FOR AGENDA

SM/02/231

CONTAINS CONFIDENTIAL INFORMATION

July 22, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Selected Issues**

This paper provides background information to the staff report on the 2002 Article IV consultation discussions with the People's Republic of China (SM/02/220, 7/15/02), which is tentatively scheduled for discussion on **Monday, August 5, 2002**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the People's Republic of China indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Blancher, PDR (ext. 36525) for Chapter I, Mr. Karacadag, MAE (ext. 34953) for Chapter II, Mr. Feyzioğlu, APD (ext. 37273) for Chapter III, Mr. R. Singh, FAD (ext. 39372) for Chapter IV, and Ms. T. Wang, APD (ext. 36573) for Chapter V.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 30, 2002; and to the Asian Development Bank, the European Commission, the European Investment Bank, the Food and Agriculture Organization, the Organisation for Economic Cooperation and Development, the United Nations Development Programme, and the World Food Programme, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Selected Issues

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Approved by the Asia and Pacific Department

July 18, 2002

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I. Exchange Rate Policy[1]

1. **Although China's exchange rate regime is officially described as a "managed float", the renminbi has in practice been tightly linked to the U.S. dollar, especially since the Asian financial crisis.**[2] This policy was credited with serving as an important anchor of stability, both for China and the region, during this period. However, as the region stabilized, the question has arisen whether China should allow greater flexibility of the renminbi—particularly in light of the continued rapid structural change in the economy, including as a result of WTO accession. While market forces will over time undoubtedly push China toward adopting a more flexible exchange rate, this optimally would be a process entailing a gradual widening of trading bands around a central rate, which needs to be supported by improvements in the exchange market so that it more fully and directly reflects supply and demand for foreign exchange, and a further strengthening of the prudential supervision of financial institutions.

A. China's External Position

2. **China's external position, resilient through the Asian crisis, has strengthened further in recent years**. Strong competitiveness and robust vulnerability indicators have combined to enhance international investor confidence in the Chinese economy.

External competitiveness

3. **Standard indicators suggest that China's external competitiveness has remained strong in recent years**. Looking forward, WTO accession offers the prospect of China maintaining its strong external position, although the impact of the manifold structural changes underway on China's external competitiveness is difficult to predict.

4. **Over the past decade, China has maintained current account surpluses reflecting strong export growth**, which averaged 11 percent between 1991 and 2001 (Figure I.1). China's export market shares have increased steadily, particularly in the United States and the European Union (Figure I.2). At the same time, China's manufactured exports (which now account for 90 percent of total exports) continued to diversify across sectors, with rapid growth in machinery and equipment exports, including electronic goods (Figure I.3).

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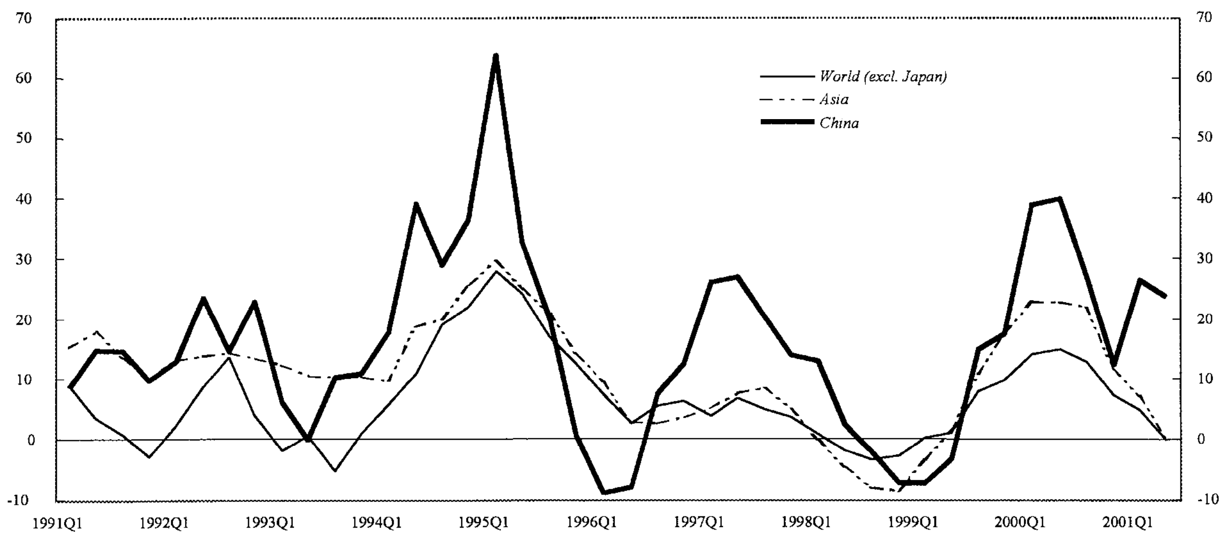
[1] Prepared by Nicolas Blancher.

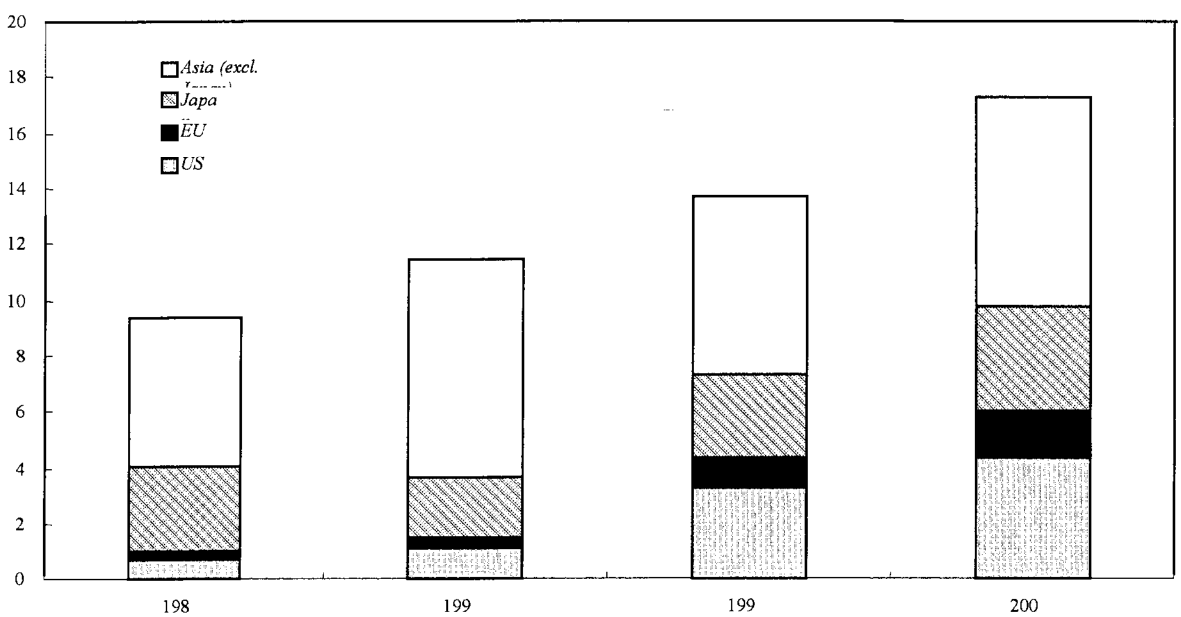
[2] Following the unification of the renminbi exchange rate in 1994, the People's Bank of China (PBC) has limited movements of the renminbi against the US dollar to +/-0.3 percent around a reference rate. Since the Asian crisis, the renminbi has been kept within an even smaller range of +/-0.02 percent. More recently, it has been allowed to move slightly outside this narrower range (mainly on the appreciated side).

Figure I.1. Export Growth Rates
(quarter-on-quarter)



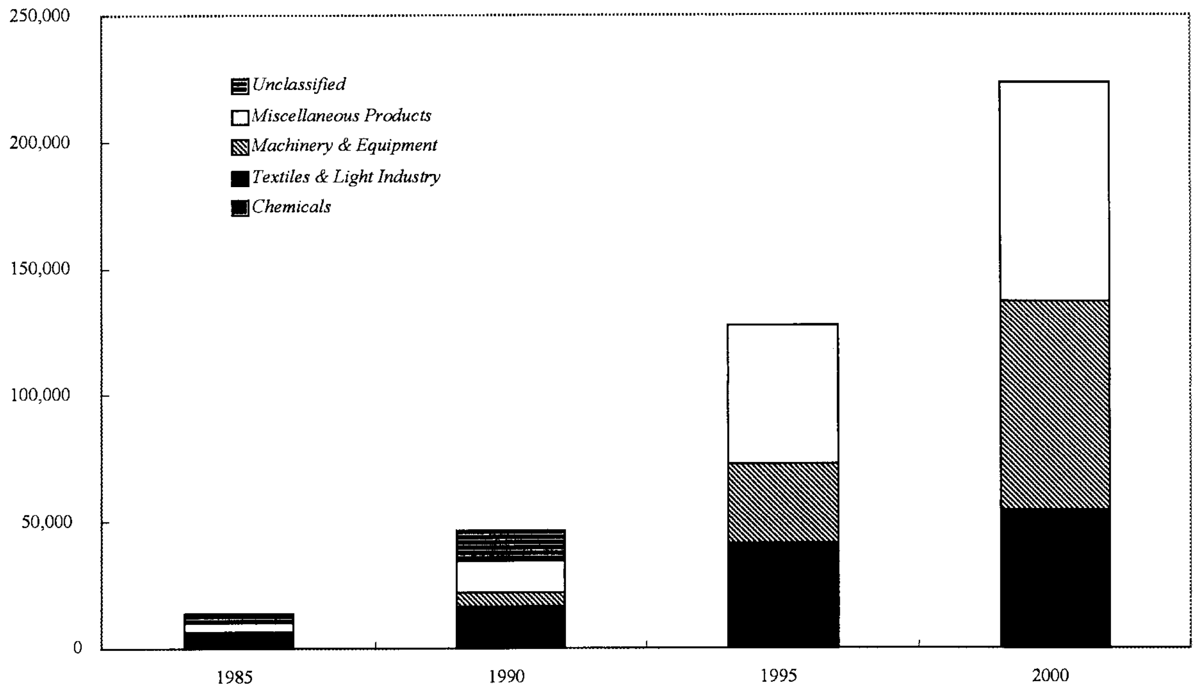
Source: IMF, Director of Trade Statistics.

Figure I.2. Evolution of China's Market Shares
(in percent of total exports)



Source: IMF, Direction of Trade Statistics.

Figure I.3. Composition of China's Manufactured Exports
(in US$ millions)

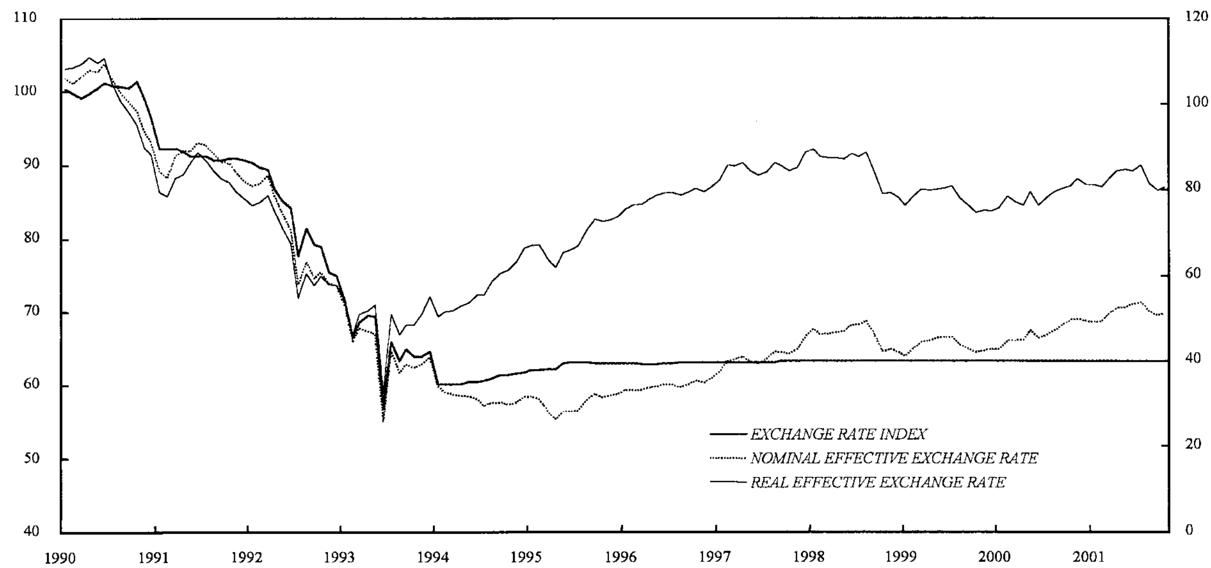


Source: CEIC database.

5. **During the Asian crisis, the renminbi came under pressure in the parallel and offshore non-deliverable forward markets**. At that time, the renminbi appreciated by about 10 percent in real effective terms. This gave rise to concerns that the renminbi might have become overvalued. However, although exports slowed sharply in 1998–99, China's export shares held up well in major export markets, suggesting that weak external demand, rather than inadequate competitiveness, was the main reason for the slowdown. The real appreciation reversed with the recovery of Asian currencies and the deflation experienced by China in 1999–2000 (Figure I.4), and pressures in the parallel and offshore markets have since subsided.[3]

[3] Weakening export growth in 2001 reflected primarily the impact of the synchronized global slowdown and associated drop in external demand; despite that slowdown, China was the only East Asian country recording positive export growth in 2001.

Figure I.4. Real and Nominal Effective Exchange Rates and US dollar/RMB Exchange Rate Indices
(1990=100)



Source: Information Notice System.

6. **The expected global recovery and WTO accession should support the continued expansion of China's exports**, although WTO accession will also result in higher imports. Initially, WTO accession may only have a limited impact on China's exports, while the short-term impact on imports is expected to be more significant as increased foreign competition and higher FDI inflows are likely to boost imports before export gains materialize. In the longer run, however, WTO accession should contribute to sustained export growth, as China integrates further into the global economy.

External vulnerability

7. **The recent evolution of some key indicators of external vulnerability shows that China's overall external position is strong**:

- China's international reserves are equivalent to nine months of imports and more than four times its short-term external debt;
- China's external debt relative to GDP (as well as to exports) is small and has been declining in recent years;
- China's capital account is relatively closed to debt-creating flows, with most capital inflows coming in the form of foreign direct investment.

8. **At the same time, pressures associated with unidentified capital outflows seem to have abated.** While capital outflows accelerated during the Asian crisis, raising concerns about the sustainability of the policy of maintaining a stable renminbi, such concerns have

diminished since then. Official data indicate that negative "errors-and-omissions" in China's balance of payments reached a peak of US$ 22 billion in 1997–98, and declined subsequently to US$ 12 billion in 2000. Other indirect measures of capital flight (based on complementary sources such as BIS data), broadly confirm this trend.

