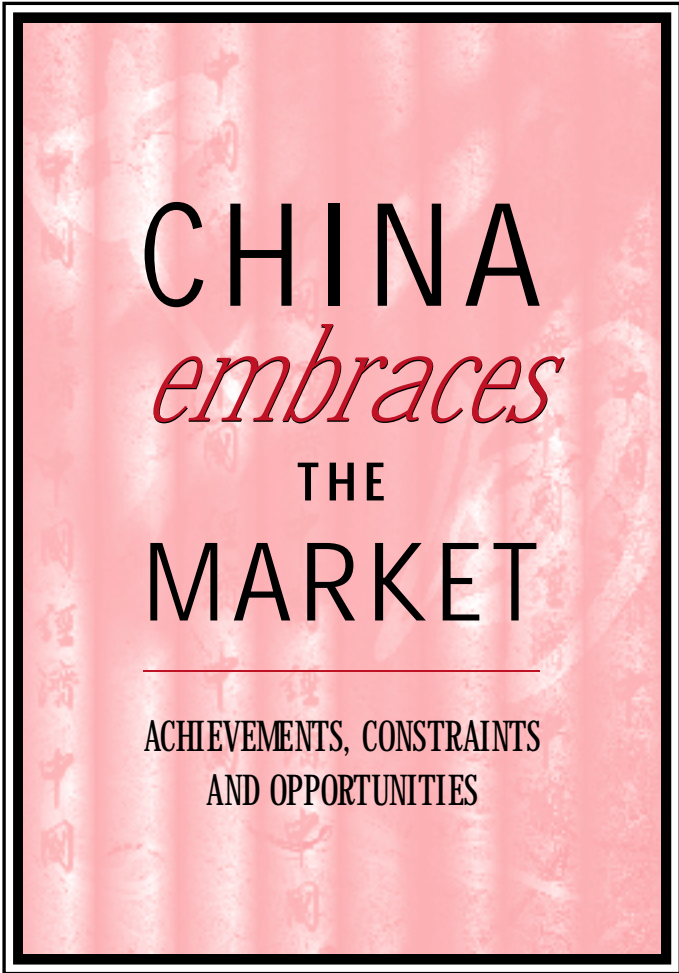


CHINA
embraces
THE
MARKET

ACHIEVEMENTS, CONSTRAINTS
AND OPPORTUNITIES





DEPARTMENT OF FOREIGN AFFAIRS AND TRADE



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The East Asia Analytical Unit was established in 1990 as the main agency within the Australian Government responsible for publishing analyses of major economic and political issues in Asia.

Located within the Department of Foreign Affairs and Trade, the Unit has to date undertaken and commissioned 15 studies on a range of topics related to Australia's trade policy interests in the region.

Staffed with 10 professionals, the EAAU also contracts a range of consultants with specific areas of expertise. It draws on a wide range of data and information sources, including reports from Australia's diplomatic and trade missions in Asia.

Reports and working papers produced by the Unit are intended to assist analysts and decision-makers in business, the Australian Government and the academic community.

Executive summaries of the Unit's reports can now be downloaded from the Internet. See access details below.

Contact details:

East Asia Analytical Unit
Department of Foreign Affairs and Trade
R. G. Casey Building
Barton
Australia 0221

Head of the Unit:
Dr Frances Perkins

Directors:
Phillip Stonehouse
Andrea Spear

Telephone: 61 6 261 3057

Facsimile: 61 6 261 3493

Internet access code: [.http://www.dfat.gov.au/dfat/dept/eaau/eaauhome.html](http://www.dfat.gov.au/dfat/dept/eaau/eaauhome.html).

CONTENTS

| | |
|---|----------|
| Executive Summary | 1 |
| China Embraces the Market | 1 |
| The Dynamic Chinese Economy | 1 |
| Sources of Economic Growth | 2 |
| Political Environment | 2 |
| Strengthening Market Institutions | 3 |
| Macroeconomic Policy Developments | 3 |
| Rapid Growth in International Trade | 4 |
| Healthy Growth in Australia-China Trade | 5 |
| Reform of the Trade Regime | 5 |
| Foreign Exchange Regime | 5 |
| China's WTO Entry | 6 |
| Foreign Investment and the Internationalisation of the Economy | 6 |
| Infrastructure Constraints and Environmental Management | 7 |
| Growth and Disparities in China's Regions | 8 |
| Major Decisions Confront Agriculture | 9 |
| The Ailing SOEs | 9 |
| The Dynamic Non-State Sector | 10 |
| Labour Markets and Migration | 11 |
| Implications for Australia | 11 |

A. SETTING THE SCENE

| | | |
|------------------|--|-----------|
| Chapter 1 | Achievements, Constraints and Prospects: Overview of the Economic Reforms | 13 |
| | The Report's Structure | 13 |
| | Wasted Decades — Economic Policies Pre 1978 | 15 |
| | <i>The Failure of Central Planning</i> | 16 |
| | <i>Mao's Great Leap Forward and Cultural Revolution</i> | 18 |
| | <i>Consequences of Central Planning</i> | 19 |
| | Economic Reforms Post 1978 | 20 |
| | <i>Reform of Agriculture</i> | 20 |
| | <i>The Dramatic Growth of Rural Enterprises</i> | 21 |
| | <i>Opening the Economy to Foreign Trade and Investment</i> | 21 |
| | <i>Lack of Progress in the SOEs</i> | 22 |
| | Achievements of the Reforms | 23 |

| | | |
|---|---|-----------|
| Major Structural Changes | 24 | |
| <i>Output</i> | 24 | |
| <i>Employment</i> | 27 | |
| Sources of Economic Growth | 30 | |
| <i>Savings and Investment</i> | 30 | |
| <i>Structure of Investment</i> | 31 | |
| Public Finance | 34 | |
| Prices and Inflation | 36 | |
| <i>Macroeconomic Management and Stop-Go Cycles</i> | 37 | |
| Foreign Trade | 38 | |
| Foreign Investment | 40 | |
| External Debt and Service Ratio | 41 | |
| Measuring China's Economic Performance | 44 | |
| China's Economic Growth Prospects and Implications for Australia | 49 | |
| Appendix 1.1 Various estimates of Chinese GDP | 53 | |
| References | 58 | |
| Chapter 2 | The Political Environment | 61 |
| | Political Background | 61 |
| | Political Change and the Economy | 62 |
| | Prospects for the Government and the Party | 63 |
| | Law and Order | 64 |
| | Political Implications of Economic and Social Change | 64 |
| | Taiwan | 65 |
| | China in the Region | 66 |
| | China's Political Prospects | 67 |
| | Appendix 2.1 The Policy-Making Environment | 69 |
| | References | 73 |
| Chapter 3 | The Market Environment | 75 |
| | China Embraces the Market | 75 |
| | <i>Sequence of Price Reforms</i> | 75 |
| | <i>Prospects for Further Reforms</i> | 77 |
| | <i>A Maturing Internal Market</i> | 78 |
| | Evolving Regulatory Environment | 82 |
| | <i>A Nascent Rule of Law</i> | 82 |
| | <i>Evolution of Commercial Law</i> | 84 |
| | <i>Regulatory Reform</i> | 88 |
| | <i>Prospects for Continued Reform and Transparency</i> | 91 |
| | Transforming the Bureaucracy | 91 |
| | <i>Recent Developments</i> | 92 |
| | <i>Who Makes the Rules?</i> | 92 |

| | |
|--|-----|
| <i>Corruption</i> | 93 |
| <i>Foreign Investors and the Bureaucracy</i> | 94 |
| Prospects for China's Business Environment | 96 |
| Appendix 3.1 Doing Business in China: Contacts and Resources | 97 |
| <i>Austrade</i> | 97 |
| <i>China-Related Business Organisations</i> | 98 |
| References | 99 |
| <i>Other Useful Publications</i> | 100 |

B. BROAD ECONOMIC POLICY ENVIRONMENT

| | | |
|------------------|---|------------|
| Chapter 4 | Macroeconomic Management | 103 |
| | Monetary Tools to Stabilise the Economy | 104 |
| | Structural Changes Affect Macroeconomic Performance | 105 |
| | Reform of The Fiscal Regime | 109 |
| | <i>Reforms to the Taxation System</i> | 109 |
| | <i>Reforms to the Government Expenditure System</i> | 110 |
| | <i>Consequences of Fiscal Reforms</i> | 111 |
| | Monetary Policy and Financial System Reform | 113 |
| | <i>PBOC as an Independent Central Bank</i> | 116 |
| | <i>Impact of Banking System Reforms</i> | 116 |
| | <i>Interest Rate Policy</i> | 118 |
| | <i>Development of Financial Markets</i> | 123 |
| | Foreign Exchange Regime Reforms | 123 |
| | Constraints on Future Macroeconomic Management Reform | 126 |
| | <i>Lack of Development of the Financial Sector</i> | 126 |
| | <i>State Banking System</i> | 126 |
| | <i>Loss-Making SOEs</i> | 127 |
| | Ongoing and Future Macroeconomic Reforms | 128 |
| | <i>Implications of the 1995-96 'Soft Landing'</i> | 128 |
| | <i>Outlook and Future Reforms</i> | 129 |
| | Appendix 4.1 Achieving the 'Soft Landing' in 1995-96 | 131 |
| | References | 132 |
| Chapter 5 | International trade | 137 |
| | Evolution of the Trade Regime | 137 |
| | <i>Decentralisation of the Trade Regime</i> | 138 |
| | <i>Foreign Exchange Reform</i> | 138 |
| | China's Dual Trade Regime | 140 |
| | <i>Successful Export Facilitation Regime</i> | 140 |

| | | |
|------------------|--|------------|
| | <i>Restrictive Formal Import Regime</i> | 141 |
| | China's Changing Trade Structure | 146 |
| | <i>Export Structure</i> | 146 |
| | <i>Import Structure</i> | 147 |
| | <i>Services Trade</i> | 148 |
| | <i>Direction of Trade</i> | 152 |
| | Australia–China Bilateral Trade | 153 |
| | <i>Australia's Exports to China</i> | 154 |
| | <i>China - A Product Processing Base</i> | 155 |
| | <i>Australia's Imports from China</i> | 157 |
| | <i>Australia–China Trade in Services</i> | 159 |
| | <i>Australia's Export Performance</i> | 160 |
| | <i>Prospects for Australia's Exports to China</i> | 162 |
| | China's Trade Diplomacy | 163 |
| | <i>International Environment for China's Exports</i> | 163 |
| | <i>China and the World Trade Organisation</i> | 164 |
| | <i>Prospects for WTO Accession</i> | 167 |
| | <i>Regional Trade Diplomacy: The Role of APEC</i> | 169 |
| | Appendix 5.1 Analysis of Australia-China Trade | 172 |
| | References | 176 |
| Chapter 6 | Foreign Investment and Internationalisation | 179 |
| | Foreign Investors: A key Tool for Development | 179 |
| | <i>Evolving Role</i> | 180 |
| | Will Double Digit FDI Growth Continue? | 182 |
| | <i>Scope for Further Growth</i> | 184 |
| | Asia Main Source of Investment | 184 |
| | The Australia-China Connection | 185 |
| | <i>Great Expectations</i> | 188 |
| | Where Investors Are Going and What They Are Doing | 190 |
| | Organisational Forms | 194 |
| | Key Success Factors | 195 |
| | What the Chinese Value in Foreign Investors | 196 |
| | What the Chinese Do Not Value | 197 |
| | Foreign Investment Policy | 198 |
| | <i>Transparency</i> | 201 |
| | <i>National Treatment</i> | 201 |
| | <i>Sectoral Restrictions</i> | 202 |
| | <i>Dispute Resolution</i> | 204 |
| | <i>Risk Management</i> | 204 |
| | Investment Liberalisation Challenges and Prospects | 206 |
| | Appendix 6.1 Lessons from Australian Investors in China | 208 |
| | Appendix 6.2 Contracted FDI Inflows by Sector | 217 |

| | |
|---|-----|
| Appendix 6.3 Chinese Investment Abroad | 218 |
| Appendix 6.4 Austrade Assistance to Investors in China | 221 |
| References | 222 |
| <i>Further Reading</i> | 223 |

C. MICROECONOMIC REFORM AND SECTORAL ISSUES

| | | |
|------------------|---|------------|
| Chapter 7 | Infrastructure and Environmental Management | 225 |
| | Infrastructure Development | 225 |
| | The Magnitude of Infrastructure Shortfalls | 228 |
| | <i>Rail</i> | 228 |
| | <i>Roads</i> | 228 |
| | <i>Waterways and Ports</i> | 229 |
| | <i>Civil Aviation</i> | 229 |
| | <i>Power</i> | 230 |
| | <i>Telecommunications</i> | 230 |
| | The Causes of Infrastructure Constraints | 230 |
| | <i>Diminished Central Government Financial Power</i> | 231 |
| | <i>Price Reform and Triangular Debt</i> | 231 |
| | <i>Divided Authority</i> | 231 |
| | <i>Stop-Go Cycles and Priorities</i> | 233 |
| | <i>Inefficient Allocation of Resources</i> | 233 |
| | <i>Ambivalence Toward Foreign Investment</i> | 234 |
| | <i>Foreign Investment Interest: Cool to Hot?</i> | 234 |
| | <i>Shortages of Related Infrastructure</i> | 236 |
| | Infrastructure Planning | 236 |
| | <i>Will the Plan Be Achieved?</i> | 236 |
| | Infrastructure Financing | 240 |
| | Foreign Private Sector Participation in Infrastructure Development | 240 |
| | <i>Strategies for Australian Companies</i> | 242 |
| | Energy Efficiency | 243 |
| | Pollution and Environmental Degradation | 244 |
| | <i>Coal</i> | 245 |
| | Environmental Policy and Reforms | 246 |
| | <i>Water Pollution Control</i> | 247 |
| | <i>Enforcement Is a Challenge</i> | 248 |
| | Opportunities for Australian Companies in Environment Projects | 250 |

| | | |
|------------------|--|------------|
| | Infinite Challenges, But Interesting Opportunities for the Astute | 252 |
| | References | 254 |
| Chapter 8 | China's Regions — Disparities and Prospects | 257 |
| | The Growth of Regional Disparities | 257 |
| | Natural Economic Regional Groupings — Coastal, Central and Western | 259 |
| | Divergence of Regional Income Growth | 261 |
| | Divergence of Industrial Growth Rates | 262 |
| | Growing Divergence of Retail Sales | 263 |
| | Causes of Regional Divergence | 265 |
| | <i>Disparities in New Investment</i> | 265 |
| | <i>Divergence in Growth of Township and Village Enterprises</i> | 267 |
| | <i>Decentralisation of the Trade Regime and Export Growth</i> | 269 |
| | <i>The Concentration of Foreign Investment in the Coastal Region</i> | 270 |
| | <i>Divergence of Regional Productivity and Cost Efficiency</i> | 271 |
| | <i>Fiscal Burdens of the Regions</i> | 272 |
| | <i>Differences in Regional Economic Policies</i> | 273 |
| | <i>Conclusions about the Causes of Regional Growth Disparities</i> | 274 |
| | Three Growth Centres in the Coastal Region | 274 |
| | <i>Pearl River Delta</i> | 276 |
| | <i>Yangtze River Delta</i> | 279 |
| | <i>The Bohai Ring</i> | 283 |
| | Government's Regional Policies | 285 |
| | Commercial Prospects in China's Regions | 287 |
| | <i>1996 to 2000: Short Term Trends for Key Areas</i> | 287 |
| | <i>2001 to 2010: Longer Term Growth Projections for Key Areas</i> | 288 |
| | <i>Prospects for Australian Companies in Regional China</i> | 289 |
| | Conclusions | 291 |
| | Appendix 8.1 Investment in China | 292 |
| | References | 296 |
| Chapter 9 | Agricultural Reform | 299 |
| | Market-Oriented Agricultural Reform | 300 |
| | <i>Production and Management Reforms</i> | 300 |
| | <i>Reforms of Price and Marketing Systems</i> | 301 |
| | Impact of Agricultural Reform | 305 |

| | |
|--|------------|
| Self-Sufficiency or Efficiency? | 308 |
| Key Agricultural Interest Groups | 309 |
| <i>The Farmers</i> | 309 |
| <i>Protected Urban Consumers</i> | 310 |
| <i>Grain Surplus and Deficit Provinces</i> | 311 |
| <i>The State Owned Grain Bureaux</i> | 313 |
| Trade Implications of Food Supply and Demand | 314 |
| <i>Factors Affecting Food Supply</i> | 314 |
| <i>Factors Affecting Demand for Food</i> | 317 |
| <i>Implications for Food Trade</i> | 320 |
| <i>Alternative Agricultural Trade Policies</i> | 322 |
| Opportunities in China's Agribusiness | 322 |
| New Developments and Prospects | 325 |
| References | 327 |
| <i>Further Reading</i> | 330 |
| Chapter 10 State-Owned Enterprises | 331 |
| Importance of SOE Reform | 332 |
| 'Grasping the Big and Enlivening the Small' | 333 |
| <i>Implications for Australian Business</i> | 334 |
| <i>'Grasping the Big' — Implications for Competitors</i> | 336 |
| <i>Large and Small SOEs as Joint Venture Partners?</i> | 337 |
| Role and Performance of the State Sector | 338 |
| <i>The Industrial SOEs</i> | 339 |
| SOE Inefficiency — Sources and Solutions | 341 |
| <i>Ambiguous Property Rights</i> | 342 |
| <i>Inappropriate Enterprise Incentives — Subsidies</i> | |
| <i>and Rare Enforcement of Bankruptcy</i> | 342 |
| <i>Barriers to Entry in Some Sectors</i> | 344 |
| <i>Inappropriate Managerial Incentives</i> | 345 |
| <i>Workers' Incentives</i> | 346 |
| <i>Generous Worker Welfare and Social Services</i> | 347 |
| <i>Redundant Labour</i> | 349 |
| <i>Government Interference</i> | 349 |
| Implications for Future Reforms | 351 |
| Appendix 10.1 Data on the Industrial Sector | 352 |
| References | 353 |
| Chapter 11 The Non-State Sector | 355 |
| Contribution of the NSS | 356 |
| NSS Development Trends by Region | 362 |
| Major Issues for the NSS | 365 |
| <i>Management Control</i> | 365 |
| <i>Access to State Bank Loans</i> | 366 |

| | | |
|-------------------|--|------------|
| | <i>Taxation</i> | 367 |
| | <i>Technology</i> | 368 |
| | <i>Labour</i> | 369 |
| | <i>Supply of Inputs</i> | 370 |
| | <i>Transport and Power Infrastructure</i> | 370 |
| | <i>Marketing</i> | 370 |
| | Opportunities for Australian Companies in the NSS | 371 |
| | Appendix 11.1 Distribution of NSS | 374 |
| | References | 382 |
| Chapter 12 | Labour Market Reform | 383 |
| | Economic Reform and Rural Labour Markets | 384 |
| | Urban Labour Market Reform | 385 |
| | SOE Overstaffing and Redundancies | 388 |
| | Social Security System Reform | 389 |
| | <i>Unemployment Benefits</i> | 390 |
| | <i>Housing</i> | 391 |
| | <i>Medical Care</i> | 391 |
| | <i>Superannuation</i> | 392 |
| | <i>Is Social Security Reform Heading in the Right Direction?</i> | 393 |
| | Rural–Urban Migration | 393 |
| | <i>Impact on Labour Costs</i> | 394 |
| | <i>Contribution of Migration to Rural Development</i> | 396 |
| | <i>Two-Tier Urban Labour Market</i> | 397 |
| | Employment and Unemployment | 398 |
| | Labour Cost Comparisons | 400 |
| | <i>Labour Cost Changes in the Reform Period</i> | 400 |
| | <i>Regional Wage Differentials</i> | 401 |
| | <i>International Labour Cost Comparisons</i> | 401 |
| | Future Reform Priorities | 403 |
| | References | 405 |
| | <i>Further Reading</i> | 407 |
| Chapter 13 | Implications for Australia | 409 |
| | Implications for Australian Business | 410 |
| | Implications for Government | 412 |
| | <i>Trade Relations</i> | 412 |
| | <i>Investment Relations</i> | 413 |
| | <i>Economic Cooperation</i> | 414 |

| | |
|---------------------------------------|-----|
| Abbreviations | 417 |
| Glossary | 419 |
| Index | 425 |
| Also by the East Asia Analytical Unit | 429 |

EXECUTIVE SUMMARY

CHINA EMBRACES THE MARKET

Since economic reforms began in 1978, China's economy has undergone radical structural change. The reforms have been bold: freeing up prices, abolishing virtually all production and trade planning, effectively privatising agriculture and allowing the non-state sector to now produce over two thirds of industrial output. But the economy is still only about half way in its transition from a centrally planned to a market economy. Difficult reforms are still on-going, in particular developing the legal, administrative and regulatory framework which supports a modern economy. This process will take at least a decade and probably longer. Until complete, China will be a challenging and sometimes complex environment in which to do business, for both local and foreign enterprises. Even so, the internationalisation of the economy has been remarkable, with the ratio of trade to Gross National Product growing from 10 per cent in 1978 to 36 per cent in 1996. China's increasing inter-dependence with the world's trade and investment systems is perhaps the most striking phenomenon of China's recent development. As a consequence, China is an active participant in all multilateral financial institutions and regional forums such as APEC.

THE DYNAMIC CHINESE ECONOMY

If as is expected, the present direction and momentum of policy reforms are maintained, China's output by around 2020 will exceed the USA's. Even so, China's per capita income still will be that of a middle income, developing country. Due to greatly improved economic policies and relative political stability, China's economy has maintained real average annual growth of about 8 per cent since 1978, making it one of the fastest growing economies in the world over this period. Despite continuous population growth, real per capita GDP increased 250 per cent between 1978 and 1994, or 6 per cent per year. On these facts alone many Australian firms will wish to trade and invest in China, even before the business environment becomes more predictable.

Economic historians estimate that China's economy was the largest in the world until the late 19th century. By 1949, it had been overtaken by the USA, UK and USSR. In 1997, its economy is again second only to the USA's, when measured in terms of domestic purchasing power. If the USA maintains its growth at 3 per cent, its average over the last 15 to 20 years, and China grows at 7 per cent per year, slightly less than its post 1978 average, China's total domestic purchasing power will overtake that of the USA by 2020.¹

.....

¹ Assuming China's 1996 purchasing power was US\$2 000 per capita.

On the other hand, China's per capita income is still very low. The World Bank estimates that 350 million people still live below the poverty level (\$1 per day). Labour productivity is among one of the lowest in the world, only slightly ahead of India's, and only 10 per cent of the USA's. This indicates both the economy's enormous development needs and its growth potential, if it applies modern technologies in agriculture, industry and services. It also indicates the vast scope for growth as China closes this productivity gap with the more developed economies. All these factors will produce immense trade and investment opportunities, as well as a need for significant capital flows into China.

The inevitable tensions between the immense economic opportunities in China and the constraints on development, including infrastructure and skilled labour shortages, and the difficulty of doing business while legal and institutional frameworks are still developing, form a major theme of this report and the implications it draws.

SOURCES OF ECONOMIC GROWTH

Since 1978 economic growth has been driven by the more efficient allocation of resources in most sectors of the economy as central planning has been replaced by a more market oriented approach in which international trade and investment have been significant. The high savings rate, high investment levels and rapid expansion of the urban labour force provide the necessary supplies of capital and labour to underpin this growth. The long term sustainability of economic growth will depend on continuing success in macro- and microeconomic reforms, accelerating structural change within agriculture and industry, and further integration into the world economy.

POLITICAL ENVIRONMENT

While the post-Deng era may see the emergence of leadership rivalries, there is likely to be broad commitment to continued economic reform and continued integration into the world economy. Economic reform has delivered strong growth and tangible benefits. The leadership also recognises that the economy needs to maintain relatively rapid growth to avoid widespread unemployment and possible social disruption.

Compared with the prospects for the economy, which appear to be moving in a reasonably predictable direction, future political structures are more difficult to judge. Political and institutional structures at lower levels of government are becoming more prominent with the reallocation of resources under China's dual taxation and revenue distribution systems. While leadership challenges in the post-Deng era could affect political structures, authority will reside with the Communist Party. As in other countries, individuals and institutions will continue to seek to increase their authority, but the collective leadership now in place is likely to be maintained and to guide the transition to a 'socialist market economy'.

STRENGTHENING MARKET INSTITUTIONS

Market-based transactions now dominate the Chinese economy, with over 90 per cent of retail prices and 80 per cent of producer and agricultural prices determined by the market. Competition has intensified considerably in internal markets, rapidly reducing the level and divergence of profit rates between industries and provinces. The Government has also progressed considerably in developing the necessary legal and regulatory infrastructure, introducing many of the basic commercial laws and regulations essential in a modern market economy.

However, building such institutions and training the people to operate them are massive tasks. Consequently, many problems remain regarding the implementation of regulations and enforcement of laws. Individuals and firms can face difficulties in obtaining legal redress. Although a private legal profession is rapidly emerging, much of the judiciary is still poorly trained and in some cases, insufficiently independent. The protection of intellectual property rights also remains a problem for many foreign investors as well as local inventors.

Administrative reform, which is also crucial to sustaining the economic reform program, has gathered momentum since the early 1990s. Reforms have attempted to resolve conflicts of law, tackle official corruption and provide reviews of administrative decision-making. However, both foreign investors and local residents still encounter problems in obtaining efficient and impartial administrative decisions. These types of problem will probably take at least a generation to resolve, as younger, better educated, and eventually better paid, administrators assume positions of authority. Encouragingly, this change-over is already starting in the central Government and more advanced provincial ministries.

MACROECONOMIC POLICY DEVELOPMENTS

In the past two to three years, the pace of reform in macroeconomic management has increased. The central Government is moving steadily from direct intervention and quantitative controls over the macroeconomy to greater reliance on the indirect fiscal and monetary policy instruments used in market economies. The central Government's direct control over the economy via output planning and price fixing virtually disappeared with economic reform. Furthermore, its fiscal authority declined when it decentralised fiscal powers to the provinces in the 1980s. Consequently, the central Government was increasingly forced to rely on direct controls over bank lending via the credit plan, to influence overall growth and inflation. However, after the major reforms flagged by the Third Plenum of the Party's Fourteenth Central Committee in 1994, the pace of macroeconomic management reform accelerated. The Government now employs monetary instruments such as bond issues to finance the budget deficit; open market operations and reserve deposit requirements to manage excess bank liquidity; and flexible interest rates in the interbank credit market to provide for a more market driven interest rate structure. Recently, monetary authorities successfully engineered a 'soft landing' moderating growth and reducing inflation from the unsustainable levels of 1993 and 1994. In 1996, inflation was reduced to 6 per cent and real growth was just under 10 per cent. These results were achieved by the use

of monetary instruments, credit allocation controls over state investment and administrative controls over some prices. Previously, authorities only succeeded in reducing inflation by severe contractions of credit and growth.

Lack of progress in solving the problems of the ailing state owned enterprises, SOEs, constrains faster macroeconomic management reform and limits efficiency gains. The central Government is unwilling to relinquish control over interest rates to a fully independent People's Bank of China, mainly because of concern about the negative impact of higher interest rates on marginally viable SOEs. In any case, higher interest rates would not necessarily restrain SOEs' demand for credit. Many enterprises are not yet forced to accept responsibility for their borrowing decisions, although this is changing and more enterprises are now forced into bankruptcy. Until interest rates can be used to control demand for credit and the banks can determine lending on a wholly commercial basis, the monetary authorities will retain some quantitative credit controls to achieve monetary targets and to control inflation. Slow SOE reform is also impeding banking system reform. The state banks cannot operate on a fully commercial basis until methods are found to reduce and eventually eliminate their massive backlog of non-performing loans. Bad debts are mounting as more SOEs suffer losses and this situation will not improve until different levels of government take firmer action to force the pace of SOE reform.

Further strengthening of the central Government's taxation capacity would enable fiscal policy to operate more effectively. This would allow for greater revenue generation and more equitable revenue sharing, providing all levels of government with increased capacity to fund social welfare policies. It would also relieve the banking system of some of its quasi-fiscal responsibilities, such as subsidising SOEs, infrastructure projects and agriculture, and enable a more efficient balance between fiscal and monetary policy in overall macroeconomic management.

RAPID GROWTH IN INTERNATIONAL TRADE

The Chinese economy has become increasingly integrated into the world economy. China rapidly emerged from its pre reform autarky to become the world's tenth largest trading nation by 1996, accounting for more than 3 per cent of world trade. While the share of labour intensive exports has grown at a phenomenal pace during the reform period, and now represents 55 per cent of exports, this trend appears to have peaked and the share of capital intensive exports has now reached 30 per cent of exports. Nevertheless, in absolute terms, labour intensive exports should continue to grow strongly for several decades providing that foreign and domestic investment move to lower cost hinterland provinces. This shift in investment is now beginning to gain momentum. With economic reform, China's trade is now closely aligned with its comparative advantage, with industries like processed food, in which China is increasingly competitive, producing a growing share of exports.

HEALTHY GROWTH IN AUSTRALIA-CHINA TRADE

Australia-China bilateral trade has grown twice as rapidly as Australia's average trade growth in the past decade. Australia's exports to China grew almost 13 per cent per year from 1987 to 1995 compared to about 8 per cent per year for Australian exports overall, while Australian imports from China grew by 24 per cent, and overall imports grew at 8 per cent. This trend should continue as a result of the natural complementarity and increasing internationalisation of the Australian and Chinese economies, and rapid economic growth in China.

Australia's export performance in China has been very successful in the past decade, with our trade share in China's market since 1988 approximately twice the level that would be expected by trade complementarity. While China holds a growing share of Australia's import market, it is still only 20 per cent higher than would be expected by the complementarity of China's exports and Australia's imports. Australia's crude share of China's imports has declined mainly as a result of the changing commodity composition of China's imports, away from primary commodities and towards capital goods and components used in the burgeoning contract trade. Nevertheless in 1996, Australia's agricultural exports to China rose 90 per cent over 1995, reaching US\$1.37 billion and making Australia the second largest agricultural commodity supplier to China after the USA.

REFORM OF THE TRADE REGIME

The trade regime has been significantly decentralised and liberalised since 1978. The pre reform system of trade planning has been dismantled and over 5 000 foreign trade corporations and over 200 000 large domestic and foreign enterprises now have trading rights. Foreign funded enterprises, including joint ventures and wholly foreign-owned firms, now play a prominent role in China's trade. In the first eleven months of 1996, they were responsible for 41 per cent of total export trade and 53 per cent of imports.

However, published tariff rates and non-tariff barriers remain high by international standards. While weighted average tariffs have declined from 32 to 19 per cent between 1992 and 1996 and will drop to 15 per cent by 2000, this is still the highest in East Asia. By comparison, Australia's weighted average tariff is 4 per cent. Licensing covers 25 per cent of imports, and covers a number of major items of importance to Australia such as wheat, wool, and other agricultural and raw materials. However, many imports actually enter duty-free or at much lower duties due to the extensive duty drawback scheme for exporters, as well as weak and inconsistent tariff collection procedures. For these reasons, tariff revenue represented only 4 per cent of the value of imports in 1994.

FOREIGN EXCHANGE REGIME

The dual exchange rate system, which complicated foreign investment and trade and distorted incentives for exporters, was successfully unified in January 1994. Foreign exchange controls were lifted progressively, and in November 1996, China achieved full currency convertibility on the current account. This means

that the renminbi is now convertible for all trade related transactions, loan repayments, and profit remittance in goods and services. Foreign funded enterprises are now able to buy and sell foreign exchange at designated banks, as domestic enterprises have done since 1994. Unification has been very successful. Foreign exchange reserves have soared since the 1994 reforms, and in early 1997, they exceeded US\$105 million. However, the Government's management of the exchange rate to keep the renminbi reasonably stable despite high current and capital account inflows has put significant upward pressure on the authorities' money supply growth targets and has required the central bank to wind back its loans to the banking sector.

CHINA'S WTO ENTRY

China's accession to the World Trade Organisation has been a drawn out process due to the complexity and lack of transparency of many of the controls remaining in China's trade regime. WTO membership would greatly benefit China's economy, increasing the certainty of its trade access to member countries and raising the efficiency of domestic industries. China's membership would also provide more modest but still significant benefits for the world economy as a whole. Modelling undertaken for this report indicates that WTO membership could deliver China a 4.6 per cent rise in GNP by 2020 and also increase Australia's GNP by 1.8 per cent. These benefits will arise largely from the productivity enhancing effects of trade liberalisation.

Australia has been an active participant in China's WTO accession working parties and through AusAID, is providing training to key Ministry of Foreign Trade and Economic Cooperation officials on WTO issues. Increased political commitment to trade reform in 1997 may accelerate the process of China's WTO entry.

FOREIGN INVESTMENT AND THE INTERNATIONALISATION OF THE ECONOMY

Since 1979, foreign investment has played a critical role in internationalising China's economy and trade, introducing capital, technology and management and marketing skills, and instigating microeconomic reform. In addition to large investors, thousands of small and medium sized companies, particularly involving overseas Chinese have invested in China over the last decade, making a major contribution to output, employment and export growth. Hong Kong alone provided 60 per cent of the US\$167 billion in foreign direct investment accumulated to the end of 1995, although US\$25 billion to 30 billion of this should probably be deducted to account for 'round-tripping', that is, Chinese capital going offshore and re-entering as foreign investment to benefit from incentives. Australia is China's thirteenth largest source of utilised foreign direct investment, with 2 500 direct investment projects in a variety of fields. Australia is also one of China's leading investment destinations.

Foreign direct investment is growing fastest along China's eastern seaboard. However, companies are increasingly looking inland for lower costs, less intense

competition, proximity to raw material inputs and attractive incentives. As infrastructure improves, foreign direct investment in regional China could expand rapidly.

Important lessons for investors, their partners and Chinese officials emerge from interviews and case studies. Briefly, investors should have realistic expectations, understand and appreciate cross-cultural differences and, especially, understand and convey effectively mutual expectations. Most foreign investors have a strong commitment to China, but lament that the operating environment remains complex and opaque. They would like to see greater commercial transparency, predictability and freedom, and less red tape. At the same time, the large multinationals that the central and local governments wish to attract into infrastructure, manufacturing and services, answer to demanding and cautious boards and shareholders who often require faster returns, more accountability and less risk than the China market can currently offer. Notwithstanding these considerations, foreign direct investment has been particularly strong over the last five years. The rate of growth of investment is likely to slow but still remain at relatively high levels. China's success in the long term in continuing to attract and keep foreign funds will depend largely on how it addresses major issues related to the business operating environment and how it responds to investment liberalisation moves throughout the Asian region.

INFRASTRUCTURE CONSTRAINTS AND ENVIRONMENTAL MANAGEMENT

Insufficient investment in infrastructure development in the past, combined with instances of inadequate project planning, management and coordination, have burdened the economy with a backlog of unfinished projects and facilities unable to cope with the rapid increase in demand. The transport and power sectors are subject to the most serious shortfalls. Indeed, analysts estimate that transport bottlenecks alone subtract one percentage point per year from GDP growth. While China is one of the world's largest electricity generators, about 20 per cent of power is lost due to the inefficient grid, causing frequent power outages.

Infrastructure service provision is growing most rapidly in civil aviation and telecommunications as these projects like airports and telecommunications are prestigious and/or offer high rates of return. Projects involving high outlays with low, prolonged returns, such as roads, railways and environmental projects proceed more slowly. Also, projects that cross administrative jurisdictions, as most infrastructure and environmental projects do, often are slowed by bureaucratic processes and internal rivalries.

Under the Ninth Five-Year Plan (1996-2000), China plans to invest US\$300 billion in infrastructure development, and hopes to attract \$45 billion (15 per cent) of this from foreign commercial lenders and direct investors. Some Australian companies, however, have indicated in interviews that their willingness to invest will depend on a considerable improvement in the highly complex, opaque and frequently inconsistent operating environment. They require a clearer delineation of how risks will be borne and shared. They are observing progress in negotiations in the power sector, where longstanding issues

such as effective caps on returns, are being addressed. Notwithstanding the impediments to investing, US and European companies seem to be making strategic decisions to be in China.

Rapid industrial growth is taking a heavy toll on the environment, raising concerns over the sustainability of projected industrial growth rates. Beijing, Shenyang, Xi'an, Shanghai and Guangzhou were among the world's 10 most polluted cities in 1995. The authorities now recognise the seriousness of the problem. However, central government directives are not always implemented locally, especially if they adversely affect large SOE employers. Despite this, authorities have significantly reduced air and water pollution in some of the worst affected areas. With many major waterways not meeting water quality standards and with serious water shortages a prospect, the Government is taking drastic measures, including closing some of the worst polluters.

Foreign companies are normally allowed to bid only for foreign funded environmental projects. Nevertheless, many opportunities are emerging for Australian firms in clean energy, water treatment, sustainable agriculture, coal washing and others.

GROWTH AND DISPARITIES IN CHINA'S REGIONS

All regions have benefitted from China's rapid economic growth, achieving growth rates that compare with the fastest growing economies in East Asia. However, the coastal provinces have grown more quickly than those in the hinterland because they are more integrated into the international economy, with more liberal policy environments and better infrastructure endowments, particularly transport links. The coastal region is also more export-oriented, producing almost 85 per cent of exports, attracting almost 90 per cent of foreign investment and having a much higher proportion, 80 per cent, of output produced by the more dynamic non-state sector. Both capital and labour productivity are higher in the coastal region than in the central and western regions, attracting higher levels of investment, much of which is from the retained earnings of the non-state sector enterprises. The hinterland is more dependent on SOEs for production and bank loans for investment. The divergence of regional growth rates has accelerated in recent years as the pace of economic reforms has increased.

Per capita income, industrial production and retail sales in the coastal region are more than double those of the hinterland and the gap is widening. While these disparities are an inevitable aspect of rapid growth, indicating opportunities yet to be fully developed, at the same time they create a major policy dilemma for the Government. While the coastal region has led market-oriented economic reforms, driving overall economic growth, increasing regional divergence has the potential to create social and political tensions.

Regional variation in cost structures is a major source of opportunity for local and foreign investors seeking lower cost production bases outside the main early growth areas on the coast. The inwards movement of foreign and local investment is already underway but the Government will need to make massive infrastructure investments in the hinterland. Ideally this should involve significant inter-regional fiscal redistribution, to ensure growth is sustained, but as noted earlier,

improvements in tax collection will be a prerequisite. Failing these improvements, governments at various levels will be forced to rely increasingly on private investment in infrastructure.

Three key areas will be the focus of rapid growth and will continue to attract the bulk of foreign investment in the next decade: the Pearl River Delta in Guangdong province; the Yangtze River Delta stretching inland along the Yangtze from Shanghai; and the Bohai Ring encompassing Tianjin and the developed coastal cities in Shandong, Hebei and Liaoning. Together, these three areas produce 33 per cent of total national GDP with only 3.3 per cent of the total land area and 14 per cent of the population.

MAJOR DECISIONS CONFRONT AGRICULTURE

The decollectivisation of agriculture produced record-breaking growth in grain output in the early 1980s, finally ending the endemic food shortages experienced since the 1950s and providing the preconditions for China's urban and industrial reforms in the mid 1980s. Despite many problems, agricultural output has expanded strongly throughout the reform period.

While administrative controls remain on strategic crops, such as grain and cotton, market forces are steadily causing Chinese agriculture to shift towards its comparative advantage. Income maximising farmers are increasingly reallocating their land, labour and capital to more profitable crops, or to non-agricultural activities. While this trend is increasing grain imports, it is also stimulating a rapid growth in higher value, non-grain agricultural exports, and has made China into a significant net food exporter in recent years. Estimates of required grain imports by 2010 vary greatly, from 136 million metric tons to 15 million metric tons, with a recent intermediate estimate of 64 million metric tons appearing more realistic. This compares with 1996 grain imports of about 10 million tons.

Although the Government is reluctant to relinquish its grain self-sufficiency policy, because of its fears about food security, the rising cost of achieving this objective will produce a major dilemma for it. China's agricultural policy-making is therefore at a crucial juncture: it can either opt for internationally competitive agriculture based on its comparative advantage, or protect selected agricultural sectors and meet the significant costs this will impose on the economy. Most of the costs of enforcing grain self-sufficiency will fall on low income farmers and grain producing provinces. As domestic prices of many major agricultural commodities have risen close to international levels, it is crucial a decision is made to internationalise agriculture before prices climb higher, and it becomes politically difficult to wind them back.

THE AILING SOES

Reform of the SOEs is the key to many other crucial reforms in the banking system, macroeconomic management and the trade regime. However, progress has been slow due to political concerns about the impact on urban employment and stability. The performance of the sector has steadily deteriorated during the 1980s and 1990s as it faced increasing competition from the dynamic non-state sector

and imports. Almost half the SOEs were reporting losses in 1996, with the value of losses up 45 per cent, to ¥ 65 billion (US\$7.8 billion). These losses offset all profit and tax payments SOEs made, so that the sector as a whole made losses in 1996 for the first time since 1949. Thus the state received no return for its massive investment in SOEs.

Despite many attempts to reform SOEs to improve their performance, many are effectively immune from bankruptcy and their costs are inflated by overstaffing, and generous salary and social service packages for workers. In many instances their initiative is constrained by a lack of clear delineation of property rights, inadequate incentives for managers and bureaucratic intervention. The World Bank estimates that the SOEs' social service payments for pensions, housing and health equalled SOE losses. Therefore, all the value added produced by SOEs, including the profits that should have gone to the State as the owner of SOE assets, were consumed by SOE workers, either as wages, bonuses or enterprise provided services.

However, the central and more progressive provincial governments now appear more determined to tackle this issue, and are restricting bank credit for some loss-makers. Under the policy of 'grasping the big and enlivening the small', medium and small sized SOEs can be leased, sold to workers, joint ventured, merged or privatised. One thousand large SOEs are being recapitalised and groomed to form future conglomerates, on the Korean *chaebol* model.

As the State still employs about 70 per cent of urban employers, the Government has been wary of wholesale rationalisation of the SOEs, for fear of the social and political consequences. However, the rapidly growing non-state sector is successfully absorbing many redundant SOE workers, even in north eastern provinces like Liaoning, increasing the Government's confidence that continued reform and downsizing of SOE workforces is feasible. This process of rationalisation should intensify over the coming period.

THE DYNAMIC NON-STATE SECTOR

The non-state sector now produces two thirds of industrial output and somewhat more of total national output, including largely privatised agriculture and the heavily privatised personal services sector. This sector is generally highly market oriented and competitive; enterprises can and often do go bankrupt. Its structure is also changing rapidly, reflecting the strength of market forces operating within it. Urban collectives, arguably the least market oriented element of the sector, have lost market share in the first half of the 1990s, dropping from 15 to 10 per cent of industrial output. On the other hand, the share of the more dynamic township and village industries, owned by rural local authorities, groups of individuals and private entrepreneurs, is still growing rapidly, increasing from 20 to 30 per cent of industrial output between 1990 and 1994. Local private and foreign funded enterprises have grown even faster, doubling and trebling their shares, now respectively producing 12 and 14 per cent of industrial output.

The non-state sector dominates light industry and has generated about three quarters of total export growth since 1978. It also produces over 80 per cent of industrial output in the coastal provinces. In fact, the preeminence of the non-

state sector in these provinces is one of the main sources of dynamism of the coastal region. In the past, the non-state sector has confronted discriminatory tax and other policies; it still has some concerns regarding security of property rights, government interference and access to the banking system. However, the leadership increasingly accepts the essential contribution of the non-state sector to creating employment and raising incomes. Legal and regulatory reforms and political developments in the 1990s have greatly improved the position of non-state sector firms, and been the main cause of the sector's dramatic growth this decade.

LABOUR MARKETS AND MIGRATION

While labour markets have become much more flexible since 1978, many constraints still remain. The *hukou* (household registration system) has been considerably relaxed, enabling up to about 100 million rural workers to find jobs in urban areas by early 1997. The numbers of migrants are still rising rapidly with analysts estimating that at least a further 100 million surplus rural workers are seeking to move to more productive jobs outside agriculture, many of which will be in urban areas.

Despite the introduction of bonuses and the greater use of contract labour, productivity growth in SOEs is well below that in the non-state sector and analysts believe up to 30 per cent of SOE workers are surplus. Mobility of SOE workers is still low due to the continued provision of many services by enterprises and inadequate service delivery in the community. Nevertheless, SOEs had made 7.5 million of their workers redundant by mid 1996 and this trend appears to be accelerating.

While unskilled labour costs are still low compared to regional competitors in South East and East Asia, they are already rising in some coastal areas, and skilled labour is generally in short supply. To ensure labour costs remain in line with productivity, so Chinese exporters can maintain their competitiveness in labour intensive products, greater labour mobility between regions and enterprises seems inevitable. This would involve further relaxation of the *hukou* system, particularly for skilled but also for unskilled labour, more organised systems to disseminate labour market information throughout the country, continued priority on SOE reforms, and more rapid development of low income housing markets and community based social services.

IMPLICATIONS FOR AUSTRALIA

China's rapid growth of the past two decades is set to continue well into the next century, as the Government maintains reform momentum in the post-Deng era, labour moves out of low productivity agriculture and industry adopts advanced technologies. Much of the economy now employs markets to allocate resources, while planning at the central and local levels is more indicative than prescriptive. However, the arguably more difficult task of establishing the legal and institutional framework needed for a modern market economy is still in progress and will take at least another decade and probably two to complete. During this process of

transition, China will not be an easy environment in which to do business for both foreign and local enterprises. Other major potential constraints on growth are shortages of infrastructure and skilled labour.

With a quarter of the world's population and rising incomes, China will become increasingly important for Australia's economic and strategic future. Many new trade and investment opportunities are developing, including in agriculture, minerals, manufactures, environmental management, infrastructure and services such as tourism and education. Bilateral Australia-China trade should continue to grow much more rapidly than Australia's average trade due to the complementarity of the two economies, continuing trade liberalisation and China's strong growth. China will also be an increasingly competitive exporter of labour intensive manufactures and agricultural products, which may stimulate further restructuring of these industries in Australia.

Bilateral economic relations will continue to focus on trade, investment and economic reform issues. China's entry into the WTO will benefit China, Australia and the rest of the world. It will increase the transparency of China's trade regime and strengthen the world trading system. Australian investment and expertise in many sectors, achieved through commercial links, official exchanges, educational transfers and the aid program, contributes to China's development. This includes institutional strengthening, technology transfer and training to assist in economic policy formulation, reform of state-owned enterprises, provision of infrastructure services, industrial upgrading and environmental management. Chinese investment in Australia is also making an important contribution to strengthening trade links and reinforcing the complementarity of the two economies. Both Australia and China have much to gain from their relationship. The constructive development of this relationship presents a key opportunity for both countries, not only at official level but also through business, academic, student and tourism contacts.

ACHIEVEMENTS, CONSTRAINTS AND PROSPECTS: OVERVIEW OF THE ECONOMIC REFORMS

Throughout most of its long history, China was the dominant economic power of its known world. Maddison (1995) estimated China was the largest economy in the world until the late 19th century. However, to achieve this status, and the rising living standards sought by China's leaders and its 1.2 billion people, the Government will need to continue to steadily reform the economy and remove the many policy and development constraints it faces. Should China again become the world's largest economy, it will generate great opportunities for Australian business, but also some challenges for the rest of the international economy, which will need to undergo considerable structural adjustment to accommodate China.

THE REPORT'S STRUCTURE

This report attempts to make judgments about the likely path of medium to long term economic policy-making in China. It aims to determine whether policy reforms are likely to remove the constraints facing the economy in a timely way, and so promote rapid and sustained economic growth in the next 10 to 15 years. It is not a 'how to do business' guide of which there are already several excellent examples (Economists Intelligence Unit, 1996). Rather this report provides a broader, strategic overview of policy development trends in China, for Australian business, Federal and state governments, academics and the community at large. It is designed to assist the Australian government to enhance bilateral relations with China by deepening its understanding of the economic reform process and the future direction of economic policies. It also aims to provide businesses with the information on which to base their own strategic plans for mutually profitable engagement in the China market. Finally, it should provide a useful, up-to-date resource for students and teachers researching the Chinese economy. Given the broad scope of the issues covered, readers may wish to access it as a reference, employing the index and table of contents to identify chapters and sections most relevant to their interests.

The first three chapters of this report set the scene for the subsequent discussion of China's prospects by providing an overview of China's economic, political and market environment. This section will be of interest to most readers. This first chapter provides a broad overview of China's economic reforms, briefly describing the pre reform economy and economic policies and growth performance under central planning and since reforms began in 1978. This snapshot of China's main economic indicators reveals the depth and success of the economic transformation

that has occurred since 1978. It highlights some important structural constraints, such as the central Government's fiscal deficit, and economic strengths, such as savings rates. The actual size of the Chinese economy is a matter of considerable debate. The last section of this chapter analyses different estimates and then compares the purchasing power of China with that of other major developing and developed countries. Finally, it discusses some scenarios for growth prospects in the foreseeable future.

China's experience over the past 50 years shows that its economic prospects rely not only on its economic resources, but also on political developments. Understanding the interaction of the fast developing market system and existing and evolving political structures is crucial to predicting trends for political institutions and economic policies. (See Chapter 2 - Political Environment.)

China has achieved much but faces many significant challenges as it develops effective market institutions, including the legal regulatory and administrative systems required to support a modern market economy. This represents the next crucial stage of the reforms, and aims at enabling the economy to be regulated equitably and efficiently by rules and laws, rather than by personal discretion and connections. This process is likely to take many years to achieve. (See Chapter 3 - Market Environment.)

The second set of chapters examines the process of China's macroeconomic policy-making. These policies will constrain, or expand the limits of overall economic growth in the next decade. Discussed first are the important macroeconomic management reforms, which in 1996 and 1997 enabled China to break the cycle of abrupt policy induced economic booms and recessions and achieve still rapid economic growth with more sustainable inflation rates. Reforms and constraints in the financial system are also examined. (See Chapter 4 - Macroeconomic Management.)

The other major policies which will determine the pace of overall growth relate to the foreign trade and investment regimes. Major reforms in these two areas have been central to China's economic success but further crucial reforms are required to lock in rapid growth rates. Particularly urgent reforms are to increase the transparency and predictability of the trade regime and to enable foreign investors to compete in the inefficient domestic distribution, financial services and infrastructure sectors. China is considering many of these reforms in the context of its WTO membership application. (See Chapter 5 - International Trade and Chapter 6 - Foreign Investment.)

The final set of chapters deals with major microeconomic and sectoral reform policies and issues which could constrain future growth, and whether and how the Government appears likely to address these problems. Outcomes in all these areas will have a significant impact on China's future growth prospects. Inadequate infrastructure is a classic constraint in many rapidly developing Asian countries, but overlapping governmental jurisdictions and the legacy of neglect due to regional self-sufficiency policies during the central planning days exacerbate this problem in China. (See Chapter 7 - Infrastructure.)

The widening income disparities between the wealthier coastal provinces and the poorer hinterland could create political tensions unless they are addressed rapidly, particularly by investing in better infrastructure in the hinterland. The lower

labour and land costs in the hinterland provinces also generate investment opportunities to which local and foreign investors are responding already, and which have the potential to significantly narrow disparities in the next few decades, so long as the necessary infrastructure is in place. (See Chapter 8 - Regions.)

Reforms in agriculture started and underpinned the whole reform process in the late 1970s. While growth and structural change in agriculture has been impressive and China no longer faces food shortages, continuing intervention to encourage self-sufficiency in grains and cotton has constrained growth of agricultural incomes and productivity. (See Chapter 9 - Agriculture.)

Although the output share of state-owned enterprises (SOEs) is rapidly shrinking, they still employ a high proportion of scarce skilled labour and bank loans. Furthermore, the failure to improve SOE performance is slowing other vital reforms, particularly of the trade and foreign investment regimes, financial system and even macroeconomic management. (See Chapter 10 - State-Owned Enterprises.)

Problems in infrastructure provision, wholesale distribution and grain purchasing, storage and marketing also are exacerbated by inefficient SOEs in these sectors, many of which face little or no non-state sector (NSS) competition. The emergence of the dynamic non-state sector has been a major source of economic growth since 1978. The Government has steadily liberalised policies towards this sector, which should maintain its high growth rates. However, it still has poor access to the formal banking system and will benefit greatly from the development of a rules based regulatory environment, reducing its current dependence on official good will. (See Chapter 11 - Non-State Sector.)

Labour markets and migration are now much freer than before the reforms but unless addressed, remaining labour market controls and information gaps could encourage wage levels to grow more rapidly than productivity increases and undermine the competitiveness of China's labour intensive export sector. (See Chapter 12 - Labour Markets.)

The final chapter draws conclusions and highlights implications for Australian business and government to help access the significant trade and investment opportunities emerging in China and enhance the bilateral relationship and commercial links.

WASTED DECADES — ECONOMIC POLICIES PRE 1978

When the Chinese Communist Party won power in 1949, one of its main objectives was to rapidly industrialise China. In 1953, in its first ambitious Soviet-style Five-Year Plan, it announced it would make China into a 'socialist, modernised and industrialised, powerful country in the near future'. In 1958, when the feverish, but short-lived Great Leap Forward campaign swept the country, Mao Zedong vowed to overtake the United Kingdom and the USA in 15 to 20 years. However, in the 1960s and 1970s, trapped in successive rounds of political and economic chaos, particularly the Cultural Revolution, and burdened with central planning, China missed the opportunity many East Asian neighbours grasped to commence economic development in earnest.

In 1978, recognising the effective loss of three decades of development, Deng Xiaoping commenced radical reforms in economic policy. The resulting market-oriented reforms and open door trade and investment policies have enabled China to sustain one of the world's fastest economic growth rates for almost two decades, even though official data may somewhat exaggerate the actual situation. (See Chapter 1 Appendix.)

The Failure of Central Planning

In 1949, after more than a decade of war, economic output was only at its 1920s level.¹ Although the economy managed to recover to its pre-war level by 1953, agricultural productivity was still too low to produce the voluntary savings needed to finance the Government's ambitious industrialisation program. Consequently, central planning was introduced progressively, replacing the existing market system, to forcibly mobilise resources for industrialisation.

By 1957, all household farms were collectivised and the state's unified procurement and marketing system replaced private agricultural purchasing and distribution networks. Agricultural output was then sold under a rationing scheme to urban consumers and industries at subsidised prices. As a result, a large surplus was transferred from agricultural producers to urban consumers and industries which consumed this subsidised agricultural output. Collectivisation also helped control farm labour migration, which the Government feared would hinder industrialisation by reducing farm output and raising food prices relative to industrial product prices. The agricultural sector became very inefficient, characterised by large losses in the storage and distribution system, poor distribution of inputs to farmers and low incentives to produce within the communes. Plans emphasised grain production at the expense of higher value, more appropriate crops and products. Regional comparative advantage was ignored and regional self-sufficiency became an overriding policy goal. Consequently, China experienced severe shortages of basic foodstuffs throughout the central planning period.

In the urban economy, all private firms had been nationalised by the end of 1957, to strengthen planning control. Private enterprises were generally prohibited. Prior to 1978, SOEs produced well over three quarters of industrial output and urban and rural collectives produced the rest. No foreign-owned or private sector existed. A system of governing authorities, usually the industrial ministries at the central and provincial level, controlled SOE production and investment. The ultimate objective of SOEs was to fulfil output targets, not to be cost efficient or profitable. The Government, through the SOE governing authorities, took SOE profits and allocated them investment funds from the budget. Motivation to produce sufficient quality and quantity of consumer goods was low, shortages were endemic and goods were of shoddy quality. Heavy and military industries received priority.

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¹ Using estimates of real national income by Maddison, if the 1913 level of income is set as 100, the 1950 level would be 111.5, well below the 1929 level of 126.1 (Maddison, 1995, Table B-10e). See discussion in Chapter 1 Appendix for the approach used to estimate China's national income.

Labour markets were replaced by a centrally planned job allocation system, while food supply, housing, education and health care were brought under tight planning controls through a strict household registration (*hukou*) system. Migration between rural and urban areas was strictly controlled, essentially excluding rural people from urban employment and social security arrangements.

Within urban areas, on leaving school, students were allocated a job, usually for life, within SOEs or in other government employment. Mobility between jobs for personal reasons was strongly discouraged or prohibited, and only allowed if it suited local authorities' plans. Workers were allocated housing for life, and the work units were responsible for pensions and other social benefits. Wages and salaries differentials for unskilled and skilled workers and professionals were highly compressed compared to market economies. Promotion was only on the basis of seniority; dismissal for poor performance was unheard of. Consequently, motivation was low.

Banks and other financial institutions were also nationalised and all capital was allocated through national plans. Only four state banks existed, with the People's Bank of China the largest. The banking system merely transferred approved budget funds into the relevant SOE and government authority accounts and provided deposit facilities to them and households. Loans were not made unless approved by the Plan. The Government determined interest rates and these remained fixed at very low levels for decades.

Macroeconomic management occurred through government controls over agricultural procurement and industrial prices, and urban wages, rather than market economy fiscal or monetary policy tools. Central bank lending (that is, printing money) financed any budget deficits and at times, caused excess demand. Since all prices were fixed, there was no inflation and excess demand merely generated shortages and increased bank deposits. Monetary policy did not exist; the Government fixed the interest rates of the few permitted banks and left these rates virtually unchanged.

Twelve centrally controlled Foreign Trade Corporations, under the control of the central government ministries, monopolised trade. Other trade was not permitted. Export and import plans covered virtually all foreign trade. Trade was only a small proportion of the economy as imports only supplied goods that could not be produced locally and exports merely paid for these essential imports. Exports were procured compulsorily from SOEs at state controlled prices. Similarly, imports were sold at state controlled prices to domestic firms and consumers. Foreign investment was prohibited and there was virtually no foreign borrowing except from a few socialist countries.

All existing laws were repealed in 1949, with only a few replaced by regulations and policy directives. Most discretion remained with the political authorities. Domestic contracts were more like declarations of intent than binding commitments. International contracts, by contrast, were usually scrupulously honoured. The legal profession virtually disappeared during the Cultural Revolution. The courts had no independence but functioned under the direct control of the Party's legal committees. The courts had only a minimal part to play in resolving economic disputes, which were usually addressed by the industrial ministries.

Mao's Great Leap Forward and Cultural Revolution

During the first Five-Year Plan (1953 to 1957), later called the golden period of central planning, real gross domestic product (GDP) increased by 32 per cent, or 5.7 per cent per year (Figure 1.1).² Growth was mostly attributed to huge Soviet-supported investment in capital construction.

In 1958, unsatisfied with the pace of industrialisation and eager to introduce more radical socialism, Mao launched a mass campaign, the Great Leap Forward, aimed at forcing an increase in farm and industrial output. Tens of millions of farmers were mobilised to set up small backyard furnaces producing iron and steel that later proved to be virtually useless. The sudden withdrawal of labour from agriculture led to China's worst agricultural failure in many decades and many millions starved. The campaign caused a huge drop in output over the period 1958 to 1962 (Figure 1.1). After 1960, the Government was forced to close many factories and halt numerous ambitious projects. Urban employment was reduced by repatriating people to the land. Farmers were given a degree of freedom to work on their private plots after fulfilling assigned work on collective land. The second Five-Year Plan (1958 to 1962) had miscarried, and no new Five-Year Plan appeared until 1966.

Soon after the economy seemed to be returning to a more stable path in 1966, Mao launched the Cultural Revolution (1966 to 1976). This campaign was apparently designed to re-establish his dominant position within the Communist Party leadership, shaken by the collapse of his Great Leap Forward campaign. The chaos of the Cultural Revolution again caused production to plunge until 1969. A slow recovery began in 1970 when more conservative forces in the leadership attempted to reassert authority. Rural enterprises were cautiously encouraged to alleviate disguised unemployment, a result of the continuous increase in population, and to help modernise agricultural production. Consequently, growth reached a modest 3.9 per cent per year over the period 1970 to 1976 (Figure 1.1).

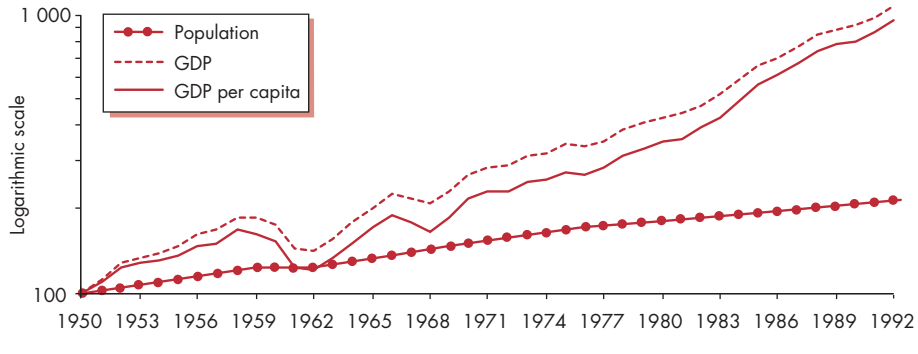
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² Estimates given are those made in 1990 international dollars by Maddison (1995, Table A-3e).

Figure 1.1

Decades of Lost Growth

Growth of China's GDP, Population and Per Capita GDP, 1950 to 1992 (1950=100)



Source: Maddison (1995, Tables A-3e, C-16e and D-1e).

Consequences of Central Planning

Over the entire central planning period, radical shifts in economic policies, institutional arrangements and political movements adversely affected economic growth. Excessive resources were allocated to heavy industry, ignoring the comparative advantage of China's labour abundant economy in labour intensive light industry. Foreign trade, particularly with non-Communist countries, was virtually abandoned. On official statistics, by 1978, the total value of China's foreign trade was only 10 per cent of GDP, little above its 1950 level.³

As a consequence, over the period 1952 to 1977, China's economy grew more slowly than most developing economies. As its real GDP grew on average by 4.2 per cent per year and population by 2.1 per cent per year, its per capita GDP increased by only 2.1 per cent per year, compared with 1.8 per cent in India, 2.3 per cent in Indonesia and 6.1 per cent in both the Republic of Korea and Taiwan.⁴

In 1977, after a quarter of a century of forced heavy industrialisation, the economy was highly distorted, with the share of industry, particularly heavy industry, much higher and that of services much lower than the average for other developing countries.⁵ Although the output of heavy machinery grew rapidly, shortages of

³ The 1978 figure is derived from State Statistical Bureau (1993a, p. 31 and p. 633) and the 1950 figure is calculated based on State Statistical Bureau (1993a, p. 33 and p. 633) and Maddison (1995, p. 191). (See Chapter 1 Appendix.)

⁴ All the GDP estimates are in 1990 international dollars which make them comparable among countries (Maddison 1995, Tables D-1d, D-1e).

⁵ In China, agriculture accounted for 42 per cent of GDP, industry 37 per cent and services 21 per cent while the average in other low income countries at the same time was agriculture 38 per cent, industry 24 per cent and services 38 per cent (World Bank, 1980b, p. 114). GDP data are adjusted to 1990 constant prices as the use of 1977 prices would give an even more distorted sectoral structure.

consumer goods and services were severe and by the end of the Cultural Revolution, even food shortages were apparent.

Although industry's share of total GDP increased to nearly 40 per cent by 1978 (Figure 1.4), agricultural employment still accounted for 71 per cent of total employment (Figure 1.7). At the same time, China's urbanisation grew only slightly, to 17 per cent from about 13 per cent in 1952.⁶ The rural–urban income gap, measured as a ratio of urban to rural per capita consumption, expanded from 2.3 in 1957 to 2.9 in 1978 (State Statistical Bureau, 1985a, pp. 562-72).⁷

ECONOMIC REFORMS POST 1978

Deng Xiaoping's 1978 reforms were not another ideologically driven campaign, nor an economically motivated 'Great Leap Forward'. In fact, his reforms did not follow any well-designed blueprint, and did not intend to challenge the basic socialist system. Rather they aimed at correcting 'leftist errors' of the past. Consequently, the reforms were pragmatic, and refocused attention on improving living standards and catching up with developed countries. Reform began in the agricultural sector and by opening the economy to trade and investment, but then focused on the urban industrial sector, the banking system and eventually, most other sectors of the economy.⁸

Reform of Agriculture

In the late 1970s, the central Government belatedly sanctioned the Anhui farmers' spontaneous decollectivisation of agriculture and approved the establishment of the household-based responsibility system. By raising agricultural prices, the Government attempted to remove the bias against agriculture and stimulate productivity by improving farmers' incentives. The rapid spread of the household responsibility system across all provinces significantly increased productivity and precipitated profound institutional changes in rural areas, culminating in the dissolution of the commune system in 1983.

An increase in the long suppressed state procurement prices and the granting of permission to sell above quota production of most agricultural products in the free market contributed to the rapid jump in agricultural productivity. Farm households switched part of their effort from producing grain to vegetables, meat and other higher value farm products because of the high demand for these products in urban markets. Despite this, grain production still increased by over 5 per cent per year from 1978 to 1984, compared with only 2 per cent from 1952 to 1977. Cash crop output grew even more rapidly. Cotton production increased by 19 per cent per year, compared with less than 2 per cent from 1952 to 1977, and oilseed crops by 17 per cent compared with almost no growth from 1952 to 1977 (State Statistical Bureau, 1993a, p. 365). The growth in agricultural productivity

⁶ Quoted directly from the official statistics (State Statistical Bureau, 1995a, p. 59).

⁷ Pre 1957 income data are not available.

⁸ The discussion in this section draws on Kueh (1985), Perkins D. (1988), Sachs and Woo (1994), Findlay, et al (1994) and Pomfret (1995).

and output brought an end to shortages of foodstuffs for the first time since the 1950s.

The Dramatic Growth of Rural Enterprises

Agricultural growth also created a huge rural market for consumer goods and generated a reservoir of savings that funded investment in rural enterprises.⁹ From 1978 to 1994, output from rural enterprises grew at 25 per cent per year, far in excess of the SOEs, at 5.5 per cent per year.¹⁰ Rural enterprises produced a range of simple consumer goods including processed foods, services such as distribution, restaurants and shops. By 1994, rural enterprises accounted for 30 per cent of total industrial output and other non-state enterprises including private urban collectives and foreign funded firms a further 36 per cent, while the SOE share had dropped to 34 per cent (Figure 1.5).¹¹ Rural enterprises also produced over 25 per cent of exports.¹²

Rural enterprises succeeded because they met the huge unsupplied demand for consumer goods, created by the excessive emphasis on heavy industry. Most SOEs were tied up with state plans and insufficiently responsive to changes in demand for consumer goods. Reforms to the central planning system gradually relaxed controls over access to production inputs and the distribution and marketing of industrial products. The shift to a more decentralised contract-based fiscal system offered local governments incentives to develop rural enterprises as local sources of revenue. Finally, the retention of the household registration (*hukou*) system discouraged permanent migration to cities but encouraged remittances and return migration. This helped develop rural enterprises by providing both physical and human capital. (See Chapter 12 - Labour Markets.)

Opening the Economy to Foreign Trade and Investment

Foreign investment and trade also contributed significantly to China's post-reform growth. Trade reform began in 1979 with the introduction of a foreign exchange retention system, which permitted exporting enterprises to use a proportion of their export earnings to purchase imports. Foreign exchange swap markets developed, enabling exporters to trade unwanted retained foreign exchange for renminbi yuan at more favourable rates than the heavily overvalued official rate. This resulted in effective partial devaluation of the yuan. Equally important, from 1984 to 1986, some local authorities and enterprises were permitted to undertake foreign trade through their own foreign trade corporations, breaking the monopoly of the central government's foreign trade corporations. The mandatory export plan was abolished in 1991, and from 1994, the mandatory import plan was

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⁹ Also called township and village enterprises although they include all other types of ownership of rural enterprises.

¹⁰ The real growth in the gross value of output by rural enterprises is derived from both the official gross value of output and the producer price index. (The annual index is converted to 1984 = 100 for industrial products.)

¹¹ The output shares by enterprise is based on current prices (State Statistical Bureau, 1995a, p. 249, p. 365, p. 377).

¹² Based on gross value of output instead of GDP using data from State Statistical Bureau (1995a, p. 32, p. 537) and Department of Rural Enterprises (1993, p. 31).

gradually dismantled. These liberalisation measures resulted in foreign trade growing rapidly, its ratio to GDP increasing to 45 per cent by 1994.¹³

In 1979, foreign direct investment (FDI) was permitted for the first time since 1949. To attract foreign investment, in 1980, four Special Economic Zones (SEZs)—Shenzhen, Zhuhai, Shantou and Xiamen—were established in Guangdong and Fujian provinces. In 1984, the concept of SEZs was extended to another fourteen coastal cities, Hainan Island and three so-called ‘golden triangles’—the Yangtze River Delta, the Pearl River Delta and the Southern Fujian (Minnan) Triangle. In the mid and late 1980s, several important reforms promoted FDI, including permitting joint ventures between Chinese and foreign firms, reducing labour charges and land use fees for foreigners, granting joint ventures access to foreign exchange swap markets, extending the maximum duration of joint venture agreements to over 50 years, permitting wholly foreign-owned enterprises to be established, and introducing legislation protecting foreign firms from nationalisation.

From 1979 to 1983, China realised only US\$1.8 billion of FDI but from 1984 to 1994, FDI increased by 39 per cent per year and reached US\$38 billion in 1995 (State Statistical Bureau, 1995a, p. 554). Foreign funded enterprises gradually became important players in China’s foreign trade, their share increasing from less than 1 per cent in 1982 to 45 per cent in 1996. By 1996, non-state enterprises dominated China’s foreign trade, generating two thirds of China’s export growth during the reform period (Perkins F, 1996, p. 1). (See Chapter 5 - International Trade and Chapter 6 - Foreign Investment.)

Lack of Progress in the SOEs

Although SOE reforms began in the early 1980s, shortly after rural reforms, they have not yet achieved significant results. (See Chapter 10 - State-Owned Enterprises.) Output of SOEs has risen, but not as fast as their use of labour, capital and other productive inputs. Consequently, their productivity growth has been almost zero and in some sectors, negative (Perkins F, 1993; Wu Y., 1993). Neither tentative attempts to introduce greater enterprise autonomy during the early and mid 1980s, nor more serious attempts to adopt a contract responsibility system after 1988 have induced SOEs to behave more entrepreneurially. A bankruptcy law introduced in the late 1980s has had minimal effect as until recently it has been rarely used because of fear of the social consequences. The delay in SOE reform also is largely responsible for delays in fiscal, financial and trading system reform. State banks still cannot refuse to extend loans to loss-making SOEs if the authorities request it. Liberalisation of bank interest rates and trade protection has been slowed because of fear of the consequences for cash strapped SOEs. (See Chapter 4 - Macroeconomic Management.)

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¹³ Undervaluation of China’s GDP, which is discussed later in this chapter, would result in this ratio being exaggerated.

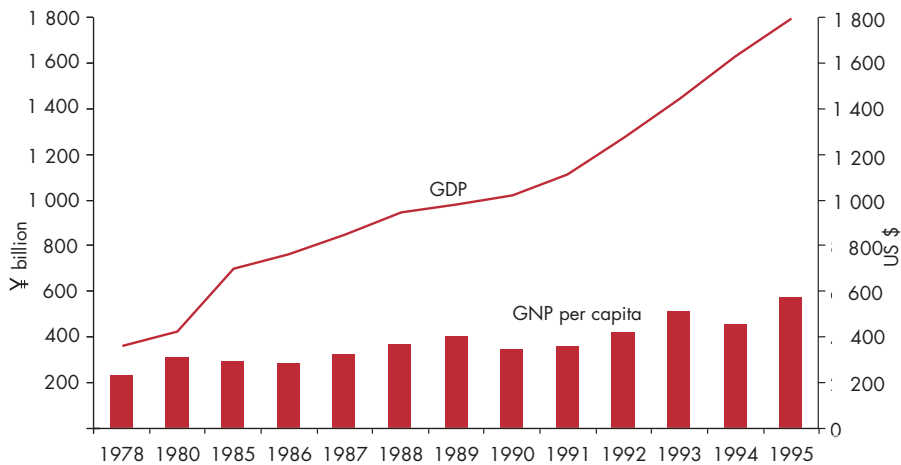
ACHIEVEMENTS OF THE REFORMS

Although the economic reforms still face many problems, they have produced impressive gains in national income and living standards. The market system is increasingly important in allocating resources, assisting China to produce efficiently, in line with its comparative advantage.

By 1995, China's real GDP was four times its 1978 level (Figure 1.2), having grown at an average annual rate of 10 per cent according to official statistics. Official per capita GNP had reached ¥ 4 754 (US\$569), up from ¥ 379 (US\$225) in 1978. (See Chapter 1 Appendix for details of measurement problems.)

Figure 1.2

Growth Takes Off after the Reforms Economic Growth in China



Source: State Statistical Bureau (1996a and previous years).

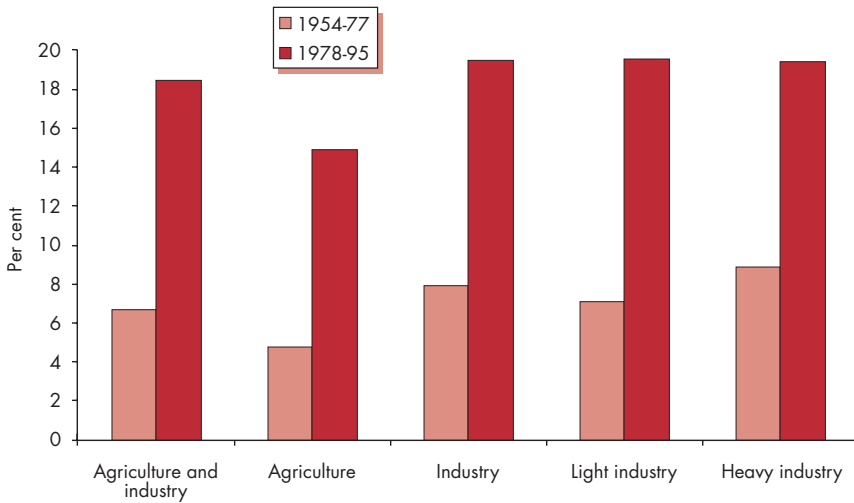
However, adjusted data indicates real GDP grew by 7.7 per cent per year from 1978 to 1992 (Maddison, 1995), the population grew by 1.4 per cent per year, so per capita GDP rose by 6.3 per cent per year (Figure 1.1). This was faster than growth in Thailand (5.6 per cent) and close to the growth in the Republic of Korea (6.7 per cent) and Taiwan (6.5 per cent).¹⁴

¹⁴ Although China's official GDP data are available for the post reform period, China's GDP growth rate quoted here is still derived from Maddison (1995, Tables D-1d and D-1e). This is not only because Maddison's estimates are internationally comparable (all in 1990 international dollars), but also because it is generally believed that China's official data tend to overestimate the GDP growth rate (Keidel, 1992; Perkins D., 1988).

All sectors of the economy have recorded strong growth (Figure 1.3). On average, the annual growth rate of the gross value of output in agriculture and industry from 1978 to 1995 was 12 percentage points higher than from 1949 to 1977. However, official data appears to over-estimate the rate of industrial output growth, particularly of heavy industry. (See Chapter 1 Appendix.)

Figure 1.3

Major Jump in Growth Rates after Reform
Growth in Sectoral Gross Output
(Trend of Growth Rates with Constant Prices 1949 = 100)



Source: State Statistical Bureau (1996a and previous years).

MAJOR STRUCTURAL CHANGES

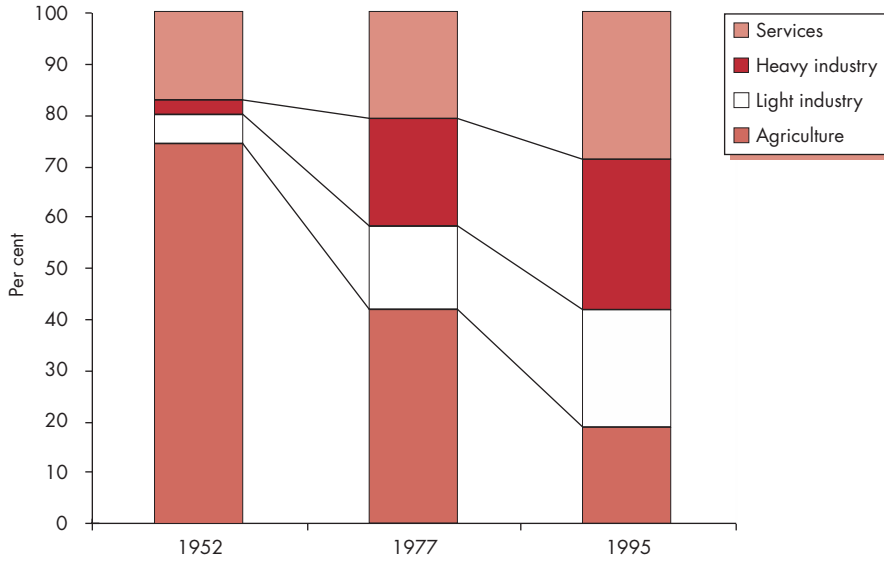
The economy experienced enormous structural changes during the reform period.

Output

From 1977 to 1995, agriculture’s share of total GDP declined dramatically from 42 to 19 per cent, while the share of industry rose from 37 to 53 per cent, and that of the service sector increased from 21 to 29 per cent (Figure 1.4). However, the share of high cost, lower return heavy industry in total industrial output remained high.

Figure 1.4

China Modernises Rapidly Major Structural Change in the Economy

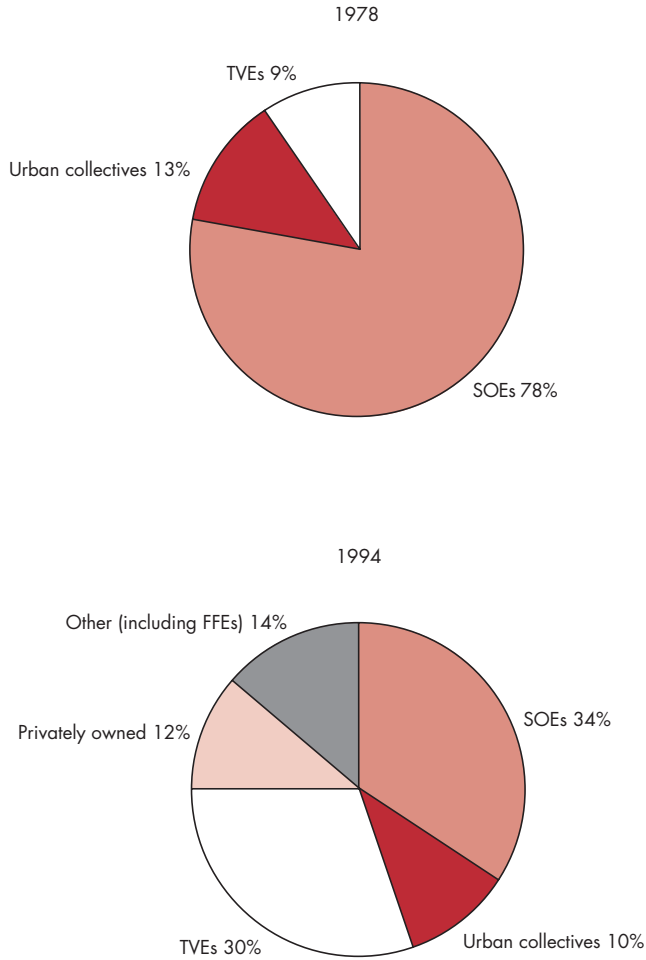


Source: Wu H. (1993); State Statistical Bureau (1996a and previous years).

The rapid development of township and village enterprises (TVEs) has successfully absorbed large numbers of surplus rural workers since 1978. Consequently, the employment and ownership structure of the economy has shifted fundamentally. Before 1978, the state sector accounted for about three quarters of industrial output and employment. Now, urban collective, township and village and other non-state (foreign and private) enterprises produce over two thirds of total industrial output and have become the engine of economic growth (Figure 1.5). (See Chapter 11 - Non-State Sector.) Although debate continues over the impact of reforms on SOE productivity performance, without doubt SOEs have been the poorest performing part of the economy. The rapid growth of non-state enterprises has transformed the industrial sector and produced the high industrial growth rates (Figure 1.5).

Figure 1.5

State-Owned Industry's Role Shrinks
Output Growth by Sector



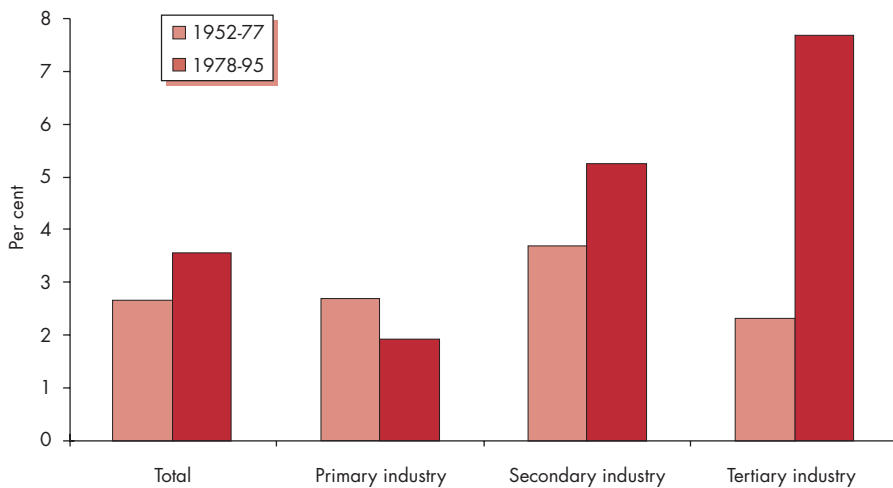
Source: State Statistical Bureau (1996a and previous years); State Statistical Bureau (1978c).

Employment

The economy is benefitting significantly from the massive shift of labour from low productivity agriculture to much higher productivity light manufacturing industries and services. Overall annual employment growth has been about 1 per cent higher since the reforms began. Tertiary industry is the main source of employment expansion. Growth in the retailing, construction and hospitality industries, spurred by the removal of restrictions on entering these industries and rising incomes, led to the tertiary sector's spectacular performance. Employment in primary industry actually fell after 1992 as agricultural workers migrated to higher wage jobs in the secondary and tertiary sectors (Figure 1.6).

Figure 1.6

Rapid Growth of Jobs in Industry and Services Employment Growth by Sector (Trend of Growth Rates)



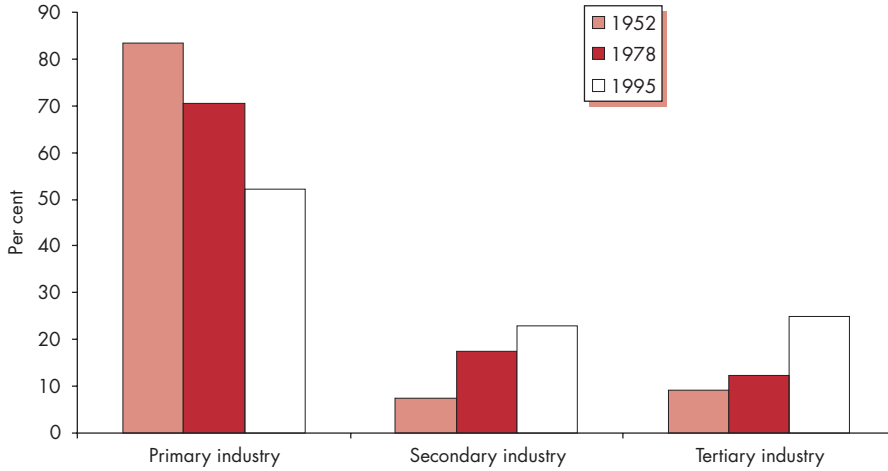
Source: State Statistical Bureau (1996a and previous years).

However, the shift in the structure of employment is less rapid than the change in output structure. At the end of 1995, China's total workforce was 690 million, more than half of whom worked in primary industry and the remainder split relatively equally between the industrial and services sectors (Figure 1.7).

Figure 1.7

Most Labour is Still in Agriculture

Employment by Sector



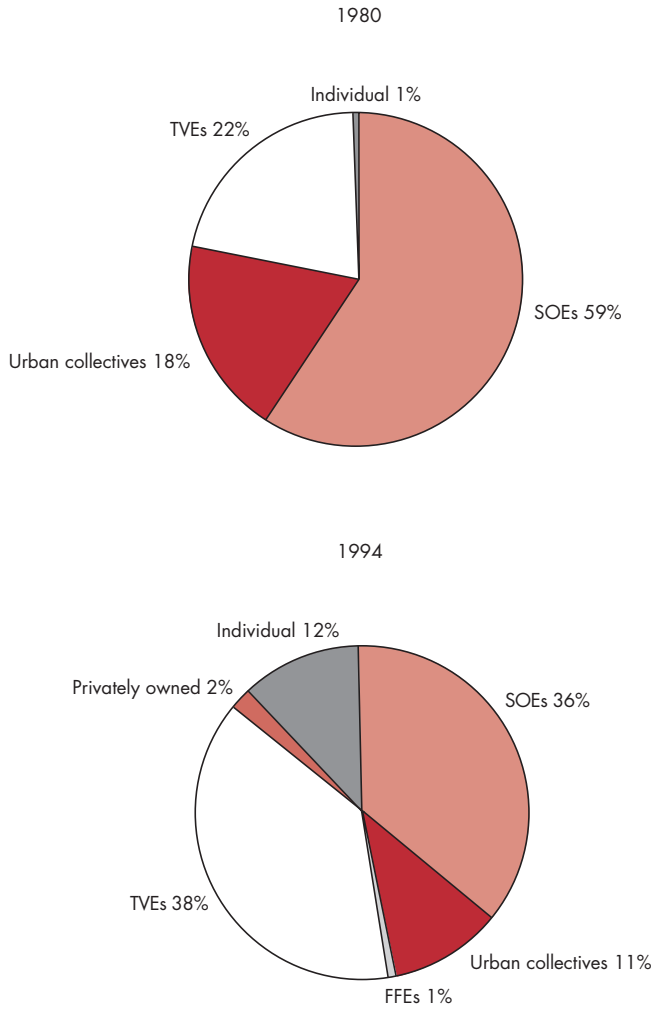
Source: State Statistical Bureau (1996a and previous years).

Agriculture's high employment share compared with its output share indicates that agricultural productivity remains low. Formal constraints on labour migration from rural areas have been relaxed but not removed. Nevertheless, the ongoing movement of surplus labour out of agriculture (up to 100 million people over the reform period) will underpin rapid economic growth in China in the short to medium term. (See Chapter 12 - Labour Markets.)

The ownership structure of employment within the rural and the urban economies has changed significantly (Figure 1.8). The share of SOEs and urban collectives in industrial employment declined steeply, while that of other forms of urban enterprises (mainly private and foreign funded) jumped from 1 to 14 per cent. In the countryside, household farms, which accounted for 67 per cent of employment in 1994, replaced communes, while township and village owned enterprises employed 27 per cent of the rural workforce, compared with only 9 per cent in 1978. The employment share of privately owned rural enterprises rose to 6 per cent in 1994 from zero in 1978.

Figure 1.8

Employment Grows Rapidly in the Non-State Sector
Changes in China's Industrial Employment Structure
by Ownership



Source: State Statistical Bureau (1996a and previous years).

SOURCES OF ECONOMIC GROWTH

Savings and Investment

China's high economic growth rates have stemmed from both productivity gains, due to the more efficient use of capital and labour as a result of reforms, and the rapid expansion of labour and capital inputs. Savings and investment were high by international standards before reform but have been even higher since 1978, both being about 35 per cent of GDP in recent years (Figure 1.9 and Table 1.1). The expansion of investment spurs high economic growth, generating more savings which in turn fund more investment.

Table 1.1

Reforms Spur Savings and Investment

Some Major Economic Indicators (Real Annual Growth Rates)

| | GDP (Per cent) | Total investment (Per cent) | Total consumption (Per cent) | Total savings as per cent of GDP | Retail price index |
|------|-------------------|-----------------------------------|------------------------------------|---|--------------------------|
| 1978 | 11.7 | na | na | 38.0 | 0.7 |
| 1979 | 7.6 | 7.0 | 17.0 | 36.5 | 2.0 |
| 1980 | 7.8 | 7.9 | 13.6 | 35.2 | 6.0 |
| 1981 | 5.2 | -0.6 | 11.2 | 32.5 | 2.4 |
| 1982 | 9.1 | 11.3 | 9.9 | 33.2 | 1.9 |
| 1983 | 10.9 | 13.9 | 10.5 | 33.8 | 1.5 |
| 1984 | 15.2 | 23.1 | 16.8 | 34.4 | 2.8 |
| 1985 | 13.5 | 37.2 | 23.0 | 37.8 | 8.8 |
| 1986 | 8.8 | 13.6 | 13.3 | 37.7 | 6.0 |
| 1987 | 11.6 | 12.4 | 13.9 | 36.1 | 7.3 |
| 1988 | 11.3 | 27.1 | 25.6 | 36.8 | 18.5 |
| 1989 | 4.1 | 10.9 | 12.8 | 36.1 | 17.8 |
| 1990 | 3.8 | 5.7 | 7.7 | 34.7 | 12.1 |
| 1991 | 9.2 | 16.7 | 15.7 | 34.8 | 2.9 |
| 1992 | 14.2 | 28.2 | 21.3 | 36.2 | 5.4 |
| 1993 | 13.5 | 55.6 | 26.5 | 43.3 | 13.2 |
| 1994 | 12.6 | 24.0 | 34.9 | 39.9 | 21.7 |
| 1995 | 10.5 | 26.9 | 28.5 | 40.5 | 14.8 |
| 1996 | 9.7 | na | na | na | 6.1 |

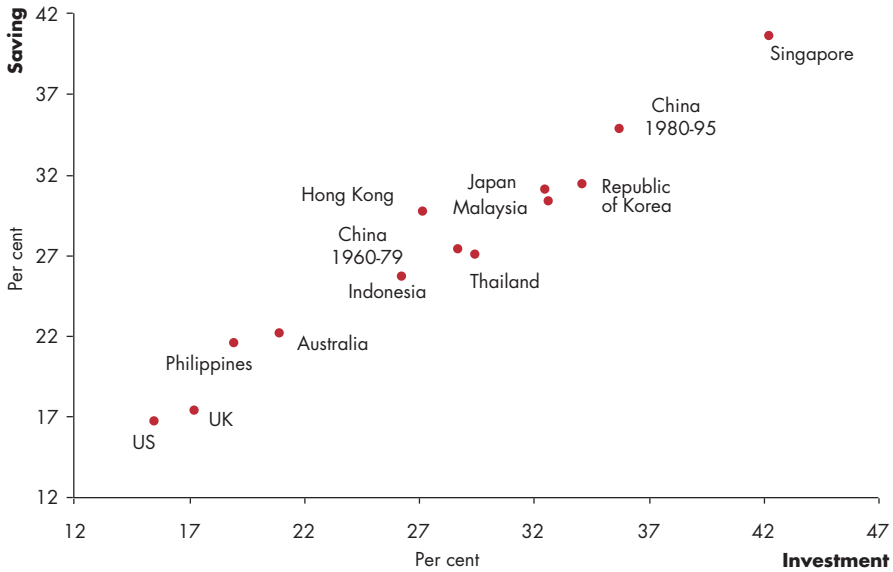
Note: na means not available.

Source: State Statistical Bureau (1996a and previous years); State Statistical Bureau (1993b).

Figure 1.9

How China's Savings and Investment Performance Compares

Savings and Investment by Selected Countries, 1980 to 1994 (Average Per Cent of GDP)



Source: State Statistical Bureau (1996a and previous years); World Bank (1996b and previous years).

Several factors contribute to China's high domestic savings rates, including rising household and non-state enterprise incomes, a lack of mortgage and other consumer credit for purchasing large items, such as housing or automobiles, confidence in the banking system and reasonable interest rate policies, which in recent years have protected savers from inflation. (See Chapter 4 - Macroeconomic Management.) High investment rates have been encouraged by reasonable political and financial stability, high after-tax rates of return in many industries, and the availability of abundant local savings for investment.

In the short to medium term, China's high saving rates and hence investment levels will continue to underpin rapid economic growth.

Structure of Investment

The shift from new fixed capital investment (plant and equipment) to real estate has been significant (Figure 1.10). This is due to the creation of land and real estate markets, increased speculation and the high profits often generated in the sector. However, all sectors except agriculture have seen strong growth in investment.

Despite the rapid growth of light industrial output, heavy industry, dominated by SOEs still receives the bulk of industrial investment, highlighting the high cost of this policy. The priority given to industrialisation in the past and the higher profits

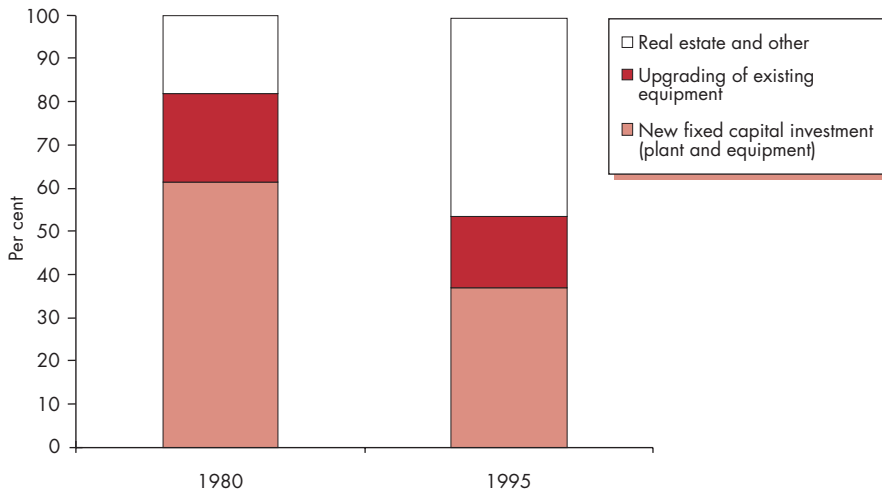
now available elsewhere result in the neglect of infrastructure investment in agriculture (Figure 1.11). Restrictions on transferring land, agricultural prices, procurement and distribution all reduce the profitability of agricultural production. These restrictions discourage the adoption of new technologies and crops. (See Chapter 9 - Agriculture.) Long term neglect of transport and infrastructure is now being redressed but huge injections of capital are needed over several decades. (See Chapter 7 - Infrastructure.)

The sources of investment funds also have changed significantly since 1978, from reliance on public sources (government budgetary appropriations) to retained earnings of enterprises and bank loans financed mainly by household savings (Figure 1.12).

The increasingly important non-state sector has a stronger incentive than SOEs to accumulate and reinvest profits because of clearer property rights to its newly created assets (Meng and Perkins, 1996; Perkins and Raiser, 1994, Table 12).

Figure 1.10

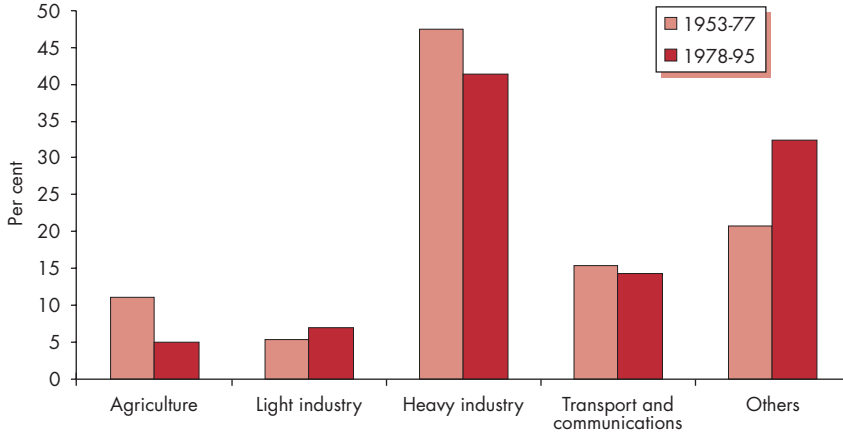
Major Shift to Real Estate Investment
Composition of Total Investment



Source: State Statistical Bureau (1996a and previous years); State Statistical Bureau (1993b).

Figure 1.11

Heavy Industry Still Gets Lion's Share of Investment
Distribution of Infrastructure Investment by Industry

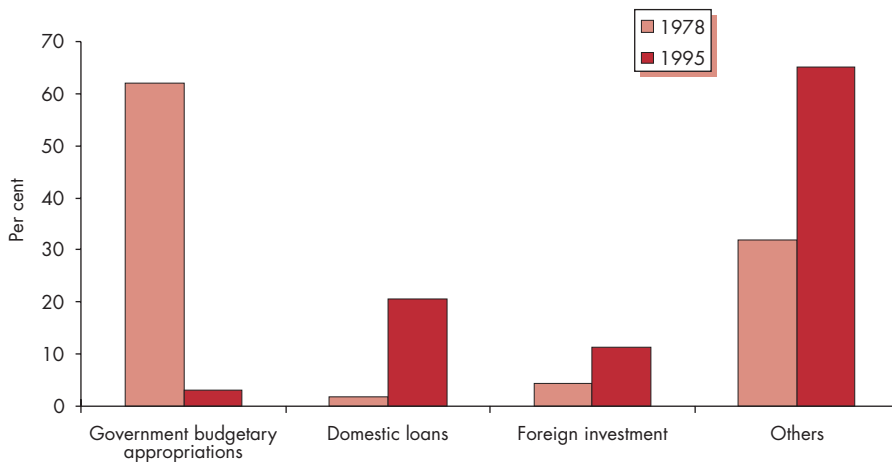


Source: State Statistical Bureau (1996a and previous years); State Statistical Bureau (1993b).

Figure 1.12

Retained Earnings of Non-State Enterprises Replace Plan Allocations

Sources of Investment as Per Cent of Fixed Assets Investment



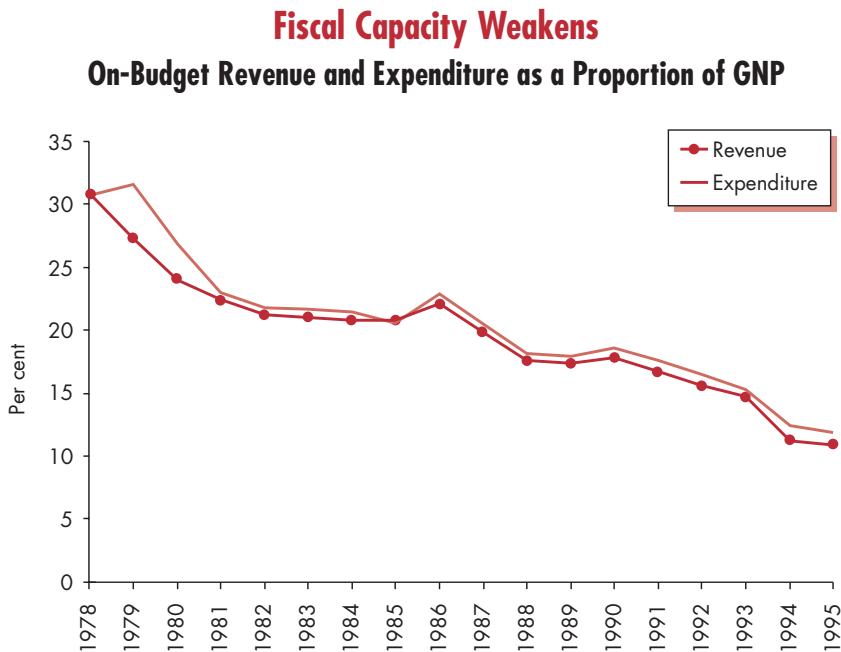
Source: State Statistical Bureau (1996a and previous years).

PUBLIC FINANCE

One of the more worrying outcomes of the reforms is the significant weakening in the central Government's fiscal position. Government revenue and expenditure declined from just over 30 per cent of GNP in 1978 to just over 10 per cent in 1995 (Figure 1.13). Even including off-budget revenue and expenditure, total government spending was only 15 per cent of GNP in 1994.¹⁵ To some extent, the decline is a natural result of the reform process, as investment in industrial SOEs is now the responsibility of enterprises and is no longer financed through the government budget.

Although expenditure has also dropped as a percentage of GNP, budget deficits have risen since the late 1980s (Figure 1.14). In 1995, the total budget deficit reached ¥ 58 billion (US\$7 billion) or 1 per cent of GNP. The major causes of poor revenue performance were the low profitability and increased profit retention of SOEs since enterprise reforms began and a failure to adequately recoup this through increased tax collections from state, non-state domestic and foreign funded enterprises.

Figure 1.13

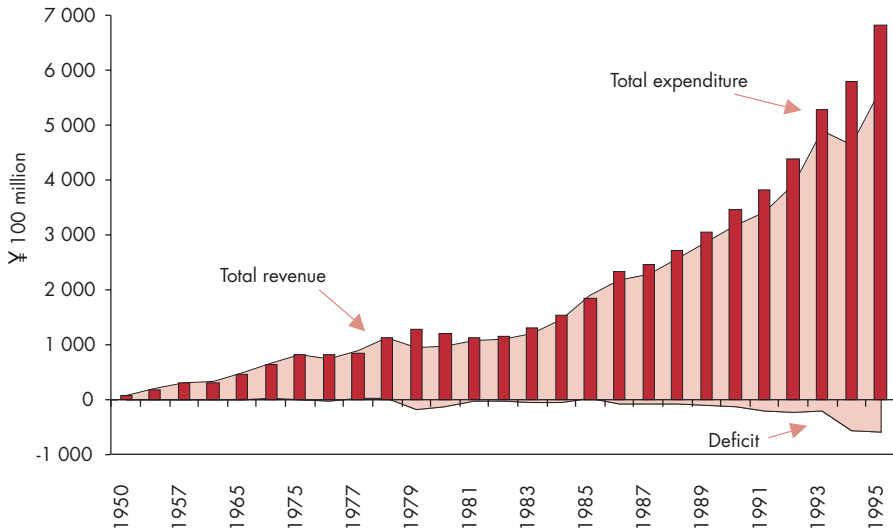


Source: State Statistical Bureau (1996a and previous years).

¹⁵ The Chinese fiscal system consists of both the formal budget and extrabudgetary funds. The latter refers to public revenue and expenditure outside formal governmental budgets, administrative departments and public enterprises.

Figure 1.14

Budget Deficit Grows
The Fiscal Situation of China
(Current Prices)



Source: State Statistical Bureau (1996a and previous years).

Weakness in the mechanisms for intergovernmental transfers is also a major issue. From 1978 to 1995, the central Government's share of total government revenue declined from 79 per cent to 48 per cent, while local governments' share of expenditure (after transfers from the central Government) increased from 46 per cent to 71 per cent. This shift reflects the decentralisation of taxation authority to local and provincial governments as well as increased local responsibility for public investment. In 1994, the central and provincial governments agreed to a new revenue sharing formula which was designed to redress the decline in the central Government's revenue share, but this has had little impact to date. (See Chapter 4 - Macroeconomic Management.)

In October 1995, the Government announced it would achieve a balanced budget by 2000. Substantial increases in tax revenue as a result of intensified reforms in the state sector, development of the taxation system and reform of intergovernmental fiscal relations will therefore be needed.

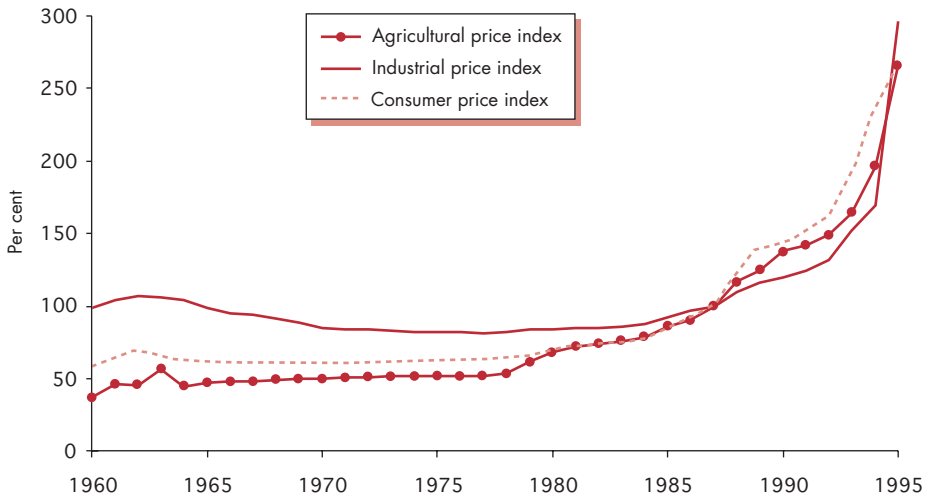
PRICES AND INFLATION

As in most countries, the key macroeconomic challenge confronting policy makers is to sustain economic growth while controlling inflationary pressures. In the pre reform period, the Government set consumer and industrial input prices, ensuring no inflation (Figure 1.15).

Figure 1.15

Inflation Has Been a Constraint

Overall Price Index (1987 = 100)



Source: State Statistical Bureau (1996a and previous years).

Inflation emerged after 1978 when prices controls were removed and the money supply expanded rapidly. The growing government deficits were financed through central bank loans, essentially by printing money. Rapid increases in SOE and private sector investment financed by bank loans and foreign investment fuelled strong increases in consumption, wages and prices. The consumer price index rose on average by 8.7 per cent per year from 1978 to 1995. Agricultural prices rose more steeply (9.8 per cent per year) than industrial prices (8.4 per cent per year) due to a long overdue realignment of suppressed agricultural prices and poor harvests in some years, such as 1993.

The relatively tight monetary policy and slower food price increases in 1995 and 1996 effectively controlled inflationary pressures, with the biggest moderation in price increases in the food price index (Table 1.2).

Table 1.2

Food Price Inflation Drives Overall Inflation Recent Price Indexes

| | 1994 | 1995 | 1996 ^a |
|---------------------------------|------|------|-------------------|
| Overall retail price index | 21.7 | 14.8 | 7.6 |
| Food price index | 31.8 | 22.9 | 8.8 |
| Consumer price index (non-food) | 24.1 | 17.1 | 10.5 |

Note: ^a Data for 1996 are forecasts by Peregrine Research Institute.

Source: State Statistical Bureau (1996a and previous years); Peregrine Research Institute, June 1996.

Macroeconomic Management and Stop-Go Cycles

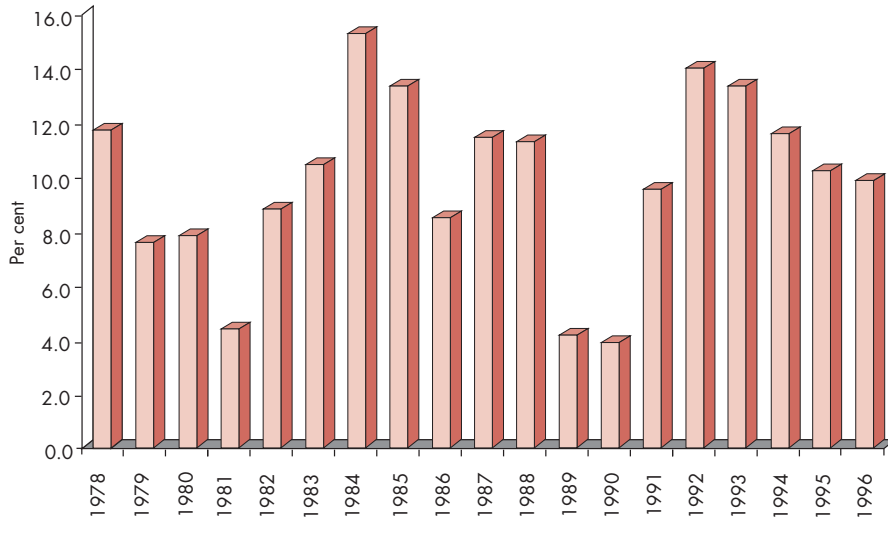
Since the reforms began, China has experienced several sharp economic cycles as a result of inadequate control of macroeconomic aggregates (Figure 1.16). Macroeconomic instability is common in transitional economies as central planning controls over the economy are often dismantled before market economy macroeconomic control mechanisms are developed fully. Macroeconomic instability often is related closely to the absence of either market or government controls over SOEs, because they can frequently obtain almost unlimited cheap credit but can rarely be bankrupted if they fail to repay it.

During past macroeconomic cycles, SOEs contributed to the overheating of the economy through their excessive demand for bank loans to finance investment in new capital construction, imports and even speculation in real estate and stocks. In the absence of indirect monetary and fiscal control mechanisms, when the economy was overheated, the authorities had to administratively impose austerity programs. These were inefficient because they hurt indiscriminately every activity of the economy, rather than just squeezing out lower return activities. However, in the last economic cycle, improvements in monetary policy controls enabled the authorities to successfully reduce inflation with less resort than previously to crude restrictions on the quantity of bank lending, and achieved a 'softer landing'. (See Chapter 4 - Macroeconomic Management.)

Figure 1.16

Booms and Busts Finally under Control?

Annual Growth of China's GDP (at Constant Prices), 1978 to 1995



Source: State Statistical Bureau (1996a and previous years).

FOREIGN TRADE

Since 1978, foreign trade has been actively promoted as a growth strategy, emulating other successful East Asian economies. The 15 per cent annual growth of imports and exports achieved since 1978 is well above overall economic growth, and the ratio of two-way trade to GDP reached 36 per cent (US\$281 billion) in 1996, up from only 10 per cent in 1978. (See Chapter 1 Appendix for a discussion of GDP measurement problems.)

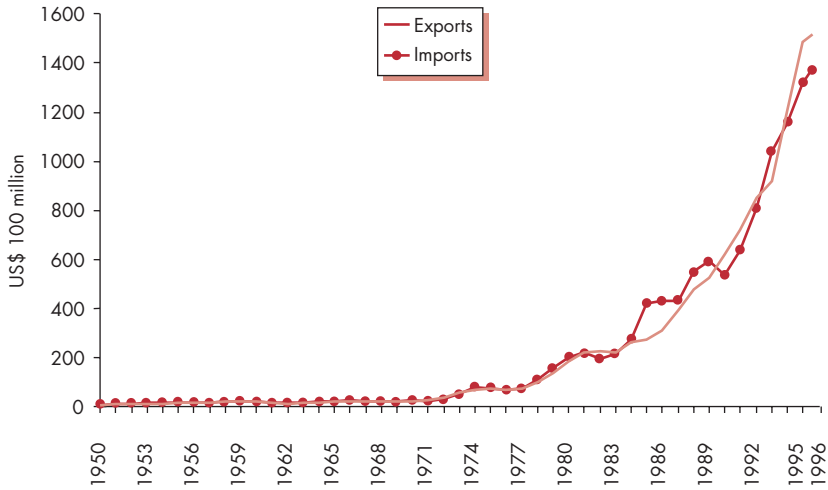
By 1995, China was the world's tenth largest trader and accounted for almost 4 per cent of total world trade.

