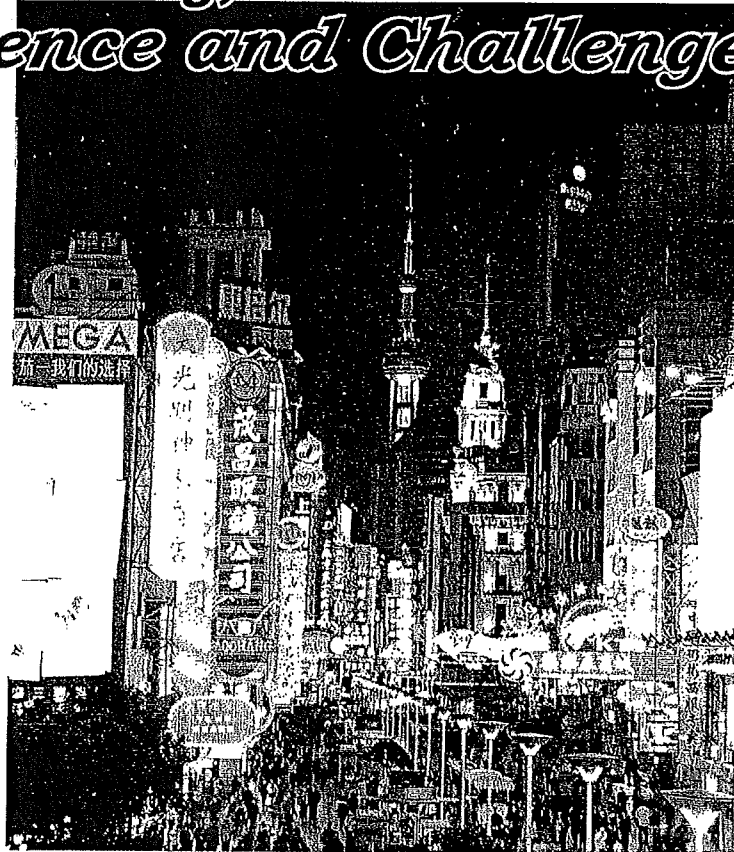


China's Economy, Resilience and Challenge

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Resilience of the Chinese Economy

China's economy has demonstrated extraordinary resilience in the face of a global economic slowdown combined with the SARS tragedy and the stresses of WTO entry. This resilience results from the successful shift to domestic-led growth prior to the global slowdown and from rising productivity caused by economic reform, rising competition, a highly entrepreneurial economic structure, and high levels of foreign direct investment. Overall, the success results from a disciplined and politically courageous process of reform and opening.

Each phase of Chinese growth and reform presents new challenges. The challenge of the initial phase was to open the economy to trade, to revive farm productivity through an orderly transition to family farms, and to move toward market prices. In the early 1990s the principal challenge was to overcome inflation. In the later 1990s the principal

challenge was to get state-owned enterprise (SOE) inefficiency and losses under control. Failure to cope with any of these challenges would have been fatal to China's economic miracle. So far, each challenge has been successfully surmounted. Along the way, major successes have been registered. Growth has been high. Poverty has fallen sharply. Trade has grown rapidly. Foreign direct investment has exceeded all expectations. A dynamic private sector has emerged as a major contributor to growth.

Three recent successes deserve particular mention. First is the shift to domestic-led growth. All of the Asian economic miracles have been driven by exports, and China initially followed this pattern. Japan continues to depend on growth of net exports as virtually its only source of economic growth, despite warnings by foreign economists from the late 1970s onward, and despite official endorsement of the Maekawa Plan in 1986, that only a shift to domestic-led growth could avoid

eventual stagnation. China on the other hand not only accepted the imperative of such a shift but also implemented it decisively, beginning at the end of the last decade. The result has been an economy driven by domestic housing, cars, retail consumption, and infrastructure investment. These founts of domestic growth have permitted economic expansion in excess of 7% even when net export growth has been negative. Indeed, China has grown rapidly in 2003 even though the current account balance for the first half of 2003 appears to have gone negative. Such a rapid shift is a remarkable feat.

