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CT (China) maintains offices in Hong Kong and Beijing; it is represented by an affiliate in Shanghai. The firm's core areas of specialisation are economic forecasting, foreign direct investment, agriculture and construction (including construction aspects of infrastructure and transportation) and political analysis.

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- *Infrastructure Newsletter* (Monthly)
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About the Centre for Economic Analysis and Forecasting at the Chinese Academy of Social Sciences

The Centre for Economic Analysis and Forecasting (CEAF) is a branch of the Chinese Academy of Social Sciences (CASS) founded in 1995. Most of CEAF's staff are concurrently researchers at CASS's Institute of Quantitative & Technical Economics (IQTE), which was China's first post-1979 research institute to engage in econometric forecasting and analysis.

IQTE began to develop econometric models for China in the early 1980s, in cooperation with Pennsylvania University and Stanford University in the United States and Oxford University in the United Kingdom.

Since 1990, CEAF and IQTE have been receiving funding for ongoing analysis and econometric forecasting work from the State Council. The World Bank, the United Nations Development Programme (UNDP), the Ford Foundation and other international institutions also support the agencies' work. CEAF and IQTE are the recognised authorities in economic forecasting in China.

Contents

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Fourth quarter 1997 review; forecasts for first and second quarters, 1998

Review and forecast highlights

- GDP growth remained depressed at 8.2% in Q4. The outlook is for similar growth in Q1 and Q2.

- Fixed asset investment rose only 8.5% in Q4, much the lowest quarterly return of 1997. The outlook is for investment to stay around this level in Q1 and Q2.

- For the first time since economic reform began, the retail price index fell in Q4, reinforcing fears about deflation.

- The central government decided to reintroduce VAT- and duty-free capital goods imports for foreign investors to sustain investment flows. Other measures to encourage new growth are expected.

- Export growth dropped from 20% in Q3 to 11% in Q4. Growth is forecast to hold up at around 9% and 7% in Q1 and Q2 respectively. Imports will rise more quickly than exports.

- Unemployment and poverty are on the increase.

Sectoral highlights

- Government determination to shake out old state industries will see 600,000 workers laid off in the textile sector.

- There is much talk, but no detail, of plans to boost growth through additional infrastructure spending. The government is expected to step up efforts to commercialise the housing market.

Notes to table of major economic indices

Special note: As of this quarter, we have discontinued two data sub-series, relating to fixed asset investment and bank lending. This is because the series are not published on a regular basis and because of qualitative concerns about their accuracy. In future, only total fixed asset investment and its real growth rate will be included in the investment series, while only total loans and their growth rate will be included in the loans series.

Units: Renminbi, billion, except for imports, exports and trade balance which are dollars, billion. Growth rates are expressed as percentages.

GDP sub-indices: Forecasts for the real growth rate of value-added of industry are modelled on quarterly data released by the SSB. Forecasts for agriculture are based on more patchy quarterly data. Those for post, telecommunications and transport; construction; and commerce are mainly implied from annual data and must therefore be treated more cautiously.

Major economic indices

Figures for 1997 are actual; those for Q1 and Q2 1998 are forecasts. All figures in billions and %.

Economic indicators	1997.1	1997.2	1997.3	1997.4	1998.1F	1998.2F
GDP	1469	1850	1797	2411	1570	1971
Real growth rate of GDP	9.4	9.6	8.1	8.2	8.1	8.0
Real growth rate of value added of agriculture	5.0	5.0	1.5	2.9	3.8	4.0
Real growth rate of value added of industry	10.8	11.9	10.3	11.2	9.5	10.5
Real growth rate of value added of post, telecomms and transport	9.7	10.5	10.1	8.6	9.6	10.0
Real growth rate of value added of construction industry	7.0	7.3	9.2	7.1	7.4	7.0
Real growth rate of value added of commerce	9.4	9.2	9.1	7.5	7.0	6.8
Total fixed asset investment	262	620	546	1220	283	665
Real growth rate of total fixed asset investment	9.8	9.6	10.5	8.5	9.0	8.8
M0	928	912	943	990	1064	1047
Real growth rate of M0	10.7	17.4	11.1	12.5	14.7	14.8
M1	2906	3107	3224	3339	3247	3666
Real growth rate of M1	18.5	24.5	16.3	15.4	18.5	18.0
M2	7989	8279	8589	9098	9354	9728
Real growth rate of M2	19.0	19.8	16.1	16.0	17.1	17.5
Total loans	5091	5209	5558	5736	5804	5990
Growth rate of total loans	21.3	20.8	21.2	18.1	13.0	14.0
Total deposits	7228	7543	7832	8240	8710	9014
Growth rate of total deposits	23.1	20.7	19.4	19.3	19.5	18.4
Individual deposits	4158	4275	4414	4630	4948	5002
Growth rate of individual deposits	19.7	18.4	17.1	18.8	18.0	16.0
Gross tax revenue	165	211	212	308	203	263
Growth rate of gross tax revenue	26	18.5	19.5	19.8	22.4	23.5
Tariff revenue	7.1	7.9	10.9	9.5	8.0	7.4
Growth rate of tariff revenue	-6.5	-4.8	6.0	21	11.6	-7.5
Retail sales of consumer goods	663	637	638	804	726	696
Real growth rate of retail sales of consumer goods	12.6	9.9	7.5	11.1	10.5	10.8
Real growth of retail price index	2.6	1.4	0.8	-0.8	1.0	1.1
Exports (US$)	35.5	45.3	48.1	52.3	38.6	48.4
Nominal growth of exports	25.7	26.5	20.0	11.0	8.7	7.0
Imports (US$)	28.8	34.2	35.4	41.6	31.8	42.5
Nominal growth of imports	-2.1	1.2	8.3	-2.8	10.6	24
Trade balance (US$)	6.7	11.1	12.7	10.7	6.8	5.9
Exchange rate. Yuan/$	8.28	8.24	8.24	8.26	8.29	8.29
Real one-year deposit interest rate	4.85	6.05	6.94	6.56	4.76	4.66

Sources: SSB historical data. CEAF forecasts

Foreword

Underlying growth in Q4 was less than 8%.

GDP growth of 8.2% in Q4 was, to say the least, disappointing. If the seasonality factors affecting China's quarterly data are taken into account, underlying growth in Q4 was less than 8%.

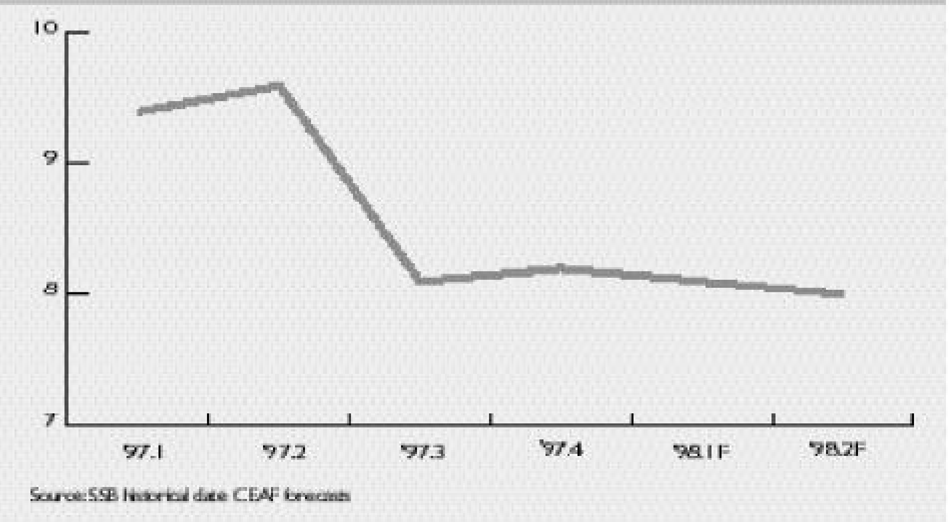
There was no single reason for the poor performance (see below), more a confluence of negative factors. There were the immediate, short-term effects of the Asian financial crisis, at this point more psychological than tangible. Reticence among investors combined with a more thrifty outlook in the banking sector, which failed to lend up to its annual credit quota (albeit by only a small margin). At the same time, the period between the 15th Party Congress in September and the confirmation of a new government at the March meeting of the National People's Congress is a fallow time for bureaucratic decision making. Short-term uncertainties caused by personnel changes at many levels of government discourage initiative.

Leaders have to agree upon and pursue new focuses of consumption.

After March, Chinese leaders will have to agree upon and pursue new focuses of consumption for the domestic economy. Low-cost housing has been held up as a non-contraversial option, yet there will be many losers if China commercialises its housing market. Recently, there has been talk of increased infrastructure spending, but with almost no detail available. It is unclear, for instance, if there might be positive implications for recently sidelined sectors such as automotive manufacturing.

Whatever the new government decides, it cannot avoid the issue of unemployment. Ten million urban state workers had been laid off by the end of 1997, and more will follow in 1998. The biggest story this year could be the unemployment one.

Figure 1. Real GDP growth, 1997 Q1 to Q4 actual; 1998 Q1 and Q2 forecasts



I. Fourth quarter review

The main themes of the fourth quarter were as follows:

I.i A slowdown in fixed asset investment growth.

The fourth quarter is traditionally (because of seasonality factors) the peak period for fixed asset investment growth. In Q4 1997, however, investment in fixed assets rose a sluggish 8.5%, exerting a powerful drag on overall growth.

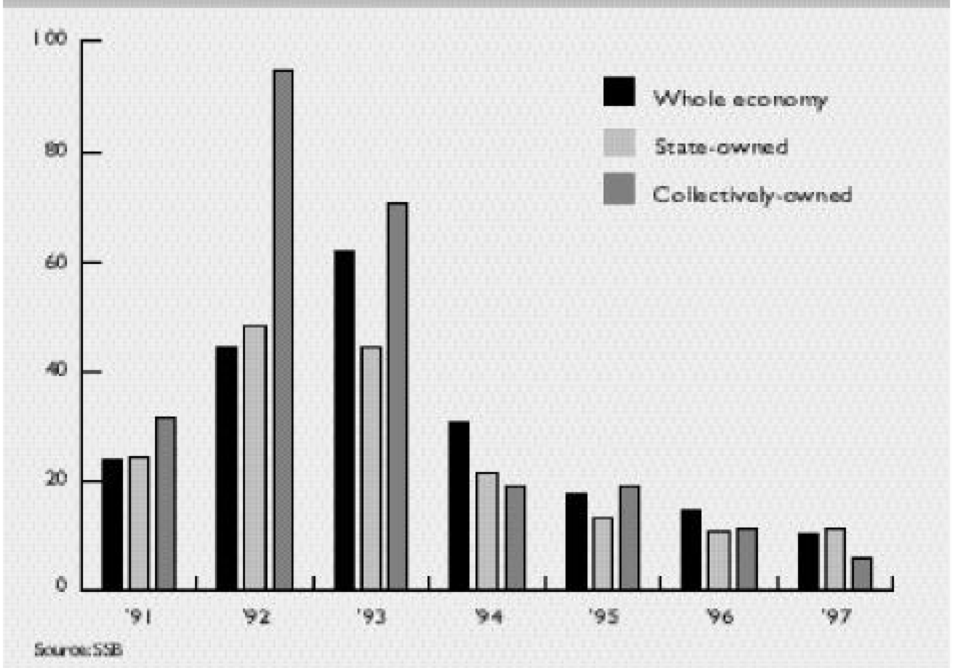
Investment in fixed assets rose a sluggish 8.5%.

On an ownership basis, fixed asset investment in the state sector posted growth of 12.5%, in line with expectations and well ahead of the average 8.5% for the whole economy. The decline in the overall rate of investment was therefore due to sharp reductions in the collective and private sectors.

New investment has been the engine of China's rapid development since the 1980s, and investment growth in the collectively-owned sector has been particularly dynamic. However, whereas in the past collective sector fixed asset investment growth almost always outstripped that of the overall economy by a wide margin, the opposite was true in 1997 (see Figure 2). Last year, fixed asset investment in the collective sector grew just 5.8%, way below the 11.3% posted by the state sector and the 10.1% average for the whole economy. Drastic declines in growth of fixed asset investment and industrial output in the collective sector indicate that a major shake-out of this part of the economy is continuing (refer to the special subject of CEQ Vol.1, Issue 3, for a full discussion). As long as the collective sector remains in the doldrums, the whole country will feel the effects in terms of both lower economic growth and higher unemployment.

