



People's Republic of China

Prudent macroeconomic policy aided the People's Republic of China (PRC) in adjusting to the Asian crisis. In 1999, growth slowed slightly and prospects are that a rate lower than the trend in the 1990s can be sustained in the medium term. The challenge will be to continue the reform process of opening the economy, improving efficiency in the state sector, addressing unemployment issues, and developing a legal and regulatory framework essential for efficient functioning of a market economy.

RECENT TRENDS AND PROSPECTS

The economy of the PRC began to decelerate in the fourth quarter of 1998 and continued through the second quarter of 1999. In response, the government cut interest rates in June and announced a fiscal stimulus package in August. These measures were effective, as growth for the year exceeded 7 percent.

Fixed investment grew 5.2 percent in 1999, down from 14 percent in 1998. Private investment, which constitutes about one fourth of total investment in the economy, has been slowing since 1996. The March 1999 constitutional amendment to officially recognize the private sector's role in the economy should improve prospects for private investment. However, the significant excess capacities in many sectors will discourage any large increase in private investment over the medium term.

Consumer demand also remains weak partly because of the increased unemployment from laying off redundant workers from state-owned enterprises (SOEs), and partly because of the uncertainties

inherent in reform measures in housing, pension, and other social welfare provisions.

Domestic prices continued to decline because of the weak aggregate demand and the overall deflationary trends in Asia. After falling by 0.8 percent in 1998, the consumer price index declined another 1.4 percent in 1999. The fall in retail prices was even sharper, amounting to 3 percent.

To counteract deflationary trends and maintain robust economic growth, the People's Bank of China lowered interest rates in 1999, reducing the benchmark one-year lending rate for banks from 6.39 to 5.85 percent, and the benchmark one-year deposit rate from 3.78 to 2.25 percent. Simultaneously, the People's Bank of China took measures to stabilize the yuan-dollar exchange rate at around Y8.3 per dollar. Other measures to control the illegal outflow of foreign exchange included (a) strengthening supervision of export receipt remittances, (b) tightening scrutiny of processing trade, (c) curbing offshore renminbi trading, and (d) prohibiting prepayment of foreign currency loans.

With the August fiscal stimulus, the 1999 fiscal deficit increased from Y260 billion (about 3 percent of GDP) in 1998 to Y346 billion (4 percent of GDP). To complement the fiscal stimulus package, a tax was imposed on interest income from bank deposits, to discourage households from saving in banks and to encourage private consumption.

Given the small fiscal deficits and modest public debt, continuing an expansionary fiscal policy to pump-prime the economy in the face of deflationary trends is appropriate. However, the official measure of fiscal deficit underestimates the actual resource imbalance of the government because it does not include the deficit spending of the SOEs, the extrabudgetary government expenditures, and the various subsidies by the state-owned banks. With these items included, the fiscal deficit in 1998 reached 6 percent of GDP. Continued fiscal pump priming to stimulate domestic demand could drain resources away from other needs. Therefore, fiscal stimulus packages to maintain high GDP growth should be used with caution.

Coupled with antipoverty programs, robust growth enabled significant progress in poverty reduction. Much of the economic growth has been pro-poor.

The official estimate of the number of rural poor declined from 42 million (4.6 percent of the rural population) in 1998 to 35 million (4 percent of the rural population) the next year. Between 1978 and 1999, 227 million people were lifted from absolute poverty. The official estimate of poverty has two weaknesses, however. It is based on a very low income criterion of about Y635 annual per capita income (\$0.66 per day using purchasing power parity), and does not cover urban areas. According to a World Bank estimate, if the dollar-a-day poverty norm is applied, then in 1997 there were about 208 million rural poor (about 23 percent of the rural population), compared with the official estimate of 50 million (5.4 percent of the rural population). There is no official estimate of the urban poor. However, unofficial estimates indicate that 12 million-15 million (5-6 percent of the urban population) are poor, with per capita income less than Y1,700 (about \$1.77 per day using purchasing power parity).

Because of the lack of reliable data, it is difficult to assess the extent of unemployment. Official data do not cover rural areas, which account for 70 percent of the labor force. Unofficial sources indicate that about 150 million, or 30 percent of the rural labor

Table 2.5 Major Economic Indicators, People's Republic of China, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	8.8	7.8	7.1	6.5	6.0
Gross domestic investment/GDP	38.1	37.8	37.8	37.8	37.3
Gross domestic savings/GDP	41.5	40.9	39.0	37.4	36.4
Inflation rate (consumer price index)	2.8	-0.8	-1.4	1.8	2.0
Money supply (M2) growth	17.3	15.3	14.7	16.0	16.0
Fiscal balance/GDP	-1.8	-3.0	-4.0	-3.0	-3.0
Merchandise exports growth ^a	21.0	0.5	6.0	5.0	5.0
Merchandise imports growth ^a	2.5	-1.5	18.2	10.0	8.0
Current account balance/GDP	3.3	3.1	1.2	-0.4	-0.9
External debt/GDP	14.6	15.2	15.7	16.2	16.7

a. Based on customs data.

