Occasional Papers No 25

HOW STABLE IS CHINA? AN ECONOMIC PERSPECTIVE

Pieter P Bottelier
The World Bank

The South East Asian Central Banks (SEACEN)
Research and Training Centre
Kuala Lumpur Malaysia

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PREFACE

The Occasional Paper No. 25: *'How Stable is China? An Economic Perspective',* was one of the 3 resource papers presented at the SEACEN Seminar on Financial Crisis in the Asian Region, which was held in Kuala Lumpur on 23-25 June 1999. The Seminar aimed at providing a forum for policy-makers from the SEACEN member banks to discuss and exchange views and insights into a wide range of issues emanating from the crisis. It was the first gathering of senior central bankers from the SEACEN countries since the onset of the crisis in mid-1997.

The Occasional Paper No. 25 provides a broad assessment of the external environment which may impact the prospects for economic recovery of the crisis-affected countries. Since becoming the world's seventh largest economy as a result of its rapid growth over the past two decades, domestic instability in China can have serious ramifications on the global economy. The paper examines China's economic strengths and vulnerabilities in the current situation as well as in the short term. It also assesses China's potential sources of instability.

The SEACEN Centre gratefully acknowledges the contribution of Mr. Pieter P. Bottelier, Senior Advisor, Office of the East Asia and Pacific Regional Vice President, the World Bank, for authoring this paper and for his insightful comments during the Seminar. We also wish to thank the World Bank for its support of the event.

The view as expressed in this paper are those of the author's and do not necessarily reflect the views of the World Bank or The SEACEN Centre.

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Kuala Lumpur
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Pieter P. Bottelier

1. Introduction

The Asian financial crisis has raised the level on international anxiety about potential instability in China. Is China as stable as she looks? Could the country's strong external economic position turn around in a short period of time? Can the society and the political system cope with high and rising urban unemployment? Can agricultural surplus labour be absorbed elsewhere in the economy? Is inflation definitely under control or could it erupt again as happened several times since the beginning of the economic reforms in late 1978? In monitoring the Chinese economy, are we missing or misinterpreting important facts and dynamics as most analysts did in the case of Thailand, Indonesia, Malaysia, Philippines and Korea? Since nobody predicted the Asian financial crisis and few "saw it coming", it is prudent to assess China's economic strengths and vulnerabilities.

As a result of turbo-charged growth over the past two decades, China has become the world's seventh largest economy (the second largest on a purchasing power party basis) and the eighth or ninth largest international trader. At current market exchange rates, China's economy is considerably larger, for example, than those of India and Russia combined. Serious instability in China would have global ramifications.

2. China's Stability Since 1978

2.1 The Asian Financial Crisis – China's External Economic Strength

The reason for China's relative invulnerability to contagion following the crisis is the country's strong external economic position:

- Unlike the Asian crisis economies, China had a sizable current account surplus in 1996 and 1997. A smaller surplus is projected for 1998. In other words, China is on balance a net exporter of savings to the rest of the world. The crisis economies (like most developing countries) were significant net users of foreign savings in the pre-crisis years.

- China's external debt of about $142 billion (about the same level as international foreign exchange reserves) is relatively modest and its maturity composition sound. Short-term external debt accounts for only about 25 percent of the total and only a slightly higher share of useable international reserves. Even if short-term debt is significantly underestimated, say by a factor of 150 percent as was the case in Korea, China's short-term debt to useable reserve ratio — a critical indicator of external vulnerability — is still safe. For comparison, Korea's short-term external debt to useable reserve ratio was more than 400 percent before the crisis broke. Most other crisis economies had ratios of between 100 – 200 percent. The total of all private foreign capital that has flown into China during the past six years (more than $120 billion), came in the form of long-term foreign direct investment (FDI), not as short-term bank loans or portfolio investments in local stock exchanges as was more common in the crisis economies.

- China's foreign exchange reserves, at more than $140 billion, are very large relative to imports and other relevant indicators. Moreover, the bulk of reserves is held in relatively liquid form and therefore useable in the event of a crisis. By contrast, only about half of Korea's international reserves were useable when the Asian crisis hit that country in November 1997. The Chinese monetary authorities wish to avoid a further build-up of official reserves. For that reason they have relaxed foreign exchange surrender requirements for exporters, permitted higher levels of foreign investment by Chinese corporations, continued the gradual process of foreign trade liberalisation and raise the amount of foreign exchange that can be purchased by Chinese travelling abroad. (The rate at which new passports are being issued to Chinese citizens for personal travel abroad is now approaching two million per annum.)

