

lower than the 10 percent average growth rate of the 1978–95 period in order to ensure an acceptable rate of economic restructuring and to moderate the boom-bust cycles of the last two decades. The implicit growth range that policymakers appear to think is compatible with achieving the restructuring and stabilisation objectives seems to be about 7.0 percent to 8.0 percent. When the Asian financial crisis hit in 1998, causing China's exports to fall, and hence rendering growth lower than intended, it was only natural that the government undertook stimulation of domestic demand to reflate the economy.

4. RESPONDING TO THE POST-1997 DEFLATION

The government responded to the onset of price deflation in 1997:4Q by cutting the average lending rate from 10.1 percent to 8.6 percent. However, the anticipated surge in credit expansion did not occur. This is largely because of the newfound reluctance of the state commercial banks to extend more credits to its traditional clients, the SOEs — especially the loss-making SOEs — creating a “liquidity trap” phenomenon that we will discuss later.

By early 1998, in the wake of the collapse of several important Pacific Asian economies, Chinese policymakers recognised that stronger reflation was required to offset the coming collapse in external demand. Furthermore, the SOE reform program announced at the 15th Party Congress in September 1997 was beginning to take bite and firms would soon begin to shed excess workers. So, stronger reflation was also desirable in order to induce the establishment of new urban enterprises to soak up the newly released SOE workers.

The reflation program sought to boost aggregate demand by trying to:

- (a) increase investment by approving faster the backlog of investment applications;
- (b) increase government spending;
- (c) loosen monetary policy; and
- (d) stimulate private spending through housing reform.

Faster Approval of Investment Applications

The State Planning Commission was literally put on an over-time schedule in early 1998 to speed up the approval of investment projects. "Increased economic openness" was a fortuitous byproduct of this measure. Approval was given to a number of large foreign projects that had been held up for several years because of concerns either about the possible domination of these particular lines of business by foreign firms or about the possible competition that they might provide to domestic firms of national strategic importance.

One unexpected check on approval acceleration as a reflation tool was that many local governments had not bothered to turn in local investment plans for 1998 because of the across-the-border rejection of local investment plans since the earnest implementation of the stabilisation program in 1994. The greatest obstacle to the effectiveness of investment approval as an economic stimulus is that approval does not necessarily translate into realisation. The translation of approval of investment into realisation of investment is usually low in times of declining aggregate demand. Hence, not surprisingly, many foreign and domestic firms postponed the actual investment until sustained economic recovery seems imminent. Partly, because of the low aggregate demand in China and abroad, but mostly because of the panic in international credit markets, actual FDI was US\$40 billion in 1999, 10 percent down from US\$45 billion in 1998 despite the "increased economic openness" noted above.⁹

Expansionary Fiscal Policy

In July 1998, the government announced the issuance of RMB 100 billion in bonds to finance new infrastructure investment by the central and local governments. (It seems that these bonds had been purchased mainly by state banks.) This announcement was quickly followed by new spending plans on telecommunications, railways, and roads. As the economy continued to slow steadily throughout 1999, a new fiscal stimulus

⁹ "Foreign capital off the rails," *South China Morning Post*, February 16, 2000.

package of RMB 60 billion was implemented in August 1999. In March 2000, the government announced that it would soon issue RMB 100 billion of bonds to finance additional infrastructure investment, especially in the interior provinces.¹⁰

A natural question raised by the recent expansionary fiscal policy is whether the level of public debt in China is still at a level that would not be too heavy a burden in the future. The issue is what should be counted as "public debt" when so much of the economy is still state owned. If public debt is defined to be the stock of government bonds that has been issued to finance budget deficits, (and held by both domestic and foreign agents), then the public debt-GDP ratio was 7.3 percent of GDP in 1996 and 8.1 percent in 1997.

It has been argued, however, that since the government is the guarantor of the state banks, the nonperforming loans of the state banks ought to be counted as public debt. Estimates of the extent of nonperforming loans range from 20 percent to 50 percent of total bank loans.¹¹ If we take the NPL ratio to be 33 percent, then the broader definition of public debt would put the "broader public debt"-GDP ratio at 37.0 percent of GDP in 1996 and 41.1 percent in 1997.

What about the debt of SOEs and other state institutions (for example, the regional trusts and investment companies, TICs)? The government could be construed as being responsible for these bad debts just as they were construed to be responsible for the bad debts held by the banks. Since the bulk of the domestic borrowing of SOEs and state institutions is from the state banks, the inclusion of nonperforming loans of the state banks in the broader definition of public debt has already taken into account the bad debts of SOEs and state institutions that are owed to domestic agents.