This rapid growth in foreign trade accompanied substantial changes in its commodity composition and direction. Exports moved significantly from natural resources to labour intensive manufactures, better reflecting China's comparative advantage. Imports of manufactured goods, especially capital goods, became more significant, while imports of primary commodities declined (Figure 1.18).

In 1995, more than 80 per cent of China's two-way trade was with Japan, USA, NIEs-4 (Hong Kong, Singapore, Taiwan and Republic of Korea) and the European Union. However, the importance of Hong Kong as a trading partner has declined dramatically since 1990 partly due to China's change in 1993 in reporting the country of destination. The importance of China's trade with Japan, USA, the European Union and the NIEs-3 (Singapore, Taiwan and Republic of Korea) has increased rapidly. (See Chapter 5 - International Trade.)

Figure 1.17

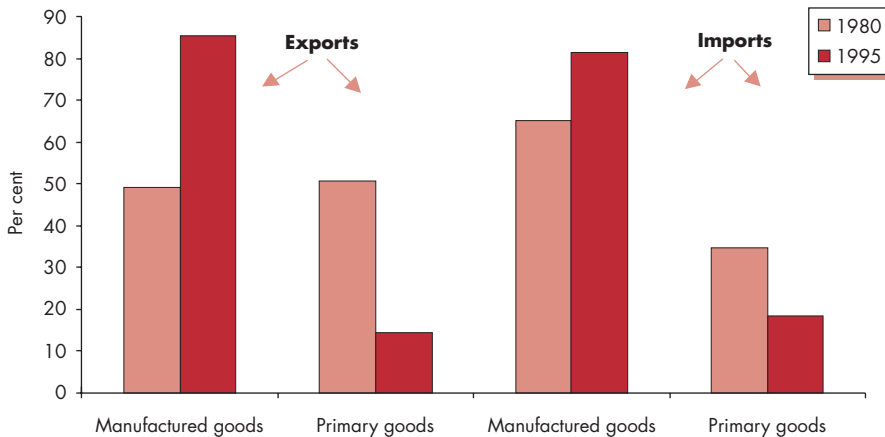
Trade Booms
Rapid Growth in Trade
(Current Prices)



Source: State Statistical Bureau (1996a and previous years).

Figure 1.18

Exports Shift to Labour Intensive Manufactures -
Imports to Capital Goods
Exports and Imports by Commodity Type



Source: State Statistical Bureau (1996a and previous years).

FOREIGN INVESTMENT

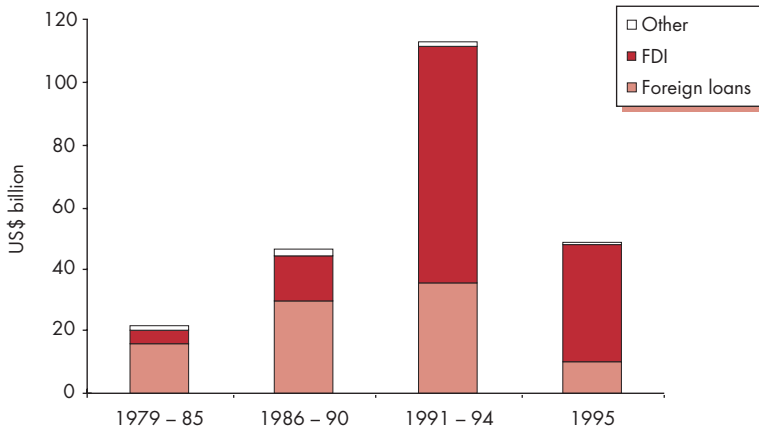
Foreign investment plays a crucial role in China’s rapid post reform growth by transferring capital, technology, training and managerial skills and assisting with product development and market access. (See Chapter 6 - Foreign Investment.)

In 1995, China signed 37 184 contracts for the use of foreign capital, amounting to US\$103.2 billion. Of the contracts, 37 011 were for foreign direct investment worth US\$91.9 billion and 173 were foreign loans worth US\$11.3 billion. However, actual use of foreign capital in 1995 totalled US\$48.1 billion, of which foreign direct investment accounted for just under 80 per cent (Figure 1.19). Among the foreign direct investments made, 51 per cent were for equity joint ventures, 28 per cent were wholly foreign-owned enterprises and 21 per cent were for different types of cooperation. More than 60 per cent of the foreign direct investment in China was from Hong Kong and Taiwan.

The Government has recently placed higher priority on foreign investment in infrastructure and agriculture and in the hinterland provinces. To date, most FDI has been concentrated in manufacturing industries (over 50 per cent) and real estate (about 30 per cent) in the coastal areas (Figure 1.20). However, foreign direct investment is slowly spreading to inland provinces as producers seek lower cost production sites. (See Chapter 8 - Regions.) This trend is already evident, albeit on a modest scale. In recent years, China has also started to open up banking and other professional services to foreign investment, but these and other important sectors like distribution and mining still remain relatively closed.

Figure 1.19

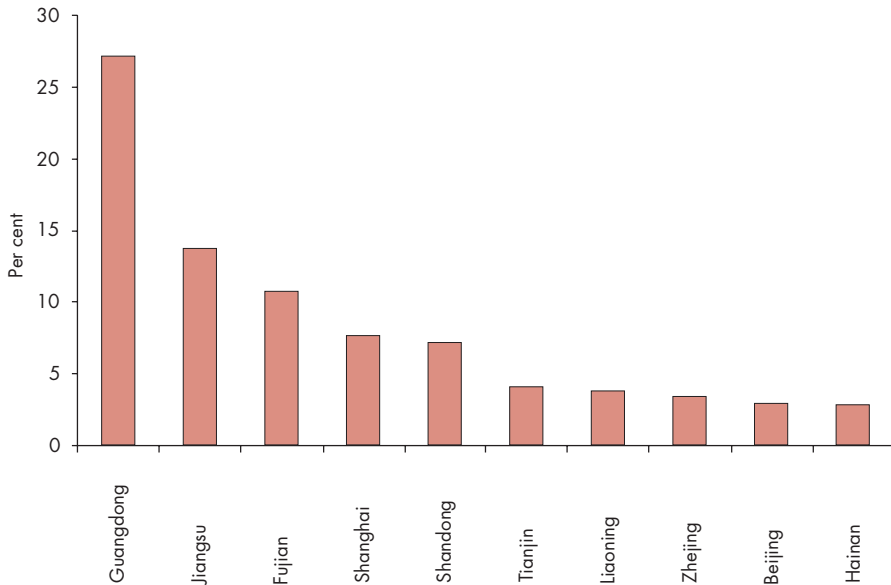
FDI Grows Dramatically Use of Foreign Capital



Source: State Statistical Bureau (1996a and previous years).

Figure 1.20

Coastal Provinces Prime Destination for FDI Foreign Capital Used, by Region



Source: State Statistical Bureau (1996a and previous years).

EXTERNAL DEBT AND SERVICE RATIO

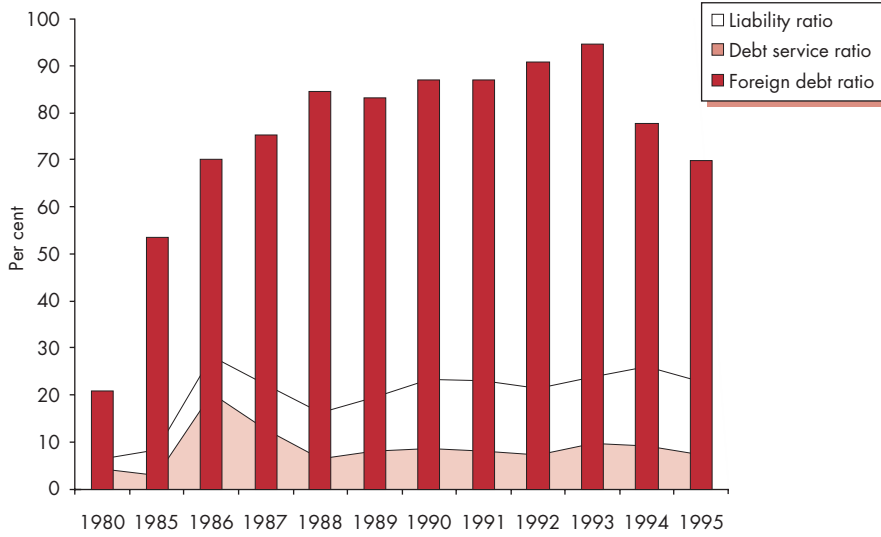
Rapid economic development and opening up to international capital markets has increased China's external liabilities dramatically (Figure 1.21).

External liabilities totalled US\$106.6 billion in 1995, up from US\$0.6 billion in 1978, having grown at an average annual rate of 24 per cent since 1980. Total external debt as a percentage of GNP peaked in 1993 with the debt service ratio dropping in 1994 and 1995. However, China's average debt service ratio from 1980 to 1994 was considerably lower than the ratios of other countries in the region (Figure 1.22).

Furthermore, over 80 per cent of China's foreign debt is long term, significantly reducing the potential for volatile short term flows (Table 1.3). The central Government and the central bank (the People's Bank of China) hold more than 70 per cent of the total external debt. Non-financial public enterprises account for a further 20 per cent while the private sector, including non-guaranteed loans, hold only about 5 per cent. Just under 50 per cent of debt is in the form of foreign commercial loans, with the remaining concessional loans from international financial institutions and bilateral aid programs. The trend towards long term, concessional financing has strengthened in the 1990s, despite the rapid increase in borrowing, indicating considerable discipline on the part of the Government.

Figure 1.21

China's Foreign Debt Modest Foreign Debt as a Per Cent of GNP

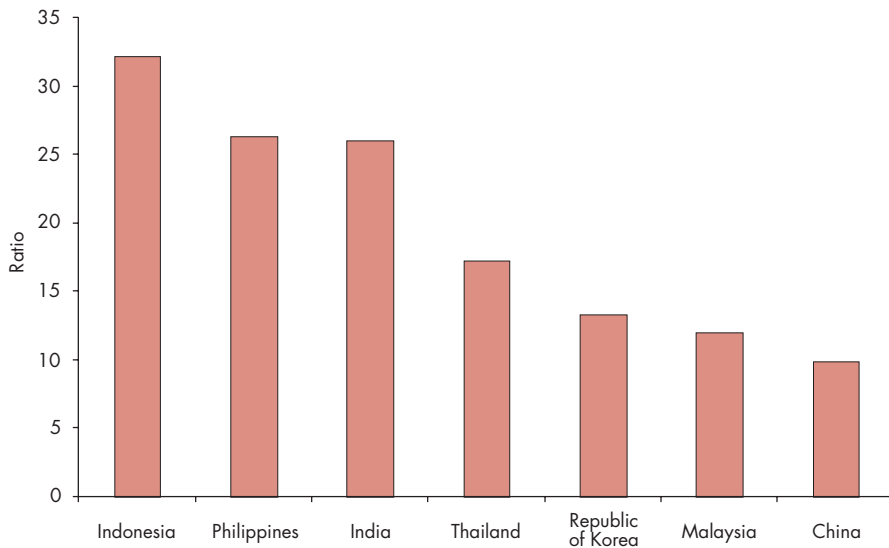


Note: ^a Liability ratio is the ratio of foreign debt to gross national product.
^b Debt service ratio is the ratio of the repayment of principal and interest on foreign debt to foreign exchange receipts from exports of goods and services.
^c Foreign debt ratio is the ratio of foreign debt to foreign exchange receipts from exports of goods and services.

Source: State Statistical Bureau (1996a and previous years).

Figure 1.22

China's Low but Growing Debt
Debt Service Ratios^a for Selected Countries
(Average 1980 to 1994)



Note: ^a The ratio of the repayment of principal and interest on foreign debt to foreign exchange receipts from exports of goods and services.

Source: World Bank (1996a).

Table 1.3

Debt is Long Term and Favours Soft Loans
Type of Foreign Debt

| | 1990 (Per cent) | 1993 (Per cent) | 1995 (Per cent) |
|---|--------------------|--------------------|--------------------|
| Duration | | | |
| Long term debt | 87.1 | 83.8 | 88.8 |
| Short term debt | 12.9 | 16.2 | 11.2 |
| Source | | | |
| Foreign government loans | 16.0 | 17.1 | 20.7 |
| International financial institution loans | 12.0 | 12.5 | 13.9 |
| International commercial loans | 55.5 | 49.2 | 49.4 |
| Other | 16.5 | 21.2 | 16.0 |

Source: State Statistical Bureau (1996a and previous years).

While there is no short term debt problem, capital use and investment efficiency in SOEs needs to be improved significantly. (See Chapter 10 - State-Owned Enterprises.)

MEASURING CHINA'S ECONOMIC PERFORMANCE¹⁶

Analysis of China's current economic performance using official data is difficult given the incomplete transition of data collection and reporting from the old Marxist material product system to the United Nations' System of National Accounts.¹⁷ Despite numerous efforts to correct this shortcoming, the contribution of services is probably still underestimated.¹⁸ For example, housing output is almost certainly underestimated because it is still heavily subsidised in urban areas.¹⁹ The output of the military sector has also been largely excluded from estimates of GDP. In addition, in the past, China's administrative system tended to encourage local officials to politicise data reporting, exaggerating good outcomes and under-reporting poor ones. A new regulation outlaws this practice.

Even if national income could be measured with reasonable confidence, international comparisons of economic performance present many challenges. The main methods currently used to convert a country's national income in local currency to internationally comparable measures are the exchange rate and purchasing power parity, PPP, approaches. As these approaches often yield very different results, it is necessary to compare these methods to have confidence in the results they produce. (See Chapter 1 Appendix.)

The exchange rate approach merely converts an economy's GDP into foreign currency (usually US dollars) at the official exchange rate. The purchasing power parity, PPP approach uses converters to adjust money incomes to better reflect the ability of a unit of local currency to purchase goods and services in its country of issue. In low income countries, PPP measures of income per capita usually are higher than the official exchange rate measures and better reflect actual living standards, as they adjust for the undervaluation - essentially because wages are so low - of non-tradeables (goods and services not traded internationally) in these countries. PPP estimates should not be used to make predictions about future

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¹⁶ Discussion in this section draws on Maddison (1995), Maddison and van Ark (1994), Ren and Chen (1994) and Wu H. (1993).

¹⁷ China has accepted the United Nations' System of National Accounts and has made serious efforts to adopt this system; however, its national accounting is still influenced by the Marxist material product system adopted in the early 1950s (following the Soviet Union), and also by national economic policies. Ensuring that GDP data collection and collation practices follow agreed UN system guidelines poses significant problems.

¹⁸ Most services were considered to be 'non-material' and hence 'non-productive' under the material product system. The change to the UN system required to appropriately measure the services sector has been costly and slow, and still has considerable room for improvement. Following the recent completion of the first national census of the services sector, the State Statistical Bureau has revised upwards its previously published GDP figures to reflect better reporting of the services sector's value added in the census.

¹⁹ It may be argued that manufacturing output is overestimated because some SOE production inputs, including energy inputs, are underpriced; thus the so-derived value added may have been inflated. However, this should be offset by equal *under counting* of the value added in the input producing sectors, such as utilities, raw materials and energy.

economic growth without careful qualifications, as the extent of this undervaluation of non-tradeable is likely to decrease as incomes rise. (See Chapter 1 Appendix for a fuller discussion of PPP methodology.)

Various estimates of China's per capita GDP use these different approaches (Appendix Table 1.1). The discussion of the merits of the different approaches in the appendix concludes that Maddison's (1996) revised estimate for 1990 GDP per capita of approximately US\$2 000 in 1990 dollars is a reasonable middle of the range estimate. This is used in the following comparison of China's GDP.

PPP estimates of the GDP of China and other selected countries in 1950 and 1990 showed China ranked as the fourth largest economy in the world in 1950, behind the USA, the Soviet Union and the United Kingdom (Table 1.4). By 1990, China was in second position, behind the USA.²⁰ In terms of per capita GDP, China is still well behind the USA and has failed to grow as fast as many other countries that had much lower incomes than the USA in 1950. From 1950 to 1990, China's per capita GDP grew by 92 per cent relative to the USA's per capita GDP, while that of Japan grew by 333 per cent, Taiwan by 392 per cent and the Republic of Korea by 350 per cent. During this period, all other countries listed, including Australia, maintained their relative positions to the USA.

The estimates of per capita GDP in Table 1.4 appear plausible in a relative sense. China's 1990 per capita GDP was about one and a half times India's, but a quarter of that of the Republic of Korea and a tenth of Japan's.

An international comparison of growth performance in China and selected countries over the period 1950 to 1992 indicates that China grew much more slowly than other East Asian countries, but more quickly than developed countries like the USA and Australia (Figure 1.23). Estimates using the PPP production approach indicate that official statistics over-estimate the growth of the Chinese economy. Maddison (1996, p. 67) shows that for 1952 to 1978, the Chinese economy grew by about 4 per cent per year compared with the official figure of 6 per cent, and for 1978 to 1994, it grew by about 7 per cent per year compared with official figure of almost 10 per cent growth.

China will take many decades to achieve the average per capita GDP of today's advanced economies. Nevertheless, in some sense a country's size rather than its per capita wealth determines its economic size. China's population is 4.6 times the US population. This raises the question of when China's total GDP in PPP terms will overtake that of the USA if the previous growth performance of each country is maintained. Graphs of alternative rates of China's PPP based GDP growth over the next few decades show the Chinese economy will have greater domestic (though not international) purchasing power than the US economy some time between 2010 and 2035, depending on assumptions made about China's 1994 per capita GDP (Figure 1.23).

²⁰ The top ten economies in 1950, measured in the 1990 international dollars, were the USA (1), the Soviet Union (2), the United Kingdom (3), China (4), France (5), Germany and India (6), Italy (7), Japan (8) and Brazil (9). In 1992, they were the USA (1), China (2), Japan (3), Russia (4), Germany (5), India (6), France (7), Italy (8), the United Kingdom (9) and Brazil (10) (from Maddison 1995, Tables D-1a, D-1c and D-1e). Note that Russia's relative decline is also due to the disintegration of the Soviet Union.

For example, if it is accepted that China's per capita PPP GDP in 1994 was US\$2 000, and that the USA will maintain its average real GDP growth rate from 1973 to 1994 of 2.7 per cent per year, while China will maintain its 1978 to 1994 real GDP growth rate of 7 per cent per year, then by 2020 China's aggregate PPP measure of GDP will equal that of the USA (the middle panel of Figure 1.24).

This analysis makes several simplifying assumptions, however, including that: the gap between the official exchange rate and PPP exchange rate will remain constant as incomes rise; the real official exchange rate will not appreciate; and the economic and political environment in both countries will remain unchanged.

Table 1.4

China Moves to Second Position

GDP Estimates for China and Selected Economies Relative to US GDP, Based on International Comparisons Project PPP, 1950 and 1990 (1990 International Dollars)

| Country ^a | 1950 | | | | 1990 | | | |
|----------------------|--|---|---------------------------------------|---|--|---|---------------------------------------|---|
| | Total GDP (Int'l\$ billion) | As per cent of US GDP (Per cent) | Per capita GDP (Int'l\$) | As per cent of US per capita GDP (Per cent) | Total GDP (Int'l\$ billion) | As per cent of US GDP (Per cent) | Per capita GDP (Int'l\$) | As per cent of US per capita GDP (Per cent) |
| USA | 1 458 | 100.0 | 9 573 | 100.0 | 5 465 | 100.0 | 21 866 | 100.0 |
| China ^b | 255 | 17.5 | 466 | 4.9 | 2 323 | 42.5 | 2 047 | 9.4 |
| Japan | 157 | 10.8 | 1 873 | 19.6 | 2 291 | 41.9 | 18 548 | 84.8 |
| USSR/ Russia | 510 | 35.0 | 2 834 | 29.6 | 1 988 | 36.4 | 6 871 | 31.4 |
| Germany | 214 | 14.7 | 4 281 | 44.7 | 1 182 | 21.6 | 18 685 | 85.5 |
| India | 214 | 14.7 | 597 | 6.2 | 1 116 | 20.4 | 1 316 | 6.0 |
| France | 219 | 15.0 | 5 221 | 54.5 | 1 009 | 18.5 | 17 777 | 81.3 |
| United Kingdom | 345 | 23.7 | 6 847 | 71.8 | 936 | 17.1 | 16 302 | 74.6 |
| Republic of Korea | 18 | 1.2 | 876 | 9.2 | 384 | 7.0 | 8 977 | 41.4 |
| Australia | 59 | 4.0 | 7 218 | 75.4 | 280 | 5.1 | 16 417 | 75.1 |
| Taiwan | 7 | 0.5 | 922 | 9.6 | 233 | 4.3 | 10 324 | 47.2 |

Note: Int'l\$ = International dollars, which are US dollars corrected to reflect the differences in purchasing power in the countries concerned using the PPP methodology.

^a Ranked by 1990 GDP.

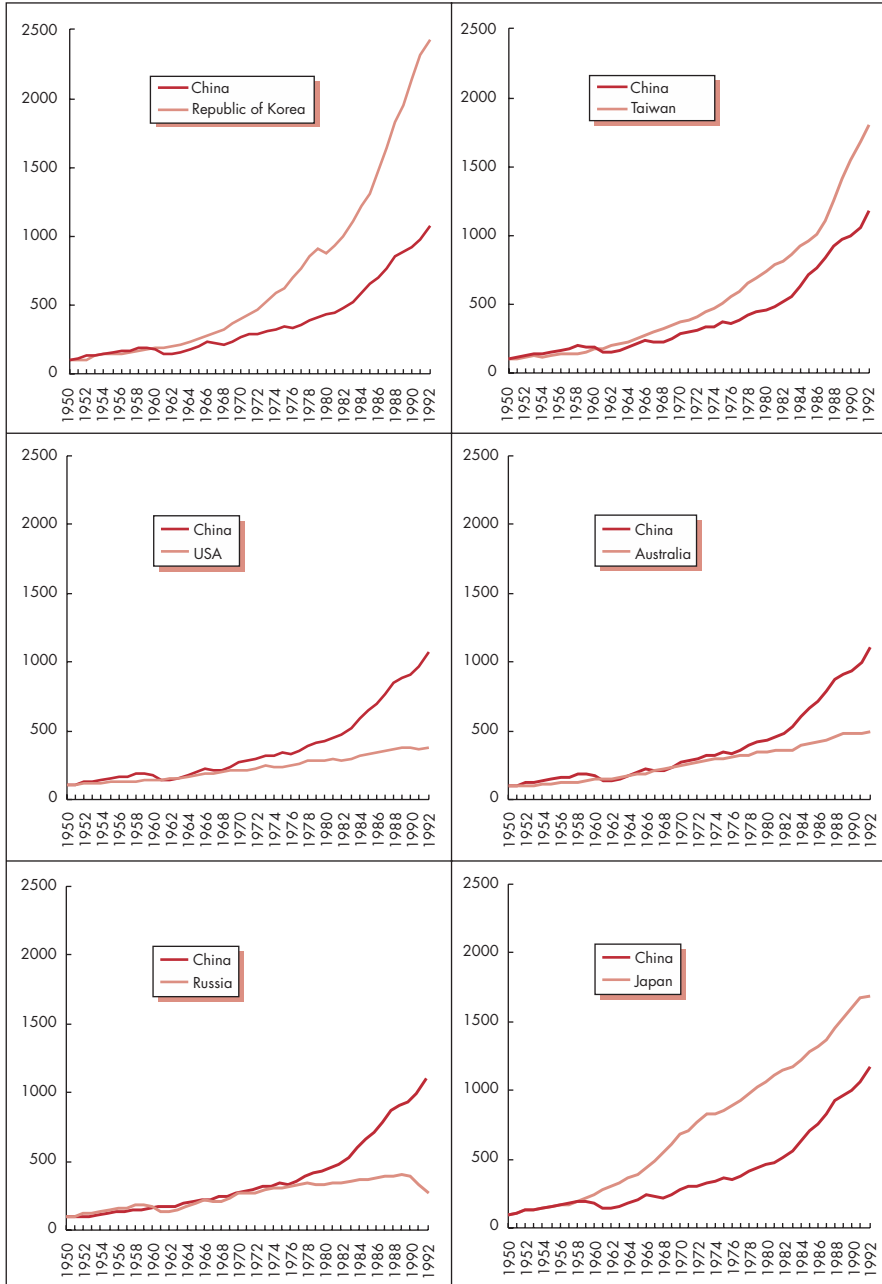
^b Maddison revised (1996, Table C-1).

Source: Derived from Maddison (1995, Tables D-1a, D-1c and D-1e).

Figure 1.23

How Well Has China Done?

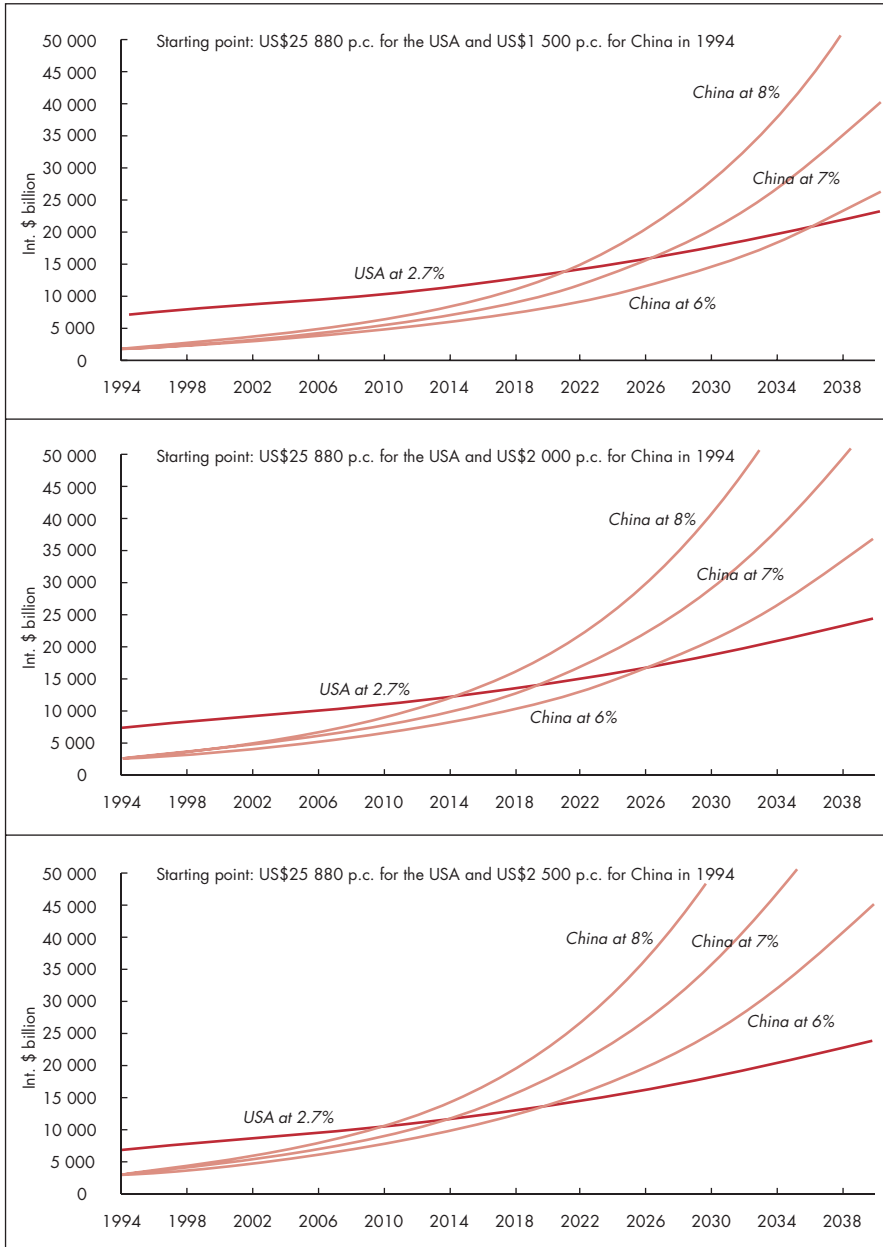
International Comparison of Real GDP Growth Performance, China versus Selected Countries, 1950 to 1992
(Index, 1950=100)



Source: Maddison (1995, Tables B-10a, B-10c, B-10e).

Figure 1.24

When Will China's Economy Be Bigger than the USA's?
Optional Projections of the Aggregate GDP Level for
the USA and China, 1994 to 2038
(in Billion 1994 International Dollars)



Source: The US per capita and total GDP are from World Bank (1996a, Table 1). The Chinese per capita GDP levels are assumed based on Appendix Table 1.1.

POVERTY IN CHINA

By 2020, China's per capita GDP will still be no more than 25 per cent of the US level. Despite considerable progress in reducing poverty over the past 15 to 20 years, some 350 million people still live in poverty - more than the entire population of Western Europe. These are the World Bank's estimates for 1993 based on its international standard of US\$1 per person per day, in real 1985 terms and using PPP exchange rates (World Bank, 1996d). National poverty estimates, using a benchmark of US\$0.60 per person per day, are much lower: 100 million in 1993 dropping to 65 million in 1996. By and large, poverty in China is more prevalent in rural than in urban areas, and in central and western provinces and autonomous regions than in the eastern seaboard provinces.

Reducing poverty in China remains a key objective for government at all levels, but is becoming progressively harder and more expensive. The remaining poverty is found mainly in more remote, inaccessible and less densely populated areas, which are more difficult to link into the national (and global) economy. The central Government's fiscal base has been narrowing, competing claims on its revenues have been intensifying, and fiscal equalisation across provinces needs strengthening. Increasing unemployment, particularly in urban areas, could be a significant new source of poverty.

CHINA'S ECONOMIC GROWTH PROSPECTS AND IMPLICATIONS FOR AUSTRALIA

This snapshot of China's economic progress since reforms shows many factors contributed to outstanding economic growth, including rapid increases in labour supply and capital investment, efficiency gains from increasing market orientation and structural change, and strong growth of exports and of local consumer demand due to rising incomes. The analysis in this report supports the conclusion that if China continues the momentum of reforms and works to remove the major constraints, such as infrastructure and skilled labour supply, it should experience strong growth of around 7 to 8 per cent per year until the end of the century, and quite possibly for a decade beyond that. Continuing rapid economic growth in China will provide Australian business with important trade and investment opportunities.

In recent years, the sustainability of economic growth in the region overall has been questioned (Krugman, 1994), particularly as a result of falling exports in early 1996 (for example see *Far Eastern Economic Review*, 30 October 1996). However,

the Krugman argument has been largely discredited.²¹ The fundamentals for growth in the region remain strong. Both the International Monetary Fund (1996b) and World Bank (1996d) remain optimistic about the region's growth potential, predicting almost 8 per cent growth for the rest of the decade, well above the world average.

However, China also faces significant challenges. Rapid economic growth, fuelled by high capital investment and coupled with inflation and fluctuations in the current account, produces a degree of volatility in the future economic outlook. Continued economic reforms will be needed to sustain future economic growth, enabling an acceleration of structural change, improved resource allocation and investment efficiency, and the smooth transfer of huge numbers of surplus workers from agriculture to more productive sectors, such as labour intensive manufacturing and services. The Government will also need to maintain its reform agenda to improve macroeconomic management to sustain its currently low inflation levels and smooth macroeconomic fluctuations, and to increase productivity to boost the competitiveness of the economy. These conditions will be necessary to ensure that the crucial export sector continues to grow and domestically oriented industries can match stronger international competition in the domestic market.

As in other East Asian economies, exports will remain a primary engine of growth. Export-oriented development has permitted specialisation and economies of scale in production and therefore major productivity gains. However, export orientation is contingent on continued access to world markets. To ensure this, China must further liberalise and integrate its economy into the world economic system and gain accession to the WTO as soon as possible. (See Chapter 5 - International Trade.)

China's economic growth prospects depend on the underlying potential of its human and physical resources and the prospects for ongoing economic reform and political stability. Labour productivity is one important indicator of an economy's growth potential. Even though China's labour productivity per hour grew at an above average rate of 3.7 per cent per year from 1973 to 1992, in 1992 it was still the second lowest of the countries listed in Table 1.5. While its labour productivity was higher than India's, it was only 33 per cent of the Republic of Korea's, 25 per cent of Taiwan's, 50 per cent of Russia's, 64 per cent of Thailand's, 83 per cent of Indonesia's and about 10 to 15 per cent of the labour productivity of the advanced economies of the USA, the United Kingdom, Japan and Australia. This labour productivity gap between China and developed countries means that China still has huge growth potential if it continues to pursue appropriate economic policies.

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²¹ Krugman argued that East Asian growth was no better than Russian growth in the 1950s, which soon faltered, as both relied on using more labour and capital to increase output, rather than rising factor productivity. This argument is wrong for two reasons. It neglects to recognise that the allocation of labour and capital in export-oriented East Asian countries is to sectors where the economies are highly efficient, internationally competitive producers, and growth of these exports will ensure continued growth of these economies. Russia allocated capital and labour on the basis of central plans to highly unproductive sectors like defence and heavy industry, that produced goods that no one wanted. Krugman's assertion that the East Asian economies have not achieved productivity growth is also wrong, as they have achieved considerable productivity improvements over the past four decades. (See Industry Commission, 1993, for a survey of productivity growth in the region.)

The ongoing shift of rural labour from the farm to non-farm sector will raise significantly productivity and economic growth.

Table 1.5

Big Potential for Further Growth **Labour Productivity in China and Selected Economies**

| Economy | GDP per hour worked (1990 international dollars) | | | | Labour productivity growth (per cent per year) | | |
|-------------------|---|-------|-------|-----------------|---|---------|--------------------|
| | 1950 | 1973 | 1992 | Rank by 1992 | 1950–73 | 1973–92 | Rank by 1973–92 |
| USA | 12.66 | 23.45 | 29.10 | 1 | 2.72 | 1.03 | 10 |
| United Kingdom | 7.86 | 15.92 | 23.98 | 2 | 3.12 | 1.97 | 8 |
| Australia | 8.68 | 16.87 | 22.56 | 3 | 2.93 | 1.39 | 9 |
| Japan | 2.03 | 11.15 | 20.02 | 4 | 7.69 | 2.83 | 6 |
| Taiwan | 1.17 | 4.13 | 11.06 | 5 | 5.64 | 4.80 | 2 |
| Republic of Korea | 1.28 | 3.22 | 8.48 | 6 | 4.09 | 4.72 | 3 |
| USSR/Russia | 3.07 | 6.59 | 5.66 | 7 | 3.38 | -0.72 | 11 |
| Thailand | 0.74 | 1.68 | 4.34 | 8 | 3.63 | 5.12 | 1 |
| Indonesia | 1.02 | 1.86 | 3.35 | 9 | 2.65 | 3.15 | 5 |
| China | 0.82 | 1.31 | 2.79 | 10 | 2.06 | 3.67 | 4 |
| India | 0.60 | 0.94 | 1.58 | 11 | 1.97 | 2.50 | 7 |

Source: Estimates made with data derived from Maddison (1995, Table J-5).

China's transition from a centrally planned to a market economy appears to date, at least superficially, to have been superior to the experiences of Eastern Europe and the former Soviet Union. However, debate is vigorous about the lessons that can be drawn from comparing the models of economic reform in these countries. Some argue that China's reform process benefits from the gradual approach it adopts while the 'shock therapy' approach of the other countries is detrimental (Singh, 1991). Others dispute this and argue that China's superior performance primarily reflects its more favourable economic structure prior to reform. China was basically a peasant agricultural society while Eastern Europe and the Soviet Union were urbanised and over industrialised. While both had problematic SOEs, these enterprises in Eastern Europe and the former Soviet Union dominated those economies, making their impact more serious. In China, rapid growth was possible because the large agricultural sector contained surplus labour and received no subsidies. Once constraints on migration across regions and between jobs were removed, this labour was available to expand new industries and non-state enterprises. By contrast, in Eastern Europe and the former Soviet Union, the extremely large SOE sectors impeded structural adjustment, employing most labour and making it impossible to start significant private sectors without first restructuring the SOEs (Sachs and Woo, 1994).

One important question is whether China can maintain its growth momentum in the next decade without restructuring its SOE sector. Since China's SOE sector is relatively small and shrinking, the non-state sector has plenty of room to grow. Consequently, China may eventually solve the problems in the SOE sector without being forced to take drastic action. However, the dilemma is that, without restructuring the state sector, financial sector and probably trade reform will be delayed and it will be more difficult to achieve macroeconomic stability and to efficiently allocate capital, skilled labour and other scarce resources within the economy. This will certainly slow the development of the market economy and reduce future growth prospects. (See Chapters 4 - Macroeconomic Management, 10 - State-Owned Enterprises and 5 - International Trade.)

Sustainable economic growth also requires political stability, legal system reform and, particularly, improved enforcement of laws. (See Chapter 3 - Market Environment.) China's leadership has demonstrated a commitment to continued market-oriented reform at both an ideological and practical level. (See Chapter 2 - Political Environment.) While future growth prospects could be adversely affected by any overt power struggle now that Deng Xiaoping has died, it is very unlikely that China would reverse the reforms. China has learnt from the past 19 years of economic reform that it must rely on the market system to achieve its objective of economic development.

Appendix 1.1

VARIOUS ESTIMATES OF CHINESE GDP

To successfully compare China's economic performance with that of other countries it is necessary for:

- national statistical offices to agree on what national accounts should measure and then implement these general principles to make estimates of GDP and its components in real and money terms, and
- analysts to devise appropriate comparisons of purchasing power parity (PPP) to convert these estimates of GDP in national currency into a common measure.

Estimates of Chinese GDP on an internationally comparable basis vary greatly because of the different methods employed. The first and simplest approach is to use the *official exchange rate approach* to convert GDP into a foreign currency, usually US dollars. The problem with this approach is that exchange rates mainly reflect the power to purchase internationally traded items. In poor countries where wages are low, items that are not traded internationally such as services and land are generally cheaper than in high income countries, so these countries' exchange rates tend to understate the true purchasing power of their GDP. The other problem with exchange rates is that they are often heavily influenced by capital movements, which in the past 20 years have been volatile. However, the World Bank (1996c, pp. 224–25), uses this method in some of its publications with some adjustments to smooth fluctuations in prices and exchange rates for each country.

The second approach used to convert GDP into an internationally comparable measure is the *expenditure approach* based on PPP converters developed by Kravis, et al (1982) during the program of research undertaken for the international comparisons project. This is basically a highly sophisticated comparative pricing exercise. It involves surveying carefully specified price information for representative consumer and producer goods and government services in each country, and aggregating these weighted prices to produce PPP converters.²² The international comparisons project converters should provide more reasonable estimates of the domestic purchasing power of GDP than the exchange rate approach. It is also the most widely used approach apart from the straightforward exchange rate method.²³ Since 1993, the World Bank has reported its own PPP

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²² Kravis, et al (1982) also pioneered new techniques for providing multilateral measures at 'international' prices, known as Geary-Khamis dollars (that is 'international dollars' used in this report). See Maddison (1995, p.163).

²³ The international comparison project program has gone through six phases and covered 87 countries for at least one year. For countries not covered, Summers and Heston (1993) developed short-cut procedures and in their latest exercise provided PPP converters and real product estimates for 150 countries.

estimates of GDP, largely based on the expenditure approach and exchange rate approach (World Bank, 1996b).

Despite its many advantages, the expenditure approach tends to overstate real income in lower income countries because of the way it calculates output of the so-called comparison-resistant services, such as distribution.²⁴

The third approach to calculating internationally comparable GDP also based on PPP, is the *production approach*, developed by the University of Groningen in the Netherlands since 1983 in its project on the international comparison of output and productivity.²⁵ It compares the real output (value added) in major sectors (agriculture, industry and services) and of branches within these sectors, as well as measures for GDP as a whole. Unlike the expenditure approach, which uses special surveys, it employs information from production censuses, input–output tables, national accounts and, more recently, individual firms. Its integrated statistics of output and input quantities, unit values and total values permit cross checks not available in the expenditure approach. It also identifies variations in the coverage of national accounts and gives high priority to measuring output and productivity in services. The expenditure approach does not explore these issues.

However, GDP estimates based on the production approach have not yet been undertaken for many countries, mainly because this approach requires much more statistical information. Furthermore, to date, the international comparison of output and productivity project has focused on two-country rather than multi-country GDP comparisons.

Both the expenditure and production approaches are more acceptable than the exchange rate approach. They share some common features, such as the use of PPP, and can be used to cross check GDP estimates, as they look at national income from different angles. The production approach is more a supplement to than a substitute for the expenditure approach.

As both the international comparisons project and the international comparison of output and productivity are based on PPP, several problems with PPP-based income comparison should be recognised, especially when this approach is used to project income growth. This approach converts GDP in national currency to a PPP measure applying international prices for a standard basket of goods and services in the countries involved. No single basket can represent the goods and services consumed by average households across all countries, especially developed and developing countries, as the average basket of goods consumed changes dramatically as income rises. When projecting income growth, this approach assumes that the initial PPP-adjusted exchange rate remains constant over the

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²⁴ As cited by Maddison and van Ark (1994, p. 21), the estimates of 1975 GDP at factor cost show that the gap between the international comparison of output and productivity project and international comparisons project, ranges from about 60 per cent for the Republic of Korea and Mexico to 94 per cent for Japan. Maddison and van Ark (1994, pp. 20-21) point out that the expenditure approach exaggerates output and productivity levels of comparison resistant service sectors in the lower income countries because it leans towards the assumption of equal productivity between rich and poor countries. For 'disguised' services, such as distribution, the expenditure approach infers that the distribution service content of various types of expenditure is the same in all countries.

²⁵ Based on Rostas (1948), Paige and Bombach (1959) and Maddison (1970).

projection period, while in reality, the gap in prices between internationally tradeable and nontradable goods should converge as a country grows richer. On the other hand, the currencies of successful developing countries often appreciate in real terms. This has occurred with the renminbi over the past three years. These two factors tend to operate in opposite directions, but the overall impact is very difficult to predict.

Projection results are also sensitive to the assumptions made about future growth rates, the starting level of adjusted GDP and any revisions to PPP converters. Having recognised these problems and the fact that regional income differentials are large and widening, the World Bank's recent report on poverty in China lowered estimates for Chinese per capita income for 1994, from US\$2 500 to US\$1 800 in 1994 dollars, or from US\$2 200 to US\$1 600 in 1990 dollars. (Appendix Table 1.1 and World Bank, 1996d.)

The estimates of Summers and Heston (1993 and 1995) and Ren and Chen (1994) are all based on the international comparisons project PPP approach. When comparing the alternative PPP estimates of China's GDP, Maddison (1995) argues that while the estimates of Ren and Chen are defensible, as they are transparent and generally conform to the traditional international comparison project methodology, when using India's per capita GDP as a reference, the Ren and Chen benchmark produced unacceptably low per capita GDP for 1990.²⁶ The estimate of Maddison (1996) of US\$2 047 per capita in 1990 dollars appears a reasonably robust one, based on a defensible methodology.

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²⁶ This method is that of applying available estimates of GDP for benchmark year(s) to an estimated time series growth index to infer the GDP levels of other years.

Appendix Table 1.1

Alternative Estimates of China's 1990 Gross Domestic Product

| Source of estimate | Approach used | Total GDP \$ billion ^d | GDP per capita \$ |
|---|--|--------------------------------------|----------------------|
| Estimates adjusted by Maddison (1995) to 1990 international dollars^e | | | |
| Summers and Heston (PWT 5.5) (1993) ^a | Expenditure | 3 065 | 2 700 |
| - S&H revision (PWT 5.6) (1995) | Expenditure | 1 816 | 1 600 |
| - Maddison revision (1996) | Expenditure | 2 323 | 2 047 |
| Ren and Chen (1993) ^{a,b} | Expenditure | 1 985 | 1 749 |
| Ren and Chen approach applied to the estimate in <i>World Tables 1994</i> ^{a,c} | Expenditure | 2 664 | 2 347 |
| Taylor (1991) ^a | Production-based PPP approach | 1 288 | 1 135 |
| Other estimates in 1990 US dollars | | | |
| Gordon (1986) ^e ; adjusted to 1990 | Expenditure | 2 356 | 2 076 |
| Ahmad (1986) ^e ; adjusted to 1990 | Reduced information method | 1 584 | 1 396 |
| Garnaut and Ma (1993) | Derived from the relationship between food consumption and per capita income | 1 260 | 1 110 |
| Wu H. (1993, Table 6) | Exchange rate | 688 | 606 |
| WEFA (1986) ^e ; adjusted to 1990 | A kind of PPP; not clearly given | 484 | 426 |
| World Bank (1994, Table 1) | <i>World Bank Atlas</i> (exchange rate) | 420 | 370 |
| World Bank's estimate for 1994 ^f (1996) | <i>World Development Report</i> PPP | 2 512 | 2 213 (2 510) |
| - Adjusted to 1990 by this study ^g | <i>World Development Report</i> PPP | 2 035 | 1 793 |
| World Bank's revision for 1994 ^f (1996) | <i>World Poverty Report</i> PPP | 1 801 | 1 587 (1 800) |
| - Adjusted to 1990 by this study ^g | <i>World Poverty Report</i> PPP | 1 460 | 1 286 |

Note: PWT 5.5 and 5.6 = Penn World Tables version 5.5 and 5.6

^a Adjusted by Maddison (1995, p. 168).

^b Cited by Maddison (1994) as processed in 1993 but published in 1994.

^c Quoted by Ren and Chen (1994, p. 390).

^d Derived from GDP per capita and the 1990 mid year population of 1.135 billion.

^e PPP based international currency for international income comparison.

^f Figures in brackets are the published World Bank estimates in the 1994 international dollars; they have been converted to the 1990 international dollars.

^g Per capita GDP is (1) adjusted to the 1990 US\$ by an index of 1.134, and (2) adjusted to the 1990 level by per capita GDP growth rate of 5.4 per cent per year (1978 to 1992) from Maddison (1996, Table C-1).

TO WHAT EXTENT HAS CHINA'S OFFICIAL INDUSTRIAL GDP GROWTH BEEN OVERESTIMATED?

Preliminary findings using the production approach

The production approach has been applied by Szirmai and Ren (1995) and Wu H. (1996) to estimate the value added by China's manufacturing and total industrial sector. The two studies used different data sources, industrial census data by Szirmai and Ren, and the combination of physical output data and input-output tables by Wu. Both studies found that the official GDP growth rate for the industrial sector was overestimated. The official industrial output growth rate is 11.9 per cent per year at official 'comparable prices' for 1978 to 1994, compared with Szirmai and Ren's estimate of 7.4 per cent (1980 to 1992) and Wu's estimate of 8.5 per cent.

Wu's exercise involves three major steps:

- a) constructing a physical output index over time for each industrial product;
- b) grouping all indices into 15 standard manufacturing branches by proper weighting;
- c) applying gross value added data from China's 1987 Input-Output Table for each branch to the grouped physical indices.

Wu's work does not involve bilateral comparison. His findings suggest that almost all heavy manufacturing industries had a slower growth in the reform period than in the central planning period, while the opposite is true for light manufacturing industries. From 1978 to 1992, the two fastest growing industries were beverages (15 per cent per year) and electrical machinery and equipment (14 per cent), while the two slowest growing industries were basic and fabricated metal products (6 per cent) and wood products (1 per cent).

The most important finding of Szirmai and Ren is that although China's manufacturing grew extremely rapidly from 1980 to 1992, its labour productivity remained at about 5 per cent of the US level.

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THE POLITICAL ENVIRONMENT

While the post-Deng era may see the emergence of leadership rivalries, there is likely to be broad commitment to continued economic reform and continued integration into the world economy. Economic reform has delivered strong growth and tangible benefits. The leadership also recognises that the economy needs to maintain relatively rapid growth to avoid widespread unemployment and possible social disruption.

Compared with the prospects for the economy, which appear to be moving in a reasonably predictable direction, future political structures are more difficult to judge. Political and institutional structures at lower levels of government are growing in prominence due to the reallocation of resources under China's dual taxation and revenue distribution systems. While leadership challenges in the post-Deng era could impact on political structures, authority will reside with the Communist Party. As in other countries, individuals and institutions will continue to seek to increase their authority, but the collective leadership now in place is likely to be maintained and guide the transition to a 'socialist market economy'.

This chapter will examine political factors that may affect the future path of China's economy, and China's relations with the rest of the world. It also will consider some of the possible domestic and international consequences of China's continued economic reform and development, as examined in the rest of this report.

POLITICAL BACKGROUND

Unpredictability and sudden, profound change have marked China's politics throughout the twentieth century, from the drastic reforms introduced in the last years of the Qing dynasty, to the policy of reform and opening after the end of the Cultural Revolution. Since Mao's death in 1976, and especially since Deng Xiaoping won control of the Party late in 1978, the main thrust of changes has been economic. Over the last 19 years, much of the remaining Maoist economic order has been swept aside or restructured more according to market principles than Marxism.

With the goal of making China rich and strong, Deng encouraged the Party to promote individual incentives and advancement, thus reversing most of the policies of the previous 30 years. In the early 1980s, the Party encouraged the dissolution of the people's communes, the institutions of collective agriculture into which the great majority of Chinese people were organised, thereby dismantling one of the main structures of Maoist socialism.

The nature of Deng's rule will be discussed for many years. It is clear, however, that Deng uniquely combined many qualities that enabled him to hold Party and country together even while introducing great economic changes. A leading Party

man since the 1930s and a senior political commissar in the armed forces in the long years of war, he was also a victim of the Cultural Revolution. Only someone of Deng's record, vision, political skills, dominating personality and implacable determination could have achieved what he did.

The political structures of the People's Republic of China were created along Leninist lines, under which the Communist Party's central bodies ran everything, either directly or through lower level Party organisations and government institutions from the national to the local level. Deng's reforms have reduced central Party and government power, as resources have moved from the centre to regions and from the state to private interests. However, to a large extent, the formal political structures remain unchanged, and do not provide clear cut mechanisms for political succession or the delegation of authority.

POLITICAL CHANGE AND THE ECONOMY

The basic question of interest to foreign governments and to businesses involved in China is the extent to which political factors may affect the direction and speed of economic developments in the next decade. Answering this involves two important judgments. The first is that a gradual consensus has developed within the leadership, the Party and society as a whole that economic reform has delivered tangible benefits and is worthwhile. Reform has developed its own momentum and cannot be reversed. The second is that the leadership recognises that China needs to maintain relatively rapid growth to avoid widespread unemployment and possible social tension.

The most likely outcome is therefore that present policies encouraging a mixed economy will be maintained. The private and collective economies will coexist with a shrinking state-owned sector. The state-owned sector will continue to be under pressure to adapt to the market, be more efficient, and shed many of its employees and welfare responsibilities. (See Chapter 10 - State-Owned Enterprises). Nevertheless, widespread privatisation of larger SOEs is not likely in the short to medium term because many groups would oppose it, including the industrial bureaucracies, local governments, SOE workers themselves, many Party officials and the poorer inland regions.

Although a clear consensus favours continued market-oriented reforms, some political issues could slow the pace of reform, and possibly also reduce the speed of economic growth. For example, if the central Government cannot maintain its leading role in pushing forward reform, then local governments and enterprises may pay less regard to central regulations, laws and directives. In some instances this might benefit foreign business (when, for example, local reforms are more rapid and interpretations of regulations are more liberal than the centre's) but it might also add to the uncertainty of doing business.

PROSPECTS FOR THE GOVERNMENT AND THE PARTY

The passing of Deng Xiaoping symbolises a change of generations in the leadership. Deng was the last of the founding statesmen, leaders whose prestige was built on their personal achievements in war and revolution. The next generation of leaders are essentially technocrats who rose to positions of authority during the pre reform period. At the Fifteenth Party Congress in 1997, many older leaders probably will be replaced by a younger generation sometimes called the fourth echelon, who are rising to prominence in the bureaucracy and other institutions. Many of this new generation of leaders have Western training or experience, and a clearer understanding of market economics and Western democracies than their elders. While nationalistic, they also are impatient for China to participate fully in the international economy and community.

In the transition following Deng's death, some aspects of the reforms Deng began may be reassessed but the most likely scenario is that, in the short to medium term, present political arrangements will continue with some minor adjustments. This is the most probable outcome because most important groupings in the country recognise the importance of stability and benefit from the reforms. Less likely scenarios include a short period of instability in the context of a leadership transition and (even more unlikely) more serious political dislocation.

A collective leadership now rules China, with President Jiang Zemin as its 'core'. Jiang has stated that China will never again produce another strongman in the mould of Mao or Deng. This means that existing or new institutions will have to provide political cohesiveness to ensure stability. Collective leadership is a relatively new concept in China but, so long as it maintains its unity on fundamental policy issues, it could enable various key interest groups to share authority and ensure national cohesion. Certainly, the leadership agrees that systemic political liberalisation should be avoided for the foreseeable future, and that only continued Party rule can prevent a slide into disorder.

The Chinese Communist Party, which in mid 1996 had 57 000 000 members, is no longer the revolutionary, highly centralised and disciplined body it once was, but it remains the preeminent political institution in the land. While the Party's ideology is likely to evolve with changing social and economic conditions, probably increasing emphasis on traditional values and nationalism, we can expect essentially the same group of people to run the country whatever structures emerge.

The Party now tolerates considerable plurality in the regions, bureaucracies and special interest groups while preventing open dissent. As economic conditions continue to improve for the mass of the population, there is no widespread popular feeling that the system itself should be challenged.

In the countryside, a degree of democratisation already is occurring with popular elections used more regularly for choosing representatives to local people's congresses. Central authorities encourage this, because it serves to increase the accountability of local officials. Personal economic freedom is also greater than at any time since the revolution. Especially in the cities, Party officials no longer determine what jobs people will have, where they will live, where their children will be educated and where they can travel.

LAW AND ORDER

The development of the legal environment in China is, of course, crucial for foreign businesses. The People's Republic repealed all existing laws in 1949, replacing only a few of them with regulations and policy directives that still gave most discretion to the political authorities.

However, the Deng era was strategically committed to building a legal system. The aim was probably to bring about not rule *of* law, as it was intended that ultimate authority should remain with the Party, but rather rule *by* law. The legal system was intended to regulate the ways in which officials function and to set up proper structures and procedures to resolve problems. Laws and regulations are promulgated by the national and lower level people's congresses. The move from a command to a market economy has produced a large volume of laws and regulations on business-related matters. (See Chapter 3 - Market Environment.) Some business disputes now are settled through the courts and the central arbitration system; the legal profession is growing rapidly; and thousands of new graduates are trained each year.

Considerable progress has been made in re-establishing laws and regulations in relation to private property and land use rights. (See Chapter 3 - Market Environment.) Since this development is crucial to the development of market economic systems, China has laid the foundation for fundamental change to the state controlled economy, enabling the continued transfer of economic autonomy to individuals, commercial entities and local governments.

Considerable progress also has been made in developing civil law, including significant new legislation passed in 1996 by the National People's Congress guaranteeing personal freedoms. However, the actual practice of civil law still does not fully protect consumers, home or land owners and those subject to arbitrary action by officials.

Despite numerous drives against corruption, official statements still identify it as a major problem, and the sums involved in serious cases publicised in the media have risen considerably in the past decade. The official media point to a rapid growth in other crime as well. Though the problem is more serious than it used to be, China's urban areas are still safer places in which to live and work than many international cities.

POLITICAL IMPLICATIONS OF ECONOMIC AND SOCIAL CHANGE

With the growth of the non-state sector, new political institutions representing the interests of the new private and quasi-private economies might be expected to emerge. In China, however, to date there has been little sign of this occurring. In the first half of the twentieth century, the growth of modern industry did not enable Chinese capitalists to become a politically effective bourgeoisie, and until recently, Chinese business communities in Hong Kong and Macau have had little direct involvement in politics. China's new private entrepreneurs are not likely to seek a direct role in politics in the short term. However, some new entrepreneurs

who have risen since the reforms have gained places in the evolving establishment.

The economic transition has created a much larger and more fragmented group. More than a hundred million peasants have left their villages in inland provinces to work in cities. Their labour has been essential to the economic transformation of the last 15 years and to continuing urban prosperity. However, it is difficult for them to acquire permanent residence in the cities and they receive lower wages than city residents. Most eventually return to their villages, taking income and new skills with them, thereby making an important contribution to the development of the hinterland provinces. (See Chapter 12 - Labour Markets.)

The economic transition also has affected workers in the many failing state-owned enterprises, SOEs. While some SOEs have adapted successfully to the market economy, others have not. (See Chapter 10 - State-Owned Enterprises.) Large numbers of redundant workers receive unemployment benefits and retraining and are being absorbed into the fast growing non-state sector, even in provinces with a high proportion of SOEs. (See Chapter 10 - State-Owned Enterprises.) Others, however, lack the skills or the opportunities to find new employment, and receive little support from their financially strapped work units.

China recognises 55 national minorities within the unitary Chinese state. Although these minorities occupy nearly 50 per cent of China's territory, they comprise only 6 per cent of the population. This means that unlike the former Soviet Union or Yugoslavia, China is essentially an ethnically homogeneous state, and the sense of being Chinese is strong among the 94 per cent of the population who are Han Chinese (and many of the remaining 6 per cent). This reduces the scope for serious internal division. Nevertheless, some signs continue of ethnic and religious tensions among different groups in some areas of China, particularly in the autonomous regions of Xinjiang and Tibet. In some cases, the relatively low level of economic development in these areas probably has exacerbated these tensions. Partly in response to this issue, in recent years the Chinese authorities have given priority to promoting faster economic growth in areas dominated by minority populations (and in other parts of western China), offering preferential policies and incentives to encourage investment.

TAIWAN

Relations between mainland China and Taiwan are vital to both sides. Handled with understanding and tolerance on both sides of the Taiwan Strait, they could continue to contribute to China's economic prosperity and integration into the modern world. A Beijing-Taipei conflict could, however, cause serious economic disruption and loss for both China and East Asia.

Economically, the dominant trend of the past decade has been towards closer integration of the two economies, which are highly complementary. Shared languages (standard Chinese, Taiwanese/Hokkien and Hakka), culture, kinship and historical roots, as well as geographical closeness all provide deep and firmly established links.

Closer economic integration, however, has not ameliorated the political differences between the two sides. While both retain eventual reunification as a long term goal, differences over the basis of reunification have sharpened. China has increasingly stressed the importance to it of sovereignty issues. Within Taiwan, rapid democratisation and economic liberalisation have driven a push for enhanced international status, to which China has reacted strongly. These pressures came to a head when Taiwan's President Lee Teng-hui visited the USA in June 1995. The visit led to the heightening of tensions that peaked during Taiwan's first presidential election in March 1996. While tensions have receded from that high point, underlying differences remain.

At present, it is difficult to predict how or when some form of reunification or political reconciliation may be achieved between the two sides. Despite the political problems, however, closer contacts in other spheres, including business, communications and culture, probably will continue in coming years.

CHINA IN THE REGION

The return of Hong Kong to China in mid 1997 will be a major event for the entire region. If this transfer successfully enables the new Special Administrative Region of Hong Kong to prosper with its economic and legal system intact, it will send a positive message to the world. It would also be of great importance for China's relations with Japan, ASEAN, the USA and the European Community, particularly the United Kingdom. As Hong Kong plays a central role in the complex web of economic links in the southern China region, its continued stability is important to all countries, like Australia, trading with and investing in China. (See Chapter 3 - Market Environment and Chapter 6 - Foreign Investment.)

Competing sovereignty claims in the South China Sea, where China has disputes with Vietnam, the Philippines, Malaysia, Brunei and Indonesia, have attracted concern in recent years. If all sides do not continue to exercise restraint, these rival claims to the resources of the sea and the seabed could cause considerable tension between China and the ASEAN states. However, China recently announced that it wishes to see the disputes resolved according to international law and to cooperate in jointly developing the region's resources. This indicates that a mutually acceptable solution could be developed. This would be compatible with China's wider interests in good relations with the states of South East Asia.

In recent years, China's relations with most of its other neighbours have improved substantially. Relations with Russia have developed well since the break up of the Soviet Union: tensions related to border issues have diminished, with the sides (including China's Central Asian neighbours) signing agreements on confidence building measures and troop reductions. In 1996, Chinese and Russian leaders declared the formation of a 'strategic partnership' between their two countries.

While maintaining its traditional links with the DPRK (North Korea), China recently also has developed close ties with the Republic of Korea, which is becoming one of China's major trading partners and sources of investment. In South Asia, China has developed better relations with India over the past few years, although commercial links remain relatively slight.

China's relationship with Japan is likely to continue fluctuating, but there is no immediate threat to their close economic ties from political or military tensions (East Asia Analytical Unit, 1996). Historical issues related to Japan's role in the Second World War continue to irritate the relationship, as does a territorial dispute over a group of islands. China also has expressed some concern over the strengthening of Japan's bilateral security relationship with the USA. Overall, however, the development of a closer relationship in recent decades has benefitted both countries, and neither wish to see this cooperation undermined by the issues on which their positions differ.

Relations with the USA have greatly improved since early 1996. Further positive development is a prospect for 1997, though ups and downs will continue in the longer term. Human rights, security issues and some trade disputes are unlikely to be rapidly resolved, but both sides acknowledge their broader strategic interest in a sound relationship. The market access concerns of the USA (and other countries) are being addressed in negotiations for China's accession to the WTO, and in the context of China's membership of APEC. (See Chapter 5 - International Trade.)

Human rights is likely to remain a difficult issue, particularly between China and Western countries, with China resenting what it considers to be outside interference in its internal affairs. While a number of countries acknowledge China's progress in legal reform, they continue to express their concern about the treatment of some individual Chinese citizens, as well as about issues of free speech, free association, some aspects of the penal system and the use of the death penalty.

CHINA'S POLITICAL PROSPECTS

Compared with the prospects for the Chinese economy, which appear to be moving in a reasonably predictable direction, the political future of China is more difficult to judge. At this stage, however, the most likely scenario is for political stability to continue under the control of the Communist Party. As in other countries, individuals and institutions will continue to seek to increase their authority, but the collective leadership now in place is likely to be maintained. The movement of state power from the centre to local government is likely to continue, though the centre is likely to attempt more taxation reform in order to bolster its revenue position. While more prosperous parts of China continue to seek more autonomy, other regions may become more vocal in requests for fiscal transfers to redress income imbalances. Chongqing and Xi'an could emerge as the natural leaders of inland provinces as China attempts to bring about the massive transfer of resources and investment from east to west needed to reduce the wealth gap.

Representative democracy is unlikely to go far beyond grass-roots elections in the near future, and community and special interest groups such as industrial and commercial bodies are likely to remain within their delegated functions. Clan structures probably will be permitted to increase their authority in many villages through election to local government positions. Religious organisations with no involvement in politics also will be allowed to function. Consumerism and family matters, especially the education of only children, will continue to be the dominant concerns of the new middle classes in the prospering cities of the east.

The growing extent of China's integration into the world economy will probably make for more rather than less stability in international relations. International economic interdependence increases the cost to China and its partners of disruption to normal international relations. Extending foreign investment from manufacturing into the financial sector, utilities, mining, distribution and other relatively closed sectors and dismantling protection to meet WTO requirements will increase this integration and its growth benefits.

Appendix 2.1

THE POLICY-MAKING ENVIRONMENT

This appendix provides a very brief overview of the policy-making environment in China, including a look at both formal and informal institutions. It focuses especially on economic policy-making.

ECONOMIC POLICY FORMULATION

As with policy-making in most other areas, the central organs of the Party make the most important economic policy decisions. These decisions are then translated into the objectives to be pursued by the State Council and are implemented by the various commissions and ministries of the central Government and through them by the provincial and lower levels of government. In the formulation of policies, senior members of the Party may call on many resources for advice, including the many think tanks established under State Council. Those various resources may and do compete strongly with each other as they seek to influence decisions.

The various commissions and ministries of the central Government are mirrored at the provincial, municipal, city and county government levels. Lower level bureaucracies report up the line to the next senior level with the provincial government structure. For example, city and county finance departments report to the provincial ministries of finance, and they in turn, take guidance from the Ministry of Finance of the central Government. Their major role is to administer the budget and the finances of the lower level of government to which they belong. Although the vertical and horizontal structures of administration provide for the integration of bureaucratic effort across China, the bureaucracies are generally very large, unwieldy and not always easy to control.

Since major economic and social policies directly affect lower levels of government, the consultative processes invariably also involve Party officials and senior government officials at these lower levels of government. For example, the draft legislation for the People's Bank of China, like all important economic laws, went through many rounds of consultation with and amendment by provincial governments and central government ministries and the State Council. Ultimately, however, responsibility for policy decision-making resides with the Politburo, with input from key leading groups. They in turn provide policy directives to the State Council for interpretation and implementation.

LEADING GROUPS

Leading groups are policy-making groups comprising senior Party and government officials, operating in a particular policy area. Leading groups usually draw on advice and opinion from a wide network of independent think tanks, official institutes, academics and elements of the bureaucracy. These various bodies serve as a sort of informal policy development network for the leading group (Lieberthal 1995, pp. 192-208). The influence of leading groups have become particularly important in the period of economic reform.

The Economic and Finance Leading Group is now chaired by the General Secretary of the Party and President, Jiang Zemin. The Vice Chairman is Zhu Rongji, a member of the Politburo Standing Committee and Executive Vice Premier. This group - which determines China's economic and financial policies - includes members from several government commissions and ministries, but stands above the State Council and any commission or ministry.

The State Council retains ultimate authority for the implementation of policies nationally and across government. For instance, State Council handles taxation, budgetary and monetary matters; investments to be undertaken within the terms of the central government budget; changes to interest rates; banking and insurance branch authorisations; policies on the accumulation of foreign reserves and on how reserves are to be invested.

International influences have become increasingly important in developing policies on the economy. For instance, it has become common practice for agencies at all levels in China to investigate the policies of other countries and to seek the views of international agencies, such as the International Monetary Fund, the World Bank and the Asian Development Bank on a wide array of topics. For example, under the auspices of the IMF, the People's Bank of China is studying the operation of a number of central banks including the US Federal Reserve, the Bank of England, the Bundesbank and the Reserve Bank of Australia. The results of such investigative work are reported in detail to ministers and to the State Council and thus become part of the broader information base from which policies are finally developed.

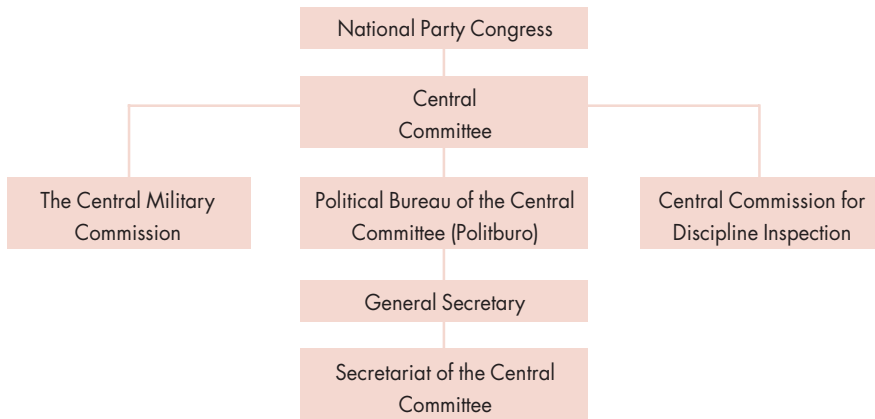
INSTITUTIONAL STRUCTURES OF PARTY AND GOVERNMENT

The Party

The Chinese Communist Party is the leading organ of society. It lays down policy which state institutions implement. The highest body of the Party is the National Party Congress, which now meets at five-year intervals. The Congress elects the Central Committee which usually meets annually, around September or October, in plenary sessions, or plenums. Crucial decisions are made at this level of the Party structure. The Central Committee, for example, elects the Political Bureau, or the Politburo, which carries on the work of the Central Committee when the

latter is not in session. The Fifteenth National Party Congress will be held in late 1997.

The Party Hierarchy



Source: Economist Intelligence Unit, 1995, Chapter 2.

Beyond this formal political structure are a few senior Party elders who have continued to exercise considerable influence long after their retirement from Party and Government positions.

Government

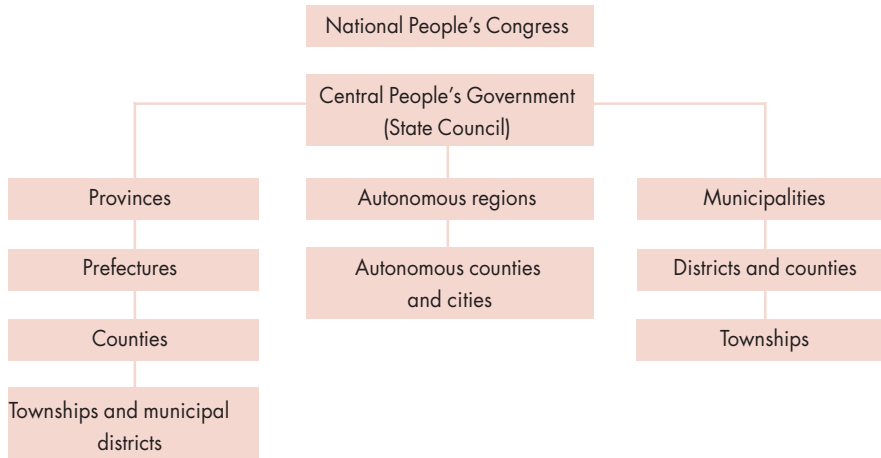
The National People's Congress (which usually meets annually in March) is the highest law-making body in the country and its work is coordinated by a special standing committee which is in regular session. The State Council, established under the National People's Congress, serves as the executive branch of the State, and undertakes the regular work of government, coordinating the various commissions and ministries of the State and overseeing the work of all agencies in the state bureaucracy.

The apparatus of the central Government reaches out across China through 22 provinces, 4 municipalities (Beijing, Shanghai, Tianjin and recently Chongqing), 5 autonomous regions (including Tibet and Inner Mongolia), 334 prefectures, nearly 2 000 counties and almost 500 cities. China is a unitary system, not a federation. Provinces and municipalities rank equally with ministries of the central Government: their authority does not derive from laws or the constitution (as in federations like Australia); instead, their powers are delegated to them from the centre. Consequently, while a provincial level ministry is required to carry out the policies determined by the central Government, it must also implement policies of the provincial government. For provincial officials, this means dual allegiances—which can complicate administration and economic management, particularly when the provincial government level has reservations about a particular central government policy.

Provincial and metropolitan Party and government representatives are quite powerful within the political system, and their authority has increased over the

reform period. While the provinces, prefectures, counties and towns also derive their powers from the central Government and therefore have their own government structures, they relate to provincial governments in much the same way that provincial governments interact with the central Government.

The Government Hierarchy



Source: Economist Intelligence Unit, 1995, Chapter 2.

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THE MARKET ENVIRONMENT

As China continues to open up and internationalise its economy and markets allocate most resources, strong basic economic institutions and effective regulatory systems will be vital for sustainable economic development. While doing business in China remains complex and often difficult, legal and administrative reforms are achieving some advances towards greater predictability. This chapter assesses reforms aimed at enhancing market efficiency and strengthening key economic institutions. It examines the prospects for continued economic liberalisation and the extent to which ongoing reforms will contribute to a more stable business environment.

CHINA EMBRACES THE MARKET

In many sectors of the economy, manufacturers, retailers and service providers now operate in a market-oriented environment, which is rapidly displacing the command economy. As private economic interests develop and diversify, a stronger legal and administrative framework for market transactions is needed.

The ideal business environment – which many countries aspire to but few fully achieve – has:

- unrestricted freedom to enter and exit all sectors, to determine prices and quantities, and to sell locally and internationally
- a consistent and stable regulatory framework and legal system which spells out clearly the rights and obligations of all participants in the market
- an efficient and transparent bureaucracy that is equitable in making decisions and implementing the regulatory framework.

China will progress in all these areas over the next 10 to 15 years.

Central to China's transition to a market economy is the liberalisation of the price mechanism. This process now is almost complete, with a few major exceptions.

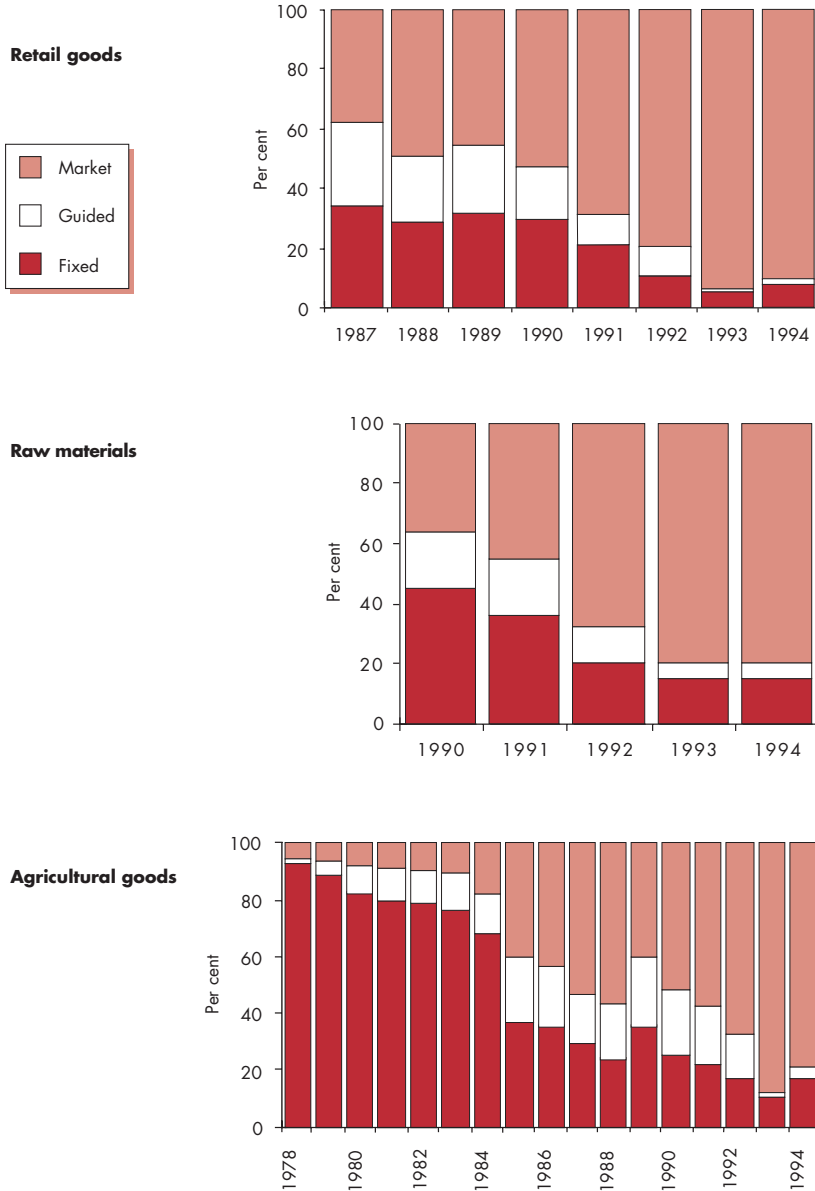
Sequence of Price Reforms

Price reform has been a most successful area of liberalisation and has generated fundamental changes in the economy. Over 90 per cent of retail prices and over 80 per cent of agricultural and raw materials prices now are set by the market (International Monetary Fund, 1996, pp. 61-63; World Bank, 1996, p. 24; State Statistical Bureau, 1995a). Figure 3.1 shows this. Furthermore, most areas of industry are now free from plan obligations and no longer receive subsidised inputs.

From 1979, reforms were implemented first in industries with lowest entry barriers, such as light consumer goods and non-grain agricultural output. Price reforms followed a two-tier path, which involved removing price controls from a growing proportion (eventually almost 100 per cent) of consumer goods and inputs, while simultaneously raising plan prices for many other goods to bring them into line with market prices. In 1975, free market prices of consumer goods were 80 per cent above plan prices, but by 1991, the gap had declined to only 5 per cent (World Bank, 1994, p. 33).

Figure 3.1

Price Controls Are Disappearing Price-Setting Mechanisms in China



Note: Prices of agricultural goods represent farm gate prices only. 'Guided' prices are determined in a process of negotiation between government and state enterprises.

Source: International Monetary Fund, (1996, Tables 26 to 28).

After the path breaking Fourteenth Party Congress in 1992, prices for coal, crude oil, steel, grain and cooking oil were partially deregulated. Prices of transport services, hitherto highly controlled, were increased to reflect more closely market levels.

The reintroduction of some price fixing in 1994 was an attempt to control prices in a period of rapid inflation. Now these controls have been largely removed. However, the most recently published price control data relates to 1994. Anecdotal evidence indicates that price reform is continuing, and fewer prices are now controlled than Table 3.1 shows.

Rural China benefitted early from price reform, allowing the prices of most cash crops and animal and fisheries products to be freed over the 1980s. The main exceptions are grain and cotton; their prices, procurement and distribution still have significant government intervention. (See Chapter 9 - Agriculture.)

Prospects for Further Reforms

Historically, price reform has been slow for those commodities, such as grains, cotton and fuels, that China's leaders have identified as strategically important. Most remaining price controls apply to such key raw materials, fuels and basic food grains (Table 3.1). While the central Government's perception of the ability of SOEs to absorb higher input prices will be an important factor determining the pace of future price reforms, steady progress should continue and few controls remain in place by 2000.

Table 3.1

Remaining State Controlled Prices, 1996

| Sector | Remaining state controlled prices |
|---------------------------|--|
| Agriculture and resources | cotton, tea, some timber, urea, salt grains including, wheat, indica rice, japonica rice, maize and soybean. Ten per cent of all grain is subject to state price controls |
| Energy and water | crude oil, natural gas, petrol, diesel oil, heavy oil, 58 per cent of electric power (domestic), irrigation water, domestic water |
| Chemicals | ammonium nitrate |
| Transport goods | railway steel, aircraft, engines |
| Pharmaceuticals | chemical, biochemical, medicinal, veterinary-medicinal products |
| Infrastructure services | telecommunications, public transport, urban housing |

Note: These sectors represent only those in which the Department of Foreign Affairs and Trade is aware of controls operating. This list does not refer to those prices over which local governments have jurisdiction (although these are now very limited).

Source: Department of Foreign Affairs and Trade.

A Maturing Internal Market

While China's export sector competes actively in world markets, some constraints on competition still apply in the internal market. This said, competition has increased considerably since 1978, due to lower entry barriers to domestic and foreign firms to most sectors. This has enabled significant growth in the non-state sector. (See Chapter 11 - Non-State Sector.)

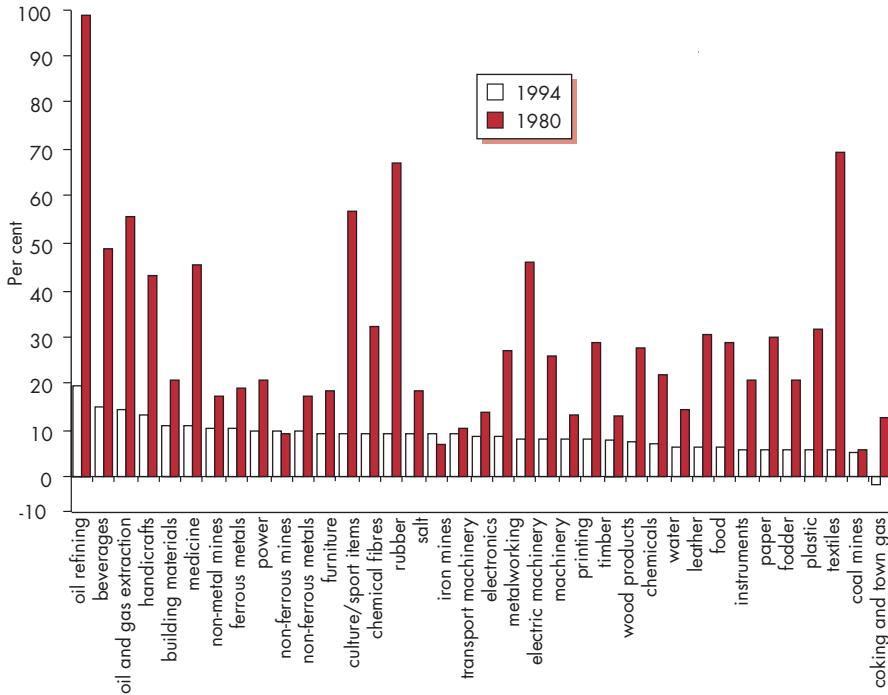
One means of judging the effectiveness of reforms in increasing competition in the domestic market is to measure how freely inputs and products move throughout the economy. In a well functioning market economy, profit rates in different sectors will converge as entrepreneurs move into high return sectors and out of low return ones. The convergence of Chinese industrial sector profit rates is clear (Figure 3.2), indicating that resources are now much freer to move between industries¹. Among the few industries to show profit rates higher than 15 per cent in 1994 were oil and gas production and refining, where entry restrictions still apply. Notable also is the fall in absolute profits per unit of fixed capital, indicating a significant growth in the amount of capital available for profitable projects and the extent of competition from new entrants and imports. The difference between 1980 and 1994 profit rates was smallest where price controls and tariffs persist, such as in coal, iron ore, non-ferrous mining and transport machinery.

China's market is increasingly competitive across a range of industries. In this context, the importance of solid market research by prospective investors and exporters cannot be over-emphasised. A recent survey of Australian businesses in China found that only one third of companies doing business in China sought information from more than one source before embarking on their venture and few firms devoted significant resources to prior fact finding and diligent project planning (Australia-China Chamber of Commerce and Industry, 1995).

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¹ The variation in industrial profit rates across industry sectors (measured by the coefficient of variation) fell from 0.69 to 0.39 between 1980 and 1994, or around 43 per cent (Mina and Wu, 1996).

Figure 3.2

Competition Increases Sharply
Variation in Industrial Profit Rates (Per Cent),
1980 and 1994



Note: Profit rates measured here represent profit plus tax/total fixed capital. 'Total fixed capital' is defined as depreciated fixed capital plus working capital. Statistics do not include tobacco industry profits, which were around 326 per cent in 1980 and 72 per cent in 1994.

Source: State Statistical Bureau (1995b and previous years); Naughton (1995, p. 237).

Regions Are Looking Outwards

During the transition to a market economy, many coastal and border provinces have formed stronger economic links with the outside world than with other parts of China. In contrast to the strong integration of many of China's coastal regions to supply chains with consumers in the USA, Japan and Taiwan, trade among China's mainland provinces has developed quite slowly. This is a natural response to internal infrastructure constraints. (See Chapter 7 - Infrastructure.)

An analysis of domestic trade flows conducted by the World Bank (1994) showed that, for all provinces, domestic trade has become less significant in relation to output over the past decade. The decline of the ratio of domestic trade to retail sales was most pronounced between 1985 and 1990 (from 63 per cent to 48 per cent) although it has recovered slightly since, growing to 50 per cent by 1992 (World Bank, 1994, p. 40).

A reason for this development could be that as China increasingly opens up, certain regions find economic complementarity with overseas economies. Examples include the economic integration of the Pearl River Delta with Hong Kong and of Yunnan province with Burma, Laos and Vietnam. Such international links may be more efficient than inter-provincial trade.

China's mountainous geography has added to the difficulty of inter-provincial trade. Until recently, transport and distribution networks between many provinces were neglected, and provinces were encouraged to be self-sufficient in many commodities.

Institutional barriers also may have reduced internal trade. Devolution of investment powers from the central Government to the provinces gave provinces an incentive to protect domestic enterprises, which they owned or from which they collected taxes (Mina and Wu, 1996, pp. 12-14). In some instances, protectionism hampers efforts by foreign investors. For example, being the preferred supplier to the Shanghai automotive industry may mean that the investor is not welcome as a supplier to a manufacturer in the north (Walsh, 1996, p. 39). The central Government has largely removed inter-provincial barriers to manufactures, yet constraints on the moving price controlled agricultural commodities like grain and cotton are still a problem. (See Chapter 9 - Agriculture.) With the removal of price controls that held down prices on many raw materials, local authorities in producing provinces now have less incentive to prevent the movement of raw materials to markets on the coast.

Trends in Industrial Profits across Regions

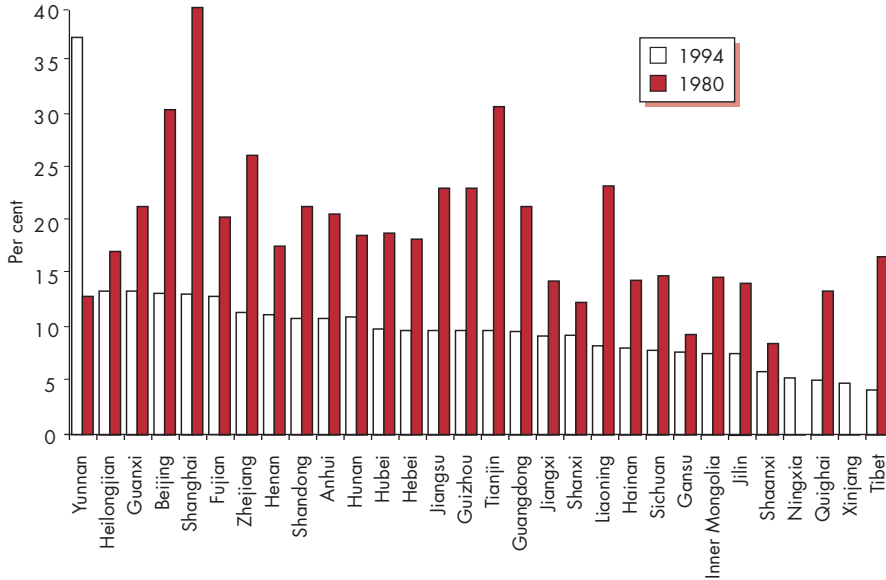
In the past decade, industrial profits have converged across China's regions (Figure 3.3), although this is less pronounced than the convergence across industries. Excluding Yunnan (which experienced persistently high rates of profit²) the dispersal of inter-provincial profit rates fell by almost 20 per cent.³

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² Yunnan province appears to have achieved this because of trade and investment links with the regional economies of Burma, Laos and Vietnam.

³ The coefficient of variation of profits (across provinces) fell from 0.36 in 1986 to 0.29 in 1994. Calculated from data in State Statistical Bureau (1995b and previous years).

Figure 3.3

China's Regions Are Integrating
Provincial Variation in Industrial Profit Rates (Per Cent),
1986 and 1994



Note: Profit rates measured here represent profit+tax/total fixed capital. 1986 data are not available for Ningxia and Xinjiang.

Source: State Statistical Bureau, 1995b and 1988b.

REACHING THE CONSUMER

Getting products to market can be a challenge. An Economist Intelligence Unit survey (1996a, p. 2) revealed distribution to be the biggest challenge facing makers of foreign consumer goods in China. Although barriers to inter-provincial trade and investment may be declining, the efficient movement of raw materials, goods, assets, or even accounting profits and losses between provinces is difficult. Government regulations, differences in products, labelling or accounting standards, and under-developed transport and distribution infrastructure can create barriers. Efficient distribution is also hampered by a range of institutional barriers, such as unauthorised taxes on goods crossing provincial borders.

These issues are examined in Chapter 7 - Infrastructure.

EVOLVING REGULATORY ENVIRONMENT

Market mechanisms now operate extensively throughout the economy, but China's greatest challenge in its transition to a market economy is to develop an effective legal system and key economic institutions to provide the regulatory framework for a market economy. This process will take many years.

Reforms begun in 1978 are gradually strengthening the regulatory environment. Regulation of foreign investment, real estate, shares and securities, intellectual property rights and corporations has been enhanced. The Government also has progressed significantly towards establishing economic and legal institutions that were virtually non-existent in 1978.

A Nascent Rule of Law

Since 1979, China has experienced radical and relatively rapid reform in the legal and commercial sectors. Starting from virtually a zero baseline, China has made good progress in establishing a commercial arbitration system modelled on international practice. The Government is working to develop a Western-style legal profession with an emphasis on civil law. While it has made modest progress towards establishing the framework for an independent judiciary, this is still some way from being achieved. Since 1949, the State dominated each of these functions, so a massive re-education of bureaucratic and public attitudes is underway.

Reforms to the commercial legal environment have increased flexibility, particularly in meeting the needs of foreign investors. This has created a more stable environment and strengthened investor confidence.

However, remaining problems include obtaining legal redress against joint venture partners or commercial suppliers and customers, and China's reluctance to enforce the protection of foreign intellectual property. Furthermore, both foreign investors and Chinese nationals report widespread corruption in the legal system. While China is improving the quality of its judiciary, some report the judiciary remains poorly trained and insufficiently independent of local and national political influence (Connell, 1996, p. 6).

Many problems are attributable to a nascent rule of law. The Chairman of the National People's Congress, Qiao Shi, observed 'the neglect of law and even overriding laws with administrative power, are relatively serious in some localities and departments' (*Far Eastern Economic Review*, 1996, p. 7).

HISTORICAL ROLE OF LAW

Throughout China's history, law has derived from the power of the rulers, who used it as an administrative and punitive system of governance and control. Notions of natural rights common in the Western liberal tradition were largely irrelevant to the law's evolution in China. Rather, a highly structured and organised system of laws emerged as an instrument of control for the elite bureaucracy. During the Qing dynasty, for example, comprehensive and detailed codes existed to punish and administer the population. Magistrates matched punishments to specific crimes detailed exhaustively in these codes.

In Chinese society today, the role of the law is probably still to provide 'rule by law' rather than 'rule of law'. However, as reforms progress, the law increasingly allows articulation and arbitration between rights and interests. This process is bound to continue as private economic interests in property develop and diversify.

Outside influences on Chinese law have, until recently, come mainly from the Continental system, which perceives law primarily as a tool to uncover facts and truths, and as a method of avoiding disruption to the order of the state, rather than a system for preserving individual rights. By comparison, common law as practised throughout the Commonwealth and the USA is based on case precedent. While not adopting common law structures, some Chinese courts are currently experimenting with the adversarial system of court proceedings found in the common law system.

China's legal system is based on fundamental national laws, local laws and regulations, and administrative regulations. National laws are promulgated by the National People's Congress (NPC) and subject to ultimate approval of the Chinese Communist Party. The NPC meets once a year. During its recess, the Standing Committee of the NPC assumes the role of the legislature. The State Council is empowered by the NPC to promulgate administrative regulations, rules and regulations for individual ministries and commissions. Administrative regulations have the status of law and can only be interpreted by the State Council. Local laws and regulations are made by local people's congresses and governments, respectively, and cannot contravene the constitution or national laws.

These laws and regulations, even in commercial-related matters, are both administrative and punitive, some are inconsistent, and many are poorly promulgated. Often these laws are not even known to the legal profession and are even less well known to officials throughout the country who are responsible for administering them.

Private Legal Profession Emerges

An independent legal profession now is emerging, motivated by private incentives and driven by responsibility to clients rather than to the state. The Government endorses private law firms and legal practitioners as part of the overall process of transition to a quasi-market economy, setting a target of 150 000 graduated lawyers

by 2000. At present, of over 89 000 registered lawyers in China, approximately one third are practising.

On 15 May 1996, the Government enacted the *Lawyers' Law*, effective from 1 January 1997. The new law regulates the services the legal profession provides and the structure of law firms. This law allows lawyers to represent clients in all mediation and arbitration activities. Previously, domestic law firms and individual practitioners applied for special licences to practise in areas such as securities law and intellectual property law.

Although foreign law firms can establish offices on a limited basis in China, the Ministry of Justice strictly controls the types of services they can provide. This protects the emerging domestic legal profession, but may reduce opportunities for training and gaining experience from foreign lawyers. Furthermore, impeding access to the full range of experienced legal advice could restrict the healthy growth of the legal system and reduce foreign investors' confidence in it.

The government rigorously stipulates qualifications for lawyers and law firms. Since the 1980s, the Ministry of Justice has administered standardised national legal examinations. Prospective lawyers must pass these exams, then practise law in a law firm in order to qualify.

Government efforts to educate the public in the law, often via detailed newspaper articles, public roadside notice boards and neighbourhood committees, have raised the profile of law and lawyers in society. Many young graduates now choose law as their profession, due to the increased status of law, perceived financial rewards, and work satisfaction from practising commercial law. More new practitioners have overseas legal qualifications and experience in international law firms. The profession, in turn, has rapidly embraced the corporate structure of international law firms as well as their management and fee structures. The *Lawyers' Law* encourages partnership-style law firms forming the basis of an emerging legal services industry with the skills and experience to service international clients.

Evolution of Commercial Law

Change in the commercial law environment has been rapid. The initial framework for foreign investment was established in the late 1970s and early 1980s, with laws regulating the establishment and operation of joint ventures and wholly-owned foreign enterprises.

The 1990s represent the next stage of legal framework development, as new economic institutions and more sophisticated commercial measures are developed. These reforms include banking, financial market and commercial legislation, such as national laws on guarantees and loans. To disengage itself from direct commercial activities, the State enacted the *Company Law* effective from July 1994, for the first time providing legal consistency to both foreign and domestic commercial entities, including SOEs.

The *Company Law* of 1994 and the public offering of shares in registered companies continue a series of market reforms that began in the early 1980s with the formal establishment of non-State run business entities. The *Company Law* introduced two new corporate forms: limited liability companies and share-issuing companies. Limited liability companies have designated registered capital, shareholders, a board of directors and articles of association. As the name implies,

shareholder liability for the obligations of the company is limited to the amount of capital invested by each shareholder. A share-issuing company has many characteristics of a limited liability company, but can issue shares for public purchase on Chinese stock markets. (See Chapter 4 - Macroeconomic Management.) Since share-issuing companies will have their stock publicly traded, these firms are subject to more disclosure and audit requirements. Most newly created companies in China are limited liability companies.

Establishing domestic stock markets and converting large state enterprises into publicly listed companies requires a sound corporate financial and accounting framework. If the assets and liabilities of companies cannot be valued properly and accounted for, proper valuation of shares is impossible. The securities industry awaits the passage of the draft Securities Law, which the National People's Congress has rejected on several occasions and sent back for revision.

Dispute Resolution Processes Improved

Private legal practitioners and reformers within the government have put dispute resolution on the reform agenda. Reforms aim to achieve both transparency in resolving disputes and a stable and consistent dispute resolution process. Both are needed for continued foreign investment and the proper operation of a market-driven economy.

The Government is systematically reforming the dispute resolution process, especially in arbitration, criminal procedures and administrative review. Arbitration is the most widely used form of dispute resolution in China and applies to most commercial and labour-related disputes involving foreign investors and the securities industry. The China International Economic and Trade Arbitration Commission (CIETAC) provides arbitration services in foreign-related commercial disputes other than maritime matters. Although many problems are associated with CIETAC, it is developing a reputation among law practitioners and potential disputants as increasingly competent and consistent. It is common practice among legal practitioners to specify CIETAC as the arbitration body to adjudicate disputes about commercial contracts and agreements involving foreign entities.

CIETAC arbitration is the most common form of dispute resolution, probably due to the lack of alternative forums in China and because overseas arbitration forums are costly. In most contract negotiations, the Chinese party insists upon CIETAC.

ARBITRATION AS A FORM OF DISPUTE RESOLUTION

Traditional dispute resolution in China—as in other parts of Asia—meant application to the courts was made only a last resort. Disturbing the order of society was serious; all parties involved in the litigation, including magistrates deciding the cases, could be punished. Commercial disputes and even minor criminal offences often were settled by mediation and arbitration by the heads of villages or clans. Even today, neighbourhood committees and work units can mediate disputes in the neighbourhood and at work.

Before the *Arbitration Law*, both foreign investors and their local counterparts preferred to arbitrate in a neutral third economy, such as Hong Kong, England, Norway or Sweden (Wang, 1996, p. 15).

The strengthening of dispute resolution mechanisms within China means many foreign investors no longer seek recourse abroad. Arbitration usually is a last resort, if differences in the relationship cannot be sorted out directly between the parties. If a commercial dispute goes to arbitration in China, usually the underlying relationship between the parties has deteriorated beyond repair.

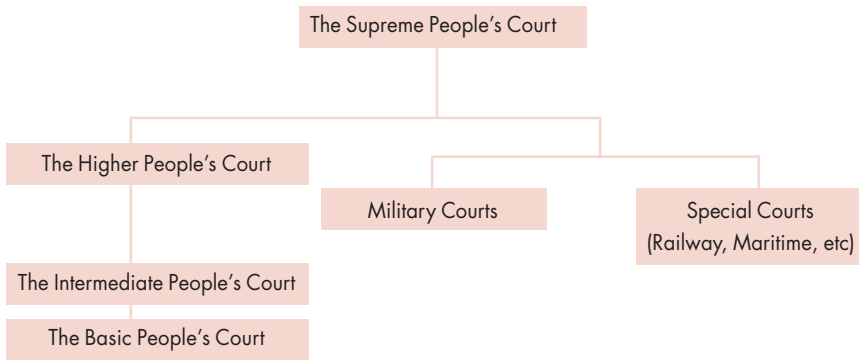
In 1995, CIETAC arbitrated over 900 cases, about half of which were foreign investment disputes, making it the busiest arbitration organisation in the world (Curry, 1996, p. 1). However, a 1996 State Council decision ended CIETAC's exclusive jurisdiction over disputes with foreign business. If the foreigner's local partner does not agree to go to CIETAC, the dispute must go to a local arbitration commission, newly established in over 90 cities across China. As yet, the enforcement of arbitral awards through these local tribunals is untested (Lubman, 1996, p. 38).

Transparency in the legal system and consistency in the application of laws have increased; consequently, court decisions can be appealed in higher courts. The Supreme People's Court, in particular, has been more active in reviewing lower court decisions. In addition, the courts now publish judicial interpretations and case decisions are publicly available. However, the common law system of precedent does not bind judges.

According to foreign legal firms and foreign companies, commercial dispute resolution usually produces fairly objective and predictable results. However, in political cases, lawyers privately note that the Party influences case reviews and results under the Political and Law Committee. Bureaucratic interference by local level Party officials and corruption in the resolution of disputes remain problems.

Figure 3.4

China's Court System



Source: Graham and James (1996).

CONTRACTS IN CHINESE BUSINESS CULTURE

Doing business in China requires a sound understanding of the Chinese business culture, particularly contractual agreements, to prevent disputes. According to Thomas Chiu* and Robert Minter#, Australian and Chinese businesses approach legal contracts differently.

Initiating the business relationship

In China, a business relationship often extends beyond a contract. In fact, the process of finalising a business deal may seem more like starting a friendship than drafting a contract. However, Australians often will be eager to begin a business relationship within the confines of a carefully worded contract. For this reason, they tend to pay particular attention to the exit clause in contracts. However, Chinese first build a relationship of trust and understanding with potential partners, without necessarily negotiating specific business deals.

Building relationships on mutual benefit

Sound business relationships need to be built on mutual benefit, rather than on *guanxi* alone. Diligent assessment of the risks involved is the first step to this process. Careful and open communication with the Chinese business partner is required at the earliest stages of the business proposal.

Keeping focused on the substance

While Australians often focus their negotiation efforts on the substance of the contract—such as price and quality specifications—and attend less to the process of negotiation, the Chinese are very interested in the strategic and tactical aspects of the negotiation process. However, issues of substance must be clarified early in the business relationship and spelt out clearly in the contract. A successful business relationship depends on the clear expectations of both parties and a mutually beneficial contract.

* Coordinator of Sydney's University of Technology Chinese Law Program.

NSW president of the Australia China Business Council.

Regulatory Reform

Accountancy Standards in Transition

China's accounting standards are changing from those used in planned economies to market economy methods. Under central planning, accounting was a mechanism to control state-owned enterprises; whereas Western accounting systems analyse the profit performance of enterprises.

Important differences remain between Chinese and Western accounting standards and also in the treatment of Chinese enterprises and foreign funded enterprises, both joint venture and wholly foreign-owned. These differences include the treatment of bad debts, inventories, long-term equity investments, plant and equipment, land, non-profit facilities, intangible assets and pensions. The legislation particular to the ownership form of an enterprise incorporates accounting laws and regulations, such as the Accounting Regulations for Joint Ventures Using Chinese and Foreign Investment administered by the Ministry of Finance (KPMG Peat Marwick, 1993, p. 30).

While the Ministry of Finance's Administration of Accounting Affairs is the top regulatory body responsible for developing accounting standards, other organisations also contribute to standards development (Zhang, 1996). The Accounting Society of China, established in 1980, undertakes research and sponsors symposia on China's accounting standards. The Securities Regulatory Commission, established in 1992, also publishes regulations on public disclosure of information by listed companies (Hui, 1996, p. 6).

The Chinese Vice Premier Zhu Rongji's statement on accounting problems in late 1995 indicates the Government's commitment to enforce financial discipline based on the recently introduced *Accounting Law*. Zhu Rongji urged accountants to be faithful to their financial responsibilities and indicated managers should not instruct or force accountants to fabricate accounting data or make fraudulent financial statements. He urged an audit of all financial statements, especially those from SOEs and warned that the Government would punish all fraudulent accounting practices aimed at avoiding budgetary supervision, hiding losses and illegal financial benefits, and evading taxes.

Competition Laws Developing Gradually

China's first legislation to deal with unfair or competition, the *Anti-Unfair Competition Law*, effective since December 1993, generally has been poorly and unevenly enforced. Progress in issuing implementing regulations for this law has been relatively slow, although the central Government has issued four supplementary regulations on unfair advertising, restrictions on competition by government bodies, improper packaging and labelling, and business secrets. By mid 1996, ten provincial governments had passed similar laws, some targeting cartel behaviour.

Laws dealing with other aspects of competition and consumer rights have been promulgated or are being developed. The *Consumer Protection Law*, was implemented in December 1993. The considerable press coverage of cases involving unsafe and defective consumer products, indicates public support for

such legislation. An antitrust law to deal with issues related to market structure also is mooted.

Bankruptcy Reform Has Been Slow

While the *Enterprise Bankruptcy Law* (Trial Implementation) took effect in November 1988, and several provinces have bankruptcy legislation, these laws are unevenly applied. Because so many state-owned enterprises are technically bankrupt, the Government fears many declared bankruptcies could destabilise the economy. (See Chapter 10 - State-Owned Enterprises.)

Although the permanent bankruptcy law was drafted in May 1994 (*Law Annual Report 1995*, p. 23), the Government has yet to promulgate it, though some observers believe it will be promulgated in 1997. The government prefers mergers and acquisitions, only dissolving an enterprise as a final resort. Consequently, until recently relatively few bankruptcies proceed to court. However, in the first half of 1996, 1 692 SOEs were declared bankrupt, double the figure for the whole of 1995. (See Chapter 10 - State-Owned Enterprises.)

Land Markets Develop

Land reform in China continues to herald fundamental political and economic changes. After 1949, the state appropriated most private land, but since 1978, China has moved gradually towards re-privatisation of land use. As land-use rights are slowly articulated and developed, the real estate sector has grown rapidly. With the Government's sanction, participants in the industry, including estate agents and property developers, provide the impetus for rapid change.

Under the newly evolving system, land-use rights are either allocated or granted. Most SOEs enjoy allocated land-use rights. The relevant land bureau, as the representative of the Government, continues to control substantially the use of allocated land. A significant restriction on allocated land-use rights is that such rights must be paid for before they are transferred to or used in a foreign funded or domestic enterprise. In contrast, granted land-use rights temporarily transfer the state's direct control over the land to the land user, for a designated time, usually 40 to 70 years. The cost for land-use rights is paid to the level of government with the previously allocated land right. The holder of the land-use right enjoys many of the rights of ownership and can transfer, mortgage and lease these rights. This is an important development for foreign investors because it allows them to acquire identifiable land-use rights for a designated time, thus enhancing certainty and stability in the investment activity.

In addition, the government allows sale and rental markets for commercial and residential buildings to operate with relatively few restrictions. The high demand for limited office and residential space has led to booming property development and construction, market speculation, and some less orthodox methods of transferring land-use rights.

INTELLECTUAL PROPERTY RIGHTS— ENFORCEMENT STILL THE ISSUE

Recent international attention has focused on enforcing intellectual property rights in China. This has slowly forced the Government to bring China's system more into line with international standards.

In the 1980s, China formulated legislation to deal with trademarks and patents; in 1991, it introduced the *Copyright Law*; and in the early 1990s, China signed the Berne Convention, the Universal Copyright Convention and the Geneva Phonograms Convention. China has recently joined key international organisations and conventions relating to intellectual property, including the United Nations World Intellectual Property Organisation (WIPO).

Enforcement is lacking

However, for both foreign and domestic owners of intellectual property, there are still risks in doing business in China. Piracy is common and affects information technology, software, books, movies, music, pharmaceuticals and production processes and products. Infringement of intellectual property rights is particularly prevalent in China's southern provinces, notably in Guangdong. Reverse engineering of industrial machinery and equipment is common. In some cases, restrictive regulations can add to the problem. For instance, when Heinz altered the packaging on its baby food products, the Trademark Office refused to allow Heinz to alter its registration to incorporate the new label (Economist Intelligence Unit, 1996b, p. 6). While the legislation to protect intellectual property is relatively well developed, it is not well enforced. This can significantly violate the rights of producers.

Prospects for better IPR enforcement

The USA has led international efforts to push for more enforcement of China's intellectual property regime. A 1995 IPR Enforcement Agreement committed China to take action to reduce piracy through central and local government crackdowns on offending factories (United States Trade Representative, 1996, p. 7). China also undertook to increase transparency and awareness by publishing laws, standards and even a guidebook to the enforcement system (Kantor, 1996, p. 1). Allegations by the USA that the agreement was not being honoured led to a dispute in mid 1996 between China and the USA which threatened bilateral trade flows of around US\$3 billion.

The situation in many provinces has improved substantially due to increased vigilance by local authorities. However, Australian businesses exploring potential exports or investments with a substantial intellectual property component should actively monitor the enforcement situation.

Prospects for Continued Reform and Transparency

Commercial and legal reforms have proceeded relatively quickly leading to a more transparent and predictable environment; however, the legal system is not without problems. Many in the Government are reluctant to relinquish power, and personal intervention still occurs.

Priority areas for future commercial law reform include improving the transparency and enforcement of bankruptcy and real estate laws (particularly the rights of foreign funded enterprises, FFEs, in major cities), securities and futures trading regulation, laws concerning trading enterprises owned by foreign investors and the insurance law, in relation to foreign participation and the scope of business.

TRANSFORMING THE BUREAUCRACY

China has three nationwide bureaucratic hierarchies: the Party, the government and the military. The Party and the civilian government have four major territorial entities - the centre, the provinces and the major metropolises, counties and cities. The lower level structures must carry out the policies determined by the centre. Therefore, allegiances are dual: to both the centre and the provincial government.

Administrative reform is crucial to any economic reform program (World Bank, 1996, p. 94). An efficient and transparent bureaucracy is essential to implement government economic policies and to promote the trust of business and the wider community. Such a bureaucracy is also important to foreign investors when they select their investment destination. This section outlines recent developments in administrative reform and examines the implications of administrative reform for both the state sector and foreign investors.

Ongoing reform aims to transform the functioning of the Chinese state and bureaucracy to ensure that rule-making accords with the law and that individuals can challenge bureaucratic decisions through an appeal process. Successful administrative reform depends on developing the rule of law, especially in formally constraining arbitrary state power.

China's constitution does not incorporate the separation of powers between the executive, legislature and judiciary. The Communist Party remains the dominant policy-maker in all areas of government administration and theoretically, the state is a unitary system with all authority centred in Beijing. Party membership is a predominant requirement for attaining senior positions in government agencies and enterprises, and party structures parallel government administrative structures in all levels of government.

Government decision-making at the local level therefore often appears to be an *ad hoc* process, closely monitored by the Party. This has led many foreign (and local) business people to rely on local contacts to guide them through the bureaucratic maze and to establish personal relationships with the decision-makers. The system of administrative law remains embryonic and inadequate in areas such as rule-making, judicial review, internal administrative review, administrative supervision, and implementation of administrative rules and regulations.

Corruption has emerged as a major concern during transition (World Bank, 1996, p. 95), as the authority of the central Government and the Party decline but new administrative controls are not fully developed.

Recent Developments

In Beijing and other economically developed cities, government officials are becoming more flexible and sophisticated in negotiating with business. They are often younger and more efficient than their predecessors, better educated, and well-informed on government policies and regulations.

Under pressure from foreign investors and local citizens, the Chinese leadership embarked on a series of administrative reforms in the late 1980s. This led to the enactment of some major administrative laws, including the 1989 *Administrative Litigation Law*, the 1990 *Administrative Review Regulations* and the 1996 *Administrative Penalty Law*. A series of anti-corruption campaigns was also launched.

Administrative reform has involved streamlining the civil service. Since 1992, the number of ministries and bodies under the State Council has fallen from over 100 to 59 and the ratios of cadres to population has fallen from 1:25 to 1:34, reflecting lower levels of appointments in the bureaucracy in recent years (Becker, 1996).

Who Makes the Rules?

One important issue yet to be fully resolved is the source of legislative power in China. Uncertainty can lead to duplication and inconsistency in law-making. For instance, local governments may exceed their legislative powers on foreign investment laws and regulations, leaving foreign investors in an ambiguous position.

Recent changes to the legislative process aim to create a stable and reliable legal system in order to attract foreign and domestic investment.⁴ Consequently, the Party no longer issues policies as laws; instead, the National People's Congress has a formal and systematic process of law-making.

The 1982 Constitution and various national laws comprise the formal legal framework, defining the roles and duties of various legislative and regulatory organs. In addition, the bureaucracy and more importantly, the Party have a significant influence in law-making.

The Constitution establishes various mechanisms for dealing with conflicts in law. Only the National People's Congress can amend the Constitution or annul or alter any inappropriate decisions made by its Standing Committee (*Constitution of PRC 1982: Article 64 and 62(11)*). The Standing Committee can annul administrative regulations or other regulations which contravene the law or the Constitution and local regulations or rules which conflict with the law, the Constitution or central

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⁴ From 1979 to June 1988, 73 laws, 592 State Council regulations and about 1 000 local congress regulations were made and put into effect, of which 71 per cent related to economic activities. See Chen Duan Hong, 'Current directions of legislative activities in the PRC's economic development', paper presented at the China: the Emerged Giant Seminar, Sydney, 14 September 1995.

