



# People's Republic of China

*The economy of the People's Republic of China (PRC) grew by 8.8 percent in 1997, driven partly by strong exports. Moderately tight monetary and fiscal policies, along with consecutive years of bumper grain harvests, contributed to abating inflation to 2.8 percent. The financial turmoil in Southeast and East Asia has thus far not spread to the PRC. Economic growth is predicted to slow down to about 7 percent in 1998 and 1999. Reforms of state-owned enterprises (SOEs) and the financial sector are expected to gather new momentum in coming years.*

## RECENT TRENDS AND PROSPECTS

**T**he PRC's economy maintained its strong growth momentum in 1997, growing by 8.8 percent. The moderate slowdown from 9.6 percent in 1996 reflects the continuing tight fiscal and monetary policies.

The growth in industrial output, which accounts for about half of the GDP, decelerated further from 12.1 percent in 1996 to 10.8 percent in 1997. SOE industrial production continued to grow at a slower pace than that of nonstate enterprises, and its share in total industrial output declined to 47 percent from 48.5 percent in 1996. The agriculture sector grew at an annual rate of about 5 percent in 1995 and 1996 because of a number of factors, such as higher public investment in agriculture, good weather conditions, upward adjustments in procurement prices, and various other supportive measures introduced since 1995 under the government's Grain Bag Policy. In 1997 GDP from agriculture grew at a lower, but still robust, rate of 3.5 percent. The rapidly growing and modernizing economy has generated a huge demand for financial, accounting, legal, wholesaling, retailing, and other support services, and the service sector grew by 8.2 percent.

A combination of administrative controls on new investments; a slowdown in net lending by the People's Bank of China, the Central Bank; the tighter project screening by commercial banks; the high real interest rate; and the excess capacity in some industries kept investment growth in check.

The Ninth Five-Year Plan, which envisages balancing the budget by 2000, continued to guide the government's budgetary policies. Revenues increased by 18.5 percent in 1997, and the share of revenues as a percentage of GDP increased to around 12 percent from 10.8 percent in 1996. Fiscal reforms introduced since March 1994 are gradually relieving strains on the government's budgetary position. Value-added and consumption taxes collected by the central government grew by 19.3 percent, which is 4.7 percentage points higher than the growth of those collected by local governments, resulting in a rise in the central government's share in the total to 56.5 percent, an increase of 0.9 percentage point from that in 1996.

Government expenditures increased by 18 percent in 1997, despite the continued strict control over nonpriority expenditures and the downsizing of the SOE sector and of the civil service. The budget deficit remained unchanged at around 0.8 percent of GDP. There has been a substantial

shift in the financing of the deficit to noninflationary sources. Since 1994 government borrowing from the People's Bank of China has contracted and that from commercial banks and the public has increased.

The government kept monetary policy tight for the fourth consecutive year. In 1997 broad money supply (M2) grew at 17.3 percent, or 7.7 percentage points less than the official target. With the tight monetary policies having helped the government achieve a soft landing of the economy, pressure to ease credit has been growing.

Tight monetary policy, good agricultural harvests that have persisted for three consecutive years, excess capacity in some industrial sectors, and weak consumer demand enabled the country to reduce inflation significantly. The consumer price index fell to 2.8 percent from 8.3 percent in 1996 and 17.1 percent in 1995. At 0.8 percent the retail price index, which excludes services, was even lower. With the easing of inflationary pressures, the People's Bank of China has started slowly loosening its monetary policy in recent months by cutting interest rates. A notable institutional development in monetary policy was the State Council's formation of the Monetary Policy Committee in April 1997, which reflected the government's resolve to pursue a more independent monetary policy.

Exports grew by 20 percent, about 2 percentage points more than in 1996. Import growth remained subdued, at 2.5 percent, because of weak domestic demand. Consequently, the PRC achieved a record trade account surplus of more than \$40 billion and a current account surplus of \$20 billion. On the capital account, the PRC received around \$45 billion in foreign direct investment (FDI). These large inflows of foreign capital, along with the current account surplus, enabled the PRC to strengthen its foreign exchange reserves further. These reserves reached \$140 billion by the end of 1997 and provided more than 11 months of import cover.

