China's Economic Squeeze

by William H. Overholt

China is in a squeeze. The domestic cause is the same familiar one that sparked the recent Asian crisis: government use of the credit system to give special privileges to certain firms (in China's case, the state enterprises). Excessive credit has subsidized underproductive sectors of the economy and inflated a financial bubble. As in South Korea, the favored enterprises have used their access to excessive, low-cost funding to create vast empires of overcapacity and inefficiency. As in South Korea, the availability of funds regardless of profit supports a labor system that assures workers in favored sectors lifetime employment and a wide range of social benefits, even if their companies provide no useful output. And as in South Korea, the banks that underwrite this system now confront a daunting accumulation of bad loans that threaten the viability of the entire financial system and jeopardize decades of improvement in the standards of living.

China's financial bubble differs from South Korea's in important ways, however. Whereas South Korea's bubble was punctured by a foreign debt crisis in December 1997, China has proportionately far less foreign debt and proportionately far greater foreign exchange reserves, an advantage that shields the bubble to some degree from external pressures, but that provides no protection from significant internal problems. Secondly, China's state enterprises are also far less efficient and competitive than Korea's *chaebol*, and the squeeze comes at a much lower level of administrative and technological development. Thirdly, the sheer scale of management problems involved in conducting reform, given China's vast size and population, is orders of magnitude greater than in South Korea. Finally, given China's lower level of per capita income and political development, the consequences of a major economic setback could include extensive starvation and political upheaval, neither of which is at risk in South Korea.

Ironically, the timing of the squeeze results from good policy—the most proactive economic reform program in the world. Because the stakes

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are greater in China than elsewhere in Asia (except perhaps Indonesia), and because it currently has a forward-looking leadership, Beijing has attacked its problems before the onset of a crisis, rather than waiting to be overwhelmed by events as Indonesia, Thailand, and South Korea were. Notably, although China is learning from the smaller countries' experiences, it adopted a reformist posture well before the onset of the "Asian flu." In fact, China's successes in the four years prior to the regional crisis rank among the most inspiring achievements in the history of economic management. From 1994 to 1997, China pressed inflation down from 22 percent to negligible, maintained growth in the 9 percent range, stimulated a series of record grain harvests, raised foreign exchange reserves from U.S.$21 billion to $140 billion, attracted foreign direct investment that reached more than $40 billion per year, and initiated wide-ranging tax, legal, and banking reforms. Such achievements would have been noteworthy in the history of almost any country, but are particularly stunning in a country with a population roughly equivalent to those of the former Soviet Union, Eastern and Western Europe, the Middle East, and South America put together.

Having achieved all this, China nonetheless finds itself in a quagmire. As in South Korea and the other great economic success stories of Asia, the methods of guiding the economy that created the great economic takeoffs have also led to overcapacity, deflationary pressures, banking breakdowns, rising unemployment, and severe social strains.

The Momentum of Reform

It seems to be taken for granted in much of the press that Chinese reform has stalled. Certainly, the state enterprise reforms are behind schedule. The Asian financial crisis, coinciding with some of modern history's worst floods in the summer of 1998, exacted a heavy price because the pace of reform is ultimately constrained by the economy's ability to employ laid-off workers. But reform has continued at an extraordinary rate. During 1998, central government ministries were downsized by half. Although the plan was to do this within three years, it was largely accomplished in a single year. Virtually all of the dismissed state employees still live in government housing. Many are being supported by retraining programs or are going back to school at government expense, and most get two to three years of income and benefits comparable to those they enjoyed on their jobs. But there have still been vast savings and efficiencies. Some 30–40 percent do not get full retirement benefits, and no officials have been hired back (as would have happened in Washington, D.C.) under the guise of consultants or contractors. Hard budget constraints have been imposed.

The downsizing has so far excluded the military and the Communist Party, but all levels of government will eventually be affected, with four million jobs eliminated. Moreover, this huge reduction has so far been accomplished without creating a collapse of morale or a burgeoning political opposition. In interviews, government officials did not appear gravely disheartened by the changes. Asked how their former colleagues were faring, they answered that virtually all central government officials had quickly been employed, usually at higher incomes, by the private sector, where their skills and connections were badly needed. Only in China's 2,400 county-level governments is there more of a backup.

Military reforms also continue apace. The Chinese military has been heavily self-supporting, following the examples of Thailand and especially Indonesia in developing a vast array of businesses. The People's Liberation Army (PLA) not only produced armaments, but grew cotton, sold Baskin-Robbins ice cream, bottled soft drinks, co-owned Beijing's plushest hotel, and ran karaoke bars in major cities. Indeed, the PLA was the best partner a foreign investor could have, since army generals could "make things happen," commanded a national transportation and distribution system, provided excellent security—and could ignore the law. In 1998, the Chinese government decided to get the military out of business, a task so vast and delicate that it seemed impossible. But the impossible has apparently happened. China has many patriotic officers who recognized that soldiers who peddled ice cream were probably forgetting how to shoot straight, and the army was no doubt glad to get out of some businesses simply because they were losing money. Still, the politics were complex and the financial cost huge because the administration paid trust funds to army headquarters for the businesses it expropriated. But in the end the job was largely completed—again, within a year.

China has initiated a total reorganization of the PLA. Some 500,000 soldiers will be discharged—a huge cut that is particularly painful when the economy is slowing and many soldiers' wives are simultaneously losing their jobs. Conscription for three to four years is being reduced to two years. Professional noncommissioned officers are becoming more important, political commissars less so, and civilian education and reserve-officer training programs are getting new prominence in an effort to produce higher-quality officers. Division-level management is frequently being eliminated altogether. The strategic doctrine is being changed. Research and development and acquisition processes are being revamped, and civilian outsourcing is being introduced for equipment, hospitals, restaurants, and other needs. Finally, the military is being subjected to firmer civilian control: for the first time no military officer serves on the Standing Committee of the Politburo.

