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China's Economic Growth with WTO Accession:

Is it Sustainable?

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Summary

China's economy has been remarkably successful economy since reforms were introduced in 1979. Its growth of real GDP has averaged 9% per annum over this period and reached an impressive 9.9% in the first quarter of 2003 despite the weak global economy.

However, recent indicators have begun to cast doubt on the sustainability of its economic growth. Chief among these is its accession to the World Trade Organization (WTO) on 11 December 2001 achieved after many years of negotiations. This opens up numerous opportunities, but also introduces risks in many ways. China's stumble has come as a surprise to many, but not to those who have studied its particular path of economic transition.

The paper analyses how the 'gradualist' path of economic reform taken by China predicted the current state of uncertainty regarding its growth prospects. The article argues that China's economic growth will rely on its successful integration into the global economy. It concludes with an assessment of the future challenges facing China and its structural problems. We can be cautiously optimistic conclusion about the sustainability of China's growth.

Introduction

China has been a remarkably successful economy since its adoption of market-oriented reforms in 1978. China's real GDP growth has averaged 9% per annum from 1979 to the present. As a basis of comparison, the United States during its widely remarked successful era had growth rates averaging 2.9% in real GDP per annum during the late 1990s.

The popular perception is that China is a phenomenally successful economy which will continue to grow. China's record, however, may mask structural problems in its economy. Unlike its counterparts in the region which have followed the International Monetary Fund (IMF) and other institutionally prescribed programmes of reform, China has proceeded on its own course for the most part. Thus, entry into the World Trade Organization (WTO) brings new opportunities, but also introduces risks as China increases its integration into the global economy. The progress and nature of market-oriented reforms of the economy will also play an important role in its growth prospects, *i.e.,* China will need to now address a high unemployment rate, large portfolios of non-performing loans (NPLs) held by state-owned banks (SOBs), rising unemployment in various forms, and the restructuring of inefficient state-owned enterprises (SOEs), to name a few. The recent doubts as to the sustainability of its growth are perhaps unexpected for those who admire its past successes, but become understandable – even anticipated – by those familiar with its particular growth strategy.

This paper will proceed in three parts. The first is a review of China's economic reform strategy and why the 'easy to hard' sequence has placed the challenges for China before it today. This is followed by an evaluation of the determinants of growth in the context of WTO accession and the aftermath of the Asian financial crisis. Finally, I identify the structural problems inherent in the economy that may confound its growth prospects and conclude with some summary assessments.

China's Path to Economic Reform

The end of the Cultural Revolution in 1976 revived the two competing forces of institutional centralisation and accelerated growth, which in contrast requires decentralisation (Riskin, 1987). In 1978, a plan of reform was adopted to deal with the systematic imbalances in the economy. In the mid 1980s, reform was implemented in urban areas heralding to the current period of WTO accession.

The transition strategy undertaken by China is termed a "dual track" reform path because there is both a planned and a market part of the economy. Understanding the evolution of this 'incrementalist' or 'gradualist' strategy will shed light on why the structural problems underpinning China's economy are expected.

"Gradualism" versus "shock therapy"

A "shock therapy" approach was not desired by China on account of reasonable economic conditions at the time of the first adoption of reforms. "Gradualism" was preferred to the more radical reform programmes, which were similar to the rapid introduction of market forces termed "shock therapy" by the Eastern European and former Soviet Union economies (EEFSU). For China in 1978, the rate of economic growth was 12.3%[1]; thus, seemingly to buttress a positive impression of the socialist system. In contrast, the EEFSU societies in the late 1980s accepted a "shock therapy" package, again under terms particular to their circumstances (notably, the lack of authority of the central government). Gradualism had been tried before the 1989 revolution without great success. One interpretation posited is that the ability to adopt gradualism or radical change depends on the extent to which the economy had stagnated and declined at the time of reform. The lower is the growth potential of the old system, the stronger are the incentives and the will to pursue radical reform.

Gradualism is further related to initial conditions and economic structures. It is more likely to be successful in an under-developed and under-industrialized economy with a large rural surplus labour force. Rural incomes had been falling compared to the urban population in China. The pre-existence of a declining sector, such as agriculture, results in a population of people who possess a strong demand for opportunities and who will also constitute a new labour force.

Thus, there are two main conditions that permit an incrementalist reform approach to be successful. First, China started its reforms before the state sector was in drastic decline, so that heavy subsidies were not needed, contrary to the situation of former Soviet firms in the late 1980s. Second, the start of rural reform and accompanying liberalisation of private economic activity in the presence of a large rural labour surplus generated growth rapid enough to outpace the speed at which subsidies to SOEs were increasing. Another favourable condition is the political continuity of the government and its ability to control the process of growth (see Murphy *et al.*, 1992[2]).

