Major objectives	Primary focus	Key tasks
Improving performances (Ensuring enterprises are capable of competing in the market)		
Economic restructuring	SOE	Improve profitability by reducing excess capacity; shedding surplus labour, lowering debt loads; and upgrading prodctive capaci. Facilitate business reorganizations to reduce industry excess capacity and improve economies of scale and scope; release resources by promoting exit of unviable firms.
Reorganization of the SOE sector	SOE	Establish the 'strategic core' where SOE will be concentrated while facilitating the withdrawal of state ownership and control from other 'competitive' industries where state intervention is not needed.
Improving behaviour (Ensuring enterprises respond appropriately to market forces)		
Establish effective corporate governance mechanisms	SOE	Establish modern ownership forms ('corporatization'); clarify ownership and control rights; separate government from enterprise management; establish effective oversight mechanisms for enterprise owners .
Financial system reform	Financial system	Provide adequate financing outlets for non-state as well as state enterprise sectors; establish credit allocation on commercial standards and exert financial discipline; provide mechanisms to transfer ownership and provide a market for corporate control.
Supporting institutions and infrastructure (Ensuring compatibility between commercial objectives and social needs)		
Social Security reform	Workers	Reduce SOE burdens for social security; establish 'portable' pension and other benefit systems to improve the functioning of labour markets.
Legal and regulatory reforms	Enterprises	Clarify property rights; strengthen enforcement of contractual obligations
Fiscal reforms	Enterprises and society	Reduce tax disparities among enterprises; increase and broaden revenue resources needed to facilitate adjustments caused by reforms and to socialize certain burdens now borne by enterprises.

Figure 2



effectively, the initial gains from reforms to bolster economic performances will be dissipated. Reforms and aggregate growth in the economy also need to be mutually reinforcing if the virtuous circle is to be sustained. Adequate real growth is needed to facilitate the absorption of displaced workers and other adjustments entailed by reforms; but adequate real growth will be difficult to maintain unless reforms can alleviate the structural problems now impairing enterprise performances.

The current problems of enterprises and their major causes

There has been a steady deterioration in enterprise financial performances since the 1980s (Figure 3), to the point that they have become a drag on aggregate economic growth. While the large numbers of loss-making SOE have received the most attention, the problems are if anything more pervasive and serious. This conclusion is supported by aggregate data, as well as an OECD analysis of a panel data set of nearly 20,000 industrial enterprises compiled by the China National Bureau of Statistics of all ownership types. By 1999, the majority of SOE and large portion of collective enterprises were either incurring losses or were only marginally profitable. Average debt loads of these enterprises are quite high compared to most OECD countries and debt servicing is a major drain on cash flow for a large portion. Financial problems are also extensive in private firms. Performances of foreign invested enterprises are bifurcated, with nearly half experiencing fairly healthy returns while the majority of the remainder are incurring low or negative profits.

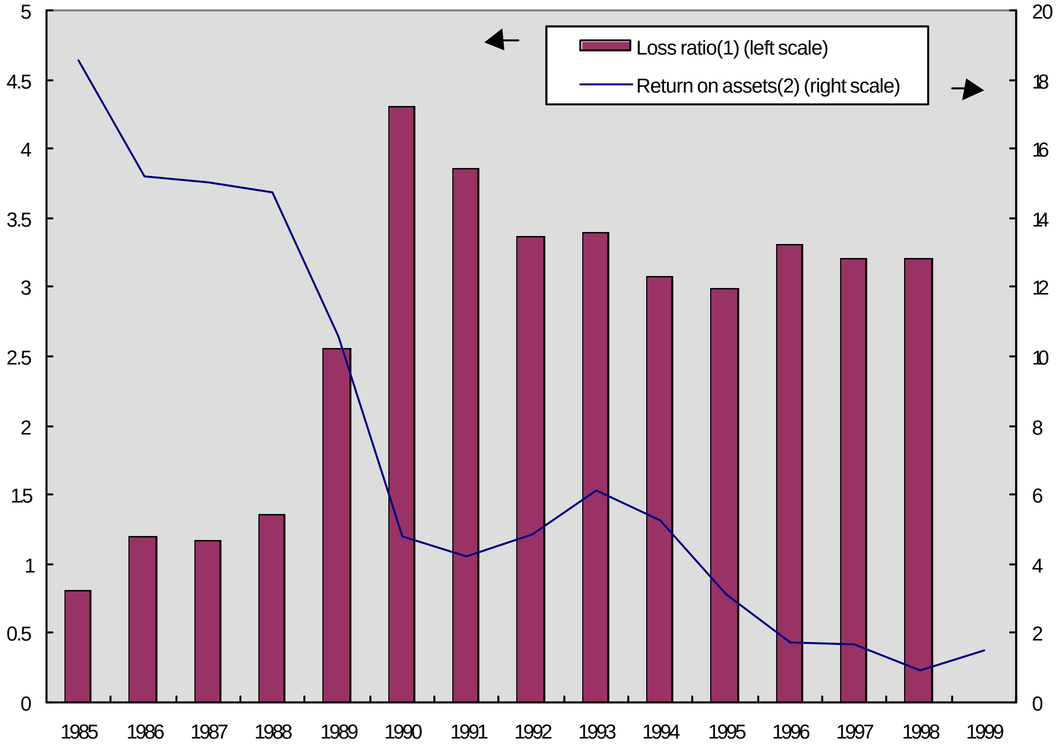
The extensive analysis in the literature of the factors behind the deterioration in enterprise performances has clarified many issues but significant controversies remain. Much of the secular decline in profitability since the early 1980s can be attributed to growing competition among state and non-state enterprises, which progressively eroded monopoly rents. However this competition does not adequately explain why profit rates have continued to decline, or why present returns are so low. Existing evidence suggests that a variety of factors have contributed to these conditions and are of two basic types.

