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China into the World Economic System

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Introduction

China in 1978 embarked on a major economic transformation, seeking to alter the stance of the previous 30 years and engage economically with the rest of the world in several dimensions -- trade, foreign direct investment by private firms, external borrowing by government from both private and public sources, education. Each of these represented a major change in policy. The transformation in the intervening 22 years has been dramatic and palpable, as can be seen in the sky-lines of the major cities. On official figures, agricultural output has grown by a factor in excess of 2.5 from 1978 to 1998, and industrial output by more than a factor of 9. The service sector, discouraged under central planning, increased eight-fold. Exports during this period grew from \$10 billion to \$184 billion in 1998, making China now the world's ninth largest trading country (just ahead of Belgium). The current account was roughly in balance over most of the last 20 years (although in surplus since the currency consolidation and anti-inflation program of 1994), but thanks to large inward foreign investment foreign exchange reserves have grown to \$156 billion, second

largest in the world after Japan. China experienced various bouts of inflation, followed by policy constriction; prices during the past year declined by 3 percent, exceptional for a developing country.

China is unquestionably on the move. Until 1998 we heard regularly about double-digit growth rates, one-fifth of mankind, and the prospect that China will be the world's largest national economy by 2020.

It is desirable first to put China's economy in global perspective. One-fifth of mankind, true. But very poor. Much less poor, on average, than 20 years ago, and growing numbers of Chinese are now actually rich; but China remains poor by world standards, with per capita income at \$750 in 1998 only about one-seventh of the world average calculated by the World Bank at \$4890, ranking 149 out of over 200 countries. The result is a GDP at market prices and exchange rates in 1998 of \$929 billion, larger than Brazil (at \$758 billion) and Canada (612), but still smaller than Britain (1264) and Italy (1166), and just 12 percent of the United States (7921).

Per capita income is sometimes calculated on a "purchasing power parity" basis, e.g., by evaluating Chinese output at international prices. This method is preferable for cross-country comparisons of economic well-being of individuals and families. On this basis, China's per capita income in 1998 was \$3220, about 11 percent of US per capita income, and just over half (52%) the world average of \$6200.

The recent World Bank calculation of Chinese GDP on a ppp basis for 1998 is \$3984 billion, behind the USA at \$7921 billion, but ahead of Japan at \$2928 billion. For geo-political purposes or impact on the world economy, however, the lower figure based on market exchange rates is much more appropriate. The World Bank has not done the world a service by projecting China's GDP in ppp terms, for that is not relevant for most of the issues that concern the rest of the world. We have learned from the experience of central and east European countries that ppp figures can be deeply misleading, for they concealed a lower quality of product that could not sell readily on the world market and were generally inferior to their western comparators.

There are, moreover, several reasons for believing that official Chinese figures exaggerate China's rate of growth since 1978. China's official figures probably under-estimate Chinese production in 1978; the figures have improved since then, thus raising the measured growth rate. Moreover, China's method for calculating inflation under-estimates inflation, and thereby over-estimates the growth in real output. One careful re-calculation suggests that China's 1978-1995 annual growth in GDP was 7.5 percent rather than the official 9.9 percent, with a corresponding drop in the growth in per capita income to 6.0 percent (Maddison, 1998, p.160). Even the revised figures register an impressive performance -- China has unquestionably been doing well -- but substantially less well than the figures usually

cited.

Future Prospects

But what of the future? At a plausible but still outstanding annual growth of 8 percent (higher than the 6.5 percent projected by the World Bank in its recent report on China in 2020, to allow for an increase in the real exchange rate in converting China's GDP into dollars), China's GDP would reach \$3.3 trillion (in 1995 dollars) in 2015, or about 27 percent of US GDP in that year, and roughly equal to US GDP in 1966. It would be larger than France, but still smaller than Germany and Japan. Chinese per capita income would increase by a factor of 3.7, making Chinese much richer than now, but still poor by world standards. Under these circumstances, China's population will be vastly different from today, with greatly different attitudes, especially among the youth. The high GDP would put the Chinese central government in a position, if it can tax effectively, to be a major player on the world scene, in armaments, trade, and foreign aid, just as the USA was in the mid-1960s.

China will have to overcome many hurdles to sustain a growth rate of 8 percent over the next 20 years. First, it will require extensive investment in infrastructure, already under strain: ports, inland transport, power, telecommunications, agriculture (including water), urban housing and sewage.