These breathtaking changes bode well for the economy as well as the military, and for the next seven or eight years will so preoccupy the PLA that China will need to avoid trouble with foreigners. What is more, the military reform has sharply reduced smuggling and permitted more accurate import statistics. This explains the amazing jump in imports that was reported as soon as the military was "put out of business." In March 1999, imports of beverages and tobacco rose 39.2 percent over March 1998, food oils rose 58.5 percent, and machinery and transportation imports rose 52.3 percent despite a weaker economy. As a result, government revenues will rise substantially because more tariffs will be collected, foreign exchange reserves will rise because less foreign exchange will be hidden offshore, and politically sensitive trade deficits with the United States and other countries will be revealed to be substantially smaller than previously believed because smuggled goods were not in the statistics.

Still, the ultimate cause of Asia's, and China's, financial bubbles is misallocation of capital. The most disastrous consequence of a popping bubble is collapse of the banking system. Hence financial reform, defined broadly as movement towards more efficient use of capital, must constitute the core of any reform. China's banks are sick, and it is uncertain whether they can be cured before a South Korean–style collapse occurs. China has chosen to emphasize that the banks cannot be made sound until their customers, namely, the state-owned enterprises (SOEs), are cured or allowed to die, because the SOEs are the source of the accumulating nonperforming loans. This is a fundamental strategic choice. South Korea has focused on fixing the banks and letting the companies fall as they may according to the market—except that the biggest companies have a death-grip on the banks and the government has therefore tried to impose reorganization. Theoretically, another option is to make the banks function on a market basis and pay the subsidies to selected state enterprises directly from the finance ministry. But financial reform has many dimensions, and it will be helpful to paint the broader picture before focusing in on SOE reform.

Macrostability helps. At the highest level, proper capital allocation is a function of macroeconomic policy. Premier Zhu Rongji's greatest contribution to financial reform in the 1994–97 era was to subdue the high inflation that was encouraging huge and wasteful investments in unproductive assets and threatening to create a real estate bubble. Zhu banned the banks from funding most such investments and brought inflation down to levels that did not encourage a real estate bubble, thereby avoiding the kinds of crises that humbled Thailand and Japan. To be sure, some smaller real estate bubbles have occurred, most notably in the office buildings of Pudong, across the river from old Shanghai, but even there rents have come down 60 percent, suggesting an old bubble popping, not a new one forming.

The currency peg hurts. On the other side of the ledger, the effort to keep the currency tied to the U.S. dollar requires that Chinese interest rates be tied roughly to American rates. This leads to extraordinarily high real interest rates in China's deflating economy and greatly inhibits the flow of funds at reasonable rates to Chinese companies. If the Chinese choose to devalue, the United States would be wrong to discourage them.

The moral hazard is declining. Asian economic models, particularly the more socialist ones such as in China and South Korea, encourage private banks to fund favored companies on the assumption that the government will guarantee its favorites. Limiting this tendency to make badly conceived loans is an absolute necessity for these economies. The central government tries to police the limits. Local companies, desperate for money, exaggerate the extent of government support, and bankers anxious for customers tend to imagine government guarantees where there are none. Just as South Korea is coming to terms with this problem through the insolvency of Daewoo, so China is dealing with it through the bankruptcy of GITIC and other prominent companies. Foreign bankers may cry in pain, but the crackdown is good for China's creditworthiness and demonstrates that China is more proactive than its neighbors. In the short run, however, foreign banks' refusal to lend to nonsovereign Chinese borrowers will worsen China's squeeze.

Contracting sovereign guarantees. Meanwhile, China has narrowed the range of sovereign guarantees that the commercial banks and leading companies like CITIC have long received. China's record in honoring those guarantees is as good as that of any country in the world, and being stingy in handing them out is vital to maintain a strong sovereign credit rating. The bond markets have rewarded China for this by giving it large amounts of money at reasonable spreads with correspondingly good ratings.[1] Similarly, China will no longer permit formal guarantees by local authorities of minimum returns on foreign investments.

Covering bad loans. China's banks, international trade and investment corporations (ITICs), and state enterprises carry nonperforming loans that amount to as much as one-third of gross domestic product (GDP). (These bad loans are what the Chinese call "triangular debt": money owed to one SOE by another, which is not being paid because a third SOE has not paid up.) The banks' bad loans are believed to amount to 20 percent of total bank assets. Official numbers are lower and some private estimates are higher. For comparison, Hong Kong banks, arguably the region's best, run 3 percent of assets in bad loans, Singapore's 6 percent, Taiwan's 5 percent officially and 8 percent according to private estimates, and Thailand's hit 49 percent. The latter result occurs when a government fails to address the problem until after a crisis hits. In addition, the rural cooperative banks reportedly hold bad debts that run 50–80 percent of total loans.[2]

In 1998 the government partially recapitalized the big banks with 270 billion renminbi raised through bonds. This was supposed to get them to an 8 percent ratio of capital to assets, the standard minimum, but international institutions regard all the Chinese banks as having negative equity. In 1999

[1] At time of writing, the spread was 145 points over U.S. treasuries. Moody's rating was A3, Standard & Poor's BBB+.

[2] All figures except private estimates for Taiwan are from central bank reports. Private Taiwanese figures came from the author's interviews with bankers in Taiwan.

the government realized that the problem of nonperforming loans and inadequate capital remained critical, so it decided to adopt a good bank/bad bank approach—relieving a bank of its bad loans, telling it to manage itself better in the future, and turning the bad assets over to an asset management company (AMC) to manage.

Chinese officials speak of following the model of the U.S. Resolution Trust Corporation. Thailand used such a model recently to auction off billions of dollars of bad assets. This puts resources back to work quickly and does so at market prices. But China is actually planning something quite different. The prototypical "bad bank," China Cinda Asset Management, will take 200 billion renminbi worth of bad loans from China Construction Bank. It will be run by seconded employees of Construction Bank who will not hold auctions, but rather try to reorganize, merge, or reshuffle the companies and assets so as to make them productive again without cutting jobs. The assets will be priced by a third institution staffed by people who are supposed to ensure independent evaluations.