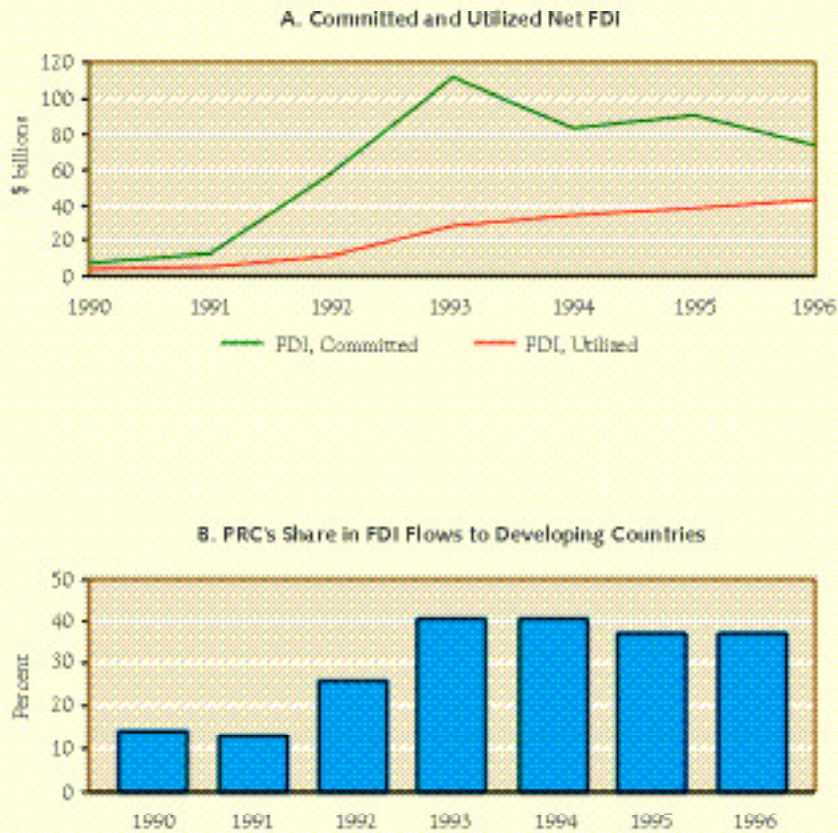
The PRC ranks second among all countries in terms of FDI inflows and first among all developing countries. Initially, most FDI went into low-technology, assembly-type operations, primarily for export, that took advantage of the PRC's low labor costs. This situation is changing, however. In 1997 most FDI inflows were invested in industries whose products cater to the domestic market, including the service sector. In the last two years large inflows of FDI were directed toward telecommunications, electric power, transportation, banking, and insurance. The liberalization of the service sector and the rapid increases in real household incomes account for this changing pattern of FDI inflows.

**Table 2.5 Major Economic Indicators: People's Republic of China, 1995-1999**  
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	10.5	9.6	8.8	7.2	6.8
Gross domestic investment/GDP	40.2	39.2	39.8	39.0	39.0
Gross domestic saving/GDP	41.9	41.4	42.6	39.0	39.0
Inflation rate (consumer price index)	17.1	8.3	2.8	4.0	6.0
Money supply (M2) growth	29.5	25.8	17.3	20.0	22.0
Fiscal balance/GDP	-1.0	-0.8	-0.8	-0.6	-0.5
Merchandise exports growth	24.9	17.9	20.0	3.0	3.0
Merchandise imports growth	15.5	19.5	2.5	12.0	12.0
Current account balance/GDP	0.2	0.9	2.2	0.9	0.4
Debt-service/exports	9.9	10.1	9.8	11.0	11.0

Sources: State Statistical Bureau (1997), International Monetary Fund (1998), and staff estimates.

Figure 2.1 Net Foreign Direct Investment:  
People's Republic of China, 1990-1996



Sources: State Statistical Bureau (1997) and World Bank data.

An important initiative in foreign exchange system reform that occurred in 1997 was allowing large domestic enterprises to open foreign exchange accounts in state commercial banks. Previously only foreign-funded enterprises had been permitted to do so. This put domestic enterprises on the same footing as foreign-funded ones. The measure also helped reduce the foreign exchange risks the government was facing when all foreign exchange was sold to the Central Bank.

The financial crisis in Southeast and East Asia have thus far not spread to the PRC. The renminbi appreciated marginally against the US dollar during 1997. The following factors explain the strength

of the renminbi compared to the currencies of the PRC's neighboring countries. First, the PRC's capital account is still not convertible. Second, the bulk of foreign capital inflows during the first half of the 1990s went into productive sectors as direct investment as opposed to portfolio investment. Third, the PRC has adopted prudent policies with regard to external borrowing, with about 82 percent of its external debt being medium and long term, and its debt to GDP and debt-service ratios being significantly below the thresholds at which the International Monetary Fund expresses concern. Finally, because of massive foreign capital inflows and strong export performance, the PRC maintained a robust

external position, with foreign currency reserves exceeding total foreign debt.

