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PRC Economy

Current and Future Issues for the PRC Economy

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Introduction

This Policy Brief is based on the articles originally appearing in the *Perspectives* series of ADB Institute's e-Newsline from March 2005 to March 2006. This is also regarded as a continuation of Policy Brief No.13 "Hot Topics for the Future of PRC and Hong Kong, China" published in December 2004. The articles included here are not necessarily academic nor technical, but rather the author tried to provide policy makers and ordinary readers who are interested in the PRC and the Asia-Pacific region with various information and some analytical viewpoints for the current and future issues the PRC economy is now facing.

Some of the articles in this Policy Brief are based on the informal discussions with the experts in the PRC as well as in Japan. The author particularly would like to thank Thomas Chan Head of China Business Centre of Hong Kong Polytechnic University, Zhao Zhijun Professor of the Economic Research Institute of Chinese Academy of Social Sciences (CASS), Chen Jianbo Professor of the Development Research Center of State Council (DRC), Liu Li-Gang Senior Manager of Hong Kong Monetary Authority (HKMA), Liu Feng Senior Research Associate of DRC, and Tracy Yang of Australian National University (ANU). Nevertheless, the views expressed are those of the author and do not necessarily reflect the views of others or any organization.

1. Regional Imbalance and Income Disparity

1.1 Decentralization or losing control—Looking through the National People’s Congress

China watchers pay close attention to central regional development strategies (中部勃兴 “zhongbu boxing”) especially since none of these interior provinces has yet appeared on the PRC’s regional top ten list for per capita income. Acutely aware that their local economies lag behind other provinces, representatives from Hubei (湖北), Hunan (湖南), Anhui (安徽) and three other central provinces appealed for strategic governmental assistance at the recent National People’s Congress (NPC).

Under Premier Zhu Ronji’s administration, requests from rural areas were largely ignored or even refused. This position was both consistent with his commitment to fight inflation and with the former premier’s strong personality. More recently things have changed. To emphasize the importance of balanced regional development, the government launched the famous “go west” policy (西部大开发 “xibu da kaifa”) aimed at developing inland areas. It also targeted state-owned enterprises (SOEs) in the northeast for restructuring. Still, central area provinces complain that other regions receive comparatively more governmental support.

How the central government will manage ongoing request for development assistance remains unclear. A primary commitment of the current administration is to realistically address regional disparities. Accompanying this commitment is a new management style and control of administrative directives that contrasts sharply from the former regime; and local officials are keenly aware of the new environment. One example is the way in which local representatives

are using the annual NPC to convey requests and engage in substantive discussions with central government officials. Unlike before, when the NPC was essentially a ceremonial event, the meeting now serves as an important opportunity for practical discussion. And though this is a significant step toward decentralization, it may also indicate a gradual loss of central government control over the provinces.

Over the past two years, the central government's response to provincial development requests has led to overinvestment that has caused overheating in certain sectors of the economy. One might expect Beijing to abandon decentralization policies and return to a more centrally planned system. That may not be possible given the current economic climate. Another choice might be for the government to pursue a "Pareto improvement" strategy to address regional disparity. By further promoting marketization and decentralization throughout the country PRC authorities could create more job opportunities for poor people through SOE reform and various deregulation measures without sacrificing the welfare of any other people. Either way, regional income disparity and development imbalances will become increasingly critical economic and social issues. (31 March 2005)

1.2 Income disparity and poverty in the PRC

China watchers and PRC officials alike now view the widening income gap between urban and rural areas, and the disparity within each of these areas, as one of the most serious problems facing the country. While there are few reliable indicators to accurately show income disparity, some of the estimates put forward by local experts are telling.

According to these experts, in 1990 the average income in eastern regions was 2.1 times higher than in the west. By 2003 this gap widened to 3.24 times that amount. Apparently, the income gap is widening more within urban areas. Recent surveys released by the National Statistical Bureau confirm this to be the case, and indicate that the urban income gap is up 11.8 times; a sharp increase from 4.16 and 5.7 in 1996 and 2000 respectively. The Ministry of Labor also reports that the top 10 percent of rich people own 45 percent of urban wealth whereas the bottom 10 percent of poor people own only 1.4 percent.

One well-known indicator for representing the degree of income disparity, the Gini coefficient, indicates much the same. The nationwide PRC Gini coefficient recently increased from 0.39 in 1995 to 0.48, which is well above the internationally recognized alert line of 0.4. And when looking at the breakdown, the Gini coefficient in urban areas increased more rapidly from 0.28 in 1995 to 0.32 in 2002 compared to a moderate increase in rural areas of 0.34 to 0.37 during the same period (see Table page 4).

At the outset of the economic reforms Deng Xiaoping's controversial statement, "let a part of the people become rich first," acknowledged that a certain level of income disparity was to be expected. Without a doubt, rapid economic growth in the PRC has alleviated poverty and steadily improved the economic circumstances of millions of people. The government officially reports that the number of rural poor declined from 250 million in 1978 to only 34 million in 1999, and that rural income has grown by 5 times since the beginning of the economic reforms. Nevertheless, the World Bank estimates the number of poor at around 200 million based on its own criteria.

Looking ahead, so long as Pareto improvement continues, social tension arising from income disparity may not become critical. To achieve this outcome the PRC must maintain its unusually high economic growth. The sustainability of such a plan may be challenged by a need to slow down economic growth to address overinvestment and respond to environmental concerns. Alternatively, income disparity may follow the famous Kuznet's hypothesis, which argues that the Gini coefficient hits its peak (or shows a reverse U curve) when a country arrives at a stage of middle income, and begins to decline as it becomes a high-income country.

Based on this idea, one could argue that the PRC is on its way from a low income to the middle-income stage where the Gini coefficient trends sharply upwards. This would suggest that income disparity would decline over the medium to long term. But for the short term, income disparity remains a social problem that may not wait patiently for the Kuznets' curve to peak. Perhaps measures not only to raise GDP growth rate but also to address the income gap directly will contribute to reducing poverty and making "efficiency" and "equity" compatible. (22 November 2005)

(Table) Gini Coefficient Estimates

	1995	2000	2001	2002
Nationwide	0.39	0.42	0.44	0.44
Urban	0.28	0.32	N.A.	0.32
Rural	0.34	0.35	N.A.	0.37

Source: Chinese Academy of Social Sciences

1.3 The real problem of regional imbalance in the PRC

There is growing concern among PRC official about the widening income gap between coastal and rural areas of the country. Yet knowledgeable business observers and foreign visitors report the contrary, saying that rural Chinese generally look happy and seem to enjoy their lifestyle. These outside observers seem to suggest that the widening income gap is not as serious as presumed, and that regional imbalance, or a two-tiered economic structure in the PRC provides a solid basis for high economic growth and strong industrial competitiveness globally. These observers acknowledge that rural poverty forces people to search for jobs and income in urban areas but argue that after they work for a few years the migrant workers return to their native homes with money to contribute to local consumption and economic development. This is viewed as a positive cycle that enables the PRC to sustain its high level of economic growth.

Such an argument makes a few compelling points, particularly in view of Japan's experience during the high growth, boom years of the 1960's and early 1970's. In Japan's case, the end of the high growth period coincided with the arrival of improved rural economic conditions and the disappearance of regional economic imbalances. The fact that rural people feel happy and enjoy their lifestyle may somehow provide an attractive model of existence for outsiders who live a more stressful, modern existence. It may also provide useful insights when considering the impacts of development assistance on the people's quality of life. Such observations do not, however, reflect on the full range of issues related to regional imbalances in a country.

After all, objective and quantitative indicators such as real income, availability of goods and services, education, sanitation, health care, and mortality rates, should be used to assess income disparity and regional imbalances. Based on these indicators, it is

difficult to deny that serious regional imbalances exist in the PRC. It is possible that rural residents in the PRC remain satisfied only because they have no way to compare their situation to urban areas. But as television and internet connectivity penetrate rural areas, local people may become aware of the discrepancy. Although PRC officials have made no announcements, there are occasional rumors that riots have occurred in rural areas. If so, one cannot be certain about the underlying causes of such social unrest. Regardless, there is much more certainty around the fact that high economic growth supported by regional imbalances and income disparity can never be sustainable long-term. (28 February 2006)

2. Industry and Economic Reform

2.1 Second chance for PRC venture capital firms

The history of venture capital (VC) firms in the PRC (风险事业 “fengxian shiye”) is short and undistinguished. In the early 1980’s many VC firms were established following Deng Xiaoping’s slogan, “science and technology constitute the main engine for production.” The VC firms generally grew out of university research institutions, but failed more often than not because of financial constraints. VC firms are still not an active part of the PRC economy. University graduates prefer to forgo the financial and personal risks of starting a business and instead seek stable employment in the government sector, with state owned enterprises, or with foreign companies. Even in areas where private enterprise is very active, like Jiangsu (江苏) and Guangdong (广东) provinces, only 2–3 percent of students have plans to start their own firms.

Because the PRC government fully appreciates the critical role that VC firms can play as a market economy reaches a certain stage of development, there is renewed support for VC development. The Ministry of Labor plans to initiate training programs that will assist students and laid-off workers in starting independent firms. Shanghai Municipality announced that financial support would be provided for start-up plans, and provisional regulations for VC firm management are soon to be approved. The provisions include the creation of investment funds and the development of a second board on the stock exchange. Rising unemployment is intensifying the competition for good jobs among university graduates (3 million per year) who are no longer a guaranteed elite. Government assistance for start-up VC firms is expected to mitigate such pressure as well.

Since PRC corporate finance relies heavily on bank loans, the main bottleneck for VC firms is how to access financial backing (see Note page 8). In order to mobilize household savings and promote higher risk investment, further development of the PRC capital market will be required. And unless PRC authorities can fully monitor the efficient use of resources for VC financing, their development may create another opportunity for corruption.

Still, there's reason to have an optimistic long-term view of VC development in the PRC. It took Japan over two decades to turn its VC firms into profitable entities, and the US has a similar long history in this regard. Of course, one difference is how the PRC's unique pursuit to achieve a "socialist market economy" will nurture VC development. Defining the proper role of government in encouraging VC firms, whether it is through minimal intervention or heavy-handed guidance, becomes more complex than is the case in capitalist market-oriented countries. (21 June 2005)

Note:

The China Business Review (July–August 2004) reports that due to VC’s limited financial accessibility, private equity investors are often the only ones with money for VC. In spite of various difficulties including opaque laws and regulations, foreign private equity investors are paying attention to the huge potentiality of private equity market in the PRC and already have some successes. It reports PRC attracted \$1.3 billion in private equity in 2003, of which \$1 billion go to venture investments.

(Table) Total Venture Capital Investment in the PRC (\$ million)

<u>Pre-2001</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
\$2,318	\$518	\$418	\$992

Source: China Business Review

2.2 Transportation sector in the PRC

Since the PRC’s entry into the WTO in 2001, the transportation sector has gradually opened up to foreign investors. 2005 marked the first year of fully open logistics, road freight transportation, maintenance, and repair markets in the country. Foreign investors can now run both joint ownership enterprises and wholly foreign-owned freight transport enterprises.

Trucking accounts for roughly 75% of the freight transport markets, and that percentage has been growing (see Table page 10). Such an increase poses a number of challenges for PRC authorities already trying to impose tighter regulations to improve transportation “safety” and encourage “energy savings.” As market demand for direct, on-time delivery has increased, so has the need for PRC officials to secure safer transportation practices. However, sector experts note that the logistics market currently faces over-competition, and freight companies tend to overload freight trucks illegally in order

to reduce costs. Such practices amount to a form of tax evasion, and result in road destruction and serious environmental degradation.

