Chapter VI How to Maintain Growth without Inflation？

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シリーズタイトル(英)	IDE Spot Survey
シリーズ番号	13
journal or publication title	China's Roadmap as Seen in the 15th Party Congress
page range	[52]-61
year	1998
URL	http://hdl.handle.net/2344/00010398

Chapter VI

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Introduction

The goal of China since the 1980s had been to quadruple the gross national product of 1980 by the year 2000. When the goal was achieved in 1995, China began moving toward the establishment of a new target for the next century. In his speech at the 15th Party Congress, Jiang Zemin called for the following targets: Doubling the gross national product of the year 2000 by the year 2010 and forming a more or less ideal socialist market economic system; further developing the national economy by the year 2021, the 100th anniversary of the CPC 10 years after that, and further improving various systems of the market economy; and substantially accomplishing the modernization program by the middle of the 21st century when the People's Republic celebrates its centenary. To realize these goals, China will basically have to continue with its high growth policies in the future.

The plan for quadrupling the GNP, however, occasionally triggered economic overheating starting in the 1980s and brought about violent business cycles. The grand goals for the 21st century may also trigger economic overheating. Economic overheating increases the growth rate for a while, but inevitably results in inflation and forces an austerity policy which lowers the growth rate. This instability in the economy has a disadvantageous effect on the absorption of foreign funds and the achievement of a fair distribution of wealth. Further, it increases the risk of the economy becoming derailed and triggering hyperinflation or negative growth. Therefore, the problem is how to realize sustainable stable growth. This chapter will throw some light on the problems in the macroeconomy and foreign economic relations.

1. Business Cycles and Inflation Since Reform

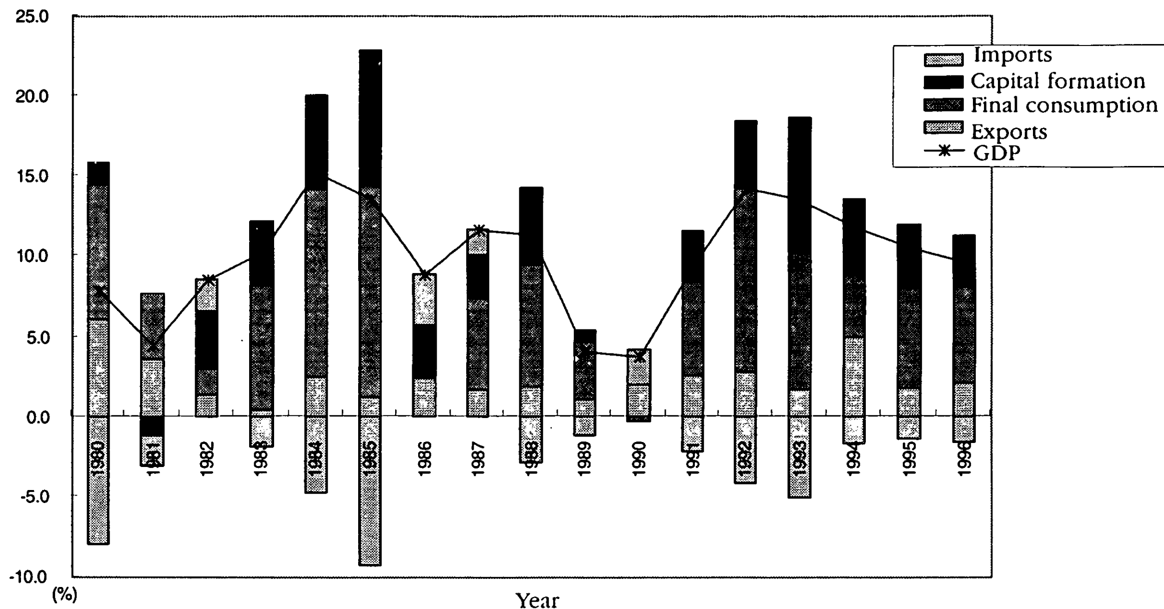
1-1. Factors in Business Cycle

China has recorded extremely high growth of a real annual 10 percent of its GDP since the outset of its reform. On the other hand, as shown in Fig. 1, there have been tremendous ups and downs in its growth rate. The real growth rate of GDP has fluctuated wildly from a high of 15.2 percent (1984) to a low of 3.8 percent (1990). Since the reform started, China has in fact experienced four business cycles. The first began in 1977, peaked with an investment boom triggered by Hua Guofeng's ambitious "Ten Year Plan", and ended in 1981. The second began in 1982, peaked with the boom in investment of 1984 to 1985, and ended in 1986. The third began with the boom in consumption of 1987, bottomed out with the fiscal austerity program starting in the fall of 1988, and lasted until 1990. The fourth began in 1991, peaked with the investment boom triggered by Deng Xiaoping's speeches delivered during his tour of the south, and has been tapering off since the second half of 1993 with fiscal austerity measures taken, growth gradually falling, and inflation calmed.

