China's Unique Transition[1]

James W. Dean
Professor of Economics
Simon Fraser University
Burnaby, BC, Canada V5A 1S6
Tel +1 604 291 3788
Fax +1 604 291 5944
Email jdean@wwu.edu
and
Kaiser Professor of International Business
Western Washington University
Bellingham, WA 98225-9170
Tel +1 360 650 7288 or 7292
Fax +1 360 650 4844
Email James.Dean@wwu.edu

Chinese Miracle

China's transition from command to market economy has been unique among planned economies of the late 20th century.[2] The economic liberalization that began in 1978 quickly triggered growth that has been sustained for 22 years, much of it at double-digit levels. China's achievement is all the more remarkable given her history for the first three quarters of the century. Until 1949, China was a battleground between feudal warlords; after 1930 she was invaded and occupied by

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[2] Mundell (1999, p. 1) suggests five reasons that China is "…a special case among [the Eurasian] transition economies…": 1. It was able to start more than a decade earlier because it was free from Soviet domination. 2. It "… entered its economic transition as a primarily agricultural economy, starting from a much lower level of economic development…". 3. Its "…transition strategy emphasized reform by sectors -- sequential incrementalism -- rather than gradualism or shock therapy …". 4. Its "… growth strategy focused on … free economic zones, the … international sector, and … foreign investment … ". 5. It kept inflation under control.

Japan; after 1945 she fell into civil war. And for almost three decades after Mao's victory in 1949, Communist rule was dominated by two economically disastrous experiments, the Great Leap Forward and the Cultural Revolution. Who would have predicted in 1978 that two decades later, Beijing would be more prosperous than Moscow?

Russian Debacle

In the mid-1980s another transition process began in the Soviet Union. President Gorbachev introduced *glastnost* (transparency) and *perestroika* (restructuring). In 1990, the process got into high gear as the Communist Party collapsed and the Soviet Union broke up, leaving Russia its most important successor. In contrast to China, economic transition was accompanied by rapid political transition. But Russia's economic transition did not proceed nearly so smoothly as China's. Unlike China's world-record growth, Russia's, for most of the past decade, has been negative.

Why was China's transition seemingly so smooth compared to Russia's? A short answer is that in China there really was no transition: the private sector grew, but the public sector didn't shrink. Crudely put, China's market economy grew from 0% of GDP in 1978 to about 60% by 2000, whereas her state owned enterprises (SOEs) shrank from 100% to 30%.[3] In contrast to Russia, the SOEs did not shrink dramatically in absolute terms, since they neither disbanded nor privatized. Hence the chaos, corruption and capital flight that was connected with rapid privatization in Russia did not occur in China.

The Chinese have also been slow to liberalize their financial sector, both internally and externally. Although a few Western economists recognized early on that financial liberalization in emerging markets should be judicious rather than "big bang" (McKinnon, 1991), conventional wisdom has only recently begun to embrace the wisdom of "sequencing" such reforms (Dean 1999a; Kolodko, 2000).[4] One telling

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[3] To be a little more precise, according to recent official data, the economy is 28% SOEs, and 12% central government. The assertion that the other 60% is "private sector" is an heroic simplification: much of the dramatic growth in China's private sector has been *formally* within public sector categories. It is "hidden" for political reasons, with the collaboration of local officials, in the state and collective sectors (Young, 1998).

[4] Sachs and Woo (1994, 1996), in an effort to defend 'big bang' transition for Eastern Europe and

statistic is that during the 1990s, Russia experienced a massive net outflow of capital, whereas China experienced an inflow second only to the United States.

The contrast between China's miracle and Russia's debacle was one of the most dramatic economic phenomena of the 20th century. It will have enormous implications for the balance of both economic and political power in the 21st century. Within two or three decades, China will probably have the biggest economy in the world, and conceivably the most powerful military as well.

Asian Trauma

Another dramatic economic phenomenon of the late 20th century was East Asia's financial crisis. It began on July 2, 1997, when Thailand lost control of the external value of its currency. The Thai baht went into free fall, and currency crises quickly spread to Malaysia, the Philippines, Indonesia, and finally South Korea, Asia's fourth largest economy and the eleventh largest in the world (Dean, 1998a,b; 1999a; 2000b; 2001b). Like China's miracle and Russia's debacle, the Asia's crisis was utterly unforeseen by almost all experts (Irvine, 1997). For two years economic growth in the world's fastest growing region plummeted. But not in China – her GDP growth rate slowed down by a couple of percentage points (or about 20% of itself), but there was no currency crisis and no sharp contraction of the real economy.

Pangloss or Panic?