Government administrative rules and regulations (*Constitution of PRC 1982*: Article 67(7) and (8)). Furthermore, local standing committees can annul inappropriate governmental decisions and resolutions of governments and congresses at the next lower level (*Constitution of PRC 1982*: Article 104). However, the extensive network of coordination through Party organs means these legal methods are rarely required. Most rules and regulations formally require the consent of the Party and higher levels of government prior to enactment. However, cases arise where local laws conflict with central government regulations, for example on permission for FFEs to undertake distribution activities. While such ambiguities may exist, until one of the regulations is amended, the central government regulation is supposed to take precedence. This problem sometimes leaves domestic and foreign enterprises in vulnerable positions.

FOREIGN INVESTORS AND CONFLICTS OF LAW

When conflicts of law emerge among different levels of government, foreign investors may find it difficult to determine which level of government to deal with. No hard and fast rule exists but the following principles are useful:

If a local law or regulation clearly contravenes superior national laws, then the local law or regulation will be held invalid.

When a national law provides only general principles and a local rule offers more detail on the same subject, the local rule will apply.

If a local rule conflicts with a national law which is unknown to the general public, then the local rule will take precedent.

When a newly adopted national law conflicts with a pre-existing local rule, usually the national law will prevail.

Source: Conita Leung, Associate Director, Centre for Asian and Pacific Law, University of Sydney.

Planned new national legislation should overcome some problems of conflicts in law among different levels of government. This proposed law aims to delineate jurisdictions between the various state organs and levels of government, preventing confusion about alternative legislative authorities.

Corruption

Corruption commonly occurs in economies in transition, when traditional controls are weakened before new legal restraints, particularly those affecting conflicts of interest, become effective (World Bank, 1996, p. 95). In some cases, corruption simply speeds up the government approval process and does not add significantly to costs. In other cases, however, it may seriously distort enterprises' capacity to compete and reduce the economy's ability to attract foreign investment (*Business Monitor International*, 1995, p. 89).

Corruption remains widespread, despite criminal penalties for officials involved in bribery. In 1995 and 1996, Communist Party leaders initiated official campaigns against corruption, resulting in the arrest of several high level officials (United States Trade Representative, 1996, p. 11).

In some cases, government officials may arbitrarily exercise power to collect money, to improperly reduce tariffs and to illegally or improperly spend fines or taxes collected. This problem is especially widespread at the local government level. New legislation aims to reduce the direct handling of fines by officials, to minimise the opportunities for corruption; the *Administrative Penalty Law* of 1996 requires that all fines collected are paid directly to the appointed Ministry of Finance bank account with the People's Bank of China, then turned over to the state treasury (*Administrative Penalty Law of PRC 1996: Article 46*).

Foreign Investors and the Bureaucracy

Foreign investors have limited rights to request a review of unfavourable administrative decisions regarding the imposition of fines, confiscation of property, infringement of business activity, refusal or failure to issue permits or licenses, and the infringement of personal and property rights. The relevant legislation for foreign investors are the 1989 *Administrative Litigation Law*, the 1990 *Administrative Review Regulations* and the 1996 *Administrative Penalty Law*.

Judicial Review

The *Administrative Litigation Law* provides for the judicial review of a specified range of administrative actions. It performs a similar function to Australia's *Administrative Decisions (Judicial Review) Act (Commonwealth) 1977* and common law but does not review administrative decisions under a broad range of grounds. Since the *Administrative Litigation Law* was passed, either internal administrative organs or the People's Courts have heard many cases; the People's Courts heard approximately 50 000 administrative cases in 1995, up 30 per cent from the previous year (Ying, 1996). However, most cases were instigated by local and overseas Chinese enterprises, and outcomes have not been reported widely.

Foreigners and foreign organisations may appoint legal representatives who are qualified Chinese lawyers.

Internal Review and Recent Changes

The 1990 *Administrative Review Regulations* systematise internal review. Either the original decision-making administrative body, the entity at the next level up in the bureaucracy, or a specially established review body can review administrative decisions.⁵

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⁵ An aggrieved party first applies for review of an administrative decision. In some cases, the law requires such a review before proceedings can go to the People's Court. If the applicant is dissatisfied with the reviewed decision, the applicant may institute proceedings in the People's Court, except where the law provides otherwise (*Administrative Litigation Law of PRC 1989: Article 38; Administrative Review Regulations of PRC 1990: Article 47*).

The May 1996 *Administrative Penalty Law* advances administrative reform by recognising in law procedural fairness, as understood in Western legal systems. The law provides hearings for those opposing the penalty imposed or the allegations against them.⁶ Although this law is new and relatively untested, it provides a strong basis for continuing administrative system reform.

DEVELOPING GUANXI WITH CHINESE OFFICIALS

Much has been made of the importance of *guanxi* (personal connections) in doing business in China. It has often been suggested that foreign investors need to spend considerable time and resources wining and dining business partners and local officials. Is *guanxi* with local officials becoming more or less important during China's transition to a market economy?

Legal and other uncertainties in China's transitional business environment add to the importance of trust and connections in commercial relations and transactions. Informal *guanxi* networks between business people can substitute for legal protection where the legal framework is undeveloped (EAAU, 1995). This, however, does not mean that *guanxi* will become irrelevant as China's legal and regulatory framework develops. Rather, the strong competition for good foreign investment projects means that *guanxi* is more important than ever, even as business law strengthens (Chen, 1994, pp. 36-46). Good *guanxi* with local officials can provide:

- prompt delivery of government approvals and services
- reliable, early information from officials on government tenders, plans and projects
- access to contracts, property, raw materials, energy or goods from government sources at the best prices possible
- important support if commercial disputes arise.

However, the extent to which foreign firms will need to rely on networks with local government officials depends on their reliance on local government for their business success. Where local government significantly benefits from the relationship, local officials themselves may begin cultivating a relationship.

In the highly competitive business environment developing in China, *guanxi* is not sufficient to ensure success in winning contracts. Firms also have to deliver on the basis of price and quality and meet local development objectives, as well as cultivate good relations with the relevant officials. (See Chapter 6 - Foreign Investment.)

⁶ It also standardises the use of administrative powers to impose penalties, regulates the procedures for implementing penalties and stipulates that the power to impose administrative penalties must be provided by relevant laws and regulations (*Administrative Penalty Law of PRC 1996: Article 3*). Administrative penalties can comprise warnings, fines, confiscation of illegal gains and property, orders to suspend production or business activities, suspension or revocation of permits or licenses, administrative detention, and other administrative penalties provided for by laws and regulations (*Administrative Penalty Law of PRC 1996: Article 8*).

PROSPECTS FOR CHINA'S BUSINESS ENVIRONMENT

While China's business environment is becoming market-oriented and competitive, market-related institutions are likely to take longer to develop. One of the highest priorities for the Government is to create an effective and transparent regulatory environment with its commercial law and bureaucratic reform. This will require efficient and consistent implementation and enforcement of laws and regulations.

The salient characteristic of China's reform model to date has been its pragmatism. In future, doing business in China should be easier, as the legal and regulatory framework grows more efficient, transparent and predictable. However, this process will take several decades of dedicated effort to achieve.

Foreign businesses operating in China's contemporary business environment will encounter many challenges apart from fierce competition. They will need diligent preparation based on research from a variety of sources, including talking to Austrade and other Australian businesses, and using bilateral chambers of commerce.

Appendix 3.1

DOING BUSINESS IN CHINA: CONTACTS AND RESOURCES

Austrade

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|------------------|--|
| Beijing | Senior Trade Commissioner Austrade Beijing Office 21 Dongzhimenwai Dajie Beijing 100600 Tel: (10) 6532 2167 Fax: (10) 6532 4606 |
| Dalian | Austrade Dalian Office Suite 804 Furama Hotel 60 Renmin Lu Dalian, Liaoning Province Tel: (411) 281 6645 Fax: (411) 281 6646 |
| Guangzhou | Senior Trade Commissioner Austrade Guangzhou Office Australian Consulate-General Rm 1505, Floor 15, Main Building GITIC Plaza 339 Huanshi Dong Lu Guangzhou 510098 Tel: (20) 8331 2768 Fax: (20) 8331 2198 |
| Hangzhou | Austrade Hangzhou Office Rm 1016 Hangzhou Hotel 260 Yan An Lu Yuquan Hangzhou, Zhejiang Tel: (0571) 517 3261 Fax: (0571) 517 3262 |
| Nanjing | Austrade Nanjing Office Rm 519, Central Hotel 75 Zhong Shan Lu Nanjing 210005, Jiangsu Tel: (25) 440 0888 Fax: (25) 470 1068 |
| Shanghai | Austrade Shanghai Office 2/F Peace Hotel 20 Nanjing Lu Shanghai 200002 Tel: (21) 6321 1333 Fax (21) 6321 1222 |

China-Related Business Organisations

In addition to the main national bilateral business association, the Australia China Business Council, a number of bilateral business associations bring together many of Australia's ethnic Chinese communities.

The Australia China Business Council has a national office and a number of state chapters in Queensland, New South Wales, Victoria, South Australia and Western Australia. The Council's national secretariat is located at:

24 Brisbane Avenue
BARTON ACT 2600

Postal Address: Post Office Box E14
KINGSTON ACT 2604

Tel: 06 273 2311
Fax: 06 273 3196

Australia now has over 200 Chinese community groups, many of which are commercial in nature. An overview of these organisations is provided in the East Asia Analytical Unit's *Overseas Chinese Business Networks, 1995* (publication details in Other Useful Publications). Another good source of information is the Australian Bilateral Business Associations Database on diskette, listing a large number of business organisations and ethnic groups across Australia. The database can be obtained from:

Australian Bilateral Business Association Database
c/- Mr Norman Barter
Australian Chamber of Commerce and Industry
PO Box E14
KINGSTON ACT 2604

Tel: 06 273 2311
Fax: 273 3286

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Other Useful Publications

A wealth of published information now exists on doing business in China. The following publications provide a starting point for further reading on China's economic conditions, the business environment and the legal framework for foreign business.

CCH, *China Laws for Foreign Business*, CCH Australia, updated monthly.

Coopers and Lybrand, 1994, *Doing Business with China*, Coopers and Lybrand, London.

Department of Foreign Affairs and Trade, 1996, *Cross Cultural Connections Series – China*, contact (06) 261 3114, Canberra.

Department of Foreign Affairs and Trade, *China Country Economic Brief*, Country Economic Brief Series, updated annually.

East Asia Analytical Unit, 1995, *Overseas Chinese Business Networks in Asia*, Department of Foreign Affairs and Trade, Canberra.

Economist Intelligence Unit, 1996, *China Hand: Investing, Licensing and Trading Conditions in the PRC*, EIU, by subscription, updated regularly, Hong Kong.

MACROECONOMIC MANAGEMENT

Since 1993, the Government has progressed considerably in the crucial area of macroeconomic management reform. As the economy becomes increasingly market-oriented and activities controlled by central planning shrink, the Government has recognised it must switch to more powerful indirect fiscal and monetary policy instruments of macroeconomic management. The Government's progressive development of these new management mechanisms helped the economy to achieve a soft landing from the high inflation levels of 1993 and 1994, bringing down inflation to 6 per cent in 1996, while maintaining growth at 10 per cent. However, macroeconomic management is still in transition, with the Government continuing to rely on both traditional direct economic controls, like setting credit quotas on bank lending under the credit plan, the reintroduction of price controls and restricting commercial foreign borrowing. As well indirect macroeconomic instruments are evolving. These include the auctioning of government bonds, relaxing bank interest rates and establishing bank asset/liability ratios.

The coexistence of the two sets of policy tools reflects the transition from planning to market-oriented economic management, but nevertheless generates tensions in the banking system and complicates macroeconomic management. However, if the Government adheres to the macroeconomic reform agenda laid out by the Party's Plenum in late 1993, it is likely to make significant progress in resolving many of these problems over the rest of the decade. As a consequence, in future, the economy should cease to have the violent stop-go cycles it has experienced since 1978 and settle into the more moderate pattern of business cycles experienced in market economies. This will significantly reduce risks for both domestic and foreign investors.

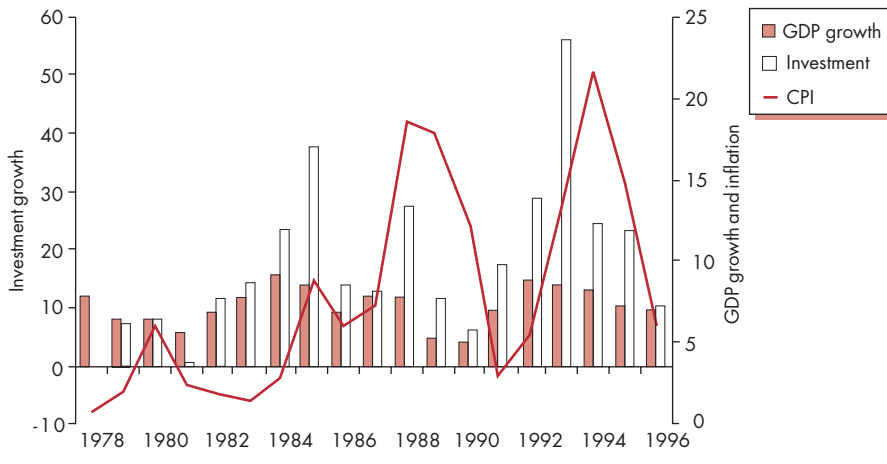
This chapter identifies the basic features of China's macroeconomic management regime, highlighting the achievements to date and some of the major remaining problems. It then anticipates macroeconomic management developments in the next decade and draws implications for foreign and domestic investors. The first section presents the dynamics underlying recent macroeconomic performance. The next three sections focus on reforms of the fiscal regime and financial system, and major constraints to the transformation of macroeconomic management in China. The final section examines likely developments in the next 5 to 10 years.

MONETARY TOOLS TO STABILISE THE ECONOMY

Throughout the reform period, the economy suffered from sharp policy-induced economic cycles and occasional bouts of very high inflation (Figure 4.1). The decentralisation of fiscal authority to the provinces, the growing importance of the non-state sector (NSS), and increasing autonomy of state-owned enterprises (SOEs) place much of the economy beyond the direct control of the central Government. However, until recently, insufficient indirect management mechanisms were available to replace the old and increasingly ineffectual direct controls.

Figure 4.1

Macroeconomic Instability Post 1978 Major Swings in Growth and Inflation



Source: State Statistical Bureau (1996 and previous years).

In November 1993, the Third Plenum of the Fourteenth Central Committee of the Party outlined how the Government intended to introduce a modern system of macroeconomic management, in order to establish a ‘socialist market economy’. The Plenum emphasised the importance of developing national markets for commodities, labour and financial assets, and monetary and fiscal policies to achieve a balance between aggregate demand and supply. It recognised that monetary policy would play a preminent role in maintaining macroeconomic stability. The Plenum¹ called for:

- transformation of the People’s Bank of China (PBOC), into a modern central bank responsible for monetary policy and supervision of the financial system, with its primary objective to stabilise the value of the currency
- separation of ‘policy lending’ (lending to support state policies) from commercial lending by the state banking system

¹ See Mehran et al (1996, pp. 1-2) for detailed discussion on the implications of the Decision of the Third Plenum of the Fourteenth Central Committee of the Party.

- transformation of state-owned specialised banks into genuine commercial banks
- separation of commercial banking from securities trading
- sale of government bonds rather than overdrafts from the central bank to finance government budget deficits
- controlled development of non-bank financial institutions and capital markets to complement the banking sector
- development of monetary instruments, such as bank reserve/deposit ratios, the central bank's discount rate, open market operations, bank interest rates and the exchange rate, as essential tools for monetary policy
- currency convertibility on the current account (for all international payments for goods and services trade, loan repayments, amortisation and profit remittance).

The scope and vision of these reforms are impressive. Although the implementation will be gradual, the Plenum announced that a functioning structure will be in place by 2000. While in the past two years, considerable progress has been achieved in most of the areas outlined, all of these policy objectives will involve major structural changes to the state enterprise sector, the financial and taxation systems that will take several decades to achieve.

STRUCTURAL CHANGES AFFECT MACROECONOMIC PERFORMANCE

Since reforms began, the economy has experienced four sharp macroeconomic cycles: 1978 to 1982, 1983 to 1986, 1987 to 1991 and 1992 to 1995 (Figure 4.1). In each cycle, strong growth in fixed capital investment triggered the upswing. Subsequently, tightened credit reduced fixed and working capital investment and ended the cycle. Until 1984, the centrally-controlled government investment plans and the state budget determined fixed capital investment. This allowed the central Government to cool any overheating in the economy by cutting back projects financed through its own budgetary outlays and the banking system. However, since the mid 1980s, local governments and enterprises have driven strong economic growth through their investments, financed not only by central government budgetary allocations but also by their own on- and off-budget revenue and borrowings.² Many of these practices are largely beyond the control of the central Government. Non-state enterprises reinvest much of their profit and also use foreign capital, while state enterprises mainly use bank loans to finance their investment. (See Chapter 11- Non-State Sector, Table 11.7.)

The decentralisation of fiscal authority and the resulting financial autonomy of local government and state and non-state enterprises made it increasingly difficult for the central Government to curb economic overheating simply by reducing

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² While local governments are not permitted to borrow they can create entities (such as development agencies) which are outside the budget but still undertake public works projects. This practice is common in many countries.

fiscal expenditure. It has also been difficult to control the lending activities of the many branches of the state banks, which also exploited the loosening of central controls. Recapturing that control by the head offices of the state banks and the PBOC has been a new and important feature of state bank lending, enabling the monetary authorities to restrict available liquidity for new local government and enterprise investment.

The increasingly significant role of the NSS and households has also changed the dynamics of macroeconomic management. Important changes in the influences on the macroeconomic situation include:

- *Increased household savings and changes in the composition of total demand.* The ratio of household bank deposits to GDP rose steadily from less than 10 per cent in 1980 to 57 per cent in 1996 (Table 4.1). This rise in household savings is associated with a fall in household consumption (down from about 50 to 45 per cent of GDP) and a rise in investment (up from below 35 to over 40 per cent of GDP) over the same period. Household savings' growth is due to a rapid rise in personal wealth, as a result of the success of agricultural reforms in raising rural incomes, the rapid rise in urban wages and the monetisation of workers' compensations. (See Chapter 12 - Labour Markets.) This wealth is largely held in cash and bank deposits in part reflecting the lack of investment opportunities in tangible and long term assets like real estate and insurance policies (Hussain and Stern, 1991).

As household savings increase, consumer expectations are becoming an important factor in macroeconomic management. Large liquid bank deposits can be used for speculative activities, including currency speculation. This complicates macroeconomic management and was a major influence in the Government's decision to unify the exchange rate in 1994.

- *Consumption-driven structural change.* Planned investment favouring heavy industry drove economic growth in the pre reform period. Now, consumption, exports and investment by fast growing NSS enterprises generate most growth in services and industries such as processed foodstuffs, textiles, clothing and footwear, furniture, household electrical goods and chemical products. (See Chapter 1 - Overview of Economic Reforms.) Investment decisions in these sectors are largely beyond government control.
- *Increasing openness of the economy.* Strong economic growth is accompanied, and in part generated by the economy's increasing openness to the world economy. Since 1989, China has achieved a significant trade surplus in all years except 1993. This strong trade performance, together with foreign direct investment (FDI) inflows of approximately US\$40 billion by 1996, caused official foreign exchange reserves to climb to US\$105 billion by the end of 1996 (Table 4.6). As the Government is managing the exchange rate to prevent appreciation, this inflow of foreign capital and net export earnings has put pressure on the money supply and complicated macroeconomic management.

Table 4.1

Key Economic Indicators

| | 1980 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|-------------------------------------|--------|---------|---------|---------|---------|---------|---------|---------|
| Gross Domestic Product | | | | | | | | |
| value (¥ billion) | 451.8 | 1 854.8 | 2 161.8 | 2 663.9 | 3 463.4 | 4 662.2 | 5 826.1 | 6 780.0 |
| annual growth (per cent) | 7.8 | 3.8 | 9.2 | 14.2 | 13.5 | 12.6 | 10.5 | 9.7 |
| Fixed capital investment | | | | | | | | |
| value (¥ billion) | 91.1 | 444.9 | 550.9 | 785.5 | 1 245.8 | 1 637.0 | 1 944.5 | 2 380.0 |
| annual growth (per cent) | 6.7 | 7.5 | 23.8 | 42.6 | 58.6 | 31.4 | 18.8 | 18.9 |
| Government budget revenue | | | | | | | | |
| value (¥ billion) | 108.5 | 331.3 | 361.1 | 415.3 | 508.8 | 521.8 | 618.8 | 730.9 |
| per cent of GDP | 24.0 | 17.9 | 16.7 | 15.6 | 14.7 | 11.6 | 10.7 | 10.8 |
| Government budget expenditure | | | | | | | | |
| value (¥ billion) | 121.3 | 345.2 | 381.4 | 439.0 | 528.7 | 579.3 | 680.9 | 799.4 |
| per cent of GDP | 26.9 | 18.6 | 17.6 | 16.5 | 15.3 | 12.9 | 11.8 | 11.8 |
| Government extra-budget revenue | | | | | | | | |
| value (¥ billion) | 80.3* | 270.9 | 324.3 | 385.5 | 143.3 | 186.3 | | |
| per cent of GDP | 15.5* | 14.6 | 15.0 | 14.5 | 4.1 | 4.0 | | |
| Government extra-budget expenditure | | | | | | | | |
| value (¥ billion) | 73.5* | 270.7 | 309.2 | 365.0 | 131.4 | 171.0 | | |
| per cent of GDP | 14.2* | 14.6 | 14.3 | 13.7 | 3.8 | 3.7 | | |
| Money supply (M2) | | | | | | | | |
| value (¥ billion) | 148.8* | 1 529.4 | 1 935.0 | 2 540.2 | 3 488.9 | 4 692.4 | 6 074.9 | 7 609.5 |
| annual growth (per cent) | — | 28.0 | 26.6 | 31.3 | 37.4 | 34.5 | 29.5 | 25.3 |
| Retail price inflation | | | | | | | | |
| annual growth (per cent) | 6.0 | 2.1 | 2.9 | 5.4 | 13.2 | 21.7 | 14.8 | 6.1 |
| Exchange rate** | | | | | | | | |
| ¥/US\$ | | 5.8 | 5.9 | 7.2 | 8.5 | 8.6 | 8.3 | 8.3 |
| Retail commodity sales | | | | | | | | |
| value (¥ billion) | 179.4 | 725.0 | 824.6 | 970.5 | 1 246.2 | 1 626.5 | 2 059.8 | 2 461.4 |
| annual growth (per cent) | 21.5 | 2.5 | 13.7 | 17.7 | 28.4 | 30.5 | 26.6 | 19.4 |
| Household bank deposits*** | | | | | | | | |
| value (¥ billion) | 40.0 | 703.4 | 911.0 | 1 154.5 | 1 520.4 | 2 151.9 | 2 966.2 | 3 876.0 |
| as a ratio to GDP (per cent) | 8.8 | 37.9 | 42.1 | 43.3 | 43.9 | 46.2 | 50.9 | 57.2 |

Note: * Figure for 1982;

** Exchange rates before 1994 are the rates from foreign exchange swap markets;

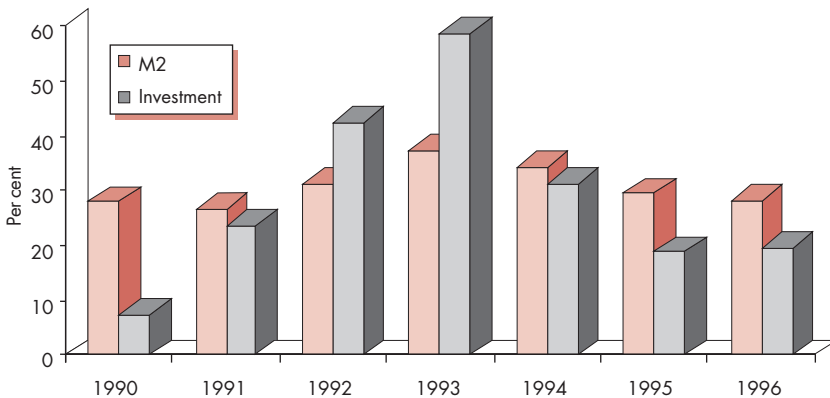
*** End of year balance.

Source: State Statistical Bureau (1996 and previous years); People's Bank of China (1996a); China's Statistical Information Consultancy Service (1997).

- *The falling share of government budgetary revenue in GDP.* Government budgetary revenue declined from 24 per cent of GDP in 1980 to about 12 per cent in 1995. (See Chapter 1 - Overview of Economic Reforms, Figure 1.13.) Including extrabudgetary revenue controlled by central and local fiscal authorities, the share of total budgetary revenue in GDP also fell rapidly, from 40 per cent in 1982 to 16 per cent in 1994 (Table 4.1).³ This has weakened the central Government's ability to influence the economy through fiscal policy.
- *The growing financial role of lower levels of government.*
- *Increasing importance of monetary policy in curbing inflation.* As the influence of fiscal policy weakens, the role of monetary policy has become increasingly important in macroeconomic management. Inflation fell to below 3 per cent in 1990 to 1991, a result of the tough policy controls on bank credit after August 1988, but rose to 22 per cent in 1994 when some direct price and lending controls were relaxed and financial institutions circumvented PBOC lending limits (Table 4.1). Monetary policy was again one of the measures used in curbing inflation in 1994, reducing price increases to 15 per cent in 1995 and to 6 per cent in 1996. Monetary policy allied with direct controls over investment and some limited administered price controls seem well able to moderate capital investment. Monetary policy has contributed in a significant way to lowering inflation (Figure 4.2).

Figure 4.2

Growth in Money Supply Drives Investment
Growth of Fixed Capital and Money Supply (Per Cent)



Source: State Statistical Bureau (1996 and previous years).

³ The Government estimated that 'extrabudgetary revenue' was approximately equal to on-budget revenue in 1992. However, as much of this so-called extrabudgetary revenue was controlled by non-fiscal government organisations such as SOEs and agencies, it could not really be defined as fiscal revenue. Consequently, in 1993, the Government redefined extrabudgetary revenue to exclude the revenue controlled by SOEs and non-fiscal organisations. This reduced the ratio of extrabudgetary to budgetary revenue to about 30 per cent in 1993.

REFORM OF THE FISCAL REGIME

The centre piece of the urban industrial reform started in the early 1980s, was a profit-retention system which permitted SOEs to retain a proportion of their profits for new investment, technological innovation and upgrading, and expenditure on workers' welfare. (See Chapter 10 - State-Owned Enterprises.) This innovation rapidly deprived the central Government of sufficient revenue for its expenditure obligations as it could not increase its revenue by adjusting the rate of profit retention from time to time or from enterprise to enterprise. To finance its expenditure, the central Government had to borrow ¥ 7 billion from the local governments in 1981 and ¥ 4 billion in 1982. Thus the reforms of the 1980s set in train the secular decline in the revenue to GDP ratio. However, the expenditure to GDP ratio also declined as the Government concurrently reduced its role in funding SOE investment.

Reforms to the Taxation System

This dilemma motivated reforms of the taxation system in 1983, 1987, and again in 1993 (People's Congress of China, 1993a, 1993b, 1993c, 1993d). The main elements of taxation reform over this period included:

- *Separation of central and local government taxation systems.* Until 1984, the tax revenue collected by the central Government was simply the total fiscal surplus of the SOEs and other state-owned organisations. In the mid 1980s, to encourage local governments to generate local autonomy and more rapid growth, the central Government introduced a variable tax revenue sharing system across provinces which enabled local governments to retain a share of the revenue they collected, encouraging them develop their own tax sources and invest to stimulate local growth.
- *Introduction of more standardised indirect taxes to replace the consolidated industrial and commercial tax.* In 1984, the consolidated industrial and commercial tax was replaced by four more standard indirect taxes, namely, a product tax, a value added tax (VAT), a business tax, and an urban maintenance and construction tax. The VAT covered almost all industries but was complex and difficult to administer with 13 different rates. The consolidated industrial and commercial tax rather than the VAT was still applied to foreign funded enterprises, FFEs.
- *Preferential treatment of FFEs.* The corporate tax rate for FFEs was 15 per cent in special economic zones, 18 to 21 per cent in open coastal cities, and 30 per cent in other areas. Moreover, almost all foreign funded enterprises were exempted from paying income taxes for the first two years and, in the following three years, they only paid half of their tax obligations. Understandably, domestic enterprises believed this policy disadvantaged them.

Taxation Reforms since 1994

Recent taxation reforms since the Third Plenum Decision are:

- to establish a clear system for tax assignment or sharing among different levels of government to reduce tax leakage
- to define clearly rules-based taxes and

- to end the system of tax contracting between the central and local governments and between enterprises and governments.

At the beginning of 1994, the number of taxes was pruned from 34 to 18 and the taxation treatment of all types of enterprise was made uniform. The reforms aimed to simplify the taxation system making it more efficient, as well as increasing the central Government's share of tax revenue.

The most important changes introduced in this reform were:

- applying a new VAT to all companies to treat equally local and foreign firms. The VAT applies to imported and domestic goods and utilities (but not exports), as well as to services related to the processing and preparation of goods. While the standard VAT rate for most goods is 17 per cent, food, water, energy, books and fertilisers are taxed at 13 per cent;
- introducing a uniform, flat corporate income tax rate of 33 per cent for all domestic and foreign enterprises, except for those in special economic zones and open cities, and central government-owned banks and extractive industries;
- standardising personal income tax, applying it equally to foreign and Chinese nationals. with the tax rate ranging from 5 per cent on a monthly income of less than ¥ 500 to 45 per cent on monthly income over ¥ 100 000;
- assigning clearly most taxes to either central or local governments, and sharing the remainder between the two levels of government on a uniform formula across provinces. Central Government taxes include tariffs, centrally-owned SOEs' income tax, and revenue submitted by railways, banks and insurance companies. Local governments collect and retain personal income taxes and company income taxes on locally owned enterprises. Central and local governments share the revenue from VAT (75 per cent for the central Government and 25 per cent for local governments); resource taxes (the central Government taxes marine resources and oil, local governments tax other resources); and taxes on security exchanges (50 per cent for the central Government and 50 per cent for local governments);
- imposing uniform accounting standards for tax purposes by the State Tax Bureau under the new Tax Administration Law. While China's taxation policies generally follow sound taxation principles, tax administration is not yet uniform in application. Moreover, the tax collection system is weak and considerable effort will be required to improve efficiency and upgrade systems throughout China.

Reforms to the Government Expenditure System

A substantial portion of investment expenditure responsibilities also were decentralised to local governments and enterprises in the early 1980s. The share of central and total government expenditure in GDP declined rapidly. Government expenditure on infrastructure and industrial enterprises fell from 15 to 4 per cent of GDP from 1980 to 1995, reflecting the reduced role of all levels of government in such economic activities (Table 4.2). (See also Chapter 10 - State-Owned Enterprises, Table 10.2.)

Table 4.2

**Major Shift from Economic Investment and Defence
to Social Spending**
Developments in Government Expenditure, Selected Years

| | 1980 | 1985 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|--|------|------|------|------|------|------|------|------|
| As a percentage of total expenditure (total expenditure = 100) | | | | | | | | |
| Economic construction | 55.3 | 48.5 | 44.8 | 42.2 | 41.5 | 40.5 | 43.1 | 41.8 |
| Culture and education | 16.4 | 22.1 | 21.4 | 22.3 | 22.1 | 22.3 | 25.9 | 25.7 |
| National defence | 16.0 | 10.4 | 8.4 | 8.7 | 8.6 | 8.1 | 9.5 | 9.3 |
| Administration | 6.2 | 9.3 | 12.0 | 10.9 | 10.6 | 12.0 | 14.6 | 14.6 |
| As a percentage of total GDP (GDP = 100) | | | | | | | | |
| Government expenditure | 26.8 | 20.5 | 18.6 | 17.6 | 16.5 | 15.3 | 12.9 | 10.1 |
| Economic construction | 14.8 | 10.0 | 8.3 | 7.4 | 6.8 | 6.2 | 5.6 | 4.2 |
| Culture and education | 4.4 | 4.5 | 4.0 | 3.9 | 3.6 | 3.4 | 3.3 | 2.6 |
| National defence | 4.3 | 2.1 | 1.6 | 1.5 | 1.4 | 1.2 | 1.2 | 0.9 |
| Administration | 1.7 | 1.9 | 2.2 | 1.9 | 1.7 | 1.8 | 1.9 | 1.5 |

Source: State Statistical Bureau (1996 and previous years).

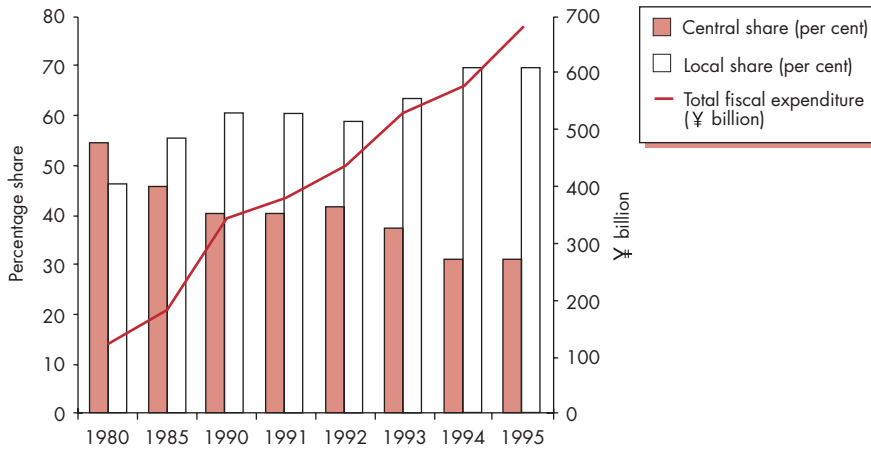
The rising share of local government expenditure reflects the fact that most public projects, such as roads, railways and schools are now planned and financed by local governments (Figure 4.3). Local governments now retain most of the revenue they collect and initiate their own expenditure. This has made the funding of major national and inter-provincial infrastructure projects more difficult. (See Chapter 7 - Infrastructure.) As a result of the increasing localisation of government expenditure, the ability of the central Government to redistribute resources among different regions has weakened significantly. (See Chapter 8 - Regions.)

Consequences of Fiscal Reforms

While the 1994 tax reform was designed partly to strengthen the central Government's fiscal position, it has yet to achieve this outcome (Table 4.1). Since fiscal revenue and expenditure are the linchpins of a traditional centrally planned economy, the dramatic decline of the share of government revenue in GDP clearly indicates that government control over the economy through budgetary expenditures has been reduced substantially. Enterprises and individuals now have considerable financial autonomy to undertake investment, causing a fundamental change in the effectiveness of alternative macroeconomic management control mechanisms (Figure 4.4).

Figure 4.3

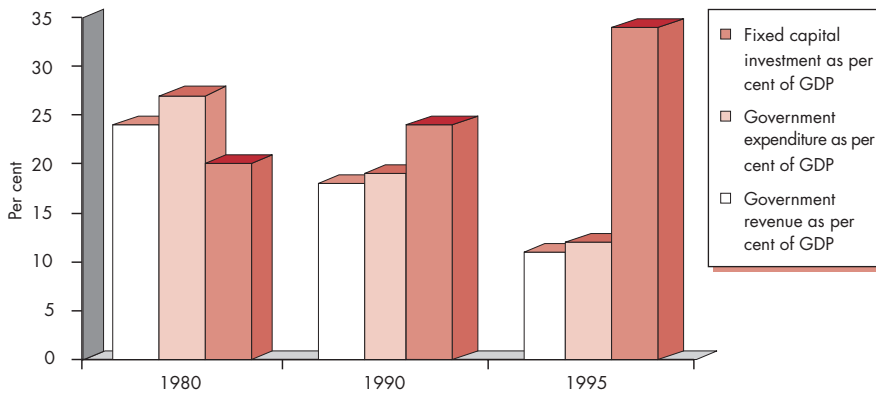
Central Government Gives Way to Local Government Distribution of Fiscal Expenditure Between Central and Local Governments



Source: State Statistical Bureau (1996 and previous years).

Figure 4.4

As Government Share Shrinks, Investment Accelerates Fixed Capital Investment and Government Revenue and Expenditure

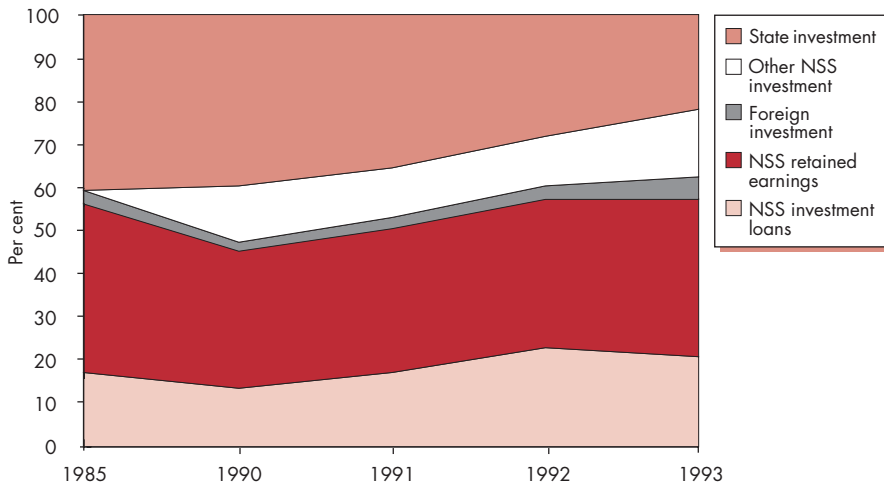


Source: State Statistical Bureau (1996 and previous years).

The central Government now has only limited influence on fixed capital formation. While state budgetary spending on fixed capital is declining, investment from non-state sources, including from firms' retained earnings, bank loans to non-state enterprises, foreign investment and individuals, is increasing dramatically (Figure 4.5).

Figure 4.5

Dramatic Growth of NSS Investment Share Shares of Fixed Capital Investment in the National Total (¥ 100 million)



Source: Zhang (1996).

MONETARY POLICY AND FINANCIAL SYSTEM REFORM

The reform of the banking system also began in 1984, with the establishment of the PBOC as a central bank. Its commercial banking functions were transferred to four specialist banks: the newly formed Industrial and Commercial Bank of China, which caters for urban enterprises and residents; the Agricultural Bank of China, which caters for rural enterprises and residents; the People's Construction Bank of China, which mainly caters for construction enterprises; and the Bank of China which specialises in foreign exchange business.

The four specialist banks have branches throughout China and together with the PBOC, have dominated the banking system since 1984 (Table 4.3).

Table 4.3

State Banks Still Dominate Distribution of Deposits and Loans between Banks and Financial Institutions

| | Total (¥ billion) | As a percentage of the total (total = 100) | | | | | |
|-----------------|----------------------|--|----------------|----------------------------------|---------------------------------|------------------------------------|------------------------|
| | | State banks | Other banks | Urban credit cooperatives* | Rural credit cooperatives | Financial trust institutions | Financial companies |
| Deposits | | | | | | | |
| 1995 | 5 386.23 | 72.00 | 2.97 | 6.23 | 13.32 | 4.64 | 0.84 |
| 1996 | 6 857.12 | 72.32 | 3.43 | 6.62 | 12.82 | 3.61 | 1.19 |
| Loans | | | | | | | |
| 1995 | 5 039.41 | 77.89 | 2.39 | 3.83 | 10.39 | 4.78 | 0.73 |
| 1996 | 6 115.24 | 77.57 | 2.68 | 4.49 | 10.41 | 3.82 | 1.04 |

Note: * Some urban credit cooperatives were changed into urban cooperative banks in 1996. The figures in 1996 therefore include figures from both urban credit cooperatives and urban cooperative banks.

Source: People's Bank of China (1996a); *Financial Daily* (21 January 1997).

In 1994, three policy banks were established: the State Development Bank (lending for major infrastructure projects); China Import and Export Bank (providing finance for traders); and China Agricultural Development Bank (providing funds for agricultural crop purchasing). These banks were established to remove the policy lending obligations from the four state-owned specialist banks to allow them to develop into commercial entities. However, as the specialist banks are required to purchase the bonds that finance the policy banks' lending, they still support these policy loans, albeit now indirectly.

With more recently established banks and financial institutions, especially the local government-owned banks and recently, a private domestic bank, the banking system has become somewhat more diversified and functional (Figure 4.6). While these new banks are more market-oriented and provide strong competition for the four specialist state banks, they still control only a relatively small (albeit growing) share of total financial assets (Table 4.3). In 1996, several foreign banks in Shanghai were granted permission to undertake limited renminbi business. This business has not yet commenced (in early 1997), but it should provide limited, though useful further competition in the financial market.⁴

Finally, PBOC lending to the state banks has been simplified greatly, making excess reserves a more useful target for monetary policy.

⁴ By January 1997, four foreign banks were allowed to conduct renminbi yuan business, including accepting deposits, offering loans and guarantees, and investing in Chinese treasury and government bonds dominated in renminbi yuan. These banks are Citibank from the USA, the Bank of Tokyo-Mitsubishi and the Industrial Bank of Japan, and Britain's Hong Kong and Shanghai Banking Corporation (*China Daily*, 3 January 1997).

Figure 4.6
An Overview of China's Financial Sector



PBOC as an Independent Central Bank

The new PBOC Law promulgated in 1995 is an important landmark in monetary policy development, giving the PBOC the power to perform central bank functions of monetary policy management and supervision of the financial institutions. While the new PBOC Law still gives the State Council a leadership role in formulating and implementing monetary policies, it also guarantees the PBOC a high degree of independence from other levels of government and individuals (Mehran, 1996, p. 19). Within this new legal framework the PBOC has effectively implemented monetary policy and is developing strategies to improve supervision of the financial system.

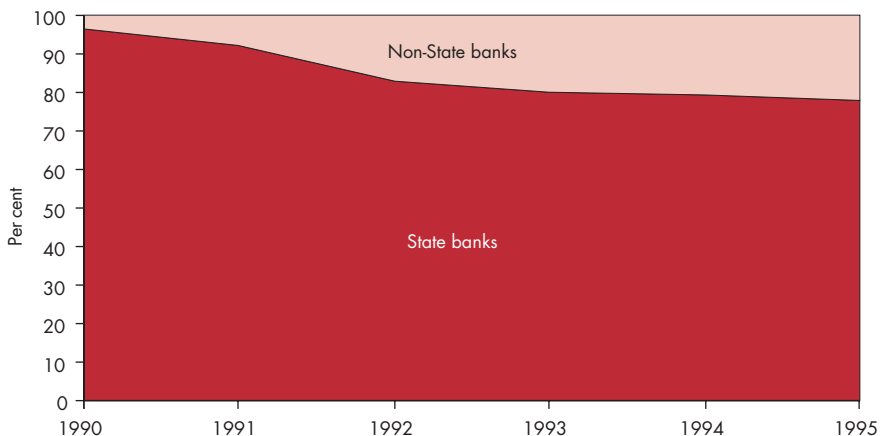
Impact of Banking System Reforms

As a result of these reforms, the new banking system has become much more important in macroeconomic management. The financial resources of enterprises and households rapidly flowed into the financial system, particularly the state banks. Increased deposits and new forms of financial institutions enabled financial organisations to distribute loans to a wider range of customers (Table 4.4). Between 1985 and 1996, total loans by state banks and other financial institutions increased by more than 24 per cent per year (Table 4.3); whereas, budgetary revenue only grew at an average rate of 13 per cent per year (Table 4.1) only a little more than average inflation at 11 per cent per year.

The shift from budget to loan financing of SOE investments meant that, in the absence of solid enterprise accountability and profit incentives, the adverse impact of this shift was borne by the banks rather than the state budget. This is the fundamental cause of the SOEs' bad debt problem.

Figure 4.7

Loans by Non-State Banks Grow Rapidly



Source: Finance Association of China (1996 and previous years); People's Bank of China (1996).

Table 4.4

Sources of Deposits and Loans of Banks and Financial Organisations, 1985 and 1990 to 1996

| | 1985 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|-----------------------------------|---------|---------|---------|---------|---------|---------|---------|
| Total deposits (¥ billion) | 447.3 | 1 410.3 | 1 807.9 | 2 346.8 | 2 962.7 | 4 047.3 | 5 386.2 | 6 857.1 |
| Deposits by: | As a percentage of total deposits | | | | | | | |
| enterprises | 45.47 | 29.06 | 27.93 | 30.64 | 29.05 | 32.56 | 31.90 | 33.97 |
| Treasury | 8.31 | 2.69 | 2.54 | 0.98 | 1.64 | 2.06 | 1.86 | 1.85 |
| government departments and organisations | 6.63 | 4.36 | 4.17 | 2.93 | 2.41 | 2.11 | 1.67 | 1.38 |
| urban residents | 23.76 | 50.49 | 51.12 | 50.10 | 51.32 | 53.17 | 55.07 | 45.00 |
| rural residents | 10.7 | 2.79 | 4.61 | 4.04 | 3.63 | 2.63 | 2.22 | 1.15 |
| other sources | 5.13 | 10.61 | 9.63 | 11.31 | 11.96 | 7.48 | 7.27 | 6.30 |
| Total loans outstanding (¥ billion) | 580 | 1 768 | 2 133 | 2 632 | 3 294 | 4 081 | 5 039 | 6 115 |
| As loans to: | As a percentage of total loans | | | | | | | |
| industrial production enterprises | 20.06 | 20.13 | 19.85 | 18.83 | 18.79 | 18.12 | 18.11 | 18.44 |
| materials supply and sale enterprises | 6.56 | 3.69 | 3.23 | 3.11 | 2.96 | 2.49 | 2.11 | 1.83 |
| construction enterprises | 25.60 | 32.63 | 31.36 | 29.17 | 27.71 | 25.00 | 24.62 | 24.29 |
| urban collective enterprises | 13.18 | 5.53 | 5.32 | 5.77 | 5.96 | 5.07 | 4.26 | 3.95 |
| individual proprietors | 0.52 | 0.23 | 0.23 | 0.26 | 0.33 | 0.38 | 0.39 | 0.46 |
| agricultural sector | 7.18 | 13.65 | 13.95 | 14.70 | 14.69 | 11.38 | 5.99 | 6.31 |
| fixed assets | 11.00 | 12.70 | 14.17 | 14.91 | 15.78 | 19.71 | 19.84 | 19.68 |
| joint ventures, foreign and cooperative enterprises | 0 | 0 | 0 | 0 | 0 | 1.94 | 1.98 | 2.20 |
| other uses | 11.89 | 7.64 | 8.40 | 9.82 | 10.57 | 13.19 | 20.63 | 22.84 |

Source: Finance Association of China (1996 and previous years), State Statistical Bureau (1996 and previous years); People's Bank of China (1996a); *Financial Daily* (21 January 1997).

The reform progress in the financial sector since 1993 has helped the PBOC to move at least partially from credit policy, under which the credit of banks is the policy target and the instrument, to monetary policy, which targets banks' excess reserves. However, even with these policies the central bank continues to maintain close control over bank lending levels through credit allocation policies. The gradual shift from credit planning and quotas towards greater use of indirect monetary policy instruments has enabled the rapid growth of the non-state financial sector to occur without weakening monetary policy. The PBOC has waived limits on loans provided by non-state banks, urban and rural credit cooperatives and other non-state financial institutions, enabling them to play an increasing role in the loan market (People's Bank of China, 1996a). By 1995, almost 25 per cent of lending was provided by non-state banks and financial institutions, up from only 3.6 per cent in 1990 (Figure 4.7).⁵ This development will reinforce the PBOC's movement away from credit ceilings towards more indirect mechanisms to control the money supply.

Interest Rate Policy

Although monetary policy instruments now play an important role in macroeconomic management (see box), the central Government's regulation of state bank interest rates limits the full use of this instrument. Since the state commercial banks can only adjust their lending rates within a specified band around officially determined rates, the marginal lending rate is not fully market driven and open market operations (the sale and purchase of government bonds to influence liquidity) operate less efficiently than would otherwise be the case. Constraints on bank credit creation cannot be fully effective if banks must lend at regulated interest rates. This is particularly true when regulated interest rates are well below potential market rates and are negative in real terms, as was usually the case prior to 1995–96. Therefore, monetary authorities must still rely partially on total credit ceilings to achieve money supply targets (Dai, 1996).

However, policy reform has been moving rapidly since 1994. By mid 1996, interest rates in the short term and interbank markets had been fully liberalised. Bank interest rates are now positive in real terms and are likely to stay positive and increasingly determined by demand and supply (Table 4.5). Some observers believe that in 1997, the monetary authorities' dependence on credit controls will be noticeably reduced (Scott, 1997).

Until 1996, the main monetary policy tool was the credit plan, under which the PBOC set credit limits on the state commercial banks thereby controlling the volume of new credit. Before 1994, the central office of the PBOC set credit limits, but the local PBOC branches could adjust their credit ceiling by 7 per cent either side of this limit. Since 1994, the PBOC local branches have lost their right to adjust their credit ceiling. However, local branches do have the right to determine the distribution of their credit quota. Now the credit plan operates in conjunction with more indirect instruments like open market operations and the interbank credit market. In addition, the PBOC also regulates the assets-liability ratios of the

⁵ Lending rates for fixed capital loans from non-state banks and financial institutions have averaged 4 per cent higher than the regulated state banks' rates since the early 1990s.

banks and financial institutions. These are very important instruments to foster the shift away from credit quotas (Scott, 1997).

THE DEVELOPMENT OF MONETARY INSTRUMENTS

While monetary policy management through indirect monetary instruments has been introduced gradually since 1984, its effect was limited until 1994, when several important indirect monetary instruments were introduced.

The Government first introduced a required reserve ratio for banks in 1984 when it established the PBOC. It initially set the ratio at 10 per cent, then raised it to 13 per cent in 1988. Since then, the rate has not been adjusted. The payment-reserve ratio, defined as the ratio of payment reserves to total bank deposits, was introduced in 1989, to perform much the same function as the reserve ratio, influencing the monetary multiplier.

Benchmark interest rates include the interest rates charged by the PBOC to commercial banks when they borrow from the PBOC, and the interest rates offered to commercial banks by the PBOC when they deposit required reserves, payment reserves and special reserves with the PBOC. The adjustment of benchmark interest rates has increasingly helped macroeconomic management, with, for example, the rate for one year loans to financial institutions being adjusted seven times since 1990.

The Shanghai PBOC branch first introduced rediscounting in 1986. This service allows banks to purchase future credits (such as loan repayments) owing to customers for discounted prices. From 1994 to 1995, the PBOC arranged for part of the monetary base to be available to rediscount discounted bills arising from inter-enterprise transactions in the coal, electric power, metallurgy, chemical and railway industries or from the production and procurement of cotton, tobacco and pork. By the end of 1995, the accumulated total of rediscounted loans was ¥ 84.4 billion with its outstanding balance at over ¥ 30 billion, which was six times higher than the level of only 1994 (People's Bank of China, 1996). This practice placed considerable pressure on the money supply, forcing the PBOC to increase the rediscount rate, which helped in meeting monetary policy targets. One of the important financial market laws introduced in 1994 was a modern law on bills of exchange.

PBOC lending to commercial banks has been an important policy instrument to control the monetary base. In mid 1996, for example, the PBOC began to cancel outstanding credit to banks, reducing bank reserves.

Open market operations in government bonds began in early 1996, with the operational target being the liquidity of commercial banks. At present, the 14 commercial banks are the first group of trading partners.

The PBOC applies special deposit requirements to specific financial institutions under special conditions, with the aim of reducing the level of excess liquidity in the commercial banks. In 1995, the PBOC absorbed ¥ 40.7 billion through special deposits (People's Bank of China, 1996).

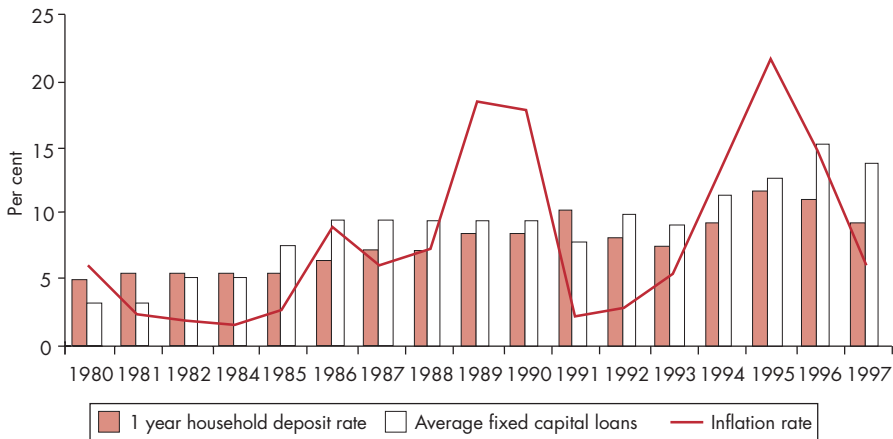
Although the PBOC mainly targets M1 (money in circulation), inflation, foreign exchange and the exchange rate, from 1995 to 1996, it also started targeting M2 (money in circulation and bank deposits) as a monetary policy target. It developed an array of monetary policy instruments, starting with the interbank market and in 1996, open market operations, targeting mainly bank liquidity.

In the longer term, with progress in SOE reform, and development of a modern payments system among banks (supported by a current World Bank and ADB project⁶ the PBOC aims to introduce a more market determined interest rate system for depositors and lenders. As a first step, it has adopted a managed floating interest rate system, setting the ceiling and floor of the loan rate for commercial banks and enabling a reasonably large margin of fluctuation. This gives more freedom to commercial banks to set their own rates according to market conditions (People's Bank of China, 1996a).

The unified national interbank market started operating on 3 January 1996, providing the commercial banks with more independence from the PBOC for funds supply and giving the PBOC more freedom to implement monetary policy. Interest rates in the interbank market are freely determined by the demand for and supply of funds.

Figure 4.8

Bank Lending Rates Now Exceed Inflation



Source: Finance Association of China (1996 and previous years); State Statistical Bureau (1996 and previous years); People's Bank of China (1996a and 1996b).

⁶ An interim payments mechanism was developed by the Shanghai Foreign Exchange trading centre in late 1993.

It is likely that bank interest rates more effectively influence the supply of deposits than demand for bank credit, because most state bank loans are made to SOEs at below market interest rates. Households have very little choice in investment instruments and bank deposits have long been the main option available.⁷ Consequently, household savings have not fallen in line with real (inflation adjusted) interest rates (Table 4.5 and Figure 4.8). However, nominal (published) deposit rates do directly affect household interest returns and hence influence households' willingness to make deposits.⁸

Recognising that households respond sensitively to changes in nominal interest rates, the Government introduced zero real interest rate accounts in the state banks in 1988 to increase household deposits and control household consumption demand. As inflation accelerated in 1992 and 1993, the state banks could not afford to maintain these accounts without substantially increased government subsidies⁹ because their lending rates were fixed well below the inflation rate. The Government withdrew zero accounts from 1990 to 1991, reintroduced them in mid 1993, and finally withdrew them at the end of 1995.

From 1993 to 1995, for the first time, increased bank loan interest rates were used to curb high inflation (Table 4.5). Until 1995 official lending rates usually failed to match the inflation rate, so state bank borrowers enjoyed subsidised interest rates that were negative once inflation was taken into account. With the fall in inflation in 1995 and 1996, the PBOC allowed borrowing rates to stay higher than inflation, making them positive in real terms (Figure 4.7). It apparently intends to maintain this position. While banks often illegally charge a premium over official interest rates and direct income into separate accounts, official lending rates are still well below free market interest rates in the informal market.¹⁰ Furthermore, higher interest rates may still not deter SOE borrowers if they believe their loans need not be repaid if the enterprise gets into financial difficulties. Consequently, SOE reform is essential before interest rates alone can be used to ration bank lending. (See Chapter 10 - State-Owned Enterprises.)

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⁷ In 1995 and 1996, household oriented savings bonds were sold on a large scale to finance the budget, providing an additional instrument for household savings. Enterprise bonds and stock market shares are two other relatively new savings options.

⁸ For example, in 1990, when the one year fixed term deposit rate was set at 13.14 per cent, households' fixed term deposits grew by 42.1 per cent. In 1991, when the one year fixed term deposit rate was adjusted down to 10.08 per cent, households' fixed term deposits grew by 30 per cent, or 12 percentage points less than in 1990.

⁹ Huge subsidies were paid to the banks by the Ministry of Finance after July 1993 to maintain interest rate indexation accounts equal to 70 per cent of their obligations. A basic interest rate was determined by the relevant bank while a zero real interest rate account was opened. In December 1994, the actual interest rate applied for the three year term deposit was 21.3 per cent. However, interest rates for bank loans in 1994 ranged from 8 per cent to 14.8 per cent (Finance Association of China, 1996).

¹⁰ As quoted by an informal source, the black market lending rate has been 6 to 10 percentage points higher than that of the state banks since 1993.

Table 4.5

Inflation Adjusted Borrowing Rates Become Positive
Interest Rates for Term Deposit and Bank Loans and Inflation,
1980 to 1996
(Per Cent)

| | One year fixed term deposit rate for households | One year fixed term deposit rate for enterprises | Borrowing rate for working capital loans | Borrowing rate for fixed capital loans | Inflation rate |
|------|---|--|--|--|----------------|
| 1980 | 4.86 | - | 5.04 | 3.24 | 6.0 |
| 1981 | 5.40 | - | 3.78 | 3.24 | 2.4 |
| 1982 | 5.40 | 3.60 | 5.40 | 5.04 | 1.9 |
| 1983 | 5.40 | 3.60 | 5.40 | 5.04 | 1.5 |
| 1984 | 5.40 | 3.60 | 7.20 | 7.56 | 2.8 |
| 1985 | 6.30 | 4.32 | 5.76 | 9.36 | 8.8 |
| 1986 | 7.20 | 4.32 | 5.94 | 9.36 | 6.0 |
| 1987 | 7.20 | 5.04 | 5.94 | 9.36 | 7.3 |
| 1988 | 8.46 | 8.64 | 9.00 | 9.36 | 18.5 |
| 1989 | 8.46 | 9.99 | 9.00 | 9.36 | 17.8 |
| 1990 | 10.17 | 9.99 | 9.63 | 7.80 | 2.1 |
| 1991 | 8.10 | 8.10 | 9.00 | 9.81 | 2.9 |
| 1992 | 7.47 | 7.56 | 8.37 | 9.09 | 5.4 |
| 1993 | 9.18 | 9.27 | 9.54 | 11.25 | 13.2 |
| 1994 | 11.61 | 10.98 | 9.99 | 12.51 | 21.7 |
| 1995 | 10.98 | 10.98 | 11.07 | 15.21 | 14.8 |
| 1996 | 9.18 | 9.18 | 10.34 | 13.68 | 6.1 |

Note: 1) All deposit and loan rates are an average of published maximum and minimum rates. For bank loan rates the average rates are based on all loan categories (terms).

2) Inflation rate is based on retail price indexes.

3) Information up to May 1996.

Source: Finance Association of China (1996 and previous years); State Statistical Bureau (1996 and previous years); People's Bank of China (1996a and 1996b).

Development of Financial Markets

In the last 15 years, a wide range of financial market instruments from post office savings and bank deposit accounts to shares, futures contracts and corporate and government bonds, have been introduced (Wall, 1996). A legal and regulatory framework also is emerging. (See Chapter 3 - The Market Environment.)

The most common financial instrument, apart from bank deposits, is the government bond. The Government's main aim in issuing bonds was to finance the budget deficit and major capital projects, given its relatively weak revenue position since reforms commenced. This decision also eliminated the inflationary impact of PBOC financing of the deficit. Since 1994, when the central Government ceased financing its deficit with PBOC borrowing, the value of outstanding treasury bonds has grown rapidly. In the first six months of 1996, total bonds issued exceeded those issued in the whole of 1995¹¹ (Table 4.6).

However, the ratio of government bonds issued to official GDP (7 per cent) was still low by international standards with 74 per cent in Japan, 43 per cent in the Republic of Korea, and 53 per cent in Malaysia (Wall, 1996). Clearly, the Chinese Government could increase government bond issues without risking excessive indebtedness.

In summary, China's financial market reforms have partially liberalised the banking and exchange rate systems and capital markets more generally. However, until this process is complete and SOEs and state banks act as fully commercial entities that are sensitive to interest rate movements and accountable for their losses, the central Government will have to retain some direct quantitative controls, such as those on state bank credit creation, to achieve macroeconomic stability. The limited development of financial markets also constrains the Government's capacity to make the most efficient use of indirect market instruments for macroeconomic management. Nevertheless, significant progress has been achieved in a short period.

FOREIGN EXCHANGE REGIME REFORMS

China's foreign exchange system reform began in 1979 with the introduction of a foreign exchange retention system for exporters, thus encouraging enterprises to export. In 1985, foreign exchange adjustment centres, or swap markets, started operating, marking the adoption of a dual foreign exchange rate system. Retained foreign exchange could be traded in swap markets at exchange rates that were consistently higher than the official exchange rate, although the difference between the two varied substantially over time. (See Chapter 5 - International Trade, Figure 5.1.)

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¹¹ In many developed economies 'treasury bonds' refer to long-term government bonds while 'treasury notes' refer to medium term government bonds and 'treasury bills' to short term government bonds. However, this distinction is not made in the Chinese terminology. In the PBOC's English publication all three are called 'treasury bonds' although with terms from three months up to ten years (People's Bank of China, 1996). Most Chinese government bonds are however with terms of 2 to 3 years and called medium term government bonds.

The most important reform in the foreign exchange system was the January 1994 unification of the official and swap market rates, which coincided with a 30 per cent depreciation of the official exchange rate. Against the background of disorderly financial and currency speculation conditions in 1993, the reunification was a bold step which was highly successful. The new exchange system is a unitary floating rate determined daily in the interbank foreign exchange market, but is managed by the PBOC. (See Chapter 5 - International Trade for more details on foreign exchange regime reform.)

Exchange rate unification and depreciation stimulated rapid export growth and a foreign investment influx, resulting in a substantial trade surplus in 1994 to 1995. As the tight credit control policy restricted imports, official reserves rose considerably, and the renminbi appreciated slightly.

In December 1996, the Government announced that it would adopt IMF Article 8, removing all remaining restrictions on foreign exchange transactions three years ahead of its original target. This includes all payments for international goods and services trade, repayments of loans and profit remittance. It also binds China not to introduce discriminatory currency practices or multiple currencies in the future. This is an important step which will improve the authorities' ability to use indirect monetary policy instruments to adjust external balance and stabilise the renminbi.¹² It will also greatly assist China's international traders and foreign investors.

The accumulation in official reserves rapidly increased money supply. In 1994 and 1995, increases in official reserves were US\$30.42 billion and US\$21.98 billion, respectively, equalling an increase in the money supply of ¥ 261.61 billion and ¥ 183.53 billion respectively, or 16 and 9 per cent of total money supply in the two years.¹³ The pace of reserve accumulation was maintained in 1996 (Table 4.6) and early 1997. Increased money supply from official reserves has required the PBOC to reduce lending to the banks to achieve monetary policy objectives.¹⁴

In fact, PBOC policy has encouraged the growth of foreign exchange reserves. All domestic institutions must convert their total foreign exchange receipts at designated foreign exchange banks. These foreign exchange banks can only hold a maximum of US\$0.9 billion; any additional foreign exchange must be sold in the interbank market. Since 1994, when the foreign exchange received by banks from export firms and foreign capital inflow increased dramatically, almost all designated foreign exchange banks had more foreign exchange than their US\$0.9 billion ceiling. The foreign exchange banks found it too costly to hold surplus foreign exchange and sold it on the open market where the PBOC felt obliged to buy it to prevent the appreciation of the renminbi. This is the reason the exchange rate has only appreciated slightly and reserves have kept accumulating.

¹² China News Agency, 1 December 1996.

¹³ US\$1 = ¥ 8.6 in 1994 and US\$1 = ¥ 8.35 in 1995. The money base increased to ¥ 1 646 billion in 1994 and ¥ 1 998 billion in 1995.

¹⁴ The financing of loss-making SOEs has also increased the money supply increasing the need for tight monetary policy.

As the Government was unwilling to allow the renminbi to appreciate significantly after reunification, the monetary authorities attempted to sell bonds in the open market to sterilise the liquidity created by foreign investment and borrowing inflows. However, as sales were insufficient to offset these inflows, a substantial part increased the money supply (Table 4.6).

Table 4.6

Foreign Investment Grows Trade Surplus, Foreign Direct Investment and Official Reserves

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|-------|-------|-------|-------|-------|-------|---------|
| Trade surplus (US\$ billion) | 9.16 | 8.74 | 5.18 | 10.66 | 7.29 | 16.70 | 12.24 |
| Actual foreign direct investment (US\$ billion) | 3.49 | 4.37 | 11.01 | 27.52 | 33.77 | 37.70 | 40.00 |
| Total foreign capital inflows (US\$ billion) | 10.29 | 11.55 | 19.20 | 38.96 | 43.21 | 48.13 | 51.00 |
| Official foreign exchange reserves (US\$ billion) | 11.09 | 21.71 | 19.44 | 21.20 | 51.62 | 73.60 | 105.03 |
| Government bond issues (¥ billion) | 18.7 | 23.4 | 28.0 | 45.6 | 113.8 | 151.0 | 155.6** |
| (US\$ billion)* | 3.1 | 3.9 | 4.0 | 5.2 | 13.3 | 17.6 | 18.7** |

Note: * The conversion rates used for 1990 to 1993 are those years' average annual swap rates. Specifically, 1990 and 1991: US\$1: ¥6, 1992 US\$1: ¥7; 1993: US\$1: ¥8.7. The conversion rates for 1994 and 1995 are based on the annual average interbank market foreign exchange rates. (See Table 4.1.)

** First six months only.

Source: State Statistical Bureau of China (1996 and previous years); *Financial Daily* (21 January 1997); People's Bank of China Research and Statistical Department (1996).

This incomplete sterilisation of foreign capital inflows helped convince the monetary authorities to move to more indirect monetary instruments like open market operations to manage bank liquidity. By mid 1994, the PBOC began to cancel outstanding credit to banks and correspondingly reduce bank reserves. In January 1996, the Ministry of Finance issued its first one year government bond using a competitive bidding system. However, continued deepening of the capital market and particularly the bond market and an efficient national payments system is needed to enable the broader use of open market operations and increase the impact of other indirect monetary policy mechanisms.

CONSTRAINTS ON FUTURE MACROECONOMIC MANAGEMENT REFORM

The three most important factors constraining the Government's impressive progress in macroeconomic management reform are lack of depth of the financial sector, continuing limits on the transition of the state banks to fully commercial institutions and the slow reform of SOEs.

Lack of Development of the Financial Sector

The financial sector is not sufficiently developed to effectively transmit signals from monetary policy instruments to the rest of the economy. The interbank market is not yet nationally integrated by a national payments system and is therefore unable to effectively distribute liquidity to the banks. Banks with a shortage of funds to meet credit plan targets are still able to seek them from the PBOC, undermining the capacity of the interbank market to transmit monetary policy signals and of the PBOC to control its own balance sheet (Mehran, 1996, p. 24).

While the PBOC no longer finances the Government's budget deficit because of inadequate development of long term savings instruments, the central bank still advances most of the credit required by the three policy banks.¹⁵ These projects often have high social benefits but low commercial returns. If the policy banks encounter loan servicing problems this would reduce the effectiveness of the monetary policy functions of the PBOC.

State Banking System

The Commercial Bank Law requires that the banks must operate as commercial entities and must be compensated by the Government if they are required to lend for non-commercial purposes. However, in practice, the four state specialist banks cannot yet operate as commercial banks. They cannot yet refuse government directives to lend to loss-making SOEs and are not usually compensated (Wei, 1996). However, the banks are being increasingly discriminating in their lending operations. Even so, their accumulation of bad debts is a serious impediment to reform. The incentive of banks to manage their funds more profitably is only now being slowly implemented, as are the changes to the organisational structure to promote adequate liquidity management and monitoring at the aggregate level (Mehran et al, 1996 p. 54). The PBOC's prudential control over the banks and other financial institutions is obviously not yet adequate, but considerable effort is now being made to strengthen this area, and improvement can be expected in the remainder of the 1990s (Scott, 1997).

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¹⁵ For example, 95 per cent of the liabilities in the Agricultural Development Bank are PBOC credits (Li and Zhou, 1996).

Loss-Making SOEs

SOEs obtain almost all their working capital and about 50 per cent of their fixed investment capital from banks. Since early 1996, over 50 per cent of SOEs were making losses (State Statistical Bureau, 1996). While bankruptcy of SOEs is increasing and will accelerate in the short term, bankruptcy numbers are still very small; most accumulate losses as bad debts to state banks. Official estimates acknowledge that bad debts equal about 20 per cent of the banks' loans (or approximately ¥ 705 billion in 1995). However, other researchers estimate that bad debts were between ¥ 900 and ¥ 1 200 billion in 1995 (eg. Yi, 1996; Meng, 1996; and Liu, 1996). Some banks are more seriously affected than others; the bad debt ratio of the Commercial and Industrial Bank of China was approximately 25 per cent, while that of Agricultural Bank of China was 40 per cent (Liu, 1996). Because the state banks continue in some circumstances to lend to loss-making enterprises, tight monetary policy and effective credit caps may in fact mainly restrict the liquidity of efficient enterprises. Consequently, the accumulated bad debts of state banks may reduce availability of funds for the more efficient enterprises.

The bad debts of the state banks will continue to accumulate until the Government is able to reform or dissolve loss-making SOEs. It could be argued that little benefit is derived from deregulating state bank interest rates if these banks must still lend to loss-making SOEs, as raising bank interest rates to the marginal market rate merely creates more loss-makers and increases the banks' bad debts. However, as banks are increasingly pressured to act as commercial entities, increased flexibility in loan rates is placing greater pressure on SOEs to reform. This is occurring and is likely to intensify (Bottelier, 1996).

There are several potential solutions to the bad debt problem. The first option is to force loss-making SOEs to solve their own debt problems by repaying debts from their own capital assets. If they fail to clear their debts in a given period, they could be forced to go bankrupt to do so. While, many analysts believe this is the most effective way of solving the debt problem (Fan, 1996), it would probably be politically unacceptable to the Government because of concerns about the impact on unemployment and social stability.

The second option is to use public funds to bail out the banks' bad debts. This would mean that the Government, rather than poorly performing SOEs would take final responsibility for the debts. A similar approach has been adopted by governments in several Eastern European countries (World Bank, 1996, p. 47). However, enterprises dealt with in this way must be effectively declared bankrupt and quarantined from receiving further bank loans. Otherwise, this approach would create a moral hazard problem; that is, banks would have an incentive to behave irresponsibly because they would believe the Government would continue to bail them out if they made a mistake. This would encourage SOEs to create more bad debts.

Some form of recapitalisation for on-going enterprises may be a reasonable option for those loss-making SOEs that would be viable if they were freed from policy constraints, such as controlled output prices or an inability to shed labour. However, in the past, public finance to clear debts was allocated to SOEs irrespective of their long-term viability. As a result, the funds injected did not

relieve shortages of working capital but merely increased the inventories of inefficient SOEs.

A third option to prevent accumulation of new bad debts, is a cash settlement system between loan suppliers and buyers along the lines of the so-called 'Three No Principles'. That is, there is no payment by the bank for purchased products and no delivery of products before the payment is settled, if there is no debt clearance by the buyer. The PBOC strongly supports this system and its implementation appears to have reduced triangular debt between SOEs. However, since many SOEs carry debts, a strict and widespread implementation of this approach would create a short term drop in production,¹⁶ particularly in the presence of tight monetary policy and may adversely affect unemployment levels. In summary, all of these mechanisms are being applied. The Government has not adopted a unified approach to SOE reform; rather the policy is to employ local solutions at the enterprise level.

ONGOING AND FUTURE MACROECONOMIC REFORMS

Implications of the 1995-96 'Soft Landing'

In 1995-96, the central Government successfully engineered a 'soft landing' of the overheated economy of 1993-94, by a mix of direct credit controls and new indirect monetary policy instruments, particularly operating on the banks' liquid reserves (Appendix 4.1). Exchange rate reform in 1994 generated a significant balance of payments surplus and capital inflows, partially offsetting efforts to tighten monetary policy. The PBOC has used direct credit controls quite cautiously, especially in 1995-96 to avoid an excessive reduction in the level of economic growth.

The monetary authorities were satisfied with the results of 1995's tight monetary policy. In 1995, the growth rate of the monetary base was restricted to 21.4 per cent, 9 percentage points lower than in 1994, and the growth rates of currency in circulation (M0), narrowly defined monetary aggregate (M1) and broadly defined monetary aggregate (M2) were 8.2 per cent, 16.8 per cent and 29.5 per cent, respectively, down 16, 10 and 4.9 percentage points from 1994. The growth of state bank loans and monetary aggregates was close to or within the targeted levels, thus realising macroeconomic objectives. GDP growth in 1995 was 10.5 per cent, down 2.1 percentage points from 1994, but the national retail price index grew at only 14.8 per cent, a significant drop from 21.7 per cent in the previous year (Table 4.1). In 1996, GDP grew 9.7 per cent and the national retail price index rose only 6.1 per cent.

The experience of 1994 to 1996 demonstrates that the monetary authorities can effectively control inflation by combining new indirect monetary instruments and existing quantitative controls. Recent inflation has been caused by structural problems in SOEs, agriculture and the provision of infrastructure such as

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¹⁶ For example, in 1995 production of finished steel decreased partly as a result of the implementation of the 'Three No Principles' approach (Zhang et al, 1996).

transportation and electricity. (See Chapters 10 - State-Owned Enterprises, 9 - Agriculture and 7 - Infrastructure.) The PBOC increasingly recognises that the forced control of bank credit will not solve these structural problems, which are likely to re-emerge once credit limits are relaxed, unless credit is allocated more efficiently, on the basis of market criteria. Consequently, it is steadily introducing the more market-based indirect control mechanisms, including freeing up the interbank market, raising interest rates closer to market levels, and selling government bonds through open market operations. The resulting macroeconomic management is very effective, reinforcing the direction of future reforms.

Outlook and Future Reforms

Macroeconomic management has changed dramatically since the reform of the taxation system began in the early 1980s. The declining proportion of GDP collected as central government fiscal revenue has caused a shift in financial power within government structures from the centre to lower levels of government and from the government budget to the financial system generally, and the state banks particularly. Confronted with these changes, the Government made the major strategic decision at the Plenum of the Central Committee of the Party in November 1993 to reorientate its role in macroeconomic management with greater use of indirect monetary instruments. The decision provided a basic framework for macroeconomic management encompassing the financial system, consisting of central, commercial and policy banks and capital markets, and a range of indirect monetary policy instruments. The decision also emphasised the importance of balancing aggregate demand and supply, and committed the Government to controlling inflation.

Since then, the Government has made a concerted effort to reform the financial system so that it can manage the increasingly market-oriented economy with indirect macroeconomic management instruments. More importantly, a consistent tight monetary policy has contained the aggregate money supply and hence inflation, producing the soft landing of 1996.

Despite these real achievements, lack of progress in SOE reforms constrains reform of the financial system. The state banks cannot operate on a fully commercial basis until they are released of obligations to finance loss-making SOEs. Until SOEs are accountable for their losses and banks are fully commercial entities, the monetary authorities have to retain some quantitative credit controls to achieve monetary targets. They have also had problems reducing money supply growth due to the rapid inflow of foreign exchange as a result of inflexibility in the exchange rate. It will therefore be necessary to speed up SOE reform, strengthen indirect macroeconomic control mechanisms and enable the exchange rate to move more in line with foreign exchange demand and supply.

The central Government is concerned about the continuous decline in its share of GDP revenue and its reduced ability to finance necessary public expenditure. Reforms to the taxation system since 1994 should eventually help it to strengthen its fiscal position, but it is also the case that lower levels of government will almost certainly develop a relatively more important role in public financing in China. In the medium to long term, effective fiscal policy based on the improved fiscal capacity at all levels of government would relieve the banking system of many of

its current fiscal responsibilities, and provide a more appropriate balance between fiscal and monetary policy in overall macroeconomic management. This would enable the banking system to become more commercialised and allow the Government to remove controls on interest rates.

Given the increasing internationalisation of the economy, with international trade and investment now contributing significantly to growth, the domestic economy cannot be insulated from the international economic system. (See Chapters 5 - International Trade and 6 - Foreign Investment.) This is another important reason for further reform and liberalisation of the domestic financial system and the development of a full range of modern macroeconomic management tools.

However, despite the many remaining challenges, the rapid development of monetary policy tools and their successful use in 1994 to 1996 to reduce inflation without a major drop in output, engenders confidence in China's present and future macroeconomic management capacity. Future planned reforms should only strengthen the monetary authorities to achieve macroeconomic stability. However, their task will be made considerably easier if necessary reforms in SOEs and the banking and taxation systems are introduced in the short to medium term.

Appendix 4.1

ACHIEVING THE 'SOFT LANDING' IN 1995-96

Monetary authorities used the following measures to tighten monetary policy in 1995:

- it informed financial institutions of the credit plan at the beginning of the year, issuing credit quota controls for the loans of the policy banks, commercial banks, rural credit cooperatives and finance companies, and quota guidance for the asset/liability ratios for the financial trust and investment companies and urban credit cooperatives. It also undertook quarterly monitoring of the value of loans issued by the four big state-owned commercial banks to ensure adherence to quotas and quarterly assessments of the loan performance of other commercial financial institutions;
- it employed refinancing, rediscounting, special deposits and financing papers to control the monetary base by recalling refinancing worth ¥ 54.5 billion in the first half year and insisted on the repayment of refinancing of financial institutions other than the state banks in the second half year. This was an important new direction in monetary policy, targeting monetary rather than credit aggregates and represented an important step in developing open market operations. In addition, it gathered special deposits from and issued financing papers to financial institutions worth ¥ 40.7 billion (People's Bank of China, 1996);
- it required certain foreign exchange banks to replenish their foreign exchange positions and strengthen their control of international commercial borrowings to relieve pressure on the monetary base created by the balance of payments surplus;¹⁷ and
- finally, it raised interest rates for refinancing and for financial institution loans on 1 January and 1 July 1995 (People's Bank of China, 1996).

In recent years, the PBOC has released very little credit in the first quarter of each year and then successively increased credit in the second, third and particularly the fourth quarter, when up to half of the credit can be released (People's Bank of China, 1996). While this is in line with the normal seasonal pattern of the economy, it also increases PBOC flexibility to correct the target credit growth rate in line with economic conditions as they develop throughout the year.

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¹⁷ As most foreign banks' funds were from outside of China, foreign banks have to replenish their foreign exchange position from their own external sources.

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INTERNATIONAL TRADE

China's rapid emergence as a great trading nation and high level of export growth has been a major source of its economic success. As a result of economic reforms, the economy is considerably more open to domestic and international competition and increasingly, trade is conducted on the basis of China's comparative advantage. The ratio of two-way trade to GDP is now 36 per cent, up from 10 per cent in 1978. China's strong labour intensive export performance indicates the success of these policies. The structure and direction of China's trade is changing rapidly as its economy grows and becomes more market oriented. Exchange rate reform is crucial to China's trade success and now is almost completed for trade transactions. This chapter will analyse the structural changes that are occurring and the factors driving them, in order to predict likely future developments in trade reforms and trading patterns.

While the trade regime is significantly more liberal, particularly for exporters, it still lacks transparency, is inefficient and is complex due to the many remaining trade controls. Some sectors remain highly protected, with trade barriers denying foreign products access to compete in the domestic market and slowing necessary structural adjustment within the economy. Negotiations over these issues have lengthened the process of China's accession to the World Trade Organisation (WTO). However, analysis done for this report indicates that continued trade liberalisation and WTO membership would greatly benefit the Chinese economy, and would also produce more modest gains for the international economy.

Australia-China bilateral trade has grown twice as rapidly as Australia's average trade growth in the past decade. Australia has maintained about double the share of China's market that could be expected, given the match of our worldwide exports and China's imports. Australia's crude share of China's imports has declined mainly as a result of the changing commodity composition of China's imports, away from primary commodities and towards capital goods and components used in the burgeoning contract trade.

EVOLUTION OF THE TRADE REGIME

Four major reforms have enabled the dramatic growth in China's trade (Lardy, 1996b, p. 226):

- decentralising powers to many thousands of enterprises and foreign trade corporations to undertake foreign trade
- undertaking widespread price reforms
- abandoning the overvalued exchange rate
- liberalising the foreign investment regime.

Decentralisation of the Trade Regime

Reforms to the trade regime have evolved iteratively over the past decade and a half, responding to prevailing political constraints. While many barriers remain, by 1996, trade reform had produced the following important outcomes.

- The foreign trade plan has been abolished. At the start of reform, it governed 3 000 commodities.
- Import and export approval procedures for controlled commodities are substantially decentralised and simplified.
- Trading rights are extended widely, although restrictions still remain. Under central planning, almost all trade was carried out by 12 giant foreign trade corporations. These corporations acted as an 'airlock' between domestic and international prices (Lardy, 1992, p. 140). While the State continues to selectively extend trading rights, by 1996 they had been granted to over 5 000 foreign trade corporations and over 200 000 enterprises, mainly foreign and large domestic firms (Ministry of Foreign Trade and Economic Cooperation, 1996a). In 1996 SOE trade monopolies applied to 4.6 per cent of China's exports and 19.4 per cent of imports in 1995.¹ (See Table 5.5.)
- Export subsidies and mandatory export planning were abolished between 1991 and 1993, although operating subsidies for SOEs still prevail.
- Tariffs and exchange rates are now more important methods of trade management. However, many non-transparent systems of licences and controls are still in force. At the end of 1995, the Chinese Government announced a significant trade liberalisation package, reducing the weighted average tariff rate from 26.9 to 19.4 per cent, with the objective of reaching 15 per cent by 2000. Although this level remains high by international standards, the rate of reduction indicates a renewed commitment to reform. Import licensing has been reduced substantially, but still affects 25 per cent of all imports.

Foreign Exchange Reform

Reforms to the foreign exchange regime have been extensive, to the point where in December 1996, the renminbi became a convertible currency for international trade transactions and China accepted the obligations of Article VIII, sections 2, 3 and 4 of the *Articles of Agreement of the International Monetary Fund*. These foreign exchange reforms evolved through three distinct stages (Wu, 1995).

Firstly, between 1979 and 1986, a foreign exchange retention system was introduced, permitting exporting enterprises to 'retain' (for approved uses) a portion of the foreign exchange they earned. Firms in special economic zones could retain 100 per cent of earnings, but the share varied by enterprise location and sector.

Secondly, between 1987 and 1993, a dual exchange rate system was formally introduced. Swap centres for foreign exchange were established across the country,

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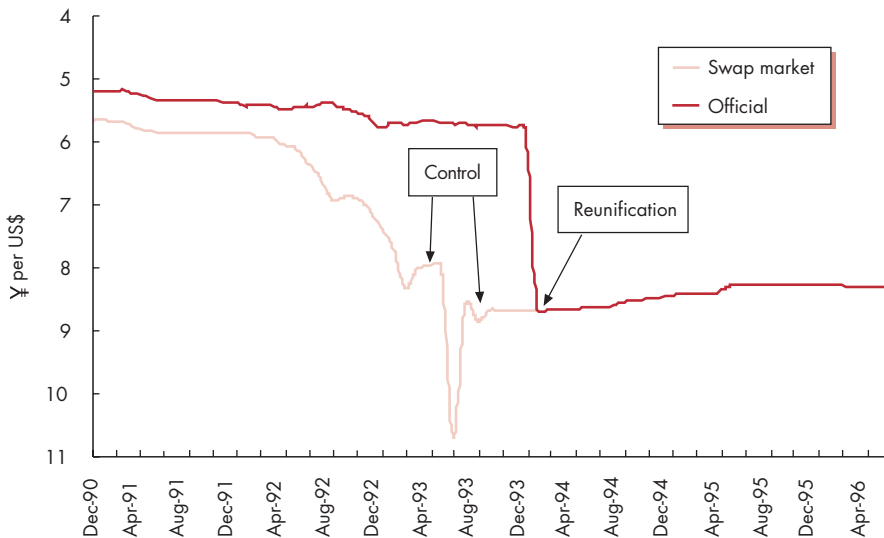
¹ Calculated by Statistical Services Section, Department of Foreign Affairs and Trade, January 1997.

allowing FFEs and some domestic firms to trade directly in foreign exchange at lower, more market-determined rates. By 1993, 80 per cent of foreign exchange transactions occurred at the swap rate (Lu, 1995, p. 11).

Thirdly, in early 1994, the former official and swap market rates were unified at the prevailing swap market rate, representing a 33 per cent devaluation of the official exchange rate. This has subsequently emerged as a reasonably stable equilibrium rate. However, the 'floating' exchange rate is heavily managed so that effectively, it is still a fixed exchange rate, albeit one somewhat responsive to market pressure. Given the significant build-up in reserves (approximately US\$105 billion by late 1996), a truly floating rate would have appreciated significantly.

Figure 5.1

Unification Stabilises the Currency Yuan–US Dollar Exchange Rate, December 1990 to June 1996



Note: The exchange rate axis has been inverted so that a drop in the graph line represents a depreciation of the yuan.

Source: Wu, 1995; International Monetary Fund, 1996a.

Since July 1996, foreign funded enterprises have bought and sold foreign exchange in banks, as Chinese enterprises have done since April 1994. On 1 December 1996, the central Government announced that Chinese currency was fully convertible for all transactions on the current account. (See Chapter 4 - Macroeconomic Management.)

A range of controls still apply to the currency transactions associated with capital movements, and the goal of full convertibility of the currency for capital account transactions remains several years away.

CHINA'S DUAL TRADE REGIME

In many ways China operates a dual economy consisting of:

- a highly efficient, internationally competitive, export-oriented largely non-state and foreign funded enterprise sector and
- a much less efficient, protected, domestically-oriented, mainly state-owned sector (Naughton, 1996).

The export sector has grown rapidly in response to trade decentralisation and exchange rate and price reforms but, given the continued presence of highly protective barriers, it has required special measures to overcome the inherent anti-export bias in the trade regime.

Successful Export Facilitation Regime

Due to extensive exemptions to the published tariff rates and an efficiently operated duty drawback scheme, available to all exporters who use imported inputs, exporters thrive despite China's high protection environment. For example, in 1993, tariff revenue constituted only 5 per cent of China's total tax revenue, compared with 55 per cent in India, although the two countries had similar average published tariff rates (World Bank, 1994).

Export processing contracts using imported materials successfully facilitate exports. These contracts usually involve trading companies or foreign-owned enterprises importing semi-finished goods and materials, processing them locally, then exporting them. Processing trade represented 50 per cent of China's exports in 1995, but also accounted for 44 per cent of imports in that year (Table 5.1).

All FFEs can engage directly in importing and exporting. Until April 1996, they were also given tariff-free entry for investment goods, and before 1995, concessionary corporate income tax rates as well as preferential access to foreign exchange. In return, they had to export agreed percentages of their output. This strategy has not yet generated positive net exports. By 1996, FFEs were responsible for 41 per cent of China's total export value, but also for 52 per cent of imports. (See Table 6.1 and Chapter 6 - Foreign Investment). However, as a high proportion of 1996 imports were probably investment goods imported before the duty exemption was withdrawn, FFE net trade contribution should improve significantly in 1997.

Table 5.1

Growing Importance of China's Processing Trade

Trade by Regime and Enterprise Type, 1995

| | Total | Others | Foreign funded enterprises | Others' share | Foreign funded enterprises' share |
|---------------------------|--------------|--------------|----------------------------|---------------|-----------------------------------|
| | US\$ billion | US\$ billion | US\$ billion | Per cent | Per cent |
| Exports | | | | | |
| Total | 148.8 | 101.9 | 46.9 | 68.5 | 31.5 |
| Ordinary trade | 71.4 | 67.0 | 4.4 | 93.9 | 6.1 |
| Processing and assembly | 20.7 | 17.8 | 2.9 | 86.1 | 13.9 |
| Processing | 53.0 | 13.8 | 39.2 | 26.1 | 73.9 |
| Imports | | | | | |
| Total | 32.1 | 69.2 | 62.9 | 52.3 | 47.7 |
| Ordinary trade | 43.4 | 38.1 | 5.3 | 87.8 | 12.2 |
| Processing and assembly | 16.2 | 13.5 | 2.7 | 83.6 | 16.4 |
| Processing | 42.1 | 7.7 | 34.4 | 18.4 | 81.6 |
| Imported investment goods | 18.7 | 0.0 | 18.7 | 0.0 | 100.0 |

Note: Others include SOEs and TVEs. See also Table 6.1 for additional information on the trade of foreign funded enterprises.

Source: Calculated from Naughton (1996, Table 4).

By contrast, domestic non-state and state enterprises enjoy fewer export incentives (Naughton, 1996, p. 12), although the Government's recent initiatives on tax, exchange rate unification and termination of duty-free imports of capital goods have reduced their disadvantage compared with FFEs. The main disability still faced by smaller domestic enterprises is their lack of rights to trade on their own account. However, many domestic enterprises have obtained access to export incentives by forming joint ventures with foreign partners, by locating plants in special economic zones and investing funds in China via Hong Kong, disguising it as foreign investment.

Trade which is not based on processing-type activities, known by the Chinese as ordinary trade, represents a relatively small share of total trade. Many Australian exports of bulk commodities are part of this ordinary trade, and a proportion is sold directly to foreign trade corporations run by the central Government.

Restrictive Formal Import Regime

On the basis of published tariff schedules and regulations, China's import regime for other than exporting enterprises appears quite restrictive, with a range of relatively high tariff and non-tariff barriers. However, the Government has recently demonstrated a commitment to liberalising the import regime. Furthermore, due to tariff exemptions, the inconsistent application of tariffs,

smuggling, customs corruption and widespread tariff evasion, actual protection is much lower than indicated by published rates (Zhang Xiao Ji, 1996).

Tariffs

Although they have fallen quite rapidly in the past few years, China's published tariff rates are still high by international standards (Table 5.2).

Table 5.2

China is Still a High Protection Economy China's Tariffs^a in Regional Context, 1988 and 1995

| Sectors | Agricultural ^b | | Industrial ^b | | Total ^b | |
|------------------------|---------------------------|---------------------|-------------------------|---------------------|--------------------|---------------------|
| | 1988 ^c | 1995/6 ^d | 1988 ^c | 1995/6 ^d | 1988 ^c | 1995/6 ^d |
| Australia | 7.3 | 2.6 | 19.3 | 5.0 | 18.1 | 5.0 |
| China | 64.6 | 16.9 | 33.5 | 19.6 | 35.3 | 19.4 |
| Canada | 6.3 | 12.3 | 7.6 | 6.8 | 7.5 | 6.9 |
| Chile ^e | 15.0 | 11.0 | 14.0 | 10.6 | 14.3 | 10.7 |
| Hong Kong | 0 | 0 | 0 | 0 | 0 | 0 |
| Indonesia ^f | 60.6 | 6.9 | 18.6 | 12.2 | 22.8 | 11.7 |
| Japan | 18.0 | 8.6 | 3.3 | 2.2 | 5.3 | 3.0 |
| Republic of Korea | 53.6 | 5.7 | 16.7 | 6.3 | 50.5 | 6.2 |
| Malaysia | 15.6 | 1.8 | 9.7 | 4.9 | 10.3 | 4.8 |
| Mexico | 77.3 | 49.0 | 46.1 | 9.3 | 52.3 | 17.0 |
| New Zealand | 15.2 | 5.2 | 23.9 | 5.3 | 19.9 | 5.3 |
| Philippines | 37.1 | 19.8 | 22.0 | 14.0 | 23.3 | 14.5 |
| Singapore | 1.9 | 0 | 1.9 | 0.2 | 1.9 | 0.2 |
| Taiwan | na | 18.7 | na | 5.8 | na | 6.7 |
| Thailand | 51.7 | 18.1 | 33.9 | 15.8 | 34.8 | 15.9 |
| USA | 6.0 | 1.9 | 4.6 | 4.1 | 4.7 | 3.9 |

Note: ^a Tariffs are expressed on a trade-weighted, average applied basis. Calculations do not include specific rates.

^b Does not include specific rates as ad valorem equivalent rates not available. Averages could therefore be higher than figures shown.

^c 1988 calculations based on pre-Uruguay Round base rates and best available import data (that is mostly 1988).

^d 1996 tariffs for Australia, China, Hong Kong, Republic of Korea, Malaysia and Taiwan. Australian calculations based on 1 July 1996 tariff rates and 1995 imports.

^e 1993 average for Chile. Tariffs in Chile have not changed.

^f Includes import surcharge.

Source: Department of Foreign Affairs and Trade Tariffs Database, 1997; GATT Secretariat, 1994; PECC, 1995.

Significant tariff reductions have occurred since 1992 when the average trade-weighted tariff rate was 32 per cent (World Bank, 1994, p. 48). In April 1996, China reduced import tariffs on more than 4 900 (of a total of 6 000) product categories by approximately one third to achieve an trade-weighted tariff of

19.4 per cent (Table 5.3). Furthermore, China has announced plans to reduce its unweighted average tariff rate to 15 per cent by 2000 (Ministry of Foreign Trade and Economic Cooperation, 1996b, p. 2).

Apart from the 50 per cent of China's imports that are imported duty-free for export-based processing, tariffs are often evaded or inconsistently applied, as local customs authorities have the flexibility to apply tariffs other than the published official rates (United States Trade Representative, 1996b, p. 4). As a result, the ratio of tariff revenues collected to total import value fell from 9.7 per cent in 1986 to only 4.0 per cent in 1994 (Naughton, 1996).

Table 5.3

Tariffs Remain High on Many Major Products

Tariffs on Major Products^a, 1996

| | China's global tariff rate (trade weighted) | Rate applying to imports from Australia (trade weighted) |
|---------------------------------|--|--|
| | Per cent | Per cent |
| Agriculture | 18.9 | 15.9 |
| Cereals | 0.2 | 1.8 |
| Wool | 19.6 | 15.1 |
| Sugar | 29.5 | 30.0 |
| Non-agricultural products | 19.5 | 8.4 |
| Textiles, clothing and footwear | 30.1 | 15.0 |
| Iron and steel products | 11.8 | 8.9 |
| Chemicals | 14.7 | 19.5 |
| Non-Ferrous metals | 8.5 | 9.8 |
| Automobiles | 67.7 | 48.3 |

Note: ^a This list of tariffs includes major industrial tariffs and products of interest to Australia. Tariffs are expressed on an applied basis. Global tariffs indicate the most favoured nation rate.

Source: Department of Foreign Affairs and Trade Tariff Database, 1997.

Non-Tariff Barriers

The proportion of trade by value that was subject to import or export licensing fell from 43.5 per cent in 1992 to 25.3 per cent in 1995 (Ministry of Foreign Trade and Economic Cooperation, 1996a). (See Table 5.4.) This is much higher than the corresponding figures for Indonesia (7.3 per cent) and Malaysia (5.1 per cent), (PECC, 1995, pp. 222–24). Protection varies widely across sectors but generally favours 'core' sectors which are dominated by SOEs.

Table 5.4

Uneven Protection Favours 'Core' Industries
Proportion of Merchandise Trade Subject to Non-Tariff Barriers, 1993

| Product | Proportion | Product | Proportion |
|---------------------------|------------|--------------------------------|------------|
| | Per cent | | Per cent |
| Agriculture and livestock | 16.55 | Printing | 0.00 |
| Forestry | 7.14 | Industrial chemicals | 11.70 |
| Logging | 93.75 | Other chemicals | 6.71 |
| Fishing | 2.70 | Petroleum refining | 31.03 |
| Coal mining | 100.00 | Misc. petroleum products | 26.67 |
| Crude petroleum and gas | 33.33 | Rubber | 10.45 |
| Metal ore mining | 28.00 | Plastic | 0.00 |
| Other mining | 1.10 | Pottery | 0.00 |
| Food manufacturing | 20.14 | Glass | 0.00 |
| Misc. food processing | 19.70 | Non-Metallic minerals | 5.32 |
| Beverages | 12.00 | Iron and steel | 87.14 |
| Tobacco | 50.00 | Non-Ferrous metals | 44.32 |
| Textiles | 41.40 | Metal manufactures | 18.88 |
| Apparel | 10.92 | Non-Electrical machinery | 14.57 |
| Leather products | 63.16 | Electrical machinery | 14.60 |
| Footwear | 0.00 | Transport equipment | 41.45 |
| Wood and wood products | 34.57 | Scientific and opt instruments | 12.50 |
| Furniture | 0.00 | Other manufacturing | 8.33 |
| Paper | 50.00 | | |

Note: Core non-tariff barriers include import licences and inspection. 1993 data are the latest available.

Source: PECC (1995, Table A.4, p. 226).

Another concern is the system of statutory testing and inspection of imports, which adds to the cost of exporting to China. For instance, the Government requires foreign pesticide producers to submit to costly testing and registration procedures, but it does not apply these requirements to domestic producers (United States Trade Representative, 1996b, p. 5). Discriminatory government procurement practices that favour local over foreign products are also a barrier to trade. Tendering processes can be non-transparent and inconsistent, and a very large proportion of projects (including projects under US\$100 000 in value) are not offered for public tender (United States Trade Representative, 1996b, p. 6).

Foreign funded firms typically have the right to import only materials for their own production; only authorised foreign trade corporations can import and export other commodities. Until recently, importation for distribution was reserved for domestic firms, but in 1996, the Government relaxed this restriction and foreign

firms which meet certain criteria will be allowed to form joint venture foreign trade corporations.

China's market for services is particularly restricted, and a substantial segment of the market remains closed to foreigners. Foreign firms are only very gradually being granted licences on a case-by-case basis in markets such as banking and legal services. The process of obtaining a licence requires firms to first establish a representative office, sometimes for several years, to demonstrate the firm's commitment to the China market. In the insurance industry, for instance, China has approved over 119 representative offices, but only three foreign insurance companies have obtained licences to sell insurance to date (United States Trade Representative, 1996b). While by the end of 1995, a total of 137 foreign bank branches and 519 offices had been approved, only a few in Shanghai's Pudong have been given permission to undertake yuan business, on an experimental basis (United States Trade Representative, 1996b). The Government's stated concern has been to give local state-owned banks and insurance companies time to improve their competitiveness before subjecting them to foreign competition, rather than to permanently protect them.

Canalisation

While formal trade planning has been abolished, a number of central foreign trade corporations and large SOEs have been given selective monopoly powers to import and export strategic commodities (Bach et al, 1996, p. 410). This process has been termed 'canalisation' by the World Bank (1994).

By 1996, canalisation applied to approximately 4.6 per cent of China's exports and 19.4 per cent of imports in 1995² (Table 5.5).

Table 5.5

Still Some Monopoly Trading Commodities Subject to Canalisation

| Imports ^a | Exports ^b |
|---|---|
| <i>Primary Products</i> | |
| Cereals, tobacco, logs and plywoods, wool, cotton, rubber, petroleum, sugar, vegetable oils, crude oil, refined oil | Crude and refined oil, tea, coal, rice, silk, cotton, tobacco, maize, soybean |
| <i>Manufactures</i> | |
| Cigarettes, acrylics, iron, steel, and articles fabricated from iron and steel, chemical fertiliser | Tungsten, tungstates, antimony, selected textiles |

Sources: ^a Compiled from Dickson (1996, p. 31) and advice from the Trade Negotiations and Organisations Division, Department of Foreign Affairs and Trade.

^b Information on exports subject to canalisation was compiled from the Ministry of Foreign Trade and Economic Cooperation, MOFTEC Gazette by Ian Dickson (1997) and advice from the Trade Negotiations and Organisations Division, Department of Foreign Affairs and Trade.

² Calculated by Statistical Services Section, Department of Foreign Affairs and Trade, January 1997.

CHINA'S CHANGING TRADE STRUCTURE

Export Structure

Like most East Asian economies early in their industrialisation process, China depends heavily on labour intensive exports (Figure 5.2). Labour intensive manufactures like clothing, textiles, miscellaneous manufactures, electronics, telecommunications equipment and footwear represented 55 per cent of total exports in 1995 (Table 5.6).

Table 5.6

Light Industry Exports Booming China's Top Ten Merchandise Exports (in US\$ billion)

| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|------|------|------|------|------|------|------|-------|-------|
| Clothing | 5.3 | 6.6 | 8.1 | 9.7 | 12.8 | 16.7 | 18.4 | 23.7 | 24.0 |
| Textiles | 5.9 | 6.6 | 7.2 | 7.2 | 7.9 | 8.6 | 8.7 | 11.8 | 13.9 |
| Miscellaneous manufactured articles | 1.9 | 2.5 | 3.2 | 3.8 | 4.6 | 7.9 | 8.8 | 11.9 | 13.8 |
| Of which: Toys, sporting goods, etc* | 0.9 | 1.2 | 1.6 | 2.0 | 2.4 | 3.5 | 4.0 | 5.1 | 5.9 |
| Electrical appliances and parts | 0.3 | 0.6 | 0.8 | 1.2 | 1.7 | 3.3 | 4.0 | 5.9 | 8.9 |
| Telecommunications and sound recording equipment | 1.0 | 1.4 | 1.9 | 2.6 | 3.0 | 3.9 | 4.5 | 6.7 | 8.4 |
| Footwear | 0.5 | 0.8 | 1.3 | 2.0 | 2.3 | 4.2 | 5.3 | 6.0 | 6.7 |
| Iron and steel | 0.4 | 1.0 | 0.7 | 1.3 | 1.6 | 1.3 | 1.1 | 1.6 | 5.2 |
| Office machines and automatic data processing machines | 0.1 | 0.2 | 0.3 | 0.4 | 0.5 | 1.1 | 1.6 | 2.7 | 4.8 |
| Manufactures of metals | 0.9 | 1.0 | 1.2 | 1.5 | 1.7 | 2.4 | 2.7 | 3.6 | 4.7 |
| Non-metallic mineral manufactures | 0.4 | 0.6 | 0.8 | 1.3 | 1.7 | 1.7 | 1.6 | 2.5 | 3.4 |
| Total exports | 39.4 | 47.5 | 52.5 | 62.1 | 71.8 | 84.9 | 91.7 | 121.0 | 148.8 |

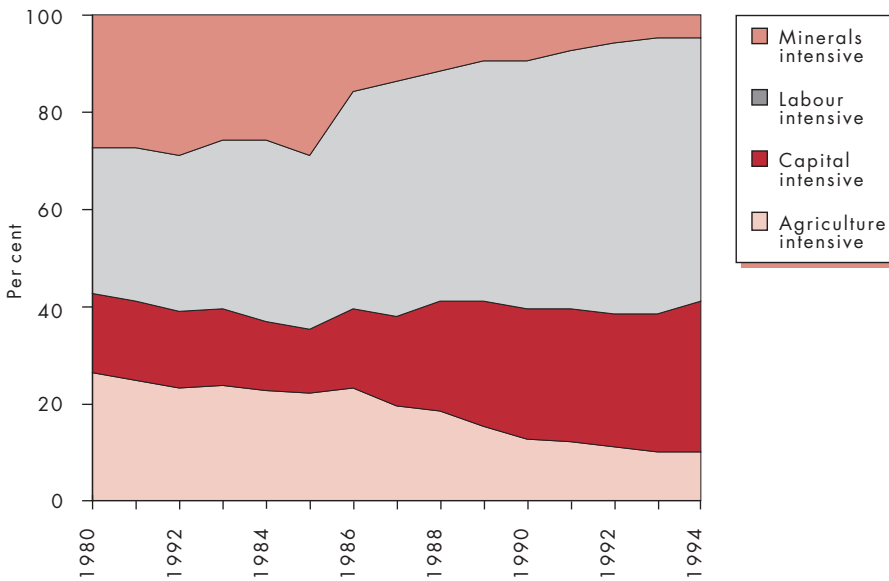
Note: Data provided reflect commodity categories aggregated to the Standard International Trade Classification Level 2. The category marked * is disaggregated to Level 3.

Source: United Nations Statistical Analysis and Reporting System (STARS) Database, 1996.

While most processing and assembly activity is labour intensive, products such as radio receivers, telecommunications equipment, heaters and white goods now account for approximately 75 per cent of exports of electrical equipment, indicating the export structure is moving to more sophisticated products requiring more skilled labour (World Bank, 1994, p. 161).

Figure 5.2

Labour Intensive Exports Dominate **Composition of China's Exports by Factor Intensity of Production**



Source: International Economic Databank, Australian National University, Canberra, 1996; Findlay and Watson (1996, p. 6).

Although labour intensive exports' share of total exports has grown at a phenomenal pace during the reform period, this trend appears to have peaked in recent years (Figure 5.2). Nevertheless, in absolute terms these exports will grow strongly for several decades as foreign and domestic investment moves further inland where labour is cheaper than on the coast, allowing exporters to retain competitiveness in labour intensive products.

Agriculture and mineral-intensive exports, which before reform had a major share of exports, are now relatively unimportant. China has little comparative advantage in minerals and will have less so in future, as its own domestic needs will exceed its output of most resources, except possibly coal. Agricultural products that are also labour intensive, such as processed fruit and vegetables, are an area where China is increasingly competitive (Table 5.8 and Chapter 9 - Agriculture).

Import Structure

The capital goods, components and raw materials required by export processors figure prominently in imports (Table 5.7).

Table 5.7

Raw Materials and Capital Goods in Strong Demand

China's Top Ten Merchandise Imports (in US\$ billion)

| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|--|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| Specialised industrial machinery | 4.9 | 5.2 | 6.5 | 5.9 | 7.2 | 8.3 | 13.1 | 12.7 | 13.2 |
| Textiles | 3.6 | 4.2 | 4.6 | 5.3 | 3.7 | 7.6 | 7.6 | 9.3 | 10.9 |
| Electrical appliances and parts | 1.6 | 2.3 | 2.4 | 2.1 | 2.6 | 4.9 | 6.0 | 7.8 | 9.9 |
| Telecommunications and sound equipment | 2.0 | 2.3 | 2.4 | 2.5 | 2.8 | 3.4 | 5.5 | 6.8 | 7.6 |
| Industrial machinery and parts | 1.7 | 2.1 | 2.4 | 1.7 | 2.0 | 3.0 | 4.7 | 6.2 | 7.1 |
| Iron and steel | 4.8 | 4.6 | 5.8 | 2.8 | 2.7 | 4.4 | 12.7 | 9.4 | 6.9 |
| Unprocessed plastics | 1.3 | 3.3 | 2.0 | 1.3 | 2.2 | 3.6 | 3.5 | 4.5 | 6.1 |
| Petroleum and products | 0.4 | 0.6 | 1.5 | 1.0 | 1.8 | 3.2 | 5.4 | 3.6 | 4.6 |
| Textile fibres (excl. wool tops) | 1.2 | 2.2 | 2.6 | 2.0 | 2.4 | 2.2 | 1.5 | 3.0 | 4.1 |
| Fertilisers | 1.4 | 2.3 | 2.4 | 2.6 | 3.2 | 3.0 | 1.5 | 1.9 | 3.7 |
| Total imports | 43.2 | 55.3 | 59.1 | 53.3 | 63.8 | 80.0 | 104.0 | 115.6 | 132.1 |

Note: Commodities have been ranked on the basis of their relative importance in 1995. Data provided reflect commodity categories aggregated to the Standard International Trade Classification Level 2.

Source: United Nations Statistical Analysis and Reporting System (STARS) Database, 1996.

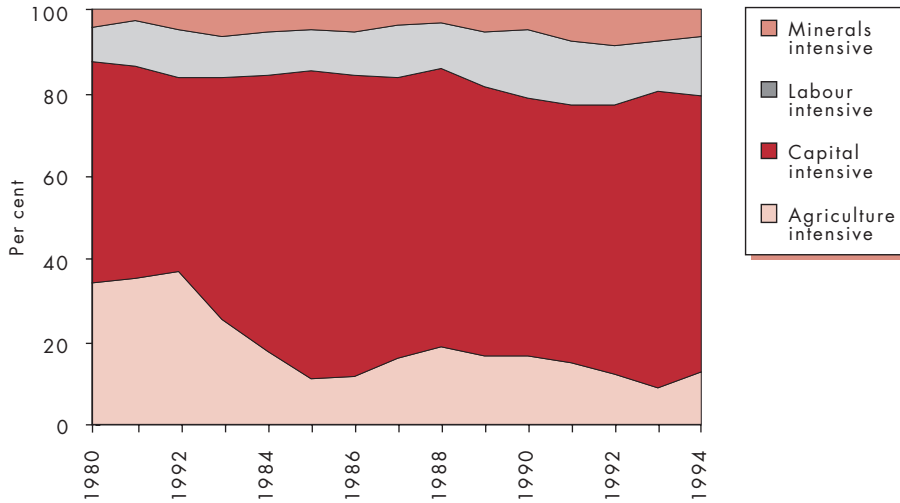
The share of total imports accounted for by capital-intensive imports has remained high since the spur to industrialisation during the early reform period. On the other hand, agricultural imports' share has dropped as reforms in agriculture have reduced dependence on imported food and agricultural raw materials (Figure 5.3). However, this share is now rising again, and should continue as the pace of industrial growth strains China's capacity to supply bulk agricultural commodities, particularly as these provide farmers with lower profits than higher value added agricultural products. (See Chapter 9 - Agriculture). Shortages of non-coal energy and other minerals will also increase this component of imports in the future as industrialisation deepens.

Services Trade

Despite the obstacles to foreign participation in China's domestic services market, services trade has grown strongly in the 1990s both in absolute terms and as a share of the total two-way trade in goods and services (Figure 5.4).

