Current State and Future Prospect of the Chinese Economy

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China's transition from a planned economy to a market economy began gradually at the end of 1978. The transition has turned China from a poor, inward looking economy into one of the most dynamic economies and largest trading powers in the world. The average annual growth rate of GDP reached 9.8 percent in 1978-97, while the average annual growth rate of import and export trade reached 15.6 percent. During this period, per capita income quadrupled and household bank savings increased 220 times. Such a rapid economic growth for such a long time in a country as large as China has never occurred in the human history. The achievement is truly an economic miracle. Such a rapid growth has also turned China into a credible economic power in the world.

This rapid growth helped create and was created by a dramatic shift in China's economic structure. First, there was a dramatic shift in the labor force out of agriculture. During the time that China opened more than 120 million individuals moved out of agriculture into industry. China's agricultural population declined from 80 to 70 percent. Within the industrial sector, the dominance of the state owned enterprises was even more dramatically eclipsed by other forms of ownership structures: collective (meaning primarily local township and village level ownership), individual (meaning private ownership), and other (meaning foreign or joint venture ownership). In 1981, some 75 percent of industrial output were produced by the state owned enterprises, but in 1997 they produced only 25 percent of the total output. The growth of the private, foreign and joint venture ownership was even more dramatic. They rose from a negligible presence in the industrial sector in 1981 to producing about 36 percent of industrial output in 1997.

Industrial Output by Ownership										
	Current prices at Billions of RMB					Real Growth (% annually)				
Year	State	Collec -tive	Indivi -dual	Other	Total	State	Collec -tive	Indivi -dual	Other	Total
1981	403.7	132.9	0.2	3.1	539.9	0.7	7.0	129.1	25.2	2.3
1986	697	375	31	16	1119	10.3	18.8	51.8	59.3	15.0
1991	1495	1008	161	160	2824	11.2	15.0	21.2	48.4	14.7
1995	3122	3362	1182	1523	9189	3.8	-6.8	16.3	27.3	4.1
1996	2836	3923	1542	1658	9959	-14.4	10.0	22.9	2.6	2.1
1997	2903	4335	2038	2098	11373	1.5	9.6	31.1	25.5	13.3

Of equal significance are the dramatic decline of the state and the rapid growth of the external sector. Government spending as a percentage of GDP has declined from 23.35 percent in 1981 to 14.42 percent in 1997. The fiscal budget deficit has meanwhile increased from 2.06 percent to 3.34 percent. This is of some concern but is still within manageable proportions. The external sector has grown enormously with exports rising from 7.86 percent of GDP in 1981 to 20.26 percent in 1997. The balance of trade has maintained in recent years a comfortable surplus of 4.5 percent of GDP. This has contributed enormously to the accumulated foreign exchange reserves of China, which is currently estimated to be at US $141.11 billion.

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Government Revenue, Expenditure and Budget Deficit and Export, Imports and Balance of Trade as a Percentage of GDP						
Year	Govt Revenue	Govt Spending	Budget Deficit	Exports	Imports	Balance of Trade
1981	21.29	23.35	2.06	7.86	7.86	0
1986	23.98	26.03	2.05	10.47	14.52	-4.05
1991	16.93	20	3.07	17.69	15.71	1.98
1995	10.11	12.94	2.82	21.24	18.86	2.38
1996	10.42	13.13	2.72	18.5	17	1.5
1997	11.08	14.42	3.34	20.26	15.78	4.47
1998#				22.6	18.11	4.49

Short Term Concerns

At present, one of the issues the world is most concerned with is whether China will devalue its currency in the near future. Ii is feared that if China does then it will lead to further instability in the crisis-hit East Asian economies and result in another round of competitive devaluation in the region. The Chinese government has repeatedly pledged that China will not devalue its currency. The Chinese government's position is credible because China will not gain much economically from devaluation but China may lose a lot politically by doing so.

The dramatic devaluation of East Asian currencies[2] has not reduced China's competitiveness as much as the magnitude of devaluation appears to be because the exports from East Asian economies are mostly products processed from imported components and materials. Statistical figures show that import costs consisted of more than 60 % of their export values. Therefore, the competitiveness gain from devaluation is automatically offset by the increase in import costs for 60 %. The gain is further reduced by an increase in the interest rate. Furthermore, the export oriented firms in the crisis-hit Southeast Asian countries are having difficulty in gaining access to credit because their banking and financial institutions have collapsed. Therefore the advantage of devaluing the RMB to the Chinese firms is limited. This argument is supported by the fact that in the U.S. and European markets, where the Chinese products are competing with products from the crisis-hit countries, China's export has expanded instead of contracted since the crisis started in July 1997.

Foreign Trade (customs statistics)							
	Billions of US$				Growth (% annual)		
Year	Total	Exports	Imports	Balance	Total	Exports	Imports
1996	289.88	151.05	138.83	12.22	3.2	1.5	5.1
1997	325.06	182.70	142.36	40.34	12.1	21.0	2.5
1998#	258.84	148.61	119.06	29.55	4.4	1.2	7.3
Note: #1998 figures are as the end of September							

[2] The range is from 20% in Taiwan and Singapore, 50-60% in Thailand, Malaysia, and South Korea to 80% in Indonesia.

