A balancing act on the road to reform

It was billed as the most important meeting in China's modern history and in retrospect it probably lived up to that name. The Chinese Communist Party Congress in September cemented president Jiang Zemin's position as the first among equals and ushered in more than 100 new faces onto the 193-member Central Committee. They included such luminaries as Dai Xianlong, governor of the People's Bank of China, Zhu Zhengqing, who heads the securities regulatory body, and a host of younger figures, including mayors and governors from various cities and provinces as well as ministry heads.

More than simply a change of leadership, the 15th Congress of the Chinese Communist Party marked a turning point in the country's development, after years of experimenting with a market economy. In order to sustain high levels of economic growth, China could no longer afford the luxury of bloated state enterprises and a banking industry on the verge of insolvency. To reform these dinosaurs meant tampering with some of the most fundamental tenets of socialist ideology: namely closing down factories and risking the ire of millions of unemployed workers.

On the eve of the Congress, few outside of China expected a clear resolution to these sensitive issues. But the results, when they came, marked a clear departure from previous stage-managed affairs. Not only did the meeting signal a smooth transition of power, it also set the country on an irreversible road to reform.

By the time the meeting closed on September 18, the Central Committee had endorsed large-scale restructuring of state enterprises and ambitious banking reforms. Above all, China's leaders stated their unequivocal support for the country's capital market as a means of raising productivity, improving living standards and strengthening the nation. "The 15th Party Congress was a triumph for Jiang Zemin," says Ho Cheuk Yuet, head of Hong Kong and greater China equities at Union Bank of Switzerland. "He is now in a position to implement widespread reform."

The world's most populous nation stands at a crossroads. Failure to reform its sprawling state enterprises and nurse its banking sector back to health could spell financial disaster. But the reforms could also unleash some of the biggest challenges in China's recent history

BY BEN DAVIES

If the party congress was a triumph for Jiang, it also strengthened the position of his right-hand man Zhu Rongji, who is credited with China's economic soft landing. Although Zhu will remain number three in the standing committee, he is expected to take up the premiership next March when Li Peng steps down from the post. One fact, however, is clear. Zhu has established himself as the undisputed master of China's reform efforts.

But he may find that he is playing with fire. China's state-commercial banks are technically bankrupt and staggering under an estimated US$200 billion of non-performing loans. Almost half of its 340,000 state-owned enterprises are losing money. And unemployment is growing rapidly. Simply to restructure the state enterprises could put tens of millions of workers out of a job and stir the prospect of social unrest or even riots in China's urban centres. It could also bring down the fragile banking system.

"No issue facing China today is more urgent and challenging than that of state enterprise reform," according to a report by Merrill Lynch. "It is a must-fight battle, with no quick win, given the complexity of the issue."

Ranged against Zhu are some potent forces. China's state enterprises account for an estimated 57% of China's urban work force or about 110 million employees. Their tentacles extend into every sector of the economy and their losses are draining the very life out of the economy. To turn around the state sector enterprise could put more than 25 million people out of work. But to ignore the problems could set the country on the road to financial ruin.

Zhu's task will be not be helped by the recent slowdown in the economy. GDP growth is expected to fall to 9% in 1997 from 9.6% a year

earlier. For the third quarter, the economy expanded by only 8% — the lowest level in almost a decade. That may seem good by many standards, but for China it is dangerously close to the level that would cause further lay-offs.

Worse still, the downturn would have been even more pronounced if it were not for the strong performance of exports, which grew by 24% for the 12 months to September. If exports are disregarded, Credit Lyonnais Securities estimates that the domestic segment of the economy grew by only 5.1% over the same period. Next year could see a dramatic slowdown in exports as China is forced to compete with cheaper goods from neighbouring countries.

"There has been a sharp slowdown in consumer demand over the last 12 months," says Clive McDonnell senior economist at SocGen-Crosby. "If there is no easing of monetary policy, I will certainly be downgrading my forecasts."

Even more worrying for China's leaders is the overcapacity that exists in almost every industrial sector. By the end of 1996, the country had stockpiled 20 million bicycles, 10 million watches and 110,000 cars. Some of these may be sold if and when consumer demand rises. But many others are of such poor quality that even if demand existed, nobody would want to buy them. A similar picture exists for steel manufacturing, petrochemicals and car making, which are desperately in need of capital to overhaul their obsolete machinery.

That dismal situation has already taken its toll on industrial output and threatens the onset of deflation. For the 12 months to September, the retail price index reached 0%. In October, it declined by 0.4% year on year, the first time that China has reported negative inflation since 1986.

Until a demand side recovery occurs, Zhou is likely to have little or no room for manoeuvre. Attempts to reflate the economy by aggressively cutting interest rates and raising the ceiling on credit would almost inevitably lead back to the boom/bust days of the 1980s and could exacerbate the position of the banks who are constrained by the weight of non-performing loans.

"The whole development experience of China is Keynesian," says Darly Ho, regional economist at Jardine Fleming. "In the past, it has grown from nothing to something, but at the expense of the state-owned enterprises and banks. The problem now is that it can no longer engineer growth through spending. Policy makers in Beijing lack an engine of growth."

The picture could hardly be more different than the position four months ago when China was being lauded as one of Asia's few remaining success stories. While Thailand suffered from falling exports and high levels of external debt, China boasted a healthy trade surplus, strong international reserves and a manageable external debt profile. According to Credit Lyonnais Securities, China's external debt at US$100 billion is similar to Indonesia's. But China's economy is 250% larger. Furthermore, China's external debt accounts for a manageable 15% of GDP with maturities ranging from five to 10 years.