- Other than the British pound, the Chinese RMB yuan is the only major currency that appreciated against the US dollar in recent years: about 5 percent in nominal terms since China's devaluation and successful exchange rate unification of 1/1/94. Taking account of the substantial cumulative inflation differential between China and her trading partners, effective appreciation of the RMB yuan between January 1994 and June 1997 was, according to the IMF, about 31 percent, much more than the net effective devaluation for exporters of 1/1/94, estimated at only 7 – 8 percent. The fact that China's exports have, until recently, continued to grow so fast in spite of this large effective currency appreciation, is remarkable. On the supply side, this can only be explained with reference to the foreign funded (mostly from Hong Kong and Taiwan) export-oriented investment boom of the early 1990s, the growing productivity of Chinese export industries, improved marketing and, more recently, decelerating domestic demand which forced many producers to look for outside markets. The post-crisis appearance of small black foreign currency markets in some Chinese cities where the yuan is traded at a discount, is an aberration due to remaining administrative controls and devaluation fear fed by currency traders in isolated local markets.

- Finally, the fact that China had not (yet) made its currency convertible for capital account transactions, made it virtually impossible for speculators to attack the Chinese currency, even if there had been a reason for trying.

2.2 Other Factors Underpinning Current Stability

External economic strength and the awareness of it, are reinforced by a number of political factors that have tended to promote stability and confidence on the part of China's leadership:

- The death of Deng Xiaoping in early 1997 did not lead to internal disturbances or destabilising political strife, as some foreign observers had expected. On the contrary, it consolidated the collective leadership style that had gradually developed since the early 1990s and enhanced national confidence.

- The restoration of mainland sovereignty over Hong Kong on 1 July 1997, proceeded without the disturbances many had expected. Since that time, both sides have observed the Basic Law of 1992. Hong Kong's monetary and fiscal independence have been fully respected. Democratic elections for part of the membership of the new legislative council were held in May as planned. The Hong Kong economy is currently depressed because of the Asian financial crisis, but there are no indications of politically induced economic problems. It is perhaps ironic that to fight economic recession, the Hong Kong Government recently reduced restrictions on private tourism from the mainland.

- Strong reaffirmation of Party commitment to intensify State-owned enterprise (SOE) reform and the development of a modern "rule of law" system, at the opening of the 15th Party Congress in September 1997 and subsequent meetings, provided new impetus and direction to China's incremental marketisation process. Broad statements of objective and method by the leadership, have historically played an important role in the evolution of reform policy and institutional development in China.

- The smooth transition in March 1998 from the Li-Peng Government to the Zhu Rongji Government in accordance with the provisions of the 1982 Constitution was another confidence and stability enhancing event. The new Government is younger, more highly educated and more internationally oriented than the one it replaced.

- The successful visit by President Jiang Zemin to the USA in October 1997, is seen in China as a milestone in the process of gaining international recognition and building a strategic partnership. The return visit to China by President Clinton in June 1998 is expected to reinforce that process.

- The fact that China's economy was not subject to sudden crisis or virulent contagion like Thailand, Malaysia, Indonesia, Philippines and Korea has reaffirmed the leadership's belief in the merits of the country's gradualist, home-grown approach to reform. China participated in the IMF-led rescue package for Thailand (third largest donor after Japan and USA) and provided bilateral crisis-related assistance to Indonesia.

2.3 The Current Economic Situation and Near Term Outlook

The economic reforms, started at the end of 1978, have brought China the longest period of sustained rapid development with stability in well over a century. The tragic Tiananmen incident did not mark the beginning of renewed instability and decline as many had feared. It led indirectly to an intensification of the development effort and an enormous (uncontrolled) investment boom that refuelled inflation. The vast majority of the Chinese population, urban as well as rural, is benefiting from the reforms and supports the Government's economic programme. Average disposable per capita income quadrupled and absolute poverty was significantly reduced. Consumer goods and food supplies, in a greater variety and abundance than ever before, are available almost everywhere in urban and rural China. Vastly improved telecommunications and infrastructure have widened and deepened domestic markets to the point where internal competition has become one of the strongest reform driving forces.

