



COUNTRY ECONOMIC REVIEW

People's Republic of China

October 2000

CURRENCY EQUIVALENTS

(as of 17 October 2000)

Currency Unit	–	Yuan (Y)
Y1.00	=	\$0.1208
\$1.00	=	Y8.2770

The exchange rate of the yuan is determined under a managed floating exchange rate system.

ABBREVIATIONS

ADB	=	Asian Development Bank
AMC	=	asset management company
FDI	=	foreign direct investment
GDP	=	gross domestic product
IMF	=	International Monetary Fund
MFA	=	Multi-Fiber Agreement
NPL	=	nonperforming loan
PBC	=	People's Bank of China
PRC	=	People's Republic of China
SME	=	small and medium enterprise
SOE	=	State-owned enterprise
TA	=	technical assistance
US	=	United States
WTO	=	World Trade Organization

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

EXECUTIVE SUMMARY

The People's Republic of China (PRC) successfully weathered the Asian crisis. Three consecutive years of expansionary fiscal policy and interest rate reductions enabled the country to contain the adverse effects of the Asian crisis, maintain a stable exchange rate, and achieve robust growth. Strong economic growth continued in the first three quarters of 2000 when gross domestic product (GDP) grew by 8.2 percent. For the whole of 2000, GDP growth will be about 8 percent. Coupled with targeted antipoverty programs of the Government, the robust growth enabled the PRC to continue its commendable progress in reducing poverty. However, PRC's fight against poverty is far from over as there are still about 230 million people (18.5 percent of the population) living below the \$1-a-day consumption norm, and about 670 million (53.7 percent of the population) living below the \$2-a-day consumption norm. The incidence of poverty is highest in the interior provinces, especially in the western region of the country. Urban unemployment and poverty are now emerging as new challenges.

After a marked slowdown in the aftermath of the Asian crisis, PRC's exports have grown strongly, beginning in mid-1999 and continuing in 2000. With the ongoing recovery of the crisis-affected countries in Asia and continued strong growth in the American economy, PRC's exports will grow robustly, although at a slower pace than the exceptionally high (33.1 percent) growth recorded in 2000. Domestic consumption growth, after slowing for several years, accelerated in 2000 and should offset any slowdown in public investment that may occur as the Government winds down the recent fiscal stimulus measures. There is scope for continuing the accommodative stance of monetary policy without causing undue inflationary pressure. During the next three years while fiscal policy is likely to remain somewhat less expansionary than in the past three years, monetary policy is likely to continue to be accommodative. In particular, interest rates will continue to be low. Overall, the macroeconomic outlook over 2001-2003 is positive (i) robust annual GDP growth in the 7-7.5 percent range, (ii) moderate annual inflation in the 2-3 percent range, and (iii) comfortable external payments position despite a gradually declining current account surplus.

Given the forces of globalization, any unexpected external shocks (such as a hard-landing of the American economy, another round of financial crisis in Asia, or the continuation of the recent exceptionally high oil prices in the international market beyond 2000) would have negative impacts on PRC's exports, foreign investment inflows, and the growth of the economy. PRC's positive economic outlook is also subject to certain domestic risks and uncertainties: (i) a deterioration in the fiscal situation, and (ii) failure to contain the social costs of State-owned enterprise (SOE) reforms within tolerable levels.

At about 4 percent of GDP, the fiscal deficit is moderate by international standards. However, this estimate of the fiscal deficit does not give a full picture of the potential fiscal vulnerability as it does not take into account (i) the quasi-fiscal operations of the Government, (ii) the unfunded pension liabilities of the Government, (iii) the Government expenditures necessary to finance the social security obligations, and (iv) the Government expenditures necessary to cover the unrealized portions of the nonperforming loans taken over by the four asset management companies. Adjusting for these factors, the fiscal situation is weaker than it appears and has the potential to pose a constraint on sustained economic growth.

As a result of the layoff of redundant workers and rural migration, urban unemployment and urban poverty have increased in recent years. The official estimate of urban unemployment

(3.1 percent) covers only the workers registered with the Ministry of Labor and Social Security (MOLSS). It does not include workers who are laid off as *xiagang* workers (workers who have lost their jobs but who keep a legal link to their enterprise and receive a small fraction of original salary and benefits). Adjusting for these limitations, the urban unemployment rate is more than 8 percent. About half of the estimated 30 million-35 million surplus workers in SOEs had been laid off by mid-2000. Additional layoffs are expected in the coming years. The social safety net needed to prevent many of the laid-off workers from falling into poverty is yet to be developed. Failure to contain the social costs of SOE reforms within tolerable levels could increase the country's economic vulnerability and erode public support for the Government's reform program. This underscores the need for a comprehensive reform of the country's social security system. Recognizing this imperative, the Government has set up a high-level Task Force to review and recommend the required changes in the social security system before the end of 2000, and established a National Social Security Fund to finance the transition costs of the pension reform program.

Over the medium term, the challenging tasks will continue to be effectively implementing the recently initiated reforms in the financial and state enterprise sectors, developing the legal and regulatory framework for a market economy, developing of the social security system, and promoting the private sector. The Government will also have to address two other development challenges on a priority basis: (i) managing the post-World Trade Organization (WTO) reform program, and (ii) promoting development in the poor interior provinces.

The PRC is likely to become a member of WTO by the end of 2000 or early 2001. Over the long term, PRC's accession to WTO and the commitments to cut tariffs, liberalize trade and investment, and open up domestic sectors for foreign participation should lead to significant efficiency gains and wider consumer choices. Several studies estimate that the long-term gain from WTO membership to the PRC will be equivalent to 1-2 percent of GDP. However, some of these benefits will take time to materialize. During the initial years, PRC's membership in WTO will pose several challenges. Addressing these challenges will require substantial structural adjustments across a wide range of sectors including agriculture, automobiles, banking, insurance, and telecommunications.

Within the PRC, not all regions have benefited equally from the exceptionally rapid economic growth during the last two decades. There are substantial disparities in regional living standards. Per capita GDP in western PRC is about two thirds of the national average and only one third of that in the eastern coastal region. The regional disparities are also reflected in other socioeconomic indicators, such as the incidence of poverty, the primary school enrollment rate, health care facilities, the development of physical infrastructure, and ecological problems. The Government is aware of the need to promote development in the poorer interior provinces. The March 2000 session of the National People's Congress endorsed the "go west" policy, a proactive strategy to promote growth and development in the western region. The formulation of the Tenth Five-Year Plan is an opportune time to develop an integrated strategy to develop the poorer central and western regions. Developing infrastructure, both physical and social, and improving natural resource management should constitute the core of any strategy to promote socioeconomic development in the central and western regions. Good physical infrastructure creates conditions necessary to attract private investment and facilitate economic growth. The development of physical infrastructure must be complemented by investments in social infrastructure, particularly health and education, and natural resource management.

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I. RECENT ECONOMIC DEVELOPMENTS

A. Growth, Investment, and Savings

1. The People's Republic of China (PRC) successfully weathered the Asian crisis. A combination of expansionary fiscal policy and interest rate reductions enabled the country to contain the adverse effects of the Asian crisis and achieve robust growth. Gross domestic product (GDP) grew by 7.8 percent in 1998 and 7.1 percent in 1999. Strong economic growth continued in the first three quarters of 2000 when GDP grew by 8.2 percent. Both the industry and service sectors grew faster in 2000 than in 1999 (Appendix, Tables A1 and A2). For the whole of 2000, GDP growth will be about 8 percent (Table 1).

Table 1: Annual Growth Rates: Aggregate and Sectoral
(percentage)

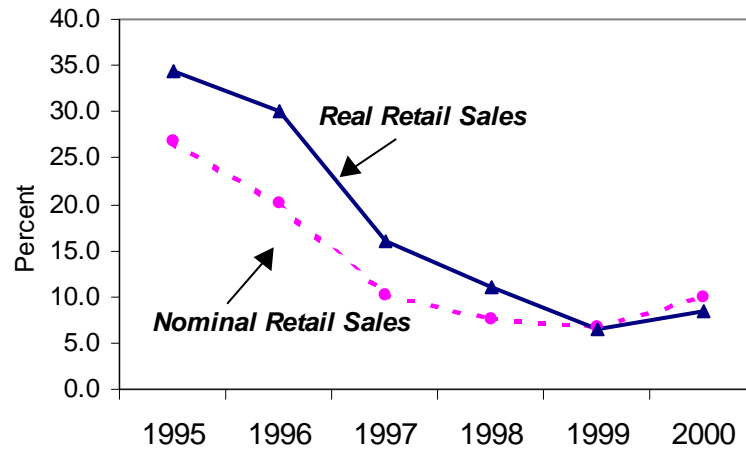
Item	1995	1996	1997	1998	1999	2000	
						Jan-Sep	Full Year ^a
Gross Domestic Product	10.5	9.6	8.8	7.8	7.1	8.2	8.0
Primary	5.0	5.1	3.5	3.5	2.8	2.2	2.0
Secondary	13.9	12.1	10.5	8.9	8.1	9.8	9.5
Services	8.4	7.9	9.2	8.3	7.5	8.1	8.0

^a Asian Development Bank estimates.

Source: National Bureau of Statistics.

