

What Is Special about China's Success in Foreign Trade and Investment? Lessons, Implications and Policy Options

Geng Xiao and Haiying Zhao
School of Economics and Finance
University of Hong Kong
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Abstract

China's foreign trade and foreign invested enterprises have been governed under many special institutions ranging from special economic zones, special enterprise laws and regulations, special provisions for foreign exchange transactions, to special tariff and tax treatment. These special institutions have isolated the foreign trade and investment sector (e.g. external sector) from many negative effects of China's backward but slowly reforming domestic legal and economic institutions and provided a solid foundation for the rapid growth of the external sector in the past two decades. The relatively advanced economic institutions and practices in the external sector have become the model for the reforms in the domestic sector. However, the remaining incompatibility between the rapidly expanding external sector and the slowly reforming domestic sector in the monetary and financial aspects has become the key barrier for future success of China's economic opening and reform. Based on China's own past experiences, the paper argues that China should speed up the introduction of modern money, banking and financial services based on hard foreign currencies, quality foreign banks and modern financial institutions into its external sector so that a complete system of modern market institutions can be firmly established in the most advanced regions and for the most dynamic enterprises in China. The proposed financial opening and liberalization in China's external sector could reduce significantly the currently high and hidden transaction costs of doing business in China with little risks to the domestic banking and financial sector. The reduced transaction costs would then attract sustained flows of foreign investment into China which could not only maintain high and efficient growth of China's external sector but also facilitate the reform of China's state enterprises and banks.

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I. China's success in foreign trade and investment and its implications

China's great transformation in the last two decades from a closed, underdeveloped, planned, and agricultural dominated economy towards a rapidly growing and industrialising open economy has been led by foreign trade and investment. During 1980-1996 China's GDP increased 469%. From 1978 to 1996, China's exports grew by 1449% and imports by 1175%. According to a recent World Bank projection (World Bank 1997), China's share in world trade could triple and exceed 10 percent by 2020. China started to attract foreign direct investment in early 1980s. The annual flows of FDI into China during 1984-1990 were only between 1 to 4 billion US dollars. The FDI flows jumped to about 12 billion in 1992 when China under the leadership of Deng Xiaoping made a decisive step towards further opening of its economy. Since 1993, foreign direct investment flows into China have exceeded 30 billion US dollar a year for five years. China have now become the largest recipient of foreign direct investment into developing countries, attracting close to 40% of the total annual flows¹.

The rapid growth of foreign trade and investment has changed the composition of China's exports dramatically. In 1985, primary goods such as oil products still accounted for more than 50% of total merchandise exports. In 1995, 86% of all Chinese merchandise exports were manufacturing products. According to Zhao (1996), among China's top ten export products (at the three digit SITC level and for the period 1990-1994), all but one are labour-intensive manufacturing products. Five of the top ten belong to the textile and apparel industry. Also, China has become the leading supplier in the United States, the EEC, and Japan for its top export products. In 1994, China was already the world's largest apparel exporter and second largest textile exporter. Apparently the increasing share of labour intensive products in China's exports is consistent with China's abundant supply of labour and shows China's successful integration into the world economy.

The success in China's export growth and foreign direct investment has allowed China to import large amount of materials, technology, modern manufacturing products as well as modern services products. These imports have changed greatly the landscape of the Chinese economy, especially along the coastal open cities. Chinese people are now experiencing un-precedent huge gains in productivity due to the introduction of imported modern products and services ranging from high ways and automobiles, container terminals and ships, airports and air-crafts, power plants, mobile phones to computer products. For many Chinese in the dynamic coastal cities, their first telephone is likely to be a mobile phone and their first computer a pentium PC with Chinese Windows 95. In today's Shanghai, Shenzhen and Guangzhou, ordinary Chinese could buy at local shopping malls of world-class quality most of the high-end consumer products available in Hong Kong if they have enough money. China has gone a long way from a shortage economy under central planning to present mixed economy with abundant supply of consumer products from luxury cars and housing to cheap household items.

¹The official statistics could over state the magnitude of FDI in China due to the so called "round tripping" phenomenon, by which we mean Chinese enterprises transfer their capital outside China and then return to China as "foreign investments" in order to qualify for tax and tariff privileges for foreign investments (Wang and Shilling (1995)).

The business environment for foreign trade and investment sector differs significantly from that for the domestic enterprises and banks. This paper argues that these differences are the key to understand the past success, present problems and challenges and future policy options for economic reforms in China.