Some of the changes under gradualism were due less to planning, but more accurately characterised as adjustment to practical circumstances. For example, one of the key steps in starting the reform process was the advent of the 'household contract responsibility system.' It was banned in 1979, but accepted when it became widely practised by rural residents. It occurred again when the rural economy was liberalised, with the rise of the township and village enterprises (TVEs), which were to become the dynamic engine of growth in the 1980s.

Lack of an objective model

China also did not have the focus that the EEFSU economies had, which was to adopt a largely privately-owned economy and rejoin Europe. For China, the motivation was recognition that a centrally planned economy was no longer viable and changes were required to promote economic growth. Consequently, without a definite model in mind, China underwent a lengthy path of adjusting reform objectives: from 'a planned economy with some market adjustment,' to 'a combination of plan and market' to 'a socialist market economy.' This path was adaptive rather than deliberate. With the rise and indeed success of the non-state sector and the decline of the state sector, popular sentiment started to shift toward the market system and the government's objective shifted and adapted.

Regional experimentation

Much of the innovation and many of the advances that occurred in the process of reform were less by design and resulted more from the Chinese government's pragmatic flexibility. The Chinese government approach can be described as 'no encouragement, no ban' (Naughton, 1995).

[1] There are always concerns over the measurement of growth and other statistics in the pre-reform period. Suffice it to say that the economic situation in 1978 was not dire; thus, the impetus for a more radical type of reform was not present.
[2] Murphy *et al.* (1992) show that the government's ability to impose and maintain quantity ceilings for goods and services sold at 'market prices' differentiates the success of China and the lack of success of the former Soviet Union.

Experiments encompassing different reform programmes at various governmental levels were encouraged, including the creation of "special economic zones" (SEZs). SEZs were specially designated areas in which export-oriented companies were permitted to flourish and become foreign-invested in these restricted locales, such as Shenzhen. Special treatment was further given to different regions and local initiatives were respected.

One reason for this success has been posited in the form of forms of co-ordination (see Qian and Xu, 1993). M-form structures of co-ordination are based on minimal interdependence among regions or industries, so that experimentation in one area of industry can be completed without its success or failure causing disruptions across the economy. U-form organisation is characterised as 'top-down' because of more interdependence and thus experimentation could affect the whole system. M-form is thought to be more conducive to experimentation and heterogeneity among units makes experimentation less applicable in U-form hierarchies. China was perhaps of the former as a result of much decentralisation that preceded the reform period, which accounts for the success of experiments in heralding further reforms.

The theory of "partial reform"

Thus, the theory of partial reform was adopted in which some markets were liberalised and permitted to sell output at market prices but also required to sell to state firms at administered prices. This "dual-track" system applied to China has been extended to cover almost all economic transactions, except for credit markets where interest rates remain tightly controlled although a black market thrives in parallel – its own dual-track in a sense. Although the reforms were not accompanied by privatisation of ownership, the resulting arrangements generated new forms of economic organisations. The most important is the creation of a parallel non-state sector to the state one. Much of China's dynamic growth can be attributed to the non-state sector, consisting of private and semi-private enterprises, including community-owned rural industrial enterprises, foreign joint ventures (JVs), and individual businesses. The appeal of this approach is in part to honour 'implicit contracts,' built up over expectations under a socialist system. The implicit contract guarantees a worker to receive at least a wage regardless of effort, and benefits such as health insurance, free housing, retirement pension and jobs for life (the 'iron rice bowl') and for offspring. This reduces market efficiency and instead reflects vested interests. The gain from the maintenance of such distorted incentives is that resistance to reform is reduced.

It is important to note that the success of this approach depends mainly on the success of the new track. If the growth rate of the new sector is higher than that of the old sector, then the old system will in the long run shrink as a proportion of the economy. For instance, if the old economy stops expanding and the new economy grows, such transition will eventually consist of the new economy.

For instance, price reform of food items by 1992 had taken place for a decade. Market prices were nearly twice that of official prices. When governmental controls were removed, convergence occurred and food sold at officially set prices accounted for less than 15% of total consumption. Under these conditions, convergence did not cause a 'shock.' Similarly for the foreign exchange market, the unification of the official exchange rate and the 'swap market exchange rate' occurred at the end of 1993 when the differential between the two rates was about 50%. At that time, only 20% of such transactions were still subject to the official exchange rate. The 'rationed' component did not shrink in absolute size but relatively to the 'new track.'