Last year, fixed asset investment in the collective sector grew just 5.8%.

Figure 2. Fixed asset investment growth by ownership sector, 1991 to 1997



In terms of investment sectors, one of the biggest losers from a slowdown in fixed asset invesment in Q4 was the construction industry. Investment in realestate rose only 7.1% compared with the same period in 1996, 3% less than had been expected.

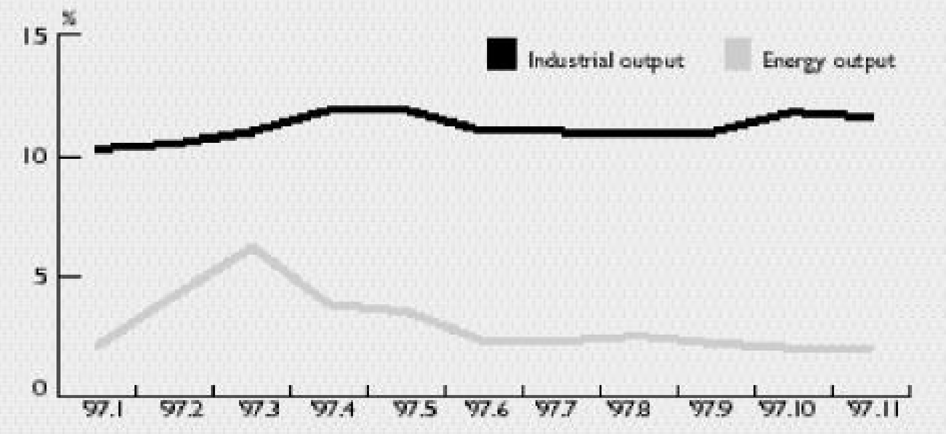
I.ii Industrial output rose faster, but the outlook is mixed

Government claimed that state sector industrial efficiency improved.

The government claimed that state sector industrial efficiency continued to improve as a result of restructuring efforts. From January to November, the offical "general economic efficiency index", which covers 370,000 state enterprises with independent accounts, rose to 89.4, 3.4% higher than the same period in 1996.

There was a rise in the growth rate of industrial output in Q4 versus Q3, but at the same time production of some raw materials and roughly half of all capital goods fell. Energy production (power, coal, oil, gas) did not increase in line with the reported growth of industrial output (see Figure 3). Indeed the gap between reported increases in industrial output versus energy output in 1997 raises many questions. The country appears to have become markedly more efficient in its energy use, something not entirely incredible given stiff price rises and past levels of waste.

Figure 3. Monthly year-on-year increases in industrial output versus energy output, 1997



Source: SSB

Energy production in the second half of 1997 slowed.

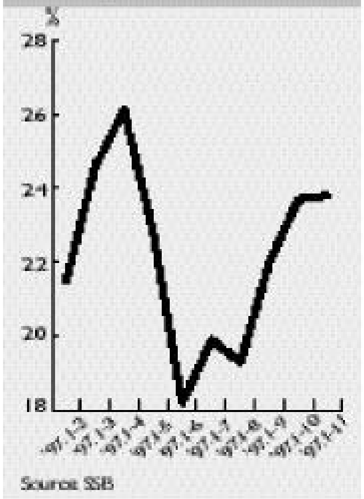
While growth in reported energy production in the second half of 1997 slowed, fixed asset investment in the energy sector remained strong, rising in Q4 (see Figure 4). For the whole of 1997, fixed asset investment in energy projects accounted for 21.9% of total fixed asset investment, up from 17.3% in 1996.

I.iii Retail prices fell, helped by a good harvest and industrial oversupply

The retail price index (RPI) fell in Q4, something unseen in China's reform period. The RPI fell 0.8% compared with the same quarter in 1996. The consumer price index, (CPI), which includes prices for services such as utilities, rose 1.3%.

Despite a reduced autumn grain harvest, caused by widespread drought, a bumper summer harvest enabled total annual grain production to reach 492.5 million tons. This was only 2.3% less than the record harvest of 1996 and helped push open market prices for grain down by around 15% in the course of 1997; state grain reserves are at record levels. There is no prospect of significant near-term rises in grain prices, while foodstuffs make up around half the value of the basket of goods on which China's RPI is based.

Figure 4. Year-on-year increases in fixed asset investment in the energy sector, 1997



Fierce competiton continued in Q4 in many industrial sectors, not least consumer goods. Factory gate prices of electronic home appliances, for instance, dropped 5% in the period. Many sectors can expect to come under additional pressure from lower cost imports, as reduced tariff rates take effect. The most significant price rises in Q4 occurred in services, accounting for a spread of more than 2% between the RPI and the CPI.

I.iv Retail sales hold up, income and bank deposit growth slow

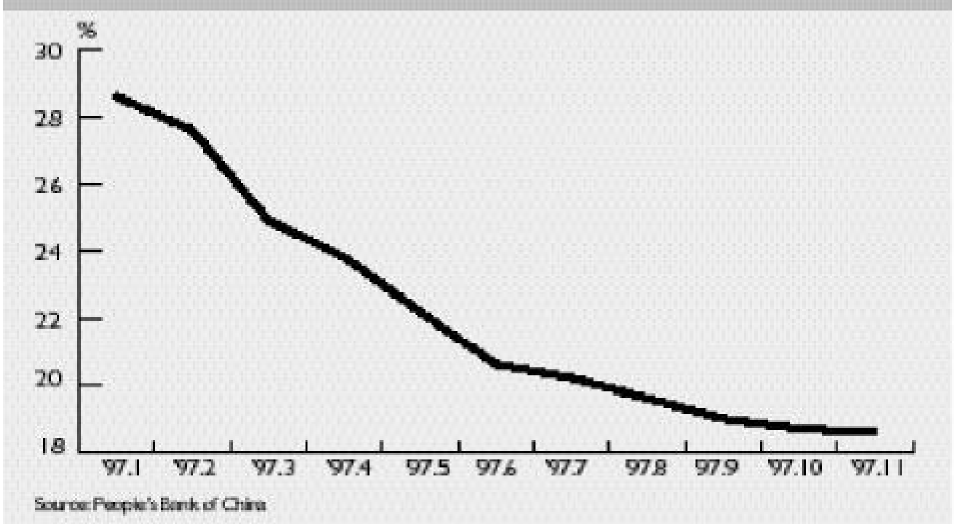
Retail sales remained relatively robust in Q4, rising an estimated 10.5%, or O.5% and 3% faster than in Q2 and Q3 respectively. Retail sales growth outpaced both the overall economy and fixed asset investment growth.

At the same time, evidence continued to mount of stagnating, or declining, incomes. In October and November the state banks reported that they paid out 3.8% and 4.3% less in worker salary payments than in the same months in 1996. These figures may be quite a good indicator of state sector income trends because of the manner in which urban workers are paid in China; this often involves them taking a so-called *shua ka* (swipe card) to a state bank each month to register their salary in their individual accounts. As a result, banks have a good idea how much money they are paying out in the form of worker salaries.

The growth of individual savings deposits continued to slow in Q4, as it has all year. The slowdown, however, has been less pronounced in the second half of the year than in the first (see Figure 5).

Growth of individual savings deposits continued to slow.

Figure 5. Monthly year-on-year increases in individual savings deposits, 1997

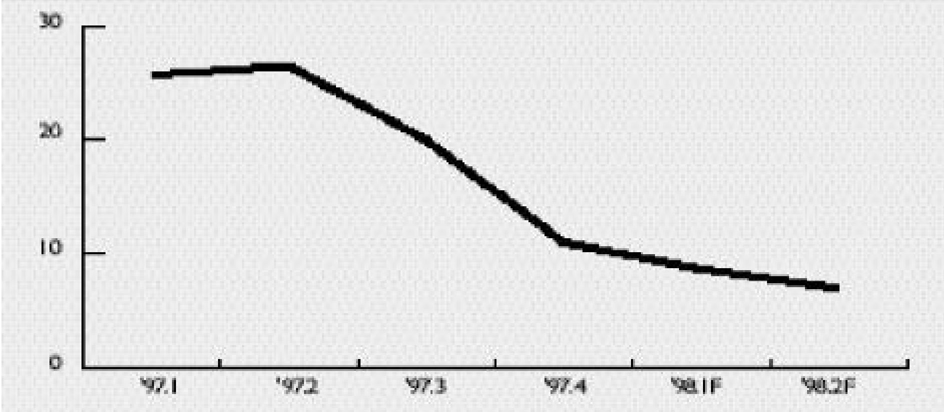


I.v Foreign trade

Tariff cuts had no effect on Q4 imports.

Despite significant tariff cuts which took effect in October, there was no apparent effect on Q4 imports, which fell 2.8% compared with the same period in 1996. However, there was some evidence that depreciation of other Asian currencies relative to the renminbi began to take its toll on exports. In Q4, the value of nominal exports rose only 11%, 13% less than the January to September average (see Figure 6).

Figure 6. Nominal export growth, 1997 Q1 to Q4, actual; and 1998 Q1 and Q2 forecasts

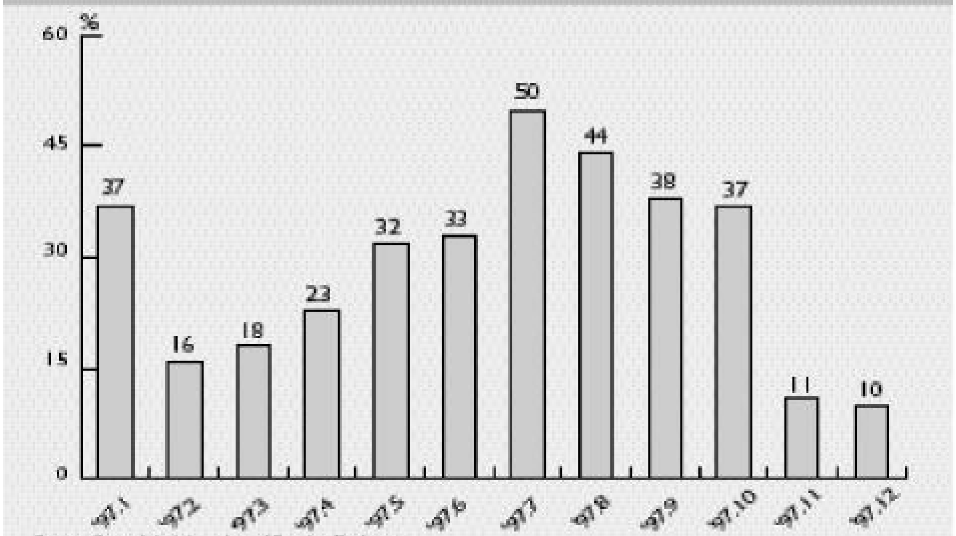


Source: SSB Historical data. CEAF forecasts

Government gave domestic trading firms permission to retain 15% of foreign exchange earnings.

In October, the government gave large domestic trading firms permission to retain 15% of the foreign exchange they earn from exports, one means to ease appreciation pressure on the renminbi. These large trading companies now hold an estimated US$2 billion outside the state foreign exchange control system. China's foreign exchange reserves increased by an average of more than US$9 billion in each of the first three quarters of 1997, but by only US$5.8 billion in Q4 (see Figure 7). China also contributed US$2.5 billion in foreign exchange to loan packages to south-east Asia.

Figure 7. Monthly year-on-year increase in China's foreign exchange reserves.



Source: State Administration of Foreign Exchange

II. Policy adjustments, causes for concern

II.i October interest rate cuts

Banks were more and more reluctant to provide loans to loss-making enterprises.

