China's Economic Outlook

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Abstract

In 1998, China's currency remained stable, but its economic growth slowed down and unemployment rose. These trends are likely to continue in 1999. The growth slowdown has been due mainly to internal problems: excess capacity in industry, banking sector stress, and low consumer confidence. Although not a major factor, lower export growth caused by the Asian financial crisis has also contributed to the economic slowdown.

China now faces difficult policy decisions: how to balance social stability and further reforms in banking sector and state-owned enterprises; and how to balance financial stability and more openness to the world.

China still has the potential to achieve relatively high economic growth in the next decade. But, the previous extremely high growth of more than 8% is unlikely to continue.

In the long run, China's currency will likely continue to appreciate, assuming China maintains modest GDP growth, continued capital influx, and a favorable trade balance. However, fluctuations in China's exchange rate could take place over the next two years, if there are adverse changes in the fundamentals or a significantly negative external shock, such as a dramatic devaluation of the Japanese yen.

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In 1998, China's currency remained stable, but economic growth slowed down and unemployment rose to a high level. In 1999, these trends seem unlikely to change. In the next decade, will China resume growth as high as that of past two decades? Or does the recent growth slowdown indicate that China will experience a long period of low growth?

The purpose of this report is to review China's economic situation in 1998, provide an outlook on 1999, and discuss major possibilities and challenges from the perspective of long-term growth during the period of 2000-2010. The report will focus on issues of economic growth and China's currency, because China will face greater challenges in promoting economic growth in the next decade and because exchange rate movement is a highly relevant issue.

1. Economic Growth Slowdown And Rising Unemployment In 1998

Overview

Since 1998, China's economy has faced great challenges, both internally and externally. In 1998, by reinforcing some exchange rate and capital controls, and enjoying a favorable trade balance and continued capital influx, China's currency – *renminbi*—remained stable. But economic growth slowed further and unemployment rose significantly.

It should be pointed out that the challenges have not arisen out of the external shocks from the Asian crisis alone, but also from internal problems. The major challenges have been: excess capacity in industry, banking sector stress, low consumer confidence, and lower export growth. The first three challenges are internal problems that make up the major causes of the growth slowdown and are more difficult to resolve than the last. The media has paid much attention to the impact of the Asian crisis on China's economy, and less attention to these important internal problems.

In 1998, GDP growth was 7.8 % (See Figure 1), one percentage point lower than that of the previous year's 8.8 %. [1] The Chinese government made many efforts to stimulate economic growth, such as increasing government spending, but the target of 8 % growth was not reached.

It should be noted that the official report of 7.8 % GDP growth is questionable. The actual growth rate is likely closer to 6 %. In 1998, the growth target became not only an economic target, but also a political concern for the new administration. Since the government leaders claimed that "the 8 % growth was guaranteed," local governments tended to overstate their economic growth. From the relationship between GDP and industrial growth in China's economy, it can be seen that the 1998 GDP growth figure is overstated. The coefficient of industrial growth to GDP growth was between 1.4 and 1.7

during the last seven years. This means that if GDP growth was at 7.8 %, industrial growth should have been at least 11 %. However, the reported industrial growth in 1998 was 8.8 %. This indicates that local governments over-reported growth in the service sector. Other authors have also made similar observations on the growth rate. [2]

Another important feature of the economy in 1998 was increasing unemployment. The unemployment rate was about 9 % (14 million) in cities, which includes about six million registered unemployed (This is the officially reported figure. "Registered unemployment" refers to the condition of never having had a formal job) and about eight million "laid-off workers (*xiagang*)" In 1998, the total number of "laid-off workers" was 12.2 million and we assume that 35% of them have been re-employed. [3] Unemployment has reached the highest level in China since 1953. The large increase in unemployment is the result of further reforms of the state-owned enterprises (SOEs) and lower growth of the GDP. Since the end of 1997, many small SOEs have been sold or taken over, and many large and medium SOEs have been transferred to stock companies. Therefore, many workers have been laid off.

Increasing unemployment has become one of the most serious issues that the government faces because it is associated with social instability. Compared with the situation in European countries in the 1980s, China's unemployment rate is not very high. But, there are some special considerations involved in the unemployment issue in China:

- There is no accumulated social security fund, either in government or in society. China has only just begun to establish a social security system, having started work on it at the end of the 1980s. This means that there are not enough funds to provide subsidies to the unemployed.
- There are ideological problems and political conflicts. China still claims that it is a socialist country, but in a socialist country there should be no unemployment and the working class should be the "leading class" in the society.
- At this time, China is a transitional society, evolving from a planned economy to a market economy, from a closed economy and society to a more open one. The transition process has led to many conflicts and uncertainties.
- The problems in China’s economy are not just business cycle phenomena, but a reflection of long-standing issues. (Section three will provide more analysis on these issues.)
- High unemployment has been concentrated in some Northern and Western cities, such as the cities in Liaoning and Sichuan provinces. Most of these cities are in low-growth and low-income regions, and the local governments have had large budget deficits and difficulty providing minimum subsidies to the unemployed.

