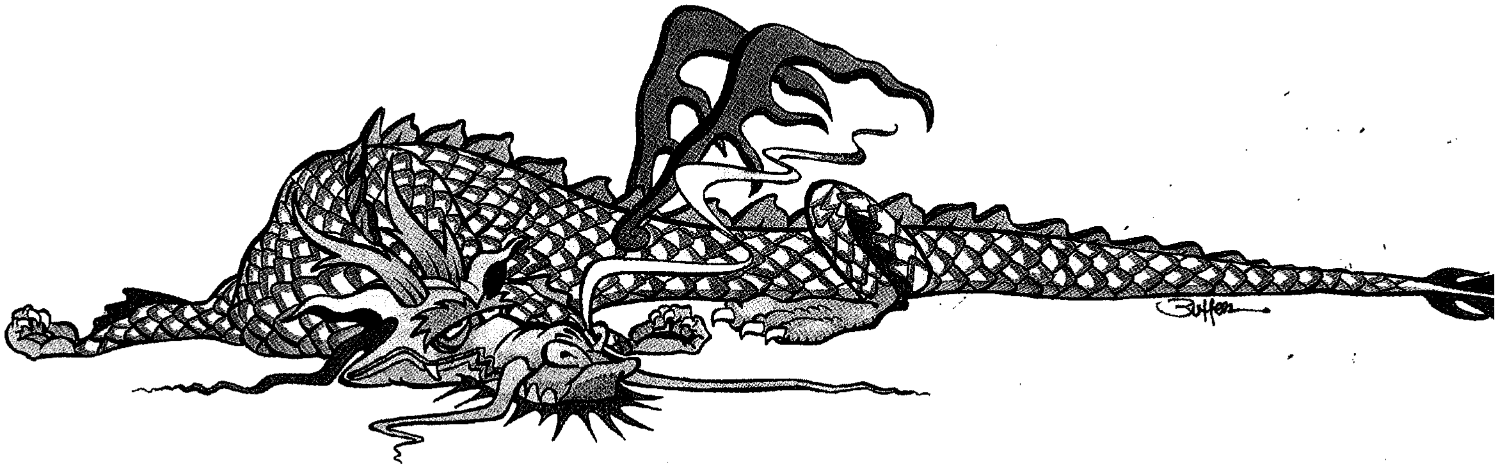

Dragon Droop

Why China's Economic Future May Be less spectacular than you think.

By Mark A. Groombridge

THE ECONOMIC PROGRESS IN CHINA since the launching of its market-oriented reform program 20 years ago is remarkable. Now the world's seventh largest economy (bolstered by the return of Hong Kong), China has averaged 9.8 percent annual growth since the early 1980s.

Even with the "Asian Miracle" turning into the "Asian Meltdown," China is weathering the regional economic storm better than most of its neighbors (with the notable exception of Taiwan). While growth rates are zero in Japan and negative in South Korea, Thailand, Malaysia, and Indonesia, China continues to expand, if more slowly.

One big factor helping insulate China from today's Asian crisis, however, is a negative one. Beijing's heavy controls on capital insulate the country from the currency attacks and investment flight experienced by freer economies. But this short-term advantage produces serious long-term costs. Being disconnected from financial market signals and pressures means serious weaknesses in China's economy are masked, and solutions deferred.

The important question is whether China is learning from the troubles of other Asian nations so it can adopt the right economic order to propel its economy into superpower status in the twenty-first century. And so far the answer to that question is mostly "no."

DESPITE HAVING THE OPPORTUNITY to observe her neighbors' errors, China is following much the same industrial path trod by several other Asian nations to their sorrow. Specifically, China is copying too much of the "Asia Inc." model made popular by Japan and South Korea.

The guiding theme in these countries was a strong role for government in the affairs of business. Their bureaucrats tried to "pick winners" by giving subsidies to select firms in the form of preferential tax, tariff, or loan policies, or sometimes direct cash payments. "The allocation of subsidies has rendered the government not merely a banker...but an entrepreneur, using the subsidy to decide what, when, and how much to produce," summarizes Alice Amsden of MIT, a booster of Asian-style industrial policy in the years before it collapsed. In return, Amsden asserts, "the state exacts certain performance stands from firms."

So the theory goes. The reality proved less attractive. In substituting political judgments for market signals, the Asia Inc. model fostered misinvestment, unbalanced production, and ultimately overcapacity. Because the government finaglings usually took place out of the public eye, the system's accumulating problems were not widely appreciated for many years. But eventually the bubble burst on government-industry "crony capitalism."

Unfortunately, China is now attempting to "pick winners" by targeting subsidies to roughly 1,000 or so state-owned super-conglomerates. The official line of the Chinese leadership is that forcing mergers of "inferior enterprises with superior ones" is "an effective way to improve efficiency and erase the number of enterprises suffering a deficit for years running." Chinese Premier Zhu Rongji asserts that "the mergers will allow the injection of enough funds into these unprofitable state-owned enterprises to revive them."