However, the old track has expanded in absolute size frequently. This is because the government has frequently taken from the more productive sectors to compensate those who suffer losses due to transformation and to expand the old sectors. The latter subsidy is usually justified as strengthening the competitiveness of SOEs through technological upgrading, so that the old track has not shrunk as expected (see Fang, 1994).

Although the non-state sector has become a major contributor to GDP, this is not the case for expenditures where the state sector remains dominant. For instance, over 80% of bank credits go to the state sector. Only this year has a law been passed to extend credit to SMEs (small and medium enterprises), which account for approximately 60% of industrial output and employ 75% of the urban workforce (NBS, 2000). Investment is primarily in the state sector despite its declining importance. State employees as a share of the labour force has not decreased as rapidly as thought; even the number of state enterprises had increased in the early 1990s. Another reason why the old track has lasted so long is because of rent-seeking by government officials. Corruption is related to the divergence of profits, among others.

Perhaps one of the lessons is that the challenge in gradual transition is not to speed up the pace of reform, but to ensure that the old track does not grow. The old track cannot be ignored because it may prosper as a parasite on the new track.

"Easy to hard" reform sequence

With decentralisation of decision-making powers to local governments and increased autonomy given to enterprises, there were a number of problems generated by this reform strategy. The gradualist approach is in actuality an 'easy-to-hard' reform sequence. It addresses the easy problems first and leaves the hard ones until later. A radical approach would do the opposite: the aim would be to maximise efficiency gains and minimise implementation costs of reform. However, restructuring may be easier with the gradualist approach as it minimises the political costs of reform. Different conditions could produce a different optimum sequence. Thus, the calls for heralding China as a model of growth should be heard with caution. The general gradualist principle, however, has gained substantially in popularity as a 'pacing and sequencing' of reforms gains in popularity at the expense of advocating for immediate liberalisation.

A Model of Growth in the Context of WTO Accession

A simple analytical framework governing our discussion of the growth model of China will be presented in this section. First, gains from increasing inputs, such as capital and labour, constitute extensive growth. Intensive growth, on the other hand, requires advances in real productivity, generally associated with increases in the technology parameter of the economy's growth model. In a simple Solow growth model: $Y = A(K, L)$, where Y is equal to national output, K and L represent capital and labour respectively, and A denotes technology. Increases in K and L will be extensive while A represents intensive growth, both with respect to Y. Thus far, increases in economic performance are largely attributed to the process of extensive growth. Studies have shown that China's growth is less associated with gains in real productivity over the reform period and more with increases in factor accumulation (for example, see the evidence cited in Wang and Yao, 2001). As an example, surplus labour in the agricultural sector was efficiently re-allocated with the creation of TVEs to absorb rural employment. This is not to discount the improvements gained from introducing market-oriented incentives in the state sector (Groves *et al.,* 1995[3]). However, the bulk of the sparse empirical evidence indicates that China's growth is more similar to the East Asian "Tigers" factor accumulation process, which is only associated with small increases in real productivity (see Chow, 1994[4]).

As a gradualist path is characterised by an 'easy to hard' sequence of reforms, such gains from better allocation of existing factors are expected to occur first, as they are easier to achieve than growth in real productivity. When gains from such growth are exhausted, then an economy will stagnate until it is able to achieve technological progress. When China announced in 1997 a five-year plan of layoffs from the inefficient state sector, the signs of the limits of extensive growth were becoming more apparent.

The process of intensive growth will require advances in productivity, which are most easily obtained through imitation of developed economies' technology. This process is well known in development and is termed "catching up." This warrants an open economy with exchanges of knowledge and technology. Adapting the economic theory to the Chinese economy in transition, it is plausible that the growth sequence for a 'gradualist' path could be characterised by closed development until intensive growth is exhausted and then open economy growth will follow. The economy is largely closed in the first stages in the gradualist path as government control is the key ingredient in implementing a system of partial reform. As economic conditions worsen and the inefficient state sector begins to destabilise the economy with unemployment, there will likely be a gradual opening of the economy to permit foreign direct investment (FDI), exploit global demand and most importantly, negotiate technology transfers. This process can also be gradual. Exports and FDI were not the major components of China's economic output until this year, notably after WTO accession. Moreover, the challenges confronting China will not require an abandonment of the existing economic reform strategy; however, it will entail substantial adoption of legal reforms due not to internal pressures but the external demands of compliance with international economic law.

Extensive growth has characterised China's growth thus far as revealed in the studies cited earlier. However, as growth proceeds, extensive growth based on accumulation of factors will necessarily need to be replaced by intensive growth, which entails increases in the productivity of factors. As extensive growth reaches its limits due to diminishing returns, limits of capacity, ceasing growth of population and especially for China, where there are already high levels of labour market participation make it unlikely that there would be a spurt. Early growth based on extensive growth is predicted to lead to a dramatic slowdown, which has been seen in other socialist economies such as the Soviet Union between 1950 and 1970s.