The East Asian crisis sparked a Great Debate among economists and others about whether it had been caused by a failure of Asian capitalism or a failure of Western capitalism (Dean 2000b, 2001b). Some said that "Asian crony capitalism" – lending to insiders that went sour – was the cause of the crisis. In contrast to the view through rose-colored lenses that informed Asian enthusiasts of the near past (for example, Fallows, 1994 and Naisbitt, 1996), these observers view the

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Russia, suggest that China's superior transition was due to the relatively small size of China's state sector (defined to exclude communal agriculture). But Benziger (1998) argues that the relatively large size of the state sector in Eastern Europe and Russia is a *prima facie* case against big bang transition, given that the state sector is too inefficient to compete at world prices without extensive restructuring: hence a rapid jump to world prices would result in massive unemployment.

symbiosis between government, industry and finance that is typical of Asian economies through a distinctly dark lens. In the dark view, the typical Asian "Governance Triangle" might better be called a "Triangle of Cronies" (Figure 1).

FIGURE 1

Other observers of the Asian crisis blamed international financial markets – unstable flows of capital from Japan and the West. The most prominent of the commentators, Paul Krugman, after a brief bout with schizophrenia, changed his mind mid-crisis. The early Krugman diagnosis was that Asian capitalism had failed due to government guarantees that encouraged crony capitalism (Krugman 1998a,b). Krugman coined the term "Panglossian expectations" to describe the unrealistic optimism about investment returns that was engendered by government quasi-guarantees. In effect, East Asian financial intermediaries, as well as direct investment vehicles, were said to be subject to severe moral hazard. The post-cathartic Krugman view (Krugman, 1999a,b) was that Asia had been unjustly punished by Western and Japanese financial panic. The original and leading exponent of the "panic" view had been Jeffrey Sachs, who attributed Asia's woes to unstable international capital flows (Radelet and Sachs, 1998).

When introducing the Great Asian Debate to economics students, I find that a standard diagram of investment and saving as functions of the interest rate is a neat expository tool for contrasting the Panglossian and Panic Views. Government guarantees on investment interact with crony capitalism to raise expectations of returns, tilting Asian countries' investment schedules from previous positions at I to new, higher and flatter Panglossian positions, at I_P (Figure 2). Financial liberalization and digital technology has encouraged international capital mobility and tilted Asian savings schedules from S to S_L. Hence equilibrium levels of investment in the 1990s were at $I_{>90}$, as against $I_{<90}$ in previous decades.

FIGURE 2

Panglossian theorists attribute East Asia's over- (and misallocated) investment to the inflated returns depicted by I_P, whereas Panic

theorists attribute it to the excessively liberalized capital flows depicted by S_L. In the Panglossian view, the East Asian crisis ensued when inflated expectations about investment returns failed to materialize: government "guarantees" on both banks and exchange rates proved ephemeral. In the Panic view, the crisis ensued when capital outflows accelerated as the result of the compounding arrears and expectations of default that followed from declining exchange rates and the consequent rising external debt burdens in terms of domestic currencies.

The Panic view is consistent with the Panglossian view to the extent that initial capital outflows (e.g. from Thailand), though not the panic acceleration of such outflows, may have been triggered by the withdrawal of implicit government guarantees (e.g. on banks). But the Panic view suggests that Asia was punished far beyond her sins, whereas the Panglossian view implies that she simply got her just deserts.

Trauma in China?[5]

If East Asia's sins were venal, China's seem mortal. China's brand of Asian capitalism carries cronyism to a higher level – the Chinese Communist Party (CCP). Whereas East Asia's Triangle of Cronies entangles government, private industry and private banks, China's Triangle of Woes (Figure 3) entangles government, State Owned Enterprises (SOEs) and state owned banks. But because China is governed by a party-state, in the sense that the ruling party and the civil service are one and the same[6], and in fact a *monopoly* party-state, in the sense that the Communist party has no competition, China's version of cronyism seems far more sinful than East Asia's. Since government, industry and finance are all controlled by the CPP, China's governance triangle seems to collapse into crony communism, as opposed to the tripartite, albeit symbiotic, relationships of capitalist East Asia. Indeed, China's official rhetoric for her own system is the "socialist market economy", something of an oxymoron to be sure, but

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[5] **This and the next three sections draw on Dean (2000a) and Dean (2001a). For related perspectives on whether China is poised for financial crisis, see Fernald and Babson (1999) and Schlotthauer (1999).**

[6] **For an analysis of implications of the party-state for corruption, see Pei (1999).**

in practice a slogan intended to ensure continued monopoly for the CCP.

FIGURE 3

The most tangible and telling evidence of the extent of Chinese crony governance is this: whereas a significant minority of the banks in East Asia were insolvent before the crisis, virtually all of China's were. They are still insolvent now. How, then, did China avert a crisis in 1997? And can it avert crisis now?

China's Triangle of Woes

China's banks are insolvent because they hold a huge stock of loan claims on the SOEs that will never be repaid. Nevertheless the banks do not close their doors – indeed, they continue to attract new deposits. As long as the Chinese – who are inveterate savers[7] – maintain faith in their banks, the banks will not fail. In fact as long as deposits grow, the banks can continue to channel new loans to the SOEs. And as long as the SOEs get new loans, they can continue to operate, even at a loss.