The high inflation (economic overheating due to excess investment in real estate and many industries) of 1992/93/94 was successfully overcome with a macro-stabilisation programme that started mid-1993. As part of this process, China shifted the emphasis in economic control from direct administrative intervention to reliance on indirect instruments of macroeconomic management. A "soft landing" was accomplished in 1996 after wrenching domestic policy adjustments and power shifts. Inflation has dropped out of sight since the middle of 1997. GDP growth gradually dropped from over 14 percent in 1993 to 8.8 percent in 1997. The successful macro-stabilisation programme has contributed significantly to China's current stability, and external economic strength. If China had not made the difficult internal policy and institutional adjustments that permitted a "soft landing" in 1996, the Asian financial crisis would probably have dragged the economy down in a much more serious way.

For the last four years, China's GDP growth has gradually slowed. The current Asian financial crisis has accelerated the slowdown; mainly through its depressing effect on exports to Japan and other countries in the region. Growth has now fallen below the magical 8 percent that China's planners consider necessary for successful reform implementation and labour absorption. The leadership is very concerned that growth is falling too far. Evidence of slack domestic demand and excess production capacity is everywhere. Unsold stocks are piling up in many sectors; prices are depressed. Public sentiment about the economy has become less optimistic. The Government's statistics indicate that GDP growth fell to 7.2 percent in the first quarter and export growth to 12 percent. However, because of the way in which the State Statistical Bureau measures growth (first quarter 1998 over first quarter 1997, rather than comparing seasonally adjusted numbers for sequential quarters, as is normal practice in most countries), these numbers can be misleading. It is possible, even likely, that GDP growth has already flattened to a lower seasonally adjusted rate. Chinese economic statistics tend to overstate growth in a downturn and vice versa. The most likely outcome for 1998 is somewhere in the range of 6 – 8 percent. If there is no revival of export demand and if foreign investment falls, as must be anticipated, GDP growth in 1999 could fall below this range.

To protect stability — a key objective of Chinese policy-making — the Government will undoubtedly do everything possible to reinvigorate the economy. The internal debate is now focussed on how this can be accomplished while at the same time improving the quality of growth, which is critical. Is there a conflict between stimulating growth and accelerating market reforms? There could be, but need not be if the interventions are carefully measured and targeted. Strong reliance on broad relaxation of monetary policy that would benefit loss making SOEs as much as sound enterprises, is to be avoided. China is not yet ready for this approach; it would buy a short-term growth spurt at the expense of greater financial sector problems in the future. China's half-reformed economy calls for greater selectivity. The Government has recently announced that the main emphasis will be on accelerated housing reform and incremental public sector investment in certain types of infrastructure. Housing reform will involve accelerated monetisation of housing subsidies and massive privatisation of house ownership in urban areas. (Rural housing has traditionally been private.) Housing reform can be a very powerful and efficient tool to stimulate China's economy. It will generate a wave of private demand for housing repairs, remodelling as well as financial reserves such as private mortgage financing.

Given the prospect of a continued strong balance of payments and taking into account the small margin of domestic value added in most exports, there will probably be less emphasis in government policy on promoting foreign demand. The Government's firm no-devaluation pledge is most helpful to China's neighbours in crisis, but it is not an act of generosity; it is also in China's interest to keep its exchange rate stable at this juncture. Should the overall balance of payments position deteriorate, a more likely scenario is that China will flexibilise exchange rate policy and allow the "managed float" system, as originally designed for the

Shanghai interbank foreign exchange market, to make gradual adjustments. Other instruments to protect exports are available:

- The Government can improve the profitability of exporters by eliminating the implied export tax (differential between VAT payable on imported imputs and export rebate);

- The Government can relax onerous depreciation rules for income tax purposes and provide other incentives;

- Many light manufacturing enterprises now located at or near the coast can and do relocate to the interior where labour and land cost savings more than compensate for higher transport costs. From an economic perspective, China is not one country, but a collection of countries with substantial differences in factor costs. The theory of shifting comparative advantage between countries at different stages of development, applies equally to China's provinces.