The following other major macroeconomic indicators provide a broader view of the economy:

- Industry grew at 8.8 %, 2.3 percentage points lower than last year’s 11.1 %.

Industry is China's leading sector for economic growth and the largest sector in the economy, representing 49% of the GDP.

- Fixed investment increased 15 % in real terms, 6.7 percentage points higher than last year's 8.3 %. Higher investment growth was pushed by additional increases in government spending (50 billion *yuan*) on infrastructure since the second quarter. This increased spending reflects the major government policy for stimulating economic growth.
- Consumer sales increased by 6.8 % in real terms, 3.4 percentage points lower than last year's 10.2 %.
- The consumer price index was -0.8 % (See Figure 2), indicating deflation in the economy.
- Exports grew by 0.5 % (US$183.76 billion), 20.4 percentage points lower than last year's 20.9 %. Imports grew by 2.2 percent (US$ 140.17 billion). The trade surplus reached US$ 43.59 billion. The significant drop in exports was attributed mainly to the recessions in major trade partner countries (Japan, Korea) and other Asian countries. Also, intensified competition arising from currency devaluation in other Asian countries affected China's export growth.
- The Chinese currency (*renminbi*) remained stable and the real exchange rate—the nominal exchange rate adjusted for relative prices between domestic price and foreign price—appreciated slightly (See Figure 3). The nominal exchange rate was 8.3 *renminbi* to one U.S. dollar on December 30, 1998. It was almost unchanged from the end of 1997. Foreign reserves reached US$ 144.96 billion at the end of 1998, slightly higher than that of the end of 1997 (US$139.9 billion). This increase was attributed to the continued trade surplus and foreign capital influx. Foreign direct investment in China reached US$ 45.6 billion, a 0.7 % increase from last year (See Figure 4). [4] Given the larger trade surplus and capital influx, China's foreign reserves should be much higher, but the reserves increased by only US$5 billion, indicating that there was large capital flight from China.

Major Causes Of Growth Slowdown

The lower GDP growth was due mainly to excess capacity in industry, banking sector stress, low consumer confidence and lower export growth.

Excess capacity in industry, a new and difficult problem for the Chinese economy, harms investors' expectations and hampers industrial growth. The utilization of production capacity in many industries was less than 50% in 1995, [5] and since 1998, the situation has gotten worse. The slowdown of industrial growth can be attributed mainly to excess capacity. This overcapacity is not just a business cycle phenomenon, but will remain for many years. It appeared at the end of the 1980s and was intensified by over-investment in 1992-94. The adjustment of excess capacity will be slow, taking several years, due to the nature of the state-owned enterprises and China's underdeveloped labor and capital markets. There are no adequate mechanisms for exit, take-over and bankruptcy in China, which creates a situation that hinders the mobility of capital stocks; and the labor force is underdeveloped and also lacks mobility. It is difficult to allow an SOE to go bankrupt even if it has continued financial losses. Underdeveloped capital and labor markets, combined with poor social security systems, have caused poor mobility of capital and labor in most areas in China, except for in Guangdong and a few other provinces.

Banking sector stress decreased the growth in new loans, which led to a slowdown in the industry and service sectors. Banking sector stress is such that the danger of a banking crisis makes banks cautious about increased lending. The huge number of non-performing loans, combined with the Asian financial crisis, caused tensions in the Chinese government and the banking sector, and state banks have been required to reduce bad loans to prevent a banking crisis. This has made the banks reluctant to make new loans, and many projects with uncertain returns have been rejected. Although the central bank has reduced interest rates several times since the third quarter 1997, these monetary policies have been ineffective in stimulating economic growth. Another related problem for the banking sector is that the debt ratio of enterprises in China has been too high. It was 65% and 71% for state enterprises and collective enterprises, respectively, [6] which has meant increased risk to these lenders.

Low consumer confidence was caused mainly by negative expectations within households. The large number of laid-off workers not only directly affected purchasing power, but also greatly lowered people's expectations about their future job security and income, a mood greatly reinforced by government announcements of the state-owned enterprise reform plans and a 50% reduction in the number of government employees. Facing a highly uncertain future, people tend to save more, rather than increase consumption.

2. Outlook For 1999

It is expected that although some fundamentals will still be sound, China’s economy is unlikely to resume its previous high level of growth. Growth of the GDP is likely to continue to slow down; unemployment will further increase; the government budget deficit will go up dramatically; and the state-owned enterprise reforms and housing reforms are likely to be slow or delayed. However, government control over the economy will still be effective; the devaluation of the *renminbi* is unlikely; the trade balance will continue to be in surplus; and the influx of foreign direct investment will continue.

Economic Growth Is Likely To Slow Down Further

It is expected that China’s GDP growth will be 7 %, slightly lower than that of last year. One of the major reasons for the continued economic slowdown is that China’s export growth will face greater uncertainty in 1999. The United States is China's second largest trade partner and its economic growth is likely to slow down. This will have a negative impact on the volume of China’s exports. The recovery of Japan and other Asian economies is expected to be slow. Given the fact that exports account for 20 % of China's GDP, if exports continue to slow down, China's GDP growth will drop further.