The second success has been surmounting the economic challenge of SARS. We do not yet know whether SARS will recur. What we do know is that SARS was vanquished as a short-term threat to the economy and the society in the first half of 2003. That threat was very severe, threatening to curtail tourism, trade, investment, education, and virtually all services that involved face to face contact. We know that small private service businesses suffered severely; these are undercounted in the economy, so the damage was probably far more severe than shows up in the statistics. Despite this, in 2003 industrial production rose 16.7% and exports 34.7%. Retail sales grew 8.9%, almost as fast as 2002's 9%. Utilized foreign investment grew slightly to US\$53.5 billion. In the face of the challenges of SARS, global slowdown, and WTO adjustment, this is a historic success.

On a third major challenge, WTO, the results are preliminary but highly auspicious. While there are innumerable foreign complaints, and many domestic stresses, following from the first year of WTO implementation (2002), the overall balance appears highly favorable. China has proceeded with WTO implementation, and the domestic consensus has held. In a few key sectors where WTO rules were believed to risk devastating problems, the result has been the opposite. Agricultural incomes, instead of declining, seem to have managed a slight bit of growth because farmers shifted to higher value-added crops. The auto industry was supposed to be devastated by WTO; instead, it created a mass market and a big win for all major participants, including consumers, domestic manufacturers, foreign joint ventures, and importers. Vehicle sales expanded by half in 2002. Transportation sector profits rose 71%. Imports increased 77%. General Motors' net income rose 387% to \$350 million. It is not clear yet, at least to this writer, whether these are typical of the overall response of the economy to WTO, but these do show that seemingly insuperable problems can be

overcome. The auto sector successes clearly do provide a template that other pressured industrial sectors can emulate. Demonstrably, globalization can be good even for those sectors where everyone expected it to be troublesome.

On the foreign side, there will be a deluge of detailed complaints about China's WTO implementation and those are about to become much more vocal. That was inevitable because of the vast educational and organizational tasks required for full implementation. There are many disputes ahead, and much diplomacy as well as concrete action will be required. However, there has not been a single major foreign actor asserting that China has strategically ignored its WTO obligations; this in itself is a preliminary success. The ascent of the WTO hill has just begun, but the early signs are auspicious.

Along with the shift to domestic-led growth, other key factors have contributed to China's economic resilience. Competition is one. In recent years, Chinese leaders have been emphasizing competition, breaking up cartels at home and encouraging competition from abroad. Although this emphasis has a long way to go, competition is why, for instance, China at the end of 2002 had over 200 million cell phone subscriptions at very low prices while India had only 10 million at higher prices. One might include under the rubric of competition the imposition of market pressures on state-owned firms. Employment in state and collective enterprises declined by 55 million in five years. China's total manufacturing employment has declined by 25 million in recent years — about ten times the parallel decline that has occurred in the U.S. This creates a vast shift of national resources out of unproductive activity into productive activity and thereby increases the economy's resilience.

A highly entrepreneurial economy also contributes. From the beginning of Chinese reform, entrepreneurship has been not only encouraged but also required. At the local level, Beijing withdrew much of the previous budget support and in return gave local officials and governments the right to start businesses and hold property rights in them. At all levels, officials as well as private citizens became entrepreneurs. Teachers supported their schools and themselves by giving the students chicks and requiring them to raise chickens. Institutes of Marxism-Leninism started business consulting operations. This went too far. For instance, along with distributing Dr. Pepper and marketing Baskin Robbins ice cream, the army became the biggest smuggler in world history, and many recent reforms have sought to bring official entrepreneurship

under control. (The army was largely removed from business.) The entrepreneurial spirit remains, and facilitates rapid adjustment to new conditions. In Beijing, virtually any student returning from abroad with an appropriate post-graduate degree can get a government entrepreneurship grant sufficient to equip an office for 10 people; the many who fail tend to go to work for those who succeed, potentially creating a critical mass of entrepreneurship.