The first are various *overhead* burdens that stem in part from past policies or macroeconomic excesses. These include policy burdens imposed on SOE in the form of excess labour, social benefit costs that in other countries would be borne at least partially by workers or the government, and disproportionately high taxation of SOE. Policy burdens account for much of the difference in measured performances of state versus non-state

Figure 3

Losses and profits of SOE

In percentage



enterprises. For example, SOE before tax profits rates are much closer to those of non-state enterprises than they are on an after tax basis (see Table 1). This tax handicap is accentuated for the most profitable and productive SOE, which pay the bulk of the sector's taxes. A second set of overhead burdens is the excess capacity and inventories arising from the early 1990s excess investment boom. These conditions have depressed output prices and production throughout industry, and seem to have been a major factor behind the decline in profit rates in recent years.

The second source of the low profitability of much of Chinese industry is *chronic operating inefficiencies* arising from inefficient productive facilities, the use of outdated technology, poor organization of operations, and low product quality. Enterprises with these problems would have difficulty earning a competitive return even if their overhead burdens were substantially reduced. Chronic operating inefficiencies are clearly widespread but their full extent is difficult to determine and sometimes is exaggerated, particularly for SOE. Overhead burdens mean that many SOE are effectively operating in the interior of their production possibility frontier and for this reason standard measures can seriously understate their potential productivity. Furthermore, despite overhead burdens, a substantial portion of SOE is profitable and competitive. Moreover, overhead burdens and fundamental operating efficiency are closely related: overhead burdens limit enterprises' capacity to make the necessary investments to upgrade technology and quality and to innovate.

An important conclusion that emerges from the analysis is the critical importance of non-state enterprises to the future performance of the overall economy. SOE still account for nearly half of urban employment, more than half of capital spending by industry, and nearly three quarters of bank loans. However, these figures are out of proportion to the contribution which SOE now make to the overall economy. Non-state enterprises have been the most rapidly growing components of the business

Table 1

Alternative indicators of industry profitability

Per cent of gross output

	SOE			Non-state enterprises		
	Sales less cost of sales	Pre-tax profits	After-tax profits	Sales less cost of sales	Pre-tax profits	After-tax profits
1993	26.9	12.9	4.3	20.0	9.7	5.2
1998	19.3	8.6	1.6	14.3	8.3	2.7

Source: China Statistical Yearbook, various issues.

sector for most of the reform period and now account for nearly 70 per cent of total industrial output. Non-state enterprises have been the dominant contributors to growth in real GDP and employment over the past ten years (Figure 4). As noted further below, distinctions between non-state and state enterprises are becoming increasingly blurred and the importance of the non-state sector will continue to increase as the state divests a large portion of its SOE. These trends, together with the serious structural problems that they are now experiencing, underscore that the future performance of non-state enterprises is crucial to the ultimate success of enterprise reforms. Indeed, a major task of enterprise reforms is to achieve a better alignment between the financial and other resources allocated to SOE versus non-state enterprises and their overall importance in the economy.

Improving financial performances

Significant progress has been made toward reducing enterprise overhead burdens, particularly of larger SOE, over the past several years. Although the exact numbers are not fully clear, official figures suggest that the number of surplus workers of SOE had been reduced by at least one-half by the end of 1999. Labour shedding has been accompanied by substantial reductions in excess or obsolete production facilities, especially in textiles, coal, steel, and other industries where excess capacity has been especially severe. If the pace of these efforts is maintained, surplus labour and excess capacity could be largely eliminated within the next several years. Substantial progress is also being made in reducing debt loads, particularly of larger SOE, under the debt-equity swap programmes of the four bank asset management companies that were created in 1999.