China does incur some costs for committing to exchange rate stability because China cannot use devaluation as a way to promote export. Indeed some of the most important costs are borne by some of the politically powerful state owned enterprises whose products have to compete directly with cheaper imports like steel from Japan and South Korea. Hong Kong as China's middleman *par excellence* to the rest of the world also suffers as profit margins from re-exports is trimmed. But the exchange rate stability commitment gives China a respected leadership position in the financial crisis. Thus when China openly complained about the consequences of the free falling Japanese Yen her voice in such matters was taken very seriously, perhaps for the first time in financial circles. Compared to these political gains, the economic cost for not devaluing is considered to be small by the Chinese leadership. There is no reason to doubt China's determination in this matter.

Furthermore, China has considerable foreign exchange reserves so that there is no reason to believe that there is any balance of payments pressure to devalue its currency. Both the current account and the capital account have registered significant surpluses in recent years. While there is a distinct possibility that the surplus on the capital account is likely to decline in the near term future as the economic prospect of the Asian region dims, it is unlikely to have any important implications for exchange rate stability given the substantial accumulated reserves.

Balance of Payments on the Current and Capital Accounts and Foreign Reserves Billions of US$						
Year	Current Account	Capital Account	Foreign Reserves	Current Account % of GDP	Capital Account % of GDP	Foreign Reserves % of GDP
1982	5.67	0.34	6.99	2.02	0.12	2.5
1986	-7.30	5.94	2.07	-2.47	2.01	0.7
1991	12.00	8.03	21.71	2.95	1.98	5.35
1995	1.62	38.67	73.60	0.23	5.52	10.51
1996	7.24	39.97	105.00	0.89	4.9	12.86
1997	29.72	22.96	139.89	3.29	2.55	15.51
1998#			141.11			21.46

Another short-term issue that has drawn much attention is whether China can achieve the 8 percent growth rate projected for this year. This is an important issue because China has to create about 10 million jobs each year for young people that enter the labor market. In addition, China also has to create additional jobs to accommodate the redundant workers that are laid off from the state-owned enterprises. The surplus workers in the state-owned enterprises are estimated to be as many as 20 million.

In the past, whenever the Chinese government relaxed credit and investment controls, the economy responded immediately with a new round of investment-led rapid growth. The GDP growth rate could easily exceed 10 percent by such an expansionary monetary policy. The Chinese government started to adopt growth-promotion policies in the fall of 1997. The interest rates have been lowered five times since November 1997. However, the economy continued to slow down. The main reason is that the growth of money supply was low at about 16.0 percent in the first 9 months of 1998. It should be noted that at the present early stage of China's economic development, where the economy is rapidly monetizing, money supply growth could be as high as 18-19 percent to sustain an 8 real GDP growth rate. The

GDP growth rate was in fact only 7.2 percent in the first 9 months of 1998. The retailed price index had turned negative since October 1997 and continued to slide down month by month. It reached –3.3 percent in September 1998. The downturn trend may be reversed in the last quarter of this year because the Chinese government has adopted a strong fiscal expansionary policy to stimulate economic growth. With the government's decisive intervention, this year's GDP growth rate may be very close to 8 percent even if it does not reach this preset target.

National Accounts, Money and Inflation						
Year	Current GDP billions of RMB	Real GDP Growth %	Current GDP per-capita RMB	Real GDP Growth per-capita %	M2 Growth %	Retail Price Inflation %
1996	6788.46	9.6	5576	8.4	25.3	6.1
1997	7477.24	8.8	6079	7.6	19.6	0.8
1998#	5443.50	7.2	4403	6.1	16.0	-2.5
Note: #1998 figures are as the end of September (for price inflation as at end of October)						

A more interesting question is why the expansionary monetary policy was not as effectively as it used to be. There are two main reasons. After the investment rush in 1992 to 1996, China has turned from a shortage economy to a surplus economy. In a shortage economy, the demand for almost every commodity exceeded its supply. It was relatively easy to find a good investment project in such an environment. In a surplus economy, the situation is just the opposite. There is oversupply for almost every commodity. The over-capacity is a prevailing problem for most enterprises in the economy. It is hard to find good investment project under the situation. Therefore, even when the government relaxes investment constraints, an investment rush will not occur.

The other reason for the lack of response to the expansionary monetary policy is the hardening of accountability in the banking sector itself. Chinese enterprises, both state-owned and non-state-owned enterprises, rely heavily on bank loans for investments. In the past, government at each level intervened heavily in bank decisions regarding the approval of loans. Bank officials did not have to be responsible for the performance of the loans. The banking sector reform in the recent years has given bank officials more autonomy and, at the same time, more responsibility for ensuring the repayment of loans. Therefore, banks became very cautious in extending credits even though their credit quota limits have been lifted.