Moreover, sluggish domestic demand is difficult to change because households' expectations will not be positive and non-state sector investment growth will continue to be slow.

Consumer sales may be slightly higher than in 1998, because housing sales are expected to increase slightly. But, overall, the slow growth of consumer sales will continue.

The growth of domestic investment is likely to remain at the level of last year. The government will increase spending on infrastructure investments by 50 billion *yuan* or more, but non-state sector investment is not expected to increase significantly. This is because the continuing excess capacity situation and the bleak outlook for exports have hurt investors' confidence. Increasing government investment will continue to be a major policy for stimulating growth, but growth will nevertheless be constrained by larger governmental debt and an increased budget deficit. Also, the experience of last year indicates that, given the consumer's negative expectations and sluggish non-state sector investment, the effects of increasing government spending on economic growth will be limited.

Unemployment Will Increase

Unemployment is likely to increase. The following factors will contribute to this increase:

- Given the fact that economic growth is likely to slow down, it is natural that unemployment will increase.
- If the government really wants to strengthen the state banking sector and reduce "policy loans" to state-owned enterprises, more SOEs will have to be closed and more workers laid off.
- If the plans for reducing the number of local government employees and "semi-government" employees are implemented, more people will lose their jobs. However, given the situation of slow growth and the pressure of increasing unemployment, the implementation of these plans carries high political risk.

China's Currency Is Less Likely To Be Devalued

Given the expectation of slow economic growth and the bleak outlook on exports, a new round of discussions about whether China will devalue its currency has arisen. But, unless the Japanese yen is dramatically devalued, the *renminbi* is unlikely to be devalued in 1999.

It is true that slow economic growth and exports are factors (or fundamentals) that tend to depreciate a currency, but China's other fundamentals remain sound. For example, the trade balance will continue to be in surplus though the amount will decrease, capital influx will continue, and inflation will be low. In view of these sound major fundamentals, there seem to be few reasons to justify a devaluation of the *renminbi.*

To analyze China's currency, one should also examine the long-term trend of real exchange rate movement. Edwards's model is a useful framework for analyzing exchange rates in developing countries. [7] He has developed an analytical framework called the equilibrium real exchange rate (ERER) to examine the determinants of the real exchange rate in the long run. The ERER states that in the short run, the real exchange rate is affected both by monetary variables and fundamentals, but in the long run, real exchange rate is mainly determined by fundamentals, such as the terms of trade, capital influx, productivity, and government expenditures.

There were two different trends in the movement of China's real exchange rate during the period of 1990-98 (See Figure 5). Continued devaluation occurred over the period of 1990-94, which contributed to subsequent reforms in exchange rate management. The currency appreciated during 1995-98, which was determined by large capital influx and other fundamentals. It can be said that the movement of the real exchange rate since 1994 is close to the equilibrium real exchange rate, because since then the unified exchange rate has been carried out.

By using Edwards's analytical framework, it can be concluded that China's currency, in the long run, is likely to continue to appreciate, assuming China maintains modest GDP growth, continued capital influx, and a favorable trade balance. [8]

High GDP growth is an important factor that has led to the appreciation of the *renminbi* since 1995. This effect will continue in the future. The Balassa-Samuelson hypothesis states that high economic growth leads to an appreciation of the real exchange rate. This hypothesis is supported by the experiences of Japan, Korea, Taiwan, and Singapore in the past three decades. As long as foreign capital continues to flow in and its magnitude does not dramatically decline, it will lead to an appreciation of China's currency under the condition of partial liberalization. It is likely that China will maintain a favorable trade balance in the next decade because China will continue to carry out export promotion policies and maintain relatively high tariffs.

Moreover, the effects of devaluation on China's exports and economic growth is marginal. The major reason for China's export slowdown has been the recession suffered by major Asian trade partners, and *not* the competition posed by the devaluation of some Asian currencies. In 1998, China's exports to the United States and Europe increased by more than 16%, while exports to Asian countries dropped by a 9.9%. Also, about 50 % of China's exports are processed, manufactured goods, so that any devaluation of the *renminbi* would increase the cost of imported intermediate goods or materials. Therefore, devaluation would also have some negative effects on China's exports.

More importantly, devaluation is highly risky and costly for China. It should be pointed out that devaluation is not always beneficial for an economy, especially for China in its current situation. The benefits of devaluation are marginal while the economic and political costs are high. For example:

- A devaluation may ignite instability in China's weak financial sector, especially in the stock markets and non-banking financial institutions. This is risky for the economy and for government leaders. The closure of Guangdong International Trust and Investment Corporation, and more expected closures, have already caused some panic among domestic and foreign bankers. A devaluation would lead to still more financial companies involved in oversea borrowings to become insolvent.
- Devaluation would cause instability in the Hong Kong dollar.
- Devaluation may have a negative impact on the confidence of foreign investors.
- Devaluation would increase trade frictions with the United States.
- Devaluation could lead to a new round of devaluation in other Asian currencies, and instability in other Asian economies. This would have negative effects on China’s economy.

