

OVERVIEW OF THE CHINESE ECONOMY



Chairman Jim Saxton (R-NJ)

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Executive Summary

Since economic reform began in 1978, the People's Republic of China (PRC) has sought the benefits of capitalism without surrendering government control of the commanding heights of the PRC's economy. The PRC has largely adhered to openness to international trade and investment, one of the characteristics of successful market economies. Not surprisingly, the PRC's greatest strength is its integration with the global economy.

Although the PRC has made some progress toward achieving other characteristics of successful market economies, the PRC retains many of the detrimental characteristics of command economies. In particular, the PRC's four major state-owned banks and other depository institutions have extended too many questionable loans to the state-owned enterprises and the state-influenced enterprises based on industrial policy, *guanxi* (i.e., connections) with government officials, or outright corruption. Along with below-market interest rates and distorted prices, non-market lending has sustained the PRC's unusually high rate of investment in capital assets (i.e., equipment, software, and structures) of 43.6 percent of GDP in 2004. In turn, this high investment rate has boosted the PRC's real GDP growth rate to 9.5 percent in 2004.

However, many state-owned enterprises and state-influenced enterprises are unprofitable. Protected through *guanxi* from bankruptcy and foreclosure, many state-owned enterprises and state-influenced enterprises are either unable or unwilling to service their debts. Consequently, non-market lending has saddled the PRC's four major state-owned banks and other depository institutions with enormous portfolios of non-performing loans. Private economists estimate that the cost of resolving the PRC's bad loan problem would be about 40 percent of the PRC's GDP.

Non-market lending encouraged the state-owned enterprises and the state-influenced enterprises to invest in too many capital assets and the wrong types of capital assets to produce goods and services to satisfy market demand. The eventual liquidation of the resulting overinvestment or malinvestment poses a significant long-term risk to the continuation of the PRC's economic growth. Given the PRC's integration with the global economy, a significant slowdown or recession in the PRC could diminish the prospects for economic growth in the United States and other countries around the world.

Joint Economic Committee
433 Cannon House Office Building
Washington, DC 20515
Phone: 202-226-3234
Fax: 202-226-3950

G-01 Dirksen Senate Office Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240
Internet Address:
<http://www.house.gov/jec>

OVERVIEW OF THE CHINESE ECONOMY

I. INTRODUCTION

In 1978, the People's Republic of China (PRC) embarked upon incremental reforms that transformed its command economy into a mixed economy.¹ Essentially, Chinese leaders have sought the benefits of capitalism without relinquishing government control of what Soviet leader Vladimir Illyich Lenin, British Prime Minister Clement Attlee, and Indian Prime Minister Jawaharlal Nehru separately described as the “commanding heights” of the economy.² However, this strategy embraces contradictions that pose considerable risks not only for the Chinese economy, but also for the global economy.

This study analyzes both the strengths and the weaknesses of the PRC's economy in light of the following characteristics exhibited by successful market economies:

- Freedom of individuals to seek employment with firms or to establish firms;
- Private ownership and control of resources;
- Freedom of firms to compete with other firms and enter new geographic or product markets;
- Resource allocation and product distribution through market-determined prices;
- Secure property rights, uncorrupt formulation and administration of laws, and impartial courts to adjudicate disputes;
- Efficient bankruptcy system to redeploy underemployed individuals and misallocated resources to more valuable uses; and
- Openness to international trade and investment.

The PRC has largely adhered to openness to international trade and investment, one of the characteristics of successful market economies. Not surprisingly, the PRC's greatest strength is its integration with the global economy.

Although the PRC has made some progress toward achieving each of the other characteristics of successful market economies, the PRC retains many of the detrimental characteristics of command economies. In particular, the four major state-owned commercial banks (SOCBs) and other depository institutions have made too many questionable loans to the state-owned enterprises (SOEs) and the state-influenced enterprises (SIEs)³ based on central government industrial policy, *guanxi* (i.e., connections) with central, provincial, and local government officials, or outright corruption by bank executives and managers. Along with below-market interest rates and distorted prices, non-market lending has sustained the PRC's unusually high rate of investment in capital assets (i.e., equipment, software, and structures) of 43.6 percent of GDP in 2004.⁴ In turn, this high investment rate has boosted the PRC's real GDP growth rate to 9.5 percent in 2004.⁵

However, many SOEs and SIEs are unprofitable. Protected through their *guanxi* from bankruptcy or foreclosure, many SOEs and SIEs cannot or will not service their debts to the four major SOCBs and other depository institutions. Consequently, non-market lending has saddled the four major SOCBs and other depository institutions with enormous portfolios of non-

performing loans (NPLs). Private economists estimate that the cost of resolving the PRC’s bad loan problem would be about 40 percent of the PRC’s GDP.⁶