Such a process is unlikely to yield market prices, for it would take a brave official to mark assets down to a few cents on the dollar, as auctions abroad frequently do. Nor will it redeploy the assets swiftly. The priority given to avoiding job losses virtually assures that progress will be slow. There is also a serious risk of AMCs' selling to related parties at cheap prices or holding onto certain companies indefinitely to get the financial and patronage benefits of controlling them. At worst, this system could become a politicized, bureaucratic nightmare. To be sure, the government has also acted to improve bank profits by liberalizing interest rates and tax policies, and the current scale of its bad debt problem is manageable, at least for a couple years. But the AMC system as planned is not reassuring to anyone who would like to see China's financial assets deployed quickly and with market efficiency.

It must also be said that China's banks have some crucial things going for them. The government has acted long before a collapse, high savings rates keep the banks liquid, and high lending rates and low deposit rates create a wonderful opportunity to recapitalize. So there is hope.

Avoiding new bad loans. The government has taken a number of steps to discourage the further accumulation of bad loans, following a path that might be called extreme moderation. The first steps have been administrative. The central bank, the People's Bank of China (PBoC), was forced to divest its commercial banking and trading businesses and become a pure regulator. This removed many layers of conflict of interest. The PBoC was also reorganized into a federal system, with each of nine newly created regional divisions covering more than one province, in an effort to render bank management less vulnerable to provincial, municipal, and party pressures. The commercial banks were in principle separated into real commercial banks, which are supposed to follow market imperatives, and policy banks, which provide subsidized or high-risk loans for approved purposes. At the beginning of 1998, the commercial banks were freed to make their own decisions and virtually stopped lending to anyone. After two months, the central bank ordered them to begin again, because half of the government's stimulus program relies on bank financing. On balance, lending has become somewhat more autonomous and substantially less focused on the SOEs, but progress has been gradual.

At the level of individuals, anticorruption campaigns have been organized. Top bank managers were given contracts subject to periodic reviews of their bad loans, and put on notice that they would be fired, or worse, if their banks performed poorly. They responded like their counterparts elsewhere in Asia by refusing as much as possible to make loans and investing safely in (increasingly available) government bonds. This produced a credit crunch just when the government desperately needed to stimulate the economy. Beijing responded with moral suasion, arm twisting, and a tremendous push to support the building of infrastructure projects by SOEs. The result was a substantial weakening of the drive against bad loans. More fundamentally, the banks have two million employees, virtually none of whom has any credit training. Only the top few have any incentives to avoid giving bad loans.

The government has also started relying on outright bankruptcy, which terminates a flow of bad loans and forces the banks to recognize their losses. To its credit, the government has gone after some very big fish rather than just chasing the minnows. The bankruptcies of Hainan Development Bank, CACTIC, and GITIC provided an unmistakable lesson. But the government has also been wary of increasing unemployment, so the total number of bankruptcies has remained small: only 540 in 1996, fewer in 1997, and probably just a bit more in 1998. By comparison, Japan, with a population only a tenth as big as China's, had 18,998 bankruptcies in 1998. Moreover, as in many other Asian countries, China's bankruptcy law is difficult to invoke.

These policies have avoided the three extremes of forcing many sudden corporate bankruptcies, allowing the banking system to collapse, or delivering all key SOE subsidies directly from the government budget. Purists would insist on one of these approaches, but the danger of mass unemployment or financial collapse argues against them. In the vast administrative expanse of China, the real risk is that the reforms will be nibbled to death by hundreds of thousands of bureaucrats.

Delivering capital efficiently. The converse of the imperative to limit bad loans is the necessity to deliver good loans. Here China faces a fundamental structural problem. Until recently, banks lent almost exclusively to SOEs, and the equity and bond markets have been equally focused on the same sector. Stock market listings are difficult and highly political. Foreign banks, which have more skill at lending to smaller borrowers, can take local deposits only up to 35 percent of their foreign exchange deposits and are permitted to operate only in limited experimental zones. But China's economic dynamism has come primarily from private enterprises, town and village enterprises (TVEs), and the small and medium-sized enterprises that banks tend to ignore. The success or failure of China's economic reform program depends on one thing—jobs—and the ability to create new jobs lies entirely outside the SOEs. The 44,000 rural credit cooperatives that once supported the most dynamic job-creating firms are mostly insolvent. So China's dilemma is that its financial institutions have virtually no capability to support the companies that will determine the fate of economic reform and ultimately of the political regime.

The government recognized this problem and took a major step when it revised the constitution to legitimate private enterprise. A second step was to declare formally that the banks should make loans to non-SOEs, form departments for lending to small and medium-sized enterprises, and create new ways of accounting collateral and new forms of guarantees that will facilitate loans to smaller companies. Some of the crippled rural credit cooperatives are being reformed and upgraded into what are called Rural and Urban Collaborative Banks, but there are only a few of them. Officials speak approvingly of Minsheng Bank, owned by the All China Federation of Trade and Industry, which lends exclusively to non-SOEs, but it is very small. The government has decided to allow private enterprises to list shares domestically and abroad, and has pumped up domestic stock markets. Thus far, China does not have a domestic venture capital market, though foreign direct investment funds are always looking for companies to buy. In August 1999 Beijing authorized a large expansion of foreign banks' authority to deal in local currency, potentially a major step because foreign banks have the credit skills that Chinese banks lack. In sum, progress is evident, but still very slow.

Delivering credit to the smaller enterprises also requires real ownership reform. For many years, the most dynamic part of the economy was the TVE sector. But ownership ambiguity has reduced incentives, diffused responsibility, and made for confused relations with financial institutions. Local governments do not want responsibility for the failed TVEs, but they do not want to lose the profits and patronage of the successful ones. The result is a morass. Privatization has occurred in some areas and been helpful, but the central government opposes its expansion.