Government Budget Deficit Will Increase

In 1999, the government budget deficit will undergo a large increase. Budget deficits existed throughout the period of 1981-98, (except for 1981 and 1985). In 1997, the deficit reported by the Chinese statistics (in which debt is not considered as revenue and debt payments are not included in expenditures), was 55 billion *yuan*, accounting for less than 2% of the GNP. The adjusted deficit (including debt payments) was 247 billion *yuan*, which was 3.3% of the GDP. In 1998, the deficit reported by the Chinese statistics was about 96 billion *yuan*, and the adjusted deficit was about 330 billion *yuan*, which was 4.1% of GDP (See Figure 6).

In 1999, the adjusted deficit is expected to be about 370 billion *yuan*, or 4.3% of GDP. The large increase in the deficit can be attributed to following factors:

- The government has planned an increase of at least 50 billion *yuan* on infrastructure investment.
- Subsidies to the unemployed will increase. In order to maintain social stability, the government will make efforts to provide a "minimum living subsidy" to the large number of unemployed. Since there is no accumulated social security or retirement fund in China, government subsidies will be the major income source for unemployed people.
- There will be significant increases in defense expenditures. Starting in 1999, enterprises affiliated with the army are to be separated from military organizations. These enterprises were important financial sources for China’s army before 1999. Now the government has to provide more funds to the army to compensate the losses caused by enterprise separation. Also, the Taiwan issue and the disputes in the South China Sea have underlined a need for the updating of military equipment.

- There will be further increases in administrative expenditures, especially in the salaries of government employees, which were low compared to the private sector. Low salaries are one of the reasons for the increasing corruption witnessed in recent years. By increasing the salaries of its employees, the government hopes to reduce this corruption.
- Collecting tax revenues from the non-state sector remains problematic. The dynamic non-state sector accounts for some 60% of GDP, but the greater portion of tax revenues (about 65%) is still collected from the state sector. For example, foreign-funded enterprises pay only a 15% corporate income tax (an incentive to attract foreign investment) while Chinese enterprises pay 33%. Further contributing to the problem is the practice of significant tax evasion that continues in private and collective enterprises, as well as in some foreign-funded enterprises. This is difficult to monitor because China's accounting and audit systems remain underdeveloped.

It should be noted that, compared to other countries, China's deficit of 4% of GDP is not very high, but the problem is that government debt has increased dramatically since 1990, and debt payments have increased considerably since 1995.

The government budget has been heavily financed by debt in recent years. During the period 1991-97, the annual government debt payment increased by 26.6%. In 1997, the debt payment was up to 191.6 billion *yuan*, which accounted for 22.2% of total government revenue. [9] If the government debt continues to increase at such a rate, then government deficit and debt will reach a dangerous level within a few years.

Among the implications for the increasing government deficit and debt are the possible return of inflation in the near future and the undermining of the government's ability to support weak state banks.

Implications For The U.S. Economy

China's high unemployment may slow the negotiations on China's WTO accession, since China would be more reluctant to further open its markets in view of the threat to its domestic industry and employment. Because of this, negotiations may well continue for some time to come.

Given the high unemployment and weak financial sector, it is more difficult for China to afford to offer concessions for WTO entry. For this reason, WTO entry may be not China's top priority at this time. The top priorities must be, 1) addressing the distress felt by the large number of unemployed workers, and 2) preventing financial crisis. These two issues are critical because they relate directly to China's political and social stability. Given the low efficiency of many domestic enterprises, the Chinese government believes that the further openness of the markets will lead to more unemployment. In light of the already high unemployment and the slowing of economic growth, it seems unrealistic to expect that China would want to further reduce its trade barriers and open its financial markets, acts that can only worsen these domestic concerns.

The slowing economic growth increases the pressure to devaluate China's currency, while pushing the more troubled among China's financial companies toward insolvency. There will be more closures and bankruptcies among such companies, and this situation will serve to may make China more reluctant to open its financial markets. In fact, since mid-1998, China has resumed some foreign exchange and capital controls, in an effort to prevent financial crisis and capital flight.

3. Long-Term Growth Perspective: 2000-2010

Over the next ten years, will China resume growth as high as that of the past two decades? Does the recent growth slowdown indicate that China will experience long-term low growth or stagnation?

Our estimate is that during the period 2000-2010, the Chinese economy is unlikely to maintain growth over 8%; the more likely growth rate will be in the range of 6 to 7 percent, assuming that the political situation remains stable.

During this period, some of the positive factors and trends that supported high growth in the past twenty years will still exist and continue to support economic growth. But, a growth rate as high as two digits is unlikely, because the contributions of some of these positive factors will decline. For example, the exceptionally large foreign capital influx is unsustainable, the boom in rural industry (township enterprises) is over, and the initial effects of some reforms are diminishing (such as the effects of price reforms in agricultural and industrial goods, the "household contract system" in the agricultural sector, and the "responsibility contract system" in industrial sector). More importantly, there are new and greater challenges for economic growth.