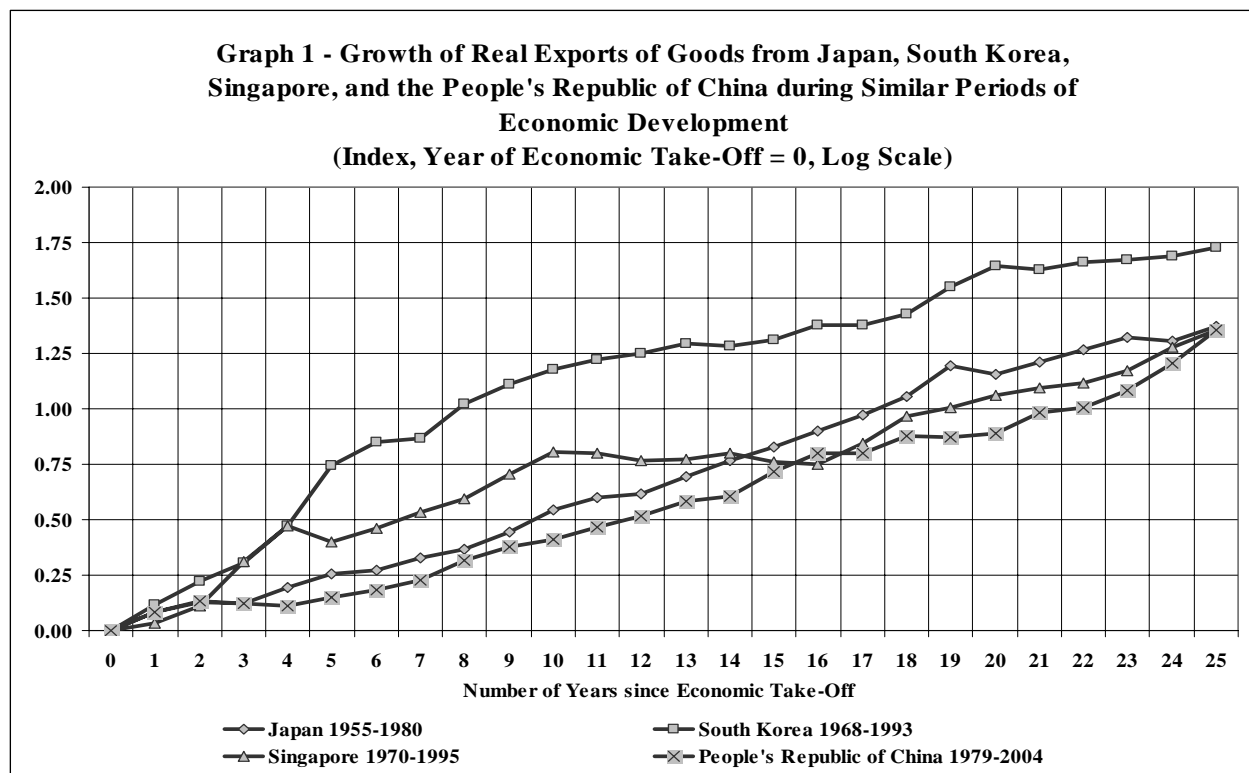
Moreover, non-market lending has encouraged the SOEs and the SIEs to invest in too many capital assets and the wrong types of capital assets to produce goods and services to satisfy market demand. The eventual liquidation of the resulting overinvestment or malinvestment poses a significant long-term risk to the continuation of the PRC’s economic growth. Given the PRC’s integration with the global economy, a significant slowdown or recession in the PRC could diminish the prospects for economic growth in the United States and other countries around the world.

II. STRENGTHS

Since economic reform began in 1978, the PRC has largely integrated into the global economy. From 1979⁷ to 2004, the value of PRC’s goods exports grew by an average of 17.9 percent a year.⁸ Consequently, the PRC’s share of world goods exports (excluding intra-European Union exports) increased from 1.2 percent in 1979 to 9.3 percent in 2004.⁹

While the growth in the PRC’s goods exports may seem impressive, it is actually quite typical for Asian economies during early stages of their development. Graph 1 compares the PRC’s export performance after its take-off in 1979 to the export performances of Japan, South Korea, and Singapore after their take-offs in 1955, 1968, and 1970, respectively.¹⁰

The PRC’s two-way trade in goods and services expanded from 15.2 percent of GDP in 1982¹¹ to 74.2 percent of GDP in 2004.¹² Table 1 demonstrates that the PRC is far more dependent on international trade than the United States or other major economies with large populations.



Likewise, the PRC relies heavily on inward foreign direct investment for economic growth. From 1982¹⁴ through 2004, the PRC received \$531.8 billion in inward foreign direct investment.¹⁵ Chinese affiliates of foreign multinational firms:

- Employed 10 million urban workers in 2004;¹⁶
- Accounted for 8.8 percent of the PRC's gross investment in capital assets in 2003;¹⁷
- Produced 31.2 percent of the PRC's gross industrial output¹⁸ in 2003;¹⁹ and
- Accounted for 57 percent of the PRC's goods exports and 58 percent of its goods imports in 2004.²⁰

<i>Major Economy with Large Population</i>	<i>Two-Way Goods and Services Trade as a Percent of GDP in 2004</i>
Brazil	31.2%
European Union (25)	25.6%
India	33.7%
Japan	22.8%
PRC	74.2%
Russia	57.0%
United States	24.8%

Because of the PRC's success in expanding exports and attracting inward foreign direct investment, real GDP grew by an average of 9.4 percent a year from 1979 to 2003, by 9.5 percent in 2004, and at an annualized rate of 9.5 percent in first quarter of 2005.²¹ According to the World Bank, the PRC's economic reforms have lifted about 400 million Chinese individuals out of poverty from 1981 to 2002.²²

III. WEAKNESSES

A. PRICE DISTORTIONS

The PRC's government significantly distorts prices in three factor markets. These policies contribute to a significant misallocation of resources in the PRC.

