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CHINA'S ECONOMIC GROWTH SLOWDOWN: CAUSES, CONSEQUENCES AND POLICY OPTIONS

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ABSTRACT

During its reform era China has experienced, and become accustomed to, high rates of economic growth, and rapid jobs growth particularly in the rural collectives and, more recently, private enterprises. Strong fixed asset investment and consumer demand in conjunction with a strong growth of net exports, provided the foundations for this. However during the latter part of 1997, after four years of monetary austerity measures, there were worrying signs that the growth of the economy was slowing considerably, primarily from a weakening of consumer and investment demand. While the growth of net exports initially remained buoyant, this has become threatened by the financial crisis afflicting other East Asian economies.

Such developments are of particular concern to China where jobs growth and social cohesion is paramount. It is widely perceived that the country must keep growth above 7-8% if enough new jobs are to be created to absorb the unemployed, and that without appropriate action by the authorities the economy will be dangerously close to this in the foreseeable future. This sharp economic slowdown will also threaten the government's attempts to restructure the country's SOEs as well as the debt laden state banks. It will have broader adverse implications for other Asian nations attempting to export their way out of their financial difficulties. The Chinese authorities currently face a severe problem of domestic deflation rather than inflation, while on the international front the country is playing a pivotal role, particularly with regard to the exchange rate, in maintaining currency stability within the Asian region.

The paper briefly reviews recent macroeconomic developments in China, focusing upon the factors contributing to the economic slowdown. The consequences of such a slowdown in terms of unemployment, social unrest, attaining further economic reform of the state owned enterprises (SOEs) and banking sector, as well as broader regional implications, is analysed. Appropriate policy responses to increase growth and expand employment opportunities, while maintaining low inflation, will be identified and evaluated.

1. Introduction

During its reform era China has experienced, and become accustomed to, high rates of economic growth, and rapid employment growth particularly in the rural collectives and, more recently, private enterprises. Strong fixed asset investment and consumer demand in conjunction with a strong growth of net exports, provided the foundations for this. However during the latter part of 1997, after four years of monetary austerity measures, there were worrying signs that the growth of the economy was slowing considerably, primarily from a weakening of consumer and investment demand. The growth of net exports, however, remained buoyant during 1997, but this has become increasingly threatened by the intensification of the financial crisis afflicting other East Asian economies during 1998.

Such developments are of particular concern to China where the maintenance of employment growth, for its rapidly expanding workforce, and social cohesion is seen as being paramount. It is widely perceived that the country must keep growth above 7-8%[1] if enough new jobs are to be created to absorb the rising unemployed as well as new entrants into the labour force, and that without appropriate action by the authorities the economy will be dangerously close to this in the foreseeable future. The current economic slowdown will also threaten the government's attempts to implement badly needed restructuring of the country's state owned enterprises (SOEs) as well as the debt laden state banks. It will also have broader adverse implications for other Asian nations attempting to export their way out of their financial difficulties, arising from the financial and economic crisis in the region. China's policymakers therefore currently face a severe problem of deflation rather than inflation. Of particular concern to China's neighbours, and indeed to the global economy, is the prospect that this deflation could be sufficiently strong that the authorities feel obliged to devalue the renminbi (RMB) as a means of regaining international competitiveness and stimulating export growth. This would have major adverse consequences for stability of both the regional and indeed global economies. The policy response to these difficulties will need to be innovative and unlike that used in the past, as China has become a quite different economy during its period of reform. In addition the country has become a significant regional economic player, and this too will have an important bearing upon its policy response. It is towards an analysis of these issues that this paper is directed.

The paper proceeds as follows. Section 2 briefly reviews recent macroeconomic developments in China emphasising developments which are indicative of a slowdown in the economy, and focusing upon the factors contributing to this economic slowdown. In section 3 the consequences of such a slowdown in terms of unemployment, social unrest, attaining further economic reform in the SOE and financial sectors, as well as the ingredients of an appropriate policy response are discussed. In section 4 a number of key issues relating to China and its regional neighbours are analysed: the impact of the Asian financial crisis on China; the likelihood that China will devalue its currency as a result of its economic downturn; China's prospective role as an engine of growth in the region; and finally the likelihood that China may actually impart instability, and impair recovery, within the region because of its own domestic economic difficulties. Section 5 critically analyses and evaluates the government's policy response to increase growth and expand employment opportunities, while maintaining low inflation. Finally section 6 provides a summary of the major conclusions from this paper.

[1] In April 1998 Huang Yukon, chief representative of the World Bank in Beijing, argued that growth below 5% would initiate substantial unrest.

2. Recent macroeconomic developments - economic growth slowdown

During the early part of the 1990s, encouraged by Deng Xiaoping's exhortations[2] for the economy to invest and grow, China experienced a major increase in investment, funded primarily through bank loans. As a consequence inflationary pressure built up within the system and became particularly acute during 1994 and 1995. In an attempt to restore order to the economy the government introduced, in June 1993, a so called 16 point austerity program. This involved pursuing deflationary policies largely through controls on state investment via credit rationing and administered price controls, with the objective of lowering economic growth to a sustainable rate and to slow the rapid increase in prices. By 1996 it appeared that a soft landing of the economy had been achieved, in which GDP growth had declined to a more sustainable rate of 9.7% and the rate of inflation[3] had been reduced to less than 6.1%. It was widely anticipated that the economy was in a position for a soft take off thereafter. However this has not eventuated, and instead a further slowdown of the economy is occurring. As can be clearly seen from Table 1 GDP growth continued to decline after 1996, falling to an annual growth rate of 7.2% by the first quarter of 1998, the lowest quarterly figure in at least 6 years and less than the government's hoped for 7.5%, from 8.2% during the last quarter of 1997 and from 8.8% for the whole of 1997. The growth rate deteriorated further to 6.8% for the second quarter of 1998, giving a growth rate of 7% for the first half of 1998.

For industrial production, similarly, growth has fallen steadily since 1994, as state firms became afflicted with declining profits. Further evidence of this slowdown in production can be found from Table 2 which identifies year on year changes in the production of major commodities in China. The production of coal, oil, vehicles and fertiliser are all lower in the first quarter of 1998 in comparison to the same period in the previous year. This declining growth of output is reflected in a steady decline in inflation, and by the second half of 1997 and into 1998 price deflation and not inflation has been occurring (see Table 1).

A number of factors have contributed towards this slowdown of the economy, some of which have arisen due to the excesses of the economic boom of 1992-95:

- **Successful macrostabilisation policy action.** The austerity measures implemented against the 1992-95 overheating of the economy since mid 1993, achieved major success in reducing inflationary pressure within the economy.
- **Excess investment in real estate.** The country experienced over the boom period 1992-95 major property overdevelopment arising from overly loose credit to this sector and from significant foreign investment. This has resulted in vacant office premises. As an indication of this, the office vacancy rate in December 1997 was 37.4% in Shanghai and 32.5% in Beijing[4]. The two highest vacancy rates of all the cities in East Asia.
- **Overexpansion in productive capacity.** Also arising from this boom period there has been an overexpansion by Chinese enterprises in areas beyond their core business, resulting in an accumulation of unsold inventories and over capacity in many industries. This will require considerable industrial consolidation in addition to the need for SOE reform. As a legacy of this development the major problem facing China at present is a lack of domestic demand

[2] During his famous tour of Southern China in early 1992.
[3] Retail price inflation (RPI).
[4] These figures are from Jones Lang Wootton, property consultants, for December 1997.

relative to the oversupply of many products.