China's banks are insolvent, but they are not illiquid. They are consistently able to meet net demands for cash. Moreover they are able to meet their cash outflow obligations: they pay salaries to their employees, and they pay interest to their depositors. Where does their cash inflow come from? Some of it comes from interest income on their loans to SOEs. Many SOEs are *not* loss-making; rather, they generate profits and pay interest on their debt.[8] The banks also receive interest on loans to regional, township and "village" enterprises, and of course on loans to profitable private sector enterprises, many of them joint ventures with foreigners. But nowadays a growing fraction of Chinese banks' income comes from interest on government debt.

This brings us to China's central government deficit, represented by D at the top corner of China's Triangle of Woes in Figure 3. China's deficit is tiny by international standards - it was only 1.7% of GDP in

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[7] China's national savings rate hovers around 40%.

[8] Data on the percentage of SOEs that are losing money is unreliable. According to Lardy (1998) the percentage ranged from 11 to 44 percent between 1990 and 1995 (Table 2-3, p. 35).

1996 - simply because government spending is also tiny. Most people are surprised to learn that the central government of the world's largest "communist" country spends only 12% [9] of GDP, a lower percentage than any other country except Nepal! But since 1996, the deficit has grown rapidly.

The main reason that China's deficit has grown is that as GDP growth has slowed down, the government has tried to stimulate it by spending. The slowdown in growth has been both secular and cyclical. Since 1992, when it peaked at (an official rate of) over 14%, China's growth has been declining continuously. In 1999, the official figure was 7.8%, and for the first half of 2000 it was 8.2%.[10] Between 1997 and 1999, aggregate demand declined sharply due to the East Asian crisis: net exports fell, and foreign direct investment, the source of much domestic investment spending, also fell. This multiplied, Keynesian-style, into sharp declines in consumption spending. Meanwhile, the SOEs, which are insulated from commercial pressures, continued to churn out products. The predictable result, by 1998, was general deflation: prices began to fall. That deterred consumption spending still further. The money supply continued to expand, but its spending velocity slowed down: low interest rates were ineffective as a spur to spending because Foreign Direct Investment (FDI) was languishing and in general, private sector investment opportunities were lacking. China found itself in a conventional Keynesian conundrum of deficient aggregate demand.

Not surprisingly, China chose to prime the pump with government spending. Over the past three years, China has undertaken massive, government-financed infrastructure projects, and the fiscal deficit has increased sharply. The deficit has been financed with government bonds, most of them bought by the banks. The interest on these is what keeps Chinese banks alive.

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[9] Total government revenues fell from 31.2% of GDP in 1978 to 10.7% in 1995, and in 1995, the public sector deficit was 1.7% of GDP (Lardy, 1998, pp. 235 and 161). This would put government spending in 1995 at 12.4% of GDP. However the situation is more complicated because of off-budget expenditures.

[10] Most China experts believe that official growth rates are exaggerated by 2 or 3 percentage points; hence the true rates may have been 11% in 1993, declining to 5% in 1999.

In short, the part of China's economy that remains in public hands -- perhaps 40% if it is defined to mean the SOEs plus the central government -- is comprised of a fragile "Triangle of Woes": a growing government deficit, insolvent banks, and unprofitable SOEs. And each corner of the Triangle poses severe dilemmas for the CCP.

The CCP's Three Dilemmas

Though China's Triangle of Woes is certainly fragile, it will probably *not* implode. Consider first the SOEs. For at least ten years, China's leadership has understood full well that the SOEs must be either terminated or made profitable. China has about reached the limits of its first phase of post-transition growth, which involved mobilization of under-employed labor from the countryside and elsewhere into the new private sector. Further mobilization will have to draw from the SOEs. China's true growth rate has now declined to perhaps 5%. Although this may seem high by developed-country standards, it is not enough to keep up with China's growing labor force; unemployment is rising. To sustain higher growth, the loss-making SOEs must go.

The CCP's first dilemma flows from the fact that the SOEs still provide almost two thirds of urban employment. They often provide a form of unemployment insurance by keeping people on the books and paying them a salary during their transition to the private sector. And for many employees, they are the sole source of housing, medical care, pensions and sometimes schooling. In fact the SOEs are still China's primary social safety net. Hence the CCP talks a great deal about "restructuring" the SOEs to render them profitable, but not much about privatizing them.

Over the past three years, the SOE dilemma has become more acute, for two reasons. First, the slowdown in growth, indeed deflation, that accompanied the South East Asian crisis has run up more red ink at the SOEs. And second, China's putative membership in the World Trade Organization (WTO) has set the scene for greatly intensified import competition, and competition from majority-foreign-owned firms. This will squeeze the SOEs further, and force the CCP to accelerate their demise.

