

privatisation. Even for the larger SOEs that are to be corporatized, the state need not be the biggest shareholder.

The thousand largest SOEs will be given preferential financing to develop into business groups (like the Japanese *zaibatsus* and the Korean *chaebols*) that allegedly will enjoy enormous economies of scale. The truth is more prosaic. Given the co-existence of conservative and liberal reformers, any SOE reform package needs to contain a component that appeases each group. The upshot is dual-track SOE reform: state-sponsored conglomerates for the conservative reformers, and publicly-traded joint-stock companies for the liberal reformers. However, in light of the 1997–98 external debt crisis in South Korea caused by imprudent borrowing by the *chaebols*, one should question the wisdom of creating such large state business groups.

We must emphasise that the key to SOE reform is not privatisation *per se*, but a transparent, legal privatisation process that society at large can accept, at the minimum, as tolerably equitable. Because an adequate privatisation program must compensate the retired and layoff workers, permit takeover by core investors, and respect the rights of minority shareholders, it is important that legal reforms be carried out simultaneously. Without a transparent, equitable privatisation process (overseen by an adequate legal framework), China is likely to repeat the mistakes of the Russian privatisation program implemented by Premier Chernomyrdin. Just as the creation of the new *kleptoklatura* in Russia has robbed the Yeltsin government of its political legitimacy, its occurrence in urban China could be socially explosive.

## 8. CONCLUDING REMARKS

We want to highlight one possible negative long-run result from the present reflation package. There is strong evidence that the larger credit growth in the third and fourth quarters of 1998 was achieved only after implicit assurances were given to bank managers that they would not be held responsible if the NPL ratio were to increase. A temporary deviation from the firm policy of cleaning up the balance sheets of the state banks

may be defensible in the midst of the Asian financial crisis, but a prolonged deviation would underline the credibility of the commitment to reforming the state banks and mean a return to the traditional socialist boom-bust cycle.

The long-term answer to the NPL problem goes beyond punishing bank managers who experienced increases in the NPL ratio; the long-term answer lies in changing both the supply-side and the demand-side of the credit market. Many changes are required on both sides of the credit market, and the most fundamental changes include the transformation of the state banks and the SOEs into shareholding corporations to make profit-maximisation their primary objective, the establishment of a modern legal framework to promote transparency and reduce transaction costs, and the creation of a prudential regulatory body to reduce excessive risk-taking by banks.

The above complex institutional changes that are necessary in order to address the NPL problem adequately illustrate that most of China's economic problems cannot be individually addressed, success depends on systemic reform. This brings us to the basic point that while President Jiang and Premier Zhu deserve much credit for their competent handling of the current macroeconomic problems so far, their position in Chinese history will depend more on their success in addressing the many and varied long-term development challenges facing China. These challenges include the slowdown in agricultural productivity growth, the decline in job creation in the rural enterprise sector, the acceleration of losses by state-owned enterprises (SOEs), the relentless growth in nonperforming loans (NPLs) at the state banks, the inability of the legal system to meet the demands of an increasingly sophisticated economy, and the inadequacy of social safety nets to cope with the temporary dislocations that are characteristic of a fast-growing economy. The ability of China to maintain its international competitiveness after the Asian financial crisis is over is conditional upon the resolution of the above problems.

China's forthcoming accession into WTO reveals recognition by the top leaders that convergence of China's economic institutions to the institutional norms of modern market economies offers China the only chance to achieve sustained high growth, and, more importantly, it

reveals the commitment of the top leaders to make sure that convergence will occur.

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