However, for China, there may still be room for gains from resource and factor re-allocation. Better utilisation of inputs of labour and capital has resulted from the introduction of market-oriented incentives and there is still room for more such gains – there is still surplus labour in its industries and capital constraints which have stifled private investment in capital stock. However, technological advancements will remain essential.

China has low levels of investment in research and development (R&D), but as with many developing countries, it adopts or imitates the technology of advanced economies. This allows for "catching up"

[3] In a study of state-owned enterprises, Groves *et al.* (1995) find that the introduction of even limited market incentives improved the performance of managers.
[4] See Chow (1994) for estimates of the production function for the Chinese economy and discussion of the contribution to national output from the various inputs. He finds that although capital accumulation played a role in the growth process, there were no real productivity gains over the period 1952-1980.

to the developed economies at low cost. At low levels of growth, the rate of growth can thus be substantial. China has done well in terms of requiring technology transfers in its foreign direct investment agreements. However, with the imposition of international economic law with WTO accession, they are subject to technology-related aspects of intellectual property rights (TRIPs) which are restrictive and based on Western laws of patents and copyrights. This is an issue that could be key to China's growth prospects.

China has achieved growth with minimal legal institutions. In fact, without private property, and thus a notable lack of property rights which are thought to underlie efficient markets. Yet, China has grown very well. It is thought that informal arrangements, such as trust or social capital – *guanxi* in Chinese – facilitated the economic transactions instead. However, there are likely to be limits to the extent that informal institutions can govern complex transactions with more remote shareholders. Thus, continued growth will require laws and regulations, especially when prompted by the contexts of WTO mandated international economic laws and the regulations needed to safeguard financial actors.

Structural Issues in the Chinese Economy

There are a number of structural issues in the Chinese economy which can impede the growth outlined above, some of which are related to the accession to the WTO and others to the aftermath of the Asian financial crisis. I will address four issues in turn: partial reform of state sector, macroeconomic stabilisation policies, WTO adjustments in the domestic economy and finally, a quick assessment of the Asian financial crisis.

Partial reform of the state sector

Reform of the state sector has been partial and as predicted by the gradualist strategy has seemingly saved the most difficult parts for last. It is important to note that reform of the state sector was preceded by rural development and TVEs in the 1980s. This section will discuss rural reform as the impetus to understanding the current state of urban state sector reform.

Once the household responsibility system was adopted, agricultural output growth soared, peaking in 1984 with a bumper crop. This spectacular success caused the subsequent claim that Chinese economic reforms began in the countryside. Reorientation of the economy thus increased the share of national income going to households by 10 to 15 percentage points. National savings and investment remained robust through the 1980s on account of the increased propensity to save by Chinese households. During this period, adjustment to the economic system on the supply side was minimised because investment was maintained at relatively high levels notwithstanding the drop in government saving. Chinese households helped maintain macroeconomic stability during this period. As a result, China's financial system began to diverge from the standard command economy model and resembled that of market economies.

Rural enterprises were firmly ensconced in the collective organisational structure in the countryside and intended to take over and provide more inputs for the successful agricultural industry. The changes which they engendered were not expected. Most communes were abolished during 1983-84 and their functions divided between townships that assumed responsibility for governmental operations and local economic committees that took over economic management. This freed TVEs to become more independent, profit-oriented entities. Given the success of the rural areas, the next phase of reform was in urban areas.

Decentralisation and institutional innovations within the state sector were both important. China has somehow managed decentralisation without change of ownership. Decentralisation has occurred in almost all areas of decision making in production, pricing, investment, trade, expenditure, income distribution, taxation and credit allocation. The main institutional innovations were the 'Budgetary Contracting System' (BCS), the 'Contract Responsibility System' (CRS), and permitting direct borrowing (Riskin, 1984). Since 1980, under the BCS, the central government shares revenues (taxes and profit remittances) with local governments. For local governments which incur budget deficits, the contract sets the subsidies to be transferred to the local governments. This fundamentally reshaped fiscal relations between central and local government. Then, the CRS in 1985 permitted SOEs to pay a fixed amount of taxes and profits to the state and retain the remainder. In principle, so long as the SOEs deliver the tax and profit remittances specified in the contracts, they are free to operate. Finally, since 1985, state grants for operating funds and fixed asset investments have been replaced by bank loans. Local governments and SOEs are allowed to borrow directly from banks. Since 1991, local governments and SOEs are permitted to borrow from household and other institutions. With WTO accession, foreign banks are also gradually permitted to extend domestic credit.

