



JOINT ECONOMIC COMMITTEE

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CHINESE ECONOMY NEEDS REFORM

The People's Republic of China (PRC) is enjoying rapid economic growth. Real GDP grew at an annualized rate of 11.5 percent during the first half of 2007.¹ Yet the PRC faces significant challenges that it must overcome to sustain long-term economic growth. These include:

- Unbalanced growth
- Corruption
- Weak financial services sector
- Severe environmental degradation
- Stress on the international economy

President Hu Jintao and other senior Chinese leaders have struggled to address these issues in preparation for the 17th National Congress of the Communist Party of China that convened in Beijing on October 15, 2007.

Development policy. Since 1992, the PRC has pursued export-led industrialization by:

- Opening to international trade and investment;
- Restructuring state-owned enterprises (SOEs) and transforming some SOEs into state-influenced enterprises (SIEs)² to reduce losses;
- Encouraging the development of export-oriented labor-intensive manufacturing of apparel, sporting goods, and toys and export-oriented labor-intensive final assembly of consumer electronics to employ surplus workers from rural areas and SOEs; and
- Intervening in foreign exchange markets to maintain foreign exchange rates that promote exports.

Under this policy, China has achieved rapid economic growth. From 1992 to 2006, real GDP has grown by an average of 10.3 percent a year.³

The PRC has successfully integrated into the global economy. In 2006, the PRC accounted for 12.9 percent of world exports and 8.9 percent of world imports (excluding intra-EU trade).⁴

To power growth and expand trade, China relied very heavily on inward foreign direct

investment (FDI) by foreign multinational firms (MNFs) in Chinese subsidiaries. Cumulative inward FDI was \$703 billion (equal to 25.4 percent of GDP) at year-end 2006.⁵ Chinese subsidiaries of foreign MNFs accounted for 58.2 percent of China's exports and 59.7 percent of its imports in 2006.⁶

The PRC has very few Chinese MNFs. Until recently, outward FDI was mainly in natural resources by state-owned oil and mining firms. Unlike other populous economies, few Chinese firms have designed their own products and created internationally recognized brands. Instead, Chinese firms are mainly contract manufacturers for foreign firms.

Unbalanced growth. The Chinese economy is becoming very unbalanced:

- Growth depends heavily on international trade. In 2006, China's two-way trade in goods and services equaled 72.1 percent of GDP.⁷ This is far higher than other populous economies.
- Since 2000, the PRC's central bank, the People's Bank of China (PBC), has intervened massively in foreign exchange markets to maintain the foreign exchange value of the renminbi within its target range. At year end 2006, the PBC had accumulated foreign exchange reserves of \$1.066 trillion (equal to 40.3 percent of GDP).⁸ In the first half 2007, the PBC's reserves grew by 25 percent to \$1.333 trillion.
- Inflation is accelerating. In August 2007, consumer prices were up 6.6 percent from a year ago.⁹ Domestic inflation is now affecting China's export sector. After five years of decline, the prices of Chinese manufactured exports are now increasing.¹⁰ The PBC's ability to sterilize its rapidly increasing foreign exchange reserves may be reaching its limit. In September 2007, the State Council deferred its plan to increase state-controlled energy prices

gradually to market levels to encourage energy efficiency and reduce pollution. Instead, the State Council resorted to the palliative of a freeze in state-controlled prices until the end of 2007.¹¹

- Growth depends heavily on investment in fixed assets. In 2006, gross investment was 40.9 percent of GDP.¹² Although SOEs and SIEs employed 35.6 percent of urban workers and 30.5 percent of rural workers, SOEs and SIEs still accounted for about three-quarters of all investment in fixed assets in 2006.¹³
- Since 1992, real per capita income increased in all areas and among all classes. However, income inequality between cities and rural areas and among urban households has become acute:
 - From 1992 to 2006, average real per capita income expanded by 217 percent to 11,744 yuan among urban households but only by 120 percent to 4,640 yuan among rural households (in constant 2000 yuan).¹⁴
 - In cities, shortages of managerial, technical, and professional workers have increased their compensation. Consequently, the ratio of real per capita income in the lowest income urban households and real per capita income in the highest income urban households exploded from 3.25 in 1992 to 9.25 in 2005.¹⁵
- The failure to replace Mao's "iron rice bowl" system¹⁶ with a comprehensive system of disability insurance, health insurance, and retirement saving plans has forced Chinese households to save an extraordinarily high share of their income. Because many small- to medium-size enterprises have found it difficult to obtain credit from Chinese banks, these firms save a large percentage of their profits to finance future investments. Because of both factors, the gross saving rate was 49.8 percent of GDP in 2006.¹⁷

Prior to the Congress, President Hu announced a series of policies that he named the "harmonious society" to reduce income disparities. These initiatives include abolishing a two-millennium-old agricultural tax, expanding health care facilities to 80 percent of rural areas, and increasing the availability of credit to small enterprises in rural areas.