Table 1
Indicators of China's Soft Landing and Growth Slowdown 1992-1998 (Q2)

	1992	1993	1994	1995	1996	1997	1998 (Q1)	1998 (Q2)
Output								
GDP (Real, % Change)	14.2	13.5	12.6	10.5	9.7	8.8	7.2	6.8
Industrial Production (Real, % Change)	21.2	—	21.4	16.1	15.1	13.2	9.0	7.7
Investment								
Total Fixed Asset Investment (Real, % Change)	23.5	25.2	23.9	10.0	12.7	10.5	12.2	
Consumer Spending								
Retail Sales (Real, % Change)	10.5	12.5	7.7	11.8	12.5	10.7	—	
Prices								
RPI (%)	5.4	13.0	21.7	14.8	6.1	0.8	-1.5	
CPI (%)	6.4	14.7	24.1	17.1	8.3	2.8	-1.0 *	
External								
Exports (% Change)	18.1	7.2	33.0	23.0	1.5	20.9	13.3	7.6**
Imports (cif) (% Change)	26.3	27.9	12.2	11.6	7.6	2.4	—	
FDI (% Change)	154.5	145.5	30.2	10.4	6.6	7.9	14.1	-1.5**

* Percent change over the period May 1997–May 1998
** Jan–May 1998
Source: State Statistical Bureau, International Monetary Fund, JP Morgan.

- **Continued reduction in domestic demand growth.** The country is experiencing a continued decline in retail sales growth, a decline in fixed asset investment growth and a prospective decline in export growth and consequential reduced contribution of the net trade balance to overall economic growth. Retail sales growth fell to 10.7% in 1997 from 12.5% in 1996, reflecting rising unemployment, increased job insecurity, and the need to save more for housing and for the payment of rent[5]. The growth of fixed asset investment has declined significantly from the breakneck growth of the early 1990s, despite the recent easing of credit after the austerity program. Investment in real estate has been particularly adversely affected declining in absolute terms. By the first quarter of 1998 fixed asset investment was growing by 12.2% over a year earlier, still well below the rates of the early 1990s (see Table 1), and bank loan quotas were going unfilled indicative of declining demand for new loans for such a

[5] From 1 July 1998 state owned housing was to be available only for sale and not rent. This represented a move towards abolishing the country's welfare housing system. Rents were to be increased to 15% of family income or the market level. However this reform has been postponed in many parts of China, and the government has decided to wait until the end of the year before raising rents on state housing. It was felt that with people having to buy or pay more rent on state housing this would dissuade them from spending.

purpose. The supply of consumer durables (cars, household appliances, and electrical equipment) has significantly outstripped growth in domestic demand for such products, a legacy of the boom period of 1992-95 when fixed asset investment hit a peak of 50% year on year, as a consequence of excess industrial capacity. This situation is likely to continue in 1998. This excess production is contributing to high stock levels, much of which of poor quality products, amounting to an estimated US$70 billion, equivalent to 8% of GDP in 1997.

Table 2
Production of Major Commodities—First Quarter of 1998

	Output (1998 (Q1))		% Change over the same period in 1997
Coal	231.29	(mt*)	-13.9
Oil	39.45	(mt*)	-0.6
Vehicles	381,000	(units)	-3.2
Fertiliser	6.74	(mt*)	-4.6

* mt = million tonnes
Source: State Statistical Bureau

- **Asian financial crisis.** The financial and economic crisis afflicting East Asia since mid 1997 has produced a major decline in GDP and industrial output growth across the region (see Table 3). The region takes approximately 60% of China's exports and contributes about 85% of its FDI[6]. This major decline in GDP growth in the region is likely to contribute to: a decline in China's exports; a decline in its FDI; a deterioration in the corporate sector's profitability and most noticeably that of the SOEs; declining government revenue; increasing non performing loans held by the state banks; rising unemployment; and a further slowdown in China's GDP growth.

Table 3
Internal Economic Developments–China and Selected East Asian Economies, 1998

	(% Change on a Year Earlier)					
	GDP		Industrial Production		Consumer Prices	
China	+6.8	Q2 1998	+7.9	May 1998	-1.3	June 1998
Hong Kong	-2.8	Q1 1998	-4.0	Q1 1998	+4.0	June 1998
Taiwan	+5.9	Q1 1998	+5.4	June 1998	+0.9	July 1998
Malaysia	-1.8	Q1 1998	-8.6	May 1998	+6.2	June 1998
South Korea	-3.8	Q1 1998	-13.3	June 1998	+7.3	July 1998
Indonesia	-6.2	Q1 1998	+10.7	Q3 1997	+59.5	June 1998
Philippines	+1.7	Q1 1998	-7.7	Feb 1998	+10.6	July 1998
Singapore	+5.6	Q1 1998	-4.5	May 1998	-0.2	June 1998
Thailand	+0.4	1997	-17.5	May 1998	+10.0	July 1998

Source: *The Economist*, 8 August, 1998, p.88.

[6] These figures are for 1995.

While China's exports and FDI held up well during the initial stage of the regional crisis, they now appear to be more vulnerable. Net exports, or the trade balance, remained very strong after 1993, and exports contributed about 2 percentage points of China's total GDP growth of 8.8% in 1997. However its contribution is anticipated to weaken during 1998. During the first four months of 1998 exports were 11.7% higher than a year earlier, but in May they declined by 1.5% year on year. This represented the first contraction in 22 months. FDI remained strong during 1997 and during the first quarter of 1998. But over the five months period from January to May 1998 it amounted to US$14.9 billion, some 1.5% less than for the equivalent period in 1997. Such adverse external developments suggest it is unlikely that China can export its way out of its current slowdown predicament, and that more emphasis will need to be placed upon stimulating domestic demand. This indeed provides the basis for the government’s policy response outlined in more detail in section 5 of the paper.

- **Price deflation.** Prices for various products have been falling. Retail price inflation was only 0.8% for the whole of 1997 and during the last quarter prices were actually falling, and this has continued into 1998. In fact by June 1998 the country had experienced eight consecutive months of falling prices. Consumer prices fell by 1.3% by June 1998 over the previous twelve months (see Table 3). This has been driven by chronic oversupply in manufacturing, resulting in declining profit margins and forced a cut back in production, and excellent agricultural production outcomes. Food prices, which constitute a sizeable proportion of the consumer basket, have fallen because of three years of excellent harvests. For example, grain prices fell by 13% in December 1997 (over December 1996) and represents the largest explanatory factor for the price declines. In addition the price deflation is partly due to an appreciation of the RMB relative to that of the yen and many other Asian currencies. This has assisted China in maintaining the country’s competitiveness by reducing the cost of imports, of capital goods in particular, and does not necessarily, therefore, represent a threat to the economy.

3. Consequences from the economic slowdown

The economic slowdown of the Chinese economy, compounded by the Asian financial crisis, has exposed weaknesses that require urgent attention. A number of urgent tasks need to be met. These include, firstly, the speeding up of reform of the moribund state owned enterprises (SOEs) and debt laden banking sector. Secondly, the implementation of measures focusing upon the domestic economy to prevent a further major downturn in economic growth, to avoid greater instability in China itself as well as in the regional and global economies. Thirdly, and relatedly, there is an urgent need to generate employment growth to absorb the rapidly rising urban unemployed, arising from labour shedding by the SOEs and from the state bureaucracy. Finally, the policy makers’ response to the slowdown will need to be more innovative than in the past, as the Chinese economy is much more market oriented. Simply loosening credit growth with the anticipation of expanding fixed investment will no longer be appropriate, or effective, in sustaining long term economic growth. But, in the event of rapidly deteriorating economic circumstances, may be expedient in the short term as appears currently to be the case.