Of all the possible factors to consider in the urban sector, we will focus on the major players: SOEs and SOBs. SOEs gained more autonomy with reform as mentioned earlier, but their budget constraints are characterised as 'soft.' It is estimated that one-third of SOEs have explicit losses, and another one-third have 'hidden losses,' which refers to the accumulation of unpaid inter-enterprise debt. According to a 1992 survey of 300 large and medium-sized SOEs conducted by the State Economic and Trade Commission, the average ratio of total debt to total assets was 180%. Other surveys suggest it is near 200%. Because of 'soft' budgets, SOE inefficiency and unemployment, however, were not concomitant until the late 1990s.

The result of the urban reforms is a decentralised state sector where autonomous local governments, SOEs and local SOBs have increasingly important roles in determining resource allocation, while the central government has become less so even though ownership has not changed. It is sometimes argued that a market economy could be compatible with state ownership if managerial incentives were introduced. The decentralisation reforms may have indeed improved the technical efficiency of the state sector, but by the standards of allocative efficiency and inter-temporal stability, the decentralised state sector is a major institutional cause of macroeconomic instability and of the divergent development of regional economies. Thus, 'soft budget' constraints remain a difficult issue for reform of SOEs in China.

Macroeconomic stabilisation

Macroeconomic policy shifted sharply in 1984 coinciding with adoption of reforms in urban areas, and also opened up an entire sphere of macroeconomic related reforms. Credit policy became more expansionary – the rate of credit creation doubled – and monetary instability increased. Expansionary monetary policy led to rapid increases in demand and growth. An extended economic boom unfolded through the mid and late 1980s. The Chinese economy became more diverse and larger. This led to inflation, as would be expected. Accumulating inflationary pressures led to a high level of inflation in 1988. Austerity measures adopted at the end of 1988 were effective, but this period of dynamic growth ended with political turmoil and low growth as seen in the table presented at the beginning of this seminar.

An increasingly significant cause of inflation is the increase in loans to loss-making SOEs. As policy loans are a must, the central authorities have encountered a dilemma in macroeconomic stabilisation. It wants to curtail monetary expansion but cannot reduce credits to loss-making SOEs which are using these credits to maintain the wage levels of their employees. Thus, a tight credit policy hurts only profitable enterprises. Brandt and Zhu (2000) estimate this phenomenon and find convincing evidence of this relationship in China.

The most important cause of inflation and economic fluctuations in the 1980s to early 1990s was monetary expansion initiated by pressures exerted at the local level. Decentralisation has produced strong local public ownership economies. Each region is led by a coalition of local governments, SOEs, SOBs and the regions compete with each other for bank credits to finance local growth. It is not market competition they engage in, but competition under soft budget constraints. It is extremely difficult to test the validity of this common assertion; what is known is that the actual money supply has always been greater than the target set at the beginning of the reform period, and that banks usually extended more credits than allowed by their credit quotas without obtaining clearance first.

Therefore, China's economy has exhibited a marked cyclical pattern. Periods of rapid growth, accompanied by accelerating inflation, are followed by contractions in which both growth and inflation fall. Possible explanations include that employment and investment growth in the state sector have been supported by government transfers in the form of cheap credits from the SOBs and money creation. When credit allocation is decentralised, the SOBs divert resources to the more productive non-state sector. While this increases output growth, it also forces the government to rely more heavily on money creation to finance the transfers to the state sector, which increases inflation. The stop-go feature of the Chinese economy may be due to the government's inability to control SOB credit allocation in the face of financial decentralisation and administrative control of credit allocation to reduce inflation. In any event, these macroeconomic policy issues remain the Chinese economy and though emphasis has shifted away from this in light of the deflationary stance of the economy, they remain. Thus, a possible reform to address the inflation problem is to scale back the commitment to the state sector and reduce the need for transfers financed by money creation.

WTO accession

There is much to say about the effects of WTO accession on the Chinese economy. This section will deal with general issues arising from WTO membership that are related to the structure of the Chinese economy and thus the sustainability of its growth.

Starting with a brief overview of the immediate effects of trade for China, manufactured goods account for over 90% of merchandise exports. China is the largest exporter of manufactured products in the developing world (Lall and Albaladejo, 2003). The growth of its manufactured exports has been among the fastest achieved by developing countries, and they are not, contrary to popular perception, based only on low-cost labour. Its exports span a broad range of technologies and are diversifying and upgrading with rapidity. Trade volumes for China place it as the fifth largest exporter in the world, surpassing the UK this year. Despite the lack of full capital account convertibility, China has become by the mid 1990s the second largest host country for foreign direct investment after the U.S. and the largest one among developing countries (not including flows through Hong Kong). It stock of FDI is estimated at US$500 billion and growing, although there is some dispute over the figure on account of 'round tripping' whereby capital leaves China and returns to take advantage of foreign capital concessions.