¹⁰ "Zhu pledges to keep cash flowing," *South China Morning Post*, March 6, 2000.

¹¹ This range reflects our selection of credible estimates (e.g. a missed interest payment does not necessarily mean that the loan is bad), so this range does not encompass all estimates that have been reported in the press. For example, Bloomberg News has reported that some analysts believed bad loans to be 70 percent of bad loans, *New York Times*, "China Hopes to Sell Bad Loans at Discount," January 5, 1999.

Foreign debts of SOEs and other state institutions may deserve different treatment from their domestic debts because of the government's great concern about China's continued access to international financial markets at favourable interest rates. In order to arrive at the "broadest" definition of public debt, we take into account all the bad debts that SOEs and other state institutions could potentially owe to foreigners. We constructed the "maximum" public debt as the sum of the broader public debt plus the entire foreign debt of SOEs and public institutions. The "maximum public debt"-GDP ratio was 50.1 percent of GDP in 1996 and 55.1 percent in 1997.¹²

Is a debt-GDP ratio of 55.1 percent too low or too high? Compared with the Italian, Swedish and U.S. situations where central government debt (after deducting intra-governmental debt) to GDP ratios were, respectively, 117.6 percent in 1995, 70.8 percent in 1995, and 50.5 percent in 1996, it might appear that there is still substantial room for the Chinese government to increase its borrowing to finance its expansionary fiscal policy without causing serious debt problems in the future. However, such conclusion would be overly optimistic. This is because China raises much less state revenue (as a share of GDP) than these other countries, and hence has a much lower capacity to service its public debt. The revenue-GDP ratio was 11 percent for China in 1995, 30 percent for Italy in 1995, 38 percent for Sweden in 1995, and 21 percent for the U.S. in 1996. The point is that until China increases its tax collection, there is a real tradeoff between restructuring the state financial sector and increasing infrastructure investment to stimulate the economy. And it is important to note that increasing tax collection is as much a political challenge as it is an administrative challenge.

Easier Monetary Policy

The People's Bank of China has cut interest rates several times since price deflation became obvious. For example, the bank lending rate was

¹² The terms "broader public debt" and "maximum public debt" are from Fan (1998), he differs from my calculations in that he assumes a NPL ratio of 25 percent.

reduced steadily from 10.1 percent in September 1997 to 5.9 percent in September 1999. Furthermore, the bank reserve ratio was lowered twice; from 13 percent to 8 percent in March 1998 and then to 6 percent in November 1999. However, the money (M1) growth rate continued its downward course from 25 percent in 1997:3Q and 1997:3Q to 13 percent in 1998:1Q, and then to 10 percent in 1998:2Q, prompting some Chinese economists, like their Japanese colleagues, in postulating the existence of liquidity traps.

This reluctance by banks to extend credit has its origin in the determined efforts of Zhu Rongji to improve the balance sheets of the state banks and to promote restructuring in the SOE sector since he took over as economic czar in mid-1993. By the end of 1997, the twin facts that Zhu Rongji would be promoted to become the Prime Minister in 1998 and that he had peremptorily dismissed bank managers when the proportion of NPLs in their banks had gone up had instilled a new sense of prudent lending in the entire state bank system. Until the typical bank manager faced personally severe consequences from an increase in the ratio of NPLs, he never had to respond to the knowledge that the demand for credit by bankrupt SOEs was always high because they really do not expect to repay any of their debts. The loss-making SOEs were engaging in a gamble of the desperate; new loans offered the only chance of a lucky investment that would pull them out of their seemingly hopeless financial straits. This new behaviour by bank managers is the reason why despite additional reductions in interest rates and required reserve ratios by the central bank, money growth continued to drop in line with the decline in GDP growth.

This slowdown in loans to the SOEs has unfortunately not been replaced by an increase in loans to non-state enterprises, the primary engine of growth in China's economy. The state banks are reluctant to lend to the non-state enterprises, partly because the latter's non-standard accounting makes risk assessments difficult. More importantly, a banker knows that while a NPL to an SOE is financially undesirable, a NPL to a private enterprise is more than that, it is also politically undesirable. The banker feared that the NPL to a private firm could result in him being accused afterward of working with capitalists to embezzle the state.

Thus, we have the present situation where the loans that state banks are most willing to make are infrastructure loans guaranteed by the central government.