The CCP's second dilemma revolves around the banks. Loans to defunct SOEs will have to be written off. But no hint of illiquidity can be tolerated -- otherwise, depositors might pull out, turning the hint into reality. To keep depositor confidence it will be critical to maintain interest payments on government bonds. It is likely that the CCP ensure that this happens.[11] Eventually, Chinese banks may simply outgrow their insolvency as lending to the private sector grows and the share of non-performing loans shrinks.[12]

A related dilemma surrounds the International Trust and Investment Corporations (ITICs). They were originally set up as a centerpiece of the effort to attract foreign investment. But Premier Zhu Rongji's decision to allow the Guangdong ITIC to declare bankruptcy in 1998 backfired; foreign investors were frightened away rather than comforted, and some 240 ITICs are now floundering. In July, 2000, it was announced that the Hainan ITIC would be closed down, as an apparent trial balloon. Zhu's dilemma is between closing more ITICs as a signal that banking reform is underway, and keeping them open in an effort to discourage a "run" of foreign investors.[13]

Perhaps the most difficult trick will be to manage the entry of foreign banks. Under agreements signed with the US and the EU in 1999 and 2000, China must allow foreign banks unrestricted access to domestic loan and deposit business within five years of entry into the WTO. This could be salutary if it forces the Chinese banks to adopt sophisticated risk assessment practices and make profitable loans. But it could also

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[11] Russia's financial crisis of August 1998 was triggered when the government defaulted on such interest payments. Russian banks were implicitly government-subsidized: they were dependent for most of their interest revenue on government bonds. When the Russian government found itself unable to raise enough tax revenue to service its own bonds, it defaulted, leaving the banks in the lurch. This in turn led to widespread losses by depositors, to a freezing up of banks' and Russia's credit lines to the West, and to a collapse in the foreign-currency value of the ruble.

[12] Lardy (1998) is not so sanguine. He states baldly, "…the combination of a rapid buildup of bank credit and a significant deterioration of loan quality is unsustainable…" (p. 193). One reason is that the ratio of incremental bank credit to annual government fiscal revenues is very high, both by historical Chinese and international standards. According to Lardy (p. 195) the ratio in 1995 was about 1.5, as against ratios in industrial countries ranging from 0.15 for the U.S. to 0.55 for the U.K. (though Japan was an outlier at 0.81). China's high ratio is evidence that an unsustainable fraction of government expenditure is being financed via sales of government bonds to the banks.

[13] I am grateful to Nicolas Kaiser, President of Saturna Corporation in Bellingham, WA, for drawing my attention to these events.

prove problematic if the foreign banks cherry-pick the best loan business, pay higher interest rates, and drain deposits from domestic banks. And ready access to foreign banks could prove downright catastrophic if it triggered a run from domestic banks and precipitated their premature demise.

The third dilemma facing the CCP is how to contain the deficit. For the past three years, deficit spending has served to prime the pump of aggregate demand and in the process it has sustained a large number of SOEs, since it is they who are contracted to undertake infrastructure projects. The deficit cannot be allowed to grow because debt service payments are becoming expensive, and also because by providing an easy source of revenue to the banks, it crowds out private lending and discourages private enterprise.

The deficit could be closed by cutting government spending, or by raising taxes. But cutting government spending is not in the cards. As the SOEs are phased out, the CCP will be forced to patch together an expensive social safety net: unemployment insurance, medical care and old age security, for a start. Indeed, work on such a net is already well underway (primarily at the central bank, of all places!). This means that the CCP will have to raise more tax revenue. To do this it will have to exert stronger control over the booming, export-oriented regions along the coast, and over the thriving regional, township and village enterprises elsewhere.

Will China's economy impode from within due to the fragile, dilemma-ridden Triangle of Woes? Unlikely. The CCP has skillfully managed the transition to capitalism for 22 years, and shows every sign of continuing to do so. Loyalty to the party is not only externally enforced by a large security force, it seems to be internalized in the hearts and minds of even the young.[14]

Is China Externally Vulnerable?

[14] In September, 1999 I was invited to be a "foreign judge" at a public speaking contest in Shanghai. Even allowing for the fact that the assigned topic was 'The 50th Anniversary of the People's Republic of China', all speakers, young and old, seemed sincere in their extravagant praise of the CCP and its role in China's economic success.

But although China's economy may be internally stable, what about external threats? After all, many believe that "panic" on international capital markets underlay the crisis in East Asia. A short definition of financial crisis is *a short sharp decline in the prices of financial assets, such as domestic currency and equities*. Throughout the East Asian financial crisis, pundits speculated that the Chinese *yuan* would be devalued. Indeed, doomsayers predicted currency free-fall, as in Thailand, Malaysia, Indonesia and South Korea. But the *yuan* has held firm, at roughly eight to the US dollar, the rate that was fixed in 1994 at the last devaluation, and the stock market did not crash. Whereas the four crisis-country indices fell by between 52% and 96% between June 1997 and March 1998, China's fell by only 11% (Box 1).