1. Accelerating the reform of SOEs and the banking sector

The economic downturn of the economy and fear that East Asia’s financial woes may eventually spread to China, explain the boldness of the reforms launched in late 1997 and early 1998 in regard to the country's SOEs and banking sector. Long regarded as the achilles heels of the economy, they represent the major threats to the economy's future growth and well being. Prior to the current difficulties, reforms aimed at these two inter-related sectors had never been much more than piecemeal. However the economic and financial crisis in Asia forced China to speed up its reforms faster than planned. The proposed wholesale reform would be optimistic even in a strongly growing economy but in an economy which is slowing down, with further negative effects likely from its regional neighbours and with the prospect of rising unemployment, the reforms may well be unsuccessful and have to be abandoned or diluted. Indeed there are already signs that this is taking place. The country's biggest test will involve transforming its loss making SOEs into viable concerns, and will be the ultimate key to China's transition to an efficiently functioning and resource allocating market oriented economy.

SOEs

The country still has a considerable number of loss making SOEs[7], many of which are suffering from overstaffing, inefficiency, and heavy indebtedness. This situation can be expected to deteriorate further in the context of a sluggish economy. In recent years they have received 80% of the loans extended by state banks, but following the guidelines of the 15th Communist Party Congress in September 1997 state enterprises have been given just three years in which to improve their performance. This will involve substantial dislocations, millions of redundant workers, and removal of social services from state firms. The difficulties involved in this process have been further compounded by the country's export and growth slowdown. Heavy loss making SOEs will be merged, sold off, or forced into bankruptcy. The smaller SOEs are being sold or merged, while the larger SOEs, the so called pillar industries, will remain in state ownership with attempts made to make them more efficient and profitable[8]. SOE reform will require the restructuring of 118,000 state enterprises that employ 112 million workers[9]. An estimated US$500 billion will be required for the task and is likely to take longer than the 3 years identified by Premier Zhu, with up to 10 years being more realistic.

For some time China's leaders have been looking to the Japanese-South Korean model of state directed capitalism, as proof that a market oriented system could be operated effectively with strong government influence or control. At the 15th Party Congress in September 1997 decisions were made which indicated that the Korean chaebol, industrial conglomerates, would be used as a model for state enterprise reform, affecting the 1,000 or so largest SOEs in China. However this strategy of building industrial conglomerates through mergers and acquisitions will have to be rethought given the recent experiences of Korea's chaebol, and the lethargy of the Japanese economy. After the bankruptcies of several Korean behemoths, Chinese officials now appear to be backing away from this option. Vice Minister Wu Bangguo, who overseas SOE reform, said recently that consolidation for its own sake, without also strengthening product and market development, would be a mistake. As for the small SOEs, China also announced in 1997 that thousands of these, mainly owned by local government, would be sold, merged or allowed to go

[7] Estimates range from about 50% of these upwards.
[8] For more details see Harvie (1997).
[9] These figures are for 1995.

bankrupt. SOE reform is fraught with danger in the short term but is essential for the longer term health and market orientation of the economy, and hence Premier Zhu is unlikely to abandon it altogether but may instead have to accept slower progress.

The Asian financial crisis has contributed to a further deterioration in the profitability of the SOEs, intensifying the pressure upon them to raise efficiency, cut costs, rationalise operations and improve management. However this comes at a social cost in the form of rapidly rising unemployment.

Banking sector

The second major area for reform is that of the banking system, which is taking place in parallel with that of SOE reform. While circumstances varied somewhat for each country, at the root of the Asian financial crisis was the existence of weak banking/financial sectors. They engaged in high risk borrowing and lending which resulted in the accumulation of substantial non performing loans. Such a development has been noted with concern by the Chinese authorities, who must now respond to similar difficulties in their own banking system. China's banks are in trouble due largely to years of state directed lending to the country's SOEs, resulting in a similar accumulation of non performing loans. Official figures from the People's Bank of China (PBC) suggest that some 5-6% of total bank loans are bad debt, and 20% of bank loans are non performing (see Table 4). Some private analysts regard these figures as being on the optimistic side, estimating that up to 30% of the country's RMB7,490 billion (US$902 billion) in bank lending is in default and that more than two-thirds may be unrecoverable. From similar sources the amount needed to put the banking system on a healthy footing is estimated at a massive US$193 billion. That is 65% more than the IMF has pledged in bailing out South Korea, Thailand and Indonesia combined. State banks, like that of the SOEs, have been given just three years in which to clear their books of bad loans and to start lending on purely commercial terms. The existing severe under-capitalisation and other weaknesses in the banking system are being aggravated by further declines in real estate prices arising from the current property glut.

Table 4
China's banking situation, End 1997

Loan situation for China's 4 State Owned Commercial Banks		
	RMB (Billion)	US$ (Billion)
Total Loans outstanding	7,490	902
Non Performing Loans (20%)	1,490	179.5
Unrecoverable Loans (5-6%)	450	54.2
Capital Base	201	24.2

Source: People's Bank of China, statement by PBC Governor Dai Xianglong

The difficulties being faced in other regional economies gives a clear message to the Chinese authorities, that if they are to avoid a similar financial crisis major reform of the banking and financial system is required. A number of recent banking reform measures have focused upon the need to strengthen bank supervision and to place the state banks on a commercial footing. In this regard the PBC announced in December 1997, and thereafter, the following reforms:

- the PBC is to be overhauled to increase its regulatory powers, and its provincial branches are to become more independent of provincial government and party control in terms of lending policy. Over the next three years, according to central bank governor Dai Xianglong, a structure similar to the US Federal Reserve will be put in place,
- the credit plan (quotas), the backbone of the command economy, was to be scrapped in February 1998 for the state owned commercial banks,
- the government has given the banking system three years in which to sort out the problem of non performing loans and its undercapitalisation,
- interest rates are to be deregulated somewhat by allowing banks to adjust their interest rates, previously fixed, within a certain band, depending on the banks' risk analysis of its borrowers,
- as of 1 January the four state owned banks were no longer to be told which sectors to lend to. This will now be based upon risk analysis conducted by the banks on a commercial basis,
- dozens of trust companies, nearly bankrupted by failed property speculation, have been earmarked for closure,
- adoption of internationally accepted loan classification standards,
- recognition of the urgency of state bank re-capitalisation. In late February 1998 the government approved a capital infusion of US$32.5 billion for the state's four largest banks. The money raised through a Treasury Bond issue will assist in bringing the capital adequacy ratio of all four institutions in line with the international standard of 8%. However this will increase the fiscal burden on government. In addition a higher level of provisioning was mandated from US$3.6 billion in 1997 to US$6 billion in 1998;
- the first Beijing based foreign bank, Rabobank of Holland, was allowed to set up a branch in Shanghai.

However by mid 1998 it had become clear that with the rapidly deteriorating labour market China had shifted policy focus from reform to maintaining growth and labour market stability, with state banks instructed to increase loans to specific sectors such as that of infrastructure, housing and exports as part of the new deal program. Hence the necessary reform of the banking sector has, like that of the SOEs, been slowed down.

