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Comment on Fan Gang's paper

China's NPL and Overall "National Comprehensive Liabilities"

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I agree with Fan Gang's conclusion that China does not have any immediate crisis with its debt/GNP ratio, no matter how the level of its government debt is measured and estimated now. As long as China is growing so fast, the NPL and debt/GDP problem is under control.

Having said this, I would also like to point out that there is no room for complacency in China. In my view, there is inadequate understanding of the important inter-relationships between the sustainability of economic growth and the necessary institutional framework behind the growth.

We know that at some point of time, a high level of NPL will spark off a crisis, which will then slow growth, and then trigger off an unsustainable debt/GNP level, and then wipe out growth entirely for a considerable period of time. But we do not understand the fragility or robustness of these inter-relationships and what triggers off this chain reaction. It could be caused by large and sudden changes in capital flows, political shocks, or natural disasters.

All we can definitively conclude from Fan Gang's study is that the sooner China deals with its NPL problems, the better the chances of sustained growth. In another word, China should seize the window of opportunities, offered by the current favorable growth and fiscal conditions, to address the key institutional inefficiency of its economy over next one to two decades.

I believe this is the same point made by Professor Jeffrey Sachs briefly in yesterday's discussion. He highlighted the public finance as one of the five key challenges for China and other Asia economies in the next 50 years, when Asia is returning to its normal share of the world economy.

In my view the central issue is less about how to measure accurately present level of national liabilities. Instead, it is more about national debt dynamics and the importance of having long-term national risk management at the early stage of economic development and population ageing.

More specifically, I think the single most important reason for short-term optimism about China's debt dynamics is the fact that China's real growth rate is well above the global real interest rate.

The debt burden multiplier as defined by interest rate minus growth rate is actually negative in China's case. This means that if China's consolidated government deficit is zero, its debt/GDP ratio, no matter how high it is today (15%, 70% or 150%), will actually decline every year simply because of high growth. China's real growth rate is

now above 7% and is likely to maintain at a level above 5% for next one or two decades, given Japan's post war high growth experiences.

On the other hand, the global long-term real interest rate as measured by the 30-year US Treasury bond has been around 3.5% for the last decade. At present, China's real interest rate for 20-year government bond is well below 3.5%, at about 2% level. Even assuming globalization and rapid liberalization of China's financial sector, its long-term real interest rate is likely to be close to or a little lower than 3.5%.

As long as China can maintain a growth rate of above 3.5%, China's debt burden multiplier can be kept negative. When this debt burden multiplier is zero or negative, the threat of debt crisis would come only from the consolidated government deficit, which is a little easier to handle.

Japan's debt/GDP ratio was kept below 50% for a few decades before 1990s when its economy was growing at a high level of above 5%. But in the last ten years, Japan's debt/GDP ratio was rising rapidly. According to OECD's Economic Outlook, it increased from about 70% in 1993 to more than 130% in 2001 and is heading 140% this year. The key reason for this rapid rise of debt/GDP ratio in Japan in the last decade is that its economy suddenly stopped growing while its real interest rate was still positive because of deflation, even when the Bank of Japan kept its nominal interest rate close to zero.

No country would like to be in the position of zero growth, high debt/GDP ratio, and a real interest rate of 3.5%. But many countries, including China, may have to face with this risk at their later stage of development because of interactions among ageing population, industry restructuring, institutional inefficiency, and globalization.

China's strong growth in the past two decades have been driven primarily by three factors: (1) catching up from a very low base; (2) rapid and steady economic opening, reform, and industrialization/urbanization; (3) young and maturing population. All these factors are likely to continue to contribute to China's future growth for one to two decades. However, after a few decades of high growth, China may run into the same problems Japan is facing now: higher-level global competition, more fundamental reform and innovation of its economic system, rapid ageing of population, and increasingly inflexible political system.

China's population profile today is similar to Japan's during mid-1970s with only about 7% in the retirement age of 65 and above, and 68% in the working age of 15 to 64. In today's China one retiree is supported almost by ten working age people. However, in today's Japan, the population with the age 65 and above is as high as 17.3%, with less than four working age people supporting one retiree. Because of China's one-child policy, the ageing process in China may come earlier and sharper than experienced in Japan today. Because of its large size, China's ageing problem will also have larger impacts than Japan's.