B. The Case for Greater Exchange Rate Flexibility

9. **A number of considerations suggest that greater exchange rate flexibility will be beneficial to the Chinese economy, especially after China's accession to the WTO**. This assessment is based on the following:

- **The impact of the multitude of ongoing structural changes on the "equilibrium exchange rate" is difficult to ascertain**. Over the next few years, trade liberalization in the context of China's membership in the WTO will open the country to greater import competition, but China will obtain better and more secure access to foreign markets. In addition, WTO membership could spur greater direct investment inflows to China. Continued rapid gains in productivity as China develops and adopts new technologies also could create pressure for real appreciation of the exchange rate. The envisaged gradual opening up of the capital account over the medium-term might lead to significant capital outflows, as Chinese residents adjust their portfolios toward foreign assets, but a move toward full convertibility could increase confidence in the renminbi, prompting a return of some of the capital that had previously flowed out of the country. At the same time, Chinese corporations and banks with improved access to lower-cost financing from international capital markets could be expected to step up their foreign borrowing;
- **China's economy does not form an optimum currency area with the U.S. economy, as the two economies are subject to different shocks**. However, under the current regime, the volatility of the renminbi's effective exchange rate reflects closely that of the U.S. dollar. To better achieve *effective* exchange rate stability and cope with a greater variety of external shocks, introducing more flexibility of the renminbi vis-à-vis the U.S. dollar is a prerequisite;
- **Preserving monetary independence will increasingly require a more flexible exchange rate.** China has used its control over capital movements to combine a fixed exchange rate with an independent monetary policy. However, capital controls are not watertight, will likely become more porous over time, and are eventually to be removed as convertibility of the renminbi is a stated and appropriate long-term policy goal;
- **China is facing the proliferation of floating exchange rate regimes in the rest of the world, especially in Asia**. In this context, should the region be hit by a shock and neighboring countries' currencies adjust, maintaining the renminbi stable vis-à-vis the U.S. dollar implies that a relatively heavier share of the adjustment burden could fall on China;

- **Factor markets in China are not very flexible, and the scope for fiscal policy to help adjustment to shocks is narrowing**. Capital mobility between regions is limited, and wages and prices are not fully market determined, despite progress achieved in recent years in increasing their flexibility. In particular, the insufficient availability of skilled labor creates bottlenecks in some fast-growing sectors;
- **China has a large and relatively diversified economy, which seems well positioned to absorb exchange rate fluctuations**. Indeed, China resembles other large economies where, nearly without exception, more flexible exchange rate arrangements are in place;
- **As illustrated by recent international experience, defending rigid exchange rate regimes becomes increasingly difficult with growing capital mobility**, and greater flexibility helps reduce the risk of sharp capital flow reversals.

C. Modalities and Supporting Measures

10. **While greater flexibility of the renminbi is desirable, the move should be gradual and carefully prepared**. Current conditions do not support a free float. Instead, a gradual move would not only give time for the corporate and banking sectors to adjust, but would also allow the development of China's foreign exchange market infrastructure and regulatory framework.

Gradual widening of the exchange rate band

11. **The introduction of greater exchange rate flexibility could start with full use of the existing *de jure* (+/-0.3 percent) trading band, followed by its gradual widening**, perhaps initially to a range of +/-3 to 5 percent. Key issues in designing and managing a wider band include:

- **Setting of the central rate of the band**. Fixing the central rate against a major international currency, e.g., the U.S. dollar, has the advantage of simplicity and clarity, but can lead to volatility in the effective exchange rate (as cross-rates between major trading partners change). Another option would be to set the central rate using a basket of currencies. This would have the merit of smoothing cross-currency fluctuations, providing a more stable environment for exporters and importers;
- **Number of currencies in the basket**. If a basket was chosen, the number of currencies should be kept relatively limited (for example, to the three main international currencies: the U.S. dollar, the Japanese yen, and the Euro). Experience has shown that the benefits of keeping the number small (in terms of transparency and simplicity) tend to outweigh the marginal gains (in terms of greater stability) from adding other currencies to the basket;
- **Basket weights**. In practice, most countries have tended to use a trade-weighted basket. However, in the case of China there may be some merits in giving the U.S. dollar a higher weight in the basket: this would have the advantage of tempering

fluctuations relative to Hong Kong SAR and reduce volatility in the value of foreign debt, which is mostly dollar-denominated;

- **Width of the band**. In general, the band should be wider the larger the shocks a country is expected to face; the more developed the foreign exchange market; the stronger the ability of the private sector to manage exchange rate risk; the weaker the central bank's intervention capacity; and the more the authorities wish to avoid periodic realignments of the central rate. In the case of China, the PBC holds substantial foreign exchange reserves and plays a central role in the foreign exchange market, while market infrastructure is still relatively weak and banks and corporates have only limited experience in managing exchange rate risk. For these reasons, a modest initial increase in the width of the band would be appropriate, followed by gradual further widening.

The development of a full-fledged foreign exchange market

12. **Substantial strengthening of the foreign exchange market is required** to support a successful transition to a situation where market forces play a progressively larger role in the determination of the exchange rate.[4] Giving market participants greater freedom in handling foreign exchange and hedging against foreign exchange risk is among the number of measures needed to allow for trading to develop and for exchange rate flexibility to be used effectively by market participants. Such measures include, in particular:

- **Allowing enterprises greater flexibility to choose the bank with which they conduct their foreign exchange business, and further reducing surrender requirements**. Currently, domestic enterprises are required to surrender their foreign exchange to one of the banks authorized to collect it (the so-called "designated foreign exchange banks") within a certain period of time;
- **Easing restrictions on foreign exchange market entry and facilitating the development of instruments for foreign exchange risk management**. Currently, "designated foreign exchange banks" accumulate buy and sell orders and send only the residual net position to the CFETS for execution. As a result, many transactions never reach the foreign exchange market, where trading remains thin and dominated by official interventions. Also, forward trading is limited by the fact that forward cover can only be provided by the Bank of China. Putting in place an appropriate regulatory framework, rather than intervening in the process whereby forward rates are set, would facilitate the development of forward (and other derivative) instruments;
- **Strengthening the functioning and capacity of the foreign exchange market.** Currently, the market is centralized and the CFETS is counterpart for the settlement of

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[4] The current foreign exchange trading system (the Shanghai-based "China Foreign Exchange Trading System"—CFETS) was established in 1994 as a nationally integrated electronic system for spot interbank foreign exchange trading.

each foreign exchange transaction. These arrangements do not allow for independent position taking, direct dealing between banks, and the emergence of market-makers. They also generate potential liabilities for the monetary authorities. Accordingly, priorities include the introduction of two-way quotes, extension of trading sessions, and improvements in settlement procedures.

Other supporting measures

13. **Prudential regulation and supervision of banks' foreign exchange transactions will need to be upgraded, in line with international best practice and Basel prudential rules on foreign exchange risks.** Specifically, foreign currency lending of banks should be monitored closely to ensure that loans are extended only to borrowers with foreign currency earnings, and effective limits should be placed on banks' open foreign currency positions (including off-balance sheet activities).[5] Close prudential supervision of the quality and liquidity of banks' foreign currency assets is also essential.

14. **More broadly, greater exchange rate flexibility is part and parcel of China's comprehensive and intertwined market-oriented reforms.** In particular, it needs to be supported by further progress in reforming the financial sector, state-owned enterprises (SOE), and monetary policy:

- **Financial sector reform**: with banks playing a pivotal role in the foreign exchange market, strengthening the banking sector will be key;
- **SOE reforms**: to become effective market participants, SOEs will need to strengthen their financial performance and capacity to manage risks, including foreign exchange risk;
- **Monetary policy and money markets**: with greater exchange rate flexibility, a greater burden will fall on monetary policy to ensure price stability. This points to the need for the PBC to further strengthen its monetary management, including through continued development of the money market and indirect monetary instruments;
- **Capital account liberalization**: while the current regime of capital controls (even though porous) appears sufficiently effective to allow the maintenance of a narrow band, it will become progressively less restrictive (by practice and design). Over time, this will likely imply a need to further widen the band and, eventually, move to a full float once the renminbi is fully convertible.

[5] These positions should also cover branches of domestic banks operating outside of China.

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II. Distressed Debt Resolution—Cross-Country Experience and Lessons for China[1]

1. **Nonperforming Loans (NPLs) in the Chinese banking system, including those transferred to asset management companies (AMCs), are estimated at US$650–900 billion, or 56–78 percent of GDP, in 2001**, the bulk of which are owed by State-owned Enterprises (SOEs). Resolution of NPLs is one of China's most difficult, but critical, reform challenges. It can help reduce the potentially large fiscal costs to the government from financial system losses, relieve banks from the burden of managing NPLs, and enable them to intermediate funds more effectively. Debt work-outs can also be a vehicle for enterprise restructuring. Moreover, a well-functioning debt resolution framework would enhance incentives for good corporate governance and sound banking by strengthening market discipline.

2. **Cross-country experience indicates that the optimal design of a debt restructuring framework depends on the sources of corporate fragility, its scale, the strength of the legal system, and the depth of asset resolution expertise in the economy**. Important questions arise on institutional arrangements, including which institutions should take the lead in debt restructuring (banks or the government), how they should be organized (centralized or decentralized), and whether the framework should be based on bankruptcy laws or an out-of-court scheme.

3. **Progress has been made in developing the institutions and regulations for debt resolution in China in line with international experience, but the framework remains weak**. Bankruptcies have been on the rise as enterprise budget constraints have been tightened, and four government-owned AMCs have been established to facilitate the resolution of bad debts. However, the AMCs are not operationally independent, their objectives are not clearly defined, and their finances lack uniformity and transparency. They should be focused on rapid asset disposal and not on corporate restructuring. To provide incentives for a quick disposition of assets, the AMCs should have a clearly defined date by which their operations are to terminate. Banks' and AMCs' ability to resolve debts is hampered by impediments to seizing collateral and exercising creditor and ownership rights, and they should be afforded special powers to overcome these impediments. Recently established work-out units in SCBs are a useful step in the right direction, but they are at an early stage of development and are not yet part of a comprehensive financial sector reform strategy. The old age and concentration of NPLs in industrial assets suggests that recovery rates are likely to be low, underscoring the importance of resolving NPLs quickly. The insolvency regime offers few options for corporate reorganization. An out-of-court mechanism for corporate debt restructuring and enterprise reorganization would facilitate NPL resolution.

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[1] Prepared by Cem Karacadag.

A. Insolvency Regime

4. **Since the mid-1990s, bankruptcies have risen significantly as courts began to apply the law on SOE insolvency introduced in 1986**. Despite improvements in bankruptcy procedures since the mid-1990s, important deficiencies remain. The regime is unfriendly to creditors and largely ineffective in motivating better enterprise performance. Senior management of enterprises often stays in place throughout bankruptcy proceedings, while asset valuations are undertaken by entities licensed by and affiliated with local governments who are often owners of the failed enterprises. Collateral securing debts is often used to pay for the costs of assisting workers affected by bankruptcies, resulting in creditors commonly recovering less than 10 percent of their claims (World Bank, 2000). There are few options for out-of-court and in-court reorganization, and creditors have limited influence in the process. Out of court, the main restructuring option for an insolvent SOE is merger. The Bankruptcy Law envisages court-supervised restructuring, but it is rarely used. Creditors do not have the right to initiate it, and the debtors and the government bodies they are associated with usually prefer mergers or takeovers over restructuring.

5. **Collateral posted as security is often inaccessible to creditors**. Laid-off workers are often entitled to "rehabilitation" funds, and entitlements are substantial for larger SOEs. Land use rights—often the most valuable asset of a liquidated enterprise—are often used to pay for the "rehabilitation" of laid-off workers and the takeover of the firm's social facilities by a local government. Similarly, the housing of bankrupt enterprises usually is transferred to municipalities, which, in turn, allow laid-off workers to assume ownership at low cost or continue occupying them without rent.

6. **International experience with large-scale corporate sector distress shows that formal insolvency procedures are often too cumbersome; judicial systems have limited capacity and expertise; and courts may be subject to political pressure from vested interests (Stone, 2000)**. Insolvency regimes in developed countries, in particular, have a liquidation bias that is impractical for transition economies where the scale of restructuring is generally large. The insolvency regime in China also has a bias towards liquidation, which has led to the widespread use of mergers. Mergers, however, have tended to enable weak companies to continue operating without undertaking the changes required to secure long-term profitability and enhance debt-service capacity.

7. **An *out-of-court* mechanism for corporate debt restructuring and enterprise reorganization would benefit the resolution of NPLs in China**. Debt restructuring can help restore debt-repayment capacity to viable firms, preserve value, and maximize loan recoveries, provided that firms are given the right incentives and relieved from the burdens—including social welfare obligations—placed on them (van Wijnbergen, 1998). Several transition countries (Hungary and Poland), as well as Asian countries (Indonesia, Korea, Malaysia, and Thailand), have adopted out-of-court schemes for debt restructuring to cope with systemic corporate sector fragility in their economies; among these examples, Poland and Malaysia stand out as perhaps the most successful ones (see Boxes II.1 and II.2).

Box II.1. Corporate Debt Restructuring and Distressed Asset Management in Malaysia[1]

The principal fora for out-of-court corporate debt restructuring in Malaysia are the Corporate Debt Restructuring Committee (CDRC) and Danaharta, the national asset management company.

CDRC was set up to restructure larger loans (over RM 50 million) and to provide an effective vehicle for resolving multi-lender and large debt situations, while preserving stakeholder value. The CDRC works closely with Danaharta, which, by virtue of its NPL acquisitions, can be one of the creditors in a workout proposal under the auspices of the CDRC. The CDRC does not have legal status and is voluntary and flexible, guided by general principles rather than binding rules.

The principles of debt restructuring under the CDRC include:

- Debt restructuring is for viable businesses with loans of at least RM 50 million.
- Decisions are made on the basis of complete and accurate information.
- Creditors are to grant a "standstill" period of 60 days so that orderly decisions can be made.
- Existing credit lines must be kept open, and new loans granted during restructuring are senior.
- The creditors committee should represent at least 75 percent of the debt of all creditors.

Danaharta was established in 1998 as an asset management company envisaged to have a life span of less than 10 years. Danaharta's principal roles are to remove NPLs from banks and facilitate corporate debt restructuring through its special administrator functions. Danaharta is an agency whose top priority is to play an integral role in the overall bank and corporate sector restructuring. It acquires NPLs with a face value of over RM 5 million, priced at market values. Secured loans are valued according to the value of their collateral; unsecured loans at 10 percent of principal outstanding; and specific large loans are acquired under risk-sharing agreements, where the surplus on recoveries are shared with the selling financial institutions on a 20 (Danaharta) to 80 (selling institution) percent basis.

The Danaharta Act of 1998 conferred two special powers to Danaharta. First, the ability to acquire NPLs through statutory vesting, which enables Danaharta to take clear title to NPLs, subject to registered interests and disclosed claims. Second, the ability to appoint special administrators to manage distressed borrowers.

Danaharta acquired RM 47.7 billion in loans through end-2001, representing around 10 percent of banking loans in the late 1990s. The average discount rate on loan purchases was 54 percent. As of mid-2000, Danaharta's NPL portfolio was composed primarily of real estate assets (30 percent), followed by loans for the purchase of shares (18 percent), financial services (14 percent), and manufacturing (13 percent). By end-2001, RM 15.2 billion in assets had been sold, with RM 9.7 billion in cash recovered, yielding a cash recovery rate of 64 percent.

Asset resolution strategies include debt restructuring, foreclosure, settlement, special administration schemes, and legal action. Debt restructuring and foreclosure was applied to nearly one-half of assets, with debt restructuring implemented only for viable loans. The goals are to maximize overall recovery values to Danaharta, ensure fair treatment of all stakeholders, and utilize Danaharta's special powers in the interest of banking system soundness, using the following guidelines:

- Shareholders take a proportionately larger haircut than creditors.
- Settlements to be more favorable to secured creditors than unsecured creditors.
- Borrowers given only one opportunity to implement a debt restructuring scheme to avoid incessant revisions without measurable progress, and the repayment period should not exceed 5 years.
- Usage of funds under the workout schemes should be clearly defined and adhered to, and can include equity kickers such as warrants and convertible loans.
- Any value realized in excess of the book value of assets (written down as part of the scheme) is subject to a sharing ratio between borrower and lender.
- Legal action is taken against the borrower if the scheme fails.

Danaharta's success in asset management and debt restructuring has derived from several factors, including:

- Professional management and an independent board of directors, with 6 out of 9 directors from the private sector.
- A market-driven approach to asset valuation and acquisition.
- The concentration of assets acquired in sectors with more easily saleable assets (e.g., real estate).
- Its reliance on special powers and an out-of-court debt restructuring framework, backed by the judicial system.
- Transparency in its operations through the publication of guidelines, semi-annual reports, frequent media updates, and disclosure of audited financial statements.

[1] See Danaharta (2000, 2002) and Kochar (2000).