Although foreign companies account for 60% of the export freight market, their share of domestic freight is minimal. The domestic freight market remains dominated by highly competitive domestic companies, which would suggest that entry of foreign companies into the sector would not significantly affect the market. However, the growing PRC economy continues to attract foreign firms to the potentially huge PRC freight logistics market. Foreign firms generally target “high value-add” transportation such as the delivery of frozen commodities requiring refrigeration or delivery of high-end, IT related goods that must be transported without vibration. In addition, foreign companies try to introduce sophisticated logistics networks, find niche markets, and coexist with PRC companies.

Like other sectors, such as banking, opening the transportation sector to foreign competition is a generally positive step that will likely accelerate the modernization and restructuring of domestic companies in that sector. To promote this outcome, PRC authorities need to consider the pros and cons of the range of transportation modalities in order to ensure that policies are efficient and conducive to environmental protection. One consideration might be to expand the use of rail transport for ordinary freight. Experts in this sector point out a continued prejudice against using rail to transport goods other than grains and raw materials such as coal. And because train tables are not fully available to citizens, there is a broad perception that rail transport is neither efficient nor convenient. Another constraint is that the government has maintained full control of the railway system until recently. In July 2005, the Ministry of Railway announced measures to promote private capital investment in railway construction and management. This is an encouraging sign. (21 December 2005)

**(Table) Freight Transportation by Modality
(hundred million ton, %)**

	Surface (road)	Rail	Water	Total
1980	38.2 (69.9%)	11.1 (20.4%)	4.2 (7.8%)	54.7 (100%)
1990	72.4 (74.6%)	15.1 (15.5%)	8.0 (8.3%)	97.1 (100%)
2000	105.6 (77.7%)	19.3 (14.2%)	13.3 (9.8%)	135.9 (100%)
2003	116.0 (74.6%)	22.1 (14.2%)	15.8 (10.1%)	156.1 (100%)

Source: China Statistical Bureau

2.3 The real issue behind postal restructuring in the PRC

The discussion around postal restructuring in the PRC is heating up among concerned parties such as China Post, the China Banking Regulatory Commission, the State Council, and also foreign investors who as of December 2005 can operate fully owned logistics and express delivery companies in the country. The discussion is fueled by reports that the State Council has decided in principle to split the current China Post into three organizations. Though details of this scheme have yet to be announced, the possible restructuring would have the State Postal Bureau concentrate on regulating postal business, have the China Post Group Corporation run various postal services, and engage the Postal Depository Bank in the deposit and loan business of postal savings. With more than RMB 1 trillion in deposits this would make the Postal Depository Bank the fifth-largest commercial bank in the PRC (see Table page 12).

One possible rationale behind the restructuring is to separate the supervisory and enterprise functions that are currently held by China Post. Delineating these postal functions would introduce a measure of fair competition into the logistics market for international express companies. A second rationale is that by establishing an independent

depository bank that engages in small loan operations, the restructuring stands to mobilize huge amounts of postal savings. Currently, not all of the RMB 800 billion that is deposited in the People's Bank is mobilized. If such a bank is created it will naturally fall under the supervision of the China Banking Regulatory Commission, and in the process China Post will lose its most profitable business.

In Japan postal restructuring has met with strong resistance from vested groups such as "specially designated postal offices," the postal labors union, and lawmakers supported by those groups. While the absence of such groups in the PRC should make some aspects of the restructuring process easier than in Japan, the China Post itself represents a powerful vested interest group. According to China Economic News, postal savings contributes almost 40 percent of the total PRC postal system revenue even though postal savings has fewer employees than do other postal services. China Post's resistance to losing its most profitable business could slow down any restructuring efforts. Much like the forces driving postal restructuring in Japan, the PRC also faces considerable external pressure to restructure its postal business. This pressure intensified once the PRC committed to an open postal business market upon joining the WTO.

Domestic bureaucratic struggles aside, the real issue for the PRC is how best to mobilize these valuable, under-utilized financial resources. Even though significant postal deposits come from rural areas through the wide rural postal network, these resources are flowing to urban areas. Finding a way to redirect these financial resources to rural areas is an important consideration for developing these areas. In this sense, the postal restructuring discussion may well be an extension of the policy debate aimed at addressing regional imbalances in the Mainland. (26 December 2005)

(Table) Growing outstanding of postal saving (billion RMB, %)

2000	457.90	(20 % increase)
2001	591.10	(29 % increase)
2002	736.90	(25 % increase)
2003	898.80	(22 % increase)
2004	1,078.70	(20 % increase)

Source: China Post

**2.4 Foreign-invested companies in the PRC:
Joint partnerships or wholly foreign-owned?**

The PRC has three types of foreign-invested companies (三资企业 “sanzi qiye”): Sino-foreign joint partnerships, joint cooperation companies, and wholly foreign-owned companies. In the past, joint partnerships accounted for roughly half of these, while the share of wholly foreign-owned companies was around 30 percent. The number has grown since the late 1990’s, and through to the PRC’s entry into the WTO in 2001, such that by 2003 the number of foreign owned companies had increased to 65.5 percent. Now, the number of joint-cooperation companies has become negligible.

Japanese companies are no exception. The proportion of joint partnerships compared to wholly Japanese-owned companies was 60:40 in the past, but since 2000 the proportion has changed to 30:70. Companies 100 percent owned by Japanese capital have gradually become mainstream in the PRC. This is partly because PRC officials have softened their attitude toward total foreign ownership (see Note page 14) since entering the WTO. Local PRC governments have also come to welcome these companies. An example of this is that foreign companies were previously required to sell all of their products outside the PRC whereas now they are merely “encouraged” to do so. This has led many multinationals to pursue sole proprietorship to

avoid management conflicts with PRC-based partners. And now, multinationals exhibit a higher degree of confidence in the PRC market since its WTO entry.

What are the pros and cons of each type of foreign-invested company? The organization and management of joint partnerships is regulated by the Joint Partnership and Company Management Act, which offers little latitude for foreign capital. While no such regulations constrain wholly foreign-invested companies, PRC authorities have adopted stringent approval policies for setting up wholly foreign-owned companies. Though even with capital constraints, joint partnership companies benefit from their PRC partners' connections to government institutions, and also from access to domestic partners' sales networks. This joint-ownership arrangement should be a valuable advantage in doing business in the notoriously difficult PRC market. To overcome this advantage, foreign companies trying to move to wholly foreign-owned status either try to purchase domestic partners' shares and convert the joint partnership into a total foreign arrangement, or a foreign company might just acquire an existing state-owned enterprise.

PRC authorities seem to accept this trend as inevitable particularly as multinational companies become increasingly borderless, and as the PRC itself pursues more open economic policies. Since prior joint partnership arrangements have not necessarily resulted in technology transfers, the most important issue may be how PRC officials can use this trend to encourage domestic companies to develop technologies that will enhance their own international competitiveness. Additionally, the PRC needs to identify sectors that may be vulnerable internationally and establish a detailed timetable for allowing wholly foreign-owned companies into those sectors. Certainly the PRC should not engage in protectionism, but it must

foster economic conditions that will avoid adverse effects on the domestic economy. (4 January 2006)

Note:

China Daily February 2006 introduces “Wholly-Owned Foreign Enterprises” as one of the latest investment policies in the PRC as follows.

They are enterprises set up in the PRC by foreign companies or economic bodies in accordance with Chinese law with the investment entirely provided by foreign investors. Such enterprises must be conducive to the development of PRC’s national economy; they must also meet one of the following requirements:

1. The application of internationally advanced technology
2. The orientation of most of the products for export

The corporate form of foreign enterprises in the PRC is generally the limited liability company. Although PRC has been late on the scene in terms of providing a system of establishment for foreign enterprises, they have grown in number rapidly over the past few years.

2.5 SME policy in the PRC: Lessons from other countries

The overall picture of small and medium-sized enterprise (SME) policy in the PRC can be observed through the Act on the Promotion of SMEs. This Act came into effect in 2003 and exists as the only SME-specific statute that includes such policy measures as financial support for start-up businesses, technological innovation, and market expansion. The Act also states that the government will provide various information and training services for SMEs. However, since the Act is both brief and ambiguous, and contains no specific provisions for implementation, it falls short of a comprehensive SME policy for the country.

Globally, there are two general approaches to SME policy. The first approach reflects the typical SME policy in the United States where SMEs are viewed as market participants and US policy makers try to ensure a fair and competitive market environment conducive to SME development. While the role of policy-lending financial

institutions is limited and SME financing is mainly supported by the government guarantee of commercial loans, support for start-up businesses is at the core of SME policy. Contrary to this principle, there are individual cases where US authorities try to protect internationally uncompetitive industries and enterprises.

The second approach can be understood by studying the Japanese experience with SME policy following World War II through to the 1970's. Compared to large enterprises, SMEs were perceived to be disadvantaged in technical skills, human resource and financing capability, which led to SME policies that protected them from market forces. Accordingly, SME policy in Japan became one of the "industrial policies" for many years and was characterized by the "industrial restructuring programs" of the mid-60's that aimed to adjust lag-behind SMEs to the new industrial structure. At that time various "market-distorted" measures such as preferential tax treatments, favorable government subsidies, and favorable loans by policy-lending financial institutions specializing on SME financing were also introduced. During this period the policy agenda was not necessarily to support start-up business and venture capital.

Following the 1980's, the Japanese government began recognizing SMEs as market participants and contributors to the national economy with diversified skills and innovations. SME policy has gradually shifted from a protectionist approach to a more market-oriented approach. Measures now aim to promote a fair and competitive market and support SME innovation to enhance competitiveness. Since the mid-1990's support for SME start-up businesses and venture capital projects has strengthened.

The PRC's current SME policy could be characterized as a mixture of both approaches. In one sense, there does not seem to be a clear vision about the role government should play in SME promotion.

This may partly reflect the transitional nature of the PRC’s “socialist market economy,” but it might also be a response to the changing global economic picture. Unlike Japan during the initial phase of SME promotion from the 1950’s to the 1970’s, the surrounding world economy has become incomparably borderless. This means that SMEs in the PRC not only face competition from large, domestic state-owned enterprises, but also from foreign enterprises and multinationals.

The most salient reason for PRC authorities to promote SMEs is the need to absorb a redundant labor force, particularly in the rural areas. In this regard, PRC authorities must first identify a basic vision for SME policy, and then proactively move on implementing specific measures. Meanwhile the government could take certain protectionist measures, and also may draw on recent progress in developing financial markets with the credit-scoring loan model, relationship banking, and the development of asset-based lending (see Note below). All of these measures could address the financial difficulties that face SMEs in the PRC. (13 March 2006)

Note:

Credit-scoring loan model — The model scores the credibility of each SME based on its past credit history and debt outstanding. Banks rather mechanically decide whether to provide loans or not based on this score, which greatly contributes to streamlining the loan processing and reducing the unit cost of loan processing. The underlying assumption here seems to be the past trends will continue, and similar enterprises generally exhibit similar behavior.

Relationship banking for SMEs — When commercial banks consider providing loans to SMEs, they put more emphasis on the level of technology, management skills of executives, and the accountability of financial statements rather than collateral and the guarantee by the representative of the company. Such a tendency stresses the importance of observing SMEs as a “going concern” from a long-term and qualitative perspective.

Asset-based lending — This approach focuses on a SME’s assets other than immovable property, such as accounts receivable and inventory. Moveable assets back such lending. Therefore an SME with an uncertain future cash flow due to information asymmetry between the commercial bank and the SME could also receive it.

2.6 System transformation in the PRC

For more than 25 years the PRC has transformed itself from a centrally planned economy to a more market oriented economy. Over this time the role of state-owned enterprises (SOEs) has diminished while private enterprises have emerged to play a more critical role. Until now, there has not been a detailed study that examines this transformation (“gaizhi” or 改制) along with the new ownership diversification to determine the impact these changes have made on governance, labor, and firm performance. The book “China Ownership Transformation: Process, Outcomes and Prospects” recently released by the IFC attempts to fill this gap by presenting valuable data from a survey of around 700 Chinese enterprises in 11 cities (see Table page 19).

