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China's Economy: Confronting Restructuring and Stability[†]

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1. INTRODUCTION

China has been the world's star performer in economic growth for the last two decades. China registered an average annual growth rate of 9.7 percent in the 1978–99 period. However, the growth rates for 1996–99 are not only below the average of the period, they have also declined monotonically from 9.6 percent in 1996 to 7.1 percent in 1999. Naturally, many questions and concerns have arisen about this four-year deviation from the average. How much of the deviation has been due to trend slowdown, how much to the internal economic cycle, and how much to the external shock from the Asian financial crisis? Furthermore, what could be done to offset the decline, and what are the long-term implications of these counter-measures?

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In the public pronouncements of Chinese officials, the usual explanation for the slowdown was a drop in consumption and the stagnation of exports caused by the Asian financial crisis. Large-scale infrastructure investment programs were started in 1998 and 1999, and a third round of infrastructure spending is planned for 2000. The rationale is straightforward: infrastructure investment lifts aggregate demand to maintain full capacity usage and alleviates production bottlenecks to ease inflationary pressures.

The above diagnosis and cure have been rejected by a number of economists. In the opinion of Thomas Rawski (1999):

> This diagnosis is mistaken and the policy misconstrued. Weakness in the economy, which pre-dates the Asian crisis of 1997/98 runs much deeper than China's leaders appear to believe. The difficulties are structural rather than cyclical. Short-term pump-priming exacerbates structural problems and undercuts long-term reform objectives.

Nicholas Lardy (1998), while not offering an explanation for the slowdown, also deemed China's reflation program to be a mistake:

> China's leadership has made its short-term growth objective its highest priority. Longer-term structural reform of state-owned banks and enterprises is being postponed. Ironically, even if the program increases the rate of growth, ultimately, the costs of postponed reforms will be even greater, meaning it likely will fail to alleviate social unrest.

We agree with some elements in each of the above analyses but we differ in emphasis, and, sometimes also, in conclusions. In this paper, we argue that:

(a) the structural flaws in China's economy in 1995, if left uncorrected, would likely cause growth to slow down in the future, say within a decade, but these structural flaws were not responsible for the significant slowdown in 1996–99;

(b) the slowdown in 1996–97 was largely the result of the austerity program that Zhu Rongji had implemented since mid-1993 to simultaneously wring inflationary pressures out of the economy and to restructure the economy;
(c) the further slowdown in 1998–99 reflected the export decline caused by the Asian financial crisis; and
(d) the reflation program of 1998–99 did not represent a wavering of commitment to restructuring; its emphasis on infrastructure investment (as opposed to a generalised increase in investment) was a sensible response to a temporary external shock.

Thomas Rawski and Nicholas Lardy are correct that radical restructuring of the state enterprise sector and the state banks system is absolutely crucial to avoiding a drastic drop in the trend growth rate in the future. The maintenance of the 1996 status of the state enterprises and state banks is not a viable option in the long run because the economy will simply not be able to support the growing burden from these two sectors.

The Chinese view that under-consumption (high saving) has made macroeconomic management more difficult is correct, a point that we will develop later, but we do not see larger state spending, even if it is in infrastructure, to be the optimum policy response. The correct response is restructuring not stabilisation; there should be financial restructuring to create financial institutions that would quickly channel the additional saving to investments with the highest rates of return.

Our general view is that the short-run costs of economic restructuring may have been overstated. Restructuring state-owned enterprises (SOEs) could worsen short-term growth while improving long-term growth prospects; but restructuring state-owned banks could improve both short-term and long-term growth. Financial restructuring is a win-win reform activity because it will eliminate the liquidity trap that now exists in credit creation, and neutralise the short-run deflationary effects of higher saving. Finally, the macroeconomic record suggests the interesting possibility that a clear commitment to a restructuring strategy based on promoting the convergence of China's economic institutions to the norms of modern market economies improves the short-term tradeoff between growth and inflation.

This paper is organised as follows. Part 2 presents the case for economic restructuring. Part 3 analyses the macroeconomic record. Part 4 evaluates the post-1997 reflation package. Part 5 takes up the question of the susceptibility of China to the type of financial crisis that had hit Asia in 1997–98. Parts 6 examines the issue of under-consumption and the need for financial restructuring, especially in the rural sector, if China's high growth is to be prolonged. Part 7 discusses the issue of enterprise restructuring. Part 8 contains brief concluding remarks.

2. The Restructuring Imperative

The successful completion of the bilateral US-China negotiations in November 1999 over the conditions of China's entry into the World Trade Organisation (WTO) marks a watershed on many fronts for China. First and foremost, China's admission into WTO marks an important improvement in the economic security of China. Trade and foreign investment have constituted an important engine of growth since 1978. The requirement for annual renewal by the U.S. Congress of China's normal trading relationship with the United States made China's economic growth vulnerable to the vagaries of American domestic politics. Through WTO membership, this engine of growth could no longer be unilaterally shut off by the United States without the action being a major violation of international law.

WTO membership also marks a watershed in China's public recognition about the primary source of its impressive growth in the last two decades. The WTO is an international economic organisation that specifies and enforces broadly similar economic policy regimes on its membership. China's willingness to join such an institution reflects more than a desire to protect itself from potential blackmail by the United States, it also reflects China's realisation that the active ingredient in Deng Xiaoping's recipe for conjuring up growth was the convergence of China's economic institutions to the economic institutions of modern capitalist economies, particularly of East Asian capitalist economies.