During his speech at the Congress, Hu set a goal to double China's per capita real GDP and eliminate absolute poverty by 2020. He favored a greater reliance on domestic consumption and services and less dependence on international trade and manufacturing for China's future growth, but did not offer specific proposals to implement this rebalancing.

Corruption. The "rule of law" remains weak. In March 2007, the National People's Congress enacted a law giving equal protection to state and private property after 13 years of debate. Despite this progress, individuals and private firms still rely to a large degree on *guanxi* (i.e., connections) with officials to protect themselves and their property.

While the PRC is nominally a unitary state, it has many levels of subsidiary government – provinces, prefectures, cities, counties, towns, and villages. The Chinese government is organized as a matrix. Each department in the central government is paired with similar departments in subsidiary governments. Policy is vertical (i.e., the heads of central government departments determine policy and direct its implementation through similar departments in subsidiary governments), but administration is horizontal (i.e., the heads of subsidiary governments make personnel decisions and fund the operations of all departments in their subsidiaries).

Since 1992, *de facto* political decentralization has allowed officials in subsidiary governments to exploit their *guanxi* to enrich themselves through corruption. Central government officials have encountered difficulties in implementing many policies. Employees of subsidiary governments have greater loyalty to officials in their subsidiary than to department heads in Beijing. The Chinese use an old proverb to describe this problem, "The mountain is high, and the emperor is far away."

Corruption is pervasive in China. According to Transparency International, the PRC scored 3.3, 70th of 163 countries, on its *Corruption Perceptions Index 2006* (10 is corruption-free), which measures corruption within a country, and 4.94, 29th of the 30 largest exporting countries, on its *Bribery Payers Index 2006* (10 is no bribery), which measures the propensity of domestic MNFs to bribe when operating abroad.¹⁸

In 2006, 825 senior officials were convicted for corruption, while more than 40,000 other officials

and government employees were under investigation.¹⁹ Outside of government, corruption is rampant in the state-influenced banking, real estate development, and construction industries.

Three manifestations of corruption have gained widespread attention in recent months:

- **Uncompensated property seizures.** Local officials have frequently seized farms and urban residences for development, from which these officials financially benefit, without paying adequate compensation to long-term lessees. Uncompensated seizures have caused frequent and sometimes violent protests. Attracting nationwide attention this spring, one family in Chongqing refused to relinquish its house until the local government agreed to compensate the family with another house elsewhere in city.
- **Pollution.** Local officials have repeatedly accepted bribes to allow Chinese firms to pollute and have threatened to remove, demote, or otherwise retaliate against government employees that would enforce environmental laws. In December 2006, the Director of the State Environmental Protection Administration Zhou Shengxian observed, "The failure to abide by the law, lax law enforcement, and allowing lawbreakers to go free are still serious problems in many places."²⁰
- **Unsafe and counterfeit goods.** Local officials have frequently accepted bribes to allow Chinese firms to sell both unsafe goods and counterfeit goods. In recent months, the Chinese press has reported the sale of tainted goods, including food products and toothpaste, to Chinese consumers. This quality problem is now spreading to Chinese exports. Over the summer, Mattel recalled 19 million toys made by Chinese firms that were tainted with lead paint or contained loose magnets. Another one million toy ovens have been recalled because children may suffer burns from getting their fingers caught in the door. A reputation for unsafe goods is a potentially serious threat to the Chinese economy. At a meeting of the World Economic Forum prior to the APEC summit meeting in Sydney, Premier Wen Jiabao stated, "The Chinese government takes product quality and food safety very seriously."²¹ Senior leaders understand that growing safety concerns could make consumers

wary of buying goods made in China, and could induce foreign MNFs to give manufacturing contracts to firms in other countries. In July, Zheng Xiaoyu, the head of the State Food and Drug Administration from 1998 to 2005, was executed for accepting bribes to allow the sale of unsafe pharmaceuticals. The State Council recently directed Vice Premier Wu Yi to launch a "special war" on inadequate regulations to achieve 20 specific product safety goals by year-end.²²