The survey tries to identify the factors that contribute to the gaizhi process, and reveals that improving enterprise efficiency is not necessarily the primary factor motivating governments to initiate privatization. Rather, it concludes that regional factors such as the overall progress of market liberalization and private sector development, can deeply affect the gaizhi process. The survey also points out that restructuring and privatization are not always associated with unemployment, but in many cases can contribute to increasing job opportunities. This one important policy implication suggests that policy makers should view the impact of gaizhi from a medium and long-term perspective. PRC authorities seem to realize this since they continue to promote private sector development as a

means of absorbing redundant labor forces that are created by SOE reforms.

The most important message from this survey is that while increased ownership diversity has greatly improved the efficiency of PRC enterprises, it has not always impacted income distribution in a positive way. Equity in income distribution continues to be an issue, and the progress of the transformation in ownership places pressure on authorities to create and enforce a more equitable market environment. It is important to remember that market mechanisms help firms perform more efficiently and achieve the Pareto optimal resource allocation; however, these mechanisms are silent with regard to income distribution. The creation of a sound regulatory framework is essential to ensure fairness, and it is important to note that many private enterprises still do not have the access to financing that SOEs do. Such a framework will not solve the current problem of a widening income gap.

In response, PRC officials have put forward the idea of a “harmonious society” and are trying to shift the policy focus more towards this problem. This shift of stance may require additional social policies and government interventions in the market. How these measures will fit with the progress of economic restructuring, in particular the development of the private sector, remains to be seen. Currently the debate in PRC academic circles, between the traditionally dominant “new liberalism school” and the newly growing “new leftist school,” reflects a measure of progress on this matter.

Another important issue worth examining is the impact that ownership diversification and private sector development have on the overall PRC political and social system. In fact, some Chinese people are worried that privatization and the diminishing power of SOEs will challenge the PRC system of one party rule. In other words, what is

the role of the State under market socialism? In some senses it appears that economic imperatives overshadow this issue and therefore, it is not given the consideration it merits. However, sooner or later, the PRC will need to confront this issue. If PRC authorities delay political reform and push aside economic imperatives by maintaining control over the economy through SOE ownership, corruption and myopic behavior on the part of both enterprises and the government may emerge. The challenge is going to be how gradually the PRC authorities can adjust the political and social systems while responding to more immediate pressures for economic development.

Source: The full text is available in the “Book Review” section of the Asia Pacific Economic Literature, May 2006 edition.

(Table) Composition of PRC’s GDP by Ownership Types (%)

	State Controlled	Nonstate	Collectives	Private*
1998	41	59	22	31
1999	40	60	20	33
2000	39	61	18	36
2001	38	62	17	38
2002	36	64	14	40
2003	34	66	13	44

* “Private” includes “red hats” and foreign invested enterprises.

Source: “China’s Ownership Transformation; Process, Outcomes, Prospects,” IFC 2005

3. Money and Finance

3.1 What the yuan can learn from the yen

The renminbi exchange rate has attracted significant attention from both market participants and government officials. Assessing how the renminbi's sharp appreciation will impact the economy of the PRC remains a heated discussion point among experts. Here history may offer us some insights (see Table page 22). Japan's economy underwent two periods of sharp yen appreciation subsequent to World War II. The first period occurred when President Nixon suspended the convertibility of the US dollar to gold in 1971. This shock led major currencies, including the Japanese yen, to shift from fixed rate systems to floating rate systems. The yen then sharply appreciated from 360 to 260, which lasted for several years. The second big yen appreciation coincided with the "Plaza Accord" of 1985 that brought radical adjustments to major currencies vis-à-vis the US dollar. Between 1985 and 1987 the Japanese yen increased from 240 to 120.

Interestingly, both periods were marked by high economic growth in the United States coupled with a subsequent deterioration of US trade and fiscal balances. Concurrently, Japan was enjoying export-driven economic growth and a significant trade surplus. Political and geographical considerations were also important. During these two periods of yen appreciation, the US was involved in the Viet Nam War and an intensifying Cold War. These periods of increased US military expenditures aggravated the US fiscal balance, much as the current situation in Iraq now burdens the US economy.

What lessons can be drawn from the yen's experiences then? Japan's primary concern during sharp appreciations was the impact of the yen on the export-driven manufacturing industries and the consequent economic slowdown. To address these worries, Japan

attempted to maintain a pegged rate system as well as minimize further appreciation by stimulating domestic demand. Excessive domestic adjustments were made to maintain the external equilibrium. Monetary policy appeared to lose its free hand. And notable, Japan's economy suffered from hyperinflation or "economic bubbles" following both appreciations. Another point to remember is that the yen's appreciation in both periods triggered large-scale and far-reaching changes in Japan's industrial structure. In the 1970's, assembly-type machinery industries such as automobile and electronic appliances became mainstream. They replaced traditional heavy steel and chemical industries. Following the yen's sharp appreciation in the 1980's more high value-added industries began growing domestically. Manufacturing companies started operations overseas by using FDI.

There is a trade-off between adhering to a fixed rate system and maintaining an independent monetary policy under free international capital transactions. While the liberalization of capital actions is not yet complete in the PRC, nuanced options other than a pure pegged system or a perfect floating system do exist. As the yen model has shown, the impacts of appreciation are long-range and far-reaching, which means the PRC need always keep in mind the eventual winners and losers from any currency fluctuation. (14 March 2005. Recapitulation from Policy Brief No. 14)

(Table) Background Comparison Between the PRC and Japan

<u>For the PRC</u>	<u>For Japan</u>
(Similarity)	
<ul style="list-style-type: none">▪ US war on terror, Iraq▪ PRC trade surplus with US▪ US inflation pressure▪ US fiscal deficit▪ High foreign reserves	<ul style="list-style-type: none">▪ US war in Viet Nam▪ Japan trade surplus with the US▪ US inflation pressure▪ US fiscal deficit▪ High foreign reserves
(Differences)	
<ul style="list-style-type: none">▪ PRC FDI surplus▪ Capital account liberalization already in place in major countries▪ Some lessons to learn▪ PRC remains a developing country	<ul style="list-style-type: none">▪ Japan FDI deficit▪ Capital account liberalization not complete in major countries▪ No lessons learned▪ Japan was already an industrialized nation

Source: Kanamori & Zhao, 2006, "The Renminbi Exchange Rate Revaluation: Theory, Practice and Lessons from Japan," ADB Institute

3.2 Reasons behind the PRC's resistance to renminbi (RMB) appreciation

Two of the most serious, unsolved policy issues facing the PRC government have important connections to the issue of renminbi appreciation: unemployment and non-performing loans (NPLs) in state-owned banks (SOBs). Although official urban unemployment figures are well below other countries, showing 4.2 percent or 8 million unemployed, the larger picture is more serious. Restructuring of the state-owned sector generated at least 10 million laid-off workers (下岗 "xiagang") in urban areas, and when added to the excess 150 million workers in rural areas, the real unemployment rate climbs to

25–30 percent nationwide. The addition of 8–10 million workers flowing into urban areas per annum raises the total labor force by about 15 million, and puts mounting pressure on the PRC’s labor markets.

Foreign direct investment (FDI) is currently seen as one remedy that can absorb excess labor and mitigate immediate unemployment problems. Many foreign companies in search of cheap labor have set up production lines that utilize rural workers, particularly in the special economic zones. Sharp renminbi appreciation could not only cause a decline in FDI by effectively raising operation costs for companies, it could also damage the already uncompetitive agriculture sector and state-owned enterprise sector creating even more excess labor. Losing FDI would thus mean an even bleaker labor market.

While NPLs are now officially reported as 15–20 percent of GDP, some experts estimate the real rate to be around 35 percent. Furthermore, the recent decline in the NPL ratio seems to be mostly due to the increase in lending volume, which means that new NPLs could surface in the next few years. PRC authorities acknowledge the need to invite foreign investors in to solve this problem. In fact, the Ministry of Finance issued a circular in 2004 on administration of foreign debts relating to external transfer of NPLs by asset management corporations (AMCs), which aims to streamline the procedure and attract foreign investors to invest in NPLs.

In late 2004, Huarong (华融) AMC reportedly targeted foreign investors in an attempt to sell a package worth 150 billion RMB, the largest deal so far. Silver Grant International Industries Ltd., which is a Hong Kong, China listed company controlled by China Xinda (信达) AMC, was established to dispose of NPLs. Silver reportedly unveiled a plan to sell more than US\$200 million worth of new shares and convertible instruments to Citigroup Global Investment Management.

In January 2005, Silver and Citigroup signed a memorandum of understanding to establish a joint venture that will invest in NPLs in the PRC. If the renminbi appreciates, foreign investors may grow hesitant to buy NPL's. These underlying factors are important to remember when trying to understand why the PRC sticks with its dollar-pegged renminbi. (10 June 2005)

3.3 A dangerous cycle: Foreign reserves, price determinants, and renminbi appreciation

PRC foreign reserve holdings have been accumulating rapidly. At the end of the first quarter of 2005 the figure stood at about US\$660 billion, almost 50 percent more than the corresponding month in 2004. Both current and capital accounts in the PRC have registered surpluses, and swelling the foreign reserves is an inflow of speculative “hot money” (热钱 “reqian”). This inflow, which has been attributed to repatriating capital flight, has grown significantly over the past three years, a period coinciding with the intensified appreciation pressure on the renminbi. Some estimates show levels of errors and omissions in the balance of payments that reflect the inflow of hot money in amounts of US\$7.8, 18.4, and 20 billion for the years from 2002–2004, respectively.

A cyclical effect seems to be occurring. The current account surplus, as well as the surplus in capital and financial accounts, drives a huge and rapid accumulation of foreign reserves that causes mounting pressure for renminbi appreciation. The heightened expectation of renminbi appreciation brings even more speculative hot money flowing in, further contributing to the accumulated reserves. Such growing expectations of renminbi revaluation, and the consequent speculative and volatile rush of hot money, adversely impact the PRC's economy by causing “leads and lags” that distort the

rational behavior of local enterprises engaged in foreign trade as well as foreign investor behavior.

Many government authorities and market participants are paying keen attention to the smallest decision about renminbi revaluation, trying to make predictions based on the slightest utterance of PRC policymakers or local newspapers. This expectation of renminbi appreciation leads to unnecessary volatility in the international foreign exchange market. An example was how in late April to early May 2005, the Japanese yen appreciated sharply against the US dollar following a local PRC newspaper report about revaluation. Although no one can control how market participants interpret messages from the PRC, it is important to recognize that PRC authorities do not welcome the growing expectation of renminbi appreciation since it ultimately damages the economy.

The PRC's trade imbalance with other countries is seen as the main force behind growing international pressure to appreciate the renminbi. Many argue that the PRC's export prices are too low because of the undervalued renminbi. But the exchange rate is not the only factor determining export prices. Production factor costs such as labor, water, power, and natural resources also determine the prices of exports. The real question is whether market supply and demand conditions in the PRC determine these factor costs at the optimal level: for instance, they may well be undervalued due to the legacy of the centrally-planned economy. Moreover, these factor costs do not properly reflect so-called "external diseconomies," (negative externalities) such as environmental degradation. We may need to think more closely about the adequacy of the price structure in the PRC first before gradually addressing the exchange rate. (16 June 2005)

3.4 A closer look at the recent renminbi revaluation

On the evening of 20 July 2005, the People's Bank of China (PBOC) unexpectedly announced the 2.1 percent revaluation of the renminbi. What observations can we make about this announcement? The first relates to timing. While many experts and media sources saw the announcement as abrupt and surprising, careful examination indicates that this was not necessarily the case. In looking at the various indicators such as balance of payment, foreign reserves, and short-term capital inflow, PRC officials actually pursued the earliest possible timing for revaluation. And to avoid the impression that external pressure had led to the revaluation move, the PRC authorities waited until such pressure was mitigated somewhat by a moment of US dollar appreciation. Moreover, given the political and economic importance of its relationship with the US, it was also predictable that the PRC would take revaluation measures prior to the scheduled meeting of each country's leaders in the autumn of 2005.