The factor analysis of growth of Fig. 1 tells us the following. First, the simultaneous and parallel expansion and contraction of consumption and capital formation have caused tremendous fluctuations in the growth rate. As opposed to this, exports and imports have conversely functioned to ease fluctuations in business. Imports grow rapidly in periods of business overheating and lower the growth rate, while exports help support growth in periods when the growth rate plunges.

The hypothesis of investment cycles gives a convincing explanation of why business cycles occur in China[1]. The main investment entity in China continues to be the state-owned sector, but the state-owned sector is subject to what Janos Kornai calls "soft budget constraint", so suffers from "investment starvation" where it tries to increase investment whenever it has a chance. When demand calms down and there is a surplus in supply, the planning authorities draw up ambitious plans and tend to listen to the demands from SOEs for increasing investment. Therefore, investment increases in an accelerated fashion. The increase in investment results in increased consumption through greater employment and higher wages. In this way, invest-

Figure 1. Analysis of Factors in GDP Growth Rate



Source: Calculated from WORLD BANK, *The Chinese Economy: Fighting Inflation, Deeping Reforms*, 1996. Figures for 1995 and 1996, however, are estimates of the author.

ment and consumption rise simultaneously and in parallel. Finally, total demand exceeds total supply resulting in a macroeconomic imbalance. The macroeconomic imbalance triggers inflation, causes violent shortages, and causes a deterioration of the current account. The planning authorities are then forced to switch to austerity measures resulting in suppression of investment and simultaneously a cool down of consumption. This theory of investment cycles sees business fluctuations as being due to the interaction of the policies of planning authorities and the investment actions of the state-owned sector. Further, it takes note of the effect of inflation in causing policy changes. Therefore, let us next take a look at inflation.