BOX 1

A quick and easy index of the severity of a financial crisis is the sum of changes over a short period of time in a country's exchange rate and its stock market prices. Over the severest period of crisis, between June 1997 and March 1998, Indonesia's crisis index measured –96%, South Korea's –69%, Malaysia's –65%, and Thailand's -52%. By contrast, China's crisis index was only –11%, since the *yuan* held firm and the stock market fell by 11%.

There were full-blown crises in East Asia because withdrawals of external, borrowed capital dealt punishing blows, both financial and real. This did not happen in China, for the simple reason that China was not, and is not, vulnerable to sharp withdrawals of external capital. Despite capital inflows during the 1990s that dwarfed those to any other developing country, China did not borrow as heavily relative to its foreign exchange reserves as its crisis-prone neighbors, nor did it borrow in the same form.

For example, even though in 1997 China's external liabilities as a percentage of GDP were (and still are) higher than South Korea's, the bulk of these take the form of direct investment, mostly joint ventures, that are highly illiquid and difficult to withdraw quickly. By contrast, nearly all of Korea's external exposure was in so-called "portfolio" form (mostly bank debt and bonds), some two thirds of it short term: that is, due to be repaid fully within one year. China is not vulnerable to an external capital account crisis because the bulk of its external liabilities are in the form of highly illiquid joint ventures; its remaining

liabilities, which take the form of foreign-held portfolio debt, are a small fraction of its foreign exchange reserves.

Nevertheless, in 1997 China did face a serious problem of capital flight. A significant part of export receipts was being retained abroad: although Chinese foreign exchange controls require all export revenues to be brought home, double invoicing had become endemic. After an emergency conference convened in November 1997 in response to East Asia's proliferating crises, measures were taken to re-enforce foreign exchange controls. By some estimates, remitted export receipts in 1998 virtually doubled as a result. Whatever the precise figures, it would seem that these capital controls played a significant role in curbing capital flight.

Besides capital controls *per se*, China deters capital outflows by restricting the convertibility of the *yuan* into external currency, by enforcing strict limits on borrowing for speculative purposes (eg, borrowing yuan to buy hard currency), and by discouraging the development of a broad or deep forward and futures markets for *yuan*. In short, China, unlike its crisis-prone neighbors, did not dismantle capital controls or currency inconvertibility during the 1990s, and was probably less prone to capital flight and currency speculation as a result. More importantly, China's history of capital controls put severe restrictions on borrowing abroad; hence China did not build up the heavy exposures in short term foreign debt that were typical of the crisis countries, and that made them so vulnerable to non-rollovers when lender sentiment turned against them (Fernald and Babson, 1999).

Is China externally vulnerable now? Scare-mongers suggest that once China permits full currency convertibility and otherwise dismantles its capital controls, capital flight will be endemic. But capital flight via Hong Kong is already available to those who really try; and although outflows are substantial, the net flow of capital is from Hong Kong to the mainland, not the other way around. China's growth rate and investment opportunities continue to be better than in most of the developed world, especially for domestic Chinese who can monitor and control the risks. Why should capital flee?

Even if China were to suffer a bout of capital flight after the removal of controls, it would be well buffered. As of June 2000, its stock of foreign exchange reserves was $158 bn, the second largest in the world (after Japan's), and by far the largest relative to GDP. Its ratio of short term bank debt to reserves is less than 25%, one of East Asia's lowest.[15] And its ratio of FDI to total external liabilities is one of the world's highest. In short, China is *not* externally vulnerable.

China's Transition Challenges

China's extraordinary two decades of double digit growth may be at an end. Eventually, secular slowing of growth is usual – in fact inevitable – for both developing and transition economies. Initially, simple mobilization of under-employed labor and capital can yield extraordinary growth: in developing countries as labor moves from agriculture to industry, and in transition economies as it moves from planned to market enterprise. But as such economies move closer to their production possibility frontiers, the allocation of factor inputs begins to matter more. In short, economies move from a stage of growth where *mobilization matters* to a stage where *allocation matters*.

Once allocation begins to matter, new challenges emerge. For China, these challenges have been evident for virtually a decade. After a visit to China in 1992, I identified the following "Five Challenges for China in the 1990s" (Dean, 1995). It is instructive to re-visit them now, eight years later.

Challenge # 1*: *"… accelerating … movement toward the free market, internally and externally, sufficiently to be admitted to the GATT …"

To become a founding member of the WTO, China needed to conclude its General Agreement on Trade and Tariffs (GATT) membership negotiations before the end of 1994. But during the second half of the Uruguay Round multilateral trade negotiations, it became clear that new issues surrounding services, investment and intellectual property rights had raised the admission bar to the WTO (which replaced the GATT in 1995) (Wenguo, 1999). It was not until mid-1999 that China

[15] In 1996, just before the East Asian crisis, the ratios of short term bank debt to reserves for Indonesia, South Korea, Thailand and Malaysia were 150%, 83%, 51% and 38% respectively (Fernald and Babson, 1999, Table 1).

was able to satisfy US demands for WTO admission, and mid-2000 that it was able to satisfy the EU.