Weak financial services sector. China's financial sector is bank-centric and state-influenced. At year-end 2006, loans at commercial banks and other depository institutions equaled 102 percent of China's GDP and accounted for 87 percent of China's domestic finance.²³

Four major state-owned commercial banks (SOCBs) inherited billions of non-performing loans (NPLs) from the central planning era. To prepare the SOCBs to operate on a market-basis, the State Council transferred \$170 billion of NPLs to four asset management corporations and injected \$98 billion into the China Construction Bank (CCB), the Bank of China (BOC), and the Industrial Commercial Bank of China (ICBC) over the last decade.²⁴ The State Council has also injected \$21 billion into credit unions and is planning to inject \$40 billion into the Agriculture Bank (AB) later in 2007.²⁵

Three of the four SOCBs have offered minority shares on the Hong Kong or Shanghai exchanges. The CCB raised \$8 billion in October 2005; BOC, \$9.7 billion in May 2006; and ICBC, \$19.1 billion in October 2006. The largest joint-stock bank (JSB), the Bank of Communications, was listed on the Hong Kong exchange in June 2005.²⁶

Foreign banks and financial institutions have become minority shareholders and strategic partners with CCB, BOC, ICBC, nine JSBs, and a number of urban banks.²⁷ Through these alliances, Chinese banks have improved their backroom operations.²⁸

However, Chinese banks still extend most of their loans to SOEs and SIEs. At year-end 2006, 65 percent of bank loans were extended to SOEs and SIEs; 24 percent, to private Chinese firms and Chinese subsidiaries of foreign MNFs, and 11 percent, to Chinese consumers.²⁹

Chinese banks have not yet developed a strong credit culture. In 2006, the IMF found, "pricing of

credit risk remains undifferentiated and banks do not appear to take enterprise profitability into account when making lending decision.”³⁰

The ratio of NPLs to total loans in all banks and depository institutions fell to 7.1 percent by year-end 2006.³¹ However, significant non-market lending, probably as the result of corruption, is continuing. Without a strong credit culture, Chinese banks may be creating new mountains of NPLs. In a debt sustainability analysis, the IMF assumed that 16 percent of all new loans are likely to go bad.³²

Since 2000, non-market lending to SOEs and SIEs has distorted China’s industrial structure:

- Many of the remaining SOEs and SIEs are in capital-, energy-, and pollution-intensive heavy industries (including steel, non-ferrous metals, cement, glass, paper, and basic chemicals) in which China does not have a natural comparative advantage. In 2006, China produced 49 percent of world output in flat glass, 48 percent in cement, 35 percent in steel, and 28 percent in aluminum.
- Non-market lending has slowed the growth of small- to medium-size enterprises, real wages, and employment opportunities for less skilled Chinese workers by tilting investment away from labor-intensive, less polluting light industries and services in which China has a natural comparative advantage. Because of these labor market effects, non-market lending has contributed to a decline in household income as a share of GDP during the last decade.³³
- Non-market lending has permitted too many small, provincially based, uncompetitive SOEs and SIEs to survive in the same industry. In 2006, for example, China had 6,959 steel firms. The combined domestic market share of the top three Chinese steel firms was 14.1 percent compared with 44.7 percent in the European Union, 63.9 percent in Japan, and 59.7 percent in the United States.³⁴
- Despite growing domestic demand, excessive investment induced by non-market lending has created significant overcapacity. In 2005, for example, China’s excess steel capacity of 120 million metric tons exceeded the 112.5 million metric tons of steel output of Japan.³⁵ In turn, overcapacity and favorable exchange rates have

encouraged SOEs and SIEs to export their excess production rather than to consolidate and downsize.

Severe environmental degradation.

Environment pollution has become acute in China. The World Bank found that pollution cost China an amount equal to 5.8 percent of GDP in 2003.³⁶

- The PRC is the largest emitter of sulfur dioxide and greenhouse gases in the world. Sixteen of the 20 cities with the most polluted air in the world are in China. Seventy-five percent of all urban residents breathe seriously unhealthy air.³⁷
- Seventy-five percent of river water and 90 percent of groundwater near cities is unsafe for human use. Fifty percent of river water is also unsafe for agricultural or industrial use. Beijing and other cities in northern China are threatened with shortages of potable water.³⁸
- Less than half of approximately 40 tons of toxic waste generated annually are treated or reused.³⁹

These severe problems have prompted unrest. In April 2005, for example, 60,000 farmers in Zhejiang Province protested against pollution from thirteen chemical plants in an industrial park near Huaxi village that spoiled crops.⁴⁰