It was only after the central bank implicitly assured the banks in mid-1998 that new NPLs incurred in support of SOEs that were producing saleable goods would be overlooked that money growth increased to 14 percent in 1998:3Q. But then caution reasserted itself as bank managers were rightly sceptical about the credibility of the government that the new NPLs would not count against them in the future. The result was that money growth, after the 14 percent spurt in 1998:3Q, declined steadily to 11.3 percent in 1999:3Q.

Hence, the practical short-run solution to this “liquidity trap” is for the government to undertake new infrastructure spending financed by the state backs (and ultimately by new reserves from the central bank). However, a larger sustained increase in credit is possible only if the state commercial banks would use the new deposits (new reserves) to extend new loans, i.e. only if banks act according to the standard “money multiplier” process. As the banks’ willingness to lend depends now on finding truly economically viable projects, the government has sought to create new safe lending opportunities to the banks by announcing housing reforms, including privatisation of the housing stock. The hope is that the banks would then expand mortgage lending on the basis that the household debt would be fully (and, presumably, also safely) backed by a marketable asset, and hence boost aggregate demand.

Housing Reform as a Short-Run Stimulus

The majority of the urban population has, until very recently, lived in virtually free housing supplied by their employers.¹³ In early 1998, the government announced that SOEs and other state institutions would stop providing free housing after July 1 and that the housing stock would

¹³ Of course, housing and other subsidies are in fact largely paid for by the employees themselves; this is why their take-home pay is so low.

be privatised.¹⁴ To compensate for the loss of free housing, and to encourage their workers to buy the houses that they are presently staying in, many local governments are giving subsidised mortgages to civil servants. By the end of 2000, government workers had purchased 60 percent of the public housing stock.¹⁵ The marketization of housing is now in full swing, marking another significant milestone on the way to a market economy. The marketization of housing will enhance labour mobility and free the SOEs to focus on production and distribution of goods.

The *China Macroeconomic Analysis* (1998:3Q issue) estimated that, with a functioning mortgage system in place, the marketization of housing would increase the annual demand for housing by 20 to 30 percent. Since housing investment is presently about 4.3 percent of GDP, the housing reform would increase GDP growth by 1 percentage point.¹⁶

However, in our assessment, the short-run result of the housing reform was a decrease in aggregate demand even though the new steady-state level of housing demand under the market regime is higher than the old steady-state level of housing demand under the entitlement regime. First, the demand for new residential construction by SOEs stopped abruptly on July 1, 1998, and because it takes time for private agencies to appear to intermediate between the builders and the millions of disparate buyers, the immediate impact was more likely to have been a drop in housing demand than an increase.

¹⁴ The practical method of privatising the housing stock is to offer the houses to the existing tenants at prices which approximate the present discounted value of the stream of low rent payments. By giving the existing tenants the right of first refusal, this method makes explicit whatever existing inequality there is in housing allocation. This method does not create new inequalities.

¹⁵ "Civil Servants own 60% of public housing," *The Straits Times*, February 24, 2000.

¹⁶ The Minister of Construction has claimed that the housing reform contributed 1.5 to 2 percentage points to the 1999 growth rate; see "Civil Servants own 60% of public housing," *The Straits Times*, February 24, 2000. The construction of housing might have contributed this amount, but the relevant question is whether the housing reform had actually increased the amount of construction without housing. We doubt this claim for the reasons given in the paragraphs below.

Second, the mortgage system was not yet in place. The banks need time to build up its expertise in mortgage lending, and the certification/registration system of house ownership is usually not standardised province-wide. More importantly, at the moment, only the richest 5 to 10 percent of the urban population can qualify for mortgage loans; and these well-to-do folks are likely to have already acquired most of the housing that they want.

Results of the Reflation Package

The reflation package has worked much better than expected by most observers. When the negative effects of the Asian financial crisis started hitting in early 1998, and slowing China's GDP growth, most observers steadily revised their forecasts of 1998 growth downward. For example, the Economist Intelligence Unit's (EIU) *Country Report on China* predicted a 1998 growth rate of 7.3 percent in the 1998:1Q issue, 6.7 percent in the 1998:2Q issue, and then 6.1 percent in the 1998:3Q issue. The credit spurt and investment splurge in the last half of 1998 disappointed all these forecasts by lifting GDP growth to 7.6 percent in 1998:3Q and 9.6 percent in 1998:4Q to produce an annual growth rate of 7.8 percent for 1998. The decomposition of aggregate demand in Table 1 shows that fixed capital formation added 4.5 percent points to the 1998 growth rate.