In South Korea, which until recently had a banking system similar to China's, bank credit went primarily to large, government-favored conglomerates, while smaller, less-favored companies were serviced by informal, largely illegal finance companies collectively known as the "curb market." Although abuses provoked periodic crackdowns and curb market interest rates were high, the smaller companies got their money and real credit skills emerged among the finance companies. In China, similar institutions have long existed, but they are inclined to create destabilizing pyramid schemes. In its caution, Beijing has in recent years cracked down on the curb market just when it is most desperately needed. The future of the Chinese economy depends on Premier Zhu Rongji's efforts to untangle two great, interrelated paradoxes of reform. China must save the banks from collapse by healing their ailing customers, but SOE reform requires laying off multitudes. Hence, the economy must be stimulated to create vast numbers of new jobs. This imperative in turn leads the government to pressure the banks into making new loans that the banks by themselves would reject as too risky. Add to this vicious circle the fact that the entire financial system is geared to support companies that cannot create new jobs and simultaneously lacks the skills to identify winners that can create jobs, and China's squeeze becomes painfully visible.

State Enterprise Reform and Unemployment

The SOEs face multiple crises. They face a crisis of marketization because they were not originally structured to cope with market prices or pressures. They face a crisis of management because government bureaucrats appoint their managers and their incentives are not aligned with market performance. They face a crisis of competition because other SOEs and new private, collective, and foreign enterprises are more efficient. They face a crisis of overcapacity because a half-century of generous financing divorced from market performance has encouraged them to expand capacity with profligacy—as with South Korean *chaebol*. And they face a crisis of finance because their lenders are being put on a market basis and no longer voluntarily lend to most SOEs. Some of these are crises of success. For China to have moved from centuries of extreme scarcity to generalized overcapacity in less than twenty years is an historic triumph. But it nonetheless creates serious problems.

The rapid shift from scarcity to overcapacity is a triumph, but a problematic one.

State enterprise reform has been under way for a long time. The disciplines of market prices were gradually imposed, and competition among the SOEs was gradually increased. For instance, China originally had only one exceptionally bad airline, whereas now it has thirty carriers, mostly of international standard. Thousands of SOEs were sold to foreigners or merged into stronger SOEs. Many jumped into the arms of foreign joint-venture partners, ceding management control and market access in exchange for financial, technological, or marketing infusions. The condition of the state enterprises varies. Power and telecommunications are in decent shape, and oil and petrochemicals went through a successful reform in 1998. But manufacturing in most categories suffers from overcapacity and obsolete technology, while weapons, timber, and coal are in especially bad shape. Airlines, railroads, and refineries vary with the economic cycle. According to the State Statistical Bureau, 42 percent of SOEs showed losses in 1997 and 45 percent in 1998, but the loss-makers were losing less, and in the first quarter of 1999 the profits of the profitable SOEs rebounded to the level of 1997.[3]

In the recent wave of reform, the slogan has been, "Seize the large, release the small." The ideology of public control is maintained by retaining state ownership of the bigger companies, with emphasis on about 1,500 of them. Several hundred thousand others have been delegated to provincial or local governments that sell them off, or strip their assets and let them die. Despite the central government's concern over the process of mass, spontaneous privatization, it appears to be continuing. This is what happened in the early 1980s when the farmers started privatizing their farms, and the reversion of agriculture to family control proved hugely beneficial. To be sure, spontaneous privatization is frequently neither equitable nor legal, but in the long run is probably efficient.

Among the large enterprises, it is difficult to quantify the results, but rapid movement has occurred. There are formal goals for reducing excess personnel and capacity in textiles, coal, and petroleum, and observers believe the programs are nearly on target. Successful reorganizations of oil and petrochemical groups and key steel mills have been completed, and telecommunications is being restructured. In 1999, the government planned to remove 4.5 million spindles from textile production and to close 28,000 coal mines with 250 million tons of capacity. Mergers, reorganizations, and management changes are the primary tools of reform, rather than breakup or bankruptcy. Initially, the government was fascinated with the idea of creating giant, world-scale conglomerates like Korean *chaebol*, but that obsession seems to have dimmed, perhaps because of the condition of the *chaebol*.

One indicator of ongoing reform is that loans to SOEs have declined to about 55 percent of total bank lending, as opposed to 99 percent a few years ago. At the same time, however, most observers agree that the government is so sensitive about adding to unemployment that most obsolete firms remain open. The best indicator of the pace of reform is layoffs. The original estimate was that about 30 million SOE jobs would have to be cut over a three-year period. Through July 1999, about 24.4 million workers had lost their jobs, but almost half of those cuts occurred by the end of 1997, and the government decided to slow the layoffs in 1998. Still, international observers believe that layoffs continue, the best indication that SOE reform is serious. Of the 17 million laid off through 1998, according to official statements, 6 million have not found new jobs and another 6 million are officially registered as unemployed. The picture one gets from these figures is of an unemploy-

[3] China has many accurate statistics and some very unreliable ones. Because of poor accounting practices in enterprises, SOE losses may be the most unreliable of all of them.

ment problem that involves large numbers, but only a small proportion of the population. Even when one doubles the unemployment numbers to include those who have been laid off but are not yet counted as unemployed, the percentage of people out of work relative to the whole workforce is still less than in the United States during the late 1970s and early 1980s.

In fact, the situation is both far better and far worse than such numbers suggest. It is far better because many of the unemployed and laid-off do in fact have gainful employment. Some 10 million workers are receiving six- to twelve-month retraining courses. Many others have "moonlighted" in private-sector jobs that pay more than their "day" jobs did at the SOEs, although it is impossible to pin down how many have benefited from this, because workers fear losing benefits if they report their real status and because opportunities vary widely from one part of China to another. But the proportion of those counted as unemployed who actually have jobs is by no means small. In some parts of the country, there are large concentrations of truly unemployed people. Recent visitors to Shenyang say that each day more than 10,000 people gather daily in the public park looking for work. The fear that has led much of the population to reduce expenditures indicates how real the unemployment problem is. And yet, the testimony of people who have traveled all over China supports the conclusion that people are not yet hungry and desperate. The government has patched together a system that provides what is called the "minimum living wage" (varying by city), training programs, job transfer assistance, and encouragement to look in the tertiary sector, and so far the patchwork is holding. Whenever it appears that the patchwork will not feed people, the government slows down reform. In September 1999 it increased unemployment payments by 30 percent to an average of $26 per month.