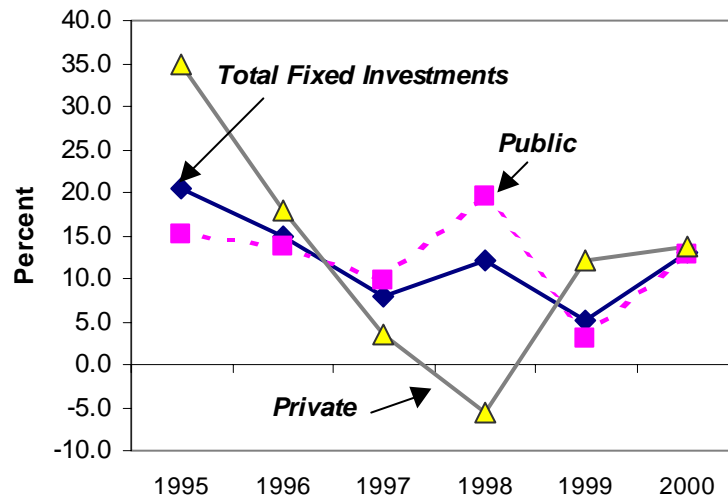
2. Growth in 2000 was mainly driven by domestic consumption and investment (Appendix, Table A3). The fiscal stimulus packages and the interest rate reductions are now having a positive effect on domestic consumption. After slowing for six consecutive years, retail sales grew by 9.9 percent in the first three quarters of 2000, compared with 6.8 percent in 1999 (Figure 1). A combination of fiscal stimulus packages and recovery in private (nonstate) investment led to strong growth (13 percent) in domestic fixed investment in the first eight months of 2000 (Figure 2). Public investment, which accounts for about three quarters of total investment, grew by 12.9 percent in the first three quarters of 2000, compared with about 3 percent in 1999. Private investment declined by about 8 percent in 1998 in the aftermath of the Asian crisis, but picked up strongly in the last two years. Following a 12 percent growth in 1999, private investment grew by 13.3 percent during the first three quarters of 2000.

Figure 1: Annual Percentage Change in Retail Sales of Consumer Goods
(1995 – September 2000)



Source: National Bureau of Statistics.

Figure 2: Annual Percentage Change in Nominal Fixed Investments
(1995 – September 2000)



Source: National Bureau of Statistics.

B. Inflation and Asset Prices

3. With the pickup in domestic consumption and investment, the deflationary trend in prices experienced in 1998 and 1999 has been arrested. Economic recovery in the crisis-affected countries in Asia and the strengthening of the oil prices in the international markets are also causing gradual hardening of domestic prices. In the first eight months of 2000, the consumer price index increased marginally, compared with a decline of 0.8 percent in 1998 and 1.4

percent in 1999 (Table 2). While the prices of food and clothing continued to decline, housing and services sector prices rose. For the full year 2000, the consumer price index is estimated to increase by about 0.5 percent.

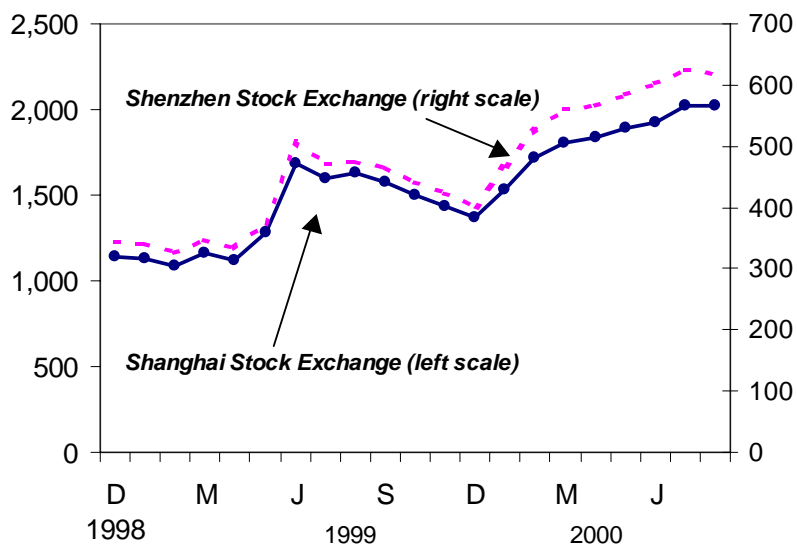
Table 2: Price Developments
(average annual percent change)

Item	1995	1996	1997	1998	1999	2000 Jan-Sep
Overall Consumer Price Index	17.1	8.3	2.8	(0.8)	(1.4)	0.2
of which:						
Food	22.9	7.6	(0.1)	(3.2)	(4.2)	(2.8)
Clothing	14.5	7.4	3.0	(0.8)	(2.7)	(1.2)
Housing	10.6	11.4	8.3	1.7	1.7	4.7
Services	20.2	16.0	16.5	10.1	10.6	14.5

Source: National Bureau of Statistics.

4. The strengthening of domestic demand and the improved economic outlook have been reflected in asset prices. The indices in both the Shanghai and Shenzhen stock exchanges have strengthened since mid-1999 (Figure 3). Property prices are also recovering gradually, although a substantial excess supply of commercial property remains in many cities. Real estate prices increased by about 1 percent in the first half of 2000, after declining in 1998 and stagnating in 1999. In particular, the prices of residential buildings and public apartments recovered significantly.

Figure 3: Composite Stock Price Indices
(Dec 1998 – Aug 2000)



Source: National Bureau of Statistics.

C. External Trade and Balance of Payments

5. With the recovery in the Asian economies, PRC's export growth has accelerated since mid-1999. Exports, which increased by 6.2 percent in 1999, grew at an annualized rate of 33.1 percent during the first three quarters of 2000. During 1998-1999, PRC's exports to North America grew strongly whereas exports to other economies especially those in Asia slowed. Export growth in 2000 was broad-based: exports to the United States (US) grew by 29 percent; Japan, by 34 percent; Hong Kong, China by 29 percent; Taipei, China by 31 percent; member countries of the Association of Southeast Asian Nations, by 47 percent; and Europe, by 34 percent. There was an equally strong growth of about 38.7 percent in imports. The pickup in domestic demand, the hardening of oil prices in the international prices, and higher imports by domestic enterprises to upgrade technology to meet the competition after PRC's entry into the WTO are the key factors driving import growth. Despite the strong import growth, the PRC will post a significant current account surplus in 2000, close to the \$16 billion surplus achieved in 1999 (Table 3; Appendix, Table A6).

Table 3: Exports, Imports and Current Account Balance

Item	1995	1996	1997	1998	1999	2000	
						Jan-Sep	Full Year ^a
(\$ billion)							
Exports ^b	128.1	151.1	182.7	183.5	194.7	182.3	235.0
Imports ^b	110.1	131.5	136.4	136.9	158.5	163.1	207.0
Trade Balance	18.1	19.5	46.2	46.6	36.2	19.2	28.0
Current Account Balance	1.6	7.2	36.7	29.3	15.6	-	16.0
Adjusted Current Account Balance ^c	35.5	45.3	78.3	70.4	52.6	-	50.0
(Annual Percent Change)							
Exports	24.9	17.9	20.9	0.5	6.1	33.1	20.6
Imports	15.5	19.5	3.7	0.3	15.8	38.7	24.9
(Percent of Gross Domestic Product)							
Current Account	2.6	2.4	5.1	4.9	3.7	-	1.5
Adjusted Current Account ^c	5.1	5.5	8.7	7.4	5.3	-	3.5
Memo Items:							
Exports (FOB, customs basis)	148.8	151.0	182.7	183.7	194.9	182.3	235.0
Imports (CIF, customs basis)	132.1	138.8	142.4	140.2	165.7	163.1	207.0

- = Data not available; FOB = free on board; CIF = cost, insurance, and freight.

^a Asian Development Bank estimates.

^b For 1995-1999, based on balance of payments accounting; for 2000, based on customs data.

^c Defined as current account balance plus net foreign direct investments.

Sources: National Bureau of Statistics, and State Administration of Foreign Exchange (SAFE).

6. Capital account developments continue to be difficult to predict, with actual foreign direct investment (FDI) declining by 8.7 percent and contracted FDI increasing by 27.9 percent during January-September 2000. However, with foreign exchange reserves of about \$160 billion, an external debt of \$148 billion that is mostly of medium- and long-term maturity, and debt-service ratio of only about 9 percent, the external payments situation continues to be comfortable (Tables 4-5).

Table 4: Capital Inflows and Balance of Payments Position
(\$ billion)

Item	1995	1996	1997	1998	1999
Net Capital Receipts	38.7	40.0	21.0	(6.3)	7.6
of which:					
Net Foreign Direct Investment	33.8	38.1	41.7	41.1	37.0
Errors and Omissions	(17.8)	(15.5)	(22.0)	(16.6)	(14.8)
Capital Receipts Net of Errors and Omissions	20.8	24.4	(0.9)	(22.9)	(7.2)
Change in Foreign Assets	22.5	31.7	35.7	6.4	8.5

Source: State Administration of Foreign Exchange (SAFE).

Table 5: External Debt and Debt Service

Item	1995	1996	1997	1998	1999	2000 Jan-Jun
Total External Debt (\$ billion)	106.6	116.3	131.0	146.0	151.8	147.6
Medium- and Long-Term Debt	94.7	102.2	112.9	128.7	136.7	133.4
Short-Term Debt	11.9	14.1	18.1	17.3	15.2	14.2
External Debt (percent of gross domestic product)	15.2	14.2	14.6	15.4	15.3	13.8
External Debt-Service Ratio (percent of exports)	7.6	6.0	7.3	10.9	11.5	-

- = Data not available.

Source: State Administration of Foreign Exchange (SAFE).

D. Money, Interest Rates, and the Exchange Rate

7. Since 1998, monetary policy has supported domestic demand and growth. Several times it was eased by lowering interest rates and reserve requirements for banks. The last interest rate reduction was in June 1999, and the last reduction in reserve requirements was in November 1999. The domestic one-year bank deposit rate is now 2.25 percent (compared with about 9.18 percent in mid-1996), and the prime lending rate of financial institutions is 5.85 percent (compared with 11 percent in mid-1996) (Table 6). Since June 1999, the domestic bank deposit rate has been lower than the comparable rate on dollar-denominated assets in the international capital market. The accommodative stance of monetary policy continued in 2000. The 2000 target for money supply (broad money defined as the sum of currency in circulation,

demand, savings, and time deposits) growth of 14-15 percent is similar to that in 1999 (Appendix, Table A5). By end-September 2000, money supply increased at an annual rate of 13.4 percent (Table 7).