1. Interest Rates

Although some liberalization has recently occurred, the PRC still regulates interest rates at the four major SOCBs and other depository institutions, keeping both nominal and real interest rates low for both depositors and borrowers when compared with interest rates in other developing countries. Because of the scarcity of alternative investments, low interest rates do not prevent the four major SOCBs or other depository institutions from gathering deposits. However, low interest rates do encourage Chinese firms to borrow heavily from the four major SOCBs or other depository institutions and invest in capital assets. Thus, interest rate controls have helped to boost the PRC's investment rate in capital assets from 25.8 percent of GDP in 1990 to an incredible 43.6 percent of GDP in 2004.²³

2. Energy

The PRC keeps energy prices below market-determined levels. The PRC requires state-owned oil companies to use some of their profits from domestic oil production to subsidize oil imports. Consequently, state-owned oil companies have not increased domestic prices for gasoline and other refined petroleum products in line with recent increase in world prices.²⁴

3. Land

In the PRC, the government effectively controls all land. In rural areas, peasants may lease land, but not formally own it. Because peasants lack legal title to the land that they farm, they cannot use it as collateral to finance agricultural equipment or other improvements that might increase farm productivity and output.

In urban areas, real estate developers frequently conspire with provincial or local government officials to seize nearby agricultural lands or raze existing urban neighborhoods as sites for new projects. In exchange for various payoffs, provincial or local government officials force peasants off their leased farmland or urban dwellers out their apartments with little compensation. Consequently, real estate developers may gain control over project sites for a fraction of their market value.²⁵

These below-market land prices along with interest rate controls have stimulated a boom in new construction. From 2000 to 2004, the amount of new floor space under construction increased by 14.7 percent a year.²⁶ In many Chinese cities, this stimulus has caused real estate developers to build new projects far in excess of the actual demand for new office, industrial, residential, or retail space. For all types of new construction, 28.3 percent of floor space completed in 2004 stood vacant.²⁷

B. STATE-OWNED AND STATE-INFLUENCED ENTERPRISES

Early economic reforms that introduced the price system and profit incentives to the SOEs did not significantly improve their performance. Consequently, President Jiang Zemin announced the *zhuada fangxiao* policy (i.e., grab the big, dump the small) at the Fifteenth Party Congress in 1997. Under this policy, the PRC retained three types of large SOEs under central government ownership:

- SOEs that produce armaments or other goods and services directly related to national security;
- SOEs in industrial sectors that the central government has targeted for economic development; and
- Inefficient and unprofitable SOEs that employ large numbers of Chinese workers.

The remaining SOEs, especially small and medium-sized SOEs, were converted into:

- Township and village enterprises owned by local governments;
- Cooperatives owned by their employees;
- Private domestic enterprises often sold to provincial or local government officials or their families; and
- Joint enterprises owned by a state-owned enterprise or a collectively owned enterprise in conjunction with other types of enterprises.

Because of the *zhuada fangxiao* policy, the number of SOEs fell by 44.6 percent over six years to 31,750 in December 2004.²⁸ However, this policy did not significantly improve SOE performance. Thirty-five percent of the remaining SOEs were unprofitable in 2004.²⁹

The PRC incorporated many large SOEs in industrial sectors that the central government has targeted for economic development. These firms, which the PRC describes as shareholding

enterprises, have issued a minority of their shares to domestic and foreign investors through initial public offerings (IPOs). While these shareholding enterprises have some of the characteristics of private corporations (e.g., shareholders, boards of directors, annual reports), the central government still controls a majority of their shares, elects a majority of their directors, and exercises effective control over their operations. On December 31, 2004, the PRC controlled 69.0 percent of the market value of all shareholding enterprises through non-marketable shares.³⁰ In the *Australian Financial Review*, Stephen Wyatt (2005) concluded:

*In fact, the entire privatization of China's state-owned enterprises is still more hype than reality. So far, only minority stakes of state-owned groups have been listed, leaving the government with primary control. ... The government's strategy is still to list minority shares in state-owned groups in order to raise capital and import better governance while ultimately retaining control ...*³¹

The PRC allows individuals to establish sole proprietorships, partnerships, or corporations. The PRC now has more than 3.3 million private domestic firms.³² However, privately owned firms are generally small, employing an average of 14 employees.³³ Private domestic firms are concentrated in service industries, oriented to local markets, and are not generally engaged in international trade or investment.³⁴ Although some privately owned domestic firms are manufacturers, they shun direct competition with the SOEs or the SIEs in industrial sectors that the central government has targeted for economic development.³⁵

The SOEs and the SIEs still control a large part of the PRC's economy. The SOEs and the SIEs:

- Employed 99 million urban workers in 2004;³⁶
- Accounted for 76.7 percent of the PRC's gross investment in capital assets in 2003;³⁷ and
- Produced 53.9 percent of the PRC's gross industrial output in 2003.³⁸

Chinese laws and regulations often lack clarity. Their enforcement may be arbitrary and sporadic. Government policy influences court decisions. In this legal environment, property rights are insecure. Individuals and private firms must depend on their *guanxi* with central, provincial, or local government officials to protect themselves and their property.