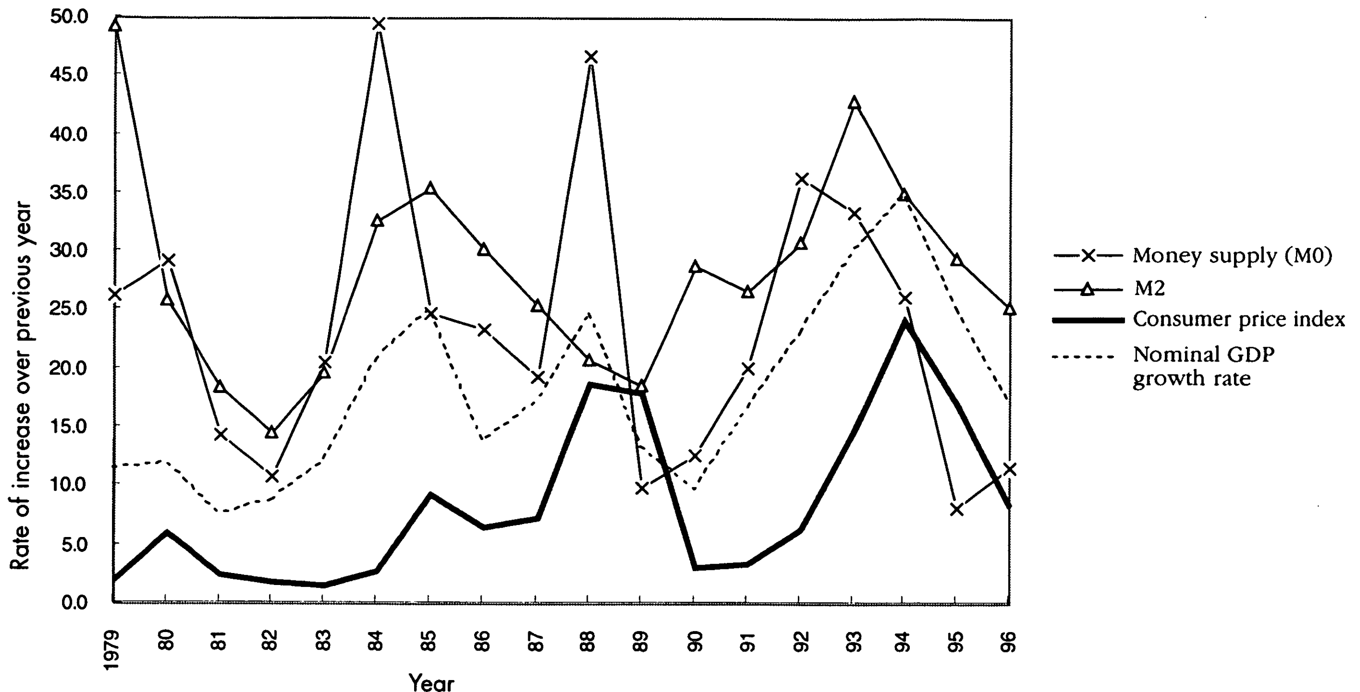
1-2. Factors Behind Inflation

The Chinese economy has been inflationary since the reform began. In particular, it was struck with violent inflation twice: at the end of the 1980s and in the middle of the 1990s. The years when price rises peaked were both at the end of periods of business expansion. The subsequent fiscal austerity programs brought growth rates down. This gives support to the theory of investment cycles which holds that inflation occurs and the government switches to austerity programs at the end of business expansions.

The primary reason for the occurrence of inflation is probably that the total supply cannot keep up with the simultaneous, parallel expansion of investment and consumption, but inflation is at its worst in the period after the growth rate peaks. Therefore, apparently monetary factors are at work in addition to the demand pull factor caused by the relationship between supply and demand. Let us then look at the relationship between the money supply and inflation since the reform began (Fig. 2). From this, we can read the rule that inflation becomes violent about one year after the money supply (M0) rises sharply.

The movement in the money supply is related with the afore-mentioned investment cycle. Starting around 1983, about 80 percent of investment in the state-owned sector of China has been funded by state bank loans[2]. Therefore, when investment grows, bank loans increase. This causes an increase in refinancing from the central bank to the state banks and an increase in the money supply. Conversely, when investment is curtailed by austerity

Figure 2. Relationship Between Money Supply and Inflation



Source: Prepared from IMF, IFS, *Zhongguo tongji nianjian* (China Statistics Yearbook), etc.

programs, bank loans are curtailed by direct government restrictions and the growth in the money supply falls. In this way, in China, investment policies are linked with financial policies. Financial policies there have never been an independent means of macroeconomic adjustment. Since the state-owned sector is subject to soft budget constraints and there is extremely low interest elasticity of investment, manipulation of interest rates etc. have not been considered an effective means of macroeconomic adjustment.

Note that the relation between M1 (cash plus the balance of ordinary deposits) and M2 (M1 plus time deposits and savings deposits) and inflation is not that marked. The relationship between M1 and M2 and inflation is probably not that marked since there are still no well developed means of payment other than cash in China. Rather, since interest rates are ordinarily kept lower than the equilibrium rate in China, when the economy overheats and inflation is expected to depreciate deposits, bank deposits are withdrawn in mass and used to purchase durable consumer goods and other assets so the money supply exceeds the rate of growth of M2 (1984, 1988, and 1992 in Fig. 2). This leads to a liquidity shortage at banks and forces the central bank to increase loans to them and also increases demand for consumer goods, and therefore speeds inflation from two directions[3].

2. Formation of Market Economic System and Soft Landing

The Chinese economy has behaved differently since 1994 than in previous austerity periods. The inflation rate fell to 8 percent in 1996 and to 0.8 percent in 1997, while the GDP growth rate didn't plummet and settled gently at the 9 to 10 percent level. One feels truly that China succeeded in an economic soft landing. Why was this possible?

First, it is necessary to look at the factors causing inflation. The inflation since 1993 was triggered by the adjustments in prices of cereals, oil, and other commodities in 1993 and 1994 which raised the prices of such basic goods. The prices of basic goods had been suppressed previously by government policy, to close the gap with interna-

tional market prices. Progress was also made in freeing the prices of producer goods. In January 1994, China also depreciated the exchange rate by a large margin and moved to a managed float system. These price reforms and the devaluation of the currency inevitably caused temporary inflation. The inflation in 1993 to 1995 was rather lighter than would have been expected from such bold reforms.

One of the reasons why China was able to stop runaway inflation was that not all of the greater income earned by the public flowed into consumption. Part went to the purchase of bonds, stocks, and other non-currency financial assets[4]. Further, the government adopted a sliding system of interests indexed against prices for long term deposits. This proved effective in preventing a surge in consumption due to mass withdrawals from the banks.

Another reason why China was able to achieve a soft landing was the way the government handled macroeconomic policies since 1993. That is, while the government launched a considerably tough austerity program at the end of June 1993, including reduction of the development zones and retrieval of illegal call loans, it eased up somewhat twice in the fall of 1993 and the spring of 1994. Each time, another round of inflation was fanned and each time austerity measures were toughened. While this inconsistency of policy caused the inflation to last longer, the result was that China managed to avoid a sudden drop in the growth rate. Further, a large amount of foreign direct investment flowed into the country in 1994 and 1995 and resulted in a surplus on the basic balance. This worked to push the value of the Chinese currency up. On the other hand, the People's Bank of China purchased U.S. dollars to stop this from happening. As a result, the supply of renminbi rose. This had the unintentional effect of easing the tight finances.