Table 6: Benchmark Interest Rates
(percent)

Item	1-Jul-95	1-May-96	23-Aug-96	23-Oct-97	23-Mar-98	1-Jul-98	7-Dec-98	10-Jun-99	Aug 2000
Financial Institutions									
Time Deposit Rate (one year)	-	9.18	7.47	5.67	5.22	4.77	3.78	2.25	2.25
Lending Rate (one year)	12.06 ^a	10.98 ^b	10.08 ^b	8.64	7.92	6.93	6.39	5.85	5.85
Central Bank Rates									
Reserve Requirements	9.18	8.82	8.28	7.56	5.22	3.51	3.24	2.07	2.07
Loans to Financial Institutions (one year)	11.16	10.98	10.62	9.36	7.92	5.67	5.13	3.78	3.78

^a Can be 20% higher or 10% lower than nominal interest rates.

^b Can be 10% higher or 10% lower than nominal interest rates.

Source: People's Bank of China. *2000 Quarterly Statistical Bulletin*, Vol. XVII.

Table 7: Monetary Developments
(in percent)

Item	1995	1996	1997	1998	1999	2000 Jan-Mar
Net Foreign Assets	25.8	44.6	48.3	10.1	13.2	21.9
Net Domestic Assets	29.9	23.0	15.6	15.7	13.2	12.5
of which: Domestic Credit	23.7	24.5	18.5	20.0	12.1	16.3
Broad Money	29.5	25.3	17.3	15.3	14.7	13.4 ^a
Reserve Money	20.6	29.5	13.9	2.3	7.3	10.6
Money Multiplier	2.9	2.8	3.0	3.3	3.6	3.8

^a For end-September 2000.

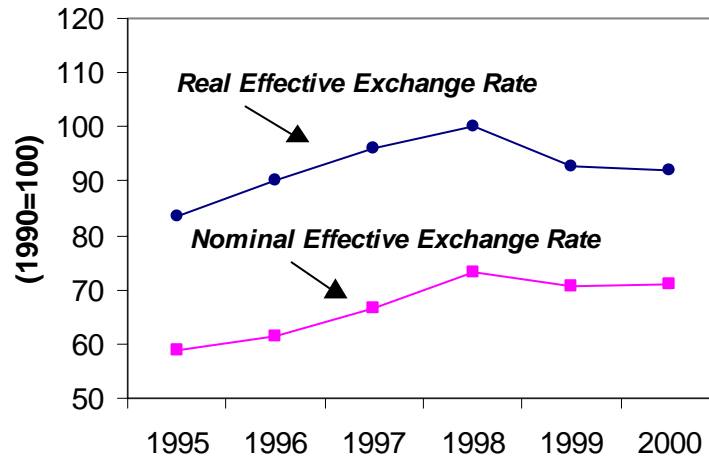
Source: People's Bank of China.

8. The yuan-dollar exchange rate continues to remain stable at about Y8.3 per dollar. Both the nominal and real effective exchange rates of the yuan had appreciated during 1997-1998 in the aftermath of the Asian crisis (Figure 4). With the recovery of most Asian currencies, however, both the nominal and real effective exchange rates of the yuan have depreciated since 1999, and are now back to their precrisis levels. With the skillful management of the economy, market speculation on a yuan devaluation has subsided. Reflecting this, the one-year forward exchange rate, which was close to Y10.5 to a dollar in 1997 (about 25 percent above the spot rate), has now fallen to about Y8.5 to a dollar, close to the official exchange rate.

9. To prepare the economy for the post-World Trade Organization (WTO) era, the People's Bank of China (PBC) is considering introducing mechanisms to gradually allow a greater role for market forces in determining the exchange and the interest rates. The Government recognizes that a more flexible interest rate and exchange rate regime would facilitate adjustment to reforms engendered by PRC's accession to WTO and also better equip the PRC to adjust to the

recent trend toward floating exchange rate regimes in the rest of the world, especially in Asia. At present, the lending rates of financial institutions are allowed limited flexibility, while deposit rates are fixed. The PBC plans to introduce further flexibility in determining lending rates, while continuing to keep deposit rates fixed in the near term. Along with the liberalization of interest rates, the PBC plans to introduce greater flexibility in the exchange rate.

Figure 4: Nominal and Real Effective Exchange Rates (1995-2000)



Source: International Monetary Fund.

E. Fiscal Developments

10. In the aftermath of the Asian crisis, the Government has followed an expansionary fiscal policy. Two fiscal stimulus packages (Y100 billion in 1998 and Y60 billion in 1999) were used to increase investment in infrastructure and pump prime growth. As a result, the fiscal deficit increased from less than 2 percent of GDP to 4.2 percent in 1999. The budget for 2000 continues the expansionary stance of fiscal policy, but with a slightly lower fiscal deficit of about 3.6 percent of GDP (Table 8). The slight reduction in the fiscal deficit was brought about largely by containing government expenditures, especially current expenditures, while the ratio of capital expenditures to GDP remained at the 1999 level. Tighter tax administration and stricter enforcement of antismuggling measures improved tax revenues in 1999 by 1.5 percentage points of GDP. At about 13.4 percent, the 2000 budget projects to maintain the tax-GDP ratio at its 1999 level.

11. The Government budget in the PRC gives only a partial picture of the actual revenue and expenditure operations of the Government due to the existence of several extrabudgetary revenue and expenditure items (Appendix, Table A4). The World Bank estimates these extrabudgetary revenues at about 7 percent of GDP, although the PRC Government believes that these revenues are lower at about 4-5 percent of GDP. Whichever of these estimates is taken, extrabudgetary operations undermine fiscal discipline, bias spending in favor of revenue-generating sectors (leaving less funds for nonrevenue-generating sectors, such as health, education, and environment), and increase regional disparities in public spending (since more

prosperous local governments are in a better position to raise such revenues and spend than poorer local governments). The Government has started to phase out some of the extrabudgetary revenues, convert others into taxes, and incorporate them in the formal budget. Completion of this fiscal reform program is crucial for better fiscal management. Other fiscal reforms that the Government is considering for implementation include (i) introducing centralized single account treasury management; (ii) improving budget preparation and presentation by requiring ministries and departments to present detailed expenditure allocations; (iii) presenting economic-cum-functional classification of budgetary operations; and (iv) linking budgetary allocation and management with strategic planning and policy at the macroeconomic level. In preparation for implementing these reforms, in July 2000 the Government reorganized the Budget Department in the Ministry of Finance.

Table 8: Trends in Public Finance
(as percent of gross domestic product)

Item	1995	1996	1997	1998	1999	2000 Budget
Government Revenues	11.1	11.3	12.1	13.0	14.2	14.1
Tax Revenues	10.4	10.2	11.0	11.8	13.3	13.4
of which:						
Taxes on Income and Profits	2.2	2.3	2.2	2.0	2.0	2.3
Taxes on Goods and Services	6.9	6.8	7.1	8.4	9.0	8.9
Customs Duties	0.5	0.4	0.4	0.4	0.7	0.6
Nontax Revenues	0.7	1.1	1.1	1.2	0.9	0.7
Government Expenditures	13.2	12.9	13.9	16.1	18.3	17.7
Current Expenditures	10.6	10.6	11.4	12.6	13.9	13.1
of which:						
Government Administration	1.5	1.5	1.6	2.3	2.5	2.5
Defense	1.1	1.1	1.1	1.5	1.7	1.7
Culture, Education, Public Health, Services	2.5	2.5	2.7	2.7	2.9	3.0
Subsidies	1.1	1.1	1.1	1.1	1.1	1.1
Interest Payments	0.2	0.2	0.2	0.2	0.2	0.2
Capital Expenditures	2.2	2.1	2.2	2.6	3.5	3.6
Fiscal Balance	(2.1)	(1.6)	(1.8)	(3.1)	(4.1)	(3.6)
Financing	2.1	1.6	1.8	3.1	4.1	3.6
Domestic	1.7	1.3	1.5	2.5	3.5	3.3
Foreign	0.4	0.3	0.3	0.6	0.6	0.3

Sources: Ministry of Finance, National Bureau of Statistics, and International Monetary Fund.

F. Poverty and Unemployment

12. Coupled with the Government's antipoverty programs, sustained economic growth and macroeconomic stability have enabled the PRC to continue its progress in poverty reduction. The number of rural people below the official poverty line declined from 42 million (4.8 percent of the rural population) in 1998 to 34 million (3.8 percent of the rural population) in 1999. It is estimated that the number of the rural poor further declined to about 27 million (3.1 percent of

the rural population) in 2000. Despite good progress, PRC's fight against poverty is far from over.

13. PRC's official estimate of poverty has two weaknesses: (i) it is based on a very low annual income of Y635 per capita, just about enough to meet the basic food and clothing requirements, and (ii) it does not cover urban areas. Estimates of poverty based on internationally comparable norms and covering both rural and urban areas are much higher. About 230 million people (18.5 percent of PRC's population) still live below the \$1-a-day poverty norm and 670 million (53.7 percent of the population) live below \$2-a-day.¹

14. The incidence of poverty in the interior provinces is much higher than the national average, especially in the western parts of the country. Also, poverty is multidimensional. Roughly half of the children in households at or below the absolute poverty line are at least mildly malnourished. Education and health conditions in the interior provinces are far below the national average.

15. The official estimate of urban unemployment at the end of 1999 was 5.8 million, about 3.1 percent of the urban labor force. However, this estimate covers only the urban unemployed who are registered with the Ministry of Labor and Social Security. It does not cover the 9.4 million *xiagang* workers who were laid off as part of the SOE reforms but have not found alternative employment. When *xiagang* workers were included, urban unemployment was about 15 million, or about 8.2 percent of the urban labor force (Table 9). Some observers believe that the actual urban unemployment is even higher, mainly because of significant unemployment among the 60 million-80 million "floating population".²

Table 9: Urban Unemployment

Item	1995	1996	1997	1998	1999
Registered Unemployed in Urban Areas (million)	5.2	5.5	5.7	5.7	5.8
Registered Unemployment Rate in Urban Areas (%)	2.9	3.0	3.1	3.3	3.1
<i>Xiagang</i> Workers (end-of-period, million)	-	-	9.9	9.0	9.4
Adjusted Unemployment Rate (%)	-	-	8.5	8.5	8.2

- = Data not available.