Box II.2. Bank and Enterprise Restructuring in Poland[1]

The Polish program sought to achieve bank and enterprise restructuring simultaneously. Among transition economies in Central and Eastern Europe, Poland was among the largest, with an economy composed of a substantial industrial sector and a large, underdeveloped agricultural sector. Not unlike China, the Polish banking system was dominated by state commercial banks and burdened by a high level of NPLs, with one-third of total loans nonperforming, most of which were owed by state enterprises.

The strategy centered on an informal out-of-court settlement approach. Banks kept NPLs on their books and were charged with restructuring and recovering bad debts through negotiated work-out programs with debtors. Banks were not allowed to extend new loans to debtors in default unless a restructuring agreement was signed and an acceptable business plan was presented. The out-of-court restructuring framework was enshrined in the Law on Financial Restructuring of Enterprises and Banks, which was in force from March 1993 to March 1996. By design, the law had a built-in sunset provision to reinforce the one-off nature of the exercise and to maximize the incentives of all parties to cooperate and restructure within the prespecified timeframe.

Debt was used as a control device for banks to play a major role in corporate governance. The law gave banks temporary powers to lead out-of-court restructuring agreements with distressed enterprises. Banks were equipped with three tools: bank-led conciliation agreements (BCAs), the sale of bank debts in the secondary market, and the option to convert bad loans into equity in state enterprises. BCAs were the most widely used vehicle. Banks assumed de facto leadership in administering the agreements—even though a creditor council comprising the bank, the Ministry of Finance, and other creditors had to be established—and a simple majority based on outstanding debts was sufficient to impose a solution on dissenting creditors and approve the BCA. While the BCA was in effect, the borrower was protected from insolvency proceedings; but if the borrower failed to fulfill its obligations, banks were empowered to terminate the agreement and pursue debtors in court. For banks to act as an effective agent for monitoring, controlling, and restructuring enterprises, they were subjected to tight prudential regulation and supervision and the discipline brought to bear by growing competition.

The program included two additional noteworthy features. First, nonviable enterprises whose immediate closure was considered too costly from a social welfare perspective were not included in the program. Instead, their delinquent loans were transferred from the originating bank to the government resolution agency, the Industrial Development Agency (IDA). These firms were restructured or liquidated with conditional support provided through the IDA, which itself was financed through the budget. Second, insolvent state banks were recapitalized based on thorough portfolio reviews conducted early in the program, giving bank management strong incentives to maximize loan recoveries. These incentives were complemented with financial incentives for bank managers, which included stock options in state banks, all nine of which were earmarked for privatization within 3–5 years.

[1] See Montes-Negret and Papi (1997).

8. **The out-of-court mechanism should confer special powers to creditors**. Both banks and AMCs should have the right to initiate the restructuring of debtor enterprises and appoint special administrators subject to certain conditions. In addition, SOEs should be limited in their ability to pursue mergers or takeovers as remedies for weak enterprises.

9. **Debtor-creditor contracts are a cornerstone of out-of-court processes for corporate debt restructuring**. Experience shows that such contracts should provide, inter alia: (1) a time-bound standstill for due-diligence and negotiations; (2) complete creditor access to financial records of debtors for due diligence; (3) joint management-creditor teams to monitor performance, develop cash flow projections, and control asset disposals; (4) milestones for completion of due diligence, development of a restructuring plan, and creditor votes; (5) voting thresholds for creditor approval of a reorganization plan; (6) mechanisms for mediation and arbitration of intercreditor differences; and (7) conversion of the case into court-supervised insolvency for failure to meet interim milestones (Kawai et al, 2000).

10. **Out-of-court mechanisms need to be supported by court-supervised processes for asset seizure, foreclosure, liquidation, receivership, and reorganization**. Without a credible deterrent in the form of court-imposed losses, debtors have little incentive to voluntarily accept business sales, equity dilution, or diminution of management control (Kawai et al, 2000). Experience indicates that an out-of-court framework may produce limited results without a reliable legal system to deter uncooperative behavior.

B. Asset Management Companies

11. **China's four AMCs acquired NPLs of Y 1.4 trillion (17 percent of GDP in 1999) at book value from their SCB counterparts**.[2] Nearly one-fourth of transferred debts were swapped for equity in about 580 SOEs. Loan acquisitions were financed by AMC IOUs of Y 820 billion issued to SCBs, and by transferring to the AMCs liabilities for PBC refinance credits of Y 570 billion previously extended to SCBs.[3]

12. **Loans assumed by AMCs are old and concentrated in industrial SOEs**. The NPL transfer included: (1) loans with no prospect of recovery as of September 1999; (2) NPLs from loans originating before end-1995; and (3) loans which were classified as "idle" (past due by over one year) at end-1998. Industrial SOEs accounted for 45 percent of acquired NPLs, followed by 16 percent for trading firms and 9 percent for real estate companies; only 10–20 percent of transferred loans were collateralized (Figure II.1). The old age of AMC

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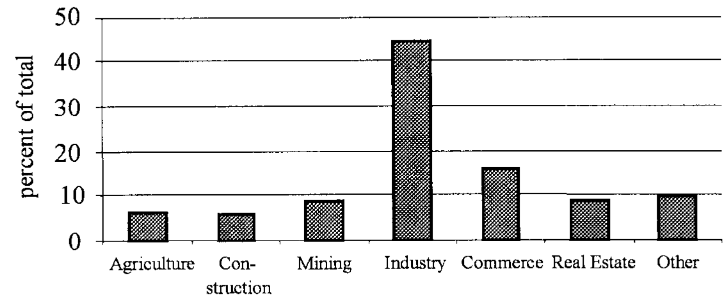
[2] The AMCs assumed loans from SCBs in the following amounts: Cinda AMC, Y 273 billion from China Construction Bank; Huarong AMC, Y 408 billion from Industrial and Commercial Bank of China; Orient AMC, Y 267 billion from Bank of China; and Great Wall AMC Y 346 billion from Agricultural Bank of China. Cinda AMC also assumed Y 100 billion of NPLs from China Development Bank.

[3] AMC liabilities to the PBC and SCBs carry a 10-year maturity and an annual interest rate of 2¼ percent.

portfolios, coupled with the small share of secured credits, suggests that recovery rates are likely to be relatively low.[4]

Figure II.1: Composition of AMC Loan Portfolios[1]



[1]Including Cinda, Huarong, and Great Wall AMCs only.

13. **AMCs have made slow but steady progress in asset disposals, aided by the use of foreign expertise**. Through end-2001, AMCs disposed of 13 percent of their assets, achieving a cash recovery rate of 21 percent (Table II.1). Another 17 percent in non-cash recoveries were made though payments-in-kind that have been difficult to convert into cash. Foreign accounting, investment banking, and asset management firms have been used in all aspects of the AMCs' operations, including asset valuation, marketing, and sales. In some instances, AMCs have formed joint ventures with foreign asset management companies, with AMCs injecting assets, while their foreign partners inject cash and manage the joint ventures. Going forward, recovery rates are likely to drop as lower quality assets are sold.

Table II.1. AMC Operations (end-2001)

(In billions of yuan)

	Cinda	Huarong	Orient	Great Wall	Total
Book value of assets assumed	373.0	407.7	267.4	345.8	1,393.9
Face value of recoveries	61.2	31.1	23.4	61.0	176.7
Cumulative recoveries	27.3	15.8	11.0	12.9	67.0
Of which: Cash	17.3	9.6	5.7	4.4	37.0
Of which: Non-cash	10.0	6.2	5.3	8.5	30.0
Assets disposed (in percent)	16.4	7.6	8.8	17.6	12.7
Cash recovery rate (in percent)	28.3	30.9	24.4	7.2	20.9
Total recovery rate (in percent)	44.6	50.8	47.0	21.1	37.9

Source: Cinda, Huarong, Orient, Great Wall AMCs.

14. **Despite the progress made, deficiencies remain in the operations of AMCs**:

- AMCs' objectives and lifespan are not clearly defined. According to the regulation on AMCs promulgated in November 2000, AMCs are charged with preserving assets,

[4] Recovery rates through end-2001 have been 35 percent in Thailand, 38 percent in Indonesia, 46 percent in Korea, and 64 percent in Malaysia.

reducing losses as much as possible while undertaking "civil responsibilities" prescribed by laws, which, however, are not precisely defined. Moreover, China has not yet enunciated a timeframe for AMCs to complete their operations.

- The AMCs are not operationally independent. All four AMCs are capitalized by the Ministry of Finance (MOF), with seed capital of Y 10 billion each. The State Council appoints senior management as well as members of the Supervisory Board. The MOF has set administrative benchmarks on recovery rates, against which AMCs' performance are evaluated.[5] Although the benchmarks are not binding, they can deter asset disposals that are financially sound, but below the expected recovery rate.

- AMCs are legally empowered with a wide range of methods to resolve debts, but their ability to exercise those powers is constrained. Resolution methods include debt restructuring and settlement; sales to the debtor company, related companies, and local governments; sales through auctions; formation of joint-ventures with foreign fund managers; and foreclosure. Debt-equity swaps entitle AMCs to ownership rights, but their ability to exercise those rights appears limited in practice, including because of government interference and lack of staff and expertise to manage the companies they own.[6]

- Progress has been made in creating a more enabling environment for AMCs, but gaps remain. Seizure of collateral has been difficult owing to slow and cumbersome court procedures, overvaluation of collateral by the courts,[7] double taxation (both at foreclosure and during the sale of collateral), and local government interference. Local governments often repossess land previously posted as collateral for debts owed to AMCs. It is also difficult for AMCs to obtain accurate financial information from the enterprises they own. Rules on multiple creditors do not enable the imposition of a settlement on minority creditors.[8] New regulations were issued

[5] According to the MOF's guidelines, debt-equity swap assets are expected to be sold at no discount (i.e., at 100 percent of the face value), while recovery rates for NPLs classified as "other" assets and "bad" assets are expected to be 30 percent and 1 percent, respectively.

[6] AMCs do not chair the boards of directors of companies in which they have a majority stake, nor are they are empowered to change management in them. AMCs can only make recommendations to the State Council and local governments, which retain authority over senior management appointments.

[7] Courts use the "historical cost" method to value collateral rather than the more forward-looking "going concern" approach.

[8] Where multiple AMCs are involved, the largest creditor develops a proposal for asset resolution and negotiates with the others. Negotiations can be lengthy because creditors have different types of guarantees and collateral. If creditors do not reach a consensus, the majority can adopt a plan of action for their portion of the debt involved, but there are no clear rules enabling the majority to implement a plan for the total amount of debt involved. In cases where both AMC and bank creditors are involved, a consensus is required.

permitting foreign investors to repatriate profits and clarifying their role in joint ventures with AMCs, but the lack of detailed guidelines has delayed asset sales to foreigners, while uncertainties remain over their tax treatment.[9]

- AMCs' financial management practices lack uniformity and transparency. Although AMCs are subject to uniform accounting standards and annual reporting requirements, their financial practices diverge.[10] AMCs' financial statements, moreover, are not externally audited or fully disclosed to the public. The absence of disclosure requirements and uniform financial practices makes it difficult to measure performance and hold management accountable.

15. **Cross-country experience offers the following broad lessons for China's AMCs**:

- The AMCs should operate on a one-time basis with a limited life span. International experienced suggests that centralized AMCs risk weakening incentives for bank and enterprise restructuring (Friedman, 2000 and Woo, 2000). To minimize moral hazard problems, the AMCs should be established from the outset as a one-time exercise with a clear deadline for completion of their operations.

- Chinese AMCs should focus exclusively on rapid asset disposal, rather than corporate debt restructuring. A survey of seven countries with AMCs established prior to the Asian crisis found that state-owned AMCs are rarely effective in corporate debt restructuring[11] (Klingebiel, 2000). Instead, AMCs' can serve effectively as rapid disposition vehicles provided that they have narrowly-defined and internally-consistent goals; assume a small and easily sellable portion of banking assets (e.g. real estate); and are managed in an independent, professional, and transparent manner. A common source of failure of AMCs in developing countries was that they received non-real estate, state-owned enterprise assets or assets related to politically-connected loans.

- China's AMCs should be given operational independence, with the sole objective of maximizing recovery values by disposing assets quickly and transparently. Financial support and other types of forbearance towards nonviable but strategic (for social or other reasons) debtors should be provided by the government, while AMCs focus on maximizing recoveries. Moreover, long-term recovery rates are likely to be higher, the sooner assets are sold. AMCs thus should have full latitude for market-based asset

[9] For example, the government has not yet approved an agreement signed in November 2001 involving the sale of Y 10.8 billion in assets from Huarong AMC to a consortium led by Morgan Stanley.

[10] For example, some AMCs do not service their interest payments owing to inadequate cash flow, while others make only partial payments despite the accumulation of cash balances on their balance sheet.

[11] Countries surveyed include Finland, Ghana, Mexico, the Philippines, Spain, Sweden, and the United States.

sales, unconstrained by administrative targets for recovery rates. Moreover, AMCs should follow uniform accounting practices and disclose audited financial statements.

- Chinese AMCs could be granted special legal powers similar to those in Malaysia. Danaharta enjoys two sets of special powers: (1) the ability to acquire NPLs through statutory vesting, which enables it to take clear title to NPLs, subject to registered interests and disclosed claims; and (2) the ability to appoint special administrators to manage distressed debtors. Partly as a result, Danaharta has been the most successful among its peers formed in the wake of the Asian financial crisis.

C. Bank Restructuring

16. **The majority of distressed debts in the economy remain on bank balance sheets.** Even after the transfer of NPLs to AMCs from SCBs (equivalent to 14 percent of total loans in 1999), SCBs reported an average combined NPL ratio of 30 percent at end-2001. Fund staff estimates NPL ratios for the remainder of the banking system (including trust and investment corporations, policy banks, and credit cooperatives) to be even higher, with the exception of joint-stock commercial banks (Table II.2).

Table II.2. Banking System NPLs and Potential Losses[1] (end-2001)

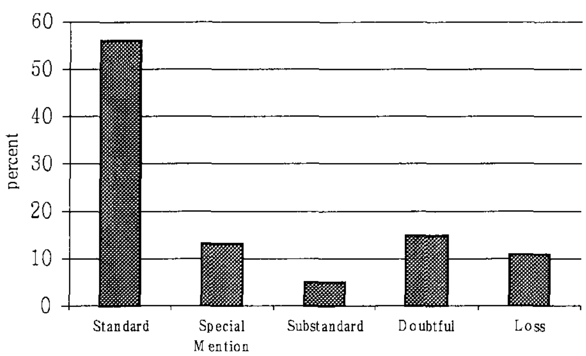
Institution Type December 2001	Credit Stock (Y billion)	Lower Bound NPL ratio (%)	Upper Bound NPL ratio (%)	Lower bound NPLs (% of GDP)	Upper bound NPLs (% of GDP)	Lower bound loss (% of GDP)	Upper bound loss (% of GDP)
SCB	7231	30	45	22.5	33.7	18.0	30.3
OCBs	1151	15	25	1.8	3.0	1.4	2.7
RCCs	1274	50	75	6.6	9.9	5.3	8.9
UCCs	550	50	75	2.8	4.3	2.3	3.8
FCs	189	40	60	0.8	1.2	0.6	1.1
SDIs	1837	40	60	7.6	11.4	6.1	10.3
AMCs	1394	100	100	14.4	14.4	11.5	13.0
Total	13626			56.5	77.8	45.2	70.1

1/ The lower bound estimates are staff estimates based on NPLs reported by SCBs and selected other commercial banks, and on qualitative information for credit cooperatives, policy banks, and trust and investment corporations. The upper bound estimates reflect the staff's worse-case scenario of NPLs. The upper and lower bound *loss* estimates assume recovery rates on NPLs of 10 and 20 percent, respectively, based on the experience of AMCs with asset sales and the relatively old age of NPLs (which suggests substantial impairment to value). The loss estimates do not take into account provisions in financial institutions, which are modest at under 10 percent of NPLs. Note: SCBs = State commercial banks; OCB = Other commercial banks, including joint stock commercial banks and city commercial banks; RCC = Rural credit cooperatives; UCCs = Urban credit cooperatives; FCs = Finance companies; SDIs = Special depository institutions, including trust and investment corporations and policy banks; and AMCs = Asset management companies.