Structural changes in the economy as it headed toward a market economy are also reasons for the successful soft landing. In recent years, most investments relied on bank loans rather than the treasury for their funding. Direct financing means such as issuance of stocks and bonds and introduction of foreign capital have also been developed. State banks are being reformed and converted into commercial banks. Due to these changes, the profitability of projects has gradually become an important element in the funding of investments. In earlier periods of austerity, investment was cut regardless of their profitability, but the diversification of funding sources made it possible to raise funds for high profit projects. Thus a sudden drop in the growth rate was avoided.

Also important has been the growth of the non-state-owned sector, that is, private enterprises, foreign ventures, joint stock companies, and so on. These often raise funds by means other than government investment or loans from state banks, both of which are susceptible to the effects of fiscal austerity programs. Raising funds from their own coffers, the stock market, private financiers, and so on can continue growing even when the government is tightening up on financing. In fact, since 1993, the growth rate of investment in the non-state-owned sector has been considerably higher than that of the state-owned sector.

If such structural changes continue in the economy and if the government does not make any serious errors in macroeconomic management, there is a chance that the upward and downward swings will be smaller in future Chinese business cycles.

3. Problems in the State Budget and Finance

3-1. Problems in the State Budget

(1) Expansion of Fiscal Deficit

The successful soft landing suggests structural changes continue in the Chinese economy, but there are many destabilizing factors at work as well. First, there is the rapid ballooning of the fiscal deficit in recent years. The state's fiscal deficit has swelled with each passing year and in 1996 reached 184.5 billion rmb[5]. This corresponds to 20 percent of China's fiscal spending, combining both the central and local governments, or 2.7 percent of the GDP. The deficit is being met by the issuance of bonds and other debt revenue. The degree of debt reliance, debt revenue divided by the central government's spending, stood at 11 percent in 1985, but rose to 29 percent in 1989 and even higher in later years until reaching 56 percent in 1996[6]. Therefore, there has been a rapid rise in expenditures for repayment of principle and interest in the fiscal spending. Not only is the fiscal deficit continuing, but the government is issuing new bonds to pay

back the principle and interest on old ones, so the debt is snowballing. At the end of 1995, the government had a domestic debt balance of 329.6 billion rmb. By the end of 1996, this had risen to over 420.0 billion rmb (author's estimate) or 6 percent of the GDP. In view of the fact that the debt balance in Japan has at its highest been over 40 percent of the GNP, the Chinese level may still not be that dangerous. Still, considering the fact that the ratio of the central government's fiscal revenue to the GDP has been falling every year, the government must be wary of the sharp rise in debt.

(2) Problems in Tax System

The fiscal debt occurs when the fiscal revenue is not keeping up with the work the state is trying to do with its budget. Therefore, let us look at the state of fiscal revenue other than that by flotation of bonds. From 1978 to 1996, the ratio of fiscal revenue, both central and local, to the GNP dropped by a huge margin from 31 percent to 11 percent. A look at the structure of the fiscal revenue shows that the government depended on state-owned and collectively owned enterprises and organizations for 100 percent of its revenue in 1978. This dependence dropped to 88 percent by 1996. Considering that, during the same period, personal incomes had grown tremendously and private enterprises and foreign ventures had grown largely as well, the 88 percent reliance on the state-owned and collectively-owned sector is too high. This reliance on fiscal revenue from a sector which has been relatively slow in growth since the reform began caused the drop in the ratio of fiscal revenues to the GNP.

The tax reforms instituted in 1994 were designed to turn this situation around. The aim of the reforms was to streamline the taxes into a value added tax, corporate income tax, personal income tax, etc. and create a tax system in which all forms of enterprises and individuals had a fair tax burden. Even after the reforms, however, the government continued to rely heavily on the state-owned and collectively-owned sector for its fiscal revenue. Revenues from personal income taxes have grown at a considerably fast pace, but still accounted for just 2.1 percent of fiscal revenue as of 1995.

The tax reforms have not proved effective because the tax collecting system has failed to function. For example, looking at the value added tax, there are frequent cases of tax evasion and illegal tax refunds. The rate of collection of personal income taxes is extremely low. The tax authorities, rather than spend the money to accurately collect taxes, prefer the easy approach of collecting fixed amounts determined by a contract system or the like from SOEs and other entities with which they are used to dealing. In this way, despite the major reforms in the tax system, the structure of tax burdens has not changed that much from the past.