Xiagang workers = workers who keep a legal link to their enterprises but who receive little in the form of pay and benefits and are free to work elsewhere.

Sources: National Bureau of Statistics and International Monetary Fund, and ADB estimates.

16. Increased urban unemployment has given rise to urban poverty. However, there is no official estimate of urban poverty since the PRC has not officially adopted an urban poverty

¹ These estimates are based on per capita consumption norms at 1985 purchasing parity. The World Bank also presented an alternative estimate of 106 million rural poor living below \$1 a day, in a study, *China; Overcoming Rural Poverty, February 2000*. This lower estimate is based on \$1-a-day income norm. The consumption-based estimate is the World Bank's official estimate of poverty in PRC; hence, our reliance on this estimate.

² See ADB, PRC: *Country Economic Review*, December 1999.

line.³ In 1997, the Development Research Center of the State Council estimated urban poverty to be in the 12 million-15 million range (4-5 percent of the urban population) using an urban poverty line of Y1,700 per capita income per year.

II. ECONOMIC PROSPECTS

A. Medium-Term Forecasts

17. During the last three years, by skillful macroeconomic management the PRC has managed the contagion effects of the Asian crisis well. After a slowdown in the aftermath of the Asian crisis, PRC's exports are growing strongly. With the ongoing recovery of the crisis-affected countries in Asia, and continued strong growth in the American economy, PRC's exports should grow robustly although at a slower pace than the exceptionally high growth recorded in 2000. After slowing for several years, the rate of domestic consumption growth is on the rise, and should offset any slowdown in public investment that may occur as the Government winds down the fiscal stimulus measures of recent years. There is scope for maintaining the accommodative stance of monetary policy without necessarily causing undue inflationary pressure. During the next three years, while fiscal policy is likely to remain somewhat less expansionary than in the past, monetary policy is likely to continue its recent accommodative stance. Interest rates will continue to be low. Overall, the macroeconomic outlook for 2001-2003 is positive: (i) robust annual GDP growth in the 7-7.5 percent range, (ii) moderate annual inflation in the 2-3 percent range, (iii) comfortable external payments position despite a gradually declining current account surplus (Table 10).

Table 10: Projection of Key Economic Indicators (2001-2003)

Item	Unit	Estimate 2000	Projection		
			2001	2002	2003
Overall GDP	% growth	8.0	7.5	7.2	7.0
Gross Domestic Investment	% of GDP	38.5	38.0	37.5	37.0
Gross Domestic Saving	% of GDP	40.0	39.2	38.5	37.8
Consumer Price Index	% growth	0.5	2.0	2.5	3.0
Money Supply	% growth	15.0	16.0	17.0	18.0
Overall Fiscal Balance	% of GDP	(3.6)	(3.4)	(3.2)	(3.0)
Exports (Customs)	\$ billion	235.0	260.0	280.0	300.0
	% growth	20.6	10.6	7.7	7.1
Imports (Customs)	\$ billion	207.0	238.0	262.0	283.0
	% growth	24.9	15.0	10.1	8.0
Trade Balance (Customs)	\$ billion	28.0	22.0	18.0	17.0
Current Account Balance	\$ billion	16.0	14.0	13.0	11.0
	% of GDP	1.5	1.2	1.0	0.8

³ ADB is providing assistance for understanding urban poverty including developing an urban poverty line through TA 3377-PRC: Urban Poverty Study, for \$410,000, approved on 27 December 1999. Among other things, the TA will establish a framework for setting regional municipal poverty lines in PRC.

18. Driven by strong domestic consumption and robust export growth, the PRC will maintain an annual GDP growth in the 7-7.5 percent range during 2001-2003. Both the secondary and service sectors should grow at over 8 percent. Domestic consumption will remain strong as the general economic environment improves. Domestic consumption is forecast to grow at about 8 percent during 2001-2003. Export growth was exceptionally high in the first half of 2000 partly because of the low base of comparison: in January-May 1999 exports fell by 5 percent. This base effect will be absent during the second half of 2000. Export growth will also slow in the next few years as the Government starts to cut the tax incentives that were put in place to encourage export during 1998-1999. Despite a slowdown, annual export growth will remain robust, in the 7-10 percent range.

19. With the pickup in domestic consumption and growth, the deflationary trend in prices will be reversed. Prices will also firm up because of (i) a successful antismuggling campaign, which has reduced the supply of low-priced, illegal imports, (ii) rising world oil prices; and (iii) strengthening of prices in the rest of Asia, especially in the crisis-affected countries. However, given the significant excess capacities in many industry sectors, including several consumer industries, inflation is likely to be moderate, in the 2-3 percent range.

20. With PRC's possible entry into WTO and the liberalization of trade policies, including a reduction in tariffs, imports will grow faster than exports in the next few years. Also, foreign businesses in the PRC—mainly those operating manufacturing for exports—will continue to remit profits overseas, and the interest payments due on overseas borrowing by PRC enterprises will grow during the next few years. The major positive effect on PRC's exports from WTO membership will be felt only after 2005 when the Multi-Fiber Agreement (MFA) will be phased out. As a result, in the next few years, PRC's trade and current account surpluses will gradually decline. However, the decline in the current account surplus will be offset by larger foreign investment inflows, especially portfolio flows, as the PRC further opens up the economy to foreign participation to fulfill the WTO commitments. As a result, the overall surplus in the balance of payments will continue to be about \$10 billion per year, more or less the level achieved in 2000. Therefore, despite a reduction in the current account surplus, PRC's official foreign exchange reserves will be close to \$200 billion by 2003. These reserves will provide more than eight months import cover, more or less cover PRC's entire external debt, and will be several times the short-term external debt.

B. Risks and Uncertainties

21. Given the forces of globalization, any unexpected external shocks (such as a hard-landing of the American economy, another round of financial crisis in Asia, or the continuation of the recent exceptionally high oil prices in the international market beyond 2000) would have negative impacts on PRC's exports, foreign investment inflows, and the growth of the economy. PRC's positive economic outlook is also subject to certain domestic risks and uncertainties: (i) a deterioration in the fiscal situation, and (ii) failure to contain the social costs of SOE reforms within tolerable levels.

1. Fiscal Vulnerability

22. At 3.6 percent of GDP, PRC's fiscal deficit in 2000 is moderate by international standards. Similarly, at about 23 percent of GDP, the total Government debt is moderate. However, these estimates do not give a full picture of the potential fiscal vulnerability as they do

not take into account; (i) the quasi-fiscal expenditures needed to resolve the problem of nonperforming loans (NPLs) of the State-owned banks and to recapitalize them, (ii) the unfunded pension liabilities of the Government, and (iii) the expenditures necessary to finance the social security obligations.

23. According to estimates of the International Monetary Fund (IMF), once the quasi-fiscal expenditures are taken into account, the public sector deficit in 2000 would be about 8 percent of GDP, and the Government debt stock would be about 50 percent of GDP.⁴ The fiscal implications of reforming the social security system and resolving the legacy of the NPLs by the asset management companies suggest that the public sector deficit could increase to 10 percent of GDP by 2003 and to 13 percent by 2008. The public debt stock could increase to 65 percent of GDP by 2003 and to 90 percent by 2008. These projections are based on an assumption that nonrecoverable bad loans with the State banks are now about 20 percent. Allowing for a higher ratio of nonrecoverable loans with the banks, say 30 percent, the ratio of debt stock to GDP would increase to more than 100 percent by 2008.

24. Whichever of these projections is taken, significant fiscal adjustment will be required to make the fiscal situation sustainable. According to IMF estimates, the annual fiscal adjustment required to maintain the public debt stock-to-GDP ratio at 65 percent by 2008 is in the range of 2-3 percent of GDP. In other words, to limit the debt stock to 65 percent of GDP by 2008, on average, the Government will have to reduce expenditures and/or raise additional revenues worth 2-3 percent of GDP. This is a challenging task, especially since Government expenditure as a percentage of GDP has increased (from 13 percent in 1995 to 18 percent in 2000) faster than revenues (from 11 percent in 1995 to 14 percent in 2000) in recent years.

25. Besides prioritizing Government expenditures and better managing the expenditure side of the budget, the fiscal adjustment will require a fundamental reform of PRC's fiscal system.⁵ After the 1994 budgetary reforms, there is a growing mismatch between the expenditure responsibilities and revenues of local governments. Local government expenditure responsibilities are now generally larger than their revenues can finance. The transfers from the central Government to local governments are not based on expenditure responsibilities of local governments, and local governments have limited revenue-raising authority. Hence, local governments have strong incentives to resort to ad hoc extrabudgetary revenues often earmarked for specific expenditure categories. About 85 percent of the extrabudgetary funds in the PRC are managed by local governments, and 40 percent of the public spending at the local level is financed by extrabudgetary funds. This practice not only reduces budgetary revenues but also makes control and management of public expenditures difficult. To address this problem, a comprehensive reform of the fiscal federal system is required.⁶ The reform program should include measures to (i) convert most extrabudgetary revenue sources into taxes, (ii) delineate the revenue bases and expenditure responsibilities of the different layers of the

⁴ IMF, People's Republic of China: Staff Report for the 2000 Article IV, Consultation, August 2000.

⁵ A World Bank study, *PRC: Managing Public Expenditures for Better Results*, March 1998, presents the challenges and options of public expenditure management. An ongoing Asian Development Bank (ADB) Technical Assistance (TA) 3253-PRC: *Strengthening Public Infrastructure Investment Policy*, for \$600,000, approved on 8 September 1999, will provide more recommendations on prioritizing public infrastructure investments, developing innovative methods of financing, and improving efficiency of public infrastructure provision.