17. **The composition of NPLs indicates a high loss content.** Over three-quarters of NPLs of the SCBs are classified as doubtful or loss, indicating severe impairment to loan values. The vast majority of NPLs are old, with over 90 percent deriving from loans made

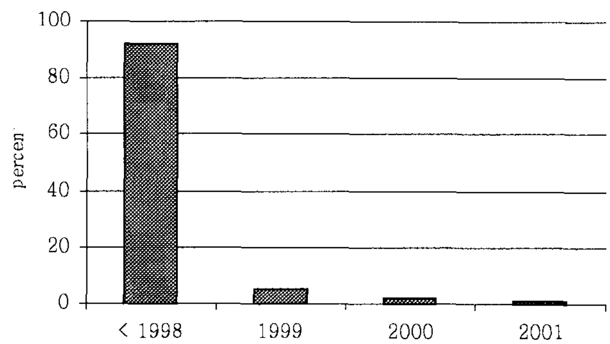
prior to 1998 (Figures II.2 and II.3). Given the rapid decline in distressed debt values over time, the overall recovery rate is unlikely to exceed 10–20 percent, despite concerted efforts to recover NPLs. In terms of borrowers, SOEs accounted for 60 percent of NPLs, followed by collectively-owned (11 percent) and foreign-funded (10 percent) enterprises (Figure II.4). In terms of sector, loans to industry represented 39 percent of NPLs, followed by loans to trade and services at 22 percent with real estate loans accounting for a modest 6 percent of NPLs (Figure II.5). The high share of NPLs to industrial SOEs also suggests that recovery rates on SCBs' NPL portfolios are likely to be low.

Figure II.2. SCBs: Loan Classification (end-2001)



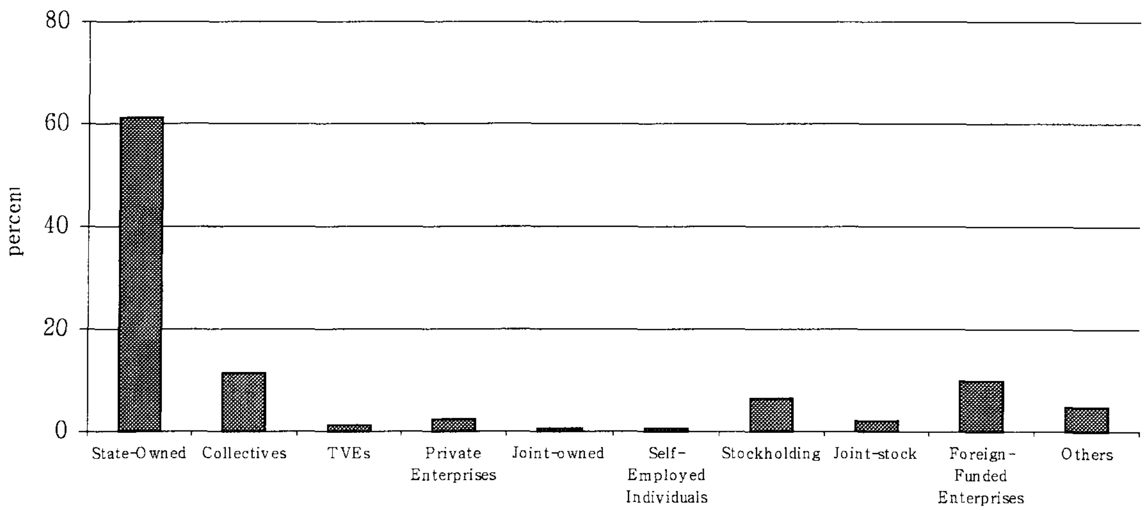
Source: All four SCBs.

Figure II.3. SCBs: NPLs by Age (end-2001)



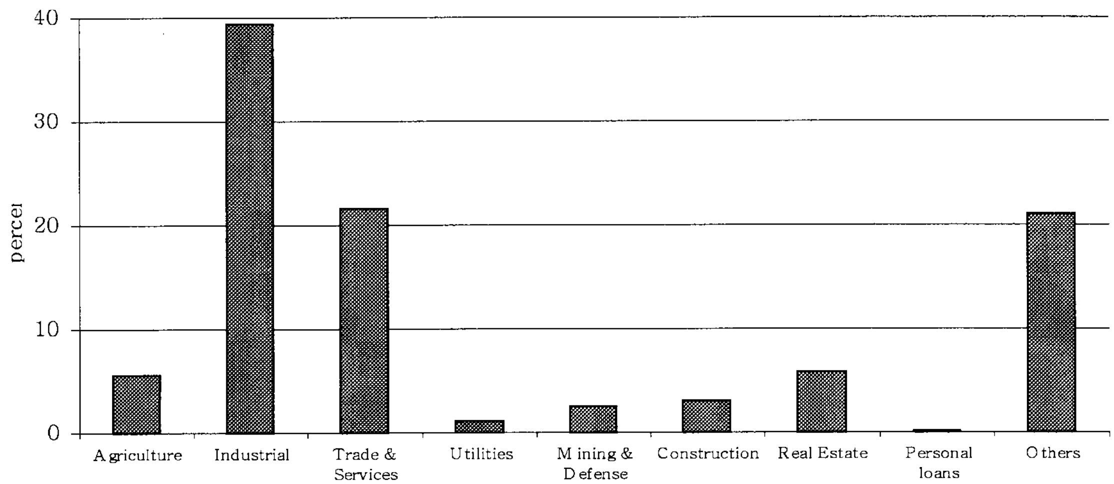
Sources: Bank of China; and Industrial and Commercial Bank of China only.

Figure II.4. SCBs: NPLs by Borrower (End-2001)



Sources: Bank of China, China Construction Bank, and Industrial and Commercial Bank of China only.

Figure II.5. SCBs: NPLs by Sector (end-2001)



Source: Bank of China, China Construction Bank, and Industrial and Commercial Bank of China only.

18. **NPL recovery has become a top priority for the SCBs**. The government has set a goal for the SCBs to cut their NPL ratio to a combined average of 15 percent by end-2005 from 30 percent at end-2001. Overall management accountability for asset quality is also being strengthened. The growing focus on solving the NPL problem has prompted three of the four SCBs to establish specialized departments dedicated to recovering NPLs. Distressed debts are primarily resolved through debt restructuring and payments in kind. Unlike AMCs, banks also extend new loans to distressed borrowers which post more collateral or provide stronger guarantees, but they are not permitted to convert debt into equity.

19. **Bank work-out units are still at an early stage of development**. Individual banks' efforts at NPL resolution should be guided by a coherent set of rules and incentives, possibly following the successful approach employed in Poland. Banks should be required to undergo portfolio reviews by outside auditors as a basis for reviewing asset quality, monitoring progress with NPL recoveries, and developing performance indicators and targets. Over time, additional capital injections by the government should be strictly conditional on achieving performance targets, combined with financial incentives for management to maximize NPL recoveries and improve the quality of new lending.

20. **Through their work-out units, banks could also play a more active role in SOE restructuring**. Banks, rather than state-owned AMCs, may be better suited to spearhead enterprise restructuring in the context of an out-of-court debt restructuring framework. Banks, more than anyone else except enterprise managers, have access to inside information on a debtor firm's prospects through their credit relationship. Even if banks are inexperienced in operating on a commercial basis, it is easier to structure their incentives towards effective restructuring, asset resolution, and privatization, compared with state-run restructuring agencies or AMCs (van Wijnbergen, 1998). Banks potentially have the most to gain from the success of restructuring debtor enterprises and recovering distressed assets, especially if their

own privatization is in prospect and management incentives are tied to those objectives. Banks also can extend new loans under the auspices of a debt restructuring agreement and a new business plan, providing incentives and the financial means for enterprise restructuring.

21. **Bank-led restructuring and NPL recovery efforts should be institutionally separated in the form of independently managed work-out units**. Managing bad loans and assets requires skills that are normally unavailable in banks, including expertise in real estate, liquidation, and various industrial sectors (Ingves and Lind, 1997). Bad-loan management and recovery can also interfere with the daily operation of banks. Separating debt restructuring and recovery efforts enables banks to establish independent and transparent financial goals for themselves and their work-out units. The separation of accounts can also facilitate the future valuation and sale of state-owned banks. Transparent and reliable accounting practices are also needed to provide a basis for measuring and monitoring performance and for supervision.

22. **Chinese SOEs should be subject to hard budget constraints, without which borrowers have little incentive to negotiate with creditors and implement work-out plans**. A critical factor in Poland's success in corporate restructuring was a legal prohibition on banks' extension of new loans, unless borrowers in default presented a credible business plan for operational changes, thus creating strong incentives for borrowers to restructure to survive. The policy also forced the government to deal with strategic, but nonviable, enterprises more transparently by relying on subsidies through the budget, rather than bank loans, to channel financial support (Baer and Gray, 1996).

23. **Bank-led restructuring needs to be complemented by strict prudential regulation and supervision of banks.** An important element of Poland's successful approach was strict prudential supervision and enforcement. Banks were compelled to establish reliable management information systems, which, in turn, enabled the supervisory authorities to verify bank's compliance with restrictions on lending to problem borrowers (Baer and Gray, 1996).

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III. China's Labor Market Performance and Challenges[1]

1. **China's labor market has undergone significant changes in the past 20 years**. A more market-oriented labor market has emerged with growing importance of the private sector, as state-owned enterprises (SOEs) have downsized. At the same time, rural employment growth has slowed, and migrants have sought jobs in the more dynamic coastal provinces. Despite the progress on reforms, a sizable surplus of labor still exists in the rural sector (about 150 million) and SOEs (about 12 million).

2. **The main challenge facing China's labor market in coming years is to absorb the surplus labor into quality jobs while adjusting to WTO accession**. Staff estimates suggest that if GDP growth averages 7 percent and the employment elasticity is 0.47 (in line with historical experience), unemployment could nonetheless double over the next four to five years to about 10 percent, before declining as SOE reform is completed. These pressures would be limited by stronger economic growth, especially in the private sector which has generated the most jobs in recent years.

A. Trends in China's Labor Market

3. **China's population remains predominantly rural, despite a strong trend toward urbanization**. Almost two out of three people were classified as rural by the 2000 census, compared with four out of five two decades ago (Table III.1). The labor force increased faster than the overall population due to a sharp rise in the working age population from 55 percent of the population in 1980 to 67 percent in 1990; it has stabilized subsequently. The participation rate also rose to average about 86 percent by the late 1990s.

4. **Urban employment growth was rapid in the 1980s and then slowed in the 1990s due to SOE reform**. Urban employment grew by almost 60 percent in the 1980s, but growth dropped to about 35 percent in the 1990s. SOE reform, which gained pace in the late-1990s, led to a halving of the SOE workforce to less than 40 million by 2001 (Figure III.1, Table III.2).[2] Employment in collectives also declined sharply from 1995 onwards. The job losses at SOEs and collectives were more than offset by: (i) job growth in the private sector (including foreign-funded enterprises), which created 17½ million jobs in the six years to 2001; and (ii) an unexplained 75 million job increase over the same period. The latter may be attributable to informal sector jobs (such as street vending and casual labor in the

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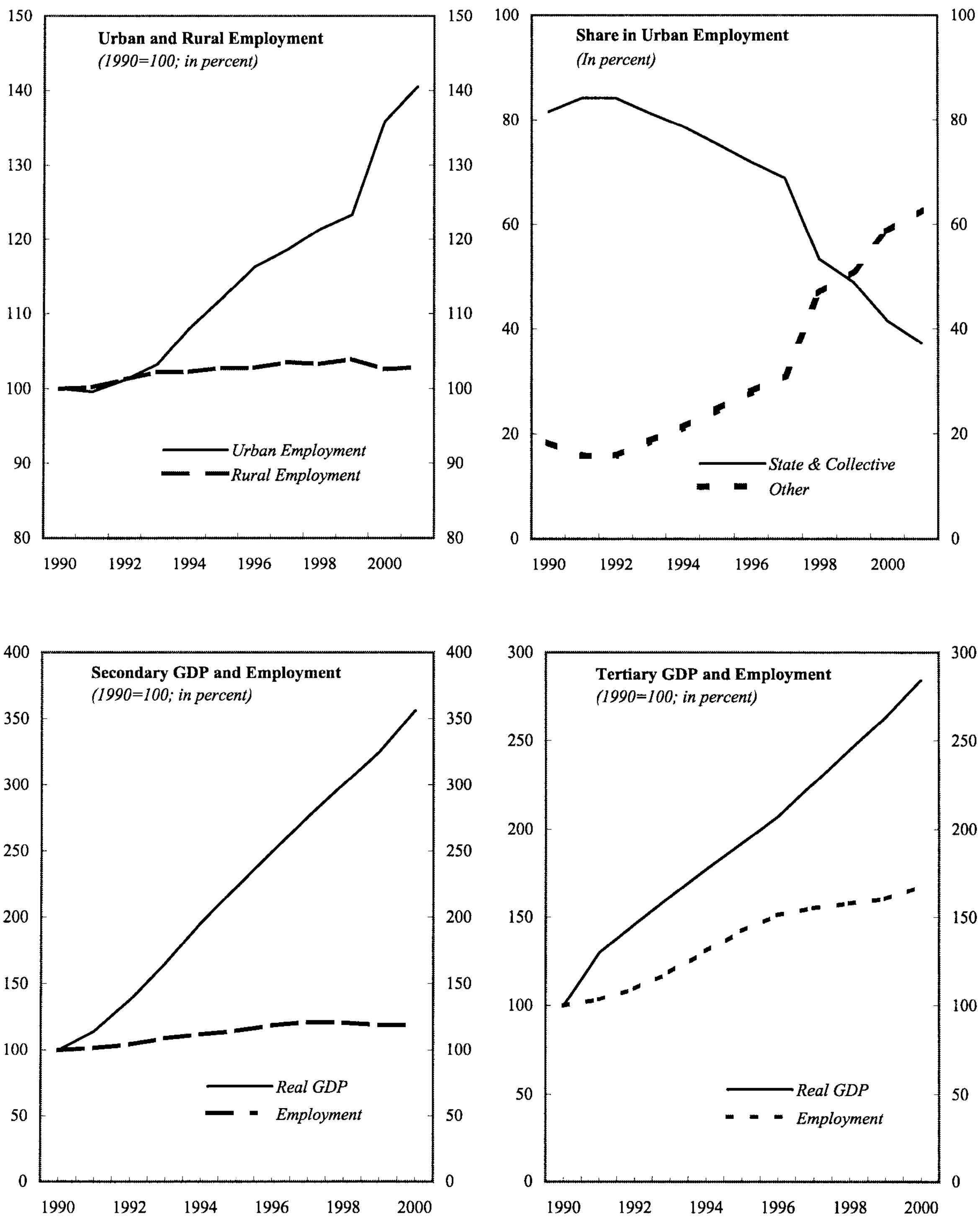
[1] Prepared by Ray Brooks and Ran Tao, IMF Beijing Resident Representative Office.

[2] Some of these jobs were not lost, however, but simply reclassified to joint ownership as SOEs were reorganized into shareholding units or formed partnerships with other entities. Separate data show layoffs from SOEs and collectives of 25½ million in 1998–2001.

Figure III.1. China: Employment and GDP, 1990–2001



Source: CEIC database.

construction industry), which are not well covered by the establishment survey of employment.[3]

5. **Most of the job growth in the past five years appears to have taken place in the service sector and in the coastal provinces**. The pace of job creation was much quicker in the tertiary sector than in other sectors (Table III.3), and was concentrated in the coastal provinces (especially Fujian, Guangdong, and Zhejian). In those provinces, the private sector (and foreign direct investment) has flourished since the government opened up special economic zones in the early 1980s (Table III.4).