The positive factors and trends that will continue to support relatively high economic growth in China are:

- High savings and investment rates. A high savings rate will continue, partly because of the Chinese culture and tradition; partly because of the expectations of rising expenditures on education, housing and medical care in the future; and partly because of the increasing uncertainty of job security as reforms continue. It is expected that China will continue to maintain a better than 30% gross national savings rate and a similarly high investment rate in 2000-2010.
- Abundant and low cost labor supply, and the improvement of human capital. Since the mid-1990s, and compared with the 1980s, more well educated and trained professionals and workers have been available in China. This is because since 1979 China's higher education has developed rapidly and the quality of high school education in urban areas has significantly improved.
- The dynamics of the non-state sector. Private enterprises, foreign-funded companies and stock companies will continue to develop and play a more important role in the economy. For example, since 1996 more than 35% of

China's exports have been contributed by foreign-funded enterprises.

- Large domestic markets. The huge population and increasing incomes offer the potential for enormous consumer markets, with consequent advantages in terms of scope and economies of scale.
- The influx of foreign direct investment (FDI). FDI will continue to flow into China, though the absolute amount may decline. This is because China is a potentially large market and China's economic fundamentals, except for the banking sector, have been fairly sound.
- The still low level of capital stock per capita. China still has the potential to achieve relatively high economic growth, and the effect of diminishing returns will not be significant before 2010. China's per capita GDP is still low (about US$800 in 1997 by the current exchange rate), so China is still far away from a matured economy such as Japan's or the newly industrialized Asian countries. According to a World Bank estimate, China's physical capital per worker in industry was US$1,600 in 1995 and will be US$13,200 in 2020. By comparison, in 1995, the physical capital per worker in Korea was US$21,500, and in Singapore, US$62,700. [10] These data show that China's capital stock level, even by 2020, will not have reached the 1995 Korean level.

Nonetheless, there are new and greater challenges facing economic growth:

- There has been excess capacity in the industrial sector and adjustment of this will take many years. This situation not expected to diminish significantly by 2005. Excess capacity has hurt investor expectations and hampered industrial growth.
- China may find it difficult to maintain the high export growth that has been so essential for China's economic growth thus far. [11] This raises the issue as to whether China can continue to follow the export-led growth pattern in the next decade. It is likely that exports will grow about 10% annually during the period of 2000-2010. Compared with the experience of export-led growth in Japan, Korea and Taiwan during the period 1950-80, China's export growth will encounter the following challenges: There are increasing trade frictions with the United States because U.S. trade deficits with China have increased dramatically in recent years; China has difficulties in technology transfers because intellectual property rights are not well enforced in China and China has a different political regime from the industrialized countries; The innovation mechanism is weak in state-owned enterprises, which is a big barrier for upgrading its technology ladder; and there has been increasing regional protectionism in the world trade.

  To maintain high export growth, China needs to upgrade its products and move up to higher technology ladders. There is limited room for further increases in exporting low-end and cheap textile goods and electronics. Also, China needs to have good international relations with its major trade partners.
- State-owned enterprises (SOEs) are still generally inefficient, and the reform

of these enterprises will be a long process. Quick, radical reform is unlikely because of the risk of social instability resulting from greater unemployment. The SOE reforms will be gradual, and will proceed at a rate dependent on the smooth reform process in related areas—social security, the labor market, the capital market, housing, government-business separation, and the legal system.

- Economic growth may be affected by financial sector risk. The banking sector is poorly managed and not well regulated (for example, more than 20% of loans in the state commercial banks are classified as bad loans). The young stock markets are in the same situation. The situation of the non-banking financial institutions is even worse than the banking sector. Thus, financial instability is highly likely to occur in China.
- High unemployment is likely to remain during this period. As the state-owned enterprise reforms and staff reduction in government and semi-governmental organizations continue, unemployment will increase further. It should be noted that unemployment in China will be a long-term problem: China is an over-populated country with 1.2 billion people; there are about 10 million new entrants into the labor force annually because China's population increases by about 13 million each year; as the state enterprise reform continues, a majority of the current 20 million redundant workers will become unemployed; there are 130 million surplus workers in the rural areas. As more rural people become educated and information is more accessible and the restrictions on moving to cities are relatively relaxed, more rural labor will move to cities to find better jobs and higher incomes. This trend will make the "disguised unemployment" in the agricultural sector ease, while intensifying the unemployment problem in cities.

To sum up, the above analysis shows that China still has the potential to achieve relatively high economic growth in the next decade, compared with mature economies. But, extremely high growth is unlikely to continue.