China's foreign trade and foreign invested enterprises have been governed under many special institutions ranging from special economic zones, special enterprise laws and regulations, special provisions for foreign exchange transactions, to special tariff and tax treatment. These special institutions have isolated the foreign trade and investment sector (e.g. external sector) from many negative effects of China's backward but slowly reforming domestic legal and economic institutions and provided a solid foundation for the rapid growth of the external sector in the past two decades. The relatively advanced economic institutions and practices in the external sector have become the model for the reforms in the domestic sector.

However, the remaining incompatibility between the rapidly expanding external sector and the slowly reforming domestic sector, especially in the monetary and financial aspects, has become the key barrier for future success of China's economic opening and reform. This can be seen clearly from the following two issues: one about the stability of Renminbi and the other about the privatization of SOEs.

If we look at China's domestic enterprises and banks, it seems reasonable to predict that Renminbi may depreciate in the near future following the foot steps of other Asian economies since China's enterprises and banks are not much healthier than those in Japan, Korea, or Thailand. This has been almost the consensus view of many investors in the international financial community.

However, if we look at the foreign trade and investment sector in China, it seems also reasonable to predict that Renminbi may appreciate in the near future since the flow of foreign investment and China's current account surpluses have brought in large amount of foreign exchange and forced China's central bank to accumulate foreign exchange reserves. This is the view of the Chinese authorities. Why is it possible to get two sharply different views on the future value of Renminbi by looking at the conditions in the domestic and external sectors separately? What should China do to make Renminbi stable not just in the short-run but also in the long-run? How to make Renminbi convertible at low risks? To answer these questions, it is crucial to understand many special institutional features of China's external sector and its relations with the domestic sector.

Another issue highlighting the importance of understanding the relation between the external and domestic sectors is the privatisation of SOEs. The Chinese authorities have now decided to go ahead with the ownership and property rights reform in the SOEs. But the privatization or partial privatization of SOEs would need large amount of private and foreign capital. On the other hand, foreign investors are very much interested in participating in China's privatization programs. Apparently there are both strong demand and supply of foreign capital for China's reform of its SOEs. The problem is China's existing banking and financial system simply could not handle both the volume, complexity, and risks involved in the privatization transaction.

Based on China's own past experiences, the paper argues that China should speed up the introduction of modern money, banking and financial services based on hard foreign currencies, quality foreign banks and modern financial institutions into its external sector so that a complete system of modern market institutions can be firmly established in the most advanced regions and for the most dynamic enterprises in China. The financial opening and liberalization in China's external sector proposed in this paper could reduce significantly the currently high and hidden transaction costs of doing business in China with little risks to the domestic banking and financial sector. The reduced transaction costs would then attract sustained flows of foreign investment into China which could not only maintain high and efficient growth of China's external sector but also facilitate the reform of China's state enterprises and banks.

II. Institutional factors behind China's economic opening

In 1978, China's reformers faced with a planned and closed economy. Hence China's economic reform has to contain two inter-related components: marketization and economic opening. To minimize shocks to the domestic economy as well as political oppositions, the reformers established special laws and regulations specifically for the foreign trade and foreign invested sector but maintained the old institutions, especially the dominance of state ownership of enterprises and banks, for the domestic sector. This reform strategy has created a dual-track economy: the advanced and efficient foreign trade and foreign invested sector and the backward but reforming domestic sector. In this section, we briefly outline the main achievements and problems of the institutional reforms in the foreign trade and invested sector. In the next section, we will discuss policy options for improving the interactions between the foreign invested and domestic sectors so that to maintain China's rapid growth in trade and economic growth.

Special economic zones in China's coastal cities

Special economic zones (SEZs) have played a decisive role in creating a market-oriented institutional environment for foreign trade and investment sector which is separated from the traditional centrally planned economic system. SEZs are special because almost all market institutions, such as market enhancing laws and private property rights, are allowed to be experimented there. In addition to these market oriented institutions, policy privileges such as tax and tariff exemptions and reductions have been created in these SEZs to attract foreign investments. To minimize political tension, all the initial four SEZs have been located in southern coastal provinces close to Hong Kong and Taiwan and far away from the nation's political center of Beijing in the north. The four special economic zones (SEZs) established in 1980 included the cities of Shenzhen, Shantou, Zhuhai and Xiamen. The first three are located in Guangdong, a neighbouring province of Hong Kong and Macau. The last one is located in Fujian, a neighboring province of Taiwan. During the last twenty years, more than 60% of the cumulative foreign investment into China has been originated from Hong Kong, Macau, and Taiwan (see Cheng and Zhao 1995).