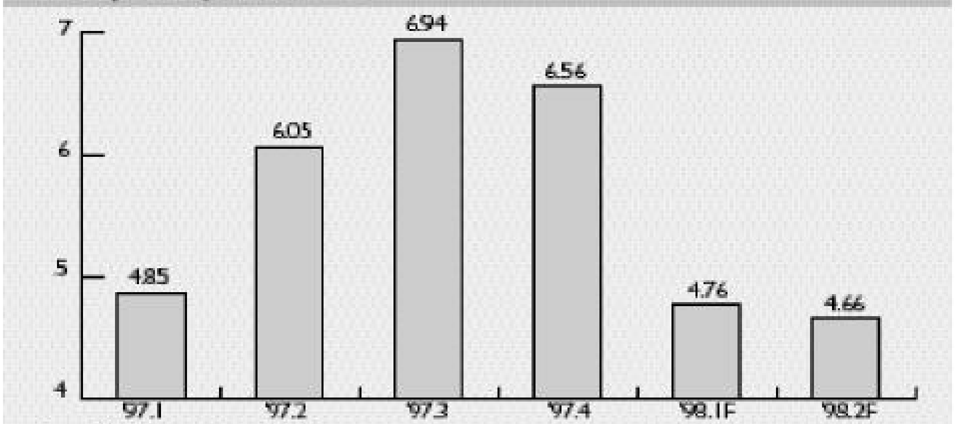
Against a backdrop of very low inflation, real interest rates continued to rise in the first three quarters of 1997. By October, the real interest rate on a one-year term deposit reached 7.8%, high by international standards. At the same time, tight monetary policy and pressure on state banks to commercialise their lending made the banks more and more reluctant to provide loans to loss-making enterprises. China's banks left a small portion of their 1997 lending quota unused.

These developments have been hard on state enterprises, which are the main users of bank credit. On October 23, the People's Bank of China moved to cut nominal interest rates for the third time since the beginning of 1996. The October cuts were quite hefty, reducing one-year deposit and lending rates by 1.1% and 1.5% respectively. However, given negative retail price inflation in Q4, the real one-year deposit rate still stood at more than 6% in November. There was no significant reduction in the the growth rate of savings deposits immediately following the cuts.

The outlook is for a further reduction in real interest rates.

The cut in lending rates reduced the annual interest burden of state enterprises by an estimated Rmb70 billion (US$8.4bn). The outlook is for a further reduction in real interest rates as inflation picks up a little in Q1 and Q2 (see Figure 8). The central bank has said another cut in nominal rates is not on its agenda at present, but the possibility cannot be discounted as the year progresses.

Figure 8. Real interest rate on one-year term desposits, 1997 Q1 to Q4; and 1998 Q1 and Q2 forecasts. %



Source: PBOC historical data, CEAF forecasts

II.ii Lending liberalisation

The central bank will no longer set an annual credit ceiling.

From January 1, the central bank said it would no longer set an annual credit ceiling for the state commercial banks. Instead the PBOC will issue lending "guidelines" or advice, on an annual and sub-annual basis, and encourage the banks to operate according to their own commerical lending plans.

The reform is an important step in China's efforts to commercialise its dominant state banks. The PBOC's independence is also being developed as it finds its own ways to meet national economic targets. The central bank's discretion in setting interest rate policy, conducting open market operations, re-lending and rediscounting to control money supply indirectly, and deciding banks' reserve requirements, is growing.

For the present, however, government policy will remain an influence on the lending parameters of the big four state banks. In January, central bank governor Dai Xianglong said targets had been set for around 10% of new credit in 1998 to go to agricultural projects, and a similar amount to residential realestate projects, particular ones of a low-cost nature. Mr Dai said the central bank has raised by a signifiant, but unspecified, margin the volume of lending that the state banks may target at foreign-invested enterprises.

II.iii Unemployment outlook bleak

Registered urban unemployment reached 4.2%.

According to a recent survey, China's registered urban unemployment rate reached 4.2% by the end of 1997, 1% higher than at the end of 1996. Meanwhile an increasing number of workers, estimated at 12 million or 7% of the urban workforce, are reckoned to be without work despite not being officially registered as unemployed. The unemployment rate is rising, with government workers and elementary school teachers among the latest waves of retrenchment, and the employment issue may be the toughest one the government faces this year.

High unemployment is particularly worrisome because China has no established social security system. At the same time, lay-offs are far from temporary because most of them result from structural problems in the economy. Government sponsored efforts at job creation are likely to become a policy theme of 1998.

III. Macro forecasts for Q1 and Q2, 1998

III.i GDP growth in line with Q3, Q4

We forecast GDP growth of 8.1% and 8.0% in Q1 and Q2.

We forecast GDP growth of 8.1% and 8.0% in Q1 and Q2 respectively. The slightly higher forecast for Q1 reflects seasonality factors. If Q1 comes in under 8.1%, look for the traditionally lower-growth Q2 to more than follow suit.

Although there is much talk of economic stimulus packages, it is unlikely that any major decision in this direction will be implemented before the National People's Congress meets to select a new government in March. Even if there is an effort to boost growth before March, it is unlikely to have a significant effect on overall growth in the first half of the year.

III.ii Minimal inflation

The retail price index will rise a modest 1% in each of the first two quarters. A sucession of good harvests has left China with abundant grain reserves. At the same time many industrial sectors are in a state of oversupply and capacity under-utilisation. Price competition in the consumer market is still intensifying. In short, there is little inflationary pressure on the horizon.

III.iii Fixed asset investment sluggish

The Chinese economy is still in a period of restructuring. Both investors and banks are increasingly risk averse. Against this backdrop, investment growth will be slow. We predict that in the first two quarters total fixed asset investment will rise 9% and 8.8% respectively.

Investors and banks are increasingly risk-averse.

Later in the year, the central government will make efforts to stimulate domestic demand to compensate for lower export demand. The government's focus will be infrastructure projects of a labour-intensive and non import-dependant nature. Irrigation works, urban and transnational transportation, low cost housing and environmental protection will see increased investment levels. The influence on growth and employment will be more noticeable in the second half of the year than the first.

III.iv Consumption flat

Slower income growth in 1997 does not bode well for consumption growth in 1998. We forecast retail sales to remain flat in the first half of the year, rising around 10.5%. Nonetheless, this will still be higher than either GDP or investment growth.

After years of experiments and false starts, it is just possible housing commercialisation will witness a breakthrough this year. A stock of 70 million square metres of unsold commercial housing has forced down realestate prices to more affordable levels. The government, however, still has to do more to end subsidised state housing and raise state rents in order to create a mass urban residential property market. Private housing loans in 1998 are forecast to reach Rmb100 billion (US$12bn); the outstanding stock of housing loans at the start of the year was around Rmb300 billion.

It is just possible housing commercialisation will witness a breakthrough this year.

Coastal provincial governments will continue to set the pace in housing reform. Shandong province has already ended the allocation of free flats to workers. Shanghai has issued laws allowing workers to buy and sell their apartments on the open market and operates by far the biggest municipal housing fund.

III.v Export growth in single digits only

The government's commitment to maintain the value of the renminbi is good for at least the first half of the year. As a result, the effects of devaluations in other, competing economies in Asia will start to show up. We forecast export growth to fall to 8.7% in Q1 and 7.0% in Q2. This will exert a significant downward pull on overall growth; in 1997, exports accounted for around 20% of GDP and as much as 3% of GDP growth.

Export growth will fall to 8.7% in Q1 and 7.0% in Q2.

If exports perform less well than forecast, we expect the government to look to stimulate new export growth through increased tax rebates. However, this will not be necessary if additional foreign-invested export capacity (funded by last year's record US$45 billion FDI inflow) can sufficiently offset the competition from cheaper Asian currencies.

III.vi Imports will rise quickly; FDI outlook unsure

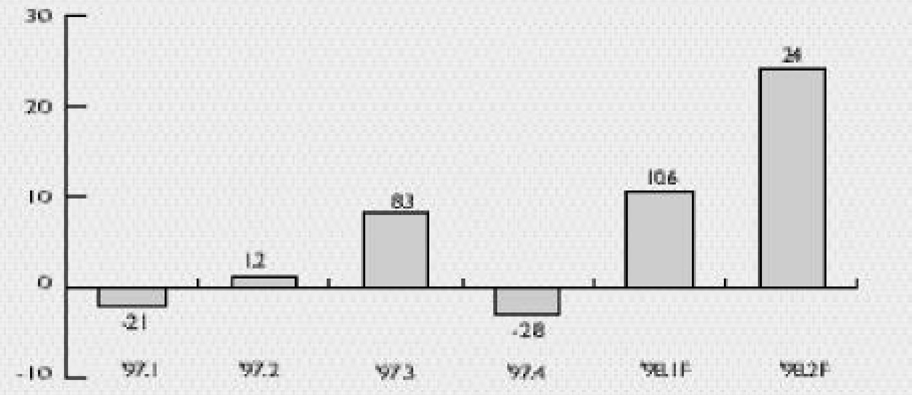
It will be much more difficult for China to attract FDI in 1998.

Asian currency movements and broader economic woes make it much more difficult for China to attract FDI in 1998. Fortunately, the government reacted in January by reestablishing duty and VAT-free treatment for capital equipment imports for many foreign investment projects. It is likely that new areas of the economy will be opened to FDI in the course of the year.

The outlook for foreign investment, however, is still uncertain. Asia, hit by economic crisis, has been the main provider of FDI throughout China's reform period.

Imports are expected to rise strongly in the first half of the year, fuelled by both tariff reductions and the resumption of the duty-free policy for FDI. The limitation on import growth, however, is sluggish domestic demand. We forecast that imports will rise 11% in Q1 and 24% in Q2, rebounding from negative growth in the first half of 1996.

Figure 9: Nominal import growth, 1997 Q1 to Q4 actual; and 1998 Q1 and Q2 forecasts %



Source: SSB Historical data: CEAF forecasts

IV. Sectoral outlook

The textile sector is the latest to be targeted for radical surgery.

The government will maintain its emphasis on the restructuring of traditional manufacturing industries. The textile sector is the latest to be targeted for a taste of radical surgery; its losses have become intolerable in recent years.

This year, government will offer subsidies and loans to state-controlled textile mills which cut spindles, reduce output and lay off workers. State banks have been told that government reserves designed to ease the process of bankruptcy should be targeted at textile businesses. At the same time, stronger textile companies will be eligible for tax rebates. The government's target is to cut 4.8 million spindles by the end of 1998, and reduce losses in the textile sector by Rmb3 billion (US$361m). Some 600,000 textile workers will need to find new employment.

2

Special subject: China's debts

The Asian financial crisis of 1997 has focused attention on China's debt position. This special subject aims to present information on China's debts in as clear a manner as possible, providing both analysis and an ongoing source of reference.

China is not a heavily indebted country. However, its debts are rising as it struggles to reform the state sector and to modernise. Prudent management of the country's external and domestic debts is essential, a fact made plain by the Asian financial crisis. This special subject addresses the full range of debt-related issues in the following three sections:

I External debt

II Domestic debt

III Unregistered liabilities

I. External debt: definitions, risk profiles, Asian comparisons

The author, Dr Yang Siqun, is an assistant research fellow at the Institute of Finance and Trade Economics at the Chinese Academy of Social Sciences

I.i Definitions of external debt

The Chinese government's definition is not the same as the international norm.

The first thing to understand about China's external debt is that the Chinese government's definition of this term is not quite the same as the international norm.

The most widely used definition of external debt* is "at any specific time the amount of paid but not yet paid off contractual debt owed by the resident of any country to a non-resident, where either the principal and interest have to be repaid (no matter whether the interest has to be paid) or the interest has to be paid (no matter whether the principal has to be repaid)".

China's current definition is slightly different. According to the *Temporary regulations on statistics and supervision over external debts*, published by the State Administration of Foreign Exchange (SAFE), external debt is: "all the debts repayable contractually to any international financial organisations, foreign governments, financial entities, enterprises or any other organisations by any departments, entities, enterprises, non profit-making organisations, financial organisations and other organisations within the territory of China in the form of foreign currencies".

The government makes its own distinctions about who is and is not "within the territory of China".

There are two obvious points of difference. The first is that the Chinese definition stiplulates the type of currency involved. Renminbi debt cannot be external debt on the grounds that the renminbi is not freely convertible. Second, and more important, the Chinese government makes its own distinctions about who is and is not "within the territory of China". This is an issue of what the international standards call "residency".