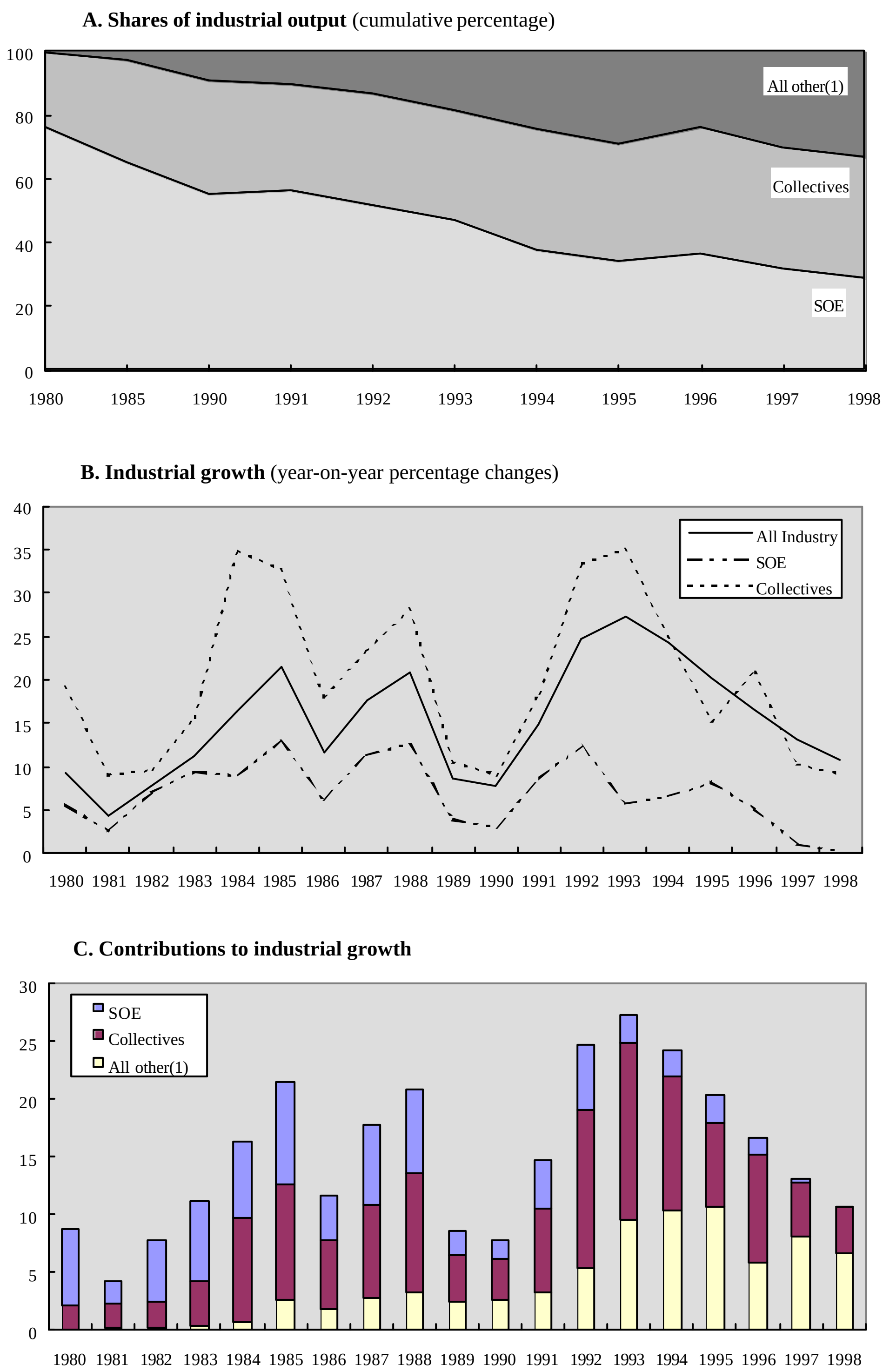
The ultimate contours of the SOE sector have also become clearer as a result of the considerable progress that has been made in its reorganization. Although complete figures are not available, the majority of smaller SOE, and including most of those in coastal provinces, have been divested into various alternative forms. Plans are also being made to divest medium sized SOE, although the process of divestiture will take a number of years. While authorities remain committed to retain state control in key industries, they are also committed to substantially reducing the size of the SOE sector in coming years. For example, the number of industrial SOE is expected to fall from nearly 75,000 in 1999 to at most a few thousand. The importance of the non-state sector, particularly the private sector, will continue to grow.

The progress in reducing overhead burdens should lead to significant improvement in enterprises' profitability over the next several years. A moderate recovery in reported enterprise profits has been underway since 1999. While much of this improvement can be traced to the revival in export growth and to the anti-smuggling campaign, it may also be a sign that reforms are beginning to have an impact on enterprise bottom lines. Recent data from the enterprise survey published by the People's Bank of China suggest that excess capacity has begun to decline and that the inventory overhang has begun to ease.

Current policies, however, are subject to important limitations that have restricted their benefits in the near-term and which if not addressed could severely impair their longer-term effectiveness. Government efforts and resources to bolster economic performances have been heavily concentrated on large loss-making SOE. This concentration is likely to reduce the benefits to the overall economy, particularly given economic

Figure 4

Industrial output



Note: Figures refer to gross industrial output of all industrial enterprises, with or without independent accounting system. – 1) Other firms include private and foreign-funded industrial enterprises.
Source: China Statistical Yearbook, Tables 13.3 and 13.4.

importance of non-state enterprises and their serious problems. Government restrictions often constrain mergers and acquisitions by SOE as well as other forms of restructuring essential to improve economies of scale and scope and break down the severe barriers to cross-regional competition and investment. Limits on government revenues have meant that SOE now bear much of the burden of supporting displaced workers, and hence have so far realized only limited financial benefits from the downsizing of their workforces.

It is also unclear how far the downsizing of the SOE sector will go and how profitable those businesses that remain under state control will be. The precise list of 'strategic' industries where the state intends to maintain substantial control has not been officially specified. Experiences of OECD and other countries suggest that SOE are rarely as efficient as private enterprises and that, unless confined to a quite narrow segment of industries where private ownership is clearly inadequate, they can become chronic burdens on public finances. Authorities have been reorganizing large SOE into large enterprise groups along lines reminiscent of the chaebol model of Korea as a means of ensuring that they compete with foreign multinationals in international markets. However, as past waves of merger and acquisition activity in OECD countries illustrate, large enterprise groupings do not automatically guarantee competitive success and have often had to be undone subsequent to their formation. Such combinations also pose management challenges that are likely to be particularly difficult in China, given the substantial constraints that remain on the autonomy of SOE. For these reasons, the efficacy of the strategy of forming large enterprise groups in China remains to be proved.

Improving enterprise behaviour: corporate governance

Experiences of OECD countries suggest that satisfactory corporate governance of state owned enterprises is very difficult to achieve under the best of circumstances[3]. The difficulties in China have been aggravated by the heavy involvement of government agencies in enterprise management, ambiguous assignment of property rights, and the lack of effective mechanisms to ensure that managers perform competently and act in the best interests of their ultimate owners[4]. The problems suffered by many SOE can be traced in part to poor management stemming from inadequacies in their governance.

The 1994 Company Law and subsequent reforms have made important progress toward establishing modern corporate governance structures for SOE. The reforms have been guided by experiences in other countries as well as the guidelines defined in the code of 'best practices' for corporate governance developed by the OECD[5]. In principle, government involvement in enterprise management has been curtailed. The exercise of ownership rights in SOE has been delegated to distinct agencies whose primary mandate is to preserve and increase the value of their state asset holdings. The establishment of boards of directors and supervisory boards provides mechanisms for monitoring management performance and establishing management accountability. Although still confined to a relatively narrow segment of firms, listing on the stock market has provided incentives for SOE to implement the Company Law and to improve the transparency of their operations.