Another objective of the tax reforms of 1994 had been to reestablish the fiscal base of the central government, which has been sinking particularly fast, and strengthen the ability of the central government to redistribute resources to correct the regional disparities in China. Therefore, the former fiscal contracting system was abolished and the types of taxes collectable by the central government and local governments were separately defined. As a result, the share of overall fiscal revenue received by the central government jumped all at once from the 22 percent of 1993 to 56 percent in 1994. To obtain agreement of the local governments over the introduction of this separate tax system, however, the central government has been refunding tax revenue to the local governments so that they can maintain the levels of fiscal revenue of 1993. Therefore, even after the reforms, the amount of revenue available for direct use by the central government has not actually increased that much.

3-2. Problems in Financing System

Since the start of the reform, China's financial assets have grown faster than the nominal GDP. That is, while the nominal GDP grew 19-fold from 1978 to 1996, the money supply grew 42-fold and the M2 86-fold. This shows that as the Chinese economy has grown and become more market oriented, monetization and financial deepening have taken place. Reform of the financial institutions to channel these accumulated financial assets to investors is a major priority. While state banks called "specialized banks" have been established since the start of the reform, the banks continue to supply funds to projects designated by the government, so there has been no major change from the era of the planned economy. Since 1994, reforms have been instituted to separate the commercial bank operations and policy-based financing operations of the state

banks by setting up new banks. Particularly important to watch here is if banks designated as commercial banks can operate soundly as truly independent financial institutions. At present, the industrial ministries still continue to allocate funds from the commercial banks as means of implementing industrial policies. The policy of making the commercial banks independent is therefore not followed in all parts of the government.

Also, the state-owned banks are saddled with huge bad loans – the equivalent of 20 to 30 percent of their outstanding loans. How they will deal with this is another problem. The government has already been allowing enterprises which have run up massive debts and have no hope of repayment to go bankrupt. Funds for writing off these bad loans – about 25.0 billion rmb in 1996, 30.0 billion rmb in 1997, and 40.0 billion rmb in 1998 has been set aside. If the total amount of bad loans is assumed to be 1 trillion rmb (16% of outstanding loans of financial institutions in China in 1996), since the interest alone would swell this by about 100 billion rmb a year, the above planned writeoffs would not be enough to keep up with the growth in the bad loans. The only solution would be to improve the ability of the borrowers to repay their loans and thereby convert these bad loans into good ones or increase the reserves for writing off bad loans. Further, the bad loans include ones created by the interferences of ministries with the banks' operations and ones which the banks made on their own. If the principle of the banks bad loans is not kept clear, it may encourage further bad loans.

Looking at the state of conversion to commercial banks and the bad loans, China still has a long way to go in reforming its financial system. In particular, if it does not release information on the state of the bad loans, the influx of foreign money and the coming liberalization of capital may be obstructed.

4. Foreign Trade and Foreign Investment

4-1. Growth of Foreign Trade

Since the start of the reform, China's foreign trade has grown at a pace faster than economic growth. From 1978 to 1996, exports and imports grew 14-fold in U.S. dollar basis (16% annual increase). The reliance on trade (exports and imports/GDP) rose from 9.8 percent (1978) to 35.5 percent (1996). Calculated from Fig. 1, exports have contributed an average 1.7 percentage points to economic growth. The growth in foreign trade has been the result of various export promotion policies and foreign investment under the policy of opening China up to the outside world. There has been growth in trade in the form of processing and assembling in particular. For example, 70 percent of the increase in exports from 1992 to 1996 and 48 percent of the increase in imports were caused by growth in this type of trade. "Processing and assembling" is a form of trade in which a foreign country supplies the materials and parts for processing and assembly in China and China exports the finished product. In this type of trade, customs tariffs on the imported materials and parts used for the processing and assembly and the machinery used to be waived. Resulting from orders from foreign companies or performed by foreign ventures, this type of trade was possible without the Chinese side having to secure export outlets or developing special technology. Further, since the taxes were waived, it was possible to make use of the advantageous position in production costs made possible by China's vast, inexpensive labor force. In 1996, processing and assembling accounted for 56 percent of the total value of China's exports and 46 percent of its imports.

For processing and assembling, which relies on the low production costs in China, the level of the exchange rate is important. Figure 3 shows the movement in the real effective exchange rate from the end of the 1970s. The real effective exchange rate was calculated for the three largest trading partners of China, that is, Japan, Hong Kong, and the United States[7]. Movement upward in the graph shows real depreciation of China's currency, while movement downward shows appreciation. The repeated reductions of the exchange rate have depreciated renminbi in 1994 to about one-quarter of its value in 1980. Correction of the value of the currency, which was overly assessed in the era of the planned economy, to a level commensurate with the real power of the Chinese economy contributed much to China's growth into a major exporter.