From 1949 to 1976, Chinese leader Mao Zedong exercised strict control over all central, provincial, and local government officials in the PRC. However, economic reforms since 1978 have given provinces and localities a significant degree of economic independence, reducing central government control over provincial and local government officials. Given the PRC's weak rule of law and the lack of democratic accountability, provincial and local government officials can exploit their *guanxi* to enrich themselves and their families through widespread corruption. In the words of a Chinese proverb, "the mountain is high, and the emperor is far away." Among other things, provincial and local government officials have:

- Bought the privatized assets of SOEs through rigged sales at a fraction of their market value;
- Demanded bribes from individuals and private firms to enforce or refrain from enforcing certain laws and regulations;

- Pressed branch managers of the four major SOCBs and other depository institutions to make loans to the business interests of provincial or local government officials or their families on favorable, non-market terms; and
- Suppressed the distribution of products competing against the products of firms controlled by provincial or local government officials or their families.

Transparency International reported that the PRC scored 3.4 out of 10 on its *Corruption Index 2004*, 71st of the 146 countries rated.³⁹ The burden of official corruption is very high. Chinese economist Angang Hu⁴⁰ estimated that corruption costs the PRC about 15 percent of its GDP a year in lost tariff and tax revenues and skimmed government funds.⁴¹ The *China Economic Quarterly* (2005) reported that provincial and local government officials extracted from private firms the equivalent of 91 percent of their profits in 2003 through non-tax costs, including fees, *tanpai* (i.e., forced expenditures on unwanted provincial or local goods or services), or *zhaodai* (i.e., entertainment of provincial or local government officials).⁴²

A weak rule of law, the lack of democratic accountability, and the disintegration of comprehensive central government planning give the SOEs and the SIEs significant competitive advantages over private domestic firms. Generally, large SOEs and SIEs have *guanxi* with Chinese leaders, central government ministries, or prominent provincial or local government officials. These patrons use their influence to secure favorable laws, better regulatory treatment, and preferential access to loans from the four major SOCBs and other depository institutions for the SOEs and the SIEs.

Many SOEs and SIEs face a “soft budget constraint” (i.e., the four major SOCBs and other depository institutions lend to the SOEs and the SIEs without regard to their ability to repay their loans). Some SOEs and SIEs receive policy loans,⁴³ while other SOEs and SIEs benefit from their *guanxi* with central, provincial or local government officials. Frequently, local government officials have more sway over the lending decisions of local branch managers of the four major SOCBs and other depository institutions than do either senior bank executives in Beijing or Shanghai or central government officials from the People’s Bank of China (PBC) or the China Banking Regulatory Commission (CBRC). Despite some recent efforts of the central government officials to curb such non-market loans, the flow of non-market loans from the four major SOCBs and other depository institutions to the SOEs and the SIEs largely continues. These non-market loans allow many unprofitable SOEs and SIEs to continue operations or to invest in new capital assets when market discipline would force these SOEs and SIEs to shutter operations or to forgo the acquisition of capital assets.

Although, bankruptcy is a necessary part of the process of creative destruction described by economist Joseph Schumpeter in *Capitalism, Socialism, and Democracy* (1975, orig. pub. 1942)⁴⁴ that promotes economic growth in market economies, bankruptcy is relatively rare in the PRC. The PRC’s bankruptcy process strongly favors debtors over creditors, making any significant recovery of debts from bankrupt firms extremely difficult. Despite their weak financial conditions, most SOEs and SIEs can avoid bankruptcy or foreclosure. In practice, only the SOEs or the SIEs whose patrons have lost favor with Chinese leaders (e.g., Guangdong International Trust and Investment Corporation (GITIC) in 1999) ever declare bankruptcy.⁴⁵

C. ***BAD LOAN PROBLEM AND DYSFUNCTIONAL BANKING SYSTEM***

1. **Scope of the Bad Loan Problem**

Before 1979, the PRC had one bank, the People's Bank of China, which accepted deposits and lent funds to SOEs under central government direction. During the next decade, the PRC divided the PBC into a central bank with responsibility of formulating and implementing monetary policy and four major SOCBs:

- Agricultural Bank of China (ABC)
- Bank of China (BOC)
- People's Construction Bank of China (PCBC)
- Industrial and Commercial Bank of China (ICBC)

In 1994, the PRC transferred "official" policy lending from these four major SOCBs to three specialized state-owned policy banks:

- Agricultural Development Bank of China (ADBOC)
- China Development Bank (CDB)
- Export-Import Bank of China (EIOC)

Thereafter, the four major SOCBs were to suppose to operate on a market basis. Since then, approximately one hundred-twenty other commercial banks, owned by a mixture of provincial governments, local governments, and other shareholders, have opened. In addition, the PRC has about 75 thousand credit unions.