The economic turmoil prevailing in Asia and its ramifications for the world economy make an accurate assessment of the PRC's economic prospects for the coming years difficult. However, given weakening domestic demand, excess capacities in some industries, and a possible decline in export growth, the economy is expected to grow at about 7 percent per year in 1998 and 1999. The industrial sector is likely to feel the main effects of the slowdown. In contrast, the government's increased emphasis on the agriculture sector should result in continuation of the 3.5 percent annual growth rate. To stimulate economic growth, the government is planning major infrastructure expenditures.

The recent depreciation of the currencies of Southeast and East Asian countries is likely to reduce the competitiveness of some of the PRC's exports. The expected slowdown of the world economy, including Japan and the United States, could also adversely affect the country's export prospects. In the interests of the region's recovery from the currency turmoil, a competitive devaluation of the renminbi is unlikely. However, the government is taking some measures to stimulate exports, such as improving the tax rebate system. Taking all these factors into account, a reduction in annual export growth from 20 percent in 1997 to about 3 percent per year in 1998 and 1999 is forecast. Coupled with the weakening domestic investment brought about by excess capacity in some industries, the slower growth in exports is likely to result in a slowdown of the industrial sector's growth to 8 percent in 1998 and 7 percent in 1999.

The government's efforts to encourage growth of the service sector to absorb surplus labor in agriculture and SOEs will lead to continued expansion of this sector over the medium term. Recent measures to liberalize the financial sector, particularly banking and insurance; to open the retail and wholesale sectors to foreign investment; and to expand transport and communication services to alleviate bottlenecks will help the sustained growth of the service sector. The slowdown in the industrial sector would, however, reduce the demand for services, and hence dampen the growth of the service sector. Taking these two opposite influences into account, the service sector is forecast to grow by 7.5 percent in 1998 and 8.4 percent in 1999.

The slowdown in economic growth and the overall deflationary trends in Asia should keep domestic prices from rising significantly. The government may, however, ease monetary policy to counter the possible economic slowdown. However, given the inflationary consequences of an expansionary monetary policy a few years ago, the government is likely to be cautious in easing money supply and credit. On balance, therefore, inflation is forecast to remain moderate, but be somewhat higher during the next two years.

Import growth will pick up in 1998 and 1999 because of the recent, and possible further, reduction in tariffs and other trade barriers, and because of increased imports from Asian countries that have depreciated currencies. Coupled with a slowdown in exports, this will reduce the trade and current account surpluses. The contraction in committed FDI inflows is anticipated to continue, reflecting a correction to their unprecedented levels in the 1990s, the gradual withdrawal of preferential policies previously granted to FDI, and the adverse impact of the financial crisis in Southeast and East Asia on the supply of FDI. Given these developments, the government is expected to take a more cautious approach toward implementing the convertibility of the renminbi on the capital account.

The central government's fiscal situation in the medium term will depend on revenue performance and the extent to which the authorities implement SOE reforms. As the new tax measures and the tax collection system become more entrenched, revenue buoyancy should increase the tax-GDP ratio. Expediting SOE reforms will also reduce subsidies channeled through the budget, which in recent years amounted to 4 to 5 percent of total government revenues.

## POLICY AND DEVELOPMENT ISSUES

Despite the PRC's recent resilience to the region's economic crisis, it may not be immune to future shocks. While the threat of a crisis may not be immediate, the country needs to draw lessons from the ongoing Asian crisis and take the necessary steps to prevent a similar crisis from disrupting its economic stability. While the economic situations of the countries affected by the crisis and the PRC are different, there are also some similarities that point toward the need for vigilance. In this context, two

of the most pressing issues facing the government are the weak financial sector in general, and the banking system in particular, and an ailing state enterprise sector.

### Strengthening the Financial Sector

One of the crucial factors that triggered the Asian crisis was weak governance of the financial sector. Weaknesses in the PRC's financial sector need to be addressed in a timely and prudent manner to avoid the problems other countries in the region are experiencing (see Box 2.1).