However, given the widespread expectation that the Asian financial crisis was going to be a long-drawn crisis, and doubts that China would be able to undertake sustained fiscal stimulus, the EIU continued to predict low growth rates for 1999 despite the falsification of its gloomy forecasts for 1998. The 1999:3Q issue predicted a 1999 growth rate of 6.7 percent. The actual 1999 growth rate turned out to be 7.1 percent, partly due to the additional fiscal and monetary stimulus in the last quarter, and partly to the rapid recovery of exports in response to the end of the Asian financial crisis.

It must be mentioned that a number of observers believe that the official growth numbers are wrong and that actual growth in 1998 was between 3 to 5 percent. The basis of this scepticism is the low usage of

electricity, the low volume of goods being transported, and the continued fall in the level of retail prices. A well-known Chinese economist, Mao Yushi, was quoted as saying that: "The GDP figure is still dubious... There must be some local government trying to please the central government by reporting inflated statistics."¹⁷ There is credibility in Mao Yushi's statements because Premier Zhu had criticised provincial leaders in early December for each reporting a provincial growth rate greater than 10 percent in the first half of 1998 when the national growth rate was only 7.2 percent.¹⁸

The 1999 growth rate of 7.1 percent, low as it is, also deserves scepticism for the same reasons. First, only two provinces, Shanxi and Sichuan, have reported growth rates below 7.1 percent. Second, the sum of all individually reported provincial GDP exceeded the official national GDP by 7 percent.¹⁹

In Woo (1998), we had found that the annual GDP growth rate in the 1985–93 period could have been overstated, on the average, by as much as 2 percentage points; and, after taking various factors into account, Woo suggested a downward correction of about 1 percentage point. The overstatement is less serious however, when the inflation rate is low. In light of our work, the negative inflation, and the scepticism expressed in the two preceding paragraphs, we think that the actual GDP growth rate could plausibly be about 7 percent in 1998 and around 6.5 percent in 1999.

Table 2 compares exports in each quarter to its level in the same quarter of the previous year. It shows that the negative effects from the Asian financial crisis reached their peak in the 1998:3Q to 1999:2Q. With the recovery of the Asian crisis economies in 1999, China's exports leaped to \$54 billion in 1999:3Q. Since the Asian crisis countries are expected to continue their economic expansion in 2000, China now has more room to undertake continued restructuring.

¹⁷ "China just misses 8 percent growth rate," *South China Morning Post*, December 30, 1998, updated at 2:43 p.m.

¹⁸ "China admits to cooking the books: editorial," *Agence France Presse*, December 23, 1998, 4:31 p.m.

¹⁹ "Beijing has \$546b chasm in key data," *South China Morning Post*, February 29, 2000.

Table 2. Export Earnings (fob, in US\$ million)

	Q1	Q2	Q3	Q4	Year Total
1996	28,249	35,803	39,979	47,166	151,197
1997	35,585	45,360	48,173	53,759	182,877
1998	40,072	46,488	47,190	49,839	183,589
1999	37,290	45,727	54,201	na	na

5. SUSCEPTIBILITY OF CHINA TO A FINANCIAL CRISIS

The Asian financial crisis was typified by (a) a collapse of the exchange rate because of heavy capital outflow, and (b) a collapse of the domestic financial system causing a shortage of working capital that, in turn, caused output to collapse. So how vulnerable is China to a meltdown scenario of this type?

A dramatic speculative attack on the RMB can be ruled out simply because the RMB is not convertible for capital account transactions in financial assets. It is difficult for a person to borrow RMB from a Chinese bank to buy US dollars to speculate against the exchange rate because the purchase of US dollars requires documentation to prove that the transaction is trade-related.

Capital outflow by foreign private agents has not occurred because most of the *foreign private investments* in China are foreign direct investments, and there is very little short-term foreign debt. At the end of 1999, short-term foreign debt was less than 20 percent of the total foreign debt of US\$168 billion. The fact that China also had US\$155 billion in foreign exchange reserves made defense of the exchange rate feasible even if all short-term foreign debts had been recalled.

Furthermore, foreign participation in the Chinese stock markets is limited to transaction in B-shares. Only foreigners can own B-shares, and B-shares are denominated in US dollars and transacted using US dollars. In short, an abrupt withdrawal by foreigners from the Chinese stock markets can affect the value of the yuan-dominated A-shares (that