The success of the four SEZs established in 1980 has had a powerful demonstration effects and led to further openings of China's fourteen coastal cities for foreign trade and investment in 1984. In 1988, the whole Hainan province were designated as a special economic zone. In 1990, Pudong area of Shanghai was designated as a latest SEZ. In July 1992, five cities along the Yantze river, four capital cities in China's border provinces, and eleven capital cities of other provinces were opened up. Also, numerous technological and development zones of various calibre have been established across China. As economic reform deepens, China's northern and inland provinces have also become more and more friendly to foreign investments and private businesses. As pointed out by some Chinese officials in the SEZs, China's SEZs are no longer so special today. This spread of market institutions from SEZs to other parts of China shows clearly the success of China's early strategy to establish SEZs.

Special laws and regulations for foreign invested enterprises

Like SEZs, foreign invested enterprises in China are also special enterprises. China has instituted a series of special laws and regulations tailored specifically for foreign invested enterprises, which include equity joint ventures, contractual joint ventures, wholly foreign owned enterprises, processing trade and other forms of business. These special laws and regulations cover establishment of business, business contract, use of land, hiring of labour, import and export, accounting practice, taxes, foreign exchange control, banking and financial services, planning and industrial policy, etc. These special laws and regulations are far from perfect compared to the legal and economic institutions in Hong Kong or the United States. However, they are much better than China's existing central planning rules as applied to the domestic enterprises. In general, the special laws and regulations for foreign invested enterprises are more favourable to investors than the standard laws and regulations for domestic enterprises. In addition, the foreign invested enterprises could enjoy various exemptions and reductions in taxes and tariffs. These favourable treatments have led to many "fake" foreign invested enterprises which are funded entirely by domestic capital having made a round-trip aboard. Low taxes and tariffs are important attractions for foreign invested enterprises, especially small scale business.

Under the governance (or "protection") of these special laws and regulations, foreign invested enterprises have grown very rapidly and their contribution to the Chinese economy has been increasing rapidly. In 1996, the foreign invested enterprises and other private enterprises already accounted for 12% of China's gross industrial output value. The foreign invested sector is also the most open segment of the Chinese economy. China's foreign funded enterprises accounted for 45.8%, 47.7%, and 54.45% of Chinese total imports in 1994, 1995, and 1996 respectively. They accounted for 28.69%, 31.5%, and 40% of total Chinese exports in 1994, 1995, and 1996 respectively. Foreign funded enterprises have also contributed indirectly by demonstrating the efficiency of private ownership, modern management and technology as well as proper work ethic in privately owned enterprises. They constitute one important engine of China's recent economic growth.

In addition to the special laws and regulations as the basic institutions, the development of foreign invested enterprises depends also on many other factors such as the degree of government intervention and corruption, the distortions in prices and foreign exchange rates, the flexibility and

effectiveness in ownership and control of enterprises, the stability of macro-economic environment, and the barriers to market access etc. These factors affect the transaction costs or hidden costs of doing business in China. They are especially important to big multi-national corporations looking for long-term investment opportunities. As will be argued below, China still needs to improve the general business environment by deepening reforms in the above mentioned aspects.

Relaxation of export and import planning and control

To promote exports, the Chinese government has gradually reduced export planning and allowed the market to determine the type, pricing and quantity of export products. In as early as 1991, China abolished all mandatory export plan and the government increasingly relied on canalization, e.g. granting of exclusive licenses to a few foreign trade corporations to export a few products under the so called category I and II classification. In 1992, exports through such canalisation accounted for 15% of total exports. But it has been reported that exports through canalisation has subsequently been eliminated (Fukasaku and Wall 1994).

The pace of reform in China's import planning and control is considerably slower. Most of the progress has been made in recent years as a result of pressures from negotiations for China's bid to join the WTO (or GATT before WTO was established), especially pressures from the United States. From May 1991 to October 1992, China and the United States have conducted nine rounds of negotiations on bilateral trade issues and reached a memorandum of understanding on market access which has been one of the most important document for China's trade liberalization commitments in the area of quotas, licences, and import control (Lardy 1994).

China's control on imports was carried out through import plans (including mandatory and guidance plans) as well as foreign exchange control mechanism. In 1986, mandatory plan accounted for about 40% of total imports. Imports controlled through the foreign exchange allocation mechanism accounted for about 30% of total imports. The remaining 30% were financed by retained foreign exchange earnings by the enterprises or by borrowing of local authorities and they were subject to selective licensing. In 1992, imports under mandatory plan accounted for only 18.5% of total imports. Starting from 1994, mandatory plan and guidance plan for imports financed by local governments are completely eliminated (World Bank 1994).