First on trade policy, what is certain is that China is already a strong international competitor in a large range of industrial products, led by simple labour-intensive manufactures, but quickly diversifying into complex, capital and technology-intensive goods. WTO accession will strengthen its competitive position across the range. While accession may not give China an immediate advantage in markets where it already enjoys Most Favoured Nation status, it will give it unprecedented access to other markets. Accession will also assure it secure access in the future and so induce more sustained investment in the development of exports. Entry into WTO will also accompany other forms of trade liberalisation, the most important being the removal of restrictions on textiles and garments by the end of 2004. Liberalisation will also induce technological upgrading, and the accompanying improvement in the business climate will make China an even more attractive location for FDI. As for the reciprocal entry into the domestic market, China has reduced the number of products subject to non-tariff barriers (*i.e.,* quotas and licenses) from an estimated 1,200 or so in the early 1990s to approximately 200 at present. The pace of tariff reform has also been rapid, where following a significant tariff reform in 1997; rates were less than 20% across the board.

China is expected now to move toward a regime based on tariffs so that quotas, licenses and designated trading are to be phased out. State trade of commodities is still permitted, subject to WTO rules. China has agreed to bind to all industrial and agricultural tariffs, so that the average tariff on manufacture is reduced to 6.95% and 17% on agriculture. Regarding textiles, China has since become integrated into the GATT Uruguay Round on textiles and clothing. By 2005, all existing quotas on China's exports of textiles and clothing will be phased out and by 2008; any special textile safeguards will be phased out. This is the only instance in which China will benefit from market access instead of gaining from reduction of its own barriers.

Foreign investors have been major drivers of China's export success, and can be expected to continue for the foreseeable future. The composition of FDI inflows is changing. In the initial stages, most export-oriented FDI came from neighbouring economies, particularly from Hong Kong. Over time, advanced industrial countries have accounted for larger shares of FDI, mostly in hopes of serving the domestic market.

Despite much evidence of considerable financial weakness, China agreed to open its financial sector as part of its accession to the WTO. This includes substantial liberalisation of the Chinese market in banking, insurance, securities, fund management, and other financial services. Historically, China has either precluded or severely restricted the ability of foreign firms to compete with domestic firms in these areas (see Lardy, 1998).

These restrictions are most dramatically demonstrated in the area of banking. Although large numbers of foreign banks have operated in China for two decades, their role remains extremely limited. Under the terms of China's protocol for acceding to the WTO, China will ultimately be required to lift all of the existing restrictions on foreign banks. For example, the number of cities in which foreign banks can offer domestic currency services is scheduled to increase until 2005, when all geographic restrictions will be lifted. However, the requirement remains that only one foreign branch can be opened per year, which when starting from a small number of locations in China, is a significant impediment. Most importantly, foreign banks will be able to conduct local currency business with Chinese corporations two years after entry and with Chinese households five years after entry, and they will enjoy full national treatment five years after accession. That means that the central bank will no longer be able to restrict the growth of the domestic currency business of foreign banks by limiting their ratio of domestic to foreign currency liabilities or by using any other non-prudential ratio to restrict their operations.

Foreign financial firms also expect to play a role in China's securities and fund management industries. China's WTO commitments in these areas, however, are less extensive than in either banking or insurance. Foreign financial institutions regard China as a huge, under-served market. The financial sector is in an early stage of development, and the national savings rate has averaged almost 40% in recent years, most of which was generated in the household sector (World Bank, 2002). A major household financial asset is outsized holdings of currency, estimated to be *renminbi* (RMB) 1.0 trillion. Foreign banks have long believed that most of these funds could be used more effectively with the introduction of a modern payments system.

China's leadership has agreed to a significant opening of its financial sector and believes that competition from foreign banks can accelerate the development of a commercial credit culture in the domestic banking system. This potential is being weighed carefully against the risks associated with premature financial liberalisation in the context of an admittedly weak state-owned banking system and a relatively new central bank with insufficient supervisory and regulatory experience. The large SOBs recognise the need to augment their capital. Their options, however, are limited. International equity markets will not be feasible for China's largest state-owned banks until restructuring has progressed and the emergence of a commercial credit culture is evident. For instance, banks will have to publicly disclose the magnitude of their non-performing loans, as measured by the new forward-looking criteria that the central bank first introduced in 1998. To date only the Bank of China has disclosed this information.