Challenge #2: " … accelerating movement toward efficiency, but with minimal unemployment …"

In 2000, this challenge remains near the top of China's economic agenda.

Challenge #3 Raising tax revenue

In reducing the role of state enterprise, minimizing unemployment is not the only challenge. So also is replacing the SOEs as a source of government revenue. In 1988, about one half of government revenues came directly from enterprise income. Now, much less does. Government revenues declined from 35% of GNP in 1978 to only 18% by 1991, albeit largely because GNP grew. But government expenditure has exceeded government revenue in every year except one since 1979.

In short, the central government's funding is tenuous. The bulk of it comes from taxes on regional and local enterprise, but regional fiscal finance is fickle. China's regional governments compete vigorously for tax revenues. One of the most perverse results is proliferating regional protectionism. China's natural geographic barriers to internal trade, given her underdeveloped highways and railroads, are compounded by tariff and nontariff barriers, and competing subsidies created by regional governments. This leads to uneconomic scales of production: for example, China produces literally hundreds of brands of cigarettes.

Challenge #4: "… channeling the cash savings of ordinary people into productive investment…"

This means developing a much more extensive banking system, diverse financial instruments, and markets for them. Large-scale entry of foreign banks and other financial institutions promises to be one of the most important benefits of WTO membership.

China's commercial banking system is chopped up between the sectors it serves: construction, agriculture, regional development and so on.[16]

[16] See Lardy (1998, Table A-1 page 224) for a breakdown of the assets of Chinese financial institutions by asset size.

Moreover, each sector and region is typically served by just one monopoly bank. What is needed is competition, both within sectors and between sectors. And regional banks should be encouraged to open branches outside their home bases, both for gathering deposits and for making loans.

Challenge #5: " … making the yuan convertible without triggering capital flight …"

China will be under intense pressure to create capital account convertibility as a condition for joining the WTO. A necessary condition to avoid capital flight is that convertibility be firmly and widely believed by Chinese residents to be permanent. Otherwise, there will be a rush to convert to foreign exchange while the window is open.

A second condition that would greatly reduce the risk of convertibility would be wide and easy availability of domestic financial instruments. China is palpably a good place to invest -- with the highest sustained growth rate in the world, it has to be -- but the absence of financial instruments blocks access to investment opportunities for the sophisticated saver.[17] Thus even if the yuan were believed to be permanently "hard", Chinese citizens might well choose to invest abroad simply because of the paucity of financial choices at home.

Capital account convertibility will mean that foreign investment -- both direct and portfolio -- will be much easier to attract without the need to create special -- and corruptible -- windows for interest, dividends and profits to be paid out to foreign investors. Moreover, foreign portfolio investors will have assurance that their principal can ultimately be converted back to foreign currency, assurance which is always less than fully credible in the absence of general convertibility.

Finally, the flow of investment is by no means one way. Increasingly, China is establishing beach-head investment abroad -- partly to establish showcases for Chinese products, partly to secure access to raw materials, and partly to garner experience with multinational

[17] At the end of 1996, some 77% of Chinese household financial assets were held as savings deposits, but only 12% as cash, 6% as government bonds, 5% as equity and less than 1% as enterprise bonds (Lardy, 1998, p. 132, Table 4-1).

enterprise. Complete convertibility of the yuan will make China's overseas investment much simpler by freeing it from the constraints surrounding allocation of foreign exchange.

Many more transition challenges will face China in 2000 and beyond - I have simply listed five. I have not, for example, discussed price reform -- the fact that key inputs and ouputs are still sold at prices that are fixed by the state at well below market values. These prices apply largely to raw materials, to grain and rice, and to energy prices, notably coal and oil. Fixed prices are rapidly being phased out. Nevertheless, key prices are still far below world levels. For example, gasoline is cheap. China uses more energy relative to its GDP than any country in the world. This is wasteful, short sighted and dangerous to the environment.

But by and large, the challenges for China are greatly outweighed by the opportunities she faces. She faces the opportunity to move wholeheartedly to a market economy with dramatic improvements in her standard of living -- improvements that have been underway for 22 years and show no sign of abating. But she also faces the opportunity to establish a market economy without the worst ravages of capitalism in its embryonic phases -- without the cycles of unemployment and inflation that plagued Europe and America in the early stages of their development, that have plagued so many developing economies in modern times, and that threaten Eastern Europe and the former Soviet Union today. China has the opportunity to direct development to outlying and rural areas rather than create seething cities with sordid slums. She also has the space and size to protect her natural environment despite a huge population. She has managed to control population growth, and to mitigate investment to cities, although not without costs to individual freedoms. These are challenges that only China can confront, and we wish her well.