In recent years, China made significant progress in relaxing import control. However, China's import regime has been very complex and it has not been easy to evaluate its actual degree of openness to imports. China once had a high average tariff rates even compared to developing countries. However, collection rate (total tariff revenues divided by total imports) was only about 5%, a level comparable to most developed countries. This is because most of the imports by foreign invested enterprises and priority sectors are subject to duty reductions and exemptions. China also was unable to implement fully its import quotas. Hence the real protection by tariffs and quotas is much lower than the official tariff rates and quota levels would indicate. On the other hand, it seems that a few sectors do have extremely high protection rates. That's why some argue that "China's import regime is one of the most protective in Asia" (Fukasaku and Lecomte 1995). Also "the protected sectors tend to be those sectors dominated by the state-owned enterprises" (Harrold 1995).

Breaking up of foreign trade monopoly

The foreign invested enterprises have been a key engine in driving China's integration with the world economy. But the domestic state-owned foreign trade corporations (FTCs) also contributed significantly to China's rapid growth in foreign trade. At the start of China's market-oriented reform a dozen state-owned foreign trade corporations monopolised all of China's foreign trade. This monopoly has been weakened first of all by decentralization, which allows local governments to set up their own foreign trade corporations, and secondly by the entry of foreign invested enterprises who have been given the freedom to export and import products that are related to their own production in China. In recent years, a small number of large state owned enterprises and large township and village enterprises have also been allowed to do international trade for products related to their own production.

With decentralization, the number of state-owned foreign trade corporations have skyrocketed and competition intensified. According to UNCTAD (1995) the number of active and direct exporters in China has reached 59,000 in 1994 and the number of importers 108,000. Competition is keen and turn-over of firms participating directly in foreign trade is high. Slightly more than half of the 59,000 active exporters in 1994 had participated in exports in 1993. For importers, slightly less than half of the 1994 importer had been active in the previous year. In 1994, regional and national FTCs still intermediated over 50% of China's exports and 44% of China's imports. National FTCs handled 27% of total imports and 12% of total exports while regional FTCs handled 17% of total imports and 40% of total exports. Clearly the regional FTCs have been able to dominate the export business because planning and control for export have been significantly liberalised.

Together with decentralization and reduction and trade planning, China also reformed the internal incentives of FTCs. Similar to the contract responsibility system practised in the agricultural and industrial sector, in 1988, China introduced export contracts between the central ministry and the provincial level administrative units and all specialised national FTCs. The contracts specified three targets: the amount of foreign exchange earnings; the amount of foreign exchange to be remitted to the central government; and a fixed amount of domestic currency subsidies on losses made in exports. The subsidies on export losses have been eliminated entirely in 1991. As the domestic prices and RMB exchange rates become less and less distorted in recent years, the export contract system also become more and more like a profit contract system similar to those applied to the state-owned enterprises. The main problem with the state-owned FTCs under the export contract system at the present is that many FTCs could not repay their export loans to the state banks due to losses brought about by increasing competition in both domestic and international markets as well as mis-management.

In addition to the contract system, China also introduced the agency system, under which FTCs only play the role of inter-mediators between the domestic buyers and foreign suppliers of the imported products and earn a service fee.

These reforms have greatly improved the efficiency of Chinese foreign trade activities. The main remaining problem is that all FTCs are state owned and no entrance of private investors and foreign investors are allowed. If foreign and Chinese private trade corporations are allowed, it will further

increase competition and improve efficiency of trade intermediation. A more efficient intermediation system will also improve the efficiency and competitiveness of Chinese foreign trade. There is also significant pressure for foreign presence in the area of foreign trade.

The multiple exchange rate regime during 1981-1993

Before 1994, Chinese Renminbi has always been overvalued. In order to promote exports, exporters have been allowed various channels to access RMB at a more devalued level. In 1981, this was accomplished by the introduction of an internal settlement rate at a more depreciated level. FTCs were allowed to use this rate to pay foreign enterprises supplying the export products. All other transactions such as remittance from overseas Chinese to their relatives and foreign tourists used to the official rate.

