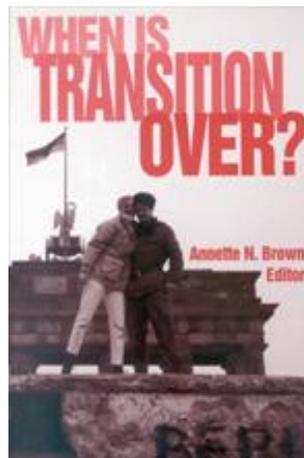

Upjohn Institute Press

China's Unfinished Economic Transition

Nicholas R. Lardy
The Brookings Institution



Chapter 4 (pp. 69-76) in:

When is Transition Over?

Annette N. Brown, ed.

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1999

DOI: 10.17848/9780585282978.ch4

4 China's Unfinished Economic Transition

Nicholas R. Lardy
The Brookings Institution

The hallmark of China's approach to economic reform is gradualism. China's reformers, in effect, have eschewed the conventional wisdom that successful economic transitions are built on the basis of rapid privatization of state-owned firms, overnight price reform, and a quick dismantling of trade barriers. Although a variety of new forms of ownership have flourished in China, de facto privatization of small state-owned firms did not get underway until the mid 1990s, and few, if any, medium and large state-owned firms have been privatized. Relative prices in China for the most part have converged to world levels, but this process was extremely gradual. Opening the economy to foreign trade was similarly gradual and was a key part of the process by which relative domestic prices have converged to world levels. Moreover, foreign trade liberalization is far from complete, as China maintains a trade system with substantial protection for many industries.

Paradoxically, China's economic performance, by almost all measures, has been superior to that in other transition economies. In contrast to a period of sharply declining output in several of the states of Eastern Europe and the former Soviet Union, China's gradual reform generated record rates of economic growth from the outset. From 1978 through 1995, real output increased at an average annual rate of 8 percent. Unlike the transition in Russia, where inflation accelerated dramatically, China has held average annual inflation to a single-digit level, despite two sharp upward spikes, since economic reform began in the late 1970s. Moreover, economic growth in China has been broadly shared among all regions and segments of society. The precipitous decline in poverty in the first seven years of economic reform was especially dramatic. By contrast, in Russia, the combination of a disintegrating social safety net and declining real output has inflicted

sharply lower living standards on large segments of the population, even as a small class of *nouveau riche* Russians enjoy ostentatious lifestyles. Finally, China's gradual reforms facilitated its progress toward integration into the world economy. By the mid 1990s, China's share of world trade had quintupled relative to the pre-reform period, and it regularly was the recipient of more foreign direct investment than any other transition or developing country. Moreover, it was the first transition economy to be awarded an investment-grade rating for its sovereign debt in international capital markets, and it has raised far more capital in these markets than any other transition economy.

THE SUSTAINABILITY OF CHINA'S STRATEGY

Despite these apparent successes, I believe that China's current economic policy mix is unsustainable and that the completion of China's economic transition will require a more accelerated reform strategy. Three trends are particularly worrisome. First, state-owned enterprises are becoming ever more indebted, particularly to banks. These firms increasingly borrow not only to finance the purchase of new equipment or other productive assets, but also to buy inputs used in production, to pay their wage bills, to provide a broad range of social services to their workers, and, in some cases, even to meet their pension and tax obligations. In short, on average they are not able to cover their total costs with the income they receive from the sales of their products.

Second, state-owned banks and other financial institutions are extending loans at what appears to be a pace that will not be economically sustainable. Loans outstanding relative to gross domestic product (GDP) have doubled since reform began in 1978. By year-end 1997, loans outstanding were equal to total output. Most of these loans from banks and other financial institutions have been extended to state-owned enterprises, and a large and rising share is nonperforming, meaning that the borrowers are no longer repaying principal or even interest on their loans. As a result, the profitability of the banks, as measured by return on assets, has fallen by five-sixths since the mid 1980s. Given the modest amount of their own capital, their tiny loan-

loss reserves, and nonperforming loans acknowledged to be equal to fully one-fourth of their loan portfolios, by Western accounting standards several of China's major state-owned banks already are insolvent. Since households continue to add enormous amounts of funds to their savings accounts, these banks remain liquid and a financial crisis has been avoided. However, this cannot continue in the long run.

Third, government tax revenues declined by two-thirds relative to output between 1978 and 1995. At the beginning of reform, taxes and other government revenues were equal to a third of the nation's output, a level well above the average of other transition economies. By 1995, revenues had fallen to about 10 percent, a level quite low in comparison with both other transition economies and emerging markets. As a result, during the reform era the state increasingly has been unable to finance normal government expenditures from the budget. Although the official budget deficit has been modest and in recent years financed entirely through the sale of treasury bonds, the broader public sector nonfinancial deficit in the mid 1990s has been running at an unsustainable level of over 10 percent of gross domestic output for almost a decade. That deficit reflects the increased borrowing demand of state-owned industrial and commercial firms, a portion of which represents social and other expenditures that should be financed through the state budget.