Several limits have prevented these structures from functioning as effectively as expected, however. Government intervention in SOE operations has not been fully curtailed, in part because state holding companies continue to exercise government regulatory as well as ownership functions. Other weaknesses have undermined the accountability of managers to the board of directors, and of directors to the shareholders and supervisory board, that is fundamental to good corporate governance. These include the continued appointment by government and political officials of top SOE management in many cases, and the dominance of insiders on boards of directors and supervisory boards.

Strengthening financial discipline

Sustained improvement in enterprise performances also depends critically on the incentives, disciplines, and capabilities provided by the external environment. External discipline is particularly critical for state owned enterprises, given the tendency for corporate governance to be weaker than in privately owned businesses. In China and other countries, the SOE that have faced vigorous market competition are generally more efficient and better managed than SOE in protected sectors.

Until fairly recently, however, China's financial system lagged development in much of the rest of the economy and has become a major source of adverse incentives in the external environment shaping enterprise behaviour. The key problem has been the use of bank lending to support loss-making SOE or for other non-commercial purposes[6]. This 'policy lending' has led to soft budget constraints for much, although by no means all, of the SOE sector. Soft budget constraints effectively face such SOE with a zero (or negative) cost of capital and they were a major factor in the over-investment boom earlier in the 1990s as well as the accumulation of massive problem loans in the banking system. A second and related defect in the existing financial system is the much more limited access to credit faced by non-state enterprises. Both defects need to be addressed if the financial system is to carry out its essential role in providing market discipline of enterprise behaviour and in ensuring that credit is allocated to the outlets where it can be used most efficiently. Although development of capital markets and key non-bank financial institutions is ultimately very important to the accomplishment of these aims, in the medium term reforms to the banking system are most essential, given the dominant role it now plays in the financial system.

Important progress has been made over the past several years in establishing the conditions for stronger financial discipline, particularly that provided of commercial banks. Loan quality has improved significantly as a result of the tightening of commercial bank lending standards and controls spurred by the 1996 banking reform. The new loan classification standards now in an experimental stage along with development of more modern accounting systems should lead to further improvements over time. The formation of the four bank asset management companies in 1999 represents a key step toward dealing with bank non-performing loans and should help to further improve banks' incentives and capabilities to maintain sound lending standards. The stock market has developed rapidly since the early 1990s, although bond markets remain relatively underdeveloped.

However, these financial reforms are limited by gaps and constraints that have circumscribed their effectiveness and which if not addressed could erode the progress that has been made. The biggest problem is that the underlying causes that have led to lax lending standards and bank non-performing loans have not been adequately resolved. Policy considerations, such as the need to maintain adequate real growth or avoid socially disruptive closures of enterprises, continue to influence bank lending and interfere with the effort to firmly establish commercial principals as the basis for lending. As a result, financial discipline for non-state and smaller SOE has been tightened considerably, but it is much less clear that discipline for large SOE that are destined to remain under state control has improved. It is also uncertain whether current policies have fully removed non-performing loans from commercial banks or will be sufficient, given the current financial weaknesses of bank customers, to prevent a substantial accumulation of new problem loans. Theoretical considerations as well as experience[7] suggest that partial recapitalization, even if substantially complete, does little to improve bank incentives to maintain sound lending standards or monitor loan performance. Unless the present bottlenecks in these two areas are broken, the gains that have been made in improving lending standards and repairing banks' financial conditions will be difficult to sustain. In addition, current efforts to alleviate the 'credit crunch' being faced by smaller SOE and many non-state enterprises seem to have had limited overall effect. Finally, the continued state ownership and dominance of the four largest commercial banks could make it difficult to ensure adequate competition in the banking sector or to avoid the 'moral hazard' and other distortions that have often arisen with state owned banks in other countries.

Improving supporting institutions and infrastructure

Important progress also has been made in developing social benefit systems to facilitate adjustments from economic restructuring and to rationalize social security programmes. The establishment of reemployment centres has provided a necessary means to allow SOE to reduce their excess labour. Much of the basic framework and infrastructure for reforms to unemployment insurance, medical care, and pension programmes has been established. Development of these programmes will help to achieve a more equitable distribution of the financial burdens for these programmes among enterprises and help to improve labour mobility.

However, the pace of reforms to social benefit programmes is sharply limited by the overall shortage of government revenue. Largely because of revenue limits, little progress has been made in reducing disparities in benefit burdens among enterprises. Over the longer-term, the revenue base for social welfare programmes will almost certainly have to be broadened if burdens on enterprises are to be contained.

Conclusions

Overall, the enterprise reform process has exhibited important strengths in terms of its comprehensiveness and pragmatism. Increases in enterprise cash flow and profitability resulting from the measures that are underway should contribute to a modest revival in aggregate real growth in the medium-term. Improved enterprise financial conditions and the measures taken to deal with bank non-performing loans – provided they can be sustained – should help to improve credit availability and allow monetary policy to play more of a role in supporting aggregate real growth and so reduce the burden on fiscal policy.

Important foundations have been laid for improving corporate governance, tightening financial discipline, and providing a modern system of social benefits.

Much more, however, needs to be done to sustain the reform process and preserve the gains that have been made so far. Progress has been greatest in reducing enterprise overhead burdens, but key obstacles now impeding effectiveness of corporate governance and financial reforms need to be removed if there is to be a lasting improvement in enterprise performances. Given the need to make effective use of the resources that have been generated by current reforms, the growing demands on limited government revenues, and the increased competition that will come with WTO entry, there needs to be rapid progress on a broad range of fronts over the next several years.