Figure 5.3

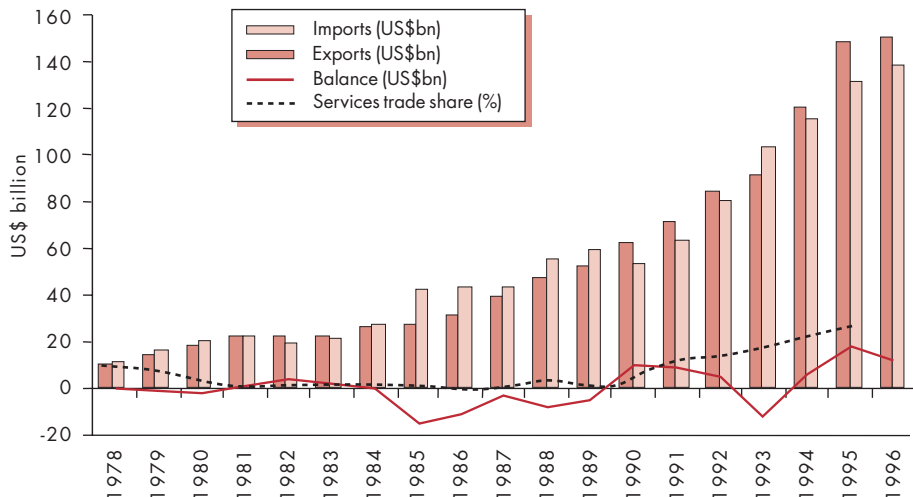
China's Growing Demand for Capital-Intensive Goods Composition of China's Imports by Factor Intensity of Production



Source: International Economic Databank, Australian National University, Canberra, 1996; Findlay and Watson (1996, p. 7).

Figure 5.4

Steady Growth in Services Trade Services Trade 1983 to 1995



Note: Services trade share represents trade in services as a proportion of total (goods and services) trade.

Source: International Monetary Fund, 1995b and 1991.

Transport services for passengers and freight together represented over 50 per cent of service imports in 1995. However, in recent years, non-transport services have been the most dynamic component. Insurance and other business services are growing quickly, with 1995 levels of imports of these services more than double the levels of 1994.

CHINA'S TRADE COMPARED WITH ITS COMPARATIVE ADVANTAGE, 1987 TO 1995

As China becomes more market-oriented and open, decentralised and financially independent firms increasingly undertake foreign trade, responding to price signals in domestic and international markets. Consequently, China's exports should increasingly match its areas of greatest comparative advantage. This was tested (Zhang, 1996) by comparing different exports' domestic resource productivity, DRP, (the amount of foreign exchange earned for a yuan of domestic resources employed) with their net export performance ratio, NEPR, (the contribution of a country's net exports of a commodity to total world exports of that commodity, compared with the country's contribution to world trade). This analysis helps indicate whether China is mainly exporting goods it can produce cheaply, that is, whether its trade has moved in line with its comparative advantage, from 1987 to 1995 (Table 5.8). The main conclusions were:

- In an increasingly open and free trade environment, commodity patterns of trade have closely correlated with China's underlying international comparative advantage and this correlation has improved over the reform period.³
- In almost all industries, over the last 10 years, China has become a more intensive net exporter of commodities in which it is most cost competitive. Processed food is a good example of this phenomenon; its cost competitiveness (DRP) jumped four places to second place in the ranking of all commodities, and its net export ranking jumped five places to third place in the net export rankings (NEPR).
- China is most cost competitive in the export of coal, processed food, animal husbandry products, textiles and clothing, building materials, wood and crops (columns 1 and 2, Table 5.8).
- While significant changes occurred in the cost competitiveness of industries from 1987 to 1995, China still maintains its strong comparative advantage in many labour intensive manufacturing activities and will do so in the foreseeable future.
- In general, China does not have a strong comparative advantage (is not cost competitive) in capital-intensive industries (last six rows of Table 5.8). However, its competitiveness in some sectors, such as machinery and chemicals is improving which may explain the slight

³ The correlation coefficient between the net export performance ratio and domestic resource productivity increased from 0.67 in 1987 to 0.72 in 1992.

increase in the share of capital-intensive manufacturing exports (Figure 5.2).

- By 1995, the DRP ranking of two agricultural product groups, crops and animal husbandry had dropped. This mainly reflects a reduction in domestic intervention and price controls in the agricultural sector and further internationalisation of the economy. This was duly reflected in a drop in the net exports (and an increase in the net imports) of these two commodities.
- Similarly, China's comparative advantage in petroleum production and refining fell, and net imports rose.
- The changes in comparative advantage trade patterns imply that in the short to medium term, China will rely more on imports of bulk agricultural products, especially food grains, and mineral products such as crude oil, metallic minerals and basic metals, but will continue to export processed food categories, coal, garments, construction materials and wood.

Table 5.8

China Trade Matches Comparative Advantage

Estimates of Domestic Resource Productivity and Net Export Performance Ratios for Major Exports and Imports, 1995

| | DRP ^a , Ratio 1995 | Ranking | Change in DRP ranking between 1987-95 | NEPR ^b , 1995 | Ranking | Change in DRP ranking between 1987-95 |
|-----------------------|----------------------------------|---------|---|-----------------------------|---------|---|
| Coal | 1.76 | 1 | 0 | 1.784 | 2 | +1 |
| Processed food | 1.47 | 2 | +4 | 0.933 | 3 | +5 |
| Animal husbandry | 1.42 | 3 | -1 | 0.727 | 5 | -3 |
| Textiles and clothing | 1.40 | 4 | -1 | 3.945 | 1 | 0 |
| Building materials | 1.36 | 5 | 0 | 0.921 | 4 | +5 |
| Wood | 1.29 | 6 | +5 | -2.926 | 14 | -3 |
| Crops | 1.16 | 7 | -3 | -0.357 | 10 | -4 |
| Paper | 1.05 | 8 | -1 | 0.652 | 6 | -1 |
| Machinery | 0.94 | 9 | +4 | -1.843 | 13 | 0 |
| Misc. manufactures | 0.83 | 10 | -1 | -0.246 | 9 | +1 |
| Chemicals | 0.67 | 11 | +3 | -1.568 | 12 | 0 |
| Refined petroleum | 0.54 | 12 | -2 | -0.187 | 8 | -1 |
| Crude petroleum | 0.46 | 13 | -5 | 0.242 | 7 | -3 |
| Metallurgy | 0.40 | 14 | -2 | -0.551 | 11 | +3 |

Note: ^a DRP means domestic resource productivity. A DRP of greater than 1.0 means that China earns more than one dollar of foreign exchange for each dollar's worth of domestic resources used in producing exports in that sector.

^b NEPR means net export performance ratio. A positive NEPR means that China is a net exporter of the particular commodity; a negative NEPR means it is a net importer.

Source: Zhang (1996).

Direction of Trade

Trade with the APEC region has grown during the reform period, particularly with Japan and North America and in recent years, Taiwan, the Republic of Korea and ASEAN (Table 5.9). Due to greater complementarity with the capital and technology-abundant economies of East Asia and North America, China's trade ties with them have dominated links with ASEAN and South Asian economies, which have economic structures more similar to China's and tend to be competitors in international markets. Australia's trade share has fallen slightly in the last decade as China's reliance on agricultural imports has declined.

Mainland China is rapidly growing as a market for manufactured goods from the Republic of Korea and Taiwan; exports from these two industrialising economies to China grew rapidly in the 1990s (Lin, 1995).

The fast growing economic links between mainland China, Hong Kong and Taiwan have accompanied and greatly assisted China's dramatic trade expansion. Hong Kong's developed infrastructure for handling international trade provides mainland producers with legal, insurance, marketing and transport services. As China's capacity to ship finished goods directly has grown in recent years with the development of modern airport and port facilities, Hong Kong's agency services have become more important in facilitating trade (Yun-Wing Sung, 1991, p. 27). Consequently, about 35 per cent of Australian exports to Hong Kong are now re-exported to mainland China (Department of Foreign Affairs and Trade, 1995, p. 14). Despite attempts to improve data on the trans-shipment of goods through Hong Kong, interpreting China's trade data has become more complicated. For example, the United States Department of Commerce Statistics estimates the US bilateral trade deficit with China in 1996 was around US\$38 billion, as exports through Hong Kong are counted as originating from China. China's statistics, which also attempt to measure the true destination of China's exports to Hong Kong, put the bilateral trade deficit at US\$25 billion (Lardy, 1996a, p. 2).

Table 5.9

Economic Partners Across the Globe

China's Trade by Selected Export Destinations and Import Sources (in Percentages)

| Partner | Share of China's exports | | | | Share of China's imports | | | | Share of total trade | | | |
|----------------------------|--------------------------|------|------|-------------|--------------------------|------|------|-------------|----------------------|------|------|-------------|
| | 1980 | 1985 | 1990 | 1995 | 1980 | 1985 | 1990 | 1995 | 1980 | 1985 | 1990 | 1995 |
| Japan | 22.2 | 22.3 | 14.6 | 19.1 | 26.5 | 35.7 | 14.2 | 22.0 | 24.4 | 30.4 | 14.4 | 20.5 |
| USA | 5.4 | 8.5 | 8.5 | 16.6 | 19.6 | 12.2 | 12.2 | 12.2 | 12.8 | 10.8 | 10.2 | 14.6 |
| Hong Kong | 24.0 | 26.2 | 43.2 | 24.2 | 2.9 | 11.2 | 27.0 | 6.5 | 13.1 | 17.0 | 35.7 | 15.9 |
| Australia | 1.2 | 0.7 | 0.7 | 1.1 | 5.4 | 2.6 | 2.5 | 2.0 | 3.4 | 1.9 | 1.6 | 1.5 |
| NIEs-3 ^a | 6.6 | 7.6 | 4.4 | 8.9 | 2.1 | 2.8 | 5.8 | 21.6 | 4.3 | 4.7 | 5.0 | 14.9 |
| ASEAN-4 ^b | 4.3 | 2.7 | 2.9 | 3.7 | 2.4 | 2.1 | 4.0 | 4.5 | 3.3 | 2.3 | 3.4 | 4.1 |
| European Union | 13.7 | 8.7 | 10.0 | 12.9 | 15.7 | 15.8 | 17.0 | 16.1 | 14.7 | 13.0 | 13.2 | 14.4 |
| Rest of World ^c | 22.5 | 23.3 | 15.7 | 13.5 | 25.3 | 17.6 | 17.3 | 15.1 | 24.0 | 19.8 | 16.4 | 14.2 |
| World Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Asia-Pacific | | | | | | | | | | | | |
| East Asia ^d | 57.1 | 58.7 | 65.2 | 56.0 | 34.0 | 51.8 | 51.0 | 54.6 | 45.1 | 54.5 | 58.6 | 55.3 |
| APEC ^e | 64.9 | 69.1 | 75.5 | 75.2 | 65.1 | 70.4 | 69.5 | 71.1 | 65.0 | 69.9 | 72.7 | 73.3 |

Note: ^a NIEs-3 comprises Singapore, Taiwan and the Republic of Korea.

^b ASEAN-4 comprises Philippines, Indonesia, Malaysia and Thailand.

^c Rest of World represents the residual of the sum of Japan, USA, Hong Kong, Australia, NIEs-3, ASEAN-4, and European Union.

^d East Asia represents the sum of Japan, Hong Kong, ASEAN-4 and NIEs-3.

^e APEC represents the eighteen member economies of the Asia-Pacific Economic Cooperation Process.

The statistics on bilateral trade are subject to a change in the reporting by China of country of destination in 1993.

After 1993, all goods for which the country of final destination could be identified were coded with that country of destination, rather than Hong Kong. This has caused some distortion to the statistics as reported above. For instance, based on US import data, the share of China's exports have risen from 19 per cent to 24 per cent; whereas, China's reported data shows much more dramatic growth—from 8.5 per cent to 16.6 per cent.

Source: International Monetary Fund, 1995c and 1987.

AUSTRALIA—CHINA BILATERAL TRADE

China's high rate of economic growth since 1978, the complementarity of the two economies and the growing economic, personal and political networks and links have led to a close trading relationship between Australia and China, which has strengthened in the 1990s (Table 5.10). In 1996, China was Australia's fifth largest trading partner after Japan, the USA, New Zealand and the Republic of Korea. China was Australia's sixth largest export market and the fifth biggest import supplier in 1995.

Table 5.10

Basic Facts of Australia-China Trade
Australia–China Trade from 1978 to 1995
(A\$ millions)

| | Merchandise trade | | | | Services trade | | | Total trade ^a |
|------|------------------------|--------------------|---------|-------|------------------------|--------------------|---------|--------------------------|
| | Exports from Australia | Imports from China | Balance | Total | Exports from Australia | Imports from China | Balance | |
| 1978 | 423 | 122 | 301 | 544 | | | | 544 |
| 1979 | 696 | 165 | 531 | 861 | | | | 861 |
| 1980 | 701 | 215 | 486 | 916 | | | | 916 |
| 1981 | 555 | 244 | 310 | 799 | | | | 799 |
| 1982 | 766 | 293 | 473 | 1 059 | | | | 1 059 |
| 1983 | 467 | 253 | 214 | 721 | | | | 721 |
| 1984 | 871 | 355 | 517 | 1 226 | | | | 1 226 |
| 1985 | 1 271 | 415 | 856 | 1 686 | | | | 1 686 |
| 1986 | 1 587 | 500 | 1 088 | 2 087 | 72 | 102 | -30 | 2 261 |
| 1987 | 1 526 | 739 | 787 | 2 265 | 78 | 111 | -33 | 2 454 |
| 1988 | 1 079 | 887 | 192 | 1 966 | 125 | 107 | 18 | 2 198 |
| 1989 | 1 193 | 1 227 | -34 | 2 420 | 202 | 142 | 60 | 2 764 |
| 1990 | 1 293 | 1 331 | -38 | 2 624 | 303 | 135 | 168 | 3 062 |
| 1991 | 1 523 | 1 727 | -204 | 3 250 | 254 | 131 | 123 | 3 635 |
| 1992 | 1 874 | 2 317 | -443 | 4 191 | 200 | 180 | 20 | 4 571 |
| 1993 | 2 297 | 2 925 | -627 | 5 222 | 268 | 324 | -56 | 5 814 |
| 1994 | 2 815 | 3 373 | -558 | 6 188 | 284 | 335 | -51 | 6 807 |
| 1995 | 3 129 | 3 861 | -733 | 6 990 | 379 | 493 | -114 | 7 862 |

Note: ^a Data before 1985 do not include services trade.

Source: Department of Foreign Affairs and Trade (1996a); Department of Foreign Affairs and Trade (1996b); State Statistical Bureau (1996).

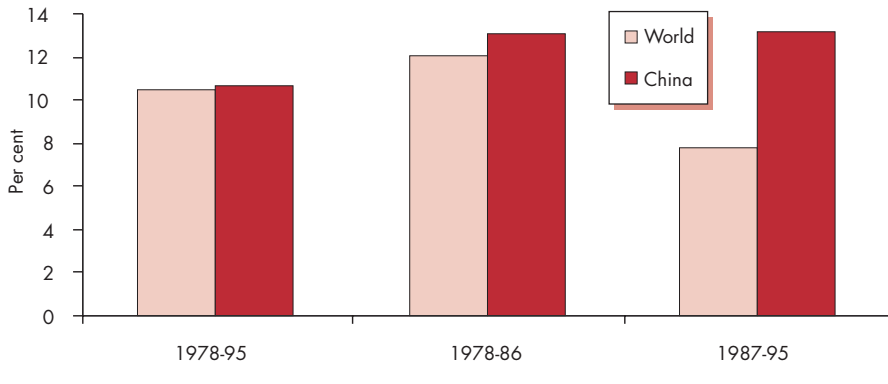
In 1995, total Australian trade with China reached A\$7.9 billion. Bilateral merchandise trade has increased at over 15 per cent per year since 1978, considerably faster than the 11 per cent growth in Australia's trade with the world. Moreover, Australia–China trade gained momentum from 1988 to 1995 when Australia's trade growth with the world was slowing (Figures 5.6 and 5.9).

Australia's Exports to China

Australia has sustained a strong export performance in China's market despite vigorous competition, due to China's rapid economic growth and reduced protection in both countries (Figure 5.5).

Figure 5.5

Exports to China Growing Strongly Australia's Exports to China and the World (Trend Growth Rates)



Source: Statistical Analysis and Reporting System (STARS) Database (1996).

Two significant trends appear in the commodity composition of Australia's exports to China. The first is that the share of primary products dropped sharply (from 73 per cent in 1978 to 52 per cent in 1995) in line with the decline of such products in China's overall imports. Secondly, consistent with the rapid increase of Australia's exports of elaborately transformed manufactures globally, the proportion of these exports to China rose from 12 per cent in 1978 to 15 per cent in 1995. The share of simply transformed manufactures also rose, from 3 per cent in 1978 to 7 per cent in 1995.

The rapid increase in manufactured exports is due to substantial microeconomic reform and structural change in the Australian economy over the past decade. While most of Australia's top ten exports were still primary commodities in 1995, most of the ten fastest growing exports were elaborately transformed manufactures (Table 5.11).

China - a Product Processing Base

The pattern of China's imports from Australia differs markedly from its imports from the rest of the world (Figure 5.6). While China's imports from the rest of the world in 1994 were mainly capital and intermediate goods, those from Australia were mainly primary products and, to a lesser extent, intermediate processed goods.

Table 5.11

Primary Commodities Dominate but ETMs Growing Rapidly Australia's Principal and Fast Growing Merchandise Exports to China

| Principal commodities in 1995 | Fast growing commodities (trend growth rate 1988–95) | | |
|--------------------------------|---|-------------------------------------|-----|
| | A\$million | Per cent | |
| Wool and animal hair | 790 | Electricity distributing equipment | 134 |
| Iron ore | 565 | Telecommunications equipment | 121 |
| Copper ores | 96 | Copper | 107 |
| Aluminium | 63 | Electrical machinery and appliances | 66 |
| Animal oils and fats | 58 | Industry-Specific machinery | 64 |
| Coal | 52 | Aircraft and associated equipment | 60 |
| Telecommunications equipment | 52 | General industrial machinery | 58 |
| Food and live animals | 51 | Flat-Rolled coated steel | 56 |
| Chemicals and related products | 50 | Textile yarn | 51 |
| Hides and skins raw | 48 | Coal | 42 |

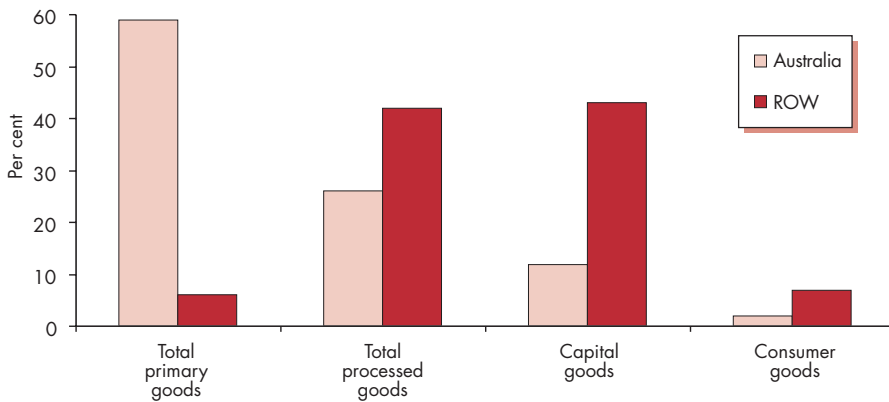
Note: ETM = elaborately transformed manufactures.

Wheat is not included in this table due to the confidentiality of the data.

Source: Statistical Analysis and Reporting System (STARS) Database (1996).

Figure 5.6

Primary Goods Dominate Australia's Exports Composition of China's Imports from Australia and the Rest of the World, 1994



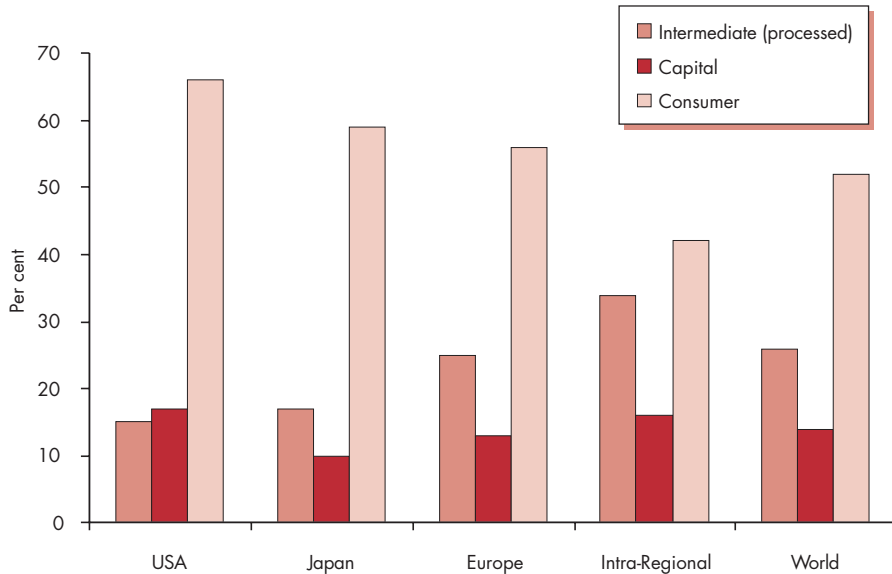
Note: ROW = Rest of the world.

Source: Statistical Analysis and Reporting System (STARS) Database (1996).

As China is a significant processing base for Australian commodities such as wool and hides and a high proportion of these final products are then exported to industrialised countries (Figure 5.7), Australia has a strong interest in ensuring that China maintains its market access to these countries.

Figure 5.7

Consumer Goods Dominate China's Exports The Pattern of China's Global Exports, 1994



Source: Statistical Analysis and Reporting System (STARS) Database (1996).

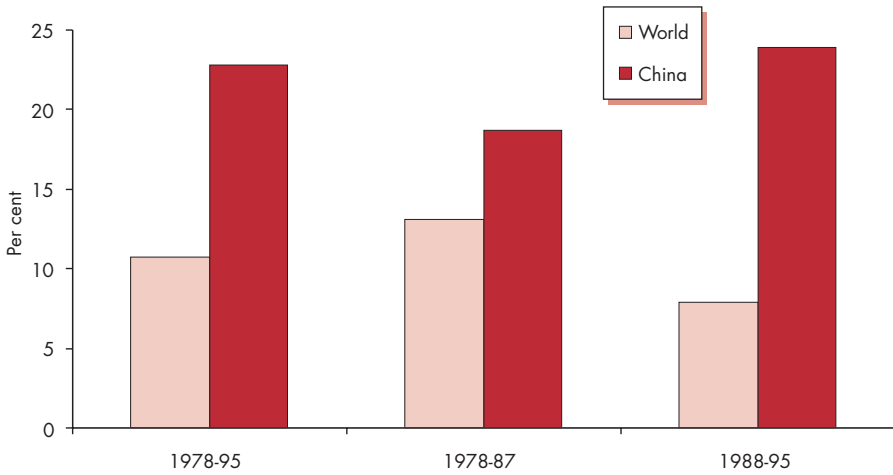
Australia's Imports from China

Australia's imports from China grew by 23 per cent per year from 1978 to 1995, well above the 11 per cent growth in global imports. Imports from China have accelerated since 1988, when Australia's imports from the world began slowing down (Figure 5.8).

The composition of Australia's imports from China has changed in the past decade because of a rapid increase in imports of manufactured goods and a fall in the significance of primary products (Figure 5.9).

Figure 5.8

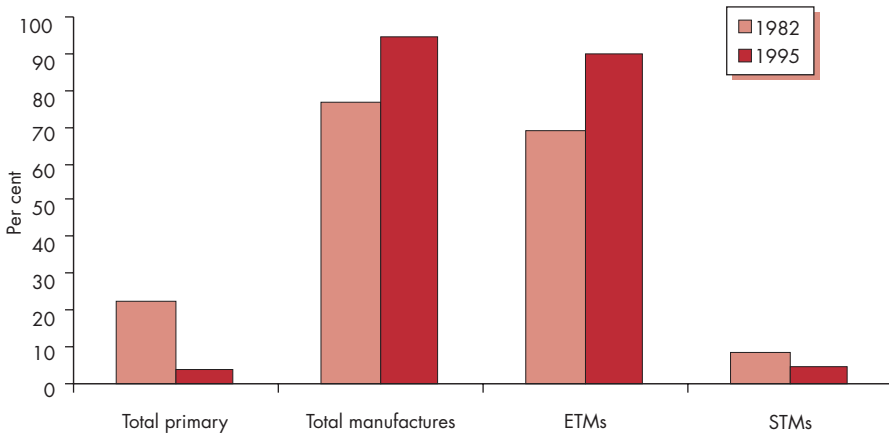
China's Exports Booming Australia's Imports from China and the World (Trend Growth Rates)



Source: Statistical Analysis and Reporting System (STARS) Database (1996).

Figure 5.9

Australia Imports Chinese Manufactures Composition of Australia's Imports from China



Source: Statistical Analysis and Reporting System (STARS) Database (1996).

Clothing, footwear, travel goods and household equipment are the major imports, together accounting for 45 per cent of Australia's total imports of these products, 19 times the share of China's next closest competitor, Hong Kong. The rapid increase in China's labour intensive manufactured exports to Australia occurred when there was a substantial drop in Australia's imports from the newly industrialised East Asian economies of Singapore, the Republic of Korea, Taiwan and Hong Kong. At the same time Australia's imports from the ASEAN-4 (Malaysia, Indonesia, Thailand and the Philippines), which are also major competitors of China, increased only slightly. The strong price competitiveness of Chinese products is the major cause of their outstanding performance.

Australia–China Trade in Services

Australia's services trade with China also grew very strongly from 1986 to 1995, with both imports and exports increasing at about 18 per cent per year (Figure 5.10). Travel services represented half of total service exports to China in 1995, up from 26 per cent in 1986.

Due to the rapid growth of two-way trade between China and Australia, shipment services accounted for half of the total imports of services from China in 1995.

Figure 5.10

Service Trade Grows Rapidly **Australia's Trade in Services with China**



Source: Department of Foreign Affairs and Trade (1996b).

AUSTRADE ASSISTS EXPORTERS TO CHINA

The Australian Trade Commission (Austrade) helps Australian businesses develop export opportunities. Its services are tailored to meet the needs of both prospective and established exporters.

Austrade can help businesses which are:

- seeking general information and advice on exporting
- selecting, understanding and entering export markets
- expanding existing export markets.

Austrade has an extensive presence in China, with offices in Beijing, Shanghai and Guangzhou, and small branch offices in Dalian, Hangzhou and Nanjing.

In-market services, for which fees may apply, include:

- detailed market intelligence (for example, on competition and market prospects)
- help in understanding the Chinese market from an on-the-ground perspective (for example, cultural factors, distribution systems and government regulations)
- introductions to distributors and other market contacts
- opportunities to promote products and services through trade displays and missions
- listing on Austrade's Internet site - Austrade World Direct.

Austrade also provides a focal point for Chinese enquiries on Australian products and services. Austrade passes on such enquiries to relevant Australian businesses and works with them to capture export opportunities.

Contact details:

Austrade Hotline

13 28 78

Web site: www.austrade.gov.au

Australia's Export Performance

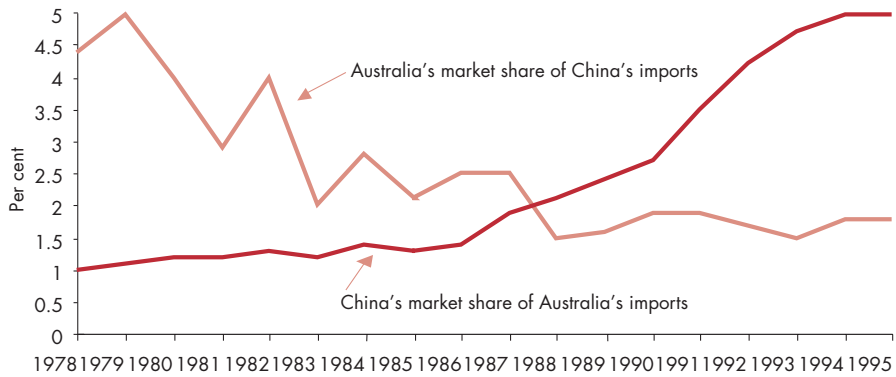
Export performance can be evaluated by referring to different performance indexes. A simple analysis of crude market share shows that Australia's performance in the China market has declined since its extraordinary heights of the early 1980s, stabilising since 1988 (Figure 5.11). A more sophisticated analysis of export performance (trade intensity analysis) shows that Australia has been very successful in the China market, improving modestly since 1988 to a level around twice Australia's average market share overseas.

As mentioned previously, the main cause of the decline in Australia's crude market share of China's imports has been the changing commodity composition of China's imports. High investment growth has generated higher relative demand for capital and intermediate goods, product areas where Australia has a lower share of the Chinese market, than for primary products (Figure 5.12).

Figure 5.11

China's Market Share Soars, Australia's Stabilises

Crude Market Share of Australia and China in Each Other's Imports

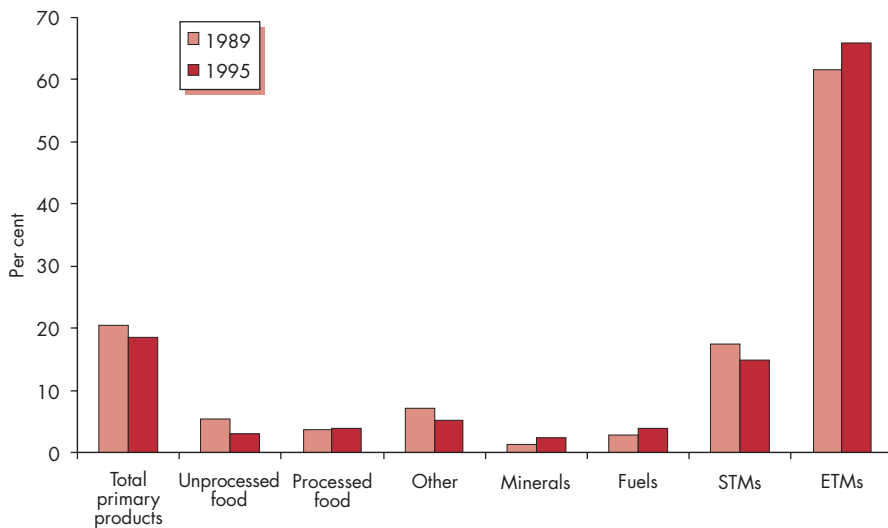


Source: Department of Foreign Affairs and Trade (1996a); State Statistical Bureau (1996 and various years).

Figure 5.12

China Heavily Favours Capital Goods

Commodity Composition Changes in China's Imports from the World (1989 to 1995)

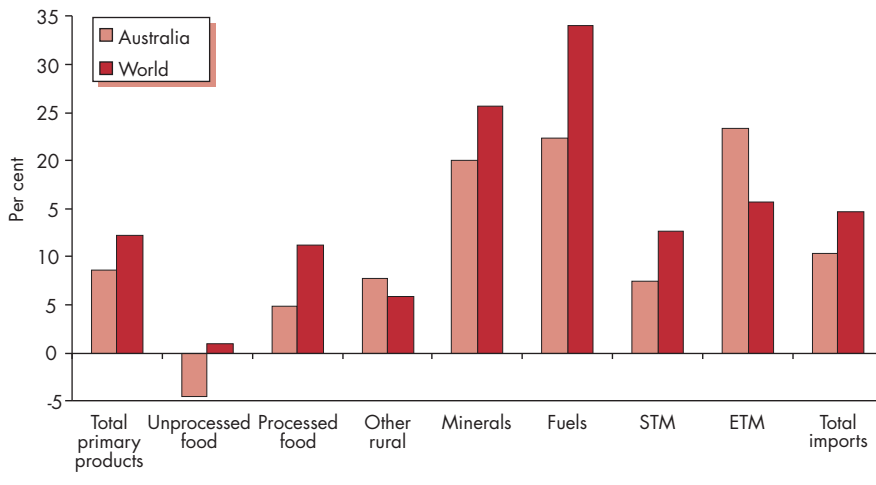


Source: Statistical Analysis and Reporting System (STARS) Database (1996).

Although the growth of Australia's exports of manufactured goods to China more than matched the growth of China's total imports in manufactures (Figure 5.13), this failed to compensate for the loss of Australia's crude market share in China's imports due to the slow growth of its imports of primary commodities. A more detailed analysis of Australia-China trade is included in Appendix 5.1.

Figure 5.13

Big Demand for Minerals and Fuels China's Imports from Australia and the World (Trend Growth Rates from 1987 to 1995)



Source: Statistical Analysis and Reporting System (STARS) Database (1996).

Prospects for Australia's Exports to China

The medium term outlook for China's economic growth provides Australia with good prospects of maintaining strong export growth until the end of the century (Figure 5.14). Australia's exports to China should strengthen in line with China's rapidly expanding demand for imported agricultural goods, energy, capital goods and services and its commitment to continuing trade liberalisation and internationalisation. In 1996, Australian exports of agricultural products to China increased by 90 per cent to \$US1.37 billion, making Australia the second biggest agricultural supplier after the USA (*China Daily*, 17 February, 1997). (See Chapter 9 - Agriculture.)

On the basis of current trends, China's import demand for Australian goods and services could account for 6 per cent of total Australian exports by 2000 compared with 3.8 per cent in 1995.

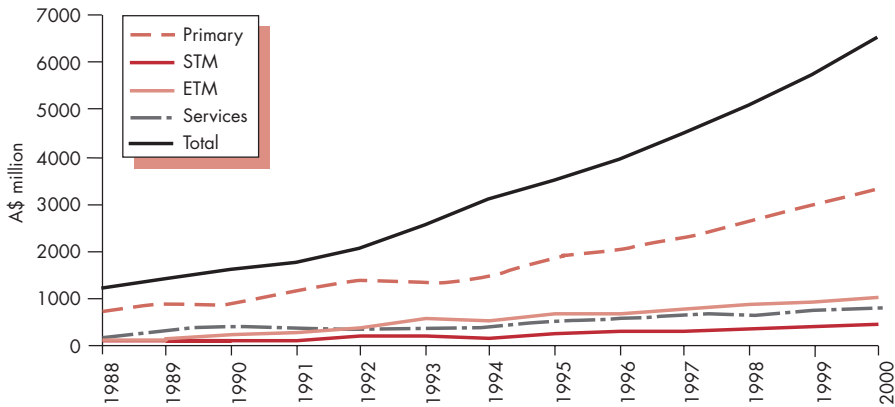
Assuming continuing strong industrialisation in China and further trade liberalisation in its agricultural sector, China's demand for Australia's primary products (agricultural and mineral resources), elaborately transformed manufactures and services should continue to grow strongly in the next decade. By

2000, primary product exports to China should account for 8.4 per cent of Australia's total primary product exports (compared with 5.3 per cent in 1995).

Figure 5.14

Good Prospects for Australia-China Trade

Projections of Australia's Goods and Services Exports to China to 2000 (in Current Prices)



Source: In-house projections by the Department of Foreign Affairs and Trade, 1997.

Australian elaborately transformed manufactures exports to China are projected to account for 4.4 per cent of total Australian exports to the world market (up from 2.8 per cent in 1995) and services 3 per cent (compared with 1.9 per cent in 1995).

CHINA'S TRADE DIPLOMACY

International Environment for China's Exports

Although tariff barriers facing China's major exports are relatively low, significant non-tariff barriers in developed country markets have consistently inhibited China's manufacturing exports, particularly of textiles and clothing (Table 5.12). Australia is not a party to the Multifibre Agreement, which imposes quotas on textiles exports from China and other developing countries to Europe and North America. Despite remaining Australian tariff barriers, China's garment and textile imports have more transparent access to Australia's market.

Table 5.12

Barriers Facing China's Exports
Incidence of Border Trade Measures Facing China's Major Exports
(Per Cent)

| | Textiles, clothing and footwear | Travel goods |
|-------------------------------|---------------------------------|--------------|
| | Per cent | Per cent |
| European Community | | |
| Tariff rate | 9.51 | 4.84 |
| Non-Tariff barriers incidence | 79.5 | na |
| Japan | | |
| Tariff rate | 8.85 | 12.49 |
| Non-Tariff barriers incidence | 20.1 | na |
| USA | | |
| Tariff rate | 14.82 | 14.34 |
| Non-Tariff barriers incidence | 71.8 | na |

Note: na means not available. Listed tariff rates represent global trade-weighted tariff rates. Non-tariff barriers incidence measures the proportion of the tariff category subject to quantitative restrictions and price control measures in 1993.

Source: Department of Foreign Affairs and Trade Tariff Database, 1996; OECD, 1996.

China and the World Trade Organisation

Although China was a founding member of the GATT, it withdrew in 1949. Since 1986, China has formally sought to enter the GATT and the World Trade Organisation (WTO). Accession to the WTO is a more difficult and involved process than negotiating entry to the GATT, as the WTO involves tighter rules, more limits on exceptions, more automatic and unavoidable dispute settlement mechanisms, and substantially wider trade coverage, including agriculture, progressively textiles and clothing, intellectual property and services.⁴

⁴ Countries, states or customs territories having full autonomy were previously able to join the GATT without joining the various codes (on anti-dumping, import licensing, subsidies and countervailing measures and customs valuation) which came out of the Tokyo Round. This is no longer the case—the Agreements which replaced these codes are part of a single undertaking, with which all members of the WTO must comply.

A CHRONOLOGY OF CHINA AND THE GATT/WTO

| | |
|------------------------|--|
| 24 March 1948 | China signs the Final Act of the <i>United Nations Conference on Trade and Employment</i> held in Havana, Cuba. |
| 4 November 1948 | China signs the Protocol of Provisional Application of the GATT and becomes a contracting party with effect from 21 May 1948. |
| 6 March 1950 | The Nationalist Government of China withdraws from the Protocol of Provisional Application of the GATT. |
| November 1984 | The People's Republic of China sends its first delegation to the Council Meetings of GATT with observer status. |
| 10 July 1986 | The People's Republic of China formally applies to resume its contracting party status of GATT. |
| October 1987 | The first meeting of the Working Party on China's Status as a Contracting Party convenes in Geneva. In the following seven years, 18 Working Party meetings are held. |
| 15 April 1994 | The People's Republic of China signs the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations in Marrakesh, Morocco. However this is not accompanied by any verification (and hence acceptance) of schedules. |
| 1996 | The first meeting of the Working Party on China's Accession to the WTO is convened in Geneva in March. The second meeting occurs in November. |
| 1997 | The third meeting of the Working Party is convened in Geneva in February. |

Source: *China Daily Business Weekly*, 25 August 1996; Advice from the Trade Negotiations and Organisations Division, Department of Foreign Affairs and Trade, 1997.

While China already enjoys conditional most favoured nation access to all major world markets, membership of the WTO would still have some important benefits for China. An important outcome of the Uruguay Round, concluded in 1994, was that market access for textiles and clothing will improve significantly as the Multifibre Arrangement is phased out over 10 years. By joining the WTO, China would participate in this phase out of textiles and clothing quotas, with significant benefits for its biggest export category.

Modelling undertaken for this report indicates that trade liberalisation associated with WTO membership would deliver China a rise in national income of 4.6 per cent in the long term, if a modest improvement in productivity were assumed (1 to 2 per cent depending on the sector). (See Table 5.13.) The textiles and clothing sector would experience output growth of almost 14 per cent if China joined the WTO and had access to arrangements to dismantle the Multifibre Arrangement—as agreed in the Uruguay Round (Mai et al, 1996).

Table 5.13

Major Benefits to China from WTO Accession
Percentage Change from the Baseline by 2020
(Assuming Productivity Increases)^a
(Per Cent)

| | Real GNE ^b | Terms of trade ^c | Purchasing power ^d | Export volumes |
|-------------------|-----------------------|-----------------------------|-------------------------------|----------------|
| | Per cent | Per cent | Per cent | Per cent |
| Australia | 1.8 (0.4) | 2.7 | 20.7 | 17.5 |
| China | 4.6 (1.1) | -4.2 | 20.1 | 25.3 |
| New Zealand | 3.1 (1.5) | 2.9 | 19.5 | 16.1 |
| Canada | 1.8 (0.4) | 0.5 | 15.1 | 14.6 |
| USA | 1.8 (0.5) | 0.6 | 18.0 | 17.4 |
| Japan | 2.0 (0.6) | 2.5 | 23.2 | 20.2 |
| Republic of Korea | 2.7 (1.2) | -7.2 | 33.1 | 43.3 |
| Indonesia | 5.1 (3.5) | -2.6 | 27.8 | 31.1 |
| Malaysia | 11.6 (9.7) | -5.7 | 17.9 | 25.0 |
| Philippines | 3.9 (2.4) | -6.7 | 31.2 | 40.6 |
| Singapore | 2.9 (1.3) | 2.1 | 8.0 | 5.7 |
| Thailand | 10.6 (8.8) | -6.8 | 42.3 | 52.5 |
| Taiwan | 1.8 (0.3) | -1.5 | 13.8 | 15.5 |
| European Union | 1.8 (0.5) | 2.5 | 11.4 | 8.6 |
| Rest of the World | 1.5 (0.1) | -0.1 | 3.7 | 3.8 |

Note: ^a Assumes commitments are phased in over a six-year transition period.

^b Figures in brackets are base case without productivity improvements.

^c Free-on-board (fob) export price divided by cost-including-freight (cif) import price.

^d The quantity of imports that can be purchased from export earnings measured by fob exports divided by cif import prices.

Source: Mai et al (1996).

Prospects for WTO Accession

During 1994, China invested much diplomatic effort to become a founding member of the WTO in January 1995. With the failure of that bid, negotiations slowed down. An important factor reducing Chinese willingness to make faster progress has been concern that increased competition arising from the application of WTO rules and disciplines could cause major disruption to the already struggling SOE sector. (See Chapter 10 - State-Owned Enterprises.) In particular, opposition to WTO accession has come from ministries representing industries such as agriculture, automobiles and machinery manufacturing, chemicals, financial services and infrastructure services such as electricity and transport, many of which have a vested interest in maintaining existing non-transparent trade arrangements and protection for their SOEs. However, in 1997 the negotiation process has been reinvigorated raising hopes that the accession process will be accelerated.

China has a strong interest in ensuring that it can participate fully in debates on the future of the international trading system and having access to WTO dispute settlement mechanisms and codes to protect its substantial trading interests. This interest is shared by China's trading partners, particularly given China's growing importance in world trade. Furthermore, China's economy would gain considerably from the increased productivity of previously protected sectors as they become exposed to international competition. Finally, WTO entry would increase the certainty of market access for China's large and growing export sector, on which much of the economy's continuing growth and prosperity depends.

The Australian Government strongly supports China's application to join the WTO and is a member of the WTO Working Party on China's accession. Since 1986, Australia has provided technical training for officials of Ministry of Foreign Trade and Economic Cooperation (MOFTEC) to assist them to better understand the benefits and obligations of WTO membership.

MOFTEC ECONOMIC AND FOREIGN TRADE TRAINING

Under its aid program, Australia provides assistance to MOFTEC to help it to upgrade the skills of key ministry officials on the opportunities and obligations for China provided by WTO membership and participation in the multilateral trading system. In 1996, 12 MOFTEC officials successfully completed a Graduate Diploma in International Economics at the University of Adelaide and 12 more commenced in February 1997. In addition, shorter term assistance has been provided to MOFTEC officials to attend seminars on intellectual property rights in Canberra. The Department of Foreign Affairs and Trade and Australian academics from the University of Adelaide have also provided workshops in Beijing on Uruguay round outcomes and WTO concepts and objectives. These activities may be expanded.

In WTO succession negotiations with China's major trading partners, two substantive issues remain:

- China's commitment to the rules and disciplines of the WTO
- the level of tariff and non-tariff barriers, including state control of trade, and the market access these will offer China's major trading partners.

China will not be guaranteed access to non-discriminatory trading relationships (or unconditional most favoured nation treatment) on its accession to the WTO. While a fundamental principle of the WTO is the principle of non-discrimination in trade (embodied in Article I of the *GATT 1994 Agreement* and Article II of the *General Agreement on Trade in Services*) Article XIII of the *Marrakesh Agreement Establishing the WTO* allows members to suspend the application of the WTO agreements to new members. China will seek assurances that this article and its principles of non-discrimination will not be invoked once it commits to the WTO.

However, actions by Congress may prompt the USA to invoke the non-application provisions unless it repeals its Jackson-Vanik Amendment.⁵ While most favoured nation status will most likely continue, removal would have grave consequences for the US and Chinese economies. The World Bank (1994, p. 158) estimates that such a disruption would cost China between US\$7 billion and US\$15.2 billion per year in lost export income and US consumers as much as US\$14 billion per year in higher prices.

As of early 1997, China's offers of reductions in tariffs, licences and quota protection are still inadequate. For example, the levels of guaranteed access and associated arrangements that China is proposing for wool, barley and sugar, in particular, are substantially less than current levels of trade in these commodities. More importantly, improving the transparency of the trade system, basing the trade regime and protection more firmly on market mechanisms like tariffs, rather than government intervention through canalisation and frequently changed quotas, would greatly assist China's position in relation to the accession. Publishing all trade regulations and trade arrangements, including central government priority projects, also would assist transparency.

Australia recognises that China's economic structure may call for innovative solutions in some areas. For instance, China can expect some leeway concerning the timing of compliance to all WTO rules and disciplines in some areas to expedite its entry, once it has a balanced and realistic WTO offer, adopting WTO rules and providing more transparent market access. Nevertheless, rapid liberalisation of the trade regime will not only produce the most benefits for China

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⁵ Due to the 1974 Jackson-Vanik amendment of its Trade Act, the USA does not automatically grant its trading partners most favoured nation status. This legislation, originally intended to sanction non-market (essentially Communist) countries that restrict emigration, is the basis for the annual decision on most favoured nation (MFN) treatment by Congress based on an assessment of China's domestic human rights situation. The US Congress has recently moved to amend this terminology to the more neutral term of normal trading partner. This process, which has to date always resulted in avoiding sanctions through the exercise of the US President's veto power, adds uncertainty every year to the status of bilateral US-China trade.

but will also be the best method of expediting its WTO entry. Modelling undertaken for this study shows that China would obtain greater benefits from joining WTO with a 6 year rather than with a 10 year transition period (Mai et al, 1996).

Regional Trade Diplomacy: the Role of APEC

APEC has provided a valuable forum for strengthening China's engagement with the region since it joined the process (along with the economies of Hong Kong and Taiwan) in 1991. The APEC Economic Leaders' Meeting in particular offers a unique venue for direct discussions with China's leader. Its value was illustrated at the 1996 Leaders' Meeting in Subic Bay, where both President Clinton and Prime Minister Howard were able to hold useful bilateral discussions with President Jiang Zemin, leading to significant improvements in relations. APEC has also brought China's ministries into discussions with their regional counterparts on a wider range of issues.

As 73 per cent of China's 1995 trade was with APEC member economies, China has a strong interest in the APEC process. APEC provides China with a unique opportunity to deal directly with its major trading partners, Japan and the USA. It also offers important opportunities for China to strengthen its relations with other countries in the region.

APEC has the potential to deliver large benefits to the Chinese economy. The 1994 Bogor Declaration commits all APEC members to free trade and investment by 2020 (2010 for developed economies). In addition, a range of initiatives designed to facilitate trade, such as cooperation to reduce the trade inhibiting effects of differing product standards, is underway under the APEC umbrella. APEC's work on economic and technical cooperation is likely to provide useful benefits in such areas as infrastructure and energy.

The Industry Commission's recent research indicates that achievement of the Bogor goal for free trade and investment among all APEC members is likely to increase the real income of the Chinese economy by 2.4 per cent in the long run. Furthermore, relatively modest trade facilitation could be even more fruitful, possibly increasing China's real income by a further 2.8 per cent. Together, benefits of APEC liberalisation and facilitation could add as much as US\$78 billion to the size of the Chinese economy (Dee et al, 1996, p. 24).

Modeling undertaken for this study confirms these results (Table 5.14). Even if free trade resulted in no productivity improvements (a very strong assumption), APEC liberalisation would increase China's GNP by 1.9 per cent. In the case of WTO entry, modest assumptions about improved productivity increased the trade liberalisation benefits to China, raising GNP by a further 3.5 percentage points.

Table 5.14

**Impact of Full Most Favoured Nation APEC Liberalisation:
Percentage Deviation from the Baseline by 2020
(Per Cent)**

| | Real GNE ^a | Terms of trade ^b | Purchasing power ^c | Export volumes |
|-------------------|-----------------------|-----------------------------|-------------------------------|----------------|
| Australia | 0.8 | 2.7 | 20.7 | 17.5 |
| China | 1.9 | -4.2 | 20.1 | 25.3 |
| New Zealand | 3.2 | 2.9 | 19.5 | 16.1 |
| Canada | 0.8 | 0.5 | 15.1 | 14.6 |
| USA | 0.7 | 0.6 | 18.0 | 17.4 |
| Japan | 1.2 | 2.5 | 23.2 | 20.2 |
| Republic of Korea | 7.9 | -7.2 | 33.1 | 43.3 |
| Indonesia | 5.4 | -2.6 | 27.8 | 31.1 |
| Malaysia | 11.5 | -5.7 | 17.9 | 25.0 |
| Philippines | 2.7 | -6.7 | 31.2 | 40.6 |
| Singapore | 4.5 | 2.1 | 8.0 | 5.7 |
| Thailand | 10.9 | -6.8 | 42.3 | 52.5 |
| Chinese Taipei | 1.3 | -1.5 | 13.8 | 15.5 |
| European Union | 0.4 | 2.5 | 11.4 | 8.6 |
| Rest of the World | -0.2 | -0.1 | 3.7 | 3.8 |

Note: ^a Assuming no increase in productivity in Chinese industry.

^b Fob export price divided by cif import prices.

^c The quantity of imports that can be purchased from export earnings measured by fob exports divided by cif import prices.

Source: Mai et al (1996).

China has played a constructive role in APEC. Although China tends to stress the voluntary nature of APEC trade liberalisation to meet the Bogor goal, China's contributions are significant. Its 1995 Osaka 'downpayment' was one of the most notable tabled, including a commitment to cut general tariffs on over 4 000 tariff lines (with a reduction of no less than 30 per cent in the simple average tariff). China's initial APEC Individual Action Plan (IAP) tabled in 1996 included a commitment to reduce the general tariff rate to around 15 per cent by 2000 (from the 1996 simple average of 23 per cent). Its commitment to review all non-tariff measures by 2000, to increase the number of licences for foreign banking and insurance companies, to align domestic standards with international standards in a range of areas, and to harmonise and simplify customs procedures are other positive aspects of its initial IAP. The process of peer and private sector review of IAPs (in the first instance at the APEC Trade Ministers' Meeting in May 1997 and through the APEC Business Advisory Council) are likely to lead to a gradual improvement in China's IAP, as well as those of other APEC economies, over time.

China places considerable importance on economic and technical cooperation in APEC. It has placed some emphasis on work on science and technology. China proposed at the Bogor APEC Leaders' Meeting that it host the First APEC Ministers' Conference on Regional Science and Technology Cooperation. This offer was accepted by the leaders and the conference was subsequently held in Beijing in 1995. China has also played an important role as a coordinator of the Industrial Science and Technology Working Group. A further proposal by China at the leaders' level for an environmental protection centre is being implemented in APEC. All these initiatives indicate China has a high level of commitment to the APEC process.

Overall, China's prospects for strong trade growth remain very good. Given the complementarity of the Australian and Chinese economies and Australia's good trade performance in China to date, this should ensure continued rapid growth in Australia - China trade. In particular, Australian export growth should be strongest in land intensive agricultural commodities, such as grain, wool and cotton, minerals and iron-coal energy exports, as well as a range of ETMs. Prospects for agricultural exports are discussed in more detail in Chapter 9 - Agriculture.

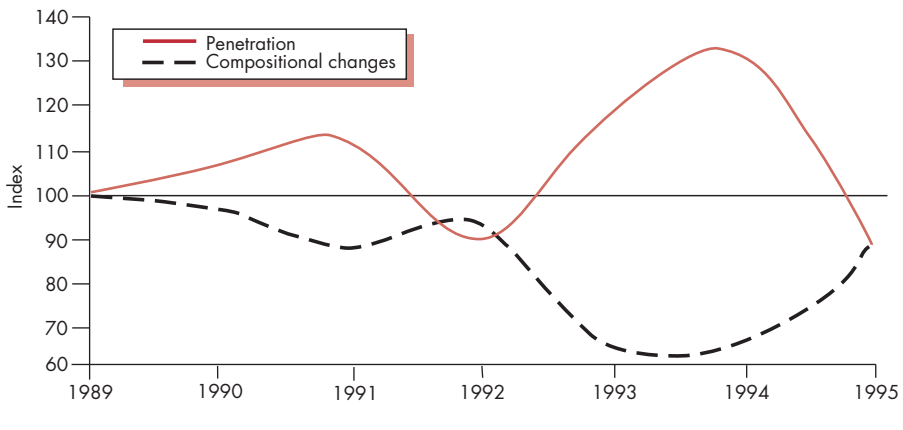
Appendix 5.1

ANALYSIS OF AUSTRALIA-CHINA TRADE

Analysis of Australia-China trade can be enhanced by trade intensity analysis which calculates indexes of export penetration and compositional change.⁶ As a value above 100 indicates that a factor contributes positively to the growth of crude market share in that particular year, the change in the composition of China's imports has detracted from Australia's crude market share each year since 1989, while Australia's export penetration has in most years positively contributed to its share of China's market (Appendix Figure 5.1).

Appendix Figure 5.1

Factors Influencing Australia's Share of China's Import Market Export Penetration and Compositional Change in Australia's Exports to China



Source: Statistical Analysis and Reporting System (STARS) Database (1996).

⁶ The penetration index (which emerges when the other element of crude market share—the compositional change effect—is held constant) measures Australia's export penetration in the Chinese market. The index of composition change measures the change in Australia's share of China's imports in the absence of export penetration changes.

While crude market share analysis measures Australia's share of China's imports, it does not provide information on Australia's export performance in China compares with Australia's export performance in other countries (or the rest of the world). Trade intensity analysis, however, measures Australia's share of one country's imports relative to Australia's broader share of world imports. This indicates whether Australia's market share in a single country is greater or smaller than its average share in the world and, hence, provides a more sophisticated analytical tool for understanding Australia's export performance in a particular country.

The intensity of the bilateral trade relationship is determined by two factors:

- the degree of complementarity of the two countries' trade structure (measured by a complementarity index which in this case, is defined as the extent to which Australia's commodity export pattern matches China's commodity import pattern compared to Australia's export match with the pattern of world imports) and
- the relative strength of the trading relationship between the two countries compared with other trading partners (measured by the bias index which is defined as the extent to which, on average, Australia's exports have more or less favourable access to China's import markets than might be expected simply from both countries' shares of world trade in each commodity). The bias index captures the effect of factors such as proximity, transport costs, competitiveness, traditional ties, or preferential trading agreements on trade.

Trade intensity indexes⁷ for Australia–China trade show that both Australia and China hold a share of the other country's trade that is well above average (Appendix Figures 5.1 and 5.2). This indicates that despite a decline in Australia's crude market share in China's imports, Australia has a higher than expected share of China's import market, given the overall structure of the two countries' trade.

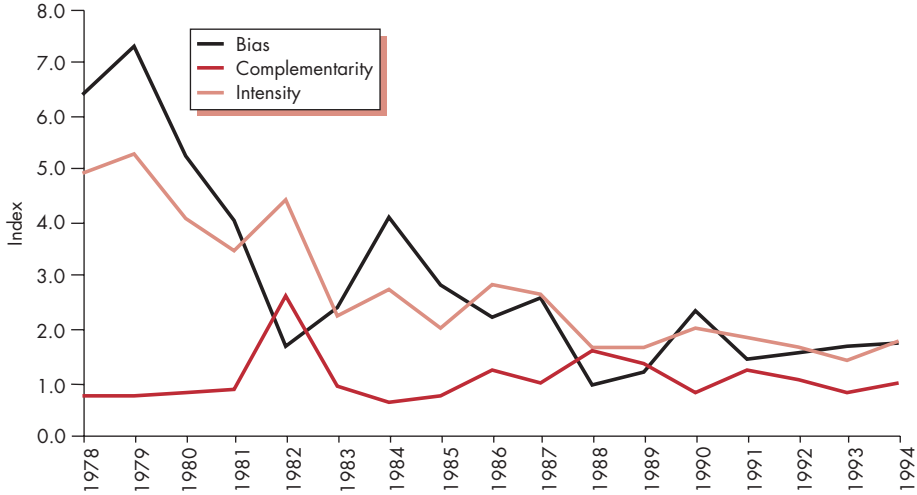
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⁷ A trade intensity index for two trading partners, Australia and China in this case, is defined as the product of their *trade complementarity index* and *trade bias index*. A *trade complementarity index* is defined as the product of the contribution of Australia's exports of a particular product to its total exports, the contribution of China's imports of the same product to its total imports and their shares of world trade in the same commodity, added across all products traded. A country *trade bias index* is estimated by dividing China's share of Australia's total exports for each commodity by China's share of total world imports of that commodity and weighting these ratios by the importance of each commodity in Australia's total trade and adding them for all products traded (Drysdale and Garnaut, 1994; Garnaut, 1996).

Appendix Figure 5.2

How Well Does Australia Do in China?

Intensity, Complementarity and Bias of Australia's Exports to China

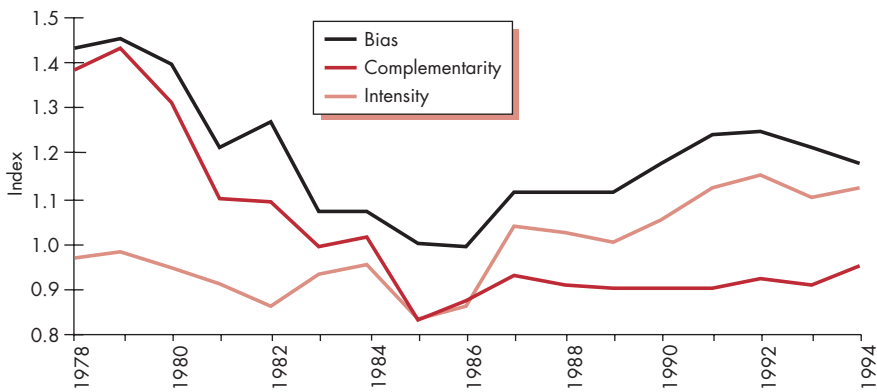


Source: International Economic Databank, Australian National University, Canberra, 1996.

Appendix Figure 5.3

How Well Does China Do in Australia?

Intensity, Complementarity and Bias of China's Exports to Australia



Source: International Economic Databank, Australian National University, Canberra, 1996.

The complementarity index for Australia's exports to China has been falling slowly since 1988. The bias index, however, has been rising, indicating a stronger trade relationship and Australian competitiveness.

The complementarity index for China's exports to Australia was on a downward trend in the first half of the 1980s but has since risen and is approaching 1.0. This suggests that China's exports to Australia have started to match more closely Australia's import patterns.

Since 1978, trade bias indexes for trade in both directions have been well above 1.0 and therefore well above average, averaging about 3.0 for Australia's exports to China and 1.2 for China's exports to Australia. This indicates that the weighted average Australian share of China's import market was three times the weighted average of Australia's share of total world trade, and China's share of the Australian market was about 1.2 times its share of world trade. After falling heavily in the early 1980s, Australia's trade bias index has risen modestly since 1988, to be almost 2.0 in 1994.

All three indexes for China's exports to Australia are lower than those for Australia's exports to China (Appendix Figures 5.2 and 5.3). However, since the mid 1980s, the trade intensity, complementarity and bias of China's exports to Australia have increased. This reflects substantial trade liberalisation in Australia in recent years, which has resulted in a growing demand for China's labour intensive manufactured exports.

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FOREIGN INVESTMENT AND INTERNATIONALISATION

China's reintegration into the world economy gathered strong momentum in the 1980s, at a time of rapid growth in world trade and considerable investor interest in Asia. In 1980, China contributed less than 1 per cent of world trade and had only just begun to allow foreign direct investment (FDI). By 1996, China accounted for 3 per cent of world trade and attracted FDI exceeding US\$40 billion, approximately 40 per cent of total global FDI.

China has become a major economic force, and most international companies are incorporating it into their long-term strategies. Similarly, China's development strategies include a strong role for overseas investors - and for its own growing offshore interests. China's increasing internationalisation is forcing it to address major issues confronting developed and developing countries alike: how to cope with strengthening global competition, rapidly changing technology, blurred economic borders and controls, and increasingly demanding international responsibilities and obligations. China's response to these challenges will have a major impact on its performance in the twenty-first century.

This chapter follows on from Chapter 5 in documenting China's increasing integration into the international economy. It analyses the major factors influencing FDI flows and assesses China's foreign investment policy environment in light of regional liberalisation trends. It also examines foreign investors' experiences in China and explores how mutual expectations are evolving. Finally, it anticipates future directions in FDI policy and the attractiveness of China to foreign investors.

FOREIGN INVESTORS: A KEY TOOL FOR DEVELOPMENT

Foreign funded enterprises have played an important role in diversifying and internationalising China's economy and trade since 1980. Prior to that, China's international trade and investment were very narrowly based. According to a widely accepted measure of economies' 'openness' used by international economists, China's openness declined by nearly half from 1960 to 1970 (Pomfret, 1996). In the early 1970s, however, discrete signs of opening appeared as China began to involve foreign companies in aid-financed turnkey projects. This opening was greatly extended by the 1979 *Joint Venture Law* and the establishment of Special Economic Zones (SEZs).¹ These measures aimed to attract foreign capital and to diversify exports by developing a labour intensive manufacturing base.

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¹ China has 5 SEZs, 12 bonded areas, and 14 coastal open cities. (See Chapter 1 - Overview of Economic Reforms and Chapter 5 - International Trade.)

Initially, foreign funded enterprises (FEEs) were admitted only to a narrow range of sectors to transfer technology and develop exports. Policy-makers particularly targeted large scale projects which would introduce advanced technologies and skills to upgrade Chinese industry. This led to many joint ventures involving large state-owned enterprises (SOEs). (See Chapter 10 - State-Owned Enterprises.) As the liberalisation program progressed, more small and medium sized joint ventures were allowed, hastening industrial development and export diversification. Township and village enterprises (TVEs) in particular became very active at combining their low cost labour with the capital and marketing expertise of foreign entrepreneurs (especially Hong Kong-based investors) to produce manufactures for export. (See Chapter 11 - Non-State Sector.) Wholly foreign-owned enterprises were permitted from 1986. China's trade boomed and FEEs' share in overseas transactions rose from virtually nil in 1980 to nearly half in 1996 (41 per cent of China's exports and more than 50 per cent of its imports² - Table 6.1). (See Chapter 5 - International Trade.)

Apart from trade, FEEs have played a crucial role at the microeconomic level, introducing new technologies, management techniques and marketing skills, and trialing prospective reforms and policy ideas.

Evolving Role

A number of factors will influence FEEs' role in coming years, including government policy decisions on:

- extension of 'national treatment', whereby foreign and domestic companies are treated equally in terms of incentives and preferences, thus removing many of the advantages foreign firms enjoy (and perhaps impediments such as access to domestic markets and finance).
- continued restrictions on foreign investment in services, infrastructure, resources and other areas, and new restrictions limiting foreign investment in, for example, chemical ventures.
- emergence of new business areas, for example, joint venture trading companies being trialed in Shenzhen and Shanghai³ (Economist Intelligence Unit, 1996b). Central and regional governments also are reportedly seeking ways to allow foreign firms to invest in low return sectors such as infrastructure by permitting them to realise higher returns from associated projects such as development of adjacent land.
- increasing flexibility in organisational structures and business operations, for example, freer access to personnel, raw materials and inputs procurement, currency convertibility. (See Chapter 3 - Market Environment.)

² Capital goods, which were exempt from any import duties, comprised a considerable portion of these imports (47 per cent in 1991; 29 per cent in 1995). The exemption was abolished as of 1 April 1996 as part of moves towards national treatment.

³ Requires registered capital of at least RMB 100 million (US\$12 million), Chinese control of at least 51 per cent and foreign participation of at least 25 per cent, plus a number of other stipulations regarding the foreign investor.

- growth of the domestic private sector. (See Chapter 11 - Non-State Sector.)
- China's emerging role as a capital exporter, combined with its growing need for overseas financing. (See Chapter 7 - Infrastructure.)

Table 6.1

FFE Contribution to Trade Grows Strongly
Foreign Funded Enterprises' Share in China's Trade
(US\$ millions)

| Year | FFE total \$ | | | FFEs as per cent of China total | | |
|-------|--------------|-----------|-----------|---------------------------------|--------|--------|
| | Total trade | Exports | Imports | Total trade | Export | Import |
| 1980 | 43 | 8.24 | 34.41 | 0.11 | 0.05 | 0.17 |
| 1981 | 143 | 32.35 | 110.87 | 0.33 | 0.15 | 0.50 |
| 1982 | 329 | 52.87 | 276.42 | 0.79 | 0.24 | 1.43 |
| 1983 | 618 | 330.36 | 288.01 | 1.42 | 1.49 | 1.35 |
| 1984 | 468 | 68.94 | 399.21 | 0.87 | 0.26 | 1.46 |
| 1985 | 2 361 | 296.70 | 2 064.10 | 3.39 | 1.08 | 4.89 |
| 1986 | 3 012 | 582.03 | 2 430.31 | 4.08 | 1.88 | 5.67 |
| 1987 | 4 330 | 1 208.09 | 3 122.18 | 5.24 | 3.06 | 7.23 |
| 1988 | 8 203 | 2 456.42 | 5 746.71 | 7.98 | 5.17 | 10.40 |
| 1989 | 13 709 | 4 913.20 | 8 796.17 | 12.28 | 9.35 | 14.87 |
| 1990 | 20 120 | 7 813.79 | 12 306.33 | 17.43 | 12.58 | 23.07 |
| 1991 | 28 954 | 12 047.25 | 16 907.00 | 21.35 | 16.77 | 26.50 |
| 1992 | 43 726 | 17 356.19 | 26 370.00 | 26.42 | 20.43 | 32.72 |
| 1993 | 67 070 | 25 237.17 | 41 833.20 | 34.27 | 27.50 | 40.24 |
| 1994 | 87 647 | 34 712.97 | 52 934.17 | 37.03 | 28.68 | 45.76 |
| 1995 | 109 818 | 46 876.00 | 62 942.00 | 39.10 | 31.51 | 47.66 |
| 1996* | 125 972 | 58 531.00 | 67 442.00 | 46.36 | 40.91 | 52.42 |

Note: *1996: Estimate based on customs data for January-October.

Source: Data for 1980 to 1993 are from State Statistical Bureau, 1994a.

Data for 1994 to 1995 are from State Statistical Bureau, 1995b, p. 553 and 1996b, p. 596.

WILL DOUBLE DIGIT FDI GROWTH CONTINUE?

Despite China's relatively restrictive foreign investment regime, FDI inflows averaged US\$1.6 billion per year from 1983 to 1987 and more than double that from 1988 to 1992 (Table 6.2). Improving investor confidence due to more vigorous moves toward a market-oriented economy in the wake of Deng Xiaoping's 1992 Southern Tour led to a steep rise in FDI to more than US\$37 billion in 1995⁴, making China the world's second largest FDI host after the USA.

These impressive figures, however, appear to contain an element of 'roundtripping': Chinese capital taken offshore (mostly to Hong Kong) so that it can re-enter the country as foreign investment and thus enjoy the incentives available to foreign companies. It is difficult to estimate the precise extent of 'roundtripping' but Harrold and Lall (1993) estimate it is approximately 25 per cent of total inflows. However, given the FDI volumes reported since 1992, even a 25 per cent downward adjustment would not alter China's success in attracting FDI.⁵ The return of Hong Kong to China and the progressive removal of preferences for foreign investors should reduce the 'roundtripping' phenomenon.

This may have begun to have an impact in 1996: early Chinese estimates indicate that FDI growth may have slowed significantly, totalling an estimated US\$40 billion, just US\$2.5 billion more than in 1995. In September 1996, UNCTAD suggested that the new tariffs on capital goods imports, restrictions on new industrial investment and barriers to entry into the services sector could slow FDI growth.

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⁴ The cumulative stock of FDI reached US\$ 167 billion at the end of 1995.

⁵ Encarnation (1995) references a World Bank study's 4:11 roundtripping adjustment. Chinese studies show that 'roundtrippers' often add foreign sourced capital to their domestic funds, making the resulting inbound capital at least partly foreign direct investment.

Table 6.2

FDI Booms Since 1992
FDI Inflows by Source Economy: 1983 to 1995
(US\$ millions)

| Source country | 1983-86 average per year | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|------------------------|--------------------------|-------|-------|-------|-------|-------|--------|--------|--------|--------|
| NIEs | 883 | 1 610 | 2 095 | 2 121 | 2 153 | 2 961 | 8 799 | 21 277 | 24 959 | 26 258 |
| Hong Kong | 876 | 1 588 | 2 068 | 2 037 | 1 880 | 2 437 | 7 507 | 17 275 | 19 665 | 20 185 |
| Taiwan | 0 | | | | 222 | 466 | 1 051 | 3 139 | 3 391 | 3 165 |
| Singapore ⁶ | 7 | 22 | 28 | 84 | 50 | 58 | 122 | 490 | 1 180 | 1 861 |
| Rep. of Korea | 0 | | | | | | 119 | 374 | 723 | 1 047 |
| ASEAN4 | 8 | 15 | 11 | 16 | 10 | 30 | 144 | 513 | 692 | 765 |
| Thailand | 6 | 11 | 6 | 13 | 7 | 20 | 83 | 233 | 235 | 288 |
| Philippines | 2 | 4 | 4 | 2 | 2 | 6 | 16 | 123 | 140 | 106 |
| Malaysia | 0 | 0 | 1 | 0 | 1 | 2 | 25 | 91 | 201 | 259 |
| Indonesia | 0 | | 0 | 1 | 1 | 2 | 20 | 66 | 116 | 112 |
| Japan | 247 | 220 | 515 | 356 | 503 | 533 | 710 | 1 324 | 2 075 | 3 212 |
| USA | 256 | 263 | 236 | 284 | 456 | 323 | 511 | 2 063 | 2 491 | 3 084 |
| West Europe | 151 | 55 | 195 | 218 | 151 | 264 | 277 | 714 | 1 634 | 2 233 |
| UK | 54 | 5 | 34 | 28 | 13 | 35 | 38 | 221 | 689 | 915 |
| Germany | 19 | 3 | 15 | 81 | 64 | 161 | 89 | 56 | 259 | 391 |
| France | 33 | 16 | 23 | 5 | 21 | 10 | 45 | 141 | 192 | 287 |
| Italy | 20 | 16 | 31 | 30 | 4 | 28 | 21 | 100 | 206 | 270 |
| Other WE | 26 | 15 | 93 | 73 | 48 | 29 | 85 | 196 | 288 | 370 |
| Other DCs | 29 | 20 | 10 | 61 | 42 | 26 | 96 | 256 | 413 | 511 |
| Australia | 25 | 5 | 4 | 44 | 25 | 15 | 35 | 110 | 188 | 233 |
| Canada | 4 | 10 | 6 | 17 | 8 | 11 | 58 | 137 | 216 | 257 |
| New Zealand | 0 | 5 | 0 | | 9 | 1 | 3 | 9 | 9 | 21 |
| Other Asia | 0 | 10 | 31 | 41 | 58 | 50 | 229 | 718 | 627 | 513 |
| East Europe | 1 | 21 | 1 | 0 | 0 | 1 | 21 | 54 | 49 | 27 |
| Latin America | 3 | 2 | 0 | 1 | 7 | 4 | 24 | 59 | 165 | 336 |
| Africa | 0 | 0 | 3 | 0 | 0 | 0 | 3 | 38 | 14 | 15 |
| Others | 55 | 98 | 96 | 293 | 107 | 174 | 193 | 499 | 648 | 812 |
| Total | 1 634 | 2 314 | 3 194 | 3 393 | 3 487 | 4 366 | 11 008 | 27 515 | 33 767 | 37 806 |

Note: NIEs: newly industrialising economies; ASEAN: Association of South East Asian Nations; DCs: developed countries.

Source: Ministry of Foreign Trade and Economic Cooperation, 1996 and previous years.

⁶ It is common to include Singapore among the NIEs, instead of ASEAN, in such comparisons.

Scope for Further Growth

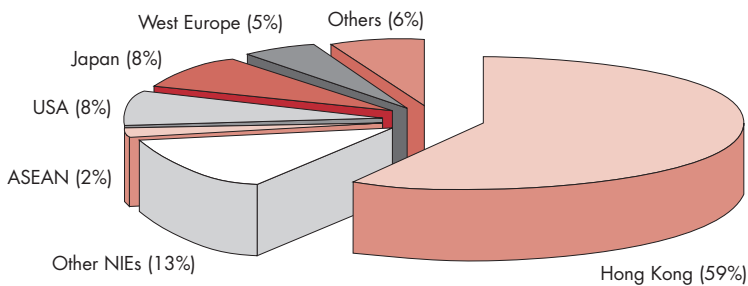
Despite strong FDI inflows in recent years, on a FDI per capita basis China ranks below key Eastern European and Latin American countries.⁷ This indicates considerable scope for further FDI growth if China overcomes existing constraints, including infrastructure bottlenecks, shortage of skilled workers, transparency issues, legal and administrative barriers. Overall foreign capital inflows, including portfolio investment, should also increase as China's capital and debt markets mature. FDI comprises 85 per cent of foreign capital inflows which is higher than in most countries (Economist Intelligence Unit, 1997).

ASIA MAIN SOURCE OF INVESTMENT

Although Hong Kong is by far China's largest source of FDI, providing nearly 60 per cent of cumulative FDI (Figure 6.1), its precise contribution is complicated by roundtripping and the routing of FDI from many other countries via Hong Kong. Asian businesses, especially overseas Chinese from Hong Kong, Taiwan and South East Asia, are by far the major investors in China (East Asia Analytical Unit, 1995, Chapters 10 and 11), with more than 80 per cent of realised FDI to date. As a group, the newly industrialising economies (NIEs) of Hong Kong, Republic of Korea, Singapore and Taiwan are the main investors. Among individual economies other than Hong Kong, Taiwan has the largest stake in China, followed by the USA and Japan.

Figure 6.1

Asia Accounts for Over 80 Per Cent Cumulative FDI Flows into China: Share by Region Realised, 1984 to 1995



Source: Ministry of Foreign Trade and Economic Cooperation, 1996 and previous years.

⁷ FDI was US\$32 per capita in China in 1996 (similar to the Philippines and just below Vietnam), \$45 in Mexico, \$50 in Brazil, \$290 in Chile, \$350 in Hungary, \$110 in Poland, \$100 in Czech Republic, but just \$0.88 in India. However, FDI per capita is around US\$75 in China's 11 coastal provinces, which account for 85 per cent of inbound FDI (Economist Intelligence Unit, 1997).

Japan and the USA have significant investment stakes, despite China being a fairly recent addition to most Japanese and US companies' strategic plans (East Asia Analytical Unit, 1996, Chapter 3).⁸ Most leading US and Japanese corporations have either a presence in or a plan for China, as do their European competitors. Indeed, in coming years, China will become one of the world's largest, most multinational investment bases.

THE AUSTRALIA-CHINA CONNECTION

Australia is China's thirteenth largest source of utilised FDI, with 2 500 direct-investment projects in a wide range of fields (*China Daily*, 4 January 1997). Almost all major Australian companies have interests in China, some quite longstanding. (See BHP box.) In addition, a 1996 Australia-China Chamber of Commerce survey indicated that 60 per cent of Australian firms were interested in China, citing the huge potential of the market, low labour costs and Australia's economic interests being largely in East Asia. According to Qin Xiao, president of the China International Trust and Investment Corporation (CITIC),⁹ 'Australia's unique expertise in developing remote areas, its technology in agriculture, transportation and telecommunications, and its experience in financial and insurance services are all of great value and use to China.' (*China Daily*, 4 January 1997).

Australian cumulative investment in China is estimated at around A\$1 billion, with realised outlays averaging over A\$200 million per year recently - mostly in manufacturing, resource development and services including infrastructure projects. Table 6.3 indicates the spread of Australian interests in China.

⁸ Japan continues to focus much of its investment in South East Asia, while US firms still generally tend to concentrate first on the Americas and Europe. *Asia's Global Powers: China-Japan Relations in the 21st Century* (East Asia Analytical Unit, 1996) examines Japanese interests in China in detail.

⁹ CITIC is China's largest overseas investment entity, as well as a major investor in China itself. It is planning to focus on finance, telecommunications, raw materials, infrastructure and trucks. It is also planning to further diversify its banking interests and expand into securities and insurance (Qin, 1996).

AUSTRALIA ATTRACTS CHINESE INVESTMENTS

Chinese cumulative investment in Australia has surpassed A\$2 billion (Australian Bureau of Statistics, 1996). Australia is one of China's main investment destinations, along with Hong Kong, the USA, Japan and Thailand. About half of Chinese interests in Australia are in portfolio, rather than direct and equity investment. The direct investments are mostly in resources (minerals and metals) and food and textile related ventures, in line with China's interest in securing long-term supplies of strategic goods. (See Appendix 6.3 for a description of total Chinese FDI and a list of Chinese investments in Australia.)

CITIC's main Australian investments, the Portland aluminium smelter, Metro Meats and textile operations, generated earnings of more than A\$150 million in 1995-96 (Qin, 1996). CITIC is also involved in trading companies, timber operations and a power station. The Ministry of Metallurgical Industries also has a A\$120 million joint venture with Hammersley Iron in the Mount Channar iron ore mine in Western Australia. In addition, Chinese investors are involved in smaller scale operations such as restaurants, farms, paper plants, wool processing, apparel production, mineral exploration and real estate. The Australian Government's Investment Promotion and Facilitation Program, with specialists in Austrade offices in Hong Kong, Beijing and Shanghai, is active in encouraging Chinese investment in Australia; recent projects range from sheep and cotton farming to tourism. (See Appendix 6.3.)

Table 6.3

Services and Manufacturing Predominate Australian Companies in China: 1996

| Industry | Sector | No. of Firms |
|-----------------------|------------------------------|--------------|
| Primary | | |
| | Minerals/metals | 29 |
| | Glass | 4 |
| | Plastics | 2 |
| | Chemicals | 1 |
| | <i>Subtotal</i> | 36 |
| Manufacturing | | |
| | Packaging | 4 |
| | Pharmaceuticals | 8 |
| | Automotive components | 9 |
| | Electrical components | 9 |
| | Food/beverages | 18 |
| | Others | 7 |
| | <i>Subtotal</i> | 55 |
| Infrastructure | | |
| | Treatment plants | 4 |
| | Telecommunications | 10 |
| | Energy | 7 |
| | Environment | 3 |
| | Building complexes | 3 |
| | Roads | 3 |
| | Other | 5 |
| | <i>Subtotal</i> | 35 |
| Services | | |
| | Tourism | 3 |
| | Advertising/public relations | 3 |
| | Project management | 4 |
| | Consulting | 15 |
| | Communications | 7 |
| | Accountancy | 4 |
| | Law | 6 |
| | Architecture | 5 |
| | Property | 6 |
| | Financial services | 4 |
| | Printing | 4 |
| | <i>Subtotal</i> | 61 |
| Total | | 187 |

Source: University of Melbourne, 1996.

Great Expectations

Surveys of Australian investors reveal a distinction among:

- those who entered the market in the 1980s to 'pre-empt the competition' and to establish a presence for the long term;
- those who invested in China after 1992 to 'test the waters'; and
- those who invested after 1992, convinced that it was the right time and place.

While many of the companies that entered the market in the 1980s are doing quite well, some have not survived. Similarly, while some of those that entered China after 1992 are pulling out, others are convinced they did the right thing and are building on their investments. A key lesson garnered from the case studies in Appendix 6.1 is to have realistic expectations when investing in China. Another is to strive to understand and appreciate cross-cultural differences. A lack of understanding of mutual expectations has been the basis of many of the problems associated with foreign investment in China.

These lessons are supported by a recent Economist Intelligence Unit survey (1997), which highlighted a number of important issues.

- Most multinational companies in China overestimated the size of the market and are adjusting their strategies to better target customers. ('China...is many little pockets of demand that require individual attention.'¹⁰) Firms selling fast-moving consumer goods and those servicing other foreign investors better estimated demand.
- Human resource limitations are the principle constraint to improved productivity and business development. This is partly attributed to China's education system which for decades emphasised narrow technical and scientific skills at the expense of professional (such as legal and management) skills. Firms responding to the survey reported one expatriate manager to every 2.4 local managers, higher than in many other countries. Also, poaching of managers and skilled staff can be a major problem.
- Labour costs of the 22 companies interviewed rose 75 per cent (nominal, before inflation) in the three years to 1996, but are still low in absolute terms. (See Chapter 12 - Labour Markets.)
- Price sensitivity is higher than expected.
- Operating profits are achieved on average in 2.5 years.
- Measuring productivity is difficult, although manufacturers reported an average 8 per cent increase in 1996 and projected an 11 per cent rise in 1997. Product distribution is becoming less onerous as major road, rail and port projects are completed but is still a problem. Also, lower demand following a national credit tightening has eased pressure on infrastructure.

¹⁰ Summary of survey results reported in *Business China*, 9 December 1996.

BHP ENTERS ITS SECOND CENTURY IN CHINA

Melbourne-based Broken Hill Proprietary (BHP) is one of the world's largest and oldest resource companies, with operations and offices employing 65 000 people in more than 60 countries. Its four main businesses, copper, minerals, petroleum and steel, are supported by specialist service companies such as BHP Engineering.

China was one of BHP's first export markets. Links were established in 1888 and the first business transaction was recorded in 1891 when BHP exported lead to Fuzhou. Trade diminished in the early 1900s as BHP's silver, lead and zinc resources declined and the company turned to iron and steel.

In the 1960s and 1970s, BHP exported growing volumes of steel products to China, and imported fluorspar, calcined bauxite and flint clay.

In 1979, BHP was a member of the first foreign consortium to sign an oil exploration contract with China. It established an office in Guangzhou in the early 1980s to support this activity and opened its corporate office in Beijing in 1984.

BHP began investigating minerals joint venture possibilities in China in 1986. In early 1993, it signed an agreement to establish the Sichuan Kang Dian Exploration Joint Venture with Chinese partners, Southwest Metallurgical Geological Exploration Company and Sichuan Non-Ferrous Metal Corporation. Together they are exploring for lead, zinc and silver in southern Sichuan province.

BHP Engineering has been active in the Chinese services sector. Its first project was to design the Shunchang Cement plant, which opened in Fujian province in 1989. It also procured the machinery, process technology, electrical services and automation, and advised on construction and commissioning. As part of its contract, BHP Engineering trained 40 Chinese specialists in Australia. BHP Engineering has also carried out industrial projects for multinational companies in China.

From 1992 to 1993, BHP Transport managed the design, construction and acceptance of eight self-discharging barges in Nanjing. Along with four tugs, also built to specifications, these barges now work at BHP Minerals' coal mining operations in Kalimantan, Indonesia.

In 1994, BHP was granted licences to operate wholly owned steel rollforming businesses in Shanghai and Guangzhou, the company's first major investment in China. The Pudong, Shanghai plant opened in May 1995, while the Guangzhou rollformer began operating in early 1996. Both supply the local construction markets.

- Early arrival in China has not always been rewarded; many Japanese and US companies which arrived in the early 1990s are showing better results than the ‘pioneers’ of the 1980s.
- Three quarters of respondents agreed that ‘the central Government has already locked most multinationals into China and is less inclined to offer them special incentives. General operating conditions will become more difficult in the next two years.’
- The bottom line was that the surveyed companies remain strongly committed to the Chinese market.

WHERE INVESTORS ARE GOING AND WHAT THEY ARE DOING

The creation of four Special Economic Zones in Guangdong and Fujian in the mid 1980s and later declaration of the 14 open cities encouraged strong FDI inflows, especially to Guangdong, and later to Fujian, Shanghai and Jiangsu (Table 6.4). Where investors from Hong Kong and Taiwan provided much of the initial capital, they preferred either nearby sites to facilitate managerial control or locations where they had family connections (East Asia Analytical Unit, 1995). Today, approximately two thirds of Hong Kong interests in China are in Guangdong, while the remainder are primarily in Shanghai, Xiamen, Ningbo and Dalian, and selected inland cities such as Nanjing and Wuhan. FDI continues to grow rapidly along China’s eastern seaboard, stretching from Hainan and Guangdong in the south to Beijing-Tianjin and Liaoning in the north. Hinterland foreign funded enterprises began to emerge in the late 1980s, characterised by:

- companies seeking proximity to raw materials inputs (for example, PPG Glass in Nanchang, Jiangxi)
- firms targeting local markets or extending regional coverage (such as Coca-Cola)
- investors attracted by special incentives (BOC Gases received significant assistance for its plant near Chongqing, Sichuan, including tax holidays from the local and central governments)
- companies attracted by inland regions’ lower costs, abundant labour and less intense competition than in coastal areas, and, say some, ‘friendlier attitudes to smaller FFEs’.

Investment in the interior will grow in coming years as infrastructure improves under official policies to encourage inland development. However, most foreign investors will continue to locate in the coastal areas in the next 10 to 15 years.

Figures 6.2 and 6.3 show the sectoral distribution of contracted foreign investment in China.¹¹ The predominant sectors are labour intensive manufacturing and real estate. Capital from other Asian countries features strongly in real estate, which has benefitted from policy liberalisation since 1993, leading to foreign investment in large shopping complexes and residential and commercial property. (See Appendix 6.2 for official figures.)

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¹¹ ‘Realised’ FDI is a better measure, but figures were not available (only about half of contracted FDI is actually implemented).

Table 6.4
**Guangdong, Fujian, Jiangsu Remain Strongholds
of Foreign Investment**
FDI Inflows into China's Provinces: 1983 to 1995
(US\$ millions, Annual Averages)

| Province | 1983-86 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|----------------|---------|-------|-------|-------|-------|-------|--------|--------|--------|--------|
| Beijing | 87 | 106 | 503 | 320 | 279 | 245 | 350 | 667 | 1372 | 1080 |
| Tianjin | 30 | 133 | 61 | 31 | 37 | 133 | 108 | 524 | 1015 | 1521 |
| Hebei | 6 | 10 | 19 | 44 | 44 | 57 | 113 | 397 | 523 | 547 |
| Shanxi | 0 | 5 | 7 | 10 | 3 | 4 | 54 | 86 | 32 | 64 |
| Inner Mongolia | 3 | 5 | 6 | 4 | 11 | 2 | 5 | 85 | 40 | 58 |
| Liaoning | 22 | 91 | 131 | 126 | 257 | 362 | 516 | 1 279 | 1 440 | 1425 |
| Jilin | 7 | 7 | 10 | 10 | 18 | 32 | 75 | 275 | 242 | 408 |
| Heilongjiang | 8 | 14 | 69 | 57 | 28 | 21 | 72 | 232 | 348 | 517 |
| Shanghai | 78 | 214 | 233 | 422 | 174 | 145 | 494 | 3 160 | 2 473 | 2 893 |
| Jiangsu | 24 | 86 | 126 | 127 | 134 | 219 | 1 463 | 2 844 | 3 763 | 5 191 |
| Zhejiang | 15 | 36 | 44 | 54 | 49 | 92 | 240 | 1 032 | 1 150 | 1 258 |
| Anhui | 10 | 3 | 28 | 9 | 14 | 11 | 55 | 258 | 370 | 483 |
| Fujian | 62 | 55 | 145 | 348 | 320 | 471 | 1 424 | 2 874 | 3 713 | 4 044 |
| Jiangxi | 7 | 5 | 9 | 9 | 8 | 19 | 100 | 208 | 262 | 289 |
| Shandong | 27 | 65 | 90 | 163 | 186 | 216 | 1 003 | 1 874 | 2 552 | 2 689 |
| Henan | 5 | 14 | 64 | 46 | 11 | 38 | 53 | 305 | 387 | 479 |
| Hubei | 5 | 26 | 22 | 29 | 32 | 47 | 203 | 541 | 602 | 625 |
| Hunan | 10 | 3 | 13 | 23 | 14 | 25 | 133 | 437 | 331 | 508 |
| Guangdong | 641 | 737 | 1 251 | 1 323 | 1 582 | 1 943 | 3 701 | 7 556 | 9 463 | 10 260 |
| Guangxi | 27 | 45 | 21 | 53 | 36 | 32 | 182 | 885 | 836 | 673 |
| Hainan | 0 | | 117 | 95 | 103 | 177 | 453 | 707 | 918 | 1 062 |
| Sichuan | 22 | 24 | 40 | 13 | 24 | 81 | 112 | 571 | 922 | 542 |
| Guizhou | 6 | | 10 | 13 | 11 | 14 | 20 | 43 | 64 | 57 |
| Yunnan | 1 | 6 | 8 | 8 | 7 | 4 | 29 | 97 | 65 | 98 |
| Tibet | 0 | | 0 | | | | | | | |
| Shaanxi | 15 | 73 | 112 | 97 | 47 | 32 | 46 | 234 | 239 | 324 |
| Gansu | 4 | 0 | 2 | | 1 | 5 | 0 | 12 | 88 | 64 |
| Qinghai | 0 | | 3 | | | | 1 | 3 | 2 | 2 |
| Ningxia | 0 | 0 | 0 | 1 | 0 | 0 | 4 | 12 | 7 | 4 |
| Xingjiang | 7 | 18 | 5 | 1 | 5 | 0 | | 53 | 48 | 55 |
| Total | 1 131 | 1 783 | 3 150 | 3 437 | 3 436 | 4 426 | 11 007 | 27 252 | 33 268 | 37 215 |

Note: Figures exclude investment in central government ministries.

Source: Ministry of Foreign Trade and Economic Cooperation, 1996 and previous years.

GUANGDONG REMAINS A MAJOR INVESTMENT LOCATION

While Guangdong is undergoing a substantial economic restructuring, it remains a preferred location for many international investors. The Guangzhou Economic and Technological Development District has witnessed astonishing growth in the past five years and is now home to 230 international enterprises, mostly in manufacturing, including Procter and Gamble, Amway, Pepsi, Kelloggs, Mitsubishi, ABB, Philips, Nestlé, Pacific BBA, BHP and others. The services sector is developing rapidly, particularly in education, an area of excellent potential for Australia.

In 1996, Guangdong attracted US\$12 billion in contracted FDI, up 12.5 per cent from 1995 and representing almost one third of China's total inbound FDI. According to Austrade Guangzhou, Australian companies do considerable business in Guangdong province, for example:

- almost 25 per cent of Australia-China two-way trade passes through Guangdong
- Australia exports up to A\$1 billion annually to Guangdong
- Australia was estimated to be Guangdong's tenth largest investor and provincial capital Guangzhou's fifth largest investor in 1995
- Australian investment in south China exceeded A\$250 million (contracted) in 1995.

Major Australian affiliated investments in the Pearl River Delta in the past five years include:

| | |
|------------------|---------------|
| ACI Glass | A\$70 million |
| Faulding | A\$40 million |
| Foster's Brewing | A\$37 million |
| CSR | A\$28 million |
| Olex Cables | A\$14 million |
| BHP | A\$12 million |
| Multistack | A\$ 9 million |
| Bundy Tubing | A\$ 5 million |

Source: Austrade, Guangzhou.

Figure 6.2

Industry, Real Estate Major FDI Bases
Accumulated Contracted FDI by Sectors: 1983 to 1995

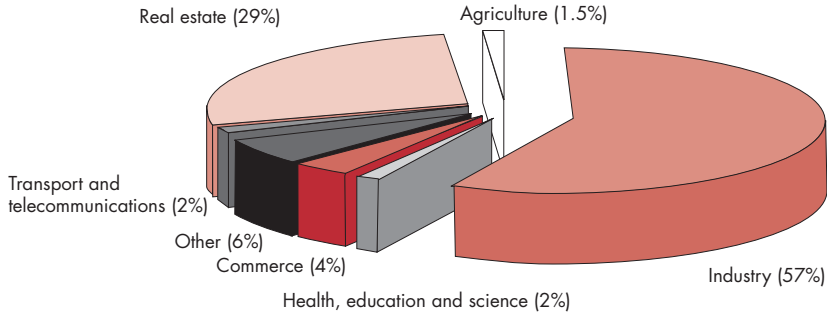
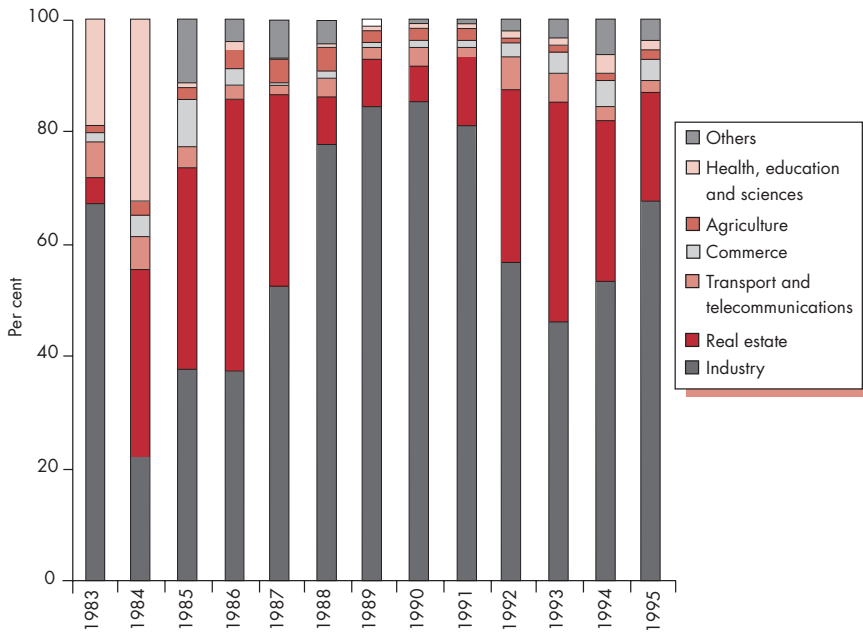


Figure 6.3

Changes in the Sectoral Composition of Contracted FDI:
1983 to 1995



Source: State Statistical Bureau, 1996 and previous years; China Statistical Information and Consultancy Service Centre, 1992, pp. 314-16; and Ministry of Foreign Trade and Economic Cooperation, 1996 and previous years.

ORGANISATIONAL FORMS

China's phased entry of foreign investment is gradually allowing more flexible forms of commercial organisations to emerge. While in the early 1980s, contractual joint ventures¹² and joint exploration contracts were the dominant forms, today equity joint ventures (often with silent partners) and wholly foreign-owned enterprises account for three quarters of FDI.

Table 6.5

Majority Ownership Increasingly the Norm Contracted FDI by Organisational Form: 1983 to 1994

| Year | Total | Equity joint venture | | Contractual joint venture | | Wholly foreign-owned venture | | Joint exploration | |
|------|--------|----------------------|----------|---------------------------|----------|------------------------------|----------|-------------------|----------|
| | | Number | Per cent | Number | Per cent | Number | Per cent | Number | Per cent |
| 1983 | 636 | 74 | 11.64 | 227 | 35.69 | 43 | 6.76 | 292 | 45.91 |
| 1984 | 1 258 | 255 | 20.27 | 465 | 36.96 | 15 | 1.19 | 523 | 41.57 |
| 1985 | 1 661 | 582 | 35.04 | 585 | 35.22 | 13 | 0.78 | 481 | 28.96 |
| 1986 | 1 875 | 805 | 42.93 | 794 | 42.35 | 16 | 0.85 | 260 | 13.87 |
| 1987 | 2 314 | 1 486 | 64.22 | 620 | 26.79 | 25 | 1.08 | 183 | 7.91 |
| 1988 | 3 194 | 1 975 | 61.83 | 780 | 24.42 | 226 | 7.08 | 213 | 6.67 |
| 1989 | 3 392 | 2 037 | 60.05 | 752 | 22.17 | 371 | 10.94 | 232 | 6.84 |
| 1990 | 3 487 | 1 886 | 54.09 | 674 | 19.33 | 683 | 19.59 | 244 | 7.00 |
| 1991 | 4 366 | 2 299 | 52.66 | 763 | 17.48 | 1 135 | 26.00 | 169 | 3.87 |
| 1992 | 11 007 | 6 115 | 55.56 | 2 122 | 19.28 | 2 520 | 22.89 | 250 | 2.27 |
| 1993 | 27 515 | 15 348 | 55.78 | 5 237 | 19.03 | 6 506 | 23.65 | 424 | 1.54 |
| 1994 | 33 766 | 17 932 | 53.11 | 7 120 | 21.09 | 8 036 | 23.80 | 678 | 2.01 |

Source: Ministry of Foreign Trade and Economic Cooperation, 1996 and previous years.

Joint ventures remain the preferred option for foreign investors who see benefits in accessing local partners' skills, markets and contacts, and for central and local governments, which seek to transfer technology, capital and skills to domestic enterprises. Wholly owned ventures are increasingly popular for the control they confer.

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¹² In the past (and at times still) joint venture partners were often assigned to the foreign investor by the authorities; the key objectives were technology and skills transfer, and export production and marketing.

KEY SUCCESS FACTORS¹³

A major 1995 benchmarking study¹⁴ identified key factors common to companies operating successfully in China:

- They have a senior company officer based in China, either running the business or acting as a mentor to the operating divisions.
- They adopt a thorough due diligence approach to partner selection and do not base their choice on governmental referral alone.
- They ensure, where possible, that joint ventures are 'greenfield' operations and that the joint venture partner brings equity, plus access to markets or supplies that are not readily available. They tend to avoid joint ventures that involve existing plant and staff. They control key management positions.
- They have a clearly defined vision.
- They have developed cautiously. They commenced on a relatively small scale, as part of an overall strategy to achieve their vision. They institutionalised the lessons learned as they gained confidence that they could conduct business successfully.
- They take a holistic approach to managing the business. Management structures differ in line with each company's culture and/or what it had found to be the best approach in China.
- They have effective selection arrangements for expatriate and local staff, and create career paths for local staff within their organisations.

Another study (Tretiak, 1996) points out that successful FFEs are generally characterised by:

Location near key market(s): Proximity to core groups of customers is essential as poor transport infrastructure often inhibits long distance transport of finished goods or raw inputs.

Strong management control: Although this often requires a high equity stake some investors with low equity shares are able to maintain effective management control by appointing assertive and capable managers with considerable experience in China to handle daily operations and guide long-term planning.

High equity: Since 3M's 1986 establishment in Shanghai of China's first wholly foreign-owned enterprise outside the Special Economic Zones, central and local authorities have grown more comfortable with the idea of majority foreign equity. FFEs are increasingly either wholly foreign-owned, or 90 to 95 per cent foreign-owned, with a silent local partner who contributes some equity, plus, for example, access to vital people, supplies or markets. Equity stakes are now normally an internal business decision between local and foreign partners, except in pillar industries where majority local ownership is still a condition of investment (for

¹³ Success factors for infrastructure and environmental projects are examined in Chapter 7 - Infrastructure.

¹⁴ Unpublished confidential source.

example, automobiles, chemicals, certain insurance ventures, large scale mining, foreign trading corporations and others).

Ability to repatriate earnings: Despite full convertibility in December 1996 this is still an issue for FFEs experiencing internal difficulties related to partner relations and holding company structures.

Effective transport/distribution capabilities: Securing inputs and distributing products in a timely, reliable fashion can be a major challenge. Companies dealing in perishables find it especially difficult. (See TNT box in Chapter 7 - Infrastructure.)

Sustained government support: This is most critical when an investment application is pending and can be the deciding factor in obtaining incentives and speedy approval. Continued government goodwill is also necessary to ensure assistance as needed and equitable treatment if disputes occur.

Reliable utilities: Few locations have reliable energy and communications supplies. (Advanced investment zones such as the Tianjin Economic Development Area are exceptions.) FFEs must often invest in their own power generators or suspend operations at regular intervals to accommodate power outages.

Advanced technology: Foreign investors remain wary of transferring their highest technology to China. However, local companies and governments are increasingly aware of technological progress and want the most advanced technology; they purchase the highest quality they can afford.

WHAT THE CHINESE VALUE IN FOREIGN INVESTORS

In interviews, Chinese interlocutors consistently identified the following as important qualities in foreign investors and conducive to successful ventures in China:

- understanding China's macroeconomic policies and planning objectives and having a long term view
- adopting a 'comprehensive supply system approach' to investment (international resource companies, for example, are expected to provide raw materials processing, develop energy and transport systems, provide environmental engineering, sell products on home and international markets, and conduct research and training)
- bringing not only capital but also advanced technology adapted to local conditions with the intention of transferring it to Chinese participants
- developing markets locally and overseas
- building mutual trust, understanding and long term relationships, through:
 - understanding and being sensitive to each other's cultures
 - communicating effectively
 - integrating management styles

- developing local managers and technology
- providing effective training and job opportunities
- introducing effective market-oriented management systems
- separating ownership from management by instituting:
 - formal decision-making processes
 - formal personnel policies
 - formal financial and auditing processes
 - codification (filing) systems
 - a corporate culture
 - localised management
- being devoted to sustainable development and environmental protection.

WHAT THE CHINESE DO NOT VALUE

The Chinese also pointed out some significant features of unsuccessful joint ventures:

- foreign investment being initiated without careful planning
- poor market understanding and lack of market research
- inadequate capital and short term speculation
- transferring (or milking) profits to avoid local taxes
- long term dependence on imported parts and components
- inadequate support services
- transfer of outdated technology
- an autocratic management style
- bias against local Chinese in senior management.

FOREIGN INVESTMENT POLICY¹⁵

China's foreign investment policy appears to have developed and matured in three distinct phases (Bora, 1996a):

1. The 1979 *Joint Venture Law*, the initial entry point for foreign investment. This cautious approach was meant to encourage investment in specialised projects and was only moderately successful. The earliest FFEs were in the four Special Economic Zones; later entrants were also able to access the 14 'open cities'.¹⁶
2. China's response to the uncertainty created by the June 1989 Tiananmen incident. Concern that the country might fall into chaos and that the government might even expropriate foreign interests led to very modest FDI growth until 1992, when Deng Xiaoping, during his famous tour of Southern China,¹⁷ indicated his support for economic development assisted by foreign investment and expressed a desire to see the pace of liberalisation quicken. Although not explicitly altering any particular policy, Deng's landmark speech boosted foreign investor confidence and led to renewed interest in China and huge increases in investment (Table 6.2).
3. Embracing foreign investment as a tool for economic development. Specific policies and regulatory measures are being enacted to facilitate foreign investment in some sectors while limiting it in others. At the same time, however, officials have been instructed to be more selective in approving proposed projects and partners (Economist Intelligence Unit, 1996a). However, with provinces being given autonomy to approve foreign investments under US\$30 million, it remains to be seen if this will in fact occur.¹⁸

The next logical step would be for China to progressively liberalise its foreign investment regime, as have most of its East Asian neighbours once they experienced the benefits of foreign investment. In coming years, investor confidence will depend largely on how successful China is in sustaining the momentum of institutional and economic reform, and providing a trained workforce and the infrastructure to support growth.

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¹⁵ Foreign investment policy for infrastructure and environmental projects is covered in detail in Chapter 7 - Infrastructure.

¹⁶ Tianjin, Qinhuangdao, Dalian, Shanghai, Nantong, Lianyungang, Ningbo, Wenzhou, Fuzhou, Qingdao, Yantai, Guangzhou, Zhanjiang, Beihai.

¹⁷ This visit set the scene for China's move away from a command economy in favour of a market-oriented system.

¹⁸ It is not yet clear how much of the suspected slowing in FDI growth in 1996 was due to more selective approvals, how much to less roundtripping and how much to any cyclical 'correction' of FDI inflows.

MULTILATERAL LINKS IN CHINA'S INTERNATIONALISATION

On 11 July 1986, China formally requested to resume its seat in the General Agreement on Tariffs and Trade (GATT - now World Trade Organisation), understanding that it must accept scrutiny of its trade policies and abide by the multilateral trading system's rules. The establishment of the World Trade Organisation (WTO) and its more rigorous system of dispute resolution and wider coverage of trade issues has important implications in terms of abiding by 'global' rules, not only for China (whose accession is still being negotiated), but for all existing and prospective members.

China's membership in the Asia-Pacific Economic Cooperation group (APEC) is another component of its increasing internationalisation. Apart from APEC's goal of free and open trade and investment in the region by 2020, key APEC tasks such as improving trade and investment data, enhancing customs facilitation and establishing mutual recognition agreements, have the potential to significantly facilitate business and trade in the region. China's participation in these processes will complement any formal liberalisation program it may undertake unilaterally, bilaterally or multilaterally (as a WTO member). (See Chapter 5 - International Trade for discussion of China's WTO accession and APEC membership.)

Table 6.6 compares China's current foreign investment policy regime to APEC's investment-related principles. While the APEC principles are limited, partly because they are nonbinding,¹⁹ they do reflect foreign investment policy in the region. They also highlight the major tasks facing developing economies as they attempt to address investment impediments.

¹⁹ See Bora and Graham (1995) for more on APEC Nonbinding Investment Principles.

Table 6.6

Room for Action

APEC Nonbinding Investment Principles and China's Foreign Investment Policy Regime

| Principle | Chinese policy ²⁰ |
|--|---|
| Transparency | <ul style="list-style-type: none"> • 11 laws, regulations and guidelines relating to investment • Approval required for all types of investment proposals • Requires significant documentation in the application process • No specified time period for processing |
| Most favoured nation status | <ul style="list-style-type: none"> • Gives no preferences relating to the establishment, expansion and creation of foreign investment |
| National treatment | <ul style="list-style-type: none"> • Extensive restrictions in various sectors. Move toward national treatment for incentives, which still favour foreign investors |
| Repatriation of profits and currency convertibility | <ul style="list-style-type: none"> • Extensive regulations related to the type of investment • Currency convertibility for trade and investment achieved December 1996 |
| Entry and sojourn of personnel | <ul style="list-style-type: none"> • Application process to obtain a visa |
| Taxation | <ul style="list-style-type: none"> • Eight different taxes affect foreign funded enterprises. Moves to uniform treatment |
| Performance requirements | <ul style="list-style-type: none"> • Exist in some industries, particularly for exports. China is not a member of the WTO, and is not bound by the WTO's Trade-Related Investment Measures (TRIMs) provision |
| Capital exports | <ul style="list-style-type: none"> • Review and notification required for all overseas investment |
| Investor behaviour | <ul style="list-style-type: none"> • Observance of law by foreign investors is explicit in Chinese constitution |
| Expropriation and compensation | <ul style="list-style-type: none"> • Subject to a social and public interest clause • Has signed bilateral investment protection agreements |
| Dispute settlement | <ul style="list-style-type: none"> • Has internal arbitration, conciliation and litigation options, and is a signatory of the International Centre for the Settlement of Investment Disputes (ICSID) convention since 1992 |
| Incentives | <ul style="list-style-type: none"> • A wide range of incentives, but gradually moving to national treatment |

²⁰ This is meant to be an indicative not a comprehensive list (Bora, 1996a).

The APEC Nonbinding Investment Principles target two key government actions: performance requirements and incentives. China uses both to guide investment into target areas. Since it is not a member of the WTO, China is not bound to be disciplined by the WTO trade-related investment measures (TRIMs) provision.²¹

Table 6.6 indicates that China has room for action on each principle, particularly two of the three fundamental principles of international investment: transparency and national treatment.²²

Transparency

Many Asian economies have adopted the ‘one stop shop’ concept, which is a simplified and transparent process for filing and processing applications for foreign investment approval.²³ This facilitates implementation of investment proposals and reduces foreign investors’ administrative costs. China, on the other hand, maintains a very complex application process. Laws are opaque, processing times are not clearly stated, and the application process is ambiguous and discretionary.

National Treatment

National treatment, the equal treatment of foreign and domestic investors, is the cornerstone of any set of principles underpinning foreign investment policy. (This should not be confused with GATT Article III which states that imported and domestic goods must be treated equally.) National treatment as applied to foreign investment parallels Article III but is much stronger since it delivers equal treatment to foreign and domestic investors.

An interesting dimension to this principle is that the wording is usually meant to discipline host governments for what is perceived to be inferior treatment of foreign investors. However, in the Chinese case, the opposite is true: foreign investors are, through incentives, often treated more favourably than domestic investors. Application of this principle will therefore level the playing field between foreign and domestic firms. While abolishing tariff exemptions on FFEs’ capital goods imports is not the same as universal subscription to national treatment, it is a step in the right direction.²⁴

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²¹ Bora considers TRIMs to be a poor instrument; a review of APEC liberalisation showed that only 5 Asian countries had made notifications to the WTO on their trade-related investment measures, mostly content requirements in automobiles (Bora, 1996a).

²² The third principle is *nondiscrimination*, but APEC has subscribed to this in an unconditional manner. Also, as a point of clarification, the *right of establishment* is usually considered a fourth international principle. However, the APEC nonbinding investment principles could not separate this principle from *national treatment*. As a result, *national treatment* applies to the establishment, expansion and operation of foreign firms.

²³ In APEC (1995b), the Republic of Korea is singled out as a good example of a country that has adopted and implemented this initiative.

²⁴ There is a debate over how rigidly national treatment should be applied to developing countries. In the case of Malaysia, much of its stock of foreign investment was the direct result of investment incentives and protection used to encourage infant industry in the late 1970s. The maturing industry now relies less on incentives.

By removing advantages that only foreign firms enjoy, China can overcome jealousy among domestic entities and abuse of the system (such as ‘roundtripping’). However, if it is too vigorous in removing FDI incentives, China may find itself disadvantaged vis-à-vis its regional competitors for investment. Bora and Pangestu (1995) suggest that Indonesia has experienced some diversion of foreign investment to China. Other countries have also, and a number are fighting back with aggressive new investment promotion campaigns and policy reforms relaxing restrictions on FDI. While China favours an interventionist view and uses incentives freely, along with others, it may soon have to curtail restrictive policies as pressure builds to include investment on the WTO agenda.²⁵

Sectoral Restrictions

The box below shows how China uses a policy of ‘encouraged’, ‘restricted’ and ‘prohibited’ foreign investment categories to control and direct inward FDI to specific sectors.²⁶ Many developing economies are progressively abandoning this practice in favour of more market-oriented policies which recognise that a host nation can secure the full benefit from FDI only when market distortions are minimised, subject to a sovereignty safeguard provision.

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²⁵ This agenda relates more to removing restrictions on FDI than to restraining countries from offering incentives (although the latter can lead to unconstructive bidding wars). There is scope for China to benefit from the APEC process on investment through other avenues such as the technical assistance program and measures to increase transparency (Bora, 1996a).

²⁶ Restrictions on foreign investment in infrastructure and environmental projects are covered in Chapter 7-Infrastructure.