Fears of contagion also seemed exaggerated. The prevalent view has been that China's export products have little in common with other Asian countries and the economy is less reliant on the external sector. Furthermore, controls over the capital account of its balance of payments were seen to virtually rule out a run on the currency.

These days, with a faltering economy and industrial output slowing, analysts are less certain. In an effort to breathe life back into the economy, the People's Bank of China lowered deposit rates by 1.1% and lending rates by 1.5% in October. The cut in interest rates — the largest in China's history — may well signal a move to spur economic growth as well as easing the debt burden on Chinese corporates. Eddie Wong, regional economist at HG Asia, expects another interest rate cut of 150 basis points to follow as early as the first quarter next year.

So far, there is little evidence that Zhu and his reformists are prepared to abort their ambitious mission. In recent months, a number of mergers have already been announced between state-owned enterprises in the petrochemical, cement and steel industries. China's leaders hope that these will eventually pave the way for some groups to compete on the international stage. But the results of the mergers could take years to come through. They are also likely to put Zhou up against some of China's most powerful bureaucrats who do not welcome the prospect of seeing their positions undermined.

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It is at home that Zhu faces his biggest challenge. Last year, 6,232 enterprises were forced into bankruptcy. This year the figures are likely to be considerably higher. Unemployment is already on the increase. Official figures suggest that urban unemployment increased from 2.9% at the beginning of the year to 4%. But the official figures do not include people partially laid off or not officially registered. Most estimates put unemployment in urban centres at more than 15% — or anything between 12 million and 30 million. Some isolated incidents of unrest have already been reported in Sichuan Province in central China. Although rare, they may herald growing opposition at grass roots level to the corruption and mismanagement that has long thwarted development of the economy.

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The stakes are already increasing. In order to finance the wholesale restructuring of state enterprises, the government desperately needs a healthy stockmarket. But the index has fallen by 50% since August, pushed down by regional concerns and by the prospects of a long list of cash hungry enterprises.

Foreign investment — another key source of funding — is also on the wane as companies become disillusioned with the tough operating environment and the lack of an even playing field. For the first 10 months of 1997, investment commitments were down 35% on the corresponding period of last year. Some businessmen believe it could fall further without measures to improve the investment climate.

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For the time being, Zhu has gained some breathing space. Despite the regional fallout, there is little pressure to devalue the Renminbi. If anything, analysts believe it may be undervalued. Furthermore, China's vast labour market and ample industrial production should also guarantee that the country maintains its competitiveness against other Asian producers.

But the problems are unlikely to disappear. Fears of layoffs from factories could in turn lead to lower expenditure and a fall in consumption. And that would place further pressure on the economy. Even interest rate cuts may take as long as six months to make their impact felt on the economy. And while the leadership is pinning its hopes on the private sector to absorb excess labour, private companies too could be hit by any slowdown.

The lack of real options throws up a dangerous spectre both for Zhu and for President Jiang, whose abilities to balance conflicting elements should not be underestimated. These were demonstrated at the recent Party Congress when he edged out Quio Shi, a long-time rival, from the Politburo Standing Committee. He has successfully rotated military leaders to make the armed forces less political and he has proved without doubt that he has the business acumen to keep the vested interests happy. "Politically speaking, Jiang is a genius," says Ho at UBS. "I believe Jiang will run China for the next 10 years."

If politically there seems little threat to Jiang's power, ultimately the need to deliver prosperity and maintain stability is likely to remain paramount. Already there are signs of a growing desperation on the part of China's leadership as it has sought to raise China's profile internationally. Jiang Zemin's recent visit to the United States, the first by a top Chinese leader since 1985, and his planned trips to Canada and Mexico, signal a fundamental re-evaluation of China's role in the world. As the century draws to a close, China can no longer survive in isolation. It needs new technology and new investment to rebuild its obsolete factories, upgrade its low-quality products and, more than anything, support its reform process.

"The Chinese are not ostriches," says one banker. "They do not bury their heads in the ground and hope the problems will go away. But preserving stability is paramount. You don't just close down all the state-owned enterprises and write off all the loans of banks. There is not going to be a quick fix. It will take time and effort and pain. But there is a very bright future and China will take its place as a full member of the international community."

Several issues could have a critical bearing on that future. How long it will take to free up the Renminbi and open up the banking sector to real foreign competition are likely to be fiercely debated by China's inner circle of power. But given recent debacles in Thailand and Latin America, the consensus is that it will not happen for at least another five years.

"It took Japan 20 years to achieve a fully convertible currency on the capital account," says Ho at Jardine Fleming. "After seeing the problems in other Latin American and Asian countries, they are likely to move slowly."

An even bigger question concerns how long the Communist Party ideology can remain in place. The rise in per capita income will be accompanied by a growth in political awareness. Greater access to the Internet could further open up districts of China that, until recently, have been virtually isolated from the world.

"Ten years from now the third generation of leadership will be gone," says one analyst. "By that time China will be no different to Russia."

Such sentiment in Beijing still amounts to almost heresy. But, few outside of the Chinese leadership deny the truth of the matter. And while Jiang is likely to remain ideologically committed to some form of socialism, his commitment to open markets and reform appears irreversible.

"Although the long-term picture is cloudy, it is difficult to be negative on China for demographic reasons," says McDonnell at SocGen-Crosby. "The government is far more in tune with foreign investors than other governments in the past. There has been a climatic change in how they operate. If they continue to operate, they have the potential to become the largest economy in the world by the year 2020." am

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