The PRC relies heavily on banks and other depository institutions to allocate its national savings:

- Deposits are the dominant form of savings. On December 31, 2004, deposits in all banks and other depository institutions were \$2.906 trillion or 170.9 percent of GDP.⁴⁶
- Loans are the primary source of funds for business investment. On December 31, 2004, loans from all banks and other depository institutions were \$2.143 trillion or 126.0 percent of GDP.⁴⁷ In contrast, the market value of all marketable shares listed on the PRC's stock exchanges on December 31, 2004, was \$141 billion or 8.3 percent of GDP.⁴⁸

The four major SOCBs dominate the PRC's banking market. Table 2 shows that the combined assets of the four major SOCBs were 53.7 percent of the assets of all banks and other depository institutions on December 31, 2004.⁴⁹

<i>Type</i>	<i>Total Assets</i> (in billions of U.S. Dollars)	<i>Market Share</i>
State-Owned Banks	\$2,044	53.7%
Joint Shareholding Banks	\$568	14.9%
Other Urban Commercial Banks	\$206	5.4%
Other Depository Institutions ⁵¹	\$987	25.9%
All Banks and Other Depository Institutions	\$3,805	100.0%

Banks and other depository institutions accumulated an extraordinarily large “legacy” of non-performing loans (NPLs) from past non-market lending, whether through policy loans, *guanxi* loans, or outright corruption. The China Banking Regulatory Commission reported that NPLs at the four major SOCBs and other commercial banks were \$221 billion or 12.3 percent of GDP on March 31, 2005.⁵² However, the CBRC estimate excludes:

- \$87 billion of NPLs which remain from \$169 billion of “legacy” NPLs that the four state-owned asset management companies (AMCs) bought at face value from the four major SOCBs in 2001;⁵³
- Non-market loans to the SOEs and the SIEs made by the four major SOCBs and other commercial banks in recent years that are likely to become NPLs; and
- NPLs at policy banks, finance companies, and credit unions

Private estimates of the size of the PRC’s bad loan problem are staggering. Standard and Poor’s (2004) estimated that the PRC’s NPLs comprise 40 percent of all loans.⁵⁴ In other words, the PRC’s NPLs are equal to 55 percent of GDP.⁵⁵ Alternatively, Roubini and Sester (2005) estimated that the PRC’s NPLs range between 46 percent of GDP and 56 percent of GDP.⁵⁶

Chinese leaders are aware of the enormous challenges confronting their banking system. Since 1998, the PRC has injected \$277 billion of government funds into its four major SOCBs:

- \$33 billion through swap arrangements in August 1998;
- \$169 billion through the AMCs in 2001;
- \$45 billion through swap arrangements in December 2003; and
- \$30 billion equity injection into the ICBC in April 2005.⁵⁷

Moreover, the PRC is currently seeking private capital from both domestic and foreign investors to recapitalize its banks. In 2004, HSBC bought a 19.9 percent stake in the Bank of Communications for \$1.7 billion. On June 17, 2005, Bank of America announced its intention to buy up to a 9 percent stake in the PCBC for \$3 billion. The PRC is planning an IPO to sell additional shares in the PCBC later this year. IPOs for the ABC, the BOC, and the ICBC are likely to follow.

Nevertheless, the ultimate cost of resolving the PRC’s bad loan problem is huge. Standard and Poor’s (2004) estimated that the total cost of resolution would be \$650 billion or about 40 percent of GDP.⁵⁸ Moreover, Standard and Poor’s (2005) estimated that the cost of recapitalizing of two of the four major SOCBs, the ABC and the ICBC, would be between \$110 billion and \$190 billion.⁵⁹

Other private sector estimates for resolving the PRC’s bad loan problem are similar to Standard and Poor’s. Even assuming a generous recovery rate of 20 percent, Roubini and Sester (2005) estimated the central government would need to issue additional debt ranging between 35 percent of GDP and 45 percent of GDP to resolve its bad loan problem.⁶⁰ At the end of 2004, central government debt was about 30 percent of GDP.⁶¹ Under this favorable recovery assumption, resolution would more than double central government debt to between 65 percent of GDP and 75 percent of GDP.⁶² Moreover, the interest expense for this additional debt would add approximately 2 percent of GDP a year to the central government’s annual budget deficit, increasing it from 1.4 percent of GDP in 2004 to approximately 3.5 percent of GDP a year.⁶³

Furthermore, the PRC lacks a credit culture that will prevent a reoccurrence of these bad loan problems. Realizing that the continued patronage of central, provincial, or local government officials virtually ensures a flow of new loans from the four major SOCBs and other depository institutions to maintain operations regardless of financial performance or invest in new capital assets regardless of expected returns, many SOE and SIE executives have developed a cavalier attitude toward servicing their debts. Indeed, domestic firms that pay interest and principal punctually are at a disadvantage with their competitors that ignore their debt obligations. Because many SOE and SIE executives regard loans as “free money,” SOE and SIE investment decisions reflect less concern about future profitability than would be the case in a market economy.

2. Macroeconomic Consequences of the PRC’s Dysfunctional Banking System

Large-scale non-market lending by the four major SOCBs and other depository institutions to the SOEs and the SIEs limits the availability of credit cards, installment loans, and mortgage loans to Chinese consumers. Individuals must save to buy a car or a home. Moreover, many insurance and annuity products are not yet widely available. Individuals must save still more to self-insure against life’s risks. Thus, Chinese individuals save a very high percentage of their income.