4. Conclusions

Compared with other Asian economies, China's macroeconomy has been sound. However, China's economic growth has been slowing down and unemployment has been increasing. These trends are likely to continue for some years. The slowdown has been due mainly to internal problems. Industrial growth has been hampered by excess capacity which in turn has dampened investor expectations. Banking sector stress has limited the increase in new loans. Increasing unemployment caused by state-owned enterprise reforms, as well as negative expectations for future job security, have resulted in a significant decrease in the growth of consumer sales. Although not a major factor, lower export growth caused by the Asian financial crisis has also contributed to the economic slowdown.

China now faces difficult policy decisions: how to balance social stability and further reforms in banking sector and state-owned enterprises; and how to balance financial stability and more openness to the world.

China, however, still has the potential to achieve relatively high economic growth in the next decade, compared to the mature economies. But, extremely high growth of more than 8% is unlikely to continue. If the political situation is stable and China makes progress in adjusting its industrial sector, strengthening the banking sector, reforming state-owned enterprises and upgrading its technology, the economy is likely to reach modest annual growth of about 7 percent in the next decade.

In the long run, China’s currency is likely to continue to appreciate, assuming China maintains a modest GDP growth, continued capital influx and a favorable trade balance.

In 1998, the *renminbi* remained stable. In 1999, it is unlikely that the currency will be devalued, because of the relative soundness of the major fundamentals, and because devaluation would bring high economic and political costs. However, fluctuations in China's exchange rate could take place in the next two years, if there are adverse changes in the fundamentals or if a significantly negative external shock occurs, such as a dramatic devaluation of the Japanese yen.

Notes

1. These and the following data are from the China Statistical Bureau. See *People's Daily*, December 31, 1998; January 11, 1999; January 28, 1999: *China Statistical Yearbook* 1994, 1998.

2. See *Economist*, "Chinese statistics: through a glass, darkly." January 9, 1999.

3. See He Jing Song, "Reemployment Target Basically Reached Last Year." *People's Daily*, January 22, 1999.

4. See *People's Daily*, January 13 and 30, 1999.

5. Source: *China Statistical Yearbook 1997*.

6. See Guoqing Song, "China s Macroeconomy: Debt and Inflation." WWW.cei.gov.cn/economy/forum, August 4, 1998.

7. Sebastian Edwards, "Real and Monetary Determinants of Real Exchange Rate Behavior: Theory and Evidence from Developing Countries." In John Williamson ed. *Estimating Equilibrium Exchange Rates*. Washington DC: Institute for International Economics, 1994. pp. 61-91.

8. See Renhong Wu, "Capital influx and exchange rate movement in China," paper presented at the international conference of the Chinese Economists Society on China’s state enterprise reform in Baltimore, USA, August 14-16, 1998.

9. Source: *China Statistical Yearbook 1998*.

10. World Bank, *China Engaged: Integration with the Global Economy*. The World Bank, 1997. p.34-35.

11. See Dwight Perkins, "China’s future: economic and social development scenarios for the twenty-first century." In OECD, *China in the 21st century*. OECD, 1996. pp. 22-23.

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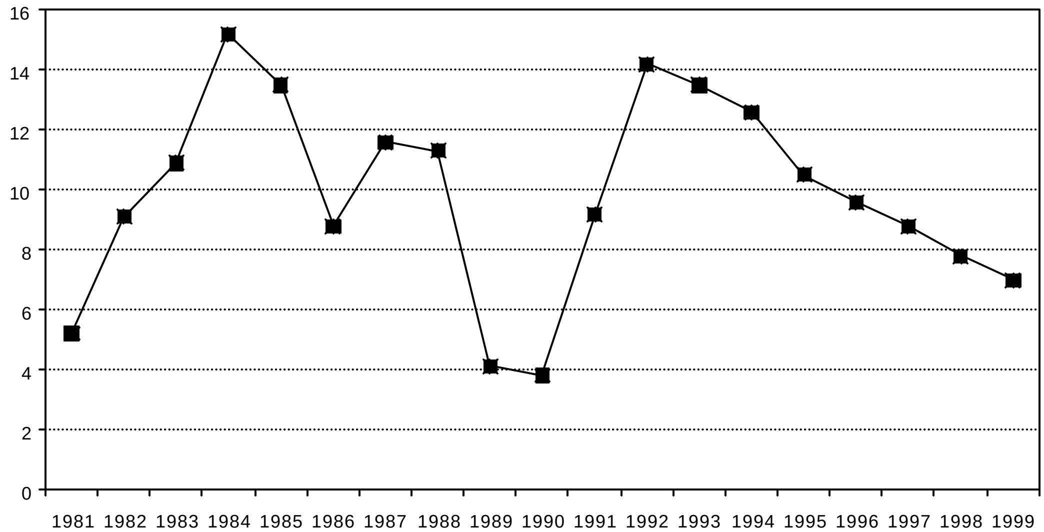
Figure 1