Sources: National Bureau of Statistics; staff estimates.

force, are either unemployed or underemployed. Even in urban areas, the official 1999 estimate of 3.1 percent urban unemployment covers only workers registered with the Ministry of Labor and Social Security. It does not include workers who are laid off as *xiagang* workers (those who keep a legal link to their enterprises but receive little pay or benefits) as part of the SOE reforms. Adjusting for these limitations, the urban unemployment rate was about 9.5 percent in 1999.

Largely because of the economic crisis in Asia, export growth was subdued in 1998 and the first half of 1999. Exports increased in the second half of 1999 as growth in the rest of Asia began to accelerate. However, for 1999 as a whole, export growth was a modest 6 percent, while imports grew a robust 18 percent.

Foreign direct investment (FDI) flows reached a high plateau during 1995-1998, and FDI inflow declined in 1999 for the first time since 1990. While FDI commitments declined 18.9 percent, actual FDI inflows went down by 9.7 percent, reflecting concern of foreign investors about weak financial institutions. The impact of this slowdown on the economy was somewhat mitigated in 1998 and 1999 by large fiscal stimulus packages.

Despite the worsening trade balance and the declining capital flows, the external payments situation continued to be comfortable. Both the external debt and the debt-service ratios are low by developing country standards. Foreign exchange reserves were about \$155 billion in December 1999 (11 months of import equivalent), slightly more than the total external debt and about nine times the short-term external debt. At less than 10 percent, the external debt-service ratio was well within prudent limits.

In the aftermath of the Asian crisis, some feared an economic downturn in the PRC. Similarities to the crisis-affected countries include indicators of structural vulnerabilities, such as the corporate debt-equity ratio, ratio of nonperforming loans in banks' balance sheets, exposure of the banking sector to the property sector, and growth of bank credit to enterprises. However, macroeconomic indicators—such as inflation, current account balance, short-term capital inflows, share of short-term debt in total external debt, and size of short-term external debt relative to foreign exchange reserves—are much stronger than that of the crisis-affected countries prior to the crisis. Further-

more, capital and exchange rate controls help insulate the economy from external shocks.

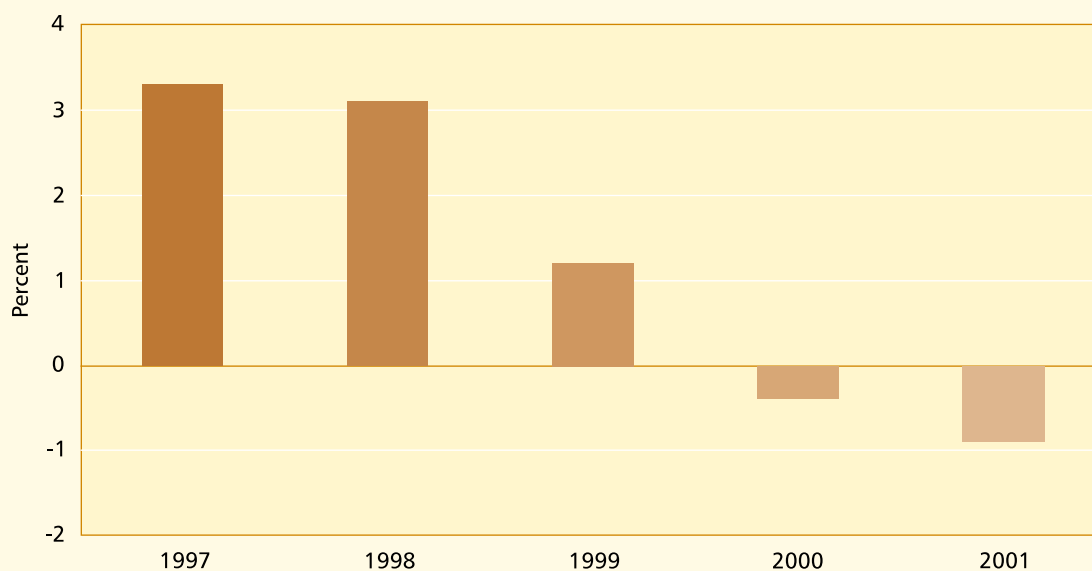
Considering both internal and external factors, GDP growth is projected to decline from 7.1 percent in 1999 to about 6 percent by 2001. Most of the slowdown will occur in industry and construction, where growth is expected to decline from 9 percent in 1999 to about 6.5 percent by 2001. The slowing economy and the SOE reforms will cause urban unemployment to increase by about 1 percent to 10.5 percent by 2001. The economic slowdown and increasing unemployment should keep inflation moderate, about 2 percent during 2000-2001. The recovery in the newly industrialized economies should improve export prospects to these countries. Domestic price deflation, continued export tax rebates, and growing import demand in the Asian region will enhance export competitiveness. However, currency devaluation in Southeast Asian economies will make their exports more competitive than the PRC's exports. Import demand will be more moderate, but sufficient to serve the growing need for capital goods. Balancing these factors, the current account is likely to shift from a surplus to a small deficit in 2000 and 2001 (see figure 2.2). Capital inflows are expected to cover this deficit and allow a modest increase in foreign exchange reserves, which stood at \$155 billion at the end of 1999. External debt outstanding as a percent of GDP should remain at roughly the same level as in 1999.