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Illustration by Ralph Butler

That might be so if markets were determining the nature of these restructurings (including the killing off of unproductive firms). But it is more often the clumsy hand of the Chinese state that makes the decisions. The "government plays a big role in these mergers" notes one Chinese professor. "Government is destined to act as the driving force in mergers and acquisitions," brags a state official. Not surprisingly, managers of the few solvent state-owned enterprises are unhappy. The president of newly formed petrochemical conglomerate complained that "he did not have enough freedom in the reorganization of the internal corporate structure, recruiting competent staff and laying off unqualified workers, or deciding how to relieve the group's debt burden."

Or take the case of the Sanqiang Textile Group in Shanghai. In the past three years it has been forced to absorb seven other less well-run state-owned firms, all of which were on the verge of bankruptcy. This meant taking on 9,000 superfluous workers and hiking the company's debt-to-asset ratio to 90 percent. "The seven companies have brought us 150 million yuan in losses and 350 million yuan in debts," complained one manager.

Even private firms listed on China's fledgling stock exchanges are being forced by state officials to take on insolvent state-owned enterprises. The enormous costs of cleaning up the leftovers of Communism are thus being dumped onto shareholders and business managers. Worse, the seeds of socialist centralism and inefficiency are being replanted into China's next generation of firms.

CHINA'S BANKS ARE likewise suffering because they are being forced to forgive bad debts and even lend additional money to state-owned enterprises, regardless of profitability. As Yang Kaisheng, vice-president of the state-run Industrial and Commercial Bank of China, acknowledges: "Supporting large state-enterprises is not only our bank's duty, but also a key strategy for our expansion." The Chinese government completes this vicious circle by throwing more public money at the banks to keep them afloat. When asked about a new proposal to inject more government funds into the banking system, one finance ministry official this March calmly noted that, "The banks belong to the government so it is natural that the government expands their capital."

What is the outcome of this cozy relationship between governments, banks, and industry? A mountain of bad debt. Officially, the governor of the People's Bank of China, Dai Xianglong, says that some 6 percent of bank loans are unrecoverable, close to 25 percent are non-performing, and loans more than two years overdue amount to 10 percent of total bank lending. Economists around the world believe the problem is actually much worse than that. While China claims that bad loans total some 20 percent of gross domestic product (compared with 8 percent in Japan and South Korea), Merrill Lynch puts the number closer to 40 percent.

STILL SOCIALIST

Major industries in which state-owned enterprises account for at least half of all Chinese production:

Food processing	Specialized machinery
Beverages	Chemicals
Nonferrous metals	Pharmaceuticals
Transportation machinery	Nonferrous mining
Ferrous metals	Gas utilities
Electric power	Coal
Logging	Water supply
Refining and coking	Tobacco
Petroleum	

Source: 1996 China Statistical Yearbook.

So far, China's banks are keeping their heads above water thanks to the extremely high personal savings rates of China's citizens. The average worker puts nearly 40 percent of his take-home pay in the bank, and these individual savings provide the large bulk of the financial assets of China's banks. One deflationary panic or other bank run, however, could crimp this easy flow of cheap capital.

China's foreign debt is much more under control. Officially, the country owes foreigners $152 billion at present, or 17 percent of GDP (compared to 56 percent in Indonesia and 30 percent in South Korea). Some bankers in Hong Kong estimate that China's foreign debt could actually be some $50 billion higher, if shell borrowings made through Hong Kong subsidiaries of Chinese firms were properly accounted for.

In any case, given China's healthy foreign exchange reserves of $140 billion at the close of 1997 there is little fear that China will default on its overseas debts any time soon. Problems may lurk below the surface, though, for a fundamental problem throughout China's financial sector is a lack of openness and transparency. As a recent World Bank report concludes, China's "accounting, risk-management, and credit-analysis are woefully inadequate."

CHINA'S LEADERS HAVE announced that they intend to keep economic growth high by stimulating domestic demand. Recently, plans were announced to push $1 trillion of public funds into new investment over the next three years. But there are reasons to doubt whether that much investment can be intelligently directed by national officials. As in much of Asia, China is afflicted in critical areas by industrial overcapacity and overinvestment. This was caused by political force-feeding of "strategic" industries, and a lack of financial discipline and profitability-testing by governments, banks, and industry.

Thanks to today's sea of overcapacity, it is now common to see Chinese newspaper headlines warning that "Price Wars Threaten." Price cuts are sweeping sales of cars, personal computers, and consumer appliances, as newly geared-up manufacturers and retailers fight to maintain market share. One retailer in Shanghai characterizes today's price wars as a "suicide policy because there are almost no profits." Dangerous downward pressures on prices are also present in sectors like the overbuilt commercial real estate markets of Shanghai and Beijing.

Government efforts to stimulate domestic demand are also complicating efforts to clean up the inefficiencies in state-owned enterprises and banks. The stimulative spending is inevitably funnelled through state lending institutions to state-owned companies. And this only serves to delay the long-term restructurings needed at these lumbering and money-losing entities.

China's leaders are not blind to these problems, but
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China's Foolish Miracle

By P.J. O'Rourke

The Chinese economy has grown amazingly over the past two decades. But what, exactly, has been growing?