Another observation regards the prevailing misunderstanding about the PRC decision to abandon the US-pegged monetary regime and replace it with a currency basket approach. Though the PBOC announcement carefully stated that the renminbi exchange rate would adjust based on market supply and demand with reference to a basket of currencies, it does not make clear whether "reference" means the same thing as "pegged" to a basket of currencies. In either case, the PBOC did not announce the composition of the basket of currencies (see Note page 27), and since 21 July has allowed the actual renminbi exchange rate to fluctuate within a very narrow range centered on the new 8.11 RMB to 1 US dollar rate. Although the announcement allows the fluctuation range of 0.3 percent, the PBOC seems to be intervening significantly in foreign exchange, and doing its best to contain the fluctuation. Recently the PBOC firmly denied the

possibility of another revaluation for the moment, which is certainly strange if the PBOC has truly moved to a currency basket regime.

Other countries and experts mostly welcomed the announcement of a change in the currency regime as a first step, but remain concerned that the new system is less transparent than the previous dollar-pegged regime. The statement, “with reference to a basket of currencies,” is vague and many fear that the PRC might more freely manipulate the RMB exchange rate by foreign exchange intervention. The 21 July revaluation is a good example of the PRC’s traditional gradualist approach: starting with a limited scope on an experimental basis and then carefully examining the impact of the move before expanding the scope. At face value, the core announcement seems to offer nothing more than a one-time, nominal revaluation that raises no expectations for any significant change in the nominal exchange rate or in the exchange rate regime. However, this is more likely a first step that needs to be watched carefully for indications on when a next step might follow. (8 August 2005)

Note:

Later in August 2005, the PBOC announced that the currencies in the basket are the US dollar, the euro, the Japanese yen, and the Korean won since these currencies represent the economies of the PRC’s four largest trading partners. The weighting of each currency is not yet disclosed. The PBOC also mentioned that other currencies in the basket, but with smaller weightings, include the Canadian, Australian, and Singapore dollars, Thai baht, the British pound, and the Malaysian ringgit.

Source:

Kanamori and Zhao, 2006, “The Renminbi Exchange Rate Revaluation: Theory, Practice and Lessons from Japan,” ADB Institute..

3.5 Direction of public finance in the PRC

Since the Asian financial crisis the PRC has taken a proactive fiscal policy by issuing national construction bonds to avoid a slow-down in the economy. The central government deficits and its proportion to GDP in 1997 was 56 billion RMB and 0.8 percent, while these figures went up to 319.8 billion RMB and 2.7 percent respectively in 2003. Following the 2003 Central Economic Conference, PRC authorities have shown signs of shifting fiscal policy from “proactive” to “prudent” in order to respond to overheating in the economy. New government bond issues were cut to 110 billion RMB in 2004 and 80 billion RMB in 2005, down from the annual 140–150 billion RMB during the years between 2000 and 2003. Central government deficit in 2004 remained at the same level, 319.8 billion RMB, but its ratio to GDP declined 2.5 percent from its peak of 3.0 percent in 2002.

Individual income tax is becoming an important tax source as revenues have increased from 41 billion RMB in 1999 to 173.7 RMB in 2004. Its ratio to total tax revenue also increased dramatically from 1.4 in 1994 to 6.8 percent in 2004. But the system for the individual PRC taxpayer remains extremely complex. Currently, individual income can be divided into eleven categories, each one subject to different rates and cost calculations. To achieve more efficient tax collection, the PRC Ministry of Finance is trying to shift towards a more unifying individual tax scheme. Already major tax reforms in 2002 introduced a new system that shares income tax between central and local governments as a means of addressing regional equity. In 2005, against the backdrop of growing per capita income and intensified sentiments of unfairness towards the tax code, the State Council proposed to raise the personal income tax exemption from 800 RMB to 1,600 RMB as a way to reduce the tax burden on the poor.

Traditional economics posit that public finance (财政 “caizheng”) has three primary functions: reallocation of resources, adjustment of business cycles, and redistribution of income. Under the previous centrally planned economy, PRC public finance served to consolidate then allocate all resources and build up infrastructure. Lengthy budget statements made by Party and government officials tended to stress how budget resources allocated in various provinces and sectors would contribute to the nation’s overall development. More recent developments indicate that the PRC authorities now realize the effectiveness of using fiscal policy as a tool to smooth out business fluctuation and they are reviewing the tax system as a way of achieving social equity in light of growing income disparities. Although these trends are the logical consequence of economic reform and marketization, the role of public finance under a “socialist market economy with PRC characteristics,” deserves further observation. (19 December 2005)

3.6 Implications for PRC’s foreign reserve accumulation

Foreign reserves began flowing rapidly into the PRC in early 2002, reaching nearly US\$8.2 billion by the end of 2005 (see Table 1 page 32). This was mainly attributed to three factors: current account surplus, influx of capital via foreign direct investment (FDI), and repatriation of PRC capital in anticipation of renminbi appreciation, reflecting errors and omissions in the balance of payments account.

There is no clear theoretical process for determining the optimum level of foreign reserves. The current ratio of foreign reserves to monthly imports is approximately 16:1 and that of foreign reserves to short-term foreign debt is about 10:1, both higher than the widely accepted figures of three months and one year, respectively. Compared to other countries, the PRC ratios rank number one for

foreign reserves to foreign debt, and number 5 for foreign reserves to imports and foreign reserves to GDP. Moreover, FDI is the source of nearly 50 percent of recent foreign reserves.

The PRC is presently working to deregulate capital account transactions and encourage Chinese enterprises to move operations overseas (走出去 “zou chuqu”). Under these circumstances, the rapid influx of foreign capital could end suddenly or even be reversed. Accordingly, to prepare for a sudden or unexpected capital outflow, particularly on the heels of the Asian economic crisis, the PRC and other Asian economies tend to accumulate foreign reserves beyond the presumed optimal level.

In terms of economic theory, the greatest concern is the monetary implications. Under normal circumstances, as foreign reserves flow into a country the central bank releases an equal amount of local currency into the domestic economy. Where there is a rapid influx of foreign capital, there is a risk of overheating the economy if too much money is injected into the market. Over the past few years, the People’s Bank of China (PBOC) has successfully used a “sterilization policy” to manage the money supply (see Table 2 page 32). For the time being there is no foreseeable need to worry about the influx of foreign reserves to the PRC, neither in terms of amount nor speed. However PRC authorities need to carefully consider the following issues:

- (i) The rapid accumulation of foreign reserves reflects the macro I-S imbalance of the domestic economy, external balance in particular. The government introduced a reform plan for the renminbi exchange rate system, but is trying to use foreign exchange rate intervention to mitigate large-scale exchange rate adjustments; the result has been further appreciation pressure.

- (ii) A vicious cycle has been created, namely that the accumulation of foreign reserves gives rise to further anticipation of renminbi appreciation, resulting in an influx of foreign capital, which in turn triggers foreign exchange intervention.
- (iii) The sterilization policy has certain cost implications. To date, the interest rate of PBOC bills has remained lower than that of US treasury bills, which is where a large part of the reserves are invested. However, depending on future developments related to domestic and foreign interest rates, this may not be able to be maintained.
- (iv) The PRC has achieved strong economic growth of 9–10% in recent years, and this has required the money supply to grow at a relatively high rate. However, a modest economic growth rate of 6–7% is envisioned during the 11th five-year plan. In order to prevent the economy from overheating, the money supply must grow at a more moderate rate as well.

How to utilize the massive foreign reserves accumulated for the PRC economy is the most important issue of all, and is not simply a matter for the PRC since other countries face the same dilemma. However the current PRC domestic economy doesn't appear to be enjoying any specific benefits from the influx of foreign reserves.

In the latter part of 2005, the government injected a total of \$60 billion from foreign reserves into the state commercial banks to strengthen their capital base, possibly giving a sign that the PRC is considering the appropriations of foreign reserves. If this is the case, there needs to be a planned appropriations effort such as setting aside reserves to create funds for projects like addressing environmental problems, promoting energy conservation, and enhancing

technological innovation. In order to avoid risks and maximize returns, a review of the current composition of the foreign reserves portfolio—roughly 60% US dollar bonds and treasury bills, 20–25% euro and 15–20% yen—may also be required. (22 March 2006)

(Table 1) Rapid Accumulation of Foreign Reserves (end of the year, \$ hundred million)

<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
1,666	2,122	2,864	4,033	6,100	8,189

Source: People’s Bank of China

* If foreign reserves of Hong Kong, China is included, overall reserves at the end of 2005 stands at \$9,432 million, which exceeds Japan’s \$8469 million for the corresponding period.

(Table 2) Money Supply and GDP (% increase)

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
GDP	9.1	10.0	10.1	9.9
M2	19.9	19.6	15.5	18.0
M1	18.4	18.7	14.1	11.8

Source: People’s Bank of China, China Statistical Bureau

4. Hong Kong, China

4.1 The fate of the Hong Kong Dollar

Immediately following the revaluation of renminbi in July 2005, the Hong Kong Monetary Authority (HKMA) released an announcement by Acting Financial Secretary, Mr. Stephen Ip stating, “The Government has no intention at all to change the Linked Exchange

Rate system which has served Hong Kong [*sic*] well for more than 21 years and has been the anchor of our economic stability.” The exchange rate between the Hong Kong dollar (HKD) and the renminbi now fluctuates within a narrow range.

HKMA’s decision to stay on the US dollar (USD)-pegged system appears sensible for the short term. The devaluation of the Hong Kong dollar (HKD) vis-à-vis the renminbi is expected to contribute to ongoing recovery of the Hong Kong, China (HKC) economy. The HKC economy has also benefited from increasing tourism from the mainland. After all, the HKC economy specializes in services including banking, securities, tourism and real estate. International competitiveness affected by exchange rate fluctuations does not impact these service sectors as heavily as they would hit manufacturing sectors.

The currency board system adopted by HKC in 1983 is a fixed exchange rate with freedom of capital flow at the expense of losing the independence of monetary policy according to the trilemma theory. HKMA’s policy is more subject to US federal policy than PRC central bank policy. However, assuming a lack of inconvertibility of the renminbi, heavy regulation on international capital flow and the immaturity of the financial system in the mainland, maintaining the status quo of HKD remains significant for continued utilization of HKC as an international financial center.

Due to the modest scale of the revaluation of renminbi in July 2005, HKMA’s decision attracted little attention. The revaluation is a first step toward a flexible renminbi with full convertibility. Shortly following the revaluation, the People’s Bank of China (PBOC) issued circulars to expand forex trading allowing renminbi and foreign currency swap transactions. These are clear indicators the PBOC envisages more fluctuation of renminbi exchange rates in the future

and feels the necessity of providing participants with more risk hedge instruments.