2. Emphasis on stimulating domestic demand

An important priority for the authorities is to prevent the economy's growth rate from declining further. With this objective in mind the government has set a target for GDP growth at 8% for 1998, although as can be seen from Table 5 other sources[10] suggest that this is overly optimistic. The Asian Development Banks predicts GDP growth of 7.2%, the IMF 7%, the OECD just over 7% and the consensus among private analysts is for GDP growth around 6.7%. Weakening consumer demand, declining export growth, stagnant fixed capital investment growth are all contributing to weakening overall growth. However with the financial and economic crisis continuing in Asia it is clear that the Chinese authorities will need to re-appraise their approach to

[10] Predictions made during the first half of 1998.

economic growth, placing more emphasis upon developing the domestic economy rather than relying too extensively upon external developments. In particular through an expansion in investment, primarily in infrastructure, and by stimulating expenditure by households. This forms the primary component of the government’s policy response discussed in section 5 of the paper. As argued in the following section it would not be either effective or appropriate to stimulate exports through a currency devaluation.

It is likely that infrastructure investment will provide the bulk of the impetus for growth during 1998, enabling the government to get close to its 8% target. Table 5 indicates that if fixed asset investment can be increased by such measures it could contribute up to half GDP growth in 1998. While spending on infrastructure may stimulate growth in the short term, it will not, however, boost the economy indefinitely. Reform of the SOEs and banking system will be the key to achieving this.

Table 5
Prospective Developments in the Chinese Economy during 1998

	Official	Asian Development Bank	Private* Consensus	IMF	OECD**
1. GDP Growth forecast (%)	8.0	7.2	6.7	7.0	7.1
2. Contributions to GDP Growth***					
Fixed Asset Investment	+14-15%	(Contribute 4-5 Percentage Points of GDP Growth)			
Consumer Retail Sales	+8%	(Contribute 3-4 Percentage Points of GDP Growth)			
Exports	+10%	(Net Trade 2 Percentage Points of GDP Growth)			
3. Prices					
CPI	+2.3%				
4. FDI	US$ 30 Billion	(-33.3% over 1997)			

* Average prediction derived from EIU; Goldman Sachs; ING Barings; Merrill Lynch; J.P. Morgan; Salomon Smith Barney; Warburg Dillon Read.
** GNP growth
*** State Statistical Bureau, chief economist, Qiu Xiaohua comments.
Source: Compiled from:
China Government sources
Asian Development Bank
IMF
OECD
State Statistical Bureau
The Economist

3. Implement market oriented growth policies

With the increased market orientation of the economy, it has become imperative, if the momentum is to continue in this direction, that more innovative and sophisticated approaches to reflation consistent with this movement are adopted. The traditional approach to re-igniting growth has been to ease bank loans and induce an increase in fixed asset investment. This approach would represent a retreat from the increased market orientation of the economy. It is also clear that it is unlikely to work, as the current downturn is quite different from that experienced by China in the past. Inflation is already very low and supply is in excess of demand. As a consequence macroeconomic management will need to focus upon means of stimulating demand while at the same time further developing the market economy. In this regard the development of a private housing market would be consistent with stimulating growth, as well as further enhancing the marketisation of the economy. It would open up new business opportunities for the banking sector, and encourage the development of various service industries such as insurance and underwriting. This would enable the attainment of three important objectives: the continuation of reform and maintain the momentum towards a market orientated economy; stimulate additional demand within the domestic economy without re-igniting inflation; and generate additional jobs for those laid off by the SOEs and state bureaucracy.

4. Unemployment and social unrest

As a consequence of reform of the SOEs there has been a considerable shedding of jobs and increased job insecurity. Many ailing SOEs will be closed, merged or sold off to investors, including that of foreigners. This will contribute to millions of unemployed workers in the short to medium run, but over the long run it should lead to the creation of more competitive businesses. Urban unemployment is believed to have increased to 11 million, and Labour Minister Li Boyong said in February 1998 that another 8-10 million SOE workers could be dismissed in the next three years. This steep rise in urban unemployment has the potential to create major social unrest unless handled with great skill by China's policymakers. In addition to this Premier Zhu has pledged to cut up to 50% of jobs in the state bureaucracy, equivalent to 4 million workers, and to halve the number of state agencies with some ministries being abolished altogether. Such a shake-up will be the most dramatic since the founding of the Peoples' Republic of China in 1949. Rising unemployment represents the biggest threat to China's economic reform program and political stability. If growth falls below 7% the economy will not generate enough jobs to soak up the 6 million Chinese entering the workforce each year, as well as the workers already laid off through SOE and state bureaucracy restructuring. Every percentage point fall in growth is estimated to create 2-4 million more unemployed. Indeed the original ambitious reform program outlined by Premier Zhu is having to be cut back due to the impact of the Asian financial crisis, mounting SOE losses, and rising unemployment and prospective unrest. Sporadic worker demonstrations have already occurred throughout the country. In response the authorities are attempting to put in place a more substantive safety net, than currently exists, to assist the millions being put out of work.

4. Impact of the Asian financial crisis on China, and implications for the RMB

Impact of the Asian crisis on China

During its period of economic reform China's internal position has strengthened in a number of areas. An improved agricultural performance in recent years has contributed to the country's soft landing with ample food supplies constraining the increase in agricultural food prices. In addition, an improved internal communications infrastructure has enhanced the significance of domestic markets and reduced China's dependence on export growth. There has also been a rapid growth of the non state sector, which now accounts for almost 70% of total industrial production, and major improvements in the management of the economy. But despite these impressive outcomes the economic difficulties currently being faced by China's neighbours have impacted adversely upon the Chinese economy for a number of reasons. The crisis has not only put pressure on the country's exports and foreign investment, but, more importantly, eroded the corporate sector's profitability. Consequently, enterprises in China, SOEs in particular, are being forced to reform in order to survive. Emphasis is being placed upon raising efficiency and cuttings costs, rationalising operations, and improving management. Attempts to improve profitability have come at a social cost in the form of rapidly rising unemployment, the extent of which has already led to a rapidly deteriorating labour market. The deteriorating performance of the SOEs also has important implications for government revenue and the non performing loans of the state banks. However most emphasis has tended to focus upon external developments.

About 85% of foreign capital flowing into China comes from Asia, equal to US$38 billion out of a total of US$45 billion in 1997. However, the growth of FDI in China has been slowing more recently for three major reasons. Firstly, the main sources of FDI for China, Hong Kong and overseas Chinese in Asian countries, have suffered severe setbacks arising from the financial and economic crisis in the region. Secondly, foreign investment in Asia generally has contracted due to the economic crisis afflicting the region. Finally, new FDI commitments to China had already begun to slow down before the crisis because of disappointment over returns on earlier investments, a downward assessment of market potential in China, as well as bureaucratic difficulties facing investors in China. However as indicated from Table 1, in the first quarter of 1998 FDI was some US$8.6 billion, up 9.7% from a year earlier, although over the extended period January to May 1998 it amounted to US$14.9 billion which was 1.5% down on the same period in 1997. Flows from a number of East Asian countries have declined dramatically during the period of the crisis. For example, Indonesian FDI in China is down 89.7%, that by South Korea is down by 55.8%, that by Japan is down by 42.2% and that by Thailand is down by 35.5%. However, there have been increased inflows from Taiwan, Europe and the USA to offset this. FDI by the EU is up by 75.4%, and from the USA by 25.4%. Hence the early indications in 1998 are that declines in FDI by the crisis affected Asian economies in China, is being offset to some extent by that from the EU and USA in particular.

