

ratio to 55 percent — still a very low level when compared with the public debt-GDP ratios of most Western European countries. As a general principle, the government's decision to let NBFIs fail is important to reducing the moral hazard problem inherent in supervision of the financial sector. Both domestic depositors and foreign creditors have to be encouraged to assess and manage risks better.

As things stand at the beginning of 2000, it looks unlikely that China will soon succumb to a financial crisis marked by bank runs, capital flight, a severe shortage of working capital, and a deep recession.

6. THE IMPORTANCE OF FINANCIAL INTERMEDIATION FOR STABILISATION AND GROWTH

Part A of Table 3 shows that total household consumption has declined steadily as a proportion of GDP. It dropped from an average of 52 percent in 1979–1983 to 46 percent in 1994–98. However, this fall in consumption is not seen in all sectors. While rural consumption fell from 33 percent of GDP in 1979–83 to 23 percent in 1994–98, urban consumption rose from 19 percent to 23 percent. But since the share of population living in urban areas has gone up from 20 percent in 1979–83 to 30 percent in 1994–98, it is not surprising that urban consumption has risen relative to GDP, while rural consumption has fallen. The important analytical issue is whether urban consumption did increase relative to GDP, once the demographic shift has been controlled for.

Part B of Table 3 presents a decomposition of the change in rural and urban consumption behaviour after taking the rural-urban movements into account. The decomposition follows from:

$$\text{Equation (1):} \quad (C_i/\text{GDP}) = [L_i/L] * [(C_i/L_i) / (\text{GDP}/L)]$$

where C_i = consumption in sector i
 L_i = population in sector i
 L = total population

The decomposition in Equation (1) can be described as:
 (consumption in sector i as share of GDP)

= (share of population living in sector i) * (normalised per capita consumption in sector i)

Taking differences, Equation (1) becomes:

$$\begin{aligned} \text{Equation (2): } D(C_i/\text{GDP}) &= [(C_i/L_i / (\text{GDP}/L)] * D [L_i/L] \\ &+ [L_i/L] * D[(C_i/L_i)/(\text{GDP}/L)] \\ &+ [D (L_i/L)] * [D\{(C_i/L_i) / (\text{GDP}/L)\}] \end{aligned}$$

The decomposition in Equation (2) can be described as:

Percentage point change in (consumption in sector i as share of GDP)
 = Percentage point contribution from the shift in the share of population in sector i
 + Percentage point contribution from the shift in normalised consumption in sector i
 + Percentage point contribution from interaction of the two shifts

We note that the normalised per capita consumption in sector i can in turn be decomposed into:

$$\begin{aligned} [(C_i/L_i)/(\text{GDP}/L)] &= (C_i/Y_i) * [(Y_i/L_i)/(\text{GDP}/L)] \\ (C_i/Y_i) &= \text{average propensity to consume in sector i} \\ [(Y_i/L_i)/(\text{GDP}/L)] &= [(\text{per capita income in sector i})/(\text{per capita GDP})] \\ &= \text{normalised per capita income in sector i} \end{aligned}$$

We now have a natural definition of chronic under-consumption, it means a secularly declining average propensity to consume.

Since per capita income in China's urban sector has risen faster than per capita GDP over the entire reform period, normalised consumption in urban sector would increase if average propensity to consume in urban sector has remained unchanged. A drop in normalised consumption in the urban sector could only mean that the average propensity to consume among urban residents has gone down, i.e. that there is chronic under-consumption in the urban sector.

A drop in normalised consumption in the rural sector is more ambiguous, it would be consistent with a drop or a rise in the average propensity to consume of rural dwellers because growth in per capita income in rural areas has lagged behind growth in per capita GDP.

Table 3. Consumption Shifts in China in Reform Period, 1978–1998

		<i>Rural household consumption</i>	<i>Urban household consumption</i>	<i>Government consumption</i>	<i>Fixed capital formation</i>	<i>Change in inventory</i>	<i>Net exports</i>	<i>Total household consumption</i>	
Part A: Expenditure Category as Proportion of GDP, 1978–1998									
									Rural share of population
	1978	30.3	18.5	13.3	29.8	8.4	-0.3	48.8	82.1
	1988	30.4	21.5	11.7	31.4	5.9	-1.0	51.9	74.2
	1998	22.1	24.1	11.9	35.3	2.8	3.8	46.2	69.6
Period 1	1979–83	32.6	19.0	14.4	27.6	6.1	0.4	51.6	79.7
Period 2	1984–88	31.9	19.5	13.1	30.7	6.3	-1.5	51.4	75.5
Period 3	1989–93	26.5	22.2	12.9	30.0	7.7	0.7	48.7	73.0
Period 4	1994–98	22.8	23.3	11.9	34.8	4.7	2.6	46.1	70.5
Part B: Decomposing the Change in Consumption-GDP Ratio									
		Change in Consumption-GDP Ratio	Percentage Point Change in Consumption-GDP Ratio Due to:						
			(a) Rural-Urban Shift	(b) Consumption Shift	(c) Interaction Effects				
<u>For the Rural Sector</u>									
	Change between 1978 and 1998	-8.2	-4.6	-4.2	0.6				
	Change between Period 1 and 4	-9.7	-3.8	-6.7	0.8				
<u>For the Urban Sector</u>									
	Change between 1978 and 1998	5.6	12.9	-4.3	-3.0				
	Change between Period 1 and 4	4.2	8.7	-3.0	-1.4				