In conclusion, the quality of macroeconomic management in China has significantly improved since the earlier reform period. The external economic situation is very strong. External debt has been managed prudently. The new Government is committed to reform and relatively well equipped to face the very tough economic challenges that lie ahead. Although the deceleration in growth has raised concern about stability, there is some room for manoeuvre and flexible, non-inflationary policy responses to the slowdown or a possible turnaround in the balance of payments. China is studying the causes of the Asian financial crisis to avoid a similar disaster at home. The crisis has added a new sense of urgency to the reform effort, particularly with regard to SOEs and the financial sector. The biggest external threat in the near term future probably lies in the possibility of continuing economic recession in Japan (accounting for almost 20 percent of China's exports in 1996) and/or a deepening of the Asian financial crisis. Yen depreciation helps on the debt side, but makes exporting to Japan harder. The current recession in Hong Kong contributes to the slowdown in China and vice versa. It is unquestionably a source of serious concern. However, the probability of instability in China due to external economic pressures remains low.

3. Potential Sources of Instability

The most important potential sources of instability in China are internal:

(i) Growing unemployment and the lack of adequate social safety nets;
(ii) Financial sector weakness;
(iii) Inflation.

3.1 Growing Unemployment

China's economic reforms have entered a new and more dramatic phase. It will become increasingly difficult to feel Deng Xiaoping's metaphorical stones as the river is getting deeper. During earlier reform phases, there were relatively few people who lost or did not gain. This has changed. Paradoxically, China's growing unemployment is as much a sign of progress in implementing SOE – and other reforms, as it is a major new problem and challenge. Most unemployment and underemployment in the past was hidden through restrictions of labour mobility and labour redundancy in State enterprises. Agricultural surplus labour, released by strong productivity growth over the past two decades, is now able (and can afford) to travel in search of work and a better life elsewhere. Forced by growing domestic competition and mandated by the 15th Party Congress and subsequent reform decisions, numerous medium- and small-scale and some larger SOEs are restructured in a variety of ways: merged, sold, scaled down or closed. Vast numbers of redundant personnel are being furloughed or laid off in the process.[1]

Transparency of the reforms, including privatisation, often leaves much to be desired, but at last, SOE reform is happening on a large scale. Nationwide, it is estimated that some 100,000 out of a total of 300,000 medium- and small-scale SOEs are available for privatisation in a variety of ways. Many have already been sold; many others will be

1. Normally, redundant workers employed in reforming SOEs are first placed on extended furlough with retention of their homes and minimal financial support. Many find other work with or without the help of State-sponsored retraining and job search programmes within twelve months.

closed for lack of buyers. The process is mostly in the hands of the enterprises themselves or their owners at the township, county, municipal or provincial level. Some provinces move faster than others. In Liaoning, for example, all SOEs in the province except two steel mills are for sale. About 15 percent of them have been sold. There are too few buyers for the remaining 85 percent. Many SOEs have zero or negative networth. The reform process is slower with regard to the 5,000 - 6,000 large-scale SOEs, some of which are the main or only source of employment in smaller towns. The Government wishes to retain full ownership and control of about 1,000 strategic SOEs. Accelerated SOE reform should reduce and eventually stop the accumulation of non-performing SOE loans in the banking system.

Slowing domestic demand is adding to the growing open unemployment problem, especially in the Northeast which has a high concentration of large, old and inefficient SOEs. Total registered urban unemployment presently stands at more than 5,000,000. To this, should be added about half of the 10,000,000 furloughed SOE workers who have not yet found another job. This yields a total number of officially recognised urban unemployed of over 10,000,000, or about 6.5 percent if the urban labour force,[2] the highest rate since 1949. In addition, there is a large, but unknown number of unemployed migrant workers who do not have a valid urban residence permit needed for unemployment registration. Many of these migrant workers are now voluntarily returning to rural areas — because rural income growth[3] has been stronger in recent years than urban income growth — or are being involuntarily returned home by police. The 6.5-percent urban unemployment rate is a national average. It hides large regional differences. In big cities in the Northeast, e.g., Shenyang, the number is probably closer to 20 percent. The problem is also serious in Wuhan, Chongqing, parts of greater Shanghai and other cities. By contrast, in young boom towns in the Southeast with few, if any, inefficient SOEs (such as Shenzen), the unemployment rate is very low. Unemployment and social distress have generated protest actions and demonstrations, sometimes of a disruptive and violent character, they could become dangerous to stability beyond the immediate area where they occur.

2. Source: Institute of Economics, China Academy for Social Sciences.

3. In rural areas that depend mainly on grain farming, incomes have stagnated or fallen in recent years because of sharp grain price drops induced by excess supply. Most non-grain agricultural production (accounting for about half of agriculture), however, has sustained rapid income growth in many rural areas.