⁶ A series of ADB TAs have been provided to the Ministry of Finance to address several of these issues: (i) TA 2118-PRC: *A Study of Subprovincial Fiscal Relations*, for \$500,000, approved on 28 June 1994; (ii) TA 2743-PRC: *A Study of Extrabudgetary Expenditures and Revenues*, for \$600,000, approved on 31 December 1996; and (iii) TA 2924-PRC: *A Study of Municipal Public Finance*, for \$600,000, approved on 27 November 1997.

government, (iii) establish a fiscal transfer system from the central Government to local governments that is responsive to expenditure needs, and (iv) enable local governments to set their tax policy in accordance with local conditions.

26. The Government is aware of these fiscal problems and has initiated measures to abolish certain extrabudgetary levies, incorporate some of them in the budget, and convert the others into taxes. About 1,860 fees generating revenue worth Y75 billion have been abolished, and another 100 fees worth about Y200 billion in revenues have been incorporated in the budget. However, the Government is facing severe resistance in converting local fees into official taxes: a May 1999 decision to convert road maintenance and vehicle purchase fees collected at the local level into a fuel tax has yet to be implemented.

2. Social Costs of SOE Reforms

27. Despite robust growth in recent years, the urban unemployment rate remains high mainly because of labor layoffs associated with SOE reforms. By mid-2000, about half of the 30 million-35 million surplus workers in SOEs had been laid off. Additional layoffs of a similar magnitude are expected in the coming years. This will raise the already high urban unemployment rate. The social safety nets necessary to prevent many of the laid-off workers from falling into poverty are yet to be developed. Failure to contain the social costs of SOE reforms within tolerable levels by reforming the social security system will increase the country's economic vulnerability by undermining the broad-based public support for the Government's reform program.

28. The response of the Government to the increasing urban unemployment has been threefold: (i) promoting the development of the private sector, especially the small and medium-size enterprises (SMEs); (ii) introducing temporary safety net programs in urban areas; and (iii) initiating reforms of the social security system.

29. The Government recognizes that a dynamic private sector could play an important role in absorbing the workers made redundant by the SOE reforms and become a major engine of growth and employment generation in the economy. The Government has adopted a series of measures to create an enabling environment for the private sector, including (i) amending the constitution in March 1999 to give greater constitutional status to the private sector; and (ii) enacting a number of economic laws to develop a sound legal and regulatory framework required for the efficient functioning of a market economy.⁷ Within this overall framework, the Government is promoting SMEs through such measures as liberalizing their entry in key sectors and encouraging banks to lend to them. More recently, the Government sought to improve access to credit for private firms by setting up credit guarantee schemes for SMEs in 70 cities, and by abolishing the quota system for new stock market listings. The State commercial banks have established SME departments to improve their services to SMEs. The Government also proposes to establish a separate board for SMEs on the stock exchange.

30. In 1997, the State Council issued a circular under which all cities and towns were required to establish social relief schemes for the urban poor by the middle of 1999. In

⁷ Details of these measures are discussed in CER: PRC 99029: *Country Economic Review*, December 1999. ADB will be assisting the Government in developing strategies and policies for private sector and SME development through a series of TAs under processing: *Policies for Private Sector Development* for \$600,000; *Development of SME Financing Policies and Mechanisms* for \$750,000; and *Development of an SME Credit Support System* for \$750,000.

September 1999, the State Council promulgated the Regulations on the Minimum Living Standard for Urban Residents. Under these programs, laid-off workers are being trained at reemployment centers and will receive some living allowances for a maximum of three years. If they fail to get a new job within the period, they will receive unemployment insurance for an additional two years. Those who fail to get new jobs after receiving two years unemployment insurance and have income less than the minimum living standard will be entitled to a minimum subsistence allowance managed by the Ministry of Civil Affairs. However, these schemes, which are funded by central and local governments and managed by the municipal governments, are still in the formative stage. The operational and financial capacity to undertake these urban poverty relief programs varies vastly across cities.

31. The existing social security system in the PRC is characterized by (i) systemic fragmentation because of unbalanced coverage and poor affordability; (ii) high level of implicit pension debt (between 50 and 150 percent of GDP), which poses significant risks for financial sustainability, (iii) inefficient administrative structure and poor accountability, (iv) absence of supplementary social insurance schemes, and (v) underdeveloped legal, regulatory, and supervisory framework for the system. With assistance from the Asian Development Bank (ADB), the Government is initiating a social security reform program to address many of these weaknesses in the system.⁸ The key objectives of the program are to help transform the existing system into a multifaceted and financially sustainable system, broaden its coverage by striking an appropriate balance between the adequacy of social benefits and their affordability, and establish an enabling environment that is beneficial to the long-term viability of the system.

32. A high-level Task Force was set up to review and recommend the required changes in the country's social security system before the end of 2000. The Task Force is expected to recommend some pilot social security reform programs for implementation in 2001. In another major step in social security reforms, a National Social Security Fund has been established to finance the transitional costs of the pension reform program.⁹ These are welcome initiatives but, given the nature of the problem, completing the social security reforms will take time.

III. POLICY AND DEVELOPMENT ISSUES

33. Over the medium term, effectively implementing the recently initiated reforms in the financial and state enterprise sectors, developing the legal and regulatory framework for a market economy, and promoting the private sector will continue to be challenging tasks.¹⁰ The Government will also have to address two other development challenges: (i) managing the post-WTO reform program, and (ii) promoting development in the poor interior provinces.

⁸ ADB's assistance in this area includes: TA 2383-PRC: *Fiscal Policy and Regulatory Framework for Social Security System Reform*, for \$540,000, approved on 23 August 1995; TA 3148-PRC: *Pension Reform*, for \$2.4 million, approved on 28 December 1998; TA PRC: *Policy Support for Social Security Reform under the Tenth Five-Year Plan*, for \$150,000 (under processing). At present ADB is also processing a loan of \$300 million to assist the Government in a comprehensive reform of the entire social security system.

⁹ A discussion of the pension reform program is presented in CER: PRC 98005: *Country Economic Review*, October 1998.

¹⁰ These issues are discussed in CER: PRC 99029: *Country Economic Review*, December 1999.

A. Implementing Financial Sector Reforms

34. The establishment of four asset management companies (AMCs) to resolve the problem of NPLs of the banking system in 1999 was a major step in reforming the financial sector.¹¹ About Y1,300 billion (\$157 billion) of NPLs, equivalent to about 10 percent of the total assets of the four big banks, were to be transferred to the AMCs by June 2000. Most of them have now been transferred. The method most preferred by the AMCs to resolve the NPL problem have been debt-equity swaps. The four AMCs have signed contracts for debt-equity swaps worth about Y200 billion with 228 enterprises and are making efforts to recover these NPLs. According to official estimates, the potential for debt-equity swaps is Y400 billion-500 billion, or 30-40 percent of the NPLs transferred to the AMCs. Hence there is scope for additional debt-equity swaps of about Y200 billion-300 billion in the next few years.

35. While the transfer of a significant proportion of NPLs to the AMCs will improve the financial position of the banks, the ultimate success of the AMCs will depend on the rate of recovery from NPLs. At present, debt-equity swap agreements exist mainly on paper, and no restructuring of the enterprises has been initiated partly because the AMCs and the enterprises cannot agree on the valuation of the equity stakes. For the AMC initiative to succeed, debt-equity swaps must be accompanied by meaningful restructuring of the borrower enterprises. This would require (i) providing legal powers to the AMCs to restructure the management and operations of the enterprises in which they become stakeholders, including the ability to replace managers wherever necessary; and (ii) enhancing creditors' rights by revising the bankruptcy law and establishing procedures for the valuation and disposal of State assets.¹²

36. Even with the best efforts of the AMCs, only a small proportion of the NPLs acquired from banks will be recovered. Of the Y1,300 billion book value of the NPLs acquired by the AMCs, optimistic assessments put that percentage which can be recovered at 30 percent; other assessments put it in the 15-20 percent range. This means that significant fiscal support will be required to prevent the AMCs from becoming nonviable. Also, the Y1,300 billion of NPLs transferred to AMCs constitutes only a portion of the total NPLs of the banks. Results from a pilot project in Guangdong, which implemented a new loan classification system for banks (that is largely in conformity with international practices) in 1999, showed that NPLs of the four big banks (defined as loans on which interest payments were in arrears for more than a year) were about 40 percent of their total loans. If the more stringent delinquency norm of either six months or three months were applied, the proportion of NPLs would be about 50 percent. A significant amount of the stock of NPLs, therefore, remained with the banks even after transferring Y1,300 billion NPLs to the AMCs. In addition, banks may also acquire more NPLs from their fresh lending activities. Tackling this flow problem will be as important as tackling the existing stock of NPLs. Ultimately, as experience elsewhere shows, a considerable amount of fiscal resources will be required to resolve the NPL problem and successfully restructure the banking system.

37. Over the medium term, the risks to the financial system could also come from the non-bank financial institutions. In recent years, the Government has made significant efforts at

¹¹ The Cinda AMC for China Construction Bank, China Chongcheng (Great Wall) AMC for Agricultural Bank of China, China Dongfang (Oriental) AMC for Bank of China, and China Hua Rong AMC for Industry and Commerce Bank of China. A detailed discussion of other financial sector reform measures is presented in CER: PRC 99029: *Country Economic Review*, December 1999.

¹² Some of these issues are being addressed by ADB's TA 3303-PRC: *Institutional Strengthening of the CINDA Asset Management Company*, for \$800,000, approved on 24 November 1999; and TA 3279-PRC: *Development of Economic Laws*, for \$1,400,000, approved on 19 October 1999.

restructuring a large number of nonbank financial institutions.¹³ The proportion of NPLs among these institutions is even more serious than in the case of banks. The Government must address the problem of NPLs of financial intermediaries outside the four big banks so as to prevent these intermediaries from transmitting systemic risks to the financial sector.