Regarding full currency convertibility, Chinese authorities are under increasing pressure to speed up currency liberalisation. On the other hand, if controls are removed, a rising RMB would add to the economy's deflationary pressure and hurt exports that are facing weak global demand. The RMB currency regime is officially described as a managed float, although the currency is effectively pegged against the US dollar. Since there are minimal portfolio flows in China, the basic balance will constitute the renminbi's underlying pressure. The current account may start moving toward a deficit under WTO. Indeed. This has happened for the first time in the first quarter of this year when China registered a US$103 billion trade deficit. However, expected strong foreign investment inflow will keep the basic balance, hence the balance of payments, in surplus, underpinning the RMB.

In short, until China's banking system and monetary policy achieve a degree of strength and reform, it would be inadvisable to adopt full currency convertibility. First, most of the benefits of capital mobility can be and have been gained from partial mobility – principally equity and direct foreign investment. Second, full convertibility invariably brings with it an enhanced risk of the 'twin crises', one in the currency market and the other in the banking sector. To date, China's lack of full currency and capital account convertibility has not hurt its attractiveness to FDI.

Finally, China's comparative advantage is moving away from agriculture and toward manufacturing, particularly in coastal regions. Increasing wage disparity on account of targeted development policies has resulted in a massive flow of rural-urban migrants into the urban areas; some estimates are as high as 140-200 million per year, which are somewhat suspect. However, there is a large inflow of labour which is exacerbating the rising urban unemployment rate related to the lack of comprehensive restructuring of the state sector.

The issue of agricultural protection is also an important one, as comparative advantage shifts against China in this area the tendency is to raise agricultural protection. On the surface, the attraction is that it appears to address rural poverty. However, as state trading of commodities will still be permitted, there are not expected to be significant changes in agricultural policy with WTO accession. However, China is expected to import more agricultural goods at least improving rural livelihood. The most recent dispute is over the U.S. attempts to impose agricultural tariffs beyond 2005.

Surviving but not immune to the Asian financial crises

Briefly on the Asian financial crises, as its immunity from the recent events has often been touted as one of the remarkable features of the Chinese path and has been interpreted to predict that China will continue to grow without reservation. I caution against such view, as China's ability to weather the crisis is likely to have more to do with the stage of its gradualist path.

I should note that it is difficult to fully understand the onset of financial crises, such as those witnessed by Mexico in 1994-95, Asia 1997-98, Russia in 1998, then the Brazilian and Ecuadorian crises 1999, and the Turkish and Argentinean crises of 2001-02. It is thought that large exchange rate changes coupled with significant domestic debt denominated in foreign currency resulted in the slump in output associated with these crises, which are also susceptible to contagion effects. I will speculate on the features of China's economic policy which in a sense guarded against these factors identified by third generation models.

In this framework, we start with the role of the IMF as a lender of last resort for countries experiencing liquidity crises. This creates a standard moral hazard problem. If the IMF will always bail out a country, then there will be an incentive for lenders to underestimate the risk of short-term lending. As capital markets are remarkably fluid and actors are sensitive to economic conditions, the collective behaviour of financial actors could have a destabilising effect on an economy. An example deriving from the third generation models built around the Asian financial crises is the role of domestic private liability. Domestic firms become highly leveraged with debt denominated in foreign currency when capital markets are liberalised. Firms in emerging markets do not always meet the accounting or transparency requirements of developed markets, but are able to obtain credit. It is argued that part of the assessment of the riskiness of lending capital to these firms involves an assessment of the firms' relationship with the government so that 'crony capitalism' suggests that these governments will not allow these firms to become bankrupt. In return, the IMF will not allow these economies to collapse. Thus, when debt levels become unsustainable for these firms, they begin to default but are not necessarily put into orderly bankruptcy proceedings. Foreign lenders react by calling in short-term loans. As some do so, others will similarly act. As vast amounts of capital flow out of a country, the exchange rate, trade and investment are all affected. As aggregate demand falls, the economies are in a downward spiral. As trade is integrated among nations in a region, there is a possible contagion effect (i.e., one nation's imports are another's exports).

In brief, for China, the lack of liberalization of trade and financial services may have insulated it from the destabilising effects in the region. In addition, the lack of privatisation, strict exchange rate controls, and limited credit available to enterprises all contributed to relative insulation. The gradualist path predicted this outcome to some extent. However, China has not been immune from the deflationary stance of the region or the global economy slowdown, and this is likely to become more characteristic as it becomes a more open economy. The need to open and liberalise may be both a boon and a bane.