The government is aware of the problems in the financial sector and is taking action to address them. Reforming the financial sector is now a priority in the economic policy agenda. In December 1997 the government announced that it would abolish the directed lending quotas applicable to state commercial banks as of 1 January 1998. It will use a set of financial indicators—such as the capital adequacy ratio, the deposit-lending ratio, the lending portfolio, and the cash reserve requirement—to control credits indirectly and, together with other macroeconomic management instruments, to maintain appropriate levels of monetary aggregates. This is a significant step toward establishing a financial system that operates on the basis of sound commercial principles and strict prudential norms.

To reduce the amount of nonperforming loans, Y30 billion (about \$3.6 billion) in bad debt was taken off the banks' balance sheets in 1997, another Y50 billion (about \$6 billion) will be taken off the balance sheets in 1998, and a further Y60 billion (about \$7.2 billion) will be taken off in 1999 and 2000. In February 1998 the Standing Committee of the Eighth Congress of the PRC approved issuance by the Ministry of Finance of Y270 billion (about \$32.5 billion) in bonds to help recapitalize the four state commercial banks. The government's objective is eventually to reach the 8 percent capital adequacy ratio, and it is committing substantial amounts of financial resources to achieve this objective. The government is also taking serious measures to tackle rural credit funds and unofficial security exchange centers and to strengthen the regulation and supervision of nonbank financial institutions.

However, reform of the financial sector faces many challenges, some of which need to be given

special attention. First, the legal and regulatory framework for the financial sector needs to be strengthened. Second, the government needs to pay continuous attention to the problem of nonperforming assets of the key financial institutions, and to ensure the timely implementation of the recently announced bank recapitalization program. Third, prudential norms and risk management procedures guiding the financial sector need to be tightened. Fourth, competition in the banking sector should be promoted by easing entry barriers and by further reducing the government's role in directing the banking sector's resources. Fifth, the government should clearly define its role as the owner of banks and as the regulator of the banking system with the objective of transforming the state-owned banks into genuine commercial banks. Finally, the capital market needs to be broadened and deepened, along with increasing the market's efficiency and transparency. Promoting associated industries, such as pension, insurance, and mutual funds, should form an integral part of the development of the capital market.

### Reforming SOEs

Many of the financial sector's problems arise from an ailing state enterprise sector. The PRC currently has more than 300,000 SOEs. The proportion of loss-making SOEs grew from around 10 percent of the total in 1985 to 47 percent in 1997. In the first quarter of 1997 the SOE sector as a whole was operating at a loss. The support of loss-making SOEs is a major reason for the high proportion of nonperforming loans in the banking system. A radical restructuring and reform of these enterprises is needed to improve industrial efficiency, maintain the economy's growth momentum, and improve the banking sector's balance sheet.

The main reason for the SOEs' poor performance is their weak governance structure. SOEs do not have fully market-based management autonomy, are not subject to strict financial discipline, and do not face a credible threat of bankruptcy. In addition, monitoring and supervision by the government, the sole capital owner, has often been ineffective. The weak governance has led to poor responses to market signals, excessive and inefficient investment, and a lack of incentives to undertake technological innovations. These weaknesses, coupled with the

### Box 2.1 The Weak Financial Sector in the PRC

Weaknesses in the PRC's financial sector are related to the banking sector, capital markets, and nonbank financial institutions.

#### The Banking Sector

There are a number of problems in the banking sector. First, the level of nonperforming loans is high. According to government estimates, of the total loans of state commercial banks, around 25 percent are nonperforming and between 5 and 6 percent are nonrecoverable. The main sources of nonperforming loans are the large financial losses of the SOEs, which the state banks were directed to lend to. Second, the financial performance of the state commercial banks has been deteriorating. The banking sector as a whole operated at a loss in 1996, and the situation is believed to have continued in 1997. This deterioration has occurred even though many banks treated accrued (but often unpaid) interest as paid income and made negligible provisions for bad debts. Third, the level of equity capital is low. During the last decade the total assets of the state banking sector increased by more than 25 percent per year, while equity capital increased only by 18 percent each year. The different growth rates led to a fall in the capital adequacy ratio from more than 10 percent in 1986 to less than 6 percent in 1996, which is low by international standards. Because of the accumulation of bad debt in recent years, the state banking sector's effective equity capital is even smaller. This has put the banking sector in a vulnerable position and caused external credit rating agencies to downgrade its credit ratings recently.