SECTORAL RESTRICTIONS IN CHINA'S FOREIGN INVESTMENT POLICY

The 1979 Joint Venture Law established the framework for foreign investment in China. This was followed in June 1995 by the Provisional Regulations for Guiding Foreign Investment, which categorise investments as 'encouraged', 'restricted', 'permitted' and 'prohibited'.

Encouraged investments:

- providing new agricultural technology
- providing new or advanced technology
- meeting international market demand
- involving comprehensive use of renewable resources, new technology and equipment for environmental management.

Restricted investments:

- using technology developed in, or introduced into China for which existing production capacity can meet domestic demand
- joining monopolies or state 'experimental' industries to absorb foreign investment (translated directly from Chinese and open to interpretation)
- exploring for and exploiting rare or valuable mineral resources
- involving industries subject to state planning and otherwise restricted by state law and regulations.

Prohibited investments:

- jeopardising national security or social and public interest
- polluting the environment, destroying natural resources or harming public health
- occupying extensive farmland, acting against protection of land resources, harming security and military effectiveness
- manufacturing products with Chinese developed and owned know-how or technology
- other projects prohibited by state laws and regulations.

Source: APEC (1996).

Dispute Resolution

Numerous studies highlight the difficulties of enforcing contracts in China (Economist Intelligence Unit, 1996a). Current efforts to introduce an enforceable dispute resolution process will improve China's foreign investment climate, as will China's recent accession to the International Centre for the Settlement of Investment Disputes. However, it will take many years to develop an institutional basis comparable to, say, Singapore or Hong Kong. (See Chapter 3 - Market Environment for progress in dispute resolution mechanisms.)

As China continues to seek more technology intensive investment activity, pressure is building to improve private property rights protection. Hence, intellectual property protection and adequate dispute resolution mechanisms are increasingly important issues in attracting the new wave of larger Western multinational companies. High profile disputes over intellectual property rights, such as those between the USA and China, may deter such companies from investing in China.

Risk Management

Companies doing business in China, as in any country, must manage the risks carefully. (See Risk Management box.) While China has developed policy initiatives to deal with many issues related to the overall business climate (see Chapter 3 - Market Environment), it is ultimately companies' responsibility to ensure that their risk-return balance is managed well.²⁷

One area that has generated difficulties in recent years is credit risk. While the central Government, with foreign exchange reserves of US\$100 billion, has a strong credit rating, many provinces, municipalities and state-owned financial institutions and enterprises do not. In the past, foreign suppliers overcame the problem of poor creditworthiness among lower level sovereign entities by securing payment with either a sovereign guarantee or a letter of credit from a top bank.

However, as commercial opportunities and competition for Chinese business expand, Chinese buyers have been able to reject requests for sovereign guarantees and letters of credit. The central Government has also become more reluctant to extend sovereign guarantees for fiscal policy reasons. (See Chapter 7 - Infrastructure.) So-called 'open account terms' (invoicing the importer directly) are becoming increasingly common.

Exporters, their financiers and their credit insurers now face the challenge of assessing the buyers' and borrowers' creditworthiness, a difficult task given scant credit information. China's credit checking industry is in an early stage of development; many local enterprises have poor accounting practices; and it is uncertain to what extent the State will cover SOEs with bad debts. China is therefore being urged to move to international accounting norms and, at the very least, clarify the extent to which SOEs will receive financial assistance in a payments crisis. (See Chapter 3 - Market Environment.) This could reduce considerably the risks facing foreign suppliers and trade creditors/insurers, and ultimately improve trade and investment flows.

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²⁷ Risk management in infrastructure and environmental projects is covered in Chapter 7-Infrastructure.

COUNTRY RISK ANALYSIS

Companies use country risk analysis to assess various categories of risks for their businesses. Typically, four key factors determine the overall risk for investments: political, domestic and external factors, and the investment climate. Often these are weighted to reflect the risks for a particular project. Similarly, the questions posed should take into account the project's particular requirements. A sampling of typical questions is included below. This report will provide many answers, but companies should seek updates and advice as they do their own risk analyses.

Political factors

- Is the political environment stable?
- How well developed is the institutional framework?
- How consistent and transparent is the policy-making process?
- How credible is government policy?
- What is the risk of external conflict?

Domestic factors

- What is the outlook for the domestic economy (growth, inflation, consumption, income, savings, investment, debt, fiscal policy, etc)?
- What are the danger points?
- How successful has the country been in achieving its projected or potential growth? How well managed is the economy?
- Is the right infrastructure in place to support this business?

External factors

- Is the country willing and able to fulfil its payment obligations?
- Does the balance of payments indicate any cause for concern?
- Is the current account position positive or manageable?
- Is the level of foreign reserves healthy?
- Is the exchange rate valued realistically?
- How open is the economy?

Investment climate

- How receptive is the foreign investment regime?
- How transparent and consistent is the investment process?
- What is the risk of expropriation or nationalisation?
- What is the risk of contract repudiation? How effective are dispute mediation mechanisms?
- What is the exchange rate risk?
- What is the risk of nonpayment?

INVESTMENT LIBERALISATION CHALLENGES AND PROSPECTS

Since 1979, foreign investment has played a crucial role in internationalising China's economy and trade, introducing capital, technology and management and marketing skills, instigating microeconomic change and efficiencies, and trialing prospective reforms. In addition to the large investors initially sought by the Chinese Government, thousands of small and medium sized companies, particularly involving overseas Chinese, have invested in China over the last decade and a half, making a major contribution to output, employment and export growth.

China will continue to require vast amounts of foreign capital, technology and expertise if it is to sustain the momentum of its development. In addition to needing massive foreign investment in infrastructure, China is attempting to attract the large multinationals that can add value in the manufacturing and service sectors. Many of these large companies, however, answer to demanding (and cautious) boards and shareholders who often require faster returns, more control and less risk than the China market can currently offer.

The challenge now is for China's foreign investment policy to underpin foreign firms' competitiveness to ensure innovation, best practice and continued investment. Reducing the list of restricted sectors (including granting market access and improving operating conditions in such areas as banking, insurance, distribution, and legal and accounting services) is one area for attention. Another is addressing the issues highlighted in Table 6.6, APEC Nonbinding Investment Principles, especially transparency and national treatment. Strengthening the institutional and market frameworks will significantly enhance the business environment; this is what will attract and keep foreign investors in the long run. Moreover, successfully addressing these issues will strengthen domestic firms as well as FFEs, enhancing China's international competitive advantage.

The next five years could well prove to be decisive for the future of foreign investment in China. Analysing which companies succeed and why will provide an insight into longer term investment patterns, which in turn could give an indication of China's longer term directions of growth.

China's steady foreign investment policy liberalisation over the past 15 years, including the recent easing of access to the banking, insurance, distribution and retailing sectors, augers well for continued FDI inflows. While there is widespread recognition among all levels of government of FDI's tremendous contribution to the economy, restrictions will remain on foreign participation in some sectors (especially where SOEs dominate) to permit them to improve their efficiency and competitive position before being exposed to international competition. The medium term goal, however, is to open all these sectors.

Competition for investment among the different regions of China and within Asia should maintain the long term momentum for reform and improvements in the business environment. At the same time, the more developed coastal provinces' attempts to select foreign investment will reinforce rising labour and land cost pressures in the more popular FDI destinations, encouraging investors to look to

newly developing locations outside the major urban areas. (See Chapter 8 - Regions.) The challenging environment and strong competition will ensure that only well prepared and well managed enterprises with good products and a flexible approach will prosper.

Appendix 6.1

LESSONS FROM AUSTRALIAN INVESTORS IN CHINA

The following companies which are operating in China were interviewed in 1996 for this report.

AMCOR

Packaging

Amcor has four operations: 2 wholly owned in Guangdong and Beijing; 2 joint ventures in Shangdong and Beijing via Singapore subsidiary Leigh Mardon Pacific Packaging, since 1993.

China is encouraging foreign investment in the packaging sector (nearly 2 per cent of industrial output) to ease shortages, secure modern manufacturing methods and reduce pollution caused by old factories.

- **Select a growth sector where your expertise is needed.** Amcor is the world's seventh largest packaging company.
- **Fill a gap in the market.** Amcor set up a successful venture to service multinational corporations in Beijing.

AWA

Communications, Road and Air Traffic Systems, Aerospace (export/import)

AWA has had a representative office in Beijing since March 1993 and a joint cooperation venture with the Ministry of Electronics Industries in Tianjin.

- **Develop two-way business with China.** AWA sells communications equipment and air and road traffic control systems; imports consumer electronics; transfers considerable technology; and trains up to 100 Chinese engineers each year.
- **Develop strong links with the ministries that oversee your business sectors.** AWA has developed good relationships with senior bureaucrats.
- **Seek concessional financing** for procurement contracts through multilateral and bilateral agencies. AWA has been quite successful in tapping the World Bank and other institutions, and was the first Australian company to win a contract in China using Japanese OECF soft yen loans (East Asia Analytical Unit, 1996, p. 106).

- **Expect teething problems** such as contract disagreements, pricing discrepancies, quality control issues, cultural misunderstandings, intellectual property protection, etc. These occur in any new venture no matter where it is located.
- **Add a margin for ‘shrinkage’.** AWA adds 5 per cent by weight when shipping small components such as nuts, bolts, washers.
- **Be well organised, extremely thorough and cautious.**

BIG M

Flavoured Milk

Big M has a joint venture: Tianjin Vic Foodstuff Corporation, established in June 1995 between the Victorian Dairy Foods (controlled by the Victorian Dairy Industry Authority) and the Tianjin State Farm Bureau’s Ling Yun Beverage Factory. Manufactures and distributes Long-Life Big M flavoured milk in 250ml TetraPak cartons.

- **Choose the right partner and understand the skills it can bring to the venture.** Ideally, the Chinese partner should bring a business site, local market knowledge, distribution skills, access to raw materials and political connections. It is important to understand the skill levels of staff likely to be brought to the joint venture by the partner. Don’t assume that sales people necessarily understand the difference between trading and marketing a product. It may also be wise to anticipate resistance to new approaches from some staff members and be prepared to deal with it.
- **Control key senior management positions.** If possible, secure the decision-making power to hire or fire the chief executive officer of the venture. This usually means having the majority shareholding on the joint venture board. The chief executive officer should have a good understanding of both Western and local business practices, as well as of the Chinese market and culture.
- **Don’t assume that physical infrastructure or human resources will be available.** In many parts of China, the level of physical infrastructure and availability of specialist service providers such as transport companies, market research agencies, recruitment consultants and others, are well below what many Western companies are accustomed to. It is therefore important to structure your operations so that they do not rely on external providers.
- **Distribution is the key.** It is important to concentrate heavily on distribution, to start locally and distribute within your own area using your own people where possible. As you learn more about the market, you can expand. It is a serious mistake to rely initially on long distribution lines.
- **Carry out thorough market research.** Although Big M was able to conduct some market research, including product sampling in several Chinese markets, inadequate funds were available for tracking work on the initial television advertising campaign to ascertain its effectiveness. Differences

between Chinese and Western markets make it important to follow up any initial promotional activity to ensure that it is reaching the target segments.

- **Identify a market niche and position your product accordingly.** When launching into a new market where knowledge of your product is nil (dairy products are not widely consumed in China), it is important to position the product appropriately to ensure consumer acceptance and retailer confidence. It is very important to set a credit strategy that will ensure prompt collection and minimal aged debts.
- **Understand your competitors.** Although no competitors may exist when initial feasibility studies are undertaken, it is likely that competitors will be in the market before your product is launched. It is prudent to expect them to react through price cuts and other tactics.
- **Don't choose a market just because its advertising costs are low.** Don't be lured by low advertising costs; generally these reflect the true value of the advertising medium.
- **Register your trademarks early.** Big M was registered in both Chinese and English prior to launching.
- **Expect the unexpected.** Be flexible, focused and determined. The Chinese market is changing very rapidly, and companies need to have a flexible approach to managing this change.
- **Expect introducing a new product to take a long time and substantial human and financial resources.** The Chinese market is only for those with a long term horizon and considerable resources.

FH FAULDING

Pharma Group: Pharmaceuticals

FH Faulding has a 90 per cent holding in Foshan Horizon Pharmaceutical Co in Guangdong; joint venture partner: Guangdong General Pharmaceutical Co.

China has targeted the pharmaceuticals sector for development to supply a rapidly growing domestic market and to export. It aims to have 10 large advanced pharmaceutical groups by 2010. Imports have declined from around one third of consumption to one tenth in recent years. China could be the world's largest pharmaceutical market by 2020 (now seventh).

- **'Deals from heaven' do happen, but executives with considerable experience in China are crucial to take advantage of them.** Faulding, which was not planning to enter China for some years, was approached in 1994 by the Canadian firm that had negotiated the joint venture with an SOE and wanted to sell its interest *in toto* due to unrelated matters. The pharmaceutical manufacturing, marketing and distribution venture had been very well negotiated, including a staff reduction of 30 to 40 per cent, had no export obligation and had no transfer of technology obligation. All local approvals were in order, making it 'too good to refuse' (Chief Operations Executive of Pharma International who has two decades of

experience in Asia and China, including selling pharmaceuticals to China out of Hong Kong).

- **Expect teething problems in upgrading production.** It took Faulding a year to replace an expatriate drug manufacturing specialist who quit unexpectedly. The COE expects it to take five years to achieve reasonable international production, technology and labour quality standards.
- **Don't believe all assurances; do your own research.** Faulding had been assured that it had 'semi-exclusive' rights to two products; it turned out that one of the products had a major Chinese supplier and the other an established international supplier.
- **Understand how territorialism can create barriers to entry.** It has been difficult to establish a presence for those two products in north and east China due to strong regionalism among firms aligned to the above-mentioned competitors.
- **Don't expect Western marketing methods to always work.** In just 12 months, Faulding has been able to establish a national network with 70 sales representatives in 21 cities of over 1.5 million population. Because drugs are distributed quite differently from Australia, Faulding has set up two teams: one to sell to hospitals and one to focus on distributors, the three tiers²⁸ of which account for most pharmaceutical sales. There is no GP network and no difference between prescription and over the counter drugs. However, Faulding expects more direct sales to develop in the emerging pharmacy sector.

GEO-ENG

Irrigation and Coal Consultancies

Geo-Eng has had joint ventures in Wuhan and Beijing, since 1993.

Formed from a staff buy-out of the State Electricity Commission of Victoria's geotechnical services division when SECV was privatised, the Geo-Eng Group now has branch offices in Melbourne, Perth, Kota Kinabalu (Malaysia), and Wuhan and Beijing.

- **Get the structure right early.** The joint ventures were established with equality in mind. A 50/50 structure was adopted with the best of intentions, but the lack of a majority shareholder has caused several stalemates to develop over the years.

²⁸ Tier 1: relatively few state-owned enterprises in Beijing, Shanghai and Guangzhou.

Tier 2: 'about 100 firms, from which one has to choose carefully to avoid those which are manufacturers in their own right run by local governments which might wish to block competitors' products, or those which on-sell unreliable third-line distributors' goods, or those which sell on their own account and may have payment difficulties.'

Tier 3: 'debt-ridden firms - not reliable partners.'

- **Closely examine the fine print of contracts and agreements.** Asserting general management responsibility has been a problem in Beijing. A particular issue has arisen over agreeing who takes charge, and how, when the expatriate general manager is away.
- **Don't set your sights too high.** Many companies set very optimistic earnings projections, often based on an assumption of securing significant work for local organisations. Local ability to pay for Western input is limited, and projects often do not leave the design board due to lack of funding. Consultants generally need to focus on overseas funded projects, or those undisputedly requiring Western technology.
- **Be prepared to put in time on the ground.** A major and consistent effort is required to ensure that management, administrative and operational systems are in place, particularly if the foreign partner does not plan to have a full-time manager in China. 'Fly in-fly out' arrangements will not deliver success. Companies are recommended to tap into expertise available in China and Australia, for legal and practical skills and experience. The Western partner will spend more time in China than initially expected or budgeted for.
- **Have a clear and shared vision.** A shared vision is an imperative for any business, and even more so for a joint venture. If the board in particular and staff do not focus their energies in the same direction, frustration and poor corporate performance will result. In the case of Geo-Eng's Beijing-based joint venture, the Chinese partners envisaged an organisation with a narrow focus and scope, established on the basis of a few Western technologies. The Australian partner envisaged a 'linking' company that would capitalise on both partners' strengths. Among other problems, this difference led to inappropriate Chinese senior management appointments. Geo-Eng strongly recommends clearly establishing the composition and alignment of the people at an early stage to avoid stagnation.

MACQUARIE TEXTILES

Woollen Mills

Macquarie Textiles has two joint ventures with French wool processor Chargeurs²⁹ and Chinese partners³⁰, in Beijing since 1986 and Fujian since 1988.

China's textile and garment industries are growing strongly, accounting for a quarter of total exports and employing more than 15 million people. They offer good opportunities for companies prepared to inject modern technology, design and management expertise and to build up skills in sales, purchasing and quality control.

- **Find a good partner.** Macquarie and Chargeurs via Lana employed a former Australian ambassador to China to help select partners and negotiate the first venture. Ten years down the track, both Chinese partners seem happy to

²⁹ Macquarie and Chargeurs have a 50/50 joint venture called Lana, registered in the Dutch Antilles.

³⁰ Beijing No. 1 Cotton Spinning Mill and Zhangshou Jute and Wool Co.

let Lana run the venture; it supplies technology and management skills, procures raw materials from Australia and Germany, and handles sales and marketing.

- **Introduce suitable technology.** ‘It doesn’t make much sense to go overboard with the latest robotics when labour is so abundant and when much advanced technology already installed in Chinese mills is underutilised.’
- **Exercise foresight.** Aware that labour quality and standards would pose a major challenge, Lana decided to recruit rather than retrain the cotton mill’s existing workforce. It drew supervisors mainly from Shanghai, the centre for skilled textile workers, and fashioned a culture emphasising cleanliness, consistent quality and attention to detail.
- **Strategic positioning can benefit Australian operations.** The China mills provide Macquarie’s Albury plant with a price competitive semiprocessed input that has allowed it to compete better internationally.

MULTISTACK INTERNATIONAL

High-tech Water Chillers for Cooling Systems

Multistack International has had a licensing agreement with Hong Kong-based Super Link³¹ to produce multistacks in Panyu, Guangdong, since 1988.

The burgeoning construction sector has created strong demand for temperature and humidity control equipment and technology.

- **Understand the market. Effectively use the local partner and look at all the influences in the chain.** Do not underestimate the central Government’s macroeconomic policy’s impact on business cycles (in particular, on the construction industry).
- **Build up relationships with local engineering and design institute networks and with relevant ministries in Beijing.** Multistack says the local partner’s initiative and invaluable contacts were an essential element in its success. By 1994, it ranked second in the Chinese market, behind US giant Carrier.
- **Invest in training, after-sales service and preventative maintenance. Adapt the product and strategies to the Chinese market.** Carrier has spent 15 years training locals and developing relationships. Certain other US competitors have failed because they refused to change their American methods.
- **Don’t become too dependent on cash flows from China.** With Chinese sales contributing 70 per cent of Multistack’s EBIT in the early 1990s, the company began to feel ‘hostage to China’s growth’.

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³¹ Super Link formed a joint venture with Panyu Light Industry No. 2, called Panyu Jiefung Co. Multistack supplied technology and the more complex components, while Super Link sourced simpler inputs locally and multistack compressors from Multistack’s US operations. These were assembled at a purpose built factory and sold as a foreign product at local prices.

- **Don't lose control.** In December 1994, Super Link acquired 59 per cent of Multistack in order to equalise the benefits of the Chinese operations and to reduce Multistack's vulnerability to takeovers. The CEO function is now performed by a three-man executive committee comprising one Multistack director and two Super Link directors; it makes unanimous decisions.
- **Don't assume that fast growth will last forever, or that Western measures of consumption and utilisation will ultimately prevail.** Multistack assumed that its Chinese cash flows would remain strong for another five years, based on assumptions that demand for air conditioning would continue to rise rapidly. Cooling represented only 5 to 6 per cent of total power consumption versus 25 to 30 per cent in industrialised nations. However, the construction sector crashed due to the Government's anti-inflationary and anti-speculation measures, inadequate infrastructure and oversupply of office and luxury residential accommodation in many cities. Multistack's profits fell from A\$13.8 million in 1995 to an operating loss in 1996, and are only expected to return to their 1995 levels in 1998-99.

COLONIAL MUTUAL AND NATIONAL MUTUAL

Life Insurance

Colonial Mutual has had a presence in China since 1994, with representative offices in Beijing and Shanghai. National Mutual has, since 1993, opened representative offices in Beijing, Shanghai, Guangzhou, and is awaiting approval in Chengdu, Wuhan, Dalian.

Although the potential of the Chinese insurance market cannot be reliably measured³², as other large markets near the saturation point, China is seen as the new frontier. Some 80 international insurance companies have set up more than 130 representative offices around China in the hope of winning an operating licence.³³

- **Be prepared to actively lobby your case in an extremely competitive and often opaque environment.** Australians should not be shy in competing with Americans and Europeans, and should enlist the help of the Australian Government. The State Council tends to determine licences on the basis of which country's turn it may be - and only then assesses an individual company's merits.
- **Other Asian markets can be a useful testing ground.** Through its wholly owned subsidiary CMG Asia, Colonial Mutual has 142 offices and over 17 000 staff and agents in Asia, making it Australia's most extensive retail

³² Life product premiums now account for 30 per cent of China's total insurance market (1 per cent in 1979), still far short of Asia's average of 72 per cent (*The Economist*, 11 July 1996). Nonlife products are expected to account for 45 per cent of the total by 2000 (Reuters, 20 December 1995).

³³ Four licences had been issued to the end of 1996: American International for Shanghai and Guangzhou, Tokio Marine & Fire for Guangzhou, Canada's Manulife joint venture for Shanghai, and Switzerland's Wintherthur (nonlife) for Shanghai. All coastal cities are to be opened to foreign insurers by 2000. However, future licences are expected to require joint ventures with one of the new domestic insurers spun off from the state-owned insurance enterprise, China Insurance Group (79 per cent market share).

financial services network. It has wholly owned life insurance firms in Hong Kong and the Philippines, and joint ventures in Indonesia, Thailand and Malaysia. Colonial also has a consulting business in Singapore and representative offices in China and Vietnam. National Mutual, through its subsidiary National Mutual Asia, has secured at least 20 per cent of the Hong Kong life products market, second only to AIA and ahead of Canadian Manulife. Its door-to-door sales approach will be the foundation of the China business, once a licence is won.

- ***Demonstrate a commitment to China, and be prepared to spend money on it. Try to differentiate yourself. Ensure that the money is well spent on activities valued by the Government and that the benefits are attributed to your firm.*** National Mutual has set up a US\$1.2 million Financial Education Foundation; conducted in-house training (in Melbourne and Hong Kong) for Chinese financial professionals; funded insurance study centres at universities; engaged in a corporate tie-up with the influential state-owned China Everbright Group³⁴; and set up the AXA/National Mutual China-Asia No.1 Fund to direct US\$500 million into direct investment, with a 75 per cent China exposure.³⁵ Similarly, Colonial Mutual has supported the establishment of the Australian Insurance Institute's examination centre at Beijing's Central University of Economy and has set up a professional executive management training course in life insurance. It also established an investment fund in early 1997.
- ***Carry out extensive market research.*** National Mutual's national survey to identify potential buyers of life products in the 13 to 15 largest cities indicated that 20 to 25 million urban residents could afford about ¥ 750 (US\$90) per year for insurance policies. Colonial Mutual has conducted similar research, which supports these findings.
- ***Develop relationships diligently and systematically.*** While China's regulatory system is developing rapidly, and corruption is not a major issue in insurance licences, building connections at all levels remains of paramount importance.

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³⁴ China Everbright, like the huge state investment trust CITIC, is controlled by the State Council, the central government's executive arm. In November, National Mutual sold a 5 per cent interest to the Hong Kong-listed China Everbright-HD Pacific, and bought a 8.7 per cent interest in China Everbright's Hong Kong subsidiary. National Mutual finds this relationship very good for testing ideas and exchanging information.

³⁵ They plan tripartite equity joint ventures in high-growth companies in the consumer and industries sectors (such as retailing and electronics). The concept is to combine Western production and management expertise and technology with local companies' market knowledge and connections and National Mutual/AXA's capital.

PACIFIC BBA

Construction Materials and Plastic Packaging

Pacific BBA has two joint ventures and since 1993, one wholly owned plant.

China is the world's fourth largest plastics producer after the USA, Japan and Germany. About 25 per cent of the annual 7 million tons output goes into packaging and another 25 per cent into daily use items. Local production of plastic packaging, building materials, agricultural materials and engineering plastics is given priority.

- ***Don't jump into things.*** Pacific BBA's strategy for its second joint venture to enter the Chinese plastic packaging market was to take it one step at a time. First it sought the assistance of Austrade, international management consultants and others to find the ideal partner who could add value to the project. It finally ('after much door-knocking and many banquets') joined forces with Changzhou Juli Plastics Enterprise, Jiangsu manufacturers with substantial interests in plastics. They formed a 51/49 joint venture to produce a range of plastic pails, industrial coatings and building products.³⁶ The firm was located in a corner of the state-owned Chinese partner's plant, allowing Pacific BBA to introduce by example its management and work practices. The venture has been very successful to date, with many cash sales and rapid bill settlement.
- ***Sometimes going it alone is best.*** While local partners have a lot to offer in negotiating with local and provincial governments and providing local market knowledge and physical facilities, this must be weighed carefully in terms of control over vital processes (such as management, production, marketing). Pacific BBA decided to set up a wholly owned plastics venture, Guangzhou Viscount, in 1996. It feels that it has gained sufficient experience through the Changzhou joint venture to run a plastics plant. The Webforge joint venture partner, Guangdong Economic and Development Authority, is an ally. Distribution is not an early issue as a contract with an Australian multinational customer located next door will take the plant through the tricky 2 to 3-year start-up period, and the plant will eventually service other multinational customers in the Guangzhou region (including Pacific BBA customers from Thailand and Malaysia). Finally, Pacific BBA will have total control, avoiding many of the problems inherent in joint ventures.

³⁶ Increased to 60/40 with the cooperation of the Chinese partners due to the need for more capital.

Appendix 6.2

Appendix Table 6.1

Contracted FDI Inflows by Sector: 1983 to 1995
 (US\$ millions)

| Sectors | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|-------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|--------|--------|---------|--------|--------|
| Agriculture | 18 | 79 | 126 | 104 | 172 | 252 | 132 | 138 | 226 | 740 | 1 219 | 981 | 1 736 |
| Industry | 1 282 | 632 | 2 384 | 1 235 | 2 261 | 4 804 | 5 317 | 5 943 | 10 055 | 33 201 | 51 644 | 44 294 | 61 648 |
| Construction | 57 | 78 | 133 | 53 | 55 | 119 | 67 | 181 | 134 | 1 839 | 3 878 | 2 394 | 1 918 |
| Transport, telecommunications | 60 | 84 | 106 | 33 | 16 | 91 | 52 | 36 | 99 | 1 547 | 1 520 | 2 030 | 1 697 |
| Commerce | 39 | 110 | 526 | 100 | 29 | 64 | 67 | 107 | 176 | 1 444 | 4 606 | 3 922 | 3 427 |
| Real estate | 95 | 962 | 2 271 | 1 617 | 1 471 | 530 | 524 | 452 | 1 504 | 18 080 | 43 771 | 23 862 | 17 835 |
| of which: hotel | 95 | 940 | | | 1 271 | 369 | 240 | 76 | 239 | 723 | 1 482 | | 936 |
| Health | | | 52 | 16 | 11 | 5 | 36 | 38 | 64 | 395 | 480 | 1 983 | 837 |
| Education, culture | 366 | 931 | 4 | 40 | 14 | 44 | 7 | 5 | 56 | 97 | 452 | 608 | 345 |
| Sciences | | | 7 | 0.2 | 1 | 7 | 4 | 32 | 19 | 62 | 588 | 274 | 278 |
| Exploration | | | | | | 2 | | 0.4 | | 3 | 81 | 54 | |
| Banking and insurance | | | | | | 12 | | | | 8 | 79 | 436 | |
| Others | | | 725 | 131 | 289 | 259 | 88 | 53 | 89 | 1 322 | 3 650 | 2 251 | 1 561 |
| Total | 1 917 | 2 875 | 6 333 | 3 330 | 4 319 | 6 191 | 6 294 | 6 986 | 12 422 | 58 735 | 111 967 | 83 088 | 91 282 |

Appendix 6.3

CHINESE INVESTMENT ABROAD

Chinese outbound FDI (not including portfolio investments) totalled US\$18 billion in 1984 to 1995; 70 per cent of this was accumulated since 1992 (MOFTEC, Balance of Payments). This cumulative figure is more or less consistent with the UNCTAD World Investment Report 1996, which shows US\$19 billion for Chinese FDI in 1984 to 1995.

Appendix Table 6.2

China World's Sixteenth Largest Source of FDI

| Source country | Cumulative outflows US\$ billions | Share of world total per cent | World ranking |
|----------------|--------------------------------------|----------------------------------|---------------|
| USA | 410.8 | 19.0 | 1 |
| Australia | 36.3 | 1.7 | 13 |
| China | 19.1 | 0.9* | 16 |
| World Total | 2 157.4 | 100.0 | |

Note: China's cumulative FDI in 1992 to 1995 accounted for 1.4 per cent of the world total.

Source: United Nations Conference on Trade and Development, *World Investment Report 1996*.

During the same period, unregistered outflows have also risen rapidly, reflected in the rapid increase in errors and omissions reported in China's balance of payments: US\$58 billion in 1984 to 1995, including US\$46 billion in 1992 to 1995.

In compiling FDI data, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) divides FDI outflows into two categories:

- 1 FDI by 'nontrade' enterprises in production, resources development and contract projects; and
- 2 FDI by 'trade' enterprises in technology, transport, communications, finance, banking, catering, tourism, consultancy, medical and other areas.

The nearly 2 000 nontrade enterprises had cumulative FDI totalling US\$2 billion in 1995 (featuring numerous small investments in the USA and Hong Kong and large investments in Canada and Australia), while the 3 000 trade enterprises had US\$3.5 billion (60 per cent in Hong Kong). However, MOFTEC figures for nontrade enterprises in particular may be unrealistically low, partly because they only reflect investments registered with the Ministry.

An OECD 1996 working paper, *Outflows of Capital from China*, by David Wall claims that Australia receives among China's highest-quality FDI, as demonstrated by relatively small equity shares in large joint ventures. Some of the major investments are shown in Appendix Table 6.3.

Appendix Table 6.3

Known Investment from North China in Australia

1. Known Chinese Investment by State-Owned Enterprises

| Name of the company | Project | Nature of the investment venture | Value input from Chinese |
|---|--|---|------------------------------------|
| Ministry of Metallurgical Industry | Mt Channar mine | Joint venture | A\$120 million |
| CITIC | Portland aluminium smelter | Joint venture | A\$130 million |
| | Metro Meats | Wholly owned | A\$103 million |
| | Real estate: - commercial - residential | Wholly owned | A\$25 million A\$1.74 million |
| | CITIC Australia Foods | Wholly owned | A\$33 million |
| | CITIC Chemical Trading Company | Wholly owned | A\$36.79 million |
| | CITIC Fashion Group | Wholly owned | A\$19.76 million |
| China Non-Ferrous Metals Import and Export Corporation | Mine development (research and prefeasibility) | | A\$70 million |
| | Office Building | Wholly owned | A\$24 million |
| China National Textile Import & Export Corporation | Cotton farm | Wholly owned | A\$12 million |
| Bank of China | Finance and real estate (hotel) | Wholly owned venture | A\$80 million |
| Beijing Real Estate Development Corporation | Real estate (residential) | Joint venture and/or wholly owned venture | A\$120 million |
| Beijing Tong Rentang Group Corporation | Pharmaceutical Manufacturing (Pilose antler) | Joint venture | A\$350 000 |
| Shanxi Foreign Affairs Service Centre | Ostrich farming and processing | Joint venture | A\$750 000 |
| Guilin International Electric Wire/Cable Group Corporation | Cable manufacturing | Joint venture | approx. A\$7 million |
| Various state farms | Agri-farm businesses | Joint ventures/wholly owned ventures | approx. A\$30 million ¹ |
| Various large state-owned enterprises under relevant ministries | Real estate/hotel | Joint ventures/wholly owned ventures | approx. A\$70 million ² |

2. Known Private Chinese Investment

| Name of the company | Project | Nature of the investment venture | Value input from Chinese |
|--|--|----------------------------------|--------------------------|
| Beijing Jishiji Company | Hotel | Wholly owned | A\$12 million |
| Qingdao Today Company | Exhibition centre | Wholly owned | A\$5 million |
| Beijing Lianheng Trading Company | Manufacturing (T-shirts) | Joint venture | A\$500 000 |
| | Date tree plantation | Wholly owned | A\$900 000 (initial) |
| Tianjin Makbam International Trading Company | Manufacturing (plastic cement product) | Wholly owned | A\$1 million |
| East Asian Xin-xin Development Inc | Real estate (residential) | Wholly owned | A\$1.8 million |
| Beijing Guoshiquan Group Corporation | Real estate (residential) | Wholly owned | A\$3 million |

Note: 1: Based on partial data released from the Ministry of Agriculture.

2: Based on partial data from MOFTEC.

Source: Austrade.

*Appendix 6.4***AUSTRADE ASSISTANCE TO INVESTORS IN CHINA**

In addition to assisting Australian exporters, Austrade also helps companies to establish business operations in China. Because of the particular characteristics of the Chinese market, forming a joint venture or wholly owned enterprise is often the most effective way to access business opportunities and develop trade.

Austrade assists companies to secure market intelligence, provides an on-the-ground perspective on the Chinese market, identifies potential partners and facilitates introductions, and provides advice and support during the negotiation and establishment phases.

AUSTRALIAN INVESTMENT PROMOTION IN CHINA

The Federal Government's Investment Promotion and Facilitation Program, run jointly by the Australian Trade Commission (Austrade) and the Department of Industry, Science and Tourism, has an Investment Commissioner in Hong Kong and investment specialists in Beijing and Shanghai.

These specialists:

- raise the profile of Australia as a location for productive investment, particularly in value-added manufacturing such as food processing, information technology, telecommunications and resource processing
- provide advice and assistance to Chinese companies seeking to invest in productive activities in Australia
- market specific investment opportunities on behalf of Australian project proponents.

Australia's benefits as a location for Regional Headquarters and call-centre operations are also promoted to multinational corporations with offices in Hong Kong.

Contact details:

Austrade Hotline
13 28 78
Web site: www.austrade.gov.au

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INFRASTRUCTURE AND ENVIRONMENTAL MANAGEMENT

Insufficient infrastructure development and inadequate project planning, management and coordination have left China with a large stock of unfinished infrastructure projects and facilities unable to cope with the demands placed on them. At present, transport bottlenecks alone may delete one percentage point per year from GDP expansion (International Market Assessment, Economist Intelligence Unit Australia, 1996). At the same time, rapid development is taking a heavy toll on the environment, raising serious concerns.

This chapter examines how China's infrastructure shortcomings and environmental degradation constrain growth.¹ It examines how the Government is addressing these impediments and assesses its likelihood of success. The chapter also considers the operating environment for international investors in infrastructure, given China's growing need for overseas funding. Clearly, China has some major challenges ahead as it seeks to overcome unproductive jurisdictional disputes between different levels of government and attract high levels of foreign investment into infrastructure and environmental projects.

INFRASTRUCTURE DEVELOPMENT

China's current levels of domestic savings and investment in infrastructure, though impressive, are not enough to sustain an 8 to 9 per cent annual expansion of the economy (Scott, 1997; Economist Intelligence Unit, 1996). The country will therefore need foreign capital inflows to fund investment in infrastructure and productive capacity.

Following many years of neglect, China's recent record of investment in infrastructure at the aggregate level is good by international standards: around 6.5 per cent of GDP, well above the developing country average of 4 per cent and close to the World Bank's recommended level of 7 per cent. Under the Ninth Five-Year Plan (1996-2000), China plans to invest US\$300 billion in infrastructure development, with \$45 billion projected to come from foreign sources (via commercial loans and foreign direct investment).²

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¹ This chapter does not include an in-depth evaluation of China's infrastructure needs; rather, it attempts to enhance readers' understanding of the country's infrastructure and environmental policy and project implementation environment. For further sources of information, see the reference list at the end of the chapter.

² See East Asia Analytical Unit Working Paper (Spear et al, 1997), for a detailed examination of plans and reforms in the transport, power and telecommunications sectors.

Table 7.1
Growth of China's Physical Infrastructure and Utilisation Rates — (1983 to 1995)*

| | Physical infrastructure stock | | | Use | | | |
|--|-------------------------------|-----------|----------------------------|--|-------|----------------------------|------|
| | 1983 | 1995 | Growth per year (per cent) | 1983 | 1995 | Growth per year (per cent) | |
| State-owned railways in operation (km) | 51 600 | 54 616 | 0.5 | Rail passenger volume (billion people/kms) | 177.7 | 354.6 | 5.9 |
| of which electrified (km): | 2 300 | 9 700 | 12.7 | Rail freight volume (billion ton/km) | 664.7 | 1 287 | 5.7 |
| Total length of roads (km) | 915 100 | 1 157 009 | 2.0 | Road passenger volume (billion people/km) | 110.6 | 460 | 12.6 |
| of which paved roads (km): | 651 068 | 1 043 390 | 4.0 | Road freight volume (billion ton/km) | 108.4 | 469 | 13.0 |
| Navigable inland waterways (km) | 108 900 | 110 562 | 0.1 | Waterway passenger volume (billion people/km) | 15.4 | 17.2 | 0.9 |
| | | | | Waterway freight volume (billion ton/km) | 578.8 | 1 755.2 | 9.7 |
| Total civil aviation routes (km) | 229 100 | 1 129 000 | 14.2 | Air passenger traffic volume (billion people/km) | 5.9 | 68.1 | 22.6 |
| | | | | Air freight volume (billion ton/km) | 0.23 | 22.3 | 46.4 |
| Length of pipelines (km) | 10 800 | 17 200 | 4.0 | Pipeline petroleum and gas (billion ton/km) | 53.4 | 59 | 0.8 |
| Installed electricity capacity (megawatts) | 76 445 | 217 000 | 9.1 | Electricity generation (terawatt hours) | 351 | 1 007.7 | 9.2 |
| Number of telephones (million) | 5 | 57.6 | 22.6 | National telephone traffic (million calls) | 266 | 10 140 | 35.4 |
| Tap water supply (million tons) | 12 800 ^a | 49 660 | 12.0 | Residential water consumption (million tons) | 3 390 | 15 810 | 13.7 |

Note: a: 1980 data.

* Statistics for infrastructure are notoriously difficult to compare. There is no one source; each ministry has its own and many are inconsistent. Source: Statistical Year Book of China 1985 and 1996; ITU Statistical Yearbook 1994; Australian Embassy, 1996.

However, a number of factors hinder the effectiveness of not only ongoing, but also future, investment:

- stop-go planning and re-prioritising
- strong ministerial and provincial autonomy (which has produced intense rivalries)
- projects built for the wrong reasons in the wrong places, wasting scarce resources
- dwindling central government capacity to fund major national projects and a reluctance to take on anything but soft credit (though this may be prudent from a debt management viewpoint)
- ambivalent approach toward foreign investment.

Big infrastructure projects confer a certain prestige, and every city wants an airport, a toll road, a mobile phone system. These are also perceived as profitable, which for local governments is an important motivation (International Market Assessment, 1996). These motives can reduce the scope for a rational evaluation of national and regional priorities, and the costs and benefits of particular schemes. Moreover, long term vision and planning capacity and attitudes are still evolving. To the frustration of many central government analysts and planners (not to mention companies), projects that cross administrative boundaries, whether among central ministries or among central, provincial and local governments often fail to go ahead, and most infrastructure projects inherently cross boundaries. These problems are attributed to system inadequacy, and may not be solved in this generation.

Achieving China's growth potential, therefore, will require not only continued massive investment in infrastructure, but also greater transparency and improved coordination in official infrastructure decision-making and implementation.

The task is enormous:

- vast geographic areas must be linked, across every type of terrain and climate;
- the historical policy emphasis on developing decentralised, largely self-sufficient regional economies³ produced inefficient localised economic structures and infrastructure and a strong sense of local self interest;
- much existing stock is in poor condition;
- disparities between the developed coastal areas and the underdeveloped inland regions have widened in recent years, requiring central leaders to give priority to infrastructure works in the interior. (See Chapter 8 - Regions.)

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³ Producing most goods locally from local raw materials for local consumption.

THE MAGNITUDE OF INFRASTRUCTURE SHORTFALLS

China's investment in infrastructure has not kept pace with demand. Physical infrastructure has expanded at half the rate of demand growth over the past decade.⁴ As a result, facilities are stretched to the limit (Table 7.1). The worst shortfalls are in transport⁵ and power, with broad flow-on effects. The least affected areas are civil aviation and telecommunications, which are growing quickly.

Rail

Despite national coverage, in 1994, China had only 40 per cent more operating railways (53 992 km in total) than in 1950, less than the USA in 1865 (56 315 km) and India in 1913 (55 762 km), both countries with a comparable land area. However, China now recognises rail is the backbone of its transport system, carrying 53 per cent of passengers and 70 per cent of cargo. It is therefore devoting considerable effort to building and upgrading lines. With demand, particularly on the highly congested north-south routes, far exceeding capacity and the average speed just 30 kph, the bottlenecks will not be resolved soon.

Estimated daily freight demand tops 120 000 cars, but existing capacity can meet only 60 per cent of this. Daily passenger demand averages about 2.8 million (and 3.8 million during festival periods); capacity is 2.5 million people (International Market Assessment/Economist Intelligence Unit, 1996). As a result, the system is choked, with millions of tons of minerals, produce and goods piled up awaiting transportation. Rail services from Guangzhou to Shanghai often require 30 days' prebooking, and the actual journey can take 20 days due to delays in loading and unloading along the route. Rail transport is further complicated by huge seasonal movements of grain, which take priority, and by the importance of *guanxi*, or connections, in securing bookings.

Roads

China averages 1.1 km of roads per 100 km² (versus 7 km/100 km² in the USA and 4.7 km/100 km² in India). Even the better developed coastal areas have only 2.5 km/100 km². The problem goes beyond shortages, as most existing roads are in very poor condition and many newer ones are substandard. Of 1.1 million km of roads, only 8 500 km are modern highways. Only 23 per cent are asphalt paved and most have poor durability. A fifth of China's roads are unusable in wet weather. Almost half are one-way roads able to handle less than 200 vehicles per day (Economist Intelligence Unit, 1996b). With the number of vehicles projected to at least quadruple by 2010, pressures are building rapidly.⁶

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⁴ Officially, GDP growth has averaged 9 to 10 per cent per year during the same period, but estimates done for this report are closer to 8 per cent. (See Chapter 1 - Overview of Economic Reforms.)

⁵ As Marxist economic analysis does not consider distribution and transport services to consumers to be productive sectors, distribution was not even measured in Net Material Product, the Marxist equivalent of GDP. Other factors contributing to inadequate infrastructure were the negative effects of 'The Great Leap Forward', 1958-1961, regional self-sufficiency policies, and the national chaos of the Cultural Revolution.

⁶ In 1995, China produced 1.45 million motor vehicles (the eleventh highest production globally) and 7.83 million motorcycles (the world's highest output). In 1996, there were 10.5 million automobiles, 18 million motorcycles and nearly 10 million other vehicles on the roads (Economists Intelligence Unit, 1996).

Waterways and Ports

For centuries, boats and ships have played an important role in transporting goods and people in China. Rivers have long served east-west routes, while canals and coastal shipping have provided north-south links. China's key ocean ports are in the SEZs and 'open cities' that were established in the 1980s. Inland waterways are concentrated in coastal and southern provinces, mainly Jiangsu, Shanghai, Zhejiang and Guangdong. Burgeoning international trade and rapidly expanding coastal shipping (as an alternative to congested roads and railways) have severely strained China's port infrastructure. The main bottlenecks are a shortage of deep water ports, inadequate handling facilities and capacity at both inland and coastal ports, undeveloped (or undredged) river routes and obsolete fleets. (See East Asia Analytical Unit Working Paper, Spear et al, 1997, for detailed information.)

Civil Aviation

Air passenger and cargo demand has expanded more than 20 per cent per year over the past decade, while air routes have increased 15 per cent per year to more than one million kilometres.⁷ The rapid growth has put air traffic control, pilot training, freight and passenger processing, airport and other services under considerable pressure. Moreover, only six of the 29 airlines are profitable (*China Trade Report*, March 1997, p.1).

COMBINING HARDWARE AND SOFTWARE FOR SUCCESS

AWA has done well in China, building on an AusAID road traffic control project. The company now locally manufactures road and air traffic control equipment, servicing seven large Chinese cities and supplying 135 airports. AWA's advantage is that its expertise is incorporated into equipment; tangible items have immediate perceived value. One success factor in bidding for Chinese airport installations is AWA's joint cooperation contracts with two factories under the Ministry of Electronics Industry. Competing successfully with such giants as Thomson, Alcatel, Siemens and Philips, AWA points out that its air traffic control equipment incorporates proven and reliable technology, is less expensive, simpler to operate and offers value for money. AWA believes that Australian suppliers are generally well regarded in China and Australian business people are seen as honest.

Source: International Market Assessment, 1996

Individual municipalities consider airports essential for attracting foreign investment, so investment levels have been high compared to many other forms of infrastructure (Table 7.1).

⁷ By 1995, China had 139 commercial airports (up from 82 in 1985), over a third of which offered direct flights to Hong Kong. Of the 139, 14 can accommodate Boeing 747s and 81 can service 737s; the remainder handle mainly small aircraft (Economist Intelligence Unit, 1996).

Power

Electricity generating capacity has doubled to 217 000 megawatts over the past decade, making China the world's fourth largest electricity producer after the USA, Russia and Japan. Capacity is expected to double again over the next 10 years. The main problem is inefficient distribution, due to the lack of a national transmission system. According to the World Bank (1994), 16 to 20 per cent of total power, and as much as 33 per cent in rural areas, is lost due to the inefficient grid. Inadequate supply creates frequent power outages, particularly in the booming southern and eastern provinces.

Telecommunications

Telecommunications is one of China's most rapidly expanding sectors, with public investment exceeding 1 per cent of GDP per year. It is also one of the more lucrative investments, providing high returns to local governments. Telephone diffusion has increased dramatically, from 0.73 lines per 100 people in 1991 to 5.5 per 100 in 1996, or 62 million installed phones.⁸ The goal is 10 lines per 100 people by 2000, but even with this, waiting lists will still be long.

Mobile phone use is soaring, with more than 6.6 million users at September 1996 and increasing cellular coverage of provincial areas. In addition to being a popular status symbol, mobile phones allow those who can afford them to circumvent the 6 to 12-month queue for a telephone connection. However, local mobile phone service providers often over commit their capacity, negating this advantage.

Data communications services are also growing rapidly, with about 12 per cent of subscribers connected to the Internet (Economist Intelligence Unit, 1996b, October). As telephone and computer diffusion grows, demand for electronic communications is expected to expand exponentially.

THE CAUSES OF INFRASTRUCTURE CONSTRAINTS

Reasons vary for China's infrastructure shortfalls. For the less commercially attractive projects, a shortage of funds is still a major constraint, but the World Bank and most foreign investors generally believe inadequacies in planning and management systems constitute a more serious problem.

Some of the more obvious causes are:

- diminished central government financial power
- low user pricing of strategic infrastructure
- low returns on investment in areas like rail
- divided, ambiguous decision-making power

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⁸ The diffusion rate is much higher in urban areas: 17 per 100 people on average. In Shanghai, more than half of households own a telephone. The goal for 2000 is 30 to 40 per cent urban diffusion, and 8 per cent rural coverage.

- police-induced stop-go economic cycles
- inconsistent infrastructure planning and prioritising
- shortage, dispersion and misallocation of funds.

Diminished Central Government Financial Power

Since 1979, financial responsibility for and control of infrastructure has been gradually decentralised to the provinces, which in 1995 controlled 70 per cent of government revenues. SOEs such as public utilities which provide infrastructure fund a growing proportion of their investment from extrabudgetary sources including bank loans, self generated funds, foreign loans and development assistance. Consequently, government budgetary expenditure on investment in infrastructure and industrial SOEs fell from almost 15 per cent of GDP in 1980 to 4 per cent in 1995. Approximately two thirds of these outlays went to infrastructure. (See Chapter 4 - Macroeconomic Management, Figures 4.2 and 4.3, and Chapter 10 - State-Owned Enterprises, Table 10.1.)

Price Reform and Triangular Debt

Until recently, the central Government maintained state monopoly and price controls over 'strategic' sectors such as transport, power and telecommunications. (See Chapter 3 - Market Environment.) While some of these have been deregulated, crucial sectors including telecommunications and railways are still under substantial government control. In sectors like electricity, decontrolled tariffs for industrial users cross-subsidise controlled household tariffs set at low levels. Oil prices are still controlled, while coal, formally deregulated in 1993, is apparently still supplied to power utilities at below market price.⁹

Triangular debt severely constrains infrastructure-related industries. Even at low prices, many SOEs still pay only a fraction of their actual power or transport bills, and public sector providers cannot cut supply. Loss-making industrial SOEs owe power producers for electricity; these in turn are in debt to both the railways and the coal mines for coal supplies (International Market Assessment, 1996). However, all are kept operating by the Government, usually through bank credit rollovers, as it cannot afford to allow any of them to close down. (See Chapter 10 - State-Owned Enterprises.)

Divided Authority

The desire to retain power and influence over large state assets has fuelled intense rivalries. One example concerns the case of the Ministries of Power Industry (MPI) and of Coal Industry (MCI). Under its 'mine mouth' strategy, the MCI plans to build power stations near mine sites in north west China, to reduce the impact of transport costs and bottlenecks, and to produce energy at source (allowing coal producers better profits). These stations are intended to connect to

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⁹ Although coal was to be formally deregulated after 1993, coal mines still must supply the Ministry of Power Industry at substantially below market price, because of the MPI's immense bargaining power and the State Council's insistence on pricing such coal as low as possible. Power utilities in coastal provinces therefore benefit from artificially low coal prices while charging unsubsidised users commercial prices.

the national grids to disseminate power across regions. However, the MPI, which controls power transmission, has not allowed the MCI to connect to the grid, a result of rivalry over who controls this more lucrative side of power generation (International Market Assessment, 1996).¹⁰ In an interesting development, the State Planning Commission is attempting to avoid such problems by awarding a similar project incorporating mining, mine mouth power plant, rail and shipping, to the Shenhua Group, which is under the State Planning Commission's direct guidance. While foreign companies interpret this as a positive sign, they do not expect to be given similar control of such large projects.

THE INFRASTRUCTURE PLANNING PROCESS

Infrastructure planning is a combination of top-down and bottom-up processes, and rather weak national coordination. Central government ministries plan 'national priority' projects, while provincial and local authorities plan regional and municipal projects.

For national projects, the respective ministries (Telecommunications, Railways, Roads and others) must demonstrate sufficient funding, either from central budget allocations or from their own provincial/local level operations. However, diminishing capacity to raise funds, bureaucratic delays, the lack of coordination among ministries and other relevant authorities, and weakened authority over the provinces, have reduced the central Government's control over the national infrastructure agenda.

Because the provinces control over 70 per cent of government revenue, through ownership of enterprises, sale of business licences and land-use rights, and various types of fees, they increasingly control infrastructure proposals. They can raise funds more quickly than the central Government, either from their own sources or through foreign investors. As a result, provincial and local authorities have little incentive to participate in projects outside their own administrative boundaries, and frequently do not coordinate with neighbouring government authorities. This significantly duplicates provincial and local projects, inefficiently uses resources and does not focus on the national interest.

The State Planning Commission retains the right of approval over infrastructure works exceeding US\$30 million. However, provincial and local authorities can bypass this process by dividing a project into smaller works of less than US\$30 million each; central authorities even encourage this when they believe that a project has merit (International Market Assessment, 1996). For projects exceeding US\$30 million, provincial and local governments flood the State Planning Commission approval system, trying to secure as many projects as possible to offset potential cutbacks in subsequent budget cycles.

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¹⁰ A basic problem is that the profitability of various parts of the electricity industry is distorted by residual price controls for different types of users, particularly households.

Because approvals are forthcoming only if finance is substantiated, the major challenge is to secure funding. The State Planning Commission indicated that projects with less than 50 per cent local funding subscribed by the end of 1995 would not be included as priority projects for 1996, and projects with less than 70 per cent of local funding subscribed by the end of 1996 would not be included as priority projects for 1997.

Once a project is approved, provincial and local officials can interpret the approval rather flexibly. The city of Zhuhai, for example, received permission to build 'an airport'. It then constructed a modern international airport with ten gates. However, only two gates operate, due to competition from nearby Shenzhen Airport, itself only a few years old, and Guangzhou's Baiyun Airport, which plans a major upgrade (International Market Assessment, 1996).

Similar rivalries exist between provincial and local authorities and the central Government, which, for example, has encouraged them with little success to allocate resources for national trunk highways. One official summed up the problem with an old proverb: 'Strong dragon cannot defeat local snake'.

Stop-Go Cycles and Priorities

While economic growth has officially averaged 9 per cent over the past decade, it has ranged from a low of 4 per cent in slow years to a high of 14 per cent in boom periods. (See Chapters 1 - Overview of Economic Reforms and 4 - Macroeconomic Management.) While improved macroeconomic management should reduce the volatility of future cycles, in the past the economy followed a roughly five-year cycle, which was not long enough to complete many larger infrastructure projects. The clamp on lending during financial tightening puts infrastructure projects on hold, and the prospect of this becoming a repeated occurrence discourages authorities from committing capital to long term projects.

In addition, priority projects that are negotiated or approved towards the end of one Five-Year Plan may suddenly drop off the priority list in the next Plan. The Ninth Five-Year Plan, for example, gave power urgent priority status, while downgrading roads.

Inefficient Allocation of Resources

Decentralised decision-making and local authorities' access to a range of financing alternatives can lead to extensive asset duplication. For example, the city of Zhangjiagang on the lower Yangtze River built a 21 berth port for ocean going vessels, while Nantong, a short distance away, also built a 21 berth port, creating excess capacity.

The World Bank (1995b) indicates that historically China has carried a stock of incomplete investments equalling 15 to 16 per cent of GDP, roughly equivalent to total state investment each year. This proportion has not changed over time.

Ambivalence Towards Foreign Investment

Despite official policies to encourage private build-own-transfer (BOT), build-own-operate (BOO), build-own-operate-transfer (BOOT), and other such infrastructure development options to meet rapidly rising infrastructure funding requirements, foreign investor uptake has been slow.

China's BOT Investment and Development Corporation attributes this to:

- relevant regulations being finalised only now
- investor caution over foreign exchange risk, although this should be alleviated by the currency achieving current account convertibility on 1 December 1996. (See Chapters 4 - Macroeconomic Management and 5 - International Trade.)
- unfavourable tax treatment
- lack of government guarantees on returns (companies argue that the return is effectively capped at a level too low to interest them)
- tariffs charged to users being so low as to cover only a fraction of investors' costs (East Asia Analytical Unit interview, April 1996).

In addition, resistance to foreign ownership of essential infrastructure remains strong; this stems from experiences in the nineteenth century when railways and coastal shipping were foreign controlled.

Foreign Investment Interest: Cool to Hot?

In 1996, responding to cool investor interest, the Government introduced additional laws and regulations covering foreign participation in infrastructure development, hoping to encourage investment in roads, bridges, airports, light rail systems and power stations. The Ninth Five-Year Plan particularly emphasises the role of foreign investor support for roads and power stations.

Foreign firms can participate in airports, seaports and rail track construction through primarily minority joint ventures. Some local authorities are selling roads to foreign investors, mainly from Hong Kong. Power transmission, telecommunications and national railway operations still remain closed to foreigners, and the oil and gas industries are almost entirely state owned.

However, companies wishing to enter sectors nominally closed to foreign investors can sometimes gain special approval if the local partner has significant influence within the relevant ministry. Telecommunications firms are hoping for special one-off projects, as these tend to precede a more general opening. Joint ventures may also become available in local rail projects, according to officials in the Ministry of Railways.

BOT INVESTMENT AND DEVELOPMENT CORPORATION

The BOT Investment and Development Corporation was established in November 1993 to develop and invest in infrastructure projects. It manages China's build-own-transfer programme for securing international private sector investment in infrastructure projects. While it can develop roads, bridges, water supply and power facilities, the BOT Corporation is currently focusing on:

- roads (mostly 30 to 80 km segments, especially toll roads)
- power facilities (four stations ranging from 24 kilowatts to 1200 megawatts).

MOFTEC and other ministries are drafting appropriate BOT-related regulations. In the interim, the Government is following the 'foreign cooperative method' (as opposed to 100 per cent foreign-owned or joint venture).

Believing that a small government investment stake not only acts as a catalyst, but also helps to build confidence in projects involving huge costs and long concessions, BOT Corporation takes an equity share in the projects it facilitates, for example:

- AIG and another developer are the major investors while BOT Corporation has 5 per cent in the Jing-Tong Expressway from Beijing to Tongxian.
- Asia Infrastructure Fund and BOT Corporation have set up a road holding company for six sections of roads in Guangdong and Sichuan.

Stages of the project proposal approval process

1. BOT Corporation receives a project proposal from a local government
2. BOT Corporation evaluates the proposal
3. If more than US\$30 million, it submits the proposal to the State Planning Commission for approval
4. If less than US\$30 million, it submits the proposal to the provincial government for approval
 - In practice, BOT Corporation tries to keep most proposals to less than US\$30 million, since the State Planning Commission approvals process can be quite lengthy
 - Sometimes, it tries to get a project approved by inserting it in a local government five-year plan, which is submitted to the central Government for approval.

To enhance relations and coordination with local authorities, BOT Corporation has established subsidiaries in regional areas, primarily joint ventures with local Planning Commissions.

Contact: BOT Corp, 8th floor, Yuquan Mansion, Yuquan Road, Beijing 100039. Tel: 86-10-6828-4525; Fax: 86-10-6828-4536

Source: East Asia Analytical Unit interview, April 1996.

Shortages of Related Infrastructure

Infrastructure inadequacies are compounded by the multiplier effect of failures in separate but related areas. The interconnection of coal, transport and electric power illustrates this. Coal provides 75 per cent of China's commercial energy, primarily from mines in the remote north west. Bottlenecks in road and rail systems, however, prevent sufficient coal being moved to where it is most needed in the industrial north east and along the coast. According to the Ministry of Power Industry's development plan, 35 million tons of coal were needed to fuel new power stations in 1996. The transport system could handle barely half this amount, resulting in higher imports. The situation may not improve, as coal use for power should treble by 2010 and quintuple by 2020 (World Bank, 1996e). The continuing power shortages in the coastal regions force alternative power generation, including small inefficient generators, raising producers' costs and lowering returns.

INFRASTRUCTURE PLANNING

China does not have a well coordinated vision for infrastructure beyond five years. Some ministries and local authorities have 10-year indicative plans, for example, the Yangtze Valley development, but these generally are prepared in isolation without considering what is happening elsewhere. No published national plan runs for more than five years, although central authorities apparently now accommodate five-year plans in informal long range plans.

Table 7.2 summarises the main provisions of the Ninth Five-Year Plan. Each sector's respective plans, administrative arrangements and reforms are covered in a separate East Asia Analytical Unit Working Paper, Sectoral and Financial Outlook (Spear et al, 1997).

Will the Plan Be Achieved?

In the past, high priority projects benefitted from preferential budget allocations and extrabudgetary financial resources. Approximately 10 to 15 per cent of state investment consisted of these 'key state projects'. However, dwindling state revenues, weak financial institutions, shifting priorities and the ambitious size of many projects are factors that, combined, may seriously affect the Ninth Five-Year Plan's achievability. Apart from telecommunications and aviation, most infrastructure investment, especially the planned additions to rail and road freight capacity, has not achieved even previous Plans' targets.

As a result, the Ninth Five-Year Plan's targets may not be realised until well into the Tenth, or even a later Plan. However, on a positive note, over the long term, stronger coordination and more consistent planning are expected to evolve in line with more realistic attitudes and greater regional interdependence. This is starting to be observed in Shanghai, for example, as it seeks to realise its vision of becoming a major Asian financial and economic centre in the twenty-first century.

Although wasteful and inefficient allocation of resources does occur, China also can effectively direct resources to important areas. (See *Three Gorges* box.) Such projects provide many opportunities for foreign companies.

Table 7.2

Power and Communications Are Top Priorities
Infrastructure Development under the Ninth Five-Year Plan
(1996 to 2000)

| Sector | Capacity to be added over 1995 levels | Estimated total capacity by 2000 | Planned per cent increase over 1995 | Estimated total investment (US\$ billion) |
|--|---------------------------------------|----------------------------------|-------------------------------------|---|
| Aviation | | | | |
| - Passenger traffic (million) | 55 | 100 | 122 | 19.7 ^a |
| - Air freight traffic (million tons) | 0.9 | 1.8 | 100 | |
| Ports and waterways | | | | |
| - Shipping traffic (billion ton-km) | 595 | 2 300 | 35 | 7.7 |
| Roads (km) | | | | |
| | 130 000 | 1 230 000 | 12 | 36.7 |
| Telecommunication | | | | |
| - Exchange lines (million) | 70 | 140 | 100 | 60.0 |
| Power | | | | |
| - Total installed capacity (gw) | 90 | 300 | 43 | 64.3 ^b |
| - Nuclear power (gw) | 17.9 | 20 | 852 | |
| Coal | | | | |
| - Production (million tons) | 230 | 1,500 | 18 | 24.0 |
| Oil | | | | |
| - Production (million tons) | 36 | 185 | 24 | 48.9 ^c |
| - Oil refining (million bpd) | 0.9 | 4.6 | 24 | |
| Gas | | | | |
| - Production (billion m ³) | 2.6 | 20 | 15 | |
| Total Capital Investment | | | | 303.4 |

Note: a. Includes US\$16.3 billion for aircraft and US\$3.4 billion for airports.

b. Half of this capital budget is to go to transmission lines.

c. Includes US\$38.5 billion for oil and gas exploration and US\$10.4 billion for oil refining.

gw = gigawatt

m³ = cubic meter

bpd = barrels per day.

Source: *China Economic News*; Economist Intelligence Unit, 1995; International Market Assessment, 1996.

THE THREE GORGES DAM

China's Three Gorges Project on the Yangtze River in Hubei Province will be the largest hydroelectric power plant in the world when completed. The main dam will rise 175 metres and span 2 310 metres, five times more than Hoover Dam in the USA. Although it will bring substantial benefits in terms of flood control, clean power generation and improved navigation, it also will have significant costs, displacing some one million people (mostly farmers), inundating 27 000 hectares and benefitting mainly downstream population centres.

Conceived in 1918 to ameliorate the damage of regular flooding, the US\$30-plus billion project was finally approved in 1992. According to current plans, it is to be completed in 2009, although the plant is to start operating in 2003.

Flood control

More than 15 million people will be better protected from flooding along the Yangtze, including in Hubei's capital, Wuhan.

Power generation

Three Gorges should generate 84.7 billion kwh per year when completed, equivalent to one twelfth of current power consumption. The main beneficiaries will be eastern and central China.

Navigation

The 660 km waterway between Yichang (40 km from the dam site) and Chongqing will open to barge fleets of up to 10 000 tons (versus 3 000 tons now), and annual shipping capacity will rise from 10 million to 50 million tons. Shipping costs will drop by one third.

Funding

The China Yangtze Three Gorges Project Development Corporation projects a total funding requirement of US\$30 billion. In addition to a national tax on electricity, which raised ¥ 4 billion in 1995, funding will include domestic borrowing, revenues from the Three Gorges project itself from 2003, and possibly foreign finance, though no details are available.

Pollution

With about 1 billion tons per year of polluted water entering the Yangtze upstream from the dam site, the World Bank has agreed to provide US\$180 million to Chongqing to deal with water pollution. The Development Corporation is responsible for cleaning up flooded towns and removing polluting industries and waste sites.

Tourism

While some famous natural attractions will be lost, Chinese officials say important cultural relics will be moved and scenic beauty will not be greatly affected. The dam itself is expected to become a tourist attraction.

Opportunities for Australians

Officials welcome foreign involvement in the dam project, especially if accompanied by concessional loans or grants. Australia has considerable experience in large hydroelectricity projects, including the Snowy Mountains project, and environmental management that could be relevant to the Three Gorges Project. The main opportunities for Australian companies appear to lie in construction, road building, telecommunications and provision of related equipment.

THE STATE PLANNING COMMISSION: CHINA'S ECONOMIC POLICY PLANNER

The State Planning Commission was a core planning ministry during the central planning period. While the economy has moved away from central planning and investment responsibility has been decentralised, the State Planning Commission remains the highest authorising body for major investments, coming directly under the auspices of the State Council, China's cabinet.

The State Planning Commission's main responsibilities include:

- drawing up plans for national economic and social development, usually on a five-year basis
- assessing infrastructure and construction projects submitted by government ministries and provinces
- approving projects deemed necessary, considering factors such as:
 - prevailing policies and regulations
 - availability of funding
 - technical and engineering capabilities
 - present stage of infrastructure development.

Approval for projects includes permission to use foreign currency and to import equipment.

In 1992, to better link the Five-Year and yearly plans, the Government adopted a two-year rolling plan system, with tentative targets for the following year. The State Economic and Trade Commission is responsible for day-to-day implementation of these plans. However, changing priorities especially affect infrastructure projects, as most are long term.

The structure of the State Planning Commission is not conducive to effective coordination. Construction industry projects, for example, must be considered by numerous departments, including the Fixed-Asset Capital Investment Department, the Foreign Capital Utilisation Department, the Priority Construction Department, and the Transport and Energy Department.

INFRASTRUCTURE FINANCING

While infrastructure and environment projects are funded predominantly from domestic sources, overseas entities play an increasingly important, indeed vital, role. Foreign sourced funds' share in fixed asset investment has nearly trebled from 4 per cent in the early 1980s. The Ninth Five-Year Plan anticipates foreign capital will account for 15 to 20 per cent of infrastructure outlays in coming years, or approximately US\$9 billion per year. The combination of funding sources has changed dramatically in the last two decades away from budget allocations (down from 60 to 3 per cent of total investment) and towards firms' retained earnings (now 52 per cent), domestic loans (from 2 to 20 per cent) and foreign investment (from 4 to 12 per cent). (See Chapter 1 - Overview of Economic Reforms, Figure 1.12.)

Infrastructure investment relies more on budget allocations and self-generated funds than general fixed asset investment. The telecommunications, power and urban water supply sectors depend least on budget funding, reflecting their ability to generate funds via user charges. Coal and rural water, both still subject to price controls, are the most budget-dependent. A separate East Asia Analytical Unit Working Paper (Spear et al, 1997) provides a more detailed examination of infrastructure financing practices, including the roles of multilateral agencies and Australia's AusAID.

FOREIGN PRIVATE SECTOR PARTICIPATION IN INFRASTRUCTURE DEVELOPMENT

The environment for foreign investment in infrastructure will need to be considerably improved if the Ninth Five-Year Plan's assumptions of strong foreign capital flows through joint ventures and BOT type arrangements are to become reality. The investment environment remains opaque and inconsistent, making it difficult to do business with any certainty. While some foreign companies achieve good returns, many others find it hard to convince their boards of directors to allow them to continue their China endeavours.

Under new regulations promulgated in 1996, foreign investors can no longer have a majority holding in port facilities; foreign interests to date have been mostly in container terminals. Similar regulations are applied to airports and airlines. Foreigners may own up to 35 per cent of an airline, but are limited to 25 per cent of voting rights. Foreign investors are not permitted to *directly* own or operate rail, road transport¹¹ or telecommunications services. Foreign investment in coal mining was approved recently, including majority ownership, but many state-owned coal mines, with their heavy debt burden and associated liabilities, may not be an attractive prospect for investors. In oil and gas exploration and development, foreign companies can bid for the exploration rights, pay the entire cost and take all the risks, then share in any developed deposits. Foreign

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¹¹ This requirement is not applied consistently, however, and differing definitions of road transport services exist (for example, company-specific versus commercial).

prospectors believe that the most prospective areas have been reserved for domestic producers, and complete geological data are not available (International Market Assessment, 1996). The Ministry of Posts and Telecommunications has hinted it may permit future foreign involvement in telecommunications.¹²

CARRYING ON

In a classical case of balancing risk with the right timing, the right entry point and the right contacts, TNT became China's first foreign funded enterprise to be allowed to offer scheduled express road freight services. Recognising an urgent need for time sensitive and reliable long distance road freight transport, TNT established TNT Shanghai Express in 1992 under the auspices of the Ministry of Communications (Beijing) with the support, cooperation and approval of the Shanghai Traffic Bureau. The business is a joint venture with Shanghai Long Distance Road Transport Corporation, a subsidiary of the Shanghai Traffic Bureau (both now under the trading name of JY Group). Although several Chinese companies provide road services, TNT Shanghai Express is the first to offer reliable express freight transport within specific delivery times. Its success and ongoing expansion reflect the rising expectations and growing sophistication of the Chinese market, which is responding enthusiastically to high levels of service and reliability.

TNT Shanghai Express now operates scheduled express freight services between its main branches in Shanghai, Beijing, Guangzhou, Tianjin and Shenzhen. Over the next one to three years, Wuhan, Nanjing, Xian and Chengdu will be added to the network, allowing the company to offer full services across the eastern seaboard.

In 1995, TNT established TNT Logistics International Trading (Shanghai), a wholly foreign-owned logistics management and consultancy business, which constitutes the first step towards an integrated logistics enterprise in China. The fast, growing demand for logistics services is driven by the trend among Western companies to focus on core business and outsource support services.

These two businesses complement TNT's first operations in China: the TNT Skypack-Sinotrans joint venture (now trading as TNT Express Worldwide) established more than a decade ago to provide express courier services linking into TNT's global air freight network.

Foreign enterprises can participate in power generation projects, including owning up to 100 per cent of BOT projects, but investment in the transmission grid remains closed. The power sector attracts considerable foreign interest, and numerous letters of intent have been signed. However, in 1995 and 1996, the Government appeared to reconsider its policy, believing that foreigners were

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¹² Some observers suggest that this may be to pre-empt foreign telecommunications equipment and service engineering companies from entering informal arrangements with Lian Tong, the second carrier (International Market Assessment, 1996). (See Spear et al, 1997.)

making unreasonable rates of return. Authorities became reluctant to guarantee long term power purchase agreements sufficient to satisfy foreign financial backers. Nevertheless, some interest is reviving following current account convertibility in December 1996, as this should be sufficient to meet foreign investors' demands for exchange guarantees in the context of BOT or similar infrastructure financing arrangements. The central and some local governments are starting to recognise that restrictions on rates of return are counterproductive. Recently, Chinese negotiators are focusing more on BOT providers' intended electricity tariffs, rather than rates of return, as a more efficient method of securing cost-effective infrastructure.

Strategies for Australian Companies

Australia has substantial expertise applicable to China's infrastructure development plans. Australian engineering companies already are active in Chinese infrastructure projects, with Australian organisations assisting Chinese SOEs to reform and corporatise, as many have previously gone through a similar process themselves. For example, Pacific Power International, the overseas engineering arm of Pacific Power, the former Electricity Commission of New South Wales, is advising the Zhejiang Regional Power Authority on its corporatisation process.

Most Australian engineering firms in China work on aid-funded infrastructure and environmental projects, which are seen as a good method of demonstrating capabilities and gaining experience in the Chinese market. However, a China-based executive of one of these companies stressed that while such projects can give contractors valuable insight into the operating environment, they constitute a very soft entry and do not necessarily provide firms with the capacity to expand to a more commercially focused and self-sustaining position. He noted that some foreign companies in China sustain heavy losses due to their lack of commercial astuteness, significant bureaucratic obstacles, strong local protectionism, highly competitive commercialism, and the low-margin, high risk engineering business.

While methods will vary with circumstances, firms operating in Chinese infrastructure indicate that some useful risk mitigation strategies are to:

- focus on niche opportunities within project consortia where other firms assume most of the project risk
- team up with major players with funds (such as companies contracted under bilateral or multilateral arrangements)¹³
- bid for projects with committed and clearly identifiable financing
- focus on areas in which you control supply
- seek projects where engineering skills can be combined with hardware (power, aviation, communications).

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¹³ AusAID, Austrade and state government trade offices (for example, International Projects Unit in the Department of Economic Development and Trade of Queensland, Overseas Projects Corporation of Victoria, Department of State and Regional Development of NSW) regularly advise Australian companies on how to access such projects.

However, many of these strategies are difficult to implement or require compromises. For example, reducing risk can mean ceding control. To ensure greater control and better profit prospects, some companies advocate revisiting the idea of developing strong Australian consortia. They claim that if engineering and construction firms could put aside old rivalries, they could form powerful groups capable of winning international tenders over established US and European competitors.

ENERGY EFFICIENCY

While energy consumption per unit of GDP has improved considerably over the past decade (Table 7.3), China remains an intensive and often inefficient energy user by international standards. To keep up with fast growing energy demand, China may need to invest \$1 000 billion in this sector, including more than \$500 billion for electric power generation (*The Australian*, 8 November 1996).

Table 7.3

Energy Intensity of the Economy Declines Energy Intensity of GDP and Growth of Electrification

| Year | GDP (billion yuan*) (1) | Primary energy (million tons of coal equivalent) (2) | Share of electricity in total energy output (per cent) | Energy intensity (kgce/yuan of GDP) (2) / (1) |
|------|-------------------------------|--|--|---|
| 1983 | 558.75 | 660.40 | 20.7 | 1.18 |
| 1984 | 643.68 | 709.04 | 21.2 | 1.10 |
| 1985 | 724.14 | 766.82 | 21.2 | 1.06 |
| 1986 | 782.25 | 808.50 | 22.1 | 1.03 |
| 1987 | 871.65 | 866.32 | 22.4 | 0.99 |
| 1988 | 969.99 | 929.97 | 22.8 | 0.96 |
| 1990 | 1 050.45 | 987.03 | 23.8 | 0.94 |
| 1991 | 1 137.30 | 1 037.83 | 25.6 | 0.91 |
| 1992 | 1 287.92 | 1 091.70 | 26.9 | 0.85 |
| 1993 | 1 460.50 | 1 117.68 | 29.2 | 0.77 |
| 1994 | 1 632.84 | 1 174.68 | 30.7 | 0.72 |

Note: * Constant 1980 prices;
kgce: kilos of coal equivalent.

Source: *China's Electric Power Industry*, 1996.

According to the State Planning Commission, China consumes on average 40 per cent more energy (on an equivalent basis) per dollar of GDP than industrialised countries. Power and steel industries, SOEs with obsolete equipment, and TVEs are the most inefficient users (*China Environment*, 1996). The high priority given to heavy industry, especially iron and steel, during the central planning period

increased energy consumption, while underpricing oil and coal has led to its inefficient use.

China's transport system exacerbates energy inefficiency. While in other countries 100 million tons of petroleum can supply 10 million vehicles on average, in China they meet the needs of only 2 million (*China Energy*, August 1995). This is partly because many vehicles are old Russian models with inefficient engines. Congestion and the shortage of modern roads further exacerbates the problem. As newer, more fuel efficient cars replace old ones and new roads are built, the ratio should improve.

Over half of China's installed thermal capacity consists of inefficient 125 megawatt and smaller units. Due to endemic power shortages, few old units are decommissioned. China's recent power development program emphasises progressively larger generation units (eg, 200, 300 and 600mw coal-fired units) to achieve economies of scale. China will produce these locally and import advanced technology.

POLLUTION AND ENVIRONMENTAL DEGRADATION

China's high levels of economic growth during the last two decades has had a major impact on the environment. Air and water quality is rapidly deteriorating due to burgeoning private and township and village enterprises, and SOEs. The central Government is now giving priority to this issue.

Beijing, Shenyang, Xian, Shanghai and Guangzhou rated among the world's 10 most polluted cities in 1995, with particulate matter indices 2.5 to 6 times higher than WHO safety limits (*Outlook*, 8 July 1996). Industry and electricity generate most of China's carbon dioxide emissions; the residential sector accounts for 14 per cent and transport only 4 per cent.¹⁴ However, because so much of the population is rural, China's per capita carbon dioxide emissions are still quite low.

Industry is the main source of water pollution. According to the State Council, 78 per cent of China's fresh water does not meet official sanitary requirements, and 50 per cent of underground water is polluted. More than 80 per cent of the 100 million tons per day of sewage and industrial waste water flows untreated into rivers and lakes, and 80 per cent of the 532 rivers monitored by the Ministry of Water Resources are polluted.

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¹⁴ The OECD estimates that for every one per cent increase in energy efficiency in power generation, carbon dioxide emissions fall 3 to 4 per cent. For both energy efficiency and the environment, pricing plays an all important role but many energy prices in China are still below economic cost, reducing incentives to improve efficiency (OECD, 1996).

Table 7.4

Pollution Growing Fast, but Is Still Low

Overall Carbon Dioxide Emissions — Country Comparisons

| | Total (million tons) | | | Per capita (tons) | | |
|-----------|----------------------|-------|-----------------|-------------------|------|-----------------|
| | 1980 | 1992 | Per cent change | 1980 | 1992 | Per cent change |
| China | 1 489 | 2 668 | 79 | 1.5 | 2.3 | 51 |
| India | 350 | 769 | 120 | 0.5 | 0.9 | 71 |
| ASEAN | 229 | 467 | 104 | 17.5 | 25.2 | 44 |
| Australia | 203 | 268 | 32 | 13.8 | 15.3 | 11 |
| Japan | 934 | 1 094 | 17 | 8.0 | 8.8 | 10 |
| USA | 4 623 | 4 881 | 6 | 20.3 | 19.1 | -6 |

Source: World Bank, 1996g.

Coal

Coal, providing more than 75 per cent of China's primary energy, is the main cause of air pollution¹⁵ and a major contributor to environmental degradation. Each year coal mining produces:

- an average 22 000 hectares of landslides, often damaging water supply and other facilities
- 600 million cubic metres of methane, plus large quantities of other gases
- 3 million tons of coal dust from loading and unloading, exacerbated when steaming coal is unwashed
- 28 million tons of untreated water.

In addition, 150 million tons of waste from open mines occupy up to 20 000 hectares. These waste mountains can ignite spontaneously, producing enormous pollution. The situation will remain serious, given World Bank (1996e) estimates that coal use for power will rise 3.5 fold by 2010 and five fold by 2020. Most coal intensive polluting industries are too far from significant natural gas reserves and sources of hydroelectricity to make fuel conversion an attractive option.

¹⁵ Industrial boilers outside the power sector account for more than one third of China's coal use (World Bank, 1996).

Table 7.5

Unwashed Coal Is Very Polluting Coal Washing — Country Comparison (1992)

| Country | Percentage of coal washed before burning |
|-----------|--|
| China | 20 |
| USA | 42 |
| Australia | 76 |
| UK | 100 |
| Poland | 49 |

Source: China Energy, 1995.

ENVIRONMENTAL POLICY AND REFORMS

Recognising the economic and political implications¹⁶ of environmental degradation, the Chinese Government is increasing resources to environmental protection and establishing administrative and legal frameworks to deal with environmental issues. It aims to spend ¥ 189 billion on 1 500 projects over five years to halt the trend in environmental degradation by 2000 and reverse it by 2030. The Environment White Paper released in June 1996 highlights steps taken to bring the situation under control and addresses key priorities, including sustainable development, biodiversity, environmental education and international cooperation.

AGENDA 21

Agenda 21 is a multilateral initiative from the United Nations Rio Environment Summit in 1992, to promote sustainable development. Signatories commit to formulate and implement policies and strategies to achieve sustainable development. China was the first country to establish an Agenda 21 organisation, which has 150 staff and operates under the auspices of the State Planning Commission and the State Science and Technology Commission.

The Agenda 21 White Paper (State Council, 1994, Chapter 2) encourages adopting sustainable development ideals across economic and social policies and programs. The Chinese Government has identified a broad

¹⁶ A variety of groups lobby hard for environmental improvements, and top officials have made a point of visiting badly affected sites. One official nongovernment organisation, the Academy of Green Culture (Friends of Nature), was established by Professor Liang Congjie in 1994. It has some 200 members and lobbies the Government to preserve forests and native species' habitats.

range of strategies, programs and projects in areas as diverse as marine environment, urban waste, forestry and 'green engineering'. It also plans to establish 30 experimental sustainable development zones and an international centre for sustainable development training (Wu et al, 1995, p. 6).

Priority projects

International financing is being sought for scores of environmental projects identified by the Chinese Government. Some target commercial investors, others bilateral and multilateral aid donors. China's Agenda 21 strategy identifies nine priority areas for environmental action (AusAID 1996, p. xii):

- capacity building
- sustainable agriculture
- clean industry
- clean energy and transportation
- conservation and sustainable utilisation of natural resources
- environmental pollution control
- poverty and regional development
- population, health and human settlements
- climate change and biodiversity conservation.

Source: AusAID, 1996; State Council, 1994; Wu et al, 1995; Zhang Kunmin, 1996.

Water Pollution Control

With water shortages expected to exceed 20 billion tons by 2000, water conservation is a high priority, along with energy conservation, solid waste treatment and reducing pollution in rivers and lakes. The Government is taking drastic measures, including closing the worst offenders, to stop millions of small industries from discharging waste into waterways. It also plans to phase out open hearth, cupola furnaces and small smelting facilities in the steel industry, develop continuous casting and use coal injection technology to save energy and reduce costs.

By 2000, China would like to be well on its way toward achieving the following targets (BBC Monitoring Services, 1996):

- 83 per cent of industrial waste water in administrative units at and above the county level
- 86 per cent treatment of waste gases
- 50 per cent recycling of solid waste material
- 27 per cent green areas in cities
- 50 per cent disposal of harmless domestic garbage

- 25 per cent concentrated sewage treatment in cities
- 5 to 10 percentage points less noise exceeding urban control standards
- control of acid rain and sulphur dioxide
- development of ecological agriculture
- reduction of soil erosion and recovery of natural vegetation
- reforestation to achieve 15 per cent of land covered by forest (13.4 per cent in 1994 versus 31 per cent world average).

Enforcement Is a Challenge

The Chinese Government has many laws, decrees and industry specific regulations, and national, provincial, municipal and county level environmental protection bureaux to monitor and enforce environmental laws. The State Council's Environmental Protection Committee provides additional authority to these mechanisms. The State Planning Commission controls environmental protection initiatives. The National Environmental Protection Agency, established in 1993, has ministerial status and provides national enforcement and policy formulation capabilities. According to the World Bank, 'the pollution control program of ... NEPA and the provincial Environmental Protection Bureaux is probably the most extensive in the developing world' (World Bank, 1996b). Monitoring procedures are also very well developed (1996).

However, despite impressive gains in some areas, enforcing compliance with the law remains a challenge. While all ministries responsible for major public works have environment departments, these can be overridden if stronger stakeholders have conflicting interests. The National Environmental Protection Agency has conceded that some projects do not proceed because of conflicting local priorities (East Asia Analytical Unit interview, April 1996).

NATIONAL ENVIRONMENTAL PROTECTION AGENCY: WATER POLLUTION CONTROL

The framework of operations and current priorities of the National Environmental Protection Agency's Water Pollution Control Division are outlined below:

History of its administrative framework

- 1984: law on water pollution control published at People's Congress, providing legal parameters
- 1986: technical regulations began to be implemented for:
 - water at origin (lakes, rivers) to control pollution
 - urban water treatment and recycling
 - waste water treatment in factories, mines, TVEs (developing technology, controlling discharge)

- 1989: the National Environmental Protection Agency and the Ministries of Health, Public Resources, Construction and Urban Development issued drinking water protection regulations and standards.
- Local authorities assist.

Waste-Water: polluter-pays principle¹⁷

- Along rivers, paper and chemical factories have grown very rapidly, particularly TVEs.
- The Government announced it would close or renovate heavy polluters (more than 30 000 MT volume) by the end of June 1996.
- This remains a difficult issue to manage politically.

Priorities

- *New technology.* For example, better paper-making techniques to effectively control discharge from paper factories.
- *Careful management of funds.* The National Environmental Protection Agency has its own budget and also receives funding from the central Government, aid donors and the levy on polluters.

Source: East Asia Analytical Unit interview, April 1996.

The central Government allocated about ¥ 3 billion (US\$360 million) for environmental protection projects in 1996. Nearly 80 per cent (US\$280 million) was to come from multilateral and bilateral agencies, and most of the remainder from provincial and local authorities. According to multilateral officials, many projects are characterised by delays, disputes between central and local authorities, and difficulties in meeting foreign institutions' accountability requirements. In some instances, authorities only undertake environmental guidelines or impact statements when they are a condition of a loan, and employ cost-cutting approaches. In one case, for example, instead of relocating residents away from a major road project as had been agreed, the authorities simply double-glazed their windows (International Market Assessment, 1996).

Nevertheless, for industry, the enforcement of environmental regulations is becoming more stringent. While the Government has collected over ¥ 24 billion in pollutant discharge fines since 1979, the deterrent effect has been less than authorities anticipated. Some industries simply factored the fines into overall production costs and did not reduce effluent levels. In June 1996, the central Government took the unprecedented step of closing several hundred TVE paper mills along the Yangtze and Huai rivers.

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¹⁷ According to the same World Bank study, 'the current pollution control system is under scrutiny because its peculiar mix of regulations and economic incentives bears little resemblance to a conventional emissions charge system. NEPA regulations specify effluent standards by sector, with the pollution levy to be paid by enterprises exceeding mandated levels. Levies are charged only on the "worst case" pollutant from each source. This "incentive system" is supplemented by more traditional pollution control measures.' Chinese regulators are debating if this mixed regime should be changed to a possibly less costly conventional system (World Bank, 1996b.)

Foreign companies in China are expected to comply with both the spirit and the letter of China's increasingly strict industrial environmental safeguards. Foreign-controlled firms are often more conspicuous and are perceived to have greater financial capacity to comply. Chinese authorities also want to ensure that foreign companies do not use China as a location for highly polluting industrial processes.

OPPORTUNITIES FOR AUSTRALIAN COMPANIES IN ENVIRONMENT PROJECTS

Australian companies can participate in two types of environmental work in China:

1. projects funded offshore, through aid or commercial finance; and
2. projects funded privately, including environmental impact assessment or environmental management for multinationals that encourage their China operations to meet global standards.

According to companies, few opportunities exist in environmental projects announced and funded by the Chinese Government. Foreign companies are not invited to bid on infrastructure or environmental projects which are not at least partly foreign-financed. Chinese institutions find it very difficult to obtain approval and funding to engage foreign environmental consultants.

Company enthusiasm for aid-funded projects varies widely. Bidding is highly competitive, and projects are often caught up in internal rivalries in China. Up to 18 months can elapse between completing the work and receiving the final payment. The World Bank, for example, makes final payment only after the host nation confirms that the project has been completed to its satisfaction.

A number of Australian-based engineering companies with substantial environmental services expertise concur that, for the time being, they would only undertake project work in China for international corporate clients (International Market Assessment, 1996).

Notwithstanding these cautions, Australia is applying its expertise in China's program for sustainable development, including:

- **Clean energy:** Australian companies have demonstrated expertise in coal gasification, with projects in Henan, Liaoning and Hubei Provinces, and in liquefied natural gas projects. China's demand for coal related environmental work will rise significantly in coming years.
- **Water treatment and conservation:** Australian firms are active in water related projects in China. While most environmental projects involving foreign firms have bilateral or multilateral funding support, private initiatives do occur. For example, the NSW-based Australian Industry Development Corporation (AIDC) and Asian investors have established China Water Company Ltd, based in Hong Kong, to invest in water development projects. Its Shenyang water supply project is the first to be 100 per cent commercially financed. ACT Electricity and Water, ACTEW, is also involved in a joint venture for water treatment and urban water supply projects.

- **Sustainable agriculture:** Australian expertise and technology are used in water efficient irrigation, forestry, soil rehabilitation, watershed management and grasslands conservation.
- **Institutional strengthening:** Australia has strong capabilities in environmental management, ranging from policy formulation and drafting of legislation to environmental impact assessment. It also has proven educational and training programs and central and local delivery systems. Many consider institutional strengthening to be the most effective form of aid.

AUSTRALIAN AID TO CHINA: 1996 TO 1997 PROGRAM OUTLINE

| Ongoing programs | Comment |
|---|--|
| Regional development | |
| Agricultural Support Services | Parallel financing with World Bank in 10 provinces |
| Hebei Livestock Production | Large project on watershed protection |
| Land Use Information Systems | Large project in Hainan |
| Jilin Grain Handling | |
| Sheep Research | |
| Regional Activities | NGO funding, wool, other departments |
| ACIAR | Small research projects |
| Education and training | |
| ASTAS (Scholarship Awards) | 89 on award from previous years and 16 new |
| ADCOS (Scholarship awards) | 118 ongoing and 12 new |
| Institutional Links Phase 2 | Funding of links with Chinese universities |
| Economic/Foreign Trade Training | Preliminary activities; Beijing Ministries |
| Other HRD | Some project development/completion costs |
| Community development | |
| Qinghai Poverty Alleviation | Large project; income generation |
| CHANGES projects | NGO activities (4) in poorest counties |
| Food Aid | |
| Health and population | |
| Ningxia Health and Family Planning | Primary/maternal health and services |
| Tibet Primary Health Care | Feasibility study for health/sanitation projects |
| Hepatitis Diagnosis Improvement | |
| Guangdong Reproductive Health and Family Planning | |

Environment

| | |
|---------------------------|-------------------------------------|
| Mine Waste Management | Mine site rehabilitation |
| Inner Mongolia Grasslands | New project; environmental emphasis |

Other

| | |
|---------------------------------|------------------------|
| Private Sector Linkages Program | 16 activities approved |
| Other | PASU, small activities |

Total aid flows **A\$54.3 million**

INFINITE CHALLENGES, BUT INTERESTING OPPORTUNITIES FOR THE ASTUTE

With infrastructure utilisation growing at double the rate of its physical development, China faces constraints which could threaten the momentum of economic expansion. Even in sectors of very rapid development, such as aviation and telecommunications, where local communities can reap returns, demand still outpaces supply. In other areas, local authorities' reluctance to assume additional financial burdens for projects with few immediate tangible benefits, such as environmental projects or contributions to national road networks, make the central Government's ambitious plans difficult to achieve. Interministerial rivalries can also frustrate projects. The central Government is aware of these difficulties and is seeking ways to improve central-provincial and interministerial cooperation, though this will be difficult.

China's investment requirements for infrastructure development and environmental management over the next 10 to 15 years are of such magnitude that they surpass the capacity of domestic capital resources. As a result, China will need considerable foreign funding to ensure sustained development. Although China has been reluctant to assume anything but soft credit, in future as multilateral agencies move more toward social benefit programs, infrastructure works, at least in the more developed provinces, will increasingly be funded commercially through loans or equity. Foreign capital may contribute as much as one fifth of China's infrastructure and environmental project outlays over the next 10 years.

International companies believe that if the Government is to attract the required scale of foreign capital, expertise and technology, it will have to make further progress in:

- providing appropriate incentives for investors
- achieving greater convergence in perceptions of risk
- overcoming counterproductive rivalry among ministries and levels of government
- strengthening the legal system to:
 - protect foreign investors and their property

- enhance transparency, consistency and predictability of the regulatory environment across government
- improve enforcement of laws and regulations.

Chinese officials similarly point out that foreign companies also need to overcome shortcomings, including:

- clearly indicating their qualifications and fully addressing particular projects' selection criteria
- meeting all the tender requirements, including submitting complete documentation
- demonstrating that committed project financing will be forthcoming as required
- being prepared to assume risk commensurate with potential rates of return
- developing the relationships and cross-cultural understanding necessary to succeed in China.

Advances in these areas, say officials, will hasten the processing of proposals and improve tender success rates.

In short, achieving China's development objectives will require continued massive investment in infrastructure, greater transparency and coordination in decision-making and implementation, effective enforcement of environmental regulations, and a better understanding of mutual expectations by foreign investors and contractors as well as by Chinese officials.¹⁸

Australia is considered to be under-represented in Chinese projects. This is attributed to a variety of factors, including easier access to other regional markets, the perceived high risk of Chinese project work, and lack of interest among many firms. Possibly such risk aversion strategies as advocated by companies interviewed for this report contribute to the under-representation.

Nevertheless, Australia has much to offer. Not only do Australian companies have the expertise, including technology and specialised equipment, applicable to a variety of infrastructure and environmental projects, but Australian public and private sector organisations have considerable capacity to assist in institutional strengthening, which often is important in China's massive multifaceted infrastructure projects.

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¹⁸ Chapter 6 - Foreign Investment covers foreign investment issues in detail.

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CHINA'S REGIONS — DISPARITIES AND PROSPECTS

While all regions have participated in China's rapid economic growth, the coastal provinces have been much more successful than those in the hinterland. The coastal area's greater integration into the international economy and more liberal policy environment have spurred a divergence of regional growth rates that has accelerated in recent years. Per capita income in the wealthier coastal provinces has been approximately double that of the poorer hinterland ones since the mid 1970s and the gap is widening. This has caused a major policy dilemma for the Chinese Government. The coastal region is the engine of market-oriented economic reforms and growth but increasing regional divergence has the potential to create serious social and political tensions.

Regional variation in cost structures is a major potential source of opportunity for local and foreign investors seeking lower cost production bases outside the main early growth areas on the coast. The movement of local and foreign investment into the hinterland is already underway, but these provinces will need huge infrastructure investments involving significant inter-regional fiscal transfers to sustain momentum.

This chapter analyses:

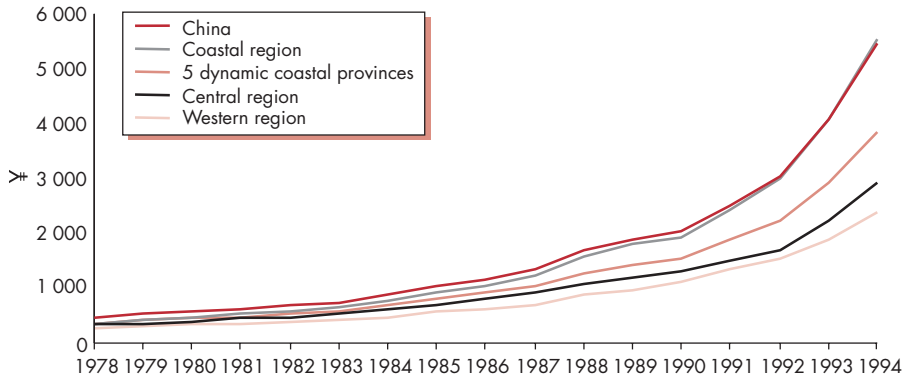
- the changing regional patterns of income, productivity and growth and the causes of this divergence
- recent government policy initiatives to address regional disparities and the likelihood of future convergence
- three emerging markets — the Pearl River Delta in southern Guangdong province, the Yangtze River Delta stretching inland along the Yangtze from Shanghai, and the Bohai Ring or Bay Area encompassing Tianjin and the developed coastal cities in Shandong, Hebei and Liaoning
- the opportunities presented for Australian investors and traders due to differences in policy approaches and endowments of the most prospective regions.

THE GROWTH OF REGIONAL DISPARITIES

The divergence in regional incomes began in earnest in the 1990s, due to accelerated economic reforms that enabled the true comparative advantage of provinces to emerge more clearly.

Figure 8.1

Coastal Region Incomes Take Off
Regional Disparities in Per Capita Income
(Yuan, in Current Prices)



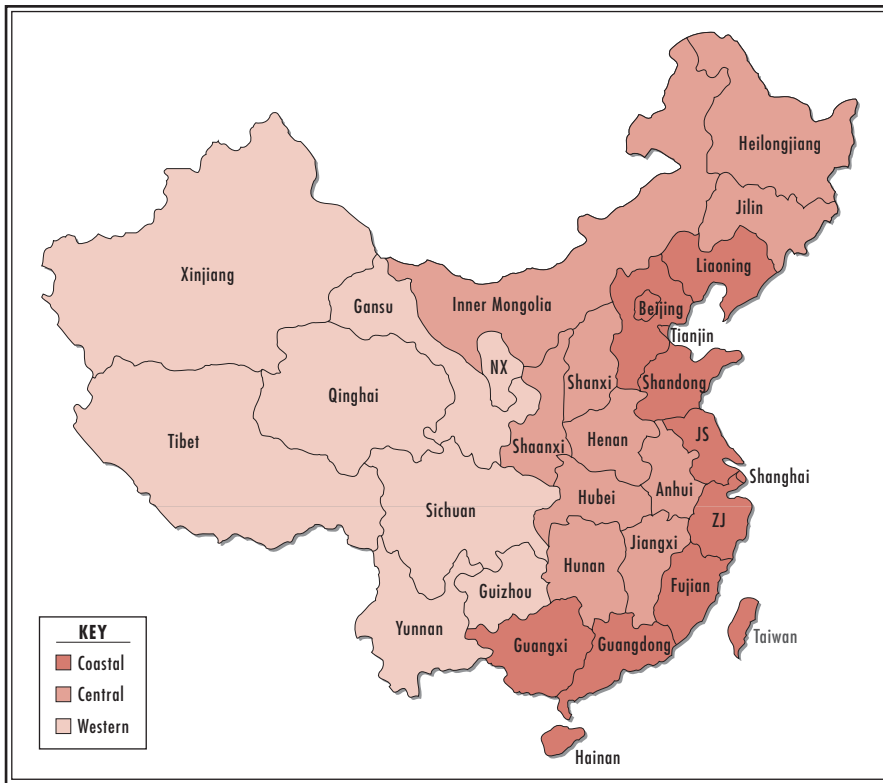
Source: State Statistical Bureau (1996b and previous years).

NATURAL ECONOMIC REGIONAL GROUPINGS — COASTAL, CENTRAL AND WESTERN

China has 23 provinces, five autonomous regions and four centrally controlled municipalities.¹ In order to analyse disparities in the provinces' recent economic performance, a useful division is simply into the coastal, central and western regions.

Map 8.1

China's Coastal, Central and Western Regions



¹ Chongqing, the newest of the municipalities, formally acquired this status in early 1997.

The distribution of income, population and land between regions is highly uneven (Table 8.1).

Table 8.1

Population and Income Concentrated on the Coast
Regional Income and Shares of Population and Land, 1994

| | GDP per capita | Share of national GDP | Share of total population | Share of national land |
|---------|-------------------|--------------------------|------------------------------|---------------------------|
| | US\$ | Per cent | Per cent | Per cent |
| Coastal | 667 | 58 | 42 | 21 |
| Central | 336 | 28 | 31 | 19 |
| Western | 277 | 14 | 27 | 60 |

Source: State Statistical Bureau (1996b and previous years).

The **coastal region** comprises the most economically dynamic provinces of Guangdong, Jiangsu, Zhejiang, Fujian, Shandong, the three rapidly growing municipalities of Shanghai, Tianjin and Beijing, the heavy industry province of Liaoning, and the poorer but rapidly growing provinces of Hebei, Hainan and Guangxi which borders Vietnam.

Traditionally Shanghai in the east, Beijing and Tianjin in the north and Liaoning in the north east coastal region were most developed industrially. During the reforms, however, the poorer southern coastal provinces of Guangdong and Fujian grew much faster and surpassed the income levels of the north-eastern provinces. Liaoning, with a high proportion of its assets in financially strapped SOEs and with many redundant workers, is now poor by the standards of southern provinces.

The first four Special Economic Zones opened in the early 1980s in the southern coastal provinces of Shenzhen, Zhuhai and Shantou (all in Guangdong) and Xiamen (in Fujian). Similarly, the 14 cities designated as open cities in 1984 are all in the coastal region (from north to south): Dalian, Tianjin, Yantai, Qingdao, Qinhuangdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai. All cities were commercial shipping ports (before and/or since 1949) and had a tradition of international as well as domestic commercial interaction. All were either Western dominated 'treaty ports' before 1949 or had substantial informal Western influence. Consequently, all 14 open cities have become important foci of foreign investment since 1984 (*Yearbook of China's Golden Coast*, 1993 and 1995; Economist Intelligence Unit, 1995).

The southern provinces of Guangdong, the strongest provincial economy in China, and Fujian currently constitute the most important part of the coastal region. Hong Kong, Macau and Taiwan are becoming increasingly economically integrated into the South China core, augmenting its economic and political strength.

The Shanghai–Nanjing area is becoming more dynamic and integrated, economically and politically. This will continue into the next century when it will be China's second most powerful economic growth area. Shanghai's Pudong, now China's most significant economic development zone, has rivals in adjacent provinces: Suzhou, Wuxi and Nanjing in Jiangsu; and Hangzhou and Ningbo in Zhejiang.

The **central region** comprises the middle and lower middle income provinces of Heilongjiang and Jilin in the north east, Inner Mongolia and Shanxi in the north, and the generally poorer central and southern core provinces of Henan, Anhui, Hubei, Hunan and Jiangxi. Although it is land scarce, unlike the coast it is not heavily industrialised. The stronger provinces in this region are Hubei and Henan; the weaker ones are Jiangxi and Hunan.

The **western region** comprises the poorest and least developed provinces: Sichuan, Guizhou and Yunnan in the south west; and the resource rich provinces of Shaanxi, Gansu, Qinghai, Ningxia, Xizang (Tibet) and Xinjiang in the north west. This remote region is well endowed with land and resources and has a relatively low population density but is very poor. It is hindered by poor infrastructure links to the coast and other major markets, and lacks integration into the world economy. Social indicators generally reflect this (Table 8.1).

The strongest province in this region is Sichuan, China's largest province, with over 100 million people and the two large cities of Chongqing and Chengdu. Sichuan has the potential to become an important economic entity even though it is overpopulated, economically poor and physically distant from the economically dynamic coastal areas. The provinces bordering Burma and Vietnam, especially Yunnan, have developed lucrative trade and investment links with their neighbours, which have strengthened their economies.

DIVERGENCE OF REGIONAL INCOME GROWTH

Three indicators provide the overall picture of the divergence:

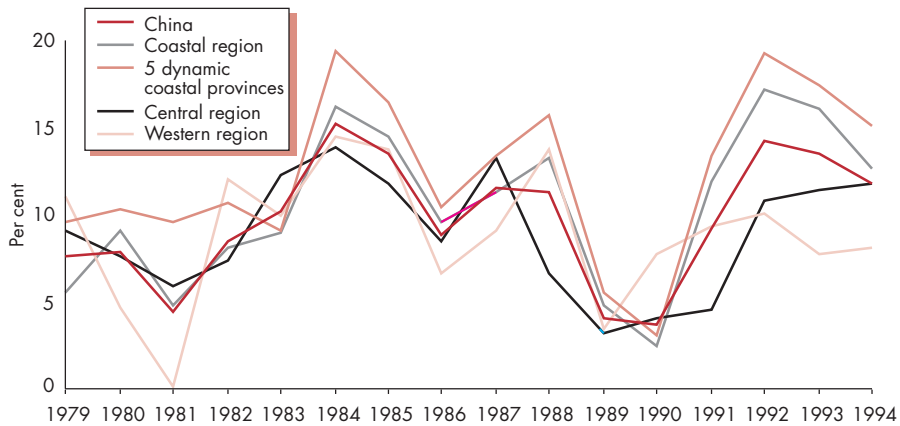
- per capita GDP, the conventional indicator of overall economic activities
- industrial output, a proxy for the rate of modernisation and development
- the gross value of retail sales, which reflects the level of effective demand and marketisation of an economy.

While the coast's growth continues to outstrip the growth rates of the other two regions, within the coastal region, Jiangsu, Zhejiang, Fujian, Shandong and Guangdong are China's fastest growing provinces, performing much better than the rest of the country or the coastal region. The contribution of the five fastest growing provinces to national GDP increased dramatically from 25 to 37 per cent between 1978 and 1994. The performance of the traditional industrial provinces and municipalities of Liaoning, Hebei, Beijing, Tianjin and until recently Shanghai, where most of large SOEs are located, is only average. For this reason, indicators on the five fastest growing provinces are presented separately in most of the following figures.

The coastal region's growth rates are consistently higher than those of the western and central regions, even though the latter are high by international standards (Figure 8.2). In fact, the divergence of regional economic growth is not a consequence of poor performance by the central and the western regions, but rather due to the outstanding performance of the coastal region.

Figure 8.2

Coastal Region Growing Faster
Annual Growth Rates of Real GDP by Region



Source: State Statistical Bureau (1996b and previous years).

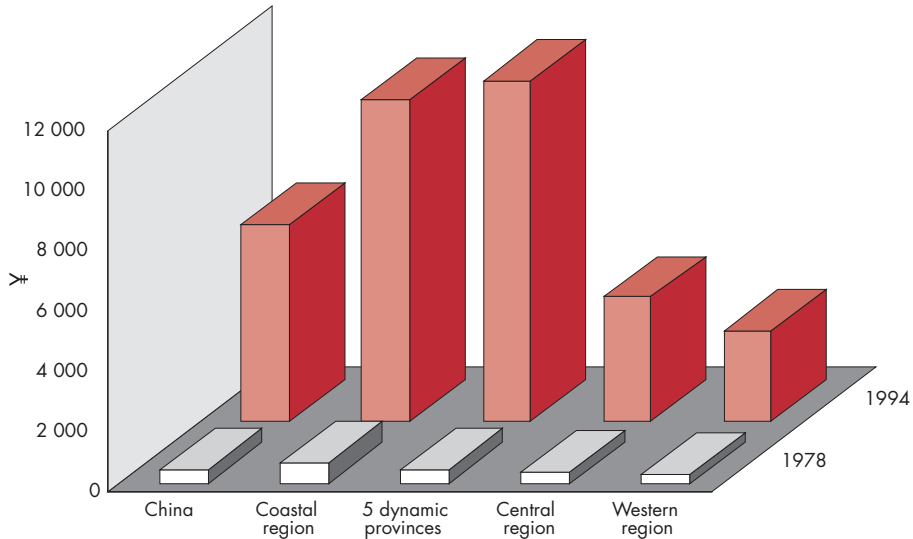
DIVERGENCE OF INDUSTRIAL GROWTH RATES

Divergence of industrial output was even greater than GDP divergence and increased by more than 20 per cent between 1990 and 1994 (Figure 8.3). Nevertheless, the western and the central regions still achieved high rates of growth in industrial output, averaging about 20 per cent per year in current prices, compared with the 25 per cent in the coastal region. The coastal region's contribution to the national industrial output edged up steadily in the second half of the 1980s and the first half of the 1990s (Figure 8.4).

Figure 8.3

Industrial Output Concentrated on the Coast

Regional Industrial Output, 1978 and 1994 (in Current Prices)



Note: Yuan is per capita.

Source: State Statistical Bureau (1996b and previous issues).

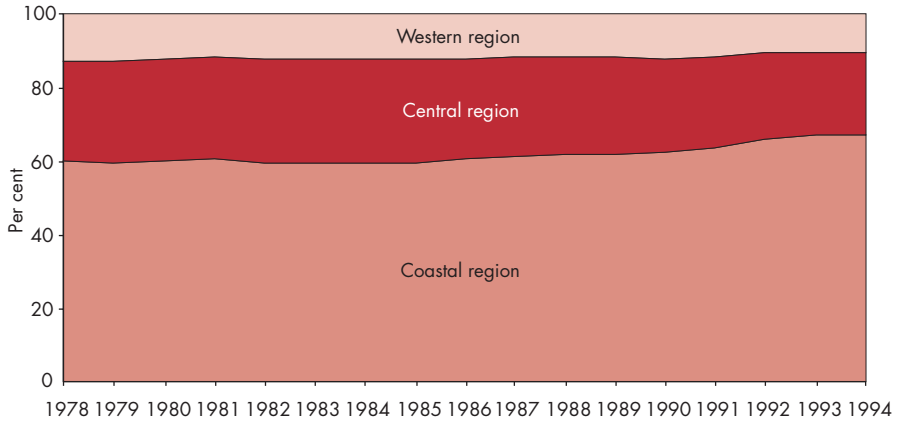
As the five dynamic provinces were not China's traditional industrial areas in 1978, their industrial per capita output was below the national average then. However, their contribution to national industrial output grew from 24 per cent in 1978 to 44 per cent in 1994, overtaking the traditional industrial provinces.

GROWING DIVERGENCE OF RETAIL SALES

The value of retail sales has also grown consistently faster in the coastal region than in the central and the western regions (Figure 8.5). This is not only due to higher incomes on the coast but also because markets have developed more rapidly there than in the hinterland, where semi-subsistence agriculture is still prevalent.

Figure 8.4

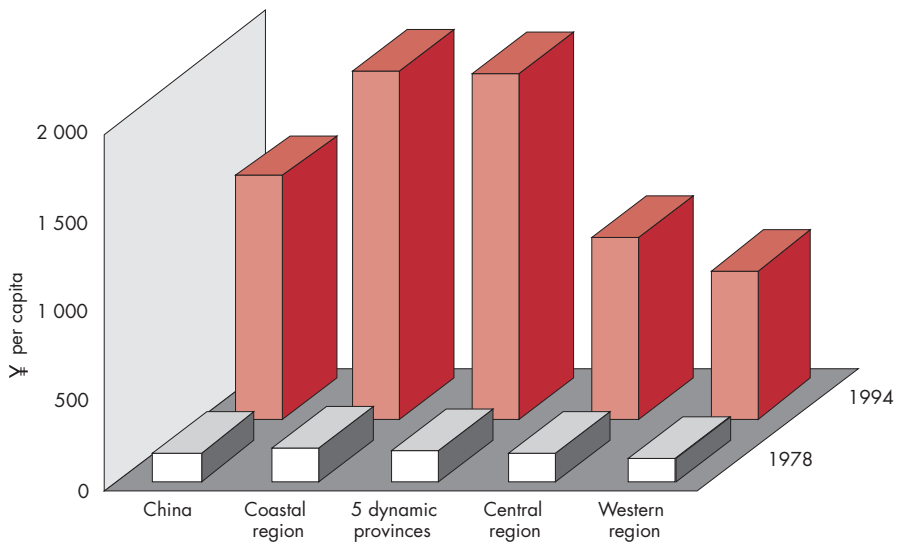
Industrial Concentration Increases
Regional Contributions to National Industrial Output
(Per Cent)



Source: State Statistical Bureau (1996b and previous years).