38. The success of financial sector reforms in the PRC will depend on progress in developing a vibrant capital market. Like the financial systems of the crisis-affected countries in Asia, PRC's financial sector is bank-dominated. The Asian crisis resulted in part from the large dependence of enterprises on banks for their finance. In most of the crisis-affected economies, bank loans represented 80 percent of enterprise debt in the region (compared with only about 22 percent in the US). Undue dependence on bank credit made the corporate sector insensitive to profitability as a criterion for making investment decisions, and highly vulnerable to changes in bank attitudes toward risk. The absence of vibrant domestic capital markets, particularly the bond market, forced enterprises in some of these countries to resort to unhedged dollar-denominated borrowing from the international capital market. When investor sentiment turned negative toward those countries, the unhedged external commercial borrowings aggravated the crisis.

39. In addition to reducing the vulnerability of PRC's financial sector, a vibrant capital market will also help in privatizing the SOEs, finance the growth of the private sector, especially the SMEs and greenfield venture companies that will generate the much-needed employment opportunities (at a time when SOE reforms are resulting in labor shedding) and enable the Government to implement pension and social security reforms. Experience from countries with mature financial sectors shows that a vibrant capital market plays an important role in reducing corporate leverage, diversifying corporate ownership, and improving corporate governance. None of these can be done well by a bank-dominated financial sector. Recognizing these imperatives, the PRC is initiating measures to develop the capital market.

40. The passage of the Securities Law, and the establishment of the regulatory agencies (such as the China Securities Regulatory Commission and the China Insurance Regulatory Commission) are major steps in developing the capital market.¹⁴ While these measures mark an end to the inconsistent and often cumbersome patchwork of regulations on the securities market, they have not addressed some of the key structural issues, such as the segregation of the market into "A" and "B" shares segments, the illiquidity of State and legal person shares in the secondary market, Government control of the process of initial public offerings, Government's dominant ownership of listed companies, and the inadequate rights of minority shareholders. The Government is now considering allowing the listing of foreign enterprises on the domestic stock market (in both the "A" and the "B" share segments). As the Government makes progress in implementing the new Securities Law and strengthens the regulatory capacity of the regulatory agencies, issues related to corporate governance and enterprise reforms will need to be addressed. The disclosure, accounting, and auditing standards in the capital market also need to be improved to bring them in line with best international practices.

¹³ The measures are discussed in CER: PRC 99029: *Country Economic Review*, December 1999.

¹⁴ ADB's assistance in this area include: TA 3032-PRC: *Legislation Drafting Support for Securities Law*, for \$150,000 approved on 24 June 1998; TA 3304-PRC: *Capacity Building of the Capital Market's Regulatory System* for \$1,000,000, approved on 24 November 1999; and PRC TA 3302: *Capacity Building of the Insurance Sector Regulatory System*, for \$700,000, approved on 23 November 1999.

B. Managing the Post-WTO Reform Program

41. With the conclusion of bilateral negotiations with most trading partners, the PRC is likely to become a member of WTO by end-2000 or early 2001 (see box for PRC's commitments for WTO accession). PRC's accession to WTO will be a turning point as it will involve significant opportunities as well as challenges for the country. It is difficult to accurately gauge the economic pros and cons of WTO membership to the PRC. Over the long term, PRC's accession to WTO and the commitments to cut tariffs, liberalize trade and investment, and open up domestic sectors for foreign participation should lead to significant efficiency gains. By reallocating resources in line with PRC's comparative advantage (from capital-intensive to labor-intensive sectors), it should also generate more employment for a given rate of growth of the economy. However, these benefits will take time to materialize. During the transition, PRC's membership to WTO will also pose certain challenges, especially in sectors such as agriculture, automobiles, banking, insurance, and telecommunications.

42. Membership to WTO will further improve the country's export prospects. At present, PRC's share of the world market in garments is kept at 17 percent due to quotas imposed under the MFA. More than half of PRC's exports to the US and about half of exports to the European Union face nontariff barriers. In recent years, the US has imposed new quotas on PRC's exports of silk, and Europe has introduced quotas on a range of other exports, such as footwear, toys, and kitchenware. Membership to WTO will eliminate these restrictions and improve PRC's export prospects. A major impetus to PRC's exports will be felt following the phasing out of the MFA in 2005. One recent study shows that WTO membership will result in significant increases in PRC's share of world exports of wearing apparel (from 18 percent to 44 percent), textiles (from 8 percent to 10 percent), electronics (from 5 percent to 8 percent), metals (from 3.5 percent to 5 percent), and other manufactures (from 8 percent to 10 percent).¹⁵ The study estimates that by 2005, PRC's share of world exports will be about 6.3 percent with accession compared with 4.6 percent without accession. Although these estimates are only indicative, one thing is clear: PRC's export prospects will improve after joining WTO, especially after the MFA is phased out.

43. For PRC's consumers, WTO membership will mean greater freedom to choose because of the increased availability of goods and services at competitive prices. The set of choices of domestic consumers will expand enormously in a wide variety of goods and services, ranging from agricultural products, to automobiles, banking, insurance, telephone, and Internet services. Most studies estimate that the long-term gain from WTO membership to the PRC will be equivalent to about 1-2 percent of GDP.¹⁶ The gain in GDP will also translate into better employment opportunities. Employment opportunities will improve because of a reallocation of resources from more capital-intensive to more labor-intensive sectors. Most of the output and employment gains are expected to occur in sectors such as textiles, garments, electronics, meat and dairy products, and services.

¹⁵ Lanchovichina, E., W. Martin and E. Fukase. 2000. Assessing the Implications of Merchandise Trade Liberalization in China's Accession to WTO. World Bank. June. (mimeo)

¹⁶ These studies are: Shoukang Li and Fan Zhai. 1999. China's WTO Accession and Implications for National and Provincial Economies. October. (mimeo.); Martin, W., B. Dimaranan and T. Hartel. 1999. Trade Policies, Structural Change, and China's Trade Growth. World Bank. November. (mimeo.); Rosen, D. 1999. China and the World Trade Organization: An Economic Balance Sheet. Institute for International Economics. Washington. June; Development Research Center of the State Council, PRC. 1998. The Global and Domestic Impact of China Joining the World Trade Organization, December; and presentations made at the ADB-funded International Conference on Developing Through Economic Globalization, 4-8 July 2000, in Shanghai.

Box Article: Highlights of PRC's Commitments to WTO Accession

PRC's commitments to accession to WTO are many and complex, covering such areas as tariffs, quotas, export subsidies, agricultural trade, telecommunications, banking, insurance, and other sectors and issues. The following is a summary of the more important of the commitments

Tariffs, Export Subsidies, and Quotas

- The PRC will cut its average import tariff for agricultural products from 20 percent to 17 percent by 2004 based on a tariff-cum-quota system with import quotas increasing over time.
- The average tariff on industrial products will be cut from 18.5 percent to 9.4 percent by 2005, with tariffs on automobile imports cut from the current 80-100 percent range to 25 percent, tariffs on information technology products such as computers, semiconductors, and Internet-related equipment reduced from an average of 13.3 percent to zero, and tariffs on products such as wood, paper, chemicals, and medical equipment reduced to 7 percent by 2003.
- The PRC will eliminate export subsidies, quotas, and quantitative restrictions on imports within five years of joining WTO.

Telecommunications

- The PRC will phase out all geographic restrictions on paging and value-added services within two years of joining WTO, on mobile/cellular services in five years, and domestic wireline services within six years.
- The PRC will allow 49 percent investment by foreign telecom service providers from the date of accession to WTO, 50 percent foreign ownership for value-added services within two years of joining, and 50 percent foreign ownership for paging services within three years.

Banking

- The PRC will allow full market access to foreign banks within five years of joining WTO.
- Foreign banks will be allowed to conduct local currency business with PRC enterprises in two years after the PRC joins WTO, and will be allowed to conduct local currency business with individuals after five years.
- Foreign banks will have the same rights (national treatment) as PRC banks.
- The current geographic restrictions on foreign bank operations will be removed within five years of joining WTO.

Insurance

- The PRC will permit foreign property and casualty firms to insure large-scale risks nationwide immediately upon accession, and will eliminate all geographic limitations

for future licenses over five years, allowing access to the key cities of priority US interest in two to three years.

- The PRC will expand the scope of activities for foreign insurers to include group health and pension lines of insurance, which represent about 85 percent of total premiums, phased in over five years after joining WTO.
- The PRC will allow 50 percent foreign ownership and remove joint-venture requirements on foreign life insurers, and phase out internal branching restrictions.
- For nonlife insurance, the PRC will allow 51 percent foreign ownership upon accession to WTO.
- The PRC will award licenses for insurance business solely on the basis of prudential criteria, with no economic needs test or quantitative limits on the number of licenses issued.

Other Commitments:

- The PRC has provided a broad range of commitments to open up the country's professional services, including legal, accountancy, taxation, management consultancy, architecture, engineering, urban planning, medical and dental, and computer-related services.
- The PRC will allow unrestricted access to the market for hotel operations with the provision to set up 100 percent foreign-owned hotels within three years of joining WTO, with majority ownership allowed upon accession.
- The PRC will allow trading rights (the right to import and export) and distribution rights for foreign firms, including in areas such as wholesale and retail trade, after-sale service, repair, and maintenance.
- The PRC will allow imports of motion pictures and 49 percent foreign ownership in joint ventures involved in the distribution of motion pictures.
- The PRC will ensure that State-owned enterprises (SOEs) will make purchases and sales based solely on commercial considerations, such as price, quality, availability and marketability, and provide foreign firms with the opportunity to compete for sales and purchases on nondiscriminatory terms and conditions.
- The PRC will allow foreign nonbanking firms to provide auto-financing.
- The PRC has agreed to US safeguards remaining in place for another 12 years after WTO accession to prevent a sudden surge in imports damaging US producers. It also agreed to the US keeping for 15 years its current method of evaluating whether PRC's goods were being dumped on the US market.