Further progress will also depend on success in overcoming or at least reducing several important gaps and constraints that have reduced the impact reforms might otherwise have had. These include: scarcity of government revenues along with uneven tax burdens; an overemphasis on larger SOE in certain areas, while non-state enterprises have often received less attention than their importance to the economy would warrant; and continued government direction in decisions best left to enterprise management or the market. To overcome these weaknesses, the study identifies several more specific areas where changes to current policies or additional measures would offer especially high payoff in terms of improving the effectiveness of the reform process and its impact on macroeconomic performance. These include:

- Greater efforts in the medium-term to address problems of non-state enterprises, in particular to improve their access to external financing
- Expedited measures to strengthen SOE corporate governance mechanisms to curtail government interference and reduce the dominance of insiders
- Completion of reforms to improve financial discipline by ending, or at least segregating, commercial bank loans that are being made for policy or other non-commercial purposes
- Liberalization of the current mergers and acquisition process to allow more scope for market forces and economic considerations
- Adoption of a narrow definition of the SOE core to include only those industries where continued government involvement is essential on economic grounds
- Accelerated and increased emphasis on increasing government revenues and reforming the tax system
- And a broadening of financial reforms, in particular to accelerate the development of bond markets; and of smaller banks and other financial institutions as alternatives to the four large state commercial banks.

Notes

[1] The author is Principal Administrator of the Non-Member Economies Division of the OECD Economics Department. This article summarizes the more extensive study prepared under the auspices of the OECD Economics Department and the OECD Centre for Cooperation with Non-Member Economies, by Charles Pigott, Young-Sook Nam, Administrator with the Non-Member Economies Division, and Quimei Yang, Consultant to the Division.

[2] The study can be ordered at: OECD Publications, Paris Centre, 2 Rue André Pascal, Paris, 71016 Fax: 331 4524 1950. Web: WWW.OECD.ORG/Bookshop. The ISBN is: 92-64-17697-7

[3] See Estrin, Saul (1998), "State ownership, corporate governance, and privatization"; in OECD, *Corporate governance, state-owned enterprises, and privatization,* proceedings of an OECD conference, Paris, 1998.

[4] For an excellent and thorough recent survey of the state of corporate governance in China, see Cyril Lin, "Private Vices in Public Places: Challenges in Corporate Governance Development in China," presented at the OECD Development Centre seminar on Corporate Governance in Developing Countries and Emerging Economies, Paris, April 2000.

[5] OECD, Principles of Corporate Governance, 1996, Paris.

[6] Cheng, Enjiang and Yug-Shing Cheng, "Banking reform and the separation of policy and commercial loans in China, " *Economic Policy in Transition Economies,* Vol. 8, No. 3, 1998; and Bouin, Olivier, "Financial discipline and state enterprise reform in China in the 1990s," in Olivier Bouin, Françoise Lemoine, and Fabrizio Coricelli, editors, *Different paths to a market economy: China and Economies in Transition,* OECD Development Centre Paris, 1997.

[7] See Aghion, Philippe, Olivier Jean Blanchard, and Wendy Carlin, *The economics of enterprise restructuring in central and eastern Europe,* Centre for Economic Policy Research Discussion Paper No. 158, 1994.

CHINA'S ECONOMY BACK ON TRACK

BY WALTRAUT URBAN

Key developments in the first half of 2000

China's *GDP* reached a growth rate of 8.2% for the first six months of 2000, which was higher than in the same period of last year (7.6%), but also higher than over the whole year of 1999 (7.1%). Furthermore, GDP growth has accelerated from 8.1% in the first quarter to 8.3% in the second quarter of 2000. *Value added of industry* rose even faster, by 11.2% in the first six months of the year.

While the expansion of the economy in the first quarter was kicked off by a surge in *exports*, growth in the second quarter was further supported by a rebound in domestic demand. The two-digit rise in *exports* (38.6%) was due to the rapid recovery of the Asian economies, but high growth in Europe and the USA as well. *Imports* increased strongly too, but allowed, nevertheless, for a substantial *trade surplus* of USD 12.7 bn in the first six months of the year.

Domestic *consumption* and *investment* developed at a similar pace. From January to June 2000, investment in fixed assets rose by 11% (in nominal terms), compared to the same period of last year. Retail trade of consumer goods expanded by 10.1%. Taking into account the continuous decline in *retail prices* (-1.9%), but a slight rise of producer prices, private consumption in real terms developed more dynamically than investment. F*oreign direct investment* reached USD 17.2 bn, in the first half of the year, a decline of USD 2.3 bn (-7.5%) compared to the first half of 1999. However, 25% investment contracts were higher than last year, indicating growing optimism of potential foreign investors.

Outlook for the second half of 2000

For the second half of the year, we expect a less dramatic rise of Chinese exports, because of a higher statistical base in the second half of 1999 and probably a slow-down in foreign demand to a certain extent. Domestic investment might lose steam as well, as it is still heavily dependent on public investment which might be less effective in the second half of the year. Foreign direct investment, on the other hand is expected to be higher than in the first 6 months. Private consumption is likely to remain expansive. Altogether, we expect the growth rate of GDP to slow down somewhat in the second half of the year and to reach about 7.6% for the year 2000 as a whole.

Asian recovery pushing up Chinese exports

Exports turned out to be the most dynamic force in the Chinese economy in the first half of 2000 and their further rapid development will thus determine whether the Chinese economy can sustain high growth rates in the second half of the year or not.