In order to reduce the negative effects on exports of the overvalued exchange rate, Chinese government allowed enterprises to retain a portion of the foreign exchange earnings starting in 1979. The enterprises could use the retained foreign exchange to pay imports or sell them at swap markets at a rate much higher than the overvalued official exchange rate and hence earn higher profits. In 1984-85, the retention ratio was 25% for local governments and enterprises. The retention ratio had increased steadily to reach on average about 80% by 1991 although the ratio had been varied across regions and sectors.

The variation of retention ratios is equivalent to a multiple exchange rate system in terms of its effects on export incentives. After 1991 regional variations in retention ratios were eliminated and normalised at 80% with 10% for local government and 10% for export producing enterprises and 60% for FTCs. Foreign invested enterprises have always been allowed to retain 100% of their foreign exchange earnings.

To bridge the demand and supply of foreign exchange among various enterprises, swap centres were set up to trade the retained foreign exchange earnings (in the form of quotas not cash) by domestic FTCs and enterprises and the export earnings and investment flows of foreign invested enterprises. The entry into swap centres was restricted to FTCs, selected domestic enterprises, and foreign invested enterprises. Sales of foreign exchange at swap centres were virtually unrestricted since December 1991. Purchase of foreign exchange at the swap centre would require approval and the purchased foreign exchange was mainly used for servicing debt or financing imports that were not under the government plan. Through foreign exchange control, the government favoured imports for producing export products and of advanced technology and restricted imports of luxury consumer products.

The transaction volume in the swap markets had been increasing steadily and the swap market rates had also been very flexible and close to the black market rates. It has been estimated that by 1993 about 80% of foreign trade was conducted at the swap market rate.

The official exchange rate of RMB had always been overvalued compared to the swap market rate. Several rounds of devaluation of the official rate has gradually narrowed the gap between the official rate and the swap market rate and paved the ground for the eventual unification of the two rates in January 1994.

The unified exchange rate regime after 1994

The above system of multiple exchange rates lasted until 1 January 1994 when the official rate and the swap market rate was unified roughly at the swap rate, leading to about 30% devaluation of the official rate. With the unification of exchange rates, a nationally unified foreign exchange market was established with significant differences from the swap centres.

- First, only selected state banks, but no enterprises and individuals, can participate directly in the new foreign exchange markets.
- Second, all foreign exchange earnings of domestic enterprises and FTCs have to be sold to the state banks at the rate set by the nationally unified foreign exchange market. No foreign exchange retention are allowed.
- Third, enterprises and FTCs who would like to acquire foreign exchange for legitimate current account transactions and approved repayment of debts or repatriation of profits can ask the authorised banks to buy foreign exchange in the nationally unified foreign exchange market at the single market rate.
- Fourth, the fluctuation of the market rate is limited in a narrow range and the central bank is ready to intervene in this market through changes in its foreign exchange reserves.

In summary, the new system is a managed floating exchange rate system with RMB fully convertible for current account transactions but only conditionally and selectively convertible for capital account transactions. The new system has made significant progress in making RMB convertible at low risks. For domestic enterprises with legitimate demand for imports it is much easier to get foreign exchange now than in the past. On the other hand, it is almost impossible for speculators to attach RMB under the current exchange control regime.

The main feature of the current exchange rate regime is that all domestic enterprises are required to surrender all of their foreign exchange earnings to the designated banks at the prevailing market rate and they are not allowed to have their own foreign exchange bank accounts. This feature was introduced at the start of the new unified foreign exchange system in order to make sure that there will be enough foreign exchange supply in the new nationally unified foreign exchange market to stabilise the value of RMB. Since the unification, China's foreign exchange reserves have increased from about 20 billion in 1993 to 130 billion in 1997. The sharp increase in the reserves comes from three sources: the accumulated savings of foreign exchange retention by domestic enterprises and FTCs since 1980, large current account surplus in recent years due to rapid growth in export and slow growth in import, and massive foreign direct investment into China since 1993.

This surrender requirement and the subsequent sharp rise in the reserves have led to the unintentional consequences of high monetary growth and inflation. In 1994 and 1995, the Chinese authorities were puzzled by the continuation of inflation at about 20% levels when a tough austerity program had already started in mid 1993. The inflation was finally under control by 1996 through unusually tight control of state bank lending. At present, although the central bank has been carrying out a kind

of Chinese-style sterilisation measures by withdrawing continuously its lending to commercial banks, the commercial banks still end up with large amount of RMB deposits due to the large inflow of foreign direct investment and current account surplus². Ideally, the state banks should use these RMB deposits for lending to the most dynamic and efficient firms such as the foreign invested enterprises. But, in reality, the state bank lending has been restricted to the state-owned enterprises. Since the state banks have been increasingly concerned with the poor performance of the state-owned enterprises, they are now very hesitate to lend to SOEs and have difficulty in finding good alternative uses for their huge deposits.