The most important effect of China's interpretation is that the foreign currency borrowings of Chinese banks, non-bank financial institutions (NBFIs) and companies incorporated overseas (including in Hong Kong) are not counted in the national external debt numbers. Despite the fact that these entities have their own legal personas and limited liabilities, the standards used by the Swiss-based Bank for International Settlements (BIS) do include their borrowings in the national total.

A second example of how the Chinese interpretation of residency plays out concerns foreign-invested banks. SAFE regulations stipulate that "foreign exchange funds borrowed from foreign-invested banks or Sino-foreign joint venture banks registered in China **shall be** defined as external debt while those borrowed by foreign-invested banks or Sino-foreign joint venture banks registered in China from a foreign country **shall not be** defined as external

* World Bank, International Monetary Fund, Bank for International Settlements and the Organisation for Economic Cooperation and Development external debt definition.

debt". In other words, foreign currency borrowed from foreign-invested banks in China is counted as external debt but the overseas borrowings of those foreign-invested banks themselves (usually from affiliates, to finance their in-China operations) are not.

The differing international and Chinese definitions have a significant effect on estimates of short-term, but not long-term, debt (see box). In general, the overall result is that the figure for total external debt published by the Chinese government is slightly lower than that published by international financial organisations like the World Bank. For example, in 1994 the Chinese government gave outstanding external debt as US$92.8 billion whereas the World Bank put it at US$100.5 billion. In tables 1, 2 and 4 below, figures are based on the Chinese definition of external debt. Table 3 uses World Bank figures.

The differing definitions have a significant effect on estimates of short-term, but not long-term, debt.

Short-term debt: one indicator, two numbers

Past figures for short-term (maturity less than nine months) debt published by the State Administration of Foreign Exchange (SAFE) have differed significantly from those published by the Bank for International Settlements (BIS). For example, the last BIS number, for the end of 1996, put China's short-term debt at US$25.4 billion. The latest SAFE number, for the end of June, 1997, puts short-term debt at US$13.66 billion.

However, in 1997 China became a member of the BIS and agreed to adopt its accounting standards. This should mean that in future, when monitoring agencies speak about China's short-term debt, they speak with one voice.

I.ii External debt and foreign direct investment

A second point to be grasped in China is that it is helpful to discuss external debt in tandem with the country's rapidly rising level of foreign direct investment (FDI).

FDI is not a form of external debt because it does not require the repayment of principal and interest over a stated period. However, FDI does aim to generate future profits, some of which will have to be remitted abroad, thereby generating demand for foreign currency. Since China has pulled in so much FDI in recent years the issue of future foreign exchange demand for profit remittances is an important one.

FDI implies future demand for foreign currency.

In the 1980s, when China began to look to foreign capital to help fund its development needs, most money was secured as foreign loans. The ratio of loans (external debt) to FDI was between half and three-quarters in every year from 1984 to 1991 (see table 1).

But as China's investment gold rush took off in 1992, the proportion of FDI in total foreign capital inflows rose to between 70% and 80%. FDI, which implies a future demand for foreign exchange to cover profit remittances, greatly eased China's short-term need for external debt.

There is no proven way to estimate future demand for foreign exchange for profit remittances.

There is no proven way to estimate future demand for foreign exchange for profit remittances. However, SAFE takes the issue seriously and for several years has endeavoured to use sample surveys of profitability in foreign-invested enterprises (FIEs) to estimate future forex demand. At present, most profits from FIEs are reinvested, but this will not always be the case.

There are no hard numbers for FIE profits. SAFE does not publish its estimates. One international financial institution which is required to produce a "guesstimate" came up with US$11.68 billion for 1996 and US$7.12 billion for the first half of 1997. However, these figures seem to imply a far higher return on the roughly US$200 billion of utilised foreign direct investment in China than anecdotal evidence would suggest. SAFE set up its own, national computer network to register and aggregate overseas profit remittances in 1997, but it is unlikely to be fully on line before the end of 1998. The first hard numbers on profit remittances, if they are published, will appear some time after that.

Table 1: Structure of utilised foreign capital inflows, 1984 to 1996. Billion US dollars and %

Year	External loans	Foreign direct investment	External debt as a % of foreign capital inflow	FDI as % of foreign inflow
1984	1.286	1.258	50.6	49.4
1985	2.688	1.661	61.8	38.2
1986	5.014	1.874	72.8	27.2
1987	5.805	2.314	71.5	28.5
1988	6.487	3.194	67	33.0
1989	6.286	3.392	65.0	35
1990	6.534	3.487	65.2	34.8
1991	6.888	4.366	61.2	38.8
1992	7.911	11.007	41.8	58.2
1993	11.189	27.515	28.9	71.1
1994	9.267	33.767	21.5	78.5
1995	10.327	37.521	21.6	78.4
1996	12.669	41.726	23.3	76.7

Source: China Statistical Yearbook

I.iii China's external debt according to traditional risk profiles

There are three traditional evaluation criteria for external debt.

There are three traditional evaluation criteria for external debt: debt-service ratio, debt ratio and debt rate. All can be applied to China.

- **Debt-service ratio** is the ratio of the amount of principal and interest repaid in a year versus the year's foreign currency proceeds from exports; it is a measure of external debt against export performance. A ratio of less than 20% is normally deemed safe and one of more than 30% unsafe. Rates between 20% and 30% qualify for "watchlist" observation, although a rate of 25% is reckoned acceptable for a developing country.

- **Debt ratio** is the ratio between a country's outstanding external debt and its foreign currency income from trade and non-trade activity; it is a measure of external debt versus total current income. International standards set 100% or less as safe, 150% as watchlist status and over 200% as excessive.

- **Debt rate** refers to the rate of external debt versus Gross National Product (GNP); it is a measure of external debt against the overall scale of the economy.

Table 2 shows these three risk indicators for China each year from 1985 to 1996. The country's debt-service ratio only once exceeded 20%, in 1986, and since 1988 has been at very modest levels of under 10%. This reflects both reasonable levels of absolute debt as well as China's rapid export growth.

The country's debt-service ratio only once exceeded 20%, in 1986.

China's debt ratio also has consistently been below the minimum safety line (100%), helped by both strong export performance and only small outflows of foreign exchange on the non-trade account (in other words, a small international services deficit).

Since 1990, China's debt rate has hovered around the most conservative safety line of 15%. The fact that the indicator is the only one close to any internationally accepted safety line in part reflects the fact that the scale of China's overall economy (as measured by GNP) is not quite as formidable as its export economy.

Table 2: Traditional risk indicators, Chinese external debt, 1985-1996. %

Year	Debt-service ratio	Debt ratio	Debt rate
1985	2.8	53.4	5.6
1986	20.3	70.0	7.8
1987	12.7	75.2	9.4
1988	6.3	84.4	10.0
1989	8.0	83.1	11.5
1990	8.5	87.0	14.8
1991	8.0	87.0	15.0
1992	7.3	90.7	14.1
1993	9.7	94.5	14.0
1994	9.1	77.8	17.0
1995	7.3	69.9	15.5
1996	6.7	75.6	14.3

Source: China Statistical Yearbook

I.iv Limits of traditional risk profiles

Table 3 shows the debt-service ratios, debt ratios and debt rates of China and selected south-east Asian and south Asian countries in 1995, in the run-up to the Asian financial crisis. The table also includes a fourth indicator, debt-service liability, which measures the ratio of due principal and interest to GNP in a given year; 5% is the most-quoted safety limit.

The table highlights two slightly contradictory points. The first is that every country which suffered a financial meltdown in 1997 had one or two external debt indicators above international safety lines in 1995. The debt-service ratio of Indonesia exceeded the 30% "critical" line. The debt ratio of both

Every country which suffered a meltdown in 1997 had one or two indicators above international safety lines in 1995.

Indonesia and the Philippines exceeded the 100% safety line. And the debt rates of Indonesia, Malaysia, the Philippines and Thailand were all above, some massively above, the 30% safety line. These warning signs are one reason why international banks, economists and lending agencies have been criticised for not predicting Asia's financial crisis.

Thailand had one of the better risk profiles in the region in 1995.

However, table 3 shows the weaknesses as well as the strengths of traditional risk indicators. Thailand, for example, had one of the better risk profiles in the region in 1995. The country's debt-service ratio, debt-liability ratio and debt ratio were all well below accepted safety norms; only the debt rate was slightly above the more liberal 30% safety limit. Yet it was in Thailand that Asia's economic crisis began.

Malaysia's external debt profile looked similar to Thailand's in 1995. In India, by contrast, two indicators - the debt-service ratio and the debt ratio - both gave cause for concern. In Pakistan, every single indicator was above international safety limits. The point is that traditional risk indicators are not the only guide to the possibility of financial crisis. Every country has a different economy and a different exposure to international capital flows, depending on levels of foreign exchange control, import regulation, foreign direct investment, profit remittances and so on. In short, one set of risk indicators does not work for everybody, as the world now knows.

Table 3: Traditional risk indicators in 1995, China versus selected south-east and south Asian countries. %

	China	Indonesia	Malaysia	the Philippines	Thailand	India	Pakistan
Debt ratio (%)	70.6	194.2	33.6	113.5	77.6	159.6	223.8
Debt rate (%)	16.4	54.5	38.6	49.4	35.3	22.6	38.4
Debt-service ratio (%)	9.9	30.9	7.8	16	10.2	27.9	35.3
Debt-service liability	2.2	8.7	8.1	7.0	4.6	4.1	5.1

Source: World Bank

I.v Beyond traditional indicators: the structure of China's external debts

The structure of a country's external debt has two elements.

The structure of a country's external debt has two elements: term and currency. The obvious guideline with term structure is to avoid too much short-term debt which concentrates repayments and puts the debtor at the mercy of unfavourable changes in the international or domestic economic cycle. In the course of the 1990s, the balance of China's short-term debt as expressed in official figures has always been below 17% and has been falling (see table 4).

A regional comparison shows that the proportions of short-term debt in Indonesia, Malaysia, the Philippines and Thailand were 20.8%, 21.2%, 15.1% and 32.3% respectively in 1995. While these ratios were all higher than China's (11.2%), they were not excessively so, with the exception of Thailand. However, by 1997, the proportion of short-term debt in each of the south-east Asian countries had risen to around 35% - a reminder of just how fast things can change.

Table 4: Repayment terms, Chinese external debt 1991-1996. Billion US dollars and %

	1991	1992	1993	1994	1995	1996
Outstanding long-term debt*	50.257	58.475	70.027	82.391	94.674	102.167
Outstanding short-term debt	10.304	10.846	13.546	10.415	11.916	14.108
Percentage long-term debt outstanding	83.0	84.4	83.8	88.8	88.8	87.9
Percentage short-term debt outstanding	17.0	15.6	16.2	11.2	11.2	12.1

* Term of nine months or more

Source: China Statistical Yearbook

In terms of the currency structure of external debt, the general rule is one of prudent diversification. A more specific guideline is to relate currencies of debt to those of export earnings. China presently has external debts in more than 20 currencies, including US dollars, Japanese yen, Hong Kong dollars, British sterling and French francs. US dollar debt is the biggest slice, at around 50%, while Japanese yen accounts for some 30% of outstanding debt. The dollar debt is appropriate given that China settles most of its imports and exports in the US currency. The significant volume of yen debt is more a reflection of a high level of Chinese-Japanese government debt. There is a clear case for some term and currency adjustment in this debt given the major fluctuations that characterise the Japanese currency.

US dollar debt is the biggest slice, at around 50%.

Diversifying external debt

The Ministry of Finance began a systematic programme to manage and diversify China's external debt with the issue of DM300 million in treasury bonds in Germany in 1988. There followed a hiatus in international fund raising until September 1993, when China issued Ecu30 billion in five-year European treasury bonds; in October the same year, China offered US$300 million in 10-year "dragon" treasury bonds in Asia. In February 1994, China issued US$1 billion of global 10-year treasury bonds simultaneously in the US, European and Asian markets; this was the first Chinese issue of global treasury bonds. In July, 1994, there was another first with the issue of Yen60 billion of five- and ten-year "knight" sovereignty bonds in Tokyo. Today, China is a proven issuer of treasury bonds in world markets, with a solid credit status.

Chen Jingyao

I.vi How China manages its external debt

The mechanism by which the Chinese government manages external debt can be summarised as follows:

- An overall quota for the oustanding balance of external debt.
- Administrative planning of public and state-owned enterprise debt.