#### Capital Markets

Weaknesses in the capital markets are also a major source of potential financial risks. Like many other emerging markets, stock markets in the PRC suffer from limited disclosure, a bunching of public offerings, weak regulation, and a circumscribed role for competitive underwriters and primary dealers. Compounding these shortcomings is the limited participation by wholesale and institutional purchasers of securities. A credit plan sets quotas on how much equity can be issued in primary markets in a given

year. The primary market for equity is then distributed by region. The government's shares, which usually account for more than 80 percent of the total capitalization of a listed company, cannot be traded. Listed companies often fail to perform up to expectations, partly because of limited exposure to market forces in the stock market. A study of 178 companies listed in 1994 found that net assets per share of these companies declined, on average, by around 70 percent from 1994 to 1997. The quota controls on equity, which limit capital market access, led to the emergence of many unofficial security exchange centers. These unofficial exchange centers provide much needed capital for the nonstate sector, which in recent years has received only about 15 percent of total state bank lending. Because these entities fall outside the oversight of any government regulatory institutions, their non-standard practices could weaken the financial system.

#### Nonbank Financial Institutions

The excessive growth in the number of nonbank financial institutions and their indiscriminate business operations constitute another potential threat to the financial system's stability. In recent years thousands of rural credit funds have emerged. These funds have developed rapidly, mainly because of the underdeveloped rural capital markets. Village and township governments in rural areas are responsible for providing social services and public goods, but do not have sufficient funds to do so. By attracting deposits from local residents and paying a slightly higher interest rate than the commercial banks offer, these funds provide a convenient and cheap way to raise funds. Many rural credit funds are now operating virtually as banks in that they take deposits and provide lending beyond their regional boundaries; however, they remain outside the government's regulatory control, and could become sources of financial instability.

The PRC currently has about 250 trust and investment companies. Because of their indiscriminate business operations, nonstandard practices, and lack of effective regulatory supervision, many of them have a disproportionate structure of assets to liabilities and are facing the threat of bankruptcy, which could generate systemic shocks.

SOEs' responsibility for providing employment and performing social functions for urban populations, have made them vulnerable to competition both from foreign imports and the nonstate sector.

In September 1997 the Fifteenth Party Congress endorsed a strategy of radical SOE reforms aimed at clarifying property rights and responsibili-

ties, separating ownership from management, and building up an enterprise system with a diversified ownership structure. Under this strategy the government will (i) corporatize large- and medium-size SOEs, with the state remaining as sole or majority shareholder for enterprises that are of strategic importance; (ii) restructure more than 250,000 small

SOEs by means of joint shareholding, leasing, contract operation, and employee and management buyouts; and (iii) encourage mergers, bankruptcies, and sell-offs to deal with the worst performing SOEs and to accelerate the reform process.

Since 1994 the government has been experimenting with bankruptcies, mergers, and corporatization in pilot cities, whose number had increased from 18 in 1995 to 111 by May 1997. During 1997 the government liquidated 675 SOEs, merged 1,022 SOEs, and took action to increase efficiency by reducing the number of redundant workers in 789 SOEs. The government has offered incentives to SOEs willing to take on the debts, assets, and workers of poorly performing enterprises to make for a more gradual increase in redundancies. The pace of corporatizing large and medium-size SOEs accelerated in 1997. The government's long-term goal is to concentrate state resources into building a core group of 1,000 companies that will dominate the PRC's major economic sectors and compete on a global scale. The last few years have witnessed a spontaneous movement to transform small SOEs through employment and management buyouts and sell-offs.

The transformation of enterprises into corporations, however, cannot on its own ensure greater operational efficiency. Concomitant changes in other

areas are essential, including enforcing a hard budget constraint by commercializing the banking sector; allowing unprofitable enterprises to declare bankruptcy; and developing competitive markets for goods, factors of production, and management talent. Similarly, the transfer of decisionmaking to managers does not guarantee the efficient use of resources. In the absence of an effective mechanism to monitor managers' performance, the transfer may simply provide them with a license to pursue personal objectives. SOE reform will be a long, drawn-out process. Supporting changes that are under way in banking, capital markets, taxation, labor markets, and social security are equally important for improving SOE performance.

The immediate challenge facing the government in reforming SOEs is redeploying redundant workers to avoid increasing urban unemployment. Estimates indicate that between 10 and 20 million SOE workers would need to be redeployed between 1996 and 2000. While the government has made substantial efforts to reduce unemployment among retrenched SOE workers by introducing re-employment programs, it should seek new ways to do so, such as setting up enterprise funds to support small, private enterprises and self-employment, which have the potential to absorb a large number of redundant workers.