The growth of exports through processing and assembling had major merits for China such as the improvement of its current account balance, the

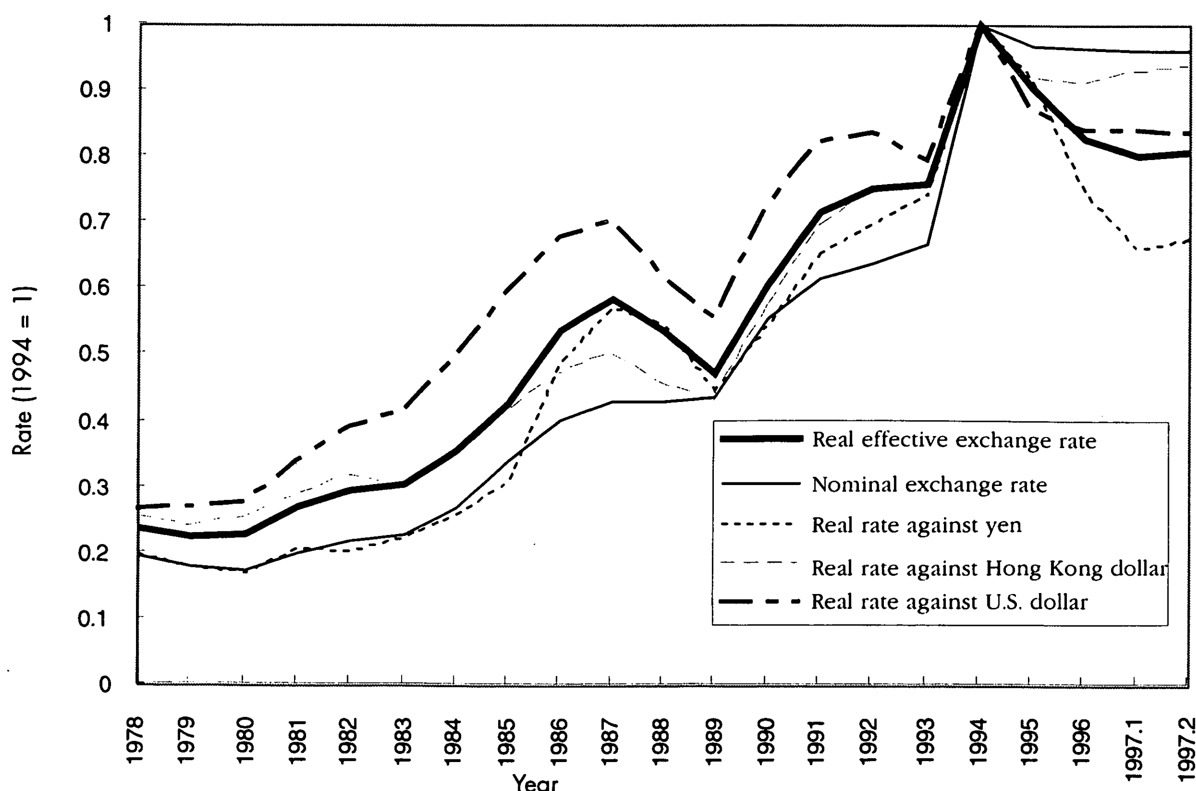
promotion of economic growth, and the creation of jobs for the surplus rural labor. Processing and assembling trade, in which fairly much the entire amount of the machinery, equipment, materials, and parts are imported, ends up almost completely "bypassing" domestic industry[8]. China's industrial structure is therefore being split between a domestic market continuing to be protected by high tariffs and non-tariff barriers and an export industry free of tariffs and trade barriers. The latter has almost no relation with the former, so the effects of increased trade, that is, greater demand, diffusion of technology, and promotion of competition, do not sufficiently reach the domestic market.

In order for China to fully enjoy the backward linkage effects of increased trade, it is necessary to eliminate this split in the industrial structure. Fortunately, policies are heading to this direction. First, the government has been lowering tariff rates and taking down non-tariff barriers in order to gain accession into the World Trade Organization (WTO). The tariff rate was lowered twice, in 1996 and in 1997, from an average 36 percent to 17 percent. As to non-tariff barriers, while restrictions on imports of fuel, machinery, remain, these will gradually be scrapped. Further, the government has been moving to retract some of the incentives set for processing and assembling and foreign direct investment. For example, it decided at the end of 1995 to abolish the tax exemptions on machinery and equipment brought into the country by foreign ventures when setting up their investments and machinery imported for processing and assembling. While there are concerns that this might cause the withdrawal of foreign direct investment from China, it is necessary to eliminate the difference in tariffs between different types of enterprises and trade regimes to correct the above-mentioned split.

