CHINA

COMPETING IN THE GLOBAL ECONOMY

Edited by
Wanda Tseng
and Markus Rodlauer

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Original calligraphy on the cover, by Jieyan Yin, represents the Chinese character for *dragon*.

Foreword

China's economic performance in recent years has been impressive by most standards. The country was able to weather the storm of the Asian crisis relatively unscathed and has sustained rapid growth in the face of last year's global downturn. These achievements have added to the visible success of economic transformation that two decades of market-oriented reforms have brought to China, including large gains in income per capita, the creation of a vibrant nonstate sector, and major inroads into poverty. One of the key driving forces of this growth and transformation has been the progressive opening up of the economy to foreign competition and investment, culminating in China's recent accession to the World Trade Organization (WTO).

At the same time, analysts point to problems in state-owned banks and enterprises, medium-term fiscal pressures, growing unemployment and income disparities, and weak governance. How will China be able to compete successfully in the global economy with these problems weighing on its economy, especially as WTO accession has set the stage for a further and decisive round of opening up?

The key task facing policymakers in China today is thus to push ahead with the unfinished reform agenda, to ensure sustained rapid growth and social stability, and to prepare the economy for increased global competition resulting from WTO accession. This book looks at those challenges and China's efforts to meet them, issues that have been at the center of the IMF staff's work on China in recent years.

The book brings together material and analysis prepared during 2000–01 by IMF staff working on China under the direction of Wanda Tseng. The team of authors was led by Markus Rodlauer and David Robinson and included Thomas Dorsey, Jahangir Aziz, Paul Heytens, Christoph Duenwald, Paul Gruenwald, Thomas Richardson, Raju Singh, George Tsibouris, Harm Zebregs, James Daniel, Cem Karacadag, Nicolas Blancher, and Yongzheng Yang.

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The opinions expressed here, as well as any errors, are the sole responsibility of the authors and do not necessarily reflect the views of the Chinese authorities, the Executive Directors of the IMF, or other members of the IMF staff.

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The following conventions are used in this volume:

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or less than half the final digit shown;

– between years or months (for example, 2001–02 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 1991/92) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

Minor discrepancies between constituent figures and totals are due to rounding.

1

Introduction and Overview

MARKUS RODLAUER AND PAUL HEYTENS

China has received much attention in recent years as its economy has performed exceptionally well by most standards: after a soft landing from an episode of overheating in the mid-1990s, the Chinese economy managed to weather the Asian crisis of the late 1990s largely unscathed and has been able to sustain rapid growth in the face of the recent global downturn.[1] At the same time, however, analysts point to serious structural weaknesses in China's economy, such as problems in the state-owned enterprises (SOEs) and banks, growing unemployment and income disparities, weak governance and corruption, medium-term fiscal pressures, and environmental degradation. There is concern that these challenges, if unmet, could undermine sustained rapid growth and stability. The key task facing policymakers in China today is how to sustain the economy's growth and development while spreading the benefits more widely across society. This book looks at those challenges and China's efforts to meet them—issues that have been at the center of policy analysis and discussion by IMF staff working on China in recent years.

Background

More than two decades of market-oriented reform has brought visible success and economic transformation to China. Since the start of

[1]Throughout this book, "China" refers to the Chinese mainland, and "provinces" refers to the set of 28 provinces, autonomous regions, and municipalities listed in Table 3.1 in Chapter 3.

reforms in 1978, GDP growth has averaged over 9 percent a year, raising real income per capita fivefold, and more than 200 million people have been lifted out of poverty. The nonstate sector, comprising the private sector, urban collectives, and township and village enterprises, now accounts for nearly two-thirds of GDP, and China has become more integrated into the global economy: its share in world trade is now over 4 percent, compared with near zero in 1978. China's recent accession to the World Trade Organization (WTO) has set the stage for further opening of the economy and acts as an impetus for accelerated reforms.

Recent Macroeconomic Developments

The Asian crisis accentuated the slowdown of growth that had followed the boom of the early 1990s. Falling demand for exports compounded weakening domestic consumption, and concerns about the continued stability of China's currency, the renminbi, fueled capital outflows and a sharp drop in the balance of payments surplus. In response, the authorities acted promptly to support economic activity and reduce external vulnerabilities. An easing of fiscal and monetary policies was accompanied by measures to encourage exports, address rampant smuggling, and intensify enforcement of foreign exchange and capital controls, while exchange rate stability was maintained. These policies, aided by the still-limited openness of the economy and the strong external position built up before the crisis, helped limit contagion from the regional financial turmoil, sustained annual growth above 7 percent, and set the stage for a rebound in a more favorable external environment.

Starting in mid-1999, growth regained momentum, sparked by a strong pickup in exports and then sustained by rapid domestic demand growth. Domestic demand continued to be supported through increased fiscal spending, especially on public investment projects; in addition, private consumption was buoyed by housing reforms, an increase in civil service salaries, and higher social spending. Rising budget expenditure, however, was increasingly matched by rapidly growing revenue, attributable to the pickup in activity as well as to improvements in tax administration, permitting a gradual reduction in the overall budget deficit from its peak in 1999.

Growth in China held up relatively well in the face of the global downturn in 2001. Although the external slowdown dampened activity, the impact was muted by continued robust domestic demand growth and rising foreign direct investment (FDI). Thus, despite sharply declining export growth, GDP still grew by over 7 percent in 2001, thanks to strong growth in investment (mainly by the state) and buoyant private consumption. Reflecting the high import content of exports, import growth also dropped, limiting the negative external contribution to growth. Strengthened foreign investor confidence (partly related to WTO accession) boosted FDI inflows, aiding the economy's resilience against the external downturn.