6. **Staff estimates suggest that a one percent increase in GDP is correlated with a ½ percent increase in employment in the past two decades.**[4] The elasticity appears to be higher in the eastern provinces (about 0.6), where there is a greater concentration of the private sector (Table III.5).[5] The elasticity was lower in the late 1990s (about 0.2), as SOEs moved to cut labor and lift productivity.

7. **Urban registered unemployment has risen since the mid-1990s due to job losses in the state sector**. The registered unemployment rate, as measured by the Ministry of Labor and Social Services (MOLSS), was relatively constant at around 2½–3 percent in the 1990s, but rose to 3.6 percent by 2001.

8. **Alternative measures show higher and rising urban unemployment in recent years**. Taking account of the rising number of *xiagang* (laid-off workers), the total for registered unemployed and *xiagang* reached about 5½ percent of the labor force in 2001.[6] However, survey evidence suggests that a significant proportion of *xiagang* should not be classified as unemployed according to the ILO's guidelines, as they work more than one hour

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[3] In general, limitations in the labor market statistics makes analysis of these data difficult.

[4] Two-way fixed effects panel regressions were estimated for nonagricultural employment data by province over the period 1978–2000. The equations (estimated in double-log form) specify provincial nonagricultural employment as a function of output, real wages, and provincial and time dummies.

[5] The estimates based on provincial data are subject to possible bias due to statistical weaknesses in the provincial GDP and employment data (neither data sum to the national total). Nonetheless, alternative OLS estimates for the period 1978–2000 using national level non–agricultural GDP and employment data suggest a similar elasticity of about 0.45, with an elasticity for the secondary sector of 0.37 and the tertiary sector of 0.67.

[6] *Xiagang* refers to workers laid-off from SOEs and collectives who remain registered with reemployment centers.

per week in informal jobs.[7] Another measure of urban unemployment, derived from the labor force survey as the difference between the urban labor force and urban employment, is more consistent with ILO guidelines. This measure rose steadily from about 3 percent of the labor force in 1990 to 5–6 percent by 2000/01.

9. **Rural employment growth was rapid in the late 1980s and early 1990s, as town and village enterprises (TVEs) evolved quickly to meet a pent up demand for consumer goods and take advantage of a pool of cheap rural labor**. By the mid-1990s, however, TVE's began to face financial problems brought on by poor management and growing competition from the private sector, and employment has remained at about 130 million in the past six years. The bulk of rural workers, however, are employed on farms. Growth of farm employment also rose sharply in the 1980s, putting added pressure on already small farm sizes, before slowing in the 1990s as rural-urban migration picked up. Migrants have tended to move first to TVEs in rural areas, then further a field to the faster growing eastern provinces (Fang, 2001). The largest concentrations of migrants are found in the Pearl River delta (Gaungdong) and Yangtze river delta (Shanghai and Jiangsu), where average GDP per capita is four to10 times that in poorer rural provinces such as Gansu and Guizhou (Table III.6). Estimates of the migrant population vary, ranging from 80–150 million.[8]

10. **Despite increased migration, considerable surplus labor persists in the rural areas**. The OECD (2002) estimates that if the average GDP contribution per worker in nonagricultural jobs is used as a benchmark, rural hidden unemployment can be estimated to represent around 275 million (where hidden unemployment is defined as low-productive employment regardless of working time). If the benchmark is set more modestly at one-third of the productivity of nonagricultural workers (in line with that in other Asian countries), rural hidden unemployment would be around 150 million.[9]

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[7] Zhao Yaohui (Beijing University) presented evidence of hidden reemployment during a seminar on Economic Reform and the Labor Market in China, December 2001, Beijing. The paper drew evidence from a 1999 survey of 6,500 *xiagang*, and showed that about 60 percent of those still registered as laid-off workers were employed in the informal sector.

[8] The National Bureau of Statistics estimates about 80 million permanent migrants (i.e., those living in urban areas for more than 6 months) between 1990 and 2000. No reliable data are available for the number of temporary migrants, with estimates in the range of 30–70 million.

[9] The Ministry of Agriculture also estimates rural underemployment of about 150 million people (Zhang Hangyu presentation to the Labor Market Reform Conference, Beijing, December 2001).

11. **The level of urban unemployment in China is similar to other countries in the region, but rural underemployment appears to be higher**. Unemployment rates in most other Asia countries rose to about 3–6 percent following the 1997–98 financial crisis (Figure III.2), around China's urban registered rate of 3.6 percent (excluding *xiagang*). In the rural sector, however, the low productivity of China's farmers compared with Asian standards suggests a higher level of underemployment than elsewhere in Asia (Table III.7).[10]

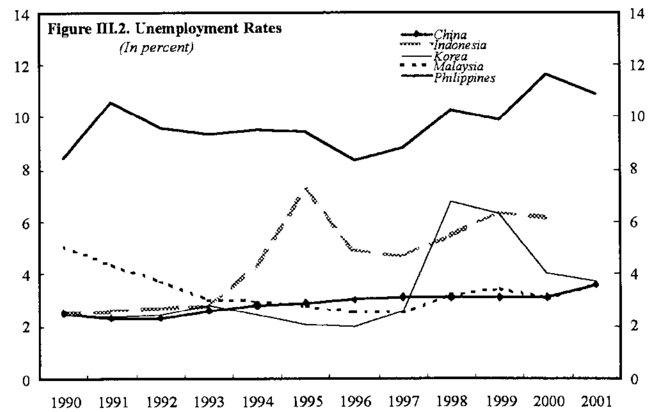

Figure III.2. Unemployment Rates
(In percent)

B. Labor Market Reforms in China

12. **The labor market has undergone significant changes since the opening up of the economy in the late 1970s**. The prereform allocation of labor was characterized by direct allocation of jobs and administrative control of wages. Employers had very little control over their workforce or the wage bill, and employees had little say in where they worked. Opening up has gradually moved toward marketization of the labor market, particularly in the nonstate sector, including greater flexibility in hiring and firing of labor (Box III.1).[11]

13. **Following the initiation of reforms in the early 1980s, a "dual-track transition" of the labor market took place with the development of the state sector**. Employment in foreign-funded enterprises (FFEs) and collectives rose rapidly in the 1980s due to labor market reforms and the opening of the economy to private and foreign investors, while SOEs maintained jobs and provided a wide range of social services for employees (including housing, health care, education, and pensions). Moreover, insolvent SOEs were supported by direct and indirect subsidies to avoid bankruptcies and widespread layoffs that might give rise to social tension.

[10] China's agricultural productivity is less than 20 percent of nonagricultural productivity. This is low compared with other Asian countries, where agricultural productivity is about one third of nonagricultural productivity.

[11] Further details on the reforms can be found in SM/99/167 People's Republic of China—Selected Issues, "The Evolution of Urban Labor Markets" by Russel Krelove.

Box III.1. Steps Toward Labor Market Flexibility

In 1980, China's first national work conference on labor market issues adopted a more flexible labor market strategy. Urban job-seekers were allowed to find work in the state, collective, or newly-recognized private sectors, and enterprises were granted more autonomy in hiring decisions. The authorities, however, continued to formulate a labor plan, but instead of unilaterally allocating workers to enterprises, labor bureaus began to introduce workers to hiring units.

Wage flexibility has been increased gradually. From 1978, firms were allowed to re-institute bonus systems (subject to ceilings) and piece wages. In 1994, the introduction of a new Labor Law also gave management more discretion over wage determination. As a result of these reforms, the share of bonuses in total wages for all enterprises rose from 2 percent of the wage bill at the start of the reforms in 1978 to about 16 percent in 1997.

A labor contracting system was introduced in the mid-1980s. This signaled a marked shift away from the system of lifetime tenures with its potentially distorted work incentives. The initial steps were modest and resulted in only moderate growth in the share of employees under contract, but further reforms in 1994 gave new impetus to labor contracting. As a result, the share of workers on contracts almost doubled from between 1994 and 1997, to about one-third of urban workers. Restrictions on movements of workers across firms were also removed, in an attempt to reduce the scale of the mismatch of labor inherent in the pre-reform system.

SOEs gained the right to lay off permanent workers. Those employees without contracts had lifetime tenure with SOEs, but in the mid-1990s, this tenure was eroded. SOEs, however, were required to established so-called "re-employment centers" (RECs) for laid-off workers ("*xiagang*"), which provide retraining and job search assistance and pay unemployment benefits. If the laid-off worker remained unemployed for more than three years, the employer could severe the relationship. From 2002, newly laid-off workers will receive only unemployment benefits, and the RECs will be phased out by 2004.

14. **As SOE reform gained pace in the late 1990s, more than 25 million SOE and collective employees were laid-off in 1998–2001 as part of a reemployment program (*xiagang*) that provided laid-off workers with a safety net**. Such employees could enter Reemployment Centers (REC) where they could stay until they found a job or for up to three years. As long as they stayed in the REC they remained officially employed by the SOE, but received a lower monthly benefit then their previous wage. Although most of the *xiagang* are middle-aged workers with few skills and poor education, more than half of them have found jobs, while others have retired. Some 7 million *xiagang* remained in RECs at end-2001.

15. **Despite the reforms, surplus labor remains in SOEs**. Labor productivity of SOEs still lags behind the nonstate sector, suggesting that if SOE labor productivity could be raised to nonstate levels, about 12 million SOE workers could be considered redundant (Table III.8).[12]

[12] In 2000, labor productivity of SOEs in the industrial sector was only 73 percent of nonstate enterprises, suggesting that if SOE labor productivity matched that of non-SOEs about 5.4 million of the 19 million SOE workers in this sector could be redundant. Given that a

(continued)

16. **Given the pressures from SOE downsizing, the government has been strengthening the social safety net outside of RECs for urban workers**. An unemployment insurance fund has been established, separate from the RECs, and its coverage has grown rapidly. In 1999, only 14 percent of workers in the urban formal sector had unemployment insurance, but by 2001 coverage had increased to 46 percent (or more than 100 million workers). Minimum wage legislation was also introduced in 1994 with the new Labor Law. Minimum wage standards have been established in all provinces, but the government has faced difficulties in enforcing compliance.

17. **The authorities are also moving to improve training and education of the largely unskilled *xiagang* and migrants**. The ILO is assisting the government's reform efforts, based on the ILO's goal of decent work (Box III.2). The World Bank (2001) notes that a variety of government programs have increased the poor's access to education in the 1990s, including an effort to achieve nine-year universal basic education by 2010. However, funding is inadequate in many poorer regions.

Box III.2. ILO Support for Reforms

In 2001, the Ministry of Labor and Social Security (MOLSS) and the ILO agreed on a program of cooperation to support labor reforms in China based on the ILO's goal of *Decent Work*. The program includes: collaboration to promote international labor standards in China; analyzing the labor market and working to improve labor market statistics; strengthening training services; promoting an expansion of the coverage of social security schemes; advising on improving occupational safety; and promoting tripartite discussions between government, employers, and workers.

The program promotes training in a numbers of areas. ILO will collaborate with MOLSS to design a range of retraining and job creation schemes, including for xiagang and disabled and disadvantaged groups. It also aims to improve entrepreneurial training and micro-credit facilities to medium and small-sized enterprises. In addition, the ILO will work with the MOLSS to improve employment services to provide better matching of labor supply and demand.

Social protection is to be improved. The aim is to strengthen the governance and administration of social security, particularly the unemployment benefit system. The program also aims to strengthen provision for employment injury insurance, while working to improve national safety and health programs.

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further 23 million SOE workers are employed outside the industrial sector, this implies a total SOE labor surplus of about 12 million. Foreign-funded enterprise labor productivity is twice that of SOEs, suggesting that if this higher benchmark is used, about half the SOE workers (20 million) could be considered redundant.

18. **Labor unions are also being encouraged, including with ILO assistance.** Unions have historically played a very limited role, despite more than 100 million members of grassroots unions in 2000. In October 2001, China amended its labor union law to clarify the role of unions. The law now provides that, if the enterprise decides on "major matters" such as business management and development, it is required to listen to the unions' opinions, thereby strengthening the say of labor in business decisions.

19. **During the central planning period, control on population movement was achieved through a combination of household registration (hukou), rural commune controls, and food rationing**. The elimination of communes and food rationing in the 1980s reduced obstacles to rural-urban migration. Hukou reforms were also initiated in the 1990s, but more significant steps were taken last year (Box III.3).

Box III.3. Hukou Reform

The household registration (hukou) system was set up in the mid-1950s to control the movement of population and effectively constrained the development of a national labor market. An urban hukou was needed to stay in cities and gain preferential access to city services such as education, health, and social security. Moreover, urban enterprises were restricted from recruiting labor from another province unless labor could not be found locally.

Since the mid-1990s, reforms to the hukou system have been initiated. In 1997, the authorities experimented with relaxation of household registration regulations in some small towns and cities, allowing migrants who had either a stable income (from a job or business) or owned a house to obtain an "urban hukou." These reforms, however, were not very far-reaching, and by end-2000 only 540,000 people had applied for a hukou in small towns and cities.

The reform gained momentum in 2001. Since October 2001, a person with stable work and a residence should be able to obtain a hukou in more than 20,000 small towns and cities, while retaining their land use rights in the countryside. In addition, the State Planning Commission stipulated that charges levied by localities on migrants, such as " temporary residence fees" and "birth control fees" must be removed by early 2002. These charges could amount to several hundred renminbi, a sizable portion of migrant earnings.

While the new reforms are a significant step toward establishing a national labor market, a number of barriers remain. First, a hukou in small towns and cities is not as attractive to rural migrants as a hukou in large and medium cities (that provide better services), where reforms have not been as far reaching. Second, the ownership of a residence is a demanding condition for most rural migrants to meet, given their relatively low income. Third, localities will likely resist reducing fees applied to migrants, given the potential loss of revenue . Fourth, those who obtain an urban hukou can only give birth to one child, while in many rural areas, two children are permitted.

20. **Labor market reforms are being driven in part by accession to WTO**. Li and Zhai (1999) estimate that job losses as a result of WTO could amount to about 14½ million, comprising 13 million workers in rural areas and 1½ million in urban areas (mainly in the automobile and machinery industries).[13] While some rural workers with good land will be able to switch to higher value-added crops, the World Bank assesses that those on marginal land could be seriously affected by WTO accession, resulting in higher poverty and/or urban migration. IMF staff estimate that growth may slow in the short-term as a result of WTO accession, due to restructuring, but benefits will come from higher growth in the medium-term of about ½ percent annually (SM/00/166, Suppl. 1, July 14, 2000, Chapter III). The textile and clothing industry, in particular, will get a boost from 2005 onwards with the elimination of quotas, and its strong cost competitiveness may lead to a sizable increase in China's world market share (see Martin *et al*, 1999). Job growth, therefore, could be enhanced by a shift of resources from the less competitive industries, such as automobiles, toward more labor intensive industries such as textiles and clothing and the services sector.[14]

C. The Road Ahead

21. **Looking ahead, the capacity of the labor market to absorb the 160 million or so surplus workers in the rural and SOE sectors was assessed by analyzing a range of projections for labor supply and demand.** Specifically, a central scenario was developed assuming the following:

- The population of working age grows by 12–16 million annually through 2010 based on projections by Wang (2001).
- The labor force participation rate stays at the 2001 level of 86 percent.
- All new entrants to the labor force seek jobs in the nonagricultural sector.
- Nonagricultural GDP grows by 7½ percent annually through 2010 under a central scenario (implying overall GDP growth of 7 percent). An optimistic scenario would be 8½ percent nonagricultural growth, while a pessimistic scenario would be 6½ percent nonagricultural growth.
- The employment elasticity is 0.47 percent as calculated for the period 1978–2000.

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[13] These workers can be considered part of the 150 million rural and 12 million SOE surplus labor estimated above.

[14] For example, if output of the textile and clothing industry increased by 50 percent while automobile and ordinary machinery output fell by 50 percent, the net increase in jobs would be about 1 million due to the labor intensive nature of the textile and clothing industry (both sectors had a similar level of output in 2000).