China's GDP Growth 1981-99

Annual Growth Rate, %

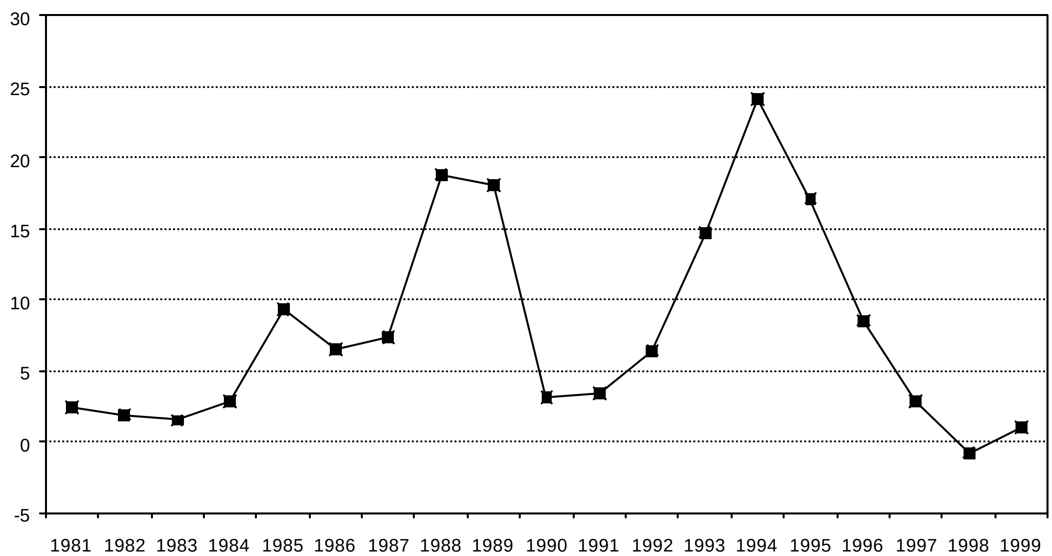


Sources: China Statistical Yearbook 1997, 1998; People's Daily, December 31, 1998; January 11,1999

Figure 2

China's Inflation 1981-99

CPI, Annual Change, %



Sources: China Statistical Yearbook 1997, 1998; People's Daily, December 31, 1998; January 11,1999

Figure 3

China's Exchange Rates 1981-98

Year	Real Exchange Rate	Nominal Exchange Rate	China's CPI	U.S. CPI
1978	1.5765	1.6836		
1979	1.4235	1.555		
1980	1.3995	1.4984		
1981	1.5824	1.7045	102.4	110.30
1982	1.8162	1.8925	101.9	106.18
1983	1.9448	1.9757	101.5	103.11
1984	2.2860	2.32	102.8	104.33
1985	3.0968	2.9367	109.3	103.65
1986	3.6115	3.4528	106.5	101.82
1987	3.8515	3.7221	107.3	103.69
1988	4.2508	3.7221	118.8	104.02
1989	4.2368	3.7651	118	104.86
1990	4.6802	4.7832	103.1	105.37
1991	5.2825	5.3234	103.4	104.2
1992	5.6928	5.5146	106.4	103.07
1993	6.4165	5.762	114.7	103
1994	10.4319	8.6187	124.1	102.53
1995	9.5113	8.3514	117.1	102.82
1996	8.7488	8.3142	108.3	102.92
1997	8.3206	8.2898	103.5	102.24
1998	8.0814	8.2793	99.2	101.63

Notes:

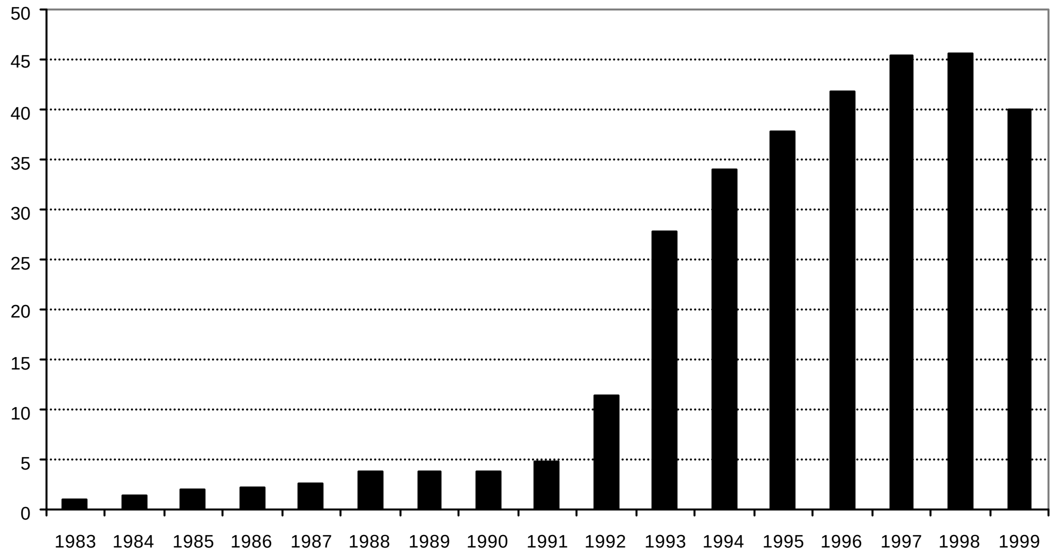
The real exchange rate is the nominal exchange rate (E) adjusted for relative prices between domestic price (P) and foreign price (P*). Real exchange rate = (E*P)/P*

Source: IMF: International Financial Statistics Yearbook 1997; February 1999.