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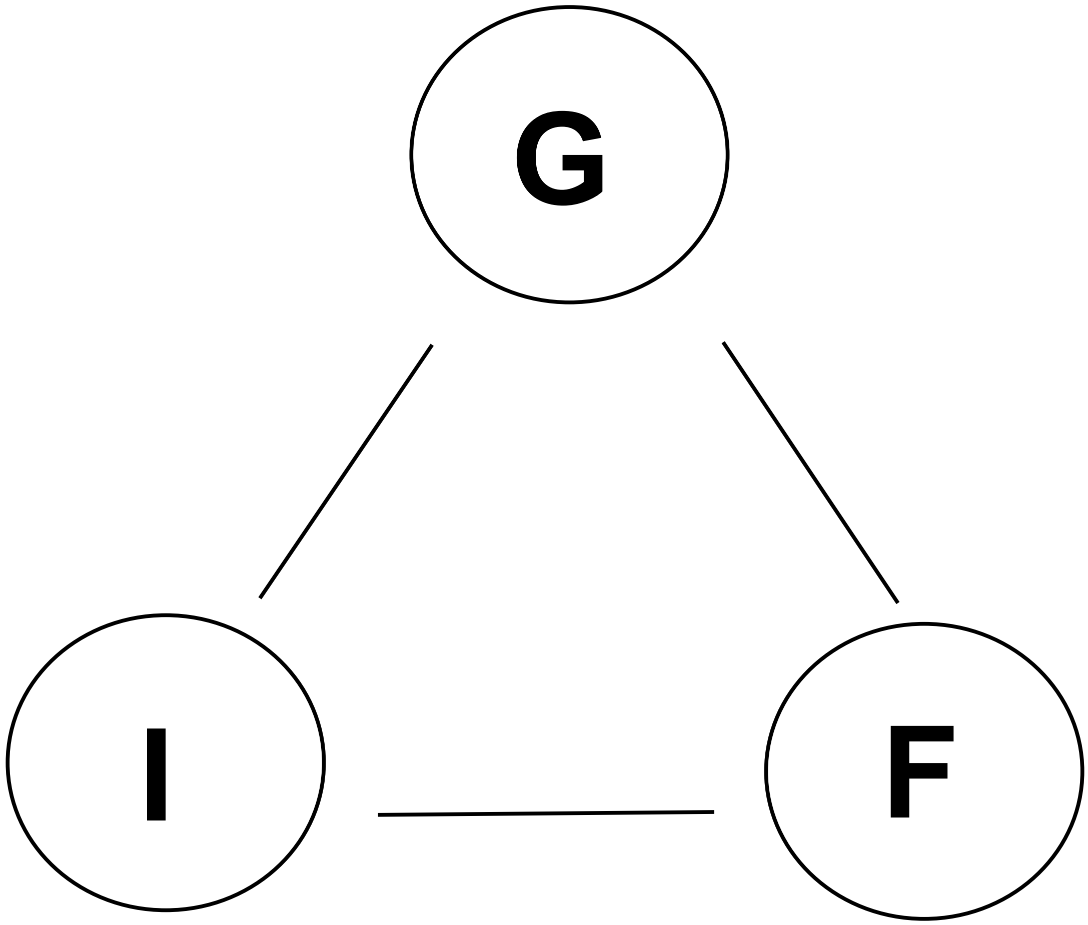
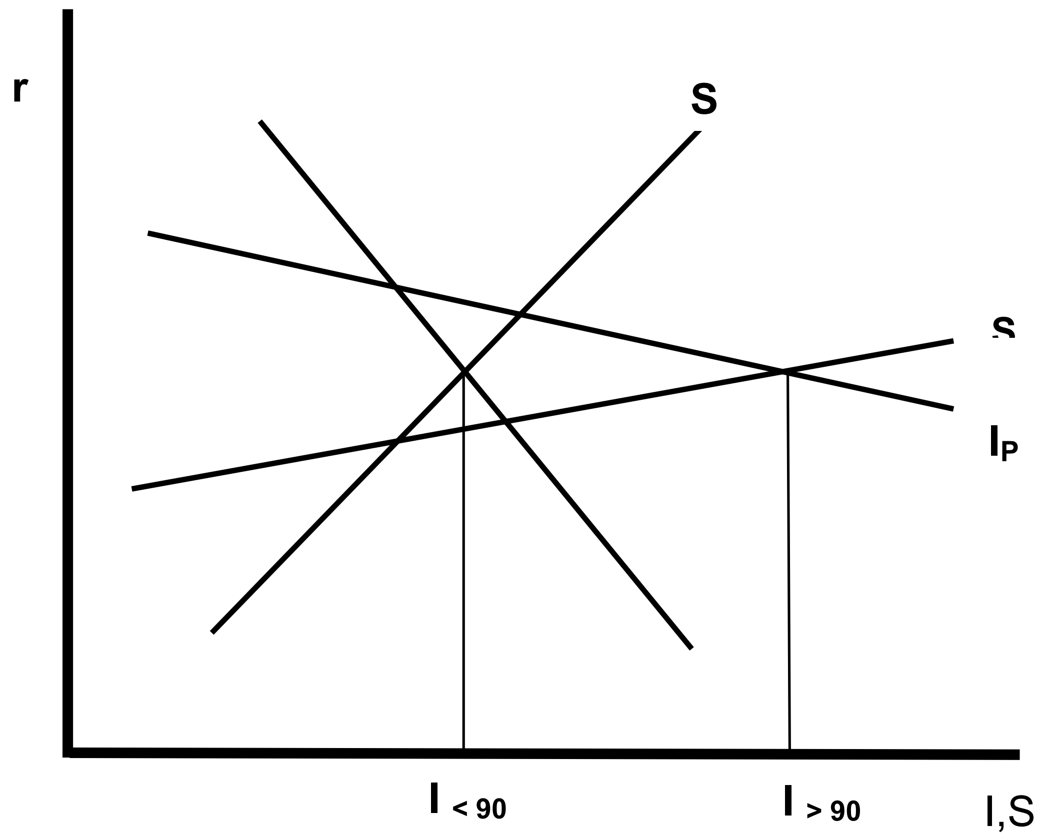
FIGURE 1
The East Asian Governance Triangle
Known to some as "The Triangle of Cronies"