Part B of Table 3 shows that there is unambiguous chronic under-consumption in urban China, and that this is also likely to be the case in rural China. There has been a downward shift of 3 percentage points in the normalised consumption of urban residents between Period 1 (1979–83) to Period 4 (1994–98), and a downward shift of 6.7 percent points in the normalised consumption of rural residents. This much bigger downward shift in rural normalised consumption suggests that the rural average propensity to consume has also fallen.

Keynes pointed out in his paradox of thrift that a rise in the saving rate could, in the short run, depress aggregate demand, and cause the economy to produce below capacity. Only if financial markets were informationally perfect would the increased saving be translated instantaneously into investments, and the level of aggregate demand be maintained. The paradox of thrift is based on coordination failure between savers and investors, and the minimisation of its occurrence requires highly sophisticated financial intermediation. In a centrally planned economy, the paradox of thrift would not exist because the planner controls both the amount of saving and the amount of investment; but then, for well-known reasons, a large portion of the saving would be wasted on value-subtracting projects.

China's marginally reformed financial system contains the worst aspects of the preceding two financial systems: the coordination failure of the market financial system, and the allocation irrationality of the command financial system. China's high saving rate is actually also partly a reflection of this serious problem in financial intermediation. The steady liberalisation of the economy has steadily increased the number and range of profitable investment opportunities. But because of the refusal of the state banks to lend to private entrepreneurs to enable them to reap these high rates of return, the private entrepreneurs have to engage in self-financing, and this requires high saving to accumulate the required threshold amount of capital.²² In short, the convergence of financial intermediation in China to the level of financial sophistication in the United States would lower China's saving rate as well as ensure

²² A formal model and testing of this argument is in Liu and Woo (1994).

the full employment of saving and allocate it to the most profitable projects.

Most of the attention on China's financial sector has focused on its urban banks. This neglect of rural financial intermediation is most unfortunate because rural enterprises (popularly known as township and village enterprises, TVEs) have constituted the main engine of China's economic growth since 1984.²³ It has been clear since the 15th Party Congress in September 1997 that China has decided to sharply reduce the importance of state-owned enterprises (SOEs) by accelerating the diversity of ownership forms. The amendment of the constitution in March 1999 to accord private ownership the same legal status as state ownership is a logical development from the 1997 policy decision. Implicitly, TVEs are expected to become an even more important engine of growth in the future.

Woo (1999) argued that this expectation of continued high TVE growth may be unrealistic however, given recent investment trends. TVE investment in the 1990s has declined relative to both GDP and total fixed investment, in a period in which total investment went from 30 percent of GDP in 1987 to 33 percent in 1997 (Table 4).

Table 4. Investment and Output by Ownership Forms

	Fixed Investment as % of GDP		Share of Fixed Investment, %		Share of Industrial Output, %	
	1987	1997	1987	1997	1987	1997
All Ownership Forms	30.4	33.4	100.0	100.0	100.0	100.0
SOEs	19.2	17.5	63.1	52.5	59.7	25.5
TVEs	8.9	7.7	29.1	23.0	32.5	47.6

²³ The industrial output alone from rural enterprises accounted for about 31 percent of the increase in GDP between 1984 and 1993; calculated from Woo (1998).

So far, the TVEs have increased their output share not only without getting any of the investment share released by the shrinking SOE sector but doing so with a decreased investment share, from 29 percent in 1987 to 23 percent in 1997. This is unlikely to be a sustainable situation. It is hard to see how the TVEs could move up the value-added chain in production without significant capital investments in the near future. So, if China's market capitals continue not to allocate sufficient investment funds to the most dynamic sector of the economy, China's high growth rate is probably not going to continue in the medium run.