In short, the strategy of gradualism of the Deng Xiaoping era appears to be economically unsustainable. Moreover, since the three trends described are closely interrelated, a strategy of focusing sequentially on the problems of banking, state-owned enterprises, and taxes is not likely to be effective. The banks cannot operate on fully commercial terms until the behavior of their principal borrowers fundamentally changes. However, many potentially profitable enterprises will find it difficult to improve their financial performance and to deal with banks on a normal commercial basis until the state relieves them of the obligation of providing a broad range of social services and of employing more workers than economically are necessary. The government will not be able to finance either these social expenditures or the needed recapitalization of the banking system from the budget until a fundamental reform of tax policy and tax administration increases government revenues relative to output. Thus, the key to reform in the future

is likely to be a strategy that addresses all three of the underlying problems simultaneously.

REFORM OF THE BANKING SYSTEM

The creation of a modern banking system is essential to improving the efficiency with which capital is allocated and to sustaining rapid economic growth in all transition economies. Banking reform in all transition economies must be based on the rehabilitation of existing banks, on the entry of new banks, or on some combination. China's approach to date emphasizes rehabilitation but also includes the establishment of some new banks and other new financial institutions. This is an appropriate mix given China's unusually high ratio of bank deposits to GDP. Relying primarily on new institutions may be a viable strategy in Russia and in the other newly independent states, where high inflation in the early 1990s so reduced the value of savings deposits that the ratio of deposits to GDP in 1994 was only one-sixth that in China. Relying largely on new institutions in China would inevitably mean the collapse of existing banks, wiping out most of the value of household savings deposits, which at year-end 1997 were RMB 4.6 trillion, the equivalent of well over one-half of GDP. That could create a financial crisis.

The rehabilitation of existing banks depends critically on their recapitalization. There is only one other alternative—a default on household liabilities. This was feasible in Russia both because the value of household deposits in the banking system was quite low, about 10 percent of GDP, and because Russia had already entered the post-communist era. The mechanism through which household savings were lost was several years of hyperinflation that effectively eliminated the purchasing power of funds tied up in bank deposits on which very low rates of interest were paid. However, the default on the much larger volume of household savings in China, whether explicit through a collapse of the banking system or implicit through the inflation tax, would likely lead to a political crisis. Thus, China's leadership is likely to eschew defaulting on liabilities to households and make good on its existing implicit guarantee of the value of all household deposits in the

banking system. That approach requires a write-off of bad debt and a recapitalization of the banks.

One approach is the gradual recapitalization of banks through reinvestment of their profits. The World Bank's 1996 *World Development Report*, which focused on the problems of transition economies, is skeptical of the long-term efficacy of using tax revenues to recapitalize banks in transition economies. This view is based in part on the early Hungarian transition experience, in which some banks were recapitalized as many as five times. The *World Development Report* favors policies that promote self-help for banks, to encourage them to build up their capital base and to grow out of their bad-debt problems.

While this strategy may have merit in other transition economies, it is much less feasible for China. The magnitude of nonperforming loans, and thus the size of the required recapitalization, are so large that the incremental rebuilding of capital through the reinvestment of profits does not appear viable. The gradual approach, sometimes called a flow solution, is feasible in the most mild cases of banking distress, where capital adequacy of problem banks, while low, is still positive. As noted, several of China's major state-owned banks are effectively insolvent; that is, the value of their liabilities exceeds the value of their assets. Moreover, the reported level of profitability of these banks has fallen to quite low levels, and, according to realistic accounting principles, is almost certainly negative. In short, there are no real profits to be added to bank capital.

The bottom line is that China's best option is probably to follow the course pursued by several transition economies in Eastern Europe: to recapitalize the banks by injecting government bonds into these institutions in an amount equal to the value of the write-offs that must be taken of the nonperforming loans. Since loans outstanding now are fully equal to China's GDP, the fiscal cost of this approach will be high. For example, if the bad loans that ultimately need to be written off total one-fourth of banks' loan portfolios and the real interest rate on government bonds is 6 percent, the annual interest the government would have to pay on the bonds issued would be equal to 1.5 percent of GDP. That would absorb about one-eighth of the current level of combined government expenditures at the central, provincial, and local levels. Since China's existing stock of government debt is quite low, for some period of time much of the interest cost could be financed by the

sale of additional bonds to the public, rather than by cutting other expenditures. Ultimately, financing the recapitalization of the banks will require increased tax revenues relative to output of the economy, reversing the long-term decline.