China's globalization makes it vulnerable to global trends, but this has been outweighed by gains in efficiency and ability to adjust. Since China is a low cost producer in many areas, it can often continue to grow even when others get squeezed. More importantly, the process of institutional globalization makes it resilient. China reaches around the world eclectically for best practice, as Japan did in the early Meiji period, remodeling its central bank after the U.S. Fed and its emergency response system after the U.S. FEMA, borrowing securities laws from Hong Kong and the U.S., choosing Taiwan's foreign portfolio investment regulations to be its own, creating huge-scale science parks modeled on Taiwan's Hsinchu with aspects of Silicon Valley thrown in, emulating France's defense procurement system, and adapting rule of law concepts from the West. Above all, China is sending its youth elite abroad for education, primarily in the U.S., to a degree probably unparalleled by any large country since the Romans turned their kids over to the Greeks. The results in China are the same as they were in Meiji Japan: growth and resilience. But globalization has gone further and faster in China than Japan could ever accept.

Daunting Challenges Ahead

As in the past, China's successes are being achieved by reforms that overcome severe challenges. The challenges for China's new leaders are as daunting as those faced by their predecessors.

One immediate challenge is a combination of foreign pressures and domestic problems created by the currency. The G-7 is bringing pressure on China to revalue its currency. In America's Mid-West and South, Japan's Kansai, and Europe's Po Valley, the politics of this issue has become feverish. These foreign pressures are largely based on bad economics. While Japan's deflation is caused overwhelmingly by domestic banking problems and industrial overcapacity, it is more convenient for Japanese political leaders to blame China for their

deflation than to undertake the politically painful banking reforms and corporate closures that would allow banks to lend freely and companies to price their goods profitably. At most 0.1 to 0.2 percentage points out of Japan's estimated 3.2% deflation could conceivably be caused by China. While an RMB revaluation would do little to increase U.S. jobs, it is easier with an election looming in 2004 to blame China than to request union and corporate patience in the face of the inevitably slow recovery from bubble overcapacity and from the inexorable consequences of productivity that grows much faster than GDP. In Europe, it is much easier to blame China than to increase resource mobility and to admit errors in the charter of a central bank that, through excessively high interest rates, is depressing growth and creating inappropriately strong incentives for investment in euros.

Having said that, China has a problem. As a result of massive purchases of dollars to stabilize the currency, the money supply is expanding excessively and the economy is blinking warning lights. First quarter 2003 GDP growth of 9.9% constituted overheating, and that overheating would have become serious had not SARS intervened. By June, foreign exchange reserves had reached \$346.5 billion dollars and M2 money supply was growing at a 20.8% annual rate (monthly figure, year on year), which is only consistent with economic stability if the real economy is growing around 15%. New loans in the first half of 2003 (1.78 trillion RMB) were nearly as large as new loans for all of 2002 (1.85 trillion RMB). Normally, such growth of money supply would create a threat of inflation, but in an economy where overcapacity is prevalent, the prices of goods are unlikely to inflate.

Instead the surplus money is feeding into such things as bank loans for fixed asset investment, which could lead to an explosion of non-performing loans, and into property, which could lead to a classic Asian property bubble. In fact, signs of such a bubble are already apparent in Shanghai, where property prices rose 15% in 2002 and 18% in the first seven months of 2003. Medium quality housing there now costs 5,000 to 7,000 yuan per square meter (US\$600 to \$850). ("New Home prices still on the rise", *Shanghai Daily News*, August 14, 2003) Old single-family houses sell for 20,000 – 50,000 RMB per square meter. ("Old houses now a hot commodity", *Shanghai Daily News*, 19 August 2003) These prices are not yet outlandish, but if they keep rising at current rates they will create serious bubbles. Such bubbles eventually pop, and when they do

economic miracles can suddenly end; that is what happened in Bangkok, Tokyo, Taipei, and Hong Kong. It would be catastrophic if China followed a similar path. In the past, Beijing has suffered sale price declines of 75% and Shanghai has suffered rental price declines of 84%, but as the percentage of the population who own houses becomes high the social and economic costs of such busts become severe.