China's service sector was suppressed during the era of the planned economy, so liberalization has spawned a huge expansion of service jobs. China has far more waitresses, child-care workers, milk deliverers, and the like than it did a few years ago, and this expansion is absorbing large numbers of laid-off workers. Moreover, these jobs are not necessarily worse or lower paying, particularly for workers who can often keep their housing and some other benefits from their previous positions. The government is also speeding up establishment of a social security system in an attempt to unify the patchwork of measures currently in place. It will allow women to retire from SOEs at the age of forty with full pensions that they will retain even when they find jobs in service industries, as the majority likely will. The government is also simplifying and reducing the legal and financial requirements for setting up private enterprises. Registration in Beijing can now be done in a week rather than months, and an extensive network of retraining centers will seek to facilitate movement of workers from manufacturing industries into services.

Unemployment and Political Risk Assessment

China's workers have not organized a vast, subversive underground, and protests have been rare (relative to China's population) and sporadic. In fact, the protests belie the common Western assumption that they reflect situations where workers have exhausted all means of redress and, in desperation, resort to protest. More commonly, workers react to layoffs by initially staging a demonstration in front of the government offices, only to figure out that the government and their SOE really have no money, whereupon they look for jobs on the open market. In those limited instances where workers are truly desperate or angry, the government buys them off. Premier Zhu has made strong, high-profile warnings that local governments must not use violence to suppress demonstrations. In other words, things are often better than they appear.

But in some respects they are also much worse. Many unemployed women over forty who lack special skills are in desperate circumstances because nobody wants to hire them. Government officials believe that the real number of unemployed—including all those currently labeled as "waiting for work" but omitted from the unemployment statistics—is about 100 million. There are another 250 million farmers who would like to move to the cities—roughly equivalent to the entire population of the United States and more than double the entire U.S. workforce. Thirteen to fifteen million new workers are added each year just through population growth, while according to some estimates the SOEs still need to shed 20 million workers in addition to the 24 million they have already laid off. These numbers inspire fear and awe. What is going on here is so far removed from most of the previous experience of the human race that it is difficult to put it in perspective. How can any reform program succeed in the face of such figures?

An analytical perspective on unemployment. Chinese statistics purport to show that unemployment used to be virtually nonexistent, rose throughout the reform period, and is now low but rising. The reality, in Western terms, is that Chinese unemployment used to be incredibly high and that throughout the reform period it is still high but has probably been falling drastically. To understand this anomaly, one must go back to fundamentals and reinterpret the whole communist period. Mao Zedong's social program is normally characterized as radical Marxist, but in fact it was an effort to return China to a form of peasant feudalism. Farmers were pinned to their villages, largely prevented from moving to other villages or the cities, and were forced to stick to traditional crops. The status of a family was to be determined not by ability or by the market, but by what the status of the parents or grandparents had been. The radical element in this feudal structure derived from Mao's desire that the rich peasants become poor and the poor peasants become rich, but the system itself was reactionary. Urban industrialization merely represented an effort to replicate peasant feudalism inside steel mills and aircraft factories. The state enterprise, like the peasant village, was to provide all services from work to housing, education, medicine, political organization, and marriage counseling; there was no modern differentiation of function. Workers were supposed to stay in the same industry for their whole lifetime, and for the most part sons would follow their fathers into the same mill.

So inconsistent was this model with the reality of rapid economic and demographic change that after thirty years a large proportion of the peasants and workers were no longer adding real economic value. Farmers grew crops for which there was no demand, and workers produced goods that nobody needed. Many workers had almost nothing to do. But the farmer whose inputs cost more than his output was worth officially "had a job," as did the worker who made refrigerators nobody bought. In the West, somebody who had nothing useful to do and was being given a subsistence wage by the state was categorized as unemployed or on welfare. In China, the peasant or worker in that same situation was categorized as employed. Hence, the statistical methods were not inaccurate or dishonest, but based on an entirely different way of thinking.

If we instead employ Western categories, we would have to judge the 90–150 million peasants of the pre-reform era who added almost no marginal value to the economy and drew only subsistence wages to be unemployed. Likewise, the 250 million who now are at subsistence levels and who could move to the cities without greatly affecting agricultural production should be counted as unemployed. There is no way to come up with a precise number, but a reasonable estimate is that perhaps 40 percent of the rural workforce was unemployed under Maoist communism.

The proportion of industrial employees doing no useful work and being given a subsistence wage by the state was just as high. The government speaks of the need to lay off 30 million out of a workforce of 180–210 million, suggesting a rate of "functionally unemployed and on welfare" of at least 15–16 percent, and perhaps much more. When Hong Kong companies buy Chinese companies, it is not unusual for an enterprise quickly to multiply production by five or six times with less than half the original workforce. There is little disagreement that cutting the Chinese central government in half, as has just been done, is more likely to raise than to reduce the effectiveness of the ministries. In other words, the rate of functional urban unemployment has probably also been approximately 40 percent.

As feudal constraints on physical mobility and job mobility have been removed, an enormous flowering of new jobs and useful employment has resulted. The TVEs created more than 100 million jobs in rural areas, and some 90–150 million migratory workers now have useful jobs in the cities. At one time, rural people who moved into the environs of Shanghai were experiencing a fast 700 percent improvement in their standards of living—the consequence of moving from functional unemployment to productive employment. Tens of millions of people who were nominally employed in state enterprises, but in reality were doing nothing useful, put their energies and resources into sideline occupations that added value and moved their families above subsistence level. Functional unemployment has thus surely declined significantly. The remaining feudally organized steel mills and clothing factories, however, eventually cease to function, or find that customers no longer want what they produce. When subjected to competition from more flexible enterprises, they simply collapse. Functional unemployment then turns into nominal unemployment and generates the statistical illusion of rising unemployment.