In light of the current slowdown in both domestic and export demand growth, intensified SOE reform, the massive recently announced civil service downsizing, continued pressure from rural surplus labour and natural labour force growth (about 15 million per annum), the open urban unemployment rate must be expected to rise. It could reach 10 percent of the urban labour force in a few years and the average period that laid-off workers are unemployed before they find alternative work, is likely to lengthen. This is precisely what had been feared most about the market economic reforms, why serious SOE reform had been delayed for so long and why the non-State economy was first allowed and later encouraged to grow so quickly. Had more progress been made in the establishment of social safety nets outside the SOE (the work unit) framework, growing urban unemployment would not have been such a serious problem. At the national level, unemployment-induced social distress is not likely to pose a major threat to stability, but in certain regions it is already a serious problem.

Since China's economic reforms cannot be reversed, some provincial governments have opted for accelerated reform, including large scale privatisation of SOEs, as the safest and quickest way to overcome the deep structural economic problems that have now become fully apparent and better understood. There is no uniform national pattern or pace of SOE reform in China. The central Government is actively promoting the establishment of non-SOE (or work unit) — based social safety nets at the national and regional level through unemployment — and health insurance, direct subsidies, pension reform, temporary public work schemes, job retraining programmes and emerging labour market information and placement services. Many programmes and lending facilities have been developed by SOEs, work units and lower level government to help unemployed workers in starting small private businesses. The scarcity of financial resources, a lack of trained personnel, inadequate institutions and corrupt practices in some areas are the main obstacles to quick progress. In most parts of China, underdeveloped service sectors such as personal care, marketing, financial services, etc., offer the best hope of labour absorption in an otherwise slowing economy. Serious efforts to facilitate adjustment to new market realities and to reduce the social costs associated with unemployment are being made in most parts of China. Since higher rates of unemployment lie ahead, these efforts need to be intensified. Social tolerances for unemployment and associated hardship are likely to be influenced by public perceptions of the quality and honesty of government, and by expectations. Widespread perceptions of corruption or mismanagement, especially at the local level, will greatly enhance the chances that labour unrest will become politicised and threaten stability.

3.2 Financial Sector Weakness and SOE Indebtedness

China's market reforms have yielded impressive economic gains in most areas, but one of the hidden costs of delayed SOE and banking reform has been the gradual deterioration of the asset quality of State commercial banks and the growing indebtedness of SOEs. Much of the SOE debt is non-performing. Consequently, China has a very large internal corporate debt and undercapitalisation problem. This has contributed to the financial weakness of State commercial banks and many other financial institutions, and slowed financial sector reform. The problem is probably worse than it was in Korea before the Asian crisis hit that country in November 1997.

In contrast to SOE debt, the State's direct internal debt, at about 10 percent of GDP, is very modest. The factor offers important potential for ultimately writing off bad SOE debt and recapitalising the State banks. The Asian crisis has heightened the Chinese Government's awareness of the dangers of financial sector fragility and excessive corporate indebtedness. If the problem is mismanaged or left unattended, it could eventually lead to a banking crisis and/or high inflation. China's internal debt problem is like a time bomb with a burning fuse of unknown length. It needs to be defused as soon as possible and the way to do it is to stop the bad debt from growing, followed by a recapitalisation of the banks and a writeoff of uncollectable debt. The Government is fully aware of this. Many corporations will also have to be recapitalised. Financial sector problems can be triggered by events outside the banking or SOE sector. The weaker the banks, the more vulnerable they are to unexpected shocks and the greater the need for Government or Central Bank intervention in case of trouble. The degree of their vulnerability is, of course, also a function of the availability of alternative options for depositors. The range of options typically widens with reforms, as it also the case in China.

The process of financial sector reform and State bank recapitalisation is being accelerated. Many unsound Stated-owned investment corporations and some regional banks that were responsible for overinvestment and subsequent losses in real estate and other sectors, have been closed and their assets disposed of. The Government is now considering the establishment of one or more Asset Management Corporations to assist in the disposal of State commercial bank assets associated with non-performing SOE loans. Resolution Trust Company-type operations are beginning to play a role in the massive, highly decentralised SOE reform and privatisation task that still lies ahead. One of the most intractable dilemmas facing the Chinese Government is the overriding need to preserve social stability and the very pressing need to restore financial sector health, often lead to different conclusions as to the appropriate pace of reform.