To avoid such bubbles, China must either revalue its currency, allow large capital outflows, encourage a large flow of imports in order to run a large current account deficit, or use some combination of reserve requirements and higher interest rates to tighten monetary policy. China must choose some combination of these that fits its own national interests, but it must choose. Otherwise the Tokyo-Taipei crisis of 1990 and the Bangkok-Seoul-Jakarta crisis of 1997 – 1998 will be followed several years from now by the Beijing-Shanghai crisis of 2005, 2006 or 2007. For the other Asian miracle economies, such a bust has caused the end of the miracle and engendered a period of political weakness.

The G-7 demarche about the currency reflects the frustrations of societies where slow growth has led to falling profits and massive layoffs and rapid productivity growth in relatively flat economies (most true in the U.S.) leads to even more layoffs. Economic recovery should naturally lead to reduction of such political pressures, but such reduction may not come quickly. Jobs recover more slowly than other economic factors, the recovery is largely confined to the U.S. and spotty even there, and the U.S. is headed into an election year. This is not likely to lead to specific action directed at the currency, both because the currency arguments are intellectually weak and because it is difficult to draft specific measures. It could easily evolve into specific measures directed against China's trade, investment and intellectual property practices; in these areas, the intellectual case is stronger and specific measures are easier to draft. The U.S. policy figures with the most global views are trying to keep the international dialogue focused on the currency issue, because currency dialogues do not endanger the trade liberalization process. For this reason it is actually in China's interest for the currency discussions to drag on for some time, and if China takes dramatic measures to open or encourage imports that will further defer the potential threat of protectionist measures from Japan (the leader on this matter), the U.S., and Europe.

The bubble risk is tightly connected to another

of China's increasingly urgent challenges, namely the banking system. While official statistics calculate non-performing loans (excluding those transferred to asset management companies or AMC's) at about one-quarter of GDP, the IMF estimates them (including those transferred to AMC's but not yet resolved) at one-half to three-quarters of GDP. If bubbles are forming, and if a whole range of new steel mills, car factories, and property developments go sour several years. Hence, the banking squeeze could become unmanageable.

Just as serious, China's economic growth now depends on successful financing of small, medium and private enterprises that the big state banks don't know how to fund. Moreover, banks' inability to enforce legal judgments on debtors who do not pay means that even highly skilled new banks cannot prudently lend to companies that do not have government backing. So the system is unable to perform the basic function of any market-oriented financial system, namely to allocate resources to their most productive uses. In this respect it is discouraging that the corporate bond market is shrinking; it cannot compete with banks that have vast resources to lend despite their problems.

State enterprise reform has hitherto taken priority over financial reform, on the reasonable argument that the banks cannot be fully reformed until their principal customers, the state enterprises (SOEs), have been reformed. While that decision on priorities has been defensible, a great deal of progress has now been made on SOE reform and the banking problem is becoming both a formidable threat to government finances and a formidable barrier to the financing of the companies that provide China's growth. Future historians writing about the accomplishments of China's new leaders are likely to focus heavily one of two stories. (A) The new leaders of 2003 implemented revolutionary reforms of the banking system and far-reaching supportive improvements of the legal process, while taking decisive measures to avoid the emergence of financial bubbles. Their decisiveness avoided a banking meltdown and enabled the nation's resources to be allocated much more efficiently. That carried the Chinese economy to a whole new level of growth and development, and it created the vast number of jobs needed for social stability. Or (B) The new leaders of 2003 continued very gradual banking reforms and mistook the emergence of bubbles as evidence of rapid economic progress; in this way they followed the errors of Japanese, Thai and Korean leaders and endangered China's future economic progress and

political stability.