Chinese exports in the first six months were 38.3% percent higher than in the same period of last year. One has to bear in mind, however, that due to the persisting Asian financial and economic crises, exports had been extremely low in the first half of 1999, showing a decline of 4.6% compared to the same period in 1998. But exports began to rise substantially in the second half of 1999, so that for 1999 as a whole, exports were 6.1 % higher than in 1998. Therefore, even if Chinese exports in the second half rose at the same pace as in the first half of 2000, due to the higher base, growth compared to the same period of last year would be less pronounced. If we assume the month to month increase of Chinese exports from January to June 2000 to continue for the rest of the year, this would result in a year to year growth rate of 30% for the second half of the year and a growth rate of 34% for the year 2000 as a whole. An annual growth rate of 30% would result if the monthly dynamics of the second half of last year was taken as a guideline, which can be assumed more realistic.

Synchronized growth in Asia, Europe and the USA fuels Chinese exports

The major forces behind the rapid increase of Chinese exports in the first half of 2000 are the fast recovery of neighbouring Asian economies from the financial and economic crises, which started in mid-1997, and a rare coincidence of sustained high growth in the USA and an upswing of the European economies. The so-called 'V-shaped' development in Asia is illustrated in Figure 1: A steep decline of economic activity in 1998 was followed by rapid growth, which began in the second half of 1999 and continued in 2000, pushing up the import demand of these countries from a very low base.

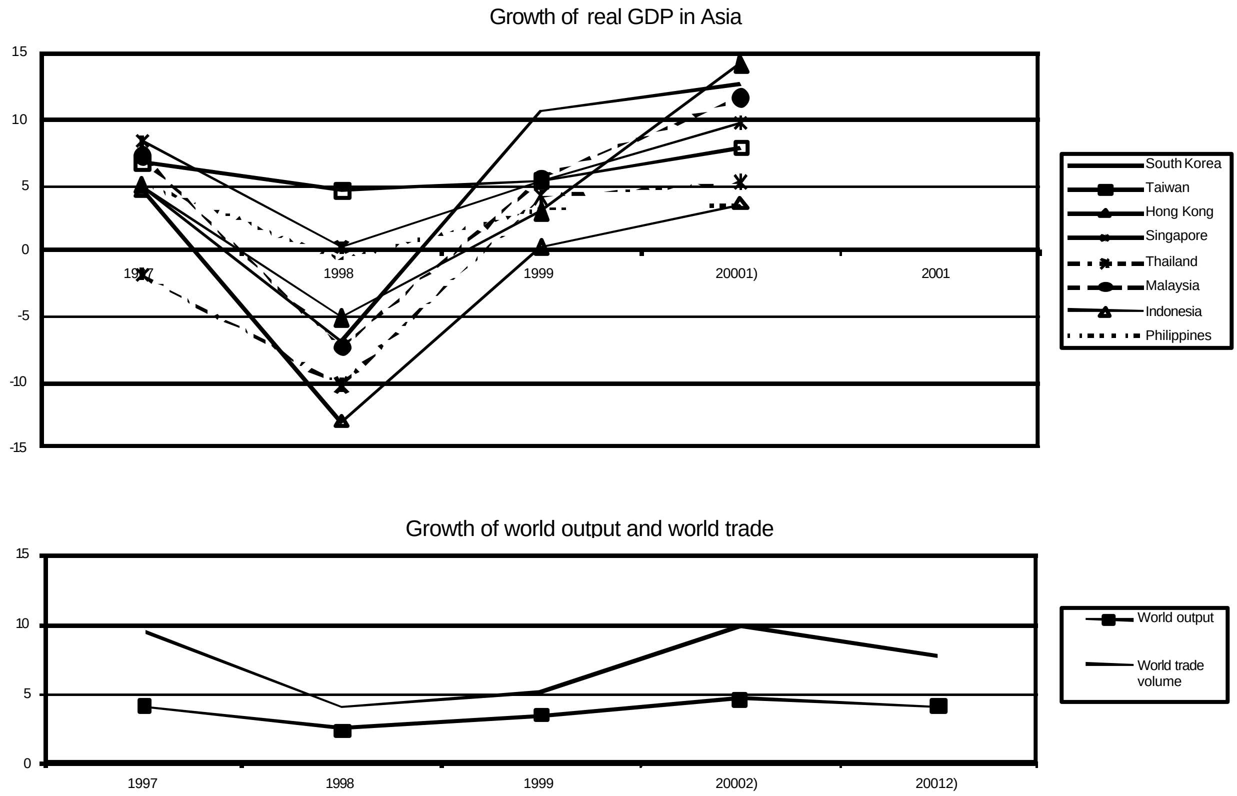
Chinese exports to Indonesia, for instance, rose by 123.7%, exports to Thailand by 84% and to South Korea by 60.7% in the first six months of 2000. Exports to Europe expanded very fast as well (40.5%)[1]. Chinese exports to the USA grew by 30%, at a similar pace as exports to Japan (34%), China's second most important trading partner. However, apart from the expected (although by no means certain) 'soft landing' of the US economy, the sharp increase of the oil price could dampen import demand and thus export growth in the second half of the year.[2] China also faces an increasing number of dumping suits from the European Union and the USA, which could dampen export growth in the second half of the year. Finally, 'tax-refunds' as a measure to promote foreign trade have already been used extensively and there is now little room for manoeuvre left. However, the granting of foreign trading rights to an increasing number of Chinese companies, another method to promote exports, is not yet exhausted. Taking all this together, we expect that Chinese export growth will stay strong but will be somewhat less dynamic than in the first half of the year, probably reaching about 30%.