Figure 8.5

Retail Sales Also Focused on the Coast
Per Capita Value of Regional Retail Sales
(in Current Prices)



Source: State Statistical Bureau (1996b and previous years).

CAUSES OF REGIONAL DIVERGENCE

Summarising, since 1989, the divergence of GDP, industrial output and retail sales in the three regions has increased markedly. The causes of regional disparities and this divergence are now discussed.

The proximity of the coastal region to sea links and more developed transport and other infrastructure is one of the most obvious causes of regional income disparities.

Disparities in New Investment

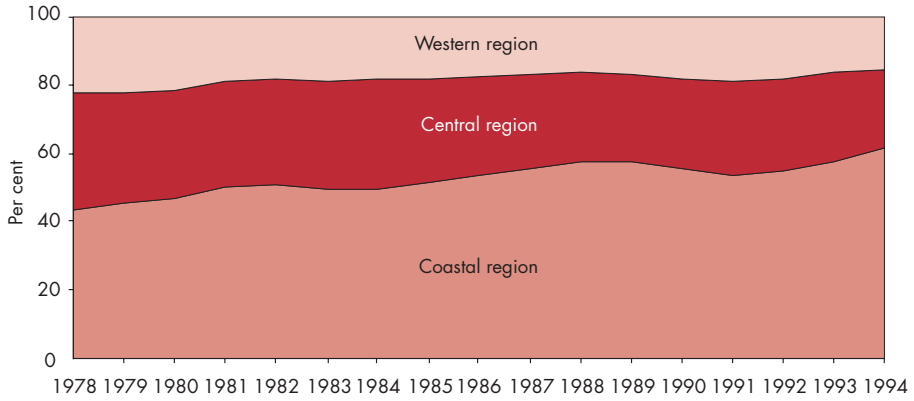
Throughout much of the pre reform period, the allocation of state controlled investment was biased heavily towards the western region, mainly for strategic reasons. However, significant decentralisation of economic power and fiscal resources from the central Government to local governments and individual firms (state and non-state) means a greater proportion of total investment now goes to the coastal region (Figure 8.6). Official population shares of the three regions remain quite static despite some relaxation of migration controls (Figure 8.7).²

The major reason the coast's investment share has risen is the declining role of the state budget and the increasing importance of enterprises' retained earnings as investment sources. By 1994, retained earnings financed almost 50 per cent of total fixed investment while only 6 per cent was provided by the state budget, with most of the remainder coming from bank loans (Figure 1.12). The coastal region obtained two thirds of all retained earnings, the remaining third being shared between the central and western regions. This was because of the greater propensity of non-state firms, now dominant on the coast, to reinvest their earnings. In contrast, state firms depend on bank loans for investment. (See Chapter 11 - Non-State Sector, Table 11.7.) The coast has also received most foreign direct investment (Figure 8.8), which is discussed later.

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² However, due to the *hukou*, household registration system, many of the recent rural migrants to urban areas may not be counted in official population statistics for the coastal region.

Figure 8.6

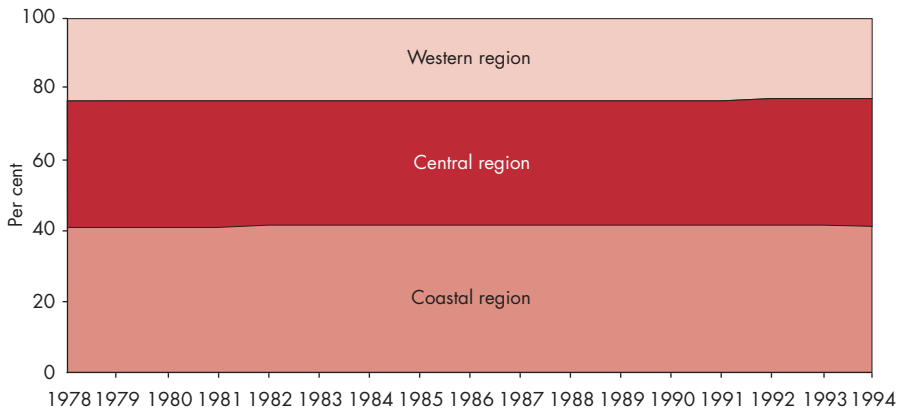
The Coast Gets an Increasing Share of Investment
Regional Shares of Fixed Investment



Source: State Statistical Bureau (1996b and previous years).

Figure 8.7

Population Shares Static
Regional Shares of the Total Population

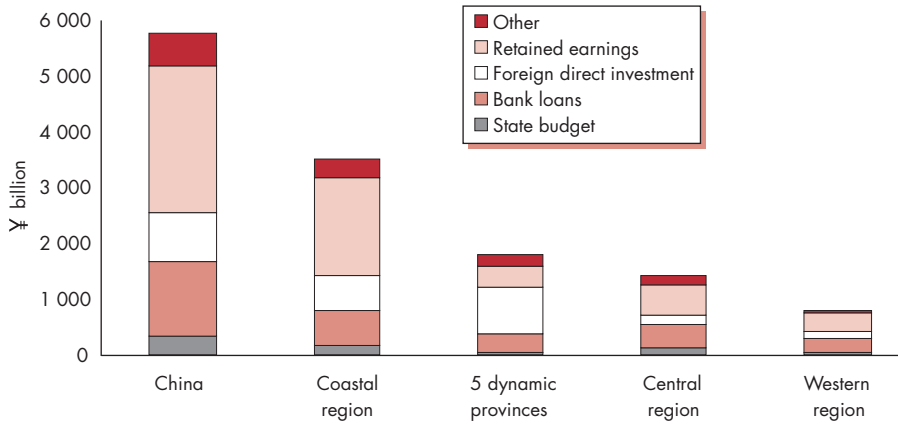


Source: State Statistical Bureau (1996b and previous years).

Figure 8.8

Retained Earnings and FDI Dominate Coastal Investment Sources

Sources of Regional Investment, 1994



Source: State Statistical Bureau (1996b and previous years).

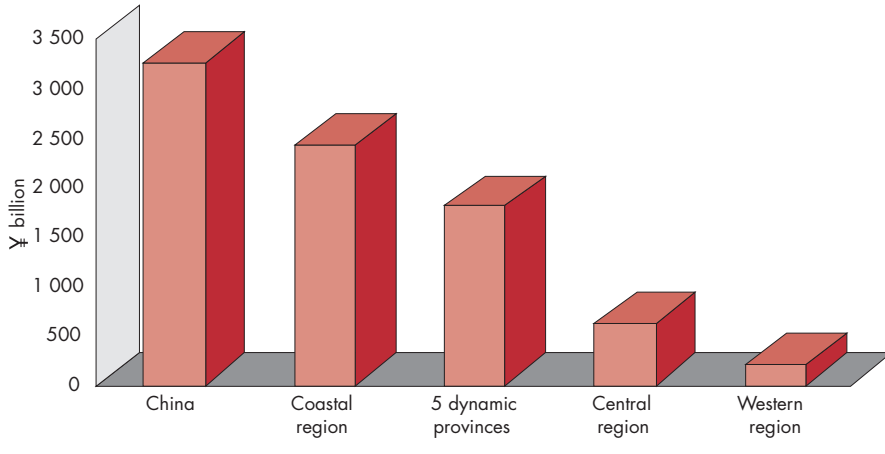
Divergence in Growth of Township and Village Enterprises

Township and village enterprises (TVEs) are also concentrated in the coastal region. (See Chapter 11 - Non-State Sector.) TVEs first emerged in the southern part of Jiangsu province in the 1970s and developed links with Shanghai's SOEs. The second wave developed in Guangdong and Fujian, initiated by individuals with relatives in Hong Kong and Taiwan, and later in Shandong, Liaoning and Hebei provinces.

Although TVEs later emerged in the central and western regions and have been growing rapidly since, their role is still significantly smaller than in the coastal region (Figures 8.9 and 8.10). The differences in TVE industrial output account for more than half of the overall regional disparity in industrial output.

Figure 8.9

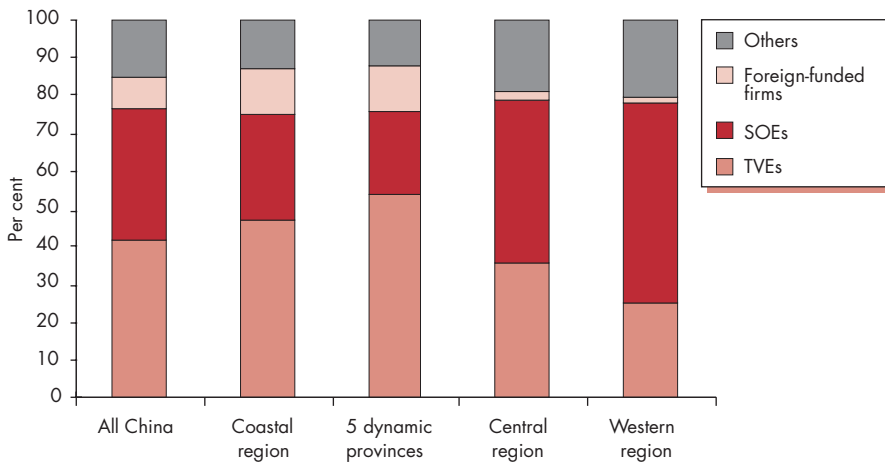
TVEs Concentrated on the Coast
TVE Industrial Output by Region, 1994



Source: State Statistical Bureau (1996b and previous years).

Figure 8.10

Non-State Firms Dominate Coastal Industry
Ownership Share in Regional Industrial Output, 1994



Source: State Statistical Bureau (1996b and previous years).

Decentralisation of the Trade Regime and Export Growth

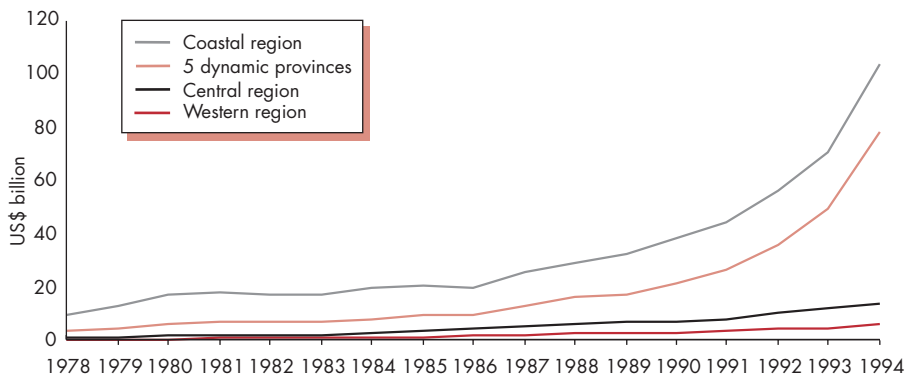
The export competitiveness of the central and the western regions lagged in the 1990s when export growth in the coastal provinces accelerated (Figure 8.11). The share of China's total exports accounted for by the five fastest growing provinces rose dramatically, from 30 per cent in 1978 to 64 per in 1994. Now these provinces are China's core export base.

Throughout the 1990s, Guangdong dominated China's international trade, accounting for about one third of total exports and imports. While Shanghai is second only to Guangdong, Guangdong's foreign trade (including contract trade with Hong Kong) is more than double the combined trade of Shanghai, Jiangsu and Zhejiang.

Several poorer inland provinces (Heilongjiang, Hubei, Hainan and Yunnan) also achieved high trade growth in the 1990s, albeit from a low base. However, their total 1994 trade volume of US\$11.4 million was still lower than that of Tianjin.

Figure 8.11

The Coast Produces Bulk of Exports Regional Divergence in Exports^a



Note: ^a The exports included are controlled by provincial trade corporations, agents and companies; those managed by the central foreign trade corporations are not. Exports are attributed to province of origin, not final export.

Source: State Statistical Bureau (1996c and previous years).

The Concentration of Foreign Investment in the Coastal Region

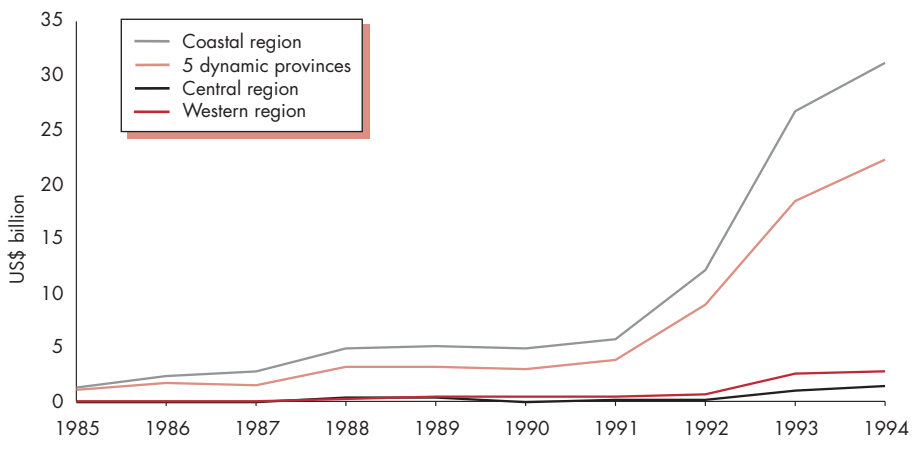
The 'coastal development strategy' initially favoured foreign direct investment in the coastal areas. (See Chapters 9 - Agriculture and 5 - International Trade.) Although the central and western regions were later given permission to open their own development zones, they have far fewer than in the coastal region. However, the modest level of foreign investment attracted by the central and western regions is primarily due to a lack of basic economic infrastructure and lower incomes, and therefore smaller markets, rather than the absence of preferential policies.

As a result, in 1994 the coastal region received 87 per cent of China's foreign direct investment, with the five fastest growing provinces alone taking almost 66 per cent of the total. In addition to capital, foreign investors have brought the region major benefits, including management skills, new technology, and knowledge of and access to international markets.

The complex system of central and local government laws, regulations, orders, notices and other policy pronouncements that govern almost all aspects of foreign investment are based primarily on international standards and provide the coast with a fundamentally different regulatory environment from that of the hinterland regions.

Figure 8.12

FDI Goes Mainly to the Coastal Region Regional Divergence in Used Foreign Investment

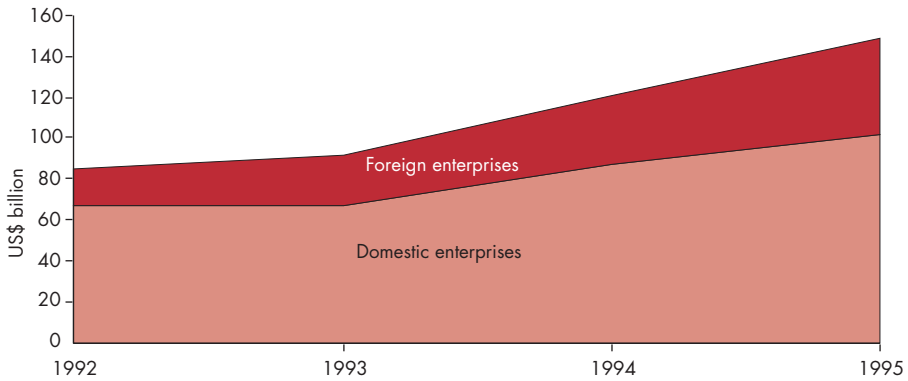


Source: State Statistical Bureau (1996b and previous years).

By the end of 1995, more than 200 000 foreign firms were registered in China, mostly in the coastal region, generating almost one third of China's exports (Figure 8.13). Their concentration in the coastal region has undoubtedly been a major factor in promoting the region's rapid export growth.

Figure 8.13

Foreign Firms' Export Share Grows Source of Exports



Source: Data for 1992 to 1994 are from State Statistical Bureau (1996b and previous years); data for 1995 are based on the reported figures from the China Xinhua News Agency.

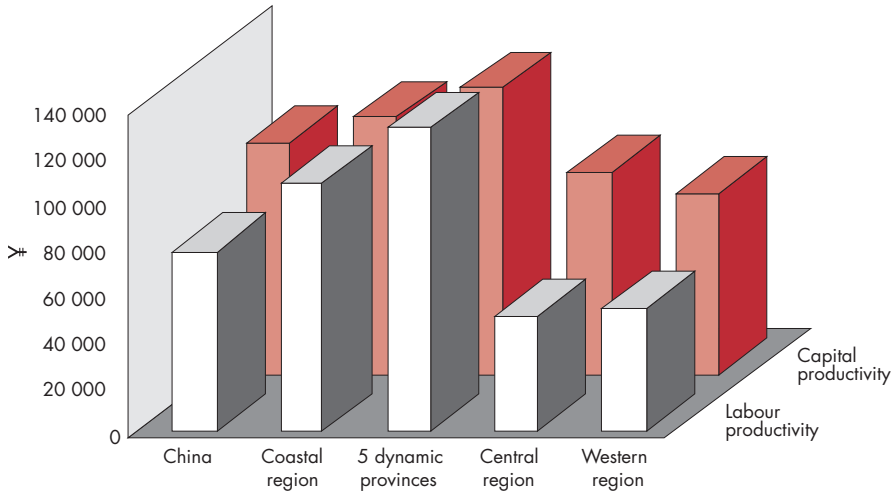
Divergence of Regional Productivity and Cost Efficiency

Industrial enterprises in the central and western regions have lower labour productivity (output per worker) and lower capital productivity (output per unit of capital) than enterprises in the coastal region; that is, they are technically inferior (Figure 8.14). The five dynamic provinces are technically superior to all other regions, using both less labour and less capital to produce a given amount of output.

In short, the divergence of regional economic growth can be explained by increasing regional differences in capital accumulation and productive efficiency. The coastal region in general and the five fastest growing provinces in particular have not only accumulated capital resources much faster than the central and western regions, but they have used them more efficiently. This divergence can be largely explained by the prevalence of state enterprises in the hinterland provinces.

Figure 8.14

Coastal Firms Are More Productive
Labour and Capital Productivity of Industrial Enterprises by Region, 1994



Note: Capital productivity is measured in terms of yuan of output per ¥ 100 000 of capital employed. Labour productivity is yuan produced per worker.

Source: State Statistical Bureau (1996b and previous years).

Fiscal Burdens of the Regions

Some Chinese analysts claim that the relatively light tax burden on the coastal provinces, due to tax concessions given to foreign firms and special economic zones, and the high tax burden on SOEs³, which dominate interior provinces, have contributed to regional income disparities, as well as to a lack of capital accumulation among SOEs (Study Group of Modern Companies of the Chinese Academy of Social Sciences, 1996).

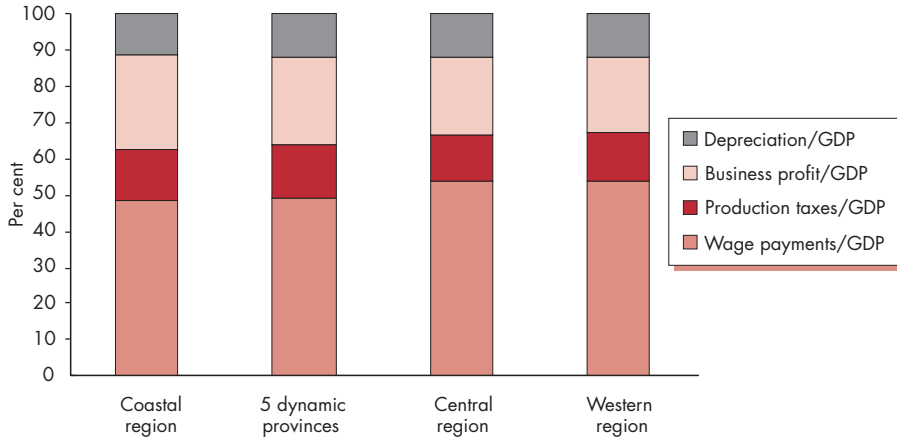
However, in 1993, the proportion of GDP paid as production taxes was 6 to 9 percentage points higher in the coastal region and five dynamic provinces than in the central and western regions (Figure 8.15). Although higher tax rates were applied to SOEs prior to 1995 (because they were supposed to include a capital charge for state investment), the actual tax contribution of SOEs was limited because many were unprofitable and therefore could not be taxed. The inland regions also paid a higher share of their output to labour and had lower profit to GDP ratios (Figure 8.15), again probably due to the prevalence of SOEs in these regions. (See Chapter 10 - State-Owned Enterprises.)

³ Before 1994, the Chinese Government levied a 55 per cent tax rate on large and medium sized SOEs when the rates were about 35 per cent for private business, 20 per cent for TVEs and 15 per cent for foreign-affiliated companies. The new tax system, introduced in mid 1994, unified tax rates for different enterprises.

Figure 8.15

The Coast Has Higher Profits and Pays More Taxes

Allocation of GDP by Region, 1993



Source: State Statistical Bureau (1996b and previous years).

World Bank data on fiscal transfers indicate that from 1978 to 1991, the coastal provinces ran budget surpluses (averaging 16 per cent of expenditure), which were transferred to the central Government. At the same time, the western and central regions had budget deficits (averaging 24 per cent of expenditure), which were financed by the central Government (World Bank, 1996, pp. 40–42). State subsidised bank loans have also heavily favoured the interior regions (Figure 8.8 and Lardy, forthcoming).

Differences in Regional Economic Policies

Since the mid 1980s, every province has had the same autonomy to encourage the non-state sector and trade, reform agriculture and SOEs, and generally develop a market economy. However, the enthusiasm with which different provinces have embraced reforms has probably differed. The coastal provinces in general, but particularly the five fastest growing ones, have quickly grasped opportunities to reform and open their economies, while the hinterland provinces have often been more cautious and conservative. The personalities and capacities of regional and municipal leaders and administrators help determine the willingness to innovate.

To some extent, every province has adopted reforms and all have achieved high real economic and trade growth rates by international standards. The divergence of economic policies and the pace of reform therefore has been relative.

Conclusions about the Causes of Regional Growth Disparities

The success of the coastal region can be attributed mainly to the shift in national economic strategies away from closed, centrally planned, heavy industry-orientated policies to more open, market-based policies that use the coastal region's natural comparative advantage. In particular, the coastal region performed strongly in developing TVEs and export-oriented enterprises, increasing productivity, increasing the rate of reinvestment of retained earnings and successfully attracting foreign direct investment. The rapid growth of household income and consumption has also supported local market and industrial development.

The coastal region entered a 'take-off' stage in the early 1990s, precipitated in part by the growing integration of key provinces and growth centres. The following section briefly examines the development of these growth areas and their role in the integration of key sections of the coastal region. Because of their natural and policy advantages, these areas also are proving the most attractive destinations for foreign investment.

THREE GROWTH CENTRES IN THE COASTAL REGION

Within the five dynamic provinces, three areas are growth centres:

- the Pearl River Delta in Guangzhou province
- the Yangtze River Delta stretching inland along the Yangtze from Shanghai
- the Bohai Ring, including Tianjin and the developed coastal cities in Shandong, Hebei and Liaoning.

These dynamic subregions have generated a disproportionately high share of income, output, exports and virtually every other development indicator, and have attracted a much larger share of foreign direct investment, domestic investment and bank loans than the national per capita average (Table 8.2).

Together, the three areas produce 33 per cent of total national GDP with only 3.3 per cent of national land area and 14 per cent of total population. Deducting this output from the coastal region total reveals that the rest of coastal region, with 17 per cent of the national land area and 27 per cent of the population produces only 24 per cent of national GDP. This suggests that China's regional economic divergence can basically be attributed to the superior performance of these three growth areas.

Together, the three areas produce about 45 per cent of national industrial output, produce 54 per cent of China's exports and receive 47 per cent of all foreign investment.

Table 8.2
Three Growth Areas Developing Rapidly
Selected Indicators of the Three Growth Areas, 1993

| | Unit | Pearl River Delta | Yangtze River Delta | Bohai Ring |
|--------------------------------------|----------------------|----------------------|------------------------|---------------|
| Population | | | | |
| Number | million | 25.2 | 73.1 | 66.1 |
| As a proportion of national total | per cent | 2.1 | 6.2 | 5.6 |
| Employment | | | | |
| Number | million | 16.7 | 44.4 | 34.8 |
| As a proportion of national total | per cent | 2.8 | 7.4 | 5.6 |
| GDP | | | | |
| Value | ¥ billion | 242 | 506 | 321 |
| As a proportion of national total | per cent | 7.7 | 16.2 | 10.2 |
| Industrial output | | | | |
| Value | ¥ billion | 405 | 1231 | 642 |
| As a proportion of national total | per cent | 7.7 | 23.7 | 12.2 |
| Average urban wage | | | | |
| Money wage per year | ¥ | 5 679 | 4 483 | 3 738 |
| Relative to national average (= 100) | index | 168 | 133 | 111 |
| Fixed capital investment | | | | |
| Value | ¥ billion | 65 | 106 | 99 |
| As a proportion of national total | per cent | 7.8 | 12.8 | 12.0 |
| Realised foreign investment | | | | |
| Value | US\$ billion | 7.2 | 7.2 | 3.9 |
| As a proportion of national total | per cent | 18.4 | 18.4 | 10.0 |
| Exports and imports | | | | |
| Value | US\$ billion | 29.7 | 40.3 | 36.2 |
| As a proportion of national total | per cent | 15.2 | 20.6 | 18.5 |
| Bank loans | | | | |
| Value | ¥ billion | 286 | 295 | 255 |
| As a proportion of national total | per cent | 10.8 | 11.1 | 9.6 |
| Passenger traffic | | | | |
| Number | million people/km | 673 | 965 | 563 |
| As a proportion of national total | per cent | 6.8 | 9.7 | 5.7 |
| Freight traffic | | | | |
| Volume | million tonnes/km | 538 | 1048 | 852 |
| As a proportion of national total | per cent | 4.8 | 9.4 | 7.6 |
| Telecom and postage | | | | |
| Value | ¥ billion | 8.0 | 7.7 | 6.9 |
| As a proportion of national total | per cent | 17.3 | 16.7 | 14.8 |
| Retail sales | | | | |
| Value | ¥ billion | 101.7 | 184.0 | 103.8 |
| As a proportion of national total | per cent | 8.3 | 15.1 | 8.5 |
| Agricultural output | | | | |
| Value | ¥ billion | 59.9 | 86.9 | 100.5 |
| As a proportion of national total | per cent | 5.4 | 7.9 | 9.1 |
| Land area | | | | |
| | '000 km ² | 62 | 100 | 157 |
| As a proportion of national total | per cent | 0.65 | 1.04 | 1.63 |

Source:

State Statistical Bureau, 1995b.

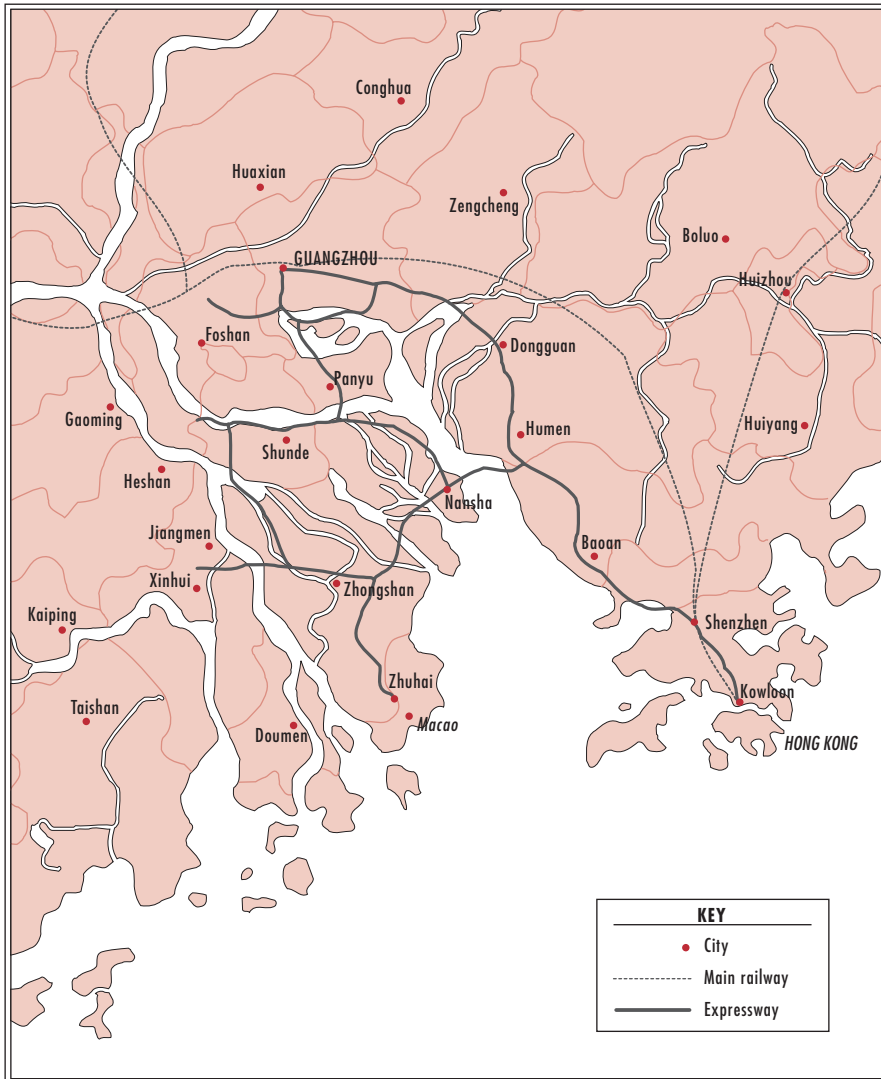
On every economic per capita indicator except industrial output, the Pearl River Delta ranked first, reflecting its higher level of development, followed by the Yangtze River Delta and the Bohai Ring. Using per square kilometre indicators, the Yangtze River Delta ranks the first on most indicators, indicating its high level of geographic business concentration and urbanisation.

The three areas took almost a third of national bank loans. In the Pearl River Delta, per capita bank loans were five times higher than the national average.

Retail sales in the three areas accounted for nearly a third of national retail sales, with Pearl River Delta per capita retail sales being four times the national average.

Pearl River Delta

Map 8.2
Pearl River Delta



The Pearl River Delta comprises the most developed parts of southern Guangdong province, adjacent to Hong Kong.⁴ During 1990 to 1994, no province came close to attracting as much capital as Guangdong due to its:

- proximity to Hong Kong
- favourable investment conditions highlighted by the establishment in Guangdong of three of the four Special Economic Zones
- good local labour pool and the immigration of talented personnel from other parts of China
- enlightened local political and economic leadership.

Investment from Hong Kong and Macau, and a natural complementarity of Hong Kong's capital and entrepreneurship to Guangdong's abundant land and labour resources motivate and drive the rapid development and integration of the Pearl River Delta into the world economy. A recent study estimated that, while the productivity of all categories of employees in Guangdong was about 70 per cent of that in Hong Kong, the wages of factory workers in Guangdong were 20 per cent of those in Hong Kong, management and technical specialists 50 per cent, and clerical staff 14 per cent. Consequently, the return on investments of Chinese subsidiaries has been approximately double that of Hong Kong firms (Tuan and Fung-Yee Ng, 1995).

Guangdong subsidiaries generally undertake labour intensive assembly and simple manufacturing processes, while their Hong Kong headquarters retain human capital-intensive, service oriented functions such as financial control, planning, marketing, customer liaison and design.

To date, most Hong Kong investments have been in small, labour intensive operations along the eastern corridor of the delta from Shenzhen to Dongguan. However, in recent years, improved roads and bridges increasingly have opened up the western half of the delta, encompassing Foshan, Zhuhai, Panyu, Shunde and Zhongshan. This area is now having some success in attracting larger, multinational investors in order to develop more permanent, higher value added industries.

.....
⁴ The municipalities in Guangdong province included in the Pearl River Delta are Guangzhou, Foshan, Panyu, Shunde, Zhongshan, Dongguan, Shenzhen, Zhuhai, Doumen, Jiangmen, Xinhui, Zhaoqing, Huizhou and Qingyuan.

SHENZHEN

Shenzhen, now a city of 3.6 million people, was a village when designated as one of China's four original Special Economic Zones in 1985. It has always been the most successful of these zones because of its proximity to Hong Kong and Macau and its dynamic political leadership. While many special economic zone privileges, such as foreign exchange retention and import duty drawbacks on inputs for exporters, now extend to enterprises outside the zones, Shenzhen manages to stay at the forefront of reform and the zone plays the role of a laboratory for experimentation with economic reforms. With Shanghai, it was the site of one of China's first two stock exchanges and has trialed many other reforms, including foreign bank participation in yuan banking and SOE reform. It has a contributory social security system for all enterprise employees, covering (involuntary) unemployment, retirement, medical and housing benefits.

Between 1980 and 1995, foreign investors established 10 800 joint ventures and wholly owned firms in Shenzhen, with investments totalling US\$6.8 billion. In 1995, about 70 per cent of foreign direct investment was for manufacturing, 20 per cent for real estate and 10 per cent for commerce. Currently, most manufacturing is light and labour intensive, including garments, textiles, bicycles and electronics.

However, Shenzhen wages and land prices are now relatively high compared with costs in other parts of the Pearl River Delta and certainly other regions of China. Consequently, in recent years, the rate of growth of new investment has levelled off. This is the main reason why the Shenzhen administration is attempting to develop beyond its original labour intensive manufacturing base and to attract more technologically advanced industries with favourable taxation and other treatment. It is encouraging labour intensive investments to locate in rural areas around Shenzhen.

The Shenzhen Government is also actively courting foreign enterprises to invest in its major infrastructure projects. It has already succeeded in attracting investors to several highway, port, electricity generation and telecommunications projects. It claims that it does not cap rates of return on such projects (Li, J.W., 1995).

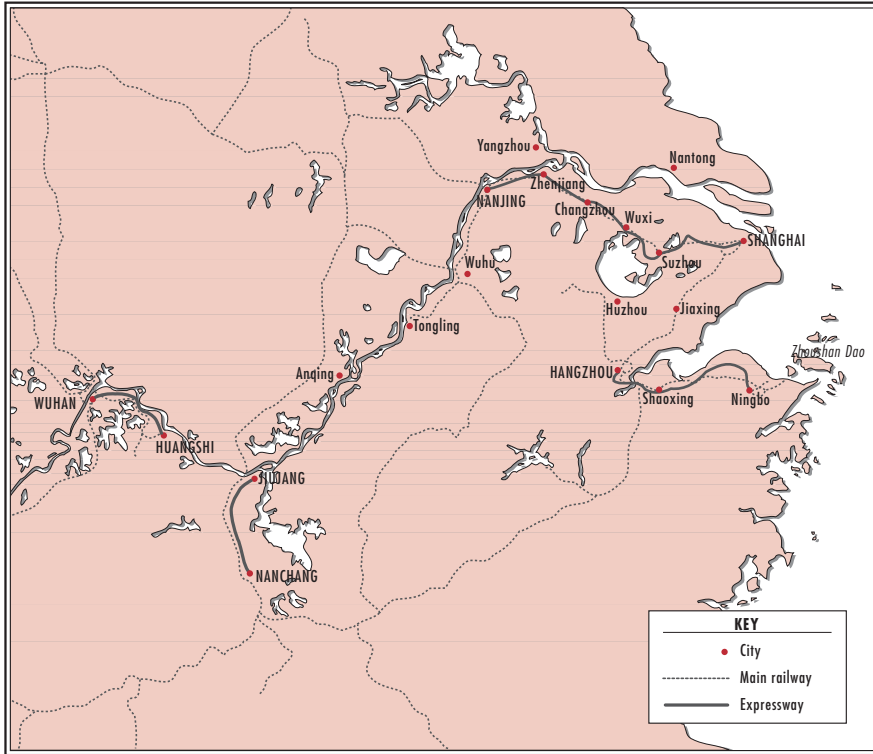
While Guangdong and Fujian attracted the lion's share of China's foreign investment during 1990 to 1994, the average rate of growth of Guangdong's foreign investment in current values (544 per cent) was not as high as that of other dynamic provincial economies, the three municipalities of Shanghai, Beijing and Tianjin (average 1438 per cent) or even most of the poorer interior provinces (1936 per cent). (See Chapter 6 - Foreign Investment, Table 6.4.)

This slowdown occurred for two main reasons: Guangdong's investment 'base' was larger than that of any other province in 1990; and foreign investors have increasingly targeted provinces other than Guangdong because of their perceived cost advantages.

Yangtze River Delta

Map 8.3

Yangtze River Delta and Valley



The second emerging growth centre is the Yangtze River Delta⁵, traditionally a major manufacturing centre, revitalised in the 1990s. It stretches inland from Shanghai, China’s largest and wealthiest industrial city, to include the dynamic TVE industrial production bases of Suzhou, Wuxi and Changzhou in Jiangsu, and Hangzhou, Ningbo and Jiaxing in Zhejiang. Most Zhejiang and Jiangsu TVEs started in the 1980s as low cost, labour intensive subcontractors for Shanghai enterprises, from which they acquired technological know-how and retired engineers and managers. This provided the initial stimulus for the area’s integration.

⁵ The narrow definition of this subregion includes Shanghai, Jiangsu and Zhejiang provinces. The municipalities included in this delta are Shanghai, Nanjing, Zhengjiang, Yangzhou, Suzhou, Wuxi, Changzhou, Nantong, Hangzhou, Jiaxing, Huzhou, Ningbo, Shaoxing and Zhoushan. However, the broader definition of this growth area includes the Yangtze River Development Region stretching along the Yangtze through Jiangsu, Zhejiang, Anhui, Jiangxi, Hubei, Hunan and Sichuan, as discussed in the section on the Yangtze River Development Strategy.

Shanghai

Shanghai was in the rearguard of China's reforms until 1990 because the central Government believed it could not risk Shanghai being subjected to premature reforms. In contrast, the central Government had very little at stake in relatively underdeveloped Guangdong, particularly in places like Shenzhen.

However, by 1995, after massive injections of infrastructure funding associated with Pudong, the liberalisation of restrictions on the establishment of non-state enterprises, and strong inflows of foreign direct investment, Shanghai had recorded four years of more than 14 per cent growth and had reached a per capita income of ¥ 18 000 (A\$3 000), the highest of any city in China.

Contracted foreign direct investment rose by 4 000 per cent between 1990 and 1994, reaching US\$10 billion per year for three consecutive years, 1994, 1995 and 1996, about 11 per cent of the national total. In 1994, US\$2.5 million of contracted foreign direct investment was actually implemented, 7.5 per cent of China's total. Shanghai's key attractions for foreign investors are its Pudong Development Zone, skilled labour, huge market, industrial base and strong central government support. Education levels are well above the national average, with over 30 per cent of high school graduates going on to tertiary education, compared with 3 per cent for China overall. Several of China's major universities are in Shanghai. The municipal leadership is now strongly supporting reform.

Trade through Shanghai increased by more than 30 per cent in 1995, as did exports produced in Shanghai. At present, Shanghai's five-year boom is continuing.

PUDONG NEW AREA

The opening of Shanghai's Pudong New Area economic zone in 1990 marked the start of market reforms in Shanghai and provided a much needed stimulus to foreign investment and growth in the Yangtze River Delta generally. Pudong, on a virtual greenfields site across the Yangtze River from central Shanghai, covers 350 square kilometres, making it approximately 12 times larger than the existing 14 economic development zones in the coastal provinces.

Within Pudong, priority has been placed on developing free trade and export processing zones, non-polluting, higher value added manufacturing, and service sectors including commerce, finance, real estate, research and educational facilities. By 1995, Pudong accounted for almost one fifth of Shanghai's output, had a per capita income twice the city's average and attracted one third of Shanghai's foreign direct investment (up from a quarter in 1994). In 1995, 84 per cent of Pudong's investment was foreign direct investment, much of which was directed to the services sector, including the new Lujiazui financial market centre.

Although Shanghai is home to a significant proportion of China's SOEs, it promotes innovative reforms, including new schemes to create social security nets and to restructure SOE management. (See Chapter 10 - State-Owned Enterprises.)

Yangtze River Development Strategy

The partnerships of Shanghai SOEs and Jiangsu and Zhejiang TVEs generated a tremendous growth in trade in the Yangtze River Delta (Hong and Cao, 1996a). Although this market-driven integration was not planned, the Government is now encouraging it via the Yangtze River Development Strategy.

Using a broad definition, the Yangtze River Development Region stretches inland along the 6 300 kilometre river, through the provinces of Jiangsu, Zhejiang, Anhui, Jiangxi, Hubei, Hunan and Sichuan, including the major river cities of Nanjing, Wuhu, Tongling, Jiujiang, Wuhan, Yichang and Chongqing, among others. The Yangtze River Development Strategy, announced by Prime Minister Li Peng in 1992, opened up many cities along the Yangtze to foreign trade and investment and gave foreign ships the right to berth at several Yangtze River ports. The main objective of this policy is more balanced and rapid development in the poorer hinterland provinces of the Yangtze River valley (Hunan, Hubei, Jiangxi, Anhui and Sichuan) by using the advantages of the more developed Shanghai, Jiangsu and Zhejiang. The Government intends to shift China's economic centre of gravity from the Pearl River Delta to the Yangtze River Delta in the 1990s, because of the latter's greater size and its links to the massive and poor hinterland provinces which represent China's heartland. The prominent role in the central leadership of many former Shanghai officials is sometimes seen as another motivation for this strategy.

Consequently, the central and Shanghai Governments have developed a vision of an integrated region along the Yangtze River, with Shanghai, the 'head of the dragon' providing technology and financial and trade services for the rest of the subregion, in much the same way Hong Kong does for southern China. The rest of the region's comparative advantage will be based on its low cost labour and land, ample water and river transport, and new transport and telecommunications links which will make it a competitive industrial base. The hinterland provinces will also produce agricultural products for Shanghai and export markets. When completed in 2010, the massive Three Gorges hydroelectric power project and other smaller schemes will modernise the region's power supply and river transport, as well as provide irrigation for large areas.

Cities in the Yangtze River Delta already produce a high proportion of the nation's iron and steel, petroleum-based chemicals, pharmaceuticals, transport equipment, electronic products, textiles, machinery, computers and cars.⁶ However, unlike the Pearl River Delta, most industrial goods produced in the region are for domestic consumption.

.....

⁶ The iron and steel enterprises in Shanghai, Nanjing and Hangzhou produced about 24 per cent of the national total in 1994; the petrochemical enterprises in Shanghai, Nanjing and Ningbo produced 14 per cent of the national total in 1993; the pharmaceutical enterprises in Shanghai, Wuxi, Hangzhou, Ningbo and Nanjing produced about 18 per cent of the national total in 1993; and the chemical fibre enterprises in Shanghai and Nanjing produced 50 per cent of the national total in 1993. This area also produced 24 per cent of transport equipment and 28 per cent of electronic products; its textile and machinery equipment industries have dominated national production since the early 1930s; and it is also the national base of such modern consumption products as computers and cars.

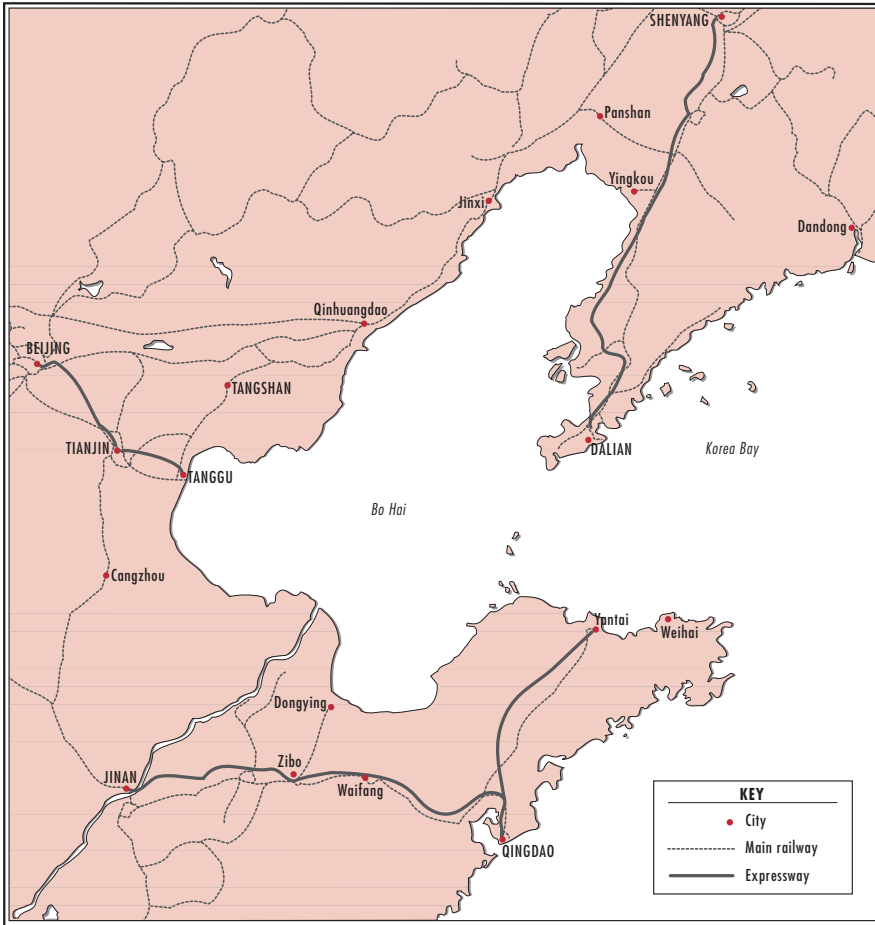
CHONGQING

Chongqing, the largest city in Sichuan, China's most populous province, was opened to foreign trade and investment in 1992. In 1997, it became China's fourth municipality, administered directly by the central Government. Including the population of counties under Chongqing's jurisdiction, it is the largest city in China, with 30 million people. As the largest industrial and commercial base in south western China, it has experienced a surge in foreign direct investment. By the end of 1995, Sichuan attracted US\$7.4 billion in foreign capital, 57 per cent of which was foreign direct investment. In 1997, Chongqing will become China's fourth centrally controlled municipality, with Beijing, Shanghai and Tianjin. Like most parts of the Yangtze River Delta, the city's economic structure is biased towards obsolete, loss-making state-owned heavy industries, particularly defence-related enterprises. However, it enjoys a large scientific, technical and skilled labour force, with wages only 30 to 50 per cent of those in the coastal provinces. Many large foreign-owned chemical, pharmaceutical, automobile and motor bike projects have been established in the city. Sichuan officials have a reputation of being very 'can do' and of being genuinely devoted to the development of the province.

Access to Sichuan's market of 113 million people is a major attraction for foreign investors. In addition, Chongqing will become a natural base for developing the power industry if the Sichuan Government adheres to its stated policy of seeking foreign assistance to develop its electricity industry.

The Bohai Ring

Map 8.4
Bohai Ring



The third new growth centre is the Bohai ring⁷, including Tianjin and the developed coastal cities in Shandong, Hebei and Liaoning. Unlike the other two growth centres, this area has significant natural resource endowments including coal, gold, diamonds, copper and zinc and accounts for 40 per cent of national oil production. It has been a major industrial area throughout China's modern history because of this resource base, its strategic location and relatively well developed transport systems.

⁷ The Bohai Ring encompasses Tianjin and parts of Shandong, Hebei and Liaoning provinces. The particular municipalities covered include Tianjin, Dalian, Dandong, Yingkou, Panshan, Jinxi, Tangshan, Qinhuangdao, Cangzhou, Qingdao, Yantai, Weifang, Dongying and Weihai.

DALIAN

Dalian, the rapidly growing port city in Liaoning, is attracting a significant share of the Bohai Ring's foreign direct investment, with US\$4.8 billion contracted and US\$1 billion actually invested up to 1996. It is China's second busiest port (after Shanghai) and a transport centre for the north and north eastern provinces of Liaoning, Heilongjiang and Jilin as well as the Korean peninsula, Russia and Mongolia. It is close to major oil, iron and steel, seafood and grain growing districts. Its port facilities are being expanded rapidly along with other transport and communications infrastructure.

Dalian's dynamic mayor, Bo Xilai, the son of former vice premier, Bo Yibo, encourages rapid reform and development in the city. For example, recently all officials were placed on contracts and required to learn at least one foreign language (*Far Eastern Economic Review*, 6 June 1996).

Although GDP grew 14 per cent in 1995, average wages remain a fraction of Shanghai's — ¥ 4 777 (A\$758) per year. Dalian's Economic and Trade Development Zone, offering taxation and other concessions, is a major drawcard for overseas investors. The major investors in order of importance are from Hong Kong, Taiwan, Japan, Republic of Korea, the USA and Europe. Dalian may provide good prospects for Australian investors and exporters of processed food, construction materials, construction and architectural services, agribusiness, grain handling and environmental technology. Several have already undertaken investments in the city.

Prior to the economic reforms, the Bohai Ring industry concentrated on heavy industry, which, in 1993 formed 64 per cent of industrial output. This compares with 50 per cent in the Yangtze River Delta and just 35 per cent in the Pearl River Delta. However, economic reforms have stimulated the rapid development of TVEs, light manufacturing, export-oriented and service industries in Shandong and Hebei. Since 1990, the non-state economy in Shandong and Hebei has dominated the state-owned economy, dramatically accelerating the market integration and growth of the Bohai Ring. As a result of its dependence on heavy industry SOEs, until recently, the Bohai Ring had grown significantly less than the Pearl River and Yangtze River Deltas. Nevertheless, the Bohai Ring's natural advantages and lower cost structures make it increasingly attractive to investors from Japan, the Republic of Korea and Western countries. This is set to continue with the rationalisation and reform of SOEs. (See Chapter 10 - State-Owned Enterprises.)

GOVERNMENT'S REGIONAL POLICIES

The Government's policies on regional development were outlined in the Ninth Five-Year Plan, released in 1996. This anticipated that each region would develop in line with its comparative advantage. The coastal provinces would focus on developing manufacturing, information and service industries, while the central and western regions would concentrate on developing agricultural and resource-based industries. This implies that the Chinese Government will not attempt to slow the fast growth of manufacturing industry in the coastal region, implying that regional divergence is likely to continue.

THE NINTH FIVE-YEAR PLAN

The Plan divides China into seven regions, with development plans based on natural comparative advantage.

1. *Yangtze River Delta and the Yangtze River Valley region*: Using its sea and river transportation advantage, agriculture, industrial base and access to advanced technology, this region will develop into an integrated economic growth belt connecting the whole Chinese economy from east to west and south to north. Within the region, the development of the Pudong New Area and the Three Gorges Dam will provide some stimulus, and the cities along the Yangtze River will form the base for growth.
2. *Bohai Ring*: Relying on its transport systems, many large and medium sized cities, its concentration of skilled human resources and its rich natural resources, this region should develop into an economic circle integrating the economies of the eastern Liaoning peninsula, the Shandong peninsula, Beijing, Tianjin and Hebei. The growth engine will be its major industries, its energy base and transport network, while the coastal cities will be the growth core.
3. *The south eastern coastal area*: Being close to Hong Kong, Macau and Taiwan, and having a high degree of openness and high overseas trade and investment, this region will continue its development as an outward-oriented economic zone within which the Pearl River Delta and Minnan triangle area will form the economic centres. Agriculture will generate more foreign earnings, while foreign funded enterprises will become more capital intensive, produce higher value added products and hence generate higher foreign exchange earnings.
4. *The south western and southern region*: Being close to the sea and having rivers and borders with South East Asian countries, rich agricultural, water, forest and mineral resources and tourist attractions, this region should develop into the national base to produce energy and non-ferrous metals, phosphorus and sulphur mining, tropical and subtropical agriculture, and tourism.

5. *The north eastern region:* Using its well developed transport systems, heavy industry, fertile land and natural resources, this region should develop into a national base for heavy and chemical industries and agriculture. The traditional heavy industry base should be reformed and upgraded. The Tumenjiang (Tumen River) area will become more open and developed; agricultural resources will be used more economically; and more value added processing of raw materials will occur.
6. *The central five provinces* (Henan, Hubei, Hunan, Jiangxi and Anhui): Relying on their agriculture and their relatively good industrial and transportation capacity, this region should emerge as a new economic belt. The new east–west Longhai railway (from Xian to Lianyungang) and north–south Jingjiu (from Beijing to Kowloon) and Jingguang railways (from Beijing to Guangzhou) will greatly enhance the region's economic prosperity. Its agriculture, raw materials and machinery industries should become nationally competitive.
7. *The north western region:* Relying on its proximity to East and Central Asia, and its agriculture and animal husbandry, energy, mineral resource and military industries, it will develop into a national base for cotton, livestock, petrochemical, energy and non-ferrous metal production. The land connection between Asia and Europe will speed up the development of water conservation, transportation and resource exploration.

Source: State Planning Commission (1996).

Nevertheless, the Government has included several policy guidelines in the Ninth Five-Year Plan to address widening regional disparities.

- High central government priority will be given to resource development and infrastructure projects in the central and western regions.
- Resource processing and labour intensive industries will be encouraged to move to the central and western regions.
- Prices of resource products will be further liberalised to increase the profitability of resource-based enterprises in the central and western regions.
- The central Government's fiscal transfer system will be enhanced, and the proportion of revenue transferred to the central and western regions will be gradually increased.
- Foreign investment will be encouraged to go to the central and western regions. The proportion of policy loans from the new policy banks will be increased and more than 60 per cent of international soft loans will be allocated to the central and western regions.
- Coastal localities' assistance to the remote, poor and minority areas will be encouraged, as will economic and technological cooperation between the coastal and interior enterprises. Coastal and interior enterprises will be allowed to cooperate in exploring for and using natural resources.

- Coastal provinces will be encouraged to invest in the interior, and the interior will be encouraged to export labour to the coast.

However, without radical taxation reform, the central Government will have limited financial resources to implement these regional policies. (See Chapter 4 - Macroeconomic Management.) Also missing are agricultural reform policies that would enable farmers in the predominantly agricultural hinterland to move out of lower value added crops such as grain and cotton and removal of price controls on these crops.

While a policy to encourage cooperation between coastal and interior enterprises may be important in reducing regional disparities, such cooperation cannot occur on a significant scale until better transport links enable coastal firms to cut production costs by subcontracting work to hinterland firms. Foreign investment will also be limited until such infrastructure is in place.

COMMERCIAL PROSPECTS IN CHINA'S REGIONS

Future trends in the regions' commercial prospects can be identified by:

- assessing trends in regional growth rates, from 1996 to 2010
- identifying emerging trends affecting regional growth prospects
- examining how each region's attractiveness to foreign investors may evolve.

1996 to 2000: Short Term Trends for Key Areas

In the next five years, the following trends may be expected.

- Guangdong will continue to attract more foreign investment than any other province, and remain the single largest investment target. Fujian's foreign investment share will continue to fall as Taiwan and South East Asian investors find more attractive, long term opportunities in other provinces, both coastal and inland.
- While major Hong Kong infrastructure investments are committed to Guangdong no similar investments are planned for other provinces and apparently will not be, at least until 2000.
- The major coastal provinces in eastern and northern China will attract larger amounts and somewhat higher percentages of foreign investment than in the 1990 to 1994 period, reducing Guangdong's share. The Shanghai-led Yangtze River basin will continue to boom, as will selected parts of northern China, particularly the Bohai Ring growth area.
- Some foreign companies will respond, albeit very selectively, to China's new policy, commenced in 1995, of encouraging inland investment. They will be particularly interested in relatively economically strong, resource rich, highly populated provinces such as Sichuan, Hubei and Shanxi. There, investments will be very focused on projects important to China such as infrastructure and ones with a strong likelihood of good returns. Key cities of Sichuan (Chengdu and Chongqing), Hubei (Wuhan) and Shanxi (Taiyuan) will attract significant amounts of foreign investment. However, the hinterlands in these provinces will remain unattractive to investors in the medium term.

2001 to 2010: Longer Term Growth Projections for Key Areas

Forecasts of regional growth rates prepared by the Institute of Quantitative and Technical Economics (Li J. W., 1995) anticipate that the coastal region will grow by 10 per cent per year in the 1996 to 2000 period, while the inland regions will achieve growth rates of less than 8 per cent. This is in line with revised estimates of China's growth rates over the reform period. (See Chapter 1 - Overview of Economics Reform.) This pattern is expected to persist from 2001 to 2010, as Li estimates that coastal growth will drop to an annual average of 8 per cent and inland provinces to 6 per cent. Other more optimistic forecasts (Economic Intelligence Unit, 1996) put China's overall annual growth at 9 to 10 per cent over the next fifteen years, and anticipate that there will still be a gap of 1 to 2 per cent between the growth rates of the coastal and inland provinces.

Li Jing Wen's 2001 to 2010 forecasts indicate:

- The **north eastern part of the coastal region** will remain sluggish. Even the relatively strong Liaodong Peninsula, led by Dalian, will have difficulty keeping up with stronger provinces to the south. Annual growth rate will be 5.5 to 6.5 per cent.
- The **Bohai Ring and beyond** will achieve the average growth rate for the coastal region. Growth will be centred in Greater Beijing–Tianjin, spreading down to Hebei's capital Shijiazhuang, west to Taiyuan and east to Tangshan; then south to another major corridor, linking the Shandong hinterland, Jinan and Qingdao, which will become China's second largest container port by 2003. Hence, the area will have two major growth areas: Beijing–Tianjin and their environs; and Shandong, from Jinan to Qingdao, including Yantai and Weihai. Both areas will be prosperous and industrialised, backed by strong agricultural hinterlands. Annual growth rate will be 8.5 to 9.0 per cent.
- The **Yangtze River Delta** by 2010, will probably be the strongest economic area in China, led by an increasingly international Shanghai and supported and challenged by the adjacent provinces of Zhejiang and Jiangsu. Shanghai–Nanjing will be the first (or second) largest megalopolis in China, interconnected by rail, road, river and air and with complementary and, at times, competitive economies. Pudong will house many key financial institutions that will have moved south from Beijing, the national stock exchange and many multinationals. It will be supported by good local infrastructure. Pudong's new container port will exceed the size of that in Yantian in Shenzhen. Annual growth rate will be 9.0 to 9.3 per cent.
- **Nearby inland provinces** such as Anhui and Jiangxi may benefit from the dramatic growth of Shanghai, Jiangsu and Zhejiang. Annual growth rate will be 8.8 to 9.1 per cent.
- The **southern part of the coastal region** may rival, even surpass, Shanghai as China's largest megalopolis; its growth rate will exceed the coastal region's average. The greater Guangzhou–Hong Kong economic area will be connected by road and rail, with key sea and air links to international markets. The Guangzhou–Hong Kong megalopolis will be a magnet drawing

Hainan, Guangxi, Guangdong, Fujian, as well as Taiwan and Macau into this dynamic economic area. Annual growth rate will be 8.9 to 9.3 per cent.

- The **western region** will remain relatively poor, with the same pockets of modest wealth in 2010 as in 1996, and with two major rival cities in Sichuan, Chongqing and Chengdu. Annual growth rate will be 5.2 to 5.8 per cent.
- The **central region** will have pockets of growth including Wuhan, while Hubei will continue to be a reasonably strong province. However, there will be no outstanding areas. Annual growth rate will be 5.6 to 6.0 per cent.

If, as anticipated by more optimistic observers, China's annual growth is closer to 9 to 10 per cent (12 per cent for the coast and 8 per cent for the inland regions), all regional growth rates could be 2 to 4 percentage points higher than those outlined.

Prospects for Australian Companies in Regional China

Australia has consistently been about the twelfth largest investor in China. In addition to the Australian Embassy in Beijing and consulates in Shanghai and Guangdong, Austrade, the Australian Government's trade promotion organisation, has established offices in six strategic cities, Beijing, Shanghai, Guangzhou, Nanjing and Hangzhou (the provincial capitals of Jiangsu and Zhejiang) and Dalian.

Many small and medium sized Australian companies face challenges in China for a number of reasons.

- Typically, they operate in only one city as a result of their smaller scale, thereby continuing to lag 'behind the learning curve' of companies from other countries that have experience in several cities. Foster's, BHP and TNT are notable exceptions.
- They are too small to make strategic alliances with major offshore or important local companies. Foster's, Lendlease and TNT are clear exceptions, although several others are in the process of creating significant offshore alliances (such as in Hong Kong).
- While continuing to develop investments and trade in the coastal region many Australian small and medium sized companies may lack operating experience and financial muscle to move inland (if necessary).
- Australian small and medium sized enterprises generally lack the human resources to make more than one or two significant investments in China. They will have to use a mix of Australian nationals of all ethnic backgrounds, overseas Chinese, and Chinese nationals to make their investments viable. These human resource requirements are and will be costly but affordable to companies already operating in China and able to relocate local Chinese staff within China.
- New Australian entrants will have to more carefully evaluate investment opportunities than would companies with longer operating experience. This will be costly but necessary to compensate for lack of experience in terms of varied locations and numbers of ventures.

These challenges and possible solutions aside, a number of Australian companies entered China early, have stayed the course, and are considered important players in their industries and the localities in which they operate.

Australian companies are heavily concentrated in the economically stronger coastal provinces and municipalities (Tables 8.1 and 8.2 in Appendix 8.1). They will and should continue this basic pattern through to 2000. When opportunities appear in economically weaker, less dynamic provinces, they should be examined carefully. Each company should use its own internal criteria to evaluate investment opportunities there. A Hong Kong consultancy firm, The Second Line (1996) has recommended that:

‘Australian companies should probably basically stick to making their investments work in the stronger areas (more dynamic provinces and cities). If they are doing well in one such area, then their next foreign funded enterprise should almost certainly be in another strong area, not in a long shot hinterland location. Investments, either in coastal or inland provinces should only be undertaken if the opportunity fits in with a given Australian company’s strengths and its overall China strategy.’

The Second Line points out that, as no Australian company is a national player in China (having investments in eight to ten enterprises and more planned), Australian companies lack the network of firms that would include investments in poorer inland provinces. However, it believes that Australian companies do *not need such investments* to be successful in the economically stronger coastal areas of China, which will continue to welcome Australian investment.

A recent survey of foreign investors by location (from 1994 to 1996) shows that most multinationals, regardless of their country of origin or industry, have opted to place their earliest and/or most recent investments in cities in the economically strong coastal provinces (Table 8.3 in Appendix 8.1). Of the 21 surveyed multinationals, which together had established 56 enterprises in China, only two had established branch companies in weaker inland provinces (The Second Line, 1996).

However, within the more dynamic regions, Australian companies may be well advised to consider locations away from the biggest cities and centres of those regions. For example, rather than investing in Shanghai, they may be more successful locating in one of the smaller towns or counties which benefit from proximity to the metropolis, in terms of access to markets and availability of skilled labour, finance and other services, but are likely to have much lower land and other cost structures and to be much keener to assist foreign investors than the bigger city, which is receiving billions in investment every year. These smaller centres may therefore provide a better investment climate, particularly for small and medium sized Australian enterprises.

CONCLUSIONS

Disparities in natural endowments means divergence of regional economic growth and incomes is likely to increase in the short to medium term, with the coastal areas becoming more wealthy and inland regions continuing to lag. However, this may not cause major concern as such divergence will occur simultaneously with rapid economic growth in every province. Nevertheless, the central Government will need to be prepared to deal with possible tension resulting from divergence for at least the next 5 to 10 years, but probably for much longer and vigorously pursue planned policies to reduce disparities.

In particular, it should give high priority to policies to speed up the public and private provision of transport, energy and social infrastructure in the poorer regions to reduce their isolation and develop their human resources. Completion of price reform for agricultural and other raw materials will also help the hinterland provinces. (See Chapter 9 - Agriculture.) Integration and growth of the three significant regional centres should accelerate, while market development will continue to occur slowly across all the coastal and interior regions.

Foreign investors, including Australian companies, will continue to locate most of their investments in the more dynamic coastal provinces and in a few of the stronger interior provinces such as Sichuan and Hubei. Government incentives to move inland to poorer provinces may not have a major impact on foreign investment flows in the short to medium term, due to their basic lack of attractiveness, poor infrastructure, lower incomes and less market-oriented economies. In the longer term, policies to reform inefficient SOEs in these provinces, the growth of smaller, more dynamic non-state firms, infrastructure investment by the Government, aid donors, and domestic and multinational firms should help to sustain reasonably high growth rates and enable these provinces to reduce the disparities between them and the coastal region.

Appendix 8.1

INVESTMENT IN CHINA

Appendix Table 8.1

Key Investments in China by Australian Companies

| Company name | Product | Location(s) | Value (if available) |
|--------------------------------|---|---|---|
| BHP | Steel roofing | Shanghai | US\$20 million |
| Boral | Plasterboard | Shanghai | |
| Bundy (division of Tubemakers) | Steel tubing | Qinhuangdao | |
| Cadbury-Schweppes | Chocolate | Beijing | |
| CSR | Fibreboard and other construction materials | Wuhan | |
| Foster's | Beer | 1. Shanghai (1993) 2. Zhuhai special economic zone (Doumen county) 3. Tianjin (with Wheelock Pacific) | US\$19 million Modest US\$50 million (est.) |
| ICI | Glass, plastics, packaging | Shanghai | US\$30 million |
| Jacob's Creek | Wine with Pernod-Ricard/Dragon Seal | Beijing | |
| Mayne Nickless | Transport and cold storage | Shenzhen | Under US\$5 million |
| McQuarry Properties | Real estate deals | | |
| Pacific Dunlop | Clothing, furniture, etc. | Guangzhou | |
| TNT | Logistics and transport | Beijing, Shanghai | |

Source: The Second Line, 1996

Appendix Table 8.2

Representative Offices of Major Australian Companies, by Location

| Beijing & Tianjin | Shanghai | Guangzhou | Shenzhen, Zhuhai & others |
|---|--|-----------|---|
| ANZ Bank (by end 1996 may become a branch bank) | ANZ Bank | ANZ Bank | China Australia Coldstore & Warehouse Co. Ltd. |
| Boulderstone Hornibrook Pty. Ltd. | BHP Steel | BHP Steel | CSR |
| BHP | Commonwealth Bank of Australia | CSR | Pacific Dunlop |
| Boral Ltd. | Hammersley Pacific | | |
| Cadbury Foods (China) Pty. Ltd. | National Mutual Life Association | | |
| CRA Ltd. | Pacific Dunlop Shoe Components Co. Ltd. | | |
| CSR | Shanghai Foster's Brewery Ltd. | | |
| Hammersley Iron | Southcorp Holdings | | |
| National Mutual | TNT Shanghai Express | | |
| Pacific Dunlop | | | |
| Qantas Airways | | | |
| Sara Lee/Kiwi Brands | | | |
| Stephen Fitzgerald & Co. Pty Ltd. | | | |
| Tianjin Foster's Brewery Co. Ltd | | | |
| TNT-Skypak Sinotrans Ltd. | | | |
| Westpac Banking Corporation | | | |

Source: The Second Line, 1996.

Appendix Table 8.3

Location Decisions of Recent Multinationals' Investments

| Location | Company | Year est. | Product | Location decision | Notes |
|----------|---------------------------------|-----------|-----------------------------|---|--|
| Shanghai | Unilever | 1987 | Cosmetics and soaps | Big market and decent factories; and Shanghai is a base | Close to market |
| Shanghai | BOC | 1988 | Industrial gas | Strong industrial base, now has joint ventures in Taiyuan, Fushun, in addition to Tianjin, Suzhou, etc. | (Now has 30 foreign funded enterprises in China) |
| Shanghai | Unilever | 1990 | Skin cream | Good location | |
| Shanghai | American Standard: Trane A/C | 1993 | Airconditioners | Leverage; the base of other products | Major long term investment |
| Shanghai | Unilever | 1993 | Washing powder | | National |
| Shanghai | Unilever | 1993 | Toothpaste | | Strategy |
| Shanghai | Braun | | Electric showers | Good site, in the marketplace | Used Gillette joint venture to speed start-up |
| Shanghai | Polaroid | 1994 | Cameras | Strong bonded warehouse | Waigaoqiao, Pudong |
| Shanghai | Medtronic | 1995 | Medical equipment | Good management and in the market | Zhangjiang, Pudong |
| Shanghai | Unilever | 1995 | Soap | | |
| Shanghai | Haagen Dazs | 1996 | Ice cream | Big market | High cost for first location |
| Shanghai | Smith Kline Beecham | 1996 | Vaccine | Second venture; first was in Tianjin | |
| Shanghai | Cummins | 1996 | Engine filters | Near large user | |
| Beijing | Unilever | 1993 | Ice cream (Wall's) | | |
| Beijing | Cadbury-Schweppes | 1995 | Chocolate | National market | |
| Chengdu | Pratt & Whitney | 1996 | Aircraft engine components | Industrial base for aircraft in place | Good partner |
| Tianjin | NEC | 1991 | Digital switching equipment | Tianjin gave it contract for digital switching as incentive | Part of national player strategy; 11 FFEs, 4 not in strong provinces |

Appendix Table 8.3 (contd)

| Location | Company | Year est. | Product | Location decision | Notes |
|--|---------------------------|--------------------------|-------------------------------------|--|---|
| Tianjin | PPG/Paint | 1995-96 | Paints for automobiles | Near automobile companies and good city | A national player; has one joint venture in Jiangxi; others in strong provinces |
| Chongqing | BP | 1995-96 | Acetic acid | Special financing and approvals | Location very challenging; insufficient infrastructure potential problem |
| Hubei & Sichuan | FELS, a Singapore company | 1994 | Coal-powered plants for electricity | Tax breaks and good market for electricity | Tough locations but good tax breaks |
| Hubei | Cummins | 1996 | Engines | Near large user | Inland |
| Guangdong | Unilever | 1993 | Tea | | |
| Zhangjiakou | Unilever | 1994 | Detergent | | |
| Hefei | Unilever | 1996 | Washing powder | Only weaker province location | |
| Shunde | Toshiba | 1996 | Airconditioner compressors & motors | Near many major consumer products ventures | |
| 14 foreign funded enterprises in many cities | Sanyo | First joint venture 1982 | Many electrical products | All except one joint venture; in fast growth provinces | 12 in the coastal region including 5 in Dalian |
| 8 foreign funded enterprises in many cities | Honda | 1981-96 | Vehicles and parts | Strong joint venture partners, good locations | All in or near coastal region |
| 8 foreign funded enterprises in many cities | Isuzu | 1985-95 | Vehicles and parts | Strong joint venture partners, good locations | 2 in Beijing; 4 in Chongqing |

Note: The 'corporate experiences' in the table are generic: any company, irrespective of nationality or previous track record in China, can expect regular operating challenges. For most, the prospects of the current and future market and using China as an export base ultimately outweigh the negatives.

Source: The Second Line, 1996; Tretiak and Holzmann, 1993.

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AGRICULTURAL REFORM

China's economic reform began with agricultural decollectivisation. Between 1978 and 1983, this reform successfully transformed collectives to household-based farming and produced record-breaking grain output growth, overcoming the food shortages experienced since the 1950s. It also provided the pre-conditions for China's urban and industrial reforms in the mid 1980s. Despite many problems, agricultural output expanded strongly throughout the reform period, growing in real terms by about 5 per cent per year from 1978 to 1995, compared with less than 2 per cent per year during central planning from 1952 to 1977. While some reforms were reversed, the overall trend is towards liberalisation.

Increasing agricultural profits and surplus labour freed by decollectivisation also stimulated a rapid development of rural off-farm activities, especially rural enterprises. These have been the most important source of China's post-reform industrial growth. (See Chapter 11 - Non-State Sector.) Income maximising farmers are increasingly reallocating their land, labour and capital to more profitable crops, or non-agricultural activities. While this trend raises grain imports, it also stimulates rapid growth in higher value, non-grain agricultural exports, and has made China into a significant net food exporter in recent years.

However, China's agricultural reforms remain incomplete. As China has 22 per cent of the world's population but only 7 per cent of the world's arable land, the Government believes it should continue to intervene in basic food crop production and marketing decisions to ensure food security. Consequently, state pricing and procurement plans still affect strategic crops, including 80 per cent of marketed grains (roughly 20 to 24 per cent of the total crop, depending on the harvest) and 100 per cent of the cotton crop. Its grain self-sufficiency target is currently set at 95 per cent, though this is not always achieved. While a two-tier system of grain marketing and distribution has developed and market sales of grain have expanded significantly, state-owned grain bureaux and remaining controls generate significant inefficiency. The Government introduced the 'Governor Responsibility System' in 1994, making provincial governments responsible for grain production and procurement targets in an attempt to achieve grain self-sufficiency by re-emphasising planning and direct intervention. However, achieving high levels of grain self-sufficiency will be very costly given China's relatively scarce arable land and abundant labour force, and difficult to enforce given the rapid marketisation of the rest of the economy.

China's agricultural policy-making is therefore at a crucial juncture: it can either opt for internationally competitive agriculture based on its comparative advantage, or pursue grain self-sufficiency, either by enforcing production and procurement targets or protecting selected agricultural sectors. Both approaches will impose significant costs on the economy. If, as at present, a forced production approach is used, most costs will fall on low income farmers and central region grain surplus provinces. If trade protection is used, most of the cost will fall on urban consumers as food prices rise. As domestic prices of many major agricultural

commodities are now close to international levels, the Government must decide to internationalise agriculture before prices climb higher and it becomes politically difficult to wind subsidies back, as is the case in Japan and Europe.

Chinese policy-makers resist more substantial moves to liberalise grain production and trade because of their concern about food security and vulnerability to foreign grain embargos. However, according to Chinese analysts, even if this risk were serious, arable land employed for vegetable and fruit production could be converted quickly to grain production (Lu, 1996).

If China does opt for an open agricultural sector, it could become a major world exporter of more labour intensive agricultural products and processed food and a significant importer of land-intensive products (grains, cotton and sugar). This development would affect significantly world agricultural markets and agricultural exporters like Australia, providing excellent opportunities for exporters of land-intensive products. Possibly reflecting this trend, Australian agricultural trade performance with China improved dramatically in 1996, with these exports up 90 per cent from 1995 to US\$1.37 billion (*China Daily*, 17 February 1997). This made Australia the second largest supplier of agricultural products to China after the USA. The internationalisation of China's agriculture already drives significant structural adjustment for industries confronting stronger competition from China's labour intensive agricultural products, such as fresh and canned fruit and vegetables. (See Chapter 5 - International Trade, Table 5.8). Australian producers of these products may need to develop specialist products and marketing strategies involving niche markets to survive in this highly competitive environment.

This chapter assesses the effectiveness of China's market-oriented agricultural reforms, particularly focusing on grain production and marketing policies. It highlights the key issues facing agriculture as it seeks both efficiency and self-sufficiency. It also attempts to analyse the food security situation by examining the factors affecting China's grain production and consumption. Estimates of required grain imports by 2010 vary greatly, from 136 million metric tons to 15 million metric tons, with a recent intermediate estimate of 64 million metric tons appearing more realistic (Wu and Findlay, 1996). Current grain imports are about 10 million tons. Finally, it draws implications for future Australia-China trade and investment opportunities in the agriculture and food sectors.

MARKET-ORIENTED AGRICULTURAL REFORM

Production and Management Reforms

China's agricultural reform was started spontaneously by poor farmers in Anhui in 1978 and supported by local officials. As a result of the reform, households became responsible for their inputs and outputs, marketing and tax obligations. Land and equipment were distributed among households within a village. The elected village committee was responsible for maintaining and sharing infrastructure and farm facilities which could not be distributed. State production plans, where they existed, were implemented through contracts between township and village authorities and farm households.

The household responsibility system spread rapidly across the country, immediately increasing agricultural output and household income. As 98 per cent of production teams had adopted this system by the end of 1983, the Government formally abandoned the commune system and accepted this *de facto* privatisation of agriculture.

Reforms of Price and Marketing Systems

The process of price and marketing system reform, especially for grain and cotton, is on-going. Despite cycles deregulating then reinstating controls, the overall trend is toward liberalisation.

During the central planning period, the unified procurement and marketing system strictly controlled sales and prices of all agricultural products. When the Government adopted the agricultural household responsibility system, it also substantially lifted state procurement prices for major agricultural products to provide incentives to farmers. In 1979, the Government increased average prices for quota sales by 25 per cent and also guaranteed to purchase unlimited quantities of above quota production. Above quota prices of grains, vegetable oil and cotton were from 35 to 50 per cent above the new procurement prices. Further major rises in procurement prices occurred in 1989-90, 1994-95 and 1996. Between 1978 and 1995, average real (inflation adjusted¹) grain prices were raised 349 per cent and cotton prices 269 per cent (State Statistical Bureau, 1996a, p. 255 and p. 269). In 1996, grain procurement prices rose another 42 per cent (Figure 9.1).²

The scope of the state procurement system also shrank. Since the mid 1980s, many products have been completely liberalised, including pork, fish, poultry, tea, fruit and vegetables. Farmers also can sell their above quota output of controlled products in rural and urban markets, both local and interregional. By 1996, only about ten controlled and partially controlled items existed, including so-called 'strategic' agricultural products, grain and cotton. These products represent about 10 per cent of total agricultural output (Table 9.1).

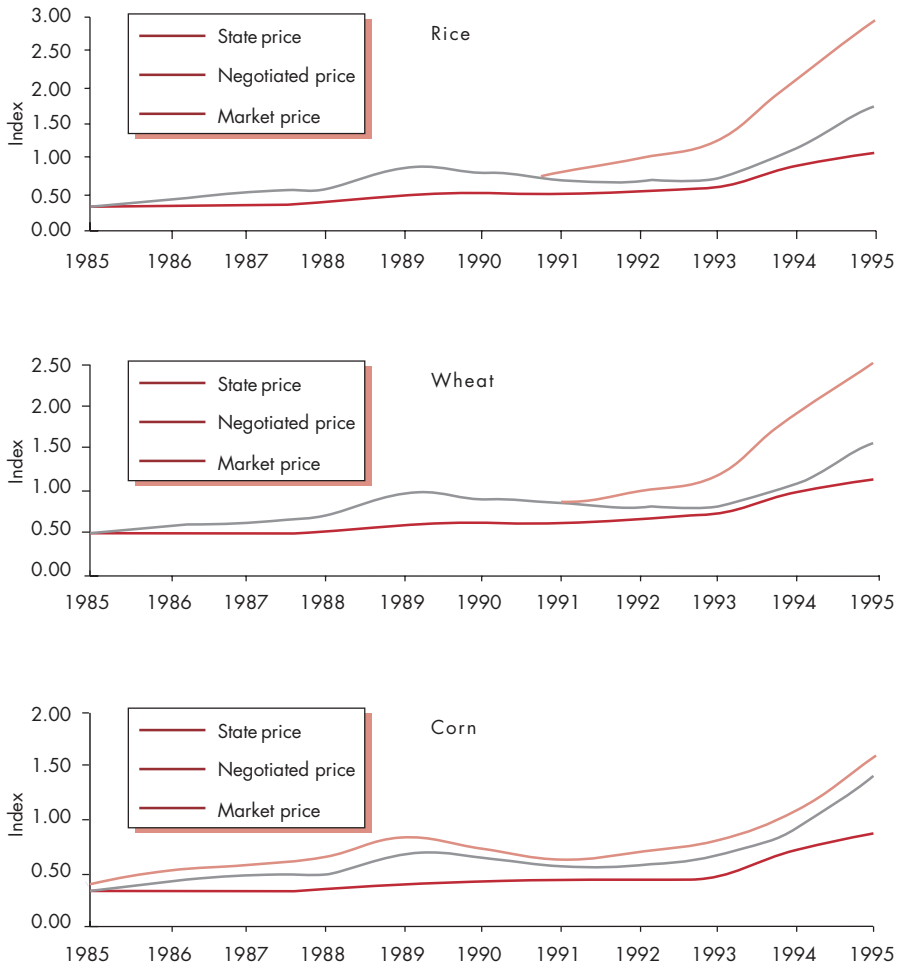
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¹ Adjusted by rural CPI (State Statistical Bureau, 1996, p. 255).

² Information on 1996 procurement price adjustments is from interviews with officials from Ministry of Agriculture, PRC, August 1996. Other data are from Guo et al (1993, pp. 293-95), Yu (1995, p. 7) and Ministry of Agriculture (1996, p. 46).

Figure 9.1

State and Market Prices Diverge

State, Negotiated and Market Prices for Rice, Wheat and Corn (Yuan per Kilogram)



Source: Ministry of Agriculture (1996, Tables 14, 15, 16).

Table 9.1

Most Products Sold in Free Markets

Extent of State Control of China's Major Agricultural Products

| | Gross value of output in 1994 (billion 1990 yuan) | Share of total output (per cent) | Status of state control by 1996 (per cent) |
|----------------------------------|--|-------------------------------------|---|
| Total agricultural output | 1 052.6 | 100.0 | 10 |
| Crops | 530.7 | 50.4 | 10 |
| Total grain products | 282.4 | 26.8 | 5 |
| of which: cereal grains | 217.7 | 20.7 | 25 |
| other grains | 64.7 | 6.1 | Nil |
| Oil seeds | 29.2 | 2.8 | Nil |
| Cotton | 28.1 | 2.7 | 100 |
| Hemp | 1.5 | 0.1 | Nil |
| Sugar | 10.8 | 1.0 | 100 |
| Tobacco | 6.7 | 0.6 | 100 |
| Medicinal herbs | 4.4 | 0.4 | 10 |
| Vegetables and melons | 92.2 | 8.8 | Nil |
| Tea, silkworm cocoons, fruit | 57.2 | 5.4 | 50* |
| Other crops | 18.3 | 1.7 | Nil |
| Wild plant gathering | 16.1 | 1.5 | Nil |
| Household handicrafts | 46.6 | 4.4 | Nil |
| Forestry | 51.7 | 4.9 | Nil |
| Afforestation | 14.1 | 1.3 | Nil |
| Forest products | 15.3 | 1.5 | Nil |
| Lumber | 22.3 | 2.1 | 10 |
| Animal husbandry | 313.4 | 29.8 | Nil |
| Livestock breeding | 177.2 | 16.8 | Nil |
| Poultry raising | 45.9 | 4.4 | Nil |
| Live animal/poultry products | 76.3 | 7.2 | Nil |
| Hunting/other animal products | 14.1 | 1.3 | Nil |
| Fishery | 94.0 | 8.9 | Nil |
| Seawater products | 51.2 | 4.9 | Nil |
| of which: cultured | 15.9 | 1.5 | Nil |
| Freshwater products | 42.8 | 4.1 | Nil |
| of which: cultured | 27.7 | 2.6 | Nil |

Note: * By mid 1996, silkworm cocoons were subject to 100 per cent state control as were some tea products consumed in minority areas.

Source: State Statistical Bureau Rural Social and Economic Survey Team (1996b, pp. 153-62). Information on the status of state control is from Department of Price Administration, State Planning Committee of China.

There have been three important attempts to reform the unified grain procurement and marketing system. The first, in 1985, was to change the system of mandatory grain procurement to a voluntary contract sales system. This reform mainly sought to reduce the huge cost of grain purchasing to the government budget. However, since the Government offered contract prices below market levels and gave returns below those for other types of agricultural output, it had difficulty signing sufficient contracts with farmers, and mandatory quotas were reintroduced in 1986.

The second attempt, in 1991-92, successfully raised urban retail prices for rationed grains for the first time since 1965. Prices were raised 68 per cent in 1991 and a further 45 per cent in 1992, eliminating the gap between the state procurement and retail prices for grains. This reform temporarily alleviated the Government's financial burden in procuring grain, and showed that freeing urban food prices was no longer politically risky (Tang, 1993; Tang, 1996).

This success encouraged some local governments to fully liberalise local grain marketing in 1992, freeing both procurement and retail prices. This spontaneous reform triggered the collapse of the state grain procurement and marketing system, before the central Government gave formal approval. However, following a food price rise at the end of 1993 as the market reacted to this liberalisation, the Government resumed administrative controls over grain production and marketing through the Governor Responsibility System (see box).

GOVERNOR RESPONSIBILITY SYSTEM

The Governor Responsibility System was introduced by the Government in 1994 in response to falling grain production and rising prices. Under the system, the provincial Governor is responsible for local grain production and supply, including maintaining land in grain production, increasing yields, holding stocks, balancing supply and demand, stabilising prices and ensuring self-sufficiency where possible.

The policy decentralises decision-making and subsidy obligations for grain production and procurement to provincial governments. The central Government believed that as local governments had benefitted considerably from fiscal revenue sharing, they should take responsibility for grain policy, particularly the price subsidies.

Analysis of agricultural performance in 1995-96 indicates that in the short term, this policy helped increase grain output, stabilise the area sown to grains, increase provincial investment in agriculture and stabilise food prices. Both grain and meat production broke records in 1996, reaching 480 and 60 million tons, up by about 3 and 15 per cent from 1995, respectively. By decentralising the grain planning system, it also enables the development of regional grain policies attuned to local conditions.

However, in the long term, stressing self-sufficiency at the provincial level will hinder efficient market development and resource allocation, imposing high economic costs as farmers are forced to forgo more profitable crops. Rather than creating an integrated market system, many provinces have reacted to the decentralisation of responsibility by erecting barriers to inter-provincial trade (OECD, 1997).

IMPACT OF AGRICULTURAL REFORM

Although incomplete, so far reforms have greatly benefitted China's grain economy. From 1978 to 1984, harvests of grain and other major farm products were record-breaking, following agricultural decollectivisation and marketing reforms. Grain output increased from 283 million to 407 million tons over this period, up by 5.3 per cent per year. Among the grains, wheat output grew fastest, up by 11.5 per cent per year. Meanwhile, both vegetable oil crops and cotton grew by 17 per cent per year (Table 9.2). One study estimates that decollectivisation positively affected farmer incentives, explaining over 70 per cent of the agricultural growth experienced between 1978 and 1984 (McMillan et al, 1989).³

Although failure to adjust state procurement prices in line with inflation in the mid 1980s adversely affected the output of grain and oil crops, these products regained their growth momentum in the 1990s. Over the whole reform period, 1978 to 1995, grain output increased by nearly 3 per cent per year, even though the area sown to grain declined by 0.63 million hectares per year, while oil crop output increased by 10 per cent per year with the sown area increasing by 0.4 million hectares per year. Because cotton continued to be heavily controlled and had lower procurement prices than other crops, its production stagnated after 1984. On the other hand, production of items freed from control early in the reform process, such as meat, aquatic products and fruit, has grown strongly.

The removal of many planning controls has enabled farmers to reallocate land from grain to more lucrative crops (Figure 9.2). The higher returns to both land and labour in non-grain crops, except for rape seeds, explains this rapid reallocation.⁴ Of the three major grain crops, producing rice and corn is significantly more profitable than wheat (Table 9.3).

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³ Although estimates on the output effect of institutional change vary greatly among studies, most show decollectivisation could explain most of output growth (see Lin, 1992; Fan, 1991). However, a recent study by Huang et al (1996) argues that technology could have been at least equally important. It found that the output effect of institutional change was only seen in 1978 to 1984. Its results show that institutional change could explain 34 per cent of rice growth, 51 per cent of other grains' growth and 37 per cent of cash crops' growth.

⁴ The assumption that natural conditions are unimportant is employed to simplify the discussion. However, although, for example, rice farmers in Guangdong cannot simply shift from rice to apple or cotton production, they could easily move into crops like sugar cane.

Table 9.2

China's Output of Major Farm Products, 1975 to 1995
(in Million Metric Tons)

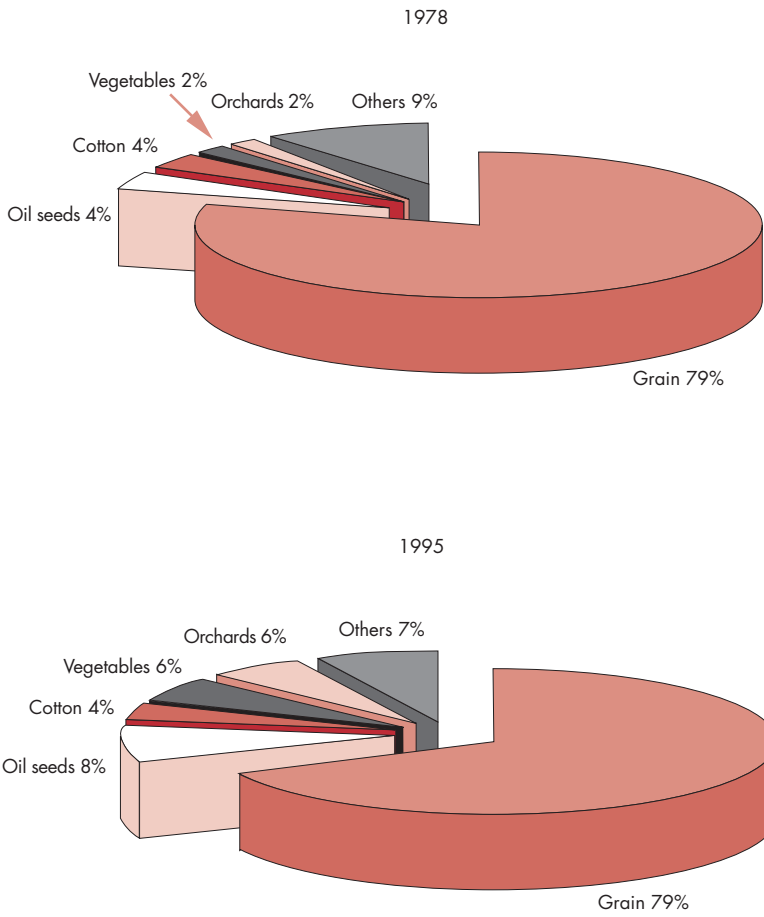
| | Of total grain: | | | | | | | | | |
|------|-----------------|------|-------|-------|--------|-----------|-------|--------|------|------|
| | Total grain | Rice | Wheat | Maize | Cotton | Oil seeds | Sugar | Fruits | Meat | Fish |
| 1975 | 285 | 126 | 45 | 47 | 2 | 5 | 19 | 5 | 8 | 4 |
| 1976 | 286 | 126 | 50 | 48 | 2 | 4 | 20 | 5 | 8 | 4 |
| 1977 | 283 | 129 | 41 | 49 | 2 | 4 | 20 | 6 | 8 | 5 |
| 1978 | 305 | 137 | 54 | 56 | 2 | 5 | 24 | 7 | 9 | 5 |
| 1979 | 332 | 144 | 63 | 60 | 2 | 6 | 25 | 7 | 11 | 4 |
| 1980 | 321 | 140 | 55 | 63 | 3 | 8 | 29 | 7 | 12 | 5 |
| 1981 | 325 | 144 | 70 | 59 | 3 | 10 | 36 | 8 | 13 | 5 |
| 1982 | 355 | 162 | 68 | 61 | 4 | 12 | 44 | 8 | 14 | 5 |
| 1983 | 387 | 169 | 81 | 68 | 5 | 11 | 40 | 9 | 14 | 5 |
| 1984 | 407 | 178 | 88 | 73 | 6 | 12 | 48 | 10 | 17 | 6 |
| 1985 | 379 | 169 | 86 | 64 | 4 | 16 | 60 | 12 | 19 | 7 |
| 1986 | 391 | 172 | 90 | 71 | 4 | 15 | 59 | 13 | 21 | 8 |
| 1987 | 403 | 174 | 86 | 79 | 4 | 15 | 56 | 17 | 22 | 10 |
| 1988 | 394 | 169 | 85 | 77 | 4 | 13 | 62 | 17 | 25 | 11 |
| 1989 | 408 | 180 | 91 | 79 | 4 | 13 | 58 | 18 | 26 | 12 |
| 1990 | 446 | 189 | 98 | 97 | 5 | 16 | 72 | 19 | 29 | 12 |
| 1991 | 435 | 184 | 96 | 99 | 6 | 16 | 84 | 22 | 31 | 14 |
| 1992 | 443 | 186 | 102 | 95 | 5 | 16 | 88 | 24 | 34 | 16 |
| 1993 | 456 | 178 | 106 | 103 | 4 | 18 | 76 | 30 | 38 | 18 |
| 1994 | 445 | 176 | 99 | 99 | 4 | 20 | 73 | 35 | 45 | 21 |
| 1995 | 467 | 185 | 102 | 112 | 5 | 23 | 79 | 42 | 53 | 25 |
| 1996 | 480 | - | - | - | - | - | - | - | 60 | 28 |

Note: '-' = Not available.

Source: State Statistical Bureau (1996), pp. 371-72; China News Agency, 15 December 1996; *Outlook*, 1997, No. 4.

Figure 9.2

Farmers Move Out of Grain Production
Effects of Resource Reallocation on China's Cultivated Land Area



Source: State Statistical Bureau, 1996, pp. 368-70.

Table 9.3

Higher Returns to Farmers from Non-Grain Crops
Net Output Value per Unit of Land (Mu) and Labour Day, 1993

| | NOV/mu (yuan) | Index of NOV/mu | Labour input/mu (days) | NOV per labour day (yuan) | Index of NOV per labour day |
|-----------------|------------------|--------------------|------------------------------|---------------------------------|-----------------------------------|
| Wheat | 110 | 100 | 13 | 8 | 100 |
| Rape seeds | 112 | 102 | 17 | 6 | 77 |
| Corn | 175 | 160 | 15 | 11 | 136 |
| Sugar beet | 188 | 172 | 18 | 11 | 125 |
| Rice | 250 | 228 | 19 | 13 | 154 |
| Peanut | 272 | 248 | 21 | 13 | 153 |
| Tobacco | 287 | 261 | 45 | 6 | 76 |
| Cotton | 339 | 309 | 41 | 8 | 97 |
| Ramie | 348 | 318 | 43 | 8 | 95 |
| Sugar cane | 528 | 482 | 40 | 13 | 157 |
| Silkworm cocoon | 756 | 690 | 96 | 8 | 93 |
| Apples | 1 180 | 1 077 | 65 | 18 | 216 |
| Oranges | 1 255 | 1 145 | 74 | 17 | 201 |

Source: East Asia Analytical Unit estimates based on data from State Statistical Bureau, Rural Social and Economic Survey Team (1996b, pp. 279-82); State Statistical Bureau, Department of Rural Social Economic Statistics (1990, pp. 180-84).

SELF-SUFFICIENCY OR EFFICIENCY?

In the next decade, policy-makers must decide whether they will continue to encourage a more efficient use of agricultural inputs to maximise rural production and income growth, or pursue policies of grain self-sufficiency, consequently losing growth opportunities and reducing farmers' incentives, output and incomes. The strong agricultural output growth of the reform period is due mainly to moving agricultural resources from lower to higher productivity activities, such as non-grain crops, and applying new technologies, in response to increased producer autonomy, market incentives, incomes and returns from agricultural investment.

To maintain agricultural growth rates, policies should be designed to ensure that farmers pay the full economic cost of inputs they use, receive the full benefit of their output and make free decisions on inputs and outputs so as to maximise their incomes. Otherwise, allocative efficiency will decline and the cost of production will rise. Consumers will pay for inefficient resource allocation with higher food prices and rural producers will receive lower incomes.

COTTON STILL HEAVILY CONTROLLED

For a completely controlled product like raw cotton, neither SOEs nor non-SOEs are allowed to purchase directly from producers; a state procurement agent, the State Cotton and Hemp Trade Corporation (SCHTC) controls procurement, handling and distribution. Farmers are paid state-set unified prices (varying by quality); the SCHTC then adds 15 per cent to procurement prices, to establish 'distribution prices' at which cotton is sold to yarn factories or state cotton trade agents for export.

However, as cotton prices have been adjusted several times to meet production costs, eliminating the gap between domestic and international cotton prices, this system does not actually provide any subsidies to domestic yarn and cloth producers. For example, in late 1993, for standard quality cotton China's state procurement price was US\$0.79 per kg and international price (New York) was US\$1.20 per kg; in late 1994, these prices were US\$1.25 and US\$1.60 respectively; then in late 1995, they were US\$1.72 and US\$1.91 respectively. Adding the State Cotton and Hemp Trade Corporation distribution charge, China's domestic cotton price for SOEs was almost US\$2.00 in late 1995. Continuing price and purchasing controls on cotton are designed to provide raw materials for SOE textile makers who employ many workers but make heavy losses. The state-owned SCHTC also employs many workers. The few non-state cotton processors buy cotton on the black market, at higher prices than the SOEs. Even SOEs sometimes are forced to buy from the black market or try to get cotton direct from farmers, as low cotton prices have created a shortage of cotton. Some analysts believe that the SCHTC diverts some cotton to the black market and retains the difference in price.

KEY AGRICULTURAL INTEREST GROUPS

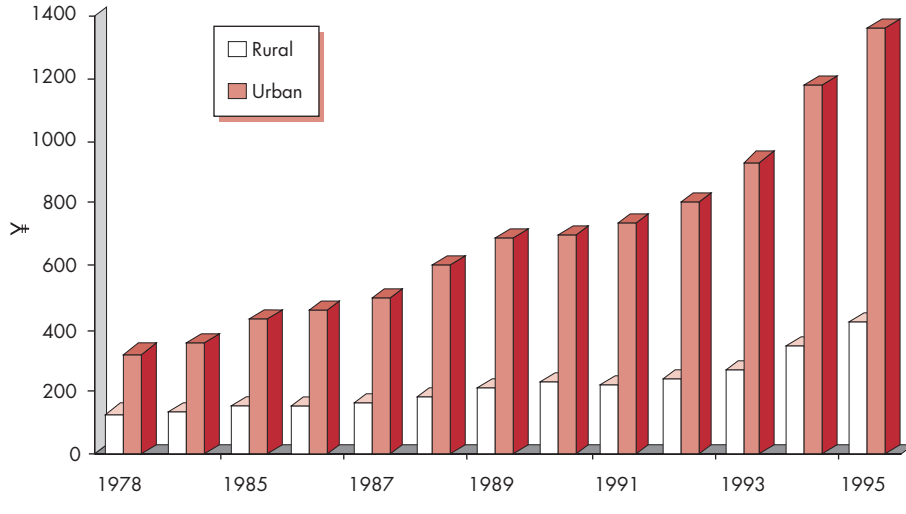
Continued government control of the grain sector is difficult and costly in today's complex economic environment, when many industries, social groups and regions pursue market-oriented objectives. The most important of these interest groups and the dynamics of their roles in agricultural production and marketing are discussed below.

The Farmers

Chinese farmers are becoming increasingly unhappy with the current system of compulsory grain procurement. Farm input prices continue to increase, offsetting rises in state procurement prices. Local governments divert funds earmarked for grain purchase to more profitable activities. In some regions, farmers are still paid with IOUs, although the Government has now banned this practice. Many local governments impose ad hoc duties and surcharges on farmers. These problems generate widespread discontent and even sporadic outbreaks of unrest.

Figure 9.3

Rural Incomes Fall Behind
China's Urban and Rural per Capita Annual Real Income
(in 1978 Yuan)



Source: Estimate based on State Statistical Bureau (1996a, p. 21).

Largely due to grain and other compulsory crop procurement policies, rural income growth has slackened since the 1990s, and rural-urban income disparities have widened. From 1990 to 1995, rural per capita incomes rose by 4.5 per cent after inflation, compared with 7.7 per cent in the urban area. The ratio of urban to rural per capita income increased from 2.8 in 1985 to 3.2 in 1995 (Figure 9.3). Much of the growth in rural incomes occurred in non-agricultural activities, so rural residents who relied heavily on income from agriculture, particularly grain production, fared even worse than the average.⁵ Regional disparities within rural China have also increased⁶ (see Chapter 8 - Regions) driving large scale labour migration. (See Chapter 12 - Labour Markets.)

Protected Urban Consumers

As reforms lifted procurement prices to encourage production in the 1980s and 1990s, increasingly expensive subsidies kept state retail prices low. These cost over ¥ 30 billion per year (US\$4 billion) since 1990 and 63 per cent of the government deficit in 1995 (Figure 9.4). Without more radical liberalisation of grain procurement and marketing policies, inflation rapidly eroded the real value of

⁵ The share of agricultural income in net farm income declined from 81 per cent in 1985 to 67 per cent in 1995 (State Statistical Bureau, 1996a, p. 301).

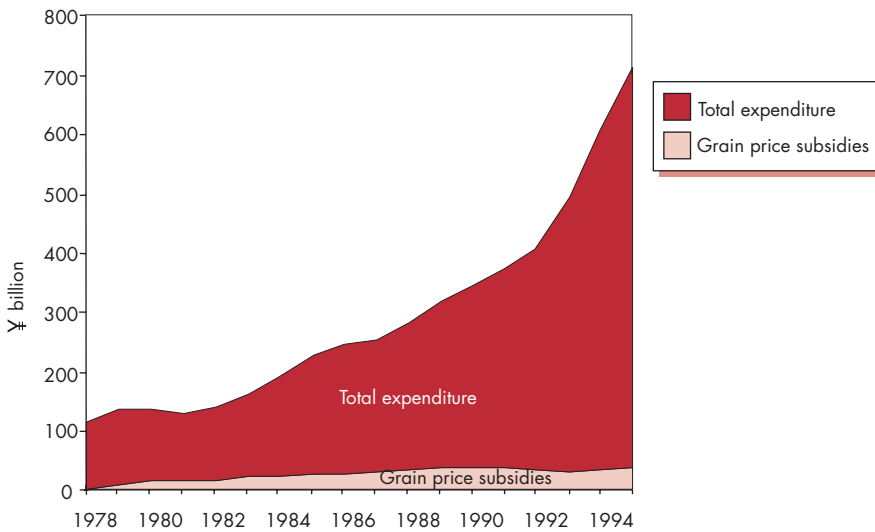
⁶ As measured by the coefficient of variation of annual net rural income per capita across provinces, regional income disparity increased by 43 per cent from 0.37 in 1978 to 0.53 in 1995 (based on State Statistical Bureau, 1996a, p. 302).

nationwide increases in urban grain prices in 1991-92 and the cost of subsidies rose again after 1994 (Figure 9.4).

After a decade of rapid income growth, food grain no longer has such an important share of urban consumer budgets, declining from 13 per cent of consumer expenditure in 1981 to 7 per cent in 1995 (State Statistical Bureau, 1996a). The fact that grain prices are no longer such a sensitive issue, was borne out by the muted reaction to the lifting of urban grain prices in the early 1990s. In fact, surveys indicate that 65 to 75 per cent of urban residents now buy grains from the free market rather than state grain stores (Tang, 1993; State Statistical Bureau, 1996a). This indicates that full grain price liberalisation is probably quite feasible.

Figure 9.4

Grain Price Subsidies Expensive but Falling Share of Expenditure
Total Government Expenditure and Price Subsidies



Source: State Statistical Bureau (1996a, p. 231, p. 243).

Grain Surplus and Deficit Provinces

The pattern of inter-provincial grain production and trade reflects not only regional agricultural resource endowments but also development strategies pursued under central planning and reform policies since 1978. In 1953, grain was surplus in 20 of 29 provinces, autonomous regions and municipalities, 12 in the south and 8 in the north⁷, and nearly all inter-regional grain flow was northward. The number of grain surplus regions declined as the economy became more industrialised. By the early 1990s, only 10 provinces had grain surpluses, only four

⁷ Southern and northern China provinces are defined by south or north of the Yangtze River.

of which four were in the south (Map 9.1).⁸ Inter-regional grain flow became southward (Wang, 1996).

Map 9.1

Grain Flows from North to South
China's Grain Surplus, Deficit and Balanced Provinces



Source: Wang (1996).

⁸ Grain 'surplus' and 'deficit' are defined as one million tons surplus and one million tons deficit respectively, except for Zhejiang whose average annual deficit during 1992 to 1994 was 0.89 million tons (Wang, 1996).

From 1953 to 1979, no real grain trade between regions occurred; central plans merely transferred grain from surplus to deficit provinces. From 1980 to 1993, a two-tier system gradually developed, with each province first having to fulfil state-set inter-provincial grain trade plans at controlled prices, then conducting above quota inter-provincial grain trade at negotiated prices.

Planned inter-provincial grain transfers at low state-set prices entail a loss to grain exporting provinces and a gain to grain importing provinces. Even in the pre reform period, this created considerable tension and several times, the central Government had to raise grain transfer prices to make planned transfers workable. Since the reform, the conflict between grain exporting and importing provinces has increased, as the costs of planned inter-provincial transfers have become more explicit in the market environment. Grain surplus provinces have a strong incentive to reduce planned transfers and secure higher grain transfer prices, while grain deficit provinces attempt to maximise their state planned transfers.

Ironically, grain surplus provinces are also unwilling to deal with grain deficit provinces via the market. This is because a rise in market demand for grains will increase market prices, making it difficult to enforce state procurement, thereby putting upward pressure on state procurement prices and the level of price subsidies. Policing planned sales at state prices has become more difficult under the two-tier system because grain markets reveal to farmers the extent of their losses in selling grain to the State. Consequently, when grain is in short supply, local governments in grain producing regions often temporarily close grain markets and establish trade barriers; this is to block grain buyers from other provinces to contain price pressures and fulfil their state procurement plans (Tang, 1996; Guo, 1995; Lin, 1995).

The lack of functional inter-provincial markets can widen disparities in grain prices and fuel inflation in grain deficit provinces, in some cases provoking government intervention. For example, when grain prices rose in 1993 and 1994 because declining returns caused a substantial decline in southern China's early Indica rice production, the resulting sharp price rises motivated the Government's regional grain self-sufficiency. However, observers believe that the development of an integrated grain marketing system linking grain deficit and surplus regions, and an effective grain reserve system would more effectively promote low food prices (Lin, 1995).

The State Owned Grain Bureaux

State-owned grain trading enterprises, the so-called grain bureaux, control more than 80 per cent of China's grain wholesale trade and 50 per cent of its retail trade, including 52 000 urban retail enterprises and 11 110 processing enterprises (Tang, 1996). These enterprises form a vast empire of over a million employees, controlling most aspects of grain procurement, marketing, shipping, processing and storage. They implement grain procurement and marketing policies and seek profits like commercial enterprises.

When the Government introduced the two-tier grain production and marketing system in the mid 1980s, it expected to smooth the transition from plan to market by establishing a free grain market and increasing the efficiency of the grain SOEs (He, 1990). In practice this has not occurred.

Loss-making grain SOEs reportedly owe state banks over ¥ 40 billion (US\$5 billion) in bad loans (Tang, 1993). While grain SOEs maintain that their mandate to stabilise grain prices results in these losses, some observers claim that rent-seeking behaviour and inefficiency are the real causes. They claim that grain SOEs frequently procure grain at low state prices and sell it for higher negotiated or market prices, transferring grain purchase costs to the state procurement account (Tang, 1993). The low proportion of urban residents now buying grain in state grain stores may imply that grain SOEs, rather than urban consumers, capture the bulk of government subsidies. As most urban residents no longer require cheap grain, grain retail price subsidies may merely operate to protect the grain SOEs (Tang, 1993).

TRADE IMPLICATIONS OF FOOD SUPPLY AND DEMAND

Due to China's size and the significant role of government policy, predicting food supply and demand, and hence international trade flows is difficult. As a result, published projections for grain supply, demand and net grain imports in 2010 vary enormously: from 136 million metric tons (Overseas Economic Cooperation Fund, 1995) to 15 million metric tons (Mei, 1995), with an intermediate estimate of 64 million metric tons (Wu and Findlay, 1996).

On the supply side, any change in the government's target level of grain self-sufficiency from its present level of 95 per cent will significantly affect production patterns and import requirements. On the demand side, policy changes in grain pricing and marketing will affect consumer behaviour.

Both Chinese and Western analysts and policy makers are concerned to ensure China will not confront a major shortfall in food production that international trade cannot meet. Whether this is a likely scenario requires an analysis of the factors affecting demand for and supply of grain and other major foodstuffs. These analyses facilitate an understanding of existing grain supply and demand problems, and also highlight business opportunities.

Factors Affecting Food Supply

Land

Over the past decade, approximately 0.8 million hectares per year of China's total of 134 million hectares of cultivated land⁹ was lost to industrial and residential developments while another 0.5 million hectares per year was reclaimed for farm use. Over the decade, the net loss of cultivated land therefore was almost 3 million hectares.¹⁰ If China reclaims its 14.7 million hectares of reclaimable land (*China*

⁹ An official land census recently confirmed that China's total cultivated land area is actually 134 million hectares rather than the previously reported 100 million hectares. However, this merely corrects a statistical error as the new survey has not changed the size of China's reclaimable land area of 35.4 million hectares (State Statistical Bureau, 1996a, p. 5), which means that most of underreported land areas are already cultivated land areas.

¹⁰ This information was unofficially released by a senior officer of State Bureau of Land, at the International Symposium on Food and Agriculture in China: Perspectives and Policies, Beijing, 7-9 October 1996.

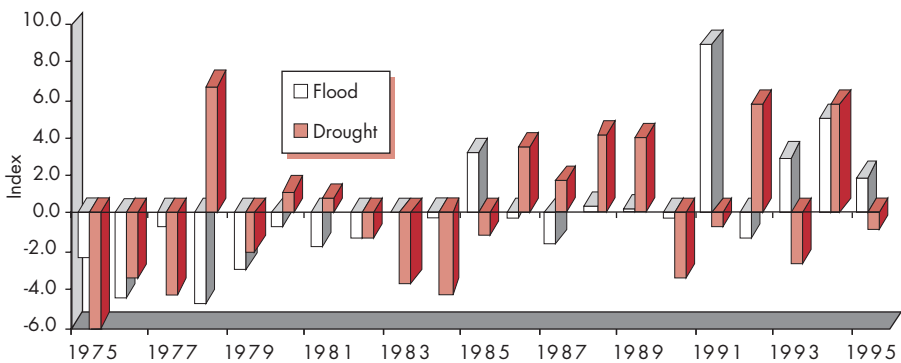
and News Report, 1996) at a rate of 500 000 hectares per year, total reclaimable land will be exhausted by 2030.

While the potential increase in arable land is limited, population growth is unlikely to stabilise before 2030, when the population will reach 1.6 billion. Throughout this period, urbanisation will be faster, putting more pressure on shrinking arable land. Urban land development increased by about 60 per cent between 1987 and 1995. Some local governments raise substantial revenue by transferring land use rights to developers, thereby encouraging excessive expansion of urban areas at the expense of agricultural land.¹¹

While land leases to farmers recently were extended for a further 15 years, land is still legally owned by the State and rural collectives, and cannot be traded. In practice, rural land use rights can be transferred, but without a well developed formal land market where land can be transferred at a market price, the efficiency of rural land allocation is reduced.

Figure 9.5

Natural Disasters Becoming More Severe
Annual Changes from Annual Average



Note: Zero level indicates the average natural disaster affected area over 1975-95.
 Flood affected area = 5.7 million ha; drought affected area = 11.3 million ha.
 Source: State Statistical Bureau (1993, p. 39); State Statistical Bureau (1996a, p. 385).