The Agricultural Bank of China (ABC) was established in 1955 to provide financial services to the rural sector, and to channel funds for the grain procurement purchases. Small-scale collectively-owned rural credit cooperatives (RCCs, *Nongcun Xindai Hezuoshe*) were started in the early 1950s, under the supervision of ABC, to be the primary financial institutions serving the rural areas. RCCs operate an extensive network of branches, savings deposit offices, and credit stations in market towns and remote areas. The number of RCC units rose from 389,726 in 1981 to 421,582 in 1984, and then fell steadily to 365,492 in 1995.²⁴ We want to highlight this decline in the number of RCC units after 1984 because this decline means a decrease in the effort to mobilise rural saving, and a decrease in the access of the rural community to investment financing.

In our opinion, the primary reason for the drop in TVE investment (as a share of GDP and as a share of total domestic investments) is that TVEs suffer from two big disadvantages in investment financing. The first disadvantage suffered by TVEs is that the still heavily-regulated financial system is directing too much of the investment funds to the SOE sector, thus starving the TVEs sector of investment funds. The second major disadvantage of the TVEs in raising capital is that, because of political discrimination against private ownership, many TVEs generally have vague, collective forms of property rights that cannot attract market-driven investment funds.

²⁴ The number of RCC units is the number of RCCs plus the number of branches, saving deposit offices and credit stations.

The deregulation of financial intermediation will allow the appearance of new small-scale local financial institutions that will mobilise local savings to finance local TVE investments. Our expectation is based on the impressive growth of folk finance (*minjian rongzhi*) since 1978 despite the absence of legal recognition and legal protection. According to Liu (1992), folk finance was the source of the development of TVEs in Wenzhou city in Zhejiang Province:

Ninety-five per cent of the total capital needed by the local private sector has been supplied by “underground” private financial organisations, such as money clubs, specialised financial households and money shops ...²⁵

It cannot be over-emphasised that financial deregulation has to be accompanied by the introduction of adequate banking supervision and of prudential standards that comply with international norms. The rash of banking crises in Eastern Europe in the early 1990s and in East and Southeast Asia recently should serve as warnings of financial deregulation without adequate improvement in the government's ability to monitor the activities of the financial institutions. Besides deregulating rural financial intermediation, it is also important that the property rights of rural enterprises are clearly defined, protected legally, and freely tradable like the property rights of shareholding firms. The present trend of restructuring TVEs into shareholding cooperatives by dividing their assets among the workers (sometimes, among the original inhabitants of the community) is a natural convergence to an enterprise form which,

²⁵ The competition from the new rural financial institutions is likely to force the ABC-RCC system to improve its operations. This expectation is again based on Wenzhou's experience: “In order to compete with [the new folk finance institutions]... , as early as 1980, a local collective credit union, without informing the superior authority, abandoned for the first time the fixed interest rate and adopted a floating interest rate which fluctuated in accordance with market demand but remained within the upper limit set by the state. Despite the dubious legality of the floating interest rate, the local state bank branches and all the credit unions in Wenzhou had already adopted it before the central state officially ratified it in 1984” [Liu (1992)].

international experiences have shown, assures investors that managers would have the incentives to maximise profits in a prudent manner.

7. THE MANY DISAPPOINTMENTS OF STATE ENTERPRISE REFORM

When China started its SOE reform two decades ago, it followed the principles of market socialism to motivate the SOE manager to maximise profits. The state entered into a profit-sharing arrangement with the firm, and gave increasing operational autonomy to the manager. The official conclusion is that the decentralisation of decision-making to the firms has failed to improve their performance.

The current problems of SOEs are: excessive investments in fixed assets with very low return rates, resulting in the sinking of large amounts of capital; and a low sales-to-production ratio, giving rise to mounting inventories. The end result is that the state has to inject an increasing amount of working capital through the banking sector into the state enterprises. (Vice-Premier Zhu Rongji, 1996)²⁶

The situation as regards the economic efficiency of [state] enterprises has remained very grim ... And the prominent feature is the great increase in the volume and size of losses. (Vice-Premier Wu Bangguo, 1996)²⁷

There has been a steady increase in SOE losses since additional decision-making powers were given to SOE managers in 1985.²⁸ The

²⁶ "Guo you qiye sheng hua gaige ke burong huan," (No time shall be lost in further reforming state-owned enterprises), speech at the 4th meeting of the 8th People's Congress, *People's Daily, Overseas Edition*, March 11, 1996.

²⁷ "Losses of State-Owned Industries Pose Problems for China's Leaders," *The Washington Post*, November 3, 1996.

²⁸ Recent evidence suggest that past reports on SOE losses (e.g. two-third of SOEs make zero or negative profits) may be understated. A national audit of 100 SOEs in 1999 found that 81 falsified their books, and 69 reported profits that did not exist; and an