The main drawback of the current regime is that domestic enterprises are deprived their right to hedge against foreign exchange risks due to the foreign exchange surrender requirement. When the unified exchange rate is stable as happened from 1994 until now, there is no risks for both domestic and foreign enterprises. When the probability of RMB depreciation becomes high, foreign invested enterprises can keep their foreign exchange earnings, hedging against RMB depreciation in the future while domestic enterprises do not have this option. For foreign invested enterprises whose income are mainly derived from the domestic market and are in the form of RMB, exchange risk hedging is also problematic.

It should be noted that a few weeks ago, the Chinese government has started to allow a few selected domestic enterprises to keep a portion of their foreign exchange (not more than 15%). One major factor leading to this policy change is the rising foreign exchange reserves in the central bank and the resulting pressures for RMB appreciation. This is certainly a good policy development which may have profound implications for China's future monetary and exchange regime as will be further discussed in the next section (see also Xiao 1995).

III. Implications for future reform

After close to twenty years of market-oriented economic reform and open door policy as outlined in section II, the Chinese economy has evolved into a "dual economy" consisting of two very different segments. The first segment is the foreign trade and investment sector which has already evolved into a very dynamic sector and is well integrated into the world economy, thanks to the vigorous reform effort and the sanction of the separate set of market oriented institutions such as private property, free entry and competition, and legal protection by the laws governing foreign invested enterprises. The rapid growth of Chinese foreign trade and continued increase in foreign investment flow into China are clear indications of China's success in this area. The second segment is the domestic sector mainly consisting of the state-owned enterprises and banks, and the rural and urban collectives. Even though the institutional environment governing the domestic sector has been improved dramatically towards market friendly direction in recent years, it is still far behind that for the foreign trade and investment sector primarily for two reasons:

² Chinese central bank cannot rely on standard sterilisation procedures such as open market operations because the government bond market is limited in size and because state-owned banks in China are not strictly commercial banks as in market economies.

First, the majority of the domestic enterprises and banks are under either state ownership or a variety of collective ownership with unclear and often unenforceable property rights as shown most clearly in the bad loans and inter-enterprise debts (Xiao 1997 and World Bank 1997).

Second, the domestic banking and financial system are still been very tightly controlled by the government and is far from being able to provide efficient financial services to the rapidly growing economy. As has correctly pointed out by some Chinese officials, China urgently needs to turn the state banks from book-keepers into real banks. Enterprise and banking reforms are probably the two most challenging and time-consuming tasks for China.

China's domestic sector has been deeply troubled by the inefficient state-owned enterprises and state banks. In 1996, SOEs produced only 28.8% of China's industrial output (falling from about 80% in 1979), but it employed 57.4% of China's urban workers, received 52.2% of China's total investment in industrial fixed assets, and about two thirds of China's bank credit. It has been reported that about 40% of SOEs are making losses. Although industrial output of SOEs have been growing at 7.6% a year during 1978-1996, their total wage bill has been increasing at 16% a year. Unlike in the market economy where asset ownership usually brings profits, the state ownership of enterprises in China brings losses on average to the state.

The state-owned enterprises have been increasingly driven out of the output markets. They are still surviving largely due to massive policy loans extended to them by the state banks which still monopolises China's banking sector (Xiao 1997 and World Bank 1997b). As a result of previous policy lending, non-performing loans in China's state banks are as high as 20% to 30%. While the state banks have to write off bad loans to the state-owned enterprises sooner or later, they have to honour the depositors. Many people are worried that Chinese financial system may very soon fall as hard as or probably worse than the other South East Asian countries (and regions). However, the situation is not as bad as it seems because with China's external and internal debts together as low as 20% to 30% of GDP and its growing economy and young population, it is not so difficult for the government to simply pay for the state-owned enterprises debt with additional government borrowing of about 20% to 30% of GDP. This way, Chinese banks can have a fresh and healthy start to completely reform its current regime. But before China starts to do this major cleaning up of its banking system, it has to find a sure way to prevent massive non-performing loans to happen again in the future.