Structural Reforms

Building on the fundamental reforms accomplished during the 1980s,[2] recent years have seen continuous progress in China's transformation into a market economy. Reinvigorated by Deng Xiaoping's famous tour of southern China in 1992, reforms over the past 10 years have completed the dismantling of the planned-economy apparatus (controlled prices and quantitative plans); fostered an increasing role for the private sector in the economy;[3] opened the economy further to foreign trade and investment; enhanced the autonomy of state-owned banks and enterprises; and established the basic building blocks of a modern tax system and indirect monetary policy. The experience of the Asian crisis and the landmark decision to join the WTO have given further impetus to these efforts, focused on improving the performance and financial condition of the SOE and banking sectors.

Nonetheless, the 1990s saw growing evidence of the costs of unreformed corporate and financial sectors. Despite greater autonomy and decentralization of management decisions, SOE performance has suffered from deeper problems rooted in the lack of tight budget constraints, weak management, and the requirement to provide job security and a range of social services. Growing competition, lower subsidies, and tighter credit (especially for smaller enterprises) revealed the poor performance of many SOEs in the 1990s and prompted new approaches to reform. The strategy included moving small enterprises out of the state sector and reforming some 1,000 large state firms that would be the pillars of China's industry. Reforms were stepped up beginning in 1998, and some progress has been made in introducing modern management systems, shedding excess labor, and lowering the social welfare burden. However, many of the fundamental problems in establishing effective outside governance and financial discipline remain to be solved, especially in the larger SOEs.

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[2]For a comprehensive review of reforms during this period, see Bell and others (1993).

[3]Symbolized, for example, by an amendment to the Constitution in March 1999 putting private ownership and private enterprise on an equal footing with the state sector.

Reform of China's financial sector has also moved up the policy agenda in recent years, and the authorities have become increasingly frank about the problems in this area. The strategy has been to relieve the state commercial banks (SCBs) of the responsibility for policy lending, while placing their operations on a commercial footing and holding them accountable for new lending decisions. In pursuit of these goals a wide range of measures have been taken, including moving policy lending to newly created policy banks, restructuring the People's Bank of China, abolishing the credit plan, partially recapitalizing SCBs and transferring part of their nonperforming loans to asset management companies (AMCs), strengthening the prudential framework, and closing many small, insolvent financial institutions. AMCs have started to dispose of their assets, including to foreigners and with the assistance of international investment banks. These steps have been complemented by the SCBs' own efforts at such reforms as revamping internal controls and risk management, reducing staff, and rationalizing the branch network. Despite these efforts, however, the financial position of the SCBs remains very weak, and much remains to be done to prevent the emergence of new nonperforming loans.

In tandem with liberalization and SOE reforms, the social dimensions of the transition have become increasingly apparent. Some 16 million layoffs from SOEs during 1998–2000 indicate the huge social challenge facing China as the "iron rice bowl" system of the past is dismantled. The goal is to shift responsibility for social services (including education, health, pensions, and unemployment) from the SOEs to the private sector or to local and provincial governments.[4] Regional income disparity has also become a significant problem: the coastal regions have benefited much more from China's opening than the poor western and central regions and those with a high concentration of SOEs. In response, the authorities have expanded their economic opening policies nationwide, directed public investment to the western and central regions, and used discretionary transfers from the budget to ease the social burden on the poorer regions. However, a more systematic revamp of the current, regressive system of interregional budget transfers is needed to address the growing imbalance between the richer provinces and those with fewer resources yet large social safety and investment needs.

More generally, the transition from a centrally planned economy to a more open and market-oriented system has been accompanied by

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[4]Experiments with such reforms are under way in a number of regions and localities, and a formal pilot program of social security reform was launched in Liaoning province in 2001.

rising governance problems and corruption. China's political leadership recognizes that addressing corruption is a top priority. Sustained success in improving governance and fighting corruption will require a broader effort to build the legal and judicial framework for a market economy, along with increased transparency and public accountability of government.

China's recent entry into the WTO marks a watershed for reform. A new push is needed to complete the unfinished reform agenda. WTO accession promises to stimulate such progress by increasing FDI, removing protection from inefficient industries, and spurring the development of the legal and regulatory framework necessary for a market economy. The authorities are aware that the benefits from WTO accession depend on the successful implementation of reforms to deal with the resulting increase of competition, and they have launched a major new effort to advance the reform agenda.

The Plan of This Book

The chapters that follow bring together recent analysis by IMF staff of these issues, focusing on four broad areas: China's growth dynamics, macroeconomic stability, SOE and banking sector reform, and global integration. In reviewing China's experience in these areas, the book highlights the elements behind the strong performance in recent years as well as the key items on the reform agenda:

- *Growth dynamics*. Chapter 2, "How Fast Can China Grow?" looks at the factors behind China's remarkable growth performance over the past two decades and whether it can continue in the future. The analysis suggests that rapid growth in the past has been underpinned by large-scale reallocation of agricultural labor to more productive uses and other productivity-enhancing structural changes. Looking forward, the chapter concludes that potential output should continue to grow at 7–8 percent a year provided critical structural reforms (mainly in the SOE and financial sectors) are implemented. Chapter 3, "Provincial Growth Dynamics," examines whether incomes across China's provinces are converging. It finds that the poorer provinces are indeed catching up with the richer ones, but that convergence weakened in the 1990s. It also finds that the incomes of the various provinces are stratifying into a bimodal distribution, and that economic structure and policies (such as the concentration of SOEs and openness to trade) are significant factors in explaining these distributional dynamics. Chapter 4, "The Growth-Financial Development Nexus," com-