¹¹ Some municipal governments also reportedly seek to expand city areas to strengthen their bargaining power to secure funds from the central authorities. More than 40 cities have proposed development plans to become international cities by early next century although the land management authorities strongly oppose these plans. If all current urban development plans are realised, Chinese cities would be able to accommodate more than 2 billion people by 2010, although the total (urban and rural) population will only be 1.4 billion.

Infrastructure

Increased investment in rural irrigation, flood control, transport infrastructure and soil conservation services would raise significantly the productivity of agricultural land. Chinese agriculture has long suffered from cyclical natural disasters, but their incidence has increased significantly since the mid 1980s possibly due to insufficient investment in agricultural infrastructure (Figure 9.5). Government expenditure on agricultural investment declined from 1.6 to only 1 per cent of total infrastructure investment between 1985 and 1995 (State Statistical Bureau, 1996a, pp. 231-33).

Except in afforestation, investment and institutional support to maintain and improve agricultural infrastructure, particularly for flood control is lacking. While the household responsibility system encourages farm households to preserve small streams from silt and erosion by planting trees on family plots, government assistance and regulation are needed to ensure local communities protect the banks of larger rivers.

Technology¹²

During the grain shortages of the pre reform period, the Government funded research into high yielding grain varieties but inadequate incentives and inefficient resource allocation in the collective farming system meant this research delivered few benefits (Lin, 1992; Huang and Rozelle, 1996).¹³ In the post-reform environment, resources for agricultural R&D are more market-driven and new, profitable technologies are adopted.¹⁴

One way to assess the potential to employ improved technologies to increase agricultural production is to compare China's average yield in producing food with that of the world's best performers (Table 9.4). The gap between China and the world's best indicates China's potential output growth, other factors held constant. For most products, China's agricultural productivity is already higher than the world average, but still is considerably lower than the world's best. For the three major grains, China's productivity is about 20 to 60 per cent higher than the world average, but only about 40 to 70 per cent of the world's best.¹⁵

¹² The discussion in this section draws on Findlay's survey paper (1996) on grain output potential in China.

¹³ China was the first nation to extend semi-dwarf rice varieties in the 1950s. Chinese scientists were also the first to develop hybrid rice in the early 1970s (Lin, 1992).

¹⁴ Even if returns to agricultural research are high, such investment may not be made in a market environment where investment is driven by profits rather than policy priorities. Rozelle (1996) and Fan (1996) found that real spending on agricultural research had dropped under the current system. They argued that strengthening property rights might help reform the research sector and improve R&D. On the other hand, market and profit-oriented farm households now tend to select crops and seed varieties which maximise household income rather than output. Wu (1996) used household survey data and found that given the market-oriented environment, compulsory sales quotas had led income maximising farmers to adopt high yield varieties and high quality seeds if they could afford to do so, because this allowed farmers to reduce the cost of fulfilling quotas and increase after quota sales in the free market.

¹⁵ Chinese yield data in Table 9.5 are estimates based on now superceded cultivated land data that understated China's cultivated land area by 25 per cent. If total output is measured correctly, then the estimated yield (output divided by area) will be overstated. In this case, technological change could play a larger potential role than this table indicates. However, the effect of under-reported land area on yield and output is still an open question and requires further research. Also see Yang (1996).

Table 9.4

Average Yield of Selected Foodstuffs: China Compared with Selected Countries and the World's Best Performers

| Country | Wheat kg/ha*** | Paddy rice kg/ha | Maize kg/ha | Soybeans kg/ha | Peanut kg/ha | Beef/ veal kg/ca** | Mutton/ lamb kg/ca | Pig kg/ca |
|--------------|-------------------|---------------------|----------------|-------------------|-----------------|--------------------------|--------------------------|--------------|
| China | 3 318 | 5 869 | 5 033 | 1 589 | 2 688 | 204 | 12 | 80 |
| India | 2 420 | 2 817 | 1 750 | 835 | 988 | 103 | 12 | 35 |
| Indonesia | na | 4 344 | 2 177 | 1 051 | 1 770 | 150 | 10 | 55 |
| Thailand | 1 556 | 2 175 | 3 167 | na | 1 486 | 200 | 15 | 50 |
| Japan | 3 718 | 6 770 | 2 485 | 1 622 | 2 424 | 393 | 26 | 75 |
| Rep of Korea | 2 857 | 6 083 | 4 167 | 1 481 | 1 700 | 257 | 14 | 81 |
| Mexico | 4 475 | 4 360 | 2 444 | 1 903 | 1 270 | 221 | 14 | 69 |
| USA | 2 526 | 6 718 | 8 697 | 2 815 | 2 995 | 318 | 30 | 84 |
| France | 6 676 | 4 555 | 7 827 | 2 620 | na | 283 | 17 | 85 |
| UK | 7 178 | na | na | na | na | 280 | 19 | 69 |
| Russian Fed | 1 449 | 2 705 | 1 697 | 818 | na | 195 | 22 | 80 |
| Australia | 1 174 | 8 336 | 5 818 | 2 079 | 2 368 | 220 | 20 | na |
| World | 2 741 | 3 651 | 4 330 | 2 182 | 1 308 | 212 | 15 | 78 |
| World max* | 8 067 | 8 336 | 9 719 | 3 606 | 6 563 | 393 | 30 | 150 |
| Country | Norway | Australia | NZ | Italy | Israel | Japan | USA | Slovakia |

Note: * excluding countries with very little total output.

** ca = carcass.

*** ha = hectare.

Source: Food and Agricultural Organisation, 1994.

However, while applying world best practices could raise agricultural yields, the benefits may not always justify the costs. The research and extension effort would be more efficient if it also considered the relative costs of sourcing grain and other foodstuffs from imports.

Factors Affecting Demand for Food

Income and Price Effects

Since economic reforms began, the quantity, quality and variety of food available in both urban and rural China have improved significantly. Income growth and price changes drive changes in food consumption patterns which can therefore differ in urban and rural areas.

From 1981 to 1995, urban per capita food grain consumption declined 2.8 per cent per year from 196 kg to 131 kg, while rural consumption remained almost unchanged at about 260 kg (Table 9.5).¹⁶ Although rural per capita meat consumption rose more rapidly than urban meat consumption, by 1995 urban consumption was still twice that of rural consumption. Meanwhile, the consumption of poultry, eggs and aquatic products rose strongly in both urban and rural areas. Changing relative prices, the result of rising feed grain prices, probably drove the shift from red to white meat (Wu and Findlay, 1996).

As in many other developing countries, in urban areas the demand for wheat flour is more income elastic than for rice and coarse grains, because urban consumers with higher incomes purchase more convenience foods like bread and instant noodles. Wheat flour therefore will meet a high proportion of the growing urban grain demand, and this trend will strengthen as urbanisation increases (Wu and Wu, 1994).

Effect of Dietary Habits

As dietary habits strongly affect food consumption, grain probably will remain a major food source even when China reaches high per capita income levels. However, research indicates that residents of larger cities appear to consume more animal products especially white meats (Wu and Wu, 1994). Pork is preferred in the south and south west; in the north and west, beef and mutton or lamb are preferred (Wu and Wu, 1994).

Adopting Western life styles also influences alcohol consumption; residents of larger cities consume beer while those in smaller cities and country towns prefer traditional grain liquor (Wu and Wu, 1994).

Population

Population size has a quantitative effect on total grain demand, while population structure has both quantitative and qualitative effects on grain demand through changes in socio-economic structure, age distribution and gender ratio. This is especially so in China which is rapidly urbanising and ageing. Although population growth rate is expected to slow after 2000 from 1.32 per cent per year in 1995 to 2000 to 0.88 per cent per year in 2000 to 2010, the population will continue to grow till about 2030, when it will stabilise at about 1.6 billion (Wu and Findlay, 1996).

By 2030, the age structure of the population will have significantly changed. The proportion in the 15 to 44 age group will fall to 41 per cent in 2030 from 50 per cent in 1995, while the over 59 age group will rise to 21 per cent in 2030 from 10 per cent in 1995. As China's population ages, both food consumption volumes and patterns will change (Wu and Findlay, 1996). Few projections of food demand and trade patterns take account of demographic change (Duncan, 1996).

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¹⁶ All measured by raw grain in order to compare rural and urban grain consumptions.

Table 9.5

Meat and Higher Value Food Consumption Rising Rapidly
Urban and Rural Per Capita Food and Implied Grain Consumption
(Kilograms)

| | Total grain | | Implied feed grain | | | Red meat | Poultry | Eggs | Aquatic products | Alcohol (kilolitres) |
|--------------|----------------|---------------|--------------------|----------------|---------------|----------|---------|------|------------------|----------------------|
| | High GM* ratio | Low GM* ratio | Food grain | High GM* ratio | Low GM* ratio | | | | | |
| Urban | | | | | | | | | | |
| 1981 | 371.6 | 335.6 | 196.1 | 166.2 | 130.1 | 18.6 | 1.9 | 5.2 | 7.3 | 4.4 |
| 1982 | 375.5 | 338.5 | 194.9 | 171.1 | 134.1 | 18.7 | 2.3 | 5.9 | 7.7 | 4.5 |
| 1983 | 391.0 | 351.2 | 194.8 | 184.8 | 145.0 | 19.9 | 2.6 | 6.9 | 8.1 | 5.3 |
| 1984 | 393.9 | 353.6 | 191.6 | 187.9 | 147.6 | 19.9 | 2.9 | 7.6 | 7.8 | 6.8 |
| 1985 | 379.7 | 340.6 | 181.7 | 181.4 | 142.4 | 19.3 | 3.2 | 6.8 | 7.1 | 7.8 |
| 1986 | 407.5 | 363.9 | 185.9 | 201.7 | 158.1 | 21.6 | 3.7 | 7.1 | 8.2 | 9.4 |
| 1987 | 401.7 | 358.4 | 180.5 | 200.1 | 156.8 | 21.9 | 3.4 | 6.6 | 7.9 | 9.9 |
| 1988 | 392.3 | 351.9 | 185.0 | 187.3 | 146.9 | 19.8 | 4.0 | 6.9 | 7.1 | 9.5 |
| 1989 | 390.9 | 349.7 | 180.6 | 191.1 | 149.9 | 20.3 | 3.7 | 7.1 | 7.6 | 9.0 |
| 1990 | 394.7 | 351.2 | 176.3 | 198.8 | 155.3 | 21.7 | 3.4 | 7.3 | 7.7 | 9.3 |
| 1991 | 401.9 | 356.2 | 172.5 | 209.7 | 164.0 | 22.2 | 4.4 | 8.3 | 8.0 | 9.3 |
| 1992 | 382.8 | 337.0 | 150.4 | 211.6 | 165.7 | 21.4 | 5.1 | 9.5 | 8.2 | 9.9 |
| 1993 | 352.3 | 309.1 | 132.1 | 199.6 | 156.4 | 20.8 | 3.7 | 8.9 | 8.0 | 9.7 |
| 1994 | 359.8 | 316.4 | 137.1 | 201.5 | 158.0 | 20.2 | 4.1 | 9.7 | 8.5 | 10.0 |
| 1995 | 350.7 | 307.9 | 130.8 | 198.8 | 156.0 | 19.7 | 4.0 | 9.7 | 9.2 | 9.9 |
| Rural | | | | | | | | | | |
| 1981 | 332.7 | 317.7 | 256.0 | 69.6 | 54.6 | 8.7 | 0.7 | 1.3 | 1.3 | 2.3 |
| 1982 | 341.3 | 325.6 | 260.0 | 73.0 | 57.3 | 9.1 | 0.8 | 1.4 | 1.3 | 2.7 |
| 1983 | 350.2 | 332.9 | 260.0 | 80.4 | 63.1 | 10.0 | 0.8 | 1.6 | 1.6 | 3.2 |
| 1984 | 364.3 | 345.7 | 267.0 | 86.7 | 68.0 | 10.6 | 0.9 | 1.8 | 1.7 | 3.5 |
| 1985 | 360.3 | 341.1 | 257.0 | 90.0 | 70.7 | 11.0 | 1.0 | 2.1 | 1.6 | 4.4 |
| 1986 | 370.8 | 350.0 | 259.0 | 96.6 | 75.8 | 11.8 | 1.1 | 2.1 | 1.9 | 5.0 |
| 1987 | 372.2 | 351.5 | 259.0 | 96.4 | 75.8 | 11.7 | 1.2 | 2.3 | 2.0 | 5.5 |
| 1988 | 368.5 | 349.2 | 260.0 | 90.3 | 71.0 | 10.7 | 1.3 | 2.3 | 1.9 | 5.9 |
| 1989 | 373.5 | 353.5 | 262.0 | 93.3 | 73.3 | 11.0 | 1.3 | 2.4 | 2.1 | 6.0 |
| 1990 | 376.5 | 356.0 | 262.1 | 95.6 | 75.1 | 11.3 | 1.3 | 2.4 | 2.1 | 6.1 |
| 1991 | 377.9 | 354.5 | 255.6 | 102.8 | 79.4 | 12.2 | 1.3 | 2.7 | 2.2 | 6.4 |
| 1992 | 372.2 | 349.2 | 250.5 | 101.6 | 78.6 | 11.8 | 1.5 | 2.9 | 2.3 | 6.6 |
| 1993 | 387.7 | 364.6 | 266.0 | 101.7 | 78.6 | 11.7 | 1.6 | 2.9 | 2.5 | 6.5 |
| 1994 | 377.0 | 354.8 | 260.6 | 97.9 | 75.8 | 11.0 | 1.6 | 3.0 | 2.7 | 6.0 |
| 1995 | 381.1 | 358.0 | 258.9 | 102.1 | 79.1 | 11.3 | 1.8 | 3.2 | 3.1 | 6.5 |

Note: *GM = grain-meat conversion ratio, indicating the kilograms of feed grain required to produce one kilogram of meat.

Source: Wu and Findlay (1996, Table 8).

Feeding Efficiency

The upper and lower limit of surveyed grain to meat conversion ratios (Table 9.5) implies that using best practice animal feeding techniques could save the average urban consumer 43 kilograms and the average rural consumer 23 kilograms of grain per year, a national saving of 35 million metric tons of grain per year.¹⁷

Wastage of Grain

Grain wastage in production, distribution and consumption is significant; over 45 million metric tons annually (*China News Report*, No. 24, 1996).¹⁸ However, unofficial estimates are higher, between 50 million and 65 million metric tons (Yu and Zhan, 1995; Zhang, 1990; Huang et al, 1995) including consumers wasting up to 30 million metric tons (Yu and Zhan, 1995). This exceeds Australia's total annual grain production of about 28 million tons.¹⁹

While some wastage is caused by out-of-date technology in sowing, harvesting, threshing and milling, the remainder is due to poor transport and storage and managerial problems, particularly in the grain SOEs. Consumer waste is largely a result of low state controlled prices for grains sold in cities. To reduce grain wastage, SOE management and marketing reform is as important as investing in infrastructure and new grain handling technologies.

Implications for food trade

Even though agricultural reform has dramatically boosted grain output, demand for grains also has increased and China has imported an average of 6.5 million metric tons of grain per year between 1978 and 1996 (Figure 9.6).

However, since the beginning of the reforms China has been a net food exporter, as the value of other food exports has exceeded the value of grain imports (Table 9.6). Exports of meat, fish, vegetables and fruit have grown rapidly since the mid 1980s, in line with China's comparative advantage in non-grain food production. (See Chapter 5 - International Trade, Figure 5.8). This trend should continue, generating significant new export income, assuming the Government reduces compulsory grain production and allows farmers to produce the crops that are most profitable.

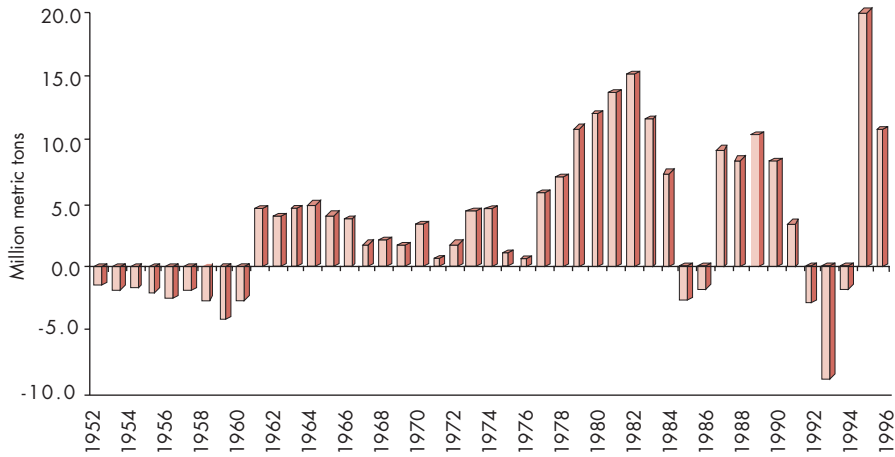
¹⁷ This is borne out by the divergence in efficiency of different meat producing countries revealed by various studies such as Garnaut and Ma (1992).

¹⁸ This is much higher than the previous official estimate of 11 million tons of wastage (Rural Development Institute and Rural Social Economic Survey Team, 1996, p. 39).

¹⁹ Based on Australian Bureau of Agricultural and Resource Economics estimate for 1993-94 production year, including wheat, rice and coarse grains (Australian Bureau of Agricultural and Resource Economics, 1994, p. 49, p. 206, p. 222).

Figure 9.6

China's Net Grain Trade
(Million Metric Tons, Positive Values Indicate Net Imports)



Source: State Statistical Bureau (1996a and previous issues); *China Daily*, 17 February 1997.

Table 9.6

China a Strong Net Food Exporter
Structure of Food Trade
(Million US\$)

| Commodity | SITC | 1980 | | 1985 | | 1990 | | 1995 | |
|---------------------------------------|------|--------|--------|--------|--------|--------|--------|--------|--------|
| | | Export | Import | Export | Import | Export | Import | Export | Import |
| Live animal | 00 | 384 | 5 | 304 | 18 | 430 | 14 | 503 | 37 |
| Meat | 01 | 361 | 1 | 448 | 6 | 791 | 54 | 1 371 | 97 |
| Dairy products | 02 | 71 | 5 | 57 | 31 | 55 | 81 | 61 | 61 |
| Fish | 03 | 380 | 13 | 283 | 44 | 1 370 | 102 | 2 853 | 608 |
| Cereals | 04 | 423 | 2 458 | 1 065 | 982 | 614 | 2 353 | 285 | 3 629 |
| Vegetables and fruit | 05 | 746 | 48 | 825 | 52 | 1 759 | 83 | 3 342 | 184 |
| Sugar | 06 | 221 | 316 | 79 | 274 | 317 | 390 | 379 | 936 |
| Coffee, tea | 07 | 328 | 56 | 435 | 40 | 534 | 30 | 516 | 75 |
| Feeding stuffs | 08 | 58 | 14 | 241 | 83 | 623 | 182 | 351 | 421 |
| Other foodstuffs | 09 | 49 | 2 | 66 | 23 | 107 | 46 | 292 | 82 |
| Total foodstuffs | | 2 985 | 2 927 | 3 803 | 1 553 | 6 609 | 3 335 | 9 954 | 6 131 |
| Total food as per cent of total trade | | 16.5 | 14.6 | 13.9 | 3.7 | 10.6 | 6.3 | 6.7 | 4.6 |

Note: SITC = Standard International Trade Code.

Source: Lu (1996, Table 6).

Alternative Agricultural Trade Policies

China's policy-makers face three major policy options in China's agricultural production and trade:

- **Maintain a food self-sufficiency policy in grain and other foodstuffs**, using international trade only to provide different food varieties and occasionally to fill gaps between demand and supply. This option is technically possible but very costly.
- **Employ a mid way, managed food trade option**, relaxing grain self-sufficiency but retaining an approximate balance in food trade (Lu, 1996). Promoting the export of competitive food products and freeing up the grain trade, better serves the interests of China's farmers and consumers, but maintaining such targets has no economic rationale and would still reduce potential rural production and income growth.
- **Adopt free agricultural production and trade policies**, resulting in a significant growth in grain and other land intensive imports and increased exports of other more labour intensive foodstuffs and manufactured products. This policy would produce the most rapid growth of rural incomes and output, as well as net export earnings.

One reason the Government maintains its grain self-sufficiency policy is anxiety that large grain imports could make China vulnerable to international pressure via embargoes on grain exports to China. Trading partners could reduce this concern by offering to renounce the use of trade embargoes. In addition, the Australian government could encourage Chinese foreign investment in grain production and handling facilities in Australia, to increase their sense of supply security. This would also provide Australian grain producers with enhanced market access security.

OPPORTUNITIES IN CHINA'S AGRIBUSINESS

The Chinese Government strongly encourages foreign investment in agriculture and food industry. However, while agriculture received US\$10.1 billion of foreign investment and aid from 1979 to 1995, most was government borrowing rather than FDI. For example over US\$4 billion was borrowed from the World Bank and Asian Development Bank for agricultural projects (Ministry of Agriculture, 1996, p. 59).

FDI in agriculture by overseas Chinese grew rapidly from 1991 to 1995. By 1995, Taiwan entrepreneurs invested US\$0.9 billion in more than 2 000 agricultural production and processing projects, most of which were export-oriented (Ministry of Agriculture, 1996, p. 58). However, Western investors have played a much smaller role in agricultural FDI. Although several Australian food processors like Cadbury, Schweppes and Foster's have made investments in China, Australia's share in total food processing FDI is negligible. For example, of the 2 689 approved FFEs in China's food industry in 1992, 90 per cent were Asian firms (mainly from Hong Kong, Taiwan, Thailand and Japan) and of the remainder, 80 per cent were

US firms and only 11 per cent were Australian firms (Chai and Riethmuller, 1996).

Exporting Western foodstuffs to China or manufacturing them locally can be profitable, but it requires careful market research, especially on food culture. Although large coastal cities have adopted several fast foods, such as hamburgers, pizzas and fried chicken, the urban middle classes treat them only as a change for special occasions. Because of strong cultural influences, changes in local tastes may be slow. Beer, introduced more than half of a century ago and encouraged by the Government because it uses less grain than traditional Chinese grain liquor, is still not the preferred drink in small towns and villages.

Cultural elements are stronger in the food industry than most others, and Western companies must allow time to learn how to enter, then strengthen their position in the Chinese food market. Other less culturally sensitive agricultural industries may be easier to enter and should also provide profitable opportunities for foreign and Australian companies. For example, Western food processors could employ advanced technology to process Chinese meat, fruit and vegetable products for the Western market, particularly Japan. As agricultural reform shifts resources to export-oriented non-grain farm production such as fruits, vegetables, meats and aquatic products, these areas should present many opportunities for Australian firms.

Other prospective areas in which Australia has a strong comparative advantage are grain production and processing, animal raising and meat processing. China is eager to import advanced technologies in these sectors to improve seed variety and quality, to reduce its enormous wastage in grain shipping, storage and processing and to increase feeding efficiency in meat production.

An Australian company, Newport Scientific, successfully distributes near infrared reflectance instruments in China, and indicates the potential for developing niche markets in China's agriculture-related sectors. The Newport Scientific experience also suggests the importance of securing government support and using local manufacturing facilities.

NEWPORT SCIENTIFIC SALES AND SERVICES IN CHINA

An Australian company, Newport Scientific Sales and Services (NSSS) imports, assembles and distributes DICKEY-john near infrared reflectance testing apparatus and other analytical equipment in China. It specifically developed this equipment for the Chinese market to test grain qualities. It is now the only supplier of such instruments providing on-site support in China. NSSS also supplies a multigrain portable moisture tester throughout China.

NSSS equipment is a pre-calibrated package designed for Chinese crops. It is used to rapidly test the protein, gluten, oil, moisture, ash and fibre characteristics of grain received at flour and feed mills.

NSSS holds 75 per cent of Australia's market for this product and is confident it will continue to make good progress in the China market. The demand for this product in China is strong and growing very rapidly. NSSS estimates current market size is about A\$5 million per year, but it could double every year in the foreseeable future. However, this market has not been actively addressed by competitors. Its two major competitors from Sweden and Germany either cannot provide equivalent quality packages or have no on-site services.

NSSS has Chinese Government support and access to food industry testing facilities at tertiary institutes. It has used the Ministry of Agriculture to evaluate the potential market for its product and run training courses through Chinese universities. Its key staff are learning to speak Mandarin and are building extensive experience in doing business in China. This can only be gained by spending time in face to face negotiations.

Like China, Australia is a large country with natural conditions suitable for many different crops, requiring high volume, long term storage and long distance freight for major agricultural products. Australia has developed many technologies that are suitable for Chinese agriculture, especially for handling, storing and shipping grains. Investment in these industries could be profitable, particularly if grain distribution and marketing is further liberalised.

At present, market entry is often difficult for Western firms. Given the size of the market, the large and inefficient grain SOEs, and underdeveloped distribution networks, direct investment will often be a more effective entry method than indirect or direct exports and franchising of local companies (Chai and Riethmuller, 1996). However, this approach requires investors with sufficient financial support. One reason for the low Australian share in the Chinese food market is probably that most Australian food processors are small or medium sized firms with inadequate financial resources and expertise to invest in China.²⁰

²⁰ As the large Australian food processors are now mainly foreign-owned, their decisions to invest in overseas markets will usually be made in line with overall global strategies in the headquarters in Europe and North America.

More opportunities will develop in agribusiness as agriculture is further reformed and marketised, expanding production of competitive labour and capital intensive products for both the domestic and world markets. Meanwhile China will increase its imports of land intensive products (grains, cotton and sugar) from countries like Australia. As income rises, urban residents will consume more Western style foodstuffs, and more processed Chinese food. All these developments will provide major opportunities for well informed and prepared foreign investors.

NEW DEVELOPMENTS AND PROSPECTS

Despite resource constraints and policy problems, the pace of marketisation of Chinese agriculture has quickened. While still emphasising high (95 per cent) self-sufficiency in grain, policies promoting FDI are hastening the sector's integration into the international market.

Another recent development indicating improving agricultural returns is that several large domestic manufacturing companies, mainly more profitable SOEs, are investing in agriculture, especially in north east and north west regions. Many of these investments are in grain production through land reclamation. For example, investment in Heilongjiang agriculture by companies from other provinces planning to reclaim 215 000 hectares of cropland, totalled ¥ 1.79 billion (US\$205 million) in the first 6 months of 1996 (*China News Agency*, 15 December 1996). Many foreign investors are also involved in similar investments. While the central Government prioritises such investment, some Australian investors who have attempted to initiate FDI in broad acre agriculture have confronted considerable barriers. Government investment in agriculture has also increased.²¹ The Government now promotes 'guided food consumption' in urban and rural areas, emphasising 'medium calories, high protein and low fat' dietary patterns. This is not only healthier and more consistent with local food culture, but is also designed to ensure consumption patterns do not exceed China's food supply capacity.

China's integration with the world grain and food market is growing despite the official claim that its international grain trade is only a 'necessary complement'. In 1996, China's net grain imports were 10.6 million tons, another high import year though down 42 per cent from the previous year.²² (See Figure 9.5.)

Australian performance in agricultural trade with China dramatically improved in 1996. An official report indicates that in 1996 Australia exported US\$1.37 billion worth of agricultural products to China, up 90 per cent from 1995, becoming the second largest supplier after the USA of agricultural products to China (*China*

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²¹ For example in 1996, ¥ 2.4 billion (US\$290 million) from the state budget was invested in a grain self-sufficiency project and a further ¥ 2.75 billion (US\$330 million) from the State Agricultural Comprehensive Development Office was invested in agricultural development. According to official estimates, improved technology played a more important role in the record breaking grain harvest in 1996 (*China News Agency*, 15 December 1996).

²² Of the grain imports, wheat accounted for 8.3 million tons, corn 0.44 million tons, rice 0.76 million tons and soybeans 1.11 million tons (*China Daily*, 17 February 1997).

Daily, 17 February 1997). This is indicative of future trade patterns as China's agricultural trade increasingly moves towards land-intensive imports in line with its comparative advantage.

The rapid growth in China's labour intensive agricultural exports, such as fresh and canned fruit and vegetables will entail significant structural adjustment for industries confronting stronger competition from these products. Australian industries of these products could consider specialist products and marketing strategies to promote their competitiveness.

Despite continuing intervention in key crops, the transition of the bulk China's agricultural sector to a free market system has been quite rapid and extremely successful. While progress has been uneven in the remaining areas like grains and cotton, the trend of developments indicates that agricultural policies, and independent actions of the key players like farmers and grain producing provinces, basically favour the further development of freer agricultural markets.

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STATE-OWNED ENTERPRISES

Reform of the SOEs is the key to many other crucial reforms in the banking system, macroeconomic management and the trade regime. However, progress has been slow due to political concerns about the impact of large scale rationalisation of SOEs on urban unemployment and stability. The performance of the sector has steadily deteriorated during the 1980s and 1990s as it has faced increasing competitive pressure from the dynamic non-state sector and imports. There is also concern asset stripping may be occurring in some SOEs. In 1996, half of SOEs were reporting losses and for the first time since 1949, the sector as a whole made a loss. This means that the State received no return from its massive investment in SOEs.

While China's leaders give priority to reforming SOEs, they also insist that at least the large SOEs remain publicly owned and will not accept mass SOE privatisation as occurred in many Eastern European countries. However, experience in many other countries, including Australia, indicates that while corporatisation and increased competition can increase the efficiency of SOEs in the short run, in the long run privatisation in an open, competitive environment is the best guarantee of permanent improvements in productivity.

Despite many attempts in the past decade to reform SOEs to improve their performance, their commercial outcomes have not improved overall. Most are effectively immune from bankruptcy and their costs are inflated by overstaffing and generous salary and social service packages. In many instances their initiative is constrained by lack of clear delineation of property rights, inadequate incentives for managers and bureaucratic intervention. The World Bank estimates that the social service payments (pensions, housing and health) of SOEs approximately equal their losses (World Bank, 1996a, p. 17). Therefore, all the value added SOEs produce, including the profits that should have gone to the State as the owner of SOE assets, were consumed by SOE workers, either as wages, bonuses or enterprise provided services.

However, the central and more progressive provincial governments now appear more determined to tackle this issue, and reportedly restrict bank credit for some loss-makers. Under the policy of 'grasping the big and enlivening the small' small and medium sized SOEs can be leased, sold to workers, joint ventured, merged or privatised. One thousand large SOEs are being recapitalised and groomed to form future conglomerates, on the Korean *chaebol* model.

As the State still employs about 66 per cent of urban employers, the Government has been wary of wholesale rationalisation of the SOEs, for fear of the social and political consequences. However, the rapidly growing non-state sector is successfully absorbing many redundant SOE workers, even in north eastern provinces like Liaoning, increasing the Government's confidence that continued reform and downsizing of SOE workforces is feasible.

This chapter first examines the basic facts about SOE performance and the constraints put on other crucial reforms by inadequate SOE reform, as well as the problems poor SOE performance are creating regarding triangular debt, bad bank debts and urban unemployment. It then analyses the Government's policy of 'enlivening' small SOEs, which may mean *de facto* privatisation, and 'grasping' or recapitalising large SOEs, and the likely implications of these policies for Australian business. After examining the still important role of the industrial SOEs in the economy, the chapter analyses the major causes of their poor performance, the solutions being trialed and their likelihood of success. It concludes by drawing implications for future reform and opportunities for Australian business.

IMPORTANCE OF SOE REFORM

Reform of the state-owned enterprises (SOEs) is crucial for China's future economic growth and stability for at least six major reasons:

- Issuing high levels of subsidised credit through the banking system and government transfers to support SOEs is inflationary and contributes to China's macroeconomic instability. (See Chapter 4 - Macroeconomic Management.)
- Channelling resources into loss-making SOEs inefficiently uses scarce private and public investment funds and skilled labour, artificially constrains the flow of capital and labour to the much more efficient non-state sector and impedes the Government's ability to fund vital areas such as education, social services and infrastructure, particularly in the poorer inland provinces. (See Chapter 7 - Infrastructure and Chapter 8 - Regions.)
- The high level of bad SOE loans held by the four big state-owned specialised banks (20 to 30 per cent of total loans, or 25 per cent of GDP) jeopardises their transformation into commercial banks, seriously slowing financial sector reform. Moreover, unless the rate at which new bad loans are issued is wound back, these bad debts could threaten the banks' viability. (See Chapter 4 - Macroeconomic Management.)
- The problem of inter-enterprise triangular debts, caused by the inability (or unwillingness) of many SOEs to pay their debts to other firms, is inflationary, and seriously disrupts production not only among the SOEs but also in the non-state sector and could potentially create a financial crisis. (See Chapter 4 - Macroeconomic Management.)
- Concern about the vulnerability of inefficient SOEs to increased import competition is one of the main reasons the Government has resisted further liberalisation of the trade regime, preventing China's accession to the WTO and forcing it to forgo the efficiency benefits the economy would achieve from freer trade. (See Chapter 5 - International Trade.)
- Some SOE managers and workers, faced with uncertainty regarding their futures and long term claims over SOE property, appear to be asset stripping their enterprises with unsustainable wage and bonus payments, as well as more overtly expropriating state assets. This exacerbates the losses being suffered by the SOEs and the State as the owner of the assets.

It is for these reasons that China's leaders have accepted that fundamental reform of the ailing SOEs is one of the country's most pressing priorities. SOE reform is the key to achieving many other major outstanding sectoral and macroeconomic reforms in, for example, infrastructure service supply the distribution system and agricultural purchasing and storage.

China cannot afford to jeopardise its high growth rates. They are necessary to enable the several hundred million surplus rural workers to be smoothly absorbed into the more highly productive industrial and service sectors over the next two decades. In the short term, high growth is also needed to redeploy the increasing numbers of workers displaced from loss-making SOEs, and so avoid the potential for social instability. For these reasons, while SOEs cannot be reformed or disposed of overnight, completing this task is more urgent than sometimes appears to be evident in the calculations of Chinese policy makers.

These 1995 statistics indicate the severity of SOE problems:

- SOEs produced less than 33 per cent of industrial output
- but used over 57 per cent of industrial investment and
- employed over 40 per cent of industrial workers.

In 1996,

- approximately 50 per cent of SOEs were making losses
- debts between firms rose to ¥ 100 billion (US\$12 billion)
- gross inventories of manufacturing SOEs exceeded ¥ 540 billion (US\$65 billion)
- SOEs together produced only 1 per cent of net industrial profits
- gross losses of the industrial SOEs were up 45 per cent, to ¥ 69 billion (\$US8.3 billion)
- because of the fiscal subsidies paid to loss-making SOEs, the state sector as a whole incurred a net loss of ¥ 3 billion (US\$361 million).¹

The inefficiency of SOEs has become increasingly obvious in the past 10 years as SOEs confront stiffer competition from newly permitted imports, the rapidly growing domestic non-state sector² and foreign funded enterprises. (See Chapter 11 - Non-State Sector.)

'GRASPING THE BIG AND ENLIVENING THE SMALL'

In 1997, the Government, via its new policy of 'grasping the large and enlivening the small' appears likely to accelerate the *de facto* privatisation of many small and some medium sized SOEs and to at least make another major effort to reform the large SOEs.

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¹ China News Agency, 13 January 1997; *China Daily*, 21 January 1997, based on State Statistical Bureau, and a State Statistical Bureau survey of over 370 000 SOEs, reported in *Oriental Daily News*, 26 June 1996.

² Consisting of township and village enterprises, urban collectives and privately owned firms. (See Chapter 11 - Non-State Sector.)

'GRASPING THE BIG, ENLIVENING THE SMALL' —*zhuada fangxiao*

As part of this policy, large numbers of small and medium sized SOEs are being merged, joint ventured or sold to their workers or other individuals, particularly in the more progressive provinces. This approach recognises the achievements of provinces such as Guangdong and Shandong in disposing of small and medium sized loss-making enterprises, with minimal social repercussions and major benefits for efficiency, state tax and profit revenue. (See the next box on these experiments.) A recent survey in Shandong, Guangdong, Sichuan, Hubei and Heilongjian provinces found that the pace of sale of small SOEs was increasing (Fan Gang, 1996). However, the more progressive provinces will be the ones to grasp the opportunities presented by this policy change and divest themselves of loss-making SOEs; more conservative provinces and localities may resist change to the status quo.

The large SOEs represent just over half of SOE output, assets and profits. They will all be 'corporatised', run by boards of directors and given a greater degree of managerial autonomy, including over foreign trade. A high priority will be to restructure their capital bases, through further (probably large) injections from the banking system, converting loan and tax obligations into state capital and allowing the enterprises to enter joint ventures or sell shares in subsidiaries. Their technologies will be upgraded and they will be encouraged to become conglomerates, absorbing many smaller enterprises and branching out into other sectors, including finance.

In mid 1996, Guangdong province announced that it had selected 70 major SOEs, representing 45 per cent of the province's total SOE assets, 42 per cent of sales and 54 per cent of profits, to be leaders of the local economy. These SOEs will receive more freedom to export and import, favourable treatment regarding import quotas and permits, support in setting up representative offices overseas and priority in undertaking local projects. They will be allowed to establish their own financial clearing centres and finance companies and to participate in urban cooperatives, trust and investment companies (*China Daily Business Weekly*, 21–27 July 1996, p. 6).

Implications for Australian Business

Over 100 000 local government controlled small and medium industrial SOEs employ about 60 per cent of industrial SOE workers but hold only 37 per cent of fixed assets, and generate only 30 per cent of sales revenue and 26 per cent of profits and taxes (Yang Qixian, 1996). The 50 per cent of SOEs making losses produce only 20 per cent of industrial output and hold less than 30 per cent of industrial assets (Lall, 1996, p. 1), indicating that loss-making SOEs are considerably smaller than average SOEs.

Consequently, freeing these smaller SOEs, by selling and leasing assets to workers, merging them with non-state enterprises, forming joint ventures with foreign enterprises, and auctioning them to private individuals should substantially reduce the financial burden on local governments. Based on several successful

experiments throughout China, ‘enlivened’ SOEs should improve their efficiency and become profitable, thereby raising profits, government tax revenue and workers’ incomes, and enabling repayment of bank loans.

SOE REFORMS IN SHUNDE

Shunde, a small city in the Pearl River Delta close to Guangzhou in Guangdong province, began experimental reforms of its SOEs at the end of 1993. These involved total or partial sale to cooperatives or private businesses of all but 50 of its 884 SOEs and township and village enterprises. By 1995, the city had:

- 50 or so enterprises wholly owned by municipal and local governments, involved in real estate, bus services, electricity and water supply, and foreign trade;
- 7 large industrial enterprises that had been made into joint stock companies, with shares owned by local and municipal governments and private investors —two with shares listed on the Shenzhen stock exchange and one in Hong Kong;
- 330 medium and larger scale former enterprises whose land and buildings were leased to employees, but whose equipment had been sold to the new cooperative owners;
- 400 small former SOEs in which the Government had sold land, buildings and equipment to former employees, who then owned shares in the newly formed cooperatives;
- 20 former SOEs that had become joint ventures with foreign investors; and
- 30 or so small loss-making former SOEs, in which employees were unwilling to invest because they did not believe they would be profitable, that were sold to private investors.

Four investment stock companies were established to control the remaining manufacturing, service, infrastructure and agricultural SOEs. They deal with only administrative issues; production decisions are left to the enterprises.

With the money received from enterprise sales, the Shunde Government invested in a pension system for retirees and paid unemployment benefits. The rest of the revenue was used to upgrade the telephone system, with assistance from Canadian investment, and for technical upgrading and capital injections into the key SOEs retained.

The new employee-owned enterprises were given priority access to bank loans and were allowed to issue bonds. Many of the former SOEs were making profits by mid 1995 and most of the rest were expected to make profits shortly thereafter. For example, the Longzheng Brewery produced only 10 000 tonnes of beer in 1993, made losses and owed ¥ 100 million to the banks. By 1995, after being made into a joint stockholding company and forming a joint venture with San Miguel from the Philippines, it

produced 100 000 tons of beer, had repaid its bank loans and was making profits. The Government owns 20 per cent of the shares and is now getting revenue from dividends and taxes; whereas, previously it merely carried losses.

Despite the rapid reform, there were no protests or social disruption. Displaced workers received redundancy payments, training and unemployment benefits, and most quickly found work in the non-state sector.

Source: Yi Zhen Qui, 1996.

ZHUCHENG AND ZHENGDIING REFORMS

In 1993 and 1994, equally rapid and successful reforms were carried out in the small cities of Zhucheng in Shandong and Zhengding in Hebei. Both cities had a high proportion of insolvent, loss-making SOEs and undertook experimental reforms. Most of their SOEs were sold to workers, but many were also merged, auctioned, leased and made joint ventures. The results were also dramatic, with rapidly growing labour productivity, profits, workers' incomes and tax payments in both cities. As a result of these and similar experiments, the Government endorsed the *zhuada fangxiao* policy.

Source: World Bank (1996b, p. 8).

The policy of enlivening small and medium sized SOEs should provide foreign investors with increased investment opportunities for joint ventures with these SOEs in the next 3 to 4 years.

'Grasping the Big' — Implications for Competitors

In March 1996, the Government announced its policy of focusing reform efforts on 1 000 large SOEs, which will remain under government control. The 800 industrial enterprises among these 1 000 hold 63 per cent of industrial SOEs' fixed capital, and generate 70 per cent of sales revenue and 74 per cent of profit and tax (Yang Qixian, 1996). The Government therefore believes that by retaining control of these SOEs, it will still hold the 'pillars' of the national economy, but its supervisory task will be more manageable. The model the Government appears to be adopting is from the early industrial policies of Japan, Republic of Korea, Taiwan and Singapore, under which selected enterprises received assistance ranging from cheap credit, market protection and assistance with technological upgrading to investment funds. Rather than forcing enterprises to embrace market-oriented reforms (which could be done without selecting them for priority treatment) the central Government may provide these SOEs with preferential policies, financial assistance, protection and subsidies to enhance their economic position. A major concern will be whether the resources so invested will be well used and produce a good long term return to the economy. Another concern is whether domestic non-state and foreign competitors will be given equal treatment with these large SOEs.

The pillar SOEs will be encouraged to become conglomerates or holding companies with many diverse, or sectorally related companies under their control, and to monitor and control the performance of subsidiaries. (See Mai, 1997, case

studies 2 and 6.) To improve their efficiency, the selected SOEs will be corporatised. However, the State will continue to hold 100 per cent of the shares in at least the parent holding companies, though not necessarily in the subsidiaries. All will receive foreign trading rights and some could be granted exclusive domestic and international trading rights in particular commodities, as is the case with the giant Sinochem company's monopoly over chemical imports.

The large SOEs already have privileged access to bank loans to upgrade their technologies (Wei Jie, 1996). Funds generated by forming joint ventures or the domestic sale of shares in subsidiaries and, in some cases, from government grants will also be injected to improve their capital structures. Bad debts with the banking system may be restructured by converting loans to equity (Wei Jie, 1996). Potential Australian investors in sectors that these large SOEs are likely to dominate may need to consider joint ventures with their subsidiaries so that they become allies rather than direct competitors. This may be essential if the SOE concerned has some regulatory advantage or monopoly.

Large and Small SOEs as Joint Venture Partners?

Although many smaller foreign joint ventures (particularly by overseas Chinese investors) have been with non-state enterprises, establishing joint ventures with SOEs, particularly in heavy, technology intensive industries such as machinery, transport equipment, petroleum and chemical industries in which SOEs dominate, also offer advantages.

The main advantages of joint ventures with SOEs are:

- the huge potential to improve productivity through better management, use of capital equipment and labour, product design and marketing
- the access to skilled staff and workers, which are in short supply in many locations
- the potential to achieve good connections with government authorities.

The main disadvantages of undertaking SOE joint ventures are:

- the possibility of ownership shares in the joint venture being arbitrarily re-determined if government authorities believe the original agreement undervalued state assets, or even if the SOE's capital assets were accurately valued. Ambiguous SOE property ownership may create ambiguity in joint ventures' property rights.
- the potential for arbitrary interference in other aspects of joint venture operations by partners or their line ministries.
- the expectation that the joint venture will keep on a large number of redundant workers.
- the potential for joint venture workers to continue to have a poor work ethic and expect a share of enterprise profits as excessive welfare and other benefits.

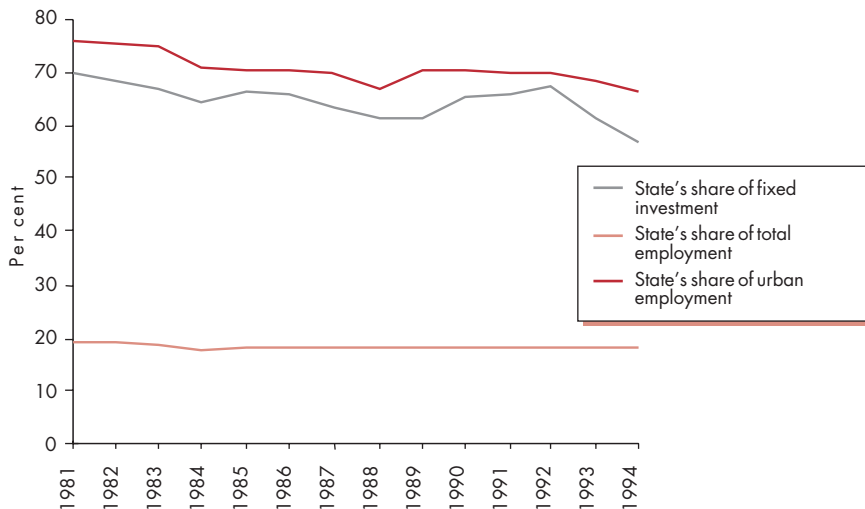
ROLE AND PERFORMANCE OF THE STATE SECTOR

China's state sector, encompassing both the industrial and tertiary sectors, is still an important component of the Chinese economy. While it accounts for only 18 per cent of the total workforce, it continues to employ 66 per cent of the politically sensitive urban workforce (Table 10.1). Although output by ownership type was only available for industries, the Asian Development Bank (1992) estimated that in 1990, the state sector produced less than 5 per cent of agricultural output, just over 30 per cent of construction and domestic trade, and less than 45 per cent of transport; that is approximately 30 per cent of total output. As SOE industrial output declined from 55 to 34 per cent of the total between 1990 and 1995, this figure will have declined several percentage points since 1990. However, the state sector still uses more than half of China's total fixed investment (Table 10.1), fully controls postal and telecommunication services, civil aviation and railway transport, and holds a majority share of many key industries, including water and electricity supply, coal, petroleum, gas, metallurgy and chemicals.

Figure 10.1

State Sector Still Significant

Share of the State Sector in China's Employment and Investment (Per Cent)



Source: State Statistical Bureau (1996b and previous years).

Nevertheless, in the 1990s, the direction of state sector investment dramatically changed (Table 10.1). Over this period, the share of investment going to industrial SOEs fell sharply, from 62 to 42 per cent of the total, while the share going to the tertiary sector, including physical infrastructure such as transport and telecommunications, and social infrastructure (education, health and welfare) rose steeply, from 30 to 56 per cent.

Table 10.1

Structural Change in the State Sector
(Per Cent of Total State Sector Fixed Investment)

| Year | Investment in | | Of which | | Investment in | | Of which | |
|------|-----------------|---------------------------|-----------------------------------|--|---------------|--|----------------|----------|
| | Industrial SOEs | Investment in energy SOEs | Other state industrial investment | | Tertiary SOEs | Investment in transport and telecommunications | Other tertiary | |
| | | Per cent | Per cent | | Per cent | Per cent | | Per cent |
| 1990 | 62.0 | 29.0 | 33.0 | | 30.3 | 11.9 | | 18.4 |
| 1991 | 58.2 | 26.4 | 31.9 | | 31.3 | 13.4 | | 17.9 |
| 1992 | 52.3 | 22.1 | 30.3 | | 41.4 | 13.3 | | 28.1 |
| 1993 | 46.6 | 19.6 | 27.1 | | 50.7 | 17.4 | | 33.3 |
| 1994 | 42.2 | 18.8 | 23.4 | | 55.5 | 21.4 | | 34.2 |

Source: State Statistical Bureau (1996b and previous years).

The Industrial SOEs

The industrial SOEs' share of total industrial output dropped dramatically from 75 per cent in 1981 to 34 per cent in 1995 (Table 10.2) due to the growth of the township and village, domestic private and foreign funded enterprises. (See Chapter 11 - Non-State Sector.) However, the SOE share of the industrial workforce has fallen much more gradually, from 50 to 41 per cent, reflecting the rigid employment practices and over-staffing of SOEs. Furthermore, industrial SOEs still undertake 57 per cent of all new industrial investments and control 65 per cent of industrial fixed assets, as a result of their preferred access to credit through the state banking system. Thus SOEs are technically inefficient, employing both more labour and capital than the non-state sector to produce a given amount of output.

Their virtually constant share of the total industrial wage bill, despite their falling employment and output share and poor profitability, indicates that SOEs pay excessively high wages and bonuses. In fact, SOEs have effectively become labour managed firms, which maximise workers' incomes irrespective of enterprise performance (Meng and Perkins, 1996).

Table 10.2

Declining Role and Efficiency of Industrial SOEs

| Year | Share of total industrial output | Share of total industrial fixed investment | Share of industrial fixed assets | Share of industrial employment | Share of total industrial wage bill | Share of urban employment |
|------|----------------------------------|--|----------------------------------|--------------------------------|-------------------------------------|---------------------------|
| | Per cent | Per cent | Per cent | Per cent | Per cent | Per cent |
| 1981 | 74.8 | 89.6 | na | 50.0 | 80.5 | 31.6 |
| 1982 | 74.4 | 88.3 | na | 49.7 | 80.4 | 31.3 |
| 1983 | 73.4 | 88.5 | na | 49.1 | 80.0 | 30.9 |
| 1984 | 69.1 | 84.9 | na | 46.3 | 77.3 | 30.0 |
| 1985 | 64.9 | 82.7 | na | 45.7 | 77.0 | 29.8 |
| 1986 | 62.3 | 82.7 | na | 44.0 | 77.6 | 29.8 |
| 1987 | 59.7 | 79.6 | 80.5 | 43.7 | 77.6 | 29.6 |
| 1988 | 56.8 | 77.9 | 78.9 | 43.8 | 78.0 | 29.6 |
| 1989 | 56.1 | 81.0 | 77.6 | 44.7 | 78.3 | 29.7 |
| 1990 | 54.6 | 87.0 | 76.9 | 45.0 | 78.8 | 29.6 |
| 1991 | 52.9 | 82.4 | 75.3 | 45.0 | 78.1 | 29.3 |
| 1992 | 48.1 | 73.7 | 74.6 | 44.2 | 78.5 | 28.9 |
| 1993 | 43.1 | 63.6 | 68.8 | 43.0 | 77.6 | 28.2 |
| 1994 | 34.1 | 56.9 | 64.5 | 40.6 | 77.8 | 26.0 |
| 1995 | 34.0 | na | 60.0 | na | na | 28.8 |

Note: na means not available.

Source: State Statistical Bureau (1996b and previous years); State Statistical Bureau (1996c and previous years).

As a consequence of their inefficiency, SOEs' financial performance has deteriorated during the reform period (Table 10.3). Their liability to assets ratios have grown and return on assets declined, while their losses have increased. Government subsidies peaked in 1989, but since then the Government has been unable to fully cover SOE losses because of its weak fiscal position, and increasingly the banking system and involuntary enterprise credits (triangular debt, see below) have made good the shortfall. The industries making the highest losses are the coal industry, followed by defence, petroleum production, non-ferrous metals, tobacco and grain milling (World Bank, 1996a, p. 15). Several of these industries still have price controls on their output.

Table 10.3

SOEs Performance Deteriorates Financial Performance and Government Subsidies

| Year | Losses of industrial SOEs ¹ | Ratio of liabilities to assets of SOEs | Return on assets of industrial SOEs | Government subsidies to loss-making SOEs ² |
|------|--|--|-------------------------------------|---|
| | ¥ billion | | Per cent | ¥ billion |
| 1986 | 5.5 | 0.187* | 19.9 | 32.5 |
| 1987 | 6.1 | na | 19.7 | 37.6 |
| 1988 | 8.2 | na | 20.2 | 44.6 |
| 1989 | 18.0 | na | 17.5 | 59.9 |
| 1990 | 34.9 | na | 12.9 | 57.9 |
| 1991 | 36.7 | na | 12.3 | 51.0 |
| 1992 | 36.9 | na | 12.4 | 44.5 |
| 1993 | 45.3 | 0.646 | 12.9 | 41.1 |
| 1994 | 48.3 | 0.652 | 12.5 | 36.6 |
| 1995 | 54.1 | 0.622 | 09.3 | 32.8 |

Notes: na means not available.

* from 1980 data.

Source: ¹ State Statistical Bureau (1996b and previous years);

² State Statistical Bureau (1996a and previous years).

SOE INEFFICIENCY — SOURCES AND SOLUTIONS

The causes of SOE inefficiency are well understood and include:

- ambiguous property rights to SOE assets
- inappropriate incentives for enterprises including subsidies to loss makers and the absence of bankruptcy provisions
- barriers to non-state firms entering certain industries
- inappropriate incentives for managers and workers
- the expensive social benefits provided to SOE workers
- redundant labour
- government interference in enterprise decision-making, including some residual prices controls.

Many of the solutions to these problems are being discussed or trialed, with varying degrees of success, in different parts of China.

This section of the chapter draws in part on an intensive survey undertaken for this study of nine large and medium sized SOEs in several provinces (Mai, 1997). The case studies give a first hand account of the problems SOEs confront and the solutions they attempt to implement.

Ambiguous Property Rights

Underlying the problems of all SOEs is that, while the State, or the ‘whole of the people’, legally own SOE assets, there is no owner, or group of owners, with a personal interest in defending the value of the capital invested and actively demanding a good return on that investment.

Although SOE managers and their supervising agencies have no legal, *de jure* property rights over SOEs, since the reforms of the 1980s, they do have many *de facto* rights to make wage, bonus, investment and production decisions in their own interests. Consequently, SOE managers and workers have effectively ‘collectivised’ state-owned properties and acquired part of the returns, which in a capitalist economy would accrue to capital, in the form of wages and workers’ benefits (Chen Kang, 1992; Meng and Perkins, 1996). In addition, in some instances corrupt SOE managers and government officials have simply diverted state assets into private hands.³

In an attempt to overcome this problem, since 1994 the Government has established asset management bureaux, sometimes in conjunction with state asset management companies and committees at each level of government. These make inventories of state-owned assets, ensure state assets are not misappropriated, and appraise SOE performance. Eventually these mechanisms are designed to replace the line ministries that traditionally controlled SOEs, and leave enterprises free to make commercial decisions subject only to the law and commercial performance targets. However, progress on this has been uneven due to rear guard action by many of the ministries concerned, lack of trained staff that are independent of the old ministries and, as yet, a lack of coherent new lines of responsibility.

In other experiments underway, one successful new state-owned asset management company surveyed in Shenzhen controls and rewards the performance of its subsidiaries merely by monitoring the rate of growth of their assets through an internal financial centre. A more conventional holding company model is employed by a large forestry equipment company interviewed. It effectively manages and controls the performance of its subsidiaries, including joint ventures, through contracts defining performance indicators, but retains authority over major business decisions including total wage bills (Mai, 1997).

Inappropriate Enterprise Incentives — Subsidies and Rare Enforcement of Bankruptcy

The most serious incentive problem facing SOEs is that, unlike private sector firms, most know that they are unlikely to be bankrupted, no matter how poorly they perform. Traditionally, the Government has protected SOEs from domestic and international competition, and bailed them out with budgetary subsidies and state bank loans if they experienced financial difficulties. SOEs therefore had little incentive to be innovative, efficient or profitable.

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³ No one really knows the extent of the problem, but one estimate puts it at a rate of ¥ 100 million per day or ¥ 36.5 billion (US\$4.4 billion) per year (*Business Time*, 30 May 1996).

This situation has changed somewhat in the reform era, as many SOEs now face competition from non-state enterprises and a few have even been bankrupted. However, the Government has frequently reiterated that bankruptcy will be used only as the last resort, and even then priority will be given to protecting the interests of managers and workers. This is not the case for collective or private sector firms, which frequently go bankrupt.

A draft bankruptcy law has been in place since 1986, but until recently has been little used in the state sector due to the inadequate nature of the law and to the Government's concern about the social implications of mass closures and substantial job losses. In the first six months of 1996, 1 692 SOEs were declared bankrupt, double the 1995 figure. However, some analysts estimate 25 per cent of SOEs could go bankrupt (Shao Ning, 1996).

WHY THE BANKRUPTCY LAW IS NOT ENFORCED

China's draft bankruptcy law has rarely been used due to the fear of high levels of unemployment which mass closures of SOEs would cause. Urban unemployment was officially 5.2 million in 1995, 2.9 per cent of the urban population (*People's Daily*, 7 March 1996), but in the first half of 1996, Central Bank Governor, Dai Xianglong, estimated that 7 to 8 per cent of the urban workforce was out of work (*Asian Wall Street Journal*, 22 July 1996, p. 3). Approximately 7.5 million SOE employees had been made redundant by mid 1996 (State Statistical Bureau, quoted in *Asian Wall Street Journal*, 22 July 1996, p. 3). By the end of September 35 000 SOEs had stopped production or were operating at low capacity, involving 6.5 million staff (*China Daily*, 2 January 1997). However a third to a half of SOEs, employing 30 million to 50 million people, could theoretically be bankrupted and their workers made redundant or redeployed if bankruptcy laws were strictly enforced. This would cost ¥ 15 billion to ¥ 30 billion (US\$ 1.8 billion to US\$3.6 billion) in unemployment benefits (World Bank 1996b, p. 30). Official statistics show a 66 per cent increase in labour disputes in 1994, mainly caused by labour shedding (Oxford Analytica, 1995). This trend did not abate in 1995 or 1996.

Furthermore, if SOEs were to shed their social functions, such as housing, health care, education and pensions, it would undermine the living standards of many previously privileged workers. Since the expansion of government provided social services and pensions has not kept pace with reform, the Government has decided that large scale bankruptcy of SOEs is not politically viable. As a universal social security system develops, funded out of enterprise, local government and workers' contributions, the Government will have more scope to allow SOEs to go bankrupt and individual enterprises to dismiss workers.⁴ (See Chapter 12 - Labour Markets.)

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⁴ The Eastern European examples caution against generous social safety nets with universal coverage. Because of China's continuing fiscal problems, a large increase in tax revenue would be required to finance such a scheme without risking an acceleration of inflation.

While both direct budget subsidies to loss-making SOEs and subsidised credit from the state banks have declined in recent years, subsidies are still substantial. In addition, SOEs still obtain large, but unquantified, transfers via involuntary inter-enterprise credits, the so-called 'triangular debt'. In the absence of bankruptcy enforcement, these sources of funds effectively maintain a 'soft budget constraint' on SOEs. (See Chapter 4 -Macroeconomic Management.) In 1994, direct budgetary subsidies to loss-making SOEs equalled 2.3 per cent of GDP, down from 7.5 per cent in 1992, while banking system subsidies represented a further 1.7 per cent of GDP, down from 3.6 per cent in 1992 (World Bank, 1996a, p. 17). Indirect subsidies to SOEs due to their failure to pay expected taxation and to generate a return on their capital at least equal to interest costs on China's international borrowing, pushed the level of subsidies to over 20 per cent of GDP in 1992 (Perkins and Raiser, 1994, Table 9).⁵

However, the credit squeeze underway since 1993 has seriously affected SOEs, since they are the main borrowers from state banks, over which the PBOC has tighter control. This has precipitated labour shedding and probably built support among enterprises and local governments for the policy of 'enlivening' small and medium SOEs. Furthermore, after several months of rising triangular debt, it was falling again by mid 1996, as viable firms refused to sell to less creditworthy ones (Lall, 1996, p. 2).

Nevertheless, the Government urgently needs further measures to reduce and then eliminate direct and indirect subsidies, particularly the less transparent ones through the banking system and triangular debt, and eventually to enforce bankruptcy on loss-making SOEs. These steps are essential not only for the health of the financial system and macroeconomic management, but also to send appropriate market signals to loss-making SOEs.

Barriers to Entry in Some Sectors

Although one of the crucial elements of the reforms has been the successful entry of non-state firms to many sectors of the economy, still total or partial barriers to their entry exist in many important industries, including utilities, logging, mining, aviation, telecommunications, distribution, metallurgy, financial services and tobacco.⁶ Barriers to entry in these industries have reduced competitive pressures on SOEs and contributed to low efficiency and poor service and product quality.

Given that overall, the State produces only a third of industrial output, those sectors in which the State produces more than 70 per cent of value added can be categorised as non-competitive. In the natural resource and utilities sectors, the Government has simply decreed that SOEs will retain a monopoly or near monopoly position. In heavy materials' industries that exhibit substantial economies of scale, entry is difficult for local township, village and private companies because of high investment costs and for foreign enterprises because of

⁵ By 1992, the economic cost of subsidies, using the international cost of borrowing as the opportunity cost of capital, was as high as ¥ 605 billion (US\$110 billion), up from ¥ 103 billion in 1980.

⁶ Appendix Table 11.2 in Chapter 11 gives the value added shares of state and non-state enterprises, by industry.

administrative regulation. In the tobacco industry, a few joint ventures with multinational cigarette companies have begun, but the Government has been anxious to retain control because of the industries' high profits. Wholesale distribution is largely reserved for the state sector, as is large scale, chain store retailing. However, the recent liberalisation of restrictions on foreign enterprise participation in international trading enterprises and domestic retailing indicate a commitment to future reform in these areas. (See Chapter 6 - Foreign Investment.)

Similarly, foreign participation has been sought in many infrastructure industries, power, roads, ports and water, but not railways or telecommunications. New laws allow joint ventures in mining, but slow negotiations indicate that reservations still remain about foreign participation in this industry. In all of these industries, the entry or threat of entry of new non-state enterprises is essential to improving SOE performance. (See Chapter 7 - Infrastructure.)

Inappropriate Managerial Incentives

At the heart of transition from planned to market economies 'lies a change in incentives, none more important than those for managers of enterprises' (World Bank, 1996c, p. 44).⁷

Both positive and negative incentives for SOE managers are weak and explain much of the poor performance of SOEs. The salaries and bonuses paid to successful SOE managers are extremely low compared with the salaries of comparable managers in private and joint venture firms. On the other hand, the negative incentives for poor performers are also weak; managers of loss-making SOEs earn nearly as much as those of profit-making ones and are unlikely to be sacked. Party cadres are still involved in the appointment of senior managers. If they fail to perform, the worst managers can expect is sideways movement to another position. Loose control over operational costs such as business entertainment, trips, executive cars and long distance phone calls can result from SOE managers' dissatisfaction with their salary packages, but such behaviour is not penalised even in the case of inadequate managers (Mai, 1997).

Few experiments have been undertaken regarding SOE management remuneration and even fewer in relation to management appointment procedures, as the latter goes to the heart of the Party's control of enterprises. Party control is also achieved through the Party Committee and Party Secretary appointed to each enterprise.

Nevertheless, Shenzhen Municipal Government indicated that it has limited the Party's role to that of providing suggestions regarding personnel, investment and enterprise operation, and training party member employees while the company's management retains ultimate decision-making rights. If the chairman of the board of directors, general manager and senior managers are Party members, the Government encourages the Party to appoint these people to lead the Party

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⁷ The case studies undertaken for this chapter indicated that the performances of SOEs were closely correlated with the capacity of their managers (Mai, 1997). In successful SOEs, managers were dynamic and ready to grasp opportunities and take responsibility for major business decisions rather than passively leave these in the hands of their governing authorities.

organisation in the enterprise to avoid potential conflict between these two sources of authority. If this is not the case, the Shenzhen Government has requested the enterprise's Party committee support the decisions of the board of directors and general manager.

Similarly, in 1994 the Shenzhen Government introduced an experiment linking managers' salaries to enterprise performance in six companies. For chairmen of boards of directors, 60 per cent of their basic salaries and bonuses is linked to increases in their companies' share values and 40 per cent is linked to enterprise profits, while for general managers, 40 per cent of their salaries is linked to increases in the companies' share values and 60 per cent to enterprise profits. However, most chairmen and general managers are still paid only an annual salary of approximately ¥ 200 000 (about US\$25 000 a year) because 'workers would be upset' if they earned more (Wang Lingling, 1995).

However, one Shenzhen distribution holding company interviewed introduced more radical reform in the area of management and worker incentives. If managers achieved ambitious profit targets, their base salaries were augmented by large bonuses and they were also given more decision-making authority, such as over wage and salary differentials of managers and workers and the appointment of middle management (Mai, 1997, p. 71).

Workers' Incentives

In the mid 1980s, attempts were made to improve the positive incentives SOE workers faced by, for example, linking enterprise total wage bills and welfare funds to their profitability and individuals' wages to their productivity, through bonus payments. However, these mechanisms were diluted and became ineffective. Loss-making enterprises still paid similar wages and bonuses, and bonuses were soon distributed equally among employees irrespective of their productivity. These measures therefore had little long term effect on worker productivity. A recent enterprise level study shows that in SOEs, wage bills were negatively related to productivity, but this was not the case in collective and private enterprises. That is, SOEs with lower productivity were paying higher wages (Meng and Perkins, 1996).

Negative incentives for poorly performing workers are also weak. Although SOE managers can theoretically dismiss or punish non-performing workers, those attempting to do so risk severely deteriorating labour relations in their enterprises and can even face threats or violence. Not surprisingly, most managers avoid using such measures to increase productivity and instead seek, probably unsuccessfully, to win the cooperation of workers by increasing wages and benefits.

Even Shenzhen has experimented only modestly in this area. In 1995, basic salaries still varied between ¥ 1 000 and ¥ 5 000 per month, depending on the industry and the grade of worker. By mid 1995, 39 companies had introduced a system whereby loss-making companies could pay no more than 90 per cent of workers' basic wages. Profitable companies workers receive full wages plus bonuses. The rather limited scope and nature of these reforms indicate the power of workers within SOEs.

However, a few more radical approaches are being attempted. In an innovative Shenzhen holding company (Mai, 1997, case study 6) the basic wage of workers

was set at only ¥ 300 (US\$31) per month, and even this was not paid in full if subsidiaries did not reach their profit targets. However, if targets were met, the basic wage represented only a very small proportion of the total wage and bonus package. Wage growth was not allowed to exceed growth in labour productivity, and the growth of subsidiaries' total wage bills could not be greater than growth of their total value added. In both 1994 and 1995, the company achieved profits of approximately 50 per cent of assets (Mai, 1997, p. 71).

In provinces such as Liaoning, where about a third of SOEs cannot afford to pay their employees' wages, workers have realised that they have to survive by themselves. Some have left SOEs to run successful small businesses.⁸ Most other workers in big cities can find labouring work or employment in the rapidly growing non-state sector unless they are unwilling to work (Mai, 1997, p. 32; Chapter 12 - Labour Markets).

Generous Worker Welfare and Social Services

One of legacies of the central planning system is that SOEs are expected to provide a wide range of social services for their employees, including housing, health care, education for children and aged pensions. Due to rapid ageing of the population, since 1992, SOE welfare spending on retirees has exceeded that for their existing workforce (Appendix Table 10.1). The share of income going to these areas rose dramatically during the reforms, probably as enterprises by-passed government controls on money wages, to the point where a recent World Bank survey found non-wage labour costs accounted for 75 per cent of the total labour costs of canvassed SOEs (Figure 10.2).

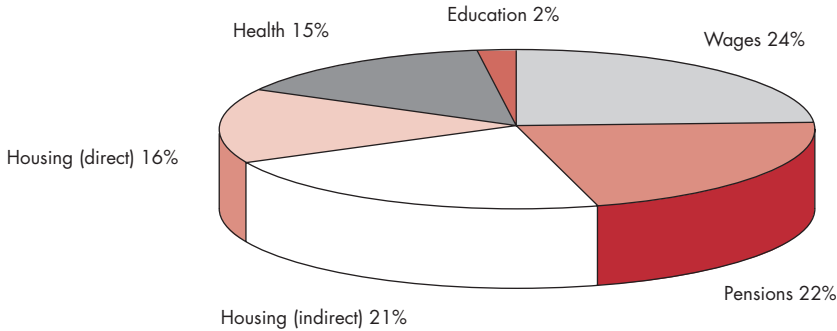
Case studies found that average annual expenditure on wage and welfare benefits could reach about ¥ 20 000 (US\$3 600) per worker, compared with the ¥ 6 000 (US\$740) per worker paid by the typical township and village enterprise (Mai, 1997, case study 5). In one enterprise, expenditure on these items reached ¥ 1 million, while total profits were only ¥ 28 000 (Mai, 1997, case study 3). This excessive level of welfare payments probably reflects the power of workers to extract revenue from enterprises rather than government requirements. Expenditure on workers' housing boomed in the 1980s (World Bank, 1996b).

Direct expenditure by SOEs on social services for their workers is now approximately equal to the budget transfers and implicit financial subsidies they receive from the banking system (World Bank, 1996a, p. 17). Since these subsidies to SOEs exceeded profit and tax payments made by SOEs to the Government in the first half of 1996, workers and retirees now effectively consume all the value added of SOEs. Thus, the owners of the capital, the Government (or the whole people) effectively receive no return on their huge investment in SOEs; workers consume all SOE net output as either wages or benefits.

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⁸ The local government has created a favourable policy environment by reducing bureaucratic barriers, making it easier to establish small private businesses.

Figure 10.2

Social Spending of Thirty Seven SOEs, 1994



Source: World Bank (1996b, p. 32).

While joint venture firms involving former SOEs must meet similar expenses for their workers, the non-state sector generally pays much lower welfare benefits or none at all. (See Chapter 12 - Labour Markets, Figure 12.2.)

The main solutions to reduce onerous social service obligations on SOEs are to privatise housing and establish municipal pension, health and unemployment insurance schemes. Currently, most urban workers live in state-provided housing. Many SOE and other public sector workers are being offered their apartments at modest prices, but some are apparently reluctant to buy if they think they can continue to pay the nominal rents still charged (often only a few yuan per month). The Government will first need to raise rents to market levels, possibly at least partially offset by wage increases, to provide an incentive for workers to buy housing. Sale prices could then be set closer to market levels. If this were done, it would establish the basic pre-conditions for developing a commercial housing market for low and middle income earners and relieve SOEs of this escalating and non-transparent cost burden.

By the mid 1990s, over 50 per cent and by some reports 90 per cent of SOE workers (Chen et al, 1996) were members of municipal pension schemes established in the 1990s. In theory, all urban enterprises (state and non-state) and workers pay a percentage of their wage bills and wages into these pooled schemes (World Bank, 1996b, pp. 33–35). However, there are apparently problems in enforcing payments from many firms, particularly marginal ones. Many enterprises see it as just another impost and, because of the potential for mismanagement of the funds collected in municipalities with less experienced fund managers, some workers and enterprises lack confidence that pensions will ever be paid (Mai, 1997, case studies 5 and 8). Greater reliance on individual accounts that workers can monitor should increase accountability and confidence.

The funding of pension obligations through flat rate payroll taxes (25 per cent in Shanghai) heavily cross-subsidises old SOEs with many retired workers from the contributions of new enterprises, including most foreign funded ones, that have

young workforces and no retirees. However, despite numerous problems, with improved implementation, pension pooling should increase labour mobility between enterprises and facilitate the closure, merger or sale of non-viable SOEs.

Attempts to transfer SOEs' education and medical facilities to municipal governments have been less successful. Two options in health care are to establish municipal medical insurance schemes on similar lines to the pension schemes, as has been attempted in Zhenjiang City in Jiangsu province, and monetise SOE-provided health services by charging fees for medical services, thereby encouraging the growth of a private health sector. At the high income end of the market, private medical services already provide the best hope for increasing health service quality and reducing waste (Mai, 1997, pp. 29–30). Similarly, as many urban residents already pay school fees at enterprise and government schools because of the funding crisis in education, *de facto* privatisation may eventually occur.

Redundant Labour

SOEs have inherited obligations to employ redundant workers, to help disguise urban unemployment. A recent World Bank (1996b) survey found that in 60 per cent of enterprises, at least 10 per cent of the workforce was redundant, leading them to conclude that at least 15 million SOE workers nationwide were redundant in 1994.

However, this estimate is relatively conservative. Chen Qingtai (1996) and *People's Daily* (7 March 1996) estimated up to 30 million out of the 100 million SOE workers were redundant in 1994. The ¥156 billion spent on the wages of these redundant workers was almost double the profits and more than double the losses made by the state sector in 1994.

Some loss-making SOEs now shed labour, often effectively privatising non-core functions such as dining facilities, guest houses and transport services, and downsizing bloated administrative and production workforces (Mai, 1997, case studies 1 and 4). While this is usually possible only as a last resort for enterprises making heavy losses and facing insolvency, 7.5 million SOE employees have been made redundant up to mid 1996, indicating that this problem is being seriously, if slowly, tackled.

Municipal unemployment insurance funds have been established to fund unemployment benefits for redundant workers, with benefits paid on the basis of national guidelines. As most of these funds are relatively new, paid-in reserves have not been sufficient to pay all of the 1.8 million workers currently receiving benefits, and the central Government has supplemented funding. The many new retraining centres around the country now assist several million redundant workers each year (Cao, 1996).

Government Interference

Despite numerous pronouncements that state enterprises should be responsible for their own profits and losses and most normal business decisions, in many cases enterprises' line ministries and Party committees continue to play an active role in enterprise management (Perkins, 1996, Tables 3 and 4). While enterprises report their autonomy is generally high for decisions related to production, purchasing, domestic sales and the use of retained earnings for wages and other purposes, it is

much lower for investment, divestiture of assets, international trade and personnel management decisions (Table 10.5).

Table 10.5

Management Autonomy in World Bank Surveyed Enterprises

| | | Proportion indicating full autonomy |
|----|--|---|
| | | Per cent |
| 1 | Selling autonomy | 97 |
| 2 | Production autonomy | 96 |
| 3 | Purchasing autonomy | 94 |
| 4 | Use of retained earnings | 78 |
| 5 | Right to decide on organisational structure | 78 |
| 6 | Pricing autonomy | 73 |
| 7 | Right to determine wages and bonuses | 65 |
| 8 | Right to hire workers | 58 |
| 9 | Right to manage personnel | 55 |
| 10 | Investment autonomy | 47 |
| 11 | Right to establish joint ventures or engage in mergers or acquisitions | 40 |
| 12 | Import and export rights | 39 |
| 13 | Right to dispose of assets | 37 |
| 14 | Right to refuse non-regulated government charges | 21 |

Source: World Bank (1996b, p. 22).

The two most successful methods of preventing this government interference have been to abolish the old line ministries, as in Shanghai and Shenzhen, and to corporatise SOEs, establishing a board of directors appointed by shareholders, accompanied by sales of shares to employees and preferably listing on the stock exchange. Once SOEs are controlled by a board of directors, at least some of whom have a direct pecuniary interest in the enterprise, and others such as bank representatives with an indirect interest, enterprises can better demand and defend their autonomy (Mai, 1997, case studies 4 and 6). Mainly for this reason, the Government plans to corporatise and list another 300 large SOEs in 1997 (Zhang Xunhai, 1996).

Remaining price controls on key energy and food products also depress SOE earnings in industries such as coal, oil and gas, fertiliser production and grain milling (World Bank, 1996a, p. 17). However, industry price controls have been steadily removed over the reform period, with energy, key agricultural crops and infrastructure services remaining the main areas of intervention. (See Chapter 3 - Market Environment.)

IMPLICATIONS FOR FUTURE REFORMS

SOE reform remains a pressing issue for China. If achieved, it will considerably improve the prospects for financial market and trade reform, ensuring a more dynamic business environment. It will also greatly assist in repairing the Government's fiscal position, freeing up resources for vital investments in infrastructure and education, essential to sustain rapid growth in the medium to long term. Failure to reform SOEs will result in a significant slowing of potential growth and retard many important reforms.

Although political constraints and fear of social instability have inhibited rapid progress in the past, the current favourable economic climate and wider acceptance of the serious long term costs of delay may embolden policy makers to permit more vigorous SOE reforms in the next two to three years. If the policy reform of enlivening the small SOEs is widely adopted, as appears quite likely in many more dynamic provinces, it could significantly improve the overall performance of the SOE sector, reducing fiscal losses and indebtedness to the banking system, and freeing up unproductive labour and capital for the more dynamic non-state sector. There should also be good opportunities for joint ventures and purchases of SOEs by local and foreign private sector investors.

The full implications of the policy of 'grasping the big' are less clear at this stage and will have to be carefully watched by local and foreign firms in affected industries. It appears possible that some large SOEs may be protected from competitive pressures and given regulatory advantages, wasting resources and raising costs for consumers and producers purchasing their products. As many large SOEs are in key raw material and heavy industries, such policies would have a negative effect on the efficiency of downstream users who constitute much of the economy and who compete in domestic and international markets.

If the big SOEs are successfully corporatised, listed on stock exchanges, given the freedom to operate as essentially private firms, exposed fully to domestic and international competition and required to achieve comparable efficiency and profitability objectives, they need not have a negative influence on China's development objectives. However, achieving this outcome will require a huge input of time and effort from high quality, disinterested bureaucratic personnel as well as significant levels of public sector funding. These public sector resources would almost certainly be much better spent in areas where private sector entrepreneurs and funding cannot be substituted, such as public administration, including macroeconomic and legal system management, non-commercial infrastructure, education and social service delivery.

Nevertheless, as conglomerates develop, there are likely to be good opportunities for domestic non-state and foreign enterprises to undertake joint ventures and form business alliances for trade and investment activities in China, Australia and third countries.

Appendix 10.1

DATA ON THE INDUSTRIAL SECTOR

Appendix Table 10.1

Welfare Expenditure of SOEs

| Year | Total money wage bill of SOEs | Total welfare expenditure | Welfare expenditure for current employees | Welfare expenditure for retirees | Retirees' benefits in total welfare expenditure paid by SOEs |
|------|-------------------------------|---------------------------|---|----------------------------------|--|
| | ¥ billion | ¥ billion | ¥ billion | ¥ billion | Per cent |
| 1985 | 46.0 | 27.36 | 15.44 | 11.92 | 42.8 |
| 1986 | 55.7 | 34.39 | 18.23 | 16.16 | 46.4 |
| 1987 | 63.6 | 41.59 | 21.54 | 20.05 | 47.7 |
| 1988 | 79.2 | 53.76 | 28.12 | 25.64 | 47.3 |
| 1989 | 91.5 | 63.55 | 32.58 | 30.97 | 48.1 |
| 1990 | 103.1 | 77.73 | 39.49 | 38.24 | 48.7 |
| 1991 | 115.1 | 91.25 | 45.28 | 45.97 | 50.0 |
| 1992 | 133.6 | 109.58 | 52.30 | 57.28 | 51.8 |
| 1993 | 162.4 | 138.65 | 63.37 | 75.28 | 53.9 |
| 1994 | 201.3 | 164.62 | 62.42 | 102.20 | 61.7 |

Source: State Statistical Bureau (1996b and previous years).

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THE NON-STATE SECTOR

The rapid growth of the non-state sector (NSS) is one of the most striking outcomes of the reforms begun in 1978. Local and central governments support this sector because they recognise it is essential to generate employment opportunities, income growth and consumer goods for domestic and export markets.

The NSS consists of four broad types of business entities:

- town and village enterprises (TVEs)
- urban collectives
- private and individual enterprises
- joint ventures (JVs) and wholly foreign-owned enterprises (WFOEs), together called foreign funded enterprises (FFEes).

Some of these entities have formal or informal ties with state-owned enterprises (SOEs); yet others have been hived off from SOEs and are now nominally independent; and others are completely independent of the state sector (Sabin, 1994, p. 953).

The NSS now produces two thirds of industrial output and over 70 per cent of total national output, as both agriculture and the personal services sector are largely privately owned. The sector is changing rapidly, reflecting the strength of market forces operating within it. The share of collectives is declining while that of the more dynamic township and village industries, local private and foreign enterprises has grown rapidly.

The NSS dominates light industry and has generated about three quarters of total export growth since 1978. It also produces over 80 per cent of industrial output in the coastal provinces. In fact, the preeminence of the NSS in these provinces is one of the main sources of dynamism of the coastal region. In the past, the NSS has confronted discriminatory tax and other policies, and still has some concerns regarding security of property rights. It also has difficulties accessing bank finance, upgrading technology, obtaining access to skilled labour and management personnel, dealing with government interference in the management of some enterprises, and securing product transport and distribution. Legal and regulatory reforms and political developments in the 1990s have greatly improved the position of NSS firms, and have mainly caused the sector's dramatic growth this decade.

Township and village enterprises are either owned by local government authorities or groups of individuals, but operate essentially as private or labour managed enterprises, as these lower levels of government usually do not have the financial resources to subsidise them if they make losses.

Collectives and private enterprises existed intermittently from 1950 to 1980, but in periods of political leftism, they either changed names or were closed down. In 1991, China's State Council broadened the term collective to include enterprises with less than 49 per cent of their assets privately owned (Sabin, 1994, p. 950). Hence, collectives may belong simultaneously to both the public and private sectors.

Registration of private enterprises was eased greatly in 1988. Prior to then, many private enterprises were registered as collectives or SOEs but operated as private entities. The Chinese terminology distinguishes two types of private business, the self-employed pedlars (*getihu*) and private enterprises (*siying qiye*). The key difference between the two is that in the hiring of staff, the former is limited to two assistants and five apprentices (eight people in total, including the owner). Private enterprises, which have no limit on employee numbers, were first permitted in the mid to late 1980s and can be quite large. In some cases, private enterprises call themselves 'collectives', to avoid problems if the current political climate changes. For example, Shanghai's largest furniture maker is classified as a collective although the general manager operates and regards it as his private family business. Although the private sector is independent of the government, that independence may increase vulnerability to changes in government policy.

Foreign involvement in the NSS is extensive, encompassing both WFOEs and joint ventures across China. As well, as with SOEs, joint venture partnerships may be made with NSS entities, such as urban collectives, TVEs or private enterprises. The third wave of foreign investment began in 1992 following Deng's Southern Tour.

Initially foreign funded enterprises were only permitted if they formed joint ventures with domestic state and non-state enterprises. JVs are established by two or more parties; at least one of which is foreign and one domestic. Generally in such entities, one party, usually the local partner, contributes land, personnel and/or manufacturing facilities while the other provides capital. After the first wave of JVs established in the early 1980s, China began to permit the establishment of WFOEs in 1986.

CONTRIBUTION OF THE NSS

By 1994, China had more than 10 million businesses in operation, approximately twice the number of 1985 (Table 11.1). The growth of privately owned enterprises was even more rapid, rising from 65 per cent of all enterprises in 1985 to nearly 80 per cent in 1990. On the other hand, the share of urban collectives in the total number of enterprises has halved, reflecting the easing of restrictions on private enterprises.

Table 11.1

Private Enterprise Takes Off
Numbers of Enterprises by Business Type
('000)

| | 1985 | 1990 | 1994 |
|-------------------|---------|---------|----------|
| TOTAL | 5 185.3 | 7 757.8 | 10 017.1 |
| SOEs | 93.7 | 104.4 | 102.2 |
| Per cent | 1.8 | 1.3 | 1.0 |
| Urban Collectives | 892.4 | 759.0 | 856.6 |
| Per Cent | 17.1 | 9.8 | 8.6 |
| TVEs | 849.7 | 909.5 | 1 006.4 |
| Per cent | 16.4 | 11.7 | 10.0 |
| Privately owned* | 3 347.8 | 6 176.0 | 8 007.4 |
| Per cent | 64.6 | 79.6 | 79.9 |
| Other (FFE) | 2.4 | 8.8 | 44.5 |
| Per cent | 0.1 | 0.1 | 0.4 |

Note: * The great bulk of privately owned business were self-employed (getihu). At the end of 1996, there were approximately 655 000 private enterprises throughout China.

Source: State Statistical Bureau (1995a and previous years).

Although joint ventures remain the most common FFE structure, WFOEs now occupy a significant share (Table 11.2). Many foreign firms are attracted by the freer and more independent structure of WFOEs, but joint ventures still offer many advantages. (See Chapter 6 - Foreign Investment.) Their share of total FFES increased rapidly after 1986, but appears to have stabilised in the 1990s (Table 11.2).

Table 11.2

WFOEs' Share Growth Slows
Types of FFES Established, by Structure

| | 1986 | 1988 | 1990 | 1992 | 1994 |
|------------------------|-------|-------|-------|--------|--------|
| TOTAL | 1 498 | 5 945 | 7 273 | 48 764 | 47 549 |
| Per cent | 100 | 100 | 100 | 100 | 100 |
| JVs | 892 | 3 909 | 4 091 | 34 354 | 27 890 |
| Per cent | 60 | 66 | 56 | 70 | 59 |
| WFOEs | 18 | 410 | 1 860 | 8 692 | 13 007 |
| Per cent | 1 | 20 | 26 | 18 | 27 |
| Others (contract, etc) | 588 | 5 | 1 322 | 5 718 | 6 652 |
| Per cent | 39 | 14 | 18 | 12 | 14 |

Source: State Statistical Bureau (1995b and previous years).

Although the largest number of enterprises operating are private, by 1994, they represented a modest, albeit rapidly growing, fraction of total output (Table 11.3). However, the output share of the NSS in total has climbed steeply from 45 to 66 per cent over the last five years.

Table 11.3

NSS Growing Rapidly
Gross Industrial Output by Business Type
(¥ billion)

| Year | 1990 | 1991 | 1992 | 1993 | 1994 |
|---------------------|---------|---------|---------|---------|---------|
| TOTAL | 2 392.4 | 2 824.8 | 3 706.6 | 5 269.2 | 7 690.9 |
| SOEs | 1 306.4 | 1 495.5 | 1 782.4 | 2 272.5 | 2 620.1 |
| Per cent | 54.6 | 52.9 | 48.1 | 43.1 | 34.1 |
| Urban collectives | 368.7 | 414.9 | 514.4 | 626.3 | 801.1 |
| Per cent | 15.4 | 14.7 | 13.8 | 11.9 | 10.4 |
| TVEs | 483.5 | 593.5 | 895.7 | 1 395.0 | 2 342.3 |
| Per cent | 20.2 | 21.0 | 24.2 | 26.5 | 30.5 |
| Privately owned | 129.0 | 160.9 | 250.7 | 440.2 | 885.3 |
| Per cent | 5.4 | 5.7 | 6.8 | 8.4 | 11.5 |
| Other (mainly FFEs) | 104.8 | 160.0 | 263.4 | 535.2 | 1 042.1 |
| Per cent | 4.4 | 5.7 | 7.1 | 10.2 | 13.6 |

Source: State Statistical Bureau (1995b and previous years).

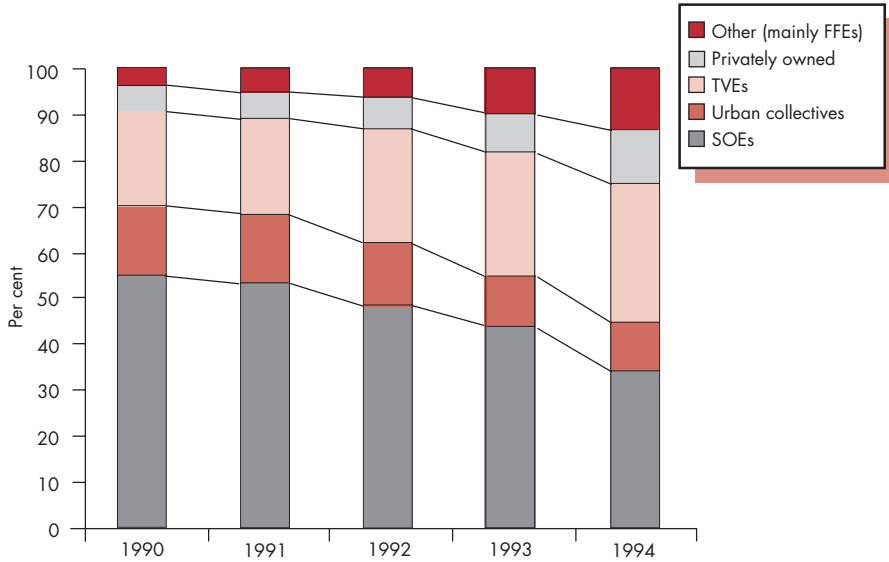
The output share of the previously dominant SOEs dropped commensurately. While the growth of TVEs more than offset the decline of urban collectives, the highest growth rates were recorded by privately owned enterprises (586 per cent) and so-called 'other' enterprises, largely FFEs (almost 900 per cent).

A similarly radical shift has occurred in employment patterns (Table 11.4). While in 1980, SOEs employed more people than all other forms of enterprises combined, within five years, TVE employment more than doubled, while SOE employment rose just 12 per cent. Overall, TVE employment quadrupled between 1980 and 1994.

Figure 11.1

Output Share of NSS Grows Rapidly in 1990s

Output Share by Enterprise Type



Source: State Statistical Bureau (1995b and previous years).

Table 11.4

TVEs Now the Biggest Employer

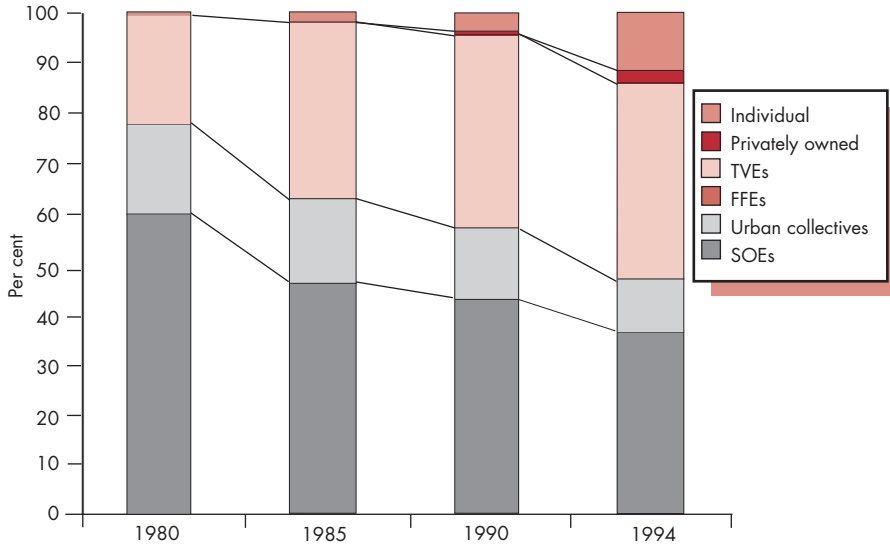
Employees by Business Type ('000 People)

| Year | SOEs | Urban collectives | FFEs | TVEs | Private | Individual |
|------|---------|-------------------|-------|---------|---------|------------|
| 1980 | 80 190 | 24 250 | — | 30 000 | — | 810 |
| 1985 | 89 900 | 33 240 | 60 | 69 790 | — | 4 500 |
| 1990 | 103 460 | 35 490 | 620 | 92 650 | 1 700 | 11 050 |
| 1994 | 112 140 | 32 850 | 1 950 | 120 170 | 6 480 | 37 760 |

Source: State Statistical Bureau (1995b and previous years).

Figure 11.2

Employment Share of NSS Grows Rapidly Shares of Employment by Enterprise Type



Source: State Statistical Bureau (1995b and previous years).

Dwarfing even the employee growth of TVEs was that of the FFEs. From a low base in 1985, their employment expanded thirty fold by 1994, but they still employed only 0.6 per cent of the workforce. Private enterprises and individually operated companies were virtually non-existent prior to the reforms but have posted the most impressive employment growth rates in the 1990s.

NSS enterprises operate in nearly all sectors of the economy, from light industry to oil extraction and processing, but are most active in the consumer goods and export sectors. In 1995, the NSS produced over 75 per cent of garments, furniture, textiles, timber, plastic and metal products, electronics and other manufactures and 60 per cent of all processed food (Table 11.5 and Appendix Tables 11.1, 11.2 and 11.3). The state sector still dominates many heavy and extractive industries, iron and steel, coal mining and petroleum extraction and refining, utilities like electricity, water and gas, banking, aviation, rail transport and because of its revenue earning potential, tobacco processing.

Table 11.5

NSS Dominates Light Industry, SOEs Heavy Industry
Sectoral Contribution of NSS, 1995
(Per Cent of Total Sectoral Production)

| Sector | Total NSS | Foreign funded | Other NSS | State-Owned |
|--|-----------|----------------|-----------|-------------|
| Garments and other fibre products | 93 | 50 | 43 | 7 |
| Other manufacturing | 92 | 31 | 61 | 8 |
| Furniture manufacturing | 91 | 30 | 61 | 9 |
| Plastic products | 88 | 33 | 54 | 12 |
| Metal products | 86 | 27 | 60 | 14 |
| Timber processing, bamboo, cane, palm fibre and straw products | 82 | 28 | 54 | 18 |
| Electric equipment and machinery | 77 | 24 | 53 | 23 |
| Electronic and telecommunications | 75 | 60 | 15 | 25 |
| Instruments, meters, and office machinery | 67 | 40 | 27 | 33 |
| Papermaking and paper products | 63 | 17 | 46 | 37 |
| Food manufacturing | 62 | 30 | 32 | 38 |
| Textile industry | 60 | 18 | 42 | 40 |
| Transport equipment manufacturing | 49 | 25 | 24 | 51 |
| Food processing | 48 | 20 | 28 | 52 |
| Beverage manufacturing | 47 | 23 | 23 | 53 |
| Raw chemical materials and chemical products | 44 | 13 | 31 | 56 |
| Non-Ferrous metals mining and processing | 43 | 1 | 42 | 57 |
| Smelting and pressing of ferrous metals | 31 | 6 | 25 | 69 |
| Electric power, steam and hot water production and supply | 22 | 14 | 9 | 78 |
| Coal mining and processing | 22 | 0 | 22 | 78 |
| Tap water production and supply | 15 | 0 | 15 | 85 |
| Petroleum processing and coking products | 12 | 1 | 10 | 88 |
| Gas production and supply | 10 | 3 | 7 | 90 |
| Petroleum and natural gas extraction | 5 | 4 | 1 | 95 |
| Tobacco processing | 3 | 1 | 3 | 97 |

Note: Data on sectoral distribution by ownership available in State Statistical Bureau (1996a) is only for accounting units, which produce about 61 per cent of total industrial output. The share of the SOEs in this data (47 per cent) is considerably higher than their share in total industrial output (33 per cent). Thus this table understates the actual contribution of the NSS, but approximately portrays their sectoral distribution.

Source: State Statistical Bureau (1996a).

NSS DEVELOPMENT TRENDS BY REGION

While all four types of NSS businesses are found throughout China, the most dramatic growth in the sector occurred in the coastal area stretching from Dalian in the north east, to Beijing/Tianjin/Qingdao in the north, to Shanghai and Ningbo in the east and to Fuzhou/Xiamen/Guangzhou in the south. The proliferation of NSS businesses contributes significantly to the coastal region's rapid growth. (See Chapter 8 - Regional China.) In these provinces, local government policies, better infrastructure and higher levels of entrepreneurial and technical skills in the population all favour NSS development (Table 11.6 and Appendix Table 11.3).

Despite regional and provincial variations, throughout China the output share of TVEs and private and individually owned enterprises expanded rapidly in the past 5 years, while the share of urban collectives and (except in the central region) SOEs contracted.

Table 11.6

Gross Industrial Output Value of Enterprises by Region, 1990 and 1994 (¥ '00 million)

| | Year | SOEs | Urban | TVEs | Private | Others | Total |
|----------------|------|--------|--------|--------|---------|--------|--------|
| Coastal region | | | | | | | |
| | 1990 | 6 570 | 9 313 | 4 072 | 626 | 978 | 21 559 |
| Per cent | | 30 | 43 | 19 | 3 | 5 | 100 |
| | 1994 | 13 262 | 16 430 | 22 323 | 4 584 | 8 180 | 64 778 |
| Per cent | | 20 | 25 | 34 | 7 | 13 | 100 |
| Central region | | | | | | | |
| | 1990 | 3 930 | 3 392 | 1 172 | 388 | 36 | 8 917 |
| Per cent | | 44 | 38 | 13 | 4 | 0 | 100 |
| | 1994 | 7 500 | 4 166 | 2 277 | 426 | 843 | 15 212 |
| Per cent | | 49 | 27 | 15 | 3 | 6 | 100 |
| Western region | | | | | | | |
| | 1990 | 1 563 | 1 149 | 385 | 145 | 21 | 3 262 |
| Per cent | | 48 | 35 | 12 | 4 | 1 | 100 |
| | 1994 | 4 220 | 1 766 | 1 819 | 1 017 | 631 | 9 453 |
| Per cent | | 45 | 19 | 19 | 11 | 7 | 100 |

Note: The coastal region consists of Shanghai, Beijing and Tianjin municipalities and Jiangsu, Zhejiang, Fujian, Shandong, Guangdong Hebei, Liaoning, Guangxi and Hainan provinces. The five dynamic provinces are Jiangsu, Zhejiang, Fujian, Shandong, Guangdong. (See Chapter 8 - Regions.)

The central region consists of Shanxi, Jilin, Inner Mongolia, Heilongjiang, Anhui, Jiangxi Henan, Hubei and Hunan.

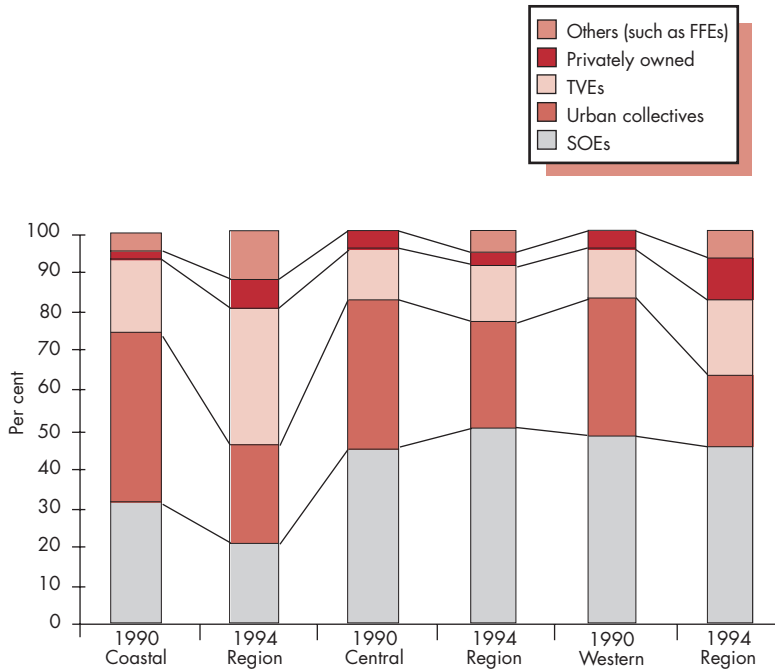
The western region consists of Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang.

Source: State Statistical Bureau (1995a and previous years); State Statistical Bureau (1991b, 1995b).

Figure 11.3

NSS Grows Most Rapidly in Coastal Region

Regional Distribution of Enterprises, 1990 and 1994



Source: State Statistical Bureau (1995a and previous years); State Statistical Bureau (1991b, 1995b).

Throughout China's regions, the NSS takes different forms and benefits differentially from central and local government policies towards the sector.

In the north eastern provinces like Liaoning, TVEs, FFEs and private enterprises enjoyed high growth from 1990 to 1994, in part because of the mounting problems of provincial SOEs, many of which suffered from triangular debt, and also because of the increasingly strong concentration of foreign investors in the region. Many collective firms became private ones, or developed links with foreign entities, thus becoming FFEs.

In many provinces, urban collectives and SOEs, which were the mainstay of economies in 1990, had declined considerably by 1994. The decline of these two sectors reflects their less pro-active marketing and product promotion activities as well as the greater capacity of TVEs and FFEs to attract foreign and domestic investment for technological improvement.

In northern and eastern provinces, many new FFEs were owned by multinationals which already operated FFEs in the south. This enabled them to employ their strong operating experience to promote their goods and begin to re-coup their investments more quickly after start-up in the north. In many cities like Beijing and Tianjin, the private sector grew rapidly.

In Shandong, one of the most dynamic provinces, SOEs have long ceased to play a significant role. Its TVEs produce goods for both domestic and foreign markets and have increasingly improved their marketing skills to promote their products. In the 1990s, Hebei TVEs shed their poor performance history to become the leading force in the provincial economy.

In several coastal provinces like Shanghai, Guangdong and Jiangsu, many private enterprises found their resources inadequate to compete with the strong and well managed FFEs, TVEs and urban collectives which offered competing products and services. Private enterprises in Zhejiang, Anhui, Guangxi and Fujian often filled niches, providing goods and services not supplied by larger competitors, hence their larger share of provincial industrial output.

In many central provinces except Sichuan, SOEs still dominate the economy. In many of these provinces, poor transport and inadequate utilities cause the NSS considerable difficulty in attracting funds, foreign or domestic, and marketing goods outside their provinces. However in Sichuan, TVEs, urban collectives, FFEs and the private sector are active. This reflects the strong entrepreneurial spirit of urban Sichuan, better infrastructure and the greater concentration of capital within the province.

In most central and western provinces, urban collectives are declining but the share of SOEs has been reasonably constant, while TVEs, the private sector and FFEs are growing strongly from a low base.

SHANGHAI'S GROWING PRIVATE SECTOR

From its dominant position in 1949, when Shanghai's 140 000 private firms produced 70 per cent of output, the private sector reached its low point in 1978, employing only 9 000 people and making a negligible contribution to the local economy. According to official statistics, the private sector now produces 6 to 7 per cent of output in Shanghai, although unofficial estimates which include output produced by self-employed people, put this figure at 15 per cent.¹ The private sector now employs about 760 000 people, or 17 per cent of the local workforce and generates 20 per cent of retail sales.

The private sector's growth began in 1980 when the city administration permitted the issue of licences to self-employed people, and quickened in 1988 when private enterprises were allowed for the first time since the 1950s. The sector still suffered from discriminatory taxation and other policies until Deng's Southern Tour in 1992, after which private firms were allowed to compete on an equal footing with the state sector. As a result, the number of registered private enterprises jumped from 2 200 in 1992 to 51 649 at the end of 1996. The Shanghai Municipal Government also encourages the private sector because of its capacity to absorb displaced SOE workers and generate tax revenue.

¹ Communication by Richard McGregor, Hong Kong correspondent to the Australian Consulate, Shanghai, 1996. (Information in this box was provided by the Australian Consulate, Shanghai.)

Private firms are apparently able to enter any industry except those controlled by the central Government, which include military related industries, finance, aviation and large scale mining. About 80 per cent of the sector engage in services such as restaurants, small shops and real estate and a further 11 per cent are in manufacturing. A more recent trend is into professional services such as law and consulting as more educated people join the private sector from SOEs, government administration and educational institutions. Pay and conditions in the private sector usually parallel those in the SOEs, although very profitable enterprises may offer much higher salaries to acquire quality staff. Currently only 110 to 120 of Shanghai's local private firms are involved in joint ventures, out of 11 000 JVs.

The private sector is now the fastest growing in Shanghai, outstripping growth rates in the state sector and FFEs. However, it still faces many problems, including:

- lack of access to capital from the state banking system, compelling firms to pay high interest rates in the informal financial market
- lack of suitable premises in which to operate enterprises
- lack of access to inputs, transport and distribution channels.

MAJOR ISSUES FOR THE NSS

Key issues which confront the NSS are management control, financing, taxation, technology, labour, input supply, distribution and marketing. These issues are addressed individually below.

Management Control

Government intervention in enterprise management depends on the enterprise type and location. In some areas, local governments still significantly control urban collectives and TVEs through what one analyst termed 'local state corporatism'. This involves local government coordinating economic enterprises in its territory as if it were a diversified business corporation (Oi, 1992, pp. 100-01).

However, since 1989, the central Government has sought to regularise taxation and control over the NSS and reduce the more arbitrary and personal influence of local administrations over the sector (Young, 1995, pp. 140-42). The central Government has promulgated many laws covering labour management (wage structure, working hours and safety), taxation and other legal obligations, to which all enterprises must adhere. While many NSS firms were brought within the taxation system, it is yet to be seen if such attempts will be fully effective.

FFEs and private sector firms are free to use profits as they please. However, after TVEs and collectives meet all their financial obligations, they are subject to regulations regarding the disposition of their retained profits reflecting initial investments by local government in these enterprises. Local government bureaux often require local TVEs and urban collectives to contribute funds to municipal causes such as educational and cultural funds and road maintenance. Such levies

vary by locale but can include fees for the old age pension, culture and education, building funds, land use and voluntary contributions (Oi, 1994, p. 112). While FFEs and private sector firms sometimes are expected to make comparable 'contributions', these are generally on a smaller scale and over a shorter period (Oi, 1992, p. 117.)

Furthermore, many TVEs, urban collectives, and FFEs are affiliated with SOEs either as joint venture partners or as former parents of TVEs and urban collectives. Such NSS firms may have to defer to their parent SOEs even though they may be direct competitors. Many NSS firms report significant problems with their SOE partners due to conflicting operating philosophies and goals such as a preference by SOEs for maximising production volume of lower quality goods rather than maximising profits by producing a lower volume of higher quality goods.

Another management issue is who has the ultimate decision-making responsibility in an FFE in which an SOE is the local partner. The same question also vexes many TVEs, urban collectives and, to a lesser extent, private enterprises which are subject to significant governmental oversight. In some cases, management personnel is determined in direct proportion to investor equity in the enterprise; in others, it is determined in relation to each individual manager's capabilities, particularly the connections, *guanxi*, which enable enterprises to acquire preferential treatment or scarce commodities.

Access to State Bank Loans

The Government retains considerable influence over the largely state-owned banking system. Loans are extended to firms based on their credit ratings which local government officials devise based on the importance of the firm within the community, scale of operations, industry within which the firm operates, and, inevitably, the *guanxi*, or connections, of the firm's management.

Thus firms which, on the basis of normal banking criteria would appear to be attractive candidates for bank loans at good rates are sometimes not extended loans at any interest rate, while banks continue to channel funds towards unprofitable SOEs which may not be able to repay their loans. (See Chapters 4 - Macroeconomic Management and 10 - State-Owned Enterprises.) While the Government has recently reiterated provisions of the Banking Act which require banks to issue loans on a commercial basis to both SOEs and NSS firms, it is yet unclear whether the four big state-owned banks will formally reorient their lending to the NSS. Many SOEs apparently illegally on-lend loans to the NSS, however, at higher interest rates.

To gain access to capital, NSS enterprises must cultivate relationships with banking officials in the municipalities where they operate or seek non-bank loans, as discussed below. Some NSS enterprises complain that the decentralisation of bank authority means that each bank branch operates autonomously and, for example, if a bank in Shanghai extends a loan to a firm, this will have no bearing on whether the same bank's branch elsewhere, in, say, Beijing, will also advance the same firm a loan. Thus it may not be possible to establish nationally a firm's credit worthiness.

However, local branches of state banks, particularly the Agricultural Bank of China, sometimes fund TVEs, if local government officials support the TVE. In some instances, local officials also could provide guarantees for such loans. However, if NSS enterprises do obtain state bank loans, they usually pay market interest rates rather than concessionary ones. Furthermore, such loans are often very short term (Ody, 1992, p. 10 and p. 26).

Since the state banking sector is overwhelmingly committed to lending funds to large, often poorly performing SOEs, the NSS usually must obtain its funding from other sources including:

- ***Non-State bank loans***

During the past 15 years, a huge informal (black) financial market has emerged, with a capacity estimated by the State Planning Commission at approximately ¥ 150 billion (US\$18 billion). Many dealers charge high interest rates, typically 10 percentage points above state bank rates, creating liquidity problems for some NSS customers. The bankruptcy rate for new enterprises is quite high.

In rural areas, non-governmental credit cooperatives have emerged, providing good interest rates to depositors and a reasonably regular source of loans for NSS enterprises. By mid 1996, they had deposits of ¥ 816 billion (US\$98 billion). Urban equivalents, urban credit cooperatives, have also developed in the past few years, providing a non-state bank source of finance for NSS enterprises in the cities. In the last 10 years, the credit cooperatives' deposits have leapt from ¥ 3.2 billion to ¥ 340 billion, or from US\$386 million to US\$41 billion (People's Bank of China, 1996).

- ***Reinvested profits***

Throughout China but especially in dynamic provinces like Jiangsu, Zhejiang, Guangdong and Shandong, successful TVEs and private firms are largely self-financing, reinvesting profits to finance expansion. (See Table 11.7, also Chapter 8 - Regions.)

In addition, workers in NSS enterprises may invest in their own enterprises, or private firm owners may borrow from family or friends.

Taxation

Since the early 1990s, local governments have had the right to collect revenue from local enterprises. However, tax contracting was replaced by more formal uniform enterprise taxation arrangements with the 1994 taxation reforms. (See Chapter 4 - Macroeconomic Management.)

In the past, governments recognised that few firms were profitable shortly after establishment and that many firms, foreign ones in particular, were concerned about the risks of making sizeable long term commitments to China. Hence, tax holidays enhanced China's attractiveness as a manufacturing and production site. This lever was first used to induce FFEs to locate in Shenzhen and the other SEZs when they were first established more than a decade ago, and then extended to the open cities. However, some now argue that such holidays are no longer needed and

should be abolished. Consequently, the central Government is trying to reduce the percentage by which FFEs may have their tax obligations diminished and the length of time for which tax holidays apply. The authority of local governments to extend tax holidays to enterprises was withdrawn in 1993.

Table 11.7

NSS Relies Heavily on Retained Earnings, SOEs on Bank Loans **Sources of Enterprises' Investment Finance**

| | SOEs | Urban collectives | TVEs | JVs | WFOEs |
|--------------------|------|-------------------|------|-----|-------|
| Plan allocation | | | | | |
| 1980-84 | 12 | 0 | 0 | 0 | 0 |
| 1985-89 | 9 | 0 | 0 | 0 | 0 |
| 1990-93 | 12 | 0 | 0 | 0 | 0 |
| Bank loans | | | | | |
| 1980-84 | 82 | 80 | na | 25 | na |
| 1985-89 | 72 | 67 | 81 | 24 | 37 |
| 1990-93 | 76 | 78 | 53 | 47 | 27 |
| Retained earnings | | | | | |
| 1980-84 | 6 | 20 | na | 75 | na |
| 1985-89 | 18 | 33 | 19 | 74 | 63 |
| 1990-93 | 9 | 22 | 47 | 47 | 73 |
| Share/ bond issues | | | | | |
| 1980-84 | 0 | 0 | na | 0 | na |
| 1985-89 | 1 | 0 | 0 | 0 | 0 |
| 1990-93 | 3 | 0 | 0 | 6 | 0 |

Source: Perkins and Raiser (1994, Table 12) from a survey of 300 coastal province enterprises.