Second, there will be a vast increase in demand for primary energy. Coal can serve the requirements for electric power, but only at the expense of extensive local air pollution, which is becoming a health problem in urban areas and will also (through ozone production) reduce agricultural yields. Demand for oil will outrun domestically produced oil, resulting in a substantial growth in imports, with their own infrastructure requirements. On International Energy Agency estimates China will import 3 million barrels a day by 2010, worth about \$21 billion a year at a price of \$20/bbl; on US Department of Energy projections, China will import 5 million barrels a day by 2015, worth about \$46 billion a year at \$25/bbl.

Growing population and growing per capita income lead to increased demand for food and particularly for staple grains and feed grains as meat consumption grows. China's policy favoring near self-sufficiency in grains will require substantial increases in investment in agriculture, both research for improved seeds and increased irrigation to improve yields and open new lands. Absent such investments, imports of grains must also increase substantially if China is to sustain a high rate of growth.

Increased import demand for oil and grains, as well as for capital goods, will require continuing increases in exports, mainly of light manufactured goods. Export growth from China has been especially noteworthy during the past two decades, at 14 percent a year, although

1998-99 saw a sharp slowdown due to the Asian financial crises. China recently passed Belgium to become the ninth largest exporting country in the world. But it still exports less than the Netherlands, and less than South Korea and Taiwan taken together.

All this is to say that China, while large and growing, is not indigestible as far as the global economy is concerned. China will both create and seek markets on a significant scale. But the process can be a smooth one, provided that China's practices in selling, buying, and borrowing do not deviate too radically from prevailing practices in the world economy. In particular, it should

a) eschew exploiting its potential monopoly or monopsony power in world commodity markets, i.e. enterprises should be given discretion in timing purchases and sales, rather than having them centrally coordinated;

b) avoid subsidization of exports, either directly or indirectly, with budgetary funds or significant tax breaks or cheap credit;

c) avoid discriminatory restrictions on imports;

d) respect financial and commercial contracts, even when they seem to have been unwise or costly after the fact.

The world economy is tolerant of wide diversity, but it functions well only when its basic rules regarding government's role in commerce are respected -- especially by large and hence visible players.

Current account convertibility of the yuan, declared in 1996, was

welcomed, but as we learned in the 1950s it will be a sham unless any Chinese resident is permitted to import goods and services without restrictive import licenses. The same can be said for the recently announced reduction in import tariffs -- desirable, but not liberalizing so long as import licenses are required.

WTO Membership

China has been a member of the International Monetary Fund and the World Bank family since 1980, and of the Asian Development Bank since 1986. It joined the Bank for International Settlements in 1997.

In 1986 China applied for acceptance as a Contracting Party to the General Agreement on Tariffs and Trade, since absorbed into the World Trade Organization (WTO). Following a major change in China's negotiating position in early 1999, China reached agreement with the United States in November on conditions of entry into WTO and on liberalization of China's market with respect to goods and services of special interest to the United States. Negotiations continue with the European Union and some other members of WTO.

The agreement with the United States has far-reaching implications for China's economy. It involved not only taking on the formal obligations of the WTO once accession occurs, but also substantial opening of China's markets in areas of significant interest to the

United States. European Union spokesmen have said that the US-China agreement covers 80 percent of EU interests, but it will want further market access for goods and services of special interest to European exporters.

China agreed with the United States that it would cut tariffs substantially, from an average of 24.6 percent in 1997 to 9.4 percent by 2005 on industrial goods, and from 31.5 percent to 14.5 percent by 2004 on agricultural products. Agricultural export subsidies will be eliminated. Auto tariffs will decline from 80-100 percent at present to 25 percent, auto parts to 10 percent. Telecommunications products will enter duty-free, down from average tariffs of 13 percent in 1997. Quantitative restrictions on imports must be phased out by 2005, and the monopoly of state-trading organizations eliminated, permitting direct importation by foreign firms for local sale, including bulk agricultural products. Qualified rights of establishment are to be extended, over a five year period, to foreign firms in wholesale and retail distribution, banking, insurance, securities brokerage and fund management, telecommunications, hotels and travel services, and some professional services.

Under the WTO rules, many subsidies must be eliminated, and state-owned enterprises must be put on a commercial basis. State ownership per se is not challenged, but SOE purchases and sales must be based solely on commercial considerations (i.e. without political

intervention).

(In exchange for all this, the United States agreed to extend "normal trade relations" to China, that is, put most-favored-nation treatment on a permanent basis, rather than year-to-year as at present. With respect to Chinese access to the US market, China agreed to the US use of selective safeguards against surges of imports for up to 12 years, continued treatment of China as a non-market economy for purposes of evaluating dumping charges for up to 15 years, and extension of the 1997 US-China textile agreement through 2008, four years beyond the expiration of the Multi-Fiber Agreement agreed in the Uruguay Round.)