Not only have bank deposits been rising rapidly, those deposits have also increasingly been owned by individual households. Individual household deposits increased from 1.2% of GNP in 1978 to 51% of GNP in 1995 (Yi 1996). Chinese households know that the government would not close the state banks and have happily put their deposits in the state banks when the interest rate paid on their deposits is above inflation. Unlike many private banks in Hong Kong, China's state-owned banks do not need to worry bank-runs. The real challenge for the state-owned banks is not how to keep their deposits as many people have worried but how to find good projects in terms of both return and risk so that state banks can get back both the interest and principal on loans to pay back depositors. With the state-owned enterprises as their main borrowers, there is little chance for the state banks to win that challenge. Past experiences show that the risks of lending to Chinese state

enterprises are so high that on average the monopoly to give loans to SOEs leads not to profits but to losses.

To solve the problems of inefficient enterprises and banks, China needs to privatise most of the enterprises and banks or at least the state should give up its control and be minority shareholders of the reformed enterprises and banks. Private individuals in China and foreign investors should become the major shareholders and run the enterprises and banks. They should also bear most of the risks of business losses, as people in Hong Kong have done during the recent financial crisis. Since private sector is better able to deal with specific business risks than the government, after the ownership reform, the government could sit back and see the value of its portfolios of state assets rise (Xiao 1997 and World Bank 1997b).

However, reform of the domestic sector cannot be accomplished in the very short run and it involves many difficult issues such as unemployment, social unrest and instability, rent seeking and corruption by officials, and other political oppositions. Given this dichotomy, in addition to speed up reform of the domestic sector, the Chinese government has to perform two tasks to ensure a smooth transition. First of all, it has to make sure that the foreign trade and investment sector can continue to grow, i.e., to keep the only true engine of the Chinese economy running, so that the dynamic foreign trade sector could grow as fast as possible to generate resources (see also Zhao (1997)), role models, effective institutions, and breathing time for reform and modernisation of the currently inefficient and stagnant state sector. Secondly, we have to realize that even with enough distinctions as set out in the last section between the domestic and foreign related sectors, the two sectors are closely linked and sometime inseparable. The art of policy-making in China's economic reform is to make right linkages as well as right separations between the two sectors. Hence policy devices have to be designed to utilize the human and financial resources in the foreign trade and investment sector to help facilitate the reform of the domestic sector. In the following we will discuss policy options to accomplish these tasks.

1. Reduce transaction cost of doing business in China: strengthening the rule of law and reduce government's role in the economy

China has all the basic conditions for attracting foreign investment: large supply of skilled and unskilled cheap labour, vast land, rapidly improving infrastructure, long coastal lines and quality ports for easy transportation, huge markets, and political and social stability. But there are two major barriers to sustained foreign investment in China: high hidden transaction costs of doing business and some macro-economic uncertainty brought about by the difficulties of reforming the state-owned enterprises and banks.

The high transaction cost of doing business in China is mainly due to China's lack of modern legal and financial services as those readily available in free market economies such as Hong Kong. The weak legal environment is not only due to the incompleteness of the current legal system, but more importantly, it is also due to the weak enforcement as is evidenced in the huge administrative content in the setting up and operation of businesses in China. For example, under the present institutional environment as outlined in previous section, foreign investors who would like to establish and run a

major foreign invested enterprise in China need to deal with countless Chinese government agencies and their officials who all seem to have veto power on projects.

Also, it is almost impossible for private investors to take over major ownership and control of a company in China by simply buying enough of its shares in the stock markets and then let the law firms and banks do the routine paper work. Without these high transaction costs China could have utilized foreign investments to transform its state-owned enterprises into competitive modern corporations. The same transaction costs, if not reduced significantly in the near future, will also erode China's competitiveness in the world markets.

In order to reduce drastically these transaction costs, China needs to replicate the legal and financial institutions of Hong Kong in the near future, at least in some advanced regions such as Shanghai or Shanghai's Pudong special economic zone. This seems a challenging but feasible reform option. Shanghai has some geographical advantages over Hong Kong, it is the economic center of China, it has some of the best port facilities in China, and it is next to the two richest provinces and industrial hub of China: Jiangsu and Zhejiang. Also, when all of the currently started projects are finished in the near future, Shanghai with its new special economic zone Pudong will have the high quality modern office and business buildings, residential housing and other basic facilities ready for international banks and corporations. Shanghai also have been able to attract large number of young talents from China's best universities, who are not allowed to work in Hong Kong. For all these reasons, Shanghai has already attracted quite a number of the world's best business such GM and best banks despite of the lack of the legal and financial institutions found in Hong Kong.