- Control of non-state external debt via tariff policy (to discourage certain types of imports) and limited allocation of foreign currency export proceeds.
- Allowing the international market to influence private sector external debt.

The government draws up annual, medium-term and long-term plans for the country's external debt load.

In procedural terms, the Chinese government draws up annual, medium-term and long-term plans for the country's external debt load. These plans cover all external debts other than those incurred by foreign-invested enterprises. All external debts are required to be registered with the State Administration of Foreign Exchange (SAFE); in reality, of course, this is more easily enforced with wholly domestic entities than with ones which have overseas branches, through which they may also borrow (see the third article in this special subject). The last element of government external debt management is to make a clear, three-fold distinction about those external debts which are sovereign: debt borrowed by the state and repaid by the state; debt borrowed by the state and repaid by local government; and debt borrowed by local government and repaid by local government. This last type of external debt is the one where external lenders must be most careful to check sovereign status.

In the next few years, China's external debt management system is likely to undergo some deregulation. At present, the government allows foreign-invested enterprises to borrow freely abroad but imposes strict approval and reporting procedures on domestic firms. This was justified in the past on the grounds that many Chinese companies had unlimited liability. However, with the passage of China's Company Law, it is possible to allow greater freedom to Chinese companies of limited liability.

External borrowing by state agencies requires close policing.

At the same time, however, the government may need to be more stringent in managing external debt for which it retains liability. External borrowing by state banks and non-bank financial institutions, government deparments, local governments and projects for which government departments or local governments offer guarantees requires close policing. It must be remembered that Chinese financial institutions are in fact state-owned enterprises with unlimited liability. Since most external borrowing by domestic Chinese enterprises requires a guarantee from a domestic financial organisation, the supervision of these entities is critical.

In the long run, China must combine deregulation of external borrowing by domestic companies with better supervision of guarantees made by state agencies. A final, necessary ingredient is information: as deregulation occurs, it is more and more important to have clear knowledge of who is borrowing what and from whom. In this way China will avoid the nasty surprises that have occurred in other Asian countries.

II. Domestic debt

II.i Recent history

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Domestic debt is not a new phenomenon in post-1949 China. After liberation, the Chinese government issued its first securities as early as 1950; they were called People's Victory Bonds. In the later 1950s, the government issued National Economic Construction Bonds and also accepted foreign loans, in the form of machinery and equipment for 156 key national industrial projects, from the former USSR. In 1959, however, the government abruptly decided to end any reliance on national debt and by 1968 paid off all its internal and external loans. For the next decade, China remained a debt-free nation.

The government resumed external borrowing with the start of the Open Door policy in 1979, and in 1981 recommenced domestic bond issuance. The background to the debt requirement of this period was that the central government needed to replace part of the revenues it gave up in the process of economic reform. This occurred for two reasons: first because the government raised purchase prices for agricultural products and second because the government started to allow state enterprises to retain a share of their profits. Fiscal revenue fell dramatically as a result of reform, while fiscal expenditure rose; as early as 1979 and 1980, China posted successive fiscal deficits. It was in this context that the State Council, China's cabinet, released its *Regulations on Treasury Bonds of the People's Republic of China* in January 1981 and that year issued bonds valued at Rmb4.87 billion.

The government resumed external borrowing in 1979.

This year, 1998, will be the eighteenth successive year of bond issuance by the central government. The scale and sophistication of today's bond market has little in common with the rudimentary nature of offerings in the 1980s. Here is a brief synopsis of key developments in government debt issuance in the past two decades:

- Through the 1980s there was no primary market for national debt transactions. Instead, most government securities were issued through government financial departments which "allocated" (through a combination of political mobilisation and administrative orders) purchases to enterprises, work units and other institutions. In essence, government employees were required to buy government bonds.

Through the 1980s there was no primary market for national debt transactions.

- In 1986, the central government approved trial trading in 61 cities of two batches of previously issued bonds which had hitherto been untradeable.

- In 1991, the Ministry of Finance approved the issuing of treasury bonds through underwriting by 70 intermediary securities institutions, thereby creating for the first time a primary market for government debt.

- In 1993, the Ministry of Finance and the China Securities Regulatory Commission published regulations governing the underwriting of government bonds and the functions and duties of treasury-bond market participants. A secondary market for government securities began to develop and to exert considerable influence on the primary market.

- In 1995, the Ministry of Finance introduced a bidding method for bond issuance - much the same as bidding systems used by governments worldwide.

- In April, 1996, China's central bank officially began open market operations in national debt. At the same time, new categories of debt were introduced, such as discount bonds and coupon bonds. Three-month treasury bills and 10-year treasury bonds also appeared.

- In 1997, a year of record bond issuance (see table 5), debt diversification continued. For example, China issued Rmb20 billion (US$2.4bn) in discount treasury bonds by means of US-style bidding; shortly afterwards the government released Rmb123 billion (US$14.8bn) of untradeable certificate bonds and Rmb40 billion (US$4.8bn) of non-registered bonds direct to retail buyers through bank outlets.

In the past there was no short-term debt under one year and no long term debt over 10 years.

China's government debt market has come a long way in the past few years, but is still developing. An area of recent attention from the Ministry of Finance has been the term structure of debt. In the past China's debt was wholly comprised of medium-term debt of three to five years maturity; there was no short-term debt of under a year and no long term debt of over 10 years. The result was debt repayment peaks which necessitated the issuance of more debt to repay principal and interest due over short periods. But without debt diversification, this simply created worse repayment peaks down the road.

Fortunately, the term structure of China's debts has been improved significantly. By 1996, the Ministry of Finance was making use of short-term treasury notes of three months, six months and one year, as well as a full range of medium-and long-term treasury bonds of three years, five years, seven years and 10 years. The nature of the debt ranges from zero-interest securities to discount securities to couponed securities. This diversification of government debt has not only improved the term structure, it has increased the market's appetite. Nonetheless, in the next few years diversification needs to continue. In particular, China may wish to issue short-term tradeable treasury bills, an important tool in macro-economic control, and more long-term treasury bonds for institutional investors.

There is room to improve the bidding process.

There is room, too, to improve the bidding process by which bonds are now issued. One effect of this should be to reduce issuance costs, which are high. A second aim is to push treasury-bond rates towards greater market regulation. The price bidding process is already based on prevailing returns in the secondary treasury bond market, but because reform of China's overall financial system still has some way to go, treasury rates tend to surpass bank deposit rates of the same maturity by fairly predictable margins.

In order to further increase the sophistication of the treasury market, it is necessary to establish a national system of debt trust, settlement and clearing. This should help break down market segmentation, make the market more liquid, reduce costs and facilitate the central bank's open market operations. The creation of a national infrastructure for the treasuries market is a priority for 1998.

A national system of debt trust, settlement and clearing is needed.

Lastly, the Ministry of Finance is trying to do more to help it key clients - individuals. Individual investors have in the past bought more than 90% of issued treasuries via over-the-counter transactions in retail banks. This tends both to raise issuing costs and extend issuing periods. In order to simplify the sale and purchase process on both sides, the government began experimenting with special "national debt accounts" for individual investors in 1997; the trial is being expanded this year. A second boon to individual investors will be the start of national debt investment funds, which should be made possible by the soon to be promulgated *Regulations on Management of Securities Investment Funds*.

II.ii Current load and outlook

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From 1981 to 1996, government issued treasuries worth Rmb665 billion.

From the resumption of domestic debt issuance in 1981 to the end of 1996, the central government issued treasuries to a total value of Rmb665 billion (US$80 bn). The outstanding balance of this debt at the end of 1996 stood at Rmb427 billion (US$51bn), or 6.3% of the year's GNP. Preliminary figures for 1997 suggest the net increase in outstanding bonds was around Rmb55 billion (US$6.6bn); this would be only a marginal increase as a proportion of GNP.

By international standards, China's treasury-bond liability ratio (the ratio of outstanding treasury bonds to GNP) is very low. The liability ratios for the United States and Japan, for example, are over 40% and 50% respectively. However, the rate at which China's domestic debt is rising, along with the government's dependency on treasuries to finance its budget, do give some cause for concern.

The scale of treasury bond issuance has exploded.

The scale of treasury bond issuance has exploded since 1994 (see table 5). Last year's record issue of Rmb241 billion (US$29bn) was itself equivalent to more than 3% of 1997 GNP (although, as stated above, the net increase in bonds outstanding was much less, at around US$7 billion). If one looks at China's debt-dependency ratio, which measures treasury sales as a proportion of fiscal expenditure, it stood at 27% in 1996 and rose to 28% in 1997.

The reasons for this are simple, and have already been alluded to in Dr Chen's article, above. In short, after 1979, the process of economic reform was accompanied by a rapid decline in central government fiscal revenue while fiscal expenditure continued to rise. As a proportion of GNP, fiscal revenue fell from over 30% in 1979 to under 12% 1996, when it was stabilised. Government revenues rose relative to GNP in 1997, a positive long-term sign, but with expenditures far outstripping income, dependency on debt issuance has become a given.

The outlook for China's treasury bond liability ratio to 2000 is that it will likely increase to somewhere between 7% and 9% of GNP in order to cover continuing budget deficits. This will still leave China a very long way from the 20-25% of GNP exposure which might give the international financial community cause for concern. So long as there is no new reason (ie. other than the budget deficit) for a more rapid increase in the stock of domestic debt, there is no problem.

Table 5: China's treasury bond issues, 1990-1997 and 1998F

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998
Planned issue, Rmb bn	19	19	38	37	102	150	195	250	280-300*
Actualissue, Rmb bn	28	28	43	38	114	154	223	241	-
% increase over previous year	43	0	54	(12)	198	35	45	8	20**

* Estimate published in China Securities News, 16/01/98

** Based on planned issue

Source: People's Bank of China

III. Unregistered liabilities

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III.i External debt.

There have been extraordinary revisions to published data about external debt.

The past year has witnessed extraordinary revisions to published data about external debt in Asian countries. As financial crisis spread from Thailand to Malaysia and Indonesia and on to South Korea, central banks in each of these countries were forced to concede upward revisions in the amounts of external debt their nations hold. The process culminated in South Korea, where the central bank raised its figure for total external debt from US$100 billion to US$168 billion, and that for short-term external debt from US$65 billion to US$100bn.

Markets do not like surprises, and the Asian experience has made observers increasingly nervous about China's published debt figures. China, after all, is the only major east Asian developing economy to have survived the financial crisis contagion. Questions have not only been raised by foreign economists. In February, mainland-controlled but Hong Kong-published *Jingji Dabao* carried a prominent article about "hidden" foreign debt in the People's Republic. While short on specifics, the article referred to unregistered borrowings by mainland entities from foreign business partners and borrowings disguised as foreign direct investment.

Asia has become a nervous place. While China continues to publish external debt data according to its own definition (see part one of this special subject), the State Administration of Foreign Exchange (SAFE) has moved quickly to international standards in its internal reporting; changes to this effect were set out in a central bank circular in January. SAFE already signed up to membership of the Swiss-based Bank for International Settlements (BIS) in 1997, and will adopt its standards in public as well as in private in the near future.

The world needs better information on short-term external debt flows.

The key realisation which is spurring SAFE's efforts, just as it has forced international financial institutions to check their numbers, is just how vulnerable economies can become through unchecked build-ups of short-term external debt. Stanley Fischer, deputy managing director at the International Monetary Fund, said in February that one major lesson from the Asian financial crisis is that the world needs better information on short-term external debt flows. The most commonly-cited information at present, published by the BIS, is on average eight months out of date. Compare this with the fact that the short-term debt build up which pushed south-east Asia into crisis occurred in the space of only about 18 months.

Fortunately for China, its closely controlled financial system has helped keep the brake on short-term external borrowings. Since 1996, SAFE has required all banks in the country to have account holders who receive foreign exchange remittances fill out a standard form to say what the remiittance is. This applies whether incoming foreign exchange is a payment for exports, a loan, or whatever. Inevitably, there are problems of enforcement. An international financial institution involved in technical assistance work with SAFE estimates that 50-60% of forms were properly filled out in 1996, rising to 70-80% in 1997. This leaves a significant gap. However, anyone who fails to report a foreign exchange loan on the way in to China is now very likely to be caught on the way out, when they try to remit foreign exchange to pay interest and principal. If a borrower uses the banking system to do this, a bank will not (unless corruption is involved) allow the remittance without all approvals and paperwork being in place. There is already anecdotal evidence that illicit borrowers of foreign funds are finding themselves in trouble when they try to service those borrowings - evidence that the new monitoring system works.