The South Korean banking transformation since 1998 may be a useful model for China. The South Korean and Chinese banking and corporate systems shared many characteristics. China chose to give priority to enterprise reform over banking reform, South Korea to banking reform over enterprise reform. The two countries have many lessons to share.

China: a Man Chased by a Tiger

Two generations of Chinese leaders have acted decisively to preempt major economic problems, and that record supports optimism that future historians will be telling story (A). But it is always the job of economists to point out the risks, as if those problems were not enough, the coming years are likely to see more of a budget squeeze than China has experienced for some years. China went through a terrible budget squeeze in the early and mid-1990s as it lost large revenues from the SOEs and shifted to a more modern system of tax collection. That shift was marvelously successful, and revenues have risen sharply in both absolute terms and as a share of GDP. However, that great wave of success may now give way to another squeeze — at a much higher level of income and competence.

In recent years the government has benefited from a virtuous circle of rapid economic growth, rapidly improved rates of revenue collection, ability to shift costs off budget to the banking system, and ability to neglect basic social services. In addition, suppressed interest rates and accounting contrivances allowed a budget with an opportunity cost deficit of 8% of GDP (according to IMF calculations) to look like a deficit of only 3% of GDP. This virtuous circle has made budget “miracles” possible, for instance allowing the military budget to grow 17% per year for four years without greatly increasing the military’s share of the total budget.

Of the five components of the virtuous circle, three are dramatically reversing and becoming vicious circles. Shifting the burdens has reached a limit that risks financial and economic instability; state enterprise losses have been shifted from the SOEs to the banks, then from the banks to AMC’s and from AMC’s to the central bank. After this, there is only one place to shift the deficits: back onto the central government budget. Similarly, neglect of the basic social services once provided by the communes and state enterprises now risks a whole series of national crises. The government

faces massive pension, social security, agriculture, environment and medical problems, along with potentially destabilizing social inequality; these will squeeze the budget for decades.

The most dramatic indication of the emergent realities is how SARS revealed that China’s rural medical system, serving 800 million people, had largely evaporated and that this could put the national economy and social stability at risk. Quite aside from SARS, the national death rate from infectious diseases has risen from a little over one percent to two percent in the past three years — primarily due to tuberculosis, Legionnaire’s disease, hepatitis, and other traditional diseases. Although 2% sounds like a small number, this increase is frightening. One further component, the ability to suppress interest rates and understate the cost of transferring budget problems to the banks, cannot be sustained indefinitely in an increasingly marketized economy.

I have not attempted to enumerate all of China’s successes; such an enumeration would have to mention the increase of its trade, the benefits of increasing competition in sectors like telecommunications, rapidly rising technological sophistication, and many others. Nor have I sought to analyze all of China’s major problems; such an analysis would have to look at demographic issues, environmental issues, agricultural consolidation, severe social and regional inequality, and many others. What I have sought to do is to portray the most decisive issues, both the great successes and the great challenges. China is like a man being chased by a tiger. It is very impressive that he runs faster than virtually anyone else in world history; it is also impressive how big the tiger is. The West’s literature on China is divided into two parts: one about how fast the man runs, emphasizing all the growth rates, the other about the tiger, emphasizing the banking, unemployment, inequality, and political problems. Any real understanding, however, must include both the man and the tiger.

Most other economies facing such a big tiger would get eaten. Indonesia, the Philippines, Argentina, and many others have been eaten by far smaller tigers. What distinguishes China is both economic and political. It has chosen a process of gradual reform and opening that has proved economically successful in several Asian countries. And for 24 years it has demonstrated an ability to form a workable leadership consensus regarding the most important problems, to implement solutions in the face of enormous political and social stress, and to overcome the stress by delivering large benefits to most of the Chinese people. Effective

politics has been the key to good economics. As of 2003 China has new leaders, how fast they can pull China ahead is about to be tested by new bubble, banking, and budget tigers. ♦

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