It is anticipated that there will be a likely fall in China's exports to crisis economies in East Asia. As indicated by Table 1 during the first five months of 1998 exports increased by 7.6% compared with a year previously, a sharp decline from the 20.9% recorded for the whole of 1997. By May 1998 exports suffered their first year on year decline for 22 months, falling by 1.5%. Some industries, such as textiles, are experiencing major difficulties. While China's trade has grown rapidly recently, with exports contributing about 2 percentage points of China's 8.8% GDP growth in 1997, its significance to the overall economy, however, should not be over-stated. Trade problems also threaten to hamper the reform program. The government has been relying partly on the robust economic performance of its export oriented coastal regions to provide employment for the millions of workers laid off due to SOE reform. Now that these areas are less able to take the strain, the pressures for delay in the government's industrial reforms has been further intensified.

Almost 30% of China's exports in 1997 was with the economies of ASEAN, Korea and Japan, which have been badly affected by the financial and economic crisis. The ASEAN economies and Korea accounted for about 5% each of China's total exports in 1997. Trade relations with Korea is complicated by the fact that many Korean export industries import components from China, and hence the net impact on trade is unclear. Although the growth of the Korean economy is slowing any expansion by the export sector could lead to expanded demand for Chinese products, although this could be offset by the increased competition from the crisis economies due to their currency devaluations. For certain products such as clothes, cheap electronics and other light industry products, China competes directly with a number of the ASEAN economies and especially Indonesia. However to offset this Indonesian exporters are having considerable difficulty in gaining access to trade credit and to maintaining their credibility as reliable suppliers, and hence may be unable to take advantage of their improve competitiveness arising from their weaker exchange rate.

Japan accounted for about 17.5% of China's exports in 1997, and hence the biggest external threat would come from a further slow down in the Japanese economy. There is likely to be a moderate reduction in export growth to the USA and the EU (conservative fiscal and monetary policies in Europe because of the Euro, combined with the effects of greater competitiveness of ASEAN countries and Korea). The overall net effect is a likely export growth slowdown from about 21% in 1997 to perhaps around 10% in 1998 (see Table 5). Sources in China[11] suggest that even with an export slowdown to 10% in 1998 its impact upon the growth of the national economy would still be relatively moderate, but in some areas such as the coastal provinces and cities, such as Tianjin, the effect is likely to be felt more intensely.

Will China devalue its currency?

Economic developments in the Chinese economy during 1998 and 1999 will have important regional and global implications. Should the downturn in the economy continue, and indeed intensify, it will contribute to a further increase in unemployment and rising social unrest, which will not only put in jeopardy the reforms in regard to the SOEs and banking system but could also result in intense pressure upon the authorities to devalue the currency. Hence if China's economic downturn deepens, the world, but more particularly the region, will be watching China's currency policy nervously. As the world's seventh largest economy, and its eleventh largest trading nation[12], China's currency policy has immense regional and global repercussions. While many participants in the region's financial markets have suggested that the RMB needs to be devalued for the sake of Chinese competitiveness, a RMB devaluation would not be an appropriate response to the Asian crisis and is in fact unlikely. China has not been subject to the currency contagion affecting countries like Thailand, Indonesia, the Philippines and Korea, due to: its successful macrostabilisation measures since mid 1993; its strong agricultural performance over the past three years; and its strong external economic position. The RMB, it could be argued, is

[11] State Statistical Bureau chief economist.
[12] See IMF, *International Financial Statistics*, March 1998.

undervalued at current levels. A number of factors lie behind the relative strength of the currency, making the prospect of a devaluation unlikely. These include the following:

Table 6
External Economic Developments — China and Selected East Asian Economies, Latest 12 months, 1998

	Trade Balance (US$ Billion)		Current Account (US$ Billion)		Foreign Exchange Reserves (US$ Billion)		Exchange Rate Per US$		
							5 August '98	5 August '97	% Change
China	+45.0	June 1998	+24.6	1997*	140.9	June 1998	8.28	8.29	Neg
Hong Kong	-16.8	June 1998	-6.7	1997**	96.2	Apr 1998	7.75	7.74	Neg
Taiwan	+4.6	June 1998	+5.7	Q1 1998	84.4	May 1998	34.5	28.7	-20.2
Malaysia	+3.8	May 1998	-4.8	1997	21.3	Apr 1998	4.14	2.64	-56.8
South Korea	+24.7	July 1998	+23.4	June 1998	38.8	May 1998	1,265	894	-41.5
Indonesia	+17.7	May 1998	-5.8	Q4 1997	16.9	Apr 1998	12,900	2,585	-399.0
Philippines	-7.6	May 1998	-3.5	Q1 1998	7.8	Mar 1998	42.4	28.9	-46.7
Singapore	-0.5	June 1998	+13.6	Q1 1998	76.1	Apr 1998***	1.72	1.47	-17.0
Thailand	+4.8	May 1998	-2.9	Q1 1998	26.7	May 1998	40.9	31.0	-31.9

* Estimate
** Visible and Invisible Trade Balance
*** Includes Gold
Neg Negligible
Source: *The Economist*, 8 August, 1998, p.88.

- **Strong external economic position** - China has experienced trade and current account surpluses since 1994, reaching record levels in 1997. In this year the country achieved a trade account surplus of US$40 billion and a current account surplus of US$24.6 billion. The most recent figures indicate that this situation still remains strong. Table 6 indicates that over the 12 month period to June 1998 the country attained a trade account surplus of US$45 billion, and that this, as well as developments in the current account, compared very favourably with its regional neighbours. During the period January to June 1998 alone the trade surplus amounted to US$18.6 billion, up by 33% from a year earlier. Although export growth was slowing import growth was declining even more.

- **China's export growth may not be adversely affected by devaluations elsewhere in East Asia** - Although devaluations elsewhere put Chinese exports in an unfavourable position, exchange rates are only one of many variables that affect export growth. For exchange rates to be significant in export competitiveness at least two conditions must be in place. First, products of competing nations must be so undifferentiated that they are nearly perfect substitutes for each other in world markets; and second, exports must embody the same proportions of capital, labour and technology as identical exports from competing economies. This is not the case in Asia, which consists of a number of diverse economies. The fall in the won, for instance, may not have much impact on China's exports because Korean products tend to be more capital and technology intensive. However devaluations in Indonesia, Malaysia, the Philippines and Thailand could have a larger impact on China. But China exports a more diverse range of products than these countries. Also, its labour costs are below the average for the region. Regional devaluations should reduce the labour cost differential relative to China, but not eliminate it. In industries such as textiles and garments, where competition is intense, Southeast Asia is unlikely to take away significant market share from China, as such trade is mainly determined by non tariff barriers imposed by leading importers such as the US. Direct competition with ASEAN countries is mainly limited to lower end technology electronics and sports articles - which overlap about 35% of China's exports. For major exports such as garments, toys, footwear, watches and clocks, China's sheer market share on global import markets offers a significant margin of protection. China's export tax (VAT export rebate below VAT import rate) has been reduced and is further reducible as an alternative to exchange rate adjustment so as to maintain exporters' competitiveness. Some industries are moving from coastal areas to the interior where labour and land costs are much lower. They do not relocate to Thailand and Indonesia. Even without moving to the interior, many of China's export industries remain competitive because of low production costs and the country's virtually unlimited pool of labour.