This development creates two kinds of dangers, neither of which necessarily derives from any rise in the overall level of real unemployment. One is that, in certain areas, pockets of workers could be left unemployed and desperate, generating a critical mass for potential revolt. The second is that the concurrent shifts from feudal security to market insecurity, from rural homes to unfamiliar cities, and from unproductive jobs into productive ones could combine to create such a high level of anxiety that the entire social order becomes vulnerable—even in the context of a general rise in living standards. People can become distraught when life is unpredictable, none of the old rules apply, rule-breakers become winners, and new rules have yet to replace the old. At this point, China appears to be coping well with the potential risk posed by the enclaves of desperate and dissatisfied people. The regime has explained itself and made visible efforts to ameliorate potential sources of discontent, so that ideologies of revolt and antagonism have been slow to develop. When people have rioted, the government has largely been able to buy them off. At the same time, it has been repressive enough to prevent discontented groups around the country from merging into a broad opposition, but not so brutal as to trigger resistance.

Given the rapid reduction of unemployment and rise of living standards over the past twenty years, and given the government's careful prevention of another Tiananmen Square–style confrontation, social anxiety has been expressed benignly in high savings rates and the rapid spread of religions, cults, and self-improvement societies. China is experiencing a renaissance of Buddhism, Christianity, Confucianism, *qi gong*, and much else. The vast Falun Gong and Xiao Gong movements testify to omnipresent insecurity and spiritual emptiness, but their energies are directed towards self-improvement within the context of the existing political and social system, not towards overthrow of the system. If the reforms foundered, or some shock convinced important parts of the population that the government was incompetent or malicious, then these individualized responses to change could rapidly develop into Solidarity-type unions, violent secret societies, warlord-type rejection of central policies, and revolutionary ideologies. None of this is happening today or appears to be in prospect. However, repression of Falun Gong, which ostensibly had more members than the Communist

Party, does risk triggering a political backlash. But continuation of the current stability depends entirely on avoiding massive economic setbacks, projecting a sense of steadily progressing reform, and maintaining the conviction that the government is competent and vigorous. Russia in the decades prior to 1917 was Europe's fastest-growing economy, and France in the decades prior to 1789 was progressing economically and attempting to institute significant reforms, but both foundered when they experienced major setbacks.

One of the most important aspects of Chinese reform and the management of unemployment has been the high-profile effort to create a national pension system. So far, its fruits have been limited. Pension liabilities are large and ambiguous, and each solution creates further problems. The government is trying to consolidate local pension pools into provincial pools, and provincial pools into a single national pool. As this happens, the units tend to make big payouts and greatly expand eligibility, which exacerbates the funding problem even as the government tries to make it better. Likewise, the reform of the SOE sector aiming at a net deficit of zero by the end of the year 2000 will admittedly have to be pushed out another two years. Even so, the goal is ambitious. Current losses are accounted as 1.4 percent of GDP (international observers believe the figure is more likely 3 percent, or $25 billion), which is actually relatively cheap if one regards it as the price of a system that covers all of China's urban workers for unemployment, medical care, education, pensions, and other social services.

Chinese thinking about the state enterprises is divided because younger, more market-oriented thinkers believe that state ownership itself is the core of the problem, while older officials tend to think that the problems have little to do with ownership. The latter, who still dominate government policy, say that it is the imposition on SOEs of social burdens such as education, medical care, pensions, and housing that makes them unprofitable, and that the government stripped their best assets and left only outdated technology behind. Hence, they argue that state enterprises can be profitable and forward looking, like Singapore Airlines, while private enterprises can also be poorly managed and reliant on state support when they get into trouble. Finally, they cite data showing that privatization in Eastern Europe accomplished little by way of improving efficiency. So China's current policy towards the big SOEs is to concentrate on efficient management, improved technology, and reduction of social burdens. Critics of this line of thought argue, on the other hand, that the market would be more ruthless in eliminating poor companies and more generous in rewarding good management, matching managerial incentives with the bottom line.

The debate between the relatively pro-socialist older generation and the relatively pro-market younger one is virtually the same as the debate between the old British Conservative and Labour Parties. But the entire spectrum of the debate has moved in a market direction at perhaps ten times the speed of the British debate. Many of the top forty-year-olds in China's government are well to the right of the Conservative Party before Margaret Thatcher, and most of the key officials under Zhu Rongji are well to the right of Labour before Neil Kinnock on the subject of state enterprises. China's fate hangs not on ideology, but rather on whether the reform program can be sustained and financed through the next three years. At this point, it appears that it can be, but it remains potentially vulnerable to extraneous events such as 1998's great floods, international confrontations over Taiwan or other issues, or weakening of reformist leaders.

Growth and the Sustainability of Reform

Anxiety has risen along with layoffs, with the same consequences as elsewhere in Asia: spending has declined and savings have increased because planned reforms of education and medical care would force families to pay new bills and in fact reduce disposable income by about one-third. Savings may have been further enhanced by the looming prospect that families may have to, or be able to, buy their apartments—for the first time since 1949. As a result, retail consumption has declined from a previous growth rate of well over 20 percent to under 10 percent in 1998 and early 1999. Efforts by the government to prop up spending by encouraging the banks to give generous consumer loans have not as yet been successful. Exports, which had been growing at more than 20 percent annually, declined 7.9 percent in the first quarter of 1999. Declines in local spending and in Asian export markets, the reluctance of banks to lend, and the flood devastation have sharply curtailed Chinese growth.