China is protected because it has no capital account convertibility.

This is how SAFE's control system is being enhanced at a micro level (it is backed by considerable investment in information technology systems). At a macro level, China is protected because it has no capital account convertibility and so is largely insulated from short term international capital flows. It is a moot question as to whether recent experience has encouraged the Chinese government to further postpone the date when the country does move to capital account convertibility. Central Bank governor Dai Xianglong's diplomatic answer to this question in January was: "There is no timetable for convertibility on the capital account, so there is no question of postponing it."

Despite presently high levels of regulation, however, there is no doubt that China does have unregistered external liabilities. For a start, there are those short-term liabilities which still do not show up in China's official debt figures but are included in those of the BIS. At present the discrepancy is a hefty US$10-12 billion, but this will be cleared up as China shifts to the BIS standard in the next 12-18 months. What concerns observers more is short-term liabilities (there is little criticism of China's long-term debt numbers, which are vouched for by the World Bank) which do not currently appear in anybody's figures.

The central bank itself has shown some concern on this issue. At a Beijing press conference in January, governor Dai appeared to concede that Chinese companies are holding upreported foreign debts. Attributing Asia's financial crisis to "private and commercial entities having excessive debt, especially short-term debt, and not reporting it to the central bank", Mr Dai warned: "We will identify and punish severely enterprises borrowing foreign debt without reporting it."

The governor offered no specifics about the sums involved.

The governor offered no specifics about the sums he believes to be involved. However, it is not difficult to identify areas where these types of unrecorded debt must exist, whether for technical reasons or because borrowers are actively evading China's debt approval process.

Foreign debt disguised as FDI. This is the most obvious area of suspicion. That domestic Chinese entities recycle investment through offshore companies in order to take advantage foreign direct investment (FDI) incentives is a given. The issue is what proportion of the more than US$200 billion of utilised FDI in China is involved; "guesstimates" range anywhere between 10 and 40% of the total. The subsidiary debt issue is what part of the "false" FDI is new capital, borrowed overseas (including Hong Kong) which creates unregistered external debt liabilities within mainland China. A secondary issue is how much unregistered, foreign currency denominated lending goes on between foreign and Chinese joint venture partners. In the period of austerity since 1994, many Chinese joint venture partners have looked to their foreign counterparts for cash the domestic banks will not lend them; but have foreign partners been willing to entertain them to any significant extent? The answer is probably not, and this second area of concern is much less serious than the basic one of external debt masquerading as FDI.

Chinese joint venture partners look to foreign counterparts for cash domestic banks will not lend them.

FDI which carries a guaranteed rate of return. In recent years, some of Hong Kong's largest companies (and one or two from outside Hong Kong) have invested in mainland infrastructure projects. In some cases, the Hong Kong companies have secured guaranteed rates of return, payable in foreign currency, and assured by provincial governments or other mainland entities with sovereign liability. The Hong Kong investments are recorded as FDI, but the fact that profits are guaranteed means the investment is really a form of quasi-debt. There is no source for the aggregate of sums involved, but the total would not significantly affect China's overall debt position; the debt is also long-term in nature.

Table 6: Who's debt is it anyway? China's registered external borrowings

Government	US$35bn
Domestic financial institutions	US$47bn
Domestic enterprises	US$13bn
Chinese partners to foreign-invested enterprises	US$25bn
Total	US$120bn

Source: Hongkong Bank China Research

Other unreported debts of mainland companies and their offshore subsidiaries. This is the most nebulous area of all. Individual foreign banks know their exposure to mainland Chinese entities, but if they have indulged in high-risk, back-door lending, they are unlikely to advertise the fact. Hong Kong is the obvious place to look for external liabilities which SAFE has not registered. The Hong Kong Monetary Authority (HKMA), effectively the Special Administrative Region's central bank, has stepped up surveillance in the past year, pressuring 350 authorized financial institutions to discuss the full extent of their regional liabilities. But while the HKMA probably has as good a take as anybody on the real scale of short-term lending to the mainland, the agency would be foolish to make public its concerns if it has any.

Hong Kong is the obvious place to look for unregistered liabilities.

Some third party observers become nervous about the situation if they make regional comparisons. In South Korea, unreported offshore borrowing by Korean corporates was the biggest single chunk of total unregistered liabilities. However, it is difficult to imagine there could be hidden debt on this scale in mainland China. For one thing, there is the control implied by SAFE's bank reporting system (see above). A senior economist at an international financial institution says that SAFE's banking supervision has been more rigorous than that of the Korean central bank since 1993, when the Chinese agency began its reforms.

Chinese red chips and H-share listings raised around US$10 billion in 1997.

While mainland corporates have been aggressively raising money offshore, most of it has been in the form of equity rather than debt. The run up in the Hong Kong stockmarket in 1997 helped Chinese red chips and H-share listings raise around US$10 billion during the year. But the external debt exposure of these companies - including convertible instruments they have issued - is limited. If there is serious short-term external debt exposure among mainland companies, it is most likely ones incorporated in Guangdong province and Shanghai, where access to equity financing has been less.

In the end, one can only look out for the presence or absence of debt warning signals. It will be interesting to see whether the annual results reporting season for Hong Kong banks (February to April) involves any significant provisions for mainland-related debts. In Hong Kong itself, however, banking analysts are far less worried about bad mainland debts at present than bad Hong Kong ones. Total loans by Hong Kong banks have risen from 99% of GDP in 1986 to 166% in 1997 off the back of a boom in realestate lending. Property loans officially account for 45% of HK$2.2 trillion outstanding. With Hong Kong realestate on a frightening downward slide, local bankers are heavily concentrated on local problems.

External liabilities of Chinese banks. The overseas deposits of the Bank of China (BOC), which is now the number two bank in Hong Kong and has by far the biggest overseas operations of any Chinese bank, raise liability questions. At the end of 1996, these deposits amounted to US$96 billion (mostly in Hong Kong). The question is what liability should be factored in to reflect a possible maturity mismatch between BOC's role as recipient of short-term deposits in Hong Kong and its role as a major foreign currency lender on the mainland, often of longer term loans. It seems inevitable that BOC must onlend from Hong Kong to the mainland because its mainland forex deposits could not cover its needs.

Large state entities have a penchant for high-risk derivatives.

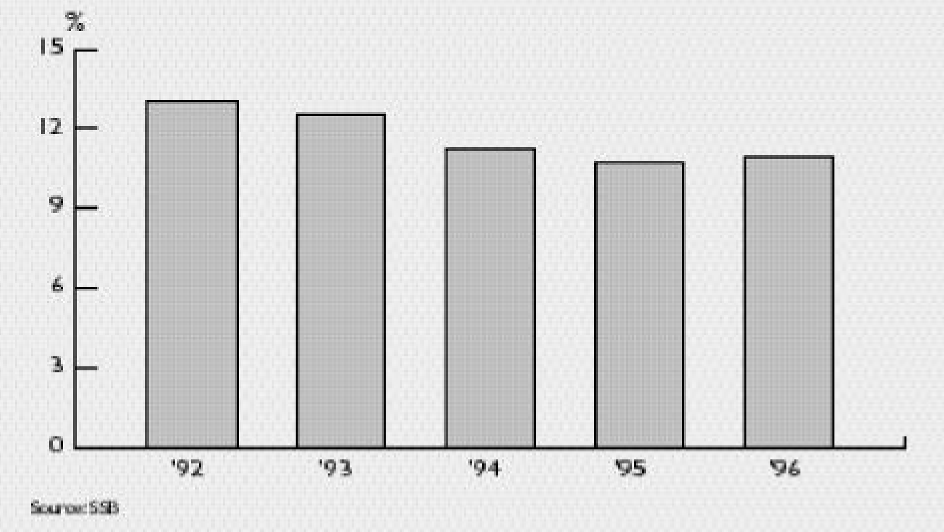
Forward contracts. There are endless possibilities for unregistered liabilities via forward contracts entered into by mainland parties. Large state entities have a proven penchant for complex, high-risk, sometimes high-return derivatives. However the failure of some state entitites to willingly pay up on soured derivatives contracts in the past couple of years, and a government clampdown on this type of activity, perhaps mean that it is less common than in the past.

Unfortunately, the above discussion asks as many questions as it answers. The most frightening aspect of the Asian financial crisis in the past year has been how little we knew about its build-up. The situation in China is no less murky, but at least the world is paying attention. At the same time, the low registered levels of external debt in China (see section one) mean that unregistered debt would have to be proportionately much higher to wreak the kind of damage it caused in south-east Asia. None of the analysts and economists who contributed to this article believes China's unregistered external debt could be more than 30% of the registered total.

At this upper limit, not one of China's external debt indicators would be pushed above acceptable levels. China's exports as a proportion of GDP, meanwhile, should continue to rise, making the country more, not less, able to service external borrowings. The World Bank's official position on China remains that the country needs to take on further foreign debt to finance its modernisation. The problem is not on the debt side, but on the revenue side, where the central government must increase its fiscal income as a proportion of GDP (see figure 1). A long decline in this respect was arrested in 1996. However, the government's fiscal problems, and those of the domestic banking sector, remain of a far greater magnitude than ones relating to external debt. Lastly, it should be remembered that if China does not have an external debt problem already, it is not about to get into one: the international liquidity simply does not exist to pay for another borrowing bust.

Not one of China's external debt indicators would be pushed above acceptable levels.

Figure 1. Central government fiscal revenue as a proportion of GDP, 1992-1996.



III.ii Domestic debt

There is no argument about the present level of China's domestic government debt. To within a few billion renminbi (final numbers have not yet been published) the Chinese government's outstanding treasury bond debt at the end of 1997 was Rmb490 billion (US$59bn). This is less than 7% of GDP. As Feng Enxin points out in part 2, China's domestic debt level is very modest. The government's budget deficit will push this level up in the next few years, but even greatly increased on-budget infrastructure spending would be unlikely to raise outstanding debt above 10% of GDP by 2000.

China's domestic debt level is very modest

There is, however, a problem. It is the claim on domestic debt that may one day be made by the need to recapitalise China's state banks. If the government and the four major state banks (see box, China's banks) cannot make sufficient provision for bad debt from current revenues, it is likely the government will need to issue additional domestic debt (see box, Four ways to rescue banks). The scale of this issuance depends on how much bad debt there really is in the state banking system.

China's banks

Banking is still dominated by four giants.

Banks are proliferating in China - dozens of new urban banks opened in 1997 - but banking is still dominated by four giants. Bank of China (BOC), Agricultural Bank of China (ABOC), China Construction Bank (CCB) and Industrial and Commercial Bank of China (ICBC) had combined assets around US$1.1 trillion at the end of 1996, or more than 90% of the banking system's total. They employ 1.7 million people in 150,000 branches.

Table 7, below, shows the assets, liabilities and capital of the big four banks, as well as those of five much smaller and newer banks. With respect to the big four, the table makes clear the extent to which their assets and liabilities dwarf those of younger competitors. At the same time, it is striking how limited their capital is.

Table 8 reveals that the capital base of CCB is less than 4% of net loans; that of ABOC is less than 5%; ICBC is just over 5%. In terms of the returns on assets and returns on equity of the big four state banks, it must be remembered that the net profit figures on which these ratios are based are questionable (see main text). Nicholas Lardy at the Brookings Institution, for instance, believes that on international accounting standards the big four banks would all be showing losses.

Returns are much lower among the big four than the five new banks.

The ratios are included in Table 8, however, because they still highlight how much lower returns are among the big four than among the five new commercial banks. These institutions, of which Shanghai-based Bank of Communications is the biggest, are not weighed down by historical bad debt and bureaucratic interference in their operations. The smaller banks may provide an indication what good business the big four can look forward to after they are fully commercialised and their balance sheets are cleaned up.