A Southeast Asian export surge seems unlikely in the near term. Many companies in the region are finding it difficult to import raw materials and parts and to obtain letters of credit and trade finance. In addition the overall disruption to their economic systems, including the high rates of bankruptcy, has increased costs of production and turned many firms into perceived unreliable suppliers, discouraging sales even though devaluations have made their prices more attractive[13]. Such difficulties do not face Chinese enterprises. This may be more important at present than a competitive exchange rate, and puts China's exporters at an advantage over their financially stricken regional competitors. The falling value of the yen also allows China to buy Japanese equipment more cheaply than before. There is also the prospect that if China can weather the economic storm in 1998 and the first half of 1999, domestic inflation in the crises countries will have greatly reduced their current competitive advantage.

Exports are, however, not the most important issue facing the country. Foreign trade still remains a relatively small part of overall economic activity[14], important far more for the coastal provinces, which account for about a third of China's GDP, than the interior provinces. Although export growth appears to be slowing this is providing only a modest drag to the growth of the overall economy. Moreover, the RMB has become more competitive thanks to the sharp decline in inflation.

- **The currency is not fully convertible -** The currency is only fully convertible on current account, as of December 1996, but is not convertible on capital account and is therefore not subject to speculative attacks. As long as China maintains its sizeable surplus on the trade and current accounts a weakening of the exchange rate will not occur. In fact there is evidence to suggest that upward pressure on the RMB remains, almost a year after the start of the Asian crisis. The government in early 1998 relaxed foreign exchange surrender requirements. Exporters have since accumulated US$6 billion in foreign accounts, money that the Peoples' Bank of China would otherwise have had to buy to prevent an appreciation of the RMB. As indicated in Table 6, over the twelve month period from 5 August 1997 to 5 August 1998, the

[13] See for example Stiglitz (1998).
[14] The trade balance in 1997 was equivalent to about 4.4% of GDP, in 1996 the figure was 1.5% of GDP.

exchange rate has remained very stable against the US dollar. This stands in sharp contrast to developments in the currencies of its regional neighbours, with the exception of Hong Kong due to its currency peg, which have experienced sizeable deteriorations during the period of the Asian financial crisis. Interestingly, the difference between the black market rate and the official rate for the RMB appears to be small, suggesting that the exchange rate is not much out of line with market sentiment. Arising from the Asian financial crisis the government has noted with concern the ability of a convertible currency to take a country's weak banking system to the point of collapse. The full convertibility of the currency is therefore likely to have been postponed indefinitely.

- **Substantial foreign exchange reserves -** China has very substantial foreign exchange reserves in absolute terms as well as relative to imports and short term debt. Buoyant export growth and record capital inflows in 1997, particularly in the form of FDI, contributed to the accumulation of foreign exchange reserves worth US$140 billion by the end of 1997. As indicated by Table 6 these stood at US$140.9 billion by the end of June 1998[15] and compared very favourably with developments in other regional economies. However the growth of foreign reserves has slowed down considerably during 1998. One reason is that since October 1997 exporters have been allowed to retain 15% of their export earnings in US dollar assets, whereas previously all export earnings had to be sold on the foreign exchange market.
- **Limited exposure to foreign debt** - China's exposure to foreign debt is limited, amounting to only 17.3% of GDP in 1997[16]. In addition, the bulk of its foreign debt stock is in long term development loans and private FDI rather than in short term debt[17]. As a percentage of total foreign exchange reserves short term debt amounted to only 27.6% at end 1997, which compares very favourably with its regional neighbours[18]. In addition China, unlike its Asian neighbours, does not have a banking and financial system with substantial foreign debts denominated in overseas currencies. The country's bad debts in the banking system are denominated in RMB and not US dollars. Finally, China's two stock markets (excluding Hong Kong) are still relatively small and would not be capable of exerting a major impact on the economy arising from a change in market sentiment.

- **Strong domestic economy** - China has achieved a strong economic performance in comparison to that of other regional economies, and has attained much greater internal stability. As a result of the previously identified austerity measures implemented in China the country has experienced a significant decline in its rate of inflation (see Table 1), and although a decline in GDP growth is anticipated in 1998, both by official and non official sources, it still remains by far and away the highest in the region. Indeed GDP growth is less dependent on export growth than is commonly assumed, with total exports amounting to only 20% of GDP in 1997. Chinese exports are very import intensive, except agricultural goods and processing

[15] These reserves were second only in the world to that of Japan's, which stood at US$219.6 billion at end 1997.
[16] As at December 1997. This compares with the equivalent figures for Indonesia - 62.4%, Korea - 32%, Malaysia - 43.3%, Philippines - 62.3%, Taiwan - 15.2%, and Thailand - 62.9%. These figures were obtained from JP Morgan.
[17] Short term debt comprised only 24.9% of total foreign debt, or 4.3% of GDP at end 1997. The equivalent figures for Indonesia are 27.2% and 17%, for Korea 37.3% and 11.9%, for Malaysia 29.8% and 12.9%, for the Philippines 24.7% and 15.4%, Taiwan 67.9% and 10.3%, and Thailand 29.2% and 18.4% respectively.
[18] The equivalent figure, at end 1997, for Indonesia is 184%, for Korea is 250%, for Malaysia is 59.4%, for the Philippines is 172%, for Taiwan is 36%, and for Thailand is 108%.

industries such as cotton textiles and leather goods. Food exports account for about 10% of China's total exports and textile exports are subject to MFA[19] quotas. Hence to try and stimulate the economy through a devaluation of the currency would not be particularly effective.

- **Negative implications for FDI of a devaluation** - If China were to devalue its currency, FDI would be hurt. Recent figures suggest that contracted FDI, new commitments by foreigners, has been declining, which is a major cause of concern to China's leaders. Foreign corporations committing capital in China to serve the local market rely on a long term strategy, which assumes, among other things, a relatively stable exchange rate that more or less reflects market conditions. If the RMB were to be abruptly devalued, the dollar return on foreign investment in China would be reduced. This would also spark fears about future devaluations, and as such would not be a prudent policy at a time when investors are already jittery about emerging markets in general.

- **Devaluation and its impact on inflation** - Devaluation could also reignite the risk of inflation, which has abated on the back of tough austerity measures. Imports accounted for around 16% of China's GDP in 1997. A devaluation would increase the domestic price of imports ranging from equipment to raw materials and intermediate goods, eventually leading to higher domestic prices for final consumption goods. Many of China's exports have a high import content, and hence this would offset any benefits from a devaluation. Sharply declining currencies elsewhere in Asia may not help reduce by much imported inflation for China, with the exception of a yen depreciation, as more than 85% of its imports come from industrial economies and Hong Kong, whose currencies have not weakened in tandem with many of Asia's.

- **Adverse global and regional developments** - A devaluation could trigger off a host of adverse developments for the Chinese authorities. An abrupt change in China's exchange rate policy would destabilise the Hong Kong dollar peg to the US dollar as well as its financial markets more generally, a consequence that China would prefer to avoid. Devaluation would cause friction with the US over an already spiralling bilateral trade imbalance in China's favour, which has allied diverse US groups, including labour unions, protectionist politicians, environmentalists and human rights activists, to lobby against China. Manipulating its exchange rate for trade advantages would also complicate China's negotiations on WTO membership. The WTO accession window is soon after US Congressional elections in the Autumn. To enhance its WTO accession, China would be better to reduce its import restrictions and to protect its nominal exchange rate.