The TVEs, previously the great engine of employment growth, have suffered as a result of weak consumption, fewer exports, and more competition. Ironically, efforts to upgrade the state enterprises have undermined the TVEs since SOE department-store prices are now close to those of the TVEs. The rural credit cooperatives that funded the TVEs are in more trouble than the big banks, creating a funding problem only enhanced by the government crackdown on informal finance companies. At the same time, foreign investment has begun to decline as euphoria over the size of the market and pace of economic growth has faded and the Asian crisis has reduced the cash available to overseas Chinese investors. China is leveling the playing field that previously gave foreign companies big advantages over domestic ones, but this will not increase foreign investment because, in these uncertain times, foreign commercial banks have simply walked away from China. In the wake of the GITIC bankruptcy, there are virtually no new loans to nonsovereign entities, and project finance is nearly gone. All this has raised the prospect that China might lose its capacity to create new jobs at a time when reforms are laying off tens of millions of workers.

Fear that weak growth and the failure to create new jobs could lead to political unrest has driven the government to insist on the necessity of an 8 percent economic growth rate. In the past, each one percentage-point growth in GDP created 850,000 jobs in agriculture and industry plus another 500,000 tertiary jobs. The government is counting on that, but the new kind of growth will probably not replicate those figures. Growth in 1998 came in at 7.8 percent and in 1999 is officially projected at 7 percent. Such growth, moreover, is being achieved only through massive fiscal stimulus: fixed asset investment and infrastructure spending, mostly in the form of government funds directed to big SOEs for projects in areas such as irrigation, electricity, telecommunications, ports, and rural roads. If the projects are well chosen and well constructed (an optimistic assumption, at best), such growth could be helpful to China's future. But it does not have the same beneficial effects on China's neighbors and it does not generate jobs on the scale of the earlier growth. Thus it is vital to get back to broader-based dynamism, both to ease the fiscal burden and to generate the jobs that can sustain reform.

Although the official fiscal deficit is only 1.7 percent of GDP, the real deficit is some multiple of that. Chinese statistics exclude interest payments from the calculation of the budget deficit, and they exclude all the deficits of China's multiple layers of provincial and local government. No precise data are available, but the most knowledgeable observers estimate the total fiscal stimulus at 8 percent of GDP or more. For now, the huge deficit is bearable. Given the reality of deflation, an expansive deficit will not immediately cause inflation. Nor will it create a debt crisis, since government debt is only about 10 percent of GDP (although inclusion of nonperforming loans would raise this figure to perhaps 45 percent). Compared with, for instance, around 100 percent for Japan, this seems quite modest, but there are limits to how long such deficits can be sustained. Whereas G-7 countries can raise tax revenues to 40 or 50 percent of GDP when necessary, China has difficulty getting much more than 10 percent. For a couple of years, the country's stellar savings rate should make it possible to float bonds and cover the deficit (as required by a 1994 law), but such stimulus cannot continue for many years. Bond issuance has already gone from 4 percent of government revenues to 20 percent between 1993 and 1998. The PBoC has repeatedly reduced interest rates. This helps, but nominal interest rates remain high and real interest rates even higher.

Aside from infrastructure development, China's economic managers, well aware that housing was the backbone of Singapore's success, have bet heavily on creation of a mass housing market. Since the government and SOEs currently control almost all housing, the hope is that a shift to a private housing market will create a great wave of building and furnishing purchases. The State Statistical Bureau says that housing construction has accelerated sufficiently not only to become the fastest-growing form of infrastructure investment, but also to spur growth in the glass and steel industries.

Unfortunately, the overall rate of housing reform has been disappointing, and resentment is growing. Wages just do not pay the cost of new housing for most people. Credit is given to the developers and construction companies for only one year and at very high interest rates, and all sorts of fees are levied for consultation and transportation. These companies are effectively excluded from issuing either stocks or bonds. Most are small in size, high in debt, and low in creditworthiness. They have to build very quickly and usually provide cheap, low-quality flats that excite little demand. Loans to consumers, who would insist on better quality, are now officially encouraged, but still rare. Because interest rates are fixed, it is impossible to securitize mortgage loans. The housing market is highly illiquid because the government and the SOEs still own nearly all of the stock. In addition, government restrictions on the sale of properties slated for privatization have kept the secondary market small, although further liberalization was announced in September 1999. In many cases, ownership is unclear. Senior executives and officials build housing for their companies or ministries and then sell it to themselves or families and friends for a song. On balance, the housing reform is a good idea and may well drive another great wave of Chinese development, but it is unlikely to take off sufficiently fast to ensure the success of the broader economic program.

China's ultimate hope is that households will begin spending and exports will rise. However, while the gradual recovery of China's Asian neighbors may in fact boost PRC exports, the neighbors' ability to produce competing exports will also revive. The fate of reform in China therefore rests with domestic-led growth, which entails a vast strategic shift from an economy driven heavily by foreign trade, investment, and financing to one driven primarily by internal engines. The risks associated with excessive dependence on foreign sources of growth and finance have been underscored by recent events including American anger over the trade deficit with China, the cessation of most foreign bank lending, the 1998 collapse of Asian demand for Chinese goods, and European protectionism. The huge fiscal stimulus necessary to keep the economy going and the concomitant enhancement of China's infrastructure may lay the basis for a future reliance on domestic demand. Significantly, this approach implies neither a return to autarky nor a rejection of the opening to the world that has taken place over the past two decades. Rather, it represents a rebalancing of the kind that the United States and Europe have urged upon Japan (quite unsuccessfully, it must be said) during that same period. If this rebalancing succeeds, then China will have reached more solid ground both in its sources of growth and in its relations with its trading partners.

Can the Reform Be Sustained Politically?

Chinese reform is one of history's most ambitious attempts to reshape a society. So much change is inherently risky at three levels: the top leadership, the implementing bureaucracies, and affected social groups. The prevailing view of Chinese reform from 1979 onward has been that it depended overwhelmingly on one man, initially Deng Xiaoping, now Zhu Rongji. This is partly correct, but mostly wrong.[4] The broad directions of reform have long since become matters of consensus. Every elite family and every social group was harmed, and often seriously, by the madness of the Cultural Revolution (1966–75), while tens of millions of people perished in the earlier Great Leap Forward (1958–61). Conversely, with no exceptions, every social group has benefited from the post-1979 reforms, so there is broad consensus at both the elite and popular levels in favor of their continuation. China has few Soviet-style leftists today, and no significant Maoists.