Stress on the international economy. China’s unbalanced economic growth is straining the international economy. The PBC’s foreign exchange interventions have contributed to the PRC’s growing current account surpluses. Without these interventions:

- An appreciation in the foreign exchange value of the renminbi would increase the real income of the Chinese people. Higher real incomes would enable the Chinese to consume more goods and services, especially imports whose prices in yuan would fall relative to their domestic competitors as the renminbi appreciated;
- Some of China’s manufacturing capacity that is now producing goods for exports would be redirected toward the domestic market; and
- Without the PBC’s ongoing interventions in foreign exchange markets, the PBC would be unable to use the U.S. dollars that these interventions generate to acquire more U.S. financial assets. As a result, the United States

would have lower current account deficit, while the PRC would have a lower current account surplus.

The PRC's large and growing current account surplus is fanning protectionist sentiments in the United States, the European Union, and other countries. Such sentiments could eventually result in protectionist legislation that could undermine an open trading system on which China's export-led development strategy depends.

Until recently, the PBC had invested a large percentage of its reserves in U.S. Treasury and agency debt securities. In early 2007, however, the State Council established a foreign exchange management company to diversify the investment of approximately \$200 billion of reserves away from U.S. Treasuries and agencies into other assets.

Unlike a private individual or firm, a government agency may not make its investment decisions based solely on wealth maximization using risk and return criteria. Instead, a government agency may forgo wealth maximization to pursue non-economic objectives. For example, a government agency could buy a large minority stake in a publicly traded corporation and use its equity position to press management to pursue certain political objectives. In the United States during the 1980s, for example, state and local government pension funds sold or threatened to sell their shares in corporations doing business in South Africa to enforce an economic boycott to end apartheid. It is unknown what criteria this Chinese company will use to make its investment decisions.

Conclusion. It is easy to assume that the PRC will continue to enjoy double-digit economic growth into the indefinite future. However, China must confront and resolve a number of significant challenges to sustain long-term economic growth. The PRC's senior leaders are aware of these problems. During his speech at the 17th Party Congress on October 15, 2007, President Hu recognized the need for additional reforms to rebalance the Chinese economy and to sustain its growth over the long-term. However, Hu did not detail specific policy changes. Widespread corruption and *de facto* decentralization may limit Hu's ability to address these challenges quickly and effectively. It remains to be seen what reforms Hu will try to implement and how successful these reforms will be.

¹ China National Bureau of Statistics (CNBS)/Haver Analytics.

² At the 15th Party Congress in 1997, President Jiang Zemin announced the *zhuada fangxiao* policy (i.e., grab the big, dump the small). Under this policy, the central government retained ownership of SOEs that produce defense goods and services, are in industrial sectors targeted for economic development, or are hopelessly insolvent, but employ millions. The central government transformed many of the other large SOEs into shareholding enterprises by issuing minority shares to investors. While shareholding enterprises exhibit many of the characteristics of private corporations, the central government still exercises effective control over their operations. These shareholding enterprises along with collective enterprises owned by subsidiary governments, cooperative enterprises in urban areas, township and village enterprises in rural areas, and private firms owned by senior officials, are collectively known as state-influenced enterprises (SIEs).

³ CNBS/Haver Analytics.

⁴ International Monetary Fund (IMF)/Haver Analytics. Calculations by author.

⁵ CNBS/Haver Analytics.

⁶ China General Administration of Customs and State Administration for Foreign Exchange/Haver Analytics.

⁷ IMF and CNBS/Haver Analytics. Calculations by author.

⁸ CNBS/Haver Analytics.

⁹ Ibid.

¹⁰ Tom Mitchell and Geoff Dyer, "Heat in the Workshop: The 'China Price' is under Upward Pressure," *Financial Times* (October 15, 2007).

¹¹ Andrew Batson, "China Is in Bind to Raise Energy Prices: Efforts to Relax Controls Are Losing Out to the Fight Against Inflation," *Wall Street Journal* (September 21, 2007). Found at:

http://online.wsj.com/article/SB119028617841133714.html?mod=hps_asia_whats_news.

¹² CNBS/Haver Analytics. Calculations by author.

¹³ Ibid. Calculations by author.

¹⁴ Ibid. Calculations by author.

¹⁵ Ibid. Calculations by author.

¹⁶ Under Mao's "iron rice bowl" system, SOEs provided their workers with comprehensive social-welfare benefits.

¹⁷ CNBS/Haver Analytics.