G: Government
I: Industry
F: Finance

FIGURE 2

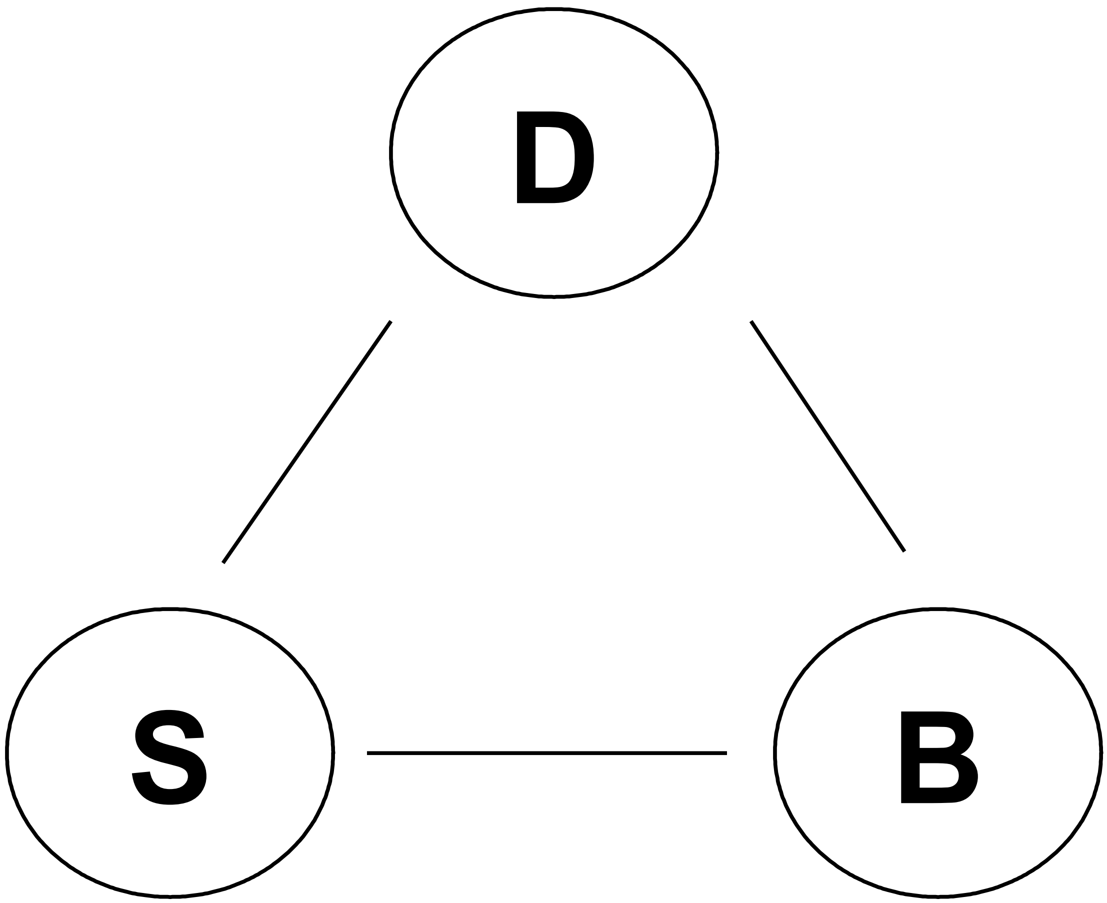
Asian "Over-Investment" in the 1990s



r: Interest rate
I: Investment schedule
I_P: "Panglossian" investment schedule
S: Savings schedule
S_L: Savings plus capital inflows
$I_{<90}$: Equilibrium investment before 1990
$I_{>90}$: Equilibrium investment after 1990

FIGURE 3

China's Triangle of Woes



D: Government budget deficit
B: Banks
S: State owned enterprises

D + (borrowing by S) = Public sector deficit