The "hard" issues

The following is a summary of the structural problems of the Chinese economy that can impede the growth model. I have grouped them roughly as they relate to the major pillars of development.

Under privation, the issues include reform of SOEs, the high levels of growing and persistent unemployment, increasing corporate governance issues, and treatment of non-state enterprises. Related to financial liberalisation, the concerns are continuing reform of the banking sector, insurance and financial sectors, exchange rates, interest rates, and credit availability. To make trade liberalization feasible, there will need to be adoption of effective laws in accordance with international economic law to address growing trade relationships and new economic arrangements. Further issues remain relating to rural and now urban poverty as well as income inequality associated with China's comparative advantage shifting away from agriculture.

Therefore, the following are some of the remaining "hard" issues in the sequence pursued by China:

- Factor price reform, including labour markets, interest rates and prices of raw materials;
- Ownership reform of SOEs, including state-owned banks;
- Governmental reform, including reform of the fiscal system and use of monetary policy;
- Unemployment, surplus labour, immobility;
- Rural-urban migration, rural-urban income divide;
- Lack of social safety net, including health, pensions, housing, unemployment;
- Laws but poor implementation, incomplete legal system especially enforcement;
- Large amounts of non-performing loans (NPLs), credit constraints for SMEs;
- Environmental degradation; and
- AIDS incidence and possibly the challenge of containing the severe acute respiratory syndrome (SARS) if it affects productive capacity and export markets.

Given these "hard issues" arising from the three pillars of development, what is the assessment of the growth prospects of China?

Conclusion

The picture, though cautious, is optimistic. This section summarises some promising signs. Growth in real GDP in first quarter of 2003 was an impressive 9.9%, deflationary environment of East Asia notwithstanding. This exceeded expectations for the economy, but the SARS epidemic has caused the government to downgrade its growth target for 2003 from 9% to 7%. Unemployment has been recognised as the serious issue which it is; thus, starting this year statistics will be revised to take into account of workers who are not officially registered as unemployed but are not employed, such as laid-off or *xiagang* workers. The urban unemployment rate could be raised from 3.6% to 8-12%. This is a first step, although it remains to be seen as to whether sufficient measures will be taken to address the issue.

There are also significant amounts of household savings in China. Increasing consumer credit can stimulate aggregate demand in an economy with little household debt. Some 530,000 km of highway have been laid in the five years since 1998. Indeed, the government's fiscal stimulus policy package implemented for the fifth year running increased public investment in infrastructure, especially in interior regions.

On the law and finance side, NPLs held by asset management companies associated with the four main SOBs have been, on an experimental basis, sold to foreign JV funds with some hope for related corporate governance changes. A law passed this year will extend credit to SMEs and other private enterprises alleviating their credit constrained growth. Legal reforms are continuing rapidly, *e.g.,* the promulgation of a mergers and acquisitions law. Shareholder lawsuits and civil cases are increasing, indicating more development of the enforcement framework.[5] And, the resistance of full currency market liberalisation despite pressures from the international financial community will at least reduce the chances of a destabilising crisis.

Finally, accession to WTO has opened foreign markets to Chinese goods and to the possibility of technology transfers on a larger scale. It could prove to be the best remedy for resolving the "hard" issues in a gradualist reform path.

China's own estimates suggest that average per capita real GDP will be US$3,000 in 2020 at a sustained growth rate of 9% per annum. China would then attain the level of a medium level developed country. This prediction will depend critically on China's ability to resolve its hard, structural issues.

I conclude with some 'cautiously optimistic' summary thoughts. China has been a phenomenally successful economy in transition without a doubt. During the period 1990-1997, China's GDP growth rate was 11.6%, as compared with the average world rate of 2.4%. As a further basis of comparison, the United States – during what is widely acknowledged as a period of economic expansion – experienced GDP growth of 3.0%. China's GDP currently ranks it as the sixth largest economy in the world. Perhaps most importantly, in stark contrast to the standard of living achieved under the planned economy, this growth is correlated with an improvement in the standard of living for the Chinese people. Whether it is sustainable has been our query.

Given the 'easy to hard' sequence that characterises China's reform strategy, there are many challenges which lie ahead. The coincidence of the "hard" issues with an opening of the economy to global trade brilliantly provides possible ways to grow within the constraints of a partial reform strategy. However, opening brings about a set of new concerns, not limited to instability and crises. The challenges of China's continued development will test the ultimate success of a "gradualist" reform strategy in an economy increasingly open to global factors.

[5] However, a recent survey revealed the minimal legal training possessed by the 200,000 judges in China and the general lack of clinical legal education.

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