- The impact of wage growth on employment is relatively minor.

22. **Projections for the central scenario of nonagricultural growth of 7½ percent suggest that unemployment could rise in coming years (Table III.9).** New job growth is projected at about 13–14 million annually in 2002–05, somewhat higher than the 8 million average annual increase in 1995–2001. Most of these jobs are assumed to be taken by the new entrants to the labor force (11 million annually). This implies that the labor market can absorb about 2–3 million surplus rural and SOE workers annually in 2002–05, without increasing the explicit urban unemployment rate. However, if most of the SOE downsizing takes place in the next three years, and about 4 million rural migrants[15] move to urban areas annually, the unemployment rate (survey based) would double to a peak of about 10 percent by 2005. The unemployment rate would then decline to about 7 percent by 2010, as the natural increase in the labor force slows and SOE downsizing is complete.

23. **The projections, however, are subject to a wide range of uncertainty**. Using more optimistic assumptions of 8½ percent nonagricultural growth and an employment elasticity of 0.6 implies that the urban economy could absorb 110 million surplus workers in 2002–10, equivalent to more than two thirds of the rural and SOE labor surplus (Table III.10). A more pessimistic scenario of 6½ percent nonagricultural growth and an employment elasticity of 0.35 suggests that labor force growth would outstrip job growth in 2002–10 by 22 million putting considerable upward pressure on unemployment. The unemployment projection also depends crucially on the assumption about migration, with migrants unlikely to come to urban areas unless jobs are available. Therefore, the urban unemployment rate may not rise significantly if migrants remain on the farms as part of the surplus rural labor.

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[15] About half the annual rate of the Tenth Five-Year plan which targeted the transfer of 40 million rural labor force into urban areas over the period 2001–05.

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Table III.1. China: Population, Labor Force and Employment, 1980–2001

	1980	1990	1995	2000	2001
			(in millions)		
Population	987.1	1,143.3	1,211.2	1,265.8	1,276.3
Urban	191.4	301.9	351.7	458.4	480.6
Rural	795.7	841.4	859.5	807.4	795.6
Urban (percent of total)	19.4	26.4	29.0	36.2	37.7
Rural (percent of total)	80.6	73.6	71.0	63.8	62.3
Working age population (15–64)	540.0	754.5	806.1	853.7	864.0
Labor force 1/	429.0	653.2	688.6	739.9	744.3
Participation rate (in percent) 2/	79.4	86.6	85.4	86.7	86.1
Employment 3/	423.6	647.5	681.2	720.9	730.3
Urban					
Labor force 1/	110.6	176.1	198.3	250.5	253.5
Employment	105.3	170.4	190.9	231.5	239.4
Unemployment					
Registered	5.4	3.8	5.2	6.0	6.8
Total laid-off workers (xiagang)	...	...	...	9.1	7.4
Registered unemployed and xiagang	...	...	...	15.1	14.2
Survey based 4/	5.3	5.7	7.4	19.0	14.0
Unemployment Rate (in percent)					
Registered	4.9	2.5	2.9	3.1	3.6
Registered unemployed and xiagang 5/	...	...	...	6.0	5.6
Survey based 5/	4.8	3.2	3.7	7.6	5.5
Rural					
Labor force 1/	318.4	477.1	490.3	489.4	490.9

Data Sources: China Statistical Yearbook various years; CEIC database; and IMF Staff estimates.

1/ From the labor force survey, defined as economically active persons 16 years and older, either working one hour or more in the reference week or looking for work.

2/ Labor force as percent of working age population.

3/ From the labor force survey, defined as those working for one hour or more in the reference week.

4/ Derived as the difference between the survey based urban labor force ("economically active persons") and urban employment.

5/ Calculated as percent of the urban labor force.

Table III.2. China: Employment by Enterprise Ownership, 1980–2001

	1980	1990	1995	2000	2001
			(in millions)		
Total Employment	423.6	647.5	680.7	720.9	744.3
Urban Employment	105.3	170.4	190.4	231.5	239.4
State Units	80.2	103.5	112.6	81.0	76.4
Of which: SOEs	67.0	73.0	76.4	43.9	39.5
Institutions	...	21.6	26.1	26.4	26.2
Governments	...	8.9	10.1	10.7	10.7
Collective Owned	24.3	35.5	31.5	15.0	12.9
Joint Units 1/	0.0	1.0	3.7	13.4	15.2
Foreign funded 2/	0.0	0.7	5.1	6.4	6.7
Private Units	0.8	6.7	20.6	34.0	36.6
Residual	0.0	23.1	16.9	81.6	91.6
Rural Employment	318.4	477.1	490.3	489.4	490.9
TVES	30.0	92.7	128.6	128.2	130.9
Rural Private Owned	...	1.1	4.7	11.4	...
Self-employed	...	14.9	30.5	29.3	...
Residual	288.4	368.4	326.4	320.5	...
			(in percent of total)		
Urban Employment	100.0	100.0	100.0	100.0	100.0
State Units	76.2	60.7	59.1	35.0	31.9
Of which: SOEs	63.6	42.8	40.1	19.0	16.5
Institutions	...	12.7	13.7	11.4	10.9
Governments	...	5.2	5.3	4.6	4.5
Collective Owned	23.0	20.8	16.5	6.5	5.4
Joint Units 1/	...	0.6	1.9	5.8	6.4
Foreign funded 2/	0.0	0.4	2.7	2.8	2.8
Private Units	0.8	3.9	10.8	14.7	15.3
Residual	0.0	13.6	8.9	35.3	38.2
Rural Employment	100.0	100.0	100.0	100.0	100.0
TVES	9.4	19.4	26.2	26.2	26.7
Rural Private Owned	...	0.2	1.0	2.3	...
Self-employed	...	3.1	6.2	6.0	...
Residual	90.6	77.2	66.6	65.5	...

Date Sources: China Statistical Yearbook various years; CEIC database; and IMF staff estimates.

1/ Shareholding units, joint owned units, limited corporations and shareholding economic units.
2/ Includes Hong Kong, Macao and Taiwan Province of China funded.

Table III.3. China: Employment by Industry, 1980–2001

	1980	1990	1995	2000	2001
			(In millions)		
Farming, Forestry, Animal Husbandry, Fishery	291.2	341.8	330.2	333.6	329.7
Mining and Quarrying	7.0	8.8	9.3	6.0	5.6
Manufacturing	59.0	86.2	98.0	80.4	80.8
Electricity, Gas and Water	1.2	1.9	2.9	2.8	2.9
Construction	9.9	24.2	33.2	35.5	36.7
Geological Prospecting, Water Conservancy	1.9	2.0	1.4	1.1	1.1
Transport, Storage, Post and Telecommunication	8.1	15.7	19.4	20.3	20.4
Wholesale, Retail Trade and Catering Services	13.6	28.4	42.9	46.9	47.4
Banking and Insurance	1.0	2.2	2.8	3.3	3.4
Real estate, social services, health, and education.	18.5	26.3	27.0	30.7	31.5
Govt, Party Agencies and Social Organizations	5.3	10.8	10.4	11.0	11.0
Others	5.9	18.0	44.9	56.4	58.5
Residual	1.1	81.2	58.9	92.9	101.4
Total	423.6	647.5	680.7	720.9	730.3
Primary	291.2	384.3	354.7	360.4	365.0
Secondary	77.1	136.5	156.3	162.2	163.0
Tertiary	55.3	118.3	168.5	198.2	202.0
Non-agric	132.4	254.8	324.8	360.4	365.0
			(In percent)		
Primary	68.7	60.1	52.2	50.0	50.0
Secondary	18.2	21.4	23.0	22.5	22.5
Tertiary	13.1	18.5	24.8	27.5	27.5

Sources: China Statistical Yearbook various years; CEIC database; and IMF staff estimates.

Table III.4. China: Urban Employment by Province, 1990 and 2000
(in millions)

	Total Urban Employment		Share in State-owned Units	
	1990	2000	1990	2000
National	170.4	231.5	59.5	35.0
North	22.6	22.4	75.2	57.4
Beijing	4.6	4.6	77.6	58.3
Tianjin	2.9	2.4	74.9	45.4
Hebei	6.7	7.3	74.6	58.0
Shanxi	4.5	4.3	75.7	66.5
Inner Mongolia	3.9	3.9	73.0	52.2
Northeast	25.4	20.1	65.0	53.8
Liaoning	10.8	8.5	62.0	49.4
Jilin	5.6	4.4	65.2	57.2
Heilongjiang	9.0	7.2	68.5	57.0
East	40.1	42.8	65.3	48.2
Shanghai	5.4	4.2	73.4	47.6
Jiangsu	9.0	8.7	59.4	48.4
Zhejiang	5.1	5.9	55.5	34.2
Anhui	5.2	5.8	63.2	48.0
Fujian	3.4	4.2	63.9	41.0
Jiangxi	4.1	3.9	74.0	61.5
Shandong	7.9	10.2	70.2	54.3
Central and South	28.6	37.6	82.0	52.6
Henan	7.3	8.6	71.7	54.0
Hubei	8.3	7.3	63.3	57.5
Hunan	..	6.1	...	61.5
Guangdong	8.5	10.8	61.9	39.5
Guangxi	3.4	3.9	75.9	60.9
Hainan	1.1	1.1	83.4	61.0
Southwest	13.6	15.4	69.4	60.6
Chongqing	...	2.8	...	52.6
Sichuan	7.2	6.5	68.9	59.5
Guizhou	2.5	2.4	74.3	65.8
Yunnan	3.1	3.5	81.6	64.8
Tibet	0.9	0.2	17.1	72.6
Northwest	7.8	11.8	...	64.3
Shanxi	4.0	4.7	78.6	58.0
Gansu	2.4	2.5	81.0	68.4
Qinghai	0.7	0.7	79.8	62.6
Ningxia	0.7	0.8	80.3	66.7
Xinjiang	..	3.2	...	70.2
Unexplained residual	7.0	61.3	...	...

Sources: China Labor Market Yearbook 1991 and 2001.

Table III.5. China: Estimates for Nonagricultural Employment 1/

Variable	National	Eastern Provinces	Mid and West Provinces	1978–1993	1993–2000
Constant	4.5	1.5	1.7	1.6	2.3
	(23.8)	(12.6)	(5.6)	(22.9)	(10.2)
Log (GDP)	0.47	0.60	0.42	0.52	0.20
	(79.2)	(15.8)	(5.4)	(18.0)	(2.4)
Log (Wages)	-0.10	-0.07	0.00	-0.01	0.01
	(4.3)	(2.4)	(0.0)	(2.3)	(2.1)
Adj. R square	0.99	0.99	0.98	0.98	1.00
Hausman test	(48.7)	(25.2)	(64.1)	(19.5)	(152.4)

Source: IMF staff estimates.

1/ A two-way fixed effect panel regression was undertaken, including provincial dummies and time dummies to control unobservable effects, using the following specification (with t-stats in parenthesis): Log (Employment) = A log (GDP) + B log (wages) + province dummies + time dummies, where: Employment is total employment in nonagricultural sectors of the province i in year j. GDP is nonagricultural real GDP(deflated by the GDP deflator) of province i in year j. Wages is the nominal wage index deflated by the CPI of the province i in year j.

Table III.6. China: Per Capita GDP by Province, 1980–2000
(RMB per annum)

	1980	1990	1995	2000
Beijing	1,584	4,878	13,073	22,460
Tianjing	1,392	3,621	10,308	17,993
Hebei	427	1,465	4,444	7,663
Shanxi	442	1,528	3,569	5,137
Inner mongolia	361	1,478	3,639	5,872
Liaoning	811	2,698	6,880	11,226
Jilin	445	1,746	4,414	6,847
Heilongjiang	694	2,028	5,465	8,562
Shanghai	2,738	5,910	18,943	34,547
Jiangsu	541	2,103	7,299	11,773
Zhejiang	470	2,122	8,075	13,461
Anhui	291	1,182	3,357	4,867
Fujian	348	1,763	6,833	11,601
Jiangxi	342	1,134	2,984	4,851
Shandong	402	1,815	5,758	9,555
Henan	317	1,091	3,313	5,444
Hubei	428	1,556	4,162	7,188
Hunan	365	1,288	3,470	5,639
Guangdong	-	-	7,973	12,885
Guangxi	278	1,066	3,543	4,319
Hainan	354	1,589	5,225	6,894
Chongqing	-	-	-	5,157
Sichuan	321	1,134	3,177	4,784
Guizhou	219	810	1,853	2,662
Yunnan	267	1,224	3,044	4,637
Xizhang	471	1,276	2,392	4,559
Shannxi	334	1,241	2,843	4,549
Gansu	388	1,099	2,288	3,838
Qinghai	473	1,558	3,430	5,087
Ningxia	433	1,393	3,328	4,839
Xinjiang	-	-	4,764	7,470

Source: China Statistical Yearbooks.

Table III.7. Selected Asian Countries. Labor Productivity, 2000 1/

	Agriculture Sector	Non-agriculture Sector	Agriculture/Non-agric productivity
	(US $ per employee)		
China	477	2,584	0.18
Indonesia	637	2,569	0.25
Korea	9,474	23,430	0.40
Malaysia	4,561	10,809	0.42
Philippines	1,179	3,607	0.33
Taiwan Province of China	8,722	34,490	0.25

Source: CEIC database; and staff estimates.

1/ Defined as value added divided by the number of employees.

Table III.8. China: Industrial Employment and Output, 1995–2000

	1995	1997	1999	2000
Industrial Sector				
Value added (in billions of RMB)	1,942.0	1,983.5	2,156.4	2,539.2
Employees (in millions)	66.1	78.7	58.1	55.8
Output/Employee (in thousands of RMB)	29.4	25.2	37.1	45.5
State-owned				
Value added	1,107.0	919.2	820.4	721.3
Employees	43.9	38.9	25.1	19.7
Output/Employee	25.2	23.6	32.7	36.6
Non State-owned				
Value added	835.0	1,064.3	1,336.0	1,817.9
Employees	22.2	39.8	33.0	36.1
Output/Employee	37.6	26.7	40.5	50.4
Ratio, State to non-state owned				
Value added	1.33	0.86	0.61	0.40
Employees	1.98	0.98	0.76	0.55
Output/Employee	0.67	0.88	0.81	0.73
Selected categories:				
Foreign funded (including HK, Macau and Taiwan)				
Value added	228.1	354.0	485.0	609.0
Employees	4.8	7.1	7.9	8.5
Output/Employee	47.5	49.9	61.4	71.6
Textiles, Garments, leather and furs				
Value added	144.6	187.1	190.5	218.9
Employees	9.5	11.1	8.2	8.1
Output/Employee	15.3	16.9	23.2	26.9
Transportation equipment and ordinary machinery				
Value added	147.4	180.0	193.7	216.5
Employees	7.8	8.2	5.3	5.1
Output/Employee	19.0	22.0	36.5	42.1

Source: China Industrial Statistical Yearbook various years; and Staff Estimates.

Table III.9. China: Labor Force and Employment Projections, 2002–2010 1/

	2001	2002	2003	2004	2005	2010	Sum for 2002–2005	Sum for 2002–2010
				(in millions)				
Non-agricultural employment	353 2/	365	378	392	405	482	...	...
New jobs (annual increase)		12	13	13	14	16	52	129
Total population	1,276	1,288	1,296	1,304	1,312	1,346	...	...
Working age population(15-64)	864	877	890	903	914	968	...	...
Increase of working age pop. (annual change)	10	13	13	12	12	10	50	104
Increase of labor force (annual change)	9	11	11	11	10	8	43	89
New jobs less increase in labor force		1	2	3	4	8	9	40
Surplus labor seeking jobs (annual flow)		7	7	7	6	4	33	52
SOE re-employment		3	3	3	1	0	12	12
Rural migrants		4	4	4	4	4	22	40
Change in Urban unemployment (survey based) 3/		6	6	5	2	-4	19	12
Urban unemployment rate (in percent)	5.5	7.7	9.4	10.6	10.9	7.5		

Source: IMF Staff estimates.