Moreover, the entire top leadership has acknowledged for about the past five years that failure to address the state enterprise and bank problems would eventually lead China toward a fate similar to what happened to the Soviet Union in 1989. A debate about SOE strategy lasted some four years, but the result was a consensus among leaders on the basic course of reform and the awarding of the premiership to Zhu Rongji with a mandate for radical change. That does not mean the decision is irreversible or that no disagreements exist. But it is clear that the leadership has a shared sense of both the problem's urgency and the direction in which a solution lies. That said, the collective leadership chose Zhu to spearhead reforms because he is uniquely forceful and coherent in implementing the strategy. If he were weakened or sidelined in favor of less-committed reformers, China would not reverse course, but it could lose momentum. And momentum is crucial for getting past the soaring unemployment and institutional upheavals before the money runs out. At this moment, the strategy is still in place and Zhu very much in charge, despite insistence from some quarters that he delegate authority over key institutions. But he and President Jiang Zemin were seriously wounded by Clinton's turnabout on Chinese membership in the World Trade Organization (WTO) and the accidental NATO bombing of the Chinese embassy in Belgrade. Some observers believe there is a slightly perceptible coalescence around Li Peng, now head of the National People's Congress, among bureaucrats upset about WTO concessions, disappointed former military businessmen, and others. Li Peng has been giving speeches denouncing hegemonism, presumably positioning himself as the beneficiary of any backlash against foreigners. But if such a grouping is in gestation it is still immature. Just three days after the peak of demonstrations over the embassy bombing, the leadership reaffirmed its determination to get into the WTO, and during its August 1999 annual retreat at Beidahe the leadership rededicated itself to reform and

With no exceptions, every social group has benefited from the reforms.

[4] See William H. Overholt, "China After Deng Xiaoping," *Foreign Affairs*, May/June 1996, pp. 63–78.

pledged to accelerate SOE reform, housing liberalization, and access for foreign banks, and to increase use of stock markets. The reform movement is still on track.

Another substantial risk, however, is that officials in the ministries and provinces might nibble the reforms to death. The premier's orders have to pass through thousands of hands in order to be implemented. China is the country that, during the Cultural Revolution, invented the concept of "waving the red flag to defeat the red flag"—shouting Mao's slogans while trying to move in the opposite direction. What makes predicting the future difficult in China is the layers of protective coloration that dissidents are capable of donning. All one can say is that, across the board, from the government to the military to the banks, implementation of reform seems to be in the hands of exceptionally capable and enthusiastic people. Certainly, there have been tactical retreats, for instance, the order in the second half of 1998 to slow down SOE layoffs, and market reforms are often implemented with a socialist twist, as in the case of the AMCs. Following the 1999 Beidahe meeting, it also appears that there will be greater delegation of authority, weakening Zhu's direct authority over key institutions. But delegated authority may pass to younger and *more* market-oriented officials.

At the popular level, China's situation is complex. Every major group has benefited from reform, but change is so rapid and potentially disorienting that the Chinese body politic could become vulnerable to anxiety attacks. For the first time, there are large groups which, although they are being provided with subsistence incomes, may see themselves as big losers—particularly SOE employees in certain parts of the northeast and Sichuan. Moreover, modern communications and a relaxation of restrictions on freedom of speech have given dissidents the ability to communicate with large numbers of people over great distances regardless of what the leadership desires. Thus far, no large groups are hungry, and while scattered protests occur, there is no widely accepted dissident ideology, labor union, or political movement. This is because most of the society believes the government is trying its best to help the people and believes it is in fact making progress. That could change in the event of major economic setbacks, but it has not happened yet.

Crucially, the intelligentsia almost uniformly backs the reform program and the premier who is implementing it. Invited to give a centennial lecture at Beijing University in 1998, I was amazed to find the campus full of supporters of Premier Zhu. Normally, Third World university students are hostile to their regimes, and South Korean students have been in usually violent opposition to their governments throughout the twentieth century. For one of the first times in modern history, universities in China today are solidly behind a reform and its leader.

But how much more stress can the system take before reform is hobbled? This is a much harder question to answer than those about financial sustainability. Resistance to change is ubiquitous, as in any society. The arguments that things are going too fast, that the collateral damage is too great, that the principles of the revolution are being betrayed, that Chinese interests are being sold out to foreigners, and that particular groups are being asked to pay too high a price, come from many directions. From abroad, China and its leaders are besieged by pressures, particularly from the United States, for economic and political concessions beyond what any Chinese leader could accept and hope to survive. Zhu's proffered concessions on WTO membership in the spring of 1999 drew particularly vociferous reactions from affected ministries, and the humiliation inflicted by Clinton's reneging on the deal did far more political damage to Zhu than has been publicly acknowledged. The subsequent student response to the accidental bombing of the Chinese embassy in Belgrade (which was *not* primarily orchestrated by the Chinese government) showed how widespread resentment and fear of the United States have become.

On balance, reform remains on track and its defenders deeply entrenched. But the severe damage done to the strongest advocates of rapid domestic reform and international opening by unanticipated problems with the United States shows that there is risk that further unnecessary shocks, either domestic or international, could endanger progress. Taiwan president Lee Teng-hui's "state-to-state" declaration in July 1999 and his August 1999 bid for membership in a regional theater missile defense alliance have enhanced the prospect of serious international conflict and damaged Zhu and Jiang Zemin relative to the hardliners. And at this point in its movement, China cannot afford to pause because, while it might slow down the loss of some jobs, it would also undermine confidence in the leadership's abilities and the wisdom of their goals. Once one has mounted the tiger of reform, the worst one can do is try to dismount prematurely.