- **Maintaining regional stability -** As Asia's second largest economy, China's role in the region is critical in containing the financial crisis and stabilising the regional economies. The government has been concerned by developments in the ASEAN 4[20] and South Korea, and its potential implications for China. While China has pledged financial support for Thailand and Indonesia[21] under IMF bailout packages, and forebore from objecting to Taiwanese

[19] Multi Fibre Agreement.
[20] Indonesia, Malaysia, Philippines and Thailand.
[21] US$1 billion in each case.

contributions, the most effective assistance it can extend to its distressed neighbours is to maintain its own fast economic growth. A Chinese devaluation would likely trigger a fresh round of competitive devaluations in Asia and aggravate the current regional economic crisis[22]. This would neither be to the region's benefit nor to China's. Hence a currency devaluation would be an extremely risky strategy in which the potential benefit to China's export competitiveness is at best uncertain, but the negative impact of such a policy could be severe. Hence this strategy is one which China is unlikely to pursue as a response to the Asian financial crisis, and Premier Zhu Rongji has steadfastly refused to engage in a competitive devaluation. China's policy of developing constructive relations with ASEAN and other Asian neighbours, also makes devaluation unwanted for external political reasons[23].

From this discussion it is clear that China has a crucial role to play in what will now happen in Asia. Most analysts agree that a move by China to devalue its currency would set off a round of competitive devaluations and depression for the entire region and the benefits to China from doing so are not at all clear.

Is China in a position to take over the economic leadership role from Japan in bringing about an economic recovery in Asia?

Because of a lack of determined leadership from Japan on the Asian economic and financial crisis, China has been thrust to centre stage. Indeed at the recent Asia Europe meeting in London[24] Japan was heavily criticised for its lack of leadership in the economic recovery of Asia, and its lack of decisiveness over economic reform of its economy. Their prescriptions for Japan were tough including: further tax cuts; boost domestic demand; and deregulate the economy. Otherwise it would not overcome its own economic slump let alone that taking place in Asia. China on the other hand received considerable praise. For example Leon Brittan (EU Trade Commissioner) praised China for "her steady response to the Asian financial crisis, notably by resisting any devaluation of her currency…..and above all the startling pace of China's domestic reform agenda". He also told a meeting of business leaders that "no country in Asia - perhaps no country in the world - is more important for the future of the global economy than China". Hence the question must be asked as to whether the Asian financial crisis marks the start of a fundamental shift in economic leadership, with the world's most populous nation edging out the world's second largest economy as the regional engine of growth? Can, therefore, China play the role which the USA played in assisting the Latin American economies to overcome the "tequila crisis" of 1994-95?

The reality is that China, at present, is in no position to fill the vacuum left by Japan. Plagued by its own internal economic problems, lack of resources and current level of development, China is far from becoming Asia's economic saviour. Rather than China playing the role of Asia's economic leader, Japan is simply not playing the role it should be playing. Even if China succeeds in getting its economic house in order (specifically SOE and banking sector reforms), it cannot in

[22] A point fully elaborated upon by Liu Lanqing, Vice Premier, at the World Economic Forum, Davos, Switzerland, February 1998.
[23] The promise not to devalue the RMB was again reiterated in early June 1998 by central bank governor Dai Xianglong at a time when the Japanese currency came under further downward pressure.
[24] May 1998.

the foreseeable future provide the kind of economic leadership that Japan could (see Table 7). China simply does not have the resources - financial, technical or managerial - to lead Asia forward. Unlike China, Japan, for instance, has enormous multinational companies to invest capital and transfer technology. Japan's investment and official development assistance is considerably larger than that of China's. Ultimately, no matter how inward looking or troubled Japan becomes, it will remain Asia's economic leader for the foreseeable future. China may one day be ready to take over the economic mantle, but that could be up to 10-15 years away if not more.

Table 7
Economic Significance of Japan and China, 1996
(US$ Billion)

	China	Japan
GDP	827	4,599.7
Imports (cif)	131.5	349.3
Overseas Direct Investment	2.1	23.4
Overseas Portfolio Investment	0.6	114.6
Official Development Assistance	n/a	11.1

Source: International Monetary Fund, *International Financial Statistics*, April, 1998
China Statistical Yearbook, 1997
Overseas Economic Cooperation Fund (Japan)

China's threat to regional stability?

While China can make an important contribution to developments in the Asian and global economies, particularly through its commitment to not devaluing the RMB and its attempts to prevent a further slowdown in its economy, some economist believe that the country actually poses a threat to the stability and economic recovery of the region in particular and the global economy in general. The reasons for this are as follows:

- **China's weak banking system -** with official estimates putting non performing loans at 20% of the total, considerable restructuring/reform of the financial/banking system will be required before these banks can be put on a commercial footing. If this is not done it could cause major problems to the economy in the future and consequently the region, as has happened for a number of other countries,
- **China's stockpiles of inexpensive consumer goods** - these have arisen from the boom years of 1993-95 and the over-capacity in many industries which has resulted. This could represent a major threat to the exports of countries like Thailand, Indonesia and the Philippines, and make a recovery of their economies more difficult,
- **China is a major and successful exporter -** its current and advantageous position relative to its regional neighbours will enable it to consolidate its strong market position, making it more difficult for the Asian crisis economies to compete,
- **China attracts major inflows of FDI** - the country attracts major inflows of FDI, because of its relative attractiveness, which its neighbours desperately require to assist their economic recovery,
- **China has the most abundant and cheapest labour in Asia -** which enables it to maintain

its competitiveness despite its less competitive exchange rate, again making it difficult for its neighbours to compete,

- **China will not take many exports from its neighbours -** China's imports, including machinery, technology and wheat, comes mostly from the US, Japan and Europe. Hence the prevention of a further downturn in its economy will not have a major influence on the exports of its regional neighbours.

5. Policy response to the economic slowdown

Since March 1998 the Chinese authorities have been implementing a domestic stimulus package, described as a Chinese style "New Deal", that will increase expenditure on public works and other projects by as much as 20% per year. Emphasis will be placed on infrastructure investment and on housing construction. By focusing upon internal growth the Chinese are signalling their resolve not to out export their neighbours, and to maintain their pledge of not devaluing the RMB. The key components of this new deal, in detail, are as follows:

- **Increased infrastructure development**: In February 1998 in Davos Switzerland, at the World Economic Summit, Chinese Vice Premier Li Lanqing announced a US$750 billion infrastructure and environment plan for China (to be spread over three years), the aim of which being to keep economic growth in China above 8% in 1998. This gave the clearest indication that the Chinese authorities were concerned about, and saw the need to respond to, the slowing economy. Such an increase in infrastructure expenditure and fixed asset investment could boost GDP by an estimated extra 2%. While the country certainly needs better roads, airports, railways, ports, bridges and irrigation schemes, housing, posts and telecommunications, particularly in the poorer inland provinces, the issue of how the program was to be funded, without fuelling inflation, needed to be resolved. The government is already running budget deficits, and this program, in conjunction with declining SOE revenue, will substantially increase the 1998 state budget deficit to as much as US$5.5 billion according to some estimates. However with a budget deficit of just 0.7% of GDP in 1997 and low domestic debt, China can afford to finance more new infrastructure projects with the issue of government bonds.