Economic integration between HKC and the Mainland, particularly the southern region of the PRC, will deepen as more HKD circulate in the PRC. More renminbi notes will circulate in HKC, as the renminbi becomes a flexible and fully convertible currency. In the future HKC and Beijing may need to revisit to the relevance of “one country, two currencies, two monetary systems and two monetary authorities which are mutually independent,” as stated by Mr. Joseph Yam, HKMA Chief Executive. HKC and Beijing may consider a re-peg of the renminbi, an abolition of the HKD, or the creation of an optimum currency area covering the PRC in light of the transaction costs, currency substitution, and political and economic factors. (3 October 2005)

Note:

Economic Review Monthly (July 2005) by the Bank of China Hong Kong seems to show a typical view (or perhaps concern) of the financial circle in HKC about the future of HKC economy and the HKD, which says, “ Hong Kong’s decision to link itself to the US economy and the USD still makes a lot of sense...Hong Kong needs to maintain its uniqueness. As China is closing the development gap between Hong Kong, the only way for us to avoid being marginalized is to maintain and leverage on our advantages...advantages lie in our high degree of internationalization and economic freedom...The HKD’s linked Exchange Rate System could be a symbol of our internationalization and economic freedom. We must therefore carefully study whether pegging to the RMB or adopting the RMB could transform Hong Kong to merely a city of China in the eyes of international investors...The initiatives of whether to change the Peg or not lie firmly in the hands of Hong Kong...” as quote.

4.2 Tourism will be king for the future economy of HKC (part 1)

Until recently, the manufacturing, financial and tourism sectors in Hong Kong, China (HKC) served as the three main engines driving the local economy. That is now changing. Because many manufacturing industries relocated to southern China in the 1990s in search of cheap labor and low office rental costs, there are now almost no manufacturing industries remaining in HKC. Presently HKC's financial sector still offers some advantages but since PRC authorities have deregulated and opened more financial markets on the Mainland as a result of WTO entry, more foreign financial institutions have started to expand in the PRC by shifting some operations from HKC to Mainland cities.

In general, the scope of business for foreign banks on the Mainland has been growing. As an example, foreign banks extended their branch networks in the Mainland from 157 operational units in 2001 to 226 in 2005, and currently have 249 representative offices in the PRC. Moreover, foreign banks are actively acquiring equity in PRC financial institutions or joining these institutions in equity participation. In some cases, the foreign stake in these participatory deals has hit the ceiling of 25 percent. Another noticeable change is that foreign banks are no longer limiting their services to corporate banking for multinational enterprises but are also offering products and services for PRC enterprises and individuals in renminbi. All these developments suggest that HKC's relative advantage in the financial sector is waning vis-à-vis the Mainland. Even though the past few years show a strong recovery for the HKC economy after its long recession, many structural problems have yet to be properly addressed. This is one reason why HKC authorities are promoting tourism as an alternative engine for growth.

To appreciate the full potential of a future HKC tourism industry, it's important to factor in both the supply and demand sides of the industry. On the supply side, HKC's main weakness is the lack of historical sites and monuments to attract traditional international tourists. Similarly, the prices of goods and services there are relatively high, even in comparison with Japan. Of course, it naturally depends on which commodities and services, but many ordinary Japanese feel that price levels on average are at least 30–40 percent higher than back home. What's more, the quality of services does not always offer value, with some tourists now claiming that even the legendary Cantonese cuisine is beginning to lose its preeminence. And although the decline of the US dollar, to which the HK dollar pegs under the currency board system, offered some price relief for tourists, that is only temporary. In the medium run, if the renminbi is further revalued and becomes fully convertible, HKC might then exit from its currency board system. At this point, price levels will again become very expensive for many foreign tourists.

On the demand side, HKC's tourism industry has most recently relied on a dramatic influx of Mainland tourists while the number of tourists from elsewhere remained stagnant. Since 2003, Chinese tourists have been making individual trips to HKC where they spend a sizeable chunk of their holiday money purchasing commodities such as gold, precious metals and top brand goods. It is reported that average per capita spending of Chinese tourists in 2003 was more than 6,000HKD, while the spending of other tourists is between 4,000–5,000HKD. Is this likely to continue?

When forecasting the growth of tourist spending in HKC, there are three variables to keep in mind. First, the PRC's economic growth may moderate in the near future from current annual growth rate of more than 9 percent to around 7 percent. Second, wealthier Chinese

may start to choose other destinations, such as Europe. Third, as consumer markets in the Mainland become more mature Chinese tourists will not need to travel to HKC to buy high-end goods.

So from both a demand and supply standpoint there may be few reasons for optimism about the future of tourism in HKC. HKC authorities may need to work out a clearer vision for regional development and find new ways to attract international tourists. Such an undertaking would be indispensable for HKC's future economy, assuming that other industries continue to become less competitive. The next article in this series will consider what HKC authorities might do to promote a more attractive tourism industry. (10 February 2006)

4.3 Will tourism be the magic kingdom in HKC's future? (part 2)

In recent years the biggest tourism project in Hong Kong, China (HKC) aimed at attracting foreign tourists was the construction of Disneyland on Lantau Island. Whether this project alone will lure foreign tourists to HKC remains uncertain. For many tourists Disneyland is already a commonplace attraction in their home countries, and many argue that foreign tourists from developed countries seek travel experiences that are completely different from a visit to a well-known theme park.

Regardless of the number of foreign tourists, the Disneyland in HKC is expecting many tourists from the Mainland (see Table page 39), which in the medium-term may provide the number of visitors needed to support the project. But there is little stopping Mainland cities such as Shanghai and Beijing from becoming competitors, in particular if the HKC Disneyland shows signs of success. This casts

doubt on the long-term sustainability of this type of tourism development project.

A better long-term approach might be for the HKC authorities to develop a tourist industry that leverages HKC's own competitive advantages while catering to many foreign tourists' preference for unique, eco-friendly travel experiences. HKC is actually well situated for such a plan since it is a geographically small urban society with a fairly good public transportation system. And, contrary to many people's preconceived ideas about HKC as nothing more than a crowded shopping area with little natural beauty, HKC actually enjoys an abundance of natural endowments. Among these natural treasures are many small islands with surprisingly beautiful scenery. The islands, as well as in the new territory close to Shenzhen (深圳), all have mountains with marvelous trekking routes. In fact, one trekking course called the "Macrohorse Trail" covers 100 km and attracts many foreign trekkers every year even though few HKC natives leave behind their congested urban areas and busy lifestyles to walk this course.

The most drastic measure that could be considered by HKC would be a plan to remove all cars and motorcycles from the town and make all of HKC an exclusive environmentally friendly "eco-region." By making the best use of its unique geographical characteristics HKC could attract many tourists from around the world, and more importantly it could showcase to the world an attractive, future model of urban development.

HKC might also have a certain advantage in implementing such initiatives since contrary to the prevailing conventional wisdom the local financial regulation and public finance policies are already somewhat interventionist in nature. However, the sad reality is that the majority of people in HKC are not yet sensitive to environmental

imperatives even though the environmental degradation associated with air pollution, mainly coming from southern China region such as Shenzhen, Guangzhou, and Dongguan, has steadily worsened. Any efforts to improve HKC's environment and strengthen its competitiveness in tourism will also need to consider the future of greater southern China. No doubt this is a challenge, but it is definitely a worthwhile task for HKC. (14 February 2006)

(Table) Growing Tourists from the Mainland

<i>Number of tourists</i>	<i>Thousands</i>		
<u><i>Country/Territory of residence</i></u>	<u><i>1999</i></u>	<u><i>2003</i></u>	<u><i>2004</i></u>
The Mainland	3,206	8,467	12,246
Taipei, China	2,063	1,852	2,075
South & Southeast Asia	1,511	1,360	2,078
North Asia	1,465	1,235	1,665
The Americas	1,155	926	1,400
Europe, Africa & the Middle East	1,149	946	1,380
Macao	417	444	484
Australia, New Zealand & South Pacific	362	306	483
Total	11 328	15 537	21 811

Source: Hong Kong Tourism Board

5. Relationship between Japan and the PRC

5.1 Japan-PRC economic relations: Complementary but asymmetric

Recent discussions about Japan-PRC economic relations seem to center on two key concepts: complementarity and asymmetry. The complementary effect of bilateral trade and capital flows, particularly the impact of Japan's increased FDI to the PRC in recent years, has greatly benefited both countries. PRC has prospered from Japan's transfer of capital, high technology and corporate governance structures and has also benefited from the resulting job creation that has alleviated social pressures related to unemployment. For Japan the growing demand for commodities such as steel and machinery has dramatically increased Japanese exports to PRC. At the same time Japan's FDI in PRC has allowed many ailing Japanese companies to reduce production costs by shifting production lines there. Overall the economic partnership has facilitated industrial restructuring in each country, impacting PRC's market reforms as well as Japan's economic recovery. As evidence, the benefits from economic interdependence are gradually changing the old perception of PRC as an economic "threat" to Japan.

However asymmetric trends in the Japan-PRC economic partnership are becoming more pronounced as international competition for FDI and market share in PRC increases (see Tables 1, 2 & 3 page 42). From the Japanese perspective trade relations with the PRC have expanded significantly over the past few years. Between 1990 and 2003 Japanese exports there increased ten-fold while exports to the United States declined 9 percent. During the same period Japanese FDI to PRC increased from 3.7 percent to 15 percent while FDI to the United States dropped by 17 percent. This increase

suggests that Japan has intensified its reliance on a Sino trade partnership, but the same doesn't hold true for the PRC. Even though Japan remains a major capital exporter to the PRC the Japanese share of its import/export markets and foreign trade is shrinking. And while bilateral trade and investment in the PRC now play a much larger role in Japan's global trade strategy, the internationalization of PRC's markets has reduced its reliance on the trade relationship with Japan.

Until now Japan and PRC have tried to separate politics from economic interests. Many characterize this complex dynamic between the two as "chilly politics and warm economics" (政冷经热 "zheng leng jing re"). But it remains to be seen whether the current political climate will lead to equally "chilly" economic ties, an unwelcome outcome that would serve neither country's interests. Because Japan and PRC are at different stages of economic development and have different comparative advantages, the two stand to gain from closer economic ties that would optimize resource allocation and promote mutual economic development. And as important economic neighbors, productive and warm economic relations between the two would most likely encourage regional cooperation and promote mutual understanding in the Asia/Pacific region as a whole. (2 May 2005)

(Table 1) Japan's Major Trading Partners (share %)

(Export)		(Import)	
2000	2004	2000	2004
US (29.7)	US (22.5)	US (19.0)	<u>PRC (20.7)</u>
Taipei,China (7.5)	<u>PRC (13.1)</u>	<u>PRC (14.5)</u>	US (13.7)
Korea (6.4)	Korea (7.8)	Korea (5.4)	Korea (4.8)
<u>PRC (6.3)</u>	Taipei,China (7.4)	Taipei,China (4.7)	Australia (4.3)

(Table 2) Proportion of FDI in PRC to the total Japan's FDI (%)

2000	2004
3.0	18.9

Source: Trade and Investment Statistics by Japan's MOF

(Table 3) Japan's Share in PRC's Trade and Foreign Investment (%)

	Export	Import	FDI
2000	16.7	18.4	7.2
2003	13.6	18.0	9.4

5.2 Localization of Japanese companies in the PRC

In recent years, many foreign companies have invested in the Mainland, establishing production lines with cheap labor costs. Japanese companies are no exception. However, the localization of staff remains one important difference between Japanese and Western companies. Chinese nationals represent nearly eighty percent of Chief Operating Officers (COO) in US and European companies, whereas

according to Japan's white paper on international trade, only twenty-eight percent of COOs in Japanese mainland-based firms are Chinese nationals. Senior positions within Japanese companies continue to be held primarily by Japanese expatriates.

Another characteristic of Japanese companies is that important decisions remain under the discretion of the parent company in Japan and little authority is delegated to local offices. Because Japanese manufacturing companies primarily produce commodities for export with few targeting the mainland market, these companies prefer to use cheap labor (员工 “yuangong”) for assembly line jobs. To facilitate good communication between their offices, parent companies tend to send Japanese managers to oversee operations. A survey by the Japan External Trade Organization (JETRO) found that companies targeting domestic markets represent only one third of total Japanese companies operating in the PRC and export-oriented manufacturing companies account for more than half.