Figure 4

Foreign Direct Investment in China 1983-99

Billion US$

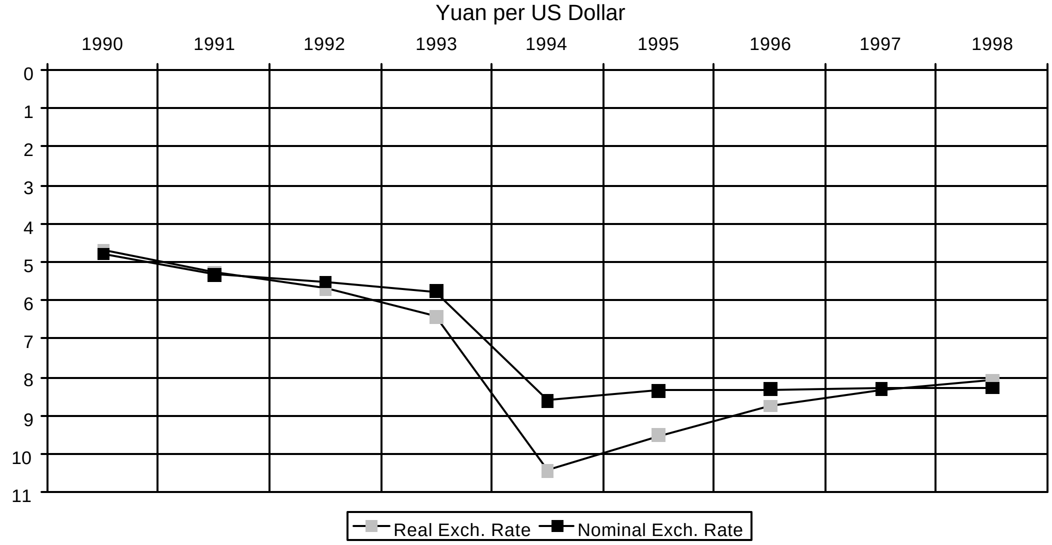


Sources: China Statistical Yearbook 1997, 1998; People's Daily, December 31, 1998; January 11,1999

Figure 5

China's Exchange Rate 1990-98

Yuan per US Dollar

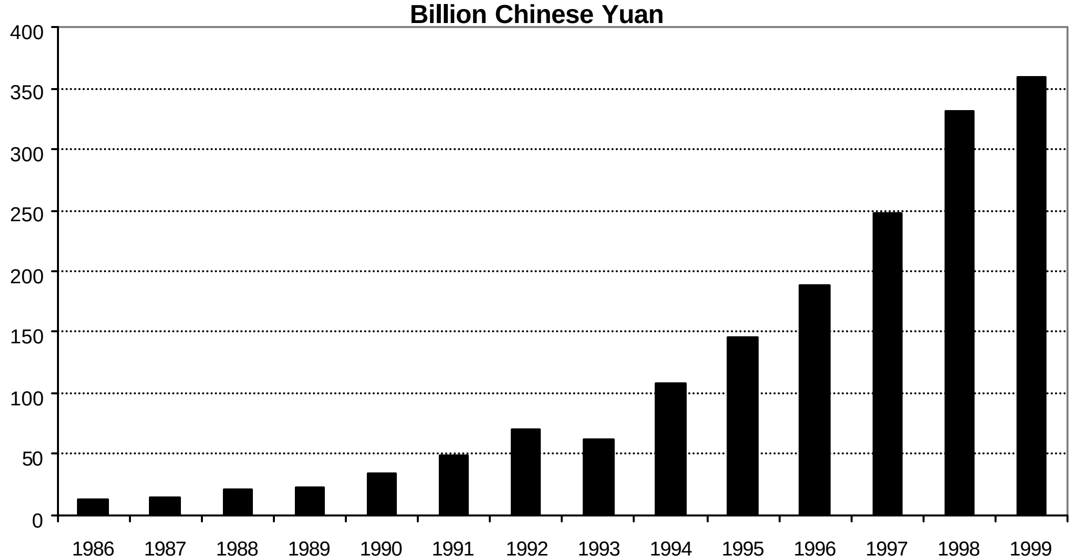


Notes: The real exchange rate is the nominal exchange rate(E) adjusted for relative prices between domestic price (P) and foreign price (P*). Real exchange rate = (E*P)/P*
Source: IMF: International Financial Statistics, February 1999

Figure 6

China's Budget Deficit 1986-99

Billion Chinese Yuan



Sources: China Statistical Yearbook 1995, 1997, 1998; A Statistical Survey of China 1998;
China Daily, March 7, 1998; People's Daily, September 1, 1998; December 31, 1998