ISSUES IN ECONOMIC MANAGEMENT

Because of the rapid growth of the economy, significant expansion of employment opportunities, and impressive achievements in poverty reduction in the last two decades, the population has come to expect ever-improving economic conditions and living standards. However, if high rates of economic growth are not maintained, employment creation may not be sufficient for the increasing redundancy from SOEs and growth of the labor force. The crucial challenge for the government is to ensure that economic growth generates enough jobs to hold the unemployment rate in check.

Under the centrally planned economy, SOEs played a key role in growth and employment generation. Often, these enterprises provided employment

**Figure 2.2 Current Account Balance as Percentage of GDP,
People's Republic of China,
1997-2001**



Source: National Bureau of Statistics; staff estimates.

at the cost of efficient use of resources because the government viewed creating employment as an end in itself, which led to considerable overstaffing and redundant labor. To maintain a reasonable pace of employment generation when enterprises are restructured and redundant labor is retrenched, small and medium-size enterprises and the private sector will have to play a larger role in the economy. Creating an economic environment to facilitate this transformation will require employment-friendly growth to reorient employment strategy in three directions: (a) from large enterprises to small and medium-size enterprises, (b) from industry to the tertiary sector, and (c) from SOEs to small and medium-size enterprises and owner-operated businesses in the private sector.

The Asian crisis exposed weaknesses in the financial and enterprises sectors, both of which need urgent attention from the government. During the March 1999 annual session of the National People's Congress, the constitution was amended to enhance

the formal status of the private sector and provide it greater political protection. Building on this initiative, the challenge is to develop a level playing field for the private sector and the public sector. Three developments are needed: a legal framework that sets the rules in a clear and transparent manner; a regulatory framework that reduces restrictions on private businesses; and improved private sector access to financial resources, both from financial institutions and the capital market.

Financial sector reforms and restructuring should focus on recapitalizing and strengthening the banks, and developing a sound capital market that promotes efficient resource allocation and intermediation. This will require

- Balanced development of different segments of the market, products, and services with due consideration to minimizing systemic risk
- Higher governance standards by both regulators and financial institutions

- Stronger legal and regulatory framework to conform to international standards
- Institutional capacities that enforce the legal and regulatory framework.

The government has taken steps in these areas in the last two years. It now needs to make more progress and to effectively implement many of the recent financial sector reforms.

POLICY AND DEVELOPMENT ISSUES

Many of the problems in the financial sector are related to ailing SOEs that account for a large portion of banks' nonperforming loans. Two of the most difficult SOE reform issues are developing alternative methods to provide the social security services traditionally provided by SOEs, and to redeploy redundant workers.

The unemployment situation worsened as a result of the SOE reforms and the consequent breakdown of the social security system that was built around the cradle-to-death employment practices of SOEs. To cope with this, the government established an unemployment insurance scheme in the mid-1980s. This was strengthened in June 1998, with central government raising contributions to the unemployment fund from 1 to 3 percent of the enter-

prises' total payroll, and requiring the employees to contribute 1 percent. Until 1999, 15.8 million workers were covered by this scheme. The government intends to use the unemployment insurance system not only for expediting SOE reforms, but also for pension fund contributions, medical insurance, and enterprise industrial insurance. The reforms, when fully implemented, should provide a sound basis for enterprise restructuring.

Another important institutional issue is to establish a sound legal framework, essential for efficient functioning of a market economy. During the last two decades, the transition to a market economy has outpaced the development of the legal and regulatory framework. Many of the elements of the legal and regulatory system needed for a market economy to function efficiently are lacking or underdeveloped. The government has set a target to establish a framework for a market economy, and beginning in 1999, a five-year legislative work program will develop and revise important economic laws and the corresponding implementing regulations. The laws covered include company, bankruptcy, trust, antimonopoly and unfair competition, telecommunications, trademark and patents, income and inheritance tax, government procurement, and state assets laws.