Rising oil prices accelerate Chinese imports

Chinese imports also developed very fast (36.2%), during the first six months of the year. This was, to a large extent, due to booming exports, as nearly half of Chinese imports are basically inputs for

Figure 1

Economic development 1997-2001



Notes: 1) Figures for Asian countries represent realised growth rates for 1st quarter 2000. - 2) Figures for 2000 and 2001 are estimates.

Source: Dai-Ichi Kangyo Research Inst.: Economic Report - Vol.3; IMF: World Economic Outlook 9/2000.

exports. The continuous strong rise of imports in July (32.2%; compared to the same month in the previous year) and August (54.6%) thus points to a continuation of the China's export boom. But the rising demand for oil and the high oil prices played a significant role as well. In the first half of the year, oil imports by China, in quantity terms have nearly doubled and expenditures have risen by 170%, that is by about USD 5 bn[3]. Import quantities and prices of other commodities have gone up as well, because of the accelerating growth of the Chinese economy and the overall increase of commodity prices on the world market. Although imports might continue to rise faster than exports, because of the lower base of the former, we still expect a massive trade surplus of about USD 30bn by the end of 2000, similar to that in 1999 (USD 29.1 bn)

Most likely, China will join the World Trade Organization (WTO) in 2001 and thus there will not yet be any effect on trade this year. But we can already see a positive effect on foreign investors' plans to do business in China.

FDI declined but investment contracts reflect optimism

In the first six months of this year, actual *foreign direct investment (FDI)* in China amounted to USD 17.2 bn, which is 7.5% less than during the same period of last year. FDI inflows to China began to decline in 1999 already, when they stayed 11.4% below the 1998 level. But contrary to the situation in 1999, when contracted investment declined even more than actual investment, in the first half of 2000 investment contracts showed an increase of 25%, indicating significantly better prospects for future foreign direct investment in China than the year before. However, while actual FDI in the first half of 2000 has increased from European Union countries (Germany, France) only, the rise of contracted investment was due to higher commitments mainly from the Asian economies, including Taiwan.

For the year 2000 as a whole, we expect actual FDI to reach about the same level as 1999 (USD 40bn).

Rebound of private domestic investment?

In 1999, investment in fixed assets had increased by 5.2% only. In the first half of 2000, fixed asset investment recovered substantially, rising by 11% (in nominal terms) compared to the same period of last year. Moreover, if the provisional figures prove right, apart from *public* investment, *private* investment (including collective and individual owners) too has begun to rise[4]. Public investment in the first six months of the year was fuelled by a yuan 100 bn special government bond on top of the yuan 60 bn special bond from September last year[5], most of which became effective this year only. To keep investment going, the government plans to issue another special government bond, worth yuan 50 bn in the second half of the year. The continuous high expenditures of the government have to be seen not only to prop up demand and thus growth and employment of the overall economy, but also to promote faster development of the Western regions and to smooth negative employment effects of the ongoing reform of state owned enterprises (SOEs).[1]

Chinese consumers opening their wallets wider

Retail trade of consumer goods (in nominal terms) was 10.1% higher than last year and 12% higher if the persistent deflation of retail prices was taken into account. This compares to a (real) growth rate of 10.1% for the whole year of 1999. However, in May, consumption was artificially pushed up by the decision of the Chinese government to extend Labour Day holidays to a full week this year. Although retail prices are still declining (-1.9%), consumer prices increased slightly (0.1%) in the first half of 2000, reflecting rising prices for services, in particular rents.

Part of the higher consumer expenditures in the first half of 2000 was at the expense of household savings, which increased considerably slower than last year and the years before.

Lower grain output expected

Because of adverse weather conditions this year and a systematic reduction of the grain sawing area, grain output, which is a major component of agricultural production, is expected to fall for the first time after three years. This will put pressure on the consumer price index in the second half of the year, but will also help to increase farm incomes and thus consumption of the rural population, which has fallen strongly behind urban consumption in recent years.[6]

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[1] For a thorough analysis of China's enterprise reform see Mr. Pigott's article in our report.

Export-led growth helps SOEs to recover

In the first half of 2000, value added of industry rose faster than GDP (11.2%) and also considerably faster than in 1999 (8.5%). Mainly, because of the export-led growth process, industrial production of state owned enterprises (SOEs) and foreign invested enterprises (FIEs) accelerated most, by 9.8% and 14 % respectively. Collective-owned enterprises, serving domestic markets mainly, lagged considerably behind (7.9%). Furthermore, It was recorded that profits of SOE's and state holding businesses in the first six months have doubled on a year to year basis, reaching yuan 90.3, losses declined to yuan 46.3 bn (-6.1%). Also, out of 6599 money losing large and medium sized SOEs, 3463 have contained their losses. The improved result of the SOE's economic performance has to be seen in the light of the overall improvement of the economy, in particular export growth, but probably as a positive result of the ongoing SOE reform as well. However, a considerable part of the recorded profit increase was due to rising prices for oil products*:* Owing to still cheap oil reserves, the petro-chemical sector alone has generated yuan 40.3 bn of profits, compared to yuan 10.1bn last year – but this is a phenomenon which depends on the future development of the oil price.

China in no hurry to join WTO

After the break-through in China's *bilateral negotiations* with the USA in December 1999, and the agreement with the European Union in May this year, China's accession to WTO came within close reach. Also the US Senate confirmed on 19 September 2000 the decision of the US Congress made earlier in the year, to grant China 'permanent normal trading rights' (PNTR)[7]. The last hurdle left now are the *multilateral negotiations* with WTO[8]. However, these negotiations, which have started already, have turned out more difficult and less speedy than anticipated. Now, after the political side of China's accession to WTO, especially with the USA, seems settled, China probably wishes to gain more time to adjust its economy to WTO membership. We thus expect China to become a member of WTO not before 2001.