If China fails to complete the transformation of its banking system, the consequences are predictable. The intermediation of funds between savers and investors by banks likely would continue to be marked by the inefficiencies already evident. As the contributions to economic growth of various one-time factors wind down, one would expect the rate of growth of the economy to slow. That trend would be reinforced by the physical constraints to growth that are increasingly evident in China: environmental deterioration, the challenge of sustaining adequate gains in agricultural output, and infrastructure shortages. Unless resources are used more efficiently in industry and commerce, it is difficult to foresee how China could overcome these physical limitations. An inefficient banking system also would impede the development of stock and bond markets; as per-capita output rises and appropriate regulatory structures are developed, these markets normally come to play an important supplementary role in the allocation of resources. The continued fragility of the banking system would limit the ability of the People's Bank, through the more active use of interest rate policy, to dampen the marked fluctuations in economic activity that have characterized the reform era. Ultimately, the failure to transform the banking system could undermine the high rate of household savings that has provided most of the fuel for China's strong economic growth.

The international consequences of China's failure to complete the transformation of its banking system also are predictable. A sound banking system is a prerequisite for moving to convertibility on capital account transactions. This factor underlies the reluctance of government officials to declare an unduly optimistic target date for achieving full convertibility of the domestic currency. Until China's banking system has been restructured and placed on a sound financial foundation, the People's Bank will almost certainly continue to require foreign financial institutions to operate under the many severe restrictions that already exist. Consequently, the expectation of the international community that China will provide national treatment¹ of foreign banks and nonbank financial institutions will not be met. This expecta-

tion is likely to be reflected in any protocol governing China's accession to the World Trade Organization.

CONCLUSION

By many measures, China's economic transition looks relatively good. However, gradualism has had a significant downside that becomes apparent once one looks at the economy, particularly the financial system, in greater depth. The cost of deferring industrial restructuring has been high. Real resources have continued to flow into enterprises that will not be viable in a market economy. These resource movements have been intermediated through the banking system, which relies almost entirely on household savings as the source of its funds. Thus, sustaining money-losing state-owned enterprises has involved the accumulation of huge liabilities to households. In addition, since the users of borrowed funds in many cases are no longer able to repay principal or even to pay interest on their loans, the liabilities of banks to households are no longer backed by real assets. This creates the potential for a domestic banking crisis that would disrupt the flow of credit and the payments system, leading to a major recession. The failure of major banks also could have long-term negative implications for the high rate of household savings, which has become the principal source of growth in the reform era.

Avoiding a financial meltdown will entail the substantial economic costs associated with recapitalization and commercialization of the banking system, with an accelerated program of privatization and restructuring of state-owned firms, and with a fiscal reform that raises the tax share of GDP. Although these changes probably would curtail the rate of economic growth somewhat in the short run, they would be highly desirable in the long run since they would help the emergence of a more efficient system of financial intermediation and a more productive manufacturing sector. Avoiding a financial meltdown also will entail substantial short-term social and political costs. Shutting down large numbers of inefficient, money-losing state-owned enterprises is a prerequisite to creating an efficient, modern banking system. Banks will not be able to operate on commercial principles if they are

required to continue to prop up inefficient firms with an ever-growing volume of loans. This will lead to reduced incomes for a significant portion of China's population, at least on a transitory basis. Already-high rates of unemployment are likely to rise further before the efficiency gains of accelerated reform lead to an improved allocation of resources and increased rates of job creation. Thus, the next stage of reform carries with it unprecedented potential for social unrest.

NOTE

1. I.e., that foreign banks will be allowed to provide the same range of services to their customers as domestic banks do.

When Is Transition Over?

Annette N. Brown

Editor

1999

W.E. Upjohn Institute for Employment Research
Kalamazoo, Michigan

Library of Congress Cataloging-in-Publication Data

When is transition over? / Annette N. Brown, editor.

p. cm.

Essays based on six presentations given at the 33rd Annual Lecture-Seminar Series of the Dept. of Economics at Western Michigan University, held during the 1997-1998 academic year. The lecture series is cosponsored by the Department and the W.E. Upjohn Institute for Employment Research.

Includes bibliographical references (p.) and index.

ISBN 0-88099-196-8 (cloth : alk. paper). — ISBN 0-88099-195-X (paper : alk. paper)

1. Post-communism—Europe, Eastern—Congresses. 2. Capitalism—Europe, Eastern—Congresses. 3. Post-communism—Economic aspects—Europe, Eastern—Congresses. 4. Mixed economy—China—Congresses. 5. China—Economic conditions—1976—Congresses. 6. China—Economic policy—1976—Congresses. 7. China—Politics and government—1976—Congresses. I. Brown, Annette N., 1966– II. Western Michigan University. Dept. of Economics. III. W.E. Upjohn Institute for Employment Research.

HC244.W475 1999

330.12'2'0947—dc21

99-24188

CIP

Copyright © 1999

W.E. Upjohn Institute for Employment Research

300 S. Westnedge Avenue

Kalamazoo, Michigan 49007-4686

The facts presented in this study and the observations and viewpoints expressed are the sole responsibility of the authors. They do not necessarily represent positions of the W.E. Upjohn Institute for Employment Research.

Cover photo: Border guard posing with tourist at the Berlin Wall.

© Corbis/Owen Franken

Cover design by J. R. Underhill.

Index prepared by Nancy Humphreys.

Printed in the United States of America.