4-2. Change in Foreign Investment Policy

Another impressive result of the opening-up policy along with the export growth was the massive influx of foreign direct investment into China. While there had been almost no growth in invest-

Figure 3. Trends in Real Exchange Rate



Source: Calculated based on data from the IMF, IFS, ADB, Key Indicators, etc.

ment from 1979 when China began soliciting foreign direct investment to 1991, investment has grown sharply since 1992 (Table 1). In recent years, China has been the recipient of as much as 40 percent of the foreign direct investment made by the world in the developing countries. It has become the world's second largest recipient of foreign direct investment after the United States[9]. Foreign direct investment accounted for 12 percent of domestic fixed capital investment in 1996. Not only did it make up for the shortage of domestic investment funds, but, by accounting for 41 percent of exports and 54 percent of imports, contributed tremendously to trade growth and technology transfers.

China's foreign investment policy had already been more than effective in attracting large amounts of foreign investment. The Chinese government reevaluated part of its incentives for foreign investment around 1993 and came out with new measures for attracting foreign direct investment. That is, it abolished several of the tax exemptions on imports of machinery and equipment at the time of investment[10]. In 1995, it issued "temporary provisions on the direction of foreign direct investment" and a "list" in which it detailed fields of investment which it encouraged, allowed, restricted, or banned. The list encouraged investment in fields which the government stressed in its industrial policy such as agriculture, infrastructure, communications, and energy, automobiles and other key industries and technology intensive industries along with investment in the inland regions. Conversely, it restricted investment in consumer product industries and labor intensive industries in which China had a surplus production capacity.

Behind this change in its foreign investment policy was the intensification in competition in the domestic market and therefore the deterioration of performance of some SOEs and the growing pressure from these SOEs to protect "national industries". The new foreign investment policy, however, is not necessarily to the liking of the foreign enterprises, so may kill off the rush of foreign direct investment. In fact, while China does indeed have too many enterprises and too large a production capacity in the consumer goods industries, the level of the technology and the brand power are generally low. There is room for foreign businesses to make money through direct investment and therefore they remain strongly interested. Even with regard to the labor intensive industries, the comparative advantage of China of its abundant labor force has still not been fully developed and foreign investors remain interested.

By limiting investment in these areas, not only is there a danger of investment falling, but also there will be limits to how far China can raise its level of technology and tap its comparative advantages. There are doubts as to the effectiveness of the new foreign investment policy as well. The local governments and the enterprises have actually become more interested in forming joint ventures with foreign businesses in order to increase their own competitiveness as competition around them becomes fiercer. The local governments have a certain amount of authority to permit investments, so the central government will not find it easy to push through its new policy.

Table 1. Trends in Foreign Direct Investment in China

	1979-83	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Investments (contract basis)	1392	1856	3073	1498	2233	5945	5779	7273	12978	48764	83437	47549	37011	25446
Value (contract basis US$ billion)	7.742	2.651	5.932	2.834	2.709	5.297	5.6	6.596	11.977	58.124	111.436	82.68	91.282	73.276
Average value per investment* (US$ million)	5.56	1.43	1.93	1.89	1.21	0.89	0.97	0.91	0.92	1.19	1.34	1.74	2.47	2.88
Value (implemented basis, US$ billion)	1.802	1.258	1.661	1.874	2.314	3.194	3.392	3.487	4.366	11.007	27.515	33.767	37.521	41.726

Notes: Calculated by contract value/number of investments.

Source: *Zhongguo tongji nianjian* (China Statistics Yearbook).

As China opens up its markets with the aim of accession to the WTO, it will find it difficult to protect its "national industries" even if restricting the entry of foreign companies. Further, if it were to force foreign direct investment to the inland regions as a matter of policy, it might cause investors to turn elsewhere besides China. Rather than squeezing foreign investment, it would be more effective to strengthen the competitiveness of domestic enterprises and improve the investment environment in the inland regions. Further, when leaving aside investment from Hong Kong, which has already reverted to China, foreign direct investment in China is not yet too high. Rather, China still needs foreign direct investment to secure the funds and technology required for future growth.

Conclusion

The problems which the Chinese economy will face in the future as it tries to realize stable growth may be summarized as follows:

(1) It will have to change the investment practices of the state-owned sector — a cause of violent investment cycles and low investment efficiency. SOEs will have to be reformed as seen in Chapter 5. Further, the investment practices of the government itself are problems. In particular, the local governments continue to recklessly pursue high growth and make superfluous investments. Further, there is some question as to if the central government, with its weak fiscal base, can streamline and maintain a suitable scale of infrastructure projects. Any fundamental change to the investment practices of the government would require government reforms such as changes in government functions. In fact, around 1993, there had been much talk about "changing government jobs" as the economy was made more market-oriented. For example, the Ministry of Textile Industry of the central government was said to be changed to a non-governmental association, named the Textile Association of China. The Textile Association, however, is still strongly a government organization in nature with, the authority to approve or disapprove projects. Government reforms are not easy in that they signify major politic restructuring. For the time being, it would be more realistic to use financial reforms to break the chain so that the enthusiasm of the central and local governments to invest does not lead to greater aggregate demand.