Without question, the quality of management staff has a significant impact on a company's development yet the nationality of the CEO or COO may not matter. Some Chinese companies show poor performance despite all management staff being Chinese and some successful Japanese companies in Japan have expatriate CEO or COO. In the PRC context, foreign-invested companies are increasingly eyeing the potentially huge demand from this domestic PRC market and as a result, competition among foreign invested companies, and between foreign and domestic companies, is intensifying as foreign companies focus on gaining domestic market share. While one clear advantage to local leadership is that locals can guide foreign companies through the maze of administrative procedures that are legally required for business transactions in the PRC. Moreover, local Chinese management staff can provide valuable

personal networks with authorities. This can prove indispensable to a company's growth and profits.

Due to the limited opportunities for promotion to senior managerial roles, Japanese companies find recruiting top-tier local hires difficult. A recent survey that listed the most popular companies to work for among Chinese employees found Japanese companies only ranked 17th and 32nd, which suggests that Japanese companies are now in a disadvantageous position to recruit local labor. Many Japanese expatriates claim that they are well aware of this situation, but nearly all say this is because the parent company in Japan does not fully understand the dynamics of the local labor market. Promoting communication between local and main offices, delegating real authority to the local offices, and actively pursuing localization are increasing matters of urgency for many Japanese companies. (11 October 2005)

5.3 Rethinking Japan's overseas development assistance (ODA) to the PRC (part 1)

Since late 2004 authorities in Japan and the PRC have been discussing whether the PRC should "graduate" from Japan's ODA program. Japan's ODA to the PRC over the past 25 years amounts to roughly 3,400 billion JPY, or about two-thirds of the total ODA received from foreign countries. Yen loans account for 90 percent of Japan's aid and the remainder has been given in grants and technical cooperation. Most of the aid has been spent on physical infrastructure development such as ports, railways, airports, and exploitation of coal and oil (see Note 1 page 46).

In determining whether Japan should continue ODA to the PRC, one must consider the PRC's growing military presence in the region. Japan's ODA Charter was revised in August 2003 and now, for the

first time, clearly states the objective of ODA as “to help Japan’s own security and prosperity” (see Note 2 page 46). This has led some Japanese to argue that Japan’s ODA runs counter to this charter because it contributes to PRC military development. It is true that since the 1990s the PRC has been trying to modernize its military. However, this modernization is primarily aimed at replacing obsolete military equipment, reallocating resources, and restructuring inefficiently organized military personnel. In fact, in recent years the ratios of publicly announced national defense expenditure to total fiscal expenditure and GDP in the PRC have been stable at around 8–9 percent and 1.2–1.7 percent, respectively.

As concerns ODA, whether the announced figure for PRC national defense expenditure is reliable and reveals the whole picture is another difficult question. A 2005 US Pentagon report estimates that the PRC’s real defense expenditure may be double or triple the officially announced figure. Japan’s own 2005 white paper on defense also referred to a lack of transparency in PRC military expenditure and expressed concern about the modernization of military equipment. The PRC aspires to becoming a leading nation in the world by strengthening its influence both economically and politically. However, because the PRC is committed to continuing its reform policies to open up to the outside world, it is unlikely to use its military presence as a “diplomatic card.” Furthermore, the PRC is preparing for the Beijing Olympics in 2008 and the World Expo in Shanghai in 2010. And the country has also taken initiative in multilateral negotiation to stabilize the political situation in northeast Asia. Accordingly, the PRC’s military modernization and expenditure may not be the best justification for reducing Japan’s ODA.

There is a second question to consider, which is whether or not the PRC is really facing a shortage of financial resources. The main

role of ODA is to give financial assistance to developing countries that face financial shortages, in particular shortages of foreign currencies, so that they may build physical infrastructure during the initial phase of economic development. At the outset, the ODA to the PRC was no exception, but financial circumstances may now be different. Although the PRC suffers fiscal deficits, the problem is not serious by international standards. Furthermore, infrastructure investment is coming to rely increasingly on private funds, which are not in short supply. Household savings in the PRC have almost doubled over the past several years, amounting to 10 trillion RMB (1.2 trillion USD) at the end of 2003. Foreign reserves have also accumulated dramatically in recent years, standing at 659.1 billion USD at the end of March 2005—about a 50 percent increase compared with the corresponding period in 2004. Therefore, the more immediate problem facing the PRC is how to mobilize these resources for investment. Assuming the role of ODA is to provide help developing countries make up for a lack of financial resources, the PRC's need for traditional ODA is definitely diminishing. (1 November 2005)

Note 1:

Overview of Japan's ODA to the PRC (Japan's Ministry of Foreign Affairs June 2005)
“Official Development Assistance (ODA) to China began in 1979 and from that time to the present, approximately 3.1331 trillion yen in loan aid (yen loans), 145.7 billion yen in grant aid, and 144.6 billion yen in technical cooperation have been implemented. Past ODA projects in China included large-scale economic infrastructure projects, including the building of roads, airports and power stations, as well as infrastructure projects in medical and environmental areas. These projects have played a significant role in the realization of China's current economic growth.”

Note 2:

The preamble of the revised ODA Charter stresses that “ It is important to have public support for ODA. It is essential to effectively implement ODA, fully taking into account the domestic economy and fiscal situation as well as the views of the Japanese people...The revision ...has the aim of encouraging wide public participation and of

deppening the understanding of Japan's ODA policies within Japan and abroad." Having said so, the first paragraph of the "Objectives" stipulates "...to contribute to the peace and development of international community, and thereby to help ensure Japan's own security and prosperity." (underlined by the author.)

5.4 Rethinking Japan's ODA to the PRC (part 2)

Because the PRC no longer needs funding to build physical infrastructure, Japan's shift in ODA focus seems to be well founded. In recent years ODA has focused more on structural problems, such as environmental degradation, poverty, rural development, and human resource development. Whether Japan terminates its ODA to the PRC, and what the appropriate timing would be, certainly requires additional political consideration and judgment. Yet even if Japan's ODA were to wind down, there are ways to enhance better understanding through education exchanges and training programs.

One Chinese scholar who studied in the United States points out that although the US does not provide any direct ODA to the PRC, it reaps many benefits from non-governmental assistance provided through university education exchange programs. Many Chinese benefit from generous scholarship programs that US universities provide to foreign students including those from the PRC. And in many cases, the positive experiences of studying and living in the US greatly contribute to better understanding and friendly sentiments towards the US. The scholar went on to point out that apart from sensitive historical issues, it would be unfortunate for Japan if the tremendous amount of past ODA contributed neither to improving relations nor to achieving mutual understanding between the two countries, particularly since a country that does not provide ODA enjoys a more favorable perception.

What can Japan do to address this problem? One measure would be to increase funding for education exchange and scholarship

programs with the PRC. Additionally, Japan could generally offer cooperation for human resource development. One avenue for cooperation would be for Japan to share its experiences of the late 1960s to the early 1970s in fighting environmental damage caused by industrial development. The most important achievement during the course of that fight was the success in enhancing public awareness about the need for environmental conservation and sustainable economic development. In viewing the issue of the environment as a “market externality,” the PRC could learn from Japan’s experience addressing market externalities by trying to “internalize” them. Towards this effort, Japan could grant financial resources to environmental projects or transfer environmentally friendly technologies to the PRC while sharing expertise through training programs that enhance public awareness of environmental issues.

As previously noted, the PRC is now facing the problem of mobilizing its citizens’ enormous domestic savings for investment. With Japan’s long history of transforming its own economic structure from external demand-driven to domestic demand-driven growth, the opportunity to learn from Japan’s efforts could prove useful to the PRC. Although education and training exchange may take some time to produce a fruitful outcome, such programs have a great potential for future cooperation between the two countries. Japan’s aid to the PRC may be most effective with such a change in focus. (2 November 2005)

6. Future Agenda for the PRC

6.1 What does the current 10th plan lead us to expect for PRC next 11th five-year plan? (part 1)

The PRC's 10th five-year plan (计划 “jihua”) ends this year. The broad thrust of the next five-year plan will be announced at the Central Committee of the Communist Party of China's (CPC) meeting in September 2005, followed by the adoption of the plan at the National People's Congress (NPC) in early 2006. Although limited information has been released about the content of the next five-year plan, it is possible to predict some features of the plan based upon the current plan in force.

Previously, the CPC decided the five-year framework without any consultation from outside groups. Now it places greater importance on ensuring transparency and democratic process, as was seen during the preparation process for the current 10th five-year plan when the CPC solicited views from scholars and enterprises. However, the extent to which these outside opinions were incorporated in the 10th plan remains unclear. Compared with past plans the numerical targets were reduced and the main numerical target was set “to double GDP by year 2010 vis-à-vis 2000.” Practically, this amounts to an average growth rate goal of approximately 7 percent annually. Because indicative figures by sectors were also included, these features could indicate that the status of the five-year plan is gradually changing from compulsory to indicative.

As for policy issues the 10th plan appears to emphasize “development” rather than “reform and adjustment.” Perhaps PRC authorities intended to signal an end to the “reform and adjustment period” and highlight that “development” under the 10th five-year plan will allow people to enjoy “a moderately well-off life” (小康生活

“xiaokang shenghuo”). Specifically, it proposed increased expenditures in health care, education, automobiles, and various housing-related services. The 10th plan also underscored the importance of addressing regional imbalances and placed the goal of increasing rural income as a high priority policy. All this reflects the concern of the PRC authorities about the widening income gap between urban and rural areas.

When the 10th plan was launched people complained that the proposed favorable treatments were insufficient to improve the regional disparities, particularly in rural areas. The 10th plan stressed a need for industrial structures to be upgraded and optimized to ensure that economic growth relies upon a more efficient use of resources. PRC authorities realized that economic growth during the 1990s was mainly supported by an increase in labor and capital. The intention of the 10th plan was to improve these growth patterns by supporting further reform, implementing more open policies, and developing information and technology (IT) to foster sustainable long-term growth. (28 June 2005)

6.2 What will the PRC’s 11th five-year plan be? (part 2)

Many things can be predicted about the PRC’s next, 11th five-year plan (规划 “guihua”) (see Note 1 page 52). Since last year the new administration has been trying to elevate the “philosophy of scientific development” (科学发展观 “kexue fazhanguan”) (see Note 2 page 52) to the same level as the Three Representations (三个代表 “sange daibiao”) and Deng Xiaoping’s theories. Although this philosophy has yet to be clearly defined, it is generally seen as a theoretical framework to foster long-term sustainable economic development while avoiding the negative effects of environmental degradation and resource constraints. The 11th plan may well reiterate issues such as

“to enhance the quality of life” and “industrial restructuring,” but this time with an overarching philosophy of scientific development. Seeing the ways that this philosophy is expressed and whether it will become a dominant framework in the PRC, will be of interest to outside observers.

One expectation is for the new 11th plan to highlight issues that address regional imbalances since this is now an urgent priority of the new administration. In fact, the administration has already launched two initiatives to develop the northeast and central regions while continuing the former administration’s “Go west” policy. The new administration deviates somewhat from the former one in its focus on building a “harmonious society” to try to correct certain imbalances. This policy direction will likely continue in the 11th plan, and accordingly the plan may receive more popular support than the previous one.

In an effort to honor new commitments since joining the WTO, the PRC has continued deregulation measures and has taken steps to open up its markets. The new 11th plan will reconfirm the traditional PRC policy of inviting foreign investment, correct the imbalance between capital inflow and outflow and its impact on the exchange rate and foreign reserves, and strengthen the international competitiveness of PRC enterprises. It is also quite possible that the plan will highlight and endorse the “Go overseas” (走出去 “zouchuqu”) policy. In fact, the Chinese Academy of Social Sciences predicts that overseas investment equivalent to US\$8 to 10 billion a year is expected during the 11th five-year plan period. This is 4 to 5 times more than was invested in the 10th five-year plan period.