¹⁸ *Transparency International Corruptions Perceptions Index 2006*, and *Transparency International Bribery Payers Index 2006*, found at <http://transparency.org>.

¹⁹ Found at:

<http://www.chinabalancesheet.org/Documents/Corruption.pdf>.

²⁰ Associated Press, "Corruption Blamed in China's Pollution" (December 26, 2006).

²¹ Ian Johnson, “Beijing Steps Up Battle for Quality,” *Wall Street Journal* (September 7, 2007), A-6.

²² Stratfor Global Intelligence Brief, “China: Product Quality, Reform and the Rule of Law,” (August 27, 2007).

²³ At year-end 2006, four state-owned commercial banks (SOCBs) controlled \$2.83 billion or 57.8 percent of all deposits; thirteen joint-stock banks (JSBs), \$853 million or 17.4 percent; and credit unions, \$440 million or 9.0 percent; 117 urban banks, \$305 million or 6.1 percent; three state-owned policy banks, \$297 million or 6.1 percent; and foreign banks, \$93 million or 1.9 percent.

Recently, the China Banking Regulatory Commission authorized China Post to open a Postal Saving Bank in early 2007. This new institution is expected to garner about 5 percent of all deposits.

Both SOCBs and JSBs operate throughout China. The central government is the majority shareholder in the SOCBs, while SOEs and SIEs are the majority shareholders in most JSBs. Urban banks, in which local governments are majority shareholders, operate within a particular city.

²⁴ Donald J. S. Brean, “Banking Reform in China: What It Means for the World,” Asia-Pacific Foundation of Canada (January 2007).

²⁵ “US\$40 bil. Reportedly Earmarked for Agricultural Bank of China Bailout,” *Global Insight* (August 6, 2007).

²⁶ Donald J. S. Brean, “Banking Reform in China: What It Means for the World,” Asia-Pacific Foundation of Canada (January 2007).

²⁷ Among the major foreign investors/strategic partners are Royal Bank of Scotland, Merrill Lynch, Temasek, UBS, and the Asian Development Bank in BOC; Bank of America and Temasek in CCB; Goldman Sachs, Allianz, and American Express in ICBC; HSBC in Bank of Communications; Standard Chartered Bank in Bohai Bank; Asian Development Bank in China Everbright Bank; BBVA in Citic Bank; Deutsche Bank, Pangaea Capital, Hang Sang Bank and International Finance Corporation in Industrial Bank; International Finance Corporation and Asia Finance Holding in Minsheng Bank; Citigroup in Shanghai Pudong Development Bank; and Newbridge Capital in Shenzhen Development Bank.

²⁸ Syetarn Hansakul, “China’s Banking Sector: Ripe for the Next Stage,” *Deutsche Bank Research* (December 7, 2007).

²⁹ People’s Bank of China/Haver Analytics. Diana Farrell, Susan Lund, Jaeson Rosenfeld, Fabrice Morin, Niyati Gupta, and Ezra Greenberg, *Putting China’s Capital to Work: The Value of Financial System Reform* (McKinsey Institute, April 2006). Percentage calculations by author.

³⁰ Richard Podpiera, “Progress in China’s Banking Sector Reform: Has Bank Behavior Changed?” IMF Working Paper WP/06/71 (March 2006).

³¹ China Banking Regulatory Commission/Haver Analytics.

³² International Monetary Fund, “People’s Republic of China: 2006 Article IV Consultations,” (October 2006), 40. Found at:

<http://www.imf.org/external/pubs/ft/scr/2006/cr06394.pdf>.

³³ Nicholas Lardy, “China Rebalancing Economic Growth,” (2007), 8.

<http://www.chinabalancesheet.org/Documents/01RebalancingEconGrowth.pdf> See also, Jahangir Aziz and Li Cui, “Expanding China’s Low Consumption: The Neglected Role of Household Income,” IMF Working Paper WP/07/181 (July 2007).

³⁴ Daniel H. Rosen and Trevor Houser, “What Drives China’s Demand for Energy” (2007), 39. Found at: <http://www.chinabalancesheet.org/Documents/02WhatDrivesChinasDemand.pdf>.

³⁵ Lardy, 6.

³⁶ World Bank, *Cost of Pollution in China: Economic Estimates of Physical Damages* (2007).

³⁷ Jennifer L. Turner, “China’s Environmental Crisis: Opening Up Opportunities for Internal Reform and International Cooperation,” (March 2006). Found at: http://www.chinabalancesheet.org/Documents/Paper_Environment_Paper.PDF.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ Ibid.