44. With the accession to WTO, PRC's governance standards across a wide range of sectors will need to improve. Accession to WTO will involve aligning the country's legal and regulatory framework to the requirements of a market economy. In particular, with WTO accession, the PRC will need to modify its domestic laws and regulations to be consistent with

its obligations under the WTO agreements and the protocol of accession. The most fundamental of these obligations are (i) nondiscrimination between suppliers in accordance with the most-favored-nation principle, (ii) nondiscrimination between domestic and foreign enterprises in accordance with the national treatment clause, and (iii) abolition of most nontariff barriers to trade and development of a trade regime based on tariff as the key policy instrument. Other stipulations will require increased transparency in PRC's trade regime, judicial review of administrative decisions, phasing out of the general restrictions on trading rights, elimination of multitier pricing systems, and purchase and sales decisions of enterprises made solely on commercial basis. Over time, WTO membership will also require the implementation of WTO-consistent policy regimes in intellectual property rights, customs valuation, and safeguard procedures and standards. WTO membership should also lead to improved legal, supervisory, accounting, and auditing standards across a wide range of sectors to cope with a more competitive environment.

45. These positive effects of accession to WTO will take time to materialize. In the interim, the commitments to cut tariffs, remove nontariff barriers, and allow foreign participation across a wide range of sectors could pose adjustment challenges. With trade liberalization, PRC's imports will increase. Since the major positive impetus to PRC's exports will occur after the phasing out of the MFA in 2005, the current account deficit will worsen until about 2005. Along with increased imports, sectoral realignments and adjustments will also be required. However, the required adjustments have been reduced because (i) the PRC has already significantly reduced both the level and dispersion of tariffs during the 1990s, (ii) about three quarters of PRC's imports at present enter at close to zero tariff rate due to several duty exemptions, and (iii) the liberalization of foreign participation in service sectors (such as banking, insurance, securities business, telecommunications, and retail and distribution) will lead to increased FDI flows to the PRC.

46. Between 1992 and 2000, the average tariff rate on all imports was reduced from 43 to 17.5 percent, that on manufactures from 45 to 17 percent, and that on primary products from 36 to 18 percent. During the same period, the dispersion of tariffs was also reduced sharply, with the standard deviation of tariffs falling from about 32 to 13 percent. Due to these tariff reductions and the presence of duty exemptions, about 75 percent of imports to the PRC now enter at close to zero tariffs: 50 percent for export processing trade, 10 percent for initial investment of joint ventures, 5 percent for bonded warehouses, and 10 percent as other exempted imports. While the tariff reforms and concessions of the 1990s and the increased FDI flows to the service sectors should reduce the transitional adjustment costs of PRC's membership to WTO, the next few years will still pose some challenges, especially in sectors such as agriculture, automobiles, banking, insurance, and telecommunications.

47. The PRC will be entering WTO with a relatively efficient agriculture sector that has the potential to be internationally competitive in many agricultural commodities.¹⁷ Despite this, agricultural trade liberalization and the commitment to give a minimum market access for agricultural imports will replace domestic production by imports at the margin and thereby reduce farm incomes and employment. This adverse effect will vary across subsectors within agriculture (labor-intensive sectors versus resource-intensive sectors) as well as across regions within the country. While farmers in the coastal areas may be able to switch to less resource-intensive and more labor-intensive products such as fruit, vegetables, meat, dairy and aquatic

¹⁷ Martin, W. 1999. WTO Accession and China's Agricultural Trade Policies. World Bank. June. (mimeo). Fenqin Zhao, T. I. Wahl and H. Wang, 2000. Trade Liberalization under China's WTO Accession: Implications for China and the U.S. Grain Markets. Washington State University. July. (mimeo).

products, farmers in the poor inland provinces working on small plots of land (at about 0.137 hectare, PRC's average farm size is one of the smallest in the world) may not be able to do so because of inadequate knowledge, technology, and infrastructure. Therefore, farm incomes and employment are likely to fall more in the poorer inland provinces.

48. To some extent, these adverse effects will be contained by the tariff-cum-quota system that the PRC will adopt upon its entry to WTO. Under this system, a lower tariff will be applied to most agriculture imports (such as rice, wheat, cotton, sugar, soybean oil, palm oil, and rapeseed oil) up to a specified maximum level of imports, and imports above that limit will be subject to a higher tariff rate. The option of charging higher tariffs on imports above the quota limit will work as a shield, and allow smoother adjustment in agriculture. The key challenge for the Government is to enable the farmers at the margin to shift from resource-intensive subsectors (such as food grains, and edible oils) to more labor-intensive subsectors (such as vegetables, fruits, meat, dairy products, and processed food) over time by disseminating technology, and providing better infrastructure and other support facilities, including finance.

49. The automobile sector in the PRC has developed behind high tariff walls. As tariffs are lowered and the sector is opened to foreign competition, domestic producers will come under tremendous competitive pressure. The over 120 PRC vehicle producers are fragmented and inefficient. Sheltered by high tariffs and local government protection, most have resisted years of rationalization attempts by the Central Government. Under WTO, tariffs on imported cars will fall from 80-100 percent to 25 percent, and foreign car makers will be allowed to supply auto-financing for buyers. All these will compel domestic vehicle producers to bring their costs down by at least two fifths if they are to survive. It is possible that many of them will not be able to withstand such competition and will shut down. Studies indicate that with PRC's accession to WTO, output and employment in the automobile sector will be significantly reduced.

50. PRC's post-WTO reform commitments in the financial sector are substantial. Foreign banks will be allowed to conduct local currency business, and restrictions on foreign participation in the securities business, auto-financing by nonbank institutions, and the insurance business will be reduced. With foreign market shares in these sectors extremely small (for example, foreign banks now account for 1.6 percent of total bank assets), the changes are potentially large. As experience elsewhere shows, in the long run increased foreign participation in the banking sector will have a positive effect on the sector by increasing competition, introducing new technology and know-how, and providing additional funds for recapitalization. In the short to medium term, however, by offering efficient services including electronic banking at competitive prices, foreign banks will wean away clients, often the best ones, from domestic banks. This will further worsen the asset quality of domestic banks. The key challenge for the Government is to strengthen domestic banks by tackling the problem of NPLs and implementing internationally comparable prudential norms and risk management practices so that these banks can adjust to international competition. Some domestic banks will have to form strategic partnerships with foreign banks to meet the post-WTO challenges. Such strategic partnerships will give foreign banks increased access to domestic currency business, while domestic banks will benefit from additional foreign capital and better know-how.

51. Like the banking sector, PRC's insurance sector will also face adjustment challenges. Most life insurance companies in the PRC have payout obligations that are significantly greater than their current return on investments. The sector is also oligopolistic in that only a few companies dominate the sector. Shortages of actuaries and professional insurance management staff have contributed to poor business practices by insurance companies. In quality of service and business skills, PRC's insurance companies lag behind international ones.

Domestic insurance companies will have to make serious efforts at adopting international business and prudential practices so that they can adjust to the international competition that will follow PRC's entry into WTO. Unlike the banking sector, the insurance sector in the PRC is relatively small. The stakes therefore are much smaller than in the case of the banking sector. Being relatively new, the insurance sector has the opportunity to leapfrog and catch up with international best practices relatively quickly.

52. Until early 1999, the telecommunications sector was predominantly monopolistic, with the Government-owned China Telecom controlling most of the business including fixed-line telephone service, cellular telephones, and Internet service. Although this situation changed after the Government decided to split China Telecom into different independent service providers, the telecommunications sector will face stiff competition from foreign companies once the PRC joins WTO. While the introduction of foreign competition to telecom services should improve service quality and reduce costs, it will put adjustment pressure on the newly created domestic companies.

53. On the positive side, PRC's telecommunications sector is undergoing significant changes. Because of the rapid growth of the sector, the PRC has about 110 million fixed-line telephone users (roughly 13 lines per 100 people nationwide, and 28.4 lines per 100 people in urban areas), 43.2 million mobile phone users, 10 million Internet users, and 15,000 Internet sites. These information technology indicators compare well with those of other large countries at a similar stage of economic development. With the increasing access to Internet, telecommunication charges are declining rapidly. For example, overseas fixed-line telephone calls from the PRC cost about \$4 a minute two years ago, but now costs less than \$1, partly because of competition from Internet phone companies.

54. To promote the orderly development of the sector and to prepare it for foreign competition, the Government has separated the regulatory functions from operations. China Telecom, the dominant player, operates infrastructure network and interconnection in the telecommunications sector, and the regulatory functions are the responsibility of the newly created Ministry of Information Industry (MII). This separation of regulation from operation is a welcome initiative. However, there are apprehensions that MII will not be able to function independently and impartially because it has a financial stake in China Telecom. As experience elsewhere shows, regulatory agencies deviate from promoting fair competition when they have a financial stake in the dominant firm in the sector.¹⁸ MII must function as an independent and impartial regulator that regulates the telecommunications industry in the best interest of the consumers. Recognizing these imperatives, the Government plans to enact a comprehensive telecommunications law. As enactment of the law will take time, the Government is now preparing a set of regulations to guide the orderly growth of the sector. The regulations are currently with the State Council and are expected to be approved soon.

C. Promoting Development in the Poor Interior Provinces

55. With annual GDP growth of close to 10 percent, the PRC has been the fastest growing economy in the world in the last two decades. As has happened in other countries, not all regions benefited equally from this rapid economic growth. The eastern coastal region was

¹⁸ For a discussion of some of these issues, see Huizhong Zhou and Limin Liu, 2000. Containing the Dominance of the Incumbent in the Chinese Telecommunications Industry. Western Michigan University, Department of Economics, July. (mimeo).

strategically better positioned to benefit from economic liberalization and opening up. Consequently the east coast grew faster than the rest of the country. As a result, disparities in regional living standards have grown during the last two decades.