As for the decision-making process, the current trend to solicit views from a wide range of groups in the society will continue and possibly even grow. The CPC and the central government now

welcome the views of scholars, research institutions, and political circles outside of the CPC, and try to implement their ideas in the 11th plan as appropriate. In addition, future planning will place less emphasis on numerical targets as the overall nature of the plan becomes increasingly indicative and qualitative. In the medium to long run, it will be important to note changes in the status or the nature of the five-year plan itself, since the plan is a kind of mirror that reflects the degree of progress toward a market-oriented economy in the PRC. (7 July 2005)

Note 1:

PRC authorities now start to use the terminology “guihua” instead of “jihua.” “Guihua” could be interpreted as “program”, while “jihua” as “plan.” It seems they try to stress five-year plan is now becoming more indicative rather than compulsory.

Note 2:

China Daily (Nov. 2003) quotes the remarks by the Minister for the State Development and Reform Commission. It says that now current Administration leaves from the traditional philosophy, which only placed high priority on economic growth. Instead a new “Philosophy of scientific development” stresses the importance of human beings. More specifically it would try to improve education, medical care, employment and coordinated development of different regions.

6.3 Final thoughts on the PRC’s 11th five-year plan (part 3)

Four key concepts will illustrate the thrust of the PRC’s next 11th five-year plan for economic policy: “urbanization” (城市化 “chengshihua”), “marketization” (市场化 “shichanghua”), “globalization” (全球化 “quanqiuhua”), and “restructuring” (改革 “gaige”) (see Note page 56). The overarching philosophy supporting these concepts will be the creation of a “harmonious society” (和谐社会 “hexie shehui”) based on the principles of scientific development. This is expected to become a symbolic guiding principle for the Hu Jintao and Wen Jiabao administration, much as the “three representation” principle was for the former administration.

Urbanization will be a key component as the role of cities in the PRC economy is set to become more important, and since the population in urban areas is projected to exceed that of rural areas. Marketization and globalization will also be crucial as the plan pursues further deregulation and the open market policies in accordance with the commitments to the PRC entry to the WTO. Once liberalization measures aimed at opening the PRC financial market are completed the PRC financial sector will be an integral part of the global financial market. And more market-oriented economic policies are expected to allocate resources more efficiently and build up the so-called “socialist market economy.” Restructuring, also referred to as “industrialization,” will reflect an attempt at changing the focus of economic growth from capital investment to human resources investment. This will allow more people to enjoy the benefits of growth (以人为本 “yirenweiben”). The ratio of investment to GDP already reached the unsustainably high level of over 40 percent in 2003.

Generally the 11th five-year plan is headed in the right direction. Yet even though these four key concepts are interdependent, some of them are compatible where others may be in conflict. For example, the opening of the Chinese market to the outside under the globalization of the world economy obviously requires more market-oriented measures. However, at the same time, developing and strengthening sound and competitive domestic industries while achieving a “soft landing” may require a more gradual approach or even some level of government intervention. This means that globalization may not be completely in line with the concepts of marketization. Furthermore, urbanization certainly calls for a tremendous shift of population from rural to urban areas, but until now this population shift has resulted in environmental degradation, poverty, and unemployment in urban

areas, in effect worsening the quality of life and thus conflicting with concepts of restructuring.

Dealing with these problems while restructuring to achieve a more balanced economy may also necessitate government intervention, which again complicates marketization. For this restructuring, if the PRC authorities try to raise total factor productivity and use their “demographic bonus” (人口红利 “renkou hongli”) to make economic growth more sustainable, they will need to define the government’s role in education, population policy, and technological development. On balance, pursuing these four guiding principles over the next five to 15 years will require examination of the interrelationships of these goals, an effort to prioritize them as necessary, and careful consideration of the roles that government and market will play in order to reach a more developed stage of the socialist market economy. (20 July 2005)

(Table) Economic Outlook During 11th Five-Year Plan by the DRC

(Average Economic Growth: %)

Economic growth is expected to be gradually slow down and sustainable

2000–2005	2005–2010	2010–2015	2015–2020
8.7	8.1 (8.5)	7.5 (8.2)	6.8 (7.7)

(GDP Structure: % share of GDP)

Growth is expected to more rely on household consumption

	2000	2005	2010	2015	2020
Household Consumption	47.8	45.7	49.6 (49.8)	51.2 (52.2)	52.2 (53.2)
Investment	36.5	41.2	37.2 (37.5)	35.7 (35.4)	34.8 (35.0)
Government Consumption	13.0	12.6	12.8 (12.3)	12.9 (12.2)	12.9 (11.7)
Export	26.0	30.5	32.3 (31.4)	34.3 (32.4)	34.9 (32.7)
Import	23.4	30.1	31.9 (31.0)	34.1 (32.2)	34.7 (32.5)

* Figures in Parenthesis assume some increase in Total Factor Productivity (TFP) and improvement in energy saving as well as further progress in high-tech industry etc., while the baseline figures assume the extrapolation of the past average in terms of TFP and technology development.

(Industrial Structure: % share of GDP)

Agriculture and manufacturing will reduce weighting, while service industry will gain. (The following table may be based on the old statistics. GDP statistics was reviewed in January 2006. According to the revised statistics, the share of tertiary industry to GDP is increased significantly. Latest statistics shows that the proportion of primary, secondary and tertiary industries to GDP in 2005 is 12.5%, 47.3% and 40.3% respectively, which is more well-balanced than it was deemed to be in the past.)

	2000	2005	2010	2015	2020
Primary	16.4	14.5	14.1	12.5	11.6
Secondary	50.2	53.2	54.2	53.1	48.2
Tertiary	33.4	32.3	31.7	34.4	40.2

Source: “中国中长期发展的重要问题 2006—2020” 国务院发展研究中心, or “Key Issues in China’s Development 2006–2020” China Development Research Center 2005

Note:

In fact, the outline of 11th five-year plan submitted to the NPC in March 2006 highlights six policy priorities, i.e. 1. to expand domestic demand, 2. to enhance industrial structure, 3. to save energy and protect environment, 4. to pursue technological innovation, 5. to further promote reform and opening-up, and 6. to pursue balanced growth by putting a top priority on the life of people. These could be summarized as four key words in the text.

6.4 Toward a more sustainable development of the PRC economy (part 1)

Environmental degradation has become a critical issue in the PRC. Greenhouse gas emissions now account for approximately 14 percent of total worldwide emissions, second only to the United States. Dioxin emissions in the PRC are the world's largest, currently 20 times greater than Japan. Auto emissions are a significant concern in urban areas. Acid rain contamination is spreading: in 1985, affected areas accounted for 18 percent of total land. During the late 1990s the amount of total land affected by acid rain increased to 40 percent. Water contamination is severe with 70 percent of major rivers reported to be seriously contaminated.

Desertification and loss of biodiversity are also concerns. Since the late 1990s an additional 3,500 hectares have suffered from desertification. Nearly one fourth of the total land has become desert. Among the 640 wild fauna and flora to be protected under the CITES convention (Convention on International trade in Endangered Species of Wild Fauna and Flora), over 150 are found in the PRC. At 15 percent, the proportion of endangered species in the PRC is higher than the world's average. Considering these facts, most observers now agree that the environmental situation in the PRC has reached a critical stage.

Given the borderless nature of environmental degradation this issue is rightly concerns neighboring countries. For example, acid rain and yellow sand storms in the PRC occasionally reach both the Korean Peninsula and Japan. The increasing emission of greenhouse gases in the PRC contributes to global warming. A key characteristic of environmental problems is that they are viewed as a market externality that cannot be automatically addressed by market forces. The PRC has vigorously pursued a market-oriented economy placing economic growth and industrial development as a top priority. It would appear that environmental impact was not given serious consideration.

For example, during visits to the PRC in early 2000 this author recalls asking some senior PRC officials what measures were being taken to address environmental problems. The PRC policymakers understood the question to be related to the “investment environment” for foreign-funded enterprises, and they proceeded to explain efforts to attract FDI by introducing favorable treatment for foreign enterprises. This response reflected the primary concern of the PRC central government at that time, which was to maximize GDP growth even if it meant accepting other negative factors to achieve that end. Local government policymakers also competed with one other to maximize growth and receive positive evaluations or promotions from the central government. This resulted in the problem of “false reporting of official statistical figures” especially by local governments. The concluding part of this article will look at how the situation is gradually changing. (16 August 2005)

6.5 Toward a more sustainable development of the PRC economy (part 2)

The sentiments of PRC authorities toward sustainable development are changing noticeably. A significant triggering event is the scheduled summer 2008 Olympic Games to be held in Beijing where municipal authorities are eager to show off its clean air and an environmentally friendly capital city to international visitors. Reports state that the municipality plans to complete all Olympic-related infrastructure projects by the end of 2006, reserving 2007 for making fine adjustments to the construction and management of Olympic facilities.

The discussion on sustainable development is extending beyond the Olympic games as is evidenced by a number of articles in local newspapers reporting on initiatives to create the “recycle economy” (循环经济 “xunhuan jingji”). In early 2005, a task force on the PRC’s circular economy development strategy under the National Development and Reform Commission (NDRC) announced overall strategic targets for developing the recycle economy. Three stages were identified to take place over the next 50 years with major economic indicators such as energy efficiency, recycle utilization rate and waste disposal in an ecological environment being slated to reach advanced international levels.

For the first stage (2005 to 2010), the strategy calls for establishing a sound legal framework, policy support system, technological renovations, and an effective control mechanism to facilitate the recycle economy. Conferences and workshops are being held with promising titles, such as “China: Building a resource-efficient society” jointly organized by NDRC, Development Research Center and the China Development Research Foundation. Many high-level PRC policymakers were in attendance.

Attempts to introduce a “green GDP” have become an urgent concern for both scholars and authorities since 2004. It is reported the National Statistical Bureau, NDRC, Environment Protection Bureau and other relevant ministries are jointly developing a calculation system for a green GDP that would incorporate the cost of protecting the ecological environment and natural resources. Preliminary estimates conducted by some experts indicate that if environmental degradation is taken into account, growth of the green GDP during the past 15 years is only 78 percent of the officially reported GDP growth rate. The National Environment Protection Bureau announced a performance evaluation system that takes account of environment-related indicators. This system has been experimentally introduced in several provinces including Sichuan (四川), Hebei (河北), and Shandong (山东). As a result, local policymakers may pay more attention to environmental protection and shift their focus from maximizing growth and tax revenue.

These policy changes appear to coincide with the inauguration of the new Administration. As such, these changes are part of the initiative to create a “harmonious society” (hexie shehui) based on the “idea of scientific development” (kexue fazhanguan), both of which the new Administration stressed at the NPC. This is a very encouraging sign, but a great deal more remains to be done if PRC is to actually realize these goals instead of only raising expectations. (17 August 2005)

6.6 Cooperating on the Clean Development Mechanism

The Clean Development Mechanism (CDM) is designed to make it easier and less expensive for industrialized countries to meet the greenhouse gas (GHG) emission reduction targets agreed to under the Kyoto Protocol. The CDM also aims to assist developing countries in

achieving sustainable development by addressing environmental degradation and at the same time promoting the transfer of environment-related technology from advanced countries to developing countries. Under the Protocol Japan committed to reduce GHG emissions by 6 percent until 2012, which like many other industrialized countries is deemed to be a very tough target to meet. This is why the Japanese government, as well as business circles, recently began to participate actively in the CDM. Japan's GHG Reduction Fund, which is supposed to be engaged in the purchase and resale of emission reduction in developing countries including PRC, was set up under the sponsorship of major Japanese private companies and policy-lending institutions.

