

## **Talk for Business Group: Challenges and Opportunities for Business in China**

The Fortune Group's September Meeting provides an excellent microcosm of the problems and challenges in working in China at the current stage of development:

- It reflected the fact that China cannot develop its full potential without substantive foreign engagement, hence JZM visiting and the event being included as a part of the official celebrations of the 50<sup>th</sup> anniversary—shows how far China has come in the last 20 years—the average increase in FDI averaged 40% over the 1990s, and China has taken around one half of all investment in the developing economies. However, this year FDI will fall by about one-fifth. With other reform options looking problematic, it is important to keep FDI up.

BUT

- The current more conservative political atmosphere and conflicts over the way forward put constraints on what JZM could say—essentially messages that were not particularly appealing to a business audience—e.g. over the possible use of force to reunify with Taiwan etc.
- The banning of Fortune's flagship magazines in Asia (50<sup>th</sup> anniversary editions) indicated that there were very clear limits to what they wanted to hear from the foreigners.

General comments about the state of reforms in China, as this is fundamental to any understanding for the business environment.

One general point-- it is worth remembering that China is an extremely diverse country that is still very poor—often get lulled into a false sense about the level of development and the potential market just by visiting Beijing, Shanghai and the South. In terms of the current situation, it is probably just worse of than India. Anywhere up to 150 million people live in extreme poverty and probably about 250 million people survive just above the poverty line. China enjoys enormous variation and in many ways real politics is local politics. One of the key effects of reforms has been that de facto power has been decentralized to the localities and they will pursue, no matter what the center says, policies that are beneficial to their own locality. Central power to enforce implementation is weakened by the lack of moral authority of the center and by the lack of effective financial resource base to enforce its will.

The most important development has been the effective decentralization of the fiscal system and this more than any other factor accounts for local variation. Only about one quarter of all state expenditures occur at the central level and the major responsibility for financing infrastructure and providing social welfare occurs at the local level. However, government revenue as a percentage of GDP has declined to only around 12 percent in 1998 (from almost 30% in the 1980s). At the same time, there has been an increase in the expectation of the kinds of services that local authorities should provide. A successful resolution of this dilemma lies not only in increasing the tax base of the government, a

solution explored by the World Bank and favored by the Chinese central government, or squeezing the rural poor through levies and fees, a strategy often favored by local authorities, but also a re-think of the kinds of work in which the government should be engaged.

This produces a sometimes unclear investment and business development climate: e.g. of Lee Kuan yew and Suzhou and GITIC. Raises the question of local power and inconsistent implication of regulations. What is the state of the reforms? First outline what they were trying to do before assessing success and then turning to outstanding problems.

In 1997-87, the Chinese leadership announced a set of reforms that if implemented would have amounted to a revolution in the relationship of the state to the economy and society.

There are 8 key components: First, a clear commitment to a mixed economy with theoretical continued dominance of the state sector. In reality, and in local response, the policy amounts to privatization in all but name.

Second, With the onset of the Asian financial crisis and the realization that China's banking system is as perilously placed as many of those that collapsed in the surrounding countries, reformers were able to push ahead with plans for an overhaul of the banking system, the centerpiece of which is the reorganization of the local branches of the People's Bank along regional lines to reduce political interference by powerful provincial Party chiefs in lending decisions. The investment and financing system is to be overhauled to prevent wasteful duplication of capital investment with the Central Bank stepping up its regulatory functions and commercial banks being allowed to operate independently.

Third, approving plans proposed a decade before, Zhu announced that China would set up a nationwide grain market to ease the country's reserves and most importantly, to reduce the massive amount of government subsidies pumped into the system because of the remaining influences of the Maoist obsession with self-sufficiency in grain.

Fourth, housing is to be marketized and "welfare housing" to be abolished. For those who do not purchase housing, rents are to rise to around 15 percent of the family income.

Fifth, Zhu revealed that a new nationwide medical care reform program would be introduced in the second half of 1998.

Sixth, the tax collection system is to be rationalized to prevent the levying of excessive fees and levies by local authorities that have been the source of much resentment and social unrest.

Seventh, Zhu announced a massive restructuring of the government bureaucracy with half the officials to be laid off and reassigned to new jobs.

Eighth, in late-1998-early 1999, the Chinese leadership (or at least JZM and ZRJ) decided that they did want to enter WTO as a part of this comprehensive reform strategy.

The key question remains the extent to which these reforms will be introduced and how implementation will be modified by interest groups at the Center and in the localities. The practice has been mixed and it seems that a more cautious approach to reform will now be pursued that places party control of the process and social stability above the economic and social transformation. Housing reform has slowed and been postponed in a number of places, as has medical reform. While banking and fiscal reforms have been pursued institutional capacity in this sector is weak, no one really knows the extent of debts, and political lending still is common.

