JOINT ECONOMIC COMMITTEE

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OVERVIEW OF THE PRC'S ECONOMY

In 1978, the People's Republic of China (PRC) embarked upon incremental reforms that transformed its command economy into a mixed economy. Essentially, Chinese leaders sought the benefits of capitalism without relinquishing control of the "commanding heights" of the economy.

Strengths

One characteristic of successful market economies to which the PRC has largely adhered is openness to international trade and investment. Not surprisingly, the PRC's greatest strength is its integration with the global economy.

From 1979 to 2004, the value of the PRC's goods exports grew by an average 17.9 percent a year. Consequently, the PRC's share of world goods exports (excluding intra-European Union exports) increased from 1.2 percent in 1979 to 9.3 percent in 2004. While the PRC's export performance may seem impressive, it is actually quite similar to the export performances of Japan, Korea (South), and Singapore during similar stages of their development.

The PRC attracted $517 billion of inward foreign direct investment from 1982 to 2004. Chinese affiliates of foreign multinational firms:

- Employ 10 million urban workers;
- Account for 15 percent of the PRC's investment in capital assets;
- Produce 31 percent of the PRC's gross industrial output; and
- Account for 57 percent of the PRC's goods and services exports and 58 percent of the PRC's goods and services imports

Weaknesses

Although the PRC has made some progress toward achieving other characteristics of successful market economies, the PRC retains many of the detrimental characteristics of command economies.

Price Distortions. The PRC distorts prices in key factor markets:

- **Interest Rates.** Despite recent liberalization, regulations keep both nominal and real interest rates low when compared with other developing economies.
- **Energy.** State-owned oil companies are required to use their profits from domestic oil production to subsidize oil imports. Domestic prices for gasoline and other petroleum products have not increased in line with recent increases in world oil prices.
- **Land.** Developers conspire with government officials to seize agricultural lands or existing urban neighborhoods for new projects, paying little compensation to displaced peasants or urban residents. Thus, developers may gain control of these sites for a fraction of their market value.

State-Owned Enterprises (SOEs) and State-Influenced Enterprises (SIEs). Since the "grab the big, dump the small" policy began in 1997, the number of SOEs has fallen by 45 percent to 31,750 in December 2004.

Some SOEs have been converted into:

- Township and village enterprise owned by local governments;
- Cooperatives owned by their employees;
- Private enterprises often sold to provincial or local government officials or their families in rigged sales at a fraction of their market value; and
- Joint enterprises owned by combination of the above

Other SOEs have been incorporated as shareholding enterprises. These shareholding enterprises have issued a minority of their shares through initial public offerings (IPOs) to domestic and foreign investors. Although these shareholding enterprises have some of the characteristics of private corporations, the central government still owns a majority of their shares and exercises effective control of their operations. In December

2004, the central government controlled 69 percent of the market value of all shareholding enterprises.

The PRC now has more than 3.3 million private domestic firms. However, private domestic firms are generally small, employing an average of 14 employees. Private domestic firms are concentrated in service industries, oriented to local markets, and are not generally engaged in international trade or investment.

Despite the recent growth of private domestic firms and Chinese affiliates of foreign multinational firms, the SOEs and the SIEs still:

- Employ 99 million urban workers;
- Account for 77 percent of the PRC's investment in capital assets; and
- Produce 54 percent of the PRC's gross industrial output

Economic reforms have loosened Beijing's control over the provincial and local governments. Given a weak rule of law and the lack of democratic accountability, provincial and local government officials have exploited this change to enrich themselves and their families through widespread corruption. Transparency International reported that the PRC scored 3.4 out of 10 on its *Corruption Index 2004*, 71st of the 146 countries rated.

These same factors give the SOEs and the SIEs significant competitive advantages over private domestic firms. Generally, large SOEs and SIEs have *guanxi* (i.e., connections) with Chinese leaders, central government ministries, or prominent provincial or local government officials. These patrons use their influence to secure favorable laws, better regulatory treatment, and preferential access to loans from the state-owned banks (SOBs) and other depository institutions for the SOEs and the SIEs.

Many SOEs and SIEs face a "soft budget constraint" (i.e., the SOBs and other depository institutions lend to the SOEs and the SIEs without regard to their ability to repay their loans). Despite some recent efforts to curb such non-market loans, their flow continues. These non-market loans allow many SOEs and SIEs to continue operations or to invest in new capital assets when market discipline would force these SOEs and SIEs to shutter operations or to forgo the acquisition of capital assets.

Thirty-five percent of the SOEs as well as many SIEs were unprofitable in 2004. Protected through their *guanxi* from bankruptcy or foreclosure, many SOEs and SIEs cannot or will not service their debts to the SOBs and other depository institutions. Consequently, non-market lending has saddled the SOBs and other depository institutions with enormous portfolios of non-performing loans (NPLs).