The bottom line for China will be substantially less protection against imports, greater internal competition, and fewer channels for supporting favored firms. These adjustments will not be easy. State-owned enterprises still account for about a third of China's industrial output, and much more of its industrial employment. They are heavily burdened with social obligations to their employees and former employees. It is reported that many of them are extremely inefficient and cannot survive competition with imports, even under a regime of moderately protective import duties. Much labor must be shed from existing SOEs, and it can be absorbed only by rapid growth of the non-state sector and by successful SOEs.¹ Moreover, SOEs are heavily indebted to the banking system, with loans that are still carried as

bank assets but in fact probably can never be repaid. Thus China faces the need for major industrial rationalization as it opens its markets extensively, and it must also re-capitalize the banking system. These are not easy tasks for any country, and will at some point put major strains on public budgets. At some point China also will probably need to allow the yuan to depreciate, which of course will mitigate the increase in import competition and stimulate potential exports.

Taken altogether, a serious approach to WTO membership implies a major change in the way business is done in China, shifting to clear, explicit rules and regulations from personal connections (guanxi) and political influence, to operate throughout China after five years. They imply that China will become a free trade area for the first time (at least for foreign goods and services), with a corresponding diminution of the influence of local and provincial political figures in commercial activities. Chinese must learn the distinction, not now made in Chinese terminology, between "rule by law" and "rule of law," the former allowing but the latter proscribing ex post facto legislation. Such an extensive societal change is not likely to be achieved in so short a period of time. Hence it is reasonable to predict that there will be many disputes between China and its trading partners in the coming five to ten years, with the central government and the court system often having to mediate between foreign firms and local authorities.

Recent Situation in China

China's recorded rate of growth has declined in each of the years since 1992, from an exuberant 14 percent in 1992 to a "mere" 7 percent in 1999. Some of the decline from the boom years of the early 1990s was desired, and indeed resulted from the anti-inflation program of 1994-95; but growth in the past two years has been lower than official aspirations.

The decline reflected partly the Asian financial/economic crises of 1997-98, which contributed to a sharp slowdown in the growth of China's exports as well as to a decline in inward foreign investment, especially from Korea. Exports hardly grew at all during 1998 (and actually declined by 4.6 percent in the first half of 1999), compared with a growth of 21 percent in 1997. Similarly, inward foreign direct investment failed to grow in 1998, and declined 9 percent in the first half of 1999 (data from People's Bank of China Statistical Bulletin for 1999-4).

China itself did not experience a financial crisis in 1997-98. Its circumstances differed substantially from those of the crisis countries in four significant respects: it was running a current account surplus rather than a deficit, so it was not dependent on continuing net inflows of capital to finance a deficit (with the result, of course, that funds continued to flow into China); it had large foreign exchange reserves; its inflows of short-term (inter-bank

and other) funds were a relatively small part of the total inflow of capital, and outstanding short-term interbank debt (\$90 billion gross at the end of 1997; \$24 billion net of interbank claims) was well below reserves; and it maintained (and subsequently tightened) controls on outflows of resident capital.

The economic slowdown in 1998 also reflected the beginning of reforms of the Chinese (state-owned) commercial banking system, with introduction of stiff guidelines for bank officials to make only profitable loans, and thus to cut back on more-or-less automatic credits to state-owned enterprises, regardless of their profitability. Fewer bank credits, plus slower growth, have limited business fixed investment, whose growth was 8.3 percent in 12 months ending September 1999, down from 19.6 percent in the preceding year.

Finally, consumers seem to have become somewhat more cautious in their spending. Disposable cash income rose 6.1 percent in the 12 months through September 1999 (7 percent in urban households, 3 percent in rural areas), while retail sales increased only 5.3 percent during the same period, implying a modest increase in (already high) household saving rates. This would also dampen the rate of growth.

The slowdown has led to excess supply of many domestic goods, and to a decline in prices of consumer goods as well as industrial raw materials. Thus consumer spending was stronger in real terms than in nominal terms, as consumers enjoyed a decline in prices on the order of

three percent.

In response to the slowdown, Chinese authorities in 1998 and again in 1999 introduced stimulative fiscal packages, financed by the sale of bonds and to be devoted mainly to improving infra-structure. Not surprisingly, most of the bonds were purchased by financial institutions; remarkably, however, over a quarter of them were purchased by the household sector, even at 10-year interest rates as low as 3.3 percent. Interest rates for both depositors and borrowers were also lowered steadily from early 1998, for example from 5.7 percent to 2.2 percent on one year time deposits, to encourage greater consumption, and from 9.9 percent to 6.0 percent on three-to-five year bank loans. In addition, a withholding tax was introduced on interest earnings in 1999, on the (mistaken) assumption that that would stimulate greater consumption.