Consequently, the PRC has a very high national saving rate. It has increased steadily from 34.0 percent of GDP in 1985 to 48.0 percent of GDP in 2004.⁶⁴ The unnecessarily high national savings rate contributes to what Chairman of the Council of Economic Advisers Ben S. Bernanke describes as a “savings glut” in Asia.⁶⁵

Large-scale non-market lending by the four major SOCBs and other depository institutions to the SOEs and the SIEs restricts the availability of loans to private domestic firms. This limits the ability of Chinese entrepreneurs to invest in new capital assets, expand their businesses, and hire additional workers.

Instead of lending to Chinese individuals and private domestic firms, the four major SOCBs and other depository institutions essentially channel the bulk of Chinese savings to support unprofitable SOEs and SIEs and to fund uneconomic SOE and SIE investments in new capital assets. In the short term, such non-market lending to the SOEs and the SIEs maintains production and creates investment that increases the PRC’s gross domestic product (GDP) in the short term. However, economic growth is sustainable over the long term if and only if firms:

- Produce goods and services that the market demands; and
- Invest in capital assets that have a positive net present value (i.e., the expected future revenues generated by a capital asset exceeds its current and expected future costs discounted by a rate that reflects the real interest rate, expected future inflation, and the risk associated with such investment).

The rapid accumulation of capital assets among the SOEs and the SIEs suggests that widespread overinvestment (i.e., the acquisition of too many capital assets for producing goods and services given expected future demand) and malinvestment (i.e., acquisition of the wrong types of capital assets for producing goods and services to meet expected future demand) may be occurring in the PRC.

<i>Economy</i>	<i>Gross Investment in Capital Assets as a Percent of GDP in 2004 (2003 for India)</i>
Australia	24.5%
Brazil	19.6%
Canada	20.1%
Chile	20.6%
European Union (25)	19.5%
Hong Kong	22.0%
India	22.7%
Indonesia	21.0%
Japan	23.8%
Korea (South)	29.4%
Malaysia	20.4%
Mexico	20.2%
New Zealand	22.7%
PRC	43.6%
Philippines	16.6%
Russia	17.9%
Singapore	25.8%
Taiwan	20.1%
Thailand	25.8%
United States	19.3%

Table 3 demonstrates that the PRC's investment rate (i.e. gross investment in capital assets as a percent of GDP) is way out of line with investment rates in Brazil, the European Union, the United States, and other Asia-Pacific economies. Non-market factors, including central government industrial policy, below-market interest rates, distorted prices, *guanxi* lending, and outright corruption, have driven the PRC's investment surge. Recent economic data, including the high vacancy rate for new construction, suggest that a significant portion of these newly acquired capital assets may be overinvestment or malinvestment.

An economic boom caused by overinvestment and malinvestment cannot sustain itself indefinitely. The inevitable liquidation of overinvestment and malinvestment will impose significant costs on the PRC in terms of lost output, employment, and income and could slow economic growth in the United States and other countries around the world.

D. SOURCES FOR GDP GROWTH

Economic growth in the PRC is mainly attributable to increases in the quantities of factor inputs rather than efficiency gains or innovation. Since 1978, the migration of unemployed or underemployed peasants from rural communities to cities increased the supply of labor available for industrial jobs. Meanwhile, low interest rates, non-market lending by the four major SOCBs and other depository institutions to the SOEs and SIEs, and inward foreign direct investment have caused a rapid accumulation of capital assets. As the quantity of capital assets increased for each hour worked, the PRC's labor productivity grew by an average of 6.9 percent a year from 1979 to 2004.⁶⁷

However, Jinghai Zheng and Anagang Hu (2004) found that the growth in PRC's total factor productivity⁶⁸ decelerated dramatically from 3.2 percent a year for 1978-1995 to 0.6 percent a year for 1995-2001.⁶⁹ Total factor productivity measures the growth in output that is not attributable to increases in factor inputs such as labor and capital assets. Thus, total factor productivity represents the gains from efficiency improvements and technological innovation.

The combination of a high rate of labor productivity and a dropping rate of total factor productivity means that the marginal productivity of new capital assets is falling. This is further evidence that domestic firms are investing in too many capital assets or the wrong types of capital assets given the PRC's comparative advantage in plentiful, low-cost labor.

IV. CONCLUSION

Since economic reform began in 1978, Chinese leaders have sought the benefits of capitalism without relinquishing government control of the commanding heights of the PRC's economy. The resulting mixed economy has both strengths and weaknesses. Because Chinese leaders have largely adhered to openness to international trade and investment, the PRC's main economic strength is its integration into the global economy.

The PRC's numerous deviations from the characteristics of successful market economies have generated all of the PRC's economic weaknesses. The PRC's four major SOCBs and other depository institutions have extended far too many questionable loans based on non-market criteria to the SOEs and the SIEs. Along with below-market interest rates and distorted prices, non-market lending has sustained the PRC's unusually high rate of investment in capital assets of 43.6 percent of GDP in 2004. In turn, the PRC's high investment rate has boosted the real GDP growth rate to 9.5 percent in 2004.