(2) If the state banks are converted to commercial banks, the central government and local governments will theoretically no longer be able to force the banks to provide financing for their projects. Whether the government will be able to restrain itself is the question. Will it be able to establish the principle of government projects being funded solely by the treasury and loans from policy-based financial institutions? If it cannot, the commercial banks will never be made responsible for their own operations and bad loans will continue to be made. Conversely, if the financial system is reformed and stability increased, China will be able to liberalize capital in the future and secure even more foreign money.

(3) Behind the government's propensity to seek official financing from commercial banks is the weakness of its own fiscal revenue base. It is necessary to set up a tax collection system suited to the market economy so as to stabilize the fiscal base. Setting up such a system in a short period of time, however, will incur considerable costs. China will have to be ready to pay for the cost.

(4) Improvement of the efficiency of China's industries will require further technological transfers and competition. In that sense, it is necessary to further open the market and introduce foreign direct investment. The state-owned enterprises, which are exposed to competition by opening up the market, however, have deep ties with the regional economies through employment and tax revenue. Pressure on them from competition would affect the regional societies as a whole. Therefore, there is serious resistance in the domestic market. As clearly indicated by the statement that "opening to the outside world is a long-term basic state policy" in Jiang Zemin's speech at the 15th Party Congress, the Chinese leadership is ready to adhere to the policy of opening the country to the outside world. Chances are high that the policies of opening up the market and positively introducing foreign direct investment will be maintained.

Notes:

1. HIROYUKI IMAI, "Explaining China's Business Cycles", *The Developing Economies*, vol. XXXIV, No. 2, 1996.
2. According to the *Zhongguo tongji nianjian* (China Statistics Yearbook), in 1996, for example, of the fixed capital investment by the state-owned sector, 4.6 percent came from the state budget, 23.6 percent from domestic financing, 6.7 percent from foreign financing, and 50.9 percent from self raised funds. In fact, however, it is considered that 80 percent of what is given as "self raised funds" were bank loans and that overall 80 percent of the financing of investment of the state-owned sector consists of bank loans, issuance of bonds, and other debt. STATE PLANNING COMMISSION, *1994 Zhongguo Touzi Baipishu* (1994 China Investment White Paper), Beijing, Zhongguo jihua chubanshe, 1994.
3. BARRY NAUGHTON, "China's Macroeconomy in Transition", *The China Quarterly*, No. 144, 1995.
4. MARIKO WATANABE, "Chugoku no kinyu shijo no ikusei" (Fostering China's Financial Market), *IDE World Trends*, No. 26, August 1997.
5. The deficit is considered the fiscal spending in Chinese statistics plus the repayments of principle and interest on state debts minus fiscal revenue not including debt revenue.
6. The degree of debt reliance was calculated by the formula of debt revenue/(central fiscal spending + debt expenditures). The method of calculation was based on *Zhongguo caizheng nianjian 1996* (China Fiscal Yearbook 1996), but the results differ.
7. The real effective exchange rate is shown by:
   $ref = \Sigma W_i \cdot \frac{r}{ri} \cdot \frac{pi}{p}$
   where r and ri are the exchange rates to the dollar of one's own country and a country *i* (indexed to the level of 1994), *p* and *pi* are price indexes of one's own country and the country *i*, and *Wi* is the share of the country *i* in one's trade. Here, the three largest trade partners of China, that is, Japan, Hong Kong, and the United States, were considered. For *Wi*, use was made of the shares of 1994.
8. For the "bypassing" in the industrial structure, see TOMOO MARUKAWA, "Ukai to kaitai: chugoku no sangyo boeki kozo no henka to kokuyu kigyo" (Bypassing and Dismantlement: Changes in the Industrial and Trade Structure of China and the State-Owned Enterprises), *Toa*, No. 356, February 1997.
9. *China 2020: Development Challenges in the New Century*, The World Bank, 1997.
10. For more details, see TOMOZO MORINO, "taigai-kaiho no tenkai to kongo no tenbo" (Developments and Future Outlook of Opening-Up Policy), AKIRA FUJIMOTO ed., *Chugoku 21 seiki e no nan-chakuriku* (China: Soft Landing for the 21st Century), Japan External Trade Organization, 1997.