1/ Assuming 7 percent GDP growth, 7½ percent non-agric GDP growth, and 0.47 employment elasticity.
2/ Base employment is reduced by 12 million to take account of remaining redundant SOE workers.
3/ Defined as surplus labor seeking jobs less new jobs less increase in labor force.

Table III.10. China: Projections of Jobs for Migrants and Laid-off Workers from SOEs 1/

A. 2002–2005 job increase, in millions

		Growth rate assumptions (in percent) 2/		
		6.5	7.5	8.5
Employment	0.30	-15	-10	-6
Elasticity				
Assumption	0.47	2	9	17
	0.60	15	25	35

B. 2002–2010 job increase, in millions

		Growth rate assumptions (in percent) 2/		
		6.5	7.5	8.5
Employment	0.30	-22	-11	1
Elasticity				
Assumption	0.47	21	40	60
	0.60	56	82	110

Source: IMF staff estimates.

1/ Defined as new jobs less the increase in the labor force due to growth in the working age population.

2/ For the non-agricultural sector. Roughly equivalent to 6, 7 and 8 percent for overall GDP growth.

IV. Fiscal Federalism in China[1]

1. In 1994, China carried out a far-reaching fiscal reform. Revenue bases were assigned to different levels of government, and a more transparent and rules-based transfer system was designed to replace the various ad-hoc bilateral agreements that had defined intergovernmental fiscal relations up to then. However, while succeeding in improving the buoyancy of the tax system and providing the central government with additional resources, the reform did not provide each province with sufficient resources to deliver a minimum standard of public services.

2. Ongoing structural change and reforms, including from China's accession to the WTO, affect output, fiscal revenue, and spending needs unevenly across regions. Economic reforms may be delayed, and regional disparities in income and public service delivery could widen further. To avoid this situation, additional changes will have to be made to China's intergovernmental fiscal relations. Such changes would include a reassessment of revenue assignments, giving sub-national governments adequate tax-setting authority, while still providing adequate resources to the central government. Expenditure assignments should also be revisited to ensure adequate funding and capacity to deliver services. The bias in current transfers arrangements toward returning revenues to the areas where they were generated needs also to be modified. Transfers would need to be defined primarily on the basis of local revenue capacity and expenditure needs, in order to ensure a minimum standard of public service in each province.

A. The Administrative Structure

3. **China's public administration has five levels**. There are 31 provincial-level units[2]; 331 prefectures and cities at the prefectural level; 2,107 counties, autonomous counties, and cities at the county level; and 44,741 townships, towns, and city districts.[3] Although the central government determines the broad outline of the system, it deals directly only with the provincial governments. For instance, it sets the revenue-sharing rules with the provinces, which in turn specify the revenue-sharing system with their respective prefectures, and the prefectures for their counties and so on. Expenditure assignments are structured in a similar way.

[1] Prepared by Raju J. Singh.

[2] 22 provinces, four cities directly under the central government, and five autonomous regions

[3] These figures exclude Hong Kong Special Administrative Region, Macao Special Administrative Region, and Taiwan Province of China.

B. Revenues and Transfers

4. **The 1994 fiscal reform clearly assigned taxes between the central and local governments (Appendix I).** Tax revenue assigned to the central government included: 75 percent of the (newly introduced) VAT; excise and trade-related taxes; and the enterprise income tax collected from central SOEs. Taxes assigned to local governments included: 25 percent of the VAT; the business tax; the enterprise income tax levied on local SOEs, as well as on foreign-financed enterprises; and the personal income tax. A national tax service was established to administer the new central and shared taxes.

5. **In addition, the system of transfers was redesigned, moving away from ad-hoc negotiated transfers toward a more rules-based and transparent mechanism.** The new system has four main elements:

- "Revenue returned" provides each province with 30 percent of the increase in VAT receipts and excise tax collection over a 1993 base.

- "Specific purpose grants" are earmarked transfers allocated on an ad-hoc basis.

- "Subsidy transfers" help ensure each province has adequate resources. They are rules-based and depend on variables, such as provincial GDP, student-teacher ratios, number of civil servants, and population density.

- "Fixed subsidies" ensure that every province has total revenues not lower than in 1993.

6. **The 1994 fiscal reform helped reverse the decline in budget revenue (Figure IV.1).** From a low of 11 percent of GDP in 1995, budget revenue increased to over 17 percent in 2001.[4] Similarly, the central government's share of total budget revenue jumped from 22 percent in 1993 to nearly 56 percent in 1994, and has hovered above 50 percent since then (Figure IV.2).

7. **The 2002 budget introduced a new sharing formula for the personal and corporate income taxes.** According to the new formula, all proceeds from these taxes above the 2001 level will be shared between the center and the provinces on the basis of a 50–50 ratio (60–40 in 2003). The share of these increased revenues received by the center is to be used for transfers to poorer provinces.

8. **With the 1994 reform, however, the transfer system remains regressive.** The predominance of transfers under the "revenue returned" principle has perpetuated the regressive character of the current system, whereby richer provinces receive most transfers

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[4] Using the IMF definition, which excludes subsidies to loss-making SOEs (the official definition includes this item as negative revenue).

Figure IV.1. Budget Revenue 1979–2002
(in percent of GDP)

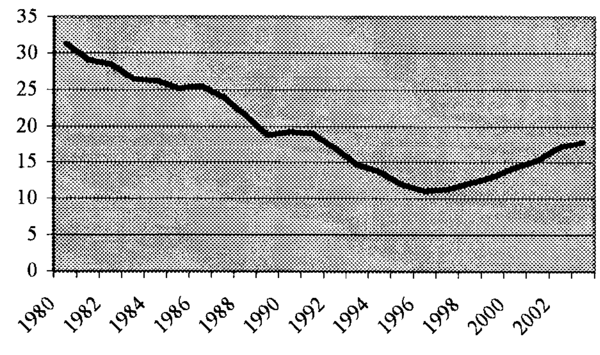


Figure IV.2. Central Government Revenue Share 1979–2002
(in percent of budget revenue)

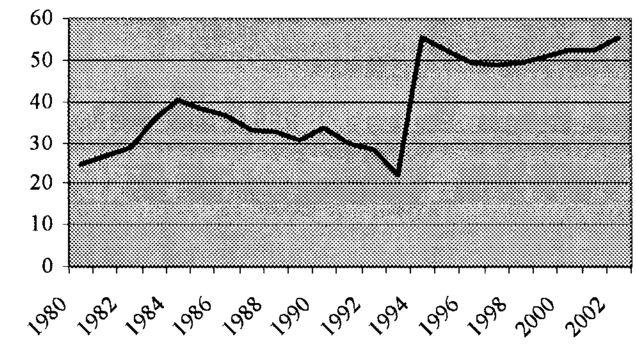
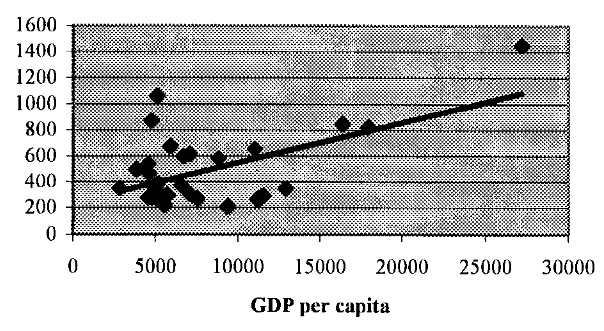
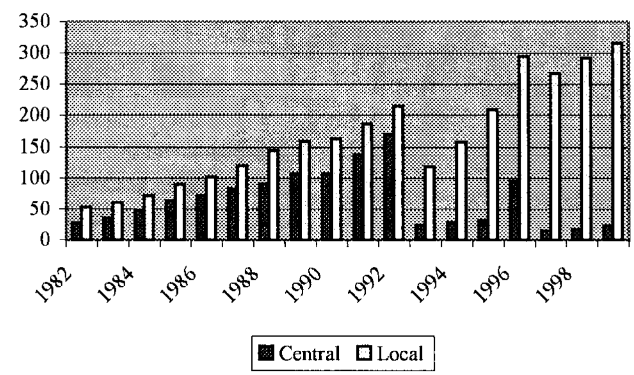


Figure IV.3. Tranfers Per Capita to Provinces, 2000
(in Yuan)



Excluding Tibet

Figure IV.4. Extra-Budgetary Funds 1982-1999
(in billion yuan)



(Table IV.1 and Figure IV.3). Although declining, these transfers still represent about 40 percent of total transfers from the center to the provinces. In contrast, subsidy transfers, although growing, still represent only a small share of the total. The system's ability to redistribute fiscal revenues and ensure a minimum standard of public service delivery in each province remains limited.

Table IV.1. Central to Local Government Transfers, 1997–2001

	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
	in percent of GDP					*share of total transfers (percent)*				
Total transfers,	3.8	4.2	5.0	5.2	5.8	100	100	100	100	100
Of which:										
Revenue returned	2.7	2.7	2.6	2.6	2.3	70.5	62.7	53.0	48.9	38.9
Fixed subsidy under old system	0.2	0.1	0.1	0.1	0.1	3.9	3.4	2.9	2.7	2.0
Subsidy	0.3	0.3	0.5	0.9	1.4	7.5	7.5	10.2	17.9	24.5
Specific purpose	0.7	1.1	1.7	1.6	2.0	18.1	26.4	33.8	30.6	34.6

Source : Data provided by the national authorities and staff estimates.

9. **The transfer system also has become less transparent in recent years.** "Specific purpose" grants represent a growing share of transfers (over one-third in 2001). A large number of different earmarked grants are allocated on an ad-hoc, negotiated basis. The increasing importance of this type of transfers undermines the rules-based and transparent character the 1994 reform aimed to introduce. Also, the central government currently lacks the capacity to ensure effective use of "specific purpose" transfers. Ongoing reforms to create a treasury system should assist in improving the transparency and control of expenditure at all levels of government.

10. **The 1994 reform did not reduce the reliance of local governments on off-budget financing.** Local governments continue to have very limited tax-setting ability, as they can only modify the rates of a few minor taxes. As a result, local governments continue to raise revenue outside the budget system, mainly in the form of fees and charges which accrue to locally-managed extra-budgetary funds. While reported extra-budgetary funds managed by the central government declined significantly after the 1994 reform, those controlled by local governments have risen (Figure IV.4).[5]

[5] A provincial pilot project, launched in 2001, aims to replace the numerous fees with a surcharge on the local agricultural tax. The so-called "tax-for-fee" reform is to be extended to one-third of the provinces in 2002.

C. Spending

11. **Local governments have large expenditure responsibilities.** While the share of local governments in total budget revenue is about half, they account for two-thirds of total budget expenditure, including health, education, social security and welfare, and infrastructure (Table IV.2).

Table IV.2. Share of Central and Local Governments in Selected Budgetary Expenditure, 2001
(In percent)

	Central	Local
Total	31	69
Social relief & welfare	1	99
Government administration	3	97
Agriculture	11	89
Culture, education, science & health	11	89
Technological upgrading and R&D	25	75
Industry, transport & commerce	28	72
Geological prospecting	31	69
Capital construction	34	66
Policy subsidies	40	60
Working capital	59	41
Defense	99	1
Government debt service	100	0

Source: Data provided by the authorities. Local expenditure includes earmarked transfers from the central government.

12. **Despite the introduction of subsidy transfers, provincial spending per capita has remained closely linked to the capacity of local government to generate own revenue.** For analytical purposes, six regions are identified within China: the North, the Northeast, the Coast, the Southeast, the South, and the West.[6] These regions differ significantly in terms of income levels, own revenue, and own spending (Table IV.3). In per-capita terms, the poorer regions of the South, the Southeast, and the West manage to generate only a fraction of the revenue mobilized in richer areas. The transfers these provinces receive from the central government do not make up for this gap.

[6] The North includes: Hebei, Shanxi, Inner Mongolia, and the municipalities of Beijing and Tianjin; the Northeast: Liaoning, Jilin, and Heilongjang; the Coast: Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan; the Southeast: Anhui, Jiangxi, Henan, Hubei, and Hunan; the South: Guangxi, Sichuan, Guizhou, and Yunnan; and the West: Tibet, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang.

13. **As a result, regional disparities in public spending and service provision have continued to grow**. The heavy reliance on self-financing implies that the provision of government services varies sharply across localities, depending on the level of local economic development. As regional growth rates have diverged since the 1990s, so has public expenditure. Among provincial units, the ratio between the highest and lowest in per-capita budgetary expenditure has increased from 5.9 in 1990 to 10.4 in 1999.

Table IV.3. Regional Fiscal Disparities, 1999

Regions	GDP	Own revenue	Own spending	Own fiscal balance
		Yuan per capita		*in percent of GDP*
Coast	12,456	726	963	-2.1
North	9,880	564	866	-4.0
Northeast	7,976	519	972	-5.5
South	4,036	276	532	-6.3
Southeast	5,154	267	473	-4.0
West	4,602	297	736	-9.7

Source : China Statistical Yearbook.

14. **The provision of basic public services has deteriorated in poorer areas**. For example, the World Health Report 2000 ranked China 61st of 191 countries in overall quality of health, but 188th in terms of fairness in financial contribution. This assessment—placing China nearly at the bottom of all countries assessed—is an indication of the unequal access to public health care in China. A similar situation exists in education.

D. Regional Fiscal Pressures

15. **While WTO accession is expected to have an overall positive effect on China's economy, it may exacerbate regional income disparities**. It is generally expected that labor-intensive sectors will benefit from WTO accession, while relatively more capital- or land-intensive sectors will face difficulties. These adjustment costs will not be spread evenly across regions. For example, in agriculture, the already poorer South and the Southeast provinces (rice producers), as well as the North and West regions (wheat producers), will likely be adversely affected.[7] In industry, the liberalization of the textile and clothing industry will benefit the richer Coastal region, but the poorer Northeastern provinces, where heavy industry plays a more predominant role, could face significant adjustments costs.

[7] Under the terms of accession, China can grant subsidies (up to 8.5 percent of production) to the regions most affected by the opening up of the agricultural sector.

16. **Restructuring SOEs usually involves the assumption by local governments of the social services previously provided by the SOEs** (including pensions, health, education, child care, and housing). Local governments typically also have to shoulder the cost of unemployment benefits if they exceed the SOEs' capacity to pay, as there is limited pooling of unemployment insurance within provinces and virtually no pooling across provinces. The uneven distribution of SOEs and related reform costs would thus exacerbate regional income and fiscal disparities. The North, the Northeast, and the West have a heavy concentration of SOEs, which employ about 20 percent of the working population and contribute about 50–65 percent of output in those provinces (Table IV.4).

Table IV.4. Regional SOE Profile, 2000

Regions	SOE output (in percent regional GDP)	SOE employment (in percent of total regional employment)
Northeast	64.4	23.9
West	57.6	18.0
North	47.6	18.7
South	37.0	8.9
Southeast	36.8	10.5
Coastal	36.3	11.7

Source: China Statistical Yearbook.

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Appendix I: Revenue Sharing Arrangements

Level	Tax	Central share (in percent)
Central taxes	Domestic excises	100
	Customs duties	100
	VAT and excises on imports	100
Local taxes	City and township land use tax	0
	Farmland occupation tax	0
	Fixed assets investment orientation tax	0
	Land appreciation tax	0
	House property tax	0
	Urban real estate tax	0
	Vehicle and vessel use tax	0
	Vehicle and vessel license plate tax	0
	Deed tax	0
	Slaughter tax	0
	Banquet tax	0
	Agricultural and animal husbandry taxes	0
Shared taxes	Personal income tax 1/	50
	Domestic VAT	75
	Business tax –if paid by railroads, headquarters of banks or insurance companies	100
	Business tax – otherwise	0
	Enterprise income tax 1/	50
	Income tax on foreign and foreign funded banks	100
	Income tax on foreign and foreign funded nonbanks	0
	Resource tax – if paid by offshore oil companies	100
	Resource tax – otherwise	0
	City maintenance and construction tax – if paid by railroads, headquarters of banks or insurance companies	100
	City maintenance and construction tax - otherwise	0
	Securities tax – if collected on stock transactions	88
	Securities tax – otherwise	0

Source: SAT, *Tax System of the People's Republic of China* (1998), p. 60.