Bad Loan Problem. The PRC relies heavily on banks and other depository institutions to allocate its national savings:

- Deposits were 171 percent of GDP in December 2004.
- Loans were 126 percent of GDP in December 2004. In contrast, the market value of all marketable shares listed on the PRC's stock exchanges in December 2004 was 8 percent of GDP.

The China Banking Regulatory Commission reported that NPLs at the four major SOBs and other commercial banks were 12.3 percent of GDP on March 31, 2005. However, private estimates of the size of the PRC's bad loan problem are much larger. Standard and Poor's (2004) estimated that the PRC's NPLs were equal to 55 percent of GDP. Alternatively, Roubini and Sester (2005) estimated that the PRC's NPLs ranged between 46 percent of GDP and 56 percent of GDP.

Chinese leaders are aware of the enormous challenges confronting their banking system. Since 1998, the PRC has injected $277 billion of government funds into its four major SOBs. Moreover, the PRC is currently seeking private capital from both domestic and foreign investors to recapitalize its banks. On June 17, 2005, Bank of America announced its intention to buy up to a 9 percent stake in the People's Construction Bank of China for $3 billion. The PRC is planning an IPO to sell additional shares in the People's Construction Bank of China later this year. Other IPOs are likely to follow.

Nevertheless, the ultimate cost of resolving the PRC's bad loan problem is huge. Standard and Poor's (2004) estimated that the total cost of resolution would be 40 percent of GDP. Even assuming a generate recovery rate of 20 percent, Roubini and Sester (2005) estimated the central government would need to issue additional debt ranging between 35 percent of GDP and 45 percent of GDP to resolve its bad loan problems. Consequently, resolution would increase:

- The central government's debt to between 65 percent of GDP and 75 percent of GDP; and
- The central government's annual budget deficit to approximately 3.5 percent of GDP a year

Macroeconomic Consequences of the PRC's Dysfunctional Banking System. Large-scale non-market lending limits the availability of credit cards, mortgage loans, and installment loans. Many insurance and annuity products are not widely available. Chinese individuals must save a very high percentage of their income to buy autos or homes and to protect against life's risks.

Consequently, the PRC has a very high national saving rate of GDP to 48.0 percent of GDP in 2004. The unnecessarily high national savings rate contributes to what Chairman of the Council of Economic Advisers Ben S. Bernanke describes as a "savings glut" in Asia.

The SOBs and other depository institutions effectively channel the bulk of Chinese savings to support unprofitable SOEs and SIEs and to fund their uneconomic investments in new capital assets. In the short term, such non-market lending maintains production and increases investment, boosting real GDP growth to 9.5 percent in 2004.

However, economic growth is sustainable over the long term if and only if firms:

- Produce goods and services that the market demands; and
- Invest in capital assets that have a positive net present value (i.e., the expected future revenues generated by a capital asset exceeds its current and expected future costs discounted by a rate that reflects the real interest rate, expected future inflation, and the risk associated with such investment)

The rapid accumulation of capital assets among the SOEs and the SIEs suggests that widespread overinvestment (i.e., the acquisition of too many capital assets for producing goods and services given expected future demand) and malinvestment (i.e., acquisition of the wrong types of capital assets for producing goods and services to meet expected future demand) may be occurring in the PRC. The PRC's investment rate (i.e. gross investment in capital assets as a percent of GDP) of 43.6 percent is way out of line with investment rates in Brazil, the European Union, India, the United States, and other Asia-Pacific economies.

Non-market factors, including central government industrial policy, distorted interest rates and prices, *guanxi* lending, and outright corruption, have driven the PRC's investment surge. Recent economic data, including a high vacancy rate (i.e., 28 percent of all types of new construction completed in 2004 stood vacant), suggest that a significant portion of these newly acquired capital assets may be overinvestment or malinvestment.

Economic growth in the PRC is mainly attributable to increasing quantities of factor inputs (e.g., the migration of unemployed or underemployed peasants from rural communities to cities and the rapid accumulation of capital assets) rather than efficiency gains or innovation. From 1979 to 2004, the PRC's labor productivity grew by an average of 6.9 percent a year.

However, Jinghai Zheng and Anagang Hu (2004) found that the growth in PRC's total factor productivity decelerated dramatically from 3.2 percent a year for 1978-1995 to 0.6 percent a year for 1995-2001. Total factor productivity measures the gains from efficiency improvements and technological innovation.

The combination of a high rate of labor productivity and a dropping rate of total factor productivity means that the marginal productivity of new capital assets is falling. This is further evidence that domestic firms are investing in too many capital assets or the wrong types of capital assets given the PRC's comparative advantage in plentiful, low-cost labor.

Conclusion

An economic boom caused by overinvestment and malinvestment cannot sustain itself indefinitely. The inevitable liquidation of overinvestment and malinvestment will impose significant costs on the PRC in terms of lost output, employment, and income and could slow economic growth in the United States and other countries around the world.

This Policy Brief is based on the Joint Economic Committee study, *Overview of the PRC's Economy* (July 2005). For a copy of this study, contact the JEC at (202) 226-3234 or visit the website www.house.gov/jec.