I was in Shanghai last June to attend an academic conference on free-trade. (The Chinese think other countries should have it.) One of the economics professors at the Chinese university sponsoring the conference took us on a bus tour of Pudong—the "New Area" being built just across the Hangpu River from Shanghai. Pudong is a mixed-use development meant to contain industrial, commercial, and residential zones. The Chinese government and overseas investors have spent more than $30 billion on Pudong's new buildings and infrastructure.

We traveled from downtown Shanghai through a homemade-looking tunnel and arrived in a flat, planned sterility of immense dimensions—the office park as Nebraska. Here and there the landscape was decorated with blandly abstract corporate art.

The professor seemed to be a reasonable fellow. He didn't actually criticize Pudong, but he winced as he explained it. He pointed to ranks of new condominiums, spartan-looking with their plexiglass-screened sunrooms and window-mounted air conditioners. He said that these sold for 100,00 to 200,000 U.S. dollars. Or rather, didn't sell. Almost all the units were vacant. "Why are these buildings empty?" The professor: "Overbuilding and overpriced."

Multinational logos were visible in every direction. Impressive edifices bore the names of Hewlett-Packard, Siemens, Sharp, Coca-Cola, SmithKline Beecham, Hoffman-La Roche, and Sony. There was just one thing wrong with this business district—no business. Nobody seemed to be there. In the middle of a Tuesday afternoon, nothing was going on. We drove up and down empty streets along concrete fences decorated with those international cross-out silhouettes indicating prohibition of this or that: No spitting. No martial arts. No cutting trees. No firecrackers. No breaking the phone.

No breaking the phone? Running beside the roads were miles of conduits with tall arches of pipe at every intersection. These were the water and waste mains. Pudong has been built in a flood plain only a few feet above sea level, on ground too muddy to dig sewers in. This hasn't slowed construction: "The floor space of high rises in Pudong," said the professor, rolling his eyes slightly, "exceeds New York City." And there's already a severe real estate glut in Shanghai. Prices fell by 30 percent in the first half of 1997.

A free market is a natural evolution of liberty. But in China, there's a missing link. China doesn't have a Darwinian economy where enterprises can evolve and prosper according to their ability to survive and grow; China has a creationist economy where prosperity is bestowed by a higher power. Pudong "prospers" by the beneficence of force.

An article in the *Asian Wall Street Journal* last year said this of the government officials in charge of Pudong: "Harking back to their authoritarian instincts...they are deploying every tactic to fill the cavernous neighborhoods they're building." The article went on to detail how foreign banks are told that they must have headquarters in Pudong if they wish to do business in Chinese currency, and how the International School has been forced to move to Pudong to lure expatriate families into the empty apartment houses.

The Chinese Communists are attempting to build capitalism from the top down, as if the ancient Egyptians had constructed the pyramid of Khufu by saying, "Thutnefer, you hold up this two-ton pointy piece while the rest of the slaves go get a couple million blocks of stone."

A few months after I took my tour of Pudong, the famous economic crisis developed in Asia. And I had been staring out my bus window right at the cause of it. (Not that I knew it then, of course, or I'd be endowing *The American Enterprise* instead of writing for it.)

Pudong-like nonsense had been going on all over the continent. Instead of money being invested where it could make as much more money as possible, money was invested in strange, showy stuff—thanks to "national industrial policies," corruption, misplaced local pride, and foolish political reasoning. From Thailand to Japan, bad credit was extended, bad equities were sold, and bad ventures were subsidized—all in hope that success could be gained by some method other than succeeding.

Since Pudong is the worst example of this type of misallocation of capital, the business failures should have started in China. But China has no floating currency to sink, or securities market free to go into free-fall. And the ordinary people of China live in desperate poverty every day of their lives; so when an economic downturn comes they live in—desperate poverty.

Thus China fools us. What has grown fastest in China is not the economy but the credulity of international corporations willing to invest there. Corporations are seduced by the idea of 1.3 billion Chinese customers. Management is fascinated, mesmerized. I worry that, even as I write this, the board of directors at Boeing is sitting around saying, "One-point-three billion! Why, if just one-half of 1 percent of those people bought a 777...."

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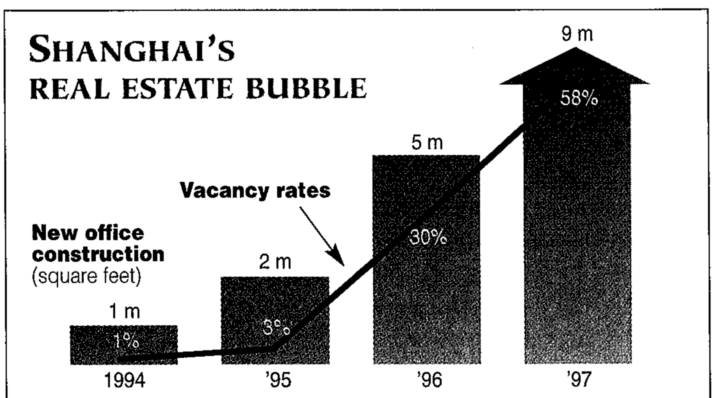

Sources: First Pacific Davies China Research; *Wall Street Journal.*