The precise degree of undercapitalisation of China's four major State commercial banks is essentially unknowable because of the poor state of their accounts. Even after the planned injection of RMB 270 billion (about US$ 32.5 billion) of new quasi equity capital by the State, their average risk-weighted capital adequacy ratio measured by international standards, remains well below the 8-percent minimum Basle standard. One or more further major equity injections will be needed. A higher rate of bank profitability could also contribute to this process as could an opening to private foreign equity participation in State banks. None of the State commercial banks have so far been audited by international firms; loan classification standards are only now being adjusted to international standards and that will be a time consuming process, because none of China's State banks have adequate provisions or reserves against which to write off bad debt. Because of underprovisioning, their profits tend to be overstated and consequently part of the State's fiscal revenues from banks are based on phantom profits. This is but one illustration of how fiscal problems and banking sector problems in China are interrelated.

In spite of their hugely inflated balance sheets,[4] China's large State commercial banks are nonetheless stable, because of the Government's implicit guarantee of deposits and most other liabilities. While the

4. The amount of non-performing loans (NPL) appearing as assets on the balance sheet of State commercial banks is estimated at about 25 percent of the total and an even higher percentage of GDP. Not all NPLs, however, are non-performing because the debtor is unable to pay. There are a number of circumstances under which debtors and creditors have shared interest in keeping loans in the non-performing category and to capitalise interest which under current rules (that are to be changed) is legal for up to two years.

Chinese State is stable and its creditworthiness not in doubt, the financial weakness of State commercial banks does not present an acute danger to system stability. A domestic confidence crisis of such magnitude that it would undermine the household deposit base of a large part of the State banking system (accounting for 60 percent of all deposits in China), is hard to imagine. Regional financial problems, however, and the failure of some smaller financial institutions may occur, as happened in recent years. The most serious problem presented by the weakness of most State-owned financial institutions in China, is that this situation may ultimately frustrate reform and modernisation efforts and contribute to stagnation. If the reforms get bogged down, the risk of instability in China will greatly increase.

As part of the process of opening domestic markets to foreign competition, it is essential that China open up much further than has been done so far to foreign financial institutions, including commercial banks that take local currency deposits. This has to be a gradual process, but China has tended to err on the cautious side. From a perspective of financial system stability, China can open up the domestic insurance and financial services market quicker than the commercial banking market. More competition in the financial sector is essential for reform and achieving greater efficiency. Unnecessary delays in financial sector reform entail significant risk for China's stability.

3.3 SOE Reform at the Micro Level

SOEs in China are no longer so important in terms of their contribution to GDP — they now account for less than 30 percent of industrial output, compared to 80 percent 15 years ago — but they account for the bulk of State bank assets and the non-performing part of it. The potential for financial system problems grows with the relative size of the non-performing loan portfolio of the banks. Macroeconomic instability is ultimately the reflection of accumulated micro – (or firm level) and banking problems. The Asian financial crisis provides ample evidence of such micro-macro linkages. SOEs in China, like the State banks, have over time become increasingly undercapitalised. The average SOE debt-to-equity-ratio is now probably in the range of 400 – 700 percent. This ratio used to be much lower in China. For comparison, the average debt/equity ratio for Korean chaebols before the crisis was about 350 percent. A normal ratio for large U.S. corporations is of the order of 100 – 150 percent. The debt/equity ratio for manufacturing enterprises in Taiwan, China is an exceptionally low 70 percent. The more highly leveraged, the more vulnerable corporations are to possible increases in interest rates as has been amply demonstrated in the Asian crisis economies, especially Korea. Devaluation and the need for high interest rates to stabilise currencies at their new level has spawned a secondary, this time internal, debt crisis in those countries. A period of high interest rates in China, should the need ever arise, would be extremely problematic for China's unreformed SOEs and State banks. It could destabilise the economy.

The amount of resources that will eventually be required for writing down the bad debt of China's SOEs and recapitalising the banks and corporations is huge, but probably not beyond China's means, provided the flow of new bad debt is stopped soon. This is the hardest part of the problem. The Chinese Government is confident that, in the aggregate, the stock (of bad debt) problem can be solved through a combination of asset sales, privatisation and long-term domestic bond issues that would not create an excessive fiscal burden. Given the large degree of uncertainty with regard to the numbers, it is very difficult to confirm this through objective analysis. China's internal debt problem is in fact even larger and more complicated than indicated above, because of the implicit, but unfunded pension debt of the State and its enterprises. This has become an issue, because China has decided to reform the pension system in the direction of funded individual accounts which means that in the future, payroll deductions for pensions are no longer available to fund current pension obligations through the transfer payment system.