Growth seems to be picking up in China in early 2000. Exports resumed their rapid growth in the second half of 1999, thanks in part to recovery in other Asian economies, perhaps in part also to an increase in tax rebates on exports. The fiscal stimulus has helped raise total demand and sustain disposable income, although consumption spending remains lack-luster. Private economists foresee GDP growth of 7.4 percent in 2000, and a decline of the current account surplus from 1.4 to 1.0 percent of GDP, as imports are expected to rise more rapidly than exports (Economist, January 22, 2000, p.106).

With the depreciations of several other East Asian currencies, the sharp decline in rate of growth of exports, and sharper import competition in some sectors, domestic pressure has been put on the Chinese authorities to devalue the yuan, which has been held unchanged at 8.3 yuan per US dollar since the currency consolidation and depreciation in 1994. Devaluation of the yuan, ceteris paribus, would increase net exports and stimulate demand in China. It would, however, violate the rules of the International Monetary Fund, of which China has been a member since 1980, which enjoins members from manipulating their currencies at the expense of their trading partners for purposes of stimulating domestic growth. Despite the slowdown in export growth and inward investment, China has maintained a current account surplus during the late 1990s, and indeed has continued to build its foreign exchange reserves (by \$8 billion during 1999, to a total of \$156 billion), which implies that if left to market forces the yuan would have appreciated during this period, not depreciated. A depreciation of the yuan would undoubtedly have riled financial markets, put downward pressure on the Hong Kong dollar, and possibly induced other countries to depreciate their currencies, thus violating the ceteris paribus assumption. Within the current international framework, there is no case for devaluation of the yuan, and the Chinese authorities have properly relied on monetary and fiscal policy to stimulate domestic demand. As China gradually liberalizes its import

restrictions, as agreed in the WTO accession negotiations, this judgment may change, and indeed the Chinese authorities should loosen the rigid link to the US dollar to allow for the possibility that the yuan should depreciate somewhat over the next five years. One way to do this without disturbing financial markets would be to choose a moment to loosen the link to the dollar when market pressures would lead to some appreciation of the yuan, as indeed would have been the case during much of 1999.

Confidence in the Financial System

An issue of potential concern is mass loss of confidence in the financial system by the Chinese public. Banks have made massive loans to state-owned enterprises over the years, and a significant portion (perhaps 25 percent, roughly \$250 billion) of these loans will not be recoverable without extensive state subsidies to the SOEs, which in the interests of reform, and of fiscal discipline, the central government has so far resisted.

During 1998-99 the government infused some additional capital into the four large state-owned commercial banks, and created separate asset management companies to take doubtful loans off the banks' books, to be dealt with later, in ways not yet specified (in particular, under what circumstances the debts will be written off, in effect through subsidies, or whether debtors will ultimately be held responsible for

them). By the end of 1999 \$42 billion in bad loans had been swapped for equity (Business Week, 2/14/00, p. 138E).

In the meantime, there is little evidence of public loss of confidence in the banks, either because of ignorance of their condition or because of an assumption that the central government in the end will keep them from failing, or at least will fully protect the depositors. The public continues to place its savings in the banks; currency in circulation has continued to grow, and indeed at 16 percent grew exceptionally during 1999, but not to an extent that would suggest a run on the banks.

The Chinese yuan is convertible for current transactions (e.g. imports of goods or travel abroad), but Chinese are not free legally to export capital without approval. The yuan trades at a discount of about nine percent relative to the official exchange rate on the black market, a rate that rose after the authorities cracked down on smuggling and under-invoicing of exports. A discount of nine percent represents a warning sign, but it is not so great, given the controls on capital movements, as to be alarming.

China faces formidable challenges in maintaining a high rate of growth, in restructuring its manufacturing and financial sectors, and in modernizing its economy. But current Chinese leaders acknowledge the difficulties, are aware of the steps that need to be taken, and seem

prepared to take the difficult steps when the moment is propitious.
They have a reasonable chance of succeeding.

Endnotes

1. One preliminary Chinese estimate suggests that 9.7 million jobs will be lost in agriculture as a result of the market opening, 580 thousand jobs in the machinery sectors, and 500 thousand jobs in the automobile sector. Against this must be set new job opportunities of 5.4 million in textiles and apparel, 2.7 million in services, 930 thousand jobs in construction, and 170 thousand jobs in food processing, for a net loss of 1.6 million jobs, mostly in agriculture. In percentage terms, the biggest gain (52 percent) is in garments, the biggest loss (14.5 percent) in autos. China Business Times, Nov. 18, 1999, p.2.

Such estimates must be treated with considerable skepticism, but their existence indicates that Chinese politicians are sensitive, as American politicians are, to the employment implications of changes in trade policy.