The economic growth rate this year will probably be on target at 8 percent. However, over capacity is a problem that has no quick fix. Over capacity will reduce not only the firms' investments but also consumer expenditures. Under an over capacity situation, the firms suffer from low profits and even losses. Therefore, workers are likely to encounter wage cuts and risks of layoff, which lead to a restraint on consumption. The reduction in consumption worsens the situation of over capacity. As such, the economy may suffer from a vicious cycle of "over capacity – reduction in investment and consumption – greater over capacity." Trade growth and fiscal expansion may release the economy from the cycle. Because of the Asian financial crisis, trade is unlikely to experience a rapid growth in the coming one or two years. The only hope for breaking the cycle is the government's fiscal expansion. However, the government's fiscal capacity is quite limited in China. Its ability to continue several years of fiscal expansion is quite doubtful. Therefore, in the coming few years, Chinese economy may struggle with a slightly lower rate of growth than the rate that it used to have.

China's long term growth prospect will have a larger impact on China and the world. Will the current slowdown in growth be a temporary phenomenon or the end to its past super performance? For the long run, there are reasons to be quite optimistic. It is very likely that China can maintain 8 to 10 percent of GDP growth rate for another 20 to 30 years. My optimism is based on the vast technological gap that China has with the rest of the industrialized world.

Technological progress is the single most important factor determining a country's economic growth. For a low-income country, it is possible to take advantage of the gap and achieve technological progress at a very low cost by borrowing technologies from advanced countries. It is because of such a technological gap that enabled Japan and the four Asian Newly Industrialized Economies to achieve dynamic growth through an open world trading system for about 40 years. The technological gap that China faced at the beginning of reform in 1978 was larger than the gap that Japan faced in the early 1950s and the four Asian NIEs faced in the early 1960s.

Like Japan and the four Asian NIEs, China has developed a considerable capacity for trade and attracting foreign direct investments. This would facilitate China's prospect of borrowing technologies and to achieve decades of dynamic growth. Unlike Japan and the four Asian NIEs, China would also have to develop her domestic market as well. If China can realize this potential she will become the largest economy in the world in the next century. It would also enable China to replace Japan and become the engine of growth for East Asian economies.

However, in spite of the overall achievement that China achieved in the past 20 years, the Chinese economy is encountering a series of problems. Each of them, if it worsens, may lead to a sudden breakdown in the economic system and jeopardize China's possibility of realizing her \ potential. The major problems are as follows:

1. The state-owned enterprises currently employed 100 million workers in the urban areas, about two-thirds of the urban labor force, and possess two-thirds of total fixed assets in China. The economic performance of the state-owned sector is extremely poor. More than one-third of the state-owned enterprises has encountered explicit losses. Another one-third of the enterprises has implicit losses. Only a small portion of the state-owned enterprises is profitable. Without the state's subsidies and protection, the majority of the state-owned enterprises may collapse immediately. The subsidies to the state-owned enterprises have drained the government's fiscal resources and limited the government's ability to invest in education and other areas that are important to future growth and stability.

2. The banking sector is extremely weak. It is estimated that about 25 percent of the outstanding loans are non-performing ones, even higher than the figures in Thailand, South Korea and other Asian countries before the financial crisis. China has not liberalized its capital account and has the ability to insulate itself from a possible speculative attack, preventing China from the contagion of recent crisis. However, if the non-performing loans and other banking problems are not sorted out, the prospect of continued economic growth

will be suffocated for a lack of financial support. It might even be possible for depositors to lose confidence in the banking sector as the economy stagnates.

3. The growth in the past 20 years was not shared evenly across regions. The economic development in the hinterland provinces has lagged far behind that of the coastal provinces. As a result, regional disparity is widening after the reform. The disparity may become disrupting social and political issues.

4. Rapid economic growth has endangered China's environmental sustainability. The situation is quite alarming. Recent floods in the lower reach of the Yangtze River and in Northeast China are good examples. If China does not pay enough attention to this issue; the incidences of such natural may become more frequent and costly for economic growth.

Among the above problems, the last one is a common issue for almost all economies in the development process. China can learn from other countries' experiences and need to take decisive measures to deal with it. The other problems are related to the gradual, incremental approach that China adopts to reform its economy. This approach allows the more efficient non-state sectors to grow while maintaining the survival of inefficient state sector by postponing some essential reforms, such as liberalization of financial sector, hardening of state-own enterprises' budget constraints, freeing the labor markets, and so on. It is generally acknowledged that this is a source of strength of China's economic transition in the early stages, but its constraints on future development are being recognized now.

China has completed the leadership transition from Deng Xiaoping to Jiang Zeming. Although how to institutionalize power transition from one generation of leadership to another generation is still a big concern, political stability in China is expected for at least the coming decade and more. Continuing the market-oriented reform is the only way to resolve China's transitional problems while tapping the potential for narrowing its technological gap for its growth. The new generation of China's leadership has the wisdom and ability to continue the reform initiated by Deng Xiaoping twenty years ago. China is therefore likely to maintain its economic momentum, become an engine of growth for East Asia, and provide a growing market for the world in the new millenium.

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