Ultimately, successful, non-inflationary SOE and banking sector reform plus recapitalisation as well as pension reform, will to a large extent depend on very substantial improvements in fiscal revenues and the budget system. None of the aggregate internal problems can or have to be solved overnight. If there is rapid progress at the micro level through privatisation, firm level efficiency improvements, closure of bad firms, manpower training, etc., the time bomb can still be diffused. However pressing the financial sector and SOE problems, China has no option but to continue pursuing a more or less gradual approach to reform. There is no room for a "big-bang" approach that would try to solve all major structural economic and financial problems simultaneously. It makes no sense to write off the accumulated stock of bad SOE debt until the flow of new bad debt has stopped. Otherwise, the expectation of and need for new capital write-offs will inevitably develop, undermining credibility of the Government and integrity of the financial system. Even if the Government wanted to pursue a comprehensive once-and-for-all solution to the SOE bad debt problem, there would not be a sufficiently reliable database on which to make firm level decisions. In the meantime, the financial weakness of China's State banks remains a potential threat to stability, because of the vulnerability to shock that are inherent to weakness.

3.4 Inflation

It may seem strange to raise inflation as an issue at this time, as the problem does not appear to be on the horizon. Yet, the half-reformed status of China's economy, the current economic slowdown and the huge internal debt balloon could rekindle inflation if too much liquidity is injected into the system in an effort to stimulate the economy or solve other problems. Fortunately, the fear of inflation and the damage it can do to the economy and social stability is deeply ingrained in China's leadership. Their ability to manage excess demand — in the past mostly due to excess investment — has greatly improved. The successful macro-stabilisation programme that was started in mid-1993 is a source of pride. No one would consciously risk monetary stability. But the dilemmas and policy conflicts are very complex and intense. Although the lessons of the past appear to have been learned well, policy mistakes can be made and inflation could reappear, also for other reasons.

Macroeconomic management mistakes that could lead to inflation appear less likely at this stage than the possibility of certain micro-level developments that could have the same effect. The stock of money supply in China (M2) has become very large in relation to GDP (well over 100 percent). The velocity of money circulation has been steadily declining over the years. This has contributed to inflation reduction and large earnings by the Central Bank in the form of seignorage. The low and declining velocity of circulation is a reflection of public confidence in continued stability, a high preference for liquid assets and low efficiency of payment systems. None of these factors are likely to be subject to sudden, massive change, but there is nothing permanent about them either. Should there be an increase in velocity, due for example to confidence loss, inflation could reemerge rather quickly as people invest liquid financial assets in goods, houses or foreign exchange. This is what happened in 1988/89. The high inflation of that period is one of the factors that contributed to popular support for political demonstrations in Beijing and other cities. Ultimately, as payment systems modernise and alternatives to liquid financial assets in local currency become more easily available, the ratio of money supply to GDP will come down, but it is essential for stability that this process be gradual.

A change in savings behaviour is another possible micro-level source of renewed inflationary pressure. The Chinese financial system depends on exceptionally large private household savings and current account deposits (about 60 percent of total deposits) to keep it afloat. A large part of these savings is invested by the banks in SOE loans that are non-recoverable, but the Government's implicit deposit guarantee protects confidence and system stability. However, a reduction in the private savings rate (which has been extremely high over many years) would weaken the deposit base of State banks and put pressure on them to accelerate debt write-offs and/or restrict new lending. Under those circumstances, Central Bank intervention to avoid unwanted bankruptcies and to protect growth, may become hard to resist. Such intervention, if it occurs on a large scale, could be inflationary.

Finally, there is of course the possibility of large agricultural production shortfalls due to natural disasters or big policy mistakes. Harvests have been excellent in the last three years and food supplies are plentiful. Grain stocks are at a historical high and domestic grain prices fell by over 10 percent during the past 12 months. (This explains all or most of the recent drop in the retail price index.) A bad grain harvest in 1998 could probably be met from existing stocks, but two bad agricultural years in a row could generate food price-led inflation, because China cannot import grain beyond a certain level, even if international supplies are available. China's reforms still have a long way to go and the possibility of renewed inflation due to either macro- or micro-level factors cannot be ruled out.

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