However, many SOEs and SIEs are unprofitable. Protected through their *guanxi* with central, provincial, or local government officials, many SOEs and SIEs cannot or will not service their debts to the four major SOCBs and other depository institutions. Consequently, non-market lending has saddled the four major SOCBs and other depository institutions with enormous portfolios of NPLs. Private economists estimate that the cost of resolving the PRC's bad loan problem would be about 40 percent of the PRC's GDP.

The SOEs and the SIEs are apparently investing in too many capital assets or the wrong types of capital assets to produce goods and services to satisfy market demand. The high vacancy rate in new construction and slumping total factor productivity suggest widespread overinvestment and malinvestment in the PRC. The eventual liquidation of this overinvestment and malinvestment poses a significant long-term risk to the continuation of the PRC's economic growth. Given the PRC's integration with the global economy, a significant slowdown or recession in the PRC could diminish the prospects for economic growth in the United States and other countries around the world.

Robert P. O'Quinn
Senior Economist

¹ While Hong Kong and Macau are special administrative regions of the People's Republic of China, the economies of Hong Kong and Macau are not considered part of the economy of the People's Republic of China. Therefore, economic statistics about the People's Republic of China do not include data from Hong Kong or Macau.

² In November 1922, Soviet leader Vladimir Illyich Lenin coined "commanding heights" during his speech to the Fourth Congress of the Communist International in St. Petersburg (then known as Petrograd). In this speech, Lenin defended his New Economic Policy that permitted the resumption of small-scale trade and private agriculture in the Soviet Union against militant communists who attacked Lenin for compromising with capitalism. Although the New Economic Policy allowed some elements of a market economy to function, Lenin declared that the state would control the "commanding heights," the most important elements of the Soviet economy. The British Labour Party adopted "control of the commanding heights of the economy" to describe its policy of nationalizing many British industries after World War II. Then, Prime Minister Jawaharlal Nehru used this expression to describe the similar policies of the Congress Party in India. Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace That is Remaking the Modern World* (New York, NY : Simon & Schuster, 1998): 12.

³ State-owned enterprises are firms owned by the central government. State-influenced enterprises (SIEs) include collectively owned enterprises, township and village enterprises, cooperative enterprises, shareholding enterprises,

and joint enterprises. Collectively owned enterprises are firms owned by provincial or local governments. Township and village enterprises are small firms owned by local government in rural areas. Cooperative enterprises are firms owned by their managers and employees. Shareholding enterprises are former state-owned enterprises that have incorporated and issued a minority of their shares to investors. Joint enterprises are firms owned by at least one state-owned enterprise or collectively owned enterprise and at least one other state-owned enterprise, collectively owned enterprise, shareholding enterprise, cooperative enterprise, private domestic enterprise, or individual.

⁴ Author's calculation based on data from China National Bureau of Statistics/Haver Analytics. This study uses economic data collected and disseminated by the various statistical agencies of the central government of the People's Republic of China. Despite recent quality improvements, Chinese economic data remains less accurate and reliable than comparable U.S. data.

⁵ Ibid.

⁶ Scott Bugie, John Chambers, Ryan Tsang, Daria Alexeeva, and Aurélie Thiellet, *Global Financial System Stress: Likelihood of Future Bank Crises Recedes, but Vulnerabilities Remain* (New York: Standard and Poor's, July 8, 2004): 15, found at <http://ratingsdirect.com/Apps/RD/controller/Article?id=385155&type=&outputType=print>.

⁷ The year 1979 is the first year in which data for the PRC is available.

⁸ Author's calculation based on International Monetary Fund/Haver Analytics data.

⁹ Ibid.

¹⁰ Ibid.

¹¹ The year 1982 is the first year in which data for the PRC is available.

¹² Author's calculation based on International Monetary Fund/Haver Analytics data.

¹³ Author's calculations based on data from U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, Banco Central do Brasil, European Central Bank, Eurostat, Bank of Japan, and Japanese Ministry of Finance, and the Central Bank of the Russian Federation/Haver Analytics and Economist Intelligence Unit.

¹⁴ The year 1982 is the first year in which data for the PRC is available.

¹⁵ Author's calculation based on State Administration of Foreign Exchange and China National Bureau of Statistics/Haver Analytics data.

¹⁶ China National Bureau of Statistics/Haver Analytics.

¹⁷ Author's calculation based on China National Bureau of Statistics/Haver Analytics. The year 2003 is the last year in which complete data is available.

¹⁸ Gross industrial output measures the value of industrial goods and services produced during a period. Gross industrial value-added subtracts the value of intermediate inputs and the value-added tax from gross industrial output.

¹⁹ Ibid.

²⁰ Congressional Research Service.

²¹ Author's calculation based on China National Bureau of Statistics/Haver Analytics data.

²² [U]sing the World Bank's \$1/day income measure, the number of poor is estimated to have dropped from about 490 million to 88 million over the same period, a decline in poverty incidence from 49 percent in 1981 to 6.9 percent in 2002. World Bank, Shanghai Poverty Conference: Case Study Summary (2004), found at <http://www.worldbank.org/wbi/reducingpoverty/docs/newpdfs/case-summ-China-8-7PovertyReduction.pdf>.