Table 7. Assets, loans, deposits, capital and profits of China's major banks. 1996, US$ billion

Bank	Total assets	Net loans*	Total deposits	Capital	Reported net profits
Agricultural Bank of China	176.8	107.8	112.2	5.1	0.3
Bank of China**	292.6	154.2	181.3	13.7	1.1
China Construction Bank	210.5	140.1	141.2	5.5	0.6
Industrial and Commercial Bank of China	437.4	215.4	229.1	11.3	0.7
Bank of Communications	48.0	24.5	38.4	2.6	0.4
CITIC Industrial Bank	13.1	6.6	10.5	0.7	0.1
Everbright Bank	5.7	3.1	3.9	0.3	0.1
Pudong Development Bank	7.8	4.2	6.0	0.3	0.1
Hua Xia Bank	2.7	1.2	2.0	0.3	0.1

*Either net of provisions or net of non-performing loans.

** Consolidated

Source: Capital Intelligence

Table 8. Generation gap: leading indicators of China's old and new banks. 1996, %.

	Capital/loans	Return on assets	Return on equity
China's old banks			
Agricultural Bank of China	4.71	0.14	4.99
Bank of China	8.91	0.36	7.77
China Construction Bank	3.91	0.28	10.62
Industrial and Commercial Bank of China	5.27	0.16	6.17
China's new banks			
Bank of Communications	10.62	0.91	16.74
CITIC Industrial Bank	10.03	0.98	19.36
Everbright Bank	8.59	1.49	32.08
Pudong Development Bank	6.23	1.36	39.95
Hua Xia Bank	28.24	1.83	14.42

Source: Capital Intelligence

Four ways to rescue banks

There are four ways in which the government is able to help the banks tackle their bad debt problems. The first two are the banking equivalent of out-patient care; the last two are more like major surgery.

Reduce the banks' tax burden.

Some observers point to the profits still posted by China's big four banks (they reported a combined net profit in 1996 of US$2.7 billion) as evidence they already have the resources to provision against significant bad debt. It is just a matter, the argument runs, of the government allowing the banks to increase their pre-tax annual provisions for bad debts, which is already happening; the provisions will increase to Rmb50-60 billion this year from Rmb30 billion in 1997. Unfortunately, the banks' current revenues and profits are not quite as they appear to be. This is because of an official accounting requirement that Chinese banks show overdue interest as income for two years after a loan goes into default. Until a couple of years ago the rule was three years; in the United States, by contrast, a bank would stop marking interest as income once it was 30 days overdue. In short, Chinese banks' reported revenue and profit figures are a bit of a nonsense.

Banks' current revenues and profits are not quite as they appear to be.

The central government knows this and has already eased the banks' tax burden by cutting profit tax from 55% to 33%. However, the operational business tax the banks must pay has increased from 5% to 8%. This hurts. One thing the government has already said it will do to help the banks is to further reduce their recurrent tax burden. The difficulty is that since the government is running a budget deficit, this merely increases its own borrowing requirement.

Lower capital reserve requirements

The Swiss-based Bank for International Settlements recommends that a bank keeps a minimum 8% of outstanding deposits on hand as reserves. The baseline proportion of outstanding deposits which the big four Chinese banks are required to keep with China's central bank is 13%; in addition they must deposit a further 5-7% in so-called "excess reserves". There is a strong case to free up some of this money, allowing the banks to earn a better return on it than they are paid by the central bank.

More optimistic economists at international financial institutions believe the two limited remedial actions indicated above could enable the big four banks to cope with as much as Rmb1-1.5 trillion (US$180bn) in bad debt over the next few years. This would allow the sort of volume of bad debt which the central bank's Mr Dai says exists to be dealt with. If more than 20% of outstanding loans (ie. over Rmb1.5 trillion) are unrecoverable, however, the banking system is going to require major surgery.

Government recapitalisation.

In essence, this would involve the government giving the state banks money to compensate for having forced them to lend to state-controlled entities which do not have the ability to repay. There is a strong argument that much of this lending ought to have shown up as government spending all along. The easiest way for the government to recapitalise the banks would probably be to give new government bonds (treasuries) directly to them. There would be no need to go to the market and sell the bonds; the banks would book them as assets and the government would pay interest. The main issue is how big the recapitalisation would need to be.

This lending ought to have shown up as government spending all along.

Issuing equity.

At present this is not an option for the big four state banks. With such poor information about their asset quality (in other words, the state of their loans) and continued bureaucratic interference in lending decisions, it is hard to see who would want to invest. However, if the banks' balance sheets are cleaned up, and the market is confident they are operating on a commercial basis, it is quite possible that in a few years they can proceed to equity offerings. Given China's high savings rate, commercial banking should be a profitable business that can attract a high premium from equity investors. First, however, the banks have to put their houses in order.

According to official figures*, at the end of 1997 20%-25% of outstanding bank loans were non-performing: 2% unrecoverable, 8% more than two years overdue, 10%-15% less than two years overdue. However, these figures almost certainly understate the true level of bad debt in the banking system.

A bank loan is non-performing when a bank registers it as such.

A bank loan is recorded as non-performing when a bank registers it as such. In theory, this should happen as soon as either interest or principal is a single day overdue; in this sense, China's reporting requirements are particularly rigorous. In reality, however, few people believe that all non-performing loans are reported. Some, perhaps many, are repackaged. If, for example, a creditor is unable to repay a chunk of due principal on an existing loan, a local bank may decide to turn the loan into a new one on which principal repayments are not immediately due. The need to register a non-performing debt is thereby avoided.

The most likely reason for this to happen is that the borrower enjoys powerful political backing in its locale; this might be because of individual relationships and shared business interests, because of an entity's importance to the local economy, or because of social considerations such as employment. In China, the influence which senior Party and government officials still excercise over state banks is considerable; indeed many officials regard this influence as entirely natural and proper.

The central bank knows how pervasive bureaucratic interference is.

The central bank, the People's Bank of China (PBoC), whose job it is to police the banking system, knows how pervasive bureaucratic interference in bank lending is. Indeed one of the biggest problems the PBoC leadership faces is collusion with, or at least tolerance of, bureaucratic interference in lending from within its own ranks. This is one reason why the PBoC decided in 1997 to restructure itself on a regional, rather than a provincial, basis - in the hope it can break down cosy relationships around the country. The reform is itself an admission of the present limitations of the central bank's monitoring capability.

The fact is that no one knows how much bad bank debt there is in China. As with short-term external debt, the recent experiences of other Asian countries have led to much nervous speculation. Observers note that in Japan, the Ministry of Finance revised its estimate of total bad debt in the banking system from Yen27 trillion to Yen77 trillion on what it called a "broader definition". The revelation begs the question of whether we should expect a similar surprise in China. In the past six months, third party "guesstimates" of bad debt in China's banking system have ranged as high as 60 to 70% of outstanding loans. No one, however, publishes explanations of how they arrive at these estimates.

Japan revised its estimate of bad debt from Yen27 trillion to Yen77 trillion.

In the second half of 1998, Nicholas Lardy, a senior fellow with the Brookings Institution in Washington and a former World Bank consultant, will publish a book arguing China's bad debt problem requires additional bond issuance

* China categorises non-performing loans on a three tier system: overdue (covering loans on which interest and/or principal has/have not been paid for between one day and two years); idle (loans on which interest and/or principal are overdue by more than two years); and non-recoverable. There is no classification system for loans on which interest and principal are being repaid.The People's Bank of China said in January that it will move to an internationally accepted system for loan classification based on five categories: standard, special mention, substandard, doubtful and loss.

equivalent to 25% of GDP. Mr Lardy, who has dedicated several years to a study of China's financial system, deserves to be taken more seriously than commentators who have thrown out bad debt estimates in the past few months. Nonetheless, even he concedes that all researchers are fumbling in the dark because of a fundamental lack of reliable data.

If Mr Lardy's analysis does prove accurate, China could have a government domestic debt load as high as 35% of GDP around the year 2000. This would be above what international financial institutions and markets would be comfortable with, but the debt level need not stay so high for long. If bank recapitalisation is combined with a move to strict commercial operations among China's big four banks, and if insolvent borrowers are cut off from credit and bankrupted, the government will be in a position to part-privatise the cleaned-up banks. Privatisation revenue could go a long way to paying down government debt (as has been the case in other transitional economies, like Hungary).

3

Markets and trends

The third section of the *CEQ* covers China's domestic stockmarkets and looks at important trends within the country's political economy. This issue contains a special revue of 1997 economic performance and an outlook for full-year 1998.

Markets

- The Shenzhen and Shanghai stockmarkets: performance in Q4 1997 and early Q1 1998; outlook for Q2 and beyond

Trends

- An SSB economist's review of the economy in 1997 and prospects for 1998; plus, an easy-reference statistics guide

China's stockmarkets: Q4 and early Q1 in review, and outlook

Ying Dingwen is an associate professor at the Institute of Quantitative and Technical Economics of the Chinese Academy of Social Sciences (CASS) and an authority on the development of China's capital markets.

China's stockmarkets stabilised in Q4.

After heavy losses between May and the end of the third quarter, China's stockmarkets stabilised in Q4. The Shanghai composite opened the period at 1,100, had a high of 1,241, a low of 1,087 and ended the year at 1,194. Shenzhen's composite index started Q4 at 3,963, had a high of 4,755, a low of 3,841 and ended the year at 4,184.

As forecast in the last *CEQ,* the potential for the markets to rebound around 20% was borne out; unfortunately, they failed to hold on to most of their gains. Daily volume was down on Q3, which in turn had been heavily down on Q2.

The October 23 interest rate cut, despite reducing real interest rates, had nothing like the effect on liquidity that two cuts in 1996 did; (these cuts did not reverse the trend of rising real interest rates). There was some nervousness about devaluation pressure on the renminbi in Q4, but the government countered with repeated assertions that the currency's value will be maintained.

Policy news in Q4 and early Q1 was almost all good. The China Securities Regulatory Commission issued regulations governing the country's nascent fund management industry; the central bank abolished renminbi lending quotas and gave state banks fuller control of their lending and asset management policies. At the same time, the government moved in December to reduce the rate of new share issuance. Despite all this, the markets remained unenthusiastic.

While the composite indices traded in a fairly narrow range in the period under review, the most interesting activity was sector or concept-driven:

Shanghai and Shenzhen composite index benchmarks

	Shanghai	Shenzhen
1997 highs (May)	1,510	6,103
Q3 opening	1,255	5,105
Q4 opening	1,110	3,936
Q1 opening	1,194	4,184

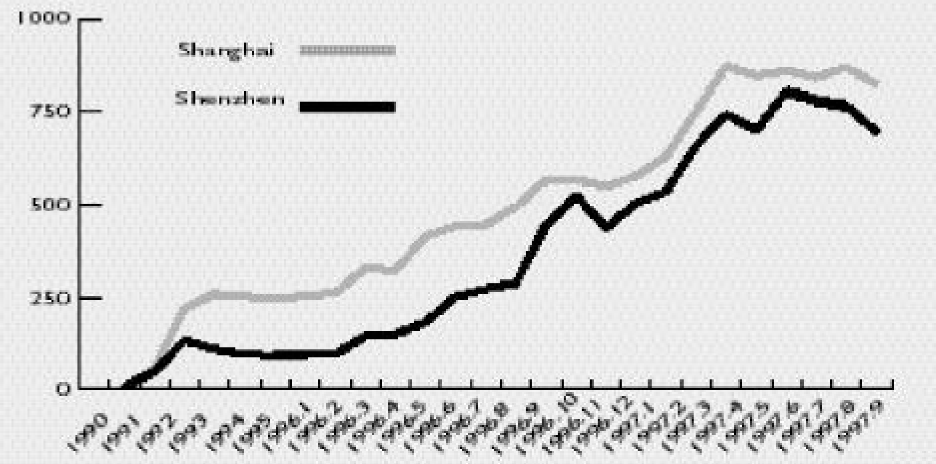
- **Restructuring.** September's 15th Party Congress laid heavy emphasis on the need to staunch losses in large- and medium-size state enterprises within the next three years. In this context, listed state companies have released a flood of restructuring and asset reorganisation plans. In the course of 1997, more 190 such proposals were issued by big state corporations. In some cases, what can only be called speculative frenzy has surrounded the releases, with individual counters experiencing heavy price fluctuations.