56. In 1998, the per capita GDP in western PRC was about two thirds of the national average, about 80 percent of that of the central provinces, and only one third of that in the eastern region. In a particularly striking contrast, the average per capita income in Guizhou Province is only 8 percent of that of Shanghai. The regional disparities are also reflected in other socio-economic indicators. For example, the incidence of poverty (based on the official poverty line) in western PRC is about 14 percent. This is more than double the national average, about four times the level of poverty in the central region, and about seven times that of the eastern region. Primary school enrollment is close to 100 percent in eastern and central PRC, but is only 95 percent in the western provinces. The number of medical personnel per capita is lower in western PRC than in the rest of the country. There is also a wide gap in the development of physical infrastructure— roads, rail, power, telecommunications, water supply— between western PRC and the rest of the country. Ecological problems such as soil erosion and water pollution are also more severe in western PRC than in the rest of the country.

57. To some extent, the regional disparities that we notice today are the result of a conscious development strategy followed by the Government. Twenty years ago, at the outset of PRC's market reforms, Deng Xiaoping laid out a two-phase program: develop the naturally advantaged coast first, while the interior waited, and then once the coast was developed, turn to develop the interior. It is now time for phase two.

58. In the new millenium, the PRC must make a concerted effort to promote development in the interior provinces. Since more than half of the absolute poor live in the western regions, a growth strategy with special emphasis on developing the western parts will be a pro-poor growth strategy. Removing major disparities in living standards will also promote social stability. The Government is aware of the need to promote development in the poorer interior provinces. The March 2000 session of the National People's Congress endorsed a "go west" policy, a proactive strategy to promote growth and development in the western region. The formulation of the Tenth Five-Year Plan is an opportune time to develop an integrated strategy to develop the western provinces. The Government plans to have an integrated development strategy for the western region by end-2000. The strategy is expected to have a twofold focus: (i) finance, taxation, and investment policies for promoting the western region's development; and (ii) policies to improve natural resource management in the region. The emphasis on natural resource management is important since soil erosion, water pollution, and ecological imbalance have been severe in western PRC. In particular, the Government intends to rescue large tracts of land from unsustainable agricultural production and promote reforestation and grassland rehabilitation.¹⁹

59. Policies used to promote regional development in other countries fall into four broad categories: (i) investing in public infrastructure in less developed regions, (ii) providing fiscal incentives, especially tax exemptions and budgetary subsidies, to encourage commercial investment in poor regions, (iii) providing subsidized bank credit for private investment; and (iv) setting up special economic zones for exports and foreign investment in less developed regions.

¹⁹ ADB has recently approved TA 3468-PRC: *Policy Support for PRC 2020 Project (Phase III)*, for \$900,000, approved on 14 July 2000 that will develop a strategy for promoting development in western PRC.

60. International experience indicates that investment in public infrastructure in less developed regions is the most effective tool in spurring regional growth and development. Good physical infrastructure and a well-managed environment create the conditions necessary to attract private investment and facilitate economic growth. In many successful examples in other countries, governments invest in physical infrastructure to stimulate regional economic development. One of PRC's strengths lies in planning and building infrastructure. Therefore, it would appear that the PRC could develop a system to use the fiscal resources of the central Government to target the development of physical infrastructure in western PRC.

61. If carefully designed and effectively implemented, fiscal incentives such as tax holidays, tax exemptions, tax rebates, and higher depreciation rates can be used to stimulate commercial investment to promote regional development. However, experience elsewhere shows that fiscal incentives fail to attract investment if the overall infrastructure facilities in a region are inadequate. Private investors, whether domestic or foreign, are reluctant to locate business units in regions with poor infrastructure, and no amount of fiscal incentives can offset the disadvantages of poor infrastructure. The PRC should take these lessons of experience into account in formulating fiscal incentives for regional development. This is especially important given the weak fiscal administration capabilities of the lower levels of government.

62. Providing subsidized bank credit for private investment in less developed regions has been tried in several countries with predominantly government-owned banking systems. Given that the banking system in the PRC is dominated by State-owned banks, the Government may be tempted to use this mechanism. This would not be appropriate. At this stage, the priority should be to develop a sound, commercially managed banking sector. The Government should not use moral suasion, subsidized interest rates, or similar policies to encourage banks to lend for projects in western PRC. Since most of the State-owned banks are facing severe problems of NPLs, encouraging them to use noncommercial factors in their lending decisions is not advisable. Such an approach runs counter to the policy of giving them more freedom and allowing them to make their business decisions based on commercial considerations. It would also make it difficult for the Government to hold the banks accountable for their lending decisions. Ultimately, the Government would need to provide fiscal transfers to take the resulting bad loans off the banks' books.

63. Government investments to set up special economic zones with preferential policies for attracting export-oriented industries and foreign investment on the east coast have been a key element of PRC's growth strategy in the past. The special economic zones were remarkably successful in attracting foreign investment and transforming the economic landscape. However, whether such a strategy will work for the western region over the next decade is debatable. Special economic zones are effective tools to promote regional development if the overall foreign trade and investment policy regimes are highly restrictive. With PRC's entry into WTO, the trade and investment policy regimes will be substantially liberalized. As a result, the advantages of free tariff and trade policies applicable to special economic zones will become less important. It is, therefore, doubtful that setting up special economic zones to promote development will be as effective in the western region as it has been for the last 20 years on the east coast.

64. Given these considerations, allocating more Government investment to the western region should form the key element of any affirmative policy agenda to reduce poverty. To some extent, a carefully designed fiscal incentive scheme with suitable sunset clauses could supplement an infrastructure investment strategy to promote growth and development in the western region. Temptations to use the banking system to lend at subsidized interest rates for

investment in the western region should be resisted. The budget and fiscal policy, not the banking system, should be used to promote growth and development in that western region.

65. The central Government will have to play a key role in a strategy of promoting development in the western region. The central Government will have to allocate budgetary funds for investment in infrastructure and natural environment projects and provide support for social development. The exact modalities of implementing such budgetary allocations need to be worked out. The allocations could take the form of direct investment by the central Government in infrastructure projects in the western region, or fiscal transfers from the center to the subnational governments. The fiscal transfers, in turn, could be tied either to designated projects or to general-purpose grants that the subnational governments could use for development purposes.

66. Ultimately, successful development of the western region will require (i) strong and sustained political commitment by both the central Government and the subnational governments; (ii) a stable, long-term strategy that does not change every few years; and (iii) policies and programs that are highly selective in targeting the regions and cities to be given priority. It will also require investing in human resource development, environmental improvement, and capacity building to complement the investment in physical infrastructure. The key to promoting development in western PRC is to provide the policy framework, investment climate, infrastructure, institutional capacity, and human resources needed to make western provinces the first choice of investors.

Table A6: Balance of Payments ^a
(\$ billion)

Item	1995	1996	1997	1998	1999
Current Account	1.6	7.2	36.7	29.3	15.6
Resource Balance	0.2	5.1	31.5	25.0	10.7
Trade Balance	18.1	19.5	46.2	46.6	36.2
Exports ^b	128.1	151.1	182.7	183.5	194.7
Imports ^b	110.1	131.5	136.4	136.9	158.5
Nonfactor Services, Net	(6.1)	(2.0)	(3.7)	(4.9)	(7.5)
Receipts	19.1	20.6	24.6	24.1	23.8
Payments	25.2	22.6	28.3	29.0	31.3
Factor Income, Net	(11.8)	(12.4)	(11.0)	(16.6)	(18.0)
Receipts	5.2	7.3	5.7	5.6	10.6
Payments	17.0	19.8	16.7	22.2	28.5
Unrequited Transfers, Net	1.4	2.1	5.1	4.3	4.9
Official, Net	0.6	0.3	0.5	0.1	0.1
Private, Net	0.8	1.8	4.7	4.2	4.8
Capital and Financial Account	38.7	40.0	21.0	(6.3)	7.6
Capital Account	-	-	(0.0)	(0.0)	(0.0)
Financial Account	38.7	40.0	21.0	(6.3)	7.7
Direct Investment	33.8	38.1	41.7	41.1	37.0
Inflow	37.7	42.4	45.4	45.6	41.0
Outflow	3.9	4.3	3.8	4.5	4.0
Portfolio Investment	0.8	1.7	6.9	(3.7)	(11.2)
Assets	0.1	(0.6)	(0.9)	(3.8)	(10.5)
Liabilities	0.7	2.4	7.8	0.1	(0.7)
Other Investments, Net	4.0	0.2	(27.6)	(43.7)	(18.1)
Errors and Omissions	(17.8)	(15.5)	(22.0)	(16.6)	(14.8)
Overall Balance	22.5	31.7	35.7	6.4	8.5
Changes in Reserves and Related Items ^c	(22.5)	(31.7)	(35.7)	(6.4)	(8.5)
Gold	0.0	0.0	0.0	0.0	0.0
Foreign Exchange	(22.0)	(31.5)	(34.9)	(5.1)	(9.7)
Reserve Position in IMF	(0.5)	(0.2)	(0.9)	(1.3)	1.3
SDRs	(0.0)	(0.0)	0.0	(0.1)	(0.0)
<u>Memorandum items</u>					
Exports (FOB, customs basis)	148.8	151.0	182.7	183.7	194.9
Imports (CIF, customs basis)	132.1	138.8	142.4	140.2	165.7

FOB = freight on board; CIF = cost, insurance, and freight; IMF = International Monetary Fund;

SDR = special drawing rights.

^a Starting 1997, data have been compiled based on the fifth edition of the IMF Balance of Payments Manual and therefore are not comparable with historical data as items, accounting methods and definitions have changed significantly.

^b Excludes reexports and imports for reexport.

^c The parentheses indicate an increase. Includes Bank of China reserves as well as People's Bank of China reserves prior to 1992; from 1992 onward, includes State reserves only.

Source: State Administration of Foreign Exchange (SAFE).