1/ The 2002 budget introduced a new sharing formula for the personal and corporate income taxes, according to which all proceeds from these two taxes above their 2001 level will be shared between the center and the provinces on the basis of a 50–50 ratio (and 60–40 in 2003).

V. CHINA'S SOCIAL SAFETY NET[1]

1. **Reform of the social safety net is a key element of China's transformation to a market economy**. Creating effective and sustainable alternatives to the "iron rice bowl" provided under central planning is critical to maintaining social stability and the consensus for continued reforms. China has already made considerable progress in reforming its social safety net, but major challenges remain. In particular, coverage of the system over time will have to be broadened to include all (both urban and rural) workers in China, and changes will need to be made in key parts of the system (especially pensions) in order to put it on a viable financial basis.

A. The Current Social Safety Net

2. **China's public social safety net is essentially limited to the urban working population, especially employees of government and SOEs**. Of the total workforce of about 730 million, only about 20 percent have any form of public social protection. Until the early 1980s, a SOE-centered welfare system not only paid for workers' pensions, education, health care, and housing, but also supported basic daily needs such as child care and transportation. Since the 1980s, efforts to create a market economy and reform SOEs have included attempts to separate social functions from the enterprises, while creating an effective alternative social safety net system. The main components of the urban social safety net are the pension system, medical insurance, and unemployment insurance for those who are working and minimum living standard assurance (MLSA) for those who may not have jobs (Table V.1).

3. **In rural areas, land-use entitlements and traditional family ties are the principal elements of social security**. For the vast majority of rural residents, the land-use entitlement[2] provides for basic needs. There is public social protection only for those deemed to be "destitute persons"[3] and those rural residents who qualify for disaster relief. Other rural residents tend to rely mainly on family relations for assistance. The government has begun to encourage the introduction of minimum living standards assurance in certain rural areas, and voluntary and self-financed pension insurance for some non-agricultural workers.

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[1] Prepared by Tao Wang.

[2] Farmland is owned by village collectives in China, which extend land lease contracts to individual farm household. There is an underlying assumption that every member of the village should have the exclusive use of a parcel of the village's collectively owned land.

[3] Destitute persons are those individuals who have no source of income, no working ability, and no family relations. The "five-guarantees" system provides them with basic subsistence, the main benefit being the distribution of grain.

Table V.1. China: Overview of Social Safety Net Programs in 2001

Program	Expenditure	Contribution revenue	Recipients	Contributors	Average benefit per month
	(billions of yuan)		(millions)		(yuan)
Social insurance					
old-age pension 1/	232.1	248.9	33.8	108.0	...
unemployment	15.7	18.7	31.2	103.6	...
health care	24.4	38.4	76.3	72.86	...
maternity	1.0	1.4		34.6	...
occupational injury	1.6	2.8		43.5	...
Other					
Disaster relief	4.1	...	60.0	...	na
Urban minimum living standard assurance	2.3	...	11.7	...	60.0
Rural minimum living standard assurance	0.8		3.4		15.0
Social welfare and relief funds	2.0	...		...	...
Pension for handicapped and bereaved	6.9	...	38.3	...	...
GDP (at current price)	9,593.3				

Sources: 2001 Labor and Social Protection Statistics Communique, Ministry of Civil Affairs, 2001 Civil Affairs Statistics Communique.

1/ Data do not include civil servants who are still under the old pension system.

The pension system

4. **The current pension system reflects various reforms since the mid-1990s toward a multi-pillar system**. The system is designed to consist of (i) a mandatory defined-benefit base pension; (ii) a (mostly) funded mandatory individual account; and (iii) a funded voluntary supplementary pension. The first two components make up the so called "basic pension" system, which is to cover all urban workers and is managed by government agencies rather than individual enterprises. However, the "basic pension" system does not yet cover all urban workers (for example, about 30 million civil servants are still covered by the old system, with pensions directly paid by the state budget), and some pensions continue to be managed by enterprises. Table V.2 shows the current participation in the "basic pension" system.

5. **The transition to the current pension system is being financed mostly by higher contributions**. Existing pension liabilities are covered mostly from contributions to the "basic pension" (through a higher contribution rate to the defined-benefit portion and the use

of funds from the individual accounts) with some additional budget subsidy.[4] Those who retired before the start of the new system in1997 enjoy the same level of pension benefits as before. Transitional workers who started working before 1997 but retire after that date receive the basic pension in the new system plus a transitional amount from the old system.

Table V.2. Number of Employees Participating in the "Basic Pension" System

	1997	1998	1999	2000	2001
	(millions)				
Total	72.8	84.8	95.0	104.5	108.0
State-owned enterprises	55.0	66.5	50.9	51.4	49.8
Urban collective enterprises	14.4	13.7	14.8	14.7	13.9
Foreign-invested enterprises	2.1	2.4	3.0	4.9	5.8
Other 1/	1.3	2.2	26.3	33.5	38.5

Source: Ministry of Labor and Social Security.
1/ Includes state share-holding companies.

6. **Although coverage under the new pension system has continued to expand, a number of problems remain**. By end-2001, the new multi-tier pension system covered about 108 million active urban workers (see Table V.2). The main problems of the new system are: (i) because of a relatively high replacement rate and the need to finance the pension liabilities of the old system, contribution rates are high;[5] (ii) the individual account is largely notional since most of these funds have been used to finance pension liabilities from the old system; (iii) lack of compliance by employers (some enterprises can not afford to pay the high contribution rates) and (iv) lack of pooling at the national and, in most cases, provincial level has led to uneven contribution and benefit levels across the country. As a result, enterprises in the richer and more rapidly growing regions (which tend to have a lower dependency ratio) pay lower contributions than those in the poorer regions, while retired workers in the better-off regions enjoy higher pension benefits. In addition, participation by private and foreign-funded enterprises has been relatively low.

7. **A provincial pilot program has been initiated, designed to address some of those problems**. Recognizing the funding and incentive problems of the current system, and in light of continued SOE labor retrenchment and the rapidly aging population, the government in late 2000 initiated a pilot social insurance reform program in Liaoning province

[4] Subsidies from the central government budget totaled about 1 percent of GDP during 1998–2001.

[5] Enterprise contribution rates are often above 25 percent, and sometimes above 30 percent.

(a province with a large concentration of SOEs). Based on the experience and lessons from the pilot, appropriate reform measures are to be adopted nationwide.

8. **The main changes in the pension system in the pilot project are:**

- *Separating the base pension fund and individual accounts, changing the latter from "notional" to actually funded accounts.* Instead of contributing to both the (pooled) base pension fund and individual accounts as is the current practice nationwide, all enterprise contributions (about 24 percent of payroll) are made to the pooled fund. Employees (including contractual workers with rural "hukou") contribute 8 percent of their wage exclusively to the individual accounts, which are portable. Base pension and individual accounts are managed separately, with individual accounts managed at the provincial level and their investment restricted to treasury bonds.

- *Increasing the base pension benefit in line with length of work and contribution.* Instead of fixing the base pension benefit at 20 percent of the average local wage (with a minimum of 15 years of contribution), it is increased with each extra year of contribution (0.6 percent of the average wage for each extra year), up to a maximum base pension of 30 percent.

- *Widening the coverage of the pension system.* Rural contractual workers, self-employed, and private-firm employees are all required to participate in the base pension system (while civil servants remain under the old system). Enterprises that had not previously participated in the current pension scheme and now are deemed to be non-viable will not be included in the pilot projects; workers in those firms are to receive the local MLSA.

- *Establishing a provincial transfer buffer fund,* equal to 5 percent of the city-level pool of pension funds (i.e., employers' contribution to the base pension), to bridge the gap between some cities' funding pool and base pension entitlements.

Unemployment benefits

9. **Unemployment benefits** include: (i) insurance for the registered unemployed[6] and (ii) basic living allowance and re-employment programs for those laid off because of restructuring. The latter was designed to mitigate the social cost of SOE reform while breaking the traditional SOE commitment of providing lifelong employment and living expenses.

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[6] In China, official unemployment only refers to the registered unemployed in the cities, which does not include those who are seeking jobs but are not registered in the urban labor force (such as migrant workers from rural areas) or those laid-off by SOEs because of restructuring.

10. **Unemployment insurance is a defined-benefit system funded by mandatory contributions from employers and employees.** According to the Unemployment Insurance Ordinance, employers are to contribute 2 percent of payroll and employees 1 percent of their salary. Actual contribution rates, however, vary among regions and cities, depending on the local unemployment situation. This has amplified regional disparities as firms and workers in areas with lower economic growth have to contribute more. Unemployment benefits last between 12–24 months[7], with most of the benefit provided in cash (at a level set by the local government) and a small part as a medical care subsidy.

11. **The basic-living allowance and re-employment centers (RECs) for laid-off workers currently cover more than 10 million people** (Table V.3). The government created the concept of "xiagang" (laid-off workers) and related benefits in 1993 in order to facilitate SOE reform. A unified policy was adopted in 1998, which stipulated that: (i) all enterprises with laid-off workers must set up RECs; (ii) "xiagang" workers' basic-living allowance and re-employment services are to be financed, in equal parts, by the government, enterprises, and other sources (mainly the unemployment insurance fund); and (iii) the employment relationship between laid-off workers and their employers is maintained for a maximum of three years, after which the laid-off workers will have either found a job or moved to the unemployment insurance scheme.

12. **The authorities intend to gradually merge the system for "xiagang" with unemployment insurance, with the RECs to be phased out.** Starting with Liaoning province, no new re-employment centers (RECs) are to be set up, and the merger should be completed in three years, by which time all laid-off workers should be covered by unemployment insurance or the MLSA.

Table V.3. Number of Xiagang Workers from SOEs

(In 10,000)

	1998	1999	2000	2001
End year stock	610	652	657	515
Change from previous year	-24	42	4.7	-142
Re-employed in the year	610	492	361	227
New Xiagang in the year (flow)	586	534	366	85
Cumulative Xiagang	1171	1705	2071	2156
Cumulative reemployed	610	1102	1463	1690

Source: Staff calculation based on official data.

[7] 12 months for those who contributed 1–5 years, 18 months for those who contributed 5–10 years, and 24 months for those who contributed more than 10 years.

Medical insurance

13. **Basic medical insurance is being established in the urban areas, guided by rules issued in 1998**. Under the old public health care system, employers (mainly SOEs and the government) paid employees' and dependents' medical expenses in full. The new system, formalized in 1998, is a mandatory system combining pooling of contributions in a geographic area with individual accounts. It is intended to eventually cover all urban employees and civil servants. Employers contribute about 6 percent of their payroll, of which about 30 percent is paid into individual accounts and the remainder to a funding pool; employees contribute 2 percent of their salaries to the individual accounts. Individual accounts pay for basic expenses, such as office visits, while the pooled funds pay for serious and chronic disease and hospital expenses (with a deductible and maximum payments for each individual). Employers can set up supplementary medical insurance, and up to 4 percent of contributions for this purpose are tax deductible. By end-2001, almost all regions and cities had initiated basic medical insurance reform, with about 76 million participating employees. Some 100 million urban residents are still covered by the old system, though they are to be transferred to the new system in the future.

Minimum living standards assurance

14. **The minimum living standard assurance is a means-tested social assistance program that aims at supporting urban residents whose income is below the local minimum living standard**. Formally adopted nationwide in October 1999, the MLSA program provides cash assistance to all non-agricultural urban residents who either have no source of income, no ability to work, and no family relations, or who have earnings below the minimum living standard determined by local governments. Evaluation of applications and management of the MLSA are carried out by community-level organizations, while funding is provided mainly by local governments, with some central government transfers, especially to poor areas. In 2001, monthly minimum living standards set by local governments averaged about Y150, while MLSA benefits averaged about Y60 to bridge the gap between recipients' income and the local minimum living standards.

15. **MLSA coverage has expanded rapidly in recent years, and the government plans to cover all eligible urban residents by end 2002**. At end-2001, some 14 million urban residents received assistance under MLSA, more than double the number in 2000. The authorities estimate that close to 20 million urban residents live below minimum living standards (5.8 percent of the urban non-agricultural population). The 2002 central budget has earmarked 4.6 billion yuan to cover all eligible residents under MLSA by year's end.

B. Key Challenges

Pension system

16. **Relatively generous benefit levels and the reliance on individual accounts to finance pension liabilities from the old system undermine the viability of the pension system**. Since the replacement rate is high and the dependency ratio is rising, contribution rates in many areas are high (some 30 percent of payroll). The government's decision to use current contributions for pension payments to retired workers also has turned the new (initially designed to be mostly funded) pension system into a PAYG system. The estimated funding gap in the base pension during 1998–2001 was about 3 percent of GDP (Dorfman and Sin, 2001) and will continue to rise if no parameter changes are made.

17. **Some key parameters of the current pension system affect its long-term sustainability**. These include, in particular, the high replacement rate (about 80 percent on average); indexation of pensions to wages; misalignment of the implicit term of individual account pensions with life expectancy (a retiree will be paid 1/10th of his individual account accumulation each year, while average life expectancy at retirement is currently about 20 years); and the low retirement age.[8] In addition, participation in the basic pension system is highly uneven, with weak compliance especially by private and foreign-funded enterprises. The resulting increased burden (higher contribution rate) for SOEs further raises incentives for noncompliance, undermining the financial sustainability of the system.

18. **The World Bank estimates the government's implicit pension debt at about 90 percent of GDP with a financing gap of about 70 percent of GDP (Dorfman and Sin, 2001).**[9] While implicit debt is lower than in most OECD countries, this reflects mainly the fact that China's pension system only covers about 20 percent of the work force, while pension systems in OECD countries cover about 90 percent.

19. **The above estimates are highly sensitive to parameter changes, and reforms of the system could significantly reduce the financing gap**. For example, Dorfman and Sin (2001) estimates that if the retirement age were gradually increased to 65 or the individual account benefit followed a life annuity payout, the financing gap of the system would be

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[8] Retirement ages are 60 for men and 50 for women (55 for those with managerial positions or professionals).

[9] *Implicit pension debt* is a measure of the present value of accrued benefits under the pension system if the system were terminated at a particular date (including benefits to be paid to current pensioners and pension rights that current workers have earned up to the termination date, which is assumed to be in 1998). *The financing gap* is measured by summing the net present value of the current balance (revenues less expenditures) throughout the projection period (75 years in the case of Dorfman and Sin).

reduced substantially. The gap could be narrowed to below 10 percent through comprehensive reforms, including: (i) gradually increasing the retirement age to 65; (ii) paying out individual accounts using annuities calculated based on life expectancy at retirement; and (iii) indexing base and individual account pensions to consumer prices.

Unemployment insurance

20. **Unemployment is expected to rise in the next few years, putting pressure on the unemployment insurance system**. Although the system is currently running a surplus,[10] it may come under financial pressure if unemployment rises as expected and the system is expanded to cover the entire urban working population. This could require either a significant increase in contribution rates, budgetary support, and/or a reduction in the duration and amount of benefits.[11]

Minimum living standard assurance

21. **The cost of the MLSA system will rise in the next few years**. Many of those who are currently covered by unemployment insurance and RECs will eventually be transferred to MLSA, implying additional costs for the government. A rise in unemployment and the intended extention of coverage to rural migrant workers in the urban areas will place an additional burden on the MLSA.

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[10] In 2001, contributions from 104 million participants totaled Y18.7 billion, while expenditure on unemployment insurance benefits (received by 4.7 million people) was Y11.2 billion.

[11] For example, if the unemployment rate were to rise to 10 percent in five years, about 25 million unemployed workers would be eligible for unemployment benefits. To finance this, the contribution rate would need to be about 7–8 percent of payroll, assuming an unchanged structure of benefits and an increase in the participation rate in the system from currently about half of the urban workforce to around three-fourths.

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