2. Reduce transaction cost of doing business in China: improve the foreign exchange regime

First, China should allow enterprises involved in foreign trade and investment sector to hold foreign exchange accounts as well as do legitimate business transactions in foreign currencies through their foreign exchange accounts. Cash transactions and circulation of foreign currencies are not essential for conducting legitimate business and can be prohibited to make the proposed reform more acceptable politically. China already allows a small number of domestic enterprises and all foreign invested firms to hold foreign exchange accounts. When more and more enterprises in China start to build up their foreign exchange deposits, the central bank's reserves may fall. But the foreign exchange deposits by the enterprises are still kept in banks located in China. The total amount of foreign exchange and reserves owned by the enterprises and the central bank in China should not change much. The increased share of this total by enterprises is also good for diversification of foreign exchange risks.

Second, in addition to current account convertibility, China should also make RMB partially convertible for legitimate transactions on capital account for enterprises in foreign trade and investment sector. For example, foreign invested enterprises whose target are the domestic market and whose income are mainly in RMB should be allowed the option to exchange RMB for hard currency in advance, the amount of which not exceeding the projected future profits to be repatriated abroad. This will provide additional stimulus to foreign investments in infrastructure and other domestic industries. This would mean that RMB will be convertible for most of the legitimate

business but will not be freely convertible for individuals with RMB deposits in the state banks and potential large speculators.

Since foreign invested enterprises and domestic enterprises involved in foreign trade and investment could hold foreign exchange accounts in domestic and foreign banks located in China under the proposed reform, there would be little reason for them to move capital outside of China if there is a crisis in RMB or in China's state banking system. More importantly RMB full convertibility and the access to foreign exchange accounts would make the foreign trade and investment sector much less dependent on the stability of RMB. In the worst case, the sector can simply use U.S. dollar or Hong Kong dollar to do all of their business. This happened in the early period of China's opening when the value of RMB was so uncertain due to a highly distorted domestic price system. The foreign investors, especially those doing business in southern China simply used U.S. dollar and Hong Kong dollar for all of their business transactions. The well-known examples were the hotels invested by the foreign investors charging only hard currencies before 1994 (Xiao 1996).

3. Reduce transaction cost of doing business in China: partially liberalize the banking industry for foreign competition

Based on China's past reform and open door experiences, we believe China could reduce significantly the transaction costs of doing business and solve much of the above problems by a controlled partial financial opening and liberalisation. While detailed discussion about the proposed reform is beyond this paper, we can outline here some of the main ideas. The objective of the proposed reform is to replicate Hong Kong's legal and financial institutions in China or at least in Shanghai's Pudong SEZ so that China's best enterprises or those in the foreign trade and investment sector can enjoy immediately the modern financial services in Hong Kong.

China should allow foreign banks in Pudong to do all kind of business they can do in Hong Kong in hard currencies as well as selected business in RMB currencies. Foreign banks should be allowed to extend foreign exchange and even RMB commercial loans to Chinese enterprises. Lending to Chinese enterprises is a high risk business which the state-owned banks are not able to do well. Letting qualified foreign banks to do the lending business in China is to allow them to take and then manage the risk of bad loans with their better experiences.

If the government is worried about the competitive pressure of foreign banks on the state banks, it can set up specific rules protecting the state banks during a transitional period. It can give rights for the state banks to share a part of the foreign banks' lending business. For example, the government can restrict RMB business to Chinese banks and joint venture banks. The government can also restrict the number of deposit-taking foreign bank branches and set the limit on their RMB deposits. Foreign banks can then borrow RMB from the state-owned banks through the inter-bank market. To ensure healthy development of the foreign banks in China, the government can also impose stringent conditions on capital requirements and other performance indicators. This kind of controlled financial liberalisation and opening will not lead to a collapse of the state-owned banking system. On the contrary, it will help to strengthen the state-owned banks by providing opportunities to learn the institutions and management in the foreign banks. The existence of many well managed

foreign banks in China would certainly train a lot of local Chinese banking managers who will contribute greatly in transferring modern banking technology and knowledge into China.

China should continue to improve the legal environment for foreign trade and investment sector by imitating the institutions in Hong Kong. Ideally China should make all contracts signed in Shanghai's Pudong SEZ enforceable according to Hong Kong law. Practically, China can copy the legal framework and enforcement experiences of Hong Kong. Implementation of the above reform measures would make Shanghai's Pudong another Hong Kong but without a border separating the flow of labour and capital between Pudong and the rest of China. Pudong then could provide modern legal and financial services to China's foreign trade and investment sector as well as facilitate the reform of the state-owned enterprises and banks.

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