Technology

The level of technology used varies greatly by enterprise and industry: FFEs tend to use the most modern technology to maximise production efficiency while SOEs and some urban collectives often rely on out-dated equipment from the 1970s or earlier. Some analysts estimate only one third of SOE and urban collective equipment is technologically advanced; the remaining two thirds is obsolete (Yeh, 1992, p. 523). TVEs are rapidly upgrading their technology, relying heavily on retained earnings (Table 11.7 and 11.8).

Table 11.8

TVEs Upgrade Their Technology The Capital Intensity of TVEs and SOEs

| Year | TVEs capital to labour ratio | SOEs capital to labour ratio |
|---------------------------|------------------------------|------------------------------|
| | Yuan/person | Yuan/person |
| 1985 | 1 362.8 | 10 434.6 |
| 1986 | 1 636.5 | 11 488.7 |
| 1987 | 2 034.2 | 12 830.2 |
| 1988 | 2 522.5 | 14 283.3 |
| 1989 | 3 148.6 | 16 459.6 |
| 1990 | 3 633.6 | 18 529.9 |
| 1991 | 4 110.1 | 21 259.4 |
| 1992 | 5 022.3 | 24 292.6 |
| 1993 | 6 532.9 | 29 571.9 |
| 1994 | 8 808.9 | 35 867.1 |
| 1995 | 11 780.9 | 39 741.0 |
| 1985-95 % p.a. (nominal) | 24.1 | 14.3 |
| 1985-95 % p.a. (deflated) | 12.2 | 2.4 |

Note: Data for TVEs refer to all sectors while data for SOEs refer to the industrial sector only. However, the great majority of TVEs are in the industrial sector.

Source: State Statistical Bureau (1993b, Table 9-57; 1996b, Tables 11-30, 11-31, 11-33, 12-3, 12-17).

For some light industrial products, NSS enterprises, especially FFEs and some TVEs, can produce better quality products, thereby increasing their products' appeal and market share, even if at a higher cost than their SOE competitors.

However, NSS enterprises are often disadvantaged in heavy industrial sectors because the Government continues to subsidise SOEs in key industries, such as petroleum production, power generation, natural gas and iron and steel, through the rollover of low interest loans from the major state banks.

Labour

Governments at all levels have enacted regulations relating to labour hiring and working conditions, several of which can hamper efficient enterprise operation. To mitigate the effects of such governmental regulations, NSS enterprises must prove to the local bureaucracy that these rules hinder growth and thereby their contribution to the local economy. Normally, with local political support, TVEs are better placed to make this case. While many NSS enterprises, especially collectives, are expected to provide some social services to their employees, these are at a much lower scale than those received by SOE employees. (See Chapter 12 - Labour Markets, Figure 12.2.)

Labour is more of an issue for FFEs than for other NSS enterprises. As labour is now allowed to move more freely between employment, the pool of potential candidates is wide and the skill levels diverse. However, retaining skilled labour is difficult as the supply of talented employees is considerably less than demand and consequently, these employees often command high salaries. Job-switching is common in prosperous coastal cities such as Guangzhou and Shanghai while it remains much rarer in the hinterland where the pool of potential employers is smaller.

With the loosening of regulations governing residence and population movement, labour has flowed into the coastal provinces. While many migrant labourers are unskilled, they do find jobs, boosting the economies of both the locations where they work and their home provinces through salary remittances. Labour costs are still below major regional competitors such as Indonesia. (See Chapter 12 - Labour Markets.)

Supply of Inputs

Depending on the industry and type of enterprise, different levels of government can influence the extent of local sourcing and price structure of inputs. Local or provincial authorities sometimes require local private sector firms and FFEs to source a certain percentage of their inputs from specific locations. While these goods may be available in acceptable quality, quantity and prices, this is not always the case and such requirements impose costs on enterprises.

Transport and Power Infrastructure

The transport infrastructure is weak, particularly port development and capacity, and rail and road networks. Power shortages are also an increasing problem. After considerable neglect during the central planning period, China is now devoting considerable effort to rectifying shortcomings in its infrastructure. However, transport infrastructure remains unable to cope with all the demands placed on it. Many manufacturers relate how they have fought for rail space to transport their goods to market. (See Chapter 7 - Infrastructure.)

Marketing

Distribution and marketing strategies present perpetual problems for many companies, but are often more pressing for NSS enterprises than for SOEs. Distribution is still SOE dominated, which creates many problems. Timely and cost-efficient product distribution is often difficult without significant connections, with relevant officials in all locales where goods are transported. Once goods reach their destination, the manufacturer may still have to provide 'inducements' to distributors, wholesalers and sub-distributors, and sometimes even retailers, to persuade them to stock their goods.

An important phenomena affecting inter-provincial marketing is regional protectionism, with the establishment and enforcement of *de facto* provincial barriers, including customs duties, preventing the free flow of goods across provincial borders. On occasions this hindered both the free flow of raw materials to coastal provinces, particularly if prices of these goods were held artificially low by price controls, and the movement of finished goods from the coast into these provinces. In some sectors, such as agricultural products, local governments

dictated that ex-provincial sales could be made only at inflated prices. In the 1990 recession, this protectionism took the form of banning imports from other regions to protect home markets for local producers (Wong, 1991, p. 709; Yeh, 1992, p. 530). Since 1993, the central Government has banned such practices and cases are now less frequent and on a smaller scale. However, instances of local protectionism probably will continue to impact on firms' marketing while coastal-hinterland disparities remain, and the hinterland feels it has not received appropriate levels of budgetary allocation and foreign investment and an equitable arrangement from residual price controls on raw materials and agricultural products.

To generate demand for their goods, manufacturers must plan and execute sophisticated advertising campaigns using television, radio, print media, billboards and in-store promotions. Such campaigns require significant time to prepare and execute. As China prepares to join the WTO, it is gradually unifying its three-tier pricing structure for advertising, but currently domestic enterprises are protected with low advertising rates; FFEs pay a substantial premium; and true imports pay an even higher rate. Some manufacturers still complain that media space is scarce and must be obtained through informal arrangements.

SOEs and NSS enterprises are subject to quite different marketing regulations. While a few SOEs still must satisfy predetermined planned output requirements before they can market goods as they choose, most SOEs, all TVEs and other NSS enterprises are free to market goods as they choose. Until the early 1990s, when most SOEs still had to satisfy some production commitments under the state plan, their output was automatically purchased by the state-owned distribution system. Now that SOEs are not held to state plan output targets, they have to compete for sales in the marketplace with NSS enterprises, such as FFEs and TVEs, generally to the disadvantage of SOEs (Zweig, 1995, p. 258).

The stop-go nature of previous macroeconomic management spurred many NSS enterprises, particularly coastal ones, to rely simultaneously on the domestic market and exports. This enabled enterprises to more easily weather downturns in the domestic economy without any significant long term damage. While such a dual strategy does not enable NSS enterprises to fully avoid the effects of economic downturns, it does enable them to cushion their fall and revive their business more rapidly.

OPPORTUNITIES FOR AUSTRALIAN COMPANIES IN THE NSS

Several major Australian companies have invested significantly in China. (See Chapter 6 - Foreign Investment.) However, these companies mostly follow the pattern of multinational corporations from other Western countries, undertaking joint ventures with SOEs and, in recent years, establishing 100 per cent or 'near WFOEs'.

Unlike overseas Chinese firms, (East Asia Analytical Unit, 1995, Chapters 10 and 11) few Western multinationals establish joint ventures with TVEs, the most

dynamic local part of the NSS, or other NSS entities. The positive aspects of TVE joint ventures include:

- greater commercial focus and flexibility
- independence from various local organisations, such as the Industrial and Pricing Bureaux, which may participate in SOE joint venture hiring and pricing policies
- willingness of local Party officials at village level, who sometimes see themselves as patrons of TVEs, to help a TVE foreign company joint venture with daily problem-solving
- ability to hire labour as needed, without being required to hire unnecessary or unsuitable workers
- in most cases, an absence of financial burdens, such as surplus labour, weak distribution systems, excessive factory space, obsolete equipment, high welfare benefit obligations to current and retired workers.

On the other hand, joint ventures with TVEs have some negative aspects, including:

- location away from major urban areas without amenities most foreign executives require
- less support from senior political leaders in provincial or central governments, possibly leading to problems of resource allocation and utilities supply
- possibility of weaker legal protection for a TVE partner if the political climate of the NSS deteriorates.

However, an increasing number of TVE joint ventures could occur within the next few years for the following reasons :

- Joint ventures with ailing SOEs, even in more dynamic provinces may be too costly as many of the better ones already have links and increasingly, companies may find that those available have poor potential. Such SOE joint ventures may require excessive investment by foreign partners with long pay-back periods.
- Some foreign companies therefore will consider joint ventures with entrepreneurial TVEs and other NSS firms. Such enterprises will be in or near major cities of dynamic provinces, and have good management personnel and capable workforces. The sites will need some amenities to attract expatriate managers from Australia (or elsewhere) to work in them.
- It may be useful for Australian companies to begin training a number of Chinese speaking staff, either ethnic Chinese or not, to explore joint ventures with NSS firms. Such officers would have to be willing to 'rough it' to establish good joint ventures as the great bulk of TVEs are outside urban areas (Zweig, 1995, pp. 268-70; Yan, 1995, p. 11).
- Future joint ventures with TVEs will occur more frequently in Guangdong cities like Panyu and Dongguan, or in prosperous areas of Jiangsu and Zhejiang. Those areas have firms with large workforces, over 1 000 people,

good transport, available raw materials and a production mentality which targets domestic and export markets. In the longer term, joint ventures with private firms could be widely scattered throughout urban areas.

In addition to joint ventures with Chinese TVEs and other NSS firms, Australian companies could consider off-shore alliances with strong overseas Chinese companies.

Appendix 11.1

Appendix Table 11.1

NSS Dominates Light Industry
Sectoral Distribution of Gross Industrial Output
Independent Accounting Units in the NSS, 1995
(¥ '00 million)

| Sector | Total | Total NSS | FDI | Other NSS | State-Owned |
|---|-------|-----------|-------|-----------|-------------|
| Textile industry | 4 604 | 2 779 | 824 | 1 955 | 1 825 |
| Non-Metal mineral products | 3 018 | 2 040 | 353 | 1 688 | 978 |
| Electric equipment and machinery | 2 594 | 2 002 | 631 | 1 371 | 592 |
| Electronic and telecommunications | 2 530 | 1 895 | 1 518 | 377 | 635 |
| Raw chemical materials and chemical products | 3 819 | 1 678 | 503 | 1 175 | 2 141 |
| Transport equipment manufacturing | 3 303 | 1 602 | 813 | 789 | 1 701 |
| Food processing | 3 045 | 1 468 | 623 | 846 | 1 577 |
| Metal products | 1 651 | 1 423 | 439 | 983 | 228 |
| Ordinary machinery manufacturing | 2 366 | 1 418 | 336 | 1 082 | 948 |
| Garments and other fibre products | 1 470 | 1 368 | 737 | 631 | 102 |
| Smelting and pressing of ferrous metals | 3 660 | 1 137 | 230 | 907 | 2 523 |
| Plastic products | 1 128 | 988 | 376 | 612 | 139 |
| Leather, furs, down and related products | 974 | 893 | 523 | 370 | 82 |
| Special purpose equipment manufacturing | 1 757 | 866 | 156 | 710 | 891 |
| Other manufacturing | 700 | 643 | 218 | 425 | 57 |
| Papermaking and paper products | 1 014 | 636 | 173 | 463 | 379 |
| Food manufacturing | 995 | 616 | 301 | 315 | 379 |
| Smelting and pressing of non-ferrous metals | 1 372 | 612 | 173 | 438 | 761 |
| Electric power, steam and hot water production and supply | 2 440 | 545 | 337 | 208 | 1 895 |
| Beverage manufacturing | 1 156 | 540 | 271 | 269 | 615 |
| Chemical fibres | 810 | 529 | 111 | 418 | 281 |
| Medical and pharmaceutical products | 961 | 469 | 188 | 280 | 493 |
| Rubber products | 620 | 372 | 155 | 217 | 248 |

Appendix Table 11.1 (Cont.)

| Sector | Total | Total NSS | FDI | Other NSS | State-Owned |
|--|-------|-----------|-----|-----------|-------------|
| Timber processing, bamboo, cane, palm fibre and straw products | 406 | 334 | 115 | 220 | 71 |
| Stationery, educational and sports goods | 371 | 331 | 186 | 145 | 40 |
| Instruments, meters, cultural and official machinery | 426 | 286 | 169 | 117 | 140 |
| Coal mining and processing | 1 155 | 258 | 3 | 255 | 897 |
| Non-Metal minerals mining and processing | 365 | 249 | 12 | 236 | 116 |
| Printing and record pressing | 412 | 244 | 74 | 170 | 167 |
| Petroleum processing and coking products | 2 028 | 239 | 29 | 210 | 1 789 |
| Furniture manufacturing | 226 | 206 | 68 | 138 | 20 |
| Non-Ferrous metals mining and processing | 322 | 139 | 2 | 137 | 183 |
| Petroleum and natural gas extraction | 1 428 | 65 | 58 | 7 | 1 363 |
| Ferrous metals mining and processing | 112 | 61 | 0 | 61 | 51 |
| Tobacco processing | 1 004 | 32 | 6 | 26 | 972 |
| Tap water production and supply | 182 | 28 | 0 | 27 | 155 |
| Gas production and supply | 76 | 8 | 3 | 5 | 68 |
| Logging and transport of timber and bamboo | 165 | 6 | 0 | 6 | 159 |
| Other minerals, mining and processing | 4 | 2 | 0 | 2 | 1 |

Note: Data on sectoral distribution by ownership form available in State Statistical Bureau (1996a) is only for independent accounting units, which produce about 61 per cent of total industrial output. The share of the SOEs in this data (47 per cent) is considerably higher than their share in total industrial output (33 per cent). Thus this table and Appendix Table 11.2 understate the actual contribution of the NSS, but approximately portrays their sectoral distribution.

Source: State Statistical Bureau (1996a).

Appendix Table 11.2

Relative Sectoral Contribution of NSS (Per Cent of Total Gross Industrial Output)

| Sector | Total NSS | Foreign funded | Other NSS | State- Owned |
|---|--------------|-------------------|--------------|-----------------|
| Garments and other fibre products | 93 | 50 | 43 | 7 |
| Other manufacturing | 92 | 31 | 61 | 8 |
| Leather, furs, down and related products | 92 | 54 | 38 | 8 |
| Furniture manufacturing | 91 | 30 | 61 | 9 |
| Stationery, educational and sports goods | 89 | 50 | 39 | 11 |
| Plastic products | 88 | 33 | 54 | 12 |
| Metal products | 86 | 27 | 60 | 14 |
| Timber processing, bamboo, cane, palm fibre and straw products | 82 | 28 | 54 | 18 |
| Electric equipment and machinery | 77 | 24 | 53 | 23 |
| Electronic and telecommunications | 75 | 60 | 15 | 25 |
| Non-Metal minerals mining and processing | 68 | 3 | 65 | 32 |
| Non-Metal mineral products | 68 | 12 | 56 | 32 |
| Instruments, meters and official machinery | 67 | 40 | 27 | 33 |
| Chemical fibres | 65 | 14 | 52 | 35 |
| Papermaking and paper products | 63 | 17 | 46 | 37 |
| Other minerals, mining and processing | 62 | 1 | 61 | 38 |
| Food manufacturing | 62 | 30 | 32 | 38 |
| Textile industry | 60 | 18 | 42 | 40 |
| Rubber products | 60 | 25 | 35 | 40 |
| Ordinary machinery manufacturing | 60 | 14 | 46 | 40 |
| Printing and record pressing | 59 | 18 | 41 | 41 |
| Ferrous metals mining and processing | 55 | 0 | 55 | 45 |
| Special purpose equipment manufacturing | 49 | 9 | 40 | 51 |
| Medical and pharmaceutical products | 49 | 20 | 29 | 51 |
| Transportation equipment manufacturing | 49 | 25 | 24 | 51 |
| Food processing | 48 | 20 | 28 | 52 |
| Beverage manufacturing | 47 | 23 | 23 | 53 |
| Smelting and pressing of non-ferrous metals | 45 | 13 | 32 | 55 |
| Raw chemical materials and chemical products | 44 | 13 | 31 | 56 |
| Non-Ferrous metals mining and processing | 43 | 1 | 42 | 57 |
| Smelting and pressing of ferrous metals | 31 | 6 | 25 | 69 |
| Electric power, steam and hot water production and supply | 22 | 14 | 9 | 78 |

Appendix Table 11.2 (Cont.)

| Sector | Total NSS | Foreign funded | Other NSS | State- Owned |
|--|--------------|-------------------|--------------|-----------------|
| Coal mining and processing | 22 | 0 | 22 | 78 |
| Tap water production and supply | 15 | 0 | 15 | 85 |
| Petroleum processing and coking products | 12 | 1 | 10 | 88 |
| Gas production and supply | 10 | 3 | 7 | 90 |
| Petroleum and natural gas extraction | 5 | 4 | 1 | 95 |
| Logging and transport of timber and bamboo | 4 | 0 | 4 | 96 |
| Tobacco processing | 3 | 1 | 3 | 97 |

Note: See note for Appendix Table 11.2.

Source: State Statistical Bureau (1996a).

Appendix Table 11.3

NSS Concentrated in Coastal Provinces
Gross Industrial Output Value of Enterprises by Province, 1994
 (¥ '00 million)

| | Year | SOEs | Urban collectives | TVEs | Private | Other (such as FFEs) |
|-----------------------|------|----------|-------------------|----------|----------|----------------------|
| Coastal Region | | | | | | |
| Jiangsu | 1990 | 948.56 | 3 260.43 | 1 131.32 | 107.04 | 104.66 |
| Per cent | | 17 | 59 | 29 | 2 | 2 |
| | 1994 | 1 959.99 | 5 654.41 | 6 078.78 | 476.39 | 1 206.25 |
| Per cent | | 13 | 37 | 40 | 3 | 8 |
| Zhejiang | 1990 | 447.65 | 1 886.29 | 664.10 | 93.80 | 30.53 |
| Per cent | | 14 | 60 | 21 | 3 | 1 |
| | 1994 | 936.01 | 1 395.14 | 4 476.73 | 1 030.01 | 577.84 |
| Per cent | | 11 | 17 | 53 | 12 | 7 |
| Shanghai | 1990 | 1 114.46 | 193.98 | 241.69 | 1.43 | 191.85 |
| Per cent | | 64 | 11 | 14 | 0.1 | 11 |
| | 1994 | 1 802.85 | 960.04 | 1 044.72 | 21.05 | 1 471.27 |
| Per cent | | 34 | 18 | 20 | 1 | 28 |
| Beijing | 1990 | 464.63 | 491.59 | 165.18 | 5.53 | 52.03 |
| Per cent | | 39 | 42 | 14 | 0.5 | 4 |
| | 1994 | 906.57 | 706.07 | 721.84 | 20.07 | 371.03 |
| Per cent | | 33 | 26 | 26 | 1 | 14 |
| Tianjin | 1990 | 404.28 | 700.73 | 199.91 | 3.99 | 36.23 |
| Per cent | | 30 | 52 | 15 | 0.3 | 3 |
| | 1994 | 648.06 | 647.55 | 729.39 | 41.85 | 415.63 |
| Per cent | | 26 | 26 | 29 | 2 | 17 |
| Shandong | 1990 | 911.88 | 710.17 | 756.11 | 158.41 | 14.37 |
| Per cent | | 36 | 28 | 30 | 6 | 0.6 |
| | 1994 | 2 012.72 | 3 107.72 | 5 051.35 | 1 041.81 | 658.26 |
| Hebei | 1990 | 554.96 | 1 065.70 | 375.51 | 114.56 | 9.71 |
| Per cent | | 26 | 50 | 18 | 5 | 5 |
| | 1994 | 1 214.53 | 442.48 | 1 823.11 | 724.20 | 232.85 |
| Per cent | | 27 | 10 | 41 | 16 | 5 |

Appendix Table 11.3 (Cont.)

| | Year | SOEs | Urban collectives | TVEs | Private | Other (such as FFEs) |
|-----------------------|----------|----------|-------------------|----------|---------|----------------------|
| Liaoning | 1990 | 983.92 | 321.45 | 291.68 | 110.44 | 58.84 |
| | Per cent | 56 | 18 | 17 | 6 | 3 |
| | 1994 | 1 966.14 | 980.62 | 1 560.01 | 654.34 | 459.02 |
| | Per cent | 35 | 17 | 28 | 12 | 8 |
| Guangdong | 1990 | 765.43 | 1 228.36 | 432.88 | 91.19 | 385.98 |
| | Per cent | 26 | 42 | 15 | 3 | 13 |
| | 1994 | 1 562.24 | 1 888.02 | 1 679.29 | 524.04 | 2 712.19 |
| | Per cent | 19 | 22 | 20 | 6 | 32 |
| Fujian | 1990 | 239.82 | 386.65 | 147.77 | 32.26 | 92.50 |
| | Per cent | 27 | 43 | 16 | 4 | 10 |
| | 1994 | 792.40 | 833.51 | 695.76 | 452.24 | 147.12 |
| | Per cent | 27 | 29 | 24 | 15 | 5 |
| Guangxi | 1990 | 255.09 | 124.92 | 37.33 | 20.23 | 5.73 |
| | Per cent | 58 | 28 | 8 | 5 | 1 |
| | 1994 | 592.16 | 227.25 | 281.50 | 305.43 | 117.96 |
| | Per cent | 39 | 15 | 18 | 20 | 8 |
| Hainan | 1990 | 33.56 | 7.97 | 3.91 | 2.08 | 5.10 |
| | Per cent | 64 | 15 | 7 | 4 | 10 |
| | 1994 | 82.43 | 29.23 | 3.09 | 16.78 | 43.14 |
| | Per cent | 47 | 17 | 2 | 10 | 25 |
| Central Region | | | | | | |
| Heilongjiang | 1990 | 695.31 | 318.70 | 77.34 | 23.29 | 2.03 |
| | Per cent | 62 | 29 | 7 | 2 | 0.2 |
| | 1994 | 1 256.98 | 142.25 | 304.69 | 111.71 | 130.39 |
| | Per cent | 65 | 7 | 16 | 6 | 7 |
| Jilin | 1990 | 388.67 | 420.50 | 67.03 | 37.52 | 1.73 |
| | Per cent | 42 | 46 | 7 | 4 | 0.2 |
| | 1994 | 798.65 | 104.55 | 256.61 | 122.73 | 103.39 |
| | Per cent | 58 | 8 | 19 | 9 | 7 |
| Anhui | 1990 | 390.42 | 312.35 | 155.26 | 62.58 | 3.18 |
| | Per cent | 42 | 34 | 17 | 7 | 0.3 |
| | 1994 | 422.58 | 594.92 | 1 036.66 | 294.28 | 620.36 |
| | Per cent | 14 | 20 | 35 | 10 | 21 |

Appendix Table 11.3 (Cont.)

| | Year | SOEs | Urban collectives | TVEs | Private | Other (such as FFEs) |
|-----------------------|----------|----------|-------------------|----------|---------|----------------------|
| Shanxi | 1990 | 321.45 | 399.50 | 136.32 | 31.02 | 9.14 |
| | Per cent | 36 | 45 | 15 | 3 | 1 |
| | 1994 | 627.70 | 165.24 | 666.63 | 249.25 | 35.68 |
| | Per cent | 36 | 9 | 38 | 14 | 2 |
| Hunan | 1990 | 455.87 | 417.09 | 137.22 | 48.57 | 3.50 |
| | Per cent | 43 | 39 | 13 | 5 | 0.3 |
| | 1994 | 855.74 | 257.48 | 775.54 | 339.52 | 97.47 |
| | Per cent | 37 | 11 | 33 | 15 | 14 |
| Hubei | 1990 | 627.79 | 707.55 | 192.03 | 43.96 | 7.40 |
| | Per cent | 40 | 45 | 12 | 3 | 0.5 |
| | 1994 | 1 342.44 | 744.04 | 1 019.02 | 382.03 | 217.39 |
| | Per cent | 36 | 20 | 28 | 10 | 6 |
| Henan | 1990 | 572.03 | 395.56 | 295.74 | 102.06 | 4.21 |
| | Per cent | 43 | 27 | 22 | 8 | 0.3 |
| | 1994 | 1 194.87 | 898.16 | 1 166.52 | 583.95 | 223.28 |
| | Per cent | 30 | 22 | 29 | 15 | 6 |
| Jiangxi | 1990 | 277.90 | 313.69 | 90.25 | 29.63 | 2.60 |
| | Per cent | 39 | 44 | 13 | 4 | 0.4 |
| | 1994 | 582.49 | 89.48 | 827.38 | 338.55 | 57.05 |
| | Per cent | 31 | 5 | 44 | 18 | 3 |
| Inner Mongolia | 1990 | 200.57 | 106.71 | 20.95 | 9.24 | 1.84 |
| | Per cent | 59 | 31 | 6 | 3 | 0.5 |
| | 1994 | 418.39 | 54.43 | 118.09 | 56.88 | 40.39 |
| | Per cent | 61 | 8 | 17 | 8 | 6 |
| Western Region | | | | | | |
| Sichuan | 1990 | 778.70 | 613.90 | 236.86 | 87.20 | 10.72 |
| | Per cent | 45 | 36 | 14 | 5 | 1 |
| | 1994 | 1 499.67 | 1 199.14 | 1 276.68 | 786.86 | 348.76 |
| | Per cent | 29 | 23 | 25 | 15 | 7 |
| Shaanxi | 1990 | 304.17 | 301.93 | 85.37 | 31.83 | 3.72 |
| | Per cent | 42 | 42 | 12 | 4 | 0.5 |
| | 1994 | 585.08 | 62.62 | 331.74 | 109.48 | 57.81 |
| | Per cent | 51 | 5 | 29 | 10 | 5 |

Appendix Table 11.3 (Cont.)

| | Year | SOEs | Urban collectives | TVEs | Private | Other (such as FFEs) |
|---------|----------|--------|-------------------|--------|---------|----------------------|
| Qinghai | 1990 | 46.46 | 12.14 | 2.60 | 1.29 | 0.07 |
| | Per cent | 74 | 19 | 4 | 2 | 0.1 |
| | 1994 | 106.39 | 14.15 | 7.20 | 3.97 | 0.63 |
| | Per cent | 80 | 11 | 5 | 3 | 1 |
| Guizhou | 1990 | 168.56 | 72.17 | 21.71 | 14.99 | 4.06 |
| | Per cent | 60 | 26 | 8 | 5 | 1.4 |
| | 1994 | 321.99 | 54.12 | 62.96 | 52.28 | 11.47 |
| | Per cent | 64 | 11 | 13 | 10 | 2 |
| Yunnan | 1990 | 264.87 | 149.03 | 38.63 | 9.41 | 1.93 |
| | Per cent | 57 | 32 | 8 | 2 | 0.4 |
| | 1994 | 696.63 | 136.46 | 140.42 | 40.47 | 22.48 |
| | Per cent | 67 | 13 | 14 | 4 | 2 |

Note: The coastal region consists of Shanghai, Beijing and Tianjin municipalities and Jiangsu, Zhejiang, Fujian, Shandong, Guangdong Hebei, Liaoning, Guangxi and Hainan provinces.

The five dynamic provinces are Jiangsu, Zhejiang, Fujian, Shandong, Guangdong.

The central region consists of Shanxi, Jilin, Inner Mongolia, Heilongjiang, Anhui, Jiangxi Henan, Hubei and Hunan.

The western region consists of Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Tibet and Xinjiang.

Source: State Statistical Bureau (1995a and previous years); State Statistical Bureau (1995b and 1991b).

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LABOUR MARKET REFORM

The low cost of labour has driven China's export-oriented growth. However, this comparative advantage may disappear if labour costs in China increase faster than in competing developing countries at a similar stage of economic development, such as Malaysia, Thailand, the Philippines and Indonesia. The rapid development of labour intensive manufacturing and services sectors in urban areas has created a strong demand for unskilled labour and shortages of some categories of skilled labour.

While labour markets have become much more flexible since 1978, many constraints still remain. While the *hukou*, household registration system, has been considerably relaxed, enabling about 64 million rural workers to find jobs in urban areas by 1994, some elements of it still persist, preventing permanent migration for most rural workers. The numbers of migrants are still rising rapidly with authorities estimating that a 100 million workers had migrated to urban areas by early 1997 (*The Economist*, 8 February, 1997, p. 31). Analysts believe that at least a further 100 million to 130 million surplus rural workers need to move to more productive jobs outside agriculture, many of which will be in urban areas.

Despite the introduction of bonuses and the greater use of contract labour, productivity growth in SOEs is well below that in the non-state sector and analysts believe at least 30 per cent of SOE workers are surplus. Since managers find it difficult to dismiss SOE workers and enterprises operate under soft budget constraints, managers have little incentive to pursue gains in their workers' productivity. (See Chapter 10 – State-Owned Enterprises.) Mobility of SOE workers is still low because enterprises continue to provide many services like housing and health care. Private and public housing, health and social service programs outside the SOEs are inadequate. Nevertheless, many SOEs now need to lay off workers to survive and redundancies are accelerating.

While unskilled labour costs are still low compared to regional competitors in South East and East Asia, they are already rising in some coastal areas, and skilled labour is generally in short supply. To ensure labour costs remain in line with productivity, so Chinese exporters can maintain their competitiveness in labour intensive products, the authorities will need to encourage greater labour mobility between regions and enterprises. This will require further relaxation of the *hukou* system, particularly for skilled but also for unskilled labour, more organised systems to disseminate labour market information throughout the country, continued priority on SOE reforms, and more rapid development of low income housing markets and community based social services.

China will need to develop flexible labour markets to allow its ample labour supply to meet the strong growth in labour demand and underpin rapid economic growth. This chapter investigates the extent to which labour market reform will enable this to occur.

ECONOMIC REFORM AND RURAL LABOUR MARKETS

Economic reform was initiated in rural China in 1978 when the household-based responsibility system was introduced and the former commune system dismantled. This change enabled production and income distribution to be organised within households. Agricultural reforms and the disbanding of rural communes increased incentives for agricultural production and caused a sharp rise in labour productivity. Underemployed agricultural labour was no longer concealed within the commune system and household members had an incentive to seek employment outside the agricultural sector when plots were too small to gainfully employ all members of the family. However, regulations still inhibited the flow of labour from rural to urban areas, so rural areas started their own industrialisation drive.

Consequently, rural industrial enterprises grew extremely rapidly. Thousands of private manufacturing, construction and other non-agricultural enterprises, so-called township and village enterprises (TVEs) were established, first in the south east and coastal areas of China, then all over the country. (See Chapters 11 - Non-State Sector and 9 - Agriculture.)

These enterprises heralded the emergence of a labour market in rural areas. Whereas, in the pre reform period, local authorities controlled where people worked, by 1985 a World Bank survey found that half of the TVE employees hired in that year had found their jobs through market methods, by answering advertisements or through personal contacts, and a further third had jobs because they invested in the firm employing them, while only a sixth had been assigned jobs by local authorities (Gregory and Meng, 1995).

Since then, the rapid growth of TVEs as well as private, joint venture and fully foreign-owned firms, which generally have the right to determine whom they employ, has increased the dominance of market mechanisms in labour allocation (Gregory and Meng, 1995). TVEs have become increasingly flexible in their labour hiring and firing to survive the stronger competition from private and foreign funded enterprises, FFEs. Wage determination within the TVEs accurately reflects labour productivity, indicating that at least in this regard they operate like profit maximising private firms (Gregory and Meng, 1995). This is because TVEs operate in a very competitive market, subject to stringent budget constraints, as their owners cannot usually afford to bail them out if they make losses. Probably as a result of these factors, the output and employment shares of TVEs have grown very strongly over the past 20 years. (See Chapter 11 - Non-State Sector, Tables 11.3 and 11.4.)

Nevertheless, other non-state sector firms are rapidly expanding in rural areas. Since the early 1990s, TVEs have employed only about 50 per cent of the total rural non-farm labour force (Table 12.1) with private firms and self-employment accounting for the other 50 per cent.

Table 12.1

Rapid Growth of Rural Enterprise Employment Composition of Non-Farm Rural Employment

| | Total non-farm rural employment | Composition | |
|------|------------------------------------|-------------|-------------------------|
| | | In TVEs | In other enterprises |
| | '000 | Per cent | Per cent |
| 1978 | 28 266 | 100.0 | 0.0 |
| 1980 | 29 997 | 100.0 | 0.0 |
| 1985 | 69 790 | 62.0 | 38.0 |
| 1990 | 92 648 | 49.6 | 50.4 |
| 1991 | 96 091 | 49.6 | 50.4 |
| 1992 | 105 811 | 48.7 | 51.3 |
| 1993 | 123 453 | 46.7 | 53.3 |
| 1994 | 120 182 | 49.1 | 50.9 |

Source: State Statistical Bureau (1996b, Table 11-29).

URBAN LABOUR MARKET REFORM

Two major weaknesses characterised the pre reform urban labour arrangements in China:

- the life-time employment system encouraged overstaffing, shirking and low productivity; and
- the wage grade system had a relatively small spread between unskilled and unskilled workers' wages and rewarded personal endowments, education and years of experience, rather than actual performance.

Since the beginning of the 1980s, labour market reform has focused on these weaknesses. To reform the life-time employment system, labour contracts have been introduced gradually (Table 12.2).

Table 12.2

Contractual Employment in the State Sector

| | Total state employment | Contractual employment | Contract workers as a proportion of state workers |
|------|-------------------------------|-------------------------------|--|
| | '000 | '000 | Per cent |
| 1985 | 89 900 | 3 320 | 3.7 |
| 1990 | 103 460 | 13 720 | 13.3 |
| 1991 | 106 640 | 15 890 | 14.9 |
| 1992 | 108 890 | 20 580 | 18.9 |
| 1993 | 109 200 | 23 960 | 21.9 |
| 1994 | 112 140 | 28 530 | 25.4 |

Source: State Statistical Bureau (1996b).

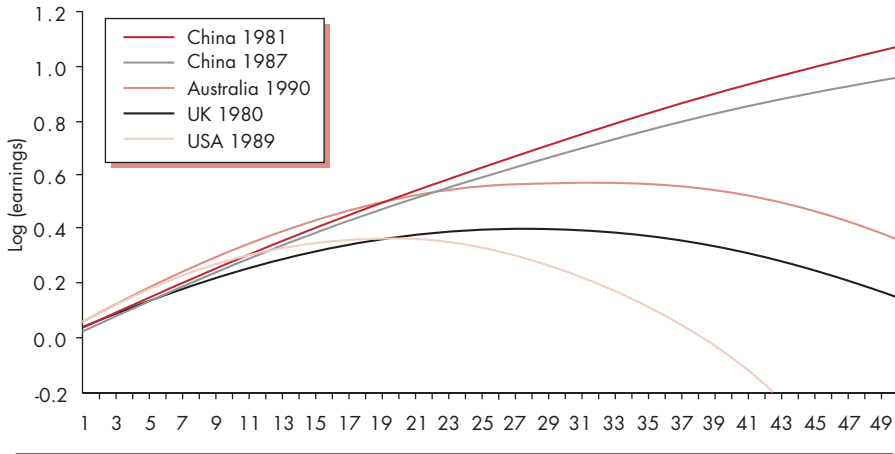
Compared with the rigid pre reform system, the labour contract system is relatively flexible, allowing firms to select and hire particular individuals. Since the late 1980s, firms began to use examinations and interviews to aid the selection and recruitment process (Research Group on Reform in Employment System, 1991). However, the contract system is still considerably less flexible than a free labour market. Although firms have greater control over hiring and firing, they must still obtain government permission before dismissing employees on the grounds of overstaffing (Mai, 1997). However, quitting a job for personal reasons, such as for a better job offer, is becoming increasingly common.

In the 1990s, in addition to the increased proportion of SOE workers on contracts, another 5 per cent of state sector workers are temporary workers. These are mainly rural migrants who perform work that urban residents are not willing to do, such as dirty and heavy labouring jobs, as well as seasonal jobs like fruit canning.

In SOEs, the wage margins for skilled and educated workers (compared with unskilled workers) remain well below the levels in market economies. An extra year of education increases earnings by 2 per cent in China compared with 5 per cent in the USA and 7 per cent in the United Kingdom. The earnings–experience profile, which relates the growth of earnings to years of work experience, is an inverse U-shape in the market economies but a rising straight line in China (Figure 12.1). This suggests that the earnings–experience profile is related to labour productivity in market economies but merely to seniority in China (Meng and Kidd, 1996).

Figure 12.1

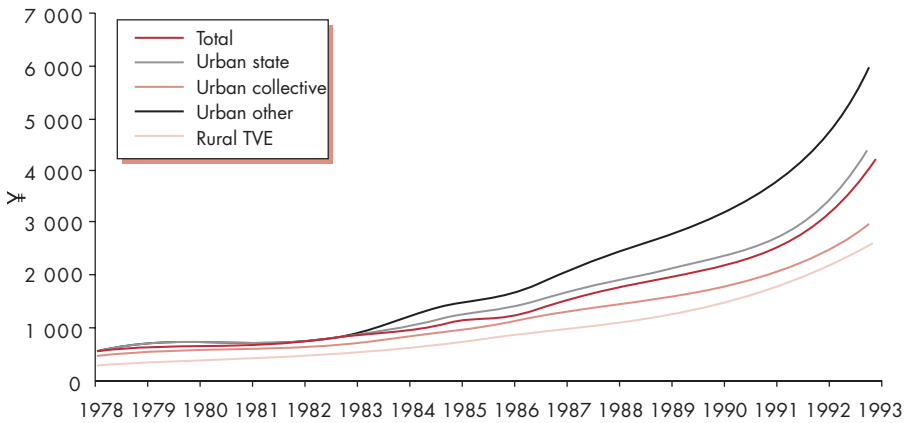
Earnings–Experience Profiles in Selected Countries



Source: The estimates for China and Australia are from Meng and Kidd (1996) and Kidd and Meng (1994); the US estimates are from Borland et al (1995); the UK estimates are from Miller (1987).

Figure 12.2

**Average Annual Money Wages by Sector
(Yuan, at Current Prices)**



Note: ^a Includes urban informal, private, joint venture and fully foreign-owned enterprises.

Source: State Statistical Bureau (1996b).

The wage structure of SOEs changed little in the 1980s, except a profit related bonus system was introduced.

Apart from the direct reform measures in the urban labour market, broader enterprise reforms have greatly affected wage determination and employment in the urban sector. Non-state firms now produce two thirds of output and most (except FFEs) have significantly lower wage structures than SOEs (Figure 12.2).

Firm level survey data from 1985 to 1992 from four coastal cities partially explain SOEs' inflated wages. They show that while private firms (domestic and foreign-owned) act like true profit maximisers, with wages related directly to worker productivity, the state and, to a lesser extent, collective and township and village enterprises act like labour managed entities. They maximise short run wages and bonus benefits by distributing part of their profits to their employees (Meng and Perkins, 1996). SOEs reinvest a very small proportion of their profits, thereby reducing their long run growth potential, while private and TVEs reinvest heavily (Table 11.7). Thus privatisation is likely to be crucial in both reducing labour costs and sustaining economic growth in China.

SOE OVERSTAFFING AND REDUNDANCIES

In the late 1980s, most SOEs introduced a system of 'optimal combination of labour', which determined a firm's labour requirements according to solely technical criteria. The demand for the firm's products and its financial situation were not considered. After this system was introduced, 10 to 30 per cent of all employees in the state sector were considered to be redundant (Asian Development Bank and Ministry of Labour, China, 1994; Knight and Song, 1995).

To help absorb this redundant labour, most large and medium sized SOEs were encouraged to establish so-called labour service companies, because the Government feared that large scale lay offs could cause social and political instability. Some of these enterprises produced a small proportion of the products originally produced by the parent enterprise; others processed by-products of the parent enterprise that were originally given to TVEs to process or worked in service areas, such as restaurants, child care centres, shops and hotels. However, the wage levels for the redundant staff transferred to labour service companies normally are set according to the parent enterprise average wage level, so these redundant workers may still remain a burden to the enterprises (Mai, 1997).

The situation in SOEs has worsened in the 1990s when, due to high inflation and government deficits, neither the central Government nor provincial governments could afford to continue supporting loss-making state enterprises. Consequently, the Government has allowed enterprises to lay off workers, with some firms closing down completely. By mid 1996, 7.5 million SOE workers had been made redundant (State Statistical Bureau, quoted in *Asian Wall Street Journal*, 22 July 1996, p. 3). (See Chapter 10 – State-Owned Enterprises.) Redundant workers receive a very low living allowance from the enterprises. Although the rate varies according to region and firm, it is between ¥ 80 and ¥ 200 (US\$9 and US\$22) per month. The State Labour Bureau now runs a large number of re-employment and re-training bureaux.

Initially, this reform created social and political unease, especially in north east China, where most SOEs are in heavy industries, established in the late 1950s and using out-of-date technology and equipment. In some cities, thousands of redundant workers demonstrated against this reform, even killing a handful of enterprise managers whom they considered directly responsible for the lay offs. The initial anger, however, gradually dissipated.

The workers generally are able to find work in the NSS. Most opportunities exist in the services sector, which rewards entrepreneurial activity with good incomes. In one north eastern city, the Government tried to help workers by setting up a street market and providing them with free access to display stands. A few months later, this street market became the most prosperous in the city (Mai, 1997).

Chinese city streets abound with small restaurants, shops and markets, owned by rural migrants and redundant SOE workers. In Beijing, many taxi drivers are ex-SOE employees. Given that up to 100 million rural migrants have found work in urban China without Government help, it seems likely that redundant workers of the state sector can also be readily reemployed if they wish, especially when most of them still enjoy government housing, food and other welfare subsidies. In cities like Shanghai, NSS firms are required to hire a quota of retrenched SOE workers before employing other workers.

Hong Kong's structural adjustment experience is relevant for China. Hong Kong's rapid and sustainable economic growth is due partly to its extremely flexible labour market and the development of its informal sector. In the past, its garment industry contributed significantly to Hong Kong's growth, but most of Hong Kong's garment industry moved to China when the Special Economic Zones were established in southern China in the 1980s. 'Individuals lost their jobs in garment production, but [as] other jobs were being created rapidly ... the unemployment rate has remained below 3 per cent' (World Bank, 1995).¹

SOCIAL SECURITY SYSTEM REFORM

The importance of reforming the state enterprise based social security system has been recognised since the mid 1980s. As the number of SOEs running at a loss increased in the early 1990s, it has become more urgent to establish an external, government operated social security system. This is needed to reduce the burden on SOEs, provide coverage for employees if their enterprise is closed and increase labour mobility between firms. Many reform measures have been implemented, though the actual instruments vary from region to region.

Pensions, employee housing, medical expenses and schooling are a significant burden on SOEs, reducing profits. (See Chapter 10 – State-Owned Enterprises.) For example, in 1993, the number of retirees from the state sector was almost 20 per cent of its total workforce. In some long established SOEs, the ratio of retirees to total workforce is 1:1 (World Bank, 1996). In case studies undertaken

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¹ While there appears to be little analysis of where the new jobs in Hong Kong were generated, the services sector has obviously absorbed many displaced workers.

for this report, the average yearly wage of one SOE was about ¥ 8 000 and the average annual welfare expenditure per person was ¥ 12 000 (Mai, 1997).

While in theory firms now can hire and fire workers, and workers can find jobs by themselves, in reality, the internal social security system seriously impedes this change. Enterprise managers and their governing authorities are loathe to dismiss workers because there is no external social security system, even though dismissals may be desperately needed to maintain the enterprise's viability. Similarly, employees are reluctant to risk employment outside the state sector for fear of losing their housing, medical benefits and pensions.

Unemployment Benefits

The unemployment benefit system was initiated in 1986 in a few large cities, such as Beijing and Shanghai. It now covers most urban areas. Generally speaking, eligibility for unemployment benefits is restricted to state sector employees who are dismissed because of the merger and bankruptcy of their enterprise, or who are identified by SOEs as redundant (State Council of China, 1994). Eligibility criteria, however, vary from region to region. For example, in Shanghai, both redundant state sector and other sector employees can obtain unemployment benefits (Asian Development Bank and Ministry of Labour, China, 1994).

Workers with fewer than five years' tenure can receive unemployment benefits for 12 months, while those with more than five years' tenure receive benefits for a maximum of 24 months. In the first 12 months, the monthly unemployment benefit is 60 per cent of the monthly basic wage; for the second 12 months, the benefit is 50 per cent of the monthly basic wage. The level of unemployment benefit is set so that it is less than the minimum wage and about 20 to 50 per cent higher than the poverty level (State Council of China, 1994). The basic wage now accounts for only about half of a state sector employee's total monetary income; the remaining half comes from bonuses and other benefits (State Statistical Bureau, 1996a). Therefore 60 per cent of the basic wage is only 30 per cent of an employee's total normal income (about ¥ 200 or approximately US\$22 per month in 1996).

Enterprises fund unemployment benefits. Each enterprise must pay 0.6 to 1.0 per cent of its total wage bill to the local labour bureau which, in turn, deposits the funds in an unemployment benefit account at China's Industrial and Commercial Bank.

The number of people reported to obtain unemployment benefits is very low, although the rate of increase has been rapid since 1990 (Table 12.3). Numbers may be low because most redundant state sector workers are still considered employees of the enterprises and therefore not entitled to unemployment benefits.

Table 12.3

Number of Unemployment Benefit Recipients

| | Number of recipients | Increase from previous year | Proportion of total SOE employment |
|---------|-----------------------------|------------------------------------|---|
| | | Per cent | Per cent |
| 1987-90 | 200 000 | | |
| 1991 | 105 000 | 110.0 | 0.10 |
| 1992 | 345 000 | 228.6 | 0.32 |
| 1993 | 1 030 000 | 198.6 | 0.94 |
| 1994 | 1 870 000 | 81.6 | 1.72 |

Source: State Statistical Bureau (1996a).

Housing

Most, but not all, state sector employees rent housing from their work units. In the past, housing was highly subsidised, so demand always exceeded supply by a wide margin, particularly in big cities such as Shanghai. Therefore, workers with subsidised housing had a strong disincentive to change jobs and forfeit their housing. Thus subsidised housing constrained labour mobility.

Housing reform started in the mid 1980s in an attempt to ease the demand pressure. Gradual increases in rental levels and wages marked a shift from implicit to explicit subsidies. However, this reform is incomplete and rents on employer provided housing remain well below market levels.

Only in the early 1990s, were employees encouraged to buy the apartments they rented. The rules for sales and selling prices vary significantly across firms and regions but, in general, selling prices are considerably below market prices, usually less than a tenth of prevailing market prices. Employees wanting to change jobs within five years of buying an apartment must sell it back to the enterprise at the purchase price, but after five years can keep their apartments or sell them on the open market. Because of this provision, home ownership has not yet increased labour mobility significantly but will eventually do so as the two-tier housing market disappears.

Medical Care

Under the pre reform medical care system, medical resources were seriously wasted, raising the cost of medical care. As either the state or individual enterprises paid for state employee medical expenses, the system encouraged overuse.

To overcome this, most enterprises adopted a system of sharing medical expenses with their employees. As in the case of housing reforms, an equivalent monetary subsidy was paid to state employees to compensate for withdrawing free medical care. The change from an implicit to an explicit subsidy should lead employees to

incur only necessary medical expenses because the money saved will contribute to their personal disposable income.

While this reform measure may discourage some unnecessary use of medical facilities, social welfare remains a financial burden to firms and restrains labour mobility. To solve this problem, a social medical insurance system was recently introduced in many large cities. At this stage, it covers only the costs associated with serious illness. Basically, firms pay a premium that is equivalent to a certain percentage (varying from region to region) of their total wage bill and, in some areas, employees also contribute a percentage of their wages. The resultant fund then covers employees or their families if they have a serious illness.

Municipal-based medical insurance should enhance labour mobility by reducing employers' reluctance to lay off workers and employees' anxiety about dealing with serious illness when working in the non-state sector. However, both the range and adequacy of the medical insurance provided and the number of regions introducing it are still very limited.

Superannuation

As the proportion of retirees in the population accelerates, the burden of pension payments on many old SOEs increases. The proportion of retirees in total state employment went from 3 to 20 per cent from 1978 to 1994. This adversely affected enterprise profitability, as most schemes were non-contributory and benefits were paid from current revenue. Enterprise based superannuation schemes also sharply reduce labour mobility.

Over the next 15 to 20 years, superannuation reform aims to make retirees the responsibility of society rather than individual firms. Pooled social superannuation funds, with both enterprise and employee contributions, were established in some cities during the early 1990s. In Beijing, firm contributions are set at 19 per cent of the average monthly wage bill and employee contributions at 5 per cent of the average monthly wage. Each individual has a social security account number, into which their own contributions are deposited. Firms' contributions are deposited in an individual's account only when a firm reaches government determined preconditions of economic performance; otherwise, the firm's contributions remain in a general fund (Beijing Bureau of Labour, 1996). The enterprise and employee contributions are different in other cities. For example, in Shanghai, firms contribute 25 per cent of the average monthly wage bill and employees contribute 3 per cent of the average monthly wage (Economic Commission of Shanghai et al, 1994). All types of enterprises participate in the Shanghai scheme. However, there are no provincial schemes and a national scheme, if one ever develops, could take decades. So although new schemes are definitely better than enterprise based pension schemes, they will still restrain labour mobility within China unless the different funds establish portability arrangements. Furthermore, existing retirees are not covered by this superannuation system, so if firms declare bankruptcy the Government has to make ad hoc arrangements for these retirees.

Is Social Security Reform Heading in the Right Direction?

China's social security reform has just begun and is not yet fully operational or effective. Although social security reform may eventually reduce the financial pressure on SOEs, enterprises still are paying for most of the new social security schemes. Firms now must pay unemployment benefits, medical care insurance and superannuation contributions, in addition to the existing subsidies to employees. During the transition period, this may be unavoidable, but in the longer term, other sources for financing the social welfare system must be considered.

The broader question is what kind of social welfare system does China need. The two extreme options are that society tries to look after everyone or people look after themselves. To have a comprehensive welfare system, a nation must be relatively wealthy and have an efficient taxation system. However, China currently has a ¥ 575 billion budget deficit, up to 50 per cent of SOEs make losses, and per capita GDP is approximately ¥ 3 748 (US\$450) at the official exchange rate, or US\$2 000 on the basis of purchasing power parity. Given this situation, it is difficult to imagine that the Government will be able to finance a universal social welfare system.

The dilemma, however, is that most urban residents, at least theoretically, receive comprehensive social security cover and expect this to continue. In time, people may adjust to changing circumstances but if reforms rapidly remove all social security nets, social and political unrest may occur. Hence, instead of abolishing the existing welfare system, the reforms aim to restructure this system, reducing enterprise responsibility. However, this will not solve the problem of who ultimately should pay for the welfare system.

If individuals were made increasingly responsible for their own welfare, they could pay a higher proportion of employee contributions into pooled provincial or national schemes, or through personal provisions. This approach would be feasible given the anticipated increase in real incomes. Vigorous East Asian economies such as Hong Kong and Singapore have successfully adopted such a system, enabling them to keep taxes low and provide incentives for enterprises and individuals. In this regard, establishing a competitive private insurance market is important. Based on the experience of mature market economies, China should aim for a fully paid in pension system as in Singapore and Japan, rather than one paid for out of recurrent government expenditure, as Australia had until it recently moved towards a national superannuation scheme.

RURAL–URBAN MIGRATION

Economic reform released millions of rural labourers from agricultural production. They were originally absorbed solely by TVEs due to migration restrictions. Later, despite discouragement from the Government, more rural residents moved to cities to work. By 1988, about 25 million migrants worked in the urban areas, but by 1994, the number had increased dramatically to 64 million, or about one seventh of the total rural labour force (Centre for Rural Economic Research, 1996) and by 1996, authorities believed the figure was 100 million (*The Economist*, 8 February, 1997, p. 31).

Migrants tend to move to either the coastal special economic zones or other cities. In the special economic zones, migrants usually work in export-oriented labour intensive manufacturing industries which dominate such economies. A high proportion of migrants in other cities work in urban services, construction and small family-owned businesses.

The major factor attracting such vast numbers of rural workers to urban areas is higher wages. The average difference is difficult to measure as rural incomes normally include payment for labour and returns to any land or other capital controlled by rural workers. However in 1993, the average annual wage in TVEs, in 1978 prices, was about 60 per cent of the wage in the urban private sector and the nominal wage was about 50 per cent (Table 12.4).² This provided a significant wage incentive for rural workers to move to urban areas. Interestingly, despite the massive migration that has occurred, this wage difference has changed very little since 1985.

Table 12.4

Average Annual Wages in TVEs and the Urban Private Sector

| | TVEs | | Urban private sector | | Ratio of urban to TVE wages |
|------|---------|-------------------|----------------------|-------------------|-----------------------------|
| | Nominal | Real ^a | Nominal | Real ^b | |
| | Yuan | Yuan | Yuan | Yuan | |
| 1985 | 696.5 | 564.9 | 1 340.9 | 990.3 | 1.75 |
| 1990 | 1 321.3 | 668.7 | 2 804.9 | 1 258.9 | 1.88 |
| 1991 | 1 482.1 | 735.2 | 3 259.3 | 1 400.0 | 1.90 |
| 1992 | 1 858.9 | 887.7 | 3 744.7 | 1 493.7 | 1.68 |
| 1993 | 2 295.4 | 973.4 | 4 731.3 | 1 652.6 | 1.70 |

Note: ^a Nominal wages deflated by the rural retail consumer price index; base 1978 = 100.

^b Nominal wages deflated by urban retail consumer price index, base 1978 = 100.

Source: State Statistical Bureau (1996b and previous years).

Impact on Labour Costs

Without migration, urban labour costs presumably would have increased even faster, and future rural–urban migration should continue to restrain urban labour cost increases. One way to judge the impact of migration on urban labour costs is to compare the wages of rural migrants and other urban residents. A survey of migrants from Sichuan and Anhui provinces suggests that rural migrants in urban areas earn significantly less than their urban counterparts (Table 12.5). In 1995, the average hourly earnings for migrants from Sichuan and Anhui were approximately three quarters of the national average of urban employee earnings,

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² The reason for choosing the urban private sector instead of the state sector for this comparison is that money wages in SOEs are not an accurate measure of labour costs because of the many implicit subsidies in the state sector wage package.

while their disposable earnings were just over half of average urban employee earnings, which included subsidised housing and other benefits (Centre for Rural Economic Research, 1996).

Table 12.5

Average Incomes of Urban Employees and Migrants in 1995 (Yuan)

| | Annually | Monthly | Hourly |
|---|----------|---------|--------|
| Average wage for migrants from Sichuan | 3 249.0 | 400.3 | 1.64 |
| Average wage for migrants from Anhui | 2 725.1 | 420.5 | 1.72 |
| National average wage of urban employees | 4 538.0 | 378.2 | 2.23 |
| National average disposable income of urban employees | 6 110.4 | 509.2 | 3.01 |

Note: Migrants from Anhui earn less annually but more monthly and hourly than do Sichuan's migrants because migrants from Sichuan work more over the year.

Source: Centre for Rural Economic Research (1996).

Wage differences among migrants to different regions are also significant. The results of 1995 surveys of immigrants in Dongguan city, Guangdong province, a developed and marketised region, and Jinan city, Shandong province, a less developed region, suggest that Jinan immigrants earned only 65 per cent the average wage of immigrants in Dongguan. In Dongguan, skills are rewarded at double or triple the rate in Jinan, accounting for more than 60 per cent of the total wage differential between the two labour markets (Meng, 1996). This suggests that the demand for skilled labour is higher in the more developed Dongguan than in Jinan.

The reason labour shortages persist and wages are higher in some regions when rural migrants can choose their urban destinations, appears to be an inefficient flow of information about employment. Most migrants' job offers are through informal channels, such as personal contacts (Table 12.6). The accidental nature of this information flow results in a less than optimal allocation of labour across regions, and implies that potential employers in higher cost provinces could benefit from direct recruitment campaigns in regions supplying immigrants.

The policy implication is that because of China's size and uneven economic development, much better employment information channels are needed. As relevant information about urban employment opportunities is disseminated more efficiently, more skilled rural labour will migrate to better developed regions, thereby reducing large regional wage differences and constraints on growth in these faster developing regions due to excessive wage growth.

Table 12.6

The Sources of Employment Information for Migrants (Per Cent)

| | Jinan | Dongguan |
|-----------------------|-------|----------|
| Relatives and friends | 76.0 | 73.0 |
| Own effort | 13.0 | 16.1 |
| Replacing relatives | 0.3 | 1.1 |
| Government | 8.7 | 4.9 |
| Others | 2.5 | 4.9 |

Source: Meng, 1996.

Although thousands of government and private job centres exist, government agencies are not as efficient as personal contacts in obtaining specific employment information. Chinese rural–urban migrants appear to be relatively averse to risk because of the operations of unscrupulous private employment agencies that have exploited the weak legal system. Migrants commonly are paid less than agreed wages, do not get paid at all, or have their payments delayed. Specific job information from personal contacts not only ensures a job opportunity exists, but also assures migrants of the trustworthiness of their prospective employers. Therefore, an efficient market for employment information will require a stronger legal system capable of enforcing the labour laws. This may reduce migrants' fears of being cheated, increasing their use of formal information channels.

Contribution of Migration to Rural Development

Rural–urban migration not only functions as a brake on urban labour costs, but also contributes to rural development. Migrants send remittances to their home towns and when they return, invest capital and introduce new ideas. Survey data indicate that immigrants in Jinan and Dongguan remit about 30 per cent of their incomes to their rural home towns (Table 12.7).

Furthermore, surveyed rural households in Sichuan and Anhui with family members who have migrated to urban areas had average per capita incomes approximately 50 per cent higher than those without access to migrant remittances (Table 12.8).

Apart from remittances, migration by family members increases per capita incomes by easing pressure on small family farm holdings, thereby increasing the per capita agricultural income of remaining household members. In addition, migrants may bring home new ideas about other ways to generate income, together with earnings and human capital acquired in the city.

Table 12.7

Jinan and Dongguan Immigrants' Remittances in 1994

| | Unit | Jinan | | | Dongguan | | |
|----------------------|----------|-------|-------|---------|----------|--------|---------|
| | | Total | Males | Females | Total | Males | Females |
| Annual income | Yuan | 6 235 | 6 684 | 5 123 | 9 511 | 11 167 | 7 251 |
| Annual remittance | Yuan | 1 744 | 2 082 | 900 | 3 178 | 3 608 | 2 526 |
| Proportion of income | Per cent | 28.0 | 31.1 | 17.6 | 33.4 | 32.3 | 34.8 |

Source: Meng, 1996.

Table 12.8

Income Differentials between Households with and without Migrants in 1995

| | Household income | | | Per person net income | | |
|---------|----------------------|-------------------------|------------------------------|-----------------------|-------------------------|------------------------------|
| | With migrants (Yuan) | Without migrants (Yuan) | Additional income (Per cent) | With migrants (Yuan) | Without migrants (Yuan) | Additional income (Per cent) |
| Sichuan | 9 409 | 6 468 | 45.4 | 1 638 | 1 042 | 57.3 |
| Anhui | 8 966 | 7 083 | 26.6 | 1 543 | 1 030 | 49.8 |

Source: Centre for Rural Economic Research (1996).

Two-Tier Urban Labour Market

Although no government regulation prevents rural residents moving to cities, the household registration system still operates. Rural residents who move to the cities can only take up jobs in the private sector, become self-employed or obtain temporary jobs in SOEs. Typically they take low status jobs that urban residents are unwilling to do. They are not entitled to subsidised housing, medical care or other welfare benefits. Furthermore, their children cannot attend government schools in urban areas, unless they pay private fees.

Without legal status, migrants working in cities also face uncertainty resulting from political or policy shifts. For example, in the late 1980s, migrants to Beijing from Zhejiang province set up a shanty town, called Zhejiang Village, with a population of 70 000 to 80 000 people. Most migrants worked in family clothing businesses. The total value of Zhejiang Village products sold to Beijing's clothing market was estimated at ¥ 1.5 billion in 1995. The migrants organised social and other services within the village, including restaurants, markets, pharmacies, child-care centres and medical clinics. However, over the period 1986–90, the Beijing Municipal Government discouraged these migrants, trying to force them to leave. Later, as the importance of Zhejiang Village to Beijing's clothing market

was recognised, the Beijing Government encouraged its development. This was reversed in 1995 when the Government decided to dismantle Zhejiang Village, destroying some buildings (Wang, 1996; Xiang, 1996).

As a result of such policies, migrants tend to stay in cities only briefly, typically from two to three years. The turnover rate in some migrant dominated, labour intensive industries is very high. This, in turn, limits the accumulation of skills and experience causing shortages of skilled labour in some special economic zones. To help overcome the problem, Shenzhen is introducing so-called 'blue card' and points systems, which are designed to eventually provide skilled immigrants with permanent residency. Under this system, new immigrants can obtain a blue card for temporary residency. Those with temporary residency who work in Shenzhen for more than two years can apply for permanent residency based on points awarded according to an individual's age, education and occupation, among other things. The Government sets a certain quota each year for those allowed to change from temporary to permanent residency; those with the highest points obtain full residency (Wang and Wang, 1995; Li, 1995).

Other parts of Guangdong also are considering responding to skilled labour shortages by easing residency restrictions on skilled migrant workers, who represent an increasing proportion of the workforce.

EMPLOYMENT AND UNEMPLOYMENT

In the pre reform period, because rural and urban economies were separate, employment was an issue for only urban residents. All rural labour was 'employed' in the commune system. In reality, rural and urban under employment has been a serious problem since 1949.

The rapid rise in TVE employment and large scale rural–urban migration reduced agriculture's share of rural employment and in 1992, for the first time in recent history, the actual number of workers engaged in agriculture fell (Table 12.9). However, up to 130 million surplus labourers exist in the agricultural sector (Ministry of Labour, China, 1996).

In the urban sector, one important development is the change in ownership structure of employers. Since 1978, the share of state and collective urban employment has declined by 14 per cent, while the share of the 'other' sectors (private including self-employment) increased by the same amount (Table 12.10). The particularly rapid development of urban private employment in the 1990s indicates that the non-state sector should eventually dominate urban employment.

Table 12.9

Structural Change of Rural Employment

| | Total rural labour force | Agricultural employment | TVE employment | TVE employment as a proportion of total rural labour force |
|------|--------------------------|-------------------------|----------------|--|
| | '000 | '000 | '000 | Per cent |
| 1978 | 306 380 | 284 556 | 28 266 | 9.2 |
| 1980 | 318 359 | 298 084 | 29 997 | 9.4 |
| 1985 | 370 651 | 303 515 | 69 790 | 18.8 |
| 1990 | 420 095 | 333 364 | 92 648 | 22.1 |
| 1991 | 430 925 | 341 863 | 96 091 | 22.3 |
| 1992 | 438 016 | 340 370 | 105 811 | 24.2 |
| 1993 | 442 557 | 332 582 | 123 453 | 27.9 |
| 1994 | 446 541 | 326 903 | 120 182 | 26.9 |

Note: Agricultural employment includes TVE employment in the agricultural sector.

Source: State Statistical Bureau (1996b, Tables 11-2 and 11-29).

Table 12.10

Structural Change of Urban Employment

| | Total employment | As a proportion of total employment | | |
|------|------------------|-------------------------------------|-----------------------|------------------|
| | | State employment | Collective employment | Other employment |
| | '000 | Per cent | Per cent | Per cent |
| 1978 | 95 140 | 78.3 | 21.5 | 0.2 |
| 1980 | 105 250 | 76.2 | 23.0 | 0.8 |
| 1985 | 128 080 | 70.2 | 26.0 | 3.9 |
| 1990 | 147 300 | 70.2 | 24.1 | 5.7 |
| 1991 | 152 680 | 69.8 | 23.8 | 6.4 |
| 1992 | 156 300 | 69.7 | 23.2 | 7.2 |
| 1993 | 159 640 | 68.4 | 21.3 | 10.3 |
| 1994 | 168 160 | 66.7 | 19.5 | 13.8 |

Source: State Statistical Bureau (1996b, Table 4-2).

Unemployment in urban China has not been a serious problem to date. Prior to 1994, official unemployment rates never exceeded 3 per cent (State Statistical Bureau, 1996a). However, reports on overstaffing in the state sector vary from 9 to 30 per cent of total state employment, with the most conservative figures suggesting 10 million surplus workers in the state sector, and other estimates at 30 million. (See Chapter 10 – State-Owned Enterprises.) Current urban unemployment is approximately 7 to 8 per cent (*People's Daily*, 7 March 1996, quoting Dai Xianglong, Governor of PBOC).

According to recent Ministry of Labour employment forecasts for the period 1995–2000, in the urban sector 54 million workers will look for new jobs, including 18 million school leavers, 17 million new rural migrants who will obtain urban residency rights, 5 million who are currently unemployed, and 14 million who are redundant from SOEs. The Ministry also forecasts that over this period, the net additional demand for labour in the urban labour market will be 36 million, of which 14 million will be to replace retirees and 22 million will be to increase production. The remaining 18 million of the new job seekers could potentially add to unemployment. According to these forecasts, by 2000 the urban unemployment rate will be 7.4 per cent and surplus rural labour will total 137 million. However, such forecasts depend crucially on assumptions about the economic growth rate.

From 1990 to 1994, urban employment increased by 21 million at an average annual rate of 3.4 per cent. During the same period, the average annual GDP growth rate was 12 per cent (State Statistical Bureau, 1996a). According to these statistics, the 1995 to 2000 demand growth predictions appear reasonable so long as China sustains its recent economic growth rates. However, the Ministry of Labour forecast does not take into account the potentially rapid growth in employment in the informal sector and increased rural–urban migration. Interviews with the Ministry of Labour indicated that the Government will attempt to 'strictly constrain the scale of rural–urban migration' during the period 1996–2000, so as to reduce the possible urban unemployment rate. However, it remains to be seen if it can do this.

LABOUR COST COMPARISONS

Given that China's international comparative advantage primarily lies in its low labour costs relative to the efficiency of its workers, it is essential that increases in labour costs reflect labour productivity growth.

Labour Cost Changes in the Reform Period

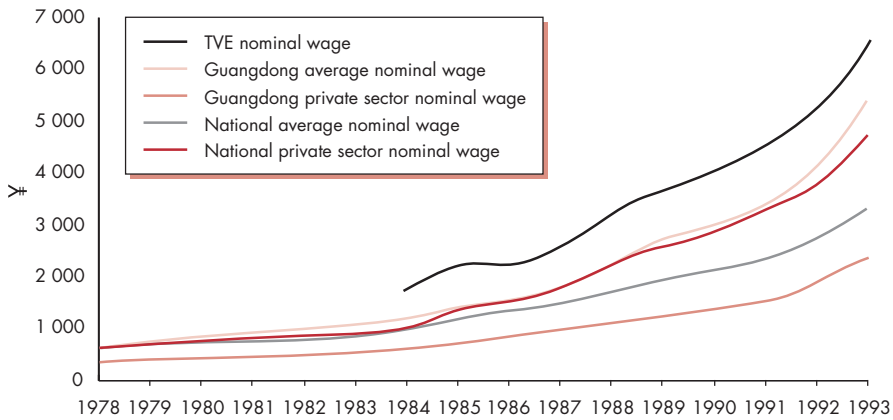
Although annual money wages for all enterprise types have risen rapidly since reforms began, the rate of increase is slower for TVE labour, 15 per cent per year, than for urban 'other' labour, 20 per cent per year (Figure 12.2). As the money wage component is only part of the cost of labour in the urban state sector and possibly the collective sector, money wages in the 'other' urban sector may reflect better true urban labour costs.

Regional Wage Differentials

While the crucial problem of labour immobility has gradually been acknowledged and tackled over the reform period, major regional and sectoral wage differences still exist (Figure 12.3). In 1994, the highest province's wage level was more than twice the lowest wage level among the 30 provinces and cities. This difference has increased considerably over the past few years. (See Chapter 8 - Regions.)

Figure 12.3

Average Annual Money Wages by Sector and Region (Yuan, at Current Prices)



Source: State Statistical Bureau (1996b).

As discussed previously, the wage difference between immigrants and other urban employees is also considerable (Table 12.5).

International Labour Cost Comparisons

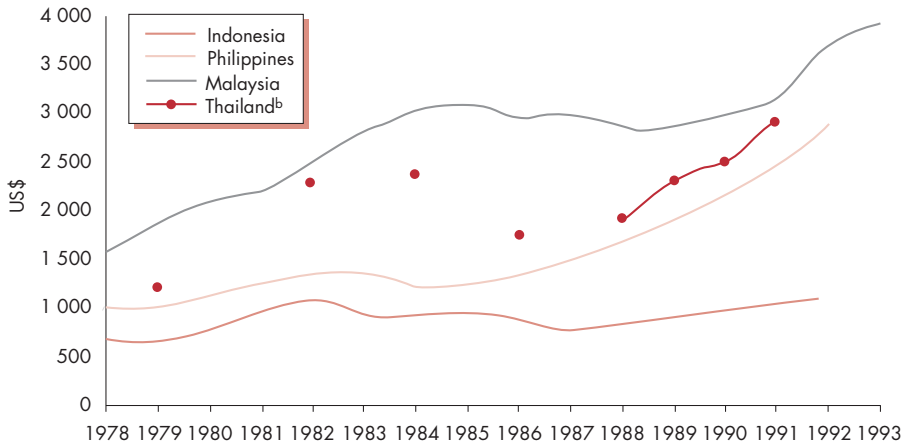
China's rapid economic growth in recent years is based largely on the growth of exports. The ratio of exports to gross domestic product increased from 5 per cent in 1978 to 23 per cent in 1994. Labour-intensive, manufactured exports constitute nine of China's top ten exports. (See Chapter 5 - International Trade.)

China is the most populous country in the world; therefore, its open door policy has greatly affected the world market for labour intensive products. The competitors in this market are basically Malaysia, Thailand, the Philippines and Indonesia, but increasingly India, Vietnam and other newly emerging economies. If China is to sustain its export growth and therefore its overall economic growth, its labour costs must remain competitive.

While directly comparable wage data are not available for all countries, UNIDO data on Malaysia, Thailand, the Philippines and Indonesia indicate that Indonesia has the lowest average annual manufacturing wage (Figure 12.4).

Figure 12.4

Annual Average Manufacturing Labour Costs^a in Selected Countries



Note: ^a The labour cost is the annual average manufacturing wage in US dollars.

^b The data for Thailand are discontinuous.

Source: UNIDO (various years).

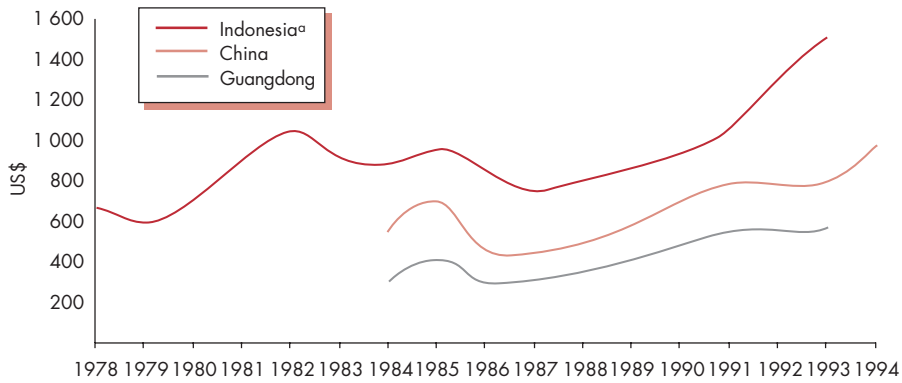
Approximately comparable wage data are available for Indonesia and China (Figure 12.5).³ Although China's urban private sector labour costs have increased rapidly, in 1993 these wages were still only about 38 per cent of those in Indonesia's manufacturing sector. Even in the highest wage region, Guangdong, the private sector's annual average wage was only about 52 per cent of Indonesia's manufacturing wage.

From this perspective, China still has a very strong advantage over its competitors in the labour intensive product market. Further labour market reform may strengthen China's comparative advantage by allowing the freer movement of labour and thus restraining future labour cost increases to equal productivity growth.

³ The data for Indonesia are from large and medium sized establishments in the manufacturing sector; whereas, the data for China (both national and Guangdong) are from the urban private sector. The data for China's private manufacturing sector were not used because limited information was available. However, recent differences between wages in the national urban private sector and those in the national private manufacturing sector have been trivial (State Statistical Bureau, 1996b).

Figure 12.5

Annual Average Wages in Indonesia and China



Note: ^a Annual average wage for the total manufacturing sector.

^b Annual average wage for private, joint venture and foreign-owned enterprises in the urban private sector (which provides a more accurate measure of the market wage rate than the state sector), converted to US dollars using the swap market exchange rate (Zhang, 1993).

Source: Indonesian Central Bureau of Statistics (various years); State Statistical Bureau (1996b).

FUTURE REFORM PRIORITIES

Urban labour market reform in China has not resulted from any ‘big bang’; rather it has been gradual. With a large percentage of the urban workforce still employed in SOEs and no national social security system, sudden, universally enforced labour reform in the SOE sector has been avoided because it might increase urban unemployment, social unrest and political tension. Unless a fiscal crisis forces the pace of SOE rationalisation, labour market reform in the state sector probably will continue to be slow until the central and provincial governments can afford a more comprehensive social security system. (See Chapter 10 – State-Owned Enterprises.) Nevertheless, continuing progress on pensions, housing and medical care provisions will increase the attractiveness of non-state sector employment and encourage greater mobility by SOE employees, enabling these enterprises to shed more surplus labour.

Beyond the SOEs, the dissolution of the agricultural communes, growth of TVEs, relaxation of controls on internal labour mobility and growth of the urban non-state sector have all dramatically changed China’s rural and urban labour markets. These massive and dynamic forces will continue to shape labour market developments in the coming decades. An expanding economy, aided by increasing reforms in other areas, including trade and distribution deregulation, will encourage the private sector to encroach on markets that were previously the domain of SOEs. This will have an impact on SOE employment, by crowding out SOE activity in an increasingly competitive and profit-driven marketplace. As a consequence, the private sector will expand, increasing its demand for labour. It

will draw on the unskilled rural labour pool, but will also seek skilled SOE employees by offering higher wages and benefits. Eventually, the private and collective sectors are likely to replace SOEs as the dominant urban employer.

In summary, further market-oriented labour market reforms will need to match the immense growth in labour supply with the hopefully equal growth in labour demand. Government reforms need to give priority to:

- encouraging labour mobility between regions and firms
- relaxing residency controls
- encouraging individuals to be self-reliant in seeking employment
- enabling individuals to meet their own welfare needs through contributing to public or private sector schemes
- providing a sound legal framework for labour contracts.

Such an approach will ensure that labour costs remain in line with productivity levels, thereby sustaining economic growth and ensuring that China is capable of creating the productive employment opportunities its huge and rapidly growing workforce needs.

This approach to labour market reform will also ensure that for several decades China remains a cost effective location for labour intensive production by local and foreign firms.

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IMPLICATIONS FOR AUSTRALIA

This chapter concludes by drawing implications for Australian business and governments from the rapid transformation occurring in China. These suggestions are designed to assist Australian business to participate more effectively in the significant trade and investment opportunities emerging in China.

The economic output and domestic purchasing power of China's economy is already second only to the USA's. While this measure does not reflect China's capacity to purchase goods in the international economy, it does indicate the total size of the domestic economy, and the capacity of the Chinese population to consume locally manufactured goods. With continued political stability and economic reform, China is expected to maintain its rapid growth over the next one to two decades, becoming the world's largest economy in purchasing power parity terms in approximately the second decade next century.¹ Nevertheless, per capita income levels will remain low for many decades. The Chinese leadership is expected to maintain its commitment to political stability and economic pragmatism, reform and growth, irrespective of any personnel changes which may occur in the post-Deng period.

Due to the economic complementarities of the two economies, Australia-China trade should continue to grow strongly, especially if it is reinforced by continuing trade liberalisation and appropriate foreign direct investment policies. China is likely to become a major source of trade and investment opportunities for Australia, and Australia should become an increasingly important source of reliable, low cost and high quality raw materials and agricultural commodities, and of a range of more sophisticated manufactures Chinese producers and consumers require.

However, Australia has much to learn about China's vast and diverse economy, population, regions and institutions. A deeper understanding of this diversity and an appreciation of the complexities of China's system of government, business and society will allow Australians to interact more effectively with China and increase the mutual benefits of this engagement.

While China is one of the world's largest and fastest growing markets with many opportunities for well informed and capitalised firms, successful investment strategies should anticipate increasingly fierce competition between foreign and local investors and take a long term approach. Investors should be aware that China is a market undergoing vast structural change. It is subject to major regional variation but is fast increasing its regional integration. It is experiencing rapid demographic change and massive migration movements, and at the same time, is

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¹ While the gap between China's purchasing power parity and official exchange rate of the yuan will narrow as China's labour costs rise, its real exchange rate also will probably increase as its exports become more competitive. Consequently, the forecasts made in Chapter 1 should be reasonably robust.

steadily overcoming inherited distortions from the old central planning system and embracing the market economy. Thorough market research is therefore essential to succeed in the China market.

IMPLICATIONS FOR AUSTRALIAN BUSINESS

1. In future, China will have a very large demand for goods and services, but at present, while incomes are still relatively low and transport links poor, markets are segmented and specialised. Australian firms will mainly need to seek out niche markets in particular sectors or regions. This will require careful market research.
2. As China continues market-oriented agricultural reforms, it will increase imports of land intensive products such as grains, cotton and sugar, increasing opportunities for Australian exports of these commodities to China. This trend is already evident, and should strengthen in the short to medium term.
3. As Chinese agriculture is reformed and marketised, it will produce large volumes of competitively priced labour intensive agricultural products, such as fresh and processed fruit and vegetables and other processed foods for both the domestic and world markets, generating intense competition. Australian producers of these products will need to develop marketing and product development strategies to meet this challenge, seeking niche markets based on higher quality.
4. As incomes rise, urban residents will consume more Western style products, including processed foodstuffs. These developments will provide good export and investment opportunities as well as for related food processing and packaging technology, equipment and expertise. Processing Chinese agricultural products for Western export markets will also present opportunities.
5. Australia, with its strong comparative advantage in grain production, distribution and processing can also benefit from the high priority China places on grain production. Australia is also highly competitive in animal raising and meat processing. Australian exporters and investors are therefore well placed to sell China advanced technologies in these industries to improve seed variety and quality, reduce the enormous wastage in grain shipping, storage and processing, and increase feeding efficiency in livestock production.
6. In the environmental field, Australian firms are active in such areas as clean energy, water treatment and sustainable agriculture, and could assist Chinese institutions to develop frameworks to deal with environmental issues. Establishing local production facilities for simpler environmental products may reduce production costs, increase their competitiveness and improve their acceptability for funding under multilateral and bilateral ODA projects.

7. Australian firms have considerable expertise in construction and management in the transport, electricity generation, telecommunications and infrastructure sectors. Many corporatised or privatised infrastructure providers also have considerable expertise that could assist SOEs to improve their regulatory and management systems and attract private investment in infrastructure. However, many projects in the infrastructure sector may be beyond the supply capacity of all but Australia's largest firms. Small and medium sized Australian firms will need to consider linking up with other firms, from Australia, China or third countries in order to participate in this market. Larger firms would strengthen their bids for projects if they formed consortia with other Australian or foreign firms so that they offered a full package of services to Chinese infrastructure customers, including management and regulatory expertise, financing and construction. Such consortia could also be organised or facilitated through the relevant industry organisations, such as the newly merged Australia-China Business Council or groups like the Tasman Institute's Infrastructure Forum. This process of cooperation and information-sharing could also be facilitated by new communications technology, such as the internet.
8. Continuing problems with the infrastructure and distribution system may impede the capacity of firms with perishable products to distribute their products nationally. Such businesses may need to treat China as a number of separate regional markets. Nevertheless, shortcomings in the distribution and transport systems should also provide opportunities for Australian firms with expertise in transport, logistics and storage.
9. In the medium to long term, significant opportunities for foreign banks, financial institutions, insurance companies and other financial services will develop in China. However, foreign investors in these sectors should anticipate continuing delays in receiving full national treatment. Until state owned financial institutions are released from obligations to lend to loss-making SOEs and are able to reduce excessive staff levels, entry of foreign firms will be restricted, as the Government believes that these factors reduce the capacity of local, usually state-owned providers to compete with foreign firms on an equal footing. Nevertheless, there are alternative innovative ways of participating in the provision of medium to long term finance to China apart from establishing bank and insurance branches including consortium financing and managing funds for Chinese pension schemes. These mechanisms are likely to become more important as China's need for capital grows, placing inevitable strains on existing sources.
10. As incomes increase, there is also considerable scope to increase the export of educational services to China, both by the establishment of campuses and courses within China, and by providing training and education for Chinese students in Australia.
11. Australian investors and traders in China should recognise that ongoing macroeconomic management reforms will result in a gradual reduction in direct quantitative controls of credit and more reliance on indirect monetary instruments. As this occurs, the economy will become subject to normal, and less abrupt, business cycles rather than policy induced fluctuations.

12. Better use should be made of Australia's ethnic Chinese communities, which have extensive links with China and overseas Chinese communities undertaking investments in China (East Asia Analytical Unit, 1995). Some suggested approaches include:
 - Employing the language, cultural skills and contacts of the ethnic Chinese in Australia in marketing Australian produce and undertaking investments in China. Bilateral business associations are an important starting point;
 - Undertaking market research in local ethnic Chinese communities on potential export products, such as new food products.
13. Access to quality and timely information on forthcoming opportunities and the operating environment is essential to succeed in the complex and highly competitive China market. Avenues providing such information include:
 - Austrade's extensive network of offices in China. Firms need to ensure their capabilities are registered with Austrade in Australia to allow trade opportunities to be passed on to them;
 - Private consultancy firms in Australia, China and Hong Kong;
 - Legal and accounting firms with China offices;
 - World Bank and Asian Development Bank publications, internet sites and briefings;
 - Connections with local officials.

IMPLICATIONS FOR GOVERNMENT

Australia has several natural advantages in engaging diplomatically and commercially with China, from our traditionally friendly diplomatic ties to extensive people-to-people-links, including many recent migrants from China. Beyond this, the Australian and Chinese economies are highly complementary. The core focus of the bilateral relationship will remain trade, investment and economic reform.

Trade Relations

1. As many Australian firms, particularly small and medium sized enterprises frequently experience difficulties in exploring commercial opportunities in China's regions, the market analysis assistance provided by Austrade's regional outrigger offices is very valuable. The Government could assess the value of establishing additional regional outrigger offices and trade correspondents in the most promising and strategically located cities in the coastal provinces and in selected hinterland provinces, such as Sichuan. Increased priority should be given to disseminating commercially valuable information gathered by such offices to Australian companies in Australia.
2. China, Australia and all other trading nations would benefit from China undertaking the necessary reforms to its trade regime to accede to the WTO. Integration of China into international trade and economic institutions is

also an essential part of China's fuller participation in the international economy. Australia has made a constructive contribution in assisting Chinese officials prepare for WTO entry. To assist this process, it is important Australia continues to play a pro-active role in assisting China to draw up a timetable for trade liberalisation and improving the transparency of the trade regime, to be undertaken before and after WTO accession. This assistance not only focuses on sectors and reforms of particular interest to Australian exporters but on other major impediments to the accession process. Existing technical assistance could be continued and consideration given to extending the scope and improving the focus of these activities to increase benefits for both China and Australia.

3. China will become an increasingly important regional and world economy within the next two decades, and one of the most important sources of economic opportunity for Australia. To take full advantage of these opportunities, it is important to improve Chinese language skills in the Australian population. Australian Federal and State governments need to ensure adequate funding of Chinese language and culture studies in both schools and universities, as well as scholarships to ensure the language skills are developed to a level useable in a business environment.

Investment Relations

4. Foreign direct investment has been one of the main sources of China's dynamic economic growth since 1978, generating employment and exports and transferring technology and technical, managerial and marketing skills to China. However, the environment remains difficult and often unprofitable for many foreign investors. Improving the business environment for both domestic and foreign funded enterprises will enhance China's growth prospects and competitive advantage. The Australian Government could encourage China to focus its foreign investment policy on improving foreign firms' contribution to the Chinese economy, to ensure innovation, best practice and continued investment. This would include continuing to encourage China to:
 - Reduce the list of restricted sectors for foreign investors by granting market access and improved operating conditions in such areas as mining, banking, insurance, distribution, and legal and accounting services;
 - Strengthen institutional and market frameworks, addressing such issues as transparency and consistency in approvals and regulatory processes, national treatment, intellectual property rights protection, dispute resolution and enforcement of regulations;
 - Take account of investment liberalisation throughout the region, to ensure China is achieving best practice in policy-making.
5. Although Australia is still a relatively small foreign direct investor in China, the prospects of many Australian exporters to China will be significantly enhanced by undertaking direct investments in China aimed at an expanded domestic market as well exports to third countries. Austrade assists Australian firms preparing to invest in China by providing advice on potential joint venture partners, market research, the decision-making

process and other issues. It is important that this activity continues to receive high priority.

6. Despite Australia's considerable experience and competitiveness in agricultural production, distribution, storage and processing industries and the high priority now placed on FDI in agriculture by the Chinese Government, Australian firms have undertaken relatively few investments in this sector. Investments in processing could also enhance Australian agricultural commodities exports to China. Increased efforts could be made to inform Australian agribusiness, grain distributors and growers of the opportunities to invest in agriculture and related processing industries in China, including through the Government's Supermarket to Asia initiative.
7. Australia is already the second largest destination for Chinese foreign investment. Joint venture investment by Chinese firms in Australian manufacturing, agriculture and resource sectors makes a valuable contribution by generating employment and promoting exports, enhancing Australian enterprises' knowledge of the Chinese market and increasing market access. Such investments could also reduce the Chinese Government's anxiety concerning resource and food security. Austrade maintains investment promotion offices in Hong Kong, Beijing and Shanghai providing advice to potential investors and it is important to ensure that these continue to be given sufficient priority.
8. As discussed above, Australia has considerable experience in corporatising and marketing inefficient government business enterprises. As this is an essential element in the reform of China's SOEs, Australia is in an excellent position to participate in projects to privatise or corporatise SOEs financed under multilateral or bilateral ODA programs, or on a commercial basis. Relevant Commonwealth and state government departments and companies could consider forming a Public-Private Sector Services Exports Team to promote knowledge of Australia's achievements and expertise in the field of government business enterprise reform. It could assist and work closely with private sector consortia in this area to identify, define and bid for SOE corporatisation and joint venturing projects in China.

Economic Cooperation

9. With a GDP per capita of US\$500 and 350 million people living in poverty, China still has huge development and poverty alleviation needs. China is also of immense economic, political and strategic importance to Australia, and this significance is sure to grow in the next century. Australia is not a major aid donor to China in volume or relative terms, but the program of development cooperation is highly regarded by China. Aid is an important component of bilateral relations, enhancing economic relations in particular. Australia's total official development assistance, ODA, to China in 1996/97 is estimated at \$55 million, making China the fifth largest ODA recipient after PNG, Indonesia, Vietnam and the Philippines. Future levels of Australian ODA to China will be determined mainly in the context of the budget.

In framing future aid budgets, a judgement needs to be made about whether Australian aid levels to China appropriately reflect its humanitarian needs and economic importance to Australia.

10. Australia's ODA program, including its objectives and distribution, is being reviewed by a committee led by Paul Simons. The future directions and shape of Australia's aid to China will be largely determined by the Government's responses to the Simons' Recommendations.

Based on the findings of this report, a case exists for focusing Australia's ODA to China mainly on institutional strengthening in support of:

- continued economic reform,
- infrastructure development,
- environment protection, and
- human resource development.

In order to magnify its impact, Australia's ODA should be combined where possible with contributions from the multilateral development banks and/or the Australian private sector.

Examples of possible areas for future aid include:

- building on the model of the current Economics and Foreign Trade Training project, technical assistance and training to core areas of the Chinese economic and trade bureaucracy. Strengthening economic policy formulation and implementation will help sustain the momentum of China's economic and trade reforms;
- using Australian experience in reforming government business enterprises, technical assistance and training for infrastructure service providing bodies such as power utilities, roads, railways, water supplies and ports to prepare China - and its regulatory environment - for private sector investment in infrastructure. This assistance could, for example, cover tendering procedures and documentation, and negotiation with potential private sector suppliers and investors;
- using Australian expertise in environmental technologies and management, provide technical assistance and training to help China upgrade facilities, management and policy frameworks relating to air pollution, waste water and solid waste treatment, land and water conservation;
- underpinning the above areas of focus with an emphasis on human resource development, particularly through training and capacity building, and exchange and linkage programs involving Australian bodies in both private and public sectors.

ABBREVIATIONS

| | |
|---------|---|
| ADB | Asian Development Bank |
| AIDC | Australian Industrial Development Corporation |
| APEC | Asia Pacific Economic Cooperation |
| ASEAN | Association of South East Asian Nations |
| ASEAN-4 | The largest four economies of the Association of South East Asian Nations (Malaysia, Indonesia, the Philippines and Thailand) |
| AusAID | Australian Agency for International Development |
| BOT | build own transfer |
| BOOT | build own operate transfer |
| CAAC | Civil Aviation Administration of China |
| CCCPC | The Central Committee of the Communist Party of China |
| CICC | China International Capital Corp. Ltd. |
| CIETAC | China International Economic and Trade Arbitration Commission |
| cif | cost-insurance-freight |
| CITIC | China International Trust and Investment Corporation |
| CNPC | China National Petroleum Company |
| DRP | domestic resource productivity |
| EAAU | East Asia Analytical Unit, Department of Foreign Affairs and Trade, Australia |
| EIU | Economist Intelligence Unit |
| ETM | elaborately-transformed manufacture |
| EU | European Union |
| FDI | foreign direct investment |
| FFEs | foreign funded enterprises, including joint ventures and wholly foreign-owned enterprises |
| fob | free-on-board |
| GATS | General Agreement on Trade in Services |
| GATT | General Agreement on Tariffs and Trade |
| GDP | Gross Domestic Product |
| GNP | Gross National Product |
| GOV | Gross Output Value |

| | |
|--------|--|
| IMF | International Monetary Fund |
| IPR | intellectual property rights |
| JV | joint venture |
| LNG | liquefied natural gas |
| MCI | Ministry of Coal Industry (of China) |
| MFN | most favoured nation (treatment) |
| MOCOM | Ministry of Communications (of China) |
| MPI | Ministry for Power Industry (of China) previously Ministry for Electric Power (of China) |
| MPT | Ministry of Posts and Telecommunications (of China) |
| NEPA | National Environment Protection Agency (of China) |
| NEPR | net export performance ratio |
| NIEs-4 | newly industrialising economies (Singapore, Hong Kong, Taiwan, and Republic of Korea). |
| NPC | National People's Congress |
| NSS | non-state sector |
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Cooperation and Development |
| OECF | Overseas Economic Cooperation Fund (of Japan) |
| PBOC | People's Bank of China |
| PECC | Pacific Economic Cooperation Council |
| PRC | People's Republic of China |
| PTAs | Posts and Telecommunications Authorities (of China) |
| SEZ | Special Economic Zone |
| SMEC | Snowy Mountains Engineering Corporation (of Australia) |
| SOEs | state-owned enterprises |
| SPC | State Planning Commission (of China) |
| SSB | State Statistical Bureau (of China) |
| STM | simply transformed manufacture |
| TVEs | township and village enterprises |
| VAT | value added tax |
| WFOEs | wholly foreign-owned enterprises |
| WTO | World Trade Organisation |
| ¥ | Yuan, the basic unit of the Chinese currency, renminbi |

GLOSSARY

| | |
|---|--|
| adjustment tax | extra tax levied on excess profits earned by large and medium sized state-owned enterprises; it was abolished in 1994 |
| Association of South East Asian Nations (ASEAN) | Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam with Laos, Cambodia and Burma likely to join in 1997 See EAAU, 1997, <i>The New ASEANs</i> |
| asset/liability ratio | ratio of an enterprise's assets (fixed and liquid) to its liabilities (debts) |
| Bohai Ring | one of the new growth centres of China encompassing Tianjin and parts of Shandong, Hebei and Liaoning provinces. The municipalities covered include Tianjin, Dalian, Dandong, Yingkou, Panshan, Jingxi, Tangshan, Qinghuangdao, Cangzhou, Qingdao, Yantai, Weifang, Dongying and Weihai |
| business tax | tax on the provision of services, transfers of intangible assets, and sale of real estate |
| competitive bidding system in government bond issuing | the process of open and competitive bidding by primary dealers and securities trading institutions for different quantities of government bonds |
| consolidated industrial and commercial tax | tax levied on various products and commercial services. In 1951, the Chinese tax authorities combined many taxes on products and commercial services into a consolidated industrial and commercial tax. In 1984, the consolidated industrial and commercial tax was abolished and replaced by product tax, VAT, business tax, salt tax, resource tax |
| corporate tax | Company income tax, which since 1994 has been levied uniformly on all enterprises and companies in China |
| credit quotas | limits on the quantity of credit issued by banks, used by the Government to directly control credit supply |
| currency convertibility | capacity to freely exchange one currency for another |

| | |
|---|---|
| current prices | prevailing market prices of a given product in a given year |
| decollectivisation | the process of abolishing the collective system in rural China |
| duty drawback | a refund of duties on goods imported and then re-exported in processed form |
| elaborately transformed manufactures (ETMs) | term used in Trade Exports Classification (TREC) by the Australian Department of Foreign Affairs and Trade denoting products have undergone a significant value-adding or manufacturing process |
| foreign funded enterprise (FFE) | a company which has foreign investment capital |
| foreign direct investment (FDI) | investment made by foreign investors in the equity of a local company, as distinct from investments in bonds, portfolio investments, international loans and inter-governmental borrowing |
| foreign exchange rate unification | action undertaken by the central Government in January 1994 to unify the official and swap market exchange rates |
| foreign exchange retention system | a system that existed in China prior to the 1994 currency reunification, allowing exporting enterprises to use a proportion of their export earnings |
| foreign exchange swap market | a system that enabled exporters and foreign enterprises to trade their retained foreign exchange for renminbi |
| Gross Domestic Product (GDP) | measures the value of economic production undertaken within the domestic territory |
| Gross National Product (GNP) | the income accruing to people, enterprises and other organisations regarded as residents of a country. GNP equals GDP plus residents' income from overseas property or productive activity less income paid to overseas residents |
| Gross Output Value (GOV) of industry | total value of industrial production, before subtracting the value of material inputs (but not labour and capital) |
| government bond | see treasury bond |
| government extrabudgetary revenue | central or local government revenue earned from fees and levies that are not included in the planned budget |

| | |
|------------------------------------|--|
| government extrabudgetary spending | central or local government expenditure based on extrabudgetary revenue |
| government overdraft | government borrowing from the central bank to finance the budget deficit |
| Governor responsibility system | a system that makes the provincial governor responsible for local grain production and marketing |
| grain-meat ratio | a feeding efficiency indicator of the amount of grain used to produce a unit of meat |
| household responsibility system | a household-based agricultural production system that replaced agricultural communes |
| import licensing | a system of selective permits for importing products or services |
| institutional strengthening | fortifying the capabilities of government institutions involved in policy development and program delivery |
| interbank credit market | also known as interbank loan market, enabling commercial banks and non-financial institutions to borrow and lend to each other at financial centres operated by the People's Bank of China. Most loans are for less than 30 days and the remainder for between 30 days and four months |
| international dollars | also called Geary-Khamis dollars; these provide parity-based international comparisons of the purchasing power of national incomes |
| M1 | an indicator of money supply, encompassing currency in circulation plus all deposits in bank savings accounts |
| M2 | an indicator of money supply, encompassing M1 plus short term bank deposits |
| Material Product System | a system of national accounts used in centrally planned economies, based on Marxist theory that regards all services as unproductive |
| most favoured nation | a situation in the international trade regime where a country accords a bilateral trading partner the best trading conditions it accords any of its other trading partners |
| national accounts | accounts outlining the state of the economy over a period of time (usually one year) |

| | |
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| newly industrialising economies (NIEs) | Republic of Korea, Taiwan, Hong Kong, and, often, Singapore |
| open cities | cities that are open to foreign investment and provide preferential policies |
| open market operations | an instrument of monetary policy involving the sale or purchase of government treasury bonds as a means of controlling the money supply |
| payment-reserve ratio | ratio of payment reserves to the total deposits of a bank, where payment reserves are the required reserves held by the commercial banks at the PBOC to cover deposit withdrawals |
| Pearl River Delta | one of the most developed parts of southern Guangdong province, including the municipalities of Guangzhou, Foushan, Zhongshan, Dongguan, Shenzhen, Zhaoqing, Huizhou and Qingyuan |
| primary industry | refers to agriculture including farming, forestry, husbandry, sideline production and fishing |
| privately owned enterprises | refers to enterprises owned by individuals, including individually owned private enterprises, jointly owned private enterprises, and privately owned limited liability corporations |
| procurement quotas (for farm products) | an assigned amount of farm products that must be procured by local governments from farmers |
| product tax | tax on industrial, agricultural, forestry, livestock, and fishery products. Since 1994, many product taxes have been replaced by VAT but a few remain on cigarettes, alcohol, electric power and petrochemicals |
| purchasing power parity | a theory of exchange rate determination, based on converters that adjust money incomes to reflect the power of a unit of local currency to buy a given 'basket of goods and services' |
| quota sales (farm products) | an assigned amount of farm products that have to be sold to state agents at state prices as a 'rent' for the collectively owned farmland; it was introduced with the household responsibility system |

| | |
|---|--|
| rediscounting | a bank service involving purchase of future credits (such as loan repayments) owing to customers for discounted prices |
| refinancing | using new financing to pay off or extend an old loan |
| resource tax | tax imposed on income gained by any enterprise or individual who exploits or produces resources such as crude oil, natural gas, coal, other non-metal ores, ferrous metal ores and salt within China |
| Southern Tour | Deng Xiaoping's famous trip to southern China in 1992 reaffirmed the move away from a command economy to a market-oriented system |
| state-owned enterprises (SOEs) | enterprises owned by the central and provincial governments |
| special deposits | PBOC deposits by commercial banks and other financial institutions, required by the People's Bank of China to reduce their excess liquidity |
| Special Economic Zones (SEZs) | specially defined areas offering preferential policies to attract foreign direct investment |
| specialised state banks | the four major banks established by the Chinese government to conduct banking for specified sectors of the economy (agriculture, construction and industry) and to undertake foreign exchange transactions |
| state policy banks | the three state policy banks providing government supported loans are the State Development Bank, the Agricultural Development Bank of China and the Export-Import Bank of China. They are the major source of long term policy credit to fund key national construction projects, agricultural development, grain and cotton procurement and exports of major machinery and electrical products |
| sterilisation | active sale of government bonds in the open market by monetary authorities to reduce liquidity created by foreign capital inflow |
| tax revenue-sharing between central and local governments | tax revenues now shared include value added taxes, resource taxes and securities transaction taxes |

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| trade intensity index | an index which measures the importance of bilateral trade between two economies by taking into account the overall trade structure of that country and its trading partner |
| treasury bonds | in many developed economies treasury bonds are long term government bonds, while treasury notes refer to medium term government bonds, and treasury bills to short term government bonds. However, this distinction is not made in the Chinese terminology. In the PBOC's English publication all three are called treasury bonds, with terms from three months up to ten years |
| triangular debt | debt chains between Chinese enterprises as a result of a failure to enforce debt payments through the courts, including through bankruptcy |
| two-tier system | a system of resource allocation based on both planning and market elements, designed to allow the market to play a role once the planning targets are achieved, and eventually designed to allow the market to replace planning mechanisms |
| urban maintenance and construction tax | tax collected via product tax, VAT and business tax for the purpose of urban maintenance and construction. Tax rates vary from 1 per cent to 7 per cent according to the size of city |
| value added tax (VAT) | tax on value added at each stage of industrial production, wholesaling and retailing |
| variable enterprise income tax | applied different tax rates to different types of enterprise. Before 1994, large and medium sized state-owned enterprises paid 55 per cent and rates for other enterprises varied from zero to 55 per cent. The variable enterprise income tax was abolished in 1994 and replaced by a uniform corporate income tax rate of 33 per cent for all domestic enterprises |
| zero real interest rate accounts | special long term deposit accounts established in the late 1980s, guaranteeing an interest rate at least equal to the rate of inflation |

INDEX

A

- agenda 21, 246
- agribusiness
 - Australia's comparative advantage 323, 324
 - foreign investment 322
- agricultural collectivisation
 - and labour migration. *See* labour migration
 - and marketing of farm products 16
 - and the central planning 16
- agricultural infrastructure
 - and household responsibility system 316
- agricultural reform
 - and rural enterprises. *See* rural township and village enterprises
 - household responsibility system 20
- agricultural technology
 - China's potential 316
 - economic cost 317
 - farmers' response to new seeds 316
- airports 229
- APEC 199
 - nonbinding investment principles 199
- arable land
 - problem of land use planning 324
- arbitration 85
- Australian companies
 - AIDC 250
 - Ancor 208
 - AWA 208
 - BHP 189
 - Big M 209
 - FH Faulding 210
 - Geo-Eng 211
 - Macquarie Textiles 212
 - Multistack 213
 - National Mutual 214
 - Pacific BBA 216
 - TNT 241

B

- bank
 - China's Industrial and Commercial Bank 390
- banking system
 - PBOC and policy banks 126
 - policy banks 114
 - policy intervention 126
 - quasi-fiscal responsibility 116
 - sources of deposits and loans 116
 - specialised state banks 113
- bankruptcy law 343
- BOT Corporation 235
- budget
 - soft budget constraints 383

C

- central planning
 - and forced industrialisation 16
 - and hukou system. *See* household registration system
 - and nationalisation 16
 - Five-Year Plan 15, 18
 - import and export plans 22
 - the agricultural system 16
 - the fiscal and financial system 17
 - the foreign trade and investment regime 17
 - the industrial system 16
 - the labour employment system 17
 - the legal system 17
- China Water Co 250
- China's open door policy 401
- Chinese Communist Party 15
 - The Third Plenum of the Fourteenth Central Committee 104, 129
- CITIC 185, 186
- coal 231, 236, 245
- Cultural Revolution 15, 17, 18

D

- Deng Xiaoping 61
 - post-Deng era 52
 - the reform 20

E

- economic reform
 - household-based responsibility system 384
 - pre-reform medical care system 391
 - social security reform 393
 - social welfare system 393
 - special economic zones 389
- economic reforms
 - agriculture reforms 384
- energy 243, 245
- environment
 - foreign participation 250
- export processing 140

F

- Five-Year Plans
 - Ninth Five-Year Plan 225, 236, 240
- food consumption
 - alcohol consumption 318
 - effect of dietary habits 318
 - effect of urbanisation 318
 - per capita meat consumption 318
 - population effect 318
 - wastage 320

- food trade
 - alternative policies 322
 - grain import 320
 - predictions 314
- foreign exchange
 - retention system 138
 - swap market 138
- foreign exchange regime
 - effect on reserves 124
 - the foreign exchange retention system 21, 123
 - the swap market 21, 123
 - the unification of official and market rates 124
 - trade effect 124
- foreign investment 17
 - Australian companies 323
 - Australian in China 185
 - by province 190
 - Chinese in Australia 186
 - food industry 323
 - in agriculture 322
 - key success factors 195
 - open coastal cities 22
 - organisational structures 194
 - policies on joint ventures 22
 - policy 180, 190, 198, 199, 202, 206
 - relationship with foreign trade 22
 - role in development 179, 198
 - sources 184
 - Special Economic Zones (SEZs) 22
 - what Chinese value 196
- foreign investment
 - corporate experience 216
- foreign trade 17
 - by non-state enterprises 22
 - by rural township and village enterprises 22
 - enterprise autonomy in foreign trade 21

G

- government expenditure
 - central vs local governments 111
 - in fixed capital investment 113
- Great Leap Forward
 - and agricultural failure 18
 - labour mobilisation 18
 - the campaign 15, 18
- growth centres in the coastal region
 - the Bohai Ring 283
 - the Pearl River Delta 277
 - the Yangtze River Delta 279

H

- Hong Kong 66, 184, 190

I

- industrial SOEs
 - financial performance 340
 - poor profitability 339
- infrastructure
 - constraints/shortages 228, 230, 247
 - financing 240
 - foreign participation 234, 240

- planning 232
- institutional strengthening 251
- inter-provincial trade 79
- international comparison of national income
 - prediction for China and the USA 49
 - the expenditure approach 54
 - the production approach 45, 54, 57
- investment
 - fixed capital investment 31
 - infrastructure investment 32
 - investment rate 31
 - structure of investment 31

J

- Japan 184, 185
- Joint Venture Law (1979) 179, 198, 203
- joint ventures with SOEs
 - advantages 337
 - disadvantages 337
- judiciary 82

L

- labour market problem
 - household registration (hukou) system 383
 - shortage of skilled labour 383
 - SOEs overstaffed 383
 - surplus rural labour 383
- labour market reform 383
 - enterprise-based superannuation schemes 392
 - external government-operated social security system 389
 - external social security system 390
 - fully paid-in pension system 393
 - internal social security system 390
 - labour contract 385
 - labour service companies 388
 - Ministry of Labour 400
 - municipal-based medical insurance 392
 - optimal combination of labour 388
 - pooled social superannuation funds 392
 - profit-related bonus system 388
 - social medical insurance system 392
 - state enterprise-based social security system 389
 - State Labour Bureau 388
 - two-tier housing market 391
 - two-tier urban labour market 397
 - unemployment benefit system 390
- labour migration 16
 - post Great Leap Forward repatriation 18
- labour productivity
 - compared with the USA 57
 - growth 50
 - international comparison 51
- law
 - and public education 84
 - conflicts in 92
 - historical role of 83
 - sources of legislative power 92
- leadership
 - Deng Xiaoping 16
 - Mao Zedong 15, 18

M

- manufactured exports
 - barriers faced in key markets 163
- market share
 - Australia's crude market share in China's imports 160
- Ministry
 - of Communications 241
 - of Coal Industry 418
 - of Communications 418
 - of Labour 400
 - of Posts and Telecommunications 241
- monetary policy tools
 - credit plan 118
 - indirect instruments 119
 - inter-bank market 120
 - managed floating interest rate 120
 - measures to achieve the 1995-96 'soft landing' 131
 - open market operation 125
 - regulated interest rates 118
 - sterilisation 125
 - zero real interest rate accounts 121

N

- National Environmental Protection Agency 248
- national income
 - overestimation 57
 - the material product system 44
 - the UN System of National Accounts 44
- national treatment 180, 201
- NIEs 184
- NSS
 - collectives and private enterprises (siying qiye) 356
 - development 356
 - employment 360
 - gross industry output 358
 - regional development 362
 - sectoral distribution 360
 - township and village enterprises 355
 - transportation infrastructure 370
 - wholly foreign-owned enterprises and joint ventures 356
- NSS major issues
 - labour 369
 - management 365
 - marketing 370
 - non-state bank loans 367
 - reinvested profits 367
 - supply of inputs 370
 - taxation 367
 - technology 368

O

- oil and gas 240
- open cities 198
- overseas Chinese 184

P

- pollution 244, 245
- ports 229

- power 230, 231, 236, 241, 243
- public finance
 - government budget 34
 - off-budget revenue and expenditure 34
- purchasing power parity
 - China, compared with other countries 45
 - estimates for China 45
 - in international comparison of national income 53
 - problems in income projection 55

R

- rail 228
- reform
 - economic reform 23
- regional development
 - government policies 285
- regional disparities
 - income growth 261
- regional diversities
 - economic policies 273
 - export growth 269
 - foreign direct investment 270
 - growth of retail sales 263
 - growth of TVEs 267
 - industrial growth rates 262
 - new investment 265
 - population 265
 - productivity and cost efficiency 271
 - tax and fiscal transfers 272
- regional groupings
 - the central region 260, 261
 - the western region 261
- regional prospects
 - longer term 288
 - prospects and challenges for Australian companies 289
 - short term 287
- risk management 204
- roads 228
- rural township and village enterprises
 - and central-local fiscal relationship 21
 - and the hukou system 21
 - and the reform of planning system 21

S

- sectoral investment restrictions 202, 203
- services market
 - foreign participation in 145
- SOE problem
 - ambiguous property rights 332, 342
 - bad SOE loans 332
 - barriers to entry 344
 - government interference 349
 - inappropriate enterprise incentives 332, 342
 - inappropriate managerial incentives 345
 - inefficiently used resources 332
 - inter-enterprise triangular debts 332
 - less internationally competitive 332
 - loss-making SOEs 333, 334
 - low productivity 333

- redundant labour 349
- welfare and social services 347
- SOE reform 331
- SOE reform strategy
 - grasping the big 336
 - grasping the big and enlivening the small 333
- Southern Tour 182
- Special Economic Zones 141
- state-owned enterprises (SOEs)
 - and macroeconomic instability 37
 - and the stop-go cycles 37
 - loss-making SOEs and state banks 127
 - performance 22
 - profit-retention system 109
 - reform measures 22
 - relationship with state banks 22
- State Planning Commission 232, 239, 248
- state sector
 - significance 338
 - structural change 338
- stock markets 85
- system
 - life-time employment system 385

T

- Taiwan 184, 190
- taxation system reform
 - introduction of standard taxes 109
 - introduction of VAT 110
 - reform after the Third Plenum decision 109
 - SEZs and open cities 110
 - tax sharing between central and local governments 109
 - taxes for FFEs 109, 110
- telecommunications 230, 241
- Three Gorges 238
- TNT Shanghai Express 241
- trade intensity analysis
 - bias index 173
 - complementarity index 173
- Triangular debt 231

W

- water pollution 244, 247
- World Bank 225
- World Trade Organisation 199

Z

- Zhejiang Village 397

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