  A number of funding options exist. Much of it is anticipated to come from the country's vast personal savings, some US$560 billion accumulated during the period of economic reform and held as deposits at the state run commercial banks throughout the country, and by expanding directed lending by the state banks. Domestic savings could be mobilised in a variety of ways: through the sale of central government bonds; letting cities and provincial governments sell bonds both locally and internationally for local projects; expanding the sale of corporate bonds which are restricted at present to under US$2 billion a year; and increasing the number of highway and railroad bonds. The government could attempt to raise funds in the Hong Kong financial markets, but the market is currently depressed and there are few relatively good investment projects. Another option is to expand, and tap into, existing "extra-budgetary" revenue. Attracting foreign investors on a build operate and transfer basis (BOT) is possible but would be difficult for projects in the poorer inland provinces. Utilising these alternative means some 117 key infrastructure projects are to be carried out this year, more single projects than in any previous year.

- **Mass residential housing program**: The second major component of the program is the construction of low cost housing with the objective of encouraging home ownership. The potential of this component of the program is substantial, but is unlikely to have an immediate impact. Many residential developments already stand vacant, and convincing Chinese people to buy rather than to rent will take time. State subsidised rents would need to go much higher before consumers would consider buying their own homes. Under proposed government reforms as of 1 July state housing was only to be made available for sale and not rent, and rent for existing tenants was to be increased to 15% of family income or to the market level. Such developments, it was anticipated, would expand the nascent consumer finance industry, stimulate specifically a housing mortgage market, as well as other services industries such as insurance and underwriting and other property ownership infrastructure. It would take time, however, for a country with an undeveloped financial system. In addition the development of a private housing market, including the sale of the current stock of housing to its occupants, would enhance labour mobility and enable the development of an effective labour market. As long as housing is limited and largely controlled by existing enterprises, labour mobility will be limited and new enterprise creation inhibited. This is particularly the case for smaller enterprises that do not have the capacity to provide housing for their employees. Private housing would also encourage the creation of small enterprises not only in construction, but also in maintenance and home improvement, including plumbers, carpenters, painters and electricians. New housing units would in turn give rise to demands for new consumer products, such as appliances and furniture. Such a housing program therefore has the potential to be an important engine for growth. However as the economy, and in particular the labour market, has steadily deteriorated during 1998, the government has postponed reform of state housing until the end of 1998, being concerned that rising rents and sale of the existing stock of housing will reduce funds available for consumption expenditure and thereby exacerbate the economic slowdown.

- **Monetary measures**: As part of the “new deal” program, the central bank has eased the austerity measures in place since 1993 in two major ways. First pressure has been brought to bear on the state banks to expand access to credit for key sectors such as that of infrastructure, exporters, and for home purchase consistent with attaining the overall objectives of the program, as well as struggling SOEs. Consistent with this, interest rates have been reduced to further stimulate infrastructure investment and house purchase. At the end of June 1998 the monetary authorities announced the fifth interest rate cut in just over a year, with commercial bank lending rates cut by an average of 1.12 percentage points to 6.5% for loans up to six months and around 6.9% for loans up to one year. Monetary policy alone, however, has major limitations in the present climate of excess capacity and depressed domestic demand, and its current role is therefore primarily to facilitate the attainment of the other major components of the program in stimulating aggregate expenditure.

- **Maintain the reform momentum:** While the first three components can contribute to alleviating the short term downturn in the economy, additional measures will be required to ensure that the growth momentum is maintained over the medium to long term. This will involve: pushing ahead with reform of the SOEs; reforming the banking sector; restructuring the economy; and reducing the size of government. As indicated in an earlier section major developments are under way in these areas. However the rapid deterioration of the economy has contributed to a rapid increase in unemployment and rising concern over social unrest. This has already led to an effective reversal of banking sector reform, with state banks once again being required to extend easy loans to key sectors of the economy. Further reform of the SOEs also appears to be slowing down as identified previously.

- **Tax rebates for exporters:** The government has offered exporters special tax rebates on exports of coal, textiles, rolled steel, cement and some machinery products to offset the loss of competitiveness brought about by the relatively strong RMB.

In addition to these core components of the stimulatory package, additional measures, or added dimensions, are likely to be required in order to make it successful:

- **Open up the interior provinces of China:** Opening up the interior provinces has the potential to boost domestic demand significantly. The government must attempt to ensure that its ambitious public works program will spread the wealth to such interior cities as Wuhan and Zhengzhou. In addition it is also important to assist the three-quarters of China's population that lives in rural areas, but which accounts for only 45% of retail sales. This is clearly a longer term strategy but with considerable potential for maintaining the growth momentum. There will need to be an important role for foreign investors in this process, who should be encouraged to invest in the interior where costs are lower rather than in coastal provinces. The establishment of appropriate infrastructure and other incentives would greatly assist in this process.

- **Create incentives to attract more FDI:** One of the ways to generate further growth employment is to continue attracting FDI. Contracted FDI has declined significantly recently, suggesting that there is a need to accelerate the approval rate for new private and joint venture projects and establish a more investor friendly environment.

- **Improve the social security system and worker retraining**: With the prospect over the short to medium term of further substantial increases in urban unemployment and rising social unrest, it will be essential to put a more substantive safety net in place for displaced workers. In addition there will be a need to retrain such workers for new employment opportunities in the rapidly expanding services sector, or for the prospective establishment of their own small businesses.

- **Devalue the RMB:** Should the government be unable to revive economic growth through the new deal program, and if rising unemployment and social unrest are creating major instability, in conjunction with pressure from business interests such as that of shipbuilding, petrochemicals and steel, the authorities may become sufficiently desperate to devalue the currency. If conducted it should be done so only gradually to avoid a major disturbance. However this would be a last resort policy, and if utilised would clearly indicate that the authorities had lost control of macroeconomic developments elsewhere.

Many of these measures have the major drawback that they will only have a lagged effect upon the economy. While the speeding up of infrastructure projects should have a relatively quick impact upon output and employment, and hence has received most emphasis, the authorities should not neglect the other measures, so as to ensure the longer term health of the economy. Otherwise the same situation may have to be faced up to again, but be more intractable next time around.

6. Summary and conclusions

China is currently facing a downturn in the rate of growth of its economy. During the period of economic reform, since 1978, such an economic downturn has not been uncommon, having generally occurred after the authorities implemented measures to curb bouts of inflationary pressure. The current downturn is quite different from that experienced in the past in that the economy is experiencing excess supply relative to demand, exemplified by: over-capacity in many industries; high stock levels; price deflation; declining retail sales growth; and declining growth of fixed asset investment. On top of this the Asian financial crisis is bringing about declining export growth and inflows of FDI. Lacklustre demand is seen as being the primary culprit, rather than tight credit, and therefore traditional methods of kick starting the economy, easing credit and expanding fixed asset investment, will not work this time. A new approach will be required.

To this end the government has put in place a “new deal” program emphasising: a public works program focusing upon infrastructure spending; housing reform; a further loosening of monetary policy; but no devaluation of the currency to boost exports. There are tremendous risks involved if this program of measures is unsuccessful in reversing the downward growth trend of the economy. As the economic environment continues to deteriorate during 1998, expediency has required the authorities to focus policy on the need to reverse this downward trend in the short term and to place less emphasis on reforms required for the medium to long term health of the economy. Growth of less than 7-8% will not be enough to absorb a growing army of laid off workers and new labour market entrants. Social unrest would loom large. The recent experience of Indonesia would pale into insignificance if the equivalent occurred in China, which would be hugely damaging for the regional and global economies.

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