Overall prospects

After years of high but decelerating growth, the Chinese economy seems now back on track. Active fiscal policy, accelerating domestic demand and surging foreign trade all helped to reverse the declining trend. However, active fiscal policy cannot be sustained for ever and domestic demand is still fragile. Short and middle term prospects for the Chinese economy will thus depend to a large degree on the future development of foreign trade. As indicated in Figure 1 above, the growth of world trade, which reached a record height of 10% this year, but is expected to fall to 7.8% in 2001. However, these estimates do not yet take into account the recent rise of oil prices and the possible negative effects, in particular on the trade in industrial products. Apart from the overall economic environment, Chinese economic development in the future will depend a lot on how the country will cope with WTO membership. While there will be better opportunities for some sectors (e. g. textiles & clothing, electronics, certain food products, chemicals), other sectors will certainly suffer (e.g. agriculture, transport equipment, the petrol industry, high quality steel and steel products). However, these impacts will become effective in the middle term rather than in the short run.

If not another world-wide oil crisis takes hold, we expect the growth of the Chinese economy to stay robust in 2001, but to develop at a somewhat slower pace than this year, GDP growth reaching probably 7.4% in 2001.

Notes

[1] Export figures for Europe include Russia which, after years of stagnation, reached high rates of economic growth in the first half of 2000. Chinese exports to Russia in the first half of this year were 70 % higher than last year. However, exports to Russia make up only a small share of total Chinese exports (0.7%).

[2] Mr. Wolfensohn, head of the World Bank and Mr. Mussa, chief economist of the IMF, both recently expressed their opinion that if the price for crude oil stayed as high as USD 30-35 per barrel, this could lead to a reduction of estimated world output growth by 0.5 percentage points in 2001 (Neue Zürcher Zeitung, 20/09/2000).

[3] Higher oil imports thus accounted for about 7 percentage points of import growth in China during the first half of 2000.

[4] Although no figures for private investment are given explicitly, we can make a guess by comparing investment excluding non-state enterprises with total investment: From January to June 2000, 'investment excluding urban and rural collectives and individuals' amounted to yuan 753.8 bn, representing a rise of 12.2% which was only slightly higher than the rise of total investment, including non-state enterprises as well (11%).

[5] See China Report 4/1999, p. 1

[6] In July this year, for instance, retail sales in urban areas had increased by 12.1%, but those in the country side by 7.5% only. By the end of 1999, urban per capita income was yuan 5870.5 (USD 709), while rural per capita income reached yuan 2202.5 (USD 266); (China Report 1/2000, p.5).

[7] Even if the USA had not granted PNTR to China formally, it could not have prevented the country's accession to WTO; but this would have curtailed the effects of membership.

[8] After the bilateral negotiations between China and Switzerland were brought to a successful end on 27 September 2000, Mexico is the only country left wishing to negotiate a bilateral agreement with China.

Table CN

China: Selected Economic Indicators

	1990	1995	1996	1997	1998	1999[1]	2000 Jan-Jun	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	3949.1	.
annual change in % (real)	3.8	10.5	9.6	8.8	7.8	7.1	8.2	7.6
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	8.5	11.2	11.0
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	.	2021.2	.
Total investment in fixed assets, CNY bn [2]	451.7	2001.9	2291.4	2494.1	2840.6	2988.0	1017.6	.
annual change in % (nominal)	2.4	17.5	14.8	8.9	13.9	5.2	11.0	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	705.8	.	.
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. [3]	2.5	2.9	3.0	3.1	3.1	3.1	.	.
Average gross annual wages, CNY [4]	2140	5500	6210	6470	7479	.	.	.
annual change in % (real) [5]	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	3114.0	1624.8	.
annual change in % (real)	0.4	12.0	13.0	9.4	9.4	10.1	12.0	12.0
Retail prices, % p.a.	2.1	14.8	6.1	0.8	-2.6	-2.9	-1.9	-0.5
Consumer prices, % p.a.	3.1	17.1	8.3	2.8	-0.8	-1.3	0.1	0.4
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	1300.6	.
M2, Money + quasi money	1468.2	5823.0	7609.5	9099.5	10499.9	11900.0	12660.5	.
Refinancing rate of NB % p.a., end of period [6]	7.9	10.4	9.0	8.6	4.6	3.2	3.2	.
Current account, USD bn	12.0	1.6	7.2	29.7	29.3	.	.	20.0
Official forex reserves excl. gold, USD bn	11.1	73.6	105.0	139.9	145.0	154.7	158.6	.
Gross debt, USD bn	52.5	106.6	116.3	140.0	146.0	151.8	147.6	.
Foreign direct investment, USD bn	3.5	37.5	41.7	45.3	45.5	40.4	17.2	40.0
Exports total, USD bn	62.1	148.8	151.1	182.8	183.8	194.9	114.8	.
annual change in %	18.2	22.9	1.5	20.9	0.5	6.1	38.3	
Imports total, USD bn	53.4	132.1	138.8	142.4	140.2	165.8	102.1	.
annual change in %	-9.8	14.2	5.1	2.5	-1.5	18.2	36.2	.
Trade Balance, USD bn	8.7	16.7	12.2	40.4	43.6	29.1	12.7	30.0
Average exchange rate CNY/USD	4.78	8.35	8.31	8.29	8.28	8.28	8.28	8.28
PPP (CNY/USD), WIIW [7]	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. - 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; since 1998 "staff on duty" only. - 5) Staff and workers cost of living index is used as deflator for calculating real wage. -6) Overnight rate. - 7) Purchasing power parity, ICP-method; see Ren Ruoen, *The Vienna Institute Monthly Report 1996/2.*

Sources: China Statistical Yearbook; International Financial Statistics; China Monthly Statistics; China Daily.

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