²³ Author's calculations based on China National Bureau of Statistics/Haver Analytics.

²⁴ Nouriel Roubini and Brad Sester, *China Trip Report* (April 2005): 17, found at www.regmonitor.com.

²⁵ Ibid.

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- ²⁶ Author's calculations based on China National Bureau of Statistics/Haver Analytics.
- ²⁷ Ibid.
- ²⁸ Ibid.
- ²⁹ Ibid.
- ³⁰ Author's calculation based on data from China Securities Regulatory Commission, Shanghai Stock Exchange, and Shenzhen Stock Exchange/Haver Analytics.
- ³¹ Stephen Wyatt, "Privatization More Hype than Reality," *Australian Financial Review* (June 7, 2005).
- ³² "Private Enterprise: Faster, Higher, Stronger," *China Economic Quarterly* (First Quarter 2005): 46.
- ³³ Ibid: 47.
- ³⁴ Ibid.
- ³⁵ Gordon G. Chang, *The Coming Collapse of China* (New York: Random House, 2001): 144-165.
- ³⁶ China National Bureau of Statistics/Haver Analytics.
- ³⁷ Author's calculation based data from China National Bureau of Statistics/Haver Analytics. The year 2003 is the last year in which investment data by enterprise type is available.
- ³⁸ Ibid.
- ³⁹ *Transparency International Corruptions Practices Index 2004*, found at <http://transparency.org>.
- ⁴⁰ The name of this Chinese economist is in western fashion with the family name last.
- ⁴¹ Julie Chao, "China is Losing Battle with Corruption," *Milwaukee Journal Sentinel* (December 8, 2002).
- ⁴² *China Economic Quarterly* (First Quarter 2005): 48.
- ⁴³ Policy lending occurs when banks make loans to individuals, firms, organizations, or governments based on government regulations or suasion rather than market criteria. Under policy lending, banks grant borrowers larger loans, lower interest rates, or more favorable terms than banks would willingly grant in the absence of government regulation or suasion.
- ⁴⁴ Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper, 1975, org. pub. 1942): 82-85.
- ⁴⁵ Chang (2001): 98-102.
- ⁴⁶ Author's calculation based on data from China National Bureau of Statistics and Money and Banking Statistics, People's Bank of China/Haver Analytics.
- ⁴⁷ Ibid.
- ⁴⁸ Author's calculation based on data from China National Bureau of Statistics, China Securities Regulatory Commission, Shanghai Stock Exchange, and Shenzhen Stock Exchange/Haver Analytics.
- ⁴⁹ Author's calculation based on data from China Banking Regulatory Commission, found at <http://www.cbrc.gov.cn/english/module/viewinfo.jsp?infoID=966>.
- ⁵⁰ Ibid.
- ⁵¹ Other depository institutions include credit unions, rural commercial banks, foreign banks, finance companies, trust companies, and policy banks.
- ⁵² Author's calculation based on data from China National Bureau of Statistics and Money and Banking Statistics, People's Bank of China/Haver Analytics.
- ⁵³ Author's calculation based on China Banking Regulatory Commission data, found at <http://www.cbrc.gov.cn/english/viewinfo.jsp?infoID=968>.
- ⁵⁴ Bugie, Chambers, Tsang, Alexeeva, and Thiellet (2004): 15.

⁵⁵ Author's calculation.

⁵⁶ Roubini and Sester (April 2005): 10-14.

⁵⁷ "Beijing Tops Up Bad-Loan Banks Again," Reprinted in the Sydney Morning Herald from the New York Times (January 8, 2004), found at <http://www.smh.com.au/articles/2004/01/07/1073437347723.html>; Ryan Tsang and Paul Coughlin, *Recapitalization of China's ICBC and ABC Could Cost US\$100 Bil. and up to US\$190 Bil.* (New York: Standard and Poor's, April 25, 2005): 1, found at <http://www2.standardandpoors.com>; and Brian Bremner with Dexter Roberts, "Wanted: A Big Broom for China's Banks," *Business Week* (May 9, 2005).

⁵⁸ Bugie, Chambers, Tsang, Alexeeva, and Thiellet (2004): 16.

⁵⁹ Tsang and Coughlin (April 25, 2005): 1.

⁶⁰ Roubini and Sester (April 2005): 15.

⁶¹ Derived from IMF, International Financial Statistics and State Statistical Yearbook.

⁶² Author's calculations.

⁶³ Author's calculations.

⁶⁴ International Monetary Fund.

⁶⁵ Ben S. Bernanke, "Remarks at Homer Jones Lecture," (April 14, 2005), found at <http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm>.

⁶⁶ Author's calculations based on data from national statistical agencies/Haver Analytics.

⁶⁷ Author's calculations based on data from China National Bureau of Statistics/Haver Analytics.

⁶⁸ This assumes a weight for capital of 0.6 and labor of 0.4 for growth accounting.

⁶⁹ Jinghai Zheng and Angang Hu, "An Empirical Analysis of Provincial Productivity in China (1979-2001)," Working Paper in Economics (SwoPEc), no. 127, ISSN 1403-2465 (March 2004).