I agree with Fan Gang that the ageing problems in Chinese cities could be dealt with through migration of young workers from rural region when China still have large amount of surplus rural labor force. But this may not be true in twenty years time. In the last two decades China managed to create 140 million non-farming jobs. In the

next two decades, China needs and is likely to create more than 150 million industrial jobs for rural population because of more economic opening required by the WTO. At that time, as an industrialized and urbanized country with one fifth of world's population, China as a whole could not be able to get around the ageing problem with internal or external migration. The relation between population ageing and ageing of political, social, and economic institutions is not well researched and documented. But I suspect the link could be close.

Japan would be in a much better position today if it reformed its financial sector during the golden growth period of 1970s and 1980s when its population was young and growth rate was high. When growth rate is well above the real interest rate, the government could use fiscal resources to reform the inefficient institutions and irrational industrial structure without worrying too much on rising debt/GDP ratio.

China now has the benefits of later comer and can draw useful lessons from Japan's past experiences. Clearly, next one to two decades is the golden period for China to address its core institutional inefficiency and competitiveness in the area of enterprise, banking, capital market, and social security.

The institutional inefficiency in enterprise, banking, capital market, and social security is the root of the national comprehensive liabilities Fan Gang is attempting to measure. The institutional inefficiency in all these areas is closely linked to the government because the State in China is still the owner or ultimate residual claimer of the losses and profits for major enterprises, banks, capital market participants, and social security system. The growth of non-state sector is giving China better hope. But the present reality with China's state sector, as documented clearly by Fan Gang and others, is still "private taking of profits and assets and nationalization of losses and liabilities."

There are two dimensions in accounting for the total costs for the government: one is to calculate the stock of national comprehensive liabilities as Fan Gang did; the other is to estimate current and future flows of consolidated government deficits. As shown clearly by Fan Gang, the costs and liabilities are all fungible among different categories such as bad loans, fiscal expenses, and social securities deficits. Hence, in principle, it is necessary to produce both a balance sheet and an income statement for the consolidated state sector, which includes the following:

- state-owned enterprises
- state-owned banks
- government capital market participants
 - state-owned brokers
 - Ministry of Finance
 - Central Bank
- central and local government social security systems

I included central bank in the list, as I believe the huge foreign exchange reserves in the assets account of the central bank could be used if necessary to offset external debts under the Ministry of Finance. The currency match in the consolidated balance sheet and income statement is important as without the foreign exchange reserves the

external debt measured in domestic currency may get out of control when the currency depreciates rapidly during a financial crisis.

On the other hand, I disagree with Fan Gang on exclusion of social security in his indicator of national comprehensive liabilities. The exclusion may not affect his assessment of China's fiscal and financial condition in the short-run but would distort the longer-term picture. A World Bank report (Wang Yan, etc. 2000) put China's implicit pension liabilities at 71% of GDP in 2000. It also projects that China's labor forces will stop growing between 2015 and 2020. The potential for serious imbalance in the social security system should be reminded as frequently as NPLs, as suggested by Fan Gang.

Ideally, both the current level of national comprehensive liabilities (stock indicator) and future streams of consolidated government deficits (flow indicator) are needed to assess the national financial fragility. The stock indicator captures the past performance while the flow indicator reflects the future performance, which depends crucially on the success of today's reform.

Fan Gang gave us very useful explanations on why both the stock and flow indicators of China's financial fragility have increased between 50% to 100% during last five years. In particular, China's official budget deficit/GDP and official debt/GDP ratios have both doubled from 1997 to 2001. The key issue for future research is whether this trend will continue or not.

If these key ratios are going to double every five years, then, in ten years, China's official budget deficit/GDP will be 12% and official debt/GDP ratio will be 65%. I do not believe this will happen in China. But China needs to monitor and study both the stock and flow dimension of national fiscal and financial costs and liabilities and have in place a long-term national risk management strategy at as early a stage as possible.

With regard to long-term national risk management, China's accession to WTO last year was at the right time and at the right terms. It provided a timely and enforceable schedule for China to tackle its core development problems when its growth potential will still be excellent. China's WTO deal also anchored China's development on a converging path towards the international best practice. China's manufacturing and domestic non-financial services sectors have already been globally competitive with extremely flexible prices and highly mobile labor because of past reforms. In the WTO deal, China rightly committed to the more difficult reform and opening in the service sector, especially in the financial services sector. As experiences in Japan and other countries show, reforms in the financial sector are difficult and time-consuming. Hence, it is very important for China to modernize its financial sector in the next one to two decades when its growth prospect is good. Given the past success of reform, current population structure, globalization trend, and strong leadership in China, I am optimistic that China will be able to catch and use well the window of opportunities.