The PRC's GHG emissions account for more than 10% of total emissions globally, making it the second largest emitter in the world. One hopes there will be many worthy investment projects for reducing GHG in the PRC. Normally project information notes (PINs) and the Project Design Document (PDD) illustrating the outline of any project are required to be submitted to the purchasers of credit emission reduction (CER). There are a couple of key criteria for screening PINs, which include environmental and social safeguard requirements (compliance with laws and regulations), project feasibility and development impacts on host country. However, the most controversial criterion is "additionality," namely whether the project contains some innovative elements to reduce GHG. If the project is a simple traditional energy-saving project, the emission rights pertaining to the project cannot be accepted, which makes the project unviable. From this viewpoint, it seems that although there a number of projects started in the PRC, there are still not so many which include such innovative elements.

Since many projects are managed by local governments and state-owned enterprises, the purchasers are required to negotiate with the governments to agree on the price of CER and it takes time, as PRC governments are reported to be quite tough about prices for CER. Private companies run some projects, but even in such cases, the company concerned is required to seek government prior approval before agreeing to the CER price. Most PRC authorities still hold to the view that all matters relating to natural resources should belong to government. Nevertheless, many observers agree that PRC is a potentially huge market for CER (see Note below). The PRC itself became aware of the importance of GHG reduction projects and fully appreciates that CDM can help promote technology transfers from industrialized countries; something that the PRC has been very keen on for many years. However, if any of the above factors become a bottleneck in cooperation between PRC and Japan, it would be a missed opportunity for both countries, since Japan has advanced technologies relating to environmental conservation, and will continue to face difficulties in achieving its reduction targets by 2012. (30 November 2005)

Note:

“Clean Development Mechanism Project Opportunities in China,” by Wei Zhihong (2002) identified following five high-priority CDM projects in the PRC.

To promote and disseminate high-efficiency electric motors (initial investment \$228 million and project life period 20 years)

To retrofit existing boilers for industrial, service and residential use (\$182 million, 15 years)

To promote renewable energy use by substituting wind for fossil fuels in power generation (\$236 million, 20 years)

To replace coal with natural gas in heating residential district in northeast region (\$20.2 million, 30 years)

To establish biomass resources gasification plant (\$0.8 million, 10 years)

6.7 11th five-year plan period will be critical for an ageing PRC

In the midst of a rapidly ageing East Asia, the PRC is no exception. According to UN criteria, PRC has already become an aged society with an over-60 aged population of 143 million, or more than 10 per cent of total population in the PRC in 2004. These figures, combined with improvements in life expectancy and the “one-child policy” introduced in the late 70’s, predict that the rate at which ageing affects PRC’s economy will be unprecedented.

A recent report by the PRC National Ageing Working Committee points out a few unique features of this situation. First, the size of the aged population is huge. It is expected that the population aged over 60 will become 200 million and then 300 million in 2014 and 2026 respectively. It will hit a peak of 400 million in 2037 and will become stable afterwards (about 30 per cent of total population will be aged). Due to these estimates the speed of ageing in the PRC is much faster than other countries. The report says that it took more than 45 years for other countries to increase the share of population aged over 65 from 7 per cent to 14 per cent, while in the PRC’s case, it is expected to take only 27 years. There are also some apparent distortions in the ageing picture. The male population is already much larger than female and this discrepancy is expected to widen. In addition, the ageing situation differs from the East coast to inland areas, and between urban and rural areas. Currently ageing in urban and coastal areas is faster, but as immigration from inland to urban areas develops, ageing in rural areas is also expected to progress rapidly.

However, the most important characteristic may be that unlike many other countries, the PRC will have turned into an aged society before it became a fully developed and matured society. In many other developed countries, including Japan and countries in Europe,

economies first became mature then aged for various social and economic reasons. In other words, these economies could afford the costs of ageing whereas the PRC economy does not necessarily have the strength yet. Moreover there is a strong cultural tradition in the PRC that families and relatives should support old people. The fact that there is no nationwide pension and social safety scheme in place suggests just how difficult the ageing problem will be for the PRC authorities over the long run.

The good news is that in the short to medium run, the abundant labor force in the PRC should lessen the impact that ageing will have on the PRC economy. Rather, population experts point out that the PRC ought to enjoy a “demographic bonus (renkou hongli)” for the next ten years thanks to the declining fertility rate (see Note page 64). Currently the population aged 15 to 65 and the population under 15 years account for 70 per cent and 15 per cent of total population in the PRC respectively. These percentages are much higher than in other developed countries. Furthermore, although theory generally indicates that household propensity to save would decline as ageing develops this is not the case in the PRC. Many households try to save more to prepare for ageing because they take into account their low incomes and the lack of a social safety net.

This can be seen as both good and bad; it will contribute to sustaining investment-led economic growth for the time being but will not be sustainable in the long run. As the outlook for 2006–2020 by the PRC Development Research Center correctly points out, ageing is one of the major risk factors for sustainable development, in particular for the critical period of 2010–2020. Therefore, it will be essential for PRC to upgrade its economy and to begin to prepare for the coming aged society during the 11th five-year plan period while the PRC can still take advantage of its population bonus. (20 March 2006)

Note:

Demographic bonus—According to the United Nations Population Fund (UNFPA), the bonus occurs when both fertility rates and mortality rates decline thanks to the family planning and investment in health services and education including reproductive health care. The proportion of productive labor force to dependent children increases, which offers countries an opportunity to build human capital and spur long-term development. However, this is one-off opportunity lasting a decade or so, because working population eventually gets old and becomes dependent. UNFPA says East Asia was the first developing region to experience the demographic bonus, and it helped to build the region's prosperity into the mid-1990s. A similar window of opportunity is opening in Southeast Asia and South Asia.

(Table 1) Population Structure—International Comparison (%)

	Less age 15	Age 15–65	Age over 65
PRC	23	70	7
Developing world (excluding PRC)	36	60	4
Developed countries	18	67	15
East Asia	22	70	8
Japan	17	67	16
US	21	66	13
Western Europe	14	66	18

Source: World Population data 2002

(Table 2) Outlook for 2000–2020 by Production Factors (%)

	2000–2005	2005–2010	2010–2015	2015–2020
GDP	8.7	8.1	7.5	6.8
Labor	0.5	0.4	0.2	0.0
Capital	6.4	5.6	5.0	4.5
TFP	1.8	2.1	2.3	2.3

Source: Baseline scenario illustrated by the China Development Research Center, or 国务院发展研究中心, “中国中长期发展的重要问题 2006—2020”

7. Other Topics

7.1 Influence of the “US school” in PRC bureaucracy

Although domestically educated officials still dominate many political and high-ranking government positions in the PRC, since the 1990s many persons who studied economic theory, particularly in the United States, have started to assume important policymaking roles in government institutions such as the Peoples Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE). The US has become the most popular study-abroad destination for young students in the PRC, followed by Australia and European countries while Japan, formerly the most popular country for Chinese students studying abroad, now comes third or fourth. This change points to a decline of the “Japan school” in the PRC policy-making process.

What factors are driving this change? One factor is that a more open PRC economy and the increased trade and capital flow with other countries motivate more students to learn English as an international language. Immigration policies and the availability of scholarships may be another factor. However, economic policy

changes within the PRC and economic trends outside the country in recent years also make the US attractive to Chinese students since the processes of converting the PRC economy to a more market-oriented economy requires knowledge on contemporary economic theory. Many view the US as the best place to study these economic theories. Economic trends outside the PRC further contribute since the US economy enjoyed a new stage of development in the 1990s while Japan underwent a long recession after the bubble economy collapsed in the late 1980s. For some in the PRC it seemed that the US might offer better economic lessons than its neighbor. And in a culture that places a premium on personal networks, many young students who aspire to succeed in the bureaucracy believe that studying in the US provides the advantage of acknowledgement as members of the same alumni group as the sons and daughters of such past PRC leaders as Deng Xiaoping and Jiang Zeming.

However, we neither recommend nor predict a dominant “US school” for policymaking in the PRC. Although nurturing policymakers who learn contemporary economic theory will promote the effort to work out market-oriented economic policies, the PRC should be careful not to rely only on neo-classical economic-based mathematical theory, but should try to learn from the wide range of experience of other Asian countries. Some foreign commercial bankers in the PRC have criticized PBOC Beijing policies as “pie in the sky” that may not reflect the reality of the local financial market. Moreover, the optimal allocation theory of contemporary mathematical economics cannot address the crucial problem of income distribution. The current Hu Jintao and Wen Jiabao administration has emphasized the importance of addressing income disparities, putting forward the idea of a harmonious society (和谐社会 “hexie shehui”) (see Note page 67). Given speculation that the

current administration has criticized and penalized some of those who pursued radical privatization in the previous administration, the influence of the “US school” in the PRC bureaucracy may now be on the decline. (31 May 2005)

Note:

China Leadership Monitor No.13 by Cheng Li points out that General Secretary Hu Jintao’s “seemingly contradictory statements and actions” in various occasions, e.g. while denying the western model of development, at the same time trying to make use of knowledge of liberalist economists, reflects the environment Hu is currently placed, namely he has to further pursue market reform and open-up policy under globalization of world economy, at the same time he needs to think about policy intervention to strengthen social safety net and address rural poverty.

7.2 Competing bureaucracies under a socialist market economy

Since the PRC’s entry into the WTO in 2001, authorities have been grappling with how to deal with the issue of preferential tax treatment for foreign-invested companies. Both foreign and Chinese companies have been paying close attention to this question, yet after more than three years of interest in the issue, no final decision has been taken.

At first glance there seem to be differing views that are complicating a rather simple situation. Heavyweight players in the PRC bureaucracy on this issue are the Ministry of Finance, State Tax Administration and Ministry of Commerce. Ministry of Finance and State Tax Administration are certainly in favor of terminating this treatment primarily from a revenue consideration, but also as a matter of applying fairness in the taxation principle. The Ministry of Commerce strongly opposes it, saying that this treatment is essential to encourage FDI, which has been the main engine for economic growth in the PRC.

The fundamental difference seems to be that while the Ministry of Commerce tries to use the tax regime as one important policy tool, one which may contribute to achieving a certain policy goal, the tax authorities want to approach any taxation regime purely from the standpoint of what makes tax logic. The PRC is not unique in this respect since the exact same situation exists in Japan.

In the past government ministries under the State Council mechanically carried out policies that were decided by the Communist Party without adding their own ministerial views and opinions on policy matters. Or rather, they did not explicitly express their views and tried to avoid giving an impression to the outside that conflicting views on a specific policy agenda were circulating among ministries and Party. However, although preferential tax treatment is just one of many policy issues facing the PRC now, it is interesting to observe that ministries now quite openly express their own views. How should we interpret such a change in the context of the PRC?

First, it is apparent that the tight Communist party control over mass media has been gradually loosened. Now the Party seems less concerned about giving an impression to the outside that there are conflicting views within the government. Second, in general the PRC bureaucratic structure has gradually changed to reflect the shift of economic structure from a centrally planned to a more market-oriented one. One milestone in this regard was the transformation of the former State Planning Commission to a State Development and Reform Commission in the late 1990s. This may indicate that each ministry has become a more autonomous entity with power to pursue its own policy. Third, there is a close relationship between the Ministry of Commerce and the foreign-invested companies that appears to be supported by the strong, influential power of foreign-invested companies. This means that a more open economy invites pressure

from outside which inevitably affects policy decision-making within the PRC. Another example of this is the recent foreign pressure to reevaluate the renminbi.

Lastly, as the bureaucracy becomes more flexible proper policy coordination is essential. In this regard the role of the Party, and maybe other administrative bodies like the State Development and Reform Commission, becomes more important. This requires PRC authorities to have even clearer ideas and policies than ever when deciding which economic policies to pursue in the future. (20 January 2006)

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