- **Consumer goods plays.** The domestic markets have witnessed greater sectoral trends since early 1996. Among the biggest beneficiaries of this market segmentation have been consumer goods plays. The outstanding enterprises in this sector, such as Sichuan Changhong (China's leading colour television producer) and Jiangsu Chunlan (a manufacturer of airconditioners, compressors, fridges and motorcycles) have experienced heavy demand. Sichuan Changhong is trading at more than 10 times its price in early 1996, while Jiangsu Chunlan and white goods maker Qingdao Hai'er are up five to six times. The run-ups have continued in anticipation of forthcoming annual reports, with Jiangsu Chunlan's price doubling in the period under review. Whether or not these companies can deliver the sort of profits anticipated by their current prices is doubtful. If they cannot, look for prices in the sector to slump.

- **New stocks.** There was a constant stream of new listings in Shanghai and Shenzhen in Q4, with the volume of new equity accelerating from Q3. While this would tend to depress the overall indices, there was considerable speculation surrounding new issues. This partly reflected efforts among listing enterprises and brokers to support new counters, and partly reflected market sentiment that the initial offerings were priced cheap. However, with a quota of Rmb30 billion for new stock issuance this year, it is unlikely that speculation based purely on new offerings will continue.

There was considerable speculation surrounding new issues.

Figure 1. Getting bigger: capitalisation of China's stockmarkets, 1990 to September 1997. Billion renminbi



Source: PBOC

The outlook for the second half of Q1 and Q2 is based on market expectations of GDP growth between 7% and 8%. Despite, or because of, the economy's slowdown, investors are looking for a further cut in interest rates and a reduction in the central bank's statutory reserve requirements (which determine the proportion of deposits state banks must keep on reserve with the central bank). There is no expectation of a devaluation of the renminbi in the forecast period.

Unfortunately, there is nothing to suggest a significant improvement in the businesses of most listed companies in the next few months. Demand is sluggish and it will take at least one more cut in interest rates to bring capital back into the stockmarkets. At the same time, while the rate of new listings has been reduced, it is not about to stop altogether.

There is nothing to suggest a significant improvement in most listed companies in the next few months.

In short, the outlook is for the markets to trade within a narrow range. Investors are waiting to hear new and more positive stories. It is possible that the National People's Congress (NPC), scheduled for early March, will supply some. However, if the NPC fails to inspire, the markets could well show a decline through Q2. The key sub-trend will be an ever-widening gap between the performance of listed companies which actually report some earnings and those which do not.

The economy: 1997 in review, outlook for 1998

Zheng Jingping is a senior statistician and deputy director of the Department of Comprehensive Statistics at the State Statistical Bureau

Preliminary estimates put 1997 gross domestic product at US$900 billion.

Preliminary estimates put 1997 gross domestic product (GDP) at Rmb7.47 trillion (US$900bn), a real increase of 8.8% over 1996. While 1997 growth was 0.8% less than the revised 9.6% figure for 1996 (see last *CEQ*, page 42), it reflected a solid performance.

The growth rate for primary industry last year was 3.5%, for secondary industry 10.8% and for the tertiary sector, 8.2%. Secondary industry remained the main engine of growth. Agriculture performed well; although the grain harvest, at around 493 million tons, was below the record 1996 yield of 505 million tons, other crops did particularly well; the cotton yield rose to around 4.3 million tons.

Inflation continued to fall through 1997, with monthly year-on-year rises in the retail price index (RPI) all below 1% after May. For the full year, the RPI rose just 0.8%, while consumer prices, which include services such as utilities, rose 2.8%. These are the lowest rates since the reform period began nearly two decades ago.

Fixed asset investment growth slowed in 1997, with the annual total likely to be confirmed around Rmb2.53 trillion (US305bn). This would represent real growth of 9%. The growth of retail consumption also eased to, in real terms, just under 11%, or an annual value of Rmb2.32 trillion (US$280bn).

The merchandise trade balance was a hefty US$41 billion. The total volume of foreign trade reached US$325 billion, up 10% on 1996. Exports rose 21% to US$183 billion, while imports were flat at $142 billion. On the foreign direct investment side, contracted investment fell, but actual utilisation continued to rise. Foreign exchange reserves jumped US$35 billion to US$140 billion by year end.

Central government fiscal revenues rose strongly; so did expenditure.

Central government fiscal revenues rose strongly; so did expenditure. However, revenues rose fastest, leading to a further improvement in the ratio of fiscal revenues to GDP after a long term decline was arrested in 1996.

Despite a year of financial turmoil elsewhere in Asia, China appears to have survived the crisis. The yuan remains stable and supplies of M0, M1 and M2 increased slower than government projections (by 15.6%, 16.5% and 17.3% respectively). Of course the slowdown in economic growth brought with it some problems. Average per capita disposable income for urban and rural residents grew 2.9% and 4% respectively, 0.9% and 3% less than in 1996. Layoffs increased, to more than 10 million by the end of 1997, of whom about six million are without work. Total urban unemployment reached some 8.5 million through 1997, with the official unemployment rate rising to over 4%. Economic slowdown was further reflected in slowing growth rates for energy production, particularly electricity.

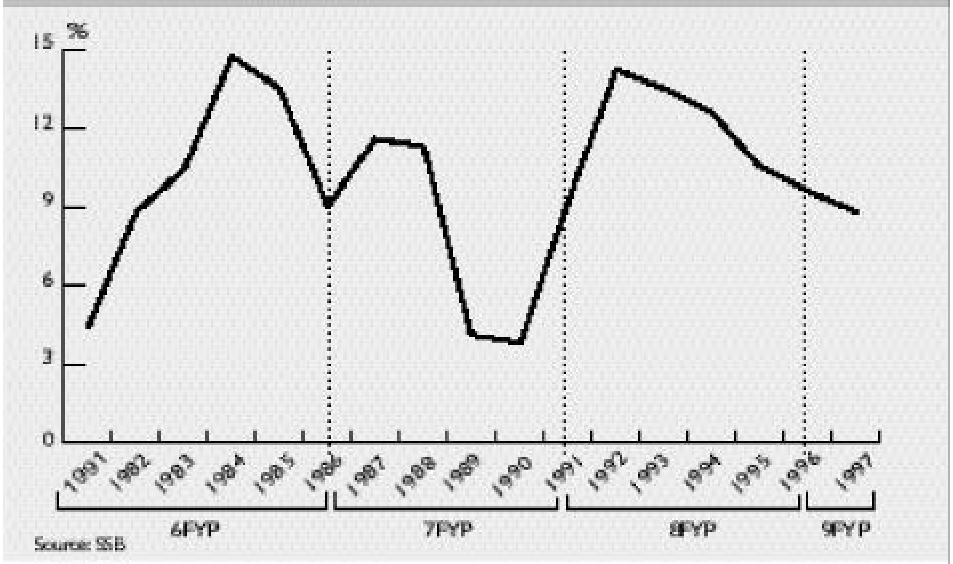
Whatever happened to the five-year cycle?

For two decades, China's socialist system of five-year planning has encouraged a distinctive growth cycle (see Figure 1). Each five-year period has started with relatively low growth, accelerated as investment plans are fulfilled and overall investment rises, and fallen back into lower growth when measures are taken to prevent the economy overheating.

In 1996, most Chinese economists hailed a soft landing after the frenetic growth of the middle years of the eighth five-year plan (1991-1996). All expectations were for another round of accelerating, investment-led growth. In the event, it never happened. Unless the government orchestrates a big increase in fixed asset investment in 1998, growth is set to fall further. The five-year cycle has gone.

Qi Jianguo

Figure 1. GDP growth in the sixth, seventh, eighth and ninth five year plans.



Outlook

Slower growth is to be expected in 1998, based on a range of internal and external factors. GDP growth slowed substantially through the third and fourth quarters and lower income growth and higher unemployment will have a negative influence throughout this year. The outlook on the demand side is as follows:

- **Consumption demand.** Despite the announcement of further interest rate cuts in October, the effect on consumption is likely to be negligible. This reflects a dearth of new outlets for consumption - there has been less progress than was expected a year ago on housing reform (see *CEQ* volume 1, issue 2) - at the same time as reforms in higher education and medical insurance are tending to curb disposable incomes. In the end, the best that can be hoped for in 1998 is that consumption growth will equal that of 1997; it is very possible it will be lower.

1997 by numbers

GDP	Rmb7,477bn
Real growth rate of GDP	8.8%
Real growth rate of primary industry	3.5%
Real growth rate of secondary industry	10.8%
Real growth rate of tertiary industry	8.2%
Real growth rate of state-owned industry	5.5%
Real growth rate of collectively-owned industry	11%
of which real growth of value added of TVEs	18%
Real growth rate of industry of other ownership	14%
Total profits in the economy	Rmb135.6bn*
Increase in total profits	19.6%*
Profits from SOEs net of losses	Rmb34.2bn*
Increase in SOE profits net of losses	18%*
Losses of SOEs	Rmb70.5bn*
Inventories of 370,000 industrial enterprises with independent accounting systems	Rmb609bn
Increase in inventories	8%
Industrial value added	Rmb3,175bn
Fixed asset investment	Rmb2,530bn
Real growth rate of fixed asset investment	9%
Retail sales of consumer goods	Rmb2,720bn
Real growth of retail sales of consumer goods	10.7%
Retail price index	0.8%
Consumer price index	2.8%
Foreign trade	US$325bn
Nominal growth rate of foreign trade	10%
Exports	US$183bn
Nominal growth rate of exports	21%
Imports	US$142bn
Nominal growth rate of imports	2.5%
Trade surplus	US$40.3bn
Utilised foreign capital	US$52bn
Utilised foreign direct investment	US$45.3bn
Growth rate	9%
Contracted foreign direct investment	US$51.8bn
Growth rate	-29%
Foreign exchange reserves	US$140bn
Per capita disposable income, urban	Rmb5,140
Real growth	2.9%
Per capita disposable income, rural	Rmb2,080
Real growth	4%
Laid off workers	12m
Reemployed laid off workers	5-6m
Registered unemployed	4.5m
Growth rate of MO	15.6%
Growth rate of M1	16.5%
Growth rate of M2	17.3%
Aggregate bank deposits	Rmb8,240bn
Of which household deposits	Rmb4,630bn
Growth of aggregate deposits	18.6%
Growth of household deposits	19.3%
Aggregate loans	Rmb7,490bn
Growth of aggregate loans	16.7%
Bad loan write-offs, 1997	30bn
Bad loan provisions, 1998	50bn
Bad loan provisions, 1999 and 2000	60-70bn
Equity issues in 1996	35bn
Equity issues in 1997	120bn

* First 11 months

Sources: SSB, PBOC

- **Investment in fixed assets.** Given falling values for contracted foreign direct investment (FDI) in both 1996 and 1997, there will be a plateauing, or more likely reduction, in actual utilisation of FDI in 1998. Globally, there is a reduced supply of international capital in the wake of last year's financial crisis. A fall off in FDI necessarily impacts on fixed asset investment, as does lower individual income growth. Government has moved to counterbalance these two tendencies with the restoration of duty-free capital goods imports for many FDI projects and lower interest rates, but it is unlikely that these adjustments alone will be sufficient. Perhaps more important will be higher levels of government fixed asset investment in infrastructure, undertaken to reflate the economy. Fixed asset investment for the full year will likely be on par with, or only slightly higher, than that seen in 1997.

- **Net exports.** China posted a record merchandise trade balance in 1997, and this will be a hard act to follow. Given lower global trade growth in 1998, unfavourable currency movements relative to the renminbi and lower tariff rates, we can expect to see a reduction in the trade surplus. Indeed, Asia's currency realignment may mean China's exports post negative growth in 1998.

All in all it seems clear that the general economic environment will be less attractive this year than last. GDP growth is set to slow to around 8%, with retail price inflation rising slightly to 3% and consumer price inflation to 5%. The biggest challenges for government will be to offset weaker external demand through efforts to stimulate domestic demand, to guarantee the basic needs of increasing numbers of unemployed, to further accelerate structural reform and to confront weaknesses in the financial system, thereby avoiding any possibility of financial crisis in China.