The case of SOEs illustrates the leadership's dilemma and how it is now paying the costs of delayed reforms. Reforms have been on the agenda since 1983/84 but never carried out completely. There are strong political reasons for central leaders not to pursue swift enterprise restructuring. The first and foremost remains the capacity of other sectors of the economy to absorb the absolute numbers of redundant workers and to develop a sufficient social welfare program. Over the years, the overblown staffs of many of these enterprises have proved to be a viable political and social solution to the problem of inefficient industrial production but now this is no longer financially viable. Economic pressures have made it impossible for the Central State to remain on the fence while the localities were pursuing de facto privatization.

Some figures display the seriousness of the problem. Of the 100 000 plus industrial SOEs, World Bank figures suggest that perhaps under 10 percent are fundamentally viable. SOEs absorb 60 percent of national investment; receive total subsidies amounting to one-third of the national budget; and net credit to SOEs reached over 12 percent of GDP in 1995. Importantly, 50 to 75 percent of household savings, mediated and directed by state banks, currently goes to finance SOE operations. The World Bank estimates that in 1996 50 percent of SOEs lost money (unofficial estimates are higher).

It must have become apparent that over the long-term government resources would be insufficient to pay depositors and bondholders if SOEs are unable to service bad debts. Thus, the leadership began to accept bankruptcies and more open unemployment. However, the fact that the Party leadership's main fear is social instability that may lead to erosion its power, potential unrest can still cause a retreat from a more expansive reform agenda. In fact, despite the rhetoric, subsidies and "policy loans" have been reinstated to try to reverse the losses in key industries such as textiles.

This more conservative mood has stemmed from a number of factors:

1. The anniversary for the 50<sup>th</sup> birthday meant that putting on a good show and stability ruled over all other concerns.

2. Hand-in-hand with this went the consolidation of power in Jiang Zemin's hands as the paramount leader of the new generation. In contrast to Zhu Rongji, he has taken a more cautious view of reform and seems to have taken over decision-making on SOE reform and other crucial areas such as WTO from Zhu.
3. Zhu's position was weakened considerably by the refusal of Clinton to accept a deal on WTO.
4. External factors played into the more conservative atmosphere: The fall of Suharto, the NATO bombing of the Chinese Embassy
5. Internal factors: fears of social unrest heightened by the activities of Falungong and the campaign to place JZM as the paramount leader of the current time.

However, Central state pack pedaling may not stop the process of reform. Again with reference to SOEs, it needs to be borne in mind that the Chinese definition of state-owned does not only include those that fall under central ministries but also those under the jurisdiction of the sub-national levels of government. It is at this level that people have to resolve real problems and as long as the state (national) does not have the money to bale them out, they will take decisions based on local interest. Here there has been a wide degree of experimentation with mergers, acquisitions and wholesale privatization

Other factors also will play a role:

1. have the limits of the current strategy for development been reached. China is grappling with the problems of delayed reform. The easy bits have been done and it has benefited from the aspects of catch-up. One of the great successes has been relatively few losers but now it is apparent to many that they will lose out. Reform has become an unpopular word. BUT as the e.g. of SOE shows time is running out and it will be difficult to stand still and try to muddle through for much longer. Deflation is a new problem in the economy and the massive investment program has not stimulated the economy as expected and in any event cannot be a long-term solution. Something has to be done to stimulate domestic demand, open rural markets and to make the economy more rational over the long-term. Demographics will sour over the next five to 10 years and this speeds the need for a resolution of pension and other welfare schemes.
2. I have dwelled on the problems of urban China but as always, the real long-term challenges remain in the countryside where many Chinese economists calculate there is a surplus labor force of some 250 million people.

Despite the economic and environmental problems, the major challenge is in the realm of political reform. This is not to say that China needs to move to a multi-party democracy overnight but throughout the system there are problems with the current governing structures and increasingly, good governance is recognized by local leaders as a prerequisite for further development. This would have consequences for the legitimacy to rule of the regime—now solely based on the capacity to deliver the economic goods and are casting around for other sources, thus the strident appeals to nationalism and patriotism and the fascination with neo-Confucianism. More democratic system would provide a residual legitimacy—may help them with the difficult transition ahead.

But it would also have practical benefits: for example, Transparency and accountability issues need to be dealt with. A major issue is of course the corruption at the local levels--. Official estimates calculate that "spontaneous privatization" with the stripping of state assets has cost the state \$6 billion a year over the last 15 years. Official statistics show that around \$15 billion has been misused in the first half of 1999, an amount equal to one-fifth of annual tax revenues for the whole year.

Political coerciveness has been applied in fits and starts and has been combined with growing economic liberalization. Requirements for China for continued high growth are high information, declining coercion, less hierarchy, and more accountability by means of representative institutions and a marketplace in which priorities of goods and services in the economic sphere are balanced by needs and wants in the political. Whether the Chinese leadership can deal with this challenge of governance will attest whether it can retain its leadership over China's development in the 21<sup>st</sup> century.